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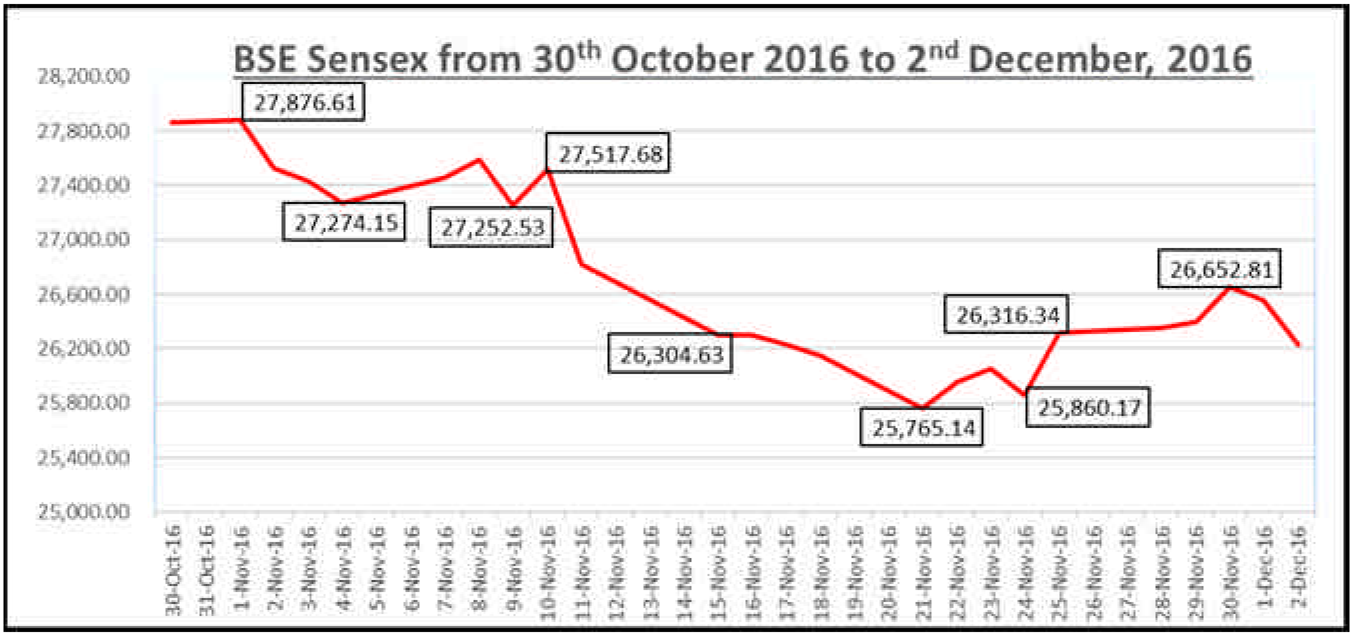
Demonetisation Drives Economy to Recession



Economic impact of Demonetisation

On 8th November at 8:15 p.m., when the entire nation was focusing on the outcome of the US Presidential election, Prime Minister Narendra Modi delivered a bombshell. He banned the use of Rs.500 and Rs.1000 currency notes as valid legal tender with immediate effect. The initial response was that of shock and awe and this step did receive widespread acceptance and accolades from the masses and the classes however, the implications sank in later.

As the days went by, the country came to a standstill as liquidity dried up and sale of goods and services declined precipitously. While the debate and discussion on the pro and cons of this government action continues, we would like to focus on the short-term impact of this rather daring move, more specifically the effect this will have on consumption.

Consumption Slows Down

Any economist will swear that consumption is what drives and economy and higher the consumption, greater the prosperity of the society. Savings and capital formation are important but most governments would not like to risk de-growth of consumption as its effects are extremely detrimental to the economy. Lower household spending leads to lower output, which in turn forces enterprises to scale back, and that in turn affects wages and income, which in turn further reduces consumption and a vicious cycle of lower income, declining prices and slower growth encompasses the entire nation. This phenomenon is called a recession and when it is quite severe, then it is termed as depression.

India, at present is in a recession. Production has slowed down significantly and the average consumer is trying to conserve / exchange currency. Spending is not a priority. One could argue that this is a temporary situation and once adequate new currency notes are in circulation, consumption will revive and we do hope that this logic is proved correct; but in the interim, corporate earnings are going to take a hit and that is the major risk factor to the stock market.

Base Effect and Negative Operating Leverage to Affect Corporate Profits

Furthermore, it is important to understand that levers which drive consumption are complex and there is an emotional quotient as well. Lower spending is infectious and once it sets in, rebuilding consumer confidence is a tall order. To make matters worse, this event has occurred at a time when revenues and profits for domestic focused companies are at all-time highs and the base effect of this in the coming quarters will mean that optically, the year-on-year comparisons, will appear to be extremely disappointing. There is also the negative operating leverage to contend with - as revenues decline but fixed costs remain static and margins are crushed and profit declines are even more sharper than drop in sales. This could dampen sentiment in stocks when quarterly results are announced in January.

Revival may be Slow and Challenging

The consensus view is that this recession will last at best for the December and maybe the March quarter and while we are in broad agreement on this count we are not convinced that lost ground will be recovered quite that easily. A more realistic scenario is that revenues will normalize but reaching pre-demonetisation growth rates will take months. Moreover, the recovery could be patchy and not across the board. Black money or the parallel economy was driving consumption or to put it more explicitly, conspicuous consumption and without going into the merits of this aspect, all that we would like to submit is that with lesser black money and higher taxes, spending may remain subdued. Simply put, if higher income tax is to paid and larger quantum of goods and services are to be paid in cheque (and at higher prices because of indirect taxes thereon), then there is less available for spending and that is going to have a negative impact on the GDP.

GST glitches and Higher Input Costs Added Headwinds

Complexities on this count will increase if GST is implemented in April 2017 as initial teething troubles could lead to further disruption and dislocation. The expected revival of the economy post the shock of the currency move may take even longer as it deals with the intricacies of a new indirect tax system. What is even more worrisome is that benefits on account of lower basic raw material prices like crude oil, metals, plastics, organic and inorganic chemicals and food items like sugar etc. will not sustain margin expansion. Rising input prices and the resultant pressure on profit margins, will limit the flexibility with corporates to reduce prices to boost sales.

Wait and Watch Approach

To sum up, we could be in the midst of a *"perfect storm"*. Consumer spending is on the ebb, input costs are rising, and there are GST implementation related risks, higher base effect of previous years and negative operating leverage may play havoc with corporate profitability and investor sentiment.

Our advice to investors would be to ride out this storm as the longer-term prospects post demonetization of high value currency notes will be undoubtedly positive for the economy and society at large. As more spending takes place in the official economy, government revenues will get a boost and that will create space to lower taxes and / or increase government spending, both of which are very positive for the economy. With huge deposits coming into the banking system, interest rates are bound to drift lower and that will also provide a fillip to industry and households through lower interest costs and EMIs respectively. Lastly, the impact of a smaller black economy on the choice of asset classes for deploying investible surpluses is an important factor to consider. Higher proportion of savings will be routed into productive assets such as stocks and bonds rather than land and bullion and that is a very positive trend.

Barrage of News, Events and Announcements

Over the next few weeks there are many important events and announcements which will have a material impact on equities. These are the

- Currency, bank deposits and tax collections in the wake of banning of Rs.500 and Rs.1,000 currency notes. This will determine the success or failure of this audacious step of the PM
- RBI Policy, where a ¼ to ½ percentage reduction in interest rates is widely expected
- Fed Meet which in all probability increase interest rates
- Italian Referendum on their parliamentary structure
- President elect Donald Trump will step into office and perhaps provide a road map to his controversial policies
- The Union Budget on 1st February where Income Tax rates could be cut
- GST implementation timeline announcement
- Earnings Season (December quarter) which could be the most important in decades as it will reveal how companies have navigated the currency crisis and more importantly, their outlook post demonetisation.

How these events will unfold will determine market sentiment going forward. In light of the uncertainty surrounding these events, we would like to adopt a wait and watch approach. Fresh investment may be contemplated if there is a sizable correction and most of the negatives are discounted.

The average returns generated by the portfolios under our management are as follows:

					ANNUALISED RETURNS AS ON	30/11/2016	From
Date From	**31/10/2016**	**31/08/2016**	**31/05/2016**	**01/12/2015**	**01/12/2014**	**01/12/2013**	**02/12/2011**
	1MONTH	**3 MONTH**	**6 MONTHS**	**1 YEAR**	**2 YEAR**	**3 YEAR**	**5 YEAR**
Elixir Equities Portfolio Performance	-7.75%	-7.64%	3.42%	6.11%	8.30%	20.07%	19.82%
SENSEX	-4.41%	-6.05%	-0.80%	1.99%	-2.59%	5.05%	6.77%
NIFTY	-4.50%	-6.06%	-0.02%	3.61%	-1.15%	6.47%	7.66%
Performance comparison	-3.34%	-1.59%	3.44%	2.50%	9.45%	13.60%	12.16%

In this month's Smart Investing Series, we are discussing "*Managing Expectations*", an important aspect of long term investing.

Dipan Mehta

SMART INVESTING – XIV
- Managing Expectations

Keeping Expectations in Check

Managing expectations of likely returns of a stock or the entire portfolio is an important aspect of investing and investors who manage their expectations are likely to do much better than those who enter the market with unrealistic hopes. Many investors enter the market with the optimism of multiplying their investment manifold in a short period of time. There are others who view equities as debt products and expect a steady return with limited volatility. Both these investors are likely to be disappointed and that is where managing expectations play a key role in keeping the interest alive in equities.

Investing in Stock is Buying Part of a Business

When we are buying a stock, we are in fact buying a part of a business and as every venture goes, there are associated risks. There are ups and downs, wins and losses, opportunities and failures, which are inherent in any business endeavor and success is not a given. There are quarterly and annual fluctuations in earnings and concomitant volatility in stock prices, which have to be traversed before success is attained. By keeping this in mind, investors will approach every investment opportunity with a better frame of mind and will be able to accept mistakes and wild movements in stock prices. They will be able move on to the next investment idea without being drawn down by the failure or volatility of the first one. Despite best efforts at measuring the risk-return profile of a company, events outside the realm of control do take place which result in diminished value and keeping this in perspective is an important facet of investing. It will make exiting a stock an easier option and evaluating the next one with a fresh approach a more conducive process.

Stock Returns Generally Track Earnings Growth

As a thumb rule, the likely appreciation of a stock is directly linked to the growth of the company. There may be periods when the company's performance and that of its stock are not in sync. However, over an extended period of time, the change in market value of a company will track its growth rates. Keeping this in mind will enable investors to judge the returns they can expect from a share. If the company is likely to post 15-20 % increase in profits, then investors can expect a similar rise in stock prices and that is the basic premise of managing expectations. Seeking returns, which are higher than the potential growth rate of the company, invariably leads to disappointment and disillusionment. The more difficult measure is estimating the growth rate of the company and that is where investor focus should be.

There are exceptions to this rule. Stocks of companies, which are quoting well below their breakup value, may also appreciate as the street starts to recognize their undervaluation. M&A activity may also throw up surprises, as valuation of business done by an industry insider may be far higher or lower than what analysts have judged; because of the embedded value of the combined entity.

Expectations on Overall Portfolio Returns

The discussion so far is on stock specific returns, however, investors may have expectations on the returns of his / her entire portfolio of stocks. In this context, the simple logic is that the returns of the portfolio would track the earnings growth of the underlying businesses. While that is true in theory, in practice, it is best to expect that the overall returns of a balanced portfolio will track the returns of a broad market index such as the Sensex or the Nifty. If the skew of the portfolio is more towards midcaps, then the value of such a portfolio will move in tandem with that of a Midcap Index. Depending upon the stock selection, there will be periods of out and under performance but expecting a balanced portfolio to do exceptionally well when the overall market trends are weak is building unrealistic expectations.

The reason we distinguish between stock specific expectations and expected returns of an entire portfolio is because there are many more moving parts and multitude of variables in play. At this stage, it is important to reiterate that we are assuming that an investor has a well-balanced portfolio with several stocks from a cross section of sectors. The expected returns of a highly-skewed portfolio will be similar to the expected returns of its top 1 or 2 holdings.

Keeping realistic expectations in line with the growth prospects of the company as regards each holding and expecting the overall portfolio to returns to track the returns of a broad market index is *Smart Investing*.

Dipan Mehta