

# TIME SEQUENCING

17<sup>th</sup> Sep 2022

## India's Covid Policy Response – Learnings from previous crisis periods

We recently came across an intriguing note from Prof K.V. Subramanian (ex. *Chief Economic Adviser*) on India's Covid policy response which was based on the key lessons learnt from India's response to the Asian Financial Crisis and Global Financial Crisis (GFC). Much has been spoken about the ***measured policy response by the government in India vs some of the developed economies which largely relied on direct cash transfers to consumers to stimulate the economy***. Before deep diving into the global and domestic macro and markets, we thought summarizing some of the key points from the note would be essential, as it helps to understand whether we are headed towards a stable growth-inflation regime from a longer-term perspective or are we kicking the can down the road to address short term problems (i.e. solution for near term growth concerns albeit inflation becomes a concern in the longer term).

The following key points revolve around – a) *macro principles* which leads to policy making, b) *how it all played out* in previous crisis periods and c) *the reaction functions*.

### Macro Principles -

- **Policies that increase demand only deliver a short-term growth and long-term inflation, while macro policies which increase both demand and supply deliver a long-term growth without high inflation –**

When only aggregate demand is raised in the economy without any change in aggregate supply, short term growth comes along with long term inflation problems. Higher inflation leads to central bank hiking interest rates which dampens private investment (as cost of borrowing increases) thereby having a negative growth impact.

*This is the problem faced by developed economies (like US, Europe, UK) at the current moment. At the onset of the pandemic, demand got stimulated from fiscal measures, but supply side measures were inadequate leading to demand outpacing supply and high inflation.*

*Moreover, from an investment standpoint, investors who believe in Capital cycle theory (also based on demand supply dynamics) by Ed Chancellor would have clearly seen this problem coming and hence they would have invested in long inflation hedges (like commodities) and made good returns in the last couple of years.*

- **Capital expenditure increases both demand and supply while revenue expenditure only increases demand –**

Unlike revenue, capital expenditure helps to invest in assets that lead to increase aggregate supply side. Likewise on the demand side it helps to increase employment opportunities across both formal and informal economy. *On a longer run, the multiplier effect (i.e. amount of increase in final income that results from injection of spending) with capital expenditure is 2.4-6.5 times more vs revenue expenditure.*

- **Moreover capital expenditure has the ability to “crowd in” private investment while revenue expenditure “crowds out” private investment –**

Capital expenditure provides boost to construction which directly influences sub sectors like steel, cement, etc and thus we see pick up in private investment to provide the necessary goods and raw materials.

- **As private investment collapses in an economic crisis, to keep the investment rate from falling drastically, the government should increase its capital expenditure.**

In case of a global and domestic slowdown, government spending, especially on the capital expenditure side, would hold the key to stimulate the economy, drive employment, increase demand and consumption, increase capacity utilization which would lead to higher private investment.

### **Global Financial Crisis -**

#### **How it played out -**

- The government increased the revenue expenditure from 24.01% in 2007-08 to 26.39% in 2008-09, while capital expenditure in the same period declined from 5.56% to 4.55%.

*This resulted in a decline of gross fixed capital formation (GFCF) as a % of GDP from 35.8% in 2007 to 31.3% in 2013. Apart from the decrease in capital expenditure, no structural reforms were carried out to improve the investment climate for SMEs who were struggling due to collapse in demand.*

#### **Reaction Functions –**

- Higher revenue expenditure (on account of farm loan waiver, etc) led to a rise in fiscal deficit without asset creation. India's fiscal deficit from being at 2.5% of GDP in 2007, remained well above 4.5% for each year from 2008-13. Absence of supply side reforms led to a runaway inflation and a current account deficit (imports increased drastically and INR depreciated sharply by record levels) which led to the macro-economic crisis in 2013.

***Higher Fiscal deficit, Current Account deficit and Runaway Inflation were the main causes that led to India being classified as one of the Fragile 5 economies.***

### **Asian Financial Crisis -**

#### **How it played out –**

- If we roll back 10 years from the GFC period, and revisit the period of **Asian Financial Crisis**, the policy responses by the government were very drastic and one which Prof Subramanian classifies as a far sighted one.

Capital expenditure increased by 23.17% in 1998-99 vs the previous year and in terms of % of GDP, expenditure rose to 3.83% in 1998-99 from 3.45% in the previous year, remaining approximately the same until 2000.

*This resulted in an increase of GFCF as a % of GDP from 25.4% in 1998 to 29.9% in 2001. Moreover reforms measures like the divestment program, significant reforms especially in the telecom sector like the reduction of government stake in VSNL, reduction in license fees for private players, increase in allowable stakes by foreign enterprises to 74%, etc helped to boost overall economic productivity.*

#### **Reaction Functions –**

- Unlike in the GFC period, some of the key macro variables like Inflation and Current Account Deficit (CAD) were under control.

Inflation which was 13.2% in 1998 following the crisis, declined to 4.7% in 1999\* and 3.8% in 2003 and 2004. On the other hand, India's exports as % of GDP increased from 10.7% in 1997 to 17.9% in 2004 and INR depreciation in the crisis period was much lower than what was seen during GFC which supported the CAD.

*\*Inflation was low between 1998 and 1999 despite GDP growing from 4% in 1997 to 6.2% in 1998 and 8.85% in 1999. This reflects the benefits of the supply side measures which was undertaken through the increase in capital expenditure as explained above.*

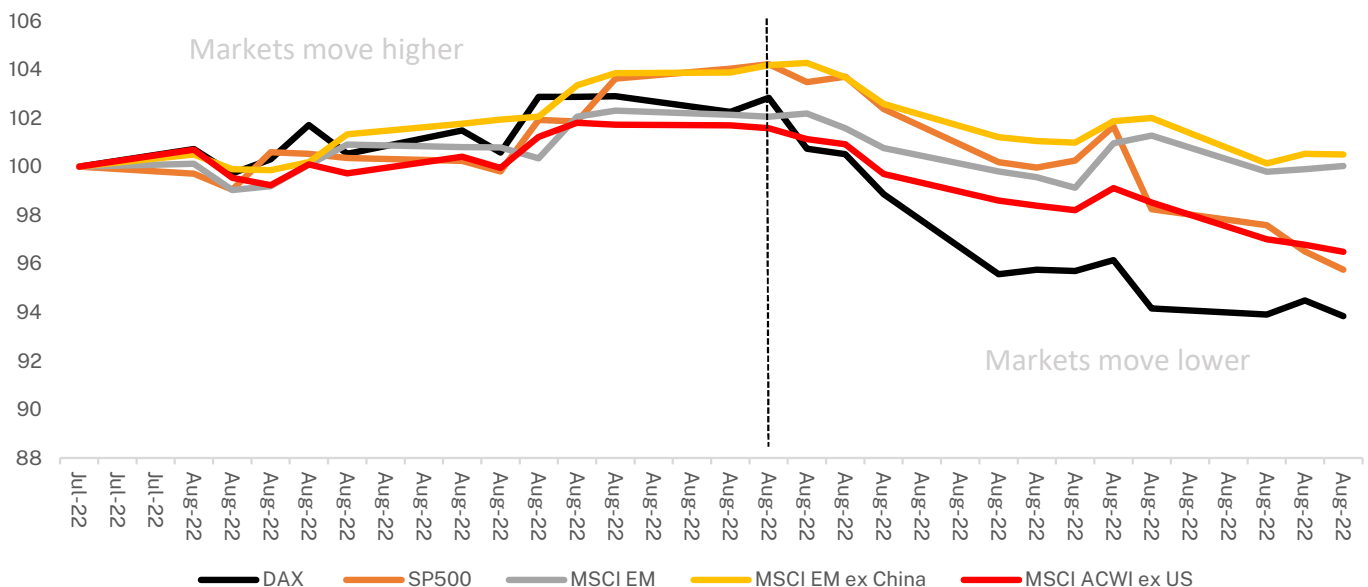
**To conclude, India's Covid policy measures were more an extension of the successful policy response from the Asian Financial crisis, although the pace of fiscal measures and structural reforms were more pronounced during Covid times. Till date, the reaction effect of Covid measures have resulted in a stable macro-economic situation. India is forecasted to be one of the fastest growing economies in the world this year and next year, in terms of inflation (measured using CPI), both in terms of inflation staying below historic levels and in terms of peak inflation for this year, we are ahead of most of the advanced and emerging economies. From a currency standpoint, although this year the INR has depreciated more than historical annual averages vs USD, but on relative basis (vs performance of other currencies vs USD) INR remains an outperformer.**

## GLOBAL MACROS AND MARKETS –

The world economy is currently on a thin ice with three seismic challenges – A slowdown in China on account of its zero Covid policy, Eurozone economies negatively impacted on account of an energy crisis, and a US slowdown on account of high inflation and policy tightening by the FED. It is rare to see **these three nations, which together account for 60%+ share of global GDP, struggle in tandem and raise the odds of global synchronized slowdown.**

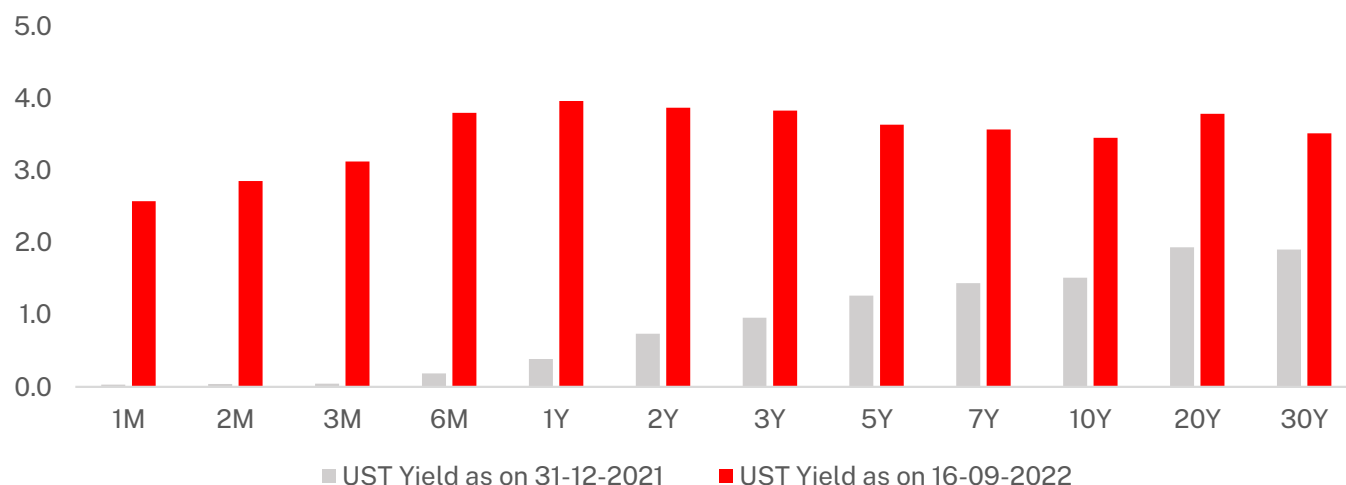
Until and unless these challenges are resolved– a resolution to the Russia-Ukraine war which may put an end to the energy crisis in Europe, the FED getting inflation under control without achieving a hard landing and the Chinese government being able to stimulate the economy and also provide a solution to rising non-performing loans in its banking system, **we believe risk assets would continue to remain volatile and price corrections may largely be associated with earnings downgrade.**

**The reflection of volatility is evident if we track the near-term performance of major global equity indices. Back to Aug 2022, it was a tale of two halves – in the first couple of weeks we saw an extension of equities on the higher side as market participants believed that weak economic data points and decline in prices would lead the FED to pivot, but in the latter half of the month, the rally reversed as it became increasingly clear (post Jackson Hole speech) that FED remains committed to bringing down inflation to 2% target.**



Source – Bloomberg, Lighthouse Canton

In the US bond markets, treasury yields across all duration have moved higher with **largest increases found in the shorter end of the curve** as shown in the chart below.

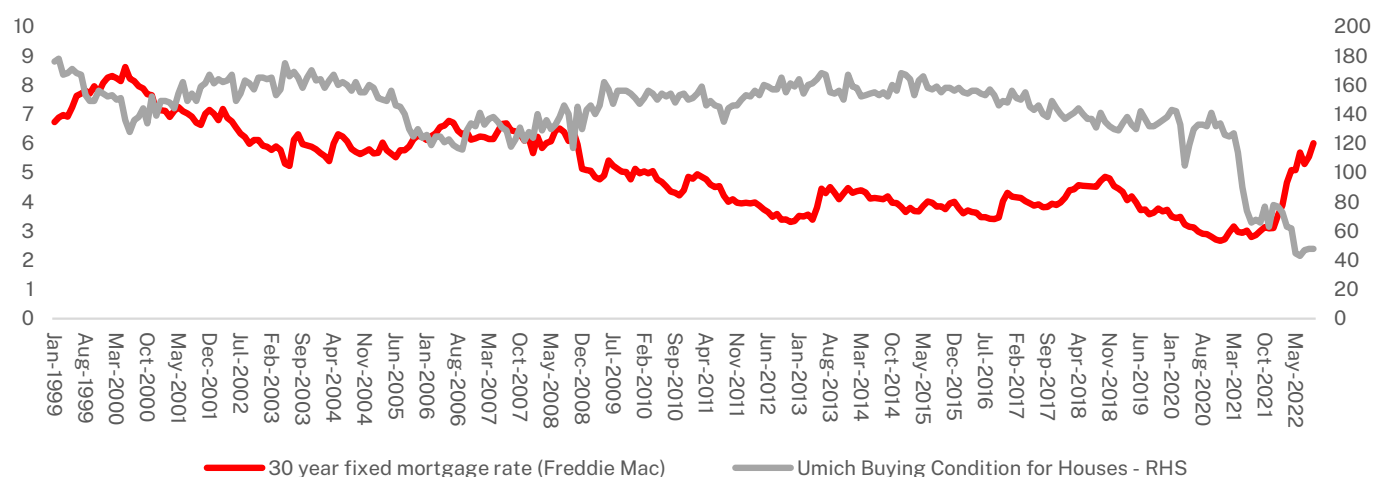


Source – Bloomberg, Lighthouse Canton

**This year has been the worst year for US bonds in history (since 1977)** - US Bloomberg Aggregate Bond Index (a broad benchmark which comprises of US Treasuries, Corporate bonds, Mortgage-Backed Securities, etc) has seen the largest decline of ~12.3% on YTD basis (as on 16<sup>th</sup> Sept 2022, Source - Bloomberg). We must notify our readers, that investors investing in US bonds are not accustomed to such kind of underperformance, as the last 40 years have been largely characterised as disinflationary period where the interest rate more often than not, has been stable.

**In terms of views on US bond markets, our thoughts are broadly the same as what we had outlined in last month's publication (titled – Conundrum). 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 the FED rate hike cycle.**

**The impact of policy tightening is also evident from the 30-year Mortgage Rates in US which has now crossed 6% - 1<sup>st</sup> time since Nov 2008 and doubling over the past year.** Historically, a higher mortgage rate has led to lower levels of buying condition for houses as measured by Univ. of Michigan (please refer the chart below).

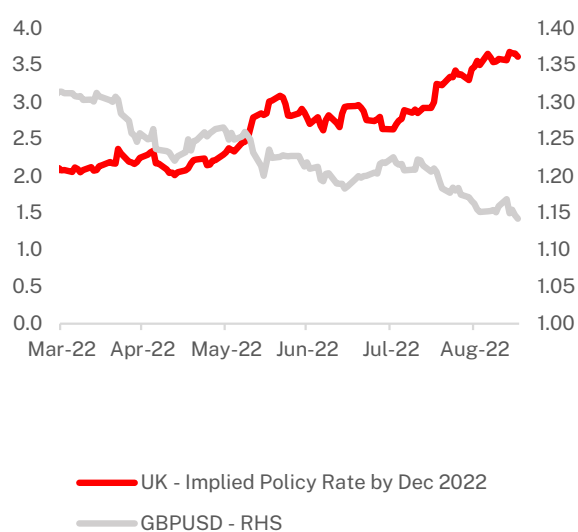
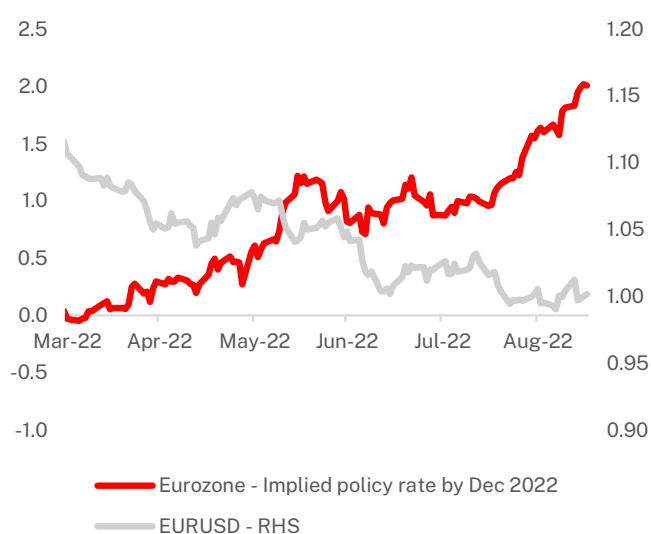


Source – Bloomberg, Lighthouse Canton | Data as on Sept 2022

US housing faces a risk of falling demand and rising supply which may lead to house prices drift lower in coming months. We would cover additional aspects like inventory levels, home price expectations and impact on shelter costs, when we dwell in deeper on US CPI.

**Moving to the performance of US Dollar Index (DXY), continued hawkish stance by the FED, and ongoing global slowdown (primarily in countries like Eurozone and UK) has led to a continued up move and the currency index has gone past levels last seen in Sept 2002.** In lieu of the 8 min short and to the point speech of Jerome Powell (FED Governor) in Jackson Hole, where his speech revolved around bringing back inflation to the target even if it means economic conditions slowing down and with core CPI no. for Aug 2022 coming above expectations, **the stage is all set for the FED to hike rates by 75 bps to 100 bps in Sept policy.** As per the FED fund futures (as on 16<sup>th</sup> Sept 2022), the implied policy rate is expected to peak at 4.4% by March 2023 (which is 200 bps above the present levels of 2.32%).

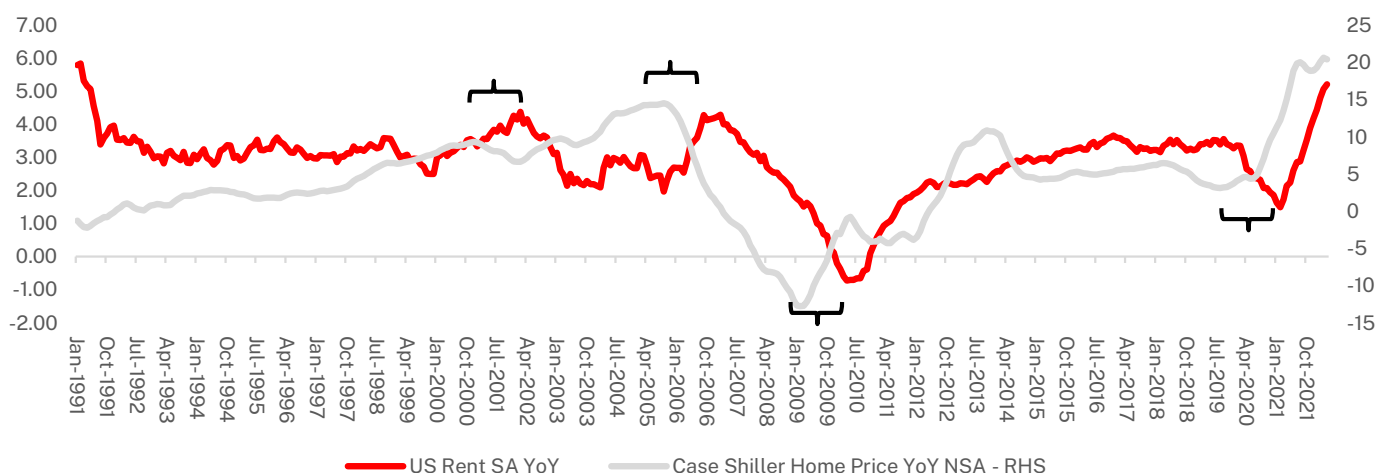
**Looking at the way the current correlations exist between EUR, GBP and DXY with the expected implied policy rate by Dec 2022, we expect the Dollar index (exhibits positive correlation) would remain strong and a key market aphorism - “don’t fight the trend” may continue to dominate in the near term.** EUR and GBP exhibit a negative correlation with the expected implied policy rate and this could be attributed to a) continued policy tightening in these economies which would further accentuate the probability of deep recession, leaving the ECB and BOE with limited headroom in terms further hiking rates and b) some of the measures adopted by governments in these regions to curb the energy price pressures, may lead to lower inflation expectations and timing of first signs of policy pivot (reduced rate hikes and prolonged pause) earlier than expected.



Source – Bloomberg, Lighthouse Canton | Data as on 16<sup>th</sup> Sep 2022

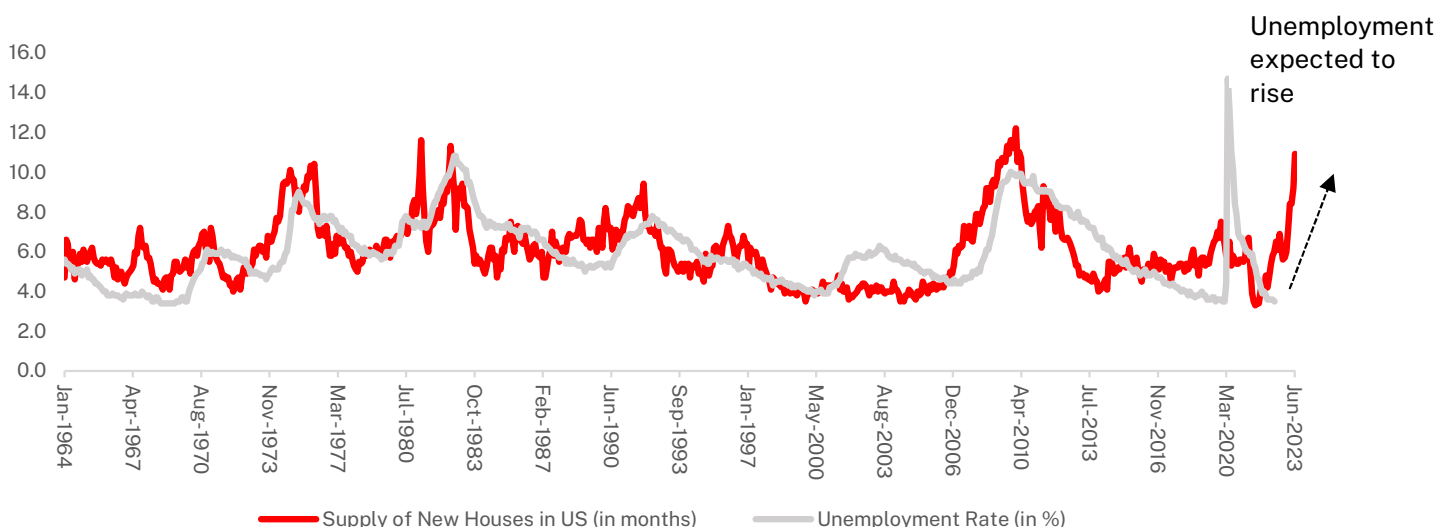


**Shifting our focus to US inflation, headline CPI for Aug 2022 came in hotter than expected, rising by 8.3% YoY. While still down from July's 8.5% YoY, market participants were anticipating a drop to 8.10%. Core CPI (all components except food and energy) moved up to 6.3% - highest level since Mar 2022. Largest driver of the Core CPI was shelter costs (~33% weight) which inched higher to 6.2% from 5.7% in the previous month. Historically as shown in the chart below, rent costs rise or fall with a lag of 14-15 months with respect to home prices.**

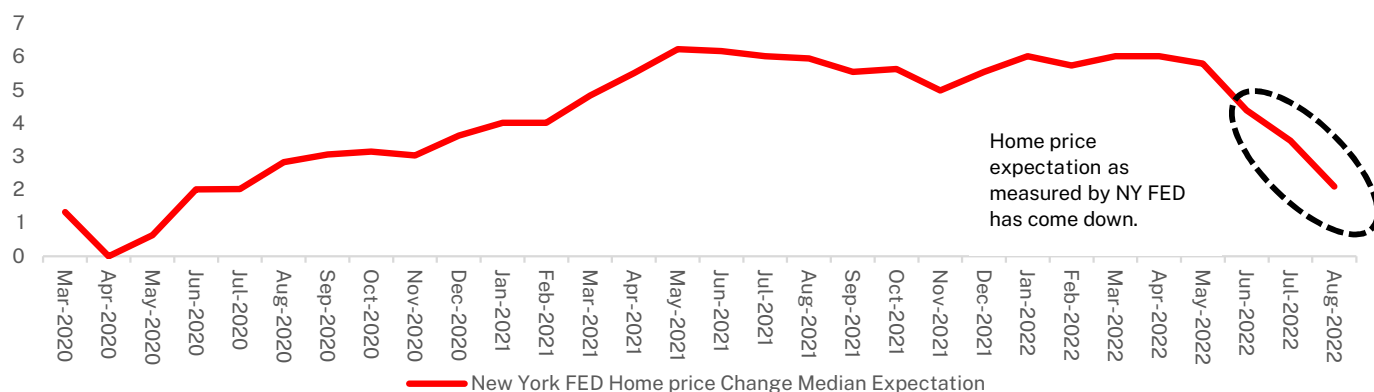


Source – Bloomberg, Lighthouse Canton

**As we have mentioned earlier in this publication, the demand side of US housing looks weak on account of higher mortgage rates and depressed sentiments. Additionally, from the supply side, if we refer the chart below, we will realize that monthly supply (i.e. ratio of new home for sales to new homes sold) has been moving higher which indicates higher inventory levels, lower home prices and with a lag negative impact on unemployment -> expect a cool off in inflation in coming months.**



Source – ST Louis FED, Lighthouse Canton



Source – Bloomberg, Lighthouse Canton

Apart from the shelter costs, there are other sets of economic indicators like the continuous decline in ISM Services and Manufacturing Prices paid, improvements in supply side pressures, cooling off in oil prices which is closely linked to inflation forward (5y5y), high base effect for inflation going into 2023, lagged impact of policy tightening (we should not forget FED has already hiked rates by 225 bps since March 2022) and ongoing balance sheet reductions. This gives us some confidence that we may see lower inflation prints going into 2023 and first signs of policy pivot (reduced no. of rate hikes and prolonged pause) may kick in sometime in Q1-Q2 of next year. Key risks which negate our lower inflation call are escalation in geopolitical tensions, supply side pressures reinvigorating, housing prices remaining sticky for longer than expected, rises in energy & food prices and revival in consumer sentiment on account of fiscal measures.

Across the Atlantic, there was a major political development which took place in the United Kingdom. Liz Truss was sworn in as UK's new prime minister and political pundits, economists and market participants are now focusing on the policy measures that may get announced with respect to price caps on energy. Price caps would have a benefit in terms of reviving consumer confidence (as less disposable income is spent on energy), reducing the depth of winter recession, and may also mean that inflation has more or less peaked in UK.

The chart below provides a scenario analysis of different levels of price caps and estimated headline CPI in the coming months –

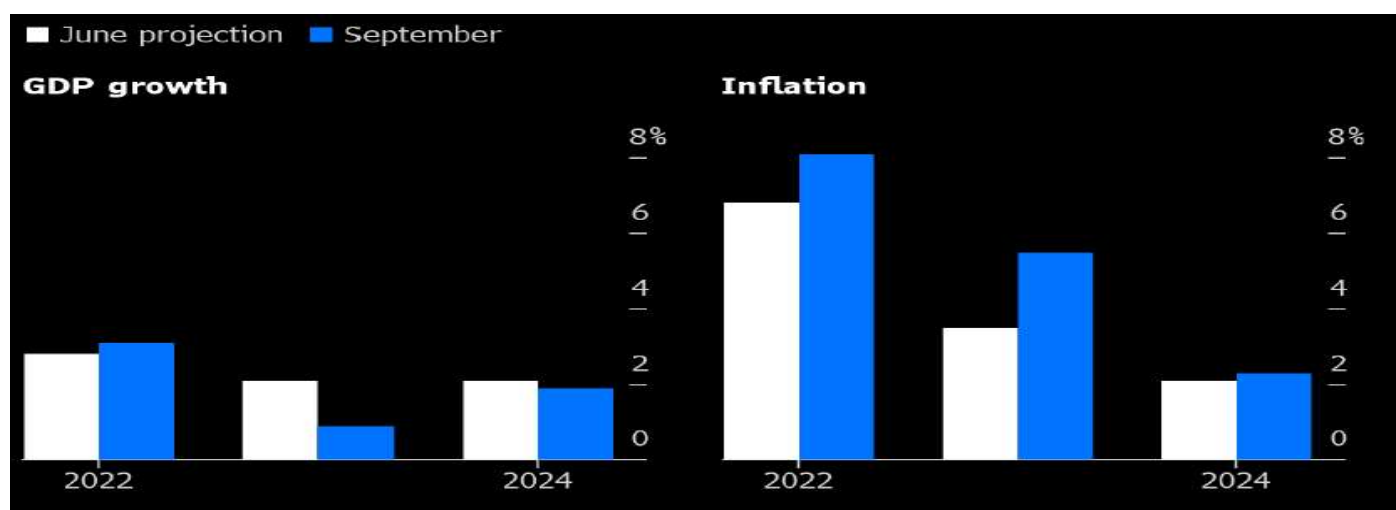


Source: Macrobond, ING



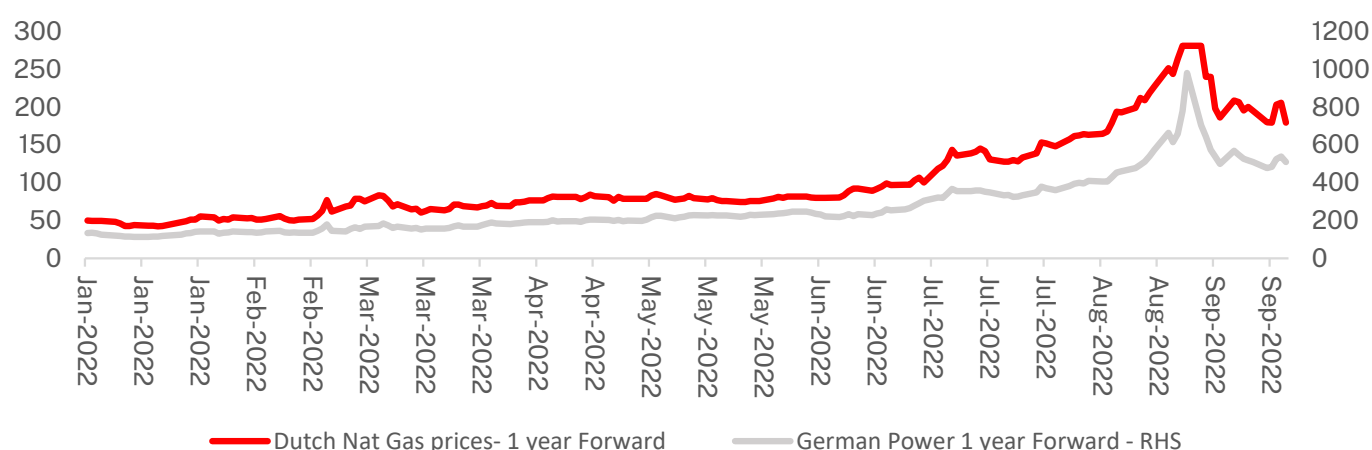
**The extra scale of the government support package could well prove to be a double-edged sword for the Bank of England (BOE).** On one hand the central bank has forecasted for a sharp rise in unemployment and prolonged recession due to ongoing monetary tightening. On the other hand, the government's support may help to reduce inflation expectations and households may have more disposable income to spend which may lead to higher demand for goods and services and a wage price spiral. **This could mean that the BOE may not need to aggressively hike rates into the future policies nor is the central bank going to pivot as early as many other global central banks in early or mid-2023.**

On the other side of the regional spectrum, the **European Central Bank (ECB) hiked rates by a historic amount of 75 bps in the Sept policy meet. New forecasts reflect a "stagflationary" outcome** – the ECB raised its outlook for consumer prices this year and next year while slashing its forecast on economic expansion in 2023.



Source – Bloomberg, ECB

**Such an emboldened decision of a jumbo rate hike by the central bank clearly indicates that the central bank has prioritized inflationary pressures over looming recession.** Eurozone CPI inched to 9.1% YoY in Aug 2022 (almost 4 times higher than the targeted inflation) vs 8.9% in July 2022. In the last month's publication – Conundrum, we shared that a primary reason for high inflation is soaring natural gas prices which has led to a rise in 1 year forward power prices in Germany and record levels in France (please refer the chart below).



Source – Bloomberg, Lighthouse Canton

**We would like to dwell on two critical points which could influence European natural gas prices going forward – storage levels and fiscal intervention.**

In the last few months, Europe has been preparing for gas shortages by accumulating inventories. Despite the drop in Russia gas imports, **Europe's storage levels are now at 85% capacity (vs 58% in June 2022, Source – Bloomberg) which is roughly in line with past years and above European Union's Nov 1<sup>st</sup> target of 80%.** As natural gas accounts for ~38% of EU residents heating use, hence higher storage levels and milder than normal winter could avoid dysfunctionalities in the economy and put a lid to the price rise.

**On the policy front, the European governments are also taking steps to shield the households from the worst of energy price hikes. Nearly 400 billion euros (Source BCA Research) in support measures have been announced so far - in the form of price caps, cash handouts, cut in energy taxes, etc.** Although these support measures will be somewhat offset with windfall profit taxes on the energy sector (which benefits from higher energy prices), the net effect will be to raise budget deficits for the region. But a temporary spike in fiscal measures may well prove to be enough to provide the missing economic stability.

In the coming months, we would keenly monitor the efficacy of these measures, the central banks reactions to fiscal policies and growth-inflation trade-offs. As developments in these regions (UK, Europe) will impact global trade and moves in financial market (especially currency), we look to update our readers in timely fashion in case there are actionable from an investment standpoint.

## **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 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).** Elevated inflation in India warrants further policy tightening, and we believe the RBI may continue to hike rates in a calibrated manner towards 6% (repo rate currently stands at 5.4%). The future policy direction would then depend upon the

timelines for the RBIs' quest to get inflation down to 4% and prevailing global and domestic growth conditions. 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 platforms) where the focus is on capital preservation and current income. **We prefer not to add significant duration to one's portfolio because of uncertainty around energy prices, USD strength vs INR (could feed into imported inflation pressures), possibility of higher-than-expected government borrowing this year and next year to support domestic growth 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 asset growth quadrant and we prefer a staggered approach. In June's publication, 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 on ~50% of invested capital from the recent run up in the markets. Indian equities have rallied strongly in last couple of weeks and despite higher volatility seen in global equities, domestic equities remain resilient. **As we believe market fundamentals may not remain decoupled from global developments and valuations currently look expensive, hence we would want to pause the staggered approach and deploy the remaining 50% of the capital at an opportune time in coming weeks.**

**For long term investors who prefer to invest more tactically, we had recommended a strategy in July's publication 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 invest the remaining two tranches (1/3<sup>rd</sup> each) only in periods of Nov – Dec 2022 and Mar-May 2023.** Our rationale for each of the period is explained below –

- **By Nov – Dec 2022, 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.** The US FED may also want to reflect on the overall impact of their prevailing policy decisions on markets and economy before deciding the next course of action. We would expect India's market to even correct and consolidate between now and end of the CY, providing a good entry point for 2<sup>nd</sup> tranche of money to get deployed.
- **Based on the current FED Fund Futures rate, implied policy rate may peak at 4.4% by Q1 i.e., Mar 2023 (vs 3.9% in Aug 2022), post which the central bank is expected to cut rates to support growth** which probably would 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 consumption and 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.