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Banks & financials riskier than mid and smallcaps: Shankar Sharma

Synopsis
“Banks and financials are where one needs to be cautious. The biggest risk in the market exists there rather than in the mid and small cap space.”

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What is happening with the market? The Fed claims that inflation is transitionary and they continue to see interest rates low until 2023. What does that indicate for equity markets?
I really woke up with a good laugh when I heard the Fed saying that we will do two hikes in 2023 or something. Who knows what is going to happen in 2023! I have been a Fed watcher for a very long time. We as a firm have watched the Fed for good 20-25 years and we have rarely seen them making a lot of sense. Right now, the way they are reacting to the data is the way any policy maker would. They are saying we understand there is a problem in terms of inflation but the economy is obviously not completely out of the woods. We cannot take a risk by raising rates and so we will keep talking in nice soothing voices and say that we will remain easy for the next couple of years. But hey! We are the Fed, we are very cognisant of inflation and we will give you two hikes at the end of 2023. That is the biggest piece of nonsense I have heard for a long, long time. It made me laugh.

The only thing here is that the US Fed has moved up the timing of the rate hikes because of inflation fears. What could that mean for inflation markets? Are we due for a fall after a great run of almost a year and a half now?
Markets in India and everywhere else are looking for a reason to correct. The reasons can come from any source and the Fed has given some reasons to at least merit a correction. So, when the market has run up so much, for no good reason it can simply have a correction and the Fed has given ample reason for it to correct 2% point which is okay. We have moved up 100-120% from the lows of last year and should be prepared to give up 5-10% in a correction. The markets have run up and I am not talking about India per se. I am talking about global markets. I would not be in the camp that believes that there should not be any correction or there cannot be any correction. We will get it and the Fed has only come as a catalyst for that particular market move to happen.

That said, as far as India is concerned, things are pretty okay at least for the wide market. For the narrower end of the market which is let us say **banks and financials**, we have not liked them for the last one year and even last year, CY2020, Bank Nifty was flat even though the broader market was up 12-13% and this year in continues to be the big laggard in the overall market. That is a space which will cause more worry than the mid and the small caps. The latter is a space easy to get into but almost impossible to get out of.

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If the bull market is like a train journey from Churchgate to Kandivali, where do you think the bull market in India has reached?
I think the bull market started last year and let me explain why I think we are in at least a two-three year kind of bull market with correction notwithstanding and the reason for that can be found in my 'lake of returns' theory. The 'lake of returns' theory is that markets are like a giant treasure bar of a lake in which a period of very low returns means low rainfall and the water level has really fallen. From that point, because of some good monsoons or whatever, the water level begins to rise.

The Indian water level in terms of **stock market** returns is at the bottom end of the lake. In 2008 January, Sensex was 21,000; today it is about 50,000-52,000 and the change in CAGR is only 6%. There is a recency bias at play here. They are thinking it has been a very strong market but the reality is that it has not even given FD returns. Plus, of course the volatility is factored in. It is worse than FD returns and therefore the reservoir of returns is very low and it will reach a more saturated level when we are going to compound at may be double digits for the next two-three years to take the low returns level back to bull market territory. That will mean 15% long-term returns and at that point we will be overflowing and go back into a cyclical bear market. That is my broad thinking on markets.

We are at the bottom end of returns. We are beginning to fill up and so let us not get too hasty in calling the end to this strange journey. I think we are just getting started. After nearly 12-13 years of very low returns -- from 2008 till 2020 and just a 6% CAGR -- it needs to go up to 15% which means we will have to go up 15%, 20%, 25% in the next two-three years on a CAGR basis for us to meet that 15% long term trend line of Indian equity returns.

Where do you think the leadership in this bull market is because at the same time last year, it was with pharma and right now it is PSUs which are making a comeback. Right now, it is a sectoral rotation but ultimately a big leader will emerge in this bull market?
The big leader is a collection of small leaders. In the midcap and the small cap space, we are seeing the emergence of several good companies. I say this with a lot of caveats because in mid and smallcap space, there are always nasty surprises around the corner. Hopefully these promoters have learnt their lessons from the previous several misdeeds that most of these guys commit with the hike of a bull market.

The market leadership clearly belongs to mid and smaller companies rather than the big caps and even a large company like Reliance which obviously will not be able to move as nimbly as a smallcap stock or a midcap stock. Those are good index positions to keep but not necessarily where you are going to make a 100%, 200% returns. I do not think you are going to make those returns in the larger end of the market.

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The same time last year, the buzz word on the Street was only Ambani. Right now, it is only Adani NSE 8.76 %. What is

going on?
We own Adani ports in our PMS, which has done very well for us. It is a good solid business and we have not bought it because we thought the stocks were going to double or triple in three months' time. We just think it is a great place to be in and by the way we have owned a lot of ports elsewhere in the world also. So it has been part of a larger understanding of where that business is going globally. The current news which is making the prices come down is just a reason for these stocks to correct more than anything fundamentally being wrong with them. You could have argued that Adani stocks were overvalued even six months or eight months back or even four months back. These debates are endless. I think markets were looking for a reason to correct them. We have found a reason and they are correcting.

I do not have a strong view on whether they will go back into bull market territory or not. But I am a personal admirer of Gautam Adani. I think he is a great entrepreneur and a lot of the news and a lot of buzz is callous. As far as Gautam is concerned, what he has achieved is not easy to build with or without government support.

Are you fully invested in the market at these levels or have you already taken profit and kept some powder dry for a meaningful correction to play out?
Generally speaking, we remain fully invested. We have a bit of cash, 3-4% or something like that, nothing very meaningful. We just wrote a letter to our investors yesterday that in fact our performance gives cause for concern because we are up 34% year to date which is 2.5 times the index and rather than dancing in the aisles, we are more concerned because these kind of numbers should make any sensible manager become cautious rather than delirious.

We are thinking cautiously which means that among some of the more high flying names, one has corrected and one has been trimmed a bit. But we have not raised cash or anything of that sort. I do not think we are going to go into a bear market but we will definitely see a correction without any doubt.

If indeed that correction comes a) what would you want to buy more of; and b) where is it that you think you need to tread with caution?
I think the ones that have flown that high are the financials and that is where one needs to be cautious. I do not think it is going to be a large-scale decimation in the better companies in the mid and small cap space. They might correct 20% in a week. We have seen that happen over decades but I think the genuine problem area for the markets are in the banks and the financials and the tape is telling the story that all these stocks have flatlined for roughly a year.

In a lot of ways, it is similar to Nasdaq and I must at this point mention a very important thing. If you look at the high flying stocks of the years prior to 2020 -- Facebook, Amazon and Microsoft -- for the last eight, nine months they have done zero. Apple was 120-125 bucks in August September last year; it is exactly the same now. It is almost like **HDFC Bank** NSE 0.93 % which is at Rs 1,400-1,450 for the last seven, eight months.

After the first rush of the rally which happened in March, April, May, it has just been flat and so are the other banks. So banks and financials are where one needs to be cautious. The biggest risk in the market exists there rather than in the mid and small cap space. That is like 40% of the index still and if they come down by 20% or 10% or 15%, you are automatically looking at a 5-7-8% cut in the Nifty just because of a large weight correcting a bit. So that is the potential risk in the market.

You also are a big believer of mean reversion, where do you think this market now needs to revert to the mean?
I told you bank and financials are way on the higher side of the V. They are not a great business by any stretch and the one truthful guy in that whole space is Sanjiv Bajaj and he has been cautious. He has told us that he is not seeing the kind of traction that the stock price appears to have shown the rest of the market and there are challenges on the poor business spread and I believe the Bajaj Group. They do not mince words, they do not try to manage stock prices, they are very honest in what they say. Therefore, if he says so and he is the marquee lender in the business, then I tend to believe that the real economy will still not support a large scale credit growth.

This again tells us that it is a big area where all the banks made money, but nobody made money by financing bridges and ports in India. I mean everybody loses money in the PSUs. So with that knowledge, the reversion to the mean will happen on the way down for the banks and financials. Obviously the metals were way below mean on a long term basis and they have gone up. It is like a giant wheel; the things at the bottom have gone up and things at top which were banks and financials which were stellar performers till 2019, will start to correct downwards and we are already seeing that. This year they have been laggards, last year they were laggards. I think the data in the tape is pretty conclusive on that.

The other powerful cycle which is at play is commodities. In today's digital and connected world, do you think the commodity cycle will be as powerful as the last commodity cycle or will this be a short lived one?
It is my belief that markets are very short term and do not have five-year moves. So I take one year. Last year, our view was that because of the dollar weakness and kind of structural deficits the US was running which was 35-40% of GDP on both the internal and the external, you would see a weakness in the dollar and if you have that then commodities will rally. So we bought steel back in May and June last year itself. We bought copper a bit later, both in our global and in our Indian products. They have done phenomenally well for us. But remember one thing that all these commodities are still just reaching their prices which were there in 2005. It is not that they have gone into a bull market in an absolute sense.

So copper was 4-4.5 bucks in 2005-06, oil was 60-70 through 2004-05-06-07-08 and even higher in 2008. You can take aluminium, lead, nickel, soft commodities and agri commodities which have rallied from the lows. In 15 years, they have not delivered any real returns and therefore if one were to believe in the theory that ultimately things revert to the mean, their mean is not negative real returns over 15 years, their mean might be like plus 2% odd or plus 4% real returns.

If you work with that number, they still could go a lot higher. It is the same, the 'lake of returns' was very low, the lake has started to fill up.

We are thinking it is a flood but it may not be close to flooding levels yet. We own a bit of these stocks in our global and India portfolio. They have done very well for us. So far, the trade seems intact but we will turn on a dime and things change tomorrow. As of now, they have done nothing for 15 years so they are due for some absolute good performance and we are seeing just the beginnings of it right now.

How should one anchor the portfolio for the next six or 12 months? Align to weakness in the dollar or is the dollar now due for a rebound because the short dollar trade is more like a consensus trade.
I think a short-term uptick is possible in the dollar and also most emerging markets have raised rates. India is the only exception. So most emerging markets are raising rates which should then put a cap on the dollar rally versus emerging markets. Russia has done it, Brazil has done it and others are making noises. They will get there.

If that were to happen automatically, we may not see a big rally in the dollar against these EM currencies which means that 91-92 on the DXY might be pretty much where it ought to be trading at. I do not think the dollar will remain or will go strong. It might have corrected a bit from the big crash it has had in the last 12 months but I do not think you are looking at a bull market in dollars anytime soon. If that thesis holds, broadly you should see reasonable strength in commodities again with caveats in place.

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