



## Build-up of asymmetric risks

*The shock absorbers that the market usually banks on are weakening.*

- 1. The domestic fund flow into equities fuelled by seemingly resilient retail investors has distorted the price discovery mechanism in the market. While the Nifty is trading at close to the five-year mean on headline valuations, this masks the risk of downgrades which look all but certain. There is no margin of safety in Indian valuations unlike the last few occasions when macro-shocks slammed into India. In mid/small cap space, the situation is revealing. The midcap indices trade at about 33-36 times trailing earnings, a big premium to the Nifty valuation. The small cap indices trade at similar or higher valuations. Are they having a superior defence against a macro shock that we are up against? The answer is in the negative. Apart from the fact that these asset classes are vulnerable to shocks in all economies, the characteristics of India's mid/small caps make it doubly difficult. They derive their demand from government capex or the extra fillip from consumption. Many are financials whose cyclical nature has been downplayed. The new age businesses who are disruptors have not yet shown consistent ability to make meaningful profits. We cannot see companies that have any IP or even technology-based barriers as a key moat. Indian Mid/Small caps have seen earnings accelerate after Covid from the K-shaped recovery in the economy. But it is the liquidity surge into MFs that have given them their valuation premium. The set-up is not primed to handle the discontinuity that we are witnessing. The impact on earnings is being underestimated by analysts even as funds continue to pile up on these stocks, now encouraged by the relative out-performance since end March, which skews the situation even more. While large caps have been sold down by FIIs, the mid/small caps do not either offer the exit liquidity or are not held so widely by FIIs. The market is losing a key shock absorber by way of proactive pricing discipline.*
- 2. We have touched upon the froth in the IPO market. The way this has panned out is nothing short of alarming. The price discovery mechanism in the pre-IPO stage is so opaque that all we can see from DRHPs is that the prices have been bid up in the immediate few quarters before the IPO launch. The ridiculous manner in which peer comparisons on PE multiples are disclosed tell it all. The sub-segment price multiples are often at 50, 60 or 70 times justifying a discount to this as enough of an incentive. The performance of IPOs that listed in the last 3-4 years shows that the post-listing performance has been lacklustre for many high-flyers. But no one seems to care. The retail liquidity into funds is absorbing the issuance, much of what is offer for sale. While promoters and strategic investors are exiting, retail is buying. There is no better example of asymmetric risks building up.*
- 3. The price adjustment in the economy by way of fuel price pass through has been insufficient. We will explain the market impact of this but once again, the result is the same – the market is pushing itself towards the precipice.*
- 4. The ability of RBI to cushion any shock has been diminished as it has fired several bullets before this crisis started, aimed at reviving demand. The mayhem in the currency has essentially removed whatever elbow room it might have to counter the supply shock which is becoming a hydra-headed menace that threatens to set in motion a vicious cycle of demand destruction following supply issues.*
- 5. The traditional defensive sectors in the market such as FMCG have been so expensive that they are not offering any safe haven. The other candidate, IT services, is facing structural challenges. While financials are overhyped (but reasonably valued), funds chase up any sector or segment that seems to offer half a chance. The envelope is being stretched and twisted.*



6. Financial stocks are offering exit liquidity to foreigners and are being sold down. They seem to offer valuation comfort. The bank balance sheets are at their best in over two decades. There is just one problem. Expectations are so primed that any rumbles on asset quality will not go down well. Banks always factor in some stress in their own models to deal with macro events such as the ones we are facing now. If the stress shows up, the banks can handle that. The market cannot digest this due to its positioning.

The above is not an attempt to build a bear case. In fact, we have made this point that the market has digested a lot of adverse developments over the last couple of years. Normally, we would want to believe that the bad news should have been in the price. It is the positioning of the domestic investors that call for a sobering thought.

Equities are viewed as a failsafe asset class. The response to any headwind is some advice to avoid leverage and extend the holding period till the outcomes you want to materialize. This is inconsistent with the basic tenets by which free markets operate. This is also inconsistent with the historic parallels elsewhere.

### The bitter pill in small doses

We do not want to wade into a discussion on the policy stance of the government. We will, however, focus on the market challenge that this policy entails.

Petrol Price change from Feb 23, 2026 to May 29, 2026	% change (\$ terms)	% change (₹ terms)
Pakistan	58	65
United States	43*	50*
South Africa	34	41
Vietnam	33	39
Sri Lanka	31	38
China	25*	31*
France	22	28
UK	19	25
Germany	10	15
Norway	9	14
Japan	7	12
India	3*	7*
Indonesia	1	6

Note: \* - For China, India, US Gasoline prices are as on Feb 27, 2026, to May 29, 2026.

Other Countries Gasoline prices are as on Feb 23, 2026 to May 25, 2026.

Source: Bloomberg, Media Articles, Spark Fund Research.

India has seen the shallowest price pass through of petrol price for any economy of substance. The preferred path of the government seems to be to adopt an incrementalist approach. There may even be a calculation to the effect that oil prices may come off thereby helping the government pass on just enough of the pain that is absolutely necessary. This choice comes with its own risks. The market has begun to assess this as a case of government writing an unhedged option on a favorable resolution of the oil crisis. The political premium it has collected seems to be the modest hit to the middle-class wallets but a heavy price is being paid by a risk that can prove very costly.

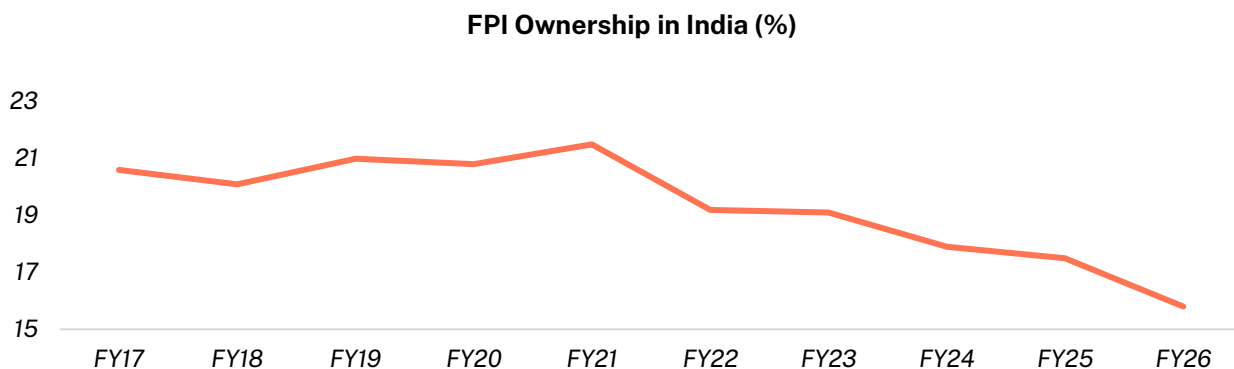


There are reasons why India believes it has the elbow room to postpone what looks to be inevitable. Some other EMs have been under the watchful eye of multilateral institutions. Yet others had limited forex reserves. India went into this crisis with what is generally believed to be excellent macros. While India's reserves at over 9 months of imports appear healthy and stand higher than in the past, some of the short-term obligations coupled with continued drawdown can result in quick deterioration. The feeling that Indian macros are in fine fettle can lead to complacency. The markets carry numerous scars from previous emerging market shocks. Every crisis in EM has seen the buildup of risks which were underestimated before it was too late. The foreign investors have seen this playbook before. This is one reason why they have been persistent sellers in India.

As the free market takes its toll through a brutal currency adjustment, the vicious cycle is already in full flow. There may be an argument that a steep price increase in petrol/diesel will affect prices of essentials which affect the poor. This could be optically true. But postponement of action does not save the poor and middle-class. In fact, experience around the world shows that early and decisive action contains the total cost and lowers the eventual pain from the bitter pill. The INR depreciation affects prices of other imports and is inflationary in itself. It has dented India's credibility as an investment destination as the stock of investments made in India for years has seen a brutal haircut. Savings of hardworking Indians has also been implicitly marked down, possibly forever. It leaves RBI with few options. RBI may likely need to raise rates at some stage to restore confidence.

### The FII exodus

This is not mere profit taking or a case of hot money going out. Look at the FII ownership trends.



Source: NSE, Ace Equity, Spark Fund Research.

While the resilience of domestic flows is a welcome change in India's ability to negotiate these waters, it would be imprudent to do chest-beating over this. The history of FII exits from markets that got into trouble is not encouraging. FIIs were sellers in Japan for two years prior to 1989 when Nikkei made a top from where there was a major crash. Japanese valuations were considered the new normal at that time when Japan looked invincible. The SIP equivalent were postal savings schemes in Japan and insurance companies which channeled domestic savings into Japanese equities. What followed was a market collapse and a nasty aftershock that went on for decades. Taiwan saw a similar retail meltdown wherein millions of trading accounts were opened in a euphoric rally which was followed by a brutal sell-off in late 1980s. China has seen deep gashes in valuations and a stock market that went nowhere for a decade. It is the institutional memory and accumulated wisdom that FIIs carry which explain their moves. A different take on this ownership transfer from FIIs to DIIs reveals a somber picture.



Cash Segment CY2021 - CY2026 YTD	Rs. Cr	NIFTY Weighted average of Exit/Entry
FII Net Selling	12,93,732	22,052
DII Net Buying	22,52,014	22,595

Cash Segment Net Inflows / (Outflows)	FII Rs. Cr	DII Rs. Cr
CY 2009 - CY2020	2,72,280	1,88,619

Note: CY2026 YTD- Data till May 29, 2026.

Source: Money control, Ace Equity, Spark Fund Research.

*This data gives a long-term snapshot and has interpretational limitations. The reported numbers, particularly in the earlier years, may not capture all the inflows into equities (QIPs, primary market and other possible data gaps and maybe some inflow was captured as FDI). But the scale of the numbers clearly brings out the fact that FIIs are cashing out from an expensive market. They have been patient sellers. What we see in the local narrative seems to glorify the maturity of domestic investors in absorbing this selling and then some more. This is being held out as Indian investors showing maturity and long-term thinking in persistent optimism on what is projected as a high-growth economy with unquestionable resilience. While there is a base growth in India that is broadly secular, the delta over that has been very cyclical. We need to stop and ponder.*

*In a sense, the flow picture represents a massive wealth transfer from middle-class Indians (who are fueling the MF buying) to foreign investors at large. The depreciation of the INR is in large measure due to the exit by foreigners which is being funded by retail Indian buyers who are unwittingly shooting at their own feet. We are unable to spot any Indian winners here.*

### **Jaywalking on the edge of a precipice**

*The build-up of risks leaves the market drifting closer to the precipice. The partial pass-through of petrol/diesel prices can work in India's favor only if the Iran war resolves in a manner wherein crude prices plunge back to below USD 80-85 in a short period and stay there. In addition to the several asymmetric risks that have been building up, there is the danger of SIP flows being viewed as a political hot potato involving the Indian middle-class savings. This will push India into a territory where an iatrogenic risk begins to loom large. This will be counterproductive for the economy, the political economy, the investors and the market. The market will look for decisive signs that the crisis is being countered with tough measures even if short-term outcomes appear to be unpleasant for the economy and for markets. This is a crisis that India did not create. The administrative management of the crisis has been exemplary. Indian action is not the root cause. However, India's status as a perennially capital-short economy with a soft underbelly does not help. If policy tries to downplay the impact, the market will continue to buy some insurance through a process of markdown. There is consensus amongst experts that India has enough resilience to avoid a crisis. A deterioration that does not qualify as a crisis can be bad enough for the market. And good enough to make a meaningful mean reversion in valuations a distinct possibility.*

**Warm regards,  
P Krishnan (CIO) and Team Spark Fund**

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