One trick pony and the blinkered bull

Something may have changed in the world in June. It is not about the Hormuz Strait. After tensions eased, crude fell more than what was generally expected. This should have been massively bullish for global stocks. But it was not.

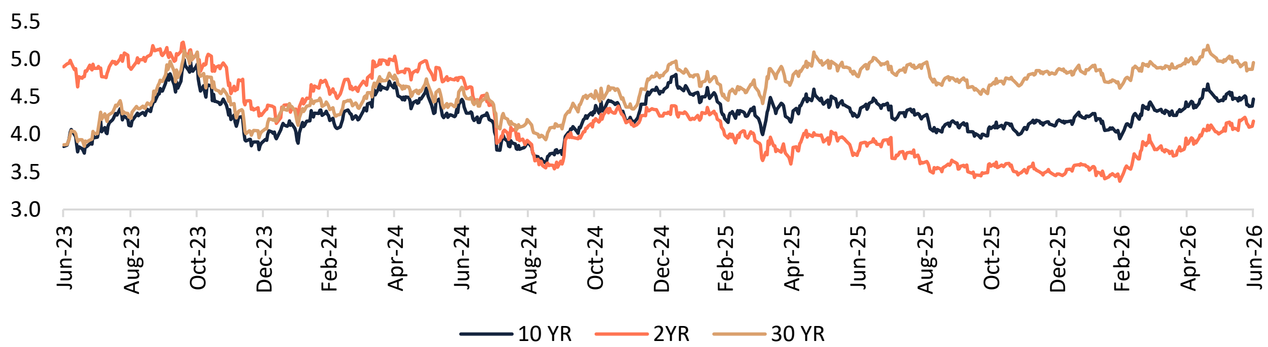
Something more important happened. Kevin Warsh took over the Fed. His first commentary was hawkish. Given that he was chosen by a President who wants lower rates forever, this raises eyebrows and justifiably so. Kevin Warsh is widely respected as someone who is intellectually very competent. His commentary should be viewed against the circumstances of his nomination. He has signalled a willingness to put credibility of the Fed above perceived affiliations. It may end up being regarded as one of the most consequential inflection points in the world of the Fed since Paul Volcker. Warsh has just begun his stint at the Fed.

The Fed Put is past its expiry – Did the pony stop on its tracks?

We had made this point that the Fed put is done and dusted when inflation spiked in the wake of the Ukraine war and Jerome Powell made a U-turn (Refer to our April 2022 newsletter). But then Powell was seen as a dove in disguise even after he raised rates. And then came the AI capex wave that put the market on steroids. Any risk to equities from the expired put was masked by the narrow but all-powerful AI boom. The first salvo from a new Fed Governor assumes great significance against this backdrop.

USD firming up on Fed Signals?

US Bond Yields point to the return of a credible Fed ?



Source: Bloomberg, Spark Fund Research

The yields at the shorter end have signalled near term firmness in rates. The Fed is not really saying that the rates will keep going up. Warsh is simply indicating that the Fed will follow its mandate – price stability and employment. Equity market stability is perhaps beyond its pay grade. This is positive for global capital in the long run. It is not great for equity valuations for the here and now. What we are seeing are early stages of an eventually constructive rationalisation for the US economy with some rocky contours in between. We can hear an uncomfortable rumble in the equity cocoon. The rumble is more audible in Taiwan and Korea for now as these exemplify the one-trick pony. Nasdaq is not far behind but it is a leviathan today as against the dot com era. The AI trade lifted many boats and some large ships like TSMC and Samsung not to speak of the Mag 7 in the US. By asserting that rates will rise if circumstances warrant, the Fed has signalled that equity bulls are on their own if they keep riding the pony. Something may have changed in our rarefied world of never-ending equity strength and the immortal bull based on beats of self-created (and often low-balled) expectations, calibrated as per our own convenience.

What does it mean for us in India?

First the good news which has nothing to do with the above *(I have been accused of calling out the bad news too often during the last few quarters)*

1. Oil has fallen. If it stays in a range of around USD 80, India has a strong case to begin mending the damage to its economy.
2. The actions taken by RBI in June are widely viewed as proportionate, adequate and positive. We agree. RBI has done whatever it could and not for the first time.
3. The developments so far, while inflationary and challenging, are not credit negative for banks to a degree where an NPA spike is imminent. This will lift the mood when June quarter results are announced in July. Equity bulls will cheer every sound byte.
4. We have been flagging positives when we spot them. In the last three newsletters, we alluded to "opportunity to deploy capital with a long-term view as the market sells off" and "The environment is ripe for us as investors to get to the desk and do some hard work". The one other comment worth highlighting is "India is very vulnerable to a global supply squeeze but is relatively resilient to global demand shocks". This should resonate in the current juncture for global outlook.

The cyclical uptick in India, pump-primed by tax cuts, may possibly resume after it was rudely interrupted by the war which no one wanted. There are many hurdles as well and it is pointless to trivialise those.

What continues to cause difficulty is the way India is sought to be projected within India. Indian investors have been relentless buyers in India. Indian market has under-performed almost every other market around the world in the last two years. If you consider USD returns, India has started to look wobbly even on longer timeframes. Foreigners have been persistent sellers. We have called out the reasons many times over. We see nothing illogical about their action. The under-performance and the massive haircut on the INR vindicate the selling which preceded this. Despite this reality check, we can't help but flag the obsession with equities as an asset class amongst the investor circles. Nifty has been touted as a symbol of India's emergence on the world stage. It is even threatening to be a political asset. This is a heady mix when we juxtapose the current global backdrop. I came across the following questions/observations in the wake of the latest developments and these merit mention.

1. Now that oil prices have come off, will FPIs turn buyers? - Obviously a leading question. The uncomfortable but straightforward answer – FPIs were sellers before the Iran war (for a long period) and hence their turning buyers because the oil may have finished a round trip (this itself is not certain) is not a logical construct.
2. Now that the AI trade is becoming wobbly, will not investors buy into India as India never participated on the way up?

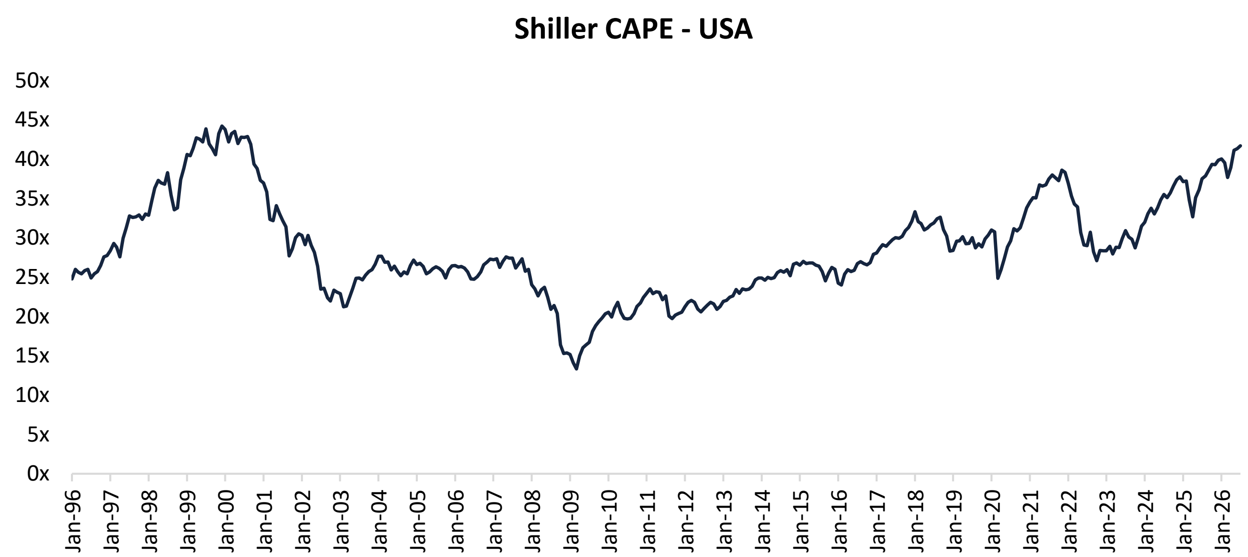
Once again, the answer is not pleasant. We did not miss the upward ride out of choice. We were not let in. There is no defendable correlation that exists to support a bull case on the basis of rotational entitlement. On the other hand, if liquidity pulls out of risky assets in EMs, India is in the firing line.

3. We came across this point that a bad monsoon is priced in. Why and how? Because the market did not panic when the rain was delayed in Mumbai?
   While everyone is entitled to their assessments, any assertion on a bad monsoon will need more data on how bad the monsoon turns out to be.
4. The other point has been on small/midcaps. The market view here starts with the principle of elimination. IT stocks are out because they have been tanking for a while. Leave out consumer sector because that is boring now. Avoid banks maybe because they are an overcrowded trade. But latch on to small/midcaps because they have shown good Q4 earnings growth. More to the point, they have outperformed from 1st of April. Very neat construct but here is the problem. Most of them are at valuations that do not offer comfort. The liquidity in these can turn on a dime. If SMIDs sell-off, the narrative might then roll over to a Buy call on IT services which by then might look to have fallen too much. India is entitled to a bull market whatever the circumstances or the data and so goes the push. Easy to be a believer but unwise to put money to work on this kind of reasoning.

If blinkered bulls drive the narrative on the only agenda that India deserves higher equity returns come what may, we may be setting up for bigger shocks. If the ageing mother bull suffers a setback, the baby bulls may be toast. We have heard the de-coupling chant earlier and that did not end well.

Whither the mother market

Many seasoned voices have been raising concerns over the AI trade and the narrow rally in the US. This spilled over into the Far East. We looked at a well-regarded measure of valuation. The Schiller PE is after all a number and not a story.



Source: multpl.com (Robert Shiller), Spark Fund Research

The implications are ominous. We will keep wondering whether history will repeat itself till the markets have had their say. We had a look at the Indian market valuations on a comparable yardstick.
There are constraints in the way we can apply this valuation measure to India. In 2022, the index earnings got re-based to use consolidated earnings instead of the standalone numbers. This depressed the PE and led to discontinuity. We must understand that the longer-term average PE measures mentioned in India during normal discourse take into account standalone earnings before FY22 and consolidated earnings after. This skews most measures of the mean on the downside as it conflates numbers on either side of the divide. Besides, India does not have a long enough history to make a ten-year CAPE a robust enough measure. We decided to use a modified Schiller PE using a five-year average and an adjustment factor on prior period earnings to make the numbers comparable. This is not perfect but tells us where we would stand if the tide ebbs away.

Modified Shiller PE	NIFTY 50 EPS - Consolidated	NIFTY 50 EPS - Standalone	NIFTY Midcap 100 EPS - Consolidated	NIFTY Midcap 100 EPS - Standalone
FY17	21x	23x	30x	31x
FY18	23x	25x	34x	35x
FY19	23x	28x	30x	38x
FY20	17x	20x	18x	22x
FY21	26x	34x	36x	47x
FY22	28x	37x	43x	47x
FY23	25x	32x	38x	37x
FY24	30x	35x	52x	40x
FY25	27x	31x	49x	38x
FY26	22x	25x	40x	31x

Note: In FY22 Nifty 50 PE calculation was changed from Standalone to Consolidated, same has been highlighted red in color above.
Source: Bloomberg, Ace Equity, MOSPI, Spark Fund Research

The market is still expensive, whichever way we spin this. The good news is this. Large caps can get valuation support if there is a fall and maybe not far from here. But if one were to extend the logic of comparing cyclically adjusted multiples to small/midcaps, we find a different picture. It is very hard to analyse this on a comparable set of earnings data over longer periods due to factors such as composition changes which are a bigger problem in midcaps than in large caps. The estimated impact is visible when we examine both the PE on both the standalone and consolidated numbers. PE on consolidated earnings is *higher* for midcaps and this is a point to note. This is on top of the higher valuation which is the direct result of fund flows into this asset class.

Whichever way you massage the data, beauty and future earnings lie in the eyes of the beholder. Any miss can be glossed over as a one-off and we can keep partying. This has been going on. This can go on until the domestic flows continue. Hypothetically, the domestic investors can keep investing until cows come home. Ipso facto, as per the law of supply and demand, stocks can keep trading higher.
So why bother about FPIs? Why talk about their return?
This is where we need to be wary. If global equities powered by the one trick pony falter, our blinkered bull may be forced to rush for the door which is too narrow for the beast. The strength in small/midcaps and the overall Indian market masks vulnerabilities on the liquidity front. This has not been tested yet. As much as I can be accused of being a spoiler, please dread that day. There will be no exit.

Back to basics

We cannot do anything more with the above analysis. It does not come with a good timing alert, though we believe it has salience. Let us get down to good old fundamentals. Low oil prices (assuming they sustain) are a clear positive for India. Inflation risk remains, monsoon risk looms, BoP does not bridge easily, AI adoption may not be pleasant and the Indian interest rates vis-à-vis developed world are not attractive enough at this point. But oil is where the optimistic turn can commence. The tariff row with the US could eventually end – and all is well that ends, no matter whether the tariff is 15% or 18%. US has managed to pull down everyone and is determined to go down with all. What matters here is certainty and not the level of tariffs. Once there is a deal and it is clear that the Indian banks will sail through the waters this year with no big hit to asset quality, the economic cycle is likely to look a lot better.

The key therefore will be earnings. Not merely whether companies are growing faster than what the opinion makers need in order to get on with their business of talking up stocks. We need to see the wheat getting separated from the chaff. We look for genuine earnings resilience, earnings visibility and valuations that can sustain a possible storm.

Indian market is not the most exciting growth story today. India is not nearly as well-placed as it was in some previous moments of crisis. India is no beneficiary of a global slowdown. India needs to figure out the AI era and while it could, that work lies ahead. All that said and done, India always had and continues to have some good businesses. We like those when they are at valuations that make sense and leave adequate room for returns. It is not proving easy and it is not a huge menu. However, whichever way you slice and dice it, it comes down to that.

Warm regards,
P Krishnan (CIO) and Team Spark Fund

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