MONEYLIFE ADVISORY
MAS WEALTH

The Useless Theory Called Decoupling

Dear Fellow Investors,

Buffeted by bad news since late last year, global markets have been falling more less in sync right until mid-June this year. Around June 17th, markets around the world made a short-term bottom and rallied fast, right until mid-August. During these two months, the Nifty rose from 15,319 on 17th June to 17,980 on 18th August a rise of 17.7%. At the same time S&P500, the leading US index, also went up 17.7%. There was no surprise here. Global markets usually move up and down in sync, in response to global macro news. But what happened next was stunning and against all conventional assumptions. From 4305 on 16th August, the S&P500 slumped 14.2% to 3693 by 23rd September, wiping out almost all the gain of the previous two months. Strikingly, however, the Nifty dropped from its peak of 17,980 of 18th August by only about 3.6%, over the same period. Nifty delivered a 10.6% outperformance over S&P500, that has turned an old maxim on its head: "when the US market sneezes, emerging markets catch a cold."

India's sharp and surprising outperformance has led to a chorus of predictions that India and the developed markets are getting decoupled. In a climate of manufactured patriotism, such ideas catch on even faster. We last heard of decoupling in the big boom of 2003-2007 when the Indian market rose more sharply than the US market. However, once this became evident, it soon became the popular view among foreign institutions and they started chasing debt-laden Indian real estate and infrastructure companies with poor growth prospects. When the 2008 crash hit the world, no market was spared. Indian markets crashed in sync with developed ones, as herd behavior of panic and fear took over. What about the decoupling this time?

For one, the concept of decoupling has come about only when Indian indices beat the US indices in the short-term. So, it is the market trend that generated this view. But just because India has outperformed the US markets in a short recent period, does not mean that this is based on fundamental reasons that are here to stay. After observing some new evidence or data, human minds are predisposed to quickly see a pattern in that data. Also, we tend to jump to conclusions and extrapolate. Can we conclude that "decoupling" will continue with the help of just two months of data extrapolated?

Indeed, since October 12-13, when the global indices turned around, S&P has gone up 9% Vs 5.9% in Nifty. So the US has caught up with its underperformance. In any case, as you know, we have no interest in such or any other macro predictions. They occupy mental energy and make you commit mistakes.

More importantly, what is the relevance of such a theory? S&P500 is a dollar denominated index while Nifty or Sensex which is a rupee denominated index. Comparing them amounts to comparing apples and oranges. Also, the outperformance of Indian indices has no real practical meaning for us because we are not investing in the US anyway. It is relevant only to those international investors who can invest both in the US and India freely. However, over any medium to long period, they would have been better served by investing in the US than in India. As measured by indices, what they gained in capital appreciation, they lost in rupee depreciation. In dollar terms, the Indian market has always been a terrible performer. In short, decoupling is neither relevant (for us), nor correct.

For a short two months (mid-June to mid-August) the Indian market attracted foreign capital and outperformed the US markets because of relative attractiveness over Latin America, China and Russia. Any post-facto justification of this move with big picture "stories" like India's booming infrastructure development, capex cycle, large market, China +1 etc. is a blend of patriotic and wishful thinking. India has an inherently weak economy with current account deficit, fiscal deficit and a weak rupee. However, as against these macro negatives (due to accountable and wasteful state and central governments) there are two huge positives: one, more and more high quality companies and two, steady inflows from domestic institutional and retail investments. This may or may not lead to decoupling, but either way, it is of no use to us in our investment approach.

Risks Foreseen

The immediate risks to the market are rising inflation and rising interest rates. However, the market will take them on its stride. Since both the main trends mentioned above – better quality companies and inflows of funds into the equity market – are longer term trends, we see the impact of such macro risks to be muted. Of course, global event risks are lurking in various jurisdictions – China, Russia, the UK and US -- and these can deal a blow to confidence.

Since we are bottom-up stock pickers, to us, the bigger risk is being able to find that quality stocks that would deliver great performance. We recently sold 3 out of 4 of our top performers and drastically pared our exposure to the 4th. The challenge is to replace these with stocks that will deliver similar performance over the next 12 months. In the previous quarters I have outlined our strategy, which remains unchanged. I would only add that we might have a shorter term horizon from now on for our new purchases. Stocks with strong earnings growth at reasonable valuations are harder to find. Holding on to new purchases for long may lead to disappointment. This is just a guess now; we will see how it goes. Of course, if the financial sector does well and software sector comes back, we may have a lot of choices to pick from.

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