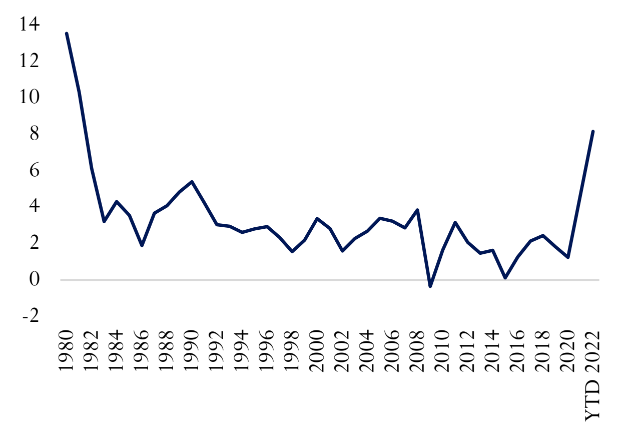
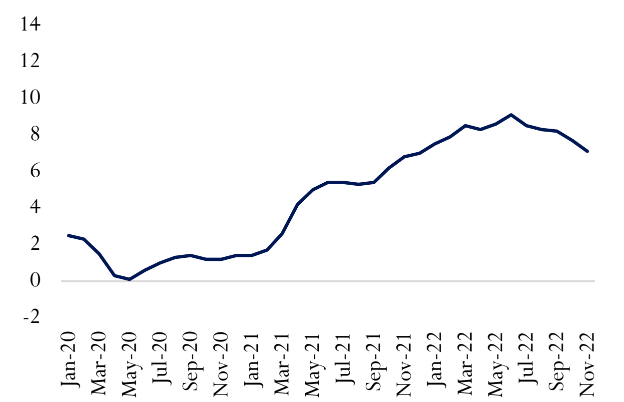
Rear View & The Path Ahead

There is no logic to markets following calendar year milestones. Yet we have a lot of analysis based on returns, missed expectations and events that transpired or were never to be. If nothing else, it is good to take stock periodically and why not at year end. Two events characterised the evolution of the world in 2022 and one more – maybe a truly epochal development – may have started to roll out by year end.

Inflation

First was the mother of all known unknowns. Inflation became the most debated and most dissected phenomenon of 2022.





Source: World Bank, Bloomberg, Spark Fund Research; Note: YTD as of Nov 2022

Inflation had begun to look ominous in 2021 itself. The pundits and the perma-bulls shooed it away, for no analytical reason. Being bullish paid off for the last decade almost invariably. This was true even at the height of Covid. The Fed Put was supposedly open-ended and after all everything was going to be all-right. This mentality was doomed to end in an accident. It did so with spectacular fanfare. All of the developed world reeled under price rises that most adults never experienced in their lifetime.

Implication 1 – **Equity valuations came off**. This was logical and was part of the writing on the wall that many refused to read for a while. Higher inflation = Higher rates = Lower PE. PE is not well-regarded by many and there may be a few valid reasons for the same. But most of the time, PE ratio is belittled for avoiding discussions on high PE ratios. Yet the measure remains a simple and straightforward one. Hence it is useful to draw attention to this. The PE was way too high. It came off and brought with it a fair amount of wealth destruction.

Implication 2 – **Fed Put expired**. In the long run, this is actually great news for free markets and for stocks. However, the expiry of Fed Put = End of one-way market = Hard time for all concerned = Not so comfortable existence for market pundits and money managers. After all, who does not like an easy life where all risks can be backstopped by Santa Claus.

Implication 3 – **Tech stocks tanked**. How could inflation have impacted tech? Only through the medium of valuations. The tech sector valuation was perhaps one of the most visible effects of the days of easy money. The chinks in the armour were exposed when the froth came off. Whether it is getting overdone now on the way down is the subject matter of another debate.

War

I have faced numerous questions on the risk of war in Kashmir during many years of traversing Europe as a fund manager. Maybe that was always a big risk and remains so and India has been plain lucky so far. That said, the war in Europe was something the Europeans and the world at large thought will never happen. Yet it came to pass.

Implication 1 – **Higher energy prices and more volatility**.

Implication 2 – **Accelerated de-globalisation**. Energy insecurity = Quest for self-reliance. This also meant that the world opened its eyes on how dependent it was on China for other elements of the supply chain. This is good news for India for the rest of this decade.

Implication 3 – **Europe is severely challenged**. This has been evident for a while. While Europe can seize the moment and reverse course, we will be surprised if that were to happen in a hurry. Poor demographics, high debt, lack of incentives to be competitive, policy & directional lethargy – you name it and Europe has issues everywhere. This has positive implications for capital outflows from Europe to accelerate and India can be a beneficiary if it delivers.

We do not want to go into the risks arising out of the war spinning out of control. They are too dire to quantify. Additionally, this is an event whose probability assessment is outside the scope of any well-reasoned analysis. For 2023, we focus on one event which has started playing out towards the fag end of 2022. Which is a China that is facing unprecedented challenges.

China – May hog the headlines in 2023

China has always been centre-stage. But the reasons in 2023 could be different. The way Covid will affect life in China may be known in the next few weeks itself. There are dire predictions and that is not the point. There are several takeaways from what transpired in China towards the end of 2022.

1. **Popular pressure forces the hands of the ruling dispensation**
   Tiananmen was the last time when Chinese people protested on a large scale. The government did not buckle then. This time, the government was forced to do a volte face. Maybe the ruling dispensation underestimated the level of public angst. Maybe the economic cost was too much of a price to pay. In any case, the manner in which the Zero Covid policy was dismantled has laid bare the fact that the iron fist has cracked. Dire predictions on China have never worked in the past. That said, this may be a turning point for the Chinese society. One way or the other, this will have implications for the rest of the world.

2. **Can the economy make a comeback?**
   This question will come into centre-stage once China gets the health emergency to pass. It is widely assumed that there will be a big boost in economic activity as pent-up demand is uncorked. There are also hopes that the government will propel the economy with a stimulus to keep the populace satisfied and get back its mojo. There is a lot that has changed in China as well as the rest of the world since 2008 when a large-scale stimulus was employed. The economy is very much likely to show some energy due to the low base effect. But it remains to be seen whether it can get the momentum going again.

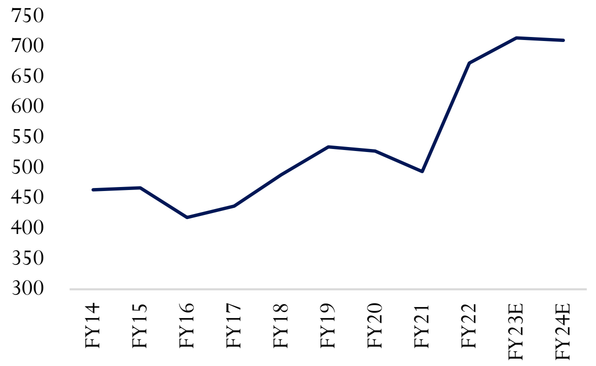
3. **Will things be the same again for China?**
   This is perhaps the most pertinent question. Will the people agree to go back to business as usual? Will there be a clamour for a more liberal regime and for political rights? Can the economy defy the demographic drag and deliver better living standards? While it is too premature to conclude on any of these, suffice to say that China will find the going increasingly difficult due to many headwinds it faces.

   The way China evolves from hereon will have an impact on the world in 2023 and beyond. Any sustained slowdown in China or anything like a disorderly development there can have implications for global markets. Markets don't like the looks of the black box. Precisely because no one knows what is inside the same. On the other hand, the eventual decline in the economic power and influence of China can be a positive trigger for India in an indirect sense. As a large market and an alternative sourcing base, India will add one more trigger to its own growth outlook even as China may be forced to adjust to the new normal, whatever shape it might assume.

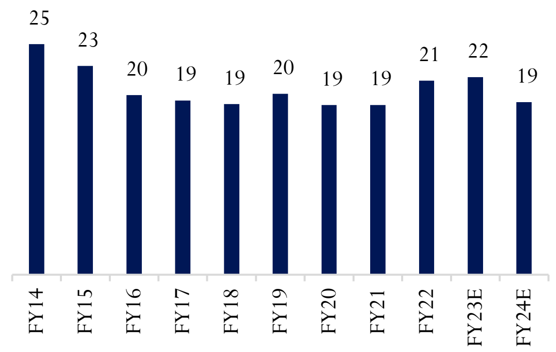
How about India?

Indian market bucked the trend in 2022. The economy was however showing the strains of the global drag by the fourth quarter of 2022. It looks clear that as far as GDP growth is concerned, India will have a difficult time in 2023 if the world continues to slow down. It is exports which is the culprit.

India's exports ($Bn)



Contribution of exports to GDP (%)



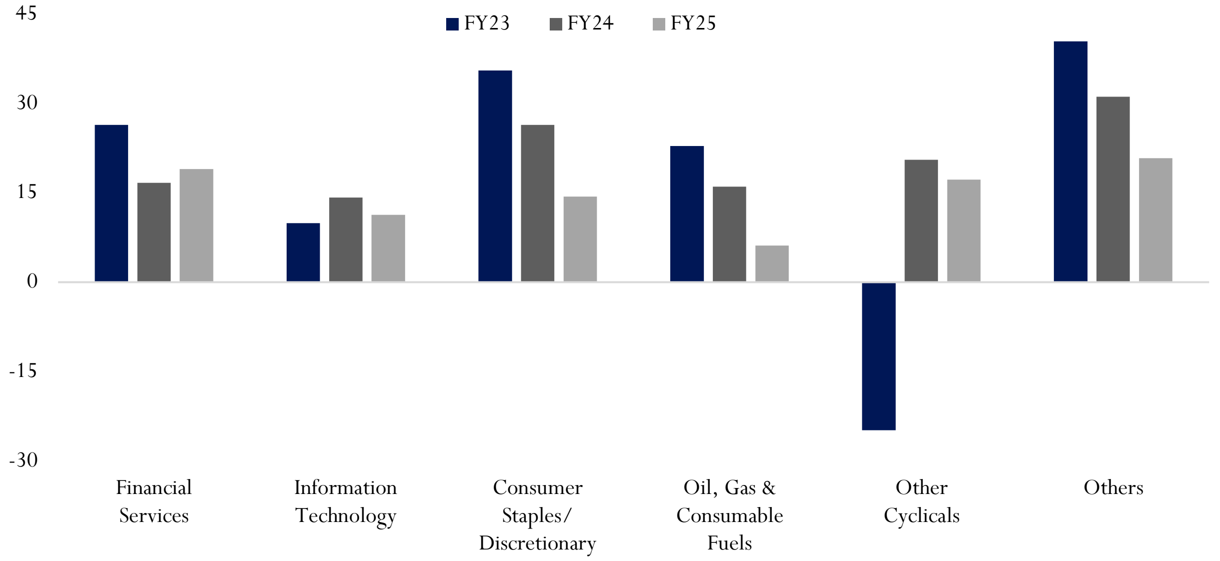
Source: MOSPI, RBI, Avendus Spark IE, Spark Fund Research

Exports have been an important contributor to India's recent resilience and that is clear from the charts above. The correction in the export share of GDP is the main reason for downgrades to India's GDP outlook. This has some implications that are negative but some promising signs show up as well.

The domestic economy is placed on a decent footing with oil prices and inflation showing signs of easing. As emphasized time and again, India's credit cycle is still young and has a long way to go. The capex cycle is looking to pick up. China's loss could be India's gain in terms of India emerging as a counterbalancing sourcing base.

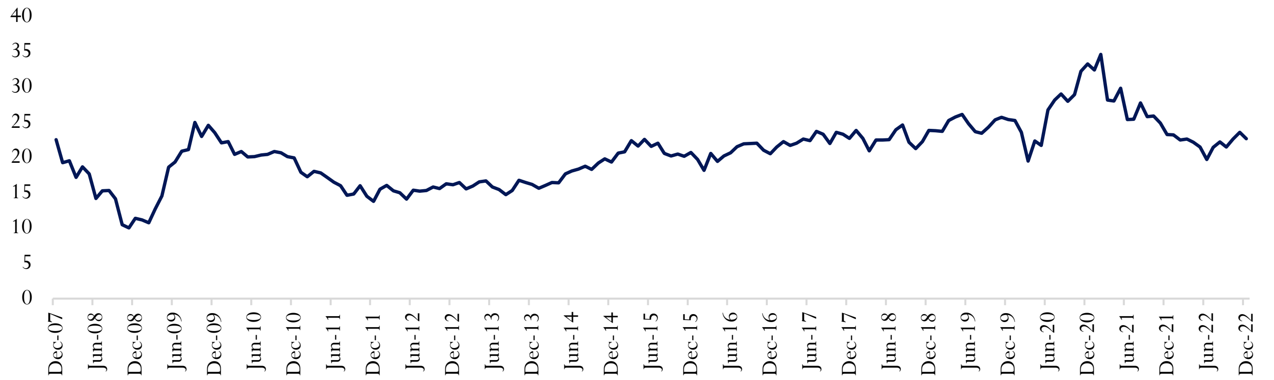
At the end of the day, it is earnings which will determine what the market could do in 2023. The earnings outlook for the domestic-oriented sectors looks fairly comfortable and reflects the ongoing re-balancing of growth drivers towards core India. While this is still work-in-progress, the trend in valuations is an eye-opener.

Nifty Profit Growth Estimates (%)



Note: Weighted based on Nifty50 Index
Source: Bloomberg, Spark Fund Research

Nifty Trailing P/E (x)



Source: Bloomberg, Spark Fund Research

While it is a common refrain that the market has become expensive, the P/E has actually moderated somewhat over the last few years. The trailing PE is a dependable number and if we are right about the growth levers of core India staying strong, the market valuation on a prospective basis is not a cause for alarm either. Large domestic-centric sectors such as banking, cyclicals and capital goods have shown a revival in earnings. These sectors are set to drive further growth in market earnings going into 2023 and beyond. The market remains sceptical about the prospects for these sectors judging by the reaction as it touched a new high in December.

We have seldom seen a major market high greeted with so much disbelief. The valuation is higher than mean but not higher than the occasions when previous highs were breached. But it was almost as if the opinion makers wanted to be apologetic for getting to a new high. There is all-around disbelief in the India story. There is no fundamental reason to support such huge scepticism even as we agree that external drivers of growth are strained. To us, this is a good set-up for the market to start navigating another year filled with uncertainties.

Warm regards,

P Krishnan (CIO) and Team Spark Fund