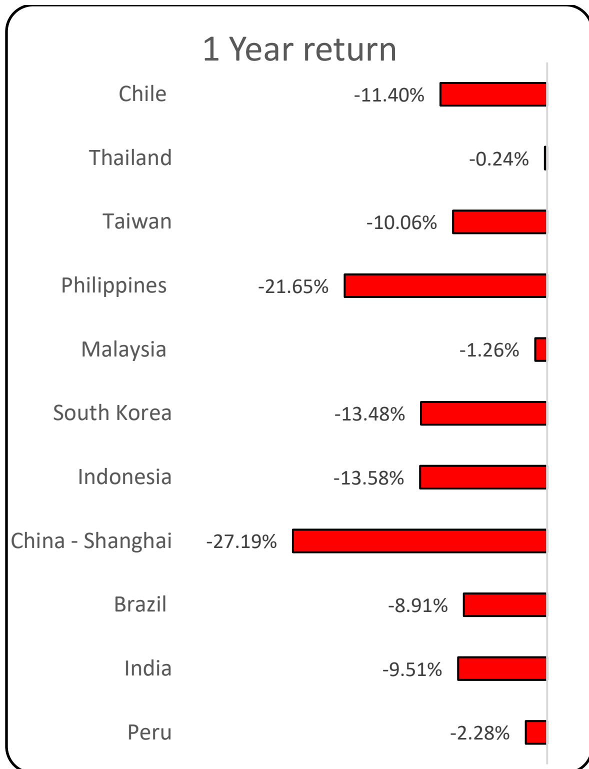

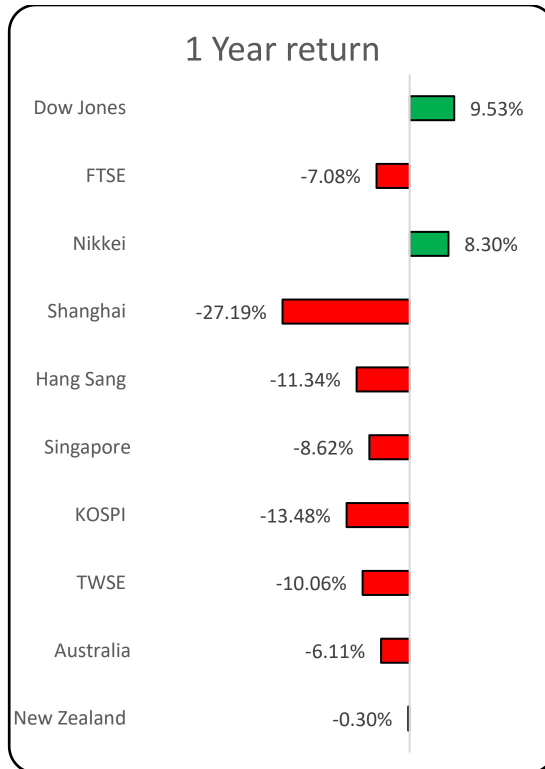

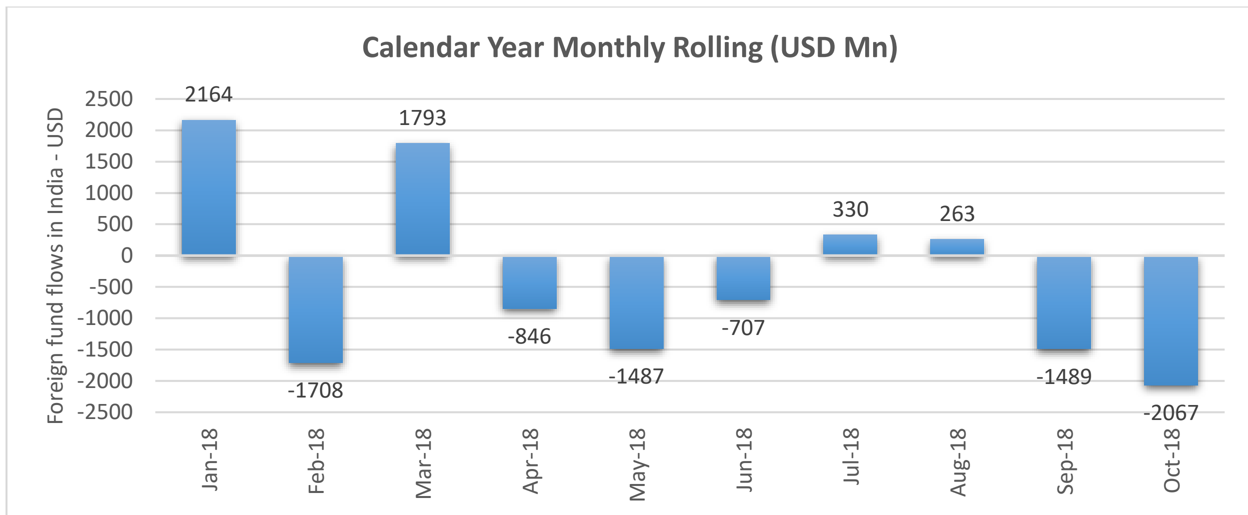

I was listening to Reuters podcast "The Exchange: Howard Marks" today morning. Found what Howard Marks said in the podcast quite interesting so let me first quote what he said and then explain how I saw a correlation with current fall in markets and the concerns among investors. I quote "There were 19 months when being too far ahead of one's time was indistinguishable from being wrong. We are never going to get the timing right. So we have to be willing to be wrong for a while. I did rather be early than late." Howards Marks, Oaktree Capital Management.

Basically, what Howard is saying is that one should never time the markets and (if one's investment thesis is right) one needs to show patience. Now let us look at the recent fall in Indian markets. As far as the markets are concerned, the factors adversely affecting the markets, according to my reading, are a combination of domestic and global ones.

1. INR movement: As mentioned in my September 28, 2018 weekly market review note, what we are witnessing today is "USD appreciation and not INR depreciation." Foreign funds have been net sellers to the tune of USD3.8bn in this calendar year and the market has been almost entirely supported by domestic mutual fund inflows. Though USD3.8bn is not a large number when compared with the total around USD400bn worth of foreign portfolio investments in India, it does act as a sentiment and liquidity dampener.

2. Increase in Oil Price - The recent increase in oil prices has put strain on India's import bill and current account. Though the oil price rise has been passed on to the consumers but global investors have turned cautious on India and this data point has added to the net outflows.

3. Non-Performing Assets plaguing the banking system: If the NPA situation challenging banking sector and oil price rise was not enough that the IL&FS issue cropped up. The government was swift in responding and the entire top management and Board was disbanded and a new Board under is Mr.Uday Kotak was installed. This was needed to avoid any contagion effect on the markets or the economy. A Lehman-like crisis was definitely avoided by this fast response. Though handled swiftly, it has been the much needed trigger for a market searching for an excuse.

I believe that with the recent correction, the reward-risk balance is likely to get reasonably attractive for large parts of the Indian market. Nonetheless, the Indian market may face turbulence over the next 2 quarters with stock prices being influenced by unfavorable global macro (includes US – China trade wars), oil and uncertain politics rather than the underlying fundamentals and fair values of stocks. The continued strength in the USD and oil prices may remain as an overhang on emerging markets in general. For India in particular the forthcoming elections season adds to the volatility as India will see three crucial state elections (Chhattisgarh, Madhya Pradesh and Rajasthan) in November - December 2018 followed by general elections in April - May 2019. This is expected to cause uncertainty from a sentiment perspective particularly among domestic investors in a market which is entirely driven by domestic flows this calendar year.

Last but definitely not the least, the recent policy meeting by The Reserve Bank of India (RBI) held on Friday October 5, 2018, where it left the rates unchanged has been a major surprise to the markets. The key highlights were – 1) RBI kept policy rates unchanged at 6.5%, 2) ruled out any special measures to shore up currency, 3) lowered inflation target, 4) pegged GDP growth forecast at 7.4% for FY2019. RBI clearly stated that its commitment was towards restraining inflation at around 4% and reiterated its hands-off approach on the INR.

Now if one were to the above, the very fact that RBI left rates unchanged shows that inflation, inflation expectation and inflation forecast are well within RBI's comfort levels. This is despite the recent rise in USD. RBI's growth forecast for FY2019 remains unchanged. If one were to look at the INR movement versus USD over the last ten years i.e. from October 5, 2008 (42.4) to October 5, 2018 (73.8) then one notices that INR has declined by 2.8% a year on a CAGR basis. The inflation differential between India and the US over the same period is at 4.2%, as Indian prices accelerated while the US suffered deflation after GFC/Lehman crisis. Seen through this prism too, INR has not depreciated as one would have normally expected and I would want to believe that RBI is cognizant of this data.

In summary,

1. strong GDP growth of 8.2% shows economy recovering fine after two major reforms - demonetization and GST.
2. Bankruptcy code and NPA recognition reforms are bringing in cultural change among borrowers and results are quite positive, troubled assets are shifting to stronger hands (Tata Steel's acquisition of Bhushan Steel is just the beginning).
3. INR in fact appreciated versus USD in CY2016 and CY2017 which also resulted in rising current account deficit. The currency depreciation by various economies, particularly China meant that INR depreciation was inevitable for Indian economy to remain competitive.
4. Weak INR is in the interest of India right now and a well thought out response to counter a world which is depreciating its currencies to maintain their export competitiveness and to prevent their countries from being flooded with imports or becoming dumping grounds of foreign goods.
5. Foreign investors do not like uncertainty. I will not be surprised if they return to the Indian markets in large numbers, based on its fundamentals, once the global uncertainty and trade wars are behind us.
6. Indian stock markets have not fallen in isolation. China, other emerging markets and world markets too have fallen.
7. So the factors which caused nervousness among foreign investors - weak INR, oil rise, and emerging markets correction, only got compounded by the IL&FS crisis.
8. Government of India did not let it blow out the way Lehman issue exploded into a financial crisis in US.
9. Last but definitely not the least, I think investors need to filter the noise or the gap between India's perception and reality, particularly when India enters major elections season spread over next 6months. It is nearly impossible to navigate through the political rhetoric, sloganeering and noise that a democratic election throws up in any democracy across the world.

I believe that global long-term investors should not panic nor extrapolate the period from 2008 to 2013 when the INR depreciated significantly. The economy is much stronger today (GDP growth is 8.2%) and inflation has remained reasonable. Weak INR in current global scenario is in the long term interest of India else current account deficit would likely be unmanageable as India becomes a dumping ground for global exports. India already faces a challenge with its import bill. Today electronics is the new gold as far as India is concerned. While India imported nearly USD88bn worth of crude oil, net imports in electronics are a staggering USD45bn.

One needs to show patience till the US versus China or US versus the world - trade/currency wars settle.

Thank you.

Aashish Wakankar
(This note reflects the personal views of the author)
October 12, 2018