India Outlook

Economic rejuvenation points towards long-term positivity

February 2017

2016 was by any standards a year of seismic economic change for India, particularly with the surprise 'currency exchange program' in November, referred to as demonetization (see below). Three months after the unprecedented move, the overhang seems to be already behind us. Industrial production surged sharply by +5.6%, capital goods within manufacturing recorded +15% growth after several months of contraction, and electricity generation picked up to +8.9%[1]. Overall car sales also reported an increase of +16% yoy[2]. These positive macro points confirmed our view that the impact of demonetization would be transitory in nature.

Structural growth in India – especially domestic consumption – remains promising over the long term. Looking ahead, we expect corporate earnings and global liquidity to remain market drivers. We will closely monitor corporate earnings, together with the GST bill rollout and financial inclusion.

Demonetization: short-term turbulence leading to long-term benefits

On 8 November 2016, the Indian government announced the imminent removal of the legal tender status of high-denomination (Rs500 and Rs1,000) currency notes, which amounts to 86% of the currency in circulation. The government's aim with this unprecedented move was to reduce corruption and eliminate any fake currency and terrorist financing. This caused a temporary disruption as the public had limited time to exchange their cash holdings for newly-printed notes or deposit any old currency into authorized banks and post offices (with specified daily withdrawal limits). If money was not exchanged during the set time limit, the old currency notes would become worthless.

In the past few months, consumption and services – such as real estate, hotels, restaurants, construction and transport – were the most affected, due to their higher propensity for cash transactions. In fact, the recently announced Union Budget provided relief for low-income individual taxpayers, who, along with small companies were the most affected by this initiative. These tax benefits will have a cascading effect that should boost consumer spending. Also, the consumption sector is already back to 'business as usual,' where we expect further pent-up consumer demand from wealth redistribution towards poorer households and lower lending rates.

In our view, the damage from demonetization was transitory, but the benefits are longer lasting. These include formalization of the economy, reduction in corruption, and improvement in ease of doing business, positive wealth redistribution, a boost to higher government tax revenues and greater financial savings. This is also in line with the government's anti-corruption initiative, and reflects its strategy of "short-term pain for long-term gain".

Corporate earnings: look at actual data and talk to management

After the demonetization event, rather than relying on the street's earnings revision estimates, we prefer to look at the actual earnings results from companies, as well as having direct communication with the management on the impact. In the midst of the earnings results season, ~60% of the companies already announced results, and most of them were able to deliver decent earnings in the face of demonetization. In any case, it would be prudent for us to closely monitor earnings developments over the next two quarters.

Currently, we believe the key is to look for companies that can potentially gain market share during the demonetization cycle. We believe these players with a competitive advantage and market share can gain at the expense of weaker, unorganized players. We believe demonetization has expedited the consolidation cycle in select sectors, and stock selection remains key to differentiate the winners from losers.

[1] Refers to November 2016 monthly data.
[2] Refers to data as of 31 January 2017

Consumption likely to benefit

We have maintained a positive bias towards consumer spending. This structural bias is supported by our long-term view that consumption will remain by far the most important economic pillar in India, accounting for two-thirds of GDP. Moreover, India is an inward-looking economy more focused on domestic economic activities, with favourable demographics that will increase consumption over time.

In fact, we are seeing a strong improvement in consumption, with the good monsoons and pay hikes recommended by the 7th Pay Commission all contributing to boosting consumer confidence. Looking ahead, together with the GST rollout and the tax benefits from the Union Budget, we expect consumption to continue to be a sweet spot for structural growth. This is the area that we are most interested in.

Looking ahead to a healthier economy

With demonetization serving ultimately to rejuvenate the economy, India has had a good start in 2017. Reinforcing this are a number of initiatives announced by the government in recent years:

- GST bill passage – The combination of 16 types of taxes into a single tax. The rollout is on track to take place on 1 July 2017.

- Pradhan Mantri Jan Dhan Yojna – Since the launch of this financial inclusion campaign in August 2014, 255 million bank accounts have been opened.

- Direct benefit transfer – Launched in Jan 2013, this program aims to transfer subsidies directly to people through bank accounts, supporting transparency and avoiding leakages and delays.

The recently announced Union Budget is also well-balanced, in our view, with proposals that will likely lead to further formalization of the economy. The budget was not a bold and revolutionary act by the government, instead it represented a series of small, creditable and realistic steps that aim to steer the economy onto a clear path towards long-term sustainable growth. The spending plans largely meet our expectations, as they fully address how the government should reflate the economy and spend money.

All of these initiatives together point to India becoming a healthier economy with more accountable cash and less black money.

Going forward, the government's policy measures to reflate the economy, corporate earnings and global liquidity are likely to remain the key market drivers. Investors will also be watching out for policy news in the US and news related to implementation of the GST.

Important Information