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As India celebrates Diwali it offers rewards for patient investors

As *India is celebrating Diwali, Money Marketing looks into the second most populous country in the world and the investment opportunities it offers.*

By Jean-Baptiste Andrieux / 24th October 2022 8:45 am

Diwali is one of the most important festivals in India, observed by different religious groups such as Hindus, Sikhs and Jains.

After two years of pandemic and lockdowns, the festive season is set to retrieve a sense of normalcy.

Asia Dragon Trust investment director Adrian Lim says: "Last month, we made our first trip back to the country since borders reopened.

"We found sidewalks were once again bustling with people and roads were congested with bumper-to-bumper traffic.

"From speaking to companies on the ground, we sensed a general air of optimism around demand and momentum staying strong in the economy."

There are good reasons for optimism in India, the economy has been on an upward trend for a while.

As *Money Marketing* previously reported, India funds topped the rankings in the third quarter of 2021.
This was not a coincidence; the country boasts tremendous human and economic potential that is starting to materialise.

Fund Calibre managing director Darius McDermott says: "We like India for the long term and it has been one of our favourite emerging markets for many years.

“It has a good demographics, a young, aspirational population and a fast-growing economy.

“India has a long way to run and has tremendous potential. If you consider that, under present prime minister Modi, only 13% of Indian households had tap water in 2015 (today it is 52%) and electricity was 56% and is now 96%, for example.

“The Bank of America estimates that cumulative infrastructure capacity in roads, railways and ports in the 10 years until 2025 will exceed all that was added in the previous 65 years of independence, you can see how much is changing and how quickly.”

A strong performer

Although emerging markets as a whole have shown poor relative returns over the past decade, India has been the only one in the asset class to outperform developed markets.

Despite the Covid-19 pandemic, India continued to deliver for investors up to 2022.

Liontrust emerging markets fund manager Ewan Thompson says: “Since the March 2020 Covid lows, India has returned 115% in US dollars against 55% for developed markets and 21% for emerging markets, a significant outperformance as well as absolute return.

“The key driver behind this outperformance is without doubt a coming together of powerful longer-term structural factors as well as a cyclical recovery from the lockdowns of 2020 and beyond.

“India saw widespread lockdowns in the first half of 2020, but was in fact relatively spared in the first Covid wave, thereby allowing a relatively rapid re-opening of the economy.

“Although the second Covid wave was famously much more acute in India, the economic impact was much more benign, with lockdowns being more localised and targeted compared to the wholesale variety experienced elsewhere.

“Therefore, India’s re-opening economic recovery has been fairly steady throughout 2021 and 2022.”

India is not only an exception among emerging markets. Its stock market is one of the few displaying a robust performance. The country not only benefits from reforms, but also from the China Plus One strategy.

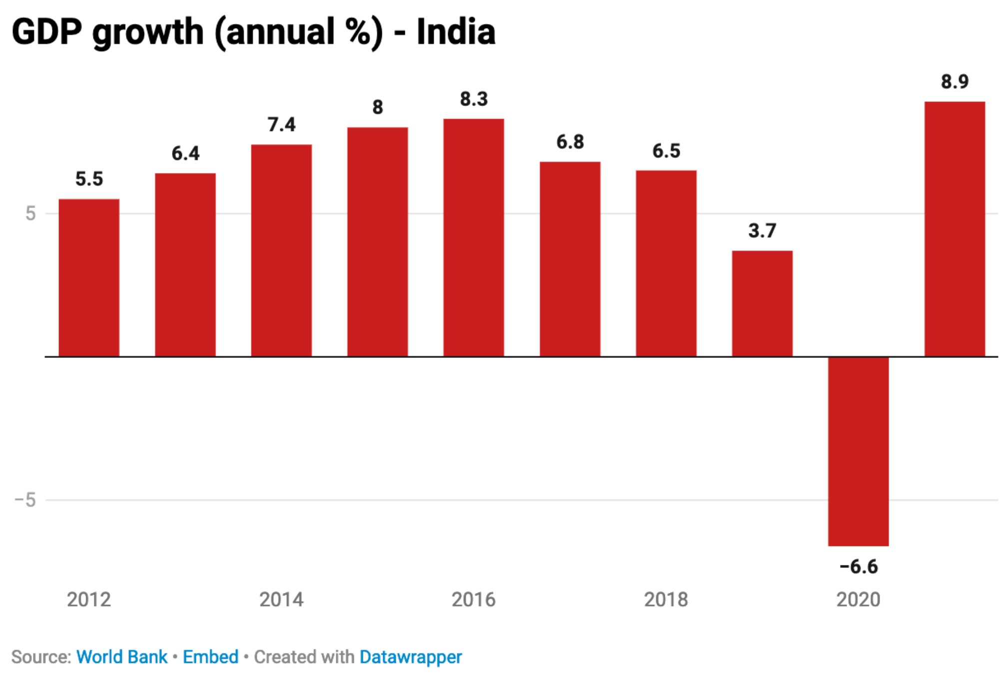
India capital growth fund chief investment officer David Cornell says: “Modi’s reform agenda has improved India’s economic stability.

“Historically in periods of global market uncertainty India performs poorly. This year of volatility in stocks generally, India has been a stand out performer, demonstrating investors’ growing confidence.

“As multi nationals are increasingly left no option but to diversify supply chain risk away from overdependence on China, India has become a credible alternative.

“In recent weeks Apple has started production of the iPhone 14 in India, and shifted airpod production from China to India

“We expect employment and manufacturing in India to benefit from this shift which also benefits domestic consumption.”



Strengths

India boasts several structural strengths supporting its growth.

Lim says: “First, it is one of the largest consumer markets outside the US and China, with a massive, predominantly young population.

“Second, the middle class there is expanding with rising levels of disposable income.

“Finally, the government is both reforms-oriented and business friendly, and has a parliamentary majority.”

The consumer story in India is a force to be reckoned with. For instance, Unilever expects India soon to overtake the US as its most valuable market.

Its stock market also has more depth than emerging market peers.

Cornell says: “Unlike many emerging market stock markets that are focused on one or two sectors like mining or textiles, India offers a wide range of investible sectors.

“The financial, consumer, IT services and auto ancillary manufacturing sectors are most attractive.”

Lim also emphasises that the Indian stock market hosts “some of the highest quality companies in the region, with highly capable management teams”.

He adds: “On a year-to-date basis, the market has outperformed both Asia Pacific ex-Japan and global emerging markets.

“Segments where India excels include financial services, consumer sector, and health care where we hold quality companies like HDFC, Maruti Suzuki and Hindustan Unilever.

“While the IT services sector is facing near-term challenges due to worries around a potential recession in the horizon, it remains an attractive segment in the long term, along with internet and renewables companies, where we hold exciting digital future companies such as Delhivery and PB Fintech, which runs the online insurance aggregator Policybazaar."

Moreover, McDermott explains that the Indian economy has been insulated from some of the weakness in the wider global economy. This is because the Indian economy is domestically focused.

Inflation-proof?

India is nonetheless not immune to inflation. In September 2022, the consumer price index spiked to 7.41%.

Thompson says: "Inflationary pressures are a reality for India, but this is of a much lower significance than in developed markets such as Europe, the UK and the US.

"While inflation has certainly picked up, it's but only at the margin and only back to levels already seen in late 2019 – a very different situation to the huge inflation shocks elsewhere, requiring aggressive interest rate responses.

"In India the macroeconomic prudence of both fiscal spending and central bank policy over the last decade has left India with a lot of wriggle room to respond to the current situation without having to resort to extreme measures.

"Although interest rates are rising in India too, the pro-active measures taken by policy makers mean has left the country well ahead of the curve."

As a result, India seems to be in a better position to withstand the current environment of high inflation and rising interest rates globally.

However, Lim warns that the gloomy global economic climate could catch up with India.

“If interest rates continue to spiral upwards, it could eventually have an impact on growth as well as on the stock market but, for now, the strength of the domestic economic story is providing a welcome balance,” he says.

Weaknesses

Despite the recent strong performances, Lim also warns that some “dark clouds loom overhead”.

“Prices of fuel and materials remain high while supply shortages mean a longer waiting time for big -ticket purchases like cars,” he says.

India has historically been vulnerable to high oil prices due to extensive fuel subsidy regime.

Thompson believes, however, that India has been working on bridging this gap.

He says: “This has significantly decreased in recent years as subsidies have largely been removed, reducing the fiscal burden of high prices.

“It is also true that India’s oil intensity of growth has reduced so that each incremental unit of GDP requires less oil than in previous periods of high energy prices.

“Indeed, India’s recent strong outperformance has come during a time of sharply higher oil prices, which is a break from precedent.”

Another weak spot India is exposed to is the strength of the US dollar.

While India owns substantial foreign currency reserves to defend its currency and take pressure off interest rates, it is not invulnerable to a strong US currency.

Thompson says: “As these FX reserves are incrementally depleted there remains the risk that the central bank will have to hike rates further than otherwise to support the currency.

“Substantially higher rates would clearly act as a break on the economic recovery story.

“The key macroeconomic risk across emerging markets is the extreme strength of the US dollar witnessed in recent months, putting pressure on all other currencies.

“It is notable however that the main victims of dollar strength in this cycle has not been emerging market currencies on the whole, but more developed market currencies such as sterling and the euro, underscoring the relative economic stability of emerging markets this time around.”

Obviously, India remains an emerging market with structural risks inherent to this asset class, such as higher levels of volatility compared to developed markets.

Thompson says: “Investors must factor this into their asset allocation.

“What is especially encouraging in recent market performance is the degree to which India (along with other emerging markets such as Indonesia & Brazil) has exhibited considerably less volatility during recent periods of market stress than traditionally more defensive markets, essentially being rewarded for orthodox and prudent policy making.

“The current backdrop of a strong dollar, rising interest rates and high risk aversion, is traditionally a period that sees significant underperformance from emerging markets, yet in this cycle this has not been the case, with the obvious exception of China.

“This, along with the sustained outperformance against developed markets over the past decade perhaps suggests investors should look at India with fresh eyes.”

However, McDermott finds the Indian stock market expensive at the moment, especially compared to developed market peers.

He says: “The Indian stock market always trades on the expensive side and it looks particularly expensive today, when so many other markets have underperformed.

“With developed markets now so much cheaper, we don’t see the need to pay up for India.

“We will wait for the market to fall back, at which point we will likely buy back in.”

Can the good times continue?

The future is by its very nature uncertain and this is even more true in the current economic environment.

While it certainly has its weaknesses, India is displaying signs that the good times will continue.

The country is increasingly attractive not only to investors but also to global firms.

“While India has certainly moved onto international investors’ FOMO (fear of missing out) list, it also seems to have headed to the top of the list for multinationals,” says Cornell.

Lim explains that the relatively small size of the Indian economy implies that there is plenty of room for robust, longer-term growth.

He says: “There are signs of accelerating credit growth. Infrastructure is being built – India already boasts impressive seven lane freeways connecting commercial areas, like those seen in Gurgaon near New Delhi.

“Consumers are also spending more while affordability in the housing market has improved, even as interest rates are rising. These are just a few examples of the turnaround that is already happening in the economy.

“In a pro-growth budget earlier this year, the Indian government earmarked significant spending into infrastructure and housing.”

Political stability is also a strong argument for India.

“The political backdrop is stable, with the BJP recording strong local election results this year, indicating the reform agenda has been well received and allowing the government to focus on the economy without having to resort to populist measures ahead of the general election in May 2024,” Thompson says.

This, coupled with companies looking to invest and a financial sector in good shape, the structural economic growth in India has the potential to continue for several years.

Lim says: “Due to the economic disruption over the past two years, there is likely to be pent-up demand for goods and services this festive season –

from smartphones to consumer electronics and apparels to big-ticket purchases like cars. E-commerce sales are also likely to accelerate.

“It will be a timely litmus test for how durable and robust the consumption story is in Asia’s third-largest economy.”

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