EDGE
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Bangladesh
Strategy Note

Commodities determine equity market cycles

2010, 2017 and 2020-21 show similar patterns

- **Bangladesh fits squarely into the "short commodities" framework:** Our analysis of macro cycles indicates that equity markets in Bangladesh rally soon after a sizeable commodity price correction. Due to the shockproof nature of Bangladesh's FX earners (RMG and remittances), savings from commodity import bills flow directly into Net Foreign Assets (one of two M2 components; mostly FX reserves). Moreover, low commodity prices translate to muted inflation risks, allowing the central bank to turn up Net Domestic Asset growth (the other M2 component; mostly domestic credit). Ultimately, M2 shoots up which leads to crashing yields; the excess liquidity in the system soon finds its way into riskier assets. Given commodity prices typically dip during times of global economic stress, our analysis indicates that Bangladesh is a natural hedge to both commodities and global economic stress.

- **DSEX is very sensitive to liquidity cycles:** All three equity market rallies in the last 12 years (2010, 2017 and 2020-21) were preceded by treasury bill/bond rallies (yield dips). Although there is typically a 6-12 month lag between yield dips and equity rallies, the relationship between the two appears to be quite straight forward.

- **Commodities drive M2 through FX reserve build up:** The liquidity cycle in Bangladesh typically transpires as follows— commodity price dips lead to sizeable import cost savings and FX build up, which shoots up Net Foreign Assets growth. Low commodity prices also relieve inflationary pressures, allowing the central bank to increase Net Domestic Asset growth. High Net Foreign and Domestic Asset growth then leads to M2 (broad money) overshooting private sector credit growth. At that point, banks end up with sizeable "excess cash" which must be deployed to treasuries, leading to treasury yields crashing. Once yields have gone down enough, the funds start flowing into riskier asset classes.

- **Keep an eye out for the ongoing commodity rally:** In our view, the liquidity led equity market rally will end shortly after commodity prices recover. Things could get particularly tight if private sector borrowing and commodity prices recover in tandem. In that case the mop of up "excess liquidity" will happen swiftly. Given (i) commodity prices appear to be recovering, and (ii) private sector borrowing is expected to recover by 2H 2021, we expect a tightening of yields in the latter half of the year. Our primary top-down approach of playing the rally would be to use 364-day bill and 5-year bond yields as the guiding points.

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Equity market is very sensitive to interest rates

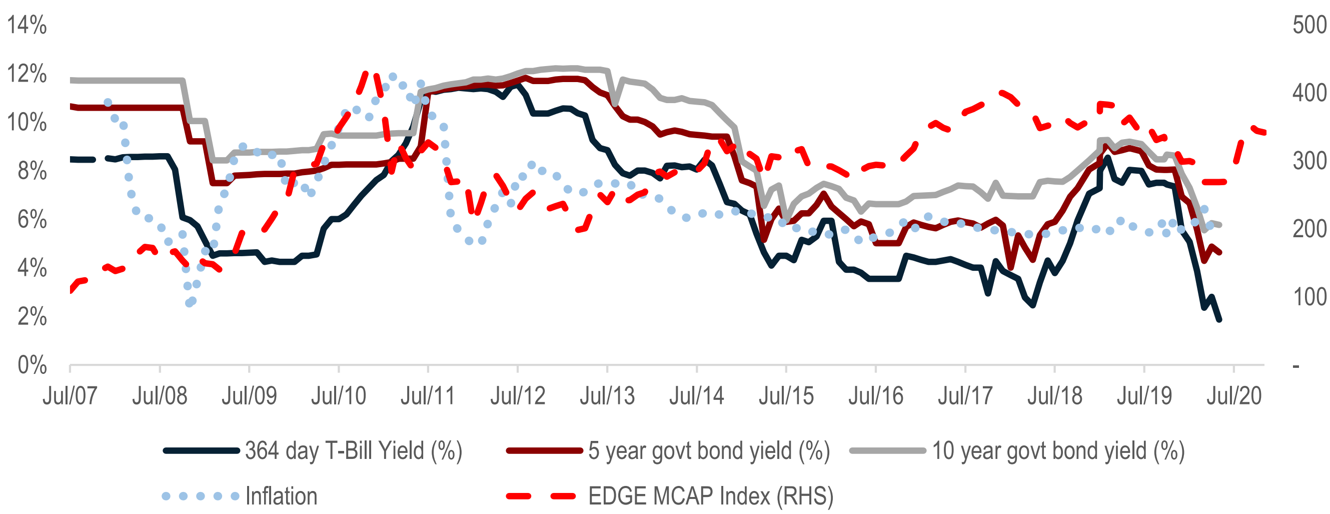
Bonds precede stocks by 6-12 months

Although EDGE has historically been bottom-up focused, the truth of the matter is that our coverage has become increasingly beta driven in the last 2 years. We think the ongoing rally has more to do with top-down factors rather than changes to bottom-up thesis, which means a top-down framework has to be applied to play this.

As shown in Figure 1 below, the Bangladesh equity market is very sensitive to changes in the yield curve. We used a custom MCAP weighted "EDGE MCAP Index" as the DSEX was only introduced in mid-2013. The relationship between treasury instruments and equity index checks out in all three rallies in the last 12 years– 2009-10, 2017 and 2020-21 (ongoing).

The broad highlight is that equities lag treasuries by 6-12 months on average; the time lag varies based on the tenure of the treasury instrument.

Figure 1: Treasury yields and equity returns



Source: Bangladesh Bank, Dhaka Stock Exchange, EDGE Research

This naturally brings us to the question of what drives treasury/monetary cycles in Bangladesh? We think commodities are the primary driver in the interest rate cycle. The following segments will explore how this pans out.

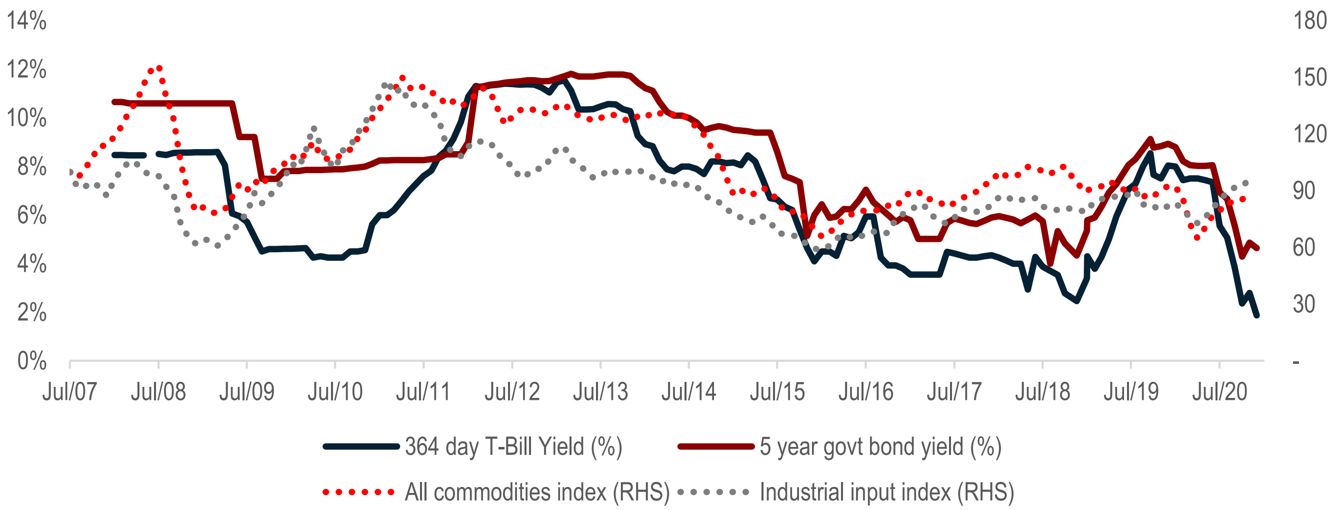
Commodities drive interest rates

Treasury yields lag commodities by another 6-12 months

The correlation of interest rates and equities naturally brings us to the question of what drives monetary cycles in Bangladesh. In our view, the short answer is that commodities are the primary driver of interest rate cycles in Bangladesh; other secondary factors include private sector borrowing demand which either amplifies or pacifies the impact on yields..

Figure 2 below demonstrates the high level relationship between the two. Yields lag commodities by another 6-12 months.

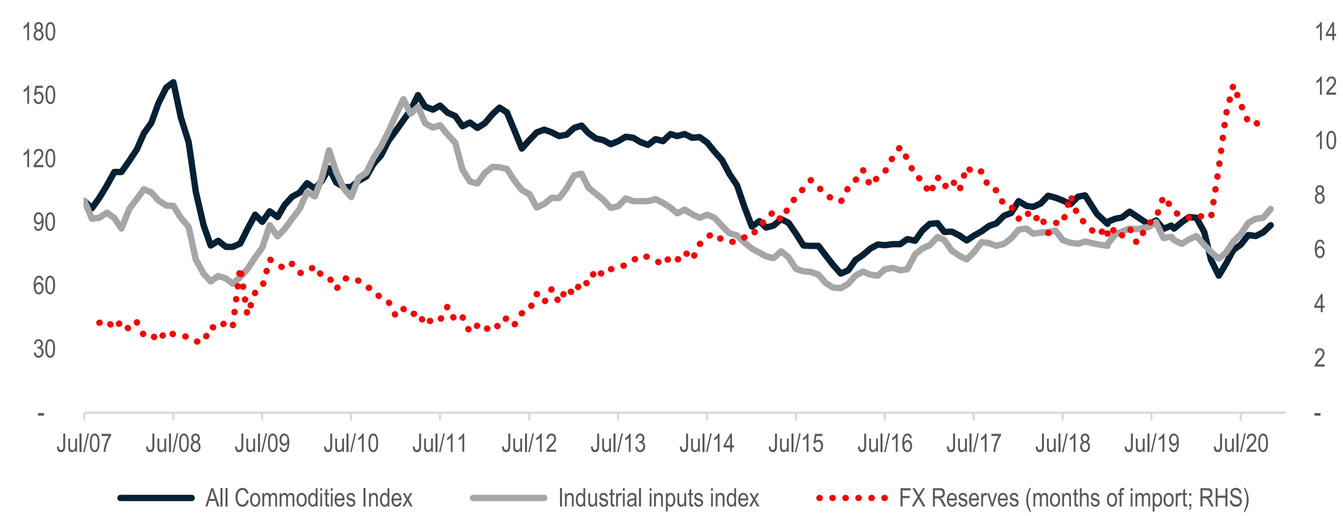
Figure 2: Treasury yields and commodity prices



Source: Bangladesh Bank, IMF

The basic transmission is through the external side. Lower commodity prices lead to lower import costs and current account surpluses and, by extension, FX reserve build up. Figure 3 below demonstrates this phenomenon.

Figure 3: Commodity prices and FX reserve build up



Source: Bangladesh Bank, IMF

Commodity imports are the primary delta in BoP

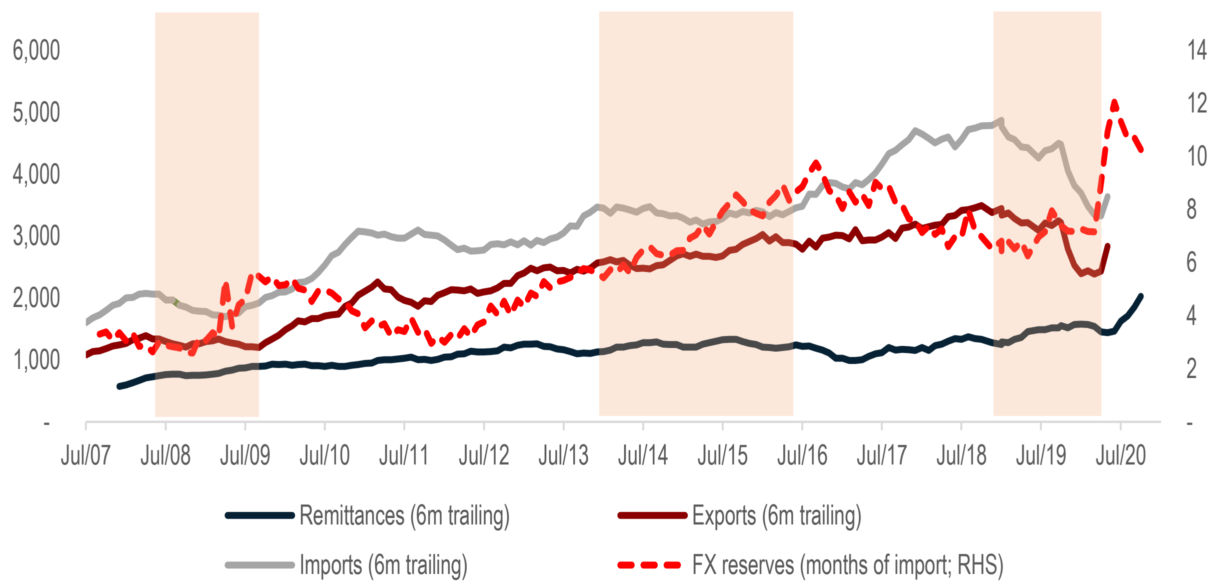
Given commodity prices typically drop during times of economic stress, the question we must ask is why don't Bangladesh's FX earners also move with the global business cycle? The short answer is that the two key FX earners, RMG and remittances, are largely shockproof and tend to grow with their own momentum due to the basic nature of the products being exported, regardless of how the rest of the world is performing. This can be seen in Figure 4 below.

Lower commodity prices lead to a period of "flat imports". A big chunk of imports is actually raw materials for RMG that are ultimately exported, meaning they grow in tandem with RMG exports. As such, stagnant imports (with increasing exports) imply imports excluding RMG raw materials must be decreasing in absolute value. The key component in the "imports excluding RMG raw materials" segment is commodity imports.

Given Bangladesh's dependency on foreign capital flows is very limited, current account flows tend to dominate Balance of Payments (and FX reserve changes) to a large extent.

As such, savings (or lack of) from commodities flow directly into the FX reserves.

Figure 4: External side



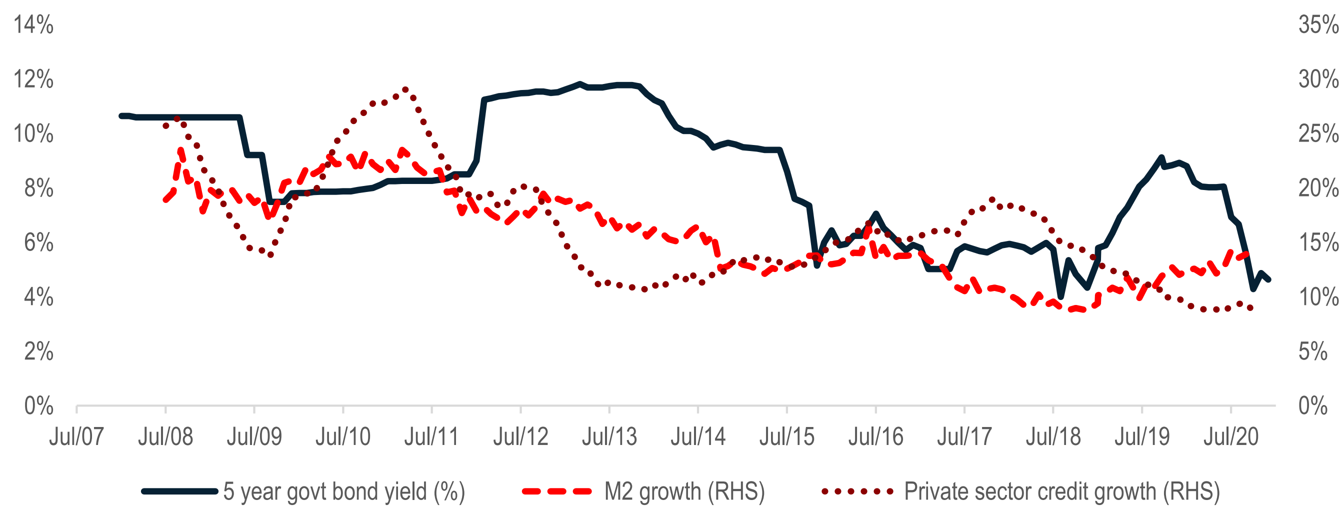
Source: Bangladesh Bank

FX build up leads to monetary loosening

Broad money (M2) consists of Net Foreign Assets (mostly FX reserves) and Net Domestic Assets (mostly total domestic credit). High FX build up leads to explosive growth in Net Foreign Assets, taking M2 growth above private sector credit growth.

Figures 5 demonstrates that, as soon as M2 growth exceeds private sector credit growth, banks are left with abundant "excess cash" which they must deploy somewhere. Naturally, the funds flow to public sector credit via treasury instruments, leading to yield dips. Once yields depress enough, the money finds its way into riskier asset classes.

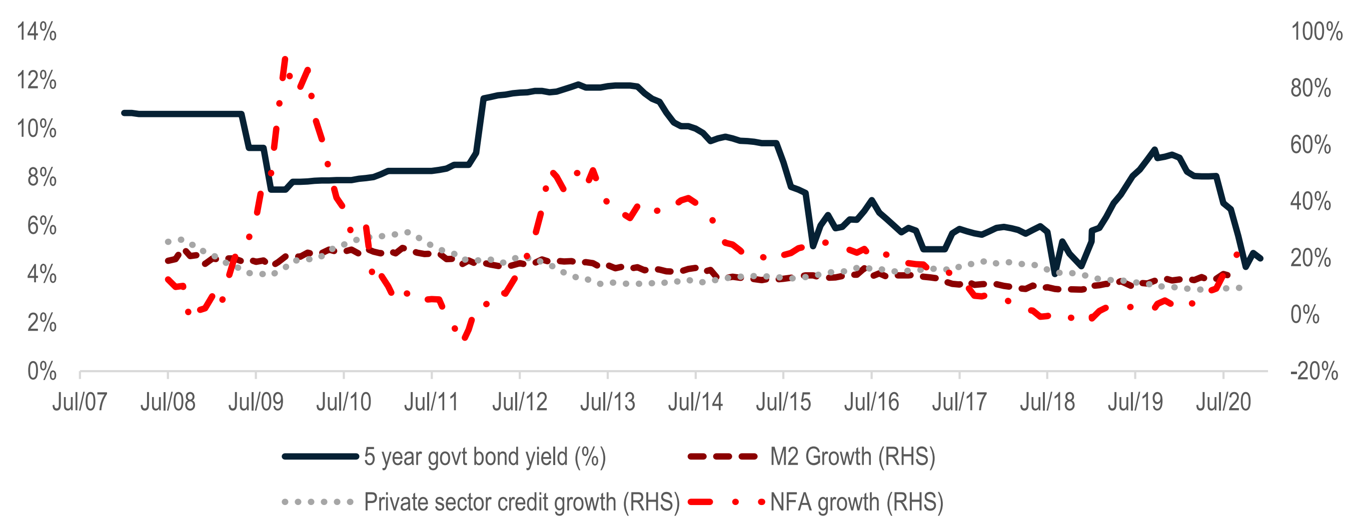
Figure 5: Yields and liquidity



Source: Bangladesh Bank

As shown in Figure 6, M2 growth exceeds private sector credit growth specifically because Net Foreign Assets (which is primarily FX reserves) shoots up.

Figure 6: Yields and liquidity continued



Source: Bangladesh Bank

Keep an eye out for commodity prices

Our high level conclusion is that the liquidity cycle will end once commodity prices start reverting. Beyond just FX reserves-led monetary growth, this will also bring in inflationary pressures which would prompt the central bank to tighten Net Domestic Assets; basically the opposite of what the central bank did during commodity price dips.

Things could get particularly tight if both commodity prices and private sector borrowing start recovering at the same time. Given (i) commodity prices are already on a recovery path, and (ii) we expect private sector borrowing to gain pace by 2H 2021, we think a credit tightening later in the year is a good possibility.

Thankfully, due to inefficiency in the financial markets, there is a considerable time lag between commodity price movements and equity prices being impacted, which should give us headroom to exit markets when the time comes. In general, our advise would be to track 364 day T-bills and 5-year bonds as a guiding point.

On a slightly different note, our conclusions from this report also indicate that top-down and bottom-up frameworks are likely to be at odds during liquidity driven cycles. This is because a necessary pre-requisite of liquidity build up is slow private sector borrowing, which typically happens during some level of slowdown in the economy.

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