JST Investments

January 2021 – March 2021 (3M) Update

This is the second quarterly letter to our Investors. Our letters will provide an update on our portfolio performance and present our views on relevant topics.

Performance

Particulars	July 2020 to March 2021 (9M)	January 2021 to March 2021 (3M)
JST High Conviction Portfolio Return	59.4%	10.0%
Nifty 50 Return	42.5%	6.1%
BSE 500 Return	46.4%	8.0%
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A Message from our CIO

Respected Clients,

FY21 has been a big learning year for all of us.

The recovery in the economy has been much faster than anyone anticipated. The stock markets have risen even faster!

The relentless rise in the market has caught many by surprise - Lower interest rates; strong liquidity has meant a lot of money is chasing very few assets!

A commodity bull run led by supply side disruptions remains a massive threat to inflation as well as global growth.

The second COVID-19 wave is spreading fast and is claiming lives.

Therefore it is time to be careful. Be Mindful of the valuations. For us, it will be always Return of Capital >>> Return on Capital.

This is the reason why we at JST investments always concentrate on capital protection for our clients. As the markets move to un-reasonable valuations, we will not celebrate. We will remain cautious.

As we had advised in the last letter:-

When the market moves irrationally down, do not panic. When the market moves irrationally up, do not celebrate. Always be humble - There is a long way to go!

Best Regards,

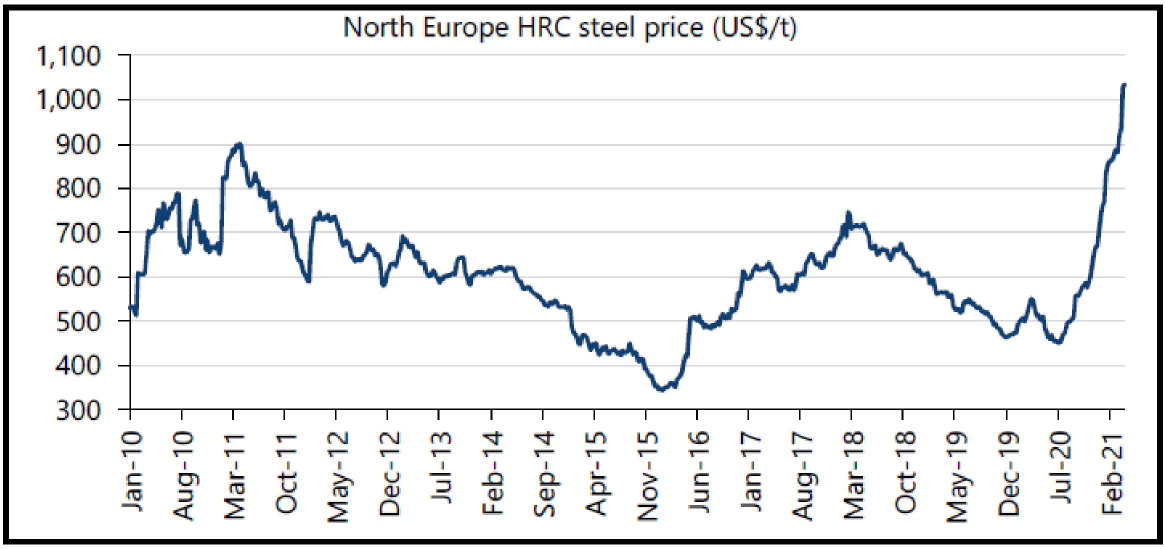
Aditya Shah, CFA

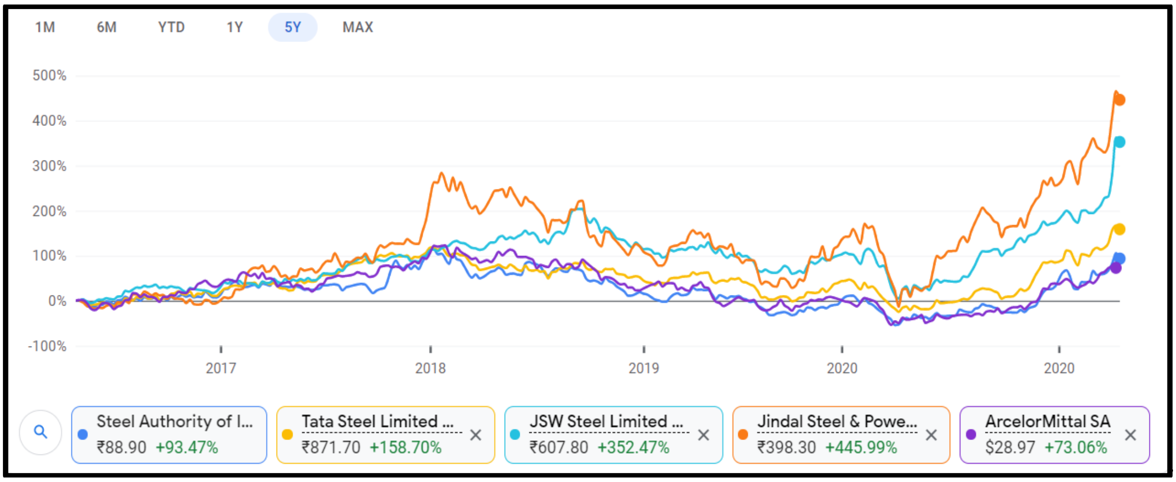
CIO, JST Investments

As is our tradition to educate investors, we present our hypothesis on what is happening in the steel sector!

The Steel Mystery

Steel prices & Indian steel stock prices are reaching all-time highs. Here's what you need to know.





Steel is the world's second-largest commodity after crude oil. It is 15 times the size of all the other metal markets combined in terms of metric tons and it is worth twice their value. It is used in the production of our roads, bridges, houses, automobiles, etc.

So, Steel is a global commodity that has similar pricing all over the world due to low transport cost compared to its value.

However, it is not the global supply & demand dynamics that rule its pricing.

The China Factor

It's China's supply & demand. As of 2020, China boasts over 55% of the global Steel capacity. (Exhibit 1) Adding to that, China is also the largest consumer of steel with gobbling up nearly 900MT in the recent year.

Top 10 steel-producing countries				
Rank	Country	2020 (Mt)	2019 (Mt)	%2020/2019
1	China	1053.0	1001.3	5.2
2	India	99.6	111.4	-10.6
3	Japan	83.2	99.3	-16.2
4	Russia (e)	73.4	71.6	2.6
5	United States	72.7	87.8	-17.2
6	South Korea	67.1	71.4	-6.0
7	Turkey	35.8	33.7	6.0
8	Germany	35.7	39.6	-10.0
9	Brazil	31.0	32.6	-4.9
10	Iran (e)	29.0	25.6	13.4

Exhibit 1: China's magnificent rise in the steel industry from controlling less than 5% in 2000 to over 55% currently.

Thus, China is both the largest global steel consumer and the largest global steel producer by a large margin, and the balance between its domestic production and consumption has been an important factor influencing global steel prices, such as in 2015, when Chinese domestic steel demand weakened resulting in a surge in Chinese steel exports.

Why is China so ahead of us? They have a huge cost advantage due to huge economies of scale, easy RM availability, Low capital cost & government support in terms of export rebates up to a mind-boggling 13% of sales (leading to a price lower than the cost of production of competitors at times), etc.

[Fun fact: Indian steel makers survive just due to protectionism by our government in terms of safeguard duties & anti-dumping duties.]

It can be observed that China's net exports have a significantly high and inverse correlation to international steel price. (Exhibit 2)

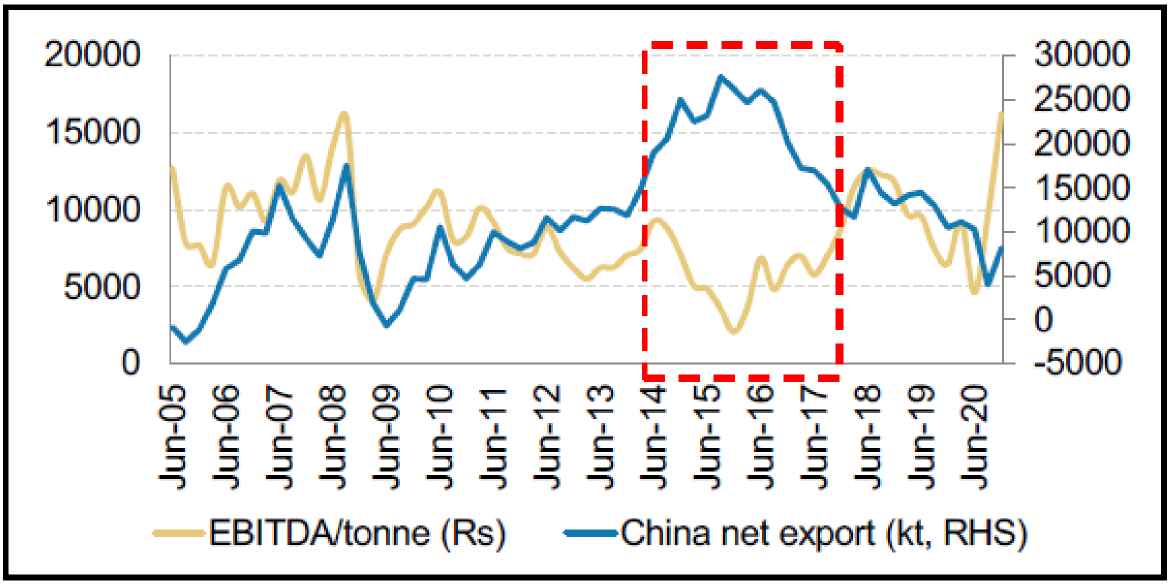


Exhibit 2: As China exports increased during the previous cycle, the profitability of all Indian steel players took a massive hit.

To delve deeper into what has been the tailwinds to the sector, below mentioned is the steelmaking process (Exhibit 3)

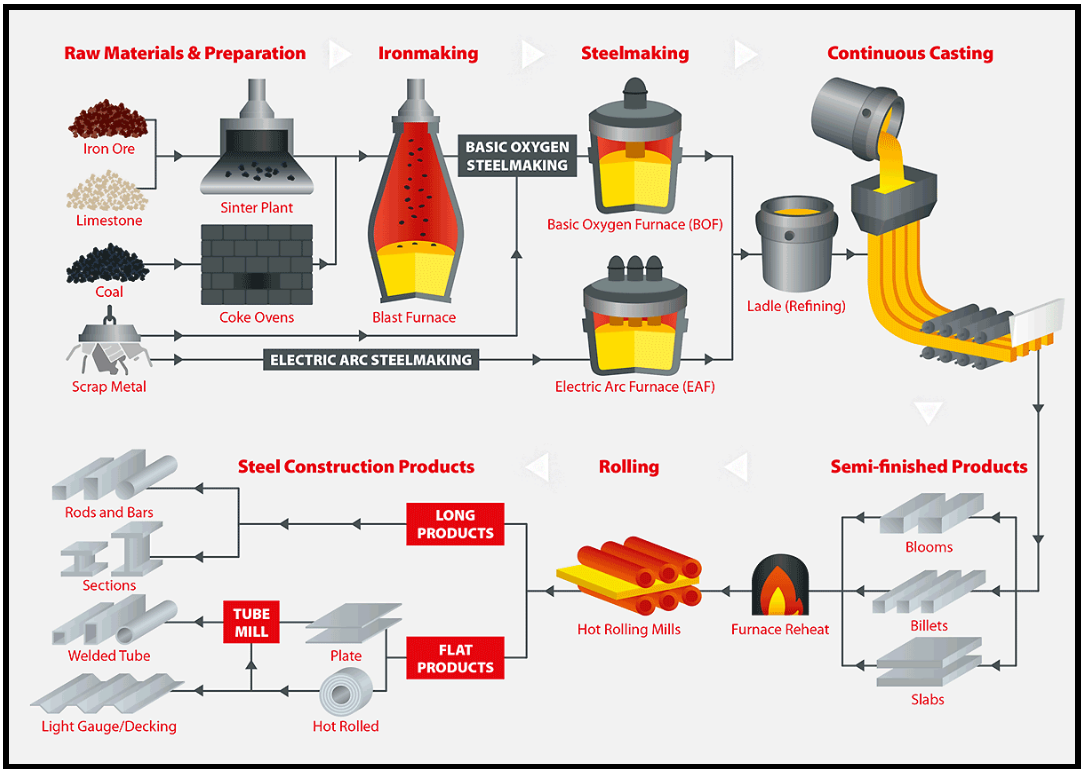


Exhibit 3: Everything you need to know about the steel making process

One can notice, Iron ore is the primary raw material used to produce steel. The whole rally in steel started due to the Iron Ore supply shocks.

Iron ore was the best performing commodity in 2020, thanks to China's early emergence from the pandemic and Beijing's heavy spending on economic stimulus, particularly infrastructure. This was mixed with supply shocks across the globe as the miners faced the COVID crisis following the collapse of the Brumadinho dam owned by Vale in Brazil and a heavy cyclone season in Australia. An increase in demand just when the Supply is down is where the magic happens.

How long will this sustain?

Brazilian output is expected to recover to normal levels by the end of 2021. Moreover, with Australia's weather back on the line, this will put significant downward pressure on steel prices (as they would have to pass on the benefits to the end-consumer industries) subject to not having astronomical demand globally. We are uncomfortable with the odds. (Exhibit 4)

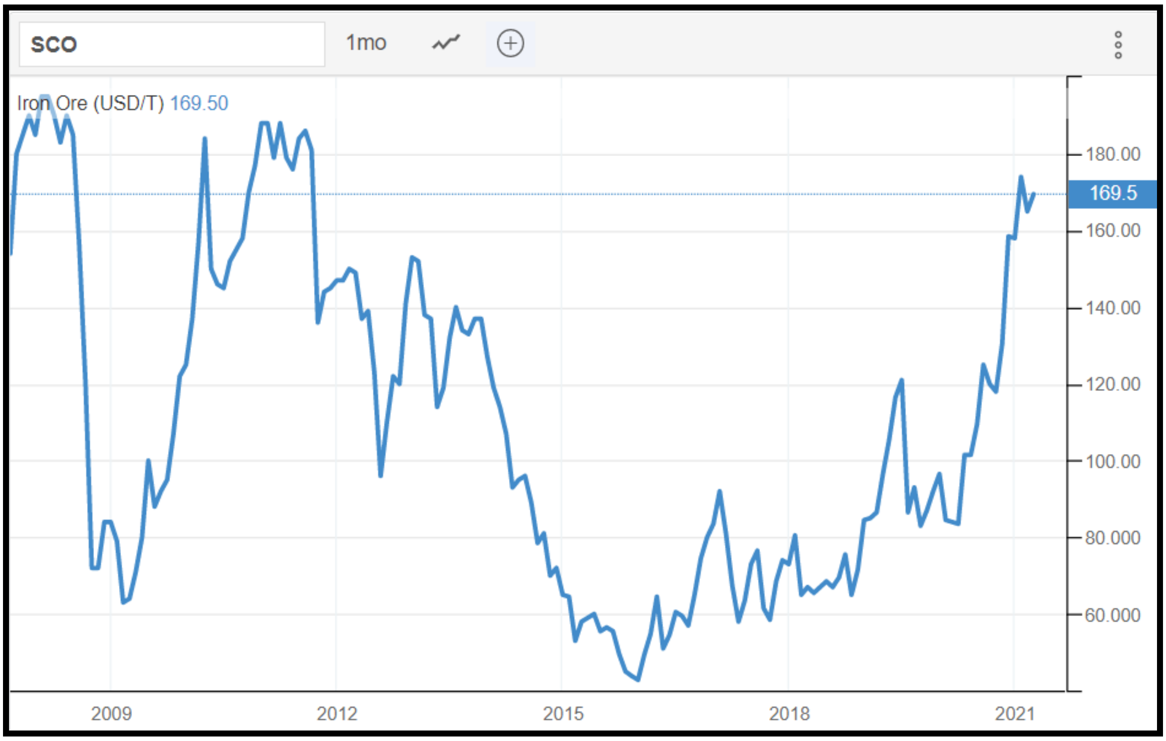


Exhibit 4: Past Performance is not a guide to the future. Iron ore prices are at their 10-year highs.

Finally, is it a super cycle or the music is dampening?

For this, one should look into the end products. Would you buy the same car at a 40% premium to a year ago price? Most probably, No.

Well, that's your answer. These companies can't keep on increasing prices after a point. As these prices in turn impact construction, the auto sector and other key manufacturing industries that are the pistons driving the global economy. Sanity prevails over time.

China's shenanigans will never stop. It's a given that in the long-term, Chinese steel demand is expected to decline, as the economy slows, the need for large infrastructure projects wanes and the pace of urbanization moderates. (Check what happened when the same thing repeated in the United States: Exhibit 5) The overcapacity doesn't bode well for steel globally.

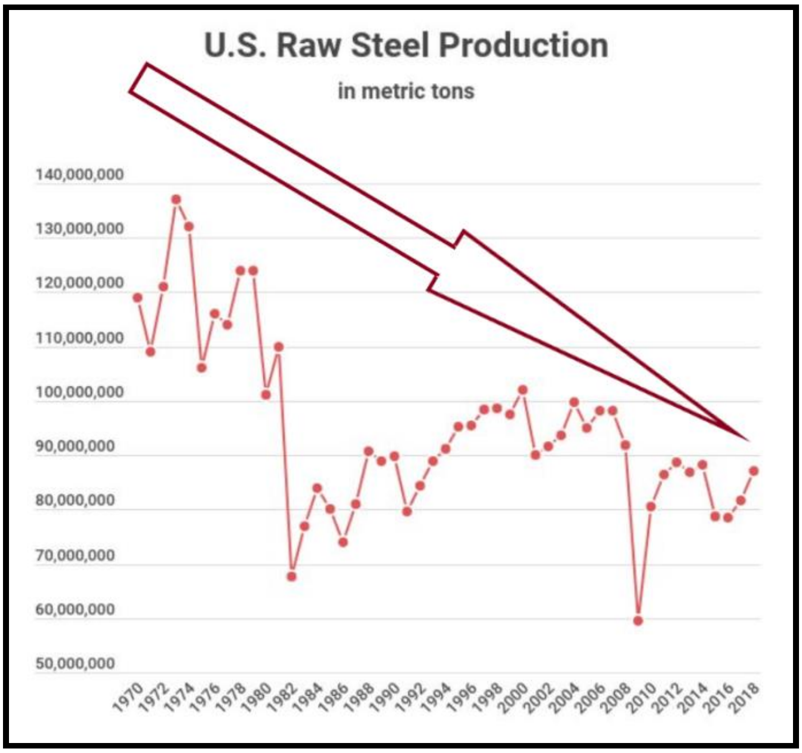


Exhibit 5: As infrastructure investments saturated in the US, the steel demand has been in a never-ending downtrend.

Your guess is as good as ours in the short term.

Additionally, the valuations of the Indian steel companies are near their past cyclical highs according to the historical data. As structurally nothing seems to have changed, we are not going to pay up.

A wise man once said- "The skill in attending the party is knowing when it's time to leave."

On Cyclicals

Buy when nobody wants to buy them
sell when everybody wants to buy them.

If you have any queries about your portfolio, about JST Investments or Investing generally do reach out to us –

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