ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

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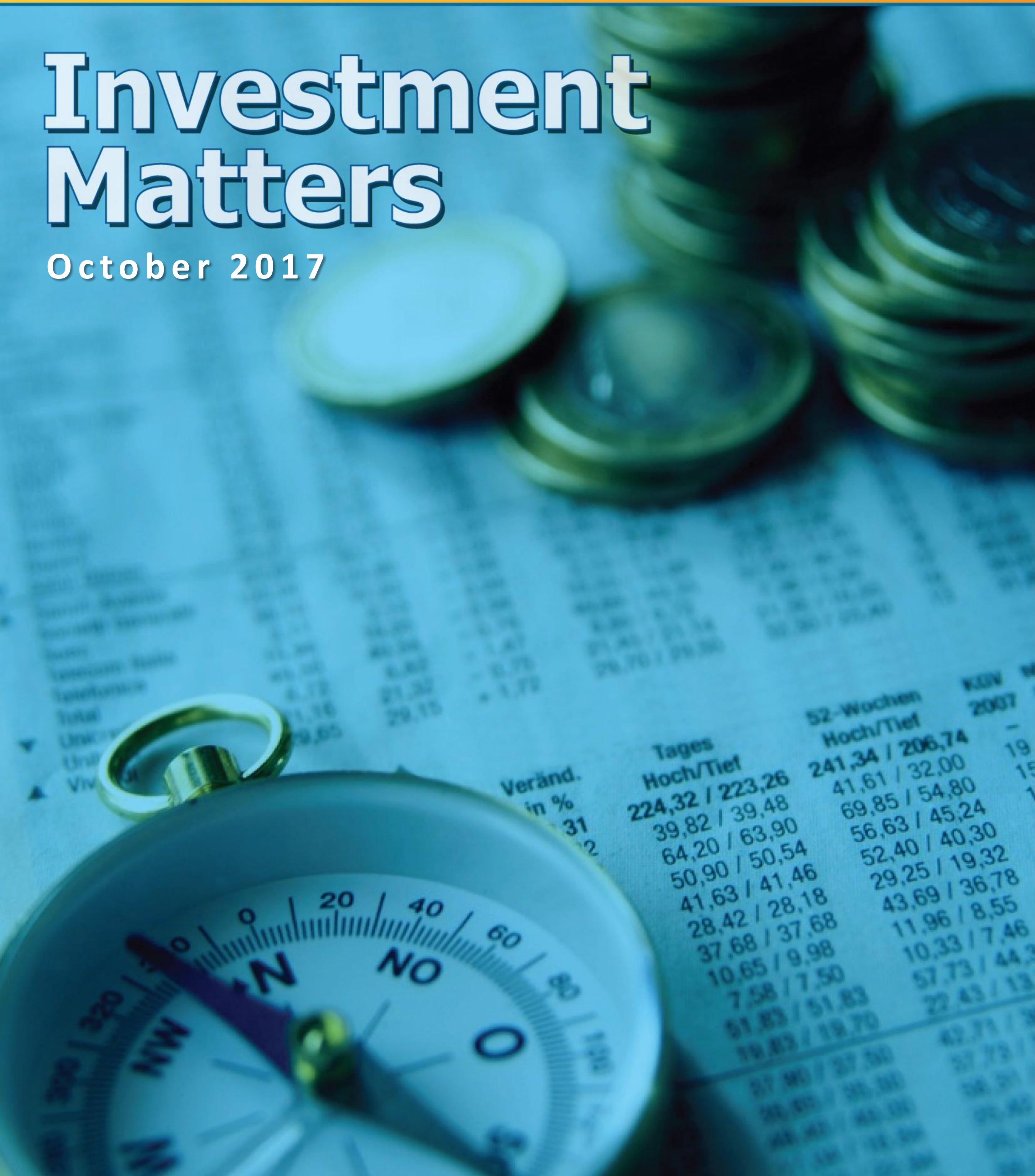

EQUITY OUTLOOK

A GDP print of 5.7% in Q1FY18 has created a flutter in both economic and political circles. This sudden drop in the growth rate, though not completely unexpected due to the roll out of GST coupled with the initial hiccups in its implementation has cast pall of gloom that all is not well with the economy. Expectedly the opposition as also some of the old guard within the BJP sprang into action to indicate that how both demonetisation and a hastily implemented GST have slowed down the economy substantially and put tremendous pressure on SME"s, exporters and small traders and businesses

Last week Prime Minister Narendra Modi joined the ongoing rhetorical debate on the state of the Indian economy with a strong defence of his government's actions over the last three years. Among other things, his intervention put the spotlight on the Indian economy—something long overdue, but not for the rhetorical charges that are being flung around on both sides.If indeed there is a pithy way of summarizing the state of affairs suffice to say that the country's economy has transitioned from a state of policy paralysis (which identified the Congress-led United Progressive Alliance or UPA) to one of investment paralysis. Both are cause for worry but for entirely different reasons. One was the outcome of a government which, for whatever reasons, went into a policy funk with disastrous consequences.The other is the result of structural disruptions—some of which, like spiralling bad loans with banks, are a legacy of the UPA regime and a few induced by policy changes, like the rollout of the goods and services tax (GST) and demonetization of high value currencies, undertaken over the last three years. So while one arose from inaction, the other is largely a fallout of not anticipating or reacting in time to address the disruptions arising from hitting the reset button on the economy. It is important to grasp this distinction. Alternatively, there is a risk of being overwhelmed by the rhetorical claims and counterclaims on the economy; and missing the woods for the trees as it were.

As such the economy is not doing as badly as the opposition is claiming—especially with almost every agency forecasting a rebound in economic growth, albeit marginal, in subsequent quarters. Most importantly, macroeconomic stability has been restored. On the other hand, it is certainly not performing to potential—This potential can be tapped only if the investment levels, which have dropped to worrisome lows, recover. But this is easier said than done. The legacy of bad debts or what Arvind Subramanian, chief economic adviser, describes as the twin balance sheet problem (because it affects the books of both companies and the banks who extended the loans) is not something that can be resolved overnight. Alongside the disruptions caused by structural policy responses like GST are causing considerable pain. As the old business structures built over seven decades are replaced, rather abruptly in some cases, the new systems are not up and ready to take over—indeed, the challenges in execution of some the bold ideas of DeMon and GST is where potentially the government underestimated. It is the fallout of this transition, which is lending hope to critics and a cause for worry to the government. But should we really worry so much? We don't think so

Yes, there will be an adjustment period and this will dilute growth and potentially push out the much needed earnings recovery further down a few quarters. As one of the CFO's of a large and very successful company told us – "when we implemented SAP in our organisation it took us a whole year to recover from the ensuing chaos and adjust to the new system, and here we are talking of implementing the most complex piece of reform for the entire country!!. What are we really talking about?" he was not wrong! We believe, as we have seen in the case of DeMon, that Indians are not only a tolerant lot but also adaptable. So people will eventually adapt to the new processes. Plus the government has swung into action and has started course correction by simplifying and reducing the compliance burden on smaller businesses, giving relief to exporters as also reducing the GST rates on several items of mass consumption. The next few months will be critical. If the momentum in some high frequency economic data like Auto sales and core sector growth, which were strong in September, hold up as also the monthly GST revenue collections stabilise, confidence will return. The current earning season will also give a few clues about re-stocking and sales trend for companies which got hit by de-stocking that took place prior to GST. In the final analysis, it can safely be said that the attention to the economy is welcome, and it has prompted the government into action. Markets could halt their sordid momentum for a while as it waits for signs of a much long awaited recovery in growth and earnings. But looking at a new and rapidly transforming India through a conventional lens is a bad idea. We remain confident on the medium and long term prospects for growth and are well positioned in companies that have the ability and capability to grow irrespective of these short term disruptions

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