LIONTRUST

India – a positive outlook for the year ahead

India has undoubtedly been one of the key emerging market success stories of the past decade, a period during which the asset class has continually struggled to recapture the strong performance of the previous decade. Indeed, the Indian market (along with Taiwan) is one of the only emerging markets that has seen a positive return over the period 2012-2022. With an impressive return of nearly 80% in US dollars, it was one of the very few emerging markets able to keep pace with developed markets over that time. This strong relative performance has been especially apparent in the post-Covid recovery period, with India up 118% (from the Covid market low to end of 2022 in US dollars) against an emerging market return of 26% and developed market return of 62%.

The Modi effect

The key turning point for the market was the election of the BJP and prime minister Narendra Modi in May 2014. This heralded a refocusing of the economy on a more pro-business and market agenda, enacting a series of at times painful reforms to unlock the potential of India. Most noteworthy of these was the Goods & Services Tax (GST) of 2016, instigated on the basis of creating 'one nation, one tax' to streamline and harmonise taxation across the country, simplifying the previous byzantine system when trading between states. Despite early hiccups, today GST registration has become mandatory for all and government benefits from one of its biggest revenues through its collection. Moreover, under the BJP India has seen corporate tax cuts slashed to 22% from a previous level of 30% in 2019, with the aim of ensuring India is a globally competitive and favoured destination for investment. Indeed, alongside the Make in India programme, a series of Production Linked Incentive schemes (PLI) has aimed to position India as a manufacturing base able to capture the new 'China +1' supply chain mentality as consumers look to diversify away from sole reliance on China.

Structural and cyclical factors

The more recent outperformance of India can be explained by a coming together of powerful longer-term structural factors, as well as a cyclical recovery from the lockdowns of 2020 and beyond. India saw widespread lockdowns in the first half of 2020, but was in fact relatively spared in the first Covid wave, thereby allowing a rapid reopening of the economy. Although the second Covid wave was famously far more acute in India, the economic impact was significantly more benign with lockdowns being more localised and targeted compared to the wholesale variety experienced elsewhere. Therefore India's reopening and economic recovery has been fairly steady throughout 2021 and 2022.

However, this cyclical improvement has come on top of what was already a powerful structural economic recovery. India has essentially been in a period of macroeconomic repair for much of the past decade and has now emerged in a much more robust condition. In 2013 India was one of the so-called 'Fragile 5' emerging market economies that were buffeted by the Taper Tantrum (an interest shock that threatened those economies viewed as vulnerable to external macroeconomic shocks). Following the ascent to power of Narendra Modi and the business-friendly BJP Party, we have seen a period of fiscal repair going hand in hand with necessary structural reforms. In particular, the banking sector had become gummed up with bad loans from the last boom and bust cycle and was consequently unable or unwilling to lend. The last five years have seen a wholesale cleaning up of bank balance sheets, leaving the financial sector in excellent health and able to lend to and support a recovering economy.

In many sectors the overcapacity apparent from the previous cycle has now been worked off – most notably perhaps in the housing sector, where inventories have finally fallen to levels consistent with price increases and affordability is at record highs. A recovery in the housing sector has been a critical missing link in recent economic cycles in India and has the capacity now to spark a wider capex recovery after more than a decade of excess capacity.

Moreover, it must also be said that India's star performance was at least in part due to a lack of alternative opportunities. China (by far the largest emerging market) has spent the past two years steeply underperforming due to its zero-Covid policy-induced economic slowdown, compounded by a slew of anti-market regulatory actions targeting the technology sector in particular. With some global investors decreeing China as 'uninvestible', by late 2022 India stood out for its 12% (and domestically driven) nominal GDP growth at a time where much of the world frets about recessionary conditions; its geopolitical status as a valued democratic bulwark in Asia (and therefore de facto ally of the US); its stable, predictable and market-friendly political backdrop.

The return of China

As we turn to the first weeks of 2023, a key shift in the market dynamic has clearly been the return of China. By far the most important development was the policy shift that emerged from the 20th National Congress held in October, which was further reinforced by the China Economic Work Conference in November. The latter recognised the economy's shrinking demand profile and the harm done by the ongoing lockdowns and highlighted the importance of getting the economy back on track, supported by a proactive fiscal policy and prudent monetary policy. The most notable policy shift was clearly the pivot away from the zero-Covid policies that have severely impacted economic growth in China. The result of this abrupt policy shift has been a rapid recovery in markets, reflecting the renewed optimism surrounding China's great reopening. From the end of October to the year-end China rallied over 35% (in US dollars) against a 2.4% return for MSCI World and 13% for emerging markets.

A positive outlook

On the ground India remains as strong as ever, with solid credit growth, banks' balance sheets in good order, government tax takings at elevated levels and business optimism buoyant. However, as always, markets are a relative game and for the past three months China has been the most eye-catching recovery story, with compellingly cheap valuations as against India's sitting at more elevated levels. Given India's 133% outperformance of China from April 2020 (Covid lows) to end October 2022 (China's market bottom), it is perhaps no surprise to see some of this performance given back with the extreme reversion we have seen. India then is a rare example of a market with (slight) negative returns to date in 2023, in stark contrast to the market effervescence elsewhere. Moreover, market sentiment has taken an additional knock from the recent news flow surrounding the business empire of Gautam Adani, which has come under attack from US firm Hindenburg Research, which has accused the (until-recently) 2nd richest man in the world of "brazen stock manipulation and accounting fraud scheme". This has seen the share prices of Adani-group companies tumble, along with the net wealth of its major shareholder.

The soaring prices of Adani-led companies was certainly one of the more intriguing and extraordinary stories of Indian markets in 2022, given that at peak the collective shares made up as much as 8% of the benchmark MSCI India index. A considerable part of this move appeared to be highly speculative, with the companies often highly leveraged, and some relying on speculative future cash flows. Essentially, backing Adani companies was considered to be a bet supporting India Inc, given their promoter's proximity to government and enthusiasm for being a major part of the modernisation and greening of the Indian economy. Given the lack of fundamental and valuation support most institutional investors have long stayed clear of these companies (despite a costly relative performance impact) and therefore the impact of the sudden share price falls will mainly be felt at an index level as opposed to discretionary portfolios.

Consequently, the impact to the wider economy appears to be relatively minimal at this juncture, with business continuing as usual. Indeed the annual budget, released in recent days, affirms the government's commitment to infrastructure investment, raising the capex budget by 25%, with significant emphasis on road and rail. The initial fears of contagion via the banking sector look misplaced given that banks overall own less than 40% of group debt, with private sector banks having less than 10%. Most of the debt is via overseas bonds and debentures, and none of the group's $7bn in foreign currency bonds mature in the next 18 months. Therefore, banks have plenty enough contingency provisions to deal with this fairly limited exposure. It is of course undeniable that the events have created unwanted negative headlines for India at time where the market was already under pressure as investors switched their attention to China.

However, we believe that the medium and long-term outlook for India remains extremely attractive, with a private sector capex cycle only just beginning, supported by stable and reform-minded government policy. Perhaps most importantly, over longer time frames, India's demographic profile remains unmatched among the large global economies. Set to shortly overtake China as the world's most populous country, India enjoys a hugely more attractive demographic profile than its key Asian economic rival. Indeed, China has recently seen its population decline for the first time since 1961. China's rapidly ageing population and worsening dependency ratio is in stark contrast to India where 25% of the population are under the age of 14 and more than two-thirds of Indians are of working age. Meanwhile only about 7% of the population is above the age of 64 against China's 12.4%. With continued political stability and a multi-year investment cycle picking up, we believe that the next decade in emerging markets firmly belongs to India.

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