NETRA

Early Warning & Signals Through Charts

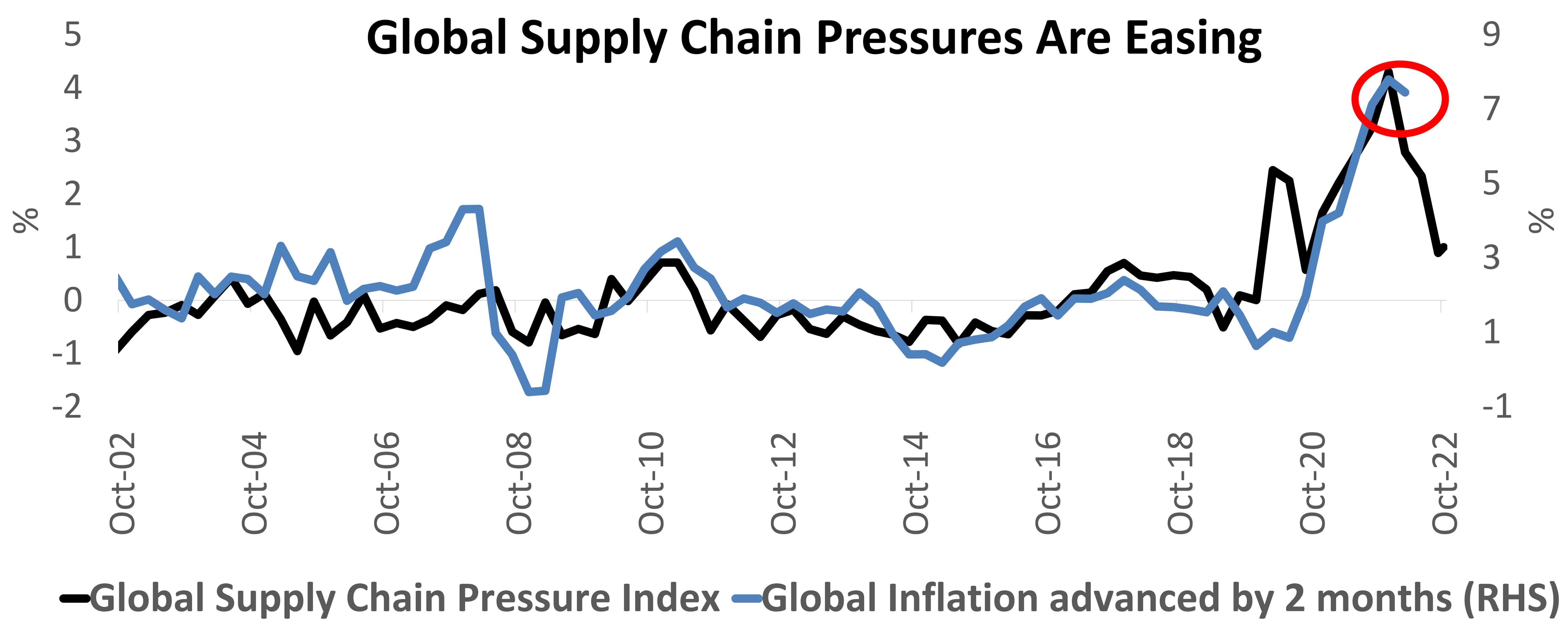
December 2022

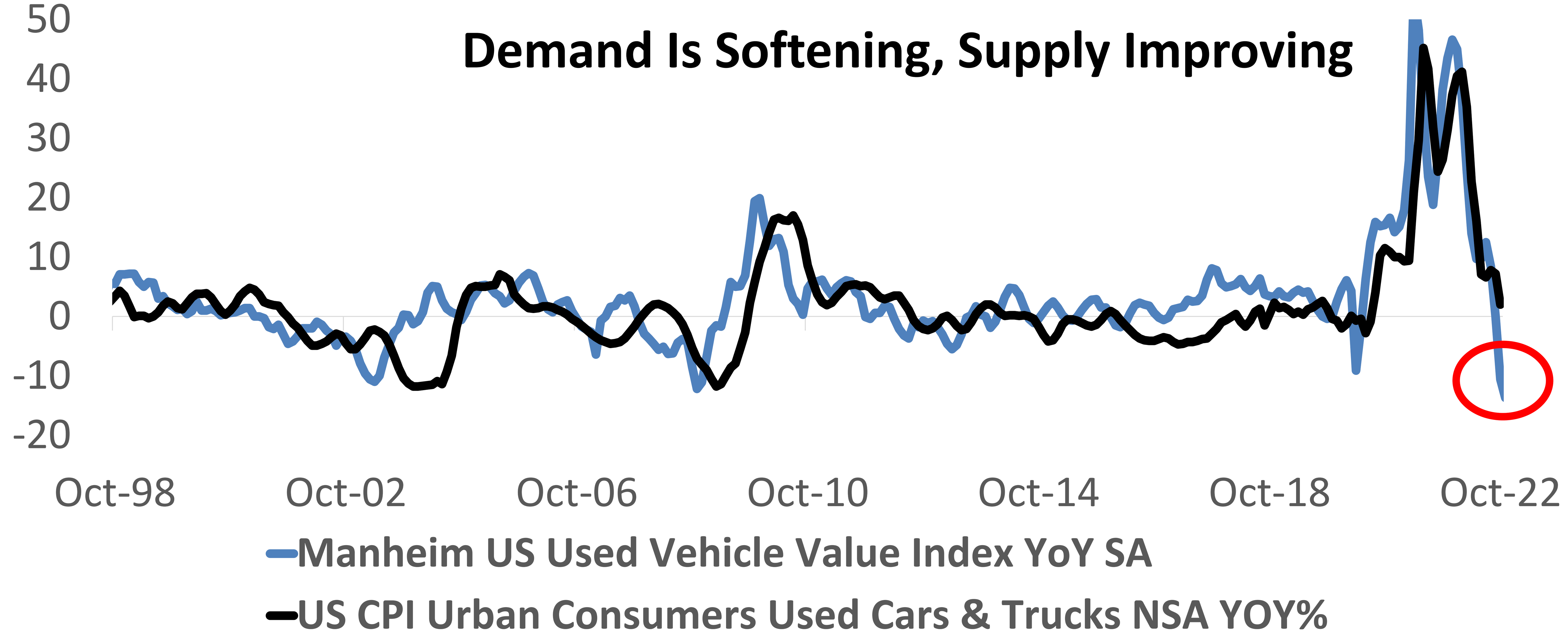
DSP

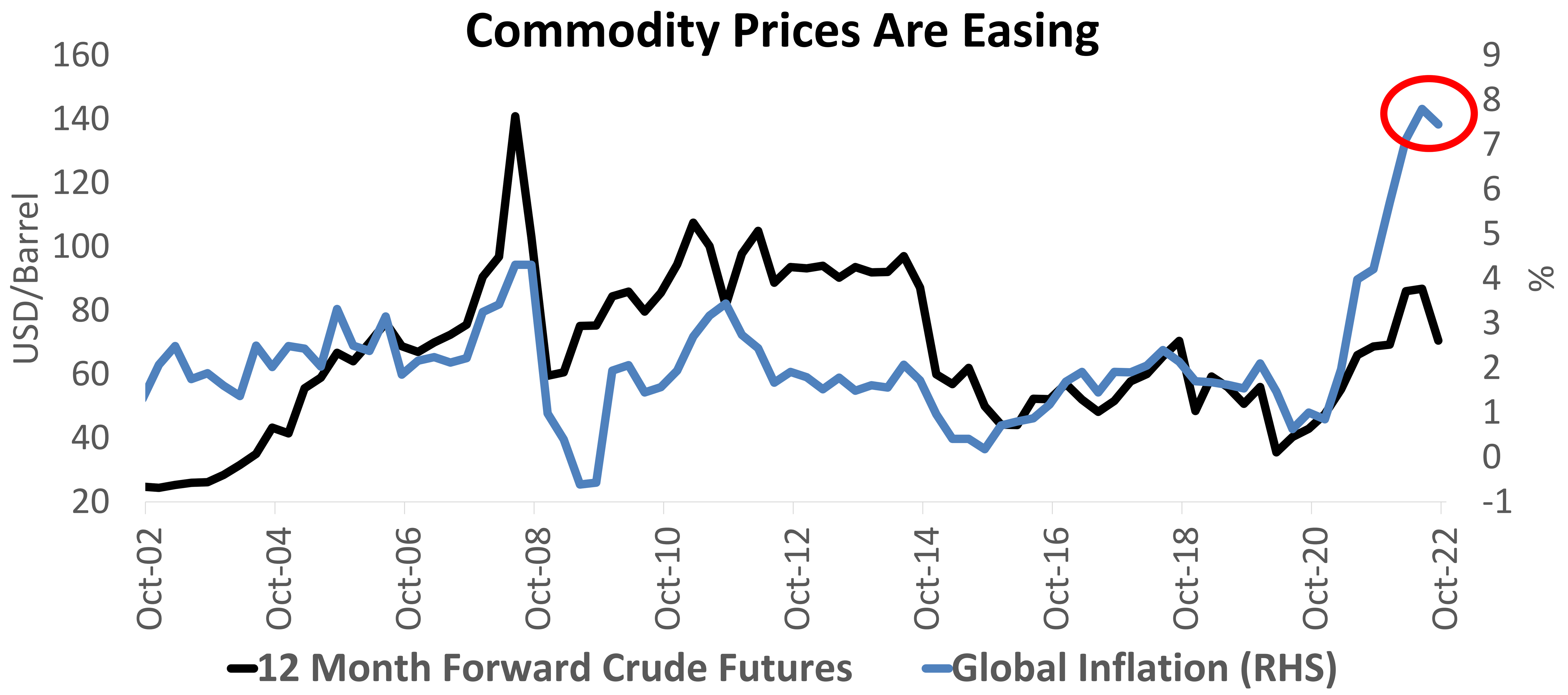
Data, Flows, Valuations – The Sync

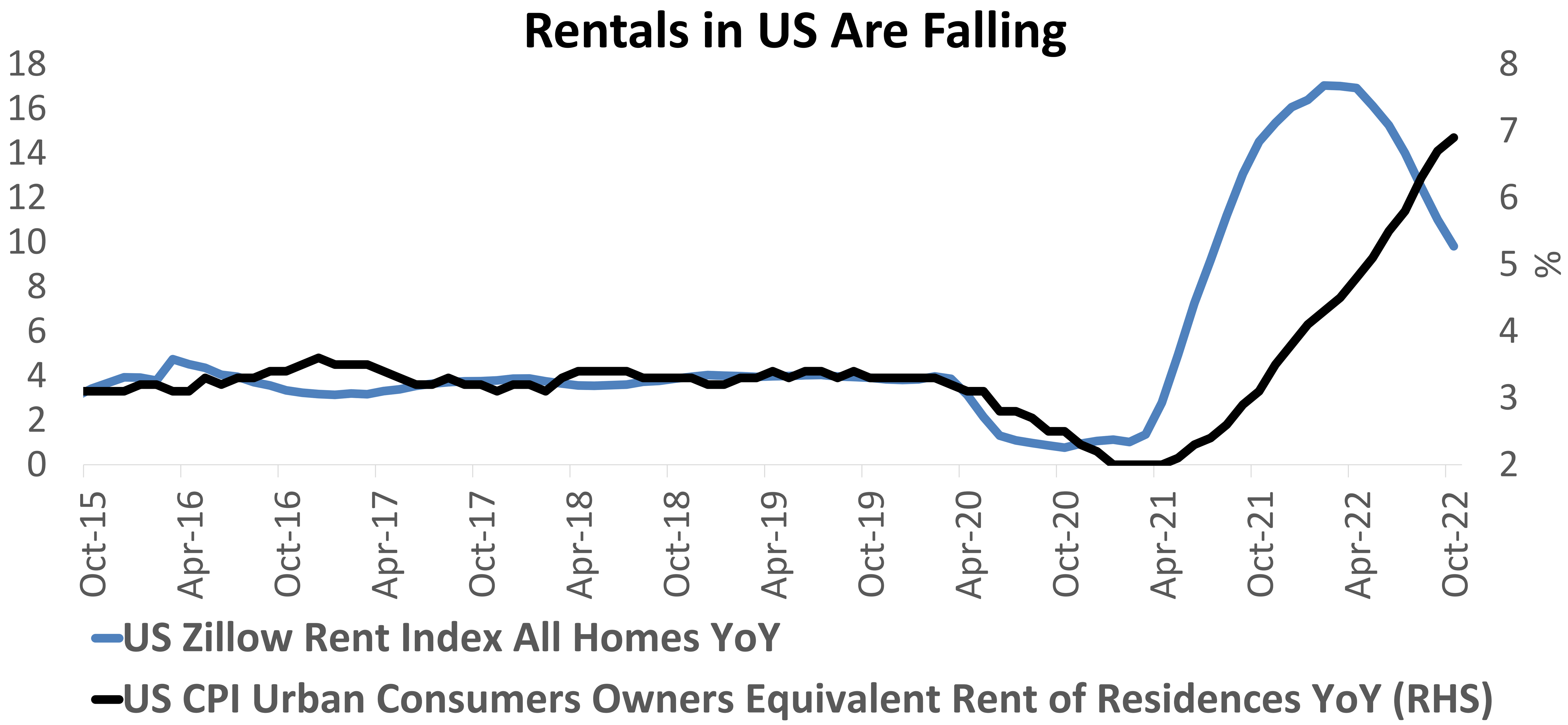
DSP

Leading Indicators Add To 'Easing of Global Inflation' Trend









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Source: AMEC, NYMEX, Bloomberg, DSP As on Nov 2022

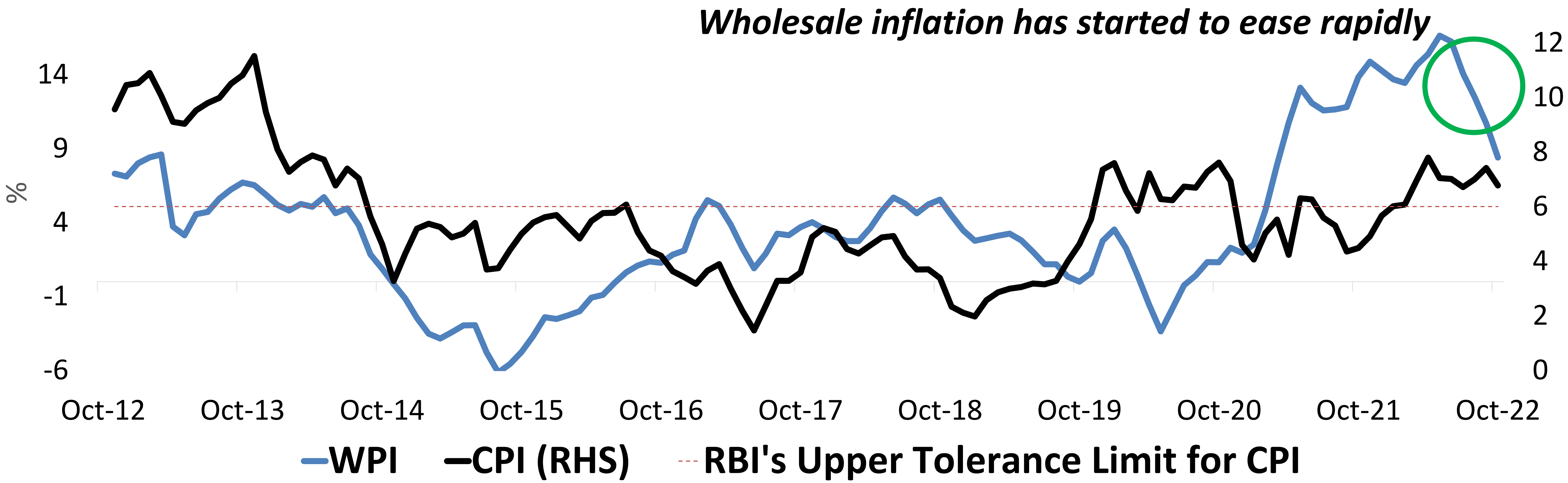
India Inflation Set To Ease

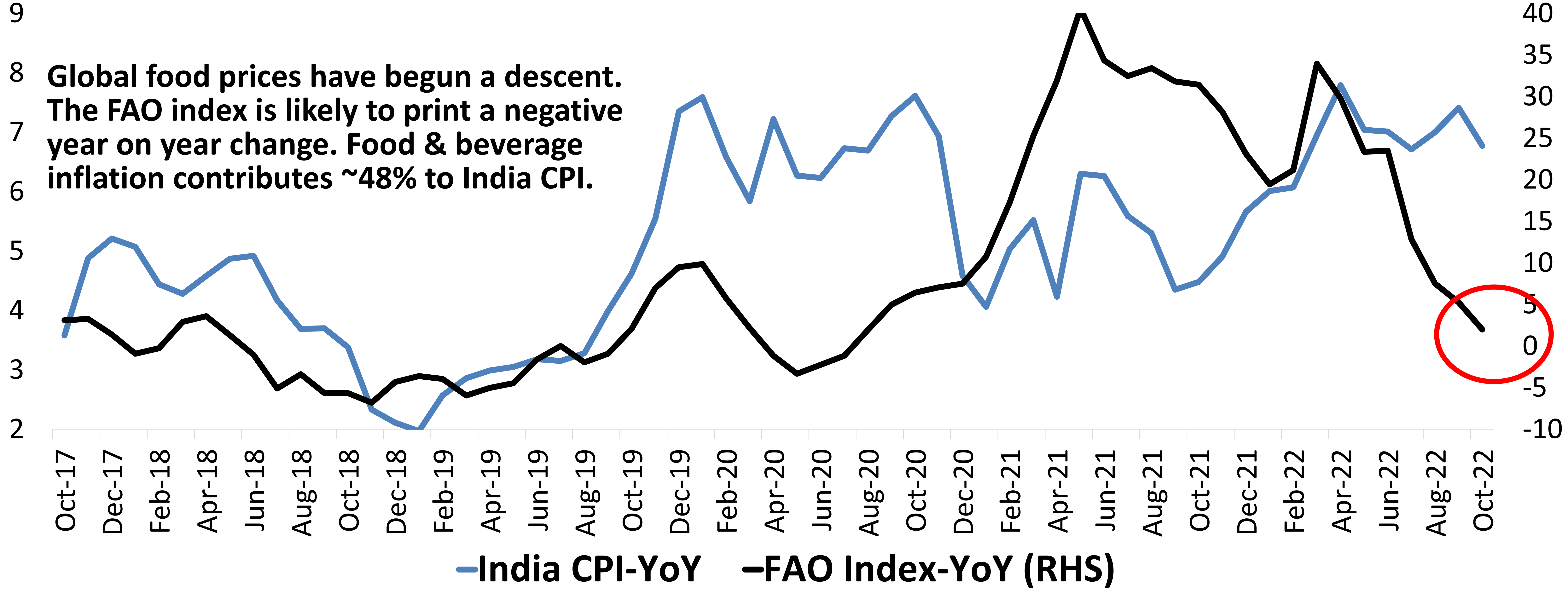
India consumer price inflation has been lower than in previous cycles. The wholesale price inflation (WPI) has been much higher on back of high primary articles prices. Sky high energy prices and a rally in food prices this year caused wholesale inflation to remain in double digits for more than 5 quarters .

Higher WPI didn't translate fully into higher CPI because a large part of energy upsurge was not passed on and some sector of the economy took a hit on their margins to absorb input price pressures.

Inflation is now in a well-set downtrend and is likely to ease further.

How will it impact the rates cycles?





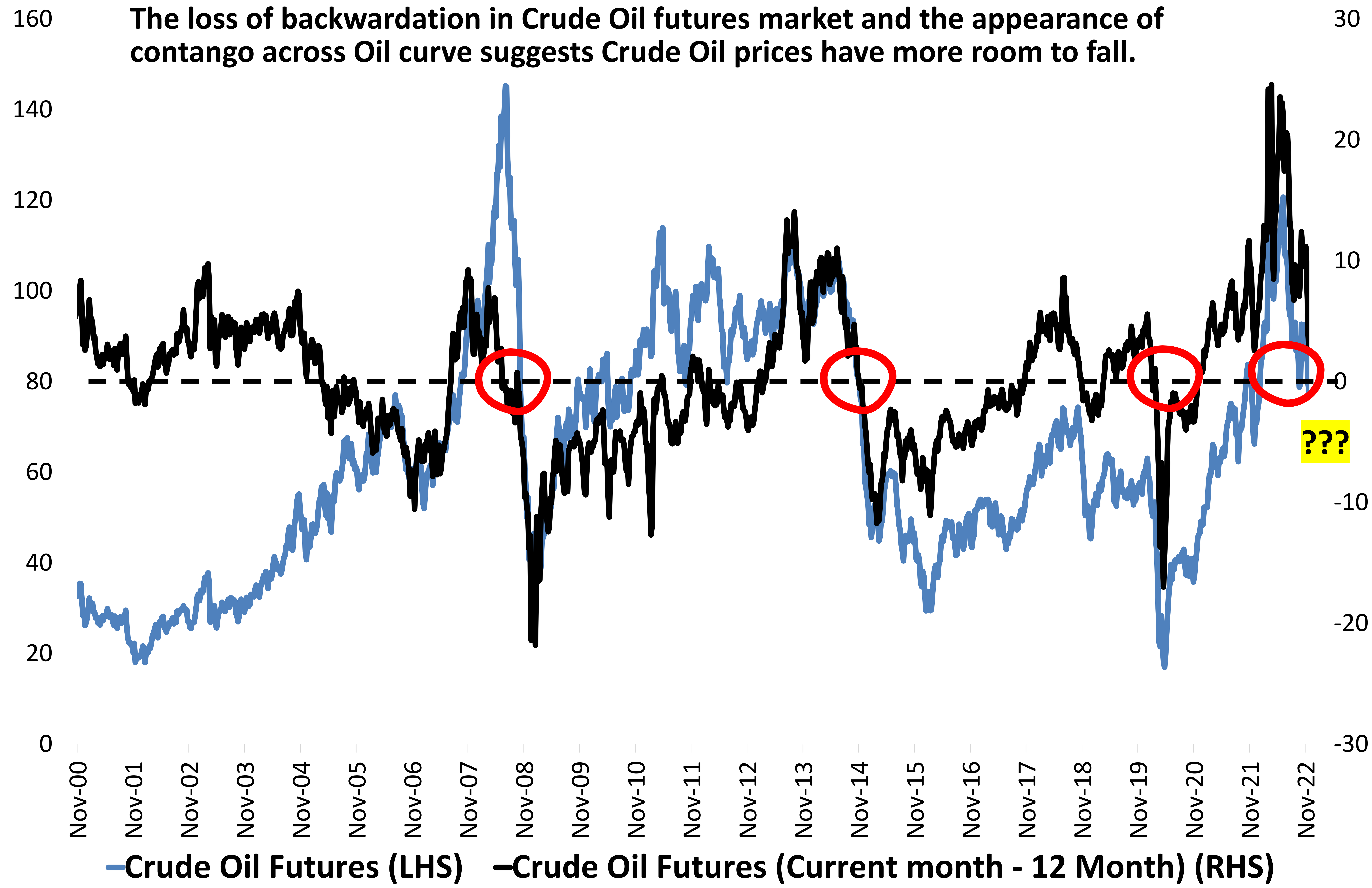
Source: Bloomberg, DSP As on Nov 2022

Crude Oil Futures Signal Softer Prices Ahead

Over the last few months #DSPNETRA highlighted several data points which suggested that Crude Oil prices were headed lower. Backwardation, a condition when current prices are higher than forward prices is bullish. It suggests that buyers are ready to pay high prices to secure the commodity today.

Recently, Crude Oil futures market gave up its backwardation which it had held consistently over the last 18 months. This is sign that at the current level of supply, there is not enough demand for Oil. This means, Crude Oil prices may head lower.

This is also consistent with slowing demand in US, EU and a failure of Chinese demand to recover. India can benefit from lower Oil prices as it's trade deficit can reduce when oil prices fall from $90 towards $60.



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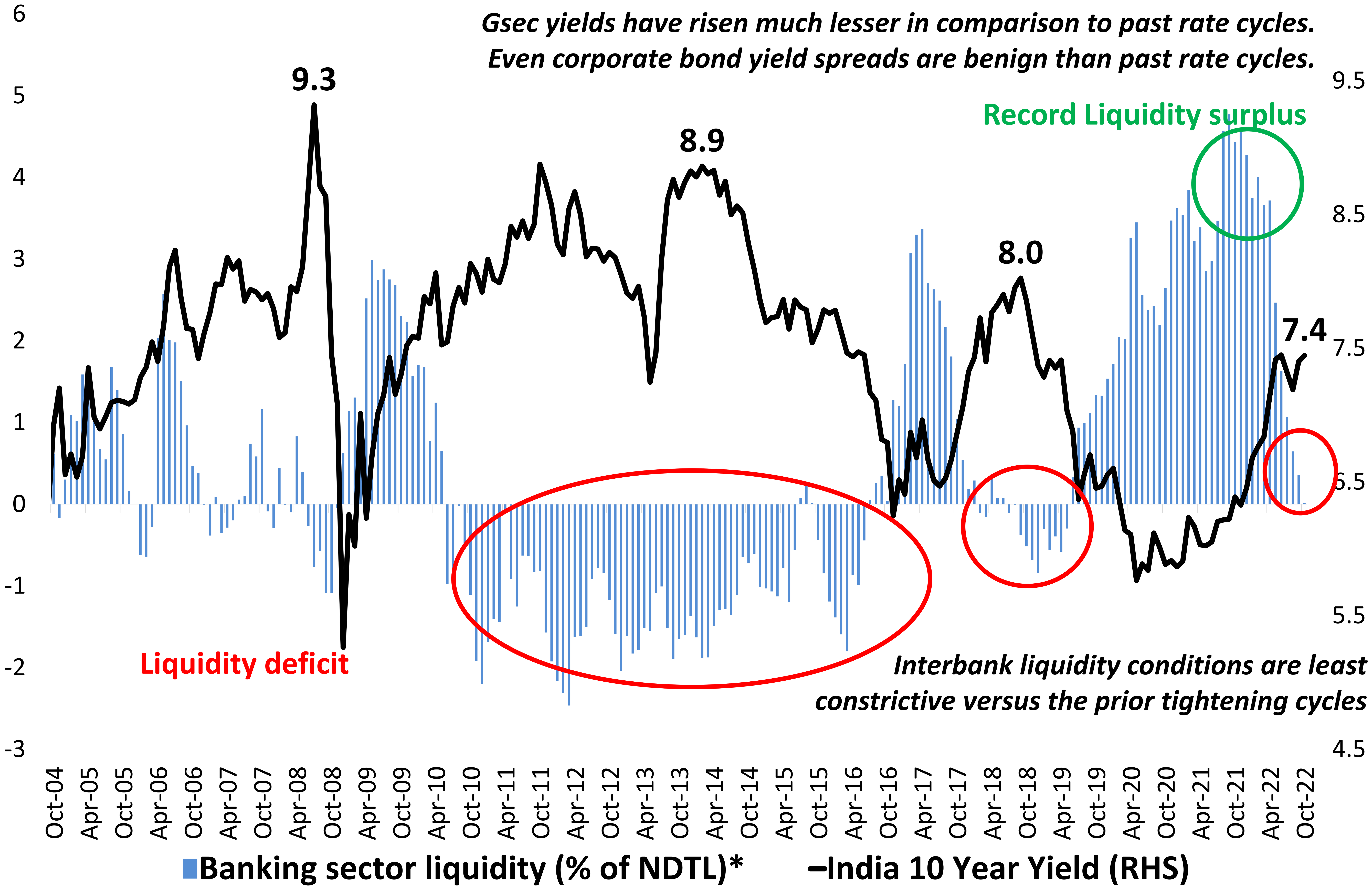
Source: Bloomberg, DSP As on Nov 2022

Least Constrictive Monetary Tightening In India, So Far…

RBI accelerated its monetary policy tightening in the aftermath of Russia-Ukraine war, to tackle a sticky inflation picture. In FY23, RBI has raised rates by nearly 190bps so far and is expected to 'do more'. However, **the monetary policy condition in India has been the 'least tight' when compared to past episodes of crisis and inflation upsurges.**

This is likely because of two reasons. Firstly, the domestic measures of Inflation have been slightly less buoyant than the past cycles when inflation reached double digit levels. Secondly, the RBI has adopted a more benign view of liquidity conditions this time. In the past, liquidity was kept too tight and restricted growth in India.

Now the question is – What happens to rates when inflation softens? How will a relatively benign monetary policy impact growth?



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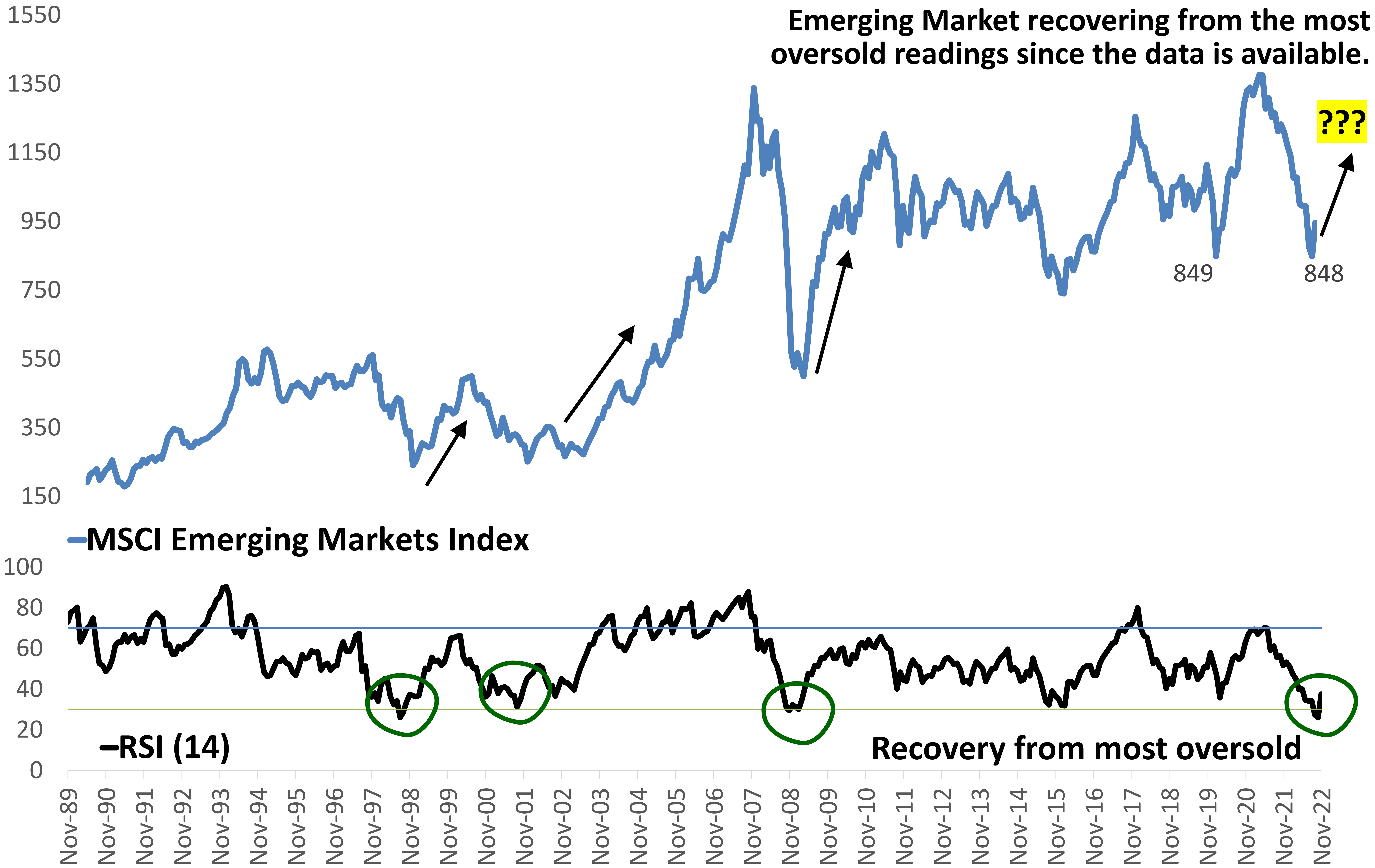
Source: Bloomberg, DSP As on Nov 2022

Emerging Markets Forming A Long-Term Bottom?

A recovery from most oversold conditions doesn't guarantee an immediate bull market. But it does suggest that the margin of safety has improved tremendously.

Emerging markets are now witnessing a reversal from the most oversold conditions on record. What's more important is that the price damage has taken the MSCI EM index back to the Covid crash lows of March 2020. Valuations are cheaper than the rest of the world and this could be the point where the index forms the 'Bullish Double Bottom' pattern.

India, as of now, leads the EM pack in earnings growth but is not cheap on a relative basis. Our data suggests that India may not outperform if momentum favours EM, but there is enough earnings driven equity performance in India to continue to remain 'Bullish' on India equities.



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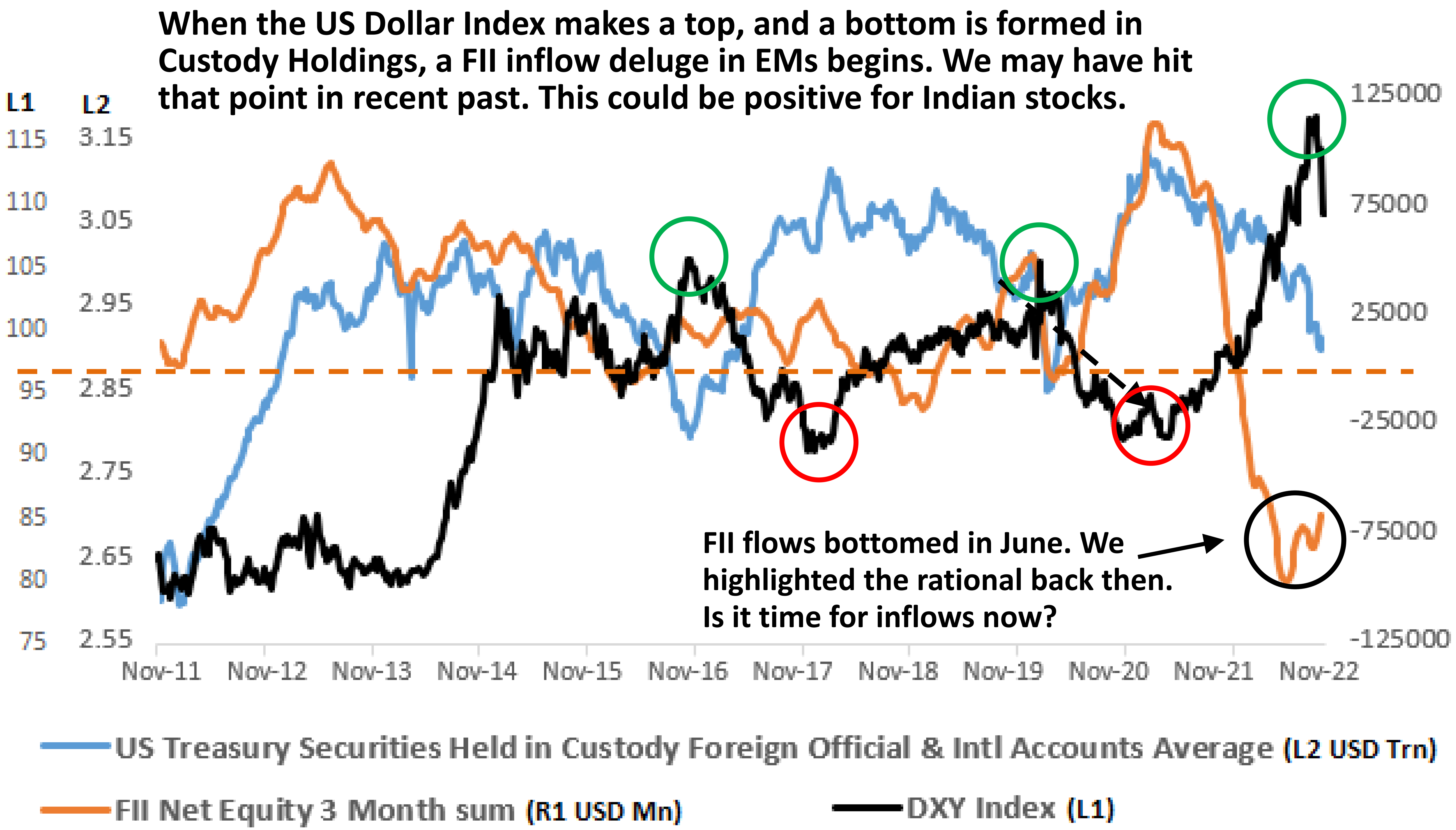
Source: Bloomberg, DSP As on Nov 2022

Is It Time For Sharp FII Inflows?

When "dollars" are more plentiful because liquidity is abundant (or not outright harmfully tight), more US Treasury bonds end up in foreign hands. The Federal Reserve custodies dollar assets of overseas central banks & large offshore commercial traders under the custody holdings series shown in the graph here. This series rises & falls with global availability of US Dollar & matches the 'tourist money'. Tourist money is the returns thirsty FII flows.

In the past, if there was a simultaneous topping of the DXY (Dollar Index) and reversal in custody holdings, which coincides with positive FII flows, a useful signal occurred. It suggests that FIIs may turn on their 'risk-on' mode. This usually benefits risk assets such as Emerging Market equities. FIIs prefer markets where earnings are growing. India is witnessing better earnings growth versus peers.



This has causation: Dollar peak, custody holdings bottom, FII outflows reverse.

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Source: St Louis Fed, Bloomberg, DSP As on Nov 2022

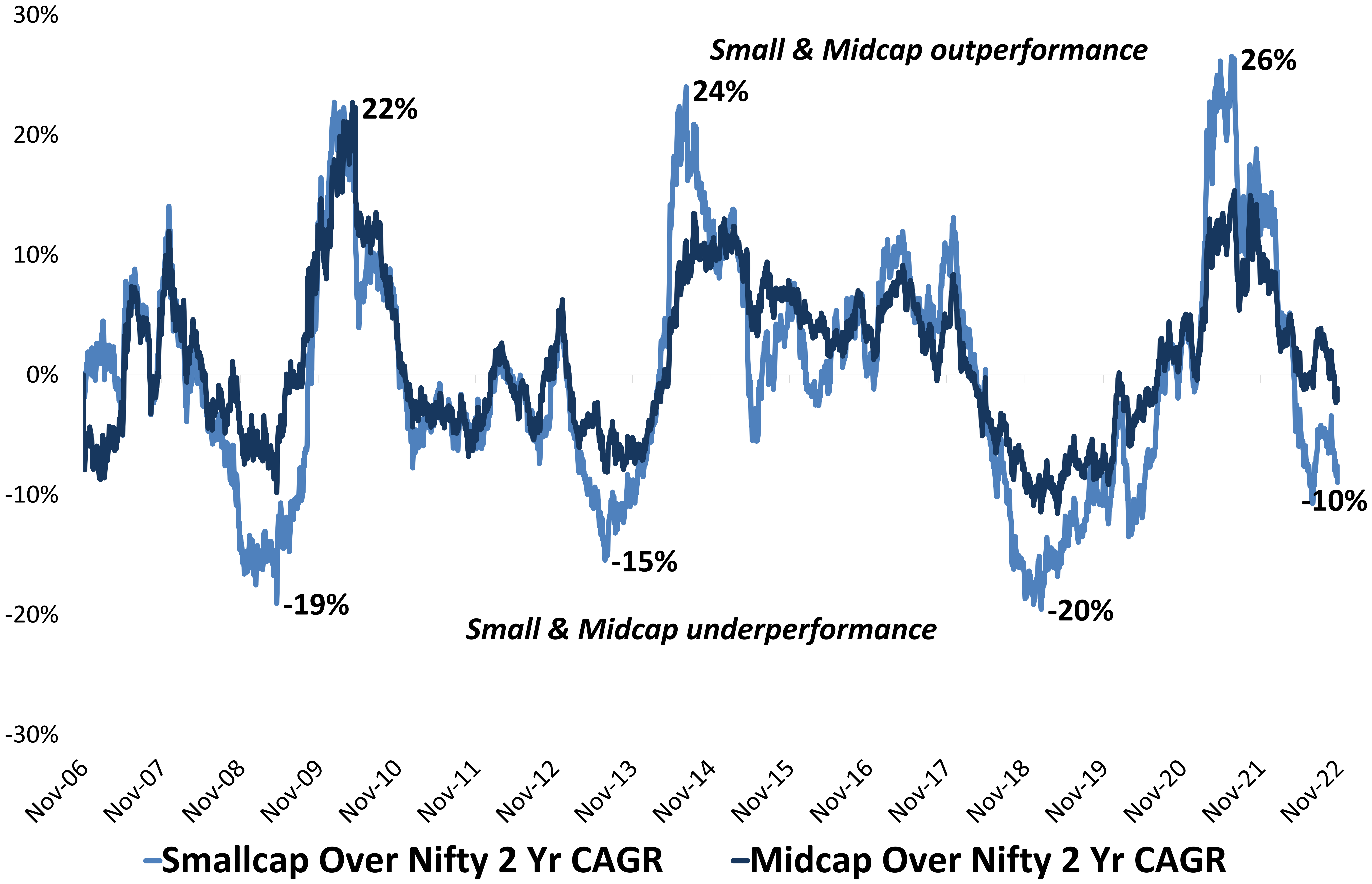
Small & Midcap Froth Removed, Outperformance Ahead?

Small & Midcap (SMID) stocks have underperformed Nifty over the last 16 months. The underperformance versus Nifty halted before reaching prior historical troughs.

Historically, Small & Midcap stocks enter a period of outperformance once they reverse from deep phases of underperformance. Moreover, on a relative valuation basis, SMID stocks are priced more attractively.

Based on trailing earnings:
Nifty Index is trading at 22x
Nifty Midcap 100 Index is at 23x
Nifty Small cap 250 Index is at 20x

This opens the room for relative outperformance for SMID, probably small & then midcaps, in that order.



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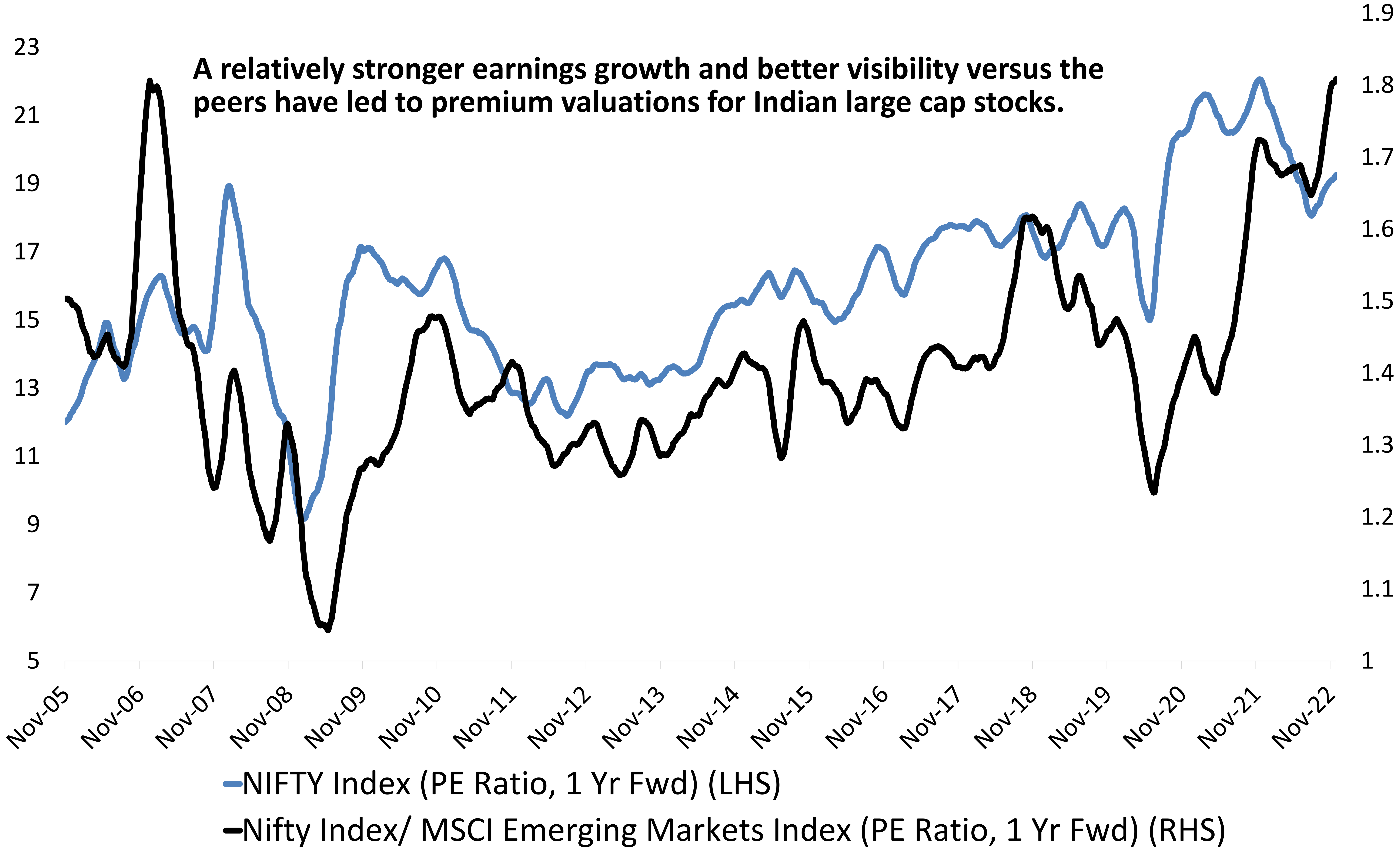
Source: Bloomberg, DSP As on Nov 2022

India Large Cap Valuations Not Cheap, Near Record Vs Peers

Large caps, as measured by the Nifty are trading at above average valuations. Although valuations have pulled back from record levels owing to earnings momentum, they are now above average after the recent rally of the last two months.

India's relative valuation to its EM peers is near record levels. This is largely a function of ultra cheap valuations elsewhere due to a cloudy outlook in EMs & dismal earnings growth. So **the valuation premium is more a function of EM peers' performance rather than just India outperformance.**

As outlook for EMs improves, the relative valuation for India may slide lower in the next few quarters. This doesn't make India a market to avoid, but to focus more on SMID segment & bottoms up opportunities. India continues to be in a long-term bull market.



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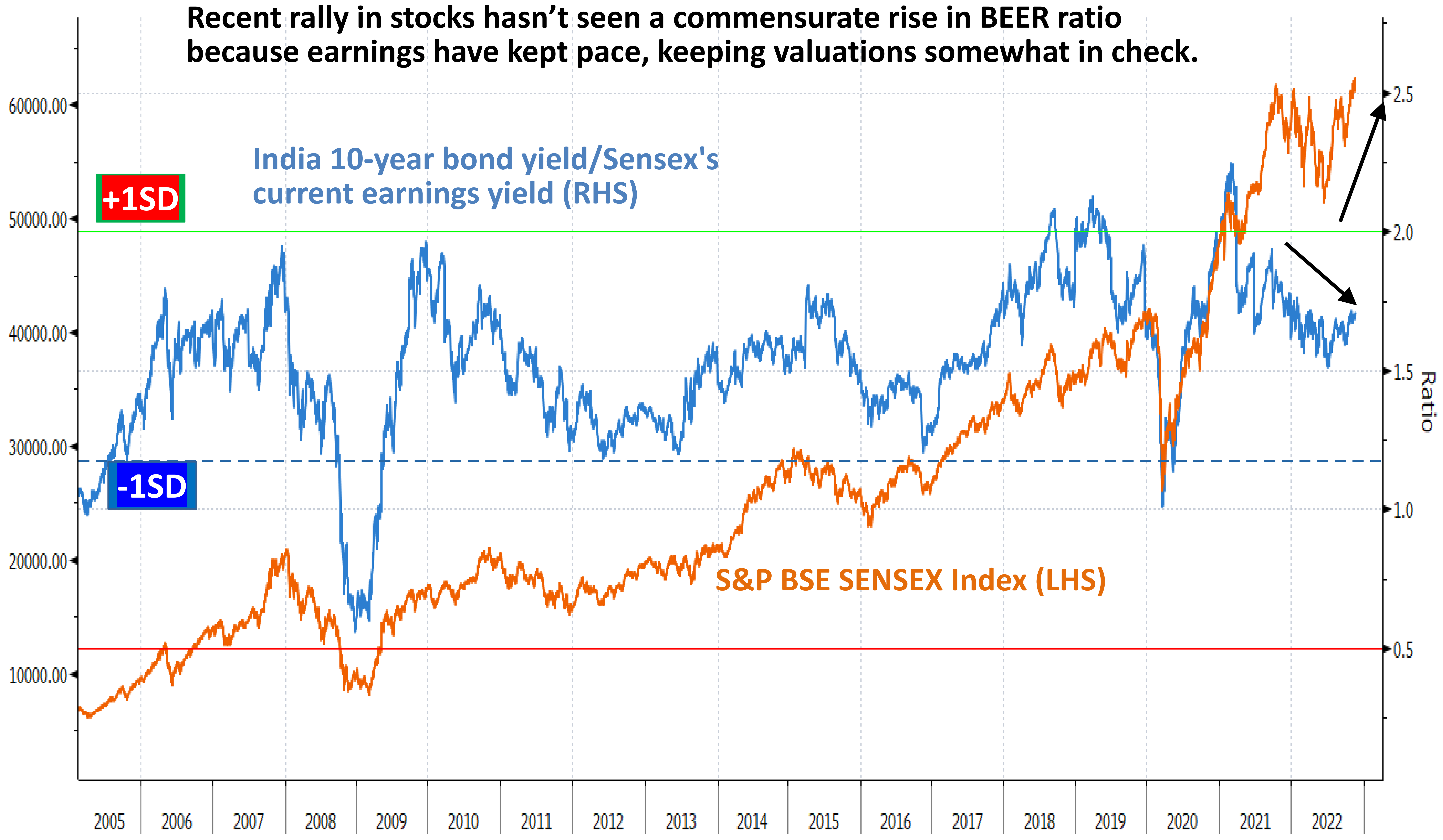
Source: Bloomberg, BSE Data as on Nov 2022

India Valuations Now Above Average, But Earnings Are So Far Supportive

As per the latest data from DSP's quarterly 'The Report Card' - ROE & operating margins are deteriorating at the margin; Balance sheets have weakened marginally with rising debt; Free cashflow generation is impacted with higher capex; Working capital cycle is getting extended. This means that corporate financials, at the margins, have softened.

Earnings growth however has been able to offset some part of valuations. The BEER ratio (a measure of how attractive are equity earnings yield versus bond earnings yield) is still not overtly expensive for Indian stocks.

This means that valuation indicators alone lack signal value. They remain far from extreme readings. It is important to focus on market capitalization cohorts, earnings growth & margins for next few quarters.



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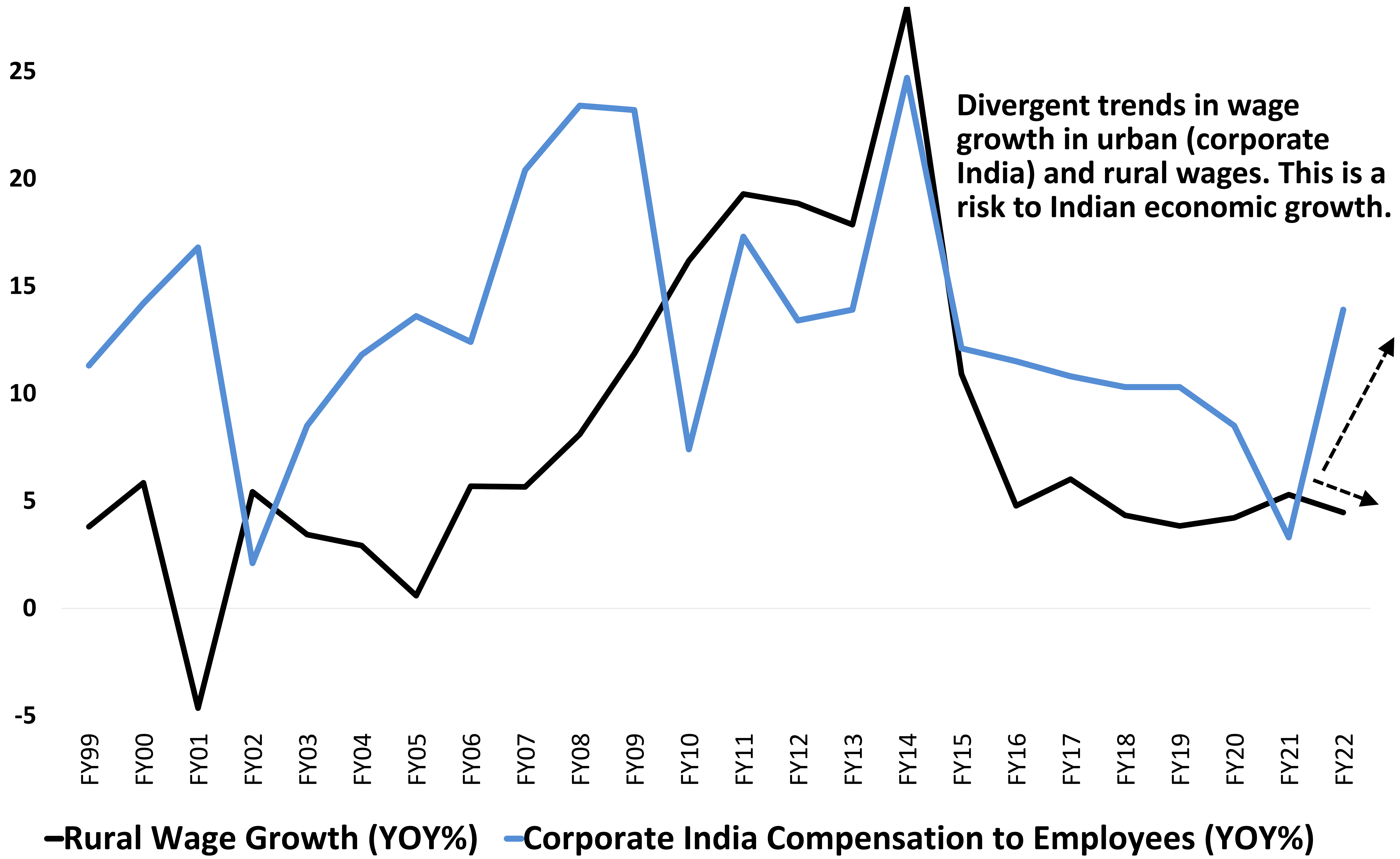
Source: Bloomberg, BSE Data as on Nov 2022

The Uneven Economic Recovery Is A Risk

The Dec'22 version of DSP 'The Transcript' notes:
"Inflation has impacted bottom of the pyramid consumption more while luxury & premium segments continue to grow. This is what people often refer to as a "K- shaped" recovery. A monthly salary of INR 25K in 2019-20 puts you in the top 10 of the Indian population .."Per capita potential" numbers must be taken with a pinch of salt in India."

This 'K-shaped' recovery poses a risk to India's growth in FY24. A large part of the Indian economy & some part of corporate India depends on rural economic recovery. Real consumption in India has just started to rise. Unless a broad based upthrust occurs, the nascent recovery will be at risk.

Pay attention to high frequency data like 2-Wheeler sales; Rural volume growth for staples and rural wage growth.



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Source: 'The Transcript', DSP As on Oct 2022

Sector Musings

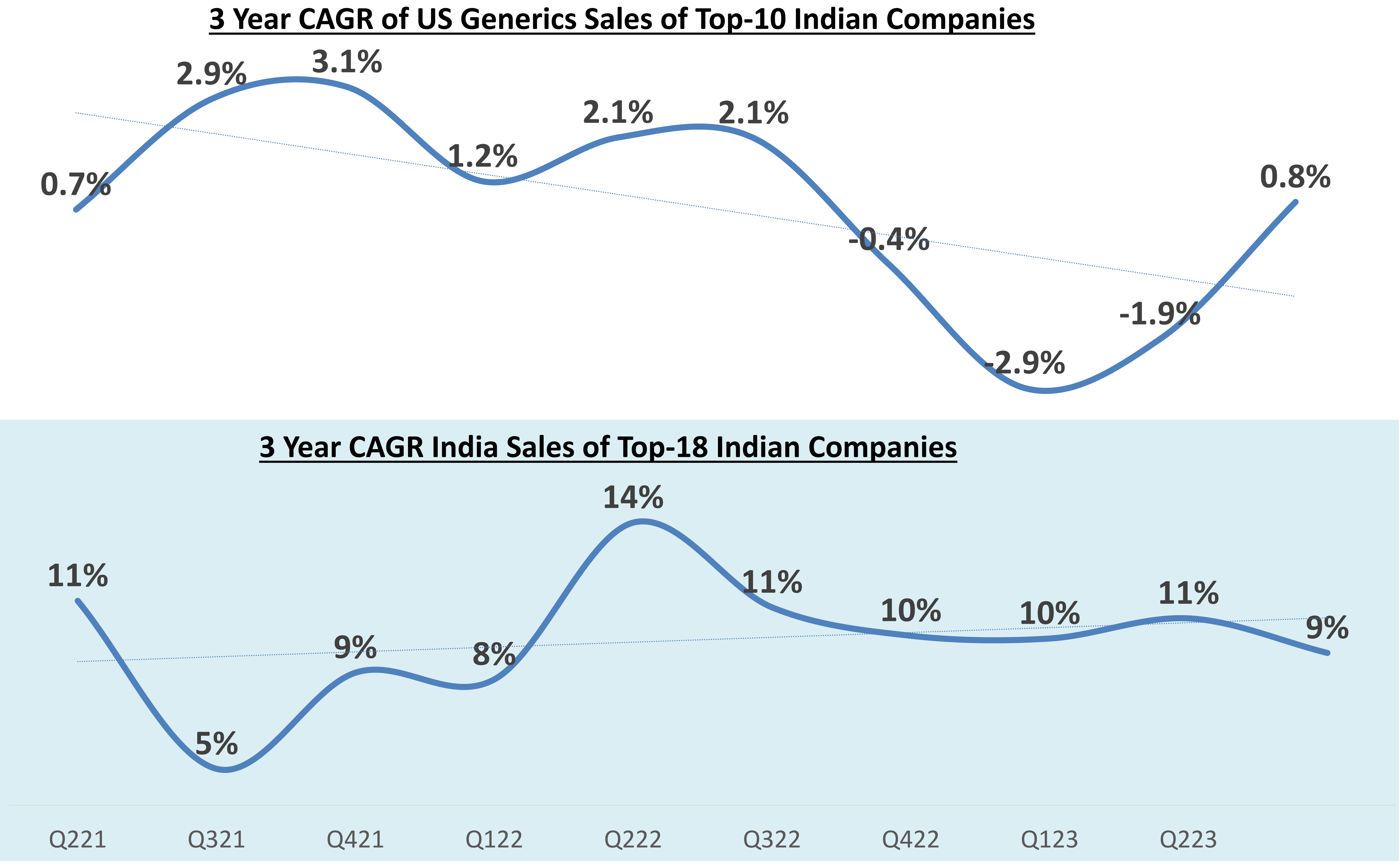
DSP

Pharma – US Generics Picking Up, India Business Stabilizing

The formulations market in India expanded at a healthy rate. Sustained traction across therapies as well as price increases of 5-7% supported overall growth. This trend is likely to continue with some seasonal adjustments and heightened competition.

The generics market in the United States increased after several quarters of decline. The price erosion moderated to low single digits in Q2 vs early teens in Q1. The gross margins improved due to softening input costs, INR depreciation and price increases in the domestic formulation market.

Pharma and broadly the healthcare sector is one of the only few sectors which has valuations below 5-year average and below Pre-COVID levels making it an attractive investment basket.



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Source: DSP 'The Report Card' As on Nov 2022

Realty Sector – Staging A Comeback?

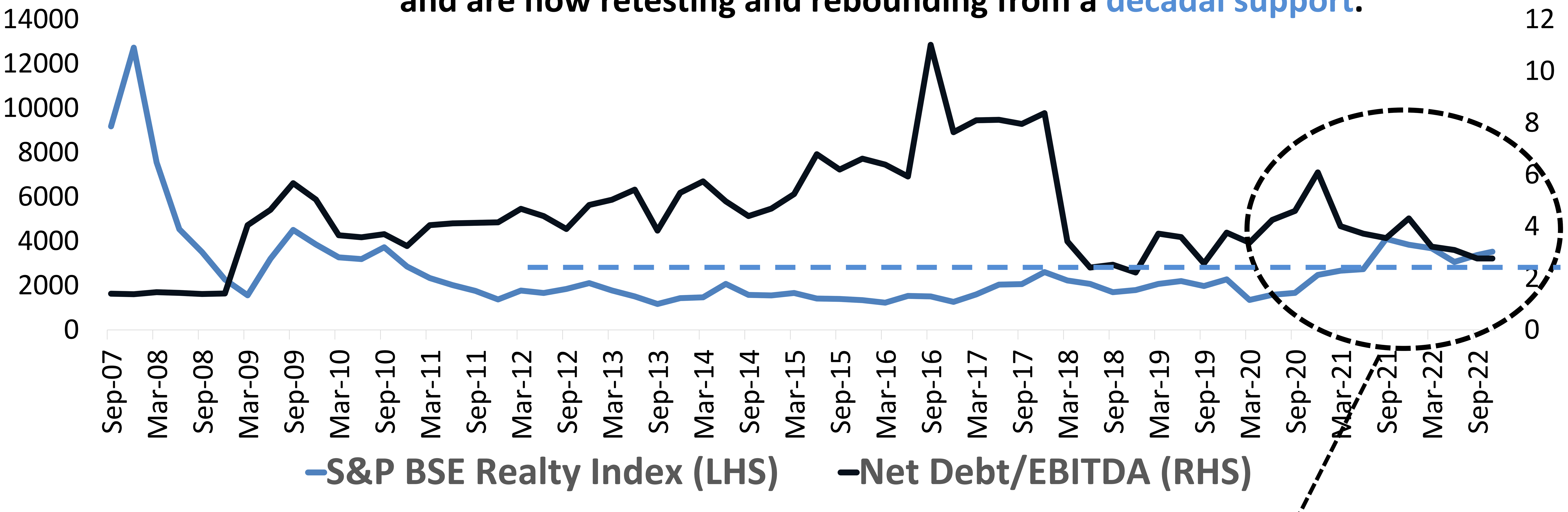
Realty sector has seen a large correction recently. This correction was preceded by a 'Breakout' in realty stocks from a 15 year consolidation after the crash of 2007-08.

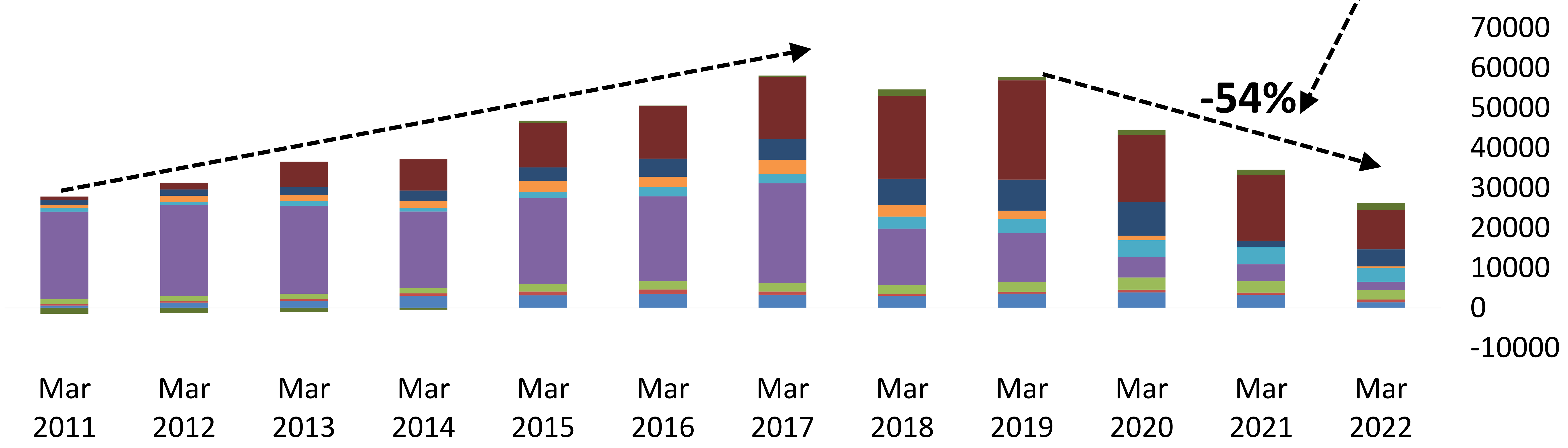
In the last 3 years, real estate companies in India have undergone a deleveraging cycle with Net Debt falling 54% on an aggregate basis of the constituents of S&P BSE Realty index. This has coincided with the sector EBITDA rising back to record levels of Rs. 10K cr annually.

The sector has also witnessed the index retesting its support levels recently. These levels are important because the index 'broke out' of this range after more than a decade of struggle.

Realty is under owned & a ripe area for exploring bottoms up opportunities with valuations being the key focus.

While companies have deleveraged, stock prices have seen a correction and are now retesting and rebounding from a decadal support.





NET Debt (INR Cr) of Constituents of S&P BSE Realty Index

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Source: BSE, Company Financials, DSP Internal As on Nov 2022

Earnings Dashboard: Financials Back At The Leaderboard

Share In Aggregate Profit After Tax By Sector

India Sectors	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Financials	20.0%	21.0%	23.3%	26.3%	24.2%	27.8%	18.2%	17.3%	8.8%	17.3%	30.6%	32.2%	28.5%
Energy	27.8%	22.3%	22.1%	21.9%	21.4%	19.8%	25.1%	26.3%	27.0%	32.6%	28.0%	26.0%	21.8%
Materials	12.5%	13.8%	11.5%	7.6%	9.7%	1.4%	0.5%	7.3%	15.4%	14.8%	13.7%	15.1%	20.0%
Information Technology	8.9%	8.7%	9.4%	11.4%	13.4%	15.2%	17.1%	16.3%	16.4%	18.9%	27.6%	16.4%	12.2%
Utilities	7.2%	6.8%	5.4%	5.6%	4.8%	4.8%	5.5%	3.3%	4.8%	6.6%	9.1%	5.7%	5.2%
Consumer Staples	3.8%	3.9%	4.2%	5.0%	3.7%	5.3%	5.5%	5.4%	5.1%	7.9%	14.8%	6.9%	4.9%
Industrials	6.9%	6.9%	6.8%	6.8%	5.0%	5.1%	5.0%	6.0%	5.7%	6.9%	8.2%	4.8%	3.6%
Health Care	2.4%	2.8%	2.7%	3.5%	3.8%	4.8%	5.7%	5.0%	3.1%	4.1%	6.1%	4.6%	3.0%
Consumer Discretionary	5.4%	10.3%	12.0%	10.0%	11.6%	12.2%	13.3%	10.0%	11.9%	-7.7%	-1.4%	-2.0%	0.6%
Communication Services	4.3%	2.7%	2.0%	1.6%	2.2%	3.5%	3.9%	2.7%	0.6%	-2.2%	-36.9%	-10.1%	-0.1%
Real Estate	0.9%	0.8%	0.5%	0.4%	0.3%	0.3%	0.3%	0.3%	1.3%	0.6%	0.1%	0.3%	0.4%

Source: Investech, DSP As on Oct 2022

Activity ≠ Investing Success

Not acting might be the best action at times.

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