SOM
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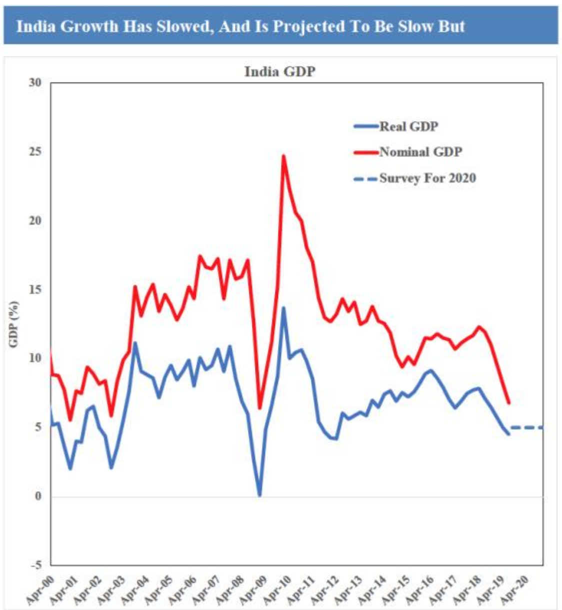
State Of the Markets: Macro Commentary

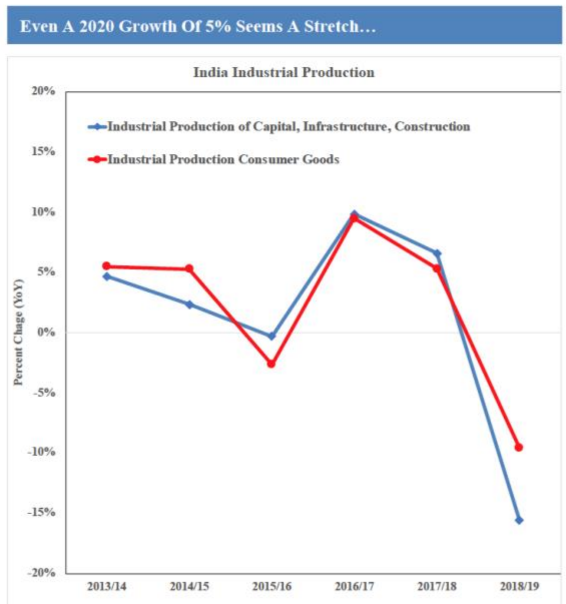
India: Bad Is Good And Worse Is Even Better—Part 1

In my last client visit of 2019, a PM pitched me on India upside. I thought the pitch was compelling but told him I had not done any work on India for quite a while but would spend some time and come up with a view. My first step, as always, was to build an economic framework on India. After building this framework, I think he is right. However, I hold this view not because I think the slowdown in India is over. Quite the contrary, my basic view is that India is in even worse shape economically than the recent bad news would suggest. Further, it is very likely that their economy will continue to slow to levels much below the recent survey of their projected 2020 real growth of 5%. It is that very slide in growth--the worse--that will generate a substantial set of stimulus packages by India that will reprice assets. I will lay out my thesis is three parts. In Part 1--the subject of this commentary--I will talk about my economic framework that supports a lower level of sustainable growth for India. In Part II, I will show the factors that are driving the current slowdown and highlight potential channels for stimulus. Finally, in Part III, I identify the catalysists that will drive India asset prices over the next year and my recommended asymmetric trade strategies.

My case for India having a sustainable growth trajectory near term closer to 4 to 5% rather than the 7% post-2011 levels starts with Figure 1 below. The graph on the lefts underscores the suddenness of the recent drop in economic growth in India. However, the government believes that the worst is over given their projections of 2020 growth.

Figure 1[1,2]

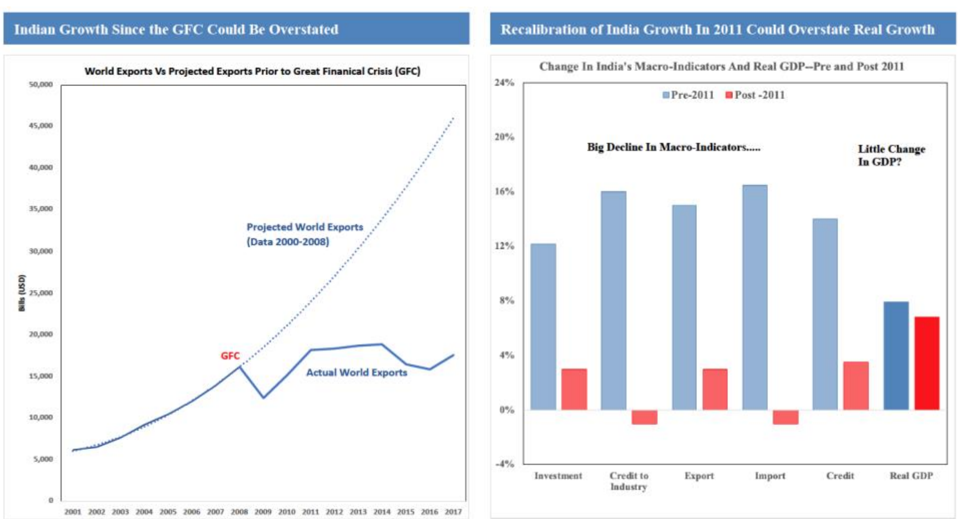




I should also add that most agencies, IMF, World Bank, OECD and others project that growth will once again move back up to the 7% level from the current depress levels. However, I believe that we have not seen the lows of growth, which could fall substantially below 5% in 2020. The graph on the RHS of Figure 1 shows that both the investment and consumer sector has basically cratered. Difficult to believe that these sectors could rebound and push up the overall level of economic growth above zero without substantial government support. But the potentially bigger issue is that a rebound to a 7% level, typical of the post-2011 Indian economy, is very unlikely. The 5% level of growth might not be a depressed level but rather the new normal… at best. Let me turn to Figure 2 to explain.

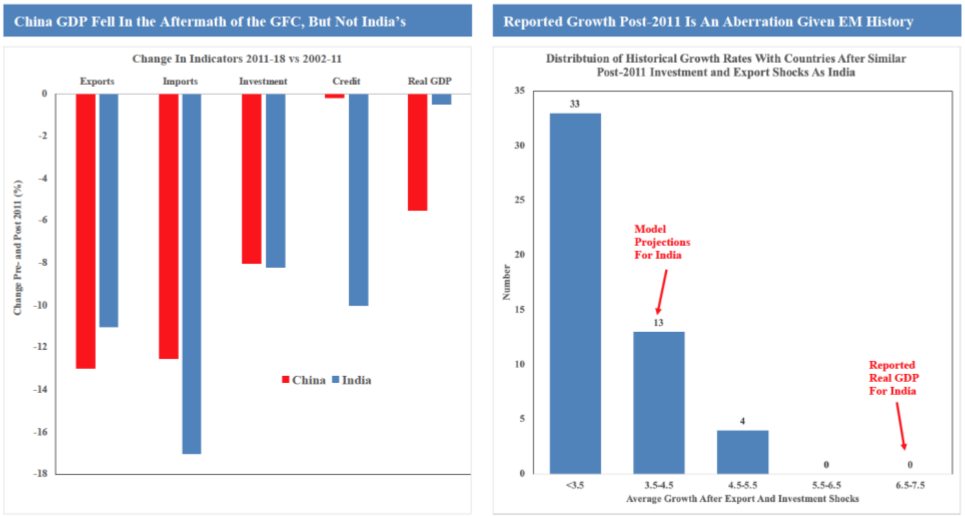
As I have talked about in other pieces, economic growth prior to the GFC was inflated by a number of factors. (Much of this work comes from Arvind Subramanian, the former chief economic advisor for Modi.) Economic growth slowed around the world after the GFC as those factors disappeared, reflected in the flatlining of world trade, as shown in Figure 2 on the LHS. Surprisingly, India growth seems to have been largely unaffected. As shown on the RHS of Figure 2, while macro factors India fell substantially, growth post-2011 looks pretty similar to growth pre-2011. The relevant question is why? One likely explanation is that India recalibrated their data on economic growth and the factors that went into calculating growth in 2011. Okay, so either economic growth pre-2011 was substantially understated, or--as I believe--post -2011 is overstated. Look at Figure 3.

Figure 2[3,4]



On the LHS of Figure 3, I show a comparison of the impact from the GFC on China and India. Both countries experienced similar shocks to major macro indicators. However, China growth fell substantially while growth in India is about unchanged. This is an even more unusual result if history is any guide. On the RHS is the results of study looking at the real economic growth in other EM countries after a similar shock to exports and investment. India's post-2011 growth is an outlier versus growth in 60 times that other EM countries with similar export and investment shocks. A model that incorporates these shocks would have predicted Indian growth at the 3 to 4% range.

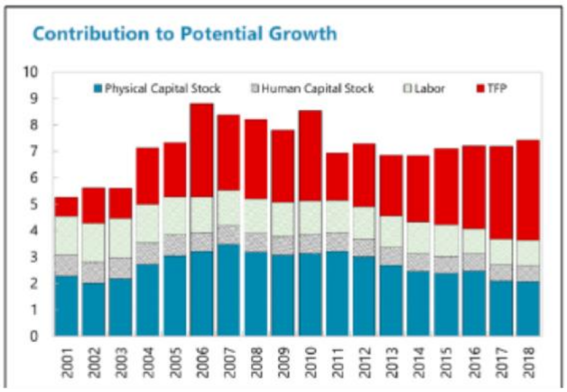
Figure 3[4]



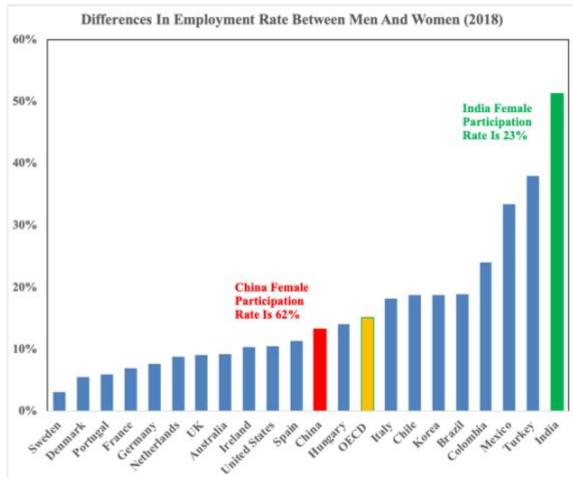
So, a good question to ask is why isn't this reflected in projections of India economic growth. The answer is simple. Empirical model of India growth are built on data and that data is being spun out of India has the inflated economic growth in the 7% range. This was a similar problem with rating agency subprime default models that were fit on the 2002-06 data. That data reflected a substantial improvement in default behavior for subprime borrowers. So, they refit their model to reflect these lower default levels by assuming a fudge factor of better underwriting. As a result, their credit support levels went down. . Of course, the missing piece driving the better performance was the impact of rising housing prices on falling default levels. Something similar is happening now. As shown in Figure 4 below on the LHS, empirical models of India real growth are trying to fit data that reflects a 7% historical growth level, while factor driven growth is falling. The solution is a fudge factor called total factor productivity to plug the gap to 7%. But then what is driving this surge in productivity in India? As shown on the RHS side it is not from women workers coming into the work force replacing men that have lower productivity.

Figure 4[5,6]

India's Slower Factor Growth Offset By Fudge Factor: Productivity



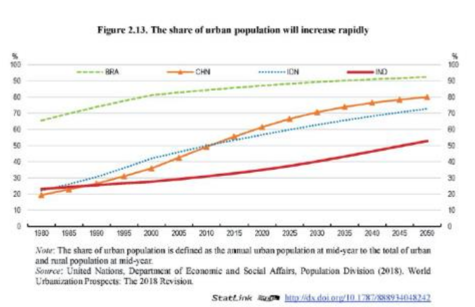
Where Is That Productivity Coming From? Not From Women…



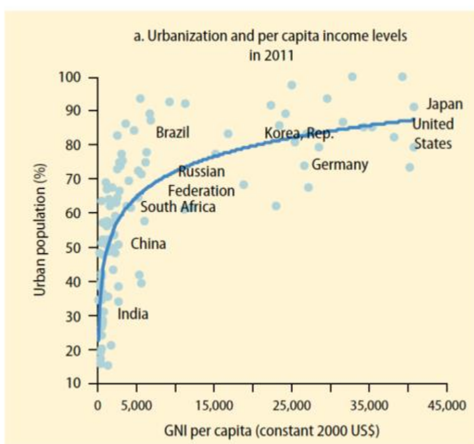
It is also not coming from urbanization. In the graph on the LHS of Figure 5, I show that India is far behind China and other EM countries in process of urbanization. And as shown on the RHS, urbanization is the typical path for EM economies to accelerate growth.

Figure 5[6,7]

It Is Not Coming From Urbanization

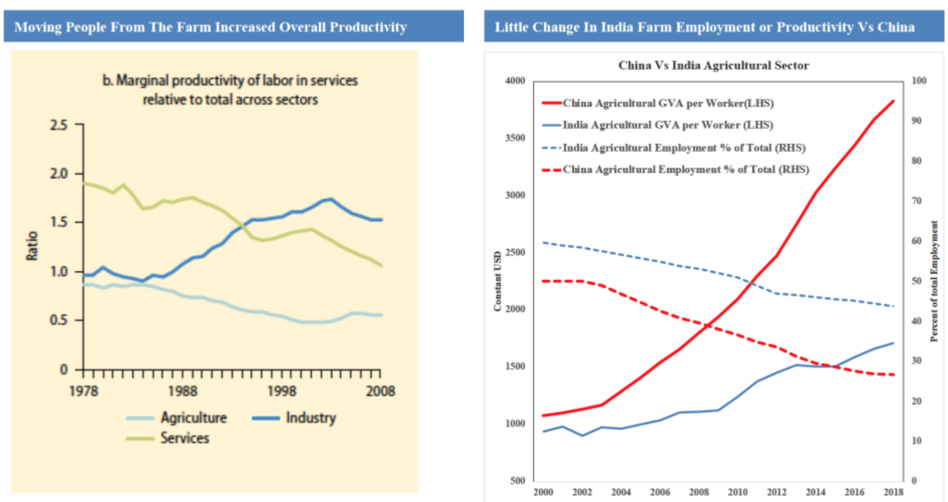


And Urbanization Was Historically The Path To Growth



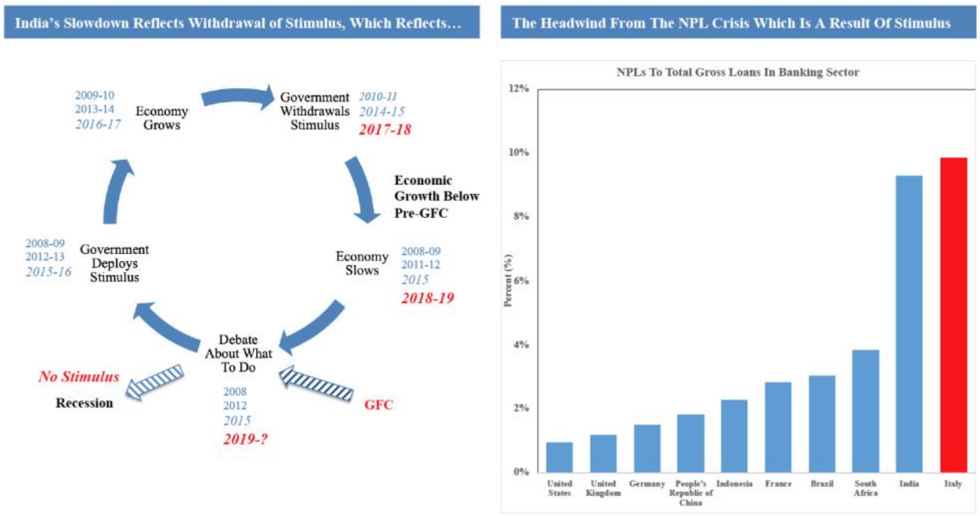
As shown in the next Figure 6 on the graph on the left, urbanization accelerates growth through increasing productivity by pulling people from the lower productivity of farming to the higher productivity of service/manufacturing. The slow pace of urbanization in India has left a substantial percent of their workforce (40%) in the lower productivity activity of farming. This is particularly apparent versus China and is exacerbated by the lower productivity level of farming in India vs China.

Figure 6[7,8]



This brings up the more important question of why is the Indian economy tanking now? Clearly, this problem of overstating growth has been around for a while. Well, the answer is pretty much the same story as has happened around the world: withdrawal of stimulus slows an economy back to lower sustainable levels, but it creates more downside as legacy issues surface such as stimulus leading to lending too much credit to many bad borrows. This is the same economic growth/stimulus cycle I have highlighted many times before as shown in Figure 7 on the left. For India the catalysis for the downward spiral of their economy is the same factor that drove the GFC, credit/NPL cycle. As shown on the RHS, NPLs on bank balance sheets (other sectors also have an NPL problem as well) led to a cratering in the corporate sector. But that is the topic I will address in Part II. And I will be pitching India upside, I will leave for Part III.

Figure 7[7]



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