

India Market Strategy

Cash is no longer king

Equity Strategy

India

Event: PM announces INR 1000/500 currency notes will cease to be legal tender

Prime Minister Narendra Modi announced today that existing Indian currency notes of denominations INR 500 and 1000 will cease to be legal tender from midnight of 8th Nov 2016. In the subsequent press conference by the RBI Governor and the Economic Affairs Secretary, it was highlighted that the RBI will issue new currency notes of INR 500 and INR 2000 on 10th Nov 2016. Existing INR 500/1000 currency notes can be exchanged from banks starting 10th Nov 2016 (till 31 Dec 2016), and the issuance of new notes would be monitored and regulated by the RBI. The stated objectives of this announcement are for curbing black money in the economy, for increasing security, countering terrorism (by restricting its financing through cash) as well as curtailing the prevalence of fake currency. This step follows through the Govt's measures against black money, post the deadline for the Income Declaration Scheme 2016.

Impact: near-term disruptive

In the near-term, this move may hurt economic activity, specifically discretionary consumption, gold and property demand. The Indian economy had INR 17.3trn (US\$ 260bn) of currency in circulation as of Sep'16. As per Mar'16 data, INR 500 and 1000 notes comprised 86% of the value of currency in circulation, or 10.4% of GDP. Currency in circulation has increased by 15% in the last one year and 42% over the last three years, ahead of nominal GDP growth. As per the Economic Affairs Secretary, the growth in INR 500 and 1000 notes has been higher than that of the aggregate currency in circulation and the size of the economy. Part of this, if unaccounted for and becomes illegal tender, also means wealth destruction with its accompanied impact on business activity.

Impact: long term positive

We believe the measure is a long term positive as it helps formalise the economy with attendant benefits of efficiency and access to lower cost of capital. We view it as a positive for financials potentially but over the longer term. Combined with GST and Aadhaar driven financial inclusion (two of India's three arrows, see [here](#) for our detailed report) this will help formalisation of the economy. The SIT (Special Investigation Team) on black money had earlier released a report ([link to press release](#)) highlighting the need to restrict cash transactions and holdings to counter unaccounted wealth. The World Bank in July 2010 estimated the size of India's shadow economy at 23.2% of GDP in 2007.

Action: Indian markets may be driven more by global factors and earnings

Despite implications for the economy, we think this step may not have a material impact on markets beyond the near-term at most. Global factors may matter more (correlation of Indian markets with global/regional markets has been near highs recently) and of course earnings will matter. Our view remains that while earnings should recover mildly in FY17-18E, disappointment on H2 growth recovery hopes will imply further cuts to street's Nifty earnings estimates. If the near-term economic impact of this measure to curb black money is material and shows up in high frequency data, then the sharper cuts to near-term earnings may hurt Indian markets.

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Valuation Method and Risk Statement

We believe the risks to our long-term estimates (for example, for corporate earnings) and macroeconomic variables (such as GDP growth rates and inflation) are an economic slowdown, a weakening currency, global economic events, and government policy changes.

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