Manulife Investment Management

Investment Note

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On 5th July 2019, the Finance Minister of India, Ms. Nirmala Sitharaman, presented the maiden budget of the re-elected BJP-led NDA government. The focus of the budget was to lay down a roadmap that will turn India into a US$5 trillion economy over the next five years[1]. The government's vision is to achieve this by recycling its own capital, rebuilding domestic savings, encouraging foreign savings and reviving investments. True to this vision, the budget is fiscally prudent and shies away from any short-term measures to revive growth. Instead, it attempts to pursue its growth agenda by maintaining fiscal stability, introducing measures to attract more foreign inflows, reducing risk aversion in the financial sector, and incentivising domestic capital formation through affordable housing. As a result, we see further scope for the Reserve Bank of India (RBI) to cut rates. We also anticipate a better transmission of lower rates which could act as a catalyst for higher growth.

Indian union budget 2019: taking the prudent path

In our May 2019 note, we argued that the new government would have a unique opportunity to lift India's growth rate if it made the right policy pivot to capitalise on the strong foundation of reforms laid down during the last five years. We suggested this policy pivot could take the form of "three R's" – **Recycle**, **Rebuild** and **Reinvest**. And, indeed, the latest budget has introduced several measures that pursue these objectives, and should be supportive of economic growth in the medium to long term:

Recycle

A roadmap of measures to free up state resources through disinvestment should underpin the government's social spending agenda without raising the fiscal deficit.

- **Relaxing SOE disinvestment norms:** The government is considering paring its stake in state-owned enterprises (SOE) to 51%. In calculating that 51%, they may include effective stakes (indirect shareholdings through other state-owned entities), which should liberate additional sources of revenue, However, it could create a supply overhang in SOE names if this disinvestment is done through the stock market.

- **Higher spending, but not at the cost of the fiscal deficit:** Because of higher tax collection and disinvestment targets, the government has been able to maintain the projected fiscal deficit at 3.3%. This is despite expenditure growth of 21% year-on-year in the budget, which is better than the market expected. In particular, spending in rural areas has increased by around 70 basis points (bps) of GDP, a 55% rise on a year-on-year basis[2]. We expect to see ongoing public investment in areas such as rural housing, roads, power, gas and water connections, which should bring a broad-based economic gain.

Rebuild

Measures announced to ease domestic credit conditions and attract foreign savings should help to rebuild savings.

- **SOE banks recap:** An increase in the recapitalisation budget to Rs$700 billion (US$10 billion) should offer growth capital to SOE banks.

- **Partial credit guarantee for NBFC assets and better supervision:** For the purchase (up to Rs$1 trillion, i.e. US$14 billion) of higher-rated pools of financially sound non-banking financial companies (NBFCs), the government, on a one-off basis, will provide a six-month partial-credit guarantee to public-sector banks. Moreover, the government gave the RBI more power to

[1] Source: India Budget 2019-2020.

[2] Compared to financial year 2019 (April 2018 to March 2019).

regulate NBFCs, including the appointment and removal of directors. These measures should reduce risk-aversion and ease the liquidity situation for NBFCs.

- **Measures aimed at attracting foreign savings:**

  1) Relaxed FDI restrictions on single brand[3] retail, airline, insurance and media firms.

  2) The issuing of government securities in the international markets. If we bear in mind that external holding of India's sovereign debt is only 5% of GDP, this could open a significant new source of funding.

  3) A potential increase in minimum public shareholding requirements to 35% from 25% for listed entities, with a view to raising India's weight in global equity indices.

  The last measure, while creating deeper equity markets over the longer term, will also generate a substantial supply of new shares in select companies.

Reinvest

Proposals to boost the investment rate should help domestic capital formation.

- **Focus on housing:** The income tax concession limit on mortgage interests[4] has been raised from Rs$200,000 per year to Rs$350,000 for the purchase of a first house priced at less than Rs$4.5 million (if bought before March 2020)[5]. This is positive, as it would effectively mean around Rs$50,000 of savings for every year of a homeowner's loan. For a 10-year loan, gross savings could be as much as 10%[6].

- **Focus on infrastructure:** The government reiterated its plan to invest US$1.4 trillion in infrastructure over the next five years.

[3] Any brand opening a retail presence on its own brand.
[4] Interest paid by borrowers on mortgages is tax deductible, i.e. it can be reduced from the taxable income.
[5] Source: Economic Times: "Budget 2019 hikes tax break on interest paid on loan for affordable housing by Rs 1.5 lakh", 8 July 2019.
[6] Manulife Investment Management estimates, July 2019.

Potential concerns

- **Increase in stock issuance:** The government is considering reducing the maximum allowed promoter holding[7] in a company to 65% from 75% (in consultation with the Indian capital markets regulator SEBI)[8]. While this move is aimed at raising India's free float and weighting in global indices, by our estimates it could also potentially result in new stock issuance worth about US$ 50 billion[9]. However, we think that the regulator will likely implement this in a phased manner to give the market enough time to absorb the extra supply.

- **Increase in the top tax rates:** The government has increased the tax rate on high-income earners, i.e. those earning more than Rs$20 million (~US$300,000) per year will see their marginal tax rates go up by 300-700 bps due to a surcharge. This could hurt discretionary and premium consumption.

  As with the various interpretations we have seen, we believe such a surcharge will be levied on capital gains too, should the gain cross the aforementioned threshold. This could weigh on near-term sentiment.

Outlook

We are happy to see that the government has, at least in principle, adopted the three-R's framework we referred to in our previous note. We believe that the government has avoided the temptation to lapse into fiscal profligacy and chosen a prudent path that will fulfil longer-term growth aspirations. That said, we would like to have seen the government target more strategic asset sales rather than using the stock market to recycle its capital. We would have also preferred a larger and more strategic programme of asset sales to raise revenue and stabilise tax rates.

Looking ahead, India needs higher investment rates to achieve its growth target. However, part of the

[7] In India, the main shareholders of a company who control the management are called promoters. This refers to what their maximum stake in a listed entity can reach. Reducing the maximum allowed promoter holding will increase free float.
[8] Securities and Exchange Board of India.
[9] Manulife Investment Management estimates (based on market capitalisation , as of 5 July 2019).

credit delivery system (almost half of SOE banks and NBFCs) is broken because of bad assets and the low capitalisation that disrupted credit flows. While this problem is being fixed through market mechanisms, the government's budgetary steps to address it through the SOE bank recapitalisation, partial credit guarantees, and better supervision should help. It is also very important to attract foreign savings at a time when global liquidity is abundant, and the government's decision to open up the capital account by tapping overseas bond markets for sovereign issues is a bold step in this direction. This will also free up domestic savings, which will be assisted by the transmission of lower rates. In turn, this will help to revive private investments.

We remain constructive. Although there is no overall fiscal expansion, rural areas and small enterprises could see a positive impulse. On the other hand, the benefits of lower rates have started transmitting to the real economy due to better liquidity conditions. Prudent fiscal management should also help to deliver lower rates.

This should benefit rate-sensitive sectors such as financials, commercial real estate and utilities. We also believe that, with a lag, those sectors that are sensitive to rate-demand will also recover – these include autos and building materials – as lower rates feed through.

On the other hand, the Indian rupee may remain well-bid because of potentially rising foreign inflows. This could be an issue for exporters, particularly in mature industries like info tech and healthcare.

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