Annual Report for Policy Holders - Economic Update

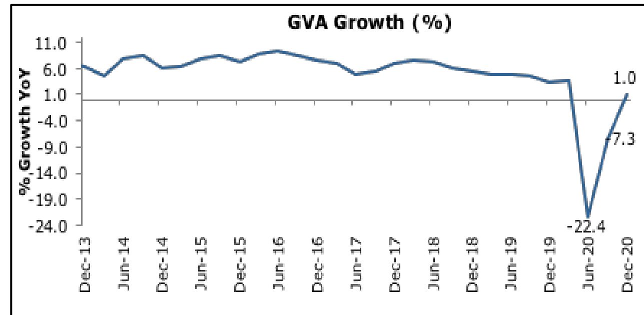
March, 2021

HDFC Life

Sar utha ke jiyo!

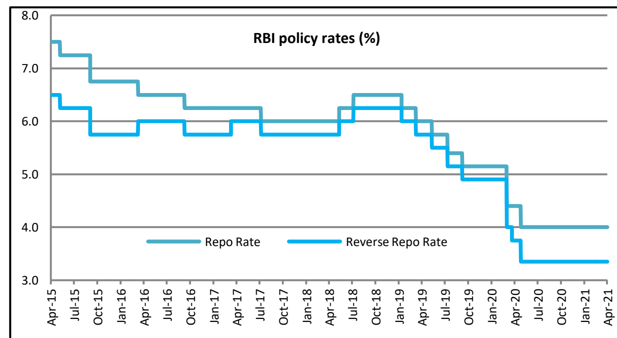
Economic Update

The year 2020-21 was dominated by the ramifications of the Covid 19 pandemic on all aspects of life. The year started with a stringent national lockdown in an effort to curb the spread of the highly contagious infection. The spread of the infections peaked around August – September, and the lockdown restrictions were progressively relaxed over the subsequent months. The curtailment of economic activities led to a sharp contraction of 22.4% in India's GDP, during the first quarter of the year, the first such contraction in over 40 years. The progressive pick up in activities in the later months led to a gradual improvement in GDP growth to -7.3% and 1.0% in the subsequent quarters. Economists' forecasts for total GDP growth for FY21 are pegged around -7.5%.

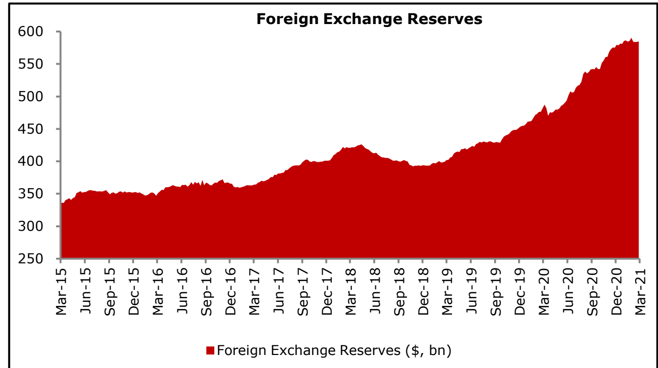


While the economy contracted, there was a clear dichotomy in the activity levels among different industry sectors. Most agriculture and rural economy oriented sectors saw limited impact of the virus and the lockdowns, while the urban oriented as well as the more people intensive and services sectors bore the brunt of the restrictions.

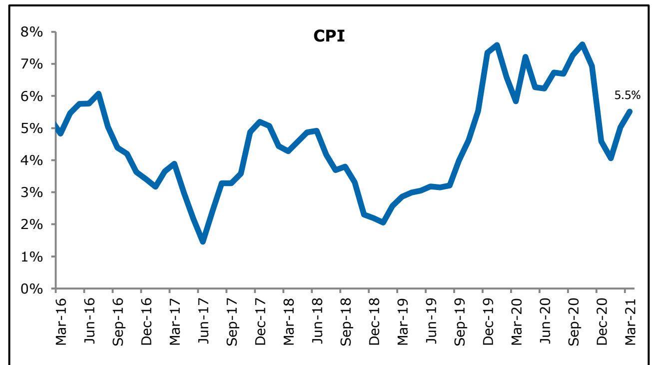
In the face of the severe impact of the Covid infection on the economy, the Government and the RBI stepped in with fiscal and monetary stimulus measures to support the economy and hasten the recovery process. RBI cut interest rates aggressively in the initial months of the pandemic, added a huge amount of liquidity in the banking system and conducted targeted repo operations to provide liquidity to borrowers. In addition, RBI also allowed banks to provide a moratorium on loan servicing and thereafter also allowed banks to re-structure loans for the stressed borrowers. In conjunction with RBI, the Government provided loan guarantees to ensure that borrowers were not starved of credit during the difficult times. Apart from the loan guarantees, the Government also provided re-financing facilities through central financial institutions, targeted at specific sectors. Among other fiscal measures, the Government provided direct benefits to the vulnerable population, provided incentives for private sector capital expenditure in specific focused sectors in an attempt to kick-start the investment cycle and improve employment. The Government also stepped up its spending, especially in infrastructure sector, despite the massive hit to its revenues, leaning, instead, on enhanced borrowings to finance the expenditure. The Government's fiscal deficit, as a result of the enhanced borrowing, expanded to 9.5% of the GDP against the budgeted estimate of 3.5% of GDP.



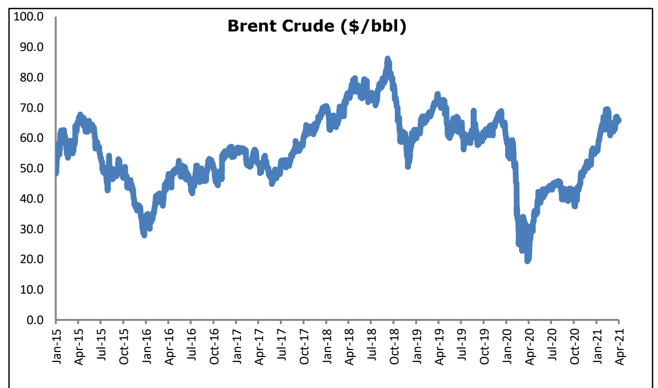
India’s external account, however, remained robust as the trade deficit for the year contracted to USD 100 bn from USD 161 bn in the previous year. Soft oil prices, weak internal demand and relatively stronger exports helped reduce the trade deficit. The Current Account, after accounting for the remittances and invisibles, is expected to result in a minor surplus of about USD 20 bn. The Capital Account, too, recorded a surplus on continued FDI and FPI flows. Thus the surplus on the BoP is expected to rise to almost USD 90 bn for the year. The RBI has been intervening in the markets to reduce volatility in the currency markets. The large BoP surplus effectively helped increase RBI’s foreign currency reserves to about USD 576 bn, rising about USD 102 bn over the year.



CPI inflation, meanwhile, rose in the initial part of the year, despite the weak economic activity and demand, as the supply disruptions, due to the lockdowns, pushed prices higher. Predictably, inflation eased, as the restrictions were lifted progressively over the course of the last two quarters of the year.



Oil prices, along with other commodity prices, saw a sharp correction in the initial months, on the weak outlook for global growth on the back of a ravaging Covid pandemic across the world. However, the opening up economies during the latter part of the year, a strong pent-up demand and greater confidence on future growth pushed commodity prices higher. Most commodity prices recovered to pre-pandemic levels, and in case of key metals and agri commodities, even exceeded the pre-pandemic levels.



The most important development in the second half of the year was the development of vaccines to protect against the coronavirus. The rapid development and roll-out of the vaccines lifted sentiments across the world and raised the outlook for growth.

However, by the end of the year, India saw a revival of the Covid infections which spread far more rapidly than the ‘first wave’ of the infections. The outlook for growth, in the near term, is expected to be clouded by the ‘second wave’ of infections.

Market Update

Equity Markets

The equity markets had their best year in terms of returns, in more than a decade. After the sharp correction at the end of the previous year, the markets bottomed out soon thereafter and rallied strongly from the low levels. The large amount of monetary and fiscal stimulus measures taken by Governments and Monetary authorities across the developed economies and most of the emerging economies, provided support to the respective economies and also channeled a huge amount of liquidity into the equity markets. The surge of liquidity provided the initial boost for the markets. The prospect of an improvement on corporate margins and earnings growth on the back of lower costs as well as a surge of pent-up demand fueling corporate revenues, helped sustain the gains. Further developments on the vaccine approvals and the outcome of the US President elections pushed equity markets higher and covered up all the losses due to the pandemic, seen in the earlier part of the year. A fiscally expansionary Budget for FY 2021-22, at the beginning of February, provided the trigger for another round of sharp gains. The large cap indices gained more than 70% for the year, while the mid-cap indices gained about 90% for the year.

Towards the end of the year, the number of Covid infections started rising again, in what was seen as the 'second wave' of the virus. However, keeping in mind the economic distress caused due to the stringent lockdown during the first wave, Governments preferred to impose localized restrictions to contain the spread, while aiming to keep most industrial activity running as usual, though with appropriate protocols. The markets were seemingly unaffected by the second wave as the impact of the lockdowns were expected to be transitory.

Portfolio positioning and Risk Management

We maintain well diversified portfolios and the portfolio positioning is based on medium to long term outlook. The equity portfolios were positioned defensively with an over-weight on sectors that were expected to see a relatively lower impact of the pandemic and the lockdowns. Our portfolios were overweight on IT, cement, pharma, consumer goods, while maintaining an underweight position in autos, PSU banks, oil and gas. The sector positioning helped the portfolios out-perform the respective benchmark indices in the initial quarters of the year. The rally during the last quarter of the year, was led by cyclical sectors as well as some high-beta stocks, which adversely affected performance in the last quarter. Based on the current economic and market outlook, we have made some changes to our portfolio. We regularly make appropriate changes to the portfolio within the overall risk management framework.

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 mixed year. The aggressive monetary policy response from the RBI led to lower yields in the initial part of the year. In addition to the sharp interest rate cuts and the addition

of liquidity into the system, RBI took a number of additional measures to support the bond markets and sustain the lower yield levels. The sharp rise in inflation during the middle of the year, did not affect the 'accommodative' monetary policy stance, as the RBI saw the inflation pressures as transient, emanating from the supply disruptions caused by the lockdowns. Bond yields eased during the first half of the year. However, the disruptions in economic activity, caused by the lockdowns, led to a large shortfall in Government revenues. The Government did not cut back on its expenditures, in order to support the economy during the weak period. The shortfall in revenues was bridged through additional borrowing from the markets. Total net borrowing by the Government shot up by more than twice the budgeted amount during the year. The humongous supply of bonds was far beyond the absorptive capacity of the markets, and pressured bond yields higher. However, RBI intervened aggressively and absorbed the excess supply of bonds, which helped maintain bond yields within a limited range. The 10-year benchmark Govt security yield ended the year at 6.18%, just slightly higher from 6.12% at the end of the previous year, though markedly higher than the low of 5.75% set during the first half of the year.

Portfolio Positioning: Duration Strategy and Risk Management

The bond portfolios were dynamically managed with active duration management through the year. In view of the aggressive easing in interest rates at the beginning of the year, portfolio durations were maintained at a slight over-weight relative to the benchmark duration. However, as the bond supply picked up during the year, we turned more cautious and pared down the portfolio durations. However, a rise in short term borrowing during the latter half of the year, for compensating states for the shortfall in GST collections, adversely affected our portfolios. Short term yields hardened more than the long term yields during this period. However, the defensive positioning is expected to continue as the interest rate cycle is expected to turn higher in the coming years.

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.