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Markets at a high, economy at a low

The markets are clear 5 per cent growth is not the new normal

Akash Prakash | New Delhi December 03, 2019 Last Updated at 00:11 IST

Whenever I meet people involved with the real economy, they simply cannot understand how markets can be hitting new highs, when the economy is in trouble. It only reinforces the perception that the markets are a casino with no logic. How can you reconcile a new high in the Nifty with the economy growing at only 4.5 per cent?

Even this 4.5 per cent number (a 26-quarter low) hides how bad it really is as government spending accounts for 1.9 per cent of this 4.5 per cent print. On a seasonally adjusted annualised rate basis, GDP only grew at 3.6 per cent. Private investment is truly non-existent as GFCF (gross fixed capital formation) grew at only 1 per cent. Nominal GDP growth fell to a new low (new series) of 6.1 per cent, almost halving from the 12 per cent growth number witnessed for Q2 FY19. In the Budget for FY20, the government had assumed a nominal GDP growth of 11.5 per cent. The undershooting of nominal GDP will make the fiscal arithmetic even more challenging. There is basically zero chance of the government meeting its fiscal deficit targets for this financial year absent savage cuts in spending in H2 FY 20. Savage spending cuts will tank the economy further, a horrible position to be in. The single-digit nominal GDP growth is also a huge headwind for corporate earnings, as over the long term, both nominal GDP and corporate earnings are highly correlated. You are not going to get 20 per cent earnings growth, with nominal GDP at 6 per cent. Besides, having nominal GDP growth lower than your incremental cost of borrowing is the path to a debt trap and rising debt/GDP for any country with a primary deficit like India. If the low nominal GDP growth continues, it is only a matter of time before the ratings agencies get worried again. Whichever way you cut it, the news on the economy is bad.

With this backdrop, how can the markets be hitting new highs? Firstly, as pointed out previously, we have very polarised markets, very few stocks are driving the market upwards. Despite the Nifty being at new highs, the mid-cap and small-cap indices are 25 per cent and 40 per cent below their all-time highs. This is entirely a large cap and quality rally. Even within the Nifty 50 index, the entire returns have come from 15 stocks. If you were to divide the Nifty into two buckets, the top 15 performing stocks and the rest, you would find that since December 2017, the top 15 stock index is up about 40 per cent, while the index of the remaining 35 stocks is down 19 per cent.

The basic point is that this is not a broad-based market advance, indicative of strong and broad economic momentum. Rather it reflects investors herding into quality and large cap stocks at virtually any price. The polarisation in a way reflects the patchy and inconsistent growth momentum.

Secondly, such a divergence between the real economy and the markets is not uncommon. As they say in the US, a divergence between the Main Street and the Wall Street is not uncommon. This is because stock markets are a discounting mechanism. They are a part of the series of leading economic indicators. They lead the real economy. Markets are basically saying that we have seen the worst, the economy has bottomed and over the coming 12 months, economic growth will reaccelerate. The combination of fiscal and monetary policy support will work to stabilise the economy and get us back to trend growth rates. Markets are betting on growth normalisation. While markets may not be clear as to how growth will recover, they are clear that 5 per cent is not the new normal for India.

Illustration: Ajay Mohanty

Markets are buying into the bullish narrative that the weak economy will force serious reform and change. Nobody expected corporate tax cuts of this magnitude and with immediate effect. Most did not expect genuine strategic divestment, but it looks to be happening. The markets seem to believe that the upcoming Budget will incorporate serious reform of personal taxation and other structural reform measures. Something on the public sector banks. The Goods and Services Tax (GST) may be simplified and tweaked. The Modi government does not want a legacy of delivering only 5-6 per cent GDP growth. It is by now blindingly obvious that at 5 per cent growth, we will not have the money to deliver on social programmes, nor will global companies be interested in investing in India. Why put up with the vagaries of Indian policy-making if we cannot grow at 7-8 per cent. We are not going to be a $5 trillion economy anytime soon, unless we reaccelerate. This slowdown will not be wasted, so the markets are betting, hopefully rightly so.

Markets in India are also no longer insular. All financial markets globally are in a risk-on mode. The S&P 500 is up over 25 per cent, and markets across the world are hitting new highs. The re-emergence of positive global flows has also driven our markets higher. Even though we are at new highs, Indian markets have significantly underperformed their global peers. Markets reflect global risk appetite, as well as relative attractiveness, thus India can also rise to a certain extent based on global factors, independent of the local situation.

Markets are betting that the Indian economy will come back. This is a reasonable bet to make as India's trend growth rate is definitely not 5 per cent.

While the markets may be ahead of themselves, they are not irrational. The next six months is the litmus test, something has to be done. We have to revive both consumer and corporate confidence. There are a series of potential reform measures that can be taken. I am sure the government also realises the bet the markets are making and the faith they are putting in growth recovering. If let down, markets can overshoot to the negative also. In addition to celebrating new highs in the Nifty, we should also understand the implicit expectations built into these new highs. The political will to do serious reform must be there. There must be a systematic and a well-thought-through game plan. Everyone's future depends on it.

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