From the CIO's Desk

June 2022

ENAM ASSET MANAGEMENT

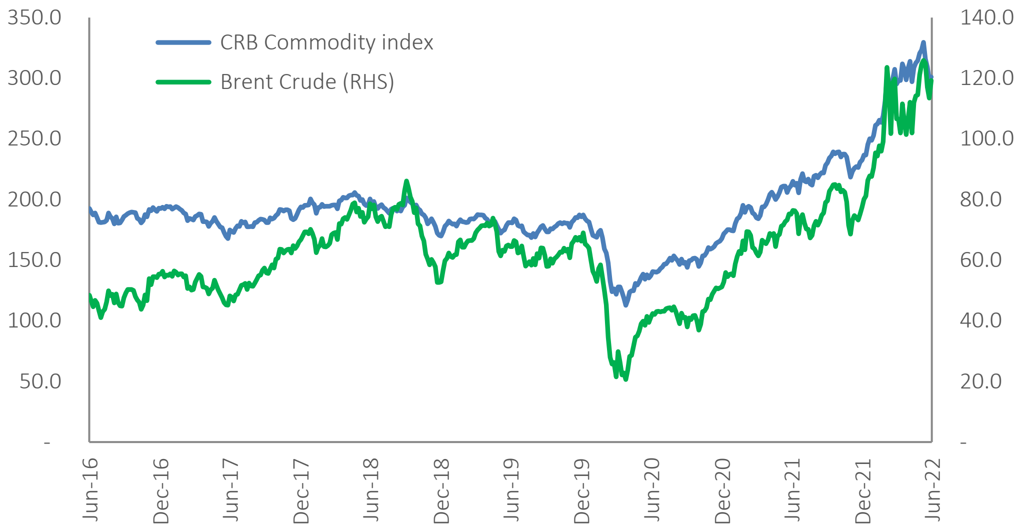
Dear Investor,

As we pen this letter, the world is witnessing a meltdown of some of the excesses built in the last 2-years on the back of expansionary fiscal/monetary policies from the developed world. Most of the asset classes from hard, soft, virtual, or real have been witnessing an accelerated slide.

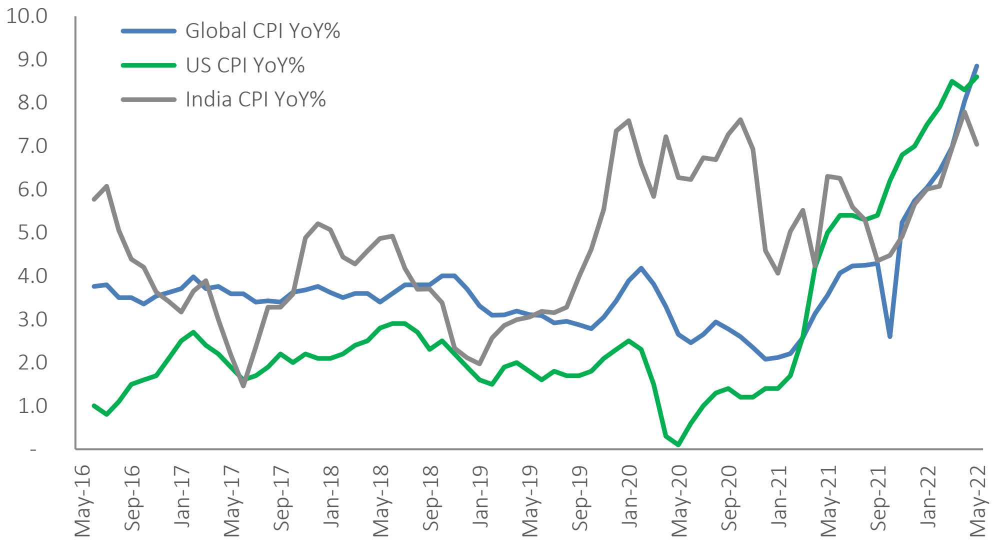
The world we have been living in for the last four decades is changing and changing fast. We are witnessing a reversal of long multidecade megatrends like globalization, benign demographics, the falling cost of capital and stable conflict-less geopolitics. The era we are used to, operated with a near-perfect demand-supply equilibrium and reliance on leveraging benefits of supply chain scale and efficiency. The recent geopolitical conflict has further exposed the fragility of global alliances in times of extreme stress.

This new world is never going to be the same. The Ukraine-Russia conflict has broken the supply chain of global trade which was returning to slow normalcy post-pandemic disruptions. With almost 25% of global trade for food and energy emanating from these two countries, the disruptions accelerated the inflationary trend in most sectors of economies. Rising Covid-19 cases and resultant lower demand from China led to further consolidation in prices of industrial metal and crude, whereas agri-commodities moved higher on the back of supply-side constraints.

Soaring commodities



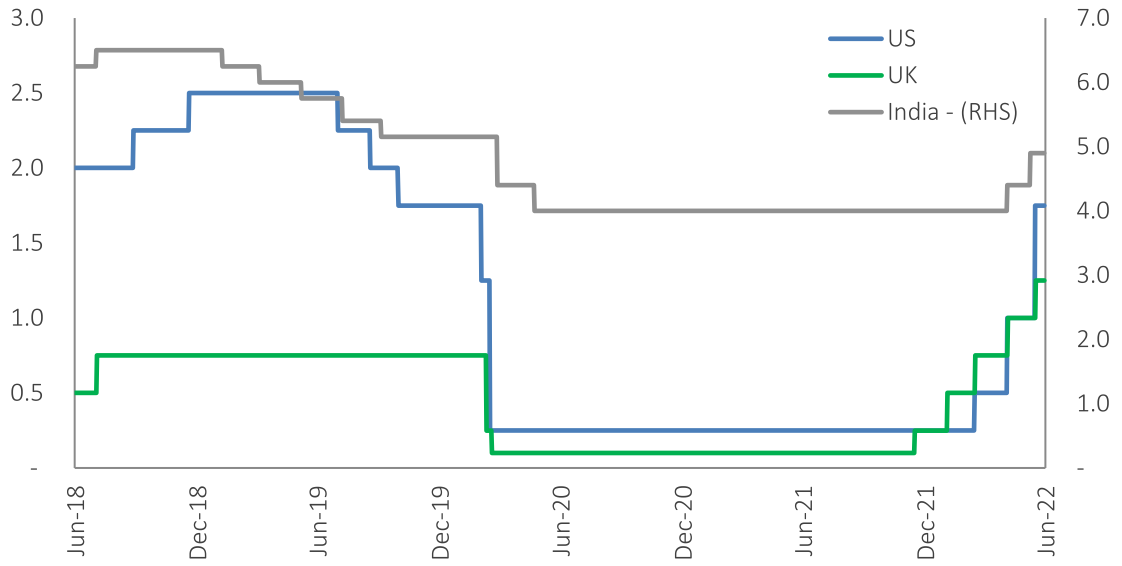
Rising Inflation



The resultant rise in commodity prices, and inflation in most of the economies, did enforce a revisit of the Fed policy. In the recent FOMC meetings, Federal Reserve hiked rates by 75bps in view of still rising inflation and a very tight labour market (wage growth at a multi-decade high). The sustained surge in inflation has created a need for further sustained hikes in interest rates. Globally, the impact of fiscal stimulus on demand is in its last leg and monetary tightening is yet to take effect. The front-loading of the tightening cycle should accelerate the downward momentum in growth and pull forward the next downturn which might last for roughly 5 quarters.

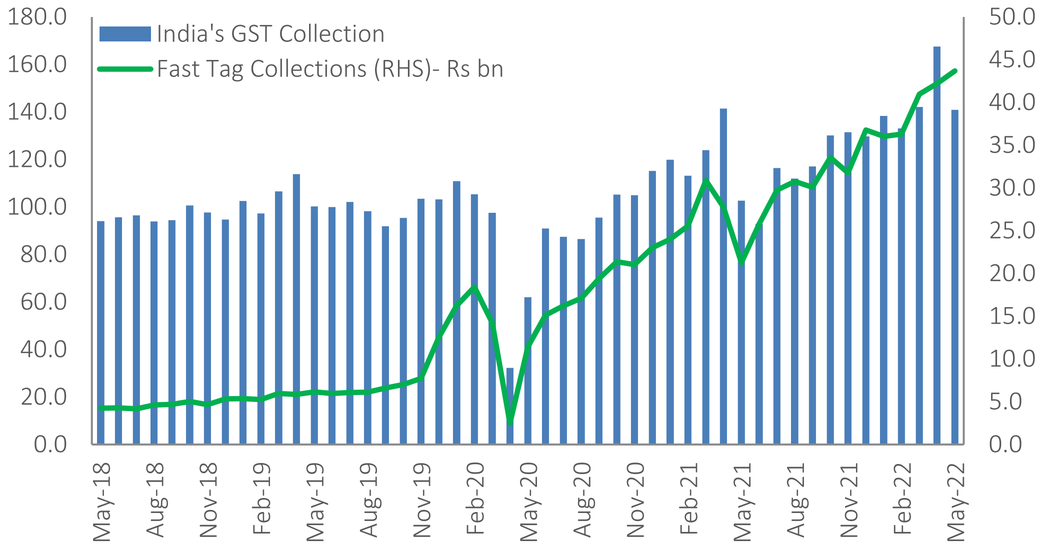
Historically, inflation and the labour market have been lagging indicators – US wage growth and services inflation, both hold up well into a recession. Already, forward-looking indicators - US housing market, PMI orders, and yield curve are flagging the rising risk of recession. Initially, the fear, and then the actions on liquidity tightening and higher inflation led to further volatility in global equity indices.

Global Interest Rates on a rise

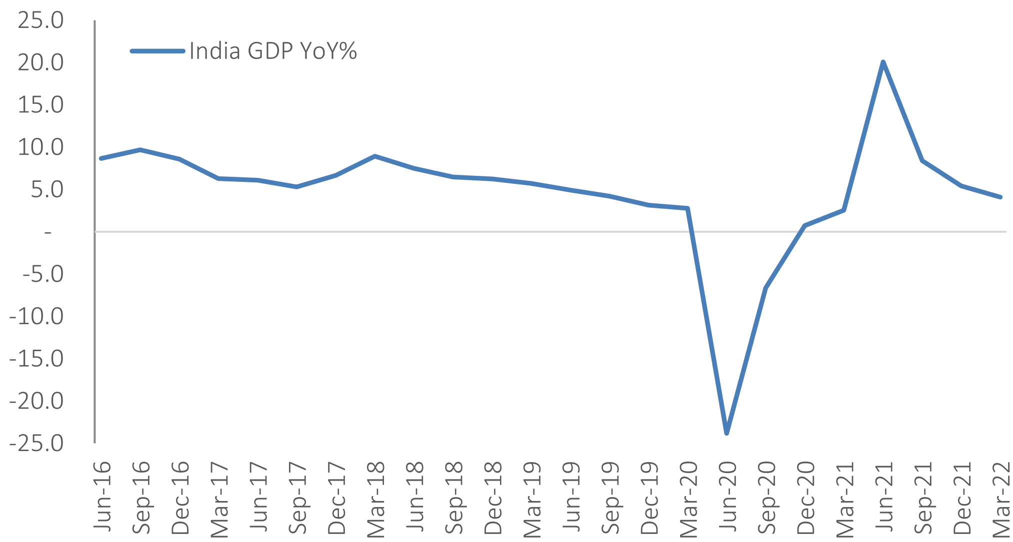


Amidst this increasingly hostile external environment, India is better placed than many other peers in terms of avoiding the risks of potential stagflation. Reasons for growth optimism include - reopening in contact intensive services, strong financial sector health (16.3% risk-weighted capital), deleveraged corporate balance sheets, strong GST collections, substantial FDI/PE flows, and a rise in private sector participation in overall CAPEX. The picture of the rural economy is mixed and expected that a normal monsoon, along with construction revival, would help the rural economy later in the year.

Improving revenue collections (GST)



GDP Growth YoY% getting normalized…



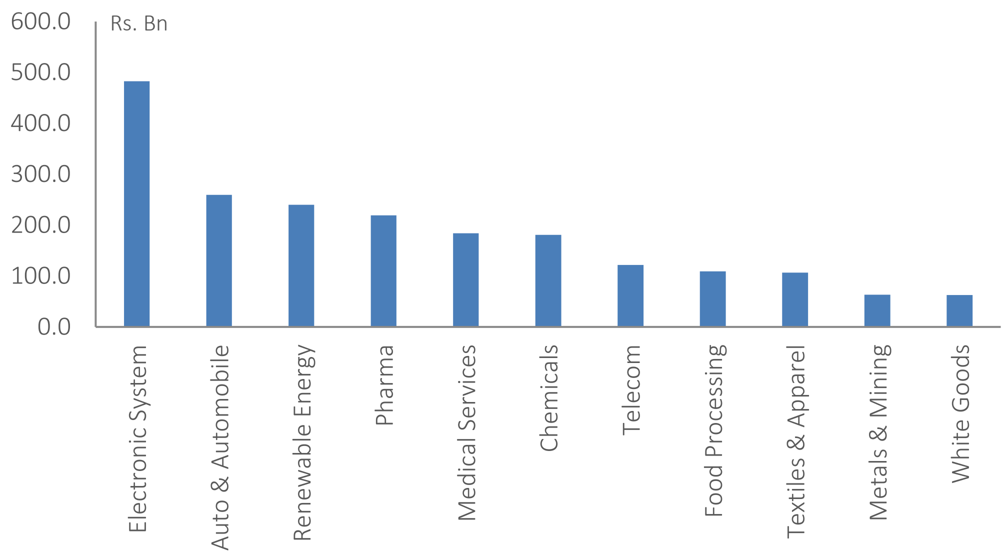
With most constituents of GDP surpassing pre-pandemic levels, domestic economic activity is gaining strength. Almost ~40% of India's inflation comes from external factors. India's response to inflation has been three-fold –

- Fiscal policy - targeted relief via subsidies on food, cooking fuel & fertilizers; Excise duty cuts on fuel and custom duty calibrations; increase in export duties on steel
- Monetary policy - increasing the reverse/repo rates up by 130bps/90bps and CRR up by 50 bps.

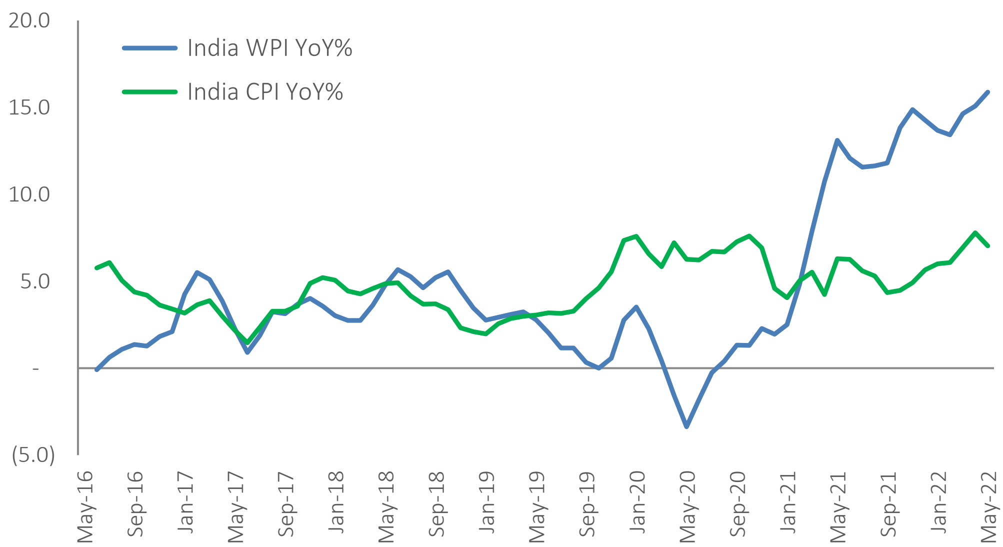
- Other policies - diversifying from hydrocarbon (EVs, ethanol, renewable); addressing logistic bottlenecks and guiding states on price stabilization funds.

The recovery witnessed thus far, demonstrates the resilience of the economy in the face of multiple shocks and the inherent strength of macro fundamentals as India strives to regain a sustainable high growth trajectory. WPI has been higher than CPI which suggests the transient struggle of businesses to pass on input cost increases fully as the economy was yet to come to a full boil. We expect CPI direction to improve from 2HFY23, as the effects of some of the policy initiatives settle in. Part of these under-recoveries would also get covered as one witnesses softening of commodity prices.

PLI Policy Stimulus



Inflation at its peak

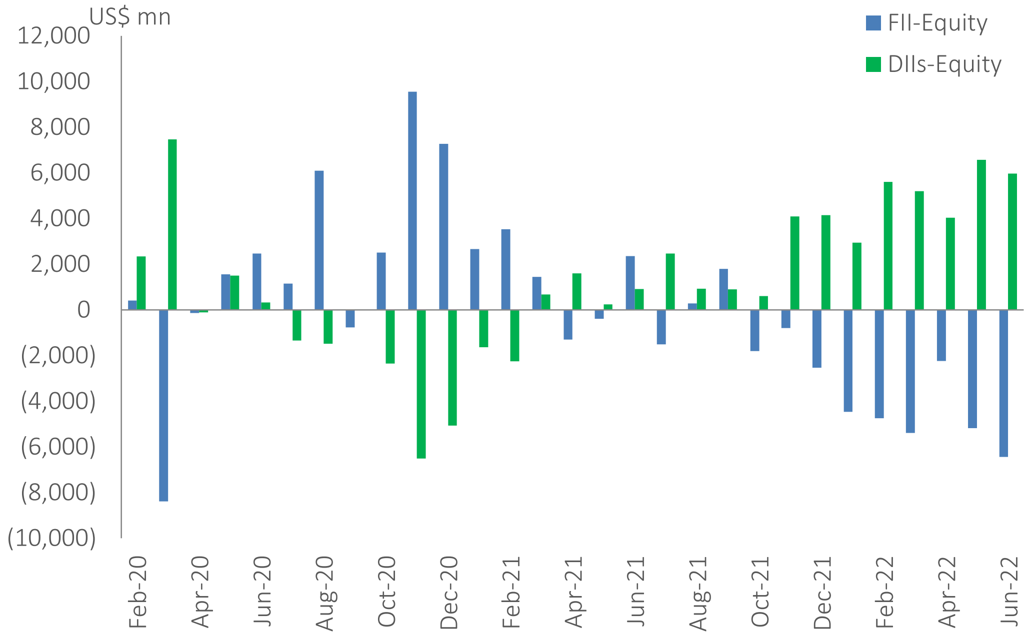


While by being connected to global markets in terms of currency, commodity, and capital - India would be subjected to interim global volatility, there exist long-term vectors of growth like proactive policy, better financial architecture, and structurally lower cost of capital (versus the historical cost of funds), improved export competitiveness and rising stature on global policy podium. The recent actions by the Reserve Bank of India (RBI) which demonstrated its commitment to price stability while supporting growth augurs well in this environment. The policy focus is on how India can emerge as an alternative to China for investments in this decade. One can expect that with policies such as PLI and corporate tax cuts, India is now better placed to attract investments in manufacturing than at any time in the past. India's large local market is a solid anchor to complement some of these aspirations.

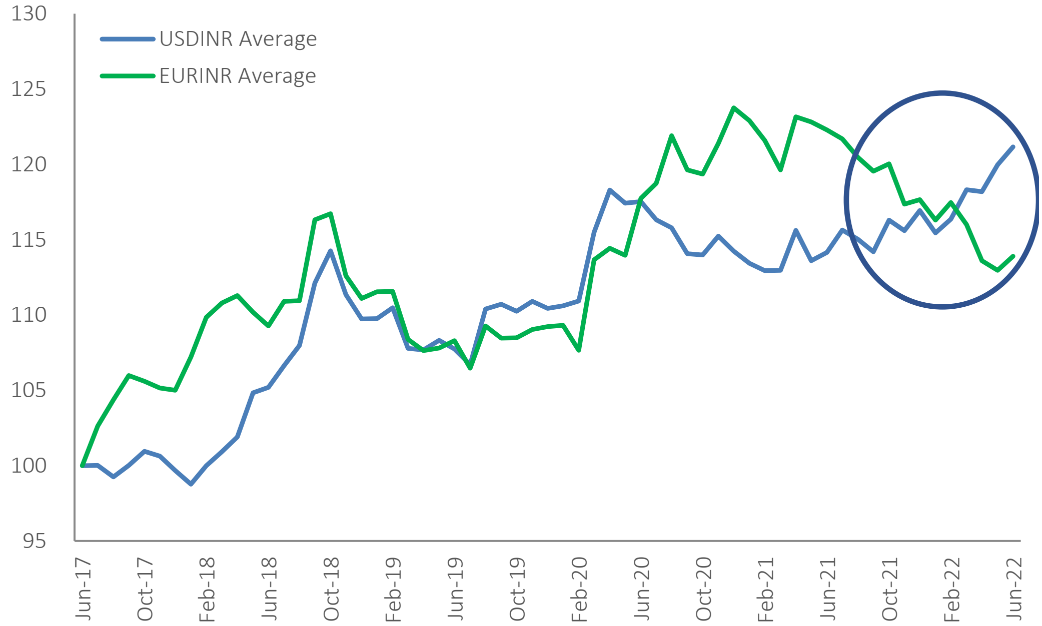
In a world where growth is difficult to seek, India is sitting on multiple favourable factors. India remains a heterogeneous market with many markets embedded in one in terms of geography, socio-economic strata, consumer culture, age profiles, Consumer behaviour & habits - with a common ethos of dominant traits of being value-conscious and yet aspirational. We expect India to benefit from megatrends of digitization, favourable demography, development, formalization, consolidation, urbanization, improving rural incomes and affordable aspirations - which create a vibrant domestic economy. As we move forward, we expect these factors to converge creating tailwinds to enable ~7%+ GDP projections (by RBI, IMF etc.) to achieve the medium-term goal of a US$5Trn economy.

Markets are driven by fundamentals (in long term), earnings (in the medium term) and liquidity (in short term). Corporate earnings are under pressure for the last two quarters primarily due to the inflationary environment. Inflation is likely to cool down once the current global geopolitical tensions settle, and the global supply chain improves. Markets in the interim are in a reset period that is reversing some of the frothy valuations of the previous regime. As we enter the earnings season, we are apprehensive of more downgrades than upgrades. While FIIs remained sellers through the last 15 months, a sustained flow of capital into Domestic Funds and sustained retail interest provided a counterbalance to the adverse liquidity. The resultant flows and concerns on twin deficits have had their effects on Rupee - which while strengthening against multiple other developed currencies has depreciated against the USD.

FII and DII (US$mn)

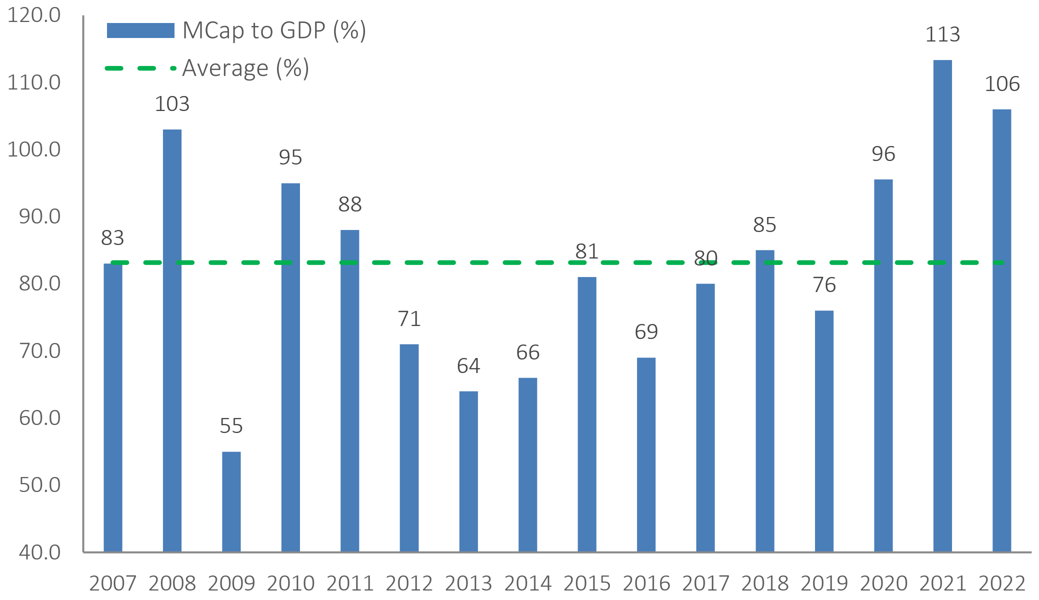


INR - Mixed Performance

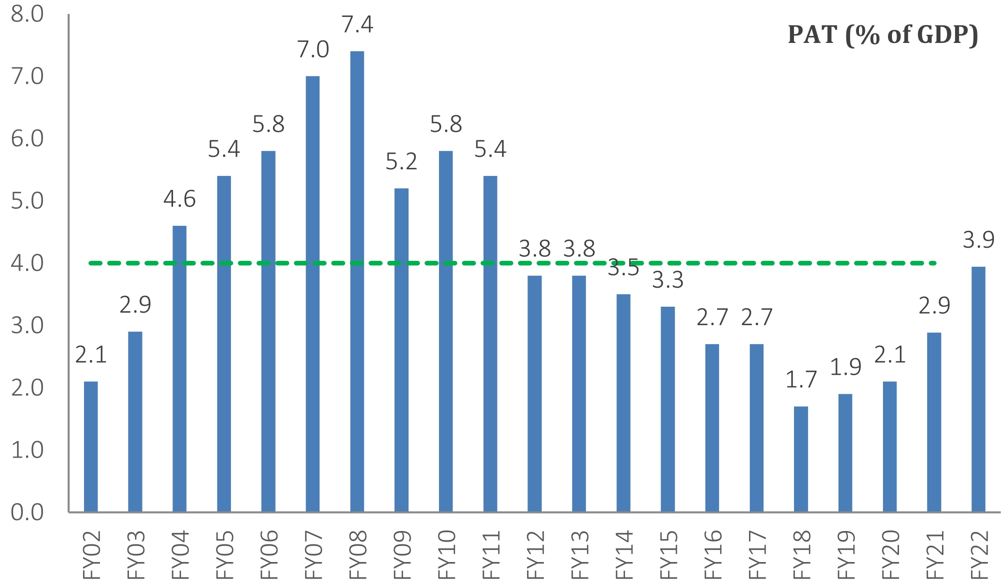


In general, markets dislike uncertainties, and they are all at galore today - be it geopolitics, currencies, commodities, or interest rates. The period gone by has exposed every business to almost every possible adversity. Tough times don't last; tough companies do. We feel current stress in a few of our core holdings is transient and these businesses have the potential to emerge stronger with their focus on products, processes, people, customers, and cash flows. In the interim, with the recent softness, markets have almost mean-reverted on valuations.

Market Cap as a % of GDP

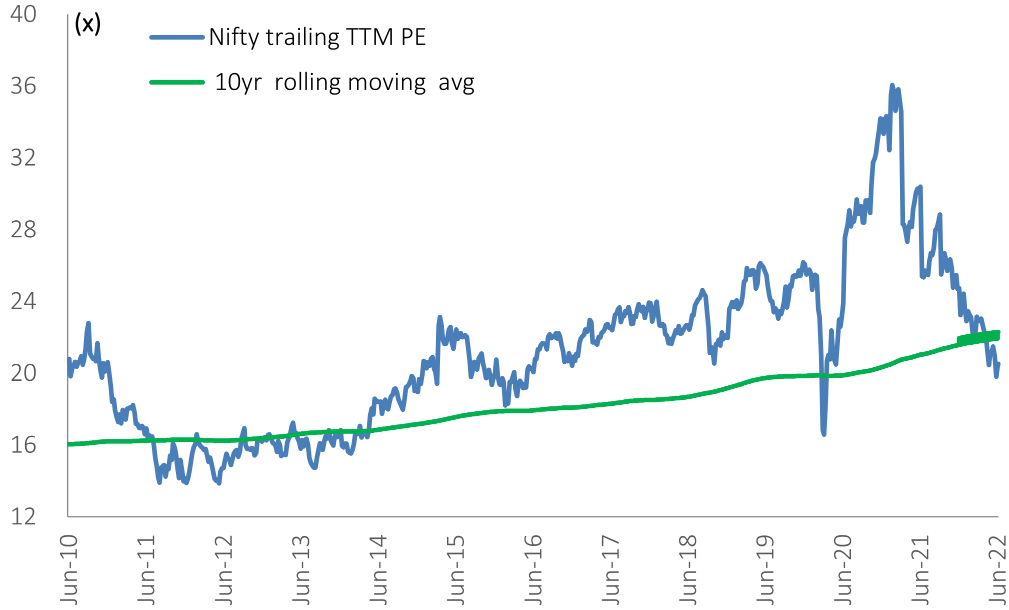


Profit after Tax as a % of GDP

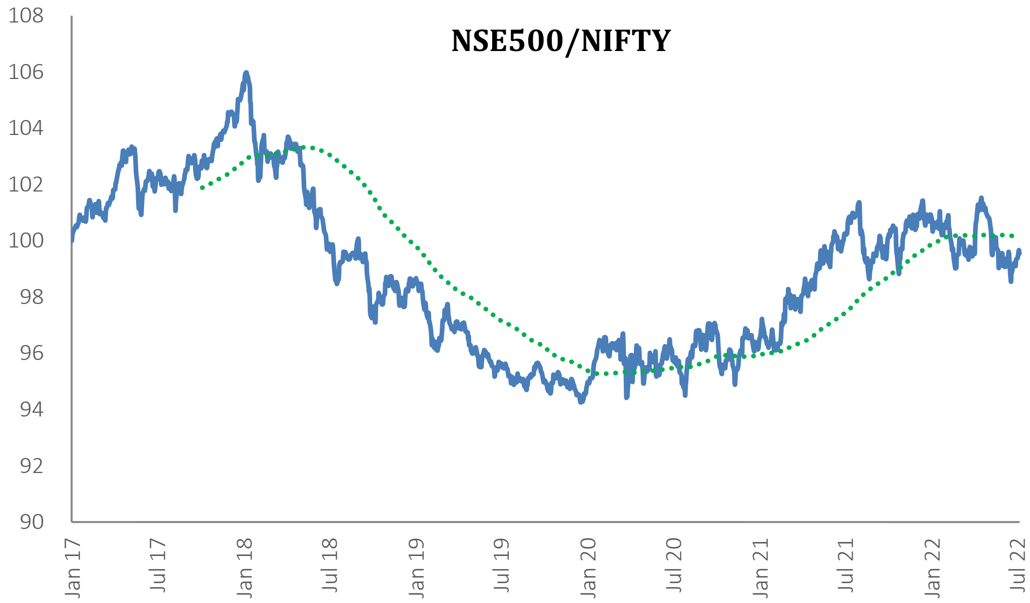


Price is what we pay while value is what we get. The market reaction in these times, like a pendulum, is swinging towards other extremes, and at the extremes lies the opportunity. The market volatility is set to offer opportunities where the price at which a business trades might get offered at a meaningful discount to intrinsic value. While short-term stress on account of inflationary inputs is real, we expect earnings growth to continue in discretionary consumption, private-sector banks, home improvement and selective exporters. Among the common thread in our portfolio holdings are - leadership, market share gains, improving margins through cost optimization, a customer-centric business model and deep relevance in exports.

Nifty Trailing TTM PE at its 10 Year average



Broader Markets in elevated pain



We at Enam AMC remain bonded to businesses that offer value and are beneficiaries of key megatrends, long-term growth opportunities, positive incremental fundamental change, a committed owner-operator structure, and an embedded margin of safety. We remain committed to lock-in these attractive entry opportunities provided by the market volatility to acquire a pie of some of the most durable, attractive, and secular prospects in the Indian markets. Among sectors, we remain most optimistic about a cyclical recovery that should benefit the financial sector and all forms of discretionary consumption.

A close look at the market structure does suggest that the price damage across broader markets is far higher than the headline NIFTY numbers (1-year Nifty small-cap 250 index has corrected 23% from its 52-week high vs 15% for Nifty; with almost ~74% of companies have corrected by 20-50% (median correction of 35%)). Most of the excesses in liquidity and sentiments causing frothy valuations have since corrected on the back of a challenging macro situation, tighter liquidity and panic selling by retail investors (particularly in small/mid-caps). Whilst macro challenges might continue to weigh on the broader markets, we believe this is a good opportunity to add attractively valued high-quality companies with improving fundamental performance.

Our investment strategy remains focused on a focused bottom-up strategy seeking long-term superior returns. While our attempt is always to seek a margin of safety at the time of investments, there are times when market volatility overpowers our conviction causing a divergence between our belief stories and their stock performance. The long-term story for India remains intact with multiple megatrends, sustained growth vectors and an attractive risk/reward set-up. We, therefore, advocate our patrons to extend the intensity of their commitment(s) with us, both in terms of time and value, to this long-term wealth creation opportunity.

Warm Regards,
Jiten Doshi
Co-Founder & CIO