Beyond 2019: Has India's outlook changed

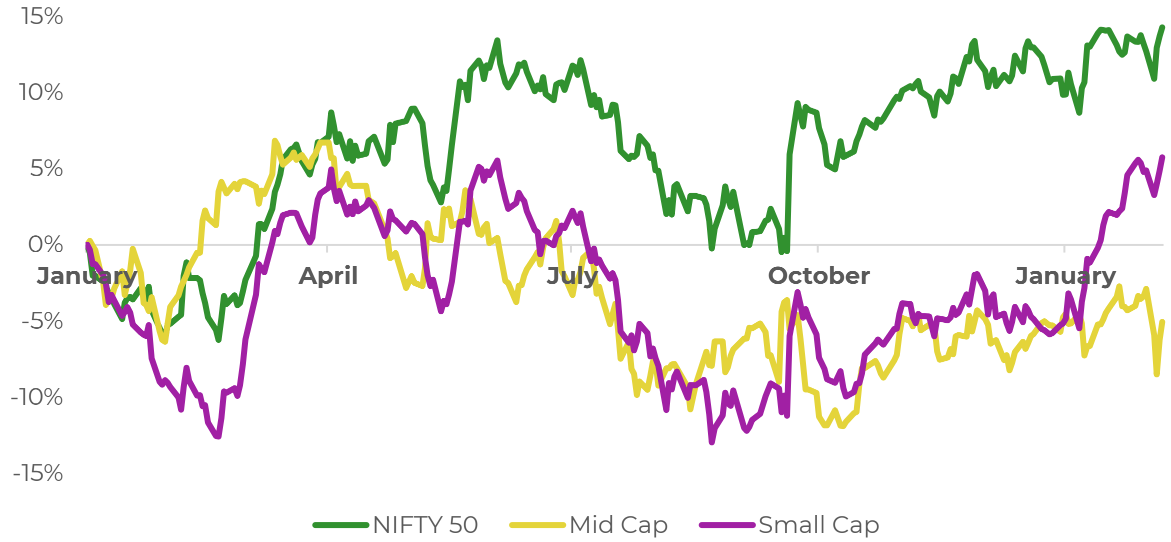
Most investors see India as a high potential growth market, and it is difficult to argue with this when looking at the long-term performance. However, 2019 saw lacklustre results with mid-cap and small-cap stocks a significant drag on performance.

With all the positive structural and economic reforms happening within India, how could this occur and does this change the medium- and long-term prospects?

This article seeks to highlight what drove the underperformance in 2019 and place it in context with the broader developments happening within India. The key outcome is that whilst 2019 was a soft year for Indian performance, especially outside the big ten companies, India's medium- and long-term prospects remain intact and attractive.

India 2019: The Summary

Despite positive expectations, India did not perform well last year. As you can see from the chart below, only the large-cap businesses did well, with medium and small companies experiencing significant pain in terms of downward revaluations.



Source: Bloomberg as at January 2019

Most investors are aware of the general 2019 backdrop that affected sentiment and markets throughout its course, namely, the US/China trade war escalation, slowing growth and fear of recession. But what were the more specific issues within India that caused the significant underperformance for all but the large capitalisation companies?

The Three Drivers of India's 2019 Negative Performance

1. NBFC Crisis
2. Government election
3. Kashmir

- **Non-Banking Financial Companies (NBFC) Crisis**

  The key driver for the general slip into negativity across many industries was an event that has not received immense publicity outside India but which, within India, was equivalent to the Lehman Brothers collapse in the United States in 2007.
  During Q4 2018, an Indian company called Infrastructure Leasing & Finance Services (IL & FS) defaulted on multiple loans and covenants to various lenders across India. This left both shareholders and lenders devastated but none more so than the NBFC, who had been responsible for much of the liquidity on the Indian system by way of short term borrowing from the banks and mutual funds. Simply put, the same banks and mutual funds stopped lending to NBFCs, because of IL & FS's default, causing an intense liquidity and confidence issue across India's institutions.

  This was reflected in the sharp downturn from Oct 2018 – Feb 2019 in index performance and multiple negative economic indicators. The crisis continues now, although its impact has been mainly absorbed and reduced.

- **Government Election**

  The Indian election returned Narendra Modi back to power. However, as is common practice across the world in the lead up to an election, the incumbent government were more focused on re-election during Q2 of 2019 than true, structural economic growth.

- **Kashmir**

  The hostilities between India and Pakistan became more violent than they had been for many years and for a period, appeared to be in full blown escalation.

Results

The factors above are not the only reasons cited for the 2019 malaise but were the primary contributors. The NBFC crisis in particular was blamed for shutting down the level of credit in the system, producing second and third order consequences across the economy. Some of the results are as below.

Sector Specific

India's automobile industry went through the worst period in twenty years. Many jobs were lost with the Society of Indian Automobile Manufacturers (SIAM) reporting the closure of over 300 dealerships.[i]

Similar conditions were experienced in the real estate sector, where Liases Foras, a real estate research company, cited the unsold housing inventory levels at 42 months. This puts the level at around 3.5 years vs the generally accepted 8-9 months in a healthy economy.[ii]

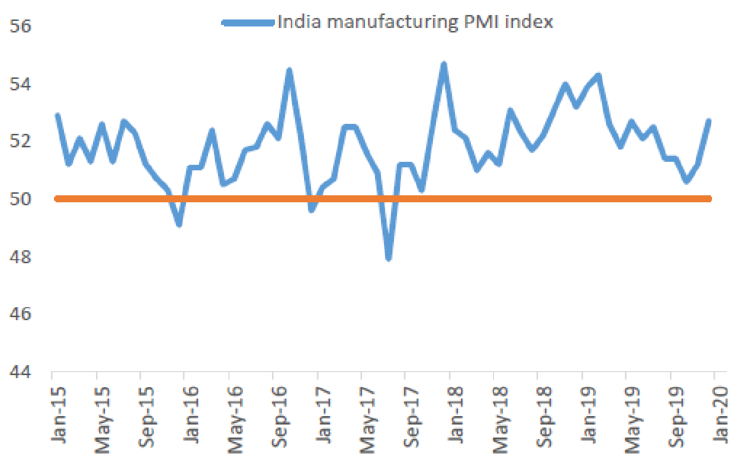
Economic Indicator	Comment
PMI	India's manufacturing PMI declined to a two-year low at 50.6 in October
Core Sector Production	Growth in the eight core sectors in September slumped to negative 5.2% YoY
Industrial Production	Despite IIP growth of 2.4% from April to August. August IIP contracted 1.1% YoY led by consumer durables and capital goods production.

Where Is India Now and Have the Long-Term Prospects Changed?

In response to the issues above, as well as others, the government and the Reserve Bank of India (RBI) launched a parallel, dual set of operations to revive the domestic economy.

On the one hand the RBI cut rates 5 times in 2019 by 1.35% in total to 5.15%. This went a significant way to shore up concerns for borrowers and lenders alike, both shy of credit after the NBFC crisis. Lenders particularly benefited as the desire to borrow, from small and medium businesses as well as homeowners, increased. This accommodative stance is still moving through the economy and is expected to provide support and a reinvigoration for some time to come. The two charts below illustrate this.

India manufacturing: Signs of recovery



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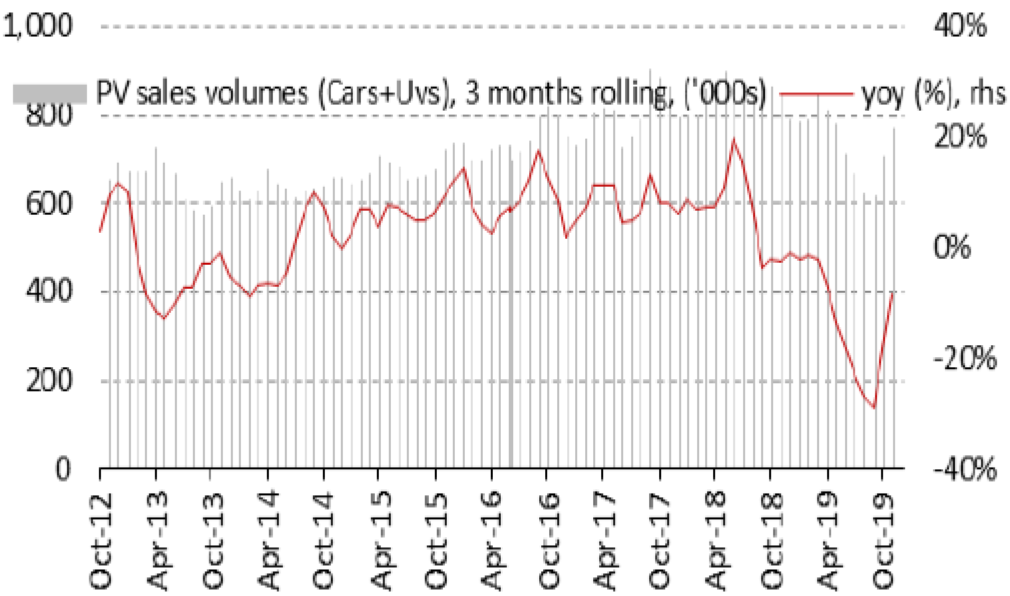
Passenger vehicle sales start to recover



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Additionally, in September 2019, the government implemented a corporate tax cut, from 30% to 22%, making it one of the lowest rates of tax for corporations in Asia.

When other governments around the world have enacted one or the other of these measures, the respective economy generally responds aggressively. India has done both in 2019, which explains the rapid positive response of the equity markets and forms a solid base for the continuity of the more structural story for India.

It is also highly informative to consider the Indian market underperformance in a broader time context. As one can see from the below, India has experienced several periods of downward pressure during different cycles, but all have then produced a recovery.

Episodes of domestic slowdown	Slowdown Period	Duration of slowdown	% fall from top to bottom	Sustained Recovery (on an average after 2-3 quarters)
Agrarian Crisis (Severe Draught)	Q4 FY2002-Q3 FY2003	4 quarters	4.30%	Q2 FY2004: 8.1% YoY (2 quarters to exceed potential)
Global Financial Crisis	Q1 FY2009-Q4 FY2009	4 quarters	10.30%	Q3 FY2010: 8.2% YoY (2 quarters to exceed potential)
Caught off in higher inflation and Commencement of taper tantrum	Q2 FY2012-Q4 FY2013 (Excluding Q2FY13)	6 quarters	6.40%	Q1 FY2015: 8.02% YoY (4 quarters to exceed potential)
NBFC crisis and current demand slowdown	Q1 FY2019-till date	6 quarters and continuing	3.13%	??

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Summary

India's broad stock market did not have a good run in 2019. This was due to a number of reasons of which the NBFC crisis, the lack of government action whilst the elections occurred, and the short-term escalation of hostilities all contributed.

However, India's central bank and government have acted aggressively to create confidence in lending and therefore, spending.

There are strong signs this is working. This reinforces the argument that 2019 is another period of correction in what has been a positive twenty-year cycle. A long-term constructive view of the country is still supported by the drivers below:

- Sustained low inflation
- Stable political environment
- Low and stable crude oil prices
- Second generation reforms – GST, Corporate rate tax cut
- Worst of the NBFC now in the past
- Good monsoon
- RBI's reaction to the crisis
- Reasonable valuations for many companies

For more information on accessing India through the ETFS Reliance India Nifty 50 ETF (ASX code: NDIA), please speak to ETF Securities.

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Information current as at 20 February 2020

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[i] https://www.indiatoday.in/news-analysis/story/why-this-economic-slowdown-is-serious-1580824-2019-08-14

[ii] https://www.indiatoday.in/news-analysis/story/why-this-economic-slowdown-is-serious-1580824-2019-08-14

[iii] CMIE

[iv] CMIE

[v] Nomura 2020