A glass a bit more than half full – will it leak?

We have finally come to the end of a long and tiring election season. The NDA may have scraped through with a majority, but the BJP has to depend on partners for the first time in ten years. Modi regime is in unchartered territory. A lot of calculations may have to be re-worked at the macro-level. Here are some points we need to grapple with:

1. The market did not get what it wanted. How much that matters are to be debated separately. The fact remains that the market was unprepared for BJP getting lower than 272 seats.
2. Given the growing influence of behavioural factors on market performance, this is a new (ab)normal that the market has to contend with. We need to show some patience to understand what has hit us or what is coming our way now.
3. Valuations are not overly stretched but there is little margin of safety left in most stocks.

Conclusion – We need to take stock of what is the way forward on the macro front.

Why does the macro matter now more than ever?

1. India is at a unique position globally where its importance in the wider world has never been higher. In the post Covid world, the geopolitical context in which India is placed in the global supply chain deserves mention. The fact that India is the fastest growing large economy in the world adds to this. The interest that global capital has in India would be a function of stability and continuity in policies if not in people. Global capital is critical for India to redeem its promise. Macro matters now more than ever.
2. Over the last ten years, the benefits of having a decisive government and process at the Centre have been increasingly appreciated. If nothing else, it has resulted in better execution on areas such as infrastructure. Macro matters now more than ever.

The obvious question is whether the current political set-up will enable stability and continuity in policies and governance.

Firstly, let us look at some data.

Year	Largest Party	Seats Won
1991	INC	244
1996	BJP	161
1998	BJP	182
1999	BJP	182
2004	INC	145
2009	INC	206
2014	BJP	282
2019	BJP	303
2024	BJP	240

Source: ECI- Election Commission of India, Spark Fund Research

Even with the reduced numbers, the BJP has larger numbers on its own than for any party that ruled from 1991 to 2014. It is just its own past and the high expectations that they have fallen short of. Similarly, the pre-poll alliance has got an absolute majority which was not the case from 1991 to 2014.

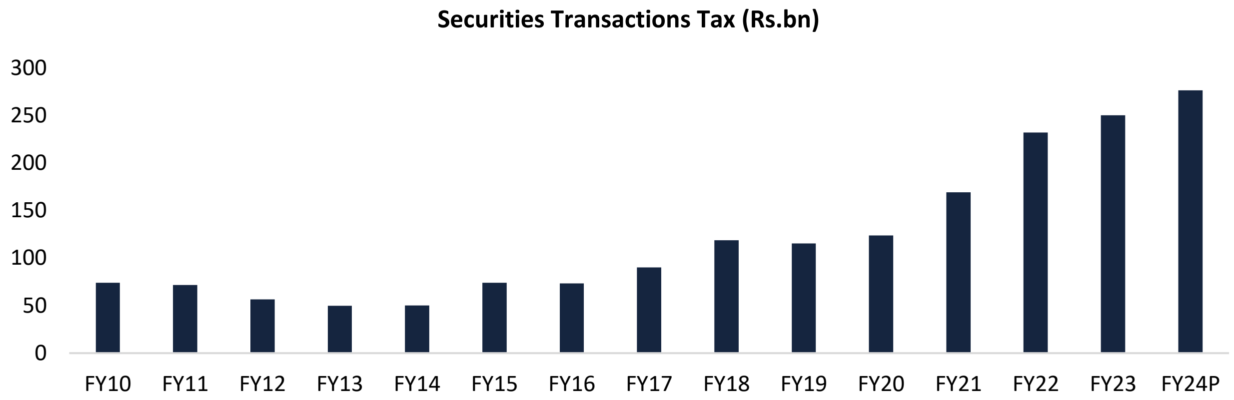
Secondly, there are two coalition partners who will take BJP very closer to the halfway mark. While there are some justifiable apprehensions on whether BJP would be able to carry them along, it need not necessarily prove as challenging as managing partners running into double digits. Thirdly, TDP which is a key player now, has a record of supporting liberal economic reforms.

Conclusion – The market is right to be concerned but it is premature to jump to any conclusion on the efficacy or longevity of Modi 3.0.

What gives?

We have to see how the new NDA navigates difficult decisions on resource allocation. We have written about the reality of the K-Shaped recovery. One of the takeaways from the election results is the discontent over unemployment. While the BJP government laid out very good safety net programs like the free food grain scheme, the challenge of creating jobs remains. They may also need to address the perception that they are pro-rich. How that would affect taxation policy is something to watch out for.

Let us look at the fears of an increase in capital gains tax. When long-term capital gains tax was reduced to Nil and a concessional rate was extended to short term gains, STT was introduced in lieu of the same. Look at how STT collections have grown. The rate and scope of STT have been increased over the years.



Source: Finance Act (Ministry of Finance), Spark Fund Research

We don't have data on how much the government gets from capital gains tax. In FY21-22, it was reported that the government could get a sum as high as Rs 80,000 crores from Rs 5,000 crores in the Covid year. While this is an indicative guesstimate or range, it shows two things. The collection from capital gains tax is less than 10% of personal income tax even in a good year. The collection is obviously next to nothing in a bad year for the market. The economic rationale for increasing capital gains taxes further is hard to see from a resource-raising point of view. For the sake of equity or optics, there is apprehension on this. That remains a risk. Foreign investors get better tax treatment from competing countries and foreign capital is necessary for India's capex plans.

The second risk is this. It has been a feature of the markets since 2008 that it goes hyper over anything that it likes. When it was private banks and consumer names, there was no ceiling on valuations if you belonged to this group. After Covid, similar optimism started to build up on public sector names and on areas related to infra/capex. The valuations in some of these names had gone crazy. All the same, the whole theme has many legs to go in a fundamental sense. In fact, without this theme clicking, it will be tough to make a positive case for Indian markets and its premium valuations. If there is a risk to the theme of capital spending, we may end up in a process of extended derating of the Indian market. This will make forward returns unexciting even from a slightly longer-term perspective. The capex story, earnings growth picture and stable market returns with valuations not going over the top are all inter-related.

The sharp market sell-off has started to bring valuations down to more interesting levels for many stocks. In one sense, the market was searching for a reason to correct some of the excesses that have been building up in the wake of the seemingly all-consuming post Covid rally. The process of clearing of the market is underway. As this finds its way forward, we need to assess the risks outlined above and weigh the broader India story. To be sure, India has survived many a political turmoil. Usually, political uncertainties have been sure-shot entry points for the Indian market. We will wait to see whether we are getting one more such opportunity.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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