NETRA

Early Signals Through Charts

Oct 2023

DSP

Consequences of ‘Higher for longer’?
What’s happening to topline numbers?
Where are we in valuations?

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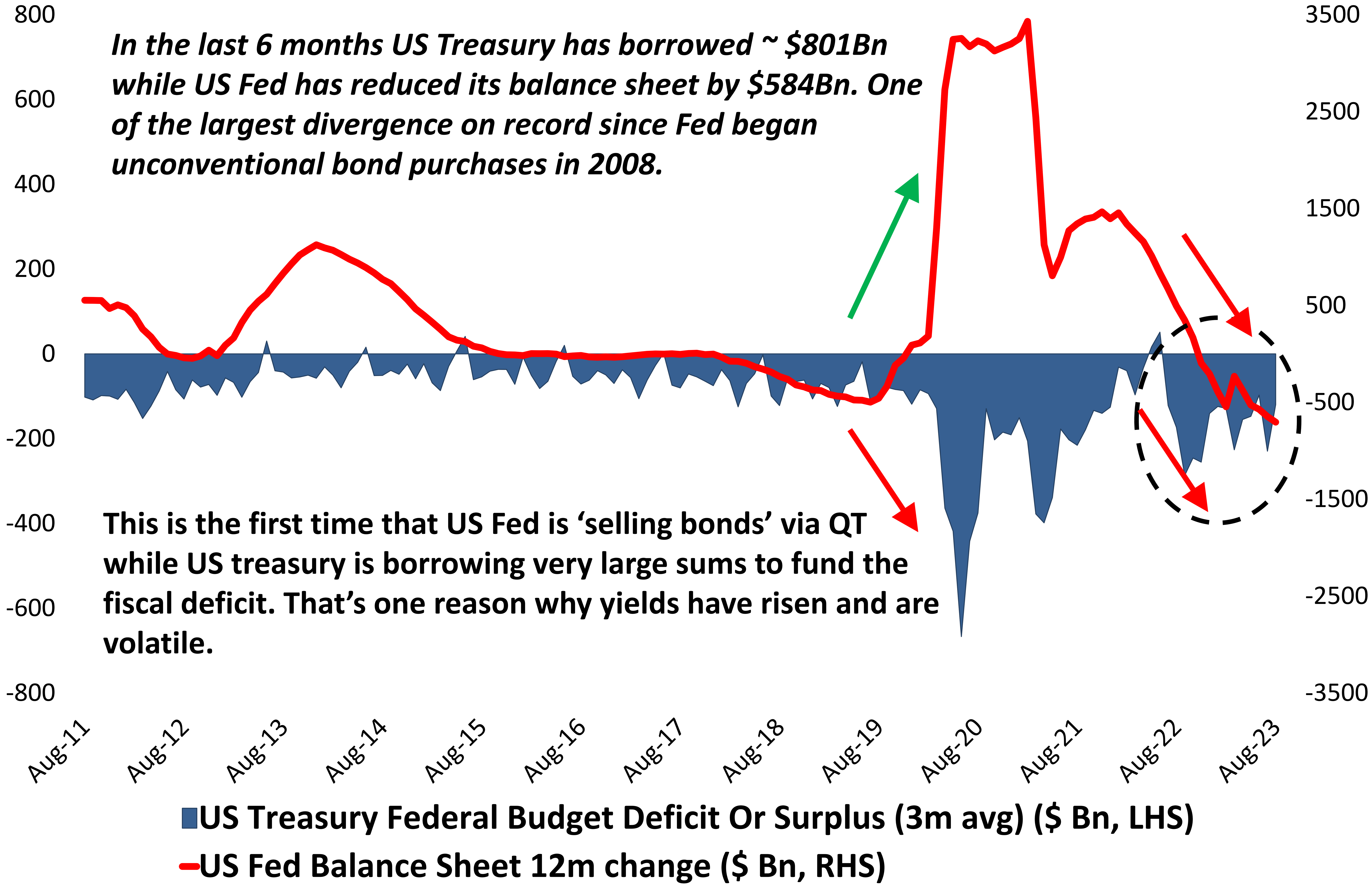
Why Is The Bond Yield Soaring in US?

The US Personal Consumption Expenditures Deflator fell to 2.1% over the past three months, indicating ongoing disinflation despite recent favorable factors. US manufacturing has declined for most of 2023, and credit growth is slowing, particularly in banking credit. This suggests a slip in economic growth. Surprisingly, long bond yields, which typically track economic growth and inflation, have risen in the last few weeks, with the US 10-year yield reaching 4.7%, a level last seen 16 years ago.

Why?
The level of budgetary deficits that US is running at this time is large. At the same time the US Fed is also selling bonds and not helping the US treasury. This is probably the first time that US Fed is selling bonds when US fiscal deficit is high and borrowing is close to monthly records. This is one reason among others why yields are rising.

The rise in yields would probably face headwinds from slowing economic growth. Watch out for US employment data which can change market expectation of rates and halt the rise in treasury yields.



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Source: FRED, DSP; Data as on Sep 2023

What Happens To Corporate Profits When Interest Rates Rise To Such Levels?

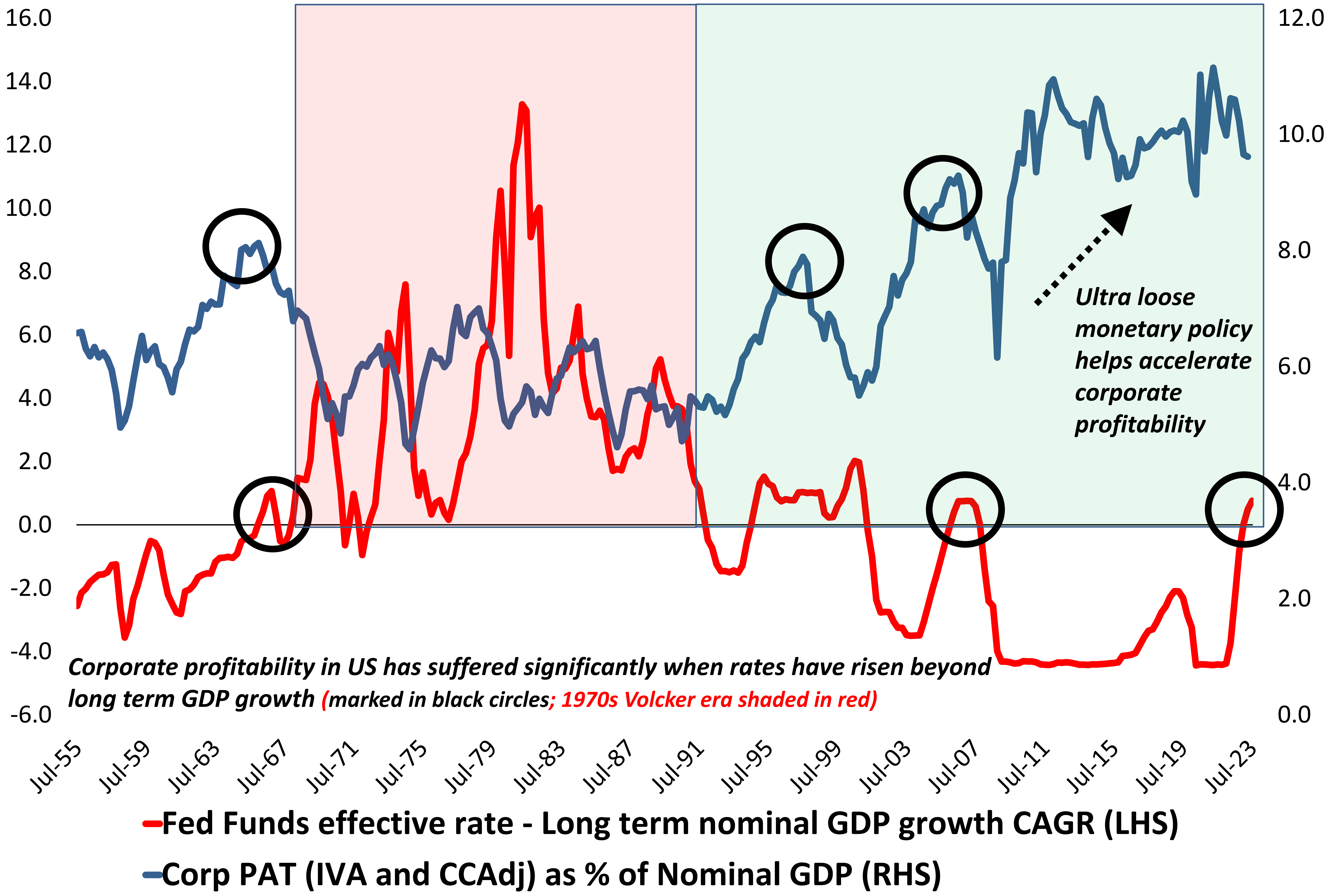
The US corporate profitability has increased at a fast clip over the last 20 years. This has been aided by two forces.

One, ultra lose monetary policy practiced over the last 30 years, especially after the global financial crisis of 2008 and the onset of quantitative easing.

Two, exceptionally strong profitability of technology companies, most of which are listed in US and commands very high global market share.

History shows that whenever US interest rates have risen beyond the long term nominal GDP growth rate (4.5% CAGR), corporate profitability suffers a significant slowdown. This is probably an outcome of demand slack which occurs because of high interest rates strangulating the economic demand for goods and services.

This time is not different.



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Source: FRED, DSP; Data as on Sep 2023

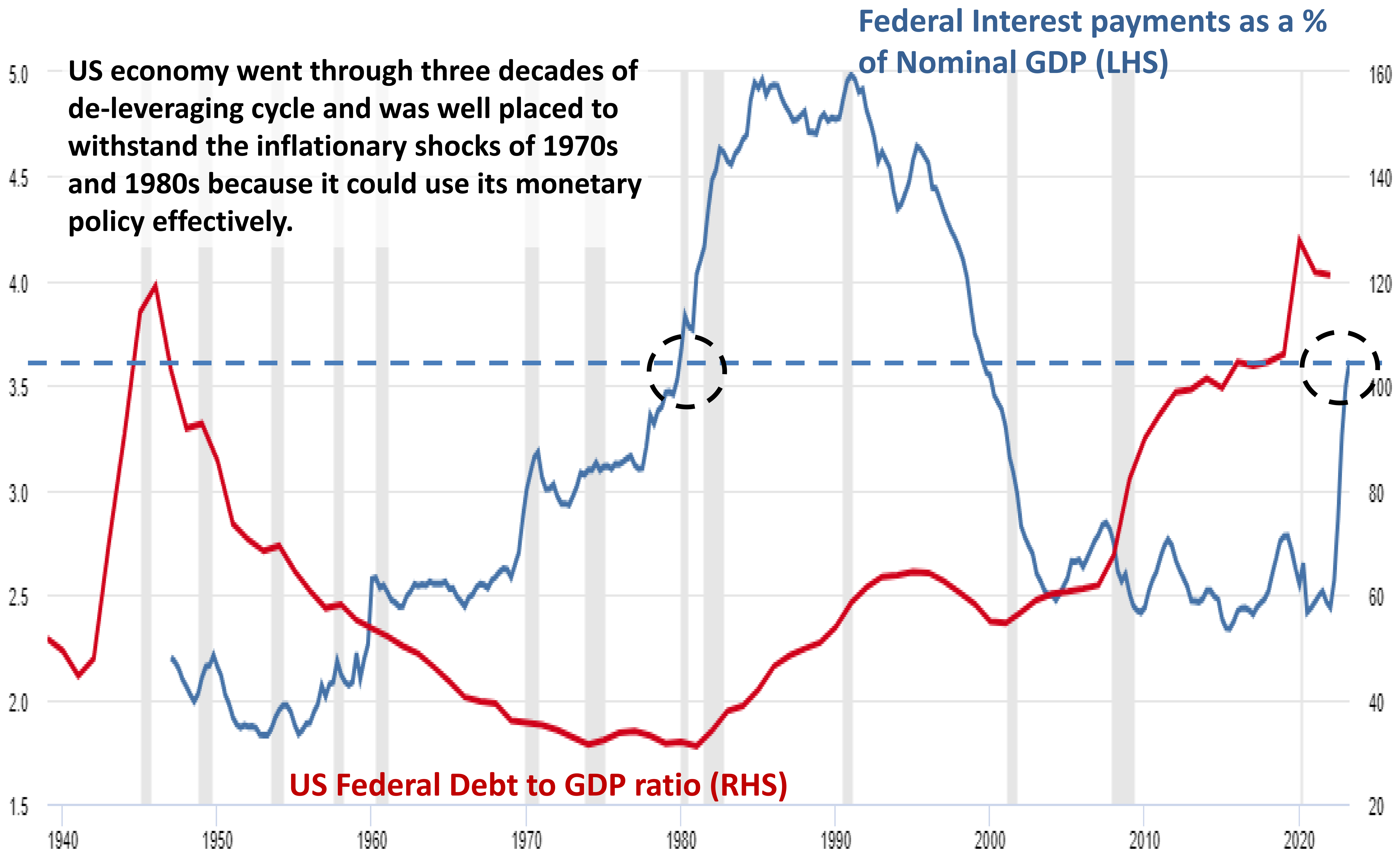
Can US Afford Higher for Longer Without Economic Slowdown?

The US federal interest payment is now at $970 billion and on course to hit $1 trillion soon. This number seems too big, but the US economy has been here before.

The last time US interest payments reached 3.6% of GDP, the debt to GDP was under 40%. The US doesn't have that favorable backdrop anymore. This means incremental fiscal support can't help the economy chug along, and tight monetary policy will sacrifice growth significantly.

The most likely outcome and target for the Fed is to cause the economy to slow down, bring inflation lower, and ease monetary policy. Otherwise, it will threaten the stability of the US Dollar as the reserve currency, which the US can't afford.

Investors who are aligned and willing to play the long inflation trade via commodity equities like base metals, Oil & Gas and such would be better off revisiting their hypothesis. These businesses may face disinflationary or deflationary headwinds ahead.



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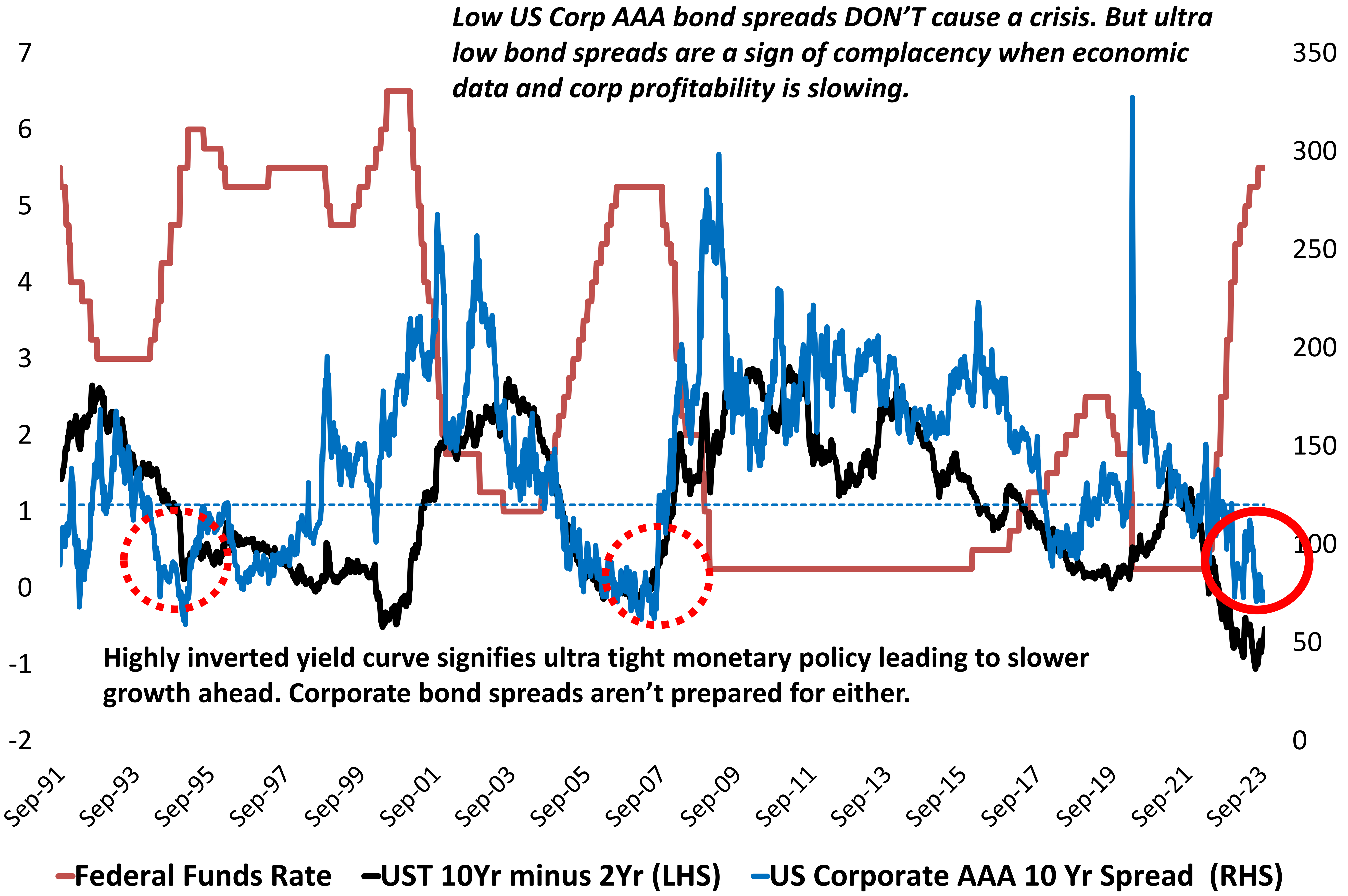
Source: FRED, DSP; Data as on Sep 2023

The Calm In US Corporate Bond Market Is Deafening

The US AAA Corporate bond spread over the US Treasury is 30bps below its long period average. The AAA Corp. bond spread over US Treasury bonds averages 110bps and is currently -80bps.The last time this happened was the week before two Bear Stearns hedge funds went under in 2007. Today, there are no signs of such stress, but two red flags are visible.

First, the US Fed has begun to shrink its balance sheet, aka bond sales, at an accelerated pace. In the beginning of 2023, QT was halted by the SVB and regional banking crises. This is tightening in earnest.

Second, the Federal Reserve is waiting to see core inflation hard data fall drastically before it eases on rates. This higher for 'so far' is making it hard for incremental consumption to remain steady. Take a look at mortgage applications, credit card delinquencies, auto loan uptake, and retail sales. All these data points are slowing.



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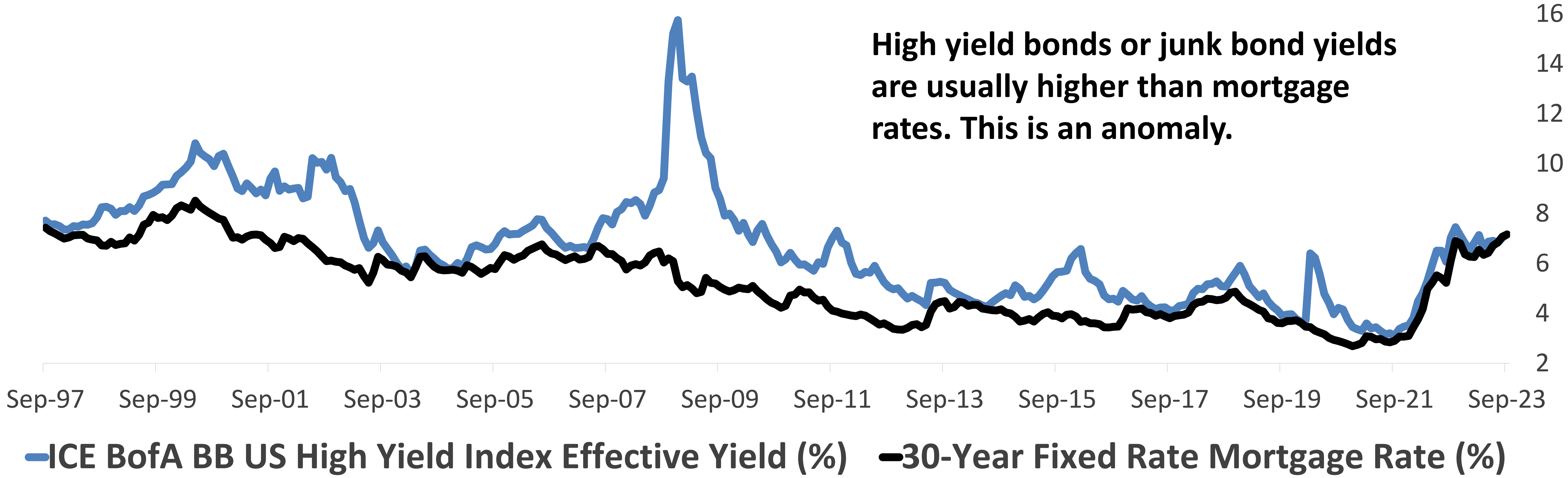
Source: FRED, DSP; Data as on Sep 2023

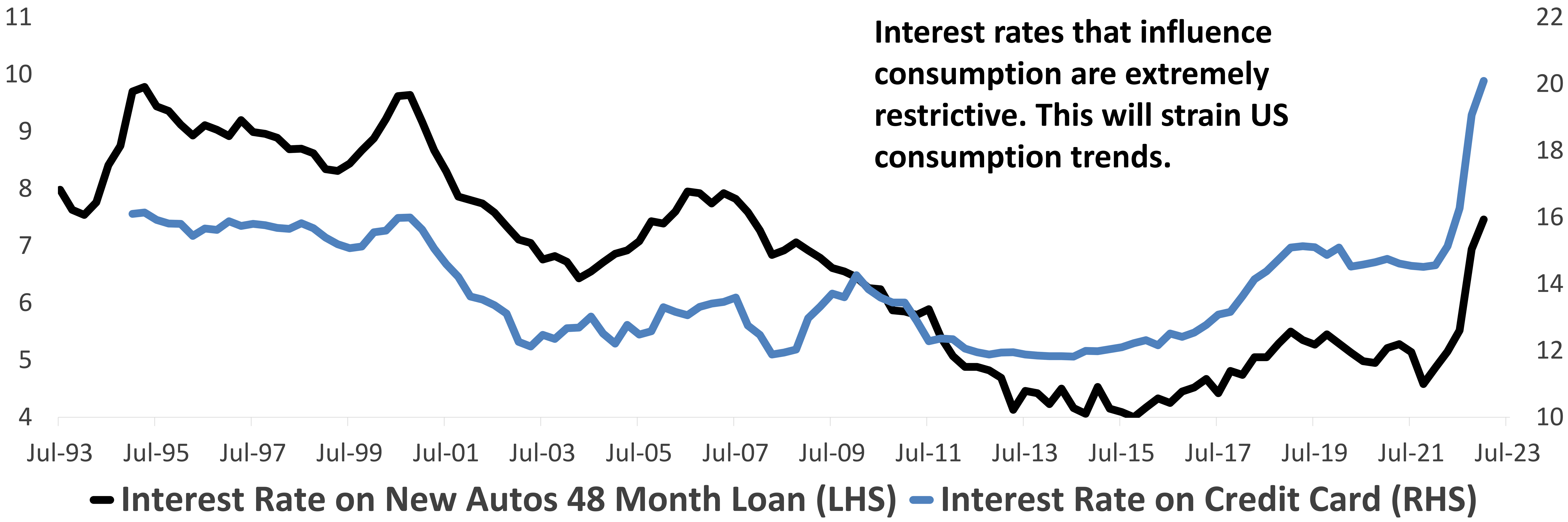
Dislocations Apparent in US Bond & Credit Markets

US high-yield (junk) bonds offer a risk premium over US mortgage rates. There have been a few past instances when this wasn't the case, usually when liquidity was abundant. Once again, US junk bonds are trading close to mortgage rates, which is unsustainable given that liquidity is drying up at a fast clip.

Credit conditions for consumers are pretty tight. Credit card interest rates are 500 basis points higher than their previous lifetime high, and auto loan rates are touching 7.5%, the highest in a decade. At these high interest rates, 7.6% for housing loans, 7.5% for auto loans, and 21% for credit cards, US consumer demand is likely to slow.

The US economy has benefited tremendously from very strong consumer demand trends and has avoided a recession because of it. This level of interest is highly restrictive and signals caution for investors. Slow demand can translate to weaker earnings growth for corporations and, hence, lower stock prices.





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Source: FRED, DSP; Data as on Sep 2023

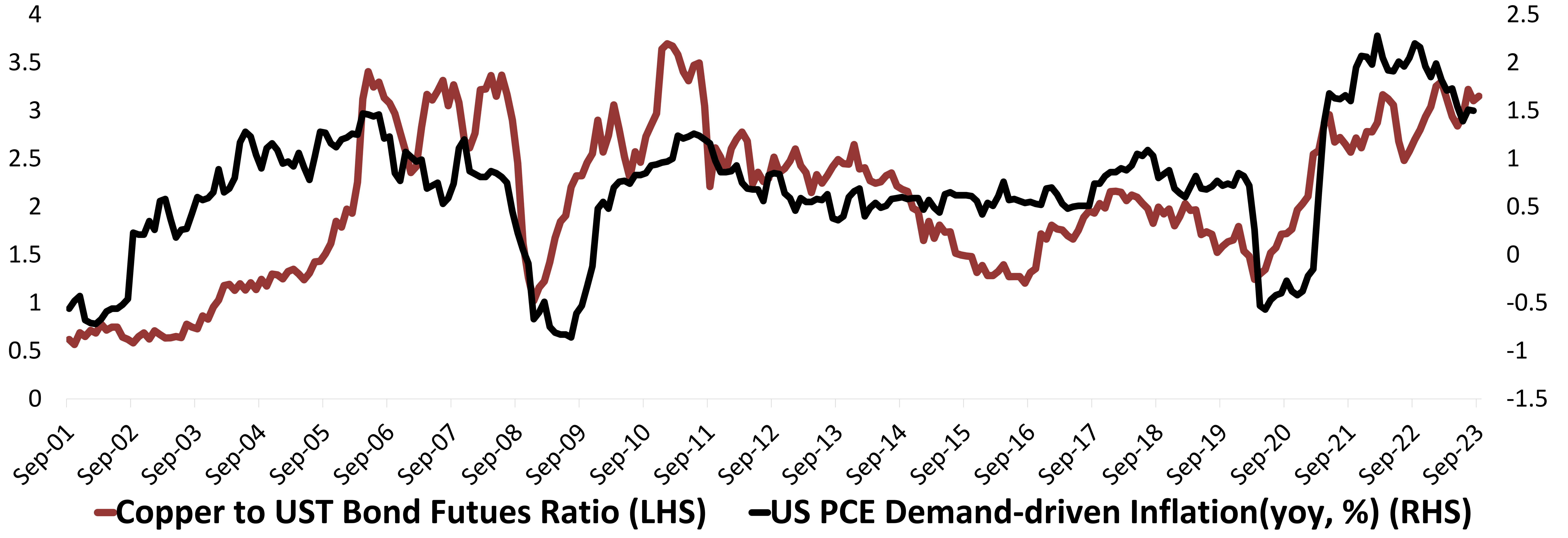
Dr. Copper Is Calling In Sick

When Dr. Copper outperforms US Treasury bonds, it is usually inflationary, but only when the ratio of copper to bonds is rising because copper prices are moving higher. Currently, this ratio is rising because bond prices are falling faster than copper prices. This is the first sign of disinflationary pressures building up.

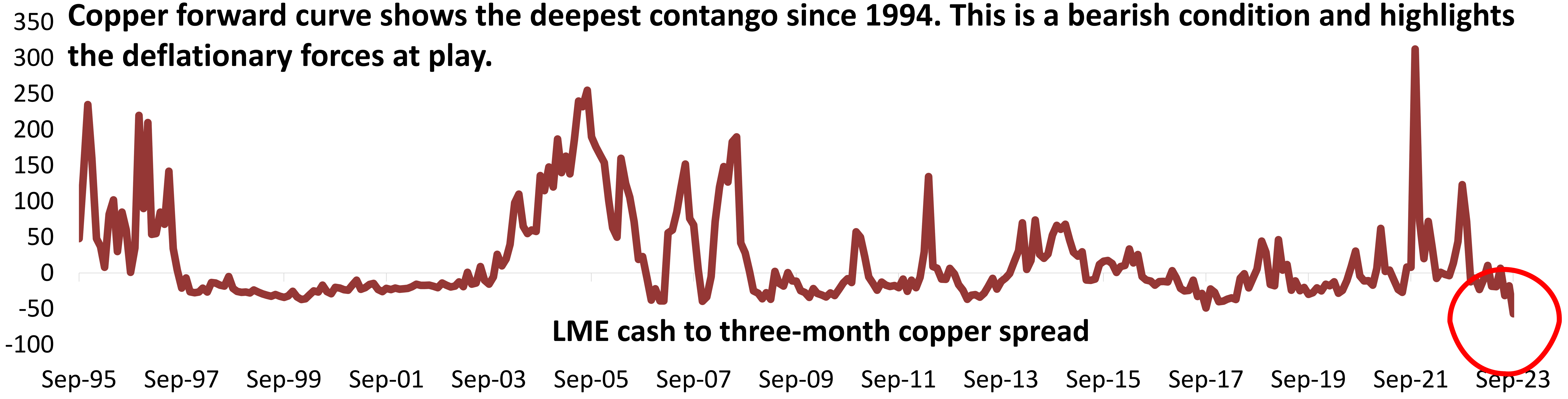
In fact, copper forward curves indicate contango. This condition occurs when current prices are trading below forward prices. The contango for copper indicates that current demand conditions are fairly benign and supply is adequate. There is little incentive to hold the metal.

Historically, demand-side inflation has moved with copper prices due to copper's close association with usage in a number of consumption-oriented old economy sectors. Expect inflation, corporate toplines, tax collections, and other headline numbers to head in the same direction. Lower.

Bond prices are falling faster than copper prices. This is the first sign of disinflationary pressures building up.



Copper forward curve shows the deepest contango since 1994. This is a bearish condition and highlights the deflationary forces at play.



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Source: US San Francisco Fed, DSP; Data as on Sep 2023

USD Once Again Overvalued Versus Peers

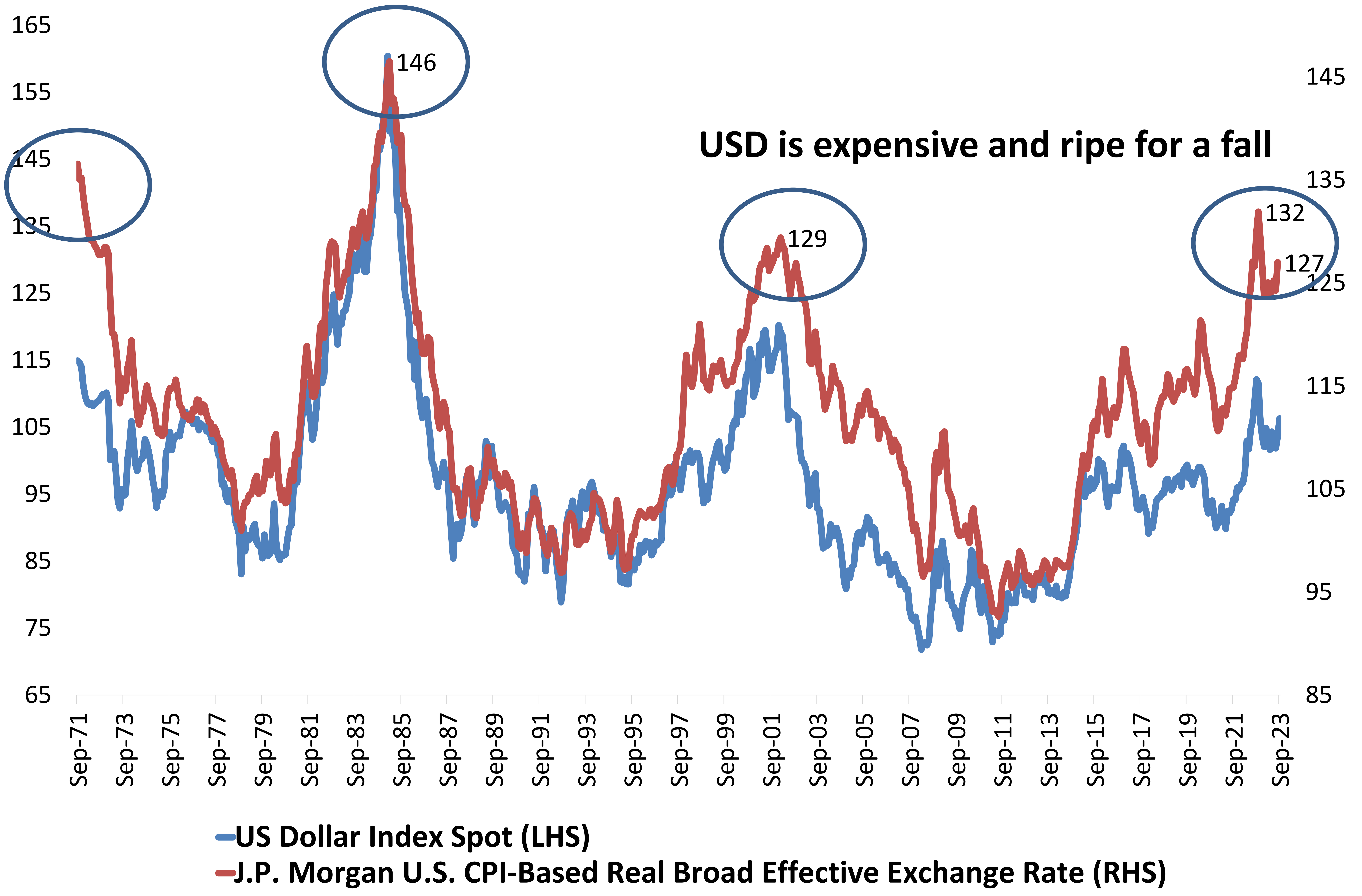
REER, or Real Effective Exchange Rate, gauges a currency's worth by considering not just nominal exchange rates but also adjusting for price level i.e. inflation differences with trading partners, offering a broader view of its value.

A very high level of USD Real Effective Exchange Rate (REER) indicates that the U.S. dollar is strong and overvalued relative to a basket of other foreign currencies.

This is the highest level that the USD REER has been at, since July 2002 and close to its last cycle peak of 129. In fact USD hasn't been as strong as it is now since the Nixon shock of 1971 barring the ultra tight monetary policy exercised by Fed Chair Volcker.

This means that USD has drifted to an extreme. This is the result of differing policies in US and rest of the world, but from here on, the ability of US Dollar to sustainably remain strong will be challenged.

Expect a weaker US Dollar to benefit one commodity the most – Gold.



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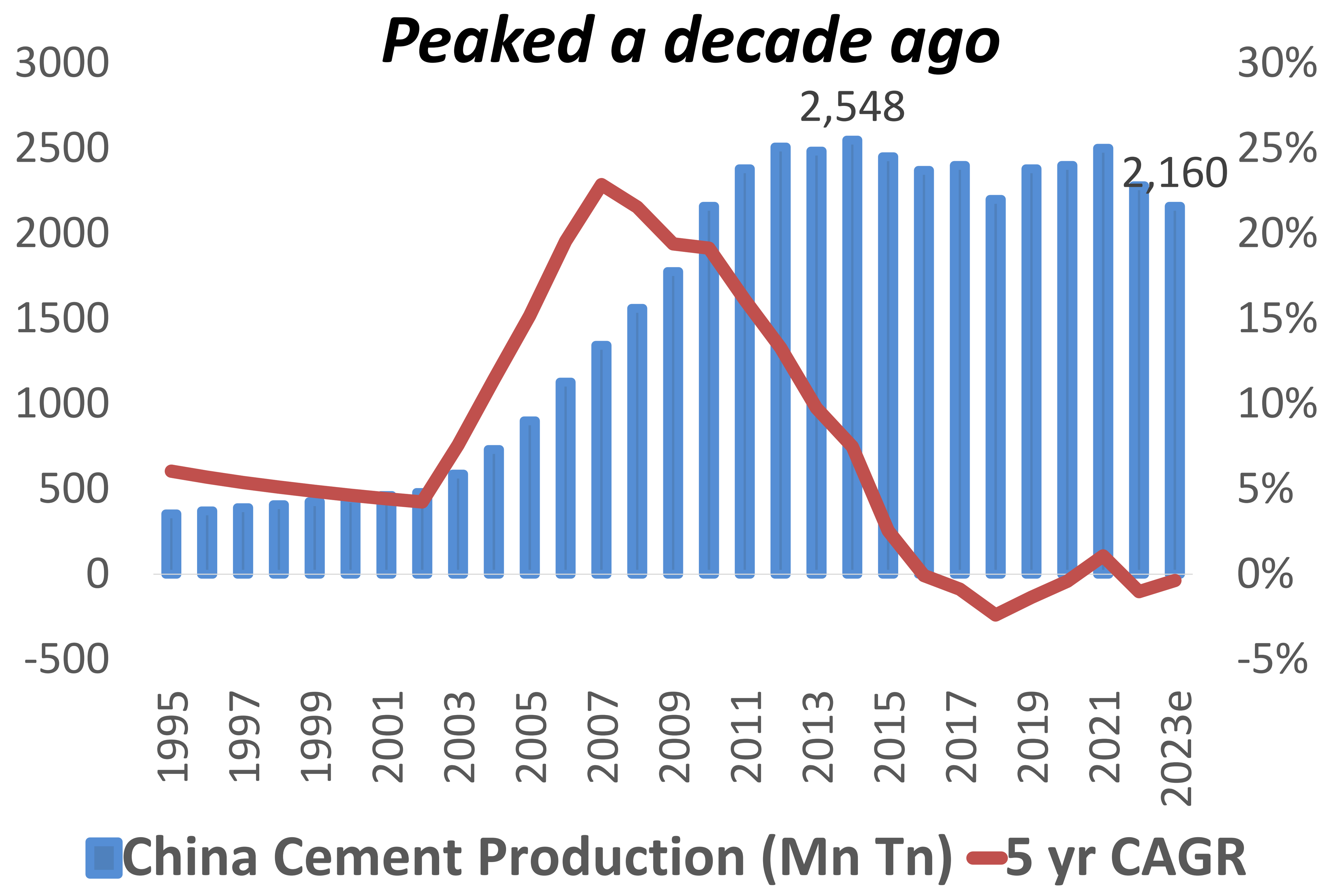
Source: FRED, Bloomberg, DSP; Data as on Sep 2023

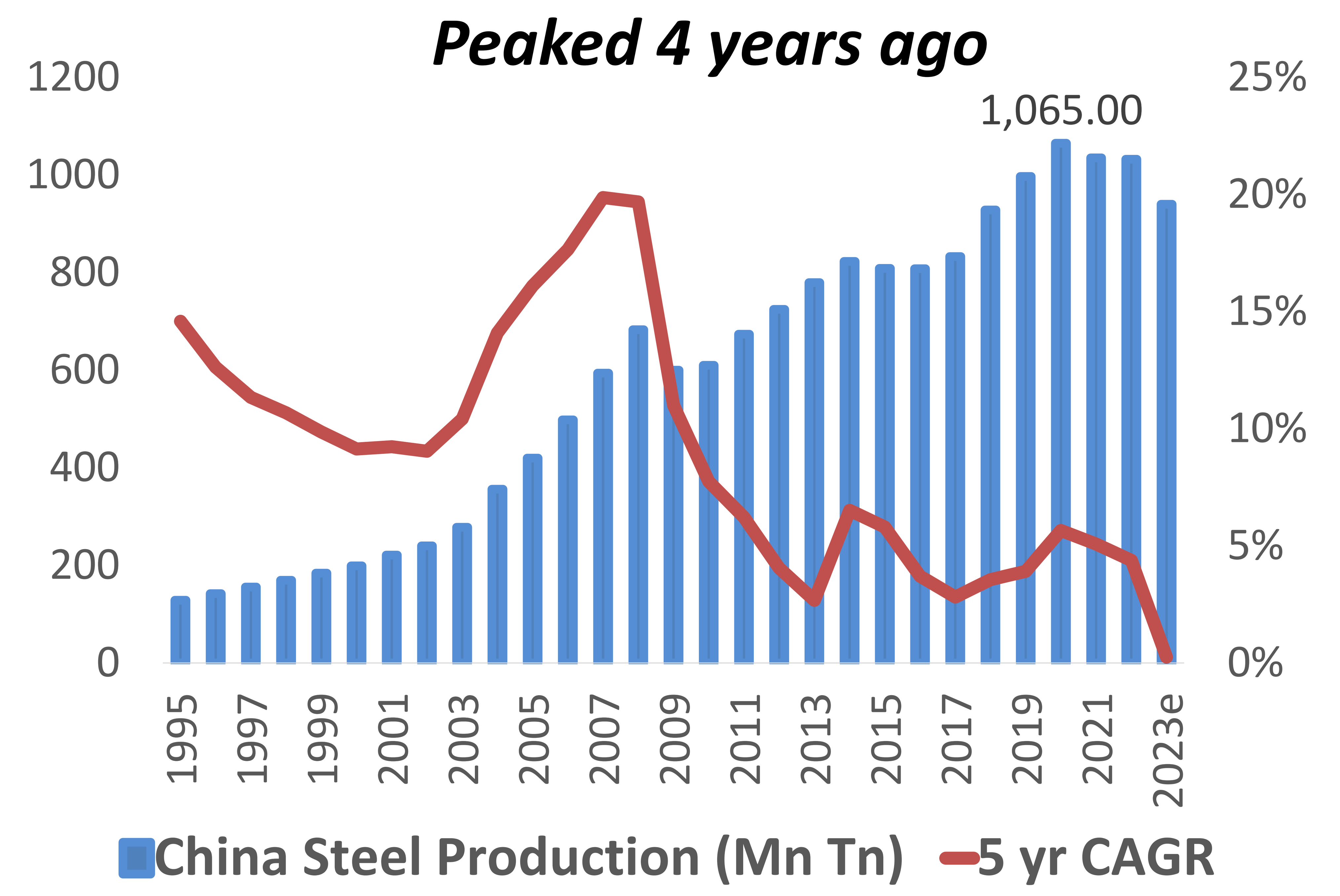
China's Industry, the Growth Pillar is Decelerating

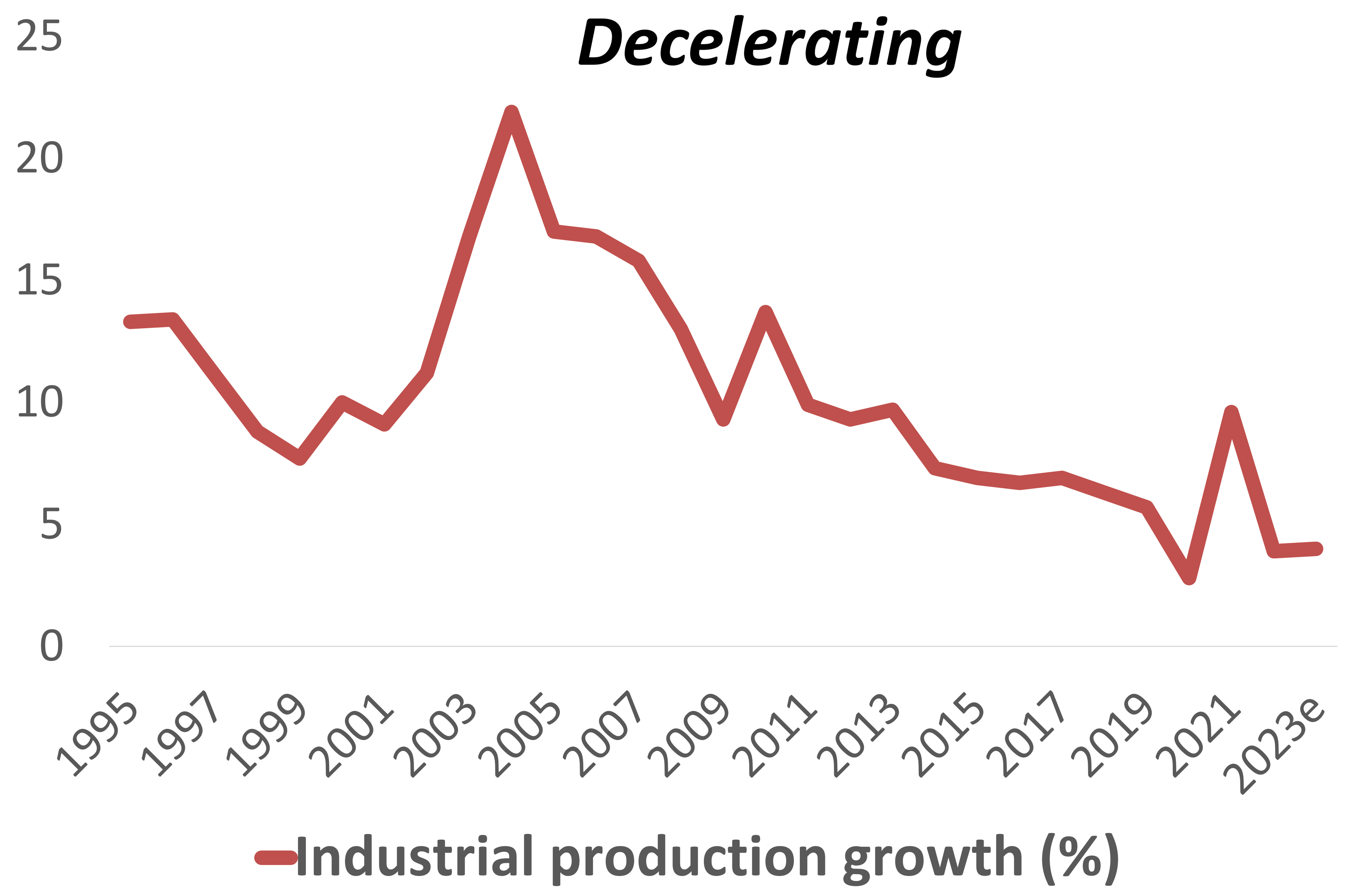
China has been transitioning from an economy heavily reliant on manufacturing and exports to one that is more focused on services and domestic consumption. As this transition occurs, the demand for commodities like cement and steel, which are essential for infrastructure and construction, may plateau or grow at a slower pace. China experienced significant overcapacity in industries such as steel and cement, partly due to rapid expansion in the past. This overcapacity has led to market saturation.

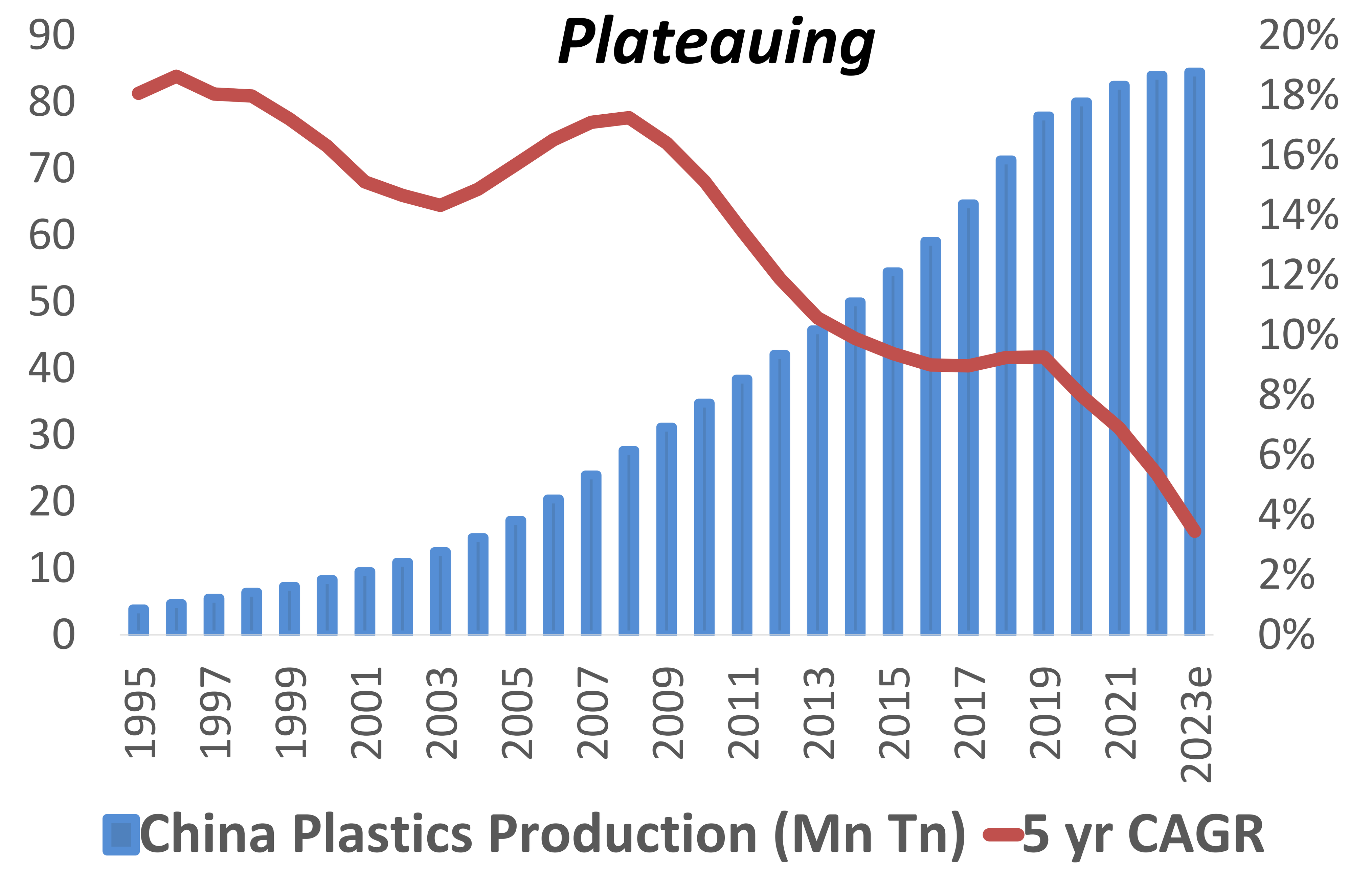
China's government has sought to control debt levels and reduce financial risks in the economy. As a result, there has been a tightening of credit and restrictions on investment in industries with overcapacity, which can limit the ability of companies to expand production.

These trends are disinflationary and point to a long and stretched phase of China's growth normalization. This is also a drag on commodity prices.









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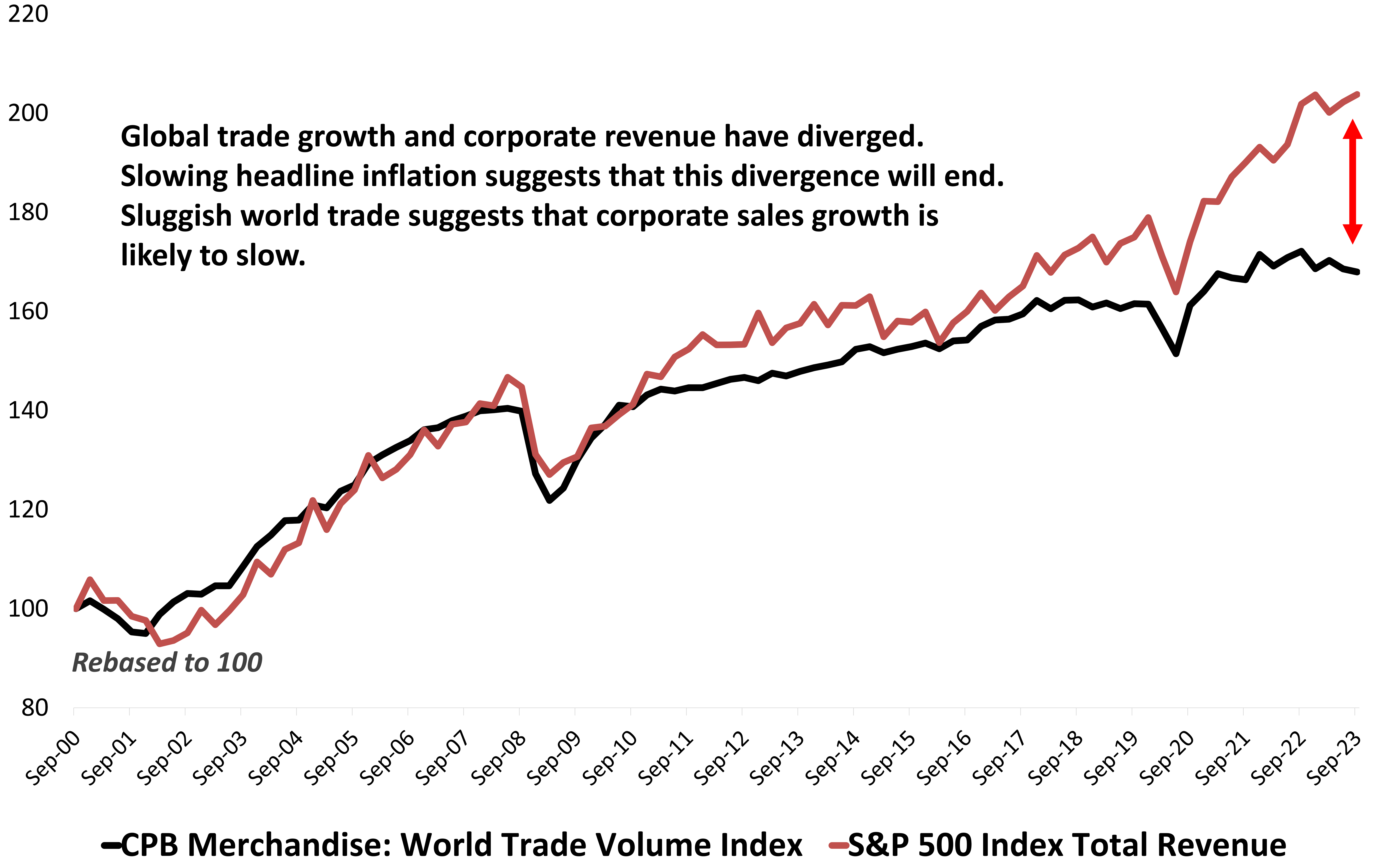
Source: China NBS, DSP; Data as on Sep 2023

World Trade & Revenue Growth Has Diverged, But For How Long?

Global trade growth and corporate toplines(revenue) move together directionally. During periods of high inflation, commodity companies benefit tremendously from high product prices, and corporate revenues rise faster. However, this relationship becomes untenable when underlying growth begins to slow. A decline in world trade volumes can be indicative of a broader global economic slowdown.

When the global economy is not growing at a healthy rate, consumer demand for products and services tends to weaken. This can result in lower sales growth for S&P 500 companies, especially those with significant exposure to international markets.

Roughly 40% to 45% of S&P 500 revenues are generated outside of the U.S. Sales growth has been a key contributor to very high corporate profitability in the US. This can be a source of reduced profitability and equity market stress in the US and elsewhere in the coming quarters.



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Source: CPB, Bloomberg, DSP; Data as on Sep 2023

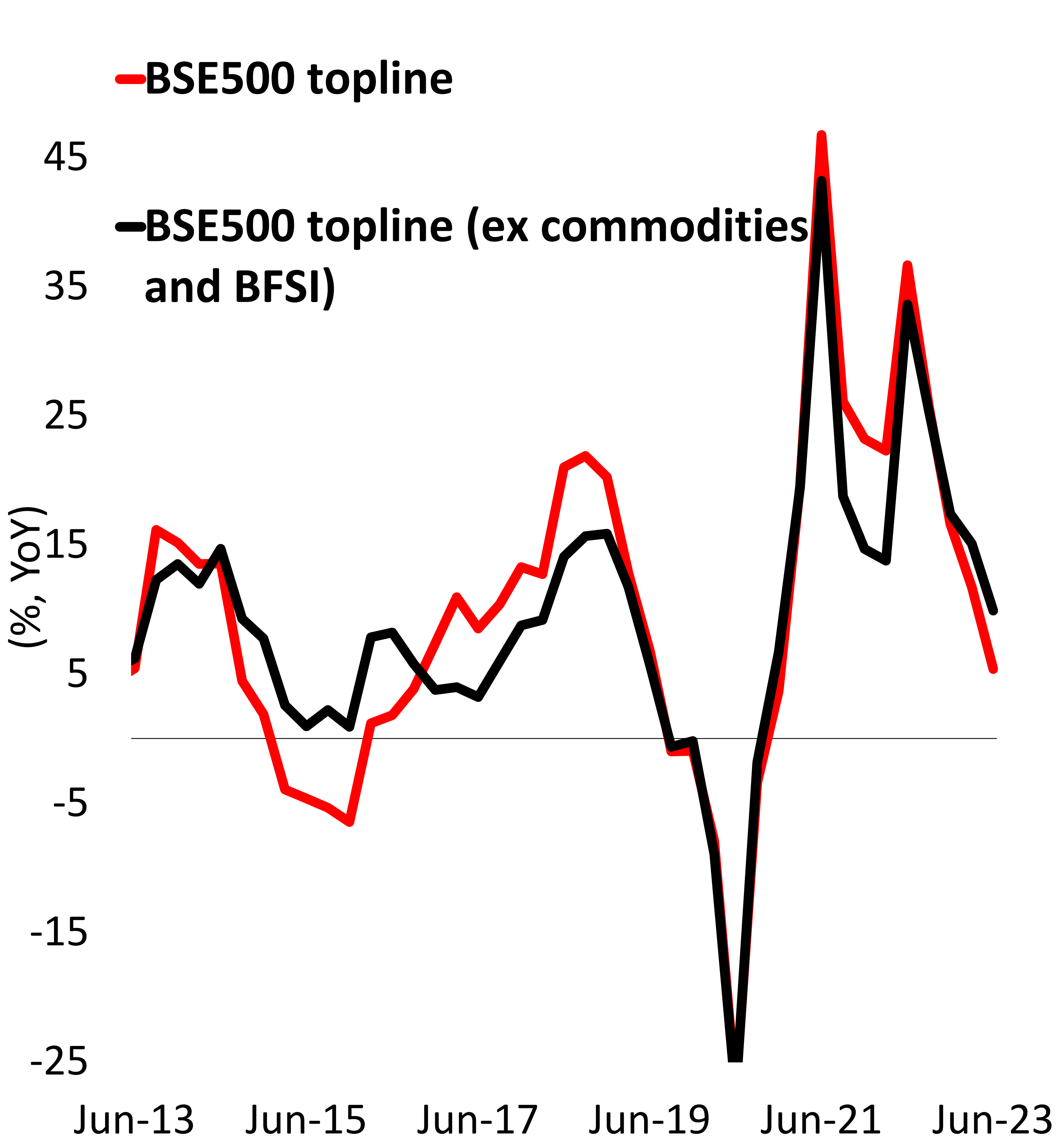
BSE500 Firms Are Struggling For Revenue Growth

The base effect is the primary driver of lower revenue growth for BSE 500 companies. But even after adjusting for base, a large number of firms are reporting topline deceleration.

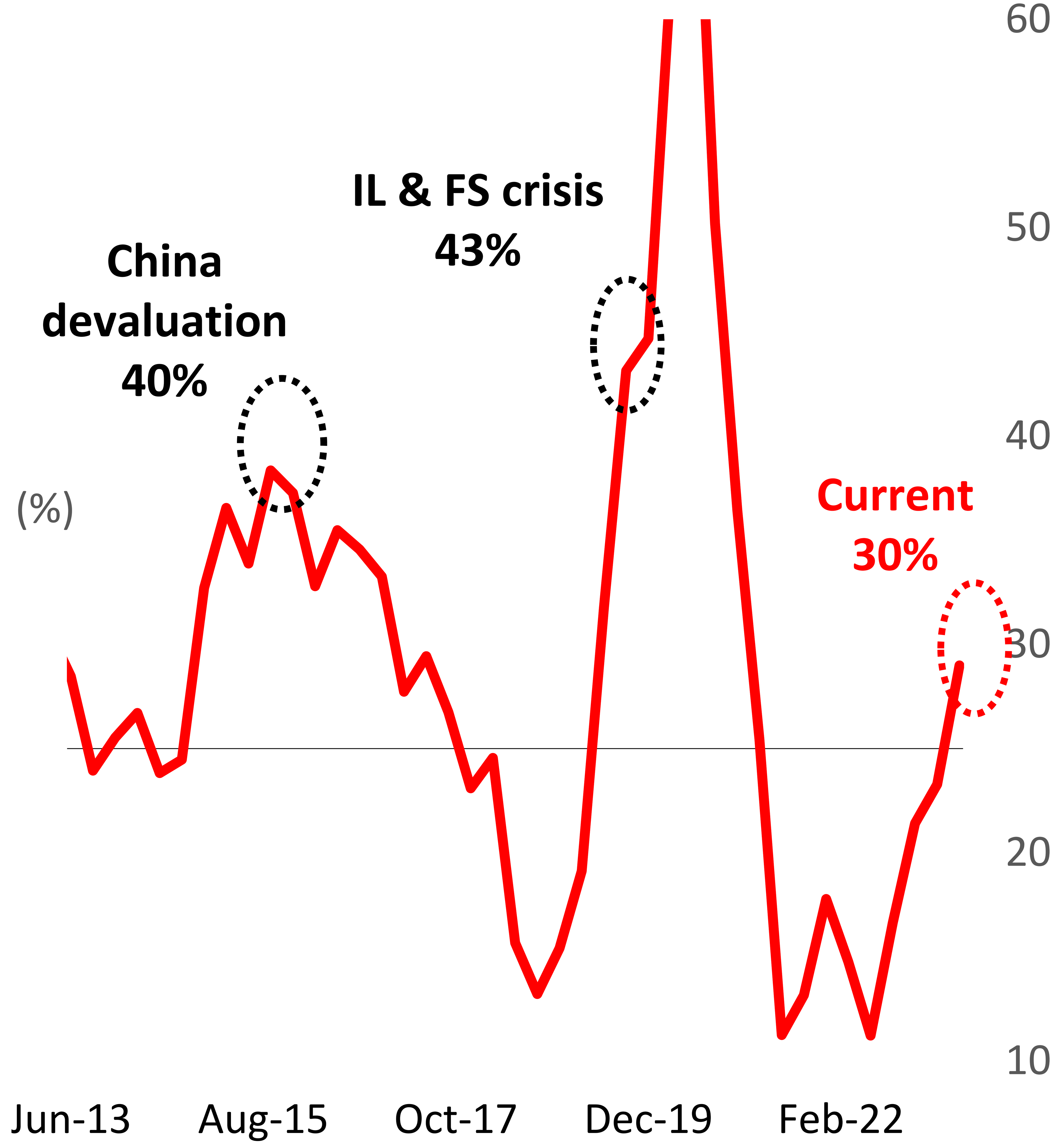
Last quarter, nearly one in three firms reported a decline in sales over the same period of last year. Post-COVID, Indian firms have enjoyed very strong profitability. The primary driver of profitability was cost cutting, an initial decline in raw material costs, and then very strong topline growth aided by fiscal stimulus across the world.

Out of these three levers, topline growth has been the key driver, along with margin expansion. We believe that the outlook for both of these vectors is becoming murky, and sales growth momentum is slowing. India has enjoyed a rich price-to-earnings multiple because it has delivered earnings growth. If earnings disappoint, valuations will also adjust lower. Watch this trend with caution.

Sales growth is decelerating



% of BSE500 companies with topline contraction



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Source: DSP, Nuvama Research; Data as on Sep 2023

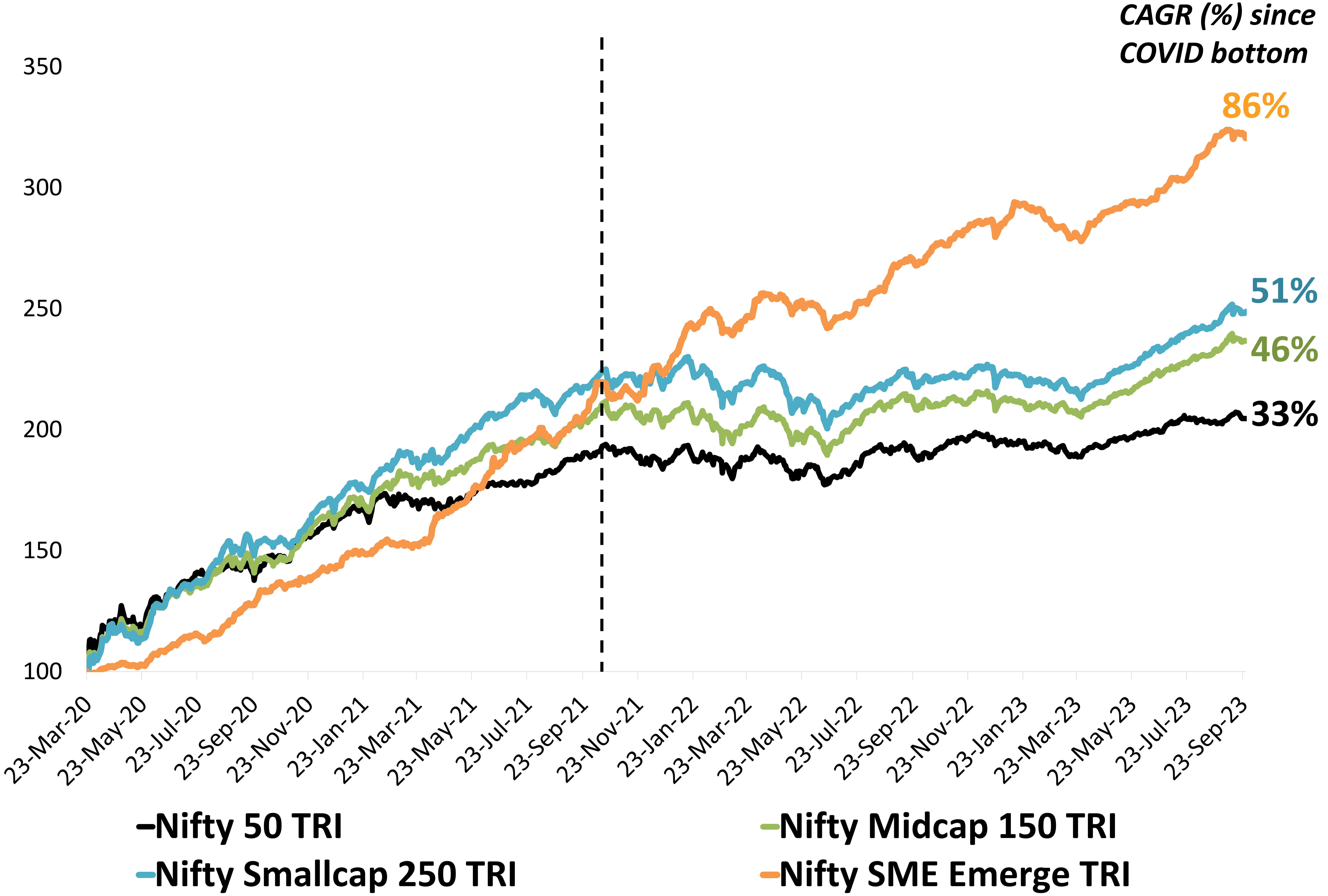
Smaller Firms Have Outperformed The Larger Ones By A Huge Margin

In Oct'21, Indian markets peaked after a stellar rally. Since then, the complexity of the market has changed. Large caps have struggled to generate significant returns, while smaller firms have performed better.

Recently, as a sign of investors chasing the recent performance, the SME segment has seen a large outperformance over other segments.

Since the COVID bottom, the SME segment has delivered stellar 86% CAGR returns. This is not just exceptional but also a sign that markets have become overheated. Some recent IPOs on the SME platform have generated exceptional interest from investors. A few IPOs garnered 286x and 450x **subscriptions for small issue sizes.**

A large dose of caution in the smaller segments would serve investors better.



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Source: NSE, DSP; Data as on Sep 2023

Where Are We In Valuations?

Currently, Nifty is trading at 22.7 times trailing earnings and at an ROE of 13%.

History shows that when Nifty trades within these broad ranges of valuations, forward returns are south of 10%. The 10-year GSec is earnings about 7.2% and a AAA Corporate bond yields 7.75% at this time. The attractiveness of equities is diminished with attractive opportunities present in bonds.

The more we stretch the valuations by purchasing more expensive companies, the lower the likelihood of earnings above average returns.

Hence, diversify. Across assets. Multi Asset.

P/E	Average ROE	3Yr Fwd Return
8-12	23.1	21%
12-16	21.3	20%
16-20	18.4	12%
20-24	14.9	11%
24-28	**13.8**	**9%**
28-32	10.9	--
32-36	10.9	--

We are here

Next 3Yr fwd returns aren't too away from bonds, if history is a guide

Source: Bloomberg, NSE, DSP; Data as on Sep 2023

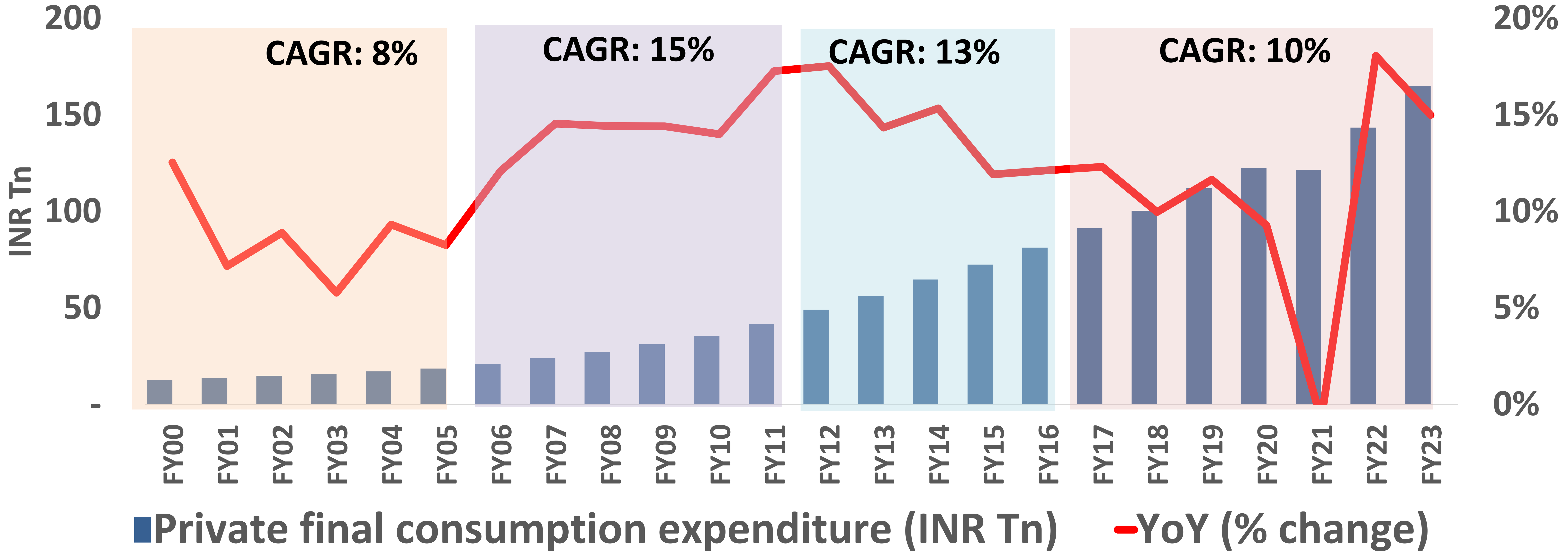
Is This The Beginning of Another High Growth Phase for India?

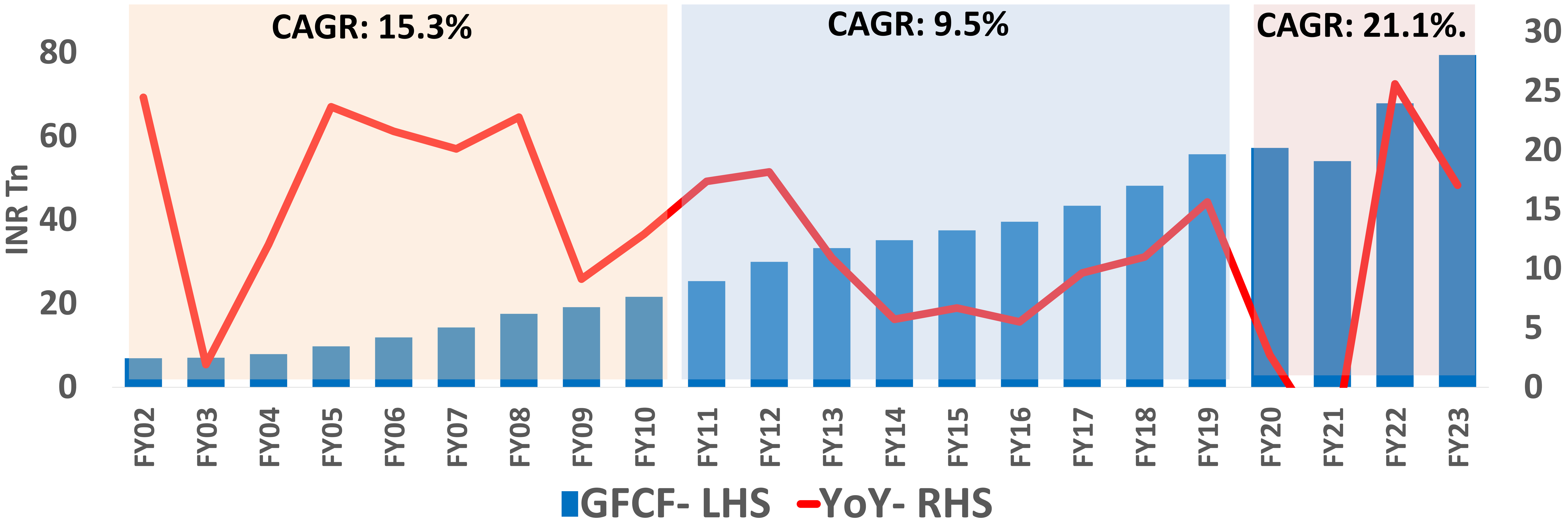
India enjoyed a steady and strong growth phase in the noughties. Private consumption (15% CAGR from FY06 to FY11) and investment (15% CAGR from FY02 to FY10) grew at a strong clip.

After the COVID slump, India's consumption and investments have started to make a comeback. This is likely to lead to a phase of steady growth. The growth rate may not be as high as the best phase in the past, but it is likely to result in an exit from the slower growth phase of the last decade.

Businesses that are profitable and can generate steady cashflows should be in focus, specifically at times when their valuations become attractive.

If the markets are correct, BFSI, Auto Anc, Healthcare, Infra, Gas Distribution, and Capital Goods would be structural focus areas to benefit from this trend.





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Source: CMIE, DSP; Data as on Sep 2023

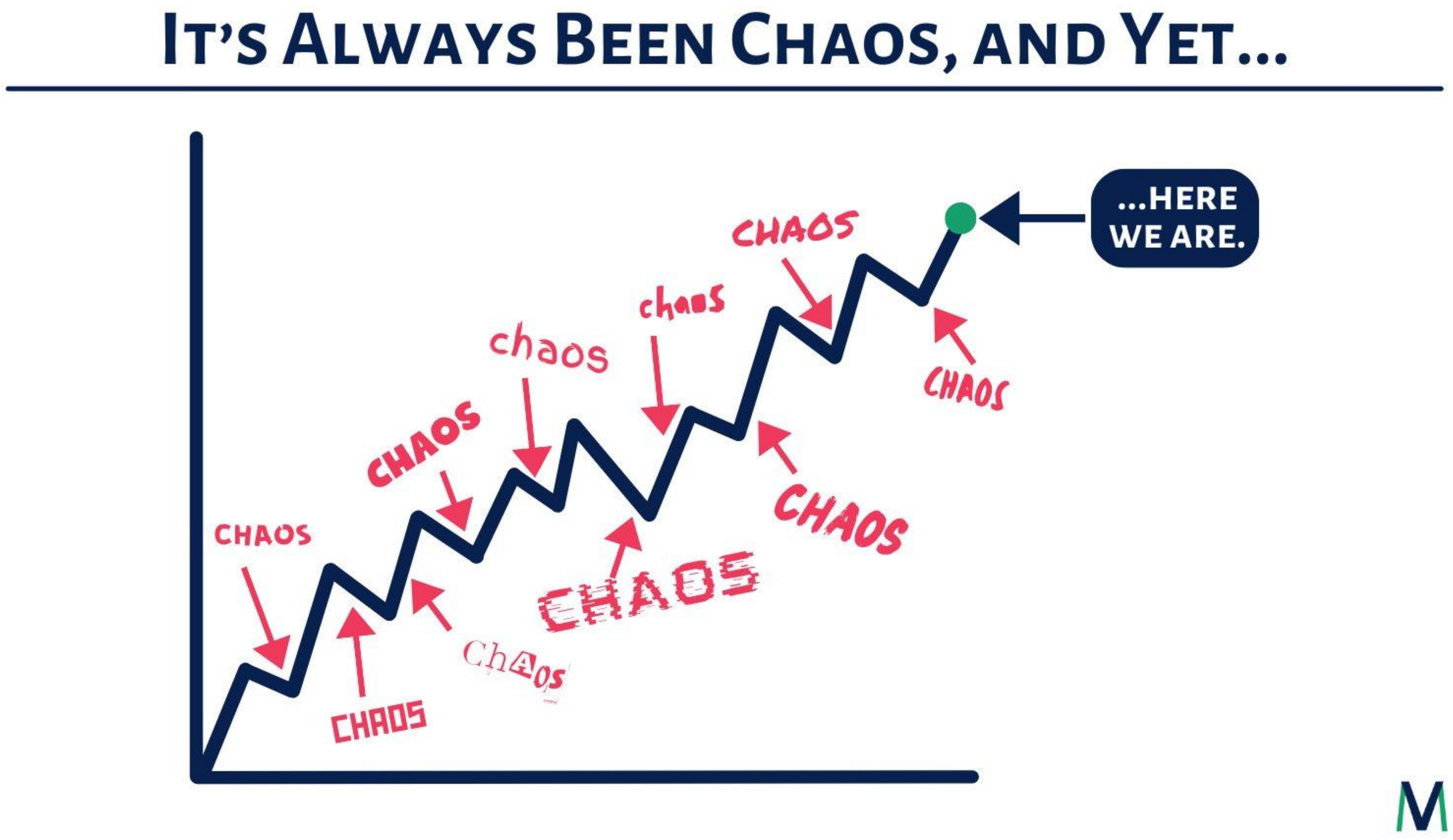
Failure Is The Norm, Survival The Exception. Survive Chaos.

20.8% of private sector businesses in the U.S. fail within the first year.

After five years, 48.4% have faltered.

After 10 years, 65.1% of businesses have failed.

Source: US BLS



Source: Money Visuals

In Conclusion

1. High interest rates have begun to impact economic growth. A slowdown ahead is likely, especially in developed economies.
2. Bonds markets are sending mixed signals. Complacency at a time of rising headwinds is a risk. **Be cautious.**
3. Global growth engines are suggesting disinflationary trends. This is likely to weigh on sales growth and therefore profitability.
4. Stellar rally in smaller companies in India is a signs of caution. India valuations are unattractive. Diversify across assets.
5. India growth trajectory is steady. Corrections will be great opportunities if valuations are right.

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