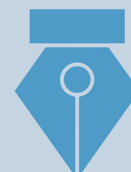
Trust Line

BizNotes

1st Nov 2022

For Private Circulation

FROM THE FUND MANAGER DESK



MONTHLY VIEW

Is gold ironically losing its shine when inflation is rearing its ugly head?

In these trying times, when inflation has begun to bite the consumers, gold should be reigning supreme. That is what conventional wisdom would say. Gold as a hedge against inflation is a textbook play, except that markets don't play to the textbooks. Markets play to the momentum. For reasons we will discover later in the section, optically, it looks like that the momentum is not with the yellow metal. How else one would explain the loss of luster in gold in times like these when positive real returns (returns adjusted for inflation) are rarity.

In inflationary times, there is always a rush to risk-off trade to protect returns against inflation. One could count on gold in such struggling times because money moves to gold when investors turn risk-averse. The current environment is one of the typical risk-off regimes where central banks globally are tightening liquidity to contain the inflation monster. But in this cycle too (as in 2013 cycle), it looks like that the typical pattern is not playing out. Or are we missing something?

First, on the gold performance, some surprising findings:

- In dollar terms, gold has fallen by over 7% in the trailing twelve months.
- In Rupee terms, optically it looks like it has delivered positive returns (one year) because of currency fall i.e. near 2% returns.
- Most surprising data point is that gold in dollar terms has remained flat over the last decade. This may not be good news for gold bulls.

One of the main reasons why gold falls (in dollar terms) during Fed tightening cycle is that it is priced in dollars. When dollar becomes dearer, which typically it becomes during the tightening cycle, gold which is priced in dollar moves down. It was no different in 2013 taper cycle. In 2013-2015 taper cycle, when dollar index rallied by over 18%, gold in dollar terms fell by 16%. It was more or less in line with the dollar index rally. But in this cycle, dollar index has rallied by over 17% in the last one year. Gold fell too, but far less than what the dollar index did. What explains the gap this time?

In the last taper cycle, inflation was not such a big worry as it is now. Hence probably gold fell in line with the dynamics of the dollar index. But in

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this cycle, with inflation out of control, probably there is new money moving into gold which explains the out-performance of gold versus dollar index. Though superficially, at the outset, it looks like that gold prices have fallen in dollar terms, in relative to dollar index rally, it has out-performed. This outperformance couldn't have happened without some momentum favoring gold. If one goes by this out-performance, conventional wisdom of gold as an inflation hedge does score some winning points. Unfortunately, the out-performance level is not adequate to compensate the rise in inflation (measured in local currencies) across different markets. For e.g., the gold has returned barely2% returns in India (in local currency) over one year while the inflation is over 7%. From this perspective, one could argue that gold has lost its luster when it comes to inflation hedge. To understand this gap, one needs to understand how momentum works.

In momentum game, rally begets rally in virtuous feedback loop. What performs gets more fuel to perform better. From this perspective, dollar has attracted more flows because of its stronger immediate past performance. In the competition between dollar and gold in the risk-off flows, the dollar has won hands-down because of the stronger momentum in its favor. Logic doesn't work when momentum is in play. That explains the unexplainable fall in gold in these turbulent times. Interesting times to watch out for.

Happy Value Investing!!

ArunaGiri N.

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CORPORATE NEWS

- Sony India and **Zee Entertainment Enterprises (ZEEL)** have agreed to sell three Hindi channels--Big Magic, Zee Action and Zee Classic—to address anti-competition concerns arising out of their proposed merger. The broadcasters submitted their proposal to the Competition Commission of India (CCI), which gave a conditional approval.
- Two-wheeler maker **Hero MotoCorp** announced its plans to enter the Philippines for which it has partnered with Terrafirma Motors Corporation for assembly and distribution of its vehicles. A part of the Columbian Group of Companies, Terrafirma Motors Corporation (TMC) will be the exclusive assembler and distributor of Hero MotoCorp motorcycles in the Philippines.
- FMCG major **Dabur India** announced that it will be acquiring a 51% stake in Badshah Masala Private Limited for Rs 588 crore. With this, Dabur has entered into branded spices and seasoning market in India, worth over Rs 25,000 crore. The balance 49% will be acquired after five years.
- Market regulator Sebi approved the Government's proposal to convert dues of over $1.92 billion by telecom operator **Vodafone Idea** to equity. The Government's stake in Vodafone after the conversion could be more than 30%, which would make it one of the largest shareholders in the company along with UK's Vodafone Group and Aditya Birla Group.
- IT services major **Tech Mahindra** announced that it has signed a memorandum of understanding (MoU) with the Gujarat Government to expand its operations by hiring over 3,000 employees in the state over the next five years. The MoU was signed to promote the IT and ITeS sector in the state under the Gujarat IT/ITeS Policy (2022-27).
- **Suzlon Group,** which has India's largest wind energy installed base, announced its new order win for the development of 144.9 MW wind power projects for the Aditya Birla Group, a leading Indian Conglomerate. Suzlon will install 69 units of wind turbine generators (wind turbines) with a Hybrid Lattice Tubular (HLT) tower and a rated capacity of 2.1 MW each.
- IT giant **Tata Consultancy Services (TCS)** said it was willing to hire at least 10,000 to 12,000 freshers in the ongoing year apart from the 35,000 it onboarded till September 30, as attrition rate remains above 20%.

MACRO NEWS

- India is likely to see the world's biggest rise in energy demand this decade, with demand climbing 3% annually due to urbanisation and industrialisation, the **International Energy Agency (IEA)** said in its World Energy Outlook. While the push for renewable energy will see it meeting as much as 60% of the growth in demand for power, coal will continue to meet a third of overall energy demand by 2030 and another quarter will be met by oil.
- With the objective of giving a boost to the domestic manufacturing segment and creating jobs, the Government is considering proposals to extend Rs 35,000 crore **PLI Scheme** to different sectors. These sectors include leather, bicycle, some vaccine materials, and certain telecom products. PLI (production linked incentive) benefits are also being considered for toys, some chemicals and shipping containers.
- **India's e-retail market** is estimated to increase to $150 billion–$170 billion by 2027. This implies that 25-30% annual growth and a doubling of market penetration to 9-10% over

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the next five years, according to a report by consulting firm Bain & Company made in collaboration with Flipkart.

- The **Ministry of Power** said the Government is mulling electricity transmission for renewable energy capacity of about 233 GW, latest by 2030, across the country. Planning of transmission system for integration of additional 52 GW potential REZ (renewable energy zone) by 2026-27 have been carried out and transmission schemes for another 181.5 GW by 2030 have been planned and the same would be taken up for implementation in a progressive manner.
- **India's vehicle retail sales** rose 57% during the Navratri festival this year, recording sales of nearly 5.4 lakh units, said Federation of Automobile Dealers Associations. As per the FADA statement, the total vehicle retail sales between September 26 and October 5, 2022, stood at 5,39,227 units as compared to 3,42,459 units sold during Navratri last year.

FUNDS FLOW DATA

Data as on 28th Oct 2022

FUNDS FLOW DATA (Rs in Cr)		
Category	**MTD**	**YTD**
FII	(1,586)	(1,70,375)
DII	10,384	2,59,948
Total	**8,798**	**89,573**

DEBT & FOREX MARKET

Data as on 28th Oct 2022

DEBT / FOREX MARKET			
Category	**Day**	**1 Mnth**	**3 Mnths**
10 Yr Yield	7.42	7.34	7.32
Re / US $	82.26	81.46	79.34

MARKET VIEW

MARKET VIEW

Comfort from cooling dollar index?

In the month of Oct, investors in India were more worried about the currency. When the dollar index was hovering around 115 level, there was a palpable fear that our currency could see a free fall which in turn could lead to a sharp slump in equities. When rupee touched a new low of 83 on 19th Oct, the narrative turned sharply negative for both the currencies and the stocks. Since then, dollar index had turned and now trading near 110 level. Overall for the month, dollar index has fallen by near 1.5%. This has brought some stability to Rupee and in turn to stocks. Overall for the month, Sensex is up by near 5% (as on 28th Oct). India's performance is more or less in line with the global indices in this month, though there was a marginal under performance in dollar terms.

In terms of FII action in Oct, there has been a net sell of over Rs 1500cr (as on 28th Oct) so far in this month. With structural domestic flows supporting the markets, indices have held up well so far. Unless one sees sustainable stability in currency, markets could go through bouts of volatility now and then. Having said that, one could be in for positive news on inflation, not immediately, but by March when inflation is expected to taper when the base effect will start taking hold. As per Mint estimates, if retail prices rise each month hereon at the same average sequential pace as seen in the past, the CPI inflation will ease to 6.9% in Oct and then slip gradually to 5.7% in March 2023. To quote Crisil report, "CPI inflation may moderate in the coming few months as base effect emerges". Globally too, base effect will take hold in March. Such a moderation is likely to ease pressure on central banks on their tightening trajectory.

It is very likely that markets will start taking cues from sequential moderation in inflation and will start discounting the likelihood of Fed becoming less hawkish at some point in the next few months. From this perspective, current volatility is a good accumulation opportunity for medium and for long term investors. Of course, geopolitics could still be a spoilsport if the conflict in Ukraine escalates for any reason.

VALUE EXTRACTS

Value Extracts

- In this section of the newsletter, we attach an extract/write-up that we believe can add value to the readers from the ***"VALUE INVESTMENT"*** point of view or others that offer interesting perspective.
- Enclosed section carries an interesting article from Business Standard titled **"Bear market patterns"** by **"Akash Prakash".**

"Every economic recovery since World War II has been preceded by a stock market rally. And these rallies often start when conditions are grim."

- Peter Lynch

Stock markets will turn, even with all the economic news still being negative, except in two scenarios

In the midst of a bear market, which we are undoubtedly in today with every asset class except commodities in the red, it is common for the sell-side commentary to become ultra-bearish. This is exactly what is happening globally. All the mistakes made in the prior bull cycle are now cruelly exposed.

Whether it be on valuations, absolute growth estimates or sustainability of growth, many investors are looking foolish at the moment. How could you have bought XYZ Company at a price/sales ratio of 40? How could you have assumed that digital penetration in ABC sector would continue growing at 35-40 per cent even after the pandemic? These are a sample of the stock-specific, micro level issues being discussed.

At a macro level, how could one have assumed zero interest rates forever? Why did you not expect inflation to surge, given the global fiscal and monetary policy dump in 2020? With the benefit of hindsight things look far clearer and obvious!

All types of awkward questions are being asked, and almost as if to apologise for their inability to have seen the excess, many commentators today are going out of their way to be as cautious and cynical as they can be. There are reams of research being written currently on why the world is coming to an end and markets are poised to collapse further. The

VALUE EXTRACTS

usual suspects and masters of doom are out in full force. The fears are understandable and real. We are probably already in a recession in Europe and poised to see at least a mild contraction in the US in 2023. Inflation is still not under control and real rates remain negative. Earnings expectations are bound to decline by 15-20 per cent, typical for a recession and we have these cuts still ahead of us. Unemployment rates are at record lows in the US. There has been no recession that has not seen employment levels fall. There are tremendous fears around normalisation of central bank policies. What will be the impact of quantitative tightening (QT)? We don't know because we have never seen it before. How will the financial system handle the rising interest rates? Again, as the crisis and near-meltdown in the UK pension/insurance industry demonstrates, no-one can predict the unintended consequences of the normalisation of liquidity and rates.

All this doom and gloom is well-understood, rational and we are in certain aspects like QT, truly in uncharted territory. Despite this, there is a hard reality in financial markets. Equity markets are discounting mechanisms. The reality, if one were to go back and look at almost all prior recessions, is that the equity markets bottom before all other real economy and financial market metrics. They tend to bottom several months before all the other indicators that investors are focused on. It is for this reason that equity markets are a part of the series of leading economic indicators used to forecast economic conditions in the US.

The normal pattern seems to be that equity markets bottom about six months before gross domestic product (GDP). After GDP, payrolls bottom and then we have earnings bottoming following that. Thus, when equity markets bottom, GDP, payrolls and earnings are still dropping. Markets will look through these indicators, even as they are declining and set up for the recovery to come. Thus, just because the news will remain poor on GDP, payrolls and earnings for some time to come does not mean that equity markets cannot bottom. The only time equity markets were a lagging indicator was the technology bust of 2000, wherein equity markets bottomed after earnings had already stabilised and started rising again. Earnings bottomed almost a full 12 months before equities troughed and there was hardly a recession at all. The unwinding of the excesses in the technology universe took much longer and the NASDAQ fell much faster and further than the broad indices, which bottomed much later.

The one economic indicator, which tends to bottom at approximately the same time as the equity markets is the Institute of Supply Management or ISM purchasing manager's index, which has historically bottomed within one to two months of the equity market trough. This is an indicator every investor should keep an eye on.

It is also my belief that in most large market declines, like the one we are going through, the bulk of the damage and drawdown tends to happen in the first 12-15 months of the decline. After this initial fall, markets either start moving up again (normal pattern) or if we have had severe sectoral and financial system excesses then the markets will just drift sideways for an extended period. Given that the US equity markets topped out in the last quarter of 2021, we should by the end of 2022/ Q1 2023 be near a point where a large part of the drawdown may be done.

While markets will remain very volatile with big daily moves in both directions, as we get towards the end of the year, an opportunity to increase the weight of equity in global markets will likely present itself. It is important to remember that the news will still remain unambiguously negative when this happens. It is also likely that the very commentators who caught the shift in market sentiment and were bearish in time, will not catch the more bullish turn. It is very rare for the same people to be right on the way down and the way up as well. At the turning point you will need to read other market commentators.

VALUE EXTRACTS

A scenario where this whole equity markets leading the bottoming process thesis will not play out is if we go through some type of financial shock. Coming after years of zero interest rates and abundant liquidity, there is a very vocal school of thought that is convinced that we cannot normalise monetary policy setting without an accident occurring in the financial system. Such an accident will mean all bets are off and it will become impossible to assess how markets will eventually play out. Another scenario is that inflation has truly broken out and will need years to get back to target. In this case again the above playbook may not hold.

A bottoming of global and especially US markets is very important from the Indian equity markets perspective. The biggest risk to Indian markets is global factors. Most allocators are convinced India is just too expensive. The markets have performed very well over the last few years and, even in 2022, have shown great resilience. India will be an ATM market for many, the one place they can still book profits, take money out and not decimate their remaining holdings. As long as global and emerging market portfolios remain under pressure, the temptation to sell out of India will be immense. We have seen $40 billion of secondary markets selling in the last 12 months. This will continue as long as global markets remain under pressure. Domestic flows have cushioned and offset this capital outflow, but it would be nice for this headwind to turn into a tailwind of capital inflows.

Yes, it makes sense to remain cautious on global markets for the time being, but one must be careful not to get too caught up in the bearish rhetoric. Equity markets will turn even with all the economic noise while still being very bearish.

- Article by Akash Prakash

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