Annual Report for Policy Holders - Economic Update

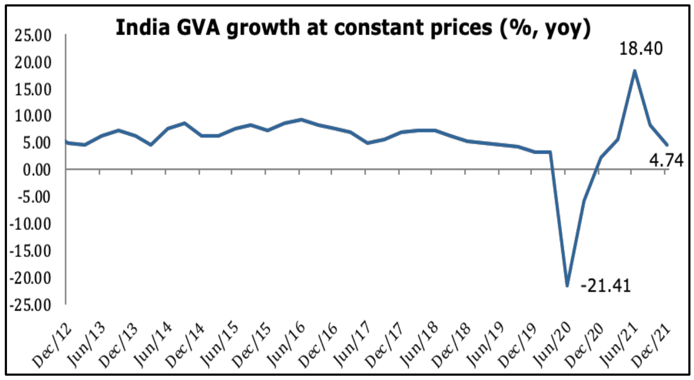
March 2022

HDFC Life

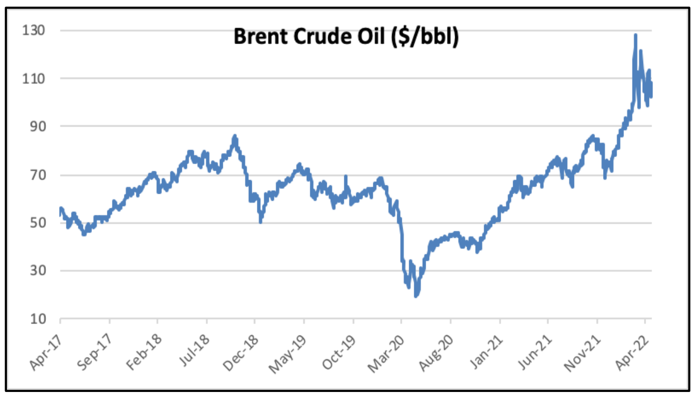
Sar utha ke jiyo!

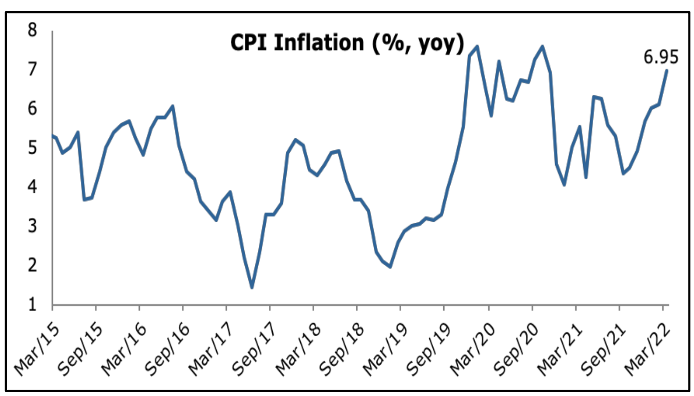
Economic Update

The year 2021-22 started in the throes of the severe second wave of the Covid pandemic. While the first quarter of the year bore the brunt of the virus, the subsequent quarters saw a steady drop in the infections, leading to progressive easing of the lockdowns and recovery in economic activity. The rapid roll-out of the vaccination coverage across the country also provided confidence to restore normal activity. A third wave of infection, during the last quarter of the year, thus, proved to be mild and did not cause any disruption. India's GDP growth numbers reflected the steady improvement in activity, though the 'base effect' caused significant volatility in the quarterly numbers. India's GDP growth is estimated to have grown 8.9% in FY 2021-22, taking it above the pre-pandemic level, and recovering smartly from the -6.6% contraction of the previous year.

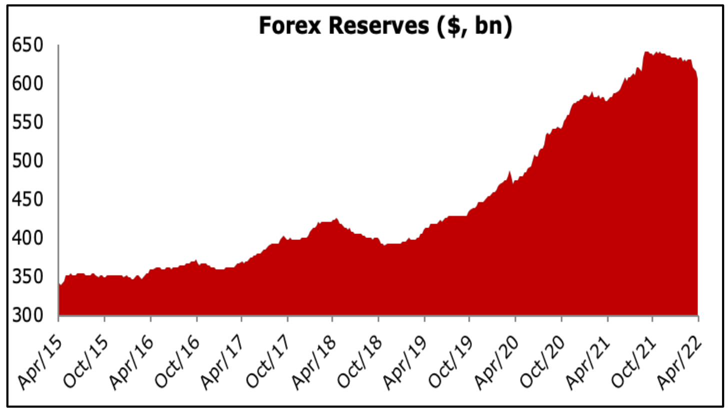


However, the last quarter also saw a rise in hostilities leading to war breaking out between Russia and Ukraine. Russia and Ukraine are large exporters of a host of commodities from Oil & Gas, fertilisers, chemicals to foodgrains. The war and the subsequent sanctions on Russia, by the Western countries, restricted supply of these commodities and led to a sharp rise in commodity prices. Crude Oil prices rose to multi-year highs in the immediate aftermath of the war, as Russia was a large exporter of Crude Oil and products. For the global economy, where demand had been stimulated through large and coordinated monetary and fiscal stimulus measures, the revival of demand was met with the still disrupted supply chains, leading to lower supply responses and a rise in inflation. The Russia-Ukraine war exacerbated the price pressures. India's domestic inflation, too, was impacted by the same dynamics as CPI inflation stayed elevated during the latter part of the year, while WPI inflation soared into double digits.





The opening up of the economy from the pandemic and the sharp rise in Crude Oil prices in the latter half of the year led a rise in the trade deficit. The total deficit for the year rose to USD 192 billion, the highest in about a decade, and almost double the USD 103 billion deficit in the previous year. The India Rupee, though remained steady through the year, despite the rise in the trade deficit, as other flows under 'invisibles' in the Current account and FDI in the Capital account, picked up to cover the trade deficit. The total BoP ended the year in a surplus of about USD 50 billion, lower than USD 87 billion in the previous year. The surplus is also evident from RBI's forex reserves that have risen substantially over the last few years. The steady currency and the large forex reserves have helped protect the currency from the global turmoil and the volatility.



Market Update

Equity Markets

After the sharp gains of about 70 – 90% in equities in the previous years, the large cap and the mid-cap indices grew about 19 and 25% respectively in FY 2021-22. The strong momentum in equities continued for the initial quarters of the year. The optimism around the progressive opening up of the economy along with the rapid vaccine coverage supported the equity markets. However, the sharp gains started faltering with global developments. The persistent rise in inflation in the US led the US Federal Reserve to signal a change in its stance of easy monetary policy to tightening, setting stage for a phased withdrawal of the huge liquidity that had been added into the system since the onset of the pandemic. The prospect of withdrawal of liquidity led to a correction across most risk assets globally. Domestic equities, too, stumbled from the peak levels seen in October. Foreign Portfolio Investors withdrew large amounts of capital from India. However, the corrections triggered by the FPI outflows were quite shallow. Domestic investors, especially retail investors, helped absorb the large amount of FPI selling. Over the course of the pandemic, retail investors' investments in the equity markets, either through mutual funds or direct investment in equities has risen sharply. The rapid increase in retail investors' participation in the markets absorbed the FPI sales.

Corporate results over the course of the year were strong as companies had cut down on costs and un-related diversifications, as also de-leveraged their balance sheets, providing a fillip to earnings. However, by the end of the year, the persistent rise in inflation affected companies on their margins, as the relatively weak demand constrained their ability to pass through the rise in input prices, while demand moderated as consumers pulled back spending in the face of rising inflation. The resultant margin pressures and the lower outlook for earnings growth kept markets range bound. The Russia-Ukraine war added to the inflationary pressure and clouded the outlook for margins.

Portfolio positioning and Risk Management

The equity portfolios were positioned to benefit from the recovery in economic activity and benefit from the margin expansion among companies that had taken efficiency improvement measures. The portfolios were largely over-weight on financials, on expectations of improvement in asset quality aiding margins, pharma, cement, automobiles, IT etc. However, the sharp rise in inflation towards the end of the year, along with the Russia-Ukraine war upended the expectations. The sharp rise in input costs with limited ability for companies to pass them to output prices meant a squeeze on margins. Secondly, stocks in the metals sector gained handsomely as commodities' prices soared. The portfolios, as a result, had some under-performance against the benchmark indices. 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 witnessed a steady rise in bond yields through the year. The primary factor for the rise in yields was the large GSec supply as the Government resorted to large market borrowing to fund its relief measures for the Covid hit economy. In the initial part of the year, the RBI intervened in the markets through OMO purchases of bonds to help contain the yields. However, during the second half of the year, the rise in inflation led to RBI stepping back from active intervention in the markets. Moreover, as the economy recovered and normalcy was restored, markets started to price in expectations of a reversal of the RBI's 'accommodative' stance.

Global bond yields, too, hardened during the year. During the latter half of the year, the US Fed pivoted to a more hawkish stance in the face of persistently high inflation. The change in the Fed's stance led the US bond markets to price in a more aggressive rate hike and liquidity withdrawal schedule, which pushed up bond yields. The rise in inflation was a global phenomenon over the second half of the year, and almost all central banks moved towards a tightening bias. Thus, the global bond market environment, too, was adverse, which underpinned the steady rise in domestic bond yields. Over the course of the year, the 10-year benchmark bond yield rose to 6.85% from the 6.18% levels at the end of the previous year.

Portfolio Positioning: Duration Strategy and Risk Management

The bond portfolios were dynamically managed with active duration management through the year. However, as the bond yields set upon a hardening path, the portfolio duration was maintained at an under-weight position with respect to the benchmark, for most of the year. There were some occasions where the portfolio duration were likely to have exceeded the benchmark duration, more as a tactical position than a steady state position. We also maintained an under-weight position in credit exposures, as the spreads had narrowed significantly. However, during the second half of the year, the credit spreads collapsed further, taking 'AAA' yields below respective maturity GSec yields.

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.