Annual Report for Policy Holders - Economic Update

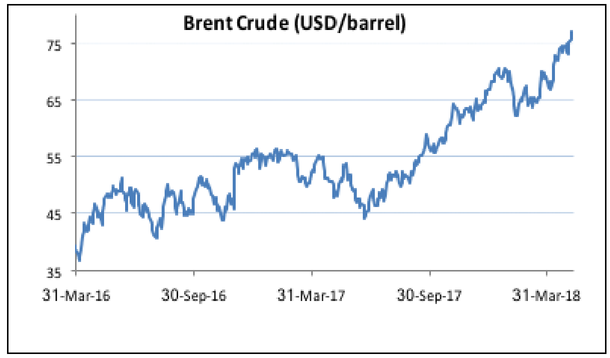
March 2018

HDFC Life

Sar utha ke jiyo!

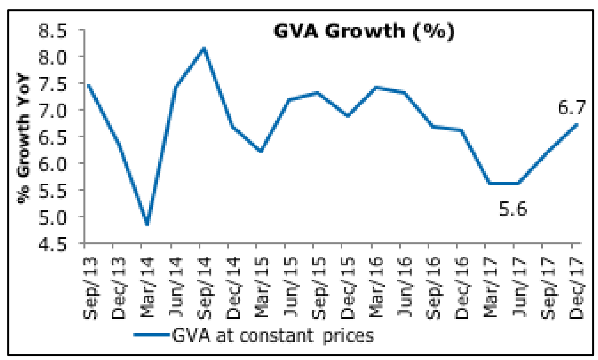
Economic update

The year 2017-18 marked an inflection point for the macro-economic trends witnessed in the previous years. Oil prices, which have a large bearing on the country's macroeconomic parameters, turned around and headed higher as the OPEC and key non-OPEC oil producers continued to maintain the production discipline agreed upon in 2016. The higher oil prices led to a wider trade deficit at $156.8 bn from $108.5 bn in FY 2017. The higher trade deficit is also likely to have widened the current account deficit. The Rupee, which had appreciated against the US Dollar on the back of strong capital inflows to Rs 63.31 levels against the USD, during the year, weakened, as oil prices climbed and capital flows slowed, during the latter part of the year.



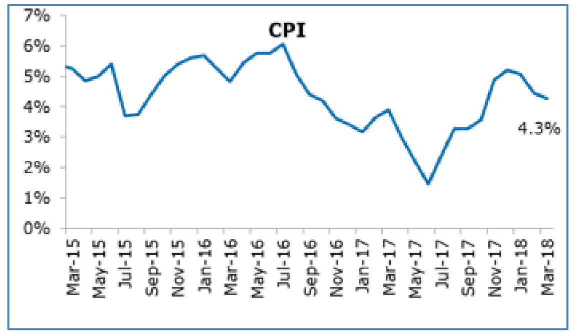
The major structural change during the year, however, was the introduction of the Goods and Services Tax (GST), which replaced the erstwhile structure of multiple indirect taxes and different tax rates for the same items across different states. This was a landmark achievement as the structure of the GST is expected to improve tax compliance as well as ease the planning and logistical bottlenecks for companies and improve efficiency of doing business across the country.

The period around the introduction of the GST saw a dip in economic activity, as companies ran down inventory across the transition. Moreover, initial teething problems with the system and the time required to familiarise with the new system led to some slowdown post the change. The GDP growth slipped to 5.7% in the June quarter, with GVA (Gross Value added) at 5.6%, marking a 13-quarter low. Growth rebounded thereafter, to 6.3% in the September quarter and 7.2% in the December quarter. RBI has forecasted a 7.4% GDP growth for FY19. The pick-up in growth in the coming year, would confirm that the 5.7% GDP growth was an inflection point in the growth trajectory as well.



The GST introduction had an impact on the Government's finances as well. The dis-locations due to the structural changes led to a slippage in the fiscal deficit for the year. The Government revised its deficit projection to 3.5% for the year, against 3.2% budgeted at the beginning of the year. The widening fiscal deficit led to an increase in the Government's market borrowing programme.

Inflation stayed low during the year, as food prices stayed muted. The soft price levels led to the CPI inflation setting a series low of 1.46% in June. However, from August, the Government implemented the HRA increase under the 7th Pay Commission award, which led to an increase in the core inflation during the latter half of the year. Notwithstanding the rise in core inflation, the average CPI rise for the year stood at 3.6% against 4.5% for the previous year. The soft CPI afforded RBI room to ease interest rates in August. The subsequent trends in oil prices and inflation have virtually confirmed that the August rate cut marked the culmination of RBI's rate cut cycle.



Globally, large economies also showed signs of an improvement in their economic growth and a pickup in inflation. Higher oil prices and improvement in GDP growth washed away the earlier concerns over deflation risks. The large Central Banks took steps to move away from the extreme monetary accommodation provided to the economies to stave off deflation. The US Fed, in addition to raising rates thrice during 2017, also started tapering down its balance sheet by lowering the amount of re-investment of maturing bonds. Other Central banks, too, embarked on tightening their respective monetary policies, or signalling their intent to do so. Bond yields and equity markets climbed across most economies signalling the success of the unconventional accommodative and reflationary policies implemented in the post-Lehman crisis period.

Market Update

Equity Markets

Equity markets had another positive year, continuing from the gains made in the previous year. The initial three quarters of the year saw significant gains for the markets as positive sentiment post the UP state elections, were re-inforced by the prospect of a structural improvement in companies' business post the implementation of the GST. Global back-drop of strong risk appetite helped sustain the gains in equities. US President Trump's proposals on tax reduction were passed through the legislature into law. The sharp reduction in tax rates were seen as providing a strong fiscal stimulus to the economy, propelling the US equity indices higher.

In the domestic markets, inspite of the positive risk appetite, global fund inflows were quite muted. FPI inflows into equities totaled about Rs 21,500 cr during the year. However, domestic Mutual Funds saw inflows of about Rs 1,41,500 cr in the same period. The strong domestic fund flows underpinned the market gains, inspite of the tepid foreign fund inflows.

The last quarter of the year saw some correction in the markets triggered by a global rise in volatility in risk assets. Expectations of a continued rise in US interest rates and lower global liquidity, were the key concerns which led to the souring of risk sentiments. However, on the fundamental side, an improvement in earnings growth for the listed companies, though with some notable exceptions, helped support the markets. The large cap NSE Nifty 50 index delivered 10.25% gains during the financial year 2017-18.

Portfolio positioning and Risk Management

Our portfolio positioning was based on the expectation of cyclical recovery in the economy. Our portfolios remained overweight on private banks, cement, auto companies, and industrial manufacturing, while being underweight on PSU banks, pharma and telecom.

We follow robust risk management policies in our funds. The portfolio deviations with respect the respective benchmark is maintained within defined risk limits. We have defined stock and sector level underweight / overweight positions limits vis-a-vis the benchmark and we actively track such deviations. Deviations are highlighted to portfolio manager and corrective action, if required, is taken in timely manner. Even though we maintained overweight stance on cyclical sectors through the year we operated within defined internal risk limits.

Fixed Income Markets

For the fixed income markets, 2017-18 was a year with two very different halves. The first half of the year was characterised by soft inflation, low growth (due to GST implementation), surplus liquidity and a rate cut by RBI in August. These factors helped maintain bond yields close to the low range prevailing over the past few quarters.

However, the second half saw a sharp turnaround in the environment for bonds. Inflation trend turned higher, albeit on a low base. Oil prices rallied significantly, as the winter demand picked up in a situation of depleted oil inventory, after a year of production cap by OPEC and key non-OPEC producers. US bond yields climbed as the markets factored in greater rate hikes by the US Fed. And lastly, the prospect of increased bond supply due to the Government's fiscal deficit woes, pushed domestic bond yields markedly higher.

Bond yields, on the 10-year benchmark bond, traded largely in the range of 6.40 – 6.60% during the first half of the year. These yields surged higher to 7.80% levels over the second half, before retracing slightly at the end of the year. The 10-year GSec benchmark ended the year at 7.40%, significantly higher than 6.68% at the end of the previous year, fully reversing the move seen in the previous year.

Portfolio Positioning: Duration Strategy and Risk Management

The bond portfolios were dynamically managed with an active duration management through the year. In view of the deteriorating finances of the Government and the upward pressure on oil prices, the portfolios maintained a low duration position in the initial part of the year. The portfolio durations were tactically raised near the end of the year with an expectation of a retracement from the high levels. However, the extent of the retracement was quite limited.

During the year, investments were maintained as per our investment policy and all prudential limits and regulatory guidelines were adhered to at all points during the year. Credit risks in the portfolios were also monitored closely. 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 companies' financials.

The fund specific performance and portfolio details can be accessed on the website (www.hdfclife.com) under the 'Fund performance' section.