

Indian Economy at an Inflection Point

Indian economy is at an important inflection point. ***Inflection Point is the point at which the curve changes from being concave (downward) to convex (upward).*** In order to appreciate the point of inflection for the Indian economy, we need to step back and understand things in retrospect.

The fiscal stimulus injected in the Indian economy in the aftermath of the global financial crisis and India's inability to withdraw it in timely manner drove India into vicious economic cycle during 2009 to 2013 with high fiscal deficit, slowing growth, sharp depreciation of the INR by 28% in 2013. India's macro-economic fundamentals were comparable to the weakest global economies and she became the part of the Fragile Five club. Thus, India's macro-economic fundamentals moved 180 degree from being the country with strongest fundamentals in 2007 to the weakest in 2013.

It's been significant hard work over the last 5 years in restoring India's macro-economic stability and getting it back on path of high growth with moderate inflation. ***The last 5 years have been a painful transition for the Indian economy during which India endured the worst industrial recession since 1991, below potential economic growth and significant disruption caused by structural reforms.***

India's IIP growth for the last 5 years averaged at 3.9% compared to long term average of 6.3% and the peak IIP growth of 15% in 2007. India has not experienced such sluggish industrial growth for such a prolonged period of time in the post liberalization era since 1991. There has been a secular decline in the savings rate and investment cycle had completely broken. Investment rate declined from 38% of GDP in 2012 to 31% of GDP in 2018.

The pain of the economy has been lying on the balance sheets of the banks with the industry level gross stressed assets rising to cyclical high of 15% and ***30% of total industrial credit turning stressed.*** The twin balance sheet challenges along with the impending fiscal prudence led to sharp moderation in overall growth and a first time ever contraction in industrial credit in Fy2016-17. From a corporate perspective, ***this has essentially meant an earnings recession with corporate profit*** growth trailing nominal GDP growth for 10 years and corporate profit to GDP at a cyclical low of 3.5% from the peak of 7.8% in 2007.

But, over the last few years, apart from fixing India's macro-economic imbalances, we have executed several structural reforms including the Goods and Service Tax, the Insolvency Bill, Real Estate Regulatory Authority, Direct Benefit Transfer to name a few. Also, ***we have changed the goal post for monetary policy with explicitly stating "Inflation Anchoring" as its primary objective, setting up inflation band of 4%-6% for the MPC and transitioning India from a relatively high inflation economy to moderate inflation economy.***

As a result of all this, Indian economy has reached an important inflection point in this cycle. India's macro-economic fundamentals are stable and inspire confidence. We are the peak of the NPA cycle in the banking system and going forward lower provisioning should create fresh lending capacity in the system.

Public investments are accelerating at both the central and state government levels and we are seeing healthy recovery in industrial capex. The order book for leading companies in capital goods industry has been growing at teens for last four quarters indicating revival in industrial capex. The resolution of stress assets over the next year should provide fillip to brownfield investments. Capacity utilization is increasing and should reach the threshold of 85% in next few years; so it's a matter of time before corporates firm up fresh Greenfield investment plans. Business and Consumer confidence is on an upswing.

Some of the reforms are game changers. ***The insolvency bill should ensure that we do not see pileup of such massive NPA in the next cycle. Logically, the GST should increase compliance and over medium term significantly enhance tax collections.*** This should improve India's tax to GDP ratio and provide the necessary funds to the government for developmental spending. Inflation targeting by RBI and prudent fiscal management should reduce macro-economic volatility and ensure India is cushioned from global shocks.

India is a potential high growth economy for a long time to come. Inflection point, such as this, does not happen often and are something that long term equity investors cannot afford to miss. If the real growth which has been below potential for quite some time does accelerate than Indian equities should do well. Though earnings growth has been very sluggish for last decade, corporate profits are at bottom of the cycle and with pick up in real growth, profit growth should surprise on the upside. A broad based economic revival can lead to mean reversion in sector performance as compared to the sharp skew we have seen in favor of few sectors in the stock markets due to narrow growth.

There are some headwinds like global trade conflicts, election cycle etc, but India is in a much better shape to deal with them. The path of India's economic policies has been very consistent since 1991 irrespective of the election outcomes. ***Investors should reaffirm their long term faith in Indian equities and today is a good time to do that.***

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