ICICI Investment Management

Investment Strategy

Executive Summary

Global / US

- Key question for investors now is – Can inflation (esp. US) be tamed without significantly slowing down the economy / a very tight labor market?
- Equities – risk of further P/E de-rating remain, therefore maintain UW bias
- Bonds – US Bond yields are pricing in significant amount of monetary tightening already – a good hedge against a potential slowdown, albeit with lot of volatility

India - Equities

- 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 and now local monetary tightening cycle, risks remain for further valuation normalization – India already at a premium
- Risk premiums need to rise to average levels for fresh addition

India – Fixed Income

- MPC has changed its priority – inflation over growth
- OIS curves indicate 200bps further tightening, alongside liquidity withdrawal
- Prefer 5year+ curve, 10year+ at yields above 7.5%+ levels

Gold

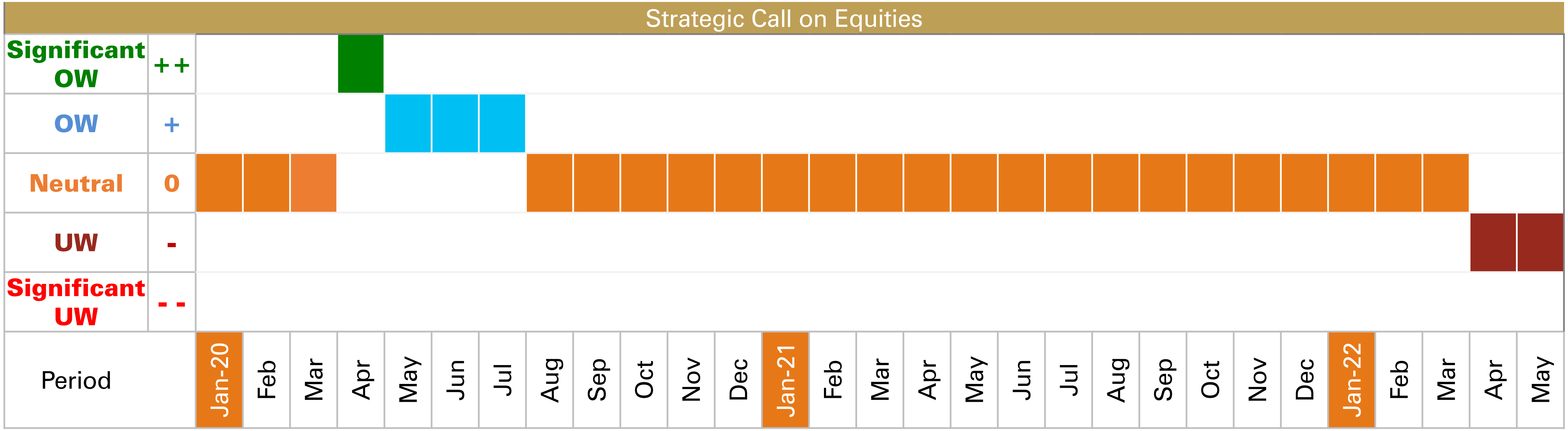
- Gold has underperformed as expected. Once speculative positions wind down somewhat, it may be appropriate to go Over Weight

Asset Allocation Positioning

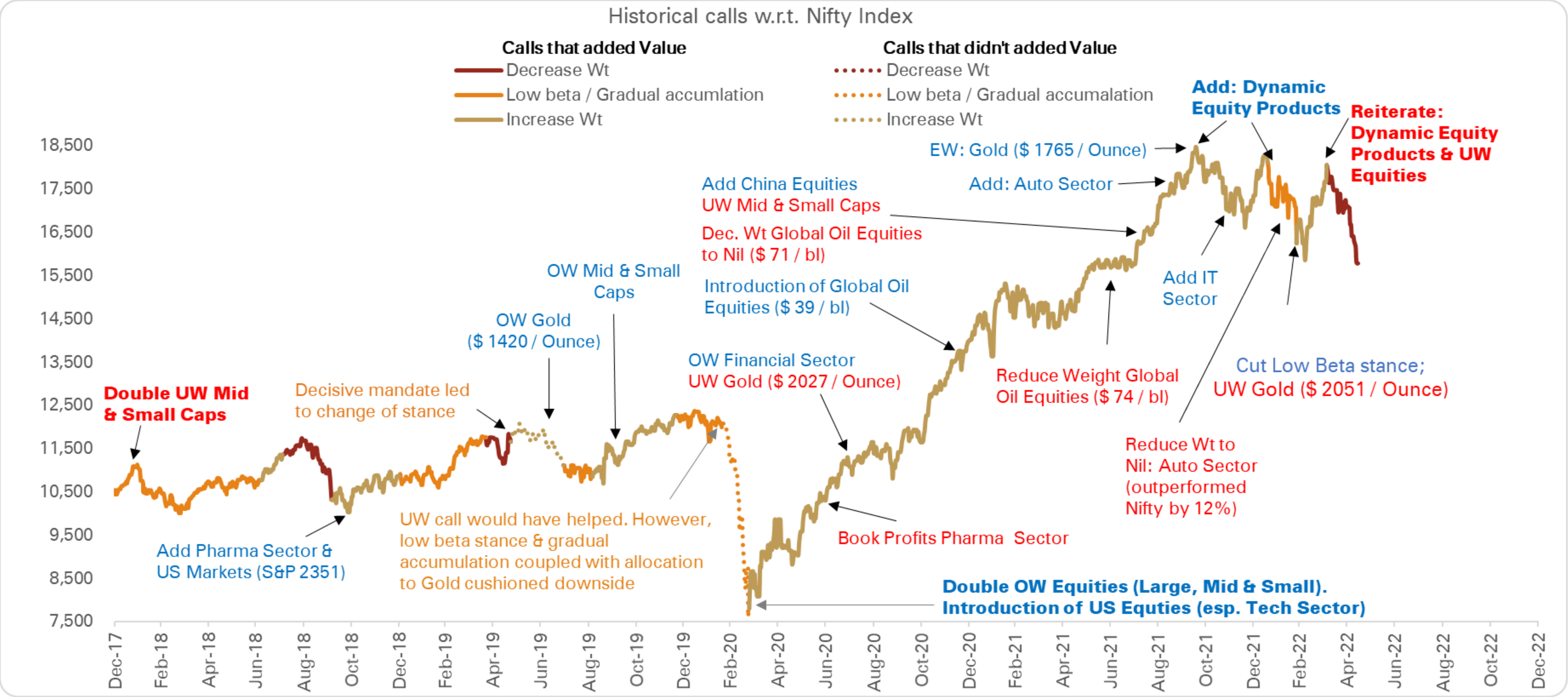
Asset Class	Short Term					Medium Term				
	- -	-	0	+	++	- -	-	0	+	++
Equities		■					■			
Large Cap & Diversified			■				■			
Mid & Small Cap		■					■			
Global Equities			■				■			
Debt			■					■		
Low Duration Debt			■					■		
Short & Medium Term			■						■	
Credit Fund			■					■		
Duration		◆	■	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

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

Strategic Indian Equity Allocation (recent history)

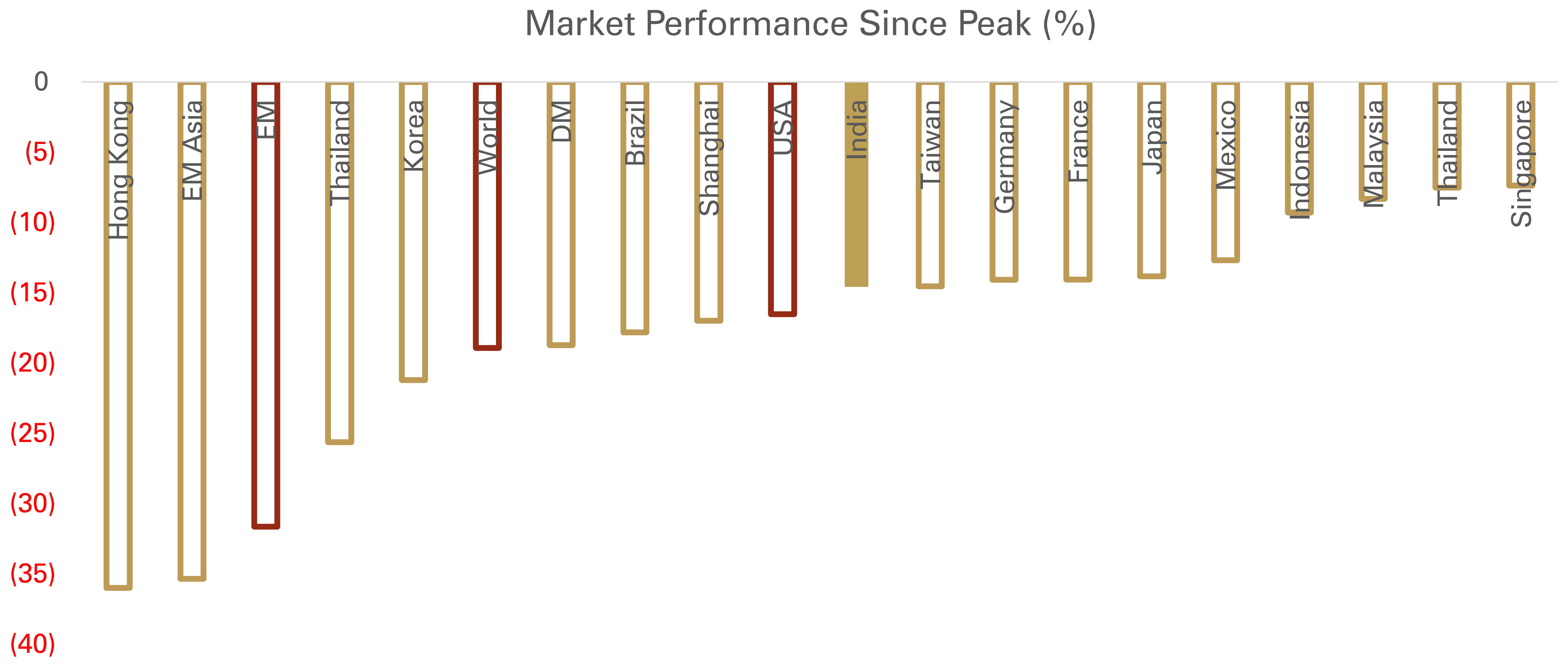


Historical Calls - Equity



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;

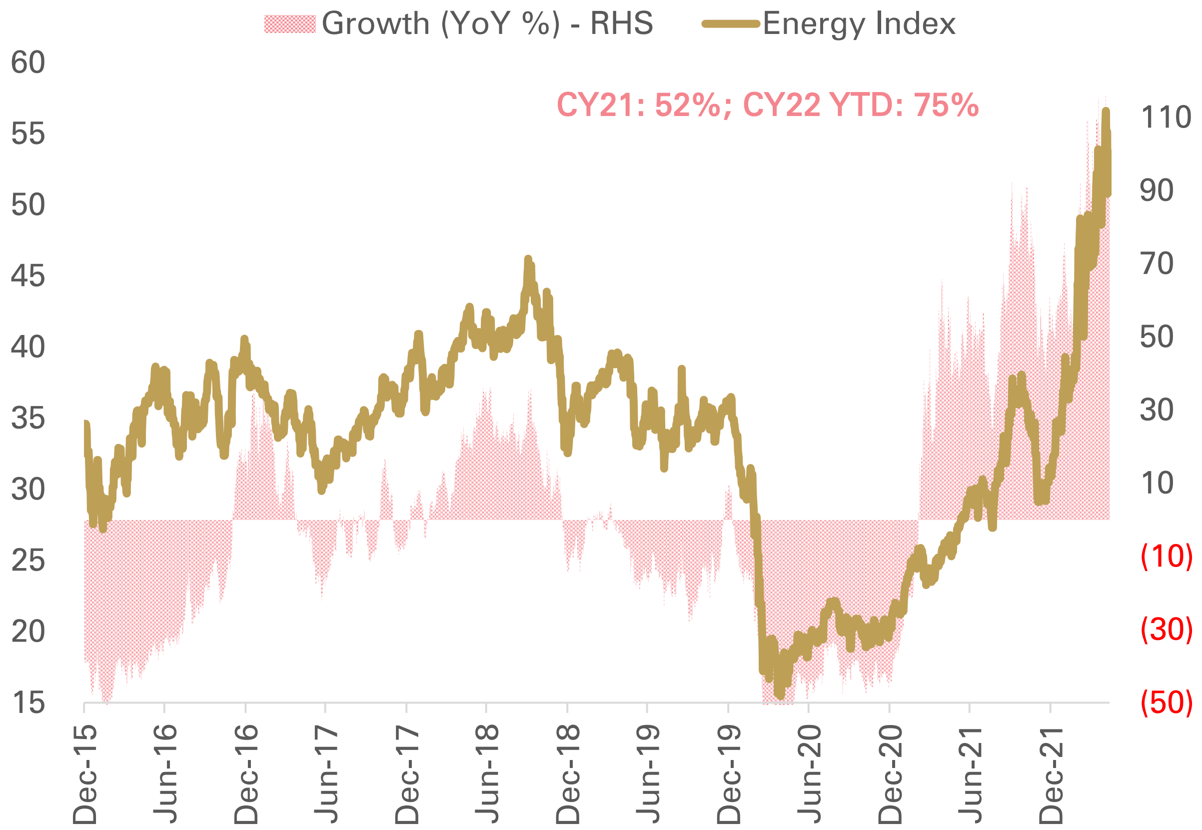
Global Equities: Performance from respective highs

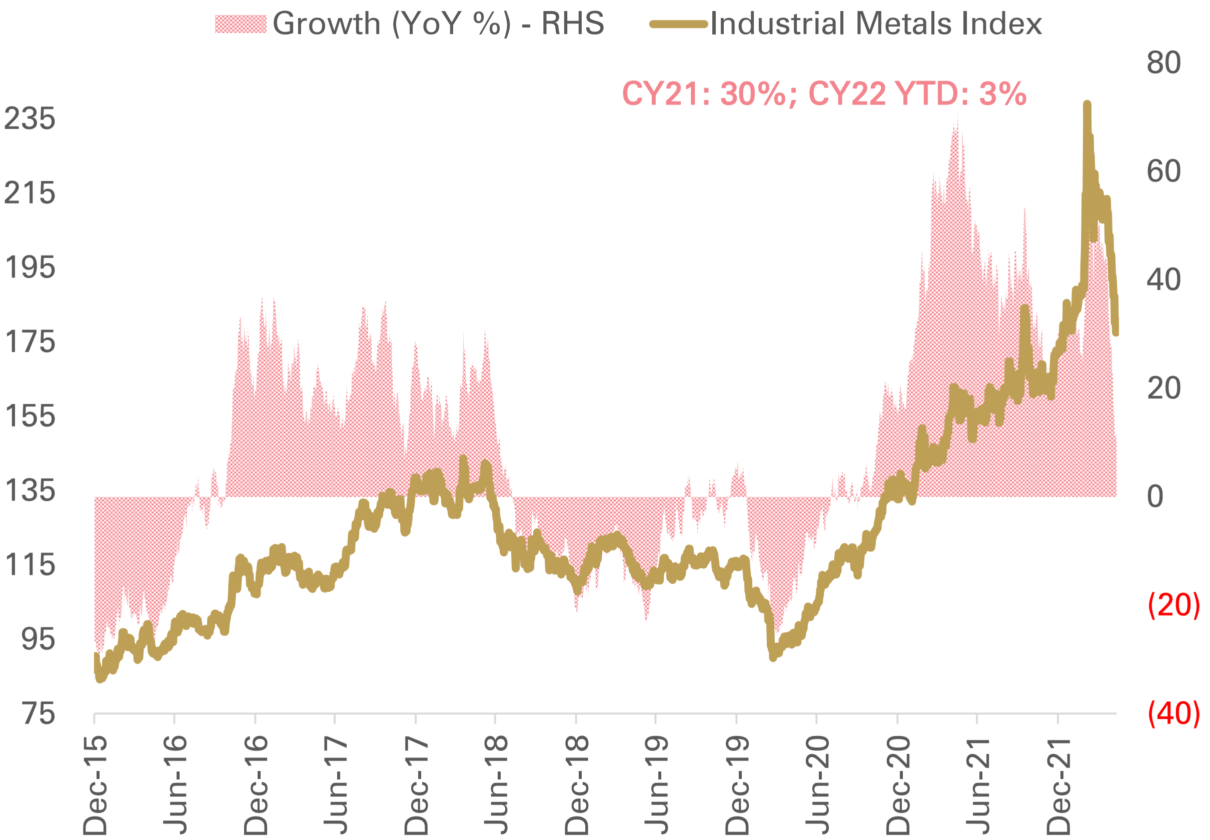


Global Markets have witnessed steep correction in recent times given risk emanating from geo-political scare, sharp rise in commodity price and monetary tightening.

Can global / US inflation be tamed without significant slow down?

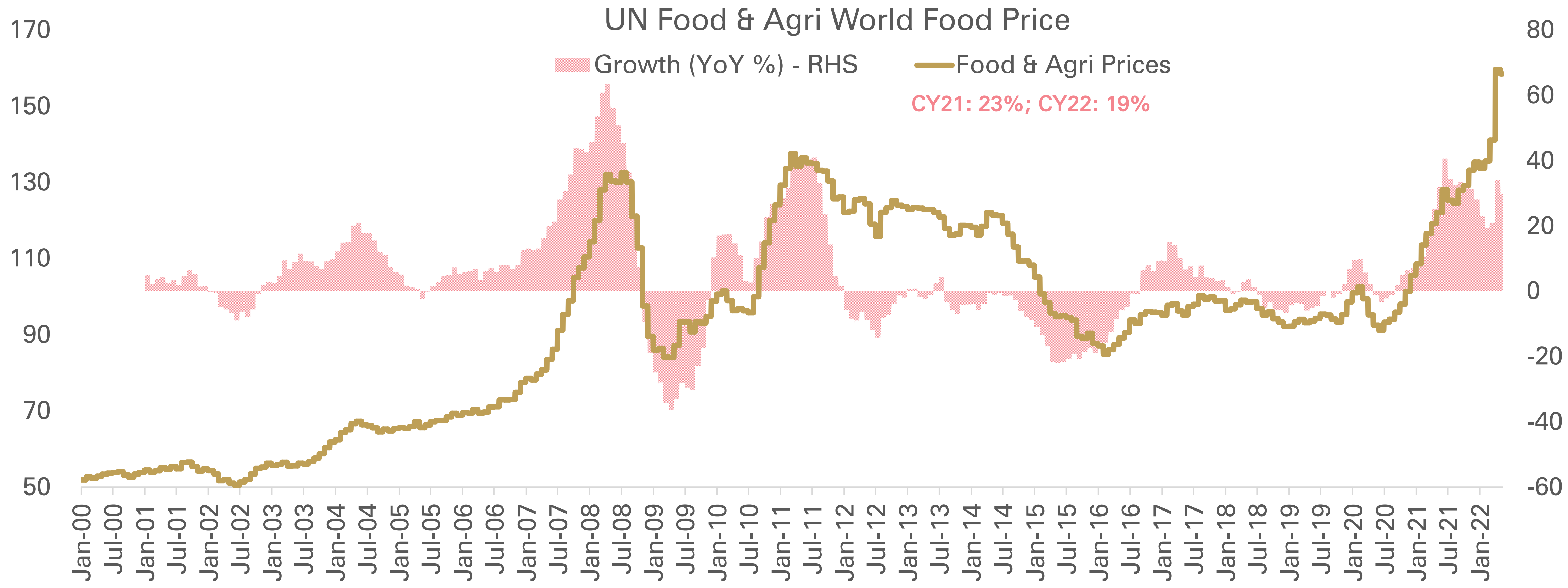
Energy & Industrial Metals have already risen substantially





Incremental rate of change matters. While energy can be some source of incremental inflation, industrial metals have already been declining given the moderating ‘growth’ outlook, including Chinese lockdowns

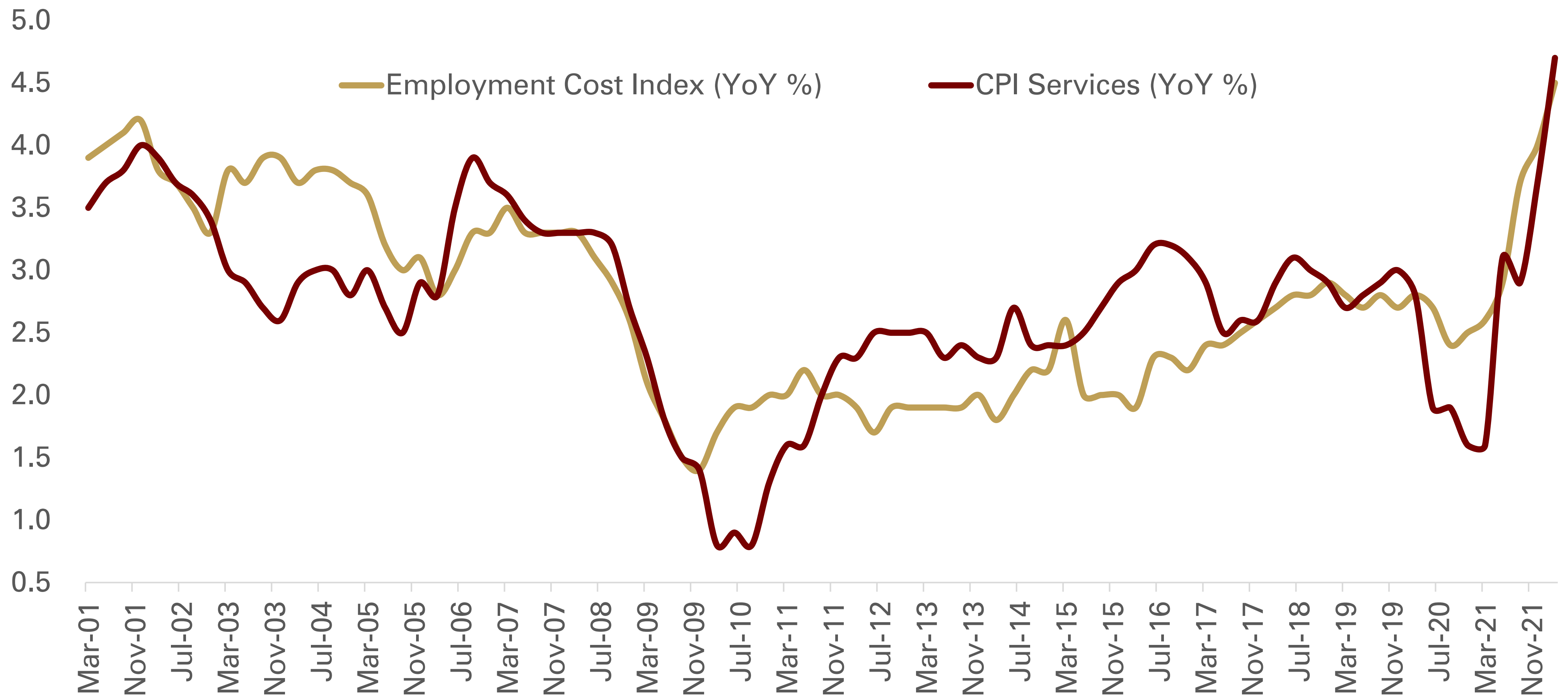
Rising food prices pose upside risk to inflation



Global Food Prices have risen from pre-pandemic levels, but are further seeing pressure due to geo-political and weather related factors

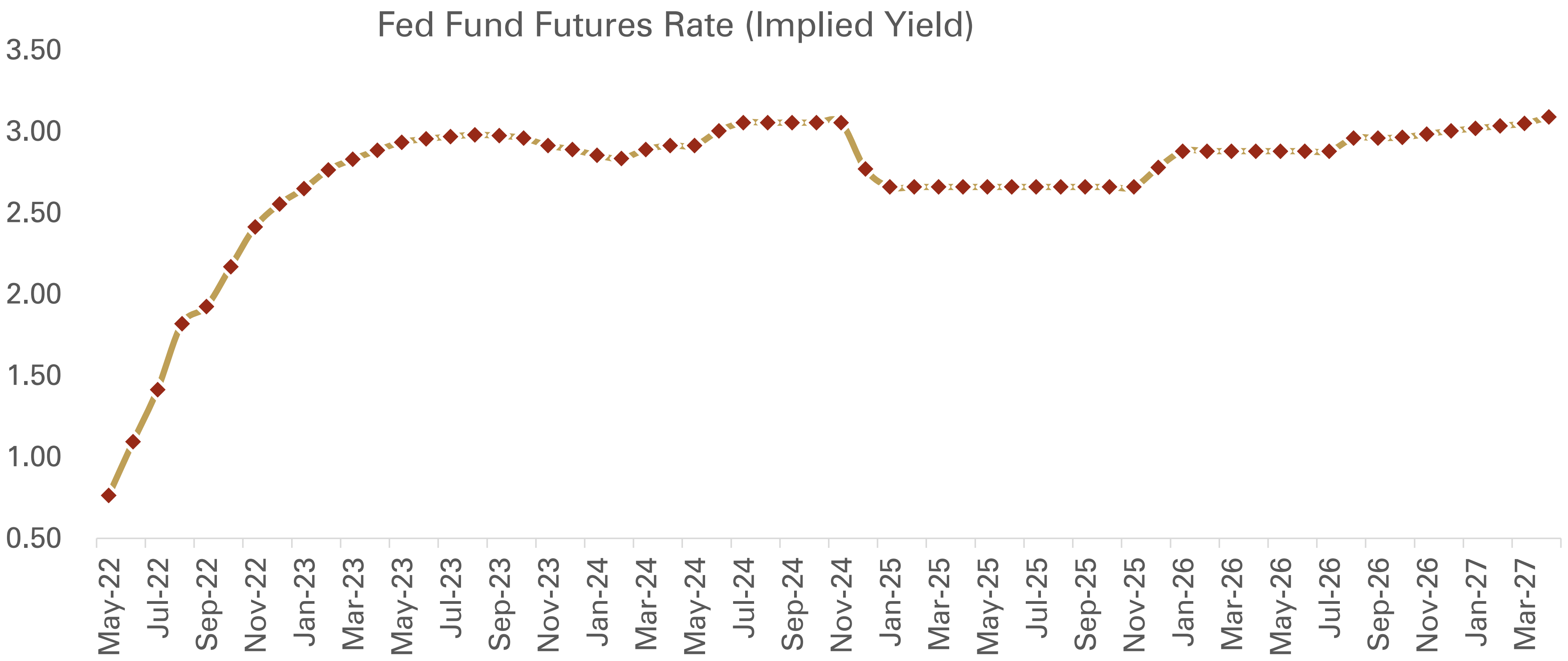
India: Rising global food prices could eventually filter into domestic prices and thus pose upside risk to FY23 inflation outlook as food accounts for a much higher weight in CPI than crude oil

Tight US labor market pressuring wages, in turn Services Inflation



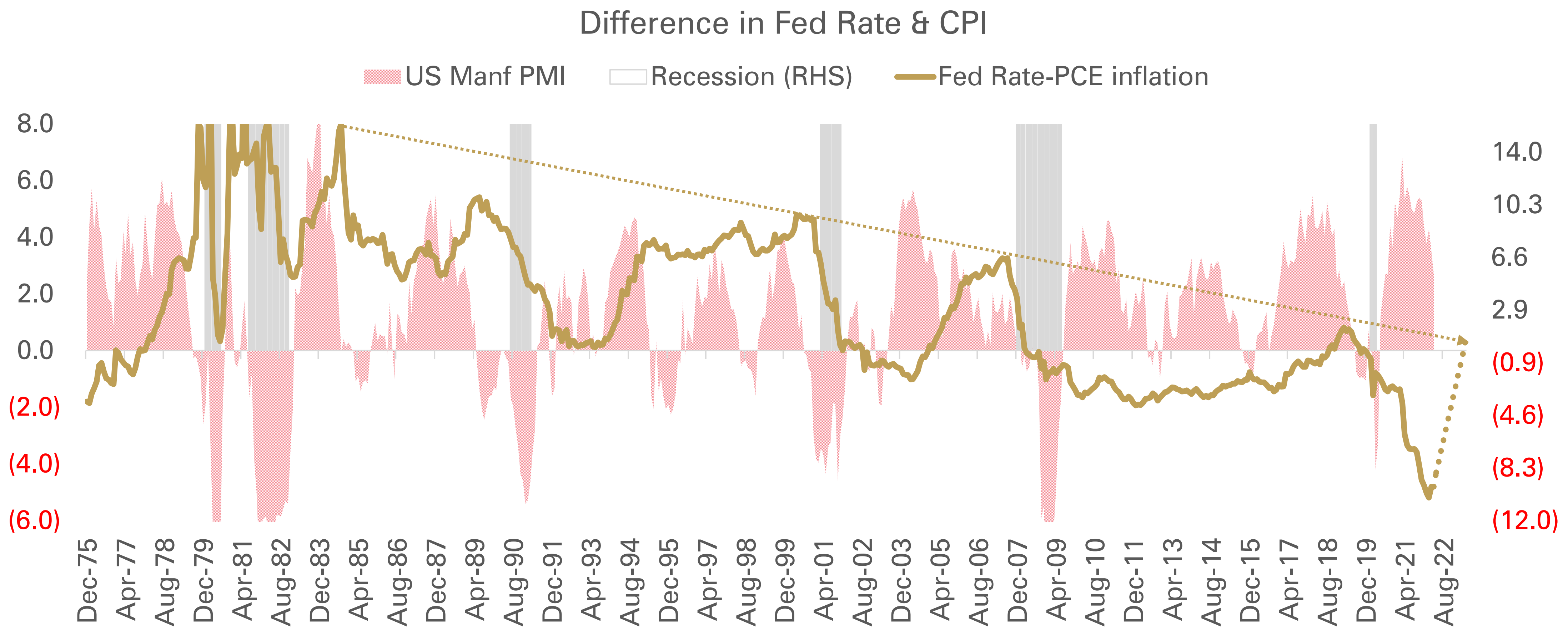
The Employment Cost Index (ECI) in US measures the change in the cost of labor, free from the influence of employment shifts among occupations and industries. This is rising at sharpest rate since data is available, due to very tight labor market in US. This is turn is putting higher pressure on Services as economies open up. **Unless labor market tightness relaxes, it may not be soon that this measure moderates!**

Fed Fund futures curve expecting +200 bps tightening



Futures curve is now anticipating +200 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.

Thus, real Fed Rate may turn +ve in '23



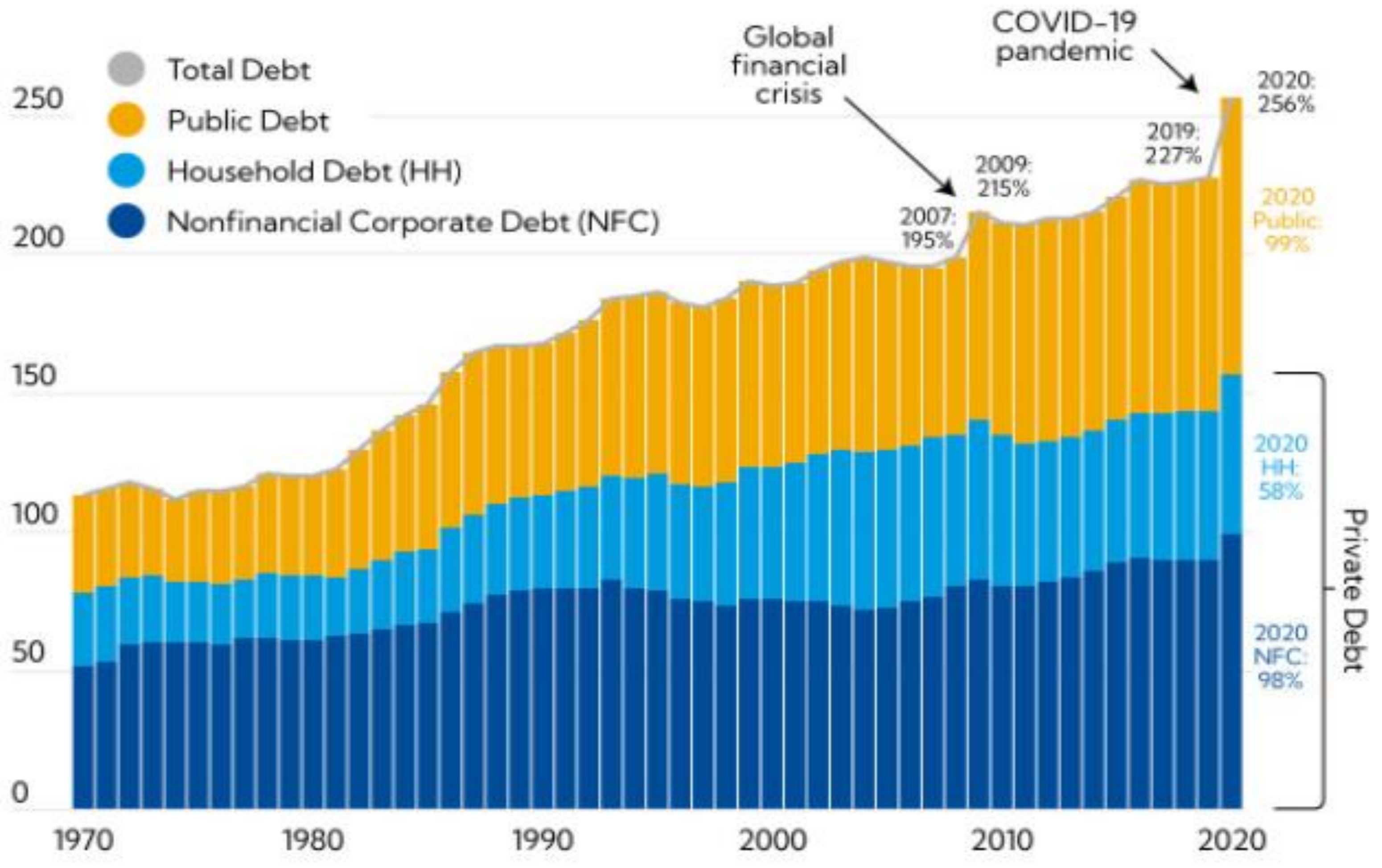
Historically, Fed Funds turning positive has had a 'slowdown' impact on the US (& global) economy. Further, the peak Real Fed Fund rate has been declining over cycles (see the trend-line), as global debt has ballooned (next slide), among other reasons. **Real Fed Funds Rate is forecast to move to positive territory by early / mid 2023**

Debt surge amplifies vulnerabilities

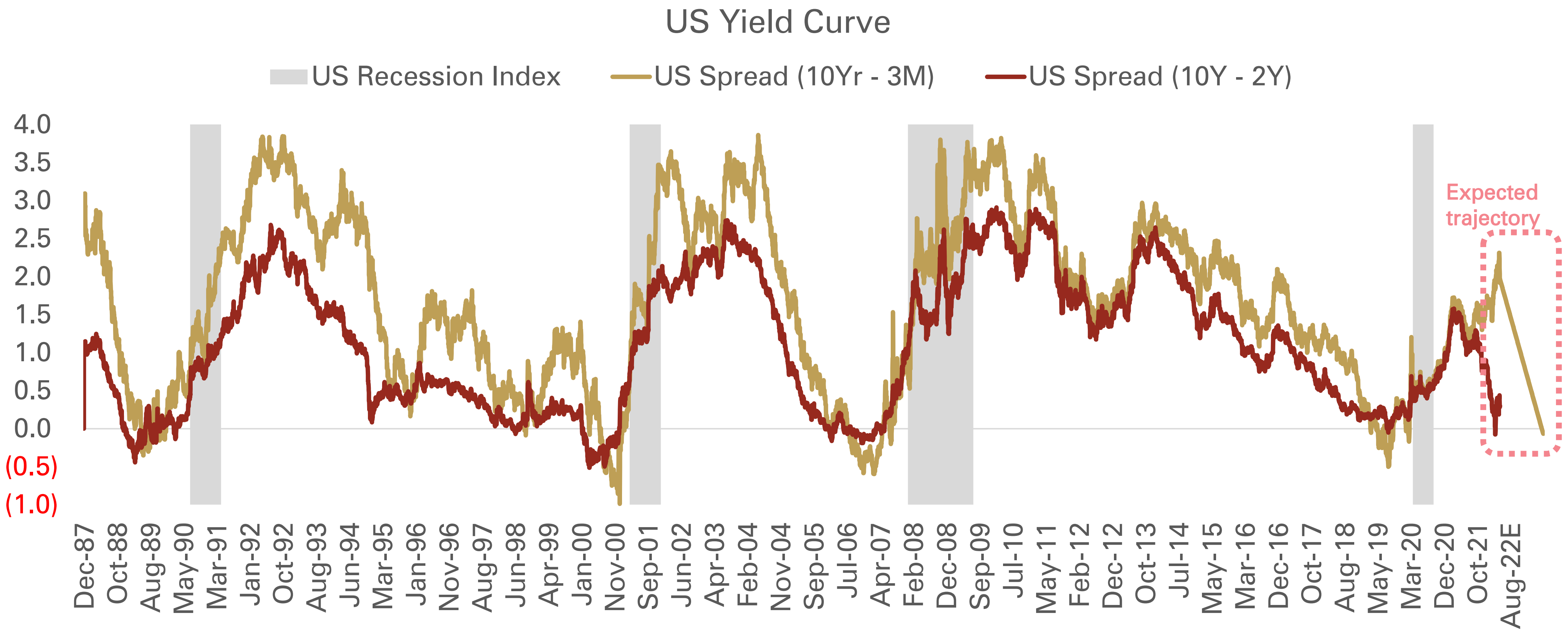
In 2020, global debt experienced the largest surge in 50 years as per IMF

US interest rates influence interest rates higher globally

As rates rise amidst ever rising debt, the ability of any economy to tolerate higher debt servicing costs have only been reducing

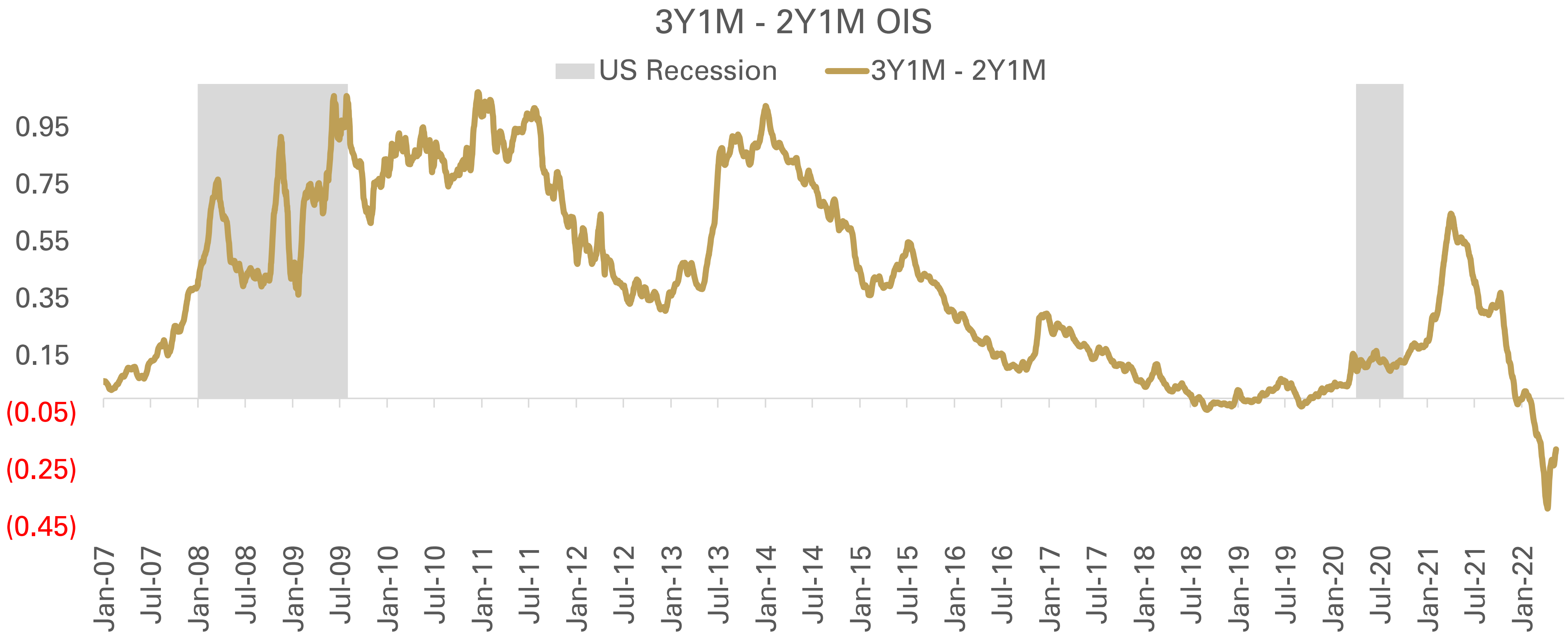


Yield curve inversions indicating economic softness ahead…



While 10Year yield minus 2Y has inverted momentarily & steepened somewhat, 10Y minus 3Month yield hasn't and the divergence is stark – not witnessed in previous cycles. However, 10Y minus 3M yield may invert in early 2023 which usually is followed by a slowdown!

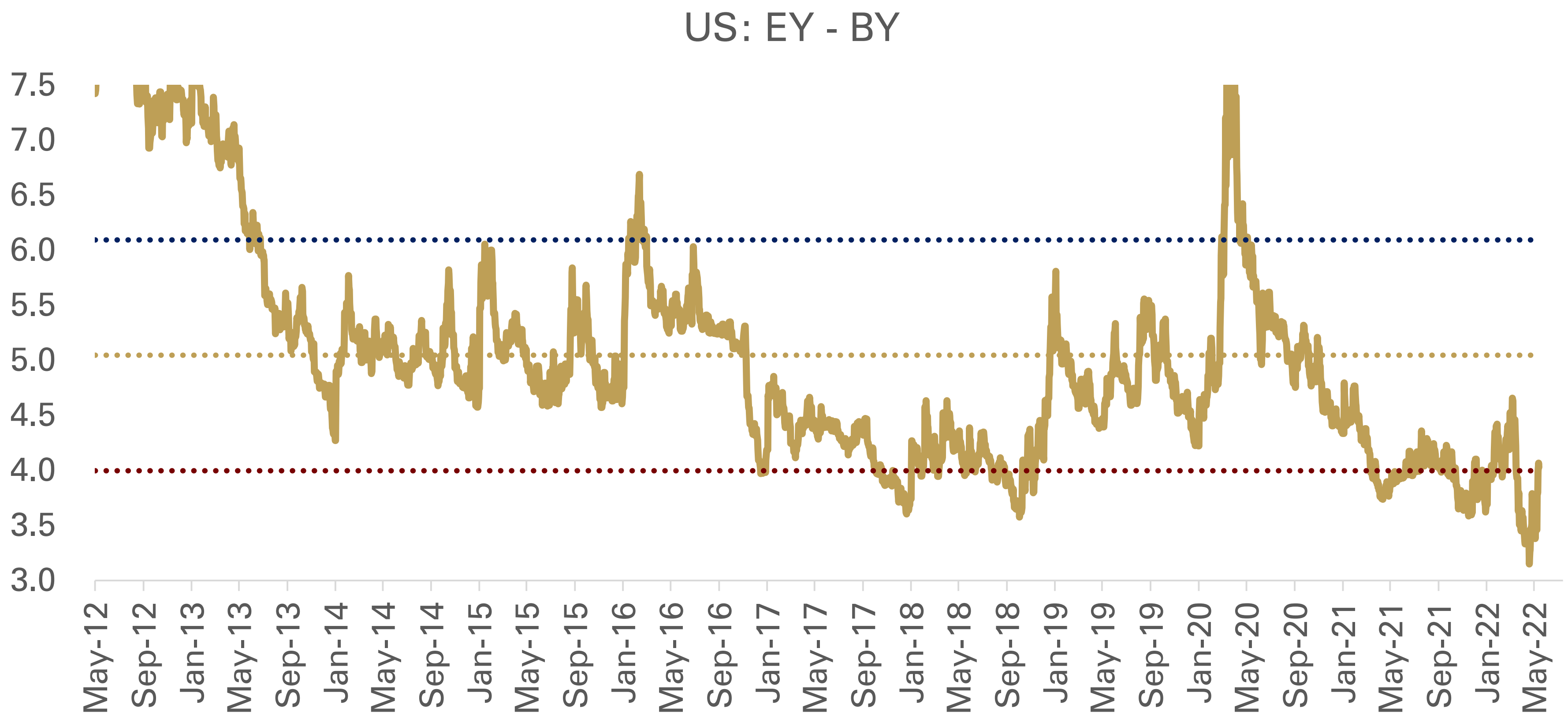
OIS (US) curve is already most inverted in this cycle



- (1M) Overnight Indexed Swaps (OIS) rate 3 years hence continues to remain 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 have to eventually reduce rates** (presumably in response to eventual slowdown)

What does it all mean? Risk premium should rise

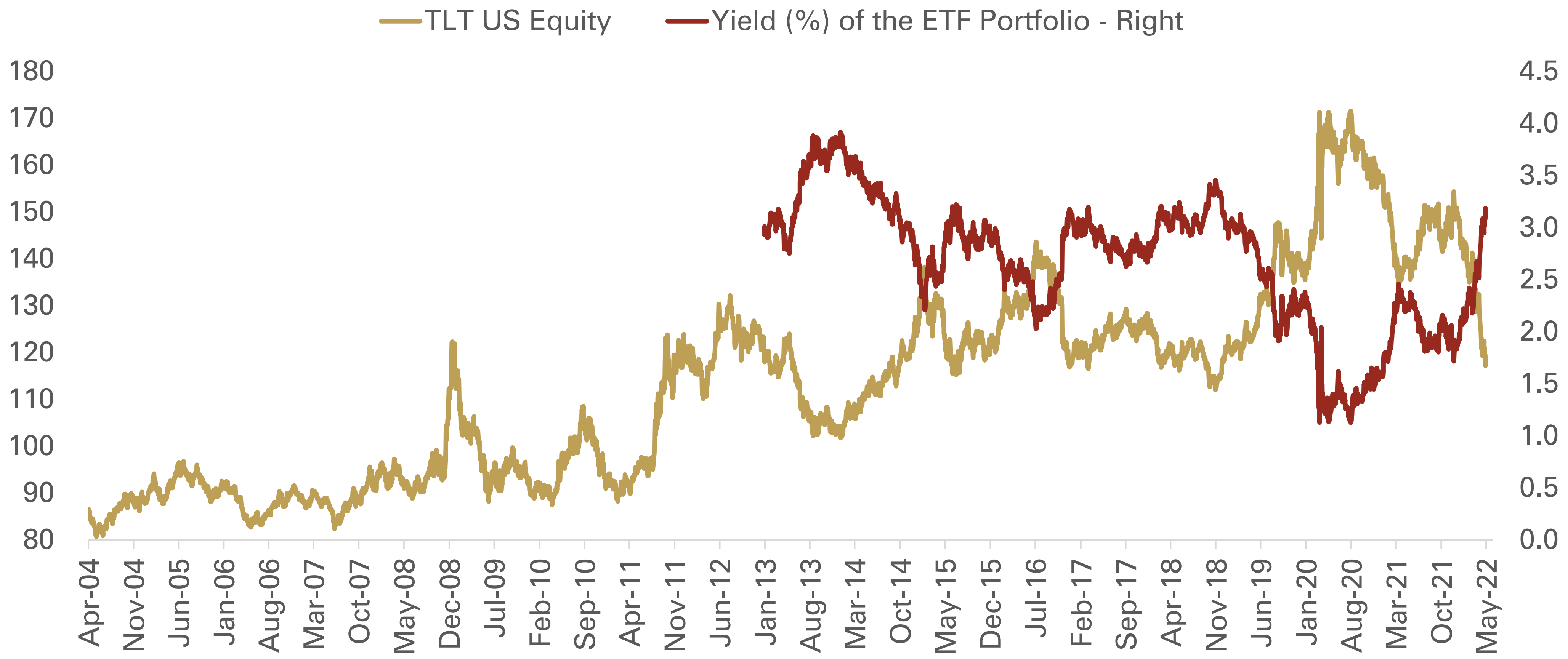
Framework to evaluate possible de-rating in valuation (basis interest rate movement)



- Once excess equity yield touches average levels, the case for fresh equity exposure strengthens
- This indicates that Forward PE multiples in US need to fall to less than ~13x levels for fresh long positions
- Earnings Yield (EY) is 1/PE*100. Bond Yield (BY) is 10Y US Treasury Yield. Difference is simple measure of Equity Risk Premium (ERP)

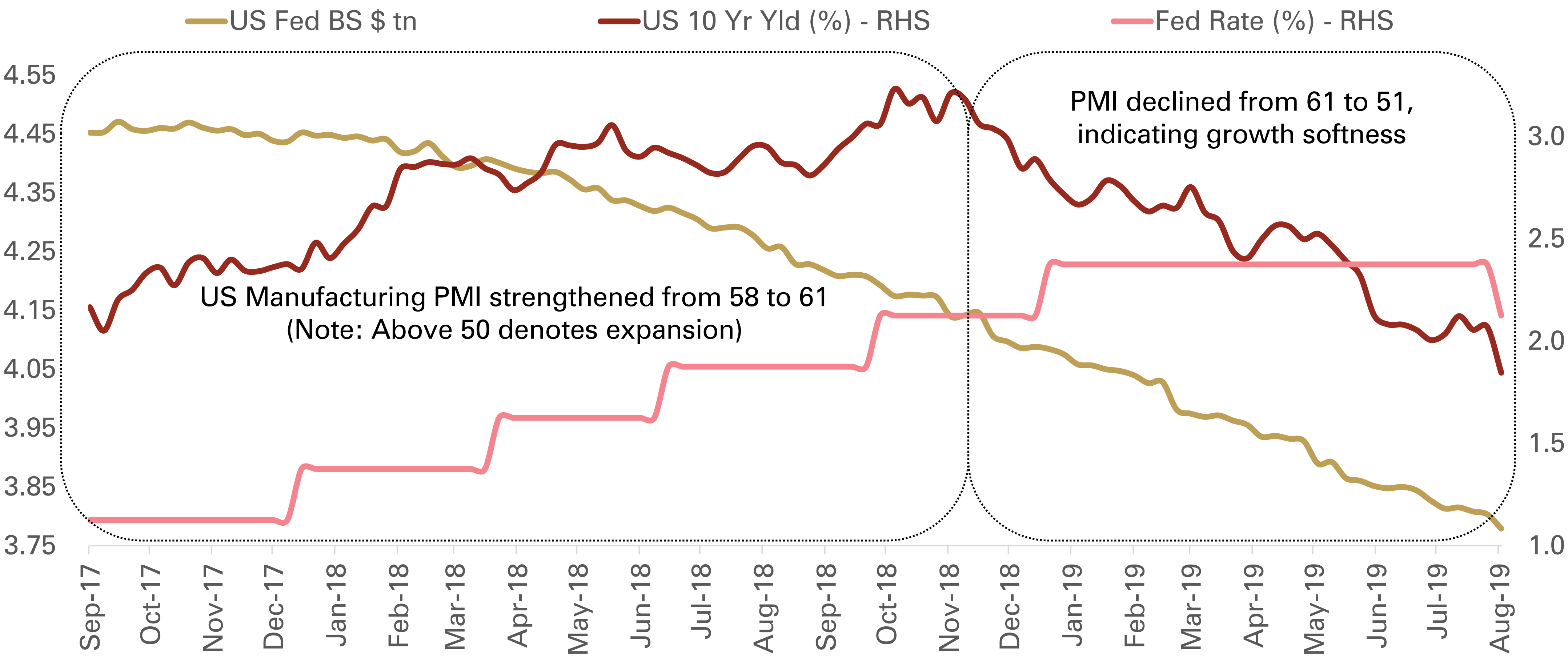
S&P 500	2Yr Frwd PE	EY - BY	US 10 Yr Yld	Likely Derating
Dec-18	12.6	5.2	2.77	
Current	14.5	4.0	2.88	
Scenario I	12.8	5.0	2.88	(11.8)
Scenario II (Avg.)	12.9	5.0	2.77	(11.1)

Did you know? US Treasuries have lost more than 30% already



- TLT is iShares 20Y+ US Treasuries ETF (listed in US). It has fallen from a peak level of 170 to 117
- **Yield has risen by 200bps on the ETF already, but can rise a little more**
- During sharp slowdowns, this has been a ‘good’ hedge

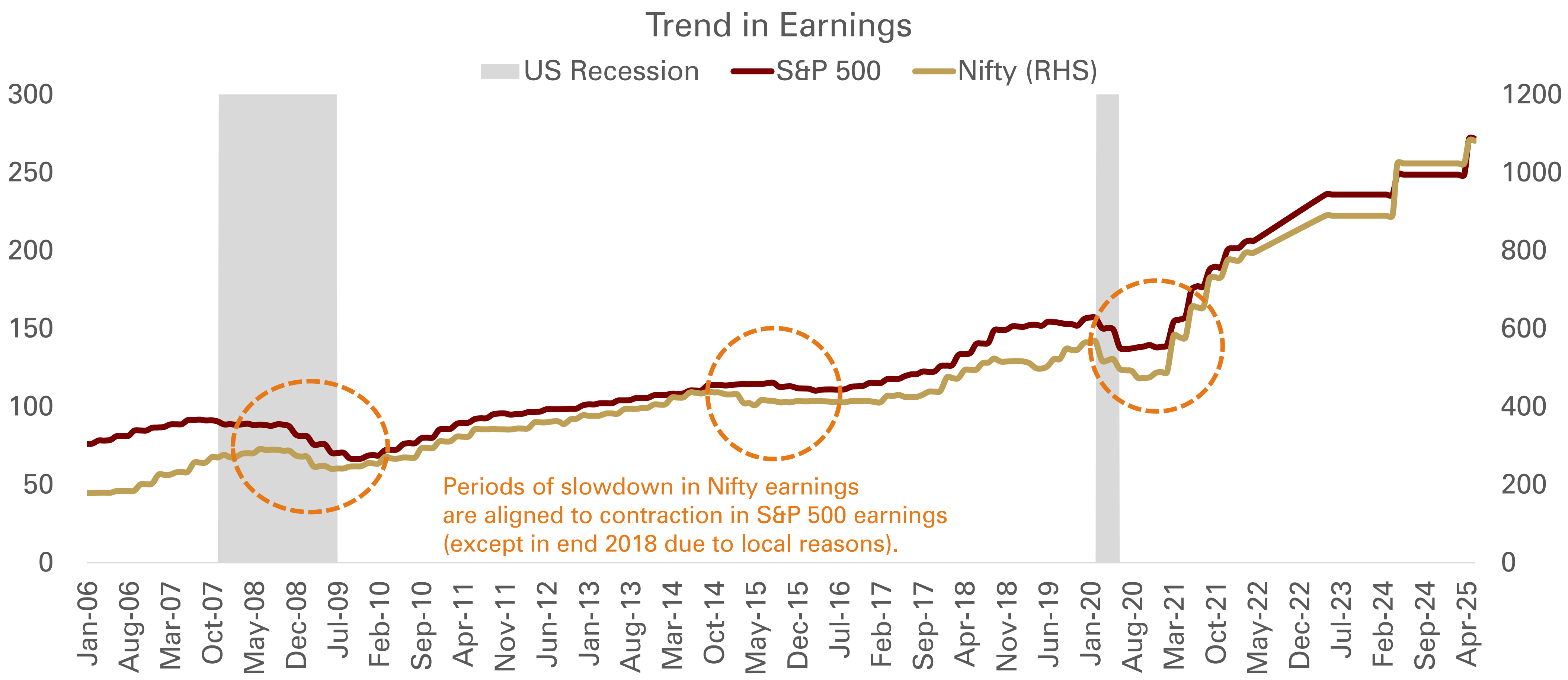
Fed Balance Sheet Contraction and US 10 Yr Yield



While the popular view remains that Quantitative Tightening (Fed’s upcoming balance sheet contraction) is likely to pressure Bond Yields, the only experience from past (2018) indicates that bond yields may rise if growth remains robust, otherwise they may witness downward movement like in late 2018 & 2019, notwithstanding a sharp reduction in Fed’s balance sheet

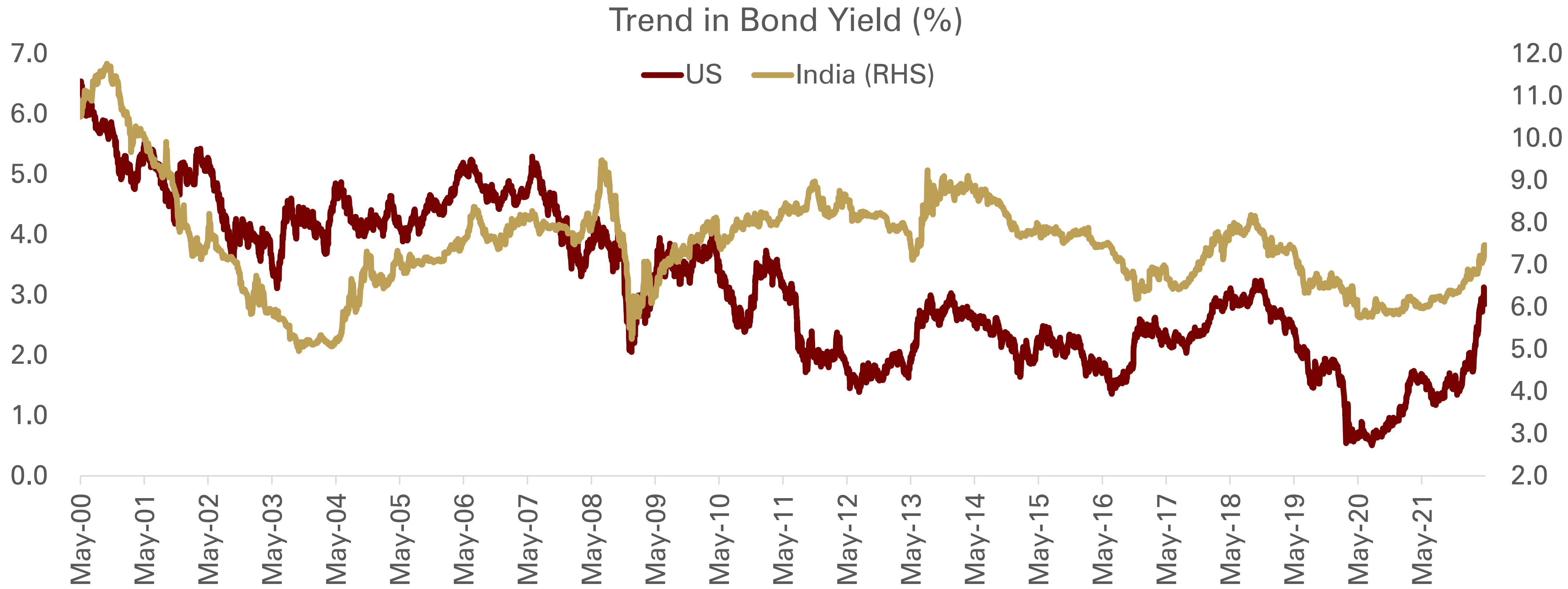
While in India, why does one have to focus so much on US markets & rates?

India's Corporate Earnings trajectory is aligned with that of US



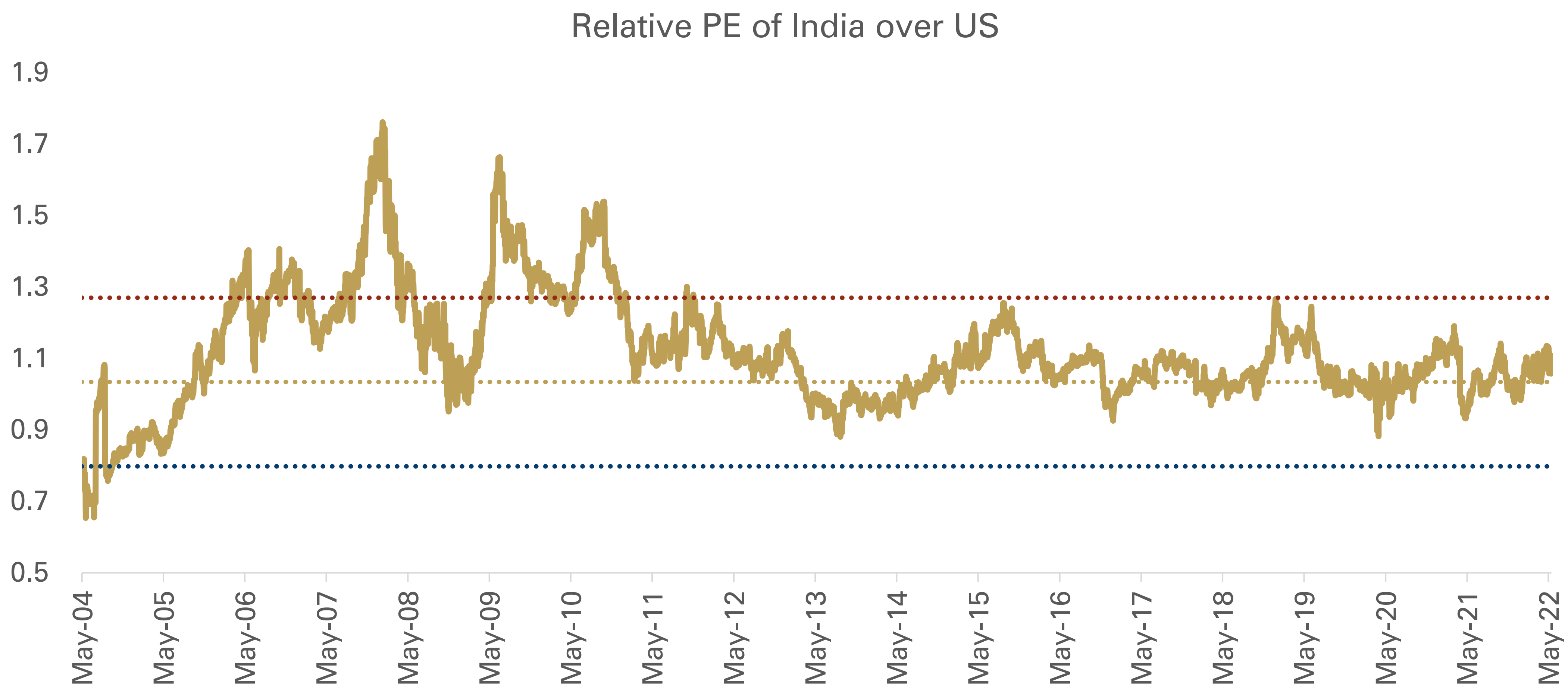
All US Earnings slowdown have simultaneously manifested in a slowdown in NIFTY earnings as well, and vice versa.

Higher US bond yields put pressure on Indian bond yields



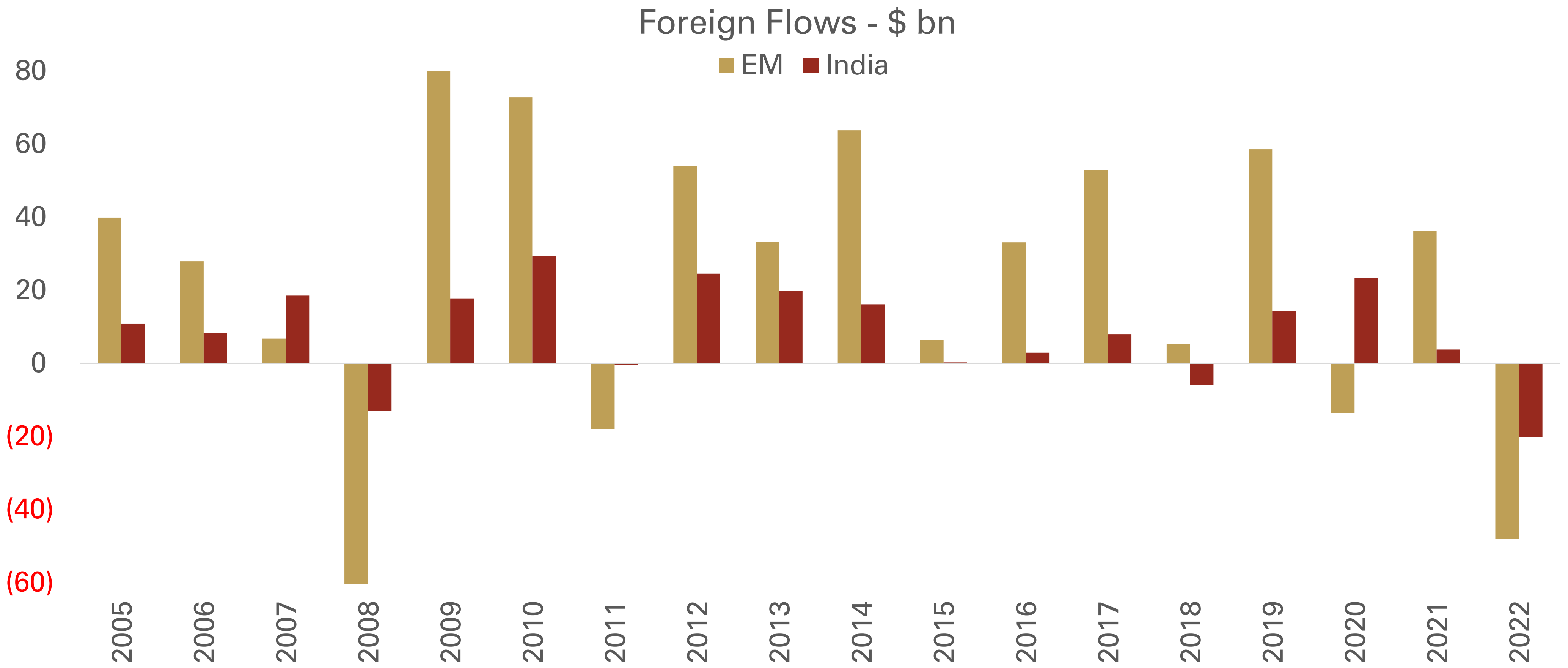
Sharp increase in US bond yields cause Indian bond yields to rise, not the other way round though

Indian market valuations tend to mean revert to that of World & US



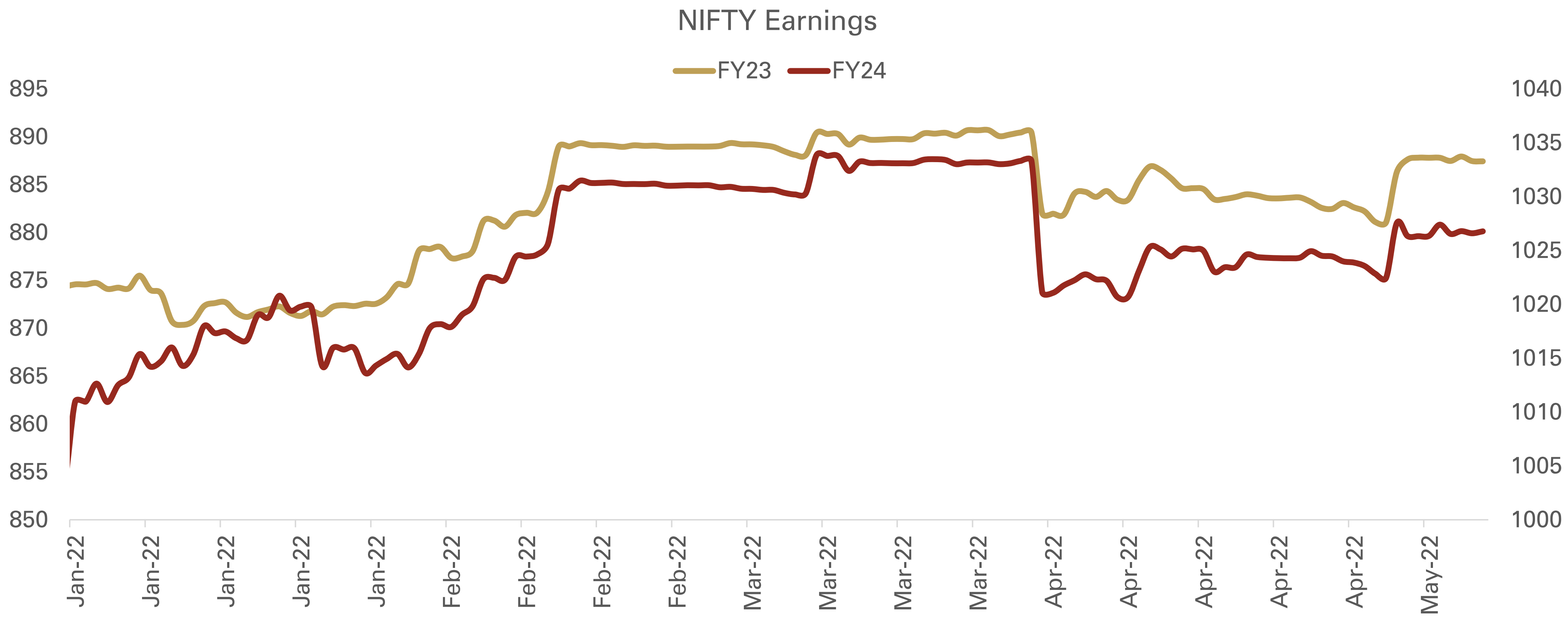
Over long term, Indian markets have normally traded in line with US Equity valuations. Any divergence typically mean reverts. Thus, if US markets correct, Indian markets tend to follow (P/E of India reverts around that of US)

Foreign flows tend to be governed by Emerging Markets as basket



India witnessed outflows this year, in line with outflows from EMs overall, like in the previous years – Interestingly it is at a scale substantially higher than 2018 which too witnessed US and India monetary tightening. 2020 was an exception since India's weight in MSCI Emerging Market Index increased by nearly a percent causing flows to adjust 'which got paid back in 2021'

FY23 EPS trajectory critical – no signs of earnings downgrade yet

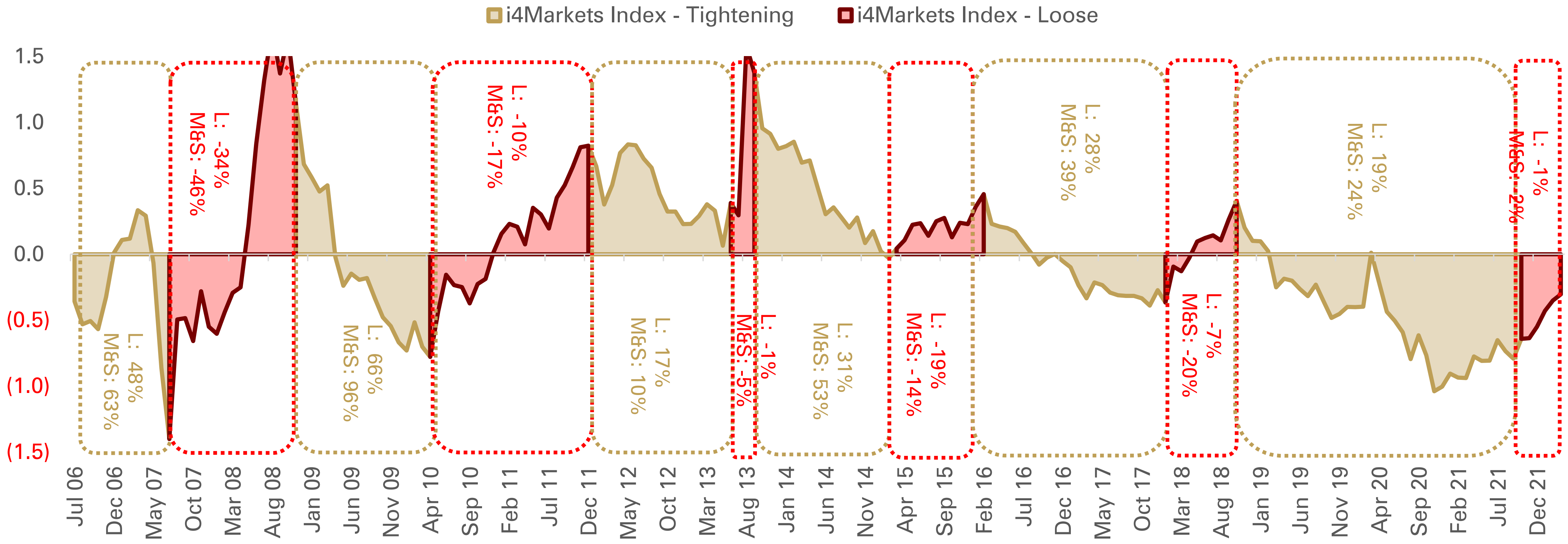


Earnings estimates have been relatively resilient – consensus expectations for FY23E (~16% YoY). Top down, we see risks to earnings downgrade given interest-rate cycle (moderation on growth) and incremental adverse impact of high input costs.

A prolonged period of high inflation can potentially impact earnings upcycle

Equity Strategy & Valuations

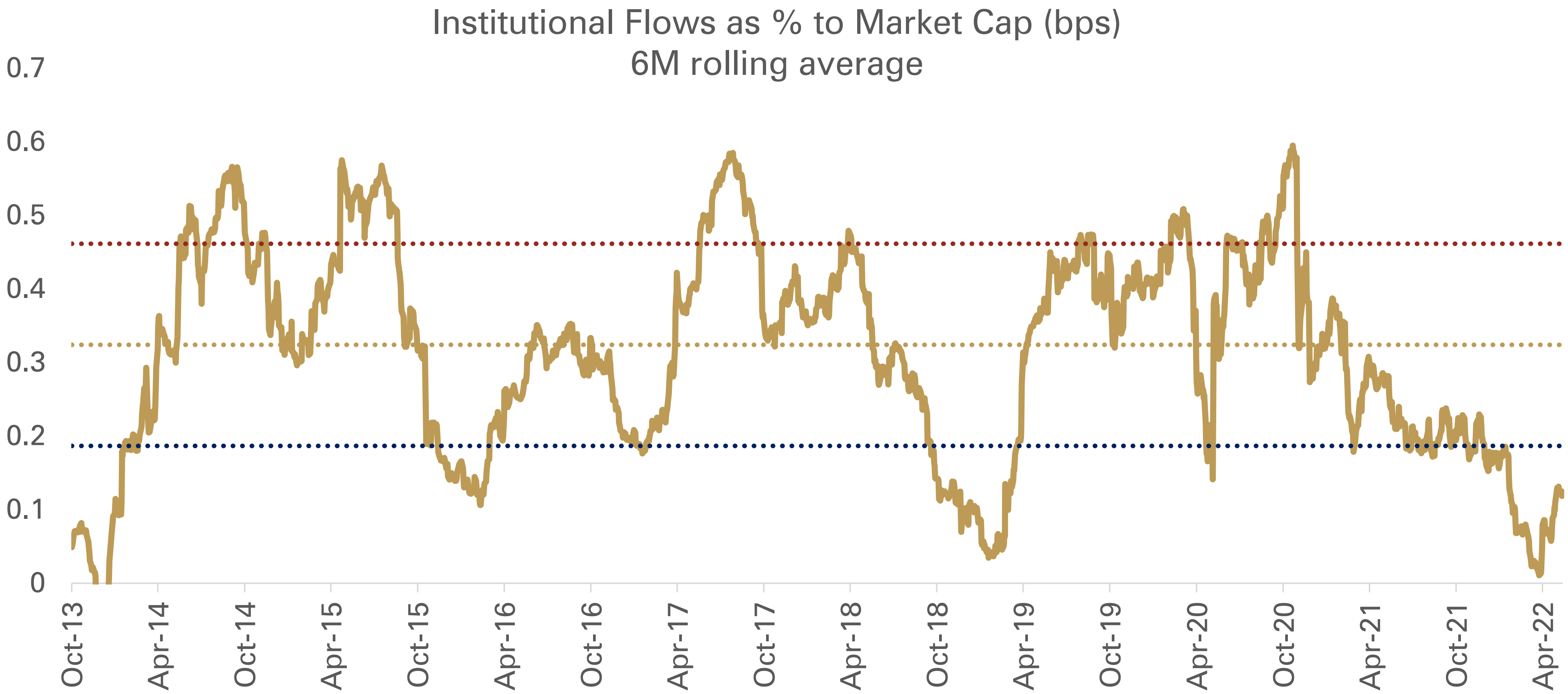
Financial Conditions may tighten going forward in India as well



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

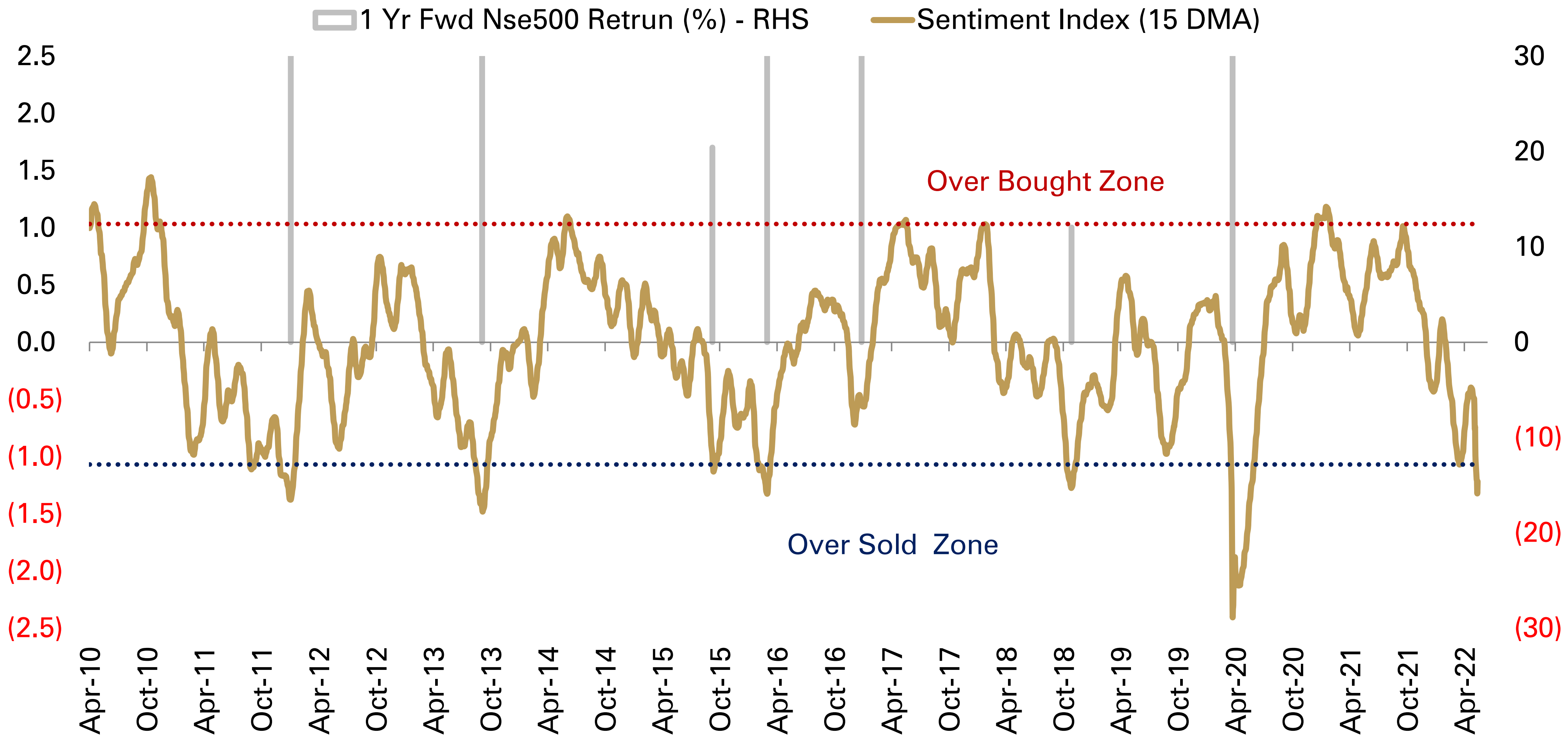
Financial conditions as per ICICI Bank's i4Markets index: Conditions expected to tighten going ahead, as inflationary pressures are likely to push global central banks to wind down monetary policy support at a quicker pace. RBI has also begun the process of normalizing its monetary policy by letting 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 have already been substantial



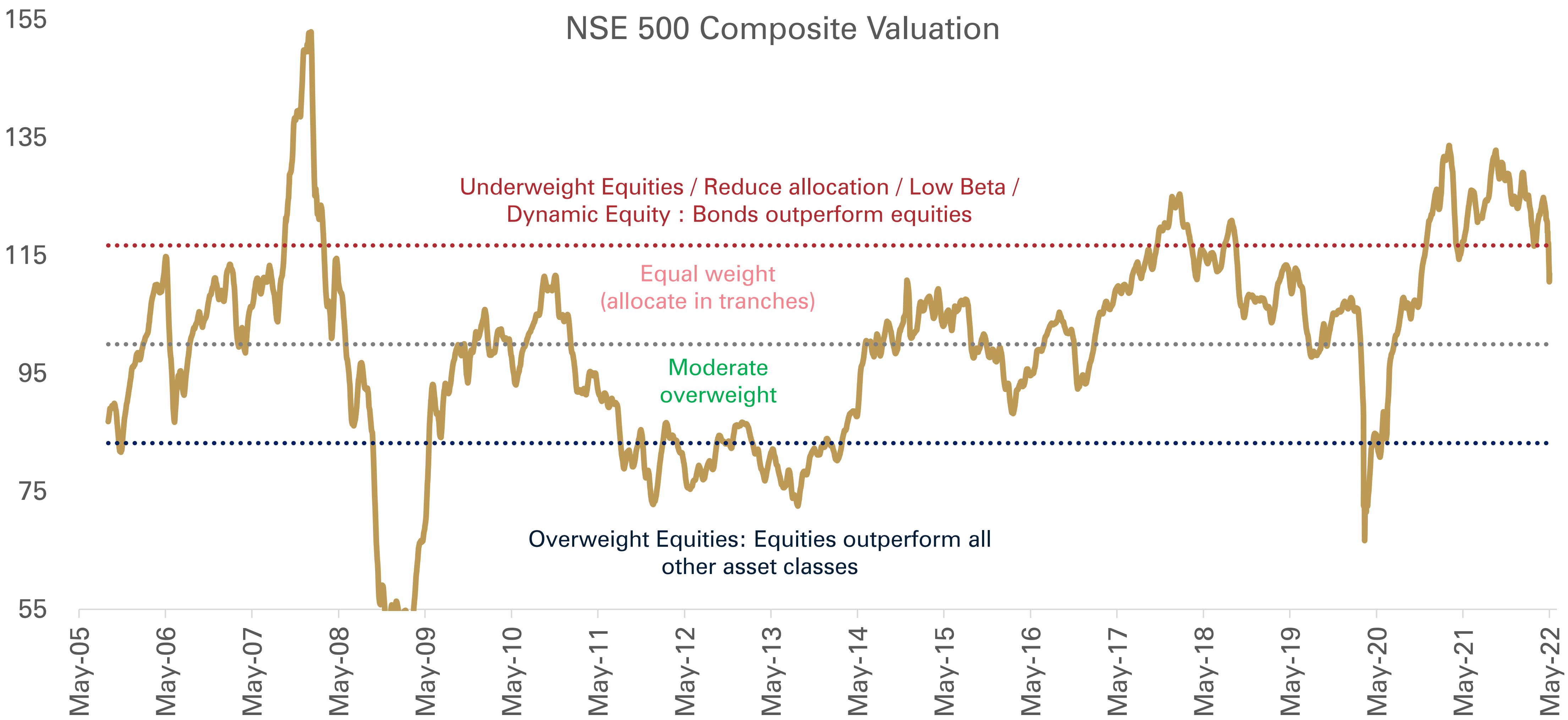
Net institutional flow (Foreign + Domestic Institutions + MF) have seemingly bottomed out. However, in context of historical trend, institutional investors flows can mean revert sometime in 2022, as in history, providing some upside potential to market.

Indian equity sentiment indicator



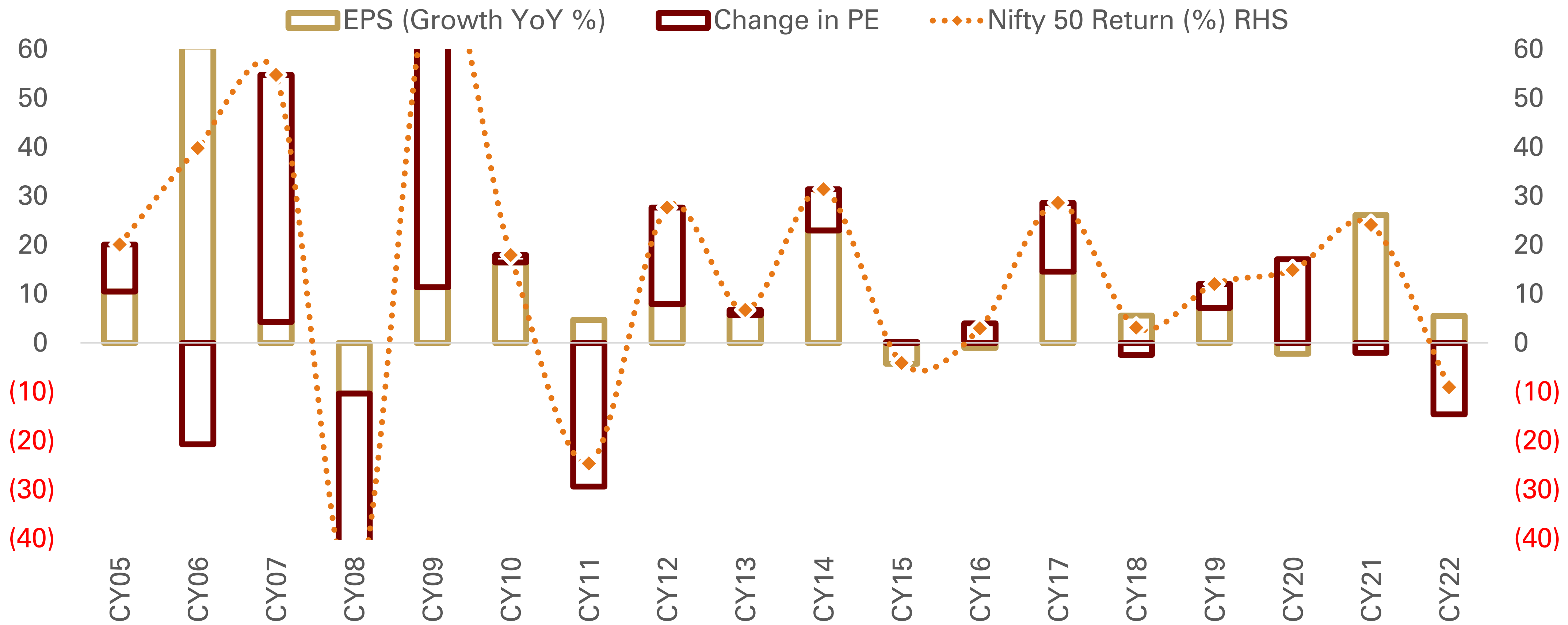
Sentiment index indicates a possible short term technical bounce back

Composite Valuation: remain expensive



Valuations have now moderated to more reasonable levels, yet not outright cheap

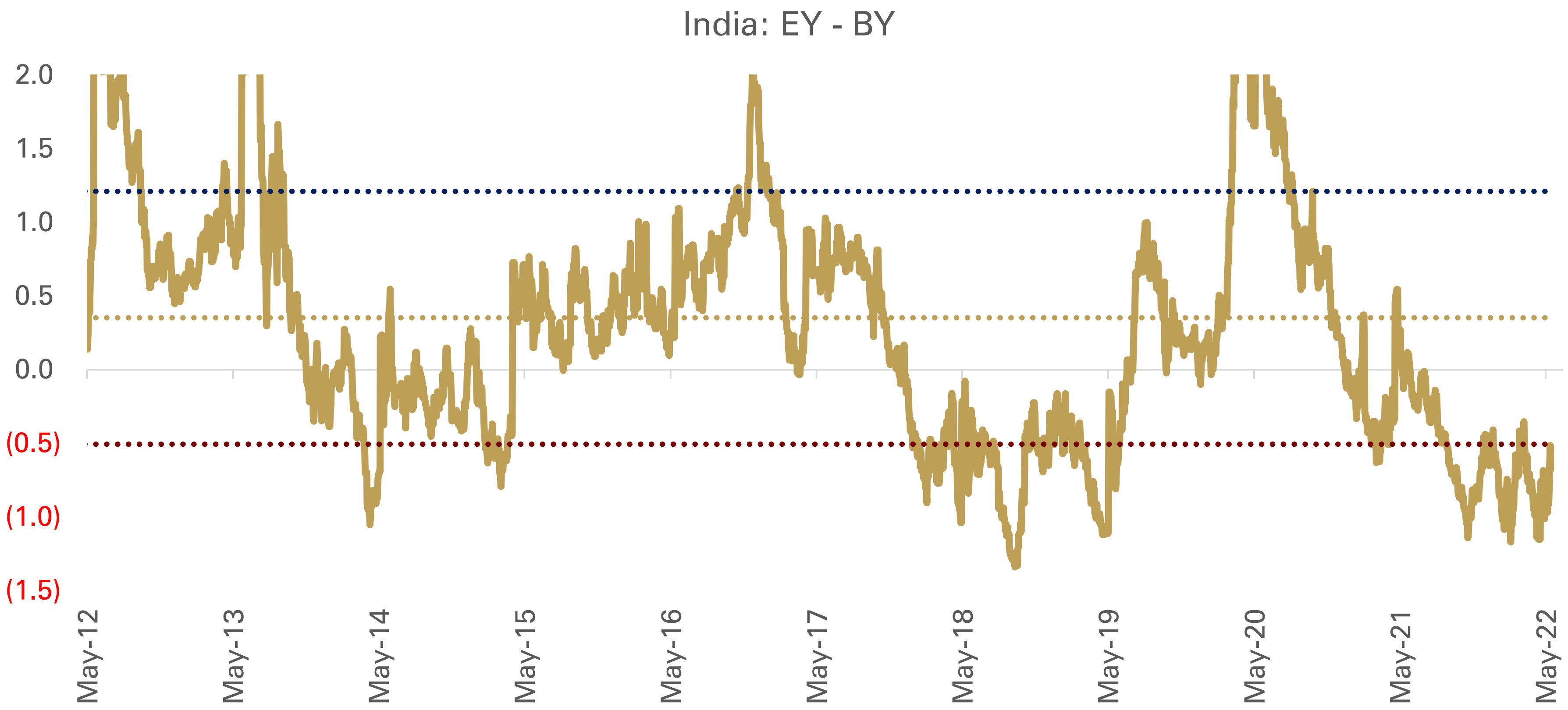
Stacking up of Nifty Returns: Valuations likely to contract in CY22



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

What does it all mean? Risk premium should be adequate

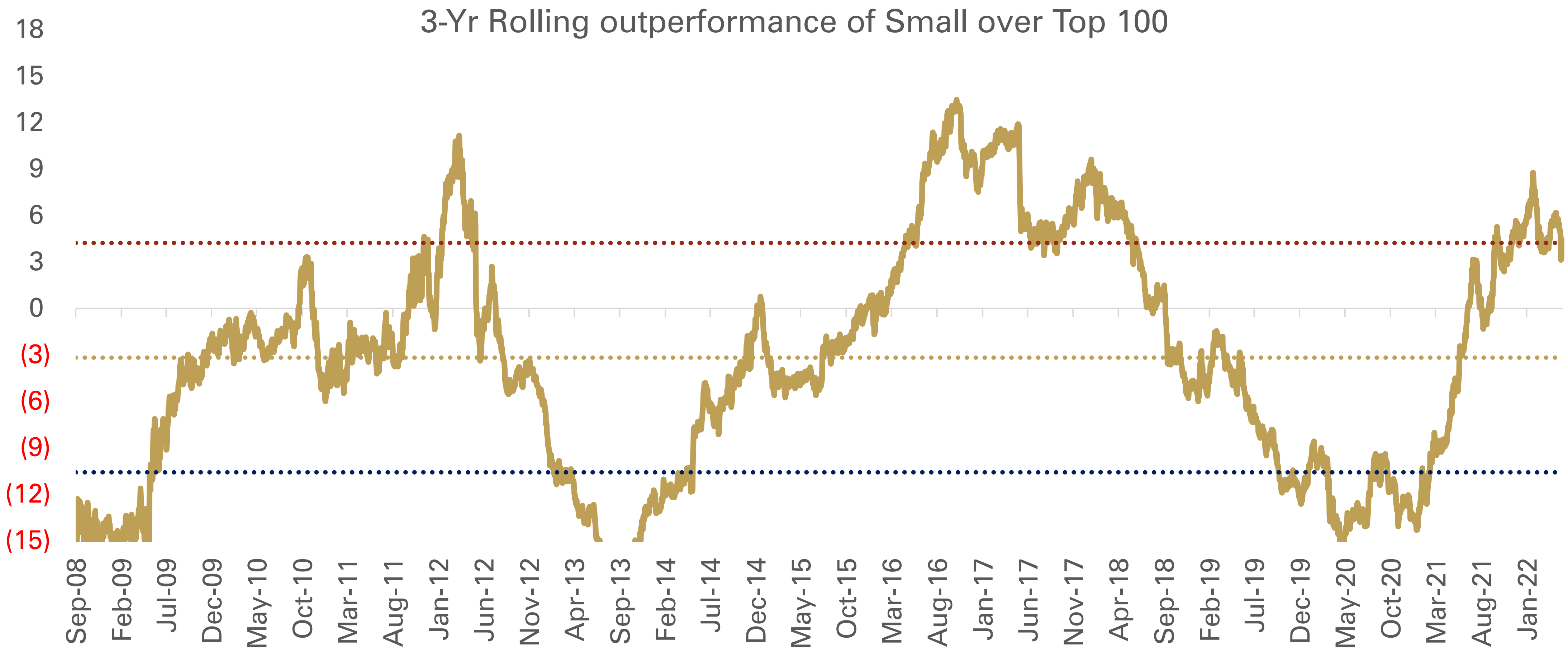
Framework to evaluate possible de-rating in valuation (basis interest rate movement)



- **Once excess equity yield touches average levels, the case for fresh equity exposure strengthens (refer slide below)**
- Framework to evaluate possible de-rating in valuation (basis interest rate movement).
- **This indicates that Forward PE multiples in India need to fall to less than ~14x levels for fresh long positions**

NSE 500	2Yr Frwd PE	EY - BY	G-Sec 10 Yr Yld	Likely Derating
Dec-18	14.2	(0.2)	7.28	
Current	15.0	(0.7)	7.33	
Scenario I	13.8	(0.2)	7.50	(8.6)
Scenario II (Avg.)	14.2	(0.2)	7.28	(5.6)

Small Caps likely to underperform Large caps



- Since Mar-20, Small caps out-performance has progressively increased relative to large caps. Current technical indicator suggest Mid & Small cap outperformance is closer to peak relative to history.
- Therefore, going forward, small caps are likely to underperform large caps given moderation in growth prospects and rise in interest rates as well.

Summary: Equity Strategy

External risks keep us on the sidelines

- Given US inflation being now driven by tight labor markets and services, risks of economic slowdown have increased, as also being indicated by yield curves
- As bond yields have risen, excess earnings yield have fallen, implying some more P/E de-rating in US Equities
- Indian Equity valuations tend to be anchored by US, all else remaining the same. Thus, any de-rating in US shall have an impact in India
- Tighter financial conditions ahead in India also likely to have adverse impact on Equities. Hence, maintain Under Weight stance (despite some meaningful valuation correction already) till risk premiums get more reasonable
- Maintain UW towards Small Caps.
- **H2 2022, may provide interesting opportunities across asset classes**

Fixed Income

An inter meeting MPC surprise

The Reserve Bank made a surprise announcement on monetary policy on 4th May. Given the background of rising global and domestic inflationary pressures, the Monetary Policy Committee of the RBI met on an off-cycle basis and decided to

- Hike the repo rate by 40 basis points to 4.40%,
- The RBI had also decided to hike the CRR by 50 bps to 4.5%.

The action can be attributed broadly to three main reasons: rising risk of inflation expectations being anchored, increasing negative effects of the Russia-Ukraine and a potential impact on rupee exchange rate given increase in global bond yields. conflict,

Inflation: CPI inflation which came on 12th May, accelerated to a 95-month high of 7.79% YoY in April above market estimates, compared with 6.95% YoY in March. On a MoM basis, CPI inflation went up by 1.4%. Both food and core inflation went up. While food inflation accelerated to 8.4% YoY from 7.7% in March, core inflation inched up to 7% from 6.3% in March.

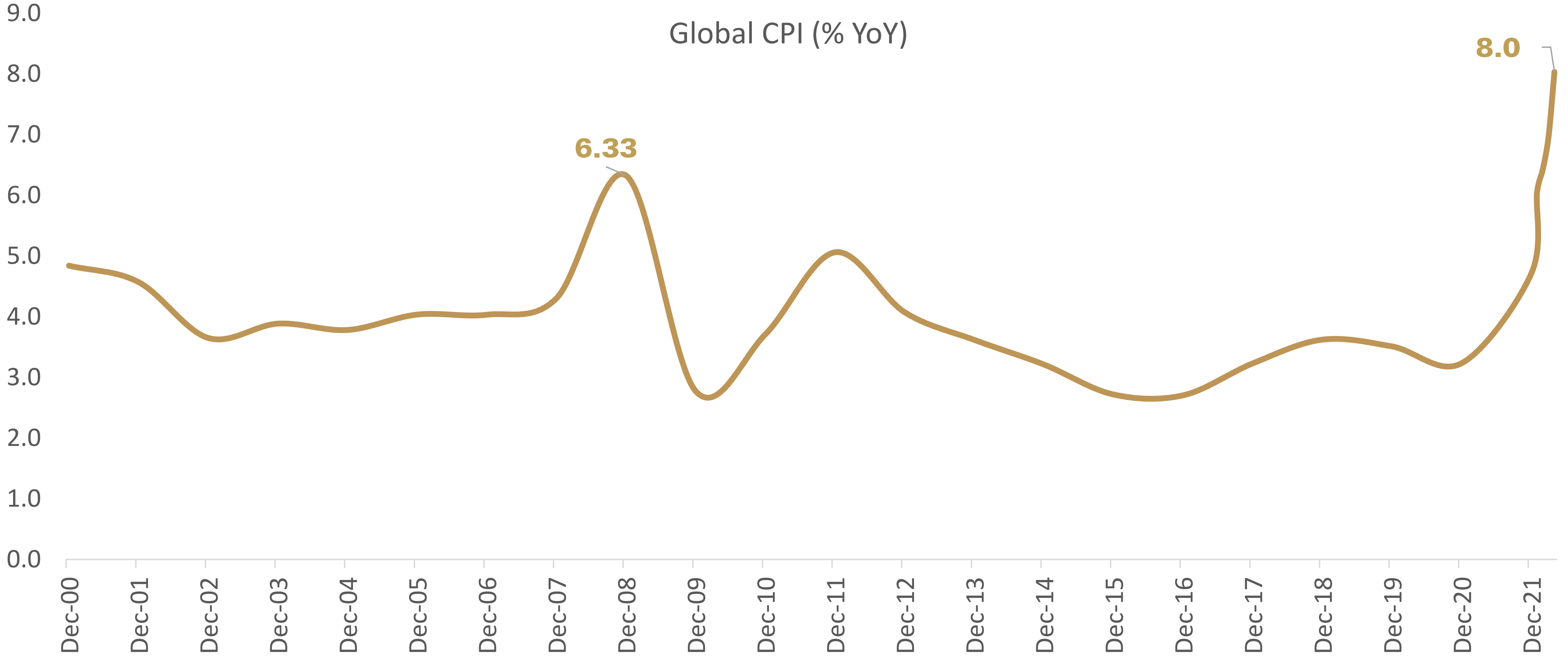
Globally, central banks have started rate hike cycle. BoE led the way with three hikes done and now turns a little sober in its outlook. So is also the case with select EM economies such as Brazil which is more mature in rate cycle. Fed just started with rate hikes and is expected to commence Balance sheet tightening soon too.

Central Banks have embarked on policy normalization

Policy Rate (in %)	Dec-19	Dec-20	Dec-21	May-22
China	4.15	4.15	3.8	3.7
India	5.15	4	4.0	4.4
South Korea	1.25	0.5	1.0	1.50
Taiwan	1.38	1.13	1.13	1.37
Thailand	1.25	0.5	0.50	0.50
Malaysia	3	1.75	1.75	1.75
Philippines	4	2	2	2
Russia	6.25	4.25	8.5	14.0
Turkey	12	17	14.0	14.0
South Africa	6.5	3.5	3.75	4.25
Brazil	4.5	2	9.25	11.75
Mexico	7.25	4.25	5.50	6.5
Colombia	4.25	1.75	3.0	6.0
Chile	1.75	0.5	4.0	7.0
US	1.75	0.25	0.25	1.0
Eurozone	0	0	0.0	0.0
UK	0.75	0.1	0.25	1.0
Japan	0.1	0.1	0.10	0.10

With increase in inflation globally, most of central banks 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

Current inflation is at decade high for many economies



Source: Bloomberg, IMF

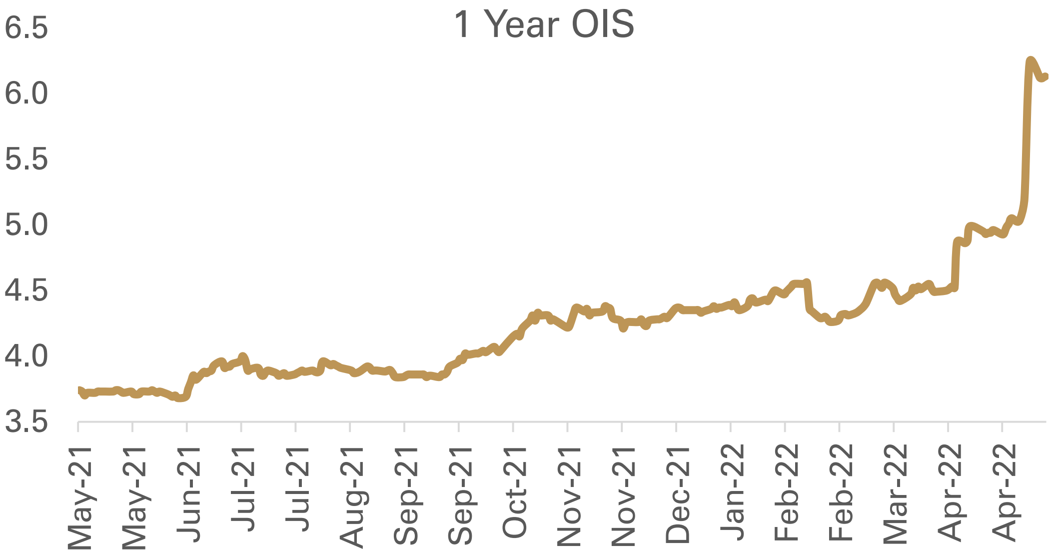
- Globally, inflation has remained well above the target for majority of the economies, prompting faster-than expected rate hikes
- India's April inflation print is much higher than the upper-target band in April'22.

Rising Global Bond Yields

10 Year Gsec Yield (% mth end)	2020 end	Mar-21	Dec-21	Feb-22	13-May-22	YTD change (in bps)
Developed market						
US	0.91	1.74	1.51	1.83	2.92	141
Germany	-0.57	-0.29	-0.18	0.14	0.93	111
Italy	0.54	0.67	1.17	1.71	2.84	167
Japan	0.02	0.1	0.07	0.19	0.24	17
Spain	0.05	0.34	0.57	1.12	1.99	142
UK	0.2	0.85	0.97	1.41	1.75	78
Emerging Market						0
Brazil	6.91	9.28	10.84	11.56	12.70	186
China	3.15	3.19	2.78	2.79	2.82	4
India	5.87	6.17	6.45	6.77	7.31	86
Indonesia	5.86	6.76	6.36	6.5	7.49	113
Malaysia	2.65	3.27	3.58	3.67	4.47	89
Russia	5.92	7.04	8.45	15.99	10.26	181
Thailand	1.32	1.97	1.89	2.14	3.27	138
Turkey	12.9	18.86	24.32	21.99	25.16	84
Mexico	5.55	6.84	7.57	7.95	9.06	149
Poland	1.24	1.57	3.67	4.1	6.80	313
South Africa	8.75	9.5	9.81	9.85	9.99	18
Colombia	5.39	6.97	8.19	9.53	11.38	319
Hungary	2.08	2.71	4.51	5.24	7.41	290

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

India: OIS pricing in front loading of rate hikes



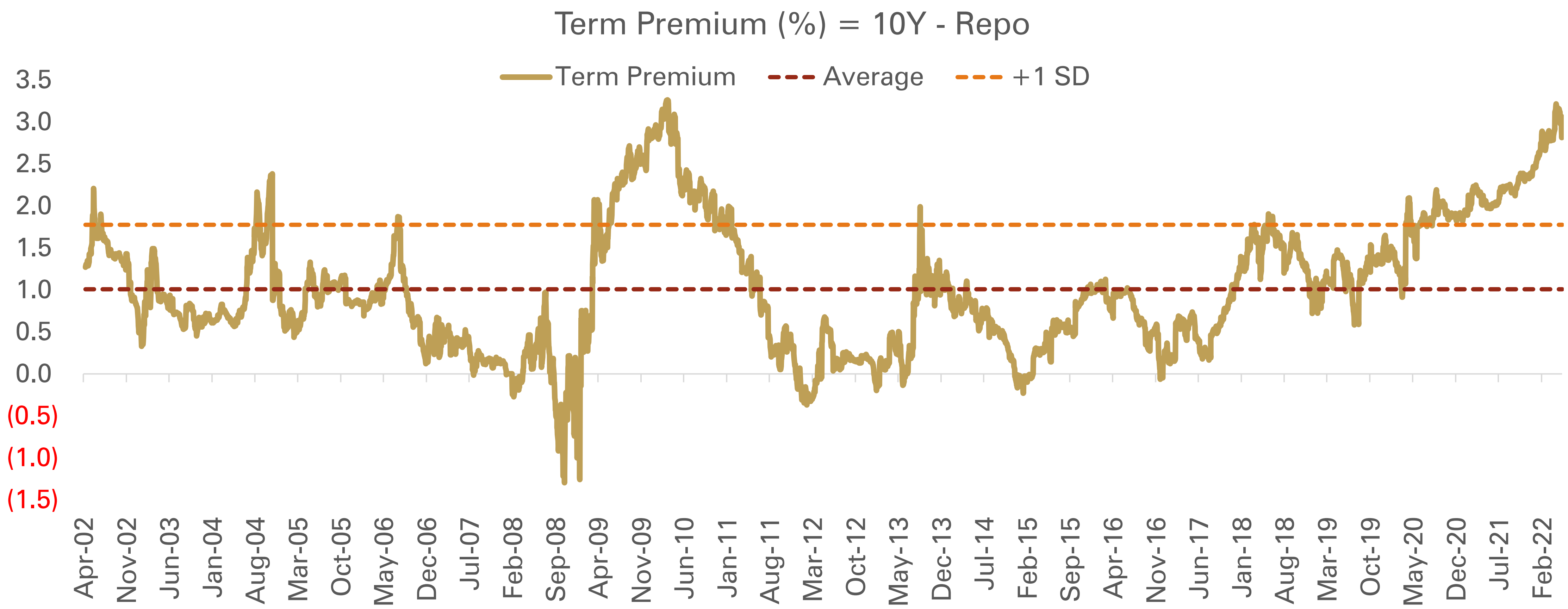
OIS markets are already pricing in 150 bps of rate hike in 1 year and more than 200 bps rate hike over 2 year period.

Rates across have gone up on anticipation of frontloading of rate hikes

Particulars	1-Jan-21	31-Dec-21	31-Mar-22	12-May-22	Change YTD Inc/ (Dec)
Call Rate	3.05	3.35	3	3.3	-5
Repo	4	4	4	4.4	40
Short Duration					
3M T-Bill	3.01	3.61	3.78	4.82	121
6M CD	3.5	4.2	4.3	5.5	130
6M CP	3.8	4.7	4.8	6.4	170
G-Sec					
1 Year Gilt	3.5	4.4	4.35	5.7	130
2 Year Gilt	4.25	4.9	5.3	6.2	130
5 Year Gilt	4.99	5.87	6.1	7.2	133
10 Year Gilt	5.83	6.47	6.82	7.3	83
10 Year SDL	6.43	6.9	6.99	7.6	70
Corp Bonds					
1 Year AAA	3.9	4.79	5	6.25	146
3 Year AAA	4.68	5.62	5.8	6.96	134
5 Year AAA	5.5	6.2	6.29	7.4	120
1 Year AA	6.7	7.1	7.13	8.3	120
3 Year AA	7.44	7.87	7.92	9	113

With inflation above RBI tolerance and action by global central banks, RBI might frontload rate hikes which is partially getting priced in by the markets

Long Duration (10Y): Offers value at above 7.5 levels



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

At 7.50% - 7.75%, one can start building duration exposure (10 year and above maturity) with a 3+ year plus view

Fixed Income Strategy

We have been of the view that terminal repo rate is expected at 6%. We continue to see that playing out with back-to-back rate hikes. However, today's rate hike was a surprise and higher than estimate of 25 bps increase in June policy.

One of the very potent tool that a central bank uses is guiding the transmission to markets of its expected policy direction. Even before the central bank moves fully in the desired direction, market forces are already doing their work for it since they are forward looking in nature. In US, market yield curves have already risen in line with a view of terminal Fed funds rate of in excess of 3%. 10 Year G-Sec has gone up by more than 150 bps even before first rate hike by RBI.

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

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.

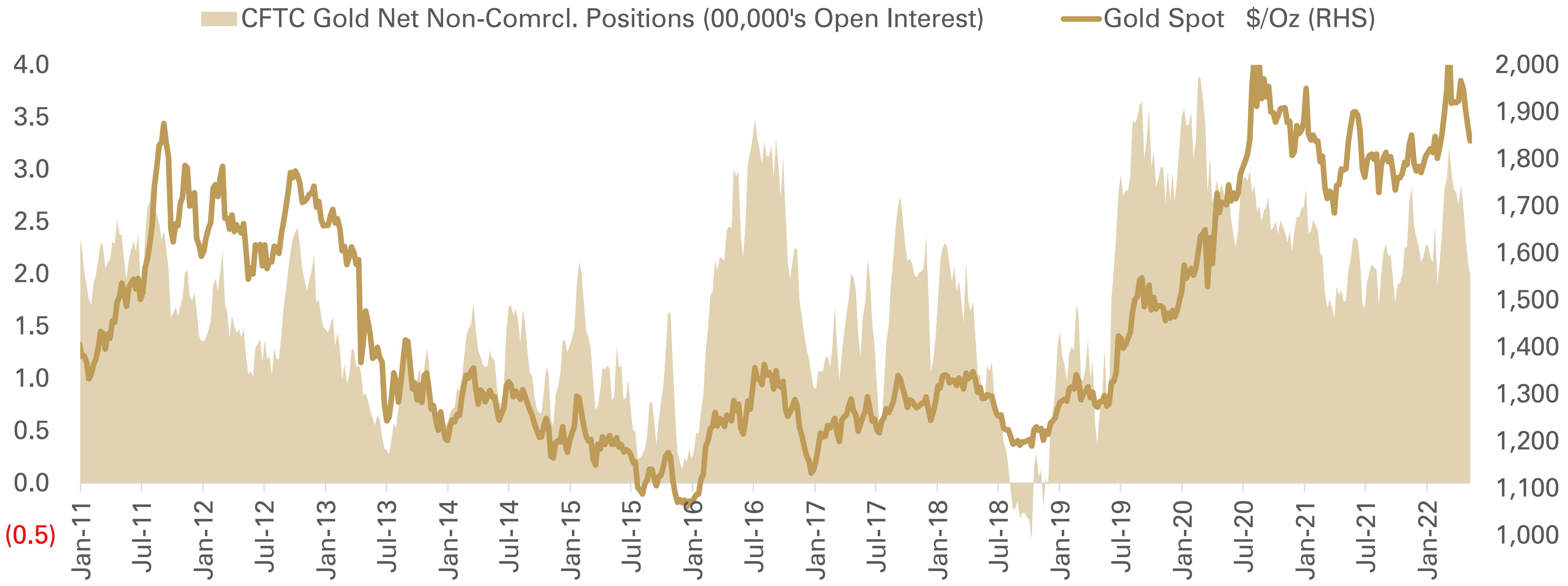
Given low rates & expectation of gradual upward movement in short term yields over time, **short term investors should consider products with duration lower than investment horizon**. Following is preferred strategy:

- **For investment horizon upto 6 months:** Prefer liquid funds, money market funds
- **For longer investment horizon (upto 1 Yr)**: investors can consider Ultra Short Term Funds, Arbitrage Funds & Deposits.
- **Horizon of more than 3+ years** – Prefer 5year+ curve, 10year+ at yields above 7.5%+ levels

Gold

Gold price trend relative to CFTC Gold Net Commercial positions

Unwinding of some positions by Gold traders may provide potential entry points for Gold investors



- 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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