Manulife Asset Management

Investment Note

6 Feb 2018

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India's 2018-2019 Union Budget: Key Takeaways

On 1 February 2018, India's Finance Minister Arun Jaitley presented his annual budget to parliament. The budget stressed numerous important themes including fiscal consolidation and increased social spending, particularly on infrastructure and rural areas.

In this investment note, Rana Gupta, Senior Portfolio Manager and India Equity Specialist, explains why this year's budget should be seen as one of continuity, supporting the administration's goal of economic formalisation. This goal will not only help India sustain better quality and balanced growth over the mid-term, but also benefit strategically-placed sectors such as financials, retail and real estate, and aspirational consumption.

India's 2018-2019 Budget Stresses Continuity

The Union budget presented on 1 February by Finance Minister Arun Jaitley largely stressed continuity. Indeed, the government hit on traditional themes of balancing the need for fiscal consolidation, while also strategically increasing spending in key policy areas. For example, the Indian government's decision to increase the minimum support price for crops could benefit farmers, but not at the cost of increased inflation or budget deficit.

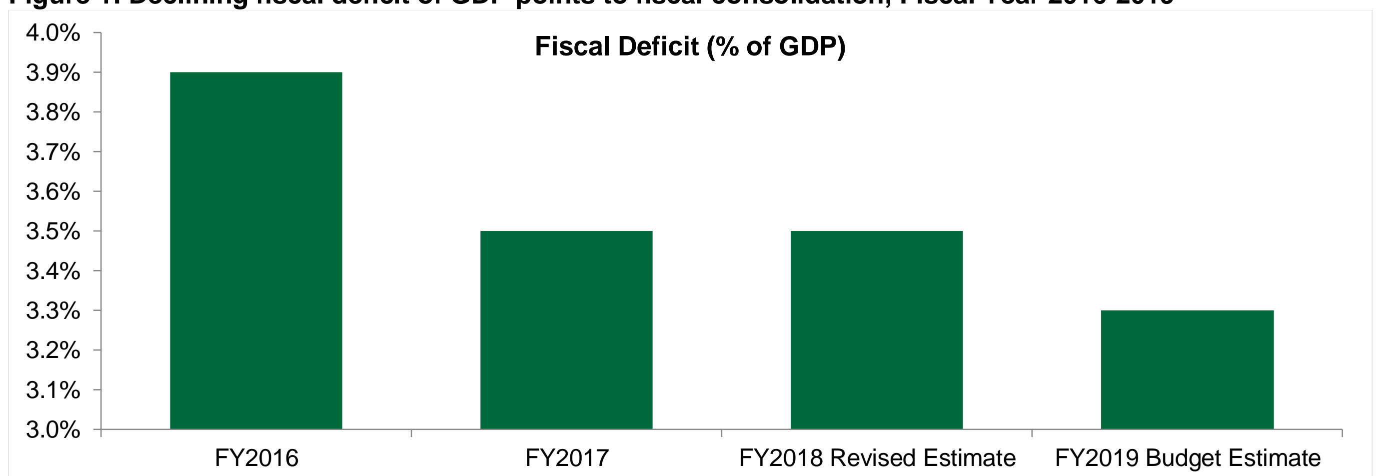
A few ideas were also reintroduced: the long-term capital gains tax (10%) was announced; though we don't expect it to have a large impact as it is lower than tax rates on other asset classes.

Overall, we see two main takeaways from this year's budget: Continued fiscal consolidation and improved quality of spending on infrastructure and rural areas.

Continued Fiscal Consolidation

Fiscal consolidation was a key theme of the budget. The fiscal deficit is pegged to decrease from the 3.5% of GDP in Fiscal Year (FY) 18 to 3.3% of GDP for FY19 (estimated). Although there was a minor slip in the fiscal deficit for this year, it is encouraging to see the government adhere to its consolidation goals.

Figure 1: Declining fiscal deficit of GDP points to fiscal consolidation, Fiscal Year 2016-2019[1]



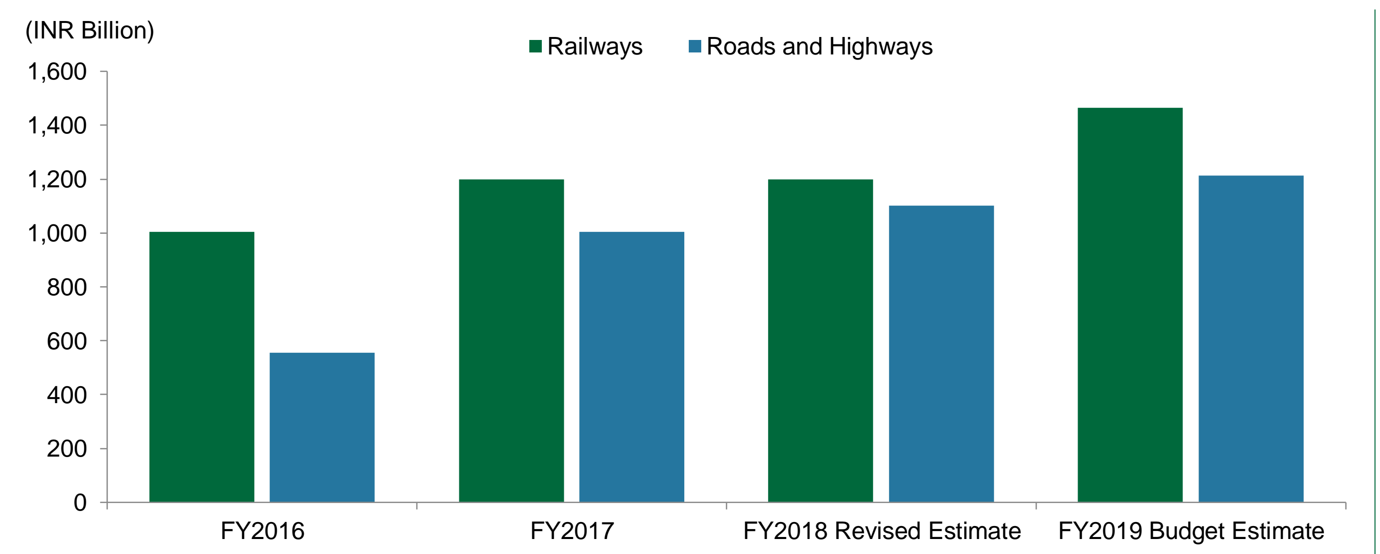
[1] Budget Documents, CSO, February 2018. FY stands for financial year (ends in March).

On the revenue side, our view is that gross tax revenue growth of 16.7% is reasonable except that their Goods and Services Tax (GST) collection goals maybe aggressive. That said, due to formalisation and a higher tax base, the government's GST collection assumption looks challenging but not insurmountable. Total expenditure growth was budgeted at 10% year on year, but quality of expenditure has been improving with a focus on rural and infrastructure development.

Improved Quality of Spending: Infrastructure and Rural

The budget's expenditure focus was on infrastructure and rural development. Transportation spending, including road and railways, was a key highlight. The government increased allocation to railways by 22% year-on-year, while allocation to roads increased 10% over the same time period.

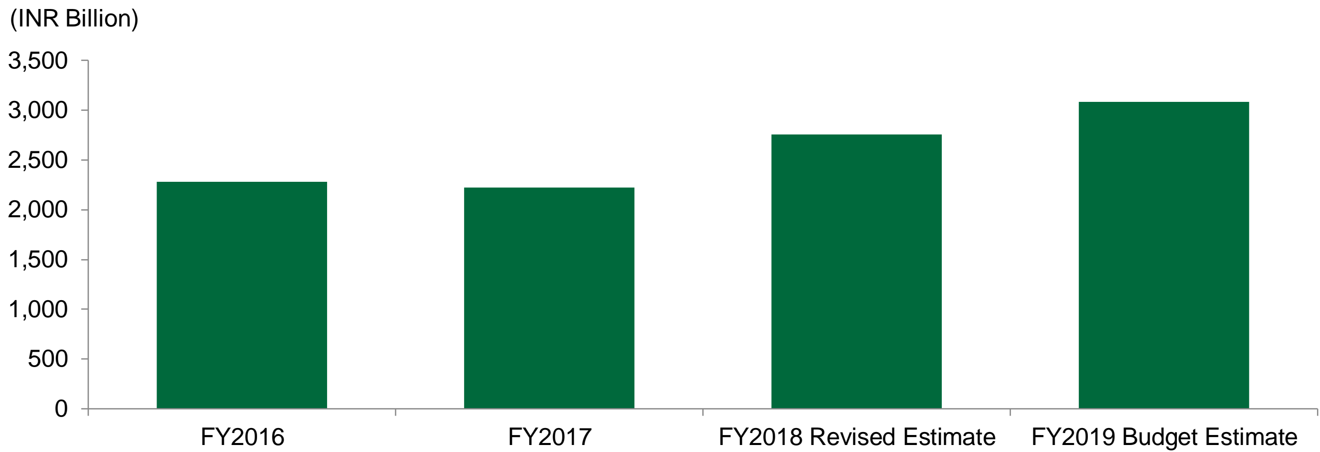
Figure 2: Infrastructure spending on railways, roads and highways, Fiscal Year 2016-2019 [2]



Government allocation to key rural schemes increased by 12.2% year-on-year; however, the bulk of this increase was driven by a 20.7% year-on-year increase to food subsidies. This policy implies a large minimum support price (MSP) hike for FY19, including a 10%-15% increase in paddy MSP. Given the current demand supply dynamics for paddies, and the limitation of government procurement, we think its impact on inflation will be limited.

[2] Budget documents, Ministry of finance, Kotak Economics Research, February 2018

Figure 3: Total spending on rural areas, 2016-2019[3]



Overall, this year's budget was an exercise in continuity, furthering the government's goal of formalising the economy. The ability to achieve this goal, while balancing the need for fiscal consolidation and targeted spending, are the key takeaways from the 2018-2019 budget.

Budget's Implications for Investors

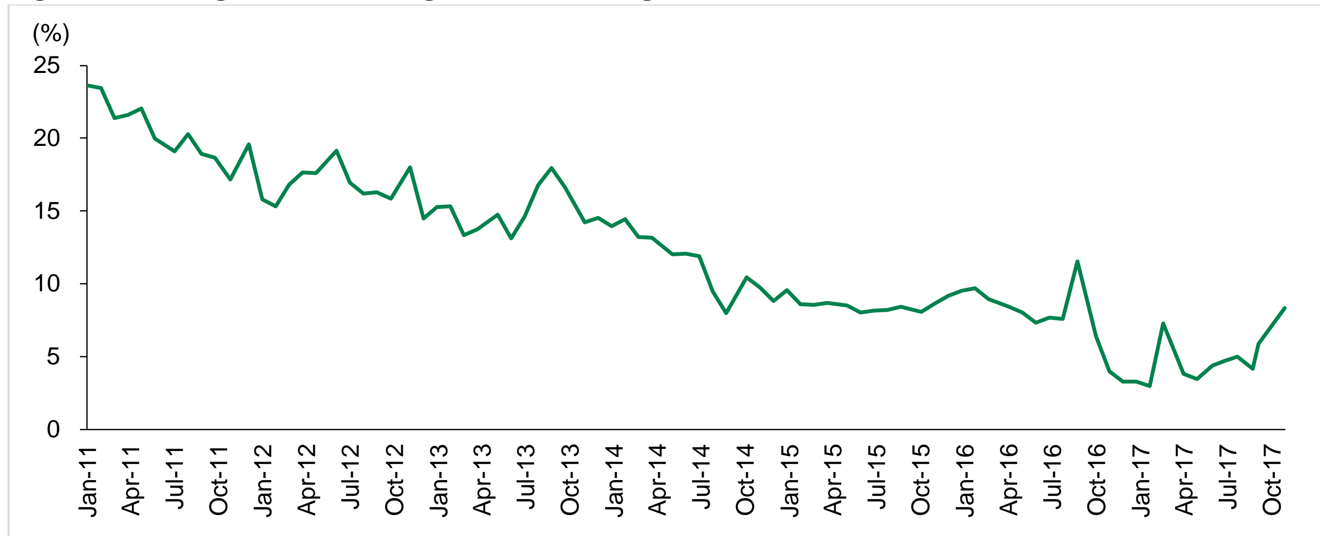
This budget builds on the progress of economic formalisation achieved over the last 24 months. This is a significant structural change, and is evident from the fact that the income tax base has gone up by 20% and that tax registered enterprises are up 50% during this time period. This reinforces our larger investment thesis of economic formalisation; we continue to be constructive on the following sectors/themes:

- **Financials:** Several trends are positive for the financial sector. The budget supports economic formalisation themes of higher household financial savings, which has led to more liquidity in banks. These factors, coupled with the recent government decision to recapitalise state-owned banks, are positive for credit growth and, by extension, banks. Insurance and mutual funds may also benefit from increased savings and inflows into the financial sector.

  Another opportunity is emerging within financials. Since the banks are looking for resolution of the current stock of high non-performing loans (NPLs) at a time when the global and local economy is improving, we think there is substantial opportunity for buyers of distressed debt and asset reconstruction companies.

[3] Budget documents, Ministry of Finance, CLSA, February 2018. FY stands for financial year (ends in March).

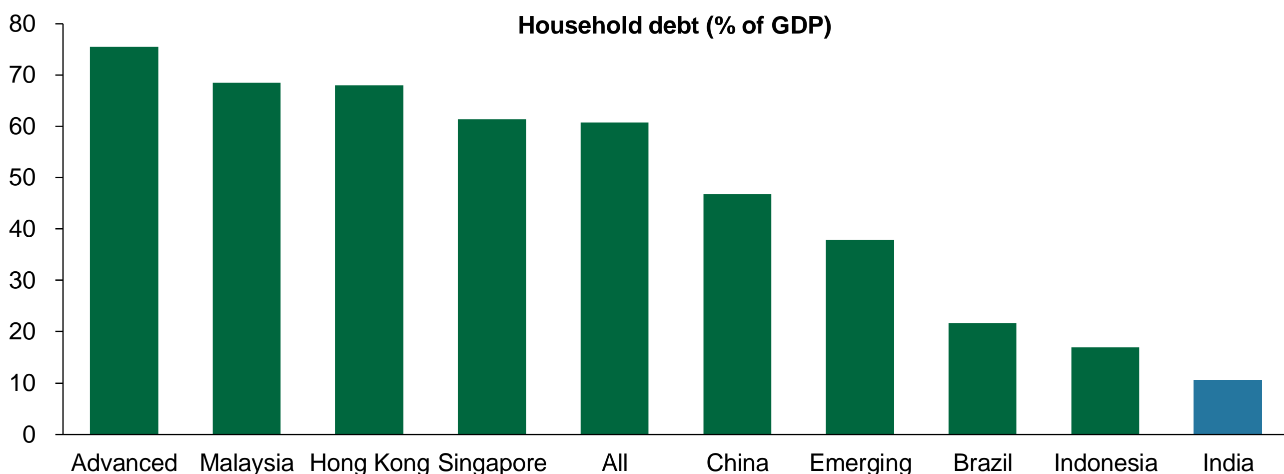
Figure 4: Credit growth shows signs of rebounding[4]



- **Retail and real estate:** As economic formalisation deepens, the organized sector of the economy will increasingly excel at the expense of informal firms, particularly in industries with high entry barriers and systematic tax collection. Retail and real estate are poised to leverage these growth opportunities over a multi-year time period.

- **Aspirational consumption:** The investment play on aspirational consumption is due to under levered consumers with increasing access to consumer credit and a low penetration rate of aspirational consumption goods. Indeed, as credit becomes cheaper due to greater financial flows and more targeted credit allocation, the purchase of white goods and passenger cars could increase.

Figure 5: Indian households are relatively under levered[5] **(% of GDP)**

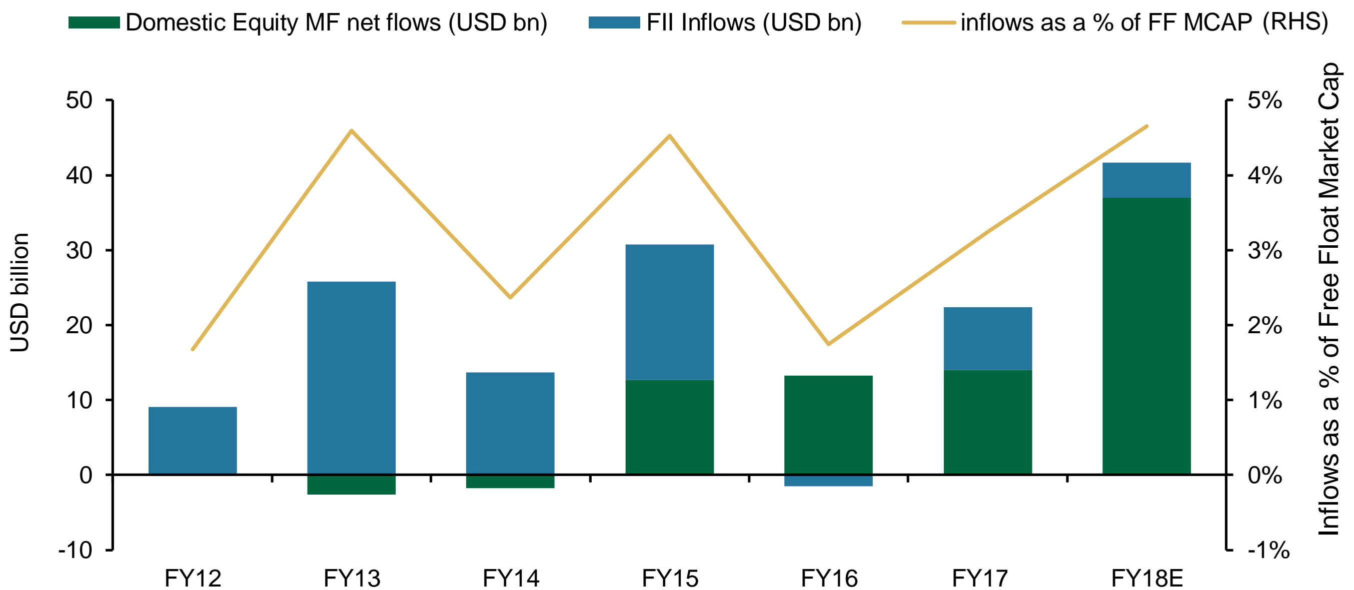


[4] RBI, Kotak Institutional Equities, as of November 2017.
[5] RBI, Kotak Institutional Equities, August 2017, as of 30 June 2017. Advanced economies: Australia, Canada, Denmark, Euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States. Emerging market economies: Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey.

- **Valuation:** Current valuation levels should be interpreted in light of a potential increase in earnings and continued capital inflows into Indian equity markets. Indeed, while current headline valuations appear higher compared to the historical median for Indian markets, earnings growth is expected to increase starting from FY19 onwards as key reforms bear fruit. We have historically seen that whenever earnings growth materially picks up, Indian markets trade above their historical median valuations.

  Equity inflows have also increased as structural reforms have led to increased financial savings. Ample liquidity support should be adequate to digest the increased equity issuances in the market during the past calendar year.

Figure 6: Flows into Indian equity markets[6]



Note: FII: Foreign Institutional Investor; FF MCAP: Free float market cap

[6] AMFI, MOSPI, CLSA, Bloomberg. FY2018 is estimated data is as of 31 December 2017, annualized for the next 3 months. FY stands for financial year (end in March).

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