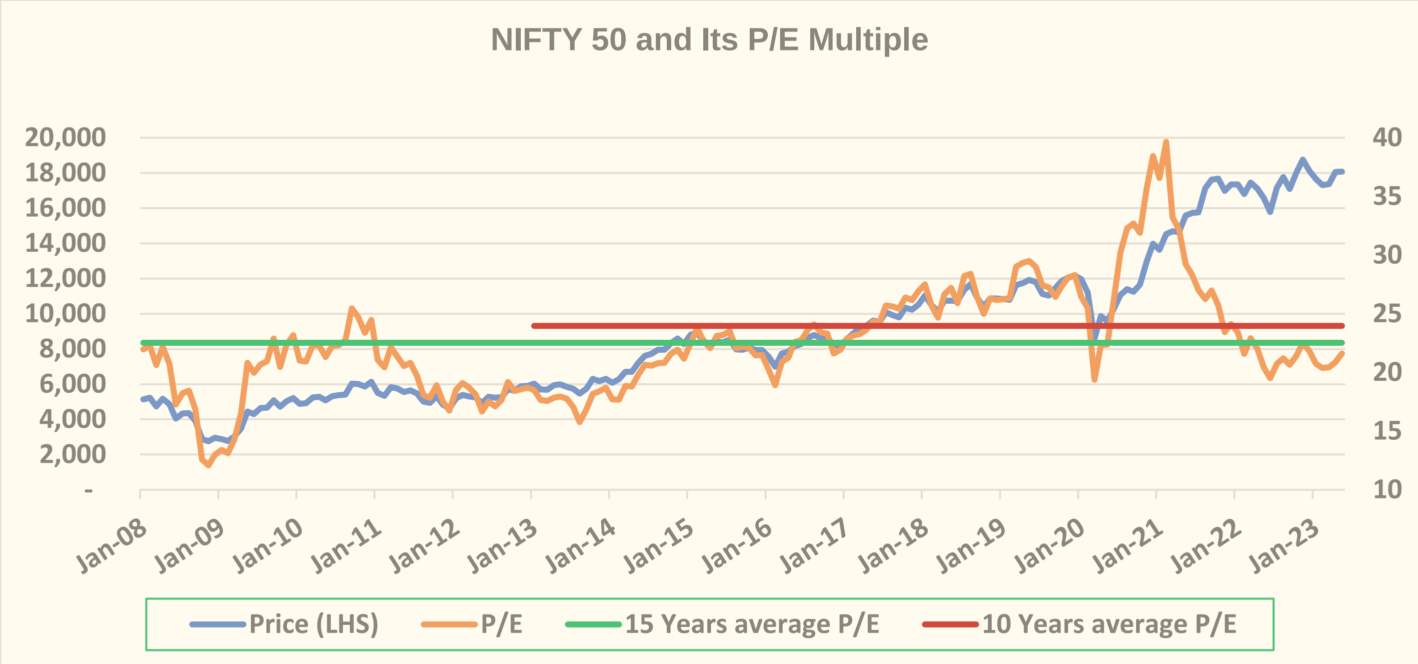
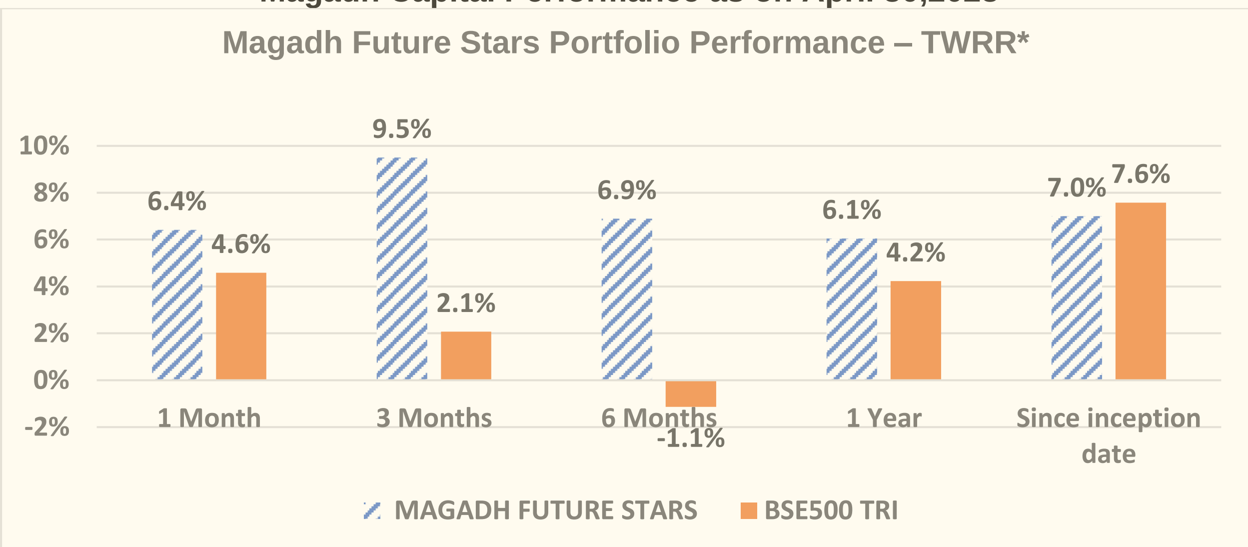
The Fed May Not Relent

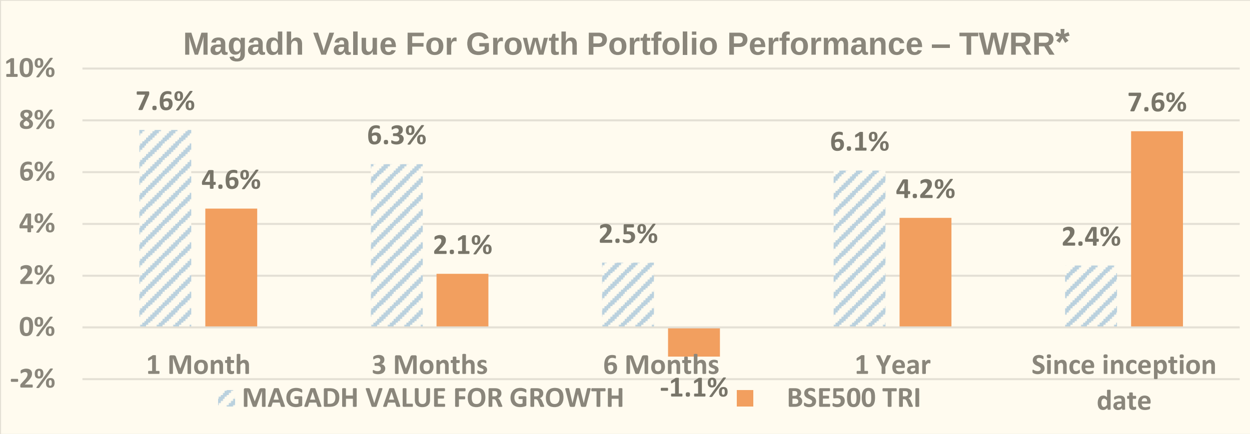
Amid uncertainties on global macreconomic situation India seems well grooved versus rest of the world India's macroeconomic environment has rarely looked as strong as it looks now. At the same time, with a sluggish trailing performance (Nifty 50 has been flattish in last 18 mopnths) Indian markets have shed their premium over other emerging markets. At 20x P/E on trailing twelve months, Nifty 50 is close to the lowest in last nine years.



If taking a 2-3 years or longer term view we find it difficult not to be constructive on Indian equities as an asset class. First, macroeconomic backdrop looks encouraging with sustained world-leading GDP growth, government debt especially external debt well under control, a descending glide path for fiscal deficit, healthy forex reserves and reduced crude oil prices. Inflation seems to have come under control even without too stringent rate tightening by the RBI. Second, reforms that have been undertaken are set to show up further in coming 2-3 years even as the next phase of reforms can be expected to start post-general elections in 2024. Then, balance sheets of corporates as well as lending institutions are at close to their best ever implying that credit cycle uptick will continue and indeed strengthen further. Ongoing infrastructure upgrade too augurs well for India's markets from here. Accordingly corporate earnings should trend at healthy levels from here.
Of course it'll be unreasonable to expect a linear improvement in markets.
We remain fully invested and see pockets of growth across sectors and across market cap categories.

Magadh Capital Performance as on April 30,2023





BSE500 TRI – BSE 500 Total Return Index
***TWRR - Time Weighted Rate of Return**
Inception date: August, 2021

The macro driver unnerving many investors in India too

Global macroeconomic cauldron – the mix of Fed funds rate, inflation, unemployment, and stability of financial system – will remain on a boil near term. The USA's Federal Reserve (the 'Fed') last week indicated that it would likely go for a pause in rate hikes from here depending on data. However with a view that inflation will tick down further US debt market is actually building in a rate cut in next 2-3 months followed by two more rounds of reduction of Fed rate in the rest of 2023. In our view, the Fed is unlikely to cut rates in next 3-4 months unless its hands are forced by a banking system disaster. Notably, many small and mid sized banks in the USA are in a precarious condition as a result of the rapid policy rate hike in last one year. If the Fed does not cut rates delivering a surprise to the debt markets, it may hinder the US equity markets too. However the pain may not be enough to cause too much stress to Indian markets especially starting 2HFY2024.

What do we expect

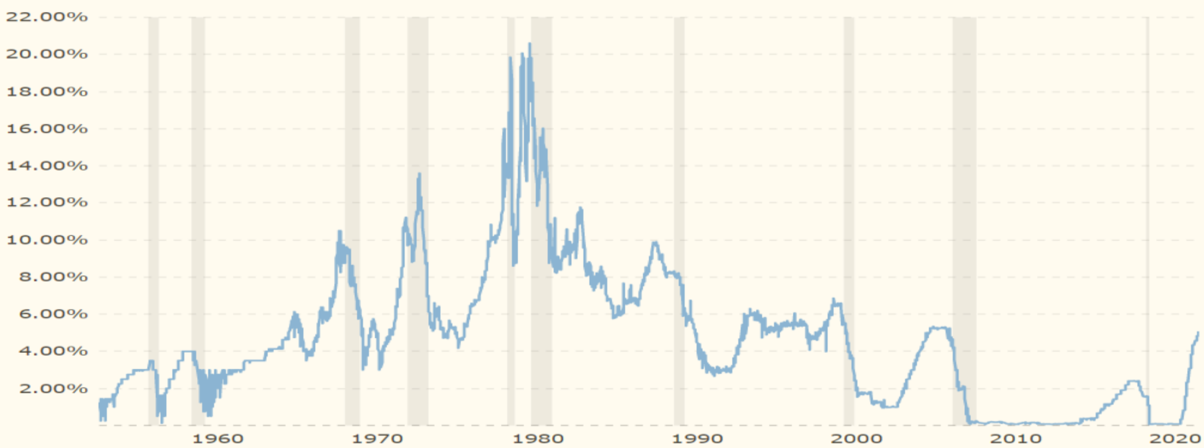
We have presented our view on the USA macro in more detail in the following pages but to sum up, in our view,

1) The Fed will prefer to quell inflation properly before thinking of cutting rates to revive economic activity
2) Bonds market, and possibly equity markets may be up for some surprise from Fed on its rate action in rest of CY 2023, unless inflation slips sharply in coming months
3) There is a decent probability of recession in the USA, even if a shallow and shortlived one, later this yeart and/or in early CY2024,
4) India too will be negatively impacted by this probable recession. However the impact should be limited given India's fundamental strength.

Fed funds rate at highest since 2006

On 3rd May the US Fed raised its policy rate , the so called Fed Funds rate by 25 bps while suggesting this may be the last hike in this cycle depending on data ahead. This was the 10th round of consecutive hike since March 2022 making this the steepest Fed rate hike in 40 years. The Fed funds rate now stands at 5.00-5.25% versus the 0-0.25% that existed in early 2022 and is now the highest since 2006.

US Fed funds rate; Historical Trend



Source: Macrotrends.net

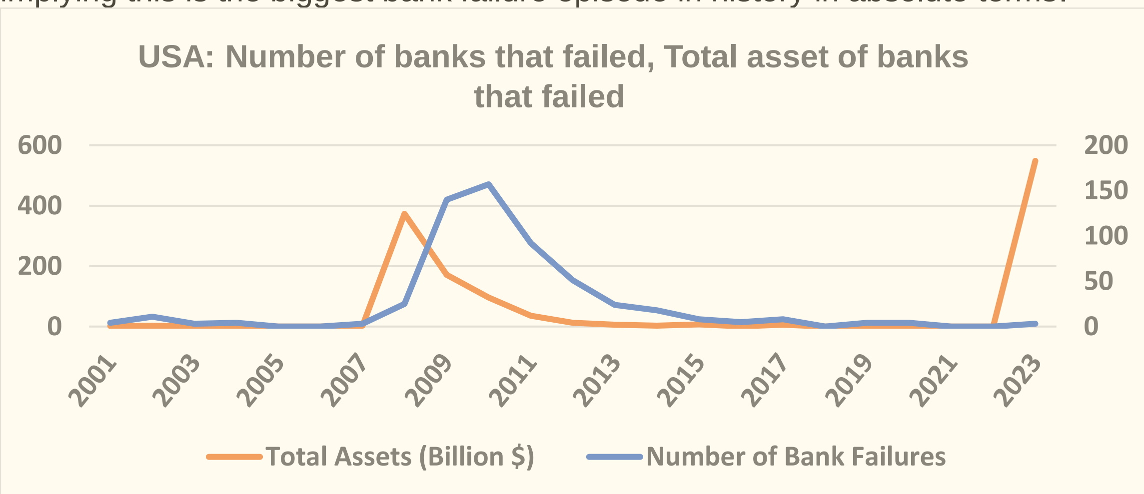
A lot has changed since the rate hike started in March 2022- Ukraine war is turning into a stalemate having raged on for about 15 months, global geopolitics has become more complicated, crude oil prices have declined by more than 35%, China's economy has continued to slow down structurally, and USA is witnessing the largest bank defaults ever. Not surprisingly the debt markets are building in generous rate cuts to begin later this year and continue through CY2024.

Unfortunately what has stayed constant here is inflation in the USA. Despite such aggressive policy rate hikes, the effects of massive fiscal stimulus unleashed post Covid and a sustained 15 years period of ultra-loose monetary policy are refusing to retreat meaningfully- at least, so far.

Naïve to expect Fed to cut rates in 2023 if the inflation does not soften decisively, or unless banking sector sinks into deeper distress

The Fed's release post last week's meeting points to a possible pivot – i.e pause in rate hikes- in the next meeting in June even if depending on data from here. This clearly points to the Fed's single minded focus on inflation as its key task. At the same time, till about 3 months ago the trade off for the Fed was between inflation and a recession. Now a third macroeconomic dimension has emerged – that of financial system's stability.

Since then three more banks in the USA have gone down and some more seem to be teetering with dropping stock prices and floundering trust in their ability to remain solvent. So far banks with cumulative asset base of about US$ 590 b have failed implying this is the biggest bank failure episode in history in absolute terms.



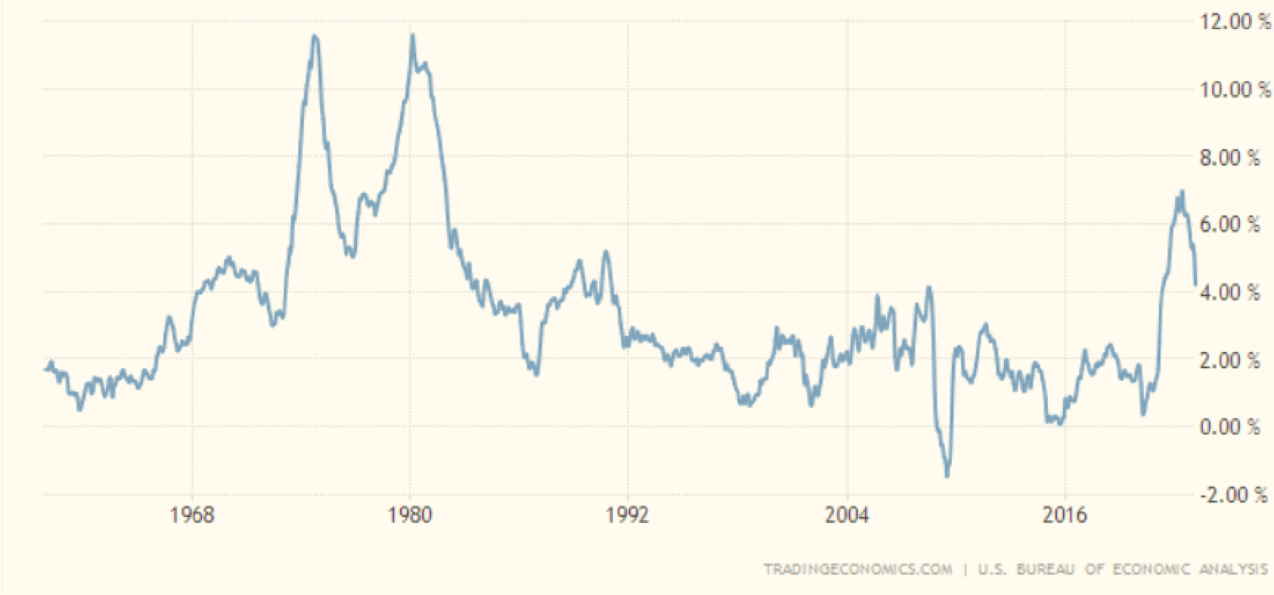
Source: fdic.gov

The steep rate hike has shaven off large chunks off the debt instruments that banks hold in the USA and hence near term asset-liability matching is turning wobbly for many banks. SVB (Silicon Valley Bank) that failed last month with asset base of more than $200 billions.(almost the size of State Bank of India, India's largest bank) had a large chunk of its assets deployed in the world's safest debt instruments – US government securities. However as the policy rates rose the market value of these debt instruments fell sharply. Many of these securities had to be marked down leading to concerns regarding solvency of the bank. Given its nature of depositors – concentrated, from the start up community- as trickle of escape soon turned into a stream prompting the USA's FDIC to step in calling curtains on the bank.

The Fed so far has been clear in its focus on inflation control even if recession plays in as a collateral damage.However its resolve may get tested if more banks slip into the vulnerable zone. To us there is one strong reason why the Fed will not waver from its inflation control mandate.

Fed probably would look to follow Fed action in 1980's, and not that in 1970's
Arthur Burns had a good reputation as as an economist when he was appointed as the chairman of USA's Federal Reserve in 1970. As a child too he had been precocious. At the age of six he had translated the Talmud into Polish language. He had migrated to the USA when he was ten with his parents from his native Galicia in what was then the Austrian empire, and in modern Poland/Ukraine.
Unfortunately the Fed under his chairmanship is believed by many, even if harshly, to have been all at sea in the era of the great inflation. The great inflation that lasted in the USA from 1968-1983 is part of macroeconomic folklore. Arthur Burns was a central character there having led the Fed from February 1970 to January 1978. The Fed' monetary policies had failed abysmally in controlling the rampaging inflation of the 1970's even though there were many more moving parts in the economic system of that era.
Global geopolitics and the related crude oil surge had played a key role in fuelling this inflation in the USA and other large economies globally. Make no mistake, the Burns Fed did follow the standard protocol when inflation reared its head initially. The Fed went for an aggressive hike from February 1972 to August 1973 as the war between Israel and Arab countries ended, raising the Fed rates to 10.8% from 3.1% in 19 months. One also must remember that till the 1970's the wounds of the great recession were still fresh in collective memories in the USA. Echoes of deep distress and the horror stories from 1930's meant that policy makers would always target unemployment ahead of inflation if it came to choosing the bigger evil to counter. Thus the Fed's inability to curb inflation decisively by early seventies still did not attract much criticism. However as inflation simmered past 7% in late 1973 economic activity slowed down in clear terms. Alarmed by the spectre of rising unemployment the Fed abandoned its inflation focus and abruptly started cutting policy rates in September 1973. In hindsight this turned out to be a mistake. As the decade wore on inflation rose past 12% becoming sticky in the process. So much so that by mid seventies economists realized that now the USA's enemy had a new name. It was not unemployment any more. It was inflation now. Starting 1977 even in the face of a steep rate hike inflation continued to climb spectacularly smashing past 14% by late 1980. Fed seemed helpless to curb this devil that continued to haunt the economy till 1982.

USA PCE Inflation index; Historical Trend



In hindsight, it was the Fed's removal of foot off the pedal in late 1973 that allowed inflation to grow into a scary and uncontrollable beast. This is what the Fed would want to avoid now.

By the way those who had invested in American equity markets in 1968 stood still in time. Their wealth did not grow till 1982 if they invested in the blue chip index of Dow Jones 30. Even if someone had invested in the more democratic S&P 500 index the inflation-adjusted return was nil in the period.

USA inflation adjusted returns

Source: officialdata.org

The fireman of the 80's

The Paul Volcker era began at the Fed in August 1979. Right from his undergraduate days Volcker had a critical view of excessively loose monetary policies in the USA. As the new Fed Chair he immediately assumed the role of a

fireman and within eight months raised the Fed rate from 11% to 20%. Even as inflation was the first to blink in this stare off, the Fed stayed hawkish through 1980 keeping rates above 10% for large part of the year. The Volcker Fed had worked with a single focused aim to defeat inflation even if it meant inviting a phase of economic recession. However once the inflation was curbed the economy rebounded sharply. As this phase of sharp inflation was coming to an end USA's stock markets embarked on a bull market journey in 1982 to 1999.

This is why in the current scenario the Fed may want to follow the template of 1980's rather than that of 1970's. They have been repeatedly alluding to a a short lived and shallow recession. Once inflation has been conquered they will turn to addressing recession if the latter were to appear. They have the ammunitions now – Fed rate is above 5% now which means they can go for a sustained phase of rate cut next year if required. However till then if inflation does not start receding the Fed will allow the inflated policy rate enough time to work on inflation – unless bank collapse goes out of hand. Indeed the risk of intensifying bank stress and possible contagion is the reason why further rate hikes may not be on the agenda anymore and instead the current levels of rates, on a sustained basis if required, is what will be preferred as a weapon against inflation.

What do we expect from here

In the current environment there is no visible pressure on economic growth even as the aims of the rate hike have not been even partially achieved. Hence it seems the bond markets are running too far in building rate cuts to start from September. At least as of now it looks difficukt to see how will inflation decline perceptibly in next 3-4 months.

Notably, inflation in last six months has displayed some signs of softening even though it is still amongst the highest in 30 years and far from the Fed's comfort zone. However we do not see a clear answer to the question of why should the Fed cut rates ? With economy not showing any signs of weakness what will be the purpose of a rate cut if it were to commence now ? Unless one expects a sharp deterioration in economic conditions and unless one is not prepared to sweat it out even for a couple of quarters in this war against inflation the case for a rate cut is not easy to build. Of course this argument won't survive a meltdown of the bankin sector in the USA.

May10,2023

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