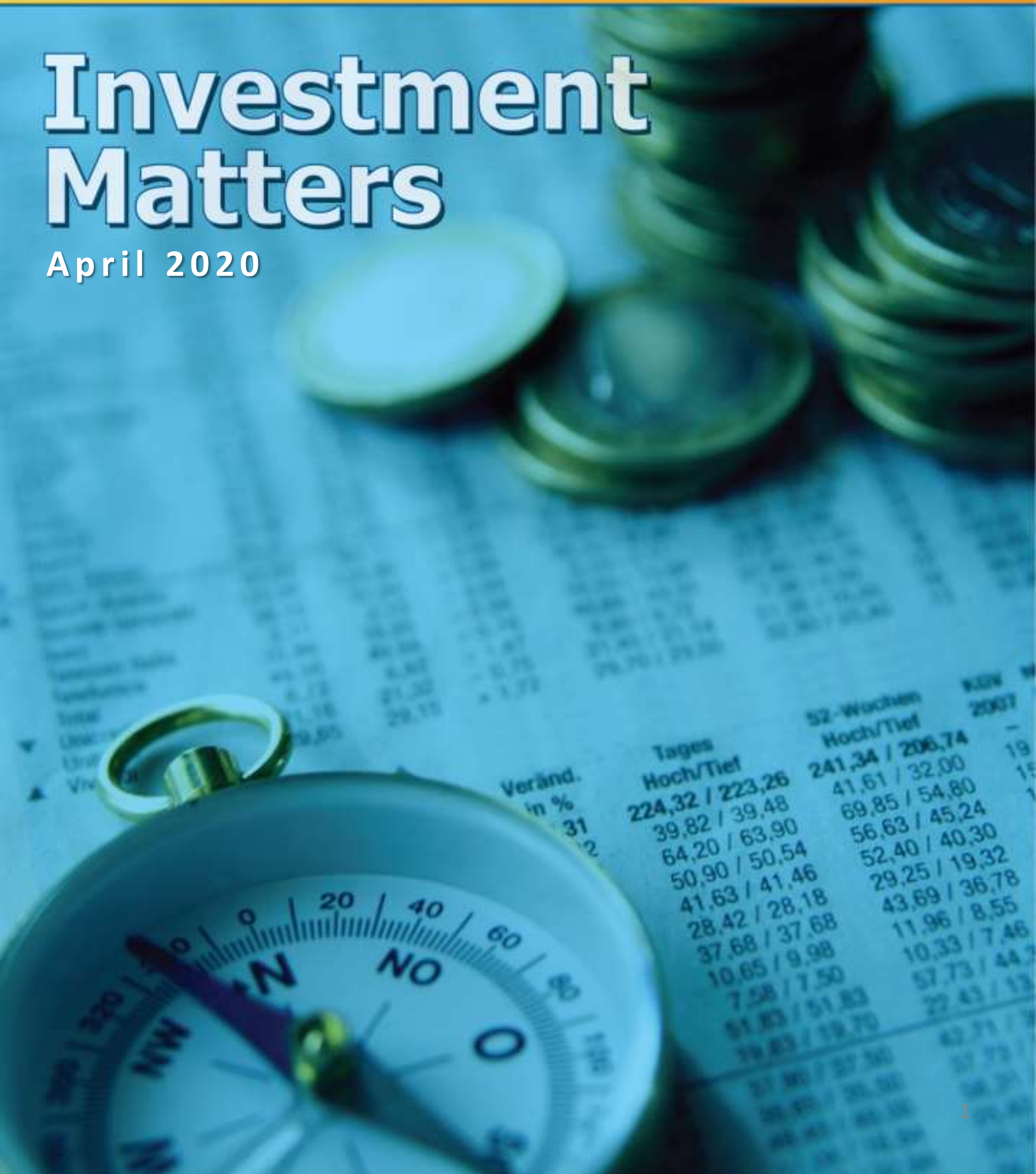
ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

April 2020



ALCHEMY CAPITAL MANAGEMENT

CIO NOTE

We are going through what by every measure is a great crisis is an understatement. The onset of the Covid-19 virus has put human lives at risk and created a global pandemic at an unprecedented scale with no known cure in the short to medium term.

However, this communication is not about the pandemic, as I am sure we all have tried our very best to understand it given the deluge of information floating around this topic from both credible and sometimes not so credible sources. This is about attempting to understand the impact of the disruption caused to economic prospects, markets and investment implications in particular.

At the outset I must admit that it is very difficult to envisage the extent and the length of the disruption caused by the virus as it is an unprecedented event and the scientific community, governments, policy makers and individuals are still trying to understand the full dimension of how to cope with this challenge. All we can say is that we must not underestimate the ingenuity and adaptability of humans, the abilities of science, and the innate faith in a higher power whichever shape and form it may be to help us to eventually overcome the gravest of challenges.

In the Indian context, given the size of our population of 1.3 billion people and the inadequacy of our health infrastructure, though we are not be singled out, as all countries are unprepared for this, the government and the policy makers had no choice but to enforce a very strict 21 day lockdown of the country to prevent a massive spread of the virus and rightly so. However, as logical and practical this decision is, a prolonged and complete lock down has serious adverse consequences for the economy, businesses and workers. Economic activity has come to a grinding halt and the supply chain disruptions have been massive. The longer the lockdown persists, the deeper will be the impact on growth, aggregate demand, increased stress to the financial and banking system, job losses and potential bankruptcies.

Pre-Covid, the economy was anyway coming out of a slow growth and an excruciating consolidation phase. Data for January and February suggests that the economy was well on its way to reviving. However, this new challenge will bring us back to ground zero and we will have to work our way back to normalcy. In order to mitigate the adverse economic impact of this pandemic and the resultant lockdown and social distancing, governments around the world have to massively intervene to provide adequate stimulus, provide massive liquidity to the financial system and more importantly provide an adequate and timely safety net to unorganized and organized workers and employees and consumers at large.

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Most developed countries have already provided fiscal stimulus to the extent of 10 to 20% of GDP which is 4-5x of what was done during the global financial crisis and the central banks have unlocked a massive bazooka to provide humongous amount of liquidity and undertaking to purchase all kinds of assets to prevent a liquidity squeeze and dislocation in the credit and money markets as was the case during the Lehman crisis.

The Indian government and the RBI have also taken some steps by unveiling a social package estimated at between 0.5% to 0.8% of GDP and the RBI has cut rates and infused liquidity in the system. However, much more would be needed to help workers, the agriculture sector, SME/MSME's and both medium and large business to help tide over this crisis. This will be very critical in determining the impact on our economy and businesses. In summary, we still have serious challenges on the economic front on our hands and the quicker and more effectively we move the quicker will be the recovery.

In response to the crisis, the markets around the world had a steep and the fastest correction ever recorded in history. The speed of the fall was unanticipated. However from there the markets have staged a recovery based on the flattening of the curve (rate of change of net new cases) in US/Europe and the massive stimulus unfurled in the developed countries. Though Indian markets have also recovered from the bottom seen in March, our markets have underperformed the global markets. The fear is that a country of our size will probably see far more cases than we have given the size of our population and that we have not yet tested enough. Secondly, the markets are also anticipating the second fiscal package.

Without sounding too pessimistic, by historical standards and precedents this does look like a relief rally or a bear market bounce. Whether this recovery in the markets will sustain or will markets go up or down is difficult to ascertain. However, the fall in the markets is akin to a deep fracture, and it is safe to assume that the markets will need a couple of months to consolidate in a range before they move towards a sustainable recovery path.

While it is both difficult and foolish to predict the short term movements in the markets, a lot will depend on the following factors:

- How quickly or soon will the nation wide lock down be lifted? Even though it is now expected that a full lockdown will not be lifted, a partial and gradual lifting of the lockdown in relatively less affected areas is most essential for economic activity to restart. We hope and believe that state governments will be given the freedom to ascertain their own policies to exit from the lock down .

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- Number of cases post lifting of the lockdown. This will be very critical; if the number of cases increase dramatically, then there maybe a need to re-introduce lock down in some form or fashion .
- The extent and the breadth of the economic stimulus package .
- The extent of FII selling, we saw a record amount of FII selling equities worth Rs 61,973 Crs *(Source: SEBI)*

Given the almost complete lockdown for 21 days and prospects of extending the same for a week or two in some of the most affected parts of the country, it is but natural that part of March 2020 and Q1 FY21 numbers of companies would be substantially impacted. The extent of the impact is difficult to ascertain at this stage. Therefore, looking at FY21 earnings may be meaningless to some extent. Definitely, as long term investors we must look through the current one to two quarters as an aberration and ideally the value of a business does not dramatically change because of this short to medium term disruption.

However, we have to be cognizant and ready to accept that the “price” as opposed to “value” may get impacted as Q4 and FY Q1 2021 numbers come through. At a company level we are assessing each of our portfolio companies on these important parameters

- Cash in the balance sheet and minimal to no leverage (ex-banks & financials) to tide over the medium term challenges .
- Ability of the business to manage their costs and hence prevent cash losses for the year .
- An assessment of the improved competitive positioning when things come back to normal .
- Extent of the direct impact and the relative time taken for recovery.

Leadership, scale, innovation, agility, being digital ready and compassion towards employees and business partners will be the key differentiators for businesses both during this tough period as well as during recovery.

It is reasonable to assume that after such a dramatic fall, markets would need to consolidate in a range and digest the challenges Covid-19 has presented. But it will also throw up significant opportunities to make long term investments as well as re-align the portfolio to capture newer opportunities and newer leadership amongst companies and sectors. We propose to use the cash created in the portfolios for the same purpose over the next few weeks and months.

I wish to thank all my investors for the faith and confidence they have shown and wish you and your families the best of health and safety.

Hiren Ved
Chief Investment Officer
Alchemy Capital Management Pvt. Ltd

Source :
Alchemy Research
Bloomberg

EQUITY OUTLOOK

We laid out our key worries for the economy in our CIO letter of Mar 23 – financial stability, a spiralling growth shock and risk aversion from banks choking credit. In this edition of the newsletter, we look at the important cues for the economy and the equity markets. The progression of COVID-19 and the tenure of the lockdown are the most important factors. We, however, are also looking at the policy responses, both monetary and fiscal, as well as the global economic cycles as key markers for the economic recovery.

Covid-19 and lockdown progression: The progress of COVID-19 is, of course, the most important variable. Rapid progress would put enormous pressure on the medical infrastructure. This would, in turn, raise the risk of the national lockdown extending beyond April 14 or, at least, be lifted with very heavy restrictions. The longer the shutdown lasts, the deeper would be the economic slowdown and the more delayed the recovery. It would also strain government resources and limit its ability to combat the economic slowdown.

Fiscal measures from the government: Fiscal support will be necessary to recover from this growth shock. The shape and size of that fiscal package will be an important lever for bringing the economy gets backs on its rails. The government, so far, has announced an income support package for specific sections. We believe that this should go further, mainly for humanitarian reasons but also to help economic stability. Moreover, we believe a fiscal boost may also be necessary, either through fiscal support to specific employment-generating sectors, or through aggressive spending. The best way, however, is a large cut in indirect taxes – that helps both aggregate demands, lowers costs to consumers and helps producers get back on their feet quickly.

Monetary policy measures: The RBI unleashed a range of monetary measures on 27 March following an out of turn MPC meeting. This included rate cuts, an EMI holiday and targeted liquidity injections to encourage banks to lend more. These were well-thought through measures and went a long way in easing nervousness in market participants. More importantly, there seemed to be an underlying tone from the RBI governor that any pockets of stress within the financial system would see a timely intervention from the central bank. This has helped calm the nervousness in the money and financial markets to a significant degree.

Bond market sentiment: The bond markets are waiting for their own set of signals. The opening up of specific securities to FPIs could pave the way for India to be added to global bond indices: this would be a key support factor. On the other hand, a fiscal stimulus would see a spike in government borrowings – that, however, could be offset by increased monetisation of the deficit. Enhancement of ways and means limits would be an important metric to track.

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Risk appetite of the financial sector: Banks will have to start lending within a short period of time. The lockdown will strain the balance sheets of large corporates and SMEs, and bank finance will be necessary to help contain that damage. Once economic activity picks up, there will be continued demand for working capital finance to fund that growth. A likely NPL spike, however, could have exactly the opposite effect. The government, regulators and bank boards will have to step in to create an environment of counter-cyclical behaviour.

Global recovery: India's linkage to the global economy should not be underestimated. A deep global recession will not do the economy any favours. Also, while low oil prices are a huge benefit to India, excessively depressed prices brings its own set of collateral challenges that hinder growth. The counter-intuitive reality is that a modest recovery in oil prices from current levels may be a net benefit to the economy.

We wish you and your loved ones safety and good health.

Seshadri Sen
Head of Research
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Source :
Alchemy Research
Bloomberg

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