Investment Strategy

Private and Confidential

Executive Summary

Global / US

- Economic growth likely to remain strong, albeit risks from Delta variant are rising
- US Jobs data indicate likely economic resilience but also nearing Fed Taper
- Trajectory of bond yields likely to determine the market move in US – Defensive vs Cyclical
- Medium term valuation likely to mean revert from rising bond yields remain intact
- **Underperformance of Chinese Equities can reverse** in medium term

India - Equities

- **Maintain Equal Weight (medium term)** as economic activity expected to pick up
- Local economic cycle far from peak, providing confidence of economic growth
- Prefer **exposure to Recovery themes**
- However, brace for some correction led by global factors amidst increasing valuations
- Move Mid & Small to Under Weight given peak valuations and narrowing market breadth

India – Fixed Income

- All signs that rates may edge up over 6 to 12 months
- Prefer medium duration portfolios

Gold

- In line with long held view, Gold has underperformed, with probable some more downside. Global gold stocks (unhedged gold exposure) are under consideration

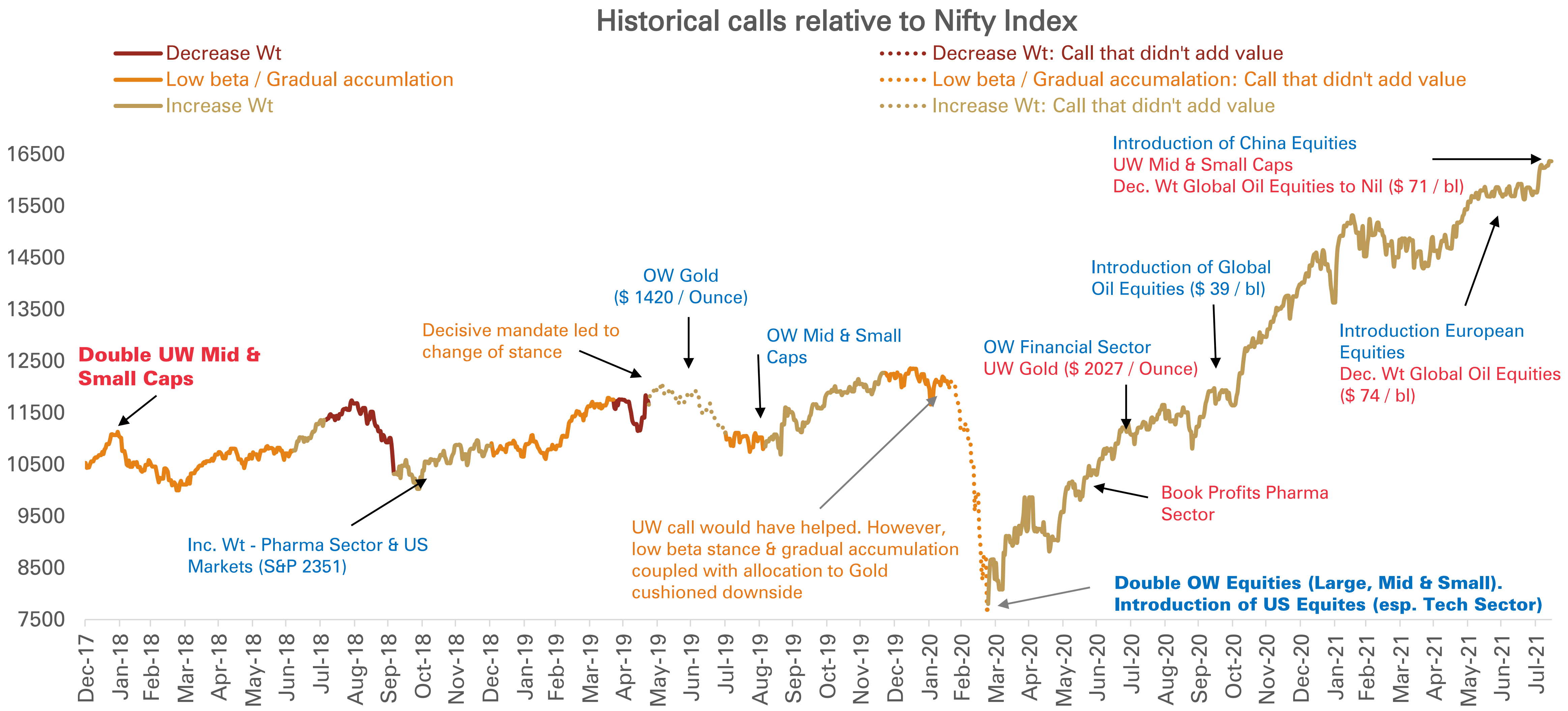
Asset Allocation Positioning

Asset Class	Short Term					Long 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

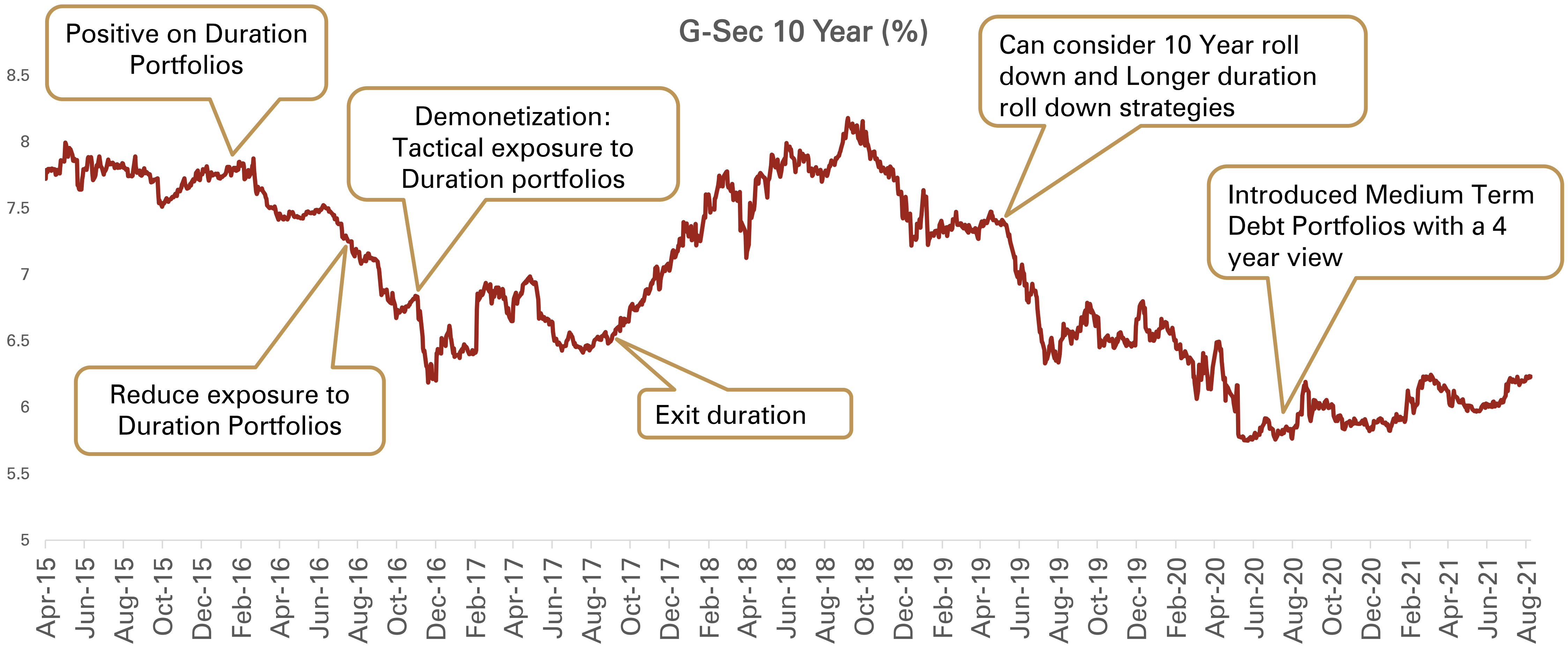
Note: *Prefer mild tilt towards Cyclicals

Historical Calls - Equity



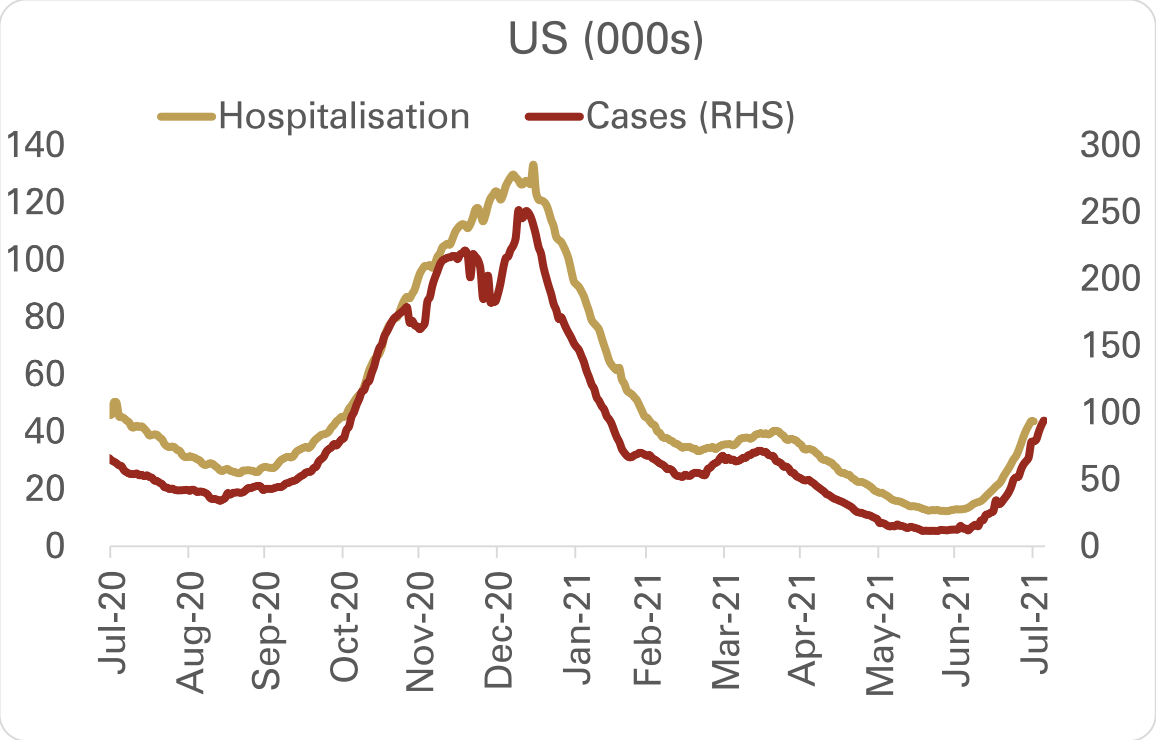
UW - Underweight; OW – Overweight; Wt. – Weight; Inc. – Increase; Dec. – Decrease;
Double OW or UW are highlighted in Bold; Increase weight in Blue; Reduce weight in Red; Calls that didn’t add value in Orange;

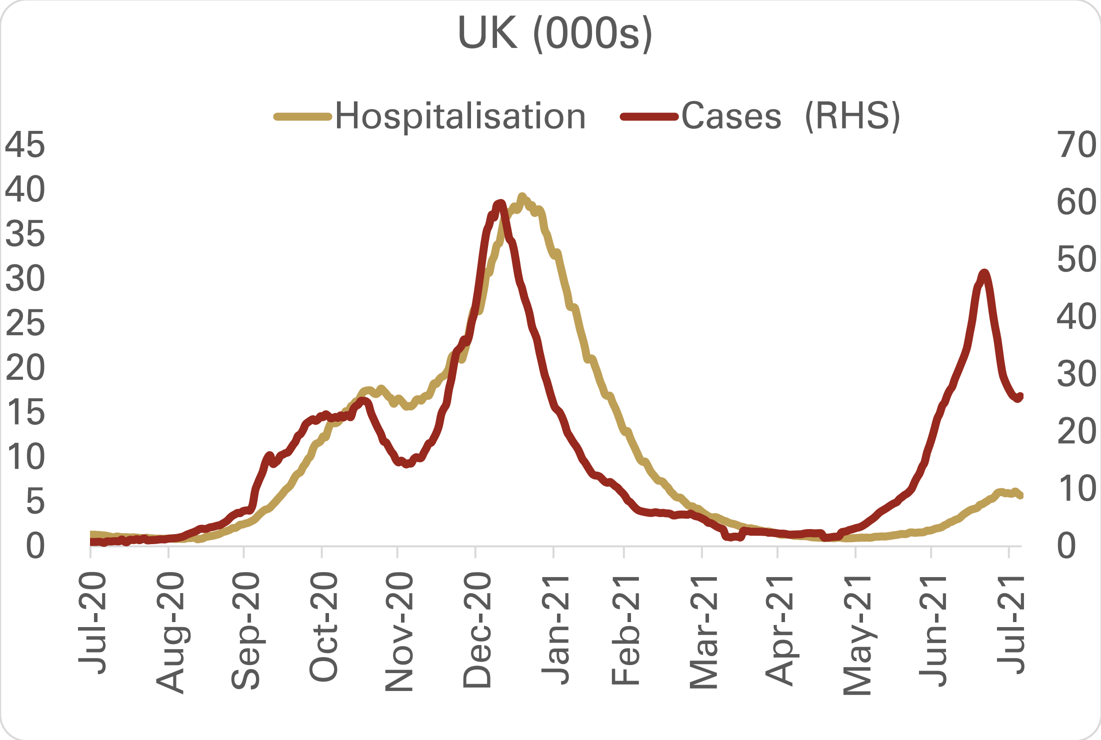
Historical Calls - Fixed Income



A Possible 3rd Wave?

Delta variant well entrenched but hospitalization rates are key

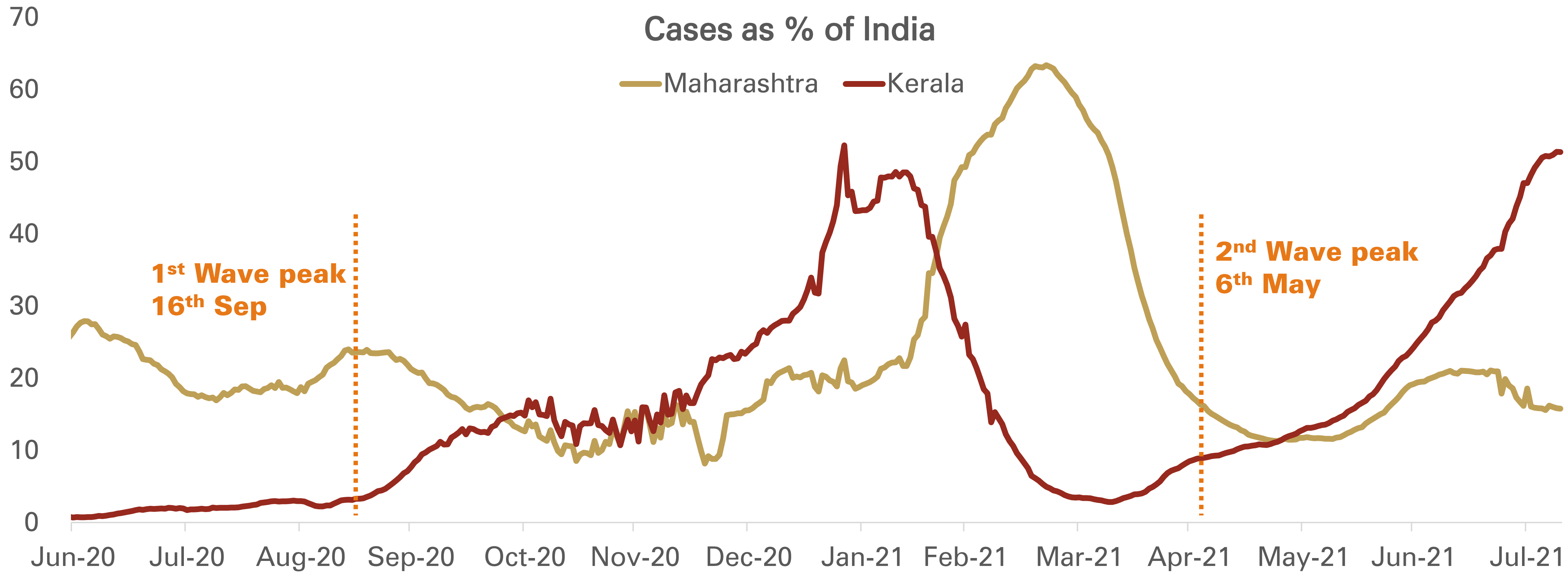




Note: US & UK have witnessed 50% & 59% of population being fully vaccinated respectively.

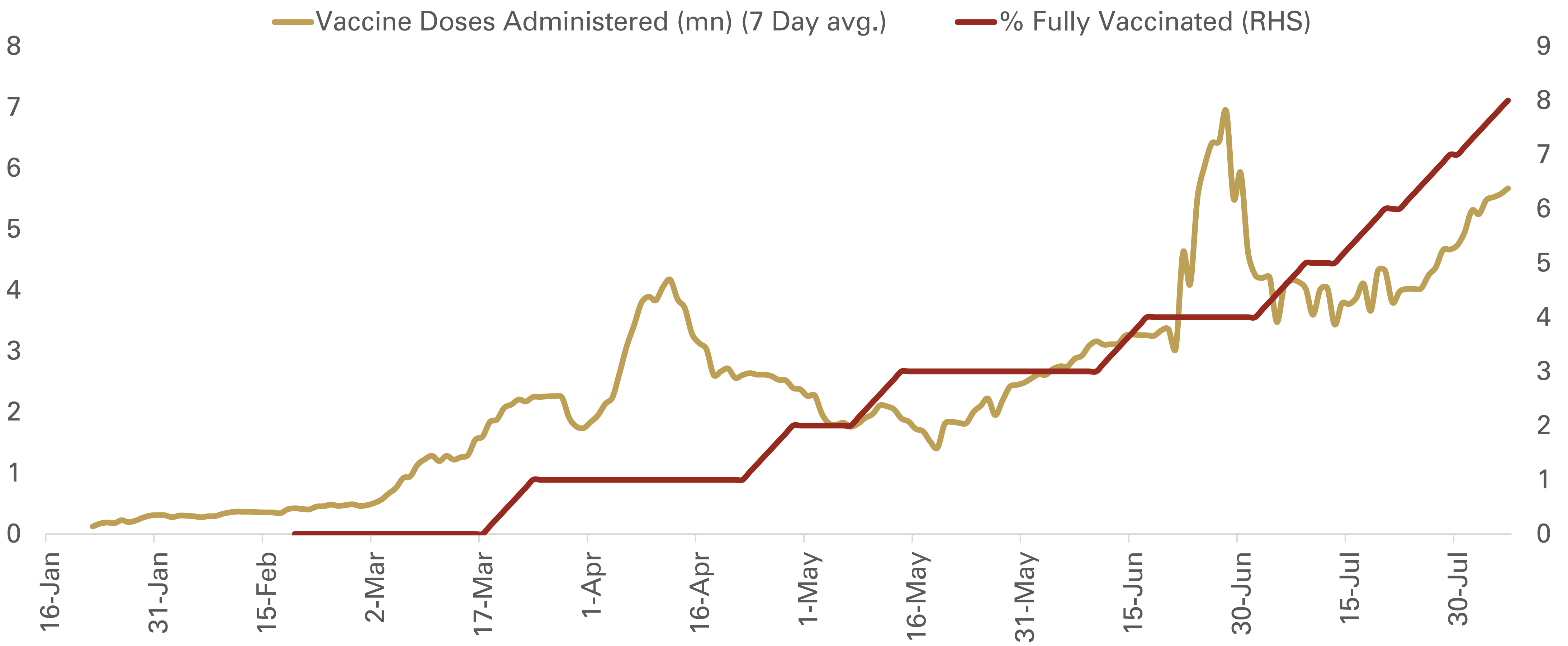
- The Delta Variant is now quite pervasive globally. US & Israel are showing lower efficacy of vaccines in hospitalization rates whereas UK so far has been better. This may imply that Astra Zeneca vaccine has been more effective in preventing hospitalization rates due to Delta variant but needs to be watched further.
- Good news is that vaccines have been generally very effective in keeping fatality rates lower

Share of Kerala rising in total India Covid cases



- Kerala has witnessed concentration of Covid cases in India. Experience of Wave 2 indicates that there is a risk of further spread in other parts of the country

India: Vaccination supply is witnessing a rise as expected



- Vaccination drive continues to pick up pace, in line with expectation with daily vaccination now averaging ~ 5Mn

Risk-on rally – Growth, Inflation & Tapering

Global markets outperformed led by Growth Stocks

Performance Since 16-Jun*	World		S&P		Nasdaq		EM		India	
Sector (%)	**Avg. Wt.**	**Return**	**Avg. Wt.**	**Return**	**Avg. Wt.**	**Return**	**Avg. Wt.**	**Return**	**Avg. Wt.**	**Return**
Total	**100**	**4**	**100**	**5**	**100**	**8**	**100**	**(5)**	**100**	**2**
Defensives	66	5	72	7	98	8	61	(6)	47	2
IT	22	8	28	8	49	9	21	(2)	17	9
Discretionary	13	5	13	7	7	14	5	(4)	6	1
Comm. Serv.	9	4	11	6	20	7	11	(12)	3	10
Health Care	12	3	12	4	17	3	17	(8)	8	(3)
Cons. Staples	7	1	6	4	5	6	6	(7)	9	(0)
Utilities	3	2	2	5	1	4	2	(4)	4	(17)
Cyclicals	34	1	27	3	2	6	39	(2)	52	2
Materials	4	2	3	3			9	1	10	7
Industrials	11	2	8	3	2	6	5	(3)	4	4
Real Estate	3	2	3	4			2	(13)	0	7
Financials	13	3	11	5			18	(2)	26	3
Energy	3	(8)	3	(9)			5	(5)	12	(6)

Note: *Fed policy

China's share market has had outsized impact on EM performance, while India has outperformed off late

Nifty 50: Recent market rally attribution

Sector	% Avg. Wt.	Return (%)	Contribution (%)
Nifty 50	100	5.3	5.3
Financials	37.4	5.8	2.1
IT	17.6	8.5	1.5
Energy	11.7	4.5	0.5
Communc. Servc.	2.0	12.2	0.2
Cons. Discretionary	6.0	3	0.2
Cons. Staples	7.8	2.2	0.2
Industrials	3.5	4.9	0.2
Health Care	3.6	4.2	0.2
Materials	8.7	1.3	0.1
Utilities	1.7	4.7	0.1

Contributors	% Avg. Wt.	Return (%)	Contribution (%)
HDFC	6.6	11.5	0.7
HDFC Bank	9.1	7.7	0.7
Infosys	8.7	6.6	0.6
RIL	9.6	5.3	0.5
TCS	4.8	8.3	0.4
Kotak Bank	3.6	8.2	0.3
Bharti	2.0	12.2	0.2
Tech M	1.1	23.6	0.2
HCL Tech	1.6	13.9	0.2

Detractors	% Avg. Wt.	Return (%)	Contribution (%)
Bajaj Fin.	2.4	(1.7)	(0.0)
Ultratech	1.3	(2.1)	(0.0)
UPL	0.6	(4.4)	(0.0)
Maruti	1.3	(1.7)	(0.0)
Shr. Cement	0.5	(3.2)	(0.0)
Dr. Reddy's	0.8	(1.7)	(0.0)
Asian Paints	1.9	(0.5)	(0.0)
Grasim Inds	0.8	(1.8)	(0.0)
Coal India	0.4	(0.2)	(0.0)

Data since 28th July 2021

Market rally (since breakout from Nifty level of 15700 / 15800) has been led by Index heavy weight sectors (led by Financials & IT) and stocks.

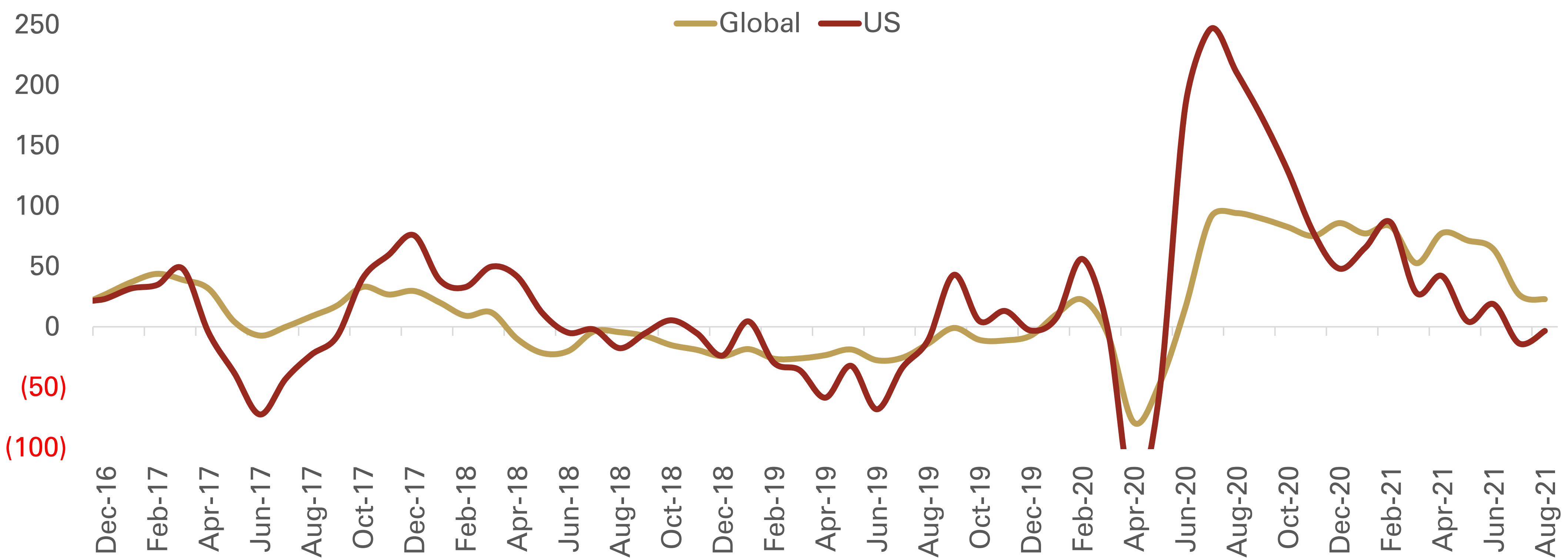
Commodity Prices witnessing moderation

Recent times have started to witnessed stabilisation in prices

$ / MT	Gold (Rs / 10 Gms)	Metal Index	Brent	Copper	Aluminium	Zinc	Steel	Lumber ($/000 board feet)
Q1 20	41,008	2,638	51	5,641	1,692	2,129	473	399
Q2 20	42,951	2,462	33	5,348	1,498	1,968	383	350
Q3 20	51,231	2,917	43	6,520	1,705	2,339	461	673
Q4 20	50,195	3,225	45	7,195	1,920	2,632	566	646
Q1 21	47,071	3,678	61	8,483	2,093	2,749	761	918
Q2 21	47,441	4,139	69	9,673	2,393	2,911	1,001	1,246
Q3 21 TD	47,789	4,209	74	9,467	2,516	2,960	932	632
Spot (Last traded)	47,464	4,230	71	9,446	2,570	2,975	920	552
Q3 CY21 (YoY %)	(7)	44	71	45	48	27	102	(6)
Q3 CY21 (QoQ %)	1	2	7	(2)	5	2	(7)	(49)

Momentum in commodity prices have stabilized over last few months. The best case scenario for markets is for Commodity prices to remain stable going forward. Any decline in Commodity prices, while good from inflation perspective, can impact earnings growth expectations globally.

Economic surprise index has seen deceleration in recent past



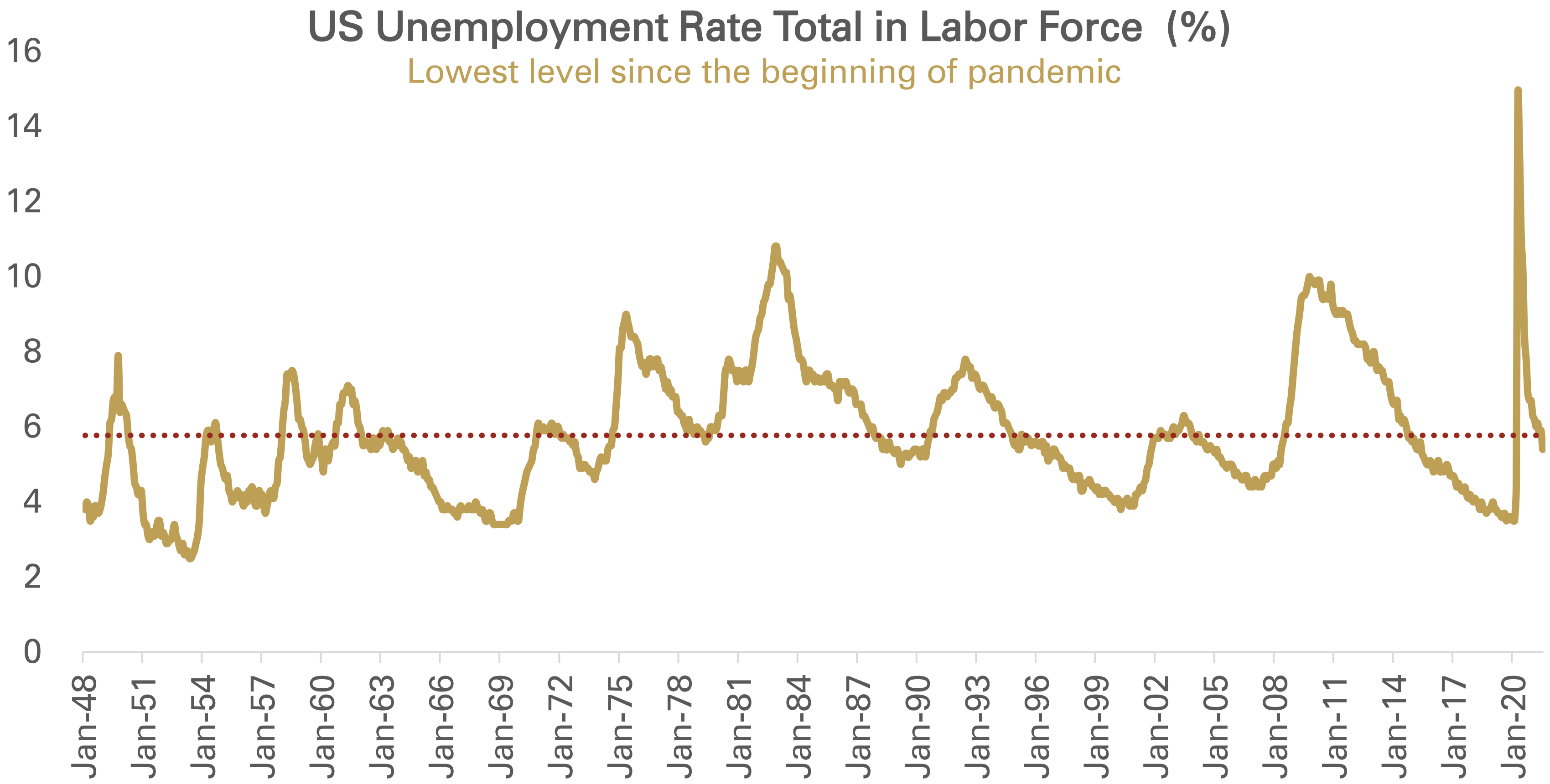
- Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that data releases have been stronger than expected and a negative reading means that data releases have been worse than expected.
- Lately, the positive surprise element in data releases have not been as stronger relative to recent past, leading to reassessment of growth expectations, and partly contributing to range bound bond yields

US Senate passes landmark $1tn infrastructure package

- $1tn spending bill that passed US Senate primarily focused on infrastructure funds aimed at building roads, bridges and tunnels in constituencies across the country. Package includes about $550bn in new federal spending over the next five years; the rest comes in funds that normally would be appropriated on an annual basis.
- Key highlights mentioned below:

Infrastructure	$110bn	• Roads, bridges, major projects - about a fifth of the federal spending in this bill (as 20% of major highways and roads plus 45,000 bridges are considered to be in poor condition). • Public transport systems would receive $39bn & airports $20bn to improve runways & terminals, as well as $5bn for air traffic control. Ports & waterways would receive $17bn, and infrastructure to support the charging and procurement of electric vehicles $15bn. • Additional $55bn set out for water infrastructure, to replace lead pipes & ensure access to clean drinking water.
Trains	$66bn	• Upgrade passenger & freight rail, with grants as well for intercity and high-speed train services including Amtrak, the national network. • Funds would also go towards connecting more areas with rail, beyond the eastern seaboard.
High speed internet	$65bb	• Allotment seeks to link up millions living in rural & lower-income communities with reliable internet access. Companies who receive a share of this government funding will need to have lower-priced plans on offer and allow customers to compare costs. A program to subsidize internet and related tech for low income families is also on the books.
Clean Energy	$73bn	• Towards new power lines, rebuilding old electric grids & expanding clean energy. Building new transmission lines with higher-voltage capacities will be key to getting this clean energy out across the country. • Over a dozen billions in addition for electrifying public transportation & building more electric car chargers. Add $21bn more to tally for cleaning up soil and groundwater in old mines and gas fields.

US unemployment rate falls below long term historical average



Unemployment rate tracks no. of unemployed persons as a % of the labor force (total number of employed plus unemployed).

US labour market added 943,000 jobs in July & unemployment rate dropped to 5.4%, in a sign that some of the worker shortages that have hampered the economic recovery have begun to ease.

Gains in July, which were the largest since August 2020, were most pronounced in the leisure & hospitality sectors, with employment increasing 380,000 as restaurants and hotels raised wages and ramped up hiring. Average hourly earnings for these workers have climbed 9.6% YoY in July. Education-related local government jobs experienced a big boost too.

In 2014, tapering commenced when Unemployment rate was higher than current levels

Fed tapering changing expectations

August 13, 2021
7:44 PM IST
Last Updated 11 hours ago

United States

Reuters poll: Fed to unveil bond-buying taper plan next month; jobless rate to fall slowly

Fed moves closer to decision on 'tapering' massive stimulus

US central bank says it has made 'progress' towards its inflation and employment goals

Jay Powell has repeatedly stressed that the economic recovery is closely tied to the trajectory of the pandemic © Financial Times

James Politi in Washington and **Colby Smith** in New York JULY 28 2021

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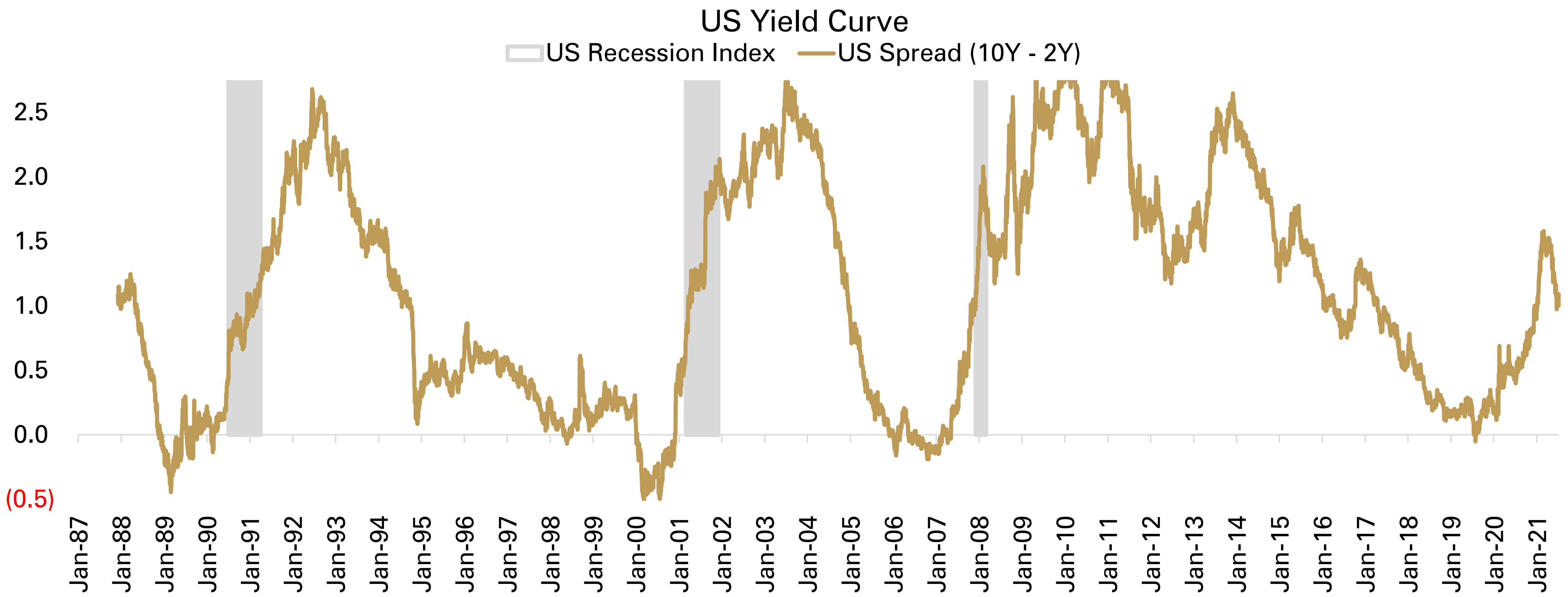
MARKETS | HEARD ON THE STREET

Jobs Report Risks Different Kind of Taper Tantrum

Robust jobs recovery could lead to pressure on the Fed to hasten a normalization of policy

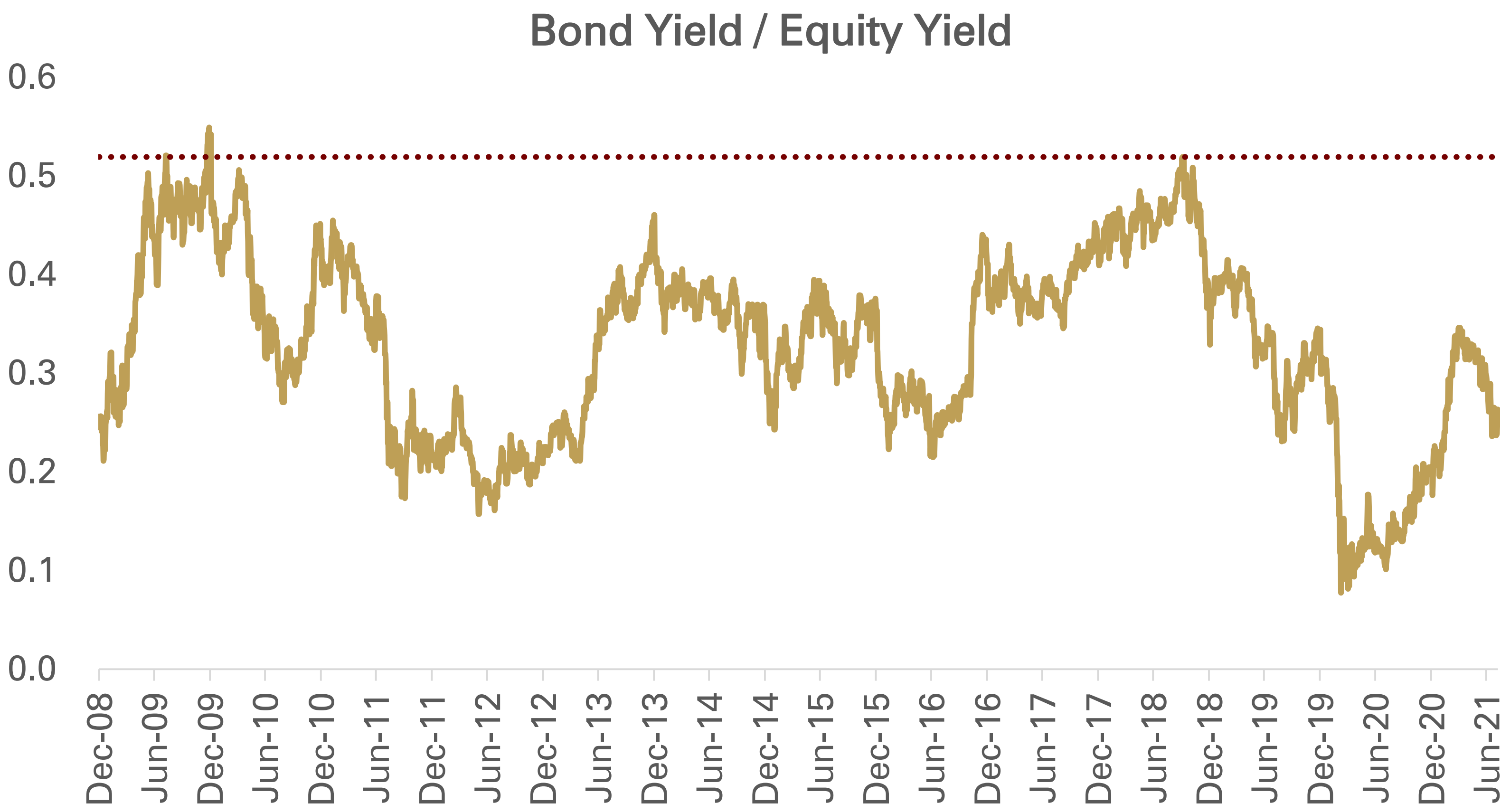
US Fed tapering expectations are now well telegraphed, and expectations have moved towards a announcement in September. **Tapering is no longer a surprise**

Yield curve should have been much steeper by now!



Yield curve was at its steepest level in Mar-21 (post-recession) but has since flattened i.e. 10-Year bond yields have fallen relative to 2-Yr. Is this abnormal? As the data shows, this move isn't abnormal & similar volatility was witnessed in early part of the cycle post 2008 recession. However, with the incoming data, Yield curve should have steepened further, despite tapering risks clearly known by market. **This remains the biggest conundrum for market participants.**

US Equities – Relative Valuation



Our favorite chart which compares Earnings Yield to Bond Yields shows that market has tended to peak out (& fall thereafter) when this ratio touches 0.5. All else being equal, if US 10 Year Bond yield were to rise to beyond 2% (& swiftly), a correction is natural to expect. If the rise is gradual / orderly, market may not witness very high volatility as there is support from ‘Economic Growth’

Range bound US Bond Yields are supportive of Equities

To conclude: Watch the Bond Yields

- Base case remains for US Bond Yields to gradually inch up

- Moderating commodity price rise along with increasing jobs are indicative that Inflation may indeed be ‘transitory’ as laid out by Fed but market opinion remains divided

- Expectations high that Fed shall also indicate its plan to taper in its upcoming meeting

- While Growth Stocks (including Tech) have outperformed as Bond Yields have fallen, base case still continues for Cyclically oriented portfolios to add relative value

- Key risk continues a sharp rise or fall in Bond Yields. An orderly rise towards 1.8% is best case for markets

China: falling weightage in Global Equity Indices

Weight (%)	End Jan-21	Mid Jul-21	End Jul-21
Global	**100**	**100**	**100**
- Developed Markets	86	87	88
- Emerging Markets	14	13	12
North America	60	62	62
Europe	17	16	17
Japan	7	6	6
Asia Pac ex Jp	14	13	12
- China	5.5	4.6	4.1
- India	1.2	1.3	1.3
Latin America	1	1	1
CEEMEA	2	2	2

China's share in Global Equity indices has fallen from a peak 5.5% to 4.1% recently, impacting EMs as well. India seems to have benefitted though.

MSCI Greater China – A reflection on extent of correction

Company (wt. %)	Revenue 5 Yr CAGR	PAT 5 Yr CAGR	2Yr Frwd Earnings Growth (%)	Price correction from peak YTD	P / E Avg. 3 Yr	P / E	P / Sales Avg. 3 Yr	P / Sales	P / CF Avg. 3 Yr	P / CF	Altman Z-Score
Taiwan Semiconductor (9.5)	10	11	15	(12)	19.2	26.3	7.7	10.6	12.8	17.7	10.6
Tencent Holdings (9.3)	36	41	21	(42)	32.2	29.3					6.7
Alibaba (8.4)	46	44	60	(27)	17.7	21.1	8.6	4.5	21.3	16.2	5.6
Meituan (4.1)	96	L	L to P	(53)	120.1	470.0	9.5	7.6	163.1	111.4	13.0
Wuxi Biologics (2.8)	59	107	28	(15)	73.7	165.7	41.3	76.4	164.1	239.4	27.3
Ping An Bank (2.2)	6	6	20	(29)	9.2	10.5	1.2	1.5	3.2	2.9	
Ping An Insurance (2.1)	13	21	12	(34)	7.8	6.7	1.1	0.8	3.7	2.1	
Country Garden (2.1)	56	65	16	(32)	30.8	36.0	8.7	8.7	30.0	36.2	7.0
Hong Kong Exchng (2.0)	7	8	20	(7)	27.9	46.0	26.2	36.1	25.1	25.1	1.3
Pinduoduo (1.9)	229	L	L to P	(57)			17.3	9.3	32.9	27.5	5.6

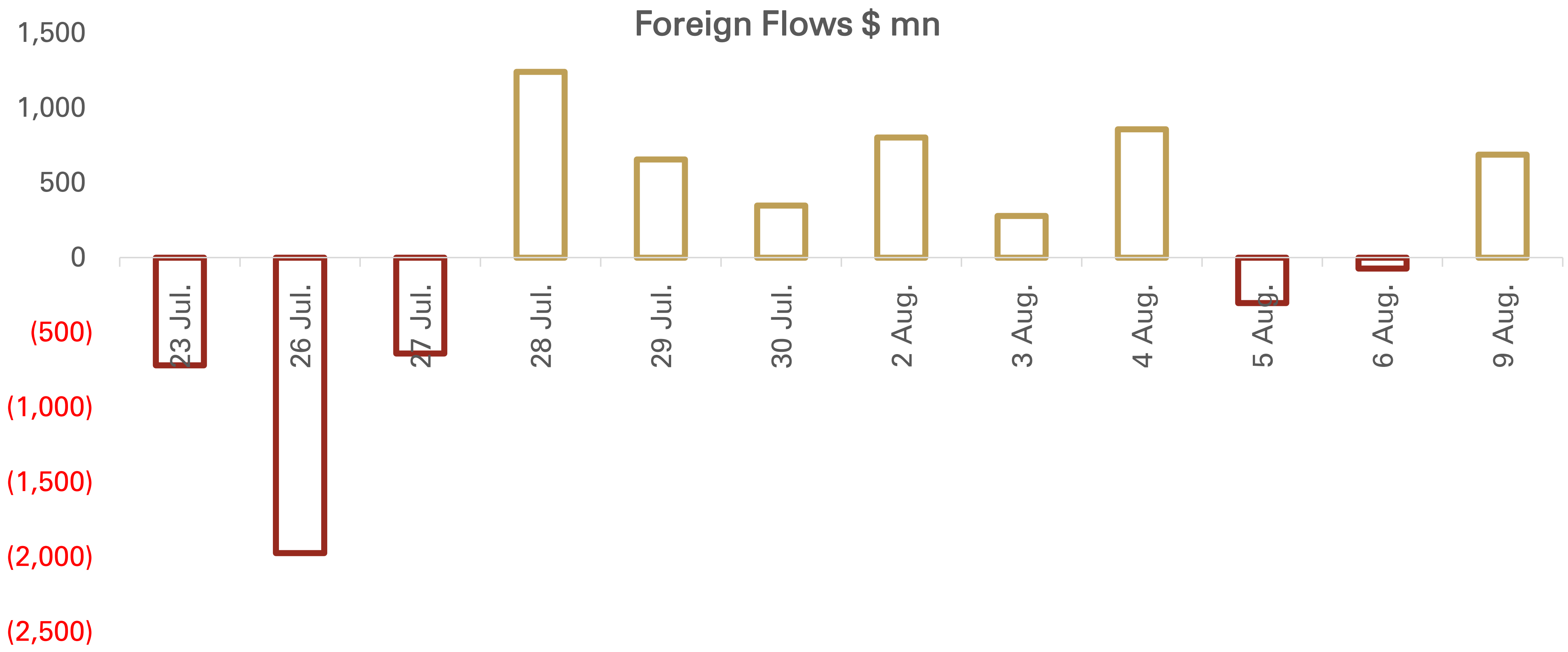
Most of the stocks have shown remarkable growth, with many expected to still witness good earnings growth on forward basis, albeit susceptible to some downgrade in expectations given ongoing regulatory action

China market valuations are below average relative to World

Relative Valuations below long term average:
Clearly the market is likely to accord a higher 'regulatory' risk premium to Chinese Equities, and thus, while MSCI China looks cheap vs. the world on relative basis (P/E), it may be some time before it trades above average levels (currently trading below its average since 2010).

Given that the relative valuations are below average levels (yet can go further lower from here), it raises the possibility of outperformance in medium term. It must be noted that China still commands ~4x weightage of India in global equity indices, with nearly 5x per capita income.

China: Foreign flows have stabilized

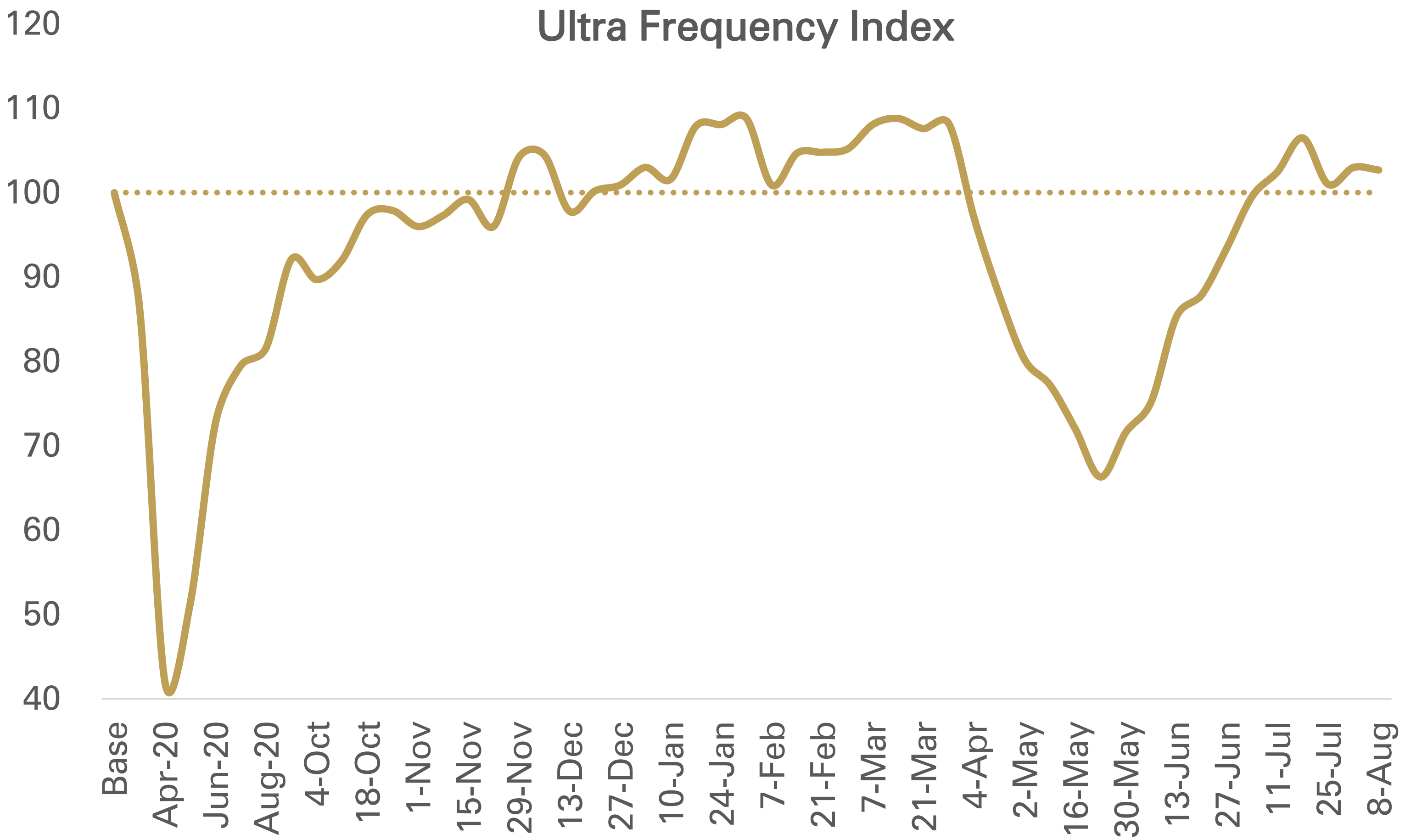


- After knee-jerk reaction, due to fall in China equity markets, foreign flows seems to have become stable.

India

Economic & Corporate cycle likely to support good earnings growth

UFI - Economic activity above pre-covid levels



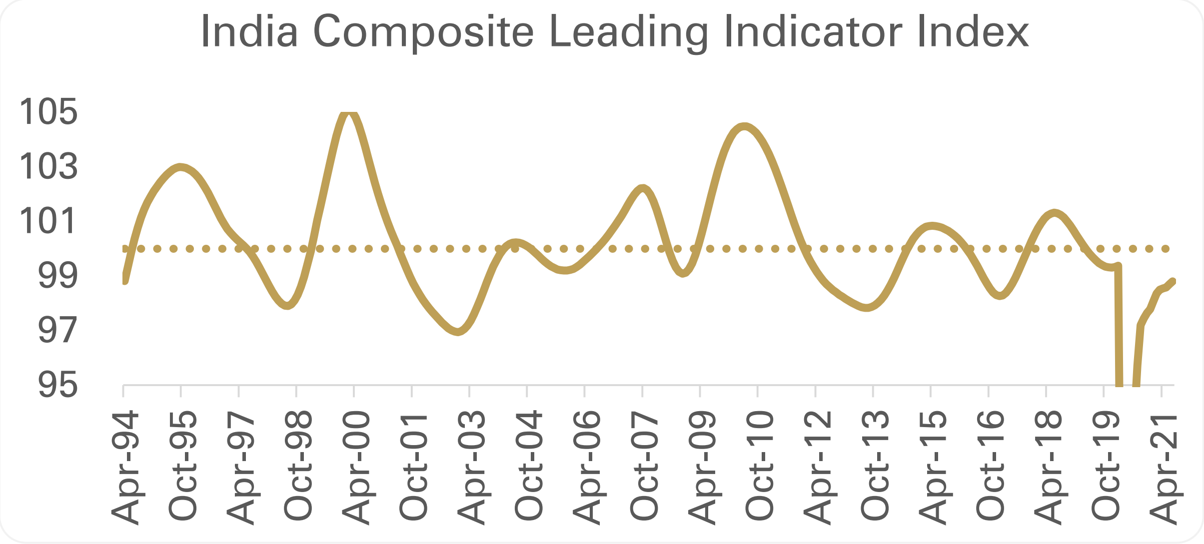
ICICI Bank's weekly UFI moderated marginally with an index reading of 102.7 vs. 103 in the previous week, but remains above pre-COVID level.

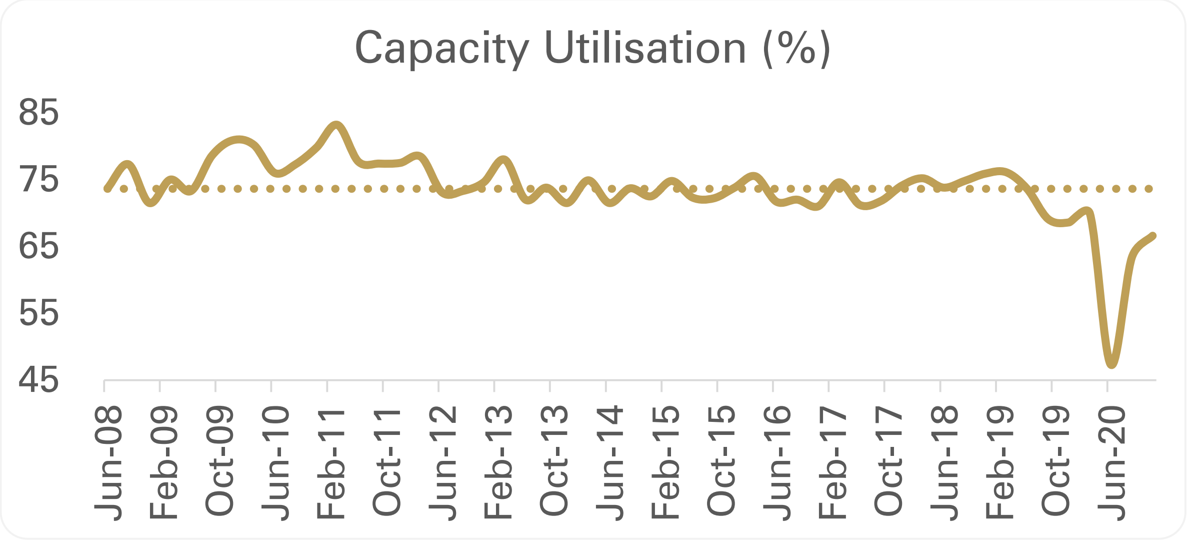
Indicators that witnessed a sequential improvement include peak power demand, mobility indicators and labour force participation rate.

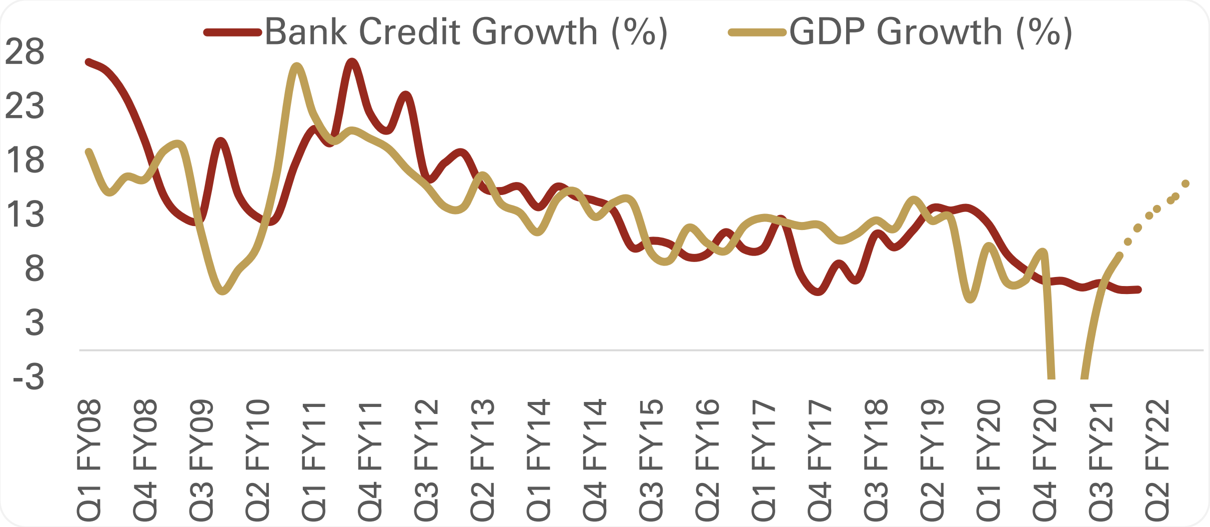
However, moderation seen in vehicle registrations, E-way bill generations, rail freight revenues along with a rise seen in unemployment rate weighed on the index performance.

With gradual opening up on the lockdown measures, almost all the states' indices have recorded readings above the critical 100-level mark expect for Maharashtra, Kerala, Tamil Nadu and Karnataka. Sustainability of the recovery will be contingent upon the pace of vaccination in respective states. However, new cases for infections for states such as Kerala and Maharashtra will remain important to watch from a recovery perspective, though a **gradual improvement over the next few months is unlikely to get arrested**.

Business cycle likely to continue uptrend







Economic parameters are on an upswing and are underpinned by improving factors.

Improvement in utilization rates and credit growth (at multi year lows) is expected to support growth going forward.

Q1 FY22 – Earnings mid term review

Q1 FY22 – mid term Earnings Review

- Key trends for the Q1 FY22 were broadly in line to a marginal miss on earnings. Strong earnings growth reported by companies in commodity sectors has led to robust growth in earnings on aggregate basis.
- From the NSE 200 set of companies that have reported, revenue, EBITDA and net profit growth stood at 43%, 34% and 116% YoY, respectively. Ex-Bharti, Interglobe Aviation & Tata Motors, NSE 200 revenue and earnings growth were ahead at 41% and 58%.
- Margin pressures most visible in Consumer / IT sectors. Overall, commodities (materials and energy) beat on margins while most consumers (staples & discretionary) have missed. Ex-Materials, EBITDA margins at aggregate level have contracted by 123bp.
- Across the board, input cost pressure has not dented earnings outlook yet indicating the ability to rationalize and pass on cost. Going forward, cost pressures may rise as operations resume in full swing and raw material prices continue to see upward pressure. But, as growth normalizes, operating leverage benefits should kick in and support margins.

Q1FY22 – Mid term Earnings review - Powered By Commodities

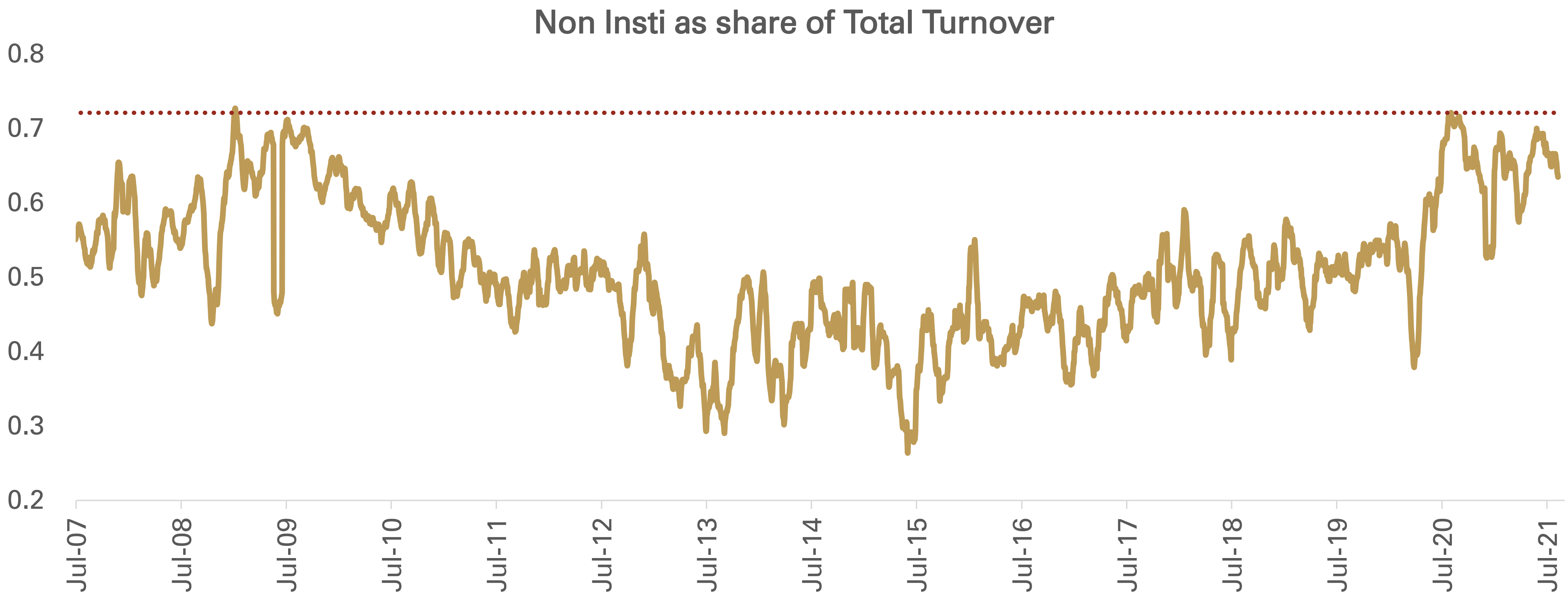
Sector	No.	Sales			EBITDA			PAT		
Rs bn	Co's	Q1 FY22	Q1 FY21	Growth %	Q1 FY22	Q1 FY21	Growth %	Q1 FY22	Q1 FY21	Growth %
Consumer Staples	13	565	450	26	122	98	25	84	72	17
Consumer Discretionary	20	1,567	760	106	113	17	560	(36)	(120)	-
Telecommunication Services	2	337	249	35	165	107	54	17	(152)	-
Cement	5	265	179	48	71	46	54	35	18	94
Domestic non-cyclicals	**40**	**2,734**	**1,638**	**67**	**471**	**268**	**76**	**100**	**(182)**	**-**
Health Care	15	388	324	20	108	96	12	58	25	133
Information Technology	12	1,378	1,171	18	342	279	23	241	192	26
Exports	**27**	**1,766**	**1,495**	**18**	**450**	**375**	**20**	**299**	**216**	**38**
Sub-Total Non Cyclicals	67	4,500	3,133	44	921	644	43	399	34	1,068
PSU Bank	7	1,167	1,007	16	532	440	21	147	69	113
Pvt Bank	11	918	801	15	448	433	4	179	151	19
NBFC	19	637	583	9	131	154	(15)	116	127	(8)
Insurance	4	252	212	19	5	20	(73)	5	15	(70)
Financials	41	2,974	2,602	14	1,117	1,047	7	447	362	23
Industrials	12	579	420	38	103	68	52	40	13	212
Utilities	7	717	573	25	182	161	13	71	40	75
Materials	5	999	515	94	272	46	493	149	(11)	-
Energy	7	3,979	2,354	69	396	272	45	210	171	22
Others	5	64	50	27	12	6	83	10	3	187
Sub-Total Cyclicals	36	6,337	3,913	62	963	553	74	479	217	121
Total	**144**	**13,811**	**9,648**	**43**	**3,001**	**2,244**	**34**	**1,324**	**612**	**116**
Total (Adjusted)*	**141**	**12,849**	**9,088**	**41**	**2,834**	**2,155**	**32**	**1,398**	**884**	**58**

Note: *Ex-Bharti, Interglobe Avi. & Tata Motors

Metals sectors lead earnings growth aided by lower reported losses / turning loss to profit by Tata Motors & Bharti Airtel

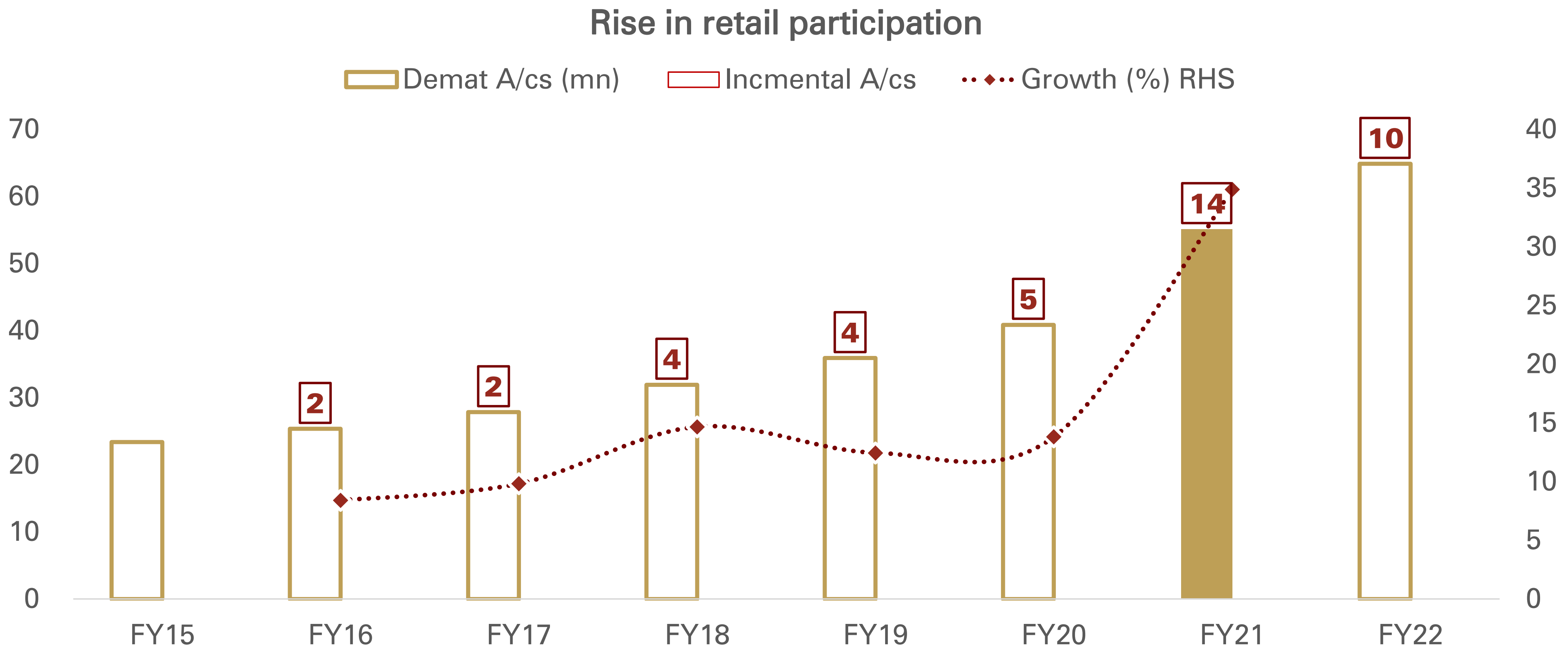
Equity Strategy & Valuations

Retail participation in markets have risen significantly



Retail participation rose last year and continues to remain elevated. Tech-savvy new millennials find it very convenient to internet-based, mobile-enabled trading platforms.

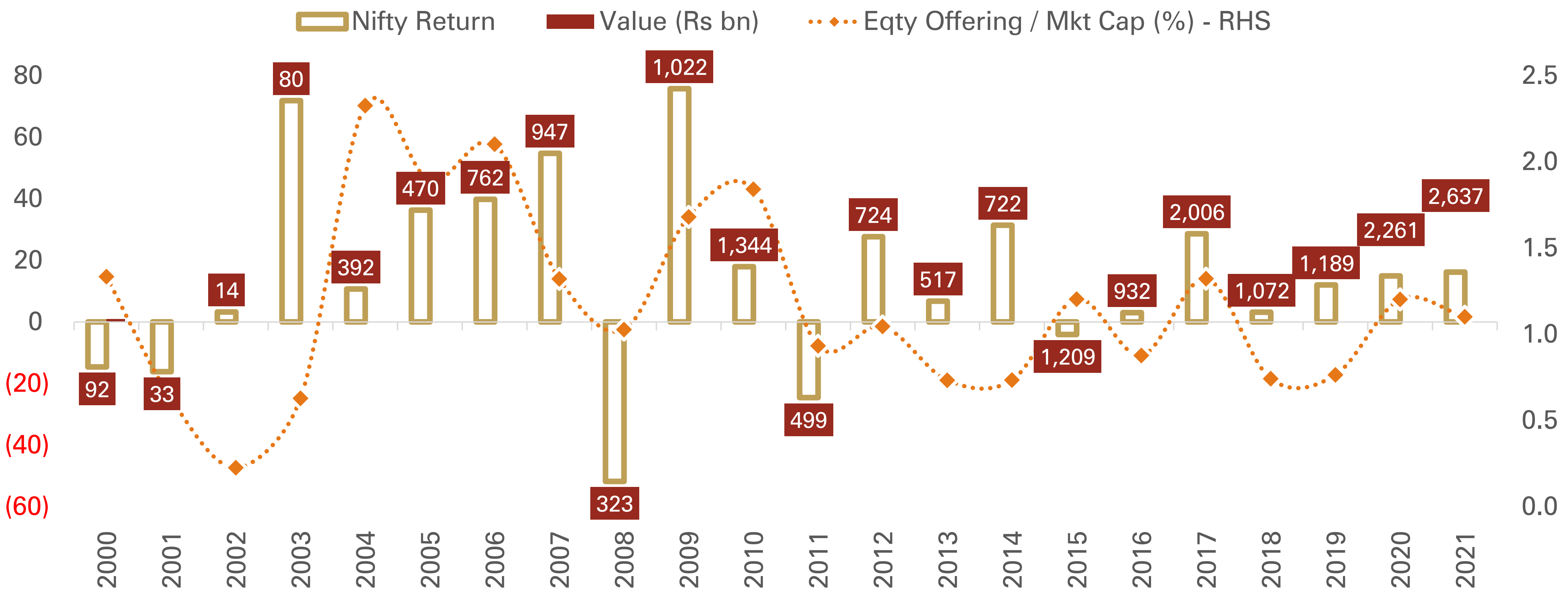
Retail participation in markets have risen significantly



Note: FY22 data till 31st July 2021

Number of demat accounts opened in the last few months is a clear reflection of rising retail participation. **At an industry level, the number of incremental demat accounts opened in the last year is more than the accounts opened in the previous 3 years collectively.**

Equity offering are rising with market upturn



Note: 2021 Equity Offering Value is annualised

Equity offering have risen during last couple of years, given elevated market valuations. However, history is replete with cases of IPO market euphoria coinciding with market peaks!

SmallCaps performance in times of changing spreads

Period	Nifty Annualized (%)	SmallCap Annualized (%)	O/P of SmallCap vs Nifty (%)	Spread (bps)	AA 5 Yr	G-Sec
Sep-06					8.8	7.6
Apr-07	20	16	(3)	216	10.2	8.0
Jan-08	90	138	48	157	9.3	7.8
Jan-09	(54)	(72)	(18)	373	9.5	5.8
Aug-10	52	90	38	121	8.9	7.7
Aug-12	(2)	(14)	(13)	220	10.4	8.2
Feb-13	26	4	(22)	119	9.2	8.0
Nov-13	2	(20)	(22)	161	10.3	8.7
Jun-14	43	112	70	73	9.4	8.6
Jan-15	33	18	(15)	146	9.1	7.7
Nov-15	(12)	(1)	11	66	8.5	7.8
Apr-16	(11)	(27)	(16)	170	9.0	7.3
Jan-18	22	40	18	96	8.3	7.3
Aug-19	0	(26)	(26)	181	8.1	6.3
Feb-20	21	33	11	119	7.4	6.3
May-20	(65)	(81)	(15)	192	7.5	5.6
May-21	60	115	55	64	6.4	5.8
Aug-21	50	92	42	107	6.8	5.7

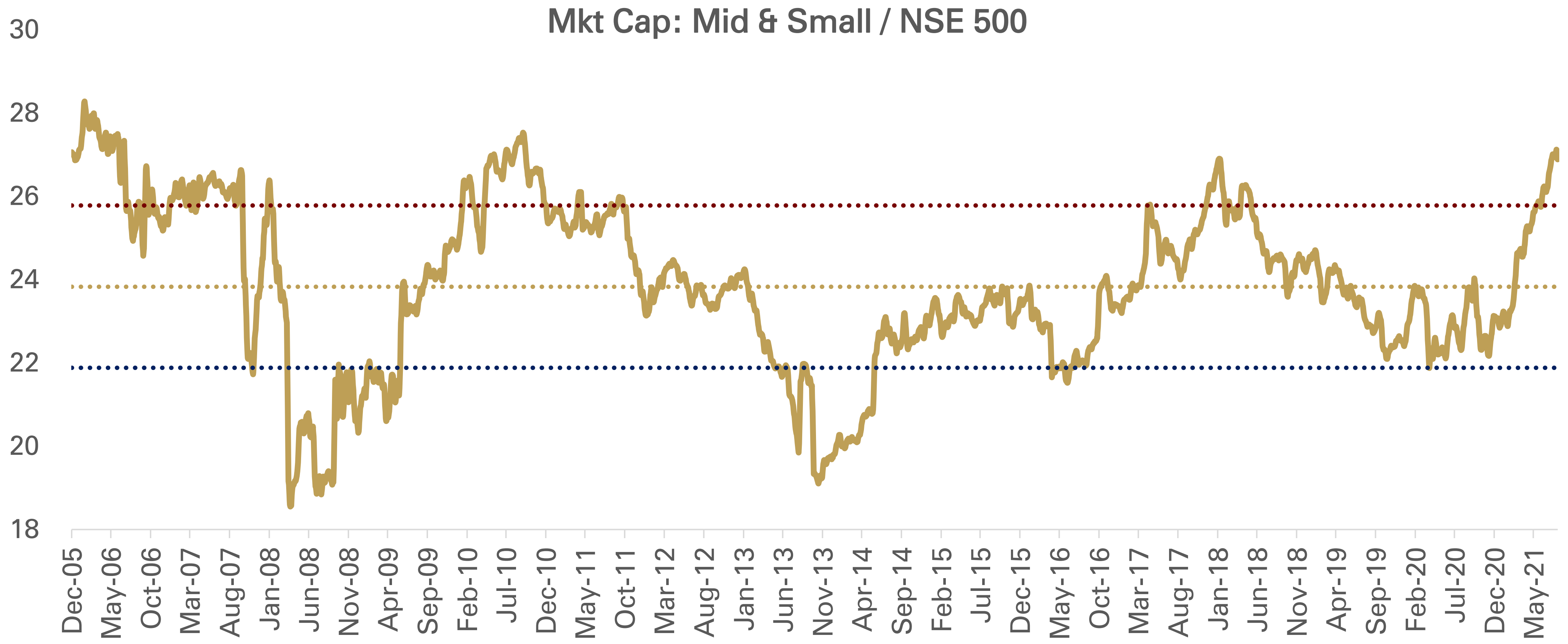
Smallcaps have outperformed Largecaps in times of falling spreads and benign liquidity conditions and vice-versa. Hence, **if spreads were to widen, performance of smallcaps on a relative basis may turn adverse.**

Small Cap Volumes on the rise

Duration of cycle				Volume (mn)			Index
Start Date	End Date	Duration	Phase	St Date	End Date	% Change	Return (%)
Jun-06	Jan-08	573	Bull	29	122	329	171
Jan-08	Mar-09	427	Bear	122	39	(68)	(78)
Mar-09	Nov-10	611	Bull	39	88	123	305
Nov-10	Aug-13	1,000	Bear	88	36	(59)	(52)
Aug-13	Jun-14	307	Bull	36	116	220	86
Jun-14	Nov-16	897	Flat	116	50	(57)	9
Nov-16	Jan-18	419	Bull	50	125	151	70
Jan-18	Dec-19	695	Bear	125	31	(75)	(37)
Dec-19	Feb-20	57	Rising	31	51	63	12
Feb-20	Apr-20	62	Bear	51	27	(47)	(36)
Apr-20	Aug-21	485	Bull	27	73	172	167
Average		409	Peak			171	135

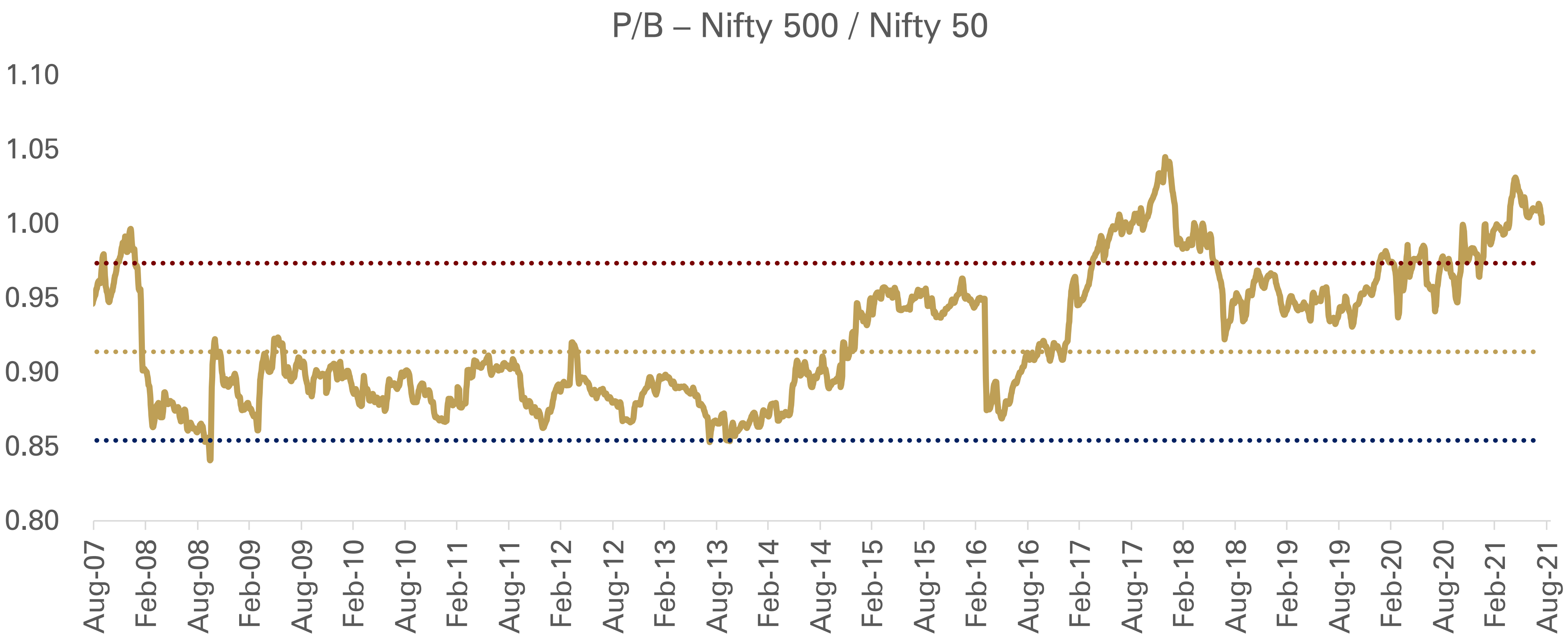
Small cap are trending closer to previous cycle peaks basis volumes and historical returns during bull phases

Mid & Small Mkt Cap vs Large Mkt Cap inching closer to highs



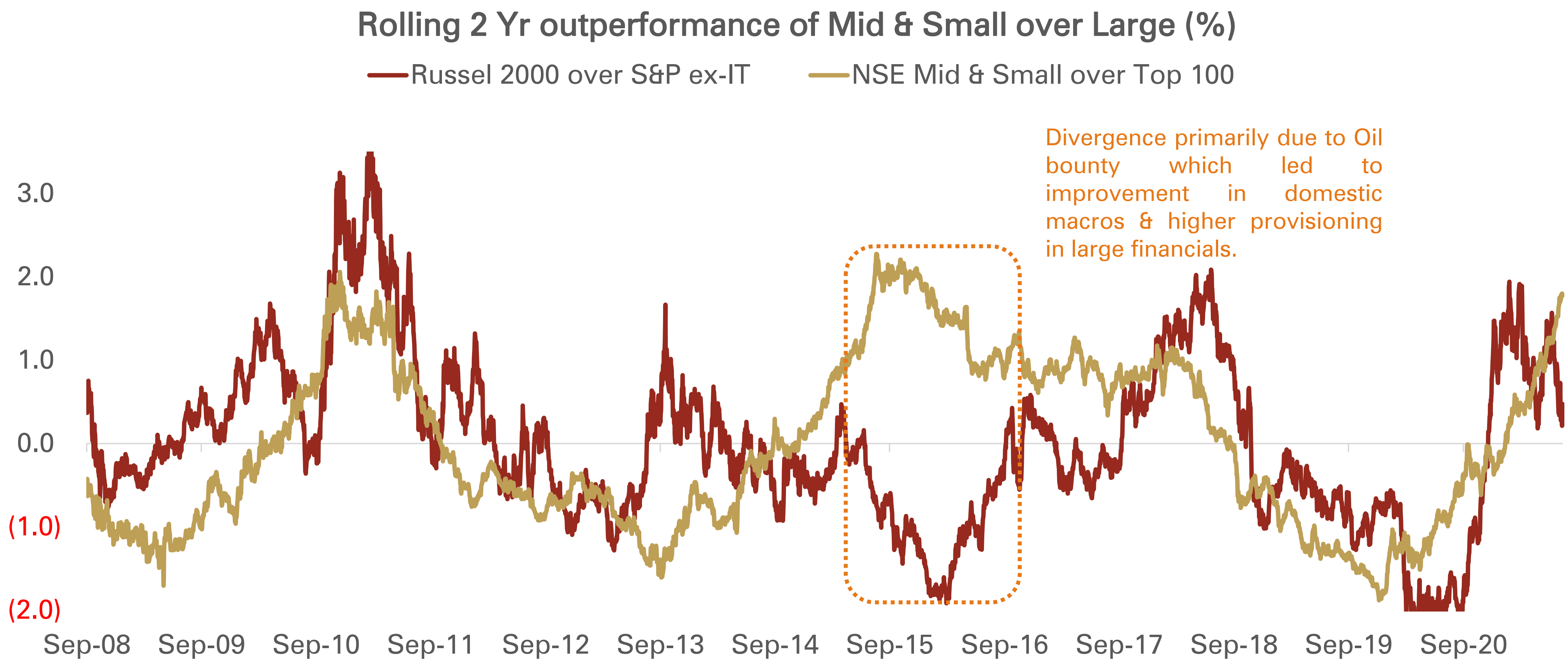
Since Mar-20, Mid & Small caps out-performance has progressively increased given the rise in their market caps relative to broader markets. Current technical indicator suggest Mid & Small cap weights are closer to peak relative to history.

Valuations: Mid & Small caps w.r.t. Nifty are relatively expensive



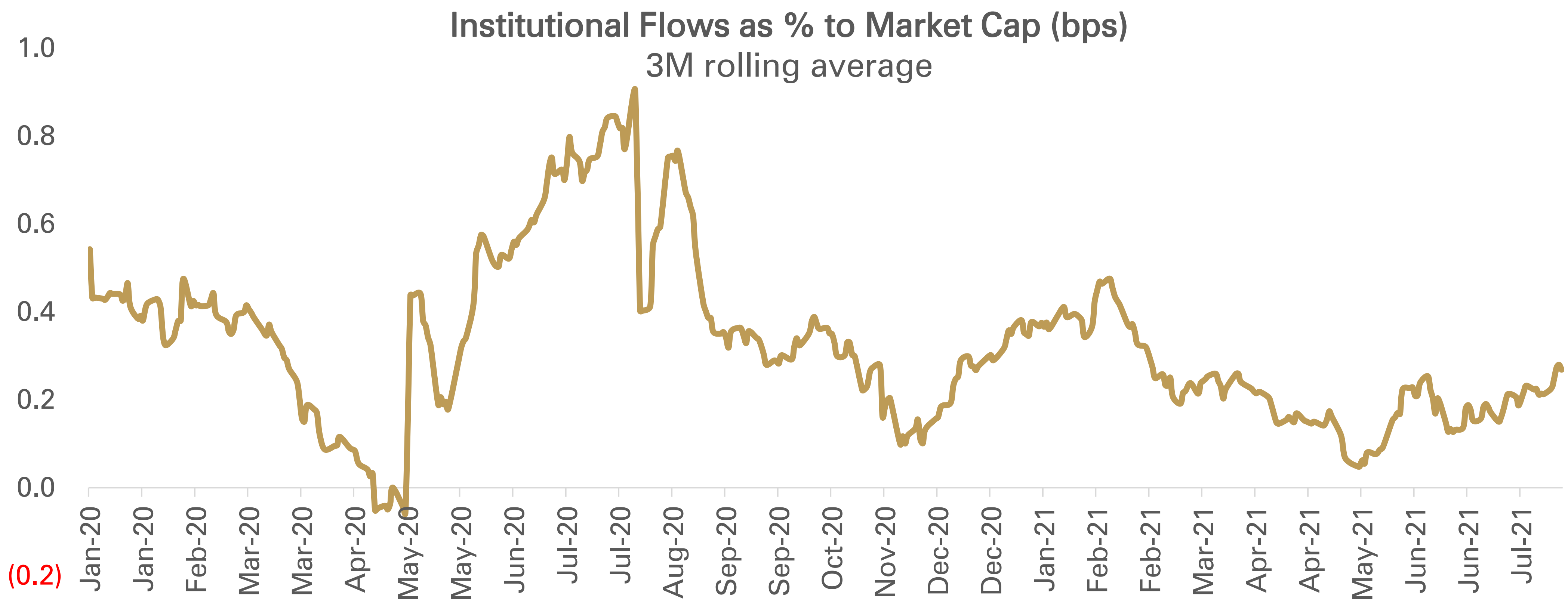
Relative valuations of Mid & Small caps (inferred from broader index Nifty 500) with respect to Nifty has edged at above +1 Std dev. and is now moving closer to peak levels witnessed in Jan 2018.

Trend in Mid & Small caps w.r.t. Large are aligned globally



Mid & Small caps outperformance in India has followed Russel 2000 outperformance, albeit with a bit of lag, but trend is largely aligned (barring 2013 – 2015 period). The falling outperformance of Russel 2000 (US Small Cap) in recent times is to be watched closely, despite differing company level fundamentals

Institutional Equity Flows remain below average



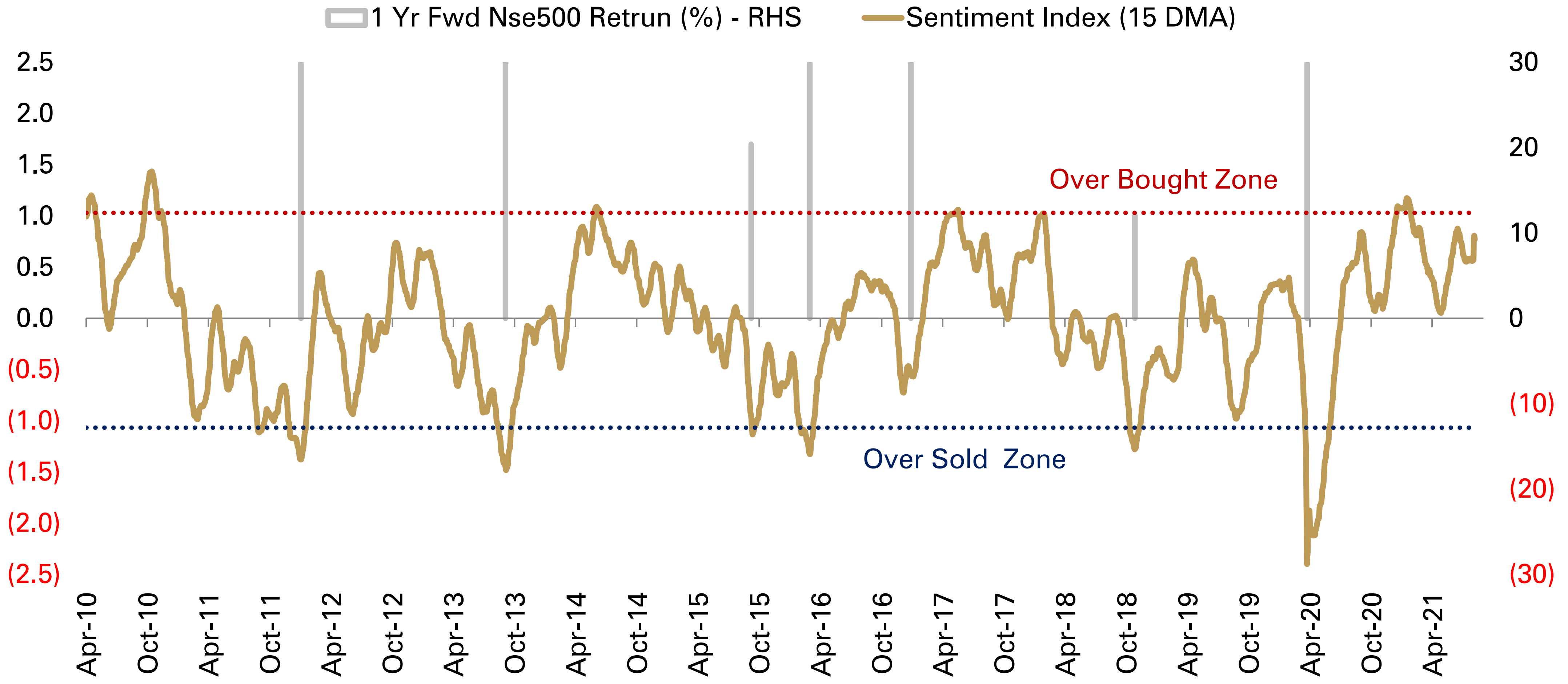
Recent market up-move haven't been led by Institutional Flows, which indicates a higher than usual non institutional participation in the market

India - Sectoral Valuation: Cyclicals are relatively well placed

Sector	Percentile Rank	Frwd PE	2Yr EPS Growth	PEG
Real Estate	1.0	33.0	7.9	4.2
MNC	0.9	36.2	11.8	3.1
Next50	0.9	23.4	9.5	2.5
FMCG	0.9	31.8	14.0	2.3
Infra	0.4	15.5	7.2	2.1
IT	1.0	25.3	12.4	2.0
Pharma	0.9	24.3	13.8	1.8
Media	0.1	13.4	8.6	1.6
NSE500	1.0	19.5	15.5	1.3
Energy	0.2	9.3	7.5	1.2
Small250	0.9	16.2	13.2	1.2
Mid	0.8	22.8	19.7	1.2
Nifty	1.0	19.2	16.8	1.1
Financials	0.7	15.7	16.0	1.0
Bank	0.7	15.3	25.1	0.6
Auto	0.9	17.3	29.6	0.6
Metal	0.7	9.7	16.9	0.6
P / B				
Bank	0.6	2.0		
Energy	0.2	1.2		
Metal	0.9	1.4		
Small250	1.0	2.4		
Nifty	1.0	2.8		

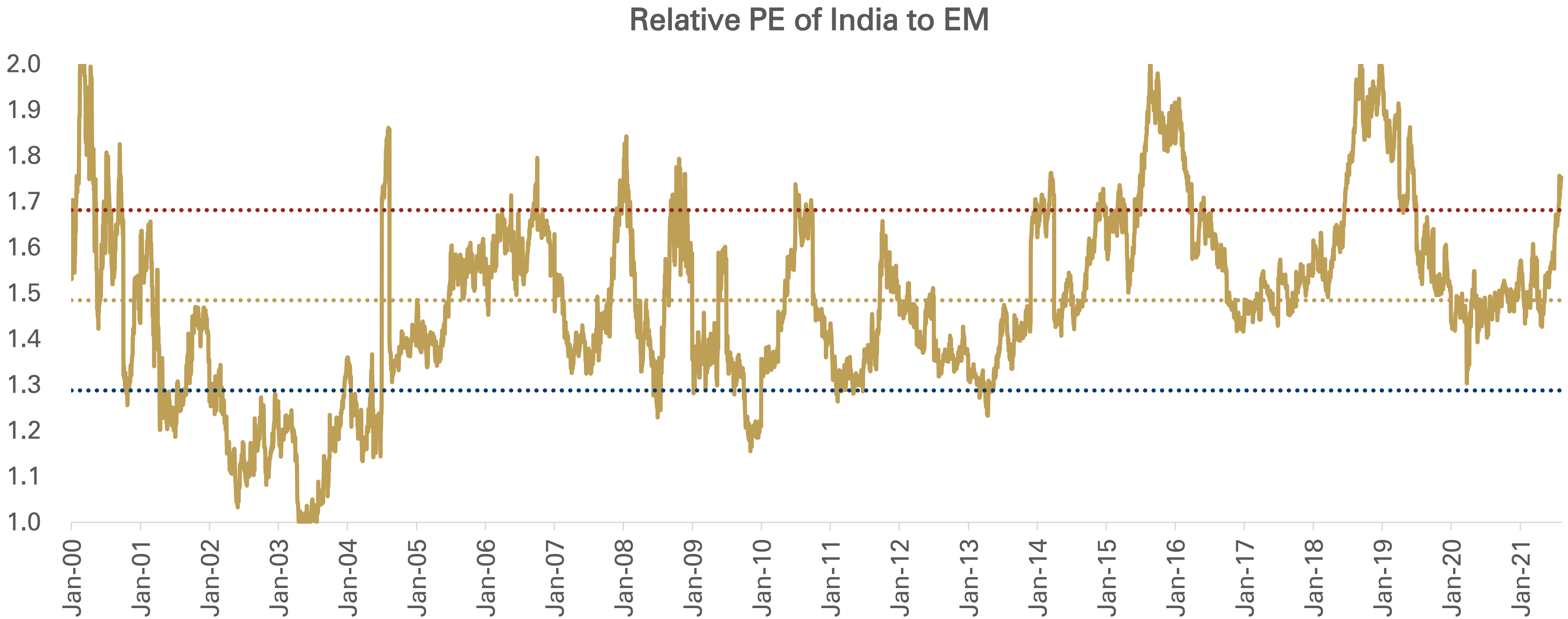
Several sectors and stocks appears to be fairly valued and offering limited scope for re rating, returns will likely follow roll forward (in earnings) or potential upgrades in earnings (as actual earnings follow expected trajectory). Banking, Auto & Industrials are still relatively cheaper.

Indian equity sentiment indicator



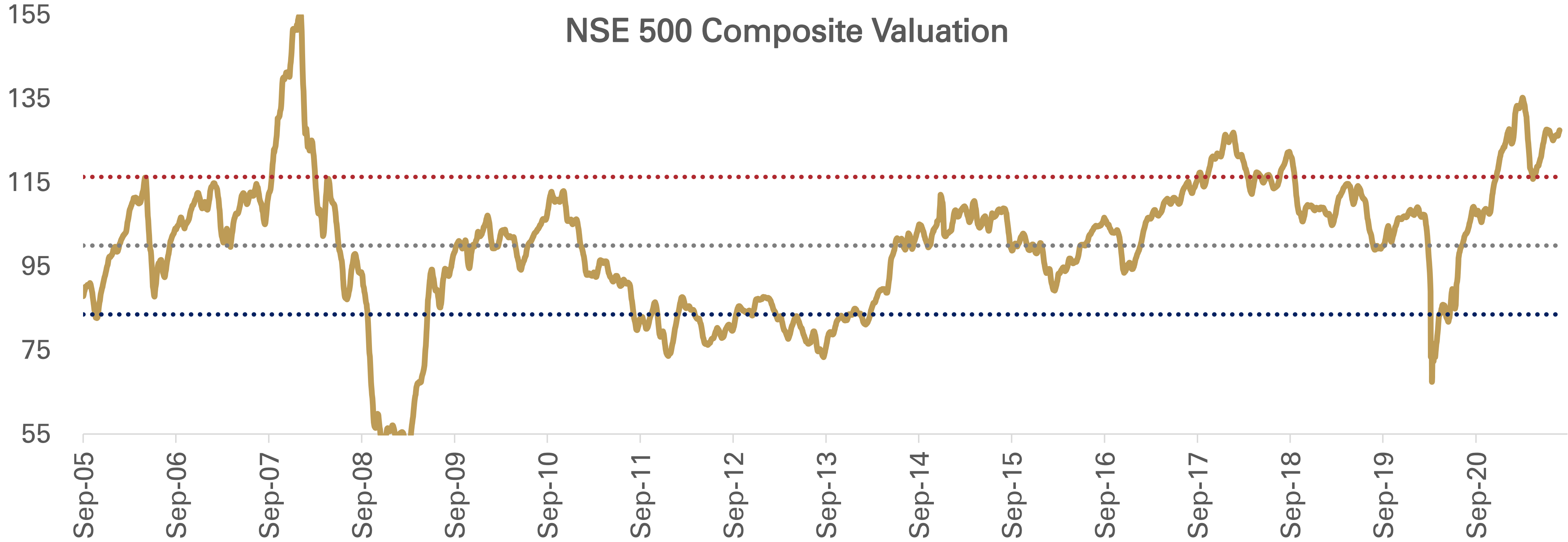
Lower Sentiment Index indicates a better buying opportunity given above avg 1 year forward return & vice versa.

Relative valuations of Indian markets remains expensive



Valuations of Indian markets are relatively expensive, above +1 stdev, when compared to Emerging markets

Valuations remain expensive but earnings growth prospects have improved too



While valuations are decisively on higher side but may not cause markets to materially correct as long as global markets and yields are stable and are well supported by superior earnings growth prospects. However, market performance is likely to be lower than earnings growth as valuations are likely to mean revert over medium term.

Theme ahead is likely to be stronger economy but volatile markets

Equity Strategy

We **maintain Equal Weight position in Equities** given the local business cycle is at an early stage of inflection with far better balance sheets (for listed corporates), likely improving profitability and credit growth far below peak.

- Earnings are likely to hold up in immediate future albeit company level commentary shall be key to future earnings upgrade
- **Valuation de-rating (in equity multiples) towards mean is likely over medium term, they may not fall materially below +1 Standard Deviation just as yet** given the overall global & cyclical tailwind
- Medium term, cyclical & economy facing sectors like **Banking**, Industrials / Capex, Energy, Auto etc. are still not in outright expensive zone & offer reasonable growth prospects
- Defensive sectors (like IT, Pharma, FMCG & select Discretionary) exhibit stretched valuations.
- "Late recovery theme" can add value from a medium term perspective

Theme likely to be stronger economy but volatile markets with rising risk of time correction

Risks

- **Higher relative valuations are now the biggest risk in medium term,** yet can sustain in near term unless there are external adverse shocks

- **Non institutional equity participation has been rising**, quite likely enthused by very low volatility observed in last several quarters. Mid & Small Caps are showing peak relative valuations

- Rising cases of Covid, despite the 2020 learnings & template, do not necessarily offer room for complacence, although our base case continues that the current spell shall be far less economically impactful vs H1FY21

- Fed taper while well telegraphed, can still tighten financial conditions, resulting in higher volatility

Fixed Income

RBI delivers status quo in line with expectations:

The Monetary Policy Committee in its August policy decided to keep rates unchanged yet again on expected lines. The RBI retained its GDP growth projection for FY22 at 9.5% and pushed up its inflation forecasts by 60 bps to 5.7%.

The MPC noted that aggregate demand is improving, but still weak and overcast by pandemic. Output is still below the pre-pandemic levels. Inflationary pressures are largely driven by adverse supply shocks which are expected to be transitory. Following were the key announcements:

1. **Extension of the VRRR Program & G-SAP:** The governor highlighted the success of the VRRR program due to the higher yield prospects as compared to the fixed rate overnight reverse repo. The RBI has decided to increase the quantum under the VRRR to Rs 4 lakh Cr in a phased manner. The G-SAP program was enhanced with 2 fresh auctions of Rs 25,000 Cr each that will be conducted on August 12th & August 26th 2021.

2. **Inflation expectation hiked to 5.7%**: The MPC cited exogenous supply shocks which it believes are temporary in nature to the spike in inflation. The MPC in its assessment raised its inflation target for the year even as it believes the ongoing progress of the monsoons and a strong kharif crop would dissipate much of the inflation towards the latter half of the year.

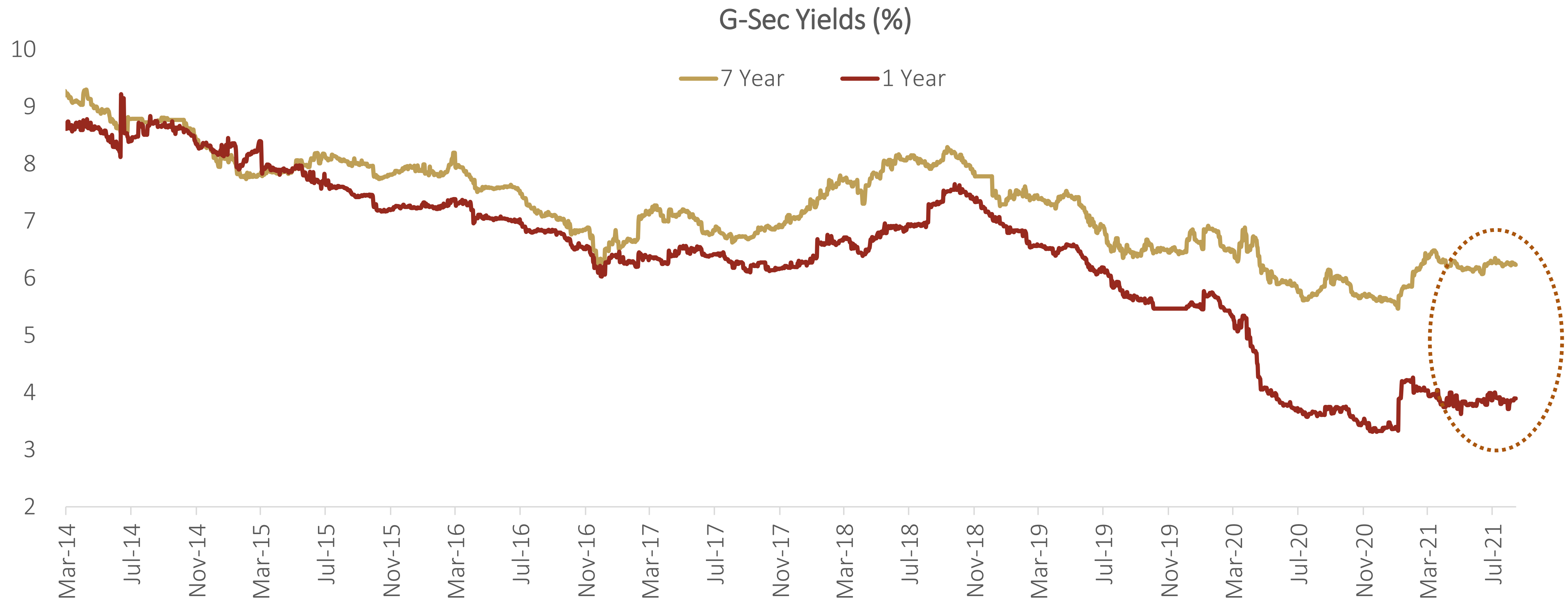
The markets post policy have remained range-bound, largely unchanged as policy action was priced going into today's policy.

Yields across the curve have gone up CYTD

Particulars	12-Aug-21	31-Mar 2021	1 Jan 2021	Change from 1 Jan Inc/ (Dec)
Call Rate	3.28	3.35	3.05	0.23
Repo	4.0	4.0	4.0	-
Short Duration				
3M T-Bill	3.37	3.24	3.01	0.36
6M CD	3.85	3.77	3.5	0.35
6M CP	4.35	4.30	3.8	0.55
G-Sec				
1 Year Gilt	3.96	3.87	3.50	0.46
2 Year Gilt	4.65	4.54	4.25	0.40
5 Year Gilt	5.85	5.84	4.99	0.86
10 Year Gilt	6.23	6.12	5.83	0.40
10 Year SDL	6.80	6.69	6.43	0.37
Corp Bonds				
1 Year AAA	4.35	4.30	3.90	0.45
3 Year AAA	5.15	5.10	4.68	0.57
5 Year AAA	6.20	5.95	5.50	0.70
1 Year AA	7.0	6.95	6.70	0.30
3 Year AA	7.93	7.86	7.44	0.49

Yields went up in the month of June with shorter end of the curve (2-3 years) rising faster than longer end

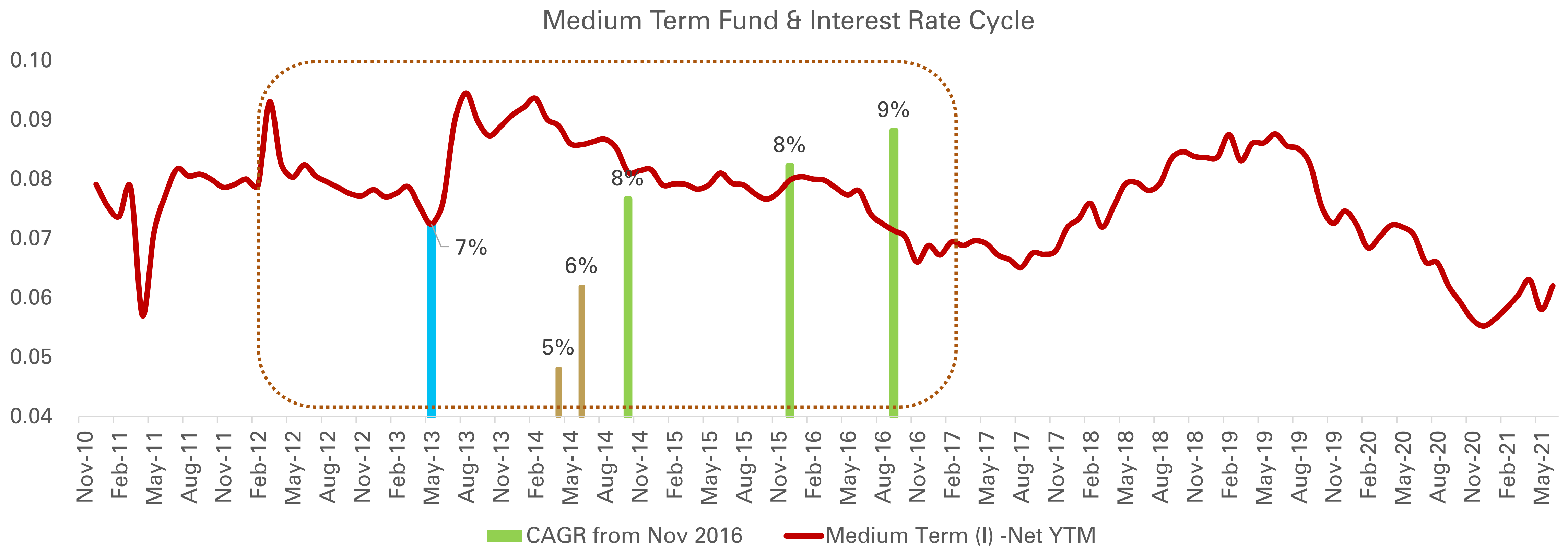
Carry opportunity in 6-8 year bucket



The yield curve is steep. As compared to 1 year yield of close to 4%, 6-8 year yields are close to 6.1-6.4%.

Funds which are targeted towards portfolio maturity 2026-2028 are appropriate for lower risk investors seeking higher visibility of returns over holding period horizon.

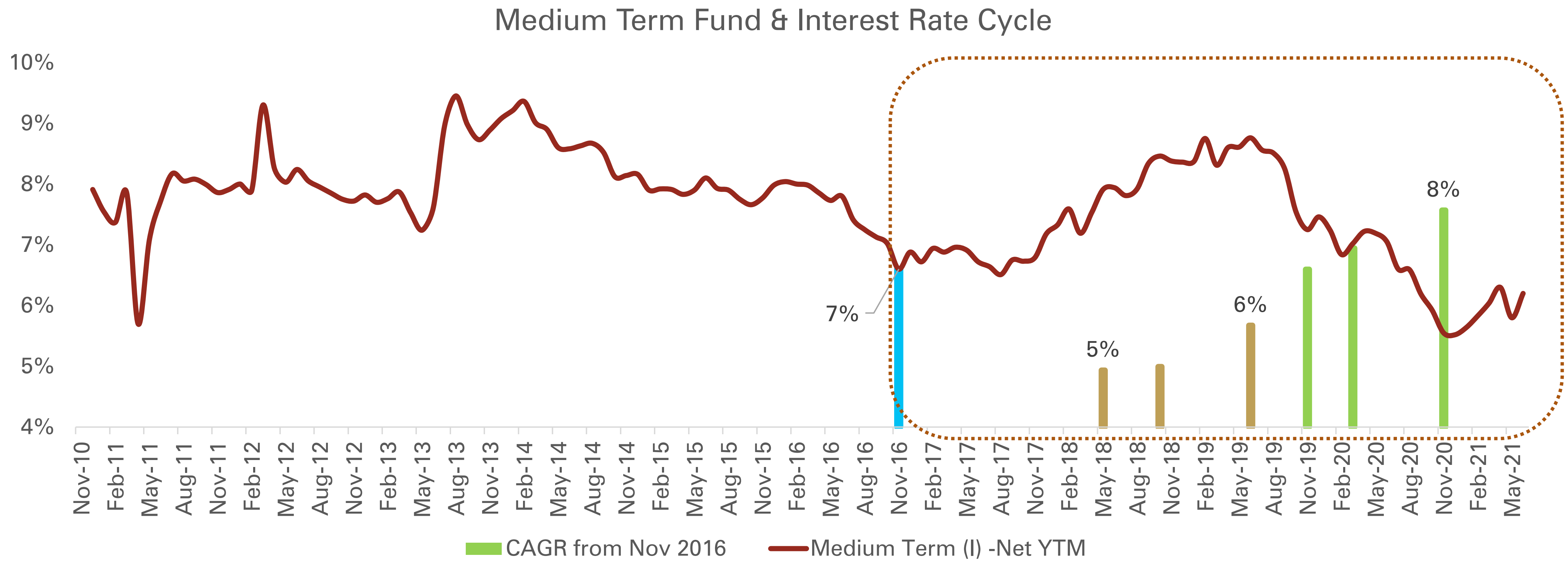
Interest Rate Cycle and Portfolio Return (Chart-I)



Since 2012, interest rates were on gradual decline till May-13, however post that due to Fed taper tantrum, the rates inched up significantly and remained at those levels for almost a year and then started to decline gradually.

Investors who invested at lower yields with investment horizon of more than 3 years were able to significantly outperform Net YTM, as full interest rate cycle played out, despite lower return in short term

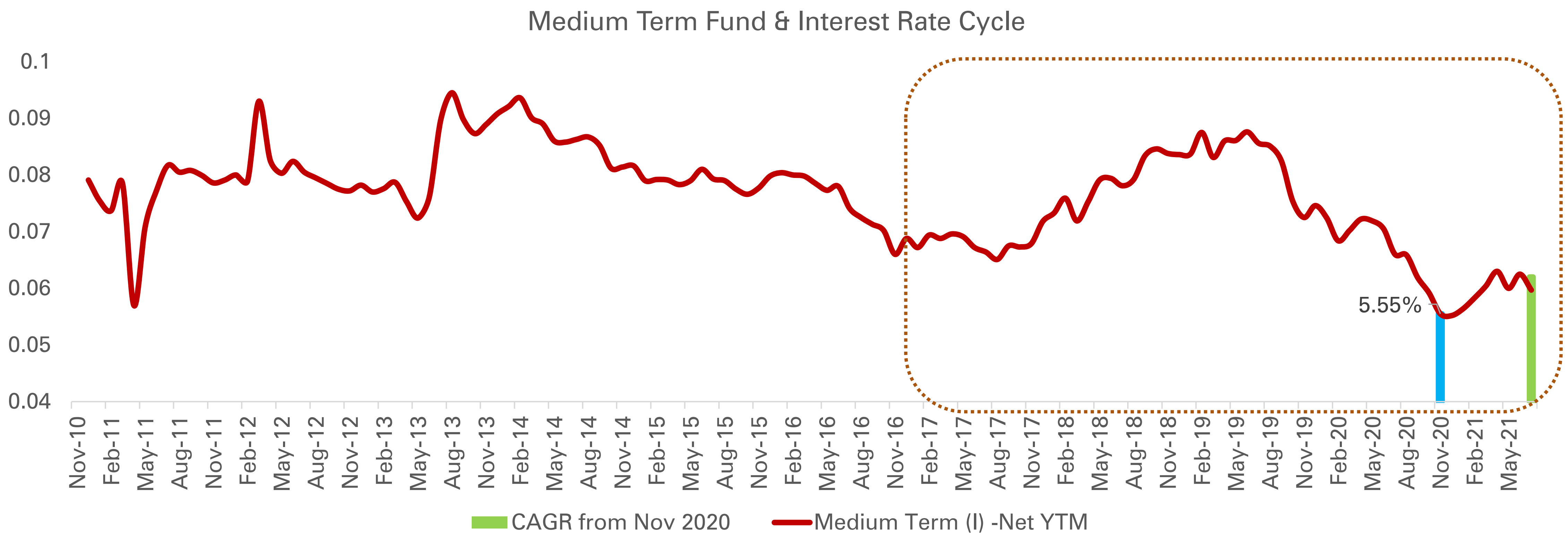
Interest Rate Cycle and Portfolio Return (Chart-II)



Interest rates again bottomed close to demonetization in Nov-16, and started to move up since mid of 2017 and further impacted by downgrades/ defaults in few of the names. Interest rates stared to come down since mid-2019.

Investors who invested at lower yields in end 2016, with investment horizon of more than 3/4 years were able to significantly outperform Net YTM as the full interest cycle played out.

Interest Rate Cycle and Portfolio Return (Chart-III)



While interest rates bottomed out in Nov-Dec 2020, there has been slight upmove in rates since then and has been volatile.

Fixed Income Strategy

MPC Policy has been on expected lines and markets had already begun pricing in a status quo. VRRR increase (variable rate reverse repo) too was on expected lines, though it may not materially move the needle as far as overnight rates are concerned

The MPC continues to remain watchful on growth while the concerns on inflation has increased – next set of inflation data points are key to shaping up policy decision making going forward.

Given low rates & expectation of gradual upward movement in short term yields over time, **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 year): investors can consider Ultra Short Term Funds, Arbitrage Funds & Deposits.

Horizon of more than 3-4 years –

- Prefer funds with reasonable mix of AAA and AA (**medium term portfolios**) which have net yields of more than 5.5%. As highlighted, strategy can outperform the current net yield over 3-4 years, and also 3 year roll down / AAA strategies.
- One can also consider 5-7 year roll down strategies, for investors with horizon of more than 4 years

We reiterate that the experience of last decade is instructive towards the interest rate cycle. After bottoming out, interest rates tend to rise, only to moderate – the overall cycle being 3 to 4 years. Hence, its critical to have a 4-year horizon for longer term investors.

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