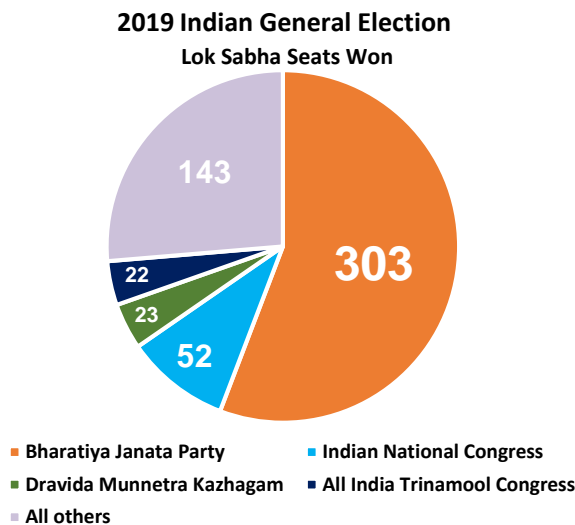


India's "Watchman" Keeps His Post

Market Viewpoint: June 7, 2019

Summary: Prior to the Indian general election last month, many began casting doubt over the ability of PM Narendra Modi to win a second term. He is known as a radical reformer, but many the changes Modi has made, while necessary, have not been easy on Indians. A loss of seats or a parliamentary majority by his party surely would have sent the country into political chaos. But thankfully, that was not the case and India look set to continue down the path of reform, growth, and, perhaps most importantly, given the current geopolitical tensions around the world, stability.



Going into India's latest national elections, many began to doubt that Narendra Modi, self-appointed as India's "Watchman," would remain the leader of the second most populous and most rapidly growing country in the world. Following his BJP party's surprise sweeping victory, however, those doubts must now be replaced with wonder at the scope of his refreshed mandate. More than 600 million Indian voters cast ballots at a million polling places for a turn-out of 67%, the highest ever. Modi's BJP won a dominant 303 seats in the 545-member lower house, known as the Lok Sabha, easily giving the BJP and their allies a huge majority, and making him the first two-time prime minister ever to come from a lower caste.

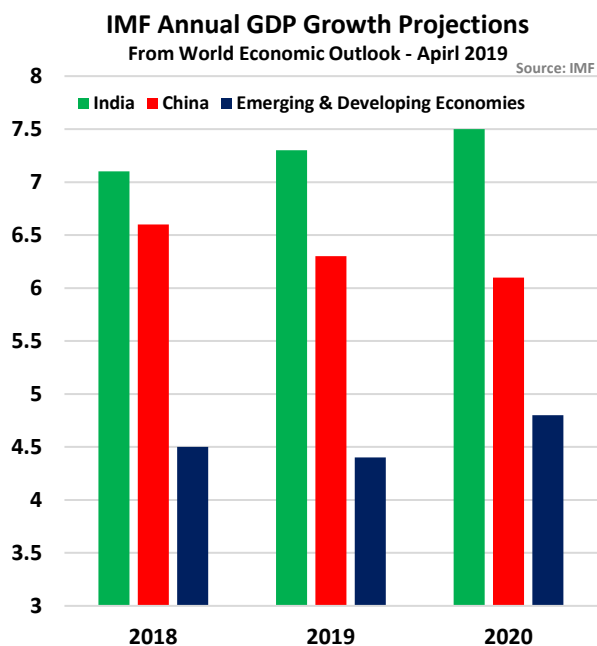
It was also a triumph for Modi's brand of dramatic risk taking in the face of withering criticism. So much faith had been lost in Modi's reforms and GDP growth had been slowing, reaching only 6.8% in FY 2018-2019 – a five-year low. Although data for the 4th quarter, showing growth of only 5.8%, played a huge role in this, the IMF and World Bank still expect stronger growth through 2019 and 2020. The IMF forecasts 7.3% and 7.5% growth, respectively, while the World bank projects 7.5% for both years. The Reserve Bank of India is just as optimistic, estimating 7.4% growth for the current fiscal year.

Modi's strategy has been a tradeoff of short-term pain in pursuit of necessary reforms that would lead to long-term prosperity. He sized up what he perceived as the most important building blocks for the dramatic change needed to drag India into the modern era to take its place as the great country he envisions, and attacked them all at once, including:

- Replacing a significant portion of a complex, individual state tax system with a simplified national sales tax, forcing millions of businesses operating in the "informal" (underground/shadow) sector to regularize and begin to pay taxes. It represents a crucial long-term step in addressing the need for sweeping infrastructure reforms, due to India's taxes as a percentage of GDP being extremely low, precisely because 81% of Indians worked outside the gaze of the central government and therefore paid



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zero taxes. In FY 2017-2018, India generated a direct tax-to-GDP ratio of 5.98%, the best in the last 10 years. The finance ministry reported corporate income tax and personal income tax in growth at 17.7% and 18.3%, respectively. In FY 2018-2019, the total tax to GDP ratio is expected to exceed 12%, also a decade high. The ministry also recorded a continuous increase in the amount of income declared in the returns filed by all categories of taxpayers over the last three assessment years.

- Greater tax revenue will likely feed directly into Modi's promised \$1.44 trillion investment in the country's infrastructure. Bloomberg reports that the government has already set aside \$57 billion for spending on roads, railways and airports in the year ending March 2020, but the BJP plans on rolling out more funds for critical electric and plumbing infrastructure.

- Modi's bold "demonetization" strategy of over-night elimination of major rupee denomination currency to curtail the "cash economy" that drove the majority of transactions was extremely disruptive. But the status quo shielded the reporting of profits and income and subsequent need to pay taxes for individuals and businesses, dealing a further blow to the government's revenue collection needs. Modi's plan forced many to open bank accounts and trade their old currency for newly issued denominations or risk losing all the purchasing power of their cash hordes, thereby forcing them into the open and assigning them ID's that could be followed henceforth. Many predicted it was an impulsive and unwise move that would prove to be his downfall. The ensuing panic exacerbated that expectation, but eventually as Modi most likely expected & hoped the populace adjusted. PwC reports that the number of people without a bank account has fallen more than 18% since 2015. With all of those new accounts, revenue at a number of India's top banks has gone up. HDFC Bank and its mortgage lender, the Housing Development Finance Corporation, both experienced increasing revenue in 2018 over 2017.
- Legislation for a new bankruptcy code required payment of outstanding bills by corporations, within a certain timeframe, or speedy filing of bankruptcy/liquidation proceedings would ensue. The purpose being to discourage companies and their elite management teams from not paying their debts in a timely manner, thus encouraging private investment. Livemint reports that aggregate bad loans of state-run banks declined 12% in the year ended 31 March, while private sector banks saw a 1.3% reduction in gross non-performing assets during the same period.
- Rollout of the Biometric Attendance System, a digital dashboard available to the public that displays the comings and goings of more than 50,000 government employees across 150 departments and provide real-time evidence of proper work attendance or proof for dismissal, as the case may be. People used to visit government offices to find officials continuously "out to tea," are cheering.
- Online bidding mechanism for government contracts to eliminate bribes previously required by local officials.
- Implementation of a plan to assign every citizen with an electronic identifier similar to a social security number, with the goal of bringing more and more citizens into the system.

- Elimination of red tape and number of steps/inspector visits required for licensing and permits to rein in and eliminate corruption and bureaucracy, including growing ability to go online for many functions previously controlled by systems of patronage, reducing the cost of doing business for many small businesses.

Of course, the dislocation caused by all these simultaneous changes was, and continues to be enormous. Yet Modi's multiple gambits that he could pull-off previously unimaginable change all at once, in his first 5-year term no less, have born enough fruit to back his equally unbelievable election victory, a notion supported by the following examples:

- The World Bank's latest "Ease of Doing Business Report" showing that India has jumped from a rank of 100 to 77, described as historic & unprecedented.
- A clothing company went from having to pay 17 taxes to 1, but had to pay a national tax of 5 to 12% instead. Some of that, however, could be recouped if their "supply chain" companies (all very small businesses that were completely off the grid) paid their taxes. When the owner of the clothing company realized that he was in essence paying his suppliers' taxes, he quickly convinced them to sign up and pay their own share. And thus repeated many times throughout the economy, while this new tax regime has been disruptive and clunky at best to implement, at this point two years later it is on its way to transforming India's ability to generate tax revenue from millions of businesses they did not even know existed.
- A small company selling products to jewelry makers were regularly visited by 12 government agencies demanding bribes. Now just 3 are involved and licenses are issued mostly online, largely eliminating those costly bribes.
- A few years ago, the owner of a restaurant had needed approval of 32 regulators to open his new business. Every approval required a bribe. Now the number of regulators has dropped to 14 on its way lower, along with the bribes.
- The success of Modi's plan to install millions of public toilets has proceeded apace (close to a million already) creating a sense of greater dignity for many of the country's poorest.

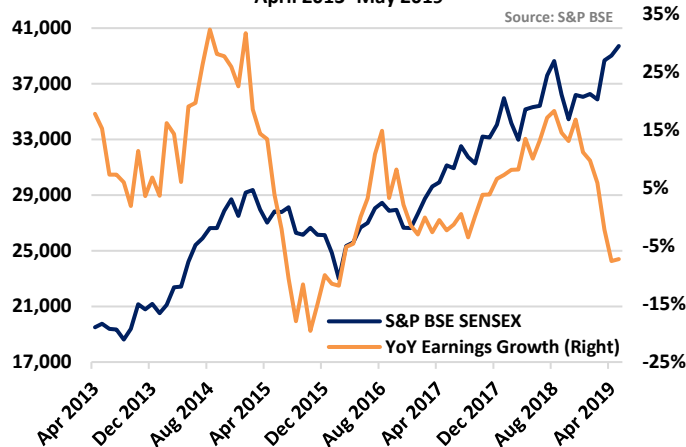
India's financial markets bounced to new highs following Modi's victory – however, we believe the election's repercussions are not completely priced in, and that there is still plenty of earnings growth coming down the pipeline:

- Daily fund flows into the iShares MSCI India ETF (INDA) spiked at the end of May, following the results of the general election. However, their peak was less than 2/3 of the highest levels of fund flows we saw following Modi's victory in the 2014 Indian general election. In that election, Modi actually had a weaker mandate than he does today with the BJP only winning 282 seats back then. As stated earlier, Modi's party now holds 303 seats. Since the beginning of 2018, fund flows are actually net negative.
- P/Es of Indian stocks seem to be heading into elevated territory, due to depressed earnings growth over the last few years. The Nifty-50 index companies' net profit rose only 7% last year, marking the fifth consecutive year of single-digit expansion in earnings. However, we expect more monetary easing by the Reserve Bank of India to boost downstream earnings this year and keep P/Es elevated.

SENSEX Price vs Earnings

April 2013 - May 2019

Source: S&P BSE

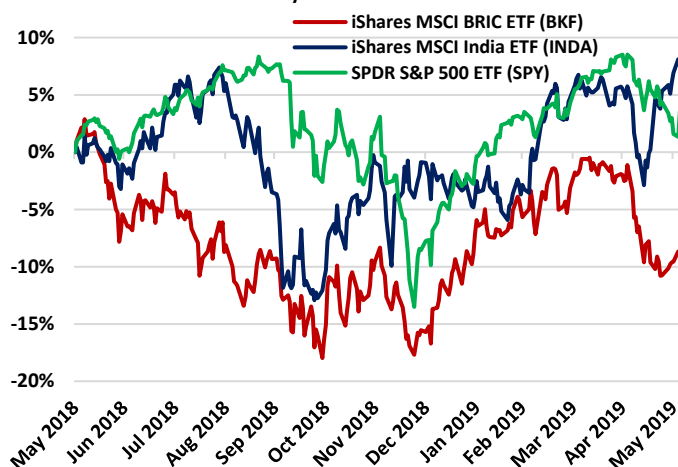


- Morgan Stanley cites more accommodative monetary policy in setting its target for India's SENSEX to 45,000 by this time next year. Modi's new Finance Minister, Nirmala Sitharaman, is due to present a budget on July 5 that many analysts expect to be expansionary.
- The INDA had been tracking the iShares MSCI BRIC ETF (BKF) in late 2018, breaking away from it briefly in early 2019, mostly due to China's weakness in the face of their ongoing trade war with the US. Uncertainty about the election saw the INDA sharply decline and break from its pattern, which looked like it was headed for a breakout. But now, the INDA looks like it's back on track and outperforming the BRICS handsomely. Our expectation is that it will continue trending upward
- Originally, MRP initiated a LONG India theme on April 6, 2017, based on our belief that Modi's reforms were finally beginning to take hold. However, we suspended the theme on January 9, 2018 due to the widespread angst, unpreparedness, and confusion wrought by Modi's demonetization. Over that period, we tracked the India theme with the INDA, and it performed just about on par with the S&P 500, returning 15% and 16%, respectively. At the time, we felt it would be best for investors to remain on the sidelines until there is greater clarity on whether Modi would be able to hold things together. With this latest election, MRP believes we finally have that clarity.

- BoAML told Bloomberg that they project India's Nifty 50 earnings to grow 24% in the next financial year. Morgan Stanley expects identical earnings growth for SENSEX companies in the same period. While that growth is expected to be relatively concentrated among financials, therefore making forecasts volatile, an oncoming easing of India's monetary policy is likely to mitigate some of that risk. Just this week, the central bank cut its benchmark interest rate, marking the 3rd month in a row that the Reserve Bank of India cut interest rates – the fastest pace of easing since 2013 – and changed its stance on liquidity from neutral to accommodative.

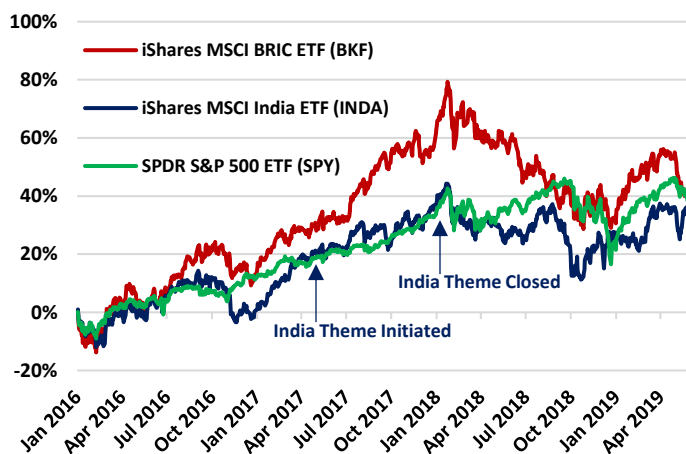
India (INDA) vs BRICS (BKF) vs S&P 500 (SPY)

May 2018 - June 2019



India (INDA) vs BRICS (BKF) vs S&P 500 (SPY)

Jan 2016 - June 2019



Investors should be aware of some challenges and expectations that greet Modi's second term, though, including:

- High and growing unemployment as Modi's promises of economic resurgence have been slower coming than the pledges his first term had assured. India's unemployment rate rose to 6.1% in the 2017/18 fiscal year.
- After surging in his first two years, direct foreign investment has tapered off.
- Continued dislocation from the demonetization has hindered needed fiscal progress.
- The need to modernize labor markets to accommodate the rapidly growing unemployed who hold degrees and advanced degrees is acute.
- Pollution of the country's cities and rivers and crumbling infrastructure remain endemic.
- While Modi has enormous backing from India's 80% Hindu majority, ethnic divisions are huge and growing.

It remains to be seen if Modi will be more successful with his "end game" during the next five years, but even with the headwinds described, it is instructive that we are talking about what is still the fastest growing of any major economy in the world, with the youngest work force, and a standard of living that, while far to go, has improved substantially.

And now, a rejuvenated and fully empowered Modi, with broad legislative support and no unions or yellow-vests in sight to derail his momentum, can look toward a third term, which would deservedly place him in the midst of the most revered of the great Indian leaders.

All of which speaks to why MRP now adds India as a thematic opportunity whose time has come! As mentioned earlier, MRP will track this theme via the iShares MSCI India ETF (INDA).



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