

India: Short-Term Pains For Long-Term Gains

We have been monitoring India as an attractive EM long-term investment for some time. India has shown interesting characteristics that other markets in the EM universe lack. In previous Thinking Man editions published in 2013 and 2015, titled “EM: Time to be Selective” and “Few & Selective Opportunities in Emerging Markets”, we mentioned investors should be careful and selective when taking investment decisions within the diverse EM universe. Later, in our Thinking Man #28 of March 2015 titled “India in a Sweet Spot”, we highlighted newly-elected Narendra Modi’s focus on developing strategic relationships with top business leaders and encouraging growth of India’s IT eco-system to help propel Indian companies across different sectors. In May 2019, Modi (NM) was reelected after his party and right-wing allies achieved to secure a strong majority in Congress. The continuation and revamping of NM’s pro-reform agenda, which seeks to modernize and open-up India’s economy, is making India one of the most attractive markets in the EM universe. We reiterate the call we made in our Thinking Man #28 and believe India continues to be in a “sweet spot”.

We see India as an attractive long-term EM bet because of fundamental variables, such as Modi’s business-friendly reforms and India’s strong economic growth, and geopolitical variables that give India an advantage in today’s global environment. For these reasons, we believe India will continue to outperform other EM markets in the long-run, with the Financials sector enjoying the furthest upside given the main reforms from Modi’s government.

The economic fundamentals: Modi’s liberal reforms and India’s strong growth

On the reforms side, the landslide victory that secured Modi a decisive second mandate has given him enough political capital to keep pushing the liberal economic reforms his government started five years ago. These reforms have been hailed by investors as modernizing acts that could help India realize its economic potential. In a conversation BigSur had with Abhishek Mehta, Founder & Principal of Blue Lotus Investments, he mentioned how the biggest advantage of NM’s re-election is the completion of the following reform projects:

- 1) Goods and Services tax reform that seeks to simplify the country’s tax code, which has already shown results through higher tax compliance and revenues. The tax take is low for such a major economy. Last year, the tax take rose to 18% of GDP, and experts believe it should go higher.

The Thinking Man’s Approach



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- India is a clear long-term BUY based on fundamental as well as geopolitical variables.
- Modi’s liberal economic reforms, India’s economic momentum, and pragmatic foreign policy are all reasons why India is on a good path to finally unlock its growth potential.
- We see India’s current economic issues as short-term pains for long-term gains.
- Although Indian equities are looking slightly expensive right now, we believe India will continue to outperform other EM markets in the long-run.
- For more tactical-oriented investors, we believe the Financials sector has the furthest upside due to Modi’s reforms.

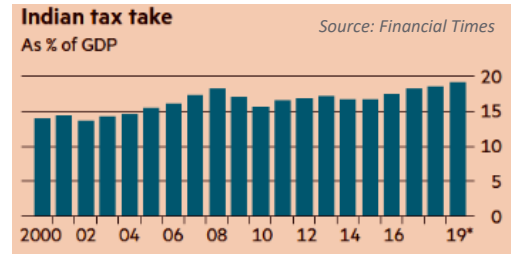
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Abhishek expects the government to simplify even further corporate and other direct taxes.

- 2) Clean-up of public sector banks in order to reduce their share of the Indian financial system and improve asset quality standards. Public institutions, such as the Punjab National Bank, were providing loans without proper regulations and due diligence. These banks are now trying to clean-up these loans, and non-performing loans should begin to drop this year from 10% to 7%.¹
- 3) Insolvency and bankruptcy code implemented to target India's "zombie companies".² The goal is to reduce the level of non-performing loans in the economy and open up space for new lucrative but fiscally-disciplined companies. According to Abhishek, the focus has been on the big-ticket cases and it is expected from NM's government to tackle the next tier of troubled corporates.



Other programs that will be pushed during Modi's second term should also help to further modernize and open-up India's economy, not only to Indian citizens but also to foreign investors. According to Abhishek, the national ID program (Aadhar card), which enables direct payments into 300 million new bank accounts,³ and other digitization efforts will help reduce informal economic activity. In addition, Modi is expected to continue reforming the Foreign Direct Investment (FDI) regime.

The implementation of certain reforms have had serious setbacks and have affected the Indian economy in the short-term. For example, the demonetization of all ₹500 and ₹1,000 notes, an effort to fight counterfeiting and curtail the shadow economy by forcing Indians to open bank accounts, was poorly executed and economic activity suffered as consequence.⁴ The reduced credit growth caused by the clean-up of state-owned banks has taken a toll on consumption, which accounts for 70% of India's GDP.

Nevertheless, the reforms have been welcomed by investors and economic setbacks are being considered short-term pains that will result in long-term gains. Although the demonetization was disorganized, it did manage to bring millions of Indians to join the formal bank system by opening accounts. Abhishek explained us that Modi's government has been able to keep inflation under control and it is known for its fiscal conservatism, which should allow the Reserve Bank of India to cut rates and stimulate growth in case economic conditions worsen.

Despite the short-term economic pains, India has been showing strong and consistent growth over the past couple of years. Just during 2018, India's economy expanded at 6.8% annual rate – a considerable growth rate in a world of deaccelerating growth. For the past two years, India was the fastest growing economy in the world, falling behind China to place #2 in April 2019.⁵

¹ Financial Times. "Indian Elections: Modal Shift," <https://www.ft.com/content/e61690ec-7d54-11e9-81d2-f785092ab560>

² Barron's. "How to Invest in Narendra Modi's India," <https://www.barrons.com/articles/how-to-invest-in-india-under-narendra-modi-51558720365>

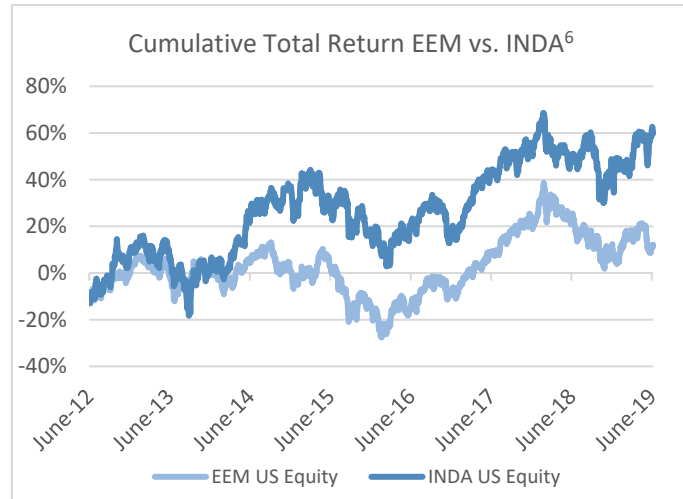
³ ibid

⁴ Financial Times. "Modi Should Opt For Reform, Not Division," <https://www.ft.com/content/6c966cb0-7b1f-11e9-81d2-f785092ab560>

⁵ BBC News. "India no longer world's fastest-growing economy," <https://www.bbc.com/news/world-asia-india-48460232>



Investors are motivated by the prospect of political continuity and are optimistic that Modi's long-term reform projects will help modernize India's economy. This enthusiasm is reflected in the outperformance India has had compared to the rest of the EM universe. Since March 2014, when Modi was elected for the first time, the iShares MSCI India ETF (INDA) has outperformed the iShares MSCI Emerging Markets Index (EEM) by 30% in terms of total return.⁷ The rally in Indian equities enjoyed another boost early this year, when renewed tensions with Pakistan prompted an escalation of nationalist sentiment, a booster for Modi's chances of re-election. Since then, INDA has outperformed EEM by 14% in terms of total return. When Modi was re-elected in March, Indian markets saw their strongest one-day gain in three years.⁸ In addition, India has been a relative EM haven from the heightening tensions between the U.S. and China.⁹ Since February 2018, when the trade war broke out, INDA has outperformed EEM by 12.5% in terms of total return. This outperformance is a reflection of investors' confidence on Modi's reform agenda and on India's long-run economic growth potential.



The geopolitical fundamentals: India's foreign policy is advantageous in today's global environment

India has maintained diplomatic and economic ties with most nations in the world, especially with countries that are in direct confrontation with one another. Some examples include U.S., Israel, Saudi Arabia, China, Iran, Qatar, among others. India's pragmatic foreign policy of "being everyone's friend" should give the country an advantage in today's complex geopolitical environment, characterized by increasing nationalism, isolationism and trade disputes.

The U.S.-India relationship is important to highlight. India has always been supportive of U.S. policies and has always found a pragmatic way to find common ground with Washington without jeopardizing its relationships with U.S. adversaries. Modi is the most pro-American Indian leader since independence, and the two countries can help each other with closer economic and security ties. According to Abhishek, the relationship between the two countries is expected to strengthen. Not only do Modi and Trump share ideological traits, but the tensions between the U.S. and China actually represent an opportunity for India to strongly position itself as an alternative partner on a non-China-centered global supply chain.

⁶ Data from Bloomberg Terminal as of 06/06/19

⁷ Data from Bloomberg Terminal

⁸ Financial Times. "India Stocks Rally As Modi Sets Course For Election Victory,"

<https://www.ft.com/content/de4acbe2-7d10-11e9-81d2-f785092ab560>

⁹ Barron's. "How to Invest in Narendra Modi's India," <https://www.barrons.com/articles/how-to-invest-in-india-under-narendra-modi-51558720365>



Risks

The risks to this long-term view are short-term in nature. In addition India's long-term potential is dependent on Modi's success in implementing the needed economic reforms. During the short-term, we can see headlines related to India's economic troubles as well as geopolitical tensions with its neighbors and the U.S. We identify two main risks:

- Heightened nationalism, like the one on which Modi and its allies campaigned in the recent election, which could increase Hindu-Muslim tensions in the country, thus putting in jeopardy Modi's modernization reform plans. Since his ascent to power in 2014, Modi has appeased and elevated extreme Hindu elements of BJP, despite pitching himself as India's protector. His government has also been accused of abusing its authority to crush the opposition and goose economic statistics.¹⁰ However, after his re-election, Modi stroke a conciliatory tone and vowed to serve the interest of all Indians regardless of their faith.¹¹ This risk should be downplayed if Modi lives up to its commitment and only uses its extremely-favorable political capital to implement business-friendly reforms.
- Execution mistakes, like the one seen during the demonetization plan, could derail Modi's efforts to finish implementing the liberal reforms. Modi's government must carry out these policies in an organized manner. Otherwise, he risks worsening India's current economic troubles.

BSP View

We believe India is a clear long-term BUY and a key country in the EM space because of fundamental and geopolitical variables. The economic reforms Modi is implementing, the economic momentum the country has experienced over the past years, and the current geopolitical environment sets India on a good path to finally unlock its growth potential.

Although Indian equities are looking slightly expensive right now (they are trading at almost 18x P/E – a ratio at the upper end of a decade-long range), we believe India will continue to outperform other EM markets in the long-run.



For more tactical oriented investors, we believe the Financials sector has the furthest upside. As Modi's government stabilizes and cleans-up the financial system, attractive opportunities can arise in the sector's private financial institutions. Not only are private banks growing and gaining market share as state-owned banks reduce their participation in the financial system, but they are also better allocators of capital. For this reason, private financial institutions have loan portfolios of higher quality compared to state-owned banks. In addition, the private financial sector in India is poised to grow even further as it is more prepared to capitalize on the digitization of the economy and banking sector.

¹⁰ The Wall Street Journal. "India Turns West but Away From Western Values," <https://www.wsj.com/articles/india-turns-west-but-away-from-western-values-11558651907>

¹¹ Financial Times. "Modi Strikes Conciliatory Tone After Victory," <https://www.ft.com/content/b425fbc0-7f63-11e9-b592-5fe435b57a3b>



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The material seeks to compare the performance of iShares MSCI India ETF (INDA) versus iShares MSCI Emerging Markets ETF (EEM). INDA seeks to track the investment results of the MSCI India Index, which is designed to measure the performance of equity securities of companies whose market capitalization, as calculated by the index provider, represents the top 85% of companies in the Indian securities market. EEM seeks to track the investment results of the MSCI Emerging Markets Index, an index designed to measure equity market performance in the global emerging market (24 countries). The iShares MSCI India ETF and the iShares MSCI Emerging Markets ETF were selected to allow for comparison of the outperformance of Indian equities to the overall Emerging Market universe. Comparisons to indices in this material have limitations because indexes have volatility and other material characteristics that may differ from the referenced strategy or security. In addition, the volatility and securities of the indices may be materially different from that of an investor. Therefore, actual performance may differ substantially from the performance of any referenced index). Investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds' ultimate performance results. Due to these differences, indexes should not be relied upon as an accurate measure of comparison and are for informational purposes only. Unless noted otherwise, all index returns are denominated in U.S. dollars.

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