Annual Report for Policy Holders - Economic Update

March, 2020

HDFC Life

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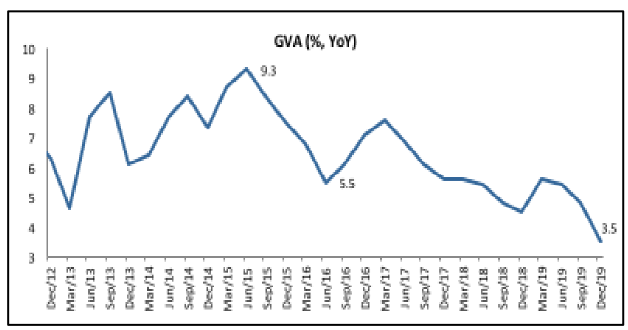
ANNUAL REPORT FOR POLICYHOLDERS

Economic Update

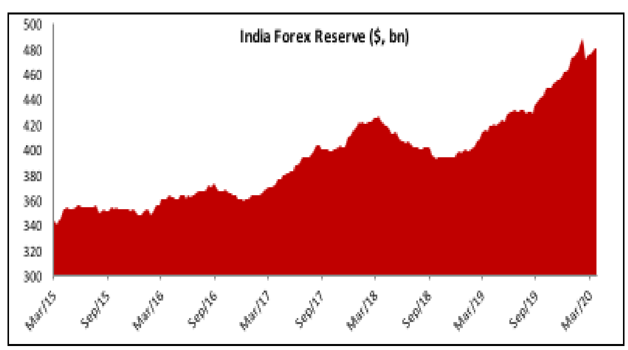
The year 2019-20 proved to be quite tumultuous for the Indian economy. The initial anxiety over the outcome of the general elections held during April and May gave way to relief and optimism as the incumbent NDA coalition returned to power. The new Government continued to grapple with the economic slowdown triggered by the NBFC / HFC defaults that had hit the economy over the previous quarters. Globally, the major economies too, slowed down over the year, as the trade frictions continued to weigh on growth. However, towards the end of 2019, the US and China agreed to a ‘Phase 1’ trade deal, which halted the vicious circle of tariffs and counter-tariffs and paved the way to more meaningful trade negotiations. The slowdown over the course of the year led the monetary authorities in the large economies to cut interest rates and ease liquidity. The increasing liquidity in the global system flowed to risk assets, notably equities and commodities, and equity markets in different countries scaled new life highs, despite weaker economies and corporate earnings growth.

In India, the RBI, too, cut policy interest rates steadily through the year. The benign inflation trends, on the back of weak demand, provided RBI the room the ease interest rates by a cumulative 135 bps over the course of calendar year 2019. The Government also provided a fiscal stimulus through multiple measures, with the most notable action being the corporate tax rate cut announced in September 2019.

The heightened risk aversion post the defaults in some NBFC / HFCs tightened the availability of credit in the system, leading to a moderation in consumption in the urban areas. The rural economy, too, had its fair share of challenges. While the 2019 Southwest monsoon ended with a surplus as total rainfall was about 110% of the Long Period Average, a late surge and heavy rainfall at the end of the season led to widespread floods and affected standing crops. Food prices surged after the kharif harvest due to the crop destruction, pushing up inflation in the Oct-Dec quarter.

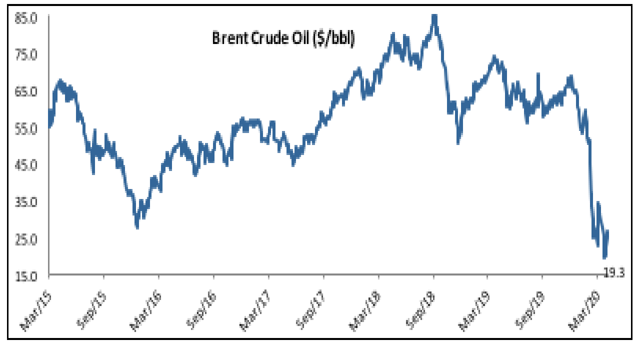


India’s GDP growth slowed through the year to 4.1% in the Oct-Dec quarter, before plunging to 3.1% in the last quarter as the Covid-19 infection and the lockdown affected economic activity in the latter part of March 2020. GVA growth slowed to 3.5% and 3.0% respectively in the last two quarters of the year.

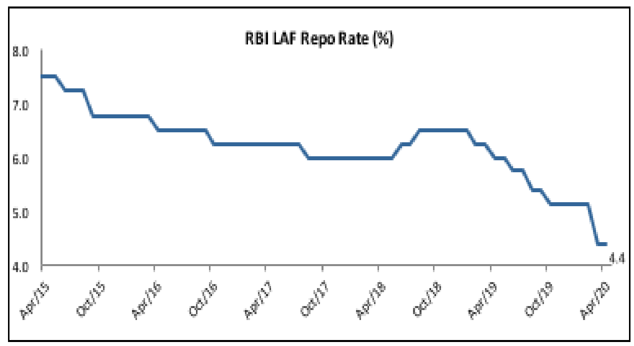


For India, while the economic indicators kept weakening over the year, the external account stayed robust through the year. Trade deficit stayed contained through the year, averaging around USD 14 bn per month, lower than the USD 16 bn during the previous year. However, inflows through ‘invisibles’ as well as Capital account picked up smartly through the year, helping end the year with a strong BoP surplus. RBI absorbed the surplus and added about USD 60 bn to its foreign currency reserves over the course of the year. The BoP surplus helped the Rupee chart a stable course through most of the year, though sharp capital outflows at the end of the year, led to a depreciation of the domestic unit.

In the last quarter of the year global economy hit a wall as a novel coronavirus – Covid-19 spread rapidly across the world. The highly contagious virus with a high mortality rate spread rapidly across Western Europe and the US, and Governments across the affected countries imposed varying degrees of lockdown to arrest the spread of the virus. The Indian Government, too, imposed lockdowns across the country in a bid to control and halt the spread of the virus. The lockdowns, in India, as well as across most large economies, led to a massive fall in activity, that is slated to tip the global economy into recession in the remainder of calendar year 2020.



Oil prices, along with other commodity prices, saw sharp correction in prices, as did equities. At the end of the year, RBI pulled forward a scheduled monetary policy meeting by a week and provided a massive monetary boost to the economy through sharp interest rate cuts, liquidity support and moratorium on borrowings from the banking system. The Government also unveiled its first set of fiscal measures to support the weaker sections of the population. The growth outlook for India, in the near term, has dimmed appreciably and a clearer picture is expected to emerge only after the spread of the infection is brought under control.



Market Update

Equity Markets

The equity markets had their fair share of volatility during the year. Notwithstanding the strong electoral mandate for the Union Government, equity markets were quite listless in the initial quarters as the weakening economy weighed on sentiments. Consumption growth stayed tepid through the year, which affected topline growth of the consumption sector – both durables as well as non-durables. Capex trends in the industrial sector and infrastructure, too, were weak, while export oriented sectors were affected by the insipid global trends. However, expectations of turnaround and a pick-up in growth in the latter half of the year saw equity markets regain their momentum. Underlying corporate earnings were also forecast to pick up as the cycle of elevated NPA provisioning for financial firms was waning while the corporate tax rate cuts provided an additional boost to earnings. The weak global growth also helped firms lower their input costs and shore up margins. The upward momentum was reinforced by strong capital inflows from foreign investors taking the large cap equity indices to fresh lifetime highs.

During the last quarter of the year, the rapid spread of the novel coronavirus Covid-19 to a large number of countries across the globe, put a tight squeeze on global activity. Country after country imposed lockdowns to control the spread of the highly contagious virus. The lockdowns and the sharp deterioration in activity are expected to tip the global economy into a severe recession in the coming quarters. Equity markets around the world saw sharp and severe corrections. In India, the large cap equity indices, too, slipped during the last quarter and ended the year 26% below the levels prevailing at the end of the previous year, while the Mid Cap indices fell around 31 – 35% in the same period.

Portfolio positioning and Risk Management

We maintain well diversified portfolios and the portfolio positioning is based on medium to long term outlook. During the first half of the year, there was an expectation of a cyclical recovery in the economy and the portfolio was positioned accordingly. As the evidence of economic weakening emerged and the Covid-19 infection spread across the world, we made changes to the portfolio. Our portfolios were overweight on private banks, cement, and industrial manufacturing, while being underweight on PSU banks, pharma and telecom initially. Subsequently we cut weights on some of the cyclical sectors and increased weight on some of the defensive sectors.

We follow robust risk management policies in our funds. The portfolio deviations with respect to the respective benchmarks 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.

Fixed Income Markets

The fixed income markets had a positive year on the back of listless growth and easing monetary policy. RBI cut policy interest rates by a cumulative 135 bps in calendar year 2019 and added liquidity into the banking system through OMO purchases and unsterilized forex purchases. Inflation trends stayed benign through the year, except during the third quarter. The spike in inflation in the Oct-Dec quarter, led by food inflation, only led to a temporary pause in RBI's rate easing cycle. However, the weak growth also led to shortfall in Government's tax revenue collections and the markets remained wary of a slippage in the Government's fiscal deficit target.

In March, in addition to the earlier rate cuts, RBI took aggressive measures to stem the weakness in the coronavirus afflicted economy. RBI cut interest rates by an additional 75 to 90 bps and added a humongous amount of liquidity to help stem the deterioration in activity levels. Over the course of the year, RBI also resorted to a number of unconventional measures to improve the transmission of its rate actions to the real economy. RBI used Long Term Repos (LTROs) for the first time in India to add liquidity, while RBI also resorted to simultaneous purchase and sale of different maturity securities in the open market (Operation Twist) to influence the shape of the yield curve. The 10-year benchmark Govt security yield eased from 7.35% to 6.12% over the 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, the portfolios maintained a cautious duration position in the initial part of the year. The portfolio durations were tactically raised in the second half of the year as RBI got more active and resorted to more unconventional measures like 'Operation Twist' and 'Long Term Repos' (LTROs). The fixed Income portfolios also maintained a conservative credit positioning of the funds as the proportion of higher credit grade exposures increased.

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. In view of the deterioration in the credit environment as the economy slows down, we continue to monitor all our credit exposures pro-actively.