THE FPI ENIGMA

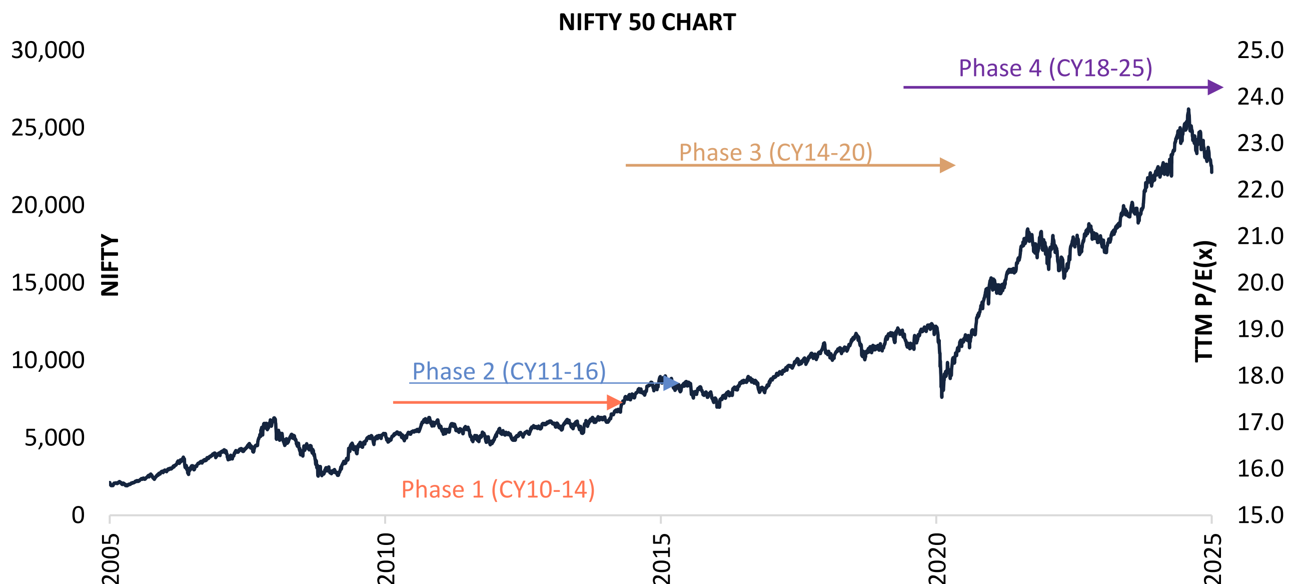
When will the FPIs stop the exodus and start buying India again?

There is consternation over the persistent selling from FPIs. If we look at facts without wearing blinkers, the picture becomes clear.

1. India remains the most expensive, large stock market in the world even after the steep correction we have seen. A section of the local narrative has papered over the same for a while now by waxing eloquent over the India growth story or underplaying expensive valuations. There is only so much distance you can go with these propositions.
2. Indian growth has slowed down. We can't pretend otherwise by taking a stance that Q3 is better than Q2 and a 6% growth in some pocket or the other is better than the 5% estimate. Growth is markedly slower. There is no point denying numbers.
3. The TINA factor does not apply to foreign investors evaluating India. India remains a peripheral market with a low impact in the bigger scheme of things. It is a small player in the global economic sweepstakes.

The above facts do not detract from the attractiveness of India as an investment destination. India remains a destination with a high degree of interest. The interest can wait till valuations cool off to a level where the risk-return reward generates enough headroom.

India has seen its weight increase in various indices followed by global investors. While the headlines celebrated India's newfound status as a big constituent in the emerging market pie, the weight was disproportionate to the GDP weight of India as a country or its share in the profit pool. FPIs started selling this market as there is no further room for buying India. Investors who follow these indices realized that such a high weight is not sustainable for now.



Phase I	Phase II	Phase III	Phase IV
Weight – <10%	Weight – < 12-14%	Weight – 12-18%	Weight–16-21%
PE (CY10-CY14) -17.2	PE (CY11-CY16) -17.8	PE (CY14-CY20) -22.1	PE (CY18-CY25) -24.0

Note: PE is the average for the specified Calendar years

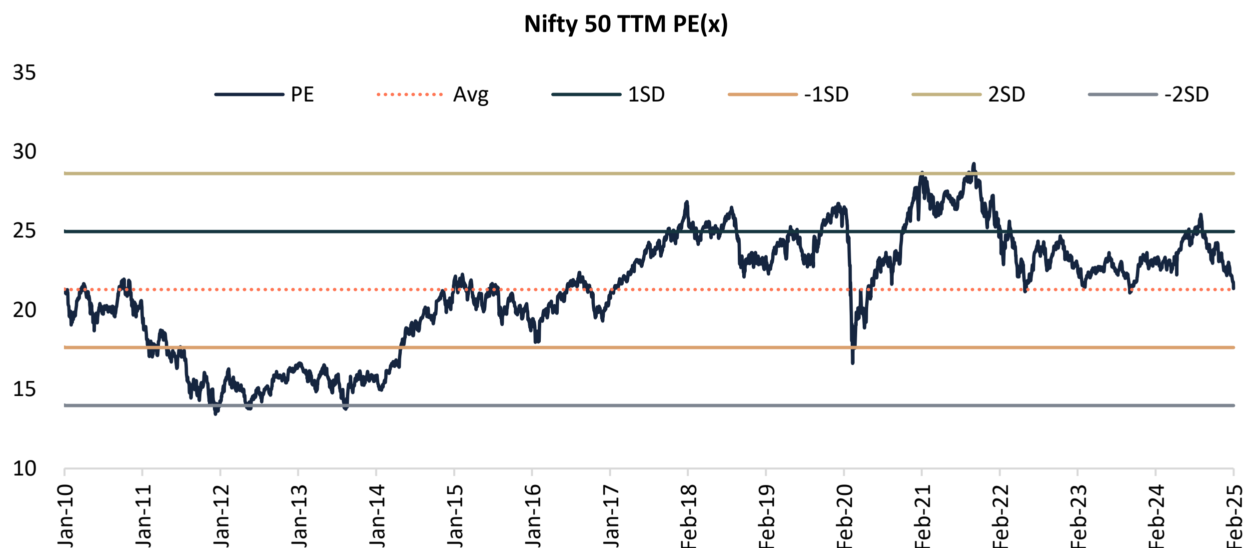
Source: Ace Equity, IIFL Securities, Spark Fund Research

Valuations moved up with the weight while the measure of attractiveness of India was steadily going down. Excitement meanwhile was building up. The stage was getting set for an exodus and resultant damage to the market.

That said, we also need to understand that the FPIs are not a homogeneous monolith. There are different sub-groups with a very wide risk preference. The sovereign funds have a different mandate as against the emerging market funds. But the fact remains that at an aggregate level, the net selling has been persistent. India has been attracting a lot of interest in the last 10-15 years and more so in the post-Covid period. We have highlighted this earlier that India managed the aftermath of Covid rather well. Across a wide spectrum of the economy, digital agility has been in evidence and the federal government has managed the finances very well too. India got rewarded as an investment destination, the K-shaped recovery notwithstanding. Liquidity is a two-edged sword, and the pendulum is now swinging to the other extreme.

Valuations matter

We have repeated this several times. Often, this point has been pushed back by conflating expected growth, need to have a long-term focus, emphasis on downplaying measures such as PE which dent the narrative and half-clever dissection/interpretation of data. Our consistent point has been that any reasonable measure of valuation exposed the soft underbelly of the Indian market. The market remained well-bid due to easy and lazy global liquidity.



Source: Ace Equity, IIFL Securities, Spark Fund Research

This brought about a lot of distortions and potential risks to the fore.

1. First of all, the PE at the level of any index is at best a rough barometer. It is skewed by the impact from cyclical profit streams and an interplay between weightages of constituents with diverse business characteristics. For instance, at present, the PE is pulled down by stocks such as ONGC, Coal India, oil companies and a few banks. In FY19, the valuations were similar, but the dispersion was somewhat better. The result is that many portfolios (of mutual funds for instance) in the large cap category itself have median PE much higher than 21 (in fact, above 30 or 35).
2. The small/midcap indices themselves trade at a PE of 35-45 even after the steep correction. The froth there has been papered over by momentum and liquidity which bestowed a false sense of impregnability amidst rapidly rising risks.
3. The postulation that stock picks offer a very different picture as against the market PE is even more suspect. In fact, several individual stocks held by funds are in new age industries/segments/categories where the PE is 100 or above. The goalpost is then shifted with an argument that these are high growth businesses. When some of these companies are showing

higher losses (or lower margins than expected) on higher revenues, the same is papered over by stating that stocks reflect future earnings streams.

Source: Bloomberg, Spark Fund Research

The above chart shows Indian earnings growth never met expectations at the broad level. The absolute level of earnings growth picked up after Covid. We are back at the slippery slope once again.

Conclusion – There has been too much storytelling over the future while the delivery has been falling behind.

Foreign investors do not have FOMO

One, FPIs have alternatives. The 10-year US bond trades close to 4.5% in USD and the USD is strong. If we add the currency risk, the geopolitical risks and the inherent risk to equity earnings in a market like India, the FPIs are not missing much at present by staying out.

Two, FPIs have the benefit of institutional memory and learning. The dustbin of investment history is littered with massive errors made by predecessors over the last few decades in Japan, ASEAN, China and Latam – not to speak of the mother markets of Nasdaq/US. Expensive markets have caused losses and once you cross the Indian border, everyone seems to be acutely aware of this.

Conclusion – There is no reason for them to be carried away.

What can turn the tide on FPI flows

The opinion makers in the local market have relentlessly pushed the benefits of long-term investing when confronted with a worsening risk-return reward. SIP has been defended as a passport to long-term financial nirvana. The echo chamber of opinions shut out the growing risk.

When we look at the data, the domestic institutions have been absorbing the quantum of stocks that FPIs choose to sell on any given day on almost all trading days since the Nifty marked a peak in late September. The SIP and buy-on-all-dips obsession have thus ended up being some sort of systematic exit plan for FPIs. It is no surprise that the selling has been relentless. Why would they not sell when they get an exit at a good price level? Meanwhile, such selling by FPIs has been one factor chipping away at the external macro-defence for India (INR weakness) which in turn has further strengthened the logic behind the exit itself.

The FPI selling can reverse if conditions change as below

1. Earnings growth returns.
2. Valuations become more attractive. (INR weakness plus price weakness)
3. We get a massive liquidity dose from global financial markets.

We need to see global macro stabilising and the midcycle correction in India settling down before earnings growth can pick up. This could take a few quarters. A fresh bout of liquidity surge from global markets looks less likely particularly when you consider the probability of an inflation spike emanating from the disruption to global trade being brought about by the new US administration.

Which leaves us with the possibility of FPI buying coming back when the markets become cheap enough. In a practical sense, we cannot time that exact moment. It is a process, and we believe we have entered that phase now. One caveat though. The macro headwinds remain all-pervasive, and stock-picking is unlikely to work well in the short run. Patient FPI money will gradually buy into India. The comfort of upward momentum sans drawdowns will remain elusive for the foreseeable future.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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