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Early Signals Through Charts

Feb 2024

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The Unsettling Calm of Low Volatility

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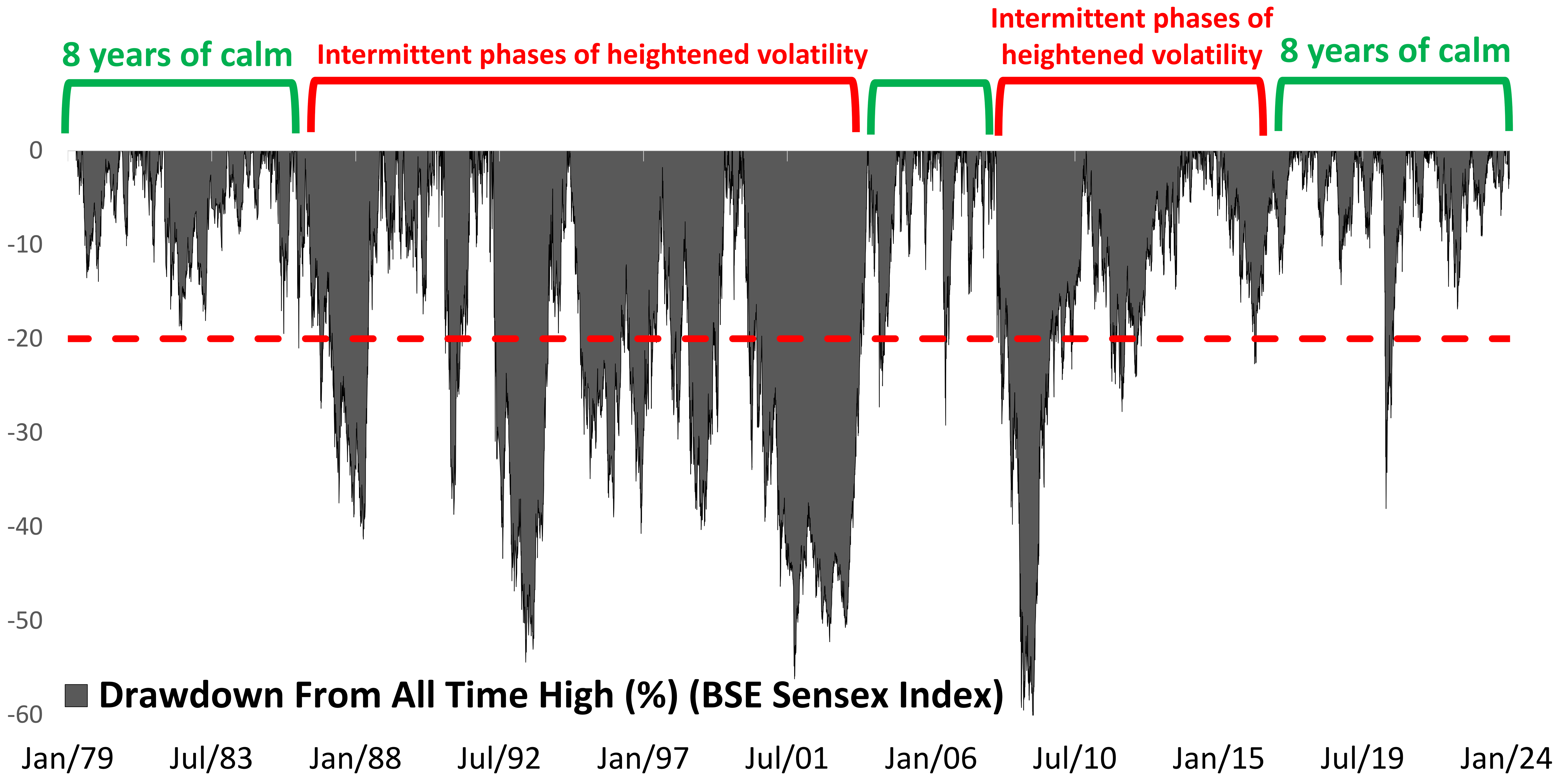
8 Years of Calm Rivals 1980s Low Volatility Era

BSE Sensex Index has now gone for almost 8 years without a bear market.

Defining a bear market:
One of the ways to define a bear markets is a decline of more than 20% and a time period of more than one year to regain previous highs. COVID decline was much deeper but the markets recovered in about 9 months to reclaim all time highs. This made sure that participants avoided the long-drawn periods of pain when stocks don't deliver returns.

The previous period of such a stable and smooth market was way back in 1980s. Volatility moves in clusters and current cluster of low volatility would likely give way to higher volatility. **We don't know when or why, though. But history tends to rhyme more often.**



One of the ways to define a bear markets is a decline of more than 20% and a period of more than one year to regain previous highs. It's been 8 years since we are in a relatively shallower drawdown phase.

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Source: BSE, DSP; Data as on Jan 2024

Recent Readings In SMID Indicate Unsettling Calm

INDIA LARGE CAP

CY	No of days with a rise of more than 0%	1%	2%	3%	Down Days	Max Drawdown in Next Year
2003	89	50	17	1	97	-28%
2006	90	40	16	7	97	-16%
2007	86	39	17	9	98	-62%
2014	110	34	2	0	98	-16%
2017	130	18	0	0	100	-15%
2023	134	10	1	0	101	

INDIA MID CAP

CY	No of days with a rise of more than 0%	1%	2%	3%	Down Days	Max Drawdown in Next Year
2003	61	56	15	2	55	-29%
2017	134	26	2	0	86	-25%
2023	139	19	0	0	87	
2014	111	42	3	1	87	-13%
2007	91	53	15	1	89	-72%

INDIA SMALL CAP

CY	No of days with a rise of more than 0%	1%	2%	3%	Down Days	Max Drawdown In Next Year
2003	48	43	29	6	63	-34%
2023	153	16	1	0	76	
2017	131	34	2	0	81	-33%
2014	107	41	10	3	83	-14%
2007	90	63	9	4	83	-77%

The number of days the Small & Midcap indices have risen by 1% or more neared previous best years in 2023. ***Such broad, 'all boats sailing' uptrend years are rare.*** In the past, such years have been followed by more than average drawdowns in the following year.

On average, calendar year drawdowns for largecap, midcap and smallcap are 19%, 23% & 26%, respectively. But the year following a bullish 'unsettling calm' year, the average drawdowns for top 5 of such years are 27%, 32% & 37% for largecap, midcap and smallcap indices respectively. This indicates that these calm years are followed by heightened volatility and drawdowns. Means, expect markets to become volatile in 2024.

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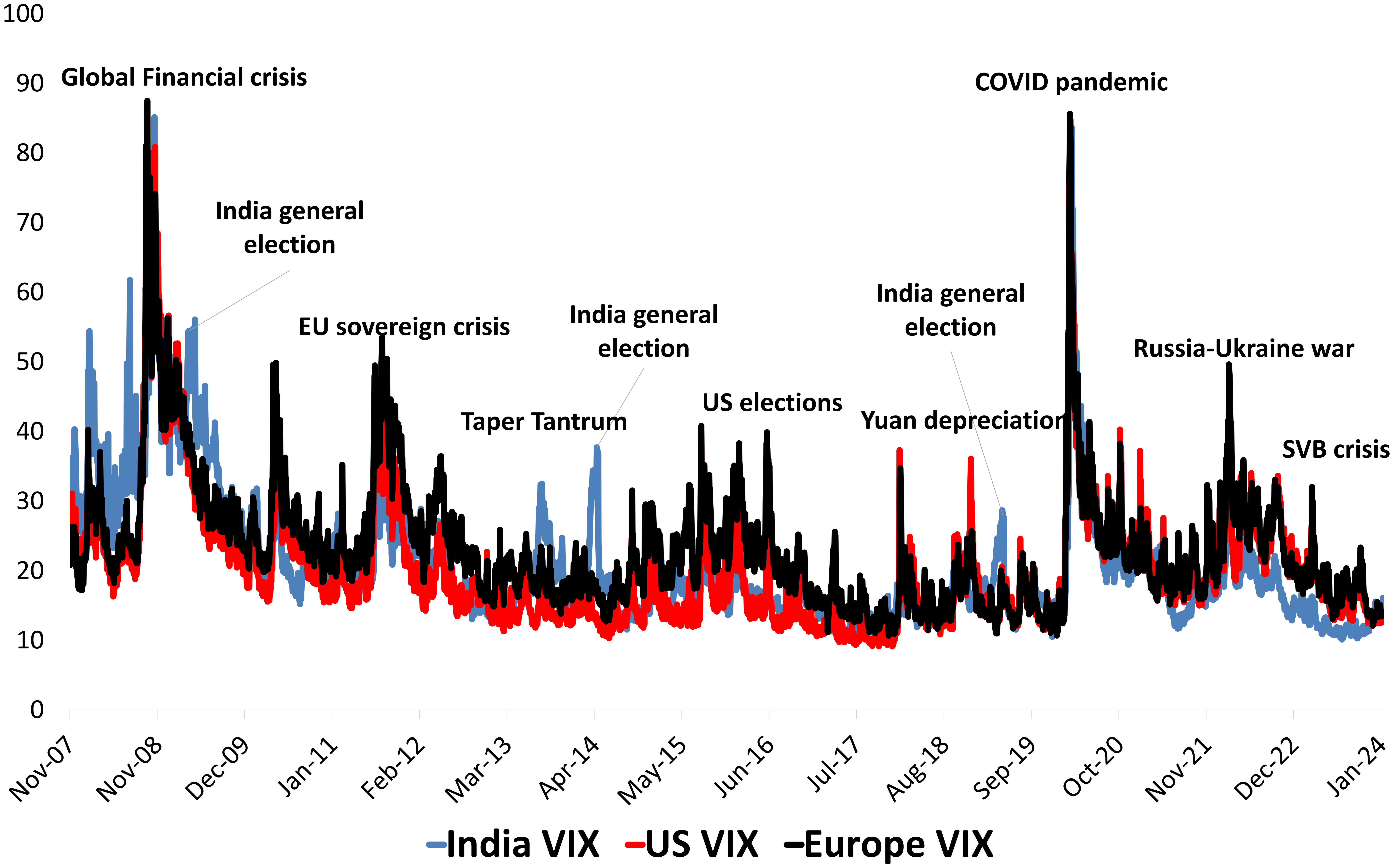
Source: S&P BSE, Bloomberg. Data as on Jan 2024

Global Equity Volatility Is In Hibernation

Volatility readings across the world are subdued. Nearly half the world population is going to vote in the next 11 months which will introduce a lot of uncertainty from a policy making standpoint. Historically this has been a source of heightened price swings.

A significant red flag is the emergence of strategies involving the sale of 0DTE (zero days to expiration) options in ETF format. The daily notional trading value of these 0DTE options has surged to approximately $1 trillion in the United States. These novel financial products employ a strategy aimed at generating income by selling put options priced either at-the-money or up to five percent in-the-money every day. This approach is not only reminiscent of picking up pennies in front of a steamroller but also introduces systemic risk to the market. On a broader scale, it underscores the level of comfort investors have in the market persistently maintaining an uptrend. An unsettling calm.



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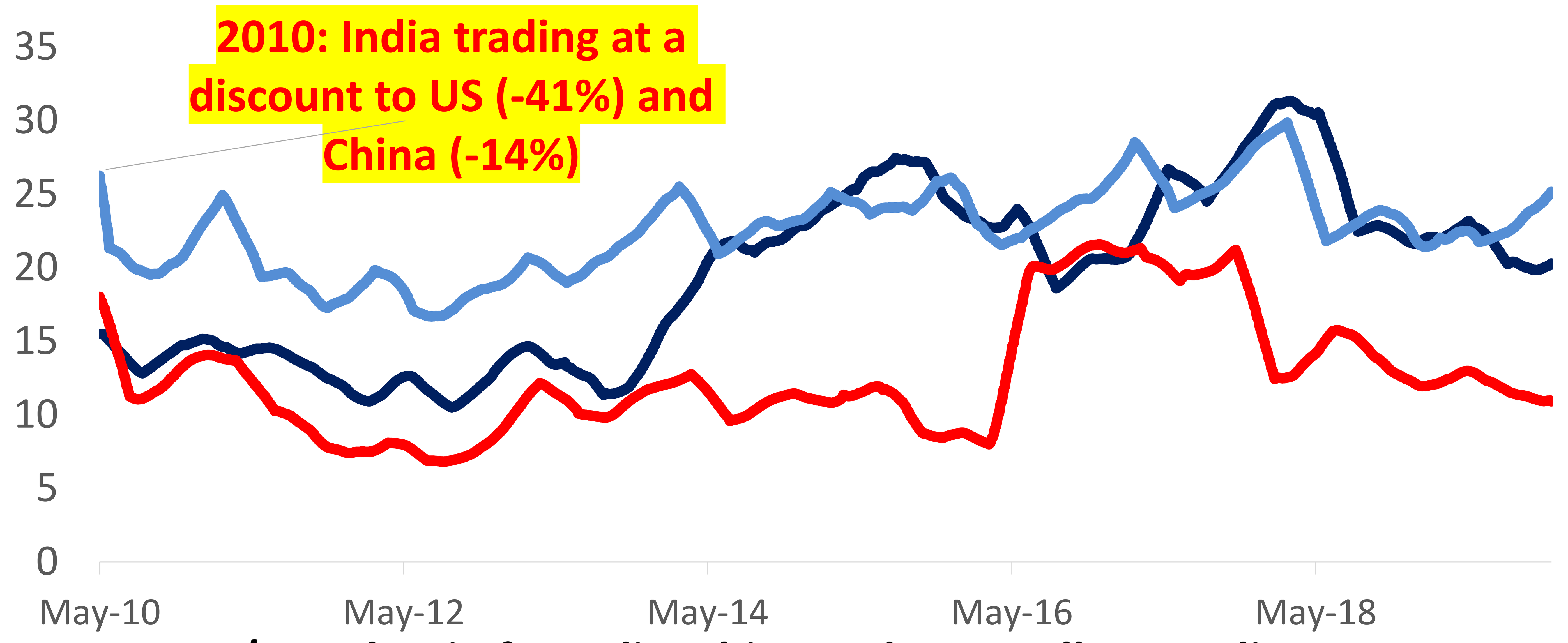
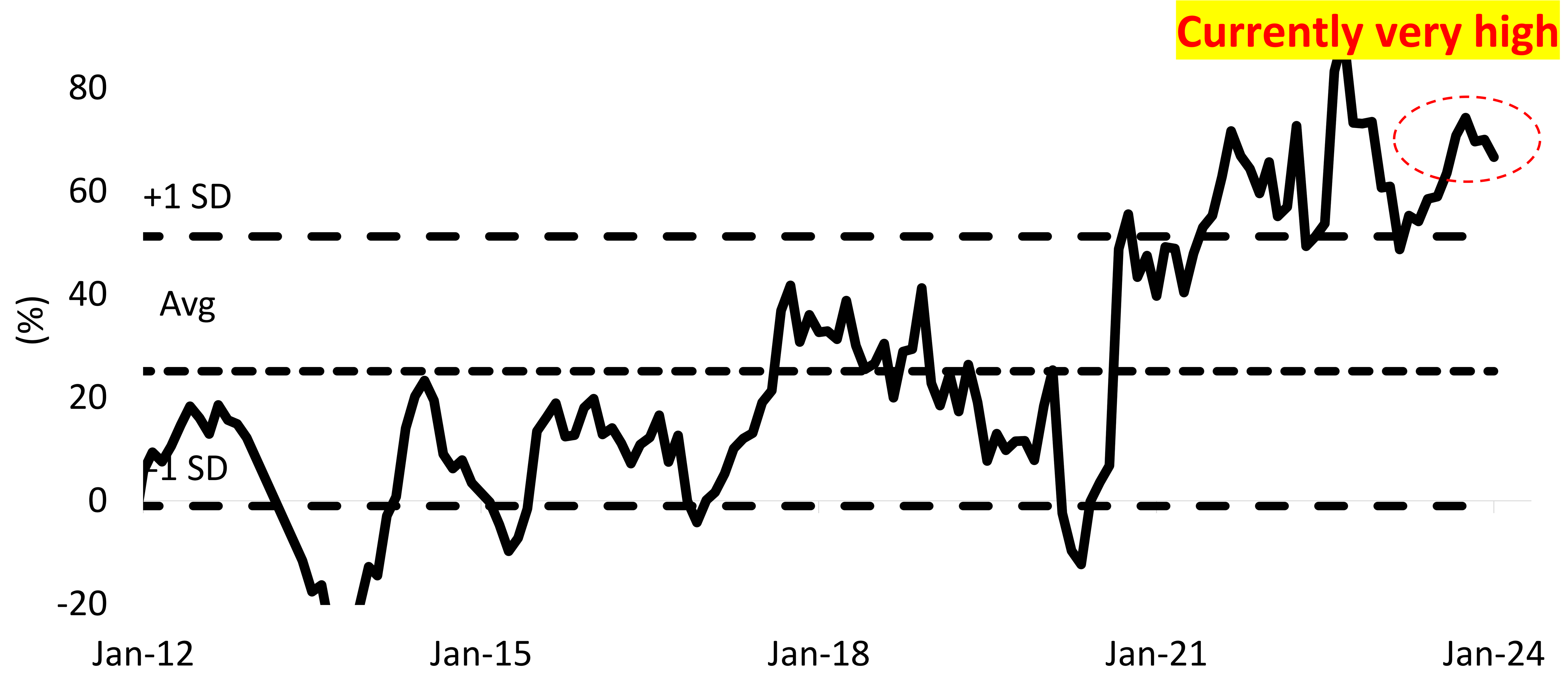
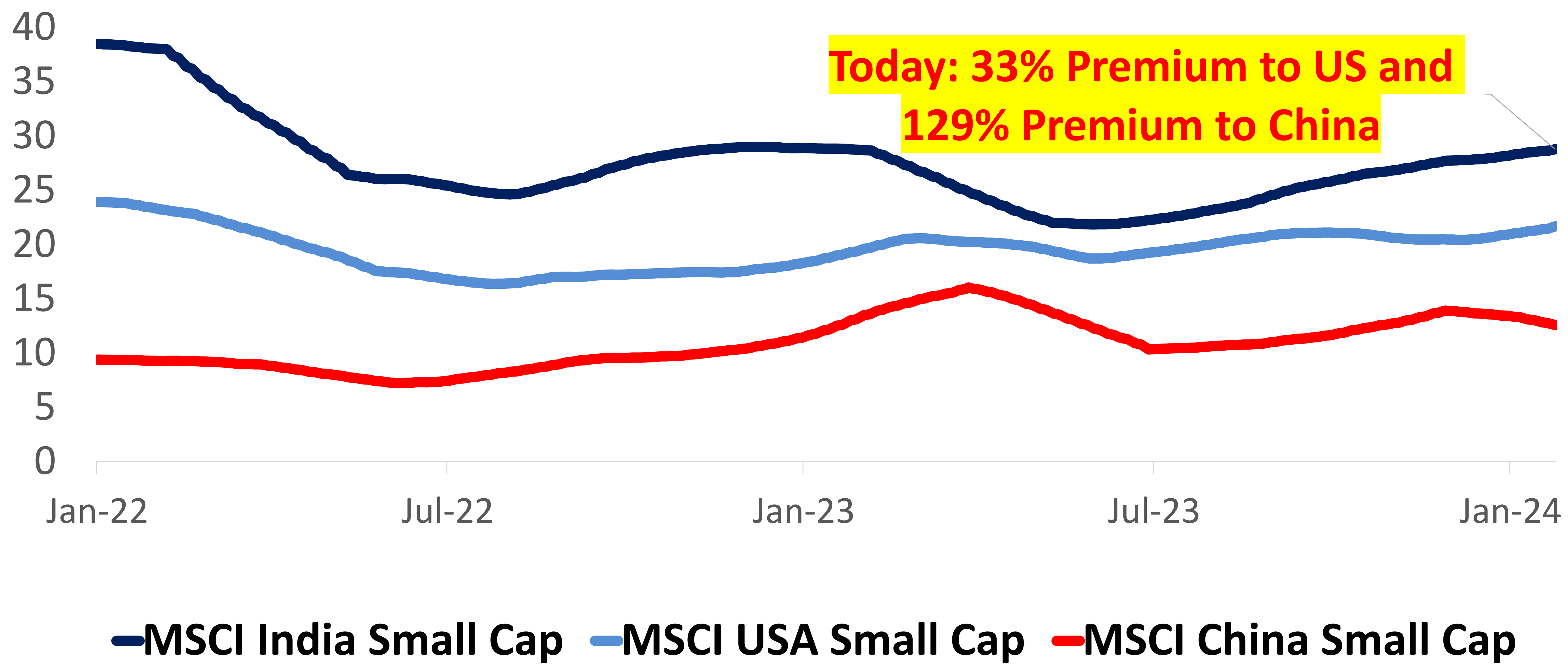
Source: Bloomberg, DSP; Data as on Jan 2024

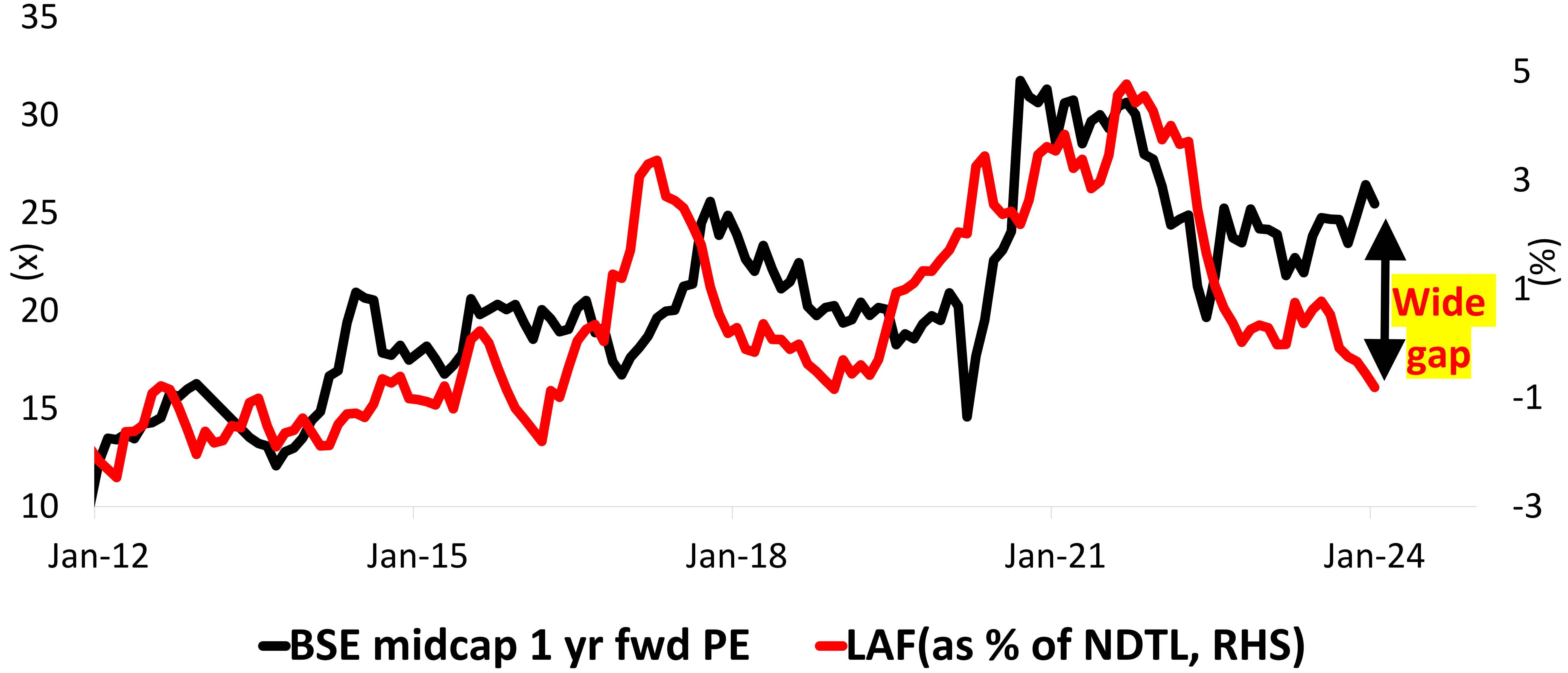
India SMID Valuations Nearing Record Vs The World



P/E Fwd ratio for India, China and US Small Cap Indices







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Source: Bloomberg, DSP; Nuvama, Data as on Jan 2024

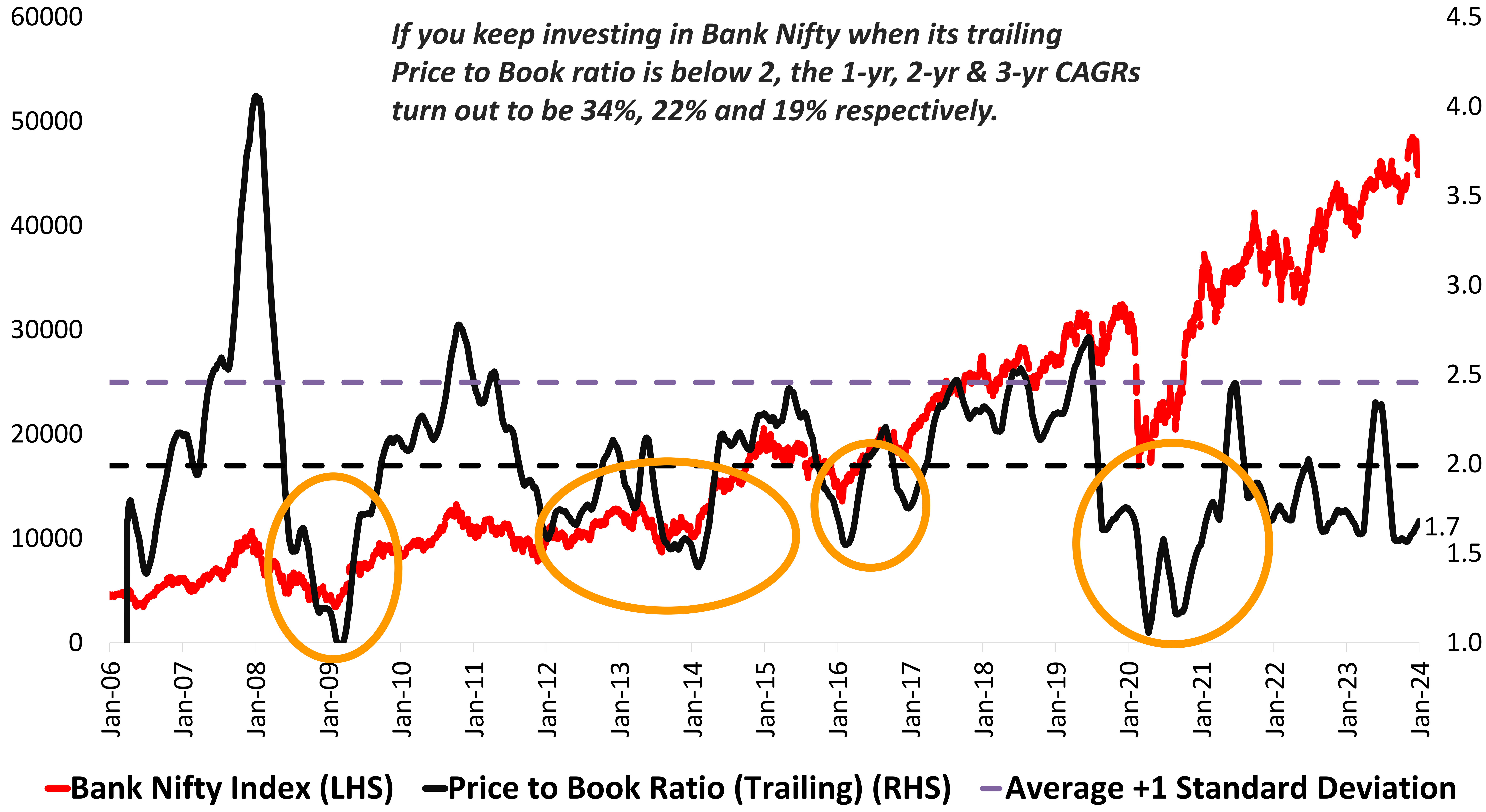
Bright Spot: What Happens When You Invest In Indian Banks Below 2X P/B

Banking sector stocks (Nifty Bank Index) have underperformed Nifty Index in calendar year 2023, at the same time the valuations have gone through a churn.

As measured by Price to Book Value ratio (P/B), the Nifty Bank Index traded below 2X P/B in Jan 2024. Historically, if you were to keep investing in the Nifty Bank Index during periods when its P/B is below 2 times, it delivers exciting returns over the next few years.

We don't know what will happen in the next few years, but history says buying Banking Sector Stocks when they are cheap can deliver superior returns.

We expect markets to experience a period of volatility, and if the banking sector faces the same price erosion, it would become more attractive. A sector to look forward to.



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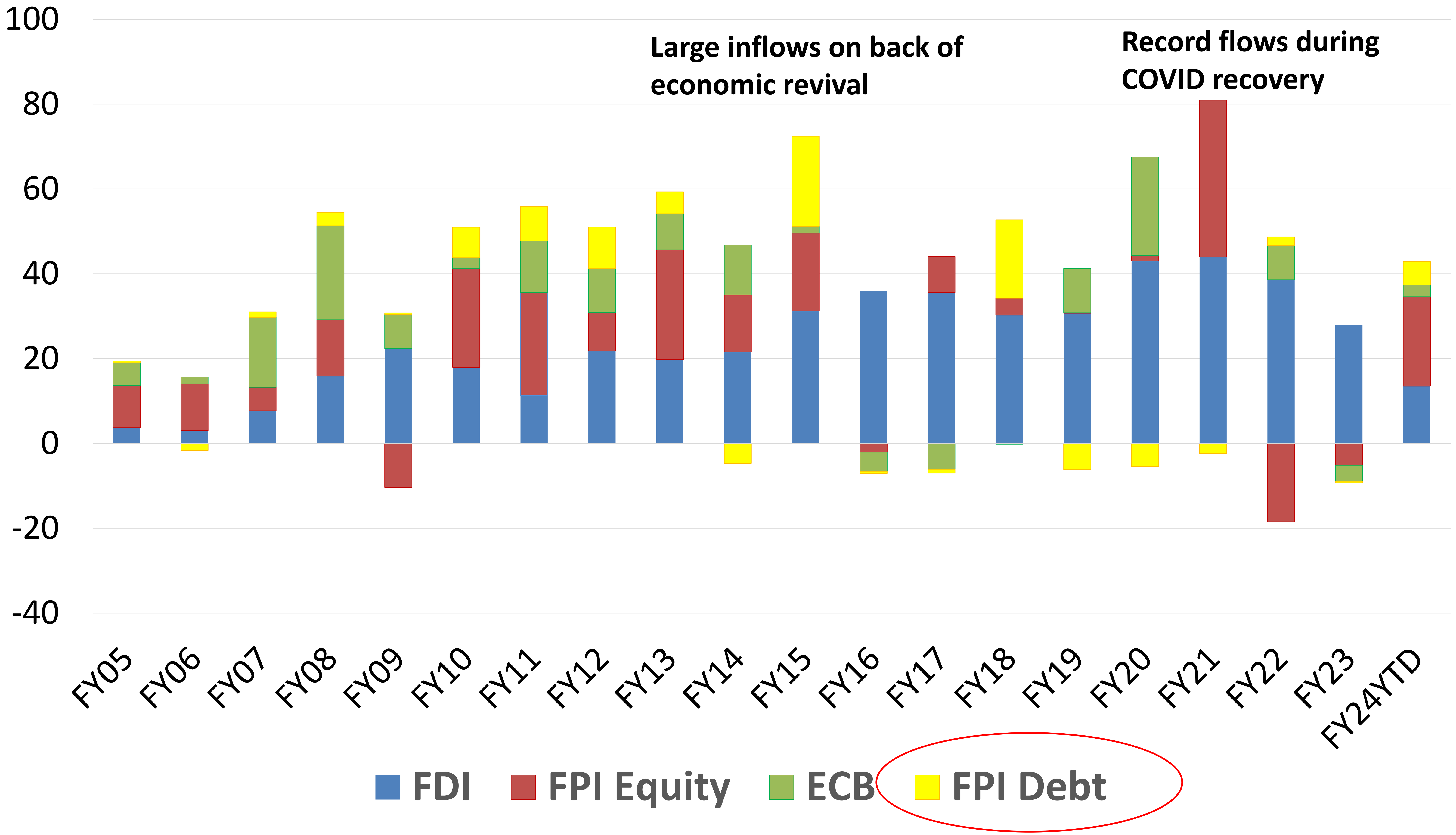
Source: Bloomberg, Data as on Jan 2024

India Cumulative Foreign Investment Flows Yet To See A Surge

India has received large doses of foreign investments, but the record is patchy. India is ranked 5th in world GDP rankings in 2024. It has delivered steady returns in equity markets, no defaults in sovereign debt and now a relatively stable currency over the last 5 years.

These changes could result in large inflows of foreign investments but are yet to fructify in hard data. FPI equity and debt flows have been the most volatile.

FPI debt flows are likely to pick up as India becomes the part of global bond indices. An opportunity to benefit from this trend may present itself in FY25 onwards by participating in long duration Govt. Securities in India. India is likely to receive $25bn in FPI inflows as it become the part of global bond indices. This can be a game changer for one category of debt funds. Funds which have bonds for long maturity. Duration.



FPI debt flows could be a game changer ahead.

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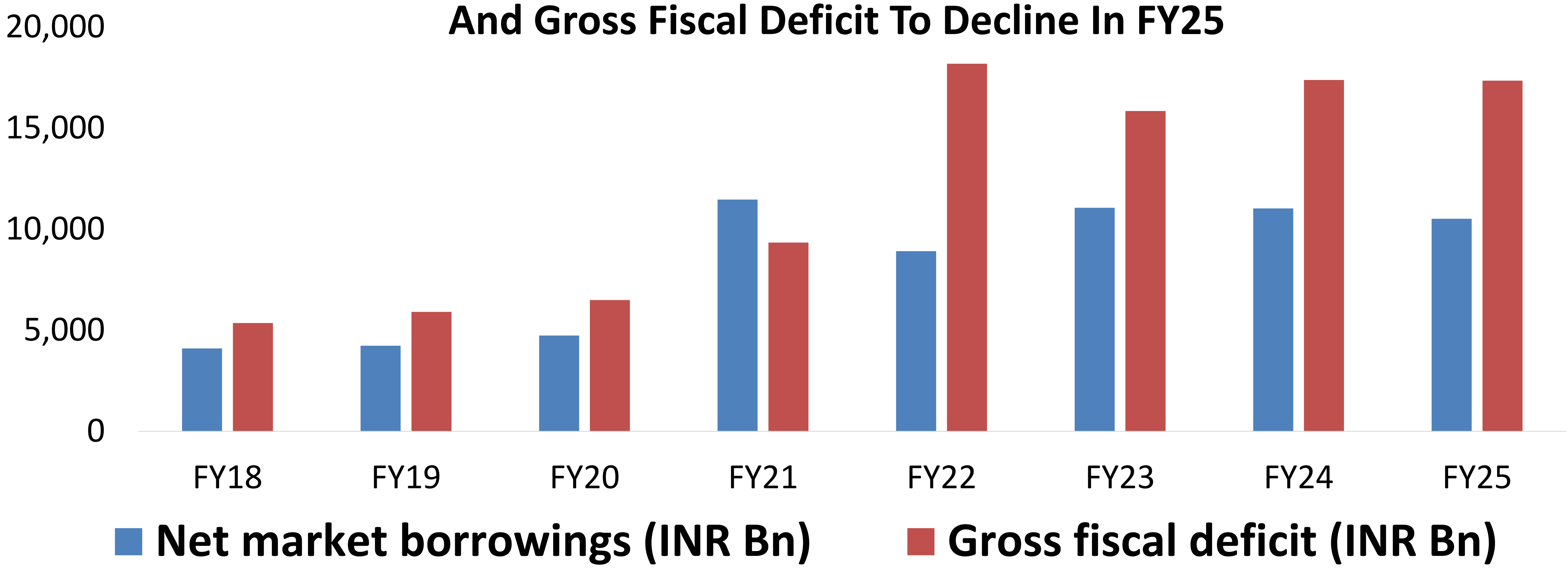
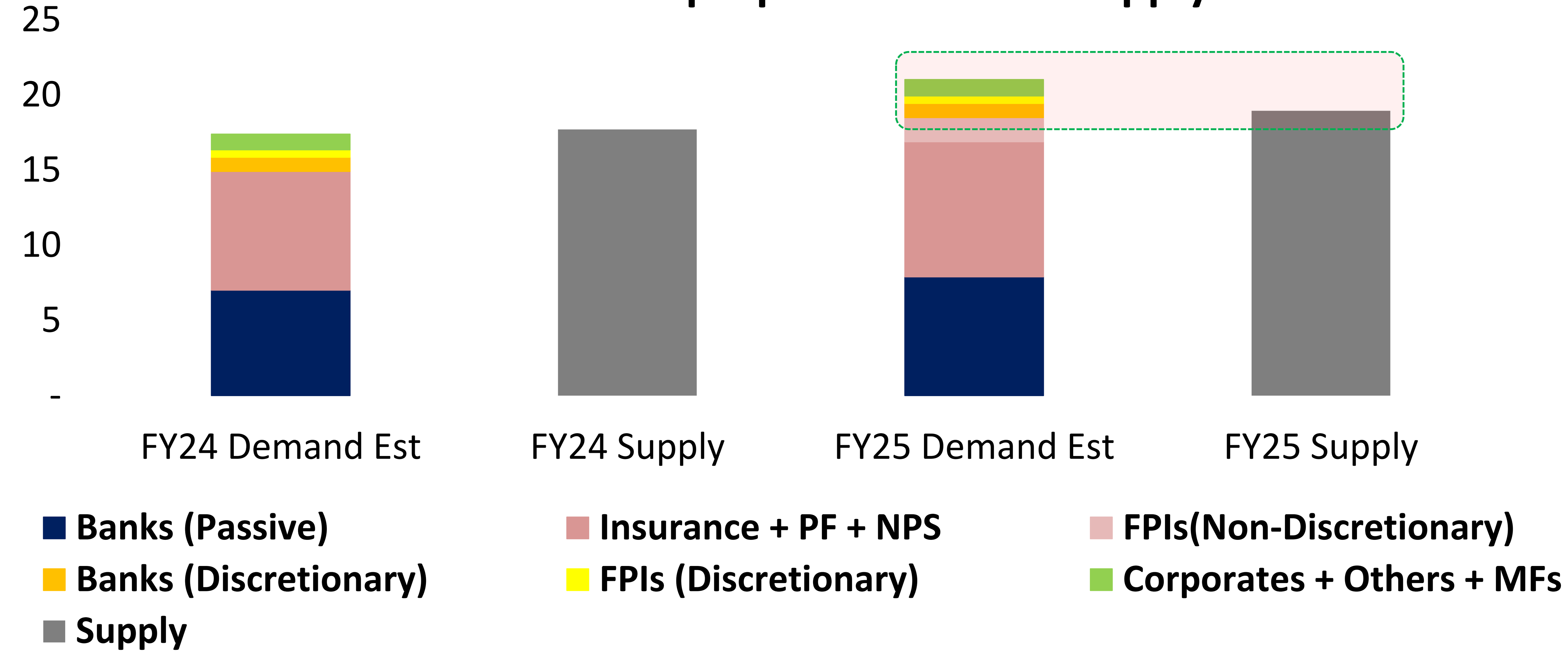
Source: NSDL, CMIE, CDSL,DSP; Data as on Jan 2024

India Long Bond Duration Is Playing Out

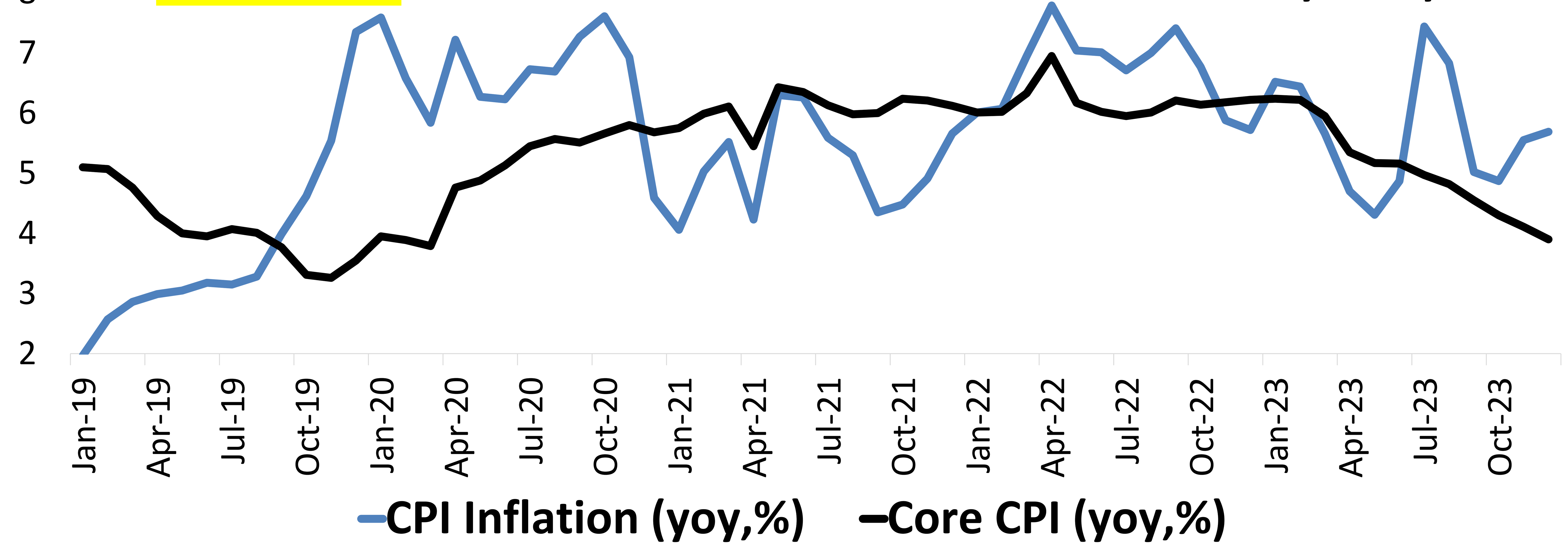
Supply Of Bonds To Reduce: Govt Borrowing And Gross Fiscal Deficit To Decline In FY25



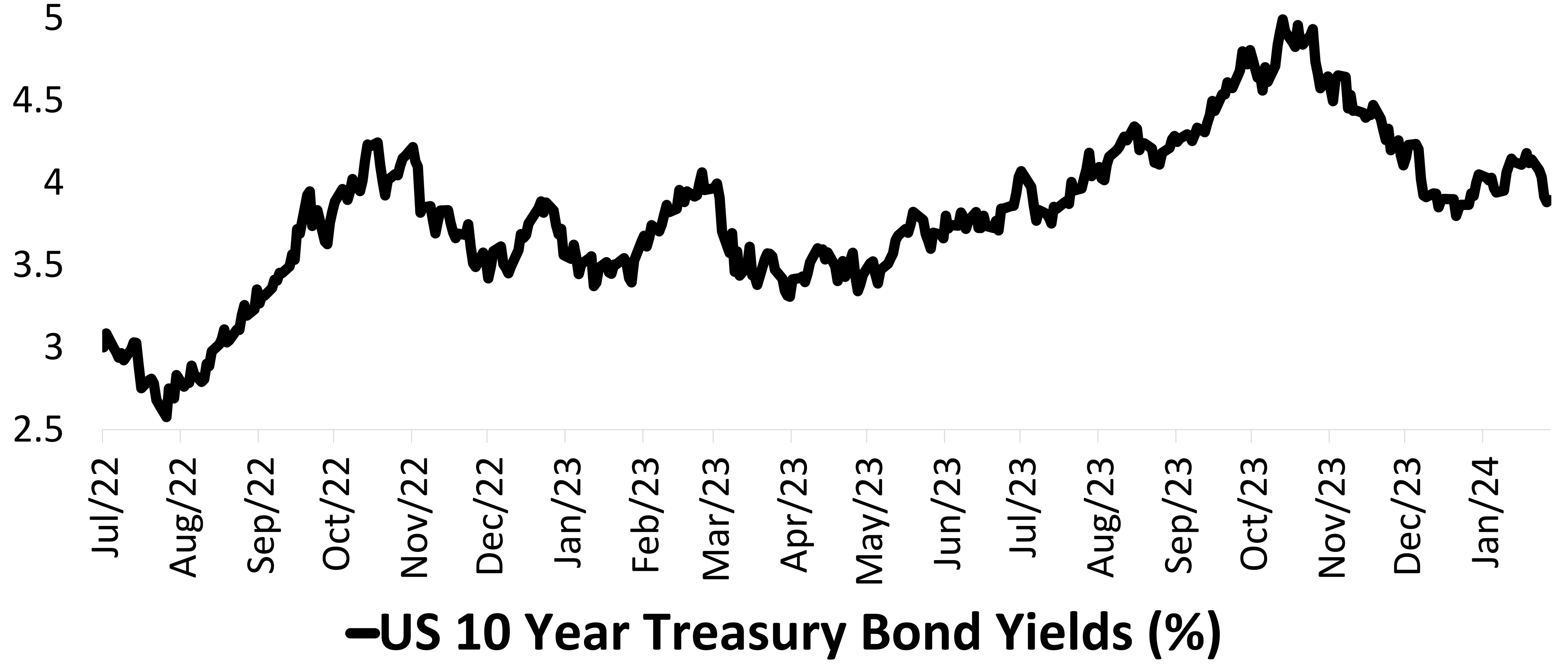
Demand for Govt Bonds to Rise: FPI Inflows Into Indian Bonds Can Mop Up The Reduced Supply



Low Core CPI To Give Room To RBI To Shift To Easier Monetary Policy



Softness in US Bond Yields Removes An Overhang



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Source: Bloomberg, CMIE, Budget Documents,DSP; Data as on Jan 2024

US Inflation & Rates

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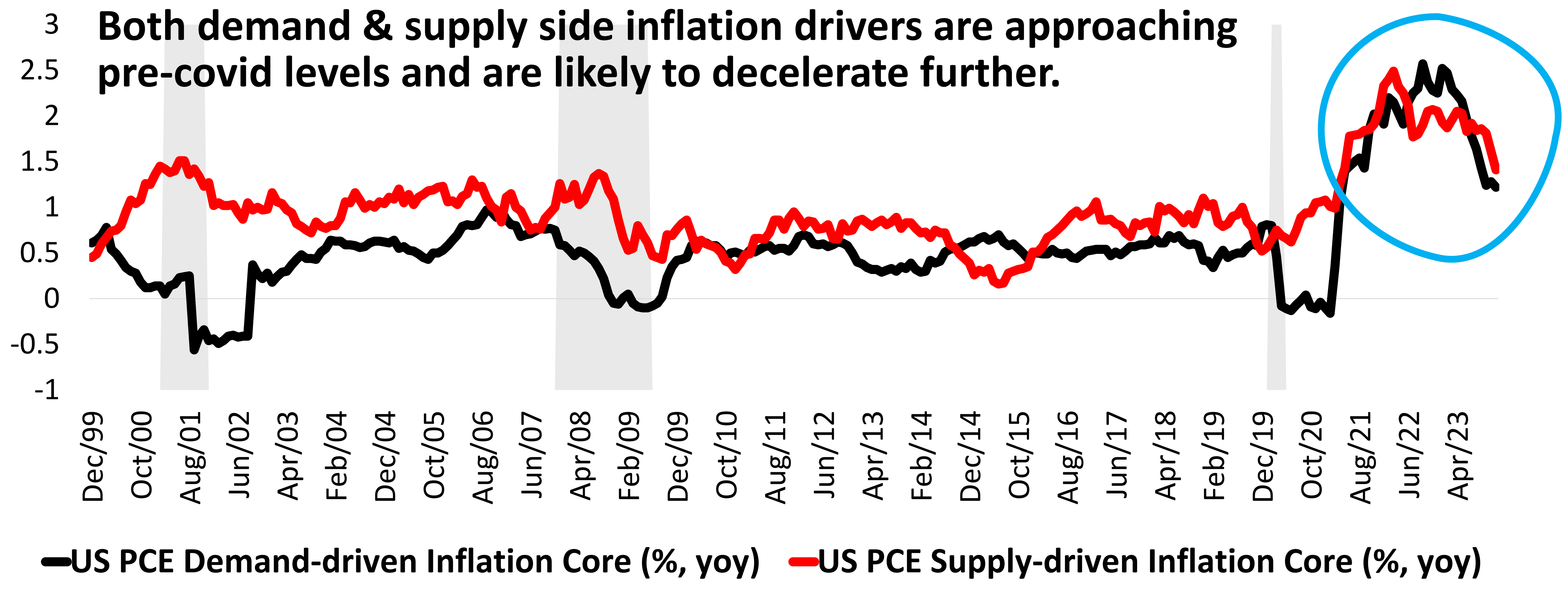
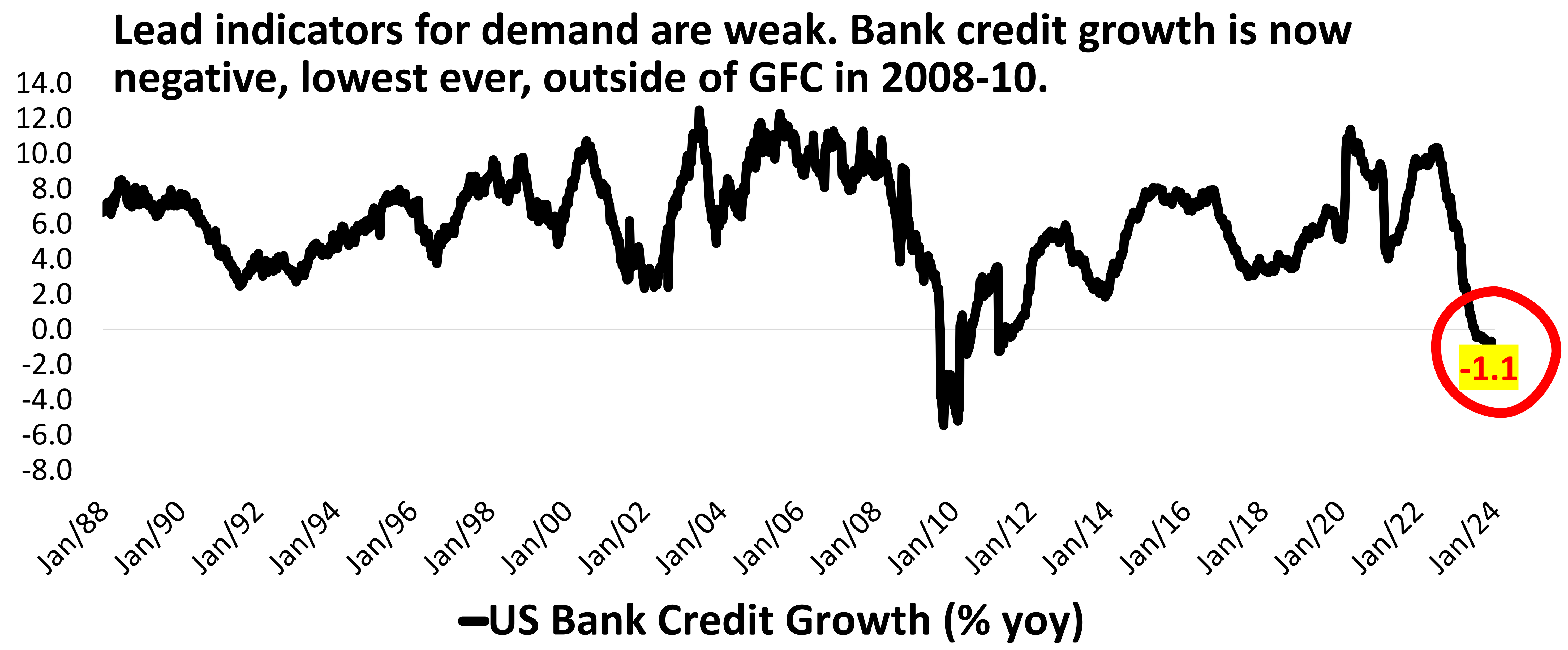
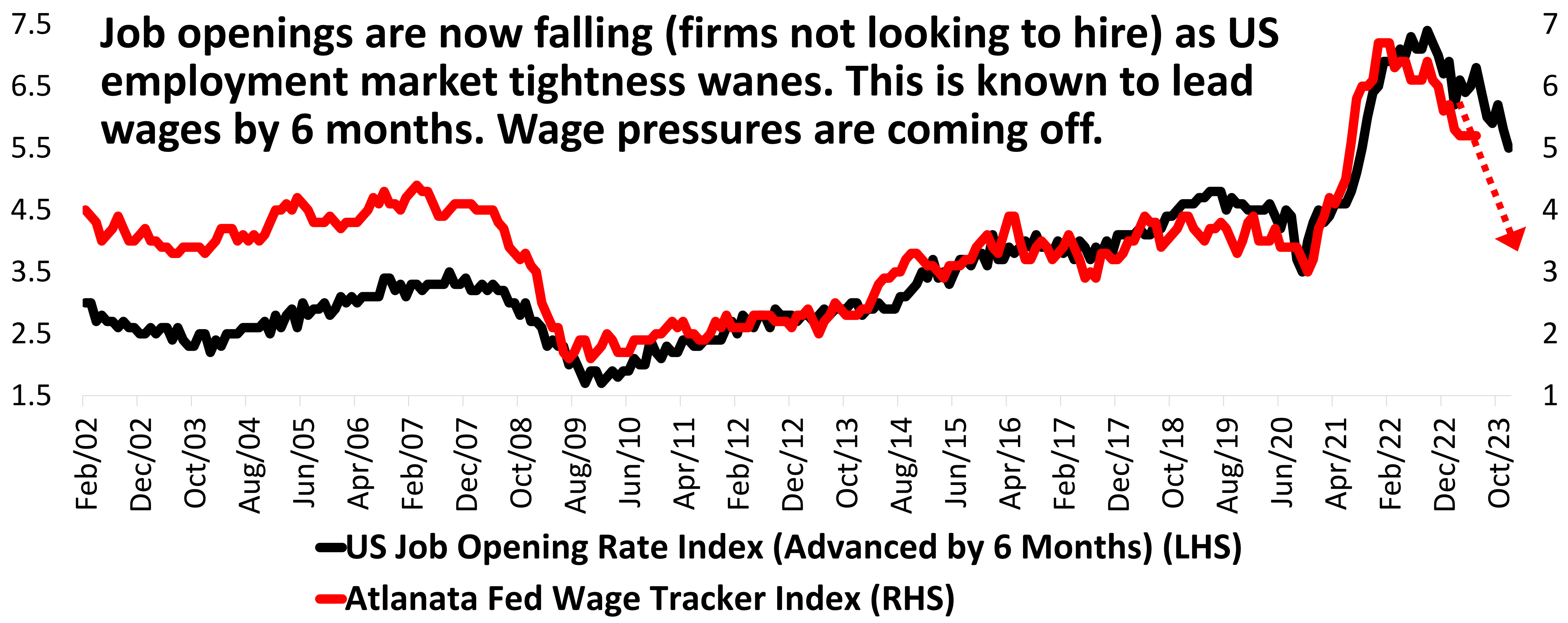
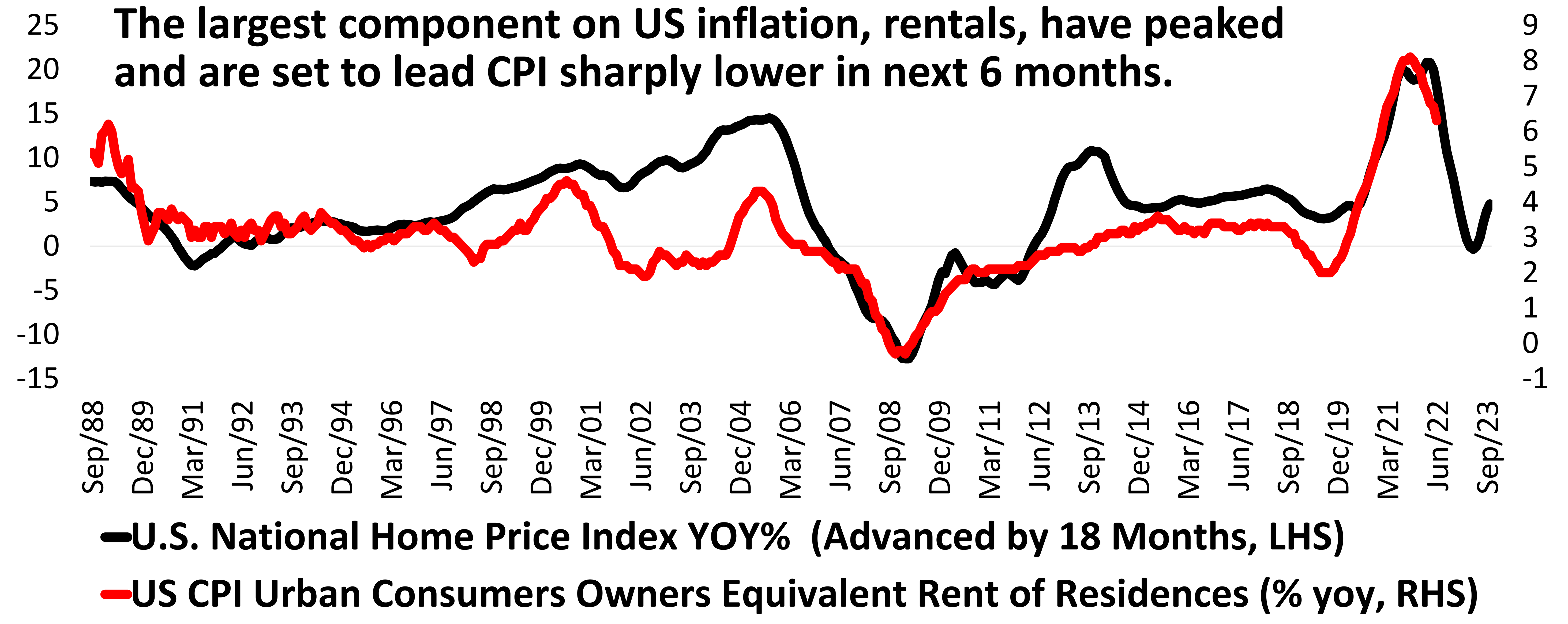
Inflation: The Driver of Fed’s Hawkish Stance Is Falling









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Source: DSP, Bloomberg, Data as on Jan 2024

We Are Amidst The Longest Yield Curve Inversion on Record

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Source: Bloomberg, Jan 2024

US Economic Expansion Is Now Over Long Period Average

Not only equity markets, but the US economy has also enjoyed one of the most stable labour market conditions (ex of the pandemic shock) and economic expansion.

COVID pandemic, a true Black Swan, disrupted the global economy but the recovery from the pandemic has been nothing short of incredible. **The economy in United States contracted for merely two months (as per NBER) and began its course of continued expansion.**

This means than US economy has expanded for the last 175 months, with only 2 months of steep contraction due to pandemic. This is the longest and most durable period of expansion ever.

As interest rates tightening begins to bite the economy and labour market tightness wanes, this long phases of expansion is likely to face headwinds.

Period	Number of months of economic expansion
Dec 1854 to Jul 1857	32
Dec 1858 to Nov 1860	24
Jun 1861 to May 1865	48
Dec 1867 to Jul 1869	20
Dec 1870 to Nov 1873	36
Mar 1879 to Apr 1882	38
May 1885 to Apr 1887	24
Apr 1888 to Aug 1890	29
May 1891 to Feb 1893	22
Jun 1894 to Jan 1896	20
Jun 1897 to Jul 1899	26
Dec 1900 to Oct 1902	23
Aug 1904 to Jun 1907	35
Jun 1908 to Feb 1910	21
Jan 1912 to Feb 1913	14

Period	Number of months of economic expansion
Dec 1914 to Sep 1918	**46**
Mar 1919 to Feb 1920	**12**
Jul 1921 to Jun 1923	**24**
Jul 1924 to Nov 1926	29
Nov 1927 to Sep 1929	23
Mar 1933 to Jun 1937	52
Jun 1938 to Mar 1945	82
Oct 1945 to Dec 1948	39
Oct 1949 to Aug 1953	47
May 1954 to Sep 1957	41
Apr 1958 to May 1960	26
Feb 1961 to Jan 1970	108
Nov 1970 to Dec 1973	38
Mar 1975 to Feb 1980	60
Jul 1980 to Aug 1981	14

Period	Number of months of economic expansion
Nov 1982 to Aug 1990	94
Mar 1991 to Apr 2001	122
Nov 2001 to Jan 2008	75
Jun 2009 to Feb 2020	129
May 2020 to Jan 2024	45
Average	43

Excluding the two months of 'Black Swan' COVID led recession, US has enjoyed nearly 14.5 years of economic expansion. The longest spell of expansion in modern history.

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Source: NBER, DSP; Data as on Jan 2024

Longest Phase of Economic Expansion Without A Policy Led Recession

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Source: FRED, NBER, DSP; Data as on Jan 2024

Has The Fed Tightened Enough To Cause A Slowdown. Buy US Treasury Bonds

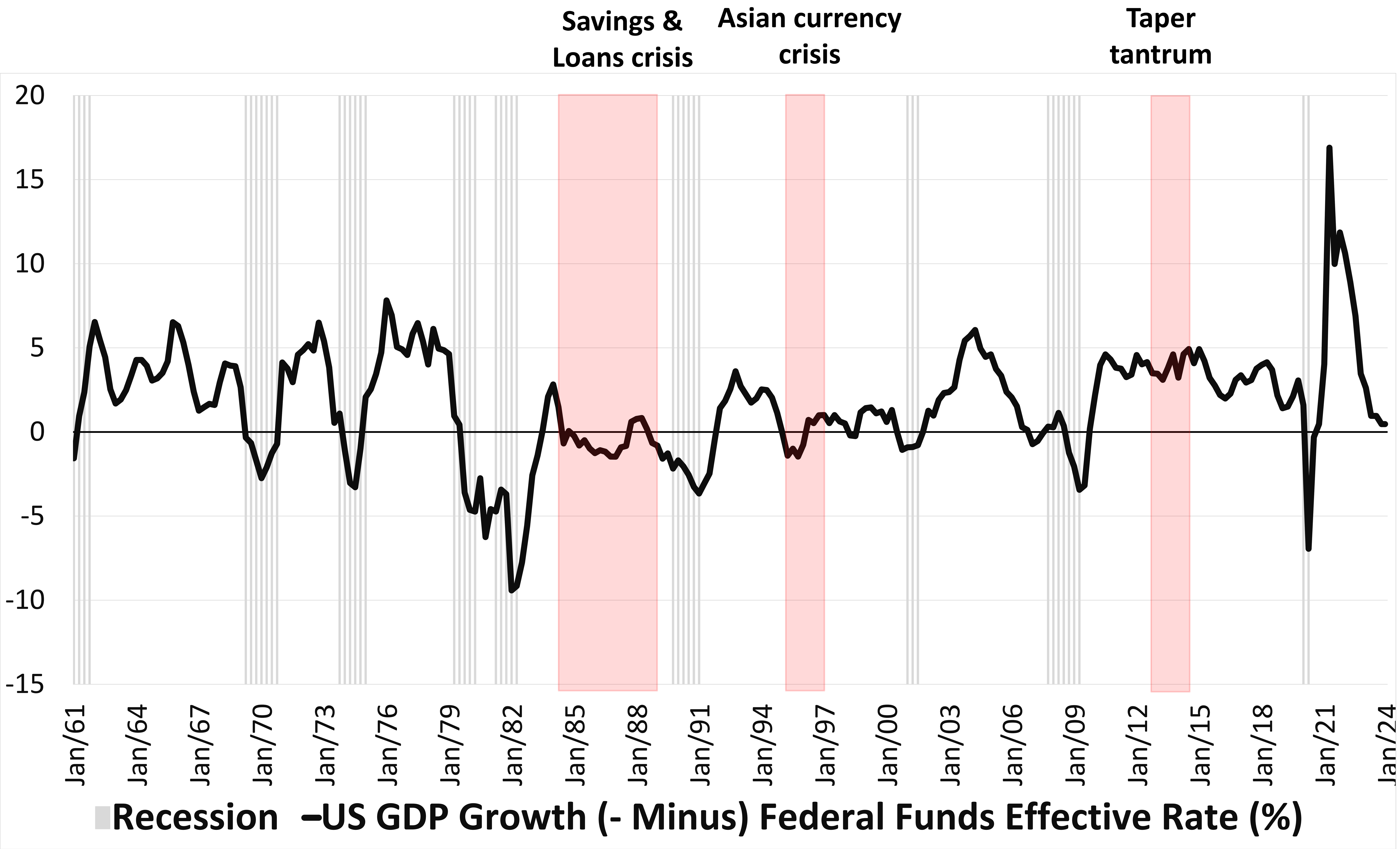
Historically, whenever the US Fed raises rates such that the Federal Funds effective rate is higher than the nominal GDP growth rates (yoy), a slowdown ensues.

There are instances when a slowdown in US hasn't resulted in recessions (like 1984, 1985) but were architects of global troubles like savings & loans crisis (1985 to 1989) and Asian currency crisis (1997).

This means that the current level of US Fed Funds rate at 5.33%, a 25 year high, is too tight for economic growth to continue unabated.

The longer the Fed holds rate at this level, the more fragile the system become in face of slowing growth.

This opens an opportunity to buy US treasury bonds as inflation slows further and Fed begins to embark on a cycle of rate cuts later in the year. The ideal entry point could be closer to US T10 yr at 4.25% to 4.40%.



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Source: FRED, BEA, DSP; Data as on Jan 2024

Long Term Return Belong To The Long-Term Investors. Those Who Wait

"…their delusion lies in the conception of time. The great stock-market bull seeks to condense the future into a few days, to discount the long march of history, and capture the present value of all future riches. It is his strident demand for everything right now – to own the future in money right now – that cannot tolerate even the notion of futurity – that dissolves the speculator into the psychopath…."

- James Buchan

Source: The Price of Time: The Real Story of Interest by Edward Chancellor

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