From the Desk of Business Head & CIO – Feb 2022

ASK INVESTMENT MANAGERS

You can hear views shared by Mr. Prateek Agrawal - Business Head and CIO, ASK Investment Managers Ltd by clicking on the link:

https://www.youtube.com/watch?v=H61fYT7Yeb4

Mr. Prateek Agrawal

Dear Investor,

In this month's outlook, we would focus on

- Market Outlook given the current geo-political tensions
- Q3 result season gone by and key takeaways
- Volatility expected in the coming period
- Valuations and Market outlook

❖ **Market Outlook given the current Geo-Political tensions between Russia-Ukraine**

- **Earnings impact:** Earnings impact of the crisis is low. Higher crude prices would impact the fiscal till the Government absorbs the increase. Once the retail fuel prices are fully passed on, it would reflect in inflation on the ground and could result in a small decline in consumption. On the positive side, sanctions may cause global players to seek another source for commodities like steel and aluminum where Indian businesses may benefit. High oil prices would benefit the upstream oil companies. Even downstream may see some positive inventory effect (transient).
- **Inflation:** The geopolitical situation could cause further disruption in global supply chains and inflation should be expected to stay higher for longer. This could imply a stronger policy response and liquidity reductions and interest rate increases by the Reserve Bank of India (RBI). We need to see how this situation unfolds. Higher interest rates would imply lower PE valuations for Indian equities.
- **Increased risk perception on higher volatility and valuations:** This is expected in any situation like the present one. Typical investor response would be to get some money back home. This could result in some withdrawals from the funds and some selling pressure. Risk premium goes up in the interim and hurts equity valuations.
- **Selling Pressure:** Russia being a part of Emerging Market basket and sanctions etc. may result in redirecting of funds / withdrawal of funds on sharp underperformance. In case Emerging Market funds witness outflows on expected underperformance (China was having issues and now Russia also), Indian market could also witness selling pressures.

How are the portfolios placed to handle the potential impacts of the scenario?

- Our portfolios are well positioned with a high allocation to defensive spaces like domestic consumption and domestic focused pharmaceuticals.
- Consumption space was in the process of passing on input price increases and should see margins improve sequentially from Q1 or Q2 of FY23. In any case, most stocks are not impacted.
- Pharmaceuticals where there is a significant exposure to Russia should get exemption to continue to export.
- Financials are not impacted materially on account of this event.
- Manufacturing supply chains are also not impacted.

What changes are being made on a portfolio level?

- As explained above, there is little direct impact as yet while the situation is still evolving.
- We have always been focused on good quality space and the correction in this space is offering us a great entry point. We are using this to build portfolios for our clients.
- We believe that the dip is on account of higher risk perception and normalization of the same should result in markets regaining their levels with valuation related adjustments.

Which sectors/ companies could be impacted?

- The impact could be limited. Consumers could see longer input price pressures while commodity businesses may benefit on account of higher prices for longer. However, we do expect this impact to reverse quickly as the situation normalizes, as it should over the next fortnight or so.

❖ Q3 FY22 Result season

Q3 FY22 result season was in line overall while there were more misses than hits. Overall post the result season the outlook on FY22 and FY23 EPS has remained more or less unchanged. IT, Financials, Discretionary, and Telecom spaces delivered better than expected numbers. Metals again provided the sharpest profit growth. Consumer staples, healthcare, downstream oil and city gas, and cement delivered lower than expected results. Higher commodity prices did result in margin impact for users. While the users did increase end-product prices, yet it will take another quarter or two to fully pass on the input price increases.

Overall, our universe delivered a PAT growth of 22% vs 25% for Nifty. For 9 months, Nifty delivered a PAT growth of 45% vs 48% for broader universes. Ex-commodities (metals and oil and gas) NIFTY delivered a PAT growth of only 12% and the broader universe delivered 13% PAT growth. This quarter has seen the broader universe see lower profit growth vs Nifty mainly on account of margin pressures. For the broader universe, sales growth has been 28% while EBIDTA growth has been only 12% and PAT growth has been 22%. Ex-financials, margins dipped by 2.5% on a YoY basis. Since the broader universe numbers are weaker than that of Nifty, it is causing the breadth of the market to fall and we would need to watch this. On a two-year basis, the earnings growth is a healthy 27.5% for the universe.

After the result season, the earnings outlook has remained broadly unchanged for FY22 and FY23. However, there has been some negative impact in higher pe sectors like consumers apart from Autos and metals while outlook has improved a tad for Oil and gas and BFSI, both lower PE sectors barring one off names. This change in profit drivers is expected to cause a pressure on Index valuations, a point that we have been noting.

❖ Expect volatility going forward

There is a confluence of many factors some of which we try and analyze as below

- **High inflation, Liquidity reductions and Interest rate increases in the West and in India**:
  Inflation has been a big worry. In the beginning it was thought to be transient, but it is proving to be more enduring and sharply higher than tolerable range and in many areas at multi decadal highs. The rate of interest rate increase expectations are going up sharply. The next period should see end of QE and start of FED increase in interest rates which are expected to be steep ~5 to 7 in 2022. From June Federal Reserve balance sheet would start to shrink by USD100bn a month as securities mature.

  This would be followed by many other countries. India too could see repo rate increases as G-Sec yields have moved up while repo rates have not. Increase in yields do cause currency volatility leading to stock market volatility as offshore participants take defensive action.

Source: ASK IM Research, Bloomberg

Moreover, for earning yield to bond yield valuation matrix, in the absence of upward earnings surprises, price would have to adjust downwards. Inflation can get controlled as logistic costs reduce. This should happen as covid is fast normalising. RBI is guiding for CPI inflation to soften to 4% vs 6% now. If inflation comes back in range, the interest rate increase expectations and the pace of interest rate increase could reduce. However, the current expectations do raise concerns of impacting growth. Moreover, post elections in 5 states, Oil price increase is expected to be reflected in fuel pump prices which will seep through the system. Hence, before reducing, there are chances of further increasing inflation in India.

- **Geopolitics around Ukraine and high oil prices:** Crude prices have already breached USD100, seeing a sharp jump from USD75/bbl just a quarter back. Crude is the largest component of Indian import basket and a USD 1 increase in crude price is over a Bn USD extra cost to India. In the current period, the situation seems worsening. Sanctions may be around the corner disrupting normal trade. However, we do expect normalization of geopolitics over next few months and crude to recede. However, sentiment in the market till the Ukraine situation is resolved is expected to stay negative.
- **Higher margin requirement in Indian F&O market**: This change in rule that is happening from Mar1 would imply that participants in the derivative markets have to shell out more cash for margins. This can be brought from savings in banks and other places or from selling stocks already owned, getting financing or maybe by reducing exposure itself. Most of these would result in some selling pressure on the market. This happened in October as well and could very well repeat and some volatility should be expected on this count as well.
- **Election results in the 5 states i**n the context of K shaped recovery where a section of population has not yet participated in growth. I do believe that the election results would be followed closely as a prelude to general elections which would come in 2024. Government policy making should stay positive and growth oriented to reduce the stress that weaker sections are facing.
- **Large LIC IPO hitting the market**: A large IPO does suck out liquidity that could otherwise have gone to secondary market and maybe also induces fully invested fund managers to sell a part of their portfolio to make allocation for the new large issue. This does cause secondary market to move sideways for some time. However, if the issue gets a good response and investors make some gains, it could result in positive sentiment. This IPO is getting new investors into the market and overall retail participation may increase even further. The reverse is true as well.

On all the above points there is an expectation that is already built into the stock market and the outcomes could cause movements on both sides. Hence, we do expect the next period to be volatile and overall, mostly sideways to down.

Growth in earnings and valuations are two factors that ultimately decide the market outcomes. Earnings outlook still looks strong though coming from more commodity sectors as observed earlier.

❖ Valuations & Market Outlook

Valuations continue to be higher than historic valuations. Nifty still is trading at a forward PE of over 19.5 @ a 6.5%/19% premium to 5yr/10yr average, down 2% vs year beginning. While changes in index composition during this period makes the longer term comparison less relevant it still leaves scope for some valuation correction. If 5 year average valuations hold, then NIFTY should see a level of 18500 over the next 1 year, delivering just about double digit returns. A low probability event is Nifty edging towards its 10 year average which could mean a close to 0 return year for NIFTY. Hence, overall, in terms of market direction, I continue to maintain that we should expect returns less than earnings growth to account for some valuation correction. This is also since earnings momentum is more seen in spaces where PE valuations are lower.

Nifty target on past 5-year averages	Nifty target level
Nifty PE of 18.6X	18493
Bond yield to Earning yield gap of 128bps	18386
PE prem to EMs	18548
PE prem to Asia-ex Japan	18547
Average	**18493.5**

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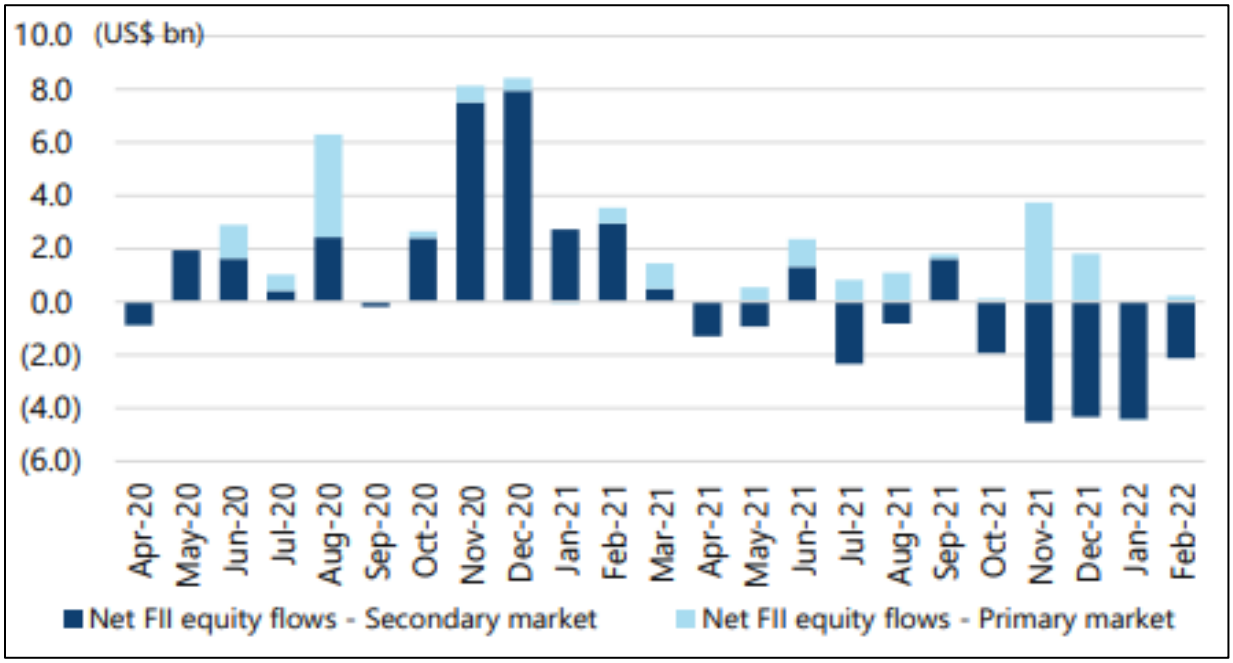
This year could be a year of two halves. In the first half commodity price inflation would cause margin stress while users increase finished goods prices to account for cost push. In the second half, as commodity prices decline, the opposite could be true. Investing themes remain the same for growth investors and include:

- Beneficiaries of China +1: Chemicals, bulk drugs and textiles
- PLI beneficiaries mainly in electronics
- Unorganised to organized beneficiaries in diagnostics, jewellery, footwear segments
- Beneficiary of focus on work from anywhere: IT and Internet businesses
- Financials would benefit from higher interest rates and higher margins

Some of these themes would be tested as the world normalizes post covid. Lower commodity prices should help our focus areas while higher competition from unorganized could hurt consumption. We are staying focused on the long term with best quality businesses which have a great compounding potential and believe this is the best manner to benefit from any volatility. Presently intense selling pressure is seen from one segment of market participants, the FPIs.



Source: ASK IM Research, Bloomberg, NSDL

Stocks where their presence is strong are underperforming other spaces where domestic presence/interest is higher. However, as the selling pressure declines, the same stocks can bounce back quickly as quality and growth thesis stays intact. Most of the uncertainties that we have talked about would find their answers over the next one month and uncertainty would reduce. Building a high-quality portfolio on dips like the present one should prove to be a good strategy.

Happy investing!

Wish you a Very Happy New Year

Mr. Prateek Agrawal

Business Head and CIO, ASK Investment Managers Ltd

Update on ASK India Select Portfolio – Feb 2022

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Investment Approach Update:

Global markets turned volatile during the month driven by various adverse events, geopolitical tension in Europe, risk of inflation sustaining higher for a period, sustained supply chain issues and its implied impact on global demand has kept all financial markets on the edge.

While the Q3FY22 earnings season was largely in line with estimate, margins continued to remain under pressure with management comments indicating inflationary pressure to remain high for next few quarters. The escalation in geopolitical situation in Europe points towards further disruption in input costs and sustained supply chain bottlenecks.

On the portfolio performance front, the benchmark index BSE500 ended lower by ~4.1% in INR terms with our portfolio outperforming the benchmark. The key outperformers during the month were Britannia Industries Limited, Dabur India Limited, Divi's Laboratories Limited, Titan Company Limited and PI Industries Limited while the key underperformers were HDFC Life Insurance Limited, Dalmia Bharat Limited, AU Small Finance Bank Limited, ICICI Lombard General Insurance Limited and ICICI Bank Limited. On the portfolio action front, we have increased weight in Sona BLW Precision while trimming weight in Vaibhav Global.

The evolving geopolitical situation has increased uncertainties. The current escalation in war implies inflation will remain higher for a period of time and global demand may get impacted. On the positive side, the rabi output is expected to be better than kharif implying pickup in demand towards the end of Q4FY22 and Q1FY23.