

Rising Oil Prices, Inflation and Geopolitical Risk – A toxic recipe or not?

India's equity markets closed at 18,308 (as measured by the Nifty-50 – a benchmark of India's 50 largest companies by market cap) on the 17th of January 2022. Over the last 3 months we have seen oil prices rise from US\$69 to US\$100 and recently saw an inflation print of 6.01% for Jan-22. Additionally, recent geopolitical issues surrounding Russia-Ukraine provide some justification for the Nifty-50 falling to 16,248 at the close of 24th of February 2022 – a fall of 11.3%. Mid-cap and Small-cap stocks, which generally have a more significant impact when sentiment sours, have fallen 16.3% and 22.1% respectively over the same period. Rising oil prices have never been an ally of India's growth story. Given India imports close to 80-85% of its oil due to rising demand, rising oil prices typically create a handbrake for India to mitigate. Typically, it leads to a rising current account deficit, rising inflation and input costs for companies and a wobbly currency.

The Russia-Ukraine geopolitical issue is unfolding as we speak and is leading to heightening risk-off sentiment, witnessed by a rising VIX. Foreign investors have been exiting India for some time, citing uncomfortable valuations, rising inflation and oil prices now accentuated by geopolitical concerns leading to general reduction in risk tolerance. Foreign investors withdrew US\$7.6bn CY2022YTD, after pulling out US\$5.1bn in Dec21Qtr.

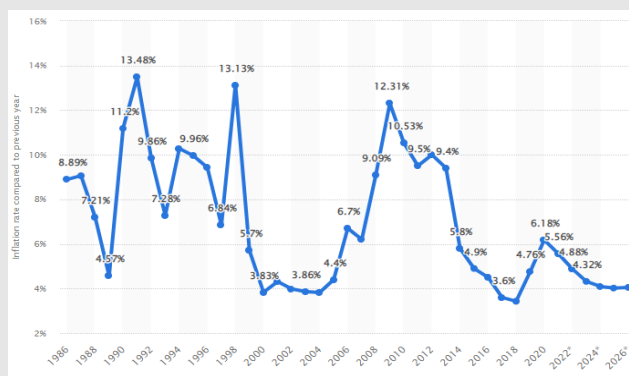
The Evolution of India's Economy and Equity Markets

It is our view that things have changed significantly since India's "fragile five" days in 2012-2013 – a term coined by a Morgan Stanley analyst to represent emerging market economies who were too dependent on foreign investment to finance their growth ambitions (Turkey, Brazil, India, South Africa and Indonesia).

Exports/Renewables

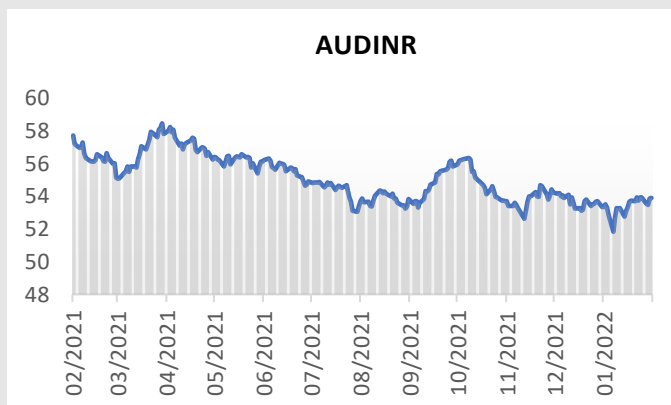
Firstly India's IT services exports for the first time now exceed India's oil imports. India's general level of exports are also rising and target US\$1trillion annually by the end of the decade (compared to US\$400bn per annum by FY22). India's increasing focus on renewable energy sources, recent free trade agreement with the Middle East and a greater focus on self-reliance should alleviate some of the stresses placed on the economy by rising oil and commodity prices. **38% of India's installed energy capacity comes from renewable sources like Solar, Wind and Hydro. The country has 150 GW of renewable energy capacity, with a commitment to achieve 450 GW by 2030.**

Inflation (Source: Statista, Oct 2021)



Inflation is heavily influenced in India by food and oil prices, which are significant components in the CPI basket. Whilst Inflation is currently at 6% and at the top end of the RBI's tolerance range, it is expected to recede due to the base effect and some improvement in global supply chains in 2H2022. The Central Bank of India has remained supportive and focused on growth, with a watchful eye on inflation. **Importantly, inflation is structurally lower than previously in India.**

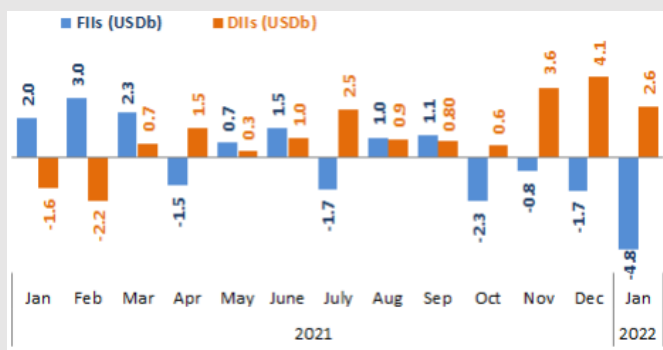
Currency (Source: Refinitiv)



Whilst the Rupee may have depreciated slightly against the USD (like all currencies when you study the DXY), its relationship to the AUD is quite different. The Rupee continues to hold firm despite rising commodity prices in general being supportive of the AUD. Rising oil prices, foreign investors withdrawing, and geopolitical tension has not weakened the INR relative to the AUD.

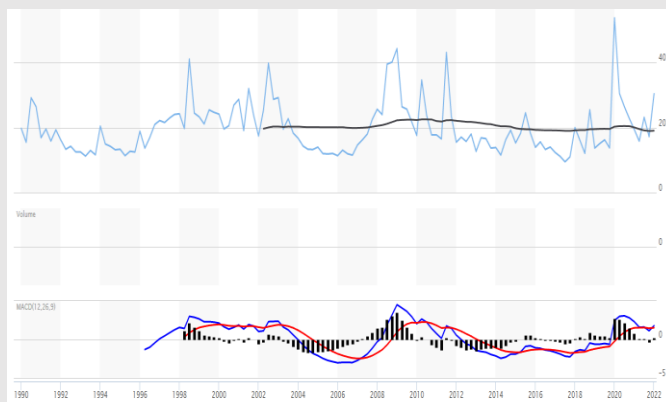
Foreign Investors (Source: Motilal Oswal)

The emerging trend over the last five years has been the underlying investment by local institutional investors (local mutual funds). **The switch from physical assets to financial assets has been structural and local institutional investors now form over 15% of market cap and is increasing in relevance in comparison to foreign investors. A decade ago, local institutional investors were a meagre 3% of market cap.**



Foreign Investors (FIIs) have been in withdrawal mode, but this has been counteracted by increasing investment participation from domestic investors (DIIs). This has significantly reduced the volatility of equity markets and increased the market breadth and participation.

Geopolitical Risk (CBOE VIX)



Vix continues to rise in the short-term and typically prior events have led to spikes above 40, but have not been sustained much further. Currently Vix is above 30 and may rise further in the event of continued developments in Ukraine and disruptions to the energy supply chain. However, it is most likely to be short-term in nature.

India's energy supply chain is unlikely to be disrupted as almost all supply comes from the Middle East, Africa and North America.

Valuations (Source: Bloomberg)

Based on consensus forecasts Nifty 50 EPS growth is expected to be 17.6% p.a. over the next two years (FY22-24) with a terminal P/E of 15.8 (FY24). **Apart from the US and India, it is difficult to find investable equity markets with a P/E for G (or commonly known PEG ratio) below 1x in the current environment.**

The Consensus EPS for the Nifty 50 stocks are as follows:

Nifty = 16248	FY21a	FY22e	FY23e	FY24e
EPS	550	745	888	1030
P/E	29.5	21.8	18.3	15.8

Our View

The India Avenue Equity Fund has lost approximately 15% in value from the close of the 17th of January to the close of the 24th of February. This has been driven by the fall in markets as well as by our positioning which incorporates exposure to mid and small cap companies (approximately 50% of our portfolio).

We continue to see a bright outlook long-term for India over the course of the decade. Ideally, clients should look to build exposure to their desired risk tolerance at points of weakness in Global/Indian equity markets, rather than topping up on momentum driven rallies (like what we find with most foreign investors into Indian equities).

We expect volatility to continue for most of 1H22 and we are simply pointing to the fact that in our view, structural changes to the India's macroeconomics and equity markets, as well valuations at current levels, appear to market attractive in the long-term relative to other equity markets.

Our Disclaimer:

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