NETRA

Early Warning & Signals Through Charts

October 2022

DSP

Cross Asset Inflection Points

The world is rushing towards a "Safe Haven", but is it too late now?

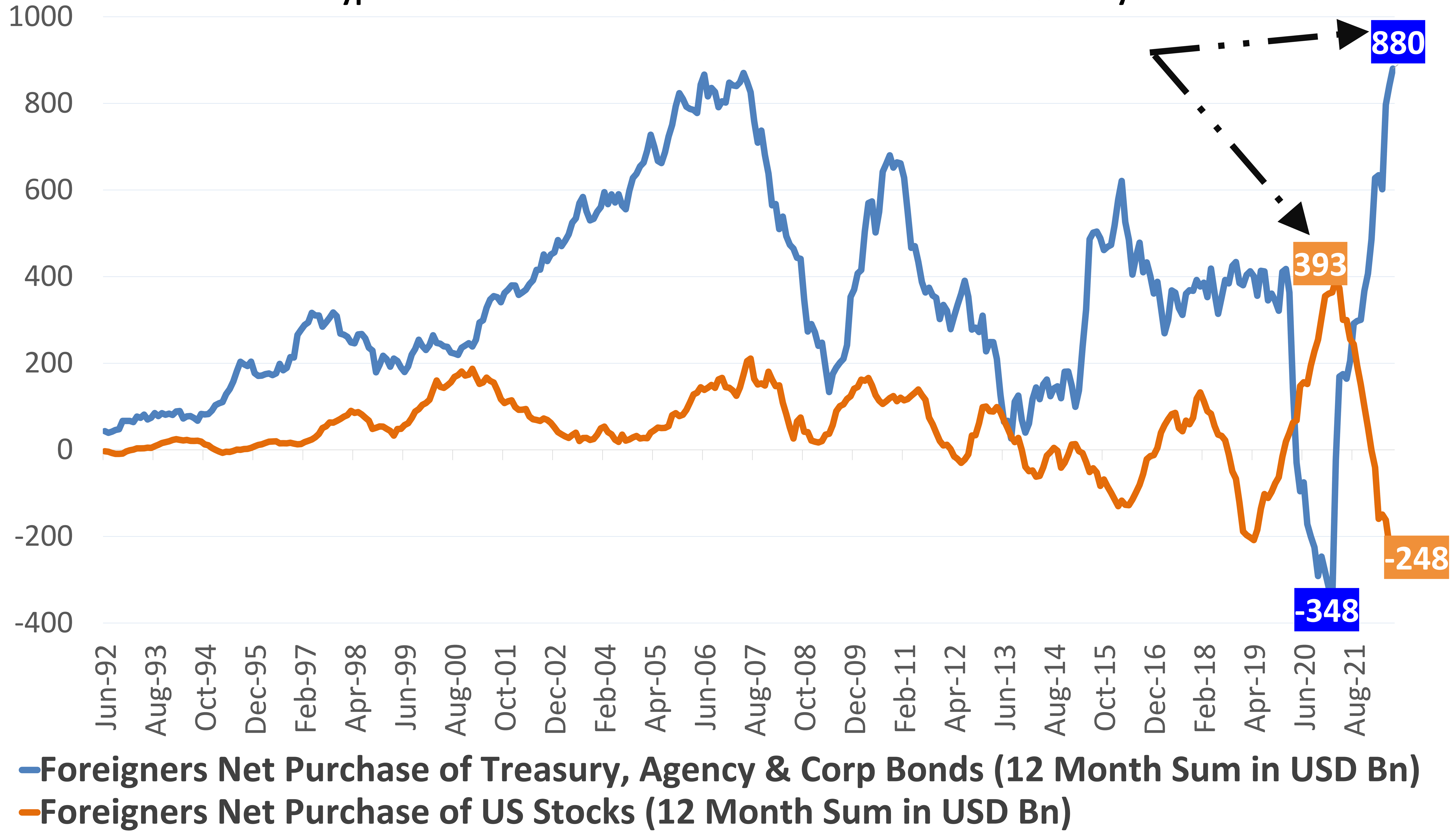
USD denominated fixed income securities have been receiving the highest number of foreign flows ever recorded. This is the classic case of 'risk-off' and a 'flight to safety'. Data is available till Jul'22 and we reckon it would have been even more stark in Aug & Sep 22.

What's the take?

1. 'Flight to safety' may have hit an extreme. This has negative implications for the US Dollar as it has seen many unlikely events come to help it strengthen like the British Pound crash.
2. Foreign fund flows could reverse towards 'riskier' assets like Emerging Market stocks and bonds once 'risk-off' sentiment abates.

We will track this data in the upcoming months, but it's possible that the 'risk-off' sentiment may have run its course for the time being. Look for a less volatile winter ahead.

An extremely sharp reversal in bond inflows AND a large outflow from stocks is a typical 'risk-off' indicator. A reversal from here means: Put your 'Bullish Hat' on!



Source: DSP, US Treasury International Capital System Data As on Sep 2022

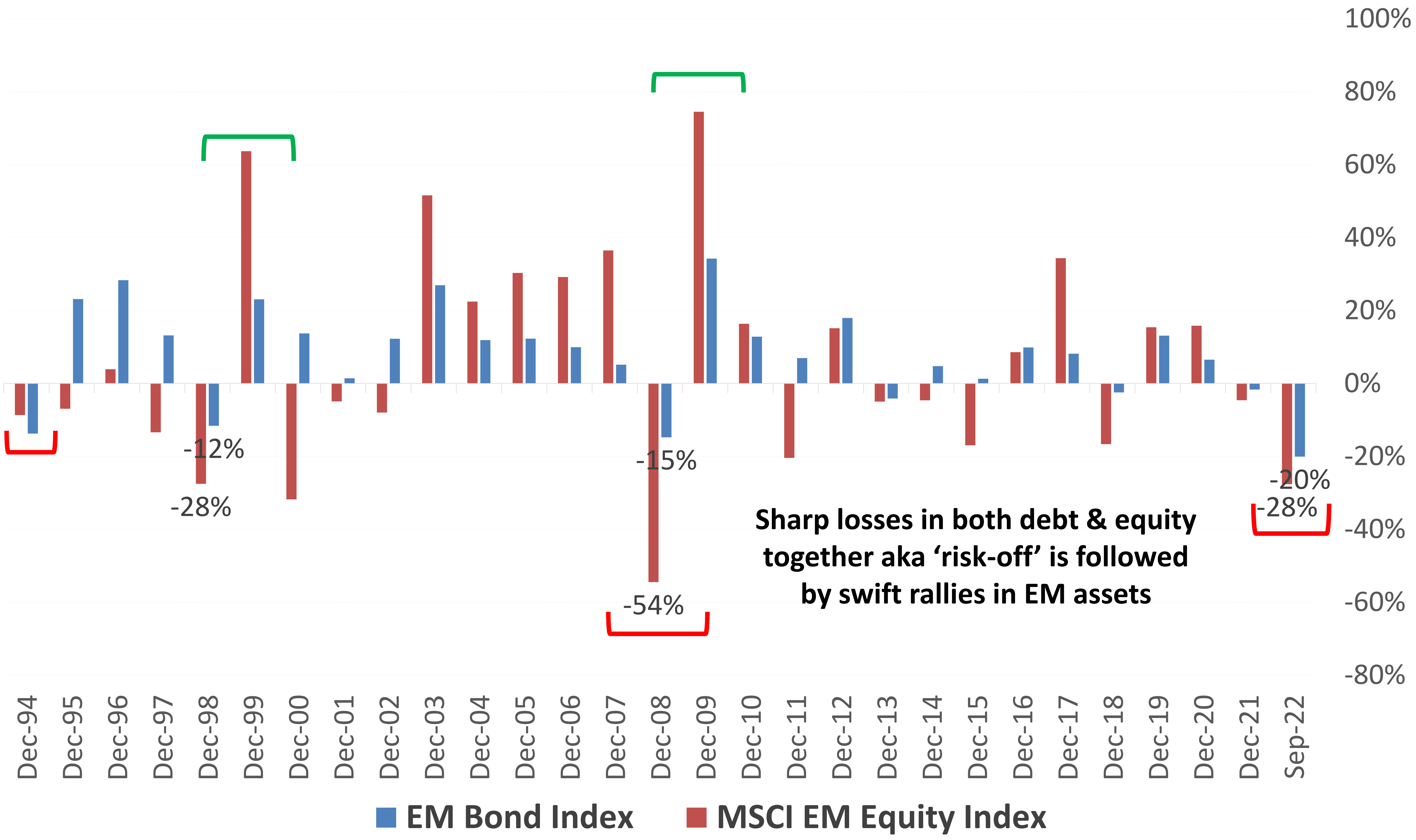
Being an Emerging Market investor hasn't been easy in 2022 so far, but what's ahead?

Losses of more than 10% in both equity & debt markets for emerging market investors are rare. In 2022, September to Date, equity losses are at 28%, Bond investors have lost 10% in broad EM indices.

Historically, we saw better times for investors when such drawdowns were observed. What's more, emerging markets are at one of the cheapest levels they have been over decades. Both on absolute and relative terms to developed markets.

In a nutshell, expect better times for emerging markets ahead. Especially if the 'risk-off' sentiment ebbs.

Don't forget the best Emerging Market when it comes to earnings growth – India.



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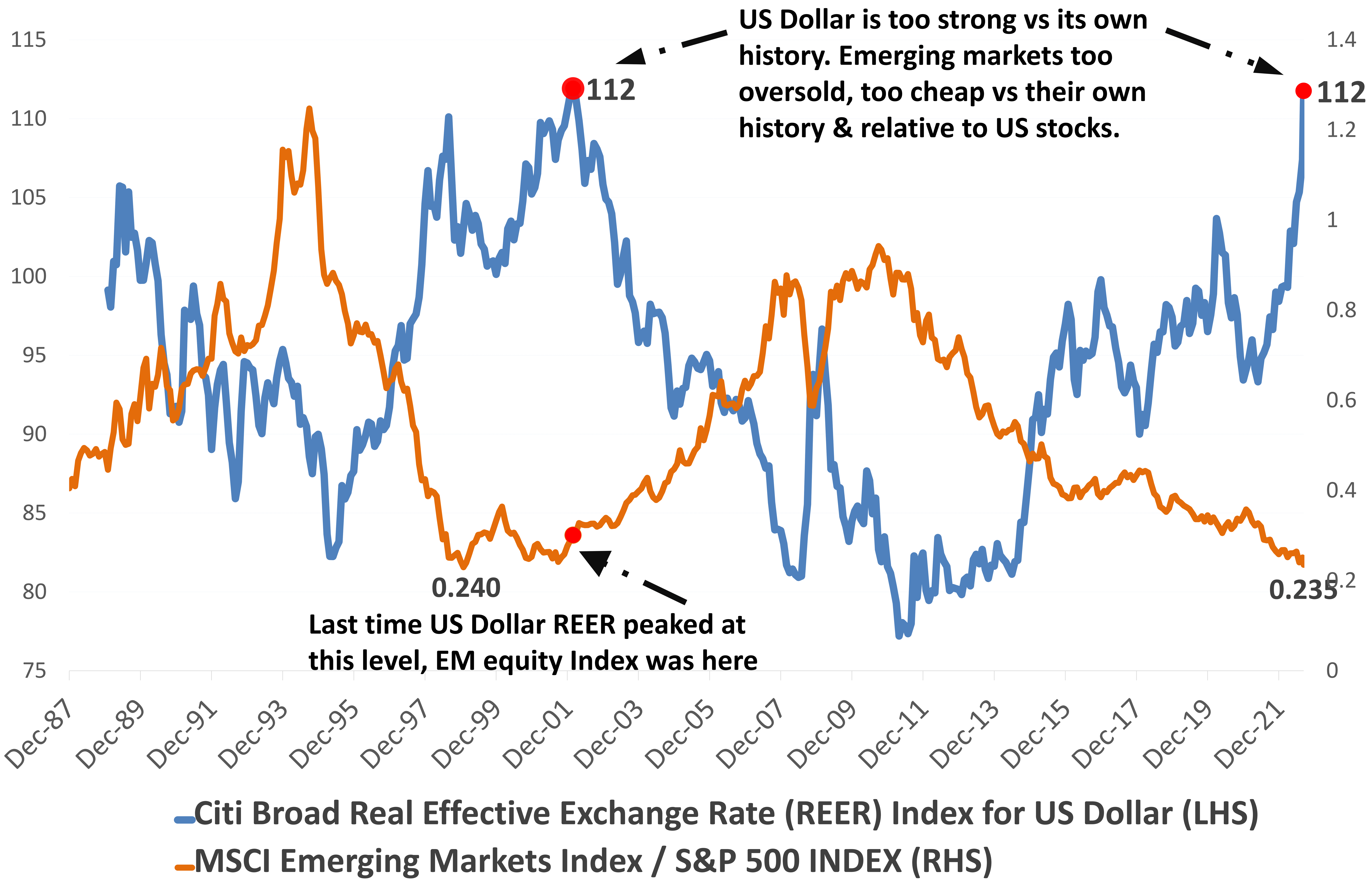
Source: Bloomberg Data As on Sep 2022

Is it time for Emerging Markets to make a comeback?

US Dollar has strengthened to its peak REER level of 2002, marking one of its strongest levels. This is the level around which Emerging Markets bottomed & entered the most ferocious 'Bull market' ever seen in EM equities.

Will they enter another similar bull market is unknown. What's visible is that emerging markets are trading at a trailing price to earnings (P/E) multiple of under 10 which is an 80% discount to the US equity valuation multiple (which itself has fallen drastically).

Emerging Markets are cheap & oversold. Look for the trajectory in the US Dollar & fund flows to ascertain when EMs turn for good.



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Source: DSP, Bloomberg, Citi As on Sep 2022

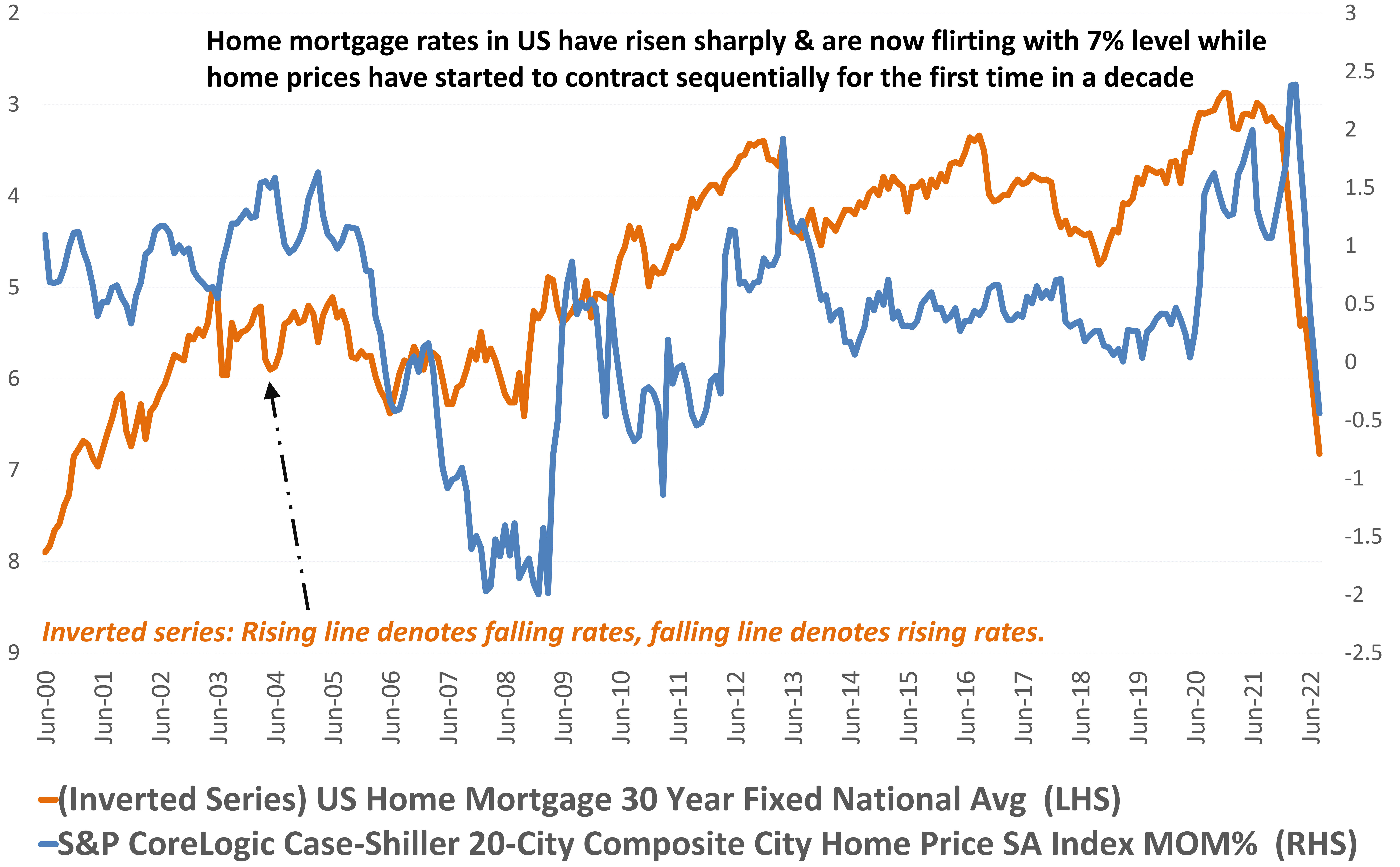
US housing market is rolling over, fast

In 2022, home mortgage rates in US have doubled to 6.8%. Mortgage rates in US are now extremely high, home affordability is at a 40 year low. Home prices have started to fall sequentially but are still up nearly 7.5% on a year-on-year basis.

Even rents have begun to fall on a monthly basis in US. Housing contributes 42% on a consolidated basis to US consumer price inflation with nearly 32% of the overall basket coming from home rentals.

Both these data points are now indicating that inflation in the US is likely to cool down in the months to come. This is consistent with our hypothesis on inflation. Read our full report here: Inflation

A change in inflation trajectory will be the most important event for financial markets. It will cause the 'risk-off' behavior to take a back seat. Watch out!



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Source: DSP, St Louis fed, Data As on Sep 2022

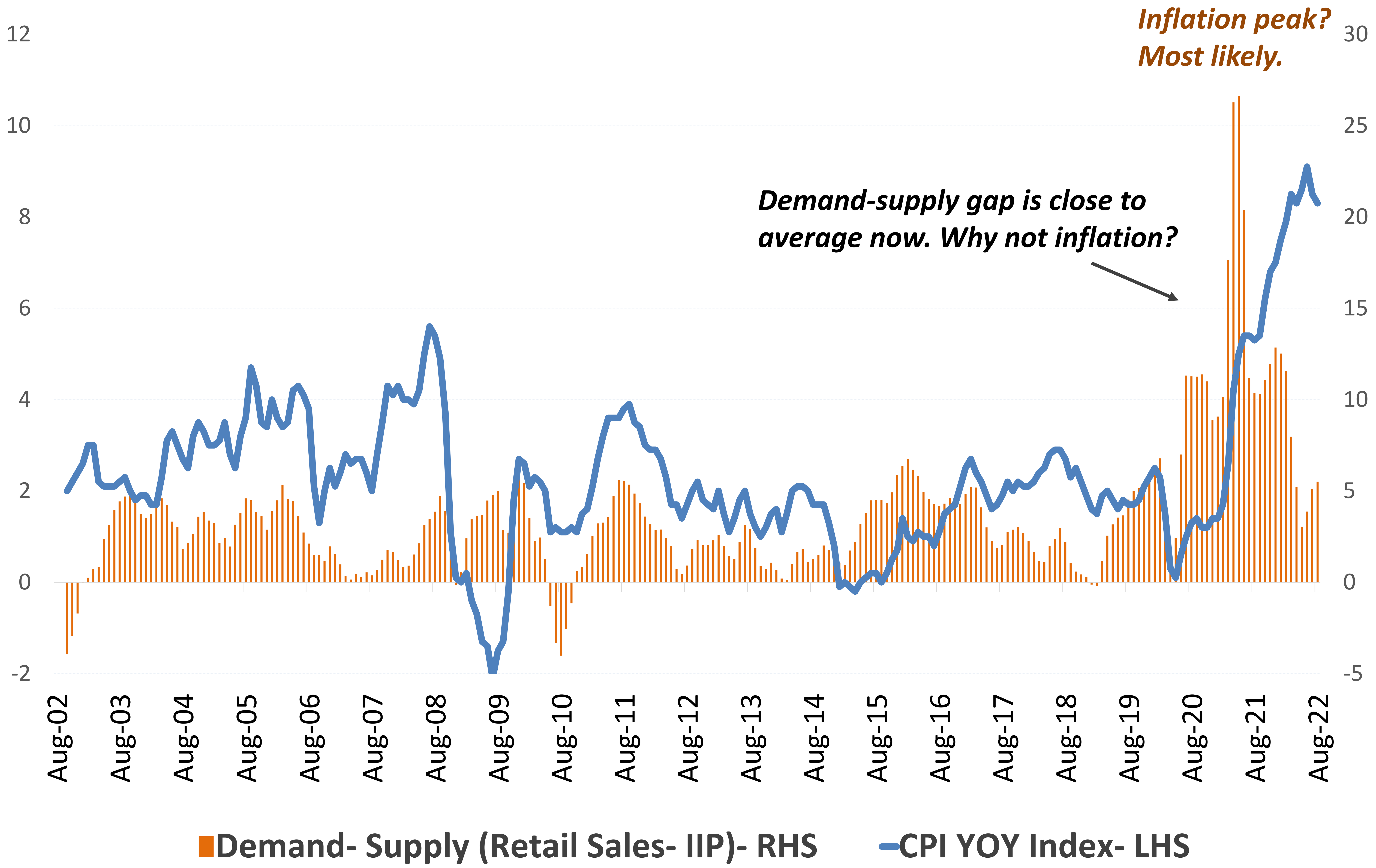
Easing of demand-supply gap structurally points to lower inflation in the US

The gap between demand & supply growth rates measured by the difference in growth rate of retail sales (demand) and index of industrial production (supply) is easing. This means less incremental demand for each unit of incremental supply.

The reasons include both a slowing demand and a rising supply. In such a scenario, how can structural inflation survive?

Personal consumption expenditure inflation is significantly down, consumer price index (CPI) inflation has turned downwards on Y-o-Y and M-o-M basis.

We believe lead indicators are aligned for a sustained downtrend period in inflation numbers from the current extremities.



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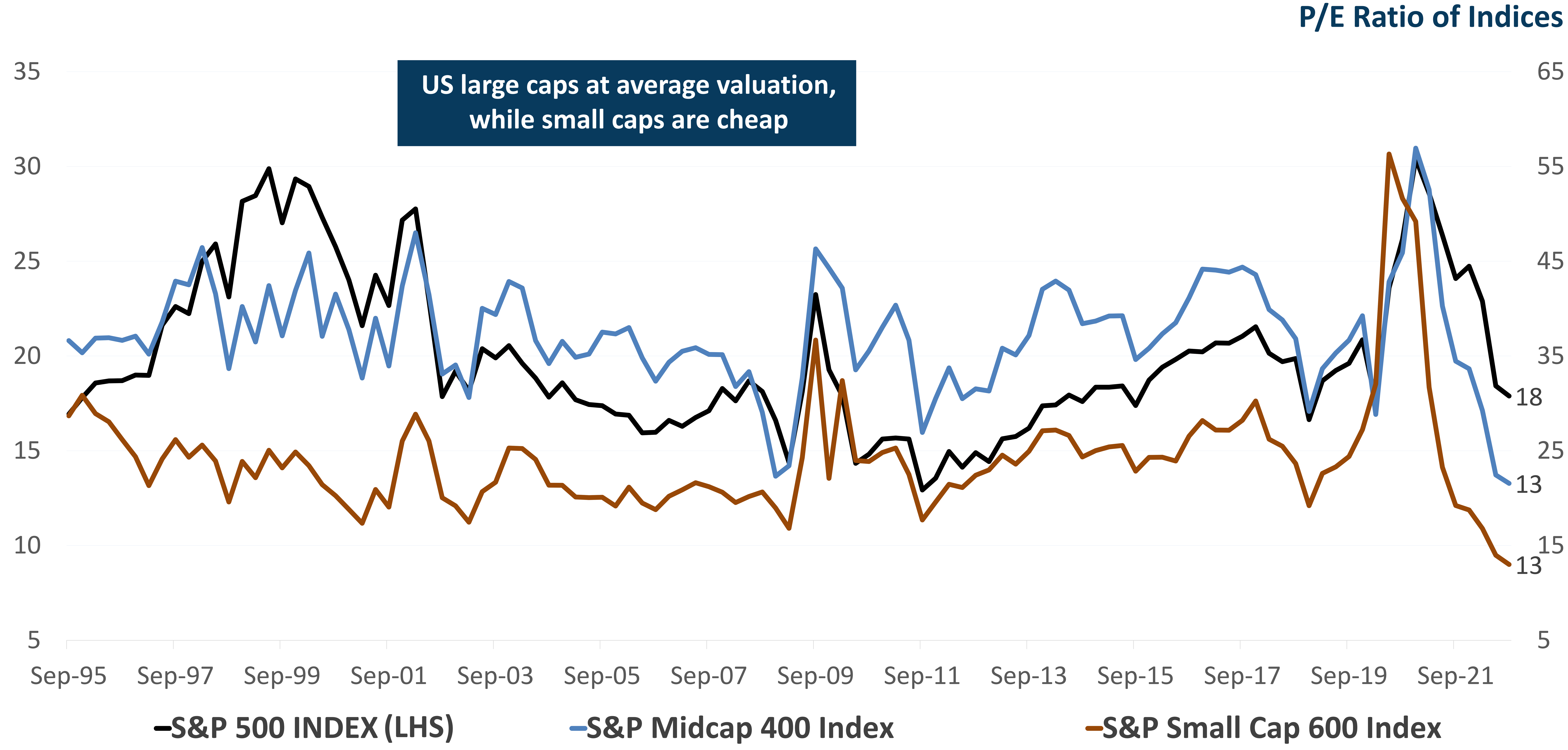
Source: DSP, FAO Data As on June 2022

Valuations: Where are we?



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Source: Bloomberg Data As on Sep 2022

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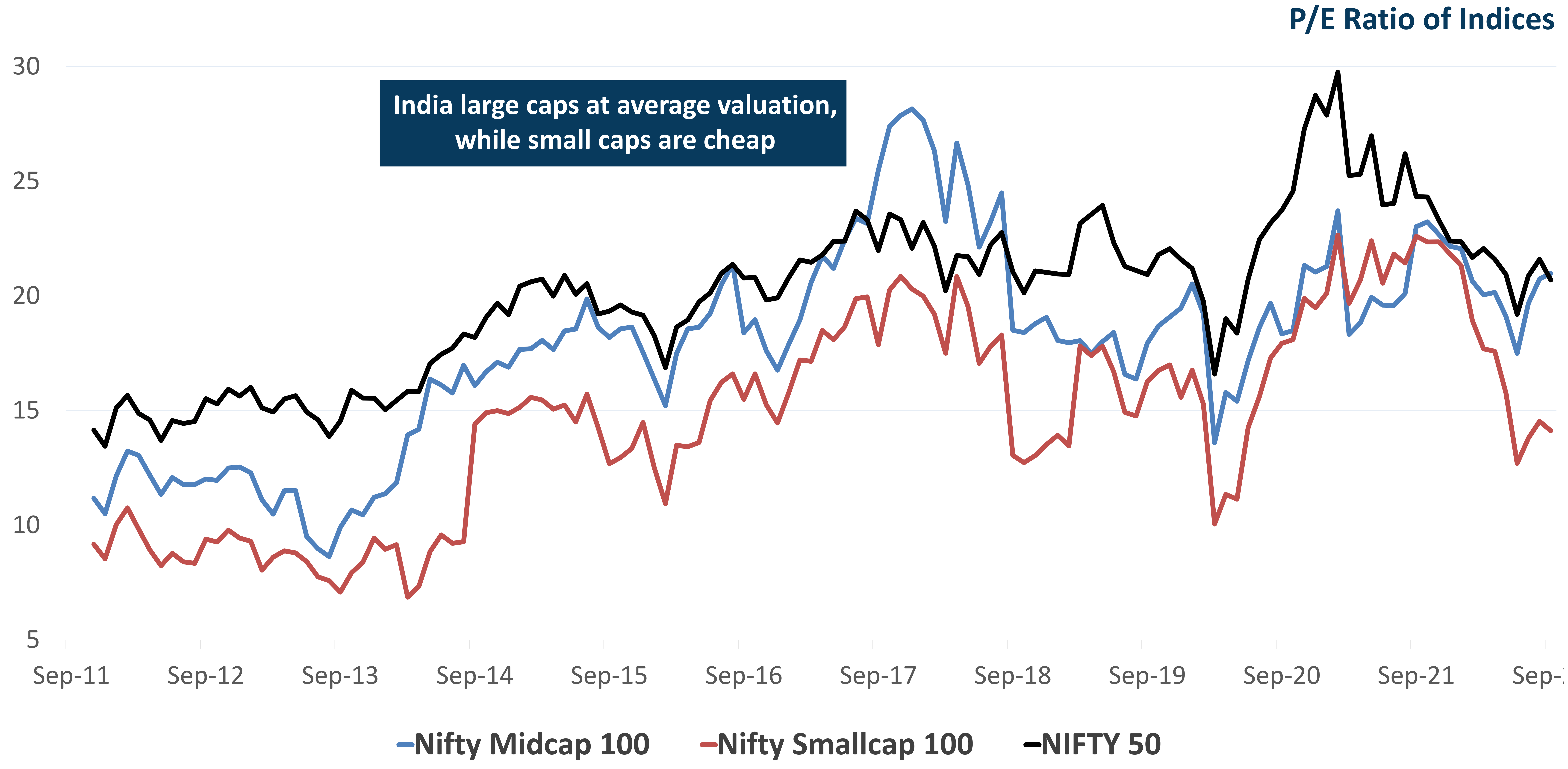

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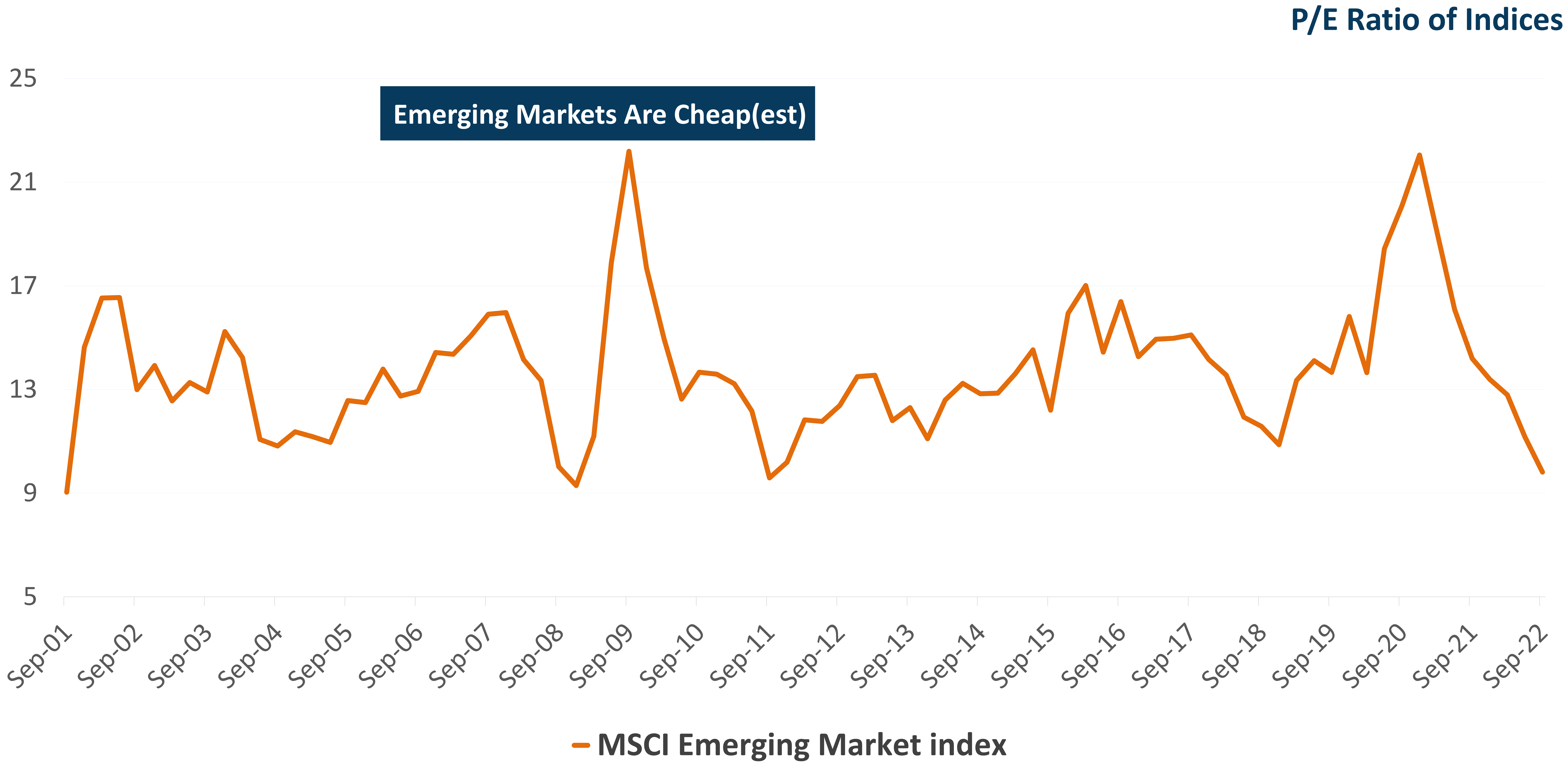

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Source: Bloomberg Data As on Sep 2022

India: Why the Outperformance?

India's growth continues to diverge from global growth

India: Steady Ship In Choppy Waters

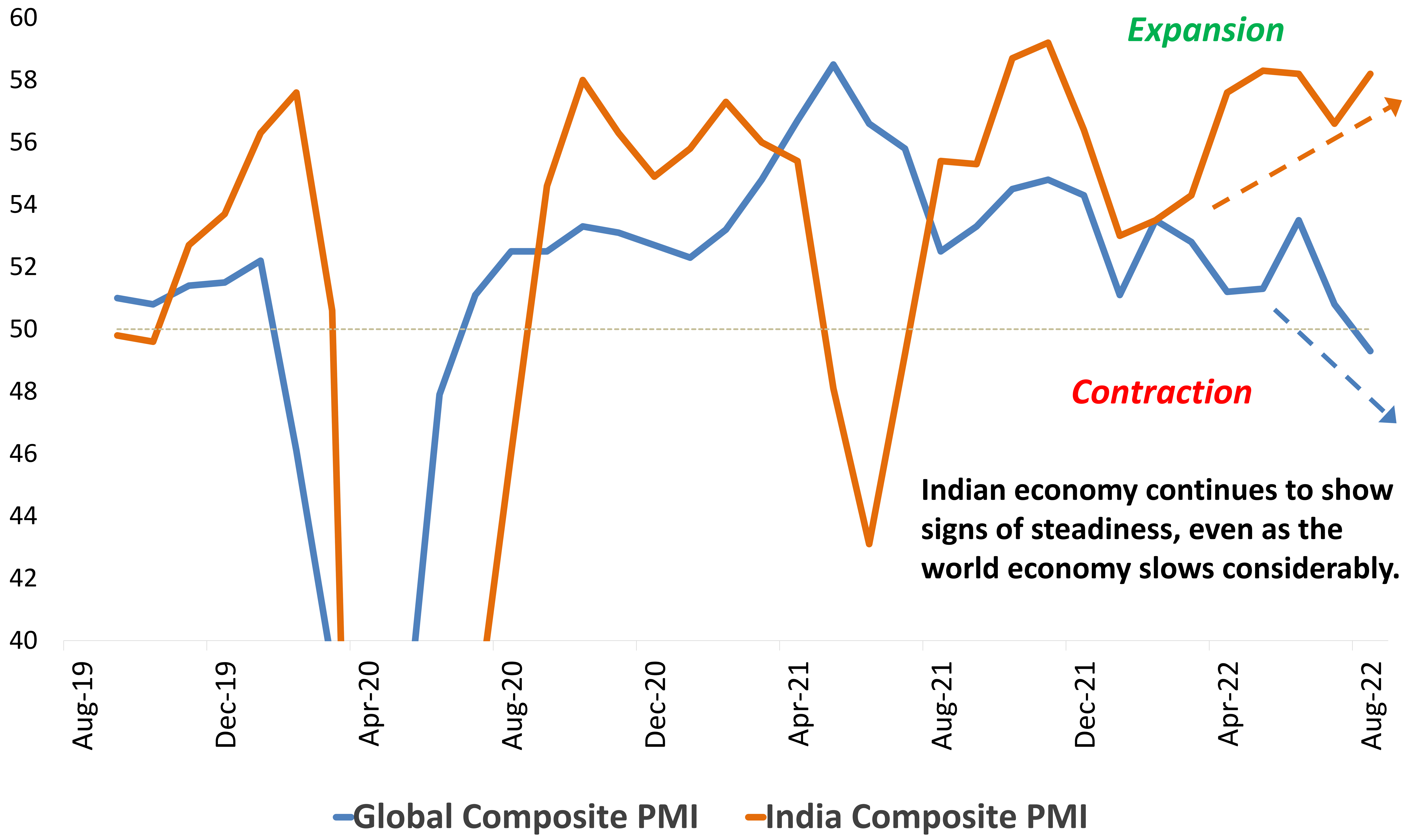
India is emerging as one of the relatively better-off economies in the post-covid world.

The collateral damage of external headwinds is visible in slow export & high import growth which is pushing FY23 Current account deficit to upwards of 3%.

Since India didn't have massive dole-outs during the pandemic, the current growth is not on crutches and is shielded from policy withdrawal syndrome.

We will continue to stick to data to assess the extent of strength in the Indian economy.

Risks from a slowing globe remain, but India's resilience needs to be tracked carefully.



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Source: Bloomberg, DSP Data As on Sep 2022

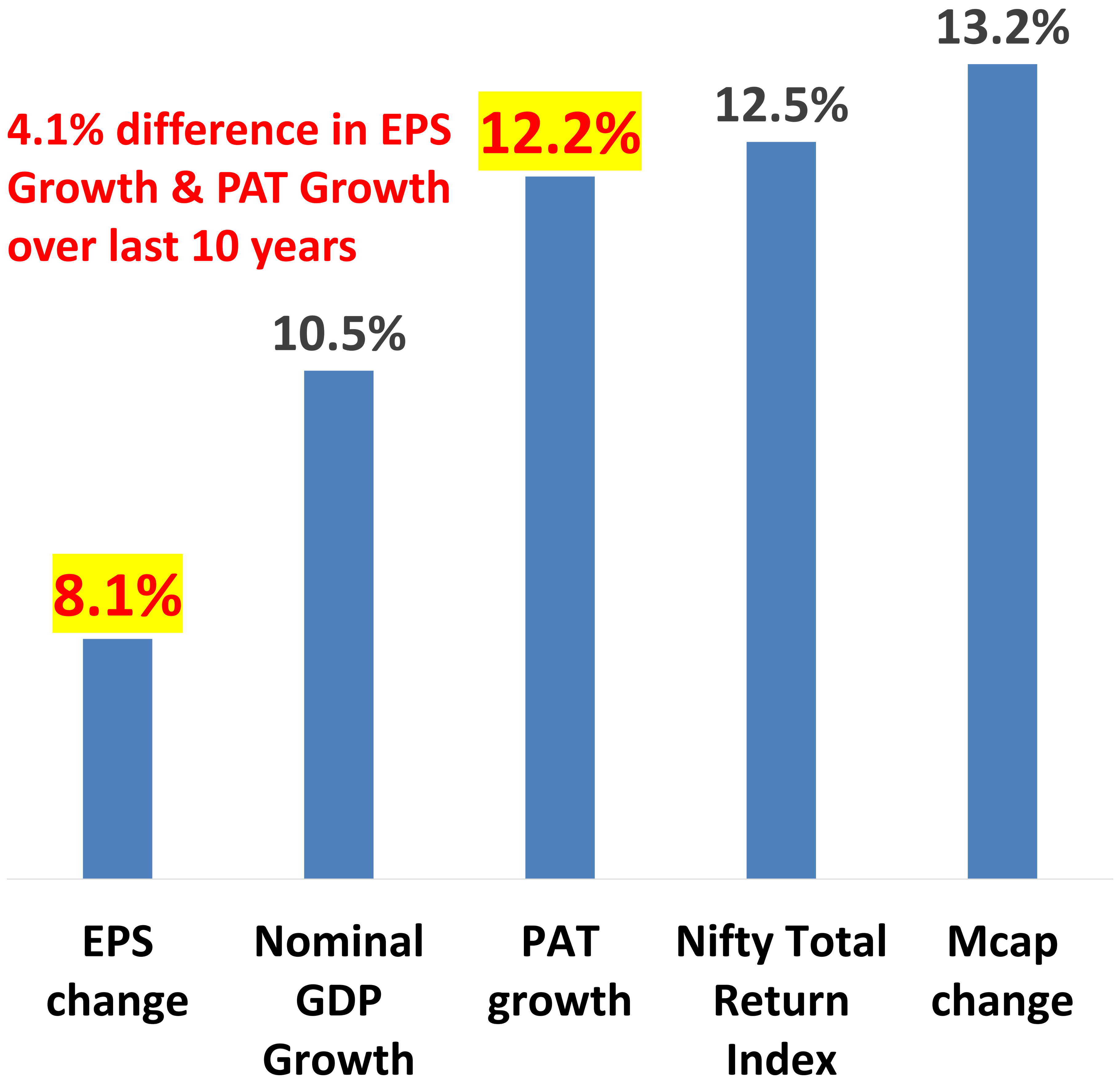
Can Indian equity earnings growth improve?

One of the reasons for Indian equities' 'pricy' levels is a large expansion in the PE multiple over the years. In the last 10 years, the average PE multiple for Nifty Index has expanded by ~200bps. Lower interest rates are often cited as the sole reason & arguments are made that valuations are likely to remain a function of interest rates alone.

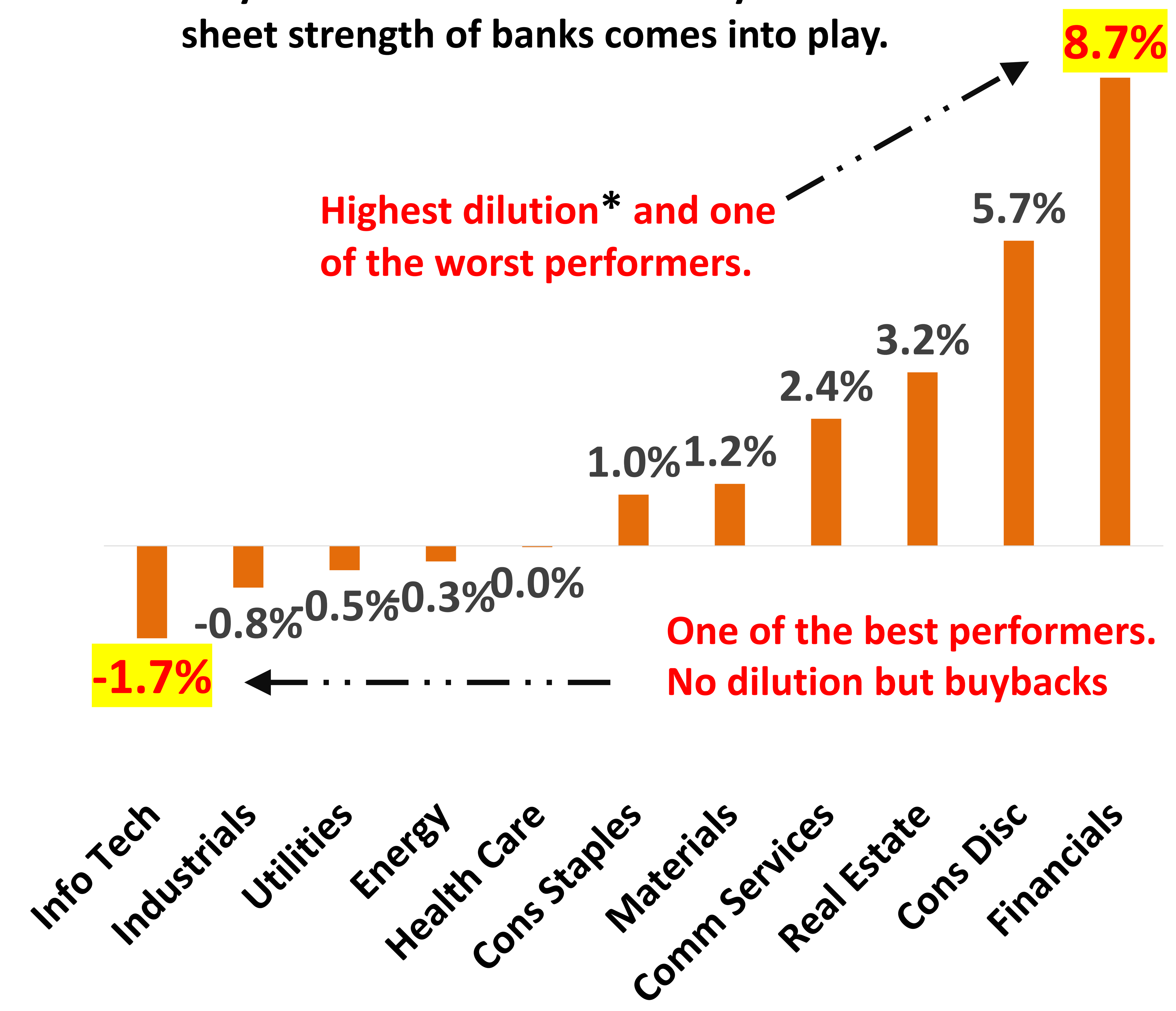
However, we note that a large amount of equity dilution has led to lower earnings growth although aggregate profit growth for the universe continues above nominal GDP growth levels. High weight of the BFSI sector which was undergoing a balance sheet clean up also contributed to poor earnings growth at an aggregate level.

In the next few years, if equity dilution tapers, which is likely, earnings growth for Indian equities is likely to be better & positive for stocks.

Nifty's EPS growth has lagged the aggregate profit growth of companies because of equity dilution & poor earnings of the high weighted BFSI sector



Financials with a 38% share of overall market cap have seen the highest equity dilution in the last 5 years. This may not continue in the next 5 years as the balance sheet strength of banks comes into play.



**The orange bars represent the number of equity shares dilution by sector. Sectors include all listed equity stocks.*

Equity dilution occurs when a company issues new shares to investors & holders of stock options exercise their right to purchase stock. This means each existing common stock owner now owns a smaller or diluted % of the company, also diluting their profit share. Since the total number of shares goes up but the company's earnings after tax stay the same, earnings per share go down.

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Source: Investec, DSP, Bloomberg, Data As on Sep 2022

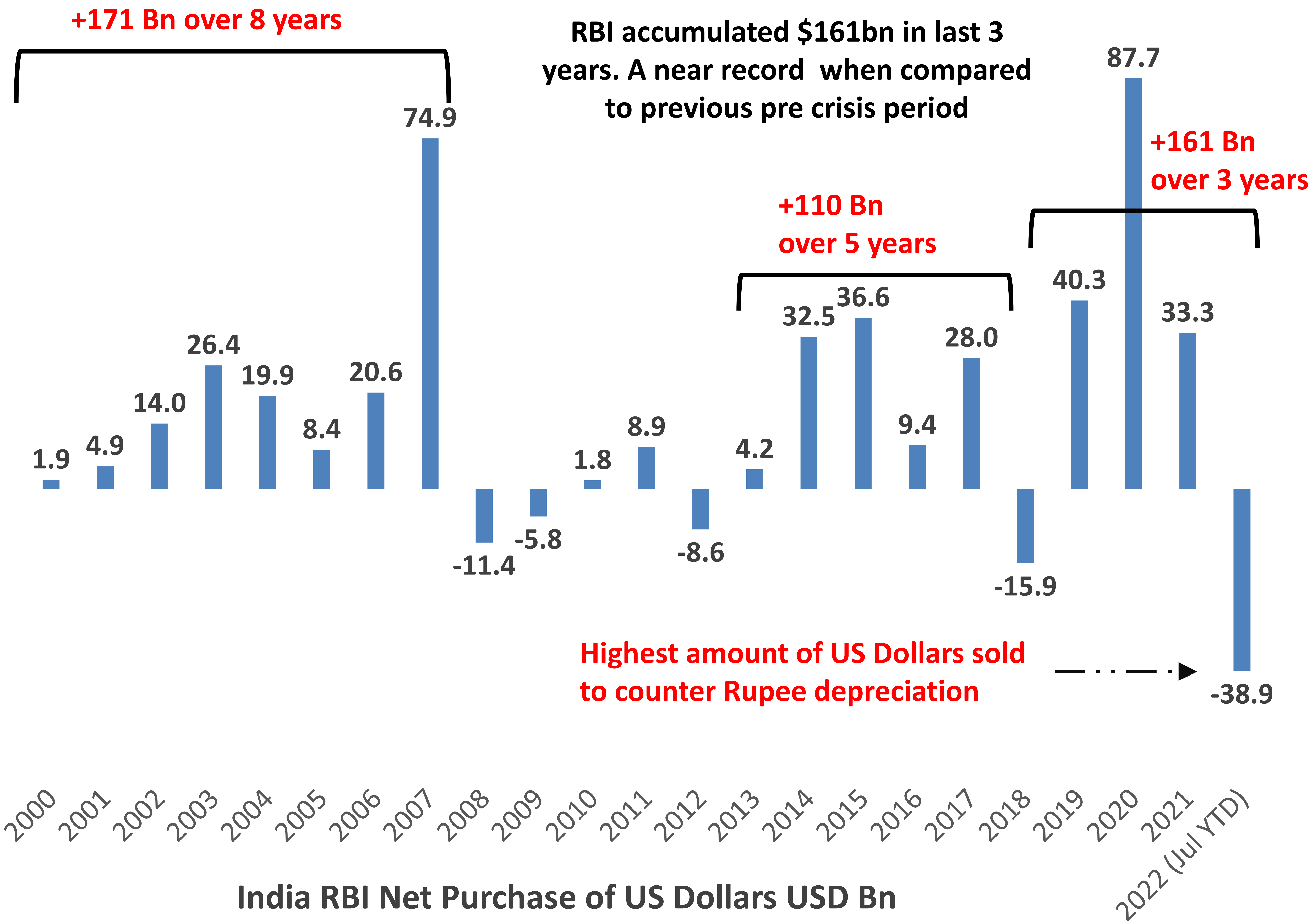
RBI has used record amount of FX reserves to support INR

RBI's intervention in the FX market is often looked at closely. In 2022, RBI has utilized nearly $39Bn (as of Jul'22) to help ease Rupee volatility.

But we note, RBI FX reserve is merely a derivative. CAD & Portfolio outflows are the primary drivers of currency movements. If the outflows continue, then the RBI FX reserves will come down naturally & diminish its ability to get the outcomes it wants.

However, foreign investment outflows have become less onerous recently & a fall in crude oil prices is likely to give some respite on the current account. This means some respite in the next few months is likely for the Rupee.

However, this remains a key monitorable risk for financial stability.



India RBI Net Purchase of US Dollars USD Bn

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Source: RBI, DSP Data As on Sep 2022

India’s Credit Impulse is a positive

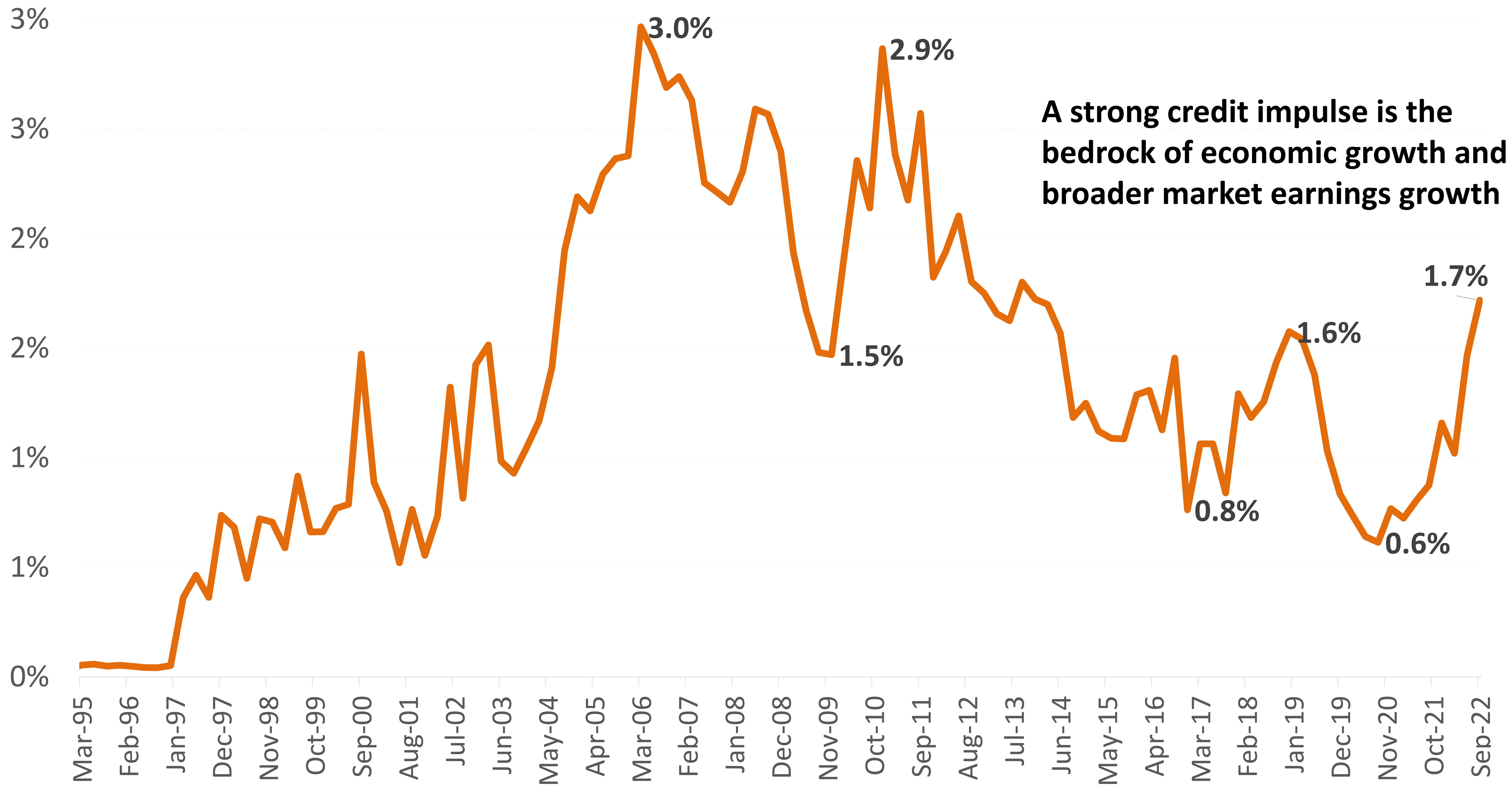
Banking credit is rising once again. India’s credit impulse has weakened over the last decade, and this is the first time we are seeing a meaningful revival in credit.

Credit Impulse represents the flow of new credit issued from the private sector as a % of GDP. It is the second derivative of credit growth & arguably the largest driver of economic growth.

This is positive for not just lenders but also for sectors where the end consumer uses credit. Consumption items such as Automobiles & Housing can benefit from this trend. Investment implications are significant for these sectors.

India Credit Impulse

Incremental Non-food credit of the banking sector as a % of nominal GDP



Source: DSP, RBI, Data As on Sep 2022

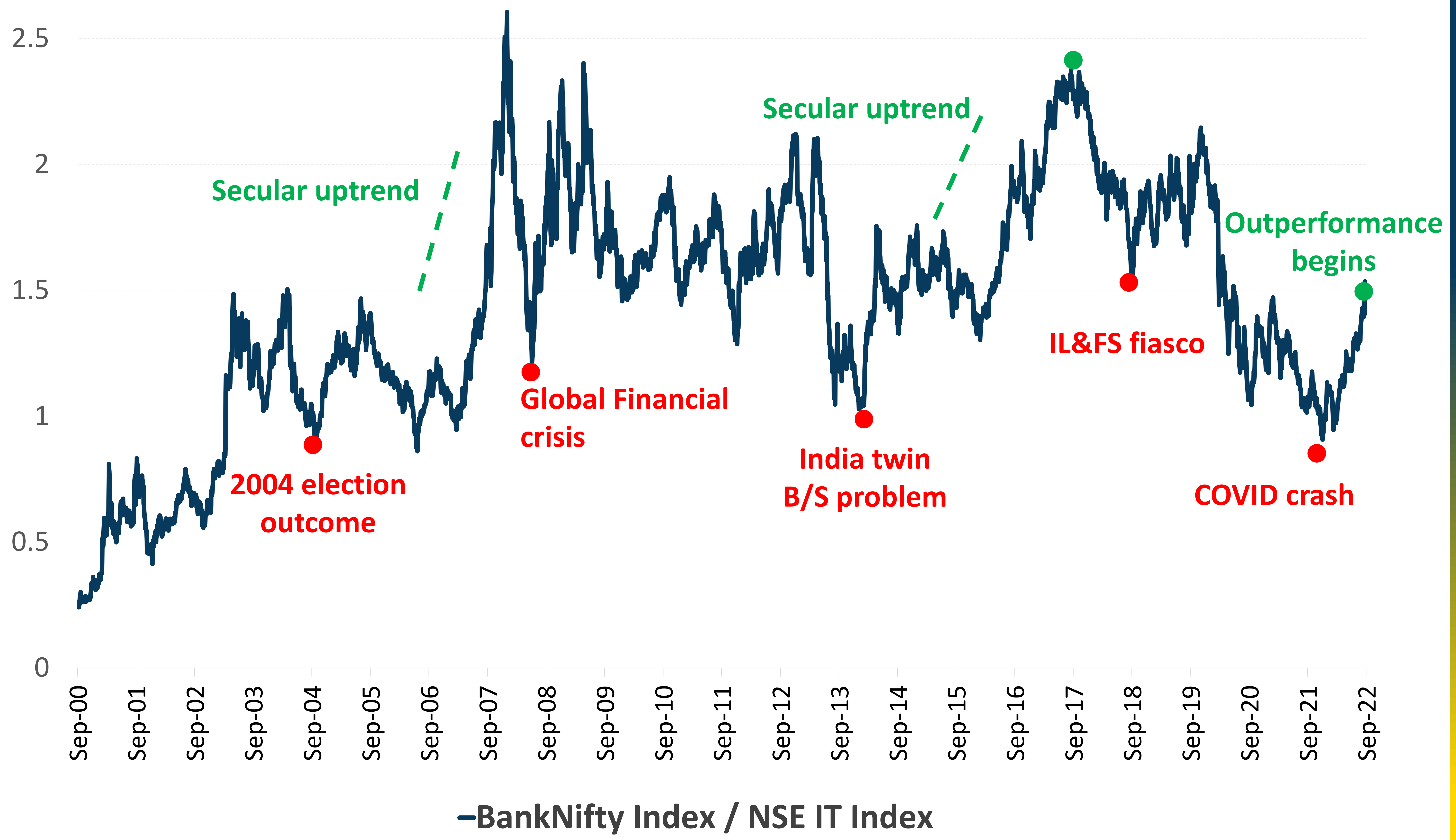
India Sectors: Banks likely to outperform

Banking sector stocks outperform when Indian equities are in a structural uptrend. In past instances of market crashes and macro economic trouble the Indian IT index has outperformed Banks. This happened as IT earnings were stickier & banking sector earnings are more closely linked to the Indian economy's performance.

In the last three quarters the banking sector has begun to make a comeback. High frequency macroeconomic indicators are suggesting continued stability in the Indian economy.

With strong credit growth, healthy balance sheet trends & improving asset quality the baking sector outperformance may have many more quarters to run.

Positive for lenders.



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Source: DSP, Bloomberg, Data As on Sep 2022

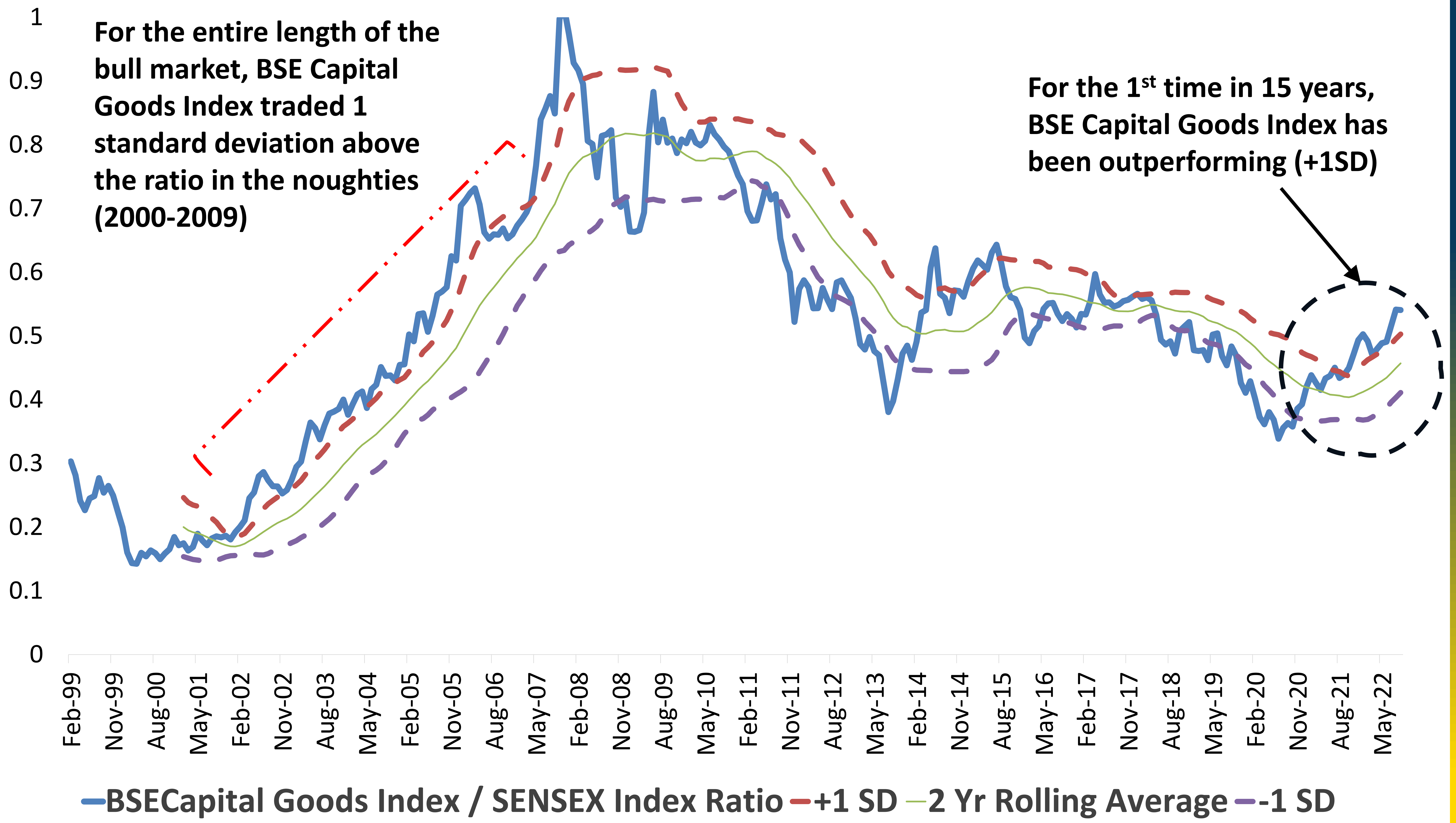
India Sectors: Capital Goods, a noughties redux?

India's investment winter has been long. It has run for more than 11 years. But things are now changing with capacity utilization levels beginning to rise and remain higher, corporate loan growth recovering and government's capital expenditure numbers looking healthy.

This is being reflected in outperformance of BSE Capital Goods Index over the broader market.

Historically, once this outperformance becomes sticky, it gives a longer horizon for investors to benefit from the capital goods sector.

Currently, it does appear that Capital Goods sector is likely to continue to do well over the long term but with its fair share of volatility.



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Source: DSP, Bloomberg, Data As on Sep 2022

Systems over solitary goals

Make winning
a Process,
not an Event.

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