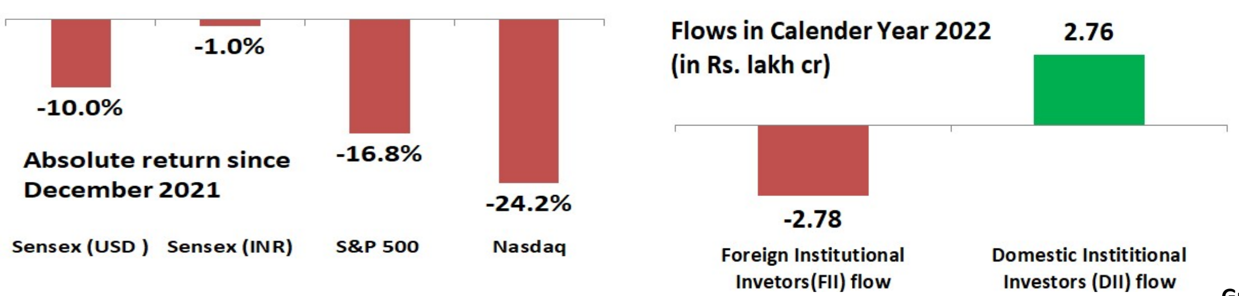
Portfolio Musing – Ladki Sayaani Ho Gayi!! (Young and fiscally fit India poised to leap)

Managing an equity-oriented portfolio at most times is like watching your own offspring evolve into an adult, it can be exciting and frustrating at the same time, but at the end it is a very rewarding experience. While you are at it, it demands a great deal of patience, commitment, and nurturing. It can be very frustrating at times, despite dedicating all the resources at our behest, as it (he/she) has a mind of its own, responses and results are seldom as per expectations. But one thing is for sure; eventually it will turn out well, like our children too. Similarly, we are very sure of the long-term return potential of equities as an asset class. It is the only asset class that will deliver inflation beating returns in the long term, despite short term hiccups and volatility. One should remain steadfast and wait for the eventuality.

We feel that in this analogy of equities vs child evolution the Indian equity market is like a teenager when compared to developed global markets like US or Europe. It will misbehave and throw tantrums (volatility), but the upside and potential are amongst the highest. So, exposure to Indian equity is inevitable if you want to make money in the next few years and every pull back is an opportunity to enter.

Volatile but still outperformed

After Stellar performance between 2020-21, global markets have been extremely volatile since December 2021. While Sensex returned -10% (USD) from December 2021 till date, it still managed to outperform other global markets. This can be largely attributed to extremely buoyant domestic flows which absorbed much of the selling by the foreigners. The local excitement for equities is a possible indicator of conviction and belief of the domestic investor in the India story, low interest rates making other options unviable and the most important factor in our view, the rapid digitization leading to higher financialization of the domestic savings, which is a long-term trend that is here to stay.

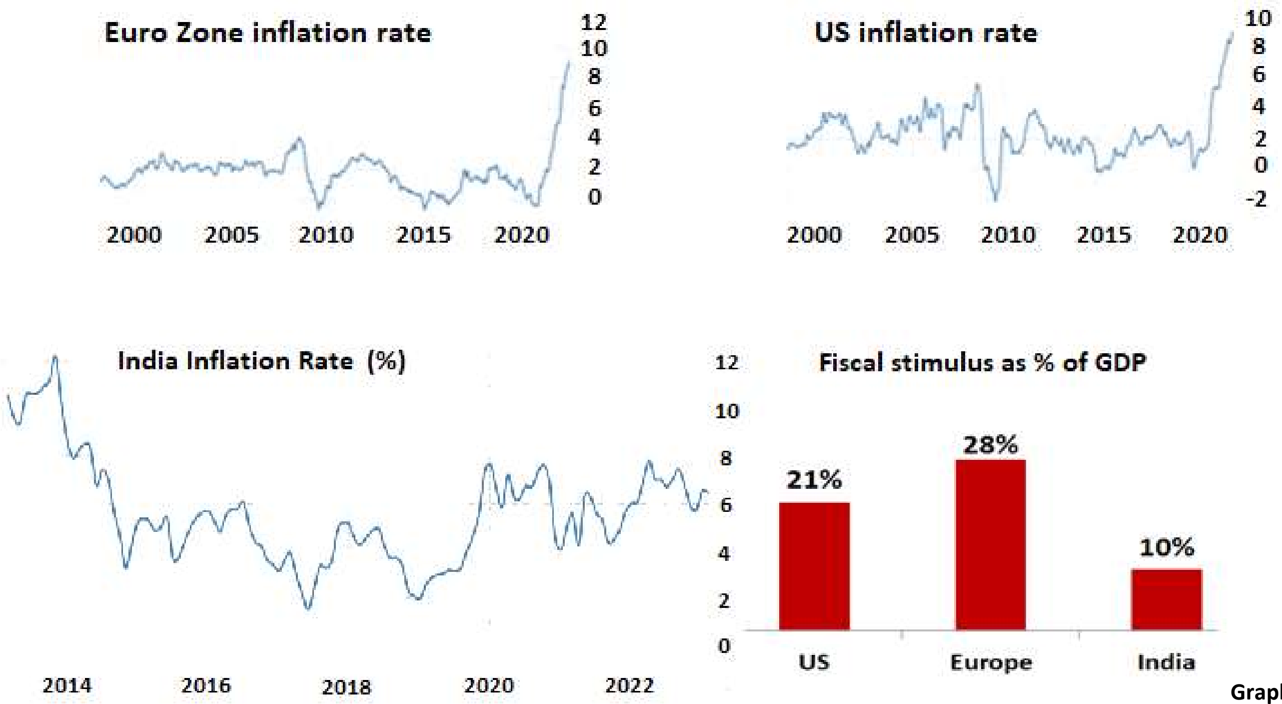


Graph-1

However, we can't deny that the insipid performance overall has had an effect on portfolio returns. The time correction has impacted the average XIRR of the portfolios. The key factors that impacted this muted performance was the return of inflation and subsequent increase in interest rates globally due to these factors

- The Ukraine Russia war - which spooked energy-based inflation across the world mainly in Europe.

- Covid induced supply chain disruptions further exasperated by the war and China's own struggle with Covid during the best part of 2022
- Unabated consumption boost by ultra loose monetary and fiscal policies by the US and Europe as a response to covid.
- We must point out here that India remained very conservative and circumspect in this, as the covid related fiscal boost was amongst the lowest in the world and also most of them were targeted towards capacity creations (Production Linked Incentives (PLI), & Infra spending) rather than merely boosting consumption which the West is facing the consequences now.



Graph-2

Strong Dollar an immediate threat but a long-term opportunity

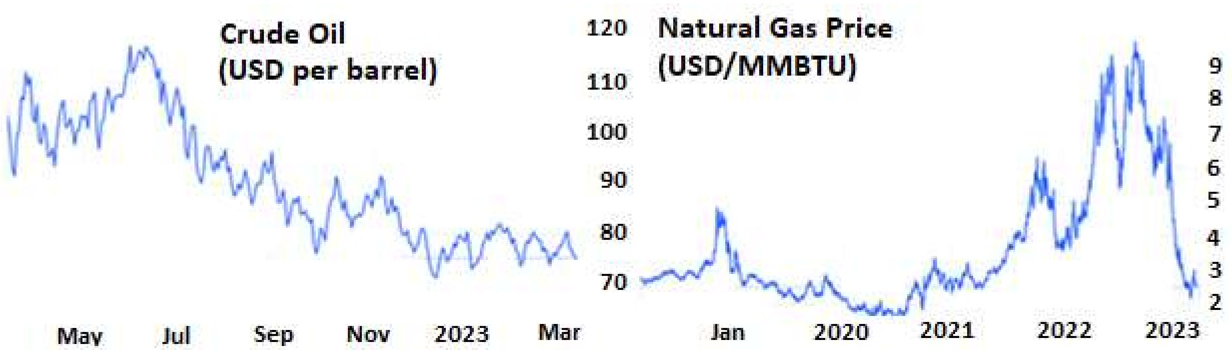
The immediate response by all central banks led by the US Fed was to increase interest rates. But the more aggressive stance of the US Fed relative to other emerging markets like India where inflation was not so much of problem, lead to an unabated strengthening of the USD. This lead to a flight of capital to the US, FII selling in India is an example of that. Essentially, the covid induced easy liquidity which lead to the rapid rise till 2021, has been reversed and likely to overcorrect , which is leading to the current pain. Thankfully, things are getting back to normal, and we should take advantage of it.

Graph-3

Silver linings clearly visible

With commodity prices falling and China getting back to normal, supply led inflation triggers are getting resolved. With higher interest rates demand led pressures should dissipate, but it's anybody's guess when that will happen. Rates can remain high for some more time, but the increases could stop or slow down, which is an indication for reversal. We strongly believe that India will be a significant beneficiary in the reversal.

*London Metal index is an index comprising of 6 key industrial metals i.e. Aluminium, Copper, Zinc, lead Nickel and Tin. Baltic Dry Index is an index of average prices paid for the transport of dry bulk materials across more than 20 routes. This index helps in understanding the global freight price movement



Graph-4

India a growth oasis amidst global uncertainty and sluggishness

- Long term wealth is only created by strong fundamentals in economy and we believe that the structural reforms implemented in the past few years by the Indian government namely GST, The Real Estate (Regulation and Development) Act, Bankruptcy Code; lower corporate taxes provide strong foundation to growth.
- India is one of the youngest countries in the world and likely to make almost 40% of the entire global work force in the next few decades. This is a huge demand driver for discretionary consumption of goods and services like financial services, real estate, appliances, travel, leisure and many more.
- The young work force and the global realization of the need for diversification of supply chains post the covid-era will make India a key manufacturing hub in the years to come. With friendly government policies like Production Linked Incentives (PLI), lower taxation and other incentives,

this has already gained momentum and is likely to create jobs and produce higher incomes going forward.

- Digitization is another unique feature of the Indian economy, which has led to India being the world's largest consumer of mobile data within a span of 6 years, and also the widespread use of the much acclaimed "India Stack" for effective and seamless delivery of government services and other benefits like subsidies, healthcare delivery, insurance, education, etc. This leads to tremendous productive gains both for the government and the population at large. This can potentially transform the economy to a Hi-tech one in the near future.

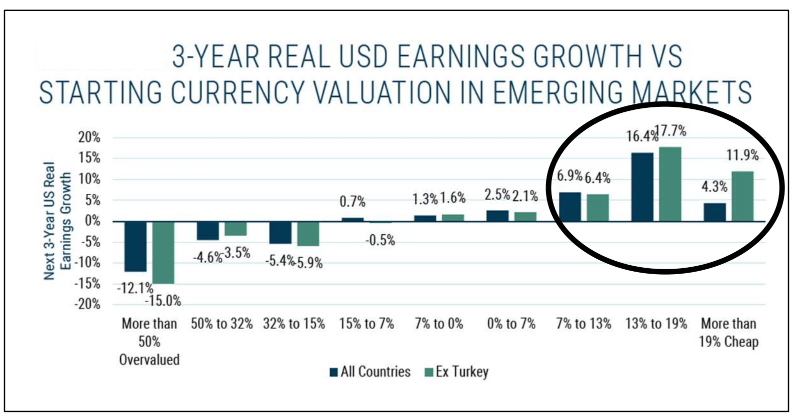
As a result of these factors, India GDP growth outlook forecasted by Global agencies like S&P, Morgan Stanley etc. is in the range 6-7% per annum, making it one of the fastest growing large economies in the world.

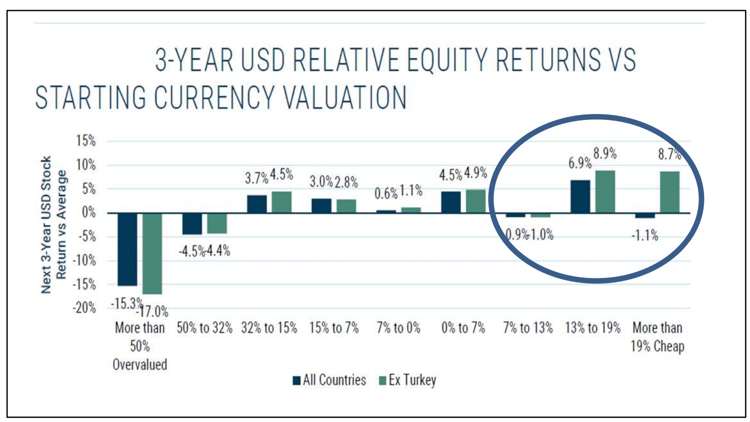
Strong Dollar a huge tailwind for emerging market equities- India a key beneficiary

A recent study by GMO, one of the most respected US based investment houses founded by Jermey Grantham on currency depreciations and equity returns for the period (1971-2022) has thrown up very interesting insights. Currently the USD is on a 35 year high and is termed to be extremely overvalued. The study finds that undervalued currencies that have depreciated substantially against the USD, generate significantly higher USD returns over the next few years. This is due to the fact that fundamentally strong companies in relatively stable economies with cheaper currencies exhibit superior earnings growth which will drive equity returns of that market. A few important quotes from the study

"Countries with substantially overvalued currencies see their equity markets underperform sharply, and countries with cheap currencies outperform substantially. This has remained true over the last two decades."

"Once again, this is not simply about cheap currencies leading to currency appreciation. The underlying fundamentals for corporations in countries with cheap currencies outperform those with expensive currencies"

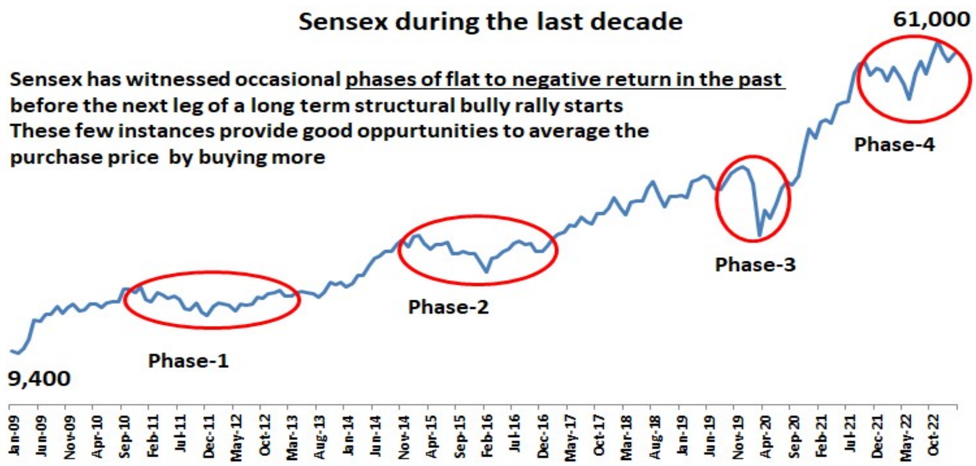




Graph-5

Indian currency is typically undervalued between 10 to 14% in the last 3-4 years and the blue lines in the images shown above are showing an earnings growth of 16-17% and an equity outperformance of about 7-8% over global average. This gives us tremendous confidence on the prospects of Indian equity over the next 3 to 5 years. Indian corporate balance sheets are in their best health and they are poised to take advantage of the burgeoning opportunity.

Conclusion and Recommendation



This consolidation phase is presenting a very attractive opportunity to invest either through lumpsums and/or SIPs

Graph-6

We feel that the market is poised for substantial outperformance backed by strong domestic structural positives and a global pivot to quality emerging markets once the current inflationary and interest rate situation normalizes.

Existing Portfolio changes

We expect strong market momentum and therefore, we would like to participate through a broader market exposure by having relatively higher weights towards mid and small cap companies. So portfolios actionable are

- Cut exposure to large cap funds
- Largest exposure to multi cap and large and mid-cap funds that on average have 30-40% exposure towards mid cap and small cap companies
- Avoid sectoral bets like IT, Materials and Pharma; we feel these have played out.
- Reasonable exposure to pure mid or small cap funds for alpha generation
- As mentioned, emerging markets like India are expected to outperform the US, so reduce US exposure and increase domestic exposure or other emerging markets if possible.
  But portfolio strategies will have to be customized depending on various risk appetites and unique circumstances

To conclude, Indian equities are like teenager/young adult in the final year of their college. All the foundation work is almost done and we are getting ready to go out there and conquer the world. The timing also is perfect as competition is relatively benign as most of the world is besieged with their own problems and issues. Of course, the road will remain bumpy but the destination is very much near.

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Graph 1- Google Finance, Financial Express

Graph 2- Trading economics, UN

Graph 3- Trading economics, Google Finance, Financial Times

Graph 4- Trading Economics

Graph 5- GMO

Graph 6- BSE