Monthly Letter June 2020

We were +0.5% in May versus -2.8% for the Nifty. On a 12-month rolling basis we are -6.1% versus -19.6% for the Nifty. We continue to maintain a defensive positioning in the portfolio, albeit cash levels are now down from over 30% to just over 20%. Our largest sectoral allocation is pharmaceuticals and healthcare (diagnostics), at approximately 30%. While the lifting of the lockdown from mid-June is a positive for the market, we expect a slow recovery for the economy, as the financial impact on businesses and the demand destruction engendered by the lockdown is likely to take time to recover from.

In line with those sectors we expect to do best as a result of the pandemic induced environment, we have been reorienting our holding towards pharma, telecom, consumer staples and online / digitally oriented businesses. While the financial sector is likely to be the worst affected in this milieu, we do hold a gold loan business, which is a likely beneficiary in this scenario, where liquidity is constrained for the masses and informal sector. The agricultural sector, on the back of ample rains and a good rabi season, is one of the bright spots in the economy. We have thus also added to our agrochemical allocation.

The Government has come out with a 'Rs 20 trillion stimulus package' which in reality was more a reform package than anything that would really stimulate demand in the near term. This package addressed the chronic issues in many sectors rather than the acute distress being faced by the Economy. By some estimates the actual stimulus would be an only 1% of GDP, which could be termed as too small to make a material difference in reviving demand. The biggest part of the stimulus package was in the form of credit guarantees from the Government for lending to the most affected parts of the economy. The effectiveness of this in reality remains to be seen. The real gap in fiscal stimulus will fall on the financial sector, which is why we are vary of it at the moment.

It is primarily because of this low direct form of stimulus that India has underperformed most other markets in terms of its recovery from the panic lows in March. However, India seems to now be benefiting from the tremendous surge in global liquidity (a multiple of that which was released post the Global Financial Crisis in 2008), as is reflected in the reversal in FPI flows from big outflows in March and April, to extremely positive inflows in May and early June. This has lifted all emerging markets in the recent weeks.

While supply chains are coming back to life as the lockdown eases, the demand side will take much longer to recover. Across all businesses the narrative is one of cost cutting, and that implies lower demand all across. Businesses that are either labour intensive or capital intensive, are likely to struggle with their cost structures and debt repayment schedules. While the easing up of the lockdown may staunch the damage, it will take time for industry to emerge from the negative spiral it is now enmeshed in. Consumers are also likely to be more measured in their spending in an uncertain environment. Thus, it is better to be defensive in one's portfolio allocation at the moment, as it is not clear how long the recovery will take, and what other unexpected damage can happen (example: the Supreme Court actually asking the RBI and Government to consider waiving of interest on loans in the moratorium period. This will stall interest payments by borrowers in the hope that this may happen, even though the chances of the same are, in our view, extremely low).

To its credit, the government has used this crisis to push through some structural reforms in many sectors and significantly in the area of agriculture. This is a big positive, and will provide an impetus to the growth of these sectors, and those sectors supporting them. The fall in interest rates is another significant positive, which will provide a big impetus to economic recovery in due course.

Our primary aim at this point in time is to focus on businesses that will survive and emerge stronger from the current environment and those with better visibility of demand and strong liquidity positions. With each crisis, more marginal players are getting thrown out, and this is a bigger crisis than the many recent ones. Future growth will go to those that survive.

Returns in the next few quarters are not as important as survival and preservation of capital, and therefore the need to be defensive.

Thank you for your support.

RC

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