The Alpha Investor

Issue #9, July 2020

finpeg®

History doesn't repeat, but it often rhymes

INSIDE THIS ISSUE

Dear Investor,

The theme of last month's issue was how markets were pricing in a near perfect scenario with absolutely no margin for error. This month, we look at lessons from history and some technical factors that could indicate a potential reversal.

We go back 50 years to look at the story of Nifty Fifty and see how the same scenario is playing today right in front of our eyes and what lessons can be drawn from the past.

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

Smart solutions for smart money

What's Inside?

History doesn't repeat, but it often rhymes

"History doesn't repeat Itself, but It often rhymes"

– Mark Twain

For a change, let's begin this issue by rewinding the clock by almost 50 years. Let me tell you the story of Nifty Fifty. No, not our Indian stock index, but a list of US blue-chip stocks in 1970s.

The story of Nifty Fifty

The term **Nifty Fifty** was an informal designation for fifty popular mega-cap stocks in the 1960s and 1970s. Most of these companies still exists – the likes of Coca Cola, GE, Xerox, McDonalds and so on (here is the full list).

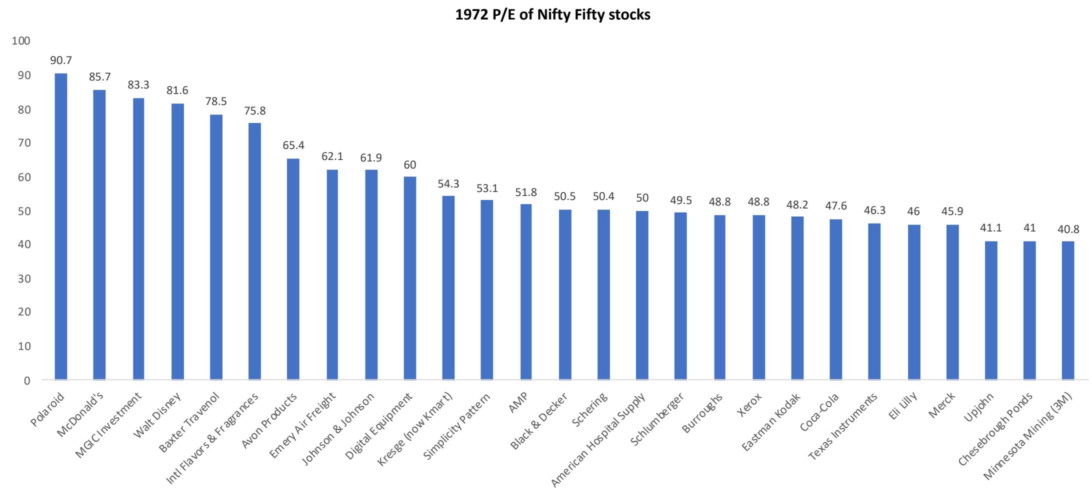
The stocks in Nifty Fifty were thought of as **must-have stocks** in your portfolio. They were described as "**buy and never sell**". All these companies were growing rapidly (and paying handsome dividends) and it was widely believed that **nothing could go wrong** with these stocks.

By late 60s and early 70s, these stocks became the darling of investors. And as these stocks kept outperforming the broader indices, their valuations soared.

> *"The delusion was that these companies were so good, it didn't matter what you paid for them; their inexorable growth would bail you out.*
>
> *Obviously the problem was not with the companies but with the temporary insanity of money managers — proving again that stupidity well-packaged can sound like wisdom. It was so easy to forget that no sizable company could possibly be worth over 50 times normal earnings."*
>
> Forbes Magazine

At the peak (December 1972), the Nifty Fifty's average PE was 42, more than double that of S&P 500 which was 19. And some of the companies were trading at an even more insane valuations – Polaroid with a P/E of 91; McDonald's, 86; Walt Disney, 82.

Exhibit 1: 27 of the Nifty Fifty companies traded above 40 PE



Source: The Nifty Fifty revisted, Jeff Fesenmaier & Gary Smith

And then January 1973 happened.

The US markets collapsed and that started the process of slow unravelling of Nifty 50 stocks. As Forbes noted, "the Nifty Fifty were taken out and shot one by one." From their respective highs, for instance, Xerox fell 71%, Avon 86% and Polaroid 91%.

This was a beginning of a gut-wrenching bear market that lasted 21 months and Dow Jones index lost 45% from its peak. In fact, Dow did not claim its January 1973 high for another 9 years.

Now, don't get me wrong. Nifty Fifty bubble was unlike the dot-com bubble. The companies in Nifty 50 were actually high-quality companies with strong balance sheets and strong earnings growth. In fact, a lot of companies actually continued to perform fairly well.

But their stock returns did not mimic the underlying performance. Because, at the height of the bubble, it did not matter what investors paid for the stocks. Even for high quality businesses, what you pay matters. High valuation "now" simply implies lower returns in "future". Even high-quality businesses can be poor investments if they are bought at extended valuations.

Lessons for today

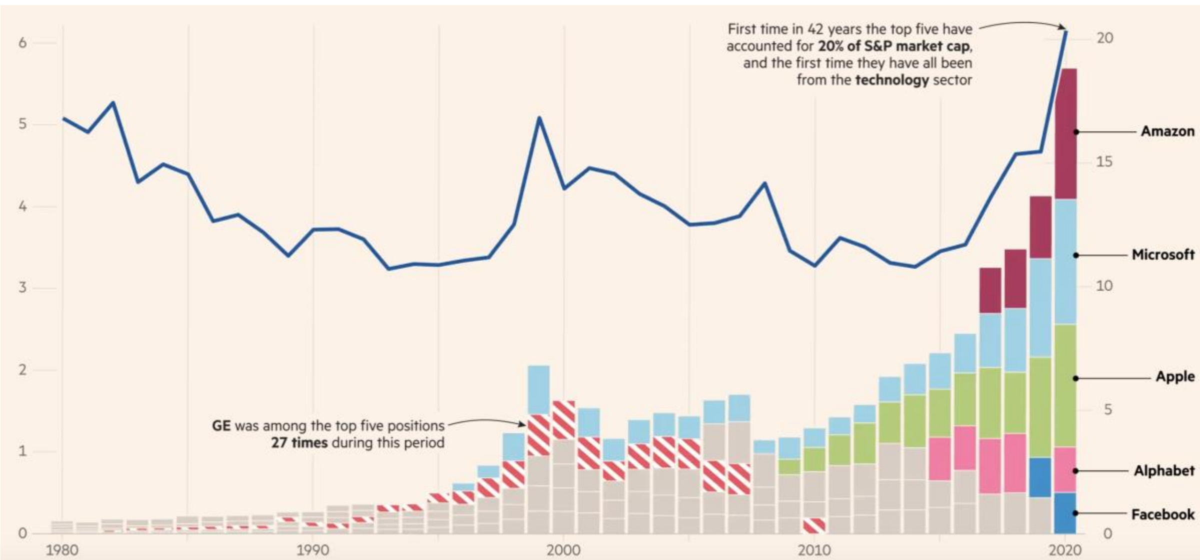
Markets today bear an eerie resemblance to heydays of Nifty Fifty in 1972. There is a group of select stocks that seem to have no ceiling when it comes to what investors are willing to pay for them. These companies are mega cap stock with strong balance sheets and strong "story".

I am talking about the mega tech stocks – Facebook, Amazon, Netflix, Google, Microsoft, Apple and Nvidia (the FANGMAN stocks). Might as well add Tesla to it.

What's happening with prices and valuations of these stocks is pretty much similar to what happened with the darlings in Nifty Fifty. No price seems high enough.

The big-5 (Facebook, Amazon, Google, Microsoft, Apple) now account for over 20% of S&P 500 index for the first time in history (Exhibit 2). And most of the rebound in S&P 500 (since March) has been led by the rebound in these stocks (Exhibit 3).

Exhibit 2: The big-5 account for 20% of S&P 500

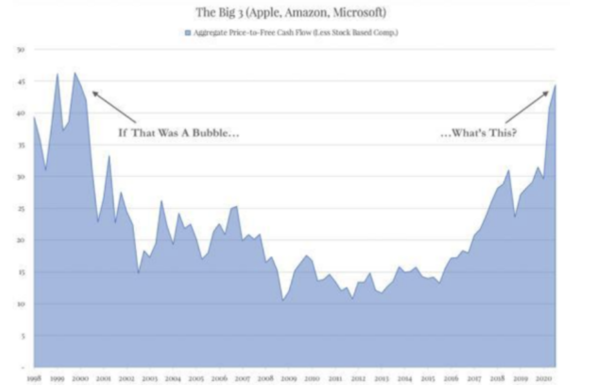


Source: FT

To get a perspective on the size of these stocks, the combined market cap of FANGMAN stocks is greater than the GDP of Japan, Germany, India etc. Market cap of Apple alone (at around US$ 1.9 trillion) is more than the combined market cap of all stocks traded on BSE.

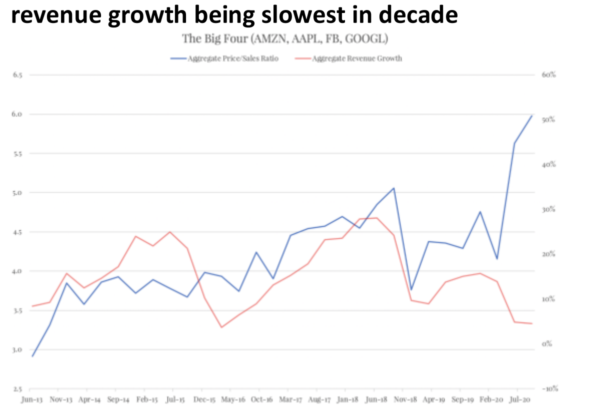
And despite rich valuations, investors keep flocking to it, with absolutely no upper-bound for valuations. Exhibit 3 below shows that valuations for the Big-3 is now at the levels last seen during the peak of dot-com bubble.

Exhibit 3: Bulk of the rally in US stock market has been led by the top tech stocks



Source: TheFelderReport.com

Exhibit 4: Big-4 valuation continues to soar despite revenue growth being slowest in decade



Source: TheFelderReport.com

And nothing highlights the mania more than Exhibit 4 which shows that despite the slowest revenue growth in over a decade, valuation of Big-4 (Amazon, Apple, Facebook and Google) continues to soar.

What's fueling this mania? Well, easy money and the belief that these mega-cap tech stocks are beyond correction. They are thought to be secular growers. Also, they are believed to benefit most from the current pandemic that has accelerated further consolidation of power towards these big tech.

Surprisingly, none of the above is incorrect. These are the strongest companies out there and will likely continue to perform well given their scale and near monopoly.

But then, that's the characteristic of a typical bubble. It always starts with an underlying assumption that is largely true (Technology did change the world – Dot Com Bubble). But soon, the underlying "truth" becomes such a strong self-reinforcing loop that investors lose the sense of reality.

At the peak of the mania, investors are willing to buy at any price. The bubble stocks can never go down. Valuation doesn't matter. Until it does.

> *Booms start with some tie-in to reality, some reason which justifies the increase in asset values, and then -- and this is the critical feature of speculative mood -- the market loses touch with reality.*
>
> John Kenneth Galbraith

What we are witnessing today is a clear sign of bubble being formed in the stock market in general and tech space in particular. Current valuation levels are simply not justified. And it would be dangerous to chase this mania.

Market internals remain fragile

If we take a closer look at this rally, we can see that the rally has been largely driven by select stocks in US. In India, Reliance Industry has been the poster boy for this rally while in US, it the pack of big tech (including Tesla).

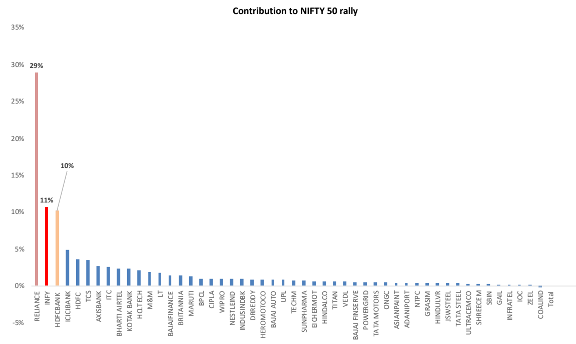
Due to their higher weightage in the index, they have also lifted the index disproportionately. The top-5 stocks in S&P 500 has increased by 33% since start of the year. On the other hand, 495 stocks have on average declined by 5% (see Exhibit 5). That's a huge divergence.

Although the breadth of rally in India has been quite decent, if we break down the performance of NIFTY 50, we find that almost 29% of the rally has been driven by a single stock – Reliance Industries.

Exhibit 5: Bulk of the rally in S&P 500 has been driven by the top-5 stocks

Source: FT

Exhibit 6: Reliance has accounted for 29% of NIFTY rally since March lows

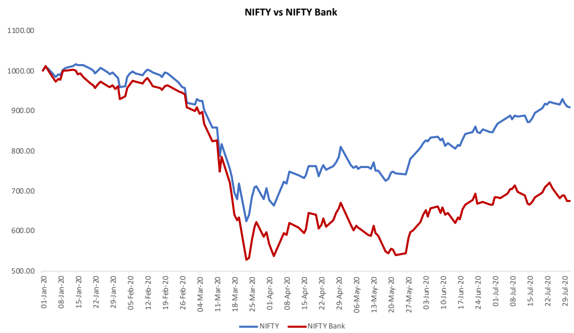


Source: NSE

And then there is the worrying signs of Banks (and Financials) continuing to underperform the broader index. A new bull market (after an end of a business cycle) is generally lead by Banks and Financials signaling a revival in economic activity.

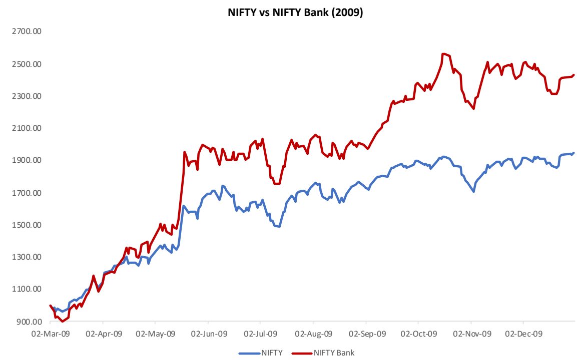
However, this does not appear to be the case so far as Banks have continued to underperform the broader index (Exhibit 7). While Nifty is down just 9.1% YTD, NIFTY Bank is down 32.6% YTD. Contrast this with what happened during the recovery of 2009 (Exhibit 8). It was the Banks and Financials that led the recovery thus signaling a true revival in underlying economic activity.

Exhibit 7: Banks have underperformed the broader index indicating a potential head fake recovery



Source: NSE

Exhibit 8: In 2009, the recovery was led by Banks and Financials



Source: NSE

Sentiment bordering on euphoria

Investor sentiment has 2 extremes – extreme risk aversion and extreme greed. It is very important to track investor sentiment as they can be a strong indicators of market bottoms and peaks. And right now, investor sentiment is bordering on extreme greed. CNBC's Fear & Greed Index (Exhibit 9), shows Investor sentiment at Greed levels. However, if we look at some other sentiment indicators like put/call ratio (Exhibit 10), we find it to be in extreme greed levels.

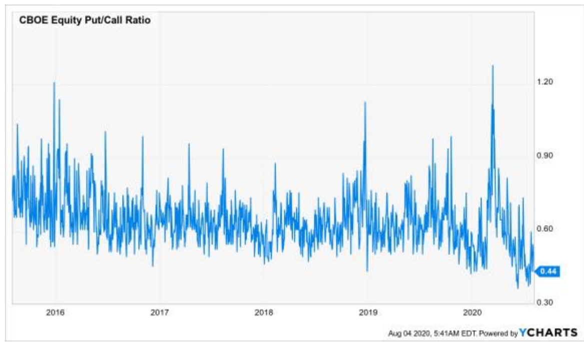
The **Put/Call Ratio** is an indicator that shows put volume relative to call volume. Put options are used to hedge against market weakness or bet on a decline. Call options are used to hedge against market strength or bet on an advance. The Put/Call Ratio is above 1 when put volume exceeds call volume and below 1 when call volume exceeds put volume. Typically, this indicator is used to gauge market sentiment. Sentiment is deemed excessively bearish when the Put/Call Ratio is trading at relatively high levels and excessively bullish when at relatively low levels.

And then we have frenzied participation from new retail investors both in India and the US. Direct equity trading has seen an unprecedented spike in retail participation since March (Exhibit 12). Never a good sign.

Exhibit 9: CNBC Fear and Greed Index showing investor sentiment as greed

Source: CNBC

Exhibit 10: CBOE Equity Put Call Ratio is at its lowest levels signaling extreme optimism

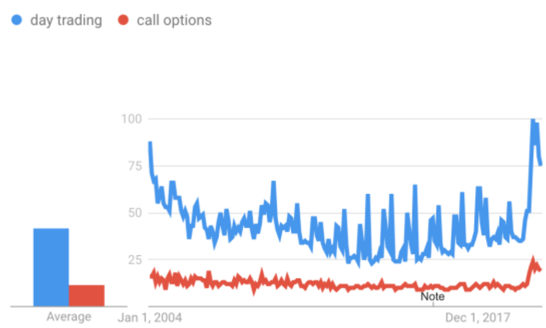


Source: Ycharts

Exhibit 11: Citigroup Panic vs Euphoria now suggests more euphoria than January

Source: Citi

Exhibit 12: Google trends for call options and day trading hit all time high



Source: Google

Listen to the bond markets

Looking at US Treasury market can give us some very important insights into the path of the economy and inflation (one of the variables in our algorithm). And unlike the equity markets, bond markets are screaming loud and clear that there will be no quick recovery.

US 10-year treasury yields have fallen to lows of 0.52% and continue to fall. While there is an argument that yields are falling primarily because there is a ready buyer in Fed. We however don't agree with this. If we trace back to previous QEs, we can see the yields actually rose in Q1 and Q3 mirroring an actual recovery in underlying economy. In QE2, yields actually kept falling. Coincidentally, QE1 and QE3 were great for stock markets while QE2 was not. Bond markets are smart, and one should listen to them.

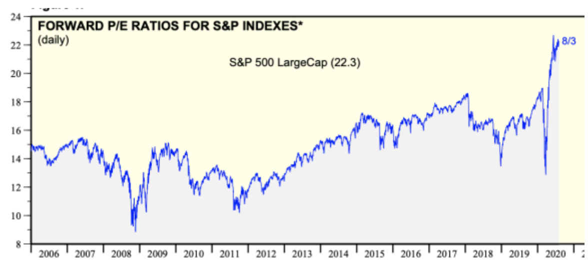
We discuss this in more detail in our Global Debt Markets section.

Be careful out there

In our last issue, we had discussed economic fundamentals and valuations as the reasons for our bearish stance. In this issue, we have focused more on history and technicals to suggest that we are in a bubble. However, no argument on bubble can be complete without one more look at valuations.

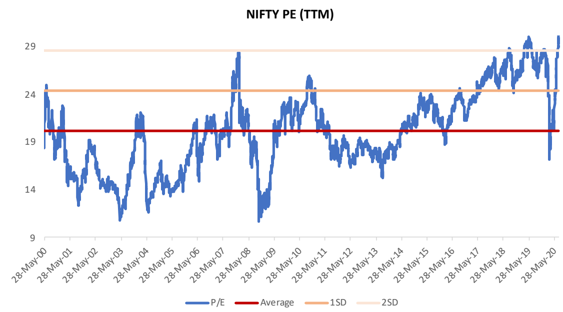
Needless to say, both US and Indian markets are near their all-time-high valuations. You don't want to chase equities at these levels.

Exhibit 13: S&P 500 forward PE ratio is at levels only seen during dot com bubble



Source: Yardeni Research Inc

Exhibit 14: NIFTY PE (TTM) is now above 30 for the first time in history



Source: NSE

Generally, it is very difficult to predict when this speculative mania ends. There can be no end to human greed (and speculative behaviour). But history tells us that once it happens, it happens fast and gets pretty ugly. We don't have to go back longer than just 4 months to realise how ugly it could potentially get.

And looking at both the fundamentals and the technicals, all we can say to investors right now is – be careful out there!

Indian Markets – On a rocket!

1. Equity Market wrap for the month

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

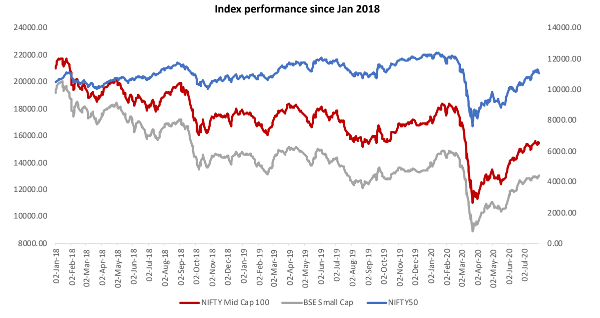
	1 Month	3 Months	6 Months	1 Year	Year to date
NIFTY	7.49%	12.31%	-7.43%	-0.40%	-9.00%
NIFTY Mid Cap	5.22%	14.59%	-14.10%	-2.83%	-9.54%
BSE Small Cap	5.18%	17.29%	-11.22%	2.60%	-4.95%
NIFTY Auto	8.34%	23.36%	-9.98%	6.25%	-11.74%
NIFTY Bank	1.26%	0.49%	-29.82%	-25.06%	-32.71%
NIFTY FMCG	2.69%	7.68%	0.32%	6.22%	2.49%
NIFTY IT	22.49%	28.09%	11.94%	15.70%	15.46%
NIFTY Pharma	11.65%	19.53%	36.99%	39.58%	38.67%
NIFTY Commodities	5.60%	12.69%	-8.25%	-7.66%	-12.01%
NIFTY Energy	6.34%	16.38%	3.17%	5.15%	-3.77%

Markets continue to rally despite headwinds

Indian markets continued to rally in July defying the underlying economic gravity. As of 31st July, NIFTY was down just 10.4% from its January highs and is up a staggering 45.5% from its march lows.

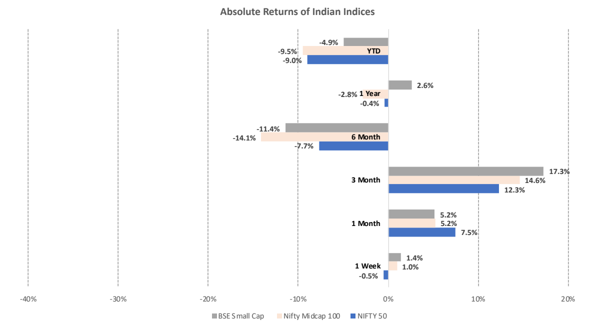
Even the broader markets (mid and small caps) continued their stellar run in July. IT and Pharma were the top sectors during the month returning 22.5% and 11.65% respectively. Banks and FMCG were the underperformers during the month.

Exhibit 15: Mid and small caps now performing in line with large caps YTD



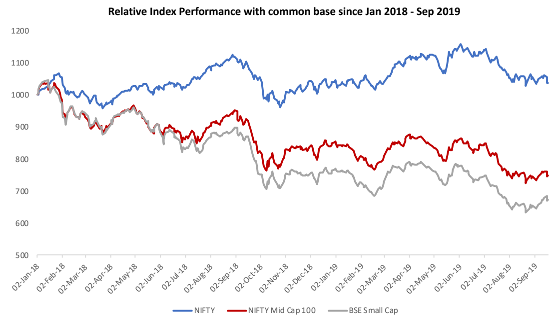
Source: BSE and NSE

Exhibit 16: Small caps outperformed NIFTY in in first 7 months of 2020



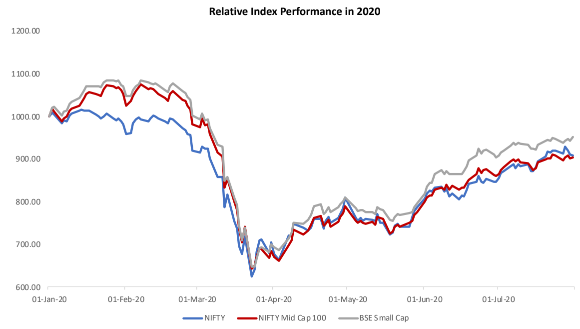
Source: NSE

Exhibit 17: Index performance with common base since Jan 2018 till Sep 2019



Source: BSE and NSE

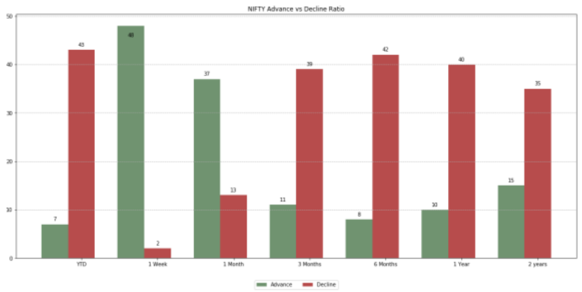
Exhibit 18: Index performance with common base since 1st Jan 2020



Source: BSE and NSE

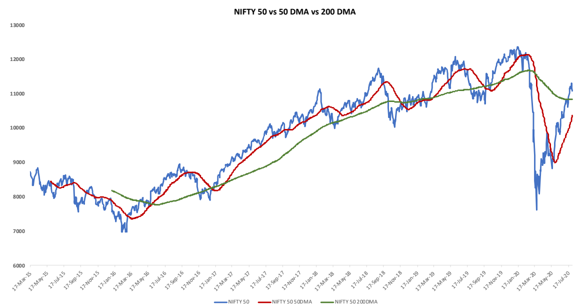
Also, as of month end on 31st July, NIFTY 50 broke its 200 dma resistance.

Exhibit 19: A broad-based rally in June for NIFTY 50 stocks



Source: NSE

Exhibit 20: NIFTY broke the 200 dma resistance in the month of July

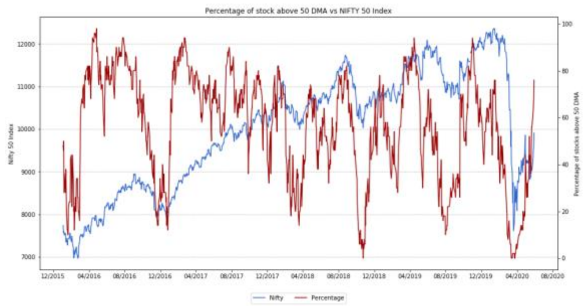


Source: NSE

Exhibit 21: NIFTY 50 vs percentage of stocks above their 200-day moving average

Source: NSE

Exhibit 22: 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 historical highs. NIFTY PE is back to 2 SD above its historical average. As on 31st July, NIFTY PE (trailing 12 months) was 30.2, the highest on record.

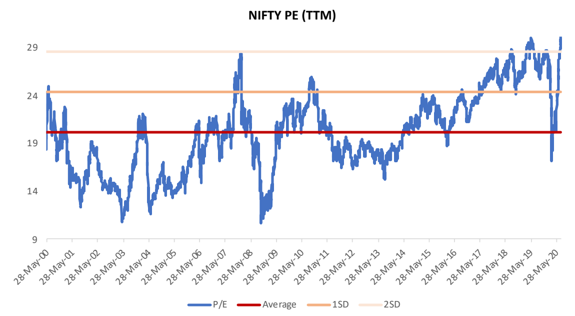
And this doesn't even account for full earnings carnage of Q1FY21 (and quarters beyond).

Even NIFTY Equal Weight index which was 1 SD above its historical average at the start of this month is now 2 standard deviation above its historical average (Exhibit 24). So, the broader large-cap space is now pretty richly valued.

Note a sharp spike in mid cap PE. This is likely due to presence of loss-making companies in the index skewing the PE ratio. If we look at the PE of NIFTY Midcap Liquid 15 (the 15 most liquid stocks), the PE is close to historical average.

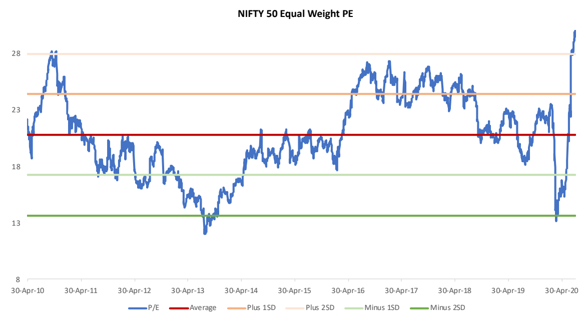
While at the face of it, mid and small caps may look fairly valued. But as we keep warning our investors, a correction (or a crash) driven by global phenomena will likely take down everything. And as highlighted in our cover section, there is a high probability of such an event happening in the near term.

Exhibit 23: NIFTY PE levels are now 2 SD above historical average



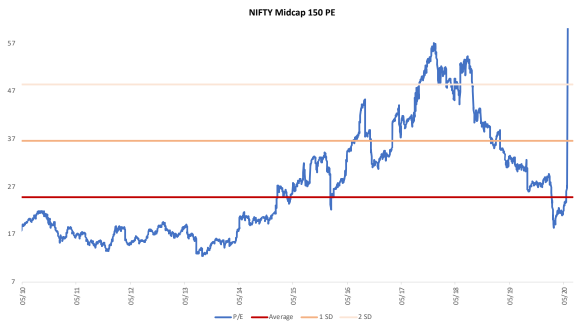
Source: NSE

Exhibit 24: NIFTY Equal Weight Index is now 2SD above historical average



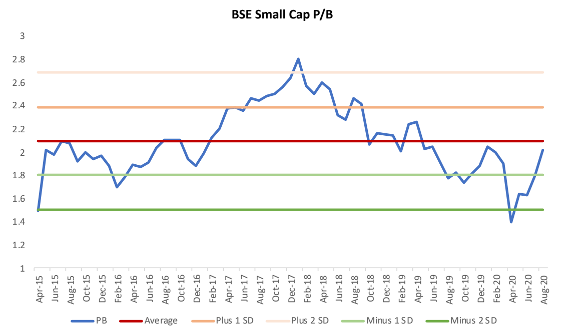
Source: NSE

Exhibit 25: Mid Cap index PE has gone through the roof likely due to losses in index constituents



Source: NSE

Exhibit 26: BSE Small cap index is trading near 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 declined marginally by 10 bps while the 3-month bill increased by 16 bps. This led to flattening of the yield curve for the first time in several months.

Likely reason for increase in 3-month yield is inflation numbers sticking around 6% (upper range of RBI). This has also led the RBI to keep the rates unchanged in its recently concluded policy meet (August 5th). The other reason is that RBI is pushing for some flattening of the yield curve by selling shorter dated securities and buying longer dated ones through its open market operations (OMO).

Year-to-date, the yields have fallen by 73 bps and 173 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.

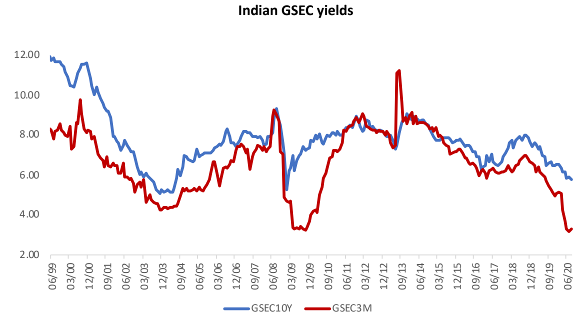
Despite rising concerns about inflation, we strongly remain in the camp that the current bout of inflation is short-term and, pretty soon, global disinflationary pressure will take over. Therefore, we are of view that yields on both short and longer dated securities are headed lower. Further, RBI's intervention to keep 10-year yields from rising gives us confidence that we are unlikely to see a sharp spike in yields in near future.

We discuss more on our inflation view here.

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

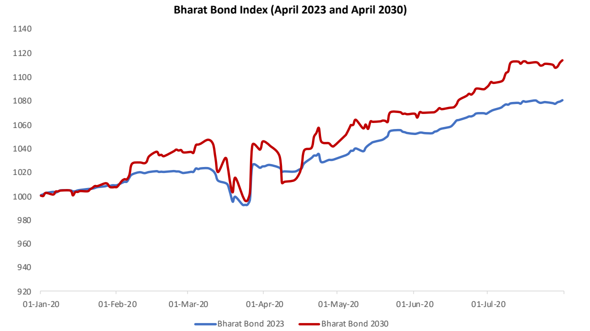
Scheme Name	1M	3M	6M	YTD	1Y
IDFC Bond Fund	1.82%	4.10%	6.29%	6.40%	11.65%
ICICI Prudential Bond Fund	1.89%	4.23%	7.21%	7.28%	13.21%
HSBC Debt Fund	1.03%	3.54%	6.35%	6.67%	10.45%
IDFC G Sec Fund	1.44%	5.61%	9.36%	10.00%	15.61%
DSP Govt Sec Fund	0.74%	4.82%	9.04%	9.55%	16.06%
Nippon India Gilt Securities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

Exhibit 27: 10-year GSEC yields decreased by marginal 10 bps in July



Source: Bloomberg

Exhibit 28: 10-year Bharat Bond Index has outperformed 3-year index



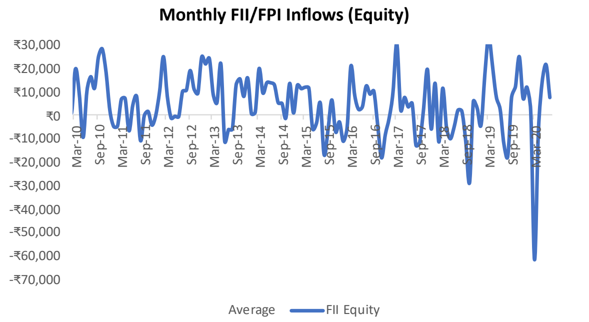
Source: NSE

4. What is the “smart” money doing?

FIIs continued to be net buyer in the month of July in the equity segment, albeit at a slower pace. FIIs bought Rs 7,663 cr in July as compared to Rs 21,832 cr in June. Year-to-date, FIIs are still a net seller in equities selling Rs 10,850 cr where most of selling happened in March. FIIs continued to be net sellers in the debt segment selling Rs 2,476 cr in the month of June.

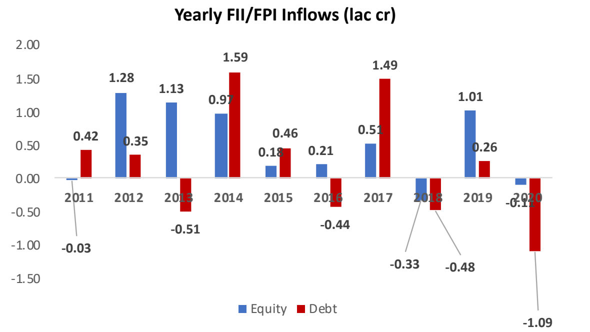
DIIs (Mutual Funds) were net sellers in Equity in July for the second consecutive month. DIIs sold Rs 7,226 cr (net) in July as against Rs 3,690 cr in June. DIIs were net buyers in the debt segment buying Rs 23,066 cr (net) in July.

Exhibit 29: Monthly FII/FPI inflows in Equity markets



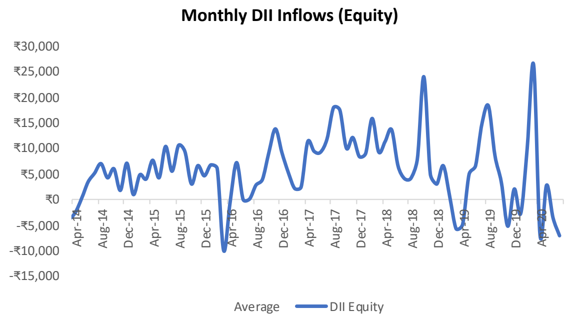
Source: NSDL

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



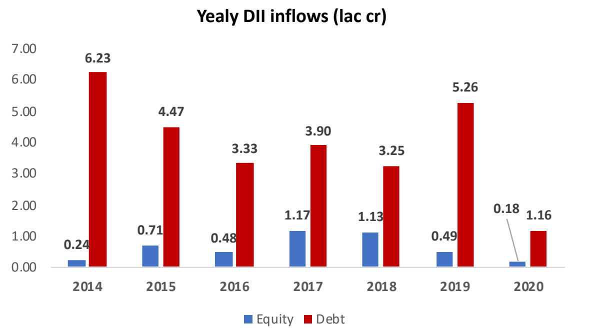
Source: NSDL

Exhibit 31: Monthly Domestic Institutional Investors (MF) inflows in Equity markets



Source: Moneycontrol

Exhibit 32: Calendar year DII inflows in Equity and Debt markets



Source: Monevcontrol

Economy – A long tedious road ahead

1. Summary and Outlook

After over 2 months of stringent lockdown, India started to slowly unlock from 1st of June with more relaxations given in subsequent months. However, things actually started slowing down in July as compared to June as surging cases forced a lot of places to force a total lockdown.

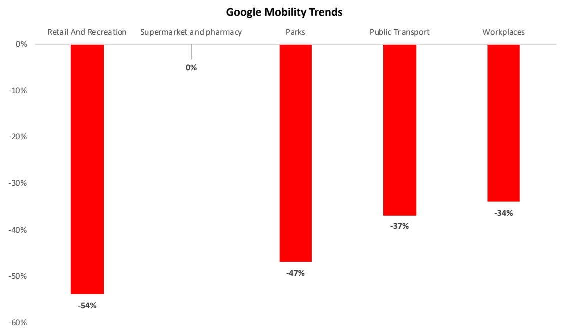
The same is corroborated by manufacturing PMI for July which slipped to 46 as compared to 47.2 in June. Even the services PMI showed only a marginal improvement of 34.2 in July as compared to 33.7 in June but still remained in sharp contraction territory.

These PMI numbers are a big cause of worry. While the rest of the world moved to PMIs above 50 in July thus indicating expansion in activity over June, India still remains in contraction. And not just that, the rate of contraction itself increased in July as indicated by fall in manufacturing PMI and almost flattish services PMI.

We believe that it is pertinent for authorities (central, state and local) to start seriously contemplating the economic impact of the lockdown. In July, we witnessed a lot of places going under complete lockdown including industrial clusters of Thane and Chennai. Total sporadic lockdowns still persist and India's biggest economic hub (MMRDA) still faces lots of restriction.

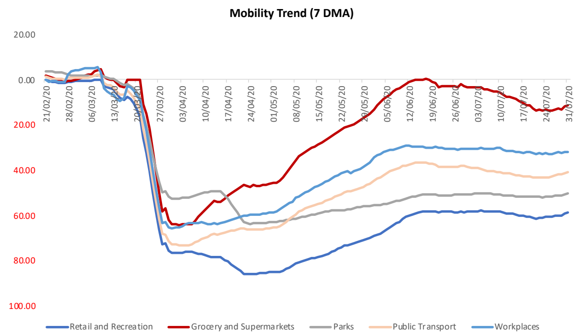
If we look at Exhibit 32 which shows Google's mobility (a proxy for activity levels) for various places/activities, we are still at very depressed levels. Exhibit 33 is even more worrying. It tracks the 7-day moving average trend in mobility. As can be seen, after early June, the recovery has flatlined and in some cases actually decreased in July.

Exhibit 32: Google mobility trend suggests that mobility levels are still very depressed



Source: Google

Exhibit 33: Mobility has flatlined since early June and decreasing in some cases



Source: Moneycontrol

The somber picture of Indian Economy and its recovery (or lack of it) makes the price actions in Indian stock markets even more surprising and hence, even more unsustainable. While consensus estimate for GDP for FY21 is de-growth of 4%-5%, we believe that we are easily on track to do worse. Given how high-frequency data is shaping up, we believe that the road to recovery will be a long and tedious one. And stock markets should catch up to this reality sooner rather than later.

2. GDP and the economy

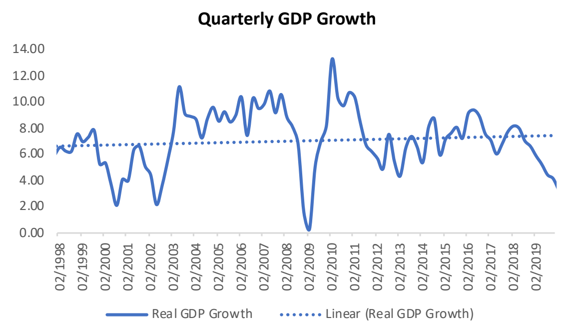
As mentioned above, the sharp uptick that we witnessed in June seems to be slowing down as we approach August, and this is a very worrying sign. As evidenced by the Google Mobility chart (Exhibit 32 and 33) shown above, we are still at depressed levels and the trend is not very encouraging.

But this is also not a surprise. Despite, Unlock 1.0 – 3.0, our reopening has been patchy at best with big industrial centers still struggling to cope with surging COVID-19 cases (read Mumbai) and total lockdowns being imposed sporadically across India.

To top it all, we now have cases growing in hitherto unaffected parts of India. From big urban center of Bengaluru to clusters in Eastern India. The surge will not help in resumption of economic activity to pre-COVID levels anytime soon. The only silver lining is that the economic hub of Mumbai (and adjoining suburbs) may have peaked. However, stringent lockdown restriction still persists.

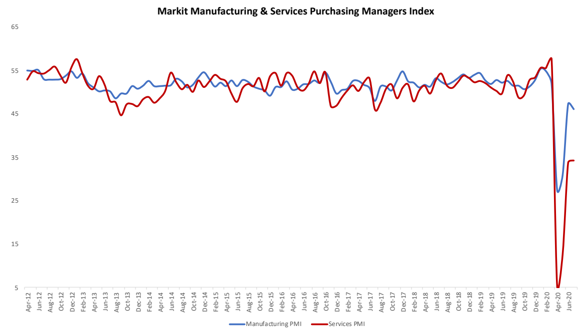
Manufacturing PMI numbers for July were disheartening to say the least. Not only did we not move into month-on-month expansion (indicated by reading above 50), a dip in PMI from June levels indicated that rate of contraction also increased. Services PMI registered a modest increase in July but still remain at extremely depressed level of 34.2. The rest of the world has moved above 50 in both Services and Manufacturing PMI.

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



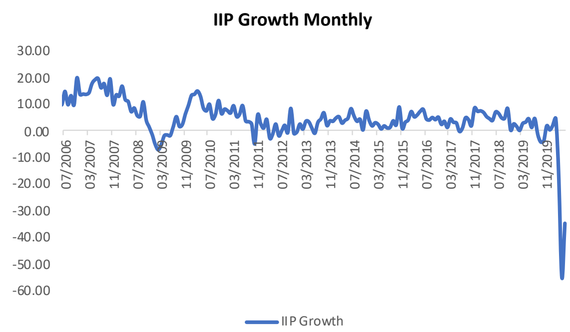
Source: MOSPI

Exhibit 36: Recovery in PMI stalled in the month of July



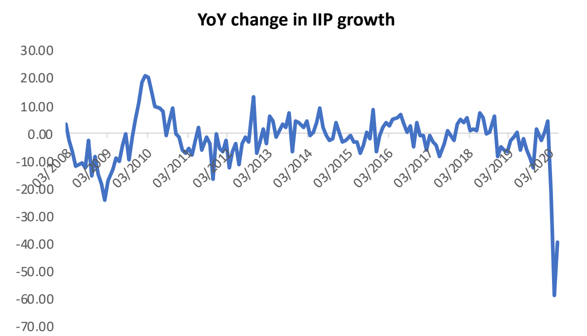
Source: TradingEconomics, Finpeg

Exhibit 37: IIP contracted by 35% in the month of May



Source:MOSPI

Exhibit 38: YoY change in IIP still in negative growth in May



Source:MOSPI

3. Inflation and monetary policy

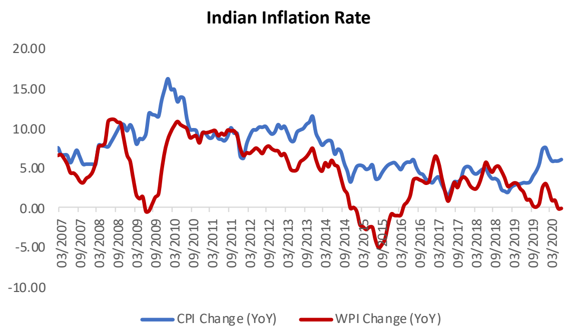
We note that headline inflation numbers (CPI and WPI) were not published for the month of March and April (as well as provisional numbers for May) as the agency was not able to complete the necessary survey work due to the lockdown. Official numbers for June have been published and CPI inched up 6.09% while WPI shrank by 1.8%.

CPI print of 6.09% is above RBIs target range and has given rise to concerns about inflationary pressures in months ahead. We however believe that the inflationary pressure is short term (driven by supply chain disruption and rising energy and commodity prices) and we will soon start seeing disinflation. WPI tends to lead CPI and if we look at wholesale price inflation, we have been seeing deflation for 2 consecutive months.

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) inflation in commodity prices seen recently.

If we look at commodities index (Exhibit 40), it is now flattening after rising sharply from its April lows. The index was up just 3.2% in July after inflating almost 40% from its April lows. Even crude prices are now flattening after sharp inflation from April lows. These rates-of-change in crude and commodities and the unprecedented demand shock reinforces our belief that current inflationary pressure is likely a transitory phenomenon, likely to give way to disinflation. Discussed in more detail here.

Exhibit 39: Deflationary pressure grips wholesale prices even as CPI remains sticky

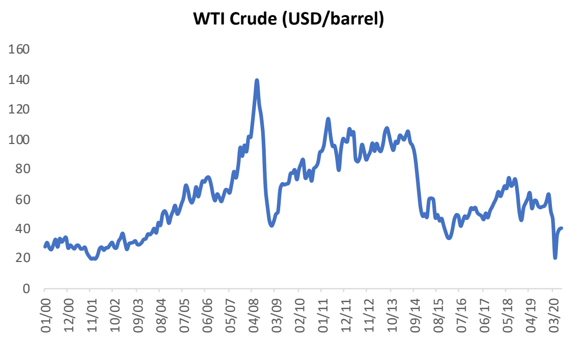


Source: CEIC, Finpeg Research

Exhibit 40: Commodity index is now flattening after rising sharply till June

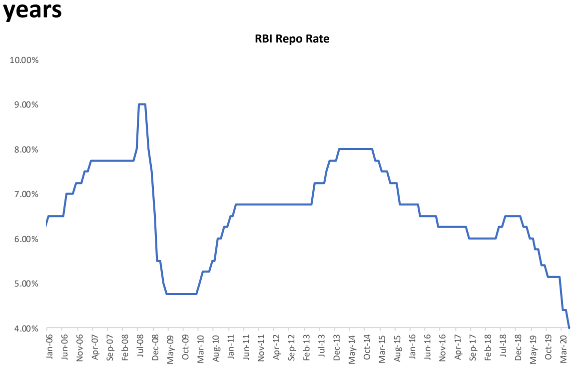
Source: Bloomberg

Exhibit 41: WTI crude is also flattening after sharp rise from April lows



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

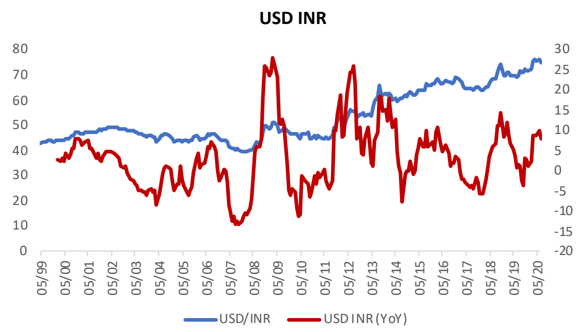
INR appreciated by 1% against the USD during the month. This was driven by (1) Overall global dollar weakness, (2) India's current account surplus and (3) Positive net portfolio flows.

Depreciating dollar has been one of the prime reasons for the bumper risk-on rally in the Indian markets. As we have noted earlier, there is a strong negative correlation of NIFTY movement with INR deprecation in the short term. 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).

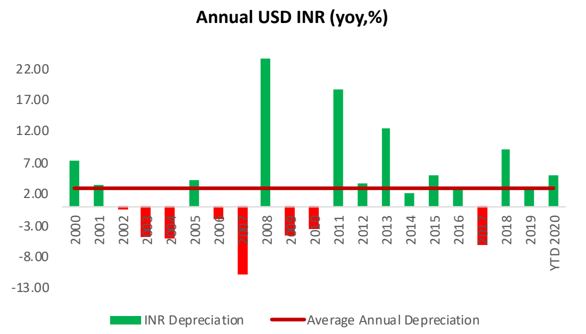
Coupled with huge portfolio flows, this would have put immense pressure on Rupee to appreciate. However, RBI has consistently intervened in the Forex market to keep Rupee from appreciating as is evidenced in RBI's massive buildup of Forex reserve over the past few months (Exhibit 45).

Exhibit 43: Rupee appreciated by 1% against the USD in July



Source: MacroTrends, Finpeg Research

Exhibit 44: Rupee has been depreciated by 5.0% YTD in 2020



Source: MacroTrends, Finpeg Research

Exhibit 45: RBI Forex continues to be above USD 500 billion in July

Source: TradingEconomics

Exhibit 46: India achieved a current account surplus in Q4FY20

Source: TradingEconomics

Global Markets – Mixed bag of a month

1. Global Equity Markets

US benchmark index S&P 500 was up 5.51% in June and is now up 1.25% year to date. US tech index NASDAQ is up for 2020 (up 19.76% YTD as of 31st July) and is well above its peak in February. We have covered this tech mania in our cover section.

Globally, equity markets had a mixed sort of month. While EMs like India were the best performers on back of risk-on mode triggered by weakening dollar, markets like Japan, UK and Hong Kong were down for the month. If we look at UK markets (FTSE), it is still down 21.8% YTD making it one of the worst performing stock markets.

Apart from US, the only other stock market that is up for the year is China. Driven primarily by regulatory support and indication from authorities for supporting the stock market. Again, very close to taking Chinese stocks to bubble territory just like 2015.

As we have argued in our cover section, we believe that global markets are rallying on fragile internals and the rally is being driven by a select few stocks. Valuations, in the process, have skyrocketed. 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	5.51%	12.32%	1.41%	9.76%	1.25%
Nasdaq	6.82%	20.88%	17.42%	31.43%	19.76%
Russel 2000	2.71%	12.95%	-8.28%	-5.98%	-11.27%
FTSE	-4.41%	-0.06%	-19.05%	-22.26%	-21.80%
DAX	0.02%	13.37%	-5.15%	1.02%	-7.06%
Stoxx 600	-1.11%	4.79%	-13.24%	-7.63%	-14.38%
Nikkei 225	-2.59%	7.51%	-6.44%	0.88%	-8.23%
Shanghai Composite	10.90%	15.73%	20.51%	12.87%	8.88%
Hang Seng	0.69%	-0.20%	-6.53%	-11.46%	-13.15%
NIFTY	7.49%	12.31%	-7.43%	-0.40%	-9.00%

Source: Yahoo Finance, Finpeg Research

2. Global Debt Markets

As discussed briefly in our cover section, signal from the bond markets is completely opposite to what Equity markets are telling us. US 10-year yields fell by another 9 bps despite the reflation narrative. German 10-year yields fell by 7 bps and Japanese 10-year yield fell by 2 bps in July.

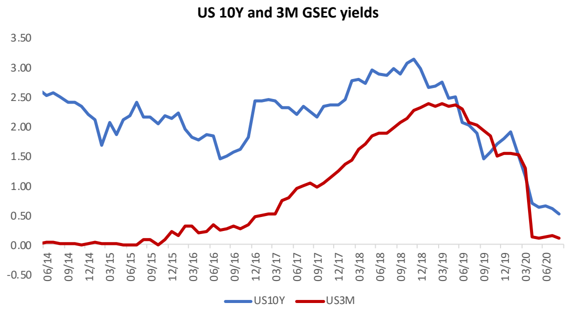
Along with the reflation narrative, we have also had repeated assurances from the FED that they will achieve their 2% inflation target (and allow inflation to overshoot as well). But Bond markets are simply not buying it.

In our last issue, we had mentioned that 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. We however argue that despite this, bond markets are sending out a very distinct and clear signal about the state of the economy ahead.

Nothing highlights this signal more than the chart in Exhibit 49 that tracks US 10-Year yields across various QE periods (gray sections). If you notice, bond yields actually increased in QE1 and QE3 signaling an actual economic recovery. In QE2, bond yields kept decreasing (during the Euro zone crisis).

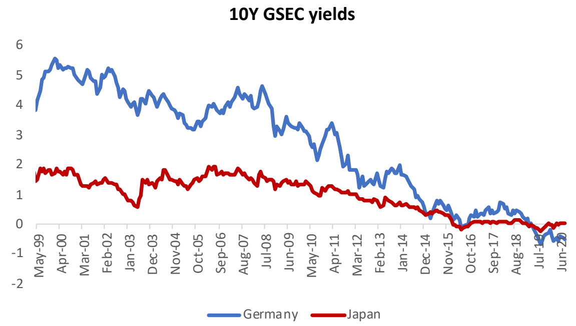
Coincidentally, equity markets delivered solid returns in QE 1 and 3 and delivered negative returns during QE2. And if we call the current period as QE4, we have a scenario of falling bond yields (just like QE2) suggesting that the recovery is likely a head fake.

Exhibit 47: US 10-year yields fell by 9 bps in the month of July



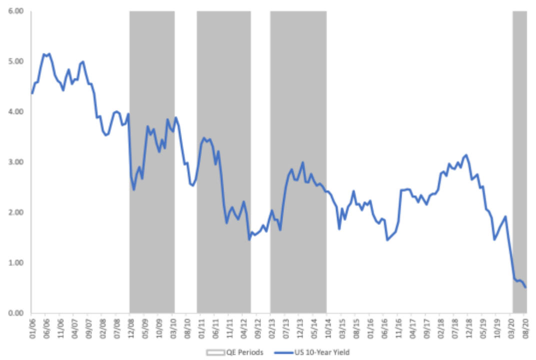
Source: Bloomberg

Exhibit 48: German 10Y GSEC yields fell by 7 bps in the month of July



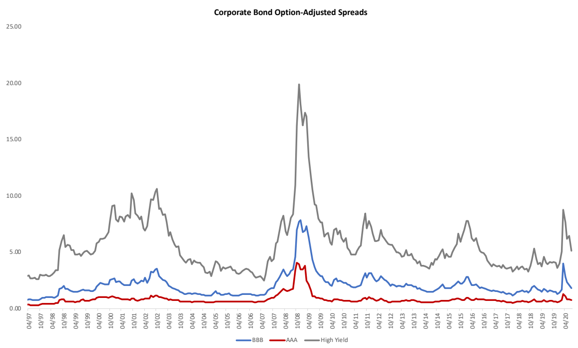
Source: Bloomberg

Exhibit 49: Bond yields have been falling in this QE unlike QE1 and QE3



Source: Bloomberg

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



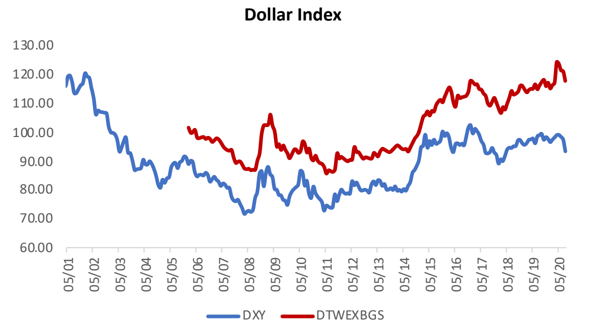
Source: FRED

3. Dollar and Gold

It was not a good month for Dollar bulls. DXY index fell by 4.1% while trade-weighted dollar index fell by 2.7% implying a broadly weak month for the dollar. Weakening dollar is also one of the prime reasons for global rally in the equity markets.

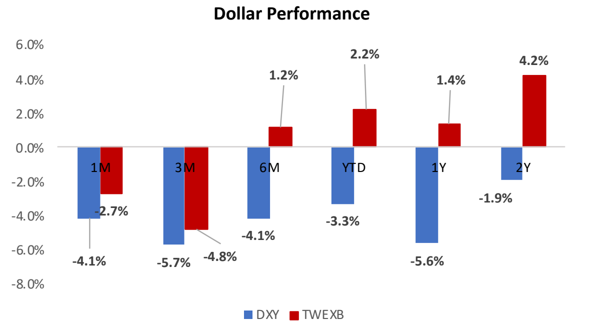
We however note that bulk of the weakness in dollar has been driven by strength of Euro (up 6.25% in July) than anything else. If we compare other DM currencies, the weakness is not that profound (Yen is up 1.9%). Even when compared to EM currencies, dollar weakness is not as bad as Euro. If we look at long-term dollar trends, we will find out that dollar has alternate cycles of strength and weakness. We were so far in a dollar strengthening cycle and with the current bout of weakness, the general consensus is that dollar has peaked, and we are at the start of a weakening cycle.

Exhibit 51: Dollar index (DXY) fell by 4.1% in July and Trade weighted index fell by 2.7%



Source: FRED, Bloomberg

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



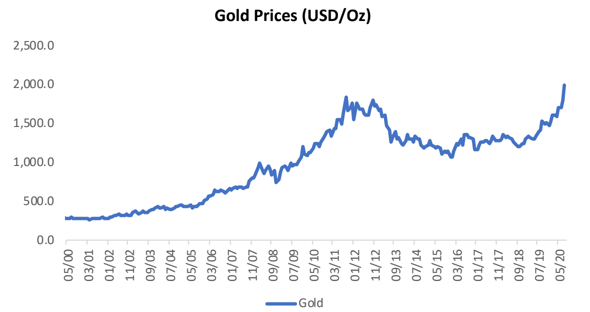
Source: Bloomberg

Gold is the new wonder kid

What a month it was for Gold. Gold rallied 10.9% in July to close the month at USD 1975/oz. And it did not stop there. As of writing this report, Gold has breached 2000 levels and trading above USD 2050/oz.

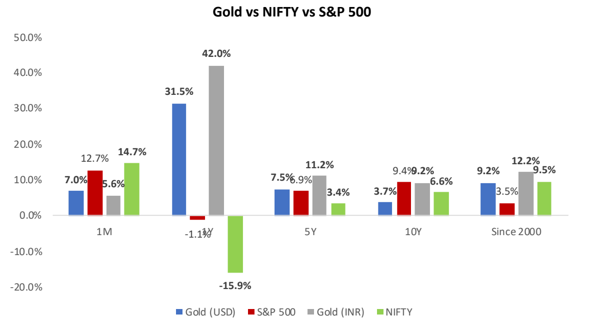
We at Finpeg, remain bullish on gold from a medium-term perspective. In our view, rampant printing of USD (as well as other major currencies) by Central Banks makes gold very attractive w.r.t fiat currencies. However, the current price action has meant that Gold is now in an overbought territory and we do not rule out a correction in the near term.

Exhibit 53: Gold is now trading at its all-time high breaching the record set in 2011



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)	-9.50%	-11.70%	-1.70%	-1.70%	-15.0%
Inflation (latest)	0.60%	-0.10%	0.10%	0.60%	0.40%
10Y Gsec (latest)	0.52%	-0.51%	0.01%	0.13%	0.07%
Central Bank Rates (latest)	0.25%	0.00%	-0.10%	0.10%	0.00%

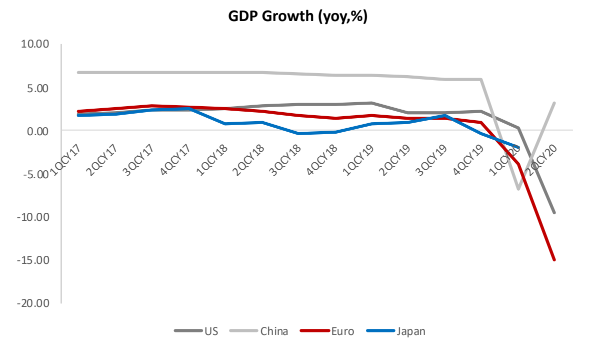
	China	Indonesia	Brazil
GDP (latest)	3.20%	-5.32%	-0.30%
Inflation (latest)	2.50%	1.54%	2.13%
10Y Gsec (latest)	2.98%	6.80%	6.47%
Central Bank Rates (latest)	3.85%	4.00%	2.00%

As can be seen from the table above, the world has slipped into a deep recession. Most of the developed economies contracted sharply in the quarter ending 30th June and this come on back of contraction in the first quarter as well.

Exhibit 56-58 show Manufacturing PMIs for US, Eurozone and China respectively for the month of June. It is worth noting that for the first time since March, PMIs have moved above 50 indicating a month-on-month expansion w.r.t June. However, the numbers are still very modest to suggest any meaningful and secular recovery.

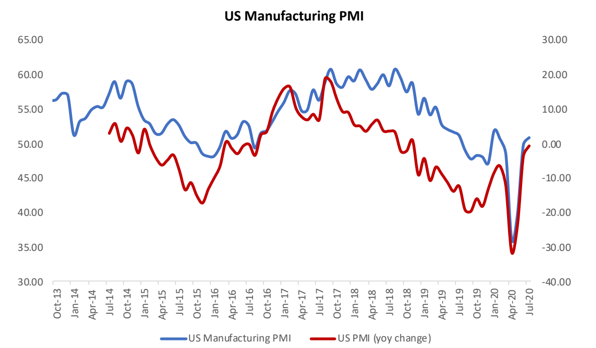
Further, cases in US started surging again only in July and slowdown in activity (owing to pause in reopening and local lockdowns) only took effect in the second half of July. At the same time, cases in Europe have started to show early signs of surge which will likely have an impact in August activity. In essence, we have to accept the fact that economies will continue to operate at a much lower activity levels till the threat of the virus is completely eliminated.

Exhibit 55: Sharp contraction in GDP in US and Euro Zone in 2Q while rebound in China



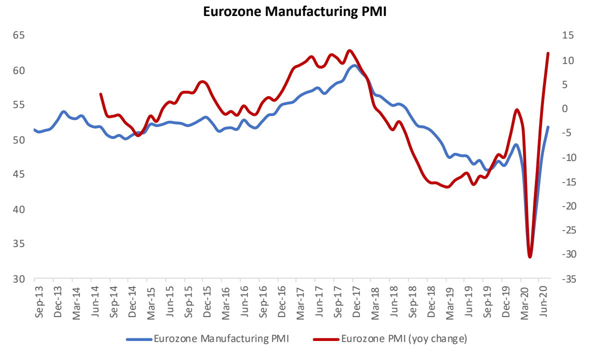
Source: TradingEconomics

Exhibit 56: US manufacturing PMI moved above 50 in July



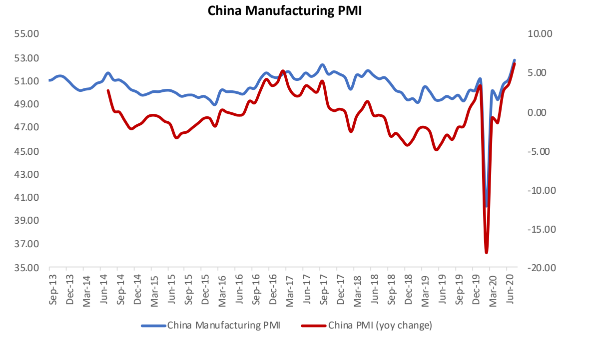
Source: Investing.com

Exhibit 57: Eurozone PMI increased to 51.8 in the month of July



Source: Investing.com

Exhibit 58: Chinese manufacturing PMI was 52.8 in July



Source: Investing.com

Commodity and energy drive near-term inflationary pressure but deflation remains the more likely scenario

Inflation vs deflation seems to be one of the most hotly debated topic in the finance world right now. The actual outcome will likely impact the price action of most asset classes (Equities, Bonds, Gold) in the next 12 – 18 months.

Right now, inflation seems to be the consensus view (bolstered by Fed’s repeated assurances) as is evident in rising inflation expectations. 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.

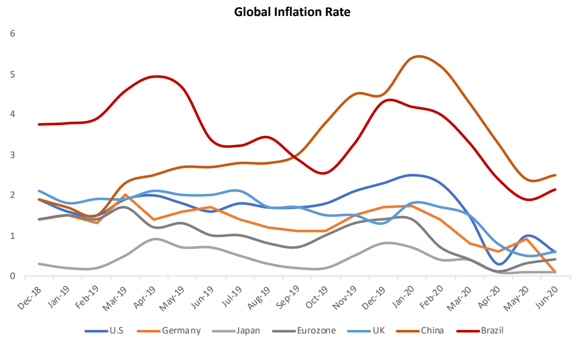
We however continue to believe that deflation (in developed economies) and moderate inflation (in India) is the more likely scenario to play out in the next 6-18 months. Inflation hawks point to “unlimited” money printing by Central Banks as the potential fuse for Inflation.

However, in doing so, they assume that complex variables like velocity of money and money multiplier are stable. However, both the velocity of money and money multiplier have been falling all through this decade (Exhibit 63 and 64) and nothing in the current economic scenario indicates that they will rise in the near term. As long as these variables don’t rise, inflation is unlikely.

The **velocity of money** is a measurement of the rate at which money is exchanged in an economy. It is the number of times that money moves from one entity to another. It also refers to how much a unit of currency is used in a given period of time. Simply put, it's the rate at which consumers and businesses in an economy collectively spend money. The velocity of money is usually measured as a ratio of gross domestic product (GDP) to a country's M1 or M2 money supply.

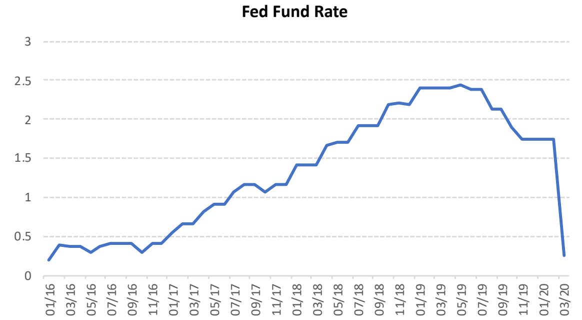
In monetary economics, a **money multiplier** is one of various closely related ratios of commercial bank money to central bank money (also called the monetary base) under a fractional-reserve banking system. It relates to the maximum amount of commercial bank money that can be created, given a certain amount of central bank money.

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

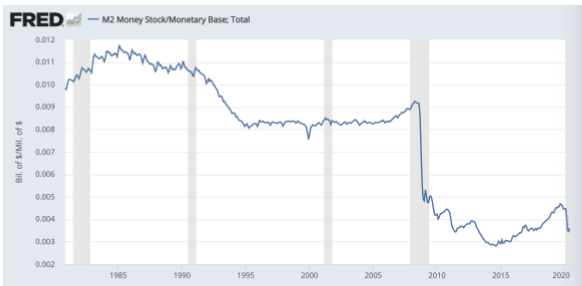
Exhibit 62: 5-year 5-year forward inflation expectation also inching up

Source: FRED

Exhibit 63: Velocity of money has collapsed in the last decade and continues to decline

Source: FRED

Exhibit 64: Money multiplies has also collapsed and unlikely to fuel inflation



Source: FRED

Performance Data

1. Best performing Equity Mutual Funds in July 2020

Best Large Cap Funds	1M	YTD	1Y
IDFC Large Cap Fund	8.9%	-3.2%	5.9%
Edelweiss Large Cap Fund	7.9%	-6.9%	2.5%
Invesco India Largecap Fund	7.8%	-4.6%	3.6%

Best Multi Cap Funds	1M	YTD	1Y
DHFL Pramerica Diversified Equity Fund	11.1%	6.4%	16.0%
Parag Parikh Long Term Equity Fund	9.8%	9.4%	18.7%
Motilal Oswal Multicap 35 Fund	8.1%	-8.1%	1.3%

Best Mid Cap Funds	1M	YTD	1Y
DHFL Pramerica Midcap Opp Fund	10.2%	10.1%	24.3%
ICICI Pru Midcap Fund	8.3%	-10.2%	-4.8%
Reliance Growth Fund	7.2%	-6.8%	1.8%

Best Small Cap Funds	1M	YTD	1Y
Union Small Cap Fund	9.1%	-2.8%	11.8%
ICICI Pru Smallcap Fund	6.8%	-13.1%	-5.1%
Kotak Small Cap Fund	6.5%	-6.7%	5.1%

Best Large & Mid Cap Fund	1M	YTD	1Y
L&T Large and Midcap Fund	7.3%	-7.1%	2.2%
Edelweiss Large & Mid Cap Fund	7.2%	-7.7%	2.7%
UTI Core Equity Fund-Reg	6.9%	-9.9%	-4.9%

Best Focused Fund	1M	YTD	1Y
IDFC Focused Equity Fund	10.0%	-3.4%	11.3%
Aditya Birla SL Focused Equity Fund	7.2%	-8.1%	1.2%
IIFL Focused Equity Fund	7.0%	-4.2%	8.7%

Best ELSS Fund	1M	YTD	1Y
ICICI Pru Value Discovery Fund	8.6%	1.8%	3.5%
HDFC Capital Builder Value Fund	8.3%	-10.2%	-4.8%
L&T India Value Fund	7.9%	-8.4%	-2.3%

Finpeg is a registered trademark of Neam Caps Private Limited. Neam Caps Private Limited is a registered Mutual Fund Distributor with AMFI Registration Number ARN – 113082

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