

## We don't know - "What we don't know"

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**Dear Investors,**

The last few weeks have been surreal. Covid-19 has turned the world on its head. While a lot is known by now to all of us about R (0), the bell-shaped nature of the Covid curve, risk of a relapse, etc., policy makers are still grappling with the economic crisis that we have on hand due to lockdown, the associated economic cost and solutions to the crisis.

The world has never witnessed a situation where 33% of the world population contributing to 50% of global output is in a synchronised locked down for an extended period of time. Even during world wars, while trade and commerce were adversely impacted, there was no synchronised lock down across the globe. While the Global Health Crisis that has emerged due to the pandemic is unprecedented, the global economic situation is on an equal footing as there are no empirical evidence for the economic crisis that has emerged due to lockdowns and the situation is still evolving. This is certainly a once in a Century Crisis. Though as an equity investor, every time I hear the word Crisis, I experience an adrenalin rush as in the world of equities both Crisis and Opportunity are synonymous.

The good news is that the Covid curve has started flattening in US & Europe (flattening of the Curve is also a process which takes time) which effectively means that government and health officials are getting a handle on the situation and are getting themselves ahead of the curve.

The synchronised lockdown has thrown the world economy into chaos at a time when it was least expecting it and was completely unprepared. After the signing of the trade deal between the two biggest global trading partners US & China on 15<sup>th</sup> January 2020, the world economy was looking for an accelerated growth in an election year for US before Covid shock emerged.

It is apparent by now; the resultant economic crisis is much bigger than any of the previous crisis viz; The Global Financial Crisis (2008), The TMT Bubble (2000), The Asian Financial Crisis (1997), The Mexican Peso Crisis (1994), The Russian Disintegration (1991) or The Latin America Debt Crisis (1982).

While, **we don't know** the exact magnitude of the crisis, it is expected the US could witness 30% contraction in output in second quarter and the full year contraction could be 5% - twice that witnessed in 2008 and worst ever in any year since 1946.

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European Union GDP can contract by 7%. The weakest links in the EU viz – Italy and Spain- are the ones most severely impacted by healthcare crisis. Both these countries get about 13% of their GDP from travel and tourism. Thus, they will have double digit decline in GDP and will need massive fiscal and monetary stimuli. The crisis will bring to the fore the issues around fiscal integration in EU and the willingness of Germany to under write debt of Italy and Spain. This could again be a litmus test for the EU experiment which, as it is, is living on borrowed time. Will the crisis be the catalyst for the EU fiscal integration or otherwise- **well, we don't know.**

India's GDP could contract by over 10% in April-June 2020 quarter, and India could negative growth for Fy2020-21- something India has not witnessed since 1980. With negative growth in 1qFy21, Indian economy will have a technical recession with consecutive quarter of negative growth.

The crisis could easily cost the world economy \$10 trillion, probably, much higher than what would be the cost of a war- **we don't know**. As per estimates, the Cost of World War II in today's \$ terms is about \$ 4.1 trillion.

### **Monetary Policies**

Global Central banks have swung into action with their traditional medicine of throwing more money and providing liquidity to real economy and financial markets so as to ensure that financial markets are functional and liquidity is abundant. At heart, the Central bankers know that they are partially handicapped and the effective solution to the problem is beyond their arsenal because it's a real economy problem. ***Yet they are fully aware that the financial markets globally are addicted to Central Bank Steroids and they need to keep inducing accelerated doses of steroids, so as to alleviate the pain if not cure the disease and buy time for governments to get their act together. And they have happily obliged.***

US Federal Reserve has cut interest rates by 150 bps in two policy meetings within weeks in March 20. Apart from that, it has reversed its course of balance sheet consolidation and embarked on path of Unlimited Quantitative Easing. The Fed has already expanded its balance sheet by \$2 trn. Not only this, it has also followed this up with other tools like allowing itself to buy Municipal Bonds, Commercial Papers, High Yield Bonds and extend loans to Small Business and Consumers through banking system. In all, the various program combined would provide more than \$6trn in liquidity to the financial and business system and expand the Fed balance sheet to \$10trn by end 2020.

Though, the Fed action was very much anticipated, the magnitude and speed of fed action is quite surprising. The aggregate stimulus rolled out is much bigger than what was rolled out during the 2008 crisis and that too at a very early stage of crisis as opposed to 2008 financial crisis where QE came at the fag end of the crisis. The Fed has also blurred the dividing line between monetary and fiscal policies by committing it to Open ended Quantitative Easing.

**We don't know** once things settle down and world moves towards normalization as to how will markets respond to this policy action.

The other central banks were not be left behind and joined the party. ECB has announced a new QE aggregating to over 7.3% of Euro are GDP. BOJ doubled the pace of purchase of risky assets including ETF's and created new loan program to extend zero rate loan to financial institutions. The world hasn't seen so much money being thrown into economy and markets to overcome a crisis and too within weeks of a crisis emerging.

### **Fiscal Stimulus**

There is massive fiscal stimulus, that's been injected by the government into the real economy to help it tide over the challenges of unemployment, business closures, debt financing, etc. US has approved fiscal stimulus \$ 2 trillion and is likely to do much more to stabilize the economy.

<b>India's Fiscal Response in Miniscule So Far</b>	
	<b>Fiscal Stimulus as % of GDP</b>
Germany	18.9%
Japan	18.4%
Singapore	13.0%
US	9.3%
UK	4.0%
Canada	3.6%
Malaysia	3.5%
Norway	3.4%
Korea	2.6%
France	1.9%
China	1.4%
Italy	1.4%
Spain	1.4%
Australia	0.8%
<b>India</b>	<b>0.8%</b>
Hong Kong	0.2%

But, **we don't know**, despite such massive monetary and fiscal stimulus, whether these measures will help revive growth in global economy once we are out of the sinkhole we find ourselves.

But there are certain things **we know as well**. At the outset, the Global Health Crisis is hugely disinflationary and will further accelerate the deflationary trends that has been prevailing in the world for over a decade since the aftermath of the Global Financial Crisis, 2008. And, that's why the massive monetary stimulus and the abundance of low cost dollar liquidity will support asset prices and put a floor beneath it. But **what we don't know** is how long will the floor last – is it temporary, intermediate or permanent.

### **The Path to Normalization**

**We don't know** the path and the time needed for the normalization of world economy. Each economy will have its own path and healing time because Covid has had varying impact on each economy. Also, **we don't know** the shape of recovery from this crisis; whether it will be “V” or “W” or “L” or “Bath Tub” or “Square Root”. But **what we know** is the new normal that we get to in a post Covid world will be lower than the previous normal with permanent loss of output as it happens in every crisis.

The output gap between the pre and post crisis normal will be significantly higher this time around than any other crisis in the past which also implies that the journey to get back to pre-Covid normal will be marathon not a sprint.

Also, the new normal will be markedly different. WFH will become the new norm and most global companies will adopt it as part of their core HR strategy. Technology is playing a vital role in helping businesses, governments and society navigate the crisis.

Thus, **What we know** is companies with cutting edge technology and data analytics solutions, Artificial Intelligence, Machine Learning will rule the new world order. Zoom, the video app service provider, has seen its user base grow 20x from 10mn in December 2019 to 200mn in March 20!

In the next decade, these technology driven companies with access to data will become the next Exxon Mobil and Saudi Aramco of the world. But **What we don't know** is which ones as these technologies are still evolving.

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### **Simultaneous Supply and Demand Shock**

The lock down has led the world to a supply shock as manufacturers and service providers are completely closed. As the lock downs are lifted gradually, the world will overcome the supply shock in due course of time. The impact of crisis will be asymmetric on businesses and different businesses will have differing path to normalization.

Analyst expect US air traffic to take 5 years to return to pre-Covid normal. While there will be massive job losses across travel, tourism, restaurants amongst others; Amazon has hired 1.75 lakh people in last 1 month and also increased the hourly pay of its workers by \$2- for over 1 million workers the crisis is a blessing in disguise.

But this supply shock will over a period of time will transmit into a much bigger demand shock as once the normalization begins the world might not be able to absorb the supply of labour and resources that's available. There will be demand postponement and demand destruction across various sectors. This will if anything further accentuate deflationary trends in global economy.

### **Consumer Behaviour**

But **what we don't know** is how consumer demand patterns will change. It was surprising and ironical to witness that after lockdown's were lifted in Wuhan- the birth place of Covid-19, consumers rushed to buy cars and within the first week car sales have achieved pre-Covid sales in Wuhan City. Consumers want to travel safe and do not want to use public transportation or shared mobility. Is the Shared economy dead or will it make a comeback – **We don't know!**

The concept of Social Distancing will extend from human beings to man to machine distancing as well whereby global hi-tech companies shall monitor and control their fully automated plants from a remote location.

We shall witness seemingly varying and surprising demand trends across various segments of the economy which can be boon or bane for respective businesses. **We don't know** how these trends will emerge and playout though **we know that** we are in midst of a once in generation tectonic shift in consumer behaviour which will make many businesses redundant just like the IPOD and Smart Phones led to extinction of Camera and Walkman.

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### **Emerging Markets & India**

The Covid crisis has been a double whammy for Emerging Markets because of higher poverty levels, paucity of resources and significant capital flight. We have already seen outflows of over \$100bn from EM since the outbreak and this has led to sharp depreciation in the EM currencies. The EM currency depreciation has been further accentuated by the oil shock as some of the EM economies are driven by commodity exports.

India has adopted some of the most stringent lockdowns in response to the pandemic. During the past global crisis including the GFC and Asian Financial Crisis, India was at the periphery of the crisis as the nucleus of crisis was in global economies and India got impacted due to spill over effects of the global crisis. But this time is different as due to lockdowns, India will witness sharp economic deceleration/contraction and is very much at the nucleus of the crisis. This has never happened before.

Given India's paucity of resources, India will not be able to give stimuli on the same scale as advanced economies. **We don't know** how the economy will respond to various stimulus measures announced/to be announced by the govt. But **we do know** that the growth recovery in India will be protracted and is unlikely to be a "V".

### **Financial Markets**

Due to aggressive Fed policy action and flight to safety the 10Y US govt bond yields have declined to 0.7% - the lowest ever. Will the aggressive policy action of US fed and the blurring of fiscal and monetary policies lead to climax in the 40 year bull market in US treasuries- **we don't know**.

The pandemic has plunged the global equity markets into bear market territories. This is the sharpest fall global equities have ever witnessed. After such sharp declines of over 40%, equities have had a sharp bounce back due to aggressive central bank actions. Given the sharp rally from the lows, the question that is on top of everyone's mind is Have equities already made the lows of this bear market? **We don't know**.

But **we do know** that while many businesses will not survive this crisis, those who do will do exceedingly well. Thus, strong companies will exit the crisis relatively stronger than what they were when they entered the crisis.

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Also, the sharp correction in markets has created pockets of deep value as the impending uncertainty and fear has increased the gap between long term fair value of business and stock prices. Investors who can decipher this anomaly and muster the courage to invest shall reap the benefits of the opportunity.

We also know that most CEO and Analysts are flying blind in terms of near-term visibility on the business until lockdowns are lifted. Thus, investors cannot look at near term earnings to assess value of business and one will have to value businesses on basis of their long-term earnings power.

**We also know** that, to make money in equities, a long-term investor need not be concerned about peaks and troughs of markets because they are known only in hindsight. As far as Indian Equity markets are concerned there are many businesses which are impeccable franchise and are trading at attractive valuations post this correction. Will they become even more attractive with further fall in prices-**well, we don't know.**

But **we do know** that every bull market is followed by a bear market and vice-versa. We will get through this bear market also during the course of the year and sow the seeds of new bull market in equities in 2020. There will be a change in leadership into the new bull market and sectors which led the last bull market are unlikely to be the leaders of the next market cycle. Which sectors will lead the next bull market- well, **we don't know?**

## **Conclusion**

By now, we know that it's a once in a century crisis, with no precedence and the situation is still evolving. The economic crisis following the healthcare crisis will be far bigger and the world hasn't seen anything like this before. This too shall pass.

### **But We don't know:**

1. The economic cost of the Health Crisis
2. Will there be a second wave of Covid-19
3. The pace of normalization for global economy
4. Growth outlook in medium term
5. Shape of growth recovery be 'V', "W", "L" or something else
6. How consumer behaviour will change in the new normal?
7. Will this be the shortest bear market in equities?
8. Are the lows for this bear market already in place?
9. Can this crisis be a catalyst for next bigger crisis down the road?
10. Can China still be engine of global growth post the crisis?

### **Well, we don't know - What we don't know?**

**Warm's Regards,**

Pankaj Murarka

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