Investment Matters

July 2019

Budget Highlights 2019

Analysts of my vintage have horrific memories of budget days in the 90s. The speech would end around 9pm, the budget papers would be flown in from Delhi and reach our offices after midnight. We would then put in all-nighters to pore over the fine print. There were devils in the detail: the indirect tax regime was being reorganised, and the earnings impact of specific proposals could be 15-20%. Remember, the market was dominated by commodity companies those days.

Thankfully, much of that has changed. The timings are more civilised (thank you, NDA-1) and tax rates are more stable. Budget days are, therefore, less impactful on earnings, markets (and analysts) – though not devoid of some googlies (GAAR, CGT, surcharge, etc). The direct impact of the budget gets adjusted very quickly and the focus shifts back to earnings.

The 2019-20 final budget reflected that trend. There were some micro-measures, both good and bad. Housing saw a small leg-up and there were some creative solutions to the NBFC impasse. On the other hand, import duties were selectively raised and the peak income-tax rate went back into a 4-handle after decades. We believe that the big news was the government stuck to fiscal discipline: this outweighs any of the tactical steps. The temptation to slip into "fiscal stimulus" mode is strong when demand is this weak: but that never has a happy ending and the markets should be cheering the government's restraint. The decision to wet feet in the overseas bond market was cheered onshore – this has to be done with great caution, though.

This Budget speech was being followed for more than just the tax proposals, though. A new FM, presenting the first budget of NDA-2, was expected to shed more light on the reform agenda. In our view, the Finance Minister (FM) did not disappoint and gave us a few positive pointers to the future. Execution will be key but a clear articulation sounds encouraging.

- The FM spoke of privatisation and asset recycling - these are bold steps forward and could change both the fiscal maths and the capital productivity of the public sector. We argued that the privatisation benefits go beyond being as source of funds, and are happy to see movement in that direction.

- The PSU bank recap is now being accompanied by governance reform. The details are still awaited, but this is critical for long-term health of the economy. PSU bank growth, while supportive of an economic recovery, has to be accompanied by prudence and better governance; or else, another NPL cycle will hit the economy a few years later.

- There is a focus on attracting foreign capital. Apart from the decision to tap the overseas markets for sovereign bonds, sectorial FDI/FPI limits are being addressed and FPI flow into REITs are been relaxed. A steady flow of foreign capital helps keep the domestic financial system stable and supports a monetary easing cycle.

- The plan to streamline labour laws was reiterated. The move to rationalise rental laws may also help unlock the real estate markets.

The long-term recovery is dependent on reforms such as those planned above. A more immediate priority is, however, to pull the economy out of the near-term slump in demand. That heavy lifting will have to be done by a monetary stimulus. The RBI has to move both in terms of cutting rates and supplying enough liquidity to enable transmission of those rates to the end-user. The progress has been encouraging: liquidity is now easier, the first signs of deposit rate cuts are visible and some of the budget measures will help that progress. The fiscal discipline of this budget (lack of fiscal stimulus, for the glass-half-empty types) will allow the monetary easing to work – trying both together may be counter-productive.

The market correction post-budget seems to be a long-overdue reality check. We expect the upcoming earnings season to be weak, a factor that the market ignored through the last six weeks. The lack of a fiscal stimulus is being offered as an excuse, but the discipline is important for overall financial stability. This correction provides an opportunity for investors with a 2-3 year horizon.

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Market Outlook

So what are the short-medium term implications of the budget on the markets?

As my colleague Seshadri mentioned, budgets are increasingly less and less about micro-math and more about policy thinking and signaling. Going by that, there is no immediate stimulus in the budget as all NDA governments have largely eschewed sacrificing fiscal prudence to pump prime growth. The government is largely going to rely on the RBI and the monetary policy to do the heavy lifting. With benign global interest rates and if oil prices behave, there is room for further easing. Keeping fiscal discipline is very important if we want to bite the proverbial apple of foreign debt capital to supplement limited domestically fiscal headroom to drive economic growth.

By recapitalizing PSU Banks and putting some sort of a floor on the NBFC crisis, we hope the transmission of lower rates and better liquidity start reaching the economy at large. However, this is a process and it may take a few months before we see lead indicators of growth turning. We still have to live with continuous deleveraging of the corporate sector. But the seeds of a long desired recovery may well have been sown. So it is fair to expect a long slow recovery. Earnings growth may still be tepid for two quarters at least.

The NIFTY/SENSEX rally was largely led by large caps in the last 12-16 months. That may take a breather and the markets could correct and go into a consolidation phase over the next few months. This may happen due to:

1. There is perceived supply of new paper due to the reduction in promoter holdings from 75% to 65%, though there maybe a period prescribed for an orderly reduction,
2. Rupee appreciation due to expected inflows from foreign debt borrowing coupled with tax on buybacks could keep the large IT sector under check
3. No immediate fiscal push for growth and tepid monsoons
4. Potential slowdown in global growth signalled by negative interest rates

The huge premium of the small-mid caps to large caps has now turned in to a discount, finally !!! but that discount may stay for a while before the larger cap market consolidation phase gets over. But it has certainly now given us a bigger universe of opportunities to look from. Investors may have to wait longer before strong returns come back but the opportunities will come beckoning in difficult markets as they always do. But we will need both discipline and patience and faith in the ultimate ability of the economy to turnaround and consequently markets to reward us, as they always do.

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