

Government and Central Bank Events in India

There were two major events in India last week which should have led to increased stock market volatility. These were related to the sudden resignation of the Governor of Reserve Bank of India, and five State Assembly elections (approximately 15% of the voting public) which took place.

However, the Indian stock market (as measured by the Nifty, an Index of India's 50 largest stocks) continued to scale upwards from its recent low of 10,030 (October 26th) to close at 10,805 last Friday, 14th December. That's a move of 7.7% upwards from the low, whilst the S&P has moved down 2.2% in local currency terms over the equivalent period (INR has also rallied relative to the AUD, USD and NZD in this period). Part of this recent move upwards is a bounce from extremely poor months in September and October. Indian markets are 2nd best performing in 2018 after Brazil (which has seen a cyclical bounce in 2018). Despite events, we see the fundamental continuing to be the main driver.

RBI Governor Shock Resignation

Dr. Urjit Patel, resigned last week after a 2-year tenure as RBI Governor, citing personal reasons. The Government of India and the RBI were having disagreements on a few contentious issues, particularly the high level of interest rates, despite inflation well below their 4% target, pressing a weak banking system during a period of traditionally tight liquidity and treatment of State-owned banks under the RBI's Prompt Corrective Action (PCA) framework. The Government was of the view that the RBI did not need to be as vigilant at a time when there were enough pressures on macroeconomics of India. However, the RBI were keen to protect the independence of their operation.

It appears from ensuing details that the resignation was put up for consideration in the mid November meeting between RBI and the Government. It is likely that both parties agreed to make the resignation public, post voting for the five state elections on the weekend before last.

A new Governor has been appointed in Shaktikanta Das for a period of 3 years. Mr Das has served as the Economic Affairs Secretary and Revenue Secretary in the Ministry of Finance. He is not perhaps the academic that Dr. Urjit Patel and this predecessor Dr. Raghuram Rajan were (both had IMF and academic experience) but played a key role in reforms of the Modi Government, like Demonetisation and GST. Thus, he is likely to be labelled a pro-Government appointment.

However, on the contrary it can be said that perhaps the previous RBI Governor has significantly over-estimated inflationary concerns (currently at 2.4%) and curtailed India's nascent capex recovery. Perhaps India needs to loosen the shackles on growth and be prepared to tolerate higher inflation than 2-4%. The new appointment should lead to a more coordinated effort between Government and Central Bank.

State Elections

The Indian states of Rajasthan, Madhya Pradesh, Chhattisgarh, Mizoram and Telangana all had their State Assembly elections. Whilst the State Elections have no direct outcome on the National Election (to be held in May 2019), it does measure sentiment towards the two parties (Modi's BJP and Indian National Congress). The first three of those states mentioned above were held by BJP in the previous state assembly and indicates a shift towards anti-incumbency. These states have a high content of farmers who have been impacted by Modi's initiatives and hence the anti-incumbency despite being

supporters in the last national elections. Typically, a Government like the BJP which has been pro-reform and pro-changes tends will likely meet resistance when it comes to impact at a personal level.

Consensus at present is that Modi may still win the National Election, but he won't be able to achieve an outstanding majority in the Lower House to be able to execute reform at the same pace. This will remove some of the "premium" associated with Modi's reforms for foreign investors.

Table 1 – Recent State Assembly Election Results by Seats

States	BJP	Congress	Regional Party	Others	Total
Madhya Pradesh	109	114	-	7	230
Rajasthan	73	99	-	27	199
Chhattisgarh	15	68	-	7	90
Telangana	1	19	88	11	119
Mizoram	1	5	26	8	40
Total	199	305	114	60	678

The table above shows a clear-cut change in voter behaviour across MP, Rajasthan and Chhattisgarh. These three states account for 17% of the population of India, 15% of GDP and 15% of Lower House seats. The remaining two seats of Telangana and Mizoram are far smaller and were won by independent parties. BJP has fared very well in the 3 big states in the prior election in 2014.

These states elections are a litmus test for sentiment but is not necessarily a great indicator for the national elections in May 2019. We have seen that in prior State assembly elections compared to the national election. Regardless, the BJP will have to strive harder in order to win and therefore we can expect favourable policy towards consumption, the rural economy and reducing some pressure on the finance sector over the next 6 months.

Our View

We expect the appointment of the new RBI Governor to be **pro-Government, economy and stock market**. This should see a period of share market volatility leading up to the national elections, which will provide a **great entry point for investors given the nascent stage of the business cycle and deleveraging of corporates over the last decade**. The catch is that this change should not come with deterioration of medium to long-term macroeconomic conditions as an outcome.

Consumption and finance sectors are likely to benefit the most over the immediate future rather than infrastructure or cyclicals, as corporates continue to hold back on significant capex until further clarity is provided on politics of India. **Bond yields are also likely to retreat further** in the face of potential rate cuts, which should provide a further benefit alongside weaker oil prices to corporates of India.

From a National Election perspective, we expect a Modi led BJP victory, albeit with a lower majority. Hence, we are with consensus at this stage. Whilst PM Modi has made some mistakes on execution and implementation, the **intent of his reform and initiative is very much needed in India**. The Indian National Congress party had many prior terms in Government and were able to achieve very little of the reform front i.e. or policy paralysis.