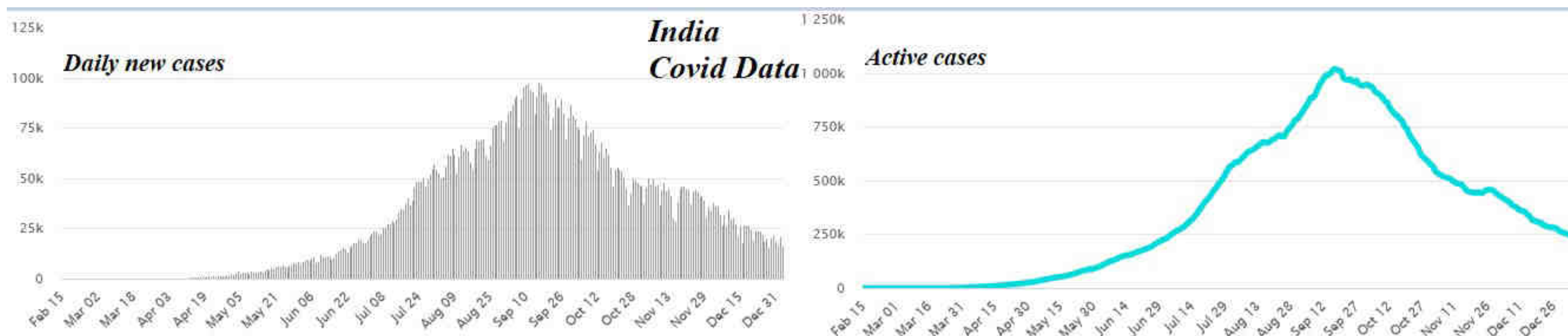
Volatile 2020 has surprisingly ended with hope!!

As we step out of one of the most volatile years individually as well for the markets and step into the New Year with Hope, we reflect back on how we have handled 2020 and what is in store for 2021 and beyond.

We had ended our last note with the quote '**Heads We win, Tails we don't loose much"**, this confidence emanated from the fact that we had already reached 70% equity allocation in most portfolios and had parked 30% in fixed income and gold. This has helped portfolios ride the equity rally witnessed in the last couple of months, without us going **All In.** We feel the next few months will provide an opportunity to do that, albeit with a bit of caution. However, individual asset allocation plans will be the cornerstone of all the actions we do.

COVID progress for India: Jugaad with some good planning, Better than most

India has responded to this pandemic with a great deal of ingenuity of the people (jugaad) combined with unprecedented government will and implementation. This has resulted in much better outcomes when compared with other countries with large populations. We are of the view that India has done reasonably well and surpassed all expectation in its handling of the pandemic by imposing lockdowns to gradually opening up, ramping up all three tools - testing, equipment and treatments facilities.



Vaccine roll out Strategy - Smart and Practical

As we write this, Indian authorities have approved two vaccines The Astra Zeneca Vaccine - manufactured by Serum Institute of India and the indigenous vaccine developed by Bharat Biotech and ICMR. The government plans to initiate mass vaccination in a couple of weeks. Also, the choice of the two vaccines is significant as they are manufactured locally and don't need elaborate cold chain import logistics which means roll out should be relatively easier compared to the ones used in the Western countries. A target of vaccinating close to 300mn people by June-July 2021 augurs well for a gradual transition into normal life for citizens and consequently economic recovery and growth.

Portfolio Action : What have we done and where are we now

We have been more active in 2020 and done more transactions on client portfolios than all our previous years combined, we would like to categorize our actions into three different stages.

Safety first

Our primary intention was to protect downside to begin with, the March moves were to book profits in equity wherever possible or cut losses, just get to safety as we increased debt/cash levels to nearly 50% across portfolios and bought gold for all portfolios.

Pragmatic

Having achieved the first objective of protecting downside, we realized that once the panic subsides markets will eventually move up recognizing underlying fundamentals. So, we started moving money back to equity gradually through systematic transfers and made sure that all portfolios have adequate exposure to equity by July-August. At the same time, we made sure that all portfolios had exposure to gold and some cash, for any eventuality given the prevailing situation at that time.

Observant

As of now all our portfolios are at the adequate level of equity exposure and we have stopped any incremental move to equity since October itself. We have reasonable exposure to gold and fixed income. However, for any new fresh money and new portfolios we are more aggressive as we are looking to increase equity exposure immediately instead of the gradual approach we normally take, as we are extremely positive on the medium to long-term prospects for Indian equities.

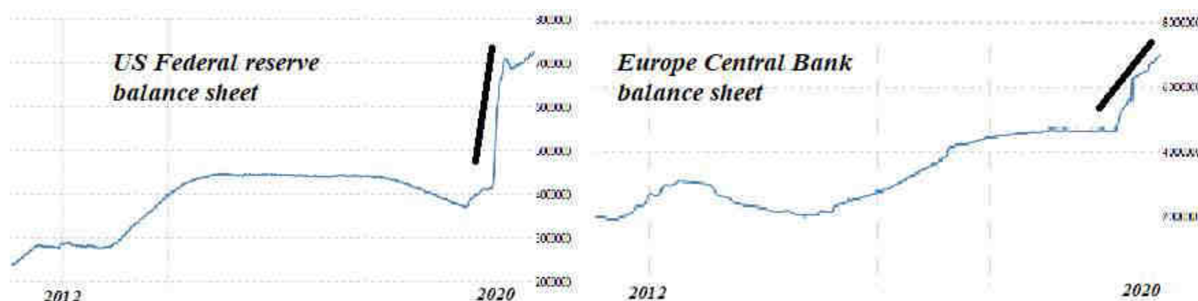
Portfolio movement in the past few months

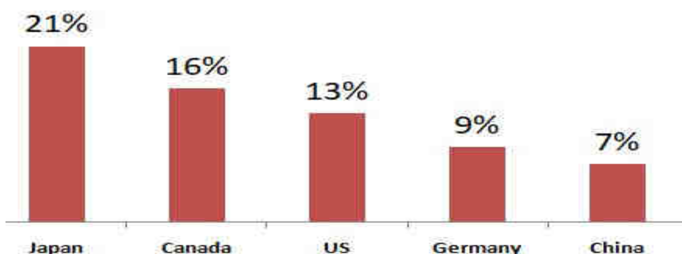
This is average asset allocations, individually portfolio asset weights may vary.

Markets have surprised us by the pace and not direction

As seen in the graphs, Sensex, the benchmark index, has recovered more than 60% from the lows of March and has been on a one-way trajectory especially, since November. Although, we had anticipated some recovery in the market post the initial panic reaction in March, we are pleasantly surprised by the pace of increase, and indices hitting new highs so soon. We explore the possible reasons for this move.

Global Liquidity





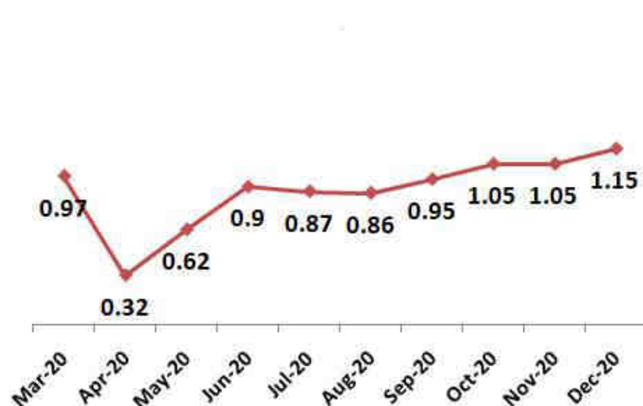
Source- trading economics, Statista

A significant surge has taken place in liquidity across the globe as a combined action by the Central banks and the governments of the major economies through both fiscal and monetary stimulus. And we believe that a part of that liquidity landed in India through FIIs, the key catalyst for this market surge.

Better than expected economic performance

GDP growth in India has been better than the projections. As per RBI 2QFY21 GDP shrank by 7.5% against an expected 8.3%. Future expectations are even more robust, with 2HFY21 to show a positive uptick of 0.4% and H1FY 22 GDP growth to be in the range of 14.2%. Moreover, GST collections have hit record high lately, further showing strong signals of economic recovery.

Nifty companies have shown significant resilience that is reflected from their quarterly financials. Although the sales have not reached last year's aggregate, several cost cutting measures ensured that the companies managed to maintain their profitability.



Source- ICICI sec, GST

Other key Economic Indicators: Improving

	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20
Manufacturing PMI	27	31	47	46	52	57	59	56
Services PMI	5	13	34	34	42	50	54	54
Passenger cars (YoY growth)	-53%	-90%	-58%	-12%	14%	29%	10%	11%
2 wheelers (YoY growth)	-40%	-84%	-39%	-15%	3%	12%	17%	13%
Railway freight traffic (YoY growth)	-35%	-21%	-8%	-5%	4%	16%	15%	9%
IIP manufacturing (YOY growth)	-67%	-38%	-16%	-12%	-8%	0%	4%	

Expectation of Vaccine

Mass vaccination programs across the world including India, has triggered renewed hope of economic recovery as normalcy might return earlier than expected.
In addition, we believe that market appreciates the fact that most of this bounce back has happened without significant fiscal stimulus by the government compared to its global peers. This signals that government has some more dry powder to stimulate economic demand in the coming year and even if that doesn't happen, the government finances are not stretched.

Outlook 2021 and beyond

Near term

Market is rewarding sectors like auto, cement, building materials and metals which have been showing significant improvement post opening up. This is apart from sectors like IT, pharma and consumption which hitherto were not affected by the pandemic, will continue to attract investor attention due to improving prospects. With an expected nominal GDP growth in the range of 17-18% for FY21-22,(real growth 10% + inflation 7%) . And if you expect corporate India to do better than nominal GDP, corporate earnings growth for FY 21-22 could be upwards of 20% which will be one of the highest in the world and should augur well for near term equity performance.

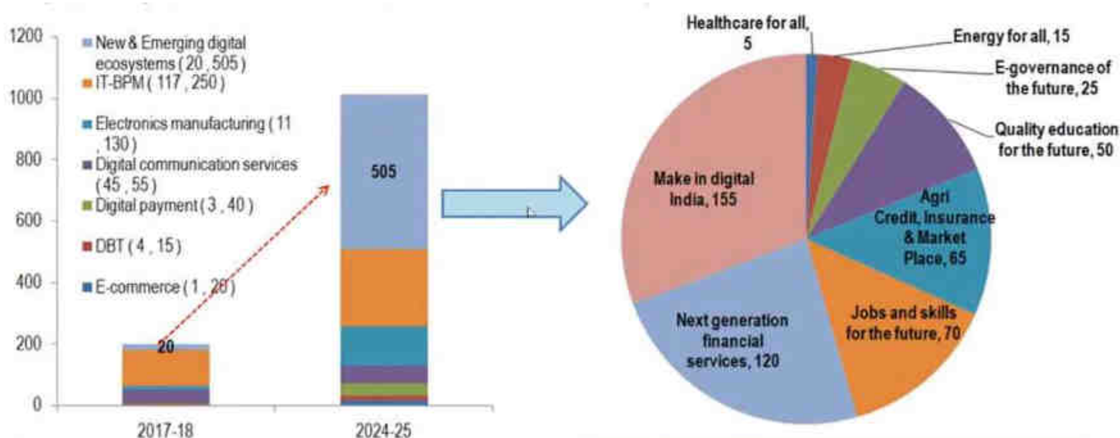
Medium and long-term economic performance

Even though it feels that the recent economic recovery is largely reflected in the price, we feel that structurally there are some drivers which can help sustain a higher growth trajectory.

- The asset quality of Indian banks particularly PSU banks have improved in the past few years. This may help to improve the credit cycle in the country to help revive GDP growth. Moreover, lending rates that are at an unprecedented low may also help revive the capex cycle, going forward. This combined with a renewed infrastructure push by the government should drive spending.

- India's GDP may get additional fillip from domestic manufacturing driven by import substitution. For ex: Chinese imports into India is at USD 90 bn, even if we produce 50% of that locally in the long term, provides a potential of USD 45 bn for domestic manufacturers.
- Electronic manufacturing can improve its size from USD 25 bn to USD 157 bn in the near term. Existing proposals for mobile phone productions are worth Rs.11 tn. for the next 5 years. This sector can provide a boost of 5% to the GDP growth, cumulatively.
- **"Data is the new oil"**- India's digital economy may improve from 8% of GDP i.e., USD 200 bn in FY18 to 18% of GDP i.e., USD 800 bn in FY25. "**New and Emerging digital ecosystem**" may improve its share from 0.8% of GDP i.e., USD 20 bn in FY18 to 11.3% of GDP i.e., USD 505 bn by FY25.

Combined power of manufacturing stressed by the government Atmanirbhar and Make in India initiatives, along with a young population who is digitally savvy, is expected to drive growth.



Long term trend reversal

Historically US markets and emerging markets like India have not performed well at the same time, in fact, when US does well India underperforms and vice versa. This is largely driven by liquidity flows as well. So we believe that since US markets outperformed India over the last ten years , there is a chance of that trend to reverse now. We see some early signs and the large FII investments into India since November also lends credence to our belief.

Risks

Although we are confident on the long-term growth of Nifty companies, as mentioned earlier, we believe that there may be some volatility in the near term. The factors that might lead to volatility are:

Valuations at premium: The valuation of top benchmark indices based on historical trailing EPS is at a significant premium. But that is largely due to poor profitability in the COVID period. So, if we assume a 20% earnings growth for next year, it doesn't appear very stretched. Nevertheless, it is prudent to remain watchful.

Inflation: Inflation levels have been above RBI comfort levels in the recent past, mainly on account of demand recovery associated with supply shocks due to COVID. But inflation of commodities like oil and metal is a little bit of concern and might limit future rate cuts. This could affect demand and the margin.

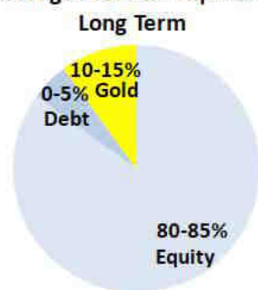
COVID Resurgence: As seen in Europe and parts of Asia like South Korea, Thailand, there is a possibility of a second wave of cases in India. If this outbreak is not contained it could bring additional restrictions which can affect sentiment and demand in the short term.

Asset allocation and Portfolio Strategy

Since our view on the prospects of Indian equity is fairly positive for the long term, all our portfolios are positioned accordingly, but for the short-term, we may want to increase our equity allocation even from these levels. We will maintain status quo for the time being.

All portfolios will have some exposure in gold as we believe that it may outperform fixed income assets in the long term. Exposure to debt funds will be minimal due to low yield on maturity, currently around 5%.

As for equity allocation, we continue to remain invested in Good Equity funds with quality portfolio and a good track record. Although we may have some tactical allocation to certain sectors like IT, Pharma and Cyclicals that we believe may perform well in the near term.



Strategically we will remain overweight on equity, but we will be flexible enough to take cash calls depending on markets and client specific liquidity needs.

Tactically, in case we see any of the risks we identified play out significantly we will not hesitate to cut equity exposure and may move to cash like we did in March 2020 but, our long-term equity-oriented stance remains firm and we urge investors to start allocating if you haven't already as we feel that this current rally has more legs. Near term rally might make you think that markets are high but if you look at markets from a 3-year basis, benchmark indices have only recently broken out of the long-term range.

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