The lessons from the UK

The UK has become the favourite entertainment spot for the Twitterati in the wake of the theatrics at the top of its governance structure. The famed British humour went into overdrive against itself for a change. Amidst all the semantics and optics, two takeaways stand out from the comedy of errors in the UK.

1. There is a limit

   To how much you can borrow even if you are the sovereign.
   To how far you can go in taking markets for granted.
   To the Goldilocks mentality that everything ends well if you hang in long enough.
   To the notion of continued prosperity based on executive fiat.

2. The fight against inflation is likely a marathon and not a sprint.

On the first point, the lessons for the rest of the world (and for India) are obvious. You cannot run to the printing press to solve the problems that governments are elected to solve and Central Bankers are mandated to counter. Growth is not a sovereign right. It is not just developing countries (like Sri Lanka) which can crash. The linkages in a world of too much money with open borders are complex. No one has the executive heft to use grandstanding to solve serious economic problems.

For India, the warning bells should ring on freebies and (lack of) fiscal prudence. The freebie culture is more visible in the states and is increasingly the tool of regional parties to try to manoeuvre around the powerful political juggernaut that rules India, the Centre. The rope is not all that long and its end might come sooner than you imagine. On fiscal prudence, the NDA-II has actually been responsible and circumspect. This is one of the reasons behind India's resilience. The government did not board a helicopter to spray money when the pandemic hit us hard. So far so good. However, the cracks are visible on the external front primarily through the USD-INR dynamics. We have been a bit blindsided on the extent of depreciation of the INR. The reason is that the world is running away from all sorts of risks and the USD is the safe haven of choice. This race to the bottom is not good for India's external balances, its ability to fight inflation and for domestic capital formation. It is to be hoped that the government will keep up the good work in terms of relative fiscal prudence (although we are way above the mandated comfort zone) and resist the temptation to do a pre-election binge or tax populism. The urge to tinker is an ever-present danger. We have no option but to keep our fingers crossed and wait. But there is a huge opportunity to capitalise on the goodwill towards India and the indicators are promising.

On the global fight against inflation, the signs are ominous more in terms of the duration rather than the increasingly infructuous business of calling the top. Thus, the optics of when exactly the Fed will pivot is less relevant in substance than how far the rates can fall and how slow. Having said that, the Fed pivot is all that the perma bulls seem to care about, possibly so that they can go back to business in taking up the markets. This time around, the markets may not be in a mood to listen.

The seeds of this inflationary spiral are sown in the debt mountain that has kept piling up. Take a look at the debt burden of various countries.

Central Government Debt to GDP (%)	2015	2016	2017	2018	2019	2020
France	77	79	80	81	81	93
Germany	45	44	41	39	37	45
India	46	46	44	44	46	55
Italy	130	130	130	130	130	151
Japan	190	195	194	196	199	221
Russian Federation	14	14	13	13	13	19
United Kingdom	86	86	85	85	84	103
United States	87	89	89	91	93	119

Source: International Monetary Fund, Spark Fund Research

Private Debt to GDP (%)	2015	2016	2017	2018	2019	2020
France	193	199	201	206	211	237
Germany	117	117	118	119	121	131
India	95	89	85	86	85	93
Italy	119	115	112	110	110	122
Japan	152	154	155	158	162	181
Russian Federation	104	99	99	97	96	116
United Kingdom	156	160	162	161	156	170
United States	148	150	152	151	151	164

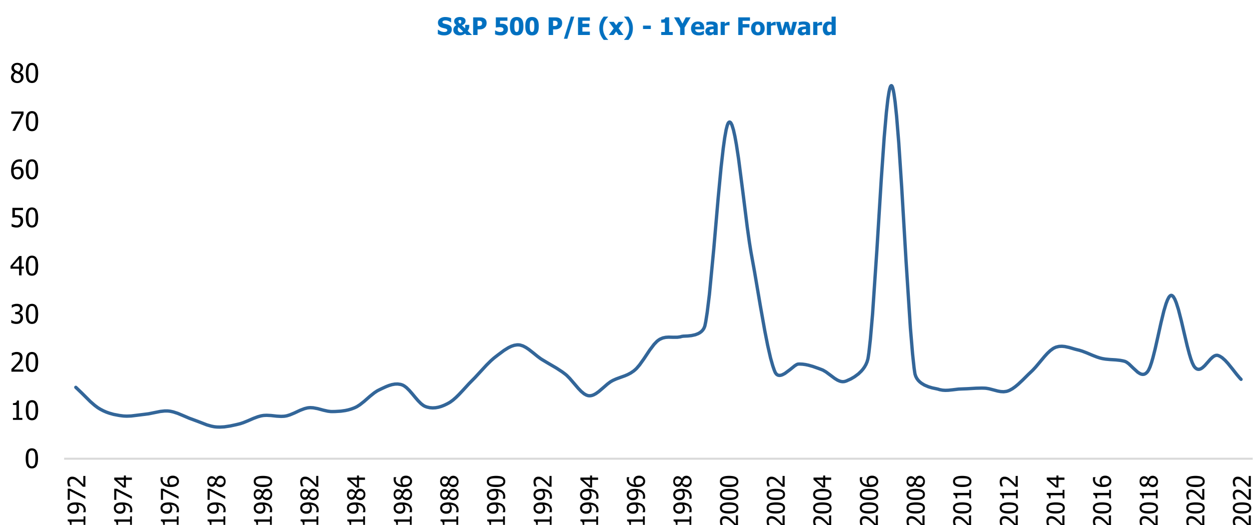
Source: International Monetary Fund, Spark Fund Research

The debt servicing ratio was kept low when interest rates were driven down by Central Bank action. De-globalisation, Covid and the Ukraine war have finally forced the hands of Central Banks and the game is up. We should believe the Fed honchos when they say that the fight against inflation is going to take time.

There is one more sinister reason that points to higher for longer when it comes to inflation and rates. History tells us that governments have used inflation as a means of settling unsustainable debt and future IOUs. UK is well on its path. Other developed country governments need to resort to this. Simple Math shows that higher nominal GDP and taxes on the same will be needed to mitigate the debt burden and pension commitments. The governments may need high inflation even as they will come under pressure politically. This will lead to muted real growth and a dent to prosperity in relative (or absolute) terms. **Rates remaining higher for longer does not mean that rates have to keep going up. Rates can remain sticky on the downside**. This has implications for stocks – globally and in India.

Valuations matter

This has been our consistent message over the last many quarters. Let us first look at longer term valuations for S&P 500.



Source: Bloomberg, Spark Fund Research

Valuations shot up in the wake of the precipitous fall in the cost of money. The inverse correlation between interest rates and equity valuations is a well-understood fact. The S&P 500 valuations have come well below the recent averages (and indeed below long-term trend levels, though the headline numbers may be inaccurate if earnings will see a dip due to a 2023 recession). What is evident is that the equity valuations have scaled back discounting the higher cost of capital (interest rates). If global inflation remains sticky and

higher than the levels of the last 25 years, equity returns cannot hinge on valuation re-rating. And the higher valuations, wherever they are, will come under severe scrutiny. It is already happening globally and in India.

Amidst this backdrop, India's out-performance has stood out.

Return in local currency (%)	CYTD-2022
Bovespa (Brazil)	10.7
Nifty 50 (India)	**4.7**
FTSE 100 (UK)	-4.2
Nikkei 225 (Japan)	-4.2
S&P 500 (US)	-19.0
Shanghai Composite (China)	-20.1
Nasdaq (US)	-30.2
Hang Seng (Hong Kong)	-36.5

Returns in USD (%)	CYTD-2022
MSCI Emerging Markets	-31.2
MSCI Brazil	10.7
MSCI India	**-8.0**
MSCI Taiwan	-41.3
MSCI China	-43.9

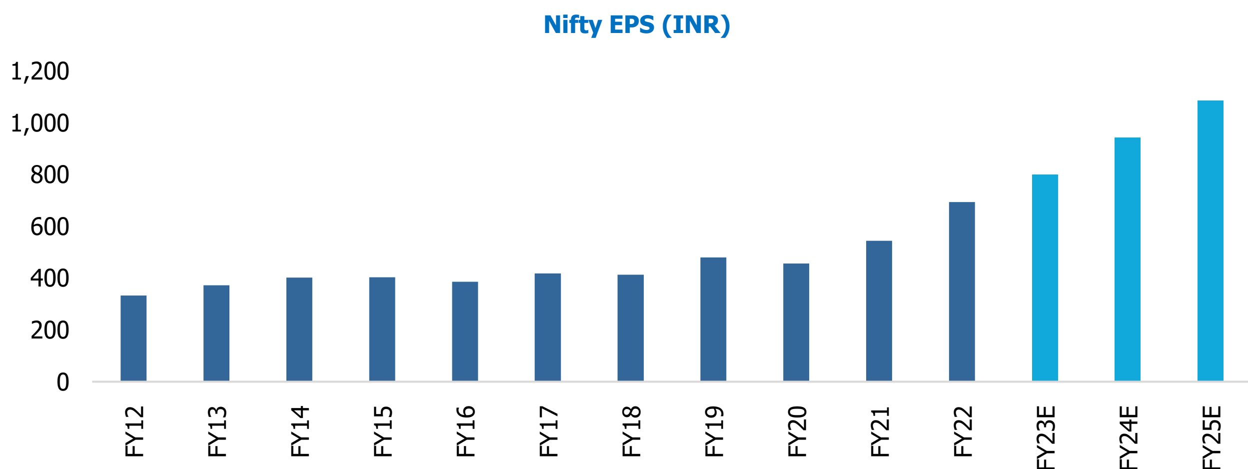
Source: Bloomberg, Spark Fund Research; Note: Prices as on 31 Oct 2022

Index	10 Year CAGR (USD, %)	MSCI EM Country Weights (%)	
		Sep 2002	Sep 2022
MSCI Emerging Markets	-1.6		
MSCI India	**6.5**	**4.6**	**15.3**
MSCI Taiwan	5.7	13.0	13.8
MSCI Korea	-0.2	23.2	10.7
MSCI China	-2.2	7.0	31.4
MSCI Brazil	-4.9	5.3	5.8

Source: Bloomberg, MSCI, Spark Fund Research; Note: Prices as on 31 Oct 2022

It is clear that India has been an outlier in the emerging markets universe. We believe that this is not an aberration nor is it illogical. At 15%, India's weight in emerging market indices is at its highest but is still lower than that of China. It is also lower than the peak weights of markets such as Taiwan and Korea during their heydays and then again, India is a much larger economy. The divergence of India from other markets is supported by fundamentals to a large extent. India's out-performance is more sustainable than people give it credit for.

Take a look at the Nifty earnings



Source: IIFL Securities, Spark Fund Research

Factoring the traction in the economy, the projections for FY24 and FY25 are achievable barring extreme outcomes for the global economy. Juxtapose these numbers against where the Nifty trades at, and the Indian out-performance as well as current levels of the index are well explained. It is possible that a shock development (by nature hard to predict and therefore in the realm of speculation) can dent this story.

Further, India's debt is largely internally funded. The banking system liabilities are all financed by domestic savings. So are most of government borrowings. The fact that the cost of capital in India generally stands above inflation is a positive. Cheap capital is not always good. A good part of India's out-performance is owed to the fact that the good listed companies in India have earned returns above their cost of capital which has exceeded inflation. Domestic retail flows into equity are well supported for now and that has already worked as a bulwark against foreign selling.

At a different level, the Indian economy has come out of Covid recession in a relatively good shape. With the benefit of hindsight, we can now say that the post-recession recovery in India has morphed into a cyclical recovery which was for long work-in-progress. This has gained some traction despite the global headwinds. What we see on the ground is a possible acceleration in growth led by financials (favourable credit cycle which can last longer than is being given credit for), revival in manufacturing (China +1, now turning into Minus China Plus One in select pockets) and a Capex cycle which can become more meaningful with time. Without getting ahead of oneself, what we see is an India which is showing signs of delivering on some of the promises it always held out. What we also see is scepticism which has always followed any uptick in India. The market may be smarter in dealing with this complex situation as against the pundits and narratives.

That said, stocks with lofty valuations need to go through a reality check. The first signs of the same are visible in the Unicorn universe where valuations are at levels not based on earnings. Look at the data below. It is clear that the same market which is near an all-time high in a bad, bad world has been very clear in doing what it has done to stocks which were draped in hype and baked in a bubble.

Company name	FYTD-23 returns (%)	Returns from listing price (%)	Returns from issue price (%)
Star Health and Allied Insurance	0	(16)	(21)
One97 Communications (Paytm)	21	(67)	(70)
PB Fintech (Policy Bazaar)	(44)	(66)	(61)
FSN E-Commerce Ventures Ltd (Nykaa)	(32)	(42)	2
Aditya Birla Sun Life AMC Ltd	(24)	(43)	(43)
Zomato Ltd	(23)	(45)	(17)
Nazara Technologies Ltd	(20)	(67)	(40)
Adani Wilmar Ltd	30	204	192
Latent View Analytics	(7)	(26)	99
Aptus Value Housing Finance	(7)	(4)	(11)

Source: Bloomberg, Spark Fund Research; Note: Prices as on 31 Oct 2022; Disclosure: Neither do the client strategies nor does the investment team of SAIMPL hold any of the above-mentioned stocks as of October 2022. The information and opinion expressed hereinabove does not constitute as an investment view at this point.

What now for the expensive market leaders of the last decade with solid fundamentals? The risk to these may be lesser due to their robust balance sheets and execution track records. But we need to watch out. Prevailing cost of capital cannot justify P/E ratios of 60 & above to put a number on the table (One year forward). Whether 60 is the line in the sand may be contextual. There is a line somewhere and that line cannot be far out if a stock is trading at 60 times. In many of these cases, valuations have expanded against earnings expectations which have fallen short. The factual data below is an eye-opener.

EPS (INR)	Asian Paints		Hindustan Unilever		Nestle	
	Reported	Expected 1 Year earlier*	Reported	Expected 1 Year earlier*	Reported	Expected 1 Year earlier*
FY23(E)#	44.4	46.6	41.6	43.9	253.5	281.9
FY22	31.6	39.2	37.5	41.4	222.5	269.3
FY21	32.7	34.9	33.9	39.8	216.0	243.8
FY20	28.2	29.1	31.2	33.5	204.2	203.2
FY19	22.5	25.5	27.9	27.9	166.7	149.4
FY18	21.3	23.5	24.2	22.4	127.1	144.4

*Source: Bloomberg, Spark Fund Research; Note: *- For FY Companies = Feb of previous year, CY Company = Nov of previous year; #- Current EPS estimate as of 31 Oct 2022; Disclosure: Neither do the client strategies nor does the investment team of SAIMPL hold any of the above-mentioned stocks as of October 2022. The information and opinion expressed hereinabove does not constitute as an investment view at this point.*

While these are great businesses, the consensus has always been on the more optimistic side on earnings expectations. Yet the narrative has been that the company earnings have usually been a "beat". This dichotomy may have been overlooked when capital was presumed to have ever lower cost. Now, the possibility that investors may have paid too much for optimism could be sinking in. In the US markets, leading global tech names have seen their share prices suffer after a period of excessive optimism followed by a reality check.

The short point is that the excesses in valuations in certain pockets in India should not be the benchmark against which we gauge the resilience of India against a backdrop of global weakness. **One may miss the trees for the woods.**

We do not want to underplay the risks to the outlook for India in a slowing global economy. Exports have been a big driver of growth for India and there are genuine concerns. The revival in capex is also yet to gain enough momentum. As and when the global situation settles down, there are more opportunities than risks. We need to digest the fact that this growth is likely to be driven by the economy sensitives. The dispersion in performance of stocks is likely to reflect the willingness of the market to be more discerning when it comes to details and bypass the optics.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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