From the CIO's desk – Market musings – February 2021

SPARK FUND

Greetings!

What has changed in the last twelve months

1. The whole world has masked up
2. Physical mobility has come off meaningfully
3. The world went through the most severe synchronised recession of the modern era
4. India went through its maiden recession and pulled back
5. The shortest bear market in history came and went

We can go on and on, but it is enough if we say we all went through a lot.

For us as equity investors in India, our considered view is that the seminal change has been in the outlook and not in the events that have passed. The outlook looks a lot better than it was in March 2020 – or at any time in the previous five years. We are saying this with the full realisation that the Nifty is up 29.7% in the last 12 months. We are also saying this with full sense of responsibility in that the risks have not receded, and the market is vulnerable for corrections. Given the rate of change in prices over various time periods within the last one year, the 5% fall from the recent all time high appears to be a teaser dose. Hence, caveat emptor.

Yet we have to say that the future for India looks brighter and the outlook for the market looks good, compared to any time in the last five years. This is because of just one reason:

The single biggest factor governing equity returns remains earnings growth and the picture for that looks good – over one, two or three years.

Much as everyone would like to propagate the secular nature of economic and earnings growth in India, that is a myth. The cyclical factors for economic growth were unfavourable for a few years before the pandemic itself. Earnings growth was in an extended draught for over a decade.

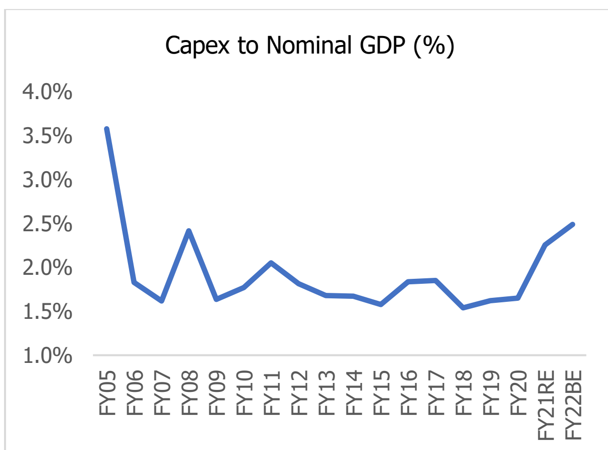
Real GDP CAGR (%)	
FY03-08	7.9
FY09-14	6.7
FY15-20	6.7

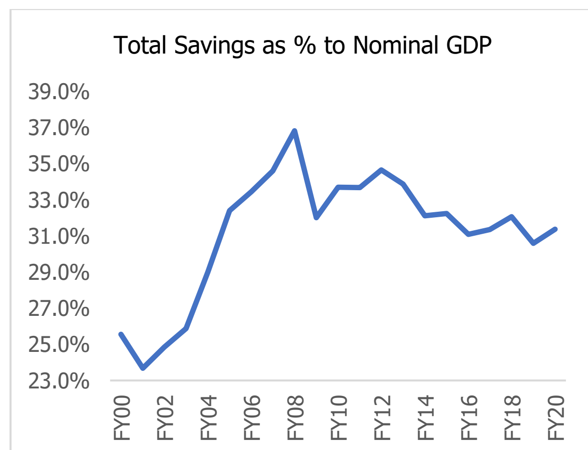
Source: Bloomberg, Spark Fund Research

Source: I-Sec Research, Spark Fund Research

So, what is changing now, why and how?

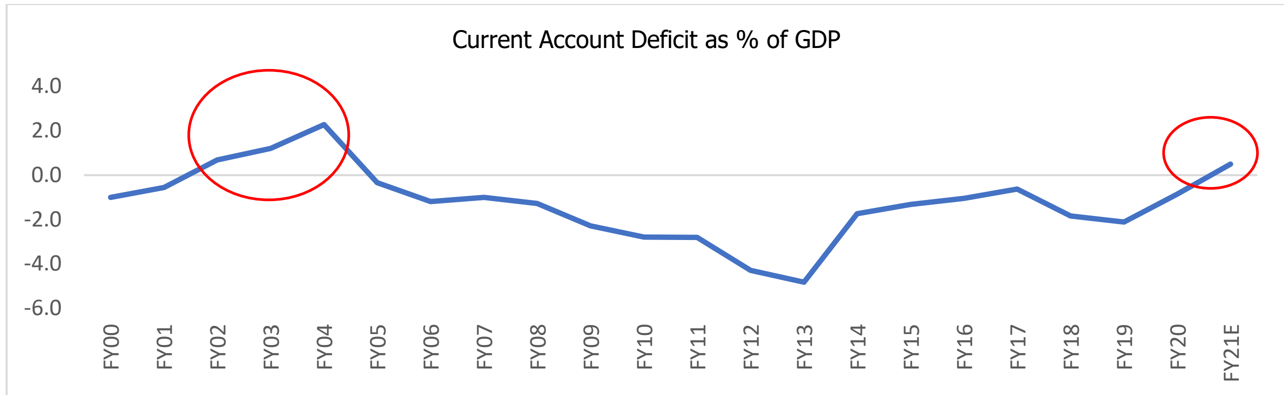
Investment cycle looks set to turn





Source: Union Budget, Spark Fund Research

The proposed capital spending outlay in the budget at 2.5% of GDP has the potential to make a big difference. Savings will only go up if household, government and corporate balance sheets improve and that will only happen when profit cycle turns up. However, there is willingness on the part of the political economy and global markets to fund deficits. There is a much better chance of investment to pick up. Given that private investments will pick up only with the profit outlook improving, the turn in the earnings upgrades for the market is helpful – and indeed a leading indicator for the cycle to turn up. Nifty EPS for the forthcoming periods has been getting upgraded over the last few months and earnings growth is set to go beyond the 25% mark (albeit off a low base) after a long time. This may not be a one off and can sustain if the macro indicators continue their journey in the direction they have been moving of late. Look at the current account position for instance;

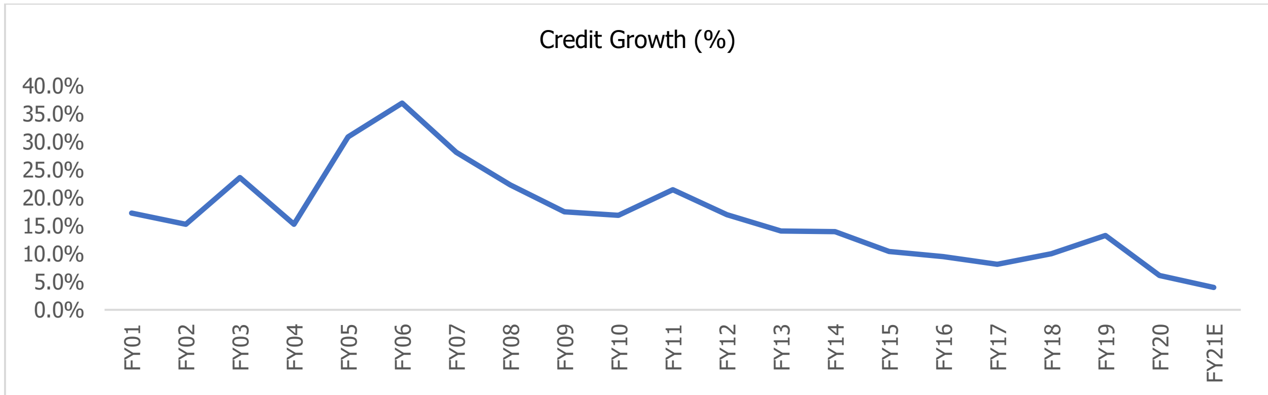


Source: Union Budget, Spark Fund Research

We highlight the directional similarity in current account position between now and in FY02-FY04 timeframe. The stage is set for the cycle to turn.

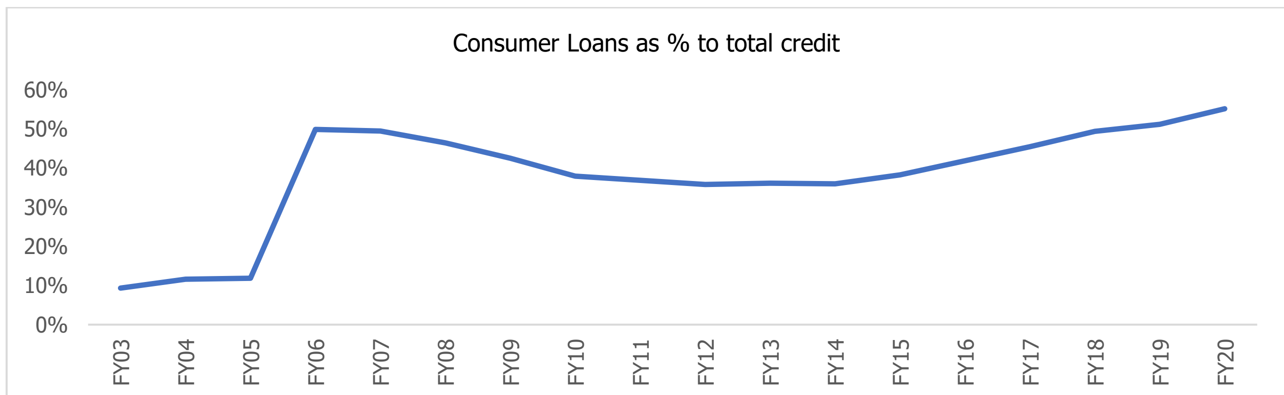
How will all this impact the economy and the banks?

There was a pretty nasty bad loan cycle in India. This and the sub-optimal trends in economic growth, as well as the drag on corporate earnings combined to contribute to an extended period of poor loan growth in India.



Source: RBI, Spark Fund Research

This in turn resulted in the economy firing on just one engine – consumption. In a large economy like India, the consumer cycles tend to be shallow and short. Look at the mix of loans even as overall loan growth faltered. The mix has moved in favor of retail loans even as loan growth was anemic. This is hardly the set up required for sustainable employment growth, income growth or corporate earnings growth.



Source: RBI, Spark Fund Research

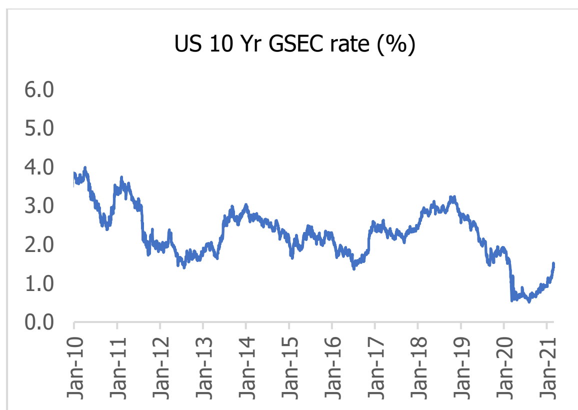
The NPA cycle for banks has shown signs of turning the corner just before the pandemic hit us. The pandemic created a deeper bottom. This led to an automated clean up the likes of which would have been impossible to have achieved in normal times.

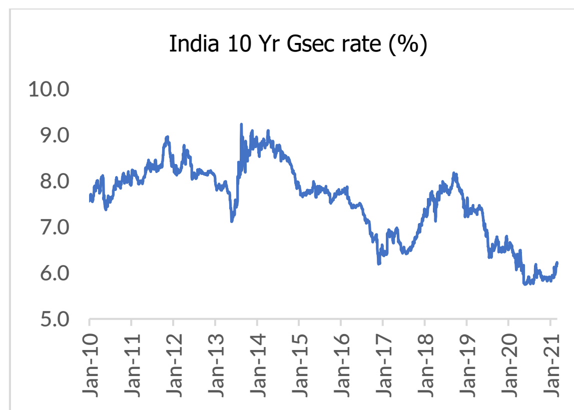
Thus, we are of the view that the Covid recession has resulted in accelerating the changes in political economy and in weaning out inefficiencies. The virus may have achieved what we could not do; To create a base for a more robust growth in the economy and earnings over the next few years. What can upset the progress of this cycle?

Covid continues to be a risk. Given that India is one of the few countries in the world that can manufacture vaccines, we believe that we are in a better position to bend the curve if that were to rear its head yet again.

However, we should worry about global liquidity. After all, that has been the fodder on which the bull has been getting fatter and running faster.

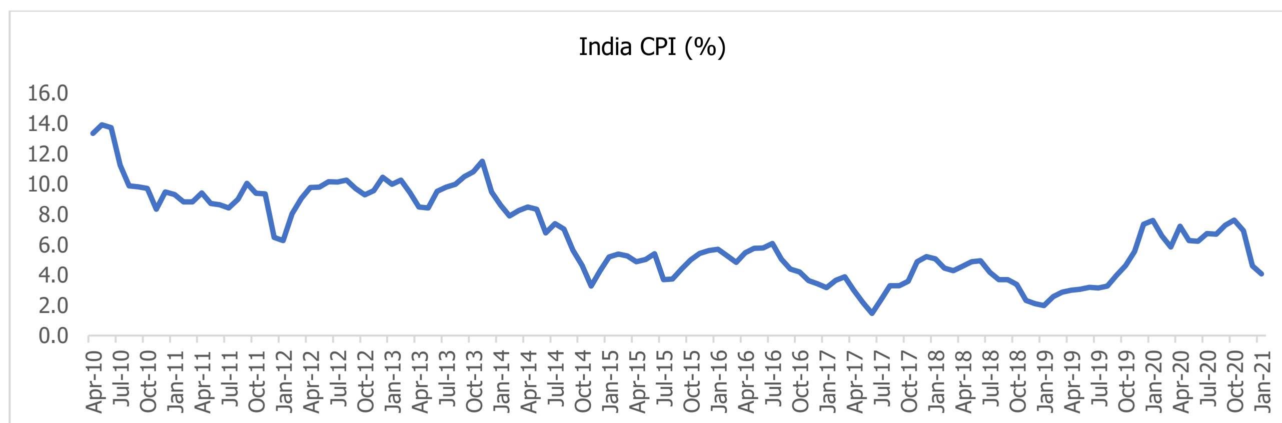
Taper Tantrum II ?





Source: Bloomberg, Spark Fund Research

THE UPTICK IN YIELDS IS CAUSING MARKET TREMORS – INDIA'S FISCAL DEFICIT DOESN'T HELP
CPI IS MUCH LOWER THAN IT WAS IN 2013



Source: RBI, Spark Fund Research

How this saga plays out is a real risk. Given that the policymakers in the developed economies have little room to take growth for granted (Covid itself will not likely recede from the scene until at least the end of 2021), the liquidity tap should remain open for a long time. There is a tantrum out there but very little tapering. The policymakers have no incentive whatsoever to tame the bull. The odds remain good that the reflationary pressure is driven by growth expectations and not from the fear over policy.

The inflation numbers in India are far more benign than in 2013 when the last saga of the tantrum played out. The growth impulses should outweigh the fear over inflation this time around. The fall in equity markets is thus more of a long overdue reality check on the momentum of the rise – which is a factor we have been warning about for a while now. To no avail earlier on. It looks like the shake out is underway now.

What happens to high valuations if interest rates have bottomed out?

Once again, we have been very clear that valuations cannot keep rising. There is always a price to be paid for the excesses and the markets will eventually extract the same. This is where it is useful to look at the earnings picture in India and how the internals of valuations stack up.

Pockets of earnings growth retain sanity in valuations as well
How earnings growth and valuations stack up – FY21E and FY22E:

Nifty constituents across sectors		Median P/E (x)	
Sector	**Earnings growth - FY22E vs FY21E**	**FY21E**	**FY22E**
Financials	36.1%	34.1	22.0
Energy	29.6%	11.8	7.2
Consumer	22.2%	62.0	52.5
Information Technology	14.6%	21.0	19.3
Auto	115.4%	26.3	19.9
Health Care	11.8%	27.5	23.4
Others	50.3%	14.6	11.6

Source: Bloomberg, Spark Fund Research

It is clear that the growth is coming through from the more cyclical parts of the market. The possibility of upgrades and sustainability are also higher in these segments. The above data captures median multiples and individual stocks within a category may be trading at even higher multiples. The data tells us that if yields around the world and in India were to rise moderately, the more expensive stocks may be more vulnerable. Overall, if earnings traction is maintained with the help of cyclical recovery, valuations can be supportive of market performance; Except in cases where valuations were driven up too high as a result of risk aversion which pushed investors deeper and deeper into high quality when growth remained a mirage.

For instance, banks are still not overvalued, particularly corporate banks and select private banks. Interest rates are still markedly lower than in the past and thus are supportive of equity market valuations to remain higher than before. We have always maintained that the issue is more about how high is high enough. The answer varies from sector to sector and stock to stock.

We remain convinced that alpha generation opportunities exist in the market. Provided we are not using fancy theories to justify high valuations, measured by P/E ratio or any other metric that has its focus on earnings, profits, cash flows or whatever name you want to call it. These metrics do not swim in completely different directions.

In emerging markets for sure, it is about the cycle and the cycle is king.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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