JON THORN/INDIA CAPITAL FUND MANAGEMENT

Fiscal populism is a one way gate, and Modi knows that

By Joji Thomas Philip
joji.p@livemint.com

SINGAPORE

India Capital Fund Management Ltd's co-founder and director Jon Thorn says that India is the lone bright spot among emerging markets (EMs). "India's macro picture is so much better than the rest of the emerging market world—lower oil prices, falling inflation; (interest) rates will fall, maybe a lot, the cycle is turning and not surprisingly, some Indian companies are producing double-digit EPS (earnings per share) growth," he said in an interview. Edited excerpts.

When you spoke to us in June 2014, you said the Narendra Modi government only needs to do one thing—get the goods and services tax (GST) Bill passed. But it now appears GST will miss the 1 April 2016 rollout target. How big is this a concern for you? Will the GST delay hamper growth?

It will definitely happen and, I believe, soon. GST is the axle of both fiscal consolidation and of less economic friction—meaning, it will reduce companies' operating costs. Removal of domestic state tariffs could add 1-1.5% to GDP (gross domestic product). Modi and finance minister (Arun) Jaitley have invested a huge amount of political capital in this and the negotiations with the states are basically done. The last budget at the end of February only makes sense with GST in place or arriving soon as it changes how the centre and the states carve up the budget pie. Opposition has come from Congress and some other parties—the delay in GST will slow growth a little but there are other strong growth drivers for India.

Is India a safe haven for investors that still want to invest in emerging markets? Does it continue to be a rare bright spot among emerging markets?

I would say it is the only bright spot among EMs. It is a commodity consumer, not a producer, as so many EMs are—India is one of the biggest beneficiaries of the falling price of oil. Also, as exports are a small part of GDP, a global slowdown does not hurt it much: for India, exports as a share of GDP is 25%. At the other extreme, for Hong Kong it is 230%. Also, Indian GDP growth is currently accelerating. It is over 7%. I cannot think of anywhere else you can say that about. India is currently in a cyclical recovery—also, perhaps, a unique case, or certainly a rarity.

Can the falling rupee revive Indian stocks?

Whether the rupee falls or rises does not have a major impact on GDP, say like the yen or the won, as exports are so low—a strong or at least stable rupee would however reduce corporate India's commodities' bill so it would be marginally better. The rupee has, however, weakened out of a misplaced sympathy with other EM currencies.

You invest exclusively in Indian equities—how do you see the markets going forward?

We are very bullish. India's macro picture is so much better than the rest of the emerging market world—lower oil prices, falling inflation, (interest) rates will fall, maybe a lot, the cycle is turning and not surprisingly, some Indian companies are producing double digit EPS growth. That's very nice.

Also valuations are attractive. You make most money by buying cheap into a growth cycle-that's what we have now in India. There was approximately $14 billion of market outflows from mutual funds during 2009 to 2013, but for this year-to-date, we have seen inflows of $5.6 billion.

When you talk to other foreign investors, what impression do you gather about India?

India's greatest strength has always been its biggest problem, in the perception of non-specialist investors. It's a messy democracy, and somehow investors think they like the certainty of dealing with an authoritarian government. They say, 'you can get things done. Yes - but just don't ask the citizens of those kind of countries if they would like to have more say in how their countries are run. India is also very complex and it is just simpler to revert to stereotype descriptions about India, rather than try to understand the complexity of what is going on there. And in spite of, or maybe because of this complexity, it has produced industry champions. India has world-class pharma, IT (information technology) and auto industries—there is not one other EM, including China, that has such a world-class corporate landscape; in short India has a real private sector.

STREET WISDOM

As someone who has been investing in Indian equities for over two decades, is this the time to be contra buyer in public sector banks?

Yes, it's 21 years now—we started on 1st September 1994. That's a very long time but I can honestly say I have never been bored... Value is good but it is less good in a growth economy. The public sector banks are cheap yes, and are in line to raise some capital which will help their balance sheets. Frankly they need it -- we don't own them as for the next 5-15 years, the better private sector banks and finance companies will grow faster and with less dilution.

It is quality stocks that have been driving the market—how long can this continue? When will growth drive the markets? These quality stocks can't endlessly hold up the markets?

Yes, in contrast to the public sector units, which are very cheap for a reason, the 'quality stocks', the FMCGs (fast-moving consumer goods), are expensive for no reason. They are not growing so well and they are looking at higher costs. I cannot see a reason to own them.

What is your verdict on Raghuram Rajan's two years as the Reserve Bank of India (RBI) governor. Do you think he should have been more aggressive in rate cuts to prop up GDP growth?

Governor Rajan is the most disciplined central banker in the world. That is a fairly general consensus even among his peers. He has been clear on the RBI's mandate and has not been swayed by Delhi. Corporate India has had a campaign for a while to vigorously express their view that rates, real and nominal, are too high. Rajan has been steadfast in saying that he wants to control inflation—the corporate world should be careful what they wish for: they have forgotten the old high inflation days from not so long ago when they suffered from rising costs and often couldn't always pass those on for long periods.

Instead, look at Rajan as India's Paul Volcker—the man who got US growth going. As an investor, lowering inflation expectations is the most important thing he can do. I think he will lower rates perhaps twice in the near term. He will cut when he is confident that he should.

When looking at India, do you think that Modi's economic reforms have lost momentum and there is a sense of drift in economic policy?

As in any political game there is the easy stuff and the harder stuff. He did some of the easy stuff—cutting fuel subsidies and indeed raising the taxes on it, and kick-starting India's diplomatic ties. He has also done some really hard stuff—raising FDI (foreign direct investment) cap levels in insurance and defence from 26% to 49%, and cutting much bureaucratic red tape to make it a lot easier to do business in India.

Also, the coal auction has been in my view the most surprising and successful thing he has done—the old coal auctions were reversed, and many re-offered in an astonishingly short time frame.

He is also on track to boost nuclear (power), natural gas, solar (energy)—all of which are the foundation for solving India's energy shortage. That was hard and yet it took less than a year. The results will also take time to show through, hence he has done all this early.

So I don't agree at all with the revisionist view that he is not doing anything. The people who say that either have an agenda or are simply not looking carefully enough. If they were to go to Delhi and talk to the top civil servants, they would go away with a very different impression. Delhi is racing around in an activity panic. They now have to key themselves in and out so that Modi knows whether they are in the office or not. I don't think many political leaders would have the guts to try that scheme.

The setbacks—for now, the GST and the land bill—were always going to be problematic. They are hard, but they will get done. Also the land bill is not urgent. Infrastructure projects can get all the land they need. In the private sector, the new state of Telangana in the middle of India, for example, is placing newspaper adverts that it has a land bank of 150,000 acres to offer to industry.

So, going forward, to address the perception issue, do you see the Modi-led government not acting or back-tracking in some reform areas, and do you also fear a revival of fiscal populism?

I don't fear that—fiscal populism is a one way gate, and he knows that. Once you go through, you sacrifice very much of the future. The budget and trade deficits are now at near-term record lows. A surprisingly large number, especially of younger Indians, understand this point and few wish to go back to what was in the past—they want Modi to invest in their future.

Why has the investment cycle not turned?

Corporate India is generally in good financial shape but is not yet confident enough to start on a new capex round. They want to see lower rates, stronger final demand and some animal spirits. In a curious way, I believe, this may be about to happen: Reliance (Industries Ltd) will shortly launch the RJio (Reliance Jio Infocomm Ltd's) 4G Smartphone. This is going to shake a lot of things up and will drive every young kid who can afford it into a store to buy one, and start using it. There is a good chance that this may be the 'zing' we need. Of course, if the global news gets worse, then there will be a zing delay.

But if you were to look at either Index of Industrial Production (IIP) or trade data, it does not indicate that earnings recovery is happening. So, are we far away from an economic pick-up?

It's early days. Retail inflation is down to 3.7%—Goldman Sachs has come out with a report to say that India can grow at a potential 8% or even 9% if reforms are even faster over the next five years, IIP is not so bad, and some companies are reporting strong revenue and EPS growth—for the latest financial year, our portfolio's EPS growth exceeded 25%. Maruti has a 50% market share in cars and its sales volumes are growing at 14% y-o-y. That alone suggests that there is robust, if selective, demand.

Your take on China—are markets over-reacting?

Not the end of the world. Over-reacting. Next question? No, seriously, China is changing, not collapsing. And China is not very good at changing and its government is not very good at a number of things, especially at managing a stock market. But China has a lot more money in the bank than most other countries; it therefore has more options than most others. Services are now a larger part of GDP than exports, so this plan, at least, is going along as intended.

You've seen the 1999 crisis as well as that of 2008. Where does the current crisis compare?

Yes, there is always a crisis somewhere! 2008 was a potential catastrophe that was averted. In the context of a list of crises, ex-2008, we are now either in a larger small crisis or a small mid-sized one.

An important part of the problem is that we face some long-term issues; Europe is aging and can't sort out its structural problems—the US Fed can't work out whether it works for the world or for US citizens, and China has to grapple with a slowing economy and a speculative stock market.

There are long term problems in the commodities—prices are not going up again for a while and many of them have not invested those recent surpluses. It's important how countries respond to this challenge—some will have it harder, like say Russia, and some much easier—India.