



INVESTING IN INDIA AN ATTRACTIVE GROWTH STORY

JANUARY 2016

Amid negative news flow surrounding weak global growth, a possible hard landing in China and rising US interest rates, India remains an attractive investment destination. India will likely emerge as one of the fastest-growing major economies in the world this year, outpacing last year's growth, and continue its growth momentum over the next few years. Further, India's central bank is likely to stay on an easing course, despite a reversal in the US Federal Reserve's monetary stance.

India's twin deficits—fiscal and current—have improved markedly over the past few years. First, its improved fiscal position was helped by fuel reforms i.e. slashing fuel subsidies, aided by lower crude oil prices. India is among the biggest beneficiaries of a sustained low oil price environment. Indirect tax revenues, meanwhile, have jumped, boosted by excise duties. Lower oil prices, coupled with curbs on gold imports and tepid domestic demand, have also helped India contain its current account deficit at benign levels.

Second, while the Rupee depreciated 4.7% against the US dollar last year¹, it has been among the best-performing currencies within Asia and emerging markets. In comparison, a US dollar trade-weighted index fell 8.5% over the year¹. A shrinking current account deficit and tamer inflation have lifted the Rupee out of the "Fragile Five" currencies². Foreign exchange reserves are also

close to all-time highs of USD350.7 billion in November 2015, suggesting that India has enough buffer to tide through difficult times.

Against this backdrop, India's economic growth prospects remain promising. The most recent measures of 2QFY16 (July-September 2015) GDP growth indicate that a business recovery cycle is underway, led by steady discretionary demand, public capital expenditure, lower commodity prices and a gradual transmission of lower interest rates.

The OECD³ projects a 7.3% real GDP growth in the current fiscal year 2016 (April 2015-March 2016) and 7.4% in FY17, the highest among 44 countries under its coverage. Other think-tanks have similar or higher growth forecasts for the country.

This is not to say that India does not face its share of challenges currently. A slowdown in global demand has hurt exports, and the weak external environment has taken a toll on business confidence, with corporates holding off investments due to low capacity utilisation.

We think these headwinds could be temporary, in light of a cyclical recovery that is underway and supportive monetary policies and structural reforms

¹Bloomberg, Datastream, as at 31 December 2015. ²Bloomberg News, as at 17 March 2015. The "Fragile Five" is a term coined by Morgan Stanley in 2013, when the US Federal Reserve announced the tapering of its stimulus programme. It was to identify the five major emerging markets with the most vulnerable currencies: Brazil, India, Indonesia, Turkey and South Africa. ³OECD: Organisation for Economic Co-operation and Development.



India's favourable interest rate trajectory will likely stimulate profits and demand. Record-low consumer inflation allowed the Reserve Bank of India (RBI) to slash its key repurchase (repo) rate four times in 2015; also as positive real rates sustained above the RBI's target range. The fourth rate cut in late September last year sent the repo rate to a four-year low. Low inflation may create room for more cuts to follow.

A low interest rate environment may help revive corporate investments, which have been sluggish due to weak capacity utilisation. The government is setting the precedent by boosting investments, with the hope of encouraging the private sector to follow suit.

Lower lending rates also mean cheaper credit for consumers, which may in turn boost consumer credit demand. Consumption will likely get another shot in the arm when India rolls out Seventh Pay Commission this year. Pay Commissions are carried out almost every decade to revise central government employees' salaries, and the current recommendation to hike employees' pay by an average of 23.5% may impact c.30 million Indian households' income.

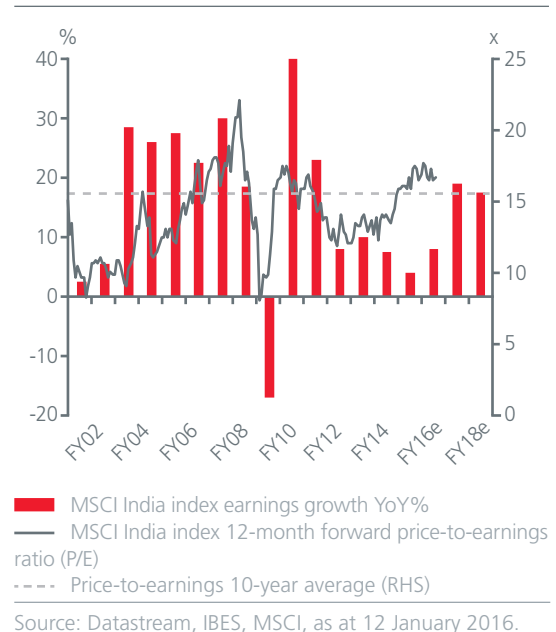
Together, lower interest rates and a pick-up in capacity utilisation and aggregate demand may help corporates realise their operating leverage and boost earnings growth

Indeed, corporate earnings, which have come under pressure over the past few years, look to be bottoming out. Earnings per share (EPS) have grown under 10% in each of the last four fiscal years, slowing to 4% in the previous fiscal year. Falling sales amid poor demand, idle capacities and higher interest charge have eaten into corporate profits over last few years. More recently, companies with profitability directly linked to global commodity prices have led the decline.

Still, profit estimates are on an uptick. Aggregate earnings are expected to grow solidly over the next two fiscal years: consensus estimates put the MSCI India Index's EPS growth at 18.9% and 17.3% in FY17

and FY18, respectively⁴. While the current consensus estimates, at high teens, might appear a bit stretched, the key takeaway is that things are looking up, after single-digit profit growth for five years.

Fig.1. Earnings growth (%) and price-to-earnings ratio (x)



Importantly, we believe India's growth recovery will be closely intertwined with the government's reform agenda, which is gradually playing out. This, though, will be a medium-to longer-term story

Big-bang legislative reforms, such as the land acquisition bill and introduction of goods and services tax have unsurprisingly been stymied by the ruling coalition's lack of majority in the Upper House (key bills have to be passed in both Lower and Upper Houses). This has attracted much negative press for the government. However, this may be a matter of displaced expectations from India's chaotic democracy.

Encouragingly, despite the difficulties passing legislative reforms, there are early signs of progress on key

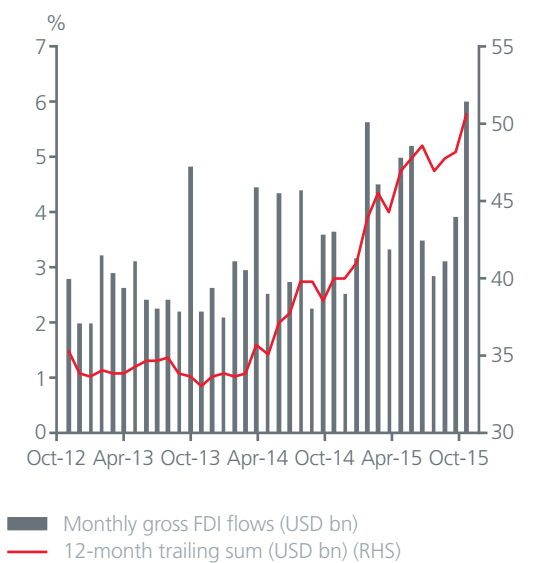
⁴Datastream, IBES, MSCI, as at 12 January 2016.



executive reforms. For example, the “Make in India” campaign, first announced in September 2014 to boost manufacturing and create jobs, appears have gained some traction. A few large foreign corporations have pledged to set up or increase operations in India, such as Taiwanese contract electronics manufacturer Foxconn and automakers General Motors and Ford.

Reforms to attract foreign direct investments (FDI) in major sectors, such as railways, defence and insurance have also reaped fruits so far. Gross FDI inflows hit a peak of USD50.5 billion on a 12-month trailing sum basis in October last year, a 25% year-on-year rise. Ease of doing business, a key thrust of the “Make in India” initiative, is also underway as India saw a rise in recent global rankings.

Fig.2. Gross FDI inflows (USD billion)

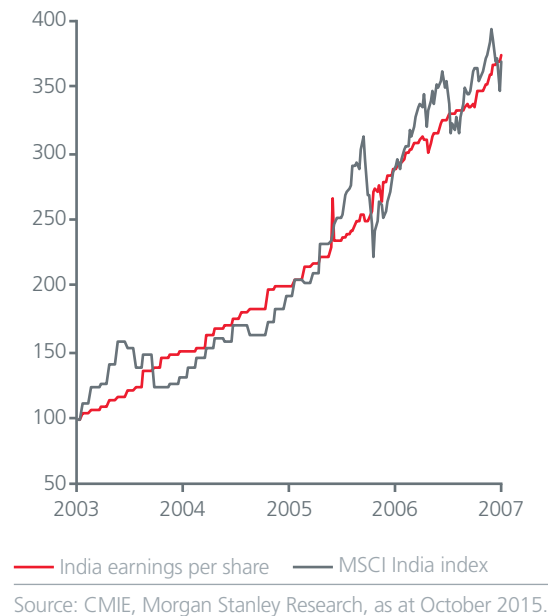


Infrastructure, another major reform area, has also seen progress. The government boosted its FY15 spending budget for roads and railways by 50% versus last year, and intends to fund the investments through higher fuel taxes and market borrowing. In 1HFY16, the National Highways Authority of India awarded more than double the kilometres of projects compared to the previous year.

CURRENT SITUATION REMINISCENT OF EARLY 2000s?

Some factors present today, such as low inflation, a slump in commodities prices, sluggish corporate investments and a development-minded government, also occurred in the early 2000s. Then, right-wing policies helped India achieve strong GDP growth for the next few years, also as equity market and earnings jumped, until the global financial crisis struck in 2008. In the present situation, falling interest rates, low inflation, ongoing reforms and rising investments may catalyse a pick-up in corporate earnings.

Fig.3. Earnings leaped and so did index



Eastspring’s India strategies stand to benefit from India’s economic recovery. Our strategies are tilted towards companies with sound fundamentals that offer attractive risk-reward and potentially superior return for investors over the long term.



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