A ‘moderate’ outlook for the capex cycle

The economy is still recovering from DeMo and GST. Add to this the IBC fallout, and it’s unlikely investment will touch new highs

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It is often said that there are two types of forecasts — lucky or wrong. More often than not, ‘wrong’ forecasts just get lucky. This ‘luck’ equation gets worse when it comes to forecasting on the economy. The phrase “forecasting folly” has come into existence because of ever-increasing instances of failed predictions for the economy and markets.

For someone who has been tracking the economic narrative closely for the last five years, it is difficult to miss how much the experts have been off-the-mark when it comes to predicting turns in the investment cycle.

When the projections of the country’s top bank can’t be relied upon (so much so that the RBI revised its GDP projections as many times as it changed its interest rates), we can certainly go easy on the experts whose call on the capex cycle has gone woefully wrong.

Instability in consumption

To see how much the experts have erred, one has to start from early 2014, when consumption started to recover and gather pace. When it gained more momentum in 2015, as a consequence, utilisation started moving up from the 60-odd per cent to over 70 per cent across various manufacturing industries.

When utilisation hits the 70 per cent mark and sustains above that level, it can trigger the next investment cycle, as corporates start investing on new plants and capacity expansions. Based on this hypothesis, experts started predicting that capex recovery would happen in late 2015 or early 2016.

But there were major surprises in store in 2016. While the early part of 2016 was wrecked by a yuan wobble, the later part was hijacked by demonetisation and US elections.

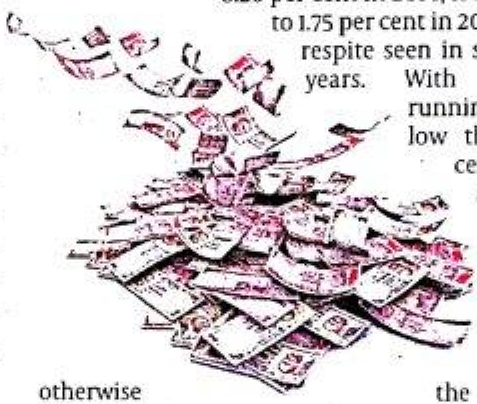
As is to be expected, shaky consumption in 2016 led to fall in utilisation that further led to a delay in the investment cycle.

Then came the time for predications of a comeback in 2017. As luck would have it, GST was introduced in the middle of 2017, and it couldn’t have been more ill-timed. The momentum in consumption which the economy would have otherwise gathered got punctured by the dual blow of demonetisation and GST, leading to further delay in capex recovery.

Downward trend

Year	Gross capital formation (Annual % growth)
2009	17.25
2010	14.08
2011	3.94
2012	4.29
2013	-3.70
2014	8.26
2015	5.64
2016	1.73

Source: World Bank



If that was not enough, the NBFC crisis triggered by the fall of IL&FS rang the final death knell for any remote chance of a rebound in the investment cycle.

In sum, experts have been predicting the turn of the capex cycle for five years in a row, but there have been no such traces in the investment cycle.

Muted growth

The annual growth in gross capital formation has been on a downward trend since 2014 (see Table). From 8.26 per cent in 2014, it came down to 1.75 per cent in 2016, with no respite seen in subsequent years. With utilisation running well below the 70 per cent level, any kind of rebound in the near future is unlikely.

But, the more important question is whether the investment cycle will ever go back to its golden period (FY10-11), when it was firing from all cylinders. Growth in capital formation was in an excess of 17 per cent during that period — 17.25 per cent in 2009 and 14.08 per cent in 2010, to be precise.

As per the captains of industry (and not expert forecasters), there is a new normal now for the capex cycle, which will be far more muted and moderate compared to earlier highs. Here are few reasons as to why they say so:

With the IBC injecting a sense of financial discipline, industry captains will be far more cautious in building new capacities through leverage, given the risks of losing business on defaults. Excessive capital formation is unlikely in the next cycle.

With crony capitalism under check, fixed asset formation will be far more driven by real demand than any *‘quid pro quo’* project deals.

With so many productive assets on fire-sale by the IBC courts, greenfield projects may be delayed. Hence, future growth will be more likely from brownfield projects than from any large greenfield outlays.

With the government’s focus on grafting and clean-up, the potential medium-term growth for the country is likely to fall by few notches.

Thus, the signals that the captains are sending out have a lot of significance for the fund and investment managers who are burning the midnight oil to identify their next winners from the capex story.

They have to factor in this new normal of a moderate investment cycle into their models, so that their earnings estimates are not erratic.

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