



Greetings!

Economy is on Earth; Markets are from Mars

Markets never cease to surprise – that is one lesson I have carried with me from years spent as a student. Don't argue too much with price action.

Markets have been stronger over the last quarter than the picture that emerged from anyone's crystal ball at the end of March. It is important to try and understand what has driven the positivity in markets, which prompted me to post the surreal header to this piece. Two points stand out:

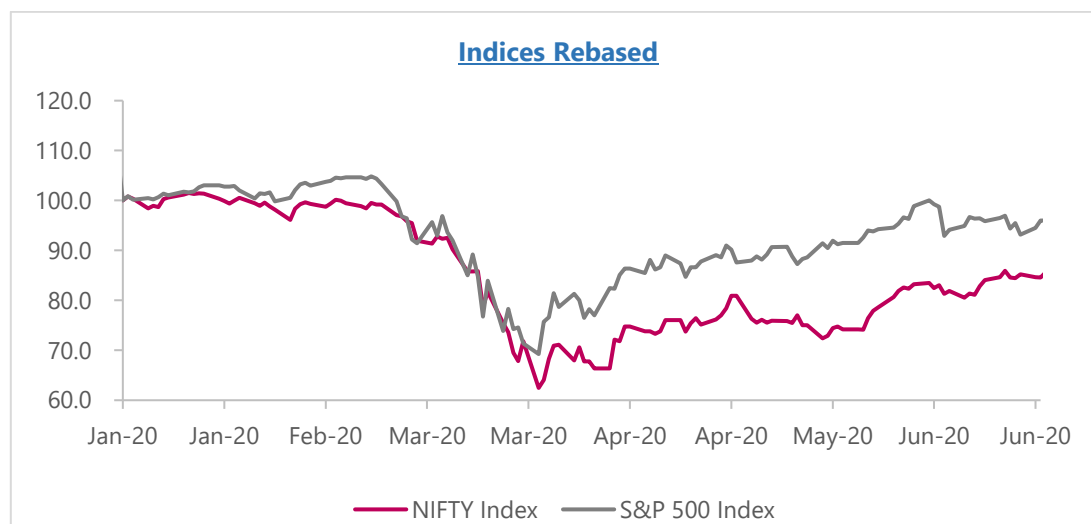
1. In a world where policy stands ready to support growth no matter what, cheap money is expected to keep the markets hydrated till kingdom come. The Fed Chairman and the US President are expected to provide rearguard support should anything go awry. The liquidity that gushes out may have ended the multi-decade run in bonds. Which is even better for equities. Equities represent a hedge against any possible inflationary risk that may come alive as paper money floods the world. In such a scenario, markets don't pay much heed to conventional valuation metrics.

There is some merit in the above argument. Equities enable access to underlying earnings streams from productive assets. This should act as a hedge against the loss in value of paper money. The only note of caution stems from the realisation that financial assets have to be priced on cost of capital and if inflation comes back, that cannot be at zero. Wiggle room is limited, but maybe the market will worry about that a bit later.

The second line of thinking is more audacious. And is more disturbing:

2. This line of thought postulates that equity markets do not represent the health of the economy or of the state of earnings of companies anymore. In fact, the assertion goes even further to suggest that they need not. In this train of thought, there are winners in the tectonic shift caused by the pandemic and they were gaining share even before Covid times. They are driving major market indices and no price is too high for them, as they will rule the morrow. Carpe Diem.

The above has relevance for Indian equities. To start with, the entire market move in India since the beginning of March is in a way explained by the correlation to S&P 500.



Source: Bloomberg and Spark Fund Research

Such tight correlation was not witnessed during the global financial crisis. Or at any time thereafter. The Indian market has, however, lagged the recovery in the US markets. Why so?

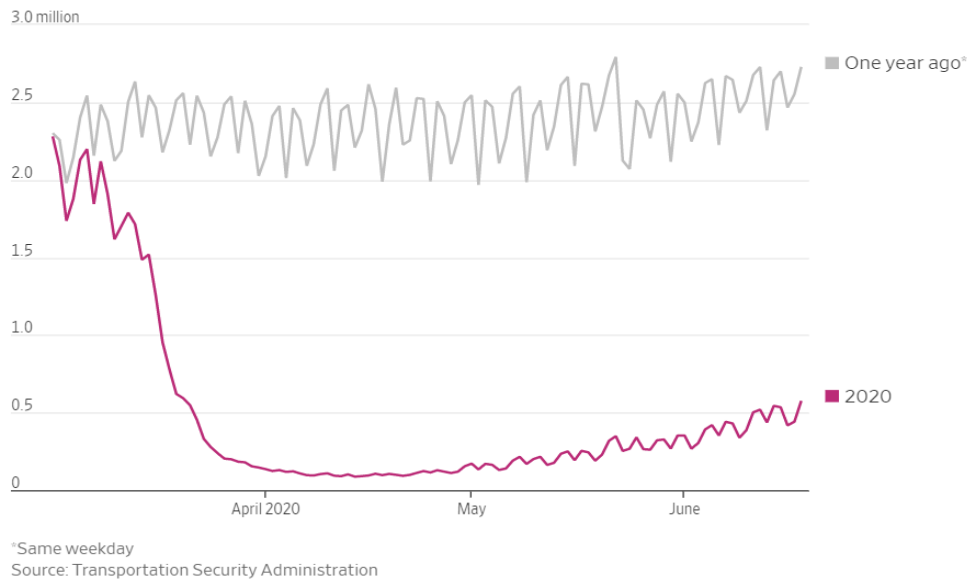
1. India, unlike the USA, does not have a currency that anyone wants to hold. Pump priming, through printing money, is not an easy option.
2. India's stark reality as a country with high poverty stands exposed. Its ability to negotiate the health crisis is circumscribed by its limited resources.
3. India has always been perceived as a growth market, which resulted in a valuation premium. Sans growth, the aura is hard to sustain.



Nonetheless, the concentration of market share and customer ownership has implications for India as well. This represents one of the few bankable themes in India. The current turmoil and India's maiden recession will place the best of the Indian companies on an even better footing. A valuation premium is, therefore, an inevitable consequence. We have been careful to hold and buy into only those companies, which, in our assessment, can maintain a pole position in their respective spheres. We are in a brave new winner-take-all world.

Armed with the two major tailwinds outlined above, the markets went to work in the last quarter. The market has taken a view that the worst is behind us. The worst obviously was April when most of the world went to near-zero activity. The incoming data has then been parsed with a positive spin. Look at the charts below:

Number of travellers who passed through TSA checkpoints



Foot traffic to businesses, change from early March baseline



The charts showing US data are used here, as the high frequency data is more current. India has followed a somewhat similar, but slightly more tepid, trajectory, thanks to the absence of a sovereign gift cheque scheme.

While the charts show a recovery, note that the activity is trending well below pre-Covid levels. There is also further apprehension that this recovery will be of a stop-start variety. At present, there is possibly a soft patch in India (as well as the USA). The trade-off between public health considerations and level of economic activity is coming home to roost, as many Indian cities continue to keep in place restrictions on activity going into the second quarter of the pandemic.



Even so, the market has chosen to focus on a future where an eventual recovery will come about. A future with governmental support to consumption; official evergreening of loans; vaccines that are deemed effective even before they are born; and a resurgent India. Add to that an expected synchronised global recovery, led by the USA. If earnings have to be factored in, it is only for FY2021-22. The current year is forgiven, with no adjustment to the time-value of money. Akin to what we saw in the last decade, future earnings in India are always supposed to be at least 20% higher every year. This time around, going into FY21-22, we have even a low base and demand that is bottled up waiting to sizzle.

Be that as it may, let me repeat my learning not to argue too much with price action. The market has a mind of its own. It looks as if the market cannot wait to get to the bright and sunny days ahead of us in India. Even as we levitate defying gravity, we outline a couple of points that keep us on our feet and thinking.

The valuation premium cannot be a carte blanche. How much is too much will be a question that will always haunt investors, so long as the rewards from investing are about financial gains and not about ego kicks. Risk, as characterised by drawdown risk as well as by volatility, will remain elevated. We have no go but to deal with this, even if the blue-sky scenario continues for Indian stocks.

Honey, I shrunk your investment horizon

The other challenge is the phenomenon of shrinking investment horizons.

There is the fabled notion of long-term investing and how that has created value and wealth. That is true and there is data supporting the same. But this could well be a thing of the past. Several things have become far too complicated to make completely passive investing a rather sub-optimal idea:

1. In a world awash with capacities and ample liquidity, investments will be made just in time. This results in shortening business cycles.
2. Digital disruption is resulting in heightened obsolescence risk. Be it in facilities, distribution channels or even in people. The resultant risk to business models shortens visibility.
3. The nature of long-term investors has changed a lot. In the past, promoters were part of the woodwork. New sources of capital come with divergent time horizons. The reference to the quick and the dead has found its way into the lexicon of professional investors.
4. Easy liquidity generates valuation excesses, which become unsustainable at some point. Investor patience is being tested constantly, to say the least.

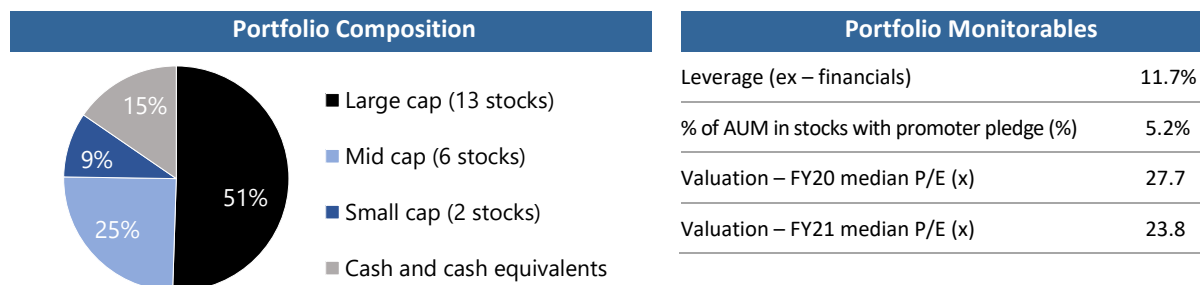
In Summary

The notion that a new valuation paradigm has come to reign over the equity markets is not new. When valuation metrics that weigh business cash flows against the price paid are dismissed as outdated, think again. It has happened before, even in India. In 1992, we heard about the replacement cost theory. In 2000, we heard about the concept of market cap per web page visited. These proved to be ephemeral.

The market has always paid a certain premium to a superior and sustainable business model or a franchise. If such premium expands and assumes a life of its own, red flags should go up. As they say, when the tide ebbs, that is when you know who was swimming naked.

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 have continued to deploy cash in a calibrated manner, based on opportunities that we identify, after putting them under our lens.
2. We made some allocation to a couple of auto stocks, after nearly three quarters of extreme caution on the sector, which was well founded. The cycle went through a vicious downdraft prior to the pandemic and is continuing into this difficult period. We believe that products and services that represent value propositions will show resilience in the coming months and quarters. Tractor demand is driven by farm economics and we see high visibility there. Two wheelers, in particular the name we chose, offer a customer value proposition that fits in very well with the deteriorating income growth dynamics in India and the need for social distancing. While concerns over health might tilt the scales in favour of personalised mobility, two wheelers may be the most preferred option in world where challenges to income could stymie or slow down upgradation to cars.
The names we chose have excellent balance sheets and earn well in excess of their cost of capital. Valuations are at reasonable levels and despite their recovery from the March lows, they made the cut in our quest to get invested gradually and responsibly.
3. We note that most of our key stocks have put in a great show post the drawdown in March and several of them are trading close to or well above the prices prevailing in early March.

Risk assessment

1. As pointed out in the last two editions, higher cash levels (higher than what we prefer in normal times – we believe these are abnormal times) tend to drag performance if the market indices move up in quick time. Though cash in portfolios has come down from April and May, it is still elevated. We continue to flag this risk, while asserting that prudent deployment of such cash is a better option than a hurried allocation into sub-optimal choices.
2. Liquidity of stocks held in the portfolio continues to be excellent and we monitor the same on a regular basis.
3. Uncertainty over company earnings for FY21 has increased, as the lockdown extends in many cities. With stock prices going up, the risk from this has only increased. We seek to mitigate this through prudent selection of balance sheets, managements and business models.
4. India VIX, a measure of volatility (risk), has come off from the astronomical levels of around 80 to about 25-30 in recent days. This is still higher than the levels of around 20 prevailing in early March. We believe volatility risk is far from being a thing of the past. The benign trajectory of India VIX in June can reverse at short notice.

Disclaimer

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