Weekly Market update

22 Aug 21

US Economy :Cyclical Peak

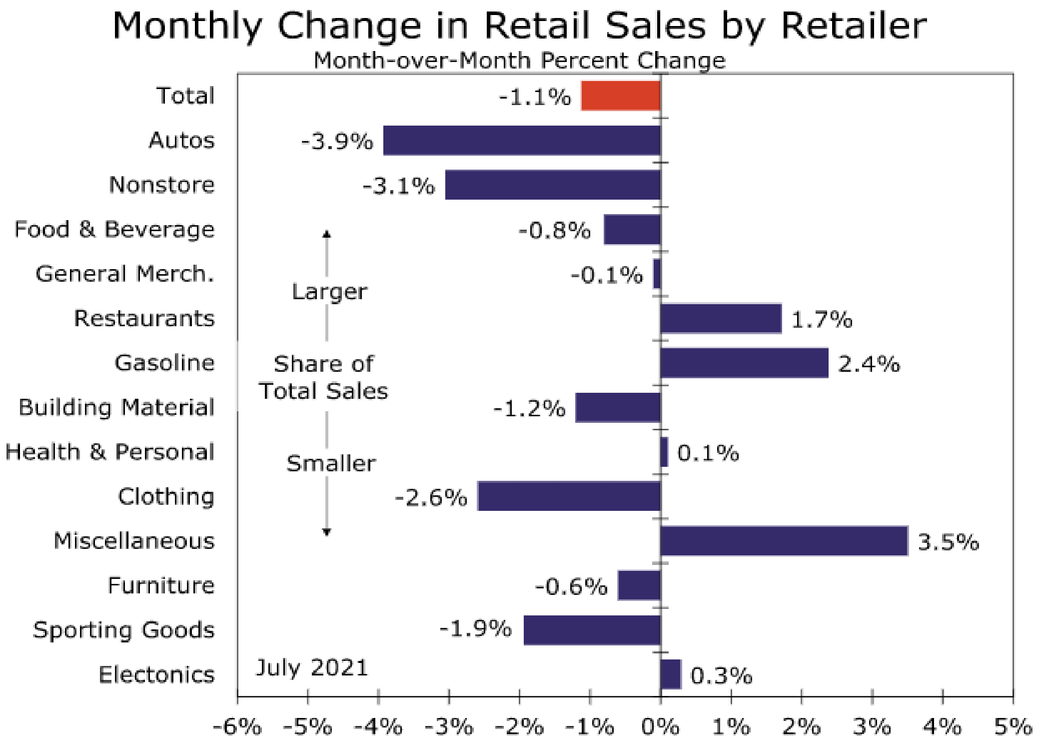
- This week growth fears hit financial markets with stock market volatility picking up, bond yields and commodity prices falling and the USD strengthening.
- **This is broadly in line with the playbook for financial markets when the business cycle peaks.**
- Worsening Chinese data and a sharp drop in US consumer confidence have fuelled concerns that global growth will disappoint, and the spread of the Covid delta variant will create new headwinds for the global economy going into the autumn and winter, when temperatures drop.
- Stocks pulled back for the week but not before the S&P 500 Index reached a new record high of 4,480 on Monday afternoon, more than double its intraday low of 2,192 on March 23, 2020.
- July housing starts fell 7%, much more than consensus expectations, but off upwardly revised May and June numbers. Building permits—a more forward-looking gauge—also rose more than anticipated. Builder sentiment fell back to its lowest level in a year, hampered in part by labour and building supply worries.
- Conversely, industrial production rose 0.9% in July, more than expected, due in part to automakers moderating or canceling plans to shut down production lines. Weekly jobless claims fell to 348,000, a bigger drop than expected and another pandemic-era low.
- Fed released the minutes of its latest policy meeting, in which most members indicated that they thought tapering could begin by the end of the year.
- Last week copper prices dropped close to 10% and oil prices declined to the lowest level since in three months. However, freight rates have shot higher again lately after a the third-largest port in the world, the Ningbo-Zhoushan port in China, was partially closed

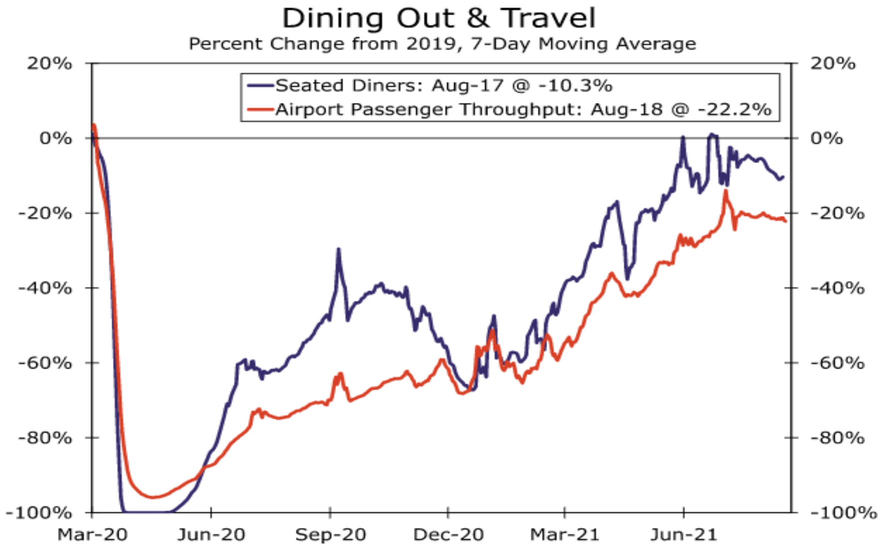
This week …

- Over the coming week we get more information on the state of the global economy with US and Euro flash PMI's as well as the German IFO – Consensus expects a small decline in all the surveys.
- Jackson Hole conference will also be watched closely for any signals regarding tapering of asset purchases.
- US also releases durable goods orders, the best investment indicator for the country. Orders have been on a steep rising path for over a year now but with tentative signs of losing momentum lately.
- US personal spending will add more information on goods vs service consumption. The question is if service consumption is dampened by the recent rise in infections as have been indicated in some high-frequency data. Goods consumption will likely decline in line with what retail sales number last week showed.
- US core PCE inflation will also be in focus to see if the monthly momentum comes down as was the case in the CPI release.

Retail Sales : Passed the peak

- Retail sales slipped 1.1% in July to $618 billion, a level of sales that remains 17% ahead of where it was prior to the pandemic in January 2020, but nearly 2% below where it was just three months ago.
- Sales were mixed among retailers during the month but it is clear that there has been some payback from the run-up in goods spending during lockdowns last year.
- Sporting goods stores and building material stores, two categories that saw fairly exceptional sales growth last year, both saw sales decline for the fourth consecutive month in July.
- Auto sales were also weak, as supply constraints have limited inventory and bid up prices. Furniture, grocery and clothing store sales all declined, and real sales likely slowed even faster, since retail sales are in nominal dollars, or not adjusted for inflation.
- There is obviously an air-pocket in goods spending as consumption transitions back to the services side of the economy, but overall the July data still present some downside risk to Q3 real personal consumption expenditures forecast





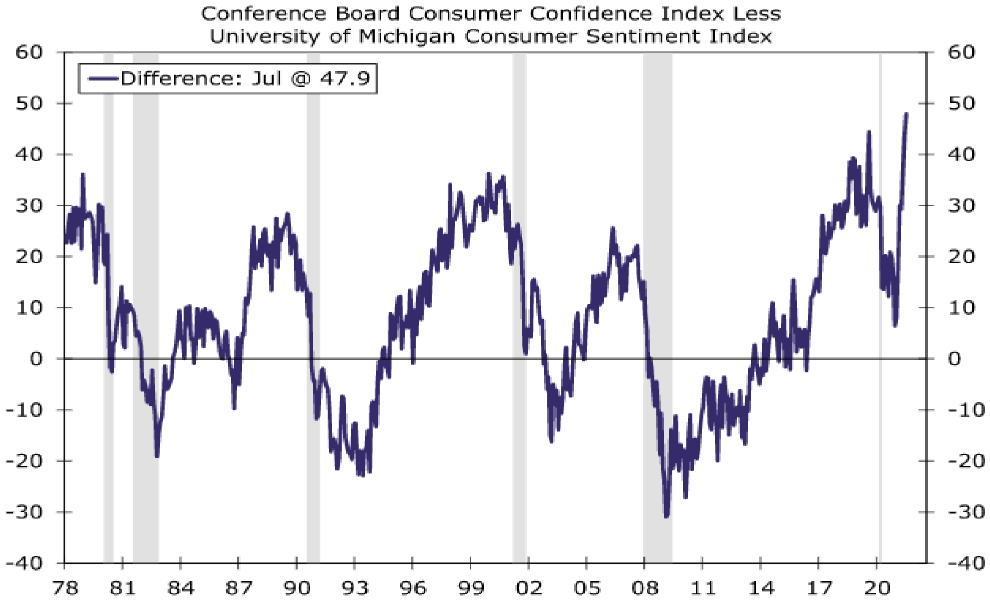
Tale of Two indices

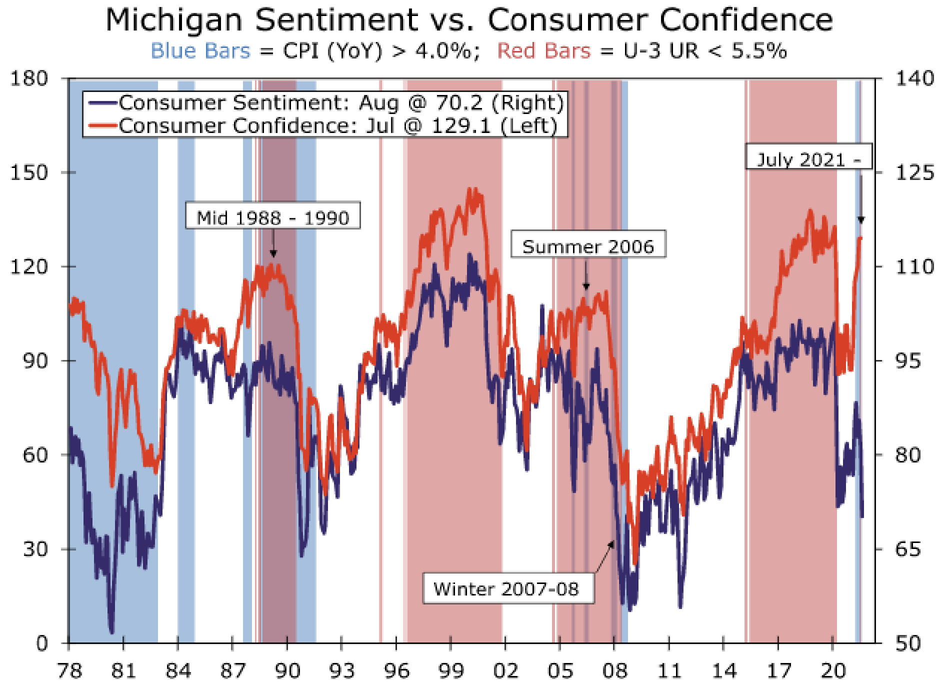
- The Conference Board's consumer confidence index (CCI) and the University of Michigan's index of consumer sentiment (ICS) have diverged in recent months - While the CCI is at its highest point in the post-pandemic period, ICS suggests sentiment is at its lowest since 2011.

- While both surveys aim to record consumers' perceptions, they differ in scope, collection methods and questions asked. For instance, the CCI's "Present Situation Index" asks for respondents to appraise their current business and employment conditions, while the ICS's "Current Economic Conditions Index" asks about buying plans and financial health

- As a result, labour force conditions tend to influence the CCI, while buying intentions tend to influence the ICS, and since big ticket purchases rely on financing, sentiment reflects movement in interest rates and inflation. These ties lead to two inverse relationships: **the ICS and inflation, as well as the CCI and the unemployment rate.**

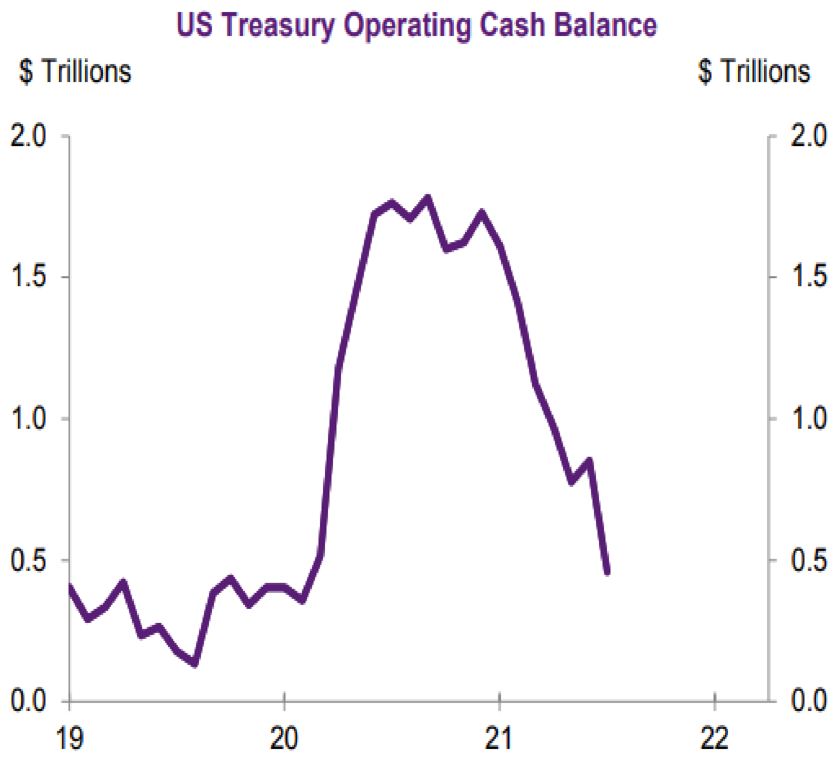
- Today, with prices rising faster than in decades amid a red-hot job market, perhaps it is not surprising that the measures' spread has never been larger. But their ties to different parts of the economy does not diminish their value, as the ICS can be useful as a "gut check" for future goods spending, while the CCI's link to the labor force could also have some predictive use





Bond bulls forewarned…

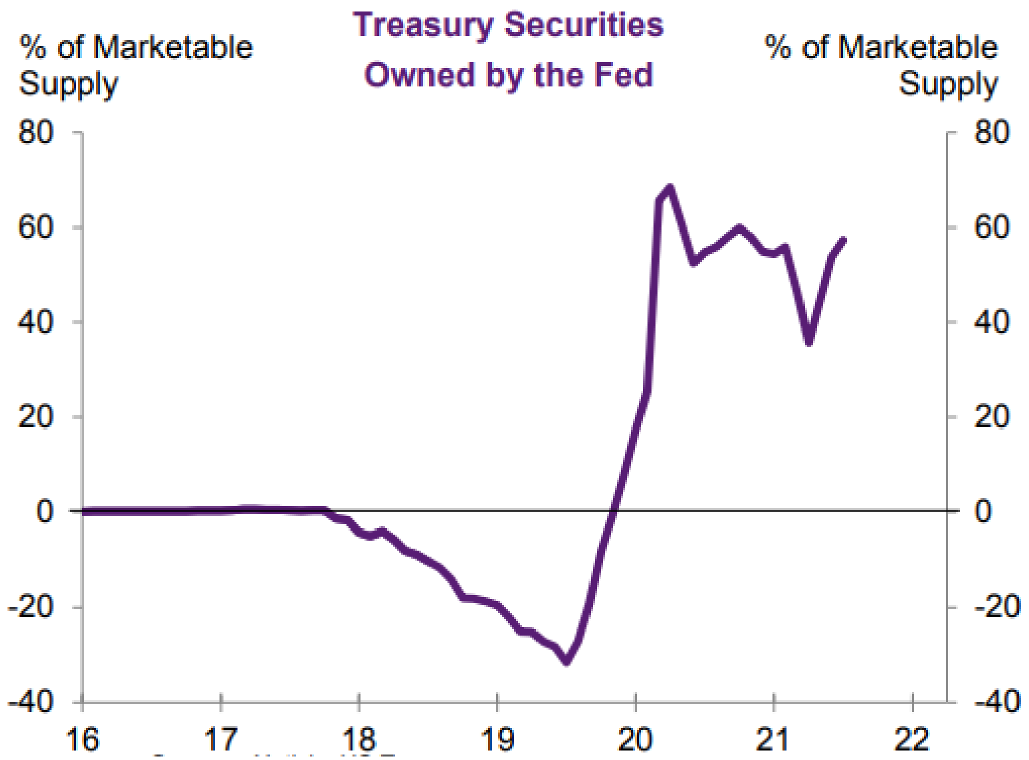
- Over the last 12 months, the federal government ran a cumulative $2.9 trillion budget deficit. However, marketable Treasury issuance increased only $1.7 trillion. The reason the government did not have to borrow more is because the Treasury operating cash balance fell sharply during this time.
- Unfortunately, since the Treasury cash balance was around $0.3 trillion pre-pandemic, there is not much scope to reduce the balance much further. Remember the Treasury needs to keep a substantial amount of cash on hand to make payments because of the timing of the distribution and collection of funds. This means that Treasury issuance is going to rise going forward but the impact on the bond market will be much larger than the numbers imply.
- According to the latest OMB forecasts, we calculate the government needs to borrow $2.2 trillion over the next 12 months. This is $0.5 trillion more than what has been issued over the last year, which is large but arguably manageable in a "normal" environment.
- The problem for the bond market is the Fed, which bought a whopping 57% of all Treasury issuance in the last year ($1 trillion). This goes away when the Fed begins to taper Treasury purchases. Bond bulls have been forewarned.



- The Treasury balance was reduced from $1.8 trillion in July 2020 to $0.5 trillion in July 2021. In other words, the government funded $1.3 trillion in spending by simply reducing the amount of cash it kept on hand.
- This is like a household drawing down cash held at the bank.

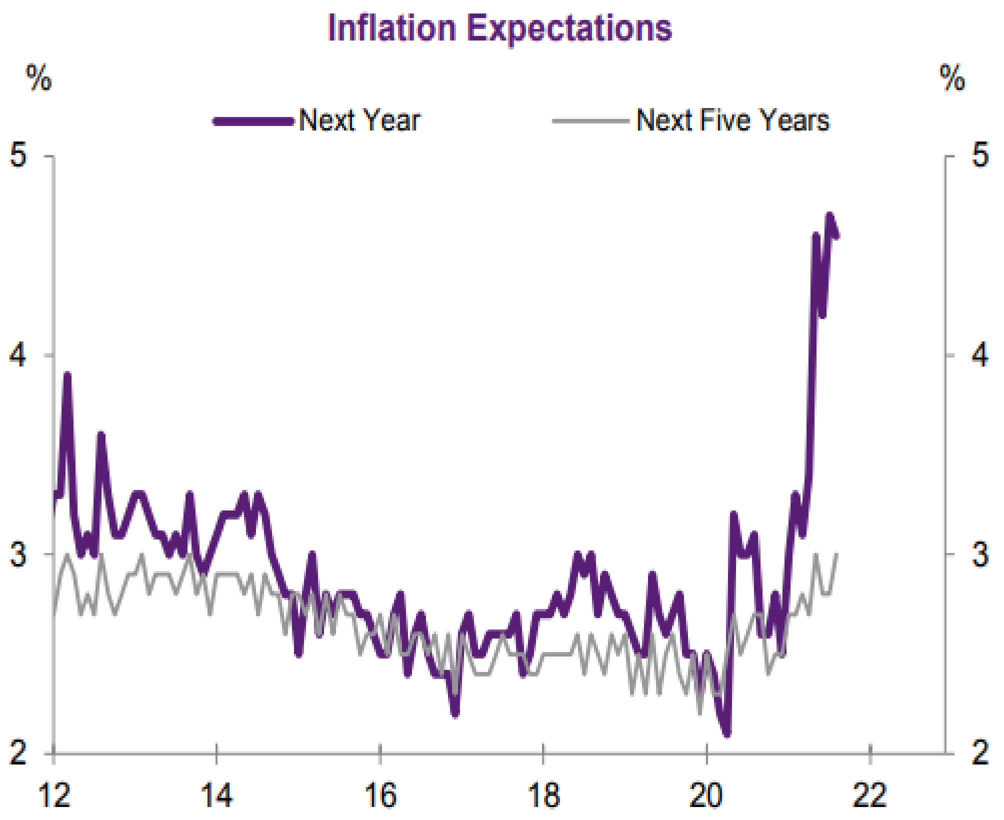
Fed Trap ahead ..

- Government debt dynamics are going to be less bond friendly in the months ahead. This situation is compounded by the increased likelihood the Fed decides to taper its asset purchases sometime within the next year.
- Over the past year, the Fed has bought 57% of all Treasury issuance In case the Fed begins tapering in January 2021, it alone will effectively create an extra $360 billion of Treasury supply for the bond market to absorb.
- Remember this is in addition to the $500 billion in financing necessary to account for the decline in the Treasury's cash balance. Consequently, the bond market is potentially going to have to digest nearly $900 billion in additional Treasury supply over the next 12 months. This is a substantial sum that could put upward pressure on interest rates
- Stocks have moved in lockstep with quantitative easing. In the process, equity valuations expanded mightily. The S&P 500 market capitalization is now 60% larger than the entire US economy. This means that Fed tapering of bond purchases could weigh meaningfully on equities.



Inflation : Permanent

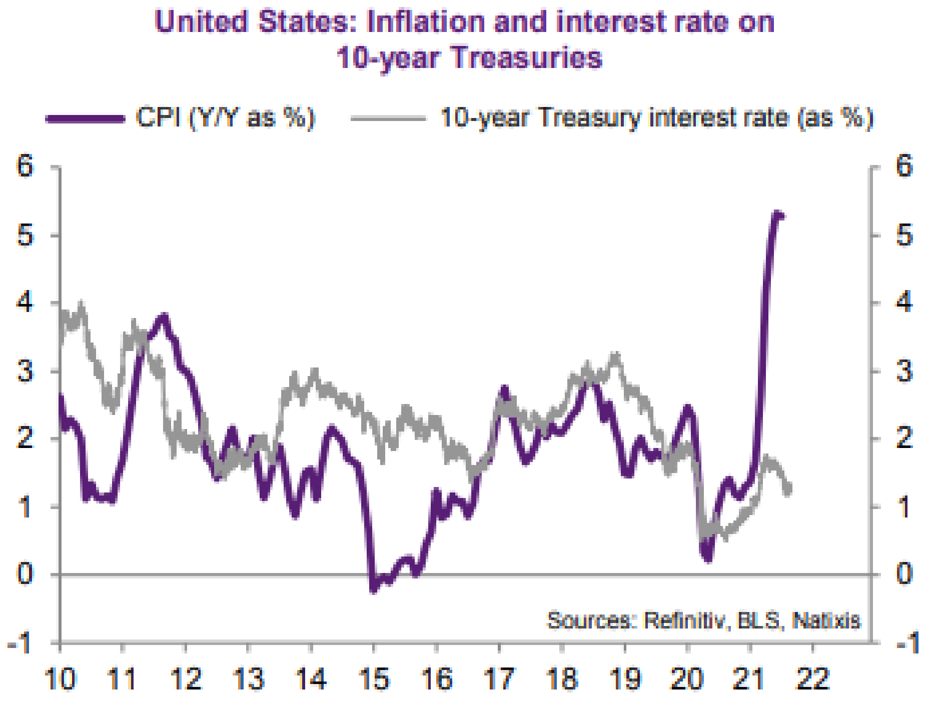
- The current inflation backdrop is distinctly different from the recent past. The factors causing today's inflation extend beyond just rising energy prices. Moreover, both short- and long-term inflation expectations are on the rise.
- With the prospect of further substantial government spending to come, the risks are rising of a transitory surge in inflation becoming permanent
- Inflation expectations has not been a concern in the past because elevated expectations were largely the result of rising gas prices. Since the latter are volatile, their inevitable price decline would eventually pull expectations back down. This time may be different
- Rising gas prices may not be the only factor pushing up inflation expectations. The share of households reporting that now is a "good time to buy" a home or an automobile has fallen to its lowest readings since 1982. There has been a near similar drop in buying conditions for durable goods. Unlike the recent past, consumers are experiencing broad-based price gains that are not limited to the gas pump.
- For now, the bond market is unperturbed. However, this may change based on the potential for further significant fiscal stimulus as a transitory inflation surge could become permanent.

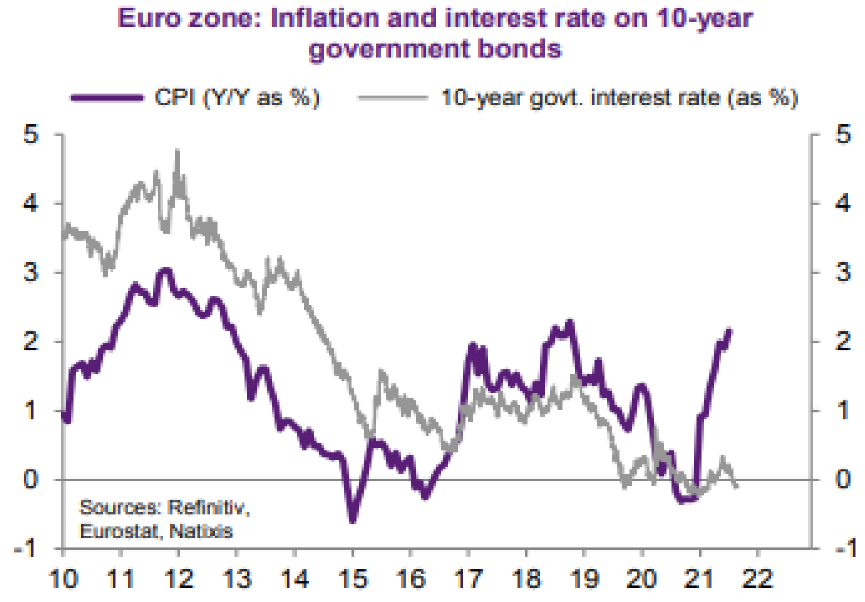


- Long-term inflation expectations are trending higher and are at the upper end of their 10-year range., 5-year ahead inflation expectations matched their May 2021 cycle high of 3%.
- The last time long-term price expectations were this high was September 2013. For the record, 1-year expectations were only 3.3% at the time and trending lower.
- Thus, it is troubling that both short- and long-term expectations are moving upward together.

Disconnect - Precedence

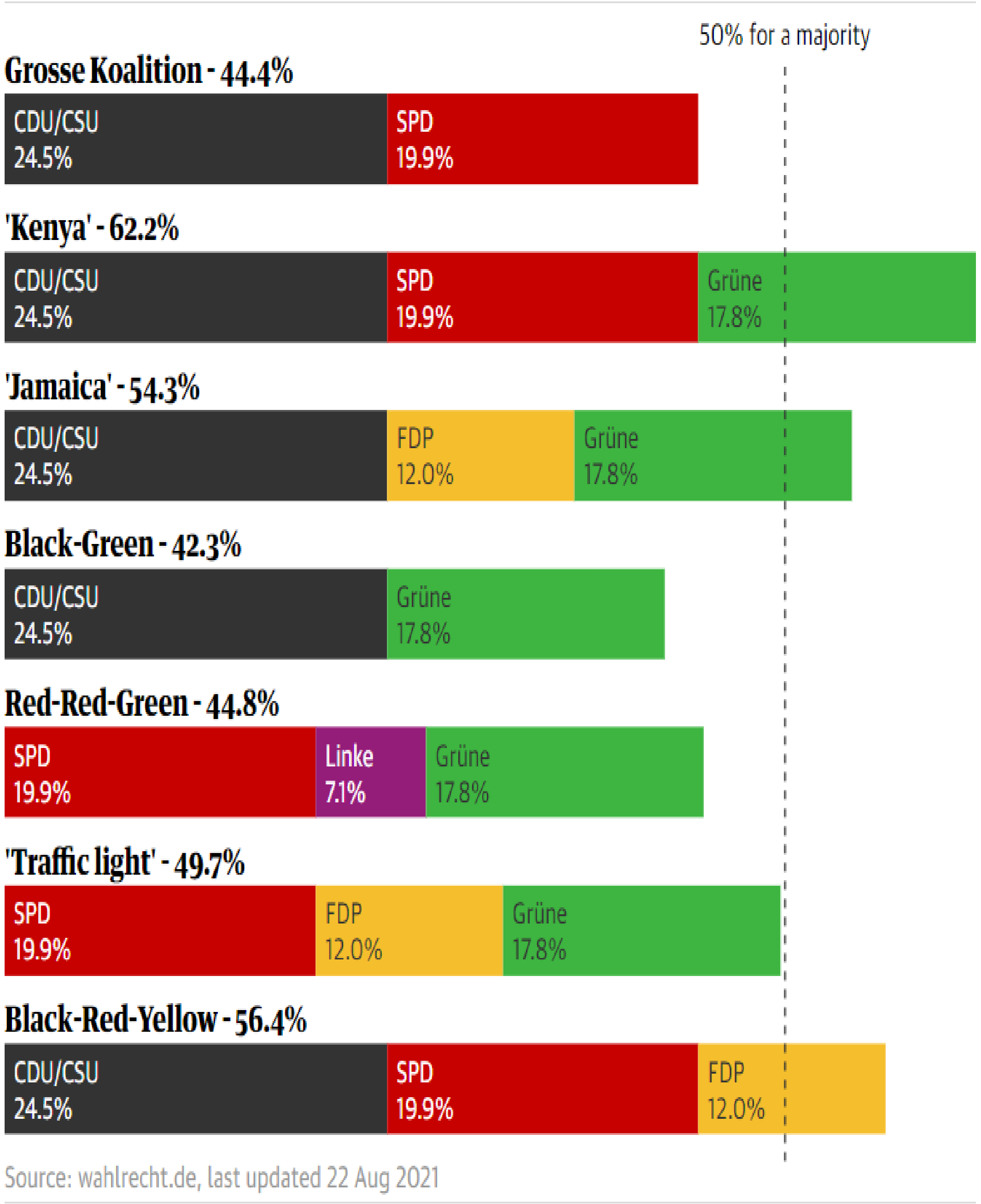
- Both in the United States and the euro zone, the rise in inflation in the recent period has had no effect on long-term interest rates
- Is there a robust explanation for the lack of an inflation effect on long-term interest rates in such previous episodes ?
- Decorrelations between rising inflation and rising long-term interest rates have previously occurred in US in 2005-2006, 2008 and 2011 and in Eurozone in 2008 and 2017-2018
- The lack of an effect of rising inflation on long-term interest rates can be attributed in US :
    - In 2005-2006 to the absence of a rise in core inflation;
    - In 2008 and 2011 to the absence of an acceleration in wages, the absence of a rise in core inflation
- In Euro zone:
    - In 2008 to the absence of a rise in core inflation and underemployment;
    - In 2017-2018 to the absence of a rise in core inflation





German Elections : Risk for EUR

- Germans will vote on Sunday 26 September to elect a new Bundestag .
- The result – after coalition negotiations likely to involve two or three parties – will decide who will succeed Angela Merkel, who is standing down after 16 years as chancellor.
- In the weekend INSA poll, Christian Democratic Union (CDU) and Christian Social Union (CSU) conservative alliance dropped three percentage points, putting it neck and neck with the Social Democrats (SPD) — both at 22 percent.
- A two-way coalition between the conservative CDU and the German Greens had long looked the most likely outcome. However, neither party fared well in their response to the devastating floods that hit Germany in July, giving a boost to the confidence of smaller parties.
- German federal elections are proportional, so the share of vote given by polling companies should be read as translating fairly directly into share of seats in the resulting parliament.
- Laschet is hoping to replace Merkel as chancellor following the September 26 election, but his SPD opponent, Finance Minister Olaf Scholz, has been gaining ground in recent weeks.
- The markets have not priced the risk of lower EUR on account of the uncertainty ., as they take German Elections as a non event as an acceptable arrangement would follow post event .
- But both CDU and CSU look very fragile as per the recent polls and further setbacks for CDU and CSU should be seen a key negative for Euro -



China : Debt Question

- Historically, excessive debt is a precursor to financial instability - China's debt-to-GDP ratio has further come down to 267% in Q2 2021, significantly lower than the earlier peak of 272% at the end of 2020 . Such an improvement was not only due to the sustained deleveraging efforts, especially in the corporate sector, but also thanks to the strong growth rebound and also inflation . On the same growth rate for Q2 2021 as Q2 2020, the debt-to-GDP ratio would have increased to 273%.
- The key driver of the slowdown in debt accumulation was the corporate sector. Not only did the value of the on-balance sheet outstanding corporate bond grew only 6.7% y/y in Q2 2021 compared to 11.7% in Q1 2021 and 17.7% in Q4 2020, but also the corporates' off-balance sheet shadow banking debt continued to fall by 9.8% in Q2 2021 due to the government clampdown . The stringent credit environment is particularly felt by corporates in a number of sectors .
- On public sector debt, the on-balance sheet government debt grew steadily as the central government and local government debt continued to increase by 2.1% and 5.3% q/q respectively during Q2. The government debt to GDP ratio increased from 78.7% to 79.3%.
- Household debt continued to grow rapidly, with the pace nearly as fast as the nominal GDP growth during Q2 2021. The most important contributor was mortgages, which defied the stricter regulatory stance on the real estate sector and contributed more than 40% of the total rise in household debt
- Moving forward, however, the economic slowdown, which is expected to be reflected in the upcoming data, looks worrisome in terms of future debt trends.
- This is not only because the denominator of the debt to GDP ratio will not grow as fast, but also as more fiscal and monetary accommodation will be needed. As such, the local government's fiscal stimulus to accelerate in H2 2021, aiming at boosting infrastructure investment. This will also be accommodated by a laxer credit environment to avoid a fast rise in the funding costs. **The consequence of such a reverse in policy is likely to lead to a surge in overall debt in H2 2021.**

Bond markets : Lack of triggers

- The members of the MPC may have unanimously voted for a status quo and by 5-1 in favour of an accommodative stance, but the first signs of dissonance were visible in the minutes of the Aug 4-6 meeting. As the key dissenting voter, Jayanth R. Varma made the most strident push to review accommodative stance and Ashima Goyal hinted at possibility of some level of normalisation within accommodative stance itself.
- RBI ‘s plan to scale up its reverse repo operations, when announced, was seen as a way of nudging the cost of the short-term borrowings just a bit higher. Understandably, markets saw the RBI stealthily moving towards normalization of its ultra-loose monetary policy.
- However, the much-feared tightening of financial conditions has not manifested, and in all likelihood, might not emerge at all.
- The 2-trln-rupee increase in the quantum of term reverse repo operations will be offset by the liquidity injected from the RBI’s bond purchases, foreign exchange operations, and a fall in the government's cash balance.
  - RBI decided to buy bonds worth Rs.800 bln over August and September under its government securities acquisition programme, including Rs.200 bln worth of papers purchased last week.
  - What's more, the central bank has been taking delivery of its maturing forward dollar purchases, boosting the liquidity surplus. At the end of June, the RBI had net outstanding forward purchases worth over 1.5 trln rupees maturing in the subsequent three months.

Nifty : Weaker range bias

- Indian markets had been on a ‘Make and break’ new lifetime highs trend since the past couple of weeks after mirroring global market indices in their move to the top.
- Now the markets have ignored negative global cues and attach more significance for the positive domestic cues.
- Nomura’s India business resumption index crossed the 100 mark for the first time after dipping in March 2020 and settled at 101.2 levels.
- With recovery brewing from the highest impacted sectors, it remains to be seen as to whether India continues to maintain this current level of commercial momentum to further drive this rally.
- Emerging market sentiment is weak especially as Chinese equity markets continue to simmer and hence it would not be possible for India to stand isolated from the pack
- Even if there is no panic sell off , the odds are for the market to spend more time in 16200 16600 range