MARKET OUTLOOK

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FROM HERE TO THE END OF THE YEAR

It's been an interesting tussle in the markets – inflationistas are ruling the airwaves again even as economies keep getting pummelled by a combination of covid driven shortages, declining consumption driven by those shortages and of course, the price rises that have resulted therefrom. There is no mistaking the fact that fiscal policy has a big hand in creating the demand spurt that has led to these scarcities, but the supply side still is not getting a fair shot at it. There is a mini-industry in calling every Fed move as wrongheaded; an almost undiluted sense of overconfidence has arisen in the reading of tea leaves and the levelling of charges against an organisation that spends each day collecting the widest and deepest level of data about the US economy. "The Fed is just shifting the goalposts" some may point out and well, correctly so, even though such utterances are utterly misled, because as even Keynes stated, "when the facts change, I change my mind." And so, I ask these soothsayers of inflation, "what will you do Sir when the facts change?"

The facts still point to a clogged global market that has seen a tremendous surge in goods demand and now, as services demand rises, it finds itself short on labour. The most impressive part has been the sudden and explosive demand for energy, not surprisingly started by increasing industrial demand in China (and then spreading elsewhere), whose export surplus continues to balloon to record levels quarter after quarter. But all of this has an expiry date – whether driven by capacity creation in goods that are in short supply or by the inevitable exhaustion of spare change available to waste. And we have not even started talking about the hit to commodities from the overturning of the Chinese real estate bubble. And has everyone forgotten that Q1 is seasonally the weakest GDP quarter?

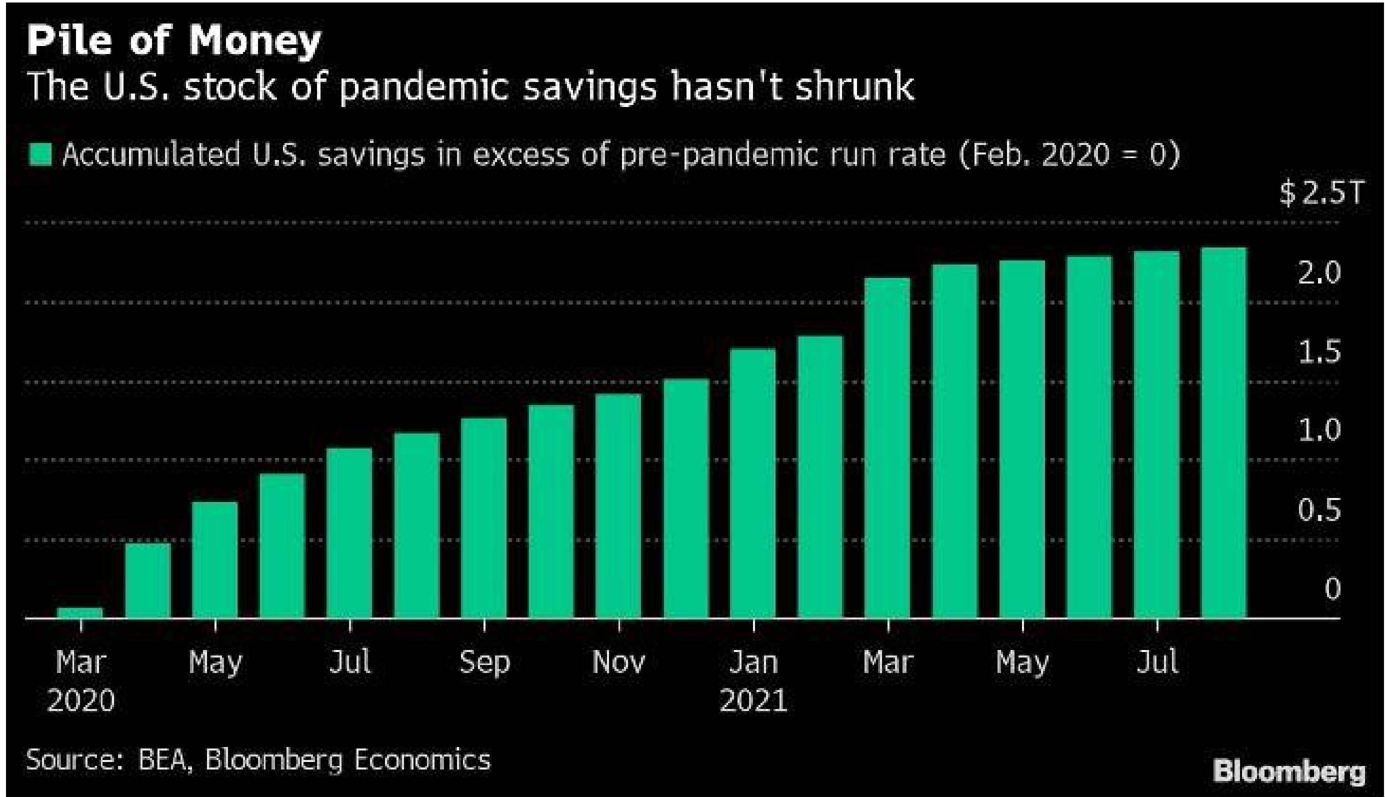
A durable, sustainable cycle of higher prices is created by durable, sustainable widespread demand or by governments intentionally trying to interfere in the normal course of business by scuttling supply responses. Transitory shortages create price pressures that are, well, transitory.

FIXED INCOME

The one chart that shows the futility of betting on lasting inflation or expecting this current bout of price growth to have any positive impact on economies is the shape of the curve plotting the difference between the 30 yr and the 10 yr yield.

All through this inflationary tale, one thing has been continuously ignored by the market – slowing growth. And while some have tried to incorporate this into a stagflationary narrative, the attempts have so far ignored the fact that most inflation is in things that are not, well, 'essential' and the consumer and business response has clearly come from a falling volume of goods demanded rather than a need to pay those higher prices and buy those goods now.

Inflation, as defined is a fall in the value of current dollars if left unspent and consumers seem to be quite happy in leaving money unspent. No wonder the savings rate has come to rest at just under 10% compared to a pre-pandemic average of around 7%. In fact, Bloomberg estimates that US excess savings pile since the pandemic has not even started to shrink!

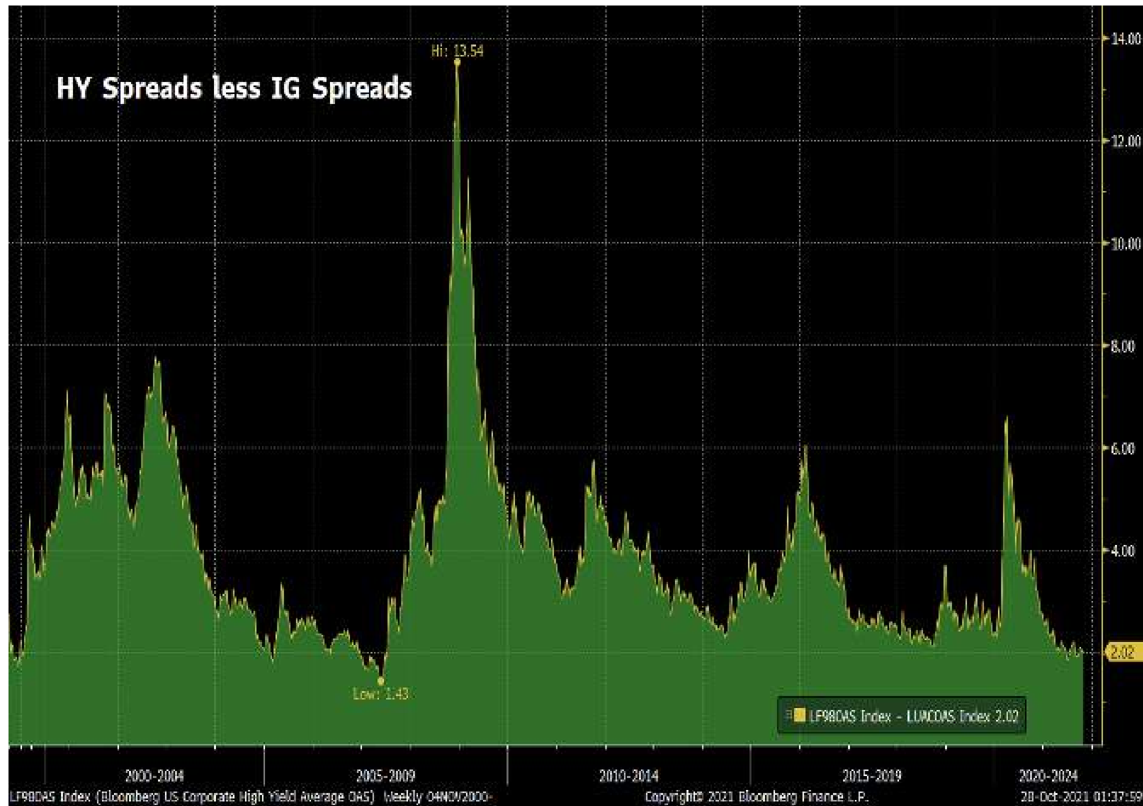


This is no inflation. This is a glut of savings looking for a home and that home could be an actual home or stocks or bonds. And despite dire predictions of bonds being uninvestable and expensive, they keep doing the job they are supposed to. What's looking expensive is inflation protection (especially TIPS) and break-evens which have exceeded levels not seen in two decades.

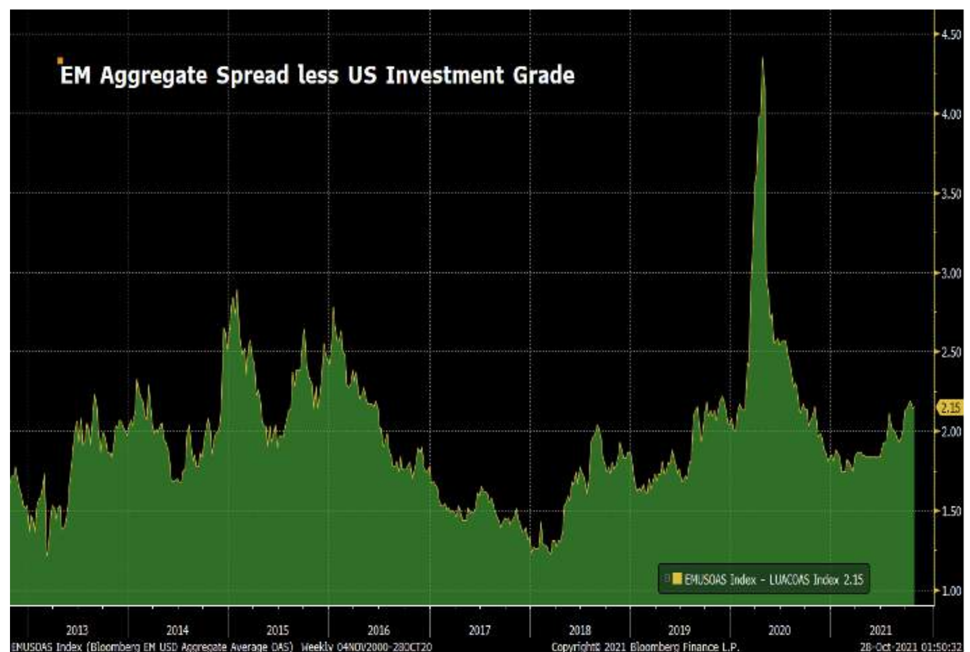
Consequently, at every opportunity, we have suggested that investors should stick with nominal bonds, especially longer dated bonds and now, even medium dated bonds have started to look attractive thanks to the flurry of rate rises being priced into the front end, leading to the sell off we have seen in the belly. We now have a positive view of 5 yr treasuries, expecting some of this euphoria around rate rises to calm down. Even if this rate cycle is going to be longer than the last one (would be a magnificent exception), it is still way too early and uncertain to price anything in the face of slowing growth and debt constrained world. And we all too quickly forget demographics. The savings we see are held by those that will spend the least and each day the world grows older and needs to spend a little lesser.

The other and possibly more exciting opportunity we see, especially if there is a return to a durable demand driven cycle that leads to a longer inflationary impulse, is EM debt, especially in local currencies. EM currencies have been battered, first by their policies, and second, by the lack of demand for what they produce – primarily commodities. While the reader may be quick to point out the commodity demand we are seeing now and how that still hasn't helped EM Fx, we would point out that such a short sharp rally is barely enough for countries to be able to recycle the current account gains into a domestic consumption and growth cycle, especially if that cycle is concentrated purely in developed markets. This environment is much more reminiscent of the cycle after the Asian crisis, where economies devastated by the crisis took years to stabilise while US risk assets made merry. As EM central banks raise rates in response to supply and inflationary shocks that have led to weakening currencies, a future benign cycle starts developing paved by cheap currencies, bottoming out of demand, and high real rates. The question we have still to answer is whether the transition to such a benign cycle itself will be benign or need a more violent reset (a la the tech bust of 2000). This may be one to focus on for next year.

On the credit side, we find little value in adding investment grade debt to the portfolio even as the relative value in High Yield gets lesser every day.

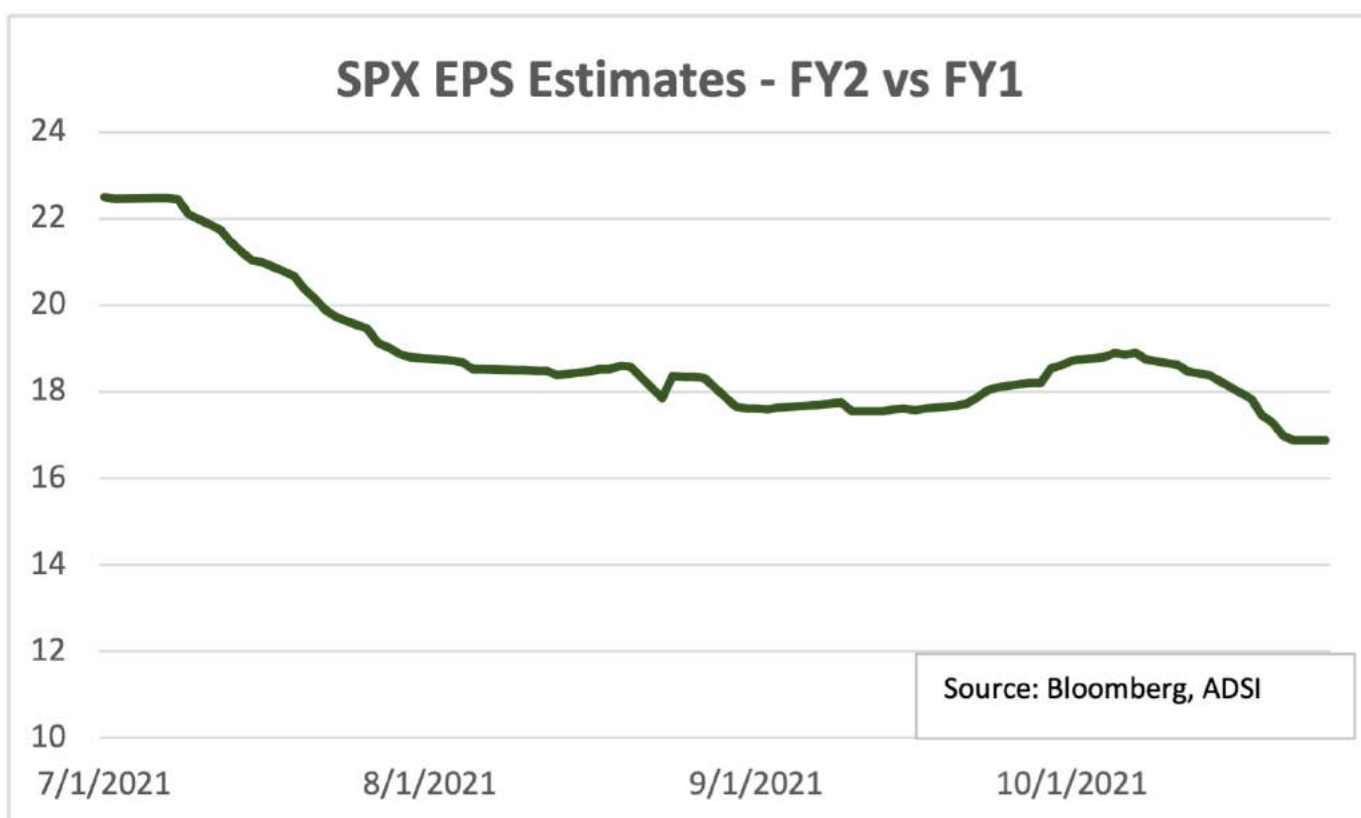


Still, this situation can last for a while, especially if rate hike expectations pull back and the economy reaccelerates. On the other hand, there may be more to gain from such a situation in EM debt, where spreads have widened this year and are larger than those available in US HY. We do recommend caution here because as we have said before this is still a very DM cycle and it will take time to be favourable to EM too.



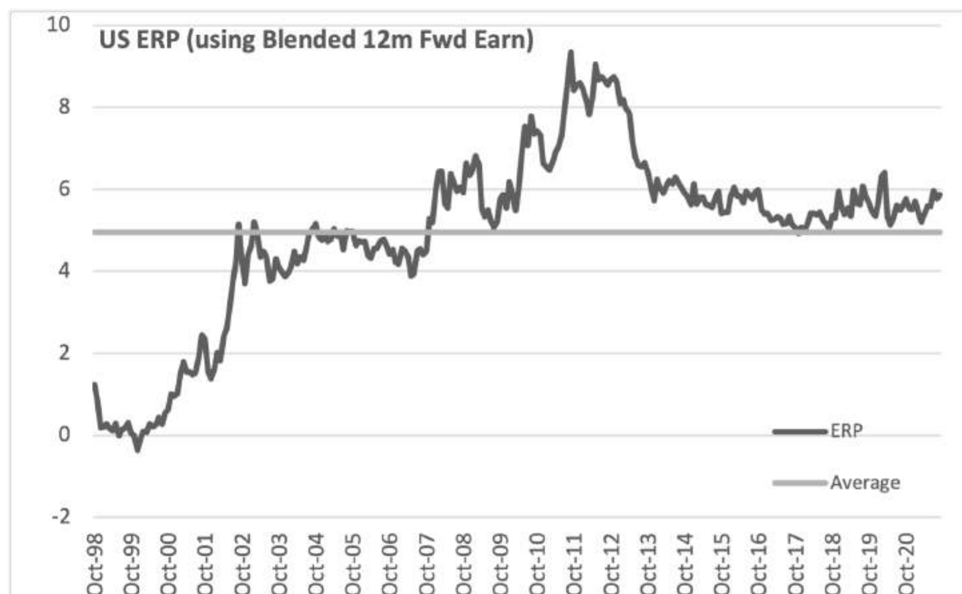
EQUITIES

It has been somewhat frustrating to not be overweight equities in the last 2 quarters in what has been again a stellar year. But since flagging valuation risks in July, the fundamentals haven't improved that much even as earnings risks have started to show up quite prominently, especially in corporate guidance for Q4. The result has been that analysts have been quite reluctant in raising their EPS estimates for 2022 for the S&P even as they keep raising their year-end 2021 EPS estimates, essentially chasing earnings announcements.



But that chase may be ending as guidance for most companies is coming much weaker than analyst expectations in the latest earnings quarter. This week many of the tech and payments names guided towards a more conservative advertising and spending environment in Q4, which is meant to be a seasonal high point, even as they met Q3 expectations. Our concerns around high expectations are currently embedded in equities, and consequently valuations, thus remain.

Forward valuations remain quite significantly above their cycle averages and that overvaluation has only grown in the last month as analysts raised expectations ahead of the latest earnings quarter. That is increasingly looking like a mistake.
The other factor holding prices at these levels is real rates. That inflation pricing is at an extreme is not an overstatement, consequently, real yields continue to hover at their lowest points...ever. This is a big factor in holding the Equity Risk Premium at these levels.



The benign case for equity markets is a repricing based on one factor - either earnings estimates or real yields, and the worst-case scenario is both acting adversely. With both of these flashing red, we still find it hard to get aggressively long equities and continue to sell rallies.

Again, non-US equities are looking much better for the same reason that EM bonds are. However, the same caveat that we gave in bonds applies here. EM equities will not perform if US equities do not, so there is little gained for now by allocating to EM at the cost of US equities.

- We still think investors should remain cautious when it comes to China as while regulation may be priced in, a slowdown in growth is not.
- While we have had a preference for India, and since that stance is on its way to becoming consensus, valuations are not cheap, and investors need to have a much longer term view.
- We find Brazil at an interesting turning point, where the Central Bank has acted decisively and aggressively to push back against inflationary tendencies and consequent currency weakness. Brazil now screens as the cheapest market in our universe and it's also one of the worst performing markets this year, down over 17% at the time of writing in USD terms. It is time to start paying attention to the market especially the domestic consumption driven names that have been hurt by a combination of economic and political factors. The country seems ahead of other EMs in the readjustment process we have been expecting.
- The Europe Value trade still is valid, but once again, we don’t expect outperformance anymore. We see risks from the links with China and unless that risk is well priced in, we think European assets cannot outperform.

Our sectoral calls remain very much similar till year end. We have a preference for healthcare, and we find ourselves inclined to look favourably at consumer staples. Expectations from consumer staples names are fairly low with analysts worrying about supply chain disruptions and rising input costs. Our pushback is that these companies have pricing power (Pepsi and Coke have shown that again) and that supply chain issues are slowly but surely becoming less concerning. In this context, it is worth noting the recent decline in Baltic Dry Freight Index.

We continue to like Energy but remain conscious of the risk of a price correction in the space, which has run hard over this year, and prefer capex/oil services plays in the space. We still do not like Materials, again on the back of the China growth risks being still under-priced.

One key sector we are doing detailed work on is Autos. Interesting things happened in the auto space this month, with one key development being the order of 100,000 cars placed by newly resurrected rental car company Hertz with Tesla. While many believe that this is an outright positive for Tesla (and rightly so), this is a bigger deal for Car ownership and what comes with it in general (as exemplified by the deal Hertz announced with both Uber and secondhand car dealer Carvana). Global Auto and Auto Parts market Cap that has continued to expand in the hopes that every one of these companies will transition to the EV supply chain, but that is demonstrably false. EVs last longer, have fewer parts and less servicing needs, and as the Hertz and Uber deals show, we won't need as many of them. In the next few months Auto makers may do well because their supply chains ease up and unfulfilled orders get delivered, but for the sector, winter may already be on its way.

OCTOBER 2021

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