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Mutual Fund

The Butterfly Effect

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In 1961, when Edward Lorenz (Mathematician and Meteorologist) was working on atmospheric forecasts, he was amazed to find that a minute change (like a rounding error from 6 decimals to 3 decimals) in the historical data, generated a completely different forecast of the weather. In a complex interconnected system, a slight change in the input can cause a large variation in the output. He presented this phenomenon in a conference with a presentation titled, "Does the Flap of a Butterfly's Wings in Brazil Set Off a Tornado in Texas?". This study later came to be known as the "Butterfly Effect". The Budget presented by the Finance Minister on Feb 1, 2021 could have set up the economy and the markets for the same disproportionate effect in a positive direction.

The Narrative has changed

Going into the budget, many expected an increase in taxes in some form: either a "Covid Cess" or increase in Income tax for higher slabs or an increase in capital gains tax. For the past few years, the government has shown clear inclination towards fiscal consolidation and hence the target fiscal deficit for the FY22 was expected to be 5.5%, a sharp reduction from FY21. However, the Finance Minister surprised the street with hardly any increase in taxes and taking a higher fiscal deficit target of 6.8% for FY22. Although the internals of the total expenditure can be debated, the intent is clear: the government is looking to spend on capital expenditure to accelerate economic growth. This commitment is not just limited to FY22. The government has chosen a higher glide path to reach a fiscal deficit target of 4.5% in FY26. This provides a good visibility for expenditure support in the coming 5 years.

This may seem like a marginal change in terms of overall numbers, but it has a profound impact in changing the narrative. The fiscal path is a guidance to the businesses that government is committed to support higher economic growth while also assuring a stable taxation system. This is a very pro-investment narrative which will encourage private investment to follow public investment.

The Confidence Multiplier

John Keynes introduced the words "animal spirits" to describe emotions that influence human behavior. He said, "Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits… and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities". Confidence is one of the important emotions that play an important role in decision making. The confidence surveys, business or consumer, hence, have a high correlation with the spending and investment numbers in the economy.

The path outlined by the budget on spending, the efforts to improve ease of doing business and the incentives provided to businesses have a significant impact on the business confidence in the economy. This has a multiplier effect. Like the Keynesian Multiplier which works on the theory that every unit of money spent by the government has a multiplier effect as it changes hands and creates income downstream, the same way the confidence multiplier generates a feedback loop of confidence in the economy.

Timing could not have been better

The timing of this pro-growth budget could not have been better: a) the country is showing a rapid recovery from the pandemic b) Large Central banks across the world are infusing liquidity into the system and keeping interest rates low c) Governments in important economies are announcing fiscal stimulus to support economic recovery d) many large MNCs are looking at India favorably as a partner in their value chain as well as an important market for their products.

With recovery in the domestic demand, favorable outlook for exports, easy liquidity, low interest rates and vibrant capital markets, the announcements made by the finance minister will snowball into a substantial upward push to the GDP growth.

Sectors and themes

As discussed in the factors above, the set-up is favorable towards the following themes which I also mentioned in my note at the beginning of the year:

- *Return of Inflation:* Low cost producers and Integrated producers in the materials and commodities sectors
- *Resurgence in Manufacturing:* Companies with competitive advantage in the manufacturing sector catering to domestic demand as well as exports demand. Companies that benefit from rising private and public capital expenditure
- *Rural Growth:* Companies that cater to rural investment and consumption demand
- *Rise of Housing:* Companies in the real estate sector, basic industries, building materials and consumer durables

What about valuations?

The markets have come a long way from the March 2020 lows and have added to the gains after the announcement of the budget. While the stock prices have largely reflected the recovery in earnings, valuation in many stocks have reached their fair value zones. The budget does improve the growth estimates and earnings visibility for many sectors and companies. These companies, sector and themes are likely to see their valuations rerated upwards. Investors, who are patient and have a long-term view will be the ones who gain from this Butterfly Effect.