D. SUKHANI decodes Budget 2018, terms it a disappointment for investors

The Budget has taken India's middle class out of equation and is a disappointment for investors, senior journalist and market expert D.Sukhani told , analysing an event that has been dubbed 'election Budget'.

Finance Minister Arun Jaitley has managed to strike a balance between populism and discipline in the Budget he presented on Thursday, but left investors and the salaried class in the lurch. The Budget has not much to offer for the salaried class, and the introduction of long-term capital gains on stock trading is a burden that investors wouldn't want to bear.

My sense is that this is an election Budget. There is not too much in it for either the middle class or the investing class or indeed corporate India. It is very squarely targeted at the farming community and rural India. The Budget speech started with that and it set the tone for what the Budget will be all about. It was pretty much all about rural India, big schemes for them and all that talk about all the stuff which addressed investing India or corporate India or middle class India actually came in the last fifteen minutes which is when the markets started going down because the first blow was that there was nothing for the salaried class. And he said that barring the standard deduction of Rs 40,000, there was not much more. So the middle class went out of the equation.

Then came the blow on the fiscal deficit. The market was prepared for some slippage, but 3.3 percent for next year is a slippage which is more than what the street had pencilled in and therefore it was mildly disappointing and the bond yields started going up then. And then came the long-term capital gains tax of 10 percent which, though they feared it, most people thought would not come and it did come about. So the combination of those three things will make this a Budget which was not very palatable for middle class or for corporate India or for investors, but for farmers and for rural India, it would go down as a very good Budget.

Q: So a lot of announcements for the farming community. What kind of impact do you see this having? Some feel that if you fix the rural problems, automatically there is a trickle up effect whereby the larger companies and the economy as a whole benefits, but there is also then the problem of food inflation. So what is your overall view on this?

A: I think it needed to be done because the rural distress has been around for quite a while now and is not getting better. Just this morning, one of the big companies of India, Dabur, which has a big presence in the rural sector, actually mentioned that for the last three quarters, things have actually not been improving for rural India. So that gave you a sense that however much we dice and slice the numbers, there was a big problem with rural India and farmers were not feeling good. You could see shades of that in the Gujarat elections as well.

Now I do not think Narendra Modi could have faced another national election with the kind of mood that exists in rural India right now. So farm waivers aside, something had to be done. So the big step out there is the minimum support price (MSP) hike to 1.5 times production costs for all Kharif crops.

For a growth turnaround to happen, we will probably have to wait for Kharif now which is many months away. Assuming that farmers actually do get 1.5 times production costs for the Kharif crop, you will see some kind of a growth rebound. But I think the more important thing is that the announcement has been made. I do not think this project has been adequately funded yet though -- because the DEA secretary stopped short of giving us a number for the entire allocation. Many of these schemes which has happened for the farming community have actually not… the funding has not been specifically cleared in the Budget statement. So we will have to see how the funding comes about. So eventually when the Kharif happens, maybe we will see some kind of growth impetus coming into rural India.

More immediately, the problem is that talk of MSP coming about at 1.5 times is going to stoke the bond yield because people will already start talking about inflationary pressures. On top of that, there has been fiscal slippage. So, a combination of these things will probably mean that the era of lower interest rates is over for good and the next move from the RBI will probably be on the way up and therefore, all expectations of a growth rebound have to be seen in the light of the fact that the cost of capital will go up in 2018.

Q: Strangely the market seemed to take the long-term capital gains tax (LTCG) blow in its stride. You saw the Sensex fall by about 400 points and then come back very quickly. So has this announcement been digested?

A: There are two points I would make out here. One is that the government actually understands the stock market very well. So I think the Finance Ministry knew that when they make that capital gains announcement, the market would fall once, it would tank. And we will not ever get to see the numbers, but there is support today for the stock market from many government agencies. I think LIC, SBI, many of these players would certainly have been instructed to support the market somewhat today. It cannot beyond a point, but at least on the day of the Budget, you could play some kind of a salvage or rescue operation. Coupled with the fact that a lot of people sold before the Budget anticipating the long-term capital gains tax, the last two days, the midcap and smallcaps have actually taken it on the chin. They have been falling quite a bit.

So it is possible that some people who sold before the Budget might be covering up their positions now or buying afresh the stocks that they sold before the Budget. So I think it is a combination of a bit of short-covering, some bit of optimism because of the rural piece that we spoke about and a lot of rescue operation from the state-owned agencies which is why the index managed to stage an intraday rebound.

Q: Also, there is a general feeling that investors are not really better off selling today. It

does not really matter. That is probably one of the reasons that you saw the market hold up.

A: Yes, because the damage has been done. Now for subsequent investments that you make, you will pay long-term capital gains tax whenever you sell if it is more than one year. For people who are holding stocks earlier, it does not matter if you sell today or you sell one week later because till January 31, your profits are protected. After that any incremental profit will attract the LTCG tax. So, any selling that we saw at the announcement was actually a knee-jerk sentiment sell off that disgust, that LTCG has come in. Beyond that, people figured out that now, we will have to deal with it.

So, it is an important question you ask because it will determine whether mutual funds continue to get the kind of inflows that they have been getting for the last year, year and a half, because that is one of the main reasons our stock market has been holding so high. If the space of inflows goes down for a few months because of a feeling that it is not such an attractive asset class as it used to be then it has ramifications for the stock market. So let us not judge the public sentiment reaction just by today's performance. Let us wait for a week, 10 days to see how the market digests this one.

Q: You mentioned the midcap stocks just a short while back. Now, has the picture changed? We have seen these stocks coming under a bit of selling pressure for the last few days now.

A: My sense is it is partly because of a couple of reasons. One is that there is a general understanding now that midcap valuations and smallcap valuations have run way ahead of fundamentals. Now they could have gone up even more, but partly what has happened is that largecap earnings have started recovering. In the last one year what has been happening is that the Sensex and Nifty earnings have not been going up. So the street essentially had the view that if largecaps are not seeing earnings growth, we might as well buy midcaps where there is more growth and there was demonstrable growth in many of the midcap companies. Therefore their valuations went to a significant premium to their largecap peers.

Now, two things are happening, a realisation that midcap valuations have gone up to very significant premium, in many cases trading at 35-40 times when their largecap peers are at 20 P/E. So there is a little bit of an adjustment because of that. Also, in January, 2018, what has happened is that foreign institutional investment (FII) money has started coming back. In January, we have seen USD 1.5 billion of inflows. FII money usually goes into largecaps. On the other hand, domestic inflows into the market has slowed down a bit and therefore, midcaps have started to ease off a little bit and FII-fuelled buying of largecaps has driven largecaps higher. So we are seeing this rotation in January on account of all these factors, the valuations premium, the earnings coming back to largecaps, FII money coming back versus domestic institutional investment (DII) money in January.

Q: So what is the signal that we are getting from the bond market? Is the equity market ignoring that?

A: It is the big question for 2018. Where will bond yields go up, not just locally, but also internationally? The biggest risk for 2018 for the equity market in India and the US and elsewhere is from the bond market. If US growth is picking up, globally growth is picking up. If that means that central banks there, start to think of winding down asset purchases at a more accelerated pace, if that means that interest rates and the bond yields start to go up in the western world, if the dynamics that we are discussing out here, the fiscal slippage, the inflation going up, that means that Indian bond yields go up. They are already at 7.5 percent plus, last I checked. If that goes up to 7.75 or something like that, then you are having a situation where cost of capital is going up which is never good for equities. The markets digested it so far but if this continues in the US, US bond yield is very important to us and if the local bond yields continue to go up, at some point the equity market will run into trouble.

Q: Speaking of rising interest rates, just a couple of days back SBI increased rates on bulk deposits and again, is the mood for equities itself

changing slowly because rising interest rate is never good news for the stock market?

A: It is, so that is what I said that the bond yield is a very important factor. Now we will see whether lending rates start to go up because so far we have seen a big jump in the deposit rate. Usually that leads to a jump in the lending rate as well. So we will have to see if banks pre-empting any kind of a RBI move actually and because of the bond yields having gone up start to tighten interest rates in the local market, which at some point will have to be calculated by or have to be factored in by the equity market as well.

Now, two things can counter this. One is that even if bond yields go up, if there is a dramatic turnaround in the earnings growth picture, if in the next couple of quarters the market feed starts to feel sanguine, that we are going to get 20 percent plus earnings growth in FY19 then I think we may have a situation, fuelled by local liquidity and with the hope of earnings growth recovering that the market might choose to ignore the initial rise in interest rate. It is a material factor, but it can be glossed over if the market continues to move well.

So, I think there are few risks. One is of course, interest rates going up. The other is capital gains tax which has come in. the third is the global angle. If all three come together at the same time, you could have a meaningful correction in the stock prices. I do not know whether the trend will change, but a 10 percent kind of correction which we have not had for the last 14 months or so, is entirely a possibility.

Q: So a bit of disappointment for corporate India as well, the much expected reduction in corporate tax rate did not really come through although there has been some relief for small and medium enterprises. So what is your view on this? Will this really help the situation at the ground level if the smaller companies are given more incentives?

A: It may on the margin, but it seems like the way the Finance Minister put it that it will work now for 99 percent of companies, up to the threshold of Rs 250 crore revenue, but in actual terms it leaves out all the big companies of India which probably make up for 90 percent of the total corporate tax generated or 75 percent of the tax generated.

So the government has still not kept its promise which it made to corporate India that the tax for all companies will come down to a level of 25 percent.

Now, whether the government given its very constrained fiscal situation is in a position to do that over the next year or two, we will have to see. But I doubt very much that will be the case, because already it is a lot of pressure because the government is announcing so many schemes. Where will the money come from? You cannot go on announcing new schemes for rural India and at the same time, keep leaking tax revenues. So I do not see this reduction for the large companies at least coming in. I think corporate India will be quite disappointed today, but it is not a big deal in that sense because companies will pay the same tax as they paid last year. In the kind of situation that rural India finds itself in, do they need the money more than corporate India? The answer would have to be yes.

So on balance, the government has done the right thing, particularly because it has an election coming up in the next few months which is another point which a lot of the political commentators will try to understand today or grapple with today is the kind of focus that we have seen on rural India in the Budget, is the Modi government signalling that we are probably going to have elections in the fag-end of 2018 calendar? Could this be the poll bugle to say that we are moving toward simultaneous polls between general elections and Madhya Pradesh and Rajasthan polls in November-December, 2018? It could very well be the case given the complete focus on rural India to the exclusion of everything else today.

Q: Now third quarter numbers were slightly better than what most analysts were expecting, but then there was also the base effect to that and if you read the economic survey, it has clearly mentioned that pick up in private sector investment, that still it will take some time. So overall, what is your outlook on the earnings pickup? Do you see that happening any time in the foreseeable future?

A: This quarter has actually not been bad. Particularly for some sectors -- like Larsen and Toubro's (L&T) numbers were quite good which is encouraging after a long time because that is a sector which has been languishing and it is such an important wind vane for the investment or capex cycle that we speak of. So, there have been disappointments in this quarter as well, ICICI Bank, United Spirits, some of the cement companies, some of the telecom companies have not done very well. But there is some recovery in earnings in this quarter aided largely by the base, but overall, there is some kind of a demand push also after many months of very lacklustre kind of an earnings momentum. Now whether this continues going forward, we will have to see because one quarter on the demonetisation base does not tell you conclusively that we have turned the corner with earnings.

So I would like to see the January-March quarter and most importantly, the April-June quarter. If the April-June quarter is a good one, the first quarter of FY19, that would be very encouraging because then the demonetisation base had started to wear out and if in that quarter we do get a good number, a 20 percent kind of a growth number, then the street will be very happy. But these are the two most important things, locally speaking. Globally we are having a massive bull rally, we are participating in that, but locally it is earnings and the cost of capital which is the bond yield and interest rates, these two, the confluence of these two will determine what stock performance is like this year.

Q: The government has been trying to do various things to fix the bad loans problem of public sector banks. What is the general view? Will the recent measures really help the public sector banks overcome the bad loan problems and have their balance sheets up and running in the foreseeable future?

A: I hope so. My mild disappointment stems from the fact that the weaker banks got majority of the capital in the bank recap, the first tranche of Rs 80,000 crore. I would have thought that SBI could have been given Rs 20,000 crore. They got only Rs 8,000 odd crore. So you wanted growth capital in the PSU banking hands. All they got is band aid capital or a large part of that is band aid capital. Now I do not see the UCO Banks and the IDBI Banks of the world actually playing a major role in the loan recovery process that you were alluding to. I think that will have to come from SBI, Bank of Baroda, maybe Punjab

National Bank and Vijaya Bank. These are the stronger banks and they did not get a lot of growth capital. So, credit growth is improving. It has gone up to 11 percent from 5 percent.

I think they will also be aided by the base, but there will be some recovery in credit growth, but not the amount that one was looking at earlier, so I think the bulk of the credit growth acceleration will still have to be driven by private banks, by non-banking finance companies (NBFC), so we will have to see how this plays out. But for PSU banks, I still think that longer term, we will still have the same problems from the weaker banks. They have got some capital which they will fix their balance sheet, maybe get some resolution deals done, but longer term, not too much in their DNA will change. So five years down the line, your bet is as good as mine on whether they will run up with similar problems they had in the past.

Q: You mentioned a short while back that you should not judge the Budget by just today's market reaction. So near-term, what is the outlook on the market?

A: It depends a lot on the global outlook because so far this year, India has underperformed most of the other big emerging markets. Brazil, China, Russia, everybody is doing much better than us partly because of oil, but also because of other reasons. So one was hoping that if the Budget is out of the way without too much damage, India might play catch up with some of the other emerging markets. It seems to me a bit unlikely that that will happen now with the long-term capital gains tax and with the fiscal deficit slippage.

So India might amble along, but if the global market rally continues, it would be very unlikely that India, in absolutely terms, actually falls a lot. We might not go up as much as some of the other markets, but I do not think we will have a massive crash in our market. However, for any reason the US bond yield going up or China problems coming to the fore, if we have a global correction, chances of India underperforming in that global correction have just gone up a lot. So, if global markets fall 3-4 percent, it is quite conceivable that India falls 7-9 percent because the mood has got affected a little bit after today.

So I do not know what happens today in the market or tomorrow, but over the next few days, all domestic investors will have to ask themselves this question about their net expected returns from the stock market adjusted for long-term capital gains tax now and whether they are feeling a little less bullish than they felt before the Budget. And if the answer to that is yes, you might have a period of consolidation, maybe even a correction. It will not be a bad thing, because already many midcaps have corrected 20-25 percent in the last one week. So even if largecaps let off a little bit of steam, I do not think it is a big deal. But today's Budget, on the margin has probably created more disappointment for stock investors rather than any kind of enthusiasm.