CYCAS
INVESTMENT ADVISORS

Dear Investor,

This past quarter began with much of the same cautious sentiment that FY2021 ended with. Inflation concerns in the US and skepticism about the Federal Reserve's statements about transitory inflation weighed down US equity returns. In contrast to this, Indian equity markets performed well despite the brutal 2nd COVID wave in April and May. **Inflation concerns quickly subsided as commodity prices eased and markets began to grudgingly accept the Fed's guidance.** It is quite remarkable how quickly the narrative moved on from inflation worries. The process of discounting a very significant but uncertain future outcome by market participants is par for the course and the volatility induced by this episode was a welcome opportunity to increase exposure to US equity assets.

Going forward the possibility that the new post-COVID world looking increasingly similar to the stagnating pre-COVID world is becoming increasingly real. **After the kind of economic acceleration the world has just witnessed there must be a deceleration.** In India's case, absent a revival of the investment cycle, it is almost certainly a question of when, rather than if.

Despite Uday Kotak himself calling for the 'printing of money', it is not immediately clear if this is really needed. While COVID casualties in rural India are peaking, the economic damage is probably not as acute as it was last year during the nationwide lockdown. **Companies catering to farmers have continued to post record profits as they have all through last year and a good monsoon will further buoy the rural economy. We seem to be at risk of conflating the humanitarian outlook with the economic outlook.** People are extremely resilient and even terrible hardship, that is specifically known to be short lived, will not impair spending. An expansion of Milton Friedman's Permanent Income Hypothesis to include social or personal volatility would likely say just as much.

The real kicker for the Indian economy will be the possibility of a renewed investment cycle. A few quarters ago I mentioned how widespread deleveraging, and not rising NPAs, was the chief concern for HDFC Bank. **The flip side of this concern is the immense opportunity that re-leveraging will bring.** India's coming post-COVID demand surge may allow for a pickup of the investment cycle and a capital formation boom reminiscent of 2003-08 that has been elusive since at least 2017.

The lack of a coherent narrative among market participants is why volatility will continue to remain elevated. This investor confusion is clearly visible through the dramatic swings of individual stocks around the world. Further, record high valuations in both equity and debt markets, and their correlated expected returns mean that cash is being used for diversification. The resulting mass inflows and outflows of capital markets is further exacerbating volatility. A total portfolio approach is key to navigating these conditions.

Portfolio Performance

Client portfolios have performed well, as has the rest of the market. Despite sporadic lockdowns throughout India aggregate corporate activity has only marginally dipped, and has quickly bounced back to pre-2nd wave levels. For international markets this past quarter has been less eventful as most post-COVID growth expectations had already been discounted. Individual client statements will be mailed out shortly.

Asset Class	*FY2022 Q1 return*	*YTD return*
[redacted]		

Continuing with the tactical shifts from last quarter, **client portfolios have broadly seen a reduced allocation to long duration fixed income securities and an increased allocation to international and domestic equity funds.** The long run trajectory of interest rates in the West is still uncertain, given that Western central banks have shown themselves to be comfortable with ultra low rates, and that social and political pressures might continue to force central banks to keep rates low.

Interest rates in India are at record lows, and there is a strong likelihood the interest cycle will start to move up over the next few quarters. Real interest rates that were zero a year ago have now turned negative, and have forced savers to take on risk, further fuelling equity markets. **As interest rates rise expected returns for Indian debt will certainly be lower than they were this past year.** In line with this view, certain high-rated bonds purchased in early 2020 with a yield to maturity of ~9% were sold earning a 14% return. The returns on these bonds have far exceeded expectations and illustrate the benefits of tactically investing a portion of portfolios in a manner contrary to the markets.

Another change to portfolios has been the addition of a new asset class - Infrastructure Investment Trusts. This asset class is rapidly becoming popular in India and offers an efficient way for companies to monetise their asset base. Road InvITs, in particular, provide for an interesting way to invest in the general economy, as well as hedge interest rate risk as their toll rates reset annually and are indexed to inflation.

The Indian Outlook

Amid India's 2nd wave of COVID the sense of doom and gloom in society was extrapolated to the economy as it was during the 1st wave. Commentators anticipated various 2nd, 3rd, and nth order effects that would cause further devastation, and now talk of the 3rd wave has become commonplace. But just as with swings in the stock market, it is important to keep in mind the context of all of these events. When an exogenous shock hits a country, our human determination is a strong force that tries to maintain normalcy. This is visible in how quickly societies and economies bounce back to normal and how sentiment turns positive once the shock ends. **Everyone is strongly incentivised to keep their personal economic engines chugging along**.

Still, the extent of the run up in Indian markets this past quarter is puzzling. **There does not seem to be much worry about inflation in the Indian context, nor about the likely possibility of higher Indian interest rates, nor possible stress on the fiscal account.**

In the US inflation concerns have come to the fore after a decade of well-anchored inflation expectations and structurally declining prices. India has no such headwinds for inflation, and does not have the same level of control over its own economy. Indeed as I have said before, **inflation in India is a regulatory phenomenon not a monetary phenomenon**. Bouts of inflation and/or populist monetary policies are a real risk in India, and it is far from clear that the RBI will have the autonomy to prudently deal with these. The Monetary Committee's recent minutes seem to indicate a wavering focus on their inflation control mandate; some member have made explicit the need to support growth. **The RBI needs to focus more on anchoring inflation expectations and not take the risk of allowing prices to rise.**

Further, India has external pressures that also need to be navigated - higher US interest rates, brought on by higher US inflation, will require the RBI to raise interest rates to prevent deprecation of the INR, just as it did in 2013 under Governor D Subbarao. This would predictably fuel domestic inflation further as energy imports become more expensive. Given this backdrop higher Indian interest rates over the next few quarters seem very likely. **Other emerging markets such as Brazil have already started to raise interest rates in response to higher prices; India remains the outlier.**

As India continues to open up it will become increasingly difficult to manage this problem of interest rates, currency and capital flows (the 'Impossible Trinity'). Despite a fiscally prudent government India's global credit rating is perched precariously above 'junk'.

Inflation
For inflation to really pick up consumers need to shift to a 'spending mindset', in aggregate everyone must prefer spending money more than they do saving it, and must believe that prices will continue to permanently rise. This entails a very significant change to consumer behaviour, for which there is not yet any evidence. **The (free) fiscal stimulus being received by people in the US is primarily being saved, or being used to pay down expensive credit card debt**. Even if there is a broad based shift to a spending mindset, prices will only rise if the supply side of the economy is unable to keep up. **In our globalised world it seems unlikely that a sustained mismatch between demand and supply like this can exist for very long**.

I have maintained this view for the last few quarters, that the risk of a high inflation future has been overstated by the media, and that **the strong tailwinds (technology, financialisation and globalisation) that have structurally reduced inflation these last few decades will continue.** This realisation is slowly dawning on market participants. Fears of US wage inflation driven by worker shortages are quickly receding as government support ends; in a few months 3.5M people will loose their US$300/week pandemic benefits and it is widely expected that this will force people back into the labour force. The risk of a future where massive fiscal stimulus is the norm is also less as Biden scales back on his free money campaign promises. Modern monetary theory and universal basic income are ideas whose time has fortunately been pushed slightly further back into the future.

Commodity prices the world over have also begun to calm down as the popular 'reflation trade' looses steam. China cracking down on commodity hoarding, easing supply chain bottlenecks and consumers substituting away from expensive commodities, like lumbar, have all worked to reduce inflation expectations.

The dramatic rise and fall of commodity prices these last few months have been an illustrative case study for how an economy might reopen after a lockdown. As renewed economic activity causes demand to ramp up, supply will eventually adjust, especially when capacities already exist and factories just need to be fired up again. We have seen this play out several times over the last year with masks, toilet paper, sanitiser, medicine, lumbar, etc. Any resurgent inflation will need to fight these basic invisible hand dynamics. **The bigger risk now is the lack of demand once the economy adjusts, and savings and consumption levels reach their old equilibrium level;** the case for a more prosperous post-COVID future is not as clear cut as the popular narrative might suggest.

Conclusion

Capital markets are basically a future discounting machine. **Companies and even entire economies are valued according to their possible futures**. By definition this means that all future events, especially those mentioned above, have been or are currently being discounted by the market. Inflation, deflation, the resurgence of COVID, and so on, have all been considered by market participant, myself included. These 'known unknown' factors will not cause capital market dislocations precisely for this reason. It is the 'unknown unknowns', the events that would blindside markets, that pose a significant risk.

For investors the biggest risk right now is the consensus view, that economies will continue to grow and earnings will continue to increase. Such homogeneity, or groupthink, in the market is an indicator of systemic risk. Granted this risk is not very large yet as most countries are still in the midst of the pandemic, but some kind of market correction is still a very real possibility. Cycas' working strategy to deal with this is to continue to stay invested, but not to increase exposure to risky assets in general. In due course certain assets or countries may provide attractive risk-reward opportunities that should be taken advantage of.

If markets continue their march upward, complacency will undoubtedly set in and it may become difficult for investors to stick to a disciplined investment strategy. In India early signs of this investor laxity are becoming visible in the form of immense volatility of certain stocks (some of which were even bankrupt), a plethora of activity in the mutual fund industry - new fund companies and new fund offerings, and a long list of companies waiting to go public. Even after actively investing through 2 market booms and busts over 8 years, it is admittedly still a challenge for me not to get swept up in all this euphoria. Hungarian financier Andre Kostolany's words are an apt warning: **"I can't tell you how to get rich quickly. I can only tell you how to get poor quickly: by trying to get rich quickly."**

Ajay Sharma, CFA
Founder & CIO, Cycas Investment Advisors

About Cycas Investment Advisors

Cycas Investment Advisors is a SEBI registered investment advisory firm (INA200013017) that offers clients wealth management solutions, that include portfolio advisory and tax planning services. Independent advice and a fiduciary responsibility to clients are the core tenants of Cycas' offerings. Risk and return, and their interactions, are thought of at the portfolio level and a broad asset allocation is used to achieve client-specific objectives.

Cycas Investment Advisors strictly adheres to the CFA Institute Code of Ethics and Standards of Professional Conduct.

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