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KNOW THE NOW

ARE EQUITIES AN EFFECTIVE INFLATION HEDGE?

JUNE 14, 2021

Dear Clients,

The last couple of months have been devastating as we watched live, the frail health care infrastructure collapse as COVID-19 breached the 4 lac daily cases threshold. The delta variant's aggression has impacted everyone, and the lack of healthcare supplies to many precious lives that were lost, has had a psychological impact that may well last longer than *Long Covid*. This may be the first time that millennials and Gen X have experienced collective grief.

Amidst the very negative and some would say, brutal international media attention, lockdown 2.0 helped bring the case nos. down and though opening up is imminent, the pace depends on how we splutter through our vaccination program. The markets caught many by surprise (and let's admit relief) with their resilience, as May '21 closed with NIFTY 50 up 6% and the midcap and small-cap indices up 7% and 9% respectively.

In this month's **Know the Now** we discuss a subject that's a growing concern for investors, companies and individuals - **Inflation**. Signs of inflation are everywhere from price of raw materials and commodities, to rising wages and even in the price of products we consume. We discuss what we make of these inflationary impulses - are they transitory or should we expect a lasting inflationary environment ahead. Sunil argues with ***Ten Reasons*** why we believe Inflation is transient and then evaluates whether equities are an effective hedge to inflation and what are the key trends to watch out for.

What I find particularly interesting is the trend on retail participation - it's a generation of young investors entering the markets as well as HNI and Family office investors increasing their allocation to the direct equity portfolio significantly over managed products. Those that are worried about how retail investors have reacted to markets historically may want to keep in mind that this time they led the march and did not come in at the fag end of the bull markets and have built buffers on their capital. Many are savvy investors who have unprecedented access to information and data and very cost effective and efficient technology led platforms to participate in the markets. This is one space we have our eyes on....

Based on your feedback, in this edition of **Know the Now: Are Equities an Effective Inflation Hedge?** we deep dive into Asset Allocation and have done an in-depth coverage across Asset Classes and their subsets. We are also happy to share with you the Ambit GPC wealth profiles that may provide you valuable inputs on how to build your portfolio basis your risk profile.

We hope you find this useful, please reach out to your bankers if you want any further information.

Until the next time, stay careful and be safe.

Amrita Farmahan

Chief Executive Officer

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Are Equities an Effective Inflation Hedge?

June 2021

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MACRO

Inflation: Ten Reasons We Believe Inflation is Transient

Updating Inflation Theory

"**Inflation is always and everywhere a monetary phenomenon**". Famous words by Milton Friedman. But global central banks have been pursuing massive ***monetary* expansion for 13 years now,** and **there has been scant evidence of inflation**. Despite monetary expansion, the predominant force over the past decade has been low inflation. If anything, monetary expansion has led to persistent deflation. Output gaps, full employment, Minsky moments, sustainable debt … concepts macro economists relied upon, have **failed to provide accurate models** as countries have blown past thresholds historically considered dangerous, without crashing. Increasingly, central bankers and economists are accepting the view that **they don't know, and "prefer to deal with today's problem** and not act pre-emptively on forecasts".

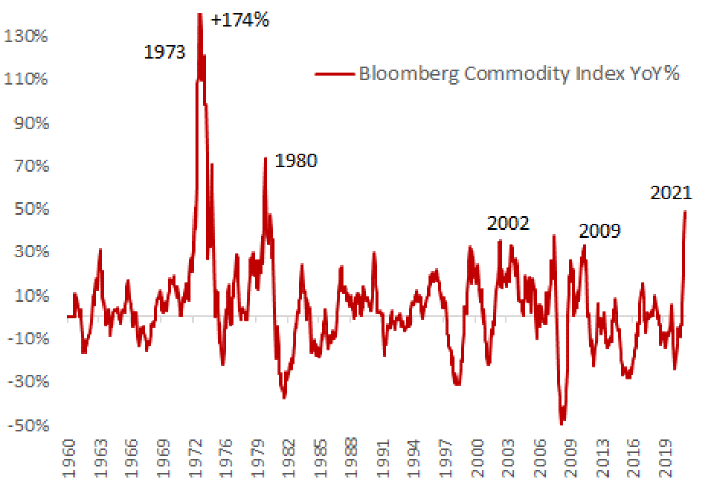
The Inflation Evidence

The Bloomberg Commodities index is up 46% YoY, with Copper, Iron ore, Steel contributing to the rise, alongside Corn, Coffee, Wheat, Soybeans. Lumber, Palm Oil etc. U.S. Core CPI rose the highest in 40 years. In addition, the U.S. has witnessed a 0.7% rise in average hourly earnings in April. Measures of U.S. long-term household inflation expectations have risen 20-25~ bps in the last few weeks. The ISM Prices Paid component is rising at an alarming rate, but the pattern is fairly similar to the 2010 recovery.

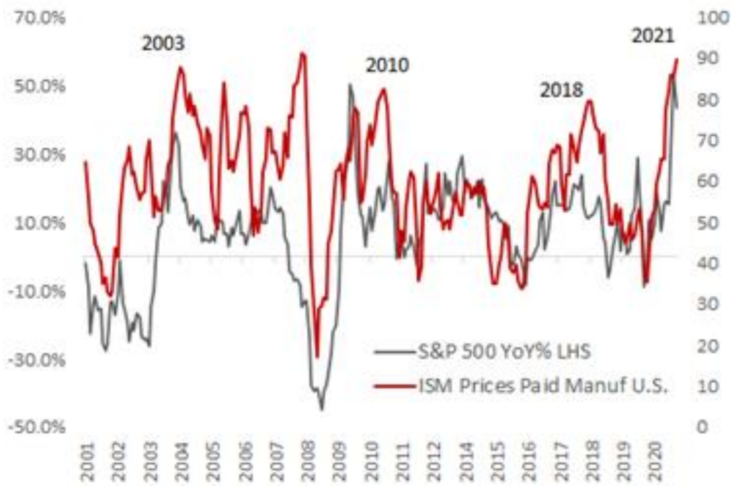
Supplier delivery times are rising, but anecdotal evidence suggests that buyers recognize the unique global environment and are content to wait, creating the possibility of a start stop economy.

The primary evidence of **inflation in India is** the **WPI** All Commodities, which crossed **+10.9% in April**. A CPI heatmap so far shows scant evidence of inflation in India.

Commodity Prices Spiked by 174% in 1973, and Rose Rapidly in the 2002, 2009 and 1980 Recoveries

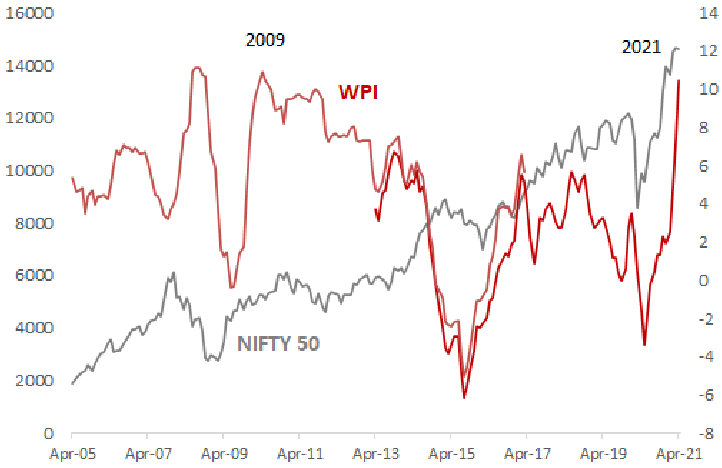


Prices Paid Are Rising, as They Did in 2003 and 2010

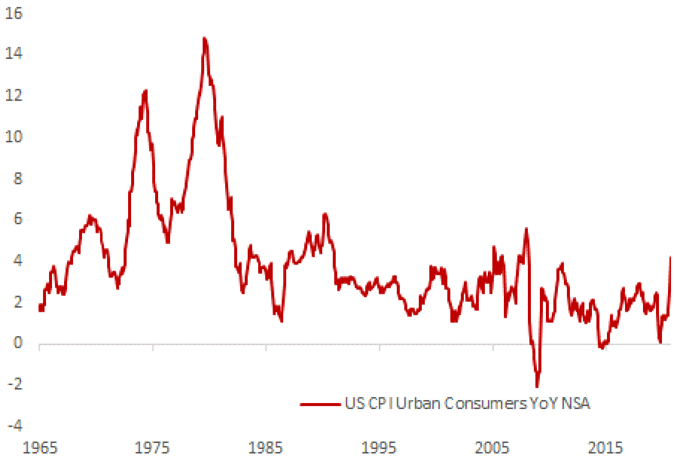


Supplier Delivery Times Have Elongated as Well

India's WPI is Rising, But It Rose in Late 2009… …And Also in 2002



…Let's Note that U.S. CPI is a Far Cry from the '70s…



…When Commodity Prices Rose 150%~ in 1973

Ten Reasons We Believe Inflation is Transient

We share reasons below why we expect Inflation to be a periodic occurrence, driven by specific events – crude oil, attractively low interest rates, supply bottlenecks - while **deflation is the structural trend**.

1. **Technology**, robotics, automation, software are dominant deflationary forces that allow for production of goods at continually lower prices.

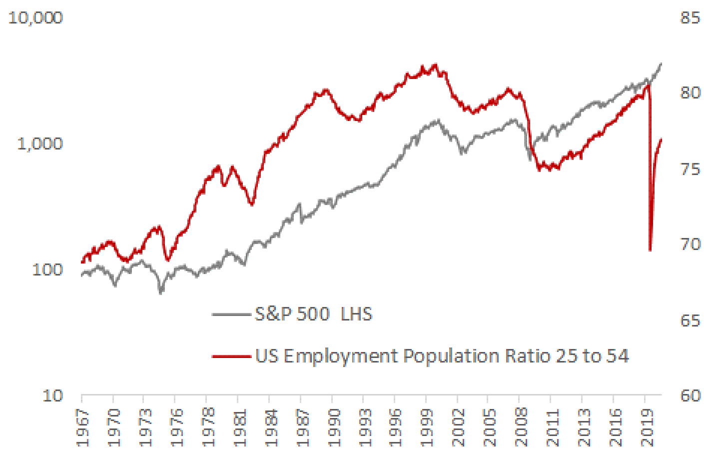
2. **Globalization and labor arbitrage** sends work to lower cost producing regions. India and China weren't on the global stage in the 1970s.

3. Anchored Consumer **Inflation Expectations** - high inflation requires a conscious behavioral change from consumers in support of higher prices. 10 year consumer inflation expectations have risen about marginally to date, suggesting consumers long term expectations remain anchored to low inflation expectations.

The Atlanta Fed measures a sticky price inflation index that measures goods that change price relatively infrequently. That index remains at 2.4% YoY, again suggesting inflation isn't pervasive.

4. **Slack in the U.S. Labor Force** – U.S. employment for 25 to 54 year olds is near the lowest levels of the past three decades. 23% of working age individuals are not working. The total labor force participation rate is at 61%, down from a high of 67% in 2000.

The Slack in U.S. Employment is a Clear Indication U.S. Wage Increases Are Unlikely to Sustain



5. **Start Stop Economy** – Anecdotal evidence suggests U.S. builders are now stepping back from high prices. Consumers are content to wait. Demand driven inflation will normalize post re-opening hysteria.

6. **Limited Pricing Power and Efficient Price Discovery** - Today, unless a company is selling critical medicines, covid equipment, building materials, or leisure in the U.S., it's got limited pricing power. The internet allows for efficient price discovery and is inherently deflationary.

7. **Past Precedent** - Today's inflation trajectory appears to be in line with the 2009 recovery and 2002.. **Inflation rose in Jan 2010, while markets did not peak until November 2010**, and the catalyst was the European debt crisis, not inflation.

8. **Signs of Normalization** - Palm Oil futures peaked at 4883 on May 7th and are now down to 4020 as of this writing. Lumber is down to 1309 from a peak of 1686. U.S. Housing starts, New Home Sales have moderated, housing inventory is down two consecutive weeks. The pace of mortgage apps has steadied. Real estate started the frenzy, and real estate steadying is a first sign of normalization.

9. **Freak incidents** and **Supply Chain Repair** – a number of freak accidents hit the global economy – the Suez Canal blockage, drought in agricultural crops, the Texas blackout, the gas pipeline burst, and underlying all this, covid. In time, supply chains will repair rapidly; the auto chip shortage is already set to resolve in Q2.

10. Finally, an aging population in developed markets is also a structural trend that trends to declining spends.

Markets Accepted Inflation in 2009 and 2002

In the 2009 recovery, inflation began rocketing higher in Nov 2009. The Nifty was at 4886, and **would rise 29%** to 6312, by November before peaking and correcting due to the financial crisis in Europe. **Underlying equities in select sectors, delivered significantly attractive returns**. More on this later.

India remains relatively insulated and much of the noise appears to be emanating out of the U.S.

Nonetheless, inflation bears watching as global economies open up, and it is premature to signal the all clear on inflation. As always, should the data change, we'll review our positioning.

In the words of the famous economist Keyne: 'When the facts change, I change my mind - what do you do, sir?'

Shift in Fed Inflation Framework = Accommodative

The shift in the Fed's framework to Average **Inflation Targeting** (AIT) means that the Fed is looking for 2% average inflation **over the cycle** as a whole. The Fed will also this time want to see clear evidence of realized inflation and maximum employment before withdrawing stimulus. It clearly appears to be a shift in policy from "outlook" to "outcome" and an adjustment to 2018, when the Fed moved too quickly on raising rates.

The **RBI also appears to be positioned pro-growth** and likely to look past transient inflation, and willing to selectively address it with tools in its arsenal.

While developed nations have experienced stable inflation since the 70s, India has experienced sporadic bouts of double digit inflation. **The evidence, however, suggests that equities, particularly quality growth, during the 2002 and 2010 recoveries, did well.**

Let's take a look at the record of how equities perform during inflationary environments in the next part of the report.

EQUITY

Are Equities an Effective Hedge Against Inflation?

Equities are an Inflation Hedge

During times of rising inflation, investors rightly seek to secure the value of their investments by diversifying into real assets. These include hard, physical assets like real estate and natural resources, commodities, **but also include equities**, **which in principle are a claim on the real economy**, **tangible property** and tangible assets. The expectation is that real corporate profits of quality listed franchises will generally grow faster than the real economy.

Equities come with the attractive benefits of instant execution, high liquidity, and low transaction costs, as well as the ability to hedge holdings.

Stocks Vs Bonds in Inflationary Periods

The **real returns of stocks are generally positive** in all inflationary scenarios, except in times of extreme inflation. In extreme inflationary environments, the real returns of both equities and bonds turn negative.

However, compared to fixed income, equities offer a certain degree of protection from inflation in the sense that the **real equity returns are always greater** than those of bonds during periods of rising inflation, and typically **bond yields tend to move higher**, impacting returns negatively, while **earnings growth during recoveries** acts as an offset.

Rising Input Costs Mentions on Earnings Calls

Recent quarter earnings and conference calls clearly indicate that margins suffered as producer prices rose during Q1 CY21, catching a number of companies off guard.

We decided to review recoveries during periods of Rising Commodity prices. Two clearly stood out – 2002 and 2009.

2009 Recovery with High Commodity Inflation:

Forward Asset Class Performance from 2009 Commodities Acceleration				
2009 Recovery	**3 Month**	**6 Month**	**1 Year**	**2 Year**
NSE Nifty Auto Index	**5.9%**	**9.9%**	41.7%	**11.1%**
NSE Nifty Pharma Index	**1.2%**	**10.0%**	35.5%	**11.4%**
NSE Nifty Private Bank Index	4.0%	9.4%	34.5%	7.6%
NSE Nifty PSU Bank Index	-5.7%	5.6%	31.3%	-3.7%
NSE Nifty IT Index	7.4%	8.1%	27.4%	6.9%
NSE Nifty Financial Services Index	-2.9%	3.5%	26.4%	1.2%
NSE Nifty FMCG Index	**-2.5%**	**7.6%**	**23.5%**	**19.2%**
NIFTY Midcap 100	4.0%	8.2%	21.2%	-3.2%
MCX GOLD	-2.4%	4.5%	21.1%	22.3%
NIFTY Smallcap 100	7.2%	6.1%	20.5%	-3.8%
NSE Nifty Services Sector Index	1.0%	2.6%	19.6%	1.0%
NSE Nifty India Consumption Index	0.3%	4.2%	19.5%	8.0%
NSE Nifty 50 Index	**0.4%**	**1.4%**	18.0%	**0.0%**
NSE Nifty 500 Index	**1.7%**	**1.5%**	15.3%	**-2.8%**
Bloomberg Commodity Index	0.0%	-9.4%	14.0%	3.6%
A Medium to Long Term Bond Index	**3.0%**	**7.1%**	9.9%	**8.7%**
Composite AA Short Term Bond Index	1.6%	4.2%	5.8%	7.3%
NSE Nifty Commodities Index	**1.8%**	**-4.4%**	4.5%	**-11.1%**
Long Term Gilt Index	**-0.1%**	**3.0%**	4.2%	**4.7%**
NSE Nifty Metal Index	**7.1%**	**-8.5%**	2.0%	**-19.0%**

2002 Recovery with High Commodity Inflation:

Forward Asset Class Performance from Oct 2002 Commodities Acceleration				
2002 Recovery	**3 Month**	**6 Month**	**1 Year**	**2 Year**
NIFTY Midcap 100	-6.5%	19.5%	119.3%	64.6%
NSE Nifty PSE Index	0.5%	33.3%	116.6%	59.2%
NSE Nifty Bank Index	4.6%	30.0%	92.7%	62.9%
NSE Nifty Pharma Index	0.2%	12.6%	87.5%	43.8%
NSE Nifty 500 Index	-6.6%	7.7%	79.8%	47.9%
S&P BSE 200 Index	-5.9%	6.4%	75.7%	45.3%
NSE Nifty 50 Index	**-8.0%**	**-3.9%**	**56.4%**	**34.6%**
NSE Nifty Services Sector Index	-11.3%	-14.6%	45.7%	39.6%
NSE Nifty MNC Index	-8.8%	0.1%	39.2%	17.6%
Bloomberg Commodity Index	**8.7%**	**10.3%**	**25.0%**	**13.7%**
MCX Gold	0.8%	6.7%	22.9%	14.1%
NSE Nifty FMCG Index	-8.1%	-0.3%	21.8%	11.6%
NSE Nifty IT Index	-18.2%	-38.8%	13.4%	22.7%
A Medium to Long Term Bond Index	0.9%	8.4%	13.0%	7.4%
A Short Term Bond Index	2.2%	5.3%	9.6%	8.0%
Composite AA Medium Term Bond Index	0.7%	5.9%	9.3%	5.5%
AAA Medium Term Bond Index	0.5%	5.6%	8.7%	4.9%
Composite Bond Fund Index	0.8%	5.2%	8.5%	4.2%
1 Year T-Bill Index	1.1%	2.9%	5.8%	4.4%

The 2009 Recovery Roadmap

As we've maintained for months, **this recovery is following the 2009 roadmap**. Inflation accelerated higher in Nov 2009, and yet the markets continued to rise from 4886 to 6310, **+29%, despite persistently high inflation in 2010**. It was ultimately the European debt crisis that derailed the recovery in late 2010.

The Jan 2010 – Dec 2011 inflation was also due to domestic supply constraints, somewhat similar to today. The bear market in 2011 saw markets falling back to 4624.

However, it's important to peel the onion. Nifty constituents included many sub-par performers that got slammed, particularly metals, commodities, PSUs and the like.

What did far better, was quality growth stocks in sectors such as **Financials, Consumer, Health Care, Materials.** Returns from many companies, in this period, were spectacular. **Indian equities – specifically quality growth – are an effective means of inflation protection, as long as inflation does not go to extremes**.

Valuations

In times of low and stable inflation (roughly between 2% and 5%), investors many times accept high stock market valuations.

Higher inflation rates correspond to lower stock valuations in terms of price to- earnings (P/E) ratios.

Significant deflationary and inflationary environments lead to lower P/E ratios, explained in part by increased risk aversion and uncertainty that characterizes inflation at both extremes of the spectrum.

High P/E ratios will be a challenge, particularly for growth stocks, should inflation persist, but expected earnings growth during the recovery will provide an active offset. We have noted already that P/E ratios have compressed as FY1 estimates rolled to the new fiscal year.

What Does the Equity Risk Premium Tell Us on Rates?

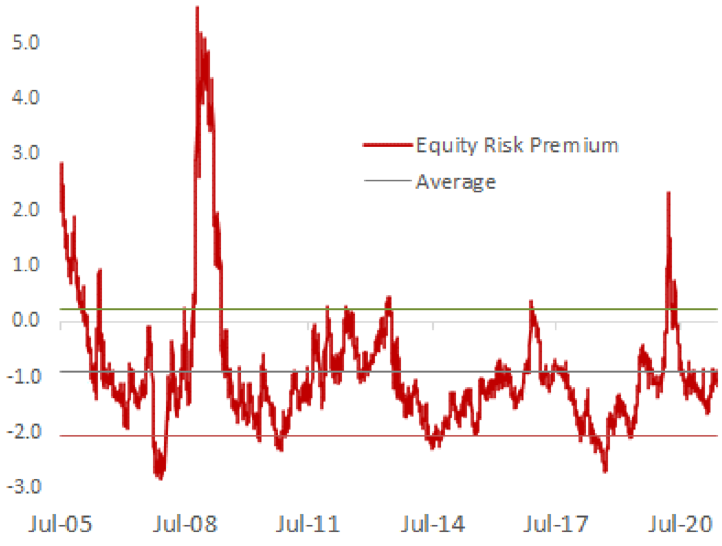
The equity risk premium is the premium an investor receives for taking equity risk versus risk free asset. The ERP is on expected earnings. **The higher the ERP, the more attractive stocks are to bonds.** This could be due to high earnings or low risk-free rates.

Today's ERP is mostly around the long term average, suggesting no excessive risk of over or under valuation.

Typically, high rates of inflation cause increasing risk aversion among investors which in turn leads to falling stock prices. However, today's structural forces include rapid financialization amongst the Millennials and young investors, a class with long time horizons and ability to act in a contrarian manner.

The prognosis for equity markets remains positive in a gradually rising inflation environment, and the prognosis for quality growth stocks remains equally positive.

The Equity Risk Premium is At Average Levels



Q1 CY 2021 Earnings Scorecard

With 606/868 Companies Reporting, Sales are Up 8% QoQ, Net Profits Up 3.5% QoQ…
…An Acceptable Performance Vs a Strong Dec Quarter…
… Input Cost Pressures Showed Up in Cons. Discretionary, While Materials Energy & Utilities Outperformed

NSE Universe > 1000 Cr	Sales Growth YoY	Sales Growth Q/Q%	Operating Profit Growth YoY	Operating Profit Q/Q%	Net Profits YoY%	Net Profit Q/Q%	Operating Margin	Net Margin
Communication Services	18.4%	2.7%	56.0%	8.9%	n/m	-23.0%	40.2%	4.4%
Consumer Discretionary	34.6%	6.6%	134.0%	-0.9%	n/m	-75.5%	13.0%	1.4%
Consumer Staples	19.1%	2.4%	30.1%	0.5%	26.7%	1.2%	20.5%	13.6%
Energy	7.4%	20.0%	293.8%	28.8%	n/m	73.6%	11.6%	8.1%
Financials	24.5%	-5.8%	-1.0%	-19.3%	68.0%	-4.1%	27.0%	10.7%
Health Care	7.6%	-2.3%	46.7%	-6.7%	75.3%	-39.4%	23.3%	11.1%
Industrials	16.0%	19.3%	43.0%	10.3%	65.6%	2.0%	14.7%	6.9%
Information Technology	9.6%	1.3%	20.6%	-1.9%	12.3%	-7.8%	23.1%	15.2%
Materials	35.1%	15.0%	92.4%	19.7%	502.5%	32.3%	24.0%	12.9%
Real Estate	5.1%	29.8%	72.9%	7.5%	123.0%	-24.2%	34.1%	11.3%
Utilities	17.2%	11.2%	59.2%	-8.4%	n/m	11.0%	21.7%	6.2%
NSE Universe	**20.0%**	**8.0%**	**49.8%**	**0.5%**	**274.4%**	**3.5%**	**19.8%**	**9.2%**

50% Co's Beat Sales Expectations, Lower than Average, While Only 42% Beat Earnings Expectations

		Sales Surprise				Earnings Surprise			
Sector	Reported	Positive	Inline	Negative	% Beat	Positive	Inline	Negative	% Beat
Materials	72 / 97	43	2	6	63%	23	10	11	46%
Industrials	49 / 79	23	3	11	53%	14	4	12	37%
Consumer Staples	31 / 37	13	1	6	45%	4	7	6	35%
Energy	7 / 11	3	0	1	43%	4	0	2	57%
Technology	23 / 25	9	7	5	70%	8	6	6	61%
Consumer Discretionary	57 / 74	30	3	9	58%	22	4	12	46%
Communications	8 / 13	2	0	4	25%	2	1	2	38%
Financials	60 / 80	25	1	8	43%	5	13	10	30%
Health Care	40 / 48	9	1	19	25%	10	6	10	40%
Utilities	9 / 19	3	0	3	33%	2	3	1	56%
Real Estate	7 / 10	4	0	1	57%	2	2	1	57%
NSE 500	363 / 493	164	18	73	50%	96	56	73	42%

Strong EPS Revisions in Materials and Health Care

Name	FY1 EPS 3MChg	FY1 EPS 1MChg	FY1 Rev 3MChg	FY1 Rev 1MChg
Materials (213)	**6.2**	**3.5**	2.6	1.7
Health Care (77)	**5.1**	**3.4**	0.7	0.6
Technology (55)	1.7	0	0.7	0.1
Industrials (168)	0.9	-0.3	0.4	0.1
Energy (21)	0.7	-1.8	-0.1	0.5
Consumer Staples (72)	-2.3	-1.6	-0.2	0.3
Utilities (30)	-2.3	-3	0.7	0.1
Financials (122)	-2.7	-2.1	8	6.9
Consumer Discretionary (168)	-4	-2.4	-1.4	-0.3
Real Estate (28)	-9.1	-6.5	-6	-7.3
Communications (39)	-12.2	-10	-2.8	-2.9
Universe	0.1	-0.5	1.2	1

PORTFOLIO

New Themes in a Post Covid World

Rising Trendline Productivity

Productivity peaked in the early 2000s and has been averaging below trend since then. Alongside rising inflation, productivity is now also trending higher.

Using the definition of output for a given number of input hours of labor as productivity, the combination of remote work, work from anywhere, alongside technology, rising ecommerce and access to the internet, are leading to a meaningful increase in productivity to above trend.

A Generation of Young Investors & Broadening Markets

Young investors, traders have entered the markets in record numbers. Volumes are up 2x to 3x from 3 years ago. The broadening out of the equity market is a welcome trend that will help reduce FI driven volatility and provide a buffer.

Digitization

We are in the midst of the digitization of everything - entertainment, business meetings, online grocery purchases, online retail etc etc. In the U.S., offers are being made on online real estate portals, without physical visits.

Consumption Surge, But…

A U.S. consumption surge appears to be in the early stages. Later this fiscal year, one can expect a similar boost in India. Given the severity of the second wave in India, however, it may only occur post vaccination and herd immunity, and the psychological hit that the consumer has taken, could impact the amplitude of the surge.

Work From Anywhere

Business has realized global workforces can be managed remotely. Deals are being closed over Zoom. There will still be in-person business conventions. Virtual conventions just aren't the same.

The Depleting Power of the Distribution Network

Companies that have spent decades building distribution, will need to contend with the likes of Amazon and Flipkart. While it won't impact certain businesses, such as autos, it will impact many categories and players dramatically, with implications for portfolios.

The Home

New consumer trends have also emerged, new spending behaviors driven by expectations of changing lifestyles.

Consumers are remodelling homes, purchasing appliances, home entertainment and the trend is shifting from small do-it-yourself projects to larger professional remodels. We expect repair and remodel demand to remain strong.

Consumers now value the ability to get home delivery of almost everything. Remote workforce adoption is expected to be permanent change. Cleaning behaviors are still significantly elevated.

We're seeing changes in buying habits. Consumers are spending more time online. They're buying more online. They are willing to try new brands, and they're eager to support local businesses.

Inflation Management

Many firms are relying on price increases to combat inflation. Meanwhile, other firms indicated they will prioritize cost-management strategies to preserve margins

What's come through clearly in company earnings and conference calls is that companies will need to be adept in dealing with inflation.

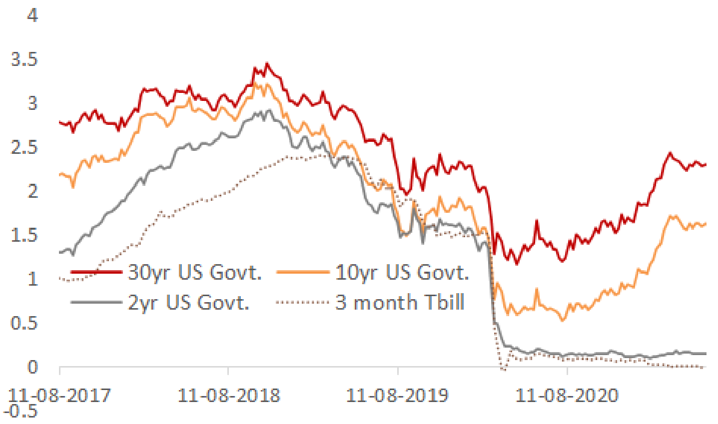
FIXED INCOME

Searching for Yield

Globally, Our Starting Base Assumption is that the Fed will Cap U.S. Treasury Yields If Necessary

The U.S. 10 year remains solidly perched around the 1.6% level since February 2021. The 30 year remains equally stable. The market clearly holds a great deal of confidence in the Fed's ability to rein in Treasury bond yields, rightly so.

U.S. Treasuries Have Been Flat Since Feb '21…



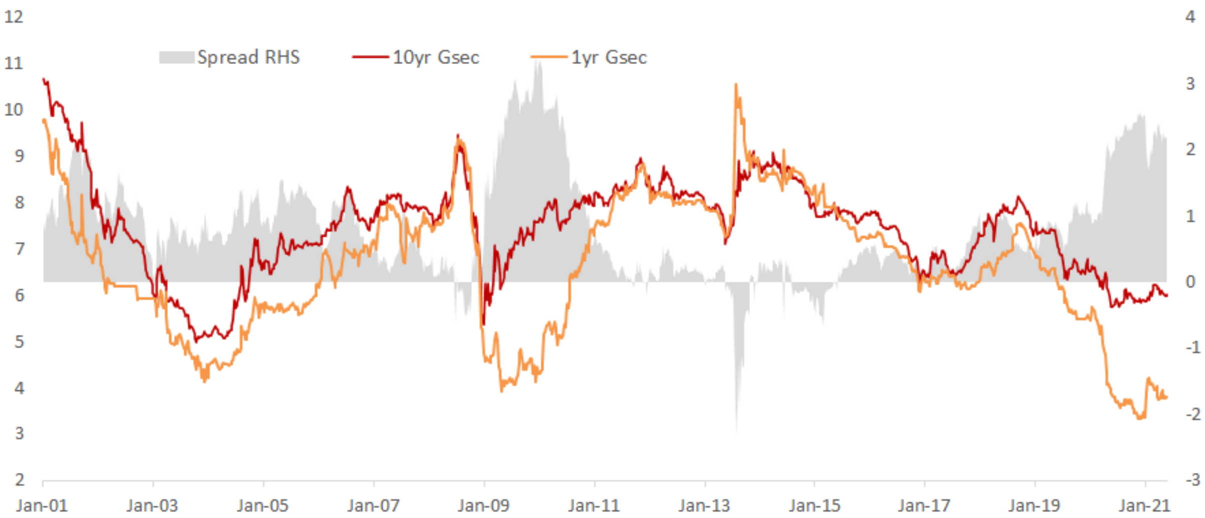
Inflation headlines have been all pervasive since the last few weeks, but U.S. TIPS – Treasury Inflation Protected Securities – have not caught a bid. Clearly U.S. bond market investors are not as worried about

…Bonds Not Moving in Tandem with Commodities Since March '21

inflation as one would believe from media headlines.

In India, G-Secs have similarly barely budged. The 10 year G-Sec bond has barely evidenced any recovery and has been flat for the most part, with low volatility. The bond market's not seeing a recovery, or the RBI's been actively involved in managing yields. This week, the RBI announced version 2.0 of its QE – GSAP, Government Securities Acquisition Program, **India's QE**.

Unlike Prior Recoveries, a Moribund G-Sec 10 Year Yield is Atypical …
…Indicating Yield Management or Limited Evidence of Economic Recovery



While purists may take issue with QE, the alternative – being labelled “a fragile economy”, at the mercy of bond vigilantes and hedge fund opportunists, as happened in the summer of 2013 – is certainly unattractive, and there **are tangible benefits to pursuing a stable currency, stable and moderate interest rate policy** centered around inflation targets.

However, a word of caution is warranted. With all new experiments, the central banker today stands atop Mt. Everest. Coming down will, ultimately prove challenging, in a direct proportion to the amount of unnatural monetary expansion.

The Slow Death of the 60/40 Portfolio

With fixed income yields fading across the planet, the yield investor’s quandary becomes a perplexing one. The disappearance of reliable high single digit fixed income poses one of the fundamental challenges in asset allocation today.

The Investor’s Quandary

There are **four choices for investors** as we see it:

1. **Increase allocation to alternative higher yielding assets** – this can be equities, long short strategies, private investments, commodities. However, none possess the AAA risk-free like characteristics that fixed income securities usually provide, and it’s generally a proportionate increase in the risk profile as well.

2. **Move down the Credit Curve** – That’s been our preferred strategy for the past year, albeit with our in-house Fixed Income Head and Head of Products, both teams have conducted extensive research in identifying credit opportunities that provide reliable, covenant protected, highly researched, high yield investment opportunities.

3. **Accept a lower portfolio return** while maintaining strategic allocations

4. Take more **active tactical approach** to generate alpha - This can be achieved by a focus on expense reduction, rotation to highly skilled managers with proven higher returns, and incorporating a tactical asset allocation approach that enhances returns in equities and alternative asset classes.

Clearly, a **review of strategic asset allocations** versus expected returns is a worthwhile exercise to conduct with your wealth manager to review strategies looking ahead. The days of high yields increasingly look to be behind us for good.

The Prognosis for Duration

While g-sec yields remain range bound for now, as the virus wave subsides, the likely probabilistic path for benchmark yields is marginally higher.

Negative Real Rates and Impacts

The silent killer in investing is the high inflation environment that masks the destruction to wealth that can occur on a real inflation adjusted basis.

The Next Milestone

The next steps globally in the business cycle will be to watch for central bankers to start **draining liquidity** from the system through reverse repos and an increase in the repo rate, fed funds rate.

That is the typical path, though we suspect given the tepid recovery, any policy action isn’t likely until well into the recovery, which we’d hazard would be spring of next year at the earliest.

As we move into the expected recovery, our preferred **sectoral preference for higher yield remains select MLDs, select corporate bonds, select credit risk, and short duration**, researched in-house by experts, prior to recommendation.

GOLD, COMMODITIES & CURRENCY

Commodity Strength, Dollar Weakness, EM Strength

Rising commodity prices typically coincide with dollar weakness, usually due to outflows to commodity producing nations, typically EM. Commodities generally tend to rise at the latter stages of the business cycle, driven by overheating demand. The recent move has largely been precipitated by generational low interest rates in the U.S., supply disturbances, and speculative capital.

How long will the rally sustain?

While many commodities have weakened in recent days, the possibility of a spike in the short term as economies emerge from covid cannot be ruled out.

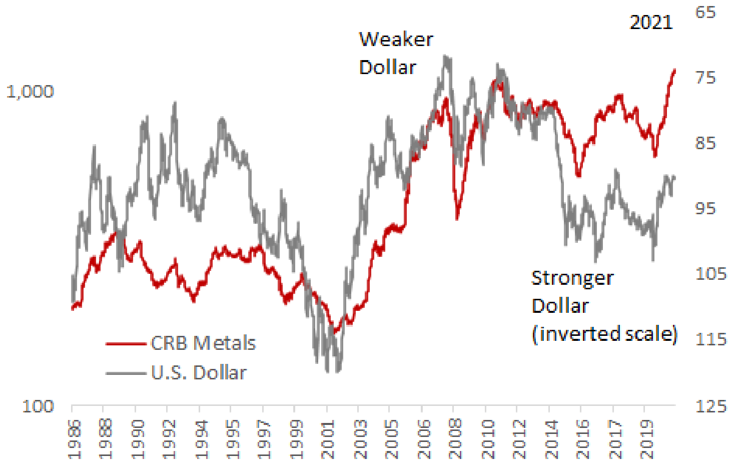
The China State Council did recently weigh in on tougher oversight of commodity markets, to crack down on speculation and hoarding, and ensuring rising prices aren't passed through to consumers. In the mid to longer term, it's our view that the **commodity rally will normalize in H2 CY21 or Q1 CY22**.

Dollar Weakness

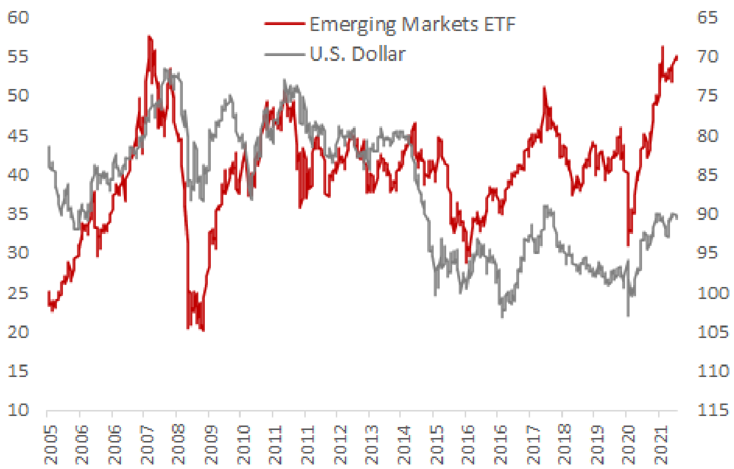
Finally, on the dollar, core to the global central bank toolkit has been the goal of achieving real debt reduction via moderate inflation, thereby deflating the size of the U.S. debt. The tightwire act involves doing so while ensuring interest rates don't rise, and Dollar stability. Unfortunately, something gives and right now, it's the Dollar, which has weakened to multi year low ranges.

A weak dollar has historically correlated well with emerging markets outperformance. The Metals index has blasted through it's all time highs recently, without meeting resistance, like a knife through butter. Money that sought shelter in low yielding instruments is now seeking shelter in physical assets. This trend, while it lasts, bodes well for emerging markets.

Rising Commodity Prices Typically Coincide with a Weaker Dollar…



…And are Bullish for Emerging Markets



ASSET ALLOCATION & TACTICAL POSITIONING

Outlook

The Good News Market

We've been fortunate to have been riding a good news market, where bad news is good news and good news is good news. In year 2 of the bull market, rising inflation impacts and rising producer prices, are likely to pose a challenge and further gains are likely to be gradual.

Asset Allocation

As we discussed earlier, **the optimal asset allocation is changing with the decline in rates and rise in inflation.** The **role of traditional bond fund structures in diversified portfolios continues to diminish**.

With inflation averaging 5-6%, nominal returns on g-secs range from 3.4% short end to 6.0% for the 10 year. Real *pre-tax* returns on government debt are negative or a meagre 1%. Quality AAA corporates at the long end are yielding on average 6.76%, not much better.

With prospects for a recovering economy, **we've focused exclusively on enhancing the debt yield** of our client portfolios by adding selective exposure to highly researched, covenant protected, market linked instruments with **indicative yields upwards of 9%**.

In House Fixed Income Expertise

Having **an in-house fixed income expert is essential** today. Malay Shah, Head – Fixed Income, alongside Mahesh Kuppannagari, Head of Products, and their teams conduct primary research on debt securities while negotiating covenants and protections.

Alternatives in **asset classes that historically offer inflation protection** are an additional means in which we're altering our asset allocation composition, with products with indicative **yields upwards of 9%** and up to 12%.

Equities As an Inflation Hedge

In a **gradually rising inflationary scenario, equities remain a preferred vehicle** given expectations of a strong demand recovery later into the year. Our expectations of transient inflation – outlined earlier - anchor our preference for equity exposure.

Style | Cap | Sector Tilts

Cap

In an **inflation challenged environment**, large caps appear to have gained some incremental attractiveness. While companies largely met on top line, bottom line earnings were impacted in the concluded quarter, more so for smaller caps.

Access to raw materials, supply chain de-bottlenecking, and managing expenses, access to capital and labor, interest costs are the domain of large cap companies.

One reason markets have stayed resilient is the **move to organized**, cracking down on GST loopholes which led to unorganized players getting hit harder during Covid. Formalization is underway and also bodes well for the larger players.

Our cap decomposition also demonstrates that large caps are better able to protect margins than smaller caps. Mid cap IT companies were an exception, benefitting from structural trends.

Offsetting the pro-large cap argument is the **strong earnings momentum** with intact margin performance that select **mid and small caps are delivering**.

As a result, we remain generally **cap agnostic**, adhering to a 70/30 mix in large vs mid and small, preferring to focus on sound business models regardless of cap, and specialized managers.

Sector

Our sectoral tilt leans towards **Materials, Health Care, Info Tech, Specialty Chemicals, and Industrials**. Financials will do well in a recovery but for now **credit offtake has been dismal**. **Health-care has the highest growth expectation** along with a strong revision trend, followed by **Materials and Info Tech**.

Consumer discretionary appears to be challenged in the near term. Weakness in the dollar could be a headwind for IT but tech capex plans look strong and robust. A break below 89 could signal the Dollar weakening to decadal lows, following the trend in Commodities. Should that occur, Emerging Markets ETF exposure would merit an allocation.

Style

In equities, we tilt towards quality **Growth** stocks with pricing power, and experienced and proven management teams, that can better manage increasing costs and supply shortages.

Quality growth performed exceptionally well in the 2010-12 inflationary period, despite a strong market correction in 2011. We remain soundly committed to quality growth, at reasonable valuations.

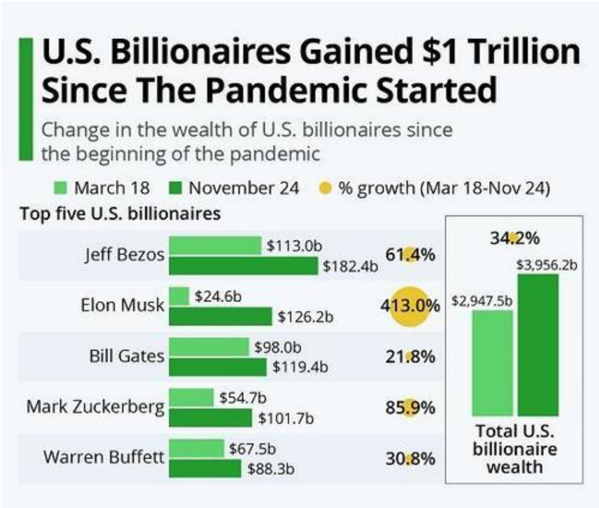
Outlook

We continue to expect markets to normalize, recovery to begin alongside vaccination progress, and the powerful deflationary forces of globalization, technology, internet and demographics to re-assert themselves as we move forward.

In the obsession with inflation, one must not lose sight of the key drivers that remain in place for our markets – the **Millennial buyer, the demographic wave they represent, rising productivity trends** and accommodative policy.

We continue to recommend a moderately pro-risk asset allocation with an **overweight in equities**, **overweight select Fixed Income**, **overweight Alternates**, underweight govt and AAA bonds, and **market weight Gold**.

Billionaires Hold a Majority of their Wealth in Equity



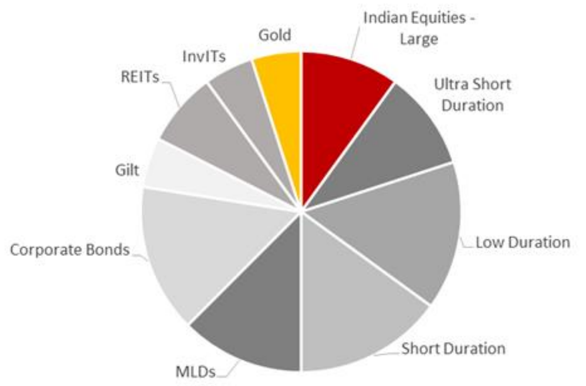
Source: Statista

Tactical Asset Class Rationale		
Equities	**Weight**	**Rationale**
India Equities	**Overweight**	India's economy was recovering well before Covid wave 2 struck. We look for a gradual recovery heading in Q3 CY21 as vaccinations gain traction and global demand recovers and global supply chains repair. We expect a stronger global recovery in the short term and an accelerating recovery for India starting Q4 CY21. The recovery will mark the re-instatement of the second year of the bull market that began in March 2020.
India Hedge Funds	**Over Weight**	The traditional 60/40 portfolio that was expected to deliver reliable 12% returns is weighed down by the weight of low interest rates on the fixed income side. Rising volatility is a constructive environment for hedge fund managers. Hedged portfolios provide the perfect complement to an equity portfolio today, providing a diversifying non-correlated asset class that enhances risk adjusted return, while holding the opportunity to provide equity-like returns with debt-like risk.
U.S. Equities	**Market Weight**	Indian HNI portfolios are dramatically underweight global equities. Diversification provides strong benefits.
Emerging Market Equities	**Market Weight**	Given the action in Commodities, and the Dollar, and valuations for emerging markets trading at reasonable levels, most inflationary risks centered in the U.S., exposure to emerging markets will add to portfolio diversification. China appears particularly well poised to emerge out of the covid crisis, and most other emerging markets are trading at reasonable valuations.
Europe Equities	**Under Weight**	While the weakening U.S. dollar is a tail-wind, we expect growth in India, Emerging markets to outpace European growth and therefore find limited compelling reasons to be exposed to Europe, except selectively at a company specific basis.
Fixed Income	**Weight**	**Rationale**
Duration	**Under Weight**	With risks on the inflation front, and demand supply dynamics eventually getting overwhelmed by supply, the likelihood of interest rates moving higher is tangible.
Accrual - Corporate	**Market Weight**	Medium maturity corporate bonds, enabling safety, liquidity and steady returns without duration risks and consequent negative MTMs.
Accrual - Credit Risk	**Market Weight**	With expectations of an improving economy, conditions will improve. Quality credits will enable a positive risk reward equation (especially with well researched and strongly constructed investments) and allocations should be in light of investor's risk appetite.
Long Short (Absolute Return)	**Market Weight**	While long short sounds good in concept, the track record of funds in this space has been below par. Selectively, long short funds that have consistently delivered post-tax 8% are a worthy addition to portfolios.
REITs	**Market Weight**	Real estate investment trusts (REITs) have lagged in the past year due to the impact of Covid on retail and urban office space. With rising threat of inflation, REITs offer an attractive inflation hedge that provides exposure to fixed assets.
Alternate	**Weight**	**Rationale**
Private Unlisted	**Over Weight**	We expect significant value and wealth creation in unlisted space in India primarily led by Technology, Financial and New Age Consumption companies. Our Direct Deal Thesis focuses on late stage companies with significant market share & profitability and our Manager Selection in early stage investments focuses on fund managers with established track record across cycles.
Gold	**Weight**	**Rationale**
Gold	**Market Weight**	Gold provides inflation protection, though the relationship isn't highly positively correlated. Gold provides currency debasement protection. It's suffered of late due to a slowdown in India Gold purchases and the rush towards Bitcoin investing in the U.S., but could be waking up to the spectre of rising inflation in the U.S.

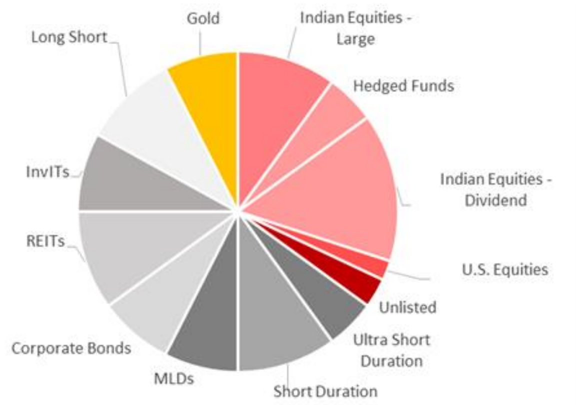
Ambit GPC Wealth Profiles - Strategic Weights

The Ambit GPC Asset Allocation & Investment Committee (AAIC) provide guidance on asset allocation via our wealth profile models below. The models are listed on a scale of rising return and rising risk and represent the most common investor profiles that we base our portfolio construction around.

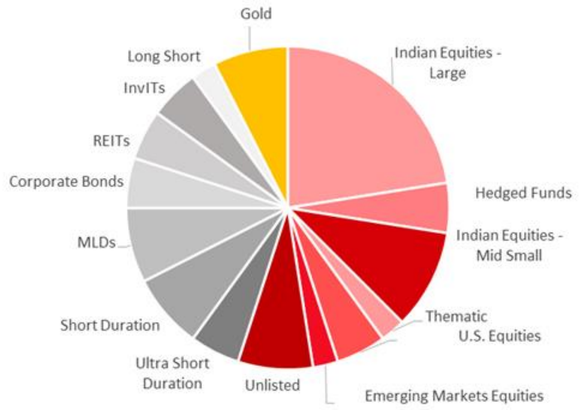
Wealth Conservation



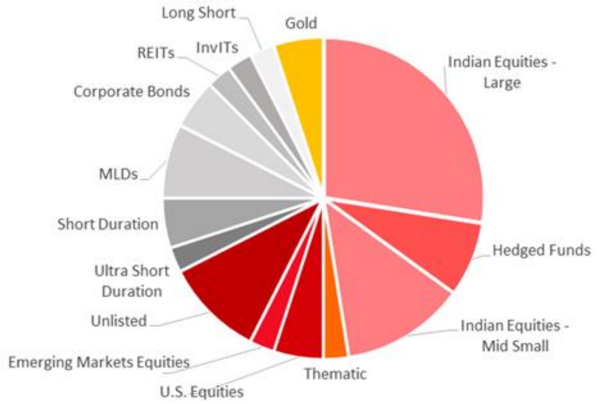
Income



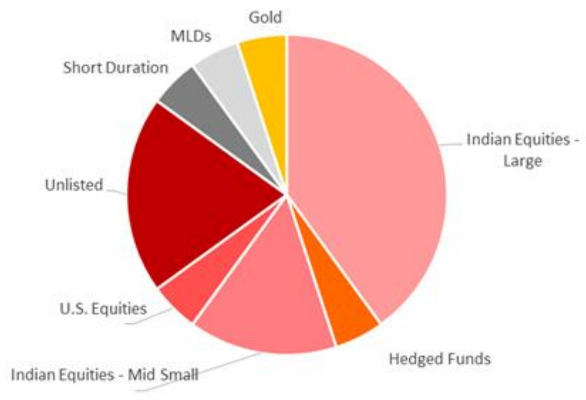
Balanced Growth



Moderate Growth



Aggressive Growth



Ambit Global Private Client - Asset Allocation & Investment Committee

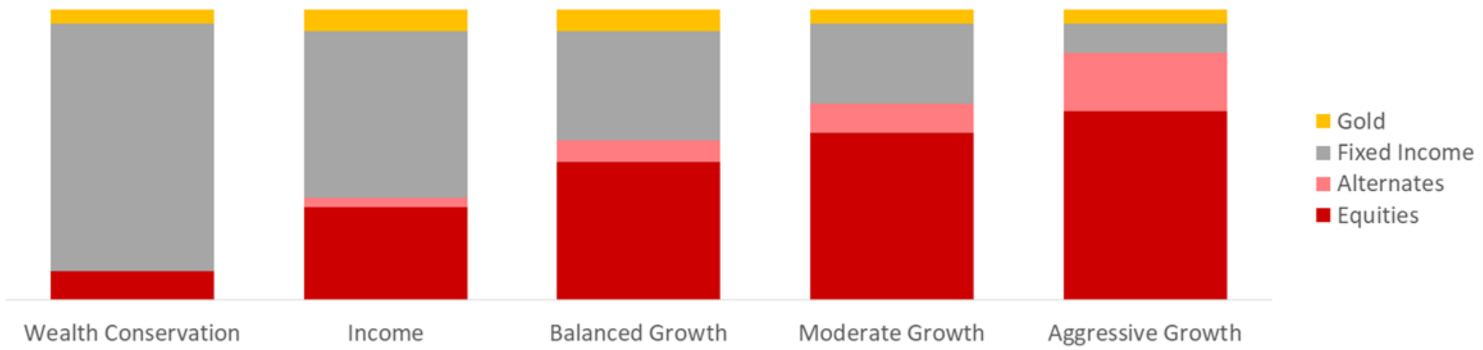
The Ambit GPC Asset Allocation & Investment Committee (AAIC) is a group comprised of the CEO, Head of Products and Alternates, Chief Investment Strategist and Head of Fixed Income (listed below). The team has over 100 years of collective investment experience in markets. The AAIC meets monthly and as necessary during periods of market volatility to discuss the economy and markets. The committee determines the investment outlook that guides our advice to clients. The AAIC continually monitors developing economic and market conditions, reviews tactical outlooks and recommends asset allocation model changes, as well as analysis, investment commentary, portfolio recommendations and reports.

Tactical Allocation Weights Vs Strategic

Asset Class Pairs	Scale			View
	← Underweight	Strategic/Neutral	Overweight →	
Equities			◆	Over-Weight
India Equities – Large			◆	Over-Weight
India Equities – Mid & Small			◆	Over-Weight
International Equities		◆		Market Weight
Long Short	◆			Under-Weight
Hedge Funds			◆	Over-Weight
Fixed Income	◆			Under-Weight
Duration	◆			Under-Weight
Corporate		◆		Market Weight
Credit Risk		◆		Market Weight
REITs		◆		Market Weight
Alternates				Over-Weight
Private Unlisted			◆	Over-Weight
Gold		◆		Under-Weight

Wealth Profiles - Summary

Strategic Asset Class Weights by Profile



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Sources: All sources unless otherwise noted are Bloomberg, NSE.

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