From the CIO's Desk

December 2022

ENAM ASSET MANAGEMENT

We must welcome the future, remembering that soon it will be the past; and we must respect the past, remembering that it was once all that was humanly possible.

George Santayana

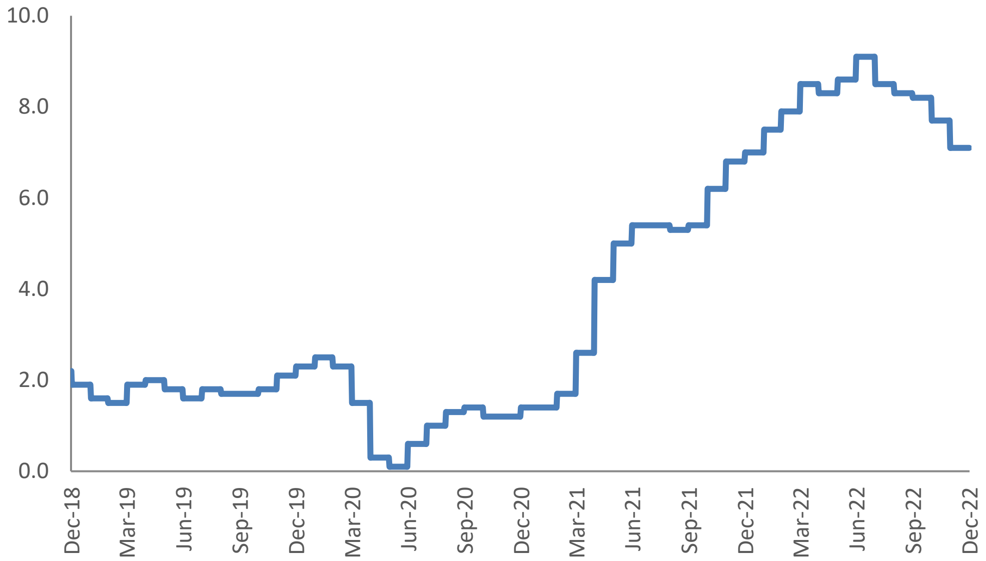
Finally… the year 2022 is over…

The Year 2022 would go down as the most volatile year. It started with the optimism of post covid recovery, followed up with a supply-driven shock of the Russia-Ukraine conflict, the resultant surge in inflation to a historic peak, a delayed yet synchronous response of the central banks of aggressive rate hikes and now a scare from China of a new series of the pandemic surge - we seem have come full circle. The smooth ride of low-interest rates backed demand growth has hit a bump - with the high level of inflation, increasing interest rates, coupled with a possibility of recession is now the commonly accepted middle ground.

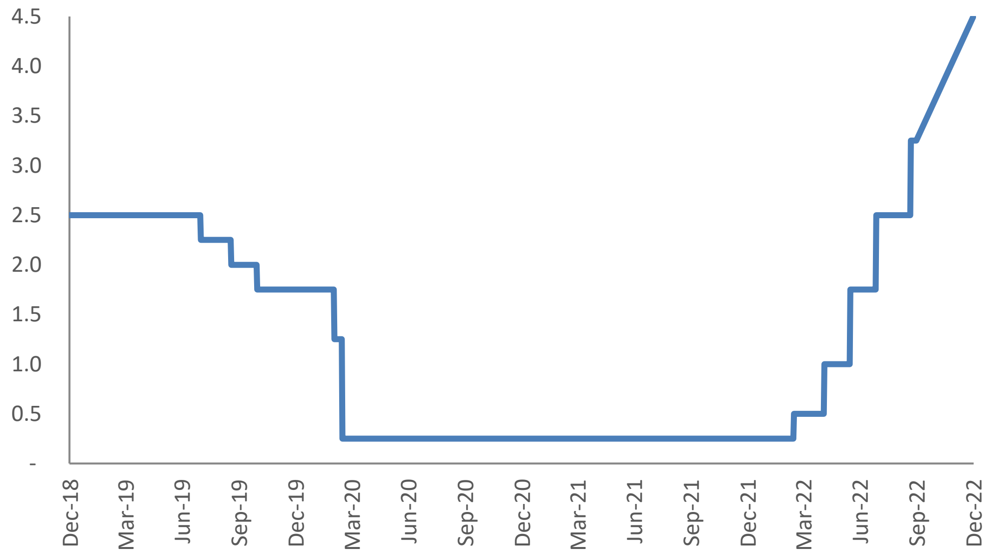
The rate hike cycle which began in 1HY22 continued through the year to gather peak momentum in December, where one witnessed three of the major central banks (Federal Reserve, Bank of England, and European Central Bank) raised their interest rates in less than 24 hours, by 50 basis points each. There was a common thread of - 1) being hawkish on the tone and forward guidance, 2) expected sticky core inflation persisting for a considerable period 3) tightness in the labour markets 4) risks of managing extraordinarily high balance sheets and 5) rising concerns for a recession. The cumulative interest rate hike through CY22 stands now at 425 bps.

We are beginning the new year where global equity markets seem to be celebrating a potential peak of inflation, currency (USD), and possibly interest rates (10-year yields). There is a popular expectation that the Fed may stop its interest rate hikes by early 2023 and may achieve a soft landing for the US economy.

US Inflation – CPI YoY



US Federal Interest Rate



Global demand has been sluggish across most of the key economies. The growth expectations for CY23E are muted on the back of higher inflation in 1H, weak real household income growth, falling confidence and tighter financial conditions. The impact of rate hikes is showing up on key metrics like consumer confidence, a sluggish housing market and an uptick in rising jobless claims in developed economies.

While the experts take pride in crystal gazing, we wish to keep things simple. We feel there are two distinct acts at play here...

a. First, where the sands are shifting in the global game (in economics, politics, and capital markets), with a permanent challenge to the 40-year+ template of sustained global growth backed by favorable trends in the cost of capital, working age population, globalization, an accepted global reserve currency and a frictionless world.

b. Second, the countries with a higher population like India, Russia, China, and regions with larger resource reserves like LatAm and MENA are finding a common ground of economic coexistence.

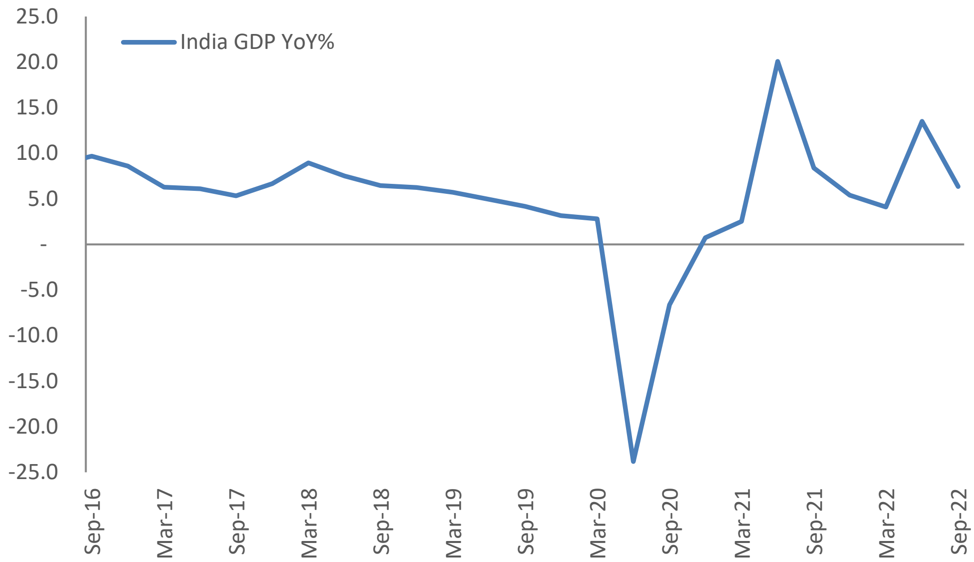
India has managed to navigate this environment with all its aces intact. It remains politically neutral in a world that is seeking alignment with one of the two divided loyalties. It has also held its ground firm when it comes to positioning the global value chain in technology, manufacturing, and knowledge support while retaining its significance of offering a strong vibrant domestic market anchor, backed by distinct advantages of its demography, digitization, development, and democracy. The policy regime too has seasoned with experience in delivering on painful series of front-loaded reforms and is nimble to manage multiple external shocks with adequate ammunition. It has already demonstrated the stress-tested performance of its low-cost-population-scale platforms for frictionless execution of its scale initiatives on trade (UPI)/ health (COWIN)/ food-for-all (PMGKAY)/ and direct benefit transfers (a Quasi UBI).

As regards the GDP data points, India's Q2 GDP for FY23 came in at 6.3% y-o-y. 3-year CAGR, GDP shows a 2.5% growth. Most of the high-frequency indicators are above the pre-pandemic averages. The average monthly collections for GST for 9 months in the current fiscal at Rs1.49 trillion have grown almost 24.9% yoy. Preliminary estimates indicate India's Economic Activity Index (EAI) for GVA grew at a much faster pace of 8.1% YoY in Nov'22. The pace was entirely led by a five-month high growth in industrial activity in Nov'22, supported by an expected recovery in the index of Industrial Production (IIP). Capacity utilization is ~ 70-72%+. Credit growth has been ~17% plus. Overall, we seem to be on track to deliver FY23E GDP growth at ~6.9 - 7.0% (the current consensus).

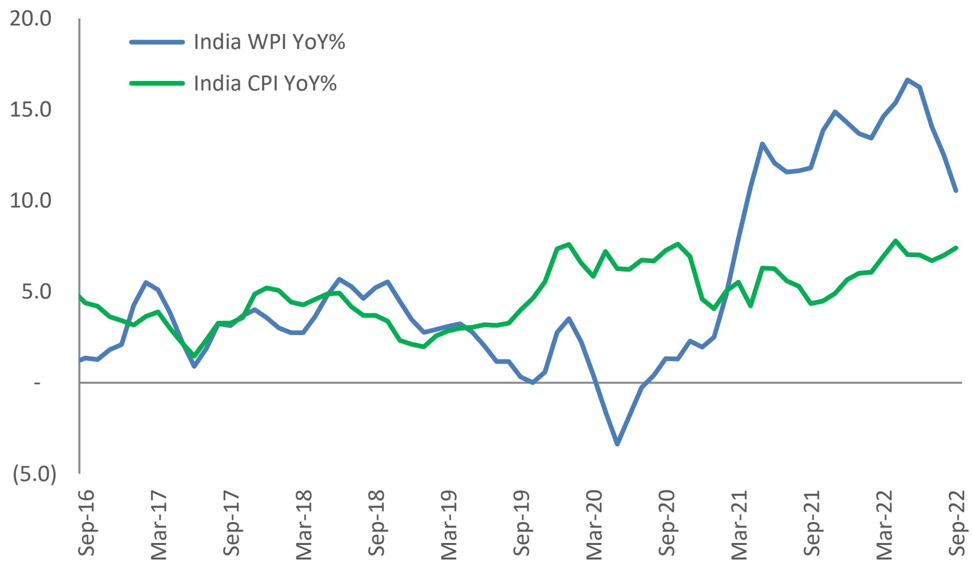
Inflation dropped to ~5.9% on Nov 22 - driven by moderating price pressures for food and beverages. The decline in food prices was linked to a strong winter harvest and lower prices for agricultural products on global markets. As per the RBI's estimates, annual inflation is seen cooling to 5.9% in January-March next year and can remain range bound between 5.0-5.4% in the next 6-9 months.

We feel fiscal for this year can be managed at estimated levels. Subsidies might remain sticky and expenditure rationalization could be a challenge. Going forward, even though India looks well poised relatively, the twin deficit viz. trade deficit and BoP funding, along with fiscal is perhaps the key roadblock to tackle. RBI has delivered a cumulative 225 bp hike so far and inflation is on a downward trajectory. While global volatility would have its impact on inflation and therefore the RBI response - we expect further hikes to be moderate. The union budget remains a significant event in the coming month - as this would be the last full-term budget for the current regime in its tenor.

GDP Growth YoY% near-normal trend



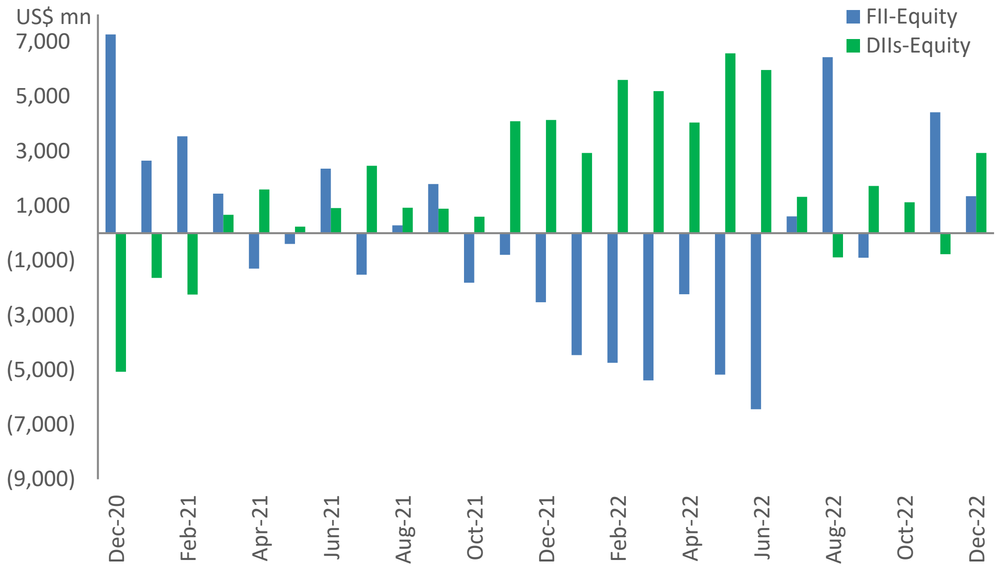
Inflation set to come off its peak



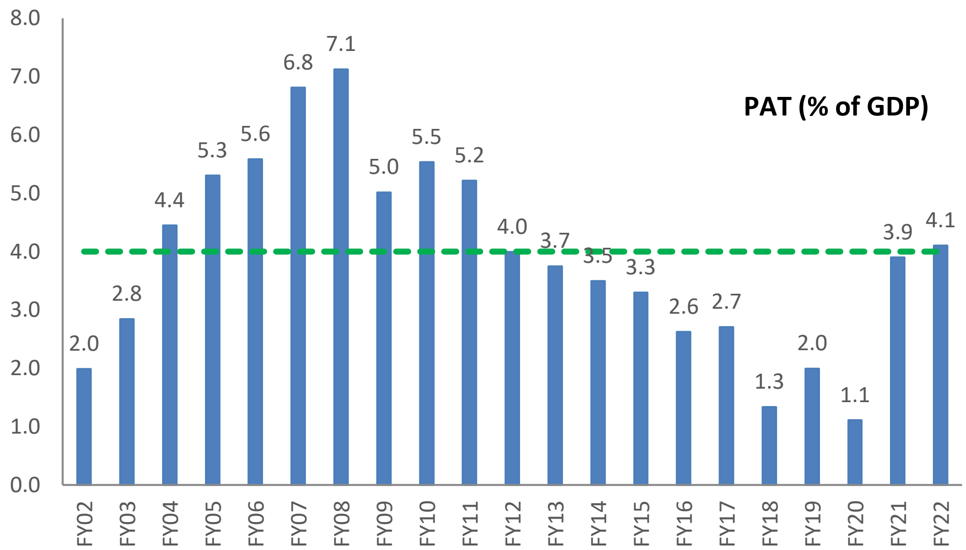
There has been softness in the economy as against initial expectations of runaway growth given the revival in activity post-pandemic, as well as a strong festive. The rural economy is yet to respond and going by the commentary of most of the consumer staple companies, there seems to be some more time before they join the consumption cart wholeheartedly.

India offers among the most diversified palette of opportunities when it comes to diversity of & dispersion in terms of sectors, market participation (DII/FII/Retail) and Market Capitalization. Financialization of savings, improved role of digitization in transactions, and increasing financial literacy remain strong vectors of systematic flows of savings towards financial assets in general and equities in specific. This has counterbalanced most of the selling pressures of the FIIs.

FII and DII (US$mn)

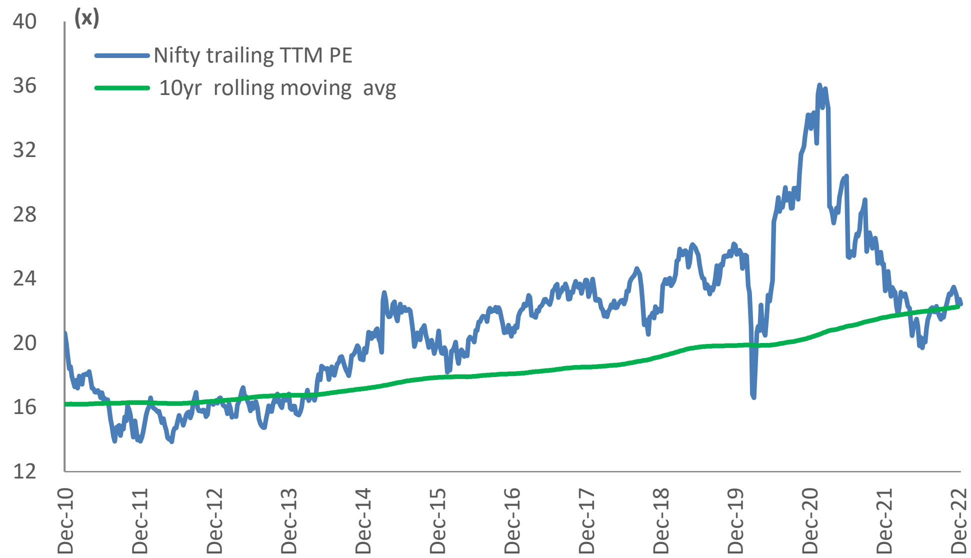


Corporate Profits as % of GDP



From the extreme pessimism that was building when we connected last time to a new high, markets have been true to their character of being a pendulum seeking extremes. NIFTY has been an outlier for almost 11/12 months while giving up some of its gains in the last month. In CY22, market performance was driven by India's 12M EPS (roll-forward) and India's rising premium to the world, as global P/E declined in a rising interest rate environment. Despite the global headwinds, MSCI India is up ~6.0% YTD and is ~53.9% above the pre-COVID peak, and valuations at ~22xPE are 15-20% above the pre-COVID/LT average. This is despite the RBI's repo rate and the benchmark 10-year bond yields now ~150bps above pre-COVID levels.

Nifty TTM PER at 10-Year average



Nifty 500 TTM PER near 15-year Average

In the short term, sentiments on global macro and valuation concerns could catch up. One needs to watch the sustenance of domestic flows. We are currently at a stage where trailing 12-month returns start turning to near-zero or negative. Any sustenance of this trade would mean the SIP commitments would need to withstand their moment of truth compared to other asset classes like gold/ fixed income. One needs to watch this balance of equations very tightly in the coming months.

India is a heterogenous market with a breadth of a continent with individual states that can equal its larger European / South American peers in terms of geographic size, population, and also prospective GDP in coming years. While retaining its variety, it has homogeneity in various strata when it comes to social values, aspirations, and consuming habits that independently reflect a separately addressable market opportunity within itself. The market is clearly segmented into four distinct types a) The Wealthy (like any developed market consumer) at the top, b) The mass affluent Neo-rich (the local market anchor for global MNCs), c) The emerging Middle-class (Bharat as they call it), and d) The Strugglers (a market akin to Africa).

India has also been investing intelligently in its social, physical, and digital infrastructure. With its young population, an accountable democracy, vibrant media, digital civilization, leadership in large-scale population initiatives and proactive policy machinery - India is a near-developed nation in its architecture. Add to this a latent vibrant young aspirational domestic market, at inflection GDP per capita of USD2200, multiple underpenetrated market opportunities, and consolidated sizeable industries. We expect the coming period to be a golden decade for India.

Human beings tend to exaggerate and extend recent trends into the deep future. We remain mindful of the interim market volatility which would test the conviction and commitment of every participant in this opportunity. While it is fair to assume short-term effects of heightened global volatility (both in terms of value and frequency), slower-than-expected post-festive demand recovery and increasing participation of algo-trading as short-term realities; we feel they also present an opportunity to board the multiyear runway of wealth creation from the India story given its multiple long-term themes, sustained growth vectors & attractive risk/reward set-up. We intend to leverage such situations to load up on our conviction bets. We remain committed to our process of finding long-term sustainable value from our investments, while remaining remain agile and equipped to add to our current positions at every prospect of divergence between prices and our long-term conviction value.

Our investment strategy remains focused on a bottom-up strategy seeking long-term superior returns. Our investment framework respects scalability, capability, leadership, character, and cash flows as important variables. Among the common thread in our portfolio holdings are - the scale of the opportunity, leadership, market share gains, superior return ratios, a customer-centric business model and relevant global competence. We prefer to invest in businesses that are beneficiaries of key megatrends, long-term growth opportunities, positive incremental fundamental change, a well-oiled execution engine, and a committed owner-operator structure, with an embedded margin of safety. The last 3-years have tested the business model resilience of every business in India - making agility, balance sheet strength, and cash flow reserves important traits to delivering superior performance.

We remain positive on emerging spaces in consumption that derive their strengths from megatrends like digitization, favorable demography, urbanization, and affordable aspirations - which create a vibrant domestic economy and opportunities in multiple sectors like Aspirational Consumption, Financials, Home improvement, Light Engineering, Textiles, Automation, etc. which leverage this strong local market anchor for exploiting exports prospects where India participate in the China+1/ Europe+1 opportunities.

Coming weeks would be colored with heightened decibels on the Union Budget. While Budget is an important exercise, one needs to also be mindful of the fact that this is the last of the full-term budget from the current regime; its significance to policymaking and execution has substantially diluted in the recent past with established frameworks like GST Council etc. We will use the budget as guide rails on validation of the direction of Government commitments towards growth, reforms, and fiscal prudence. We would advise our patrons to stay away from the interim noise and keep adding to their commitments through the coming period to this long-term wealth-creation opportunity.

Warm Regards,
Jiten Doshi
Co-Founder & CIO