

DOMINO EFFECT

14th Oct 2022

“Third major shock” or “Worse is yet to come” were the recently remarked statements by RBI governor – Shaktikanta Das and IMF Chief Economist – Pierre-Olivier Gourinchas during a recent RBI policy meet in Sept 2022 and at the time of release of World Economic Outlook for Oct 22. The excerpts from where these statements were referenced are mentioned below –

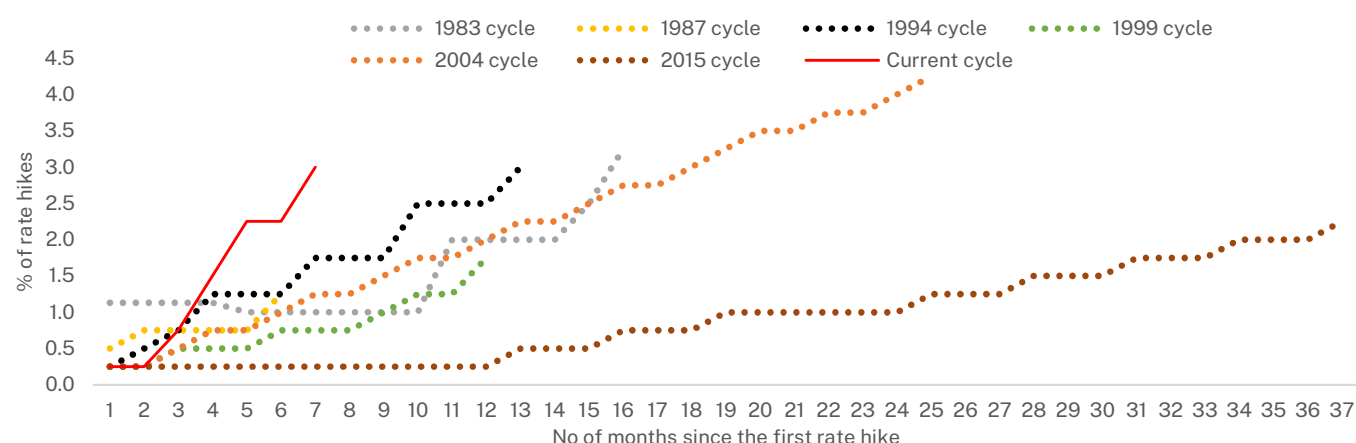
“In the last two and half years, the world has witnessed two major shocks – the COVID-19 pandemic and the conflict in Ukraine. These shocks have produced profound impact on the global economy. As if that was not enough, now we are in the midst of a **third major shock – a storm – arising from aggressive monetary policy actions and even more aggressive communication from Advanced Economy (AE) central banks**. The necessity of such actions is driven by their domestic considerations, but in a highly integrated global financial system, they inevitably cause negative externalities through global spillovers. **The recent sharp rate hikes and forward guidance about further big rate hikes have caused tightening of financial conditions, extreme volatility, and risk aversion**. All segments of the financial market including equity, bond and currency markets are in turmoil across countries.” – Reference from RBI Governor Statement as on 30th Sept 2022.

“Global growth forecast for this year is unchanged at 3.2%, while projection for next year is lowered to 2.7% – 0.2% lower than the July forecast. The 2023 slowdown will be broad-based, with countries accounting for about one-third of the global economy poised to contract this year or next. The three largest economies, the United States, China, and the euro area will continue to stall. Overall, this year’s shocks will re-open economic wounds that were only partially healed post-pandemic. **In short, the worst is yet to come and, for many people, 2023 will feel like a recession**” – Reference from IMF Blog as on 11th Oct 2022.

“The IMF warns that the risk of monetary, fiscal, or financial policy miscalibration has risen sharply and financial markets are showing signs of stress. **The IMF believes that over-tightening risks pushing the global economy into an unnecessarily harsh recession**” – Reference from Yahoo Finance article reported on 12th Oct 2022.

We draw the attention of our readers to one of the most significant points which is highlighted in bold in the paragraphs referenced above – *sharp rate hikes, aggressive communication or forward guidance and overtightening*. This is the key driver for the ongoing stress in financial markets and lead cause for economies moving into recession in the coming months.

In our June publication titled “Hike, Hikes & More Hikes”, we mentioned that globally, central banks (chief being the FED) are trying to build their credibility - from earlier calling inflation to be transitory to now realizing and emphasizing that inflation is a big problem. One of possible ways we describe the current policy is – **“Central banks opt for shock and awe to tame inflation”**. As a case in point, if we track the FED Fund rate in US, this is already higher by 300 bps since March 2022 and more rate hikes of 150-175 bps are expected by March 2023. On a rate of change basis, the current policy is the fastest rate hiking cycle in modern history as shown in the chart below –



Source – Bloomberg, Lighthouse Canton

As monetary policy works with a lag, the impact of rate hikes would be visible in coming months. Already we have seen a negative impact reflected in key sectors like housing (as stated in our last month’s publication titled “Time Sequencing”), manufacturing (new orders measured by ISM and FED surveys are coming down) and even the **US Conference Board Leading Economic Index**. The index is used to forecast future economic activity and has been falling for six consecutive months.



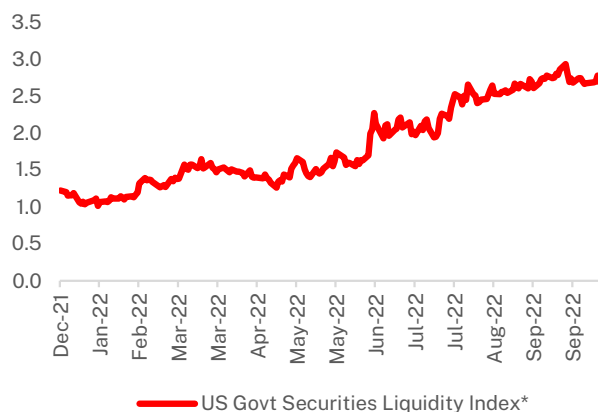
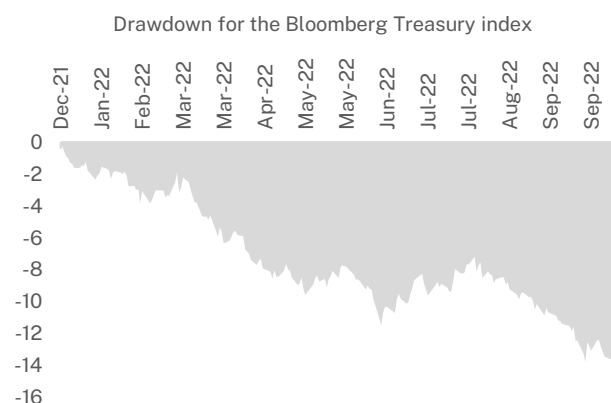
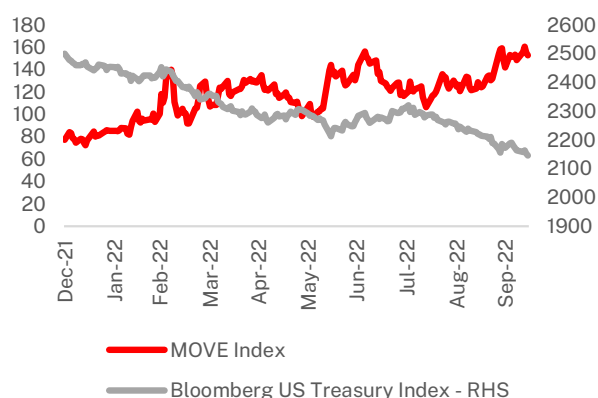
Source – Bloomberg, Lighthouse Canton

In its Sept policy, the FED released an updated version of its Summary of Economic Projection. In the update, officials have revised the FED Fund rate estimates from 3.4% in June 2022 to 4.4% by end of 2022 and 4.6% by end of 2023. Readers should note that the current FED fund rate (upper bound) is at 3.25%. Officials expect inflation measured using PCE and Core PCE to be high at 5.4% and 4.5% respectively in 2022 and that it will gradually slide down towards 2% by 2024-2025. On the growth front, real GDP is expected be barely positive in 2022 and move higher in the range of 1.2% to 1.7% (below longer run target of 1.8%) in 2023 and 2024. **It is clearly evident that FED officials have prioritized inflation over growth for now and they are ready to front load rate hikes even at the cost of demand slowing down.**

Revisiting our Aug publication titled “Conundrum”, the current and future policy setup brings back the debate of hard vs soft landing. To that, we would like to share a very interesting point presented by Dr. Ashima Goyal (member of RBI Monetary Policy Committee (MPC)) in the Sept 2022 RBI policy minutes released last week. Dr. Goyal referred to a recent Bank of International Settlement (BIS) study on past tightening cycles across 19 Advanced economies and 6 Emerging economies during the period of 1980-2018. **The conclusion of the study was - frontloaded actions by central banks tend to be followed by soft landing but average 45% of the policy rate rise was frontloaded in soft landings and the mean nominal rate hike was 2%. As the FED has hiked rates by 3% and is expected to do more by end of this year and signs of growth slowdown in some of the key sectors is clearly evident (as mentioned above), we believe probability of hard landing in US has increased.**

The likely negative impact of US Fed policy tightening is not only evident on the US economy but also has its say on global trade, debt, and financial markets. On the trade and debt side, with the US Dollar being a global reserve currency, **a strengthening of the greenback vs other currencies on account of aggressive US policy stance, leads to imported inflation pressures and rising debt burden for some of the emerging economies.** We have seen an increase in volatility across asset classes and destabilization in some of the financial markets which has led to forced intervention by central banks – Bank of Japan to support yen (by using its large FX reserve) and Bank of England to support gilt market. There exists a policy divergence between Bank of Japan (currently undergoing Yield curve control) and the US FED which has led to downside pressure on the Japanese Yen (JPY), and we have seen USDJPY appreciated by ~30% on YTD basis (as on 14th Oct 2022). This was the first time post the Asian Financial crisis in 1998 that BOJ had intervened in the FX market and market speculation is rising that Japan will need to start selling its holding in US treasuries to further prop up the yen. On the other side, the United Kingdom truly saw one of the black swan events with a crisis unfolding in the pension fund industry – with gilt yields moving higher, defined benefit pension funds were faced with margin calls which led to forced selling of underlying exposure, driving yields further higher. By committing to buy long dated gilts, Bank of England was able to break this functioning loop and bring back temporary stability in the UK financial market.

Stress is also evident in the US Treasury market as volatility in the bond market are at levels which we have seen during historical periods of recession. Moreover liquidity is now becoming an area of concern too.

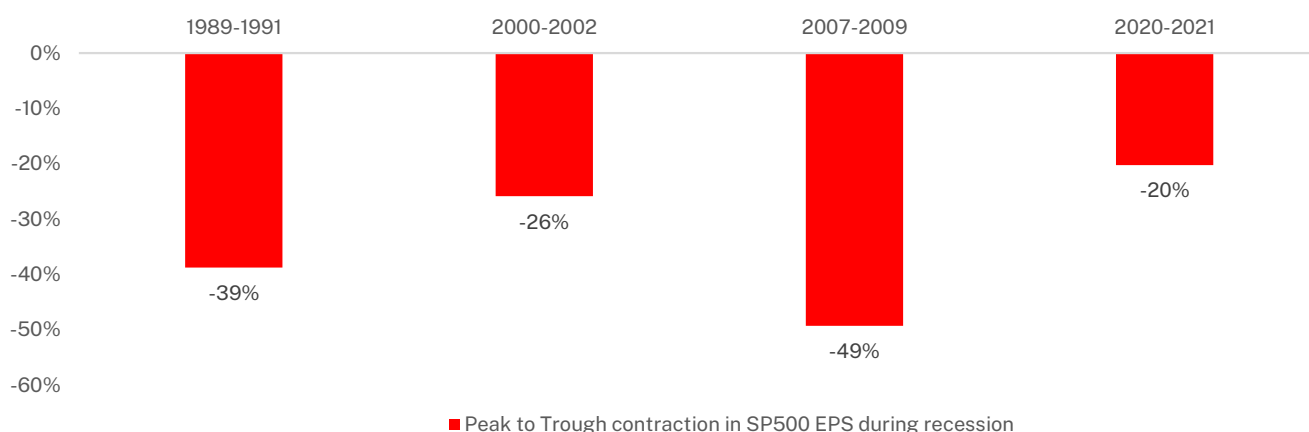


Source – Bloomberg, Lighthouse Canton | Data as on 14th Oct 2022 | *Liquidity Index displays the average yield error across the universe of US Treasury notes and bonds with remaining maturity 1-year or greater. When liquidity conditions are favourable the average yield errors are small as any dislocations from fair value are normalized within a short time frame. Under stressed liquidity conditions, dislocations from fair value implied by the curve fitter can remain persistent resulting in large average yield errors.

Even with the 10-year Treasury rate at 4%, large Japanese investors (pension funds, insurance companies) are stepping away from US treasuries on account of higher hedging costs. The biggest buyer of all is the US FED. It doubled its debt portfolio in last two years to \$9 trillion, now the central bank is progressing towards “Quantitative Tightening” and it is expected to offload Treasuries from its balance sheet to \$60bn a month. Demand from US commercial banks has dissipated too as deposits have slowed down and as the FED policy tightening drains reserves out of the financial system.

We believe the situation needs to be monitored very carefully as bonds (especially 10-year treasury) are a true reflection of investor sentiment, economic confidence and bond yields also impact equity valuation. Until and unless the FED shifts away from its current policy or there are temporary changes to supplementary leverage ratio to allow financial institutions to increase market making activity or some measures are announced by the US Treasury department (speculation is the department is assessing the merits of buying back off the run bonds to improve liquidity in these securities), new buyers in treasury market would demand for higher risk premium.

Before we move to our next section, we would like to draw our readers' attention to the following chart on US earnings.



Source – Bloomberg, Lighthouse Canton

As we can see, in the last four recessions, the S&P500 trailing EPS fell between 20% to 49% from their peak to trough. However, consensus estimates on earnings this year and next year, are down just ~3% from this year's high.

As mentioned earlier, the probability of a hard landing in US has increased, and we may be subjected to further downward revision in earnings in the coming weeks and months. At the time of writing this publication, we are into the Q3 earnings for US companies and Q2 earnings for Indian companies. We will be monitoring the key earnings trends and share our observations in the upcoming publications.

INDIA MACROS AND MARKETS –

In the Sept policy, the RBI hiked repo rates by 50 bps to 5.90% and the Monetary Policy Committee (MPC) decided to remain focused on its withdrawal of accommodation to ensure that inflation remains within the target going forward while supporting growth. The policy announcements were on expected lines and further tightening is warranted as inflation for the first three quarters of 2022-23 is above the upper tolerance band.

Some of the other key announcements from the central bank are as follows –

- The **inflation forecast for 2022-23 and Q1 23-24 remains unchanged** at 6.70% and 5.0% respectively.
- **Growth forecast for 2022-23 is revised lower** to 7.0% vs earlier forecast of 7.2%.
- **On the demand side of India's economy**, urban consumption is being lifted by discretionary spending ahead of the festive season and rural demand is gradually improving. Investment demand is also gaining traction, as reflected in rising imports and domestic production of capital goods, steel consumption and cement production.
- **Outlook for growth** – Government's continued thrust on capex, improvement in capacity utilization in manufacturing and pick up in non-food credit should sustain the expansion on industrial activity. Headwinds from geopolitical tensions, tightening global financial conditions and slowing external demand pose downside risks.
- **Outlook for inflation** – High and protracted uncertainty surrounding the course of geopolitical conditions weighs heavily on inflation outlook. On one hand, softening in commodity prices, late recovery in kharif sowing, prospects for rabi crops buffered by comfortable reservoir levels augurs well for lower inflation. On other side, crop damage from excessive/unseasonal rains (may have negative implication on food prices), elevated imported inflation amplified by rising USD, uncertainty around crude oil prices are deterrent factors.

Split views among internal and external members of the MPC - The minutes of the Sept 2022 policy meeting was interesting and the document highlights divergence in commentary across members of the MPC. Some of the members noted uncertainties arising from global spillovers, especially for inflation, and some highlighted risk of overtightening on growth.

External members like Dr. Ashima Goyal and Prof Jayant Varma commented that a) the MPC should focus on a 6 months to 1 year ahead real rate as this is the horizon where the monetary policy will have the greatest impact; b) monetary policy works with a lag and pace and speed of hikes should be monitored to avoid negative impact on growth; c) based on internal forecast of RBI, inflation is expected to be 5% by Q1 2023-24 and with current levels of repo rate, the real rate would be positive and likely above neutral rate (i.e. restrictive for growth); and d) lastly, not be guided or have a fear driven over reaction to curb the interest rate differential with respect to US policy rates.

Internal members like Shri Shaktikanta Das, Dr Michael Patra and Dr Rajiv Ranjan commented that a) economic activity should gather momentum on account of the festive season and higher household savings, b) certain components like food and core inflation currently remain sticky towards the upper tolerance threshold and it is important to restrain broadening of prices, anchor inflation expectations and contain second round effects and c) to provide financial stability and orderly functioning of financial markets by minimizing volatility in exchange rates.

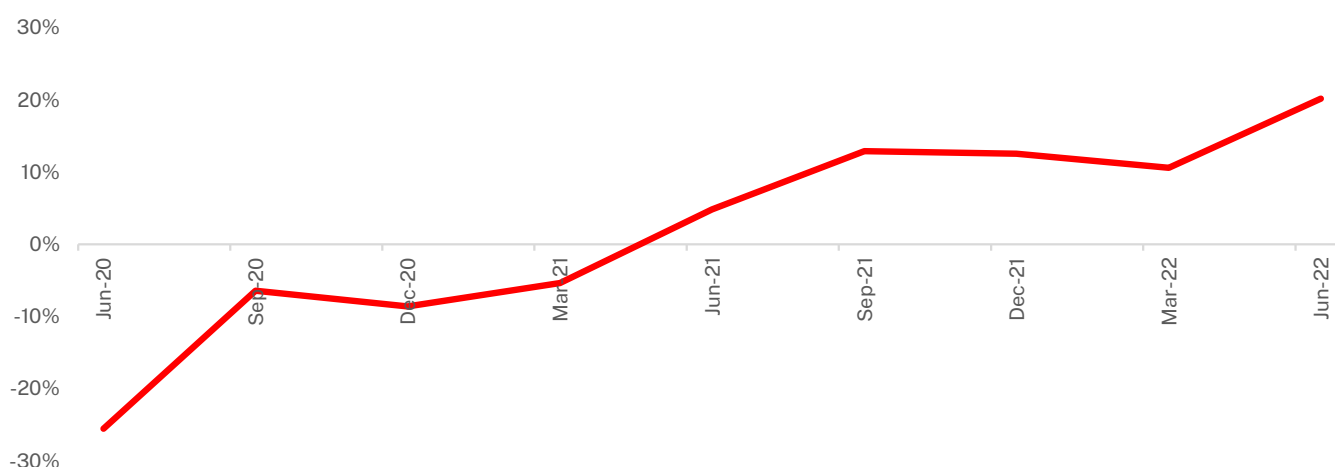
We believe the RBI would hike rates by 35-60 bps in the next policy meet and take the repo rate to 6.25% to 6.5%. Post the policy, we would expect RBI to pause and monitor factors like growth inflation trade-offs, policy tightening by the FED and geopolitical risks before hiking/cutting rates.

Before we move to our investment outlook, we would like to share our thoughts on the growing rhetoric of India decoupling from the rest of the world.

Although India may be an outperformer on a relative basis vs its peers in terms of macro and financial stability, the domestic growth will be negatively impacted if we witness a global recession. One of the key reasons behind this statement can be attributed to the adverse impact on exports which would a) impact GDP negatively, b) have ramifications on consumption and financial sectors and c) lead to external imbalances and dampen prospects of the FX reserve accretion.

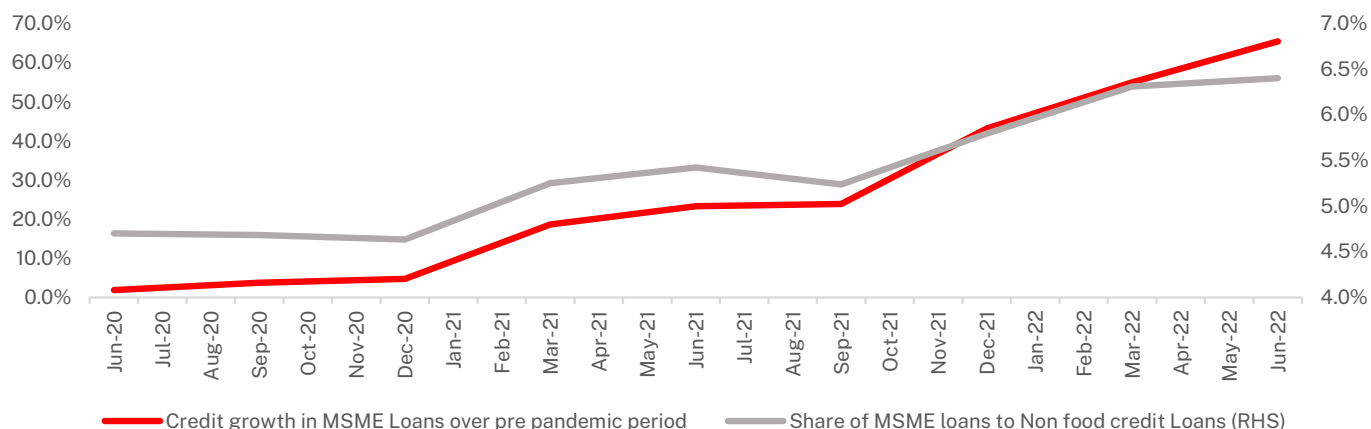
Exports have played a vital role in terms of India's growth recovery in the pandemic period. This is reflected by the fact that comparing the % share of exports to India's GDP, in June 2019 this stood at 19.8% and now the share has inched higher by 3% to 22.9% in June 2022. Additionally, growth in exports of goods and services over the pre pandemic period has been rising steadily in last 2 years as evident from the chart below.

Growth in Exports of goods and services over pre pandemic period



Source – CMIE, Lighthouse Canton

Further, if the global situation were to exacerbate, it would negatively impact the labour intensive MSMEs, as they contribute to 45% of the total exports (Source – Kotak Economics Research). Not only would we see ramifications on consumption on account of lower employment, wage cuts, etc but as MSMEs have been a key driver of credit growth, we would see a negative impact on financial sector – loan growth over pre pandemic has risen substantially for MSMEs and the % share of MSME to non-food credit has also risen by 1.7% from 4.7% in June 2020 to 6.4% in June 2022 (please refer the chart below).



Source – Bloomberg, CMIE

The drop in exports coupled with relative strong domestic demand (i.e. more imports) could lead to external imbalances (higher current account deficit), higher imported inflation and higher volatility in the exchange rate. This may affect the monetary policy and the RBI may be forced to tighten. Additionally, in a slowing global economy, capital flows typically seek safe haven assets like USD, etc which may lead to lesser flows through FDI/FPI or money moving out of India, thereby dampening prospects of FX reserve accretion.

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 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 hedges through market neutral strategies.** Central bank policy making and developments on geopolitical front would be the foremost reasons for higher volatility in risk assets and **we expect long short fund managers to benefit from dispersion in returns across sectors.**

On return stability quadrants, we continue to prefer allocations to short-term bond funds and/or roll down funds (match funds duration with the investment time horizon). As mentioned above, we believe the RBI may continue to hike rates towards 6.25%-6.5% (repo rate currently stands at 5.9%). Short term bond funds have become attractive with the upward move in yields in recent months across the 1-3-year segment. Investors who are looking for visibility of returns could invest in high quality roll down strategies across a 3-5 years duration. Investors could also look to invest in well managed credit funds (on the AIF platform) where the focus is on capital preservation and current income. **We prefer not to add significant duration to**

one's portfolio because of the uncertainty around energy prices, USD strength vs INR (which could feed into imported inflation pressures) and insufficient risk premia (spreads between longer end and 5 year) for investing in longer duration bonds.

We continue to avoid lumpsum deployments in equities – part of the asset growth quadrant and we prefer a staggered approach. In our June publication titled “Hike, Hikes & More Hikes”, we had outlined a strategy for long term investors (in a time horizon of 3 to 5 years) to stagger allocation over the next 6 months. Investors who have followed this strategy would have benefited on ~50% of invested capital from the up move in the market from its recent lows. In our last publication titled “Time Sequencing”, citing our views that India may not remain decoupled from global developments and with valuation on expensive side, we had suggested investors to pause their staggered approach. **The strategy of pausing flows has worked well as the market has corrected by ~5.5% from last month's high to low. We continue to hold the same view and we would suggest investors to deploy their remaining 50% of capital at an opportune time in coming weeks or months.**

For long term investors who prefer to invest more tactically, we had recommended a strategy in our July publication titled “Revalidate”, to deploy the first 1/3rd of the money in July on account of more reasonable valuations and improved macro-economic condition in India. We would invest the remaining two tranches (1/3rd each) only in the periods of Dec-Mar 2023 and Q2-Q3 CY23 (FYI – there has been a change in deployment timelines vs what we had mentioned in our earlier publications). Our rationale for each of the period is explained below –

- By Dec-Mar 2023, the US economy would conclude its mid-term election and we may also get greater clarity with respect to growth and inflation dynamics and US corporate earnings. On the basis of FED fund futures, the implied policy rate is expected to be around 4.5% by Dec 2022 (i.e. 150 bps rate hike between now and Dec) and around 5% by March 2023. It seems that the FED is expected to frontload rate hikes in lieu of sticky core CPI and ongoing labour tightening. **As long as the FED remains aggressive with their policy measures, the probability of a hard landing would continue to increase. Risk assets like US equities would need to adjust lower both in terms of valuation multiple and earnings forecast. Indian markets too would need to undergo some of these adjustments, although in the near-term, the festive season and Q2 earnings would dictate the course of the markets. We believe that the next 4-5 months would be volatile for the markets with risks tilted towards the downside, which at some point would give a good entry point to deploy the 2nd tranche.**
- **For the third tranche of deployment, we would only want to invest when we get certainty around the change in the US FED's policy stance.** There may lie a risk of delayed deployment as markets may discount change in stance well in advance and we may lose out on potential gains. But with ever evolving macroeconomic conditions, “the biggest challenge an investor faces is dealing with uncertainty”.

If the above-mentioned implied policy rate by March 2023 holds true, we believe the FED, either through policy rates or forward guidance, may indicate a pause. This will be to assess the overall impact of their prevailing policy decisions on markets and the economy before deciding the next course of policy action. As we stand now, we tend to believe the next policy step would be measures to support growth and there lies the possibility of rate cut in the second half of next year. Our view is in line with what is currently indicated by the Eurodollar curve and FED Fund futures. Thus, sometime around Q2 or Q3 CY23 would be a good time to deploy the 3rd tranche.

Funds which benefit from domestic growth led by government spending and policies and selective consumption and export opportunities could be considered as an investment opportunity. **Allocation to the 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.

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