Investment Note

Manulife Asset Management

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Indian equities: State election result unlikely to derail reform progress

Indian equity markets fell following the recent loss in the Bihar state elections by Narendra Modi's National Democratic Alliance and muted second quarter earnings results, but have since regained positive momentum. In this note, Rana Gupta, Manulife Asset Management's India Equities Specialist examines the implications of the election loss on the reform process and outlines why he expects corporate earnings to pick up going forward.

More reforms announced following election loss

Indian Prime Minister Narendra Modi's National Democratic Alliance (NDA) suffered a setback in the Bihar state elections on 8 November. The incumbent Janata Dal United party and the Grand Alliance coalition consisting of the Indian National Congress and Rahstriya Janata Dal achieved a comfortable victory, winning 178 of the 243 seats, while Modi's NDA won 58 seats[1]. Bihar, in north-eastern India, is the third largest state by population.

The NDA's loss by a higher-than-expected margin triggered a temporary equity market correction as investors were concerned that the results might derail Modi's reform agenda. However, we do not believe that the Bihar election result has dented the reformist zeal of the Modi government and markets have since recovered on signs that the government's commitment to implementing reforms remains on track. Following the result, the government announced further measures, including the streamlining the power distribution sector and opening up more sectors to foreign investment, including potentially sensitive sectors such as agriculture, media and defence.

Nevertheless, the pace of legislative reforms could slow, with the constitutional amendment required to introduce a goods and services tax (GST) still before parliament. However, following the commencement of the winter parliament session on 26 November, we are pleased to note that senior figures of the ruling NDA, including the prime minister, have reached out to opposition parties to try to form a consensus and gather support for the passage of key bills.

Successes to date

In previous notes we have highlighted how the government and the Reserve Bank of India (RBI) have so far achieved key successes such as reducing inflation and the current account and fiscal deficits. The government has also attracted significant interest from foreign investors as a result of Modi's foreign visits and the simplification of investment rules. Meanwhile, the Indian rupee has stabilised and is the third best performing emerging market currency year-to-date, after the Chinese renminbi and new Taiwan dollar[2]. Better macroeconomic stability has also allowed the RBI to cut interest rates by a cumulative 75 basis points year-to-date[2]. In addition to these successes, we believe other ongoing reforms are likely to contribute to increased consumption and economic growth. These include:

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[1] International Business Times: Bihar election results 2015, http://www.ibtimes.co.in/bihar-assembly-elections-2015-results-live-vote-counting-begins-653781
[2] Bloomberg, as at 20 November 2015.

Direct benefit transfer (DBT) of subsidies – The direct transfer of subsidies to consumers is expected to reduce the government's overall subsidy burden by plugging leakages and empowering lower income consumers.

Infrastructure spending – The government has allocated a higher amount to infrastructure spending in its 2015/16 budget, increasing capital expenditure in roads, railways and mining. In our view, investment in infrastructure will have a multiplier effect and lay the foundation for future growth.

Encouraging financial savings – The government is working to improve financial services and encourage financial savings rather than investment in gold or real estate, as savings are required to fund a productive investment cycle.

We have already seen a revival in urban consumption as real incomes have risen due to lower inflation. We anticipate lower interest rates going forward and a partial revival of certain infrastructure sectors such as roads and power generation. By March 2016 we expect to see two more pieces of reform introduced, including the simplification of the income tax code and a gradual reduction of the corporate tax rate and the introduction of a comprehensive bankruptcy code that will likely help in resurrecting stalled (but viable) investment projects with new backers[3].

The end goal of the government's reforms is to provide a solid macro environment, simplify regulations, lower costs and maintain a favourable environment for businesses which are willing to deploy capital and technology. We see the government continuing firmly on this path, with the increase in foreign investment limits and higher foreign direct investment in certain sectors as further testimony to these efforts.

Earnings to pick up in FY2017

Despite the reforms highlighted above, second quarter fiscal year 2016 earnings came in below expectations. Earnings year-to-date have struggled as a result of the broad macroeconomic adjustments initiated by both the government and the RBI. This is also the fourth consecutive quarter where BSE 30 Index earnings (excluding energy) have not grown[4].

However, we believe fiscal year 2017 will likely see a confluence of positive factors. Firstly, we anticipate an increase in urban consumption as the cumulative impact of lower energy prices and an expected pay rise for government employees following a once-a-decade pay review is likely to further boost consumer sentiment. Secondly, we expect the government to focus on further measures to boost economic growth now that macroeconomic stability has been achieved. Finally, we believe an increase in earnings growth is likely, albeit from a relatively low base.

The near term earnings disappointment and negative election sentiment saw the Nifty Index fall to a one-month low of 7,732 on 18 November, with a 14x price to equity (P/E) ratio based on one-year forward estimates[2]. Although we do not speculate on specific index levels, Indian markets have historically found support at around 13x P/E (except in 2008) one year forward multiples, with returns in the next year often exceeding 20%[5].

While Indian equities remain well placed over the medium to long term, the market could experience further volatility over the short term due to global or regional shocks. Such transient volatility may be an opportunity to add to further exposure.

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[3] Bloomberg: India Targets Century-Old Bankruptcy Law to Revive Momentum, http://www.bloomberg.com/news/articles/2015-10-18/modi-targets-century-old-india-bankruptcy-law-to-revive-momentum
[4] Kotak Institutional Equities report, 16 November 2015.
[5] Bloomberg, CLSA; 20 November 2015.

That being said, a pickup in earnings may not be uniform across all sectors given global economic uncertainty and the potential for disruption to certain sectors following the adoption of new technology. A focus on fundamentals and bottom-up analysis will be required to identify sectors and stocks that have the potential to benefit from of the factors discussed here.

We continue to be positive on:

The consumer discretionary sector – Higher real incomes due to lower inflation are likely to translate into higher consumption in urban areas in particular. We are positive on categories with low penetration like passenger cars and white goods such as air conditioners. We are also positive on the digital media and pay television sectors.

Financials – We are constructive on privately owned banks focusing on retail and consumer lending. Anticipated interest rate cuts could help retail/consumer loan volume pick up while the growth of e-commerce should pay off for banks that are focusing on digital initiatives such as mobile banking platforms.

Potential risks

Despite the potential upside over the medium to longer term, India's economy and equity markets remain subject to domestic and external risk factors that need to be reviewed carefully. These include:

Commodity prices – If oil and other commodity prices bounce back and remain at higher levels, some of the progress made on improving India's current account deficit and inflation could be reversed.

Investor sentiment – While India's capital flows, balance of payments and the currency remain relatively stable and we see no reason for this to change, all three could face transitory pressure in the coming quarter amid periods of market volatility and fragile investor sentiment.

Policy risk – During the last parliamentary session, the ruling NDA was unable to secure parliamentary approval for a constitutional amendment necessary for a planned national GST as opposition parties continue to hold a majority in the upper house. If reform-oriented bills continue to be stalled in the upper house, confidence in the government's ability to effect real policy reform could dwindle.