Manulife Asset Management

Investment Note

15 November 2016

Investment note: Welcome to India's new high-value notes; the election of a new US president

Two recent events affecting India warrant investors' attention in this update. First, cash may no longer be king in India. In a surprise announcement made on 8 November, Prime Minister Narendra Modi banned Rupees 500 and Rupees 1,000 notes, sweeping away nearly 85 percent of the total currency in circulation. Second, a new US president, Donald Trump, was elected on 9 November.

Manulife Asset Management's India Equities Specialist Rana Gupta sees Modi's recent move as a long-term positive, a way to kill two birds with one stone: obliterating unaccounted stash of cash and reducing the government's fiscal deficit, ultimately resulting in to lower rates and benefitting the country's banking sectors. Gupta sees the US elections having potential mixed implications for India, focusing on the IT, healthcare and natural commodity sectors.

Welcome to India's new high-value notes

India Prime Minister Modi's surprise announcement to demonetize the Rupees (Rs) 500 and Rs 1,000 currency notes caught many in the markets off guard. The primary motive for the policy was to fight corruption and reduce tax avoidance, money laundering and terrorist financing. As substitutes, the new Rs. 2,000 note and Rs. 500 note were introduced, which have features that make them easier to track and difficult to forge[1].

Photo: Prime Minister Narendra Modi banned Rupees 500 and Rupees 1,000 notes (shown in picture) on 8 November 2016.

India is still an economy based on cash (see Figure 1), with an estimated US dollar 240 billion[2] worth of currency in circulation. A substantial portion of this circulating cash, estimates vary between

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[1] Source: HDTV, hindustantimes, as of 12 November 2016.
[2] Source: RBI Annual Report, as of 31st March 2016.

25-40%[3], was unaccounted for by the government; the scrapping of these notes will render approximately US dollar 60 to 90 billion worth of Rupees worthless.

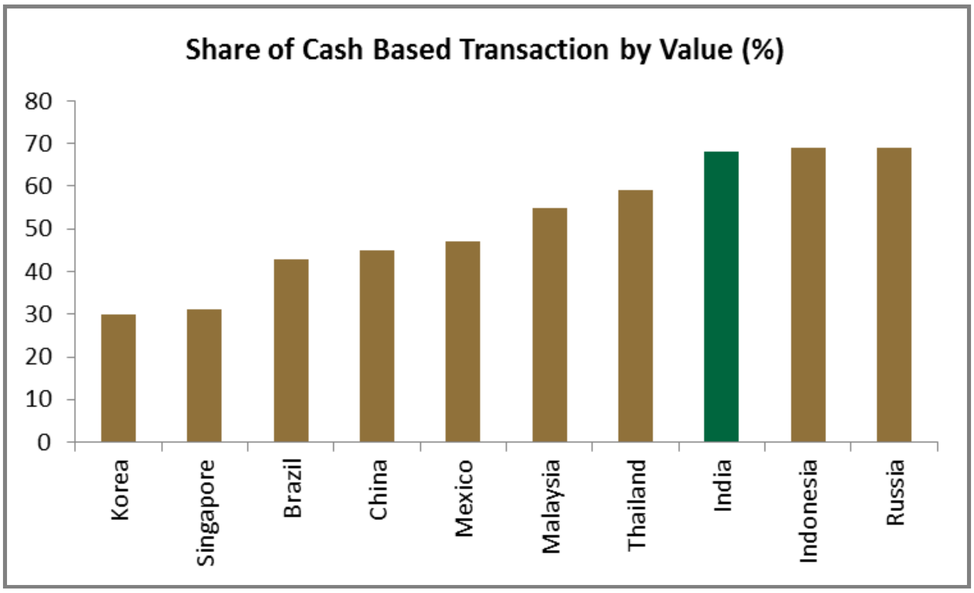

Figure 1: India is one of the leading cash economies[4]

While Gupta sees some negative implications arising over the short-term, long-term gains will make this policy move positive for investors:

Short-term:

- Two negative implications are expected over the next three months:
    - **Risks to asset prices**: Some of the unaccounted for money was used to purchase land, property and gold. With the notes now void, these asset classes may face downward price pressure. Sales of consumer durables and building materials are also expected to weaken as the note destruction represented a substantial loss of wealth for some individuals.
    - **Asset linkages may hurt smaller financial firms**: Some of the smaller financial services companies may be vulnerable after the policy's implementation as they have exposure to individuals/companies that lost money. Also some of the non-bank financial company used to collect payment in cash, they can also face challenges. An increase in delinquent payments in the industry should be watched closely.

Long-term:

- Over the long-term, India's sustainable growth push will be supported due to the following factors:
    - **Stronger government balance sheet and currency**: According to our understanding, the Central Bank (Reserve Bank of India) will be able to extinguish liabilities on its balance sheet for the value of the cash that doesn't

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[3] Manulife Asset Management estimate, November 2016.
[4] Mastercard, September 2013.

come back to bank deposits. We estimate that 25% - 40%[3] of the money is not accounted for (US dollar 60 billion to 90 billion, roughly 3 to 4% of gross domestic product, GDP); therefore, it will not be deposited. Gains from this can be transferred to the government as dividends, reducing the current fiscal deficit (3.5% of GDP) and allow for more fiscal spending options. This may also lead to a stabilization of the currency. It's not just fiscal deficit that reduces, even, current account will structurally improve due to lower gold imports. India's gold import was 1.5% of GDP, whereas, current account deficit was – 1.1% of GDP.

- **Lower interest rates through lower inflation**: The wealth destruction is expected to bring in near-term disinflation, which may lead to more rate cuts by RBI. Government borrowing is also expected to decrease due to a stronger balance sheet (see previous point) and with banks flushed with liquidity; a market rally may lead government bond yields to decrease, bringing yields on Government bonds lower.
- **Sizable increase in domestic tax base and compliance, lowering tax rates**: We expect tax compliance to improve going forward. This will result in higher tax revenues, yet lower tax rates in the medium to long term. In addition to this policy, Indian citizens having a digital identity and online transaction ability, as well as the Goods and Service Tax (GST) will significantly bolster tax rates and compliance. This should contribute to lower tax rates over the mid-to-long-term.

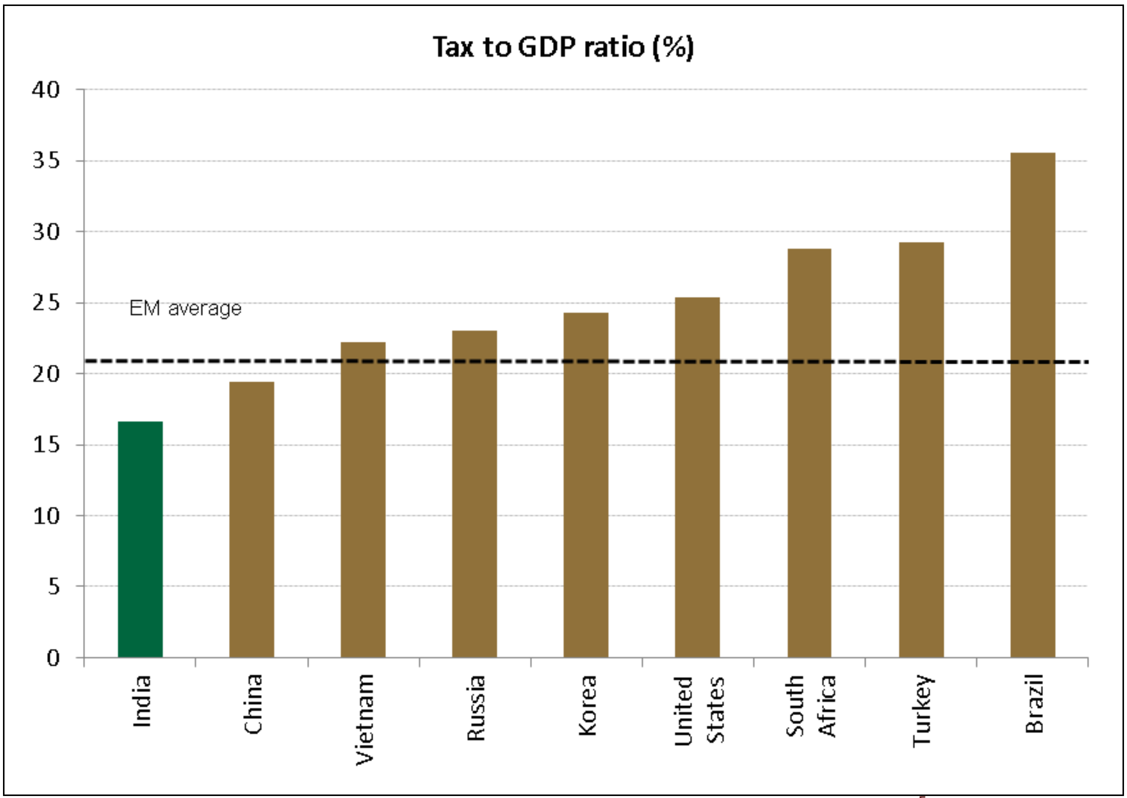

Figure 2: India has one of the lowest tax revenues-to-GPD ratios among emerging markets[5]

[5] OECD, CEIC, Economic Survey of 2015 to16, International Monetary Fund, Kotak Economics Research

- **Increased investment opportunities, particularly for equities (banking sector)**: Financial savings will increase and more deposits will become available at a reasonable cost. We are positive and overweight on the Indian banking sector. Indian equities are also attractive as an asset class due to the boldness of government reforms and stable, sustainable economic growth amidst decelerating inflation. We reiterate that long term positives may outweigh near term negatives.

The election of a new US president

On 9 November 2016, Donald Trump was elected as the 45th President of the United States. Trump's election has led investors to question its potential implications for India. Gupta thinks that the US election would have mixed implications on India, depending on the policies ultimately enacted.

During his campaign, Trump spoke of potential policies to limit offshoring of American jobs and further reform of the nation's health care system[6]. Because there is often times a difference to policies discussed on the campaign trail and those ultimately enacted, the specific impact of policies would depend on final legislation.

Gupta thinks that an attempt to increase costs for the Indian IT sector through additional regulations or visa limitations could impact their margins. Even prior to the US election, US IT clients were moving towards cloud solutions.

Generic pharmaceutical prices could also come under pressure if Trump moves forward to repeal sections of the Affordable Care Act, or promotes aggressive negotiations via Medicaid and Medicare with pharmaceutical companies over drug pricing. Faster approvals from the Food and Drug Administration were already putting pressure on generic drug prices. Thus, we are cautious on both the IT and health care sectors in India.

Finally, Gupta believes that if Trump passes a major infrastructure stimulus package, as he has indicated that he will in the first 100 days of his presidency[6], this may be positive for Indian metal producers with significant capacity.

[6] https://assets.donaldjtrump.com/_landings/contract/O-TRU-102316-Contractv02.pdf

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