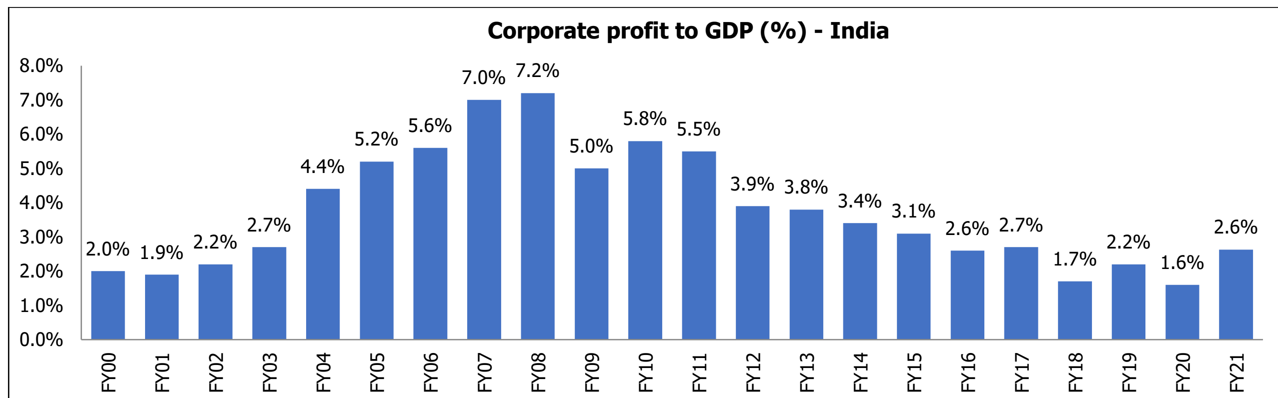
Greetings!

Reading the tea leaves

Over the last couple of months, we have been cautioning investors to smell the coffee. Risks have been on the rise. The market has held up at the level of the indices such as the Nifty. Many individual stocks and now some high-octane segments of the market have seen deeper cuts. Given the extent of froth, this may not be the end of such corrections in stocks and sectors where the price action was way too much. It is not that the companies in question have an issue. The aura of invincibility at the stock price level has been getting overdone. There is always a price at which any stock becomes a sell. Period.

That said, the market has been factoring in a recovery in the economy. The possibility of a strong cyclical revival has only been strengthening over the last several months. The incoming data gives more credence to this. To delve into the mind of the market, we focus on a top-down metric that sheds some useful light on the subject.



Source: Ace Equity, Spark Fund Research

Why is this important?

This broadly represents the tug of war between the producers and the consumers. The terms of trade have continuously favoured the latter for many years. This is not the last word and the producers have no god given right to claim a certain higher share of the pool of economic value creation all the time. At the same time, it is common sense to surmise that producers will have lesser incentive to keep investing in creating capacities if this situation were to persist. The Nifty EPS growth at 5% over the ten years to FY20 (pre-pandemic) tells it all. Corporates have been in pain even as the consumers benefitted in a broad sense. This pain was far from being uniform. More of that later.

What is important to note is that the level of under-investment and consequent consolidation at the upstream ends of the supply chain may have reached a climactic turn. Recent disruptions in the supply chain in power production which threatened to put us in the dark literally is symptomatic of a deeper malaise. The economy needs the investment cycle to start revving up. One cannot sustain the single engine mode with the consumers and the so-called new economy firing away even as infrastructure & manufacturing keep getting marginalised. The forces of change are the need of the hour and the turn in the cycle was anyhow imminent. The pandemic may have catalysed this in a big way. Given the efficiency gains forced upon the corporates by the pandemic and a bit of tilt in pricing power, we expect the economic cycle to be in play. This will likely result in the cyclical growth surprising the market over the coming quarters. This will also result in profits as % of GDP trending up. Assuming that the same will claw back to 4% of GDP by FY24, we see the following impact on the Nifty profit pool.

Year	GDP (INR trn)	Listed Corporate Profits % to GDP	Listed Corporate Profits (INR trn)	Nifty 50 Profits (INR trn)
FY19	188.9	2.2%	4.2	3.4
FY20	203.5	1.6%	3.3	3.1
FY21	197.5	2.6%	5.2	4.1
FY22E	227.1	3.0%	6.7	5.7
FY23E	254.3	3.5%	8.9	7.4
FY24E	284.8	4.0%	11.4	9.7

Source: Ace Equity, Bloomberg, Spark Fund Research

We believe this is what the market has started to sense. This represents a nearly 30% yearly profit growth for Nifty over the next two fiscal years. The Nifty EPS (on which headline valuations are measured) may grow slower as the dispersion of profits may not favour all the companies having high weight in Nifty. This would still mean that the Nifty EPS can grow from INR 727 in FY22 (estimated) to a range of INR 1,000 to INR 1,100. The Nifty valuations appear more sustainable in case this pans out. This would then mean that the market can continue to give reasonable returns albeit with higher risks and indeed more volatility as well as change in leadership. The market is positioning for this but that means there will be a change in leadership.

The Great Rotation

During the period of draught for corporate earnings, the profit drag was not uniform. The consumer facing companies were impacted far less as compared to the typical B2B names. The commentary on these names kept getting more and more positive and the narrative has been that these managements can tread water. No doubt that the execution capability of these managements and the capital discipline were hallmarks of excellence for most part. All other aspects were given a go by. Now that the terms of trade and the bargaining power are shifting, we see threats to gross margins. This may just be the beginning even as we have no doubt in the ability of these companies to navigate these waters. It is just that these companies can operate at lower margins and they have done so in the past. The jolt seen in Q2 of the current year may not be a one-off.

Let us now look at how the Nifty profit pool can look like a couple of years from now.

Sector	FY24 Profit (INR trn)	Profit CAGR FY22-24
Basic Materials	1.1	20%
Energy	1.7	15%
Financial	2.5	30%
Industrial	0.4	30%
Technology	1.2	15%
Utilities	0.4	22%
Consumer	0.5	15%
Healthcare	0.2	19%
Others*	1.6	152%
Grand Total	**9.7**	**30%**

**Profit growth in 'Others' is high due to the low profit base in FY22E* *Source: Bloomberg, Spark Fund Research*

The Great rotation is well and truly on and the leadership is shifting. We believe this is no bad thing for the market if we want all the great tidings we expect from it to play out in a sustained manner. As we like to reiterate, the pace of price action in India and elsewhere means that the risks have gone up. That needs to be negotiated and overall, return expectations have to moderate.

The above assessment presumes that the economic recovery will continue to gain traction. There are a few pushbacks to this

1. The comeback of inflation
2. Oil prices
3. The investment cycle has flattered to deceive in the past

On inflation, India has a bad track record with the same. One point to note is that this becomes a serious concern if and when the economy starts to over-heat. The current bout of inflation is driven by a supply side re-set of sorts and is not likely to sustain though that does not mean commodity prices will come down. All we are saying is that there may not be a spiral. A high oil price is always a risk for India but oil at USD 80-90 in 2021 and the same level in 2007 are not comparable. The economy has added more heft in the interim and can withstand higher oil prices a lot better. That apart, there is a crucial difference now. In this round, the pass through has been seamless and therefore the increase in oil prices is being well-absorbed as we pen this down. Oil is a risk but India is better placed. The last point on the false starts in investment cycles is based on the observational error of bias from the recency effect. All economic cycles have their day in the sun and the longer they are a no show, the sharper they are likely to come back. We strongly believe that this run has many legs and stronger momentum.

A few leading global brokerages have downgraded India in October based on the fact that the Indian market's premium over Global Emerging Markets and China has touched an all-time high. We agree that the Indian market valuation has been a matter of concern and have repeatedly stressed on that point. But this piece of statistic emerges from the fact that the expensive end of the market has become incredibly expensive. The other part of the market, while at higher valuations than in the past, may actually be trading cheaper than the optics of it if you discount the potential lift to earnings. Moreover, the benefit of lower cost of capital from a secular drop in interest rates should benefit these companies as well.

This is what is driving the great rotation into the cyclicals and industrials. While this shift in allocation has its risk, the one factor which we will watch out for is the strength of the recovery. Many recovery indicators suggest that the recovery has tailwinds and it is way too early to get sceptical on it. The recession may have extracted efficiencies which would have been impossible to glean out in normal times and this is a point which we have talked of. It is worth repeating. Do not underestimate the momentum and longevity of this cycle.

Then there are risks

We have talked about the level of froth in the IPO market. That can certainly be a big spoiler. Most of these IPOs are massively mispriced according to us. There is too much being attributed by way of future growth only because no one knows the future and that ostensibly gives a license to be as optimistic on the same as the spreadsheet can allow one to get away with it. We remain watchful on this.

The digital economy, which is here to stay and thrive, is a disruptor for many industries. The growth in the same is exciting to behold, but dangerous to embrace for many. Then there is the question of how far you can travel with the deep cyclicals. The lesson from history is that when cyclicals appear cheap, sell the market.

Many lines in history have been re-written. However, exercising caution will never go out of fashion when it comes to investing. We have tried to read the mind of the market which has refused to oblige those who want a deep correction. The market can well change its mind.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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