Cartica Management, LLC

Macro Insights

February 2018

Same Tiger, Different Stripes

India's economic drivers are strong but shifting

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One month into 2018, investor sentiment on India seems to have flipped – the Indian middle class is "a myth", inflation is getting out of hand, and the newly-released budget will apparently blow out the deficit. Hold your tigers. While some of India's economic drivers might indeed be running out of steam, we see others picking up the slack. We believe the Indian story remains intact.

2017 was a rosy year for Indian markets, with the MSCI India index rising 37% in US dollar terms. This occurred despite considerable pain at the microeconomic level, as businesses absorbed the twin shocks of demonetization and the Goods and Services Tax. Exporters in particular struggled with the new tax regime. High leverage and low capacity utilization kept a lid on private investment.

Arguably what drove market performance in 2017 was the macro picture. For most of the year, economic fundamentals were broadly positive. Inflation fell to a historic 1.46% in June, the INR appreciated 6.35% against the US dollar, and the RBI cut the benchmark rate by 25bps towards the middle of the year.

Towards the end of 2017, however, the picture reversed, and macro conditions started deteriorating. Rising oil prices fueled inflation and the current account deficit widened. The ruling BJP party only just managed to scrape together a win in the Gujarat state elections, Modi's home turf. As a result, fiscal rhetoric turned more dovish, raising fears of a larger budget deficit. The Indian 10-year bond yield rose above 7.3% from a low for the year of 6.4% in mid-January and in line with its five-year average.

As these conditions continued into 2018, the mood turned. India's small and mid-cap companies started the year with disappointing performance compared to their large cap peers. India's market performance has been falling behind other emerging markets with MSCI India lagging MSCI EM by 4.11% YTD[1]. As icing on the cake, on February 1, the Indian government announced its 2018/2019 Union Budget, complete with a new capital gains tax and higher agricultural support prices. People rightly worry that the populist bend to the budget risks sending India off the fiscal consolidation path. The day following the announcement, MSCI India fell 2.72%.

Notwithstanding the headwinds, we at Cartica believe there are plenty of reasons to remain optimistic about India's year ahead. To start, the micro picture is now looking up. Despite some fiscal slippage, the budget should support demand at the grassroots level, particularly in the rural economy. If successful, the bank recapitalization scheme should move along private investment, which is already showing green shoots. This should help drive growth in the run-up to the 2019 elections. Bloomberg consensus forecasts for real GDP growth in FY2018 and FY2019 are 6.6% and 7.4%, respectively. We believe India is poised to reclaim its title as the fastest growing large economy, having temporarily lost the crown to China.

[1] As of 2/6/2018 close

The main risk to the sustainability of growth remains inflation, but there too we might see some relief this year if oil prices ease from recent highs due to US shale coming back online. Therefore, markets should continue to be buoyant and we believe our portfolio companies are well-positioned to benefit from an increase in demand, healthier rural growth, and the continued push for the formalization of the economy.

Furthermore, the pullback in some Indian stocks that we saw in January is no doubt tied somewhat to their outstanding performance in 2017 and in some pockets, stretched valuations. Anecdotal evidence suggests many foreigners left the Indian market in December 2017 only to return through ETFs in January, which might partially explain why large caps performed relatively better. Increased participation from domestic retail investors in the equity markets might also be adding volatility to the mix.

Looking through the short-term noise, we maintain that India remains one of the best investment stories in emerging markets over the long term.