

This Too Shall Pass

The ongoing US-Israel-Iran conflict continues to dominate global headlines and our Mindspace.

In such times, narratives dominate our thinking and often create panic / anxiety. There is a need to step back and evaluate the impact through a rational and long-term lens.

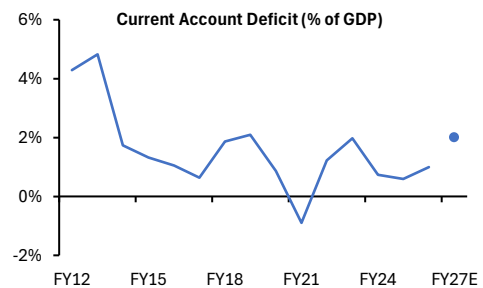
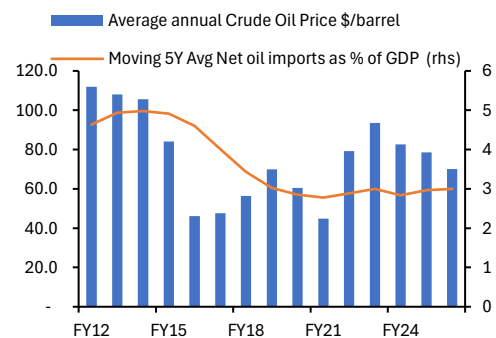
History tells us that conflict is as old as civilisation. The current conflict is neither the first nor the last one. Ironically, the first documented war in human history is generally considered to be the Sumer-Elam war in 2700 BC in Mesopotamia (modern day Iran and Iraq). While the long-term impact of conflicts on the warring countries has ranged from marginal and transient to debilitating and permanent, impact has generally been low and transient for the rest.

The impact of the current conflict is marginal and transient for India in our opinion. The only meaningful impact is because of higher prices of crude oil & gas and a disruption in availability.

India's vulnerability to oil has considerably moderated over time. Oil imports as a share of GDP have declined from over 5% in FY2013 to 3% currently. This along with rising services exports have played a key role in moderating India's Current Account Deficit (CAD) to nearly 1% compared to 2-3% in the past.

Indian economy displayed remarkable resilience even when oil prices rose from USD 25/bbl in 2000 to USD 140/bbl in 2008. The real economic growth during this 8-year period averaged ~7% p.a. !

Oil prices averaged around USD 70/bbl in FY26. While it is tough to forecast oil prices especially for next few quarters, even if they average USD 100/bbl for the entire FY27, India's oil imports would rise by USD 45-50bn, (~1% of GDP). Other things remaining the same, CAD would rise to nearly 2% from ~1% in FY26. This is quite manageable at least for a year or two given the Foreign Exchange Reserves of USD 700bn.

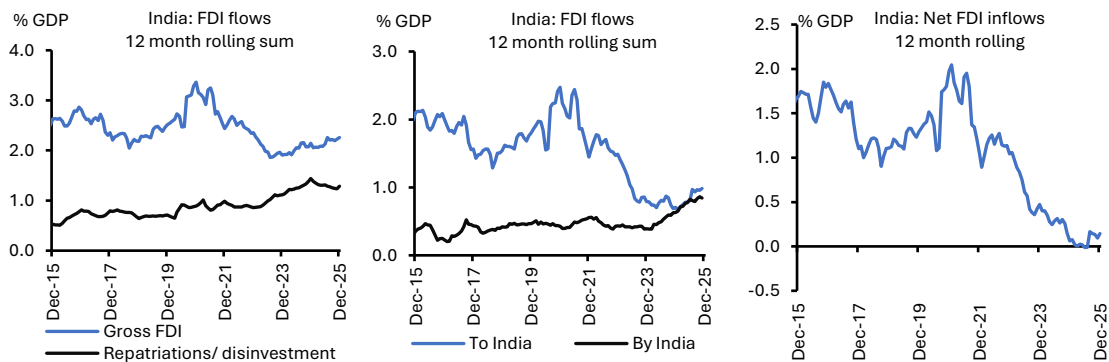


Source: RBI, PPAC, 3PIM.

The 3P way. Simple but not easy.



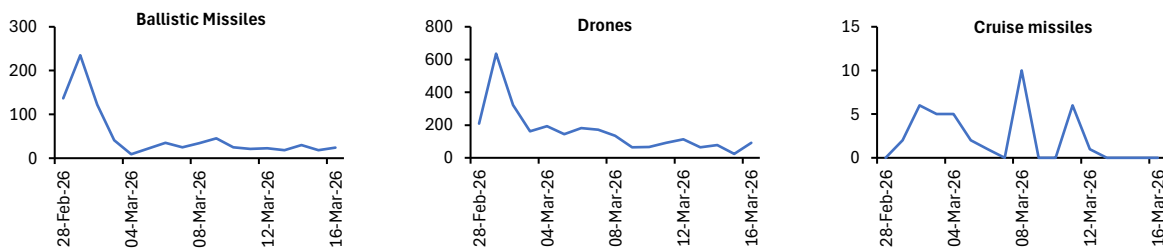
The impact on Balance of Payment (BOP) is likely to be even lower. This is because, the last two years have witnessed a spike in stake sales by Private Equity and MNCs in their investee companies and their Indian arms respectively. This has sharply increased the repatriation of FDI from India. Given the current market conditions and a sharp fall in interest in participation in such issuances (2 out of 3 are under water), net FDI that had fallen to NIL in last two years should improve. India could potentially save around 0.5-0.7% of GDP (USD 20-25 bn p.a.). The spike in outbound FDI could also moderate given the uncertainty and weakness in capital markets. These two would offset the increase in oil import bill substantially thus moderating the impact on BOP.



Source: HSBC, RBI, 3PIM.

How long before the guns fall silent

The reader would agree that when the authors of this note have no ability to forecast near term market movements even after 35 years, they have no ability to opine on the conflict. Yet the fact that the military capabilities of the warring nations are not comparable, the sharp fall in daily launches of missiles and drones by Iran and the common interest between Iran and USA of keeping the oil flowing albeit for different reasons suggest that this war should not last long.



Source: Bloomberg Economics. Note these are daily launches on Gulf countries

Iran's economy is approximately USD 450 bn in size. It is heavily reliant on oil exports (USD 50-60 bn revenue) for foreign exchange and for government revenues. Any sustained disruption in oil revenues could therefore be catastrophic. On the other hand, USA and other consuming countries clearly want moderate prices and a well-supplied market. This congruence of interests should in

The 3P way. Simple but not easy.

1P
Prudence of creating a portfolio of sustainable and reasonably valued businesses.

2P
Patience with businesses and markets. Risk in equities reduces as investment horizon increases.

3P
Performance is the outcome.



our opinion discourage the warring countries to not attack oil / gas fields and supporting infrastructure. With Israel claiming that Iran's nuclear and missile capabilities have been marginalised, focus should shift to oil and to flow of oil through Strait of Hormuz.

US has taken / suggested the following steps in this direction

- Removing sanctions on Russian oil for 1 month
- Deliberating temporary removal of sanctions on Iranian oil stranded in tankers
- No more attacks on oil infrastructure
- Naval escort of tankers through the Strait of Hormuz

Iran has also commented that they would allow Non-US / Israel tankers to pass through Hormuz.

Equity markets - Is the pain priced in

Nifty has declined by ~12% from the 52-week high. Indian markets have also seen a time correction of 18 months. This time and price correction in the markets has lowered Nifty valuations by 20%.

Nifty Index has low exposure to companies that have direct impact of higher crude and gas prices. Impacted sectors like OMCs, paints, ceramics, CGDs, autos, airlines, cement, food processing, etc are a relatively small part of NIFTY / markets. Further, in most of these sectors the impact would be transient as higher input costs would over time be passed on to consumers. It is also pertinent to remember that equities are a hedge against inflation as companies' revenues / earnings tend to grow faster in line with inflation.

The prevailing valuations of Nifty of 17.5x 1-year forward earnings are reasonable and have room for some rerating apart from returns driven by nearly 12% earnings CAGR over the medium term.

Even from a demand supply perspective there are reasons to be optimistic. While the popular refrain is when will the FII flows come back, in our view it matters little. This is because primary markets have been a large source of supply of stock. With nearly 2 out of 3 issuances under water, in our opinion the capital that will be raised by such issuances will be sharply lower in the foreseeable future. This means that bulk of the flow of equity capital with DIIs should get deployed in secondary markets.

FII selling has seen a massive spike in last month (USD 8.4 bn). As and when the war situation / oil markets stabilise, it is reasonable to expect this selling to stop / moderate. Sharp underperformance of India vs other EMs in last year, normalisation of India's premium over EM's, underweight positioning of FIIs, the size of India's economy, strong growth prospects and strong macros should encourage FIIs over time to not just not sell but to buy.





3PIM INTERNATIONAL
(IFSC) LLP

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Conclusion

Indian economy is well placed and is in a strong position to manage the impact of a rise in oil / gas prices. Impact on corporate profits should also be marginal and transient.

Capital raised by primary markets should be sharply lower in the foreseeable future. DII flows are large and sustainable and should largely get deployed in secondary markets. These should absorb any FII selling.

The 18-month time and 10-15% price correction in large caps and higher correction in small / mid-caps has created room for some rerating over time. Expected earnings growth of 12% CAGR is in any case a strong tailwind for markets and returns.

Markets thus offer a favourable risk reward over time. Investors should in line with their risk profile evaluate increasing exposure to equities, preferably in phases over the next few weeks.

We would like to end with the words of Warren Buffet

It is better to be approximately right than be precisely wrong.

Warmly,

For 3PIM International (IFSC) LLP

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Vice President – Investments

“The war will end. The leaders will shake hands. The old woman will keep waiting for her martyred son. That girl will wait for her beloved husband. And those children will wait for their heroic father. I don’t know who sold our homeland. But I saw who paid the price.”

– Mahmoud Darwish

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