



Greetings!

Growth pangs – what the data says, and doesn't

The GDP print is at 4.5% for Q2 of the current fiscal, down from 4.9% for Q1. What does this multi-year low mean?

Growth for FY20 will come in around 5% or even lower. That will represent a downward revision of the current estimates, which have already been getting marked down over the last few months.

Earnings growth will once again come in the teens (or lower), marking a decade of misses. This will be for the index and is helped along by financials and base effect. For the broader market, the numbers may be less edifying.

The government will likely miss the fiscal deficit target for FY19-20.

This data is, of course, a backward-looking number. We are seeing a slowdown the seeds of which were sown by demonetisation and exacerbated with the GST. Things came to a head with the bad loan mess and the NBFC squeeze.

What the data does not reveal?

- Some part of the slowdown is cyclical but there is something structural as well.
- The cyclical part will roll over and growth should pick up in the next couple of quarters.
- But there are some factors that will linger on to keep the economy constrained for a while, at least.

While the cyclical recovery should be good enough to get India back on a 6-7% growth rate, several factors make us sceptical on whether growth can sustain above that range -

One: Demographics is a double-edged sword

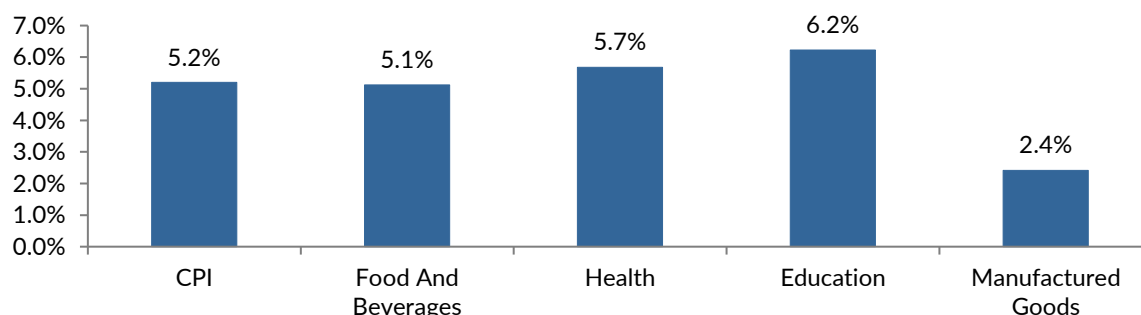
The story of young India has been the subject matter of many roadshows and has been bandied about ad nauseum. But it does not take much for the demographic dividend to turn into a demographic drag. The issue is with skill sets needed to change the productivity of a young work force. A majority of the Indian work force is still in the unorganised sector. India's inability to impart a skill-based education system has started to emerge as a liability. There is a mismatch between required and available skills in the work force.

Two: Consumption basket has gotten ahead of income generation

The urban Indian is probably biting more than she can chew. Whilst wage growth has been steady over the years, the consumption basket has expanded at a frenetic pace. The millennials today have a huge plate of temptations to contend with and disposable income is not keeping pace. Something has to give. This is evidenced by growth rates in some categories (e.g.: air-conditioners) accelerating, thereby questioning the slowdown itself. On the contrary, that the consumer has to juggle a number of priorities within the same budget is causing the slowdown to aggravate. Inflation in services (education, health care) has been higher than the price rise in manufactured goods. Services inflation in the official data (see below) does not even capture the full impact of the cost escalation in items such as education/health, as consumer choices have moved towards private service providers. The changing consumer preference is also captured in the share of spending in areas other than traditional avenues – and such spend is on the rise, reinforcing our thesis that the consumption basket of the millennial is far more eclectic, even as incomes log tepid growth. These are the first signs of the middle-income trap that is hitting India prematurely.

INFLATION IS HIGHER WHERE INCREMENTAL DISPOSABLE INCOME IS GOING

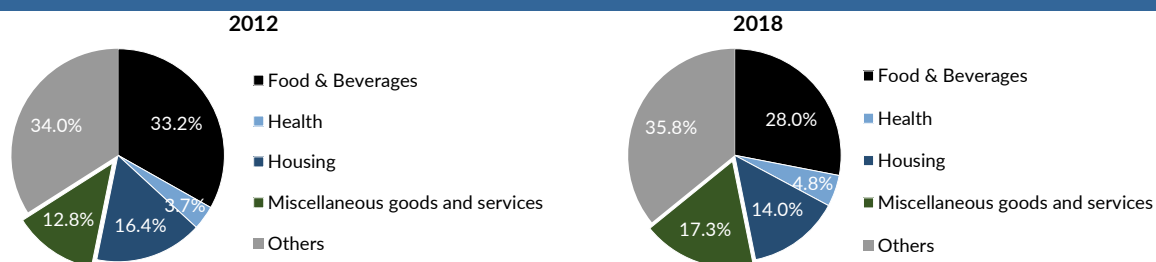
2012-2019 (annual rate)



Source: MOSPI, Spark Fund Research



THE EVOLVING CONSUMPTION BASKET OF THE INDIAN HOUSEHOLD



Source: MOSPI, Spark Fund Research

Three: Business failures are at an all-time high and the confidence is at a new low

Reforms have exposed the weak underbelly of the Indian business. For many small-scale units, gaming the tax system was a competitive advantage. Transparency comes at a cost. While many of the entrepreneurs will eventually make a transition, it is not painless. We are in the midst of that painful journey, which takes time.

On the other hand, India has liberalised end markets for consumer goods as well as its capital markets. This has led to fierce competition. However, labour markets and land are still held hostage by inflexible laws. Judicial reforms have lagged and the commercial dispute resolution process is out of sync with the pace at which the real world of business moves forward (e.g.: the telecom sector case took ~ 14 years to resolve, a timeframe unheard of in the modern world of commerce. Technology has made several transitions in the interim). These rigidities make for a heady mix. The no-show on investment spending has to do with the impact from all of the above.

Is there a way out?

The question that is ringing loud all over the Dalal Street is about when the tide will turn and why and what might make it happen.

While some of the problems (such as the challenge on skills) don't present easy solutions, cycles turn because a lot of factors come together one by one to get the economy to a tipping point. A few such factors are:

- The bank NPL issue is largely behind us. The recent Supreme Court ruling, which strengthens the NCLT-led work out of bad loans is a game changer.
- The GST is finally settling down and the business is coming to terms with it.
- The inventory adjustment phase in the wake of the demand slowdown is now behind us and re-stocking can be a source of surprise. Capacity utilisations can pick up and the investment cycle is crying out for a breakout.

Finally, the government seems to have taken a resolve to do whatever it takes. In India, reforms have happened only when the country had its back against the wall. The corporate tax cut has been a high-risk move from the government. The move has given instant benefit to those corporates from whom the cost of tax collection was quite low for the government. It stands to reason that the government will follow through with other reforms to fuel the momentum generated by the tax cut. Else, this move will prove a major blunder and an exercise in futility.

Privatisation may be the first test of the government's resolve. As the reform wave rolls in, the economy should rev up and start to accelerate. More aggressive asset sales may be on the cards for 2020 and beyond. This can pave the way for resolving some of the structural rigidities.

Amidst the worst slowdown in almost a decade, the market is at an all-time high. While the rally is narrow, it is here. And it looks like the market breadth is widening. What is in the mind of the market?

- The market is a mechanism for discounting the future and is not an instrument for sizing up the past. The market may be sensing more reforms and is giving it a positive spin.
- The market is pricing in a lower cost of capital as well. This has a positive impact on valuations.
- Alternatives such as real estate and fixed income look unappealing and equities have become a default choice

The market has been discerning in that the way the economy has transformed itself, large players have an edge. Which is reflected in the performance of the large-cap indices. Big is beautiful and the market seems to agree. Though large-cap indices such as Sensex and Nifty are at or near an all-time high, most equity investors may have missed out on the rally, given its highly polarised nature. It is, in a sense, reflective of the flux in the economy where market shares and profit shares are getting concentrated.



That said, we have now reached a point wherein the valuations in many of the index drivers leave little room for a sustained rise in share prices. The obsession of institutions to load up on winners has been the driving force behind this dichotomy between prices and valuations.

What will change the picture and why?

For confidence to come back into the economy, we need the government to stay the course on its commitment to take some bold steps. The cut in corporate taxes is the first step in this direction. It is clear that the tax cut is one part of a broader reform push which should unfold in the coming months. The next obvious milestone is privatisation – and here again, it is reasonable to expect that the strategic disinvestment drive will continue into the next few years. The revival of the investment cycle is integral to the India growth story. The balancing act between sustaining the social spending and raising resources for infrastructure can be achieved only with asset sales.

The gradual pick up in growth expectations will help the market navigate the rough waters and the lack of options for the country and its masters will keep the economy on course for a revival.

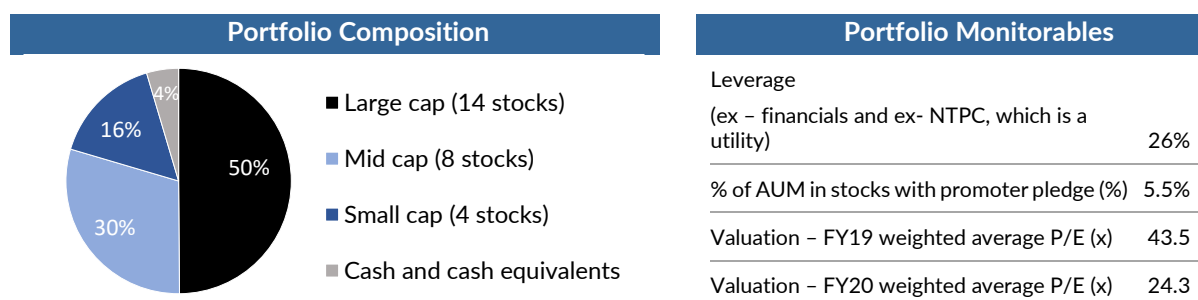
There is always the risk of the reform push going astray and in such an event, there will be a painful backlash. We assess the probability of such an eventuality as rather low. When confronted with a crisis, India has responded well. We are at one such moment yet again.

Our portfolio positioning

Our investments are positioned to benefit from the economic recovery that we anticipate in 2020. We have been reluctant to chase up high P/E stocks to ride short-term momentum. Having said that, we have exercised prudence in picking stocks that are well positioned from the point of view of their balance sheet and management bandwidth. We don't believe that the revival will benefit everyone uniformly. Quality will stand out, but the returns cannot come from just an expanding quality premium. 2020 promises to be a year when investors rediscover growth and quality at reasonable price.



Portfolio composition



Note: Represents portfolio of a typical investor onboarded in February 2019 when the strategy commenced; actual portfolios may vary depending on timing of entry into the strategy. Note: Market cap as per SEBI guidelines

1. Our investment in stocks continues to have bias towards large caps and larger midcaps. About half of invested capital is in large caps; a good part of the midcap exposure is in larger midcaps.
2. During the month, we partially exited the position in Container Corporation. While this is a privatisation play, the nature of its business terms with the Railways leads to uncertainties on medium-term value. We have opted for locking in some of the profits here.
3. We exited Dr Reddy's as the complexity of the business has become harder to assess and price in. The generic drug space continues to be in a flux in the US, the major market for the company. The last few quarters have seen several adjustments in the accounts on expenses. It has become increasingly difficult to anchor earnings expectations and we felt it prudent to move on.
4. Overall, the predominant part of the portfolio remains stable with a view to stay in for the longer haul. The changes are at the margin and should be viewed in context of a challenging market environment and our effort to improve alpha. The general thrust of our effort is to continue with winners and stable performers for a longer time while chipping away at some of the laggards or stocks where uncertainties have increased. This has prompted us to reduce the portfolio risk by either cutting weights or pruning positions where evolving circumstances have brought in material change to the outlook.

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