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PRANITYA

Market Outlook May 2022

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Initial Commentary

Global geopolitical risk is extreme and most of the markets remain choppy across the globe and have given up all gains made over last 6 months. We would like to analyze the situation as follows.

FII Selling

FIIs are selling continuously and in last 6 months the number has touched 25 billion USD. This happened during 2008 where we had global financial crisis and Lehman Brothers defaulted. That period, FIIs sold close to 9 billion USD and now you will understand current selling is almost three times. Just to give general approximate numbers, FIIs have invested just over 200 billion USD India in the last 20 years at cost. Market value of it is close to 600 billion USD. Also note FPI or FII flows to emerging markets have been very strong post 2008 thus it's not correct to compare absolute numbers. It's the first time after 2008 that FIIs have been sellers for consecutive seven months.

Now, why are FIIs selling? Looking at the pattern of selling, it is evident that it is across globe and not India specific. Fed hiking rates, the Russia- Ukraine war and unseen commodities inflation together led to redemption of funds across the globe. Carry trades have long unwound and now we see further redemption in emerging market funds on account of Fed rate hikes.

India has 15% share in the emerging market index. Lock down in China and extended Russia Ukraine war is likely to affect emerging markets harder than developed countries. Situation in Sri Lanka and in Indonesia made many investors more nervous and which might have led to further redemption. It is natural that India, being part of the index, has been selling though Indian macro indicators are very stable till now.

Inflation

As expected earlier, this time inflation is not transient and is here to stay. Many countries have seen inflation touching historical highs. Usually, such inflation leads to demand destruction. In India we have seen petrol consumption dropping by 19%.

We expect demand will certainly come down with lag, though there is no immediate impact because in the last two years people have saved a lot and their ability to sustain price pressure is better than normal situation.

Festivities, marriage season and revenge travel also helped to hold the demand for some sector. We feel it is a question of time where demand will crash. Inflation also led to low volume in sales as affordability factor made people buy whatever is available within their budget. Best example is gold ornaments whereby people will spend same amount and buy less quantity.

Similar is the case for most of the discretionary consumer goods. This is finally going to lead to lower business industry wide. Inflation is usually linked to money supply, in USA during pandemic M3 went up to 22% from usual of 7% and now came down to 10%. India didn't do too much stimulus, but we too are facing higher money supplies which lead to inflation.

Though many of us thought, that it's a supply side inflation and thus a transient one, the extent of inflation is very high, and RBI has to take a note of it. We don't think that monetary actions will help solve the inflation pressure, but Central banks are equally confused.

RBI Action :

RBI will raise rates by 50 bps immediately till September 2022 and markets have already factored that in. Subsequent hikes depend upon the actions of the US Fed. The US Fed has to raise rates quickly now and may have to take it to 1.5% to 2% in US, so that in case of any crash landing of the economy, they will have some fire power to cut rates at that point of time. It is very likely that Fed will have to cut short the rate hiking cycle to support economy towards the end of this calendar year.

US has also seen demand resilience as they did a huge stimulus and actual transfer of cash to the citizens during the pandemic.

We feel RBI will be very slow and calibrated in its approach while raising rates.

State of Indian Economy

Looking at micro numbers we feel Indian economy is doing well. Electricity consumption, GST collection, income tax collection, tax to GDP, unemployment situation has touched pre-Covid levels.

GST collections were around Rs. 1.68 Lakh crore in April, which were the highest ever. India is sitting on decent Forex reserves of over 610 billion USD. The trade deficit is widening but share of manufacturing exports growing which is a good sign. RBI has managed finances is really well and have armed themselves well.

India will grow at 8% in GDP terms and earnings are expected to grow at 17 to 18%. FDI is expected to be robust and expected to get 60-80 billion USD in 2022 23.

Oil can be a spoilsport, but efforts are made to keep oil cost low by finding new channels of import like higher blending of ethanol.

Divestment program at DIPAM is in full swing and with 6% to 8% GDP growth for medium term will make India fastest growing economy. India is the largest Market for most of the large global companies and we do not see any possibility of anyone imposing sanctions on India.

India Opportunity

India has its own charm when it comes to attracting investments. India handled the Covid situation better than any developed country. The Indian economy is opening up, demand is back, and the banking system is very stable with no big visible NPA after 2014. China plus one, PLI helped Indian corporates to grow in 2021-22 and now we can see mid-size European and US companies shifting their production facilities to India on account of new geopolitical equations. Government infrastructure spend will act as a filler till the India Inc. starts investing again.

Credit pickup has improved and robust hiring in IT sector shows that they have decent growth plans going ahead

Wage hike is expected to be 10% on an average and unemployment is again at an all-time low. The monsoon, which is critical for India's self-reliance on food, is expected to be normal. We expect serious amount of outsourcing of services to continue. India will gain more investments from shift from China due to loan default and lockdowns seen in China.

Equity markets

Indian equities have seen outflow from FPIs as discussed earlier. Dollar index is at 109 which is a forty-year high and Indian VIX around 20 indicates that volatility is here to stay. Market is stuck in the 16800 to 18000 range for the time being. Valuations are trading at premium to 10-year average but are at a marginal premium when compared to 5-year average.

Midcaps too are trading in line with large caps and are at marginal discount when compared to 5-year average.

The Q4 results season has started and as per expectations, it is a mixed bag so far with no large disruptions. Large caps like the HDFC twins, ICICI Bank, Axis Bank and large IT stocks faced the worst of FII selling due to their over ownership. There is absolutely nothing wrong with the performance. Having said that we see most of the cost pressures to come in Q1 results and we may see serious impact on margins. Markets are already factoring this and that is why prices are not moving up in spite of good Q4 results of some of these companies. For example, UltraTech Cement- which is a market leader in the cement industry and has shown good Q4 performance on all counts - did not move. This may be due to the cost of coal and other input costs including transport which went up in Q1 and is expected to affect the next quarters profit.

IT sectors did move up in a hurry pre Q4 results and re-rating of the sector was not justified due to moderate top line margin growth (though wage cost impact was known to the market).

Wherever we see margin expansion like Tata Elxsi and Persistent, stocks held on to their partial gains.

What to expect from equities going ahead?

There is always a silver lining to these dark clouds. Indian markets corrected 7.5% with a 26 billion USD selling in last 6 months whereas in 2008 it tanked 50% with early 9 billion USD selling.

Technically even if we are in a bear phase, one must note that bear phase has lasted for few days to few years. No one can predict exactness of fall or rise in the market. We would like to reiterate that in the long run markets move with the fundamentals and returns are in line with the nominal GDP growth of the country for market as a whole. If you are buying right set of stocks with good management and growing earnings, then we are at the most taking a time risk and not a price risk looking at the valuations today. As we expect first half to be volatile and flat for the market naturally, we need to moderate return expectations for the current financial year.

Keeping your asset allocation right is very important as it is proved over and again that asset allocation gives 80% of the returns and the rest 20% attributed to the product selection within the asset class.

Global investing

We were never fond of investing abroad, not that we have little understanding about it or we were expecting their markets to correct more than India. It was simple thinking that India was looking attractive and we wanted to avoid any geographical or currency risk.

China corrected 40%, while the US corrected (Nasdaq) 20% and recovered 50% of its fall till now.

Global investing is definitely attractive looking at the quality of companies held in NASDAQ One can avoid China and Europe and look at good global index funds or Nasdaq index funds for their global allocation looking at the current geopolitical situation

Gold

Gold as an asset class now looks good as we are expected to live in this uncertain geopolitical world. If Russia ends the war, then gold will drop off drastically in the near term but in case of any currency war, gold will be a very attractive asset class, and hence moderate allocation may be considered in a gradual manner.

Fixed income

As expected, the 10-year G-Sec had touched 7.2% and is hovering around 7.1 % as of now. This is factoring 50 bps hike by RBI immediately. Looking at overnight rates and 10-year G-Sec we are indirectly factoring 150 bps total hike by RBI in days to come.
If US is to crash land in the next two quarters, we don't think RBI will do further hikes and we may not see 10 years' G-Sec crossing 7.30% (as expected in our March market Outlook)

One can safely start looking at allocating to medium term funds and very long-term money may be invested in long term or bond funds gradually over the next six months in STP manner.
Very conservative investors can look at some unique options within mutual funds, Real Estate Investment Trusts ('REIT') and Infrastructure Investment Trust ('InvIT') space identified by us.

Conclusion

- Equity in the long term is the best asset class so don't avoid it completely.
- Returns are going to be volatile in the near term and it's worth taking the time risk.
- Returns are made by investing in uncertain times with a lot of patience.
- Stick to quality, bottom-up approach of stock picking and allocate properly to each asset class depending upon your risk appetite.
- Never assume any extreme situation investing as every problem has a solution.