MONEYLIFE ADVISORY
MAS WEALTH

A Calmer 2023, But A Bull Run?

Dear Fellow Investors,

At the same time last year, all markets and economies were in a turmoil. Russia had declared war on Ukraine and the world was on the brink of an energy crisis. Inflation flared up, economic growth was down and Covid continued to play havoc on many parts of the world, mainly China. There was nothing that was going right anywhere in the world, except perhaps India where the economy continued to do alright. Compared to the scare scenario of early 2022, we have a calmer economic environment now. This is likely to continue but we don't expect any major economic growth anytime soon.

The main reason to expect a calmer 2023 is that a period of high inflation is behind us. Barring unexpected new economic shocks, inflation is not likely to be of serious concern. That does not mean that we will have a period of benign inflation. Inflation will remain higher than before and will fluctuate in a higher band. This means both cost of capital and cost of goods and services will be higher, which will have important implications for investing.

Let's take the first factor, first. As the cost of capital went higher due to higher interest rates in 2022, it meant a major change for valuations. We had a regime of extremely low cost of capital that has lasted for more than a decade. A low cost of capital supported stocks and other risk assets. Stocks were valued on cash flows projected far into the future. Growth stocks and risk assets like crypto became the place to be. But interest rates rose sharply across the world in 2022, as the main job of central banks and politicians was to tame inflation. This immediately devalued risk assets such as stocks. The second impact of war and higher interest rates is higher material cost, which has affected the profitability of every kind of company. The third impact of higher interest rate is the impact on consumers in slowing consumption. All these three factors constitute a deep structural change, the impact of which will not be short-term.

But equity markets are nothing if not optimistic. As 2023 rolled in, a consensus started developing that inflation has been tamed and that the Fed is done increasing interest rates. The US market quickly rallied 10%. Such bouts of optimism are normal but often misplaced. Sure enough, a month later, one started hearing the phrase "higher for longer" referring to how long and high the Fed will push US interest rates to. For five months, optimistic equity investors have been looking for a "dovish pivot", meaning pausing or even cutting rates by the Fed, but it has been elusive.

Markets can always rally 7-10% when economic climate starts to look benign. But that is not a definition of a bull market. As an example bull run is like what stocks did in 2016 and 2017, or in the post-Covid period. But for that, we need interest rates to decline continuously and stay low. Our view is that, this will not happen soon. Meanwhile, we will have to go through many up and downs, many false moves, many times when it seems sunny.

Risks

Contrary to many bullish voices we see stagnation across many industries. What may have come as a shock to many people is a sharp decline in the sales of branded innerwear, a product that would seem to be delinked from the economic climate. Indians are more brand conscious now and so it is surprising to see such a sharp contraction in just two quarters. Clearly, there are trends in the economy that don't match with the headline numbers such as GDP growth and infrastructure spending. Where volumes are growing, higher costs have dented margins like in quick service restaurants. The market senses this, which is why trading volumes have shrunk and confidence is low. Trading volumes are so low that many well-known companies don't even offer enough of liquidity to buy 2-3% of our AUM easily and we are among the smaller PMS. In this climate, neither value nor growth strategies will work well. Growth stocks will be sold off due to high valuation and value stocks will not find many backers due to low confidence. The few stocks that would do well are where earnings growth is clearly visible. We have tried to buy a few of these this month, replacing earlier growth stocks. However, we are keeping a close eye on them because some of them are bound to disappoint and we need to weed them out just as quickly. This will also mean a slightly higher turnover as we adjust to a sluggish market climate. While we expect the economic and market sluggishness to continue, we would be open to change our mind if the macro facts on inflation and interest rates change.

I mentioned last time, if the financial sector does well and software sector comes back, we may have a lot of choices to pick from. Of this, the financial sector is doing well but the market is not convinced. Bank Nifty P/E is near 5-year low. There has been a revival in software stocks and we have participated in the rally.

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