Greetings!

What is in the mind of the market

Investors like us who are driven primarily by fundamental analysis start with companies, sectors and the economy. We analyse these to arrive at fair value of stocks. On the other hand, the price discovery in the market is a function of an interplay between all types of investors. These include investors with different time horizons, investors who allocate to different economies and those that invest in multiple sectors. On the other hand, the type of investors has also multiplied manifold with a range all the way from small ticket retail investors to sovereign funds with megabucks. Obviously, it is the interplay of this complex web that has made behavioural aspects of the market much more important these days. It is a worthwhile exercise to try and make sense of what is in the price and what is not.

The market move during the progression of the pandemic is itself an eye opener. When the black swan like event hit the world in 2020, the markets, including India witnessed a steep bear market. It proved the shortest bear market in history. Somewhere during Q2 of 2020, the market made up its mind. It was able to see that policy will be so accommodative that equity as an asset class will remain the best option for investors. It was able to see that we would move towards the so-called K shaped recovery in many economies. Equity markets realised that they were aligned to the upwardly mobile stroke in that recovery. In India, the earnings recovery was something that the market saw well ahead. In all of this, the digital economy has been a strong driver of the market.

What now?

The known unknowns

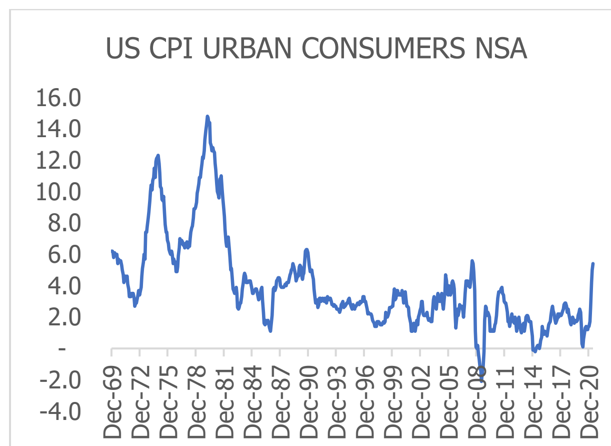
This is what should supposedly be in the price. The market has shown amazing clairvoyance in knowing these unknowns better. These include

1. Global interest rate trajectory
2. Prognosis for inflation
3. Prospects for digital economy
4. The winner take-all nature of the recovery, particularly in India
5. More power to equities, again a trend that is probably still young in India

The US Fed has been most helpful in oiling the equity markets by leaving no stone unturned in taking the surprise effect out of the interest rate trajectory. So, the Dot Plot (a pictorial representation of the future intent of the decision makers in the US Fed based on their best judgement) has become the holy grail for those following the liquidity trail in advance. The US Fed is so far out in the business of riding the tiger on this one that the tiger has grown far too big to get off even with some protection. It is fair to say that the markets all over the world have implicitly bought the updated and improved version of the (in)famous Greenspan put. For the uninitiated, the US markets (global markets catch the cold if US sneezes) started placing huge bullish bets on equities after investors took a calculated risk that the Fed may not wish to upset asset prices, in particular equity prices. The bet has since been that if asset prices (read equity assets) go down too much and too fast, the Fed can be trusted to intervene in favour of the bulls. Though the Fed never explicitly became the saviour of last resorts for the perma bulls, the Fed action has always been benign towards the equity bulls for a long time now. This subject is not our topic of interest now. Suffice to say that the Greenspan Put has become the Fed Put and equity markets count the Fed amongst its avid supporters.

Such faith has been reinforced by Fed actions of seemingly endless injections of liquidity. This situation where everyone seemed to come out a winner has been in play for a while now so much so that investors have felt bold enough to push up valuations of equities. Inflation has now begun to seed some doubts in the minds of the bulls. Why are investors so scared of inflation?

We have to go back to the 1970s to understand this. The oil shock which resulted in a supply crunch caused an inflationary spiral which caused US Govt Bond rates to go well into double digits. The charts below amply tell us the story.



Source: Bloomberg, Spark Fund Research

It took a tough inflation hawk by name Paul Volcker to tame the inflationary surge. The massive global bull market in equities was born in the early 1980s when the Fed went after inflation and by the reckoning of many, is still raging on.

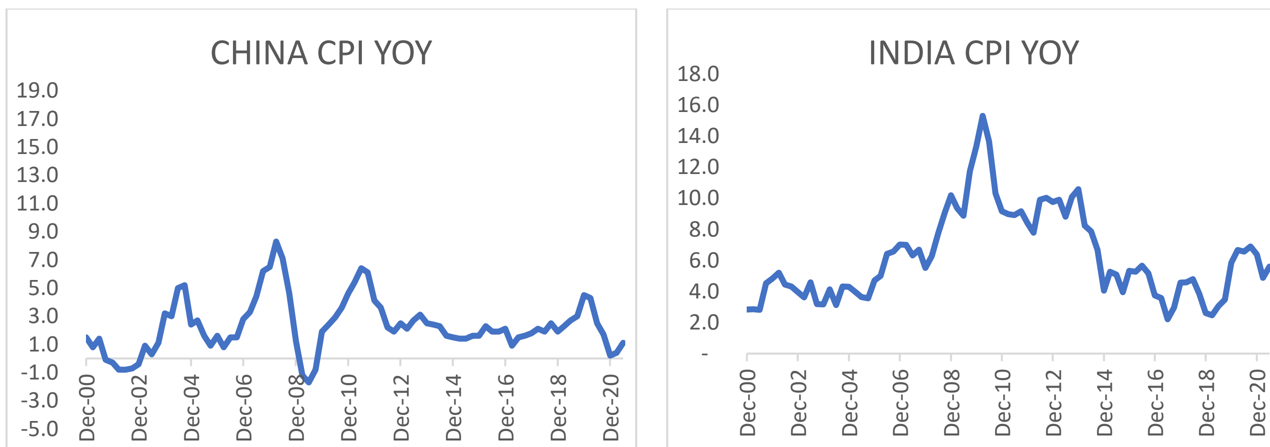
How does inflation affect equity markets?

One, it erodes the value of savings and sows so much uncertainty in the minds of the productive savers that capital formation is hit. Borrowers love inflation as you repay lesser amount in real terms than what you borrow. This kind of a skew is no good news for future growth outlook. Equity valuations derive their sustenance from future growth outlook and now you begin to see why bulls of this world live in morbid fear of inflation. There has been a new twist to this story. An inflationary spiral is normally tamed by stepping up the heat on the cost of money. As interest rates go up, what you earn from bonds look attractive as compared to what you can hope to make from equities, particularly given the fact that P/E ratios of 50,60 or 100 perforce bring down equity yields to low single digits in percentage terms (Equity yield = E/P or inverse of P/E). This is a dangerous double whammy and that is why the markets should be running scared of inflation.

That said, there is quiet confidence in the ability of the Fed to tame inflation even without increasing rates. In fact, the yields on a certain category of bonds in the US markets known as TIPS (Treasury Inflation Protected Securities) are in negative territory. To keep it simple, the investors in these bonds are betting that inflation will stay too low to bother with. If inflation turns out to be transitory as the markets believe now, equity bulls will go back to their business of pushing up the valuations. The one worry with this kind of a behavioural equation is that everyone seems to be on the same camp even as current inflation numbers continue to track higher. Such situations are an ideal breeding ground for financial accidents-in-waiting.

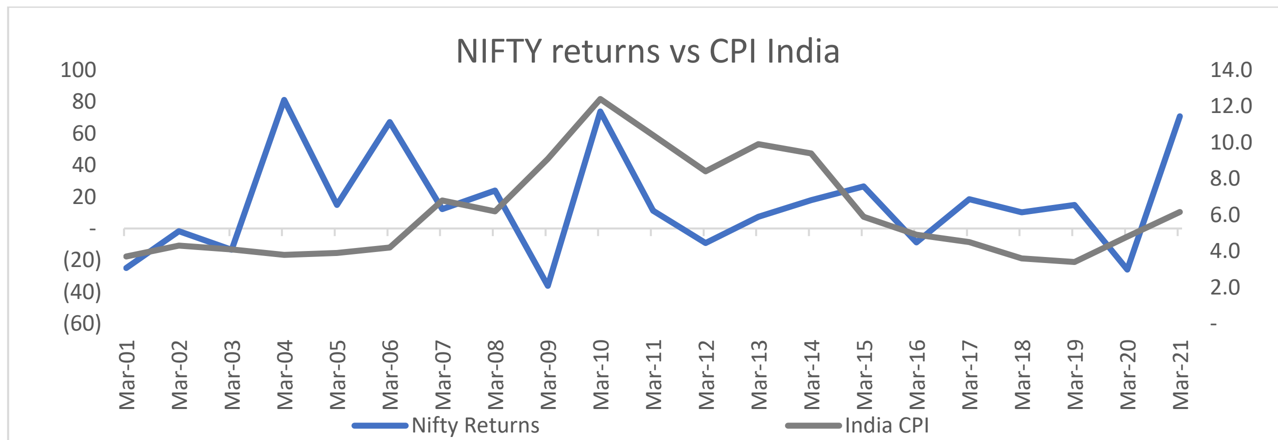
What is India's score on inflation? India has always been a high inflation economy and that is an understatement. Look at the comparison with China, with whom an inevitable comparison is often made.

Chart on inflation comparison with China – CPI – 2001-2021



Source: Bloomberg, Spark Fund Research

Let us look at the correlation between Nifty returns and inflation.



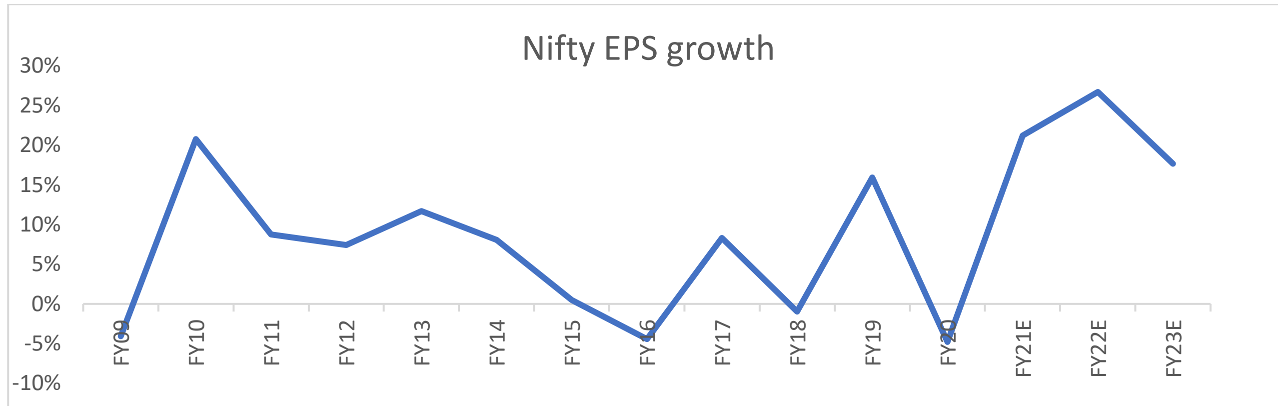
Source: Bloomberg, Spark Capital Research, Spark Fund Research

The results are unedifying though it has to be stated that in the early stages of an inflation surge, markets do well. After all, producers in a market which are used to lesser competition benefit when nominal prices gallop. At the end of the day, consumers lose out and it

comes back to bite producers. Devaluation of currency and debasement of wealth have been clear consequences. Persistently high inflation is one of several reasons why India has punched far below its weight.

Apart from prospects for interest rates (which are expected be low) and inflation (which is expected to cool off), the clout that the digital economy is expected to wield is something that seems to be priced in by the market rather generously. We don't have to go beyond the market cap of Zomato to see that this is indeed the case. Further, the market consolidation which makes the big even bigger is something that the market has tended to price in adequately. This is evident from the premium valuations enjoyed by market leaders of all hues. Finally, the market has sensed that the asset allocation shift to equities is in a relatively nascent stage in India and the trend is truly structural.

Amongst the known unknowns that is not yet in the price, what takes the pole position is the growth revival in India. All the positives listed above have tended to push up the P in the P/E ratio. There has been little confidence in the E and its future. Of course, the market cannot be blamed for its cynicism. Look at the Nifty EPS growth for the last twelve years.



Source: IIFL Research, Spark Fund Research

The manifestation of a long-awaited growth revival in India is the one thing the market is yet to price in wholeheartedly. This can result in the denominator in the P/E ratio getting a boost. If market gods are kind enough to keep the P/E ratio stable, this would be a key return driver for Indian equities in the next few quarters.

The unknown unknowns

On this, your guess is as good as mine. Covid is an example of what can happen when one of these things hits us. By definition, we don't know what they could be. The one risk we all need to understand is that the market is highly vulnerable to actual negative news when one hits us. This is because the bears who would normally have acted as shock absorbers in the system have been made almost extinct. The positive spin is that it could be a Santa Claus who will be waiting after the next turn. It is always good to sign off on that rather optimistic note.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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