FULLERTON FUND MANAGEMENT

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India's Demonetisation Move – Short Term Pain

The Modi government's bold demonetisation move to fight 'black money' has proven to be a major disruption for the economy and markets in the short term.

Weeks after the announcement was made to phase out the 500 and 1,000 rupee notes with immediate effect, and to replace them with new 500 and 2,000 rupee notes, there are still snaking queues outside bank branches across the country, as people queue to withdraw cash and exchange old currency notes for new ones. A huge jump in net deposits of approximately INR 6.2tn (~US$92 billion) till date for banks has sparked a massive rally in government bonds which in turn prompted RBI to temporarily increase CRR in an effort to drain excess liquidity.

On the economic front, business activity has taken a major hit as more than 90% of transactions are in cash. Anecdotally, companies across sectors such as cement, autos, agriculture, textiles and consumer staples have reported a drop in volume of between 20% - 60% since the announcement was made in early November.

From a growth perspective, the measures taken are a drag on near-term growth due to a combination of lack of liquidity at households and businesses as well as a negative wealth effect. Notwithstanding the near-term growth headwinds, the demonetisation move will bring about longer-term benefits for the economy. These measures are positive for banking sector liquidity as broad money (M3) growth switches from currency in circulation to bank deposits over the next few months. On the fiscal front, these measures could potentially help to increase the tax base of the economy, which would be positive in the medium term.

Over the longer term, the demonetisation move and the targeted rollout of the Goods and Services Tax in April next year, will mean a structural shift, albeit positive, in the way business is conducted in India. As an example, small businesses which rely on tax arbitrage will likely cede market share. Digital transactions will also capture a bigger market share as consumer payment habits evolve.

	Value	% wow Change
Equities		
Dow Jones Indus. Avg	19,152.1	+1.5
S&P 500 Index	2,213.4	+1.4
MSCI AC Asia Pacific	135.7	+1.3
S&P/ASX 200 Index	5,507.8	+2.8
Hang Seng Index	22,723.5	+1.7
Ho Chi Minh Stock Index	675.9	+0.4
Jakarta Composite Index	5,122.1	-0.9
FTSE Bursa Malaysia KLCI	1,627.3	+0.2
KOSPI Index	1,974.5	0.0
Karachi 100 Index	42,999.7	+1.6
S&P BSE Sensex Index	26,316.3	+0.6
Shanghai SE Composite	3,261.9	+2.2
Stock Exch Of Thai Index	1,500.4	+1.8
Straits Times Index	2,859.3	+0.7
Taiwan TAIEX Index	9,159.1	+1.7
TOPIX Index (Tokyo)	1,464.5	+2.5
Bonds / Currencies		
US 10YR Treasuries	2.3572	0.0
EUR/USD	1.0589	0.0
USD/JPY	113.22	+2.1
GBP/USD	1.2342	+1.1
Commodities		
Gold (Spot)	1,190.1	-1.5
Crude Oil (WTI)	46.1	+0.8
RJ/CRB Commodity Index	185.7	+1.4

Source: Bloomberg (last trading price for week ended 25 November 2016)

In terms of equity market impact, we expect earnings downgrades to continue, given the short-term drag on growth. Earnings estimates for FY2017 and FY2018 are also likely to be revised downwards. Nonetheless, we should still expect earnings per share growth for FY2017 (which ends in March 2017) to be in the high single digits, which means that the market has not 'de-rated' as such. While specific sectors such as real estate face long term issues, the rest of the market could experience a V-shaped recovery. Additionally, we expect the government to be decidedly growth focused when it presents its next budget on 1st February 2017. Rural and infrastructure spending especially are likely to see a significant boost.

We are optimistic on India's equity market over the longer term. The Indian government remains pro-growth and the economy continues to be supported by an increase in rural subsidies and infrastructure spending, as laid out in the FY2017 Union Budget. This notwithstanding, volatility could persist and any equity market correction in the near term could offer an opportunity for bottom-up stock pickers like us to buy/add to quality companies with sustainable earnings growth and good growth prospects, at better valuations.

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