

# CONUNDRUM

18<sup>th</sup> August 2022

## GLOBAL MACROS AND MARKETS -

**Global central banks have been in a state of conundrum with respect to growth and inflation trade off.** On one hand we have seen inflation at historic highs across most of the economies and on the other side, economic growth has been decelerating and some of the economies may be in a state of recession.

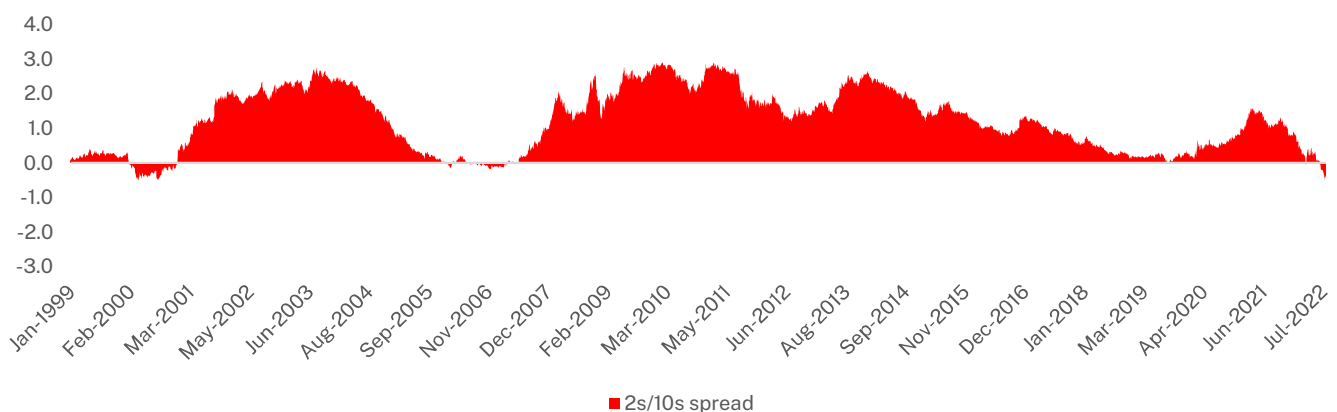
Two key mandates for central banks like US FED are price stability and unemployment. **We believe that growth slowdown should tend to increase unemployment rates and as per the “Phillips curve”, due to inverse relationship between unemployment and inflation, higher unemployment rates would mean that cost pressures should come down.** Policy making in such scenarios would be less restrictive as the focus would probably lie towards supporting growth.

Looking at the way things currently stand in US, job openings are almost twice the no. of unemployed and inflation is at historic highs – in a way a divergence from Phillips curve and various lead indicators of growth pointing towards a growth slowdown, thus the policy making becomes really complicated. It's more of a hope to achieve a soft landing (GDP growth closer to the trend or slightly below) rather than hard landing (i.e. recessionary condition) especially in case of over tightening of financial condition. Market participants in such instances greatly focus on speech from members of policy committee, central bank policy meets and also the minutes of these meets, to understand the possible outcomes for interest rates and accordingly make investment decisions.

If we focus our attention to the FED policy meet held in July 2022, two things really stood out for us – a) Though the monetary policy revolved around controlling the inflation, but unlike the past policy statements, the July policy also emphasised on growth indicators like spending and production softening and b) No forward guidance - FED committee members wanted to be data dependent i.e. monitor the implications of incoming information for the economic outlook in assessing the appropriate stance in the future. **We believe the markets may have perceived the policy more balanced rather than unidirectional which focuses solely on inflation and hence we saw a strong rally in risk assets like equities (S&P 500 is up ~17% from its recent lows in June 2022, Data as of 17<sup>th</sup> Aug 2022).** We also believe that being data dependent and no forward guidance could lead to volatility in the bond markets, especially around the time when high frequency indicators for growth and inflation are released.

Dwelling further on the US bond market, what is interesting to see is **the spread between 2s and 10s US Treasuries going below 0 in July 2022 and is currently closer to the levels last seen in 2000.** In April, when we had released our note on “*Eye on RIDIC environment and Mind of Asset Allocation*”, we had remarked on

similar instance when the spread had gone negative, and why the curve inversion may not be a lead indicator for recession at that point of time. Since Mar 22, we have seen FED hiking rates by 225 bps and balance sheet reduction measures are also announced. **Currently our belief is, we could see a sustained inversion in the yield curve and the pace of inversion would depend on the outlook on growth and inflation and FED rate hike cycle** - front end of the curve which reacts more to central bank policy announcements may remain firm as long as we don't see a policy pivot and the longer end of the curve is expected to have a downward bias due to slowing growth environment and expectation of inflation decelerating in coming months.



Source – Bloomberg, Lighthouse Canton

After many months, good news was finally announced on inflation front. **US CPI increased by 8.5 YoY in July 2022 vs 9% in June 2022 and on MoM basis, US CPI remain unchanged vs 1.3% increase in June 2022.** The decrease in CPI on relative basis was led by decline in energy prices, airline fares, used cars and trucks, communications, and apparels. All other price indicators like decline in ISM Manufacturing and Services prices, Producer Price Index (PPI), 5y5y forward breakeven, etc, waning supply side pressures and ongoing correction in commodity prices gives us an impression that US CPI may decelerate in the coming months. Risk to the inflation call would be rise in shelter costs (which contribute nearly 33% weight in CPI) which lags home prices by 14-15 months (as per in-house analysis) and home prices are yet to peak. **As outlined by various FED officials, as long as CPI is well above the targeted rate of 2%, we may see the hawkish FED policy to continue in order to curb the demand side of the economy and an over tightening of policy may imply an even greater risk i.e. a recessionary outcome.**

Across the Atlantic, the recent CPI print is not good news for United Kingdom. **UK inflation accelerated more than expected last month to the highest in 40 years intensifying a squeeze on consumers and adding pressure for action from the government and Bank of England. CPI rose 10.1% in July on YoY basis vs 9.4% increase in June 2022.** The increase was mainly led by higher food prices. **Higher than expected inflation reading sets the stage for another 50-bps rate hike by**

**Bank of England in Sept 2022 policy meet and also accentuates the risk of a recessionary outcome. As per the Overnight index swap (OIS), the implied overnight rate is set to increase by ~150 bps up by Dec 2022.**

**On the other side, in Europe, inflation inched to 8.9% YoY in July vs 8.6% in June 2022, although on MoM basis we saw inflation coming down to 0.1% from 0.8% in June 2022. The increase in inflation was largely driven by higher energy prices. European economies currently are facing exacerbated pressures on account higher power prices (as Benchmark German power for next year rose to record levels of 455 Euros a megawatt-hour, likewise the French contract was up to record levels of 622 euros a megawatt-hour, Data as on 10<sup>th</sup> Aug 2022) due to increased demand on account of heat waves and supply side disruption with key water ways (like Rhine River) drying up – used to generate hydropower, cool nuclear plants, and ship energy commodities. Other factors like Russia’s supply of gas to European economies especially during winters and gas rationing and storage levels across economies should be monitored closely to understand and gage the inflation and growth impact.**

**In the last policy meeting in July, beside hiking the rates by 50 bps, the ECB announced a new crisis management tool – Transmission Protection Instrument (TPI). As mentioned in our last publication – “Revalidate”, the tool would provide a mechanism to protect the bond yields for peripheral markets like Italy from rising on account of concerns of high debt levels and tighter financial conditions. We found the policy announcements w.r.t TPI as “black box” - even though the central bank outlined the four eligibility criteria (compliance with EU fiscal framework, absence of macroeconomic imbalance, fiscal sustainability and sound and sustainable macro-economic policies) but no specific details were provided on quantitative aspect on what could trigger activation of the tool. Long-term bond yields in Italy, Spain have come down in last few weeks, partly due to the ECB announcements on TPI (positive sentiment in the near term though execution would be important in long term) and partly on account of global bond yields declining.**

**Shifting our stance from global macros to corporate earnings, the recent quarterly earnings in US has progressively been better than earlier expected. Top line numbers have been strong at 14% and earnings have grown by 7%. Sales and earnings growth was more robust for Cyclical as Energy, Materials, and Industrial gains outweighed softness across Discretionary and Financials. Sales and Earnings surprises for SP500 were largely supported by sectors like Utilities and Healthcare, while Technology and Communications weighted on SP500. Since the beginning of the earnings season, we have seen earnings estimates revised on the lower side – as per Bloomberg, 2022E EPS has been revised down -1.7% to \$226, largely due to lower estimates in the 2H of CY22 and 2023E EPS has been revised down -2.4% to \$244. We believe these estimates may undergo further downward revision if domestic and global economic outlook deteriorates further.**



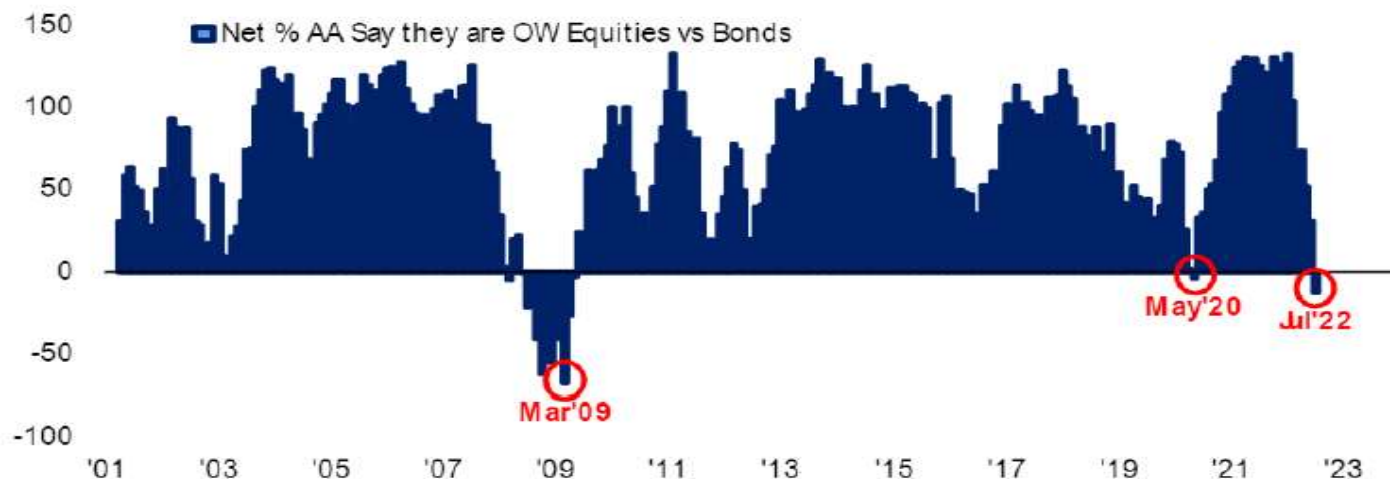
Source – Bloomberg, Lighthouse Canton

Some of the key observations from the results season are as follows –

- We would remain watchful w.r.t the understanding the **trend of new orders to inventory vs YoY EPS growth**. Collapse in the ratio points to destocking and margin pressures.
- **Slowdown in hiring and cut in ad spends reflect a weaker demand** - Large corporates like Facebook, Google, Tesla, JP Morgan, Microsoft, etc have outlined plans to slowdown hiring. In a rare move, we saw Apple firing 100 contract workers as a part of a push to rein in spending. Moreover, companies like Google and Microsoft have seen a decline in ad spends which have negatively impacted their topline numbers and missed analysts estimates.
- **Continued USD appreciation may act as a headwind for SP500 companies** which derive larger business revenues from outside United States.
- **Commentary from Semi-conductor companies** like Qualcomm, Micron, Samsung Electronics, etc **signals plans to dial back investment outlays on account of lower demand** as Russia's war on Ukraine and rising interest rates dampen economic activity.
- **Consumer Electronic manufacturers saw a steep slowdown in demand** which resulted in inventory management from their side for the next year. This resonates with our view on weak demand for semiconductor and consumer discretionary.

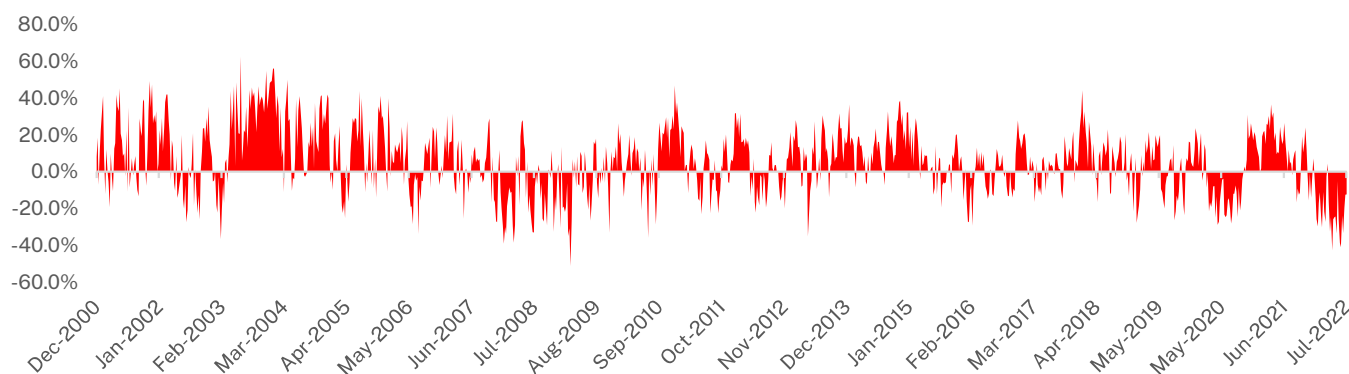
Before we move to examine India macro and markets, we would like to present some thoughts on the recent equity market moves. **There has been uncertainty w.r.t inflation coming down. Its possible impact on central bank policies, both in terms of possible rate hikes and tightening of liquidity conditions, indirectly has negative impact on growth. As such we have seen equity valuation multiples contracting significantly in the past few months, which has led investors and fund managers alike to having a deep negative outlook on the economy.**

**Citing a chart from the Global Fund manager Survey sourced from Bank of America, we see that the fund management community is least overweight in equities vs bonds – July 2022 levels closer to levels seen in Global Financial crisis.**



Source – BoA Global Fund Manager Survey, Bloomberg

**The difference between bullish and bearish sentiments among individual investors echoes the same conservative stance on equities.** If we rank the spreads between bullish and bearish from lowest to highest, we will see that 3 of the top 5 instances where the sentiment spread was negative falls between April and June 2022.



Source – American Association of Individual investors, Lighthouse Canton

**With such depressed sentiments, a bout of goods news could have catapulted the prices, and that is what really happened post the FED policy.** Our understanding is markets took the FED policy meet as more balanced and, in a way, it reflected a shift in narrative from worrying about sustained inflation to fears of recession, thus building up on the expectation of FED policy pivot sooner than later. **Another key highlight that we saw was that before the earnings release, stock price corrections may have factored in the downgrade in earnings. As such we saw the mildest**



**two-day price reactions vs past quarters in stocks, despite not having met the earnings forecast (Source – Bloomberg). Other factors which have fueled the rally include the drop in commodity prices especially food and energy which may lead to lower CPI, high frequency indicators on growth front reflecting a downward bias fueling expectation of supportive monetary actions, etc.**

**Going forward, what remains important is whether the central banks around the world can tie down inflation back to their targeted levels without causing recessionary outcome. If we avoid a hard landing, we may see the rally being extended further. In case we have a hard landing, we believe equities may correct on account of a) valuation multiples contraction - during recession, multiples are significantly lower and b) higher probability of earnings downgrade. It may well be possible that we may revisit and even surpass the recent lows made in June-July 2022. Another key monitorable would be on geopolitical front – escalation of tensions between China and Taiwan and any renewed conflict between Russia and Ukraine.**

## **INDIA MACROS AND MARKETS -**

**Moving onto India, we saw a sharp up move in Nifty 50 up ~9% recovering almost all the losses incurred in H1 CY22.** Fall in domestic bond yields in line with fall in global bond yields, correction in energy prices, good progress of the monsoon, strong corporate results especially from high weightage sectors like Banks and positive rub off effect of global equity rally are some of the factors which led to a strong rally in Indian equities. Another positive development for the Indian equity markets is the exhaustion of selling from FIIs to a tune of INR 6567 crs in July 2022 vs an average of INR 40-50k crs number over the last many months.

**During the month of Aug 22, we saw RBI hike rates by 50 bps with an aim to anchor inflation expectations and focus on reigning consumer prices back into its target range.** We also believe the policy indirectly may help to support INR as rising USD can feed into imported inflationary pressures – RBI's latest estimate of exchange rate pass through suggests a 1% depreciation of INR pressures CPI inflation by 8 bps (Source – JP Morgan). *We would encourage readers of this publication to go through our note on RBI Monetary Policy for Aug 2022 which is available on our website.*

**On the inflation side, we saw the headline moderate but remain above the RBI target range. The headline CPI in July 2022 came in at 6.71% vs 7.01% in June 2022.** The relative decline in inflation was led by decline in prices of meat and fish, and oils and fat. On the other hand, fuel and light inflation rose to 2% on MoM basis and 11.8% on YoY basis primarily on account of higher kerosene prices. **The FY23 inflation forecast of 6.7% was retained by RBI in the last policy meet and inflation is expected to drop to 5% only in Q1 FY24.**

**RBI is expected to hike rates in the next two policy meets by 35-60 bps (Source – Kotak, Yes Bank, Bloomberg) and then pause to assess the impact on growth and inflation. The future policy direction would depend upon the timelines for RBI's**

quest to get inflation down to 4% target and prevailing growth conditions. In case we do not have a US led global recession and commodity prices increase, we believe rates may go above 6%. Although analysing the statement from Dr Jayant Varma (external MPC member) published in Aug MPC minutes, we rule out the possibility of peak policy rate of 6.5% at this point of time. **In case of a recessionary outcome and keeping in mind monetary policy works with a lag, we believe peak policy rates to be around 6%.**

From corporate India earnings standpoint, we have come to an end of Q1FY23 earnings for corporate India, and we have summarized some of the key takeaways –

- **For 1QFY23, Nifty Sales, EBITDA and Profits grew by 35%, 14% and 23% YoY respectively.** Excluding Financials, profit for Nifty constituents rose by 18%.
- **As per MOSL research, Nifty FY23 EPS estimate is cut by 2.7% to INR 843.** Currently the markets are trading at ~21 times forward P/E which is well above the long-term averages. **Thus, we expect limited upside from the current levels.**
- **Margin pressures continue** - Although the top line growth was strong across sectors (exception being Healthcare), but companies especially across cyclical and export sectors like Autos, Industrials and IT faced margin pressures.
- **1QFY23 earnings were led by BFSI segment** which posted a strong loan growth on QoQ and YoY basis. Credit quality and credit cost trends across most of the banks are at cyclical lows.
- **Capital goods companies** (like ABB, Siemens, Thermax) **reported strong P&L and order flow growth** which gives a strong visibility on revenues for multiples quarters.
- **Consumer Discretionary companies** (like Varun Beverages, Trent, ABFRL, Titan) saw a very strong growth in top line and bottom line on account of reopening and pent-up demand.
- **Despite rise in interest rates, the outlook from property companies on pre-sales was strong.** Margins in the quarter was supported by price hikes and some moderation in construction costs vs the previous quarter.
- **Pick up in infrastructure spends, housing and real estate segments would drive the demand for cement sector.** Correction in energy prices and other key raw materials could help to subside margin pressures.
- **Good monsoon, higher crop realization, revival in rural demand should help to drive the top line for consumer staples companies.** Although the sector may witness some margin pressures going forward on account of higher costs towards raw materials and packaging.
- **IT companies** had posted a steady revenue growth on YoY basis although the companies **faced margin pressure due to wage hikes, revival of travel and facility spends and attrition.** **The outlook for these companies remains positive** as we expect tech spending to remain a critical enabler for enterprises to transform in preparation for the new normal (cloud migration, digital transformation, IoT, cyber security, etc).

## **INVESTMENT OUTLOOK -**

Taking the cue from our previous publications, we would like to reiterate that investors are encouraged to have their **“Eyes on ever evolving Macro economic landscape and Mind on Asset Allocation” – calibrate investment decisions by carefully monitoring the economic and geopolitical data points and its knock-on effects.** Marrying our inhouse Asset Allocation framework (comprising of 4 quadrants - Asset Growth, Return Stability, Inflation Hedge and Volatility Hedge) with our current stance on markets (as explained above), we build an investment outlook as follows –

We continue to have **higher allocations to volatility hedge and return stability quadrants** through market neutral strategies and short-term bond funds and/or roll down funds (match funds duration with the investment time horizon) respectively. Short term bond funds have become attractive with the upward move in yields in recent months across 1–3-year segment. Investors who are looking for visibility of returns could invest in high quality roll down strategies across 3-5 years duration. Investors could also look to invest in well managed credit funds (on AIF platform) where the focus is on capital preservation and current income.

**We continue to avoid lumpsum deployments in equities – part of asset growth quadrant and we prefer a staggered approach. Couple of months back, we had outlined a strategy for long term investors (time horizon of 3 to 5 years) to stagger allocation over the next 6 months. Investors who have followed this strategy would have benefited from the recent run up in the markets.** We would want to remain disciplinarian and deploy another tranche of money this month especially in periods when markets witness a steep decline.

**For long term investors who prefer to invest more tactically, we had recommended a strategy last month to deploy 1/3<sup>rd</sup> of the money on account of more reasonable valuations and improved macro-economic condition in India. We would avoid chasing the current market rally and deploy the other two tranches (1/3<sup>rd</sup> each) only in periods of Nov 2022 and Mar-May 2023.** These periods have been derived keeping in mind the market expectation of US policy rates and prevailing valuation for Indian markets. Our rationale for each of the stage is explained below –

- **By Nov 2022, US economy would conclude its mid-term election and we may also get more clarity with respect to growth and inflation dynamics and corporate earnings.** FED may turn out to be less aggressive in terms of rate hikes and the central bank may want to gage the overall impact of their prevailing policy decisions on markets and economy before deciding the next course of action. Any shift away from aggressive rate hike stance could be a good time to deploy the second tranche. Also, in between now and Nov, we would expect correction and consolidation in the market after a strong rally of ~2500 plus points in Nifty 50 (from the recent lows of 15200).



- **Based on the current FED Fund Futures rate, market participants expect the central bank to pivot and start cutting rates to support growth by Mar-May 2023** which probably would again be a good time to deploy our third or the last tranche.

Funds which benefit from domestic growth led by government spending and policies and selective export opportunities could be considered as investment opportunity. **Allocation to asset growth quadrant should be consistent with the risk profile of an investor.**

**Allocation to gold which is a part of inflation hedge quadrant should be maintained** in one's portfolio. Gold has an inverse relationship with real rates and gold also acts as a good hedge against economic uncertainty, and it may even attract buying from central banks especially in times of de-dollarization.

## Disclaimer

---

The contents of this document are confidential and are meant for intended recipient only. If you are not the intended recipient, please delete all copies of this document and notify the sender immediately.

This document, provided as a general commentary, is for informational purposes only and is not to be construed as an offer to sell or solicit an offer to buy any financial instruments in any jurisdictions. This does not constitute any form of regulated financial advice, and your independent financial advisor should be consulted prior to taking any investment decision(s). This document is based on information from sources which are reliable but has not been independently verified by LC Capital India Private Limited ("LCIL"). LCIL has taken reasonable steps to verify the contents of this document and accepts no liability for any loss arising from the use of any information contained herein. Please also note that past performances are not indicative of future performance.

This document is prepared by LC Capital India Private Limited ("LCIL") which is incorporated in India and is an Association of Mutual Funds in India ("AMFI") registered Mutual Fund Distributor (License No. ARN 171014 and a registered Authorized Person of Axis Securities Ltd. (BSE: AP01316301116454; NSE: AP2064002463)). The contents of this document may not be reproduced or referenced, either in part or in full, without prior written permission of LCIL.

LC Capital India Private Limited ("LCIL") is not affiliated to Lighthouse Canton Pte Ltd ("LCPL"), Singapore, and any views and/or advice provided by LCIL does not represent nor constitute as the views held by LCPL. Lighthouse-Canton brand and logo are owned by Lighthouse Canton Investment Holdings Pte Ltd ("LCIH") and have been granted for use to LCIL and LCPL by means of Licensing agreements.

**Common Risk Factors:** Investments in securities are subject to market risks. The value of the Portfolios can go up or down depending on various market factors. Past performance of the Portfolio Manager does not indicate the future performance of the Products or any other future Products of the Portfolio Manager. There are no assurances or guarantees that the objectives of any of the financial product(s) / instrument(s) will be achieved.

The investments may not be suited to all categories of investors. Investors are not being offered any guaranteed or indicative returns through any of the products/recommendations. The names of the Products do not in any manner indicate their prospects or returns. The performance of the Products may be adversely affected by the performance of individual issuer companies, changes in the market conditions, micro and macro factors and forces affecting capital markets like interest rate risk, credit risk, liquidity risk and reinvestment risk. Derivative/future and options products are affected by various risks including but not limited to counter party risk, market risk, valuation risk, liquidity risk, basis risk and other risk.

Please read the Disclosure Document of the proposed investment before investing.

**MF Specific Risk Factors:** Mutual Fund investments are subject to market risks, read all scheme related documents carefully.