Morgan Stanley

INVESTMENT MANAGEMENT

Connecting the Dots

Overcoming the Deficit Mindset

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS EQUITY TEAM | MACRO INSIGHT | SEPTEMBER 2016

Regular readers of *Connecting the Dots* might have noticed that the subject matter of our essays typically revolves among three broad areas; i.e., the economy, stock market trends and investing styles (usually with a dose of the behavioural side). As we sat to ideate the topic for our next essay, we noticed that we haven't discussed the economy for some time. After all, it may not be an exaggeration to say that much of the recent discussion in the media around the economy of late has centred largely on the personalities of the outgoing and incoming governors of the Reserve Bank of India!

While many seem to have given up on forecasting the elusive inflection point, a closer look at some of the recent trends in the economy seems to be quite encouraging. Consumer Price Inflation has come down to a five percent handle, led by softer food inflation.[1] Decent monsoons accompanied by higher sowing acreage have aided the benign trend in food prices. Current account will likely be in surplus for the June 2016 quarter, albeit led by lower gold imports. Foreign inflows have been encouraging, including foreign direct investment (FDI). Naysayers of the rupee are grudgingly considering the possibility of a stronger rupee in the medium term, within a secular framework of gradual depreciation. The government ten-year bond is trading below the psychological seven percent mark.[2] While a momentary and fleeting favourable alignment of these economic variables does not get us excited, we need to watch closely if these trends sustain.

AUTHORS

AMAY HATTANGADI
Managing Director
Morgan Stanley
Investment Management

SWANAND KELKAR
Executive Director
Morgan Stanley
Investment Management

[1] Source: CEIC, Morgan Stanley Research. Data as of August 2016.

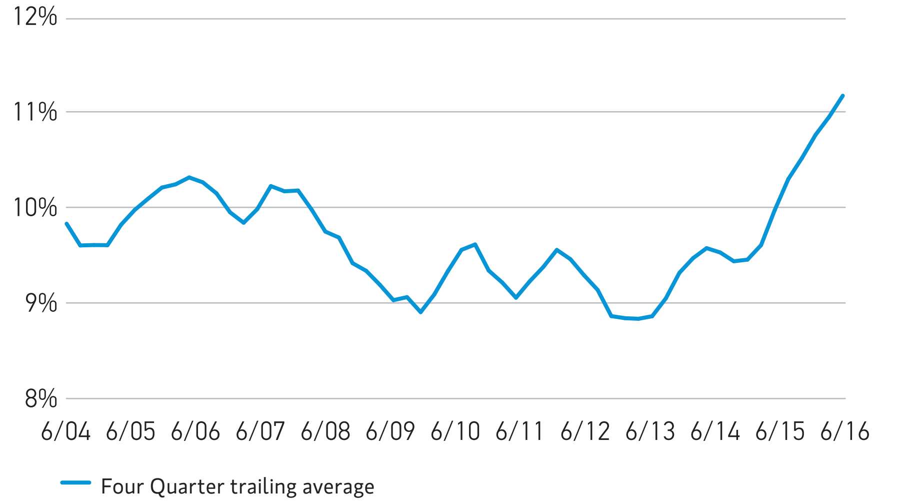
[2] Source: Bloomberg. Data as of September 16, 2016.

Indians have traditionally operated with a 'deficit' mindset. Burgeoning twin deficits on the fiscal and current account, high interest rates and inflation, and supply-side bottlenecks have traditionally been a standard operating template for India. In fact, it would not be wrong to say that this deficit mindset has been ingrained in our DNA over the generations. Notice how passengers disembarking from an airplane at Mumbai's sprawling new international airport make a dash, literally sprinting their way up to the immigration desks. Most are fully aware that there are 45 immigration counters (to their credit, of course, not all are usually manned) and the sprint would not make much difference to the overall time needed to complete the immigration process. Such behavioural traits are observed in almost all walks of daily life in India—whether jumping to board a train or scrambling to be early in a queue for passport applications. The fact is that, until recently, demand has far outstripped supply in most segments of the life of an Indian. So even when the outcome is not 'first come, first served,' the urge to be at the front of the queue is hard to resist.

Historically, India has been a capital-starved and labour-surplus economy. Capital has been in short supply, and hence expensive. In contrast, labour was cheap and available in abundance. So quite naturally, Indian businesses made frugal use of capital and had a tendency to overstaff. The result was that businesses deferred investing in automation, capacity enhancement and technological upgrades and often stretched the limits of capacity utilisation by employing more semiskilled workers and running extra shifts. 'Low cost' became the winning mantra, and the associated terms that emerged in the Indian business lexicon included 'frugal engineering' or its more desi,[3] and sometimes derogatory, version: 'jugaad.'[4]

DISPLAY 1

Employee expenses as a percentage of net sales (BSE 500 index companies)



Source: Capitaline, Morgan Stanley Research

Export-oriented industries in textiles, health care and information technology (IT) thrived on this low-cost delivery model. Very few companies focused on cutting-edge world-class technology or spent significant amounts on research and development.

Of late many companies have been complaining that cheap labour (both skilled and semiskilled) that formed the bedrock of India's low-cost delivery model has been getting more expensive. Better standards of living, higher aspirations and sustained consumer inflation have resulted in ~10 percent annual wage inflation as per Aon Hewitt.[5] Employee expenses as a percentage of net sales for the companies in the BSE 500 index has crossed 11 percent, up from a low of 9 percent four years ago (see *Display 1*). Indian companies are taking measures to deal with these inflationary pressures. IT companies in India that have traditionally operated on an hourly billing rate model are using automation to reduce the linearity between effort and billing. Pharmaceutical companies facing U.S. FDA regulatory audit issues, often due to human error or oversight, are resetting their production and testing processes to involve less manual intervention. Digitisation will reduce the head count needed at branches of most banks.

The big question, however, is whether capital for Indian businesses is set to become more abundant and cheaper in a global environment of zero or even negative interest rates. Lower bond yields, strong foreign portfolio inflows, steady flow of FDI and, more recently, opening up of new options to raise money from overseas investors through Masala Bonds[6] will have the effect of lowering the cost of capital. If these trends sustain, Indian entrepreneurs will have to contend with this new reality and adapt business models for a new level of cost of capital. The new model, we guess, could involve more spending on technology and automation, with lower manpower intensity. What impact this might have on labour demand and wage inflation will be a completely different debate for another essay.

[3] Desi is a Hindi word meaning local.

[4] Jugaad is a colloquial Hindi-Urdu word that can mean an innovative fix or a simple workaround.

[5] "Entering the era of the 'New Normal' in salary increases in India" (Feb. 16, 2016). Retrieved Sept. 16, 2016, from http://aon.mediaroom.com/news-releases?item=137382.

[6] Indian rupee denominated overseas bonds.

The manifold implications of a shift from deficit to abundance of any resource or product are difficult to forecast. We have seen this with mobile phone connections and the revolution it has created, first with voice and now data. Recent announcements by the Central Electricity Authority that India will be energy surplus by 1.1 percent this year is another example. Similarly, we think the traditional 'cheap labour' and 'scarce capital' equation for India is witnessing unprecedented changes. It would be naive to say that we fully comprehend what the long-term implications would be if these trends sustain. In the recently released movie 'Sully,' Capt. Chesley Sullenberger (played by Tom Hanks) makes a successful emergency landing of an airplane in New York's Hudson River after the plane is struck by a flock of geese. In a response to a National Transport Safety Board inquiry on whether standard operating procedures were followed, Sullenberger replies, "everything is unprecedented until it happens for the first time!" We are keenly monitoring these unprecedented trends in the Indian economy to see where it leads us.

Explore our new site at
www.morganstanley.com/im

1597488 Exp. 21/09/2017 8703611 _KC-0916 Lit-Link: INVVIEWCNTDOT0916