Morningstar Managed Portfolios – Insights

Markets Observer

Data as of July 18, 2022

Morningstar Investment Adviser India
July 2022

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Markets Overview

Market dashboard – Equities and commodities

Global equity markets have witnessed high volatility in 2022 owing to an uncertain macro environment. Economies recovering from the pandemic were dented by a further disruption in global supply-chains driven the Russia-Ukraine geopolitical tensions and high commodity prices which fanned the inflation surge further. Faster monetary tightening by major central banks to arrest inflation which is at multi-decadal highs, its spillover effects on other economies and the zero COVID policy by China has raised concerns over a slowdown in global growth. The tech-heavy NASDAQ 100 has underperformed the S&P 500 by a fair margin as valuations for the former were stretched. Over the last decade, EM index trailed DM index, with Indian equities underperforming U.S. equities. Crude oil prices have corrected sharply from its recent peak on concerns over slowing global growth and tepid demand from China. Gold has corrected owing to strength in the dollar index amid expectations of faster tightening and rise in U.S. Treasury yields.

	Returns (%) (INR)						Fundamental Measures
	CYTD	3 Mo	1 Yr	3 Yrs	5 Yrs	10 Yrs	P/E
Indian Equities							
S&P BSE 100	-4.69	-5.21	3.99	13.94	11.78	13.83	21.63
S&P BSE Mid cap	-6.40	-5.89	1.51	18.67	10.15	15.56	21.52
S&P BSE Small cap	-10.91	-10.35	-0.43	25.69	11.57	15.86	-
S&P BSE 500	-5.66	-5.68	3.22	15.64	11.78	14.38	21.94
Indian Fixed-income							
CCIL Tenor 5-10 yr	-1.58	0.45	1.18	5.30	6.50	8.05	
Global Equities							
Morningstar EM Index	-11.87	-6.29	-17.51	6.59	6.74	7.82	10.55
Morningstar DM Index	-13.84	-8.42	-7.95	12.34	12.30	14.15	15.50
S&P 500	-12.80	-8.14	-3.64	15.95	16.18	17.22	18.44
NASDAQ 100 TR USD	-21.35	-10.26	-12.58	21.34	21.35	21.99	22.01

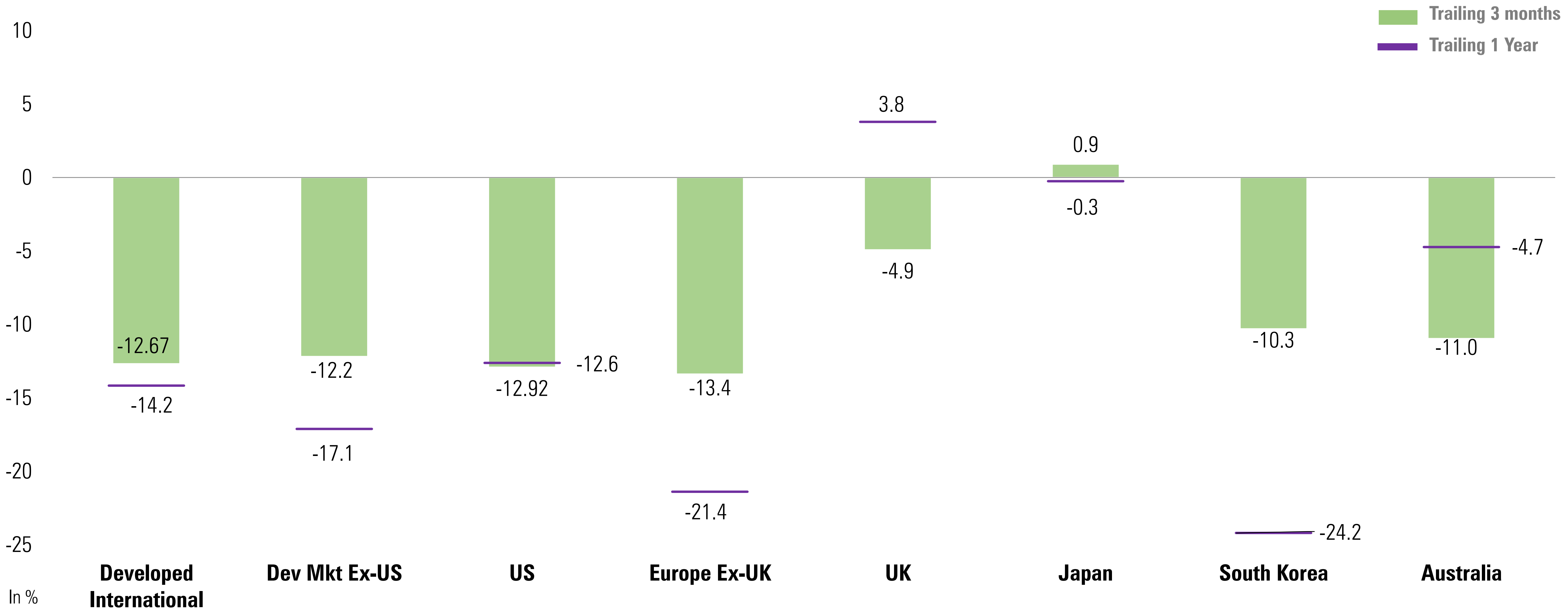
Commodity	Returns (%) (USD) Price	CYTD	3 Mo	1 Yr	3 Yrs	5 Yrs
Crude Oil-Brent ($/Barrel	106.27	37.58	-4.11	42.72	20.50	17.26
	Returns (%) (USD)					
Gold (₹/10 gms)	1,723.65	-5.30	-12.53	-5.40	6.64	6.85

USD Billion FPI flows	3-M	6-M	1-Yr
Equity	-15.25	-28.98	-32.97
Debt	-1.63	-2.38	-0.58
Domestic Flow:	16.25	30.02	42.83

Returns are as of July 18, 2022. Returns of more than 1-year time period are annualized. Fundamental measures are latest available numbers as of July 18, 2022.
Source : Morningstar Direct, BSE, NSE, us.spindices.com, LBMA, EIA

Developed market performance – U.K. and Japan lead the pack

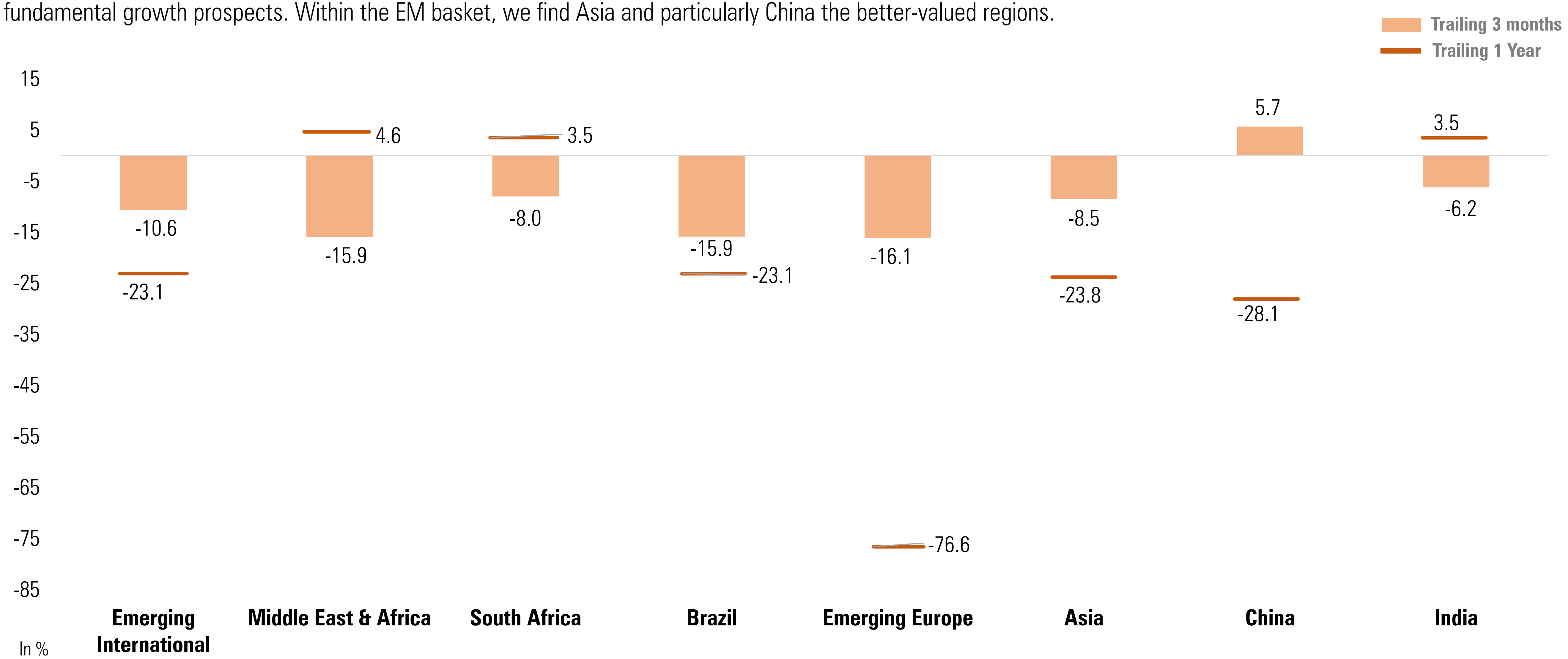
Japan and United Kingdom equites outperformed their developed market peers over the past three months. Japanese equities have outperformed owing to lowering of COVID-19 restrictions and continued accommodative monetary policy by the BoJ to support growth contrary to tightening by major central banks. Outperformance of U.K. equities has been due to relatively attractive valuations, and a high exposure to commodity producers and financials which tend to benefit during times of rising rates. European equities have been weighed down owing to high energy prices, concerns over disruptions in gas supplies and rising expectations of tightening by the ECB. From a valuation lens, European, Japanese and U.K. stocks offer a better reward for risk than U.S. equities which seem relatively expensive from a valuation perspective.



Morningstar Indexes. Returns are in Local currency terms. For country groupings, the returns are in US dollar. Returns are as of July 18, 2022.
Source : Morningstar Direct

Emerging market performance – Chinese equities see some respite

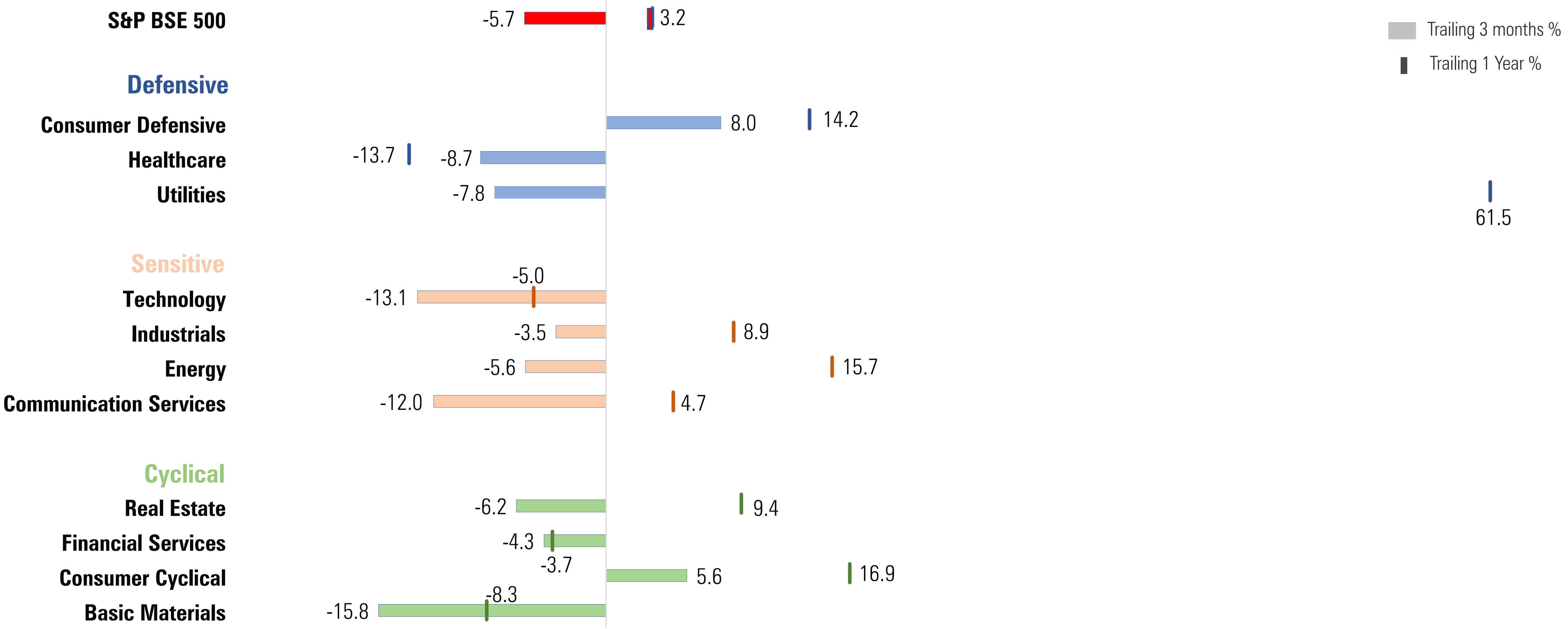
Emerging market equities have outperformed their developed markets over the last three months. Chinese equities have outperformed their EM peers. Chinese equities saw a relief rally recently amid relaxation of COVID-19 restrictions, supportive measures by the central bank and expectations of additional fiscal measures. Chinese equities have faced headwinds over the past year owing to regulatory crackdowns on the tech and real estate sectors, and a zero COVID-19 policy. Indian equity markets have outperformed most peers over the last year due to a quicker-than-anticipated recovery in economic activity, accommodative monetary policy and the long-term fundamental growth prospects. Within the EM basket, we find Asia and particularly China the better-valued regions.



Morningstar Indexes. Returns are in terms of Local currency. For country groupings, the returns are in US dollar. Returns are as of July 18, 2022.
Source : Morningstar Direct

Domestic sectors performance – FMCG and auto stocks outperform

Consumer defensives and consumer cyclicals outperformed the broader market during the last three months. Within consumer defensives, HUL and ITC have delivered wholesome returns, while Mahindra & Mahindra and TVS Motors have outperformed within the consumer cyclicals pack aided by a fall in industrial metal prices and easing supply-side concerns. Technology stocks were weighed down due to concerns over valuations amid slowing growth and a sharp increase in employee costs. Metal stocks have seen a sharp correction owing to concerns over slowing global growth and subdued demand from China. Over the near term, commodity prices, demand-supply dynamics and pass through of input costs and its potential impact on discretionary consumption, would weigh on corporate earnings.



Source: Morningstar Direct.
Morningstar sector classification. Performance as of July 18, 2022. Sectoral performance of S&P BSE 500 TR Index.

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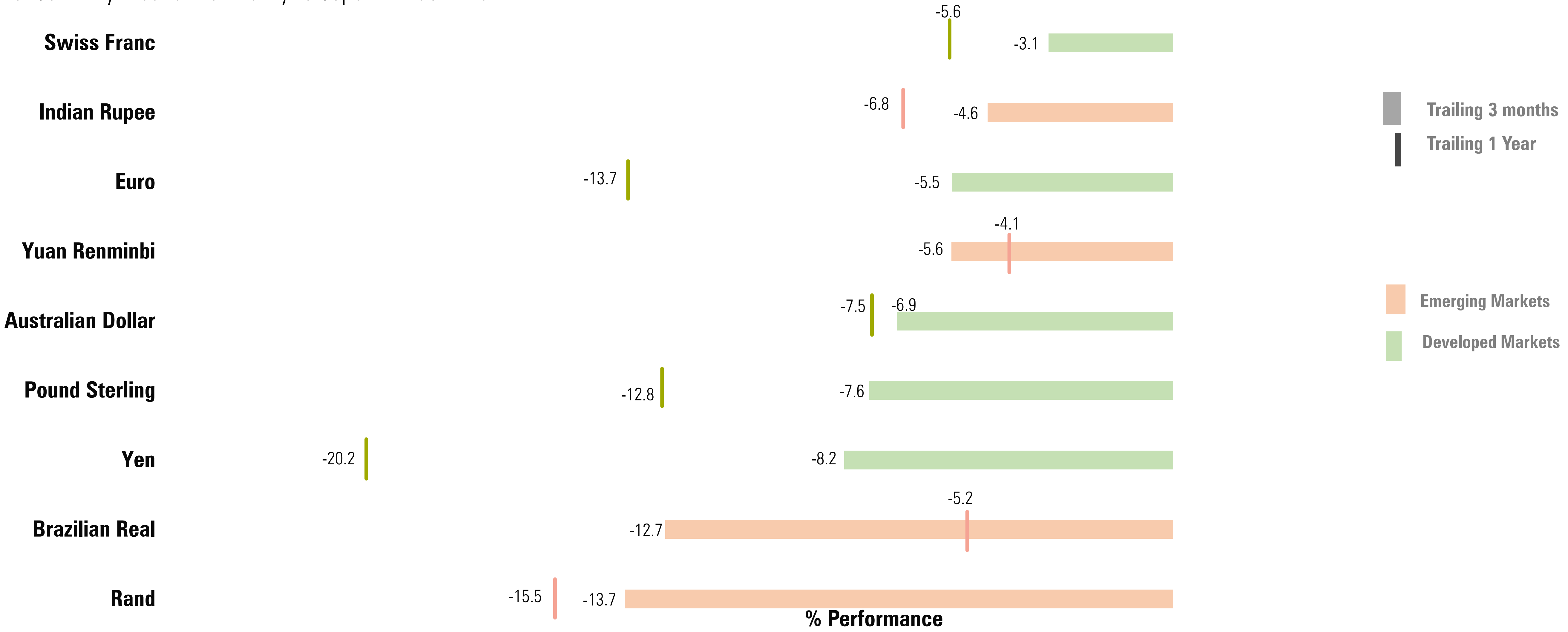
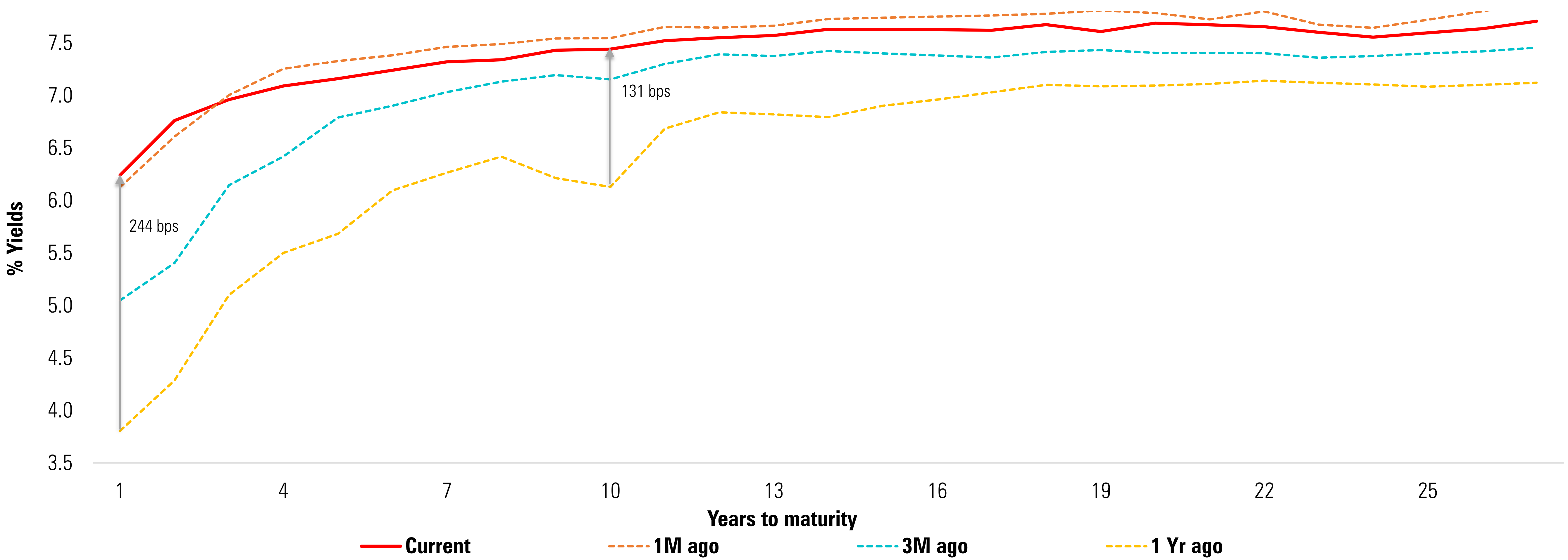
US dollar index soars to near 20-year highs

The U.S. dollar has outperformed most currencies in the last one-year period, rallying sharply amid expectations of aggressive tightening by the U.S. Fed to tame inflation which has risen to multi-decadal highs. The rupee's fall vis-ß-vis the dollar has been cushioned by RBI's intervention in the spot and forward markets. The Euro, Pound Sterling and Japanese Yen have fallen drastically vs the dollar owing to a widening interest rate differential relative to the U.S., as they have maintained an accommodative stance contrary to aggressive tightening by the U.S. Fed. Europe and U.K. have high dependence on Russian energy supplies and recent sanctions have increased uncertainty around their ability to cope with demand.



India G-sec yield curve

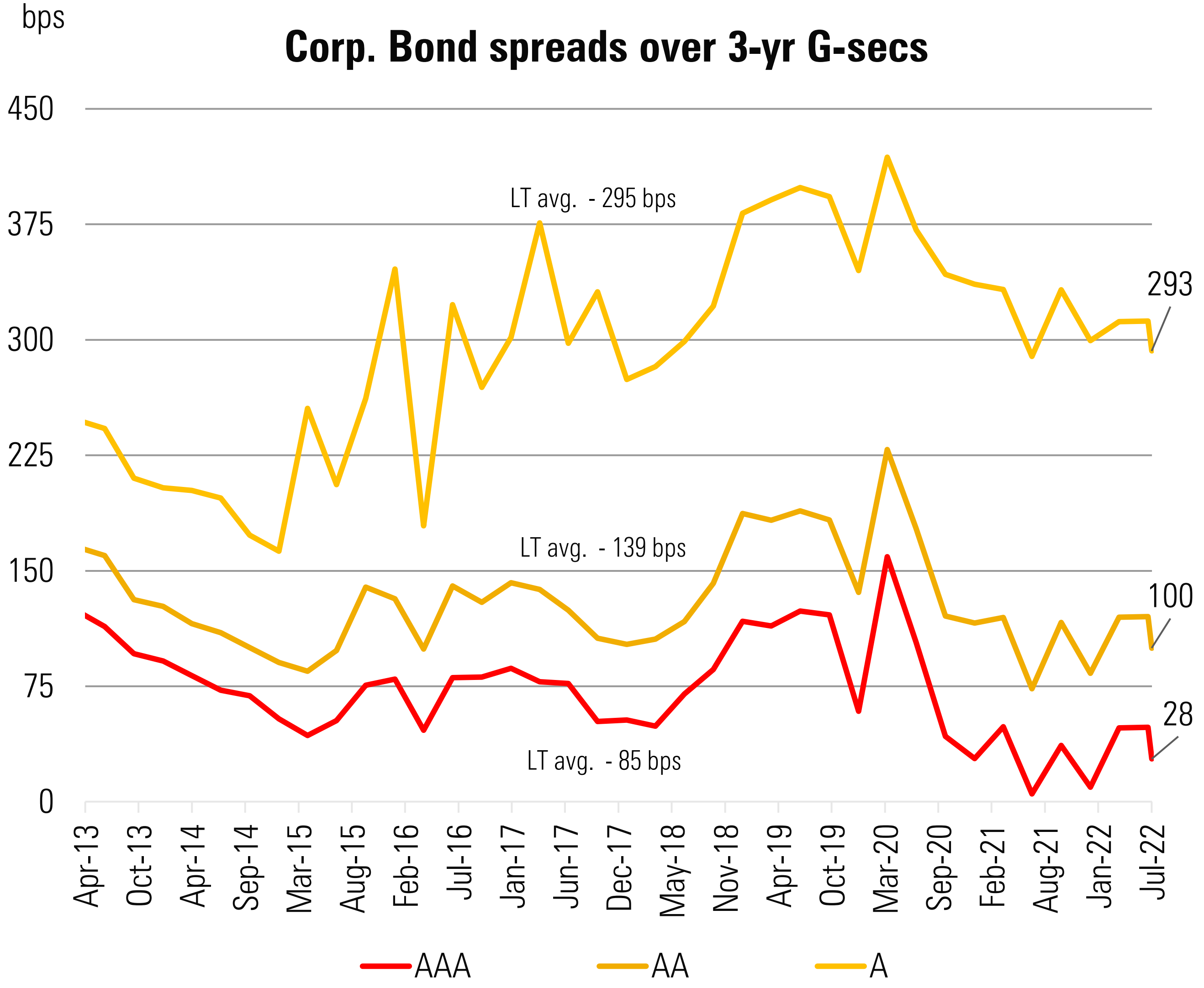
The yield curve has shifted upwards meaningfully in the last one-year owing to tightening measures by the RBI, high commodity prices fanning concerns over inflation and tracking the rise in U.S. Treasury yields amid concerns over aggressive tightening by the U.S Fed to tame the persistently high inflation. The RBI has been focused on 'orderly evolution' of the yield curve and has not yet intervened via operation twists or OMOs to manage the curve like it did earlier last year. In the last one month, yields have cooled-off a bit recently owing to a sharp slide in global commodity prices, with crude oil too seeing a meaningful correction. Based on our valuation implied return framework, the medium-to-long term debt segment (5-10 years maturity) looks relatively attractive than cash and high credit quality short term debt, given the high real term spread (10-yr G-sec vs 3-m T-bill) which is currently ~2.1%, higher than its long-term average of 1.5%.

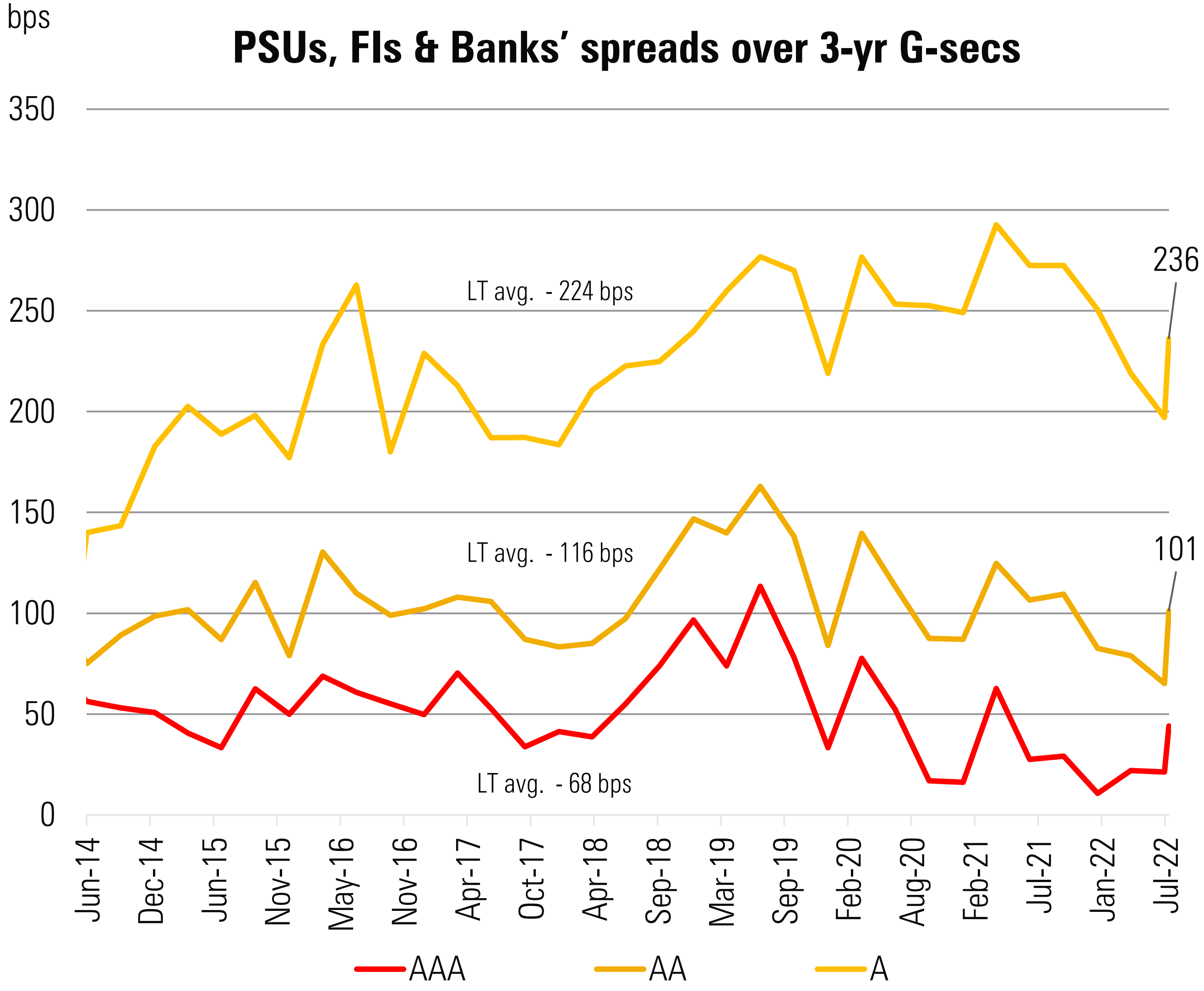


Source: FIMMDA. Data as of July 18, 2022

Bonds spreads continue to remain subdued for corporates

Corporate bond spreads (for AAA and AA securities) have seen some uptick in the YTD period but continue to remain lower than their long-term historical averages amid tepid issuance (FY22 was the lowest in 6 years) and sustained demand. Spreads on bonds of PSUs, FIs & Banks too have witnessed an uptick during the same period. Based on our valuation-implied return forecasts, the short-term debt segment (3-5 years) for AA & below rated corporate bonds continues to look more attractive than the corresponding G-sec segment.



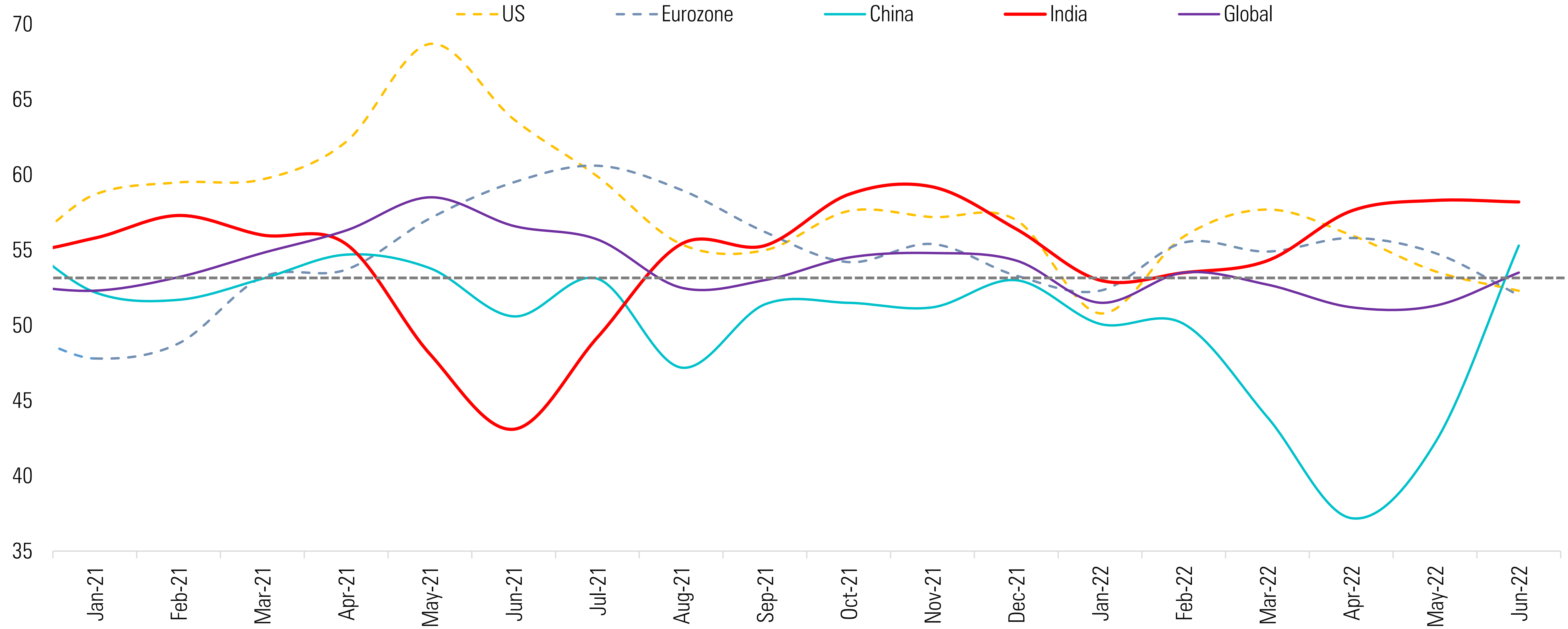


Source: FIMMDA. Spreads are as of July 12, 2022
Long term average spread for AAA and AA segments is based on data since January 2010, and those for other segments is based on data since April 2013.

Economic Indicators

Global Composite PMI – Business activity (ex-China) impacted by weakening demand

Global business activity growth (excluding China) witnessed some moderation in June, amid the impact of inflation on consumer spending and concerns over global recession with aggressive tightening by most central banks. New order growth eased to a near two-year low, global trade declined and business confidence slumped to its lowest since September 2020. China has witnessed a revival in activity on the back of some relaxation in COVID-19 restrictions. The rates of increase for input costs and output prices eased to the lowest relative to that at the start of the year. Going ahead, global business activity would be impacted by level of commodity prices, supply-chain pressures and evolving demand situation amid a slowing global economy following tightening by major central banks.

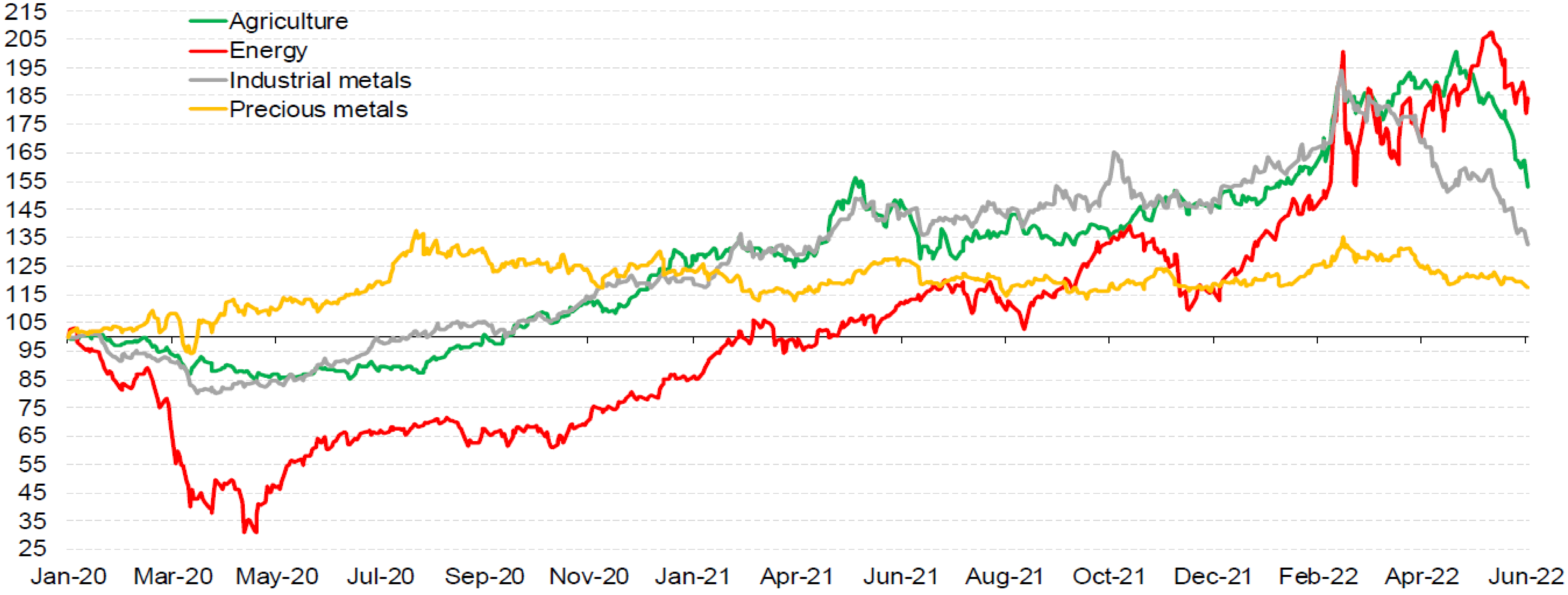


Source: Composite Purchasing Managers' Index (PMI) – Markit Economics

Commodity prices have seen some moderation recently

Global commodity prices have seen some moderation since May, owing to lockdowns in China – a major importer and on concerns over weakening global demand amid the backdrop of faster-than-anticipated tightening by central banks. Crude oil prices are down ~25% (as of July 18, 2022) from their peak in March 2022, while base metals, precious metals and agricultural prices are down over 20% from their 52-week highs. The moderation in commodity prices is likely to assuage concerns over the unwaveringly high inflation.

GSCI commodity prices, indexed at Jan'20



Source: Bloomberg, Axis Bank Research

Inflation trend and Policy rates

Inflation in the advanced economies is at multi-decadal highs printing much higher than the target inflation rate of most central banks. Recovering global demand amid huge fiscal and monetary stimulus, followed by the spill-over effects of the Russia-Ukraine war which impacted global supply-chains have resulted in this inflation surge. Major central banks have been behind the curve having earlier estimated it to be 'transitory' and have resorted to aggressive tightening recently to tame the surging inflation raising concerns over a potential recession. The RBI was initially focused on nurturing growth, given the rise in domestic inflation was not much severe relative to its target rate. However, it has recently jumped into action in response to a higher-than-anticipated spike in inflation owing to the impact of persistent geopolitical tensions and recovering demand.

Below target by more than 0.5% | Within +/- 0.5% of target | Above target by more than 0.5%

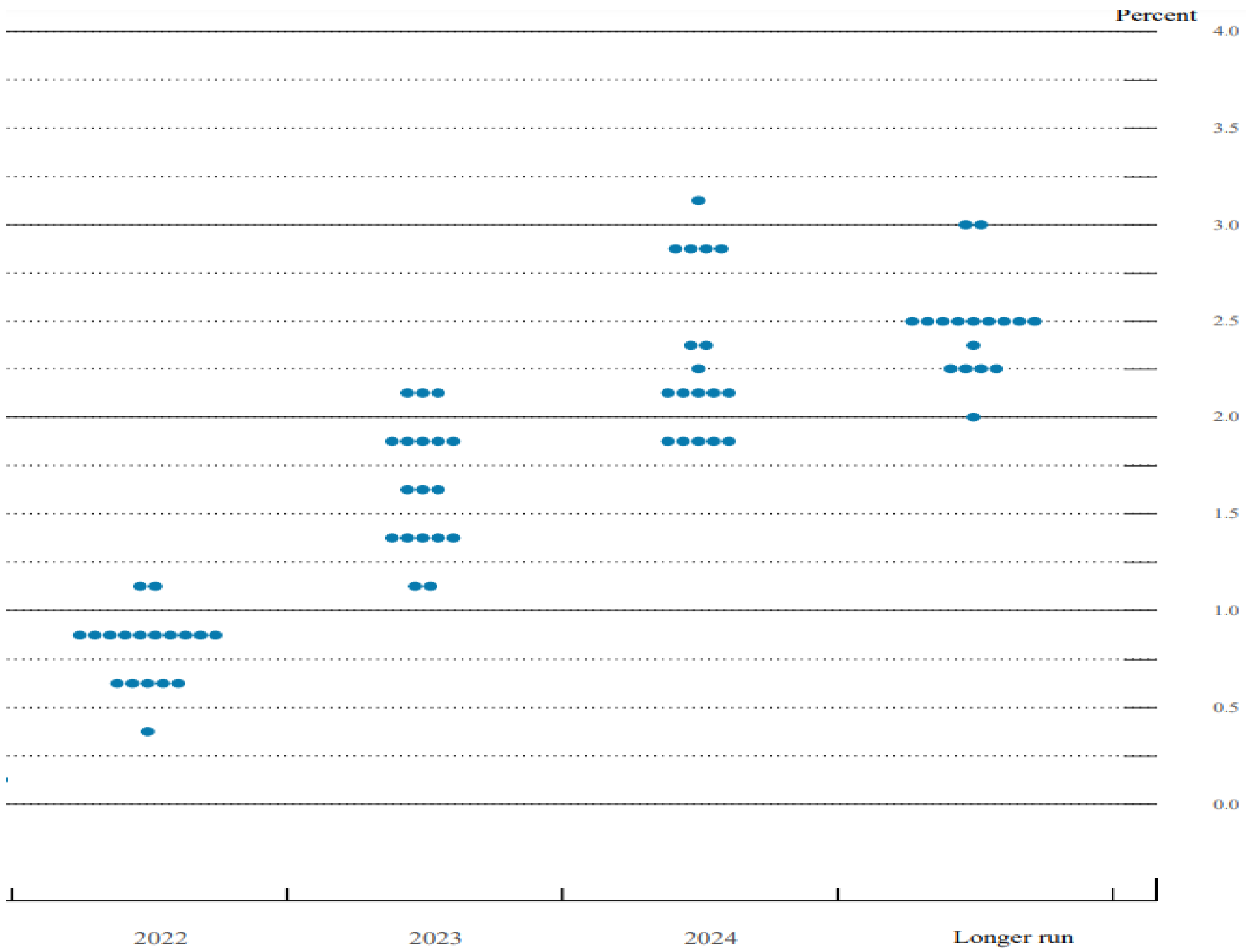
Country	Monthly Inflation Trend (Year-on-Year change)													Central Bank Inflation Target	Key Policy Rate
	Jun-21	Jul-21	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22		
US	5.4	5.4	5.3	5.4	6.2	6.8	7.0	7.5	7.9	8.5	8.3	8.6	9.1	2.0	1.50 to 1.75
UK	2.5	2.0	3.2	3.1	4.2	5.1	5.4	5.5	6.2	7.0	9.0	9.1	9.4	2.0	1.25
Euro Area	1.9	2.2	3.0	3.4	4.1	4.9	5.0	5.1	5.9	7.4	7.4	8.1	8.6	2.0	0.0
Japan	0.2	0.2	0.4	0.8	0.9	1.5	1.7	0.8	0.9	1.2	2.5	2.5	2.4	2.0	-0.1
China	1.1	1.0	0.8	0.7	1.5	2.3	1.5	0.9	0.9	1.5	2.1	2.1	2.5	3.0	3.70
India	6.3	5.6	5.3	4.4	4.5	4.9	5.6	6.0	6.1	7.0	7.8	7.0	7.0	4.0	4.9

Inflation US (CPI), Euro Area (Harmonized Index of Consumer Prices), rest all are CPI inflation. Central Bank policy rates used here are : Federal funds rate - Federal Reserve (US), Main refinancing rate - ECB (Eurozone), Official bank rate - BOE (UK), Policy rate on the aggregate balance of all financial institutions' current account at BOJ (Japan),One Year Lending Rate - People's Bank of China, Repo Rate - Reserve Bank of India

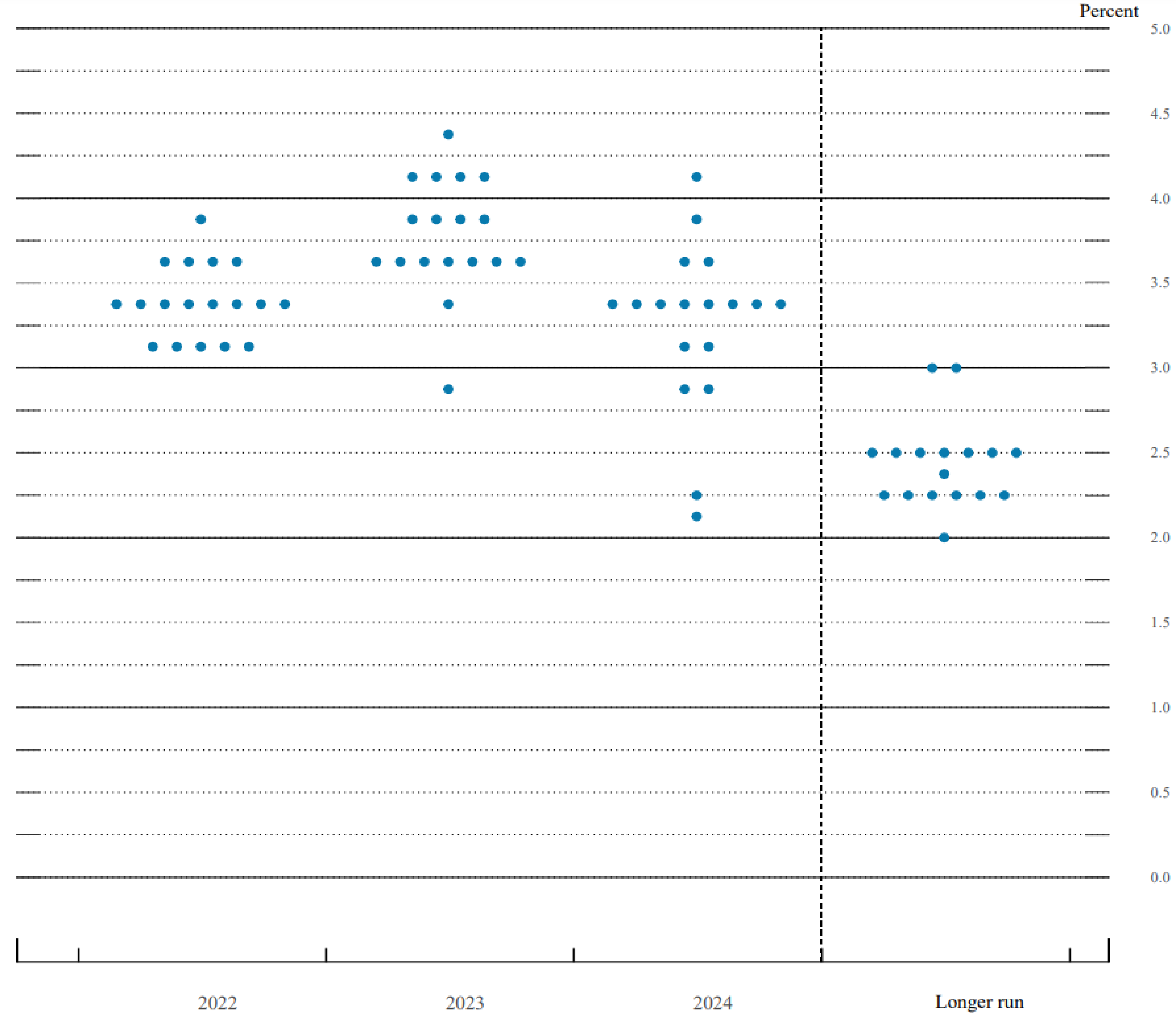
U.S. Fed dot plot indicates tighter conditions to persist till 2023

Persistently high inflation print has led to Fed officials re-assessing their expectations of policy rates. The dot plot indicates the significant upward shift in expectations of monetary tightening in the near term given inflation has been far from 'transitory'.

Dec-21



Jun-22



Source: U.S. Federal Reserve

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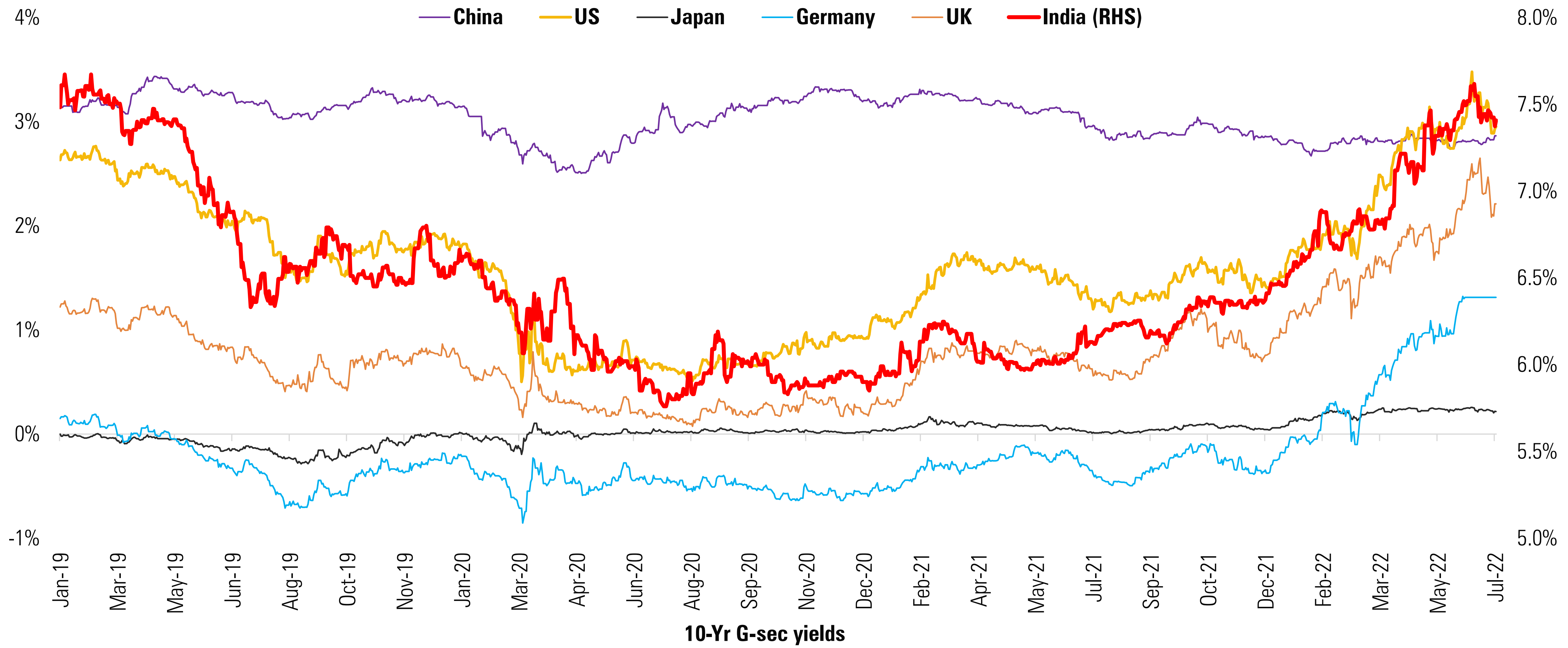
High inflation has nudged central banks to hike rates

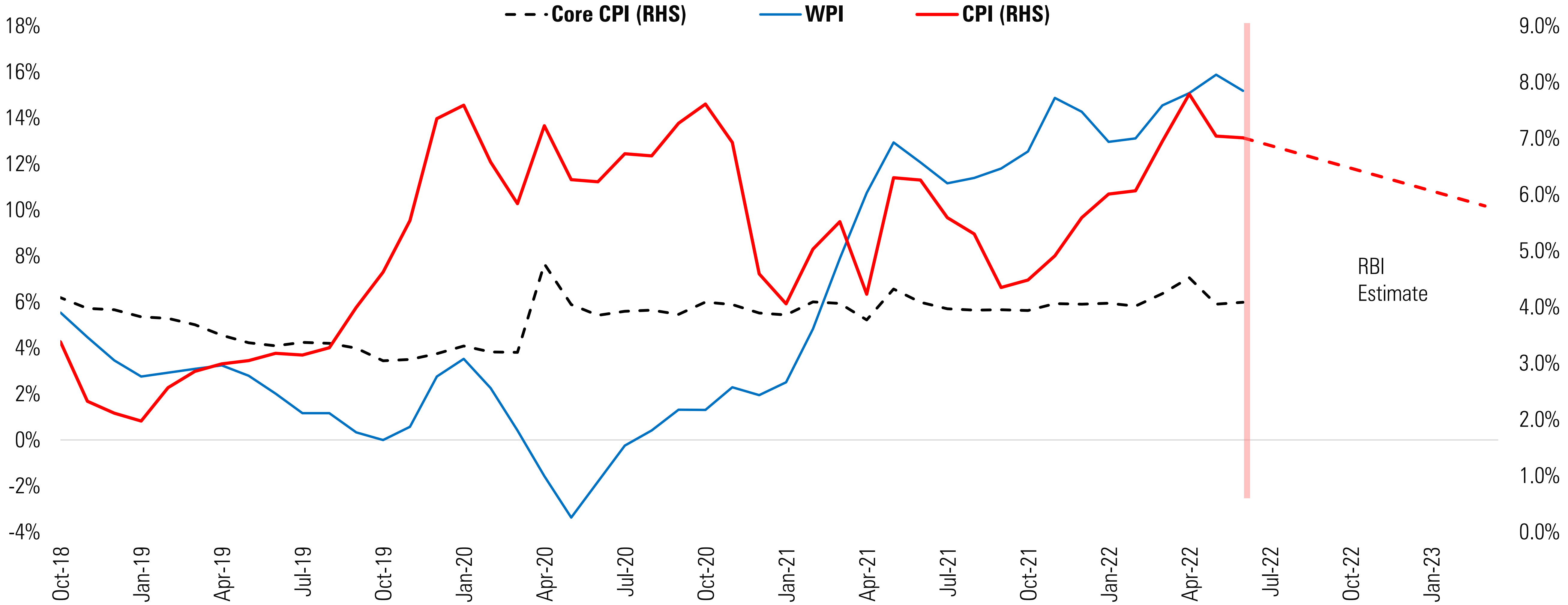
Contrary to expectations of being transitory, inflation in most major economies has persisted for long amid high commodity prices and supply-chain disruptions with economic activity gathering pace. Bond yields have shot up sharply recently on expectations of aggressive tightening by major central banks, with spillover effects seen on bond yields in emerging markets. Bond markets are now pricing in multiple rate hikes over the next year, with the U.S. Federal funds rate expected at around 3.50 to 3.75% by 2023 end. China has witnessed some easing in bond yields over the last one year, amid supportive measures by its central bank to aid its slowing economy.



Source: Investing.com; Data as on July 05, 2022

Gap between WPI and CPI points to inflationary pressures

Retail headline inflation stood at 7.01% in June, printing above the upper end of the RBI's tolerance band of 2% to 6% for the sixth straight month. Food & beverages inflation, which accounts for nearly half of the CPI basket stood at 7.56% led by inflation in vegetables (17.37%) and fuel & light (10.39%). Core inflation was stable at ~6%. A cut in excise duty on petrol and diesel helped ease the pressure on the inflation print. Going ahead, a pass through of input costs to consumers could nudge inflation higher. A good monsoon boosting agricultural output and the recent correction in commodity prices (which have moderated recently) could help alleviate inflationary pressures and provide room to RBI to gradually withdraw accommodation. WPI inflation continued to print in double digits and has softened to 15.18% in June from 15.88% in May. Inflation appears to have peaked out and is expected to trend lower aided by a fall in global commodity prices and slowing global demand.

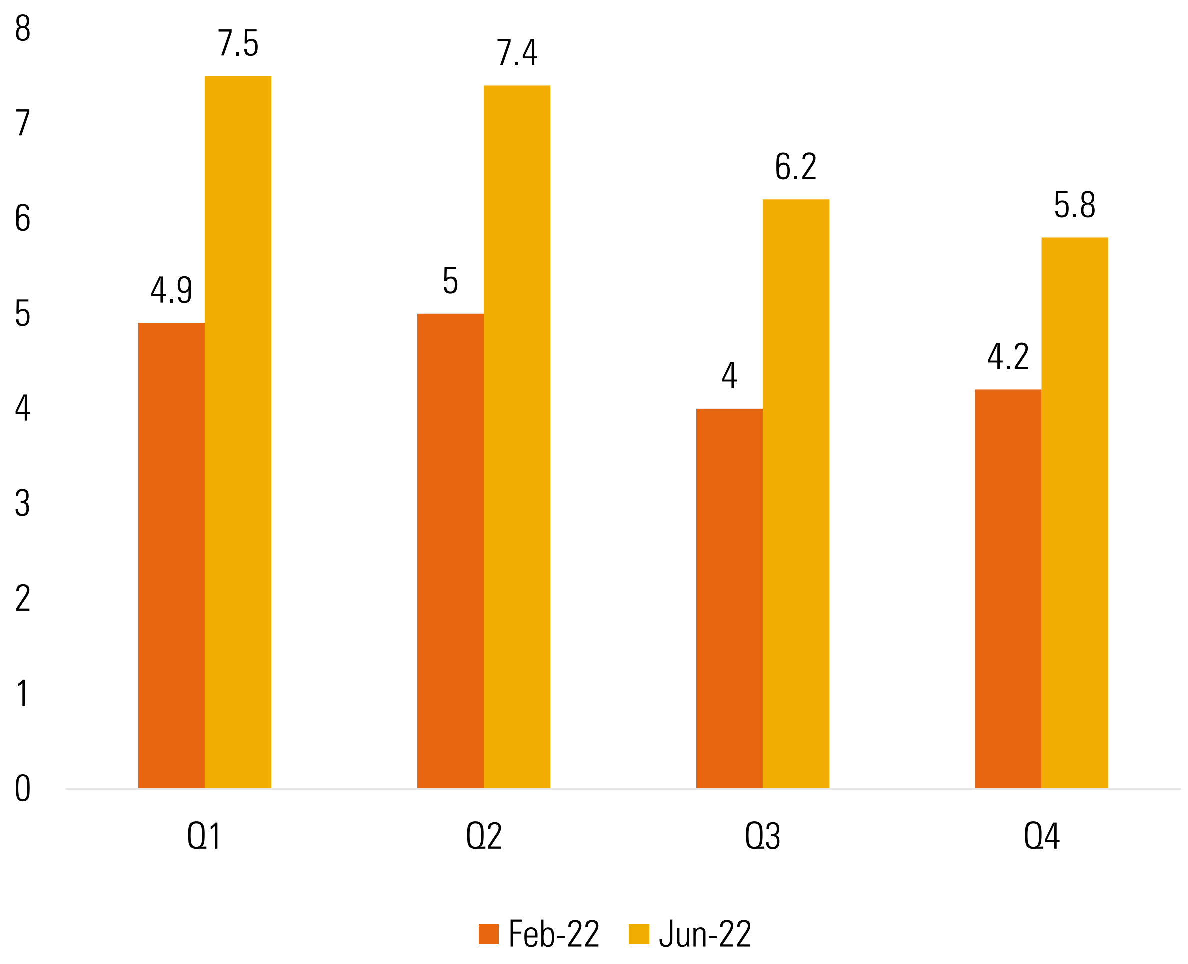


Source: MOSPI

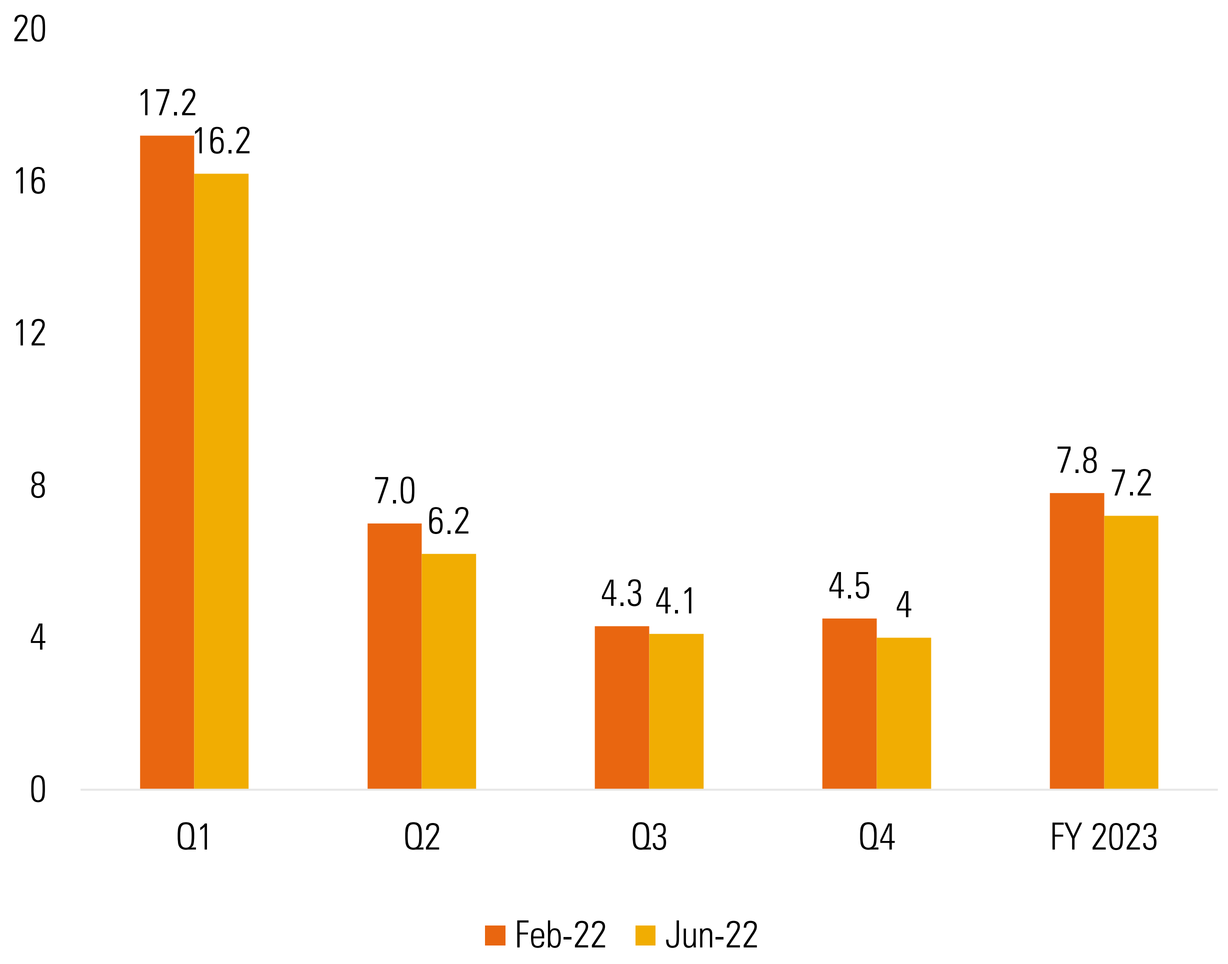
Inflation and Growth estimates adversely impacted

Concerns over rising inflation led RBI to shift focus towards inflation from growth. Assessing the impact of the outbreak of the Russia-Ukraine war and supply-chain disruptions, the RBI revised its inflation estimate upwards to 6.7% in FY2023 from 4.5% estimated at the beginning of the year. GDP growth estimate was lowered to 7.2% from 7.8% estimated at the beginning of the year. Inflation appears to have peaked in Q2 backed by the recent fall in commodity prices and is expected to trend lower going ahead.

RBI Inflation estimates - FY2023



RBI Growth estimates - FY2023



Source: RBI

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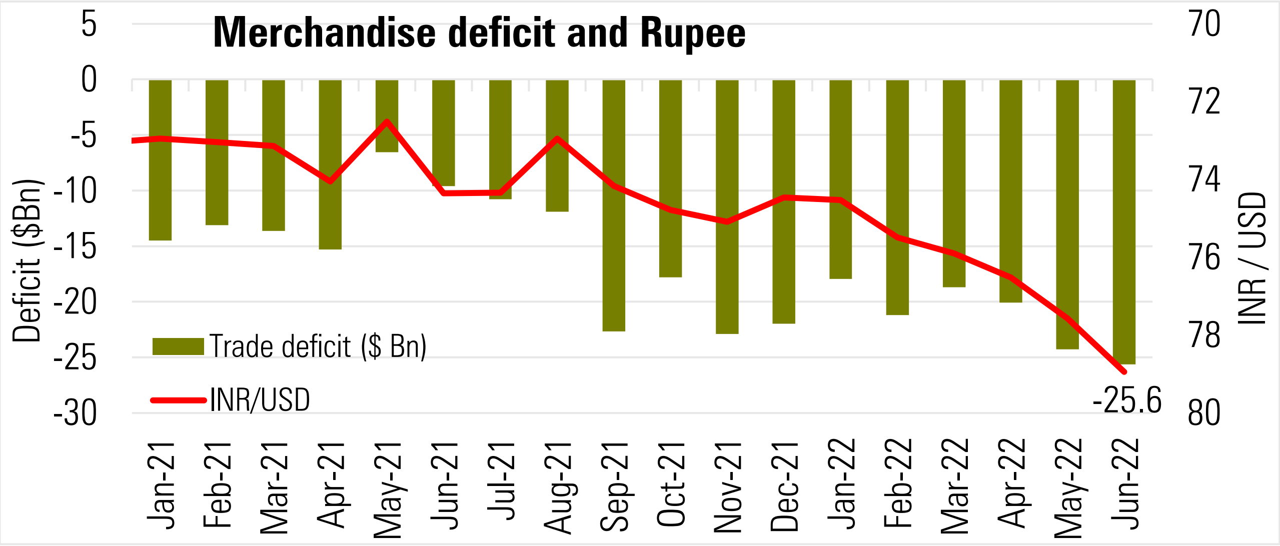
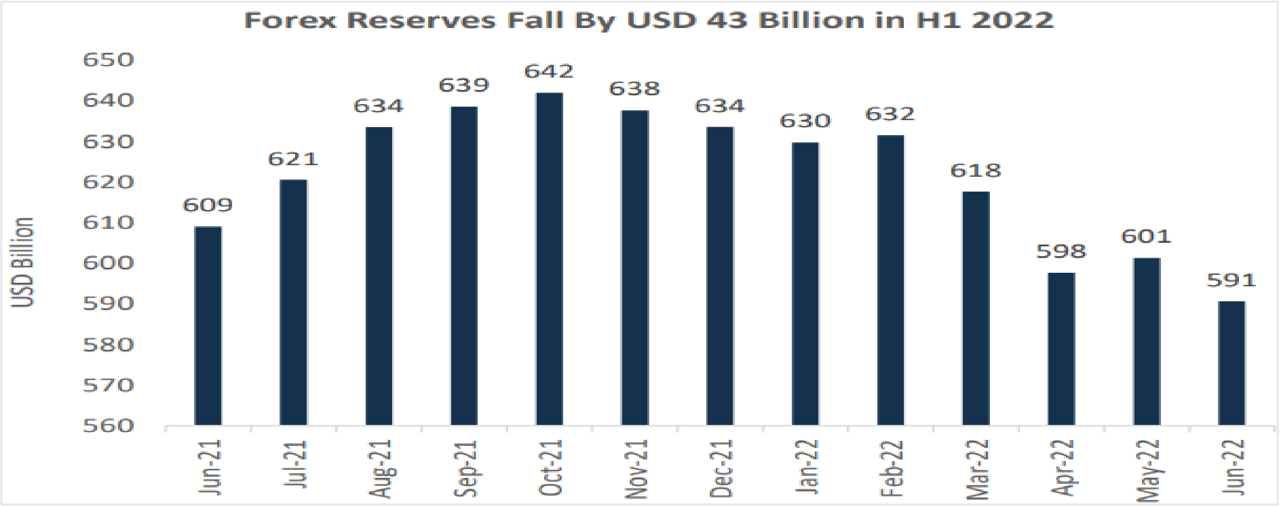
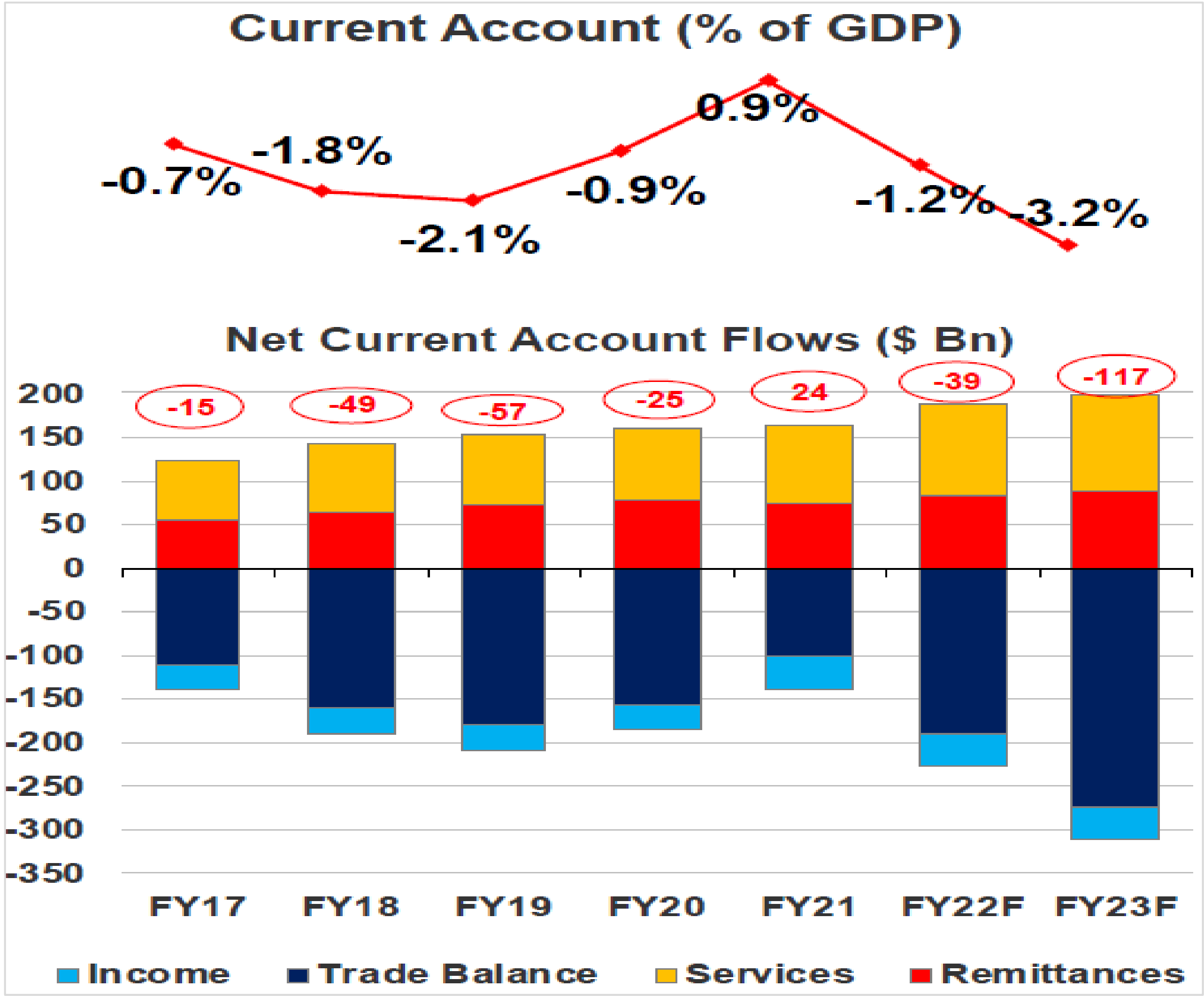
Rupee depreciated sharply in CYTD

The U.S. dollar index has rallied to a 20-year high amid anticipation of aggressive tightening by the U.S. Fed and safe-haven demand amid concerns over global growth. Consequently, the rupee has depreciated sharply in the YTD period aided by a widening current account deficit and stood ~7% lower versus the dollar (as on July 18, 2022). However, the rupee has found support following rate hikes (90 bps since May 2022) and intervention in the spot and forward currency markets by the RBI. Very recently, the RBI has announced additional measures to shore up the rupee such as liberalization of forex flows and allowing international trade settlement in INR.







Source: RBI, Axis Bank Research. Data as of June 30, 2022

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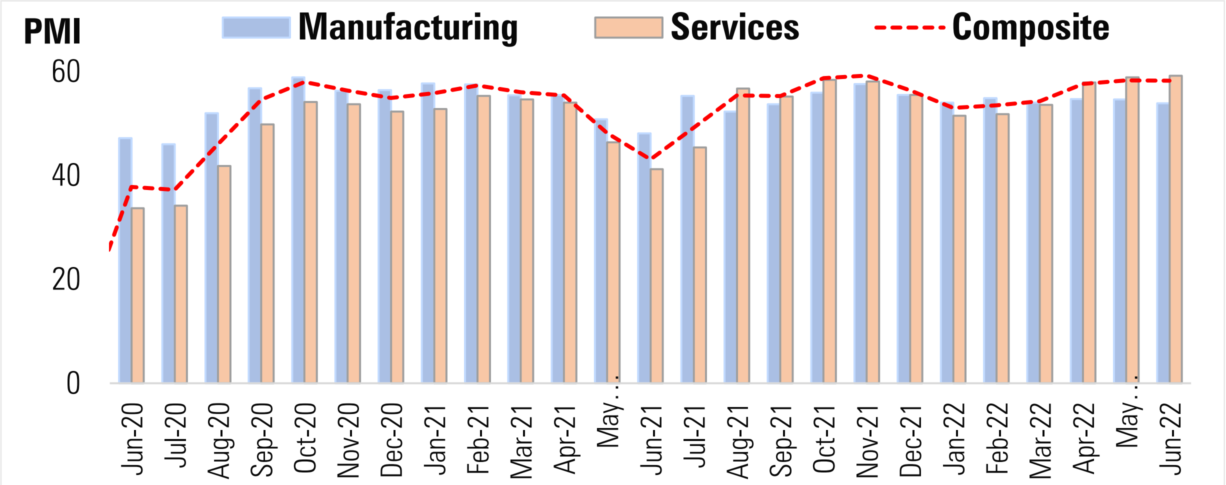
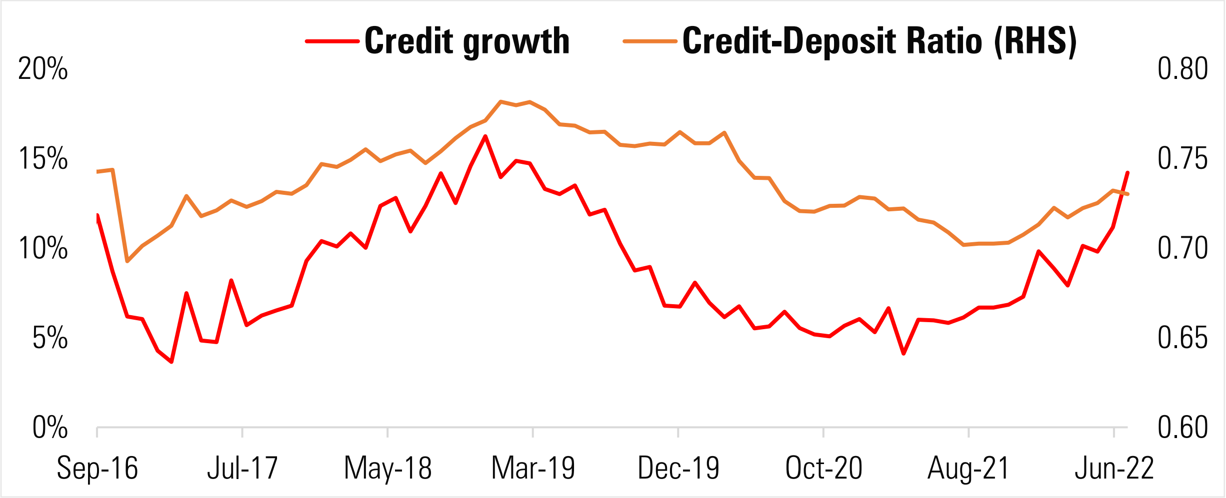
Lead indicators show mixed signals

Recent lead indicators (imports, GST collections, power consumption, credit off-take) suggest a further recovery in demand. Capacity utilization has improved to near 75%, which could likely kickstart the investment cycle. Services activity rose at the fastest pace in 11 years.. However, the growth momentum has slowed pressured by inflation. Private consumption has been weak and export momentum is now slowing amid weakening global growth. Manufacturing activity expanded at its slowest pace in nine months in June as elevated price pressures continued to dampen demand and output. Rural demand is yet to pick pace as indicated by weakness in two-wheeler sales which are still ~20% down from the pre-pandemic levels. Elevated commodity prices amid ongoing geopolitical tensions, supply-chain disruptions and pass-through of input costs could potentially dampen discretionary consumption demand in the near term.

Sector	Indicator	High Frequency Indicators- Services Growth (y-o-y, per cent)				Growth over 2019		
		Mar-22	Apr-22	May-22	Jun-22	Apr-22/ Apr-19	May-22/ May-19	Jun-22/ Jun 19
Urban Demand	Passenger Vehicles Sales	-3.9	-3.8	185.1	19.1	1.6	10.6	31.6
Rural Demand	Two Wheelers Sales	-20.9	15.4	253.2	23.4	-29.9	-27.4	-20.7
	Three Wheelers Sales	0.5	51.1	2161.6	183.9	-54.7	-44.7	-48.5
	Tractor Sales	-14.3	40.6	47.4	-14.4	55.5	41.1	24.5
Trade, hotels, transport, communication	Commercial Vehicles Sales	18.8	112.2			7.8		
	Railway Freight Traffic	6.7	9.4	14.6	11.3	20.9	25.5	23.7
	Port Cargo Traffic	0.7	5.6	10.2	12.4	8.1	11.4	14.7
	Domestic Air Cargo Traffic	-1.0	7.9	54.7		2.7	1.9	
	International Air Cargo Traffic	1.1	-0.9	-4.6		-5.2	-13.6	
	Domestic Air Passenger Traffic	37.7	87.8	474.7		-1.5	-2.0	
	International Air Passenger Traffic	105.7	155.6	722.8		-36.6	-28.0	
	GST E-way Bills (Total)	9.7	28.0	84.1	36.2	43.3	35.6	49.7
	GST E-way Bills (Intra State)	11.8	28.4	83.3	38.6	50.8	45.5	58.7
	GST E-way Bills (Inter State)	6.6	27.4	85.5	32.2	32.9	21.8	36.4
	Tourist Arrivals	177.9	465.8			-49.3		
Construction	Steel Consumption	0.7	1.8	18.6	13.3	18.6	5.3	7.8
	Cement Production	9.0	7.4	26.3		8.3	10.9	
PMI Index	Manufacturing	54.0	54.7	54.6	53.9			
	Services	53.6	57.9	58.9	59.2			

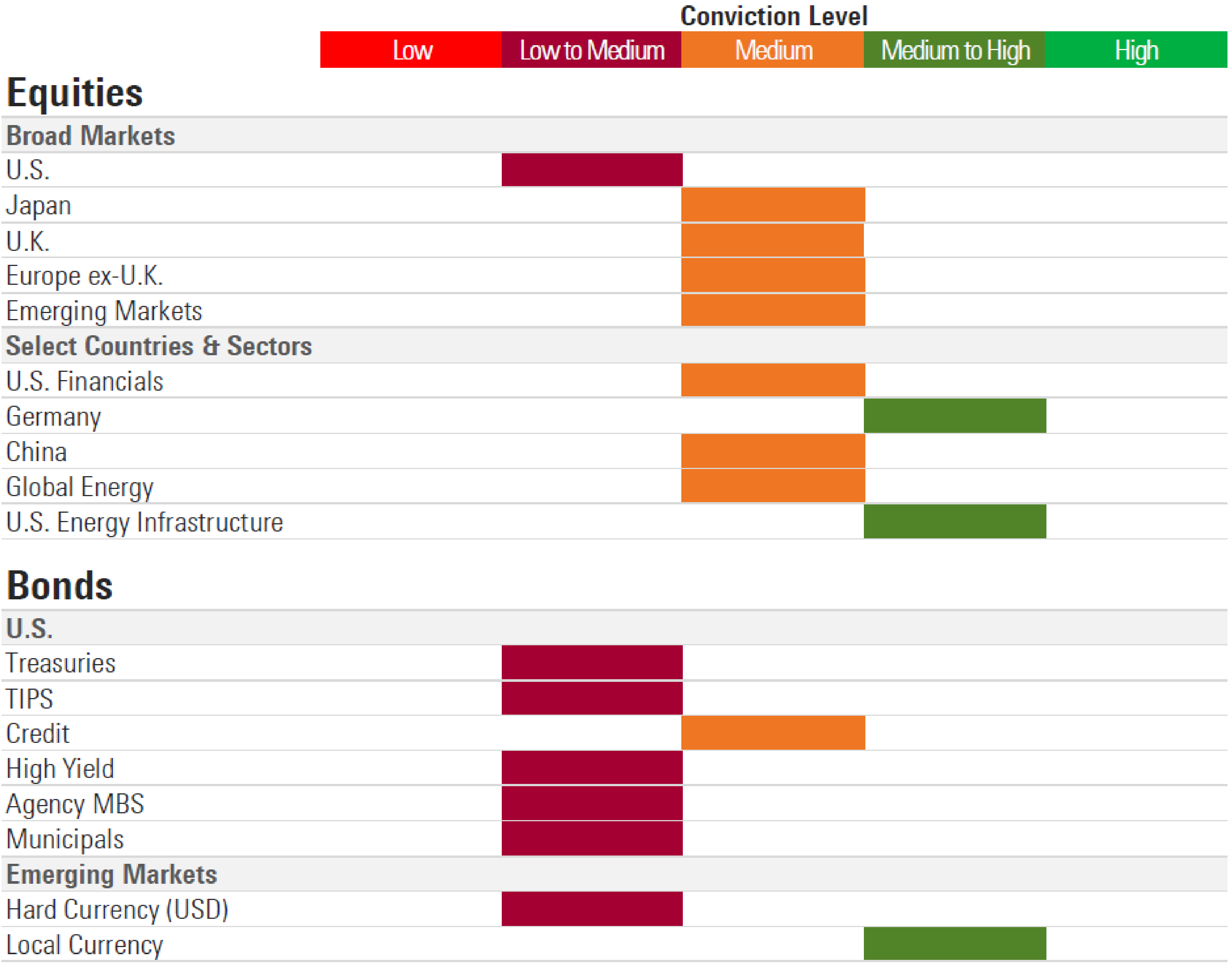




Source: RBI, S&P Global,

Asset Class Conviction and Managed Portfolios Positioning

Morningstar Global Conviction Update



Our long-term valuation models indicate that the expected 10-year return of global stocks has improved in the year-to-date period as markets have corrected owing to geopolitical tensions and expectations of faster tightening.

Global bond yields have risen sharply over the YTD period amid concerns over aggressive tightening by major central banks to combat surging inflation leading to some improvement in their valuation. We know from history that a relatively low starting yield can have a sizeable impact on future return expectations, and our valuation framework supports this notion, with emerging market debt offering better prospective return expectations than developed market peers.

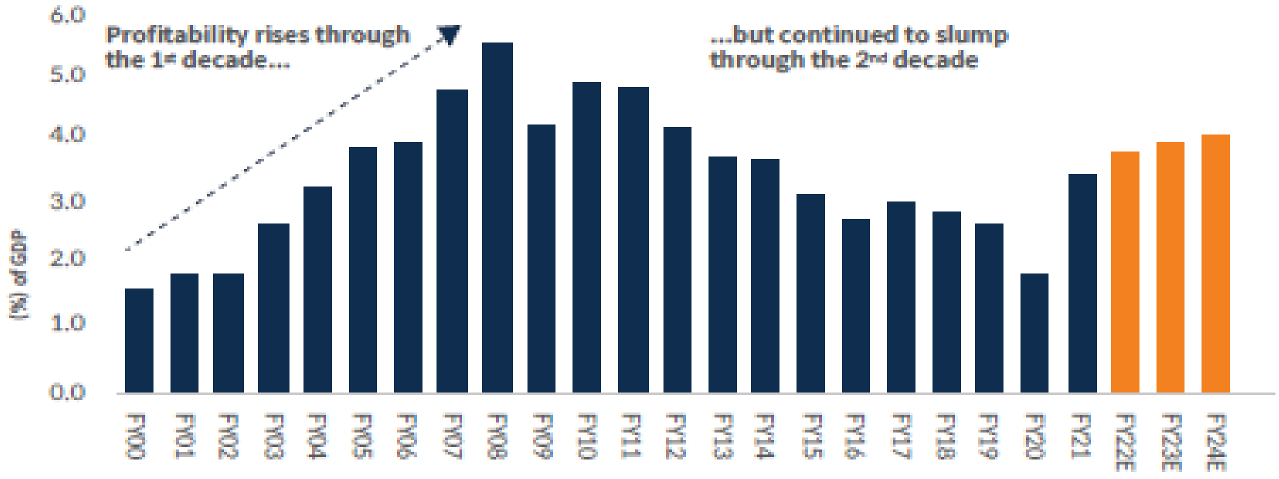
Our long-term conviction scoring system is based on four criteria: absolute valuation; relative valuation; contrarian indicators; and fundamental risk. In assigning an asset class conviction, an analyst trades off the aspects of an investment opportunity that argue for and against it, culminating in the expression of a conviction level.

Source: Morningstar Investment Management, conviction levels as of June 2022

View on Indian equities

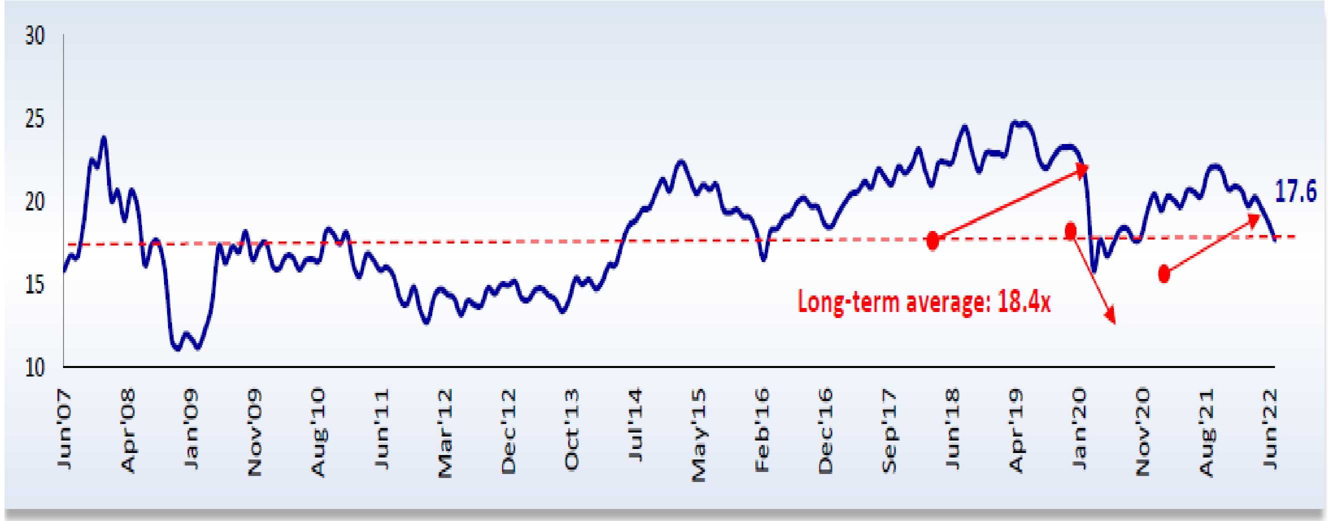
Following the sharp correction in the YTD period (~17% from peak – S&P BSE 500 TR INR) and recovery in earnings, Indian equity P/Es have moderated and are now closer to their long-term average. The current valuations indicate a premium to our fair value assumption.

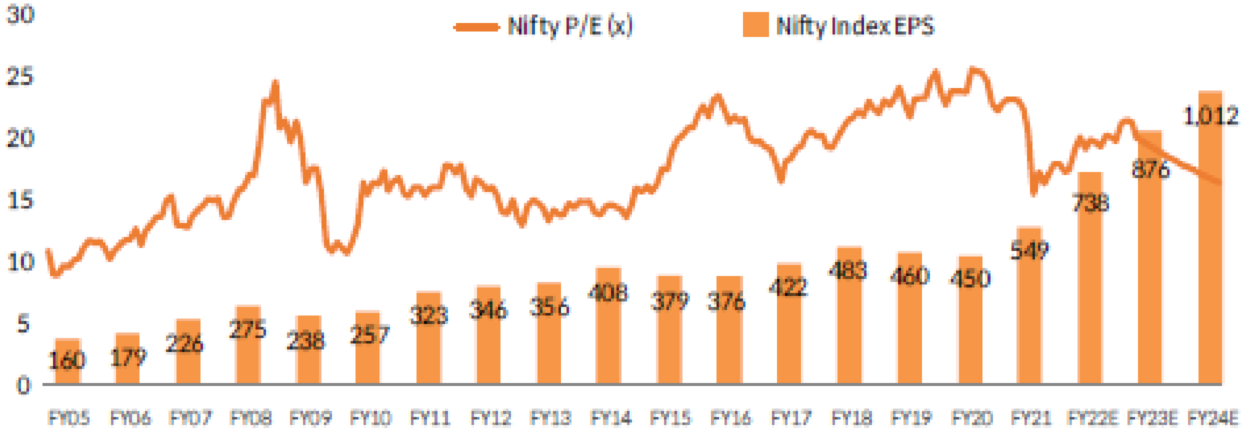
Corporate profit to GDP ratio to improve



Source: Factset, CMIE, Jefferies, as on 31st Dec, 2021. Past Performance may or may not sustain in Future.

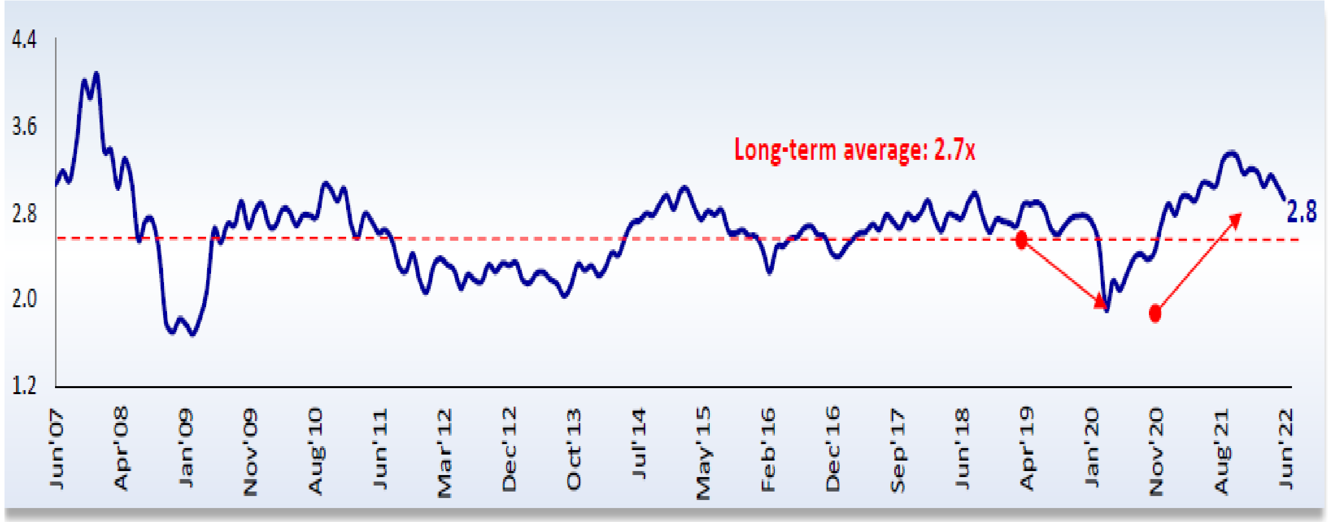
12-month forward Nifty P/E (x)





Source: Bloomberg. Data as of 31st December 2021. Past Performance may or may not sustain in Future.

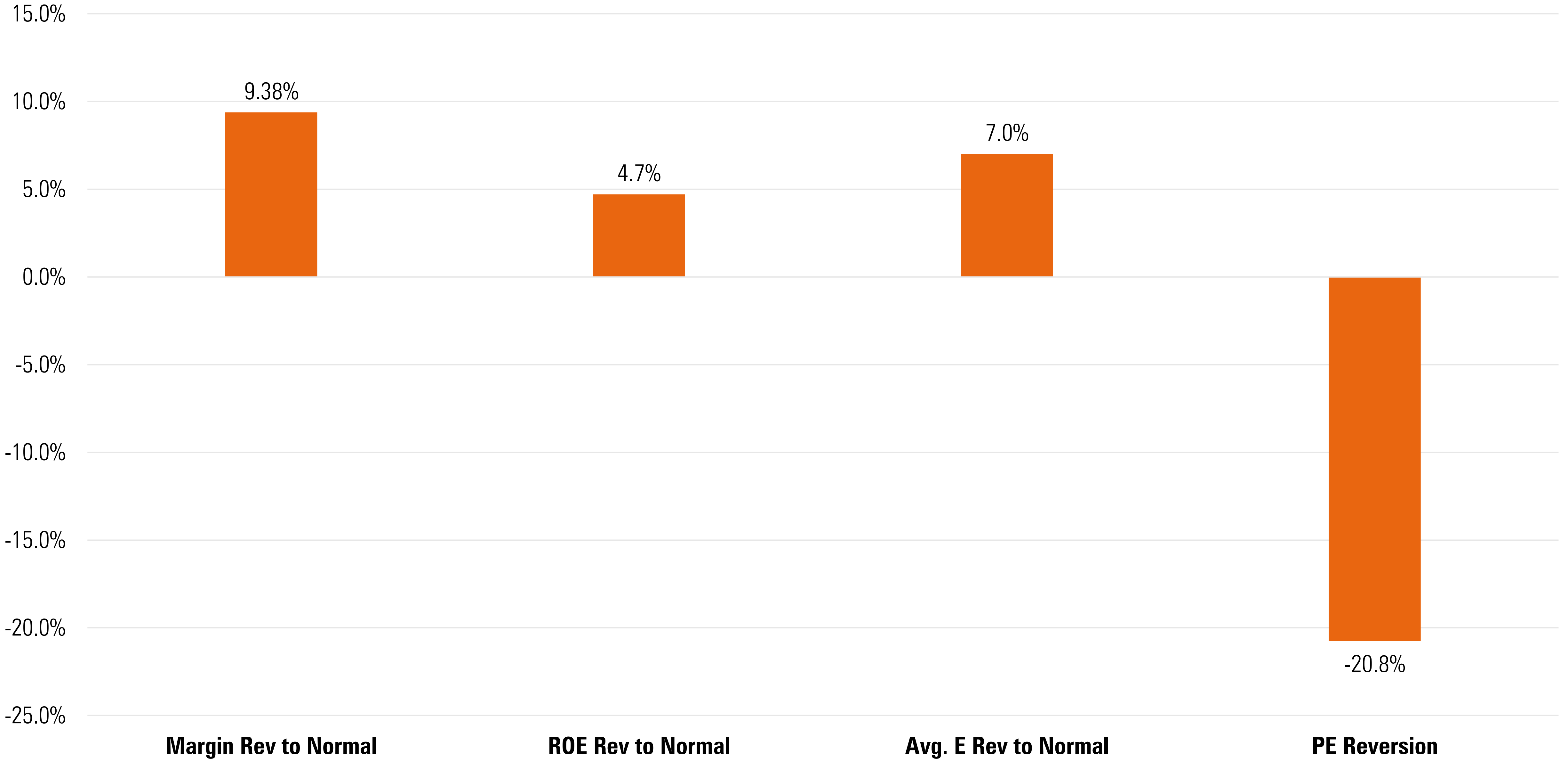
12-month forward Nifty P/B (x)



Source : Motilal Oswal and Mirae Asset India

View on Indian equities

The current margins and ROE are lower than the fair (long-term) assumption. Our valuation implied return framework factors a higher long-term margin and ROE estimate as compared to the current low margin and ROE that Indian equities offer – indicating a positive reversion impact on the return expectations.



Source : Morningstar Investment Management; Based on data as of June 30, 2022

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Morningstar Managed Portfolios – How are we positioned

- Markets scaled record highs near the fag end of 2021, recovering from the pandemic driven lows seen in March 2020, on the back of unprecedented monetary and fiscal measures and optimism over economic recovery following discovery of vaccines. This led to stretched valuations, particularly for mid and small-cap equities.

- However, markets have witnessed a sharp correction in the YTD period (drawdown of 17.10% by S&P BSE 500 TR INR) on concerns over faster monetary tightening to arrest persistently high inflation, persistently high commodity prices and disrupted supply-chains in the backdrop of Russia-Ukraine tensions and subdued demand from China.

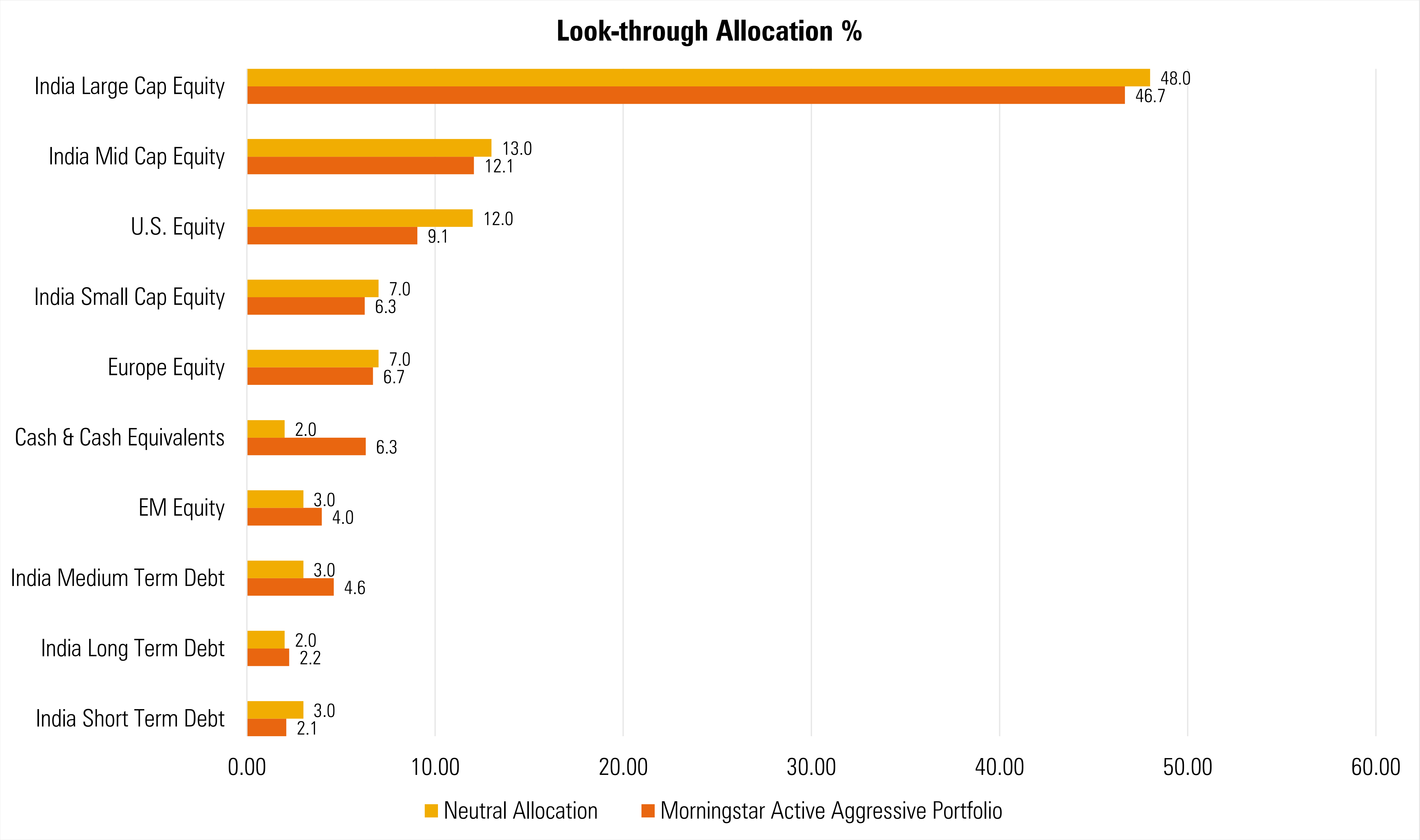
- Our valuation implied return estimates for markets and asset classes, when compared to its long term or fair return, helps us decide whether the market/asset class is attractively priced. At the current juncture, we continue to favor domestic large cap equities over mid and small cap equities, where we are slightly underweight as compared to our neutral/benchmark allocation

- Based on our valuation implied return (VIRs) forecasts, the medium-to-long term debt segment (5-10 years maturity) looks relatively attractive than cash and high credit quality short term debt, and we continue to remain overweight in this segment. AA and A rated corporate bonds (3-5 years) continue to look relatively attractive over the short-term debt (G sec) segment. We continue to maintain our exposure to the credit segment as it looks favourable relative to the G-sec segment from a risk-reward perspective

- Among international equities, we are underweight U.S. equities as compared to our neutral or benchmark weight as U.S. equities (Tech in particular) continue to rank amongst our least favored country/region. We have reduced the magnitude of underweight on U.S. equities after the recent market correction. Europe, U.K., and EM look relatively more attractive than U.S. equities, and we continue to remain overweight these regions as compared to our benchmark allocation.

- We continue to focus on risk-adjusted returns—not just returns—and have a constructive view on our ability to navigate different market pathways going forward. In this unique economic situation, we are actively reviewing our views across asset classes and portfolio positioning

Portfolio Positioning – Morningstar Active Aggressive Portfolio



Source: Morningstar Investment Adviser India. Data as of June 30, 2022

Global winners and losers : The benefits of diversification

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	CYTD*	CAGR*	Max DD GFC	Max DD COVID-19
U.S. Equity	-22.2	22.7	12.2	20.6	20.0	50.3	15.2	5.5	15.4	14.2	3.9	34.2	23.7	28.0	-14.2	14.4	-43.0	-30.2
Developed Markets Equity	-26.0	26.4	9.5	12.5	20.6	44.5	7.8	4.7	11.4	15.8	-0.3	31.0	19.0	23.2	-13.8	11.4	-44.8	-29.8
Multi-asset portfolio^	-13.3	38.1	11.3	-6.3	21.7	5.9	24.2	3.5	10.8	18.2	3.3	13.0	16.5	15.7	-3.9	10.2	-25.9	-17.3
Indian Equity	-57.6	92.7	17.9	-26.4	33.4	4.9	38.9	0.4	5.2	37.6	-1.8	9.0	18.4	31.6	-5.7	8.2	-65.9	-38.1
India Fixed-Income	24.5	-6.3	4.4	3.7	12.7	2.2	17.5	7.4	15.6	2.4	8.3	11.8	13.0	2.2	-2.2	7.8	-11.2	-2.4
European Equity	-34.7	34.9	3.0	4.7	25.2	41.7	-4.7	3.6	3.4	19.4	-6.7	28.5	9.1	18.7	-17.4	6.9	-52.3	-33.8
Emerging Markets Equity	-42.9	75.6	17.1	-3.3	23.5	10.8	1.3	-9.1	14.2	27.9	-5.0	21.2	21.5	1.7	-11.9	6.8	-56.8	-30.7

Source: Morningstar Direct, in INR terms, *As on July 18, 2022; ^ Composite index constituting S&P BSE 500 TR Index (40%) + MSCI ACWI (10%) + S&P GSCI Gol Spot (5%) + CCIL All Sovereign TR Index (45%). Performance of Indian Equities is represented by S&P BSE 500 TR Index, of Developed Market Equities by Morningstar Developed Market Index , of Emerging Market Equities by Morningstar Emerging Market Index, of U.S. Equities by Morningstar U.S. Market Index, of Europe by Morningstar Europe Index,, and of India Fixed-Income by CCIL All Sovereign Bond Index. This is for illustrative purposes only and not indicative of any investment. CAGR performance shown is from 2008 till date.

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Key Takeaways

1. Market valuations seem to be pricing in improved demand, fall in commodity prices and the recent fiscal measures announced by the government.

2. Few key risks still linger which may not be fully priced in. They are an inflationary squeeze, rising interest rates, global recessionary/slowdown preconditions, and tightening corporate profit margins.

3. Bond returns have been negative lately after ~1% surge in G-sec yields so far in 2022. With the yield curve now closer to the pre-pandemic levels, bond prices are attractively priced than before

4. In this uncertain environment, investors should stick to their target asset allocations and re-balance any material drifts

5. We are positioning portfolios to reflect forward-looking expectations.

Empowering Investor Success.

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