Impact Consultancy Private Limited

Fault lines

The Big Picture

24th November 2014

Overview

The week that just passed was quite momentous. **China** cut interest rates unexpectedly on Friday by 40 basis points to 5.6%, stepping up a campaign to prop up growth in the world's second-largest economy as it heads toward its slowest growth in nearly a quarter century. Economic growth has slowed to 7.3 percent in the third quarter and policymakers feared it was on the verge of dipping below 7 percent - a rate not seen since the global financial crisis.

In the **Euro-Zone,** on the back of high unemployment, growth-sapping low inflation and anemic economic growth, the European Central Bank (ECB) started buying asset-backed securities in a move to encourage banks to lend and revive the economy. The ECB had already initiated several stimulus measures to reverse disinflation, including cutting interest rates to record lows and announcing plans to purchase covered bonds and asset-backed securities – none of which have really worked and leave Europe on the brink of deflation.

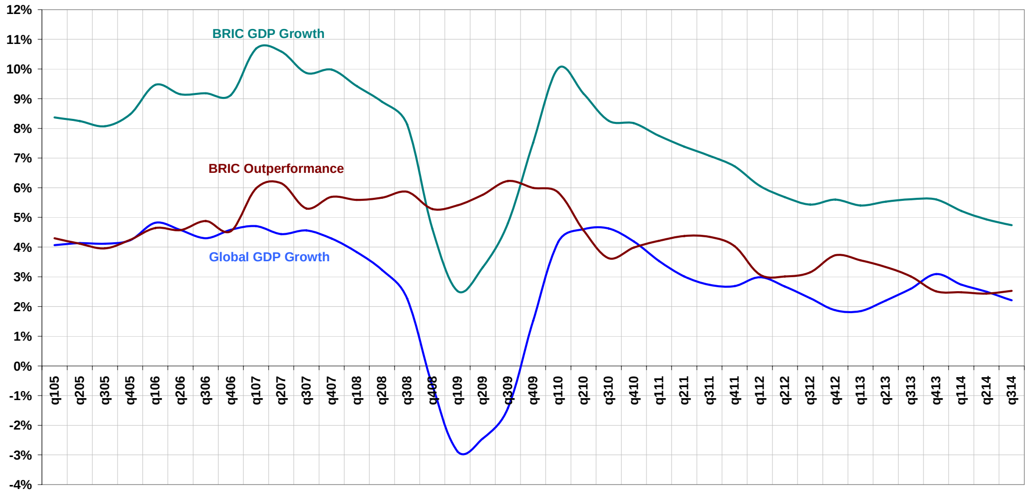
Japan, the world's third-largest economy fell into recession after gross domestic product (GDP) contracted by 1.6% in the third quarter. Despite PM Shinzo Abe's "three arrows" approach, - massive government spending, a torrent of money from the Bank of Japan and a series of reforms to promote economic growth - Japan's economy remains stuck in recession this year.

Russia, which produced an anemic GDP growth of 0.2% in the third quarter, is likely to slip into a deep recession if oil prices stay where they are (oil prices have fallen 30% from last June). Russia's energy exports constitute two-thirds of its total exports and the Ruble has already declined by 30% against the dollar this year. Russia's last economic crisis in 1998, led to a government default (and the infamous LTCM collapse). A string of bank failures, corporate defaults and a deep recession look likelier this time. And if firms in one commodity-driven economy start to default on their dollar debts, then investors will worry about others—such as **Brazil,** which already slipped into negative territory in the 2nd quarter .

Global growth

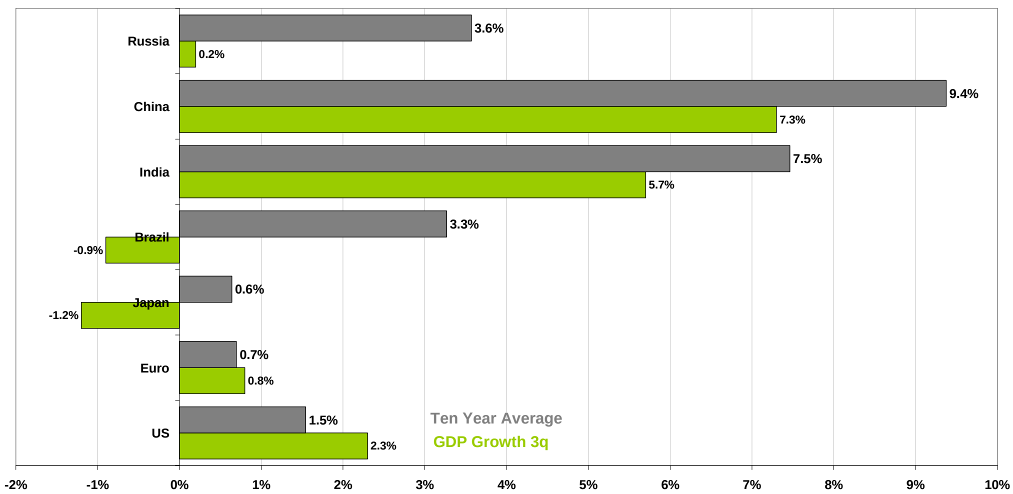
The key observation from looking at GDP growth rates is the secular decline in the growth of the BRIC (Brazil-Russia-India-China) economies in the last five years – once touted as the new engines of global growth. Barring a post-2008 bounce, the growth rate has not been anywhere close to the pre-financial-crisis rate of over 9%. In the last five years, growth has in fact halved from over 10% to less than 5% now. The BRIC economies, which used to out-perform the global growth rate by over 5%, now barely outperform by over 2%, with a much higher inflation rate to boot.

GDP Annual Growth Rates



Global GDP growth continues to be stable largely because of resilient growth of the **US** economy. Among the large economies of the world, only the US economy continues to do significantly better than the 10-year averages. The US economy appears robust and has put the financial crisis problems well behind – GDP grew at 2.3% in the 3rd quarter while unemployment at 5.9% is less than the long-term average of 6.8% and inflation of 1.7% is less than the Fed's threshold of 2%.

Current GDP Growth Rates v/s Long Term Averages

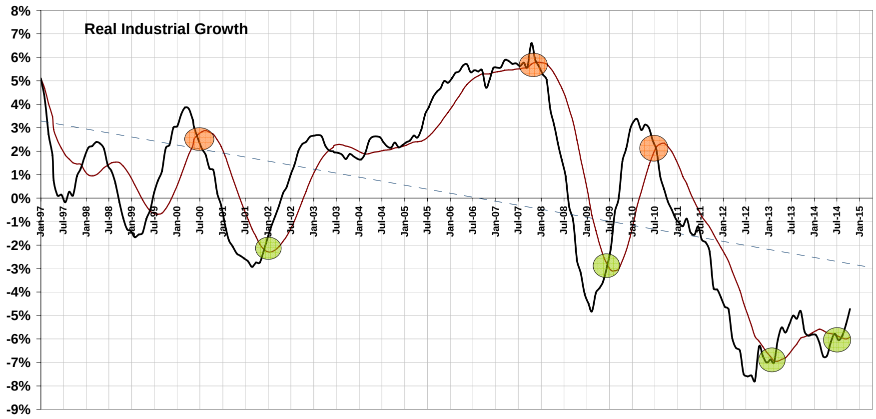


Data for India & Brazil are for 2nd quarter 2014

<u>Indian Macro-Economic Outlook</u>

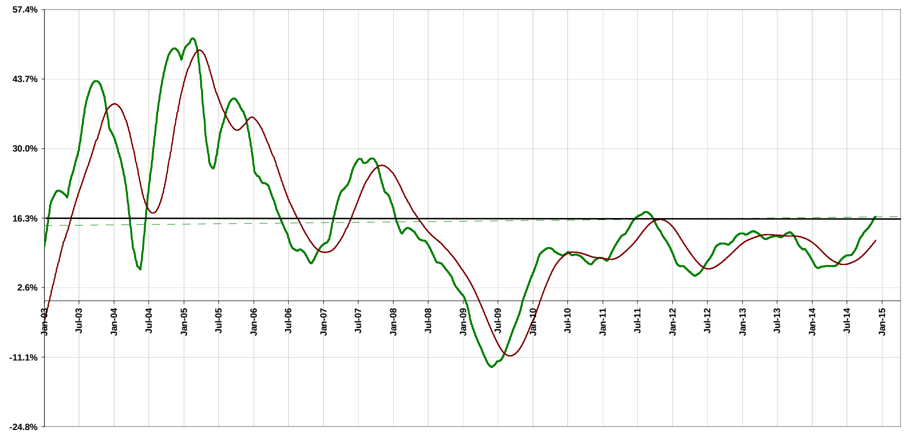
Like the US, **India** appears to be the other bright spot in the world. Although Real Industrial growth (adjusted for inflation) is still negative it does appear that there is a structural recovery in place, albeit a disappointingly slow one. The optimism generated by the new government is still in place, inflation is at a 3-year low and the fall in oil prices is a huge positive. Although the pace of reforms continues to be exasperatingly slow, the incremental actions such as deregulation of diesel prices and reallocation of coal mines are positive.

India's Real Industrial Growth



Even the Nifty earnings growth has been tepid but encouraging. Earnings growth at 16.6% is marginally higher that the long-term average of 16.3% (although it is at a 2-year high) and it does appear that an earnings up-cycle is in place which could push it to 24%+ by mid-2015. However, Price-earnings ratios of most indices are at the upper end of the valuation band and so the risk of correction exists.

Nifty Earnings Growth



Outlook

It has always been our belief, and there is sufficient evidence to show, that Quantitative easing (by the US Fed) or the various loose monetary policies adopted by other central banks have not led to any significant recovery in the real economies, but only resulted in higher asset price inflation. High debt burdens cannot be fixed by more debt and without actually addressing the core structural issues. The issues may be different – Japan and Europe's productivity, China's over-investment, Russia and Brazil's over-reliance on commodities – but the outcomes are similar, too much debt and too little growth.

It is therefore hard to be enthused by more of what has already not worked. Rate cuts and bond buying have a shelf-life, which seems to have long passed. Japan has been printing money since 2001 to try to revive an economy that's been on life support much of the last two decades. No doubt, such measures are still good at stoking asset price inflation and we may yet see a short-term bounce. Since we are now going into December, we may still see a "Santa Claus rally" – (global markets in the past have risen 2.8% on average in December).

Happy Investing.

Sashank Vipparthi
sashank@idika.com

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