Issue 17 | November 03, 2021

AMBIT
Acumen at work

Global Private Client

KNOW THE NOW

POSITIONING FOR GROWTH AMIDST SUPPLY SIDE INFLATION

PREFACE

Dear Clients,

One who has never known the turbulence of life, such a one may seem happy, may seem a saint, his single track mind may impress the multitude with its power but he is ill equipped for life's true adventure into the infinite - ***Rabindra Nath Tagore.***

Making money in the markets has never been easy, it requires nerves and more often than not it requires investors to ignore the noise and cut through the clutter. Turbulence is part and parcel of investing and a little bit of it should not derail investment strategies. From the onset of the black swan event, we have tried to navigate our clients through choppy waters starting in Mar'20, ***Know the Now: The Pendulum shifts to fear. Know the Now: What to do now… in the midst of the fastest bear market ever,*** when we advised a hedge, protecting 20- 25% of the portfolio from the ensuing market crash, to then releasing the hedge when we saw Central Banks infuse unprecedented liquidity, ***Liquidity Gush May'20***. Since then we have been overweight on equities refer to ***Know the Now: Shifting winds Aug'20***, ***Know the Now: Seeing the light at the end of the tunnel Nov'20.***

With the headwinds around inflation, interest rates, commodity prices and supply chain issues our Asset Allocation Committee has been meeting regularly and debating on the pros and cons. And in this edition of ***Know the Now: Positioning for growth amidst supply side inflation***, Sunil Sharma, Chief Investment Strategist takes stock of all key factors and concludes that despite the unappetizing environment for equities created by rising interest rates, commodity prices, crude inflation clubbed with potentially hawkish turns by central banks, additional considerations are at play.

Earnings are growing at a rapid trajectory, profit margins are at decadal heights, while limited availability of raw materials due to breakages in the supply chain are a primary driver of price rises but we may be turning the corner on supply chain woes with normalcy expected back in 2-3 quarters, the central bank policymakers appear committed to supporting growth, retail investors seem to be quite energized and committed to the markets on the back of wealth gains, strong productivity gains, shift to the organized sector, and a lack of alternatives make us choose to ride through what appears to be supply chain induced inflationary stress amidst improving economic growth and healthy demand outlook.

Headwinds make a plane fly higher...headwinds in the short term but higher altitude in the long term kind of summarizes our perspective on the markets. As always we recommend choosing your managers with care and urge you to look at the **Ambit Select** shortlist.

As the festive season dawns on us we hope you get quality celebratory time with your loved ones. Best wishes from all of us for a very happy and prosperous Diwali!

Amrita Farmahan
Chief Executive Officer

INVESTMENT COMMENTARY

Positioning for Growth Amidst Supply Side Inflation

Sunil A. Sharma
Chief Investment Strategist

In early March 2020, we called on clients to protect equity portfolios via hedges, a call that led to 20-25% downside protection for portfolios. We moved to a market neutral weight on equities during the covid summer (Know the Now, What to Do Now, March 2020). Since late last year, we've been bullish and overweight on equities. (Know the Now, Light at the End of the Tunnel, November 2020).

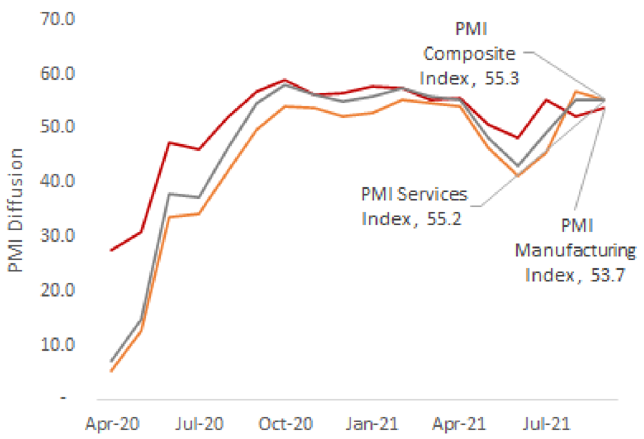
Recent commentary by companies, action in rates and commodities mark important milestones in the business cycle. We share our views on the market environment, evaluate unique features of the current cycle and update our investment outlook.

Business Cycle

<u>The Economy</u> is Growing…

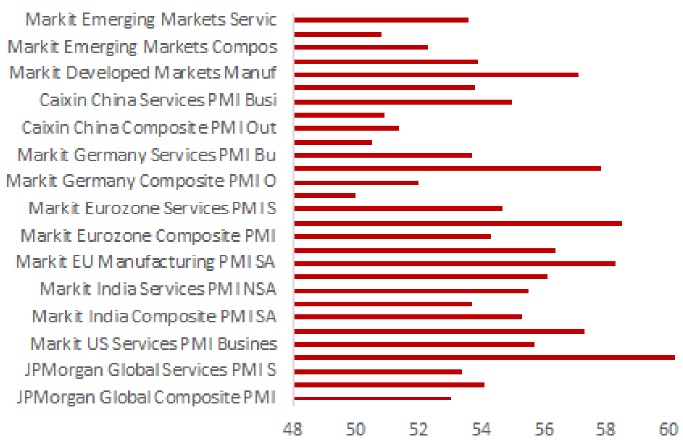
The PMI indices are a fairly decent proxy for current and incremental economic activity. All three indices are maintaining good growth outlooks, perched solidly above 50. Recent data suggests further growth acceleration around the holiday season, boding well for current quarter earnings.

India PMIs are Solidly in Growth Mode



Domestic indicators continue to show the economy on a healthy recovery trajectory. However, economic surprise indices for emerging markets have turned markedly lower. U.S. economic surprises are also in a steady downtrend since the summer, essentially indicating that incremental global economic data is underperforming versus expectations as a result of supply chain disruptions, which look set to persist for the next couple of quarters, alongside rising demand as economies open.

Global PMIs are Solidly in Growth Mode as well



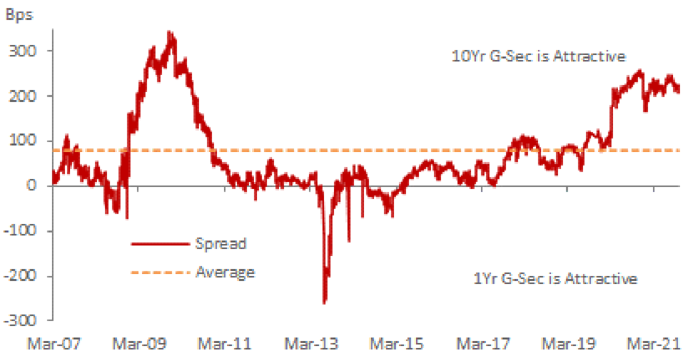
<u>Interest Rates</u> – Rising, with Curves Flattening

Domestic short term rates have risen in recent weeks, faster than the long end. The AAA 3 month corporate bond yield has shot up by 50 bps in the past 2 months. Meanwhile spreads – both the 10yr /3mo, and govt/corp have narrowed. Rates are factoring rising inflation in the short to medium term, continuing supply chain challenges and an improving economy.

The AAA Corp 3 Mo Yield is Up 50 bps to a Cycle High

Short rates after declining precipitously last year are now reverting back to normal levels, and embedding rising inflation premium expectations, leading to curve flattening, providing a milestone in identifying where we are in the business cycle. Improving growth and rising demand for short term funds are additional factors driving rates higher, as firms look to finance rising working capital requirements. The **curve steepening phase** of the business cycle looks to now be in the rearview mirror.

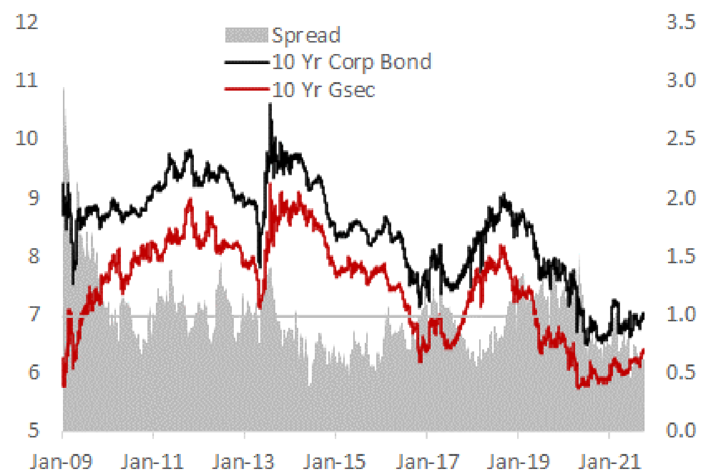
The 10/1 G-Sec Spread has Peaked and is Now Narrowing



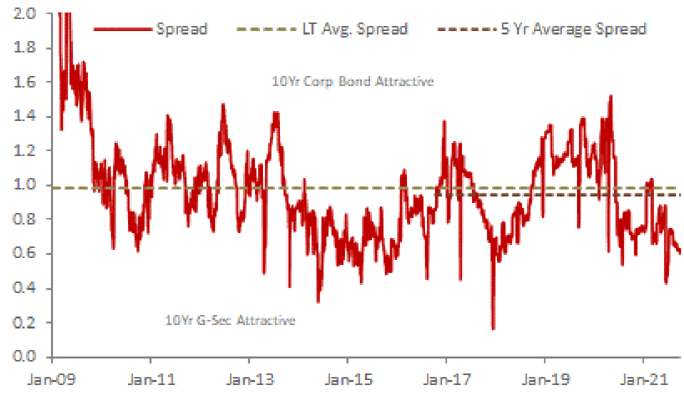
Spreads between g-sec and corporate on the 10 year have also narrowed. Net net, **bond yields are rising** across the curve, and short rates are rising faster.

As a result, for longer term investors, **high grade corporates** will represent **an attractive opportunity in the coming months** as we approach peak cycle yields, with a duration add on opportunity.

G-Sec – Corporate Spreads have Narrowed



G-Sec – Corp Spread has Narrowed

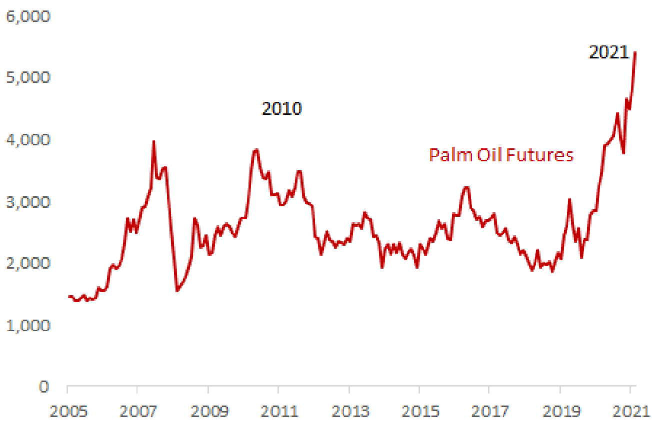


Rising rates will lead to higher borrowing costs, rising inflation will impede margins. **Lower quality credit** will typically struggle in such an environment.

<u>Commodities</u> – Supply Chain, Rising Prices

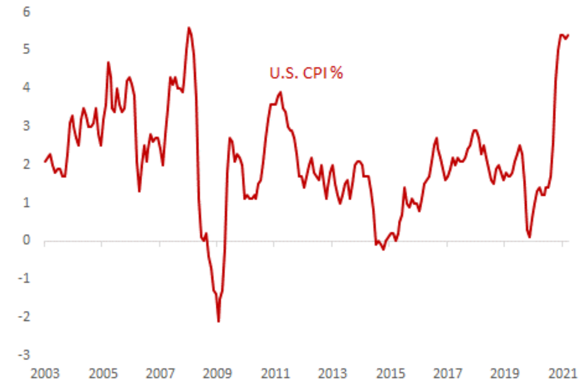
Supply chain issues are now front and center in the recovery. As a result of supply chain challenges, commodity prices across a host of raw material inputs across the agri and industrial supply chain have skyrocketed. Palm oil is one example of rising prices in the pipeline, given it's ubiquitous nature as an input across processed foods, cosmetics, soaps, toothpaste etc.

Key Inputs Prices – like Palm Oil - are Soaring

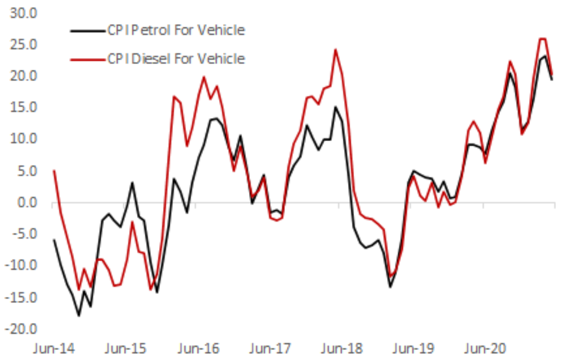


Similarly exacerbating the inflation scenario are **Coal**, **Urea** and **Natural Gas**. **Copper** remains extended, the Bloomberg **Base Metals** Index remains at multi year highs, as does the Bloomberg **Commodity Index**. As a consequence, **U.S. CPI** has now accelerated to a multi-year high. **Petrol** and diesel prices have risen alarmingly in India and commentary from Unilever, Asian Paints et al suggests **inflation** – while not evident in the reported numbers at an index level – is now **impacting corporations**, particularly in consumer related industries.

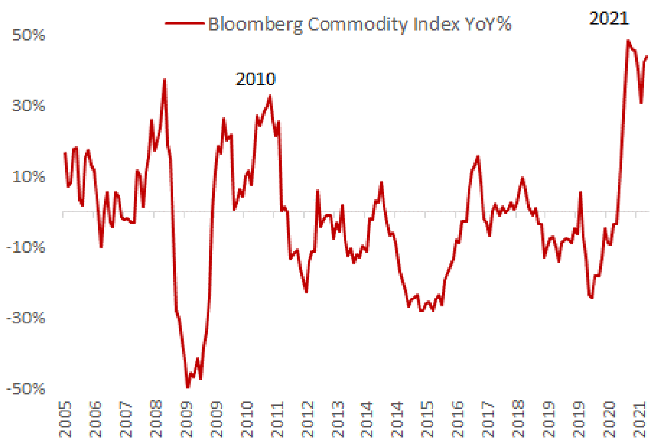
U.S. CPI has Risen to Above 4%, a Decadal High



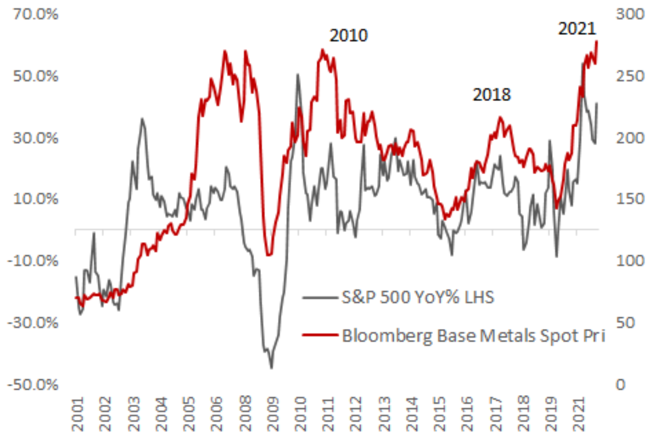
India CPI Petrol & Diesel are up 20% YoY



Commodity Prices Remain Persistently High YoY



Base Metals Prices Continue to Rise



Finally, **global shipping container costs** have exploded higher, further adding to challenges for corporates.

Supply Side Inflationary Environment

Typically, economic expansion and inventory replenishment leads to strong demand for commodities at this stage in a recovery, and reflects in higher commodity prices. This time around, limited availability of raw materials due to **breakages in the supply chain are a primary driver of price rises**.

One silver lining is that anecdotal evidence from CEO earnings calls suggests that the **worst of the supply chain woes are behind us**, and it looks **likely that we are around two quarters away from normalcy**.

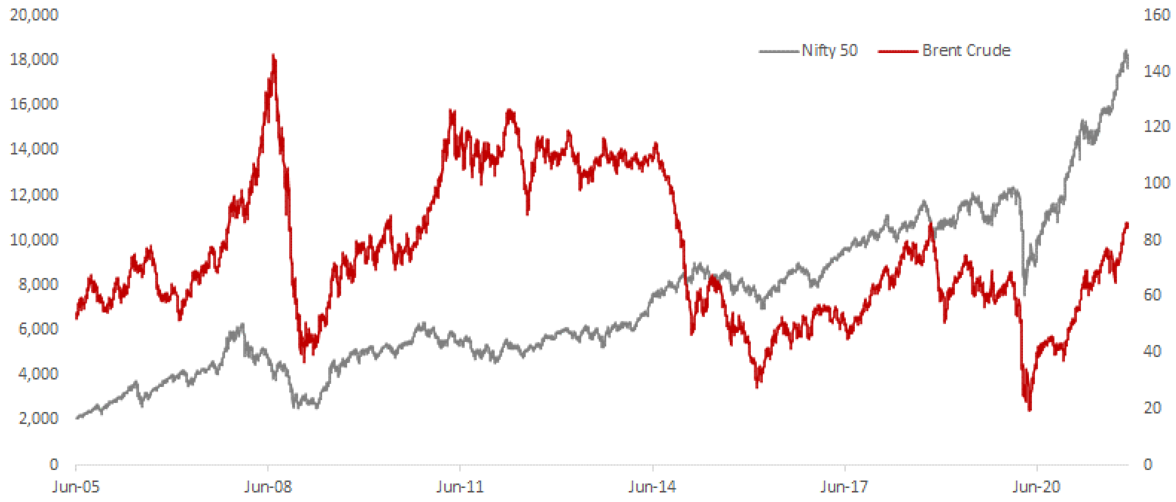
Central Bank Accommodative Policy Stance at Risk

With rising inflation, rising CPI, central banks face a critical choice. **Will rate hikes solve a supply side issue?** Clearly, a nuanced and ideally patient and gradual response that doesn't squash emerging global growth would be ideal. What's safe to expect is that the **tone of accommodative policy is likely to tilt** to neutral and potentially hawkish in coming weeks.

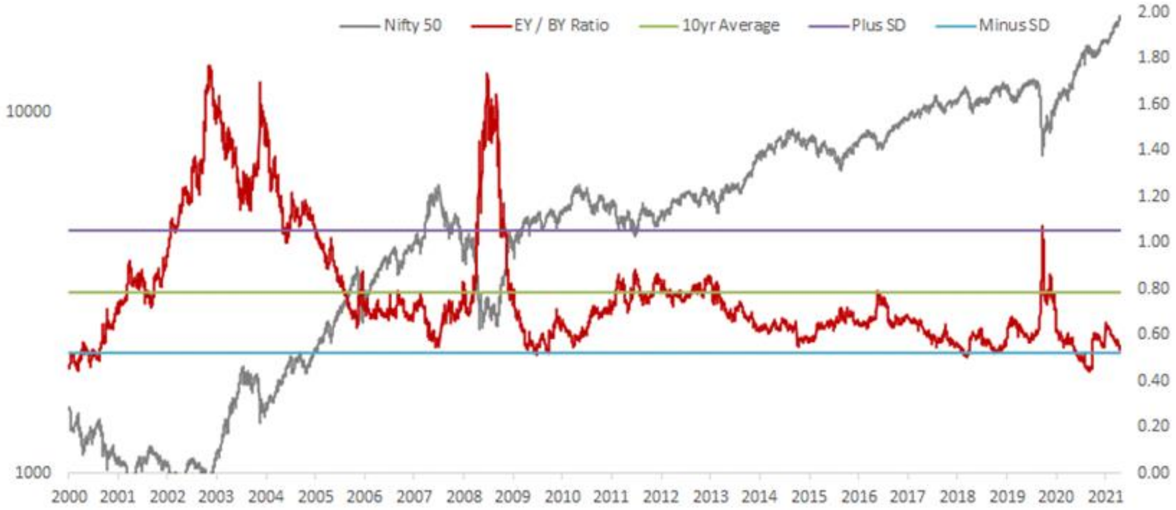
Earnings & Valuations

Ultimately for equities, earnings growth is paramount and we evaluate the factors and outlook for earnings next.

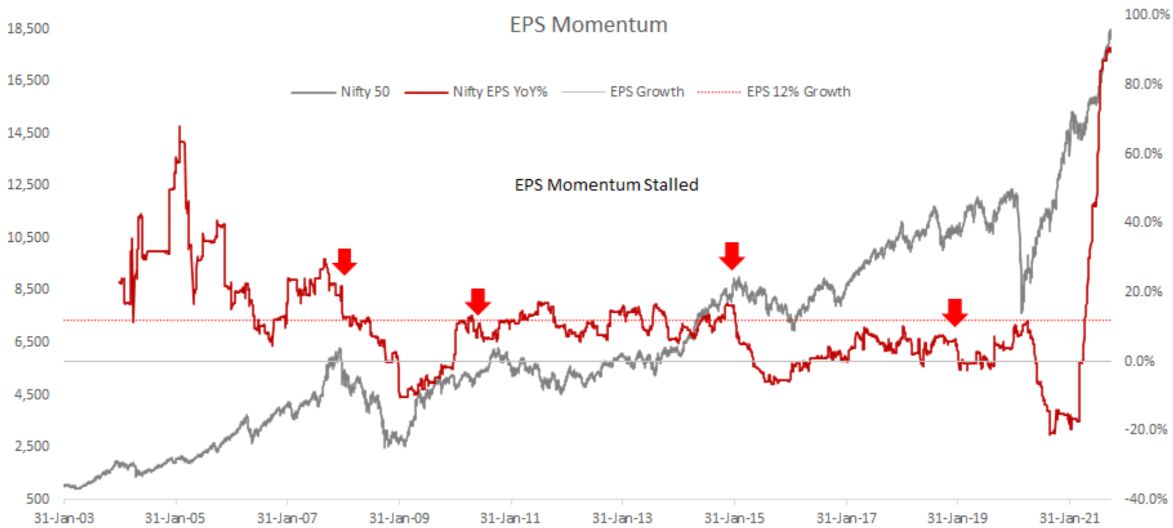
High Crude Oil has Typically Led to Corrections in Equities…



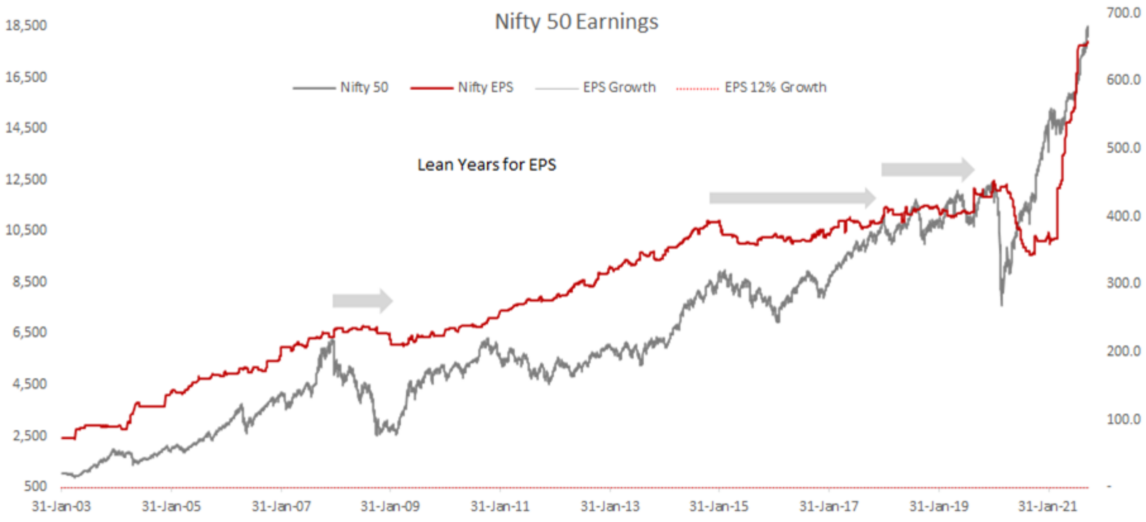
…The Relative Earnings / Bond Yield Model Favors Bonds Relative to Equities…



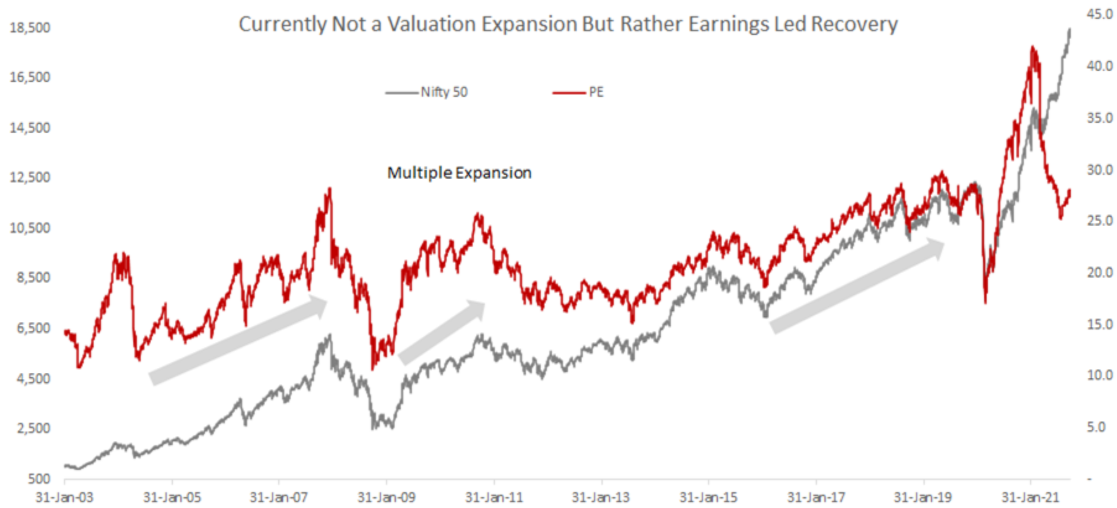
…But, Earnings Momentum in This Recovery has been the Best in 15 Years



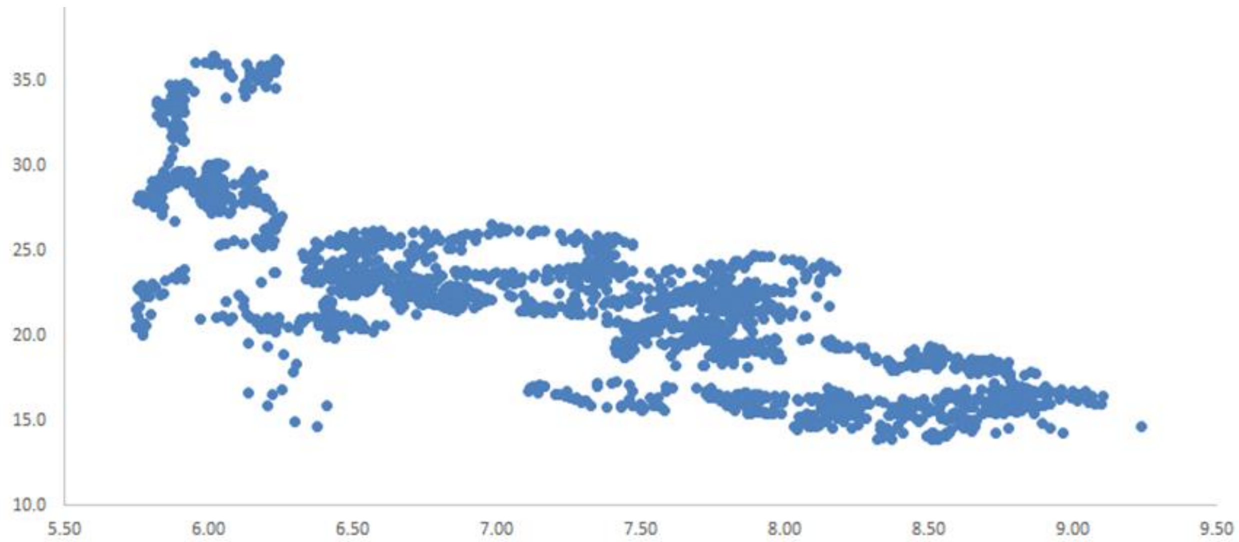
Nifty 50 Earnings are Finally Growing at a Rapid Trajectory…



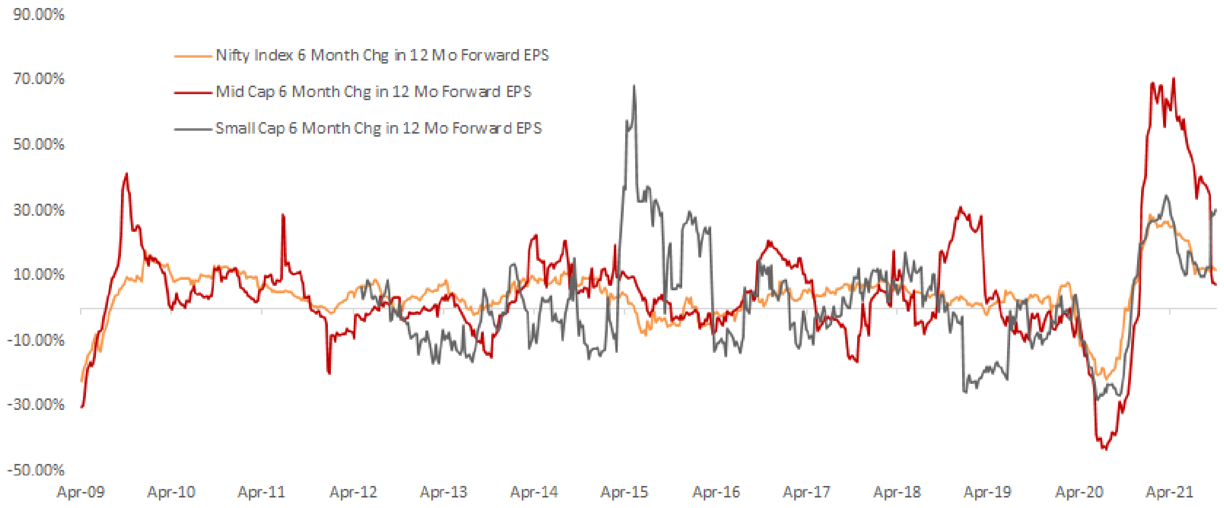
…And Unlike 2010, 2014, 2017, Earnings - Not P/E Expansion - has Driven Equities Higher



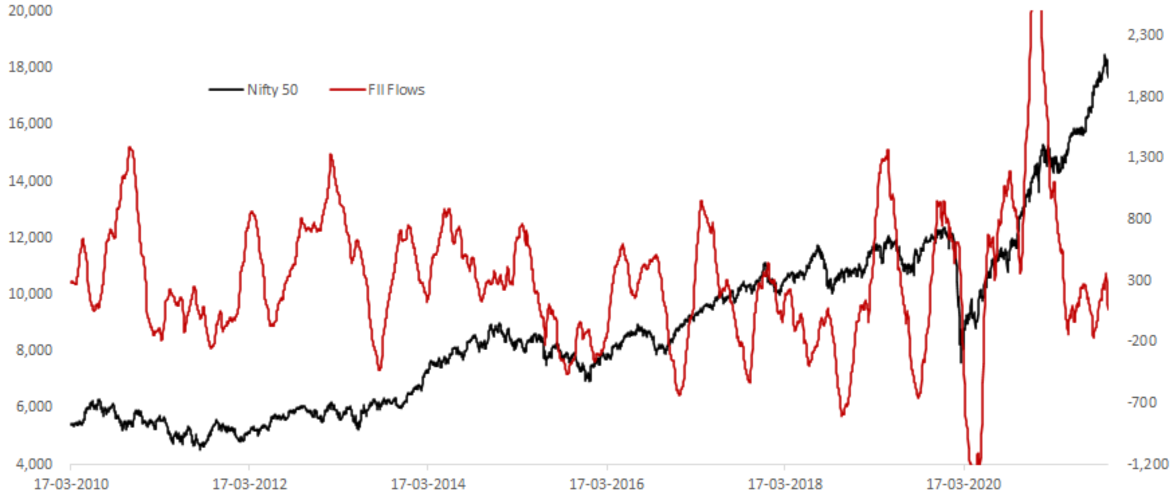
As We've Discussed in the Past, a Scatter Plot on Nifty Trailing P/E and 10 Year G-Sec Rates Shows Valuations At the Index Level are Near Trend



Large Cap EPS Revisions have Stayed Resilient…



…Finally, Retail has Driven Equities Higher while Trended FI Flows have been Modest in This Leg Up



Relative Yields Favor Fixed Income over Equities

As a result of the rise in rates, and rising equities, the relative yield model prefers bonds over equities. The track record of this indicator is good.

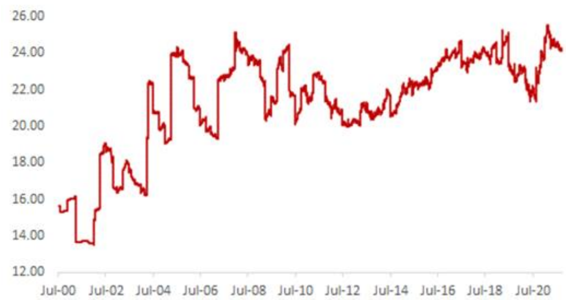
Earnings Growth Strength

One of the notable features of the past couple of years has been the dramatic rise in earnings. We've witnessed the fastest earnings growth in over a decade. We attribute the strength in earnings to rising productivity from Work From Home, the decimation of the unorganized sector, constituent changes in the benchmark and broad sectoral resurgence across IT, pharma, manufacturing, consumer, banking, specialty chemicals et al.

Profit Margins are Healthy

EBITDA margins are at decadal highs and afford corporates the ability to pass on price increases, while maintaining profitability. Consumers are flush, having built up their balance sheets over the past year and a half, and benefitting from the equity wealth effect.

EBITDA Margins are Near Decadal Highs



OUTLOOK

Investment Strategy

Fixed Income

AAA corporate yields are now rising skirting above 7%. The business cycle stage suggests yields will continue to rise, and a strategy that looks to lock in high yields in high quality corporates with potential duration benefits as the cycle peaks is worth considering and positioning for.

We'd average in on signs of commodity prices stalling, rates rising at slowing rates and stabilizing, amidst signs of a tapering in second order growth factors.

In a rising inflationary, rising rate environment, it typically becomes challenging for lower quality corporates to ride the credit rating curve; however, well-researched, strong balance sheet credit opportunities remain attractive in an improving growth environment.

Equities

We've clearly laid out a case that rising interest rates, rising commodity prices, crude and inflation, not to mention hawkish central bank testimony create **a potentially unappetizing environment for equities over the next couple of quarters.**

But…we believe **additional considerations are at play**….

Commodities Pack has been Losing Momentum

Steel stocks have been flat for the past few weeks and losing leadership. JSW Steel has been stagnant since late April. ONGC and Oil India enjoyed stellar runs, driven by rising crude, but Oil India has given back a chunk of the recent gains. Coal India had a rough week, likely a result of the commodity price correction in China this week. The commodity pack seems to be losing momentum.

That in turn confirms what we're hearing from corporate commentaries that the worst of the supply chain issues may be behind us.

Price Pass Through

Based on previous inflationary cycles, Indian corporates are adept at managing a rising inflationary environment. With robust demand, and high profit margins, corporations seem to be well positioned to pass on price increases.

Current Quarter Earnings Look Impressive

With more than a third of companies reporting, top line growth looks to be up 24% y-o-y and earnings up an equally impressive 24% y-o-y. To date, limited evidence of earnings margin compression is coming through at the index level. Profit margins look to be above 11%, again, impressive relative to prior quarters.

Taxation

Many investors are likely sitting on short term gains. For these, a 15% tax is an immediate hurdle that must be overcome on any tactical exit call. Does it make sense to pay a 15% tax, only to find that the market correction was a 10-20% variety.

Timing of Re-Entry

As many investors found out, or were reminded of last year, exiting the market is a lot easier than re-entry. Any exit decision can only be evaluated upon successful timing of the re-entry. That is far more difficult to accomplish and not assured.

India is certainly one of the most attractive markets to hold for the next 10 years. Avoiding a correction in the short term is not more important than ensuring participation in the long term wealth creation cycle.

Flows and Financialization

Last month saw meaningful selling, sell volumes approaching those seen in March 2020, but accompanied by equally strong buying support. Yet the index and most portfolios exited the month basically flat. Much carnage occurred in lower quality mid and small caps. Most notable was volatility in quality momentum growth stocks. This will inevitably reverse at the first sign of improvement in supply chain resolution.

FI Flows Have Dried Up but Will Return

FIs have been pulling back over the past few months in this leg up in markets. Of late, DIs have also been sellers. At some point, FI money will re-enter the market, and significant cash remains on the sidelines that would likely enter should the correction deepen.

Valuations are Not a Concern at the Index Level

Valuation excesses exist in many frontline growth stocks, driven by a recognition of their exceptional growth prospects. At an index level, however, valuations aren't excessive. Per our historical regression between P/E and interest rates, **the market is less than 10% above historical fair value, with fair value currently around 16,900.**

Unique Factors in This Cycle

1. Earnings recovery looks much stronger than prior cycles.
2. The retail investor appears to be energized and committed to equities, and financialization via easy to use apps is paving the way for increasing retail participation.
3. Central bank liquidity has been the highest ever, and policy makers appear committed to supporting growth and appear likely to be patient on supply chain stresses.
4. The lack of alternative investments – particularly in fixed income – that deliver positive, inflation adjusted real returns.

Strong productivity gains, gains in organized market share, strong demographics, resurgent real estate, beneficial wealth effects, rising savings, a lack of attractive alternatives, and healthy demand will provide offsets that are likely to sustain equities.

Therefore, for reasons outlined above, **we chose to ride through what appears to be supply chain driven inflationary stress**, which may be prevalent another 2-3 quarters, but indications of marginal improvement is what markets will be focused on, which are likely to come forward early next year.

That's a sensible choice relative to the tangible risk of timing the market *twice – entry and exit – in the coming months.* Our long term thesis on equities remains optimistic and unchanged. **We'd be buyers on market weakness** and look to raise our allocations to equity.

Cap, Stock and Sector Selection

As always, stock selection and sectoral allocations will be important determinants of portfolio alpha.

Our cap positioning favors multi cap, with a skew towards mid and large in the short term, but a willingness to own quality dominant smaller caps that meet our investment criteria.

Sectoral Preferences

Looking ahead, real estate appears resurgent and we look forward to incremental multiplier benefits from a real estate recovery.

More importantly, tectonic shifts in the way the world functions are underway, and we remain focused on companies positioned to benefit from disruption and the shifting nature of commerce.

Finally, geopolitical trends continue to benefit India and opportunities in resurgent industries remain worth exploring.

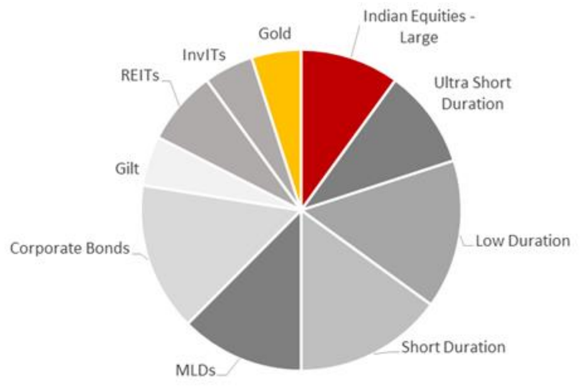
Tactical Asset Class Rationale

Equities	Weight	Rationale
India Equities	**Over Weight**	We continue to witness a gradual recovery that is gaining traction, as the covid data improves and inflation remains under check for now. Global demand is recovering and global supply chains are unlocking. We expect a stronger domestic recovery for India starting Q4 CY21. The second year bull market that began in March 2020 continues, with the key risk being central bank policy and inflation, leading to a moderately bullish outlook.
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. Marginally Under Weight, due to our view that the economic recovery is gathering pace gradually.
U.S. Equities	**Market Weight**	Indian HNI portfolios are dramatically underweight global equities. Diversification provides strong portfolio optimization benefits. U.S. equities have dramatic barriers to entry and global leadership.
Emerging Market Equities	**Under 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. Most notably, political risk in China has risen, therefore we prefer exposure to non-Japan, non-China emerging markets that are on growth trajectory.
Europe Equities	**Under Weight**	Growth in India, emerging markets is likely to outpace European growth and therefore find limited triggers to gain exposure to European equities, 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.
Corporate	**Market Weight**	With rates rising, absolute yields are heading into attractive levels, particularly with the future possibility of duration led yield enhancement on subsequent weakness. We'd look to build exposure to long term high quality corporates as the interest rate cycle peaks.
Credit Risk	**Market Weight**	With rising inflation, rising rates, low quality credit takes on additional risk. Quality standalone credits provide a positive risk reward equation (especially with well researched and strongly constructed investments). Allocations should be in line with investor's risk appetite.
Long Short (Absolute Return)	**Over Weight**	Selectively, long short funds that have consistently delivered post-tax 8% returns are a worthy consideration for portfolios.
REITs	**Over 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	**Under 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. Given our view of a growth cycle, we tilt our positioning to a marginal underweight.

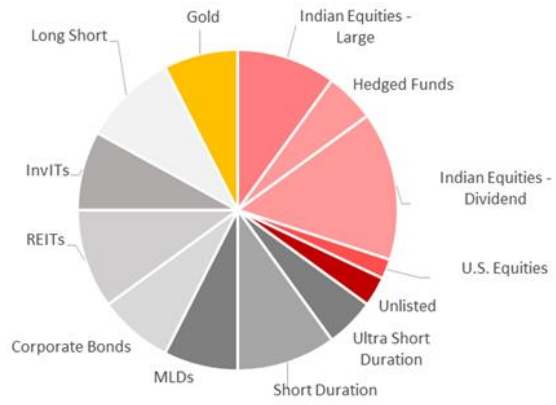
Ambit GPC Wealth Profiles - Strategic Weights

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.

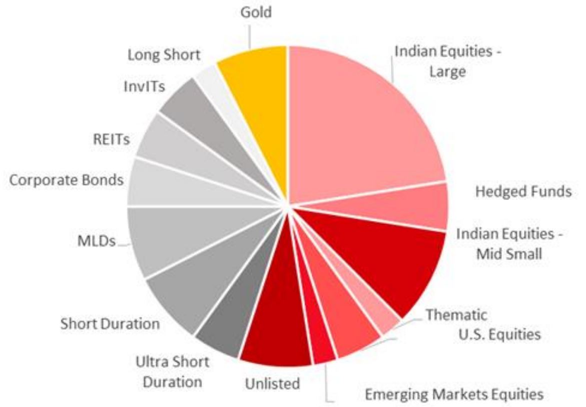
Wealth Conservation



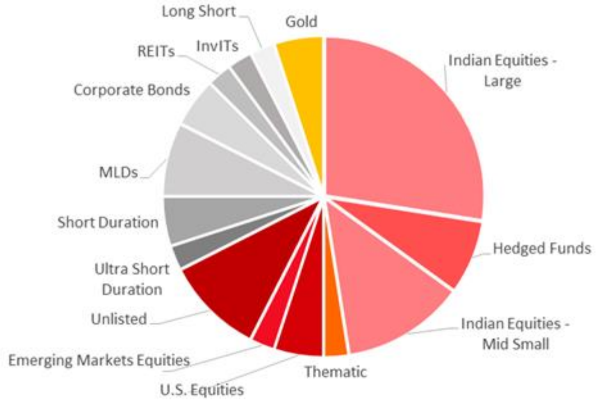
Income



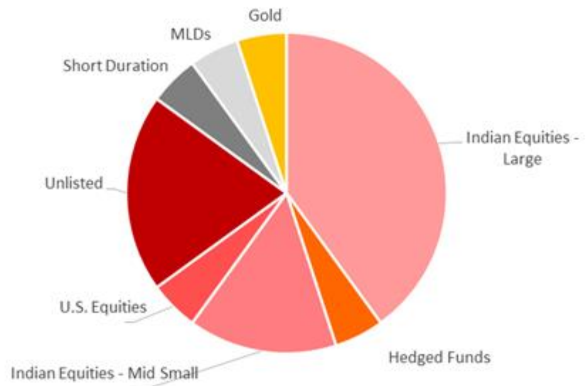
Balanced Growth



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.

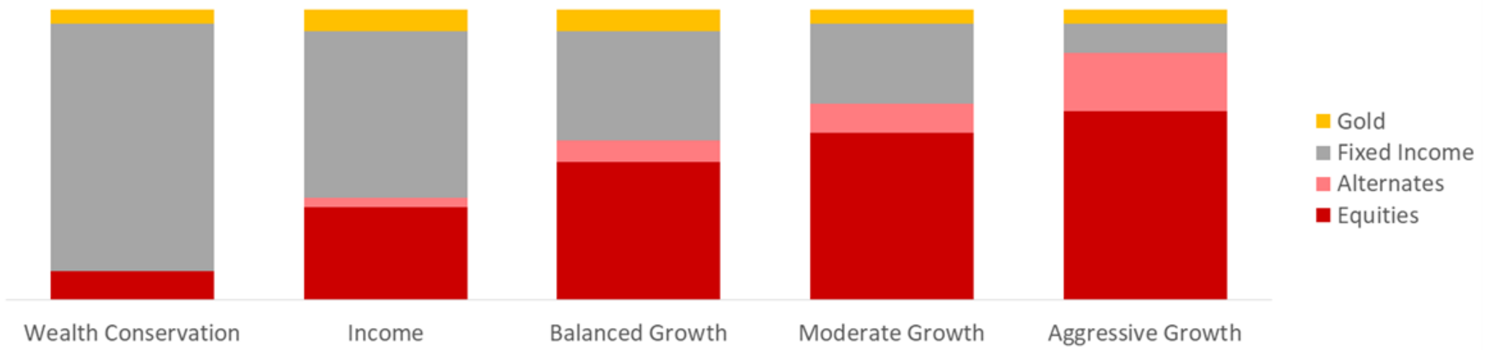
Tactical Allocation Weights Vs Strategic

Asset Class Pairs	Underweight ←					Scale		--> Overweight				View
	-5	-4	-3	-2	-1	0	1	2	3	4	5	
Equities								◆				Over-Weight
India Equities – Large								◆				Over-Weight
India Equities – Mid & Small							◆					Over-Weight
International Equities						◆						Market Weight
Long Short							◆					Over-Weight
Hedge Funds							◆					Over-Weight
Fixed Income					◆							Under-Weight
Duration			◆									Under-Weight
Corporate							◆					Trending Over Weight
Credit Risk					◆							Market Weight
REITs							◆					Market Weight
Alternates												Over-Weight
Private Unlisted								◆				Over-Weight
Gold				◆								Under-Weight

→ Shift from Prior View ◆ Under Weight / Over Weight Relative to Strategic Weight

Wealth Profiles - Summary

Strategic Asset Class Weights by Profile



Ambit Global Private Client – Asset Allocation & Investment Committee

Amrita Farmahan	Mahesh Kuppannagari	Sunil A. Sharma	Malay Shah
CEO, Global Private Client	**Head – Products & Advisory**	**Chief Investment Strategist**	**Head – Fixed Income**
Amrita.farmahan@ambit.co	Mahesh.kuppannagari@ambit.co	Sunil.sharma@ambit.co	Malay.shah@ambit.co

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