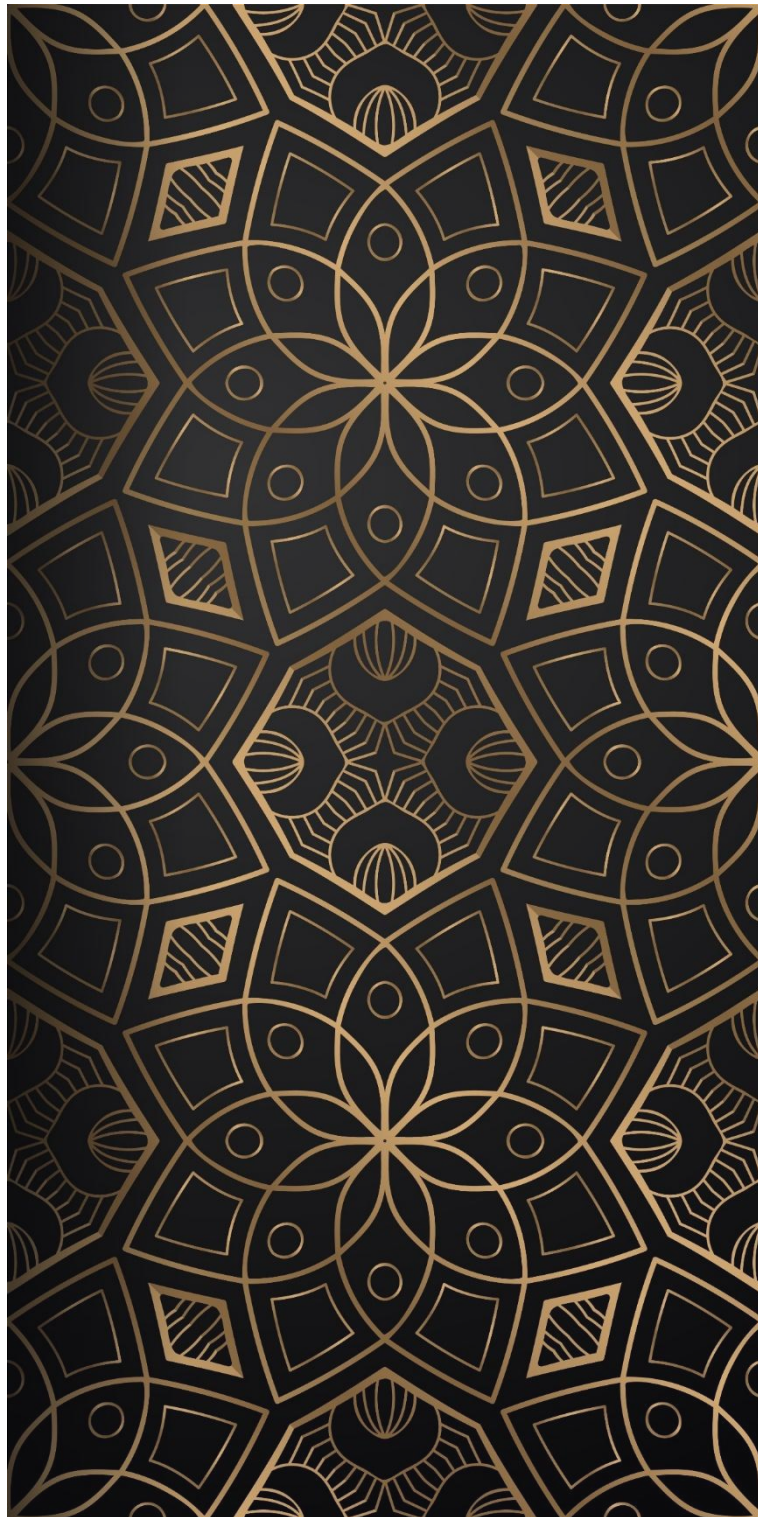




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Inflation, Interest rates and Investing

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Summary

A key question concerning investors globally today is the medium-term trajectory of interest rates and the consequent impact on equity markets. This uncertainty is nudging some investors to increase cash positions in anticipation of a market correction. In this newsletter, we argue that not only are interest rates movements unpredictable, even their impact on equity market returns either from a quantum or a direction perspective is unpredictable. Moreover, analysis of Indian benchmark indices over the past three decades shows that the benefit associated (i.e. lower prices) with investing only in drawdowns gets neutralized by the opportunity cost of staying out of the market. As the adage goes, 'time in the market' is more important than 'timing the market'.

Inflation is picking-up in the US

The US labor department on May 12, 2021 released the Consumer Price Index (CPI) for the month of Apr-21 which came in at 4.2% higher than expectations of 3.6%. Interestingly, this is the highest level of inflation seen in the US since the global financial crisis of 2008. As a result, the Nasdaq Composite Index fell 2.67% intra-day following the release, similar drawdowns were seen throughout major global indices. The inflation numbers also drove the 10-yr treasury yield higher to about 1.7% (though still below the pre-pandemic peak of close to 2%).

This release has further fuelled an already intense debate on inflation rising globally. While the Fed has been maintaining its stance that inflation this year will be transitory, there are many experts who believe that inflation may persist and Fed may be behind the curve. If the experts are to be believed, volatility in equity markets is likely to increase with the highly priced growth stocks taking the maximum hit. Such volatility in the US is likely to be felt throughout the globe and may have significant ramifications for the Indian equity markets in the short-term. Hence, many investors are grappling with two key questions – (1.) where are interest rates headed and (2.) how will interest rate movements impact equity market returns.

Where are interest rates headed?

Numerous studies including Brooks and Gray (2004), Mitchell and Pearce (2007), Baghestani (2009b), Baghestani (2018) and Stark (2010) conducted in the past show that long-term interest rates forecasts fail to beat the random walk benchmark effectively implying that interest rate trajectories have rarely been predicted accurately by “experts”.

The last decade has further raised questions on the likelihood of predicting interest rate movements accurately. We have not come across any literature where market experts or economists predicted in 2009 that interest rates would be at the level, they are in 2021.

Interest rate is a classical example of a macro variable that is important but largely unknowable.

How will interest rate movements impact equity market returns?

Here, we discuss two major historical events in the US where interest rate trajectories were accompanied by opposing stock market reactions.

#1 Paul Volcker's interest rate shock to counter inflation

Appointed in August 1979, Paul Volcker started increasing the fed funds rate to counter the roaring inflation in the US during the 1970s. From an average of 11% in 1979, Volcker increased rates to a peak of 20% by 1981. While this

sharp increase in interest rates led to the US recession of 1980-1982, it helped contain inflation in the late 1980s. During the Volcker tightening period i.e. 1979-1982, the Dow Jones Industrial Average (DJIA) fell by more than 25%.

#2 Alan Greenspan's 2004-07 gradual interest rate increase

The US Fed under Alan Greenspan started increasing the fed funds rate gradually in mid-2004 following a period of benign interest rate in the early part of 2000s. From levels of a meagre 1% in May, 2004 the fed increased rates to 5%+ by 2007. This period was accompanied by the DJIA increasing by almost 40% amidst a strong global economy. Indian indices over the same period grew much more for example the BSE SENSEX increased 4X in the three-year period.

The key learning from the two episodes is that the interest rate trajectory itself may not be a good predictor of equity market returns. Macroeconomics is complex with many interplaying variables.

So, what should Indian investors do?

Let's consider an investor who has cash at the start of every year and has the option of investing in one of the two ways – (1.) invests only if there is a steep correction in markets and (2.) invests consistently throughout the year equally every month i.e. 12 deployments each of 8.5% of his starting capital. Average 3-yr, 5-yr and 10-yr returns for the two strategies over the past three decades is shown in the table below.

	Strategy 1: Invests only when there is a steep drawdown			Strategy 2: Invests consistently throughout the year	Differential (Strategy 2 minus average Strategy 1)
	15% drawdown	20% drawdown	25% drawdown		
BSE Sensex					
3 Years	10.9	11.9	9.4	10.5	(0.2)
5 Years	11.4	12.1	10.6	10.5	(0.8)
10 Years	12.0	12.5	11.9	11.2	(1.0)
BSE Midcap					
3 Years	12.3	12.3	13.6	12.9	0.2
5 Years	9.6	9.8	10.7	10.2	0.1
10 Years	11.2	11.4	12.1	11.6	(0.0)
BSE Smallcap					
3 Years	13.1	12.0	11.9	12.6	0.3
5 Years	10.7	10.6	11.1	10.4	(0.4)
10 Years	11.9	11.7	12.3	11.6	(0.4)

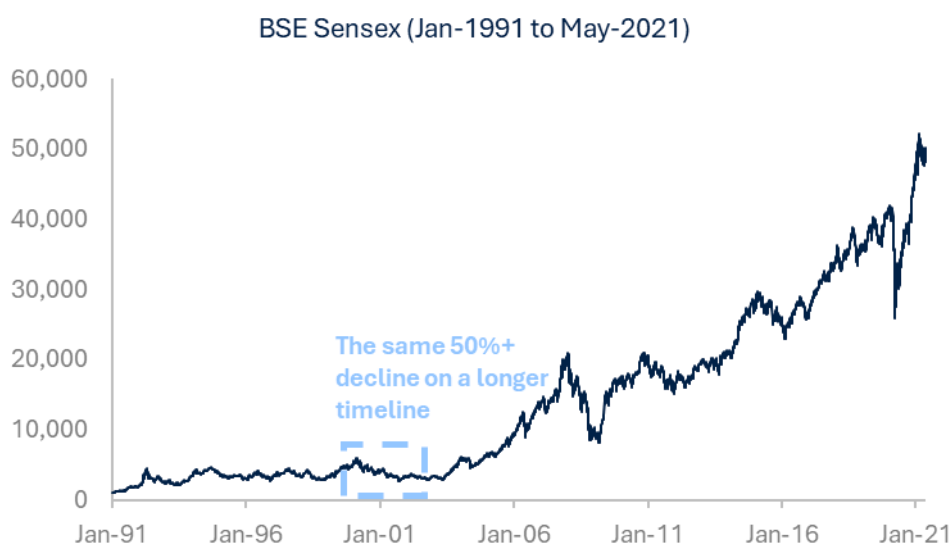
A couple of interesting insights from the above table – (1.) there is hardly any difference in the long-term results between the two strategies i.e. the benefit of investing at lower prices gets neutralized by the opportunity cost of staying out of the market. In fact, from a practical standpoint investing in a drawdown may lead to inferior results as there may be execution inefficiencies due to low volumes, psychological factors, among others, (2.) waiting for a larger drawdown as compared to smaller drawdowns may actually lead to poorer results for e.g. average 5 year returns on BSE SENSEX were lower if one waited for a 25% drawdown vs 20% drawdown i.e. 10.6% vs 12.1% respectively and (3.) the differential (last column in the above table) in small and mid-cap is lesser than SENSEX as historically these indices have compounded at a faster rate and hence the opportunity cost of staying out of the market is higher.

Over the long-term staying invested in the market is likely to be more fruitful than investing only when there is a drawdown i.e. 'time in the market' is more important than 'timing the market'.

As a visual aid to the above point, we take the example of BSE SENSEX's price movement from 1992-2021. In early 2000s markets throughout the globe started crashing and continued their downfall for 1.5 years. This was a painful period for market participants – below is a graph showing what the crash looked like.



The graph below shows the same crash on a different timeline. Time in the market matters!



To know more about how we approach investing, please visit www.burmancapital.com or write to us at info@burmancapital.com.

About Burman Capital Management

Burman Capital Management is a part of Burman Family Holdings, the strategic investment platform of the Burman Family, which over the last twenty years has invested over US \$500 million in various businesses primarily in India and have partnered and joint ventured with many of the leading Fortune 100 companies from around the world. The Burman family are the control shareholders of the Dabur Group. Dabur was founded in 1884 by Dr. S.K. Burman and is today one of the largest Indian Fast Moving Consumer Good Company in India with over US\$1 billion in revenue and a market capitalization of over US\$12 billion.

At Burman Capital Management, we are long-term investors with deep passion for identifying and investing in exceptional businesses early. We are fundamentals-driven bottom-up investors and run concentrated portfolios focusing on small to mid-size companies.

We are a SEBI-registered Portfolio Manager with registration number INP100007091.

Performance snapshot*

Monthly performance (Absolute returns, %)	Apr	May			
FY2021-22	6.5	6.8			
	Returns since inception (23-Mar-21, Absolute returns, %)	Returns in FY21-22 (Starting 01-Apr-21, Absolute returns, %)	Sortino Ratio	Sharpe Ratio	
Burman Capital Management	14.5	13.7	0.59	0.38	
BSE Sensex	3.3	3.9	0.07	0.06	
BSE Midcap	7.0	7.3	0.14	0.12	
BSE Smallcap	13.9	13.7	0.28	0.24	

Note: All returns till 28-May-2021

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