Greetings!

Forecasting the known unknown of an Indian recession

Let's face it. We are going to get the first Indian recession in living memory. It is useful to breathe in an extra dose of humility and bring ourselves to say – WE DON'T KNOW ENOUGH!

- We don't know how Indian consumers will behave when they face job and income losses
- We don't know how Indian companies will negotiate a recession
- We don't know how the government will manage when tax revenues tank
- We don't know how investors will adapt when they see sharply lower profits
- We don't know the second-order impact from a recession

And, YES

- We don't know how long this Coronavirus will stay amongst us
- We don't know when the peak of this pandemic will be behind us

The forecasts we see on the Street are modelled with the above as backdrop. Yet, we don't see enough by way of a disclaimer on the clairvoyance, which is conspicuous by its absence. More the uncertainty, more the volatility, as the process of price discovery becomes a tug of war. More the uncertainty, more the margin of safety that investors should demand. On that count, the market behaviour is perplexing. But then, let us repeat - WE DON'T KNOW ENOUGH!

Caution is in the air and why it is justified

Financial markets are in the business of pricing in optimism for most part and at most times. Optimism has become second nature for global equity markets. While optimism is a great quality to have in life, a sense of balance is in order for those defending capital. To make a fair assessment of the value of assets, it is imperative that we see things the way they are, not the way we all would like them to be. Our focus should be on outcomes, to the extent we can gauge them, and not on whether policymakers responded well and on time. Let us leave that to the cognoscenti, including those on the couch.

Covid has created a situation where economies are left to function at a sub-optimal level for an extended period. There appears to be an inverse correlation between how aggressively economies can normalise and the prospects for public health. This is true across the world. India is likely in a tighter spot due to its densely populated urban areas and limited resources. The data now points to an Indian recession which may be deeper than feared. The contraction in output could exceed 5%.

While difficult to forecast, consider the following: Output in April is estimated to have fallen by over 40% from preliminary estimates of indicators such as the PMI, core sector numbers, electricity consumption, sales of durables and credit contraction. The figure for May could be in the region of 25-30%. While June should see positive traction, the first quarter may end up with a contraction of at least 25%. This bakes in a GDP destruction of well over 5% of the annual output. The rest of the financial year should now see positive traction compared with the same period last year (and not sequential growth from Q1) for the contraction to be below 5%. The asking rate climbs up and runs away from us with every month of lower activity.

Once again, it is in good order to highlight the constraints in normalising or pump priming activity too soon and by too much against a backdrop of the negative correlation on safety.

Therefore, media reports on activity showing a robust rebound should be taken with a pound of salt. Activity in April/May were at levels never seen in modern economic history and a rebound is natural. We are watching with trepidation the data that shows that the rebound is falling short of the strength you would expect from the abyss. If the activity year-over-year does not go back into positive territory on a sustained basis, earnings will keep getting downgraded.

Caution is quite handy on a few occasions in life.

What will an Indian recession look like

In the Indian context, it is that phenomenon which we have not seen in our lifetime. Unlikely to be pleasant.

- As against the double-digit wage increases the young population is used to, brace for an actual drop in take-home income.
- Recessions are not mere speed breakers to growth; they shift the base of growth.
- Just because it is India, a recession may not be kinder. If anything, the lack of match practice may accentuate the pain.
- Recessions destroy demand. Normal cost rationalisation tricks may not suffice. You need a scalpel, not a balm.
- Indian companies have been drawn into this recession simply unprepared. The response to this is still work-in-progress.
- India did not anticipate the reverse migration challenge when the lockdown started; its response has been behind the curve. Urbanisation involves migration of labour from rural areas to overgrown and filthy cities. Be that as it may, such movement multiplies income by 4-5 times, as the same labour force sees such an improvement in their wages. Not to speak of the cascading positive effect this has on consumption and growth.
- Reverse migration implies an automatic unwind. There is no escaping that. There are those who make a case for the labour to return to cities after a brief hiatus. However, this was not a holiday trip. Migrants have been bundled out of cities unceremoniously. The reverse migration process away from cities is itself yet to be completed, as we write this. Expectation of restoration of status quo ante in quick time is the height of misplaced optimism. We would hold our horses.

The power of positivity

Yet, there is reason to be optimistic on equities once we've navigated through this dark tunnel

- Recessions are market clearing events. They bring about efficiency and pave the way for return on smart capital to go higher.
- Recessions may also likely bring about the so-called structural reforms which elude consensus in a democratic polity.
- Recessions tend to lead to market consolidations. Winners emerge stronger.

In summary, we believe India will form the base for a sustained high growth era on the other side of this crisis. The challenge is to get the timeframe right and hasten slowly.

Ironical as it may sound, equities offer the best hiding place in such a situation. For one, they offer the best option to access a rising earnings stream when the economy gets back on the rails. Secondly, stock picking can make a difference, given our view that winners will emerge stronger for longer. Third, we have seen a brutal correction, which offers a few attractive risk-return trade-offs. The thrust of the points being made in the previous sections of this piece is merely that there are no prizes for bravery here. Because, we don't know enough – YET.

We have taken a guarded view on capital deployment. In the short run, that leads to sub-optimal outcomes, as sharp market rallies tend to be concentrated on higher-beta names that were beaten down a great deal during the fall in March. Higher cash is also a drag during such recoveries. Our focus is on improving the quality of the portfolio by populating it with companies that have the wherewithal to survive this recession year and participate in growth that will come at the other end.

Warm regards,

P Krishnan (CIO) and Team Spark Fund
