بنك أبوظبي التجاري
ADCB

# India: optimism remains amid sluggish investment

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

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

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

- **Economic growth accelerates mainly on consumption, many indicators suggest continuing momentum**
- **Capital spending yet to recover which could have implications for sustainability of growth and inflation in medium term. However, spare capacity does not pose any inflationary risk in the short term**
- **Inflation has turnaround to move towards the upper range of the RBI target with rising upside risk. Inflation, outflows related to maturing Foreign Currency Non-Resident (FCNR) deposits makes us believe that any further interest rate cut is unlikely. For the same reasons, we believe that the Govt. bond 10yr yield is close to bottom.**
- **The country's external balances continue to improve with the current account deficit declining as low as 1.1% of GDP last quarter which supports the currency. However, global events and FCNR related outflows in the final quarter of 2016 might create some volatility.**
- **Financial stability has further improved with the clean-up of bad loans in the banking system. We believe that the fulfilment of the large provisioning requirements will require the government to inject capital into banks.**
- **We do not expect any direct impact on the financial markets from the exit of Mr. Rajan from RBI later this year. However, it will be important to see how the new incoming governor will perceive the inflationary dynamics and the bad loans issue. Any significant deviation from current policies could be perceived negatively by the market, as it could undermine financial stability in the long term.**
- **India's equity market remains one of the better bets in the volatile global environment with significant downside growth risks. A turnaround in sales and earnings this year as producers' deflation abates is expected to be a supporting factor while the relative valuation is still attractive. We remain overweight on the Indian equity market.**

## Reform push to attract investment spending amid growth acceleration

GDP growth accelerated in the first quarter to touch a six quarter high amid global growth uncertainty. Notwithstanding some high frequency data such as monthly industrial production and credit growth numbers reflects not so positive outlook, many other real time indicators such as strong growth in fuel consumption, pick-up in steel and cement production and sales in the two wheeler motor bikes suggest continuing growth momentum. We do believe that the investment side of the economy, especially private sector investment, is lagging and until now has not been able to recover sustainably. However, what is heartening is that the effort from the government is underway to remove the structural obstacles for the private sector investment recovery and sustainability. Streamlining the approval process for investment proposals, cleaning up of the banking sector balance sheet are some of the important steps taken by the authorities in the recent past. In the ongoing effort to support capital spending and further attract foreign direct investment (FDI) in the economy, the government continues to liberalize norms for FDI in many important sectors such as pharma, defence, aviation and single brand retail. These are sectors with huge growth potential and likely to attract large investments in the coming quarters. These are important structural reforms capable to determine – dependent however on the overall global environment - higher sustainable growth in the coming quarters.

Visit our Investment Strategy Webpage to read our other reports.

*Please refer to the disclaimer at the end of this publication.*

## Growth remains consumption driven

The acceleration in economic growth last quarter was largely consumption driven as a sustained investment revival remains elusive. Private consumption picked-up slightly further while government spending largely maintained the same pace. Both investment spending and net external trade contributed negatively to the growth. The pick-up in consumption is heartening but capex needs to accelerate for the sustainability of overall growth without again stoking domestic inflation.

| YoY growth | Q1 2016 | Q4 2015 |
|---|---|---|
| Total real GDP | 7.9% | 7.2% |
| Private consumption | 8.3% | 8.2% |
| Govt. consumption | 2.9% | 3.0% |
| Gross capital formation | -1.9% | 1.2% |
| Exports | -1.9% | -8.9% |
| Imports | -1.6% | -6.4% |

Source: CSO

## Consumption is likely to remain the main driver in the near term

Private consumption, almost 55% of the economy, has been the main driving force behind economic growth in recent quarters. We believe that the acceleration in consumption growth came mainly from urban households as the rural economy continues to struggle due to the poor monsoon season over the last two years. However, government's focus on rural spending in its last budget has started to spur revival in rural consumption as well. The sale of the two wheelers (motor bikes) and anecdotal evidence of rise in consumer goods companies' sales are two good indicators of revival in rural demand. Moreover, expectation of a not so bad monsoon season this time around are likely to provide a direct impact on the economy through higher agricultural production as well as stronger consumer demand supported by higher income.

Another factor which will be supportive to consumption is the expected wage hike for central government employees, which will be followed by wage hikes for state governments' employees later this year or early next year.

## How long can consumption sustain growth?

In the absence of any significant support from other segments of the economy, especially investment which constitutes almost 30% of GDP, a key question is how long consumption can support the growth? The answer is not very straight forward. However, it is more or less certain that consumption led growth leads to inflation as productive capacity lags behind demand, creating an inflationary tendency in the economy. Given that industrial capacity utilization has further declined particularly in consumer durables and non-durables sector, strong growth in consumption is unlikely to put any significant upward pressure on inflation in the near term. However, the longer the delay in the revival in investment, the higher the risk of inflationary pressures coming back into the economy which could put the consumption growth under pressure.

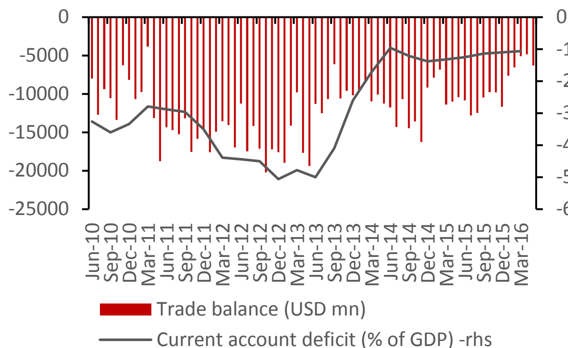
## Investment revival could still be a couple of quarters away

Although we have seen signals of capex revival led by government spending last year, it did not spill over to the private sector. The lackluster performance of private sector investment spending has its roots in the policy failures of previous years which created excessive capacity in many sectors including infrastructure sector such as power, which was not able to generate cash after investments. This caused a sharp rise in bad debts that reduced the banking sector ability to extend loans to those sectors which need to increase productive capacity. At the same time, the decline in exports over more than a year adversely impacted capacity utilization in export oriented sectors. We see progress on both fronts as the government renews its efforts on resolving issues which hampered sectors to generate cash after building productive capacity. Power projects are an example where many power plants could not be operated after completion due to lack of fuel supply or issues with transmission etc. At the same time, the Reserve Bank of India, the banking regulator, has focused on bad debt over the last couple of quarters cleaning up the balance sheet of the banking system, thus facilitating lending again with further capitalization from the government. We also see some signs that the exports will stabilize in coming months after a decline of more than a year, primarily due to stabilization in commodity prices, especially oil prices. Note that refined oil products are a large constituent of India's exports basket (almost one-fourth of the total exports).

## Macro stability improves further

This is the differentiating factors for India from most other emerging markets. The continuously improving macro stability provides a solid base for the sustainability of the economic growth in coming years.

First, lower commodity prices seem to be helping further in improving the external stability as the trade deficit shrinks significantly recent months. The larger decline in imports as compared to exports could even turn the current account balance in positive territory temporarily. Adding to the improvement in the external balance, foreign reserves have also increased further to USD 363bn which is equivalent to the 14.5 months of imports.

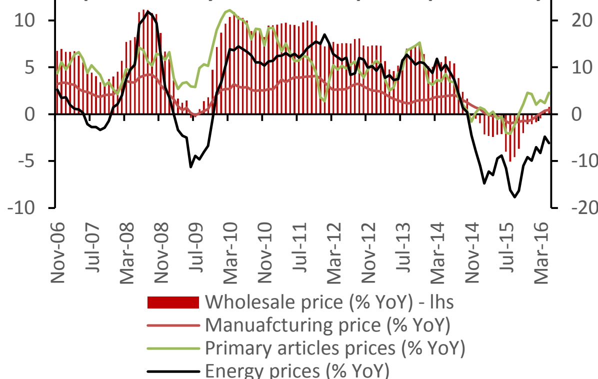



Source: Bloomberg

Second, fiscal consolidation remains on track as the government is committed to reduce the fiscal deficit to 3.5% of GDP in the current fiscal year. The recent right track record does not provide any reason for doubting the government commitment.

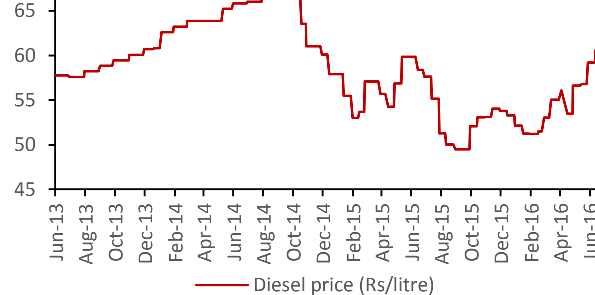
## Upside risk has risen for inflation outlook….

Price stability is getting more traction as wholesale price inflation moves into positive territory after deflation for more than a year. Besides reflecting broader price stability, we consider this development positive as it shows return of pricing power for corporates which is likely to help their revenues and earnings to grow. We expect wholesale inflation to pick-up further later this year as the base effect of lower energy prices kicks-in.




Source: Bloomberg

However, the flip side of the above development is an added risk factor for consumer price inflation. The return of wholesale inflation into positive territory and likely further upward movements, and the base effect of commodity prices which feeds through mainly diesel prices to consumer good prices, suggest that despite moderate inflationary expectations in coming months, the upside risk to consumer prices has increased. Domestic diesel prices have moved above the 2015 peak which typically has a cascading effect on prices of consumer items, as it increases the transportation costs of goods. Such price development is not only being reflected through the wholesale price or feed-in price but also through the consumer price index which has gained almost one percent from its bottom levels in March.




Source: Bloomberg

The monsoon, the rainy season starting in June through September, is also becoming a risk despite a prediction of above normal rainfalls this year by the official meteorological department. The start of the season has been quite disappointing until now as the cumulative rainfall deficit of 25% below normal on a season-to-date basis (1st June to 17th June) raises doubt on that front. Any possibility of a deficit monsoon in terms of total rainfalls or a lack of proper distribution over the national territory and over time could have an impact on food prices, feeding into prices of other items and general inflation.

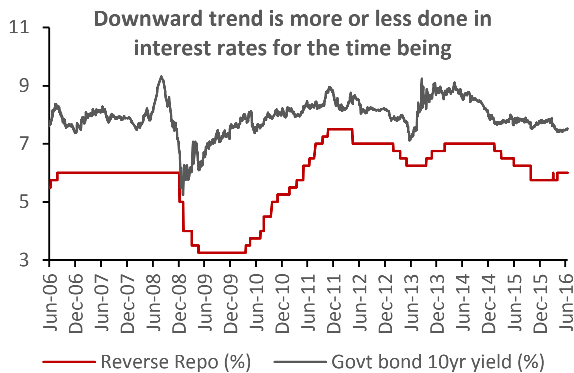
## ….rate cuts more or less done for the time being

A gain of almost 1% in the Apr-May period in the consumer price to 5.8% brings the CPI close to the upper range of the corridor set by the RBI for inflation which is 4% with 2% deviation on either sides. Along with this an upside risk to prices due to the base effect, a possible deficit monsoon and an upturn in commodity prices, have dimmed the prospect of further interest rate cuts by the Reserve Bank of India. Although the market expects another rate cut of 25bps by the RBI in the current year, we believe that the inflationary dynamics and FCNR outflows are unlikely to provide any room for any further rate cut. However, risk to our call is a possibility of change in policy towards inflation targeting by the RBI as soon as the new Governor takes over in September.

## Sovereign bonds yield seems to have also bottomed

The upside risk to inflation which is already close to the upper range of RBI's target will keep the bond market cautious in coming months. Yields on the government 10-yr bonds have eased almost 1.75% since the peak of late 2013. The decline in yield was aided by 150bps cuts in policy interest rates and a decline in inflation. We

believe that the yields have much less room left for further declines as we expect no further rate cut this year amid rising upside risk to inflation.




Source: Bloomberg

**Financial market gets hiccup from the government owned banks**

Amid broader structural macro improvement, we believe that the financial stability has also improved over the last few quarters, notwithstanding the issues related to public sector banks. We believe that a better currency and interest rate management has been the main reason along with focus on improving structural factors such as external balance, inflationary dynamics and fiscal deficit. This is reflected through a lower volatility in the financial and currency markets.

**Significant rise in NPLs ---** The asset quality in many government owned banks (Public sector banks or PSBs) has deteriorated significantly in the past few quarters, especially after the RBI directive to increase provisions to cover visibly stressed assets in the second half of 2015. According to Moody's, reported Non-performing loans (NPLs) for the 11 rated PSU banks more than doubled to INR 4.1tn at the end of FY2016 (Mar-2016) from INR 2.0tn a year ago. The gross non-performing loans (GNPLs) of some of the larger banks such as PNB, Central Bank and IDBI doubled from a year ago. Despite large provisioning, the coverage ratios for major banks are still short of stressed assets, in some cases only half of those assets.

| | Gross NPA | | Net NPA | | Coverage ratio | |
|---|---|---|---|---|---|---|
| | FY15 | FY16 | FY15 | FY16 | FY15 | FY16 |
| SBI | 4.3% | 6.5% | 3.8% | 2.1% | 69.1% | 60.7% |
| Bank of Baroda | 3.7% | 10.0% | 1.9% | 5.1% | 65.0% | 60.1% |
| PNB | 6.6% | 12.9% | 4.1% | 8.6% | 58.2% | 51.1% |
| Central Bank of India | 6.1% | 12.0% | 3.6% | 7.4% | 55.2% | 51.5% |
| IDBI | 5.9% | 11.0% | 2.9% | 6.8% | 66.6% | 57.2% |

Source: Company financials

**PSBs may face further stress; support required from the government ---** RBI's targets the balance sheet clean-up of the banks to be over before March-2017. This potentially implicates further large provisioning in the current and upcoming quarters which will have an impact on the capitalization of these banks. According to Moody's, there is a need for external capital requirements of around INR 1.2tn for the 11 rated PSBs, however, the government has set aside only INR 700bn for capital infusion in PSBs during the period 2016-2019, of which a sum of INR 250bn has already been disbursed. The mounting recognition and provisioning of NPLs would require a higher capital addition by the government.

**Every cloud has a silver lining** ---- We believe that the capital situation in PSBs is sufficient to weather the current NPLs storm. The capital levels at the Indian banks has improved on the back of new RBI rules that allow them to recognize revaluation reserves, deferred tax assets and foreign currency reserves as common Tier 1 capital in line with the Basel Committee guidelines.

Capital Adequacy Ratio

| | FY15 | FY16 |
|---|---|---|
| SBI | 12.00% | 13.12% |
| Bank of Baroda | 12.60% | 13.17% |
| PNB | 12.21% | 11.28% |
| Central Bank of India | 10.90% | 10.41% |
| IDBI | 11.76% | 11.67% |

Source: Company financials

Besides a reasonable capital position at the moment for most PSBs, we see normal business growing at a decent pace as reflected through operating profits. For most banks, operating profits were healthy and provisioning was the line item which affected net profits.

| | (in INR bn) | Q1 FY16 | Q2 FY16 | Q3 FY16 | Q4 FY16 |
|---|---|---|---|---|---|
| | Total Operating Income | 188.2 | 204.5 | 197.84 | 259.86 |
| | Total Provisions | 55.1 | 63.87 | 84.83 | 129.28 |
| State Bank of India | Net Income | 36.92 | 38.79 | 11.15 | 12.64 |
| | Total Operating Income | 54.99 | 56.79 | 57.91 | 52.2 |
| | Total Provisions | 24.11 | 23.18 | 28.67 | 85.95 |
| Punjab National Bank | Net Income | 7.21 | 6.21 | 0.51 | -53.67 |
| | Total Operating Income | 44.27 | 43.88 | 38.18 | 51.05 |
| | Total Provisions | 11.5 | 22.13 | 50.46 | 58.03 |
| Bank of Baroda | Net Income | 10.52 | 1.24 | -33.42 | -32.3 |
| | Total Operating Income | 21.36 | 24.56 | 21.34 | 27.74 |
| | Total Provisions | 10.03 | 13.99 | 33.01 | 33.31 |
| IDBI | Net Income | 1.35 | 1.2 | -21.84 | -17.36 |
| | Total Operating Income | 22.6 | 23.86 | 22.35 | 21.24 |
| | Total Provisions | 6.9 | 7.35 | 14.98 | 11.38 |
| Central Bank of India | Net Income | 2.04 | 1.13 | -8.37 | -8.98 |

Source: company financials

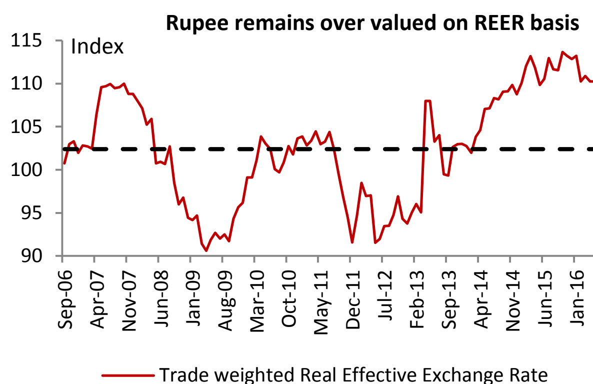
Furthermore, the government has introduced various debt recovery schemes, whereby, banks can convert part of corporate loans exposed to power sector into bonds backed by respective states. This approach will help in reducing corporate loan exposure. Also, the new bankruptcy code should help creditors in dealing with the large debtors for the resolution of distressed assets.

Having said so, the change of guard at the RBI will create some uncertainty as many in the establishment

were critical of the way Mr. Rajan, Governor of RBI, has been handling the clean-up of non-performing loans in the banking system. This could bring-in a new dynamics in the recognition of bad loans and provisioning for the same once a new governor takes over in September.

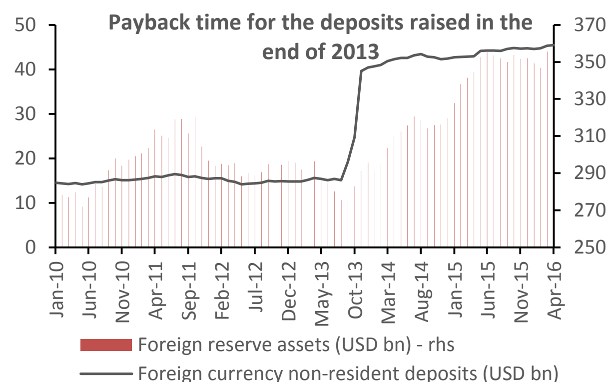
## Currency stability

The Indian rupee derives its stability from remarkable improvements in the current account deficit, fiscal consolidation and inflation control. The nominal value of the currency against the US dollar has not crossed the lows touched in August 2013 when the country was facing a crisis. On a real terms basis (Real Effective Exchange Rate - REER), the currency has been stronger, mainly due to a relative sharper depreciation in many of its trading partners' currencies. Therefore, we see a slow nominal depreciation of the rupee against the US dollar in the range of 3-5% per annum.




Source: Bloomberg

**A large amount of Foreign currency non-resident (FCNR) deposits maturing this year could create volatility** --- Notwithstanding the fundamental strength of the currency, the exit of the incumbent Reserve Bank of India Governor, Raghuram Rajan especially at a time when the FCNR deposits will be maturing during the fourth quarter of 2016, could potentially create short term volatility in the Indian rupee. A large amount of these deposits (around USD 25bn) were raised in 2013 for three-year terms, which will mature in the final four months of 2016. Since the deposits were made by Non-resident Indians, it is unlikely that all of them will be withdrawn. However, the deposits were highly leveraged as banks had the central bank's guarantee of return of capital on hedged currency. The aggregate leverage ratio is not available, estimates suggests that it could be as high as 70-80%. Therefore, the outflows could be as high as USD 20bn during the period.

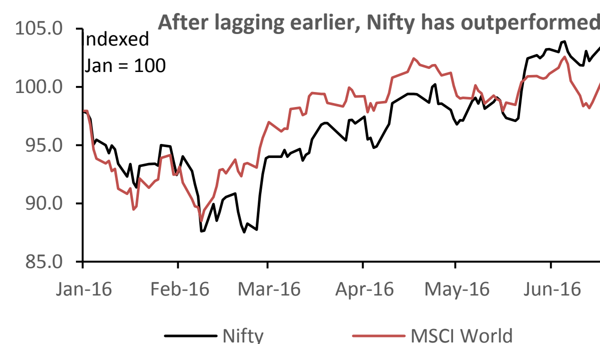



Source: Bloomberg

The large expected outflows are largely manageable given that the central bank has more than enough foreign reserves (USD 362bn) and, in anticipation of these outflows, the central bank has taken large long forward positions in dollar (USD 29bn). However, according to the RBI's statement in April 2016, the maturity of forward purchases is front-running the maturing deposits. This will create a maturity mismatch which could have a transient impact on currency liquidity, creating volatility in the currency market. The volatility could aggravate if the global capital flows environment is not particularly supportive.

## Equity market remains one of the better bets

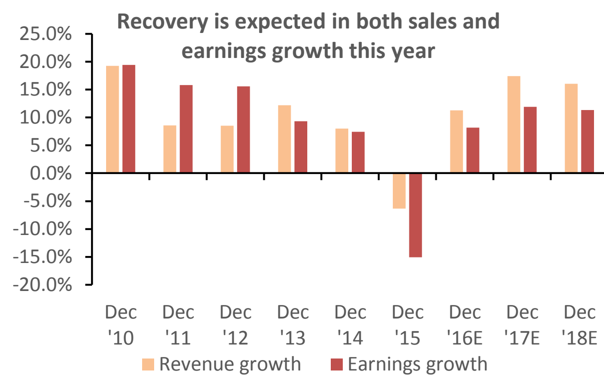
Notwithstanding the recent sharp gains in the Indian equity market, which was largely a catch-up run, we see improving economic fundamentals to support equity markets in the medium to long term. Therefore, we remain overweight on the equity market.




Source: Bloomberg

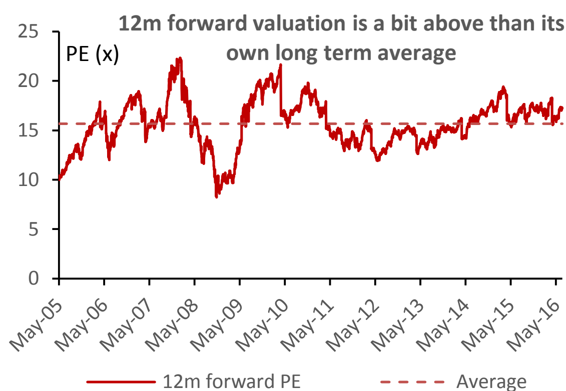
A deflationary trend in the wholesale price last year affected the sales growth and earnings as prices of broader goods declined at producers' level due to a decline in commodity price, large spare capacity in industrial sector and declining exports, and despite a relatively strong domestic demand. Most of these factors have turned around as we witnessed a turnaround in commodity prices and signs of stabilization in exports in recent months along with an

expected strong domestic demand. Market expectations of an EPS growth of 11.3% in 2016 on the back of 8.1% growth in sales seem to be reasonable with an economy growing at close to 8% in real terms. A further pick-up in earnings growth in 2017 also seems reasonable as economic growth picks-up further with the persistent reforms and the feed through of the recent cuts in interest rates. A decent first quarter result with Nifty index companies posted a lower double digit growth in earnings is a good signal that earnings could further accelerate.



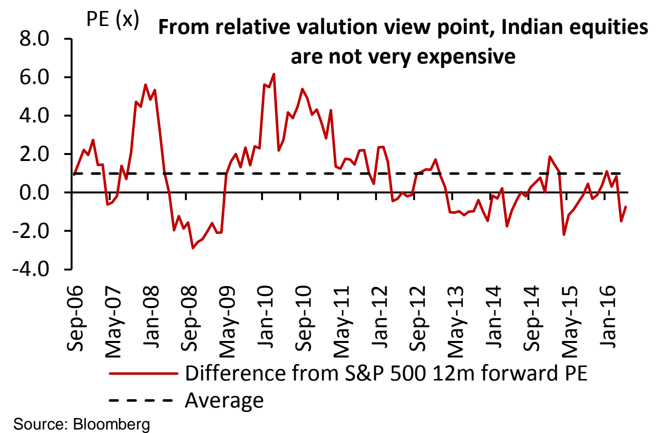

Source: Bloomberg

From the market valuation point of view, it has moved towards the higher side of the valuation, especially after the recent good rally. However, as has been the case historically, the market has often given a premium for valuation to Indian equities for the inherent structural strength of the economy.




Source: Bloomberg

Relatively speaking, when compared to the valuation of the S&P 500, we see that the Indian equity market has still some value left. Historically, Indian equity market has traded on a premium as compared to the US market, whilst current valuation is lower than that of the US market.




Source: Bloomberg

ADCB بنك أبوظبي التجاري

## 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*

## Disclaimer

*This publication is intended for general information purposes only. It should not be construed as an offer, recommendation or solicitation to purchase or dispose of any securities or to enter in any transaction or adopt any hedging, trading or investment strategy. Neither this publication nor anything contained herein shall form the basis of any contract or commitment whatsoever. Distribution of this publication does not oblige Abu Dhabi Commercial Bank PJSC ("**ADCB**") to enter into any transaction.*

*The content of this publication should not be considered legal, regulatory, credit, tax or accounting advice. Anyone proposing to rely on or use the information contained in the publication should independently verify and check the accuracy, completeness, reliability and suitability of the information and should obtain independent and specific advice from appropriate professionals or experts regarding information contained in this publication.*

*Information contained herein is based on various sources, including but not limited to public information, annual reports and statistical data that ADCB considers accurate and reliable. However, ADCB makes no representation or warranty as to the accuracy or completeness of any statement made in or in connection with this publication and accepts no responsibility whatsoever for any loss or damage caused by any act or omission taken as a result of the information contained in this publication. This publication is intended for qualified customers of ADCB.*

*Charts, graphs and related data or information provided in this publication are intended to serve for illustrative purposes only. The information contained in this publication is prepared as of a particular date and time and will not reflect subsequent changes in the market or changes in any other factors relevant to their determination. All statements as to future matters are not guaranteed to be accurate. ADCB expressly disclaims any obligation to update or revise any forward looking statements to reflect new information, events or circumstances after the date of this publication or to reflect the occurrence of unanticipated events.*

*ADCB does and may at any time solicit or provide commercial banking, investment banking, credit, advisory or other services to the companies covered in its publications. As a result, recipients of this publication should be aware that any or all of the foregoing services may at time give rise to a conflict of interest that could affect the objectivity of this publication.*

*Past performance does not guarantee future results. Investment products are not bank deposits and are not guaranteed by ADCB. They are subject to investment risks, including possible loss of principal amount invested. Please refer to ADCB's Terms and Conditions for Investment Services.*

*This publication is being furnished to you solely for your information and neither it nor any part of it may be used, forwarded, disclosed, distributed or delivered to anyone else. You may not copy, reproduce, display, modify or create derivative works from any data or information contained in this publication.*