CYCAS
INVESTMENT ADVISORS

Dear Investor,

Introduction
As of writing this letter we are two quarters into the rising interest rate cycle, and it has been a bumpy ride to say the least. The amount of volatility and confusion caused by an event that was known by all in advance shows how complicated our modern economic world is. Just this quarter, global markets have dropped and rebounded more than 10% as investors grappled with the implications of a new high inflation high interest rate world. It should be of some relief to investors that **every day of uncertainty is part of the mean reversion process** that moves the economy closer to an equilibrium steady state.

This current process of mean reversion is restoring global interest rates in the West to levels not seen since before the Great Financial Crisis of 2007. Investors are broadly repricing both real and financial assets according to their expectations of the future. As observed in previous letters, for an adjustment of this magnitude, **there has been little outright chaos in markets. Instead market movements have been relatively orderly**, with occasional bouts of volatility that have quickly subsided.

Currencies continue to bear the first-order effects of changes to interest rates. They provide immediate feedback to central bank policy. The depreciation of the Yen, Pound, Euro, and even the Indian Rupee relative to the US Dollar convey concern about these countries' relative attractiveness to global capital flows. Some of the lagged effects of higher interests are already becoming apparent in the form of more cautious consumer spending and slowing home sales in the West. **India seems to be a rare outlier amid the global downturn with industrial activity continuing to pick up.**

As we approach the metaphorical 'glass ceiling' for interest rates, there will be more and more stress on the financial system. Bond markets, in particular, that have tremendously benefitted from copious liquidity are already starting to creak. Just as the US repo rate market freeze prompted the Federal Reserve to cease raising interest rates in 2019, the very recent UK pension fund crisis has done the same in the UK. **Thankfully India does not have withdrawal symptoms of its own, but will still have to deal with contagion from other countries.** This is all the more worrisome given our persistently highly valued equity market and its reliance on foreign capital flows.

Cycas Updates
The completion of this past quarter also saw Cycas submitting its annual audit to SEBI, and a newly christened regulatory authority, BSE Administration and Supervision Ltd. (BASL). Over the years compliance requirements for SEBI Registered Investment Advisors have become onerous, and now include elevated net-worth requirements and periodic reporting of software and cybersecurity capabilities, among other requirements. While these regulations have increased the compliance costs for RIAs, forcing some to surrender their registrations, SEBI's intention to bring organise the investment advisory profession and to safeguard client interests is welcome. Hopefully the next regulatory action will be to address the huge regulatory disparity between tightly monitored RIAs and mutual fund distributors who are still entirely self-regulated and do not face any SEBI scrutiny.

Portfolio Performance
Portfolio returns this past quarter have improved owing largely to the rebound in Indian equities, and firmer interest rates. Individual portfolio performance updates have already been sent to clients.

Asset Class	*FY2023Q2 return*	*FY2022Q2 return*	*FY2023Q2 12M return*
[redacted]			

As anticipated in the previous quarter, the returns on debt mutual funds have increased relative to cash equivalent mutual funds as they have reinvested their capital in newly issued higher yielding bonds. Going forward **we expect that the return on corporate bond funds will comfortably exceed the return on liquid mutual funds.**

The Indian stock market's resilience in the face of declining global asset prices these last few weeks have once again given rise to the notion that India's capital markets are 'decoupling' from US capital markets. But it is very hard to believe that Indian markets have suddenly stopped moving in sync with US markets. **As long as foreign capital flows are allowed to move in and out of India, there is little reason to think that Indian markets are immune to global events.**

Between June and September the Nifty jumped 14% as foreign capital suddenly gushed back into India. This level of volatility, even if on the upside, was very surprising, and in hindsight can be attributed to several reasons. Compared to Latin America, China and Russia, India's emerging market story has come to dominated the market narrative; the other countries are either flirting with socialism, have opaque governments, or are un-investable. **India's deep capital markets and stable politico-economy are a boon for hot money**. Add to this low energy prices and India is was perceived as a safe haven market. Emerging market money had nowhere else to go and pushed the Nifty to a 52-week high, even as the S&P500 dropped to a 52-week low. Indian markets are clearly enjoying their moment in the sun and **despite what the media says this situation is still precarious and is determined largely by factors outside of India's control.**

As interest rate opportunities in the fixed income space become more attractive, **Cycas expanding its advisory offerings to include direct fixed income securities.** To this end strategic partnerships with bond dealers in Mumbai are underway that would allow Cycas to directly facilitate private bond investments for clients. This would expand Cycas' offerings to clients as well as reduce dependence on 3rd parties and their conflicts of interests.

An often misunderstood fixed income instrument is the market-linked debenture (MLDs). In India these unique instruments are almost exclusively used by the rich to earn superior short term returns. Issue sizes are often no more than Rs.100Cr and minimum ticket sizes range from Rs.10L to Rs.1Cr. Issuers are not generally well known, nor of a high quality; they sell MLDs to diversify their funding profile, as well as to secure relatively low cost funding. The net cost of this funding to issuers is similar to any short term loan. **But for investors the benefit of MLDs is greater than what they would get from investing in short term debt instruments because of the way these instruments are taxed.** For holding periods of less than 1 year MLDs are treated as any other debt instrument, taxed at the slab rate, but for holding periods beyond 1 year MLDs are treated as equity instruments, taxed at 10%. The catch here is that these privately placed instruments need to be sold before they mature to avail this tax benefit, if they mature then they are taxed at the slab rate. Of course, these instruments are fraught with risk and not suitable for all investors, but for those willing to do the work of managing risk and assessing the credit risk of the issuers themselves (instead of blindly relying on credit ratings), MLDs can increase post-tax returns by several percentage points without increasing portfolio risk.

An Inefficiency in Indian Bond Yields

Since the start of the current interest rate hike cycle, **Cycas' advice has consistently been to tilt fixed income portfolios toward the short end of the yield curve.** This tactical call was made because higher interest rates cause the value of existing fixed income securities to fall as they are repriced lower so that they return the same as an equivalent newly issued fixed income security. However **in India market interest rates have not risen as expected**. The RBI's repo rate has risen from 4.4% to 5.9% and the market-determined interest rate for money market securities (the call rate) has also rise to approximately 6%. **The oddity here is that the long term 10 year government bond yield has only risen from 7% to around 7.38% over this same time period, implying that the yield curve has significantly flattened.** Over this same time the US 10 year government bond yield has increased from 0.03% to 3.57%. The spread between Indian and US 10 year government bonds is at an all time low of just 3.6%. In essence, **foreign investors are being paid just 3.6% more to invest in Indian bonds over US bonds,** this barely covers the historical rate of depreciation of the Indian Rupee.

Investors undoubtedly expect US interest rates to continue rising in response to persistent US inflation, hence are pricing US 10 year bonds at increasingly higher yields**. Indian bond investors do not seem to be pricing in higher Indian interest rates, perhaps due to tamer Indian inflation expectations.** This is a very delicate balance and currently it seems prudent to avoid long term Indian debt instruments; it is increasingly likely that Indian yields may jolt up, causing bond prices to fall. **This makes the mutual fund industry's latest fancy, target maturity funds that 'lock-in' high interest rate, a fad to be wary of.** The time to start buying long duration bonds will likely be after a few quarters when rates rise further.

The Indian Rupee

The RBI has been very proactive in defending the INR, without outrightly admitting to do so. Since the Russian invasion of Ukraine in late February, the RBI has heavily drawn down its reserves. From US$631 billion on February 25, they have dropped to US$545 billion as on September 16. This is the situation across most of the developing world - **every day almost US$2 billion of foreign reserves is spent by developing countries to bolster their currencies**.

Actions of the RBI have done a very good job at stemming the bleeding. The Indian Rupee is among the best performing currencies in the world today, having depreciated in an orderly fashion by just over 7% against the greenback, outperforming the Euro, Pound and Yen. **But as long as the current macroeconomic scenario persists there will continue to be pressure on the INR, and pressure on the RBI to continue raising interest rates**. The lead economist at brokerage firm Emkay Global very aptly described the situation as one where the RBI's war chest is depleting faster than the war is fading.

For several quarters these letters have stated just as much. As India began re-opening post the COVID lockdowns and our current account returned to a deficit after being in surplus for a few blessed months, it was inevitable that the INR would keep on depreciating unless it was directly financed by foreign capital inflows. If foreign investors decided to buy into India, as they did in 2020 and 2021, the INR would strengthen and allow the RBI to accumulate foreign reserves. If foreign investors decided to divest, as they are currently doing, the INR would weaken.

Conclusion
The theme of FY2023 is regime change. **It is a law of nature that volatility appears in clusters; when one aspect of human life is disturbed, the contagion spreads to other areas.** The dislocation to capital markets that COVID has caused is interrelated with the geopolitical tension we see through the simmering Russia-Ukraine war and the creation of a multipolar world based around US/Europe and China/Russia. It has also fed into social turmoil through the economic inequality that rising financial asset prices have caused. However understanding these macro-gyrations may not be necessary for financial success. Instead, for most investors it is more important to ensure a sound investing process and the determination to stick to a prudent strategy. Chasing trends and following the herd is a lot of work, and does not result in superior performance.

There is an immense amount of pressure to react to volatile markets, almost as if in attempt to control the outcomes to our portfolio. Trading activity noticeably spikes as investors participate, and even contribute, to the volatility. During times like these it can be helpful to remember the words of legendary investor Bill Miller - **"It's time, not timing that leads to real wealth accumulation. Most investors would be better off ignoring short term considerations if they are to enjoy the benefits of long term compounding."**

Ajay Sharma, CFA
Founder & CIO
Cycas Investment Advisors

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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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