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MARKET COMMENTARY

Ashmore

India – Good karma for equities

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The election earlier this year of Narendra Modi and the BJP party may come to mark a significant turning point for India. The broad popular support for economic growth and job opportunities – underscored by the BJP's recent victories in local elections – may provide the momentum to push through difficult and painful new policies and greater fiscal discipline. Although such reforms can boost long-term economic growth potential, they often create economic dislocations that can slow economic activity in the near term.

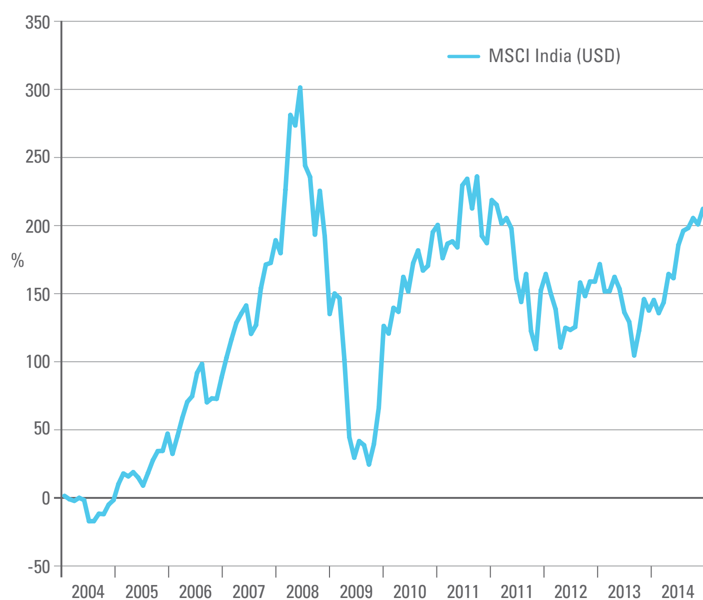
But India's economy seems poised for a cyclical upturn that could ease the near-term transition while longer-term reforms, if they materialise, could provide a wealth of opportunities for India's local businesses. The likely impact on earnings growth has not got the attention it deserves from most commentators on India's future.

The elections which took place in May this year have been pivotal for India. The BJP, led by Modi, won an absolute majority in the lower house of parliament, the first time a single party has won a majority since 1984. The election success came on the back of a sustained drive to promote growth, development and jobs, and the new government is approaching this with a refreshing sense of urgency.

There are, of course, challenges ahead. Modi's party does not control the upper house, though progress has been made at the state level, indicating that a majority in the upper house could be in place by the end of 2016.

In the meantime, what can Modi do? The main challenges are political: gathering consensus on reform; cutting red tape to facilitate investment; and unlocking bottlenecks in deeply needed infrastructure spending. All of this will inevitably lead to discussions on further reforms and it will also sustain the economic recovery which is already under way.

Fig 1. **MSCI India Net Index (USD) – Cumulative monthly returns, January 2004 - October 2014**



Source: Bloomberg.

India's economy is showing life, with real GDP growth expected at 6% for 2015/2016. Inflation is falling and the current account deficit has eased considerably

The BJP party is adopting a strict economic discipline, by targeting a fiscal deficit of 4.1% by end of FY 2015, deregulating diesel prices and raising rail passenger fares. At the state level, recent wins have helped keep up the momentum on policy announcements. The market has responded well to these developments, with Indian equities charging ahead this year after several years of lacklustre performance.

The immediate advantage for Modi is that India's economy is showing life, with real GDP growth expected at 6% for 2015/2016. Inflation is falling and the current account deficit has eased considerably. Furthermore, industrial production is on the upswing and is set to finish on a high for the first time since 2012. In our view, India is at a turning point.

This is good news for foreign and domestic investors alike. Overall savings rates in India are approximately 30%. This compares to 49.5% in China, and about 33% for Emerging Markets as a whole (Source: IMF, as of end 2013).

Households save approximately 22% of GDP and over the long term, households typically pour in 50% of their savings into financial assets. Assuming only 10% of these financial assets find their way into equity markets, for an economy that is approximately USD 2 trillion in size, we could expect local investors to pour USD 20 billion or more annually into the market for the next several years. We believe this is a conservative number.

Domestic investors, who make up the vast majority of Indian equity shareholders, have been net sellers since 2008. As a result, we believe, domestic investors are significantly underweight domestic equities and recent political and economic developments are providing the catalyst for a big return to the market. So the annual investment into equity markets, given recent positive sentiment, could be much higher.

Fundamental strength

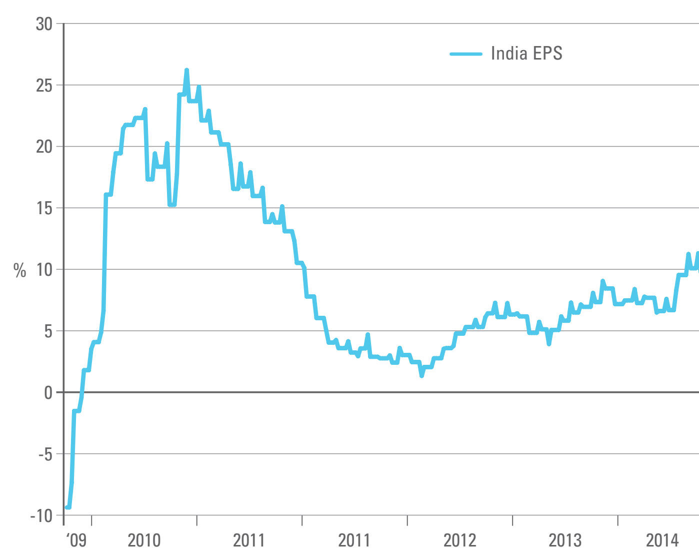
One of the key developments this year is the down-trend in inflation rates. High real rural wages (a consequence of the previous government's liberal rural employment guarantee programme) drove up the price of food, and strong energy and materials prices globally did little to help. In mid-2013, India's policy makers started cutting fiscal spending and put a squeeze on gold imports. The Reserve Bank of India (RBI) has kept rates stable in a bid to curb inflation expectations and the results are starting to show. A tailwind for India is lower crude-oil prices, which have a cascading effect on inflation and consequently on consumer sentiment and behaviour.

Since 2010, companies have had to deal with soft demand, pressure on margins, excess capacity and high leverage. As inflation subsides and demand comes back, we expect an improvement in contribution margins. Companies are likely to use cash flows to reduce debt, and over time, lower rates should help as well. We expect to see a strong combination of operating and financial leverage to come into play for corporate earnings over the next three years.

In fact we have already started observing an increase in profit growth and forward earnings expectations. We expect revenues to grow 10-12% p.a. with earnings growth at 25-30% p.a. over the next few years. Earnings are likely to surprise on the upside as the market will be somewhat impatient at a slower pace of reform in the immediate term.

A rapidly rising GDP will provide a strong tailwind to corporate earnings, with small and mid-cap stocks likely to benefit more than large caps

Fig 2. **India EPS – 1 year % change**



Source: Thomson Reuters Datastream.

Which sectors will benefit?

A rapidly rising GDP will provide a strong tailwind to corporate earnings, with small and mid-cap stocks likely to benefit more than large caps. The simple but powerful mathematics of growing from a small revenue and earnings base argues in favour of outperformance from smaller companies during economic expansions. So too do falling interest rates, which are closely associated with the early stages of most cyclical upturns and afford vulnerable smaller companies greater room to manoeuvre. Over the past decade, mid-cap stocks have tended to outperform large caps by a wider margin when GDP growth is highest.

More specifically, the drivers of Indian companies' expected margin expansions in coming months in many respects mirror those of the 2003 to 2007 market rally. Industrial production accelerated during most of that period, driving top-line earnings growth while relatively low debt and falling interest rates contributed to a dramatic expansion in earnings. Although oil prices rose, in contrast to the recent period during which oil prices have fallen, they increased from a relatively low base and at a much slower rate than in the 2009 to 2011 period.

One of the markers of the budding expansion in India recently has been the strong demand for autos. This includes both cars as well as heavy trucks that signal growing business investment. We expect mid-cap lenders providing financing for autos and housing to benefit in the current environment as lending growth and asset quality improve. Growing domestic consumption and private investment both favour the Consumer and Industrials sectors that are a much larger share of the small and mid-cap indices.

Falling commodity prices have done more than boost corporate margins recently. As global fuel prices have come down, India, along with other Emerging Markets countries such as Indonesia and Egypt, have seized the opportunity to begin deregulating domestic fuel markets and reducing fiscally disastrous subsidies. In an effort to demonstrate quick results, the Modi government is widely expected to put greater pressure on local government officials to free up investment projects bogged down by bureaucratic delays. These efforts could have a meaningful impact within the mining and construction sectors in particular. For example, the recent decision by India's Supreme Court to abolish private-sector mining leases has exacerbated an already tight coal supply chain, which is dominated by Coal India. A boost in domestic coal production would relieve pressure on utility companies, who have been forced to rely increasingly on more expensive imported coal.

Increased government investment in infrastructure and policies to encourage private investment would provide long-term benefits to the economy as well as more immediate opportunities for civil engineering and construction companies and private port facilities, for example. One of the more ambitious reforms would be the introduction of a Goods and Services Tax (GST) that could supplant layers of provincial taxes that contribute to the fragmentation of the Indian market, in which the transport of goods and investment across provincial borders are subject to costly delays. Successful passage of such a policy would enable retailers, manufacturers and others with significant overheads to seek economies of scale across a national market.

Continued overleaf

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Conclusion

Key risks remain for India, notably the strength of exports to its juggernaut partners in the West. India's exports are dominated by the US and EU, which have shown some growth but are not yet reaching full steam. A rapid recovery in oil prices can create headwinds and slow the pace of growth in the medium term. A poor monsoon season in 2014 could also hinder domestic growth in the short term.

The evidence and the trends we are seeing however leave us optimistic. The election results may provide the catalyst for sustained growth and evidence indicates that India is already on a cyclical upswing. As demand improves, corporate profits are likely to be further boosted by expanding margins, driven by improved operating leverage and declining costs.

All of these events demonstrate that India is a truly remarkable story of reforms in Emerging Markets.

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