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The tale of two problems

RBI increased the policy rate in May midway between regular review meetings. In a way, this has set the cat amongst the pigeons. The range of inflation expectations has become wider. There are forecasts that hint at the CPI bridging the gap with WPI. The WPI is at about 15% and CPI is at about half that number. There are also observers who believe that CPI will peak out soon. This kind of divergence in expectations has roiled the equity markets. To say the least, the markets have been volatile and beneath the surface, the pain has been intense. This has been so globally as well.

We try to cut to the chase. We believe that there is a clear case for bifurcating the problems in the equity market from the problems in the economy.

The equity market problem

The equity markets around the world have a simple problem. Many investors, including institutions with influence and sizeable funds, assumed that money will remain cheap practically till kingdom come. They believed that the Fed Put is for free and perpetual. Maybe the Fed behaved in a manner which gave the perma-bulls a lot of confidence. Maybe, the Fed did not feel it necessary to emphasize what was always true – which is that their dual mandates were for price stability and low unemployment. Asset markets were never part of the Fed mandate. Whatever it was, the Fed has now made it known that their mandate is what it always was on paper – price stability and low unemployment. With 8% inflation in the USA, prices cannot be termed as stable. It is now clear that the Fed will relax their view on rates only if inflation is back in their comfort zone and/or job losses mount.

We have argued repeatedly that what is good for the geese holds good for the gander. If valuations expand when interest rates come down, they have to contract when interest rates move up. In an era of easy liquidity, the equity markets developed many blind spots. Here is a sample

Error of extrapolation – Interest rates will keep dropping and valuations will keep expanding.

Error of relying on convenient metrics – PE was not a good measure (Because it did not suit the purpose of the bulls) but other measures anchored on cash flows, management strength or leadership were great (even though it was suspect how these could diverge from profits and hence PE for long; the advantage obviously was that there was no reference point for some of these measures and hence it was convenient – how do you quantify management premium or what on earth is the limit for leadership valuations).

Error of relativity – Most forecasts are increasingly compared with expectations – not even with similar period sequentially or last year. What mattered was whether the earnings missed or exceeded the expectations of a bunch of analysts – no matter what assumptions they used. For some companies, expectations in 2018 were originally for growth at 2-3 times nominal GDP and hence high valuations were deemed as justifiable. When the outcomes were below half of that, the goal post changed. These companies became Buys at even higher valuations because they have beaten analyst expectations which by now had moderated! Unbelievable but true.

Error of infallibility – Some managements were (and ARE though the aura is wearing off) considered so great that misses in expectations relative to low bars were also kosher. They were (are) considered to be possessing the golden touch. After all, the need for quantifying outcomes goes away when you put these companies in exempted category.

Error of stretchable timeframes – From one-year forecasts which were considered possible to get a handle on in a risky domain such as India, we moved to next year and then two-year forward earnings. Now, there are reports who barely mention which timeframe an earnings forecast refers to when it comes to a target multiple. In an era where business cycles are becoming shorter, the fallacy of this kind of approach is self-evident.

Error of relying on semantics – When it comes to the so-called Unicorns and other IPOs which caught the market fancy, semantics mattered more than the substance. Path to profitability, Gross Merchandise Value (In a different era, trading firms used to have very high GMV or equivalent but such trading turnover was never presented in cleverly packaged metrics), body language (always wonder what has body language got to do with valuing a firm) and investor pedigree (what does it matter if a private equity investor has a successful past – a PE investor is still a pure financial investor) et al - have become buzzwords. If some companies have 2040 projections to anchor expectations, enough said. If anyone mentioned the word bubble, that alone was an inappropriate expression.

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Now that easy liquidity is seemingly deserting the asset markets, fear has started to grip investors. That is the nub of the problem in equity markets. Equity markets are in a nasty hangover which resulted from a motley cocktail of opportunistic positioning, greed & exuberance. Unfortunately, this has always ended badly for investors.

The economy problem

Inflation is the obvious villain. Here, we want to try and see if there is a more sanguine picture ahead.

Let us first look at the trajectory of inflation in India then and now (from 10 years back when there was an inflation/currency scare in emerging markets)

Particulars - India	2012	2013	2014	2018	2020	2021	2022
CPI (%)*	9.8	8.5	8.5	4.6	7.2	4.2	7.8
WPI (%)*	7.5	3.7	5.1	3.6	-1.6	10.7	15.1
10-year Bond rates (%)*	8.7	7.7	8.8	7.8	6.1	6.0	7.1

*Source: Bloomberg; Note: * the data pertains to the month of April for each year*

The CPI is lower now. Note that WPI has a steeper base effect from the recession and WPI was done away with as the primary reference point for policy because of its inherent limitations. Real interest rates were negative for a long time in India (even before 2012) and that was a key problem. Now, the RBI has addressed the issue right when the problem has started to aggravate. This is a crucial point to note.

Now let us look at CPI in the USA

Particulars - USA	2012	2013	2014	2018	2020	2021	2022
CPI (%)	2.3	1.1	2.0	2.5	0.3	4.2	8.3
10-year bond rates (%)	1.9	1.7	2.6	3.0	0.6	1.6	2.9

*Source: Bloomberg; Note: * the data pertains to the month of April for each year*

India had negative real rates then while the US is in that position now. In fact, it is the first time in over 40 years that the US has real rates are way behind India. We are not suggesting that this is sufficient reason for capital flight from the US to India. While India has always been a high-inflation country, the current inflation problem is imported be it in terms of the source of the category (commodities) or the geography (the developed world). It does not mean the pain is any different. However, it means that we should also pay attention to how India is placed otherwise.

Particulars		FY12	FY13	FY14	FY18	FY20	FY21	FY22
Bank NPAs (%)	SBI	4.4	4.8	5.0	10.9	6.2	5.0	4.0
	Banking system	2.8	3.2	4.1	11.5	8.4	7.5	6.7
	HDFC Bank	1.0	1.0	1.0	1.3	1.3	1.3	1.2
	Average for SBI, PNB, BOB	3.0	3.8	4.4	13.9	9.9	9.3	7.5
	Average for HDFC Bank, Axis, ICICI	1.9	1.8	1.8	6.0	4.1	3.5	2.6
Bank Credit Growth (%)		19.3	14.4	14.1	10.2	5.0	5.6	9.7
Cement Demand (mmt)		230	244	251	300	327	324	344
Cement Capacity (mmt)		343	368	386	473	502	518	542
Steel Demand (mmt)		71	73	74	91	100	94	106
Steel Capacity (mmt)		91	97	102	138	142	144	154
Hind Unilever Sales Growth (%)		17.0	16.2	8.1	1.1	2.6	18.1	10.6
Asian Paints Profit Growth (%)		15.8	13.6	8.9	2.1	25.6	7.2	-3.9
Infosys Dollar Revenue Growth (%)		17.0	5.0	11.9	7.1	8.3	5.7	20.6
TCS Dollar Revenue Growth (%)		25.0	13.1	17.0	8.5	5.7	0.0	16.4
L&T Order Book/Trailing Sales (X)		1.7	2.0	2.5	2.8	2.8	3.5	3.3

Nifty EPS Growth (%)	7.4	11.7	8.1	-1.0	-4.8	19.0	42.5
GDP Growth (%)	5.2	5.5	6.4	7.0	4.2	-7.3	8.7
India Forex Reserves (USD bn)	294	293	304	424	476	588	618
India Current Account (% of GDP)	-4.4	-4.8	-1.7	-1.8	-0.9	0.9	-1.1
Fiscal Deficit (% of GDP)	5.8	4.8	4.6	3.5	4.6	9.2	6.9

Source: Bloomberg, AceEquity, Company Annual reports, RBI, JPC, Spark IE Research

Note that the markets and economy are forward-looking. The NPAs in the banking system are on their way down now and not about to go up. The reported NPAs were lower ten years back only due to lax recognition standards and rampant evergreening. The seeds of trouble in the banking system were already firmly sown back then. Given the tepid loan growth in the last 4-5 years, it is hard to argue how new NPLs can become a headache. NPAs will either succeed reckless lending and high leverage (post 2010) or follow economic shocks (post 2020 – India seems to have weathered that rather well).

Demand over-heating and capacity constraints are not the problems we face right now. Supply chain disruptions exist but they should blow over. Commodity prices have no doubt undergone a reset but they were depressed for over a decade. Given weak global demand, a spiral is unlikely.

Save the fiscal balance, India seems to be positioned reasonably well on most metrics. The average EPS growth for the Nifty from FY11 to FY20 was 4.4%. The average earnings growth in FY 20-22 stood at 30.2%. There is no doubt a base effect from the pandemic recession. Recessions are supposed to be market clearing events which extract efficiencies. It is likely that the earnings growth will remain reasonable for at least 2-3 years.

India seems well placed to come back strongly as and when the global inflation scare is tackled. It might come at the expense of a tax on global growth (likely - the US may already be in recession though a shallow one at that). Expectations in India have moderated to adjust for a lower global growth which will retard the Indian growth as well. The Indian GDP expectations are now trending below 7.5% for FY23. This is a far cry from the double-digit growth expected for FY23 some 6-9 month ago. The post Covid recovery seems to have fizzled out. We are now on level ground. There are risks no doubt – oil going above USD 150, tail risks to the banking system from a post-Covid recovery going into a coma etc. But these are not high-probability outcomes and the upside to the economy later in FY23 and FY24 can come from traction from a private capex cycle now in its baby strides, continued momentum on the GST front, reversal of capital flows to India and signs of stability on the commodity front.

The problem for the equity markets remains. Unless the equity markets agree to shed the excess flab and unless there is a realization that equities are financial assets with a finite intrinsic value (whatever the metric, there are boundaries), the market struggle could continue. The mini bubble in the market (mini because it was only in expensive stocks of all shades) may have been pricked. We are on a long journey towards sanity check. Stock selection will matter. Avoiding stocks or stock de-selection is very much an integral part of this adjustment process.

Warm regards,

P Krishnan (CIO) and Team Spark Fund