India: muddling through a difficult environment

Rahmatullah Khan
Economist
Tel: +971 (0)2 696 2843
rahmatullah.khan@adcb.com

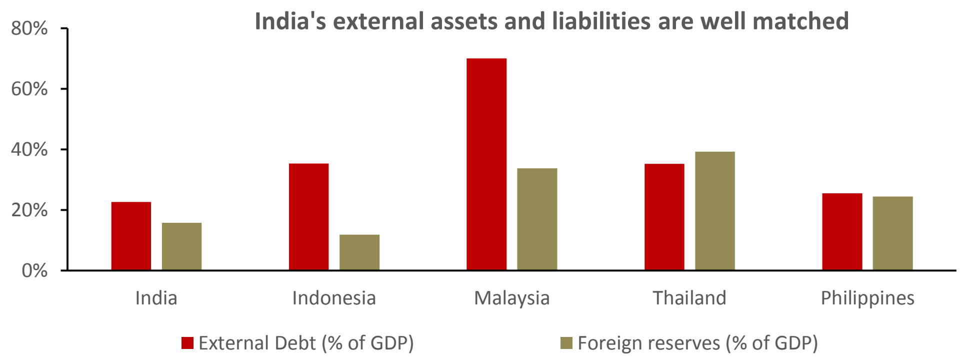
Wietse Nijenhuis
Equity Strategist
Tel: +971 (0)2 696 5123
wietse.nijenhuis@adcb.com

Luciano Jannelli, Ph.D., CFA
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

- **India remains a long term positive story based on its economic and demographic potential despite disappointments in the recent pace of recovery. The global economic environment is not very supportive for growth to gather pace**
- **Higher pressure on the central government to push reforms after the state election debacle – there seems to be some new reform momentum**
- **Despite the recent pickup, inflation is likely to remain under control**
- **A further rate cut is unlikely until uncertainty around Fed policy clears but it remains a possibility in the second quarter next year**
- **An improved external balance continues to provide support to the currency, we see a stable currency with a small depreciation bias**
- **Valuations for equities (PE multiples) have corrected towards their long term averages but further upside will need to be driven by earnings growth going forward. We see potential for improved margins in the coming quarters if we ignore the very near term.**

A stable currency and low interest rates to continue to underpin Indian financial assets

Notwithstanding the slow pace of domestic reforms, in particular disappointing progress on critical reforms such as the Land Acquisition Bill (LAB) and the general Goods and Services Tax (GST), the government has made headway in other areas, thereby placing the domestic economic environment in a stronger position compared to a year ago. Inflation is likely to remain well behaved in the medium term which could potentially create further room for interest rate cuts next year. Most importantly, a stabilizing factor for the country is its well-balanced external assets and liabilities which provide a strong buffer for its currency in the event of an adverse global shock. Valuations for equities have come down to their long term averages and the earnings downgrade cycle has more or less run its course as we see a turnaround in margins. We don't see much scope for absolute multiple expansion. Therefore, any upward movement in the equity market will likely need to be driven by earnings growth. The risk to our outlook mainly comes from a further deterioration in the global growth outlook, particularly in Emerging Economies. Another risk to the Indian market comes from any sharp rise in energy prices which could reverse the improvements in the external balance, inflation and fiscal consolidation.



Source: Bloomberg

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Government on track for further reforms

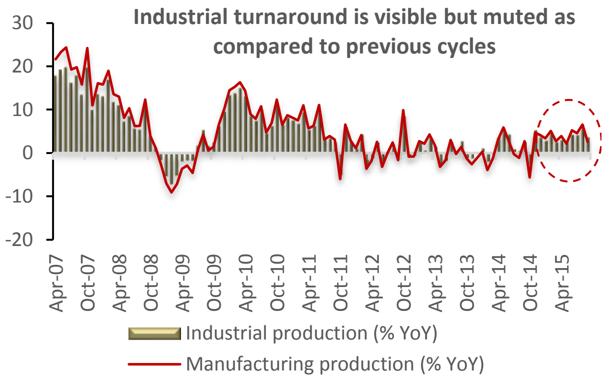
Notwithstanding some disappointment on "big ticket" reforms such as the LAB and the GST Bill, many micro reforms over the last one year have improved domestic economic dynamics. The energy subsidy reform has reduced the government's overall expenses, and also increased its efficiency. As such the reform should have a lasting beneficial impact on both the government's finances, financial inclusion of poor people, as well as the economy's efficiency.

More recently the central government has come under renewed pressure to push reforms after a debacle in one of the state elections. The government seems also to be in active mode again with a reform announced to further liberalise the foreign direct investment regime for almost fifteen sectors. We see some further effort for coordination with the opposition parties for still passing the GST Bill and discussing the LAB.

Real indicators improving but slowly

Partly also because of the above mentioned improved policy momentum, we have now seen some improvement in economic indicators. In particular we have seen an increase in durable goods and vehicle sales, reflecting an improvement in consumer sentiment, albeit mostly limited to the urban segment of the population.

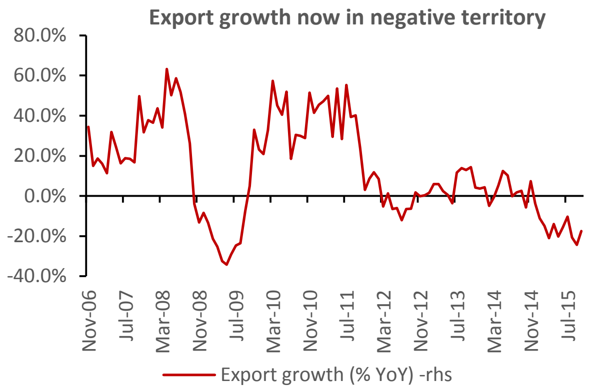
Having said so, the improvement is short of our expectations, as well as those of the market. The industrial recovery remains one of the slowest in the last couple of business cycles.



Source: Bloomberg

Difficult external environment making the recovery slower

Indeed, and the despite the favorable improvements in many structural factors, India needs to do more to revive the investment cycle which collapsed during the 2012-13 down-turn. Indicators in that regard remain mixed, only providing tepid signs of revival. An uptick in the cycle seems to be hampered by the weak external environment, hurting the country's exports. Merchandise exports have declined by 17% YoY during Jan-Oct 2015 which has not only reduced the incentive for investments in export oriented manufacturing industries, but has also decreased capacity utilization. Weaker commodity prices have also affected investments in the mining industries which were one of the prime drivers of the previous investment cycle. The silver lining here is the government's focus on infrastructure projects, in particular roads. At the same time, public sector companies are sitting on huge cash balances which could also be used to boost the investment cycle.



Source: Bloomberg

Fiscal consolidation continues

Fiscal data from the first few months reflects that fiscal consolidation is on track. The monthly fiscal data for the first half of the current financial year suggests that the fiscal deficit is lower than that of the same period last year (total deficit INR3,784bn in H1-FY2016 vs. INR4,388bn in H1-FY2015, 14% lower). The monthly number also reveals that the quality of government spending is better, given that the proportion of capital spending is higher.

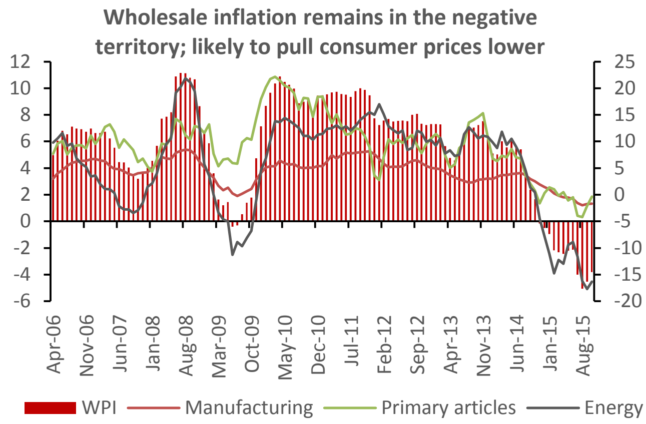
However, fiscal consolidation will somewhat suffer from the implementation of a wage increase for central government employees (something that happens approximately every ten years). In fact, these wage increases will push government expenses up by around 0.45% of GDP, which will mean that the budget deficit for the financial year 2016-17 will be 3.9% of GDP instead of the target of 3.5% set earlier. It should be noted, however, that this increase will constitute a boost to domestic consumption, and thus growth, albeit mostly concentrated in the urban areas.

Inflation is expected to remain well behaved

Despite the recent uptick in consumer inflation, it is likely to remain contained in the medium term. The uptick was a result of the combined influence of base effects as well as a temporary surge in the prices of some food items.

Moving beyond this base effect (which should not last more than a few more months), however, we would expect inflation to remain relatively well behaved in the medium term, because of positive structural factors.

One of those structural factors is the broad-based persistence of negative wholesale price inflation. We believe that the feeding effect of declining prices at a producer level will contain consumer prices. Another important structural factor is fiscal consolidation particularly in the discretionary current spending. Finally, the low level of capacity utilization caused by subdued industrial production and declining exports over the last many months should also weigh on headline inflation.



Source: Bloomberg

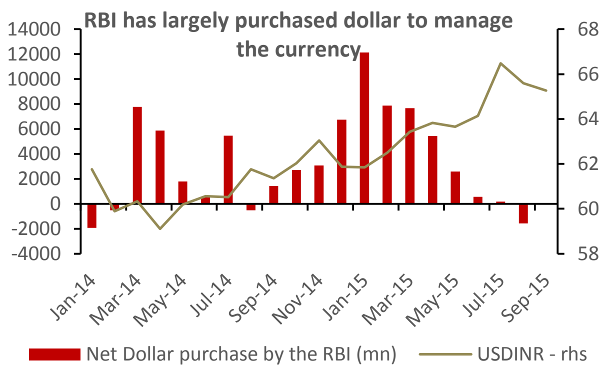
Rupee likely to be stable with a small downward bias

The country has achieved a remarkable improvement in its current account deficit in a very short period of time. The deficit improved from over 5% of GDP in FY2012-13 to only slightly above 1% of GDP in the current year. The deficit is expected to remain at current levels for the next two years.

Besides the current account improvement, the country's external assets and liabilities mismatch – while in line with smaller economies such as the Philippines and Thailand - is also in a much better shape as compared to its major Asian Emerging Markets peers. Foreign reserves stand at around 16% of GDP while external debt is around 23% of GDP. However, the composition of external debt is stable given that around 25% of the debt is deposits by Non Resident Indians (NRIs) with the Indian banking system. This source of debt is unlikely to create any headwind for the currency as the large Indian diaspora working outside of the country are unlikely to withdraw these deposits in the event of an unfavorable global shock. Around 20% of the total external debt is external commercial borrowings (ECBs) by corporates which we also believe poses little risk to the currency. Recent monthly data from the central bank shows that Indian companies are able to rollover their foreign currency debt, and raise fresh new debt with relative ease.

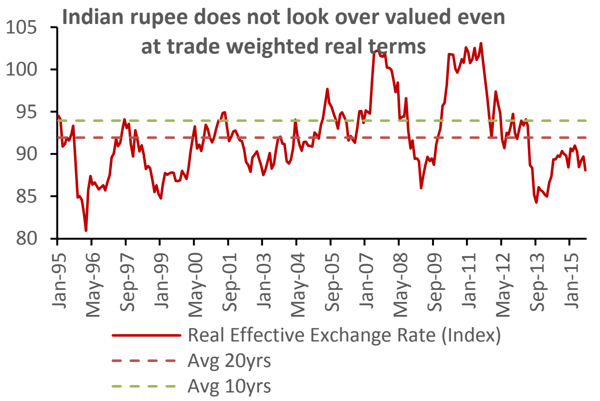
Source: Bloomberg

The flow of dollars has kept the Reserve Bank of India busy in managing the currency largely by purchasing dollars unlike many other countries which have been selling dollar to manage their currencies. The net dollar purchases have largely been positive each month this year except during the yuan induced global risk-off period during August and September. Moreover, even during the peak of the recent global turmoil Indian corporates were able to roll-over their external debt and issue new debt (USD1.9bn was rolled-over and USD0.7bn was new debt in Sep while USD2.1bn was new debt issuance in Oct).



Source: Bloomberg

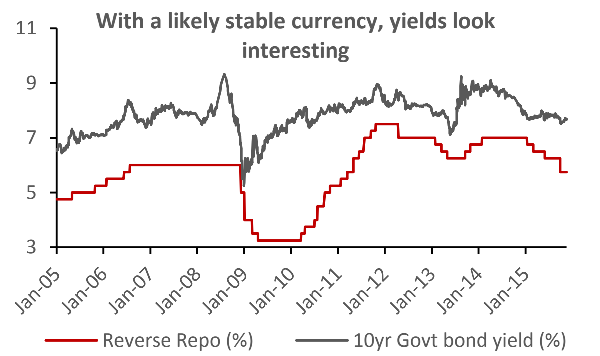
The currency also seems to be a little undervalued on a trade weighted real basis (estimated by the Bank of International Settlement, though RBI estimated index suggests the currency being overvalued). That has put the Indian rupee in a relatively stable position as compared to its peers in other Emerging Economies.



Source: Bloomberg

Fixed income still looks interesting

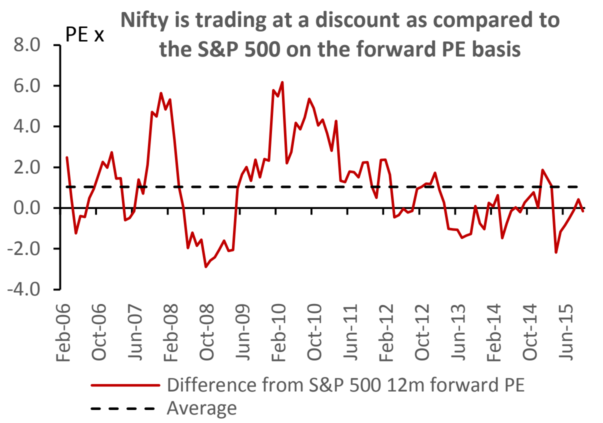
In line with our expectations at the start of the year, the Reserve Bank of India delivered more rate cuts than the market was expecting (*please see our February report on India*). We believe that there is some further room for rate cuts to the tune of 25-50 bps which are unlikely to come before the end of Q1 next year. The central bank will likely wait for the market reaction to a possible Fed rate hike in December. However, this does not take away from the attractiveness of Indian financial assets, in particular fixed income. With a likely stable currency and a subdued inflationary environment, we believe that local currency securities continue to look attractive.



Source: Bloomberg

Equities likely to see more calibrated gains

The disappointing pace of the economic revival caused earnings expectations to be revised downward recently, and was one of the main reasons that equities gave back some of their earlier gains. Despite this, Indian equities have outperformed most peers in the emerging markets space. We believe that the earnings downgrade cycle is more or less done as we see some tick-up in consumer demand, while lower interest rates should support margins. The valuation of the index has also come down to close to its longer term average PE of around 16x, in addition it now trades in line with the S&P 500 (see chart below).



Source: Bloomberg

Going forward, the market will need to be driven by earnings growth rather than by multiple expansion. We believe that earnings should get support from lower interest rates and signs of a revival in urban consumption as well as slow (but positive) signs of the capex cycle picking up.

Conclusion

Although there has been disappointment from the pace of economic reform process, structural factors have moved in the right direction over the last months. Growth is yet to gather pace but downside risk has ameliorated. More importantly the market expectations seem to be more balanced. Improvement in the inflation dynamics not only improves the structural growth story, but also makes the fixed income assets more attractive. We expect relative stability in the country's currency and moderate gains in the equity market.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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