Investment Note

9 February 2017
For institutional investors

Investment note: India Union Budget 2017-2018 and RBI rate decision

On 1 February 2017, India's Finance Minister presented the government's 2017-2018 Union Budget to parliament. The budget offers the government's estimates of the country's financial health and fiscal priorities for the upcoming year. On 8 February 2017, the Reserve Bank of India (RBI) announced it would keep interest rates on hold.

Manulife Asset Management's India Equities Specialist Rana Gupta views the 2017-2018 Union Budget as a stable, continuation of existing government priorities The budget's focus on consolidating the fiscal deficit and spending on core priorities, such as infrastructure and the rural sector, should reassure investors in an increasingly uncertain economic environment. Post RBI policy on 8 February, Gupta also believes an end to the rate cutting cycle is near, but, rates will remain lower for longer. These events reaffirm our conviction in financials, consumer (staples and durables) and building materials related equities.

Three main takeaways from the latest Union Budget

On 1 February 2017, India's Finance Minister Mr. Arun Jaitley presented the government's budget to parliament. Overall, the budget was predictable and a welcoming continuation of government policy in key areas such as fiscal consolidation and reaffirming key spending priorities.

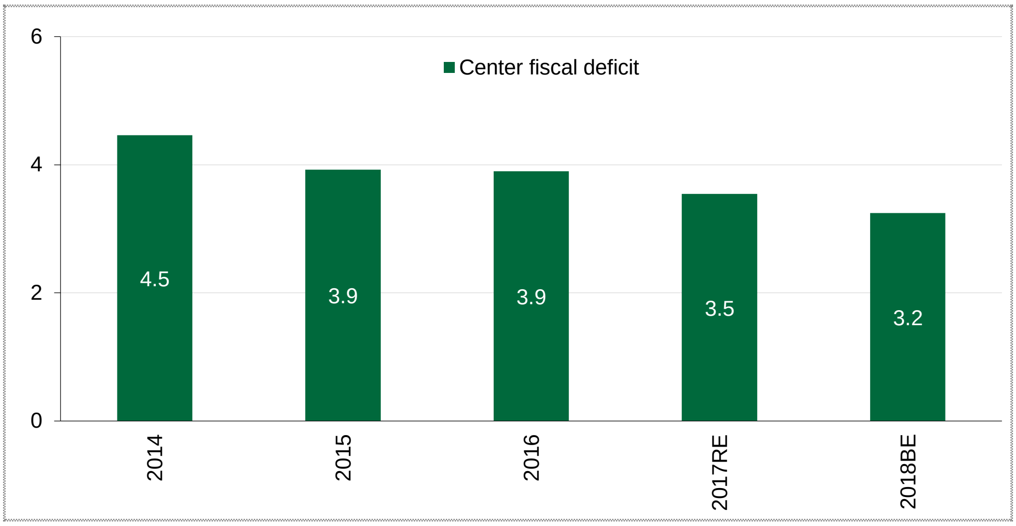
Three main takeaways from this budget support our current constructive investment thesis on India.

1) Fiscal consolidation remains a priority

We were encouraged by three developments.

One, the central government's fiscal deficit is forecast to decrease over the next two years: the 3.5%/gross domestic product (GDP) forecast fiscal deficit for financial year (FY) 2017 is estimated to decrease to 3.2%/GDP in FY 2018. As a result, the government will need to borrow less than expected over the budget, US$52 billion, a 3% year on year decline from previous levels. The government did not introduce populist themes that might illustrate a potential loss of discipline.

Chart 1: India's central government fiscal deficit, 2014-2018[1]



Second, the Finance Minister made conservative financial assumptions. The assumption of top-line revenue growth of 8%, with tax receipts growing by 12%, seems reasonable. This is particularly so as the government has not factored in potential revenue gains from the demonetisation policy. Any gains from the current voluntary income disclosure scheme would provide further upside to revenue estimates and additional fiscal room. Finally, expenditures are tapped to grow 6%; however, the quality of spending is increasing: investment in infrastructure and rural areas (see point 2) will promote long-term economic growth.

Overall, we view that government estimates validate our view that revenue would increase on the back of improved tax compliance. This has positive knock-on effects: a lower fiscal deficit and lower borrowing costs for the government leaving spending for other issues. The government's goal of a 3.0% fiscal deficit by FY 2019 is reachable.

The government followed up on the demonetization policy. To discourage use of cash for large transactions, a cap on cash transactions was announced at US$4,400. Transactions above this threshold will have to happen through a formal channel like banking or digital, which can leave an audit trail.

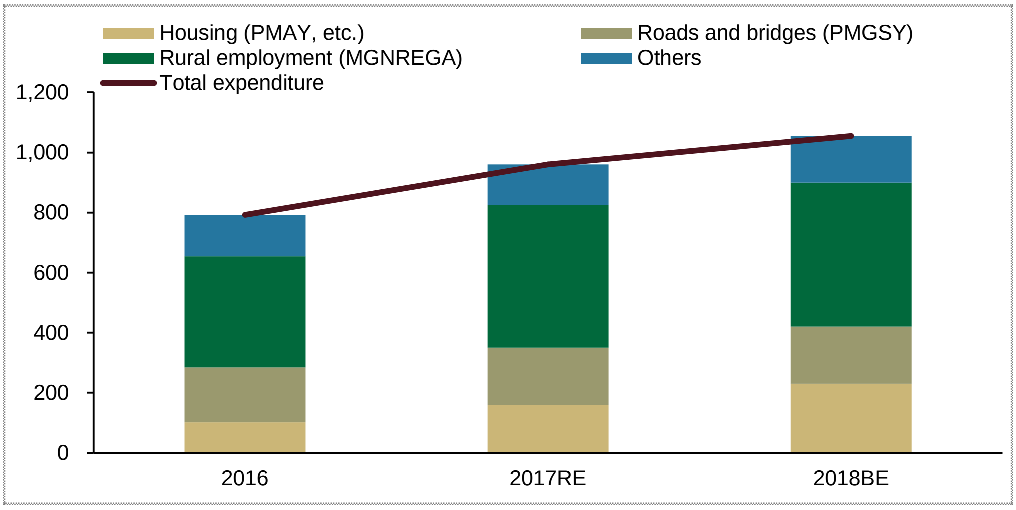
2) Improved quality of government spending

The majority of the 6% increase in government spending was for rural areas, affordable housing and infrastructure. This is in line with current administration priorities for building roads, water bodies, and housing. The budget had a 40% year on year increase for housing.

[1] Source: Reserve Bank of India, Kotak Institutional Equities

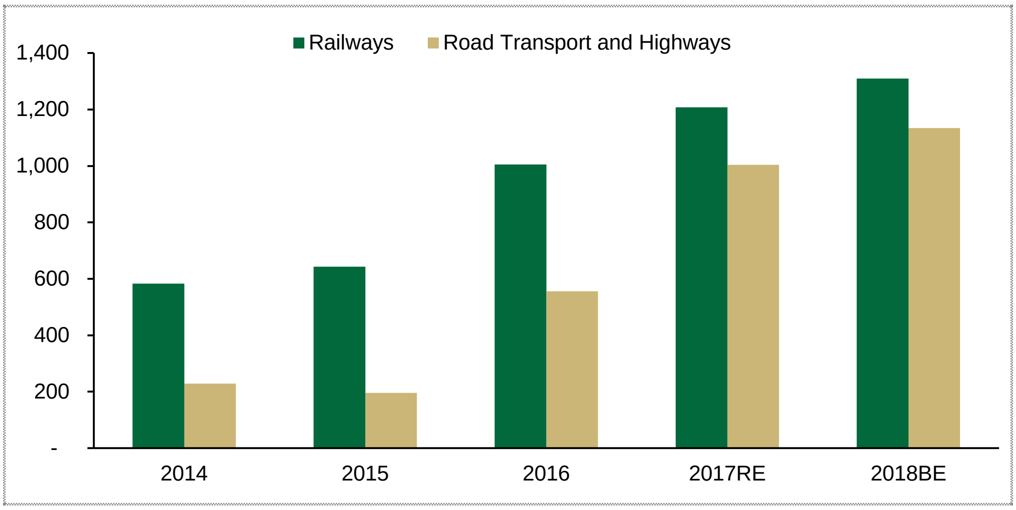
In addition, affordable housing now has ‘infrastructure’ status; this means related projects are eligible for lower interest rates and long-term funding from insurance and pension funds. They will also be eligible for tax breaks.

Chart 2: Spending on housing and rural infrastructure, 2016-2018 (E)



The government also increased spending on road and railways by 10.5% (year-on-year)[2].

Chart 3: Spending on railways, road transport and highways[2]



We view increased government spending for physical infrastructure in rural areas and transportation as a structural long-term positive.

3) Moderate taxation reforms

The government proposed moderate reforms for taxes. Tax rates on personal income for individuals earning less than USD 7500/ year were substantially reduced. Tax rates were also reduced for

[2]Source, India’s 2017/2018 Union Budget, Kotak Institutional Equities

small and medium enterprises (SMEs) with annual turnover of less than US$7.5 million per year. A feared tax on capital gains was not ultimately adopted by the government.

Stability and predictability in tax administration is welcome. The government's effort to widen the tax base and deepen formalization of the economy will eventually result in stable revenues and a reduction in tax rates. Higher revenues will also mean that the government will not need to borrow heavily leaving more savings for productive use

Takeaways from the RBI's decision

On 8 February 2017, the RBI announced that it would keep the policy (repo) rate unchanged at 6.25%. The RBI announced several reasons for the decision. First, it citied potential upside risks to the FY 18 inflation estimate of 4.5% including: 1) higher crude oil prices; 2) volatile exchange rates; 3) impact of higher allowances under the seventh pay commission. The RBI cited that the Union Budget's focus on fiscal consolidation should help mitigate such risks. Finally, the RBI also decided to withdraw all limits on cash withdrawals from savings bank accounts starting 13 March 2017.

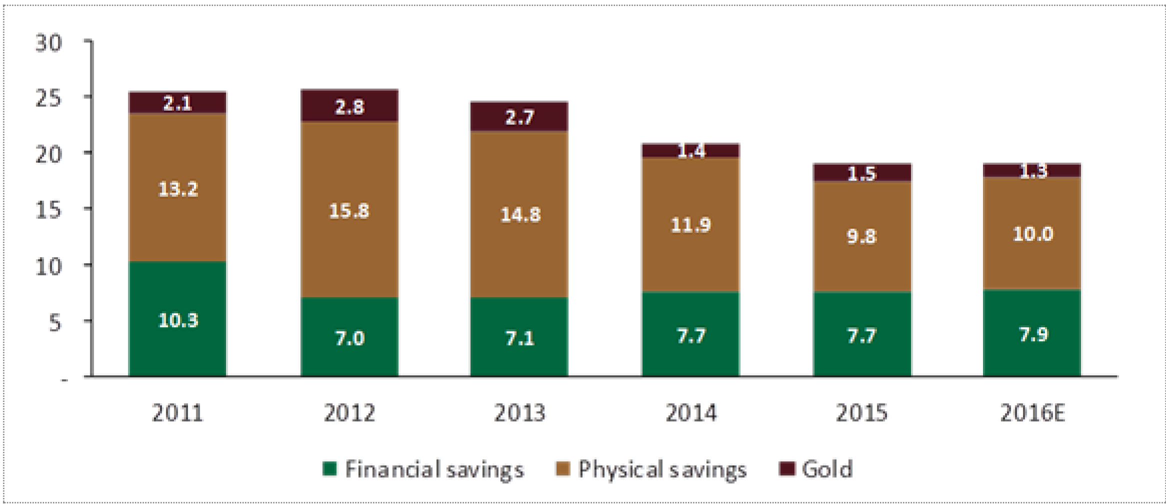
We believe that the RBI may be towards the end of the rate cutting cycle, as the Monetary Policy Committee has changed its stance from accommodative to neutral and reemphasized the 4% medium-term inflation target. Our base case is for a long pause given that our inflation estimates are in line with RBI estimates and real interest rates are significantly positive at current policy rates. The RBI's decision to withdraw all cash limits also shows that remonetisation is nearly complete.

Although markets focused on a potential rate cut, we think these larger trends in growth in household formal savings will drive the interest rate outlook:

1) Increasing formal financial savings

Households' formal financial savings are increasing due to higher real interest rates. We expect a further increase on the back of demonetisation, as more savings flow to formal financial channels over real estate and gold

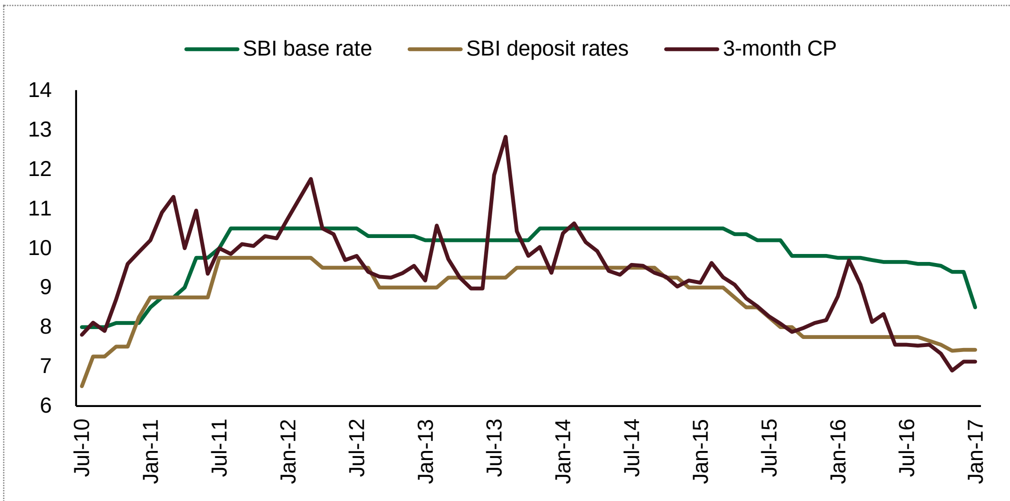
Chart 4: Trends of household savings as a proportion of GDP, 2011-2016E (%)[3]



2) Lower rate trajectory

The inflow of savings in formal financial institutions, coupled with fiscal consolidation and lower borrowing needs, is driving rates lower over time. More savings will be available at cheaper rates: Chart 5 shows decreasing rates over time for lending, deposit, and three month commercial paper. We think rates will remain low for an extended period of time, and growth should increase as lower costs of borrowing transmit through the economy

Chart 5: Trend of State Bank of India's (SBI) lending, deposit rates, and 3-month commercial paper[4]



[3] Source: RBI, Kotak Institutional Equities estimates
[4] Source: Bloomberg, Kotak Institutional Equities

Budget and monetary policy’s impact on our strategy

The budget’s continuity and spending goals align with our views on India. We remain optimistic on the domestically-driven story of India in times of increased global volatility. Our constructive view is underpinned by a positive view on the following:

- **Increased formal financial savings:** We are positive on financials as savers put more of their savings into formal financial savings institutions (e.g., bank and insurance) rather than real assets. As a result, the cost of funding will decrease resulting in both a deposit and lending rate cut. Formal financial savings are increasing due to higher real rates and the government’s crackdown on informal businesses, providing a simple and efficient path to join the formal economy- trends that are expected to continue.
- **Formalisation deepens:** The informal economy accounts for nearly 40% of India's GDP. Due to focused initiatives like financial inclusion, digital banking, indirect tax reform, demonetisation and increased scrutiny on income tax, we think it will be difficult for sections of informal economy to evade taxes. They will have to formalise their business and/or corporate sector will gain market share. We believe the formalization theme will be positive for consumer durables and consumer discretionary stocks.
- **Productivity improvements:** The government’s focus on providing physical infrastructure in rural India and in transportation will eventually lead to better connectivity, access to markets leading to more efficiency and productivity gains. Over time, this should translate in to rise in income levels in rural India. This is a positive development for building-related stocks.