The Alpha Investor

Issue #8, June 2020

Markets are pricing in perfection

INSIDE THIS ISSUE

1. Cover Story
2. Indian Markets
3. Indian Macro
4. Global Markets
5. Global Macro
6. Performance Data

Dear Investor,

The theme of this month's issue is how markets are pricing in a near perfect scenario with absolutely no margin for error.

We analyze how stock markets have completely dislocated from underlying economic reality. 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 bearish as we believe that risk-reward ratio is not at all favorable for equities at this point of time.

Happy reading!

Shubham Satyarth

Co-founder, Finpeg

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What's Inside?

MARKETS ARE PRICING IN PERFECTION.......... - 3 -

WHAT'S DRIVING THIS GRAVITY-DEFYING RALLY?.......... - 3 -
VALUATIONS ABOVE JAN 2020 LEVELS.......... - 4 -
IT'S NOT GOING TO BE A V.......... - 5 -
DIMINISHING MARGINAL ABILITY OF THE FED.......... - 7 -
MARKETS ARE IGNORING THE GEOPOLITICAL RISKS.......... - 8 -
AND FINALLY, THE ELEPHANT IN THE ROOM – COVID-19 HAS NOT GONE ANYWHERE. IN FACT, CASES ARE SURGING.......... - 8 -
PORTFOLIO AND ASSET ALLOCATION.......... - 9 -

INDIAN MARKETS – 20% UP FOR THE QUARTER!.......... - 10 -

1. EQUITY MARKET WRAP FOR THE MONTH.......... - 10 -
2. EQUITY MARKET VALUATIONS.......... - 12 -
3. DEBT MARKET WRAP FOR THE MONTH.......... - 13 -
4. WHAT IS THE "SMART" MONEY DOING?.......... - 14 -

ECONOMY – SOME REBOUND BUT A LONG ROAD AHEAD.......... - 15 -

1. SUMMARY AND OUTLOOK.......... - 15 -
2. GDP AND THE ECONOMY.......... - 16 -
3. INFLATION AND MONETARY POLICY.......... - 17 -
4. EXCHANGE RATE – STABLE DURING THE MONTH.......... - 18 -

GLOBAL MARKETS – THE PARTY CONTINUES!.......... - 19 -

1. GLOBAL EQUITY MARKETS.......... - 19 -
2. GLOBAL DEBT MARKETS.......... - 20 -
3. DOLLAR AND GOLD.......... - 21 -

GLOBAL MACRO.......... - 22 -

1. GLOBAL MACRO SNAPSHOT.......... - 22 -

PERFORMANCE DATA.......... - 24 -

1. BEST PERFORMING EQUITY MUTUAL FUNDS IN JUNE 2020.......... - 24 -

Markets are pricing in perfection

Indian stock market (along with the rest of the world) has had a breath-taking rally since it bottomed out on March 23rd. Since then, NIFTY 50 has rallied a whopping 35.4% (as of 30th June close) and is down just 16% from the peak (on 14th Jan 2020). US markets (not surprisingly) have performed even better. S&P 500 has rallied 38.6% from the lows of March 23rd and is just down 8.4% from its all-time high.

And all this has happened when we are still in the middle of probably the worst economic shock in living memory and the COVID-19 pandemic has anything but come under control. This makes no sense at all. Equity markets at this stage are completely disconnected from what's happening in the real economy.

What's driving this gravity-defying rally?

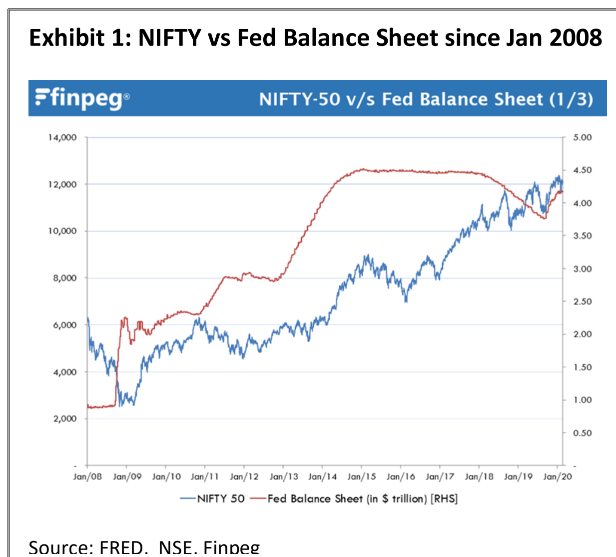
We have covered this a number of times in our Alpha Investor series. It's the Fed. Or more generally, an overwhelming injection of liquidity (money) by global central banks.

Readers would remember how the humongous amount of money printing that the Fed did in the aftermath of the 2008 crash helped increase liquidity in the global financial system dramatically and ultimately all that liquidity found its way into stocks, which in turn helped NOT just stall the downward spiral in equity markets in 2008-09 but helped equity market rebound back by new all-time highs by 2014-15.

Pretty much what is happening again in 2020.

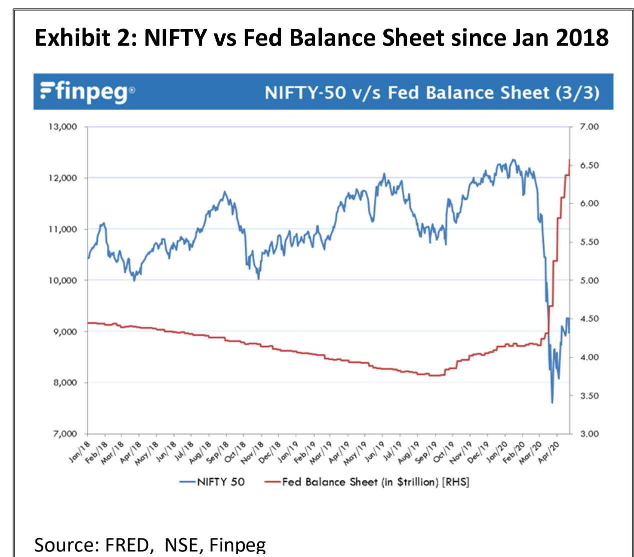
Below is the chart of NIFTY compared against Fed Balance Sheet (a proxy for liquidity injection):

Exhibit 1: NIFTY vs Fed Balance Sheet since Jan 2008



Source: FRED, NSE, Finpeg

Exhibit 2: NIFTY vs Fed Balance Sheet since Jan 2018



Source: FRED, NSE, Finpeg

As you can see, the red line (Fed balance sheet) has gone up from under $4.1 trillion in Feb 2020 to over $7 trillion by June 2020. That's more than $2.9 trillion in just the last 4 months. I will let that sink in – in the last cycle, the Fed printed $3.7 trillion over 6 years between 2009 and 2015. In this cycle, they have already printed $2.9 trillion+ in just 4 months, and they are NOT done yet.

That's the scale of money printing that is happening… and this extraordinary scale of liquidity addition is what has driven the rebound you see in the blue line above (NIFTY) since March.

But is this sustainable? Can Fed continue to print trillions of dollars to just keep the markets propped up? We really don't think so. And that's why, we believe that there is a high likelihood of the recent strength in global equities fizzling out soon and equity markets, in fact, starting a second leg down from here.

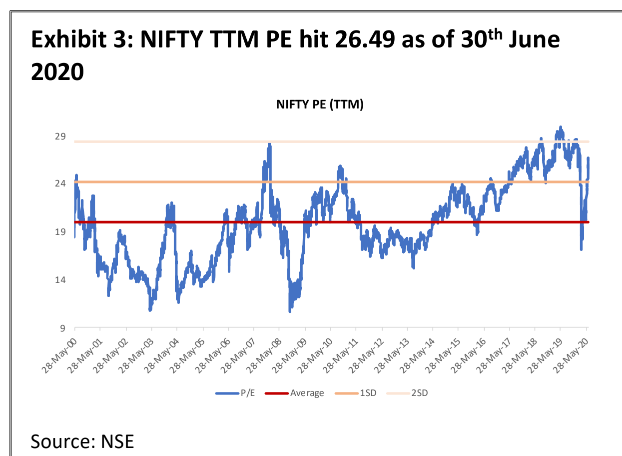
Another reason for this rally has been the optimism around the reopening of the economies. A sharp rebound in May economic numbers (compared to April) has fuelled what can only be termed as "reopening euphoria". As we will later argue, this is just an illusion and there won't be a V-shaped recovery.

Below, we will present arguments for our bearish stance.

Valuations above Jan 2020 levels

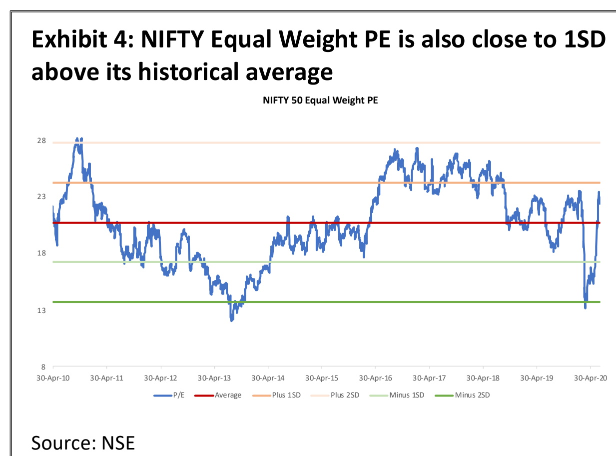
Yes. You read that right. NIFTY PE (as on 30th June close), was 26.49 (see chart below).

Exhibit 3: NIFTY TTM PE hit 26.49 as of 30th June 2020



Source: NSE

Exhibit 4: NIFTY Equal Weight PE is also close to 1SD above its historical average



Source: NSE

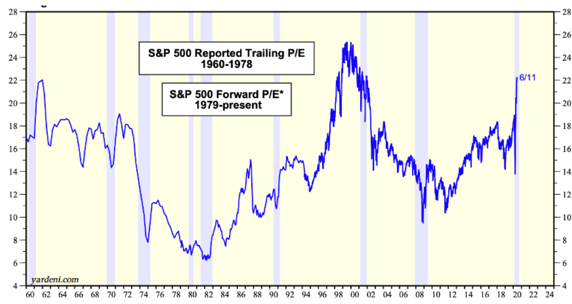
Now, even without any adjustment, this is **1.5 standard deviation** above historical average PE (around 20) and is above **91st percentile**. But this is just half of the story. Do remember that these are trailing PE numbers (includes earnings up to recently concluded March quarter). While we are not a big fan of forward multiples (owing to invariable error in forward EPS forecasts), what we know for sure is that FY21 NIFTY EPS will be way below FY20 EPS.

Assuming an extremely optimistic scenario of just 10% EPS shrinkage in FY21, we are talking about PE of 29.4. A 20% EPS shrinkage would imply a PE of 33.1 (the highest valuation NIFTY has EVER seen).

To give you a perspective of possible EPS carnage in FY21, let's recall what happened in 2008-09. While going into the crisis, analysts estimated flat EPS in FY09. However, actual EPS ended up 15% lower than FY08. **And FY21 should be much worse than FY09**.

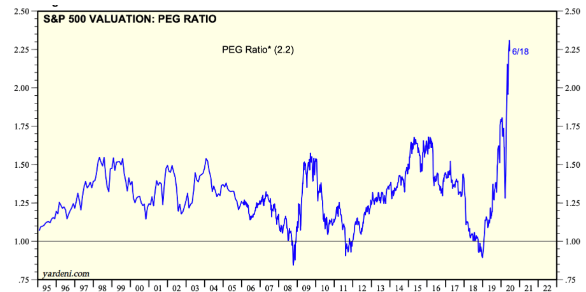
And if India is overvalued, US is clearly in a bubble zone. See charts below. S&P 500 1-year forward PE is just second to levels seen during dot-com bubble. In terms of PEG ratio, the valuations are highest they have ever been. Do remember, if US corrects (or crashes), India will follow.

Exhibit 5: S&P 500 forward PE ratio is at levels only seen during dot com bubble



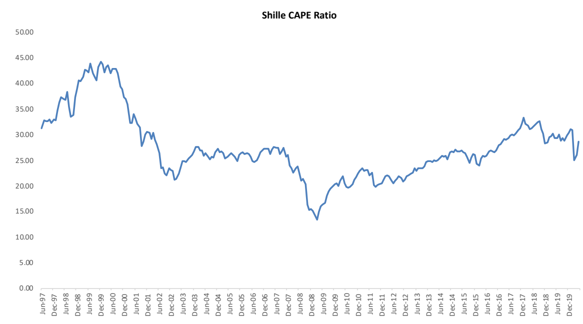
Source: Yardeni Research Inc

Exhibit 6: S&P 500 forward PEG ratio is the highest it has ever been



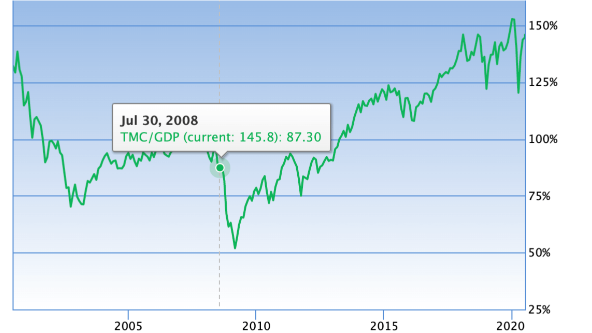
Source: Yardeni Research Inc

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

It’s not going to be a V

As highlighted above, markets are under a spell of “reopening euphoria”. As economies unlock, data for May and June has shown a sharp (and expected) rebound in economic activity and unemployment. This has led investors to believe (and markets to price in) a V-shaped recovery where everything is back to Jan 2020 levels by the 3rd quarter to of this year.

We argue that this May and June rebound numbers are just that – “rebound” and carry no meaningful insights as to how the actual recovery will play out. Let’s take an example. US unemployment numbers for May posted a huge positive surprise. As against an estimated increase in unemployment by 8 million, unemployment actually decreased by 2 million (see exhibits 9 below). This was such a big positive surprise for the markets that it prompted Mr. Trump to call a press conference.3 Obviously S&P 500 was up 2.6% on that day.

Now, its key to understand here that April was the month of a complete lockdown across US. Starting May, a lot of states started reopening. So, it was obvious that most of the jobs that were lost due forced lockdown would return. In that sense, a jump in payroll numbers should not have been a surprise.

What is more important is the second chart of Initial Jobless claims. It is worth noting that just in the month of June, almost 6.5 million people have applied for initial jobless claims. Who are these people getting fired now when almost everything has reopened?

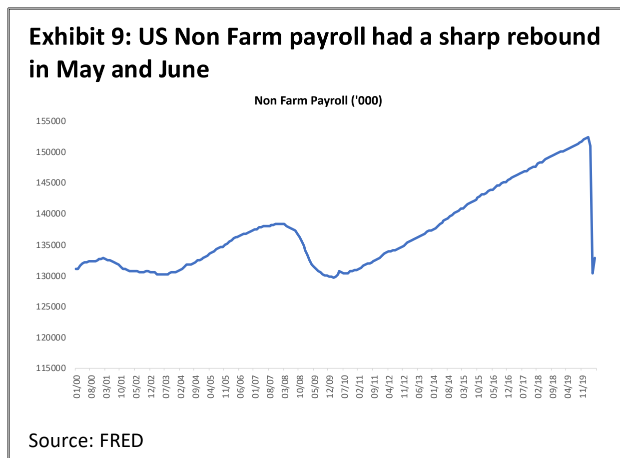
And this is not a small number. Even at the peak of 2008 crisis, weekly unemployment claims never crossed 600,000. Here we are talking about jobless claims in millions even after reopening. That is a big red flag for us.

The same story is true for India as well. Recent data by CMIE suggests that unemployment rate in India has fallen back to pre-lockdown levels of 8.5% from peak of 23.5% in April. Again, this was bound to happen as India also reopened. However, it should be noted that bulk of this fall in unemployment has been Government targeting rural unemployment through MNREGA. Urban employment (the real growth driver for the economy and corporate profits) remain elevated. And higher-value job losses are still ahead of us.

One way to determine the extent of damage is to look at the PMI numbers released for US and Eurozone capturing activity levels in June (see Exhibit 11).

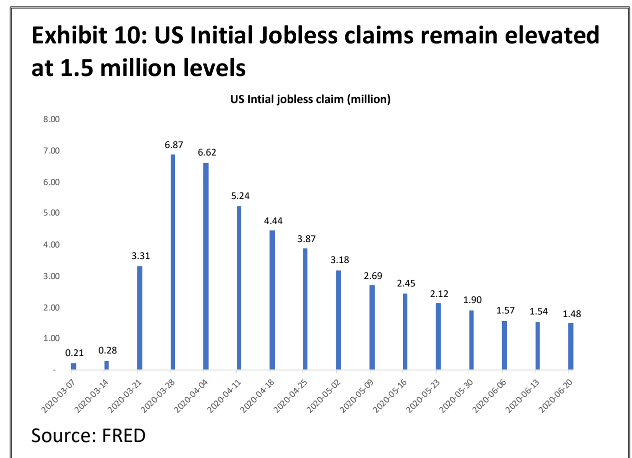
As can be seen, none of the DM economies reported PMI above 50. While the chart may look like a "V", we would like to remind that PMIs are a month-on-month diffusion index. A level below 50 indicates contraction w.r.t previous month. This implies that despite reopening, both US and Eurozone had contraction in manufacturing activity in June (from already depressed levels of April and May). Same is true for Service PMIs as well. This is pretty bad and definitely not a "V".

Exhibit 9: US Non Farm payroll had a sharp rebound in May and June



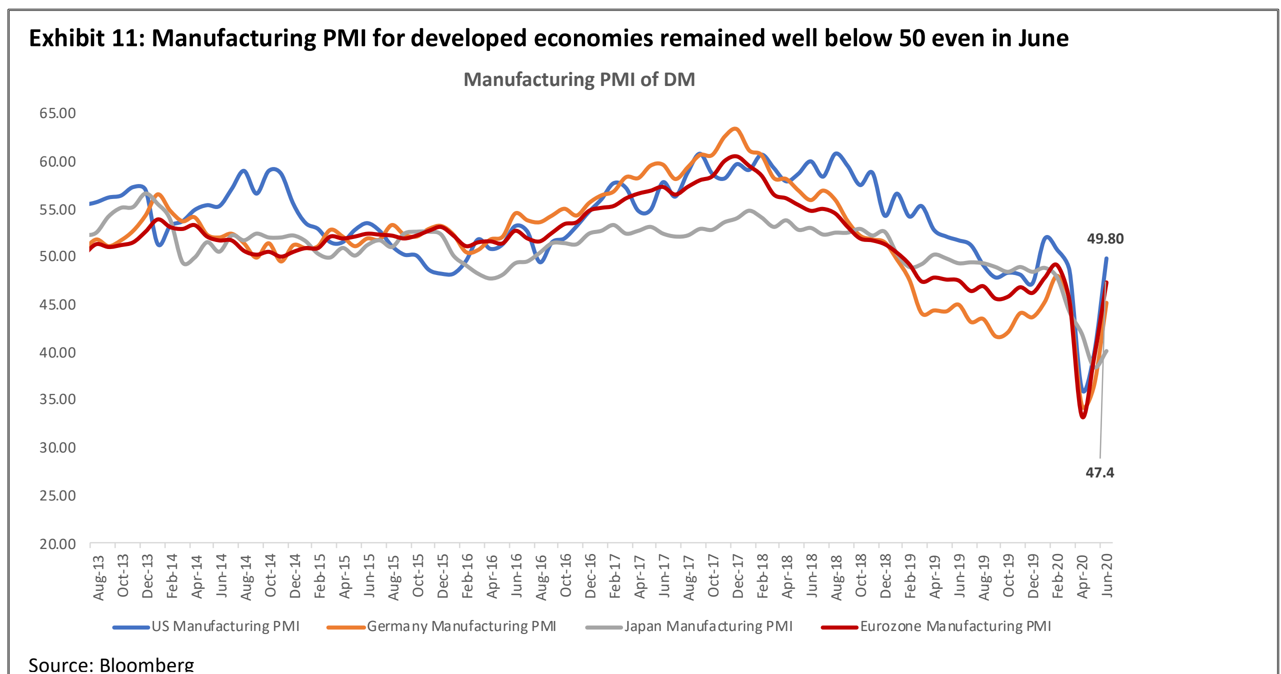
Source: FRED

Exhibit 10: US Initial Jobless claims remain elevated at 1.5 million levels



Source: FRED

Exhibit 11: Manufacturing PMI for developed economies remained well below 50 even in June



Source: Bloomberg

While some may argue that markets are forward looking and it's the rate-of-change that matters. We have a different perspective. Markets are pricing in an almost perfect "V", return of levels seen in Jan 2020 by the end of this year. In our view, that's highly unlikely to happen. A simple clue as to why this won't be a "V" lies in the fiscal and monetary responses of various countries. If this was indeed a V-shaped recovery, why are politicians talking about a second (or third) round of stimulus and why are Central Banks still pumping liquidity?

And that brings us to our next point….

Diminishing marginal ability of the Fed

Central Banks ability to prop up the markets has its limits. While we have seen unprecedented amount of fiscal and monetary stimulus, there is a clear case of diminishing ability to keep the markets propped up.

> *'Will the Fed spent trillions of dollars every year forever to support the market? Is that its role? It's not its role.' - Howard Marks*

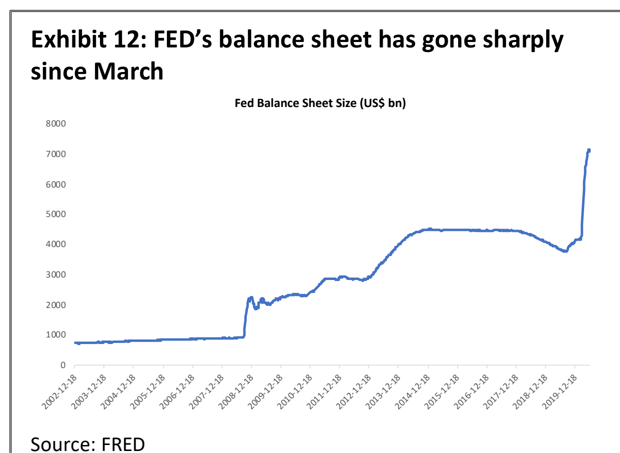
Central Banks ability to prop up the markets has its limits. While we have seen unprecedented amount of fiscal and monetary stimulus, there is a clear case of diminishing ability to keep the markets propped up.

In the last cycle, $3.7 trillion of money printing helped push up equity markets more than three times between 2009 and 2015. This time round the Fed has printed $2.5 trillion already and markets have gone up by 35%-40%. In short money printing is increasingly proving to be ineffective in propping up markets.

And that brings us to the next point of the "rate" of money printing and fiscal stimulus itself. $2.9 trillion in just 4 months along with almost $3 trillion in stimulus. Are these rates sustainable? Will fed continue to inject at the rate of $1 trillion /month. It has to start reducing sooner rather than later. How will the markets, that are completely addicted to this liquidity, react? Well, your guess is as good as mine.

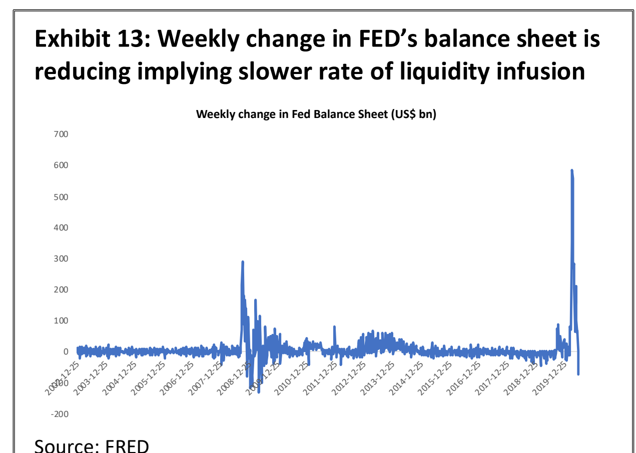
And the rate of liquidity injection is already slowing down. Look at the chart below that tracks the weekly change in Fed's balance sheet. While the balance sheet is still expanding, the rate at which it is expanding is constantly coming down. In fact, in the week ending 17th June, Fed's balance sheet actually shrunk by $ 74 bn.

Exhibit 12: FED's balance sheet has gone sharply since March



Source: FRED

Exhibit 13: Weekly change in FED's balance sheet is reducing implying slower rate of liquidity infusion



Source: FRED

Markets are ignoring the geopolitical risks

The world is on tenterhooks. Global trade is collapsing and shows absolutely no signs of revival. At the same time, tensions are flaring up everywhere. Between US and China, between EU and China and, closer home, between India and China. Then we have the race riots in USA. But markets are completely ignoring any potential impact from any of these events. As mentioned, markets are pricing in perfection and more!

And remember, this is election year in US. With every passing day, Joe Biden seems to be increasing his lead over Donald Trump. In an event that a democratic president is elected, there is a high likelihood of increase in both personal and corporate income taxes and strict regulations against share buy backs. Buy backs were one of the key reasons that kept the US markets propped up for last 3-4 years.

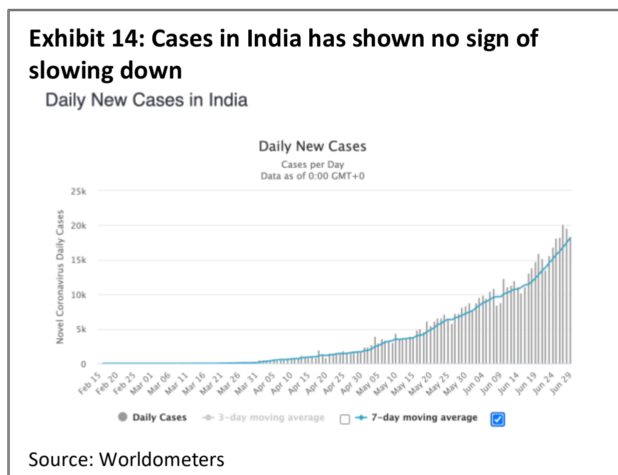
The point we are trying to make is that there is a lot of uncertainty going forward. Not just economic uncertainty but geopolitical and political uncertainty. And we believe that markets are not pricing these risks (uncertainty) at all.

And finally, the elephant in the room – COVID-19 has not gone anywhere. In fact, cases are surging.

Judging by the way markets have behaved, it would seem that COVID-19 pandemic is behind us. Truth is, it's far from over. The cases are surging, both in India and in US. Exhibits 14 and 15 below clearly shows that daily new cases are on a rise.

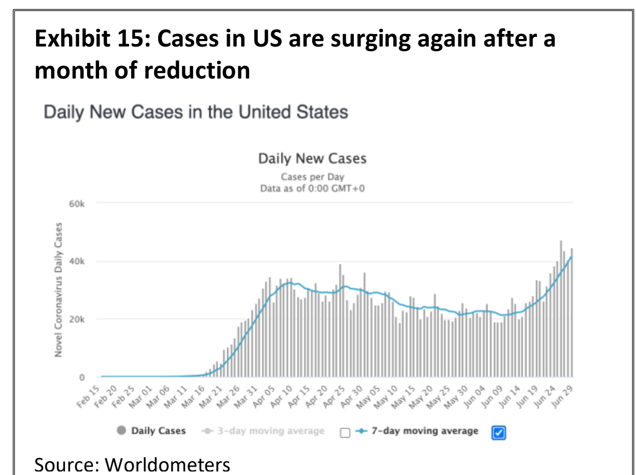
While it never came down for India, in the US, cases have started to rise again. Check out the 7-day moving average of daily cases in US. A secular uptrend. What's more worrying is that this time around, the spread is more broad based unlike March and April when NY and NJ were the epicentres.

Exhibit 14: Cases in India has shown no sign of slowing down



Source: Worldometers

Exhibit 15: Cases in US are surging again after a month of reduction



Source: Worldometers

But so far markets have clearly ignored this surge. One possible explanation is that there is an underlying assumption that there won't be a lockdown despite rise in number of cases. This might only be true to a certain extent. However, once you have your hospitals operating at 100% capacity, administration will have fairly limited options and a localised lockdown will be inevitable.

And then there is behavioural impact of rising cases. People get scared and it impacts their spending and consumption pattern. Just think about what's happening back home in India. Since 1st of June, most of the cities in India have been allowed to reopen shops and restaurants. But there is hardly any footfall. As per media reports, a lot of restaurants had to shut down again due to complete lack of demand. We should not ignore the behavioural impact of this crisis.

Plus, we have the risk of a second wave. Most of epidemiologist agree that the chances of a second wave is fairly high. Just as a reminder, Spanish Flu in 1918 came in 3 waves and the second one was the deadliest. We are already seeing instances of a second wave outbreak in places where the situation was under control:

- China had to lockdown Beijing due to a fresh outbreak
- Germany had a regional outbreak forcing it to lockdown an entire town
- UK's town Leicester has gone into a lockdown again

Simple point is that the virus has not gone anywhere and it is not going to go anywhere anytime soon. There will be waves as well as sporadic outbreaks. And till that continues, life and economic activity just CANNOT return to per-COVID levels. Also note that even a return to 90% activity levels in next 18 months is not just your average recession. It's close to a depression.

And don't be fooled by news of a potential Vaccine by the end of 2020. It's not going to happen. Vaccines, on average, take 5-6 years to hit production. And that is assuming that a Vaccine can be found. We don't have a vaccine for a lot of known viruses (including HIV). Even in the best case scenario, vaccine development and mass production is not going to happen before end of 2021. On a side note, if there is one thing that I would like to be spectacularly wrong about, this is it.

While these are the fundamental reasons for our bearish stance, a lot of technical indicators also suggest that we are not at the beginning of a new bull market. Increased retail participation (bordering on euphoria), extreme bullish option positions (determined by put-call ratio), elevated volatility levels (both SP 500 and NIFTY VIX above 30) are just things that don't happen at the start of a bull market. And we have not even covered all the possible "things that could go wrong" such as a banking crisis in EU and a pension crisis in US.

Bottomline is that there is an endless list of potential downside risk (some clearly visible and some not so much). And markets are not pricing in these risks. As a matter of fact, markets are pricing in perfection and some more.

Portfolio and asset allocation

As a Finpeg investor, you would know that our strength lies in following a dynamic algorithm-based asset allocation strategy. Our approach helped us ride out the March storm when we were 75% in cash (liquid/arbitrage funds) when NIFTY made its all-time high on 14th Jan. And when the crash started, we used this cash to buy equity funds at incredibly low prices. In fact, our last tranche of deployment happened on the day NIFTY bottomed on 23rd March.

We went overweight equities by March which allowed our investors to fully benefit from this ripping 38% rally. Patience and the ability to stick to a rule-based approach worked for us (and our investors). And we intend to continue doing that.

Indian Markets – 20% up for the quarter!

1. Equity Market wrap for the month

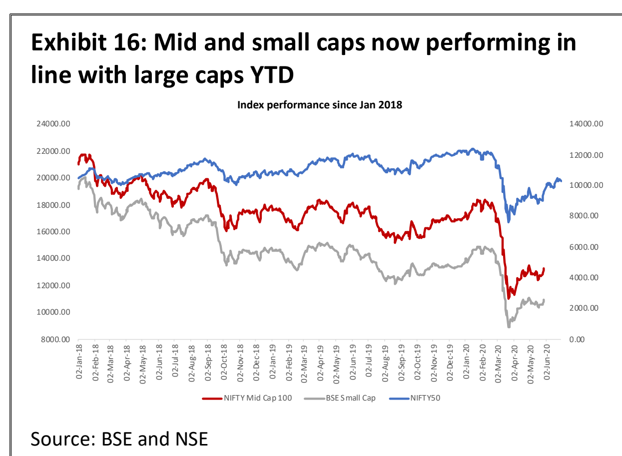
Table 1: Index Returns as of 30th June, 2020

	1 Month	3 Months	6 Months	1 Year	Year to date
NIFTY	7.53%	19.82%	-15.44%	-13.50%	-15.44%
NIFTY Mid Cap	10.78%	25.63%	-14.02%	-17.16%	-14.02%
BSE Small Cap	13.66%	28.85%	-9.63%	-13.32%	-9.63%
NIFTY Auto	8.05%	42.01%	-18.16%	-16.49%	-18.16%
NIFTY Bank	10.74%	11.63%	-33.43%	-31.69%	-33.43%
NIFTY FMCG	2.62%	10.04%	-0.57%	1.19%	-0.57%
NIFTY IT	5.31%	15.60%	-6.16%	-8.21%	-6.16%
NIFTY Pharma	2.22%	39.14%	24.08%	23.25%	24.08%
NIFTY Commodities	4.88%	24.62%	-16.81%	-21.66%	-16.81%
NIFTY Energy	10.23%	29.42%	-9.95%	-10.70%	-9.95%

A solid month across the board

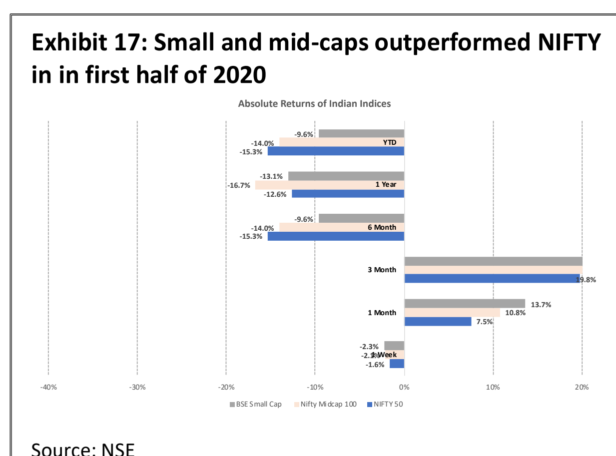
As can be seen from table above, it was a solid month across the board for Indian stocks. In fact, the beaten down sectors like Bank and Auto outperformed the broader NIFTY 50 index. Even mid and small caps outperformed large caps in the month of June. At the same time, the best performing sectors of FMCG and Pharma were relatively muted in June. If we look at first 6 months of 2020, only Pharma has been able to deliver positive returns.

Exhibit 16: Mid and small caps now performing in line with large caps YTD



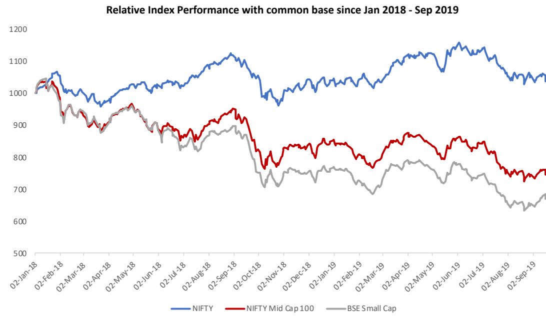
Source: BSE and NSE

Exhibit 17: Small and mid-caps outperformed NIFTY in in first half of 2020



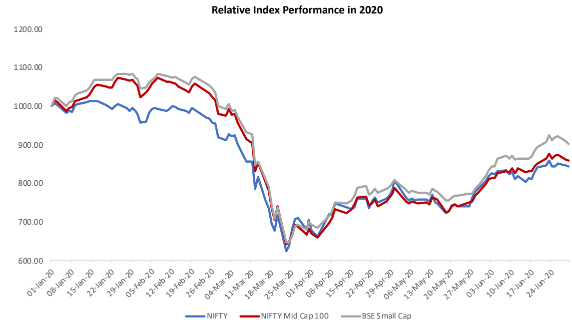
Source: NSE

Exhibit 18: Index performance with common base since Jan 2018 till Sep 2019



Source: BSE and NSE

Exhibit 19: Index performance with common base since 1st Jan 2020

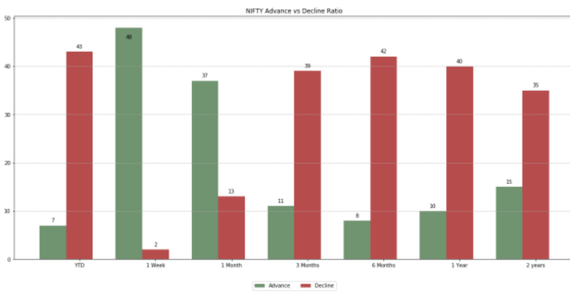


Source: BSE and NSE

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 30th June, NIFTY 50 was well above its 50 DMA and is now inching closer to its 200 DMA level (Exhibit 18).

Exhibit 20: A broad-based rally in June for NIFTY 50 stocks



Source: NSE

Exhibit 21: NIFTY well above 50 dma and inching closer to 200 dma

Source: NSE

Exhibit 22: NIFTY 50 vs percentage of stocks above their 200-day moving average

Source: NSE

Exhibit 23: 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 the end of march and early April, the current rally has ensured that valuations are now back to being expensive. NIFTY PE is back to almost 1.5 SD above its historical average. On a percentile basis, it is above 91% of all PE values historically.

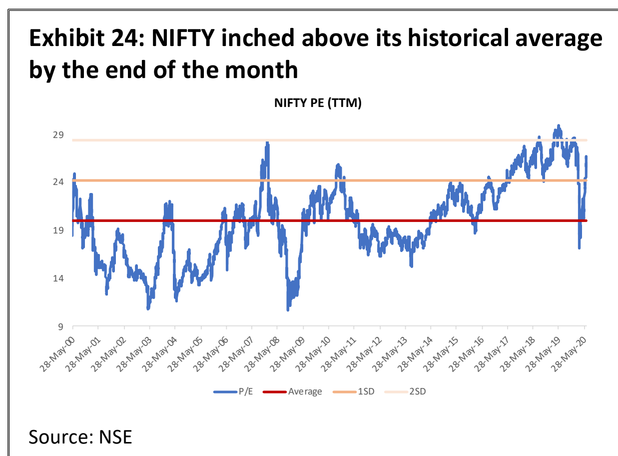
And these are unadjusted numbers. Unadjusted for EPS carnage that we will likely witness in FY21.

As highlighted in our cover section, these are trailing PE numbers (includes earnings up to recently concluded March quarter). While we are not a big fan of forward multiples (owing to invariable error in forward EPS forecasts), what we know for sure is that FY21 NIFTY EPS will be way below FY20 EPS.

Assuming an extremely optimistic scenario of just 10% EPS shrinkage in FY21, we are talking about PE of 29.4. A 20% EPS shrinkage would imply a PE of 33.1 (the highest valuation NIFTY has EVER seen).

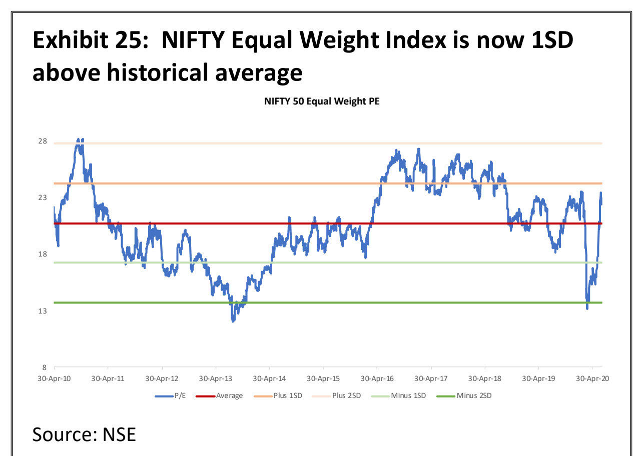
Even NIFTY Equal Weight index which was 1 SD below its historical average at the start of this month is now 1 standard deviation above its historical average (Exhibit 25). And then, if we apply our "EPS carnage" rule, even the Equal Weight index now looks extremely overvalued. Even the mid cap index has now inched above its historical average PE

Exhibit 24: NIFTY inched above its historical average by the end of the month



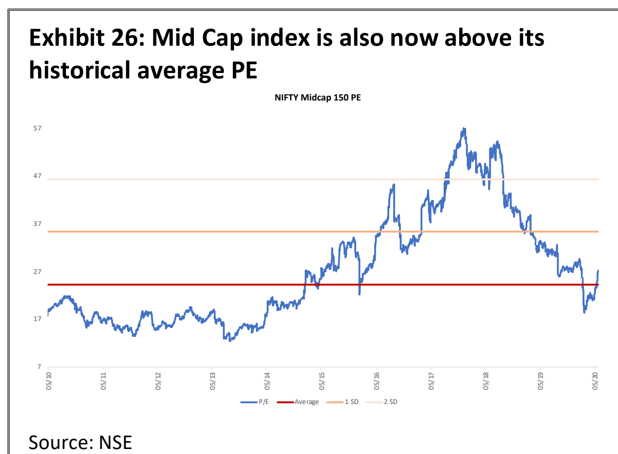
Source: NSE

Exhibit 25: NIFTY Equal Weight Index is now 1SD above historical average



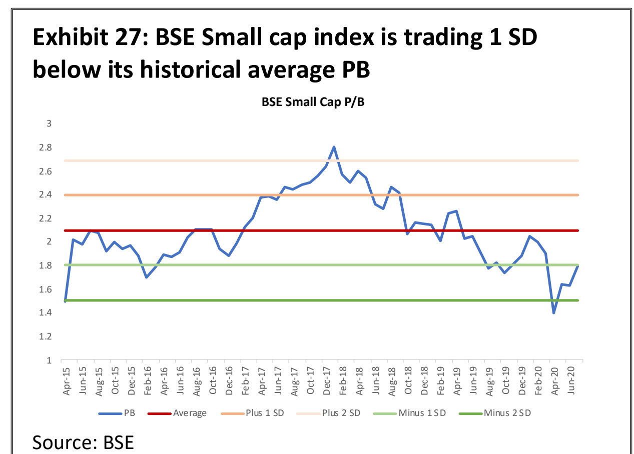
Source: NSE

Exhibit 26: Mid Cap index is also now above its historical average PE



Source: NSE

Exhibit 27: BSE Small cap index is trading 1 SD below its historical average PB



Source: BSE

3. Debt Market wrap for the month

June was a relatively muted month for bond markets as 10-year GSEC yield actually inched up by 9 bps while the 3-month bill declined 13 bps. Year-to-date, the yields have fallen by 63 bps and 189 bps (for 10-year and 3-month) making bonds one of the best performing asset class (along with gold) in the first half of 2020.

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

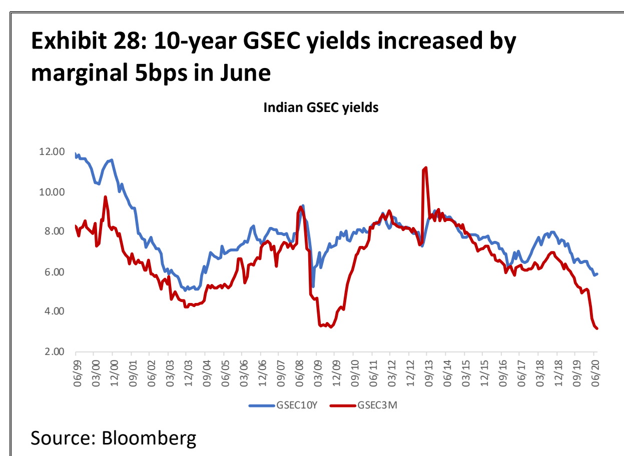
It should be noted that 10-year yields started inching up during the month of June as pressure from increased Government borrowing and sovereign downgrade weighed in on the markets. Yields spiked to a high of 6.3%. This is when RBI announced OMO and brought the yields back down to sub 6%. RBI has decided to buy longer dated securities and sell shorter dated treasuries in order to flatten the yield curve due to the reasons mentioned above.

Notwithstanding the rise in yields in June, we would like to note that bond yields have not spiked despite fiscal deficit and downgrade. This is because of the "measured" fiscal stimulus package and interventions by the RBI to keep the yields in check.

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

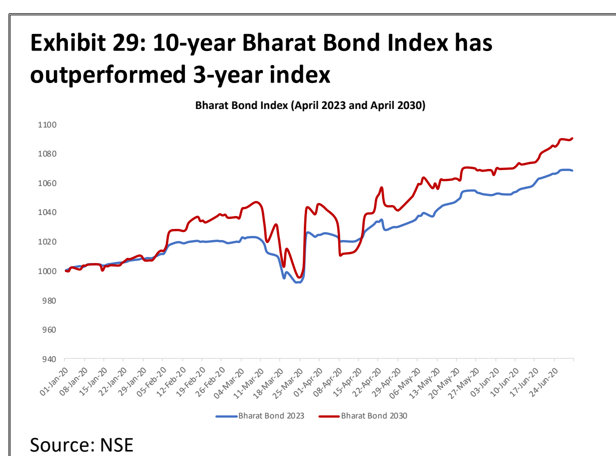
Scheme Name	1M	3M	6M	YTD	1Y
IDFC Bond Fund	1.82%	4.10%	6.29%	6.40%	11.65%
ICICI Prudential Bond Fund	1.89%	4.23%	7.21%	7.28%	13.21%
HSBC Debt Fund	1.03%	3.54%	6.35%	6.67%	10.45%
IDFC G Sec Fund	1.44%	5.61%	9.36%	10.00%	15.61%
DSP Govt Sec Fund	0.74%	4.82%	9.04%	9.55%	16.06%
Nippon India Gilt Securities Fund	1.11%	4.75%	8.02%	8.55%	13.52%

Exhibit 28: 10-year GSEC yields increased by marginal 5bps in June



Source: Bloomberg

Exhibit 29: 10-year Bharat Bond Index has outperformed 3-year index



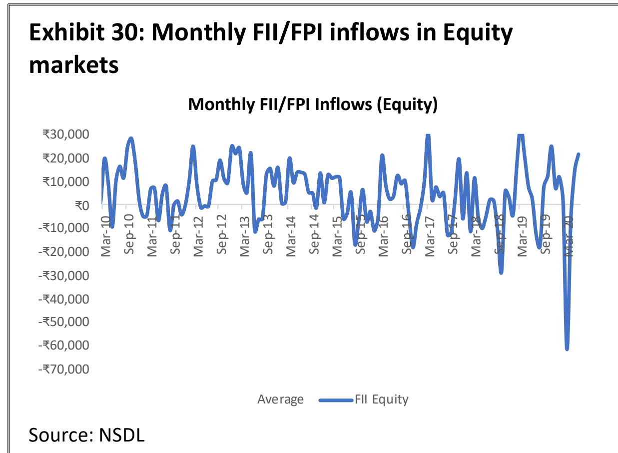
Source: NSE

4. What is the "smart" money doing?

The month of June saw big FII buying in the equity segment. FIIs bought Rs 21,832 cr in June making it the best month in 2020 and second consecutive month of above Rs 10,000 cr. FIIs continued to be net sellers in the debt segment selling Rs 1,545 cr in the month of June.

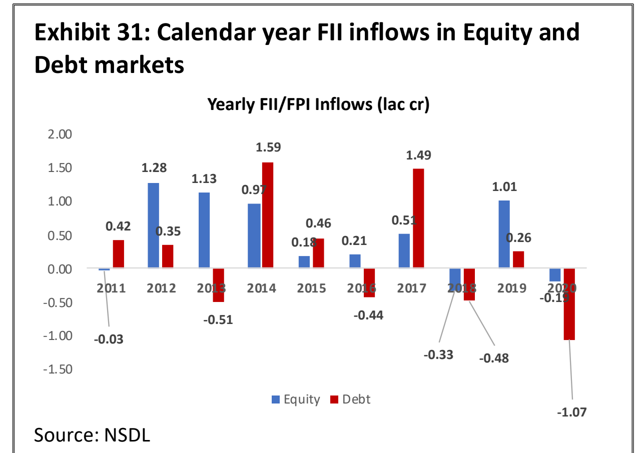
DIIs (Mutual Funds) were net sellers in Equity in June, although only marginally. DIIs sold Rs 3,690 cr (net) in June as against net buy of Rs 2,702 cr in May. DIIs were net buyers in the debt segment buying Rs 38,012 cr (net) in June.

Exhibit 30: Monthly FII/FPI inflows in Equity markets



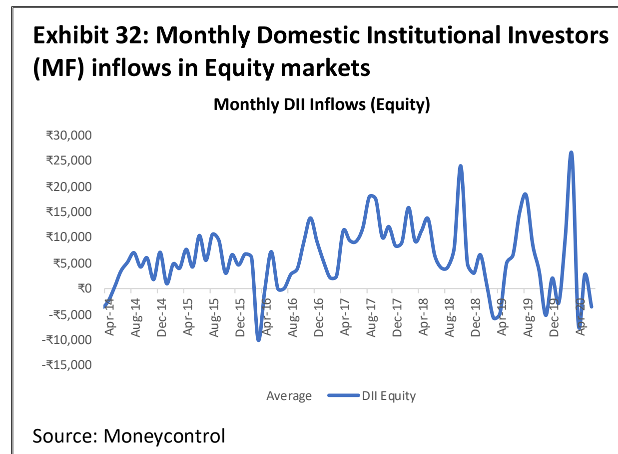
Source: NSDL

Exhibit 31: Calendar year FII inflows in Equity and Debt markets



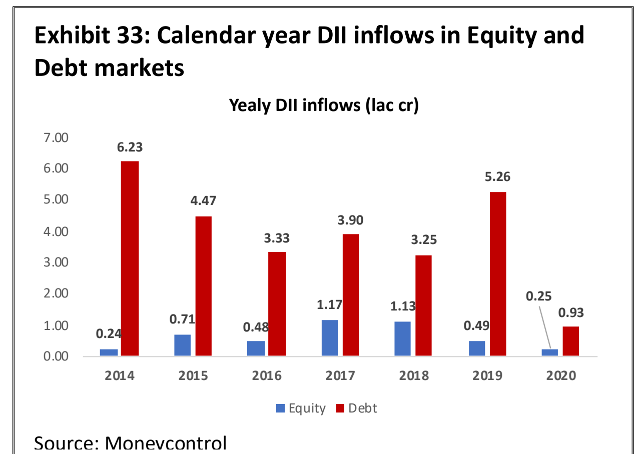
Source: NSDL

Exhibit 32: Monthly Domestic Institutional Investors (MF) inflows in Equity markets



Source: Moneycontrol

Exhibit 33: Calendar year DII inflows in Equity and Debt markets



Source: Moneycontrol

Economy – Some rebound but a long road ahead

1. Summary and Outlook

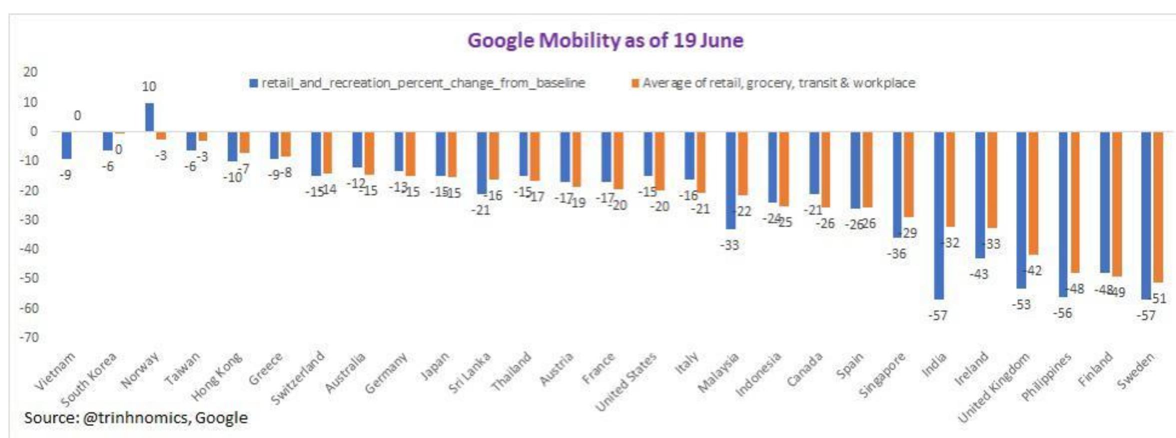
Unlock 1.0 that started in June has started to have some impact on economic activities as evidenced from rebound in sale of passenger vehicles, tractors and industrial activity. The same is corroborated by manufacturing PMI for June. Although still in contraction at 47.2, it was way above consensus.

It is also worth noting that the rural economy has rebounded much sharply than urban economy. This is primarily because of (1) Urban centers like Mumbai, Chennai and Delhi have faced the biggest brunt of the lockdowns and (2) a lot of Government stimulus effort has been directed towards rural economy. A clear indication of uptick in rural economy is a double-digit growth (yoy) in tractor sales in June.

However, the path to recovery remains a long and painful one. With COVID-19 far from being under control, we continue to see reemergence of sporadic lockdown in places like Chennai and Mumbai.

By now, even the most optimistic forecast of India's growth has turned negative for FY21. The most recent being IMF which revised its April forecast from 1.9% positive growth to negative 4.5% for FY21. And if we look at Google's mobility report (that tracks movement of people for various activities), India continues to be one of the worst impacted countries.

Exhibit 34: India remains the worst impacted when it comes to retail and recreation mobility



Source: Google, @trinhonomics

And to top all this, we now have a brewing military and trade tension with China. So, in all probability, brace for a slow and painful grind back to pre COVID-19 levels. And our thoughts on what this means for stock markets has been covered in our cover section.

However, as we keep highlighting, 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

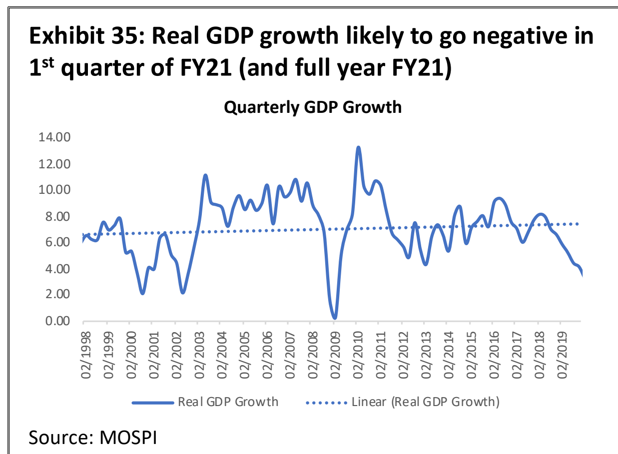
The sharp month-on-month uptick in activity was pretty much expected, to say the least, as India entered Unlock 1.0 in June. If you shut down almost the entire economic machinery for 2 months and then reopen, you are bound to get sharp rebounds. We are seeing that in US, Europe and in India as well.

However, it should be noted that our recovery is still muted when compared to economies in US and Europe. As evidenced by the Google Mobility chart (Exhibit 34) shown above, we are still lagging other countries. And this is also not a surprise. Despite, Unlock 1.0, our reopening has been patchy at best with big industrial centers still struggling to cope with surging COVID-19 cases (read Mumbai, Delhi).

International Monetary Fund (IMF) was the latest to join the bandwagon of negative growth in FY21 (almost a hard consensus now). IMF revised its April forecast from 1.9% growth to negative 4.5% for FY21.

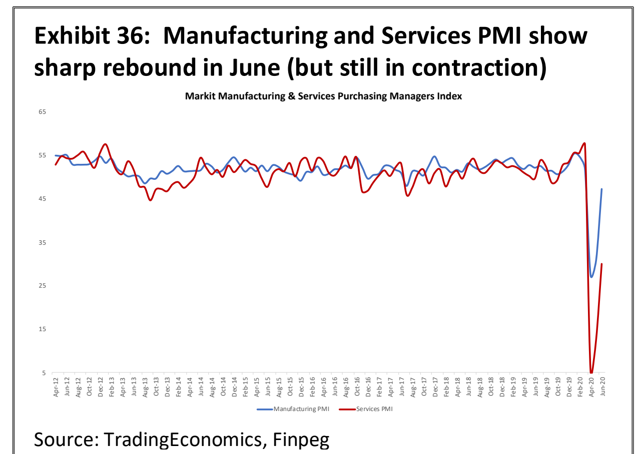
While manufacturing PMI showed a sharp (and expected) rebound in June, it still remains in contraction zone. However, there are some encouraging signs coming from our Rural Economy. Tractor sales are up year-on-year and there is a sharp uptick in rural spending. There is a growing consensus that Rural India would lead India's recovery in the post lockdown world. And this is not surprising given that the biggest disruption by COVID-19 has been seen in big urban clusters.

Exhibit 35: Real GDP growth likely to go negative in 1st quarter of FY21 (and full year FY21)



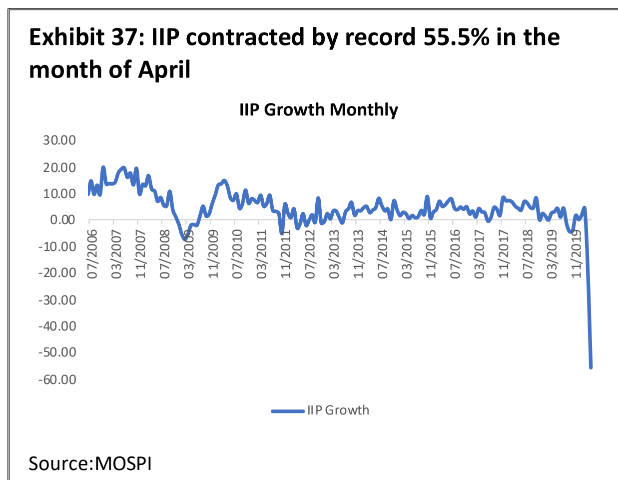
Source: MOSPI

Exhibit 36: Manufacturing and Services PMI show sharp rebound in June (but still in contraction)



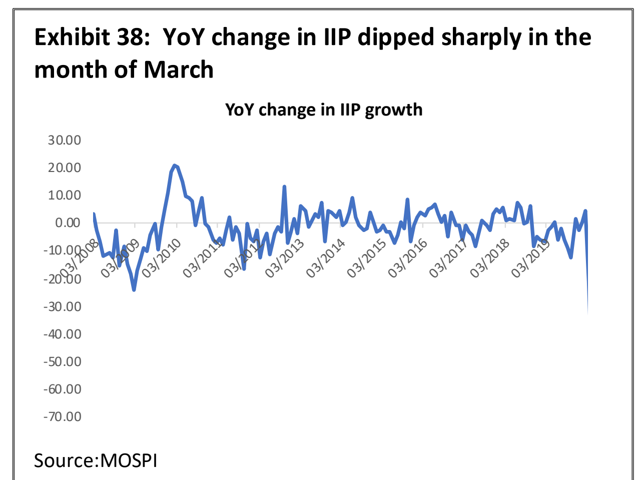
Source: TradingEconomics, Finpeg

Exhibit 37: IIP contracted by record 55.5% in the month of April



Source:MOSPI

Exhibit 38: YoY change in IIP dipped sharply in the month of March



Source:MOSPI

3. Inflation and monetary policy

We note that headline inflation numbers (CPI and WPI) were not published for the month of March and April (as well as provisional numbers for May) as the agency was not able to complete the necessary survey work due to the lockdown. However, the Government did publish certain selected portions of Inflation including food inflation. India's food prices saw a sharp acceleration of 9.28% in May due to supply chain disruption.

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.

However, there is an opposite thought process taking shape which is now calling for an inflationary world as economies reopen. The inflation narrative is fueled by following reasons: (1) Unprecedented monetary and fiscal stimulus, (2) Disruption in supply chain owing to COVID-19 and trade war and (3) spurt in consumer spending due to pent-up demand.

Commodities seem to be agreeing with this narrative with Commodity index up 8% in June (after rising 21% in May). Even crude oil prices were up 10% in June (Exhibit 41). We however remain in the camp that Inflation is still some distance away. We are likely to see deflation first (in developed economies) and then inflation. Signals from bond-yields (across the globe) corroborate our hypothesis.

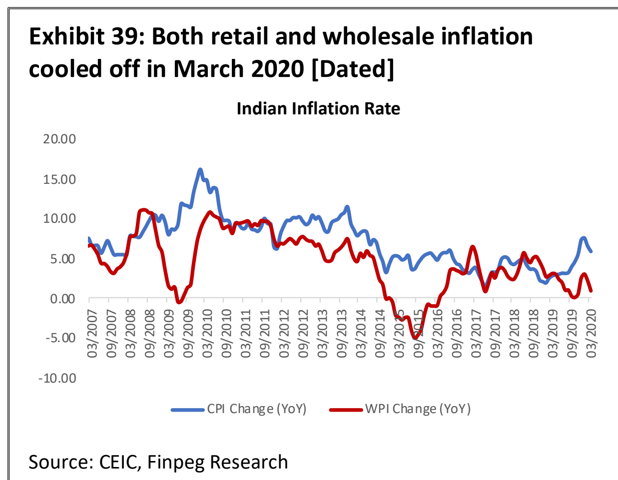


Exhibit 39: Both retail and wholesale inflation cooled off in March 2020 [Dated]

Source: CEIC, Finpeg Research

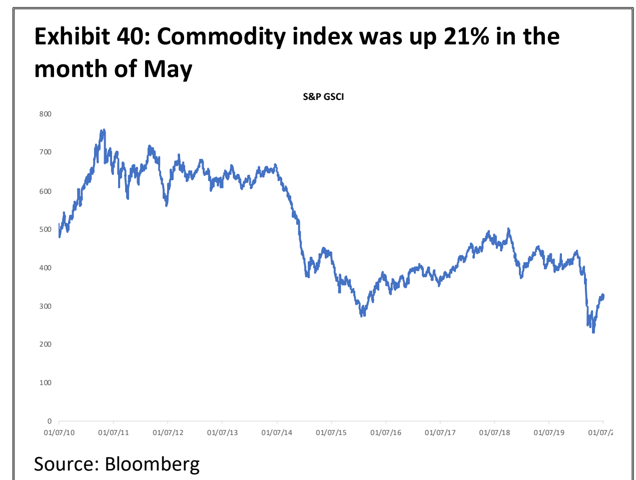


Exhibit 40: Commodity index was up 21% in the month of May

Source: Bloomberg

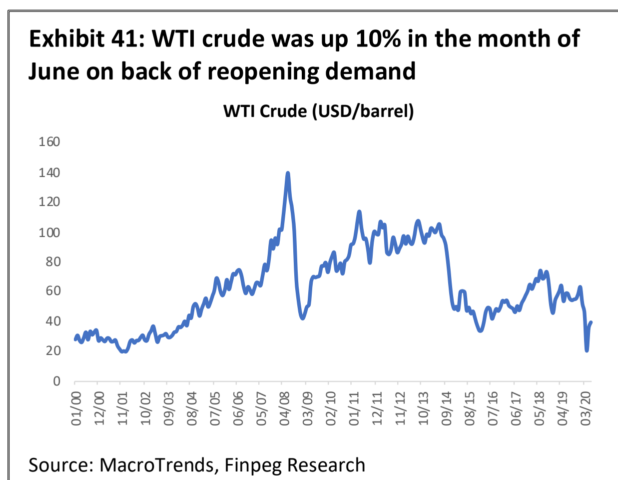


Exhibit 41: WTI crude was up 10% in the month of June on back of reopening demand

Source: MacroTrends, Finpeg Research

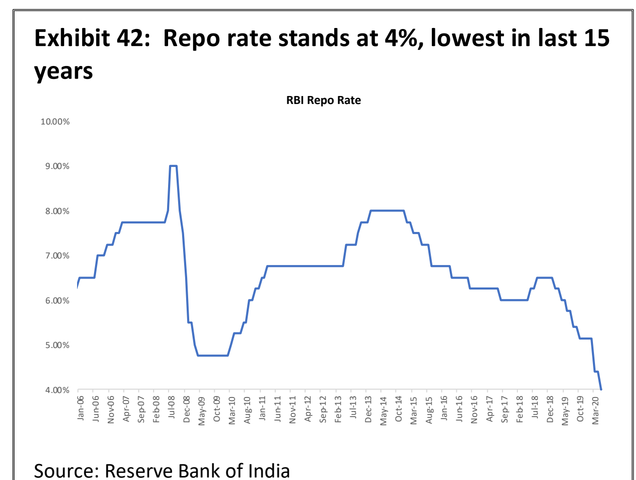


Exhibit 42: Repo rate stands at 4%, lowest in last 15 years

Source: Reserve Bank of India

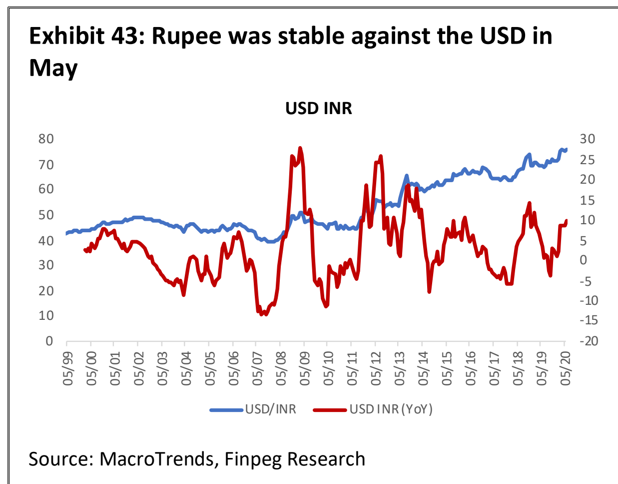
4. Exchange Rate – Stable during the month

INR was stable in month of June against the dollar 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.

It is worthwhile to note that the Rupee would have likely appreciated sharply had it not been for the RBI. India's current account went into surplus in Q4FY20 (Exhibit 46) for the first time in 10 years. This was driven by fall in oil prices and subdued oil demand (due to lockdown).

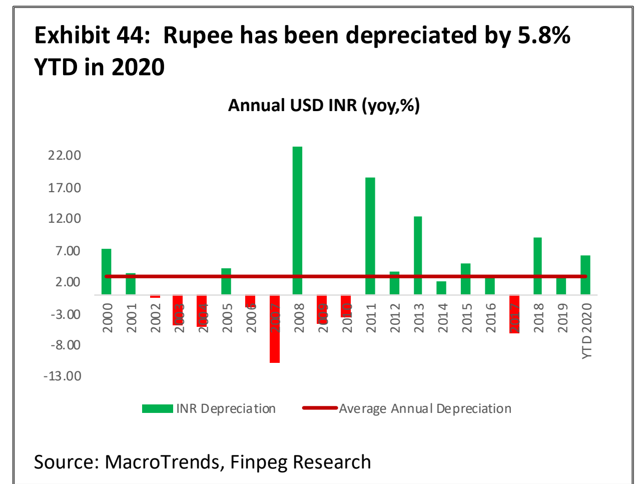
Coupled with huge portfolio flows, this would have put immense pressure on Rupee to appreciate. However, RBI has consistently intervened in the Forex market to keep Rupee from appreciating as is evidenced in RBI's massive buildup of Forex reserve in the past 2 months (Exhibit 45).

Exhibit 43: Rupee was stable against the USD in May



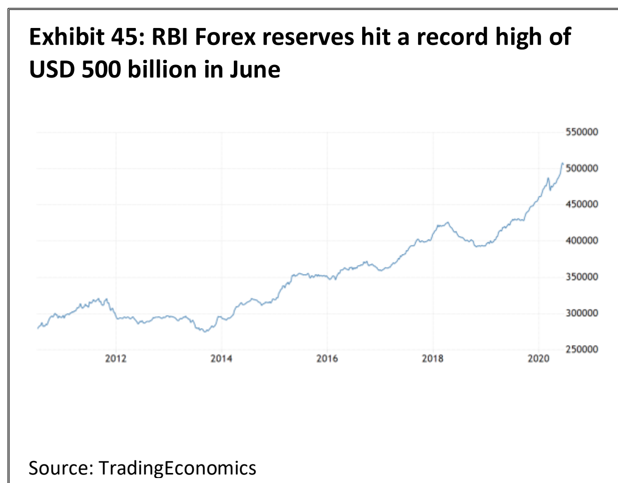
Source: MacroTrends, Finpeg Research

Exhibit 44: Rupee has been depreciated by 5.8% YTD in 2020



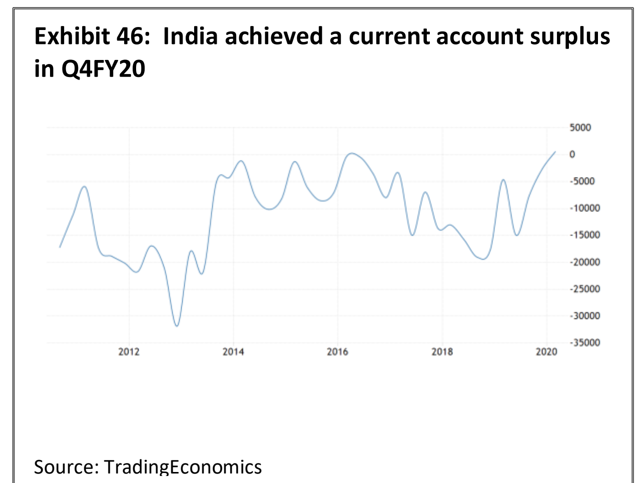
Source: MacroTrends, Finpeg Research

Exhibit 45: RBI Forex reserves hit a record high of USD 500 billion in June



Source: TradingEconomics

Exhibit 46: India achieved a current account surplus in Q4FY20



Source: TradingEconomics

Global Markets – The party continues!

1. Global Equity Markets

US benchmark index S&P 500 was up 1.84% in June and up 20% for the quarter making it the best quarter for S&P since 1987. US tech index NASDAQ is up for 2020 (up 12.11% YTD as of 30th June) and is above its peak in February.

Globally, equity markets had a good month and a phenomenal quarter after bottoming out in March 2020. The only exception being HK which has been facing headwinds from recently imposed security law by China. It is also worth noting that European markets have outperformed US markets in June as COVID-19 seems to have been brought under control in Europe. This is unlike US where cases are still surging and making daily new highs.

As discussed earlier, this global 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.

As we have argued in our cover section, we believe that markets are now priced for perfection and we don't believe that there will be a V-shaped recovery. In our view, equity returns are likely to remain negative (or low) over the next 6 - 12 months. In fact, at these levels, there is a high probability of sharp correction (or even a crash).

Table 4: Performance of major indices across the world

Indices	1M	3M	6M	12M	YTD
S&P 500	1.84%	19.95%	-4.04%	4.59%	-4.04%
Nasdaq	5.99%	30.63%	12.11%	24.32%	12.11%
Russel 2000	3.40%	25.00%	-13.61%	-7.99%	-13.61%
FTSE	1.53%	8.77%	-18.20%	-17.71%	-18.20%
DAX	6.25%	25.42%	-7.08%	-1.68%	-7.08%
Stoxx 600	2.85%	12.59%	-13.35%	-7.10%	-13.35%
Nikkei 225	1.88%	17.82%	-5.78%	2.57%	-5.78%
Shanghai Composite	4.64%	9.15%	-2.15%	-1.98%	-2.15%
Hang Seng	6.38%	3.49%	-13.35%	-15.41%	-13.35%
NIFTY	7.53%	19.82%	-15.44%	-13.50%	-15.44%

Source: Bloomberg, Finpeg Research

2. Global Debt Markets

Bond markets continue to remain range bound. On one side we have the Fed buying Treasuries and keeping the yields down, on the other hand, there is a growing camp of inflationistas. It seems that so far, Fed and the deflation narrative is winning with US 10-year yield down 3 bps in June. German yields were down 1 bps during the month.

In our view, US yields are unlikely to inch higher anytime soon primarily because (1) we believe that we will likely see deflation (or very low inflation) and (2) Fed will not allow it. Point number 2 is important because US, with the amount of debt that the Government holds, cannot afford to see a rise in yields. This would increase their interest expense. Therefore, Fed will likely make sure that bond yields do not soar high. This intervention by Fed in US treasury markets have distorted the price signals that is generally used to read into what is happening with the economy and other asset classes. As our investors will be aware, we use signals from US treasury markets as one of the variables in our asset allocation algorithm.

An interesting observation for the month of June comes from the corporate bond market in US. The high yield spread (interest over treasury for worst quality bonds) started inching up again after declining since March. It went up from 6.18% to 6.44% during the month (Exhibit 50). This, despite a Fed backstop even in the high-yield market. This could potentially be a signal of stress building up again and a precursor to the wave of insolvency that lies ahead. Yet another reason for our bearish stance on equities.

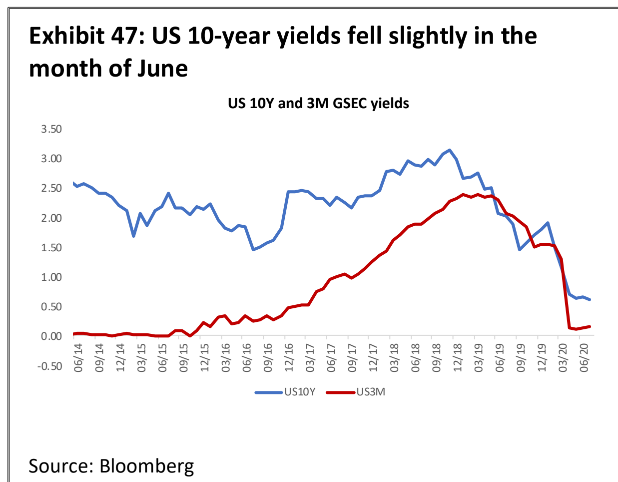


Exhibit 47: US 10-year yields fell slightly in the month of June

Source: Bloomberg

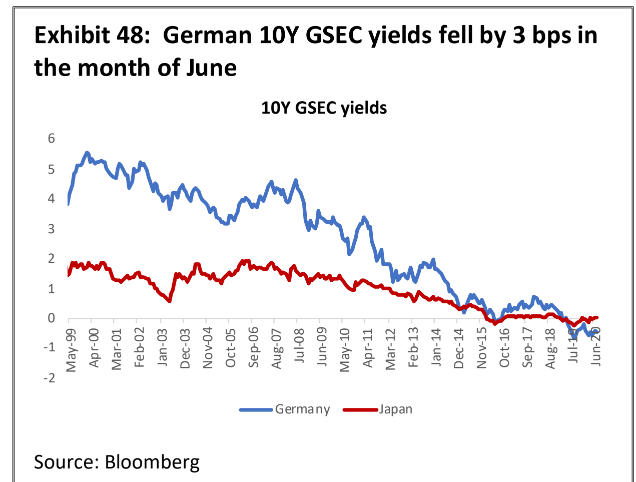


Exhibit 48: German 10Y GSEC yields fell by 3 bps in the month of June

Source: Bloomberg

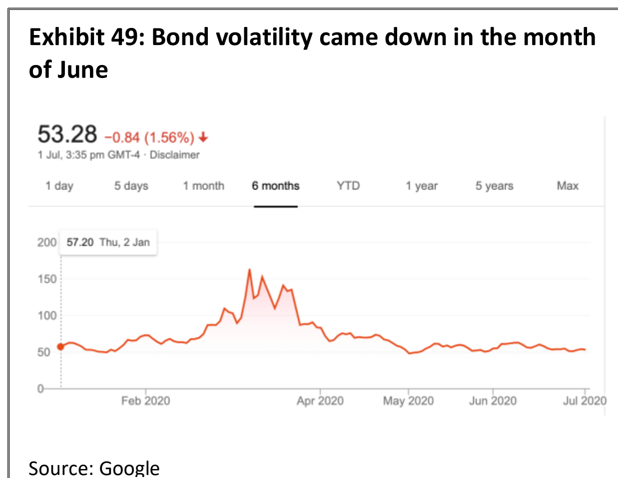


Exhibit 49: Bond volatility came down in the month of June

Source: Google

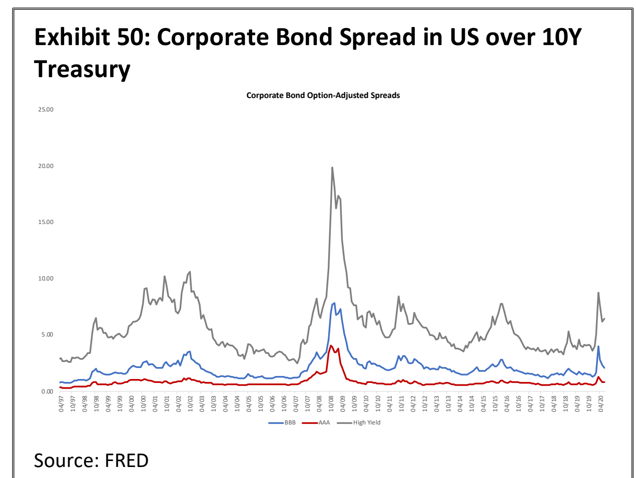


Exhibit 50: Corporate Bond Spread in US over 10Y Treasury

Source: FRED

3. Dollar and Gold

Further evidence of the risk on mode is available in the weakening of dollar. DXY was down by 1.0% in the month of June. And Dollar continues to weaken in the first few days of July as global equity rally continues.

It should be noted that during the entire crash (and recovery) in the first half of 2020, Dollar has been almost perfectly correlated with global equity markets. A rising dollar when markets where in a free fall followed by weakening dollar as markets recovered and rallied. Even during recovery phase, bouts of weakness in equity markets has been associated with spike in dollar strength.

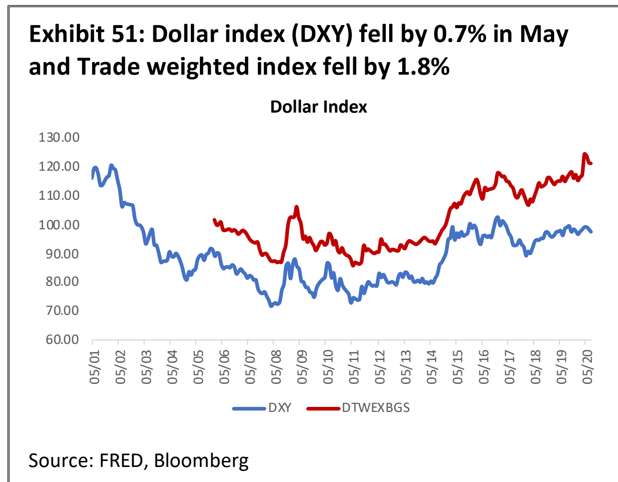


Exhibit 51: Dollar index (DXY) fell by 0.7% in May and Trade weighted index fell by 1.8%

Source: FRED, Bloomberg

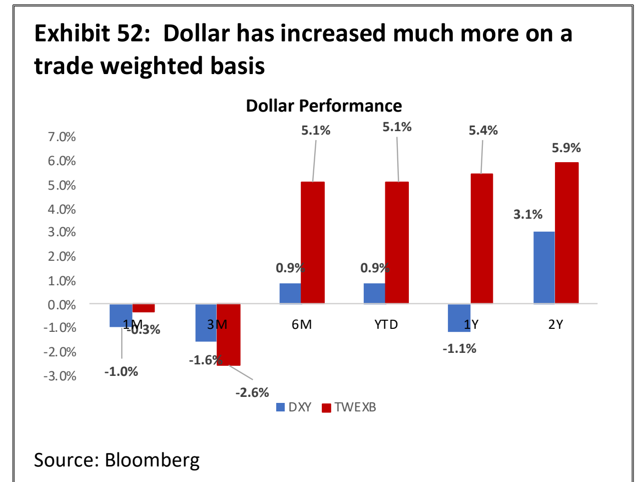


Exhibit 52: Dollar has increased much more on a trade weighted basis

Source: Bloomberg

Gold breaks out in June

Gold finally broke out of its range in June. After being range bound for better part of April and May, Gold closed the month of June at USD 1781/oz and even broke the psychological barrier of USD 1800/oz in July (for the first time since 2011).

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.

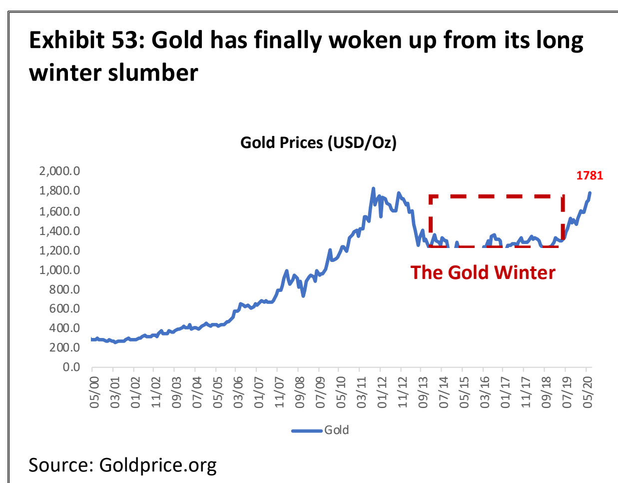


Exhibit 53: Gold has finally woken up from its long winter slumber

Source: Goldprice.org

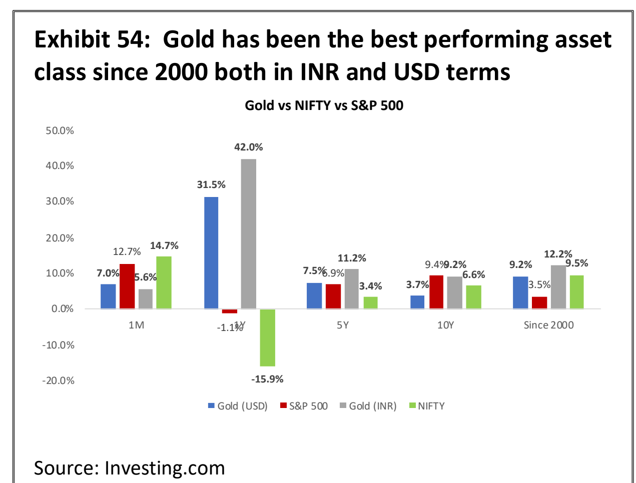


Exhibit 54: Gold has been the best performing asset class since 2000 both in INR and USD terms

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%	-1.70%	-1.70%	-3.60%
Inflation (latest)	0.10%	0.90%	0.10%	0.50%	0.30%
10Y Gsec (latest)	0.68%	-0.40%	0.03%	0.21%	0.07%
Central Bank Rates (latest)	0.25%	0.00%	-0.10%	0.10%	0.00%

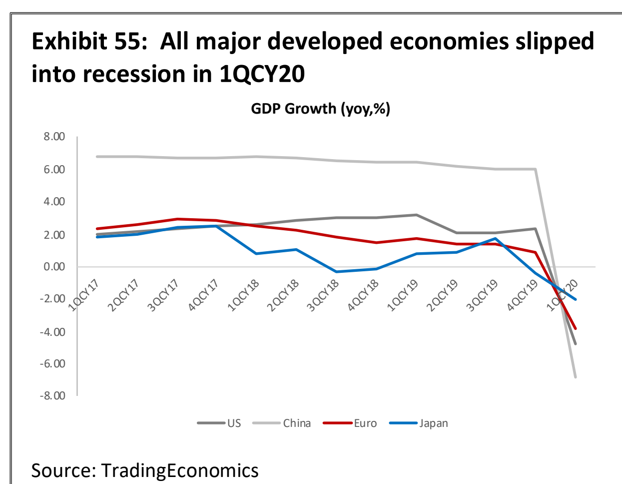
	China	Indonesia	Brazil
GDP (latest)	-6.80%	2.97%	-0.30%
Inflation (latest)	2.40%	1.96%	1.88%
10Y Gsec (latest)	2.89%	7.24%	6.61%
Central Bank Rates (latest)	3.85%	4.25%	2.25%

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 56-58 show Manufacturing PMIs for US, Eurozone and China respectively for the month of June. While the PMIs show a recovery from months of April and May, it should be noted that it is an illusory recovery. In fact, activity in June contracted as compared to May, albeit at a slower rate. Therefore, in all sense, June was actually worse than May.

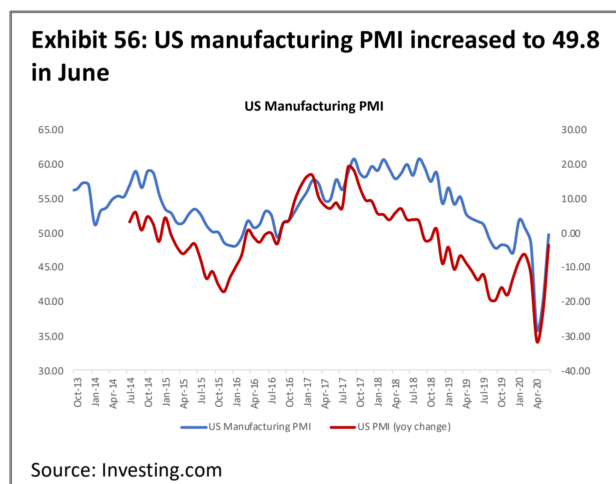
Let's focus a bit more on Chinese PMI numbers (Exhibit 52). Since falling to 40.3 in February, the PMI has been around 50 indicating minor month-on-month improvement. While the chart might look like a V-shaped recovery, the fact is that Chinese activity is almost at the same level as it was in February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

Exhibit 55: All major developed economies slipped into recession in 1QCY20



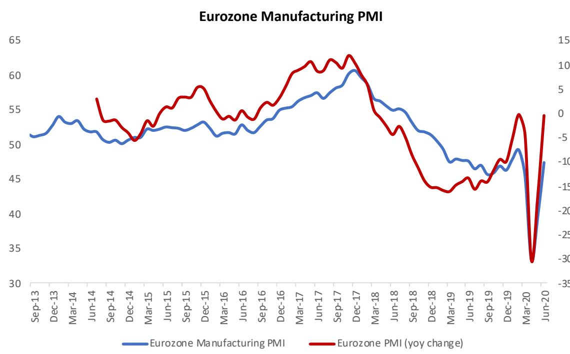
Source: TradingEconomics

Exhibit 56: US manufacturing PMI increased to 49.8 in June



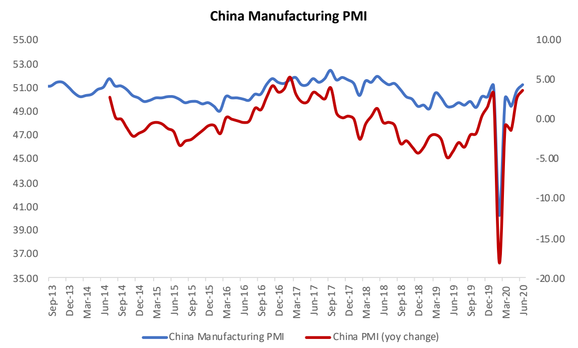
Source: Investing.com

Exhibit 57: Eurozone PMI increased to 47.4 in the month of June



Source: Investing.com

Exhibit 58: Chinese manufacturing PMI was 51.2 in June indicating muted expansion

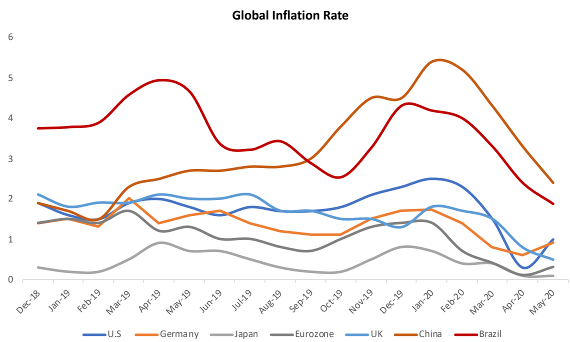


Source: Investing.com

Inflation slowing but commodity prices indicate expectations of reflation

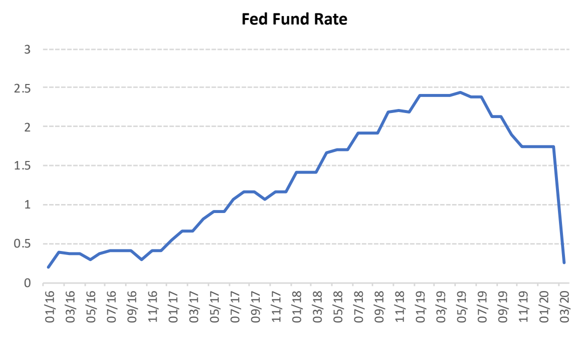
As we have been highlighting, we expected a significant moderation in inflation and that seems to be playing out (Exhibit 59). However, a sharp rally in commodities indicate that market is expecting reflation (return of inflation) and is looking beyond near-term deflation worries. If we look at 5-year breakeven inflation in US (Exhibit 61), 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 59: Inflation inching down globally as oil and commodity prices remain muted



Source: Investing.com

Exhibit 60: US Fed brought the rates down by 150 bps in 2 back-to-back emergency cuts



Source: Bloomberg

Exhibit 61: 5-year inflation expectation has been inching up

Source: FRED

Exhibit 62: 5-year 5-year forward inflation expectation also inching up

Source: FRED

Performance Data

1. Best performing Equity Mutual Funds in June 2020

Best Large Cap Funds	**1M**	**YTD**	**1Y**
Mirae Asset India Equity Fund	7.9%	-14.8%	-11.7%
Kotak Bluechip Fund	7.8%	-13.5%	-8.3%
Edelweiss Large Cap Fund	7.7%	-13.7%	-10.3%

Best Multi Cap Funds	**1M**	**YTD**	**1Y**
Reliance Multi Cap Fund	9.1%	-25.7%	-27.9%
HSBC Multi Cap Equity Fund	9.0%	-13.9%	-12.3%
DSP Equity Fund	8.3%	-10.8%	-5.6%

Best Mid Cap Funds	**1M**	**YTD**	**1Y**
SBI Magnum Midcap Fund	12.2%	-8.9%	-10.2%
Aditya Birla SL Midcap Fund	11.5%	-17.1%	-18.0%
HDFC Mid-Cap Opportunities Fund	10.8%	-11.1%	-12.5%

Best Small Cap Funds	**1M**	**YTD**	**1Y**
HDFC Small Cap Fund	14.3%	-17.7%	-24.9%
DSP Small Cap Fund	14.1%	-9.4%	-11.6%
Sundaram Small Cap Fund	12.8%	-15.5%	-21.6%

Best Large & Mid Cap Fund	**1M**	**YTD**	**1Y**
Mirae Asset Emerging Bluechip	9.3%	-10.7%	-5.0%
DSP Equity Opportunities Fund	9.2%	-12.7%	-7.7%
HDFC Growth Opp Fund	9.1%	-16.7%	-16.0%

Best Focused Fund	**1M**	**YTD**	**1Y**
Reliance Focused Equity Fund	8.9%	-16.0%	-16.8%
HDFC Focused 30 Fund	8.8%	-19.0%	-21.3%
Franklin India Focused Equity Fund	8.6%	-14.8%	-16.6%

Best ELSS Fund	**1M**	**YTD**	**1Y**
IDFC Tax Advt(ELSS) Fund	10.3%	-14.9%	-18.1%
Mirae Asset Tax Saver Fund	9.8%	-12.4%	-7.9%
JM Tax Gain Fund	9.5%	-15.0%	-11.2%

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NEAM CAPS PRIVATE LTD.

Unit no. 325, C-1, 3rd Floor, Soham Plaza, Manpada,
Thane West, Maharashtra – 400607
Email: hello@finpeg.com
Phone: +91 90829 13729

Plot no. 564-A57, H. No. 1257, Road No. 42, Jubilee Hills, Phase III,
Hyderabad, Telangana – 500034
Email: madhu@finpeg.com
Phone: +91 98484 91415