Valentis Advisors

Revive the animal spirits!

Jyotivardhan Jaipuria
jyoti.jaipuria@valentisadvisors.com

Stable Political environment- What next?

With the massive victory of the BJP-led NDA in the Lok Sabha elections, political risk for the next 5 years is behind us. Expectations for big bang reforms (land, labour, PSU bank privatization etc) are already running high in the market, especially with expectations of a NDA-majority in the Rajya Sabha also by late 2020.

30-day agenda

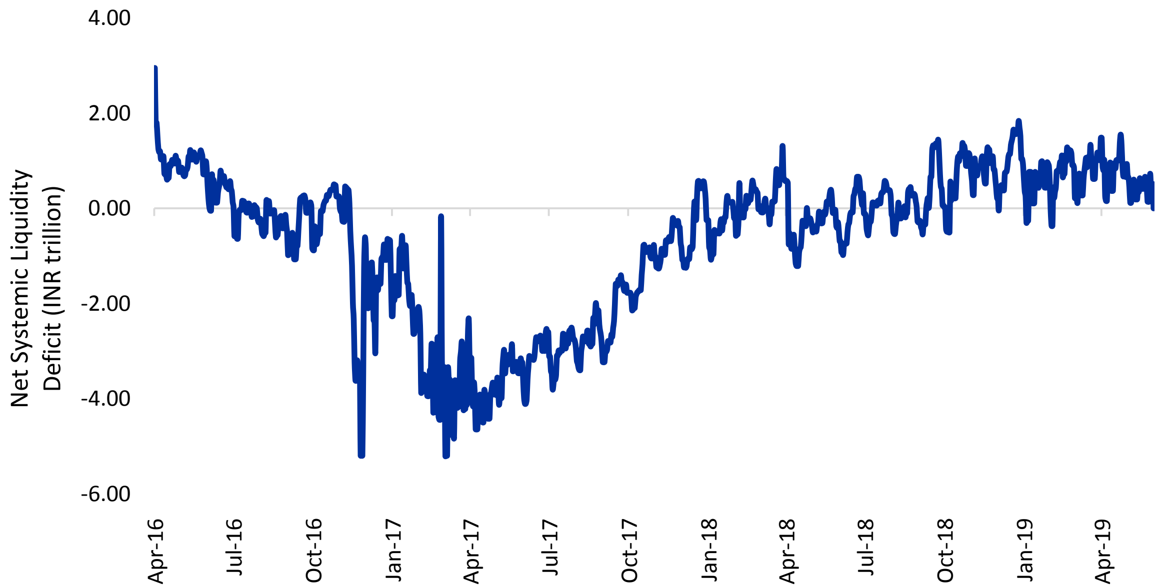
While we agree that these structural reforms are important to drive India's growth for the next 5 to 10 years, we think these reforms take time politically to build consensus. Probably the immediate attention of the Government should be on reviving the economy which has slowed and slowed considerable in the last few months.

1. Liquidity Flood and Interest Rate cuts

We think there is an urgent need to infuse massive liquidity in the economy to kickstart growth. Some economists would argue that liquidity would return back to the system as (a) Government spending starts and (b) high cash that is typical of the election period normalizes.

We agree with the above view but believe (a) inflation is low enough to not worry if liquidity turns a bit excess (b) the economic slow-down is acute and we do not have the luxury of waiting for liquidity to normalize on its own.

Chart1: Net Systemic Liquidity running negative past six months



Source: Bloomberg

Apart from liquidity, real interest rates in India are high at over 350 bps. We expect RBI to cut rates by 50 bps over next 6 months. But with transmission of rates remaining a question mark, surplus liquidity may result in lower rates percolating to the economy.

2. The NBFC crisis - tackling both the solvency and liquidity worries

One of the reasons for the consumption slow-down is that credit is not easily available from the NBFCs, most of whom are collapsing their growth rates. Both mutual funds and banks are now reluctant to lend to the NBFCs largely due to lack of confidence in their solvency. We think the Government may have to take steps to address both the liquidity issue and the credit solvency issue of NBFCs. We think this may take the shape of easier securitization norms or a special line from the banks. However, this will be accompanied by greater RBI regulation of the NBFCs in terms of ALM and Asset Quality norms. An Asset Quality Review may lead to disruption in the near term but is probably the only way to re-build confidence in the financial system on the solvency of the NBFCs.

3. Re-start Government spending

The Government spending in infrastructure was the biggest driver of investment growth in an environment where private sector capex is missing. Given the Model Code of Conduct during elections, all new project sanctioning was halted. The Government should quickly get back to accelerating infrastructure spend. With the key ministries like roads, highways (Nitin Gadkari) and railways (Piyush Goyal) remaining unchanged, we think they will be able to get things moving urgently.

One debate here would be on the ability to spend given the fiscal deficit constraints. We would be ok if there is a small increase in fiscal deficit if and only if it is solely for increasing infrastructure spend.

Longer Term Reforms

There are lot of reforms that the street is factoring in. Some of the other reform expectations:

1. Re-capitalization of Public Sector Banks: We do not expect privatization of PSU banks. But we expect (a) recap of PSU banks funded by return of surplus capital from the RBI and (b) consolidation of the PSU banks into fewer, larger banks.

2. GST rationalization of rates and simplification of the process.

3. Privatization of Public Sector Units and using that money for infrastructure investment.

3. Lower corporate tax rates while removing many incentives. However, this is unlikely before the Feb, 2020 budget with the committee evaluating the Direct Tax code yet to give its report.

4. Land and labor reforms. We think this is unlikely in the next one year given the lack of a majority in the Rajya Sabha.

10 point wrap on our market views

(see details in our earlier note https://valentisadvisors.com/wp-content/uploads/2019/01/Valentis-Outlook-2019_25Jan2019.pdf)

1. Single digit return next 6 months: Valuations mean that we expect a range-bound market with single digit returns over next 6 months in the large cap stocks.

2. Mid-cap stocks likely to out-perform: We think mid-cap stocks will out-perform the large cap stocks. Post their under-performance, valuations are relatively much cheaper.

3. Fed rate cuts towards end-2019 could boost emerging market equities: This could reverse the strong developed market outperformance since 2008.

4. Recessionary conditions in developed world is biggest risk: While the US-China trade war will keep making market nervous, we think the greater risk is of a recession in the developed world.

5. MSCI changes may mean lower India weight: The China A shares have been included in the MSCI EM index last year with a small weight. We expect the weight of China A shares to rise and hence correspondingly reduce weight of other countries including India.

6. Political stability to help markets next 5 years: With the clear majority of BJP in the Lok Sabha and a possible NDA majority in the Rajya Sabha, political stability will help markets next 5 years.

7. ...but structural reforms likely to take longer than expected: We do not expect big bang reforms (land and labour reforms, PSU privatization) to get implemented in the near term.

8. Valuations are expensive: Markets are clearly not in the cheap territory trading at close to 19x 1-year forward earnings. A revival in corporate earnings is essential to justify the premium valuations.

9. Onus on earnings to deliver market returns: Over the past 5 years, most of the stock market returns came from valuation re-rating with corporate earnings being missing. The next 5 years market returns will mirror corporate earnings. We expect earnings to double over next 5 years.

10. Rate cuts could support markets: The market will have to contend with a weak set of earnings in the June quarter. However, interest rates are clearly headed down and this could raise expectations of a turn in the earnings cycle. Interest rates in India are high and we expect a 50 bps cut over next 6 month and maybe 100 bps over the next 12-15 months.

Valentis Advisors

Disclaimer

- Valentis Advisors Pvt Ltd. (Valentis) is a registered Portfolio Manager with Securities and Exchange Board of India.
- This report/presentation is strictly for information and illustrative purposes only and should not be considered to be an offer, or solicitation of an offer, to buy or sell any securities or to enter into any Portfolio Management agreement.
- This report/presentation is not intended for distribution to public and is not to be disseminated or circulated to any other party.
- Valentis does not offer any guaranteed returns nor is there any capital guarantee in the Valentis PMS. Valentis Advisors shall not be liable for any losses that the client may suffer on account of any investment or disinvestment decision in the Valentis PMS or based on the information or recommendation received from Valentis Advisors on any product.
- Investments in the Valentis PMS, as in any other equity product, may go up or down due to various factors affecting the market. There are market risks, political risks, financial risks etc in equity investments. Investors should take into consideration all their risk factors and their risk profile before investing. Clients should also take professional legal and tax advice before making any decision of investing.

Valentis Advisors Private Limited

+91-22-67470251

pms@valentisadvisors.com