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Bull vs Bear

APRIL 25, 2020

Summary

- Implications & lessons – Franklin Templeton fund freeze
- Fed's time and size of stimulus – versus 2001 and 2008
- The bull and bear case for equities
- Investment outlook and asset allocation

Déjà vu in Credit Markets

History repeats, and investors pay a steep price

History Repeats - the Templeton Fund Freeze

History – recent and older - is replete with examples of painful outcomes when investors stretch for yield in fixed income. The Franklin Templeton freeze is the latest instance in a long series. Yet again, **caveat emptor – buyer beware – remains the guiding principle on investment.**

Time and again, a well packaged proposition is presented to investors, but the reality of the investment process is eventually revealed to be shockingly mediocre.

The fund freeze could not have come at a worse time. Markets were stabilizing on the news of the Jio Facebook deal. Markets will now need to deal with renewed worries in the debt market, the impact and run-on effects this will have on credit risk funds, market liquidity and confidence.

Spreads have widened, driven by a sharp decline in 3 year G-Sec yields

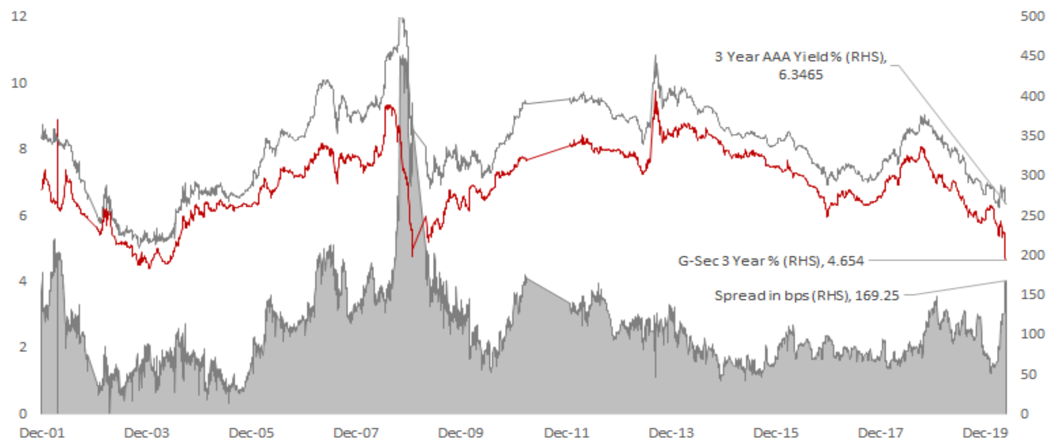
Corporate G-Sec Spread Rises to Near 10 Year Highs, But…

As the charts below evidence, spreads have widened, but we'd note that corporate yields have not spiked; rather **the spread widening is driven by lower G-sec yields**.

NBFC AAA 3 Year Spread Surges to 10 Year Highs

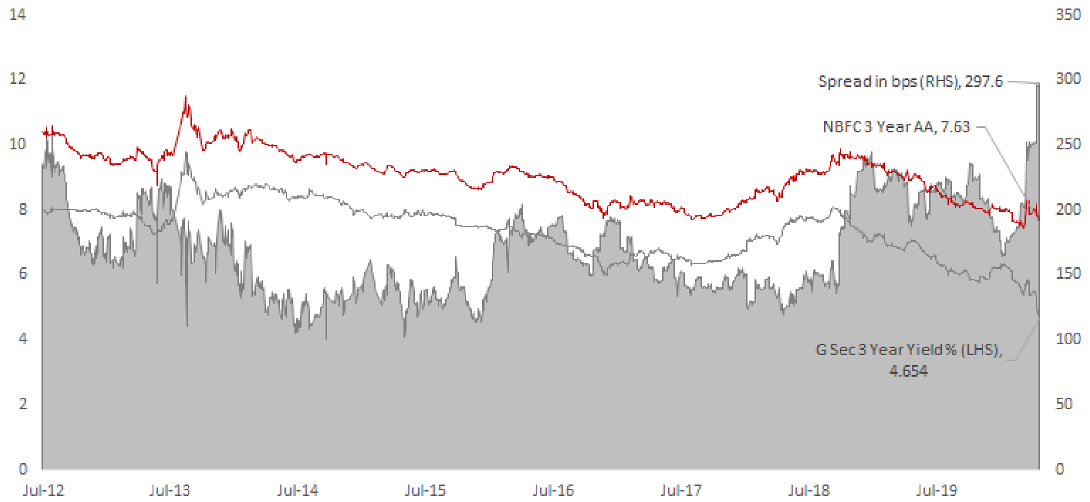
A similar pattern is evident in AA NBFC 3 year paper. On the flip side, many AA and lower names aren't liquid, so the quoted yields may not necessarily be indicative and accurate. So far, the RBI appears unwilling to step forward.

Spreads on Corporate Bonds Have Widened but AAA Yields Have Not Spiked



Source: Bloomberg

Spreads on AA NBFC Have Also Widened but Difficult to Ascertain True Yields Due to Illiquidity



Source: Bloomberg

Evaluating the Bullish Case for Equities

Global Markets : The Fed's Fastest & Biggest Stimulus Ever

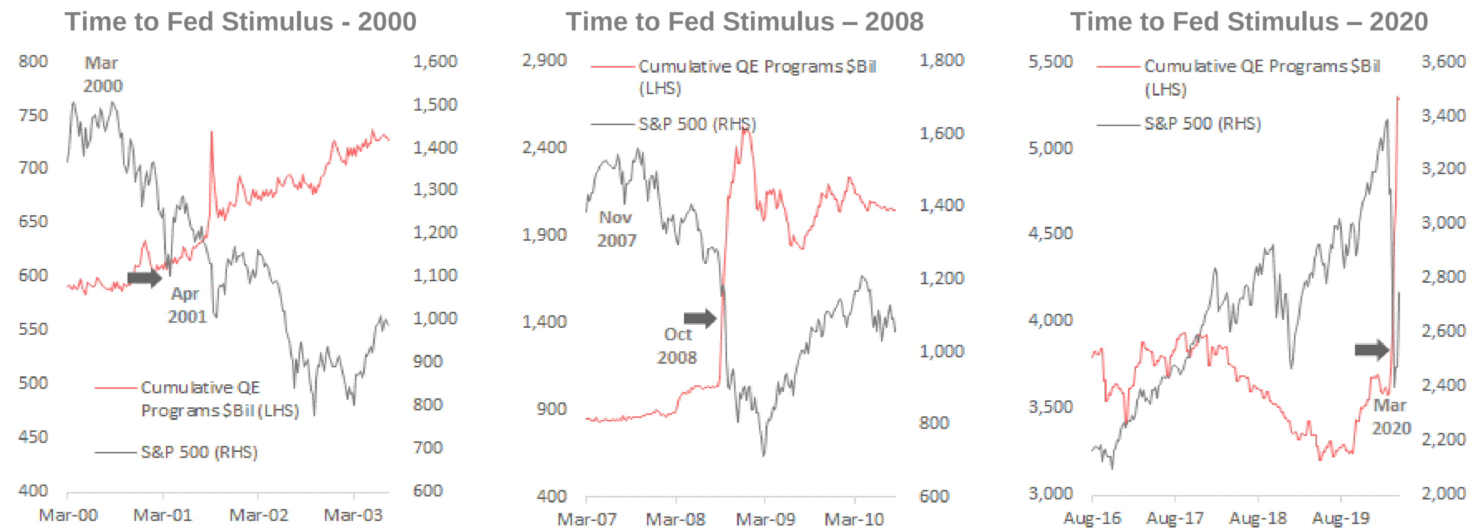
The Fed has engineered the fastest and biggest Stimulus ever

Eleven months post the market peak in 2000

Little did Greenspan know that by bailing out Long Term Capital Management – headed by quant luminaries including Myron Scholes – he was creating the playbook that would be used time and again over the next 20 years.

During the tech crash of 2000, Greenspan raised liquidity from $580 billion to roughly $680 billion, roughly $100 billion. QE hadn't been born yet. Greenspan's liquidity boost began in April 2001, 11 months post the peak in the Nasdaq. The delayed and relatively muted response didn't do enough to mitigate a painful two year bear market, but great prosperity followed in the next five years, and another bubble. The Fed put was born.

The Fed has Engineered the Fastest & Largest Ever Response



Source: Bloomberg

Eleven months post the peak in 2007

In 2008, the Bernanke Fed was bolder but late to recognize the crisis. Faced with systemic collapse, QE programs were launched, FX liquidity swaps were introduced. This time the balance sheet swelled by roughly $1.5 trillion. Markets recovered soon thereafter, and the can was yet again kicked down the road. In the years that followed, the Fed balance sheet swelled to almost $4 trillion by early 2018.

U.S. junk bond market yields have stabilized post the Fed stimulus

Two months from the peak in 2020

In contrast, Fed Chairman Powell has acted swiftly, with shock and awe thrown in for good measure. The Fed acted within two months of the market top this time, and has expanded cumulative QE from $3.2 trillion, to roughly $5.3 trillion, or $2 trillion in QE, with more coming.

The Fed has engineered the fastest and largest response, ever, to a crisis. The stimulus allowed markets to form a bottom, including the Nifty at 7,600 in March 23, 2020.

The stimulus is a key reason the markets have rallied since March 23, 2020.

U.S. Money Supply has accelerated to the highest pace in 20 years

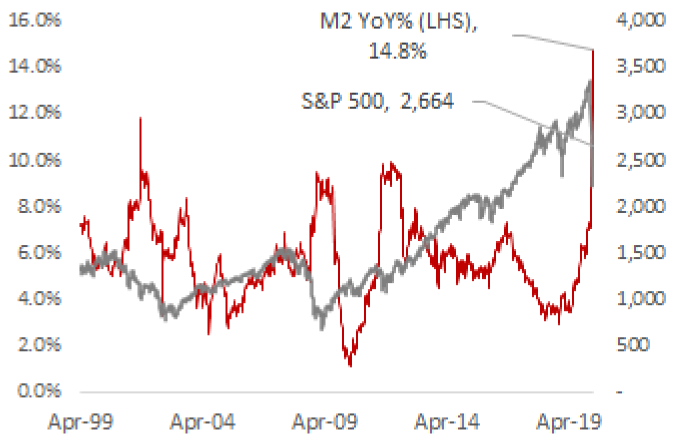
The Fed Establishes Itself as the Buyer of Last Resort

The Fed has transmitted that it will do everything in its power to backstop the U.S. financial markets and economy, including but not limited to high yield junk bonds, corporate bonds, potentially equities, repo market, FX liquidity swaps, mortgage securities, and systematically important entities.

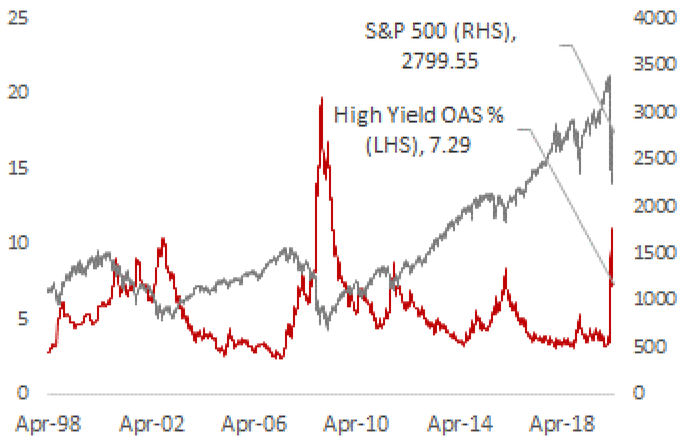
U.S. M2 Money Supply Has Accelerated to 14.8% YoY

Another marker of prior crises has been a rapid rise in money supply, which generally leads to recovery. It has now, as well, accelerated to the fastest pace in at least 20 years, and was a pre-condition to market bottoms in 2003, 2009, and 2011, as well as prior instances.

U.S. Money Supply Is Growing Rapidly



Junk Bond Yields Have Come Back Down



Source: Bloomberg

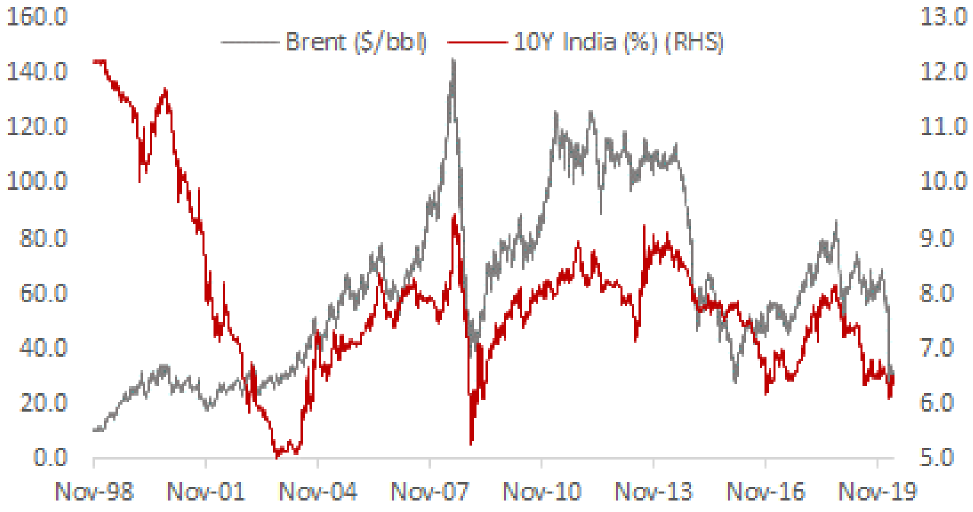
The U.S. Junk Bond Market Yields Have Come Down

U.S. high yield rates are another marker of stress and corporate debt defaults were a key concern this time around, particularly in energy. The high yield index peaked prior to the market bottoming in Oct 2002, at 10.3% and March 2009. Yields hit 11.0% in March 2020 and have since come off to a more benign 7.2%. It will remain to be seen if the index takes back the highs set in March 2020 or if it has peaked.

Crude Oil is at Historic Lows and Historically Precedes Market Bottoms

Crude oil is plummeting as worldwide demand is dropping. Few imagined that the front month crude would get to a negative number. With no storage facilities available, the near term cost of storage is essentially infinite, which means there is no practical limit to how far the front month contract can fall, which is what we witnessed this week. The decline in Brent preceded market bottoms in 2003, 2009, 2013, 2016 and is primed to do so now.

Crude Oil Drops Have Historically Preceded Bottoms all the Way Back to the 1970s



Source: Bloomberg

Domestic Markets – Valuations Back to Fair Value

Domestic Valuations Reached Attractive Levels on March 23rd, 2020 But Have Since Bounced Back

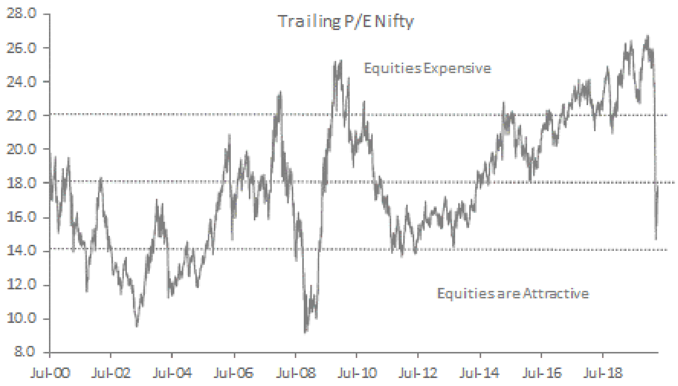
Domestic Valuations reached attractive levels on March 23rd. They are back to neutral valuations

We share below the trailing P/E for the Nifty 50, the trailing earnings yield - bond yield spread, more commonly referred to as the Fed model, and the same charts using real earnings and yields. The real yield spread is an arguably more relevant measure as it accounts for the denominator – cost of capital in a future flows discount model.

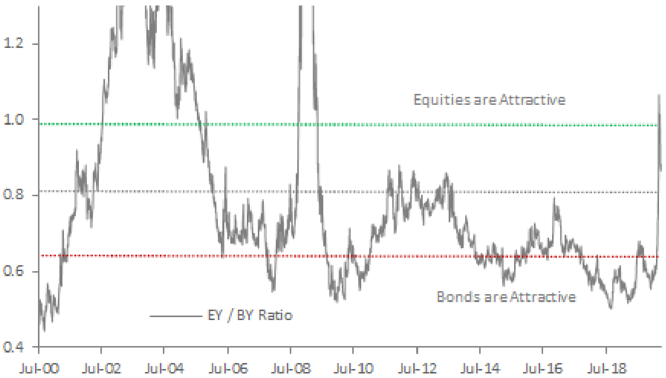
The Price to Book last month approached the trough valuations of 2008, but not 2002. P/B remains a relevant measure for financials, but is problematic for certain industries.

The Trailing P/E and Real Trailing P/E, the Price to Book, Price to Sales for the Nifty Dropped in March. These Indicators Have Recovered Since Then. The Yield Gap Has Also Come Back to Neutral Ranges

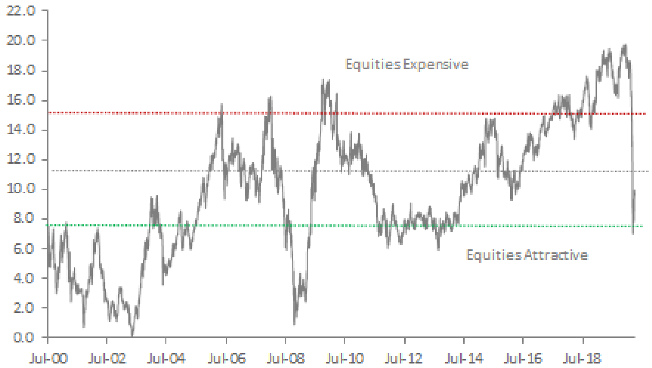
Trailing P/E - Nifty 50



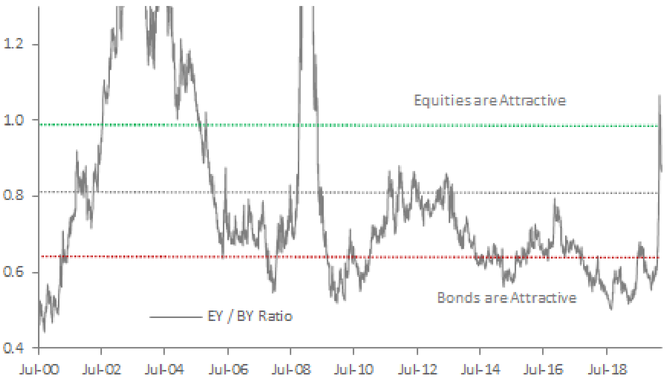
Trailing P/E - Bond Yield Spread - Nifty 50 & 10 Year



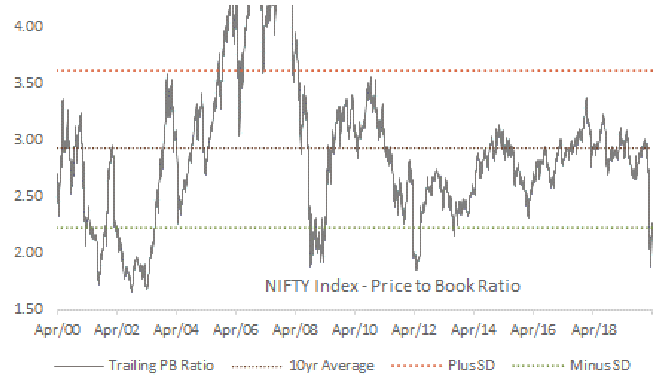
Real P/E Nifty 50



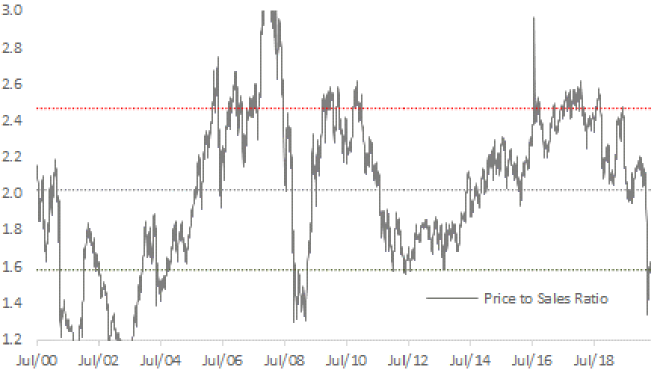
Real Trailing P/E - Bond Yield Spread



Price to Book - Nifty 50



Price to Sales - Nifty 50



Source: Bloomberg

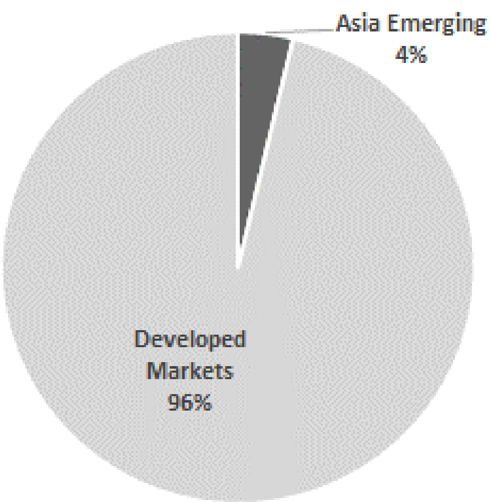
Finally, the Bull Case is built on a Benign Coronavirus Scenario

A first cut view on the data on corona is surprising. **96% of the coronavirus cases are occurring in developed markets**. The Chinese were travelling to all countries all over the world, so the notion it arrived late in India does not resonate. Second, one would expect China's neighbors - **Hong Kong, Vietnam, Thailand, the Philippines, Japan, Indonesia** – would be badly affected. Yet, not one of these countries features in the list of most infected.

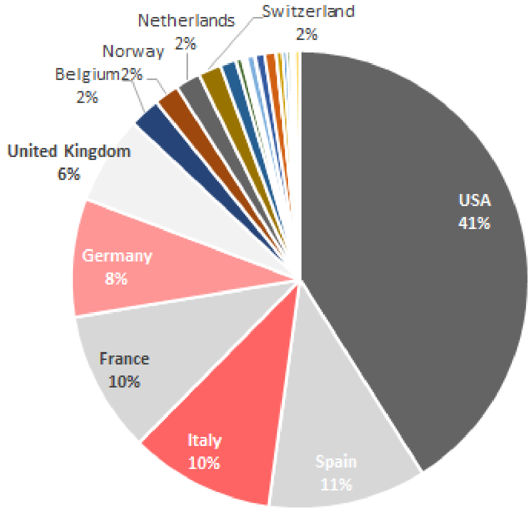
While India carries its particular set of risks with millions living in cramped spaces and no concept of social distancing, the data – to date – does seem to indicate that South Asian economies carry a differentiated ability to be affected at a lower frequency than advanced economies. It could be a function of built up immunity to constant virus attacks. Should this trend continue, it could be a positive for South Asian economies in terms of recovery.

Only 4% of Corona cases are in South Asia Countries ex China

Coronavirus Cases



Coronavirus Cases – Top 6 Countries



Source: Worldometer

The Bullish Case for Equities Is Based on Stimulus and Benign Corona

To summarize, a continuation of the bullish case for equities revolves around the large central bank stimulus, and a benign outlook for Coronavirus spread in India, or an optimistic prognosis on a coronavirus cure.

The Bullish Case for equities largely rests on the Fed's enormous stimulus seeking a home, and a benign outcome for corona

The Bearish Case for Equities

Opening Up the Economy Carries Risks and the New Normal will be an extended Lower Level of Activity

Consumers have suffered the triple whammy of concerns around job security, losses in investment portfolios, reduced interest rates on debt and concerns around safety. That's a toxic cocktail that will impede consumer demand.

In a complete lockdown over the past few weeks, the data suggest that countries have been able to flatten the spread of the virus. However, how **the situation fares as economies are opened up remains a key concern**. Sectors such as airlines, hospitality, retail, leisure, fine dining, real estate will feel the impact and a **vicious spiral downward** can occur.

We're likely staring at a vicious cycle of reduced consumption leading to businesses suffering stress and shuttering or laying off employees, or implementing salary cuts.

The Bearish Case for equities rests on the stress building up in various industries, risks to the financial sector, hidden second order impacts, and a corona virus scenario that lasts longer than expected

Second Order Unseen Effects – Negative Oil, Negative Rates, the Junk Bond Market, the Repo market, the Templeton Fund freeze

The bearish case is underpinned by negative oil prices, market dislocations, negative rates possibly in the U.S., frozen debt markets and other unforeseen stresses that lurk under the surface.

A Quick Resolution to the Worst Crisis in 90 years is Unlikely

The bearish case argues that expecting the virus situation to be resolved in two months with markets already bottomed in the worst crisis experienced in 90 years seems to be wishful thinking.

Risks for the Financial Sector

At the center of the storm remain financials and the financial systems. India will not have the ability to ring fence the financial system should the crisis unfold for longer or a vaccine cure isn't found.

The Bearish Case for Equities

The bear case remains driven by the hidden stresses manifesting as a result of the lockdown, systemic risks, the mayhem in global markets that are erupting with regularity, and coronavirus leading to a prolonged shutdown, with a permanently lower level of economic activity.

Investment Outlook

Step 1: What's the Plan?

Yesterday is gone. Now would be a good time to ensure, or put in place a plan – and team - for the post corona future. If you're convinced you've got a great team, then asset allocation is the logical next step.

Portfolio Positioning with 100 Year Events Unfolding

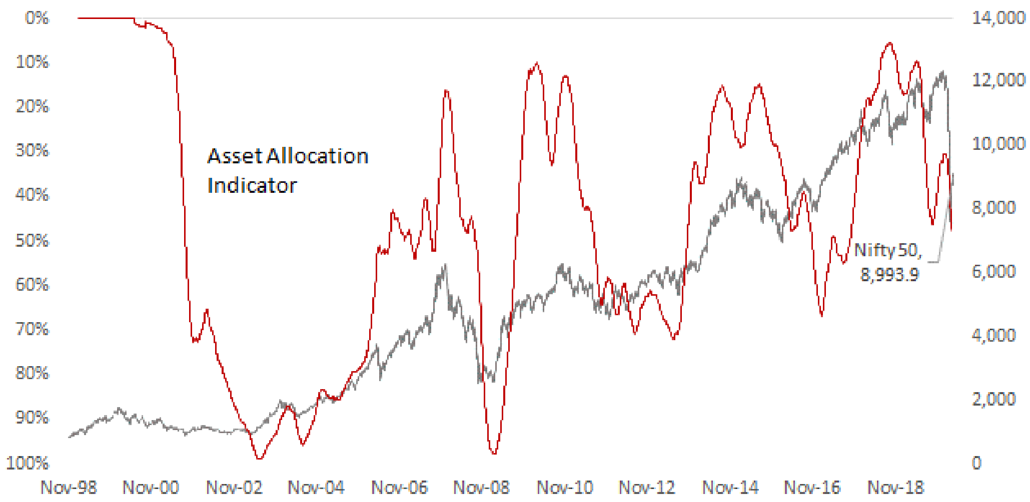
Whether we consider the pandemic, a once in a century event, or negative yields, negative oil prices, respected fund houses shutting down thousands of crores of debt, let's recognize that **we are living in extraordinary times**.

Good outcomes are a result of sound plans and competent analysis

In such times, nimbleness and insight become more important than ever. **Choosing the right team, one that is trustworthy, intellectually competent, honest, will be the most important decision to make.**

Asset allocation has re-asserted itself as a key determinant of market returns. On March 6th, March 13th we recommended capital protection against the waterfall drop in the stock market. We've been recommending clients exit credit risk funds since the summer of 2019.

Our Asset Allocation Indicator Has Warned on Prior 4 Market Tops



We've executed two trades in the past year on duration, both highly profitable. **We repeatedly warned investors a sharp snapback rally was likely** to unfold. So far, the market has followed a typical bear market script.

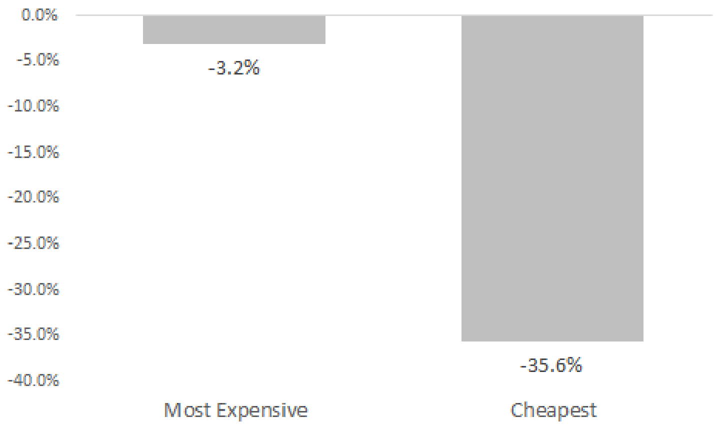
The factor model below incorporates key leading indicators for the Indian markets and signaled major market tops in 2000, 2007, 2010, 2015 and 2018-19. **The notion that investors should suffer significant 20-30% drops is something that we endeavor to protect against.**

Step 2: Review and Reposition Portfolios

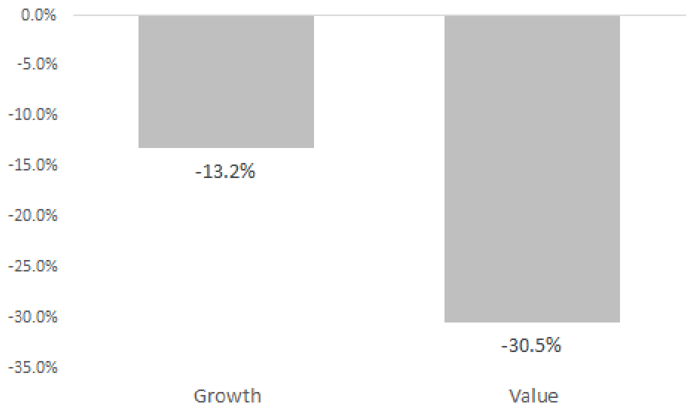
There's a lot of confusion out there. Should I buy cyclicals? Should I buy value? Should I buy expensive names? Let's review the data…

Expensive Stocks Are Down Only -3.2% YTD
Some simple metric checks provide meaningful insights. The cheapest decile - cheapest 50 stocks by P/E ratio - in the NSE 500 delivered a -35.6% return. Meanwhile, **the most expensive 50 stocks in the NSE 500 delivered a -3.2% return YTD**. Growth stocks outperformed value by 32.4%.

High P/E Has Outperformed Low P/E by 32.4% YTD



Growth Has Outperformed Value by 17.3% YTD



Source: Worldometer

Growth Has Outperformed Value by 17.3% YTD
A broader measure of Value delivered -30.5% YTD. Meanwhile, Growth delivered -13.2% YTD. In other words, Growth outperformed Value by 17.3% year to date.

Quality Has Outperformed Value
If you owned an Abbott India, Divis Lab, Hindustan Unilever, Nestle or Avenue Supermarts, all quality growth, you wouldn't know that we'd had a crash. The average return from these stocks year to date is 23.6%. The range of returns is 17.2% to 29.4% year to date.

Large Caps Have Trounced Small Caps by 21.6% YTD
The largest 50 stocks by market capitalization delivered -15.3% YTD. Meanwhile, the 50 smallest cap stocks in the CNX 500 were decimated further, down -36.9%.

Using the SEBI cap classification, large caps delivered -16.0%, midcaps delivered -16.6%, while small caps were down -24.6%.

The **selloff year to date, has yet again reinforced the dominance of quality** – whether it be tech stocks in the U.S. or consumer stocks in India. Quality, as represented by a Coffee Can, continues to outperform the broader market in downturns and during bull markets.

Recommendations on Style / Factors

It's abundantly clear from the data that stock selection, cap selection and manager selection are key actionables that will impact portfolio performance. We favor:

- Large caps over small caps
- Quality growth at reasonable prices, regardless of capitalization. Our definition of quality already, and always, includes companies that have ample cash, strong balance sheets, low debt.
- Managers with strong track record of performance and proven, consistent methodology.
- Consistent growth over cyclicals. There is a fair likelihood some so called beaten value stocks may have trouble surviving the corona crisis. If one of these finds its way into a portfolio, it will severely impede returns.
- Sectors that are beneficiaries of the new post corona world order.

Step 3: Market Outlook

The **market has clearly run ahead of economic fundamentals, driven yet again by the Fed stimulus,** and the news flow is likely to worsen dramatically in coming weeks.

That view must be balanced by the **low probability that a virus cure could be announced as early as next month** and news of economies opening up.

Continue to Favor Large Caps Over Mid and Small Caps

Source: Bloomberg

For a true barometer of the global economy, one need look no farther than crude oil demand and supply. While the coronavirus hangs over our heads, the situation will continue to worsen behind the scenes.

So while the directionality remains difficult to predict; in such times, **prudence remains a viable choice.** In our opinion, the prudent course of action is owning quality managers, quality stocks in viable sectors, and an **asset allocation that remains positioned to take advantage of opportunity** should it emerge.

Patience inevitably, must accompany prudence. How that translates to your positioning is a portfolio specific exercise. We advise **a portfolio strategy that incorporates worst case scenarios,** and plan to benefit from such scenarios.

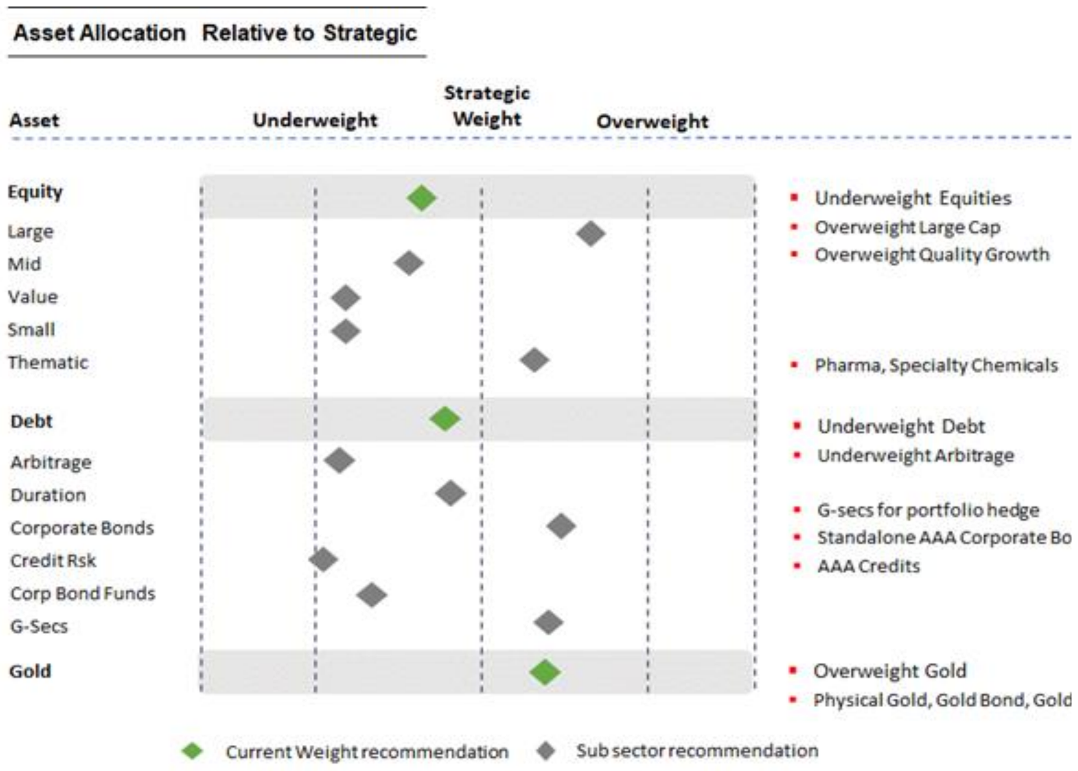
For those unwilling to miss out on the potential upside, **further refinements can be discussed including long tail structures** that position the portfolio to reflect outcome expectations.

Step 4: Tactical Trades

Opportunities in equities, debt and gold continue to crop up. The ability to nimbly re-position portfolios will dramatically improve return outcomes. Our Products team will continue to share a stream of well thought, low risk, optimal risk reward ideas in equities, debt and gold, at manager level and investment level.

Step 5: Leadership Stocks for the Next Bull Market

Finally, identifying stocks that will be leaders of the new bull market will be our ongoing focus.



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