August 30, 2013

Dear clients and colleagues,

Emerging markets are once again in the limelight but for the wrong reasons. Current Account Deficits (CAD) in most Southeast Asian economies raise the question of whether we are heading into another Asian financial crisis. Most Asian currencies are making new lows, from the Thai baht to the Indonesian rupiah. As of writing, the Indian rupee experienced the biggest intraday drop since 1993 and has taken center stage. This week we revisit India.

Following a careful assessment of the country, we do not see a repeat of the Asian crisis or a global shock.

The Ugly first

India's CAD continues to hit record highs. In fact, it runs the largest trade and current account deficit in Asia excluding Japan. India's CAD has widened more than five-fold to 4.8% of GDP compared to 1.3% in 2008. While debt increased, foreign exchange reserves declined, indicating India's stretched external vulnerability. Forex reserves cover only 75% of the external debt.

The recent surge in oil prices and India's love for gold continue to worsen the CAD and could lead to a repeat of the 1991 crisis when India was forced to pawn gold to pay for imports.

Liquidity-driven rallies are like ocean waves; they come and go and have been a key feature of Bombay Stock Exchange movements in the last four years. For instance, in 2007 Foreign Institutional Investors (FII) pumped $16B into India and the market rose 48%. However, this rise was followed by an abrupt 52% drop in 2008 when FIIs withdrew $12B. In June 2013 it had the highest monthly FII-equity and debt outflows in history.

Currency Impact

India is a large importer of commodities. A depreciating rupee makes these raw materials expensive and hence impacting operating margins. Company earnings have slowed since last year due to the falling rupee.

We see exports as the silver lining in the current environment, as they have increased 11.6%, the biggest increase in the last 12 months. However inflation has also increased with the CPI up 9.6% in July. Slow global growth does not help the situation. The one sector that is reaping the benefit is the technology outsourcers.

Interest rates

Markets expect the Reserve bank of India to cut rates to support growth. But a depreciating rupee and capital outflow does not help unless the currency stabilizes. The RBI appears more focused on signaling that financial stability concerns outweigh the growth concerns.

Elections and Policy

India's parliamentary elections will take place in May 2014. Politicians are busy playing the vote bank games. India recently cleared the Food Security Bill in the lower house, which expanded the world's largest food subsidy program. This bill will increase the cost by $4B placing an additional burden of 0.3 – 0.4% on GDP according to Moody's. The heart of the bill is at the right place but the cost is not.

Will the benefit really reach the poor? We don't think so given the corruption levels. According to a study by the Planning commission in 2005 "For every Rs 4 spent on the public distribution system, only Rs 1 reaches the poor".

Corruption

The most crucial factor facing the country at the present time is corruption. India suffers from systemic corruption as opposed to personal corruption. Scandals in the telecommunications and coal mining industries have cost tax payers billions of dollars. The increasing dollar value of the scandals makes one wonder if it's just the tip of the iceberg. India has more than 600M people living under poverty, the country cannot continue to allocate its resources so ineffectively.

No government in India has attacked corruption since the 70's. This should not come as a surprise when one considers that one-third of the elected officials face or have faced criminal charges according to India's election watchdog. In fact the RajyaSabha adopted a bill allowing those in jail to contest polls. The corporate space is no different; in fact, India does not have any laws to safeguard whistle-blowers. Corruption is the elephant in the room that needs to be tackled.

GDP

Where is the GDP heading given the current background? India's GDP grew 4.4% in the April-June quarter, slowest since March 2009. India's oil subsidy further increased the fiscal deficit. According to Macquarie research a US$10/bbl change in crude oil could increase/decrease GDP by 0.36%. BNP Paribas estimates that GDP could fall to 3.7% in 2014, the slowest since 1992. We anticipate a slightly less pessimistic forecast given the favorable monsoon season, which should ease inflation. Election relating spending should also contribute together with a slight pick-up in the global economy. Until then India's economy has to battle strong headwinds due to high leverage, high interest rates and policy uncertainty.

The good

From a price/sales perspective, a falling Rupee has led valuation back to levels seen during the global financial crisis. If the negative perception on India continues, a further decline in the market is possible. The structural economic issues are indeed serious and need to be addressed quickly.

There are grounds for optimism. The current crisis forces policymakers to undertake structural reforms to boost productivity and longer-term growth prospects. Higher costs in China are leading some labor-intensive manufacturers to look for alternatives in Asia, creating an opportunity for India. However, with elections due next year reforms are unlikely.

We do not expect a repeat of the Asian crisis as we have moved into a floating exchange rate regime. Currency depreciation might continue but most probably at a slower pace. In fact the Asian crisis set the foundation to open their doors to foreign investment. The current currency depreciation might further help these economies to further expand their reforms and prepare them for the next leg of growth.

The long term

Liberated in 1947, India is still a young country. Twenty years of economic reform have helped transformed India from an elephant to a tiger. Like any growing economy, India has its share of challenges. We expect them to be resolved over time.

India's economy is currently estimated to be approximately $1.8 trillion, the same size as Canada's. It has one of the youngest populations in the world with over 400 million people under the age of 15. This is a much better demographic profile than China or Russia. The country has a strong savings rate, currently sitting at 30.8%.

India today is where China was a decade ago. The government has launched various market-friendly policies; now a third of these projects are financed by private sector, vouching for the projects' financial feasibility and turnaround time.

Rural India now accounts for 70% of India's population. A move to urbanization as we saw decades ago in China will no doubt contribute to future growth. Only 35% of the population currently has access to banking services. The government is relying on improving credit delivery to help reach out to those untouched by the nation's economic progress.

The sharp sell-off in the markets since July has been led by all sectors which might be due to the free-fall in the rupee. After the market sell-offs in 2008 and 2011, we did see periods of consolidation. Hence we are of the opinion that the time is near to be once again optimistic on India; however, we prefer to have some additional clarity after elections and/or some stability in the currency.

Have a nice weekend.

Regards,
The Global Alpha Team