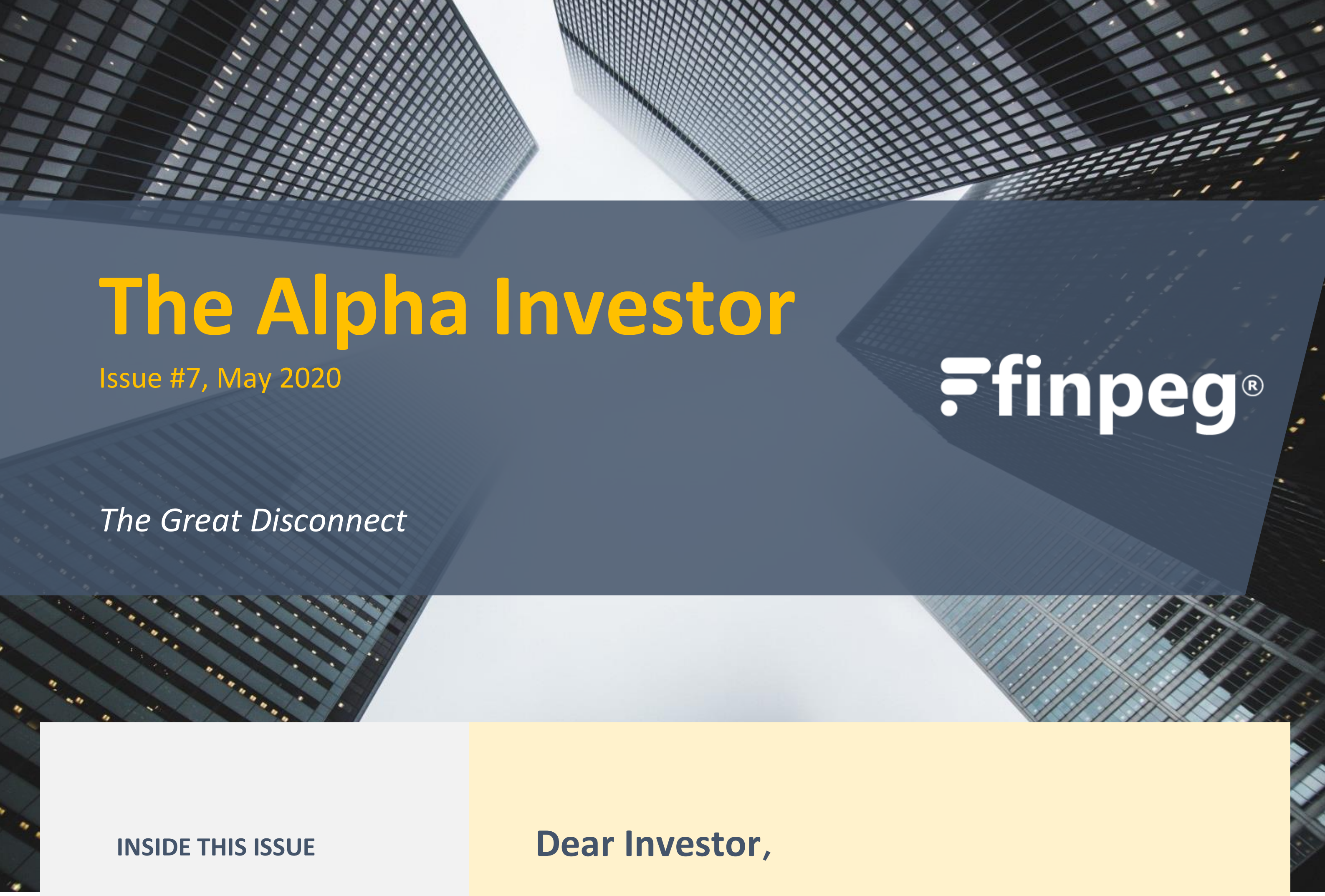


The Alpha Investor

Issue #7, May 2020

The Great Disconnect

INSIDE THIS ISSUE

Dear Investor,

The theme of this month's issue is "The Great Disconnect" between the real economy and the stock markets.

We analyze how stock markets have completely separated from reality which is far more grim and likely to get grimmer. And in doing so, how stocks have gone back to valuation levels seen just before the COVID-19 crash.

In light of the recent "euphoric" price action, we have turned really cautious and our recommendation to investors right now would be to "tread with caution"

Happy reading!

Shubham Satyarth

Co-founder, Finpeg

Smart solutions for smart money

What's Inside?

The Great Disconnect

Ever since the financial markets stabilised post the crash in March, the theme of the recovery can be broadly classified as The Great Disconnect. And the disconnect itself can be broadly categorised as follows:

1. The disconnect between the stock markets and the real economy
2. The disconnect between stocks in emerging and developed markets
3. The disconnect between stocks in different sectors

Let's just jump right into these disconnects.

The disconnect between stock markets and the real economy

This one is apparent and clearly visible. While the real economy is in tatters, the stock markets continue to rally.

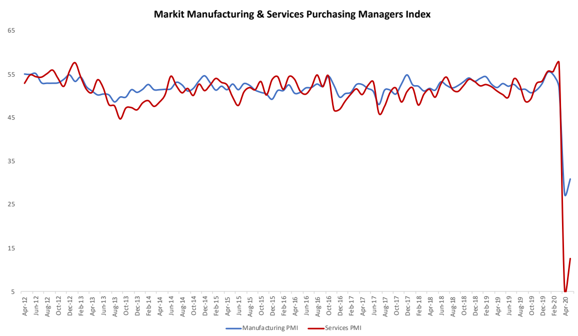
At the time of writing this, NIFTY 50 is down just 18% from its peak on 14th January and is up 33% from its bottom on 23rd March. Similarly, S&P 500 is down just 8.1% from its peak on 19th February and up a staggering 39% from its bottom on 23rd March.

And the real economy (and hence the corporate profitability) continues to deteriorate. While April was arguably the worst month with almost every country under a lockdown, the recovery in the month of May appears non-existent.

Activity in May (as evidenced by manufacturing PMIs) continued to contract albeit at a slower rate. India's manufacturing PMI increased to 30.8 in May from 27.4 in April (Exhibit 1). While this looks like an increase, we have to understand that PMI is a month-on-month diffusion index. Any reading below 50 indicates contraction over previous month. And hence, May was actually worse than April.

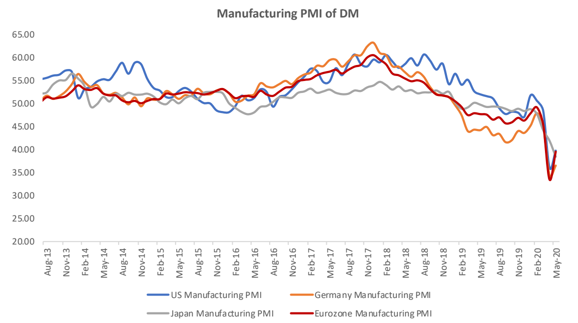
Even for the developed economies, the activity continued to contract in the month of May as compared to April (Exhibit 2). Although PMIs increased, they were well below 50 indicating significant contraction in May vis-à-vis April.

Exhibit 1: India's activity continued to contract in the month of May



Source: TradingEconomics, Finpeg

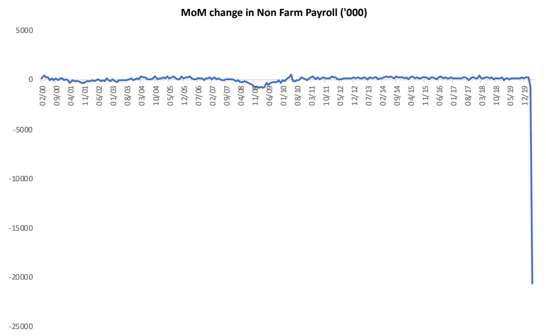
Exhibit 2: Manufacturing activity in developed economies also contracted in May



Source: TradingEconomics, Finpeg

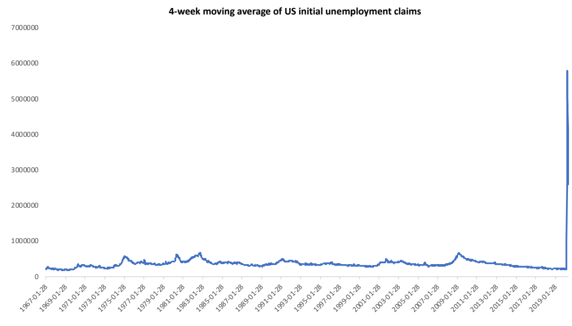
At the same time, unemployment continues to rise across the world. Official unemployment figures in US for April was around 14%, higher than recorded in GFC of 2008. And this is only getting worse as evidenced by initial unemployment claims filed every week (Exhibit 4). By some estimates, over 40 mn people in US have lost their jobs and the number continues to rise.

Exhibit 3: MoM change in US non-farm payroll shows that unemployment has hit a record high



Source: FRED

Exhibit 4: US initial unemployment claims continue to be above 2 mn every week



Source: FRED

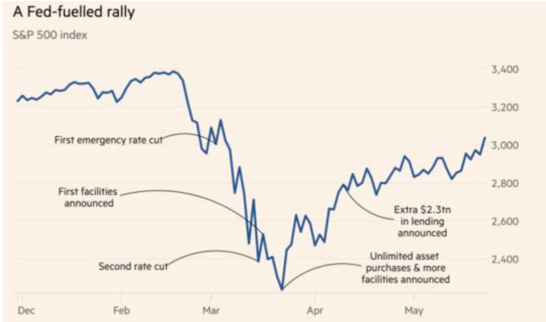
The same employment story is true for the rest of the world as well including India where the numbers are likely to be worse. Remember the vicious cycle of falling employment which leads to lower consumption which leads to lower corporate profitability which leads to further unemployment.

US GDP contracted by 5% in Q1 2020 and is expected to contract by over 30% (seasonally adjusted and annualized) in Q2 2020. Indian GDP grew by 3.1% in Q4 FY2020 and is likely to contract in Q1 of FY21. It is also likely to contract on a full year basis in FY2021. This is the worst slowdown in India in the last 40 years.

And yet, stock markets are not reflecting this somber picture. Why?

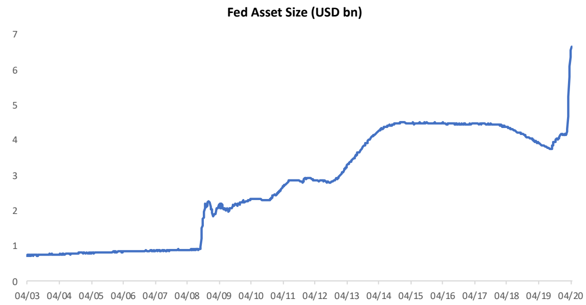
In our previous issue [A tale of two opposite forces!](), we had discussed how Central Bank liquidity (esp. the US Fed) is trying to pump up stock prices against the economic reality (gravity). Well, so far it seems that Central Banks are winning.

Exhibit 5: Global stock markets are on a central bank fueled liquidity high



Source: FT.com

Exhibit 6: Fed has gone nuclear with its balance sheet expansion aka liquidity injection



Source: FRED

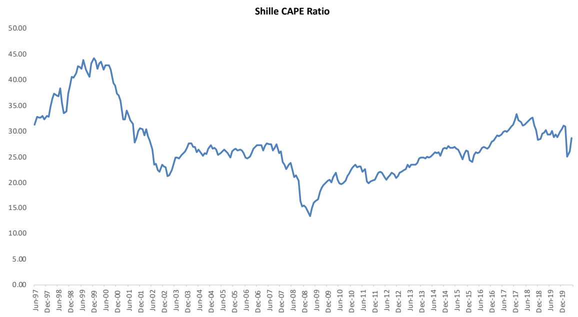
- 4 -

There is a justification floating around that as the economies reopen, the worst is behind us and hence stock markets, being forward looking, are pricing in a recovery.

While we will not debate about how sharp the recovery will be, purely from a valuation perspective, US stock markets are now almost as expensive (if not more) than they were in February (before the crash). And this at a time when the world economy is facing its worst recession in over 100 years (or perhaps even a depression).

See Exhibit 7 and 8 depicting Shiller CAPE and Market cap to GDP ratio of US stocks. Note that both these are trailing measures and do not account for sharp fall in EPS and GDP respectively that will be seen in 2020. Adjusting for that, it would be safe to assume that US stocks are more expensive than they were before the crash.

Exhibit 7: S&P 500 CAPE ratio is within striking distance of highs in Feb



Source: Dr Robert Schiller

Exhibit 8: US market cap to GDP ratio is now again in extremely over valued zone

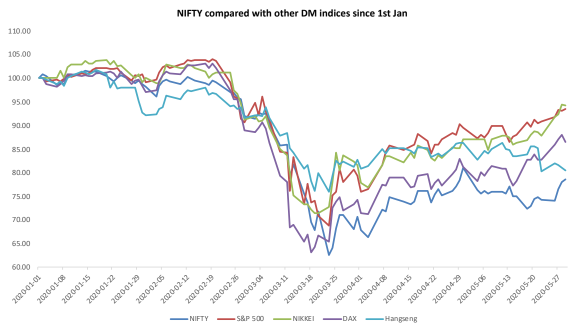
Source: Guru Focus

The disconnect between stocks in emerging and developed markets

The other big disconnect is the performance of stocks in emerging and developed markets. Exhibit 9 shows how NIFTY has underperformed other developed markets since its March lows. Exhibit 10 highlights overall underperformance of EM space compared to the developed markets.

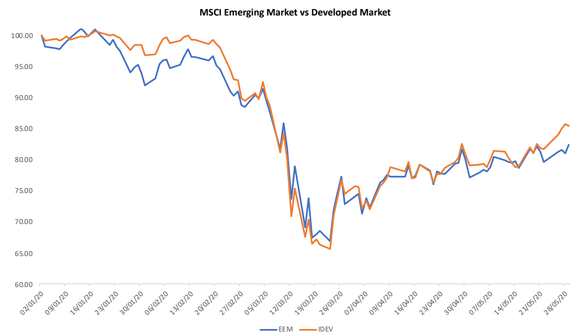
The reasons for this underperformance are primarily (1) most of the emerging market economies are in relatively worse shape compared to their DM counterparts, (2) investors seeking more mature markets in times of uncertainty and (3) unprecedented monetary and fiscal stimulus in DM economies. Also, we note that bulk of DM outperformance has been driven by US and Japan.

Exhibit 9: NIFTY has clearly underperformed developed markets since lows of March



Source: Bloomberg

Exhibit 10: EM stocks have generally underperformed DM stocks in this recovery



Source: Bloomberg

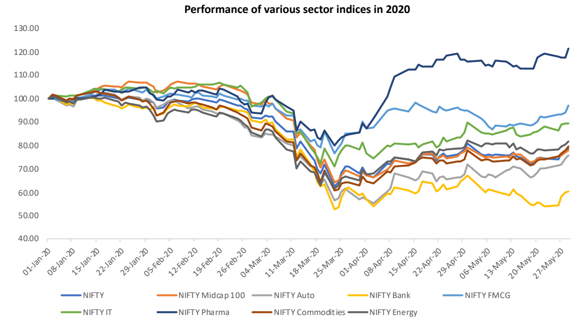
The disconnect between stocks in different sectors

The third and final disconnect we will discuss is the disconnect between stocks in different sectors. The rally post March 23rd has primarily been driven by large and mega cap tech companies and healthcare stocks in US.

Similarly, in India, pharma stocks have been a standout performer in this rebound. Banks have been the worst performer followed by Auto, Energy and Commodities.

It should be noted however that in the last week of May (and first week of June), we saw a reversal in this trend as banks rallied massively indicating an improvement in the breadth of the rally.

Exhibit 11: Sectoral disconnect visible in Indian market with Pharma & FMCG outperforming



Source: NSE

Exhibit 12: Healthcare and Tech have massively outperformed other sectors in US

Source: FT.com

It's time to tread with caution

So, where do equities go from here? In our previous issue, we discussed about the 2 forces that are trying to pull the markets in the opposite directions. Fed's actions are trying to pull it up while economic gravity is trying to pull it down.

As of now, it looks like the Fed has an upper hand with US markets barely 8.1% from their peak in February. While Indian markets have not rallied as much as US, they are still up 33% from its lows (NIFTY 50). Again, when juxtaposed against what's in store for the economy and corporate earnings, the rally simply cannot be justified.

Given the current nature of "euphoria" and the underlying valuations, we feel that time has come to start being cautious again. While Indian valuation might not look stretched on paper, if you factor the rout in earnings that is upon us, valuations will look pretty expensive. On top of that, US market valuations are clearly in a bubble zone. And we know that a big correction in US markets invariably has a ripple effect on Indian markets as well.

The current rally has been fueled by massive fiscal and monetary stimulus and doesn't have any fundamental backing as such. We believe that while monetary policy can put a floor on stock prices (for a while at least), but all of it (and even more) has now been priced. Markets are almost priced to perfection. All in all, risk-reward ratio of equities is quickly becoming unfavorable. We continue to diligently keep track of our algorithm signals and will take action on our client portfolios if the signal merits one.

Indian Markets – Surge to finish the month

1. Equity Market wrap for the month

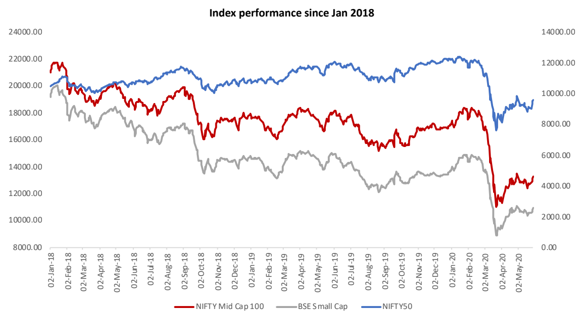
Table 1: Index Returns as of 31st May, 2020

	1 Month	3 Months	6 Months	1 Year	Year to date
NIFTY	-2.84%	-14.47%	-20.54%	-19.65%	-21.36%
NIFTY Mid Cap	-1.70%	-20.93%	-22.93%	-26.09%	-22.39%
BSE Small Cap	-1.88%	-20.54%	-19.67%	-26.73%	-20.49%
NIFTY Auto	5.38%	-9.92%	-23.09%	-23.93%	-24.25%
NIFTY Bank	-10.39%	-33.79%	-39.59%	-38.50%	-39.89%
NIFTY FMCG	2.19%	-0.05%	-5.42%	-1.85%	-3.10%
NIFTY IT	-0.69%	-7.90%	-6.58%	-13.30%	-10.89%
NIFTY Pharma	4.73%	28.93%	19.28%	15.54%	21.39%
NIFTY Commodities	1.75%	-9.56%	-20.54%	-26.00%	-20.68%
NIFTY Energy	-0.72%	-4.33%	-19.54%	-21.13%	-18.31%

Banks and financials have been the worst performer YTD followed by commodities and energy

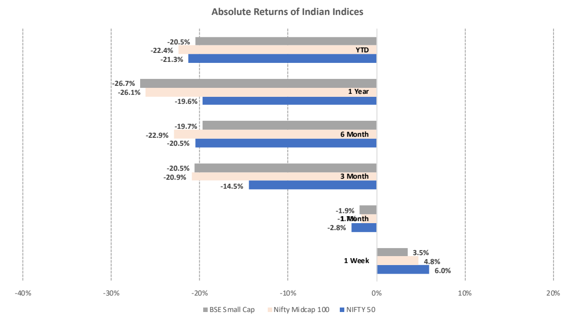
As can be seen from table above, Banks have been worst hit during this crash with NIFTY Bank Index down almost 40% YTD as against NIFTY which is down 21.3% YTD. This, despite a significant rebound in bank stocks in the last week of May. Underperformance of Banks is very typical of any big cyclical downturn as wave of insolvencies impacts banks and NBFCs the most. Year-to-date performance of small and mid-caps is now almost in line with large cap NIFTY 50 index. In fact, small and mid cap indices outperformed NIFTY in the month of May.

Exhibit 13: Mid and small caps now performing in line with large caps YTD



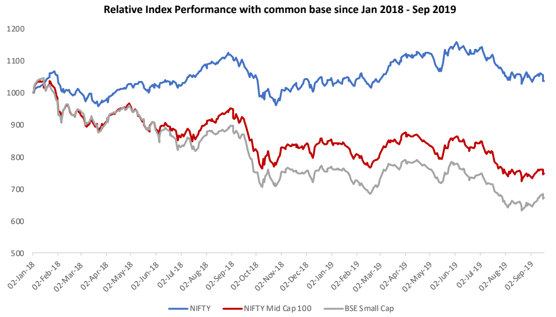
Source: BSE and NSE

Exhibit 14: Small and mid-caps outperformed NIFTY in May



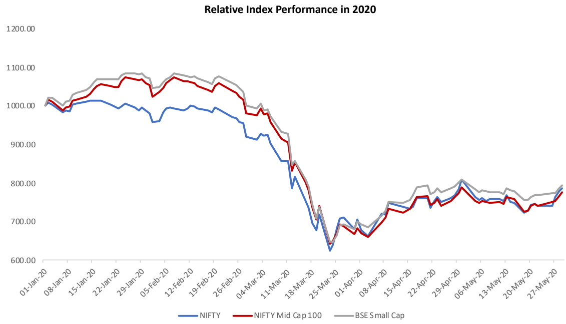
Source: NSE

Exhibit 15: Index performance with common base since Jan 2018 till Sep 2019



Source: BSE and NSE

Exhibit 16: Index performance with common base since 1st Jan 2020

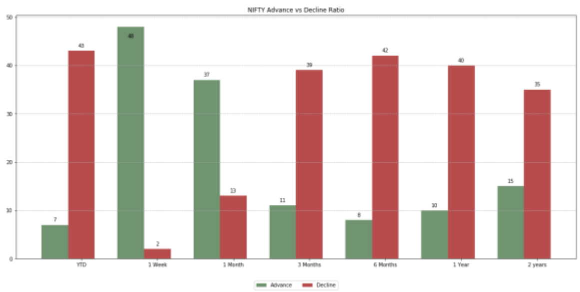


Source: BSE and NSE

A sharp rally in the last week of May which has continued in the first week of June has been fairly broad based with and advance decline ratio of 48:2 implying 48 out of 50 NIFTY stocks went up in the last 1 week.

Also, as of month end on 31st May, NIFTY 50 has breached it's 50 DMA resistance level (Exhibit 18) although it remains well below its 200 DMA for now.

Exhibit 17: A broad-based rebound in the last week of May



Source: NSE

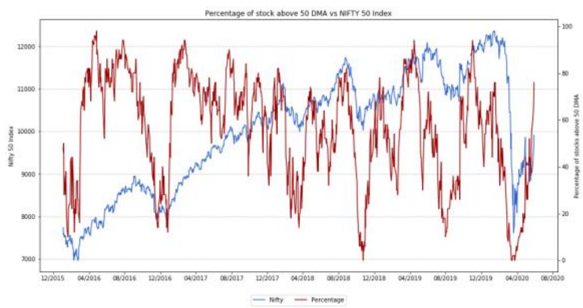
Exhibit 18: NIFTY surges past its 50 dma as it rallied in the last week of May

Source: NSE

Exhibit 19: NIFTY 50 vs percentage of stocks above their 200-day moving average

Source: NSE

Exhibit 20: NIFTY 50 vs percentage of stocks above their 50-day moving average



Source: NSE

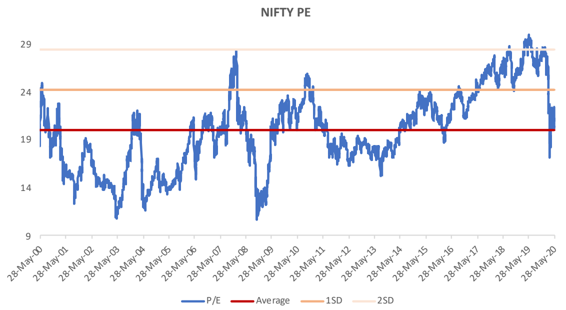
2. Equity Market Valuations

While valuations started looking really attractive by end march and early April, the recent rally has ensured that valuations are now back on the expensive side. NIFTY PE is back to almost 1 SD above its historical average.

Although mid and small cap look attractive on paper, there are reasons to be cautious (as highlighted in our cover section – It's time to tread with caution):

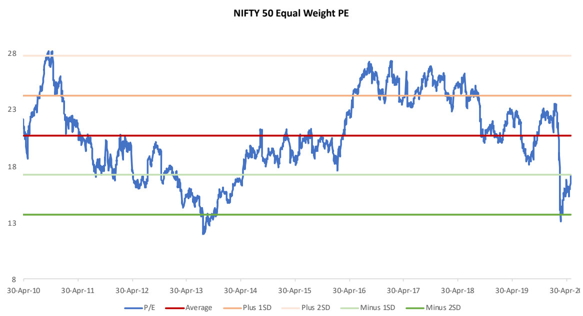
1. These numbers are based on trailing 12-month (TTM) earnings. While we are not big fan of forward PE (owing to invariable error in forward earnings forecast), in this case, we know for sure that earnings will take a significant year-on-year hit in FY21 (probably decline by almost 20% or even more). If we factor that in, NIFTY PE is back to extremely overvalued zone of 28.
2. Last 2 cycle ends (major market corrections) of 2000 and 2008 saw market bottom at NIFTY PE of 10.9 and 10.7. This time, the bottom was 17.2 on 23rd March. Nowhere close to where we landed the previous 2 times.
3. The current rally has been fueled by massive fiscal and monetary stimulus and doesn't have any fundamental backing as such. We believe that while monetary policy can put a floor on stock prices (for a while at least), they cannot continue to push stock higher beyond a certain point. Given this, the risk-reward ratio of owning stocks has deteriorated very rapidly.

Exhibit 21: NIFTY inched above its historical average by the end of the month



Source: NSE

Exhibit 22: NIFTY Equal Weight Index is still 1SD below historical average

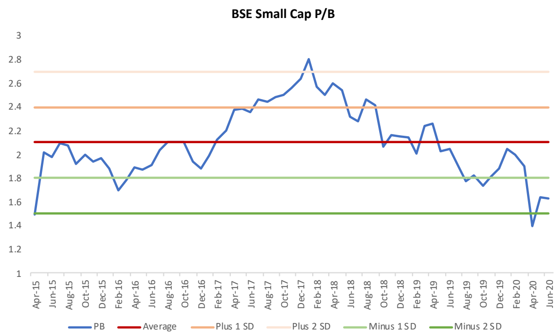


Source: NSE

Exhibit 23: Mid Cap valuations still below historical average and remains attractive (on paper)

Source: NSE

Exhibit 24: BSE Small cap index is trading 1 SD below its historical average PB



Source: BSE

3. Debt Market wrap for the month

May was another strong month for bonds as the 10-year GSEC yields fell 33 bps and 3-month treasury yield fell 37 bps. Year-to-date, the yields have fallen by 69 bps and 163 bps making bonds one of the best performing asset class (along with gold) in 2020.

India's yield curve continues to steepen. It is the steepest we have seen since 2009. Shorter end has obviously benefitted from another 40 bps rate cut by RBI in May, the longer end has surprisingly held up against headwinds of increased Government borrowing and a sovereign downgrade.

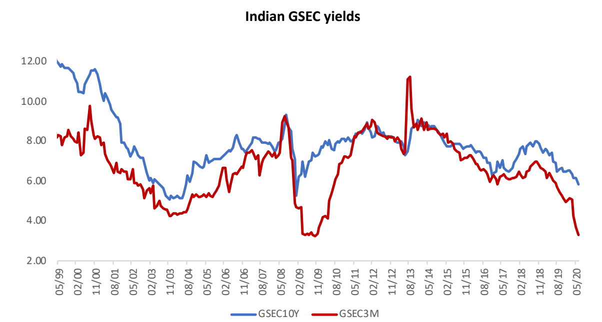
Indian Government increased its borrowing target for FY2021 from 7.7 lac cr to 12 lac cr. Also, Moody's downgraded India's longer-dated borrowing (both foreign and domestic) from Baa3 to Baa2. Generally, one would expect these events to cause a sharp rise in yields and hence an underperformance in bonds. But the yields have continued to decline.

One of the reasons why bond yields have not spiked up is because of the "measured" fiscal stimulus package and a very strong forex reserve balance. In the much-hyped INR 20 tn stimulus package (10% of GDP), actual government spending is closer to 2% or less. While one can argue about the efficacy of this package, one thing can be said with certainty - it has not spooked the bond market. At the same time, India's forex reserve rose to record USD 487 bn. This at a time when most EMs have seen their forex reserve being drastically eroded. This also acted as a calming influence for the bond market.

Table 2: Returns of Gilt and Medium to Long duration Funds

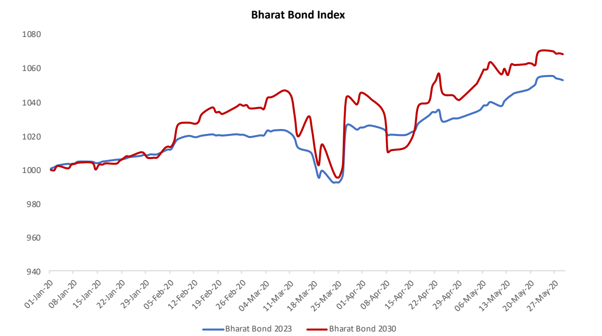
Scheme Name	1M	3M	6M	YTD	1Y
IDFC Bond Fund	1.92%	2.68%	4.62%	4.64%	10.03%
ICICI Prudential Bond Fund	1.90%	2.42%	5.18%	5.26%	11.51%
HSBC Debt Fund	1.37%	2.42%	5.27%	5.62%	10.65%
IDFC G Sec Fund	1.92%	4.67%	9.10%	8.60%	16.33%
DSP Govt Sec Fund	1.96%	4.46%	8.79%	8.79%	16.06%
Nippon India Gilt Securities Fund	1.43%	3.64%	7.73%	7.47%	14.52%

Exhibit 25: 10-year GSEC yields fell in the month of May by 33bps



Source: Bloomberg

Exhibit 26: 10-year Bharat Bond Index has outperformed 3-year index



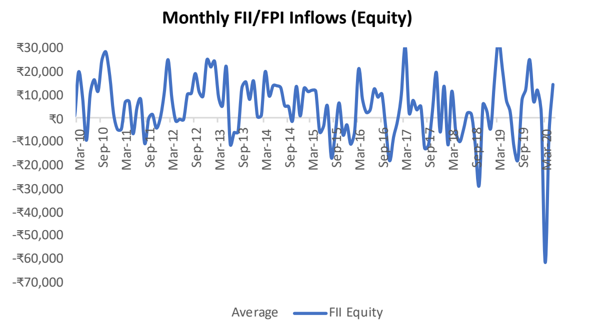
Source: NSE

4. What is the "smart" money doing?

The month of May saw FIIs turn net buyers of Indian equity after being net sellers in the months of March and April. FIIs bought Rs 14,569 cr in May making it the best month in 2020. FIIs continued to be net sellers in the debt segment selling Rs 8,366 cr in the month of May.

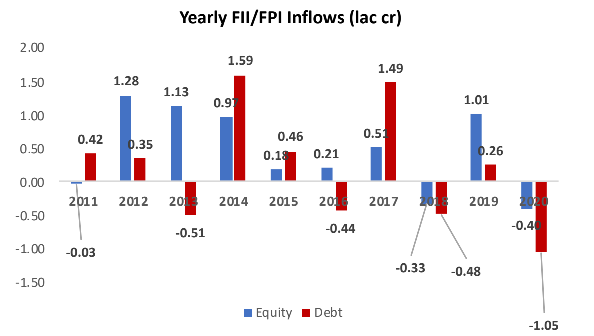
DIIs (Mutual Funds) that were net sellers in Equity in April turned net buyers in May, although only marginally. DIIs bought Rs 2,702 cr (net) in May as against their monthly average buying of Rs 5,858 cr. DIIs were net buyers in the debt segment buying Rs 9,238 cr (net) in May.

Exhibit 27: Monthly FII/FPI inflows in Equity markets



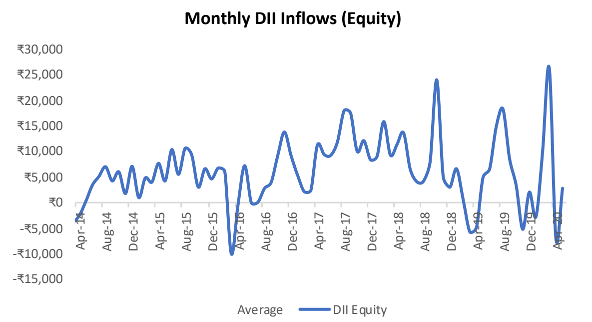
Source: NSDL

Exhibit 28: Calendar year FII inflows in Equity and Debt markets



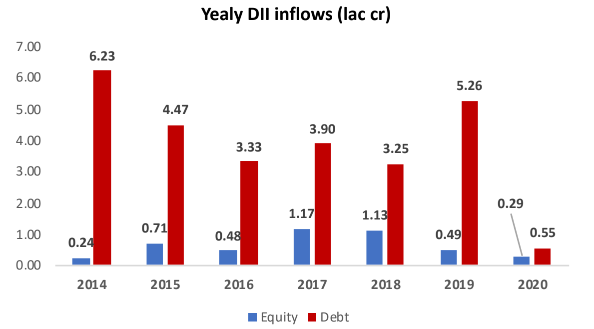
Source: NSDL

Exhibit 29: Monthly Domestic Institutional Investors (MF) inflows in Equity markets



Source: Moneycontrol

Exhibit 30: Calendar year DII inflows in Equity and Debt markets



Source: Moneycontrol

Economy – GDP revision paints a somber picture

1. Summary and Outlook

Indian economy was already slowing and deleveraging before COVID-19 hit. But what's even gloomier is that the slowdown that we had observed from official GDP numbers now appears stronger as the numbers for FY20 got revised downwards in the latest release.

GDP growth in March quarter was 3.2%, slowest since the 4th Quarter of FY2009. What's even more worrying is the fact that growth estimates for previous 3 quarters were all revised downwards. With a full year growth of 4.2%, FY20 was the slowest growth year since FY09.

We already came wounded into the COVID-19 crisis. And then obviously COVID-19 happened.

As we have reiterated, the cost of locking down the country is simply unfathomable. And the Government has now realized that economic cost outweighs the health cost and hence the rush to reopen despite cases still rising at an alarming rate.

If April was the month of extreme outcomes, May was worse, despite some relaxations in the lockdown. India's manufacturing PMI rose to 30.8 in May (from 27.4 in March). Now, at the face of it, this may sound like a recovery. But we should not that PMIs are month-on-month diffusion index. Any reading below 50 implies contraction over previous month. And a reading of 30.8 implies a very significant contraction over previous month. So, May was actually worse than April!

The month of June has seen significant relaxations being introduced. In fact, it has been renamed Unlock 1.0 instead of Lockdown 5.0. However, biggest industrial cluster of Mumbai (and surrounding areas) still remain pretty much shut. And pretty soon, we will start seeing the second, third and fourth order impact of shutting down the entire economy.

In all likelihood, India's GDP will shrink in FY21. We have to let the enormity of this statement sink in. This was unthinkable a few months back. India has not had a negative GDP growth year in the past 40 years. So yes, things look pretty bleak and we don't even know the extent of the damage yet.

Now comes the optimistic part.

Always remember that most of the great structural reforms have happened during crises. It happened in India in 1991 and it has happened all over the world throughout the human history. A crisis jolts us out of our inertia. And perhaps, we needed that jolt.

We are already seeing a slew of structural reforms being pushed forward by the Government. There is palpable urgency to create India into a manufacturing hub. And more structural reforms are expected as we move forward.

Therefore, we believe that once all this is over and we go through that slow and painful process of rebuilding and recovery, there will be a lot going on for the economy and hence the markets. We continue to remain a long-term India bull.

2. GDP and the economy

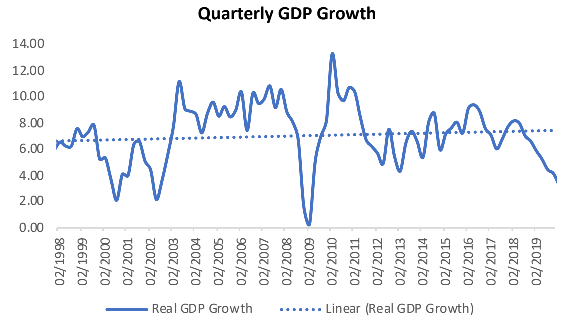
GDP growth in March quarter was 3.2%, slowest since the 4th Quarter of FY2009. What's even more worrying is the fact that growth estimates for previous 3 quarters were all revised downwards. Q3FY20 was revised down to 4.1% (from 4.7%), Q2FY20 was revised down to 4.4% (from 5.1%) and Q1FY20 was revised down to 5.2% (from 5.6%). Full year growth for FY20 was 4.2%, lowest since FY09.

The consensus estimate is that India's GDP will shrink by 4% - 5% in FY2021. That's huge! India has not had a negative GDP growth year in the past 40 years.

Don't get fooled by recovery in IIP numbers in Exhibit 32. As explained, IIP, being a month-on-month index, a reading below 50 implies a contraction in activity w.r.t previous month. And a services PMI of 12.6 says that May was actually much worse than April. Even manufacturing PMI (at 30.8) shows than manufacturing activity was significantly worse in May. The only silver lining is that rate of contraction has slowed down.

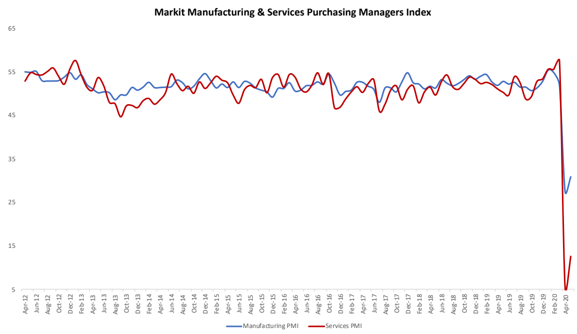
IIP contracted by 16.7% in the month of March (Exhibit 33). And this was when we only had 7-10 days of lockdown in March. April and May numbers are likely to be much worse.

Exhibit 31: Real GDP growth likely to go negative in 4th quarter of FY20



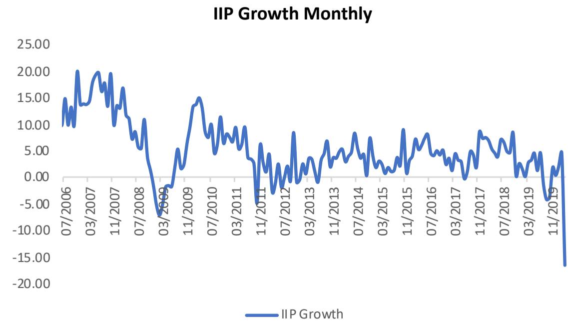
Source:MOSPI

Exhibit 32: Both manufacturing and services PMI indicate further contraction in May



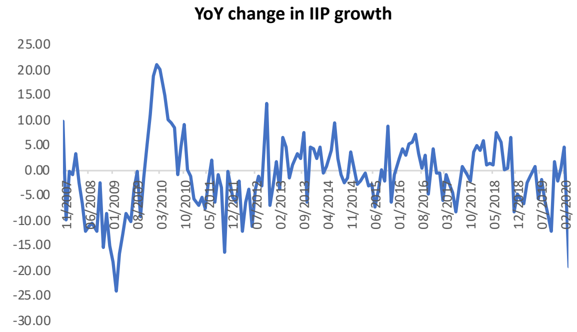
Source: TradingEconomics, Finpeg

Exhibit 33: IIP contracted by record 16.7% in the month of March



Source:MOSPI

Exhibit 34: YoY change in IIP dipped sharply in the month of March



Source:MOSPI

3. Inflation and monetary policy

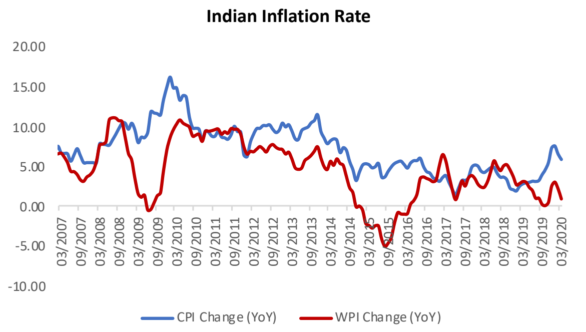
As we have been highlighting, Inflation (or lack of it) will be one positive thing to come out of this crisis. While the developed economies are grappling with deflation possibilities, we in India do not face such problems. A deflationary world would mean a benign (and positive) inflation in India.

That is good as it allows much more headroom for the RBI to ease and keep the real rates low to kick start the economy. RBI reduced the policy rate by further 40 bps in the month of May along with slew of other liquidity measures.

We note that headline inflation numbers (CPI and WPI) were not published in the month of April as the agency was not able to complete the necessary survey work due to the lockdown. While we could have seen some spike in food prices owing to disruption in supply chain, we believe that the shock was temporary, and inflation is likely to be muted in coming few months.

Commodities and oil were up sharply in the month of May (Exhibit 36 and 37). This sharp rebound has fueled a reflation narrative which in turn has further boosted stock prices. We however still believe that the reflation is the lesser probability scenario and the bounce off the lows is simply a reflection of reopening demand anticipation. We don't anticipate a sharp spike in both oil and commodities to spark serious inflationary concerns. Just to put the numbers in perspective, commodity index is still down 23% from a year ago and down 28% YTD. Similarly, oil is still down 39% from a year ago and down 39% YTD.

Exhibit 35: Both retail and wholesale inflation cooled off in March 2020

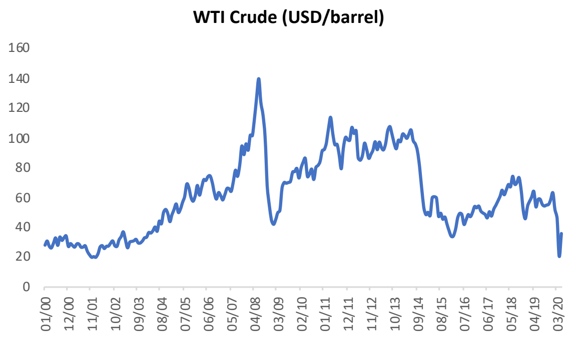


Source: CEIC, Finpeg Research

Exhibit 36: Commodity index was up 21% in the month of May

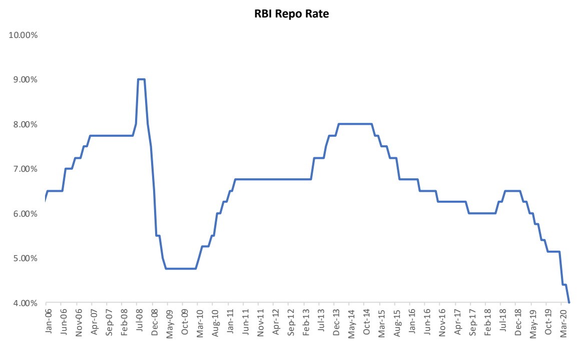
Source: Bloomberg

Exhibit 37: WTI crude was up 77% in the month of May on back of reopening demand



Source: MacroTrends, Finpeg Research

Exhibit 38: Repo rate stands at 4%, lowest in last 15 years



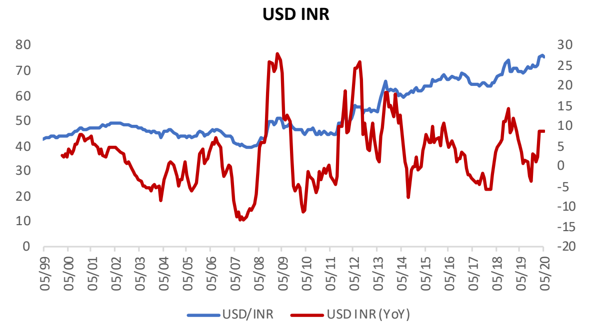
Source: Reserve Bank of India

4. Exchange Rate – Stable during the month

INR was stable in month of May (slight appreciation) as risk-on mode returned in the market and FII outflow reversed. As we have noted earlier, there is a strong negative correlation of NIFTY movement with INR deprecation in the short term (owing to FII flows).

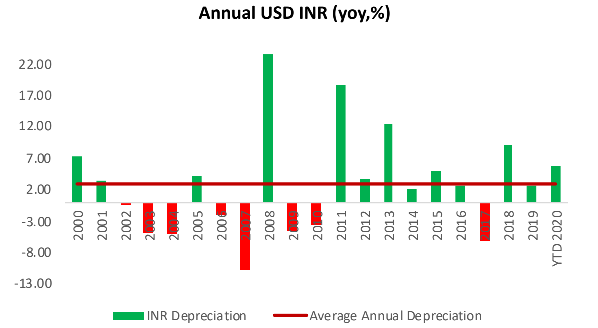
Roughly at the time markets bottomed (23rd March), INR had depreciated by almost 7% before bouncing back as stock markets also rallied. This simply shows how INR, in the short term, is driven by portfolio flows.

Exhibit 39: Rupee was stable against the USD in May



Source: MacroTrends, Finpeg Research

Exhibit 40: Rupee has been depreciated by 5.8% YTD in 2020



Source: MacroTrends, Finpeg Research

Table 3: INR against major currencies (% change, positive number is depreciation)

Currency	1 Month	1 Year
Euro (EUR)	2.88	8.41
Canadian Dollar (CAD)	3.81	8.20
Australian Dollar (AUD)	7.10	7.66
British Pound (GBP)	0.77	7.95
Singapore Dollar (SGP)	0.93	6.54
Japanese Yen (JPY)	-2.15	8.64
Indonesian Rupiah (IDR)	6.00	8.16
Korean Won (KOW)	0.00	5.80
Thai Baht (THB)	2.46	8.34
Hong Kong Dollar (HKD)	-0.11	10.41
Chinese Yuan (CNY)	-0.70	6.13
Brazilian Real (BRL)	7.05	-19.00

Source: Economic Times

Global Markets – As if nothing ever happened

1. Global Equity Markets

May was relatively subdued for the markets as compared to April where stocks rebounded sharply after the COVID-19 crash. Even then, most of the indices continued their rally and posted handsome gains during the month. The rally got more pronounced in the last week of May when most of the emerging markets also joined the party.

US benchmark index S&P 500 was up 4.53% in May and is down only 6.5% YTD. In fact, the bounce back was so pronounced that the US tech index NASDAQ is up for 2020 (up 4.4% YTD as of 31st May). At the time of writing this, S&P 500 is down just 8.1% from its peak in February.

As discussed earlier, the rally has been primarily driven by a whatever-it-takes stance by the Central Banks. Plus, there is a hope of a V-shaped recovery as economies begin to reopen again.

We however have turned cautious. In our view market is pricing "perfection" and no negative news seems to bother the markets. Markets are behaving as if nothing ever happened in 2020. This calls for caution.

We believe that markets are ignoring (1) already elevated valuation levels as discussed in our cover story, (2) potential wave of bankruptcies and defaults that is likely to follow in coming months and (3) a second wave of COVID-19.

Table 4: Performance of major indices across the world

Indices	1M	3M	6M	12M	YTD
S&P 500	4.53%	3.05%	-3.08%	9.39%	-6.55%
Nasdaq	6.75%	10.77%	9.51%	25.74%	4.37%
Russel 2000	6.36%	-5.58%	-14.19%	-6.44%	-16.36%
FTSE	2.97%	-7.66%	-17.29%	-15.43%	-20.09%
DAX	6.68%	-6.31%	-12.46%	-2.12%	-13.44%
Stoxx 600	3.04%	-6.73%	-14.01%	-5.44%	-16.53%
Nikkei 225	8.34%	3.48%	-6.08%	4.47%	-7.52%
Shanghai Composite	-0.27%	-4.70%	-0.68%	-1.84%	-7.55%
Hang Seng	-6.83%	-12.13%	-12.85%	-15.69%	-19.56%
NIFTY	-2.84%	-14.47%	-20.54%	-19.65%	-21.36%

Source: Bloomberg, Finpeg Research

2. Global Debt Markets

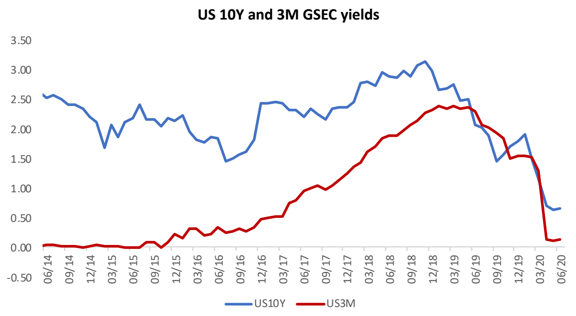
Bond markets took an opposite turn in the last week of May as yields started rising. US 10-year yields were up by 2 bps in the month of May. But this hides the true picture. In the first week of June, the yields have shot up 19 bps (at the time of writing this report).

German yields were up 14 bps during the month and has further increased by 10 bps in the first few days of June. Same is true for Japanese yields.

Rising yields have fueled a reflation narrative and has added further leg to the stock market rally. Last week of May and first few days of June can truly be classified as a comeback of full risk-on mode as markets anticipate recovery and reflation. Bond yields have risen, commodities have rallied, dollar has weakened, cyclical stocks have rallied, EMs have rallied, and credit spreads have narrowed – in short, risk on is back!

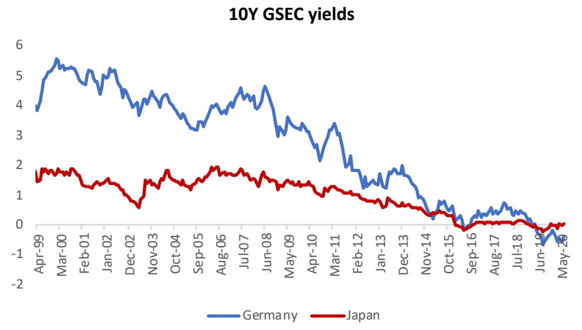
Nothing illustrates the return of risk on mode better than the collapse in corporate bond spread in US. As US Fed backstopped the corporate bond market, there has been a surge of inflow into high yield market as well as a surge in new debt issuance. High yield spread has dropped to 6.18% from highs of 10.87% seen in March (Exhibit 44).

Exhibit 41: US 10-year yields increased slightly in the month of May



Source: Bloomberg

Exhibit 42: German 10Y GSEC yields increased in the month of March.

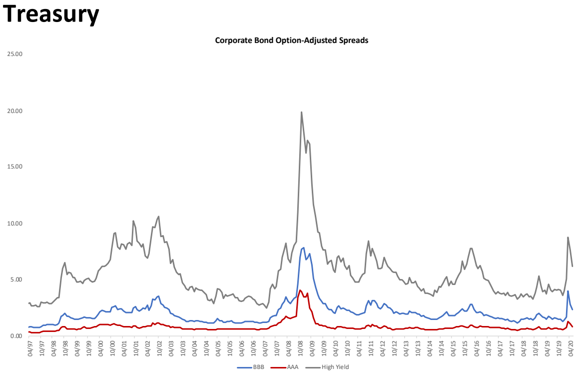


Source: Bloomberg

Exhibit 43: Bond volatility is inching up again as yields start to rise

Source: Google

Exhibit 44: Corporate Bond Spread in US over 10Y Treasury



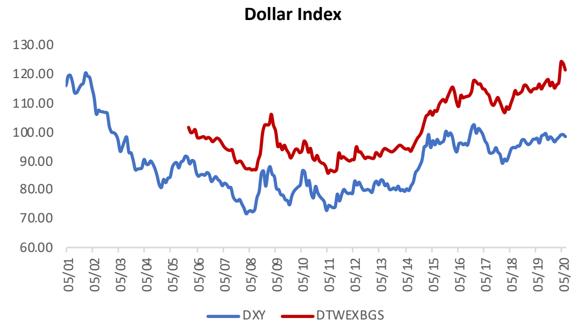
Source: FRED

3. Dollar and Gold

Further evidence of the risk on mode is available in the weakening of dollar. DXY was down by 0.7% in the month of May. But that was just a start of a further slide. In June DXY has further weakened by 0.8%. Weakening dollar is yet another signal of reflation narrative taking hold.

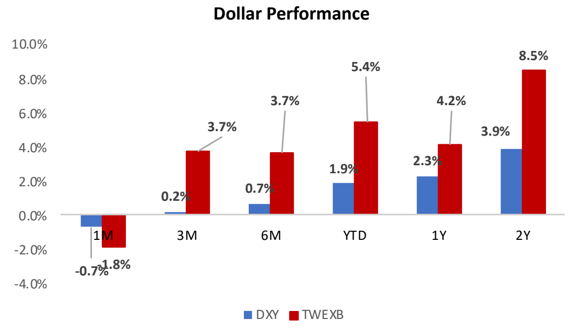
It should be noted that in general, strong dollar is not good for stock markets (including the US stock markets). Historically, a weakening dollar is generally associated with strong rallies, especially in the emerging market stocks.

Exhibit 45: Dollar index (DXY) fell by 0.7% in May and Trade weighted index fell by 1.8%



Source: FRED, Bloomberg

Exhibit 46: Dollar has increased much more on a trade weighted basis



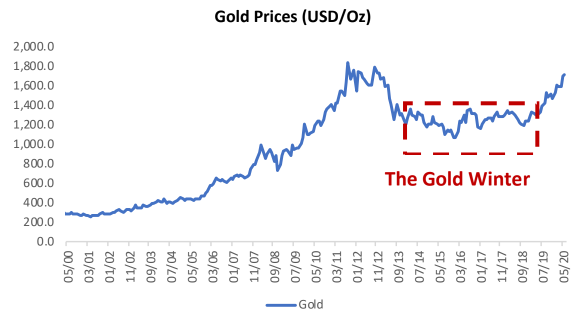
Source: Bloomberg

Gold remains range bound in May

Gold seems to have disappointed both the bears and the bulls as it remained range bound during the month of May. While April was a great month for Gold (up 7%), Gold was almost flat during the month of May. In the process, Gold has disappointed the Gold bugs who have been waiting for a break-out in Gold prices on back of unprecedented monetary debasement. At the same time, those hoping for a correction on back of rising real rates have also been disappointed. However, first few of days of June have seen pries fall below USD 1700 levels indicating that rising real yields have started to weigh in on Gold price.

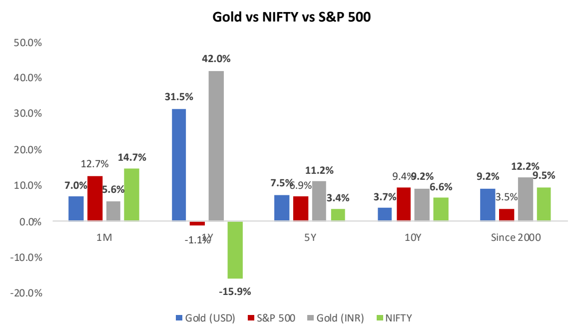
We at Finpeg, remain bullish on gold from a medium-term perspective. In our view, rampant printing of USD (as well as other major currencies) by Central Banks will eventually make gold very attractive w.r.t fiat currencies.

Exhibit 47: Gold has finally woken up from its long winter slumber



Source: Goldprice.org

Exhibit 48: Gold has been the best performing asset class since 2000 both in INR and USD terms



Source: Investing.com

Global Macro

1. Global Macro Snapshot

Table 5: Overview of major and emerging economies

	US	Germany	Japan	UK	Euro
GDP (latest)	-5.00%	-2.30%	-2.00%	-1.60%	-3.80%
Inflation (latest)	0.30%	0.60%	0.10%	0.80%	0.10%
10Y Gsec (latest)	0.66%	-0.35%	0.04%	0.28%	0.22%
Central Bank Rates (latest)	0.25%	0.00%	-0.10%	0.10%	0.00%

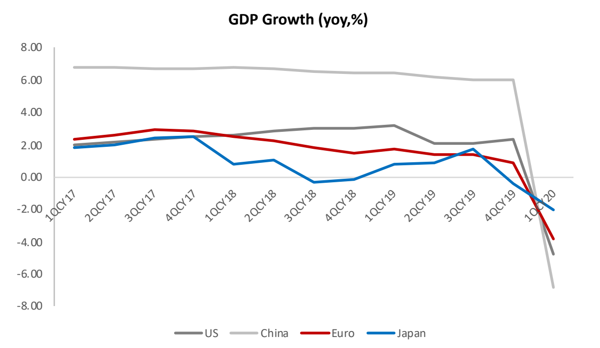
	China	Indonesia	Brazil
GDP (latest)	-6.80%	2.97%	-0.30%
Inflation (latest)	3.30%	2.19%	2.40%
10Y Gsec (latest)	2.84%	7.03%	6.71%
Central Bank Rates (latest)	3.85%	4.50%	3.00%

As can be seen from the table above, the world has slipped into a recession. Most of the developed economies contracted in the quarter ending 31st March and the current quarter will be much worse as the full impact of lockdown starts taking effect.

Exhibit 50-53 show Manufacturing PMIs for US, Eurozone and China respectively for the month of May. While the PMIs show a recovery from absolute bottom in April, it should be noted that it is an illusory recovery. In fact, activity in May contracted as compared to April, albeit at a slower rate. Therefore, in all sense, May was actually worse than April.

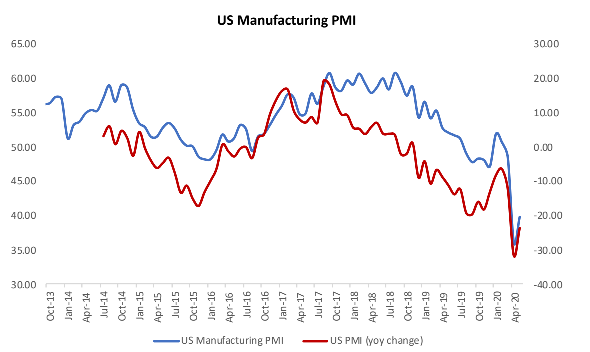
Let's focus a bit more on Chinese PMI numbers (Exhibit 52). Since falling to 40.3 in February, the PMI has been around 50 indicating minor month-on-month improvement. While the chart might look like a V-shaped recovery, the fact is that Chinese activity is almost at the same level as it was in February since PMI around 50 indicates same level of activity as previous month.

Exhibit 49: All major developed economies slipped into recession in 1QCY20



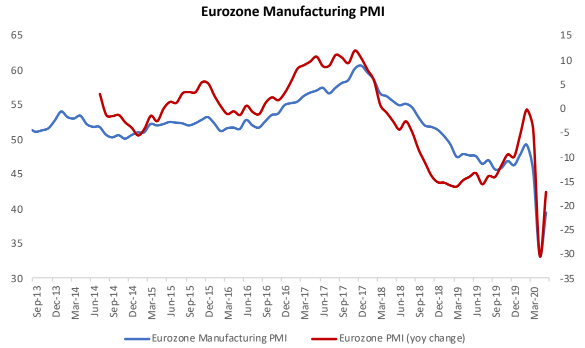
Source: TradingEconomics

Exhibit 50: US manufacturing PMI increased to 39.8 in May



Source: Investing.com

Exhibit 51: Eurozone PMI increased to 39.5 in the month of May



Source: Investing.com

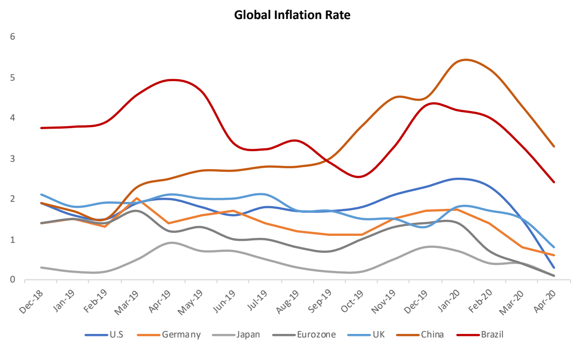
Exhibit 52: Chinese manufacturing PMI was 50.7 in May indicating muted expansion

Source: Investing.com

Inflation slowing but recent spike in bond yields and commodity prices indicate expectation of reflation

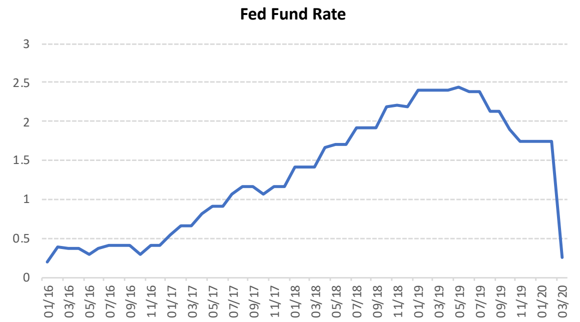
As we have been highlighting, we expected a significant moderation in inflation and that seems to be playing out (Exhibit 53). However, a recent spike in bond yields and a sharp rally in commodities indicate that market is expecting reflation (return of inflation) and is looking beyond near-term deflation worries. If we look at 5-year breakeven inflation in US (Exhibit 55), it has been inching up showing markets increasing conviction about a reflation. 5-year breakeven inflation essentially tells us the market expectation of inflation in next 5 years.

Exhibit 53: Inflation inching down globally as oil and commodity prices crash



Source: Investing.com

Exhibit 54: US Fed brought the rates down by 150 bps in 2 back-to-back emergency cuts



Source: Bloomberg

Exhibit 55: 5-year inflation expectation has been inching up

Source: FRED

Exhibit 56: 5-year 5-year forward inflation expectation also inching up

Source: Bloomberg

Performance Data

1. Best performing Equity Mutual Funds in May 2020

Best Large Cap Funds	1M	YTD	1Y
Franklin India Bluechip Fund	2.88%	-18.12%	-19.26%
ICICI Pru Bluechip Fund	2.37%	-19.91%	-16.95%
SBI BlueChip Fund	0.91%	-20.57%	-18.30%

Best Multi Cap Funds	1M	YTD	1Y
Parag Parikh Long Term Equity Fund	7.21%	-6.20%	0.24%
Franklin India Equity Fund	3.31%	-19.49%	-20.95%
DHFL Pramerica Diversified Equity Fund	3.27%	-10.00%	-10.78%

Best Mid Cap Funds	1M	YTD	1Y
UTI Mid Cap Fund	1.63%	-14.75%	-14.86%
Baroda Mid-cap Fund	1.30%	-11.36%	-14.57%
IDBI Midcap Fund	1.29%	-16.86%	-18.66%

Best Small Cap Funds	1M	YTD	1Y
HSBC Small Cap Equity Fund	2.49%	-20.39%	-30.42%
L&T Emerging Businesses Fund	-0.49%	-28.05%	-32.26%
Aditya Birla SL Small Cap Fund	-1.18%	-29.44%	-37.35%

Best Large & Mid Cap Fund	1M	YTD	1Y
UTI Core Equity Fund	2.06%	-21.62%	-22.84%
ICICI Pru Large & Mid Cap Fund	2.06%	-22.11%	-21.07%
Essel Large & Midcap Fund	0.90%	-22.01%	-22.01%

Best Focused Fund	1M	YTD	1Y
ICICI Pru Focused Equity Fund	6.72%	-8.46%	-12.57%
Franklin India Focused Equity Fund	1.57%	-21.49%	-24.37%
IDFC Focused Equity Fund	1.28%	-17.65%	-16.01%

Best ELSS Fund	1M	YTD	1Y
ICICI Pru LT Equity Fund	3.12%	-20.93%	-19.15%
Quantum Tax Saving Fund	1.89%	-21.54%	-25.52%
Franklin India Taxshield	1.26%	-23.96%	-25.06%

2. Best and worst performing NIFTY stocks in May 2020

Top-10 NIFTY stocks	**1M**	**YTD**	**1Y**
Bharti Infratel Ltd.	28.4%	-12.0%	-16.7%
Mahindra & Mahindra Ltd.	20.1%	-17.9%	-32.6%
Adani Ports and Special Economic Zone Ltd.	14.4%	-12.1%	-21.9%
Grasim Industries Ltd.	14.2%	-22.4%	-35.6%
Zee Entertainment Enterprises Ltd.	13.4%	-37.4%	-49.7%
Eicher Motors Ltd.	10.4%	-26.5%	-18.6%
Bharti Airtel Ltd.	9.4%	24.1%	59.5%
UltraTech Cement Ltd.	7.8%	-6.3%	-20.0%
Cipla Ltd.	6.6%	32.0%	10.6%
Hindalco Industries Ltd.	6.3%	-35.4%	-30.6%

Bottom-10 NIFTY stocks	**1M**	**YTD**	**1Y**
IndusInd Bank Ltd.	-17.4%	-73.9%	-76.7%
State Bank of India	-17.0%	-52.7%	-55.5%
Bajaj Finserv Ltd.	-16.0%	-54.3%	-48.7%
Bajaj Finance Ltd.	-16.0%	-54.0%	-44.5%
HDFC Ltd	-15.3%	-33.3%	-27.2%
ICICI Bank Ltd.	-14.0%	-39.1%	-22.7%
Axis Bank Ltd.	-12.1%	-47.8%	-51.9%
Bharat Petroleum Corporation Ltd.	-11.8%	-33.6%	-21.7%
Coal India Ltd.	-9.8%	-36.8%	-48.7%
Kotak Mahindra Bank Ltd.	-9.4%	-26.6%	-19.7%

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