DOES POLITICS MATTER NOW

This question comes up roughly once in five years and everyone knows why. Over the last two decades, this has been answered by stating that the India story is largely autonomous and politics has little influence on the growth prospects. Ipso facto, the market need not worry a great deal other than about the potential volatility that elections bring about. Is it a big deal this time?

We think it is a bit more complex this time.

There is context and nuance here. We need to examine both.

Let us go back to where it all started. In 1991, a minority government started the economic liberalization and that can broadly be regarded as the watershed moment for the India growth story. Sensex was in the vicinity of 1000 and it has compounded at some 14% since. The economy has gone up from less than USD 100 billion to over USD 3.5 trillion. In the interim, India had coalition governments at the helm all the way till 2014. India story did not really stop. Indian market did not stop either. At the same time, going up from the current level to the possible milestones of USD 6 trillion and further on to USD 10 trillion will prove to be a much steeper climb.

Average Real GDP growth (%)	20Yr	15Yr	10Yr	5Yr	Economy Size (Tn $)
US	2.0	1.7	2.1	2.0	26.9
China	8.4	7.3	6.2	5.3	19.4
European Union	1.5	1.1	1.7	1.5	17.8
India	6.8	6.1	5.7	4.0	3.7

Note: Data as of CY22; Economy size- Nominal GDP
Source: International Monetary Fund, Spark Fund Research

Other than the US and China, no country has gone past USD 10 trillion in GDP. For India, low hanging fruits are no longer there to be plucked. Nor are we in a world economic order where the leading central banks are on standby to backstop growth. We need to run fast to stay in the same place. We need to do more to get ahead. We need all forces including politics (to some extent at least) to align so that we are in with a chance. That is the context.

Then we come to some subtle nuances that are at work.

China is no longer offering a deflationary impetus and delivering never ending happiness to the global consumer. Quite the contrary. The over-reliance on the China centric global supply chains is now seen as a major risk. India is part of the solution to that problem, provided the world can trust India. Trust is in short supply these days.

Geopolitics has become complicated. China's stance on Taiwan is much more of an issue than the Korean imbroglio or even the Russian misadventure in Ukraine. The world has too much of TSMC and their chips everywhere. Everyone including US and China know that. India fits in well and is finding itself on the right side of most debates.

These augur well for India. However, we cannot be naive and imagine that India is indispensable. Far from it. India is useful provided it plays its part. Let us look at how India stacks up.

INDIA IS STILL RELATIVELY SMALL

Country	Share of world population (%)	Share of world nominal GDP (%)	Share of world trade (%)	Share of world market cap (%)
US	4.2	25.4	8.3	44.3
China	17.8	18.1	12.1	9.3
European Union	5.6	16.6	30.2	10.0
India	17.8	3.4	2.5	3.6

Note: Share of population, nominal GDP & trade data as on CY22; Share of market cap. data as on 30th Sep 2023
Source: International Monetary Fund, World Bank, Bloomberg, Spark Fund Research

India is interesting to foreigners and is even exciting. The share of India in GDP, trade and market cap can go up a lot. However, the world will not become dark if India closes its eyes. This is the nuanced view we need to take as India is sprinting into election season. We will try to answer some questions that inevitably come up as the world's largest democratic exercise gets underway.

In the long run, the markets have ignored politics and marched on. Can't we just focus on the long term?

Nice thought. But hard to follow through on this. You can't get to the long term without negotiating the short term. The journey is going to be very painful and no point glossing over it.

Nifty Trailing P/E (x)	
2004	18.7
2009	16.5
2014	18.8
2019	29.3
2023	22.2

Note: Trailing P/E data as on 30th Apr of respective years. For 2023, trailing P/E as on 30th Sep 2023
Source: Nifty Indices, Spark Fund Research

Valuations are higher than at any time other than before the 2019 elections. Global interest rates are much higher (from 2019) and this combination does not leave any margin of safety for the markets. Further, we are not in 2004 or 2009. We don't have the cosy political consensus that might have been there for decades. Stakes have been ratcheted up. The world is not a nice place either. We can't just ignore politics this time.

What if we remain invested in defensives?

There is just one problem. Which is finding out what the defensives are and what is the source of protection. Historically, the consumer sector, pharma and IT acted as defensives. Let us look at what is happening to these.

Consumer stocks

Companies	Trailing P/E (x)	10Yr Average Trailing P/E (x)
Asian Paints	77	64
Avenue Supermarts	100	126
Britannia Industries	47	49
Havells India	81	49
Hindustan Unilever	57	55
Titan Company	86	68

Note: Trailing P/E data as on 30th Sep 2023, For Avenue Supermarts data is from 21st March 2017.
Source: Ace Equity, Spark Fund Research

It is clear that there is nothing defensive about the above numbers. In the pharma sector, the valuations may be more reasonable. However, a good part of their profits typically come from US generics. The regulatory uncertainties hardly bestow a defensive sheen on these names. And then there is IT services. Three factors blur the picture now. One, global growth outlook is not looking anything great and revenue visibility is the worst it has been in a few years. Two, there is a major technology disruption afoot brought about by AI. Everyone sounds confident that Indian IT services will adapt to the new order and will get lots of business. That might be the case. However, one clear fallout is that AI is intended to do more with lesser people. The model for Indian IT has always been to do more with more people. Re-inventing the business model may not be painless. Thirdly, the margins are already down and are on the edge of a precipice. For some companies like Wipro, HCL Tech and Tech Mahindra, they have tripped and fallen. It is just that the market is looking the other way for now. This hardly looks like a defensive set-up for us.

The fact is that erstwhile defensives don't appear to be having the mojo to lead the market in the event of election led volatility.

After all, politics and elections may only affect the PSUs and a few other pockets. Why bother?

The market performance has been broad-based because earnings growth has become broad-based. It is the expectation of continued earnings growth that can sustain the markets. Nothing else. It is not about PSUs or about investment centric sectors as that would be inverting the logic. The fact is the following – for the market to sustain, earnings must grow. For that, the economy has to fire and not just on the back of consumption activity. The investment engine which has come alive after a deep slumber has to keep going. PSUs and certain other sectors have come into the limelight because they have a presence in what we call core India. Thus, it is growth expectations on core India that are driving PSUs. It is not politics that is driving them. Do not miss the wood for the trees.

What is the risk from elections this time around?

It is about continuity and confidence. And that too in a relatively well-priced market in a world full of uncertainties. There is a unique opportunity for India that may be a once-in-a-lifetime opening. This is driven by a growth starved world and by geopolitics which has catapulted India into the centre-stage. India will easily miss the bus if there is threat to that continuity and the rest of the world will not pause.

It is quite possible that there is continuity in policies whatever may be the political formation that rules India. The problem is this. The alternative to the present dispensation has literally gone on record to hint that their only priority is to break the continuity. They have all but proclaimed that they have no common agenda and they are together only to unseat the present government. This can hardly inspire any confidence to investors if the probability of regime change becomes meaningful – and the new dispensation does not assure broad continuity (whether such a mandate will be available is very unclear).

What can or what should investors do?

Not much really. The fact is that India presents a great story and there is no going back on that fact. There is a binary risk from the forthcoming elections and investors need to be aware of it. There is no easy hedge here. If it transpires that there is continuity, the market may price in the future thick and fast. It is not possible to time this. However, it is fair to believe that upsides from now on till we know what is in store for the country will be a laboured one. Given the rally we have seen in the last few months, it may be a good idea to pause and take stock. The other practical way forward is to follow earnings growth and that is likely in core India. That is not defensive by conventional wisdom. By the same wisdom, equities are not about being defensive. Certainly not in today's world order.

Investors will do well to understand that politics and the outcome of general elections in 2024 will matter more than the previous ones. While there is no hedge, the following should remain valid.

1. Understand and control your risk exposure
2. Do not try to overinterpret what cannot be analysed easily – election is one such event
3. Focus on companies that can drive their growth and the market beyond the middle of 2024
4. Stay prepared and stay agile

There is nothing new we are saying here. Except that complacency over the political event ahead is not going to be helpful.

Warm regards,

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