Greetings!

## The near-perfect storm

Equity markets have been in the eye of this storm. The storm is, of course, raging in the real world. And it is not exactly the virus, though the virus is a catalyst. The storm is all about the disruption caused by the digital economy.

This disruption is one of the key drivers of equity prices through the spring. And, these are early days in this saga. Nothing exemplifies this better than the quarterly results posted by Amazon, Netflix and Apple. In a US economy that shrank by a third in the quarter, they reported robust revenue growth. To be clear, this extent of GDP destruction has never been seen before. Yet, these and other tech companies have shown growth. In a nutshell, this captures the winner-take-all economy that we have waded into, with the market acting like a mirror capturing the storm underway.

Equity markets have become a medium and barometer for pricing in the extremities of the changes afoot – they are sizing up the concentration of economic power being witnessed. The economic power play has miles to go, it appears. The rumblings amongst US lawmakers demonstrates the sense of despair over the widening gap between digital haves and have nots. Politicians will be compelled to address this in some way, but the train carrying the forces of change has long since left the station.

India is not all that removed from these forces. The investment implications are broadly the same. Winners will party long into the night while the also rans fall by the wayside

## Will markets have the legs?

The answer to this question lies in the realms of behavioural science. Earnings estimates have missed analyst expectations every year for the last decade. Yet, we have seen valuation multiples expand during the time. Perceived lack of alternatives is driving flows into equity as an asset class. Low interest rates ever since the financial crisis have fuelled the equity cult so much that financial models have gone on to value firms at a multiple of two- or even three-year-forward earnings. Once anchored on such estimates, there is no ceiling on valuations, as there is no question of measuring outcomes against expectations. The day of reckoning is so far away.

The uncomfortable, but inescapable, conclusion is that higher valuations will not be the showstopper for markets. Ergo, the market rally may have many legs. However, it is unlikely to be a smooth ride. The risk factors that can trip the rally range from geopolitical factors such as the China-US spat to political uncertainties such as the US election and basic issues such as unemployment numbers. Not to speak of the health crisis, which is yet to be resolved.

It stands to reason that volatility will keep pace. The change in market leadership will continue to drive stocks that propel the digital economy or the ones who benefit from the same.

## Implications for Indian investors

The Indian market continues to track that of the US and global liquidity. The theme of concentration of economic power is finding an echo here, too.

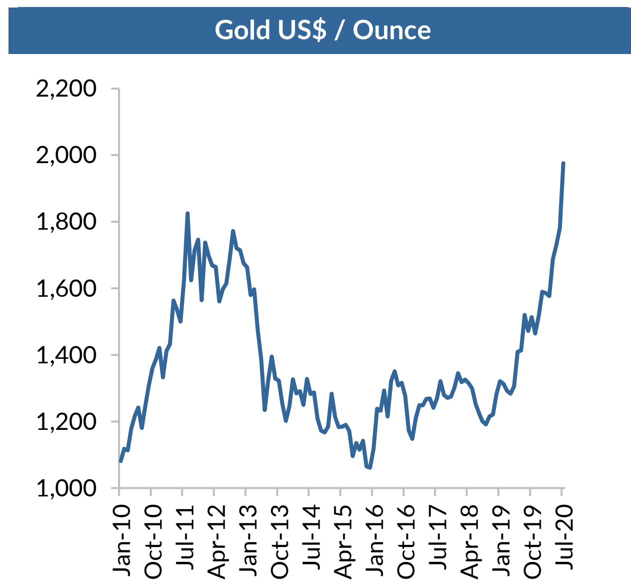
An analysis of corporate results in Q1 of FY21 shows that the trend of leadership consolidation has gathered pace. Leaders in various segments are weathering the storm, even as the broader economy has taken it on the chin. The pain in the economy is likely to be felt in the banking system. This has been camouflaged by the optical illusion created by the moratorium extended by the RBI. The market appears to be ahead of the curve in reading the tea leaves. Bank stocks lost their pole position as a sentiment driver of the equity market after many years.

While mid- and small-caps have made a comeback, one has to tread with caution on this front. A weak topline environment, which is what a recession engenders, is hardly what smaller companies thrive on. That said, there are companies that benefit from the turmoil in the economy and on that count, we remain market-cap agnostic.

The digital disruption has already seen its reverberation in India. On the one hand, there is Reliance Industries, which is riding the crest of this wave and has just finished the biggest capital raise in Indian corporate history. On the other, the performance of IT services majors is a reflection of the inherent strength in their business model. What stands out is the amazing execution displayed by companies across the sector. They have demonstrated utilisation in a quarter where they had to deliver from home at short notice. Yet, the revenue loss has been minimal. The new business momentum is a pointer to the fact that the Indian IT names will get their due share of the digital advance in the Western world. Whatever shape and form the new normal takes, IT will play a key part in the same. It so happens that valuations here are not at their lifetime highs and return ratios remain strong.

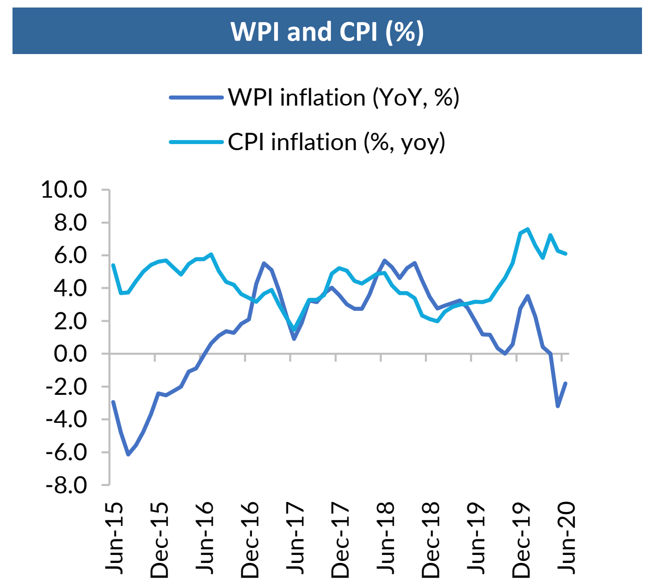
## The red flags

Gold US$ / Ounce




*Source: Bloomberg*

WPI and CPI (%)




*Source: eaindustry.nic.in*

The move made by Gold is a significant indicator of the rut the global economy is in. This has come about at a time when the demand for physical gold has been weak. India and China, the two countries that devour the yellow metal, are both seeing demand contraction. The flight to gold has been driven by financial investors. This is the direct result of the imminent risk of debasement of global currencies, particularly the US Dollar. The US Fed has seen its balance sheet expand much faster than during the 2008 financial crisis, as it provided the backstop for an economy that froze on its tracks in April. Gold has quickly become the sole haven for USD refugees. This is not the sort of stuff that leads to happy endings in equity markets or the global economy. Extreme caution is in order.

For India, lockdowns have compressed demand and supply. We have seen the peculiar phenomenon of stubborn inflation on CPI, while producer prices have cratered. The dislocation in the labour market due to reverse migration towards rural India will keep labour costs high and productivity low. We are in a strange situation wherein sluggish demand is in a convenient equilibrium with a slack on supply. We are in an economy that is being compelled to operate at sub-optimal capacity while waiting for the health crisis to abate.

The pent-up demand from severe restrictions in April is perhaps giving an impression that the economy is coming back fast. It is hard to make a case for the momentum to sustain in the face of unemployment and even more potent impact of under-employment. The lockdown may have boosted household savings for some segments, as avenues for spending have been choked. This is temporary. Moreover, the lack of spending on some categories creates a vicious cycle of lower income elsewhere and loss of jobs. In all of this, government stimulus has played only a small role in India. While the precarious position of the government balance sheet is a clear constraint, this can hardly qualify as good news. It is also useful to keep in mind that we are rookies in handling a recession. After all, we never came face-to-face with one.

## Where does that leave us?

In a difficult place, as far as comfort is concerned. We are unlikely to see blue skies. However, this also creates the room for gaps in price discovery, which is what active managers seek to exploit. The import of what we infer from our scenario analysis is that there will be winners. They stand to benefit disproportionately in this environment. The market looks set to reward them asymmetrically as well. This is already evident in the dispersion of sector and stock returns over the last few weeks.

Given the relatively high starting valuations for this stage of the economic and market cycle, there is a case for locking in returns when they appear overdone. In our view, we are in an environment where timeframes tend to get compressed. One of the most devastating phases of wealth destruction in modern market history happened over less than three weeks earlier in March. In comparison, the market crisis of 2008 unfolded as a train wreck in slow motion. There is much merit in keeping an open mind while negotiating these waters.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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