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India: Balancing Excitement and Pessimism

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The Indian stock market has been one of the strongest performers globally since the start of this year. Leading equity indexes in India are up more than 25% so far in 2017, reflecting investor expectations that a pick-up in GDP growth is likely to boost earnings for India's publicly traded companies.The positive change in sentiment toward India follows a series of positive developments. First, fears of demonetization-led demand destruction receded as corporate commentary had suggested that consumer demand is normalizing. Second, there was widespread fear in the market that the government would likely resort to looser fiscal policy in the 2017-2018 fiscal year. However, this did not materialize. Third, Prime Minister Narendra Modi's BJP party won a thumping victory in India's largest state—Uttar Pradesh. This reinforced the belief that the Modi wave is still alive and that Modi is very likely to come back to power in the next general election. Lastly, reported earnings growth in the third quarter of the 2017 fiscal year was far better than expected on the back of substantial earnings growth within the energy and materials sector, led by increases in commodity prices.

While these events are transitory, Modi's government has indeed been focused on making structural changes to the economy. Over the past three years, the government has consistently taken steps to push for further formalization of the economy. There was the opening of Aadhaar-based bank accounts for the poor, the demonetization of 500 and 1,000 rupee notes and the push to implement Goods & Services Tax (GST) bill—a part of the government's carrot-and-stick approach to reducing the reliance on cash in the economy in favor of more digital and formal financial transactions.

It also is important to acknowledge that the government has not diluted the bias of the central bank's tight monetary policy. There was a widespread fear that former Reserve Bank of India governor Raghuram Rajan's departure would lead to easier monetary policy. If anything, current real rates are the highest in the past three to four years. The government's actions suggest it is keen on keeping inflation in check.

Structural changes as highlighted above are likely to improve the government's tax revenues, allow for greater flexibility in infrastructure spending, create employment and make government spending more productive in terms of reducing poverty. Greater formalization of the economy along with employment generation should also create new drivers of growth for organized players in the economy.

Amid all the investor excitement toward India, it is also important to note the risks and highlight the issues that market participants might be missing. Currently, valuations are somewhat stretched and have priced in a reasonable amount of positive sentiment. Risk of disappointment is noteworthy at current prevailing prices for many publicly traded companies. We continue to shy away from public sector banks as they are saddled with nonperforming loans and the Reserve Bank of India has taken minimal steps to resolve the issues. Similarly, we continue to avoid the power sector as the government has yet to pass any meaningful reform such that power distribution companies continue to be loss-making and will need fiscal support to keep them operationally viable.

To conclude, I agree with Warren Buffet's statement in this case to "be greedy when others are fearful, and be fearful when others are greedy." In India today, it looks like there is no shortage of greed and very few proceeding with trepidation or fear. While the government seems intent to follow through with reforms, investor expectations may be running ahead of company fundamentals.

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