July 2022

Nepean Long-Term Opportunities Fund II

"I said they're storm clouds," Dimon warned. "They're big storm clouds here. It's a hurricane [and] that hurricane is right out there down the road coming our way. We just don't know if it's a minor one or Superstorm Sandy."

- Jamie Dimon, Chairman & CEO, JP Morgan Chase, June 2022

HIGHLIGHTS FROM MY U.S. VISIT:
I spent the last 4 weeks on the East coast, mainly in Boston and New York. This was my first visit in over a year and I observed the following trends that are impacting the US and as a result, the rest of the world:

- **Inflation is real and in your face** and there's no escaping it. Right from a cup of coffee to UBER rides, hotel rates, groceries, eating out, etc. In all my visits to the US from the time that I studied in California, I have never seen it so expensive.
- **Labour shortages** are very visible in the US.

The housekeeping maid at my hotel in New York said that she used to work at a doctor's clinic that paid $18/hour, but now prefers working in the hotel as **they pay her as much as $30/hour** ! Other hotels that I stayed in couldn't afford to service the rooms every day and could only do so twice or thrice a week. Below is a notice from one of my hotels:

During this visit, I met a cross section of US investors and financial intermediaries whose views I have summed up below:

- Inflation is the #1 issue in the US today. **The first 175 bps in rate hikes by the Fed seem to have had no impact on inflation.** Therefore, the Fed has no choice but to increase rates and the US seems to be headed for a period of stagflation.
- Most investors were glad that new Tech valuations were finally seeing a massive correction and no one seemed to want to buy into the fall. In the Private markets, down rounds have begun and they expect more will follow. Hedge funds and crossover funds that took bets in private markets have been badly bruised.
- Stocks with low hedge fund concentration (YTD -14%) did much better than those with high hedge fund concentration (YTD -24%).
- Of the original BRICs countries, the interest in Brazil and China is tepid; Russia is out of bounds. **Hence, on a purely relative basis, India does look better** *but* there's no appetite *currently* to invest in any EM.
- Passive funds continue to attract more funds (by a mile) than active funds.
- US funds have lost a lot of money in China, *especially in China Tech*. While most funds were disappointed with China, some did admit that valuations are starting to look attractive.
- The one question that came up was why are all emerging markets bundled together as an asset class called EM ? For example, issues impacting Mexico are not the same as those impacting India or Indonesia and vice versa. Hence, when global funds go risk-off on EMs, it unfortunately impacts the entire universe and they do not distinguish between a stronger country and a weaker country.

VIEW ON THE EQUITY MARKETS:

While the YTD Performance of various Asset classes is mostly negative, India's benchmark index, the NIFTY50, has done relatively better than the US markets.

Crude Oil	+55%
Natural Gas	+45%
Gold	-2%
10 year US Treasury	-11%
NIFTY 50 (in US$)	**-16%**
MSCI Emerging Markets	-17%
MSCI Developed Markets	-20%
S&P 500	-21%
NASDAQ 100	-29%
Bitcoin	-58%

Asia (ex-China) has seen over $111 Bn of net foreign portfolio investor (FPI) selling since January 2021, surpassing the $93 Bn of selling witnessed during the GFC. YTD China has seen $10.6 Bn of FPI inflows. The FPI selling has to a great extent been offset by retail buying in India, Korea and Taiwan. YTD in 2022, these 3 markets have seen $51 bn of domestic buying thereby absorbing much of the foreign selling. This year India ranks #2, after Taiwan (-$33.2 Bn), in FPI selling. **In fact, the current FPI selling in India is the largest peak-to-trough selling in the country's history. Also FPI ownership is now at a 9 year low of 21.6%.**

Since the peak in October last year, the Indian market has been in correction mode with over **$40 Bn in FPI selling; that's 2.7x the $15 Bn sold during the global financial crisis**. The $29 Bn in FPI selling this year (the month of June alone saw $6.4 Bn of selling) has been offset by $30.7 Bn of domestic mutual fund buying.

We believe that the Fed will do whatever it takes to clamp down on inflation in the US, but its impact will be felt all over the world given that globally the US Dollar remains the reserve currency. **EMs and India are collateral damage of the Fed's interest rate hikes**. In fact, the Euro has just hit a 20 year low against the strengthening US dollar. Hence, in India, if the RBI doesn't keep step with the Fed in raising rates, the INR will depreciate even faster than the 6.25% fall we have witnessed so far this year. This in turn will add to the already high imported inflation. Higher interest rates in India have two major impacts:

1. Higher financing costs for corporates and retail alike
2. Equities start to become less attractive as fixed income yields rise

India has been and remains the most expensive market in Asia trading at 18.3x CY2023 P/E vs. 11.6x for Asia (ex-Japan), 11x for China and 15.8x for the S&P500. Having said that, India does have one of the highest earnings growth estimates for next year at 14-15% vs. an average of 10% for EMs.

While the headline NIFTY50 has fallen 10.5% in local currency terms (but 16% in US$ terms), individual stocks have fallen significantly more. Analysis of the **BSE500 universe** reveals:

- **148 stocks have corrected 40%** or more from their respective 52 week highs
- **370 stocks have corrected 20%** or more from their respective 52 week highs
- **Hence three-quarters of the BSE500 stocks are in a Bear market**

The S&P 500 and the NIFTY 50 this year (in local currency)

CONCLUSION:

1. While we continue to look for stocks that have triggers, the high cash levels that we have maintained for the past several months gives us the ability to pick stocks that have seen major corrections.
2. While the price of Oil falling below $100/bbl is positive for India, it does not reflect any improvement on the supply side but instead the increased risk of recessions in the US and Europe.
3. The one caveat is potentially a sudden end to the war in Ukraine. This will help further reduce commodity led global inflation and which, we believe, will prompt the Fed to scale back on rate hikes.
4. **We sincerely hope that the *storm clouds* result in a minor hurricane and not a *Superstorm Sandy* !**

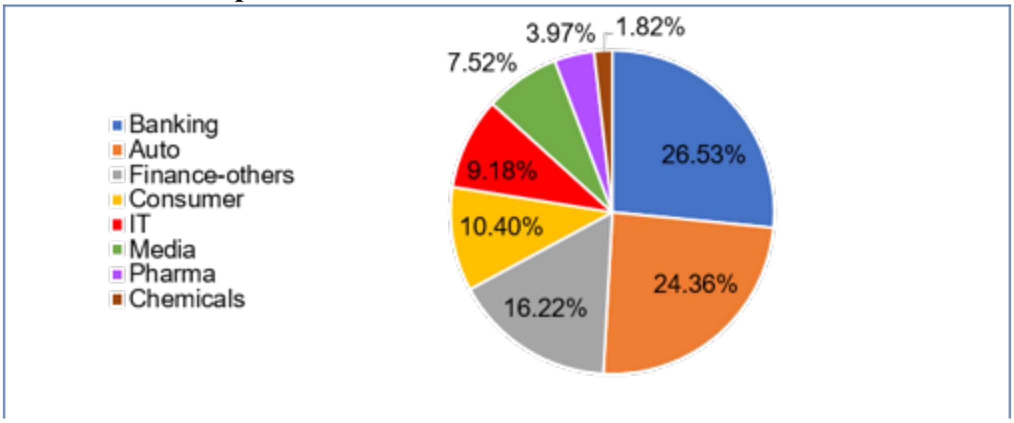
FUND PERFORMANCE (in INR, net of fees and taxes):

Performance YTD 2022			
Category	**Fund**	**Nifty 500**	**Outperformance**
A1	-2.7%	-10.7%	8.1%
D1	-2.3%	-10.7%	8.4%

Performance since inception (between Oct 13, 2021 and June 30, 2022)			
Category	**Fund**	**Nifty 500**	**Outperformance**
A1	-3.0%	-14.4%	11.3%
D1	-2.4%	-14.4%	11.9%

A1: Investors via Distributors
D1: Investors who are Direct

Sectoral Break-up of the Portfolio:



STOCKS ADDED IN THE PAST QTR:
Bajaj Finance (BAF IN)
Bajaj Finance is undergoing an immense fintech transformation. Its first business transformation over the past decade has built a formidable customer franchise of >50mn customers with the most innovative product offerings, and this second transformation will

build an omni channel ecosystem offering frictionless movement of customers from online to offline and vice versa. We believe this will result in a sticky customer profile as the company embarks on its journey of acquiring another ~50mn customers over the next 4-5 years, half the duration of the first 50mn. With an outstanding management and strong data mining capability, we believe it will aggressively grow its digital capabilities as it enhances its share in customer wallets. Trading at ~5.3x FY24E P/B, we believe the recent FPI sell off has provided us an attractive entry point in India's #1 NBFC.

HDFC Bank (HDFCB IN)
The recent sell off on the HDFC-HDFC Bank merger news has provided us an attractive entry point into one of the most formidable banking franchises of the country. The merger, which will take another 12-15 months to consummate, is likely to produce a behemoth in the financial services industry with a balance sheet size of Rs.27 Tn/$35 Bn and a combined market cap of over $150 Bn. We see positive strategic intent in the merger and believe that the merger will be value accretive as a) overall cost of funds decline b) enhanced share of mortgage portfolio would result in capital release c) will offer the opportunity to underwrite large projects as govt. infra spends pick up. With the stock trading at ~2.3x FY24E P/B, below its 10-year mean, we see limited room for downside and believe the merger synergies offer strong optionality to the stock.

Varroc Engineering (VARROC IN)
Varroc is a global tier-1 automotive component company with end-to-end capabilities across design, R&D, engineering and manufacturing. The company's principal business is in the design, manufacture, and supply of a wide selection of auto components in India, primarily to 2-wheelers and 3-wheeler OEMs, including exports. This diversified set of components ranges across three product lines: polymers/plastics, electricals/electronics, and metallic components. Varroc recently sold its loss making American & European businesses for $631 Mn. With this sale, the company is now debt free and management is refocusing on its core India business which we believe will result in a turnaround in both profitability and ROEs.

Motherson Sumi Wiring India (MSUMI IN)
Recently listed following the reorganization of its parent Motherson Sumi, MSWI is a leader in the wiring harness space catering to automotive and mobility OEMs operating in India. It is a JV between Motherson Sumi and Sumitomo Wiring Systems. The company provides supply solutions for a variety of vehicles ranging from PVs to CVs and operates through 23 manufacturing and technical centres across India. Growing at 25+%, with a debt free balance sheet and an ROE of 50%, it is a superior play on the premiumization of the auto ancillary industry in India.

MEDIA:

CNBC India (English): https://www.youtube.com/watch?v=24bonPan94Q
CNBC Awaaz (Hindi): https://www.youtube.com/watch?v=nyM5K6WkGeg