Dear Investors,

"If you have trouble imagining a 20% loss in the stock market, you shouldn't be in stocks" – John Bogle

One bright side of Bear markets after a few good years of Bull market is that it realigns investor behaviour and expectations to more realistic levels and also helps in shaving off some irrationalities and froth that usually tend to get manifested during a euphoric bull market like the one we saw since the lows of March 2020 till few months back. **Asset classes valuation gets a reality check and absurdities get corrected** like what we are seeing in cryptocurrencies, SPACs and other new age startup valuations. If one spends some time pondering on how and why the current state of the global economy and markets has been reached, it seems the writing was on the wall and the ingredients were falling in place and finally had a trigger in the form of the Russian invasion of Ukraine to start the domino falling over each other. In my previous **investor letter written in March 2022**, I had covered the various concerns which the world was facing at that point of time. Seems the world hasn't changed much from then though the fear factor and concerns of a recession hitting developed markets has grown.

"In bear markets stock return to their rightful owners" – JP Morgan

Global headwinds emanating from geo political uncertainty, disruption of supply chain, rising crude and commodity prices and global food shortage has led to aggressive increase in interest rates by central banks globally including in India. **The rate tightening cycle is far from being over** with further increase of 50-100bps in India in next 3-6 months and more than 150 bps hike expected by the US Fed during this period. In this context there is a **beautiful quote which summarizes the Fed's position**. "I like to compare the Fed's problem to the challenge of adjusting the shower in an old hotel, where there's a lag of 20 or 30 seconds between the time you turn the faucet and the time the water temperature changes. It's very difficult to avoid either scalding yourself or freezing yourself. You turn, and nothing much happens, and so you turn more, and then, all of a sudden, you're jumping out of the shower. That's the kind of problem that the Fed has" – Lawrence Summers, former US Treasury Secretary.

Sustained high crude oil prices and shortage of key components is slowly pushing major economies towards recession and raising the cost of living of common man in these countries. However in the midst of all this, **we see India is in a unique position given its quite resilient domestic demand, discounted Russian Oil imports, self sufficiency in major food items, deleveraged corporate balance sheet and Govt support towards domestic manufacturing & Infra spends and job creation**. Though the domestic investors have been able to absorb bulk of the FII selling from past 3 quarters, but the same could see some waning off as last 1 year returns turn negative for most new investors in recent months. Nevertheless we believe India will continue to remain as a major growth engine and current geopolitical impasse will only increase opportunities in both domestic and global markets.

Russian Ukraine conflict – where are we on that after more than 100 days?

The Russian war seems has reached such a stage that everyone wants it to end but no one would want to be the first one to step down due to ego

This war like most wars has had unexpected outcomes and unexpected winners so far. America, UK and European Union jumped at the first shot of the tanks from Russia and went overboard in putting sanctions on Russia with a view to destroy the Russian economy and dethrone Mr Putin. Am sure President Joe Biden was smiling behind closed doors that he got the biggest opportunity of his Presidential term to garner more support from the Americans and international community. However **Mr Biden's administration faces a double disaster after its Ukraine miscalculation, namely a US recession and a second strategic humiliation in the space of a year after Afghanistan.** The US economy is almost certainly in recession, while oil prices drive inflation that has cut workers' real pay by about 6% year on year. Russia meanwhile earned a record €93 billion (US$97 billion) from energy exports during the first 100 days of the war, a Finnish study has reported. China and India, which refused to join Group of Seven sanctions against Russia, reportedly are buying oil at a discount of $30 to $40 per barrel, while American and European consumers are paying the full price. Interestingly EU hasn't sanctioned some of the key Russian Gas producers and Banks which help them in this gas trade as it would choke their own economies then. This again brings to light the hypocrisy of these sanctions and their real motives.

The war has surely **cemented the long tried and tested friendship between Russia and India and this is working towards India's advantage from strategic and economic point of view**. Europe and America seems to be the worst impacted from the war and the world economic order is going through some major changes. Renewable energy is no longer the buzz word and Coal and Oil has gained the limelight and reinstated its dominance in global energy landscape. The trillion dollar question remains, "When will this war end"? We believe **though the intensity of the war has reduced in recent months, but a complete ceasefire seems quite remote in near term** though EU leaders would want it to happen. However, Uncle Sam doesn't seem to be wanting the same and NATO leaders have been making statements that the war is far from over. Even if the war ends physically, the economic sanctions which are more damaging, would persist and that would keep inflationary pressures high.

US underestimated the resilience of the Russian economy and the capabilities of the Russian military. Climbing down off this ledge won't be easy for US. It may be impossible. Biden denounced Russia's leader as a war criminal, averred that he couldn't be allowed to remain in office and bragged that US sanctions would cut the Russian economy in half. A compromise in Ukraine with significant territorial concessions to Russia – the only conceivable way to end the war – would humiliate Washington. However a negotiated solution to the Ukraine war seems the most likely solution. Washington could continue to portray itself as the defender of Ukraine's sovereignty while encouraging European leaders to do the dirty work and force Ukraine into negotiations with Moscow.

US Fed's aggressive rate hikes and balance sheet tightening is going to push their economy deeper into recession which will take years to come out of

Inflation is killing economies and has a different construct that's not similar for all

Interestingly the inflationary pressures which are hurting India and those hurting America and Europe are of different nature. **Our inflation is more supply side inflation** which has been created due to supply chain disruptions leading to rise in commodity and food prices and Oil prices. However **the inflationary pressures in western world is both demand and supply led** because their central banks have pumped in trillions of dollars into the economy over last 2 years in order to artificially support their economy and companies and that is now coming to haunt as bulk of the money led to asset class bubbles. This inflation is more sticky and would not come off easily unless interest rates increase sharply and destroy consumer sentiment & demand which in itself is going to push the economy into recession. In contrast, our inflation back home in India can be addressed easily once oil cools off and supply side issues get addressed. Unfortunately the Fed is seen fighting the inflation which they have themselves created to a large extent by tightening the interest rates harder and faster. **This has the dangerous potential to plunge their economy into recession as consumer sentiment is at 40 years lows** and there has been massive wealth destruction due to the carnage on Wallstreet. The Biden administration vastly underestimated the inflationary impact of the $6 trillion Covid stimulus package, which began under Donald Trump's administration but doubled under Biden.

India Inc. with its strong balance sheet, growth prospects, private capex cycle and cost efficiencies, seems well poised to ride the next economic upcycle

India Inc is a bright spot in an otherwise gloomy world

A recent study by a institutional research team of about 1,800 companies for which data is available for FY22 gave interesting takeaways**. Sales of this group of companies grew ~26% and net profit grew by ~54%;** manufacturing sector did better (27% and 68% respectively). Profitability was driven by lower employee expenses and interest cost (as % of sales), amongst other factors. Wage bill of IT sector crossed that of manufacturing companies for the first time. Chemicals, metals and mining, and IT services grew the fastest in FY19-22 while automobiles, airlines, hotels, and media & entertainment are yet to recover to FY19 levels. **Leverage of non-finance companies is down, extreme leverage even more so.** Non-finance companies with Debt/Equity of over 2x now account for ~18% of the system net-debt, lowest on record. The bigger story, as is probably well known, is in profitability of companies. Net profit margins of non-finance companies improved to 7.9% (manufacturing sector at 9.2%) highest since FY11 but still well below profitability levels seen in FY06-11 period. **Automation and higher labor productivity is a key theme in manufacturing and that accelerated during the pandemic**. That is reflected in cost trends, with employee cost as % of sales for manufacturing falling to 9.7% in FY22, near its lowest ever. On the other hand, the IT services sector has seen consistent increase in employee cost over the last 10 years (and during the last 2 years all the more). It is pertinent to note that IT sector's wage bill crossed that of manufacturing sector for the first time in FY22.

Nearly 30% of the non-finance companies have net-cash on balance sheet, highest ever. Non-Finance companies' Net debt/equity fell to 0.6x, from a peak of 0.82x in FY20 and is the lowest since FY11. The most important highlight is in extreme leverage – proportion of companies with Debt/Equity of over 2x was 6% (as compared to 13% in FY12), lowest seen in the last 15 years. These companies accounted for ~18% of total system net-debt, compared to a peak of ~43% in FY15. With private capex picking up across sectors and India increasingly gaining market share in the global landscape coupled with a robust domestic demand, we see strong earnings growth trajectory for India Inc. in the medium to long term once the current war clouds pass by.

Rural India is seen coming from the ashes after a span of 4-5 years and could be the harbinger of Indian economic revival

Agricultural economy recovery is big silver lining for Indian economic revival after 4-5 years

Agriculture has always been a key driver of Indian economy and last 4-5 years it had taken a back seat which also got reflected in the poor GDP growth rate for India during this period. The recent yield of Rabi crops fell by ~5-10% in the current season due to heatwaves in March'22, leading to early maturing of Rabi crops. However what is heartening to note is **that Agri produce prices have jumped sharply, which would help farmers get better realization for their produce**. Also the Agri terms of trade for cotton, soyabeans, maize, and wheat have turned favourable, raising hopes of strong rural demand recovery.

With nearly 65% of India's population living in Rural India, the revival of this segment in both spending power and job opportunities would open up massive growth triggers for India

Global food prices are up 20.8% YoY in May'22 on tight global supplies which doesn't seem to be ending anytime soon. This has led to a sharp uptick in Agri exports from India, a positive factor for rural demand recovery. Also, wheat export ban would not have any meaningful impact on India's Agri exports as it contributed less than 5% to India's total Agri exports in FY22 (only 0.2% in FY20). Most weather forecasting agencies (including the international agencies) have predicted a near normal monsoon this year. While monsoon progress is slow in the first two weeks of June'22 (rainfall down 37% from the normal rainfall), July and August are the key months for sowing in the monsoon season. Moreover, water availability in reservoirs is quite good, which would encourage early Kharif sowing as reflected by record-high fertilizer sales in Apr'22. **We see rural demand being a key driver for India's resilience in the coming year as all the indicators are pointing that it would not disappoint**.

Government's rural spend (Centre + States) has been budgeted to increase 11.3% yoy in FY23, up from 3.1% yoy growth in FY22. Also the central govt is focusing on building rural roads, drinking water facilities and toilets in FY23. All this is estimated to lead to Real rural wage to turn positive, from -4.4% in Mar'22 to +2% by Dec'22 as wage hikes happen with a lag. Also **domestic remittances are back to pre-Covid levels as migrant workers return to work places in the cities**. Interestingly land prices have jumped 15-20% in rural areas and nearby cities in the last two years (after remaining nearly flat for 10 years) which would create a positive wealth effect and also lead to increased consumption in Rural India. Subsidized food by the Govt. is coming to people's rescue against high food inflation. Farmers are however facing labour shortage pan-India and this is leading to farm mechanization with farmers using tractors, cultivators, and harvesters as a substitute for labour. Non-agri usage of tractor is also on the rise due to shortage of labour and tax advantage, resulting in structural demand for farm equipment and small tractors. There are early indications from online platforms that demand is picking up in the hinterlands and they are deepening their network there. Demand for AC, flat screen TV, smartphone, fridge, and washing machine is on the rise in rural areas though a bit patchy currently to show a clear trend.

What should investors do now at 15000 Nifty-50 levels?

Patience is the key in the market currently. Not a time to throw in the towel on equities

It is quite natural to get tempted to throw in the towel in current market conditions when all you hear and read is about recession hitting US and Europe, Russia war continuing and Inflation killing economies followed with the central banks on their rate hike spree. However if we look back over the last few decades of our market, it will be evident that this is not the first time such despair has been seen and such fears have taken center stage. FIIs who continue to sell Emerging Market ETF will also come back as India's economic resilience becomes more evident and money comes back through India dedicated funds rather than part of ETF allocation. Bulk of the outflows now are part of ETF redemptions and due to re-aligning of the weights towards India owing to India's outperformance among other emerging markets and even MSCI EM index.

In any investment decision we see how well the company is managing the 'controllables' and we pay lesser attention to the 'uncontrollable'. In that same analogy, India is managing the 'controllables' well – policy decisions on balancing inflation and rural growth, keeping fiscal math under control, protecting the currency dynamics, excess savings as a shock absorber, healthy growth in jobs/ wages/ personal tax collections, strong balance sheets of corporates/ banks/ individuals, creating the environment for capex cycle to recover and market share gain in exports. Hence our positive outlook remains on India notwithstanding the obviously challenging 'uncontrollables' in geo-politics, commodity prices, central banks' action, reversing portfolio flows, etc. All the more, the recent sell off in our markets has brought valuations of headline Index Nifty-50 below the 10 year average 1-year forward P/E multiple and if we look at individual companies the valuations are close to 2-Standard Deviation below the historical means. Risk reward has become more favourable though we are not proposing a sharp rally in the markets, but the bulk of the correction is done and from here on we see selective sectors and companies leading the pack and markets in general consolidating in a narrow range over the next 2 quarters. Time correction could be there but it would also throw opportunity for long term money to get into good companies at cheap valuations.

Happy investing and stay safe with your families.

Yours Sincerely

Aniruddha Sarkar

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