

# The 'Pause' & Its Conundrum

17<sup>th</sup> Feb 2023

In our market outlook last month, titled '2023, From Up Over a Crow's Nest', we pointed out that 2023 is the year market participants anticipate a shift in stance from global major central banks. Eyes are primarily on the US Federal Reserve, who were expected to reflect on their current relentless rate hike spree and allow a breather /pause to assess the impact of the same on underlying growth and inflation dynamics. As we head into the new year, let's assess how this trajectory is unfolding and review the various actions of the global central banks.

## US Federal Reserve Activity So Far

The month of Feb'23 started with the US Federal Open Market Committee (FOMC) hiking Federal Funds Rate by 25 bps, their 6<sup>th</sup> consecutive hike in interest rates in as many meetings, but a downshift nevertheless, from 50 bps in their last meeting in Dec'22. This was immediately followed by an extremely robust Non-Farm Payroll Jobs data for Jan'23 which printed net additions of 517,000, easily surpassing the forecasted number of 185,000. Unemployment scenario continues to be upbeat, with unemployment rate at 3.4%, the lowest in 53 years. Hourly earnings meanwhile decelerated marginally, growing 4.4% for the month compared to 4.6% previously.

US CPI data release for Jan'23 came in marginally higher than with market expectations, having grown by 6.4% YoY and 0.5% month-on-month (MoM) (expected 6.2% and 0.4% respectively). Core CPI continues to be resilient, having grown 5.7% year-on-year (YoY) and 0.4% MoM again marginally higher than expectations. The latest Retail sales data, another key metric which the FOMC tracks, registered a growth of 3%, which was the largest monthly gain in 2 years.

While Fed chair Powell, in his recent speech, did acknowledge the probability of a slowdown in economic growth amid a resilient employment scenario and that 'disinflation has begun', he still cautioned on higher-than-expected rate hikes provided underlying employment and inflation continues to beat the US Fed's estimates. We believe there is scope for at least two more rate hikes this year though it can be higher if inflation continues to spike upwards.

## How Are Markets Reacting :

US 2-Year and US 10-Year yields climbed ~60 and 50 bps respectively from the lows post Fed policy decision on the 1<sup>st</sup> Feb'23 whereas NASDAQ and S&P 500 have corrected by ~1% with Dow Jones being relatively flat.

## Japanese Inflation At Multi Decade High :

Inflation in Japan has reached a multi-decade high and has started to pressure the Bank of Japan (BoJ) in ending its decade long Negative Interest Rate Policy. A first step toward this was the BOJ's decision to loosen its grip on the Yield Curve Control (YCC) in Dec'22. Market participants are expecting BoJ to relinquish the YCC altogether as inflation begins to inch up at an uncomfortably rapid pace. If that happens, one of the last standing frontiers of easy monetary policy will be abdicated.



Source : Brevan Howard , Lighthouse Canton

## How Are Markets Reacting :

Although the inflation data increases the probability of a hawkish stance from the BoJ, the appointment of a new governor, which is most likely to be Mr. Kazuo Ueda, and his stance on monetary policy will be keenly awaited. Initial market actions post the announcement of Mr. Ueda succeeding Kuroda has been negative on USD-JPY, the currency pair gave up gains from 128 handle to currently trade around the 133 mark, while Nikkei continues to be on an upward trajectory, breaching the 27,500 mark as on 15<sup>th</sup> Feb. This highlights markets are pricing in a relatively dovish stance from the incumbent Governor with a hike in benchmark rates not on the cards in the immediate future. Participants will await the outcome of the next BoJ Monetary Policy on 28<sup>th</sup> Apr'23.

## **European Central Bank (ECB) Set to Tread the Path of Rate Tightening; Inflation Remains High :**

The ECB hiked their benchmark rates by 50 bps to 2.5%, and confirmed another hike of 50 bps in the Mar'23, meeting. This follows four rate hikes in 2022 as headline inflation continues to be high, printing 8.5% in Jan'23 while core inflation registered a YoY growth of 5.2%. Energy costs continued to be the biggest driver of inflation, though the pace of increase was slower at 17.2% YoY in Jan'23 as compared to 25.5% in Dec'22. Food prices though, registered a marginal increase, up 14.1% as compared to 13.8% in the previous month (YoY terms).

Notwithstanding the current anemic pace of economic growth in Q4'22 at 0.1%, ECB Chair Christina Lagarde hinted at a relatively resilient economic environment which is expected to improve over the next few quarters backed by stable energy supplies, easing supply side pressures, rising wages and growing consumer confidence. Hence market participants would be bracing for more rate hikes this year with terminal rate expectations of 3.75% which we believe will be reassessed with every macro economic data release periodically.

## **How Are Markets Reacting :**

Eur-USD currency pair has been on a path to recovery after hitting an all time low of 0.97 (below parity) in Sep'22 primarily owing to the central bank policy divergence to register a peak of 1.09 as on 31<sup>st</sup> Jan'23. Since then, the currency pair has weakened marginally to currently trade around 1.07 levels.

Euro Stoxx 50 which tracks 50 blue-chip stocks from 11 Euro zone economies, has been buoyant, the index rising 13% in CY'23 so far.

European Government bond yields have seen a sharp spike with 10-year yields of all major economies driven higher by 27-30 bps on a MoM basis.

## USD Index Resumes Its Up move :

The USD Index, which is used as a barometer to track the strength of the USD and as a measure to assess flight of capital to USD assets, resumed its up move from a near 4 month low of 101 levels to currently trend at 104.5 levels (as on 17<sup>th</sup> Feb'23). DXY had touched an all time high of 114 levels in Sep'22 and has since registered a steady decline. The current up move in the index comes at the backdrop of robust jobs and retail sales data and resilient core inflation and points to higher probability of a further hawkish interest rate trajectory from the US Fed.



Source : MarketWatch , Lighthouse Canton

## Gold And Silver Surrenders Gains Amid Robust US Economic Data :

Gold prices had registered a scorching pace of growth since it touched a 30-month low of US\$1602/ounce as on 27<sup>th</sup> Sep'22, touching a high of US\$1960/ounce on 2<sup>nd</sup> Feb'23, an absolute return of 22.5% in 4 months. However, a series of robust data release as highlighted above, sparked off another round of USD rally, thereby leading to the precious metal giving up some of its gains to currently trade around US\$1821/ounce (as on 17<sup>th</sup> Feb'23), down 7% in absolute terms.

Silver followed a similar trend, gaining 34% in absolute terms over a 5-month period (US\$ 17.8/Ounce as on 2<sup>nd</sup> Sep to US\$23.9/Ounce as on 6<sup>th</sup> Feb'23) however, gave up some of its gains to currently trade around US\$21.44/Ounce, down roughly 10% in absolute terms.

## **Indian Equity Update :**

For most of the previous month, Indian indices were trading in a broad range. As on 24<sup>th</sup> Jan'23, the Nifty 50 was up 0.07% while BSE Sensex was up 0.23%. This all changed with the release of the Hindenburg research report on the Adani group which put forth various allegations on the group and that they have initiated short positions on various entities in the group. As a result, India lenders and Adani group companies corrected noticeably in the last 7 days of the month.

The Nifty 50 index ended the month down ~2.45%, closing at 17,662 while BSE Sensex was down ~2.12%, closing at 59,549 level. All sectoral indices closed on a negative note except Auto, IT & FMCG. The biggest fall was seen in the Nifty PSU Bank index which fell 7.22% followed by the Nifty Bank index which fell 5.42% in Jan'23.

## **Quarterly Earnings Update:**

Q3FY23 earnings for Nifty 50 companies turned out to be a mixed bag. While 34 companies in the index posted growth in profits, 13 reported decline in bottom lines with 3 entities reporting unchanged profit numbers as reported by Trendlyne as on 16<sup>th</sup> Feb'23.

***The aggregate revenue growth of 49 companies, which have announced their Q3 numbers so far, stands at 18.7% YoY, and the total operating profit of 49 firms grew by 12.4% YoY.***

Overall, 11 companies in the Nifty50 Index reported more than 50% growth in their net profit in Q3FY23, with Tata Motors being at the top with a YoY growth of 295%, followed by Britannia Industries, Maruti Suzuki, Bharti Airtel, and DR Reddy's Laboratories with 152%, 130%, 92%, and 75.37%, respectively.

The banking sector emerged to be the strongest segment, with several banks reporting their highest-ever quarterly net profit numbers in this quarter. The public sector banks extended their strong show, driven by lower provisions and higher net interest margins.

Indian IT biggies also delivered a strong performance in the December quarter and much needed clarity emerged on the demand scenario, which it turns out is not as bleak as had been projected previously.

In addition, the auto industry put out a good showing, with several companies reporting increases in sales. Maruti Suzuki reported a 130% jump in its net profit in the third quarter at ₹2,391 crore, beating analyst estimates.

On the flip side, major steel companies posted a sharp drop in their earnings, owing to higher energy costs and slowing demand. Steel major Tata Steel reported a consolidated net loss of ₹2,502 crore on the back of higher expenses, a sharp dip from net profit of ₹9,598 crore a year ago.

## **India Fixed Income Update :**

Feb'23 was kickstarted with the Union Budget and the Finance Ministry's guidance on the fiscal deficit for the upcoming fiscal year which was kept at 5.9%, lower than market expectations. This was followed by the RBI monetary policy decision on interest rates and as was widely anticipated, they delivered on a rate hike of 25 bps. The Governor's speech though indicated the probability of further rate hikes as he pointed towards a targeted CPI range of ~4% which was much below the inflation glide path of 5.4% for FY'24. The Jan'23 CPI print which was released a week later highlighted a yoy increase of 6.52%, a sharp spike from Dec'22 levels of 5.72%. Primarily led by spike in cereal prices even as core inflation remained sticky.

Indian bond yields celebrated the lower fiscal deficit guidance and 10-year yields fell to 7.26%, also the level at which the new 10-year issuance maturing in 2033 started trading at. However relatively hawkish guidance's from both the RBI and US Fed, along with a spate of robust economic releases from the US and a spike on Indian CPI data led to a selloff in bonds with the new 10-year yields trading around 7.34%.

***The sovereign yield curve has also flattened considerably indicating the shorter end (maturities up to 5 years) has risen at a sharper trajectory as compared to the longer end. The spread between 5-year and 10-year sovereign bond yields have now compressed to only 4-5bps as compared to 14-16 bps at the same time last month.***

As highlighted in our RBI policy note released on the 8<sup>th</sup> of Feb'23, we believe there is a significant probability of at least 1 more rate hike when the FOMC meets next in FY'24. Additionally, the announcement of the borrowing calendar, and the overall fiscal situation in addition to the US macro economic data release will serve as a key guidance for Indian interest rates going forward.

## **INVESTMENT OUTLOOK:**

Taking the cue from our previous publications, we would like to reiterate that investors are encouraged to adhere to 'Asset Allocation' and calibrate investment decisions by carefully monitoring the ever evolving economic and geopolitical data points. 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 –

- The first 45 days in CY'23 indicates increased volatility in financial markets as market participants await global central banks to allow an interest rate breather even as every data release so far underlines the need for an elevated interest rate trajectory to prevent inflation from being deeply entrenched. In this current backdrop, we continue to be bullish on the volatility hedge allocations played through long short and market neutral strategies.

- On return stability quadrants, we continue to prefer allocations to short and medium-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 6.75% (repo rate currently stands at 6.5%) followed by a long pause extending into Q4 CY'23 or Q1 CY'24. Short to medium term bond funds continue to be attractive at current levels especially for Investors with an investment horizon of 3 years. 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 continue to avoid lumpsum deployments in equities – part of the asset growth quadrant and we prefer a staggered approach. For long term investors who prefer to invest more tactically, 1/3<sup>rd</sup> of the money can be deployed before the end of current financial year on market corrections given moderate earnings growth & a balanced budget. We would invest the second tranche at the end of the Fed rate hike cycle, which is expected sometime in H1-2023 (in the past, markets have generally been positive 6-12 months out from the last rate hike). The third tranche can be deployed prior to a possible Fed pivot, however that is not expected to materialize in CY2023.
- USD-INR pair gave up on all its gains in the month of Jan'23 and retraced towards 82.75 levels, similar levels as on last week of Dec'22. Going forward , a widening trade and current account deficit as well as renewed 'flight to safety' phenomenon is expected to keep the currency pair under pressure in the near term.
- 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.
- While Gold prices have taken a breather recently as highlighted earlier, we continue to believe in continued allocation to this asset class and expect CY'23 to be a rewarding year for investors in this precious metal.

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