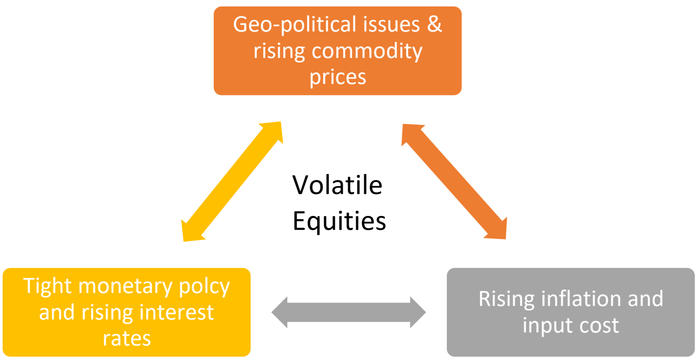
In the last 15 years central banks kept interest rates lower to support growth amidst multiple crisis starting from sub-prime to the most recent Covid-19. However, one of the aftermaths of easy liquidity is that it fuels inflation, which the world is already witnessing since the start of this year. Moreover, Covid 19 and Russia-Ukraine war has further exacerbated and elongated global supply chain disruptions which has spooked inflation levels globally.

The US for example had an annual inflation of 8.3% in April and 8.5% in March which was a 41-year high. The UK inflations hits 9% (40-year high). India too saw its retail inflation numbers rising to 7.79% which was well above the RBI inflation level target of 4% (with a tolerance band of +/- 2 percentage points).

For Central Banks, this is a big problem since negative effects of high inflation are considered more harmful than the positive effects of easy liquidity. Hence, central banks have set out on a path to rapidly increase rates and put a cap on rising inflationary pressures.

Impact of Inflation and rising rates on Equities

The conundrum of rising commodity prices, rising inflation and thereby tight monetary policy may keep volatility intact in equities for some time.



Higher inflation brings with it rising interest rates which in-turn impacts multiple sectors and its growth prospect. With higher commodity prices, businesses grapple with high input costs, resulting in passing on higher prices to consumers. Higher prices in-turn impacts demand.

However, historical evidence suggests that equities have done well after initial phase of volatility recedes in a rising interest rates environment. In fact, equities have delivered one of the best returns during 2004 to 2008 period when interest rates and inflation kept rising.

Table below shows how equity markets have performed during different rate cycles

Time frame		Duration (no of days)	Interest Rate Phase	Policy Rate	Change in Policy Rate(bps)	Nifty Absolute returns during the period
18-09-2004	11-10-2008	1484	Hike	Repo 6% to 9%	300	113.9%
11-10-2008	13-02-2010	490	Easing	Repo 9% to 4.75%	-425	39.4%
13-02-2010	10-03-2012	756	Hike	Repo 4.75% to 8.50%	375	14.1%
10-03-2012	20-09-2013	559	Easing	Repo 8.50% to 7.25%	-125	14.8%
20-09-2013	15-01-2015	482	Hike	Repo 7.25% to 8.00%	75	43.1%
15-01-2015	06-06-2018	1238	Easing	Repo 8% to 6%	-200	31.3%
06-06-2018	07-02-2019	246	Hike	Repo 6% to 6.50%	50	4.5%
07-02-2019	08-04-2022	1156	Easing	Repo 6.5% to 4.00%	-250	66.7%
08-04-2022	26-05-2022	48	Hike	Ongoing	40	-8.8%

Source: RBI website, Bloomberg, Past performance may or may not sustain in future

However, this conundrum of high inflation and rising interest rates may impact earnings of businesses in each sector differently. The data below shows how different sectors have performed during high inflation and low inflation conditions in last 10 years. As seen, Auto, Pharma and Banks have performed well during high inflation regimes while businesses that have their demand and input costs sensitive to inflation and rising rates have done poorly.

Index	Inflation Above 6%	Inflation Below 6%
NIFTY AUTO - TRI	3.37	-0.13
NIFTY PHARMA - TRI	3.18	-0.05
Nifty Private Bank - TRI	3.05	0.74
NIFTY METAL - TRI	2.72	0.51
NIFTY BANK - TRI	2.69	0.72
Nifty Financial Services - TRI	2.65	0.83
NIFTY IT – TRI	2.61	1.18
NIFTY COMMODITIES – TRI	2.37	0.59
NIFTY MEDIA – TRI	2.33	0.09
NIFTY CONSUMPTION – TRI	2.30	0.79
NIFTY ENERGY – TRI	2.29	0.99
NIFTY MNC – TRI	2.27	0.86
NIFTY 50 – TRI	**2.26**	**0.64**
NIFTY SERV SECTOR – TRI	2.26	0.81
NIFTY FMCG – TRI	2.14	0.90
NIFTY INFRA – TRI	2.00	0.43
NIFTY REALTY – TRI	1.77	1.30
NIFTY PSU BANK – TRI	1.51	-0.06

Source: Bloomberg, Past performance may or may not sustain in future, Data from Jan 2012 to April 2022.

During such periods, sectoral winners change dramatically, and it is important to keep portfolios well aligned to reality. Hence, it is crucial to position sectoral and stock allocation well during such periods when market returns may not come from broader group, but select businesses and sectors.

How are our portfolios positioned?

Across our long only equity funds, we have positioned the portfolio well to navigate the current situation and have been adding more exposure to businesses and sectors that may be resilient or benefit during the current economic phase of high inflation and rising interest rates.

We are broadly positive on below sectors across our portfolios and have actively taken overweight positions in select quality businesses within these sectors.

1. **Consumers:** Consumer companies that have pricing power continue to do well during high inflation-interest rate regime due to its essential nature in day-to-day consumption. They tend to hold their demand and margins during high inflationary regime as demand for such goods generally tends to be inelastic to inflationary pressures. Within this space we are selectively positive on businesses that have pricing power and have better brand acceptance.
2. **Industrials**: When interest rates rise the economy is usually on a stronger footing to withhold this regime change and hence, industrial activity tend to remain strong and resilient. Industrial manufacturing businesses are also mostly beneficially of high commodity prices since they can pass on the higher cost without impacting demand to a large extent. We have actively taken exposure to

such industrial manufacturers who have pricing power and demand is picking up for their products. These are businesses which have done well in last couple of rising interest rate cycles.

3. **Lending financials:** The financial sector has historically been among the most sensitive to changes in interest rates. With profit margins that expand as rates climb, entities like private banks and lending financials benefit from higher interest rates. We have active exposures in such lending financials across our portfolio, mainly select private sector lenders and some dominant lending franchise that are expected to do well in this cycle.

Snapshot of active stocks positions in these sectors across our long only equity funds:

Financials	Consumers	Industrial Manufacturers
ICICI Bank Ltd.	Crompton Greaves Cons Electrical Ltd.	ABB India Ltd.
Axis Bank Ltd.	Trent Ltd.	Cummins India Ltd.
Cholamandalam Investment & Fin Co Ltd.	Greenpanel Industries Ltd.	
State Bank of India	The Phoenix Mills Ltd.	
Can Fin Homes Ltd.		

Portfolio holdings as on 29th April, 2022. The above stocks are currently part of the portfolio and have active exposure (% allocation higher than benchmark). There is no assurance or guarantee of future position in the above stocks.

Disclaimer

The purpose of this product is to offer a brief & simplified rationale behind our investments in certain businesses/themes in our long only portfolios. The Sector / Stocks /issuers mentioned in the presentation do not constitute as any research report / recommendation and the fund may or may not have future position in these stocks / sector / issuers. This Note is for information purposes only for distributors and does not constitute an offer or recommendation to buy or sell any scheme of Edelweiss Mutual Fund. This also does not constitute an offer or recommendation to buy or sell any financial products offered by Edelweiss. Any action taken by you on the basis of the information contained herein is your responsibility alone and Edelweiss Asset Management Limited (the AMC)/Edelweiss Trusteeship Company Limited/ Edelweiss Mutual Fund or its directors or employees will not be liable in any manner for the consequences of such action taken by you. The AMC takes no responsibility of updating any data/information in this material from time to time. The information shall not be altered in any way, transmitted to, copied or distributed, in part or in whole, to any other person or to the media or reproduced in any form, without prior written consent of the AMC.

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully.