A homegrown bull in the shadows of the big bear

There are not many positives to talk about these days when it comes to financial markets. There is a synchronised destruction of wealth across almost all asset classes. Bonds are suffering as interest rates go up. Equities have suffered a big blow from the withdrawal of liquidity and now we have a US recession to reckon with in all probability. Real estate has been a problem for a while and new kids on the block such as the Cryptos have taken a major pounding. We have been pointing out that Goldilocks has probably ended and a painful unwinding is underway. This is nature at work through free markets.

As India is suffering collateral damage from the second order impact that has followed the hollowing out of liquidity, the narrative is not encouraging from most pundits. Now that the damage is done, we see commentary which suddenly says why the Nifty should go down another 10-15% as that would bring valuations below the ten-year mean. We cannot resist asking why such narrative was nowhere in sight when the Nifty traded at 30 times trailing earnings and a lot of stocks (and indices) were 2-4 standard deviations above the mean.

Then there are those who believe that India will suffer structural damage and we will follow the world into the dark days of stagflation. This argument is premised on oil going haywire and causing an inflation spiral in India (and of course the world). This scenario projection also takes into account India's past record in managing macros – India has a record of averting absolute disasters only when it reaches the edge of the precipice. These risks cannot be brushed away lightly. But then, there is less of analysis and more of scenario building here. What if there is de-escalation in the conflict in Europe? Since it is hard to assign probabilities here, we would prefer to hold our horses on this one.

If we leave this aside for a moment, we see a different picture emerging. While it is too early to thump the table, it may be appropriate to call out the nuances of the current global slowdown and the way India is getting impacted. To be amply clear, we are not calling for de-coupling. We have been there before and it does not work. India is far too intertwined with the global markets particularly on capital flows to dodge the bullets. And it is true that India's past record is a chequered one. We also don't want to say that this time is different; that seldom works.

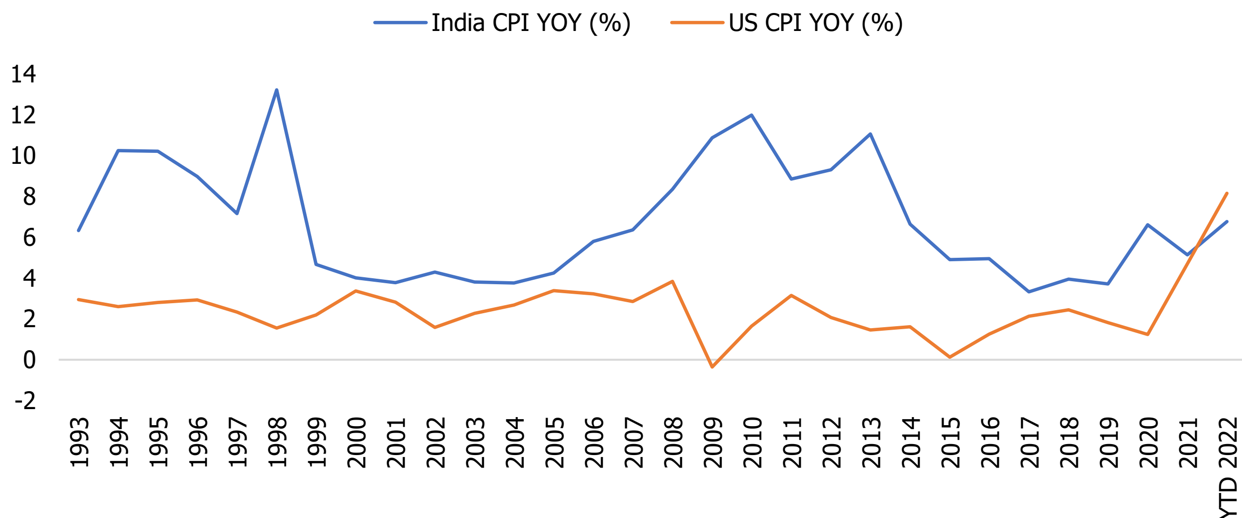
Having said that, India is placed better than other emerging markets, better than a lot of the developed world and better than its own past. Here goes:

1. The US inflation is higher than that of India this time around. This has not been the case at any time in living memory and it looks like the US inflation is likely to stay sticky.
2. US real interest rates are deep in the red. India is clearly better placed over here.
3. India does not have an issue of demand over-heating nor does it have capacity constraints (other than in infrastructure, which is a perennial issue).
4. Importantly, the Indian banking system is in the best shape it has been in two decades.
5. India did not go overboard with stimulus during Covid and the calibrated response gives some elbow room for policy making.
6. Unlike in 2011-14, RBI did not go into denial mode this time.
7. Corporate and household balance sheets are in decent shape, other than in pockets such as small businesses, micro-finance and a few other areas.

All the above have profound implications on how the economy can negotiate the waters. The one problem that India has in common with the rest of the world is a serious distortion in asset prices. Equity markets were (and in some pockets, are) seriously mispriced and the hot capital has caused even more serious distortions in the unlisted (Unicorn) space. These can present risks to the economy. For now, let us look at the glass half full.

The inflation differential

The story of the inflation differential between the US and India is captured below



Source: World Bank, Bloomberg, Spark Fund Research

The INR depreciation shows reasonable correlation to inflation differential over longer periods of time. Since currency values are relative, this metric holds prime importance and we need to pay attention to this.

Period	India CPI (CAGR, %)	US CPI (CAGR, %)	Inflation differential (%)	INR Depreciation (CAGR, %)
From 1991	6.9	2.5	4.4	4.0
From 2001	6.4	2.4	4.0	2.3
From 2011	6.0	2.4	3.6	4.6

Source: World Bank, Bloomberg, Spark Fund Research

We don't want to be naïve and conclude that the US inflation will remain above that of India for a long time. We don't know. However, there is a good chance that the US inflation will remain stubborn for the foreseeable future, viz – 1-2 years. That is a long enough window for India to capitalise in our view.

INR and FPI flows

The inflation differential has been perhaps the single most important factor that has affected the direction of INR over the last three decades.

In the shorter run, what has influenced INR are FPI flows. See below

Start date	End date	Duration (months)	USDINR (start date)	USDINR (end date)	INR Depreciation	Net FII Flow (INR Cr)
31-01-2008	28-11-2008	10	39.4	50.1	-27%	-43,592
31-08-2011	30-11-2011	3	46.1	52.2	-13%	-9,953
29-03-2013	30-08-2013	5	54.3	65.7	-21%	-24,175
31-03-2015	31-01-2017	22	62.5	67.9	-9%	-21,165
31-01-2018	31-01-2019	12	63.6	71.1	-12%	-86,089
31-05-2021	30-06-2022	**13**	72.6	79.0	-9%	**-2,23,860**

Start date	End date	Duration (months)	USDINR (start date)	USDINR (end date)	INR Appreciation	Net FII Flow (INR Cr)
31-03-2009	29-07-2011	28	50.7	44.2	13%	3,01,663
30-09-2013	31-03-2014	6	62.6	59.9	4%	90,744
31-01-2017	31-01-2018	12	67.9	63.6	6%	2,22,320
31-10-2018	31-07-2019	9	74.0	68.8	7%	74,031
31-03-2020	31-05-2021	14	75.5	72.6	4%	1,38,103

Source: SPARK Capital, SEBI, Bloomberg, Spark Fund Research

The current bout of FPI selling has been so persistent and prolonged that the INR has had no chance to show any kind of resilience vis-à-vis the USD based on inflation differentials. However, we can end up with an under-valued currency and the capital flows can reverse. That too in a material manner.

The outlook for inflation

We need to see a stable to positive outlook for inflation in order that the capital flows start to reverse. Let us look at the contributory factors to inflation in relation to previous periods

1. Commodity prices – This has been the prime culprit. In particular, that of oil. Given the fact that the US Fed has decided to take its mandate of stable prices seriously, it is clear that they would rather tolerate a US recession rather than an inflation spiral. We can't see how commodity prices can keep going up when the world is in a recessionary mode. We believe that much of the commodity price related inflation may be behind us.
2. Fiscal deficit – This is an issue but in a relative sense, India is not badly placed. Further, the tax collections have been robust and India is in a reasonable position to prevent a slippage from the target levels. On an absolute basis, the fiscal deficit remains high and this has the tendency to crowd out private investments. However, the system liquidity is adequate enough to keep borrowing costs in an acceptable band – the rates may not head South by much but the Indian economy is probably one of the few major economies which will find a 6-7% Govt bond rate as par for the course. India is used to higher rates and these rates are not likely to affect growth.
3. Capacities and Demand – When we get to an 8% plus GDP growth for 2-3 years in a row, the demand versus capacity debate can come back. We are not there yet. As of now, it is not the lack of capacities but supply chain issues that is more of an issue. This issue is on the mend.
4. Inflation expectations – We are not in that kind of a celebratory mood in India that pricing power is in favour of producers. Covid has extracted efficiencies from the system which can give a lot of buffer. This has been so for sectors and industries that have been able to adapt. That is still a good place to be in.

What the above means is that there is a reasonable probability for the data in India to improve on inflation. It is not a slam dunk. However, the narrative and the markets have not priced this in. Therein lies the opportunity.

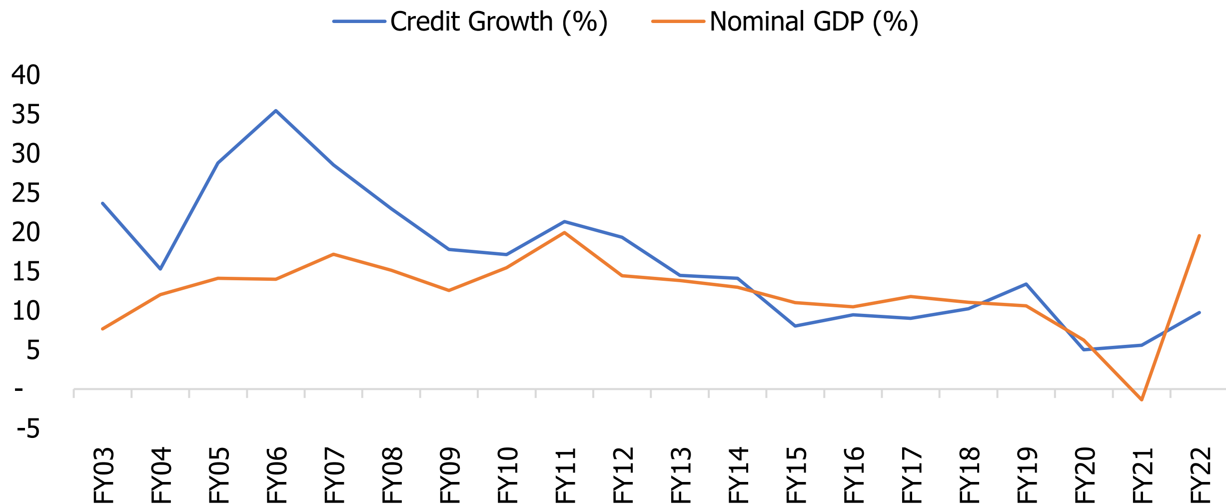
Where is the problem?

It is in financial markets, notably in select pockets within the equity markets. We have time and again highlighted the distortion in pricing of high-quality stocks across sectors, but particularly so in some segments which happened to be considered a one-way investment opportunity in an era of unlimited liquidity. The correction in prices in these segments is as yet work-in-progress.

But then, the banks have value yet they have fallen as well?

Yes – that is true. The possible reason has all to do with the capital outflows. FPIs hold banks in plenty and banks are also the most liquid part of Indian markets. Estimates show that over half the FPI selling in India has been in banking stocks. This is why the banks have taken a serious beating. We don't believe the Indian

banks have an issue at present. The liabilities for Indian banks are mostly domestic and the lending is also mostly to the local economy; though we can't say that everything is domestic. More importantly, the lending growth in banks has been below trend for the last few years and the balance sheets have got stronger. This does not look like a set-up from where asset quality issues emanate.



Source: RBI, Bloomberg, Spark Fund Research

Right now, there is lot of turbulence. And hence it is easy to equate the fall in the price of solid banks (private or public sector) with fintech names and other high-fliers. That would be a mistake. The context needs to be appreciated.

In summary, we are not yet saying it is time to open the champagne bottles. It is a difficult environment out there. However, it is a situation pregnant with positive possibilities for India. We continue to believe that the domestic economy is the place to be – and of course the well-managed companies regardless of sectoral orientation. Provided they have not been bid up to crazy levels. And when the hype cools off. As the cliché goes, it is a stock picker's world.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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