Business Standard

Why are FPIs selling?

We need to see a concerted attempt to make India an easier place to do business

Akash Prakash July 30, 2019 Last Updated at 00:01 IST

We have recently seen significant selling of Indian equities by foreign portfolio investors. In July, the selling has touched almost $2.5 billion, and is now seems to be accelerating. Consequently, India has had a very tough year on a relative basis. While the markets globally are hitting new highs, we are struggling to stay in positive territory. Indian mid-caps and small-caps continue to get decimated — downdouble digits for the year. In a ranking of the top 50 equity markets, in terms of performance year-to-date, we are ranked 43rd. What is surprising is that we are doing poorly despite what one would think is a very favourable backdrop.

The government that investors wanted has come back with a much stronger-than-forecast mandate. Oil prices are stable, and seem to be in a range: The top end of the range does not seem to be a level which will disrupt our economy. The rupee is very stable, it has, in fact, appreciated post the Lok Sabha election. Globally, liquidity is very easy and rates are declining everywhere. We are on the verge of starting another round of central bank easing, led by the US Federal Reserve and the European Central Bank. Amazingly, nearly 25 per cent of all investment-grade paper globally (both corporate and government combined) is now trading at negative yields. We are seeing bond yields for Greece (till recently a basket case) decline to below equivalent US treasuries. An odd environment!

With yields so low and falling, growth should be at a premium. India has always been seen as the one economy offering long-term, secular and sustainable growth. Demographics, low starting point, the catch-up effect, etc. No one really doubts that India will be the fastest-growing major economy over the coming decades and definitely grow faster than China. With growth scarce, India should be bid up. Yet, despite the very favourable backdrop, the Indian markets are struggling. Why?

There are many reasons, but according to me, these are the most important ones.

There is total frustration with the lack of corporate earnings growth. This has been the single-biggest disappointment in Indian equities over the last eight years. Few people realise that back in 2008, the share of corporate profits/GDP in India and the US was basically the same at about 7 per cent. Today, these ratios are near 10 per cent in the US and just over 2 per cent in India. There has been a total collapse in corporate profitability in India. We have compounded earnings at less than 5 per cent over the last eight years. There are various reasons for this earnings recession. The corporate bank NPA clean up, higher taxes, technological disruption, economic shocks, no private investment, an overvalued rupee, etc. Be as it may, the fact remains that no one has been able to forecast the turn in corporate profitability. No one can explain when and why earnings will accelerate, beyond the obvious point that corporate profits cannot keep dropping as a share of GDP. We are already at all-time lows. This has to bottom out! Given the current weakness in the economy, this will be another year of an earnings disappointment. The phase of multiple expansion for our markets is over. Thus, despite bond yields dropping by almost 100 basis points, the markets are still falling. It is unlikely that the markets can resume a sustained uptrend in the absence of strong earnings growth. Most investors, tired of waiting for the earnings inflexion, will now only increase India allocations once earnings are delivered. On current earnings, the markets are simply too expensive.

Illustration: Ajay Mohanty

Second, the economy is genuinely weak. I have not seen corporate sentiment this bad for years. Investors hear a barrage of negative news when they interact with companies. Animal spirits seem absent. Everyone just talks of deleveraging and hoarding liquidity, and there is no interest in setting up new capacity. Demand seems to have hit a wall. Non-banking financial companies (NBFCs) are in survival mode. Many businesses have no access to credit. Business confidence gets even more shaken when states, like Andhra Pradesh, attempt to renegotiate signed contracts. The government to its credit has tried to lower rates in the economy, and thus boost consumption and investment. This will help, but in addition to easing monetary policy, investors would have liked to see more attempts to push the next generation reforms in land, labour and judiciary, and make India an easier place to do business. The government, obviously, has an economic game plan, to get us out of this funk. There has to be a better articulation of the government's economic philosophy, priorities and game-plan for the next five years.

Third, there is also a perception that India may have moved more to the Left in the economic policy than most investors expected. No one can deny that we need to spend as much as possible in improving the basic quality of life of the average Indian. This government won a landslide victory as it was able to put in place basic infrastructure in rural India, providing roads, housing, electricity, and cooking gas with very effective execution. Much more needs to be done. It will need money.

The present approach seems to be to focus on the existing narrow tax base to get the required resources. This is killing animal spirits. So is fear. There has undoubtedly been huge abuse of the system by Indian industrialists. Just look at the NPA crisis. Many should be punished. However, every large Indian industrialist is not a crook. Ultimately, it will be the private sector that will create jobs.

We need to find a way to broaden the tax base and be far more aggressive in monetising government assets to get the money needed. Given the need for resources in rural India, we cannot afford to give bailouts of lakhs of crores to PSUs, be it the banks, Air India or BSNL/MTNL.

In addition, the required returns to make an investment in India are also rising. Risk premiums will rise when you have judgments like the recent NCLAT judgment on Essar Steel, or the Andhra fiasco. Taxes also raise the pre-tax returns needed to justify allocating capital to the country. If risk premiums rise, the markets have to be cheap enough to deliver the higher expected pre-tax returns. Public equity markets are currently not cheap enough.

Sentiment in India is very poor at the moment, among both domestic investors and industrialists. This negativity is now affecting the global investor base. It is unlikely global investors will pre-empt the domestics. We need to see the domestic sentiment turn. For that, we need to see a concerted attempt to make India an easier place to do business. Be it taxes, regulations, reforms, etc.

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