



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.
- Finally, recessions are accompanied by a sharp drop in company earnings. The market trades at multi-year high valuations by default. The denominator (earnings) is falling apart. *(Refer table on page 3)*

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,

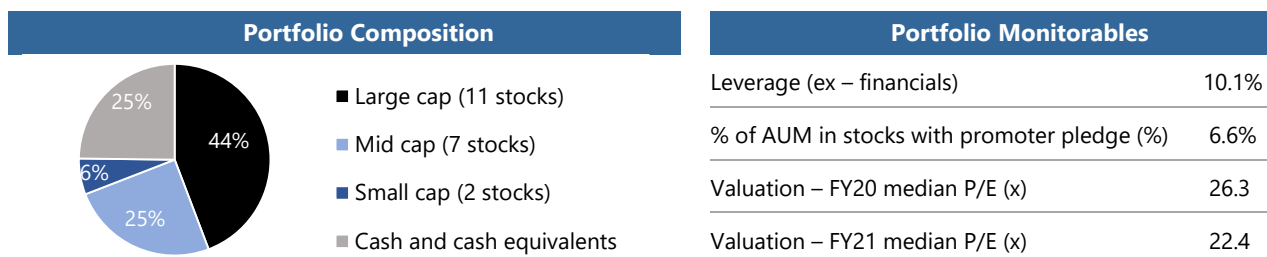
P Krishnan (CIO) and Team Spark Fund



Indices EPS (Source: Bloomberg)

Year	S&P 500 Index	NASDAQ	Hong Kong Hang Seng	Japan Nikkei	German DAX
29-12-1972	6.2				
31-12-1973	8.0				
31-12-1974	9.4				
31-12-1975	7.7				
31-12-1976	9.8				
30-12-1977	10.9				
29-12-1978	11.6				
31-12-1979	14.6				
31-12-1980	15.0				
31-12-1981	15.2				
31-12-1982	13.8				
30-12-1983	13.3				
31-12-1984	16.8				
31-12-1985	15.7				
31-12-1986	14.8				
31-12-1987	15.8				
30-12-1988	22.8				
29-12-1989	24.0				
31-12-1990	21.6				
31-12-1991	15.6				
31-12-1992	17.9				
31-12-1993	21.1		633.8		
30-12-1994	29.9		741.5		
29-12-1995	34.6		854.3		
31-12-1996	39.0		1,006.1		
31-12-1997	43.6		1,122.8		388.6
31-12-1998	43.7	22.8	821.7		378.8
31-12-1999	50.2	71.5	1,251.3		215.2
29-12-2000	54.6	68.9	-43.7	190.6	413.2
31-12-2001	43.0	-15.4	600.7	293.4	53.3
31-12-2002	46.0	17.2	643.0	106.7	12.1
31-12-2003	54.1	35.8	702.5	247.2	92.3
31-12-2004	65.5	59.5	980.1	720.4	270.8
30-12-2005	73.8	59.2	1,276.0	603.2	370.6
29-12-2006	85.7	64.4	1,318.9	745.2	473.8
31-12-2007	84.2	80.9	1,650.8	867.7	589.9
31-12-2008	54.0	64.0	1,162.7	362.8	242.0
31-12-2009	58.9	61.5	1,397.2	-73.9	280.4
31-12-2010	81.6	93.3	1,794.6	542.8	555.9
30-12-2011	93.7	114.8	2,029.5	395.0	534.8
31-12-2012	99.1	143.4	2,029.5	501.5	439.2
31-12-2013	106.2	149.7	2,118.4	735.2	520.1
31-12-2014	112.1	161.3	2,387.9	880.7	590.4
31-12-2015	108.8	151.0	2,055.1	898.9	486.5
30-12-2016	109.0	187.7	1,797.4	858.8	593.3
29-12-2017	122.5	193.1	2,414.0	1,370.8	839.4
31-12-2018	150.9	261.6	2,553.8	1,357.4	742.6
31-12-2019	152.3	268.3	2,505.9	1,130.5	570.1

- No rocket science to conclude that recessions go hand in hand with earnings slumps. Almost a truism.
- The extent of slump in earnings and the time taken for the earnings to climb back to previous levels is the point to note.
- Earnings go back to pre-recession levels with a gap of a few years and never in the very next year.
- While India could be different, we are not even one quarter into this recession year. Too early to form opinions, including positive ones.

**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. The relatively high cash level continues but we used the correction in May (Nifty went below 9000 briefly) to deploy some capital. Cash is down from April.
2. Allocation to large caps has increased from the levels in the first quarter of CY20, reflecting the better risk-return trade off we see in certain names in this category, given the environment.
3. As we go forward, bottom-up stock picks from the other market-cap buckets may make the cut to find a place in the list of holdings.

Risk assessment

1. Higher cash level in the portfolio presents a risk of under-performance relative to the benchmark should the market continue to rally. In our assessment, this is a prudent risk to take considering the possibility of capital erosion given that we are in the midst of a vicious bear phase.
2. Liquidity of stocks held in the portfolio continues to be good and we believe our effort in monitoring the same has been effective.
3. Earnings risk to companies in FY21 has increased due to the uncertainty over demand and offtake. We believe that our preference for robust balance sheets and companies with leadership/niche presence should mitigate this to some extent.
4. We reiterate that the current phase in the economy is fraught with several uncertainties that are hard to model. Volatility risk continues to remain high.

Disclaimer

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