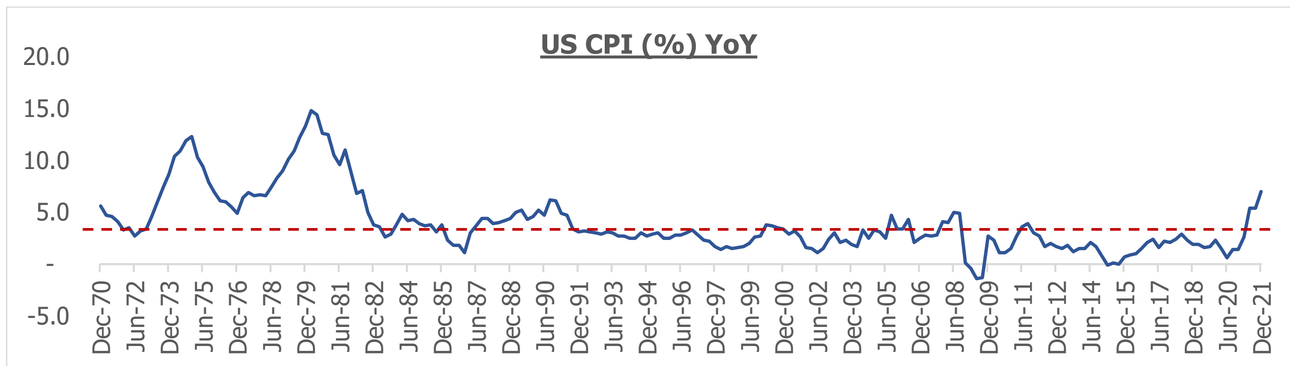
WHY IS THIS INFLATION SCARE DIFFERENT

Inflation is all over the headlines. To us in India, inflation is nothing new. Price rise is supposedly an election issue in the assembly elections around the corner. Our political economy has always hyper-ventilated over inflation or price rise as it is loosely referred to.

First of all, let us get this right. Price rise is a bit different from the inflation scare we are dealing with. Price rise implies inflation no doubt. However, inflation measures the rate of change in prices. It measures how fast prices are rising. Prices can rise but inflation can fall. The current debate on inflation may not be only about price rise in general or about the impact on consumers.

It is going to be much more about the impact on asset markets. Which is why we need to pay attention. Let us start by taking a look at the long-term movement in inflation in the one and only market that counts at the end of the day – the US market.



Source: Bloomberg, Spark Fund Research

It is quite apparent that the oil shock of 1973 resulted in an inflation spiral in the 1970s. The US Fed, under Paul Volcker, started the process of confining the inflation genie in the bottle. This played its own part in the US consolidating its position as the leading economy of the world. This led to income generation and unprecedented prosperity. Here is how.

As inflation started to ease off, consumers developed confidence that their savings will retain value when they retire. Today's savings equates to tomorrow's consumption and therefore, expectations on long term value of savings has a signal bearing on attitude towards current consumption. Consumers felt confident enough to spend more of their disposable income. In addition, lower inflation led to lower interest rates and lower cost of borrowings which in turn fuelled a housing and consumption boom never witnessed in history. In short, it is fair to say that the Goldilocks economy was born after inflation was bottled up.

The conquest of inflation also engendered a bull market in equities that has gone on for forty years.

S&P Index compounded annual growth rate (%)			
1981-till date	1991-till date	2001-till date	2011-till date
8.9%	8.8%	6.0%	12.2%

Source: Bloomberg, Spark Fund Research

It is pertinent to note that the long-term returns were clearly impacted by the global financial crisis in 2007. The returns have picked up significantly from 2011 which represents the post-crisis period. Let us see now whether the economic growth resurgence and earnings growth were commensurate.

US Nominal GDP compounded annual growth rate (%)			
1981-Dec 2021	1991- Dec 2021	2001-Dec 2021	2011-Dec 2021
4.9%	4.3%	3.7%	3.6%

Source: Bloomberg, Spark Fund Research

S&P Index EPS growth (%)		
1991-till date	2001-till date	2011-till date
8.9%	11.9%	7.5%

Source: Bloomberg, Spark Fund Research

It is clear that the rise in equity prices in the US has been running ahead of earnings growth over the last decade. Further, the equity returns have accelerated at a period where the economic growth has decelerated. The point of concern to us as investors emanates from the fact that the bull market over the last ten years seems to have been fuelled much more by the fall in interest rates and the resultant surge in liquidity rather than by improvement in the core economy. It is not that the core economy has not improved. It is just that the rate of change in asset prices has been out of step with the progress at the core. The lower interest rates and the massive liquidity boost by the US Fed were made possible to sustain because inflation remained benign. Stable prices (low inflation) happen to be a key mandate of the US Fed. As inflation has picked up, interest rates have tended to reverse and liquidity has begun to cool off. Consequently, the market will have to put itself under the lens over this fact and rightly so.

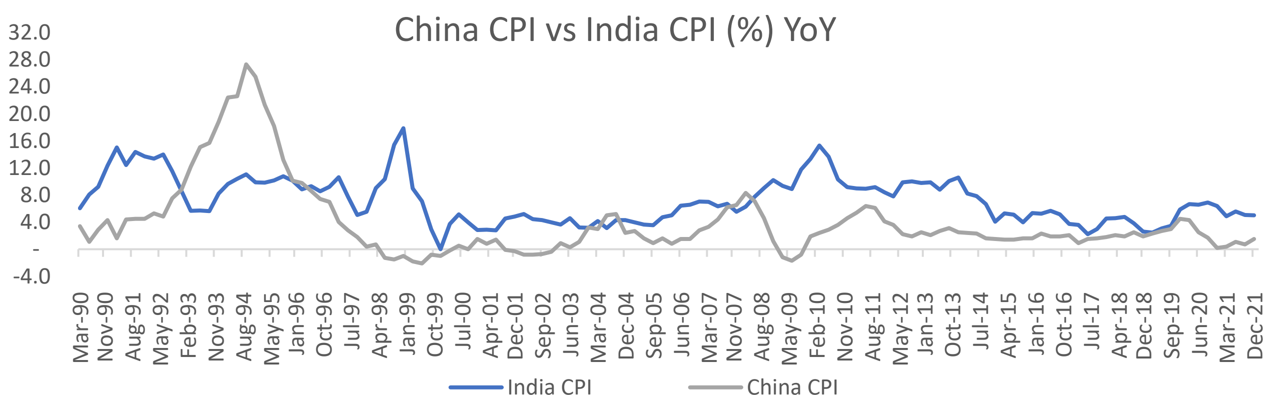
It has been a lot about the Goldilocks markets than about the Goldilocks economy. The seminal question is whether we have reached the end of the proverbial rope. While this is a question that we are not qualified to answer, the fact that inflation has breached levels not seen since the days of Paul Volcker is a wake-up call. The perma-bulls aver that the US bond yields may have gone up from around 1% to nearly 2% while they have fallen from the mid-teen levels prevailing in early 1980s. Here is why that is a fallacious argument.

For one, the movement underway from under 1% to an expected level of about 3% in a few quarters will represent a 200% rise in the rates (or cost of servicing debt). Secondly, the investors have justified the high price multiples of recent years by pointing to the fall in bond yields and the low-cost capital it signifies. The discourse has been that if interest rates can fall from 4% to 1%, the P/E ratio can go up from around 25 to about 100 (P/E being measured as the inverse of the rate). Pardon the over-simplification. This has been the narrative nevertheless.

If this were to be the case, then the multiples have to be shrinking if the rates were to reverse. One has to be biased beyond reason to deny this. The US Fed still has price stability as one of its key mandates. A 6% inflation leaves the US Fed in a difficult spot and they have already said so. Let us not make the mistake that a 1-2% increase in interest rates is small compared to the double digit fall we saw over 50 years. For asset classes, this rate of change is Armageddon. The steep change in asset prices happened towards the fag end of the fall in rates. When rates move up, they might take a heavy toll right when the reality of the reversal begins to sink in.

India and inflation

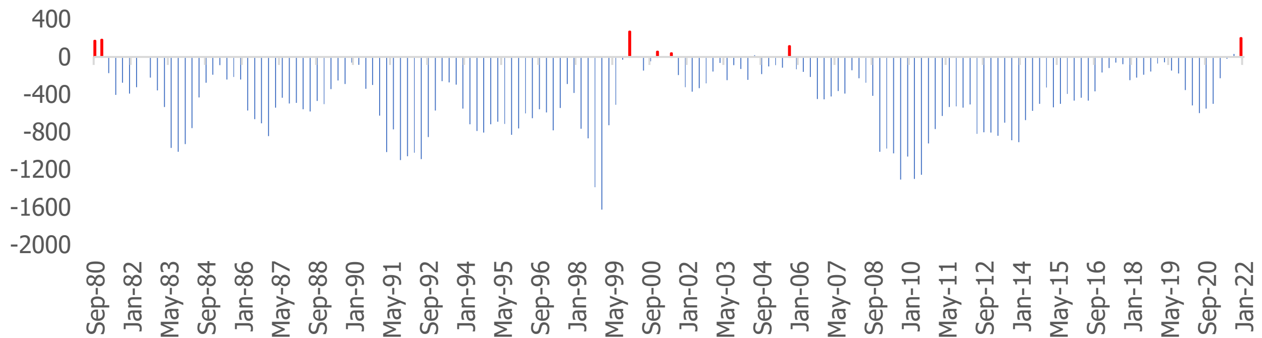
India has a chequered record on inflation. The political economy has always raised the decibel level over inflation but successive governments have shown little resolve in taming inflation the way other successful economies have done.



Source: Bloomberg, Spark Fund Research

This is one reason why our incomes have not gone up as much as China. Once again, pardon the over-simplification as there have been many factors at work. Suffice to say that India has happily countenanced inflation much to our relative detriment. Over the last twenty years, there has been a gradual change in the attitude towards inflation. The ever-increasing linkages with the global capital markets have ensured that the policy-makers needed to address the issue of inflation not just from the point of view of the domestic audience.

International investors have become stakeholders and much as we might like to deny this, the fear of rating downgrades has been hovering over us like a Damocles sword. This has begun to do India a lot of good. While we cannot say that we have tamed the inflation scourge, we have been getting better in controlling it. We highlight a development that might have a seminal impact on how India will be viewed by global investors.



Source: Bloomberg, Spark Fund Research

What this chart reveals will have far-reaching implications for the Indian economy and how India will be viewed as a manufacturing/services base. The chart shows that almost for the first time in ages, our inflation is tending to fall below that of the US. **Further, this is almost the first time that our real interest rates (nominal rates less inflation) are positive while for the US, it is deep in red**. In other words, in relative terms, the US is destroying the value of savings relative to India for the first time. This will imply that the capital flows to India can accelerate. This could include flows into bonds as well. Secondly, India may become more competitive as a manufacturing destination. The virtuous cycle may mean relatively lower rates in India (relative to where we are and not lower than the global rates) for longer.

These are very big positives for the Indian economy over the rest of this decade. This presupposes that India will manage its own affairs to ensure that inflation remains under control. So far, the signals are encouraging.

This has positive implications for growth in the economy and ipso facto on earnings led by that growth. Further, there is some evidence that is suggestive of the fact that an initial period of moderately higher inflation can be beneficial for producers. In the last tightening cycle, the cyclicals and financials did well

Performance of sectors in 2002-2007 when rates tightened

Index	Returns (x)
NSE Nifty 50 Index	4.6
NSE Nifty IT Index	1.5
NSE Nifty Bank Index	7.0

Index	Returns (x)
NSE Nifty Pharma Index	2.1
NSE Nifty FMCG Index	1.9
NSE Nifty Energy Index	6.1

Source: Bloomberg, Spark Fund Research

We don't want to over-emphasize this for a few reasons

1. Inflation will hit consumers eventually. That is never good
2. Persistent inflation will hit the value of savings. This is never a good thing
3. The financials, which form a big part of the Indian market, may see issues crop up over time if inflation moves up
4. In India, inflation has proved to be a hydra-headed monster. The record of policy-makers is that they tend to close the stable after the horse has bolted out in full speed.

All that said and done, the peculiar positioning of the developed world in the current saga puts India in a position of advantage. Following possibilities afford reasonable probability scores

A. Capital flows can increase materially

B. Indian bonds can become attractive. This may be a new, new thing for India

C. Indian manufacturing can pick up

D. Capex spending can pick up. Capex will track growth in nominal profits and higher commodity prices will spur investments in capital intensive segments

E. INR can show strength. INR has tracked the inflation differentials over long periods and coupled with increased capital flows, INR can appreciate. An appreciating INR is still an incipient thought in the making as many forces are at work (including USD strength versus all currencies). We have to be open to this possibility going forward.

What lies ahead?

Short answer - **More volatility.**

Having noted the positives, there are two significant caveats, both of which may impact us near term rather than the beyond.

One, India may not decouple on the foreign portfolio flow front for the now and here. When investors pull out money from the mother market (US equities), they are unlikely to buy stocks in an emerging economy like India instantly. To be sure, the foreign investors have been sellers for several months now. We may not have seen the last of such selling yet.

The second aspect is more disturbing. Once again, we have to highlight valuations at the cost of repetition. Indian market has a dichotomy on valuations which is stark.

P/E of Nifty and sectors on 12-month (Trailing twelve month or the last twelve month) earnings

TTM PE (x)	
NSE Nifty 50 Index	24.7
NSE Nifty IT Index	33.6
NSE Nifty Bank Index	23.2
NSE Nifty Pharma Index	39.6
NSE Nifty FMCG Index	38.9

TTM PE (x)	
NSE Nifty Auto Index	88.3
NSE Nifty Metal Index	6.8
NSE Nifty Realty Index	63.4
NSE Nifty Energy Index	12.0

Source: Bloomberg, Spark Fund Research

Price/Sales of companies that listed in the bourses in the post-Covid period (including many Unicorns)

Company Name	Mcap to Sales
FSN E-Commerce Ventures Ltd	32.0
Zomato Ltd	35.7
One 97 Communications Ltd	21.2
Sona Blw Precision Forgings Ltd	24.0
PB Fintech Ltd	40.3
Clean Science & Technology Ltd	46.7
Devyani International Ltd	17.8
Aptus Value Housing Finance India Ltd	35.8

Company Name	Mcap to Sales
Metro Brands Ltd	20.7
Aditya Birla Sun Life Asset Management Co Ltd	12.3
Medplus Health Services Ltd	4.2
Latent View Analytics Ltd	32.2
Anupam Rasayan India Ltd	11.9
Indigo Paints Ltd	13.3
Nazara Technologies Ltd	14.9

Source: Bloomberg, Spark Fund Research

The expensive pockets are the ones which have performed the best over the last few years and are also the biggest beneficiaries of the tsunamis of liquidity. They ought to be more vulnerable and early signs are suggestive of that. This makes the whole market vulnerable.

Unicorn IPO price, listing price and Current Market Price

Company Name	CMP (INR)	Issue Price (INR)	Listing Price (INR)	% change from listing price
FSN E-Commerce Ventures Ltd.	1652	1125	2001	-17%
Zomato Ltd.	90	76	115	-21%
One97 Communications Ltd.	917	2150	1955	-53%
Star Health and Allied Insurance Company Ltd.	768.	900	848.8	-10%
PB Fintech Ltd.	795	980	1150	-31%
Aditya Birla Sun Life AMC Ltd.	519	712	712	-27%
Latent View Analytics Ltd.	498	197	530	-6%
Nazara Technologies Ltd.	2122	1101	1971	8%

Note that the listing price matters for secondary market investors. Even the most hyped-up of the above are trending below the listing price and this should be viewed as a warning sign. To make it even more dangerous, the current free float available for selling is low which will change materially when the lock-in period for pre-IPO investors ends. They may still be seriously in the money as their cost of acquisition could be well below the IPO price itself. Almost all of them are financial investors. Their stance on paying scant attention to profitability indicators and instead laying emphasis on metrics such as price to sales and price to Gross Merchandise Value (a new term which in the earlier era denoted the revenues of trading companies and which rightly met with investor scepticism in associating stickiness to the same) is based on the seemingly endless unidirectional flow of global liquidity. That source may be drying up now.

In a scenario where the discourse on these companies exempts profits from being debated, this can prove to be a dangerous cocktail. When push comes to shove, the debate stops and the market action shifts to the price decline with rather dreadful consequences for those involved. Sadly, it will be naïve to conclude that the damage will be limited only to this segment. That said, post the Dot-Com bubble which burst, there was a period when other sectors which were not prone to the levitation syndrome, performed rather well.

In time, the market will figure it out. The bigger point for India is that there is a tremendous opportunity to attract capital and for delivering growth, both in the so-called old economy and in the Unicorn universe. The return potential for secondary markets will depend on the entry price. **For long, the narrative from many was that entry price does not matter. We have always been sceptical on that claim.** The time of reckoning is upon us. What you pay for what you get always matters.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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