Listen to Japan

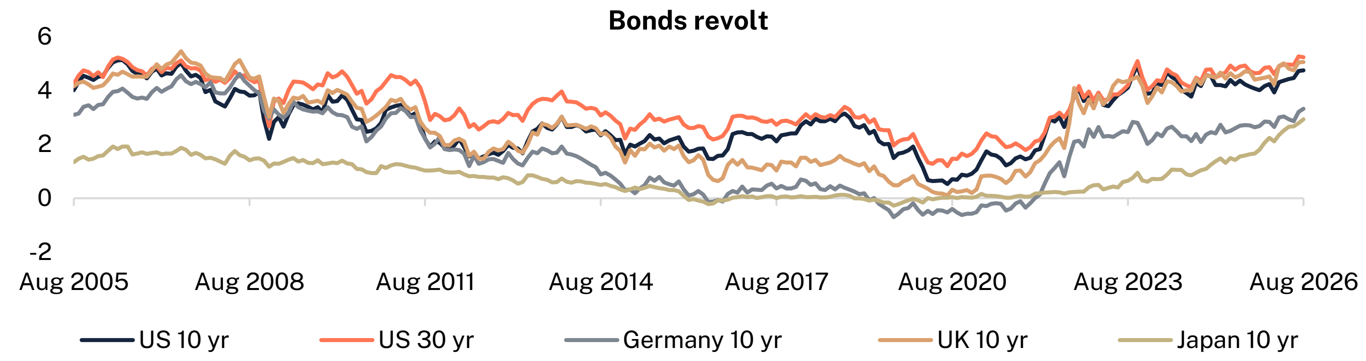
Japanese bond yields have been rising. The Yen has been weakening. This is more than a once-in-a-lifetime moment. Japan is more significant than is apparent. Japan remained the cheapest source of duration for the world for decades. The floor has now shifted and that is seismic.

- Japan remains one of the world's largest net international creditors
- Japan is a key overseas holder of US treasuries
- Japanese rates were near zero for way longer than for any other wealthy nation's debt
- Legions of fund managers raked it in by borrowing in Yen and playing the world.
- The word carry trade became synonymous with borrowing in the Yen
- For India, Japan is the cheapest source of international capital
- The marginal Japanese buyer has been the most agnostic to prices & valuations in India

Something has upended this template. We need to pay attention. We will do so by presenting a series of visuals which connect the dots and lead us to one big conclusion – Cost of capital is not low in the world anymore and is unlikely to walk back.

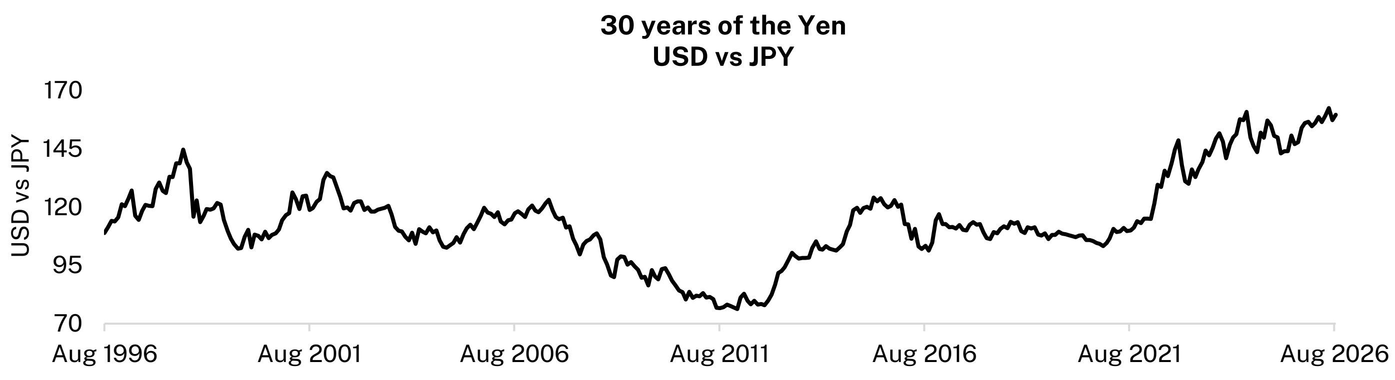
Indian assets, in particular equities, benefitted from low global cost of capital. Do not therefore extrapolate the proximate exuberance into a future where Indian investors can decide for themselves that Indian stocks can be valued at whatever multiple they deem fit.

Global bond markets are saying enough is enough



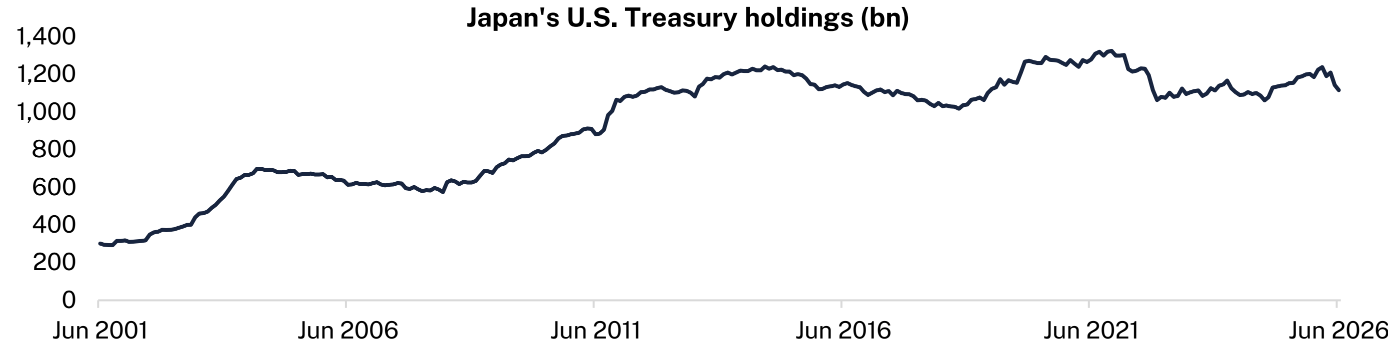
Source: Bloomberg, Spark Fund Research

The hardening of the yields is across the world. This clearly represents the steepening of the term premium – the excess returns that investors in bonds demand for holding longer-dated paper. Global policy makers can talk up the short end of the curve. It is almost impossible to flatten the curve – the increase in term premium is due to the apprehension about the long-term ability of big countries to service their debt – in particular that of the United States.



Source: Bloomberg, Spark Fund Research

This breached a nearly 30-year level. The US government intervened to save the Yen in a move that almost everyone agreed is unprecedented. Most saw it as a desperate crisis response. It seems to be coming a cropper so far.



Source: US Treasury Department, Spark Fund Research

It is still high but beginning to come down. Which is precisely why the US intervened

The sequence tells us the story:

US is reliant on a significant number of non-US investors to finance its debt

Japan is one of the largest of the brigade

Japan saw the JPY depreciate

Japan is heavily dependent on imported energy – and has been seeing retail inflation accelerate

JPY fall exacerbates the pressure on Japanese households – remember that Japanese folks have not known what inflation is like for more than a lifetime

In order to rein in the Yen, Japan needs to buy Yen – it needs to pay in dollars

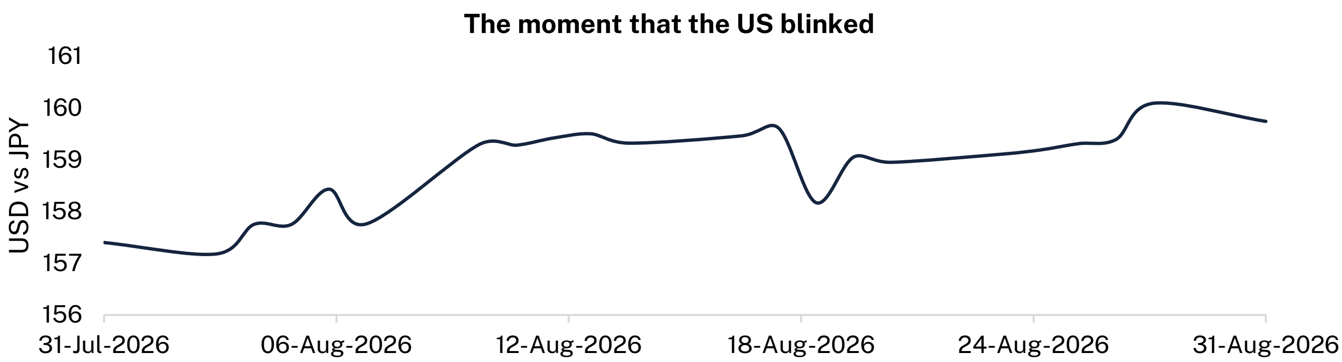
In order to get dollars, Japan needs to liquidate some of its US bond holdings

Such selling would exert enormous pressure on US bond yields – which are already high

Higher US bond yields would make the cost of servicing debt formidable for the US government.

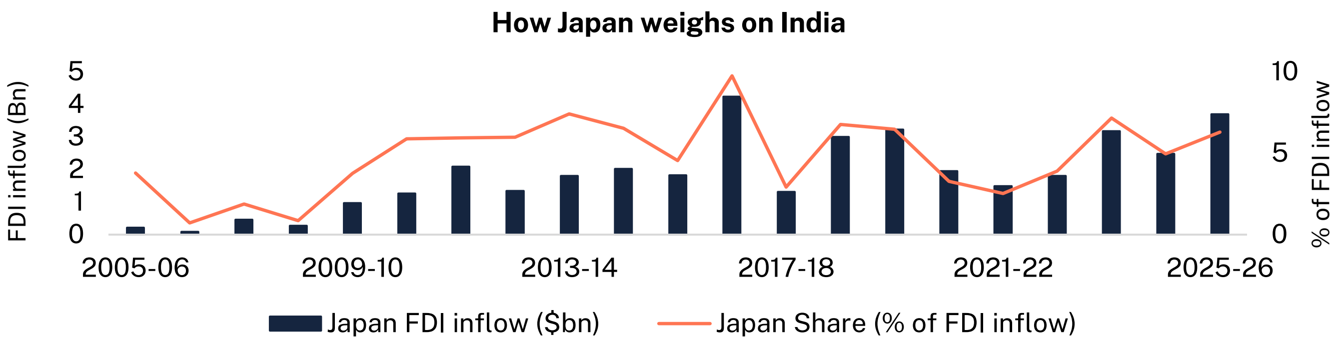
A recent treasury auction saw takers at 5.2%, a thirty-year peak

Now, it is clear why US intervened



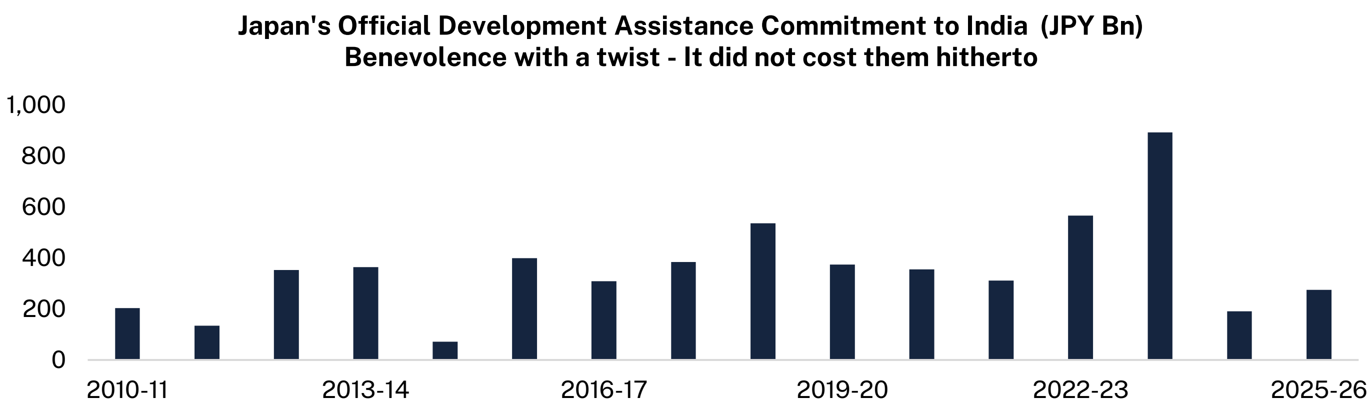
Source: Bloomberg, Spark Fund Research

While the JPY appreciated closer to 155 as soon as the news of the US intervention came through, the gains never sustained even for a day. The market remains unconvinced.



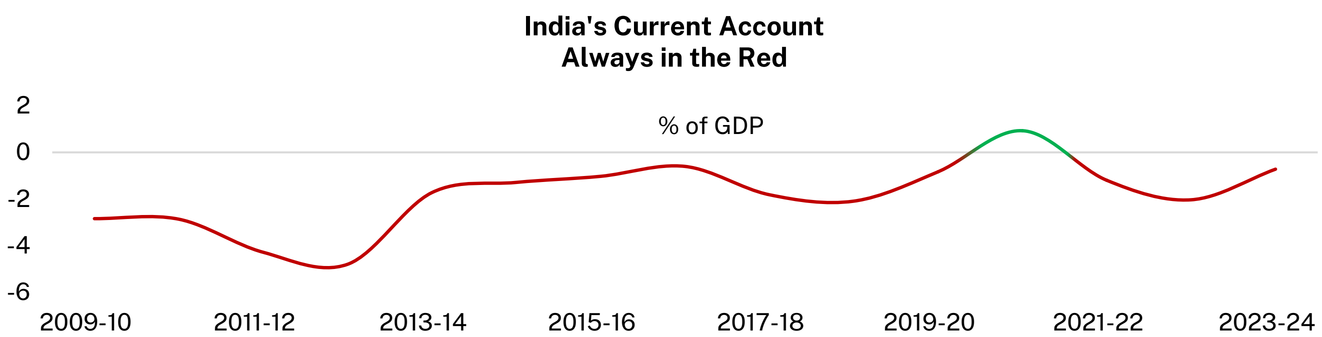
Source: Reserve Bank of India, Spark Fund Research

Japan remains a key investor in India. What is more important than the quantum is that the marginal Japanese investor has been willing to pay much more for assets. They have been patient investors by a big margin, the epitome of tolerance. If Japanese domestic bond yields (essentially risk free) return almost 3% for Japanese households (3% represents a logarithmic jump from almost zero – which is what Japanese folks are used to getting for a lifetime and more) – this FDI will be at risk.



Source: India-Japan Embassy, Spark Fund Research

Japanese development funding followed from its low cost of capital and the interest Japan had in garnering the business opportunity that comes from this investment. Japan has been a constant when it comes to financing India's infrastructure projects – be it major railway projects or anything else. This was facilitated by the fact that the Yen yielded almost nothing for the Japanese. No longer the case. It is futile to expect the funding appetite to remain what it used to be.



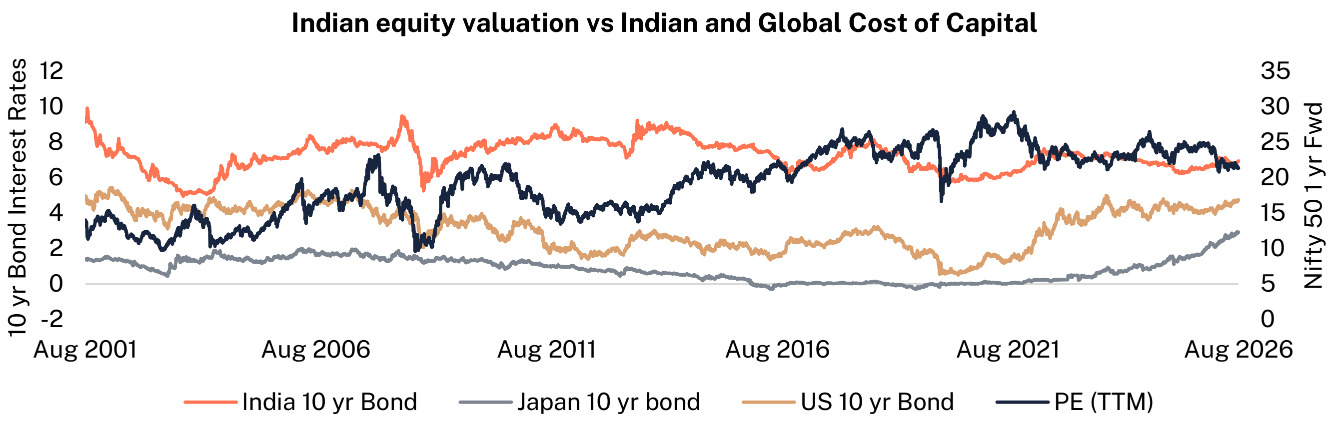
Source: Reserve Bank of India, Spark Fund Research

The point to note is that the current account has been under water almost always. This is in sharp contrast to other Asian countries.

	Current Account (% of GDP) - CY25
China	3.8
Japan	4.9
South Korea	6.6
Taiwan	17.4
Thailand	2.8

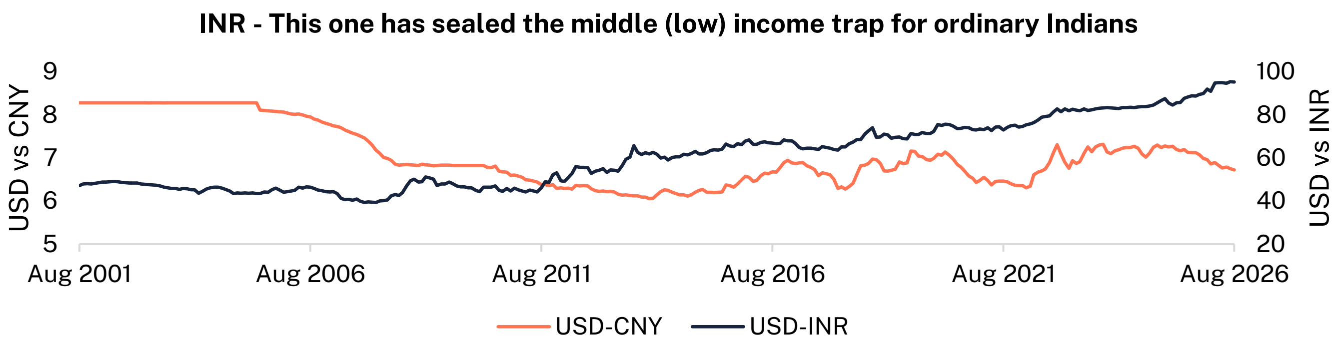
Source: World Bank, International Monetary Fund, Spark Fund Research

INR has reflected this reality. Indian policymakers and much of the economic think tank have been guilty of consistently making light of this. This forever deficit has made India dependent on foreign capital, eroded value of private savings and kept India relatively poor. In 2013, the cost of global capital was low and India got away lightly. The present conditions do not look reassuring and worse still; a lot of the market narrative is supremely indifferent to this reality.



Source: Ace Equity, Bloomberg, IIFL Securities, Spark Fund Research

The inverse relationship between the global cost of capital and Indian valuations is palpable. Note that the Indian bond yield never drove higher valuations in India. Indian SIP may now be supporting the high valuations – the end game as it has played out elsewhere when the global liquidity wave rolls back is uniformly terrifying. No one values history as long as it is someone else's story.

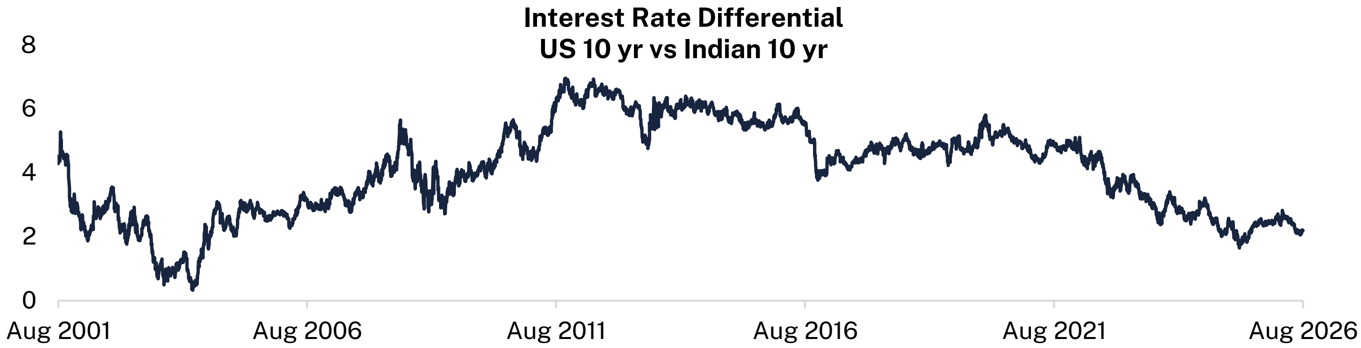


Source: Bloomberg, Spark Fund Research

Relentless plunge. This has been papered over by Indian policymakers. However, a weak currency means

1. A clear debasement of domestic savings
2. A clear increase in cost of living
3. A clear loss of foreign investor confidence (they need to earn in USD or EUR – INR has fallen against everything)

A stable (not necessarily appreciating) currency is the bedrock of the long-term escape plan from low (middle) income trap. There is increasing credence to the assertion that the growth we are seeing is driven by the rising stroke of the K. It may be real and for certain companies, material enough to create earnings growth. This growth by itself does not lead to a sustainable trajectory. If K keeps driving equity prices higher, equity owners may continue to benefit momentarily from the rather high-risk ride. Volatility will inevitably manifest, which is what we saw in the last two years.



Source: Bloomberg, Spark Fund Research

The fall in the differential shows that the global cost of capital has been rising even as Indian bond yields remained in the higher band. The difficulty is that India needs US dollars. The RBI felt compelled to attract USD by facilitating a 12% (or higher) effective risk-free return in USD to NRIs (the FCNR-B scheme in effect offers that after taking into account the leverage offered by almost all banks). The lesson is clear. At a certain high cost, India can raise any amount of USD. It needs to service this next. The pain is going to be felt albeit in a staggered manner. It is evident that the payoffs from the latest mop-up of USD at a steep price did not quite match the overall cost. This is one reason why RBI capped the inflow by closing the window one month ahead of schedule. They realised perhaps that a 12% effective USD yield is akin to a prince's ransom compared to the 4-5% that USD would return otherwise. The fact that India had to rely on a closed sub-set of NRIs demonstrates the other chink in India's capital account. It is fully open for equity capital where the vulnerability is masked but comes home to roost when there are challenges and/or better alternatives. It is not fully open when it comes to debt capital and when there is a crunch, Indians are forced to pay heavily, often in a disguised manner.

External account remains India's Achilles heel and the conduit for transmitting global contagion. India's domestic economy cannot claim to be immune to a global surge in the cost of capital. Indians have to pay by way of higher imported inflation, debasement of savings and eventually a growth retardation.

What Next

The writing on the wall is clear. Indian equities cannot look to global capital to sustain their premium valuations. It is also foolhardy to complacently forecast that Indian investors will keep funding the valuation binge. Implication – The environment for equities will remain challenged despite the recent hopes that Indian markets are all set to soar.

At the same time, there is a silver lining. The fabled story of the Indian equity market premium over its emerging market peers was founded on the bedrock of some great Indian businesses charting their own path in a capital starved economy some 25 years back. We are at similar crossroads now though time period comparisons have limitations. Companies having access to capital and those who exercise capital discipline are at the top of the list of stocks that we want to own. We feel they should also have business model resilience in a K-shaped world. Further, we like to see our stock picks passing the test of not being too dependent on Indian labor (where we see productivity bottlenecks). When we screen on these criteria, there are companies that stand tall – what the market seems to be wanting to pay for what these companies earn remains an enigma. Whichever way the dice rolls, the winners of tomorrow need to make the cut while dealing with a world in which capital will be much more discerning. There are Indian companies that make the cut, but the ask rate is where angels might fear to tread.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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