

# **The Coming Collapse Of Inflation & How To Benefit From It**

**JULY 2022**

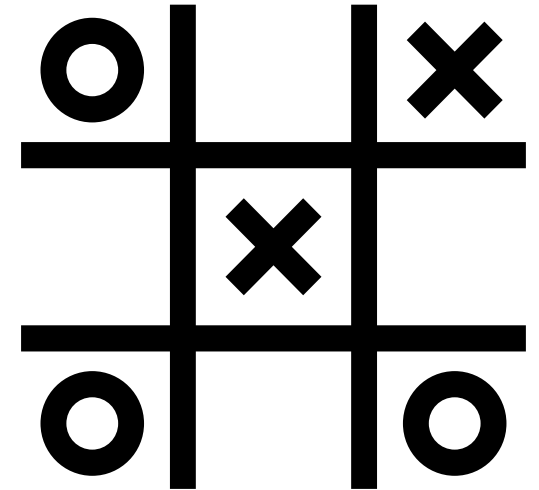
**DSP**  

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## “I don’t track inflation for investing”: 52-year-old investor with negative returns over 10 years

- Who wins this game of tic-tac-toe? The ‘O’ guy if he gets to move first, else nobody wins. It’s a chaos.
- Inflation moves a lot of things in investing. From sentiments to real input costs, from valuations to duration. It is also a double edged sword, we definitely want some inflation but not too much of it!
- Inflation changes the macro environment swiftly. Lower inflation warrants better interest rates and better growth prospects and therefore better margins for some industries.  
**When inflation cycle turns, it is important to focus on sectors that can benefit.**
- Our view is that inflation cycle is set to turn hereon. **The sectors to benefit from it are: consumption especially autos, banking and cement.. In the debt space, duration starts to benefit when inflation falls. Technology could also benefit as valuations normalize.**

If you’re the lucky ‘O’ guy, better to move now



## What Are We Saying?

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1. Biggest driver of inflation – commodity prices – are falling. US Housing, the core inflationary component is red hot. This is likely to cool off and mean revert.
2. Market based indicators like ‘Yield Curve Inversion’ and trajectory of rates indicate a slowdown ahead and hence a drag on prices.
3. India inflation which was driven by food & fuel is peaking and is likely to fall.
4. **A combination of weakening demand, improving supplies, a mean reversion in commodity prices and ‘Base Effects’ are likely to cause inflation to peak in the rest of 2022.**
5. **What will benefit:** Duration plays in bonds, commodity users like auto, cements and consumption. Banking will do well as disposable incomes rise and demand for credit strengthens further.

But there are risks to this hypothesis.

## What Could Go Wrong With This Hypothesis? The Three Risks

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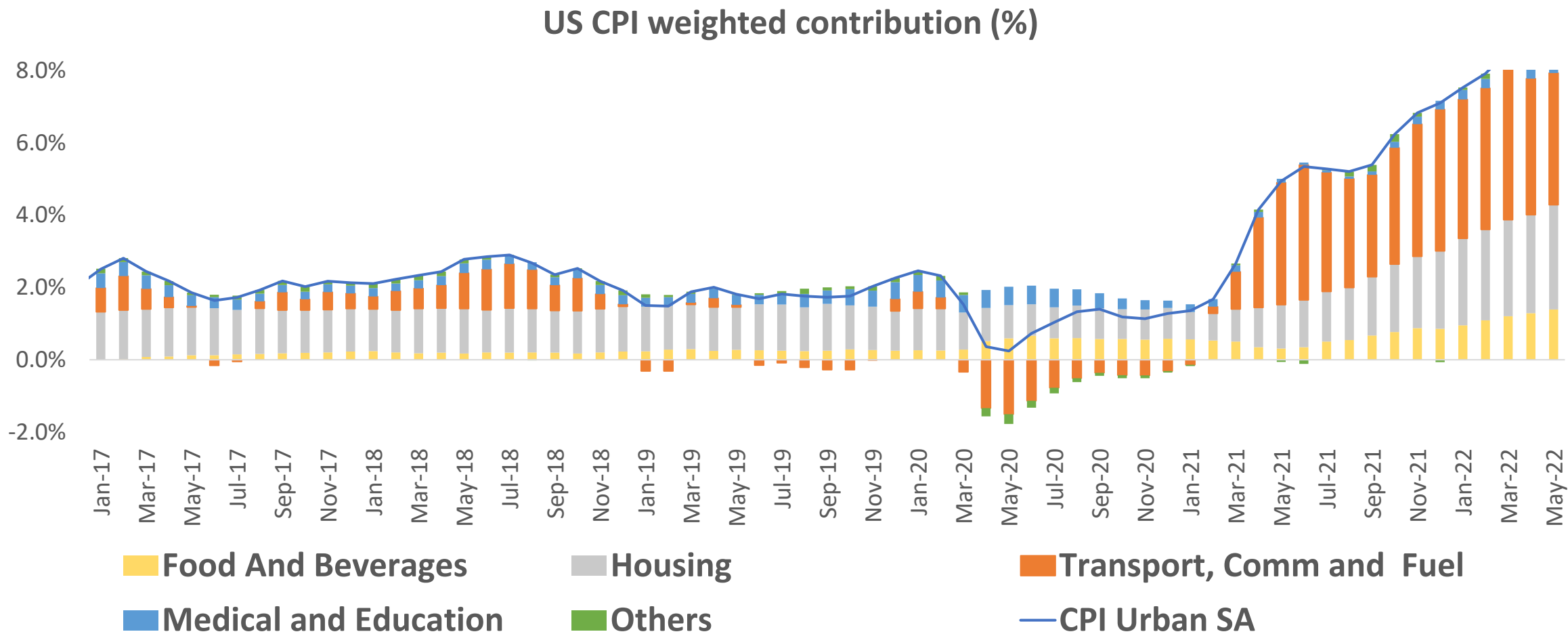
1. This biggest risk to our hypothesis is a flare up in Russia-Ukraine tension which spills over to NATO. This could cause a sustained period of high and rising energy prices. At the current juncture, markets seems to have priced in the disruptions caused so far.
2. Continued demand side strength leading to stickier inflation levels. The slowdown being witnessed across many advanced economies is without a meaningful reduction in employment. This augurs very well for subsequent recovery but could result in a more resilient consumption trend than anticipated. This could delay the cooling off of core inflation pressures in the economy.
3. A mega stimulus from China boosting global growth. So far China has given measured doses of stimulus to revive its economic growth post the COVID induced lockdowns. Although a low probability event, a mega stimulus from China can revive global growth and can have a strong impact on commodity prices delaying the mean revision in inflation.

# Why Inflation Is Likely To Cool

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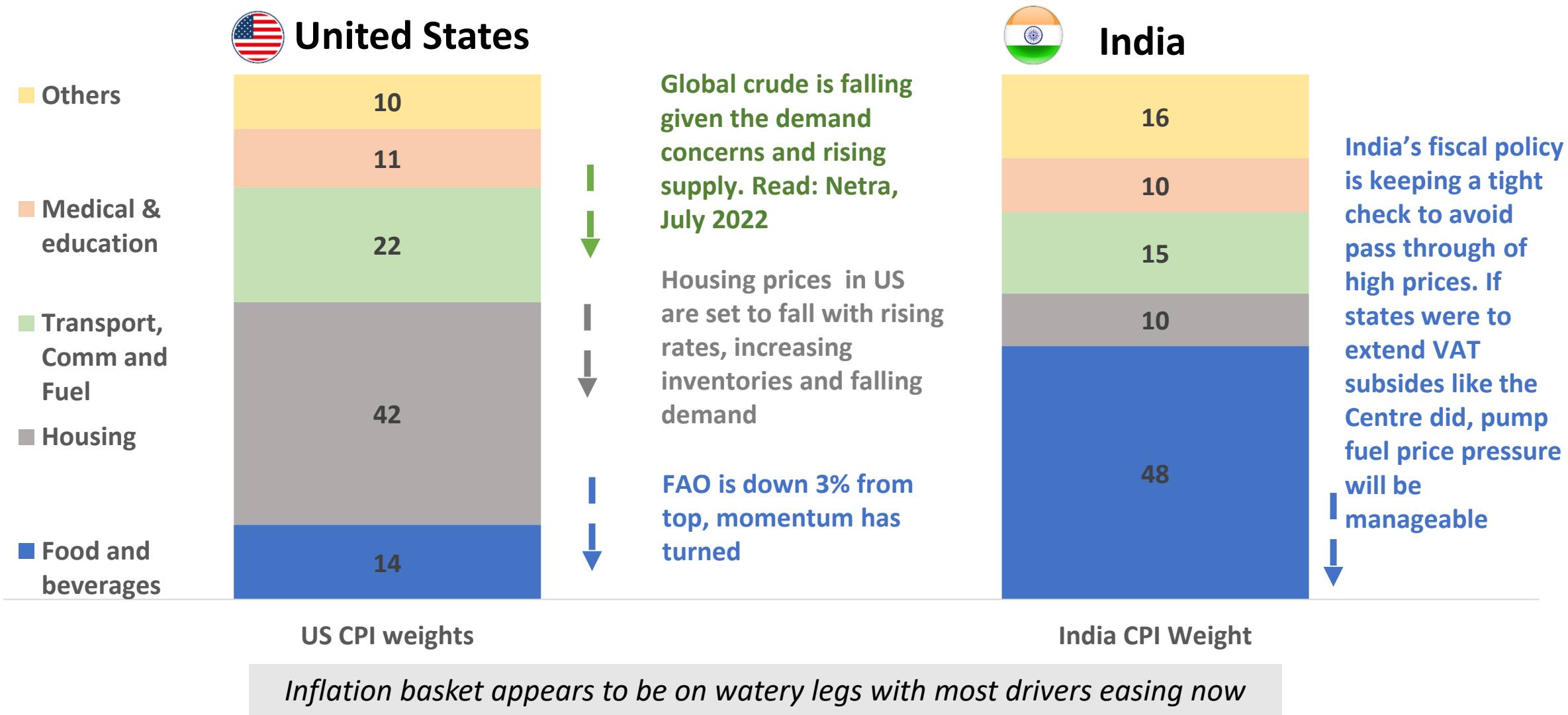
- One of the biggest drivers of inflation – commodity prices – are now falling. Most agricultural ‘softs’ are down on a year-to-date basis and agri index is down nearly 35%. Industrial metals have seen sharp cuts with Copper and Aluminium down 35% and 40% from their recent highs. Crude Oil prices have also started to soften, down 20% from recent highs.
- Fiscal and monetary stimulus are now working against inflation. Wage pressure is likely to dissipate as stimulus ‘Sugar Rush’ ends. This is likely to contribute to a reversal in one of the core inflation drivers, especially in US, the housing market.
- US housing market is so hot that its ‘too hot’. Prices are rising at the fastest pace, rental vacancy is at all time low of <6%, housing inventory is near all time low of just about 2.2 months of supply. At the same time new home sales have begun to slow, new housing starts are now contracting sequentially. Housing contributes ~42% to US CPI inflation. This is likely to be a major source of dis-inflation in US in coming quarters. What’s more important is a reversion to mean in US housing will impact not just inflation in US but demand for a wide variety of raw materials which are causing inflation globally. US Real estate contributes ~18% to US GDP and about 4.5% to global GDP. It’s the elephant in the room.
- India inflation has been more well behaved than global inflation trajectory. Domestic food prices and a delayed recovery helped India to avoid double digit consumer price inflation. Now with agri prices cooling off (Food & beverages contribute 48% to India’s CPI), inflation trajectory in India appears to have peaked.

# What Drove Inflation in the US to 9.1%: Housing Rentals, Oil & Gas and Food

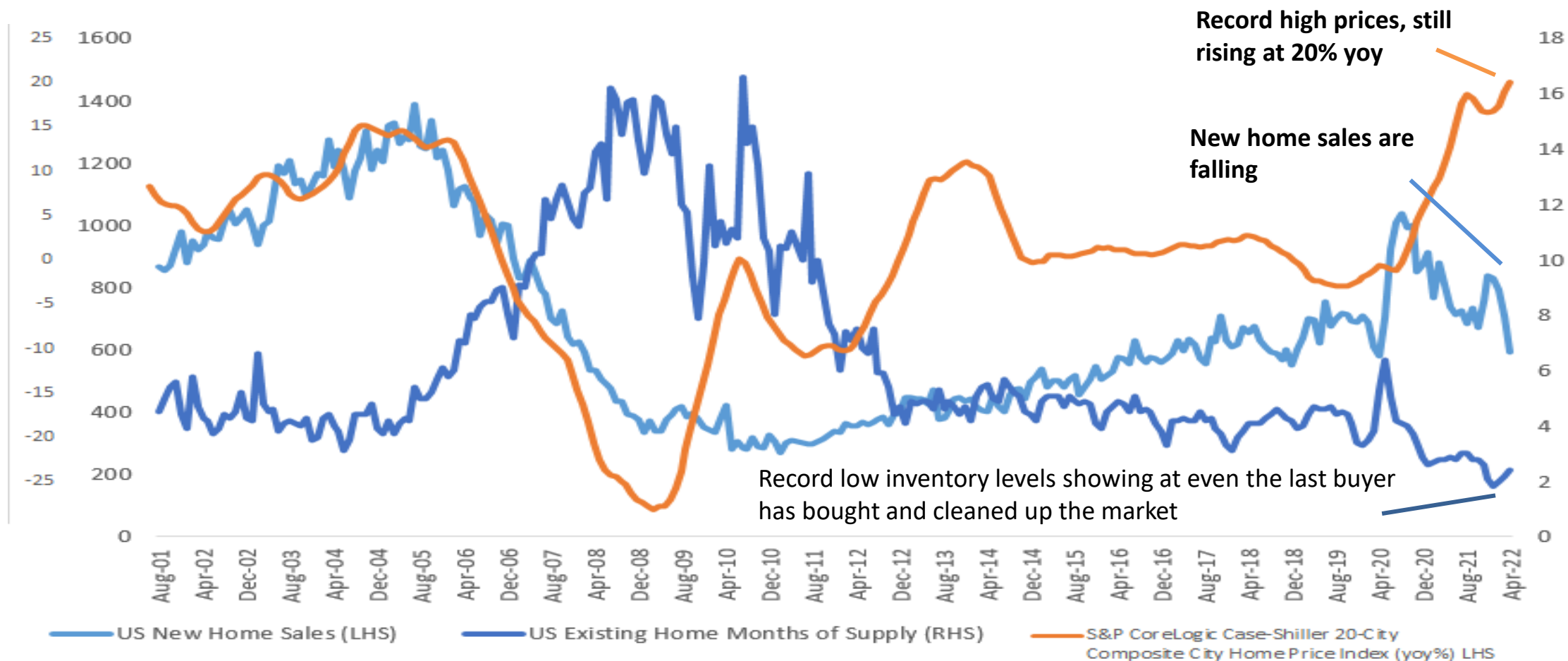


*Apart from rising energy & agri prices, a red hot US housing market has been a key contributor to inflation in US.*

# The Constituents of Inflation

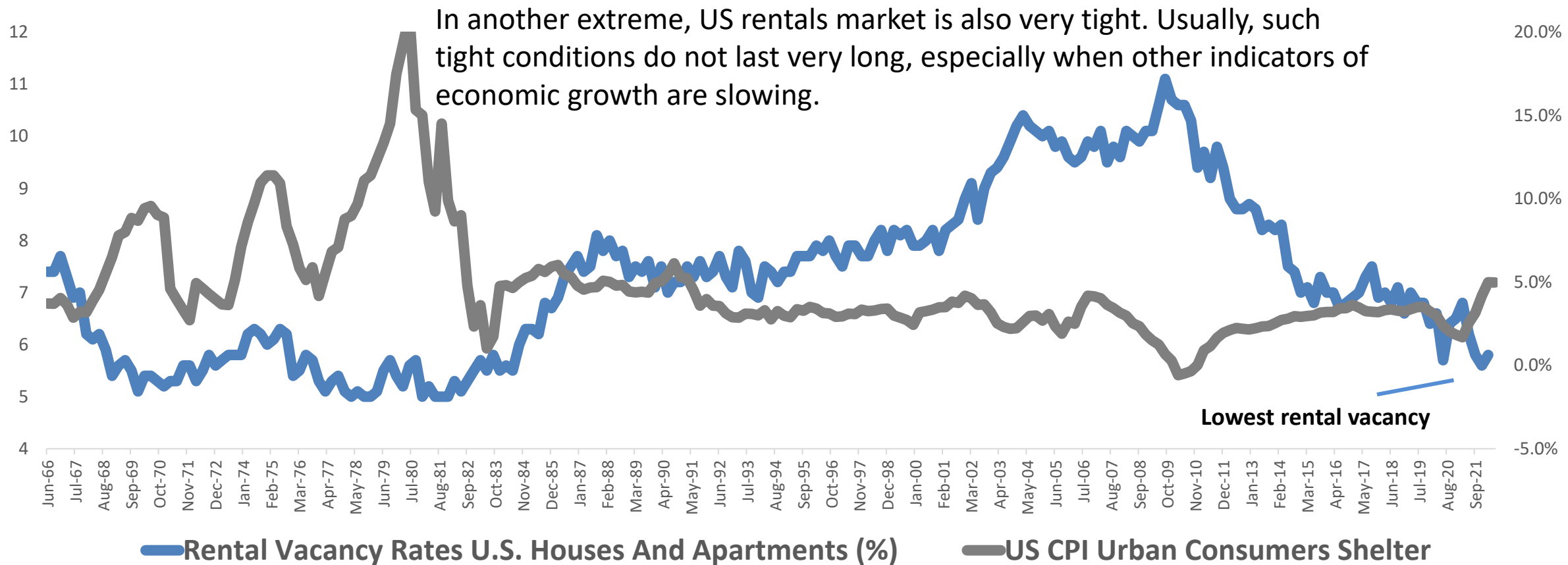


# US Housing Market: Wretched Extreme



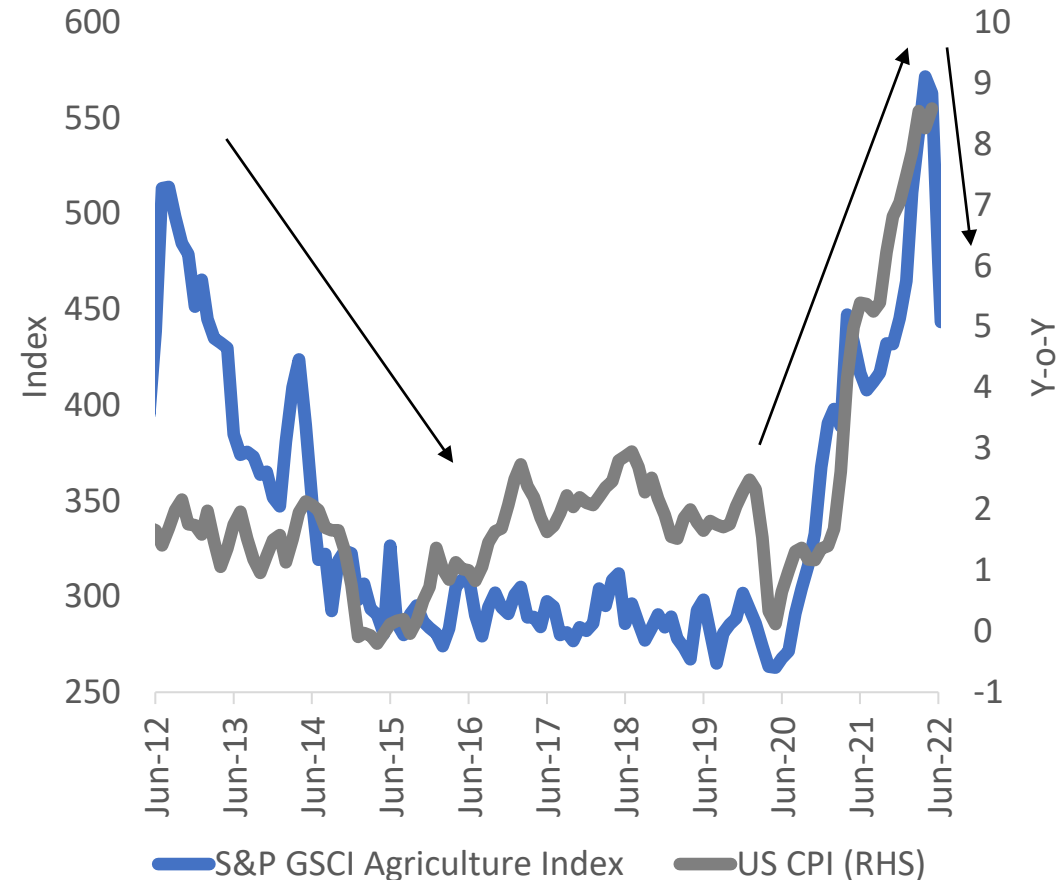
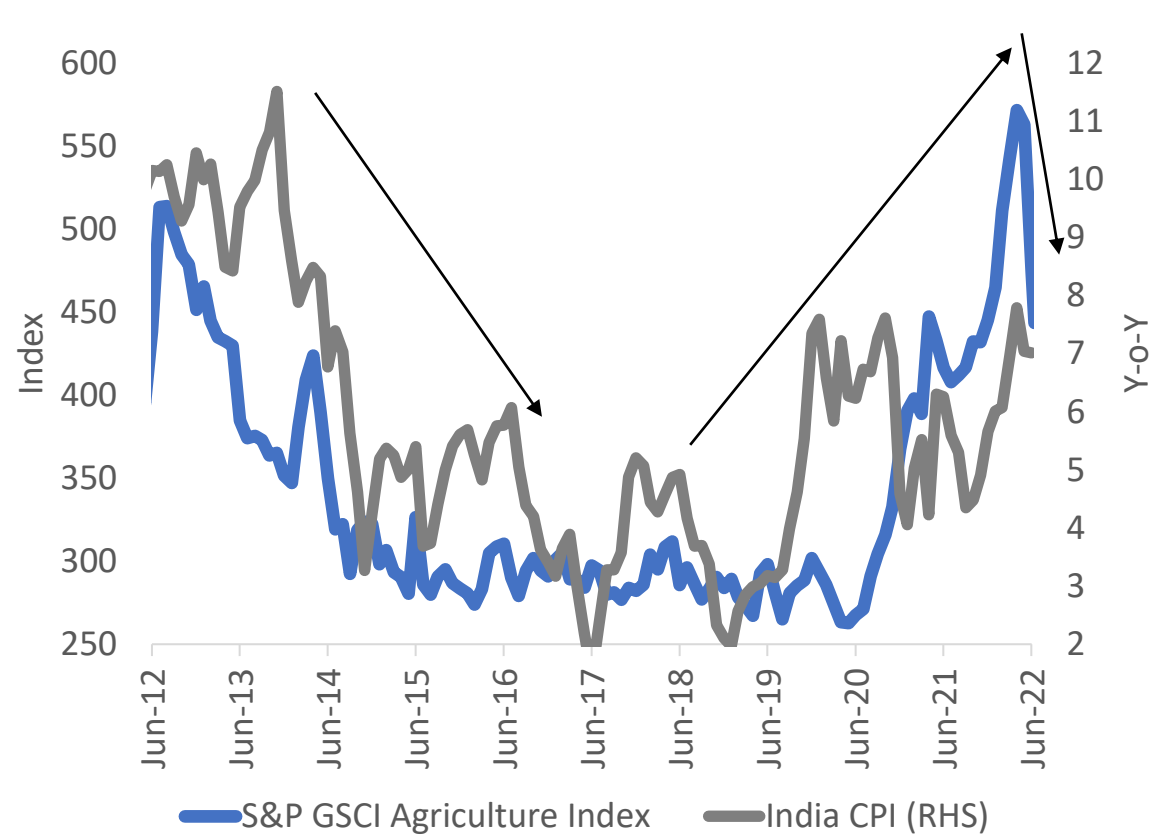
*US Housing is so good that its bad. As and when the US housing market slows, it will cause rentals to also fall. This will have a massive impact on inflation numbers in the US.*

# Wretched Extreme: US Rentals Are Rising At The Fastest Pace With Lowest Vacancy



*From residential construction to rentals and to commercial real estate, US housing is showing signs of mean reversion. This means the housing inflation trajectory is in its 11<sup>th</sup> hour.*

# Food & Beverage is 14% of US inflation and a whopping 48% of India's inflation



The fall in food inflation is a strong leading indicator of the coming collapse.

# Energy costs are elevated but for how long?

The demand for oil is falling whereas the capex continues. Softening in oil prices hereon looks very likely

**China & India's oil demand growth was higher than any large country across any period**

**59% of incremental demand was driven by India & China**

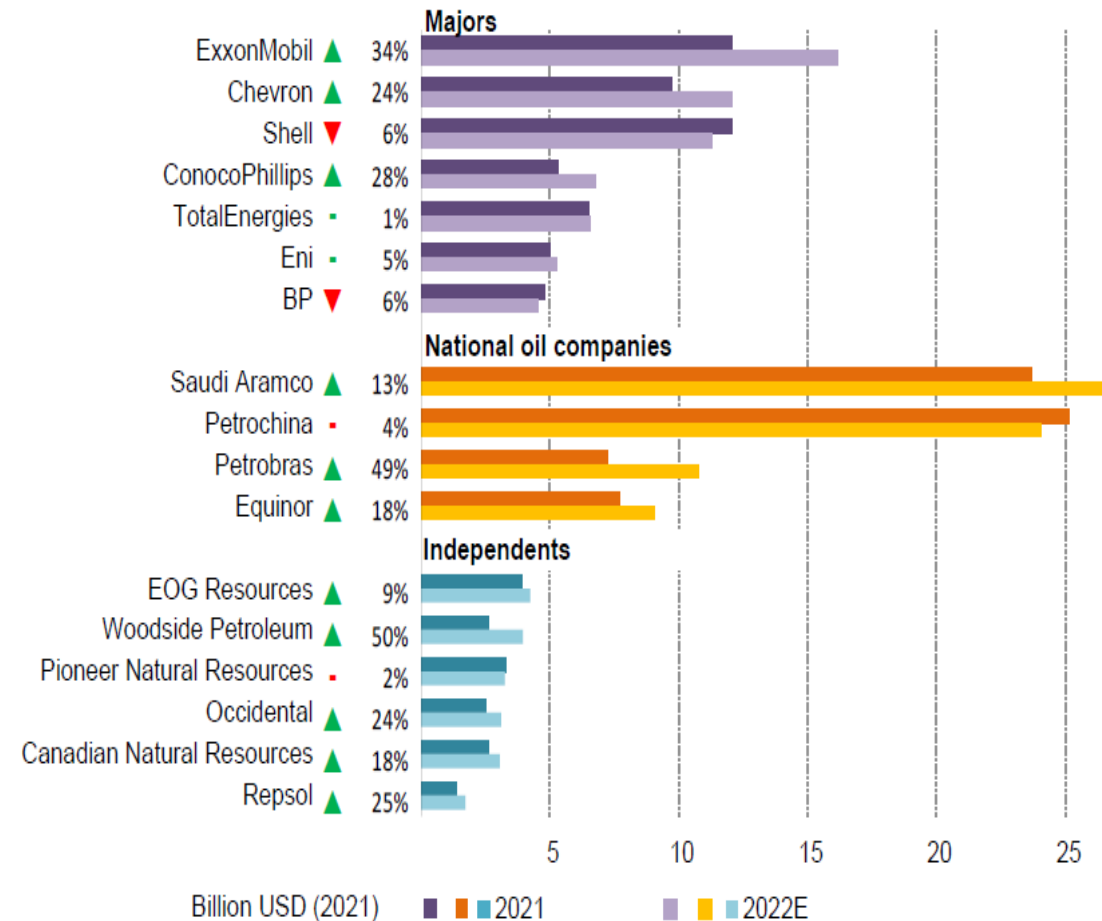
China and India GDP grew at a much higher pace than the world and peers. In the next 10 years the growth rate for both these countries is likely to be lower than last 20 years.

**Assuming China and India growth to slow to 6% & 5% respectively for the next 10 years, Oil demand growth is likely to de-grow as well. Therefore, even maintenance of CAPEX could be a threat to prices.**

**Refer to NETRA July Issue for more insights.**

**Link: [NETRA July 2022](#)**

## CAPEX By Major Oil And Gas Companies



# China's 9% Growth of last 2 Decades May Not Repeat: That's A Drag On Commodities

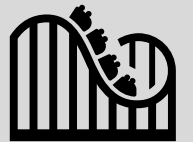
Commodity	China's rank in consumption	China's rank in consumption
Steel	1	In 2019, China consumed 940 million metric tonnes of steel
Oil	2	China consumes 14% of global oil and is right behind US
Wheat	1	China consumes 148 million metric tonnes of wheat- more than any other country
Copper	1	China consumes 54% of global copper consumption
Total Energy	1	China contributes 25% to global energy consumption
Consumer products	1	In terms of Purchasing Power Parity(PPP), China remains the largest consumer market globally

# The Biggest Consumer Of Metals Is Facing A Structural Downward Trend

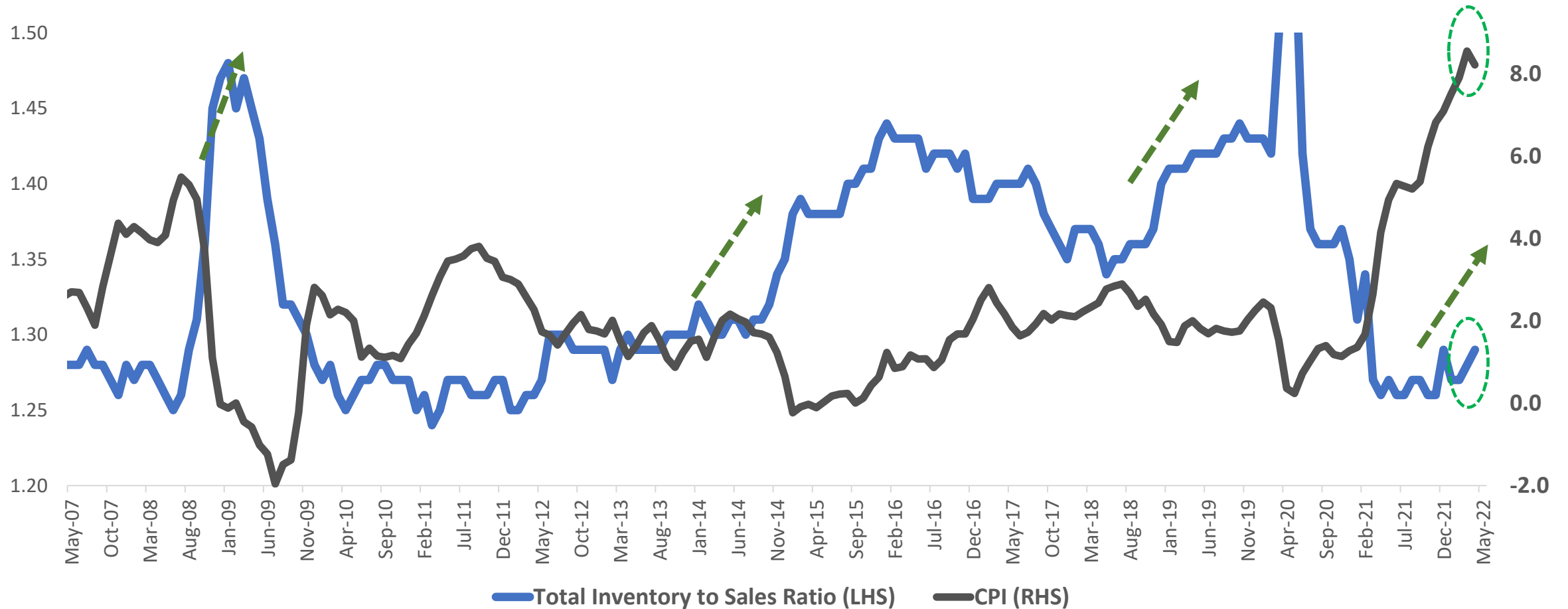


*For more than one reason, China's industrial output will remain in structural downturn:*

- a) Growth is not coming back*
- b) There's a policy shift towards consumption*
- c) Geopolitical environment is not aligned for Chinese exports*

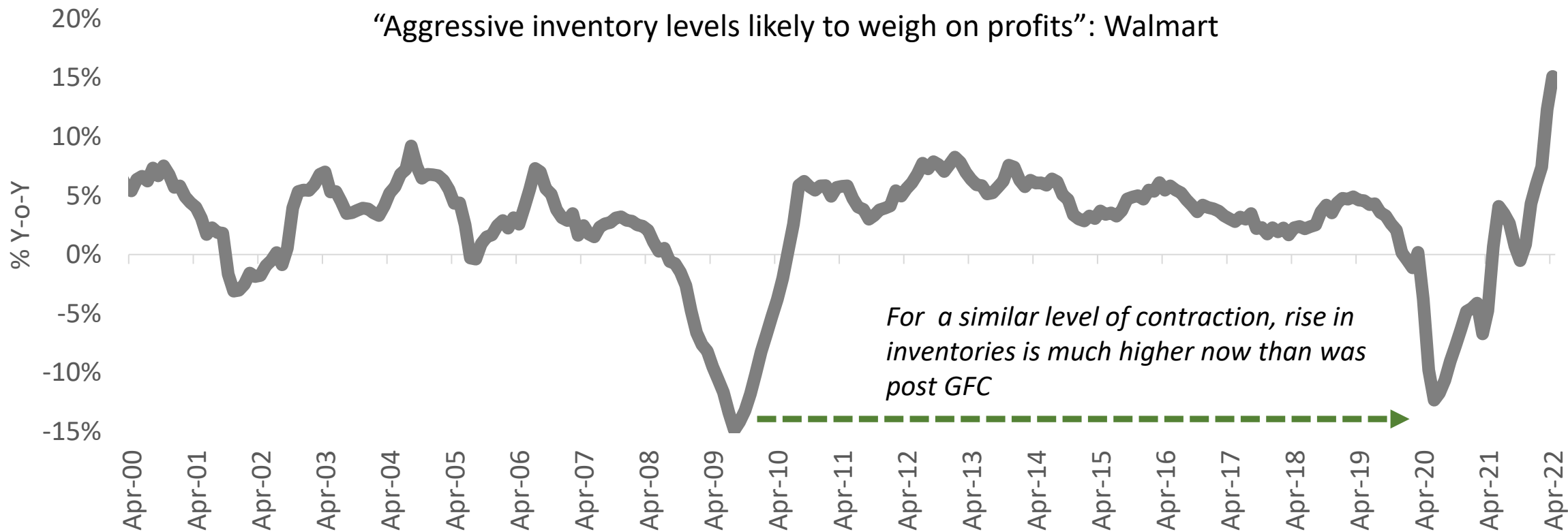


# Supply is Back: Inventories Are Rising



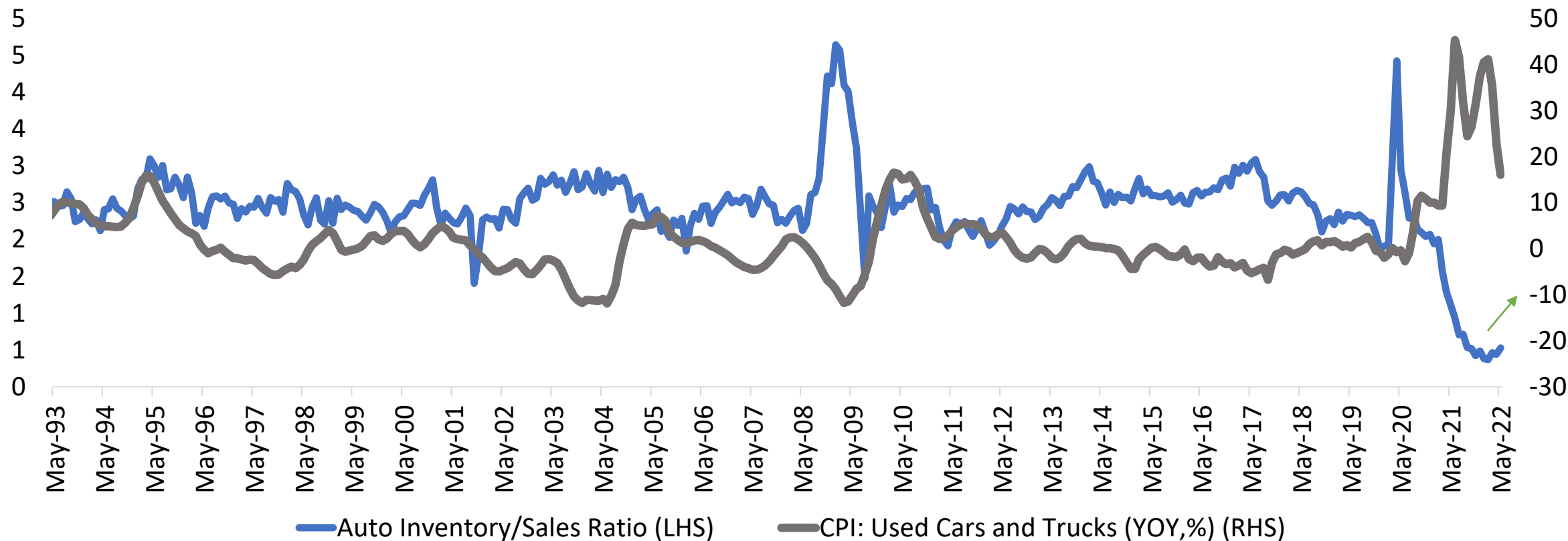
US retailers' inventory is rising at a fast pace. If there's a paradigm shift from "supply squeeze" to "supply glut", where are the prices going? This surely doesn't look inflationary.

# All Shortages Are Followed By Gluts



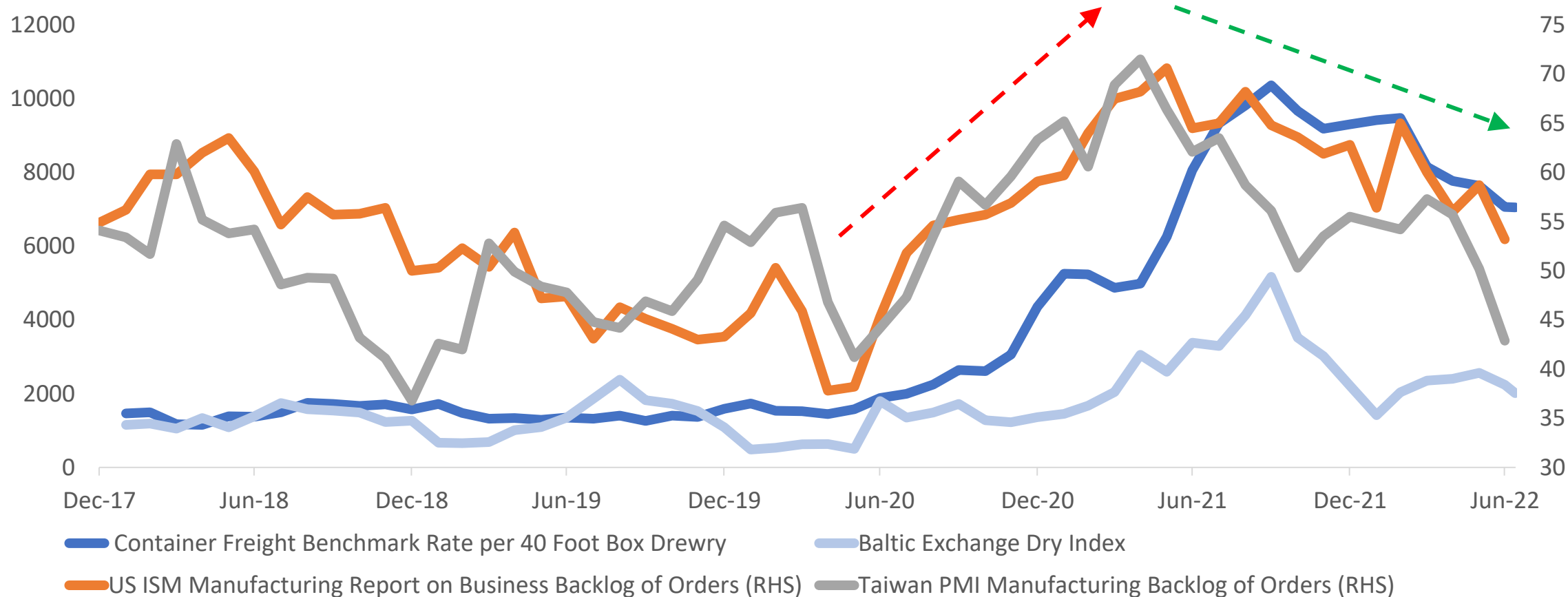
Retailers like Walmart and Costco are reporting rising inventory levels. This rise is higher than that witnessed in the aftermath of global financial crisis in 2008. This inventory is not going to be sold at a premium and thus will be a drag on inflation ahead.

# US Auto Inventories Have Bottomed, Used Car & Trucks Inflation Has Peaked



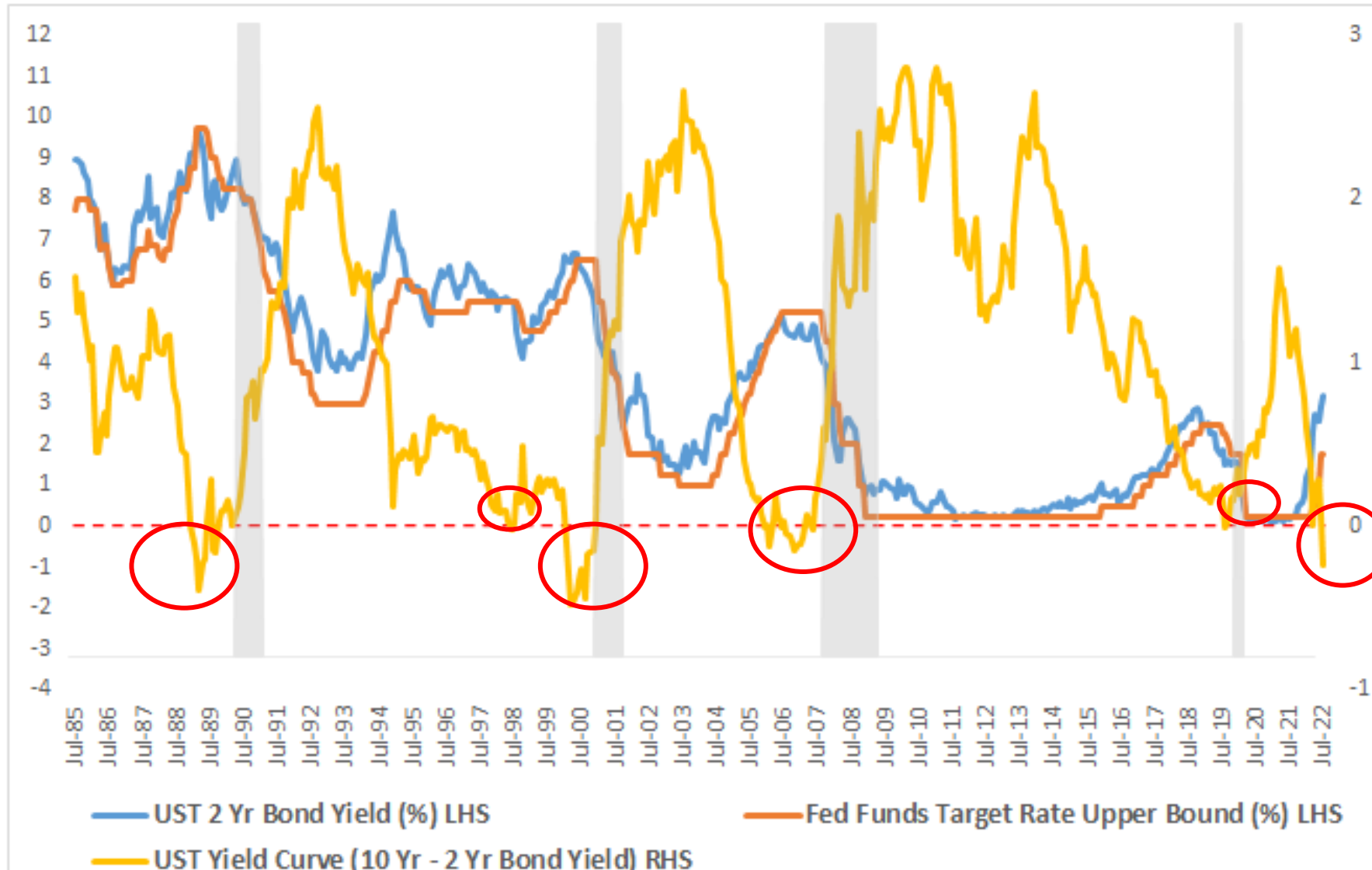
One of the largest contributors to inflation in US, used cars and trucks prices have begun to decline. This happened because semiconductor shortages are getting over, new cars are available and there is simply not enough demand. Another inflationary driver turning into dis-inflation.

## Freight and logistics' cost is now falling



*Drewry's composite World Container Index is now down 20% year on year and 32% from its peak in late 2021. Similarly, Baltic dry index is down, and CASS Freight index has begun its descent. Semiconductor inventories are also rising across producers indicating a reversal of tight supply side across the globe. The backlog of order in US and semiconductor major like Taiwan is back to pre-covid levels.*

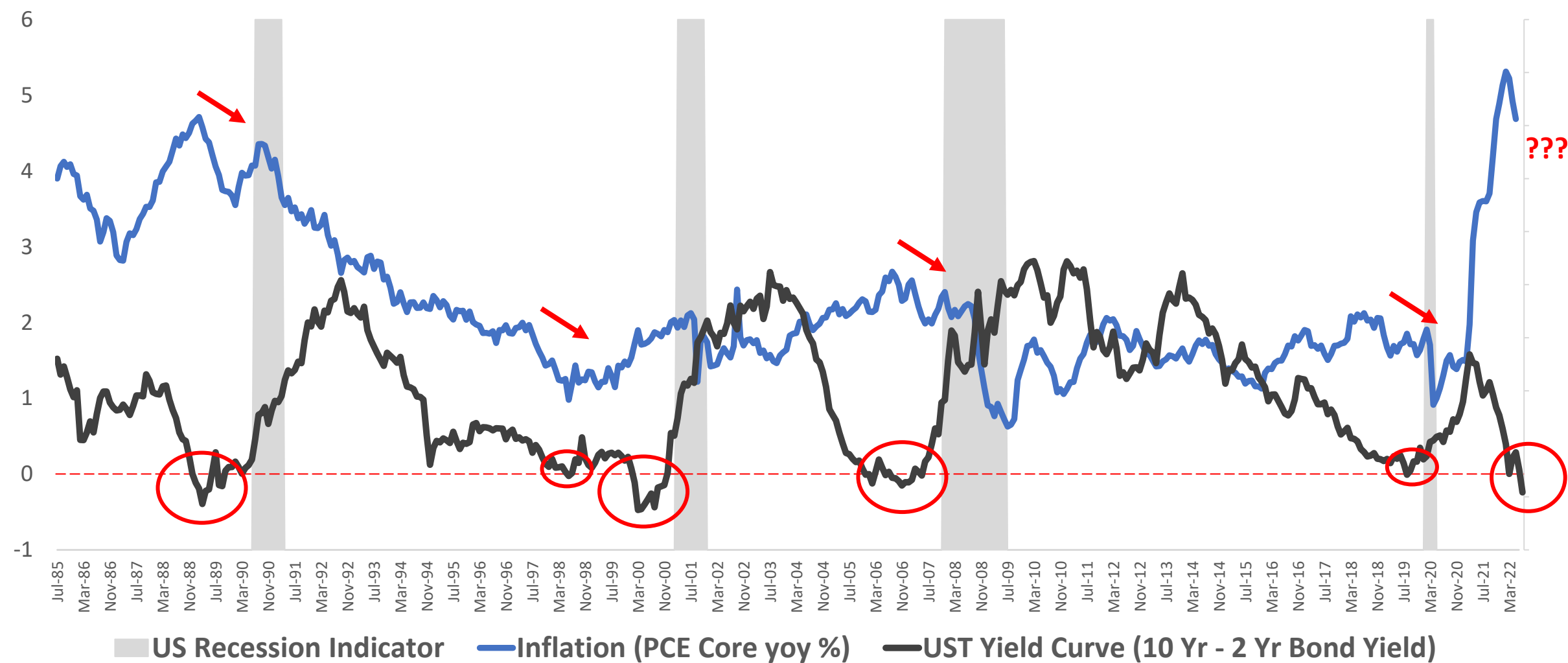
# US 10 Yield Curve Has Inverted Sharply, Though More Rate Hikes Are Pending



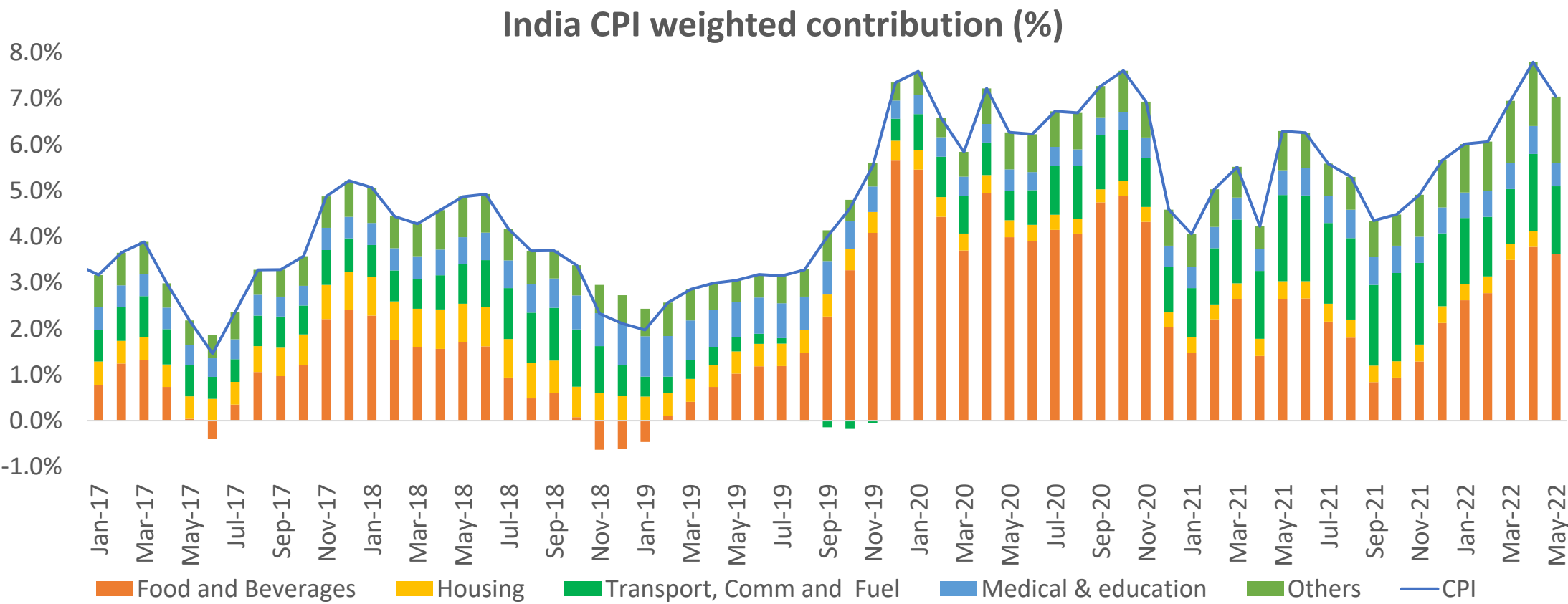
US Fed rate hikes are now working against long term bond yields as growth expectations fall

US 10 – 2 yield curve is the most inverted it has been in the 21<sup>st</sup> century. Inversion are followed by slowdown / recession in most instances.

# Inflation Hasn't Survived Many Yield Curve Inversions In The Past



# India Consumer Inflation Has Been Driven by Food & Fuel

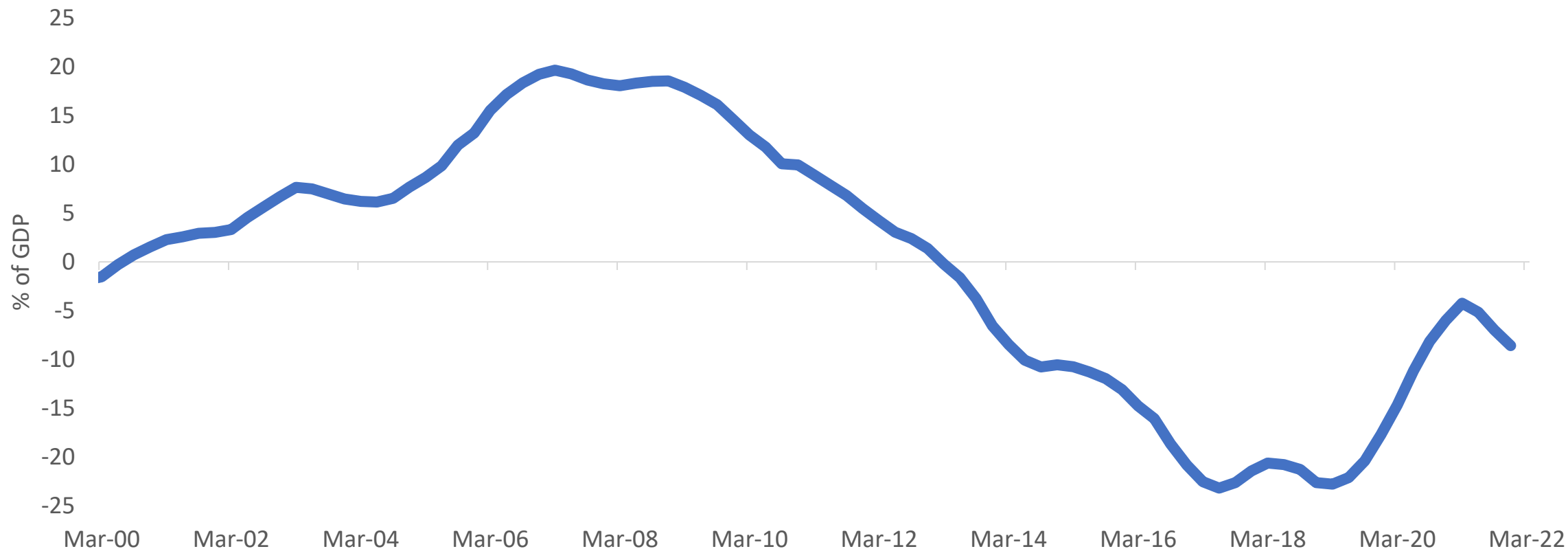


*Food and Fuels – The largest contributor to Inflation also commands the highest weight in the CPI basket. As per our classification, food & fuels on a cumulative influences nearly 63% of inflation basket in India. With both these drivers now cooling off, inflation has likely peaked or is near to peaking in India in the next two quarters.*

# Policy Wheel Is Inclined Towards Inflation Control

- There's a coordinated fiscal and monetary policy attack on inflation
- Measures by the Government such as cutting excise duties on petrol and diesel has limited the pass through of elevated global prices to domestic consumer. 'Transport and Communication' inflation sequentially eased in June and will ease further in July when the policy support has seen a full pass-through
- Also, the measures on windfall tax were passed with the intend to boost domestic supply and keep domestic prices in check
- Monetary policy on the other hand is raising rates and has shifted the focus to tackling inflation expectations. If RBI was to reach interest rate to 90bps and long term inflations are at 5%, repo rate is likely to be in the band of 5.75-6%
- RBI also takes note that 12% of all CPI inflation is imported and therefore INR protection aligns to inflation control. While INR is making fresh lows now, we believe it could turn soon, possibly triggered by FII inflows restarting.

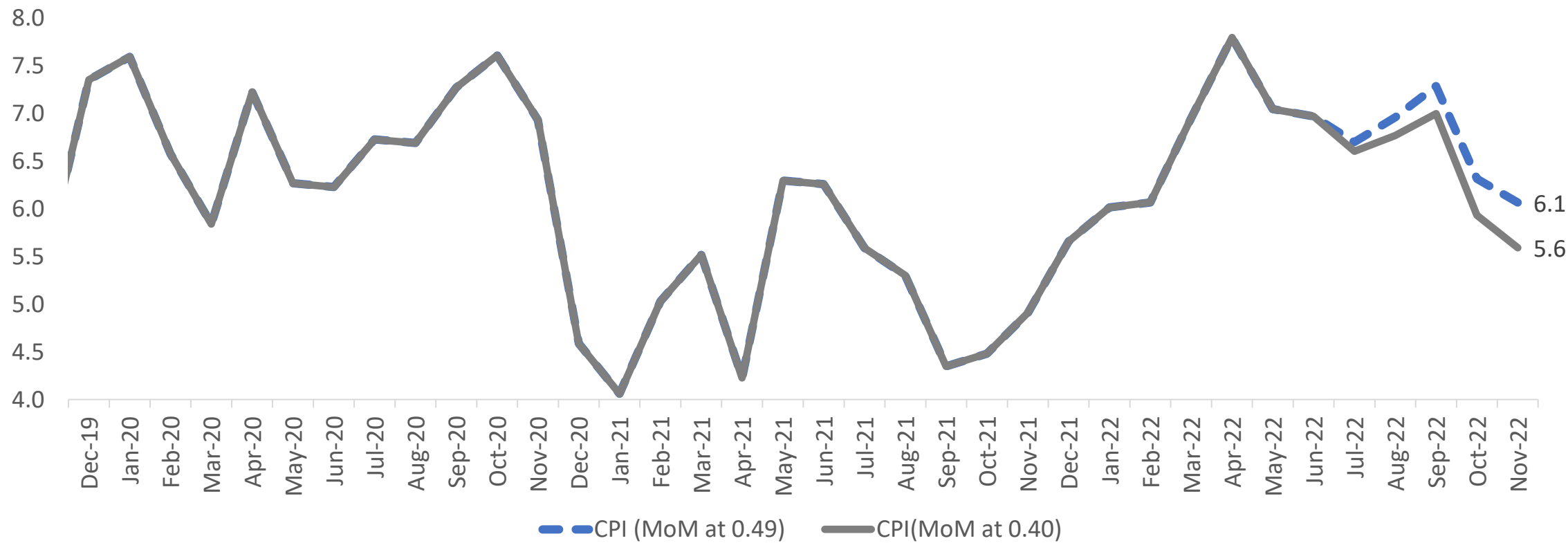
# Structural Inflationary Drivers Are Absent: In India, Credit Gap Is Still Negative!



*Despite the rising credit, the credit gap remains negative. Why? Credit is still sub optimal. With nominal GDP improving, credit needs an accelerated growth. At current pace, it is not inflationary*

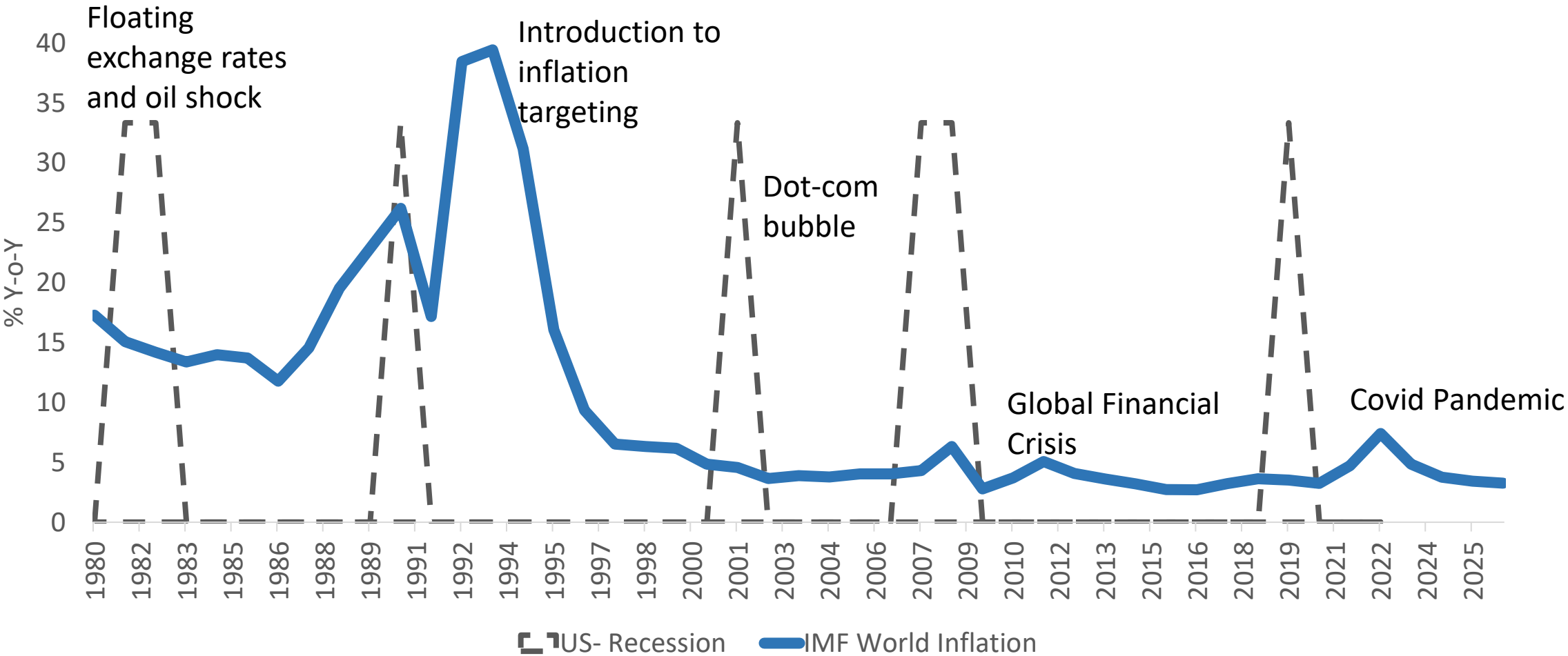
*Credit Gap= Current credit to GDP- Current Credit to Potential GDP*

# Mind The Base- Statistics Alone Can Bring Palatable Outcomes



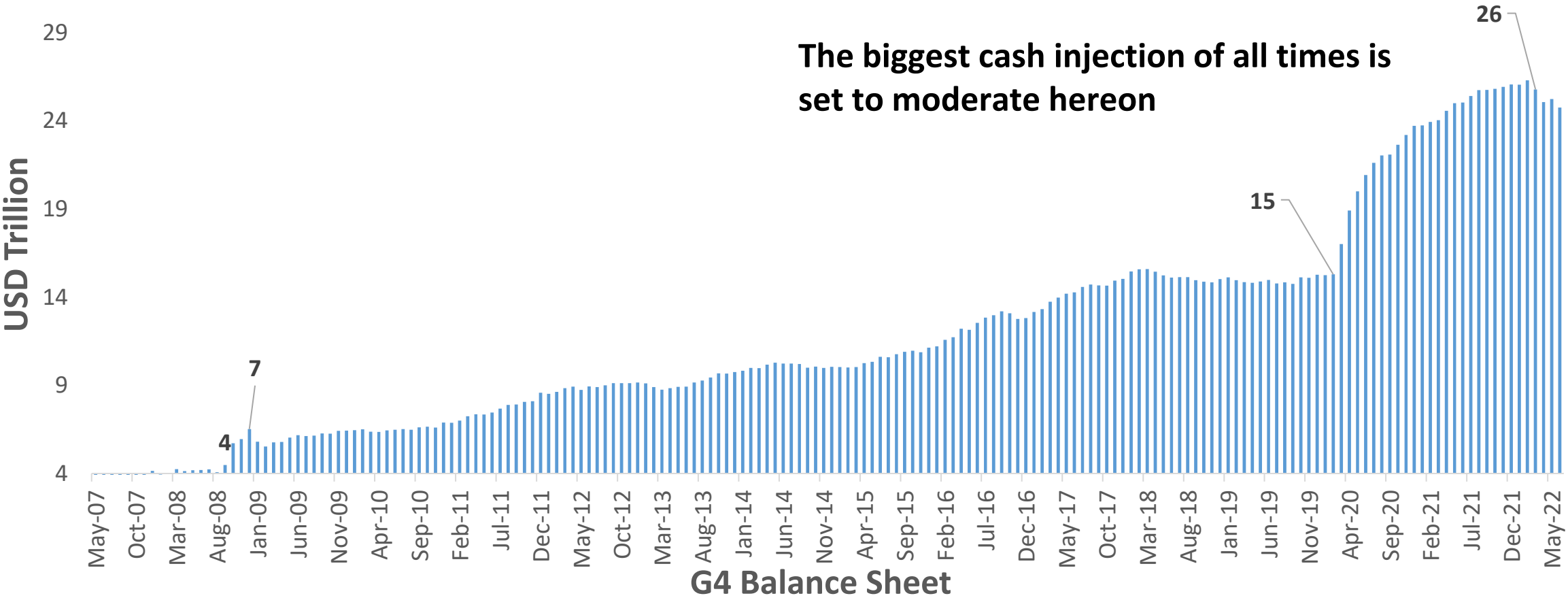
*Even if CPI growth averages, 49 bps M-o-M ( average number of last 5 months), the top is already formed, and we are within the RBI's expectation of 6.7% for FY23. In a more likely scenario, if it reduces, numbers can surprise positively.*

# Bye Bye Sugar High! Post Crises Collapsing Of Inflation Rush Is A Passe



*The rising of inflation post crises due to imbalances is a norm. Easing off it as the imbalances correct is also a norm. As we stand today, supply is coming back and demand is slowing pointing towards easing of inflation hereon.*

# Without The Cash, A Cool-off In Inflation Is Likely

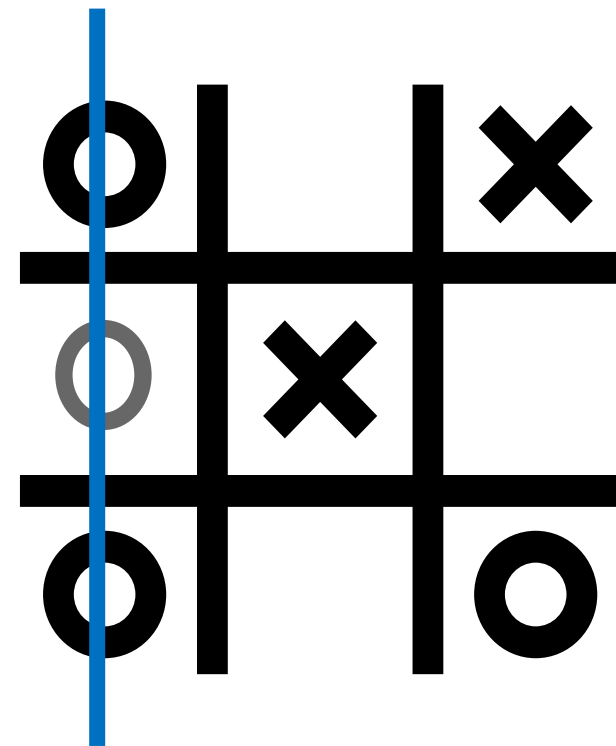


While it is difficult to comment on how far will this Quantitative Tightening go, it is still safe to assume there will be no additional quantitative easing. This means the liquidity driven inflation will take a pause. We have lost approximately USD 2 trillion of central bank injection so far in CY2022 but this could dip further.

## Now, how to benefit from it? Comments from our analysts

**Duration Bonds:** India long bond yields (10 year) have enjoyed a very high term premium. This term premium began to fall as RBI started to increase interest rates. But the underlying inflation trajectory has been a influence on keeping rates high. Our fixed income team has highlighted the role of demand and supply mismatch in the Gsec market in FY23 as a key driver of bond yields. Markets are volatile and (i) a secular fall in yields is unlikely, (ii) short duration has priced in many rate hikes. Because of this we prefer to avoid long maturity (>8 years) just now, and prefer to invest in medium maturity (4-6 years) gradually in event spikes, and keep part of portfolio in low maturity (< 1 year). We remain on the look out for duration plays as inflation cools and central bank forward guidance changes.

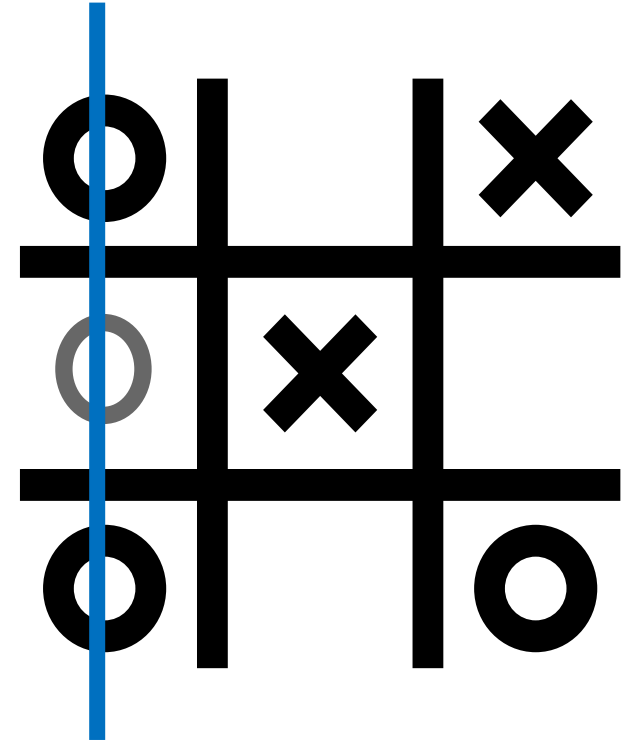
**Banking/Lenders:** Banks enjoy strong business environment when demand for credit is strong and they are able to price loans better. Currently banks are in a good health with clean balance sheet and adequate provisions ( with large banks ) reporting 80% or higher provisions. Moreover, on an aggregate price to book basis the large banks are trading below 2 times making them attractively priced. Rising credit growth and a possibility of better NIMs as investments move to loans could augur well for Banks.



## Now, how to benefit from it? Comments from our analysts

**Autos:** Sharp increase in commodity prices lead to a need of 8-10% increase in vehicle prices in the last few quarters. This is much higher than the usual 2-4% price hikes cos take annually. OEs could only pass the cost increases partially and are currently seeing margins which are 200-400 bps below long term averages. The falling commodity prices will definitely be a much needed relief both for the OEMs and end consumers - OEMs could see their margins recover and risk of consumer demand disruption from unprecedented price hikes reduces.

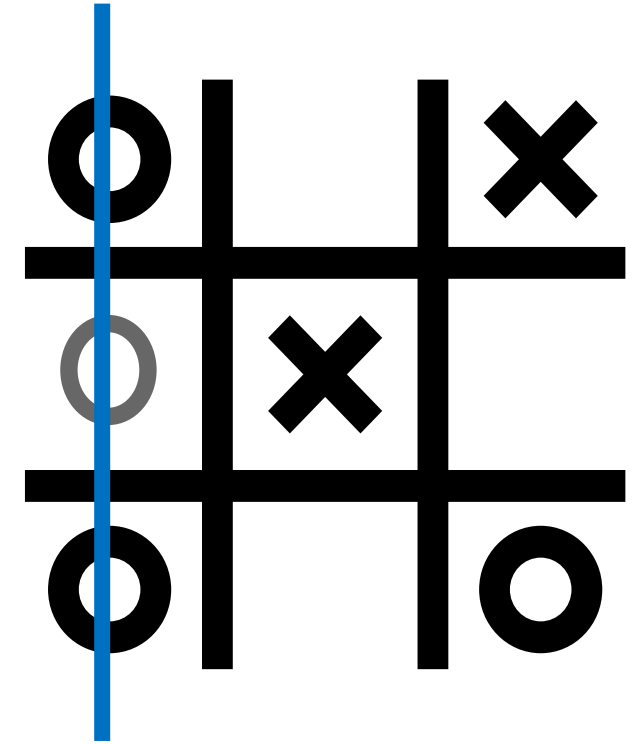
**Cement:** Higher fuel prices (petcoke, coal and diesel) have hit sector profitability massively in the last couple of quarter and likely to hit more going ahead. Market leader Ultratech Cement has seen its Ebitda/ton fall from ~Rs 1500 to Rs 1100 in the last four quarters; companies are indicating that there would be impact of another Rs 200+ per ton in Q2FY23. This clearly indicates companies are finding it difficult to pass on cost increases to consumers in a very high inflationary environment. Correction in prices of the fuel basket would be like manna from heaven for the sector.



## Now, how to benefit from it? Comments from our analysts

**Consumption:** While higher prices leads to revenue expansion of consumption stocks, the volumes soon start to contract. The current inflationary bout wasn't reflecting robust demand, wage pressure continues and state of rural economy can at be termed as modest. Consumption companies have been unable to pass on the increased prices and in fact the narrative of "shrink-flation" has been common. Lower inflation will fuel discretionary expenditure, help the volumes and will keep growth and sentiments positive.

**Global Technology:** Over the last one year technology has seen a large de-rating in multiples and a loss in earnings momentum. The ultra high growth period of post covid boost is unlikely to return but with technology sector back to long term average valuations, there is opportunity. Global technology and innovation based companies have been able to growth their earnings at ~16% to 18% CAGR over last one and half decade. This trend of heightened technology spend is here to stay. Lower inflation will support growth oriented technology sector though decline in interest rates.



*“We are not giving fund recommendations because this is not a sales note. As smart investors, you know the portfolio tilt that will suit you when the themes we are highlighting do well.”*

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