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Black & White And More

- Raj Nair

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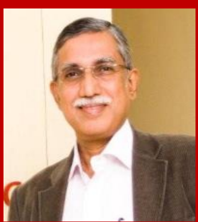
ABOUT THE AUTHOR



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Black and White no more

By **Mr. Raj Nair,** Chairman of Avalon Consulting

'What is past is prologue', said Shakespeare. The three Black Swan events of 2016: the Brexit vote, Trump's election victory and Indian demonetisation, are just that but there is no agreement in their consequences in 2017. I was therefore tempted to write the epilogue and depend upon Pythia, the Oracle at the temple of Apollo and the Sage Asita from ancient India to provide the main story about 2017.

But that delayed my paper for 2017 by ten days because, Pythia, who could help me understand the implications of Trump, the President, and the aftermath of Brexit, reveals her prophecies only on the 7th of each month. To add to my woes, the Indian source, Sage Asita (who had predicted that the new born, Siddhartha Gautama was no 'ordinary clay' but would go on to become the Buddha) on whom I was to rely to help me navigate the sea of conflicting information in India after demonetisation of 86 per cent of the entire currency stock of India, was not available on new year's day. True to the ancient lore, Asita was on his annual visit to the World of the Gods to recharge his special powers.

I had to wait. After all, Pythia helped me last year to warn that there would be serious attempts to short certain currencies. George Soros and some others lost a few million dollars trying to short the Yuan but Crispin Odey and many investors and Hedge Funds made a pile shorting the Pound Sterling. They also helped me to predict that oil prices would fall by end Jan 2016 and rise towards the year end and also to get all the other predictions right about China, India, Japan, the ME, etc. However, Pythia could not tell me about the 3 Black Swan events of 2016. She will not be able to this year too. Hence I added Asita this time like the ancient Greeks used to visit multiple oracles with the same questions.

The two soothsayers reeled out a number of things like:

- Trump will spend on infrastructure, reduce taxes, try to mend fences with Russia, try to undo Obamacare, make partners pay for war costs if America takes part, undo the Trans Pacific Treaty, Curtail Global Free Trade, bully companies serving the US market with manufacturing capacity outside the US, etc. People say that it could make the dollar stronger and weaken the competitiveness of US exports but I feel that there are other reasons for the dollar to weaken
- Given that the world continues to grow slowly just a shade above 3% - not nearly a recession and a year of tepid growth for the global economy, it will be interesting to look at things at the margin. 2017 will produce outliers, things that could be surprisingly good and a few disappointingly bad. East Africa, Central Asia, Malaysia and India will be bright spots. The important problem economies will include Brazil, Nigeria, Venezuela, Greece, Portugal, Russia, and Ireland.
- The US with its dominant size will probably grow at around 2.1 to 2.5 % whilst the UK economy will do well despite Brexit @ 2 to 2.3%.
- Europe which has the added burden of elections in major countries like Germany, France, the Netherlands, Italy, Czech Republic, Finland, Norway, etc. faces uncertainty on the economic front. The major EU countries may see 1 to 1.8% GDP growth.
- Japan will continue to struggle to register any growth whatsoever
- Developing countries in Asia will average around 6.3 anchored by the China but faster the stars will include Bangladesh, Myanmar, Laos, Cambodia and India
- China continues to worry the World because this big demand creator for the world is moving steadily towards producing things that its huge population needs. The other worry about China is the weakening financial sector, ridden as it is with infrastructure investments that produce no returns, loans that may never be repaid, leveraged housing investments whose prices may wobble and trip, etc. China will have a soft landing in 2017 despite the looming infrastructure and real estate bubble and bad debts with a GDP growth of about 6.2%. The Chinese will revert to heavy Government spending to prop up the economy in this all important year for Xi Jinping to extend his hold on power for some more years. This could mean that more bubbles may be created to prevent the existing ones from bursting.
- India will struggle till around April to shake out of the impact of demonetisation of 86% of its currency in November 2016 and it will take a little longer for domestic investment and Foreign Direct Investment to regain momentum. Despite that a growth of 7.5% is on the cards

- Africa, barring old favourites like South Africa, Angola and Nigeria, will grow strongly with at least 10 countries likely to grow @ 5 to 8 %
  - Commodity prices will stay up whether it is oil or iron ore. Oil prices will not crash to the 30s (US dollars) but may not cross the 60s in a hurry
  - Syrian war and the Arab-Israeli conflict will remain nowhere close to resolution and meddling by the Russians, Americans, the Turks, the Arabs and the ISIS, in the conflict between President Trump and his opponents, will only muddy the already muddied waters

I had to respectfully stop them because almost all my readers already knew all that and request them to tell me something, starting with Trump that may seem a bit like divining.

Pythia said, "As a strategy consultant, you should do what you would normally do- study all past material available on Trump to understand his DNA and ignore the noise that he makes. That is how all successful military leaders have got the better of their enemy. Egypt was not able to complete the kill in the Yom Kippur War of 1973 with Israel after the initial gains because its leaders did not bother to learn from books written on Israel's strategy to win the Six Day War in 1967. There is enough material to understand Trump's DNA including his own book, "Art of the Deal." He displays a megalomaniac exterior to cover his insecurities and his very vulnerable ego. He is more a deal maker than a leader. I leave it to you to fathom the rest of it."

My subsequent journey through material on Trump leads me to conclude that:

He recommends and also uses 'hope' and 'fear' most of the time to soften his counter party or his own people to accept his proposition and then sells them a grand dream which is beyond their stretch, to win them over. The electorate lapped it up. He gave them some hope and a lot of fear during his campaign. He will continue to do that with counterparties in negotiations. His ego is easily punctured and vengeful acts are par for the course. Stateside Companies that seek low cost manufacturing locations close to the US will not want to take him on in his current belligerent mood.

He also believes in having Plan A, Plan B, and even Plan E if required and may even pose as if he is pursuing A as a negotiation strategy when he really wants C. He is acutely aware that he may not win the deal most times if he sticks to one plan, and consequently gives an impression that he is a scatter brain. An extract from his book says it all: 'For starters, I keep a lot of balls in the air, because most deals fall out, no matter how promising they seem at first. In addition, once I've made a deal, I always come up with at least half a dozen approaches to make it work, because anything can happen, even to the best laid plans.'

He is openly pro-Israel and has appointed David Friedman as US Ambassador to Israel, but watch out for Thomas J Barrack, a Lebanese American with very close relationship with the Saudi Royalty, who is his close friend and the one planning Trump's January 20th inauguration. He is likely to have a very special role in his group of Advisors. This will make it possible for Trump to keep all options open while pursuing his Plan for the ME and is also a door opener for the Saudi Royalty to seek deals. He is threatening to dump the Trans-Pacific Partnership because it was Obama's brainchild (and surely has been told that TPP was designed to choke China's economic progress by excluding it from the Pacific basin group of countries that account for 60% of the World's GDP) and may even start the process but before he acts decisively on it, he will want to strike a deal with China on job creating investments in America, China's exchange rate policy, etc. The Oriental wisdom of the Chinese will set them on course for deals with Trump after which the TPP can be given the promised burial.

That will be in keeping with his desperation to show some results if not complete results, to build his credibility.

Trump's desire to show that he is acting against China which took away most of the offshored jobs, will put him in a situation where he has to choose between direct trade war with China or faux-confrontation with China (plus Mexico and India) combined with carrot & stick for Multi-National Companies to bring back jobs to the US. The latter will be a loop hole for smart Chinese entrepreneurs to exploit. You will see a lot of that, much like when the Japanese set up manufacturing plants in the US a few decades ago. The fact is that many American companies are struggling with manufacturing in China and that small robots for manufacturing have become so cheap that they don't cost much more than the annual salary of a Chinese worker. That will also help Trump show some results. His advisors will keep him off a 'battle' with China which has lent $1.112 Trillion to keep the US economy comfortable but has already dumped $41.3 billion recently. More of the latter will not be good. China has also kept it options to increase non-dollar denominated trade, which beyond a point, could destabilise the US economy. US risks a strike back because 2017 is the year of the 19th National Congress of the Communist Party of China and Xi Jinping will not suffer any challenge to his image from internal or external sources. Since Trump cannot build a wall along the entire border with Mexico, barring a few symbolic stretches, he will erect a trade & commerce wall to claim victory. He will go after the NAFTA to punish Mexico but the reality is that the two-way trade is nearly half a trillion dollars and the adverse deficit for the US is just about 10%. There are easier ways to fix it. India's IT services sector will hurt due to the probable raised cost and difficulty in procuring H1B visa quota in 2017 but may not suffer much in the long term because reinvention of the Indian IT business model was already overdue. Acquisitions of American companies in IT, analytics and related services by Chinese and Indian companies will rise sharply in 2017. Some US companies which have not got their IT and ITES outsourcing act to India right, may close shop to win Brownie points as well. This will include captive centres which are usually less cost effective than third-party outsourcing. Potential action against Iran which will delight Israel could see oil prices being disturbed all over again.

It is therefore safe to conclude that eventually, Trump's bite as the President will be markedly weaker than his bark during his campaign. After, the initially flurry of decisions in his first few weeks in office, to show that he acted as threatened, he will let his chosen team do more reasonable things.

When I shared these thoughts with Pythia, she added, "Given Trump's brazenness, easily punctured ego and tendency to sail close to the wind, there is a risk that he will, at some time in his Presidency, score a self-goal and end up getting impeached.

"Currency shorting will be back in 2017 and this time it could be the US $ which has shot up after Trump's triumph. Not only is it over valued but clearly if Trump resorts to high deficit financing to pay the bill for high government spend on infrastructure whilst reducing taxes, he will cause inflation. Not only that but also the fact the EU and perhaps Japan, could put downward pressure on the US $ because they may reduce their versions of QE once inflation in the EU and Japan rise to the targeted levels.

"His wanting to mend fences with Russia is real (and probably goes back to his business dealings with the Russians), whether or not, they have the 'goods' on him. The Russians cannot afford to keep up with the US in the arms race as long as the Oil price is sub-$ 60 and they want the sanctions taken off. They may 'oblige' him with a deal for both countries to cut back on their nuclear arsenal so as to get the sanctions removed. It can be made to look like a 'win-win'!"

Will the UK pay a price for Brexit in 2017?

"While exit may take time and even be tame because Article 50 which will kick start a 2 year process for orderly exit, may not be signed before March, there will be a serious power struggle between Europe and the UK to displace London as the financial capital of the World. Paris, more than Frankfurt, may take away some parts of the financial services engine that drives the London economy. Some of that may happen this year. And by the way, Trump is very likely to enter into a sweet heart deal with the UK in 2017. That will offset the common worry in the UK about inflation and general uncertainty" said Pythia. "Britain does not want refugees and Trump looks down upon the EU immigration policy for refugees, not because of concern for Europeans but to signal that he will not have any of that in the US. He will want to back off from funding commitments to UN, The World Bank, IMF and even the NATO Alliance. He does not want to pick up their tab and will thereby, reduce US influence on global policies but he will get moderated by wiser counsel in his administration. The deal maker and egoist in him will officially give them some freedom to suggest otherwise, as a ruse to back out from some of his rash moves."

Oil has been one of the dominant themes in my previous nine annual papers. I know that Electric Vehicles (EVs) have the potential to disrupt the Oil industry eventually. Will it happen this year?

Asita, the sage, who used teleportation for his annual visit to the World of Gods, immediately answered "Eventually, but not this year. Lithium Ion Battery cost has come down substantially and if it drops at the current rate for another 4 years, EVs will be attractive for users and for manufacturers and in about 10 years it will not be a subject of debate any more. EVs have become an obsession for nearly all the mainline automotive manufacturers. The first cars and trucks that can do 320 km on a single charge will be marketed in the US this year. City Buses that can be given top-up charge at each stop in 30 seconds and fully charged in 5 min at the end of the day will hit the roads in Europe this year. Even in India, where EV cars have been around for a decade with conventional batteries, you will see an EV truck being introduced, first probably by Eicher. Lithium Oxygen and thin film Lithium Ion batteries which are under development will hasten the use of battery technology in automobiles. In less than 15 years, you will wonder why anyone should manufacture diesel and petrol engine vehicles. Somewhere between now and then, probably 2021, the Oil prices will get disrupted because it takes just a demand drop of 2 million barrels per day to send the Oil prices spiralling down to what we saw in 2014. Oil is safe in 2017 and in fact, since most oil producing countries know about the future disruption, they are likely to make good money now by controlling oil production rather than over produce to gain market share at low prices. On December 10, 2016 the OPEC and non OPEC countries agreed to reduce the global Oil output by 1.2 million barrels per day from January 2017. Oil prices will firm up but not as much as the OPEC want it to be, because Iraq and Iran have not been very co-operative in the recent months and USA under Trump could even boost Shale Oil and Gas production. The 'higher' Oil price may not be sufficient for most part of the year, for oil exporting countries to balance their Budget without cut backs. Saudi Arabia and other OPEC compatriots will face another tough year despite the oil price hike, and will see some combination of reduced expenditure in their annual Budgets, increased taxes, and higher prices for locally consumed fuel, etc. At the same time, Abu Dhabi and Saudi Arabia will attract serious capital for large oil downstream projects to make non fuel downstream products for the chemical and petrochemical industry. So less Oil will be sold for fuel eventually."

Do you think that Solar PV technology will also impact conventional energy production in a big way?

"Yes", said Pythia, "I can clearly see that happening eventually but it will not disrupt operating conventional power plants for a long time. The cost of generating power from solar cells has been dropping rapidly in the past few years. In less than a decade, the unsubsidised cost may drop to 5 cents or less (~Rs 3) per KWh. Why would anyone then use power transmitted from a conventional power plant? For this commercial reason and not just due to environmental considerations, there will be serious project evaluation to determine whether a new Power plant, say coal based, even in 2017 should be approved at all, India included. Think of it, some day in the not-too-distant future, the cost of local solar power generation, will be lower than today's transmission cost from a distant power plant. Government subsidies could actually hasten the arrival of that situation. The best days for conventional power has long gone and a cocktail of new technologies like solar, wind, ocean, fuel cells, etc. will deliver a body blow to conventional power plants. Oil. This will be good stuff for your future annual papers but for now, new build of long-gestation conventional power plants will decline starting this year."

(Read 'The Future Is Here' for more details on this and other technology disruptions at: http://www.consultavalon.com/our-thinking/insights/)

Talking about disruption, the mother of all disruptions for India was the demonetisation announced on November 8. The debate on its merits and when normalcy will return, has divided families and friends, and sent many cash-based consumer and logistics businesses for a toss. When will normalcy return?

"Indian economy will reach normalcy sooner than most people think", said Asita. "Citizens will not feel the need to hoard notes when access to currency notes at ATMs and Bank branches show definite signs of easing. That 'feel good' will happen much before end March. There are Indian experts who expect it to take between 3 to 7 Quarters to recover from demonetisation. Here is why it might be sooner. If Indian Security Printing Presses manage to deliver Rs. 8.75 trillion (Rs. 8.75 lakh crores) to the economy by end March (assuming that they are in full throttle for 5 months and some amount was printed before Nov 8, 2016), one could expect normalcy to return by the end of March. The capacity of Indian Security Presses, reportedly 3 billion notes per month can be directed to print Rs 1.75 lakh crores worth per month of various denominations (Rs 2.25 lakhs crores are possible if the mix has only high denomination: 0.5 billion of Rs 2000 and 2.5 billion notes of Rs 500). Before end March, it could supply Rs 8.75 trillion (Rs 8.75 lakh crores). If the going gets tough, don't rule out the possibility of the Government getting Rs 2 trillion printed overseas before end March. There are banking experts who believe that the RBI will not permit notes being printed abroad to ease the shortage."

The sage, Asita, was aware that the Parliamentary Committee on Public Undertakings had rapped the RBI and Finance Ministry for outsourcing Rs 1 trillion worth of currency notes in 1997-98. Asita added, "But extraordinary situations call for extraordinary solutions. This could be one. Of the 171 currency-issuing authorities globally, 85 print some portion of their currencies outside their own countries and nearly 20% of all the issued currency in the world is outsourced. What is so special about India? But even I cannot predict what Indian politicians will do or prevent."

"But what about the likely GDP numbers for India in 2016-17? Aren't my friends right in worrying because India's GDP is about 10.8 times the currency stock and the 86% of the entire currency stock that has vaporised has only been partially replaced?", I ask, because there is inadequate data and a wide range of predictions.

"Not surprisingly" he said. "But ignore the hopelessly pessimistic prediction of 4% in some quarters and also the Government's estimate of 7.1%. Go with a range between 6.25% and 6.8% growth. The real GDP growth in agriculture will be 4.1% by March end- much higher than in the recent years, and only some sectors of the manufacturing and services sector would have tanked due to currency shortage."

I sceptically told him that there is so much pain in manufacturing now; for instance, the automobile numbers look really bad in the past 2 months. He reminded me that car sales have not been badly hit (just

1% drop in Dec 16 over Dec 15) because they are usually bank financed and purchased by cheques or digital transfer but 2 wheelers which are purchased in cash and mostly without bank loans, have been badly hit (a year on year drop of 22% in December). However, for the nine months starting April, cumulative passenger car sales rose by 9% YoY. On the whole, demonetisation killed demand in many sectors and postponed demand in many. Thus GDP was hit.

"If you look at each sector in this manner, you will realise that in the year ending March 2017, things will not look as pessimistic as it would seem at the surface."

You have clarified the confusion about India's likely GDP growth in 2016-17, but will demonetisation really produce any real results and kick up the GDP in 2017 by 2% as some politicians claim it would?

"I will answer that and a few more questions of my own", said Asita, "Sadly most of the black money which was expected to disappear has got back into bank accounts because of the 'ingenuity' of dishonest people. Will the Government go after account holders whose balances have surged inexplicably? Yes, but only selectively to make an example of a few corrupt people since the task is too huge for the existing Government machinery. They will do just enough in this year to make Modi's act of demonetisation not look like a failure.

"All the currency which the RBI thought could be cancelled crept into Banks but they don't think they have enough good quality lending opportunities. Therefore, the RBI will need to suck out the Banks' excess cash, which in turn, will put paid to the RBI's hopes of a bumper profit and the Government's hope of a huge dividend. That is one unanticipated impact of demonetisation.

"Indian Banks will not only continue to struggle with bad debt overhang but will see the start of a long period of technological disruption. India will take amazing technological strides in digital payments and many banking transactions. In addition, Fintech start-ups will start challenging the monopoly of Banks as an intermediary between a saver and a borrower, investor and investee, etc. You will also hear chatter about Fintech companies and a few progressive Banks experimenting with various technologies to exploit the accelerated digital payments trend thanks to demonetisation, but also trying several technology initiatives including Block Chain technology (whose impact will not be felt this year). Watch out for changes in select Public Sector Banks and Private sector that will set them apart from the rest of the sector, starting this year.

"How on Earth will mere demonetisation automatically cause a GDP rise by 2 %, which is a 27% jump on a base of 7.5%? Most of the purchases made through 'white to black' and 'black to white' transactions are already captured by GDP computation; what is probably missing are 'black to black' transactions which also include terror financing, drug and other trafficking. This may add at best 0.5 % to the absolute GDP growth rate but GST, better tax compliance and enforcement and digital payments will add to Government revenues. That will lead to lower inflation and higher ability to invest in nation building."

Asita chose to comment on his prophesy about lower tax rate regime, greater push to make it easier to attract foreign investments, and likely push to bring to book the big tax evaders who subverted Modi's well-intentioned demonetisation scheme and despite GST getting pushed further down the road. Asita expects GDP growth of no less than 7.5% in 2017-18 though it is unclear whether he has built in the probability of normal monsoons. I will not be able to comment on the monsoon now because this year the influence of local factors like the Indian Ocean Dipole may be significant (and will not be known till end May 2017) given that El Nina is expected to recede by February to become ENSO Neutral.

Since it is well known that the sectors to watch out for in 2017-18 in India would be Travel, Tourism and Hospitality, Healthcare, Telecom, Education, Automotive, Non-conventional energy, Fintech and IT (which is to expected to painfully transform due to the final acceptance that the Time & Material based services model has outlived its value), I posed one final question to Asita.

Demonetisation seems to have helped Mobile Wallet providers; one company in particular, Paytm struck gold. Will 2017 be the year of mobile wallets?

"To some extent, 2017 will be good for them but not really much longer since banks will move swiftly to offer UPI. Banks will actively try to block Mobile wallets from intruding into their space", replied Asita. "Wallets have one big disadvantage. You cannot put money from Paytm wallet into a merchant's MobiKwik wallet since there is no inter-operability between digital wallets. The UPI platform which is currently denied to mobile wallets, allows frictionless transfer virtually from anyone to anyone. BHIM app and ABPS will compete for space with Mobile Wallets. Further, once you put money into a wallet, it earns no interest. All in all, Mobile Wallets will not end 2017 with as much hope and excitement as they ended 2016 unless they change and regulations allow them to become very convenient to use. Spare a thought for credit card companies which will need to struggle with pressure on transaction charges as well as numbers growth. It may herald disruptive innovation or decline. The ability to be nimble and respond to new situations is going to be very important."

Does all this call for a change in our approach to business? Edwards Deming is reported to have said, **"It is not necessary to change. Survival is not mandatory."**

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