

Shift Away from Reflation?

Prepared by LC Capital India

August 2021

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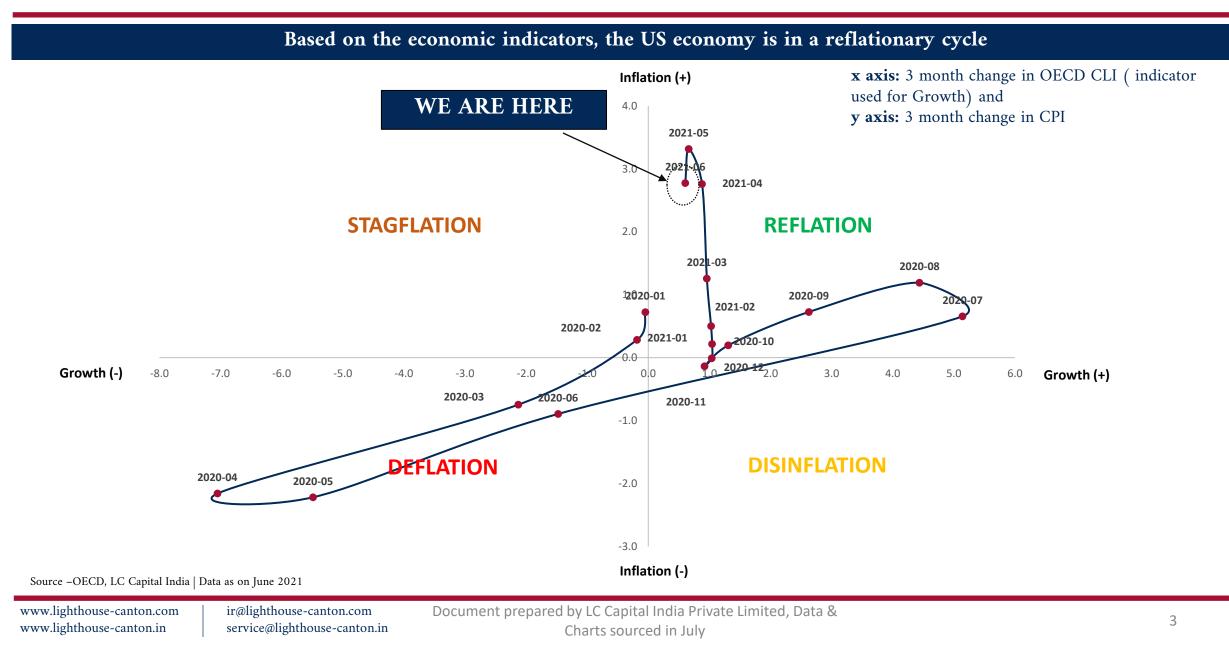
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US: Reflation, Whither?





Executive Summary



- Do we see a shift from the current reflation cycle in the US
- Going forward which are the various factors which may influence Inflation and Growth
- What are the bond, currency and equity markets signaling
- Track the pace of vaccinations administered in US
- How will Indian markets be impacted
- Investor standpoint



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The Question is...Do we See A Shift?



Let's consider and deep dive into factors which may influence

% Inflation



Growth



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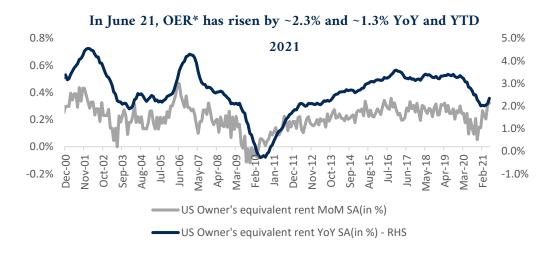
Inflation...

could rise, though opposite forces may keep the rise in check

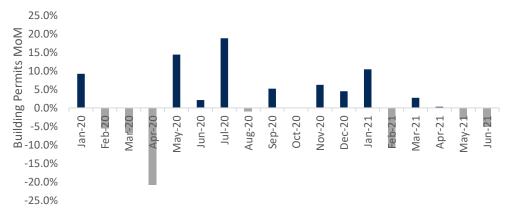


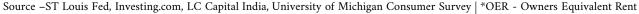


We expect the pricing pressure to continue in the near term for this segment which contributes ~33% to overall CPI basket

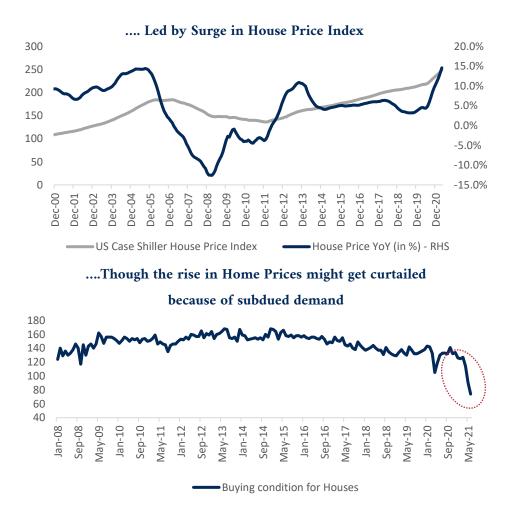






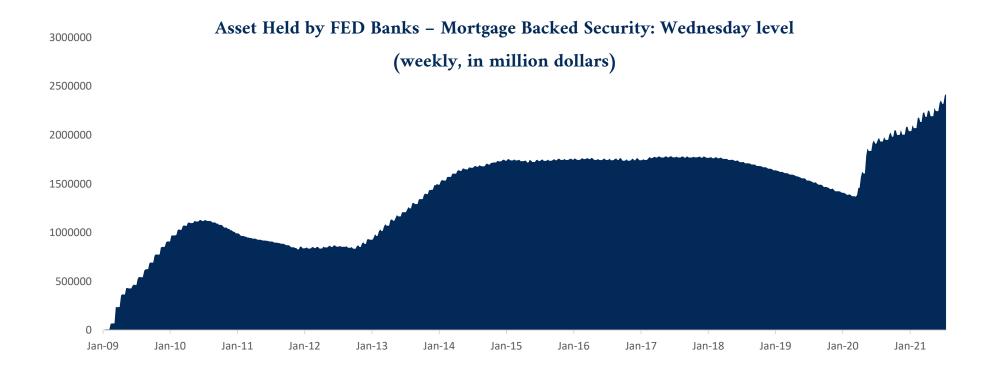


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Since April 20, the FED has bought Mortgage Backed Securities worth ~1.7x. This has led to low mortgage rates which may incentivize buyers to borrow and buy houses (high demand)



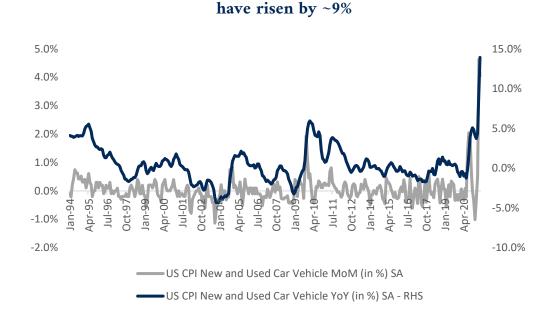
Source -ST Louis Fed, LC Capital India

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We expect the pricing pressure to continue in the near term for this segment which contributes ~7% to overall CPI basket

On YTD basis, the CPI for new and used vehicles





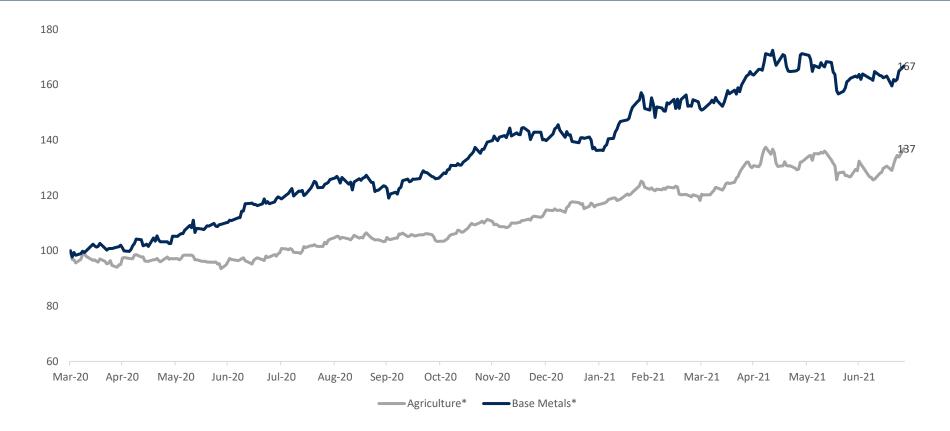
....Pandemic led shortfall in chips have led to lower

Source -ST Louis Fed, LC Capital India

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Tailwind for Inflation: Rising Agriculture & Base Metal Prices

Pandemic led disruption and climate changes have led to a demand supply mismatch, thereby directly or indirectly affecting various components of CPI basket



*For Agriculture and Base Metals, we have considered Invesco DB Agriculture Fund and Invesco DB Base Metals Fund (Zinc, Copper, Aluminum) | Source - St Louis FED, LC Capital India

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Way Forward: Little Respite



Inflation may remain anchored on the higher side



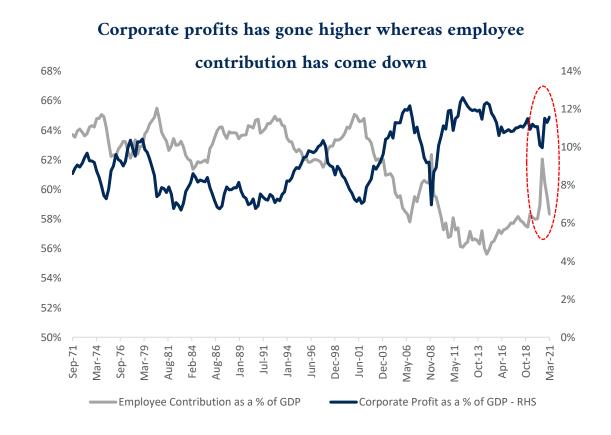
Index at an all time high

Source – Bloomberg, LC Capital India

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View on Corporate America: Corporate profits have been rising, employee costs declining – Is the trend expected to reverse?

Ongoing unemployment benefits and pandemic fears may have led to people staying at home. Companies may have to incentivize with higher pay to bridge the demand and supply gap.

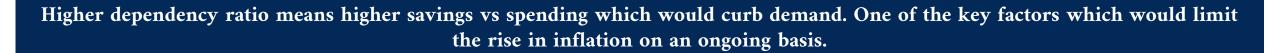




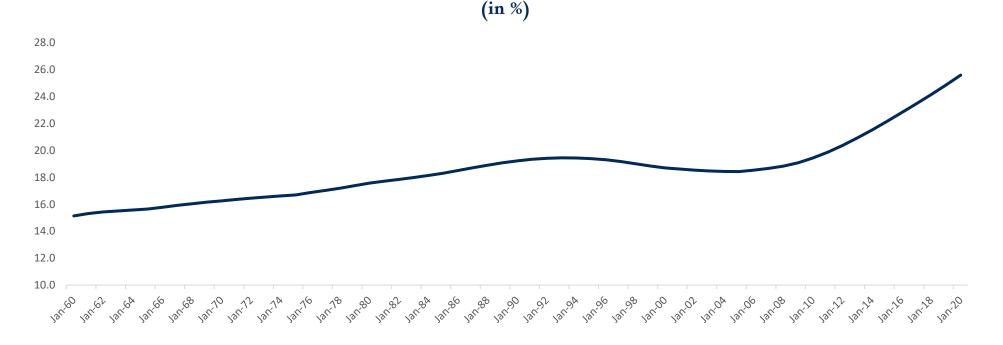
Source –ST Louis Fed, Bloomberg, LC Capital India

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Headwind for Inflation: Unfavorable Demographics

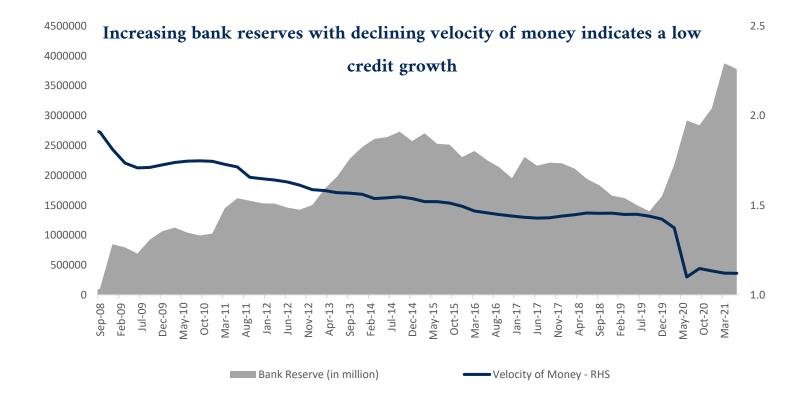


Age Dependency Ratio: Older Dependents to Working Age Population in US NSSA



Source –ST Louis Fed, LC Capital India

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Source – Bloomberg, LC Capital India

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Growth...

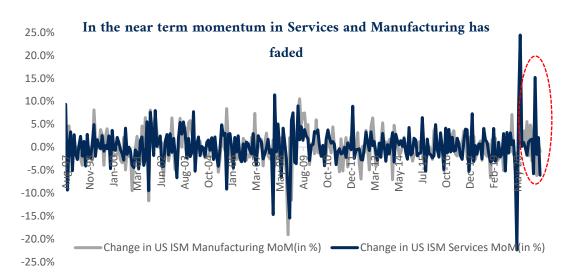
Is there a slowdown?



Headwind for Growth: Has the Momentum Halted?



Slowdown could be attributed to rise in Delta variant cases and reduced pace of vaccination. We may be in for negative surprises in stock earnings for 2HCY21



US Consumer Sentiment Index still below pre pandemic in spite





Source –Bloomberg, LC Capital India, University of Michigan Consumer Survey | Data as on 30th June 2021

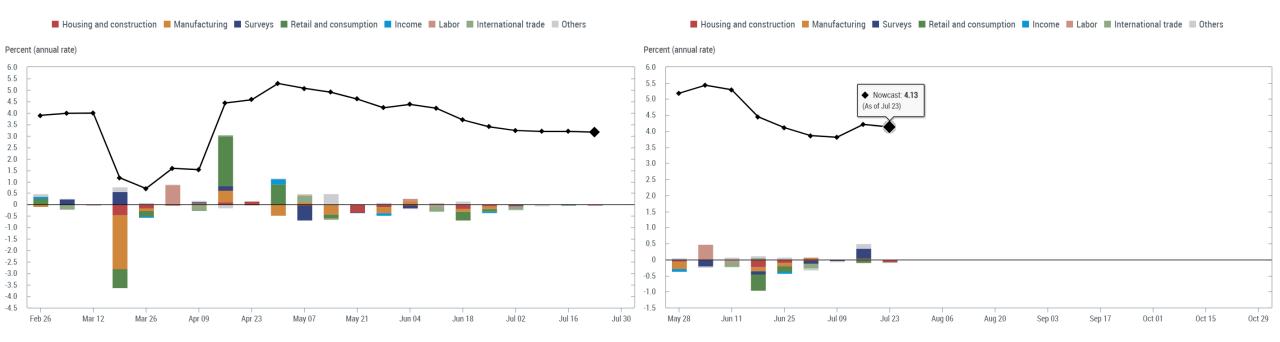
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Advance growth estimates from NY FED Nowcast model for Q2 2021 and Q3 2021 reflecting downward revision

Q2 2021

Q3 2021



Source - NY Fed (click here)

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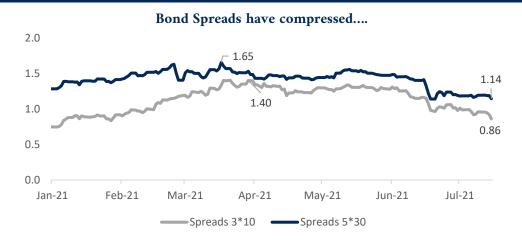
Market Signals...

likely shift away from reflation



Shift Away from Reflation: Yes: Longs on Both Bonds and Dollar

Rise in Delta variant cases, fears of growth slowdown and transitory narrative on inflation have led to market participants moving to safe havens



COT* Non Commercial Net positions - 10 year treasury



....Dollar at key resistance 104 102 Trend line 100 98 94 92 90 88 Jan-21 May-21 Jan-19 May-19 Sep-19 Jan-20 May-20 Sep-20

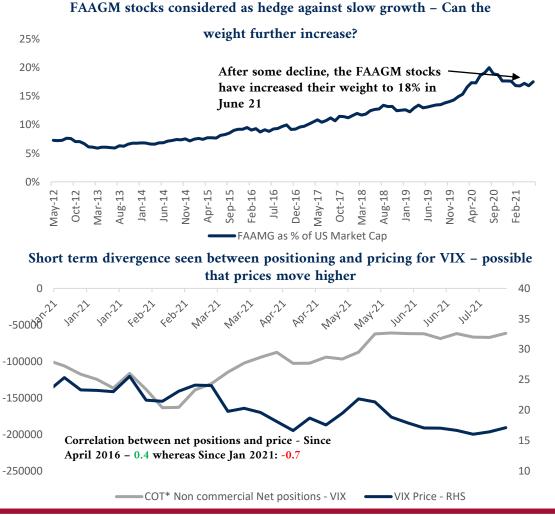
COT* Non Commercial Net positions - US Dollar

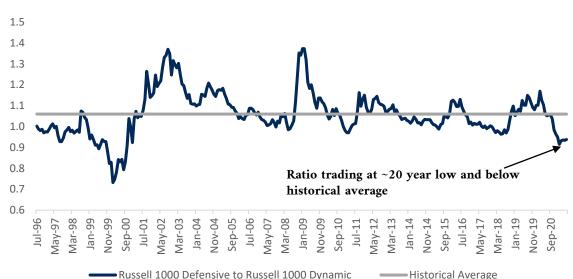


Source – Investing.com, LC Capital India, Jefferies, Barchart.com | * Commitment of Traders| Data for COT is as on 13th July 2021 and on weekly basis every Tuesday

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We would need to keep an eye on how the Implied Volatility, Tech stocks and defensives perform going forward





....Is mean reversion possible?

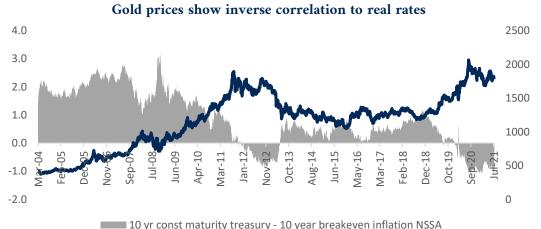
Source – Investing.com, Yahoo Finance, LC Capital India, Barchart.com | * Commitment of Traders| Data for COT is as on 13th July 2021 and on weekly basis every Tuesday

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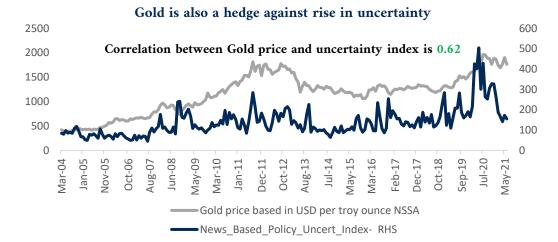
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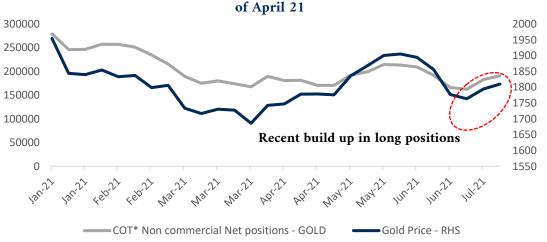


Real rates and economic and policy uncertainty would be key drivers for gold prices. Any upward movement in gold would signal a shift



Gold price based in USD per troy ounce NSSA - RHS





Source - Investing.com, Yahoo Finance, Nasdaq.com, ST Louis FED, LC Capital India, Barchart.com | * Commitment of Traders| Data for COT is as on 13th July 2021 and on weekly basis every Tuesday | Source for uncertainty index -'Measuring Economic Policy Uncertainty' by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

After initial correction, Gold prices have recovered from the lows

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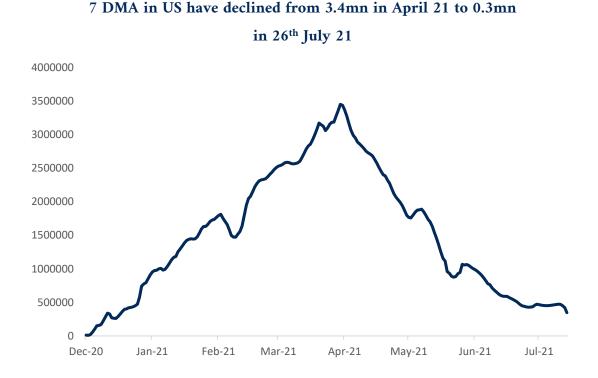


Vaccination rates...

will determine the pace of recovery



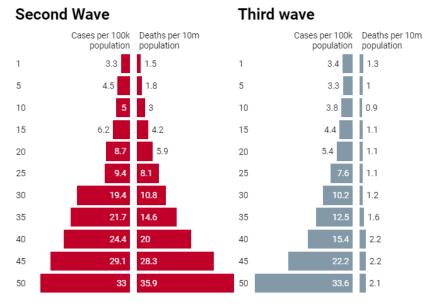
We would keep a close eye on the pace of vaccination in order to alter our views on growth and inflation



Source - Centre for Disease control and prevention (CDC, Click Here)

Efficient vaccination drive may help to reduce mortality risk and drive recovery

Cases versus deaths over days 1–50 of the UK's second and third Covid waves



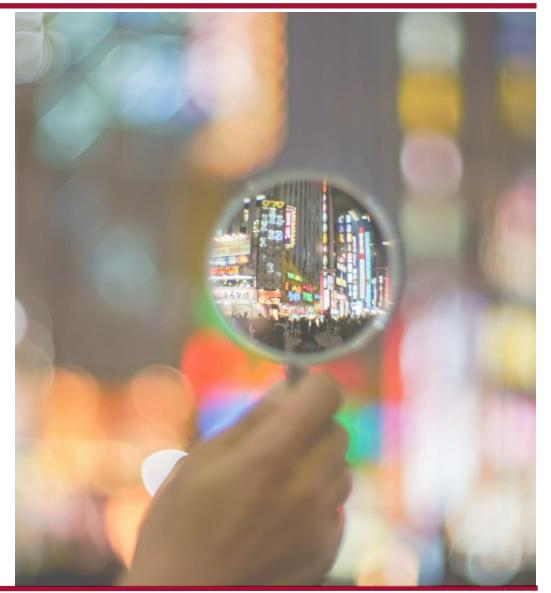
Calculations based on a seven-day rolling average of daily recorded cases and deaths. Second wave is recorded from 8/9/20, third wave is recorded from 14/5/21. Source: UK Government, ONS

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Summary: Key Macro Points



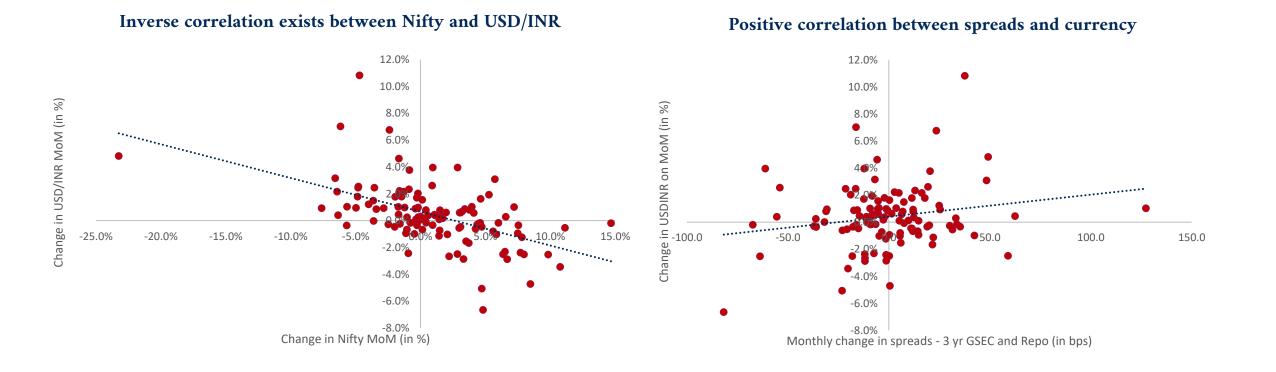
- The US Economy is currently in a reflationary economic cycle.
- In the near term we expect inflation could remain high because of demand and supply side mismatches. Though factors like demographics, low credit to deposit ratio and falling velocity of money could keep the rise in check.
- There could be some fears of growth slowdown because of rise in Delta variant cases and a slowdown in the pace of vaccination.
- Recent moves in bond and currency markets support the fact that we may see a shift away from the reflation narrative; albeit from equity and gold markets point of view we would need to wait and watch to conclude the same fact.
- Though its too early to conclude, but we may be heading towards a stagflation cycle because of prospects of high inflation and low growth. In case the inflation momentum drops then we may also head towards deflation cycle.



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Historical precedence indicate that rise in USDINR negatively impact equity and fixed income markets



Source – Investing.com, Yahoo Finance, LC Capital India | Data from Feb 2012 to June 2021

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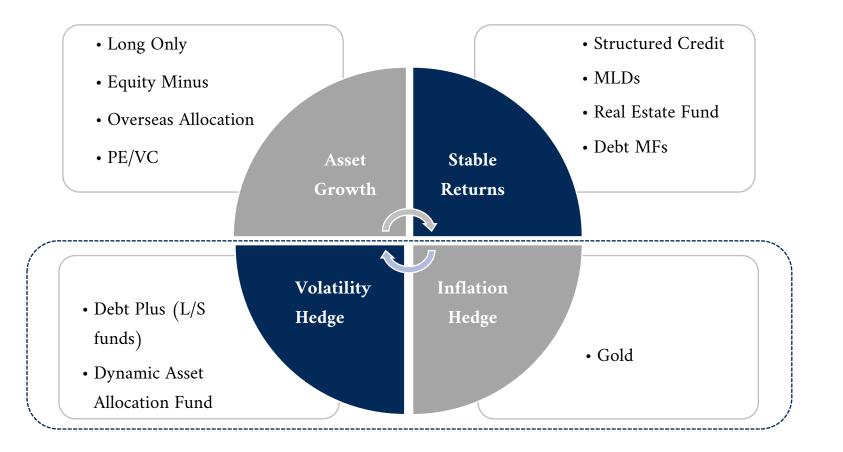
Investor Standpoint

Use an asset allocation framework – to earn better risk adjusted return





In times of shift in economic regime and current phase of financial markets, investors may look to increase allocation to Volatility and Inflation hedges.



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