Event Update
The war and economic impact on India

With oil above USD 110, what are implications for India's fiscal deficit at a macro level and for various sectors at a market level?

As we speak, the crude oil prices have come down by 10-15% from their recent peaks, but yet at its highest since 2008. If the crude oil prices were to remain at elevated levels, then it has several implications for India. Firstly, by virtue of being a net importer of its energy needs (36% of its total), India's value of energy imports as a share of the GDP is one of the highest among major economies. However, this ratio has been coming down steadily from about 8% at the start of the past decade to about 3% during the pandemic phase (4% pre-COVID)[1]. With the current surge in oil prices, this is threatening to go back to the levels seen 10 years back. **So it will put enormous stress on the government balances and deteriorate the fiscal deficit situation** (as a ball park, $1 increase in oil prices increases our import bill by USD 1.4 bn on an annualized basis). In addition to oil prices, the geopolitical crisis has impacted the prices of other energy sources like gas, coal and also other commodities like edible oil, fertilizers, Aluminum, Nickel etc., given that Russia and Ukraine are net suppliers of these commodities too. So, elevated prices for basket of these commodities also raises India's import bill further, putting additional stress on the finances.

At a sectoral level, the impact can be varied and the it will be felt both at the input level (cost) as well as demand side (growth). So accordingly, escalation of input costs would adversely impact sectors like Cement, Auto (including auto ancillaries & tyres), Consumer durables, Consumer staples and paints, to name some of the worst affected ones. On the contrary, commodity producers (metals, energy companies), would be beneficiaries. Sectors like IT, Health Care, Utilities are not going to see much impact (neutral). On the demand side, there would be ramification of sustained elevated crude prices on constituents such as Auto (fuel costs) and other discretionary consumption (due to inflationary impact). As a result, higher oil prices can pull down the economic growth (GDP) due to the spiraling effect of the demand slowdown.

We are beginning to see economists bringing down their GDP growth estimates. It is early days but extent of cut in GDP estimate is in the range of about 1%[2].

FPIs continue to sell Indian stocks – even as some speculation suggests that Russia going out of MSCI indices will mean higher weightage for Indian markets. What is spooking FPIs about India?

Both MSCI and FTSE will delete Russia at zero price, which is effectively a write-off Russia process from the index. This makes sense as investors cannot sell Russia stocks so index providers cannot delete at any other prices. Russia's weight is currently 1.5%[3] in MSCI EM. There is very less likelihood of Russia getting added back to the indices in the near term even if the accessibility improves (due to the ongoing conflict). Theoretically, deletion of Russia should lead to outflow from Russia and inflow to other countries in EM, such as India. Some estimates peg the net inflow at ~USD 700 mn[3] (with about 19 bps higher weight in MSCI EM Index post Russia exclusion[3]). However, it is not as simple as this. The reality is that Russia has banned foreign investors from selling any Russian equities so investors cannot sell Russia stocks. The deletion of Russia has happened at 0 price which means that EM Indices will see a sharp price fall (of ~1.5% purely from Russia being written off). In addition to this price hit, the current environment might reduce investor appetite for EM equities as an asset class. If EM funds were to see outflows, then the funds will be forced to sell other EM countries. **Hence, in near term we don't expect to see immediate inflows to other EM countries, such as India.** In general, that while theory suggests that sharp outflows from some EM country might benefit India, it never plays out this way. Looking at what happened in mid-2021 when China saw a barrage of regulatory concerns pop up - theory would suggest that funds would sell China to buy India but that is not what really played out (India witnessed net outflows of USD 4.8 bn in 4QCY21[4]).

On the question of FPI outflows, there are multiple factors at play, resulting in outflows from India. **Firstly**, if we take the period from COVID recovery to late last year (Apr 2020 to Sep 2021, i.e. 18 months), India had garnered significant share of global FPI flows to EMs at USD 38.5 bn of net inflows. India was also one of the top performing equity markets for most part of 2021 as well. So, we are seeing a trend reversal on this front (starting Oct 2021 – till date) as **FIIs tend to reallocate flows from outperforming markets** (valuation premium being a consideration element) as part of the portfolio reshuffle process. **Secondly**, a related point to the first factor, we have seen rotation within EMs, with some of the underperforming markets getting a larger allocation over the past 3-4 months as part of the larger growth to value rotation theme (for example, we saw ASEAN markets, Brazil etc., seeing inflows on the back of reopening trade, growth to value rotation etc.). **Finally**, the interest rate cycle and US Fed tightening are also aspects that are influencing FPI flows and India's valuation multiples compared to history was trading at a premium, post the outperformance.

India has seen net outflows to the tune of USD 19.1 bn from Oct 2021 (when the outflows began) out of which USD 14.1 bn happened this year itself (USD 4.5 bn in March). DIIs have counter balanced by having a net inflow of USD 16.6 bn from Oct 21 to Feb 22. The recent surge in outflow can be attributed to the ongoing geopolitical crisis and India's sensitivity to elevated oil prices being significantly higher, the FPI outflows are higher. [4]

All commodities are spiking up – not just oil. What implications do you see on inflation and on earnings of consumer facing sectors in particular and the overall earnings growth story from a medium term perspective?

In the overall world trade, share of Russia is about 1.5% and share of Ukraine is about 0.6%. But in some commodities, their share is disproportionately high. Russia currently accounts for ~9-10% of global aluminum exports, ~11-12% of nickel exports, ~20% of thermal coal exports, and ~12% of global steel trade (excluding intra-regional trade). 40% of worlds Krypton and 50% of Neon come from Ukraine (in 2014 it was above 70%) and both are in-feeds for the semiconductor industry. This proportion has come down from 70%+ levels of 2014 but is still high. In addition to these, there are several agri-commodity exports from the region (wheat, barley etc.). Western sanctions on Russia has hit the trade supply dynamics, impacting the prices of these commodities. In addition to this direct impact, there is an indirect impact of the conflict, which is the disruption of the global supply chain. This is further raking up the prices of other commodities as well. The global supply chain was already under disruption owing to COVID imbalances & restrictions and the recovery was underway, before the crisis hit. So it has put the brakes on the return to normalcy and thereby pushing the global commodity prices higher.[5]

Coming to assessing the impact of the higher commodity prices on earnings growth trajectory, it will be difficult to predict in a precise manner as we are still grappling with the scale of the current conflict (i.e. can it worsen from a regional conflict) as well as duration of the crisis. So those are the blind spots from assessing the medium term impact on earnings point of view. The impact on inflation is also not fully known yet, as to whether the current scenario will pave way for a sustained stagflation scenario or lead to a demand shock which can pull down key resource prices, providing a transitory impact. However, one thing is for certain that the near term impact on earnings will be there owing to the higher input prices and as a result there will be earnings cut across sectors. **Basically, there are four variables that would impact earnings trajectory in the near to medium term viz higher oil prices, higher metal prices, INR depreciation and increasing interest rates (inflation hardening).** However, the sequence of the impact would be more gradual for interest rate hikes and the impact of first three variables are going to be felt more in the near term.

The magnitude of earnings impact will be significant in Paints, Auto, Consumer Electricals, Tyres and OMCs. In some sectors, earnings changes have already happened in line with the movement in the key variables to some extent. For instance, Upstream O&G have already seen some upgrades (not fully though) while, Consumers goods, Industrial Construction, and Cement have seen downgrades. downgrades are yet to significantly happen in the Consumer Electricals, Paints, Gas Utilities, OMCs, Agriculture, while significant upgrades are yet to happen in Metals, Upstream O&G, Technology etc. Impact of higher interest on banks can be positive but the demand impact should be assessed, especially if the current crisis was to drag on (as there would be an economic growth impact too). Increase in prices of metals will unsurprisingly benefit Metals & Mining only. However, higher metal prices are generally negative for earnings, and we expect Consumer Electricals and Auto to lose the most. Increase in crude oil prices will benefit Upstream O&G significantly while this is negative for demand and economic growth in general. Tyres and OMCs would potentially be the worst-hit sectors from crude price rises. INR depreciation favours IT and Metals & Mining, while Tyres and Travel & Leisure are the worst affected sectors.

On an aggregate basis, there would be cut in FY23 estimates. Here too, these are early days and consensus hasn't begun to cut their estimates. However, the earnings cut is not likely to permanent. That means, they would spill over to FY24. We spoke to a couple of sell-side strategists, who are expecting about 8% cut in FY23 earnings but only 4% cut on FY23+FY24 earnings. (Note: these are not consensus view yet but views of only 1-2 strategists)

Conventional wisdom suggests that when oil prices shoot up, small caps suffer the most and large caps is where one gets relative safety. Is this a time to move into large caps?

In a very generic way, higher commodity prices would mean margin pressures (due to rise in input costs), which would need price hikes to offset the adverse impact for firms. In addition, higher oil prices can put brakes on the economic recovery as demand gets impacted due to inflationary environment across the board. So in such a scenario, the small cap names being price takers, would tend to get impacted the most in general. That is because, the bigger or dominant firms within the industry have enough margin cushion to operate at a lower price scenario and also realign product portfolio to cater to the lower demand scenario. As a result, the smaller firms within the industry will be at a disadvantage owing to their inability to raise prices (sharper margin impact), while the larger firms gain market share at their expense.

Having said that, there are many exceptions to this broader thesis, as we have seen many small cap or midcap names emerging as dominant players in their spheres of existence (sectors or segments). So as a result, their ability to sustain the adverse situation will be similar to that of dominant firms in large sectors.

We look at stocks in a bottom up manner and hence it makes sense to stick or add to those names, which are dominant or leading players in their respective sectors, rather than applying the filter of large / mid / small caps in a general manner. But, we would agree to the thought process that it may make sense to lighten up exposure to small cap names, where they are vulnerable to the changes brought about by the current dynamics and / or small cap names, part of the large sector consisting of dominant players, where they are likely to witness market share loss and / or without pricing power.

How are you navigating your portfolios – in terms of sectoral realignment – in the face of recent developments?

In the near term, the market may remain focused on the risks emanating from the conflict. However, as we have seen historically, regional conflicts have had little lasting impact on global growth, suggesting that while the current event will drive volatility, and exacerbate energy issues for a time, but not change underlying trends.

We remain focused on the fundamentals of our investee companies and especially the earnings growth trajectory. Geopolitical events such as these will not alter the fundamental drivers of the investee companies, even as prices undergo some short term correction, only to recover later. So while our portfolio strategy remains unchanged, **we are using the recent correction to add to our conviction bets or those names that have seen sharper correction than what the fundamentals warrant.** But we will reassess the scenario on a regular basis, especially in light of the earnings impact on rising input costs and any structural changes in our thesis w.r.t investee or potential investee companies.

Looking ahead, we see liquidity withdrawal (US Fed taper) and rate hikes in the US to dominate investor discussion for most part of 2022, as the US Fed plays catch-up against the backdrop of strong growth and high inflation. The market is expecting at least 5-6 hikes spread across 7 policy meetings scheduled for this year (cumulative hikes of about 150-175 bps). However, slowdown in demand and the geopolitical tensions, may force Fed to rethink the course of the rate hike cycle including the start of the cycle and quantum of hikes during the year.

Document Date: 10 March '22, Data as at 08 March '22 unless otherwise given. Source: Bloomberg, HSBC Asset Management India, [1.] Credit Suisse estimates, [2.] Initial trends and estimates, HSBC AMC, [3.] Macquarie, data as on 02 Mar 2022, [4.] Bloomberg & MOSL, latest data as on 08 Mar 2022 (provisional) [5]. MOSL & IIFL estimates

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