India: real indicators taking longer but outlook still positive

Cutting through the confusing GDP release of India's Central Statistics Office

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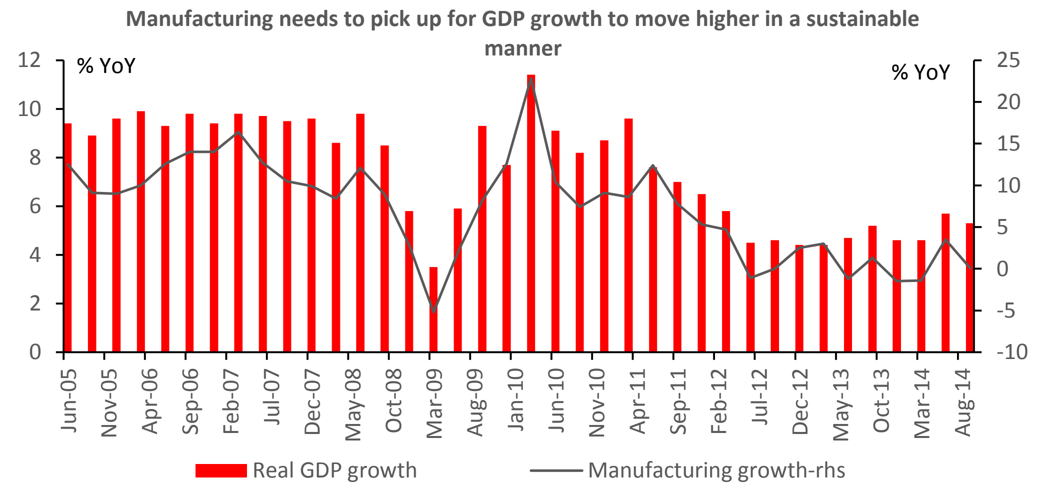
- **Notwithstanding the recent revised GDP data, real indicators suggest slower recovery than expected**
- **Fiscal constraints put onus on monetary policy to push growth**
- **Gradual enactment of micro-economic reforms, credible fiscal discipline combined with improving external accounts favor a more accommodative RBI stance. Fiscal slippage and sharp rebound in oil price are risks to this view**
- **Both fixed income and equity provide opportunity for investors even though we don't expect a repeat of the 2014 equity performance**
- **Currency movements are unlikely to be significant**

Is economic activity really catching up with financial exuberance?

A rather confusing sharp upward revision in recent economic growth numbers seems to suggest that India witnessed strong growth over the last six-seven quarters. However, high GDP growth estimates are not corroborated by more concrete numbers such as earnings growth of listed companies, credit growth, import growth etc. A case in point is manufacturing sector growth that is estimated to have grown 6.8% in the current financial year, something that is not corroborated by monthly data. Putting aside the distortion in growth numbers, the new government has been able to uplift the consumer and the business sentiments with its right emphasis on reform and intention of speeding up implementation. In a changed domestic policy environment, global developments such as a sharp decline in crude oil price have also turned supportive to the domestic growth outlook. The deflationary environment in major developed markets has prompted central banks to inject liquidity some of which is finding its way into economies such as India where the growth outlook has improved. These flows have been reflected in financial market performance in recent months. The market exuberance, however, is yet to be backed up by an effective improvement in real economic data.



Source: Bloomberg

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A myriad of micro-reforms to push the much needed pick-up in capital spending

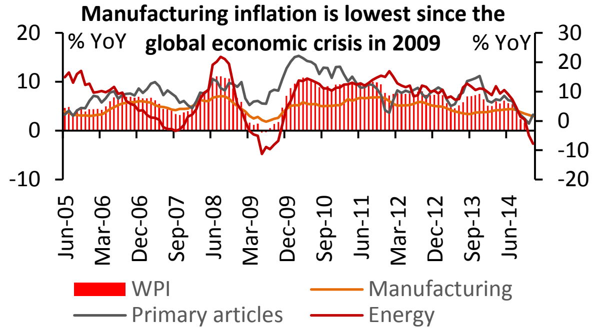
The previous growth slowdown was mainly due to a crash in capex cycle, as we have highlighted in our recently released *Quarterly Investment View*. The Government has already revived the reform process in terms of liberalizing the FDI regime for politically sensitive sectors such as insurance and defense, while at the same time removing domestic supply bottlenecks by liberalizing the Land Acquisition Bill, allocating coal blocks etc. Moreover, many large infrastructure projects have got recent environmental and other clearances. In the absence of much room on the fiscal front, the government is pushing public sector companies, which are having almost 1% of GDP equivalent cash, to start investment.

Fiscal constraints should be balanced by monetary support

The policy rate cut by the Reserve Bank of India ahead of its scheduled meeting on 3rd February underlined the importance of monetary support which the Indian economy needs in order to revive growth. This has also gained higher importance amid the government's tied hands on the fiscal side. With a commitment of not only containing the fiscal deficit but also reducing it over the coming years, the government has little possibility to provide any substantial fiscal stimulus. This puts the onus on monetary policy to support growth. Fortunately, the general macro-economic situation has turned less inflationary such that more accommodative monetary policy seems warranted.

Inflation dynamics has turned supportive to a deeper rate cut

The sharp correction in oil prices has not only come as a boon for the government's fiscal management, but it also provides an opportunity to contain the domestic inflationary momentum. The generally benign global commodity environment is not expected to turn around soon, thereby ensuring for the foreseeable future less inflationary pressure. The moderation in Government spending and subsidies in the rural sector has determined lower wage and prices pressures in this still very important part of the economy.



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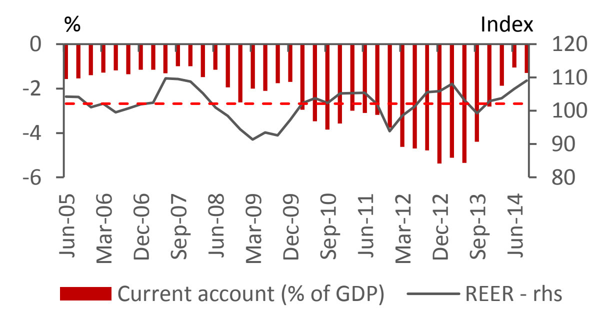
The Reserve Bank of India will be buying dollars rather than selling to manage currency

A remarkable improvement in the external sector in recent quarters also provides comfort for the central bank easing monetary policy. The current account deficit has come down to around 1% of GDP. Thanks to the drop in the oil price it could even temporarily turn into a surplus. On top of this, capital flows are expected to be higher in coming months, both due to the improving domestic economic outlook and ample liquidity in global financial system. This could result into a temporary rupee strength. Given that the rupee is already overvalued in terms of the real effective exchange rate, the central bank will continue to intervene to avoid any sharp appreciation in the currency. A lower domestic interest rate environment will also be helpful in avoiding any appreciating pressure on the currency.

Current account could turn into positive territory, putting pressure on the rupee to appreciate



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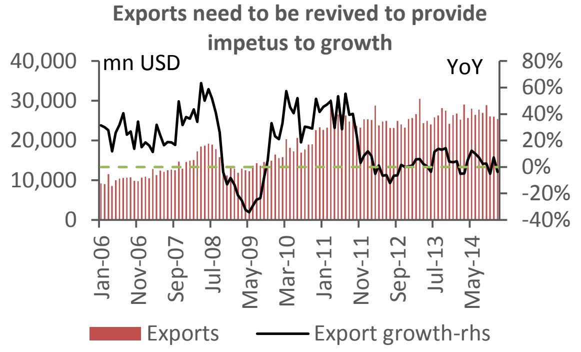

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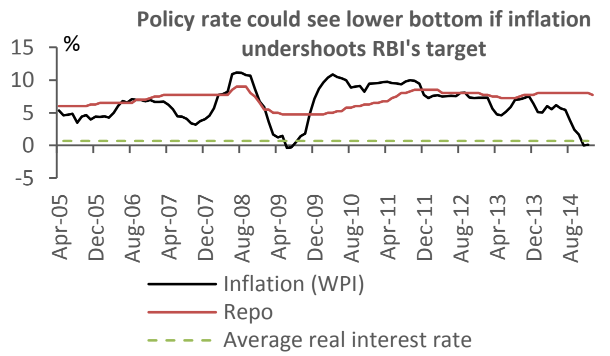
We see a possibility of lower bottom for the policy rate in the next two years

Notwithstanding the confusion created by the recently revised GDP growth figures, all the factors mentioned above seem to suggest that the Indian economy would need a lower interest rate environment. Therefore, we expect that the RBI will further cut policy rates in the near term. Moreover, we believe that the bottom of the policy rate could be even lower than 7%. Moderation in consumer price inflation as well as inflation expectations have provided room for a more aggressive rate cut. Historically the very low real interest rate maintained by the RBI also supports our view.



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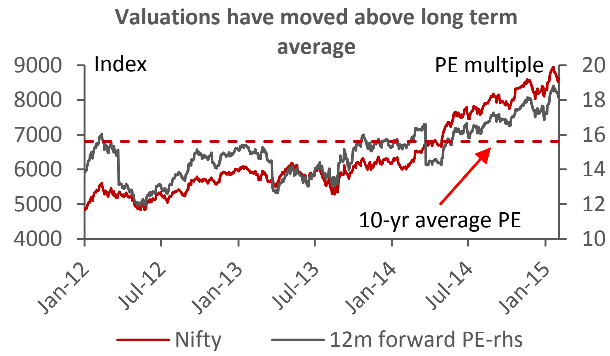
Lower interest rate bodes well for both equity and bonds

With our dovish view on the interest rate environment, we believe that fixed income assets provide a decent opportunity. For instance, sovereign 10yr yields have come off more than a percent over the last one year. Market expectations are of a further reduction through 2015, even in the absence of surprise policy cuts. There are some reasonable opportunities on the corporate side, yielding around 8% or more.

The improving growth outlook with lower interest rates and a stable currency still provides opportunity in the equity market even after last year's solid run. Although we do not see a repeat of last year's performance (+30%), as valuations has moved towards "higher" levels, we see opportunity in rate sensitive sectors such as banking and autos, while we remain constructive on infrastructure.



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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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