Managed Portfolios - Insights

The 2022 Selloff: What, Why & Where We Stand

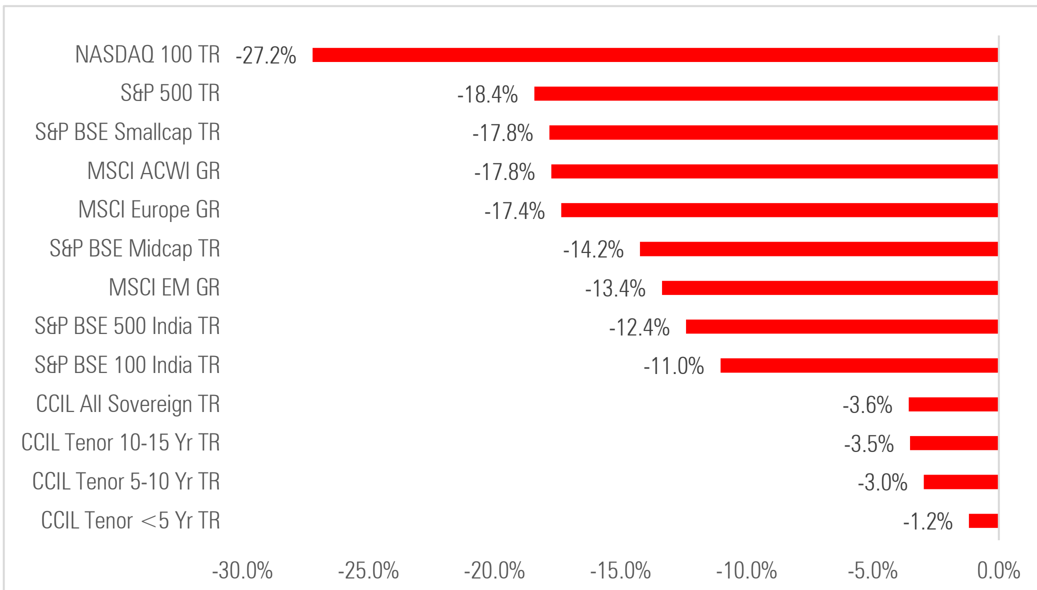
Morningstar Investment Adviser India

June 2022

What's Happened Thus Far

So far in 2022, investors have faced substantial volatility across markets and asset classes. Markets have seen corrections, connected by a thread of high inflation and resultant high-interest rates. Major developed market economies are witnessing high inflation (8% plus) for the first time in 40 years. As a result, in response to inflation, the expected trajectory of policy rates in developed and emerging economies has risen sharply.

Returns: Year-to-Date



Source: Morningstar Direct. YTD performance as of June 17, 2022

Digging further into the market backdrop thus far in 2022, most broad equity and fixed income markets declined year-to-date as markets grappled with the reality of higher interest rates and the potential knock-on effect on economic growth. Commodity prices remain high, particularly crude oil. With Europe imposing a further ban on Russian supplies, crude oil prices may continue to remain elevated in the near term. A large part of the rise in inflation is primarily attributed to global supply shocks linked to the war, resilient demand in developed economies, and in recent times to higher food prices.

Also notably, year-to-date, bonds lacked defensiveness, particularly those with longer maturities. Investors had come to expect that bonds would be a source of portfolio stability during periods of equity market volatility – and this was certainly the case during the significant equity markets selloff in response to the advent of the pandemic in early 2020. With the benefit of hindsight, it has become clear that the regime, or backdrop of policy rate accommodation, significantly aided debt returns during that time frame. With the rise in government security yields in anticipation of higher policy rates as the economy grapples with inflationary pressures, the regime has shifted as year-to-date returns for debt as an asset, are also negative.

Domestic equities faced another round of sell-off with broader equities correcting by 7.9% in June 2022. The large-cap index (S&P BSE 100) fell by 7.8%, whereas the mid-cap index (S&P BSE Mid-Cap) was down 7.9% and the small-cap index (S&P BSE Small-Cap) was down 8.4% as of June 17, 2022. The negative performance was largely driven by expectations of aggressive policy rate hikes by global central banks and the Reserve Bank of India, and high inflation concerns – its impact on corporate margins and consumption demand.

Our Positioning

In our January and April 2022 quarterly updates, we stated that markets seem to have priced in most of the positives and are missing out on pricing some of the near-term risk factors. We had two concerns. First, as valuation-conscious investors, high equity market valuations in our estimation was worrisome. This was particularly true for mid & small-cap equities which had rallied sharply post the pandemic.

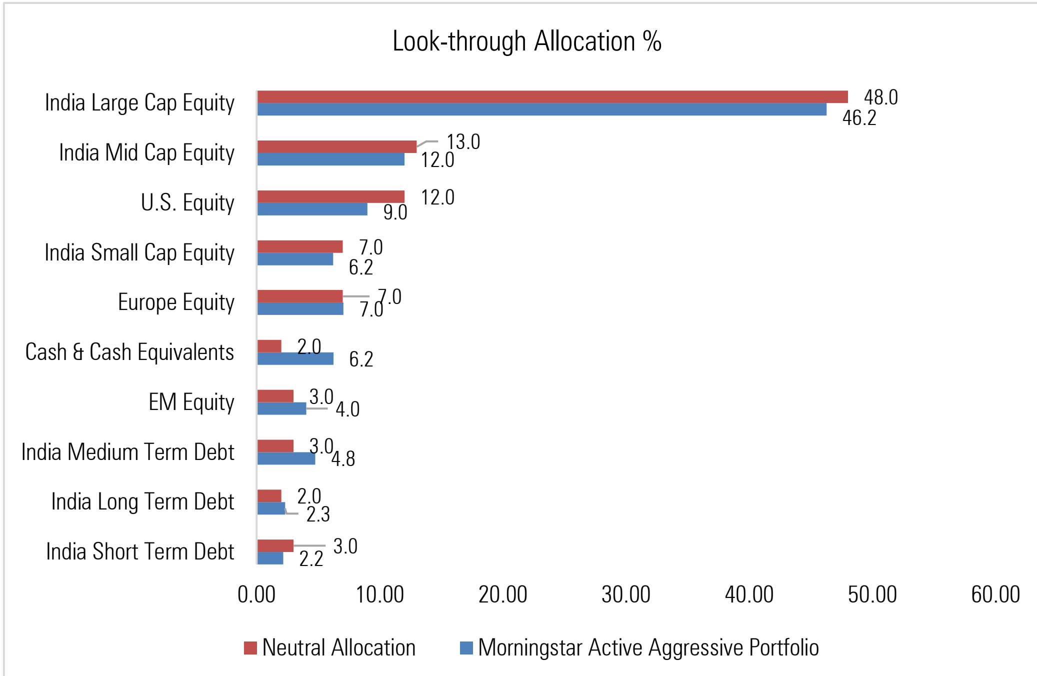
In addition to valuation concerns, we were wary of the macroeconomic environment. We don't spend much time forecasting inflation and interest rates but globally, the growth-inflation dynamics are skewed towards taming high inflation. The follow-on, of course, was the impact on interest rates. And as investors value equities by discounting forecasted earnings into the present with interest rates, higher interest rates can undercut their attractiveness.

Our valuation-driven asset allocation process ranked domestic equities low relative to domestic debt, European and EM equities. Accordingly, we remained underweight overall growth (equity) exposure by 0.75% to 4% across four portfolios around the start of 2022 as compared to neutral/benchmark allocation.

Early May, our risk-reward framework, which ranks assets/markets as per valuation attractiveness, still favored Europe, EM, and domestic debt over Indian equities. This simply means that the relative attractiveness of Indian equities was low as global equities have witnessed a sharper correction, improving their valuation attractiveness. We reduced allocation to domestic equities by 1% to 1.5% across all four portfolios around the start of May. Although, due to prevailing regulatory restrictions which curb investments in India domiciled mutual funds investing in international markets, we are unable to add allocation to EM & Europe, which saw improvement in its overall risk-reward rank relative to other markets. The allocation was shifted to fixed income. We are currently underweight overall growth (equity) exposure vs benchmark by 1.75% to 5% across all four portfolios. This helped us to limit year-to-date portfolio drawdowns (i.e. a fall from the recent peak to trough) at -15.7% and -14.7% for Active Aggressive and Active Aggressive Plus, respectively, vs the broader equity index which witnessed a drawdown of -16.8% and a drawdown of -16.7% witnessed by peers (multi-cap funds) for the same period.

On the fixed income side, the recent surge in yields may create some pain for investors who have entered the debt market in the last six to twelve months. The expectation of another 25-40 bps in the August policy meeting seems to be largely priced in the current yield levels. The term spread (10-year Government security yield minus 3-month T-bill yield) is now ~2.5% vs 3% around the start of the year, although higher than the long-term average of ~1.5% – still retaining its relative attractiveness. Short-term rates for PSU and corporate bonds have also moved up by ~2% since the start of the year, although real rates remain low or negative.

Morningstar Active Aggressive Portfolio Positioning vs Benchmark



Source: Morningstar. Allocation as of June 17, 2022.

As markets have sold off, we are continuously reassessing our positioning taking stock of market valuations. The way the portfolios are constructed, we would expect the portfolios and underlying funds to do well over the long term. Looking forward, we remain confident that our valuation-driven asset allocation approach and the fund line-up will help us deliver better long-term risk-adjusted outcomes. Ultimately, our process looks to identify assets that we think will help deliver superior investor outcomes over the longer term. We continue to focus on risk-adjusted returns—not just returns—and have a constructive view of our ability to navigate different market pathways going forward. We continue to actively monitor our asset class views & positions relative to markets to identify attractive opportunities as they arise.

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