Indian stocks shrug off the coronavirus crisis

The pandemic has been catastrophic for India, yet the stockmarket is hitting record highs. Investors are right to remain optimistic about the long term, but they are pricing all the good news in, says Cris Sholto Heaton

Covid-19 has spent the last 18 months overturning expectations around the world and India has been no exception. When the pandemic first took hold, there were fears that such a populous country with limited healthcare would be very badly hit. But after an initial wave of cases and a chaotic lockdown that left millions of migrant workers stranded around the country, the worst seemed to be over.

By the end of last year, the economy had reopened, new cases remained relatively low and it looked plausible that India had somehow built up enough immunity to return to normal while keeping coronavirus at bay. Unfortunately, that turned out to be very wrong.

In April, cases soared to record highs. Exactly why remains unclear, as with much about coronavirus. Some put the blame for spreading the virus around the country on a number of crowded events, including election rallies and religious pilgrimages. Others point to the emergence of a more transmissible variant called B.1.617.2, or Delta. (The fact that many other countries that initially coped well, such as Thailand and Vietnam, have now seen large outbreaks, while Indonesia seems to be following a similar trajectory to India, suggests that India's mass events probably aren't solely responsible.)

The healthcare system collapsed, even for relatively affluent patients who would normally be able to get adequate medical care. Hospitals were overwhelmed and oxygen supplies frequently ran out. The official death toll now stands at more than 400,000, but that is known to be a vast underestimate – some estimates suggest the real figure is five to ten times as high. Cases are now declining – they are down around 90% since the peak in May – and vaccines are slowly being rolled out: around 300 million people out of a population of 1.3 billion have received at least one dose. But India is still very much a country recovering from disaster.

Stocks shrug off the crisis

So it probably sounds baffling – and not a little inappropriate – that the stockmarket is at a record high. The MSCI India index, which dropped sharply along with global markets in March 2020, barely wobbled this time. It's up 15% so far in 2021 and 55% over the past 12 months.

This looks entirely at odds with the state of the economy, which shrank by 7.3% in the year to 31 March. That includes the impact of the first wave of coronavirus and the shutdown that brought much of the economy to a halt, but not the more deadly wave that struck this year. The immediate impact of this outbreak may not be as large, because more of the economy remained open despite soaring cases and deaths, but some analysts fear that the medium-term consequences may be huge: unemployment soared, many who still have a job have suffered pay cuts and household debt rose as people struggled to get by.

"Stocks are up 55% in 12 months, yet the economy shrank 7.3%"

Optimists think that when the crisis is past and the immediate rebound is over, growth could settle down at 7% or more, in line with the trend of recent years. Others think that the after-effects could mean a new trend of 5% or lower. These outcomes make a big difference to whether India can catch up on the potential output it lost in the crisis, argues Sudipto Mundle of the National Council of Applied Economic Research, a think tank, in an article last week in financial newspaper Mint. The 7% scenario would see it catch up on lost growth by 2029-2030. That's around the time when the country's demographic dividend – meaning a high ratio of young people to older dependents, which can be a powerful force for growth in emerging economies – begins to reverse.

A slower growth rate and a failure to catch up with the pre-pandemic path will mean that some of that demographic dividend is squandered, says Mundle, and extensive reforms will be needed to avoid this happening. These include the healthcare system, whose deficiencies were badly exposed by the pandemic, but also education, the financial system – where bad debts that were a worry before the pandemic will have become worse – and critical infrastructure such as the energy sector.

Modi needs to deliver

Whether the crisis will be a catalyst for these long-overdue changes remains to be seen. It would be unfair to expect the government to have all the answers at this point; policymaking is difficult for many reasons while a pandemic rages and managing the crisis is the immediate priority.

However, sceptics may take the view that while Narendra Modi, the prime minister since 2014, is often described as a pro-business reformist, his record on economic reforms is weaker than one would hope and sometimes overstated by analysts or investors who want to be able to point to progress in India. (Conversely, his energy for pursuing Hindu nationalist policies that increase social tensions or authoritarian flexing that erodes democracy seems to be unbounded and risks taking India down a very unwelcome path.) If he has the desire for big changes, it's time to deliver.

On the plus side, Modi this month carried out his largest cabinet reshuffle since taking power, with 12 ministers – including the minister for health – being replaced, which implies a significant effort to reinvigorate the government. There are important state elections next year and the next general election will take place in or before 2024, so the need to convince voters that the ruling Bharatiya Janata Party has a better, bigger plan than the opposition for post-pandemic recovery is increasingly pressing.

As well as making reforms more urgent, it may be that the pandemic and other recent events will have accelerated some opportunities. The most obvious are in the manufacturing sector. The disruption to global supply chains, years of trade tensions between the US and China, and growing evidence that China is becoming more closed to the rest of the world, has reinforced something that multinational companies already knew: they need to diversify away from China by sourcing from a wider range of manufacturers or investing in factories in other countries.

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Start-ups such as Zomato will help transform the digital economy

A number of emerging markets in Asia are likely to benefit from this – it's an extremely positive trend for Vietnam, for example, as we've previously discussed in MoneyWeek. India is not well-placed to take advantage of it at the moment, but that may change.

At present, manufacturing accounts for around 17% of the economy, compared with a government target of 25% by 2025, and has not greatly increased since Modi launched a "Make In India" initiative in his first year in office. Restrictive labour laws that make it less attractive to hire large manufacturing workforces and difficulties in acquiring land for construction due to unclear or overlapping ownership are among the main issues that have prevented it from building a major export manufacturing sector.

That said, there are areas in which India is already strong (eg, pharmaceuticals, where it is the third largest in the world by volume) and others where there are recent signs of progress (eg, electronics, where major international manufacturers such as Samsung and Foxconn are expanding their factories). The government is now expanding a subsidy scheme (known as the production-linked incentive) aimed at increasing output in some key sectors.

More importantly it has finally pushed through some labour reforms, with four new codes that simplify a tangle of existing laws. The fact that the government is willing to use its majority to push through contentious changes like these is a positive signal, says Capital Economics; it might open the way to further labour and land reforms that would substantially improve growth prospects.

There are few things that would be more bullish for India than a huge expansion in manufacturing, because this would bring many of those in the rural areas (around half the workforce) into a modern industrial economy. Indeed, given that the government has also passed laws to reform the farming sector – by reducing regulations on how produce can be sold and removing guaranteed prices – it looks increasingly vital to deliver this. Over the medium term, these changes are likely to see many small farmers pushed out by larger ones and failure to provide new jobs for younger workers who would otherwise have gone into agriculture could create significant social problems.

The changing composition of the market

While manufacturing still needs reforms, new opportunities are much clearer in services, where India has – like much of the rest of the world – seen a substantial leap in how much is done remotely over the past year. Digital payments, online services, e-commerce and in the future education and healthcare will play a major role in productivity and growth. But the growth in digitalisation is likely to have greater consequences than many investors yet realise, because at present much of the activity is still happening in unlisted companies, says David Cornell of the India Capital Growth Fund (see page 24). India is creating large numbers of new digital start-ups – there were 14 new unicorns (privately held tech start-ups valued at over $1bn) in the first six months

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"India's tech sector has created 14 new unicorns so far this year"

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of this year – and some will go public in the months and years ahead. Food delivery app Zomato carried out an initial public offering this month, while others including payments firm Paytm and e-commerce giant Flipkart (Amazon's rival in India) are set to list soon.

This will mean that the Indian market starts to include local equivalents to firms such as Alibaba and Tencent that now dominate China's indices and have become hugely popular with global investors. At the same time, some of the families that control older listed companies are selling out to private-equity buyers or other investors – in part because under Modi they no longer have the political access they once enjoyed and doing business has become harder work. These kinds of shifts mean that the make up of the stockmarket will change, says Cornell.

Pricing in the good news

So there are real reasons to be optimistic that India will stage a strong recovery, but this optimism is perhaps the biggest risk for investors. The MSCI India index trades on a price/earnings (p/e) ratio of around 22 times forecast earnings (current earnings are meaningless given the disruption caused by the pandemic), compared with 16 for MSCI China, 14 for MSCI Indonesia, or nine for MSCI Brazil (to pick a particularly low-priced non-Asian economy).

India is usually more expensive than many other emerging markets: the quality of many listed firms is much higher. This premium isn't new: when we last looked at India's prospects in-depth in MoneyWeek almost two years ago, the market was on almost exactly the same p/e ratio. However, these sorts of valuations remain at the upper end of where the market has traded over the long term. That's not surprising: in a low-growth, low-rate environment, investors are desperate for anything that promises decent growth and are happy to pay up for it. There is no immediate reason for this sentiment to change overnight – but if it does, India will be vulnerable.

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Agricultural reforms are unpopular with small farmers

Potential problems could be local: the fragility of some banks (bad debts will have risen further in the crisis) could hold back lending for investment and be a headwind for growth. More likely, they will be global: a surge in inflation could be bad for India, which is a large importer of key commodities such as oil – among other problems, this would expand the trade deficit and put pressure on the rupee (so even if stocks kept pace with inflation, foreign investors could be hurt by a weaker currency). Most of us at MoneyWeek remain keen on India for the long term, given its growth potential if reforms go even moderately well. Local investors are also likely to keep a greater proportion of their wealth in stocks (instead of gold and property) over time and this should make the market less vulnerable to swings in sentiment among foreign institutional investors (a perennial problem for smaller emerging markets).

That said, the market looks more than a little frothy now and it doesn't feel like a compelling time to make a big investment. Instead, investors should know what they want to buy (see below) and be ready to take advantage of any major corrections.

"The MSCI India index is on a p/e ratio of 22 times forecast earnings"

Five ways to buy into India

India is a large and diverse stockmarket – large enough that it's possible to run a single-country fund without having to bulk the fund out with sub-standard stocks, unlike many smaller emerging markets. In general, I favour closed-end funds (ie, investment trusts), simply because when investors sour on emerging markets, they tend to pull their money out quickly. In that scenario, managers of open-end funds (ie, unit trusts and open-end investment companies (Oeics)) may have to dump assets at unfavourable prices to raise cash for redemptions.

India has enough large liquid stocks that this risk isn't as great as in some markets: any large-cap open-end fund should be able to cope with outflows. However, given that the investment case for India is based on its long-term prospects and managers should be taking a long-term view, I think there is still a convincing argument that investment trusts with their base of permanent capital are the most appropriate vehicle. The fact that you can still buy most of the trusts at a respectable discount to net asset value (NAV) makes them even more compelling.

The largest of these trusts is **JP Morgan Indian Investment Trust (LSE: JII)**. I always tended to view this as a relatively cyclical fund that does well in good times and less well in downturns – but its record over the past decade is actually the weakest of all the trusts. Conversely, **Aberdeen New India Investment Trust (LSE: ANII)**, which always looked like the more defensive choice in stock selection, has led the field over ten years. Past performance is no guide to the future, but with both trusts on similar discounts to NAV (at 15%), the Aberdeen trust continues to look the more obvious choice. The ongoing charge last year was 1.02% for JII and 1.16% for ANII.

India Capital Growth Fund (LSE: IGC) is a smaller trust, with assets under management of £145m versus £690m and £410m for JII and ANII respectively. It focuses on mid-cap and small firms, unlike the two above, which are weighted towards large caps. The fund suffered a period of poor performance in recent years, in part due to exposure to struggling finance companies. When I met with portfolio manager David Cornell just before the pandemic began, the investment process had just been overhauled in an effort to turn around performance. So far, the changes seem to have worked, with the trust delivering strong returns since then (the NAV return in the 12 months to June was 77.8%). This improvement, combined with the bias towards smaller stocks that offers something different from the other trusts, means that it seems worth watching. The discount to NAV is 11% and ongoing charges were 1.82% last year.

The specialist India trusts also include **Ashoka India Equity Investment Trust (LSE: AIE)**, a more recent arrival that listed in July 2018. This has an unusual fee structure, with no annual management charge (although ongoing charges still amounted to 0.41% last year) and a performance fee of 30% of returns in excess of the MSCI India index. The short record makes it hard to form an opinion so far, but the fact that it trades at only a small discount to NAV (2.7%) when the other trusts trade more cheaply would make me inclined to wait to see more.

If you prefer to invest using a passive fund, there are a number of London-listed exchange traded funds that track the MSCI India, Sensex or Nifty indices, which have broadly similar performance (all are large-cap benchmarks). One option is the **iShares MSCI India (LSE: IIND)**, which has an ongoing charge of 0.65%.