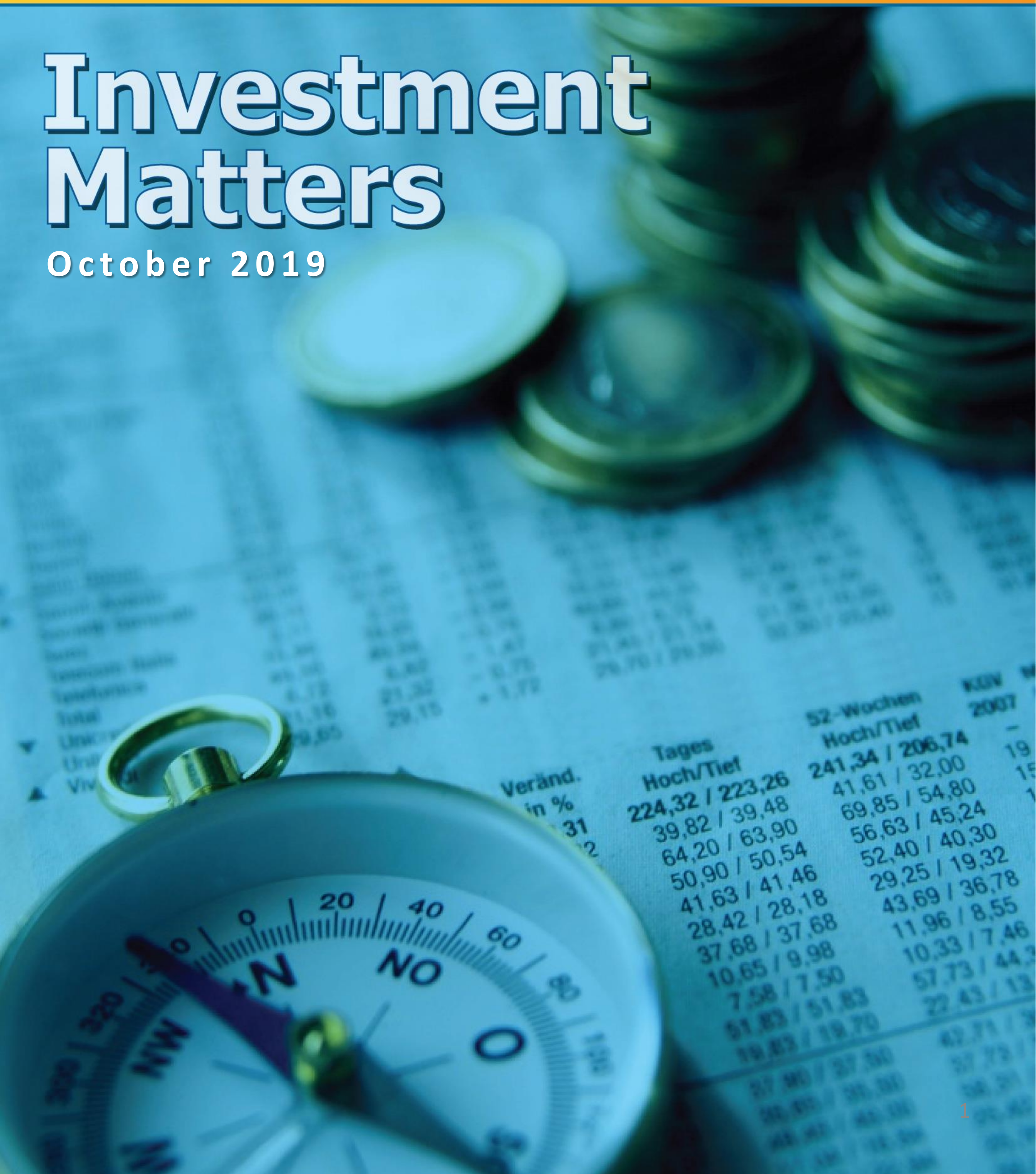
ALCHEMY
CAPITAL MANAGEMENT

# Investment Matters

## October 2019



**A wait-and-watch quarter**

The decisive policy moves in 3QCY19 have dampened the pessimism around the markets and provided some support. The efficacy of these measures should be more visible in 4QCY19. We will continue to track some important indicators to assess the probability of an economic revival in CY20. There are some areas of risk that need to be addressed: we believe that some decisive action on the real estate sector is warranted.

**Interest rates and transmission**

The RBI cut rates by 25bp on Oct-4, taking the cumulative cuts in 2019 to 135bp. We expect transmission, which has been tardy so far, to accelerate in 2HFY20 and there are a few enablers now in place.

The system has been in surplus liquidity since June, and the confidence is now beginning to impact bank Asset Liability Committee (ALCO) decisions on deposit rates. The new liquidity framework, if accepted, should give further comfort to the banks. SBI deposit rate fell ~30bps in 3QCY19 as compared to a flattish/marginal increase in 1HCY19.

- The transition to external benchmarks should help transmission to borrowers, and, hopefully, nudge banks to cut deposit rates faster.
- Bonds have held up after the tax cuts, largely because the government kept the second-half borrowings unchanged. This gives rise to optimism that the tax cuts would be funded through aggressive privatization and asset sales.

Rate cuts, and their transmission, are an important driver for the economic recovery. India was late to cut interest rates when inflation started slowing in 2018 and partially caused for the severe slowdown in 2019. A large part of the consumption basket – property and cars – is primarily bought through consumer finance. A rate cut would help lower the net cost to the consumer and positively impact demand. There are other factors behind the slowdown, but we think that lower cost of debt would incrementally help demand.

**Monsoons**

The headline data on monsoon rainfall has been very strong at 110% of the long-period average. There has been, however, uneven distribution both geographically and week wise across the monsoon season. The kharif sowing, consequently, has been down 1% y/y. The individual crop patterns have been varied, with cotton, coarse cereals and oilseeds all quite strong. The good monsoon may not have benefited kharif very strongly, but we do expect the rabi crop to be much stronger. Also, it may help recover the battered rural sentiment, which has been ebbing for the last 2-3 years.

A turn in rural sentiment could have an indirect impact on sentiment as well. Anecdotally, many consumer companies have complained about rural demand being the major pain point in the last 3-4 quarters: improved momentum there would help create a more positive environment in the segment.

**Tax cut effects**

The September tax cuts have a multi-layered positive impact on sentiment, as we said soon after the announcement. These will take some time to play out. The key near-term trend to watch are a) whether the companies choose to pass the benefits on in terms of price cuts and b) whether the turn in sentiment affects the demand for higher-end consumer products, especially in the critical Diwali period. The tax cuts are a significant expansionary macro-economic boost and we do expect it to help aggregate demand, at the margin. This may take, however, some time to play out – especially the longer-term effects on investment demand.

**Privatization**

One measure of structural reform accompanied the tax cuts – privatization. In the last two-three weeks, the government has announced privatization of ConCor, BPCL, and Shipping Corporation. This measure, as we have said before, has twin benefits. First, it helps the government bridge the fiscal deficit without having to borrow from the market, taking the pressure of bond yields. Secondly, it improves the efficiency of these companies as they pass into private ownership, which benefits the government's residual ownership and the overall economy. A long-term privatization program would also help the government reduce its budgetary support for weak PSUs, compounding the positive effect on the fiscal deficit.

**The Real Estate overhang**

The biggest risk factor is the real estate overhang. Many residential projects are stalled and this is cascading into credit risk for developers, NBFCs and banks. Credit to the sector has dried up, blurring the distinction between liquidity and solvency stresses for the entire eco-system. The government does not have an easy solution. On the one hand, a direct intervention or bailout would raise issues of moral hazard. On the other hand, forcing an Asset Quality Review (AQR) style solution may drive the sector into a deeper rut. The solution has to be multi-pronged: near-term demand boosters and encouraging more credit flow. Some specific measures have already been taken and monetary transmission should also help: the government could think of additional measures along the same lines.

**Earnings season**

The upcoming earnings season would also be an important marker for the market. Expectations are likely to be muted as high-frequency indicators have already indicated that top-line growth is likely to be weak. Nifty earnings growth slowed from 12% in FY19 to 2% in 1QFY20. The importance of 2Q earnings has been diluted by the sharp correction since July and the street has largely factored in weak numbers. A significant part of the focus during earnings season would be on the festival demand and management commentary on 2HFY20 growth.

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