ASIA MACRO STRATEGY

Implications of India’s Bold Tax Cuts

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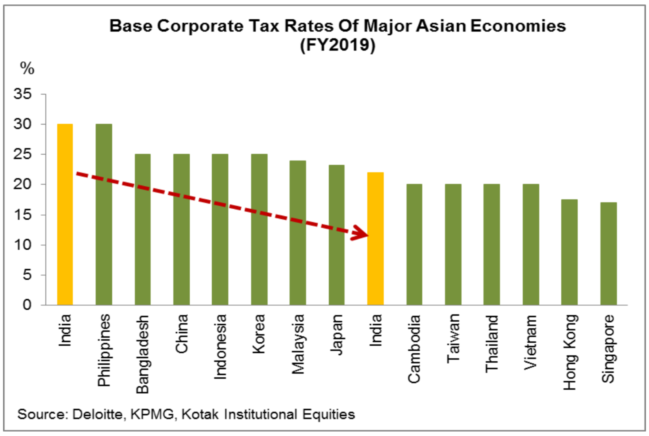
Surprised Policy Change

Better fiscal and monetary policy coordination is one of our major global investment themes in the coming years. In Asia, we have argued that China leads in deploying simultaneous fiscal and monetary stimulus (despite their current measured pace relative to China’s past easing cycles). Now that India’s surprise tax cut has hit the news, is this fiscal stimulus for real?

On September 20, India’s finance ministry announced a $20bn (0.75% of GDP) corporate tax rate cut from 34.9% to 25.2% (effective tax rate). This represents a sea change from its long-held fiscal consolidation stance (note headline corporate tax rate will reduce to 22% from 30%).

The Government also announced a special lower tax rate of 17% for new manufacturing investments aimed to attract companies affected by supply-chain disruption during the prolonged US-China trade war.



In addition, the minimum alternate tax (MAT) rate will be reduced from 18.5% to 15%; the surcharge on capital gains for all classes of investors has been removed; and listed companies that have announced a buyback prior to July 5, 2019 will not be subject to the new buyback tax.

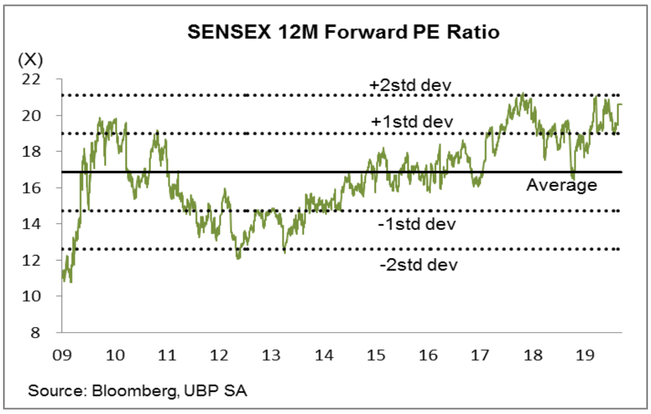
Prime Minister Narendra Modi seems to be taking a calculated risk in injecting badly-needed animal spirits into the corporate sector to reinvigorate capex and consumption growth. He seems less worried about any potential near-term negative implications for Indian sovereign rating with the renewed fiscal deficit expansion.

Local equities (SENSEX index) rallied over 8% since the announcement of tax concessions, local government bond yield jumped 23bps to 6.79% and the INR/USD exchange rate firmed up 0.5%.

Equity Valuations

On equities, we expect a 15% upside potential for the SENSEX (Bombay Stock Exchange index) is likely on improved economic sentiment in response to the policy changes. This is also partly due to an estimated 6-8% points (consensus) cumulative boost to FY19 and FY20 earnings per share (EPS) forecasts (to around 17-19%) to support current rich market valuations.

MSCI India’s 12-month forward price/earnings (P/E) ratio is currently trading at 19.4x, one standard deviation (sd) from the 10-year mean. SENSEX is at 20.6x forward P/E, close to 2 sd from mean, and 2.5x forward price-to-book (P/B) ratio which is modestly below mean.



There are two important issues to consider here. Firstly, roughly two-thirds of the listed companies (in MSCI India coverage) have an effective tax rate above 25%. The bold tax cut will have significant impact on selective sectors, noticeably banks, consumer durables, autos and certain material industries.

However, the caveat is that large Indian firms are relatively cash-rich because of the lack of business and investment opportunities over the past years. The benefit from tax reduction may not be as direct as suggested.

Also, companies may prefer to lower prices to stimulate demand (especially consumer products) so tax cuts may not boost earnings immediately until total revenues pick up. Firms could also either reward shareholders from the tax benefits or repay debts with their better cash-flow positions (i.e. positive for fixed income market).

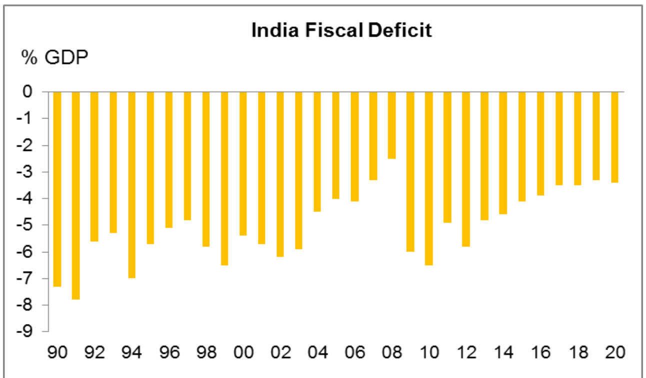
Secondly, Indian equities are under-owned by global investors but on relatively rich valuation. And this renewed 'Modi premium' is likely to stay on with forward P/B ratio possibly trading up again from current 2.5x to about 3.0x as seen in previous market rallies.

Fiscal Fundamentals

The key question is – can India afford bold tax cuts? Fundamentally speaking, it cannot. This is especially in light of the country's chronic fiscal deficit and low revenue-to-GDP ratio.

Investors are still waiting for any equivalent revenue-generation measures to support the tax cuts which was absence in last Friday's announcement. Rating agencies S&P and Moody's have given rating warnings over the weekend in response to Modi's bold moves, despite the rally in Indian equities.

The Union Budget for FY2020 announced in July was almost a non-event with conservative measures which aimed to maintain fiscal deficit at about 3.4% of GDP and not to depart from the government's medium-term fiscal consolidation target.

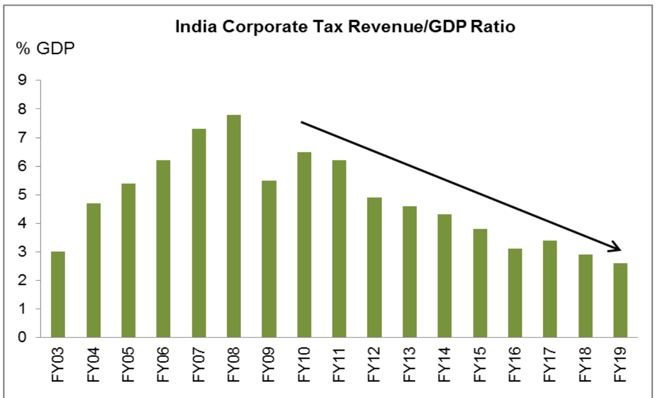


Source: Bloomberg, UBP SA

This is important as even though the budget shortfall has improved steadily from recent peak of 6-7% of GDP in 2008-12, the augmented fiscal deficit (including public organisations outside central and state governments) was some three times larger than that reported in the state budget.

However, cyclically, the impact of corporate tax cut on fiscal revenue may not be too costly as corporate tax revenue as a share of GDP has fallen to a mere 2.6% from a peak of 7.8% in FY2008.

The potential revenue slippage may not be too serious to the state budget. And if the tax cuts can revive growth and demand, it will eventually contribute more tax receipts back to the government.



Source: Bloomberg, UBP SA

USD Credit Market

Indian five-year credit default swap (CDS) jumped on the tax news but the USD credit market remained relatively stable with a tight average spread (investment grade + high yield) of around 240 basis points over US treasury.

Indian credits remain an attractive alternative to diversify from China-US trade war risk, unless the country's sovereign rating is under downgrade threat.

INR/USD exchange rate

The INR/USD exchange rate is most sensitive to equity flows so current equity rally could be the main underpinning factor for a firmer currency.

However, India's reduction of current account deficit (to 2.1% of GDP from 5% in 2015) was largely thanks to falling oil prices and recent volatility remains a risk.

Rising gold prices is no longer a major current account threat since local residents have significantly reduced the use of gold as an inflation hedge since disinflation started in 2013.

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