DHFL Pramerica MUTUAL FUND

From the CEO's desk – June 2018

Should we be worried about developing political risk in Italy?

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Global markets had an interesting month in May 2018. Some events that grabbed the headlines included:

- Softening of stance by US and China on trade disputes
- Brent crude rising to $ 80 per barrel post US pulling out of Iran deal
- US 10 year yield touching a 11 year high at 3.09%.
- US and N. Korea cancelling the summit and then again deciding to go ahead.

However the event which the world's thought leaders are evaluating in terms of a political risk is thanks to the outcome of the Italian general elections. The anti-establishment 5-Star Movement, Italy's biggest party, and the far-right League party won more than half the votes in March's parliamentary elections. Both the parties are critics of single currency system of Eurozone and have advocated the exit of Italy from the Euro as a currency. A new vote is now expected in late July in terms of important economic berths.

And some of this the markets have already started to discount - for example Italian government bond yields are already at a 3 year high; flight to safety - 10-year US Treasury yields fell to 2.78%, its lowest from 3.12% just several weeks ago. The euro sank to $1.1529, its lowest since Jul'17; US DJIA lost 2.6% since the start of the crisis.

So for financial markets, the Italian political crisis is akin to the Greek debt crisis three years back that questioned the existence of the Euro. Either ways if the Italian president agrees to giving power back to the coalition or coalition wins the next election, it would be seen as a referendum vote against the Euro. And yes Italy's political establishment can make enough noise for exit from the Euro and pushing global investors towards what is popularly known as "Risk Off" trade.

The US Dollar Index is the one to watch in the short term for a break out and rally up due to so many of these impending developments. Crude price can only get volatile - the potential "Risk Off" situation can result in falling global growth and a fall in Crude prices vs current US-Iran situation that has led to the sharp rise lately.

Given the global backdrop and stiff inflation back in India it will be a prudent for investors to be at the shorter end of fixed income and participate through short term and accrual funds. The current YTMs in the range of 9.20% to 10% with maturities between 2-3 years and thus offers superior risk reward with lower volatility.

Similarly on equity side, large caps still continue to offer a relative valuation comfort. For investors looking at equity exposures with low volatility a hybrid fund scores the highest. Also equity portfolios with built in margin of safety in terms of high ROE, low debt to equity and good value orientation make immense sense as we all get ready to face volatility - thanks to global headwinds and of course India's next 2-3 quarters going into an election mode.

From a long term perspective it would be worth remembering that 'this too shall pass'...

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