Market Outlook

Indian equity market held up reasonably well in 1H 2019, despite moderating economic growth. FII flows, signs of bottoming in corporate profitability and strong NDA victory leading to hopes of revival in economic activity led to the NIFTY touching new highs in early June. These gains have been eroded in July. Nifty was down 5.7%. Mid and small caps are deep in red. Sentiments have turned negative with unfavorable tax developments, lack of strong fiscal support towards growth, tight financial conditions and reduced growth visibility.

While other key macro-parameters for India (inflation, external account and fiscal situation) look stable in 2019, we have had our reservations on growth for some time, though we were hopeful of improvement in situation post-election. Budgets for 2019-20, of both state and center, had corroborated that with the weakness in revenue buoyancy, the government sided with fiscal prudence. The farm income support scheme could help rural incomes but has met with implementation challenges owing to lack of land-records digitization across many states.

Just as banking sector started recovering, NBFCs saw signs of stress, which has been persisting for 11 long months now. The end-2018 liquidity crunch and subsequent developments are still hurting. This has percolated into other parts of the system given the connections between the real estate developers, HFCs, banks and bond markets. Residential real-estate had been leaning on the NBFEs to refinance its loans, keeping them afloat in the face of flagging demand. As the demand remains muted and funds are much harder to come by, NBFCs loan books loaded with realty loans are no longer attractive, creating a multi-layer squeeze. Early resolution is critical.

There are evidences of serious slowdown in consumption as reflected in sales of automobiles, FMCG, air travel, textiles and other discretionary products amidst patchy monsoon. Domestic issues have come to the fore at a time when the US-China trade conflict is leading to generalized moderation in global growth (and hence export demand).

We expected investment cycle to pick up in 2019 owing to improved utilizations across sectors such as airports, power, cement, oil refineries, chemicals, textiles, steel, capital goods and autos and improved financial health of businesses, implying both the need and the ability to undertake the capex. Further, having mended NPA situation, banks were in a better shape to undertake riskier industrial credit. But, now with both consumption and exports demand slowing, the investment pick-up could get impacted.

Structurally, the weakness in employment and household income prospects combined with reduced risk appetite of lenders are affecting growth. Cyclically, the global growth issues and challenges in NBFCs are also at play.

Over the last several years, India's growth was mainly supported by consumption. Between FY13 and FY18, personal consumption expenditure has outgrown household income. Not surprisingly then, household savings have fallen from 34% of disposable income in FY10 to as low as 21% in FY18. And the share of consumption has increased from 56.2% of GDP in FY12 to 59.1% in FY18. Annual household liabilities have been building up at 3-4% of GDP every year or 4-5% of disposable income. Household debt has hovered at 33-37% of Disposable income. To sum, Indian consumers were dissaving and consuming more than their income growth, helped by increasing access to the leverage. Such growth has its own limits. Given the limited social security net in India, there is a natural floor to the levels to which savings can fall, which in turn will put a natural break to the consumption growth in India.

Muted rise in asset prices—most notable in the real estate and more recently in the capital market as well leads to negative wealth effect. Consumer sentiments had weakened over time owing to weak income growth, negative wealth effect, slow job creation coupled with depressed farm sector, GST and liquidity/funding struggle in the unorganized sector. While the decline in inflation (primarily led by fall in food prices) is hugely positive, it increased the real indebtedness of farmers. Hence, for the consumption growth to sustain, it is imperative that we see income growth improvement alongwith creation of 10 million jobs per year over the next decade.

India's share in global exports has plateaued. More than soft world growth, domestic bottlenecks are key drags. Weak infrastructure facilities, lack of innovation, low productivity and high capital and compliance costs are impacting competitiveness of Indian exporters. Along with the focus on import substitution, equal attention is needed to promote additional FX generating avenues (for instance tourism) and incentivize R&D in India.

Weak corporate profit is a big headwind to growth. US corporates have enjoyed extraordinarily good profit run since the 2008-09 crisis fueled by favorable monetary policy, lower tax rates, improved labor productivity and rise of exceptionally profitable tech firms. This has helped them to have the longest economic expansion in history. On the other hand, India, despite clocking one of the fastest economic growth, has not seen commensurate profit for its businesses. Business profitability is essential—it reward savers, incentivizes innovators and creates surplus funds for investment. While the effective corporate tax rates have come down world over, taxes on capital has substantially risen in India. Conducive environment for capital formation is critical for growth and job creation.

India's tax to GDP stands around 16-17% as of FY19, which is only 4% higher than 1980s and low compared to other BRICS nation (China at 20%, Brazil at 32%, Russia at 22%, South Africa at 26%). As a result, India suffers from underfunded public services, leading to reduced spend on social and physical infrastructure. Demonetization and GST led to a jump in the number of direct and indirect tax filers. However, the recent policy actions to raise tax rates across direct and indirect tax-regimes may erode the benefits of the aforesaid reforms. History has conclusively proved that Laffer curve works in India. Lower tax rates improve tax compliance and collection.

Despite the 75bps cut in policy rates and a comfortable inter-bank liquidity since June, financial conditions have not eased that much. While the liquid segments (overnight call money rate, G-sec and AAA corporate bond yields) have responded to monetary easing, spreads in the other segment (lower rated corporate, bank lending) continues to remain high and equity inflows have been weak, reflecting the weak risk appetite. Bank credit growth was improving since November last year, but has begun to moderate since March, both for demand and supply reasons. Even, as bank industrial credit growth has picked up a bit, 96% of the incremental industrial credit has come on the account of large corporates, leaving small and medium enterprises in want of funds and reflecting continued risk aversion. Monetary easing and comfortable liquidity are instrumental for further easing in financial conditions. Given the risk averse environment, transmission has been weak, requiring larger monetary accommodation to get the same effect.

Along with reduction in cost of capital, there is an urgent need to restore the confidence amongst the business and investors community. The animal spirits (for both lenders and borrowers) must revive, and that can only happen by two set of forces; buoyancy in the global growth or by stability and predictability in fiscal policy environment.

Amidst the current environment, we shouldn't ignore structural strength factors. Government, with significant political capital, can leverage on the bold policy actions taken during last regime (such as IBC, GST, RERA, MPC set-up, DBT). Moderating global growth aside, global situation favors India. Global investors are in hunt for markets with macro and political stability and prospects for economic growth. While revisiting the recent policy moves, concerted efforts are needed to attract foreign savings. The efforts of financial inclusion, financialization of savings and access to credit were key positives in last couple of years. Policy actions should not allow strength of those factors to be eroded. Indian backdrop is such that low penetration and rising aspirations of the youth bodes well for structural consumption story. The government, in the present environment, should focus on those infrastructure segments which are shovel ready, can create jobs and have multiplier effect on growth. As we had discussed before, Indian businesses had seen capacity utilization improve and were also balance-sheet ready to undertake capital formation. Ironing out the cyclical challenges can catalyze the investment cycle pick-up in India. We are hopeful of conducive policy actions to leverage on inherent structural strengths of Indian economy.

Dark clouds are always followed by a shining sun. This time will not be any different.

Navneet Munot
CIO – SBI Funds Management Private Limited
August 3, 2019