



Cyclical Upturn, But Not a Strong Secular Growth

Dear Fellow Investors,

I have no views on the long-term economic future beyond a simple framework that a large population and a prosperity level we have reached will keep the economy humming at a certain rate. Most headwinds are temporary or cyclical. I have no interest in speculating whether India will become a trillion-dollar economy or an economic superpower. But since I keep getting asked about where the economy is headed here is my two bit, with the caveat that this is not a prediction. It is a hypothesis based on certain logic. I am willing to change or discard the hypothesis as soon as facts prove me wrong. So here goes my short-term and long-term hypothesis.

Short-term view: While the global gloom and doom scenario of 2022 (inflation, higher interest rates, and economic slowdown) seemed to continue into 2023, the economic climate has changed over the last few months. Inflation is falling in most countries. In the US, it is down from 9.1% of June last year to 5% now. Despite Russia cutting off gas supplies, Europe has dealt well with the energy crisis through the winter. In Eurozone inflation is down from 10.6% at its peak to 7% now, with Spain recording as low as 3.3%. With the benefit of hindsight, against each wave of crisis of 2022, the Indian market has held up well. If anyone asked you to guess Nifty return in 2022 calendar year, you would probably say 10% down. Doesn't it seem that last year was terrible for stocks? The fact is, Nifty was actually up 4.33% in gloom and doom calendar year of 2022, as the market staged a strong rally in the second half of the year.

There is a lot of optimism in the air that we have crossed the winter of high interest rates and inflation. The latest fuel to the optimism came when the Reserve Bank of India decided to pause its interest rate hike on 6th April. Experts are already predicting that the rate hike cycle in India is over. Given that the RBI has a dovish governor (although the decision on interest rates is taken by an independent monetary policy committee), it is most likely that he will look for an opportunity to cut rates. Even a pause means that a big weight has been lifted. Interest rates hikes are the strongest headwinds for any market because they affect both business profitability and consumption in a vicious cycle. With the pressure of interest rates off, markets will breathe easy. The problem is we are endowed with nearsighted vision. We can only see a quarter or two ahead. And we quickly forget the past. So, here is some reality check with a long-term view.

Longer-term view: Even if we have a more favourable economic climate it is hard to see how India can notch up high economic growth rates year after year. Only a cyclical downturn will be met with a cyclical upturn. The reason for this is poor structural changes, poor governance and high level of corruption that is increasing income inequality and cannot be covered up by a tax-and-spend policy. To become prosperous (forget about becoming an economic superpower) and achieve lower income inequality, economic growth needs to be sustained for a long time, supported by low inflation, low-interest rates and a stable currency. No matter how powerful the government is, it cannot control these factors. They are symptoms of how healthy the economy is.

India's actual inflation and interest rates remain high while the currency has weakened, reflecting internal economic weakness -- it is just like high body temperature reflecting the presence of some infection. In the case of the economy, that infection is structural issues: deep-rooted corruption, too much of red tape, poor justice system, all of which create a higher-cost economy, high frictional cost of doing business, reduce investment, sap enterprise, lower productivity and ultimately show up in inflation, weak currency, high interest rates and reduced consumption of the masses. This exactly why we have had a periodic boom-bust scenario for the past five decades and we have a K-shaped growth now.

Structural Issues: A strong structure stands can stand up to shocks, which in turn is only possible through responsive rules, systems and strong institutions. Otherwise, growth will stall and a majority of the people will not benefit from the sporadic high growth periods. This is not a conjecture but learning from history. In the previous periods of high-growth in the mid-80s, mid-90s, mid-2000 and again in 2010-12, we had superficial, headline-grabbing high growth which quickly fizzled out without reducing income inequality.

The growth spurt of the mid-'80s pushed India to the brink of default, at one time leaving India with foreign exchange worth less than two weeks of imports. The growth of the mid-'90s immediately generated high-interest rates and inflation that punctured the euphoria of liberalisation. The growth in 2003-2007 was more solid but the global financial crisis exposed our fundamental weaknesses. The 2010-2012 growth phase, goosed up through easy money, brought upon us higher inflation and higher interest rates leading to a foreign exchange crisis in mid-2013. There is a simple reason why such high growth periods have been unsustainable. The moment growth picks up, businessmen turn bullish. Their actions set off a chain of higher demand growth. Accelerating demand and sensing a bullish financial outlook, financial markets go euphoric, leading to irrational capital allocation. But an institutionally weak economy, full of hidden frictional costs, cannot handle the demands of such high growth and sudden capital rush. Supply takes a long time to catch up. If supply does not come up fast enough, strong demand growth fuels inflation, which has to be curbed with higher interest rates. From boom, we inevitably go to bust.

Only an economy that can quickly respond to higher demand by keeping inflation and interest rates moderate, while ensuring continued growth, will slowly succeed in spreading prosperity and reducing income inequality all around. This calls for highly adaptive and responsive institutions and regulatory systems. For example, in a boom, there will be a higher demand for hotel rooms. Can hoteliers add to the supply quickly enough? Not with scores of state and central permits that take years to be cleared. It is the same for every industry. Unfortunately, no government has done much to make our regulations fair, transparent and institutions accountable. Their actions have been quite the opposite -- arbitrary, unfair and unaccountable.

K-Shaped Growth: Last week I was chatting with a director of a kitchen appliances company and he mentioned that "pots and pans are not selling well." This is borne out by the poor sales growth of all kitchen appliance companies. On the other hand, India's largest luxury and premium watch retailer, Ethos, which sells Omega, Jaeger LeCoultre, Panerai, Bvlgari, Longines, Baume & Mercier, Tissot, Raymond Weil, etc. each of them costing lakhs, reported a 44% increase in sales and 262% rise in net profit for the March quarter. While underwear sales have collapsed and two-wheeler sales have crashed to the 2012 level, BMW has reported 37% higher sales for its luxury cars in 2022. This kind of lopsided growth is called K-shaped growth or K-shaped recovery because some parts of the economy may experience strong growth while others continue to decline, like two arms of the letter 'K'. The worst kind of K-shaped growth is when a small number of (very rich) people do very well while the vast majority languish.

Perhaps reacting to chatter about this lopsided prosperity, the government has talked about reducing income inequality by taxing the rich a bit more. This is a silly idea, probably more political than economic. Unless the government finds a way of getting to the source of this income -- rather, spending -- disparity, it cannot do much to reduce inequality. That leads us to the question, why is India experiencing K-shaped growth? I don't profess to know why the lower arm of K, that is items of daily consumption not selling well. After all, this government has apparently been pouring money into rural areas through a variety of schemes and has been claiming that the holy

trinity of Jandhan, Aadhaar and mobile (JAM), have targeted benefits so very accurately, that leakage and wastage have been eliminated. Maybe inflation in real life is much higher than the official number, which has sapped the purchasing power of the middle class and the poor. But I can make a partial guess about why the upper arm of K, the luxury items, are selling well. The short answer is widespread corruption.

Corruption is rife everywhere in states, municipalities and panchayats. Every month, newspapers publish stories about action against government officials and the recovery of crores of rupees in cash and jewellery from their homes. But most of them are not caught. It is well-oiled system. In an interview with Outlook magazine in February '22, VN Khare, former chief justice of the Supreme Court said, "Corruption is rampant in the lower courts". Widespread corruption is holding back India's economic growth because it kills the virtuous cycle of enterprise, productivity and wealth creation. Rampaging corruption also sends out the vile signal that it is alright for people with power (netas and babus) to acquire undeserved wealth and spending power. Unless we have structural changes including punishing the corrupt, we will not create a genuine merit-based enterprise economy and enough prosperity for all.

However, the fact we do not have a genuine merit-based society does not come in the way of picking stocks. We do have a strong enterprise culture which is throwing up many high quality companies. We believe we have selected some of them for the portfolios and will select more.

Risks

Now for mandatory risk perception. The main risk I see is in the US, which may enter a period of turmoil, as higher rates are sending shock waves throughout the economy. An old hand like Stanley Druckenmiller, whose views I respect, is baffled for the first time in life unable to figure out where the economy and markets are headed. I don't see too many risks in India where the macroeconomic condition is stable and lots of companies in several sectors are doing very well. Our strategy remains the same although we have tweaked it a lot this year and the results have started to show. That's all for this time.

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Debashis Basu,

Founder & Principal Officer

