HAS THE MARKET RUN INTO A WALL

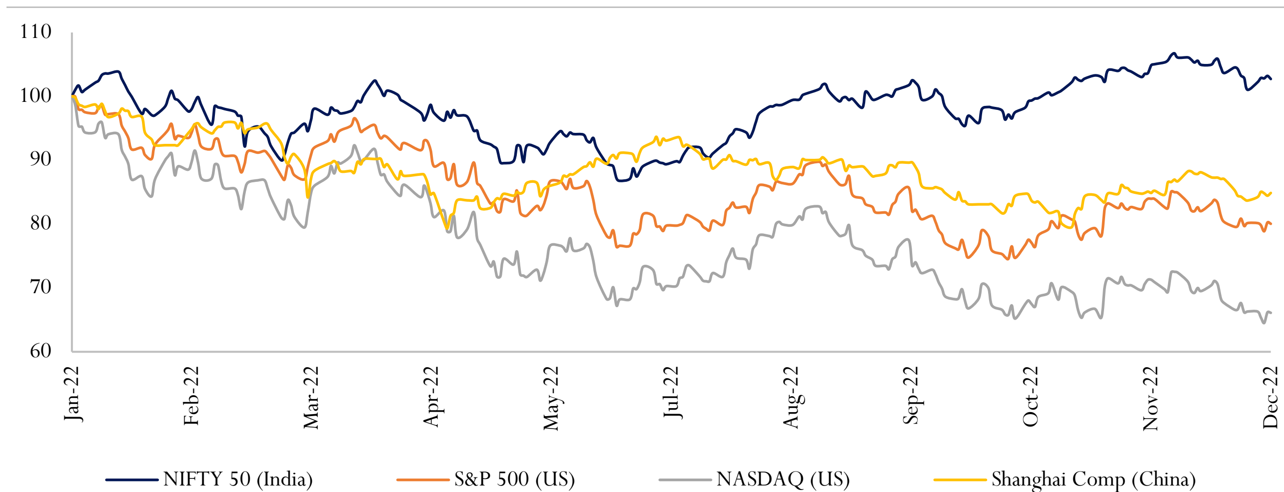
The simple answer is – Yes. It has certainly hit a wall of worries. The more difficult question to answer is – How steep is it this time. We will know in time but at this point, let us look at what is bothering the market.

At the outset, let us keep the following in view

1. The weakness in India is a reflection of the developments in global markets, particularly the market that matters most – which is the US market.
2. Nifty has seen an 8% correction so far. No big deal.

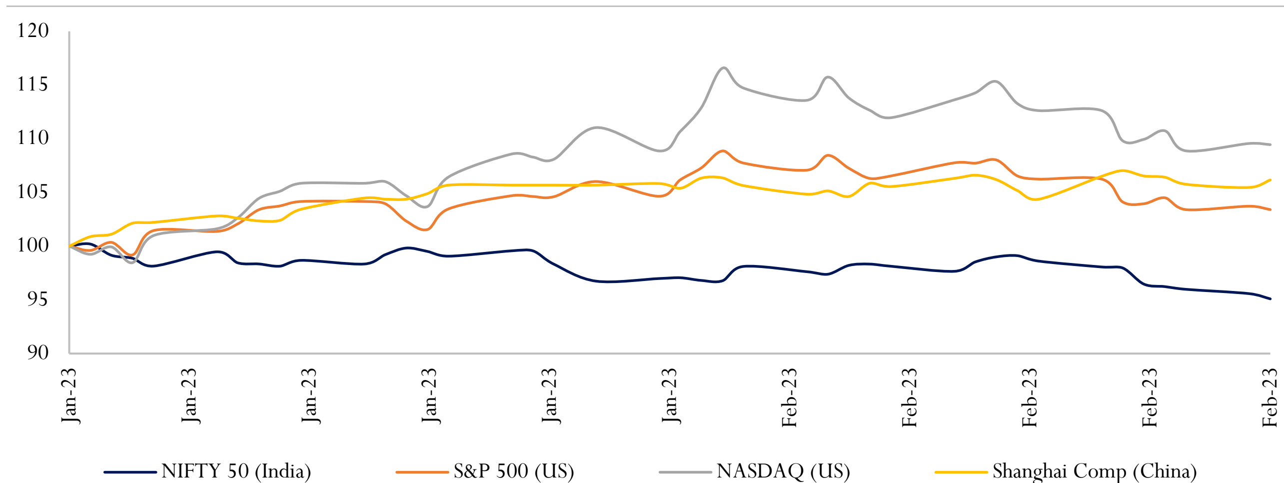
The weakness has raised more than its fair share of curiosity and debate because India has lagged the US and global markets in the last 2 months.

2022 Performance



Source: Bloomberg, Spark Fund Research

YTD 2023 Performance



Source: Bloomberg, Spark Fund Research

It is quite obvious that it is too premature to call out this under-performance as India was a stand-out performer in 2022. Yet this debate is relevant because of the following.

1. The global backdrop of growth and the views on the outlook for the same.
2. India's ability to buck the trend as it were.

Global Backdrop

If we cut out the noise element which is deafening, the global outlook is not great. The discussion in recent weeks has been intensifying around the type of landing that the US economy is headed for. Even a "No landing" scenario has been brought in. There is a lot of hair-splitting over each scenario and the information overload is so much that we risk losing the plot. Some simple questions to ask would be.

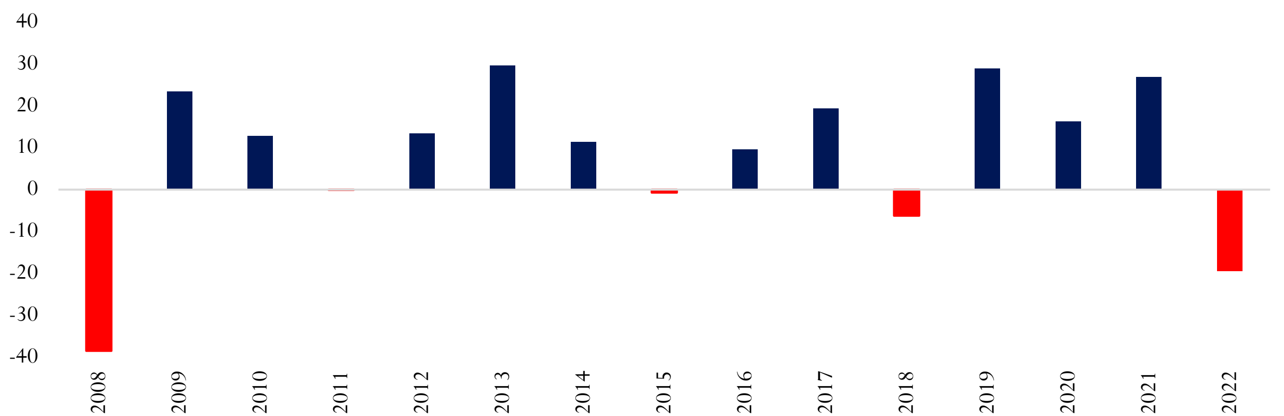
Is inflation looking like it has been conquered? The broad answer would be NO. Not yet.

Are interest rates going back to 2%? Answer would be NO again. Not in a hurry.

Is US growth looking to accelerate meaningfully? Answer would be NO. Not on a consistent basis as all the stimulus on the monetary and fiscal side has probably exhausted itself and you can stretch the envelope only by so much.

Therefore, it would appear that all that the market participants want is a positive spin for the near-term outlook. If the interest rate hikes are seen as ending, the market believes it can find a sustainable bottom. There is an inherent bullish bias embedded in this.

S&P 500 Annual returns (%)



Source: Bloomberg, Spark Fund Research

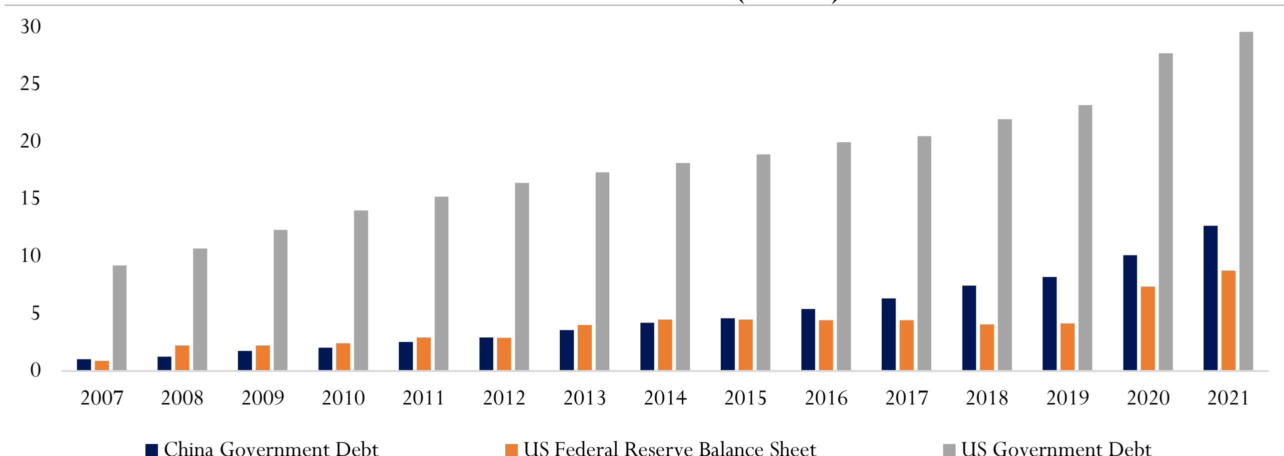
2022 was the worst year for S&P after the global financial crisis. What is useful to note, and ingrain is that this happened two years after Covid and there was no economic crisis like in 2008. At the worst, we are only talking about a shallow recession (as of now).

What gives then?

Severe headwinds ahead and not just air pockets

One - Debt levels across the world have gone up steeply.

China & US – Debt levels (USD Tn)



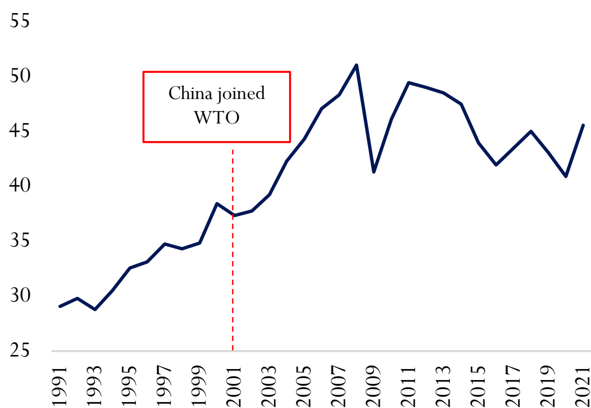
Source: International Monetary Fund (IMF), US Treasury, US Federal Reserve, Spark Fund Research

This heralds a new era in financial repression which could be more inflationary than is being currently factored in. Therefore, the tug of war in the mind of the market is between the near-term gratification that might come from the possible end of tightening (if that were to happen – no one is sure) and the overwhelming reasons as to why inflation cannot easily be bottled up. The proponents of financial repression as a theme that is here to haunt us for a while argue that the governments in the developed world will want to see inflation at higher levels. It would help them in dealing with debt servicing in the medium term at the cost of effectively punishing the savers who are the creditors in this case. The savers include China of course. In any economy, the savers will be fewer in numbers as against the vast majority of people who owe money, and the inequality has only made this equation more lopsided. Why would politicians bother about the smaller voter base representing the savers?

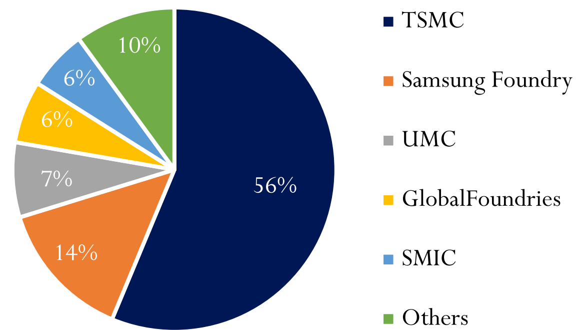
All this is okay until you look at history. Prosperity and long-term market returns have resulted from low and sustained levels of inflation over long periods and if we are staring at the opposite, the equity cult itself will come under threat. We don't have enough data to conclude in favour of these extreme views. But global markets are right about worrying.

Two - De-globalisation

Global (Exports +Imports) as a % of GDP



Global Foundry Market - 127bn USD

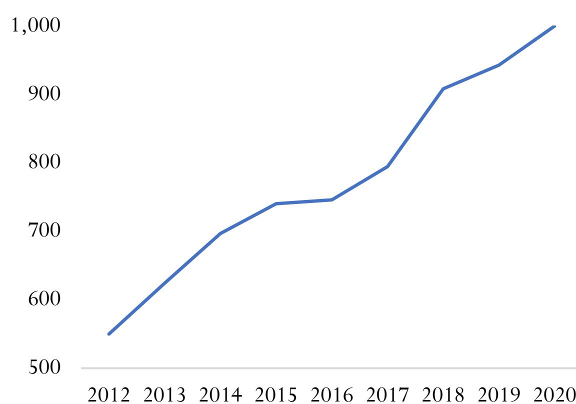


Source: Bloomberg, Company reports, Industry reports, Spark Fund Research

China was undoubtedly one of the big driving forces behind globalisation of trade. Look at how trade boomed after China entered WTO. This was already in decline when geo-politics got really nasty with the war in Eastern Europe. Take one look at the market share of foundries in Taiwan. It is quite apparent that the impact of any tension in Far East on global supply chain is nothing short of catastrophic. Now that the war has not gone the way Russia wanted it, there should be relief that China will think twice about any high-handed action in Taiwan. But the writing on the wall is clear. We are in an era where countries will look increasingly inwards and sideways. There will be limits to scale economies and supply chain efficiencies.

This bodes rather well for India. Look at the unit labour costs for China and how they have moved.

China - Average monthly earnings of employees in manufacturing (USD)



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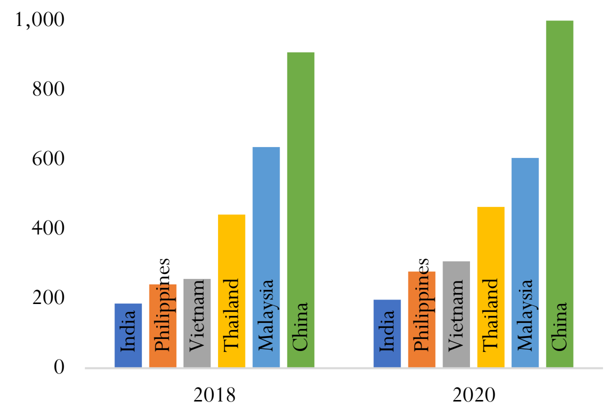

Source: International Labour Organisation, Spark Fund Research

De-globalization is not such a bad thing for India. However,

China provided the deflationary momentum which kept price rises low in an era when debt was riding inside a balloon inflated by central bankers. Due to geo-politics and labour force dynamics, that force is absent now. The Central bankers have also re-discovered the joy of sticking to their primary mandate. Equity markets have every reason to feel orphaned in 2023 after the reality of the last 18-24 months has started to sink in.

Where is India in all this?

India is very much tied to the global dynamics. The nuanced view here is that Indian economy stands to benefit to some extent at least from the emerging scenario. For one, financial repression is not new for India and Indian policy making. SLR is a legally sanctioned medium of financial repression. While rising government debt will do no good, India has been there before. Secondly, Indian government debt is largely funded by domestic savers. Here again, Indian savers are used to this forever. For India, a 4% inflation will be no bad development (relatively speaking). For the developed world, 4% will not give any comfort other than from a very short-term point of view. Thirdly, India stands to benefit from supply chains branching out and developing many nodes. India may not be the most efficient producer in several areas. But it has the potential to be competitive. It also has a large market within. In tradeable services, it has proved its mettle. It can do an encore in manufacturing. Finally, India's banking system has got a lot healthier than people realize. The pandemic has been a great washing machine for all the residual dirt that the extended credit downcycle produced over a decade of trouble.

It is fair to say that Indian economy is likely in an air pocket than in any sort of bigger trouble. However, the Indian stock market must contend with the new normal. If interest rates are going to be generally on the higher side, valuations are likely to normalize which many investors cannot cope with. The 65% return in the last five years was powered by a post-Covid binge of optimism on leading index names powered by a valuation expansion which is what is raising the height of the wall of worries that the market has hit.

The reasonably healthy outlook for the economy and manufacturing over the next 3-5 years needs to be balanced with the challenge of dealing with vastly exaggerated valuations amongst the leaders from the post-GFC easy money era. Whichever way it cuts, the outlook cannot be great for index hugging.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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