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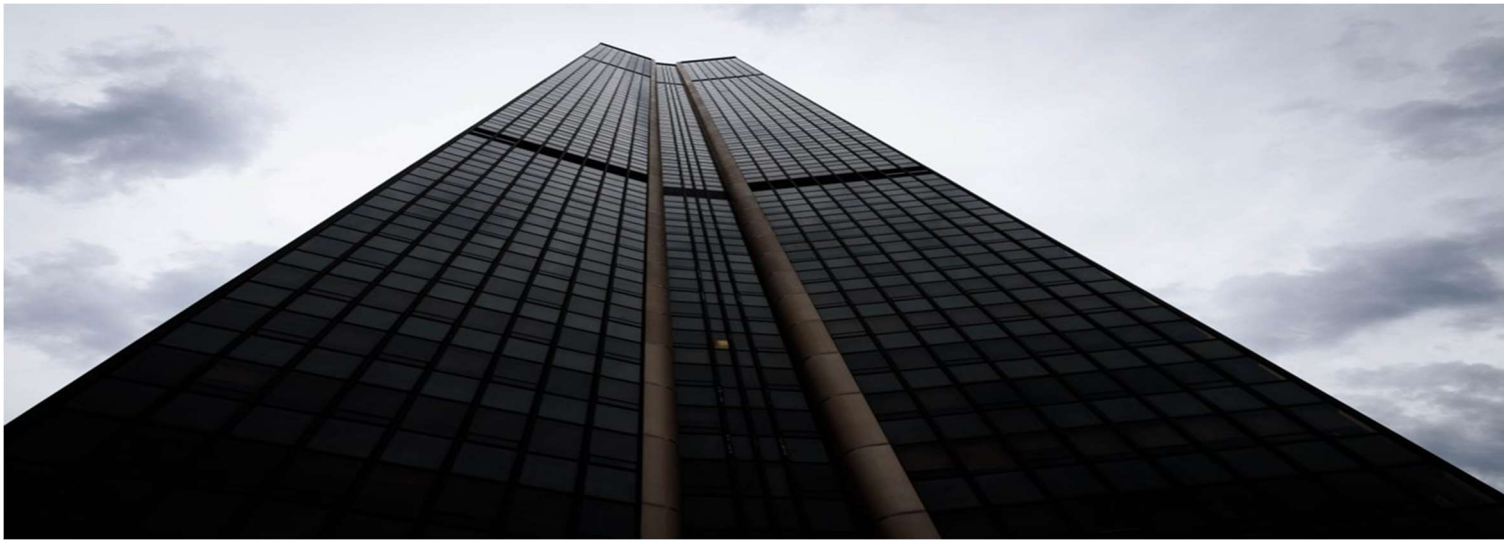

Global OmniView Jul 2022

Are all Negatives already Discounted by the Market?

If yes, where do the markets move from here?

Enhance Safety, Enhance Growth, Enhance Returns

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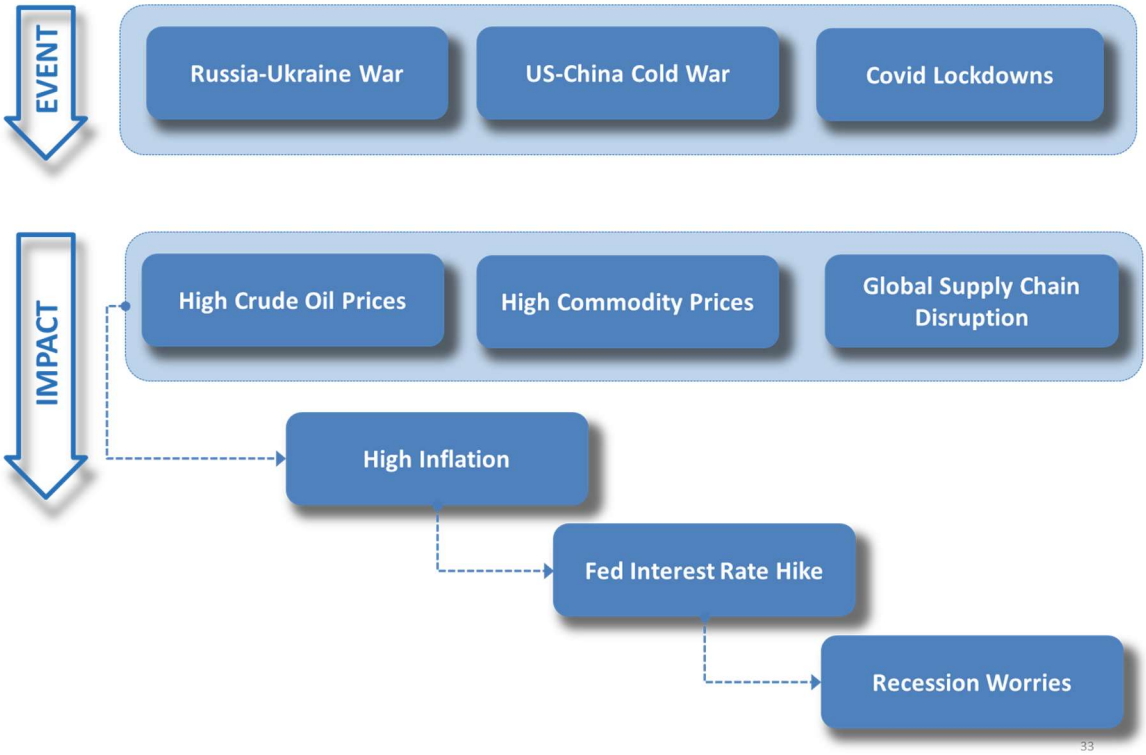
"I have seen a lot of business cycles now. And no one predicts recessions. But in this one, everyone is predicting a recession" -- Mark Zandi, Chief Economist, Moody's Analytics

Everyone is convinced that a recession is imminent!

There are several global macro factors which are driving people to these kinds of sentiments. The factors cited are inflation, Fed interest rate hikes, high oil prices, Russia-Ukraine war, global supply chain disruption, US-China trade war, Covid lockdowns, high commodities prices and US and global recession worries.

How the Global Macros Resulted in the Current Situation

While these are cited as a laundry list of factors, there is a relationship between them as shown in the accompanying chart. The driving events are the Covid Lockdowns, the Russia-Ukraine war and the US-China cold war. (While most are still calling it a US-China trade war, most defence analysts would likely suggest that a US-China cold war is a more appropriate term.)



While the crude oil and commodity prices were already rising due to the high economic growth, the Russia-Ukraine war caused a huge spike and consistent increases up till early June.

The global supply chain was disrupted due to the Covid Lockdowns in the Asian supplier countries throughout 2020-21 and continued into 2022. While the extent of the global supply chain disruption due to the US-China cold war cannot be estimated, it cannot be denied as a very critical factor.

The heady mix of high crude oil, high commodities prices and global supply chain disruptions in strong US economy with significant buying power resulted in high inflation. Consistent high inflation for several months and quarters put pressure on the Fed.

“Don’t just sit there, do something.”, the Fed seemed to hear.

Even though, production or supply disruptions cannot be controlled or impacted through interest rate increases, the Fed was and is under pressure to be seen as doing something to bring price stability, one of its mandates. This also gave the Fed to continue its Covid-interrupted agenda from 2018-19 to bring the interest rates back to normal post the Global Financial Crisis.

Thus began the hawkish tone from the Fed and an aggressive interest rate hike path, bringing it to normal, which it projected for the next year and a half. This brought in focus the recession worries which were caused by Mr. Market’s price action in both equity and debt markets.

When the security prices go down, Mr. Market starts forecasting negative fundamentals, in most cases, irrationally.

Do Bear Markets Predict a Recession; Or Fed Actions Caused a Bear Market?

The accompanying table showcases how, practically, all asset classes are in a bear market or severe correction. Based on John Burr Williams's "Theory of Investment Value", these negative prices were triggered by the hawkish statements from the Fed, starting in December, about interest rate hikes to and liquidity reduction "normal" levels.

Index	Category	Fall/Returns
US Equity		**Fall from peak**
S&P 500	US Large caps	-18%
Russell 2000	US Small caps	-26%
Nasdaq Composite	US Tech	-27%
International Equity		**Fall from peak**
MSCI EAFE	International Developed	-20%
MSCI EM	Emerging Markets	-22%
Bonds		**1-year returns**
S&P US Govt. Bond Index	US Govt. Bonds	-9%
S&P 500 IG Bond Index	Investment Grade Corp Bonds	-14%
Commodities		**Fall from peak**
S&P GSCI	Commodities	-20%
S&P GSCI Crude Oil	Crude Oil	-22%
S&P GSCI Gold	Gold	-15%
Real Estate		**Fall from peak**
DJ US Real Estate	US Real Estate	-18%
S&P US REIT	US REIT	-19%

A normal interest and liquidity regime would result in the use of a normal discount rate for assets and result in lower asset prices. The downwards price movement across asset classes is a result of the use of this higher discount rate. This could be termed rational.

What is not so rational is that this negative price action has resulted in huge negative sentiment and expectations of a recession.

Sometimes there is a risk of the so-called "theory of reflexivity" actually making it come true. The quote from Mark Zandi at the beginning of the article continues as follows:

"So, when sentiment is so fragile, it's not going to take a whole lot to push us in. I think with a little bit of luck, and some reasonably good policymaking by the Fed, we're going to be able to avoid a recession. But I don't say that with a lot of confidence."

Mark Zandi is worried that it could become a self-fulfilling prophecy.

If someone were to assume that the Fed will just keep hiking interest rates and reducing liquidity irrespective of macro-economic indicators deteriorating to a point beyond a slowdown in growth rates, then predicting a recession would make sense. Of course, there is some risk of a recession getting triggered even with a vigilant Fed since the global economy is a complex dynamic system.

However, the kind of an unprecedented belief in a recession seems irrational.

Are The Data Consistent with a Recessionary Scenario?

Let us look at some hard data from 2021.

US Economic Data 2021	
Real GDP Growth	5.7%
Inflation	4.7%
Nominal GDP Growth	10.4%
Unemployment rate	3.6%
GDP Size	$23 Trillion

In 2021, the US GDP was nearly one-fourth of the global GDP growing at more than 10% with all-time low unemployment rates. This is despite the year plagued with supply chain disruptions.

As seen in the accompanying table, more recent data shows that the number of job openings were nearly twice the number of unemployed workers in May 2022. Non-farm payrolls are increasing at the rate of nearly 370,000 jobs per month. Further, the Fed funds rate is still at 1.5% to 1.75%.

US Economic Current Data		
Job openings	11 million	May 2022
Unemployed workers	6 million	May 2022
Non-farm payroll	372,000	June 2022
Fed Funds rate	1.5% to 1.75%	July 2022

Let us use the Fed's crystal ball, the FOMC dot plot and related data, to peek ahead to the rest of 2022. (The Fed's crystal ball is as good as anyone else's. They definitely have access to the most detailed data on the economy, and probably, they are less biased compared to most others.)

US Economic Outlook 2022 (Fed-FOMC)	
Real GDP growth	1.7%
Inflation	5.2%
Nominal GDP growth	6.9%
Unemployment rate	3.7%
Fed funds rate	3.4%

The Fed has pulled down the expected real GDP growth rate to just below 2% and the nominal GDP growth rate to nearly 7%. Unemployment rate remains at 3.7% which is clearly inconsistent with a

recessionary scenario. Inflation is expected to get tamed at 5.2% for the year and the Fed funds rate Is expected to reach an above normal 3.4% and remain high into 2024 before normalizing to 2.5%.

It is not surprising that the Fed funds rate is expected to be high given the high expected inflation.

The Congressional Budget Office projects the US GDP to be $25 trillion in 2022.

The above data looks quite positive, and definitely a growth-oriented one.

Macros Look Fine, But Scientific Investors Care About Valuations & Growth

Equity Market Valuations		
Category	PE (projected)	Earnings Yield
S&P 500 – Large Caps	16	6%
S&P 600 – Small Caps	11	9%
S&P 500 – IT	19	5%

Let us look at expected long-term growth rates as well.

The US nominal GDP growth rate, in the long-term, is expected to be around 4%. Long-term emerging market nominal growth rates are expected to be around 6%-7%. Keeping in mind that S&P 500 has nearly half of revenue coming from international markets, one could conclude that the expected, blended growth rate for S&P 500 revenue growth, in the long-term, is around 5%-6%.

Estimating Expected Returns from Headline PE Ratios and GDP Growth Rates

The expected returns from equities, in long-term, can be estimated using the sum of free cash flow yield and growth. Operating cash flow can be approximated as earnings + depreciation. This means that the operating cash flow yield is slightly more than the earnings yield.

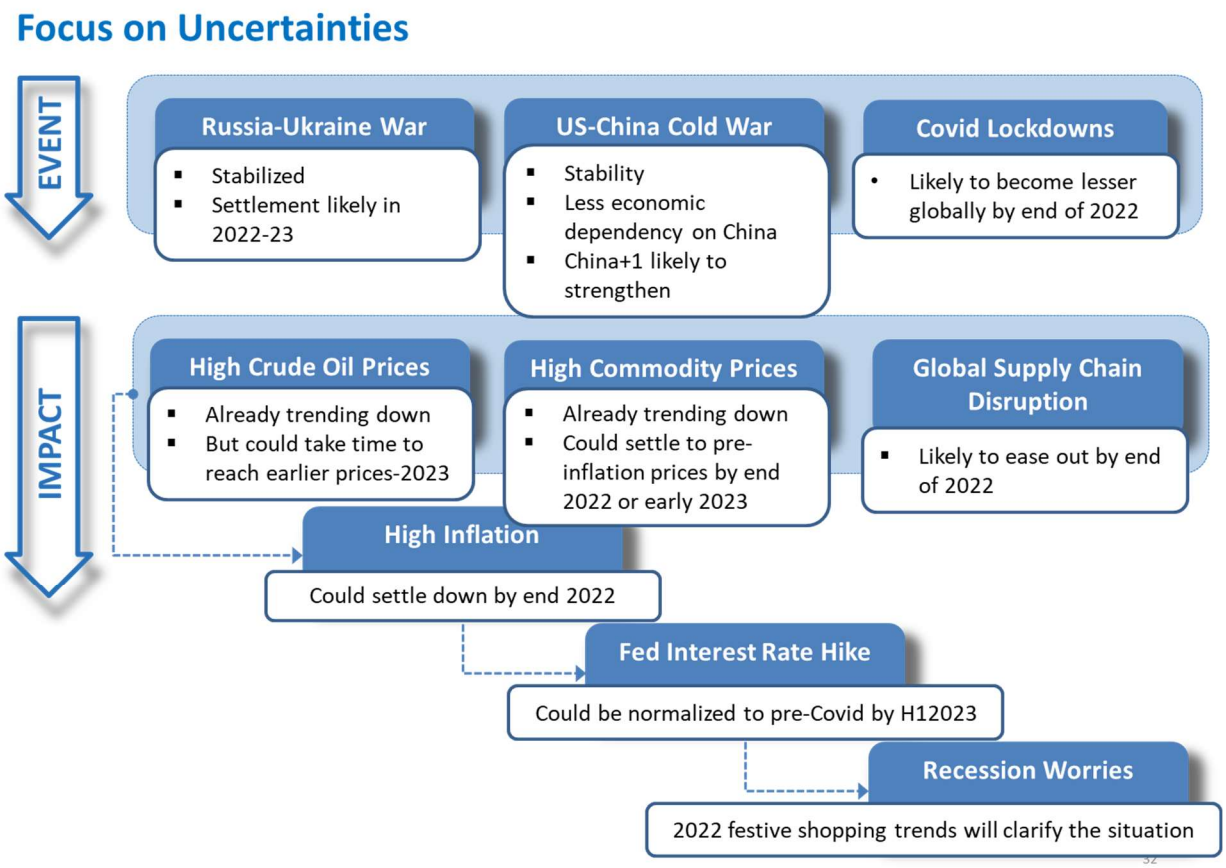
Free cash flow can be approximated as (operating cash flow) – (maintenance capex + growth capex).

Assuming, that maintenance capex = depreciation, FCF yield should be slightly less than the earnings yield. Let’s say, FCF yield is 80% of Earnings Yield.

One could conclude that, with high probability, the markets are valued currently below their intrinsic value and, probably, the small caps are likely priced at an even larger discount to their intrinsic values.

Given that information technology requires low capex and have high growth rates, the IT stocks look like a high-growth sector available as a value sector.

Which Direction Would Markets Move if Uncertainties Start Resolving?



Since most uncertainties are already well-known for several quarters and, hence, already priced in, what do we expect as they start getting resolved?

Let us consider them one-by-one. Keep in mind that the following is more of an opinion based on qualitative and quantitative data and trends currently available. No one can predict the future, but this is the most likely scenario based on our understanding. In reality, there is always a reasonable chance that lower probability scenarios could manifest or our guessed probabilities were wrong.

Russia-Ukraine war has already stabilized in terms of how the war is likely to proceed. There are calls and attempts for a settlement by both sides and it is likely to happen in some shape or form around end 2022 to H1 2023.

Settlement of the Russia-Ukraine war could result in lower crude oil and commodities prices. However, since crude oil prices are controlled by an oligopoly and higher prices are in their favour, it would probably take the full 2023 before they reach pre-pandemic price levels. For most commodities without oligopolies, commodities prices could settle down much earlier, even sometime in 2022 or Q1 2023.

The US-China cold war, which started in the Trump-era, has also stabilized and accepted by both sides. US and allies, including Europe, has accepted that they need to reduce dependency on China in the long-term and hence have started moving to a China+1 policy. This means diversifying production and supply sources away from China to other Asian countries.

The China+1 policy of diversifying production and supply sources, Covid Lockdowns reducing further and the need to supply for the US festive season, should result in the Global Supply Chain Disruptions easing out significantly by end 2022.

With the expected timeline for the above factors, inflation could significantly settle down by end 2022 and H1 2023. With inflation stabilizing, Fed could normalize the interest rates by H12023.

Recession worries, most likely, overblown could be resolved once data for the festive season shopping of 2022 starts coming in Q4.

Return on Uncertainty can be High

Given the strong economic fundamentals, the uncertainty causing factors likely to get resolved soon, and the attractive market valuations, one can conclude that Return on Uncertainty could be quite high.

OmniInsight

"Most market participants chase alpha but get risks, while one could chase safety and get alpha"

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Dr. Vikas V. Gupta
CEO & Chief Investment Strategist

- Founder of OmniScience Capital & Inventor of Scientific Investing concept
- At an earlier firm he incubated the global equity vertical with US SEC license. The firm won international awards and rankings
  Former Professor/faculty at IIT Kharagpur & University of California and B.Tech (IIT Bombay), Masters and Doctorate, Columbia University, NY
- Columnist at Seeking Alpha, Mint, Moneycontrol, Economic Times

Ashwini Kr. Shami
EVP & Portfolio Manager

- Co-founder OmniScience Capital & leads advisory services and manages US, India & Technology portfolios
- At an earlier firm he set up one of the first Indian US SEC registered global money managers on the Interactive Brokers platform
- Previously worked at Goldman Sachs covering US and International stocks
- B.Tech and M.Tech from IIT Bombay; MBA from IIM Lucknow and Toulouse Business

Varun Sood
VP Quantitative Research

- Co-founder OmniScience Capital & heads investment research
- At a previous asset management firm, he developed 12 global strategies for US, UK & EU
- Earlier, at ING, Trefis and Masan group he covered US and International markets
- B.Tech from IIT Roorkee and earned his MBA from IIM Bangalore and EDHEC School of Business, France.

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