MACRO REVIEW AND MARKET OUTLOOK FOR 2023

"Courage taught me no matter how bad a crisis gets...any sound investment will eventually pay off"

- Carlos Slim Helu
### TOPICS

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Global Market Update:

2022 may be remembered as a watershed moment in global history, signalling the end of one era and the beginning of another. The year saw major geopolitical and economic events that shaped various countries’ international relations and economies. The year saw major historical events ranging from the funeral of Queen Elizabeth II to the assassination of former prime minister of Japan, Shinzo Abe, to Liz Truss who resigned as UK prime minister after 45 days in office. Global economies were shellshocked with Russia declaring war against Ukraine which resulted in a major energy crisis as besides the middle eastern countries, Russia has a major share in crude oil export. The demand supply mismatch resulted towards global inflation shooting upwards across economies and disturbed the financial equilibrium.

Factors that were going to break the backs of the Indian stock market indices included the conflict between Russia and Ukraine, which caused fluctuations in crude oil prices, the rupee’s weakness, problems with the global supply chain brought on by the pandemic, and the staggering inflation that was well above the consumer price index (CPI) inflation of 4% within a range of +/- 2% set by the Reserve Bank of India. Instead, it has been the opposite. As of December 15th, the Nifty 50 had generated 4% absolute returns, compared to the US Nasdaq, which had dropped by 30% due to global headwinds. India's significant GDP growth of 6.3% year on year in Q3 2022, compared to the US’s stagnant 1.9%, which was driven by a steady expansion in private consumption and strong growth in investments, partially offsetting lower government spending and a higher trade deficit could be attributed for the outperformance of the domestic market in comparison to the developed economies.
Overall, on a broader scale, Nifty 50 TRI has given a return of 7.5% backed by reduction in covid cases and thereby opening up of economy in truest sense after 2 long years leading to strong pent-up demand. This helped corporate revenue growth leading to increase in credit growth and good GST collection numbers. On a sectoral level, Nifty Metal is the best performer because of constraints on supply side due to Russia-Ukraine war, whereas the Nifty IT Index is the worst performer so far in CY’22 as rising interest rates increased concerns of global economic slowdown and could result in curtailment in IT spending by corporates.

Outlook:

The rate of macro growth is strong and economic activities are closer to the pre-pandemic level. Government spending has resumed, employment is on the rise, and supply bottlenecks are lessening, which should somewhat offset the negative effects of the lagging effect of rate hikes.

The Indian economy should be supported in the medium term by stable political scenario, favourable policy environments, the effects of PLI programmes, possibilities brought about by changes in the global supply chain, government emphasis on infrastructure spending, etc. We anticipate easing of the lag effect caused by the rise in global commodity prices, both for food and non-food items.

The ongoing rebound in FPI inflows may be short-lived, as falling global growth can alter their risk appetite. Though DII flows are as meaningful as FPI flows, with retail flows increasingly being directed in markets through Insurance, EPFO and MFs. Current monthly SIP Book of MFs in India is ~13,000 Cr should provide good support to the markets in case we witness continued FII withdrawals.

GDP Growth is expected to normalize over the coming quarters. Additionally, lower crude oil prices should begin contributing positively to terms of trade. However, downside risks are increasing from global factors and the lagged impact of monetary tightening.

For the first time since Russia invaded Ukraine in late February, oil prices have dropped below $80 per barrel. However, given that there appears to be a great deal of uncertainty regarding Russian oil supply coupled with EU’s ban on Russian crude oil and OPEC+ supply restrictions, and US supply growth will not be able to fill the gap, we think Brent crude will once more reach $100 per barrel.

As the cost of funds rises and supply chain bull-whips continue to unwind, exports are likely to be pressured, reducing the momentum from normalising employment and the restart of general government spending.
There was huge polarisation witnessed within the Nifty 50 stocks itself. The performance dispersion between the best and the worst performing stock was massive underpinning the thesis that within the most active segment as well, it has become more and more critical to get the stock picking right. Merely picking a market cap segment and sticking to it may not result in desired outcomes.

The Nifty 50 index was dragged down mainly by the underperforming IT sector stocks that were impacted due to the global market turmoil affecting the advanced economies (AEs), leading to a high attrition rates and layoffs for the sector. The banking sector which has a major share in the index, saw significant performance backed by the increment in the repo rates which resulted towards better net interest income margins for the retail banking sector.
Portfolio positioning of Equity Schemes in CY 2022

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<tr>
<th>Sectors</th>
<th>CANARA ROBECO FLEXICAP FUND</th>
<th>Relative Weight (%)</th>
<th>CANARA ROBECO BLUE CHIP EQUITY FUND</th>
<th>Sectors</th>
<th>Relative Weight (%)</th>
<th>CANARA ROBECO EMERGING EQUITIES</th>
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<td>Energy</td>
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</tr>
</tbody>
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Source: Internal Analysis; Data as on Dec 15, 2022. The sectors mentioned above should not be construed as a recommendation. The funds may or may not have future position in the above-mentioned sectors.

‘Consistency’ is a virtue needed for sustained long term performance

Volatility in the Capital Markets is a constant, it can swing from extreme pessimism to extreme hope in a matter of days. In CY 2022 we all have experienced this, the year started with Russia – Ukraine war which resulted in spike in crude oil prices. And due to increase in inflation, Federal reserve started aggressive rate hikes and it continued during the year which resulted in global economic slowdown.

While our Equity Investment strategy will remain tilted towards *Growth and Quality* style of investing, we also leave some room to pick up *Value* stocks which may become attractive during periods of high volatility and would offer good long-term growth potential.

With the volatility expected to remain elevated in the coming year, we believe that the Large Caps could outperform other market cap segments in the coming year.

As an AMC, our endeavour is to ensure a pleasant ‘investment experience’ for our investors across our schemes. We strive to achieve that by maintaining an unwavering focus on our Investment Process, Investment Objectives and by following a stringent risk management process. These have remained to be our key pillars that has given Canara Robeco MF Schemes the required consistency for wealth creation over a longer-term.

Markets are unpredictable and it may result in some short-term aberrations in the performance, however, time and again, through our Investment Process and prudent stock selection process, we have prioritized the objective of investors having a good experience during their investment journey with Canara Robeco MF Schemes over the longer run.

The heightened volatility in CY 2022 resulted in the Fund Managers facing an extremely challenging year. It is a year which has demanded a lot from the Fund Managers to keep their head above the water. Canara Robeco MF continued to follow its robust Investment and Risk Management processes which it has built over so many years and that has helped the Schemes deliver consistent returns over the long-term.
Global Economy Update:

Macro Backdrop:
- 2022 is coming to an end. It was a tumultuous year with an ever-changing macro landscape.
- 2022 began with global economies slowly recovering from pandemic-induced disruptions and looking forward to economic relief before being hit by Russia’s invasion of Ukraine.
- The conflict led to host of sanctions on Russia leading to an energy crisis (Russia being one of largest supplier of crude oil and main source of natural gas for European nations). Apart from oil & gas, Russia is also a large exporter of key minerals.
- Commodity prices in general skyrocketed, though they would come down later.
- The pandemic disruptions engendered high inflation in advanced economies (AE), which had surged probably on back of supply chain disruptions, as well as demand side impulses led by Central bank stimulus and government handouts given during the pandemic.
- Expectations of reversal of the inflation trend, as pandemic disruptions eased and supply chains recovered to normal levels, had prevented Central banks from reversing ultra-accommodative monetary policies.
- Hit by Ukraine conflict, inflation continued to surge, blindsiding global central banks. Faced with 40-decade high inflation across AEs, global central had to act swiftly and decisively.
- The US Federal Reserve (FED) has raised the key FED Funds rate by 425 bps since March 22 to 4.25%-4.50% range. This includes raising 75bps each in four consecutive FOMC (Federal Open market committee) meetings.
- Other AEs followed suit, raising rates from zero/negative to positive territory to levels not seen since the Global financial crisis (GFC) of 2008.
- The Bank of England (BoE) has raised rates by 275 bps to 3%, while the European Central Bank (ECB) raised its key refinancing rate to 2.5% from 0%.
- The Bank of Japan surprised markets by raising its benchmark interest rate to 0.5% from 0.25%, sending the yen higher and ending a long period in which, it was the only major developed-nation central bank that did not raise rates.
- Further, global central banks, concurrently, reversed the quantitative easing (QE) policies, which they have been adopting since the GFC for managing dis-inflation to quantitative tightening (QT) i.e., withdrawal of excess liquidity added to the system since pandemic.

Events that happened in CY22 and the corresponding Yield movements:

Source: Bloomberg, Internal Product Research; Data as on Dec 15, 2022
Indian Economic Growth:

Macro Backdrop:
- In this hostile international environment, the Indian economy remained resilient, drawing strength from its macroeconomic fundamentals. India’s financial system remains robust and stable.
- Banks and corporates are healthier than before the war crisis. Bank credit is growing in double digits for 8 months now.
- India is widely seen as a bright spot in an otherwise gloomy world.
- India’s inflation remained elevated for most part of the year, as in most parts of the world. Global spill overs continue to impart high volatility and uncertainty.
- According to the latest data released by National Statistical Office (NSO), real gross domestic product (GDP) posted a growth of 6.3 per cent year-on-year (y-o-y) in Q2:2022-23, driven primarily by private consumption and investment.
- Going into Q3:2022-23, economic activity continued to gain strength.
  - Urban consumption firmed up further, driven by sustained recovery in discretionary spending, especially on services such as travel, tourism, and hospitality.
  - Passenger vehicle sales and domestic air passenger traffic posted robust y-o-y growth. Rural demand is recovering as reflected in the pace of tractor and retail two-wheeler sales, with rising farm activity. Investment activity is also gaining traction.
  - Non-food bank credit rose by ₹10.6 lakh crore during April-November 2022 as compared with an increase of ₹1.9 lakh crore last year.
  - The total flow of resources to the commercial sector expanded by ₹14.7 lakh crore during 2022-23 (up to November 2022) as compared with ₹6.8 lakh crore in the same period of 2021-22.
  - On the other hand, the drag from net external demand further accentuated in October as merchandise exports contracted by 12.1 per cent (y-o-y) after expanding during the previous 19 months. Merchandise imports expanded by 10.0 per cent in October.

RBI’s response to Global and Domestic Events:
- With India being no different from rest of world, the RBI had to react when CPI inflation started consistently breaching the RBI’s comfort zone of 6%.
- In a surprise off policy move, RBI Monetary Policy Committee (MPC) raised rates by 40bps in May 22 and followed it with 3 consecutive 50bps rate hikes before slowing down to 35bps in Dec 22 MPC meet.
- Repo rate was raised by 225 bps from 4% to 6.25% in just over 7 months.
- RBI was also working on reducing the extremely easy liquidity conditions created during pandemic and started by raising CRR by 50bps.
- Other tools were used to bring down liquidity to manageable levels over a period, including the introduction of the standing liquidity facility (SDF) to replace reverse repo rate. The SDF is placed 25bps below repo rate.
- The combined impact of rate hike and liquidity withdrawal has pulled up the overnight rate from 3.00-3.40% at start of 2022 to 6-6.50%, effectively raising daily borrowing costs by almost 300bps.
- Both private consumption and investment rate edged up in Q2 FY23 compared with the corresponding quarter of previous year supported by higher economic activity.
- However, the global growth slowdown has weighed on the net exports.
Inflation:

**Global:**
- There are signs of inflation easing, especially amongst emerging market economies (EMEs).
- The US CPI inflation eased markedly to 7.1 per cent in November 2022 from 7.7 per cent in October. Inflation based on the US personal consumption expenditure (PCE) index eased to 6.0 per cent (y-o-y) in October 2022 from 6.3 per cent in September.
- In the Euro area, annual inflation slowed to 10.0 per cent in November 2022 from 10.6 per cent in October due to negative momentum in the cost of energy and services.

**India:**
The provisional data released by the National Statistical Office (NSO) on December 12, 2022, showed that inflation, as measured by y-o-y changes in the all-India consumer price index (CPI), moderated to 5.9 per cent in November from 6.8 per cent in October. The easing was primarily driven by the sharp moderation in food inflation. The index declined by 11 bps month-on-month (m-o-m), which along with a favorable base effect (month-on-month change in prices a year ago) of 73 bps, resulted in a fall in headline inflation by around 90 bps between October and November.

**Trends and Drivers of CPI Inflation:**

Source: Bloomberg, RBI Bulletin

Note: CPI inflation for April-May 2023 was computed based on revised CPI indices for April-May 2020.

Sources: National Statistical Office (NSO), and RBI staff estimates.
Bond Yields & Spreads:

- **Rate markets**, expectedly, have been extremely volatile during the year.
- While the direction of rate markets has been upward, these were punctuated by relief rallies on any rate positive data.
- **US 10Y yield** rose from ~1.6% to a high of 4.25-30% before retreating to ~3.65% as of now.
- **Indian markets** got a taste of volatility when RBI MPC hiked 40 bps in a surprise move in May 22.
- **G-Sec 10Y yield** started 2022 at 6.46%, climbed to 7.62% (in June 22) and now has moderated to ~7.30%.
- **Markets discounted multiple rate hikes after the first move**, as the long end of the curve did not move appreciably higher after the initial jump in May-June 22.
- **Short-term rates** moved *slowly higher* on the back of consecutive rate hikes by RBI MPC in all scheduled meetings in the year.

![India Bond Yield & Spread Movements](source)

Source: Bloomberg; Data as on Dec 15, 2022. Past performance may or may not sustain in future.

![Credit Spread](source)

Source: Bloomberg; Data as on Dec 15, 2022. Past performance may or may not sustain in future.
GSEC Yield Curve (Jan 22 vs Current):

The above chart shows the yield curve movement wherein the yield curve is now flat.

- Short term rates have moved the highest, with less 1-year rates moving up by 225-275 bps in the calendar 2022, whilst 10Y moved up by about 80bps.

- Flat yield curve provides opportunity to investors to invest in short to medium term funds, without foregoing on yield pickups associated with a steep curve, while reducing interest rate risk from shorter duration in such type of funds.

Investment Thesis:

- Current market conditions are akin to 2013 mini-crisis, especially for India.
- That period was characterized by high inflation (in India), sharp rupee depreciation, high oil prices (brent oil was above USD 100/bbl for prolonged time) and US FED announcing end of quantitative easing policy, though rate hikes did not start till 2015, it had adverse impact on all asset markets.
- Indian rate markets had reacted sharply upwards in immediate aftermath of US FED announcement, and consolidated over a year, before yields came down over a period of 2-3 years.
- A similar situation is playing out now with high inflation (this time in AEs), rupee depreciation (though marginal), high oil prices (in early part of 2022) and coordinated global tightening cycle (though this time it is much faster).
- Global inflation seems to have peaked with headline numbers trending down in the last few months.
- AE central banks resorting to large rate hikes seem to start having effect on demand in interest rate sensitive sectors leading to economic slowdown.
- Commodity prices have dropped with the CRB (Commodity Bureau BLS spot) Index now at a lower level than what it was at the start of 2022.
- While AE central banks may be reaching the end of this swift and swift rate hike cycle, rates may have to stay higher for longer to ensure that the inflation threat is firmly under control.
- India’s growth inflation dynamics are likely to favor inflation, with adverse risks emanating from global slowdown and lagged impact of interest rate hikes.
- Growth is likely to slip to around 6% in FY2024 from projected 6.8% for FY2023 (RBI projections) as higher interest rates bite.
- RBI is likely to be cautious on inflation outlook as it may likely hover between 5%-5.5% in 1HFY2024. As global inflation likely remains a concern, there are no expectations of rate cuts in early FY2024.
- Indian bond markets are expected to have some respite in FY2024 from (1) moderation of inflation (2) peaking of interest rate cycle (3) expected fiscal consolidation.
RBI MPC is likely to remain in prolonged pause (with last expected hike of 25bps in Feb 23) with repo rate at around 6.5%, evaluating the lagged impact of 250bps rate hike as inflation may remain sticky around 5%-5.5%. Any case for rate cuts may only emerge at end of CY2023.

With limited case for rate cuts in near future, markets may consolidate in a range (like experience of 2013-14). With repo expected to peak around 6.5%, 10Y G-Sec yield may not drop much below 7% in the near term.

Short-term yields may remain elevated on the back of higher repo rate as well liquidity tightness.

However, markets are pricing in easing by end of CY2023 or early CY2024 as prolonged bout of high interest rates are likely to lead to slow growth/recession in AEs, bringing inflation down to mandated levels. This provides for investment opportunities from 3+ year perspective.

The current yields of +7%, in the short to long term, may provide investors with good levels to invest across various fund categories.

We believe that with the rate hike cycle near peaking, further sustained up move in yields is not likely.

From a medium-term perspective, it could be good levels for investors to increase allocation to debt funds.

Way Forward:

Global:

Global economy is likely to be marked by slow growth, moderating but elevated inflation, peaking policy rates, and continuing geo-political risks.

Inflation seems to have peaked in major countries, though reasons to cheer may still be far away.

The sharp rise in rates by the US FED and other central banks points to the seriousness of this inflation problem.

AE inflation is in the high single digits and in some cases is in double digits. The mandate in these countries is to have inflation around the 2% mark. While the sharp rate hikes are coming to an end, with the US FED slowing down to 50bps in Dec 22 FOMC (Federal Open Market Committee) meet, most of the central banks are of the view that rates may have to stay higher for longer for the inflation genie to be put back into the bottle. This view seems to conflict with general market consensus that FED may start easing in end 2023 (and other central banks following suit) whilst the FED projections point to easing starting 2024. AE Central banks may be reluctant supporters of growth in backdrop of unprecedented high inflation and may err on the side of caution, waiting for inflation to trend down meaningfully.

India:

In India, macro situation is better. Growth while remaining resilient is likely to slow down to below 6% in FY2024.

CPI inflation has fallen to below 6%. RBI MPC has already delivered 225 bps rate hike taking repo rate to 6.25%. Inflation has receded from highs of 7.8% in April 22 to 5.90% in Nov 22. While this is a positive development, core inflation remains sticky above 6%, a concern flagged by RBI MPC as well. Expectations of 25 bps hike to take repo to 6.5% are priced in by the market. India macro conditions are likely to be punctuated by global demand slowdown in the shadow of volatile geo-politics with risks of persisting negative surprises.

The rupee (INR) has depreciated 10.39% against the US$ (3/Jan/22 to 16/12/22). This is broadly in line with other major currencies as a sharp rise in US rates has led to unprecedented appreciation of the USD against major currencies.

A persistent rise in trade deficit on the back of slowdown in exports, has impacted INR value, though positive FII equity flows in Oct/Nov 22, helped the INR to recover. Going to end of fiscal 2023, INR could trade in range of 81-84/US$.
Funds in Focus:

Investment horizon of 6-12 months:

Canara Robeco Savings Fund may endeavour to provide reasonable returns in a scenario where short-term rates have adjusted sharply higher with 1 year certificate of deposits trading around 7.40-7.60%. If rates rise soon, this fund could benefit from positive mark-to-market (MTM) movements over 6-12 months.

Investment horizon of 3+ years:

Canara Robeco Banking & PSU Debt (CRBPSU) Fund may be an ideal product for investors for longer term. CRBPSU invests in Banking & PSU papers, indicative of high credit quality. Current portfolio investments are AAA. There is high liquidity in this portfolio due to the nature of investments. The duration of fund is around 2-2.25. The fund duration is likely to be increased to 3-3.5 in the coming months. The fund would likely generate MTM gains if the yields ease in 2-3 years, adding to overall returns for investors.

Benefits of an Active Fund Management Strategy:

We believe that active fund management is a good option for investors and provides flexibility on returns as well as liquidity. Actively managed funds provide:

- Flexibility to investors to capture substantial portion of rate cycle up move as the fund manager is likely to actively manage duration in sync with rate cycle.
- Market currently likely nearing end of rate hike cycle. Rate easing may start in a year or two. In 2-3 year time, an open ended active fund is likely to be in a good position to take advantage of rate easing cycle.
- In a scenario where rate cycle remains adverse for longer than expected (in next 1-2 years), an open-ended actively managed fund has an option to move to low duration.

To Conclude:

- 2022 was characterized by extreme volatility across asset classes on back of reversal of pandemic restrictions, Ukraine conflict, high commodity prices and high inflation in AEs.
- AE Central Banks reversed the ultra-accommodative pandemic era monetary policies in a swift and dramatic fashion on back of decade high inflation.
- US FED rate went by 425 bps in span of 9 months taking the FED funds rate to 4.5% and on track to reach rates of 2007-08.
- Pace of rate hike slowing, indicating end of a swift and aggressive rate hike cycle.
- Inflation remains high (compared to 2% mandate across large economies) squashing any expectations of swift reversal of tight monetary stance.
- RBI MPC raised rates at a more sedate pace, taking repo rate higher by 225bps to 6.25%.
- India CPI eased from high of 7.8% in Apr’22 to 5.90% in Nov’22. Further moderation is expected on back of crash in vegetable prices.
- RBI MPC is likely to hike 25bps to 6.5% before pausing for an extended period.
- High core inflation may delay any easing stance till end of 2023/ early 2024 (in line with global rate expectations).
- Markets are likely to consolidate with most of the policy tightening priced in.
- Yield curve has become flat with most of the curve above 7%.
- Investors have opportunity to invest across yield curve at similar yields depending on their investment horizon.
- Short term investors can consider Canara Robeco Savings Fund for allocation from carry perspective.
- Long term investors can consider Canara Robeco Banking and PSU Debt Fund from perspective of very high credit quality, liquidity, and moderate duration, benefiting from expected easing of interest rate cycle in 2-3 years.

Source: RBI, MOSPI, CMIE, FIMMDA, NSDL, Bloomberg.
Product Labels:

Canara Robeco Savings Fund - An open-ended low duration debt scheme investing in debt & money market instruments such that the Macaulay duration of the portfolio is between 6 months and 12 months. A relatively low interest rate risk and moderate credit risk.

Canara Robeco Banking and PSU Debt Fund: An open-ended debt scheme predominantly investing in debt instruments of banks, public sector undertakings, public financial institutions, and municipal bonds. A relatively high interest rate risk and moderate credit risk.

CANARA ROBEKO FLEXI CAP FUND
(Flexi Cap Fund - An open-ended dynamic equity scheme investing across large cap, mid cap, small cap stocks)

CANARA ROBEKO BLUE CHIP EQUITY FUND
(Large Cap Fund - An open-ended equity scheme predominantly investing in large cap stocks)

CANARA ROBEKO EMERGING EQUITIES
(Large & Mid Cap Fund - An open-ended equity scheme investing in both large cap and mid cap stocks)

*Investors should consult their financial advisers if in doubt about whether the product is suitable for them.
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