Aftershocks

The man-made earthquake struck the global economy on February 28 when the Gulf war commenced. The aftershocks have been reverberating since then. They are intensifying. That is the real issue. Particularly for a country like India. Let us face some crucial realities.

Country	Energy Self Sufficiency	Oil Sufficiency
Japan	16%	0-5%
European Union	25%	10-15%
India	65%	13%
China	85%	25-30%
United States	100%	90-100%
Russian Federation	100%	150-200%

Source: Media Articles, Spark Fund Research

The above sums up our situation. We are amongst the worst affected because of the crisis. Unlike the EU or Japan, our political economy has a significant proportion of relatively poor people to contend with. The government is in an unenviable situation. They have been doing a great job. Investors should avoid dissecting this as that is not our primary focus. We need to weigh the impact on our investments. Our lens should be on how we can preserve capital and put it to work in a sensible manner.

A good proportion of equity investors in India went into this crisis with a baggage of complacency spanning several quarters. These are the sort of events that cause a reset in the markets. If 2001, 2008, 2013 and 2020 never happened, valuations would never have reverted towards meaningful levels. Every bull gets weaker with age and at some point, falls by the wayside.

At the same time, the violent unwind of a bull market sows the seeds of the next uptrend. This statement has been used as a cliched expression to peddle equities and that approach is to be avoided. A fair and neutral assessment is the need of the hour. No one accepted that the bear was quietly at work for two years or more. We may still be not far from the earlier stages of a debilitating economic shock. Since equities react early and hard, the recognition of the value destruction is already playing out. In that sense, equities usually bottom out earlier than the economy. What we need to recognize is that It might take time to rebuild the market. This is no ordinary crisis. It is important to understand the aftershocks.

It is about linkages and unintended consequences

The world at large and the US (administration) for sure underestimated the power of the linkages that keep the various moving parts of the world economy in what can only be called a deadly embrace.

The tiny 45 km stretch that separates Iran from the rest of what the US believed was a saner world packs more destructive potential for the global economy than the tons of ammunition that the US is pounding Iran with. It is not only 20% of world's crude oil that passes through it. It is a meaningful percentage of global growth that flows through it. The inter-dependency is profound. For India, the impact is likely to play out through wave after wave.

First order impact	LPG shortage, oil price hit, INR depreciation, dearer chemicals, disruption in fertilizers
Second Order impact	Diesel/Petrol price increase, FMCG cost push/price hike and demand risk, Auto demand impact, supply chain for all product exports
Third Order Impact	Asset quality risk in banks, Possible severe hit in sub-prime lending, Current Account impact & Interest rate management, Demand contraction in real estate
Further Impact	IT services through global recession risk, Remittances coming under pressure, Global and Indian food production impact from fertilizer supply threat (India is the largest consumer of food in the world), Lag impact on GDP growth from persistent inflation and policy pressures.

There have been observations that India is better placed as compared to previous oil shocks. That could be true from the point of view of crisis management. When we look at the impact of linkages, such optimism is disingenuous.

Consider these variables that influence the balance of payments for India and currency stability

Reasons	Variables	Influence on Balance of Payments
1	Exports	Already affected by tariffs and indifferent global growth
2	Imports	Hit hard now by crude and all that came through Hormuz
3	Services Exports	IT exports is already challenged. Global growth outlook hardly helps
4	Inward remittances	Predominantly come from the Gulf. Outlook is impaired for now
5	FDI inflows	Has been negative lately (unbelievable but true)
6	FPI inflows	Consistently negative for many quarters
7	Interest rate differential with USD	Is not attractive enough to offset the risks as things stand now

Indian balance of payments was never one of its strong points. The current scenario is the worst we have seen in at least 25 years.

Meanwhile, the stock market has not given itself any margin of safety over the last two years. While brokerages have come out with impact analysis on many sectors and some of the impact could be in the price, the effect of linkages is more acute compared to previous shocks. The unintended consequences pose a bigger risk to earnings than is being realized right now. The specter of a food crisis and the squeeze on the supply chain for semiconductors are examples of how this war is beginning to affect countries which are far removed from the conflict. The economists have been hinting that the impact can be contained if the crisis is resolved in a couple of weeks. Unfortunately, this cannot be a rolling expectation. We are over one month into the conflict. The linkages will take their toll. Investors are not exempt.

The wall of worries for investors has got steeper

The market did not go into this with a lot of comfort. The AI disruption threat had already crippled the IT services sector. The Indian currency was on its knees. The IPO market has been in a bubble of its own making. FPIs have been persistent sellers. The fledgling growth revival was still work-in-progress. Much as everyone wants dollops of optimism to soothe frayed nerves, stock market has never been forgiving when a house of mirrors was placed on a wax castle. The stock market created the kind of wealth on the way up which was disproportionate to fundamentals. It usually does not spare those who get it wrong when the music stops. We had repeatedly highlighted this risk. Now it is too late to be proactive. We need to take stock and do some hard assessments.

There are three worries that we need to confront. We have a currency that can be on free fall if bitter pills are not popped in. Two, we have FPIs on the selling side and domestic liquidity is on a limb and a prayer (the liquidity supporting stocks is not emanating from promoters or strategic investors in recent times). Three, we are a more cyclical economy than we like to accept. Add to this an overarching point – those who argue that valuations do not matter too much (or do not matter at all) should present alternative anchor points for investors. There are none. Finally, we need earnings visibility for valuations to have an anchor point. Prudence demands that we wait for more data before we know better.

Even before this crisis commenced, Indian rupee had sold off against the EUR and the USD even as most of the peers had weakened against the EUR while strengthening against the USD. Foreign investment flows have played a key part in this.

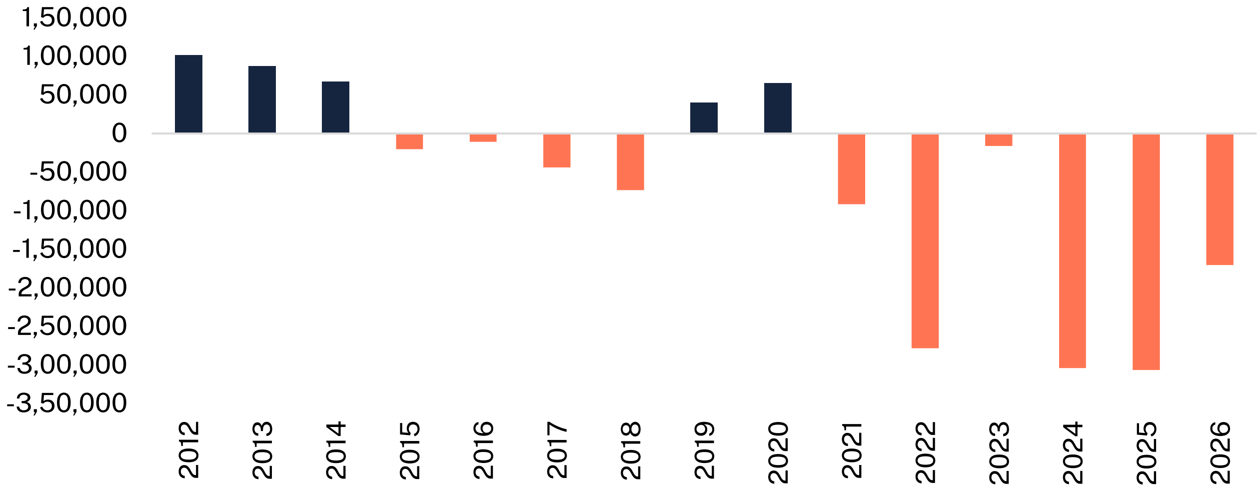
Appreciation / (Depreciation) – FY26	Vs INR	Vs USD
Brazilian Real	22	10
Euro	18	7
Chinese Yuan	17	5
Taiwan Dollar	15	4
Thai Bhat	15	4
Pound	13	2
Dollar	11	
Japanese Yen	5	(6)

Source: Bloomberg, Spark Fund Research

Worst yearly depreciation for the Rupee	INR Depreciation vs USD (%)
FY09	26
FY12	14
FY26	11
FY14	10
FY20	9
FY23	8

Source: Bloomberg, Spark Fund Research

Net FPI/FII Yearly Flows - Cash segment (Rs. Cr.)

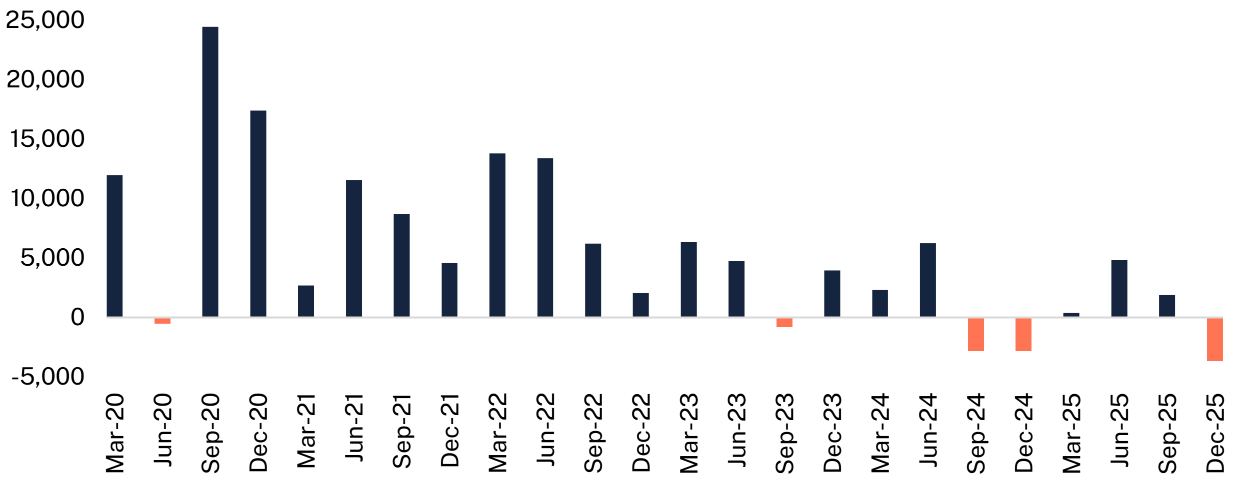


Source: Moneycontrol, Spark Fund Research

An analysis of the above data is startling. FPIs have sold cash equities worth INR 11.7 lakhs crores from 2021 to date. They brought in only INR 6.7 lakh crores from 2012 to 2020. Obviously, they have been booking massive profits at the aggregate level. When we warned that the unsustainable (in the long run and long run is upon us now) and unreasonable valuations have enabled an easy exit for FPIs, there were few takers. The data speaks for itself. Indian investors have transferred wealth to foreigners. At the aggregate levels, DIIs have bought INR 17.5 lakh crores of stock from 2023 at a weighted Nifty level of 23710.

One more point. The trailing 12-month median PE valuation of the top 502 market companies (with Mcap of Rs 10000 cr or above) stands at 37x right now. In March 2020, the same was at 14x. The market breadth indicators showed a highly oversold situation then and shows the same now. But look at the valuation differential. The point is simple. Mere wealth destruction need not make a market attractive.

Quaterly Net FDI Inflows ($. Mn.)



Note: Date is from Jan-20 to Dec-25
Source: RBI, Spark Fund Research

The FDI flows (supposedly long term and stable) round up the picture. This has turned negative because there is easy exit for foreign investors through offers of sale in IPOs.

We have made this point rather forcefully that FPIs will not be back in India just because some local experts believe India is the lone growth island afloat (Chemistry of flows – Our newsletter dated Nov 2024). FPIs have choices. They always had and they still do. They will come if the risk adjusted opportunity is compelling.

The currency may need to be stabilized by increasing interest rates, thereby offering a credible backstop to the solidity of the unit of measure/store of value that the incoming capital will need to assess. Obviously, that requires accepting a growth cut which is anyway inevitable. Will we bite the bullet?

The inescapable conclusion from all that has transpired in the last two years is that India is a cyclical growth economy. More cyclical than the narrative build-up seemed to suggest. Be it IT services, which was considered a multiyear high growth secular story for many years even after data showed otherwise. Or retail where a leading name was expected to grow 35% for a decade before Covid – which then grew in teens. Growth compounding has been repeatedly interrupted by one development or the other. In investment lexicon, that is called cyclicality. Cyclical sectors (and markets) give up their valuation premium. India still offers a baseline growth that is reasonable and the cyclicality is on top of the baseline. The five-year mean of most widely used valuation measures looks elevated because of five years of complacency. Besides, none of the major fund portfolios have median valuations anywhere close to the market mean. This disconnect is all too obvious

Where does that leave us?

It leaves us in a vulnerable spot and there is no other way to put this. The market needs to heal by treating the causes (complacency, refusal to accept basic investment principles, too much story-peddling, high decibel marketing push likening equity investing to spectator sport) rather than the symptoms/effects (fear and drawdowns)

There is an opportunity to deploy capital with a long-term view as the market sells off. India has historically been good at crisis management. This is assuming that a full-blown disaster will be avoided by the world at large. As we deal with the aftermath, buying opportunities will emerge. Now is the time to stand up and say that we cannot time the markets beyond a point. When Nifty was at 26000 and above, the cracks were visible and we called them out. That was the time when the risk return reward deteriorated as the market kept scaling new peaks. **As the market slips further, we stress that the risk return reward is bound to improve.** However, even here, we are not saying that mere price destruction is a good reason to invest. The buying opportunity has to be palpable and well-reasoned on sound investment principles.

We need to assess which companies will be left standing when the tide ebbs away. The eventual recovery will be driven by themes that many may have seen as boring in the past. Growth is not going to come easy. India is likely to settle down into a market for adults. It is time to grow up.

Warm regards,
P Krishnan (CIO) and Team Spark Fund

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