

## Message in a bottle

May 2009 - Author: Jamshed Desai, Fund Manager

**The results of 15<sup>th</sup> general elections in India were unlike anything expected by the vast majority of people, including the political parties themselves and... yours truly. The Congress led UPA (United Progressive Alliance) emerged as the largest alliance with 262 seats, 10 short of the simple majority; while BJP (Bharatiya Janata Party) led NDA (National Democratic Alliance) won 160 seats. The Third (comprising regional parties and the Left) and fourth front (another set of regional parties previously part of the UPA) managed 79 and 28 seats respectively.**

This is a defining step for the 710 million people who were eligible to cast their vote this time. The 415 million who actually did cast their vote in the 1.2 million ballot boxes, have sent us some messages in a bottle this time, all quite loud and clear.

- i) The biggest positive to emerge is that the Congress party need not rely on coalition partners to sustain its parliamentary majority. This ought to give it enough latitude to govern the country and to push ahead with reforms in the manner it had always desired, but could not implement because of the presence of the Left parties' (who supported the previous coalition) objections on almost every economic policy issue.
- ii) It showed just how skin deep the allure of the regional fronts was. Almost all the regional parties had little to offer by way of what they would do if they came to power. In any case, each regional faction had its own view of the country and the world, which would be all too incoherent if they ever got together to run the country - and people clearly saw through that this time.
- iii) This is not just a victory for the Congress party alone, but a huge coming of age of the electorate which has discerned the importance of voting on matters of national importance and who sought stability, rather than voting around narrow regional issues. It could well have been a BJP-led NDA victory for that matter, and the country and stock markets would have rejoiced as much.
- iv) The anti-incumbency theory was flung out the window. For this, one had to look no further than the voting in the state of Maharashtra, of which Mumbai is capital and the capital itself, i.e. New Delhi. The anti-Government backlash post the 26/11 terror attacks was so strong, it cost the Congress its Chief Minister. In spite of such a negative sentiment, Mumbai returned all six Congress party candidates to Delhi victorious by wide margins. The story repeats itself in New Delhi where the Congress made a clean sweep.
- v) The Congress's ability to project Dr. Manmohan Singh as their clear Prime Ministerial candidate who is non-controversial, has a clean image and has been a vocal proponent (and a pioneer too) of economic reforms in India, helped immeasurably. The spirited campaigning by Rahul Gandhi and his mother, Sonia Gandhi (wife of ex-Prime Minister Rajiv Gandhi), this time also made a huge difference. The electorate wanted someone just like Dr. Singh and they will get him back without any rancour among the Congress party ranks.

On the other hand, a BJP-led NDA, whose leader Mr L.K. Advani is even older than Dr Singh, but whose leadership always had communal overtones and was seen as adversarial rather than a soft-spoken yet consensual one as Dr. Singh, also worked against it. The BJP's communal leanings make it less palatable to alliances with other regional parties, all of whom are mostly secular in character.

- vi) The final message in that bottle is that India is now ready to shed the last vestiges of communism where it existed. The Left parties have been marginalized this time in their traditional bastions and have won a grand total of just 24 seats compared to 60 last time.

### Outlook for the stock market and economic governance

This result has sparked off huge investor expectations. Ahead of the election results, most investors of all ilk, including ourselves, were sceptical about their outcome. Sentiment among domestic and foreign investors is bound to undergo a sea-change now, and much of the earlier scepticism will be replaced with at least cautious optimism. A vast majority of investors, including the retail crowd, have been underweight or under-invested in Indian equities, choosing to sit on piles of cash. This pile of cash, plus the correction of portfolio positioning in India, will make valuations subservient to such technical considerations in the short to medium term.

However, the stock market will now look forward to some important milestones in the weeks ahead, the first of which will be the formation of the new Government and allocation of Cabinet portfolios. The Congress party will also, therefore, retain all the key portfolios, barring one or two which may be shared by its two key partners the DMK from the South and the Trinamul Congress from the East. The second important event will be the Union Budget for the FY09-10. This should be the first policy document which will mould and fashion the fiscal correction process and also lay the path for reforms in future. Clearly expectations will run very high from where short term disappointments on content and quantum are very likely.

One of the key factors that propelled and pummelled the India growth story thus far was the external funds flow factor in both directions in the last few years. A rise in general global risk appetite, coinciding with the positive resolution of politics, rekindled hopes of reforms form a perfect recipe for India to come right back on the emerging market centre stage for the remaining part of 2009 and into 2010. India's soft spots last year were the widening current account, aided by rising oil prices and huge portfolio outflows, and could very easily reverse now given that oil prices are unlikely to stage a rally anywhere close in its ferocity. This could lead to the currency strengthening sharply from here, reversing much of the under-performance that Indian equities have suffered in the past year.

### Macroeconomic implications

Specifically, this government now has the chance to enact some of the policies that were blocked by coalition partners before. One can envisage the economic benefits of such actions to be divided broadly into two:

- 1) Provide greater access to foreign capital: India, being a capital deficient economy, could see substantial capital inflows through the FDI and portfolio routes. Further liberalisation of policies in areas such as retailing, insurance, defence etc., are required.
- 2) Rebalancing the fiscal problem: India's combined fiscal deficit would reach around 11-12% this year. The immediate task would be to reduce it sharply without sacrificing growth. Rather, the twin objective would be to balance it in such a way that GDP growth remains supported above 6-6.5%, even as the deficit is crunched. This can be achieved initially without necessarily resorting to harsh measures such as an increase in taxation.
  - a. Privatisation may be regarded not as a policy in itself, but more as a means by which fiscal imbalances can be quickly improved. It can cut Government debt by raising capital through the path of least resistance, i.e. sell off residual Government stakes in public sector companies, auction 3G licenses, etc. This will lead to lower interest costs for the Government and prevent it from crowding out the private sector from the debt market.

- b. Attack subsidies in the system with missionary zeal - fuel and fertilizer subsidies being the main ones, especially at a time when oil prices are soft relatively and where political resistance would be least.
- c. Liberalise access to sectors like retailing, insurance and banking so as to attract greater FDI. Additional capital inflows through the capital markets would combine to reverse the weakness of the Rupee structurally. Remember that the Reliance Industries gas and Cairn Energy oil over the next few years will be additional positives towards improving the position of balance of payments.

The stock market will view all this with optimism as a consequence of the likely change in the macro-environment arising out of:

- 👑 the bond yields trending lower
- 👑 the rupee strengthening
- 👑 inflation remaining low
- 👑 infrastructure projects backlog being cleared owing to better availability of domestic and foreign funds
- 👑 return of foreign investors - lower risk aversion, lowering of risk premia for the market as a whole, leading to positive re-rating of the market
- 👑 earnings upgrades likely, though only moderate in FY10, but could be stronger for FY11. This could make the markets look less expensive as they do today on first appearance.