



Greetings!

The Black Swan of 2020

By far, the Covid 2019 appears to be the most difficult unknown that the world has been confronted with since 2008. The risk to a connected world from a global pandemic has been flagged off by experts. The probability of such an event was always difficult to factor in – and indeed there are still some doubts on whether the corona virus scare will escalate to become a pandemic. That said, there is a crisis at hand – even with an outcome on the relatively benign end of the spectrum, the damage is setting in. Much of North Asia and possibly many parts of the developed world will likely experience a recession in the first half of 2020. Indeed, several countries may already have entered that recession.

What remains to be seen is whether the duration and intensity of the plunge will be severe enough to trigger a valuation reset in asset classes – equity being of particular concern to us.

We are not, by any means, trivialising the human cost of this episode. Medically, there are several questions to which answers are not in place yet. We will try to bring some perspectives on the economic costs, while remaining sensitive to the human side of the equation and noting that the two may well be interlinked.

What makes this a difficult one:

1. Global policy makers have countered previous economic shocks by trying to pump prime activity. To get a handle on this one, it looks increasingly clear that you have to slow down activity for a while. For how long, we don't know yet. To the extent some containment has been seen in some geographies, that has been the result of severe restrictions on movement of people, closure of activity centres and curtailing economic exchanges. That is a Catch-22 for the world at large.
2. This is a supply shock. Previous supply shocks have typically been centred around resources, oil in particular. They were shocks at the centre of production, usually one of the major ones, even as the alternatives were attempting to keep the supply chain well-oiled, to use the pun. This shock could be impacting supply sources and the entire distribution chain – including the point of last delivery in many instances. This is unprecedented.
3. The whole picture is complicated because the world ignored the possibility of such a risk by concentrating production to stretch the envelope on the theory of comparative advantage. Even if a nut or a screw is missing, a product does not get shipped. The least valuable part of the global sourcing jigsaw can force the entire production to a grinding halt. The degree of intricate linkages is so pronounced that the impact may be difficult to estimate at this stage.

Potential impact points:

1. Recession in many parts of the world in the first half of 2020. The trajectory of the recovery is unknown. Could be sharp or a laboured one.
2. Human cost is yet to be estimated. Economic impact of the same remains unknowable for now.
3. Once the event passes, global supply chains may go for a restructuring and this may bring inflation in manufactured goods, a territory we have not seen for a while.

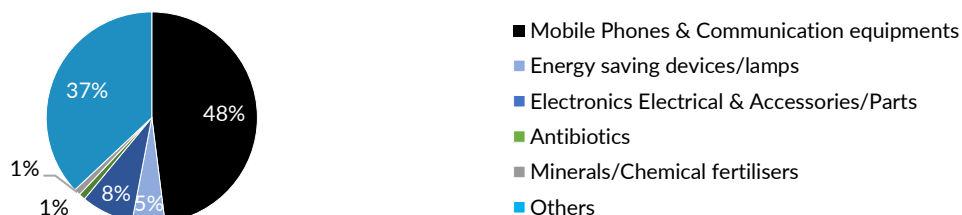
Impact on India:

As we write this, India is seeing an increase in the number of people affected with the virus. Given the risk of invisible carriers, the pathogen could indeed be going viral. While we have no data points to sound alarmist, any event that slows down an already stagnant economy can result in outcomes that we (or anyone) have not modelled. Can growth slip from the sub-5% levels in the next couple of quarters? That is a possibility.

On the other hand, India will benefit from low commodity prices when the dust finally settles. There is also the opportunity for exports in select sectors, as the world diversifies its supply sources. For now, India has a certain level of dependency on China for various inputs and to the extent it affects manufacturing or activity in sectors, that will be a dampener. See the chart below



Estimated composition of Indian imports from China



Source: Government of India and Spark Fund Research

At another level, since economic activity is anchored on a low base, things may not be so bad for India if we navigate the health scare well enough. There is the universal hope that the onset of summer will weaken the virus, even as such hopes are based on insufficient data. We are indeed in uncharted territory.

Possible risks to stock price metrics:

Of the two metrics, earnings and valuations, it is possible to model the former with some scenario analysis. The latter is a tougher one to crack. Given that they have been so far away from averages, the possibility of mean reversion is now becoming more real. Once again, the overvalued pockets in the market including some index heavyweights and consumer names will be in focus. It is quite likely that the next leg of slowdown, if it comes to pass, will be consumers capitulating – albeit for entirely unexpected reasons.

What are we doing:

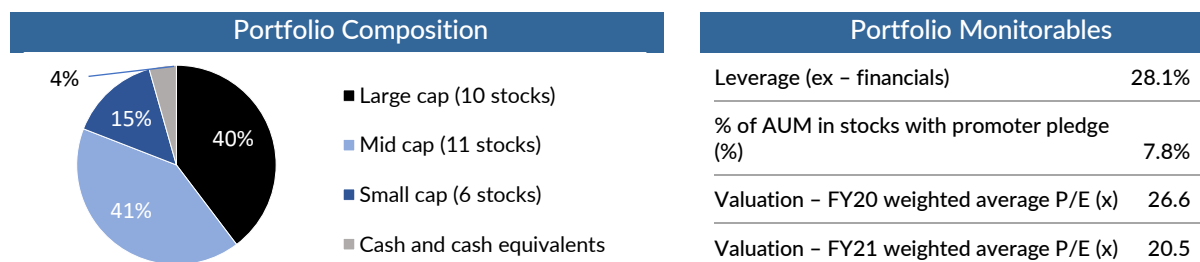
From an investment perspective, experience suggests that remaining invested in businesses that have sound managements, robust balance sheets and salience beyond the hump ahead will never go out of fashion. We have been invested in such businesses and we have largely avoided crowding into high P/E stocks. That said, all stocks will come under the hammer when this kind of risk-off is in play.

Given the magnitude of the uncertainty, we consider it prudent to keep cash at a relatively higher level, including in our more mature portfolios. This has had the consequence of some unanticipated portfolio churn. We have pruned our bets in some of the more expensive names with a potential vulnerability to earnings from a pullback in consumer sentiment. We have singled out underperformers as well in this exercise. We have taken care in ensuring that there is no meaningful tax liability to most of our clients due to this action (A few of the positions that have been cut incurred capital losses. Our preference has been to cut losing stocks wherever warranted). We believe the core of the portfolio will remain stable and the cash will come handy when the situation looks to stabilise. In the meantime, the relatively higher cash level acts as a natural hedge during these exceptional times.

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



Portfolio composition



Note: Represents portfolio of a typical investor onboarded in February 2019 when the strategy commenced; actual portfolios may vary depending on timing of entry into the strategy; Market cap as per SEBI guidelines

1. We exited the losing position in NTPC during February. While fundamentals remain strong and valuations are attractive, there is increasing foreign investor apathy for companies which are seen as environment unfriendly (coal is the source of consternation here). On top, the government has been seen as a persistent seller here, with no concern for what value it is realising (they have been selling down stake at successively lower levels). We failed to read the extent of impact from these factors. We considered it prudent to exit the position and make room for better investment alternatives.
2. In Rail Vikas Nigam, we decided to prune the investment after the numbers surprisingly fell below expectations. In this space, we have seen that companies who execute well are the only ones who have a chance to generate shareholder value in the longer term.
3. IRCTC turned out to be a stellar performer during the month. While we had made the stock pick at much lower levels, the extent of appreciation in stock price has been surprising. Some of this price rise has been premature and hence we believe the stock became too overvalued. Even as we believe in the longer-term future of this business, we took some profits here.
4. We continue to monitor the liquidity in our holdings closely and the same remains comfortable.
5. The risk to our holdings from earnings appears limited while the market volatility from polarisation of investor preferences towards fewer and fewer names continues to be a cause for worry.
6. The risk from the major event of Coronavirus scare has been discussed in the newsletter itself and we view this as an external macro event led risk which is very different from the stock specific risks. The latter is what we actively seek to control through our research, monitoring and risk management initiatives. Nevertheless, we have increased the cash level which will give us room in bouts of volatility.

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