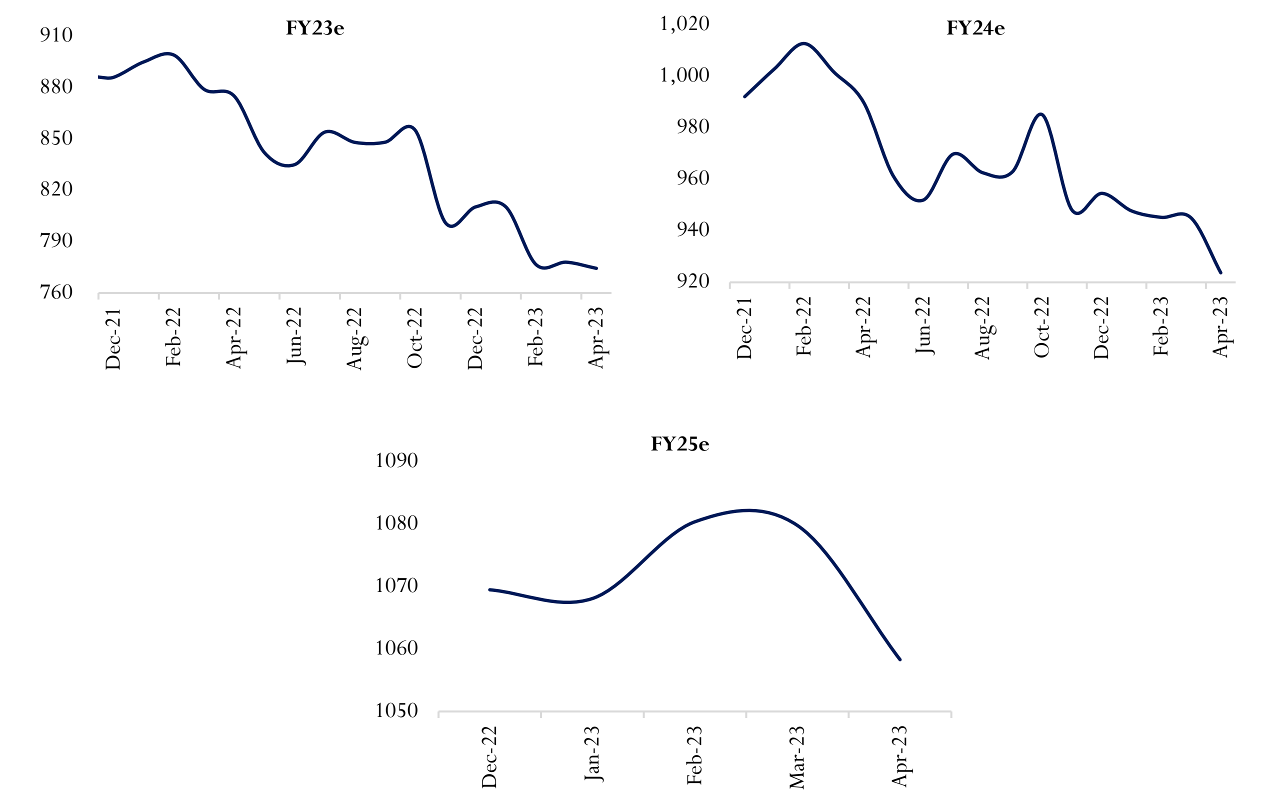
What worries the market? What can go right?

Nifty had a negative return year in FY23, the first time after FY20. FY20 returns were skewed not just because of Covid but also because the worst of the impact happened in March 2020. Despite the market having a negative or at best sideways movement for over 18 months now, there is a palpable lack of confidence. What worries the market?

1. Earnings downgrades

Nifty EPS (INR)

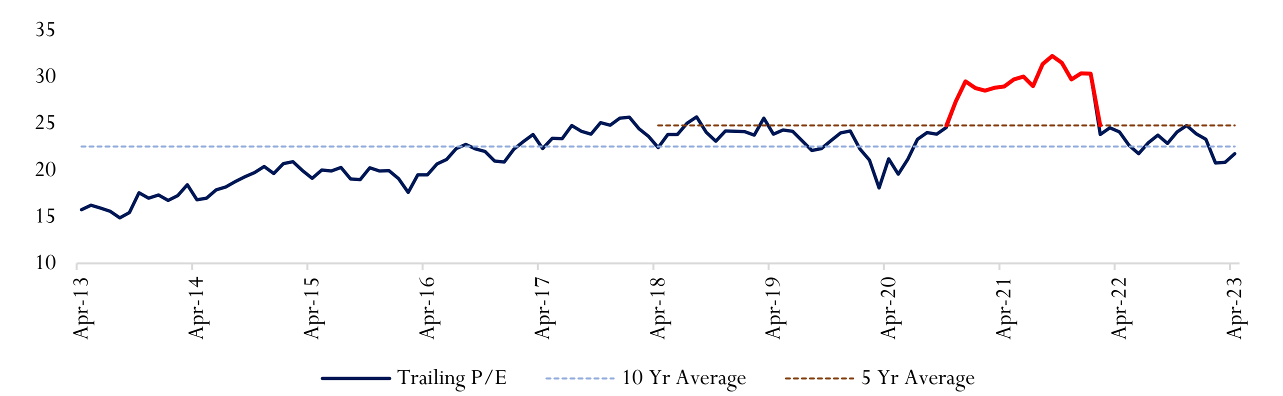


Source: IIFL Securities, Spark Fund Research

Earnings estimates have been coming off for a while now. That said, contrast the earnings delivery from 2011-20 vs 2021-24E. As against a CAGR of 4.4.%, earnings are growing at 19.3% so far in this decade.

2. Valuations

Nifty Trailing P/E (x)



Source: Bloomberg, Spark Fund Research

While the argument is that the valuations have come to the mean level or thereabouts, there is a big catch. The ten-year and to some extent the five-year mean is distorted by unusually low global interest rates which fuelled an equity market exuberance in valuations. That era is firmly behind us. In that sense, any forward-looking analysis of a possible mean five years from now is not exciting. The market realises that more than the analysts. This is a clear headwind.

3. Dispersion

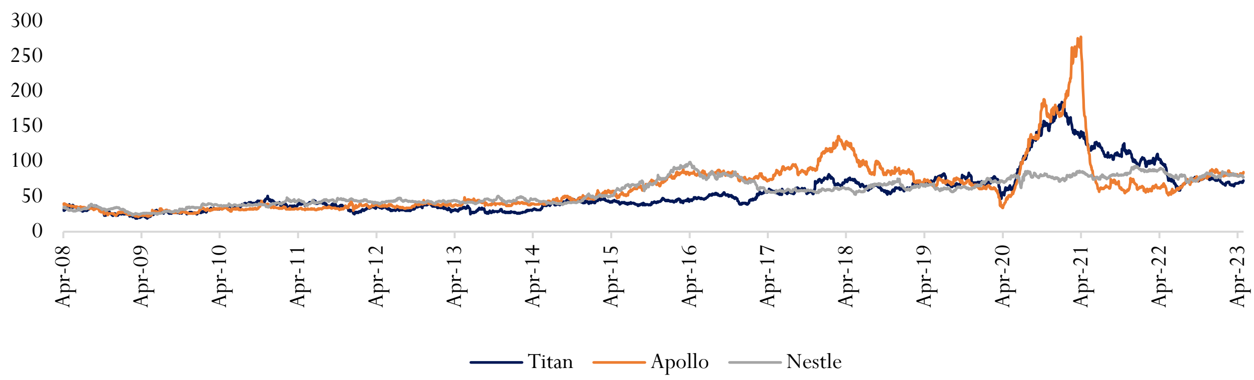
Trailing P/E (x)

Most Expensive			Least Expensive	
Adani Enterprises	107		ONGC	5
Nestle India	88		Coal India	5
Apollo Hospitals	85		Tata Steel	8
Titan	78		Hindalco	8
HDFC Life Insurance	77		NTPC	10

Note: Nestle is Standalone, Prices as of 28th Apr 2023, TTM EPS as of Dec 2022

Source: Ace Equity, Spark Fund Research

Trailing P/E Band (x)



Source: Ace Equity, Spark Fund Research

While PE may be treated by some as an inappropriate measure, trailing PE is not subject to forecasting errors (selective optimism has been a thorny issue for long) and over a period, the trends are clear enough. Further, any other measure of valuation is likely to point to similar conclusions in the sense that valuations have re-rated for the top names. Neither the forward outlook nor the delivery in recent years is supportive of such re-rating sustaining. There is enough evidence now to show that the re-rating was driven by ever lower global rates which inflated equity assets across the world.

4. Sector woes

Over here, IT services is on top of the heap of worries. Despite a marked under-performance which saw the weight of IT services drop from over 16% in 2021 to 12-13% by March 2023, the sector tanked in April. Here again, the valuations are in the middle ground - off the highs but nowhere near the five-year lows. To compound the problem, we note that a lot of the analysis is excessively focussed on incremental factors and that too on quarterly changes.

Last year, the margins fell for almost all the IT services names. But the focus towards the year end was on sequential improvement and that too fell short. Little attention is being paid to the fact that FY23 saw one of the most significant bouts of INR depreciation in many years and yet the margins fell and how. Look at the EBIT margins of the top five players over five years or ten years. The picture is clear. The margins are down structurally and/or are skirting along the ground desperately searching for a sound footing.

EBIT Margin (%)

Company	FY23	FY18	FY13
TCS	25.6	27.7	28.8
Infosys	22.9	28.7	31.7
HCL Technologies	18.0	21.9	21.0
Wipro	17.4	19.9	21.8
Tech Mahindra	12.5	16.4	16.7

Note: EBIT includes other income.

Source: Ace Equity, Spark Fund Research

Now, look at the long-term revenue delivery vs people addition for Infosys and TCS.

FY05-23 CAGR (%)

Company	Inflation adjusted Revenue	Headcount
TCS	13.1	16.2
Infosys	12.3	14.1

Note: Inflation is a blended number across India (2/3rd weight) and US (1/3rd weight)

Source: Ace Equity, World Bank, Bloomberg, Spark Fund Research

The sector model is clearly reliant on adding people to generate revenues. If the prognosis on AI having an impact on this kind of a model is correct, the companies have to adapt. They have an impressive record in doing so. However, it will be naïve to believe that the process is a done deal or will be without disruption. Too naïve in our view. If revenue growth does not come back soon enough, we can expect a more serious crack in margins.

Then, there is banking & finance which is the biggest constituent of the market. Here, the valuations of private sector banks have moderated and that of public sector banks are low enough to warrant sufficient interest. However, there is so much scepticism that it will take some doing for the market to climb the wall of worries here.

On other sectors, consumer space is showing some strains on revenue growth, in particular, volume growth. We have pointed out the issue on the valuation front already. Most other sectors have stock-specific dynamics and from an overall perspective of sentiments, cannot influence the market returns.

In summary, the market has a lot on its plate and at the aggregate level and there is an obvious lack of momentum. However, should we always be in a momentum-driven market, or can we be in one always? Once we digest this legitimate question, we see some scope for optimism.

What can go right

We mentioned the banks above. The last credit cycle for Indian banks was not just very nasty, it was also over-extended. First there was lack of recognition of the issues (2013-2016). The long judicial process in India and the very nature of the same in many instances of bad loans may have resulted in more losses for banks than was warranted - due to losses from time value of money and from deterioration in available collateral. In the second phase (2016-2020), the economy failed to help (GST related disruption was one factor). In the final phase, Covid dominated the course of events. Towards the end game for the NPA cycle, several positives emerged.

1. Banks created a capital buffer and ended up well-capitalised for growth as bad loans from Covid were lesser than feared.
2. Covid would have driven every potential defaulter into doing so. Banks have been left with a book that has been put through an actual stress test of grave impact. What has emerged is obviously robust.
3. We have always argued that recessions lead to higher productivity on most fronts. We are seeing that play out in many areas.
4. With the notion of free money going away globally, banks are in a generally better place. Reversal of disintermediation and de-globalization are positive for Indian banks which are a very domestic-centric business.

In summary, analysts and observers may be under-estimating the extent to which the upcycle can go this time for the economy and for the banks. That is a big positive as and when it plays out.

The second is the Rupee. The INR has become a large currency in terms of trade flows and capital flows, and it is on a managed float. The RBI has always maintained that it is interested in controlling the volatility and not the level of INR. The past behaviour of INR assumes significance.

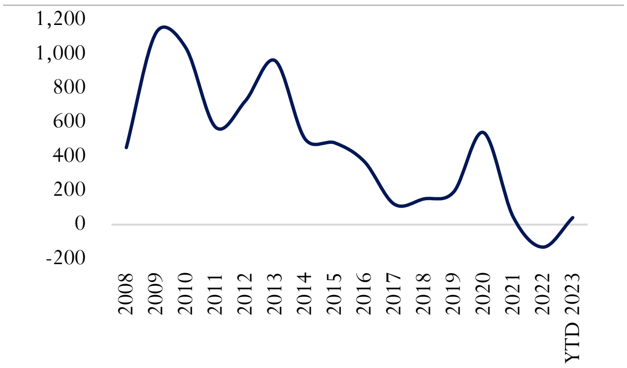
Bouts of Rupee depreciation

Start date	End date	Duration (months)	USDINR (Start date)	USDINR (End date)	INR Depreciation (%)	Average USDINR in the next 2 years
13-Jan-2022	19-Oct-2022	9	73.9	83.0	-12	Awaited
03-Feb-2012	28-Aug-2013	19	48.7	68.8	-41	62.0
15-Jan-2008	03-Mar-2009	14	39.3	52.0	-32	46.7
13-Aug-1997	28-Dec-2001	53	35.7	48.3	-35	47.6

Source: Bloomberg, Spark Fund Research

The INR has tended to appreciate slowly after a bout of heavy fall. There is one more factor at work now. The inflation differential between the US and India has now come to almost zero. In fact, over the last 18 months, the differential has been in India's favour. This has not happened in the past. A long run analysis of USD-INR shows that there is a reasonable correlation between INR depreciation and the inflation differential.

US - India Inflation differential (bps)



Inflation differential vs Movement in INR

CY 2007-22	
Inflation differential – Annual mean (%)	4.7
USD INR Average depreciation (%)	4.4

Note: YTD as of Mar 2023

Source: World Bank, Bloomberg, Spark Fund Research

When we look at the history of emerging market currencies, successful emerging markets have seen currency appreciation at some stage.

Currency Movements

Country	Start date	End date	Duration (months)	Currency appreciation (%)
Japan	31-Dec-84	31-Dec-87	36	108
South Korea	31-Dec-97	29-Sep-00	33	43
Taiwan	30-Sep-85	31-Dec-87	27	42
China	30-Jun-05	30-Jun-08	36	21

Source: Bloomberg, Spark Fund Research

There is very little by way of debate on how and why a strong rupee (strong need not mean constant appreciation) can be a huge positive for the economy, capital flows and incomes. Recent reports on some part of the oil imports (from Russia) being settled by INR can be a sentiment driver for INR. The general weakness of USD, after a period of strength, sits in well with the case for a relatively stronger INR in the coming few quarters.

1. A stronger (and stable) currency is good for inflation management.
2. A stable currency and lower inflation are very important for growth in disposable incomes and for domestic capital formation.
3. A stronger currency is good for capital inflows.

4. Obviously, a stronger currency may not be great for exports. However, a stable currency will eventually not stand in the way of export competitiveness. Why should exporters get the continuous benefit of a depreciating currency at the cost of destroying the value of domestic savings?

For the IT services sector, which has a strong sentiment linkage with the market, a stronger or stable INR will not affect their competitiveness. But margins? That is a different story.

Most businesses are bound to see pressure on margins if the economy grows as per its potential. Look at China - the margins in most businesses (and the return ratios) are lower even as the country has become prosperous. The high return ratios enjoyed by many Indian companies is because of pricing power that comes from the protection offered by a depreciating currency and tardy capital formation which ensures capacities are late in coming (or never come).

If we get a surprise on the growth front, the market can do better than expected but it need not be the same old story with the same names leading the market. If growth is not there, there is no India story left. This is not a Hobson's choice. It is just that the leadership can change a lot. It is not out of place to mention here that most of the constituents of BSE Sensex of the 1990s are no longer in the reckoning anywhere. Brace yourself for some changes ahead.

Warm regards,

P Krishnan (CIO) and Team Spark Fund