ROHA ASSET MANAGERS
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EQUITY OUTLOOK - NAVIGATING INFLATION AND WAR

When perceived risk is high, real risk is low!

Recent equity market volatility is driven by many factors such as inflation and expected US interest rate hikes, prolonged Russia-Ukraine conflict, supply chain disruptions as well as deserved correction of excess valuations in new-age tech businesses.

The resurgence of geopolitical tensions between Russia, NATO and Ukraine has contributed to market angst in recent weeks. Global supply chains are still recovering from shocks triggered by the US-China trade war and COVID-19. Looking beyond the obvious areas like oil and gas while considering geopolitical dynamics reveals significant Russian leverage over global and especially western supply chains. Following the onset of the Ukraine crisis, the European economic and corporate landscape has been severely scarred. Nevertheless, India's trade with Ukraine is negligible at 0.4% of imports and 0.1% of exports while with Russia it is 1.5% of imports and 0.8% of exports. There won't be any structural material impact on fundamentals of India business, except that we may have to grapple with higher import bill on oil for some time and commodity cost inflation (as Russia is a producer of many commodities). The Russian invasion of Ukraine and likely lower exports of Russian crude oil will keep crude oil prices elevated for an uncertain time period. The Indian economy is estimated to incur an additional US$60-70 bn burden (1.8% of GDP) versus FY2022 levels at an average crude price range of US$ 100-120/bbl.

We do hope that higher oil prices may eventually ease as supply increases from US Shale gas, Iran or with eventual ending of Russia-Ukraine conflict.

An era of high inflation and severed supply chains - The larger pain point for corporate India is of higher raw materials cost pressures or commodity cost inflation driven by supply chain disruption including energy and freight cost challenges. Supply chain disruptions have got extended post covid due to Russia-Ukraine crisis. The war in Ukraine may end soon but supply chain disruptions are likely to continue since sanctions are unlikely to end. This may probably have temporary negative impact on the margins of corporate sector in the near term (largely reflected in earnings of 1QFY23). Though firms with pricing power and ability to pass-on cost hikes are better placed.

While the US FED has turned hawkish by signalling multiple rate hikes in 2022 to counter inflation trends, we believe, RBI has ample strength to take care of liquidity. RBI's acknowledgment and onset of the policy normalization process was much awaited.

Though we expect first rate hike from RBI sometime in August, **interest rate tightening in India is expected to be slower than rest of the world.** Besides, RBI has over $630 bn of forex reserves to counter any currency shocks.

Despite several concerns on inflation and war conflict, there are reasons to be positive on Indian markets given that **Corporate capex** outlook is looking up after many years of continuous decline driven by corporate deleveraging, improving financial health of banking sector post covid and increased localisation trends. Earnings of capital goods companies are at cyclical lows and can improve significantly as there are all indications of capex cycle picking up. India manufacturing PMI for Feb came in at 54.9 vs 54 in the previous month showing some sequential improvement. Furthermore, **sentiment has improved, underpinning business expansion plans and return of normalcy.** India's macro data shows that recovery is building. GDP, fiscal, PMI, core sector and credit data suggest that after a hiccup in Jan, fundamental recovery is building up, but gradually. This is validated by **India's soaring tax collections** - Gross tax collection of Rs. 27.07 lakh crore during April 2021 to March 2022 compared with budget estimate of Rs. 22.17 lakh crore.

Going forward, **govt's capital expenditure is expected to accelerate in defence and railway sectors.** The move towards indigenisation of defence procurement creates new opportunities for India's military industrial sector.

Our equity investment strategy is to stay put and ride the storm of volatility and panic corrections. There are several companies that are benefiting due to shift from **unorganised to organised** sector (real estate/building products), **digital wave** (technology), **import substitution** / local manufacturing (pharma/chemicals/electronics/defence) and **green energy** (sugar ethanol/electric vehicles beneficiaries) that make sense for long-term investing. We are witnessing strong **cyclical recovery** in real estate sector (low interest rates), financials/NBFCs (worst of NPA cycle behind) and engineering and capital goods (due to higher capex cycle). **Any exaggerated reaction or volatility in equity market should be an investment opportunity,** as markets are likely to face temporary or short-lived corrections. Over time, despite hurdle of near term cost and margin pressures, equity market will be driven by strong growth recovery in several Indian businesses from consumption to real estate and capex-led cyclical, that have come out of a multi-year slowdown.

We have been **cautious in our previous strategy notes on excessively priced IPO (primary issues) given frenzy valuations in majority**. We had highlighted that it's better to buy growth companies that are reasonably priced. Several new age digital companies that came to market, were indiscriminately chased by retail investors without looking at their business models or valuations closely. While they are disruptive companies, many are still in cash burn stage and valuations have been driven by hope and were pricing or discounting far ahead of time. Hence margin of safety has been limited. It is possible that some of disruptive businesses can themselves get disrupted and only a few will survive or make it big. This along with higher valuations will continue to lead to capital losses (investors at such frenzy valuations already tasted their first round of losses in the recent past). We continue to be cautious and selective in this space.

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"The relationship between price and value holds the ultimate key to investment success. Buying below value is the most dependable route to profit. Paying above value rarely works out as well."

Howard Marks

The rise in domestic equity culture and flows into equity market due to financialisation of savings continues to be impressive. Domestic institution investors (DIIs) and retail investors have demonstrated strength to counter FII selling. Growing **equity culture in India is just the beginning and at tip of the iceberg!** Traditional forms of investments like fixed deposits/gold, is no longer a preferred asset class. This domestic investment itself will overtake or absorb FII outflows, if any. As per Association of Mutual Funds in India (AMFI) data, net inflows into equity-linked schemes rose over 43% month-on-month (m-o-m) in March to over Rs 28,463 crore amid sustained interest from retail investors in the equity markets, despite global headwinds, equity inflows in March were the highest in the last four years. This truly reflects rise of India's equity culture and maturity as inflows occurred despite on-going war and consequent market volatility.

Overall, the structural foundation of this bull market is very much on with low interest rates and earnings revival despite near term cost pressures. Though, some pockets of market are no longer cheap and one needs to be selective and **increase tenure of holding period to expect reasonable returns.** Every war is different but most are not associated with a recession and stock markets usually find a bottom early in the conflict. Fear is already getting discounted by the market and lessons from history suggest that such war-like events, in disguise, prove to be great investment opportunity for long term investors. Hence, buy and hold approach in portfolio makes sense to take advantage of the beginning of a very secular growth in the economy. **It is wise to remember that equities have generally paid off in the long run!**

STAY SAFE & HAPPY INVESTING,

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