

**February 2017****India budget and the liquidity supercycle****Kunal Desai, Head of Indian Equities**

*Kunal Desai, manager of the Neptune India Fund, comments on how India's 2017 budget will impact the Indian economy and equity market.*

The significance of the Indian budget has been reducing over the past few years - major reforms such as the Goods and Services Tax bill and demonetisation have taken place outside the annual event. Nevertheless, the Indian government tabled a strong and responsible budget that focused on continued fiscal responsibility, whilst tilting spending towards social expenditure. The longstanding fiscal deficit target of 3% by March 2019 was kept in place, which relieved both equity and debt markets as fears of fiscal spending indulgence proved unfounded. This will likely keep bond yields at a lower level, whilst this will afford the central bank room to resume its rate cutting cycle. The equity market cheered the announcements, rallying 1.8 in response.

As we've argued before, the economic fallout from the government's demonetisation drive will likely be less severe than market expectations. The temporary liquidity squeeze from a lack of currency in circulation is abating, with caps on ATM disbursements now being removed. At the same time, the worry of a negative wealth shock from consumers writing off their cash holdings has not played out. Around 97% of the demonetised cash has found its way back into the formal banking system which will result in a sharper revival in consumption than was initially expected. Indians, it seems, are canny people and have deftly innovated their way around this temporary disruption.

Companies too have adapted well and have initially reported revenue growth numbers in excess of market expectations. We are roughly halfway through earnings season and more than 70% of companies have reported earnings either in-line or that have beaten analyst expectations. Many had relaxed incentive schemes and payment terms, whilst the organised sector continues to take significant share from the disorganised space, as the playing fields are levelled by the formalisation of business practices. We believe it is a great time to be exposed to the listed equity space which benefits disproportionately from this shift.

I believe mid-caps and small-caps will be the most exciting areas to be investing in. In the 3 weeks after demonetisation, more than 30 million bank accounts were set up as more rural parts of the market moved their savings from cash and gold towards financial saving schemes. Banks across the countries are now looking to cross-sell a wide array of equity and debt saving schemes as their deposits have surged. Household equity holdings as a share of financial assets will now move up from multi-decadal lows. Indeed, in the two months post demonetisation, inflows into equity schemes have more than doubled to over \$2.3bn compared to the 2 year average of under \$1bn. This potential domestic liquidity supercycle will boost the mid-cap and small-cap space most, given the composition of domestic Indian mutual funds. It seems that now more than ever before, if you're considering allocating to India, it's crucial to know exactly what you're investing in.

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