

# On the minds of investors

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## What's behind India's slowdown?

Last Friday, India released its first quarter gross domestic product (GDP) results for the 2019-20 fiscal year<sup>1</sup>. Real GDP grew 5% year-over-year (y/y), sharply below median estimates of 5.7%. Though the Indian economy had been facing challenges since the de-monetization in 2016 and establishment of the goods and services tax, the recent pain is the result of a shadow banking crisis and the consequent slump in the auto industry.

The detail of the report were not encouraging. The manufacturing sector has been hit hard, with growth diving to 0.6% y/y from 12.1% a year ago. The growth of the construction as well as financial and real estate services sectors fell to 5.7% and 5.9% y/y from 9.6% and 6.5% respectively. Private consumption, which makes up about 55% of India's GDP, slowed to 3.1% y/y growth compared to 7.3% last year.

India's commercial banking sector was just starting to recover from a crackdown on its record high share of non-performing loans, when another source of weakness emerged from within the shadow banking sector. Following the default of Infrastructure Leasing & Financial Services, one of the largest non-bank finance companies (NBFCs) in late 2018, the rest of the shadow banking sector experienced a worsening liquidity crunch along with a rise in borrowing costs as lenders withdrew capital. This was detrimental to several segments of the economy, particularly small and medium enterprises, who had been dependent on NBFCs to fill the void of larger commercial banks already encumbered with bad debts. Such an effect is more pronounced in the auto sector which had already been facing headwinds from lower Chinese demand and regulatory tightening. NBFCs were responsible for providing credit for over 50% of commercial vehicles and nearly 65% of two-wheeled vehicles in India. The recent crisis forced many dealerships to close and consumer auto loans slumped. As a result, auto sales dived, with latest July data showing a 31% y/y fall in sales of passenger vehicles. Companies such as Maruti Suzuki saw new vehicle sales drop by over 35% y/y in August. Industrial production for motor vehicles, trailers and semi-trailers plunged by 13.9% y/y in June. The result has been job cuts and hiring freezes in the auto sector which accounts for a large portion of the labor market. The Automotive Component Manufacturers Association of India estimates that up to 1 million people could be laid off if the trend continues.

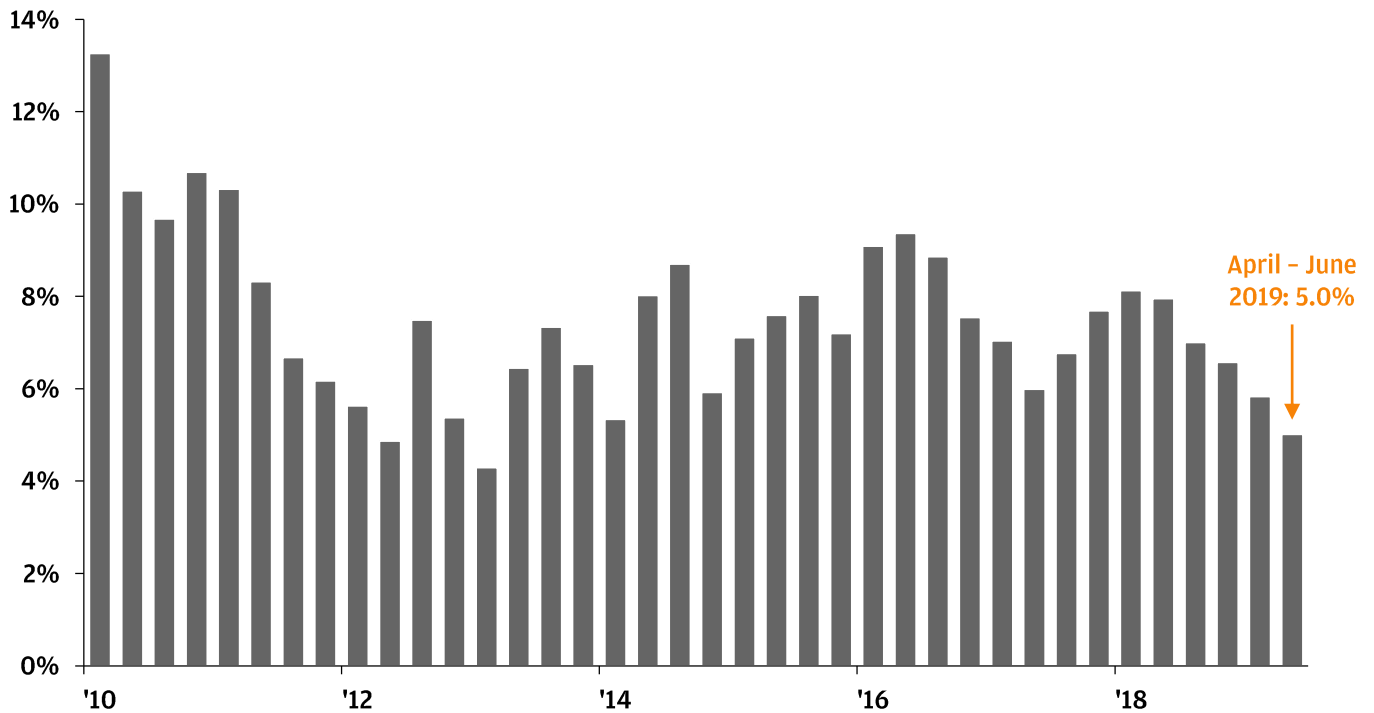
To stem any further slowdown, the government announced several measures. Large state-run banks will be merged to consolidate the banking sector and 552.5 billion rupees of capital will be injected into the new entities in an attempt to boost lending. Foreign capital is exempted from additional levies to encourage inflows. The auto sector also received some reprieve with a proposed increase in government spending on new vehicles, higher rate of depreciation and a delayed rise in registration fees.

<sup>1</sup> For India, its fiscal year begins in April, so 1Q19 in this case refers to April-June 2019.

Ian Hui  
Global Market Strategist

Marcus Yiu  
Market Analyst

**EXHIBIT 1: INDIA REAL GDP GROWTH**  
YEAR-OVER-YEAR CHANGE



Sources: CEIC, Ministry of Statistics and Program Implementation, J.P. Morgan Asset Management. Data reflect most recently available as of 04/09/19.

### Investment implications

Despite the large miss in growth expectations, the decisiveness in deploying targeted stimulus measures should provide some support to investor sentiment. Given that the Reserve Bank of India (RBI) has already cut policy rates by 110 bps and still expected to ease further, additional initiatives are welcome. On the fiscal end, given worries over expanding deficits, the recent restraint in deploying large scale government spending or tax cuts is commendable. Nonetheless, a recent one time transfer of excess capital from the RBI to the government has freed up additional fiscal space of up to 0.3% of GDP that can be deployed if the economy outlook deteriorates.

Investors worried about possible systemic risks to India’s financial system can take comfort at the fact that loans to the auto sector only amounts to about less than 1% respectively of total gross bank credit deployed by 39 representative commercial banks surveyed by the RBI. The relatively low exposure and continued government efforts to recapitalize the banking sector should contain any contagion effects and risks of a broad-based liquidity squeeze. Overall, the challenges facing India’s financial sector will serve as an impetus for reforms to improve capital efficiency, clean up balance sheets of major banks and reduce reliance on the shadow banking sector. From an investment perspective, India remains to be an attractive destination as unlike many other countries, India is still at a very early stage of economic development and the long-term drivers of growth—demographics & productivity—are yet to play out.

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