April 2019

TAVAGA MACRO UPDATE

POLITICAL RHETORIC AND MONETARY EASING

Election uncertainty an opportunity to enter equity markets

Indian and the Global markets context has shifted significantly, since our macro outlook in February 2019 (link here). Some of the themes that we had discussed are unfolding in the way we envisaged, including the recent rally in India equity markets (NIFTY up c.8% from lows in January, up c.7% YTD).

In this note, we revisit the recent developments affecting the investing community.

THE INDIAN POLITICAL LANDSCAPE

Rise of election-related rhetoric has resulted in the election fight being fought on the economic and national security fronts. While demanding results from the incumbent BJP on the economic front, Congress party in this respect has promised a Minimum Income Guarantee scheme of INR 72,000 / year with unclear details and debatable assumptions. Clearly the target audience for the populist move is the 2019 electorate and like elections in the past, opposition parties have engaged in populist promises.

Similarly, on the national security front, the rise in India-Pakistan tensions has shifted the political landscape.

Both these moves are likely to have a marginal net impact on the fortunes of the respective parties, with no major changes in our expectations of a fractured mandate in 2019 elections. Both parties' track record for implementation of election promises has been weak; and, for market participants, predicting an Indian general election is no mean feat and we don't intend to speculate on that either.

Rather we focus on high probability outcomes for market participants in the coming year. While we believe that a full majority for ruling BJP is unlikely, the base-case scenario would be a BJP-led coalition government. The other major case would be a government led by Congress party with even weaker hold on major policy decisions. A third outlier scenario would result in a government coalition led by smaller parties with outside support from one of the major parties.

In each of the cases, coalition politics (and election promises thus made) is likely to push government spending higher and therefore result in fiscal easing. Combined with the monetary easing already in place w.r.t. RBI in India and Fed/ECB globally we expect Indian equity markets to rally further regardless of election outcome. The monetary easing aspect is discussed separately.

In the third outlier and unlikely case however, we would expect a short market selloff of 10-20% because of increased uncertainty and likelihood of an unstable government like the ones seen in 1996-1999 period. Even in this case, we are likely to see fiscal easing as the incoming parties try to boost their political mandate. However, the ability to execute their mandates will likely remain in question in this case because of increased coalition politics and fractured electoral mandate, with increased likelihood of frequent re-elections in coming years.

Tavaga

GLOBAL AND LOCAL CENTRAL BANK POSITIONING

Three important events have played out since we wrote our outlook in February. These events mark a giant monetary boost that risk markets have received over the past month or so.

ECB (7 Mar 2019 announcement): ECB has announced TLTRO III ("Targeted Long-Term Refinancing Operation III") while maintaining the benchmark rates at current levels. Thus, the talk of an ECB lift-off has now faded into history and more than a U-turn is on the cards, with the effects going well beyond Mario Draghi's term.

Fed (20 Mar 2019 announcement): From being "on auto-pilot" to reduce the Fed balance sheet and telegraphing two 2019 rate hikes just six months back to telegraphing no further rate hikes in 2019 via dot plots, the Fed has also done a complete U-turn. Furthermore, it went ahead to announce that maturing MBS would be re-invested into Treasuries going forward – thus effectively maintaining the size of the Fed balance sheet at current levels.

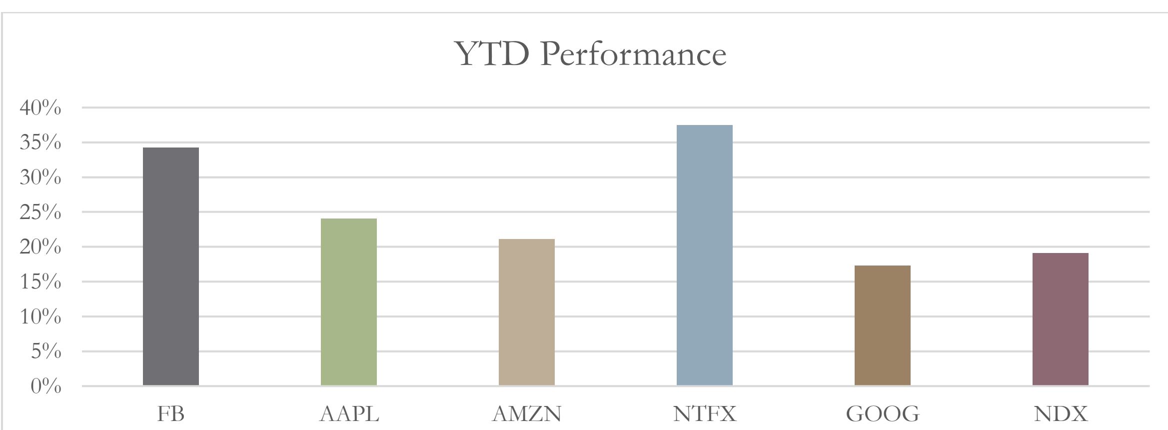
RBI (4 Apr 2019 announcement): Current RBI governor Shaktikantha Das has been in a dovish mode since taking over at RBI with rates being cut for the second consecutive meeting. Various banking sector problems created during former governor Urjit Patel's tenure seem to be getting resolved with a tilt in favour of the government.

Thus, over the past 6 months we have seen a significant change – almost a u-turn in central bank posture from the global central banks – Fed, ECB (driving FII risk flows) as well as the RBI.

While mainstream wall street research focuses on binary outcomes related to these announcements, we believe there is a strong path dependence that is associated with monetary policy announcements. Initial result of monetary easing surprise results in a risk rotation towards bonds, while medium to long term effects cause adjustments to lending and real economy thus boosting M3, risk assets and equities in the medium to long run. In the Indian context, we expect a similar story to play out, especially post-elections, with the additional driver of elections being monitored actively by the investment community.

FAANG AND NDX UPDATE

Tavaga offers a bouquet of six ETFs for retail investors, one of which is the Nasdaq 100 exposure. This serves as a diversifier as well as a hedge against depreciation of INR. To summarize and conclude, we show the performance of FAANG and NDX. In the context of the monetary easing described above, US tech stocks have been one of the prime beneficiaries YTD.



Data Sources: Yahoo Finance, Central Bank websites

This report is authored by Nitin Mathur & Ajit Bhide. Tavaga Research has issued this report for information purposes only. This is not an Investment document. Please refer to https://tavaga.com/terms.html for disclosures.