Annual Report for Policy Holders - Economic Update

March 2019

HDFC Life

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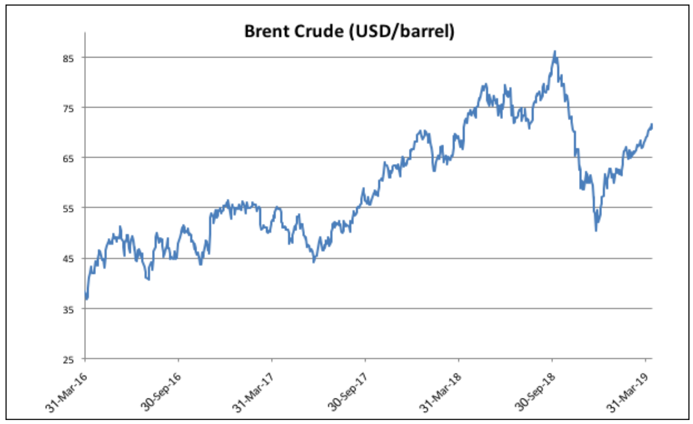
ANNUAL REPORT FOR POLICYHOLDERS

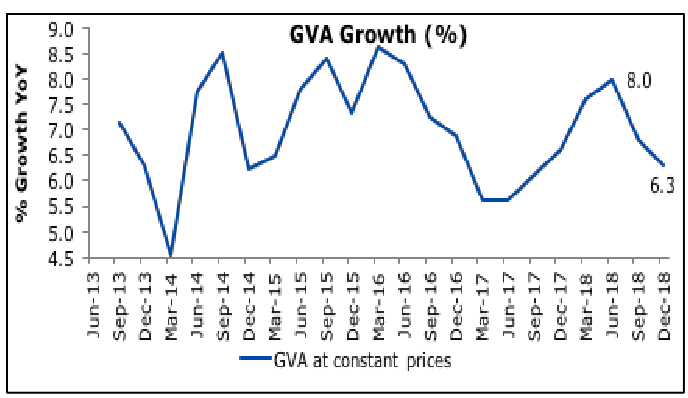
Economic Update

Financial year 2018 – 19 was a year of inflection, as the two halves of the year saw diametrically opposite trends. The year started on an optimistic note as the large global economies benefited from a synchronized pick-up in growth that had been underway for a few quarters. The US economy saw a marked acceleration as the fiscal stimulus provided by tax cuts, at the beginning of the year, took effect. Other large economies, too, saw an improvement in their growth indicators.



Commodity prices, notably oil prices, appreciated in response to the improvement in growth prospects and inflation readings in the developed countries ticked up. Along with the pick-up in growth, oil prices were also supported by production cuts by OPEC and non-OPEC countries.

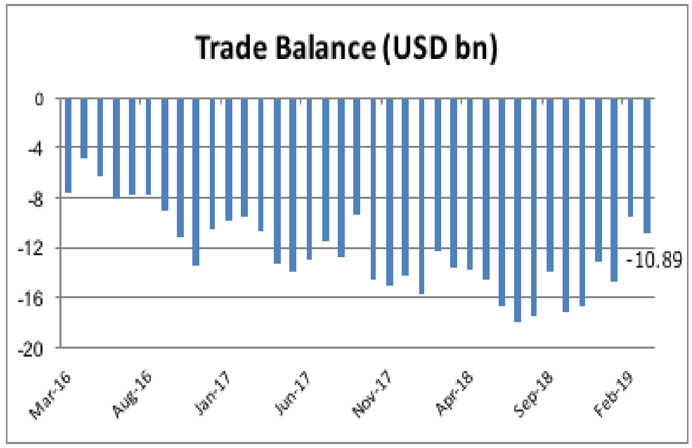
The highlight of the year was the escalation in the 'Trade War' between China and the US, as the US imposed tariffs on a large number of imports from China, and China retaliated in same measure. Protectionist rhetoric picked up in trade between the US and other countries as well, and global trade volumes slowed down over the latter half of the year. The slowdown in global trade coincided with a slowing down of economic activity in major developed economies and large emerging economies, as well. The waning of the fiscal stimulus in the US seemed to be the key reason for the slowdown in the US. At the beginning of 2018, the IMF had estimated 3.9% global growth for 2018 as well as 2019. At the beginning of 2019, the growth estimates had been pared down to 3.7% for 2018 and 3.5% for 2019. Oil prices retreated as rapidly as they had risen in the previous quarters. Monetary policies saw a marked shift from a tightening bias to an easing bias, in a bid to support growth.



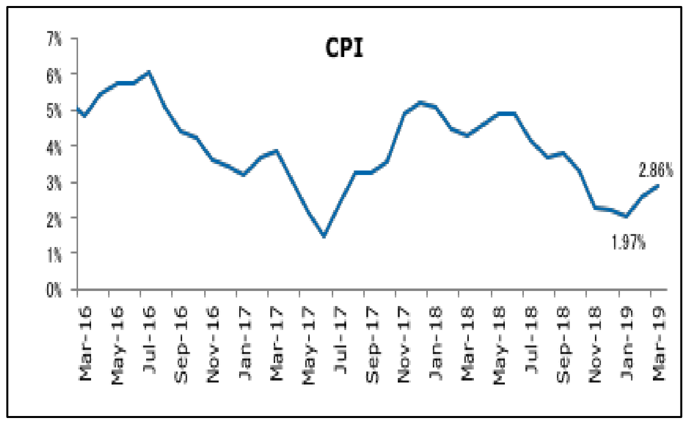
The domestic economy, too, followed the gyrations of the global economy as GDP growth clocked a rapid 8.0% growth in the first quarter of the year. The growth surge was driven by higher domestic private consumption as the economy emerged from the demonetisation and GST induced slowdown of the previous year. However, over the subsequent quarters, consumption growth, for both

Government as well as private sector, slowed down, while investment growth continued to stay low. Q3FY19 GDP growth slowed to 6.6%, while GVA growth slowed to 6.3%.

The trajectory of India's trade deficit followed the path of oil prices. The monthly trade deficit narrowed to about USD 10 bn by the end of the year, in sharp contrast to the USD 17 bn deficit in the middle of the year, when oil prices had seen a sharp rise. As oil prices receded, the deficit, too, contracted. For the full year, though, the trade deficit was about USD 176 bn, as the oil import bill rose almost 30% over the previous year.



Domestic inflation eased significantly and consistently surprised on the lower side during the second half of the FY19, as food inflation almost disappeared. The slower growth in the second half of the year also helped core inflation stay soft as demand pressures were quite weak. Headline CPI averaged just 2.54% for the second half of FY19, significantly lower than the 4.32% for the first half of the year.



The two halves of the year, also saw two facets of RBI's monetary policy. RBI raised policy interest rates twice in the first half of the year, in response to higher oil prices and robust growth, only to reverse stance and the cut interest rates in the second half. Bond yields followed suit, as they rose in the initial half of the year and eased thereafter, as RBI switched the interest rate cycle.

Market Update

Equity Markets

The growth optimism in the first half of the year saw mixed performance in the domestic equity markets. Large Cap indices gained significantly to trade at new all-time highs in the second quarter of the year. Mid-cap and small-cap equities, however, did not share the same optimism. The tight financial conditions post the default in the IL&FS group led to a sharp slide in prices as risk appetite diminished. However, a global rebound in risk assets in the last quarter of the year, helped domestic equities recover most of the fall of the previous quarter.

Earnings growth for listed companies saw greater traction, led by financials, as the cycle of non-performing asset recognition and provisions tapered down. The differences in sector performances was quite stark during the year, as also the differences in performances between the larger companies versus the smaller ones. The large cap indices out-performed the mid and small cap indices over the year.

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, 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

Bond yields, too, followed the gyrations seen in the global economy and oil prices. Bond yields rose steadily through the first two quarters as Oil prices continued rising. Global growth outlook and global bond yields were on the upswing. RBI raised the Repo rates twice in the first half of the year to pre-empt a pick-up in inflation due to the rising oil prices.

The default by IL&FS group companies, during the year, affected the bond markets adversely. Liquidity in the corporate bond markets dried up and credit spreads widened. Apart from the defaulting entity, a number of other NBFCs and Housing Finance companies saw an increase in stress in their balance sheets due to the drying up of liquidity.

Over the second half of the year, global growth outlook darkened and global bond yields softened. The domestic inflation trends continued to stay benign, and growth outlook weakened in conjunction with the rest of the world. Domestic bond yields, too, softened in the second half, ending the year almost unchanged, as the 10-year benchmark bond traded at 7.35% at the end of the year, against 7.40% at the end of the previous year, though before setting a high of 8.21% for 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 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 in the second half of the year with an expectation of a retracement from the high levels.

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 default by the IL&FS group, during the year, affected the bond markets adversely. Some of our portfolios had a miniscule exposure to the defaulted entity, and suitable provisions for the exposures were made in response to developments in the defaulting company. The portfolios did not have any exposures to any of the other stressed companies in the NBFC and Housing finance sectors. We continue to monitor all our credit exposures pro-actively for signs of any changes in the credit outlook for the investee companies.