QuestPMS Newsletter - December 2019

Indian Economy – Murphy's Law at play in the last few quarters

Structural reforms initiated by the NDA government since 2014 has had the broader support of the country with the belief that while there will be short term pain, all of us will be better off in the medium term. Fortunately for India, drastic fall in crude oil prices and robust world economy in the early years of NDA 1 regime ensured that the pain wasn't felt much in the initial period of reforms. It was expected that demonetization (November 2016) and introduction of RERA (2016) & GST (2017) in quick succession will be disruptive and it will take the economy a couple of years to fully absorb the impact and normalize. Indeed, the Indian economy had started to normalize before it was hit yet again by some of the unintended consequences of demonetization and GST as well as a few other developments both in the local and the global economy.

Default by IL&FS last year was a seminal moment in the history of India's financial services (particularly NBFC) industry. Its impact was further accentuated by the fact that the two very large sectors, real estate and MSME, that had high dependence on NBFCs for funding were already reeling under the pressure of RERA and GST. Turning off of the liquidity tap to NBFCs and thereby to these two sectors at this crucial juncture was like sounding the death knell to them. Also, events in quick succession such as changes to the axle load norms, increase in cost due to changes to safety norms and terms of third party insurance cover, excess inventory in the channel, cyclical downturn in sub segments like tractors, confusion relating to downward revision in GST rates, baseless fear of BSIV vehicles not being allowed to ply on road post April 2020 and finally much tighter credit norms for dealers as well as 'financed' vehicles meant that the entire automobile industry went into a 'free fall' for almost two quarters! Further, trade war between US and China meant huge decline in global cotton and yarn prices, making Indian yarn uncompetitive in the global markets, resulting in another large sector taking a bit hit with over 10% of domestic spinning capacity shutting down.

With three of the biggest sectors of the economy i.e. real estate / construction, automobile and textile under stress, it was but natural that there would be perceptible overall slowdown in the economy given the direct and indirect linkages of these sectors to other parts of the economy. Consumption economy, that had been the engine of growth till 2018 in the absence of private capex, also started to struggle in 2019 as the impact of deficient rainfall for the last couple of years (2017 and 2018) and the unintended consequences of low food inflation started impacting rural disposable income. While monsoon in 2019 has been plentiful, it was late and continued till early November which meant that the lean period for sectors like construction and mining extended much longer than usual and the unseasonal rains adversely impacted the Kharif crops in some states (particularly in Maharashtra) as well. Add to the above negative developments, the general slowdown in global economy impacting exports from India, and it will not be out of place to say that almost everything that could have gone wrong, did go wrong for the Indian economy in the last few quarters!

Worse is probably over, but how bright is the future is the big question

It is important to note that it is not the first time post liberalization that the country is facing slowdown of this magnitude. GDP growth did plummet to ~ 4% during the early 2000s and below 5% in the latter half of UPA 2 regime when India was grappling with policy paralysis and the 'PIIGS' crisis had rendered global growth unsupportive. Both these periods of slowdown lasted for about a couple of years before growth rates reverted to 7%+ in the subsequent years. There were other (though shorter) periods of slowdown as well, led by external factors such as the East Asian crisis (1997) and the global financial crisis (2008-09).

Every crisis leading to slowdown is different and so is the case this time around as well. Highly significant but completely disparate developments (stress in real estate, automobile, textile or rural slowdown have no common elements) conspired almost simultaneously to bring Indian economy to its knees in the last couple of quarters with the GDP growth falling below 5% for the first time after 6 years! As the reasons for the current slowdown are different, we believe that the remedies also need to be customized accordingly.

We are seeing early signs of recovery thanks to the recent measures taken by the government to counter the slowdown. After many quarters, banking liquidity is in surplus of ~INR 3 lac crores. However, risk appetite is still low as is evident from credit growth of less than 8% despite mid-teens growth in retail credit. Channel inventory in the auto sector is back to normal and October-November retail sales have been encouraging. India has seen good cotton production in the current season and global cotton and yarn prices too are on the mend with trade relations between United States and China improving. This will make the Indian spinning industry competitive again in the global markets. Plentiful monsoons have been mixed for the Kharif crop but they are likely to be an unqualified positive for the Rabi crop. Food inflation has been inching higher off late and this too should be positive for the rural economy.

While we are seeing the hitherto stressed sectors like Automobile and Textile showing signs of recovery, it is the recovery in the construction / real estate sector that will determine how much time India takes to revert to 6.5%+ GDP growth rates. Government has taken measures such as allowing banks to buy pooled assets with credit rating of upto BBB+ under the partial credit guarantee scheme to unclog the NBFC & HFC sectors. Also, last mile funding is being arranged for stalled housing projects. Success of these measures along with government's ability to find funds for the infrastructure sector (in the face of rising fiscal deficit) will be critical in determining the pace of recovery of India's GDP in 2020.

QuestPMS Performance

2019 has been a very unusual year. We have not only seen huge dichotomy between the real economy and the major indices such as Nifty50 and Sensex but also between these major indices and the broader markets. While Nifty50 and Sensex have yielded ~12% and ~14% return in CY2019, both the mid cap and the small cap indices are in the negative territory. Also, as is very well documented by now, rally in Nifty50 and Sensex has been among the narrowest ever with only a handful of stocks accounting for most of the gains.

It is quite normal to see the bigger and stronger companies doing relatively better than their smaller counterparts on the stock market in times of slowdown due to their greater resilience and ability to absorb shocks. However, during the current down turn, the gap in stock market performance has been much wider as cleansing of the corporate sector has brought to the fore corporate governance issues in Indian companies making investors highly risk averse. Also, technical factors related to investment norms for various fund categories have further accentuated the divergence. These new developments forced Quest to relook at is portfolio positioning about 12 months back. As mentioned in the earlier notes, we decided to bring about significant changes to our portfolio construct which resulted in increase in portfolio churn as well. However, we believe the repositioned portfolio has weathered the market pressure much better over the last 12 months and that today we are in a superior position not only to face market volatility but also to benefit from the turnaround in the Indian economy as and when it happens.

Quest PMS performance across time periods and comparison with the six indices is listed below:

(Returns above 1 year are CAGR)

	PORTFOLIO	SENSEX	NIFTY 50	BSE MID-CAP INDEX	NIFTY MIDCAP 50	BSE SMALL-CAP INDEX	NIFTY SMALL 100
3 Months	3.0	6.7	6.0	6.1	7.0	4.0	4.3
6 Months	(5.2)	4.7	3.2	1.1	(3.5)	(3.8)	(5.9)
1 Year	(0.7)	14.4	12.0	(3.0)	(4.7)	(6.8)	(9.5)
2 Years	(8.5)	10.1	7.5	(8.4)	(7.9)	(15.6)	(19.9)
3 Years	7.0	15.7	14.1	7.6	8.7	4.4	0.3
4 Years	7.2	12.1	11.2	7.7	8.3	3.7	0.8
5 Years	8.2	8.4	8.0	7.6	6.9	4.3	2.0

The Above returns are of a Model Client as on December 31, 2019. Returns shown above are post billed fees & expenses.
Returns of individual clients may differ depending on time of entry in the Strategy.
Past performance may or may not be sustained in future and should not be used as a basis for comparison with other investments.

Final outlook

Markets are always ahead of the real economy by a quarter or two. Broader markets peaked in Q1CY18 while the GDP growth peaked at 8% in Q2CY18, before it started its downward journey. The last 5 quarters (Q3CY18 to Q3CY19) has seen sustained deceleration in the GDP growth and the current quarter numbers i.e. October to December 2019 are unlikely to be very different from that of Q3CY19 given the extension of monsoons into early November. However, a few green shoots have started to become visible. Fuel consumption (from a low base) and airline traffic witnessed good growth in the month of November. Auto retail sales in November too were encouraging (except for M&H CVs) despite the fact that Diwali this year was in October unlike last year when it was in November. Also, with two big global overhangs viz. trade war and Brexit seeing positive development, one is already looking at the prospect of global economy growing at a faster pace in 2020 vis-à-vis 2019. Indeed, the fear of global recession is fast disappearing.

India still faces several challenges, key ones being lack of fiscal space to provide meaningful stimulus to the economy and the ongoing stress in the residential real estate sector. However, above normal monsoons in India after many years resulting in significant uptick in the ground water situation (providing comfort for Rabi and possibly the next Kharif season as well) is a big tailwind and its positive impact on rural economy and therefore rural demand should not be underestimated. Besides, stable rupee, range bound brent crude prices and likely improvement in growth outlook for the global economy provides some comfort.

The Reserve Bank of India has reduced repo rates by 135 basis points since January and the government too has taken several targeted steps to reduce stress in the identified sectors as also reduced corporate tax rates to levels never seen before. There obviously will be a lag before the impact of these steps start to become visible. Further, there has been intermittent speculation about reduction in personal income tax rates to give a boost to demand. However, the overall net tax collections have hardly grown year to date making reduction in personal income tax a very difficult decision for the government.

Given this backdrop, management of strategic disinvestments to boost fiscal spend on infrastructure (without completely spoiling the fiscal deficit print) and stability in the residential real estate space will be crucial in determining the pace of economic recovery in the coming months and quarters. NDA government till now has shown adequate resolve to address the stressed sectors' issues as well as to work on structural reforms, particularly those related to labour. However, given the recent political setbacks, it remains to be seen if government will be able to maintain its focus on the economy and continue on its chosen path of difficult but longer term beneficial economic and structural reforms. Our job in the meanwhile at Quest will be to carefully monitor developments in the economy and continue to identify resilient business models so that we can generate superior risk adjusted returns for our clients.

Ajay Sheth
December 31, 2019