

“Eye” on RIDIC Environment and “Mind” on Asset Allocation

12th April 2022

A REVIEW OF THE ONGOING NARRATIVE AND OUTLOOK FOR NEXT FEW MONTHS: Thrills, Chills: (R)ecession Looming, (I)nflation at historic levels and Normalization of Monetary Policy, De-(D)ollarisation, (I)mpact of Russia-Ukraine Crisis, and Rise in (C)ovid cases.

For economists, investment managers, advisors, or investors, transitioning through the current challenging environment which we characterize as “**RIDIC**” (*meaning preposterous or absurd*) could be an exciting (*thrills*) or scaring (*chills*) time depending upon the outcomes of portfolio returns or an investment advice or a macro call is right or wrong. As these outcomes and advice are based on one’s judgements, we would like to share a quote from the author “Daniel Kahneman” here – “***You seem confident in your conclusion, but this is not an easy problem: there are cues pointing in different direction***”.

What is recommended to market professionals in such challenging times is to adapt to *deliberative system of thinking* to give better investment advice – using experience and information to more objectively update one’s belief to represent the world more accurately. The more accurate one’s belief is, the better the foundation of the advice and the outcome of the portfolio returns.

Before we cover more details on deliberative system of thinking and how we at Lighthouse Canton adopt to such a thought while building our investment outlook, let’s dwell in deeper to review the “**RIDIC**” environment and why we characterise the current environment as challenging.

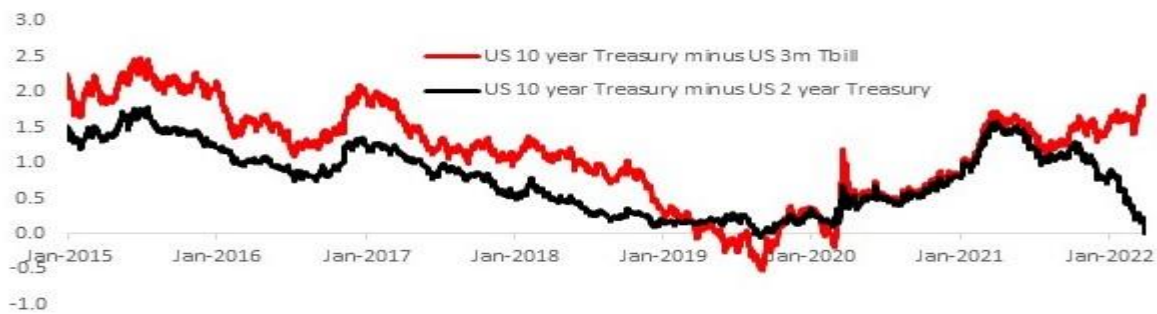
(R)ecession Looming

Every US recession since 1960 has been preceded by an inversion in Treasury curve. Since the spread between 2y/10y is often considered as a leading indicator, an inverted yield curve raises the question of looming recession.

We believe the QE program of the FED where the central bank has been buying longer dated bonds has distorted the longer end of the curve and hence 2y/10y spread may not be the lead indicator to predict a recessionary outcome in the current environment. Our argument gets supported from the fact that 3m/10y and 3m/3m 18 months forward rate curve remains steep.

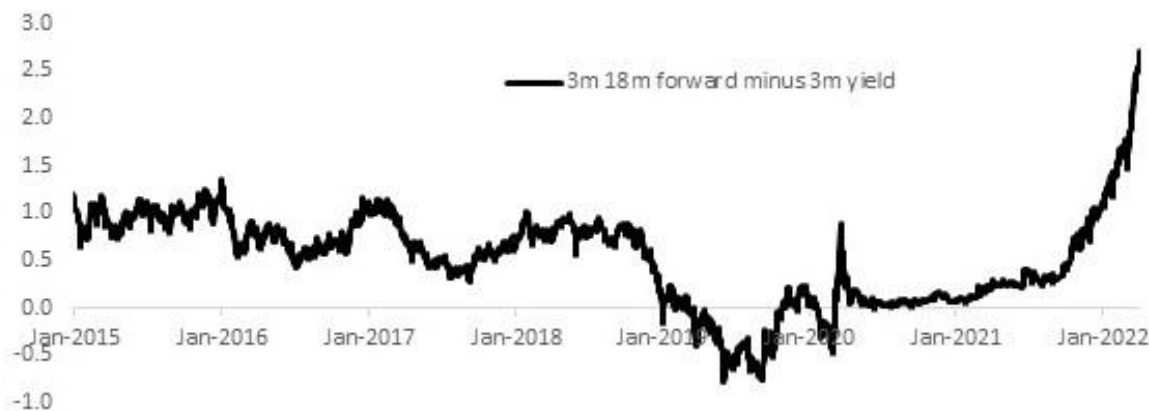
We expect the curves should flatten as and when aggressive rate hikes and balance sheet reduction measures are announced by the central bank.

Spread between US 10Y and 3M TBILL and 2Y



Source - Bloomberg

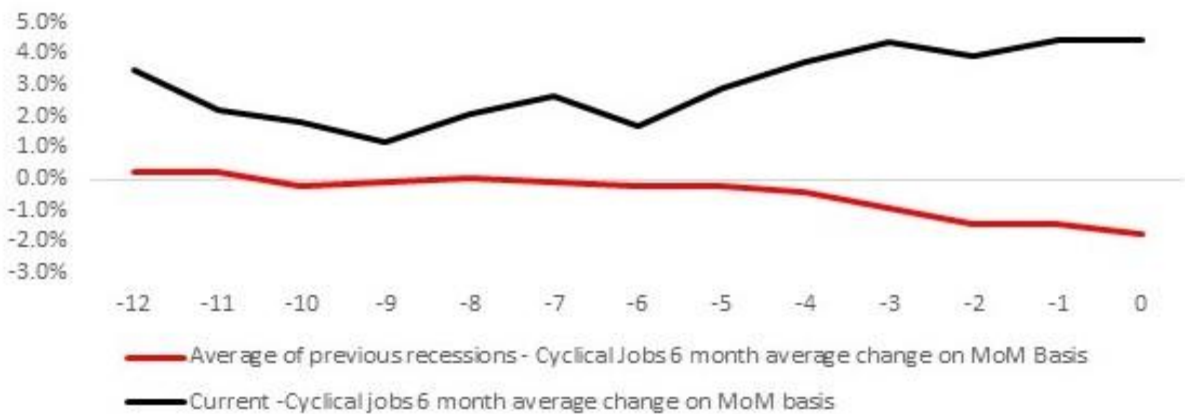
Spread between US 3M 18M Forward and 3M



Source - Bloomberg

Moreover, historical evidence states that US jobs in cyclical industries like construction and manufacturing is also a good indicator to predict recession. We have shared a chart below comparing the current vs average change in jobs across previous recessions (starting from 1990) – chart indicates that we are nowhere close to recession currently.

Current state of cyclical jobs vs. Previous recessions



Source – ST Louis FED, Lighthouse Canton

US (I)nflation at Historic Levels

US inflation in Mar 2022 was at 8.5% YoY – highest in last 4 decades. We believe the inflation story should be understood from two sides – the demand side and the supply side.

The demand side - In the last few years, US consumers have amassed higher savings primarily because of high fiscal stimulus and high wage growth. Higher savings eventually led to higher spending in economy for buying cars, houses, durable goods, etc which eventually led to rise in prices (Please Note – Used and new vehicles alongside shelter contributes to ~40% of US CPI basket).

As a casing point for wage growth, we have shared a chart below which states the wage growth has picked up across income levels, although the growth has been higher for bottom end of income distribution (primarily because of workers being unavailable because of Covid concerns).

Wage Growth across Income Distribution



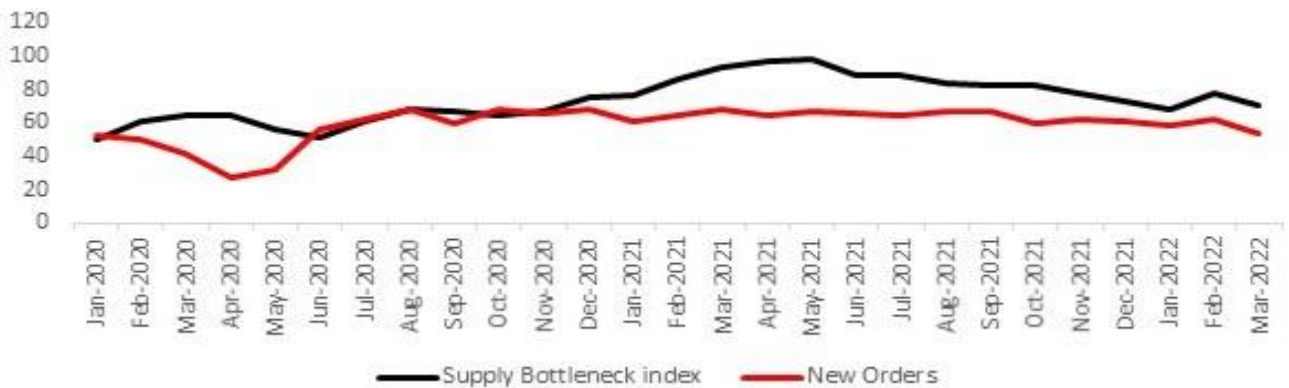
Source – Atlanta FED

Various indicators like decline in rate of change in real earnings (wages adjusted against inflation), drop in personal savings as a % of disposable income, weaker consumer sentiment (study by University of Michigan) on 12 months forward basis with respect to economic conditions and buying of vehicles, durable goods, houses, etc indicate that demand side pressures should wither away. Also, because of unemployment benefits in US being lapsed, the incentive to resume work will strengthen too which should also lead to less of wage growth pressure.

The supply side – The pandemic led to a lockdown of economies which propelled the rise in supply side issues too. An interesting study by Bloomberg economics states that the past correlation of 2 decades (prior to Covid) between wage and core CPI stands at 0.72. Given this fact, the predicted core inflation should have been capped at 2.4% far below the actual 5.5% in Jan 2022. This demonstrates that the surge in inflation has been driven by other factors like supply chain.

We believe that supply side pressures are slowing weaning away - In the graph below we see that the supply bottleneck index (in house customised index) has started coming down.

Supply Bottleneck Index vs New Orders



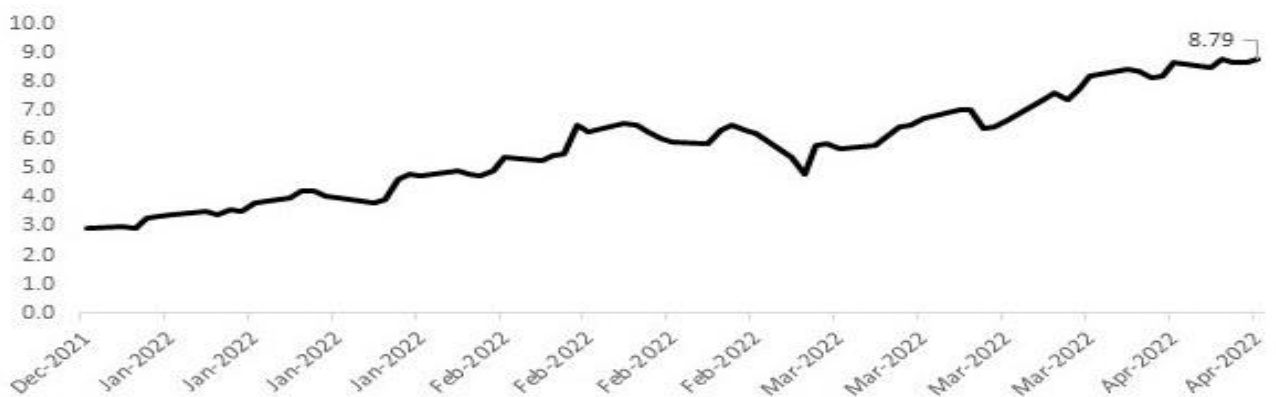
Source – ISM, Lighthouse Canton

Going forward risks to supply chain persists because of ongoing geopolitical uncertainty and this is a key monitorable for us.

Normalization of Monetary Policy – Across economies, central banks are facing issues in terms of inflation breaching their targets. This has resulted in dial back from the dovish stance to a much more aggressive policy tightening (*rates hikes plus balance sheet reduction*).

As of 8th April 2022, market participants expect FED to hike rates by ~8.8 times by Dec 2022. Just to recall last month, FED has hiked rates by 25 bps first time in nearly three years.

Number of FED's interest rate hikes by Dec 2022



Source – Bloomberg

The aggressive policy stance from FED is also evident from the recent comments (as on 5th April 2022) from FED vice chair (nominated) Lael Brainard. She suggested that the central bank was prepared to take “stronger” action on raising interest rates and that it would begin a rapid reduction of its \$9tn balance sheet as early as May 2022.

We believe more than focusing on the number of rate hikes, it's important to see till when the aggressive stance of the FED is maintained. In lieu of rising geopolitical uncertainty and slowing economy, financial markets indicators may turn volatile, and probability of recession (watch out for increase in unemployment rates) may rise which may eventually lead to the central bank reversing its aggressive stance.

*We would encourage readers to read our latest note on recently concluded RBI Monetary Policy Meet where we have provided insights on key highlights of the policy and our views on the same – **Click [here](#)**.*

De-(D)ollarization

The likely evolution of global trade, economic and political dynamics resulting from the Russia-Ukraine crisis may encourage FX regionalization. It's quite possible that other currencies like Euro, Pound and Yuan benefits as more economies would probably tend to diversify their reserves outside US Dollar. ***Currently Dollar tops the reserves allocation with 59% in 2021 (as per IMF data) though the share has dropped from 70% 20 years ago.*** Even in terms of foreign exchange turnover and international debt denomination, Dollar share is quite high at ~41% and ~62% respectively (Source- Bloomberg).

To recall an article from Reuters dated August 2019, the idea on alternative reserve currency was tabled by Mark Carney – Governor of Bank of England. In the article, Carney had clearly outlined the risks of over dependence of Dollar in global trade especially in times of protectionist and populists measures adopted by US. Moving to today, Russia which has been reducing Dollar denominated reserves since the time of Crimea Annexation in 2014 (from 41% to 16%, Source- Bloomberg) could further move towards Euro or Yuan to trade with partners like China.

We believe although the de-Dollarization trend could put some pressure on the greenback, but because of its dominance in global financial system and because of lack of credible options, Dollar collapse is unlikely.

(I)mpact of Russia-Ukraine crisis

More than the direct impact (contribution of both economies to global GDP is ~1.9% in dollar terms), the world is going to face a sizeable indirect impact of Russia-Ukraine crisis. Russia is the world's second largest oil producer of oil (~12% of annual global output), world's top exporter of natural gas, produces two thirds of all ammonium nitrate – main source of nitrogen-based

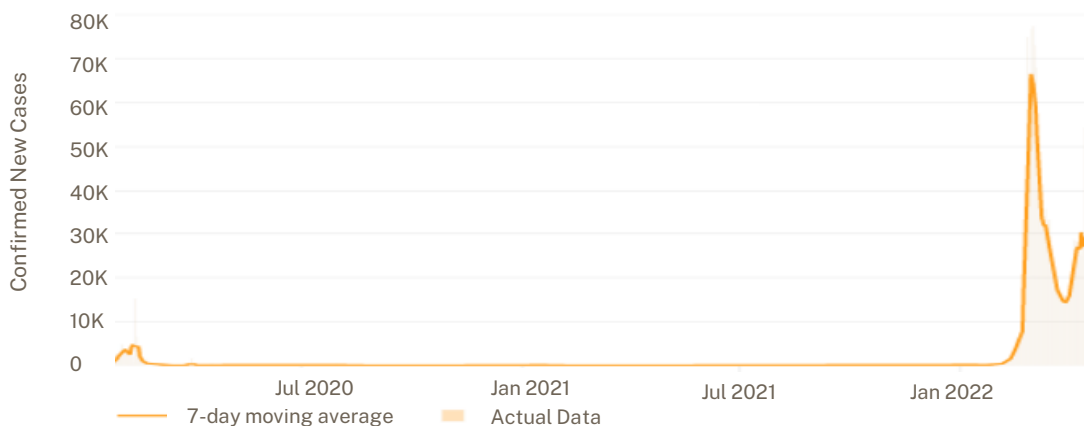
fertilizers, significant producer of nickel, copper, aluminium, etc and about half of European natural gas imports come from Russia. Together with Ukraine, the economy accounts for quarter of global wheat exports and these two economies are also significant producers of potatoes, corn, sugar, etc (Source – BCA Research).

As a result of rise in commodity prices and supply side disruption, the OECD estimates that the conflict could shave about ~1% of global GDP this year (Source – OECD Economic Outlook Interim Report 2022). Earlier in December 2021, OECD Economic Outlook projected global GDP growth of 4.5% in 2022 and 3.2% in 2023.

Rise in (C)ovid cases in China

The Russia-Ukraine crisis is not the only risk we are beckoned with. Rise in Covid cases especially in China is also a major risk both from both the demand and supply side perspective. The authorities have locked down Shanghai, which is home to 25 million people, and if the country adopts to Covid zero strategy and goes for a nation-wide lockdown, that would not only slow down demand of the 2nd largest economy in the world (in terms of GDP) but also lead to dampening impact on commodity prices. Outlook on inflation remains clouded at the current moment.

China Confirmed New cases



Source – John Hopkins University

Globally we may be in for a slower growth and slower inflation regime (i.e., deflation) or slower growth and high inflation regime (i.e., stagflation).

To Summarize our thoughts on RIDIC environment –

Although there are signs that US economy is slowing but we believe it is too early to call for a recession based on 2y-10y curve inversion. Outlook on inflation in the near term is clouded by geopolitical uncertainty although signs of demand and supply side pressures are waning. US and global central banks may resort to aggressive policy tightening and in times of slowing growth, these measures may tilt the economy

towards recession and lead to lot of financial market volatility. We belief that FX regionalization speed up could put some pressure on USD. But to expect a Dollar collapse would be premature at this point of time. Russia-Ukraine crisis and rising Covid cases in parts of China may have a negative impact on economic activity and could create uncertainty in the near term.

Outlook –

We would not encourage our investors to take a one-dimensional call-in spite of recent moves in risk assets which may induce a sense of Fear of Missing Out (FOMO). Reiterating what we had mentioned in the [March 2022 version of Smell the Coffee](#) - We need to carefully monitor the economic and geopolitical data points and its knock-on effects and calibrate our investment decisions. In times like this, a well-diversified portfolio is the need of the hour.

We reflect our deliberative system of thinking through our inhouse Asset Allocation framework which comprises of 4 quadrants - Asset Growth, Return Stability, Inflation Hedge and Volatility Hedge. *Marrying our thoughts outlined while reviewing the “RIDIC” environment with our inhouse asset allocation framework, we build an investment outlook as follows -*

We would want to have higher allocations to volatility hedge and return stability quadrants through market neutral strategies and high-quality roll down funds (match funds duration with the investment time horizon) respectively. The recent surge in yields along with steep yield curve offer very attractive rates for investors to lock in. We would like to have a neutral allocation to long only equities which is a part of asset growth quadrant as we expect the asset class to be volatile in the near term (on account of central bank policies, geopolitical risks and rise in Covid cases) and if corporate earnings expectation is trimmed down because of rising input prices and slowing demand, then valuation comfort may no longer exist for investors. New investors who would like to make fresh equity allocations or existing equity investors may look to rebalance their existing investments and focus on funds which benefit from domestic growth and export opportunities or transformation to “war economy”. Allocations to equities should be staggered and lumpsums may get deployed in large declines. On PE/VC space - part of asset growth quadrant, we see serious alpha in professionally managed early-stage ventures as the number of unicorns and soonicorns (soon to be unicorns) are set to increase. Allocation to gold which is a part of inflation hedge quadrant should be maintained in one’s portfolio as it acts as a good hedge against economic uncertainty, and it may attract buying from central banks especially in times of de-Dollarization.

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