Union Budget 2021 preview

Prioritize growth over fiscal consolidation with elevated deficit

27th Jan. 2021

Executive summary

- Pre-Covid, the economy was already in a declining trend since FY17 to reach 4.2% real GDP growth rate in FY20.
- Outbreak of Covid-19 led to a collapse of the bond and equity market globally. Since March 2020, the pandemic induced lockdown led to a historic contraction in economic activities in Q1 FY21.
- Co-ordinated monetary and fiscal support across the globe supported the population during uncertain times. Effective support by the Indian government was less than 2% of the GDP, which is lower than the global average.
- Post re-opening of the economy, India witnessed better than expected recovery during Q2 FY21. Surplus liquidity and lower interest rates fuelled the equity markets across the globe.
- Despite rise in mobility, India is seeing a continuous decline in infection rates. We are not anticipating a second wave of infections in the country. With vaccination drives starting across the globe, public movement is likely to normalize to pre-Covid levels by FY22.
- Sustainability of the recovery is the key concern. Private consumption and capacity utilization levels are subdued, thereby leading to muted private capex. Lower revenue for the government is expected to put pressure on its ability to support the economy further.
- First advance estimates forecast a 4.2% decline in nominal GDP in FY21. The agriculture sector is the only performer and the fiscal deficit is at elevated levels.
- There are immense expectations from the forthcoming Union Budget to trigger the accelerated revival of the economy.

What we expect the budget to focus on:

- Higher allocation for the healthcare sector (including fiscal support for the vaccination drive).
- Continued infrastructure spending and revised roadmap for NIP funding.
- Further boost for manufacturing.
- No additional incentives anticipated for the farm community.
- Boost exports by lowering cost and entering into international trade agreements.
- Massive asset monetization to fund the expected stimulus.
- Focus on growth over fiscal consolidation.
- No change in corporate and personal tax rate

Prelude:

Our economic growth was in a declining trend since 2017 and the last annual reported GDP growth was 4.2% in FY20. There were structural issues, which had to be addressed so as to take the potential economic growth back to historic levels of 7-8%. At the start of CY 2020, sentiments were buoyant, developed economies were doing well and world economic growth was expected to rebound. The Indian economy was also no exception, as high frequency indicators in Jan. and Feb. 2020 were showing firm signs of economic recovery. With green shoots visible, the Finance Minister unleashed a medium term reform in the 2020 Union Budget to grow India to a USD 5tn economy.

The outbreak of Covid-19 across the globe in early 2020 turned sentiments sour. With subsequent prolonged lockdowns across the globe, major economies went for tail spins resulting in a short technical recession except in China. The Indian government implemented one of the most stringent lockdowns to control the infection spread, with subdued economic activities for almost six months, all pre-existing budget plans and calculations went awry. Equity markets across the globe and in India reacted to global lockdowns and collapsed.

During this period, coordinated monetary and fiscal support by the global central banks and governments were implemented. To convert the crisis into an opportunity, the Indian government unveiled a massive "Atmanirbhar Bharat" initiative in May 2020 with economic package worth Rs.30tn (USD 420bn). The policy is aimed at making the nation self-sufficient. To boost local manufacturing, the government also introduced the production linked incentives (PLI) scheme for Rs.1.5tn spanned over five years. As a result of this, global and domestic equity markets witnessed a sharp rally, thereby erasing most of the losses due to the pandemic. However, there was a wide divergence between the economy and equity market performance. Most of the global economies reported double digit contraction in GDP but are anticipating a sharp turnaround in 2021. India reported around 23.9% contraction in GDP in Q1 FY21. However, post unlocking of the economy, India witnessed a GDP contraction of just 7.5% in Q2 FY21 (a 23% sequential surge in the GDP), as compared to the consensus expectation of another double digit contraction. Since then the pan-India mobility indicators have improved with private activities reaching 95% of pre-Covid levels in Oct. 2020. Also, despite the pandemic gloom, FDI inflows in Indian equities grew 15% Y-o-Y in H1 FY21 to USD 30bn.

Despite demonstrating fast V-shape economic recovery, we feel that the economy is still not out of the woods. The economic recovery is focused on the formal sector and not the informal one. We are certain that the unorganized sector and many MSMEs are still reeling from the lockdown. Improvement was mainly due to cost cutting undertaken by companies, such as a reduction in wage bills (which declined by 22% for small firms and were flat for large firms). Continued rise in unemployment (9.1% in Dec.) can lead to weak demand in the coming months. Due to such uncertainties, there was a sharp jump in household savings to 21.4% of the GDP in Q1 FY21 as compared to a gain of 7.9% in Q1 FY20. Core sector production, manufacturing & services PMI and fuel sales have been weaker in the latest release. Despite having lowest interest rate, credit growth has been stable (in fact remained low on Y-o-Y basis) with virtually no increase in credit to industry. Private investments are expected to be muted, because pre-Covid, utilization levels were below 70% for two consecutive quarters. The government's consumption support to the economy was weaker in Q2 (-22.2%) as compared to (+16.4%) in Q1 of the current fiscal. Thus, all the three components of demand - private consumption, fixed capital formation and government consumption - have contracted, but the first two at slower pace than in Q1. Nevertheless, The RBI forecasts mildly positive GDP growth in Q3 and Q4 of FY21.

Recovery from pandemic in India was exceptional as compared to other major economies. With lower infection & death rates, improved recoveries and developed immunity among the population, the nation has so far dodged the second wave of virus infection as seen in other countries. Considering the current declining infection trend and starting of the world's largest vaccination drive by the government, we firmly believe that the scar of Covid-19 pandemic is behind us and gradually the nation will return to normalcy.

In our view, for FY22, the government will target higher nominal GDP growth of 13% so as to compensate the growth lost (of around USD 500bn) due to the pandemic. Despite double digit growth in FY22, the GDP will be lower by 5.8% relative to the pre-pandemic level. The key concern is, if the loss of output is converted into loss of consumption and employment, then the damage to the economy will be compounded. Thus there are immense expectations from the forthcoming Union Budget to trigger the accelerated revival of the economy.

Our expectations from the budget:

- **Health sector to be the focus area:** The fight against the pandemic is on and the vaccine distribution in a large country like India will require considerable fiscal support. Secondly, the pandemic has exposed the poor health infrastructure, arising from the historical neglect of the sector. Total expenditure by the government was 1.3% of GDP in FY20, which is a magnitude lower than OECD countries. This needs to be addressed expeditiously. The government should spend more on the healthcare sector, especially on primary healthcare infrastructure. Other countries (like China, South Korea, Taiwan etc.) with efficient primary healthcare have effectively countered the impact of the virus. The government should work towards getting more people covered under health insurance and steps should be taken to achieve the long term goal of universal health coverage, taking into account the entire value chain of healthcare - prevention of diseases, treatment and health insurance.

- **Continued infrastructure spends and revised roadmap for NIP funding:** In the near-absence of private investments in the aftermath of the pandemic, the role of government spending as a growth catalyst has assumed utmost importance. The government should continue to handhold the economy by expanding the infrastructure projects that generate employment and have higher multiplier effects. Normally the multiplier effect of infrastructure is over 1.5x and thus is likely to be the major factor in boosting growth in the coming years. The Infra space had grown over 5% CAGR in the last five years, however, it was battered during the pandemic. Huge expenditure in infrastructure will boost the demand for steel & cement and contribute to rise in employment & income generation, which in turn will generate demand. Before the last budget, the government has introduced the National Infrastructure Pipeline package amounting to Rs.111tn. The plan had an outlay of higher allocation in the initial two years, however due to the pandemic the government will need to analyze the shortfall in its investment targets, so that they can be realigned for the balance of the period.

- **Further boost in manufacturing:** The manufacturing sector has played a stellar role in growth and development of any industrialized country. The emerging and developing countries place manufacturing at the driver's seat in their journey of economic growth. The Indian manufacturing sector's contribution to the GDP has been in a secular declining trend. From 17% contribution at the start of decade, it has steadily declined to current level of 13%. For advanced & developed nations the average contribution is around 17-18%, while for emerging & developing countries the contribution ranges from 10-30%. Indian policy makers (The Manufacturing Council) had earlier set a target of raising the share of manufacturing to 25% by 2022, this may be unachievable in the current climate.

  Since the initial days of the pandemic, there was a global demand to have an additional manufacturing source (other than China) to mitigate the supply risk. Many South East Asian countries have moved ahead of India in terms of attracting the manufacturing firms leaving from China. India was also behind in attracting new investments in manufacturing due to its global cost incompetence. Sensing this and post the success of PLI schemes in mobile manufacturing, the government in Nov. 2020 approved PLI scheme for 10 sectors with an outlay of Rs.1.5tn for a five year period. The success of the scheme can be demonstrated from the response received from various sectors. Auto & auto components received a lion share of Rs.0.57tn followed by Rs.0.18tn and Rs.0.15tn from battery and pharmaceutical sector, respectively.

  From this budget, we are expecting a further push to the "Atmanirbhar Bharat" policy by expansion of the PLI scheme to other sectors, easing higher cost pressure (like power, logistics etc.) and ease in multiple statutory compliances, which cumulatively would attract investments, boost employment and exports.

- **No additional incentives anticipated for the farm community:**
  Agriculture is the only sector, which has supported the economy during the pandemic. The first advance estimates released by government show that the farm sector is likely to grow at 3.4% in the current fiscal year. The outlook seems to be promising for the next year as well, mainly due to relatively higher water reservoir levels and improved rabi crop production.

  The government has implemented number of schemes in the past, like direct benefit transfer under PM Kisan, higher allocation for MGNREGA, Rs.1tn agriculture infrastructure fund, interest subvention etc. Thus, we are not anticipating additional incentives from the budget. We feel that a one time full transfer (instead of three installments a year) of PM Kisan support, higher allocation towards Agri-infra and MGNREGA will assist in further boosting the rural consumption.

- **Boost exports by lowering cost and entering into international trade agreements:** Exports have been a concern for the past few years, mainly due to the lower global competitiveness of domestic produce. Foreign trade this year was disrupted due to the pandemic, with exports declining 17.8% in the first eight months of the fiscal, with imports declining at a faster rate of 34%. As a result, the trade deficit declined sharply from USD 113bn to USD 42bn. However, this situation may not be comfortable for exports, which are declining even though the deficit has come down sharply.

  Since 2018, India has been a victim of a trade war between the US and China. Now with Joe Biden as the president of the US, there is optimism in global trade. India must now focus on openness in its policies by reducing the tariff and non-tariff barriers in a time bound manner. Protectionism is not the way to an atmanirbhar India, competition must drive industry. Thus letting the domestic producers compete with the world in the local market will make their products globally competitive. No country's manufacturing will be competitive globally, unless it is competitive in the local market.

  On the international trading bloc front, India cannot remain isolated for too long while other countries are increasing their global participation. Due to issues regarding local farm and dairy, India did not join Regional Comprehensive Economic Partnership - the world's largest trading bloc. Growth prospects are higher in trading with developing/emerging countries than with developed countries. So India must open up global trade and investment by joining global supply chain and realize its potential to be an economic powerhouse.

- **Massive asset monetization to fund the expected stimulus:** As for disinvestment, the government had budgeted an ambitious disinvestment target of Rs.2.1tn for FY21. However, the disinvestment receipts so far have been about Rs.0.18tn or 8.6% of the FY21 target, due to the pandemic. Because of fiscal strain, the government was not able to provide respectable stimulus during the pandemic. It announced an "Atmanirbhar Bharat" package of Rs.420bn, of which the fiscal support is around 2% - compared to other developing countries with stimulus packages of around 5% of their GDP. Despite proactively moving towards disinvestment of certain companies, the government till date has not been able to execute any targets. Disinvestment of key strategic assets like BPCL and Air India are likely to be concluded in next fiscal year.

  The highly anticipated IPO of LIC of India was announced during the last budget. However, there has been limited progress made, as only the actuarial firm has been selected to decide the embedded value of the entity's large asset base. Therefore, in the current fiscal, the government would have to rely on the proceeds from buybacks and dividends from CPSEs to shore up the non-tax revenue.

  While announcing the flagship 'Atmanirbhar Bharat" package, the government had also announced the opening up of all sectors for private sector participation. In the strategic sectors, the PSU firms are to be limited to a maximum of four units. Consequently, we are expecting divestments of more PSUs in next couple of years with the FY22 disinvestment target being similar to the FY21 levels, with a relatively higher confidence of meeting it.

- **Focus on growth over fiscal consolidation:** The fiscal position of the government was not robust pre-pandemic. The stress was further amplified due to the pandemic led lockdown, which resulted in lower tax & non-tax revenues and higher expenses towards public health measures. During the Union Budget 2020, the government had penciled a fiscal deficit of 3.5% on a nominal GDP growth of 10% in FY21. Further government borrowings were estimated at Rs.7.8tn. However, anticipating lower revenue due to the pandemic and to boost infrastructure spends, it has increased the borrowings to Rs.12tn.

  As per media reports, the government is expected to report a net revenue shortfall of Rs.3.2tn (considering a massive shortfall from the disinvestment proceeds, while partially offset by higher excise duty collection on mobility fuels), while at the same time expenditure will be higher by Rs.3.3tn. Consequently, the deficit could be in the range of Rs.14.5tn, which when compared with a nominal GDP contraction of 4.2%, fiscal deficit comes out to be 7.4% for FY21.

We feel that for FY22, the government would try to target higher nominal GDP growth of 13% so as to compensate for the lost growth (of around USD 500bn) due to the pandemic. Despite double digit growth in FY22, the GDP will be lower by 5.8% relative to the pre-pandemic level. Thus to achieve higher growth in the short term and to lay a path for stable medium term growth, the government has to boost spending without concerning themselves with the actions of the rating agencies. As state fiscals are under strain, state funded projects can be brought to completion with the aid of central government funding. Extra investments would be required to revive growth, as such, the government must be ready to tap foreign capital. We are in a comfortable position with debt to GDP ratio of 72% and this year it is expected to be around 85%, which is anticipated to improve with revival in growth. Inadequate stimulus or spending would have a cascading negative impact on the future growth prospects of the country. We are likely to see a fiscal deficit similar to FY21 with a fresh roadmap of fiscal consolidation.

- **No change in corporate and personal tax rate:**

With the corporate tax rate deduction last year, we are anticipating status quo to be maintained in the corporate tax rate. Rather, some actions would be taken in reducing tax concessions.

On the personal taxation front, in the last budget, the government has introduced an optional simplified personal tax regime with lower tax rates (for the individual taxpayers who forgo certain deductions and exemptions). Thus this time, we are not anticipating any change in the personal tax rate. However there will be some relaxation, in terms of allowances of more deductions in the new tax regime to make it more attractive. We are also expecting relatively higher exemption limit under 80C and 80D (mainly medical insurance, HRA etc.)

Existing income tax slabs and rates			
Taxable income slab (Rs.)	**Existing old regime tax rate**	**New regime tax rate**	**Expectations**
0 - 2.5 lakh	Exempt	Exempt	No change in the personal tax rate, but anticipating higher deductions under 80C and 80D.
2.5 - 5 lakh	5%	5%	
5 - 7.5 lakh	20%	10%	
7.5 - 10 lakh	20%	15%	
10 - 12.5 lakh	30%	20%	
12.5 - 15 lakh	30%	25%	
Above 15 lakh	30%	30%	

Source: Choice Broking Research

Equity market outlook:

Shrugging off the Covid-19 pandemic blues, domestic equity market ended the calendar year 2020 with a positive return of 14.9%. This is the fifth consecutive year of positive return. This comes mainly on the back of liquidity surge from several global central banks and better than expected economic recovery.

The year started with a dull note. Following global equity markets, domestic benchmark crashed by around 40% in Mar. 2020 (to a four year low) due to expected economic turmoil cause by the pandemic. However, with co-ordinated liquidity and fiscal support from the global central banks and governments, domestic equity market have recovered by more than 70% since.

The prime reason for the sharp recovery was the collapse in the debt market, flat gold market and illiquid real estate investments. Equities remained the preferred mode of investment. Foreign portfolio investors (FPI) have pumped in over Rs.1.7tn (USD 23bn) into the Indian equity markets in 2020, encouraged by stimulus programs across the globe, especially from developed countries. Faster economic recovery aided in taking domestic equity benchmarks to higher levels in 2020.

Out of the total FPI inflows in 2020, 67% (i.e. USD 19bn/Rs.1.4tn) came in the last two months, which is among the highest for emerging markets baring China. Considering the recent flows, we anticipate that FPI flow will continue in the next fiscal year. The premise of this is that the US will not raise interest rates, at least for the next 12-18 months despite witnessing early inflationary pressure. Other major markets are also likely to recover faster and contribute higher to the incremental global GDP than the US. Consequently, this will put pressure on the USD, which is already in the bear phase. Normally, a declining USD is positive for the emerging markets. According to Bloomberg Survey, India is among the top five preferred emerging markets for 2021 and thus is likely to witness continued FPI inflows.

Going forward in 2021, the market movement could also factor in the success of vaccination efforts. The rally in 2021 has put faith in the vaccination drives across the globe. However, early evidence shows that globally, the vaccination drives are showing concerns, which could pose a risk on the market expectations of economic growth.

The situation in the US and many countries of the Euro region is dire, there has been limited vaccination despite adequate procurement and distribution of vaccines. In major global economies, post rollout of vaccination drive, there is evidence of rising infections & deaths, lower consumption levels and rising unemployment rate.

In the US, 9mn people have been vaccinated, against the target of 20mn people by the end of 2020. In the United Kingdom, 2.5mn have been administered vaccine shots. Italy, Germany and Spain have each vaccinated less than 1mn people, while France has administered 0.19mn shots.

India began the largest vaccination drive in its history on 16th Jan. 2021, with over 0.2mn people vaccinated across the country. The government has set an target to immunize 30mn frontline health workers and later 270mn of the population in the most vulnerable category by Jul. 2021. A lot is expected to change before this deadline. Given the nation’s experience in childhood immunization and administering millions of doses in extremely diverse geographical conditions, we feel confident on the scale up of the vaccination drive.

At 22x, Nifty’s one year forward P/E ratio is at an all-time high and is around 45% premium to its 15 years average. The market is factoring robust earnings growth in the mid-term mainly on the back of budget stimulus for consumption, massive infrastructure spending by the government and continued lower rates in the developed markets.

For 2021, midcaps and small caps are likely to fare better, as the difference in earning growth during a recovery phase will be higher in broader markets as compared to large caps. At the end of 2020, midcaps and small caps were down by 1.2% and 22.5%, respectively from the Jan. 2018 highs, while the Nifty has gained 34% during this period. If the vaccination results are favorable, we feel that cyclical sectors like metals, real estate, construction etc. could be in focus, else, defensives like consumer focused, utilities, healthcare will be focus. Concluding on the equity market outlook, we feel that the fundamentals for domestic equity market are more favorable than in the past and thus we anticipate a continued positive momentum/sentiment among the investors.

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Sector expectation:

Sector	Budget expectations	Key sectors/stocks to watch out for
Agriculture and Fertilizers	Rationalize fertilizer subsidy through DBT	Positive for fertilizer companies
	Increase in the agricultural credit	Positive for Sector
Aviation	Change in excise duty on ATF	Interglobe Aviation and Spicejet
Auto and Auto Ancillary	Increase in income tax deductions	Bajaj, Escorts, Hero, TVS, Maruti and M&M
	Increase in rural spends	Positive for 2Ws and entry price PVs
	Introduction of scrappage of old vehicles	Positive for commercial vehicle companies
	Infrastructure focused budget	Ashok Leyland, Tata Motors, M&M, Eicher Motors
BFSI - Banks	Setting up of development finance institution	Positive for the sector
	Bank recapitalization	Positive for the PSBs
BFSI - NBFCs	Measures to improve liquidity issues of NBFCs	Positive for whole NBFCs
	Increase in allocation towards affordable housing	Positive for housing finance companies
	Higher tax exemption of home loan principle and interest payment	Positive for housing finance companies
BFSI - Insurance	Higher deduction limits under 80C and 80D	Positive for insurance sector
Cement	Higher allocation for infrastructure	Positive for the sector
Consumption - Discretionary	Reduction in import duty on Gold	Titan
	Deferral of statutory dues for the hotels	Indian Hotels and Lemon Tree
FMCG	Increase allocation of funds to rural schemes such as MNREGA and other rural schemes	HUL, Colgate, Dabur, Emami, Jyothy Lab etc.
Infrastructure	Higher allocation for road projects	Positive for IRB Infra, PNC Infratech, KNR Construction, Dilip Buildcon, Sadbhav Engineering, Ashoka Buildcon etc.
	Higher allocation for railway projects	Positive for Texmaco Rail, Titagarh Wagon, BEML, L&T, ABB and Siemens
Metal and Mining	Reduction in custom duty of key raw materials	Tata Steel, JSW Steel, JSPL and SAIL
Oil and Gas	Lower excise duty on crude	Positive for oil marketing companies
Pharmaceuticals	Increase in allocation for health sector	Positive for the sector
Real Estate	No price cap in classification of affordable housing	DLF, Godrej Properties, Puravankara Projects and Prestige Estates
	Continued focus on affordable housing segment	Sobha, Brigade, Kolte-Patil and Sunteck Realty
Telecom	Reduction in regulatory levies like licenses fees and spectrum usage charge	Bharti Airtel, Vodafone Idea and Reliance Industries

Source: Choice Broking Research

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