Cycle is King

It is fashionable by far to regard India as a secular growth story, and sometimes this obsession extends to viewing many stocks and sectors in India as compounders. Business cycles are not part of this playbook and so goes the narrative. Let us first look at some numbers.

Index	CAGR (%) in Local Currency		CAGR (%) in USD	
	5 Years	10 Years	5 Years	10 Years
S&P 500 (US)	7.3	9.5	7.3	9.5
Nifty 50 (India)	11.8	11.6	7.0	6.9
Shanghai Composite (China)	-2.0	3.8	-3.4	2.5
FTSE 100 (UK)	-1.3	1.8	-4.9	-1.9
BOVESPA (Brazil)	8.2	6.4	-2.8	-3.6
MOEX (Russia)	-1.2	3.0	-2.0	-3.6

Source: Bloomberg, Spark Fund Research; Note: data as on 30 Sep 2022

No. of Stocks	With 10 Years price history	Annual returns >20%
India - Current Mcap > USD 1.5bn	222	82
US - Current Mcap > USD 5bn	860	98
China - Current Mcap >USD 2.5bn	445	84

Source: Bloomberg, Spark Fund Research; Note: returns in local currency, data as on 30 Sep 2022

While it is generally believed that India has produced more multi-baggers than other markets, the data above shows the following

1. Indian market has produced superior returns in local currency. In USD terms, it is of course better than all except the US itself. USD has been too strong.
2. There have been a good number of companies in US, India or China that have compounded returns at a healthy clip. One can say that India has enjoyed a good hit rate for the listed companies who have made the cut as against those who fell by the wayside.
3. Given that India's market size and economy size are far lower, the Indian record may be viewed as impressive or otherwise. The stock universe that is investible is narrower and hence foreign investors have struggled to deploy capital. This also explains in part the scarcity premium enjoyed by Indian stocks. This in turn raises some question marks over the repeatability of this record.

Therefore, this notion and narrative that India is some sort of a compounder in a world full of cyclically challenged economies is something that needs a re-look and scrutiny. Yes, listed companies in India have done better than how the country has done on a relative basis. India may have beaten the likes of Russia and Brazil on growth but remains a poor country by far.

Per Capita Income	10 Years CAGR (%)	2022 (USD)
China	8.4	14,096
India	5.7	2,515
United States	3.9	76,027
Russia	-1.9	12,575
Brazil	-3.6	8,570

Source: International Monetary Fund, Spark Fund Research

The possible reasons for this phenomenon are

1. Cost of capital has always been high in India and that has ended up favouring the efficient incumbents as against ambitious start-ups. It is these efficient incumbents that have tended to produce compounded returns. Bulk of the stock market returns have come in from the top quartile of listed companies and the tail has always faded away.
2. Reforms in India benefitted the new age industries in a more marked manner. The relatively robust college education system in India has been an engine that has produced talent for the new age industries. Capital has been more easily available to these industries (IT, new age banking, niche manufacturing etc). India has adapted very well to the globalisation of services and services-led manufacturing (e.g. – Generic Pharma)
3. The inability of the broader economy to keep pace led to an artificial scarcity premium of sorts. This propped up valuations and the process has come to assume a life of its own.

By the way, we have seen such trends play out in Taiwan (and before that in Japan and that did not end so well) only to moderate over the real long haul. Taiwan Semiconductor Manufacturing Company (TSMC), which was once a pricey tech stock, later became a yield play!!!

There is no evidence to support the view that India has become a unique economy overall in terms of productivity, innovation, fiscal rectitude, or any such. We see neither milk nor honey on the streets.

Which brings us to the power of cycles. Here some trends are worth noting

1. Market cycles may be getting shorter. We had the shortest bear market in history soon after Covid hit us. It was over before it began. Maybe, the world may now be reeling under the effect of the same causative factors, but this will qualify as the handiwork of a freshly minted bear.
2. Business cycles are getting shorter. Capital and labour have become much more mobile and have seen fewer barriers over the last 2-3 decades. More pertinently, there has been the democratisation of information access delivered online. Velocity of information flow has also been at a different level. All these have had the effect of reducing the mismatch in supply and demand which is what leads to cycles. If business cycles become shorter, wont markets follow?

Then there is a worrying thing about too much of capital (money) in the world at large as against the quantum of real economy. The result is even higher volatility.

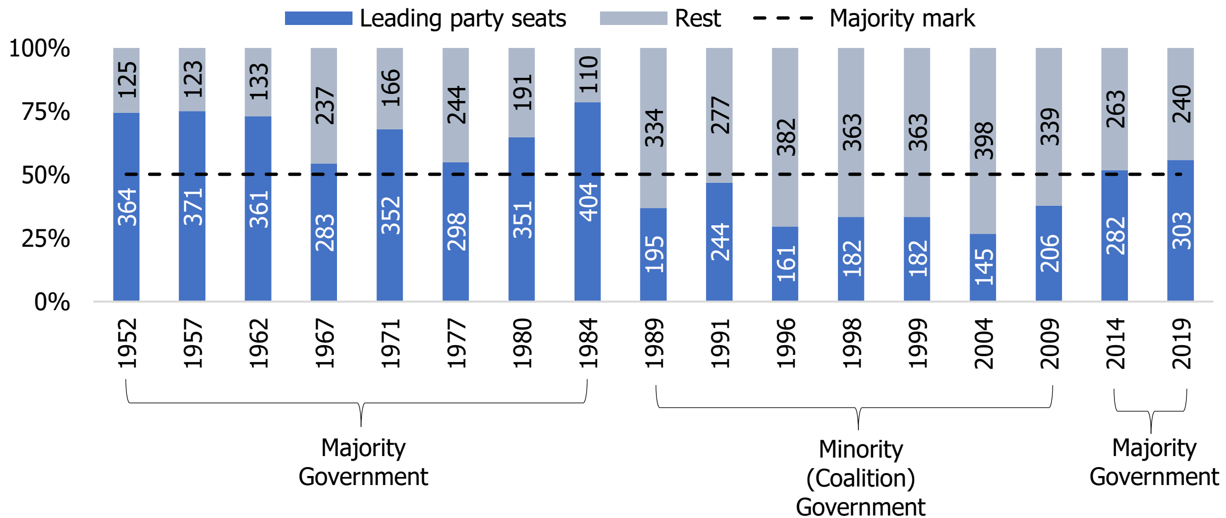
One important fallout of this is that the cycles are invading industries that were considered cycle-proof. IT is a case in point. In the 1990s and 2000s, the industry never knew what a demand slowdown meant. 2007 possibly changed that around a bit. Before the ascendancy of the IT sector, the baby-boomer generation possibly gave that kind of fillip to many consumer segments in the US in the last quarter of the 20th century. At the end of the day, all businesses develop cyclical characteristics when they mature. No one remains an adolescent forever.

While cycles in metals or energy can be long and dirty, the cycles in services may be short – and still nasty. The reason is that investors and businesses are accepting of the cycles in old economy sectors. There is a marked reluctance to accept that the new age businesses can go through ups and downs. Lopsided expectations can lead to nasty outcomes. This has implications for India.

India and its cycles

Political cycle

Majority versus minority governments since 1947



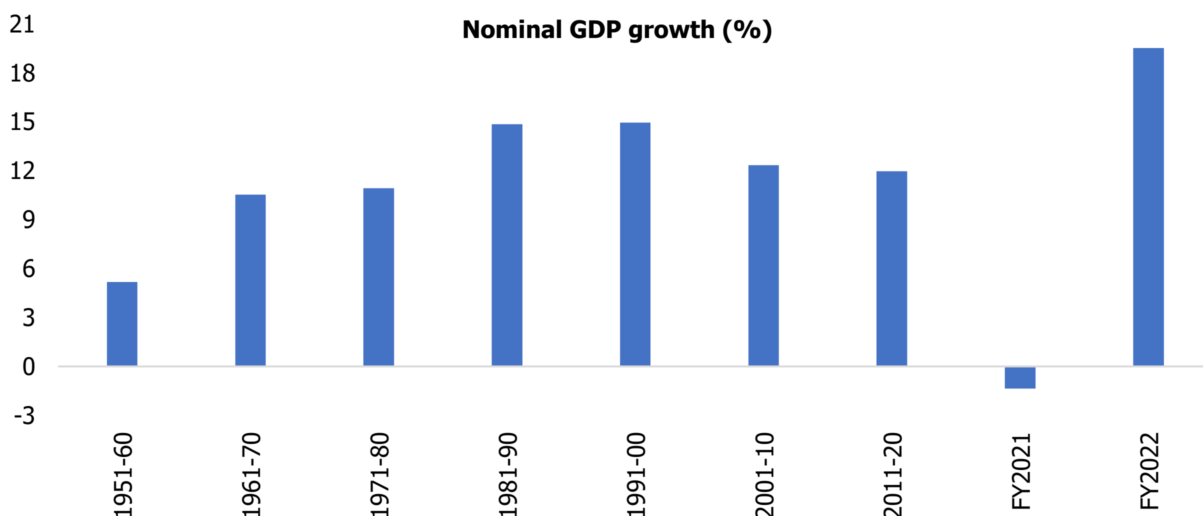
Source: Election Commission of India, Spark Fund Research

Political cycles in India have been long (so far). In the last down cycle, we had the lowest point (point is a phase and not a moment in this) between 1989-1999. We had reforms, very dramatic positive after effects, mayhem (1996) and a slow recovery punctuated by ups and downs (1999-2014).

From 2014, politics at the Federal government is seemingly going back to the days of the Congress except that it is someone else in command. The full benefit (to the extent these things affect the industry and the markets) takes time to flow through to reforms. We surmise that India is possibly beginning to get the best results from the reforms that a majority government alone could have brought about (GST, stable tax regime, incremental but steady progress on other fronts). To that extent, we are at the early stages of a good thing going for us.

Economic cycle

Growth cycle may be picking up

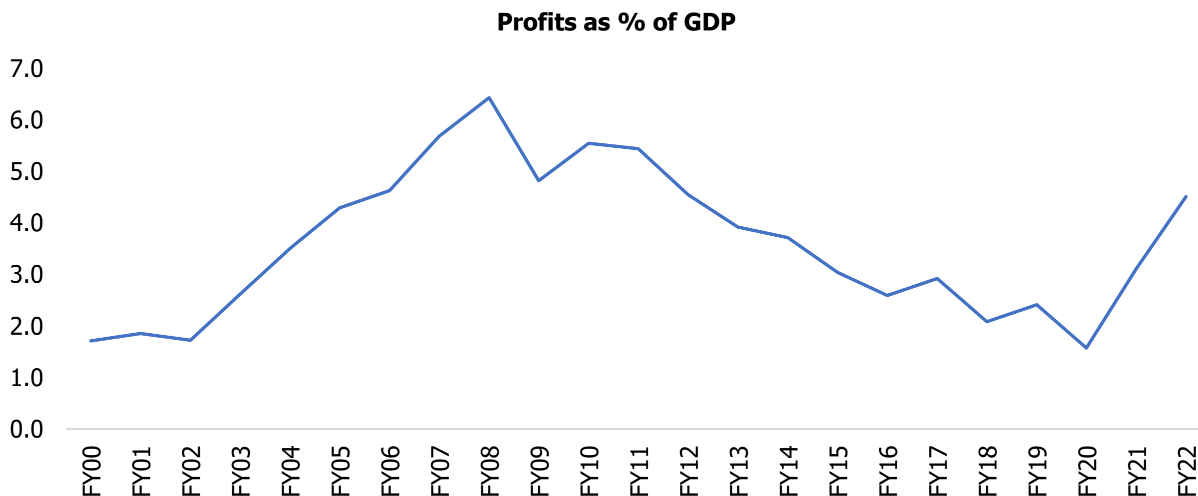


Source: MOSPI, Spark Fund Research

The cyclical recovery in the economy is gathering pace based on various indicators (though the gradient of recovery is hampered by global developments).

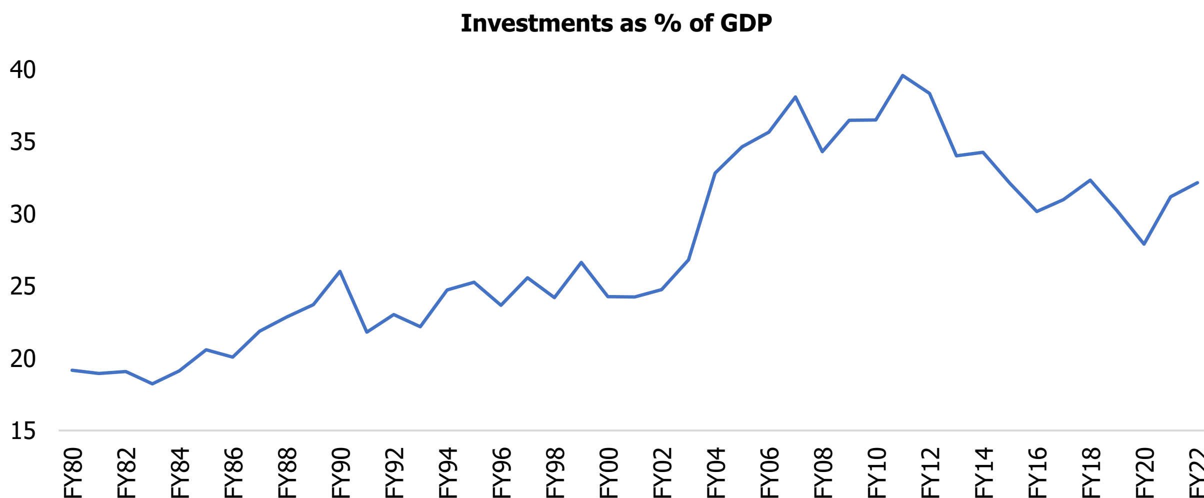
Profit cycle

This has already picked up. In fact, earnings growth trailed economic performance in the decade after the global financial crisis. It was a decade of never-ending earnings downgrades.



Source: ICICI Securities, Spark Fund Research

Capex cycle



Source: Bloomberg, Spark Fund Research

This is one cycle that showed major cracks in UPA-II and continued to unravel thereafter. Our thesis has been that private capex cycle has to pick up once profit cycle turns. The lead lag correlation is visible in the period between 2000-2010. We are on the cusp of a robust capex cycle in India.

What we must be cautious about is the fact that the extent and duration of the upcycles may be impacted by various new factors in play. These include a fragile global backdrop, imbalances everywhere and rapid adjustments brought about by a surfeit of capital and information flow.

Market impact

This is the most important point we want to stress on. In the environment we are in, global cycle is not in sync with the Indian cycle and that will remain a drag on India. There is and there will be no de-coupling. However, we have stated this time and again that India is differently placed and in a better way. In this scenario, if we make a case for cycle being the king, flexibility deserves to be the emperor.

What does flexibility mean?

1. Industry/Sector choice – Segments which led the market from 2007-2020 may fall behind. Not all but some. Not forever but maybe for a while. May be a long while. Maybe not. We should not second guess and need not.
2. Stock choice - Stocks within certain sectors which were considered perpetual growth stocks may fall back. Nothing is cast in stone. Least of all leadership.
3. Iconoclastic views – No prizes for being boxed into views such as – Don't look at PSUs, Don't buy commodities, Buy only if there is a certain ROE/ROCE et al. Everything has a context.
4. Holding periods – Buy and hold for long period if it is justified to do so. There is no ideal holding period in an era of shorter business and market cycles. Tail should not be allowed to wag the dog.

Does this mean we have to be short term in our thinking. The answer is a big NO. In order to think long term on capital, we should make sure that the capital stays safe with us and we have measurable metrics with which we can monitor the progress. The long term is nothing but a summation of consecutive periods in time where forecasting errors can be contained and sensible assessments can be made. Breaking up the long-term thinking into periods where thoughts can add practical value is the best long-term approach in our times.

Someone said this about the forex markets that long-term is after lunch. We need not be so skittish about equities. That said, if the market is not to end up having you for lunch, it makes sense to listen to it. Let the data that flows in decide the best course of action on choice of stocks, sectors, risk levels and investment horizons.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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