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THE BREXIT PHENOMENON-HOW WILL IT IMPACT THE INDIAN MARKETS AND THE ECONOMY?

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ABSTRACT

The "Rexit" phenomenon took the Indian stock markets by storm. As the markets rebounded slowly there came the "Brexit" phenomenon, the exit of Great Britain from the EU. This article looks at the impact of Brexit on the Indian stock markets in general and the sectors in particular. It also analyses the impact on the currency, bonds and the gold market. The overall effect on the economy and the GDP in particular has been examined. The oil scenario has also been looked into. While some companies and sectors have large collaborative agreements with the EU, the impact can be quite profound. The article concludes by saying that India will now have to explore economic ties and alliances with other major economies.

KEYWORDS: *stock markets, Sensex, liquidity, economy, Rexit Phenomenon*

I. INTRODUCTION

The Indian stock markets barely recovered from the "Rexit Phenomenon", the exit of Reserve Bank of India Governor Raghuram Rajan's from the central bank once his term finishes in September when it was struck by the tycoon the "Brexit Phenomenon", the exit of Britain from the EU. The recovery from Rexit was largely made possible by the FDI reform measures announced by the government. But the jolt of the Brexit on the global financial markets has been catastrophic. The stocks currencies and bonds in all the major economies went for a spin. But many economists strongly believe that if one could survive this shock with some patience the economies can subsequently better position themselves. The Sensex crashed some 1000 points on its initial reaction to the Brexit but it soon recovered 250 points as astute investors went shopping in this downturn scene.

Britain serves as an important trade partner to India and also as an important gateway to the EU. In the 2016 financial year, India-UK bilateral trade was worth $14.02 billion. India exported goods and services worth $8.83 billion while imports from the UK were at $5.19 billion. Thus the decision by the UK to leave the EU will impact the economy in multiple layers. However many economists feel that one should not be overly worried as India has always proven to be resilient.

II. THE MULTISECTORAL IMPACT

II. 1. Impact on the Stock Market:-

As already pointed out the Brexit phenomenon did have an adverse impact on the markets. "Brexit is a big, once-in-a-life kind of event. It's consequences will last longer than we can think," says Motilal Oswal, CMD, Motilal Oswal Financial Services. Brexit took the market by a huge surprise as most were of the opinion that Britain will not vote out of the EU. The Brexit further has opened a pandora's box as other European countries have become to contemplate their exit from the EU membership. This it is felt will increase risk averse to investing.

II.2. Impact on the Currencies:-

Among all global currencies the Japanese Yen and the US dollar appreciated for these currencies are always considered safe. One must note that currency depreciation will increase the risk aversion among investors and put further downward pressure on already weak Asian currencies.

The Asian currencies could be further affected if more EU countries follow suit. The Indian rupee it is felt will not be greatly adversely affected. The effect is expected to be minimal. "The direct trade impact (on the rupee) is limited from UK, but global risk will likely weigh on India in the near term. So we revise our 2016-17 average US dollar target to Rs 68.5 from Rs 67.9," says the Kotak Economy Report.

It is feared that the direct impact of the Brexit vote will be on the rupee. But too India looks well-placed to handle the situation. "India has a record foreign exchange reserves of $340 billion and with the expected forex outflows in September 2016 on the FCNR (B) front already covered, RBI is likely to intervene to stamp out any unusual volatility in the currency market," said Bodke. "The rupee has been more stable compared with other emerging market currencies. We are by no means an outlier," RBI Governor Raghuram Rajan said on Friday. "Where liquidity is needed, we will provide liquidity whether domestically or internationally." He said Brexit would not impact the rupee as much as it is feared widely We can now look in detail at some of the stocks which adversely reacted to the Brexit phenomenon.

II.3. Auto and Auto Components:-

The BSE index for auto and automotive components were badly affected. Tata Motors was the worst affected. It lost 8%. This is because over 90% of its profits comes from the subsidiary Jaguar Land Rover Plc., which sells about a third of its cars in the UK and Europe. It is a net importer with Europe. But light is is store for the company as it has hopes of offsetting the loss with increased exports to China. Trade with China will become remunerative as the pound depreciated against the dollar. Maruti Suzuki India Ltd's shares fell by 2.25%. It will suffer the indirect impact of Brexit. The 10% appreciation of the Japanese yen, could lead to a 8-9% downgrade in fiscal year 2017 earnings. Among the auto component firms shares of Moth erson Sumi Systems Ltd fell the most (8.48%) as Europe comprises of half its revenue.

II.4. IT companies:-

As one can easily predict, the shares of the information technology (IT) companies with the largest exposure to the UK and Europe fell the most. Tech Mahindra Ltd and HCL Technologies Ltd, which get about 30% of revenue from Europe, fell sharply. But it is not yet clear whether these companies will lose or gain as a result of the UK referendum. According analysts with a multinational brokerage, it is too early to say how things will play out. They feel that Brexit could lead to increased outsourcing work.

II.5. Metals:-

Tata Steel Ltd's stock plummeted by 6.37%. It was the biggest loser among metals that will face the direct wrath of Brexit. The EU accounted for 57.5% of its revenue in FY16. The sizeable foreign currency debt on its books adds currency risk too. Hindalco Industries Ltd's shares were down by 5.17%. It has a direct and substantial exposure to the EU via its subsidiary Novelis Inc, which makes value-added aluminium products. There are those firms that may suffer an indirect impact. Thes are Vedanta Ltd, Steel Authority of India Ltd, JSW Steel Ltd and Hindustan Zinc Ltd. Some risk also exists as the dollar's strengthening could see the prices of popularly traded metals in financial markets, such as copper, aluminium and zinc, take a beating.

II.6. Oil:-

Brent crude oil too has fallen sharply. But one should note here that lower crude oil prices are positive for Indian economy considering its huge import requirements. However, if pressure on prices persists, then the anticipated inventory gains for June quarter for state-run refining and marketing companies such as Bharat Petroleum Corp. Ltd, Hindustan Petroleum Corp. Ltd and Indian Oil Corp. Ltd will be lower than expected. At the same time, lower crude oil price is obviously negative for oil producers such as Oil and Natural Gas Corp. Ltd (ONGC), Oil India Ltd and Cairn India Ltd. Analysts expect a strong dollar versus the Indian rupee to be positive for Reliance Industries Ltd (RIL) earnings.

II.7. Aviation:-

Lower crude oil prices should benefit the aviation sector in general. This is because fuel costs account for a good portion of operating costs. But Jet Airways (India) Ltd stock dropped. With 60% of its capacity (Q4FY16) deployed on international routes, the concern is about Brexit denting travel demand, due to weaker currencies and any economic slowdown in the UK or Europe, at least in the near term.

II.8. Pharmaceuticals:-

The impact may be minimal for most pharma firms as the US is their bigger market, not Europe, after which comes India. Apart from the currency volatility that will have a bearing on company financials, trade

agreements between countries and whether the UK would now have a set of separate regulatory approvals. Even if EU approvals are in place, have given rise to uncertainties.

II.9. Infrastructure:-

The stock of Larsen and Toubro Ltd took the greatest beating. The country's largest infrastructure player has no exposure to projects in the EU. But analysts fear that cost of borrowing for companies may increase due to volatile currency movements in the near to medium term. Among the capital goods multinational corporations, Cummins India Ltd exports to Europe through the UK. Analysts say they would have to see how things pan out, as the parent firm will have to perhaps rework its strategy on exports from India.

III. IMPACT ON THE ECONOMY

III.1. Impact on GDP:-

"We have lowered our aggregate 2016 GDP growth forecast for Asia excluding Japan from 5.9% to 5.6% and India's 2016 GDP growth forecast to 7.3% from 7.6%," said the Nomura Report. Thus it can be concluded that Brexit will have a negative impact on India's GDP. But The government is also taking steps to boost the GDP growth. The steps such as the recent FDI liberalisation will certainly help in achieving it. Thus even though India will be affected by the global event, it will be much better off compared to many others in the world. "Indian markets should perform better compared to most other emerging markets and also the developed markets," says Dipen Shah, Senior Vice-President and Head, Private Client Group Research

The impact on the GDP can be further predicted to ba positive one, as the slowdown that Brexit will trigger in several economies globally will lead to a fall in the prices of commodities like crude. This will help India save a lot on its import bill (every $1 drop in crude prices leads to roughly $1 billion savings in India's oil import bill). This will help reducing its trade and current account deficits (CAD). "It will also counter any negative impact due to foreign capital outflow that may happen as part of movement towards safe haven assets," says Ajay Bodke, C . CEO & Chief Portfolio Manager - PMS at brokerage Prabhudas Lilladher. He further said that lower commodity prices would dampen 'imported' inflation. After the crash of 2015, commodities have already entered the bull market on the back of a weakness in the dollar, stabilisation in the Chinese economy and demand revival. Oil prices are up close to 80 per cent since they hit their 13-year lows earlier this year. This has ended India's honeymoon with low inflation, with consumer price inflation showing a spike for two consecutive months. But this can be offset by the Brexit and the resultant low commodity prices. This will enhance the competitiveness of the Indian economy.

India emerged as the recipient of the highest FDI inflows in 2015 surpassing China and the US. This was the outcome of the open door policy pursued by the Indian government. It did so by increasing the caps on foreign holdings in many crucial sectors and improving measures of ease of doing business. Iyer of JP Morgan India says with Britain deciding to exit the EU, a risk-off event may ultimately help India stand tall when the dust settles. "You will have lower commodity prices that will help the macro fundamentals: be it fiscal deficit, current account deficit or inflation, which will give the government more levers to pump up the investment cycle," he said. India's strong fundamentals will draw investors to its shores in a depressed global environment. It is further felt by some that post the Brexit uncertainty may weigh upon the performance of merchandise and services exports. This will delay the concretisation of investment plans, partly moderating the expected benefit of the recent FDI reforms.

It now brings us to the question of how central banks will react and respond. It is felt that more central bank intervention cannot be ruled out to minimize the volatility in the financial markets. The liquidity position globally is set to improve from the current levels. This is positive for interest rates. However, the recent spike in inflationary pressure may force the RBI to not go for accelerated cuts.Rtae reduction might not happen in a hurry though the rate direction will still be downward. Invetsors can now consider rate sensitive sectors such as auto, infrastructure, banking, etc. The top gainers post Brexit were PNB, Exide Industries, Dabur. These were rate-sensitive companies and those catering to domestic demand. Similarly, investment in long-dated debt funds and tax-free bonds will also benefit from a rate reduction. This is an option investors could explore now

III.2 Uncertainty for the IT sector:-

Great uncertainty looms over the IT sector. According to the IT lobby group Nasscom, as much as 30 percent of the industry's $100 billion revenue comes from the European market. This is the second largest for the India's IT-BPM sector. Preliminary analysis reveals that in the near term a likely decline in the value of the British pound could render many existing contracts losing propositions unless they are renegotiated. Thus it has been pointed out that the uncertainty surrounding protracted negotiations on the terms of exit and/or future engagement with EU could impact decision making for

large projects Nasscom said. However, Sanjoy Sen, doctoral research scholar, Aston Business School, in the UK, does not see the negative impact on the IT sector to more than 1-2 years. This is the time by which alternative trade arrangements between the UK and other European countries will be put in place.

III. 3. Bad for Automobile Sector:-

According to Subrata Ray, senior vice-president, co-head, corporate sector ratings, ICRA, the EU today accounts for 35-40% of auto component exports from India. He sees this getting potentially impacted by market volatility and by any slowdown in the region due to policy uncertainty. Apart from auto components, OEMs (original equipment manufacturers) also export passenger vehicles from their Indian manufacturing units. This may get impacted in the event of any slowdown. Further, relative depreciation of GBP (pound) and euro may impact their margins as well. "The overall 'Brexit' process however is expected to be slow. The formal process should take about two-years. While potentially manufacturing based in UK can face EU import tariffs in the future, the final outcome would depend on how the existing trade & regulatory arrangements are negotiated said Ray of ICRA.

IV. Oil Price may Fall but Stronger Dollar will Offset:-

In response to referendum, oil prices immediately declined by 5%. This is expected to be a short-lived phenomenon as core oil fundamentals still remains unchanged. "Oil prices have been range bound in the last 3 weeks above $45/bbl and a stronger demand and supply outlook has elevated prices in the last one month or so on the back of supply disruptions helping to curb inventory build-up in the US. The uncertainty surrounding the British and European economies have depressed the pound and the euro and Brexit verdict has strengthened the US dollar which in turn suppresses crude prices which are traded in dollar making it more expensive in other currencies," it has been said. Further the shift from an oversupplied to a balanced market may overcome the impact of slightly weaker demand due to currency effects. The overall impact should be positive for PSU upstream companies , so long as oil prices are within $40/bbl-$45/bbl. GoI also stands to gain through lower subsidy burden

V. Bonds:-

Bonds did not react adversely to the Brexit unlike the equity and currency markets. A 10-year government security yields went down by only half a basis point. The market took a more sanguine view of Brexit due to several reasons. One, it has opened up the prospects of more monetary accommodation in India and the rest of the world. Two, slower global growth will feed into lower commodity prices and help keep inflation down in India as already discussed earlier.This will trigger further rate cuts. But then, foreign fund flows don't matter all that much for Indian bonds and, on balance.

VI. Gold:-

It is most natural that investors sought refuge in gold, a safe-haven asset. Hence gold prices in India shot up as much as 6% and 4.2% versus the US dollar. At one point, it was up as much as 8.1%, the biggest rally since 2008. The outlook is bullish for the yellow metal in a period of likely prolonged uncertainty as other European countries might be tempted to follow the UK. The chances that the US will hike rates before December have also declined to near zero, which is another boost for gold prices. The rate hikes increase the opportunity cost of holding gold.

VII. Companies:-

As pointed out earlier, currency volatility will straightaway hurt revenue and profits for some of those big companies doing business with the UK and Europe. But that a matter of more concern is in the longer run Britain's exit may affect easy access and movement of goods across unified Europe. The actual impact depends on what kind of a trade agreement is drawn up to replace the existing free market access. Reports say that EU trade agreements with other nations will cease to apply to Britain. Each country will have to now renegotiate with a country in its own capacity.

VIII. CONCLUSION

We have extensively discussed in the previous sections that with Britain exiting the EU, India has lost its gateway to Europe. India is now forced to go into alliances with other countries of the EU. This could be good for India in the long run. It is to be noted that India is already trying to build trade negotiations with Netherlands, France, Germany, and others, though in a small way. Netherlands is India's top FDI destination as of now. A Brexit could force India to build trading partnership with other EU nations in order to access the large EU market.

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