Global economy is at an interesting juncture with protectionist narrative defining economic backdrop. US China trade war, Brexit woes, geopolitical concerns in rest of Europe have posed a legible threat to growth in last one year. Moreover, in recent months, global markets were spooked by possibility of recession as indicated brief inversion of US yield curve and negative yields on German bunds. However, a deeper look indicated that this might be the case of growth slowdown, rather than full blown recession. Dissecting the global slowdown further we observed that that global GDP growth and manufacturing are seeing a pre-mature slowdown led by protectionism and not an overheating led cyclical slowdown. The inflation and unemployment rates in most developed economies remained stubbornly low. Consequently, the low inflation and threat to growth have pushed global central banks towards easy monetary policy again. While Fed has indicated that it would not raise interest rates in 2019 (markets are even hoping for a rate cut), ECB has already announced TLTRO-III for Sep-19, to support European economy. This would mean relatively easy liquidity to global markets in FY20.

On domestic front, Indian economy too witnessed a mild growth slowdown in FY19 with real GDP growth expected at 7%yoy against 7.2%yoy in FY18. Variety of high frequency indicators – IIP, Core industries, automobile sales, air passenger volume growth etc, exhibited similar slowdown. While part of this slowdown can be attributed to domestic stress in agrarian economy and informal sector (which saw disruption post GST implementation in FY18), part of slowdown is also influenced by global weakness in manufacturing and industrial output.

While last 5 years have been amongst best fiscal consolidation years post liberalization India, FY19 saw some stress on fiscal side emanating from weak GST collection. Total indirect tax collection grew by a mere 2%yoy in 11 months till February in FY19, while revised estimated growth for the year is expected to settle at 16%yoy, which most likely will be missed. The GST collection has suffered from moderating growth and weak compliance. Competitive populism is another fiscal challenge that entered the backdrop late into FY19. Incumbent party, BJP, announced a support scheme worth Rs6000 per annum for small farmers. In what seems to be the beginning of welfare wars to win the electorate (Congress announced a common minimum program, promising Rs72000 annually to poorest 20% in the country), poses the biggest challenge to fiscal sanity of the country in recent years.

Oil prices volatility is another challenge faced by Indian economy in FY19. While FY19 saw Brent prices correct by 2.6% in the year, the year was marked by strong volatility in oil prices, with Brent touching a high of US$86.3/bbl and low of US$50.5/bbl. Given that India is a net importer of oil, oil volatility reflected in rupee exchange rate volatility as well. Consequently, Rupee depreciated by ~15% from April-18 to October-18 on weak flows and volatile oil prices. The foreign portfolio flows were also weak till January-18 as Fed was still in rate hike mode. As Fed became more accommodative and NDA gained momentum in opinion polls, FII's flows became stronger in last two months of FY19. FDI also became stronger Dec-18 onwards. Owing to improvement in foreign investment flows, rupee has been stronger at Rs69/US$, towards end of FY19. Hence, India's CAD position remained manageable at ~2.6% of GDP for 9 months in FY19 and expected to settle even lower for entire FY19.

Owing to easy food prices - globally and locally, India's inflation trajectory continued to undershoot RBI's inflation projection in FY19. The slower growth trajectory nudged RBI to cut repo rate by 25bp in Feb after hiking it twice by a total of 50bp in early 2018. RBI followed up rate cut with another 25bp cut in its first MPC meeting for FY20 while maintaining the neutral stance. Despite recent rate cuts, system liquidity has seen variety of challenges, as: a) the cost of borrowing has not come down, led by an all-time high credit deposit ratio at 78% in Mar'19 as deposit growth has been lagging the credit growth (by ~450bps) for over a year now, b) net liquidity in the banking system has been in deficit mode for nearly a year, c) as bond markets are expected to be flushed with government bonds in FY20 (on an ambitious interim budget presented in Feb-19), long end of the yield curve has been sticky. Hence, borrowing costs have remained high.

Moreover, bond markets continue to see increasingly higher crowding out. This is again led by two factors: a) as government's approach to welfare schemes became unhinged, while it struggled on indirect tax collection, fiscal space has seen tougher time. This, consequently, has led to an expected larger borrowing program (Rs12.5trn by state and centre combined in FY20), thus leaving little space for private players to borrow, b) secondly, India's household financial savings rate has continued to fall have continued to fall with FY17 financials savings rate at 6.7% of GNDI. The main reason for the dwindling HH savings is a sharp jump in HH financial liabilities, which have nearly doubled to Rs8tn. A weakening trend in net household financial savings will make it difficult to finance India's borrowing domestically, thus pushing it to external markets to borrow. If not taken care of, this will pose a challenge to India's CAD and exchange rate in near to medium term.

Upcoming general elections are amongst the biggest events that markets are going to watch out for in FY20. Competitive populism and welfare wars to win over electorate will pose the biggest challenge to fiscal space of the economy in near term and prudence in these matters should be rewarded by markets.

Equity Markets

India's equity markets witnessed a dichotomy in FY19 with Nifty up by ~15% during the year while BSE small and mid-cap indices were down by about 12% and 3%, respectively, during the same time. Owing to global liquidity tightening cycle and volatile rupee during the year, FII's invested only US$1.8bn in Indian equities during the year. Majority of the inflows came in during Feb and March-19 as cumulative net equity outflows by FII's stood at US$6.8bn till Jan-19, for the fiscal year. Led by mutual funds, DII's however, invested close to ~US$10bn in Indian equities in FY19. As autos volumes took a hit in middle of the fiscal year, Autos became the worst performing sector of the year with a 23% decline in CNX autos index in FY19. Banks, Energy and IT were amongst the best performing sectors for the year.

Portfolio positioning and Risk Management

The focus of the portfolio was towards large cap stocks, and the exposure to mid and small caps was reduced significantly towards beginning of the year. The key overweight sectors during the year were IT and pharma, given the negative bias on the markets and also to benefit from INR depreciation and improving fundamentals in these sectors. Further an overweight on corporate banks also positively

contributed to the performance. Towards the end of the year, the portfolio also benefitted from an underweight stance on discretionary consumption such as Auto. Performance was party impacted by an underweight stance in consumer staples, which rallied despite steep valuations.

Robust risk management practices are followed in portfolio positioning and performance analysis. Portfolio performance and positioning is frequently monitored using attribution analysis. The investment policy sets maximum limits on exposure to Mid/small caps stocks in the portfolio which limits risk to the portfolio to acceptable levels. Any divergence from such limits and deviation in performance is highlighted to the fund manager who has to take corrective actions.

Fixed Income Markets

Fixed Income markets saw a year of volatility where in the first half of the year, fears on crude price surge and inflation uptick saw 10y benchmark yield rising to over 8% levels. This was accompanied by a near rupee-crisis like 2013-14 with persistent foreign outflows. Later, in the second half of the year, the RBI started its easing cycle again in the midst of very low headline inflation, slowing growth and high real interest rates. This, accompanied by the INR 3 trillion OMO purchases by the RBI again pulled back the yields to 7.50% at the end of the year. Credit spreads, though, did not ease much, and trade at multi-year highs. Most of this is due to the loss of confidence and secondary market liquidity in the NBFC bond market.

Portfolio Positioning: Duration Strategy and Risk Management

The volatility in yields warranted a hands-on active approach to duration management. Consequently, an overweight position on duration was adopted with respect to benchmark for H1FY19 as we believed that the market had overreacted and the OMO purchases by the RBI would result in lower yields. However, post the IL&FS default, we decided to generate liquidity in our funds which resulted in us having to maintain a lower duration in our portfolios with a lower credit risk and interest rate risk appetite. Credit risks in the portfolios were monitored with utmost attention. Addition of new credit exposures were made after a thorough analysis and due diligence process. Existing credits were monitored regularly for any developments that could be beneficial or detrimental to the standing of the particular entity.