Valentis Advisors

Fear, uncertainty and opportunity

April 4, 2020

Key points

- Markets have weathered many diseases earlier and have bounced back quickly. However, the Covid-19 is different since (a) it has spread globally - the last time we encountered something like this was more than 100 years ago. (b) It has provided a triple shock to markets - the medical shock and the consequent lockdown leading to a demand as well as a supply shock.
- While it's too late to sell with lot of the price damage having been done, markets will remain nervous near term as the number of infections in India as well as USA rise. Markets will bottom once the Covid infections peak out even though the economy will take much longer to mend. We would continue to invest very gradually in the market.
- Given the uncertainty on the virus being brought under control and the consequent lockdown, economic forecasts remain uncertain. Probably, it is safe to assume a negative double-digit GDP growth for Q1FY21. Once the virus is brought under control, we come to familiar problems on the economy where monetary and fiscal stimulus will start having any impact.
- Why should we invest in so much uncertainty? The reason is returns can be outsized from here. Just to give a few examples -(a) December 2008 was the worst quarterly performance before the current March quarter. Investing at the end of that quarter would have given us 81% return 1-year later (b) Past history has shown that markets typically take 24-30 months to revert to their peak. From their lows, markets have tended to give 25+% returns in a year's time frame.

Triple shock: medical shock, supply shock and demand shock

We generally never like to say "this time it's different" . Market corrections are never pleasant for investors. Yet, in our 30+ years of tracking markets, we have seen a 30-50% drop in markets once every 8 years on an average.

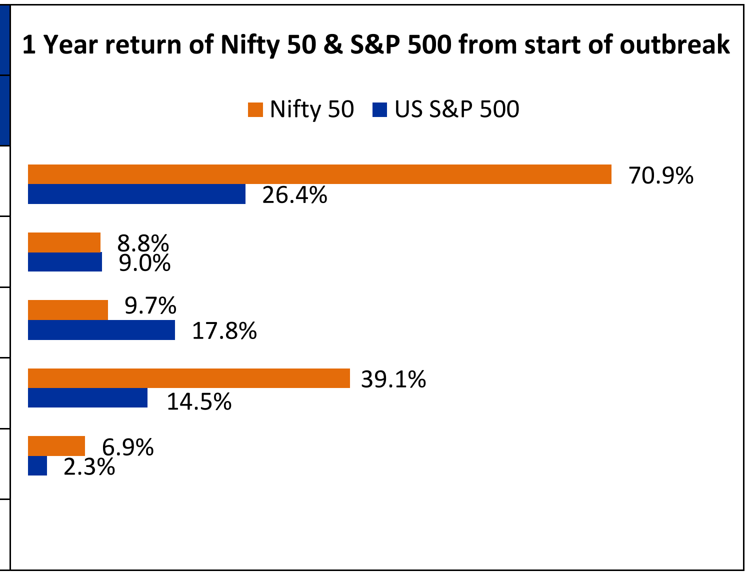
But this time it actually is different since the correction has been led by a medical shock (covid-19) the likes of which we last saw 100 years ago. The medical shock has of course led to an economic shock as well - both demand and supply shock- as the world goes into a lockdown to avoid the virus.

Market correction led by a global pandemic

It's not that we have not seen diseases past 30 years - indeed there have been many of them which the market has weathered and emerged higher.

Table 1: Market reaction during virus outbreak

Virus	Estimated period of outbreak	fall from peak	
		S&P 500	Nifty 50
SARS	Jan 03 - March 03	-14.1%	-11.1%
Avian Influenza	Jan 04 - Aug 04	-8.2%	-27.0%
MERS	Sept 12 - Nov 12	-7.4%	-3.7%
Ebola	Dec 13 - Feb 14	-5.8%	-5.7%
Zika	Nov 15 - Feb 16	-13.3%	-13.6%
Covid-19	Jan 20 - Present	-33.9%	-38.4%



Source: Investing.com, Valentis Research

However, the difference this time is that the disease has spread globally unlike the earlier occasions listed above where the disease was contained regionally. The last time we saw anything like this was more than 100 years ago (way back in 1918) when the Spanish flu infected nearly 50 crore people (over a fourth of the world population) and killed 5 crore people.

Covid-19 uncertainties abound - Fear of the unknown

What is easier to predict is that the markets will bottom, at least short term, when we see number of infections globally from Covid-19 start to plateau and slow-down. What is totally unknown at this stage is how long this will take though everyone is hoping this will happen in next 1 to 3 months. With limited medical knowledge what we can attempt to put out is some of the observations and questions:

1. We know that some of the early countries plagued by the virus like China have seen things coming back to some sort of normalcy giving hopes that we could see an improvement in other countries too over next few months.
2. Europe seems to be flattening out in terms of cases though still at a high level. This reinforces that lock-down measures will reduce the intensity of the virus over a period of time.
3. India and USA will likely see a sharp increase in new cases over the next few weeks.
4. Soon with the onset of summer, we will know whether the heat causes the disease to recede.
5. Unless we find a cure to this (a vaccine is probably more than a year away), will we see a second wave of infections once the lock-down is lifted? Of course, if we buy time we may be in a better position to combat the disease by having more testing kits and more ventilators.

If and when we have seen the worst of COVID-19 behind us, we will have to worry about the economy which will be in disarray. But that is something which will get us to more familiar grounds.

Economic recovery nipped in the bud

Market corrections have typically been led by economic factors which investors know, or at least they think they know, how to forecast a solution and end to. The correction this time (though markets were expensive and had a long bull run as is normally the case before corrections) has been led by the rapid spread of the corona virus across the world.

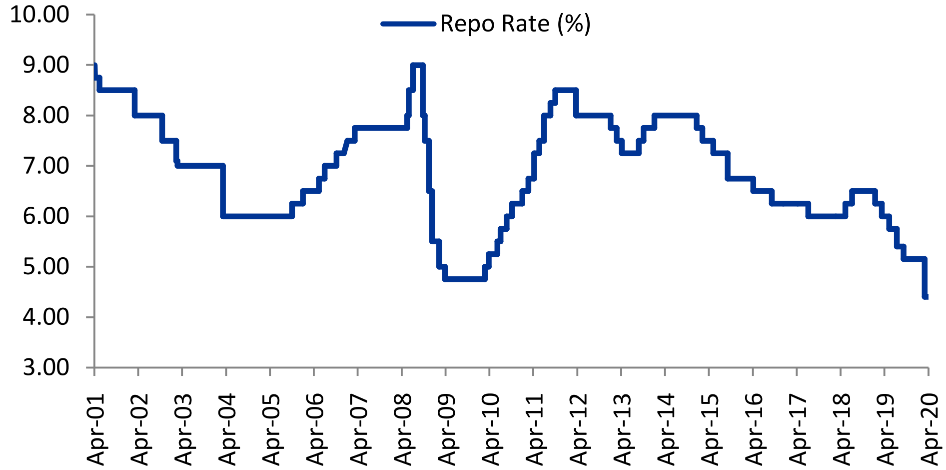
The economic and earnings environment has become impossible to predict and depend on the extent of the virus period and the consequent length of the shut-down. Once the impact of the disease recedes, the market will start to focus again on earnings and the economy. While the economy is broken, tackling the economy brings us to more familiar grounds where monetary and fiscal stimulus would make an impact.

- It is easy to say that there will be a sharp cut in the Q1FY21 GDP growth and earnings will probably be negative for a whole lot of companies depending on whether the shut-down gets extended. While putting exact numbers at this stage may be meaningless, a double digit drop in GDP in the quarter is likely.
- While we may see some quick bounce in the economy as re-stocking takes place once the lockdown is lifted, it would be safe to assume a more U-shaped rather than a V-shaped recovery with FY22 being a more normal year.
- One bit of positive data point is from China where the latest PMI showed that the Chinese economy has bounced back very sharply post the lockdown. This may again represent the re-stocking impact.

There are 3 factors which could help a recovery:

1. Easy monetary policy: Globally central banks are easing monetary policy with interest rates in the developed world close to zero. In India too interest rates have fallen substantially and RBI has provided liquidity infusion as well as forbearance to meet short term liquidity problems

Chart 1: Repo rate (%) lowest in last 20 years



Source: RBI, Valentis Research

2. Fiscal stimulus: Governments across the world are likely to provide huge stimulus to protect the economy. USA has already announced a stimulus of 10% of GDP and many other countries are expected to have similar sort of fiscal stimulus packages. We expect India too to announce a huge fiscal package to help the economy and not focus on fiscal consolidation at this stage. Our sense is that the Indian Government may announce piecemeal stimulus rather than a one-shot big bang approach.

3. Falling oil prices: With Saudi deciding to hike oil output, oil prices are on a downward spiral. This provides a huge benefit to India - every $10/barrel drop in oil prices reduces the current account deficit by 40 bps. If Government retains the oil price fall by way of higher taxes, it means a reduction in fiscal deficit of 40 bps for every $10/brl fall in oil prices. Our view is Government will probably retain some part of the benefit and pass on the rest to the consumer helping lower inflation.

What to do in markets now?

So should we sell now given the uncertainties or do we buy given the fall? What is the bottom for the market? We attempt to answer these questions below:

1. It is too late to sell though we are probably going to see some more downside to the market. The market will bottom when the infections from the corona virus start to plateau. We are hopefully getting there in Europe but USA and India will see a rise in cases over the next 2 weeks.
2. Whenever the lockout is lifted, and we believe it extend longer than April 14th announced currently, the focus will move to repairing the economy. This brings us to more familiar territory - monetary and fiscal stimulus will start working here and India has the added advantage of low oil prices. Markets will bottom before the economy does though we could have a consolidation period in markets thereafter.

3. So where will the markets bottom? Frankly, it is impossible to call a bottom and we know it in hindsight after the market has sustained a rally of probably 15-20% higher. While valuations are not very useful in calling an absolute bottom, a P/B at the low point of FY09 (of 1.7x) would correspond to a 7200 nifty index level while a market cap to GDP level of FY09 (of 55%) corresponds to around 7800 nifty level. Earnings are totally uncertain this stage and so earnings based valuations are less useful but we could make the case for even lower Nifty levels. Our strategy is to invest gradually at market falls rather than waiting to make any lump-sum investment at a particular level.
4. Why should we look to invest in the market at all? If the corona virus lasts beyond a couple of months this could a correct question. Hence, our call to not invest all the money at this stage but invest slowly. However, rallies can also be sharp if there is any positive news on the virus. Moreover, if the virus subsides by this quarter, the markets could give out-sized returns as seen by a few examples below:

   (a) Helicopter money: The Fed has increased its balance sheet by $1.4 trillion over past few weeks which is even higher than the just under $1 trillion they did in 2008-09.

   (b) Q1CY20 was the worst quarter we have seen in market performance falling 28.6%. The previous worst quarter was the December 2008 quarter which gave a negative return of 25%. If we had bought at the end of that quarter, we made a 81% return over next year with a maximum drawdown of 15.4%. Similarly, October 2008 has been the worst monthly fall we have seen in history. One year later market was up 62.4% though we were down 16.6% in the interim.

   (c) A similar message come if we look at other past meltdowns. This is the fastest fall ever. Recoveries in markets from such falls are swift. But even if we look at all falls, 1-year returns from lows have typically been 25%+ and the index has reverted back to its peak in 24 months from the lows and 30-36 months from the start of the fall.

   (d) We believe equities offer outsized returns in the medium term when the trinity of (a) low valuations (b) bottom of earnings cycle and (c) broken investor sentiment converge. We are there now for the first time after CY13 when India was part of the "fragile five".

#1: Worst quarter in history

March, 2020 was the second worst month in history (and just escaped being the worst month due to rally in markets on the last day ie March 31st) and the March, 2020 quarter was the worst in history.

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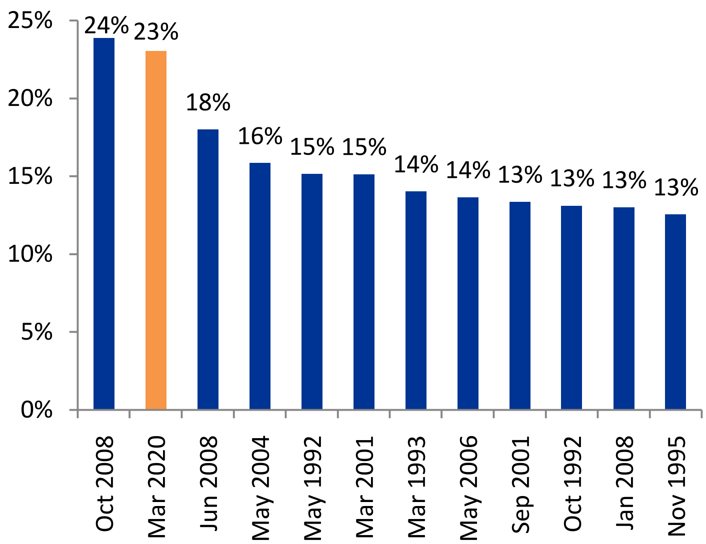
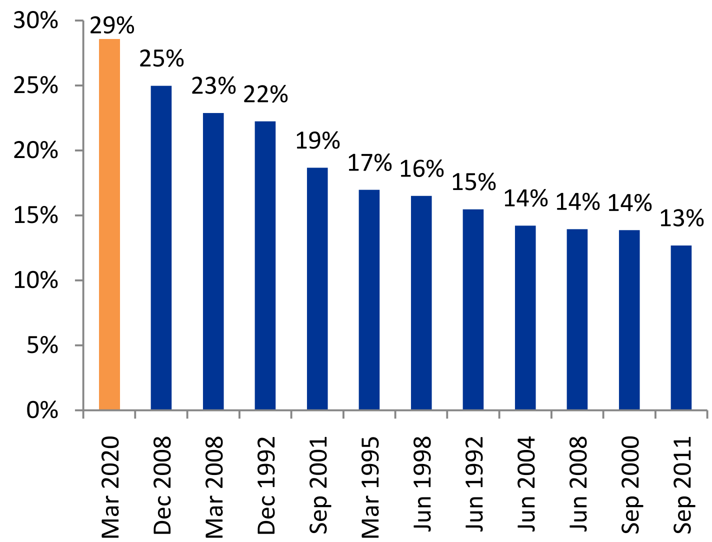
Chart 2: Worst months for markets (% fall)



Source: ACE Equity, Valentis Research

Chart 3: Worst quarters for markets (% fall)



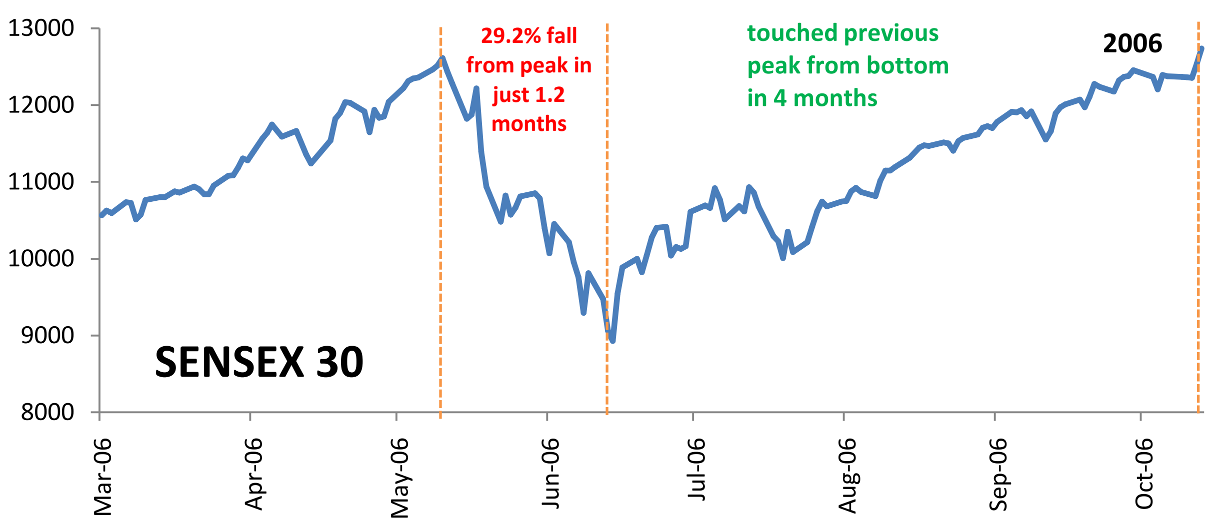
Source: ACE Equity, Valentis Research

#2: Fastest fall in history

We have had 3 distinct periods where markets dropped sharply - (a) in 1992 post the Harshad Mehta bull run (b) in 2001 when the tech bubble burst and (c) in 2008 due to the Global Financial Crisis (GFC). However, none of these could match the speed of the present market fall.

In fact, the nearest we came to such a quick fall was in 5 weeks between May2006 to June 2006 when markets fell near 30% as global central banks led by the Fed hiked rates and spooked the markets. However, this period was quickly forgotten since markets recovered all their gains in 4 months and went higher through 2007.

Chart 4: 2006 was second fastest fall



Source: ACE Equity, Valentis Research

#3: Looking at past market meltdowns

The table below gives some of the sharp falls in the market over the past 30 years. Key observations:

1. This is clearly the fastest fall in a short span. On earlier occasions when we fell over 25% in a span of less than 6 months, we were back to previous peaks in less than 12 months.

2. Buying the fall has proved very profitable on a 1-year and 2-year basis with CAGR returns of over 25%.

3. The index typically reaches back to its peak over 24-36 months from when the fall started. Faster the fall, typically faster is the time to regain the peak.

Table 2: Past market meltdowns

Peak Date	Peak	Bottom date	Bottom	% fall from peak to bottom	No .of months to correct	Months taken to cross previous peak from peak date	Months taken to cross previous peak from bottom date	% Return from Bottom		
								6M	1Y	2Y
22-Apr-92	4467	26-Apr-93	2037	-54.4%	12.3	28.1	15.8	34.4%	85.6%	60.3%
12-Sep-94	4631	02-May-95	3015	-34.9%	7.7	35.3	27.5	13.5%	26.9%	27.4%
18-Jun-96	4069	04-Dec-96	2745	-32.5%	5.6	12.1	6.5	40.7%	28.5%	3.8%
05-Aug-97	4548	28-Jan-98	3210	-29.4%	5.9	23.5	17.7	0.3%	2.6%	66.2%
21-Apr-98	4281	20-Oct-98	2764	-35.4%	6.1	14.7	8.6	24.6%	78.8%	34.0%
11-Feb-00	5934	21-Sep-01	2600	-56.2%	19.6	47.4	27.8	35.2%	16.3%	62.2%
14-Jan-04	6194	17-May-04	4505	-27.3%	4.1	10.7	6.6	33.1%	43.5%	171.2%
10-May-06	12612	14-Jun-06	8929	-29.2%	1.2	5.2	4.0	47.6%	59.1%	70.1%
8-Jan-08	20873	09-Mar-09	8451	-59.5%	14.2	34.4	20.2	89.5%	101.8%	118.6%
05-Nov-10	21005	20-Dec-11	15175	-27.8%	13.7	36.3	22.7	11.1%	28.3%	36.5%
14-Jan-20	41953	23-Mar-20	25981	-38.1%	2.3	?	?	?	?	?

Source: ACE Equity, Valentis Research

#4: Trinity of low valuations, bottom earnings cycle and negative sentiment now converging

It has been our long standing view that we make outsized returns in the medium term if we invest when (a) Valuations are low (b) Earnings cycle is at a low point and (c) Investor Sentiment is low.

It is not very often that we get all 3 of these factors in our favor but we seem to be getting there. Till the market correction, our view was that 3-5 year market returns will be below earnings growth. Post correction, we could now see returns from the stock market being higher than earnings growth as valuations revert back to mean.

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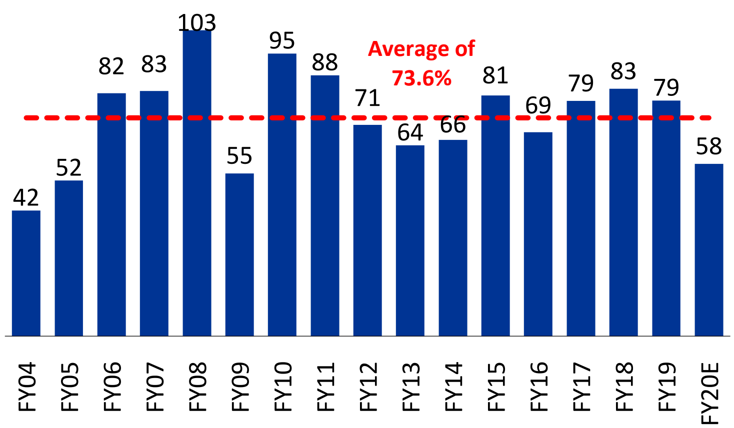
Valuations getting attractive; can go lower

Valuations are clearly cheaper than they have been over past few years. However, given the fear and uncertainty of the Covid virus and then the recessionary conditions in the economy, we could see valuations go cheaper near term. But we expect them to revert to mean over the medium term as the pandemic blows over and the economy normalizes.

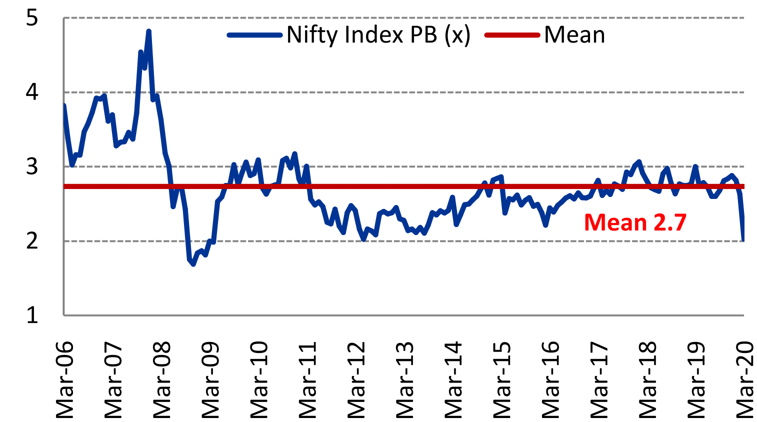
1. Market cap/GDP and P/B both look attractive in a historic context: The market cap/GDP has reached levels similar to the lows of 2008-09 from where we saw a sharp rally in the markets. The P/B is slightly above the levels reached at the lows in Fy09. If the P/B goes back to the levels reached at its lows in FY09 (of 1.7x), it corresponds to a Nifty level of 7200.

Chart 5: Market cap to GDP ratio (%)



Source: MOSL, Valentis Research

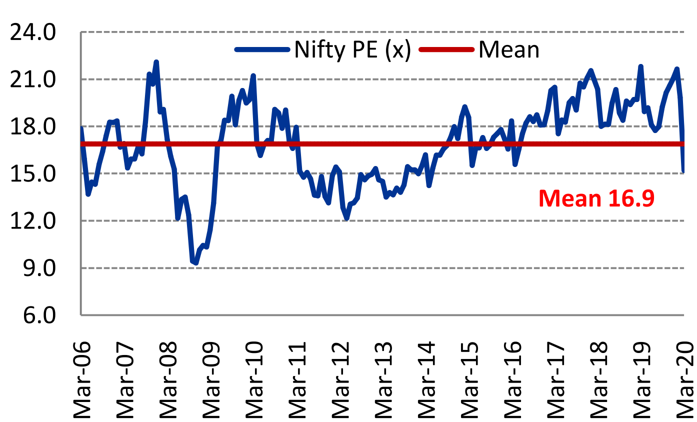
Chart 6: 12M forward Nifty Index PB (x)



Source: MOSL, Valentis Research

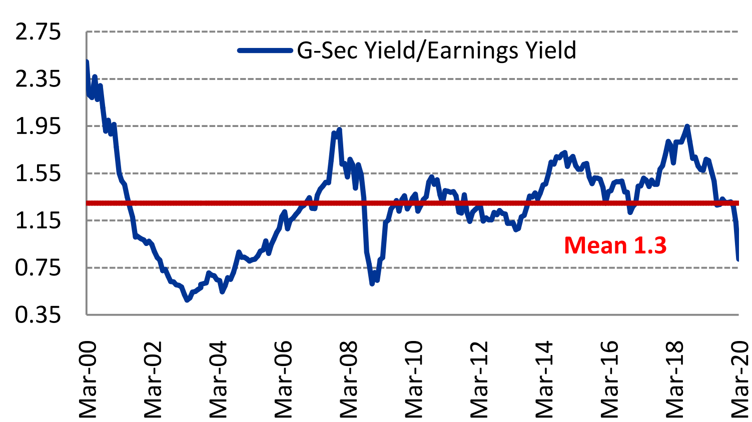
2. P/E ratio and Bond Yields/Earnings Yield: Given the close to zero visibility on the economy and earnings, valuations like PE may be more difficult to figure. We have taken a 10% cut to analyst forecasts for FY21. Based on that both PEs and earnings yield look attractive but are not as low as that at the lowest point of 2009.

Chart 7: 12M forward Nifty PE



Source: MOSL, Valentis Research

Chart 8: BOND YIELD vs SENSEX EARNINGS YIELD (%)

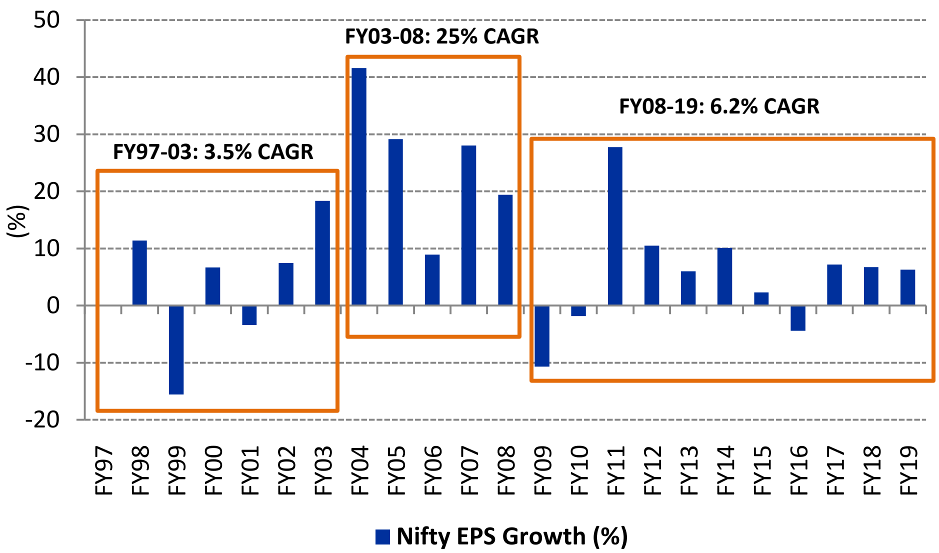


Source: MOSL, Valentis Research

Earnings cycle: near term uncertain but we are close to bottom of cycle

Earnings in India has clearly disappointed past few years as demonetization, GST and the clean-up in bank balance sheets depressed earnings. We had sensed a turn in the economy for the past few months and we expecting earnings to see a sharp recovery in FY21. while earnings for FY21 will clearly see huge downgrades, we think earnings should normalize from FY22 and should bounce back next few years.

Chart 9: Earnings growth trend



Source: MOSL, Valentis Research

Sentiment low

The current fear of the unknown is leading to investor sentiment being low. Returns from equity are below fixed deposits now over a long period

Index	Returns (CAGR %)			
	1-year	3-years	5-years	10-years
NIFTY 50	-26.0%	-2.1%	0.3%	5.1%
SENSEX 30	-23.8%	-0.2%	1.1%	5.3%
NIFTY MIDCAP 100	-35.9%	-12.0%	-2.1%	4.3%
NIFTY SMALLCAP 100	-46.1%	-19.9%	-8.6%	-0.1%

Source: ACE Equity, Valentis Research

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