Investing in Turbulent Times

27th Mar-2020

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What will we cover

- Pre-existing Credit & Asset Bubble - COVID-19 merely the ‘’pin’’
- Higher probability now for an extreme ‘’monetary’’ event & retrospective of the secular inflationary/deflationary regimes through history
- Inflation/Deflation watch – what is the ‘’message of the market’’
- Can we estimate the extent of the possible decline in Equity
- Our template for investing in turbulent times
- Comments and Observations on Indian markets
- Some final words of advice

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“It ain't what you don’t know that gets you into trouble.
It's what you know for sure that just ain't so”

- Mark Twain

“Fed’s Yellen: Not another financial crisis in ‘our lifetimes’’

"Would I say there will never, ever be another financial crisis? You know probably that would be going too far, but I do think we're much safer and **I hope that it will not be in our lifetimes and I don't believe it will be,"** Yellen , 73 said at an event in London in June 2017.

COVID – 19, the trigger

- COVID-19 has triggered a collapse in movement of goods & people across the world.
- This has initially spooked the financial markets and increased volatility.

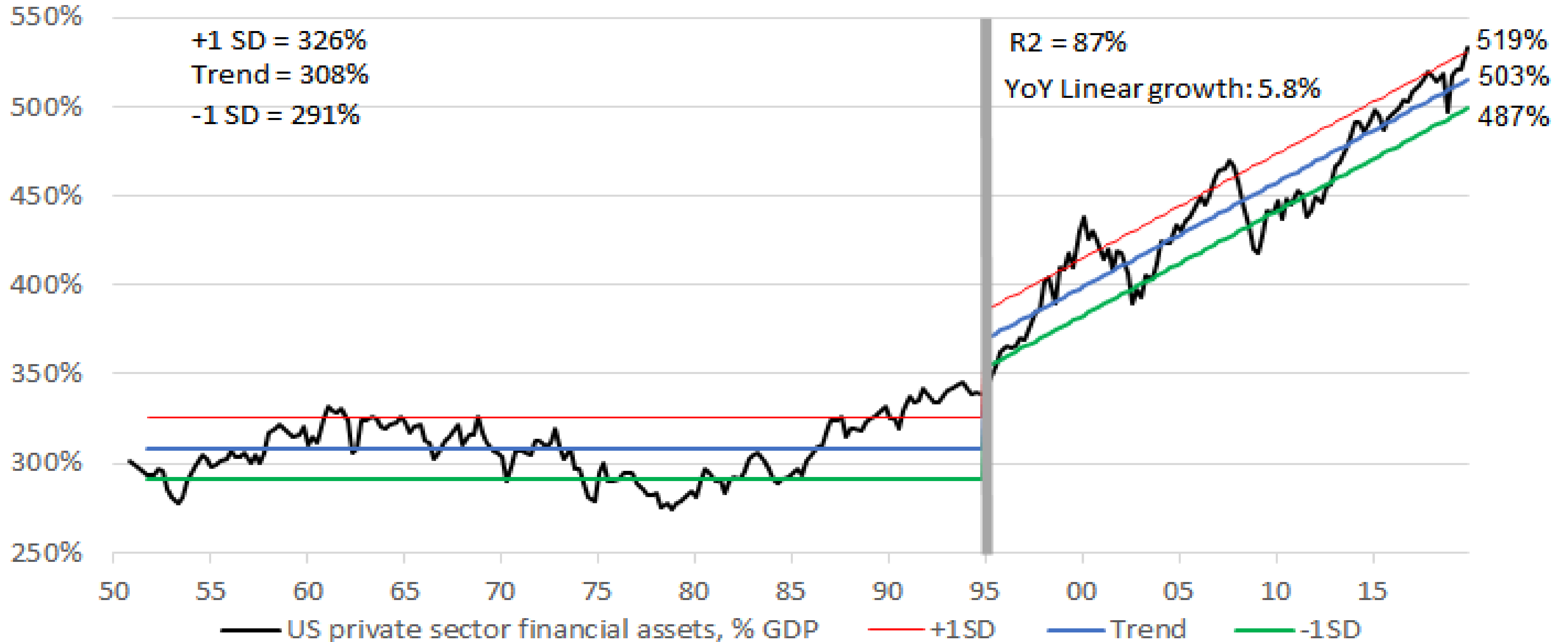
- The event has also resulted in unprecedented actions by governments across the world to check the spread of COVID-19 with several secondary effects on the economy.
- While COVID-19 is the proximate reason in the narrative for current financial crisis, it is nothing but **a trigger for already existing credit and asset bubble and imbalances to manifest**.

- These imbalances have their origin Central Banks' policies, that incent consumption over 'real' savings and production, incent leverage over strong balance sheets that would otherwise support financial flexibility; financial engineering via buy-backs that promote asset bubbles & mal-investments.

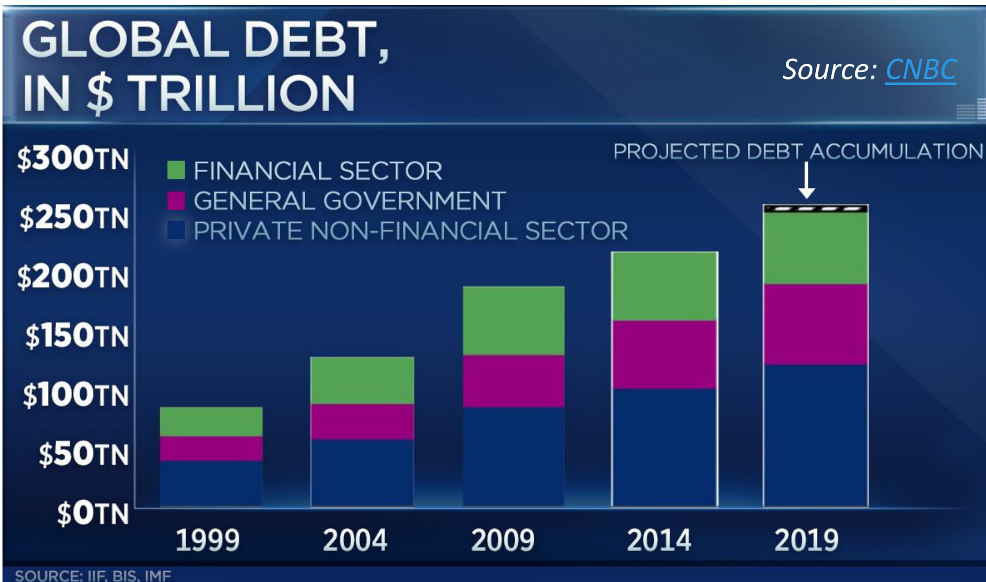
- History has shown us that availability of easy credit and suppressed volatility (the ''Fed put'') has a tendency to invoke speculative behavior in the markets and excesses.

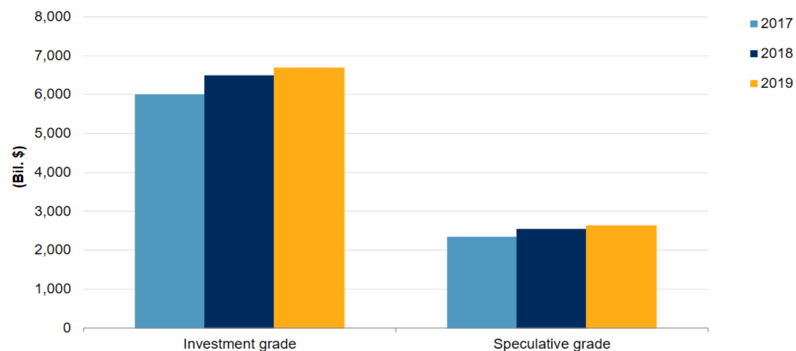
- **We are likely thus witnessing a 3rd burst of the Credit Bubble since 2000. We have seen unprecedented credit growth over last decade. It had been supporting GDP ''growth'' as well as allowing financial markets being unhinged from ''real''productive economic activity… in what is known as the "Everything Bubble".**

Household Net Worth to GDP



In the short term this is just a giant "margin call", so far!





As rated by S&P only

- While global debt levels have exceeded $250 tn, it appears that immediate reactions have been felt by investors owing to margin calls and liquidation of securities.
- Apart from leveraged market positions, immediately, at risk are high yield corporate debt across the world.
- We estimate at least $10 tn+ securities.

  US BBB rated outstanding (only S&P rated): $3.8 tn+

  US speculative grade (only S&P rated): $2.6 tn+

  Emerging markets forex debt (non-bank): $3.7 tn+

- Thus far, US Fed has been providing liquidity to the tune of $1 trillion of overnight lending, $1 trillion of 14-day loans every week and has conducted $500 bn worth of asset purchases. Latest we also saw Fed announcing buying of corporate bonds as well as provide direct credit to companies.
- Liquidity has been infused or made available by most central banks.
- Despite all this, volatility has continued in financial markets, indicating a bigger asset-liability mismatch.

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Implications for Investment Strategy

- QE – has suppressed volatility, allowed **credit risk to be mis-priced**, increased asset prices by lowering the discount rate and increased the proclivity to take on debt and increase leverage.
- **Absent ever increasing QE, liquidity would be tighter and asset prices would revert to the mean; where the marginal investor earns at least the required historical rate of return on the asset.**
- **Continuing QE and variations will eventually will lead to an extreme monetary event – either extreme price inflation or extreme price deflation**
- Investors will need to **embrace long volatility strategies, minimize credit risk and be very selective in security selection.**
- Making positive returns will be about investing in **Business Models and Balance Sheets** !
- **Very few securities will rise (10%) to astronomical valuations as they acquire "money-ness"while 90% will trade towards 0 !**
- Asset Classes will behave **idiosyncratically** and NOT as they have done historically since Post WWII

Governments have hitherto "outsourced" the economic cycle to Central Banks

Central Banks are a ''one trick pony'' – they lowered
Interest Rates & then lowered them again

Credit Inflation

Brings forward consumption/''mal-investments'' especially;
Consumption in Real Estate and/or durables (auto's) that can be easily financed
An "artificial boom" is created leaving **a subsequent gap in demand that has to be filled**

Debt deflation
(defaults)

Monetary deflation
(banking system failures)

Price deflation
(demand destruction)

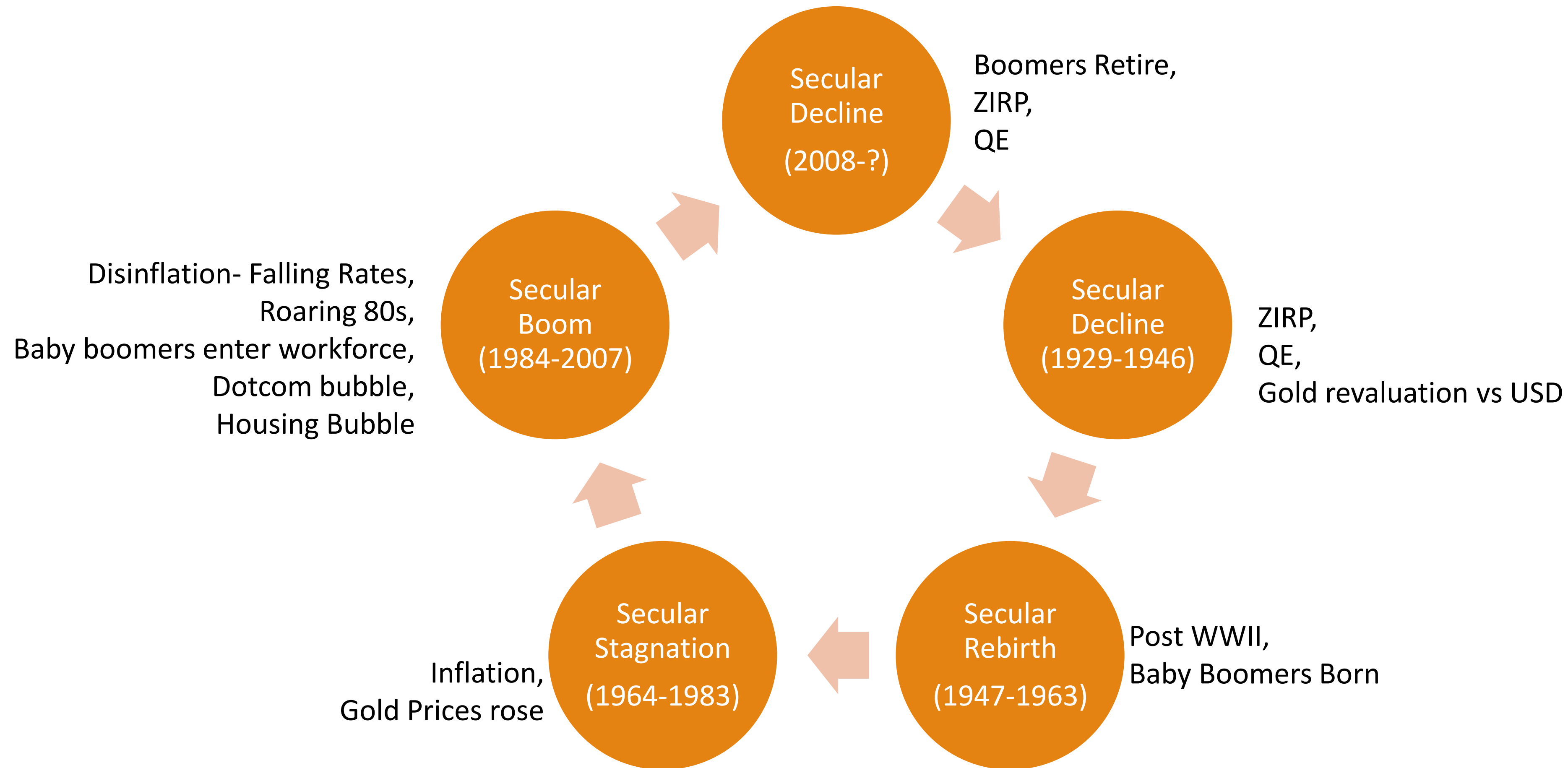
Debt deflation
(defaults)

Central Banks & Government intervene with

Monetary inflation
(helicopter drops of "money"
By monetizing government deficits)

Price Inflation

How the Cycle moves actually…



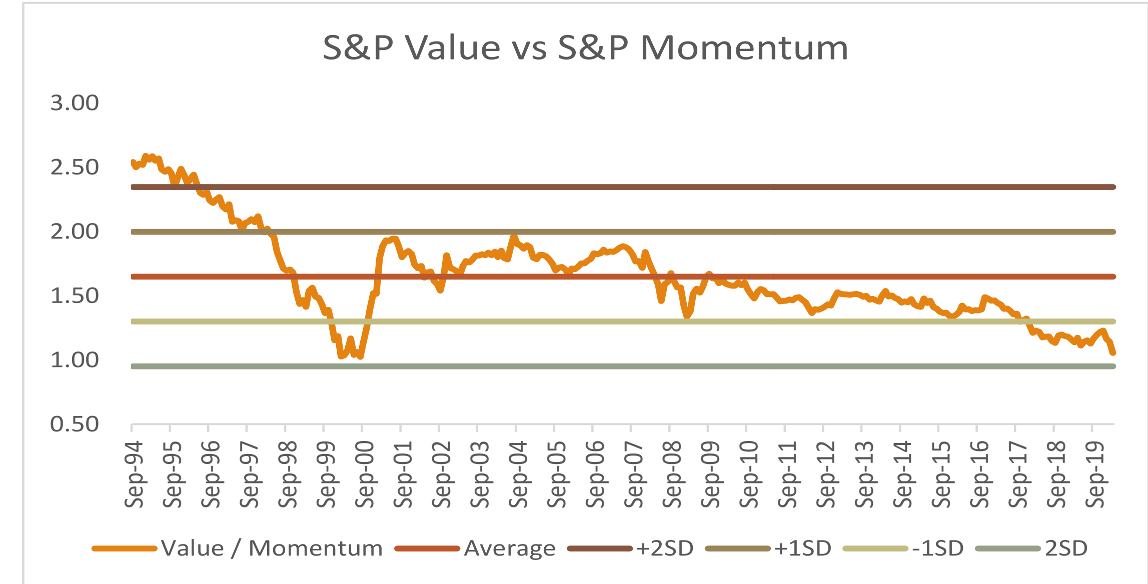
Asset Class Performance in Four Regimes – Real, Annualized Return (median), (1872 to 2018)

Direction of inflation

Level of inflation	Falling	Rising
High	**Disinflation** [30% of years] *Equities 8.8%* *Bonds 1.3%*	**Inflation (Fire)** [12% of years] *Equities (12.1%)* *Bonds (5.1%)*
Low	**Deflation (Ice)** [17% of years] *Equities (0.1%)* *Bonds 9.8%*	**Reflation** 41% of years] *Equities 4.6%* *Bonds (0.1%)*

Source: Man GLG, Robert Shiller (Yale University); as of 3 April 2018.

Value and Momentum

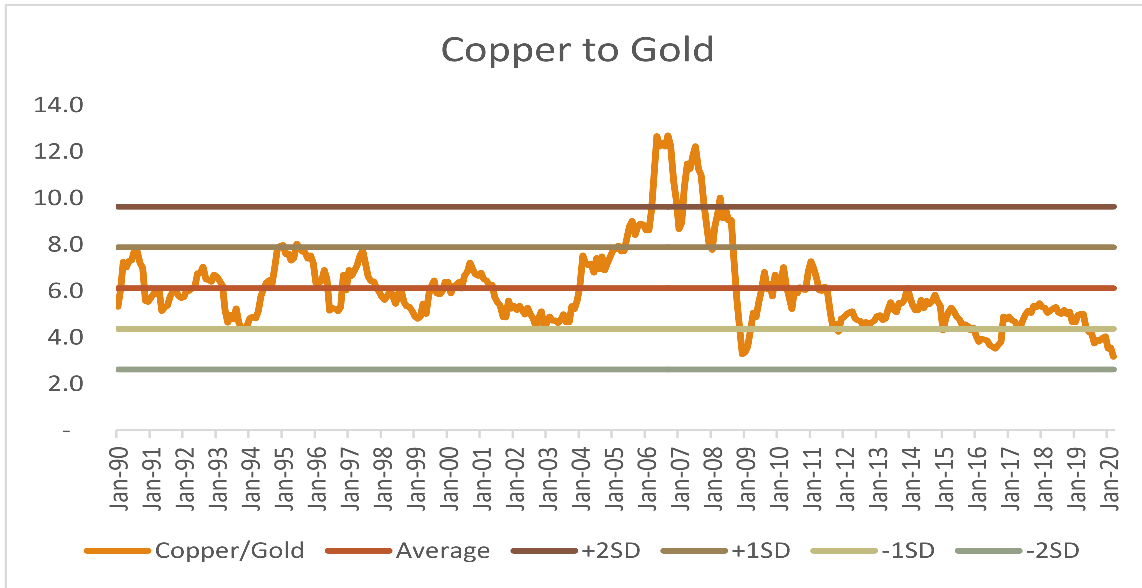


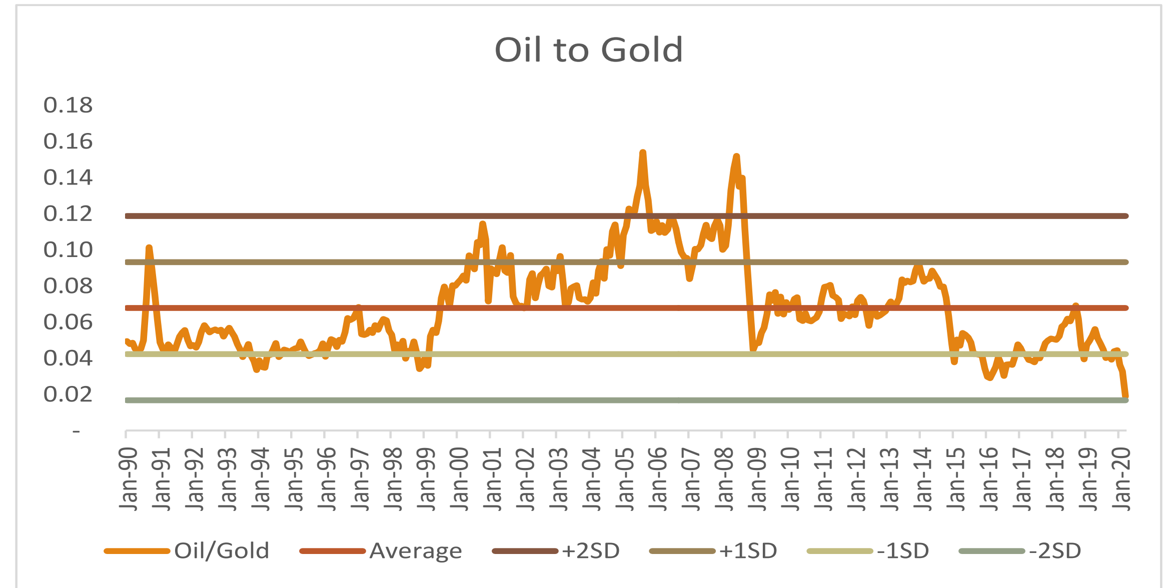
- Value stocks generally have levered balance sheets.
- If reflation policies were working Value stocks should do better.
- Rising prices of everyday items make value stocks an attractive play on improving numbers, relative to momentum stocks.
- Current indicators suggests deflationary stance taken by the market.

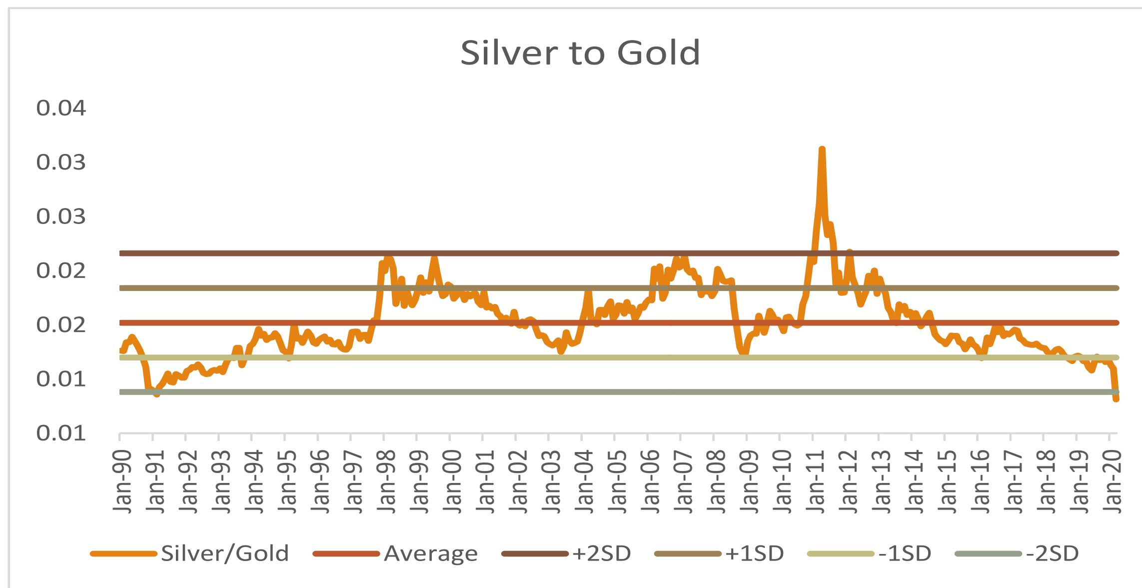
Emerging Markets

- Emerging markets, especially commodities rich emerging markets- can witness outperformance vs. S&P 500 (developed markets) in inflationary scenario. We had witnessed that trend during the commodity run up between 2004 and 2008.
- Emerging market currencies can also appreciate in such scenario.

Industrial Commodities vs Gold

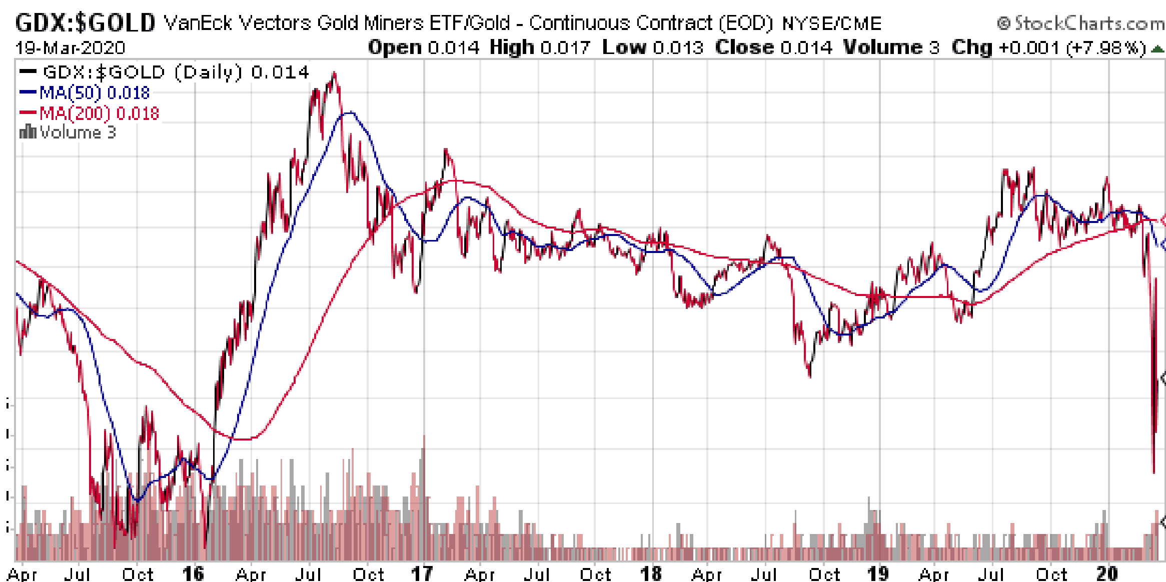


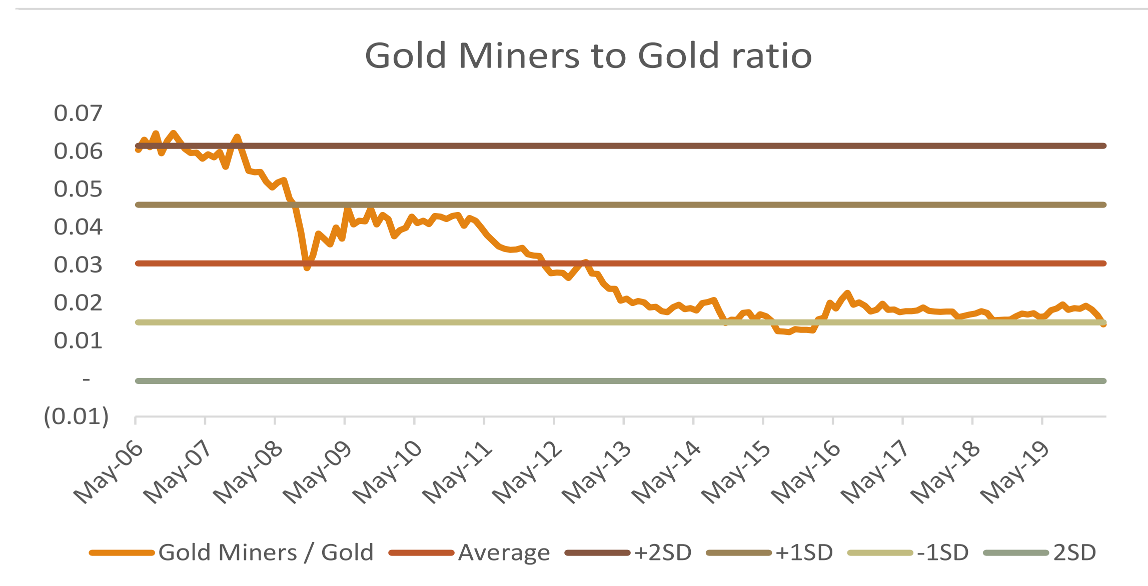




- In general, inflation causes industrial commodities to rise against gold.
- On the other hand, deflation causes Industrial Commodity to Gold ratio to decline.
- Current ratios indicates deflationary outlook.

Gold mining companies vs Gold





- Though not a very strong indicator currently, the ratio of Gold Mining companies to Gold can be tracked to get an indication of what scenario the market is anticipating.
- **During deflation, costs for mining companies go down, increasing their profitability, while the nominal price of Gold remains steady. This makes gold mining companies perform relatively better as compared to gold prices**.
- The trend for last some years has been ambiguous as this indicator has not performed consistently with the other indicators. Gold prices have moved in-line with central bank's balance sheet expansion.

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Inflation – Deflation Summary

Below is summary of our expectations how asset classes can behave during goods and services inflationary and deflationary regimes. One may want to consider this while constructing a robust portfolio as a hedge against central bank's actions and as the markets start to anticipate a different regime.

	Asset Class	Goods and Services Inflation	Goods and Services Deflation	Current Indication
Currencies	**USD**	Weaker	Stronger	Deflation
	Gold	Rising	Rising (also stronger vs stronger USD)	Deflation
	Emerging Market Currencies	Stronger	Weak / Very Weak	Deflation
	Commodity Countries Currencies	Stronger	Weaker	Deflation
Bonds	**US 10 Year Interest Rate**	Higher interest rate / Lower bond prices	Lower interest rate / Higher bond prices	Deflation
	Yield Curve	Steep	Inverting	Deflation (early signs of inflation)
	Credit Spreads	Narrow / Narrowing	Wide / Widening	Deflation

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Inflation – Deflation Summary

	Asset Class	Goods and Services Inflation	Goods and Services Deflation	Current Indication
Equities	**Developed Market Equities (DM)**	Neutral	Falling	Deflation
	Emerging Market Equities (EM)	Rising	Falling	Deflation
	DM/EM Equities	Declining	Rising	Deflation
	Value Stocks	Rising (especially in reflation)	Falling	Deflation
	Momentum Stocks	Neutral	Rising (vs. value stocks)	Deflation
	Gold Mining Companies / Gold ratio	Gold rising vs. GMC	Gold falling vs. GMC	Ambigous
Commodities	**Industrial commodities – (Iron Ore/Copper/Oil/Silver) vs. Gold**	Rising	Falling	Deflation
	S&P Commodity vs S&P 500	Rising	Falling	Deflation

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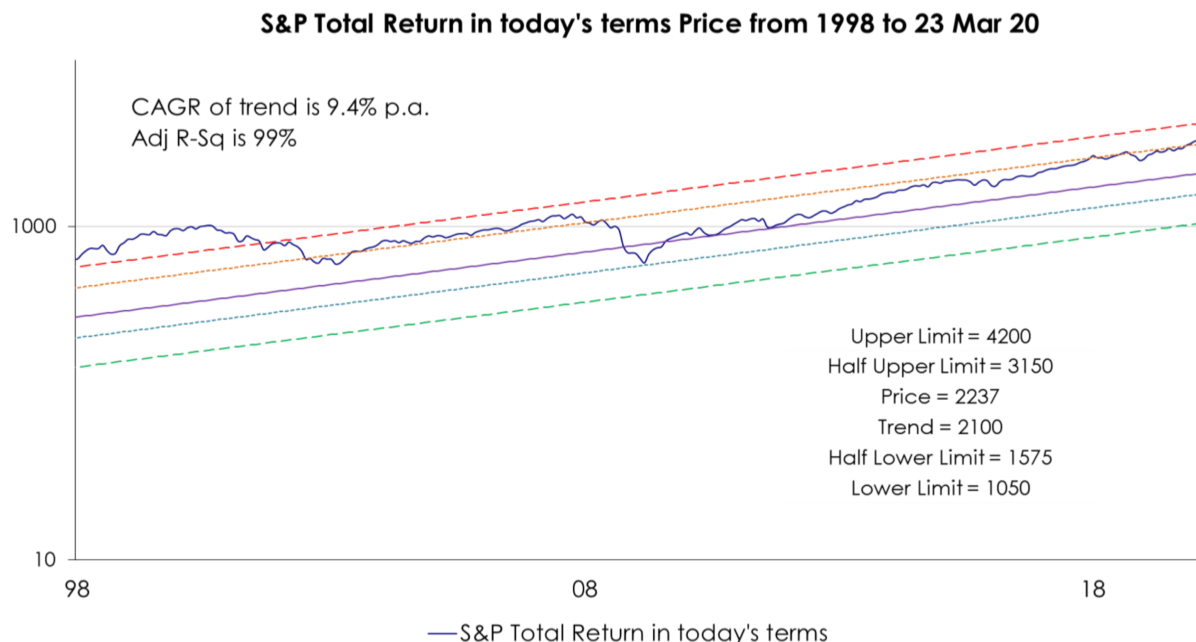
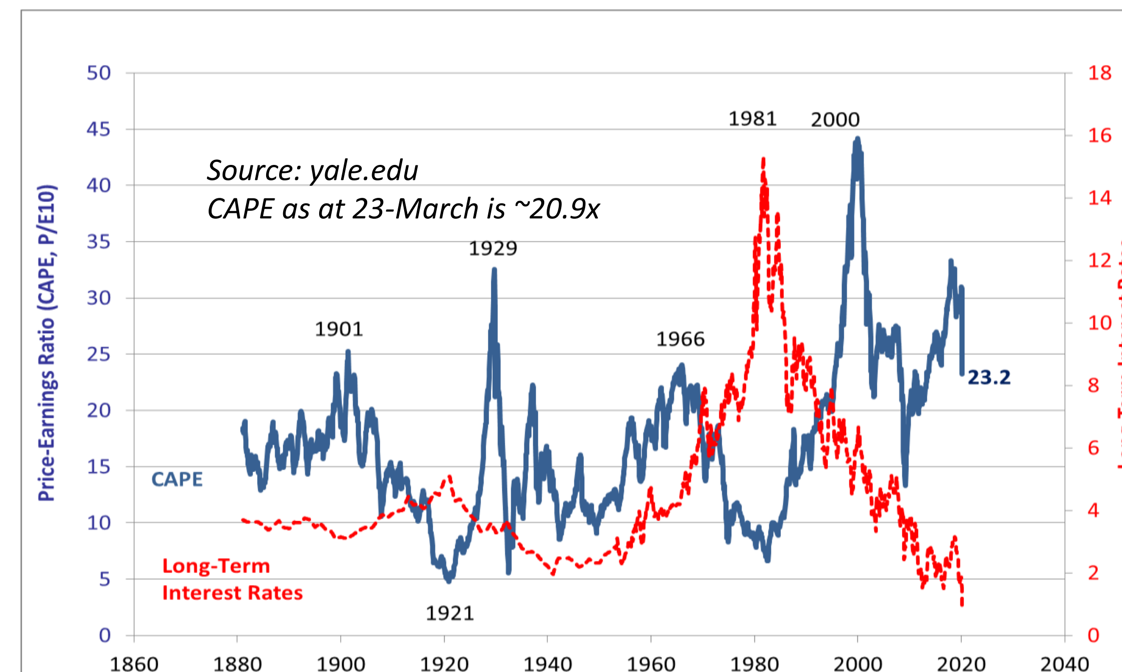
How far are we from historical lows?





- Despite steep decline, the S&P 500 is still 10-15%+ above its long term trend line.
- 2008-09 crash S&P500 had found bottom -22% below trend line, near half lower limit. Current half lower limit level is 1575.
- On CAPE basis, S&P 500 was at 23.2x as at 12-March. Thus, based on latest level of 2,237, it is at 20.9x. During 2008-09, it bottomed at 13x CAPE.

"Gold Is Money, Everything Else Is Credit" JP Morgan, 1912.

- Cash – **Highest Quality Cash Asset is Gold**. Inevitably financial assets will be repriced lower in ‘real’money/Gold.

- Gold is the only monetary asset that is no one else’s liability. It is the only monetary asset that has zero credit risk.

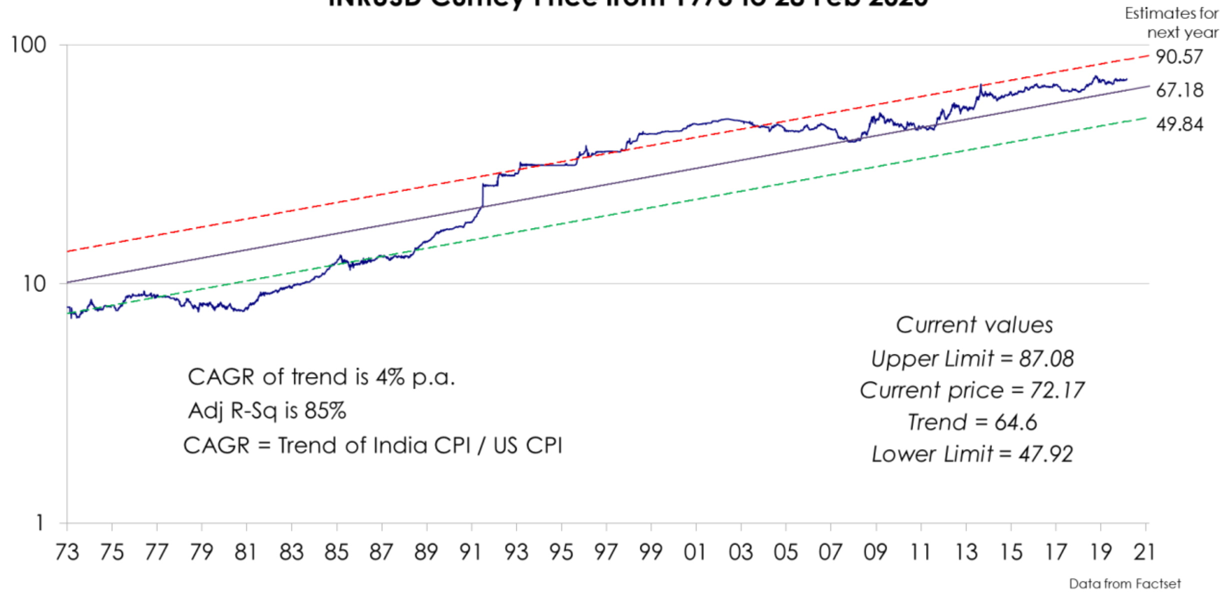
- Bonds – Invest only in the bonds of **Net Creditors-net creditor Sovereigns or net creditor Corporates**

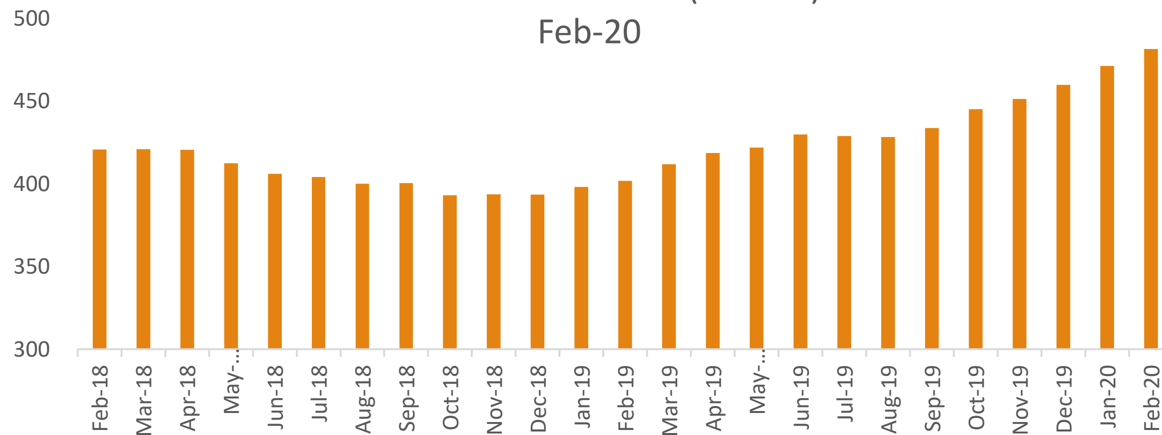
- Equity – invest only in **High Quality Equity** : Sound Business Models – characterised by Moats , either Network effect or Strong Consumer or Business preference businesses and pristine Balance Sheets.

- Real Estate & Real Assets- Invest only in Prime Location REIT’s, Infrastructure Companies that are effectively Toll collectors (Airports, Ports, Electricity Power grids, Toll Roads) and the lowest cost Natural Resource Producers

- **Need to be at the Highest Quality end of each asset class to ensure that a portfolio declines relatively the least, and ideally provides a positive return as investors in the asset classes “crowd’’ a few securities.**

INR





… INR has broken its trading range and has moved above 75 against USD.

… While the trade deficit remains favorable, capital flows has probably dictated move in INR recently.

… Forex reserves stood strong at $481 bn as at end of Feb-20 but have come down sharply rceently.

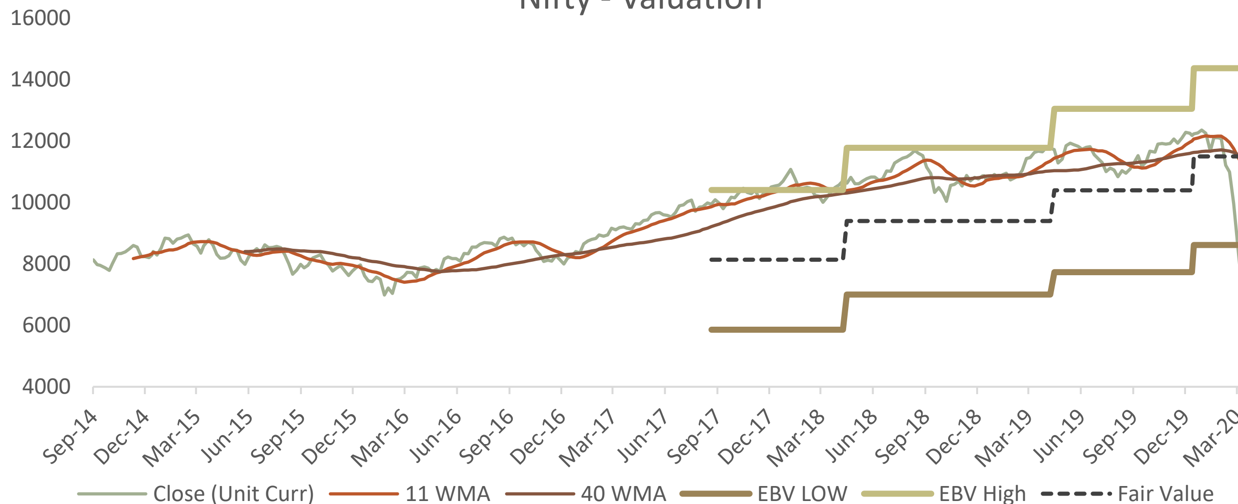
… Based on recent move in USD:INR, it appears that India saw major capital outflows (or lower inflows) during first half of Mar-20.

… RBI has also provided with USD liquidity to the tune of $2 bn by way of USD INR swaps after INR saw major depreciation during last fortnight.

Indian Markets

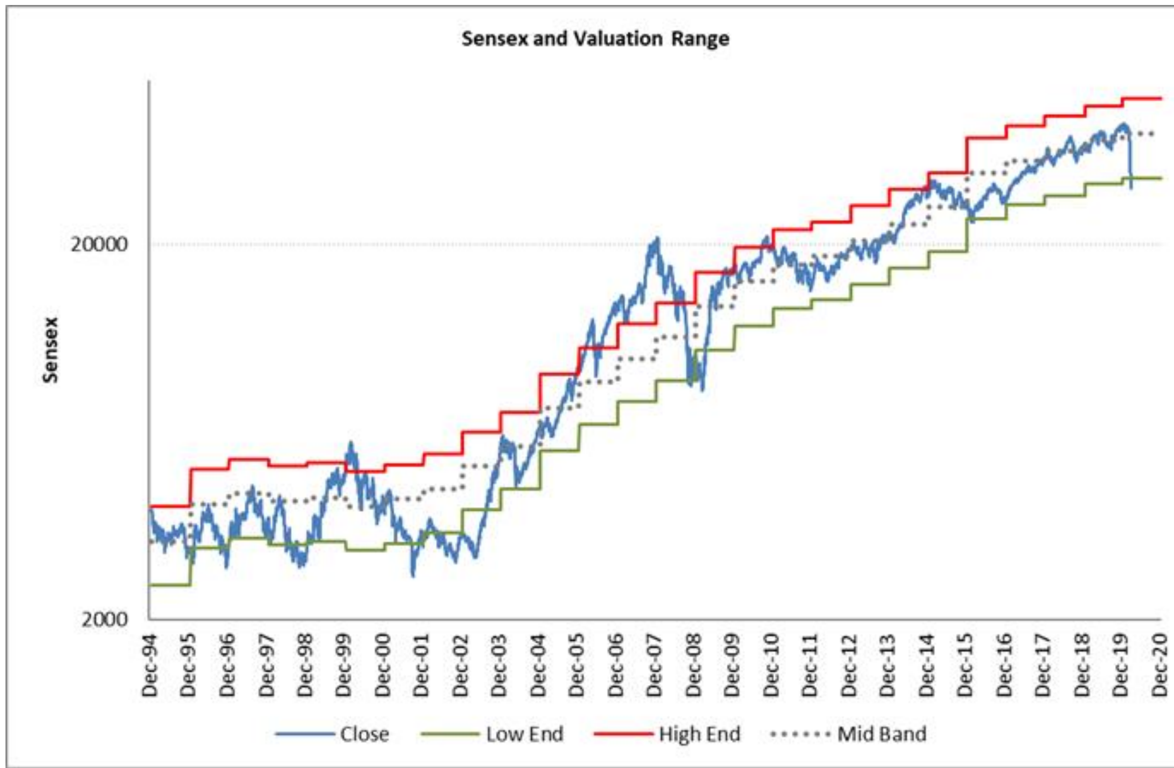
Rise in spread of India's 10 year against US 10 year Treasury

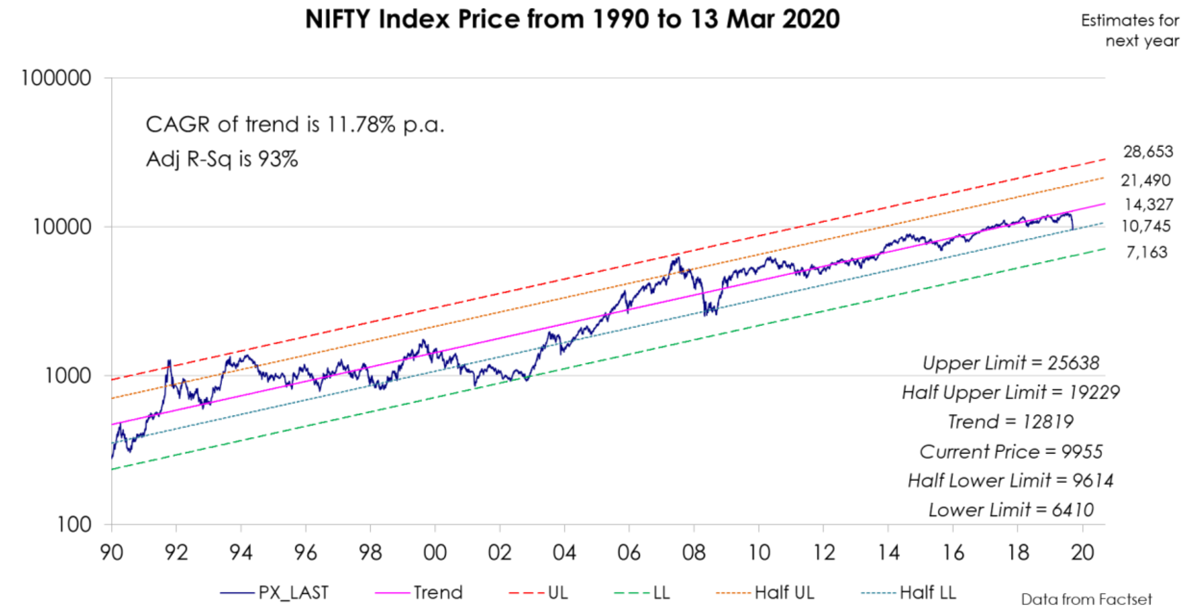
Nifty P/FV has reached near low end of our valuation range.



- The crisis has aggravated economic headwinds for India that it was already facing before the outbreak of COVID-19.
- India also witnessed a "Sell Everything" moment in financial markets.
- Bond yields have risen on anticipation of high government borrowings, suppressed to some extent by RBI interventions.
- **Equities have declined significantly and has reached the lower end of our Estimated Business Value band.**
- *(Though note that valuation ranges can decline to some extent moving forward with lower earnings growth).*

Sensex and Nifty – Valuation

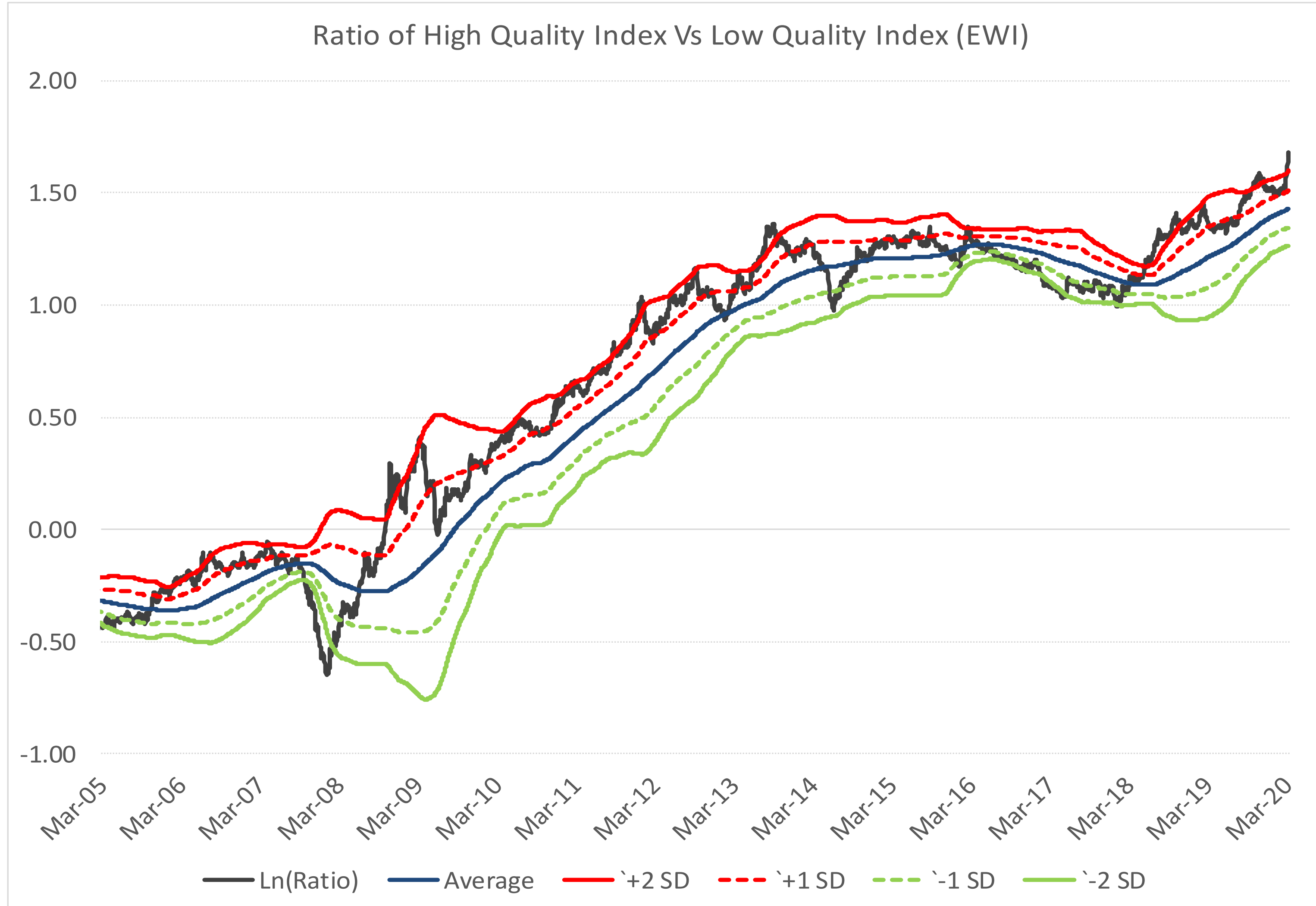




… Sensex has dropped towards low end of valuation range based on long term average (normalised) growth rates and returns.

… Nifty has dropped below half lower limit of 9,614. It’s lower limit one year down the line is 7,163.

Sentiment – HQ:LQ Index



Performance during the month	Mar-20 (first half)
High Quality	-7.7%
Low Quality	-16.1%
Sensex	-11.0%
BSE Mid	-13.4%
BSE Small	-14.2%

… We have seen a spike in pessimism during first half of March-20

Sentiment – Regulated Utility Index

Pessimism

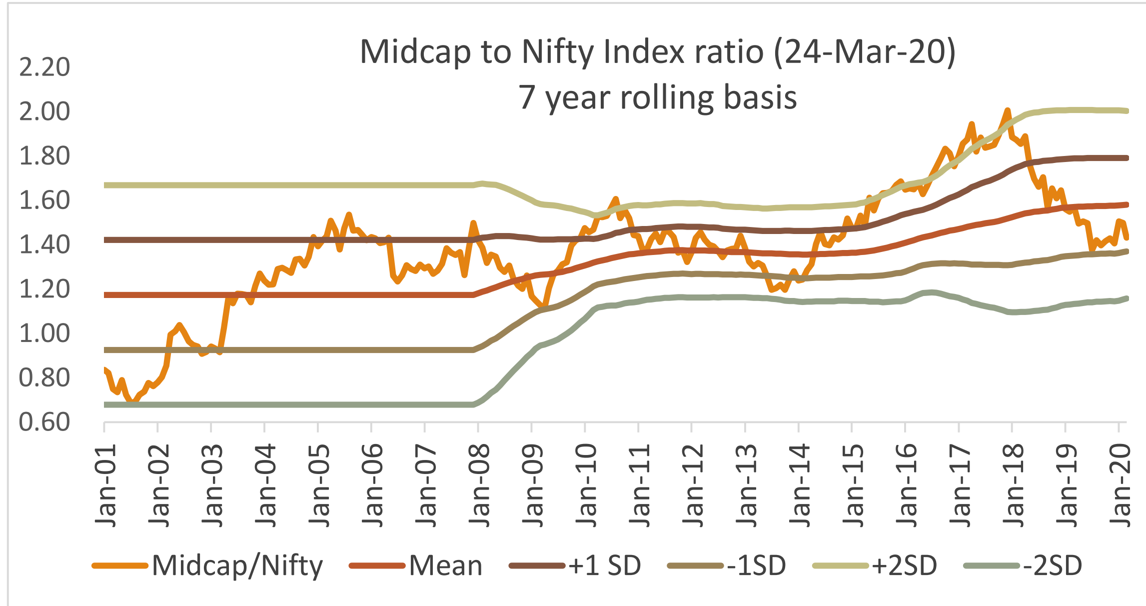
Optimism

Risk Premium	
+2 SD	9.5%
+1 SD	7.6%
Average	5.7%
-1 SD	3.7%
-2 SD	1.8%

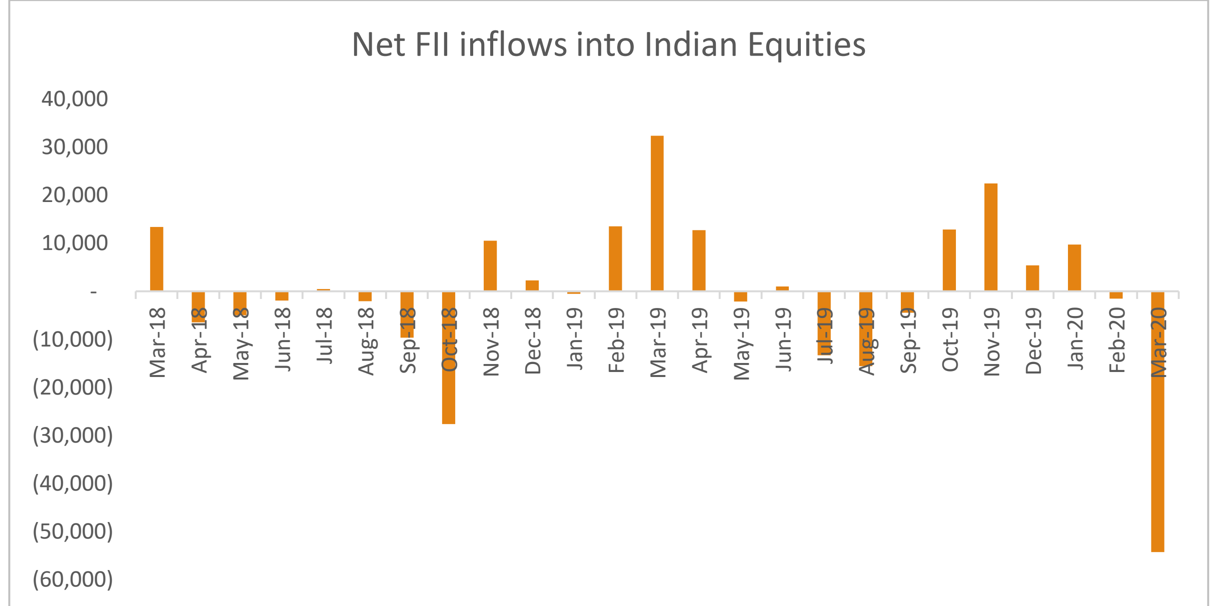
… RU index has spiked beyond +2SD suggesting extreme pessimism.

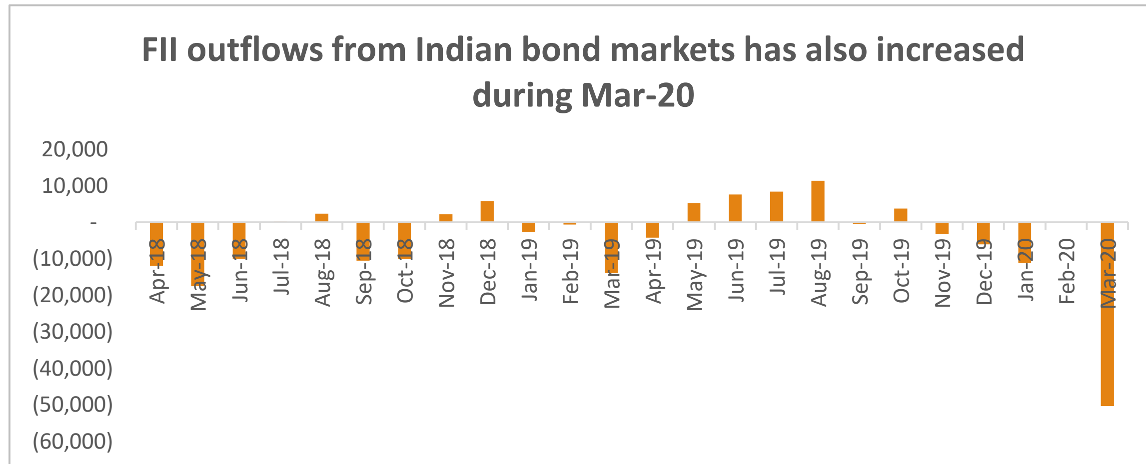
Indian Markets

Sell off has been across the board, Midcap/Nifty ratio remains near -1SD



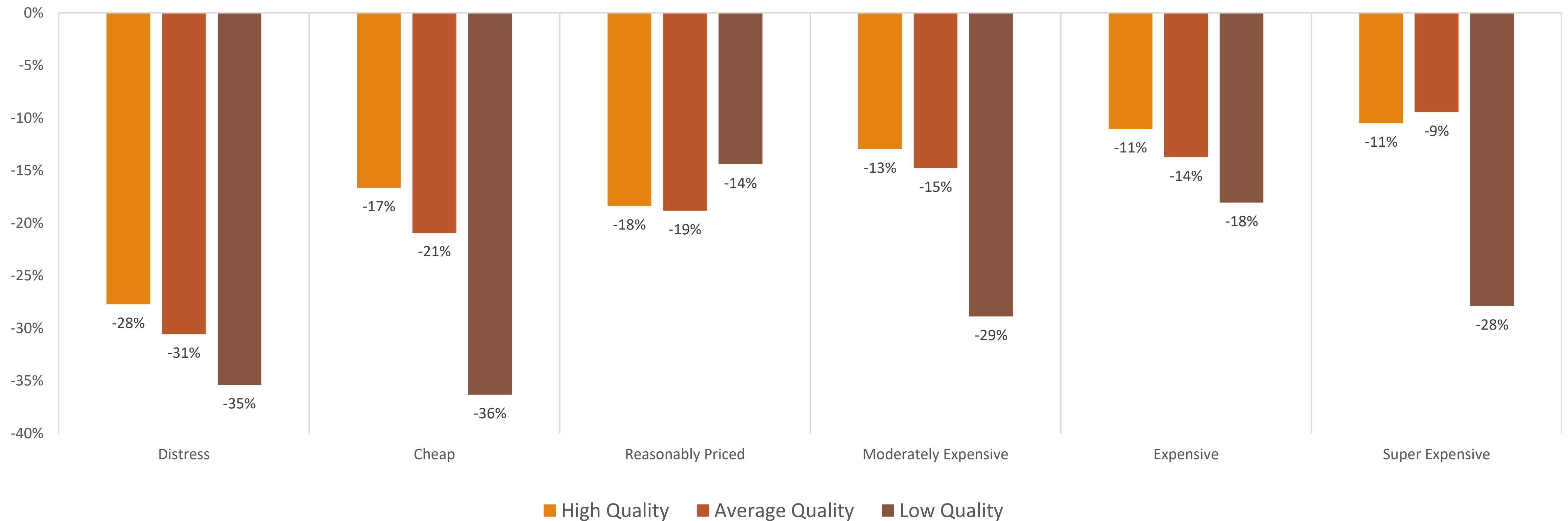
Equities has seen one of the biggest outflows in such a short span of time.





Returns Attribution

Returns buckets for the period between 11-Feb-20 and 12-Mar-20 or ~1 month.
316 companies as covered by Multi-Act are considered for this. *(There are 37 low quality and 71 high quality companies in the set. Hence, there might skew in some of the buckets.)*



During recent market declines, High Quality companies has seen lower drawdowns. LQ companies has seen significantly higher drawdowns.

Implications for investing in Indian markets

- We will witness a rise in fiscal deficit for India as well as most other economies. The most likely scenario is that Governments will be forced to increase budget deficits to record levels at the same time suppress administered interest rates
- Lower crude oil prices should help India's trade deficit however, it remains net importer of goods and services. Capital outflows thus remains a major concern for INR.
- Our preference remains towards **companies with strong balance sheets, especially providing essentials** (strong consumer preference stocks, regulated utilities, industrial goods required as consumables for manufacturing, etc.). Recovery in these can be expected to be quicker than the more discretionary industries.
- We also recommend **inflation hedges** across asset classes.
- India unfortunately does not have inflation protected bonds, but certain Quasi Fixed Income Equity securities and Natural Resources producers with low cost structures, could provide an inflation hedge- albeit loosely correlated to inflation- over a period of time.

Very few advisors prepared for the secular regime change of turbulent times ?

1. An advisor with an average age of say 45-60 years would have seen the economic cycles from 1960 till date. In India perhaps from 1991, his most likely experience may even be shaped by the 2003-2007 boom !
2. The period from 1980 till 2008 was a massive secular boom. It was interrupted by the 2008-9 collapse, but CB's extended the price boom ,obscuring the true nature of money, by ''doing what it takes''.
3. During this period of the secular boom, for instance, buy-the-decline strategies, would have returned positive results.
4. But such strategies would have failed or not returned meaningfully, for about 75 out of 92 years from 1928. Investors would have lost money ''buying the dip''.
5. Advisors who have experienced only the Secular Boom phase tend to apply modern investment strategies the centerpiece of which is the higher the risk-higher the return.
6. They are essentially carry strategies that generate yield by assuming additional risk, leverage and taking on hidden counterparty risks.
7. So a majority of advisors may not be ready for the true extent of the fall, continue to have faith in CB's ability to keep asset markets functioning and levitated.
8. READ THE HISTORY OF FINANCIAL MARKETS – PREFERABLY AS FAR BACK AS YOU CAN !

FOR EDUCATIONAL PURPOSE ONLY
BASED ON A RESEARCH PIECE BY CHRIS COLE OF ARTEMIS CAPITAL MANAGEMENT L.P. TITLED *'THE ALLEGORY OF THE HAWK AND SERPENT'*

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