

Reversion to the Mean in Politics and Investing

Our desire to see India change for the better results in us overestimating the pace of change in the country in the short-medium run. This creates valuation anomalies that one can profit from. Selling wholesale market funded lenders and buying IT and pharma stocks would be the obvious way to profit from disruptions in the market's pre-conceived notions of change in India.

“Falling farm incomes in rural Maharashtra might be an important factor fuelling the current spate of protests by the Marathas, who are demanding reservation in educational institutions and government jobs. The net returns from farming....declined for most of the major crops in the state between 2006-07 and 2014-15, reveals an analysis of data available from official sources...” – howindialives.com quoted in The Mint on 2nd August 2018

The India which changes...

When I moved to India in May 2008 I met several people who believed that the country was changing for the better. Within months the global financial crisis engulfed India and no sooner had the after-effects of that worn off, the country was hit by a series of major corruption scandals which jammed the capex cycle so comprehensively that it still hasn't recovered. Investors who had bet on capex-centric stocks a decade ago obviously suffered in the wake of this savage reversal in the capex cycle.

More recently, for the first time in Indian history, we are seeing annual flows into financial savings exceed those into physical savings. The cost of capital has fallen – the ten year bond old is between 7.5-8% now whereas it was 1.5x that rate at the turn of the century. Availability of debt and equity capital for SMEs seems better now than it was a decade ago not least because of the existence of numerous private sector lenders (who borrow funds from an active wholesale money market). Direct tax collections are growing at 18-19% per annum every year and the early signs with regards to GST are promising.

So why is it that inspite of these positive developments over the past decade, the country finds itself with a burgeoning current account deficit (expected to be close to 3% of GDP in FY19 as against 1.9% of GDP in FY18), a weakening currency (the INR is down 7% versus the USD in CY18 so far), incipient inflationary pressures (at 5% the CPI is well above the RBI's target of 4%), rising interest rates (the ten year bond yield is up 150 bps over the past 12 months), a broken banking system (stressed assets account for 12% of loans outstanding) and a comatose capex cycle?

...interplays with the Indian which doesn't



There is one major constant in India - the interplay between the Government and politically active voters - is stubbornly resistant to change. Most readers of this piece do NOT constitute a politically active vote bank because they do not act in concert to lobby for subsidies and favours. Politically active voters are not only farmers, they are not only rural voters but they also include their extended families who might have migrated to the cities (but who are firmly plugged into rural politics for reasons which seem to revolve as much around identity/caste/jati as economics).

Most of these politically active vote banks still do not have robust sources of income either because they are working on unproductive asset (eg. as a hired labourer on a farm) or because they can be squeezed very easily by more powerful agents in the supply chain (eg. agricultural middlemen who control the APMC wholesale markets and who themselves are skilled political lobbyists). Hence the economic viability of these political active vote banks hinges on the largesse of the Indian state for things like NREGA (which puts a floor on wages for farm labour) or farm loan waivers or subsidised fertiliser (both of which are mitigants for the rent seeking activities of politically connected middlemen). It is not surprising therefore that spend on NREGA has risen at a CAGR of 17% over the past 5 years. Farm loan waivers are expected to rise to US\$40 bn (1.5% of GDP) by the General Elections next year and the fertiliser subsidy accounts for 3% of the Government's spend. Anyone who believes that these numbers will drop then has to convince the rest of us that the central narrative in Indian political life will change.

Handouts aside, there is another route via which the politically active vote banks draw succour from the Indian state. The state is the main provider of healthcare (low cost medicines, dispensaries), education (free schooling and subsidised colleges), power (electricity and kerosene), transport (roads, trains, buses) and law & order (cops, courts, not mobs) for these groups. Whilst the quality of these services that the Government provides is uneven, increasing the outlay on these items gives political parties more leverage on their vote banks. Overall Government spending (the Centre plus the states) now stands at 26% of GDP down marginally from 28% 15 years ago.



Investment implications

The dynamics of the great game creates some macroeconomic constants which one can use to invest profitably in Indian stocks:

1. The low productivity of labour and of farm land reduces the overall productivity of the Indian economy. As a result, to stay competitive, the Indian economy needs the INR to slide by at least 3-4% per annum to the USD. When such a devaluation hasn't happened for five years and when one can see that the competitiveness of exporters (of goods and services) has been damaged then one knows that a major correction in the INR is overdue. Hence my reckoning is that the INR will breach Rs 70/USD with oil prices and domestic inflation being the obvious catalysts for this. Therefore, as I have been saying for the past 8 months, buying leading IT Services, Pharma and Chemical exporters make sense as does unearthing smaller companies who have credible export franchises.
2. This November three key northern Indian states will head into Assembly Elections and then the General Elections beckon. Hence as we move into the festive season, one should expect money to be showered on vote banks, inflation to rise (as low income voters splurge their cash) and interest rates to rise (in response to inflation rising). This has two straightforward investment implications – one should buy companies which make money in rural Indian (FMCG, tractor and two wheeler companies) and one should sell lenders who borrow money in the wholesale market (especially if these lenders lend to urban consumers like you and me).

Saurabh Mukherjee is the author of "The Unusual Billionaires and "Coffee Can Investing: the Low Risk Route to Stupendous Wealth". The views expressed are personal.