

One move at a time



Viswanathan Anand, the former world chess champion, has this to say when faced with most frequent question faced by any chess player – How many moves one has to think ahead?

"...if the path ahead is like a highway and you simply have to follow it, then its possible to see far ahead since it's a straight road. The alternative is entering a dense forest, where after every step there is a choice of three or four steps... for every step, the opponent has three or four responses...in these kind of positions, you invariably see less....infact, the longer the calculations, the higher the chances of making a mistake"

The above statement is true for the present state of the economy, corporate earnings and equity markets too. You just have to imagine Covid as the unpredictable Chess opponent.

- India has done a relatively good job in controlling the spread (though the spread in red zones continues to be worrying), the impact on the economic activity seems to be getting more prolonged than earlier expected.

- Post-lockdown, the return to normalcy is likely to be uneven and staggered with pre-conditions that might prevent the same level of pre-Covid efficiency.
- The supply chain linkages across red, orange and green zones is also likely to make the resumption challenging.

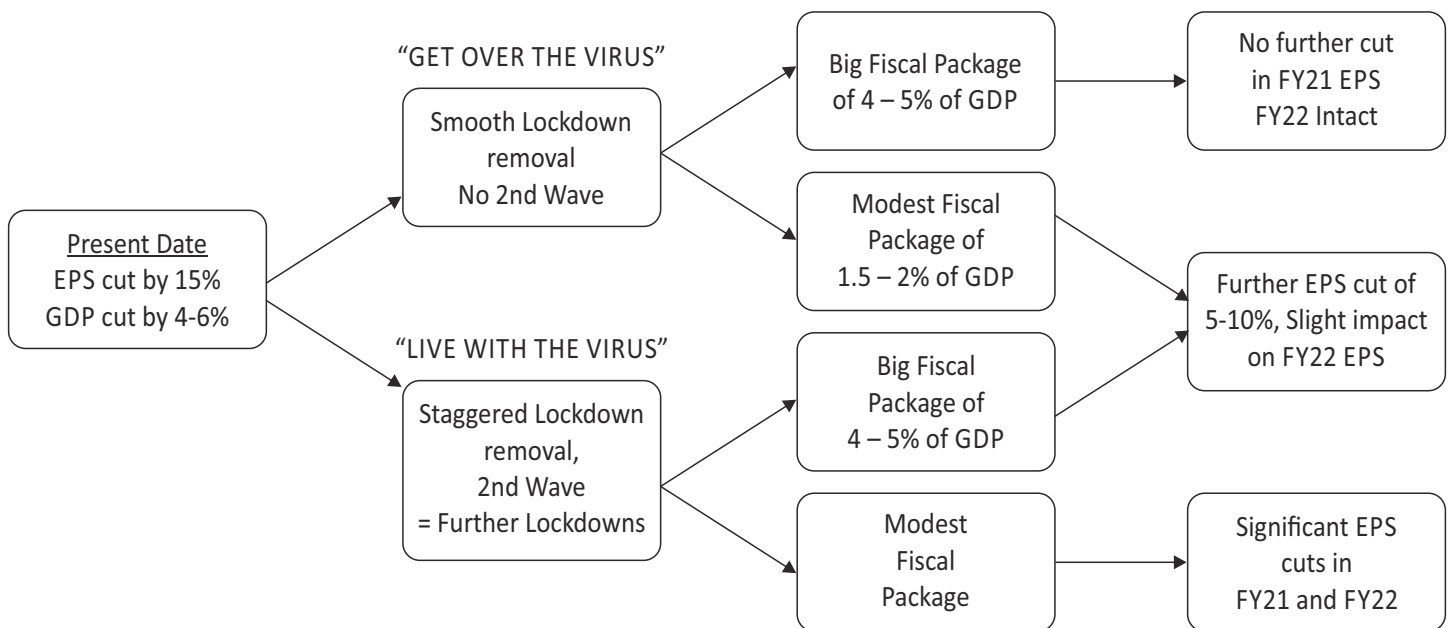
As a result, the Nifty EPS estimates have been already reduced by 15% and more downside cannot be ruled out after the June quarter. But it isn't all gloom and doom.

So what to expect next?

Government has been building a base for the next fiscal package or maybe a series of targeted support to the stressed sectors esp. SMEs. Given the revenue shortfall due to lower growth or decline in GDP, some of the below has created room for a fiscal package.

1. Government's borrowing programme for FY21 has been increased by INR 4.2 lakh crore
2. Excise hike in petrol and diesel can generate INR 1.5- 1.8 lakh crore of revenues.
3. We expect the direct or indirect deficit monetisation to continue as RBI will play its role.

Though any fiscal package is unlikely to be big bang given the need to protect the sovereign credit rating, the various scenarios can be simply summarised in the picture below. As can be seen, the range of outcomes is very wide depending on the trend of Covid cases, the pace of normalisation and the extent of fiscal/monetary support over the next few weeks.



So what should be the next move?

Equity valuations (even if we assume a further 10% cut in FY21 earnings) is at Price to Earnings ratio of 17.5x forward 12 months earnings, not very expensive but not cheap either. It should also be noted that FY21 is kind of an extraordinary year and FY22 will witness some normalisation. Notwithstanding the above, there is a need to acknowledge the wide range of possible economic outcomes as shown in the picture above. The equity portfolios therefore need to reduce risk in the short term even as we keep an eye on the gainers from an eventual recovery as well as the structural long-term trends post-Covid.

Towards that end, cash calls and lower equity allocation in hybrid funds have reduced the portfolio risk in the short run. In addition, identifying the sectors with most to lose/benefit post-Covid is critical to generate long term portfolio performance.

- The most impacted sectors are retail lenders/SME, travel leisure, mid-tier IT, capital goods and discretionary consumption. While our portfolios were earlier geared up for growth leading to high weight on Banks/Financials, we have actively rebalanced the weights to account for the downside risks.
- In contrast, Utilities, Telecom, Pharma/healthcare, FMCG and chemical exporters would be least impacted or gainers from the structural trends (eg. China plus one) when the dust settles down. Our portfolio changes over the last two months have reflected some of the above.

In summary, we are passing through the "thick forest" and will need to navigate through the risks during this fiscal year before we hit the "Highway" again.

Stay Safe and we shall meet soon!

Happy Investing!



Rahul Singh

Chief Investment Officer (CIO) - Equities

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