

State Of the Markets: Macro Commentary

India: Bad Is Good And Worse Is Even Better—Part II—Why Now?

In my last commentary I talked about the slowdown in India growth and why growth could be even slower given measurement errors of India's GDP. In this commentary, Part II, I am going to outline the reasons for the sudden drop in India's growth--as if it hit a break wall--is shown in the LHS of Figure 1 below. Economic growth had accelerated after 2015/16 redenomination event driven by a surge in credit. Growth then hit the brick wall of a credit crunch (RHS). As shown in Figure 2 below, credit dried up reflecting the impact the surge in NPAs.

Figure 1.1,2

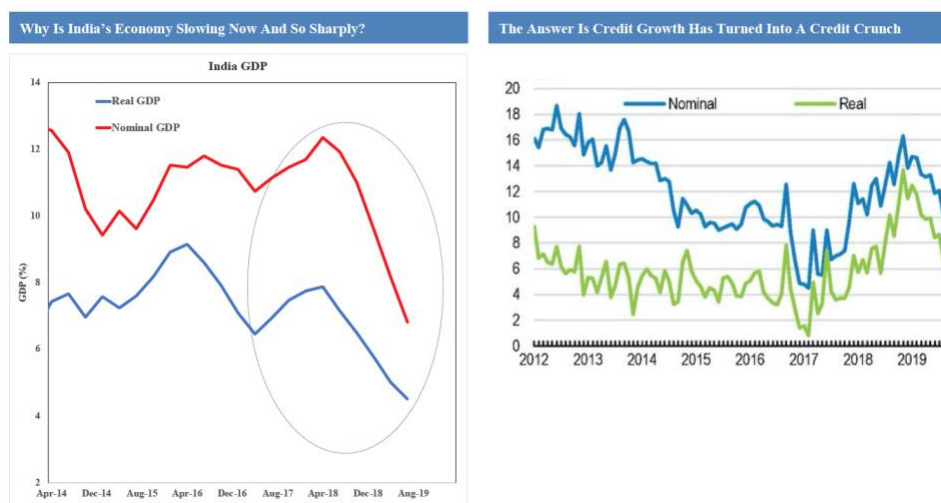
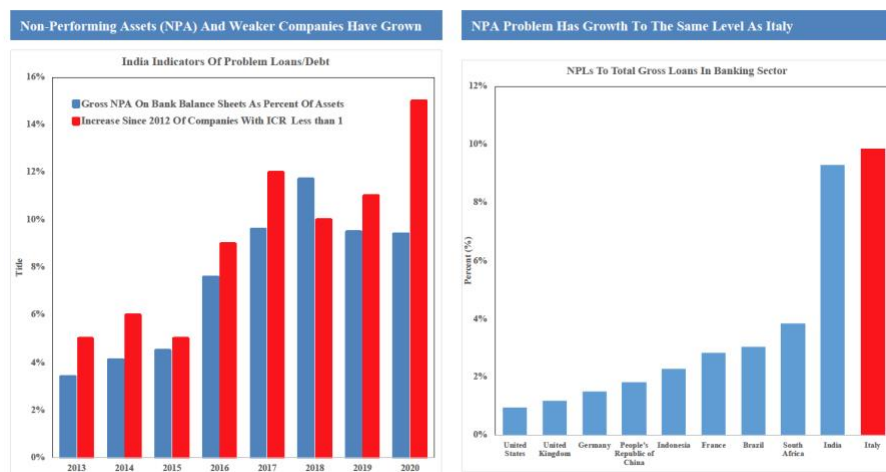
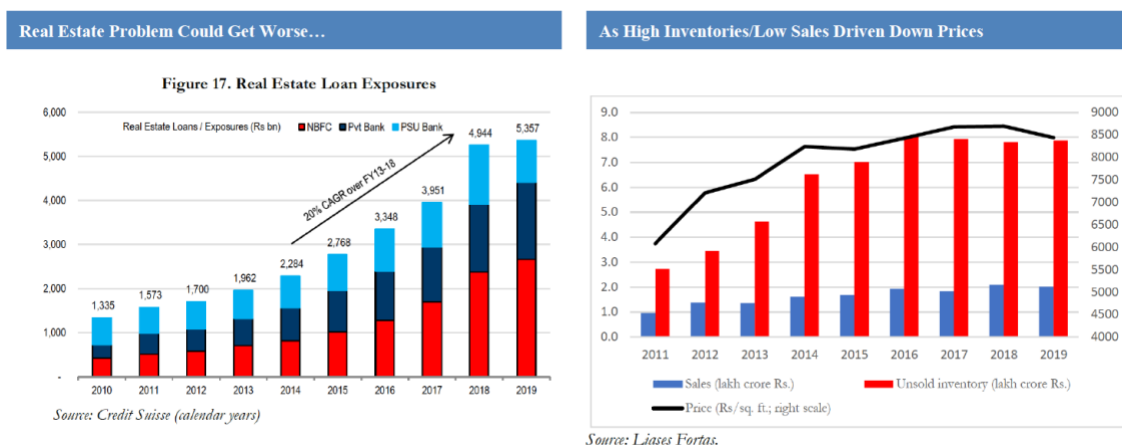


Figure 2.2,3



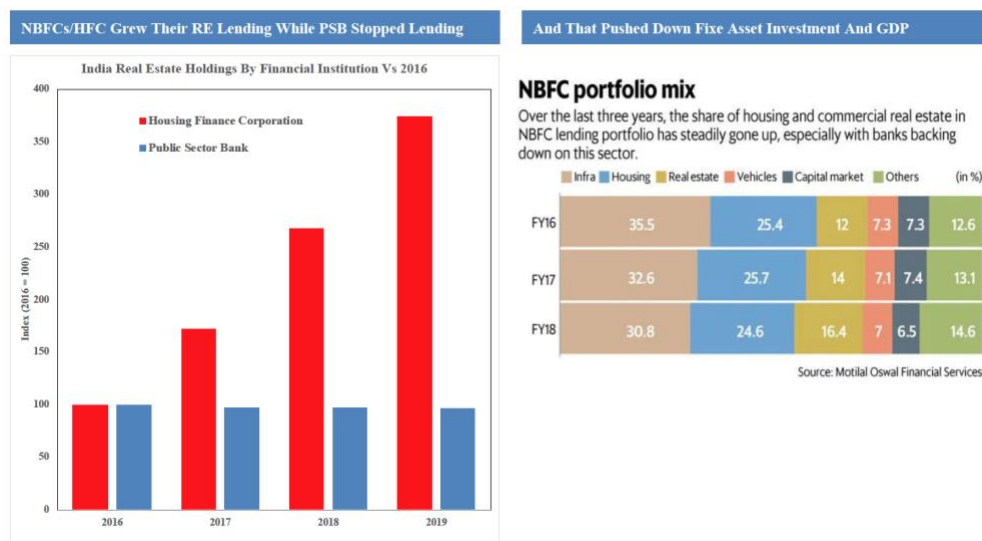
The real question at this point “is the NPA cycle over?” As shown in Figure 3 below, the answer could be no. This figure points to a potential real estate (RE) NPA cycle, reflecting increasing exposure on financial institution balance sheets of RE loans (LHS). This RE sector could be under pressure as inventories have grown much faster than sales (RHS). This potentially could end up pushing down RE prices and increasing defaults.

Figure 3.3



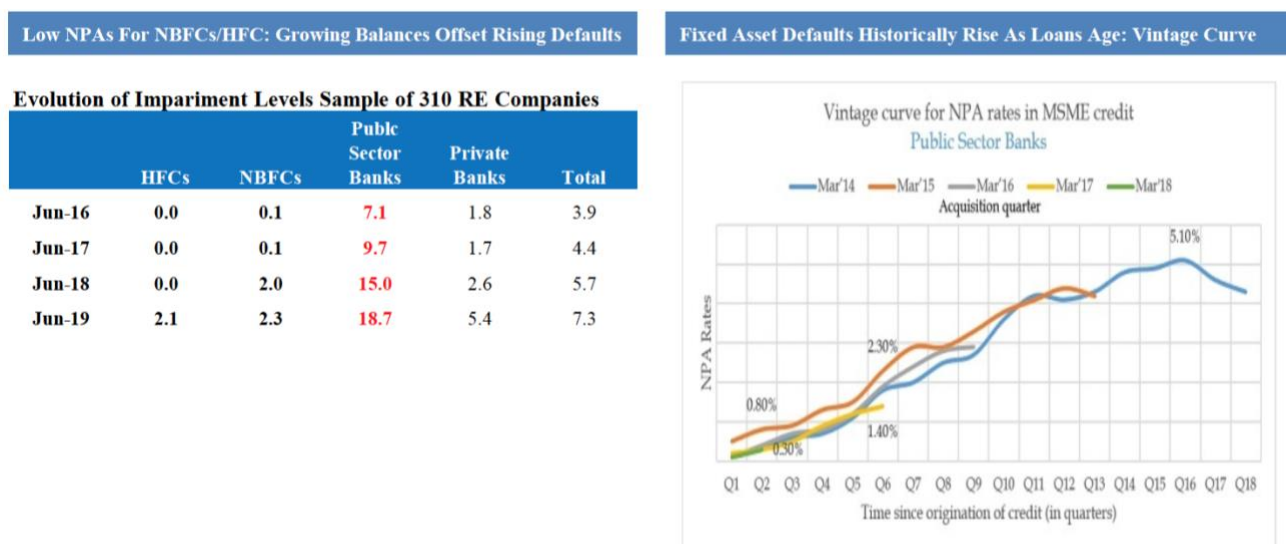
The impact of the softness in the real estate market could fall on the weaker part of the financial system, the NBFC/HFCs. Already problems in these institutions have already surfaced with the default of IL&FS, a large infrastructure lender. This could potentially be the tip of the iceberg the NPAs. As shown in Figure 4 below on the LHS, HFC have grown their real estate portfolios substantially, stepping into the void created as PSBs stepped away from lending in the sector. NBFCs are similar, RHS.

Figure 4.4,5



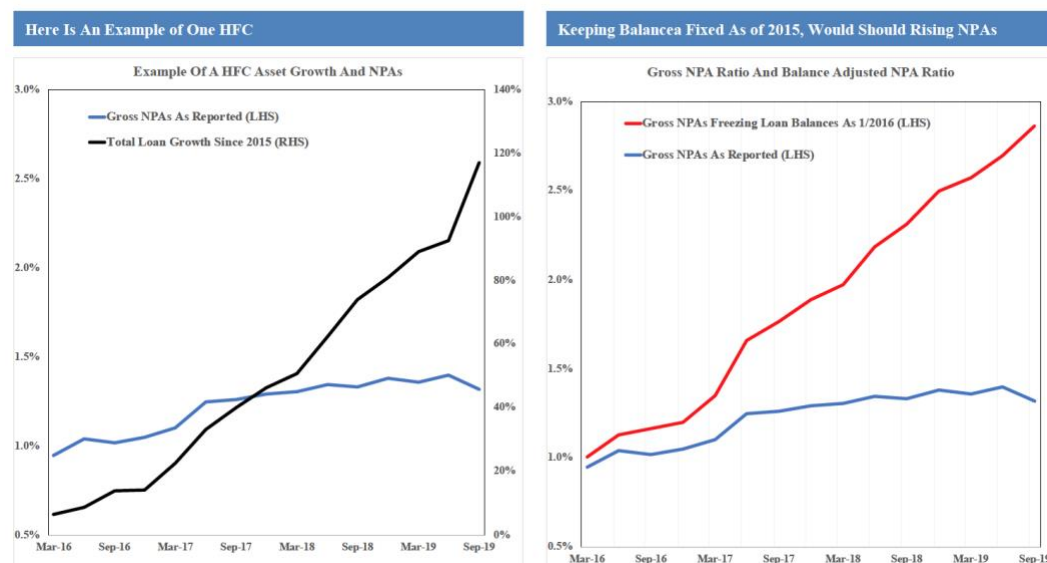
The problem in lending in the sector is already evident in the NPAs of Public Sector Banks (PSB) as shown on the LHS of Figure 5. The relatively low levels of NPAs on HFC/NBFC balance sheet are understated and could rise substantially as a result of the two factors. First, HFC/NBFC loans are early in the vintage default cycle, as shown on the RHS, given the recent surge in new originations. The second factor is that the sheer volume of new originations is swamping the rising default rates of earlier vintages. (This phenomenon was a problem in the surge of mortgage originations of the subprime crisis in the US.) As shown in the RHS, new originations have naturally lower default rates, for a variety of reasons. Defaults will rise over time along this vintage curve. However, the overall default rate of the total balance of the loans could actually fall if new originations are surging versus the level of past originations. Figure 6 below walks through a hypothetical example for a specific HFC

Figure 5.6.7



The RHS of FIGURE 6 shows the surge in originations of RE loans by a specific HFC, while NPA of the overall pool are actually unchanged. One simple way to offset the impact of the two factors mentioned above is to extract the vintage curve by holding the balance of the loans constant as of the end of 2015, but then attributed all of the NPAs to this vintage of loans. This is likely a lower bound on actual NPAs of the 2015 and earlier vintages. As shown on the RHS of this figure, this would imply that NPAs are actually rising. In contrast, the NPAs of the PSB are not affected by either of these two factors, by and large, given they have stopped lending to the sector. This could mean that the defaults on HFCs/NBFC balance sheets could end up at much higher levels, and closer to those of the PSBs.

Figure 6.8



So, the next part of my commentary, Part III, I will discuss what India is likely to do given the rapid slowdown in growth and the potential NPA problem facing India's financial sector. More importantly, I will discuss strategies to capture these actions.

1. Bloomberg
2. OECD, Economic Survey of India, 2019
3. Subramanian, Felman. "India's Great Slowdown: What Happened? What's The Way Out", CID working paper 370, December 2019
4. RBI
5. Economic Times Nov 2019
6. India FSR, 2019
7. TransUnion CIBIL
8. Author's calculations

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