ICICI Investment Management

Investment Strategy

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Executive Summary

Global / US

- The equity view has once again shifted to a defensive stance given low risk premiums
  - Rising inflation, monetary policy on aggressive rate hikes plus quantitative tightening
- At the same time, yield curves & market implied expectations are showing growth worries
- If inflation doesn't subside, policy makers may have to tighten aggressively which may decisively induce moderation in economic prospects

India - Equities

- Economic activity continues to improve but risks are emanating from supply chain issues and rapidly increasing input cost
- Earnings growth for FY22Q4 are likely to be met but risks of earnings downgrade are back in reckoning, after earnings upgrade for several quarters now
- Given global situation and monetary tightening cycle, risks remain for further 'P/E derating'
- Waiting for risk premium to rise to average levels for fresh addition

India – Fixed Income

- MPC has changed focus to inflation, pivoting from earlier growth focused stance.
- Prefer roll down funds of 4-6 years with a 4 year view

Gold

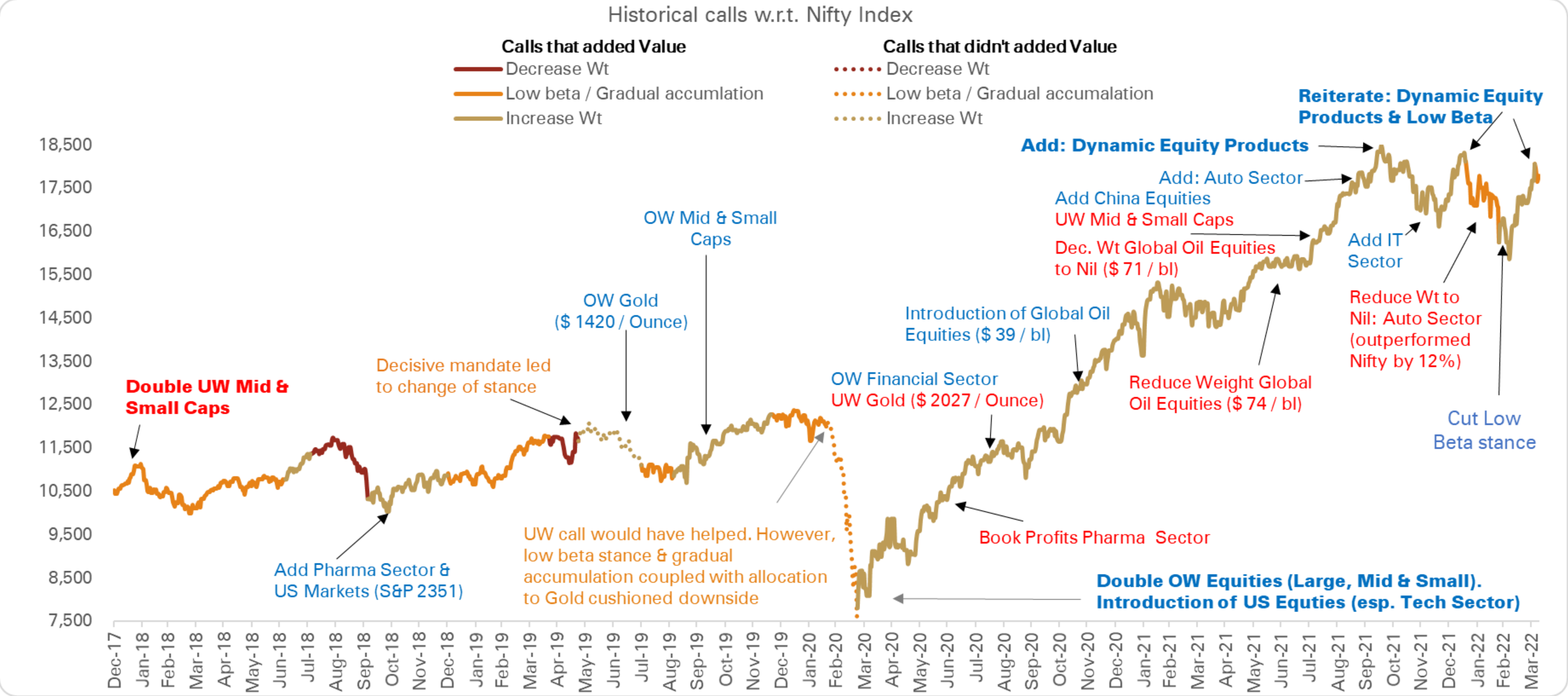
- Gold has underperformed as expected. It may bottom out as rate hikes in US firm up and real yields peak out

Asset Allocation Positioning

Asset Class	Short Term					Medium Term				
	- -	-	0	+	++	- -	-	0	+	++
Equities		■					■	◆		
Large Cap & Diversified			■				■	◆		
Mid & Small Cap		■					■			
Global Equities			■				■	◆		
Debt			■					■		
Low Duration Debt			■					■		
Short & Medium Term			■						■	
Credit Fund			■					■		
Duration		■						■		
Gold			■				■			

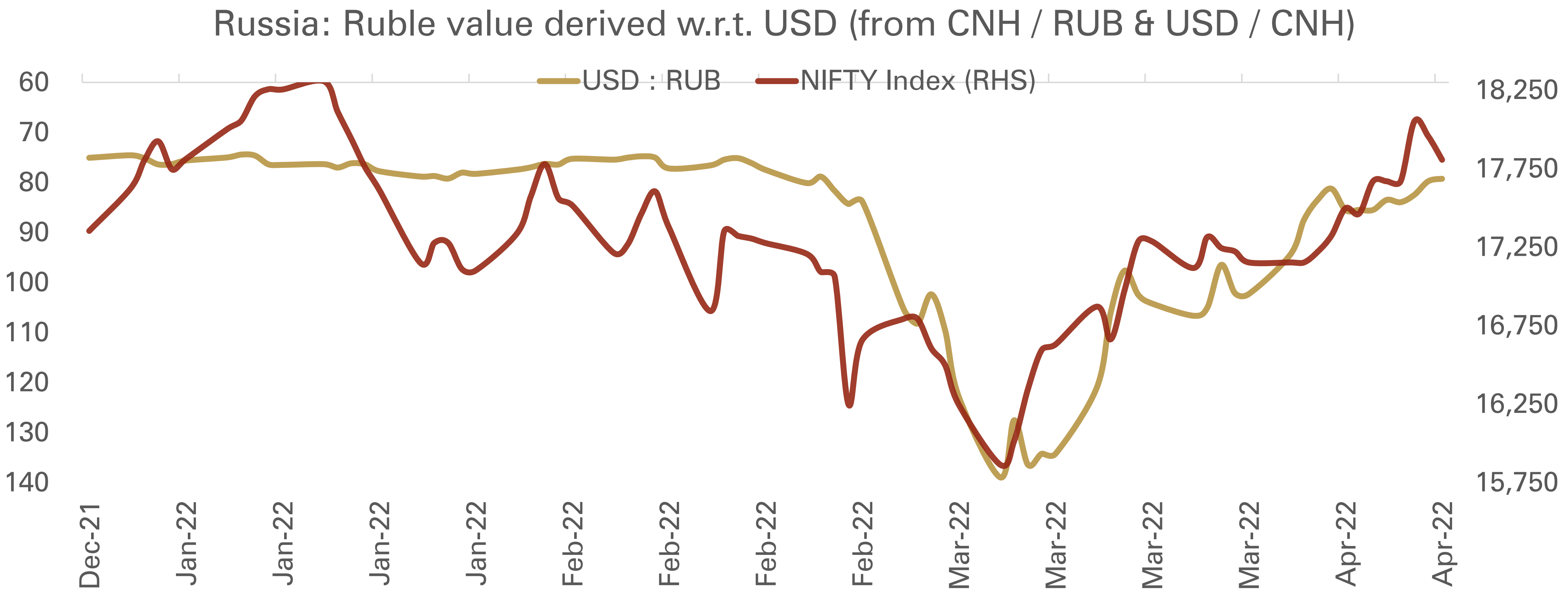
Legend	
++	Strong Overweight
+	Overweight
0	Equal weight
-	Underweight
- -	Strong Underweight
◆	Previous Position

Historical Calls - Equity



UW - Underweight; OW – Overweight; Wt. – Weight; Inc. – Increase; Dec. – Decrease;
Double OW or UW are highlighted in Bold; Increase weight in Blue; Reduce weight in Red; Calls that didn't add value in Orange;

Trivia: As Ruble stabilized, so have equity markets!

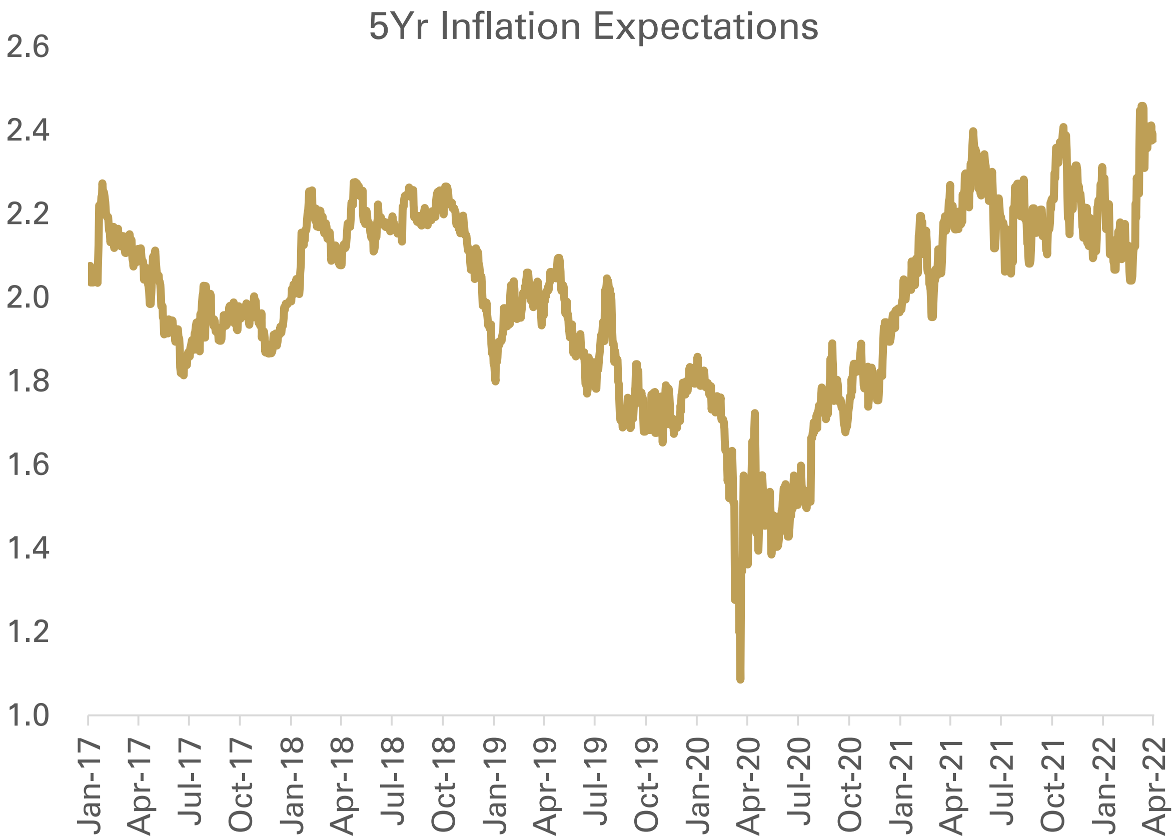


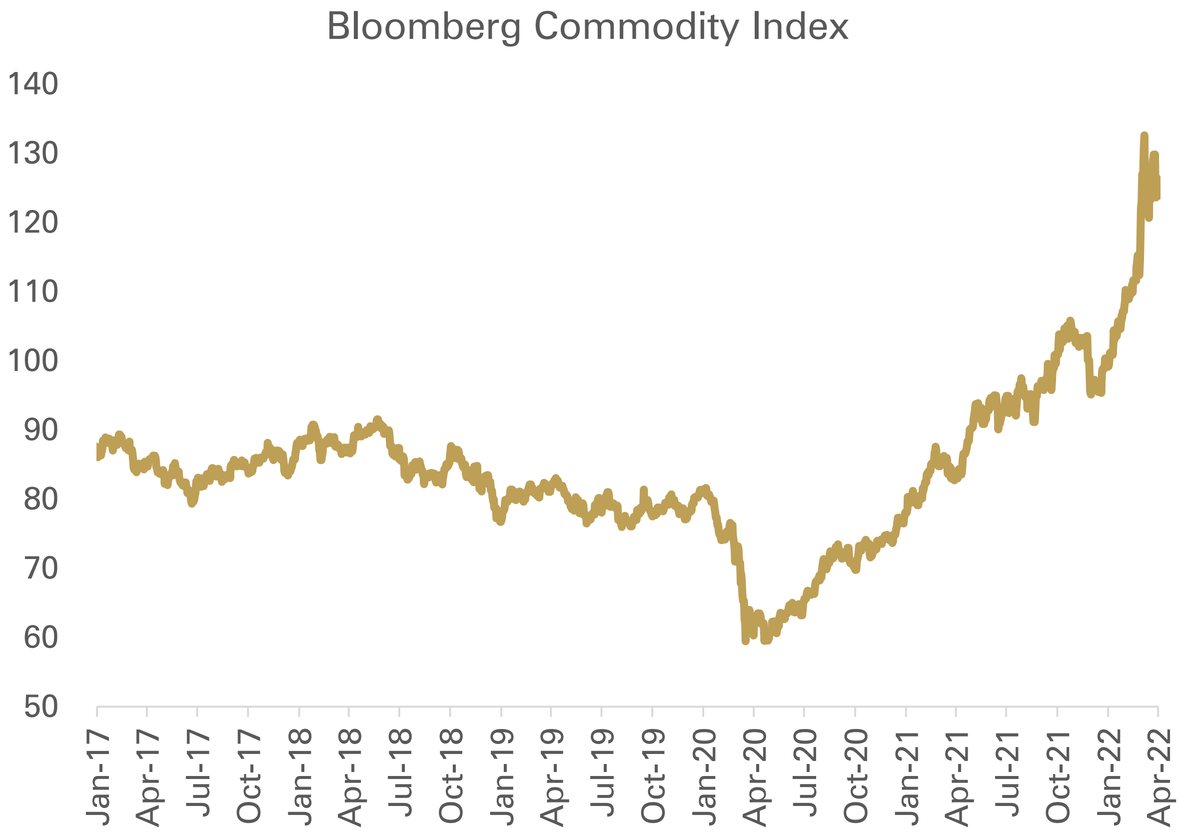
CNH is the offshore delivered Chinese Renminbi (Yuan). The Russian ruble is the official currency of The Russian Federation

- Russian Ruble stopped trading in USD after a sharp fall and hefty sanctions
- However, other currency pairs (like CNH) have continued. Value of Ruble vs. CNH (and therefore derived value in USD) fell and recovered – so have equity markets, implying the declining ‘invasion premium’

Deteriorating Global Macro

Spike in food & commodity prices poses upside risk to inflation

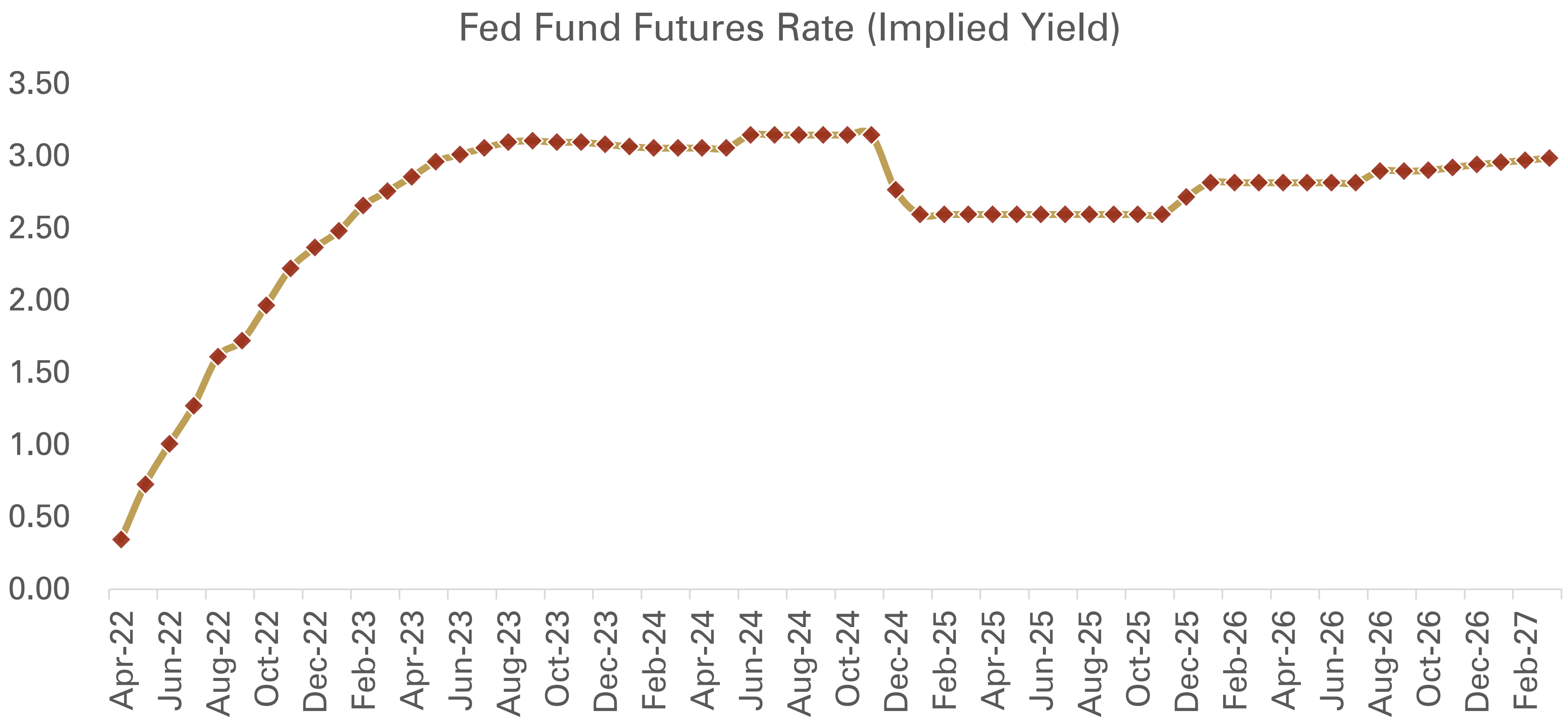




Geopolitical tensions have not only led to flare up in oil prices, but have also sent global food prices soaring. 5Y Forward inflation expectations have inched up, and now highest in recent history.

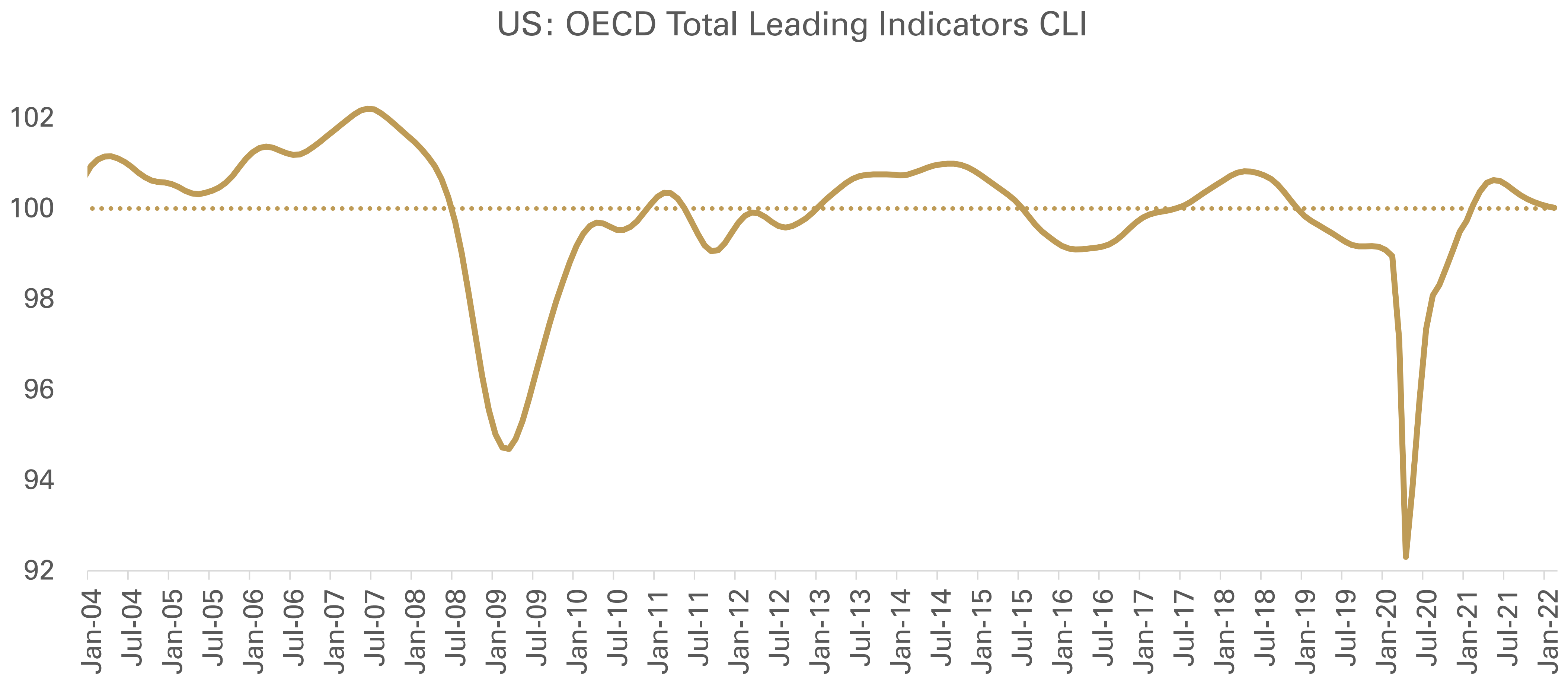
India: Rising global food prices could eventually filter into domestic prices and thus poses upside risk to FY23 inflation outlook as food accounts for a much higher weight in CPI than crude oil.

Fed Fund futures curve expecting +275 bps tightening



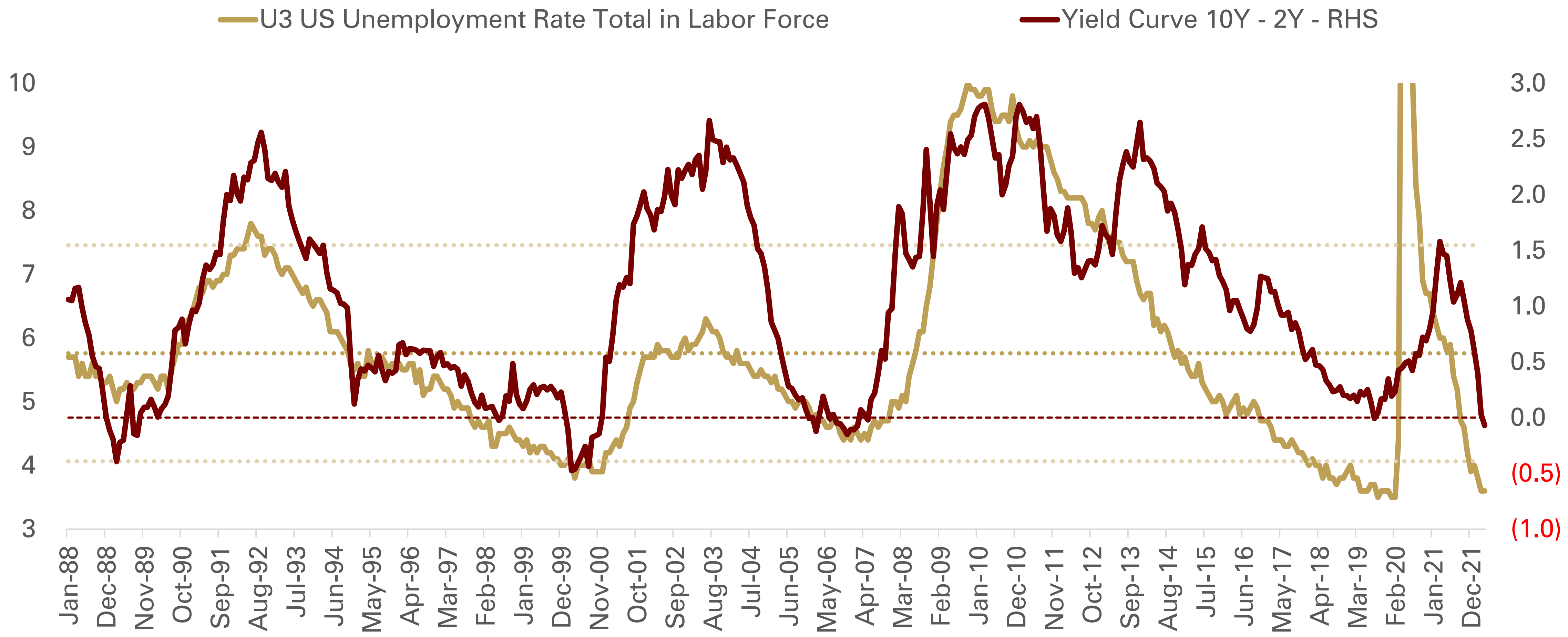
Futures curve is now anticipating +275 bps of fed tightening by mid 2023. Yet the fed fund futures curve also implies a first fed rate cut later in 2023. This would seem to imply expectations that more aggressive fed action achieves its desired effect of **slowing economic conditions sufficiently** that the inflation concerns gradually dissipates.

OECD CLI indicates moderating economic growth



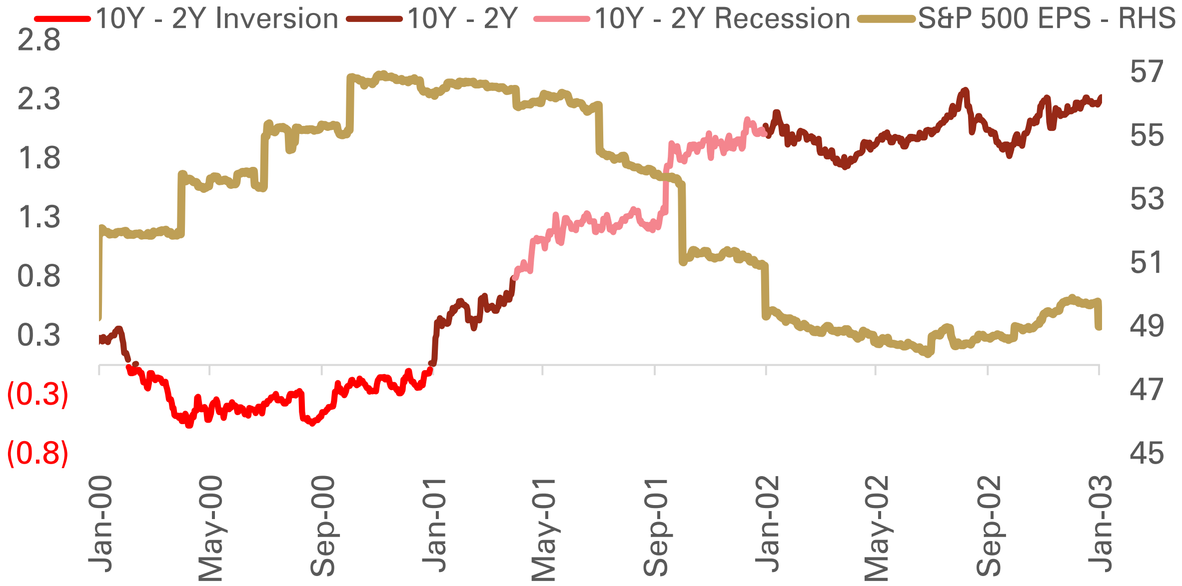
- Composite leading indicator (CLI) is designed to provide early signals of turning points in business cycles showing fluctuation of the economic activity around its long term potential level.
- **Lately it has shown sign of moderation in economic activity**

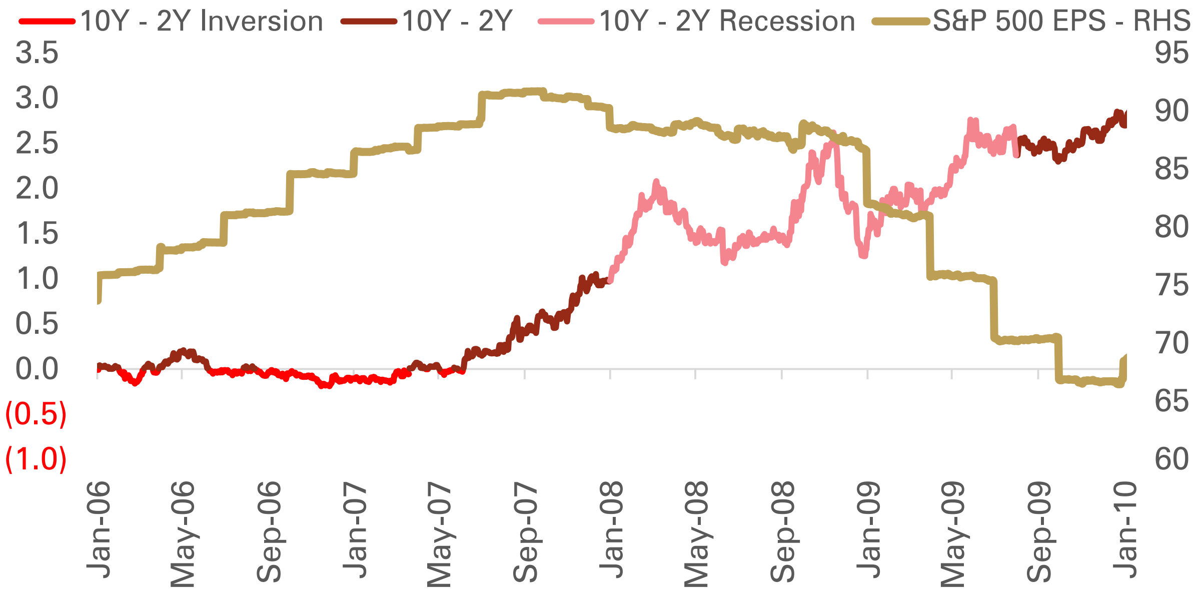
Unemployment and Yield Curve trend is aligned



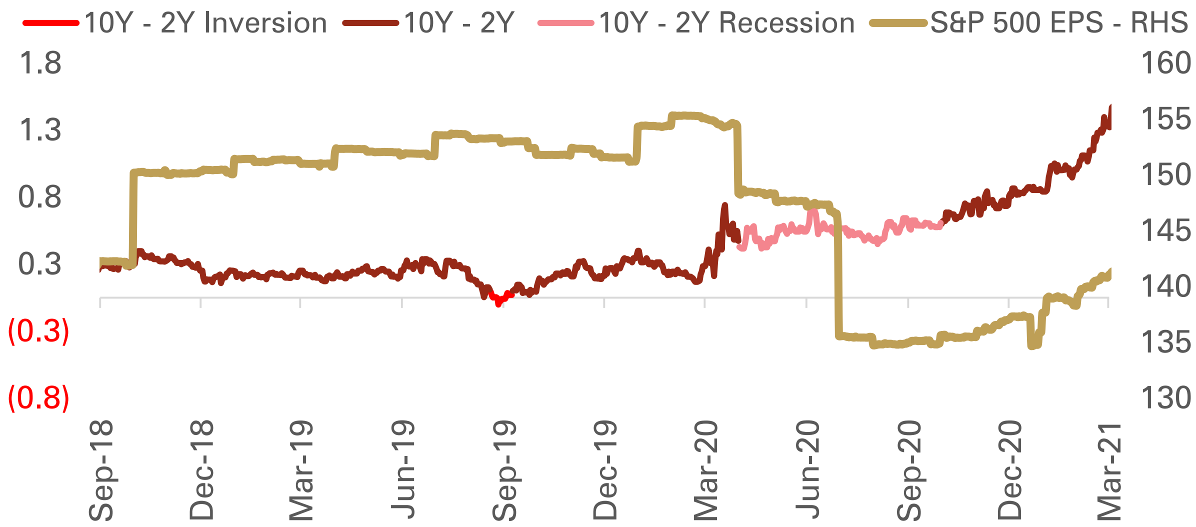
Yield curve (10 year US treasury yield less 2 year) has inverted without any meaningful rate hikes. Market has adjusted to the economic cycle and as always the yield curve has inverted with Unemployment rate at lowest point already. Historically, this level of inversion has been witnessed only after meaningful rate hikes

Corporate earnings witness slowdown after yield curve inversion

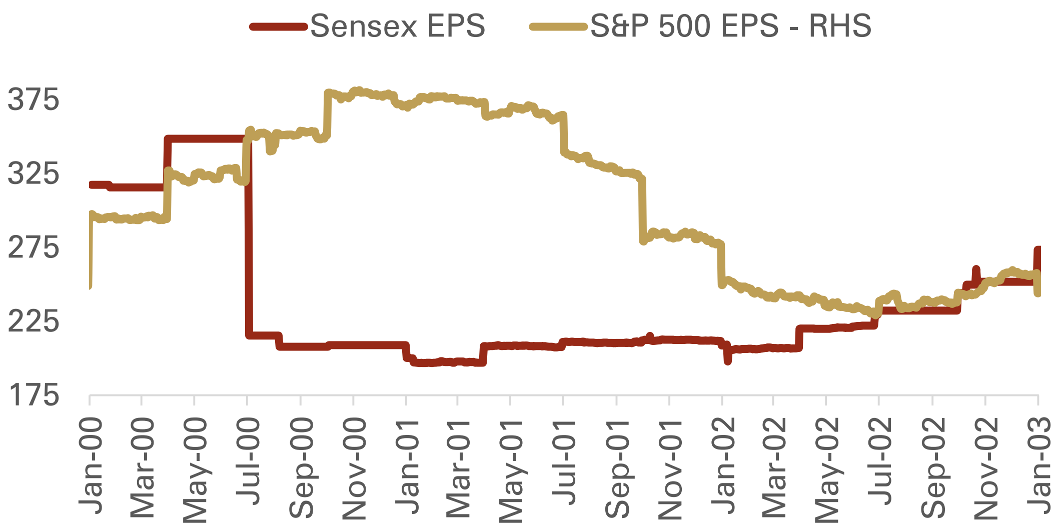


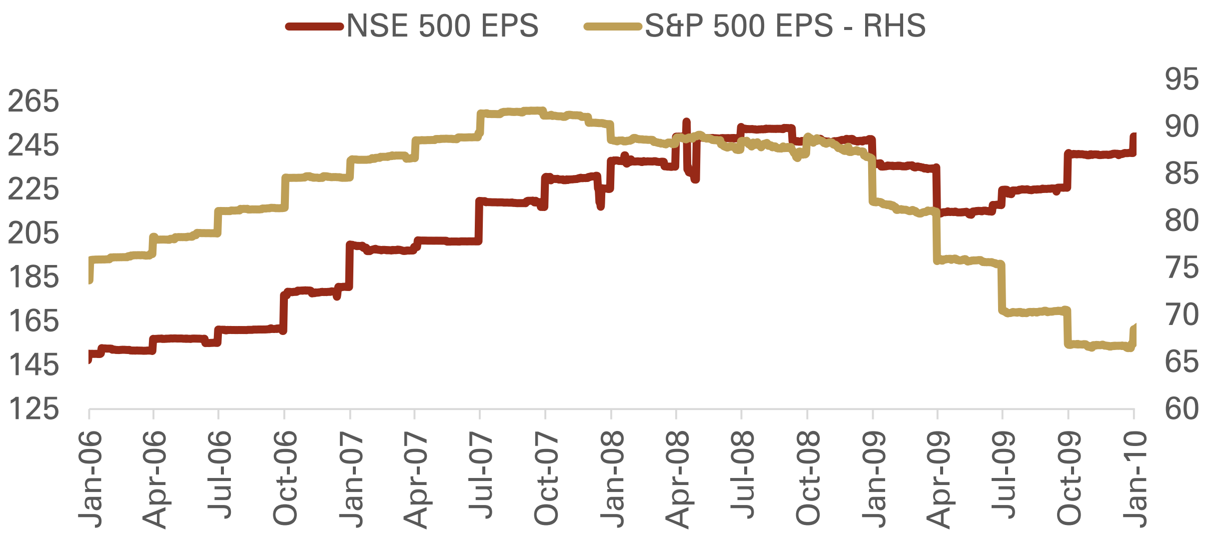


- Historically, all such inversions have been followed by economic recession in US & in World as spill over effect
- Corporate earnings tend to witness slowdown in following 1 to 2 years (after inversion), impacting equity markets in US & world over
- **Good news is that this happens over 1 to 2 years, and not immediately**

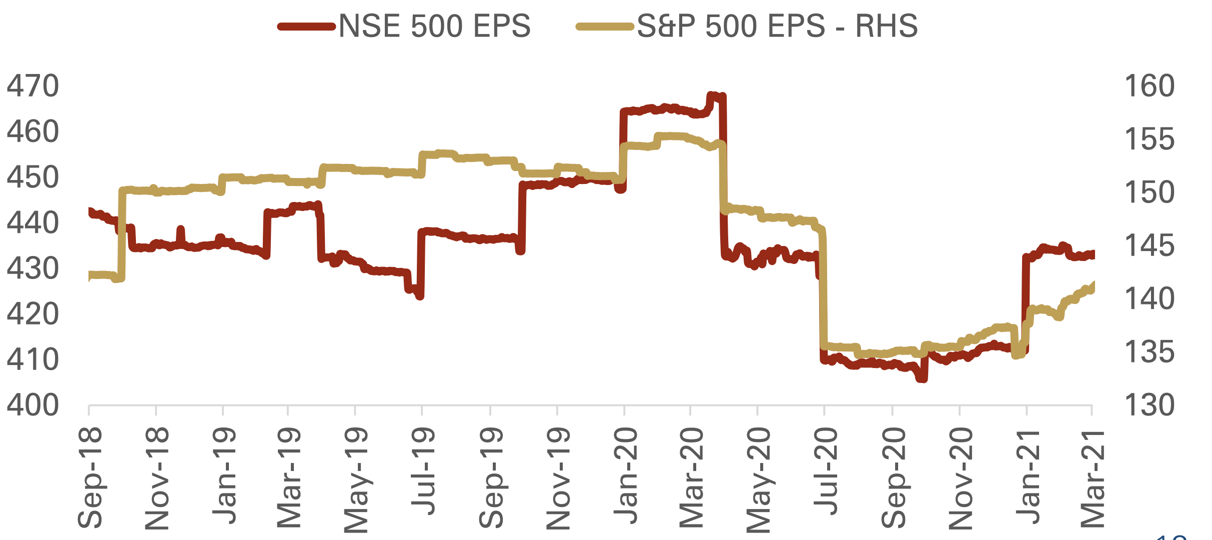


What about Indian Corporate Earnings post curve inversion?

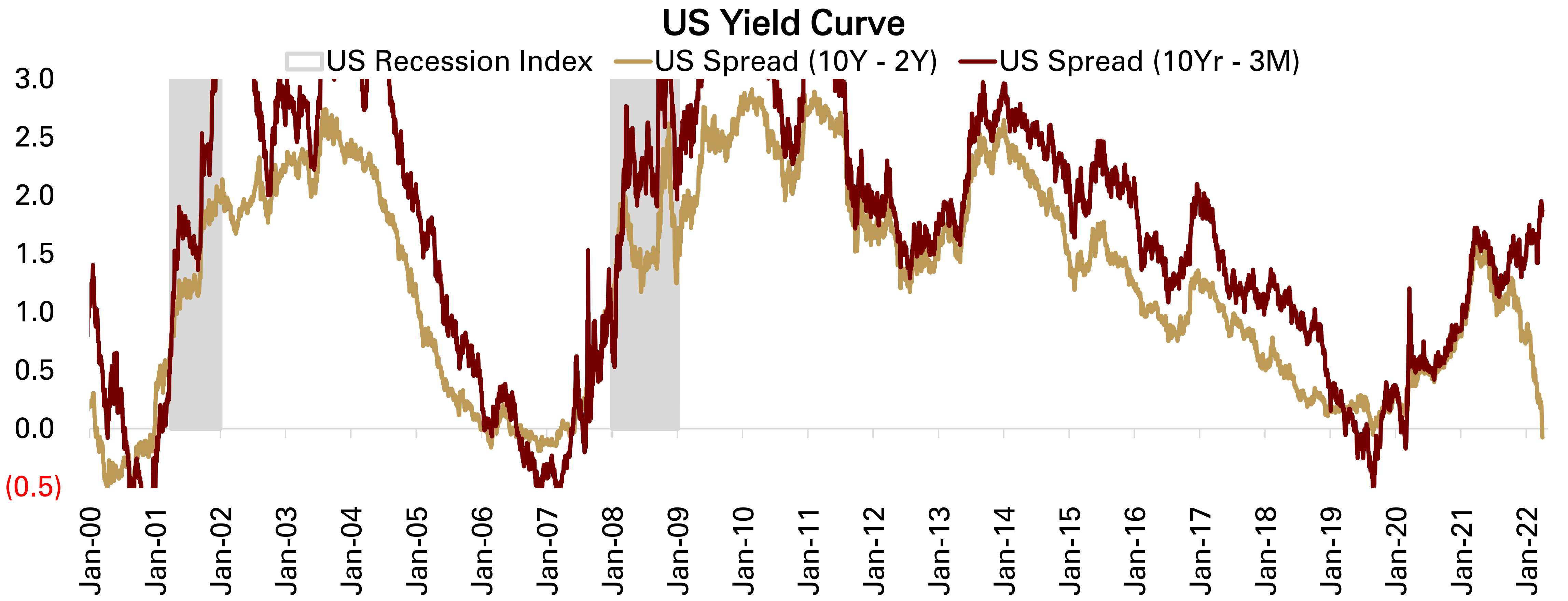




- India Corporate earnings have slowed down either before or following a US earnings slowdown
- Invariably, equity markets have corrected (almost bear market) coinciding with global markets
- Good news is that this phenomenon usually doesn't happen immediately post inversion

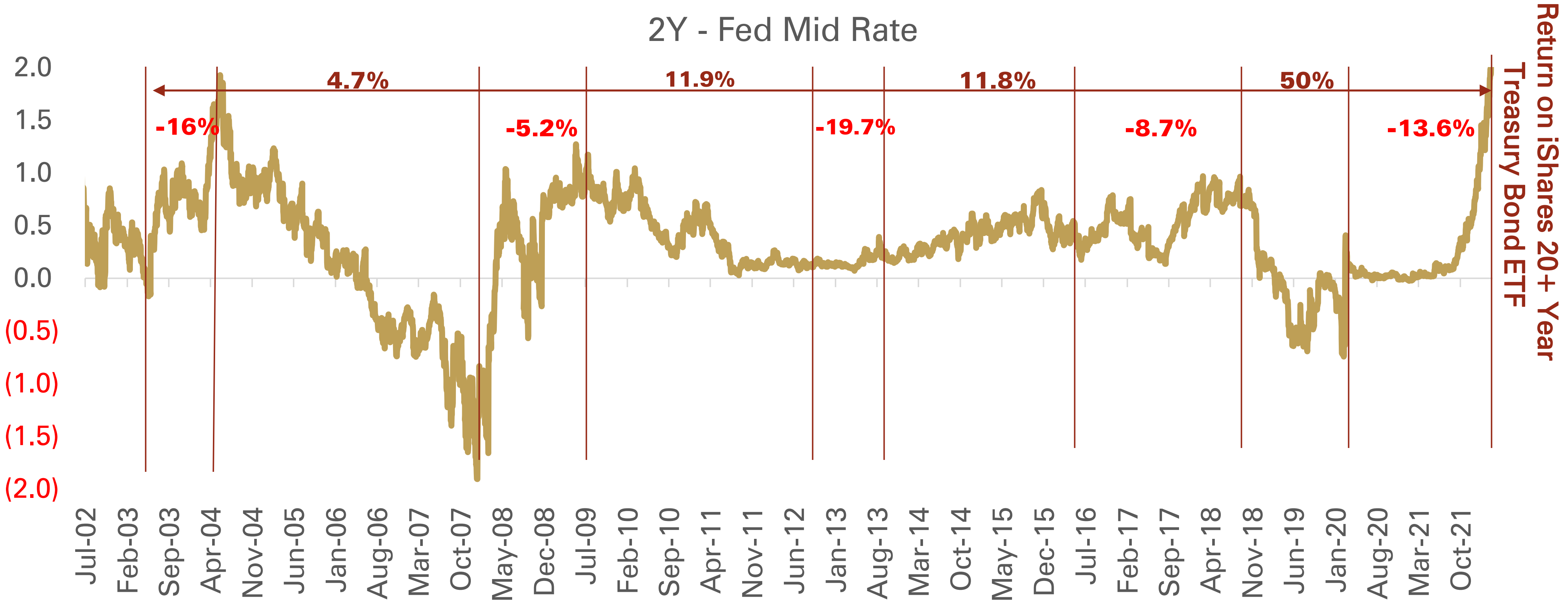


Is this cycle different?



While 10Year over 2Y has inverted, 10Y over 3Month yield hasn't and the divergence is stark – not witnessed in previous cycles. This gives hope that a slowdown may be more back-ended as 10Y – 3M inverts – may be late 2022 or 2023 phenomenon.

US Yield Curve inverts signaling impending moderation in growth



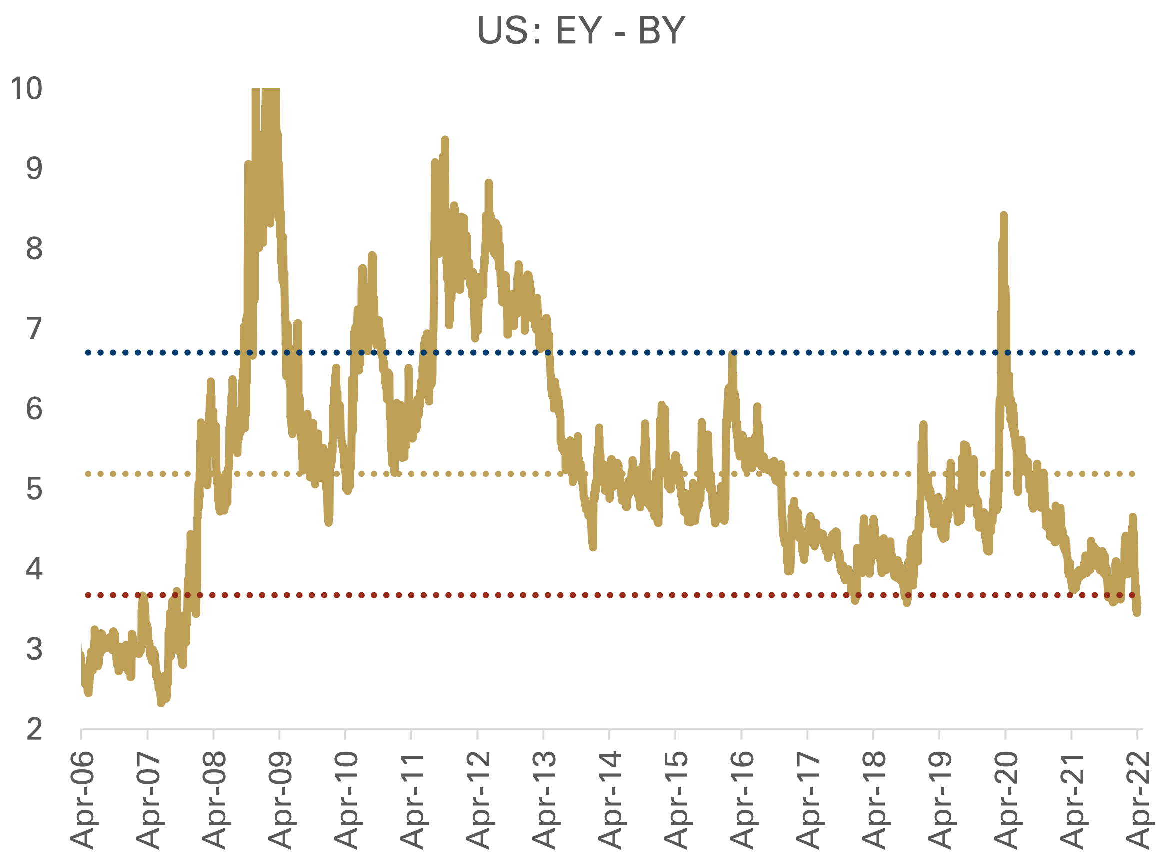
We are watching a potential investment opportunity in long duration US bonds when 2Y UST less Fed rate inverts

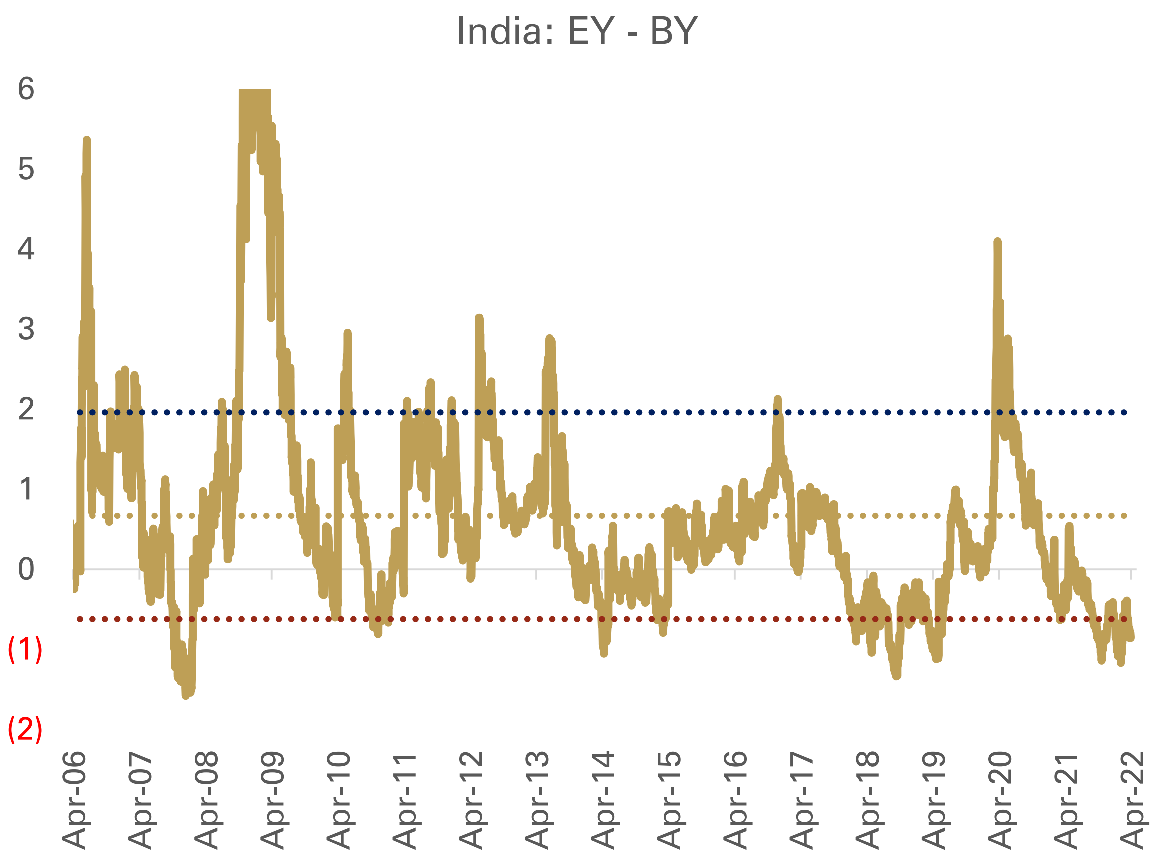
OIS (US) curve is already most inverted in this cycle

- (1M) Overnight Indexed Swaps (OIS) rate 3 years hence has fallen lower than 2 year forward rate. Usually, 3 year forward OIS contract should trade higher than 2 year.
- **An inversion indicates that rates market is getting concerned that US Fed may not be able to raise rates as much as being forecast as growth may moderate**
- **The level of inversion is the highest for this cycle!**

What does it all mean? Risk premium should be adequate

Framework to evaluate possible de-rating in valuation (basis interest rate movement)





- Earnings Yield (EY) = 100/PE. Bond Yield = 10 Year Treasury Yield. EY – BY indicate excess earnings yield over bond yields – a simplistic measure of Equity Risk Premium
- **Once excess equity yield touches average levels, the case for fresh equity exposure strengthens (refer slide below)**

Equities Scenario analysis: Likely valuation derating

S&P 500	2Yr Frwd PE	EY - BY	US 10 Yr Yld	Likely Derating
Dec-18	12.5	5.2	2.77	
Current	16.6	3.3	2.68	
Scenario I	12.9	5.1	2.68	(22.5)
Scenario II (Avg.)	12.5	5.2	2.77	(24.3)

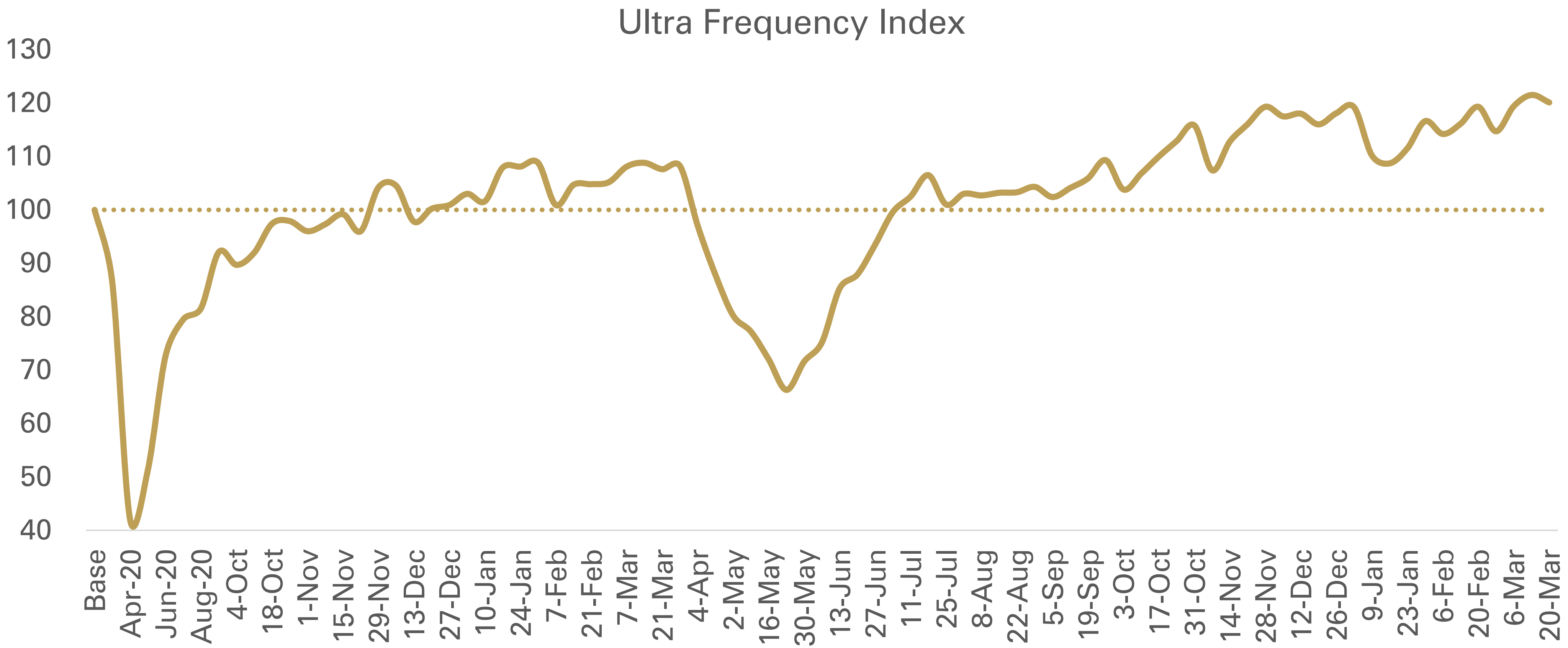
Nifty 50	2Yr Frwd PE	EY - BY	G-Sec 10 Yr Yld	Likely Derating
Dec-18	14.2	(0.2)	7.3	
Current	17.2	(1.3)	7.1	
Scenario I	14.6	(0.2)	7.1	(15.2)
Scenario II (Avg.)	14.2	(0.2)	7.3	(17.5)

- Framework to evaluate possible de-rating in valuation (basis interest rate movement) given the experience of Dec 2018 market lows (in response to monetary policy tightening)
- **This indicates that Forward PE multiples in US need to fall to less than ~13x levels for fresh long positions and ~14.2x in India**

Indian economy and corporate earnings

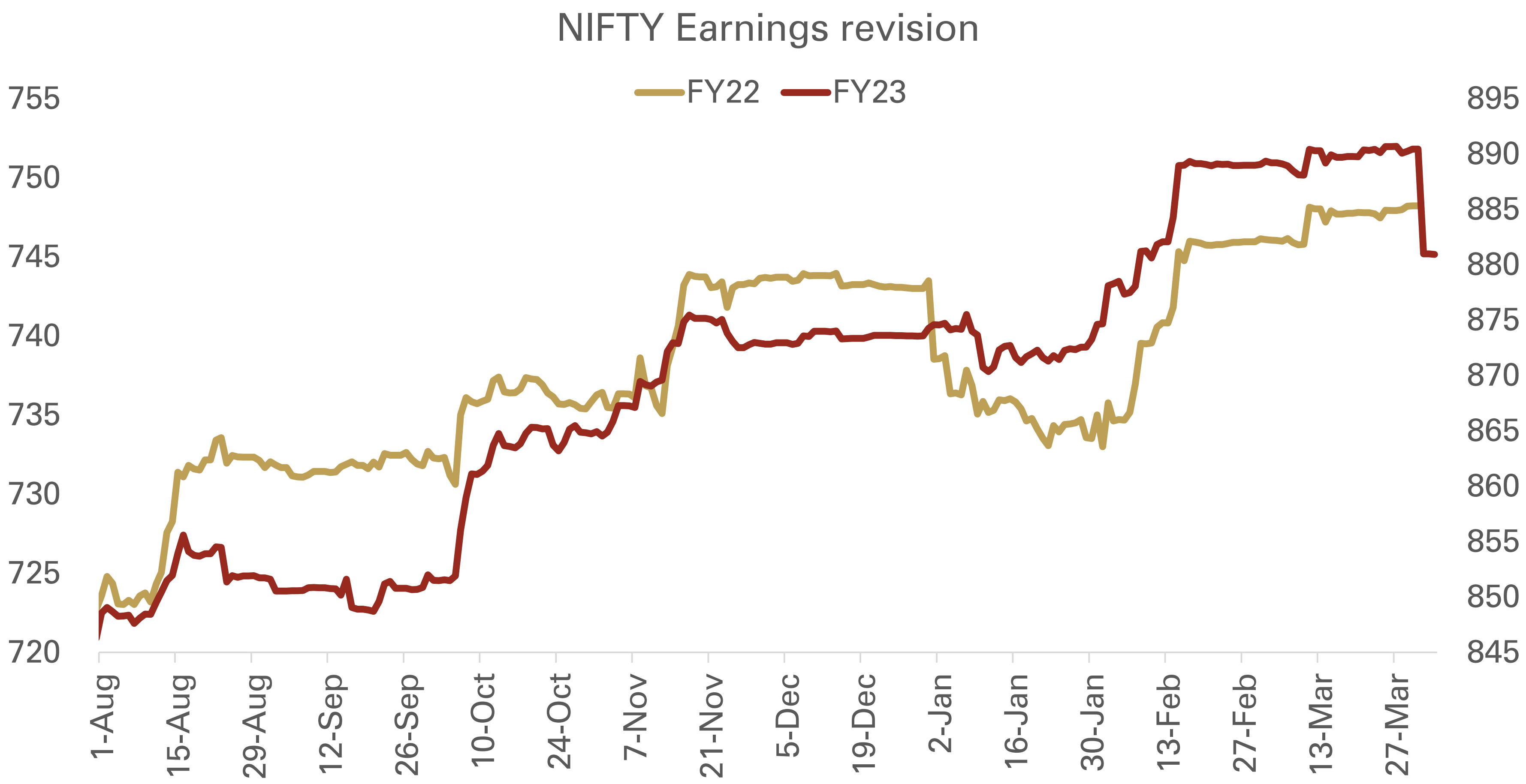
Earnings delivery remain key support for incremental market performance

Higher intensity of price rise pose challenges to Business cycle



ICICI Bank's weekly UFI - Economic activity may face downside risks
While underlying economic activity is expected to improve on the back of easing of restrictions, but rising commodity and energy prices pose a challenge.

FY23 EPS trajectory critical

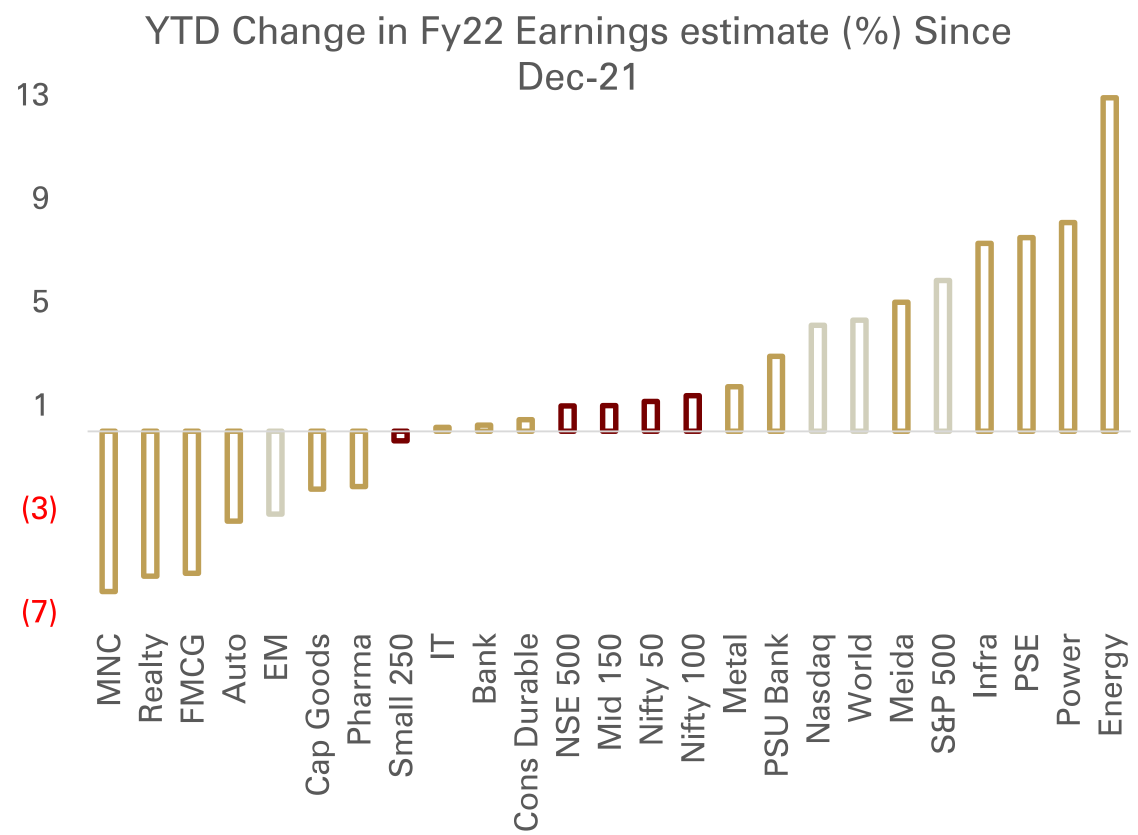


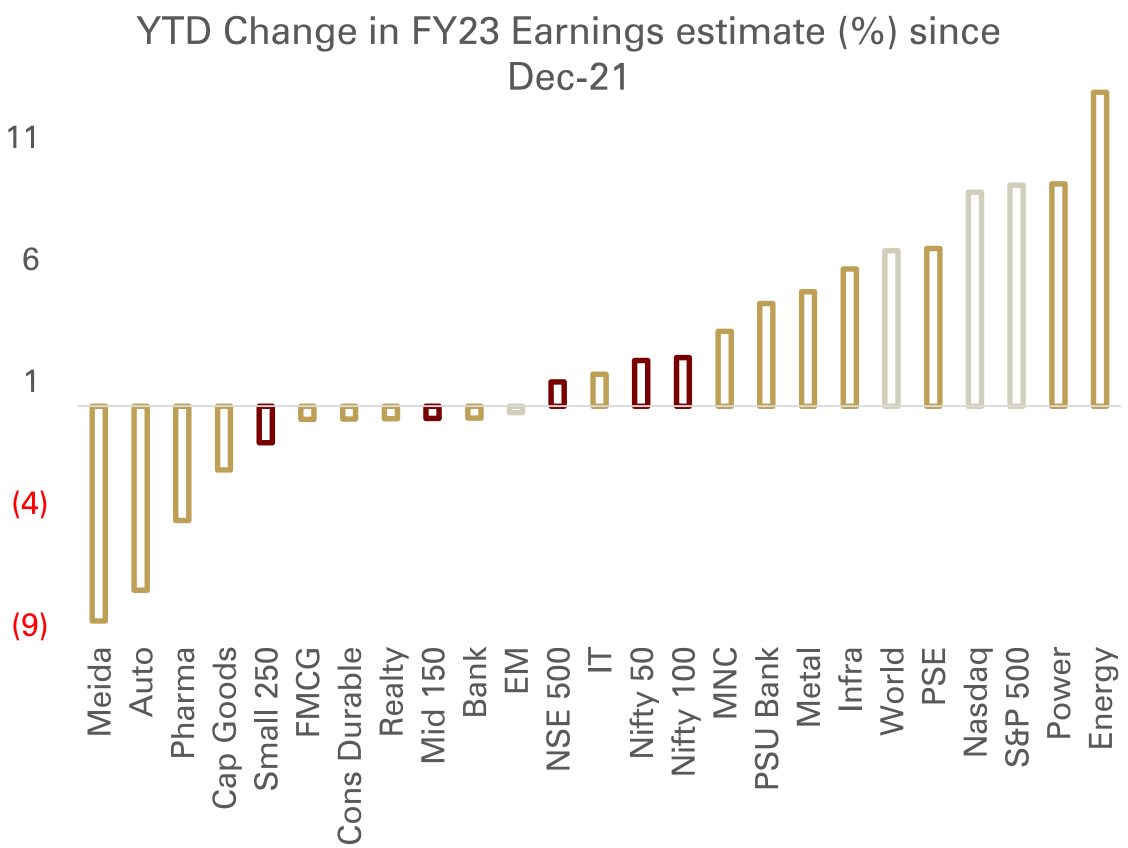
- Nifty earnings delivery has witnessed improvement vs expectations leading to earnings upgrade and supporting market performance.
- Nifty earnings have witnessed upgrades to the tune of 5%.
- FY22 Q4 results season will remain critical (as domestic oriented non commodity sectors may witness earnings downgrade).

Despite the high inflationary environment and some rise in cost of funds, earnings have largely remained in line with expectations Nifty FY 22 /FY 23 estimates, at an aggregate, earnings continue to see a marginal upward revision though the extent of upgrades have come down.

- **However, a prolonged period of high inflation can potentially disrupt earnings upcycle.**

Sectoral Earnings Revisions



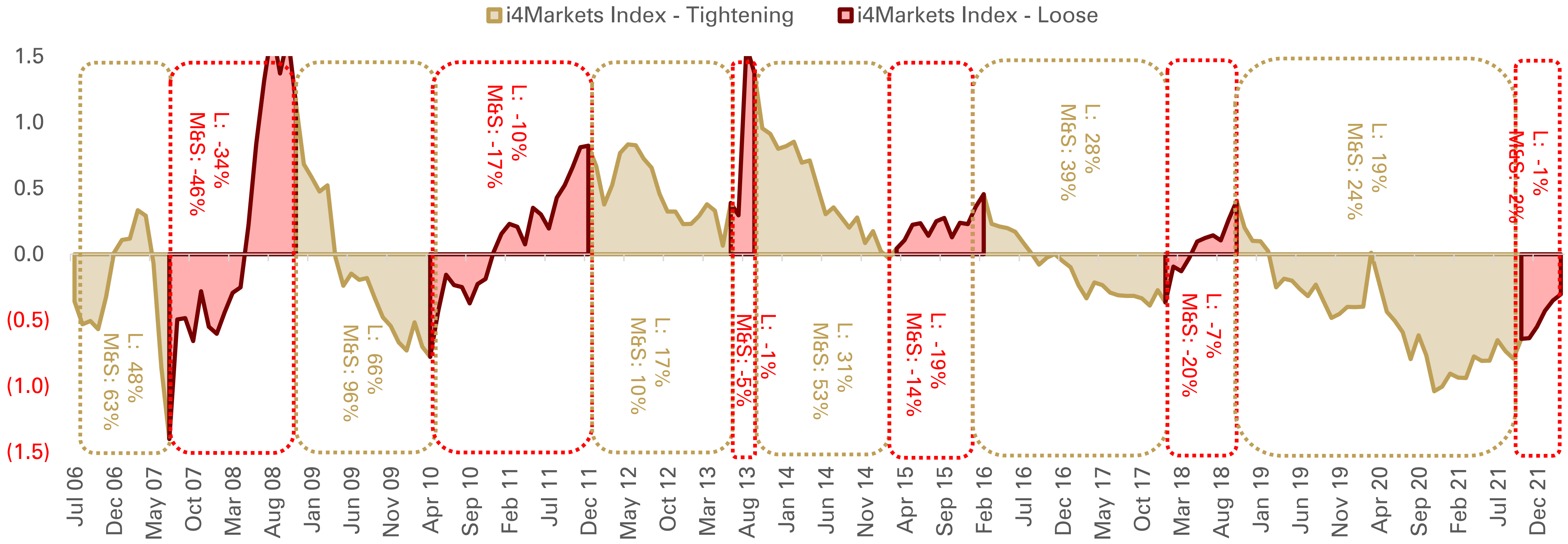


Earnings on an aggregate basis for current fiscal has largely remained stable but sectors have witnessed changes in earnings expectation. While Commodities have witnessed earnings upgrade; FMCG sector has witnessed downgrades (given high input cost pressures).

Profit margins in the first half of 2022 may be constrained, as companies will be absorbing higher material costs and general expenses as the economy opens up.

But financial conditions are expected to tighten which can impact overall market performance

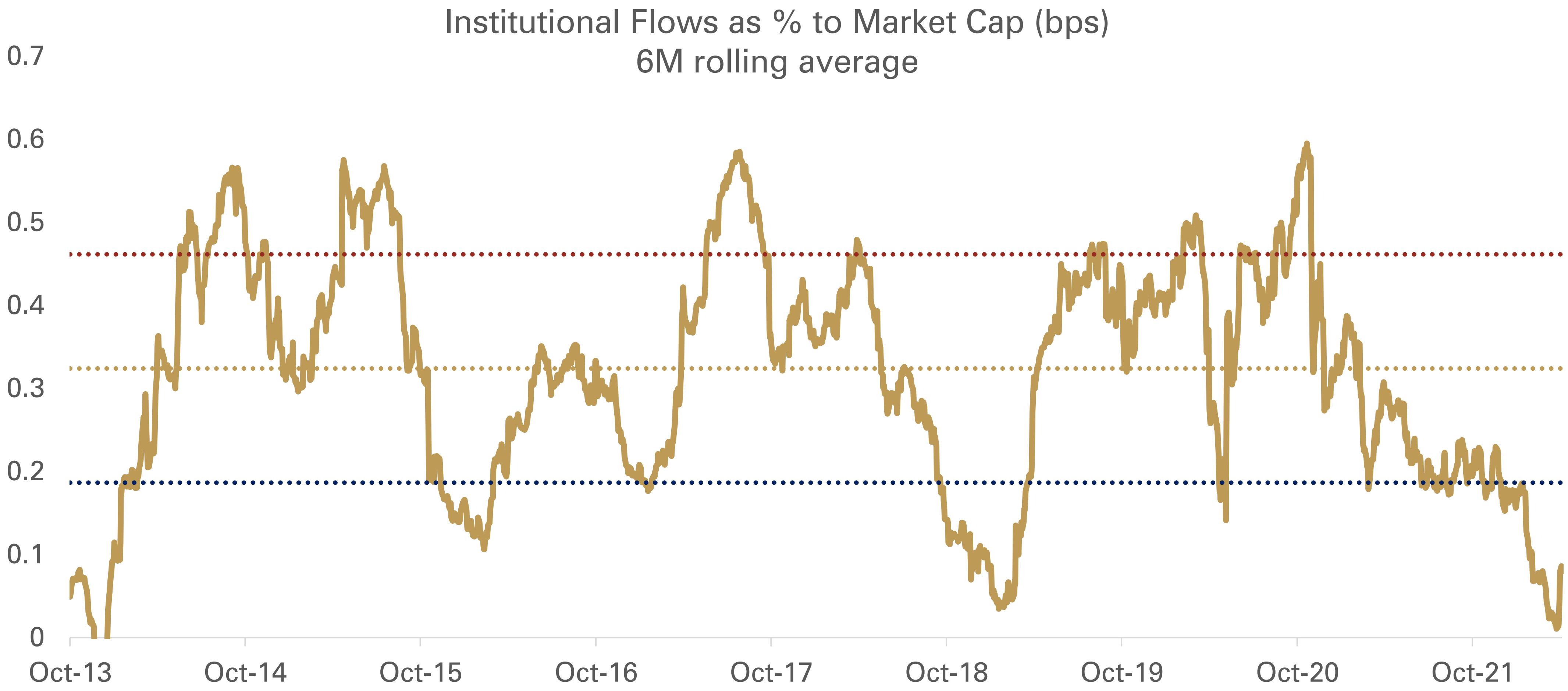
Financial Conditions may tighten going forward in India as well



L – Large Caps; M&S – Mid & Small Caps; Performance of Large, Mid & Small Caps are in CAGR for period >1Yr and on absolute if <1Yr

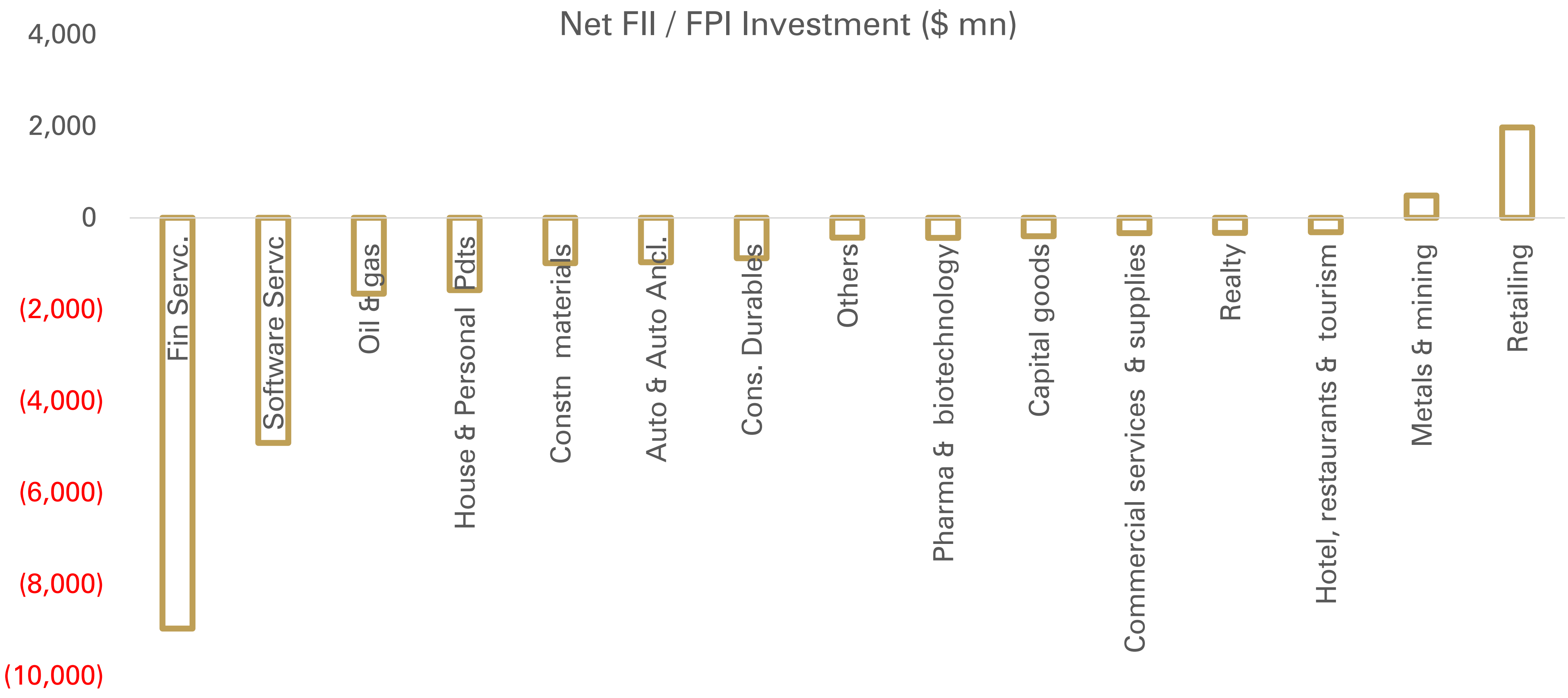
Financial conditions as per ICICI Bank's i4Markets index: Conditions expected to tighten going ahead, as inflationary pressures are likely to push global central banks to wind down monetary policy support at a quicker pace. RBI has also begun the process of normalizing its monetary policy by letting short end bond yields rise (through VRRR auctions). Lower Balance of Payment surpluses may also gradually weigh on systemic liquidity, esp. if credit growth picks up. **During previous episodes of financial conditions tightening, Equity markets have usually underperformed.**

Institutional (out)flows seem to have bottomed out



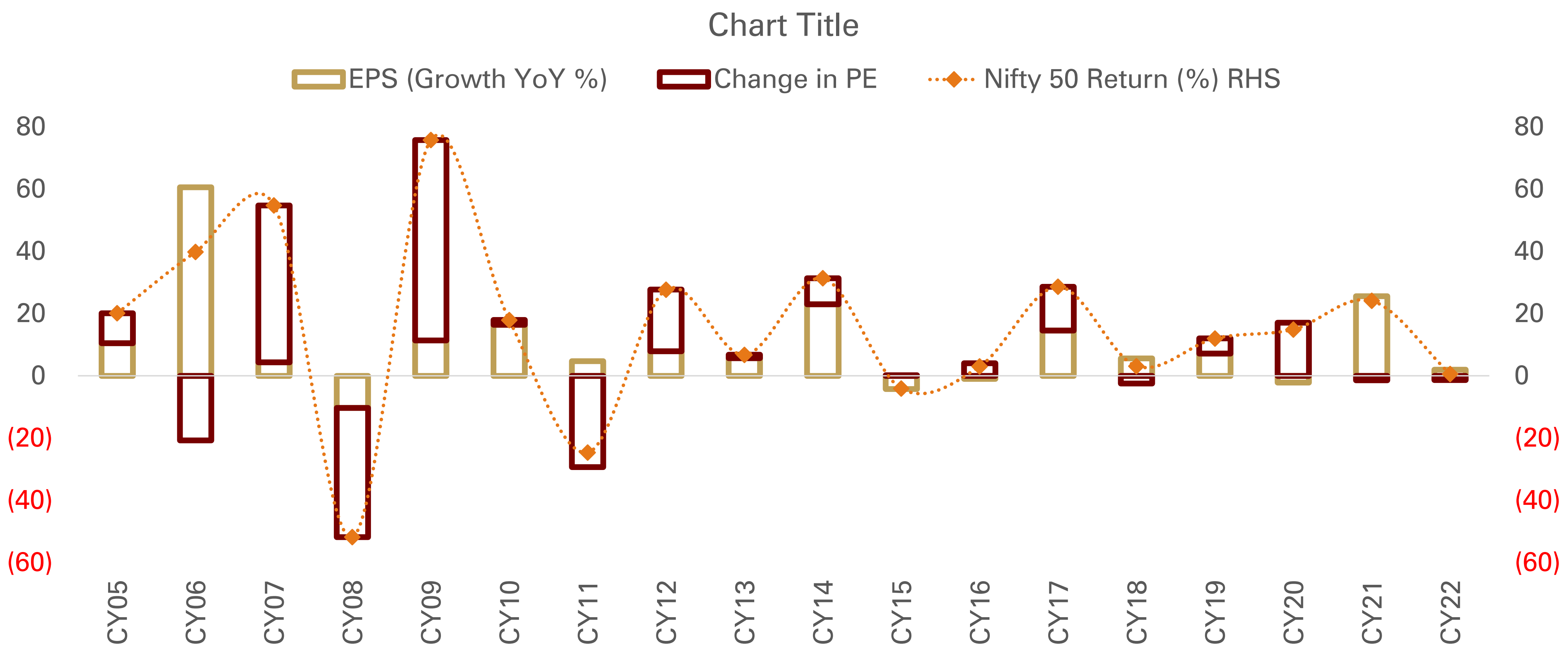
Net institutional flow (Foreign + Domestic Institutions + MF) have seemingly bottomed out. However, in context of historical trend, institutional investors flows can mean revert sometime in 2022, as in history, providing some upside potential to market.

Sectoral FPI (out)flows since market peaks



Institutions have been sellers esp. led by FPI's. However, in context of historical trend, institutional investors flows is closer to bottom with respect to market cap and can mean revert sometime in 2022, as in history, providing some upside to market.

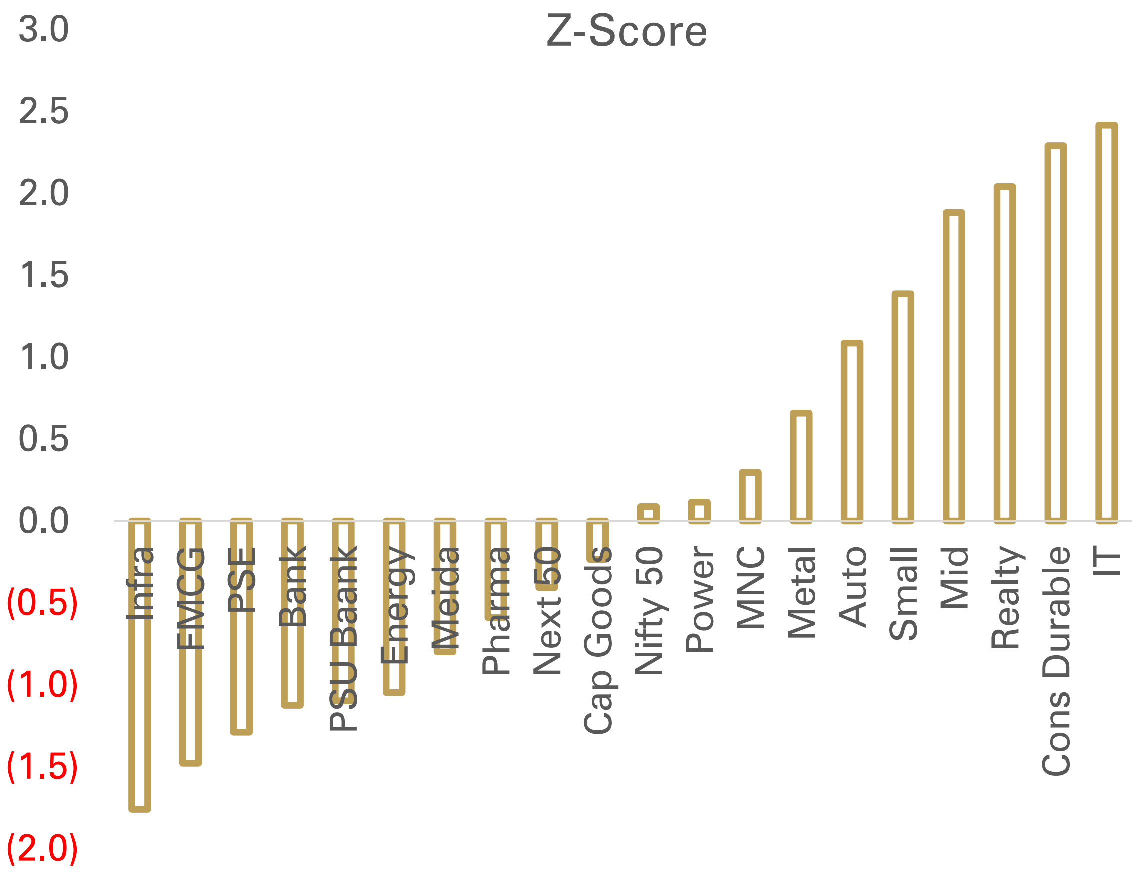
Stacking up of Nifty Returns: Valuations likely to contract in CY22

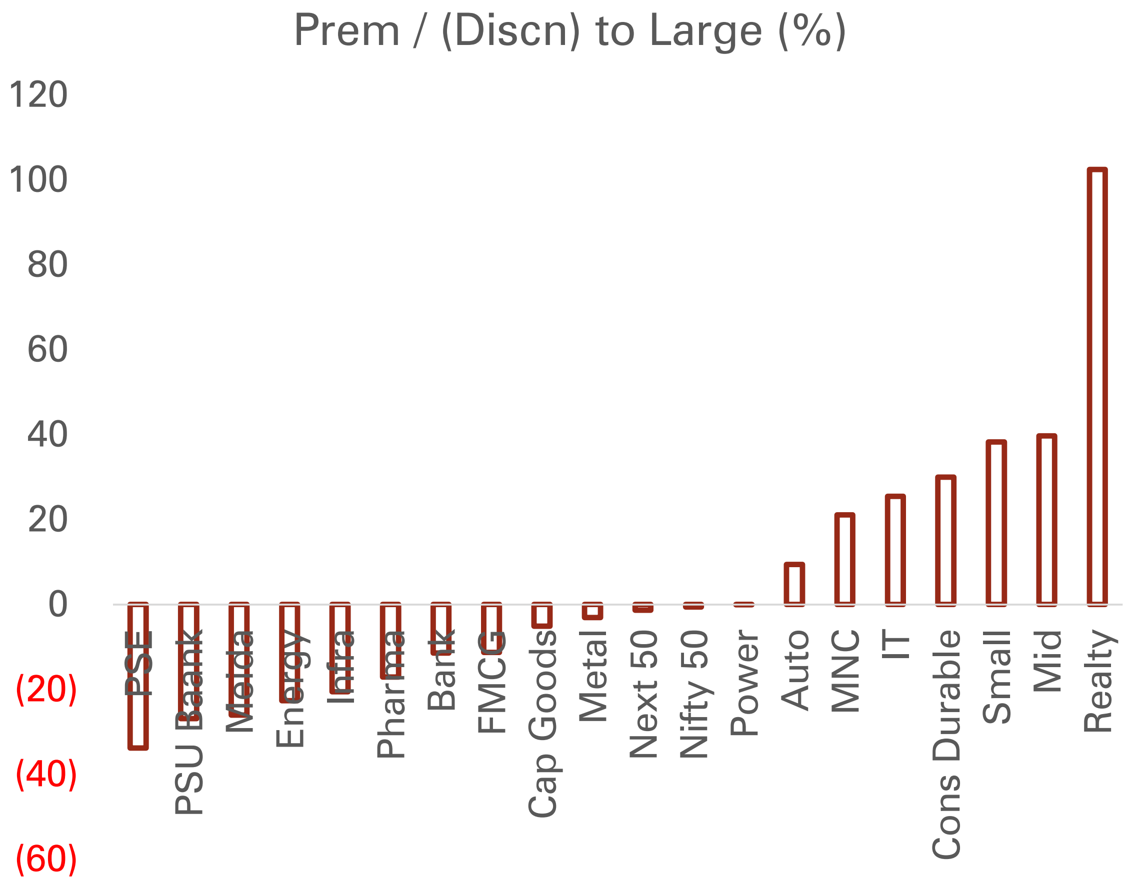


Nifty returns have been dominated by expansion in PE valuations in recent years. Going forward, earnings growth may remain key driver for market performance as valuations may not be supportive. Interestingly, Nifty has delivered positive returns for last five years, posing some risk for 2022

Equity Strategy & Valuations

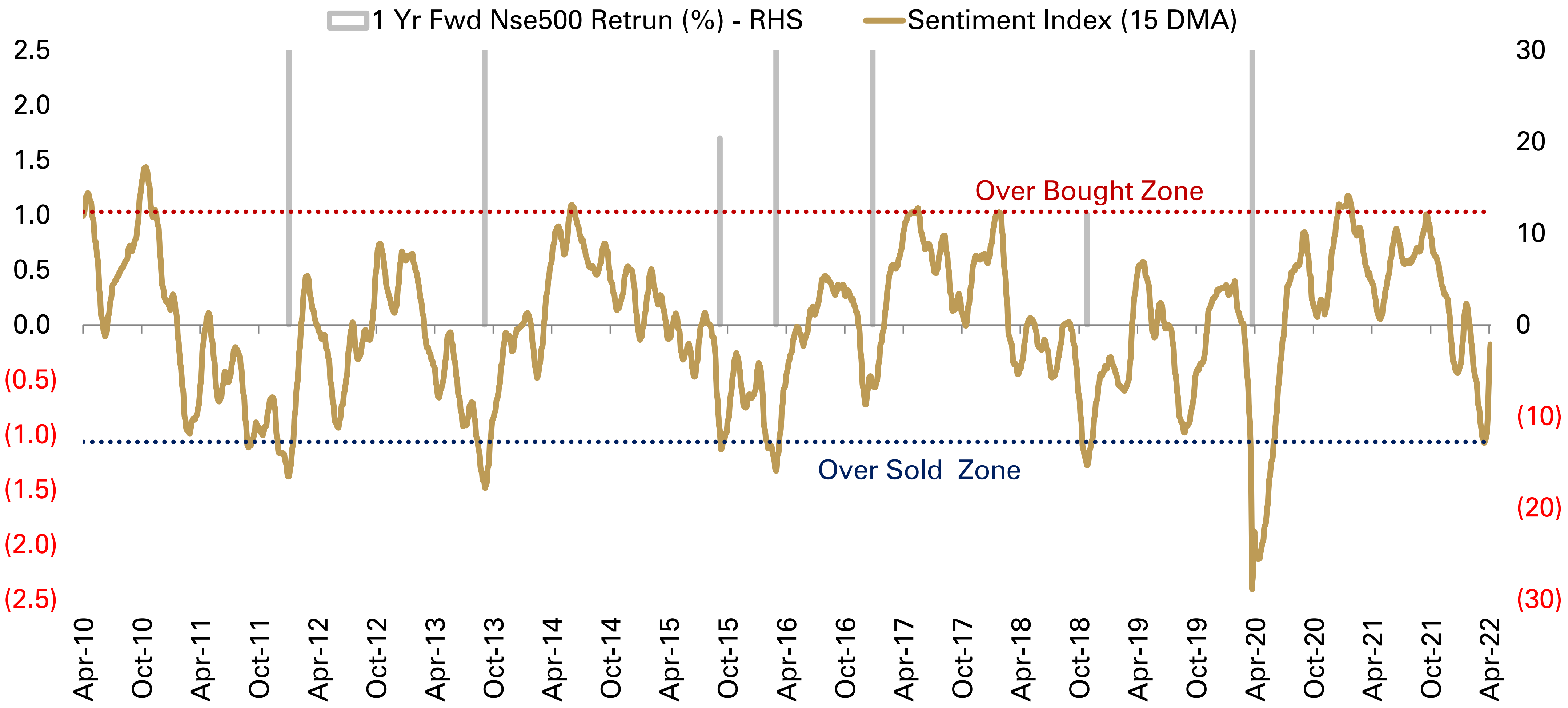
Sectoral Valuations





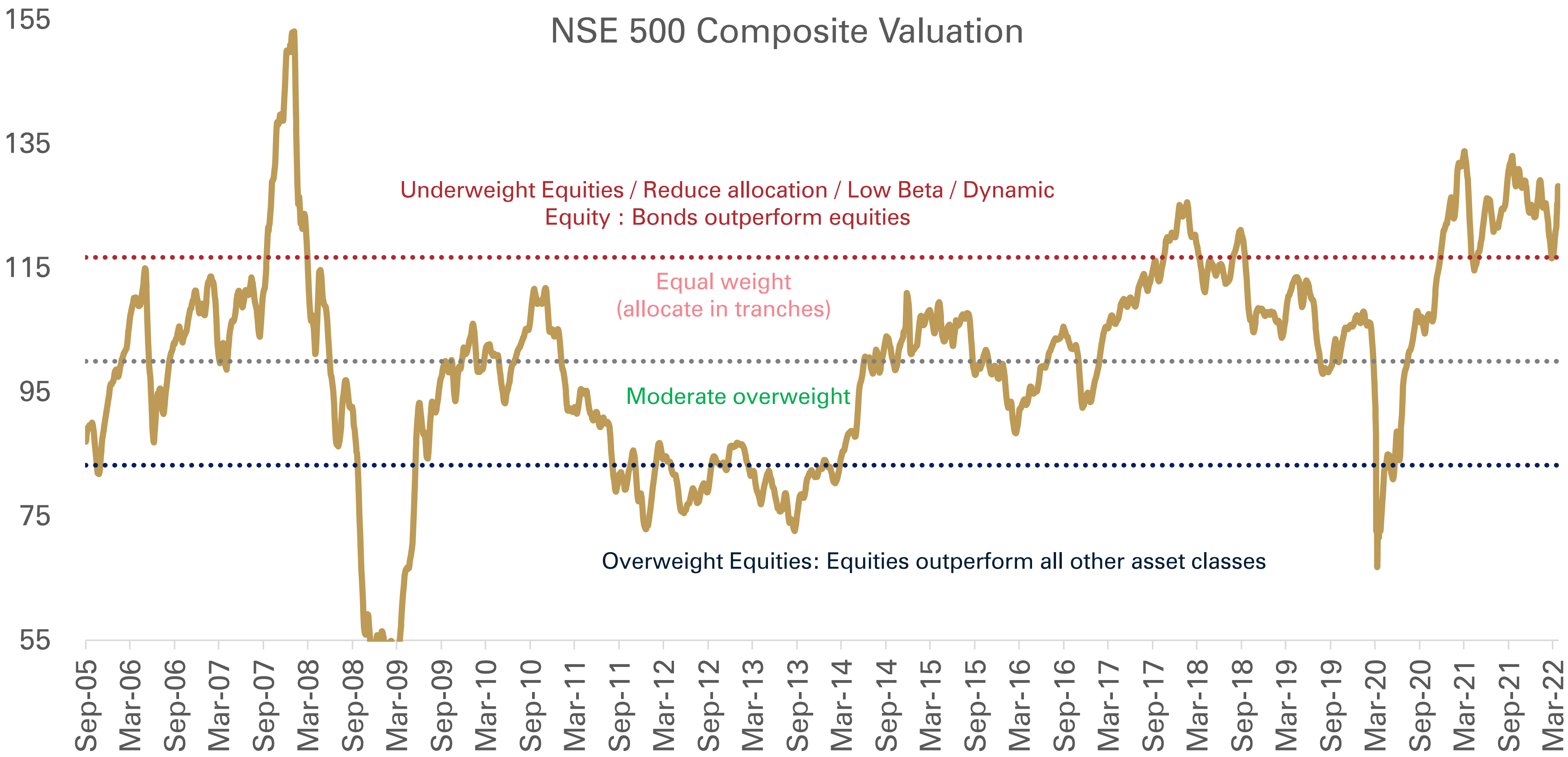
Financials, FMCG and Infra valuations have moderated

Indian equity sentiment indicator



Sentiment index has witnessed improvement in recent times and is now closer to average levels.

Composite Valuation: At above average levels



Despite the recent pullback, Nifty P/E is above its historical average

Summary: Equity Strategy

External risks continue to rise in CY22, given rising oil prices and geopolitical scare

- Yield curve inverting, likely monetary conditions tightening and a potential slowdown in growth trajectory aren't conducive for incremental investing in equities, especially when valuations are on the higher side
- Yet, foreign portfolio 'outflows' have broken all records already – this therefore is a downside support. Flows usually mean revert, providing some upside potential
- Therefore, while a defensive stance is appropriate once again but we refrain from taking large cash calls just as yet
- Medium term outlook on equities, however, remains colored by the deteriorating global macro. Fresh long positions are appropriate to be taken once risk premiums are adequate
- At the margin, we maintain mild OW in Banking (growth at reasonable price)

Fixed Income

MPC Review – A much needed Pivot

As expected, the MPC kept rates unchanged, continued with an accommodative stance, and added "**focusing on withdrawal of accommodation**" (all decisions 6-0), given "**sizeable upside risks to the inflation trajectory and downside risks to domestic growth**".

RBI introduced a new **Standard Deposit Facility** (SDF) wherein it can absorb any quantum of bank deposits at 3.75%. While reverse repo rate remained at 3.35%, SDF will now become the operative rate. The forward guidance also changed as under:

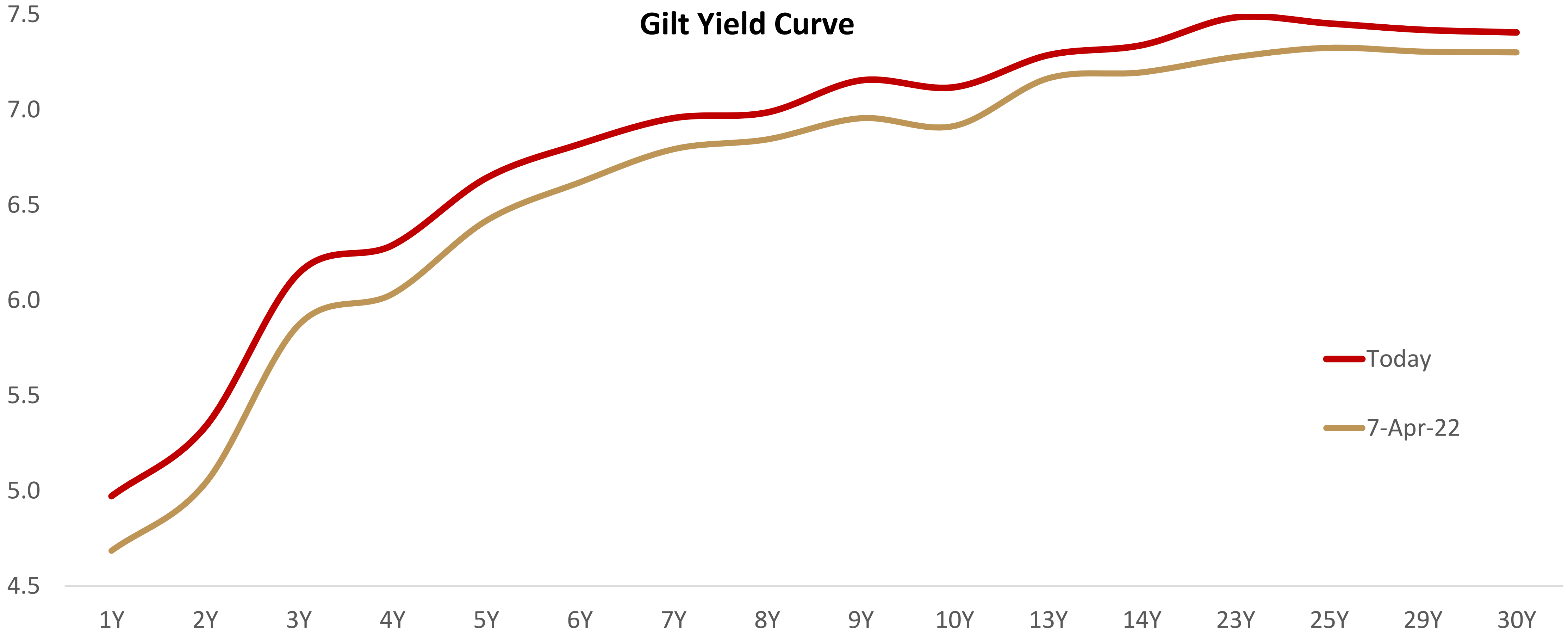
- First, while stance is accommodative, "**withdrawal of accommodation**" is part of the guidance
- Second, inflation has found precedence over growth in the April policy. While up to February 2022, growth recovery on sustainable basis and mitigating impact of Covid-19 took precedence

GDP Growth for FY 2023 lowered to 7.2%, Inflation target hiked to 5.7%: With a sharp revision of global growth to 2.6% from 3.6% earlier (UNCTAD), citing challenging economic conditions, commodity prices, higher interest rates and lingering COVID conditions, the RBI has lowered its growth forecasts from 7.8% to 7.2%. Further, inflation forecast for 2022-23 was marked up sharply from 4.5% to 5.7% (projection is based on USD 100/bbl oil price). RBI is currently projecting an inflation of 5.5% in Q4FY24.

Market Impact: The markets post policy saw a material sell off across the curve. The benchmark 10-year G-Sec crossed the psychological 7% threshold. Money markets rose 20-25 bps while long bonds rose 15-20bps

Standard Deposit Facility (SDF) is uncollateralized liquidity absorption tool as against fixed reverse repo facility which is collateralized liquidity absorption tool.

Yield curve up across yield curve post MPC policy



Yields have moved up by 10-25 bps across the yield curve

Central Banks have embarked on policy normalization

Policy Rate (in %)	Dec-19	Dec-20	Mar-21	Jun-21	Sep-21	Oct-21	Nov-21	Dec-21	Mar-22
China	4.15	4.15	3.85	3.85	3.85	3.85	3.85	3.8	3.7
India	5.15	4	4	4	4	4	4.0	4.0	4.0
South Korea	1.25	0.5	0.5	0.5	0.75	0.75	1.0	1.0	1.25
Indonesia	5	3.75	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Taiwan	1.38	1.13	1.13	1.13	1.13	1.13	1.13	1.13	1.37
Thailand	1.25	0.5	0.5	0.5	0.5	0.5	0.50	0.50	0.50
Malaysia	3	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Philippines	4	2	2	2	2	2	2	2	2
Russia	6.25	4.25	4.5	5.5	6.75	7.5	7.5	8.5	20.0
Turkey	12	17	19	19	18	16	15.0	14.0	14.0
South Africa	6.5	3.5	3.5	3.5	3.5	3.5	3.75	3.75	4.25
Brazil	4.5	2	2.75	4.25	6.25	7.75	7.75	9.25	10.75
Mexico	7.25	4.25	4	4.25	4.75	4.75	5.00	5.50	6.5
Colombia	4.25	1.75	1.75	1.75	1.75	2.5	2.5	3.0	4.0
Chile	1.75	0.5	0.5	0.5	1.5	2.75	2.75	4.0	5.50
US	1.75	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
Eurozone	0	0	0	0	0	0	0.00	0.00	0.0
UK	0.75	0.1	0.1	0.1	0.1	0.1	0.10	0.25	0.75
Japan	0.1	0.1	0.1	0.1	0.1	0.1	0.10	0.10	0.10

Many EMs are already at an advanced stage in hiking cycles. Developed markets also have embarked on policy normalization, however at this point, policymakers obviously face even more uncertainty regarding the growth outlook, the immediate risk from the latest rise in energy prices and near-term inflation outlook

Inflation is above target range for most of economies

Countries	Inflation target range (%)	Latest inflation print (%)	Last 6 month avg inflation (%)	Latest inflation print higher than target band (Yes/No)
Emerging Economies				
China	~3.0	0.9	1.3	No
India	4.0 ± 2.0	6.1	5.2	Yes
Indonesia	3.0 ± 1.0	2.1	1.9	No
Taiwan	2	2.4	2.6	Yes
Thailand	1.0 - 3.0	5.3	2.9	Yes
Malaysia	2.5-4	2.2	2.7	No
Philippines	3.0 ± 1.0	3	3.5	No
Russian Federation	4	9.2	8.4	Yes
Turkey	5	54.4	33.3	Yes
South Africa	3.0-6.0	5.7	5.4	No
Brazil	3.5 ± 1.5	10.5	10.4	Yes
Mexico	3.0 ± 1.0	7.3	6.9	Yes
Colombia	2.0-4.0	8	5.8	Yes
Chile	3	7.8	6.8	Yes
Developed Economies				
United States	2	7.9	6.8	Yes
Eurozone	2	6.2	5	Yes
United Kingdom	2	6.2	4.9	Yes
Japan	2	0.9	0.5	No
South Korea	2	3.7	3.4	Yes

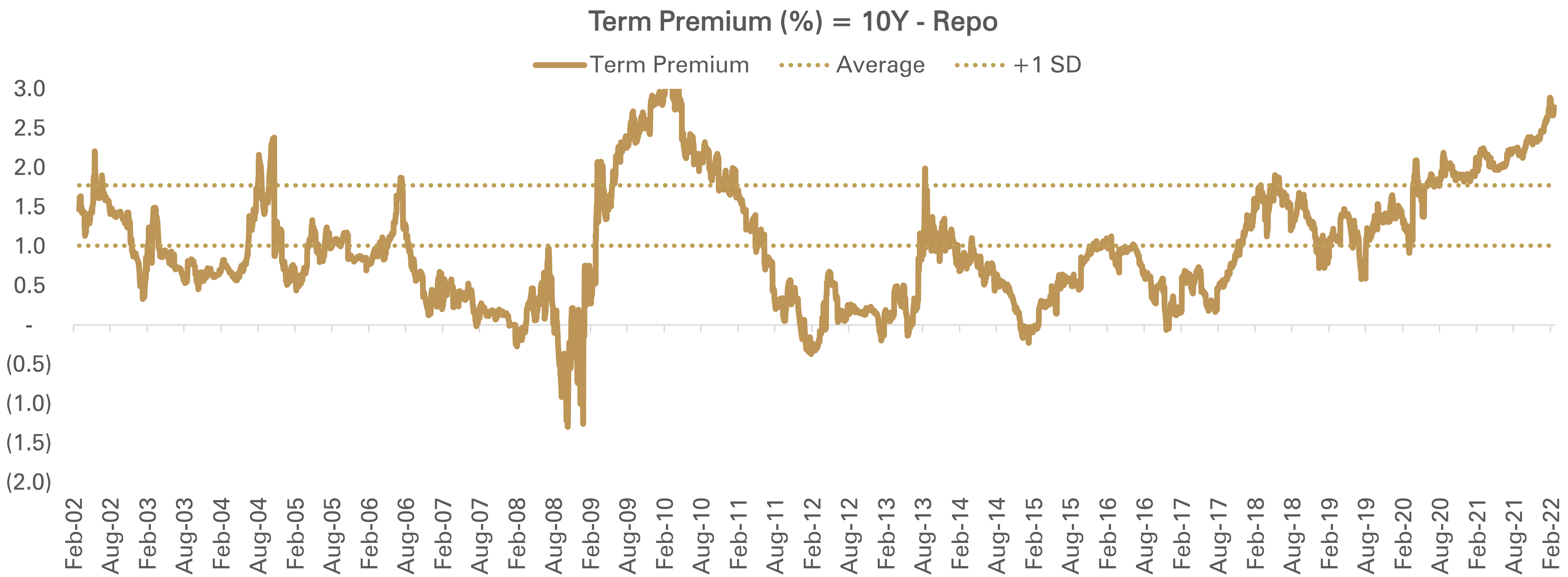
- With energy prices moving further up due to recent issues inflation is likely to move up further. Globally, inflation has remained well above the target for majority of the economies, prompting faster-than expected rate hikes
- India's inflation has remained within the upper-target band

Rising Global Bond Yields

10 Year Gsec Yield (% mth end)	2020 end	Mar-21	Dec-21	Feb-22	8-April-22	YTD change (in bps)
Developed market						
US	0.91	1.74	1.51	1.83	2.70	119
Germany	-0.57	-0.29	-0.18	0.14	0.70	88
Italy	0.54	0.67	1.17	1.71	2.36	119
Japan	0.02	0.1	0.07	0.19	0.24	17
Spain	0.05	0.34	0.57	1.12	1.68	111
UK	0.2	0.85	0.97	1.41	1.75	78
Emerging Market						0
Brazil	6.91	9.28	10.84	11.56	11.61	77
China	3.15	3.19	2.78	2.79	2.80	2
India	5.87	6.17	6.45	6.77	7.1	65
Indonesia	5.86	6.76	6.36	6.5	6.89	53
Malaysia	2.65	3.27	3.58	3.67	4.04	46
Russia	5.92	7.04	8.45	15.99	10.84	239
Thailand	1.32	1.97	1.89	2.14	2.18	29
Turkey	12.9	18.86	24.32	21.99	25.48	116
Mexico	5.55	6.84	7.57	7.95	8.91	134
Poland	1.24	1.57	3.67	4.1	6.06	239
South Africa	8.75	9.5	9.81	9.85	9.6	(21)
Colombia	5.39	6.97	8.19	9.53	9.40	121
Hungary	2.08	2.71	4.51	5.24	6.78	227

Inflationary pressures & increasingly hawkish monetary stances by major central banks across the globe resulted in higher bond yields.

Long Duration (10Y): Offers value at above 7.50 levels



At G-Sec level of 7.50 and above, it will price in terminal repo of 6.0 (rate increase of 200 bps) and spread of 150 bps.

At 7.50 one can start building duration exposure (10 year and above maturity) with a 5 year plus view

Fixed Income Strategy

- RBI is likely to move to neutral stance in June and can start rate hike cycle with 25 bps rate hike. Terminal repo is likely to be at 6% (vs. 5.5% earlier estimate), implying 200 bps of rate hike over course of next 18-24 months, with 100 bps hike likely to be in FY 23.
- Yields are likely to continue upward trajectory during the year on the back of rising US yields, elevated government borrowing and CPI inflation remaining above RBI's upper tolerance band of 6%.

We believe yield curve is likely to flatten as short-end yields are likely to see a larger increase on the back of repo rate hikes going forward. **Indian bond inclusion in global indices has the potential to anchor the long term curve.**

Given low rates & expectation of gradual upward movement in short term yields over time, **short term investors should consider products with duration lower than investment horizon**. Following is preferred strategy:

For investment horizon upto 3 months: Prefer liquid funds. Individual investors can consider bank savings upto 3 months as other categories can be volatile.

For longer investment horizon (upto 1 Yr): investors can consider Ultra Short Term Funds, Arbitrage Funds & Deposits.

Horizon of more than 3+ years –

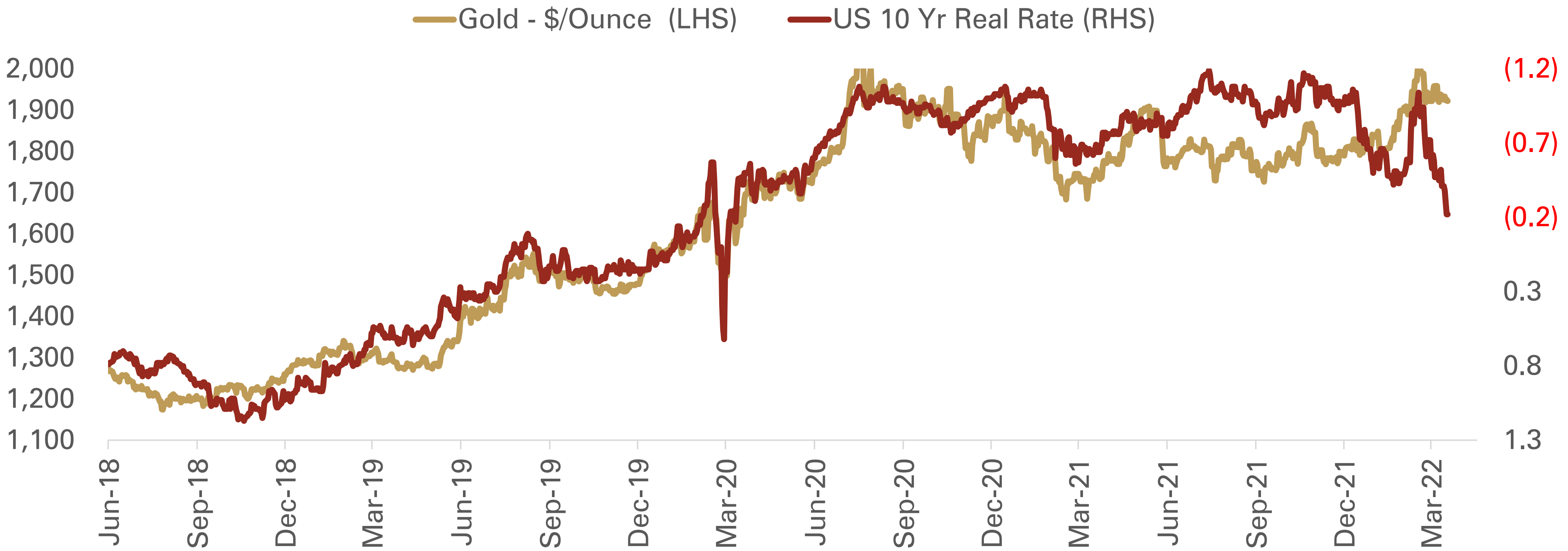
- Consider 4-6 year AAA roll down strategies, for investors with horizon of more than 4 years
- At 10 Year G-Sec above 7.5%, one can start building long duration exposure with 5+ year view

Today's policy likely marks a pivotal shift in RBI's stance. Hence, its critical to have an at least 4-year horizon while investing debt funds, for longer term investors.

Gold

Gold price have tracked real yields

Some 'uncertainty premium' that has got built up (vs. Real yields). Eventually, as yields rise further, Gold may see some downward pressure



- Gold has corrected as the 'geo political' risk premium has fallen. However, it is yet maintaining some risk premium relative to real rates, and may be susceptible to further downside volatility in near term.
- Gold may bottom out as US rate hikes get fully priced in by the market

ICICI Investment Management

Thank you

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