Investor Behavior in the Times of Covid

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COVID-19 episode has once again proved that forecasting investor behaviour in equity markets is a far tougher exercise than what's perceived. If someone had perfect foresight as to when the pandemic would start and how it would be followed up with more than one wave, the rational prognosis would have been that investors would become risk averse in such an environment. However, in reality investors after a very brief period of extreme risk aversion in March-April 2020 have been progressively increasing their risk appetite towards stocks in general which is being reflected by the performance of the NIFTY-50 index which has more than doubled from their 2020 lows. The relatively riskier mid and small cap universe have in fact outperformed the benchmark NIFTY-50 index by a wide margin which further indicates the rising risk appetite of investors. This trend is no different from that seen in other parts of the world such as the developed markets of US. Measures of investor risk appetite such as the fear index or VIX have scaled down significantly over the past one year. Also the discount rate for equities have dropped significantly driven by central bank actions in terms of driving down the risk free rate as well as the equity risk premium by reducing interest rates and unleashing unprecedented quantitative easing which has reduced the probability of bankruptcies for corporates.

To be sure, the overall economic activity is yet to normalise to pre-pandemic levels although there is ample evidence to suggest that global growth including that in India is expected to see strong revival going ahead once the pandemic subsides and since stocks are forward discounting machines the optimism of investors is not unwarranted. However, as the optimism keeps rising there are risks that speculative behaviour may start emerging in certain pockets of the market.

Breaking the investor base into retail and institutions, there are some distinct differences. Household financial savings picked up sharply following the pandemic hitting a high of 21% of GDP in Q1FY21 driven by rise in holdings of fixed income instruments, insurance, mutual funds as well as currency holdings. The sharp drop in household borrowings was also a big contributor to the rise in financial savings. However as economic activities normalised, household savings reverted to normal levels and hit 8.2% in Q3 FY21 as per RBI data. Another key feature despite the pandemic is the trend of steady SIP inflows into equity schemes of MF and showing further improvements over the past few months to reach Rs100bn per month. Also the strong trend in new demat accounts being opened indicates improving awareness amongst retail investors to participate in the equity markets in India. However, there have been net outflows from mutual funds especially during Nov'20 to Feb'21 which indicates profit booking as well.

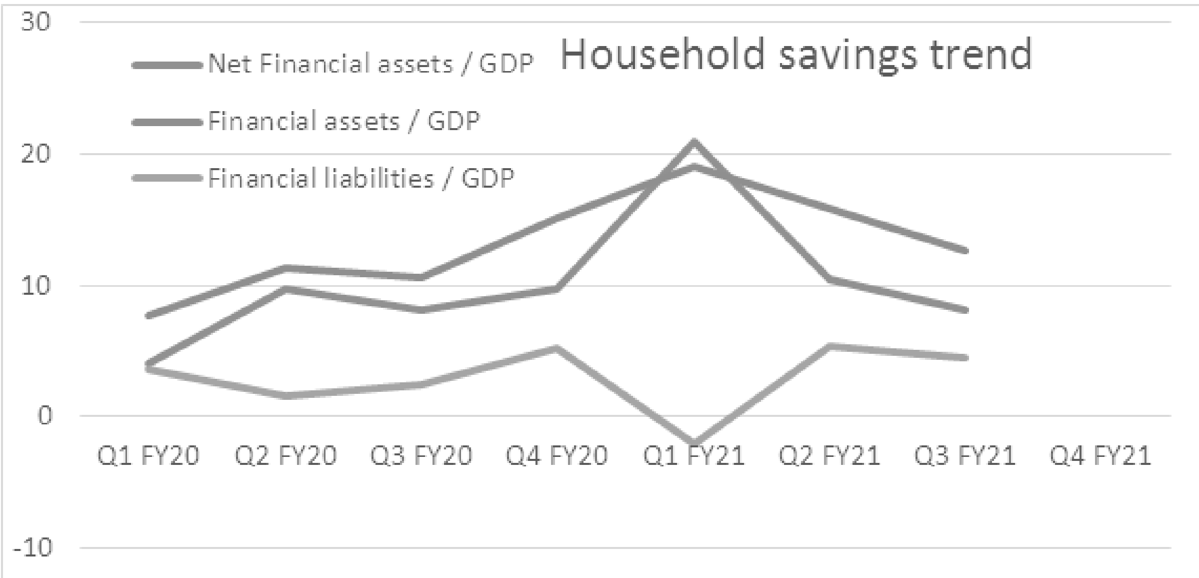
Appetite for primary market issuances was also very high in 2020 as companies raised ~Rs1.8tn through QIPs, IPOs etc. This trend is expected to improve further in 2021 with high demand for IPOs of new age economy companies such as Zomato etc. The high demand for new age economy stocks which are yet to demonstrate profitability is another indication of increased risk appetite of investors who are willing to take bets on the long term prospects of such businesses instead of fearing the losses in the near term.

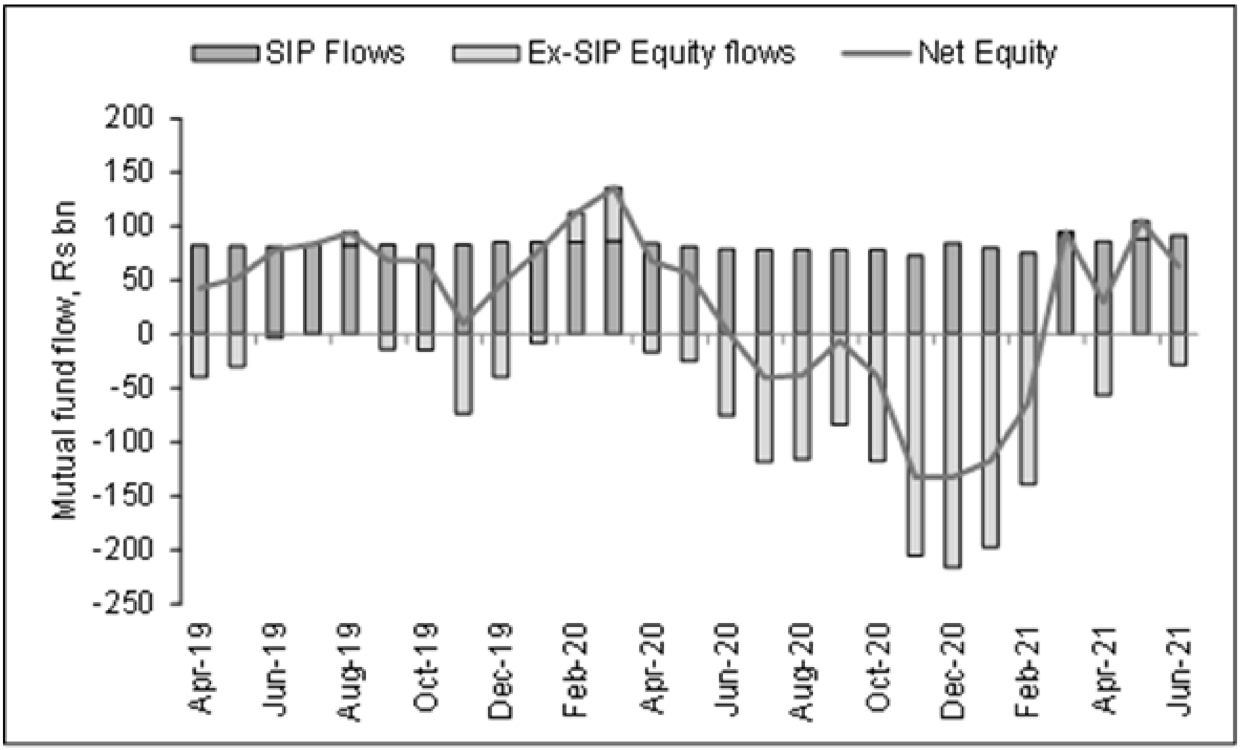
After the initial sharp outflows in Apr-May'20, FPI flows in general have been largely positive during the entire COVID period except for Apr-21 where they turned negative. This is clearly reflecting rising risk appetite and surplus liquidity in global markets driven by the unprecedented quantitative easing by central banks. Apart from the liquidity measures by central banks, developed market economies like US have seen record direct fiscal spending towards relief measures for the economy. The sharper revival in economic activities and relatively high vaccination coverage in developed markets like the US is also driving the risk appetite. Apart from strong FPI inflows, India stood out as an attractive destination for global investors as it was the recipient of the fifth highest FDI inflows globally at USD 64bn in 2020 largely driven by the investments in information and communication technology (ICT) sector. The impact of a current account surplus in FY21 and record capital inflows resulted in India's forex reserves rise to a record USD 611bn currently.

Strong returns from equities in the recent past provides the answers to future return expectations which should ideally moderate. However, typically investors tend to get swayed by the momentum seen in stock prices in the recent past thereby resulting in unreasonable expectations which typically results in disappointments. Thankfully the general narrative on the street is indicating caution in terms of valuations being high and forecasts being more measured which is probably the key reason why Q4FY21 turned out to be the fourth quarter in a row to show higher earnings beats than misses. Going ahead it is clear that incremental dip in interest rates or increase in liquidity infusion by central banks are ruled out as global demand normalises and will not be the drivers of optimism for investors. On the other hand, growth revival from pandemic lows will be the key driver of investor behaviour and if growth keeps surprising investors on the upside investor optimism will continue to rise. On the flip side if growth starts to disappoint some of the high investor optimism could start to fade but it will also mean that central banks will be accommodative for longer than expected thereby supporting markets.

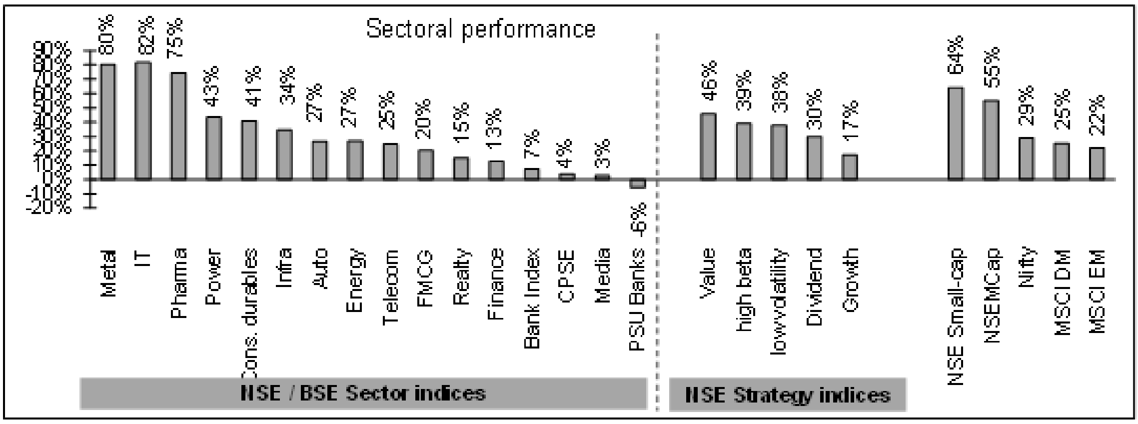
Growth outlook will be determined by how globally governments focus on reviving investments as the stimulus effects of 'dole outs' will start to fade out. On the other hand, reviving investment rate in the economy can lead to higher multiplier effect on demand and result in a more durable recovery. Currently the factors which are conducive for investment rate to pick up are counter-cyclical fiscal policy of large economies focussing on infrastructure development, low interest rates, surplus liquidity, resilient commodity prices which can attract investments in such sectors and overall improving demand. Also one should not forget the high investment demand being created in new age sectors such as the digital companies and green energy initiatives. Policy making from the government has been pro-growth and conducive over the past several years in terms of implementing the Goods and services tax (GST), Real estate and regulation act (RERA), Insolvency and bankruptcy code (IBC), Production linked incentive scheme (PLI) for promoting manufacturing, enhanced FDI limits in various sectors, labour reforms etc.

Key unknown variable for investors at this juncture is the question of whether there will be a third wave of COVID-19 and how much will it impact the economy. However, if the pandemic does not flare up again and demand continues to pick up in the second half of 2021, investor risk appetite could continue to be elevated assuming central bank remain accommodative as promised. Corporate profitability of the listed space in India showed a sharp reversal in FY21 as PAT to GDP touched a seven year high of 3.1%. Continuation of the long awaited earnings revival in India will be a key factor in determining investor behaviour. Earnings revival is being led by cyclicals which has positive implications for the investment cycle as their linkage to the capex cycle is significant.





Sector and style performance since CY20



Source: Bloomberg, I-Sec Research