From the CIO's desk – Market musings – April 2020

Greetings!

Search for the new normal

Enough has been said about flattening the Covid curve. We will leave it to health experts. The questions confronting the financial markets are:

1. Will the world be the same?
2. What will the recovery look like when it shows up?

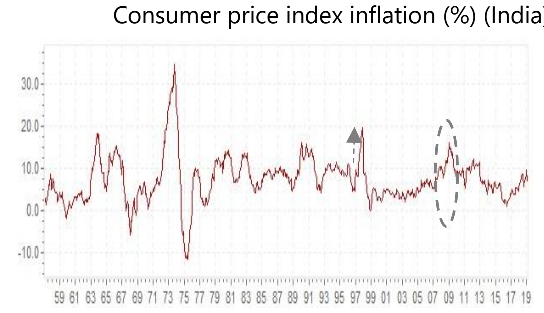
The short answer for the first question is a resounding NO. The probable answer for the second one is that no one knows. It may not resemble any of the stereotypes that recovery paths are supposed to chart - V, W, U or L. The following cynical one-liner best describes the challenge faced by the economy – Growth is created by people who buy things they don't need with money they don't have. The role of discretionary spending and credit has never come in for a more intense scrutiny than at present.

Given the cliff effect on economic activity on a scale never seen in modern times, it is fair to say that we don't know what shape and form the recovery will take, once the world gets a handle on the health scare. Nevertheless, it is useful to keep in mind the following which will have a bearing on investment returns in equities:

1. As against less government and more governance, there will be a lot of government and indifferent governance. Bureaucrats will drive the agenda on prioritising economic activities. In the Indian context, this could be a throwback into the pre-liberalisation era with all attendant challenges for business.
2. Governments around the world have resorted to stimulus packages, which are not without costs. The bill has to be paid one day. For emerging economies, there is limited wiggle room for big-bang spending. India does not have a currency that people are queuing up to buy.
3. In the last crisis, the governments resorted to socialising private losses. In the current one, governments will have to do some amount of privatising social costs. In other words, taxes will go up. If not, or additionally, deficits will shoot up. Some of the deficits could be monetised. The balancing act between inflation, growth and social security in an economy operating at sub-optimal capacities is not going to prove an easy task. Something has got to give.
4. Equity markets have taken a view in April that the new normal is the same as the old abnormal. At least in valuation terms. This is a dangerous position. Any trouble in pockets of the economy (e.g. – debt mutual funds) has been viewed as a problem for the government to resolve, come what may. It is almost as if equity markets have bought a 'No-Cost-Sovereign-Put' option that insures it from the real economy. We are afraid the government has not issued such a put nor is it in a position to do so.
5. Bear markets in India of the last 25 years saw fiscal deficits spiral up. These periods were also inflationary for India. The market took its own time to form a base, even as growth slowed and the macro parameters deteriorated. For now, the economy is still sustaining body blows of a magnitude never seen before. Healing has to happen afterwards.

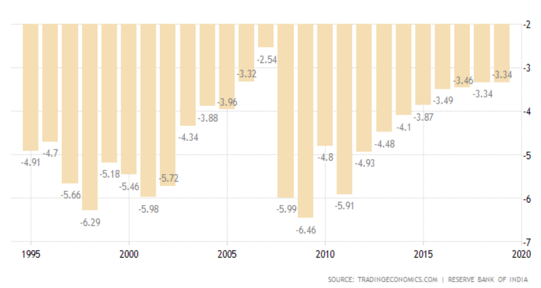
Slowdown phases are punctuated by rise in deficits and inflation

Consumer price index inflation (%) (India)



Source: *www.inflation.eu*

Fiscal deficit as a % of GDP (India)



Source: *www.tradingeconomics.com*

Having said all of the above, we will eventually see a recovery in the economy. The points of interest to us are:

1. Recovery and growth will be uneven - Across countries, across sectors and across companies in the same sector.
2. The current abundance of liquidity in the markets appears to give a false sense of safety to valuations. The 20% ++ fall in indices from the recent peak gives an impression that the market is a bargain. However, earnings are in the process of being downgraded by about the same extent. At best, we are where we were in February. Only that the world has turned upside down and we are staring at a possible abyss or, at best, an uncertainty.
3. The extreme nature of the event is exemplified by the oil prices, which went to the netherworld at -$37 per barrel. Though volatility in Indian equities has come off steadily through April, do not hasten to write an ode to it.

Going forward, what would interest us a lot is the uneven nature of the recovery we expect. Therein lies the opportunity for us to pick stocks and add value. Bear markets do not mean a loss of value in all assets. There will be opportunities as well. Our decision to maintain cash at relatively high levels and not chase this rally has been driven by the conviction that patience has a lot of value in bear markets.

Picking the winners

This involves modelling a recovery phase following a possible maiden recession in the Indian economy post liberalisation. We have no parallels to fall back upon. The following activities and sectors are likely to face demand contraction in FY21:

Credit (Banks/NBFC): Cliff effect on activity and commodity prices

Discretionary spending: Constriction in income should force the consumer to prioritise

Leisure & Travel: People will take a break from these; new paradigms may emerge

Infrastructure & Construction: Labour dislocation and credit non-availability

Recovery in the second half of FY21 depends on the return of confidence. Healthcare and consumer essentials may see resilience in demand, but we have to be watchful here. Demand slowdown may not spare these sectors, though they may fare better. Investors have flocked to many of these stocks indiscriminately and bid up valuations.

Longer term, we believe the trends which were already evident before this crisis may accelerate:

1. **Market share consolidation** – Death of the also-rans
2. **Sustainable growth** – Clean energy, Good governance, Social equity
3. **Digitisation and automation** – Employee productivity, Innovations in workplace

Our efforts are now directed at screening the market for the winners that will take us to the new world that we will walk into over the next few quarters.

Risk management

Risk management remains an integral part of our process. We have often talked about this in our communication to you. In this volatile phase of the market, any rally poses the risk of causing under performance should we choose to keep cash levels high in the portfolio. When we weigh that against the risk of loss in value due to shocks that are lurking and hard to forecast, it is prudent to go about in a cautious manner when it comes to capital deployment.

A note on investment horizons. We believe that core holdings are meant to generate value over time. However, there are factors at work that compress investment horizons. One is the tendency of business cycles to be short and the flux associated with the same. Second is the disruption in business models brought about by reforms or by crisis. Then, there is the tendency of the stock market to price in positives within a short span of time, leaving little room for further value creation. The abundance of paper liquidity and the paucity of good quality assets create a situation where an active investment management style has clear merits over an overly passive style.

Warm regards,

P Krishnan (CIO) and Team Spark Fund
