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TalkingPoint

Indian equities: is it safe to get back in the market?

Manish Bhatia, Fund Manager for Indian equities, looks at how investors should position themselves for the next phase of India's economic cycle and discusses whether the worst is now over for the country's equities

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Almost everything that could go wrong within an economy, went wrong in India in 2011. Inflation soared, corruption scandals erupted, and the government went through a period of policy paralysis. However, in 2012, India's markets got off to a stunning start, surging ahead of the wider region by a strong margin. But just as the rally started to seem too good to be true, it proved itself to be just that.

Investors will be forgiven for looking at the performance of Indian equities year to date, and wondering what has gone right in India. The brief answer is, unfortunately, not much – we believe the markets bounced too high, too fast, and the slump we've seen more recently may be a sign that we are in for a few more turbulent months for India. While this does not mean that a genuine recovery is not on the horizon, it does mean that investors may need to hold on tighter for a little longer. Our view is that a more sustainable rebound is likely to occur in the second half of this year but, until then, Indian equities are likely to endure a few more twists and turns.

The rebound: if not now, when?

In the first weeks of this year, Indian equities benefited from the global trade in oversold assets. As well as being the most oversold market in the region last year, Indian equities were boosted by the improved investor sentiment triggered by the fall in inflation. Food inflation, in particular, fell sharply at the end of last year – the result of a good harvest – and markets soared on the news. However, non-food inflation remains elevated and, for us, this is still a key concern. Also, with the effect of the weak currency yet to flow in, inflation is likely to stay high for some time. For these reasons, and because the fundamentals of the economy have yet to turn a corner, we believe the rally came a bit too early, justifying the subsequent sell off.

While the long-term fundamentals of the economy are strong, India still has some economic corners to turn before we will see a sustained improvement in equity performance. Firstly, inflation and interest rates need to come down. In order for this to happen, we need to see a slowdown in growth. This is already starting to play out, but investors must be prepared to hold their nerve a little longer. Overall, a lot went wrong in India last year. Inflation and interest rates soared, corruption scandals rocked the corporate sector and the government failed to make key policy decisions. The good news for investors is that 2011 is over, and there is a lot of scope for improvement in 2012. However, it will not happen overnight. As a result, we are likely to endure more blips in market performance over the coming months.

> India has a large share of private companies and the market is driven by entrepreneurs who tend to be very shareholder focused."

What should investors look for in a sustainable rally?

A sustainable equity rebound will need to be preceded by a cut in interest rates – this is unlikely to happen until the second half of this year at the earliest. However, before any rate cut, we will need to see a slowdown in the economy

– this, in many ways, is already playing out. Consumption has been slowing for six to nine months now; investment for over a year. As economic growth continues to ease, we expect structural inflation to also start coming down. We estimate that this will start to happen in the next four or five months.

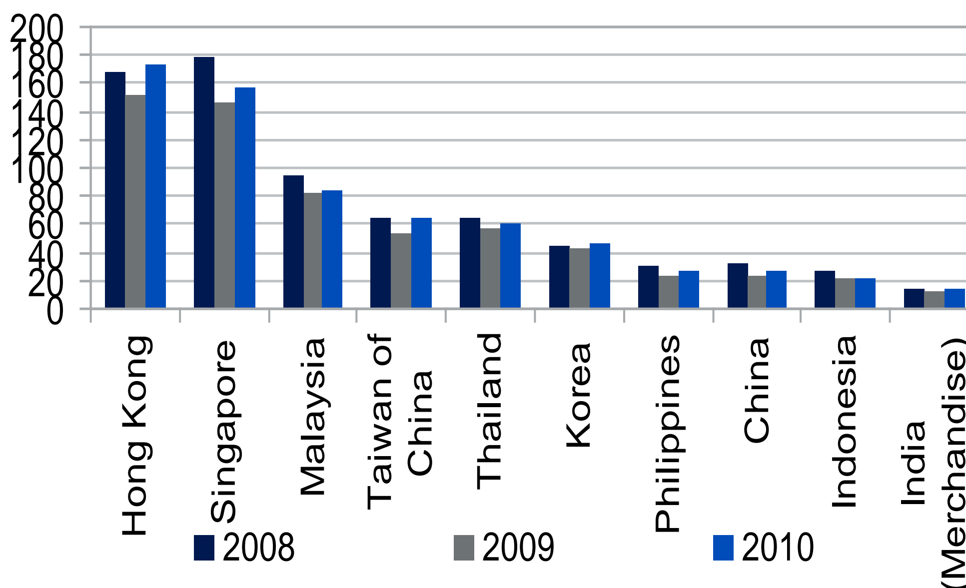
As this scenario unfolds the government will have to reverse policy to kick-start investment and consumption. This will mean restarting stalled infrastructure initiatives: building roads and power plants, firming up policies on fuel, water etc. At this point, we'll see the investment sector picking up and consumption will start to come back. Soon after, markets will start to respond and the bottoming out process should begin in earnest. We are watching closely for this because this will make way for a sustainable rally from there on.

Should Indian investors be worried about what's happening globally? How exposed is the Indian economy to the slowdown in the West?

India is a very capital-starved economy. There is always a shortage of capital, therefore, it tends to have high interest rates and is strongly dependent on external capital for growth. As a result, the weakness in global capital markets is a significant headwind. Conversely, India doesn't have a large external trade reliance – unlike its peers it does not rely heavily on export demand from the West as illustrated in chart 1 – and this should keep India fairly resilient to any deterioration in global economic conditions.

Chart 1: India's vulnerability to export slowdown is the least amongst Asian peers

Exports/GDP ratio for major economies, Calendar year-ends, 2008-10 (%) – US$ bn



Source: World Bank, IMF, Kotak Institutional Equities estimates
Source: RBI, Ministry of Finance, Citi

How has your outlook on the market changed over recent months?

Inflation is an issue that we have grown more concerned about. Structural inflation appears to be taking root and we suspect that over the next five years the trajectory could be higher at 6 to 6.5%. This is fine for a high-growth economy like India, however, it is an issue that, if not monitored closely, could pose a problem for the most indebted areas of the economy. In addition, populist government policies such as money transfers to rural sectors and welfare schemes will mean the fiscal deficit is likely to remain high. The implications of this are that inflation and interest rates will, over the medium term, be higher than what the market has previously been used to.

In light of current conditions, what themes are guiding your investment decisions?

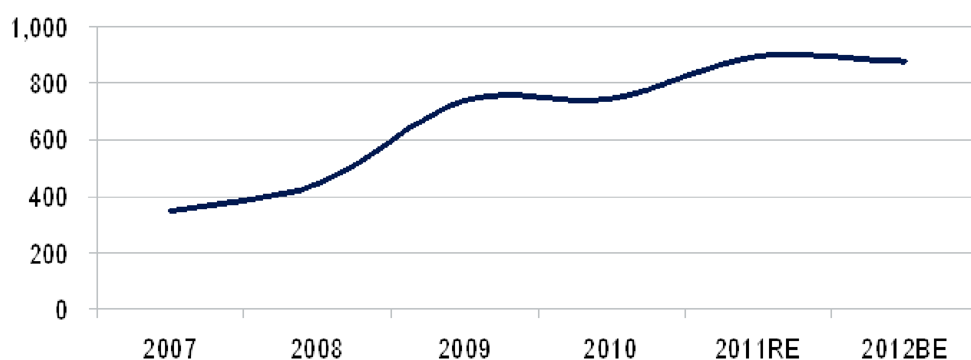
Despite the present challenges, we continue to find exciting ideas in the market as our fundamental bottom-up approach allows us to target the best long-term opportunities in what is one of the fastest-moving economies in the world. Like many investors in the region, we are aware that the consumer will be the driving force behind economic

growth in the region as well as globally. However, we do not believe it is wise to follow the crowd by investing in the obvious consumer names as these are now significantly overvalued. Instead, we are finding innovative ways to access this growth. In particular, we are targeting companies that are able to tap into the potential of the rural consumer.

Government money transfer schemes, commodity inflation and agriculture schemes are boosting incomes across rural India – see chart 2. Still, consumption in these regions remains low, in per capita terms. This area of the market is, therefore, likely to see the most consumption growth going forward. Rural communities are increasingly aspirational, and looking to buy such things as electronic items, including TVs, in large numbers.

Chart 2: Rural consumption has been boosted by government spending

Government's rural spending, March fiscal year-ends, 2005-12BE (Rs bn)



Source: Ministry of Finance, Expenditure Budget, Kotak Institutional Equities

Another theme we are very focused on is healthcare and, in particular, pharmaceuticals. Within the Asian context, India has some very interesting pharmaceutical companies that are making inroads into Western markets. As Western governments look to cut costs, they will be inclined to use generic drugs rather than the more expensive branded products. Indian pharmaceuticals are likely to be a key beneficiary of this trend.

The IT services sector is likely to benefit from a similar shift. However, in this case, rather than governments looking to cut costs, it is Western companies that will be looking for cheaper alternatives, and will increasingly outsource IT services to India.

As the market moves into an environment of slower growth, what risks are you most conscious of?

The issue we are most concerned about is corporate sector debt as we move into this economic phase. With interest rates likely to remain elevated this year, the burden of payments will weigh heavily on companies with excessive debt. We are particularly cautious about companies that have foreign currency loans because we think the rupee may be on a moderate declining path due to India's trade deficit. Therefore, leverage is something we look at closely when making investment decisions.

In terms of sectors, we are very cautious on the banking sector, particularly government-owned banks. In India, there are private banks and state-owned banks, and the latter are starting to report heightened levels of NPLs, largely from the agricultural sector and SMEs.

The final area of the market we are avoiding is the telecommunications sector. This is due to the high levels of competition within the sector and the increasing regulatory risk these companies face as the government aims to address corruption issues.

What are the most compelling reasons why investors should consider re-entering the Indian market in 2012?

After the turmoil of 2011, all signs suggest that the economy is over the worst and investors should now start to consider taking the opportunity to build exposure to India's long-term growth story. Here are the key reasons why India should be a key part for any global portfolio:

- Quality companies: the Indian market is dominated by private companies – unlike in many other markets in the region, most notably China. With its large share of private companies, India's economy is driven by entrepreneurs who, in turn, tend to be very shareholder focused.

India – interesting facts:

- **India is one of the youngest nations with 53% of population under the age of 25**
- **34% of Microsoft's & 28% of IBM's development team, and 17% of Intel's scientists are Indians**
- **Pool of 23 million professionals - increasing by half a million every year**
- **Houses largest number of USFDA approved plants outside of US**
- **Over 50% of Fortune 500 companies outsource from India**
- **Fourth Largest Economy on PPP – adj basis (10th largest on absolute GDP basis)**
- **Indians have accounted for 45% of H1B Visas issued in US over the last few years**
- **India is home to world's largest Film Industry, producing over 800 movies every year!**

- Government policy: after the recent political impasse and the long list of things that went wrong in the Indian economy last year, the market heavily underperformed, bringing valuations to reasonable levels. Policymakers are now under increased pressure to proactively manage the economy through its present challenges. We expect to see further government action to drive the economy once the slowdown takes hold later this year. Once we see the investment cycle picking up – which it should start to do in H2 – we are likely to see the economy return to a more even keel.

- Long-term dynamics: while the economy will experience many short-term blips along the way, India's long-term growth dynamics remain intact. Unlike China, whose population is rapidly aging, India is one of the youngest countries in the world, with more than 50% of people under the age of 25. It is a democracy with an aspiring population and its economy is fairly open, by the standards of the region. Despite its population of 1.2 billion people, the economy is only about a third of that of China; this indicates that India still has a lot of growing to do….

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