Thoughts On The Year That Was And The Year That Will Be

Newsletter for January 2023

2022: The Year Of Long-Term Trend Reversals

2022 was a year where many long-term trends were broken and reversed. Some of the trends were multi-decadal and some of the reversals were accelerations of reversals that had already started earlier. This created a sharp re-pricing of assets. The strong overvaluation of growth assets became more rational, benefitting investors like us who tend to have a value bias. The trends that reversed were:

1. **Inflation:** The bonanza of low inflation, in spite of a deluge of liquidity infusion over the past two decades, seems to have come to an end. The underlying causes are structural and sometimes markets lose focus on that. The reversal of globalisation, combined with recent demographic trends in countries like China (and increasingly India too), have the strong longer-term implication of global inflation. These countries, as they integrated into the global economic system over the past few decades, introduced a huge surplus of good quality labour. This led to a perpetual deflationary pressure on labour costs. Also, the commodity over-investment cycle has reversed, partly because of a muted longer-term demand expectation from markets like China and increasing costs related to ESG issues. The third deflationary force – technological innovation - remains. But it could also have a cyclical slowdown as the cost of capital for this sector normalises up. So, inflation is here to stay over the longer term, though the short-term numbers are moving down.

2. **Interest rates:** This is a follow through on the inflation trend. Global rates have been dropping for the past nearly forty years. That trend has run its course and sharp increase in rates in 2022 is a sign of "higher for longer". This has multiple implications for both the financial markets and the real economy.

3. **Geopolitical risk:** The world has not seen a genuine geopolitical conflict, leading to a war, between major powers since the late 1980s. Europe has not seen a full-scale war on its soil since the Second World War. That suddenly changed. The economic impact of that is much higher than that of wars in parts of Africa or in places like Syria. The Ukraine, Belarus and Russia are very larger suppliers of oil seeds, grain, crude oil, natural gas, some industrial gases, etc. to the rest of the world. This has created a large disruption. Also, the slow reduction in dependence on supply chains passing through countries that are politically hostile is creating economic disruption of the kind not seen since the 1980s. Even the slow disentangling of the Chinese and American economic inter-dependence has huge repercussions. Corporate profits, investment decisions, capacity rationalisation and supply chain resilience all become worse.

4. **Asset valuation:** Across the board, the valuation of financial assets corrected sharply. The more speculative the valuation, the bigger the fall. Crypto, high growth pre-profit tech stocks, SPACs, zero yield bonds, etc. were representative of all that corrected. Some of them simply had a valuation problem with the underlying assets still very useful. These could give good long-term opportunities.

5. Other than these broad trends, we saw the reversal of some of the short- to medium-term negatives. Covid-related inflationary pressures dissipated, demand broadly normalised and, by the year end, even China started normalising (as written about in our last two newsletters). The commodity/ energy market had a hugely profitable year, though by the year end some of the prices normalised down. Here, we feel we are at the cusp of a broad commodity upcycle. The unique feature is that this is more supply-driven (rather, the lack of it) than a boom in demand, as was seen in 2001-2008.

We will leave our 2022 analysis at this and go on to our views on 2023.

2023: Five Investment Themes To Focus On

As 2023 takes off with strong returns across the world (especially China), it would be good to have a clear view on some of the new themes we could turn our attention to. As some of the older themes lose steam (some temporarily) and some themes like China opening and regulatory normalisation gain momentum, we would like to add five ideas to our overall basket of themes. These add to the underlying picture we have in the background as we create a portfolio of stocks. Our current running themes on China opening up, commodity supply constraints, inflation temporarily coming down and rates peaking remains. Our five additional themes for 2023 are:

1. **Consumer staples:** Over the last year, raw material inflation, supply chain disruptions and a Covid-driven stop-start of the Chinese economy have thrown cost structures of consumer companies out of kilter. To add to this, consumer demand itself weakened because of high inflation impacting household budgets severely. Companies across the sector engaged in foods, beverages and personal care have taken large price increases in their efforts to protect their profit margins. They have enjoyed limited success and with a lagged effect.

   But as we walk into 2023, we find several of the conditions that laid this sector low in 2021 and much of 2022 already having reversed on the cost side. This will put many of these companies in the happy position of benefitting from not just their profit margins reverting to their pre-pandemic long-term average first, but also, in some instances, improving even further towards the back half of the year.

While this sector has yet out-performed selectively in the developed markets, in emerging markets and Asia it has had a patchy record of performance. With the US dollar possibly having peaked, it is more than likely that this additional burden has begun to ease and will ease further through the year.

At a time of weak growth, high macro-economic uncertainties and an era of relatively high endemic inflation, consumer staples is one sector which includes a large swathe of well-managed, highly profitable companies with strong brands and franchises whose virtues were under-appreciated, and remain so, more so in Asia. We think that the paradigm of investing will shift towards appreciation of slower and steadier growth that generates strong and durable free cashflows and dividends and strong balance sheets. This has begun in 2022 and will accelerate in 2023. This will happen at a time when the sector itself will benefit from 1) a more benign cost environment, 2) improving aggregate demand as even China will emerge from the pandemic before long, and 3) earnings upgrades from analysts who had cut estimates when they gave no credence for companies to improve on their 2020-21 trough metrics.

2. **Commodities, selectively:** We have been bullish on the long-term prospects for select hard commodities through 2022. We remain bulls thereof but go into 2023 with some trepidation on the likely course stocks might take.

   The long-term demand-supply equation looks strongest and skewed to the upside in non-ferrous metals such as copper, aluminium and nickel and, to a lesser extent, in zinc and lead. However, the demand side of the equation in 2023 is somewhat unclear.

   This is mainly on account of the uncertainty of the pace of recovery in China post its return from the pandemic and, more importantly, the recovery of its property sector. China and its property sector are copious consumers of these commodities and will play an important role in determining the short- to medium-term price profile of these metals. Also, this is a time when the US and Europe are likely to slip into recession themselves and their demand also must be assumed to be weaker.

   Having said this, however, we look beyond 2023, towards a situation where China reverts to its trend growth and the West grows out of its recession. This would coincide with a time when the last remaining vestiges of supply side responses in these metals would begin to exhaust, leaving the markets prone to sustained upside risk in the underlying price. A weaker US dollar expected in 2023 and beyond will further buttress the price of these metals. We remain hawk-eyed and alert to grasp opportunities amidst this developing situation in the year.

3. **A relook at innovation leaders, pre-earnings growth stocks:** There is a large group of companies involved in disruptive innovation. They are primarily in the technology, biotech, life sciences space. Most are pre-profit and some even pre-earnings. A few of these are companies will disrupt large currently entrenched businesses. Some of them will create products which do not exist today. These are the companies at the confluence of private and public

markets. As a group, the stocks of this kind of companies have corrected by 50-80% over the past eighteen months. It might be time to have a re-look at them as a group. They include the future Amazons, Googles and Teslas. This group always has its believers, who have been badly hurt in the past eighteen months. We would be looking to pick through that carnage. Remember, Amazon fell 93% from Nov 1999 to Sep 2001, and then rose 31,600% over the next twenty-one years.

4. **REITs, selectively:** REITs benefit from strong economic growth (leading to higher rentals and NAV growth) and low rates (lower cap rates and they look more attractive vis-à-vis fixed income options). The current environment is exactly the opposite – relatively low/ slowing growth and high rates. As these negatives start getting reflected in NAVs, DPUs and stock prices, we will start getting good entry points. Longer term rates might come off from the peaks of today and economic growth might stabilise. We think REITs might see attractive bottoms sometime this year.

5. **Indirect China opening plays:** The direct plays on China opening/ normalising are the obvious plays for 2023. Chinese consumers have been heavily saving over the past three years. The annual household savings rate has gone 15-20% (2013-2019) to 33% in 2022. These excess savings are projected by JP Morgan at about USD 827 bln. Most of these are in bank deposits. Given the opening up history of the rest of the world, we could see a lot of "revenge buying". The less obvious way to play this is through a bunch of companies outside China (mostly the rest of Asia) which will directly benefit from this re-opening. From consumer stocks in Korea to tourism and property plays in Asean, this is a big list.

In conclusion, we look at 2023 as a year of opportunities. The poor market returns in 2022 have created strong value rationalisation. Also, we see some clear new trends emerge which we hope to catch earlier than the rest of market. While 2022 was a year of strong relative outperformance for us, we hope 2023 will be a good year in both relative and absolute terms.

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