Interest Rate Cycles and Equity Valuations

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Warren buffet famously said that 'interest rates act as gravity for stocks' or in other words as interest rates rise they result in contraction in equity valuations. The above adage has been the most relevant factor driving capital markets over the past one year as major central banks began increasing interest rates. The initial signalling and rate hikes were an attempt to reverse the period of ultra-accommodative monetary policy or QE (quantitative easing) which they embarked upon post the advent of covid. However, the Russia-Ukraine conflict in March 2022 added a completely new dimension to the rate hike cycle which spooked capital markets.

The aforementioned conflict resulted in a spike in commodity prices across the board which included the most essential crude oil and gas, metals (steel, aluminium etc) along with food prices. Environment of a global spike in commodity prices and resilient demand in the US and other developed economies post the lifting of covid restrictions resulted in an unusually high inflation print which spooked central banks resulting in an aggressively hawkish stance. Narrative drifted to a likely repeat of the 1960s-80s type of environment wherein an unfettered inflationary environment resulted in the US bond yields rising to an unprecedented mid-teens level. This resulted in lost decades for US equities wherein the market compounded at less than 1% for two decades. Such fear and pessimism fed into equity valuations which resulted in the NIFTY50 one year rolled forward P/E contracting from around 23x on Oct'21 to a low of 17x during the lows of June'22.

However, the 1960s-80s type of structural rise in bond yields argument weakened as commodity prices started showing signs of reversing. Global commodity prices across the board started declining along with freight rates, which weakened the structural inflation argument due to commodity prices. Also, the feared wage-spiral conditions appear unlikely given the softening outlook for job market going ahead as growth moderates and fear of a recession in developed markets such as US and Europe get stronger by the day.

Although CPI inflation in the US has not yet started to decline, the equally important core PCE inflation continued to dip, while US 10-year bond yield dipped sharply to below 3% after spiking to almost 3.5% in Jun'22. India CPI also showed signs of slowing down. Even as inflation is slowing down, the high frequency indicators such as GST collections, PMI numbers, export growth, core sector growth and Q1FY23 results declared so far indicate that demand is robust.

Activities related to gross fixed capital formation and manufacturing showing robust demand, but cost pressure impacts earnings. Infrastructure, capital goods, construction and building material demand robust. Robust volume growth shown by cement companies, strong order book growth infrastructure majors and rising power demand indicates improving construction, industrial and capex related activities. Building material and real estate companies also provided strong in line Q1 results. However, cost pressures dented profitability for most companies. Oil & gas showed robust growth on record high GRMs which have reversed (sharply lower) in Q2FY23 and will, therefore, keep earnings muted going ahead. Metals have delivered better-than-expected results although absolute growth slumped on declining realisations and cost pressures. Chemical companies had a mixed quarter with some robust results and a few misses. Auto and ancillary companies have shown improvement in demand but raw material costs impact earnings growth. Unlike the fear of a slump in overall consumption demand, Q1 results for did not disappoint for consumer staples companies.

Normalisation of discretionary consumption demand in the contact-intensive areas of physical retail, entertainment, gaming and leisure as covid-related restrictions fade away. Q1FY23 results of retailers, cinema chain, spirits, hotel operators, QSRs indicate that post removal of covid restrictions, physical channels of retail sales, entertainment, gaming and leisure are returning to normalcy fast and the upcoming festive season could see strong demand patterns. Anecdotal evidence also indicates the rising demand trends observed across the physical consumption channels like malls, cinema, tourism etc. However, higher input cost including power and fuel cost, plus rise in employee cost impacts earnings.

Most lenders have indicated advances growth between 3% and 5% QoQ so far which corroborates the rise in overall non-food credit growth of scheduled commercial banks of around 12% seen in Q1FY23 so far. Fortnightly data available for July'22 indicates credit growth has moved up further in Q2FY23 to reach the 14% mark. There is a hint of rise in GNPA QoQ although overall it remains under control which is also evidenced by lower credit costs.

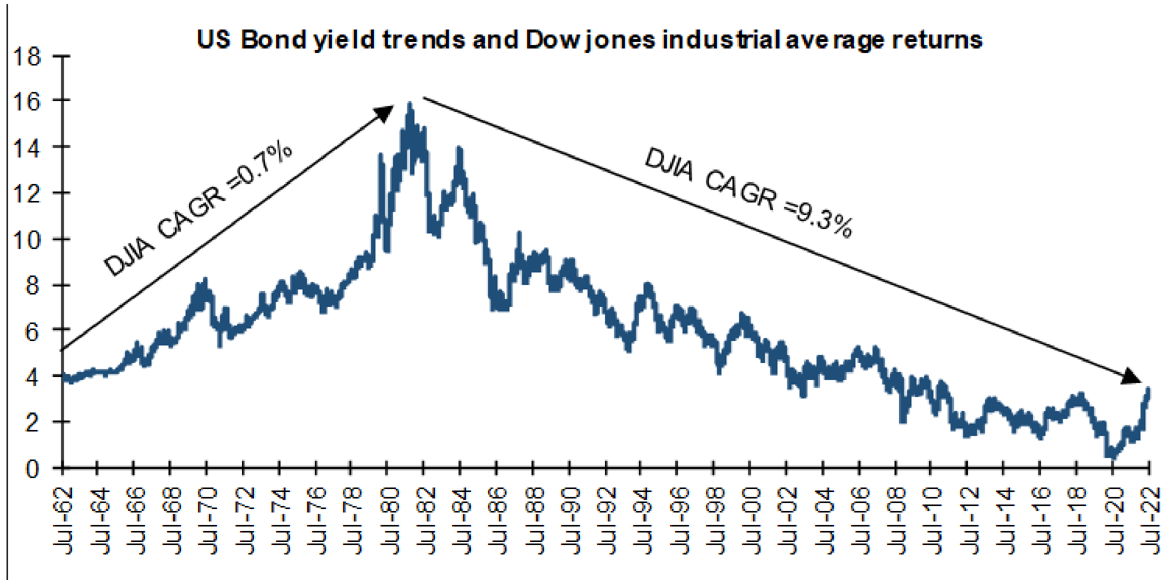
Software exports demand robust although cost pressures impact earnings. Most IT services companies have declared in line or better than expected topline growth indicating demand environment remains robust although cost pressures driven by higher attrition impact earnings.

Overall, Q1FY23 results so far has been the better than expected topline growth (+30% YoY for non-financials) driven by not just a favourable base effect but better-than-expected volumes as well as price realisations. On the flip

side, EBITDA and PAT growth have lagged due to cost pressures across the board. Financials on the other hand are exhibiting improving topline growth (NII growth) as well as PAT growth driven by lower credit costs even though other operational expenditure remains elevated.

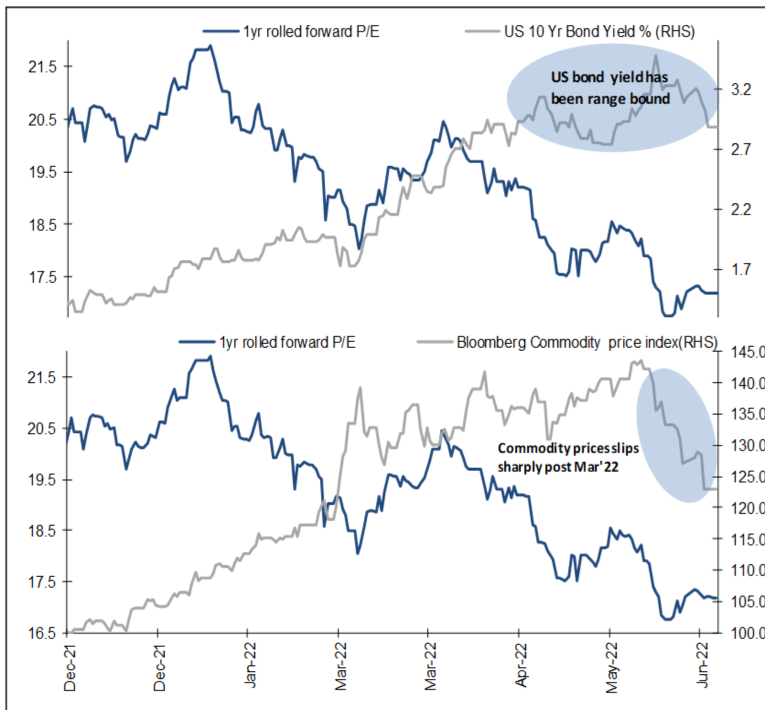
As equity valuations find a floor after the stabilisation of bond yields at a much lower level than originally expected, the sharp drop in commodity prices seen across the board in recent times could tilt the scale going ahead towards improving profitability for non-financial companies, if the robust demand pattern persists and input costs slump.

Chart 1: Fear of a structural rise in US bond yields like the 1960s-80s drive equity valuations lower



Source: Bloomberg, I-Sec research

Chart 2 After spiking in Mar'22 on war fears commodity prices have fallen sharply while US 10 year bond yields have been range bound



Source: Bloomberg, I-Sec research

Note: Bloomberg commodity price index has been reset to 100 at beginning of Dec'21.