Greetings!

Equity markets – Are they showing a disconnect with the real economy?

We respect the market. We constantly try to make sense of what the market is telling us. So that we do not end up being out of step with the reality of the market itself. While market may have gone up ahead of earnings, it is increasingly clear that market and earnings are not going in different directions any more. Market may be a lead indicator of a strong upcycle for India and that too a cycle which holds promise.

As the stock market has reached an all-time high and has kept soaring, there are legitimate concerns. In its report on financial stability, RBI has highlighted the challenges ahead for banks in terms of asset quality. The RBI Governor has expressed apprehensions over soaring asset prices. Elsewhere, Jeremy Grantham, the veteran Fund Manager with decades of investing experience has explicitly warned investors that the excesses in the equity market would eventually end in tears. After all, the rally in stock prices is not originally Made in India. Markets around the world have given an impression that the pandemic induced recession is well and truly behind us and we are on our way to a recovery.

In India, there is some degree of disconnect between the extent to which stock prices have moved in such a short span of time and the state of the economy. We can debate on the extent. We argued before the pandemic that the polarisation of returns within the leading indices and resultant over valuation poses certain risks. These risks played out in March 2020 albeit triggered by an event which was completely beyond the scope of forecasting. We also witnessed the market regaining lost ground with a vengeance. The market has soared even higher. This time around, the dispersion of returns has broadened out. Almost all sectors have gone past the pre-pandemic levels. Stocks are at an even higher valuation than was the case before the pandemic, as measured by the simple P/E ratio. At the same time, India is having its worst year ever in terms of economic growth. This may qualify as a disconnect to many observers. What people are missing is the fact that the market is a mechanism for discounting what is likely ahead of us. In this era of low cost money, such discounting may get exaggerated at times. This is irrespective of whether we use a simple metric such as P/E or more complex analytical tools. Use of novel methods of valuing equities cannot change a simple fact. The liquidity propelling the market has led to the market finding comfort in extremes and beyond as against the mean.

Caution over the above is warranted and we have highlighted the risks time and again. The risks did not manifest themselves for a long time. When they did, they created unprecedented market drawdown. Then came the mother of all market recoveries. This sort of volatility can come back to haunt us, though with lesser intensity. In terms of asset allocation, there is a need to proceed gingerly as one of the features of all past bubbles is that most investors have been wiser only with the benefit of hindsight. While many aver that this is not a bubble, semantics don't matter. There are obvious excesses in the stock market. It pays to be forewarned.

That said, there are significant tailwinds for Indian equities for now and for the next few quarters. Here are some points to ponder

Recessions spawn recoveries

Look at the economic growth in the US after each recession over the last 50 years

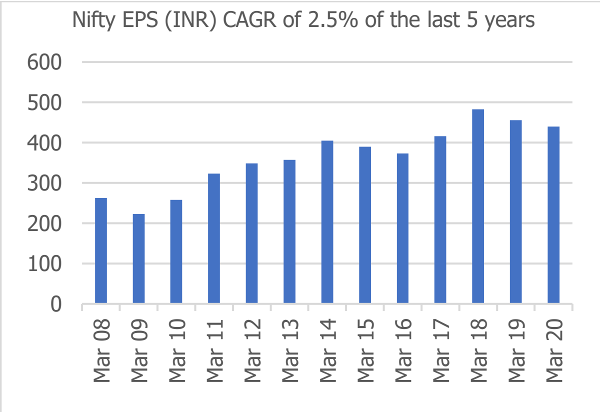
Period	Fall in GDP (%)	Average (%) Growth in GDP over next 3years	S&P 500 Return over next 3 years from low of recession period to high in the next 3 years	Trends that marked those years
1974-1975	(-0.5%) & (-0.25%)	5.2%	73.1%	Supply shock involving oil. Inflation targeting and the use of monetary policy tools became important levers of policy
1982	-1.9%	5.4%	107.0%	Reagan era & end of cold war. Interest rates commenced a multi decade descent. The longest expansion in stock prices in the US (and the World at large) which lasted all the way till 2007 began. The rise and rise of equities as an asset class started.
1991	-0.1%	3.4%	51.2%	Genesis of the technology boom. The story of US productivity improvement was seeded.
2001	1%	2.8%	25.7%	Rise of China and Globalisation. Low rates powered a mortgage boom & bust in the US. Low rates also fuelled consumerism and global trade.
2008-09	(-0.3%) & (-2.8%)	2.1%	81.2%	Emergence of Ultra low-cost money. A new Fed was born that could never disappoint the market. Global central banks played in chorus
2020	-3.4%	3.8%	72.3%	What Next?

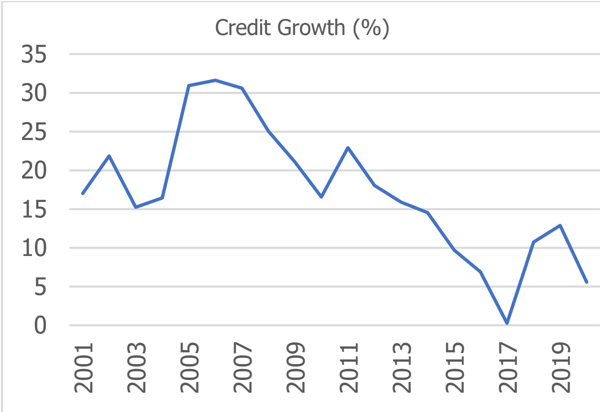
Source: Bloomberg, Media Sources, Spark Fund Research

Public policy has always supported growth during recessions. Recessions have the beneficial fallout of eliminating the flab in the economy. Wheat is separated from the chaff. Innovations in business result from the need to survive and thrive. The seeds of the next growth wave are hidden away in the destruction that recessions inflict.

For India, here is a simple truth that is not yet fully appreciated. This is our maiden recession (practically so). It is but natural that we take some time to fathom the variegated impact of the same. No doubt many sections of society have been hit. Some have emerged stronger than before. It so happens that the leading listed companies may find themselves on the right side of this divide. **Stock prices and market indices are obviously to do with those who make the cut and not about those who are left behind.**

India had a terrible run even before the pandemic hit us. Look at the bank lending growth and earnings



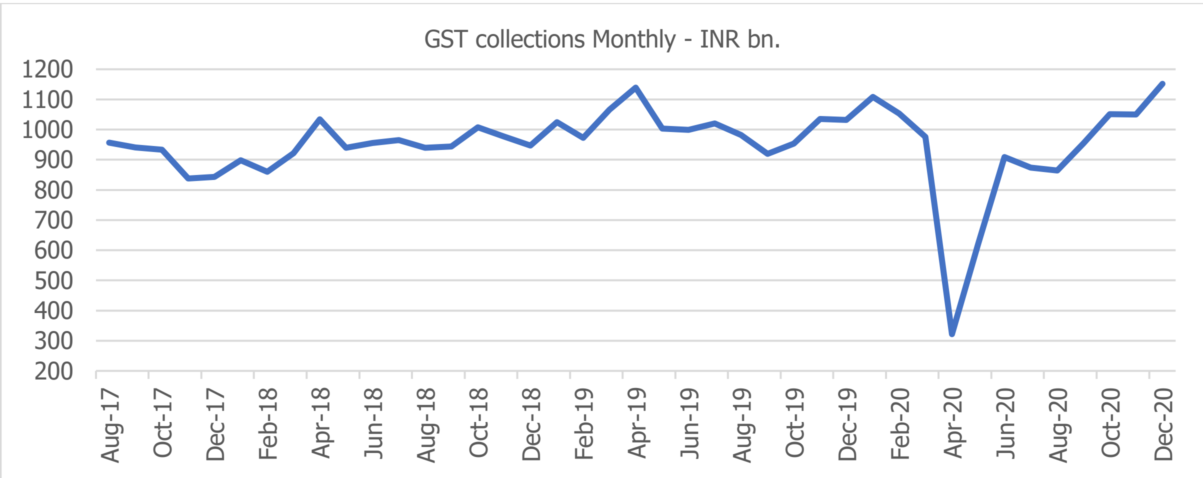


Source: Bloomberg, Media Sources, Spark Fund Research

Both these figures are to be viewed against the GDP growth at 6.8% per annum between FY09 and FY20. This economic growth did not benefit listed companies at large even though the size of the economic output added resulted in opportunities which a narrow set of companies took advantage of.

Nifty returned 10.4% per annum from FY08 to December 2020, lower than the 14.4% since its inception in 1996 all the way to FY08. The drop in long term returns of Nifty reflects the deep-rooted pain in corporate India. It probably took a recession for public policy to start pulling all stops to go for growth.

GST collection trends since August 2017



Source: Spark Capital Research, Spark Fund Research

Look at the trends in GST collections. They have been so stagnant that it is hard to believe that there was any meaningful growth in the economy before the pandemic hit us. The Covid lockdown was the proverbial last straw on the camel's back. India tanked and in fact had one of the deepest recessions for any G20 economy.

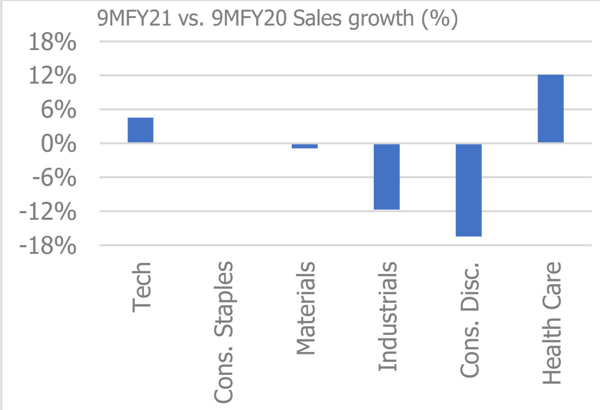
As we are recovering from such a cataclysmic slide, it is reasonable to believe that the upward momentum could be underestimated for quite a while. We are quite likely in the early stages of this phase where expectations are tepid and there is disbelief over earnings.

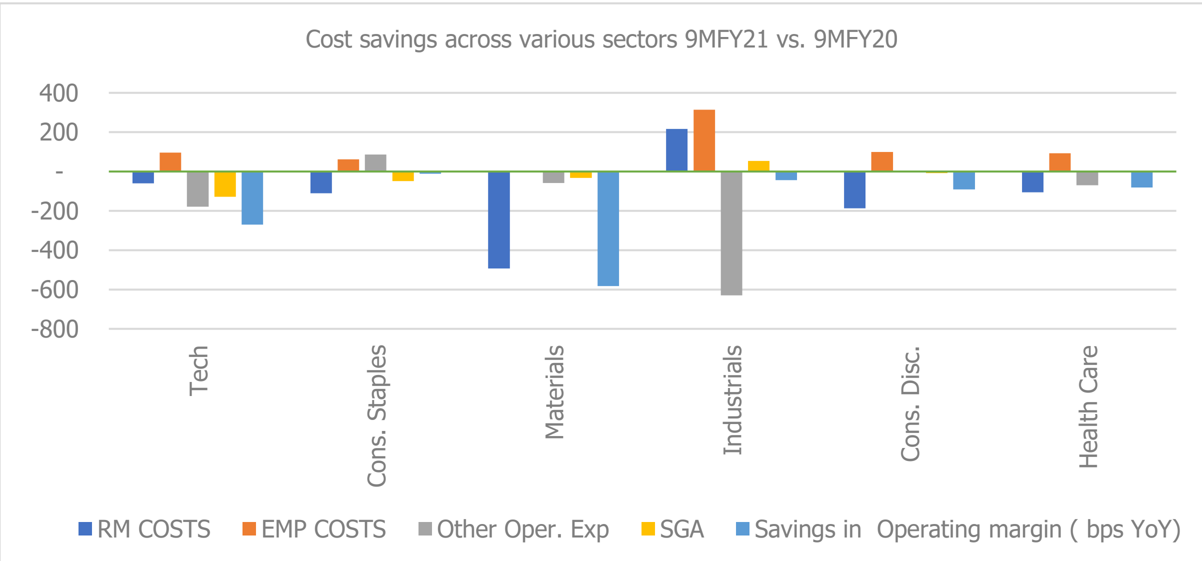
Profit outlook – The most important driver of market performance

Between GDP growth and earnings growth, the latter matters more for stock prices. Between these two and liquidity, liquidity matters even more, at least in the short run. Given that economic activity is normalising, the focus of the market is rightly on the earnings trajectory.

The profit drought for corporate India (save a few exceptions) has been palpable over the last 12 years. The pandemic has forced a diet regimen on companies which was almost involuntary. In a sense, companies discovered cost savings which would not have been easy during normal times. The best in business have become lean and mean.

So much so that the margin uptick we have seen in the last couple of quarters can sustain. Of course, we need revenue traction to pick up for margins to stay put. Raw material costs are no longer benign and it is a slippery slope for the companies. Demand recovery is also not to be taken for granted. That said, a good portion of cost savings may be retained and when demand starts to come back from the abyss (as is likely to be the case though we do not want to make linear extrapolations), margins may hold up. We are likely to see profitability inching up from the pre-pandemic years. The ROE curve may be headed up for India Inc.





Source: Ace Equity, Spark Fund Research

The impressive margin performance for companies in the first nine months has come about despite depressed revenues. The unique nature of this recession paved the way for cost savings for all those companies which were able to cope. In the quarters ahead, the revenue traction can be meaningful as base effect kicks in. Operating leverage has been seeded into the metrics during the pandemic and this is what can cause earnings beats.

The mind of the market and the method behind the madness

The rally in the market is best explained by the near zero interest rates in the developed world and the gush of global liquidity as an initial trigger. The market has been building on the gains with the help of a budding earnings recovery. Add the scepticism at every step of the way and we have got this crazy roller coaster ride in the last ten months.
The thrust of the Union Budget is consistent with what public policy has done elsewhere when growth fell off a precipice. Maybe, it packed a surprise punch in not choosing to surprise negatively.
For the market, the pendulum may have swung too much on the other side which is why a small cautionary note may be in order. Such caution should not be extended to doomsday mongering. The global liquidity may not reverse anytime soon. We reiterate that earnings can continue to power on – at least for companies who have made the best of the situation. In some cases, earnings upgrades may have also got front ended and price movement may have factored in the same and some more. As the expansion in the economic cycle gathers momentum, we would like to believe that there is enough play out there.
The challenge in 2021 is to negotiate the volatility and to stay the course.

Warm regards,
P Krishnan (CIO) and Team Spark Fund
