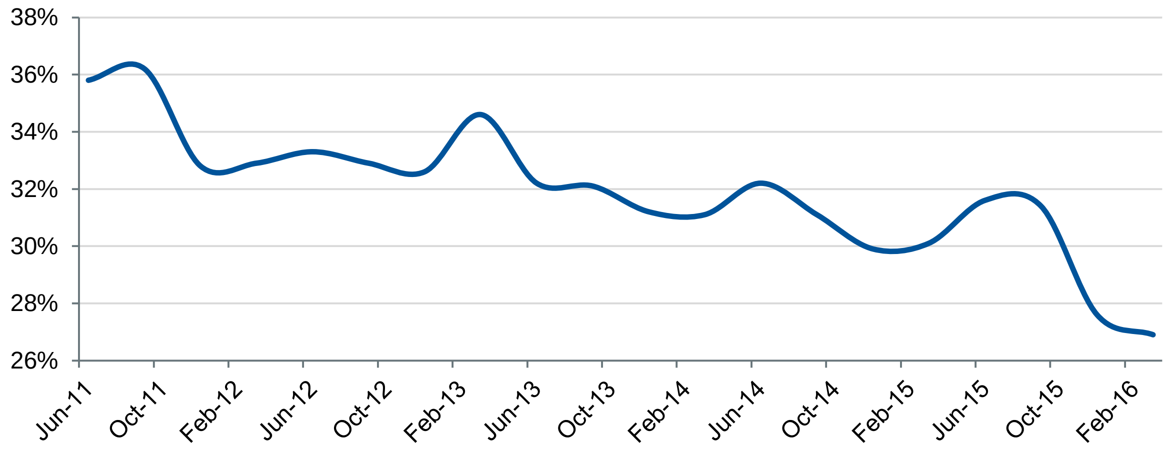
Time to put INDIA back on the radar

The reversal of the US Dollar's upward trend (in March and again in June) has prompted a sharp recovery in emerging market equities in which India participated in absolute terms but underperformed. In the first instance, higher beta markets such as Brazil, Russia and Turkey recovered more, simply because of a lower starting point, but stronger fundamentals and better opportunities will play out over time. Indian equities trod a different path to the emerging peer group in May, the latter falling sharply again (-3.9%), as expectations of a US rate rise quickened and the US Dollar rallied again. India continued to perform however (+4.1%), demonstrating that its superior macroeconomic situation is better able to withstand the inevitable reversal of fund flows that tighter US interest rates forces on riskier asset classes. India's sturdier macro is not new news, implying incremental positives have since emerged to enhance the investment argument. It is the combination of these developments that is supporting India's ability to differentiate itself from its Emerging Market peers.

India completed fiscal 2016 on a strong note, reporting fourth quarter GDP at 7.9%, the best of the four, and enabling full year GDP to rise 7.6% year over year (7.2% in FY15). Private sector consumption and manufacturing drove the growth whilst the service sector delivered consistently, though slightly weaker year over year. The major disappointment was fixed capital formation (capex) falling 2.4% in the final quarter, registering full year growth of just 3.8% versus 6.0% in 2015.

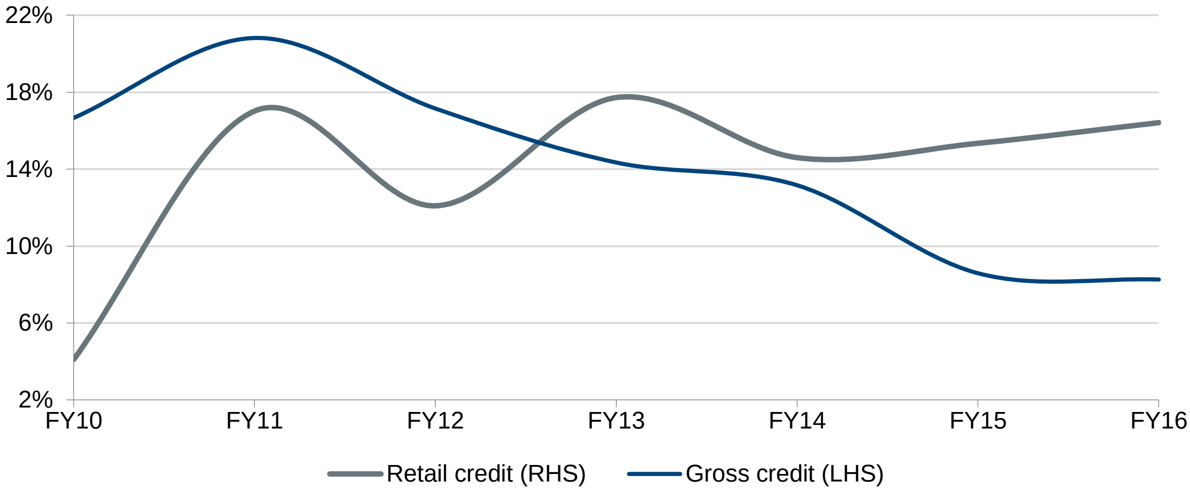
Chart 1: India's nominal gross fixed capital formation growth



Source: Bloomberg

Private sector capex remains the missing link and is the vital ingredient for sustaining future economic momentum, following the Government's efforts to "crowd in" the private sector. These initiatives have been supportive, but the public sector contribution can only go so far, particularly as there will be less "fiscal flexibility" in the central Government's 2017 budget. At State level however wider sources of funding (as "ease of doing business" improves) may become possible, meaning public expenditure as a whole could surprise positively. Indeed the fruits of significant investment in roads, railways, power, and telecommunications alongside strategic initiatives such as Modi's "Make in India campaign" have yet to show up in the numbers and will support future economic growth at a higher level. "Hand in hand" with weak private sector capex is poor credit growth, although now more specifically limited to industry, which is still in the process of fixing its balance sheet sufficiently to warrant further meaningful credit dispersal. That consumption remains the pillar of the long-term India story was amply demonstrated in the 2016 full year GDP numbers, and looking ahead there are high hopes that this year's monsoon will reinvigorate rural spending (though not until September). Urban consumption will also benefit from the full impact of the recent (and substantial) increases in public sector salaries.

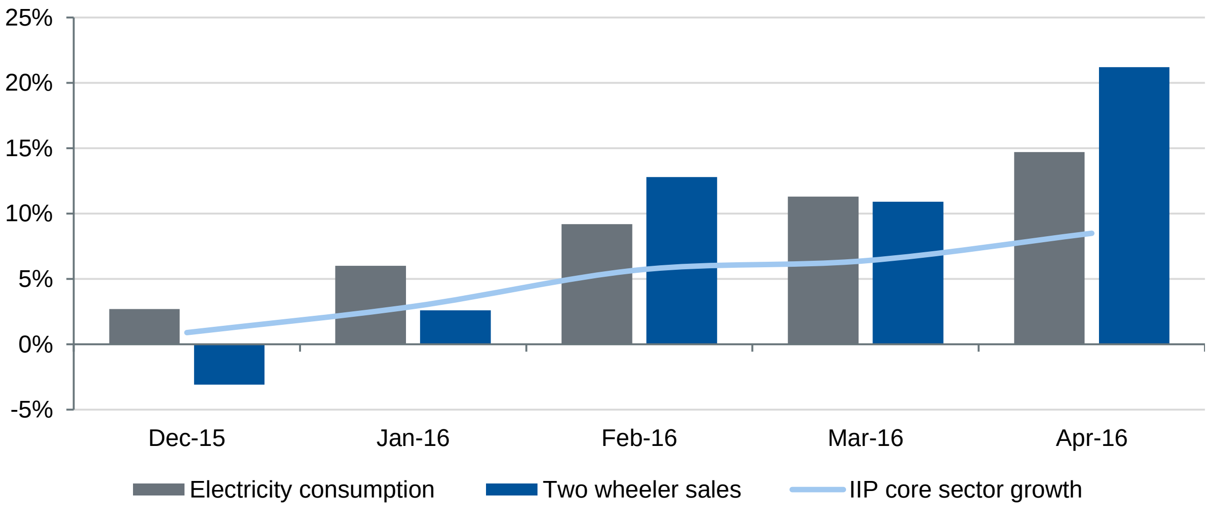
Chart 2: Credit growth - Gross vs Retail (YOY)



Source: B&K Securities

In support of healthier GDP momentum there is mounting evidence at a “grass roots” level of a broadening range of improving economic indicators. These include, but are not limited to, airline traffic (five year high), robust petrol and diesel sales, double digit growth in electricity generation plus stronger two wheeler and utility vehicle sales. In infrastructure, new project announcements, outstanding “stalled” projects, and completed projects are all improving, albeit slowly, and whilst IIP remains a volatile series, core sector growth is showing a healthy upward trend.

Chart 3: Leading indicators (YOY growth)



Source: Kotak Institutional Equities

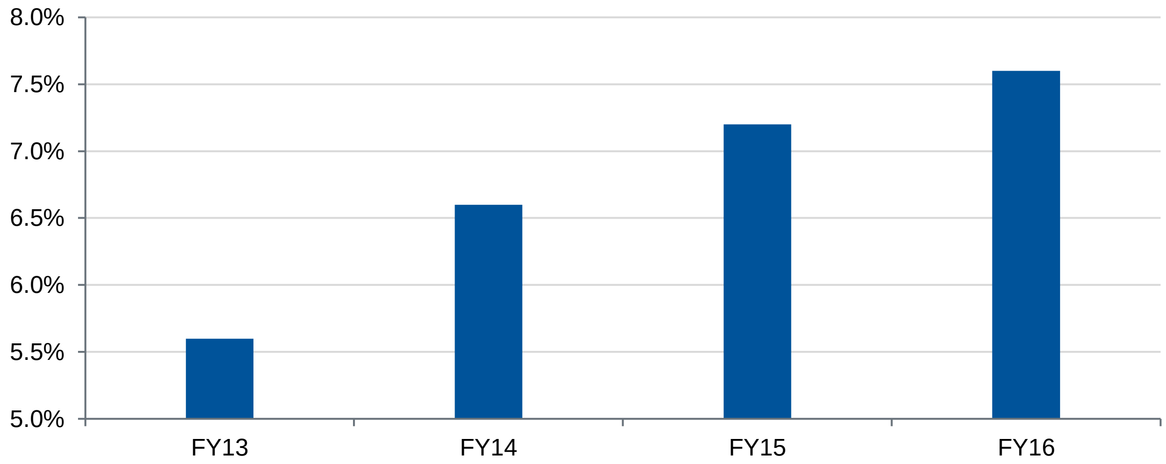
Whilst it is encouraging to see evidence that the broader macro is improving, India’s relative superiority in this regard has rarely been in doubt. Investor concerns have concentrated more on the reasons *why* healthy GDP growth has not yet filtered through to corporate profitability. Here too some signs suggest that the worm has turned.

For the fourth quarter 2016 (now fully released), domestic facing companies led the way beating market expectations across a wide range of sectors including consumer, auto, cement, and utilities. In most cases the upside came from margin expansion (on the back of lower input costs) as opposed to revenue growth. Since commodity prices and oil have recovered (raising input costs) the key to future upside will come from stronger top line growth now needed to offset rising input costs. Although oil at US$50 increases costs for corporates and consumers alike, prices in this range work well for India. Significantly lower oil, whilst lowering costs onshore also resuscitates global deflationary fears, with anything north of US$60 likely to trigger domestic inflationary concerns. Today's oil price feels good, particularly as the Government has been true to its word in passing on these additional costs to the consumer as never before.

Returning to reported numbers; public sector banks dragged the aggregate numbers lower due to substantial increases in provisioning, leading to lower profits. Here, the Reserve Bank's efforts to force greater transparency in the banking system is succeeding, and although question marks still exist as to how exactly this will play out, there is a real sense that the bottom is being reached. Recent meetings with four of these banks suggest more provisioning can be expected in the quarters ahead, but net additions will be lower. In sectors more exposed to the global market place, downside earnings revisions have eased in lockstep with the recovery in commodities and oil. True, there is yet insufficient data here to be assured of a sustained earnings recovery, but be clear about this - earnings "in aggregate" are starting 2017 from a low base, whilst sell side analysts will be "behind the curve" at the top *and* at the bottom of the cycle. Valuations are not cheap, but neither are they expensive, (as represented by India's premium to the broader emerging market asset class), which are currently in step with the long run average. In a relative context, both earnings growth and GDP growth are trending higher *and* at a faster rate than the peer group, where in many cases growth is *at best* stagnating, and *at worst* receding. Equally, the Indian equities have been range bound for 26 months allowing sufficient time for the earnings cycle to catch up to the market.

We have long argued the deep rooted structural changes initiated by Rajan and Modi (both "outsiders" to the system) would take time to evolve, particularly in a weaker global backdrop. But now the Reserve Bank, led by Rajan, is succeeding in "de-risking" India's external vulnerabilities. This is a consequence of lowering the current account deficit, building the country's foreign exchange reserves (thereby reducing currency volatility), whilst working with the Government to restore fiscal credibility and structurally lower inflation. As a commodity consumer, India has been fortunate to have benefitted from deflationary trends, but nonetheless policy makers must take the credit for reducing consumer price inflation (of which food is the significant component) from double digit growth to a stable 5% range and this *despite* a succession of failed harvests. Indeed there is little sign of inflationary pressure in the economy; neither in wages, operating capacity, inventories or households' "future expectations", giving confidence that the Reserve Bank will cut interest rates further (likely to be 50bps) once the Fed has moved, the Brits have "voted" and there is clarity on the quality of the monsoon. Lower nominal interest rates, in combination with Modi's efforts to reduce corruption, improve transparency, re-engineer regulation whilst encouraging intra-State competition, are all coinciding to creating a better environment to do business. And it's working. Anecdotally we are hearing enough to support these assertions. Indeed the successful passage of the Bankruptcy Law (finally some proof that Modi can bring about "headline" reform) will further support this, both in sentiment and in practice.

Chart 4: India's Real GDP Growth (YOY)



Source: Kotak Institutional Equities, Ambit Capital

Reform based policy requiring parliamentary approval has been a noticeable failure of Modi's tenure in office since his election (GST being the prime example), principally due an obstructive opposition and a refusal by the BJP to look for a consensus. The BJP's recent surprise election victory in Assam, (previously considered unwinnable), could have far reaching consequences. Earlier losses for Modi in Delhi (over confidence) and Bihar (poor tactics) rattled foreign investors, but the win in Assam, combined with increased share of vote in four other States, has calmed nerves. Crucially, Congress' failure *cements* the BJP's position as the sole national party. Their vote share is rising in areas where they are relative newcomers, suggesting the market may start to believe in Modi's re-election chances of 2019. And though the BJP will not have a majority in the Upper House until 2019, the number of seats held by "blocking votes" is falling away. This is partly due to technical factors (of the two yearly seat rotation), but principally because allying with the Congress Party is now increasingly being seen (even by the Left) as the "toxic" option. Moreover, a recent splurge of high profile corruption scandals involving Congress politicos is adding to the party's problems, further reducing their credibility as the "recognised" opposition. This opens the door for potential safe passage of the Goods and Services Bill (GST) in the next Parliamentary session.

Despite expectations of further rates rises in the United States and fears over "Brexit", the global backdrop remains supportive of India. The long running underweight in Emerging Markets is rational enough given slower growth in China, fears of a depression in Brazil, economic sanctions in Russia and the political mess of South Africa. Equally though, rarely has a single county allocation to India looked more persuasive, and should the markets provide a valuable entry point over the summer months, taking that opportunity should play out well over time.