Q2 GDP review: first sign of a slowdown?

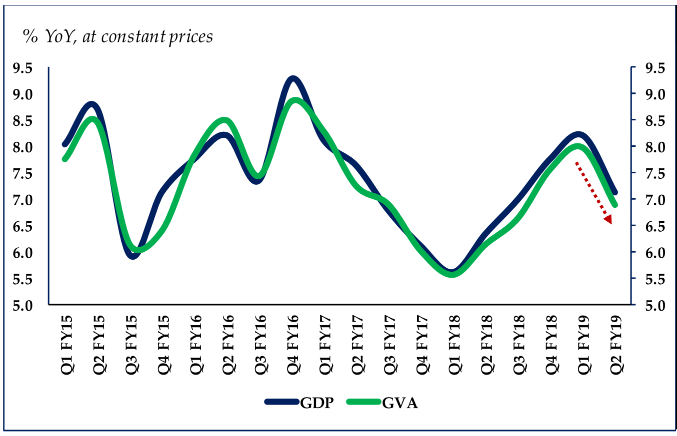
India's Q2 2018-19 GDP growth slowed more than expected to print in a 7.1% y/y increase - *higher than last year's 6.3% expansion in the same quarter but more than a full percentage point lower than last quarter's 8%+ growth. Growth in GVA also eased to sub 7% in comparison to the healthy 8.0% recorded in Q1 FY2019.* ***A slowdown of this extent despite a favourable base effect implies two things***

1) *Economic recovery that was seen over the last two quarters could not be sustained and the weakness that set in because of various macro side pressures is perhaps more entrenched and broad-ranging than earlier thought of.*

2) *With an average growth of 7.65% in the first half of FY19, the residual for the second half works out to be 7.35%, given our estimate of 7.5% GDP growth for the full FY19. This, might need to be revised downward.*

While we are not immediately downgrading our forecast for the year, we remain watchful of the incoming high frequency data to be better able to assess the situation.

Chart 1: Data reflects a discernible slowdown in the economy



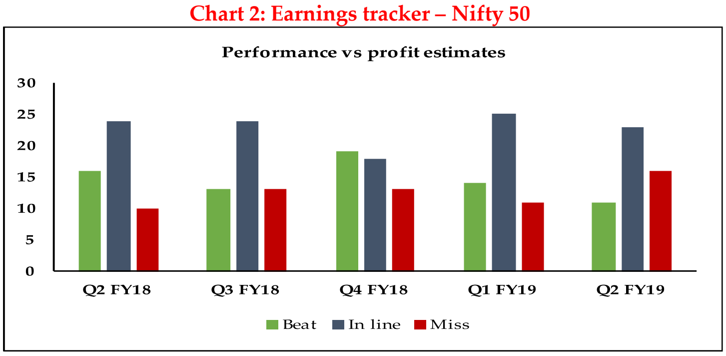
YoY%	Q2 FY2018	Q1 FY2019	Q2 FY2019
GDP	6.3	8.2	7.1
GVA	6.1	8.0	6.9
Agriculture, Forestry and Fishing	2.6	5.3	3.8
Industry	6.1	10.3	6.8
Mining and Quarrying	*6.9*	*0.1*	*-2.4*
Manufacturing	*7.1*	*13.5*	*7.4*
Construction	*3.1*	*8.7*	*7.8*
Electricity, Gas, Water Supply and Other Utility Services	*7.7*	*7.3*	*9.2*
Services	6.8	7.3	7.5
Trade, Hotels, Transport, Communication and Services Related to Broadcasting	*8.5*	*6.7*	*6.8*
Financial, Real Estate and Professional Services	*6.1*	*6.5*	*6.3*
Public Administration, Defence and Other Services	*6.1*	*9.9*	*10.9*

Source: CSO, CEIC & HDFC Bank

Key takeaways

- ***The growth estimates came in lower than ours and consensus GDP forecast of 7.4% growth.*** *While agricultural sector growth came in line with our estimate of 3.8% growth, industrial and service sector growth have come lower.*
- ***While we had pencilled in the impact of the macro side pressures (oil+ rupee +higher funding costs) on the industrial sector growth, sharper than anticipated deceleration in the mining sector and the manufacturing sector (though to a lower extent)*** *has pulled the growth lower than our estimate.*
- ***While some of the external macro pressures have now started to ease off, these are likely to extend benefit to the corporate sector more in the fourth quarter.*** *This imply that we are likely to see another subdued quarter of manufacturing activity in Q3 FY19.*
- ***Moreover, domestic side headwinds - an uncertain demand scenario during the pre-election period, a fading favourable base effect, liquidity pressures and weak private sector capex - continue to remain as we go into the 2H.***

Chart 2: Earnings tracker – Nifty 50

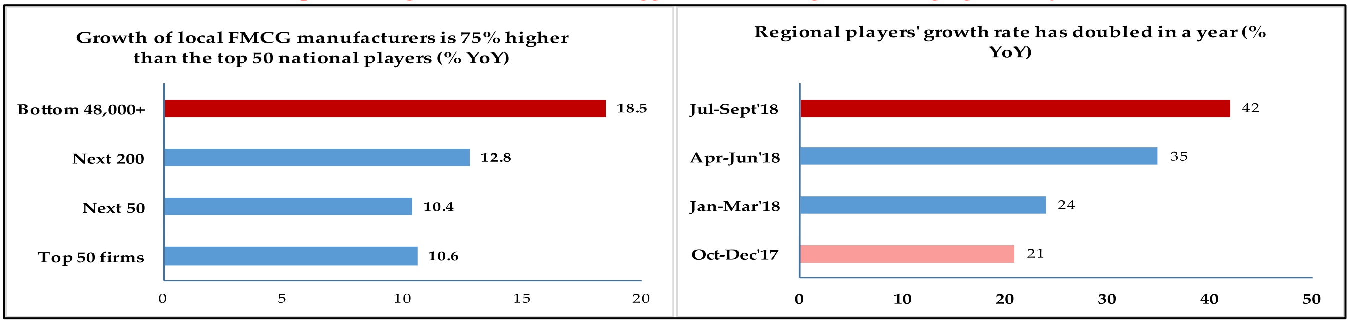


Source: Bloomberg & HDFC Bank

FY19 earnings estimate for Nifty 50 companies that either beat or met forecasts fell to its lowest in at least five quarters

- ***However, on a slightly more positive note, there are tentative signs emerging that the SME sector has*** **started to recover from the teething troubles of the "DeMo" + "GST" impact.** If this continues, it could bode well for the industrial sector growth in the following quarters and also to some extent in subsequent revisions as well (with a more comprehensive coverage of the small & medium enterprises).

Chart 3: Does sharp rise of regional FMCG brands suggest downtrading or an emerging recovery in the SME sector?



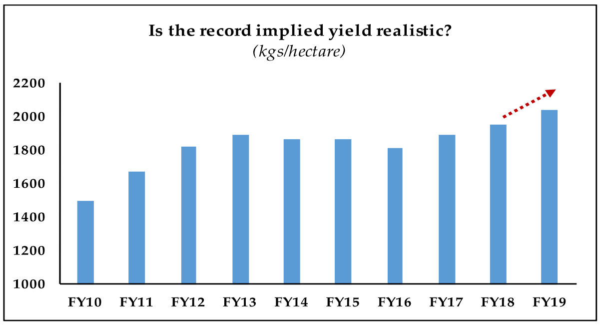
Source: Nielsen, Business Standard & HDFC Bank

- *The other segment of the economy, which is likely to disappoint, in H2 FY19, is the agricultural sector.*

  While the first official advance estimates for the 2018-19 kharif season ***project a marginal increase (0.6% YoY)*** in food grain production, these could be revised lower given a 3.5% decline in the area sown during the kharif season. ***The area sown under rabi crops, so far (till 2nd Nov), has also been disappointing, down 7.3% from a year ago.***

  Subdued sowing is visible in all the major states and has been on account of a weak monsoon, apart from depleting water resources. *The water level in 91 key reservoirs across India stands at 101.73 bcm, 63% of the total capacity, according to data released by the Central Water Commission. The current water level is 1.0% lower on year, and 4.0% lower than the average of the last 10 years.*

Chart 4: Agricultural growth likely to disappoint in FY19



Progress of area coverage under Rabi crops			
	Area sown (as of 22nd Nov)		
Crops	2018-19	2017-18	% change
Wheat	112.0	110.7	1.1
Rice	6.8	9.6	-29.5
Pulses	88.7	99.0	-10.4
Coarse cereals	24.2	35.1	-31.1
Oilseeds	57.3	57.3	0.1
Total crops	288.9	311.7	-7.3

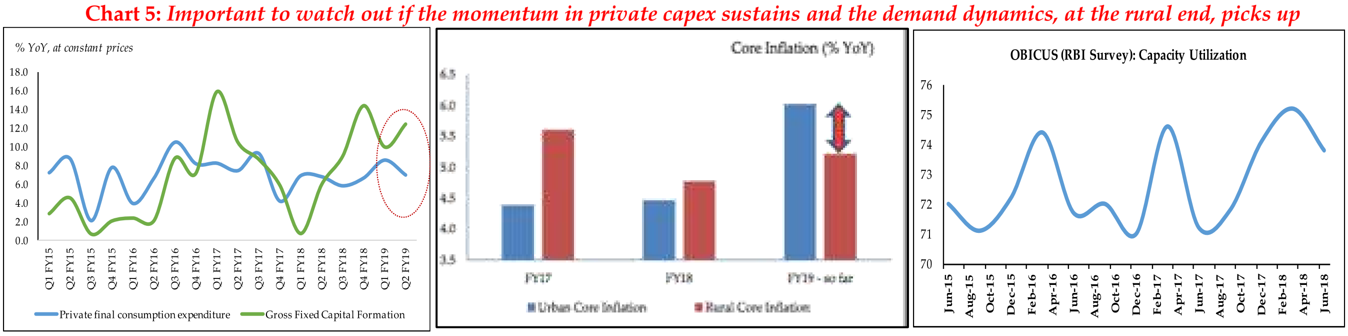
Source: Department of agriculture, CMIE & HDFC Bank

- *What is more worrying being the fact that the nominal growth in the agricultural sector has come in lower than the real growth, which implies* ***a loss of purchasing power in the rural economy*** *– a widening* core inflation gap between rural and urban areas in FY19 corroborates this trend.

- **Such an emerging trend is not comfortable given that the FY19 higher growth trajectory (in comparison to FY18) is premised primarily upon a higher growth in private consumption.** And the Q2 FY19 data substantiates our worry. The pace of growth of private consumption moderated to 7.0% in Q2 from 8.6% recorded in the previous quarter.

- **The other critical component of the demand side is gross fixed capital formation**. While the GDP data suggests that the recovery continues in investments, other related indicators such as RBI'S OBICUS survey on capacity utilization and capital goods component of the IIP suggests that the **recovery could not be sustained and remains sector specific**.

Chart 5: ***Important to watch out if the momentum in private capex sustains and the demand dynamics, at the rural end, picks up***



Source: CSO, RBI, CEIC & HDFC Bank

- **The service sector's performance also remains uncertain as far as H2 growth trajectory is concerned.** While the "trade, hotels, transport, communication and services related to broadcasting" component of the sector might see a seasonal pickup towards the end of the year (tourism and trade usually picks up in the second part of the year), the "public administration" component, which was a major contributor this quarter, could register some slowdown, as we go ahead.

- Going by the general sense, it may seem that government expenditure will likely pick up in run up to the elections. But historical evidence has been inconclusive on this hypothesis (expenditure went up during NDA-1 & UPA-I period but declined during UPA-II). **Moreover, given that serious fiscal constraints looms, the government, in our opinion, is unlikely to go the fiscal profligacy path. In fact, a possible cut in capital expenditure (in a bid to balance the fiscal equation) is also likely to weigh on investments as well.**

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