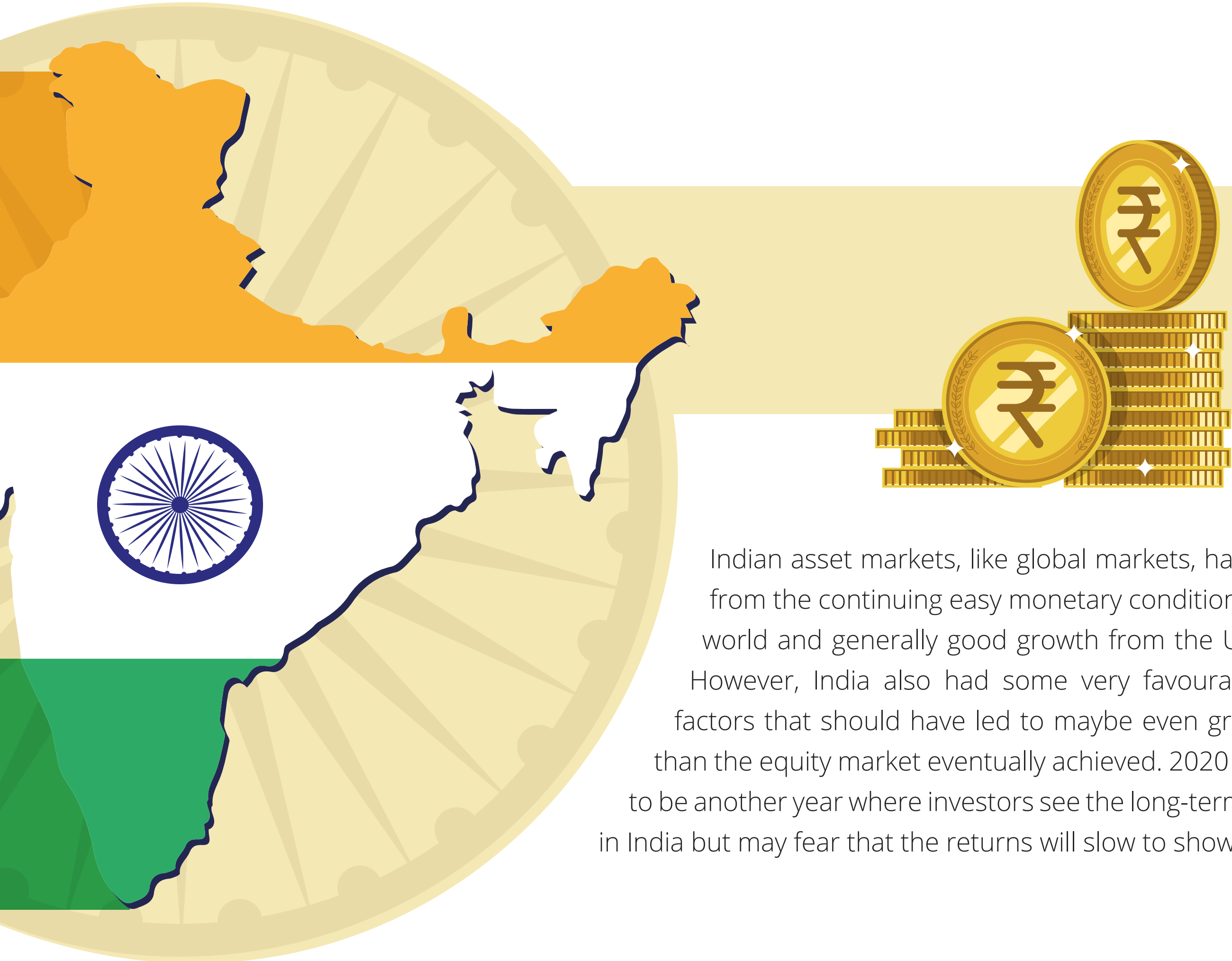
India – Patience Required

Indian assets have the scope to deliver double-digit returns, but at the start of 2020, there is much to put you in two minds. Given the lack of momentum in domestic growth, we would encourage equity investors to be patient and wait for some absolute weakness to add to holdings. Fixed-income investors can be bolder as we expect the central bank to remain on course to provide further cuts in interest rates over the course of 2020.

Chart 1: Nifty Equity Index maintains its uptrend

Source: Bloomberg



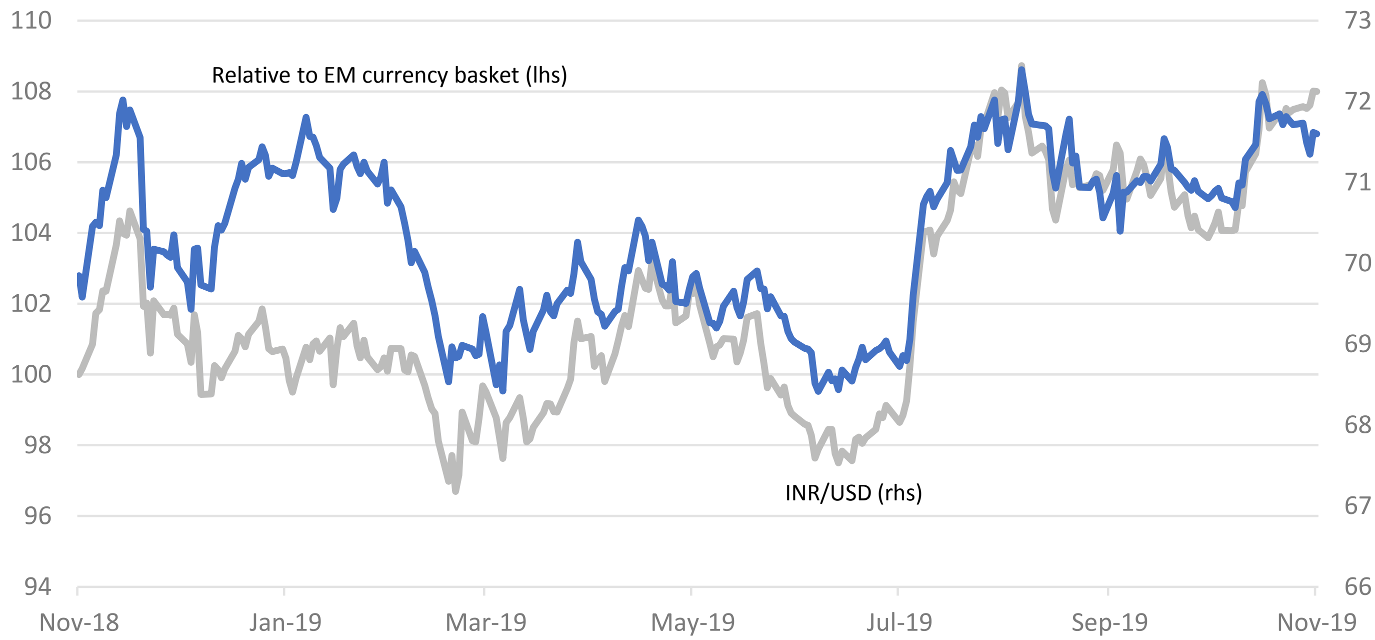
Indian asset markets, like global markets, have benefitted from the continuing easy monetary conditions around the world and generally good growth from the United States. However, India also had some very favourable domestic factors that should have led to maybe even greater returns than the equity market eventually achieved. 2020 is shaping up to be another year where investors see the long-term opportunity in India but may fear that the returns will slow to show through.

Chart 2: Indian 10-year government bond yield falls close to recent lows

Source: Bloomberg

Looking back at 2019 is instructive at framing how 2020 may work out for the Indian asset markets. Indian equities, like many equity markets, started on a strong note, rebounding from their December lows. As the end of the year approaches, they looked likely to outperform the emerging market equity index modestly. However, looking back, you might have expected much more. The central bank cut interest rates by 135 basis points. Long -term interest rates fell in line with short rates. Politics was very favourable with Prime Minister Modi achieving an even greater majority in the general election. The Indian Rupee was generally well-behaved tracking the general trends of the broad emerging market currency basket. However, all the good news was offset by the slide in growth. India was the world's fastest-growing economy in 2018; however, by the fourth quarter of 2019, growth had slipped to below 5%.

Chart 3: Rupee holds its own against other emerging market currencies



Source: Bloomberg

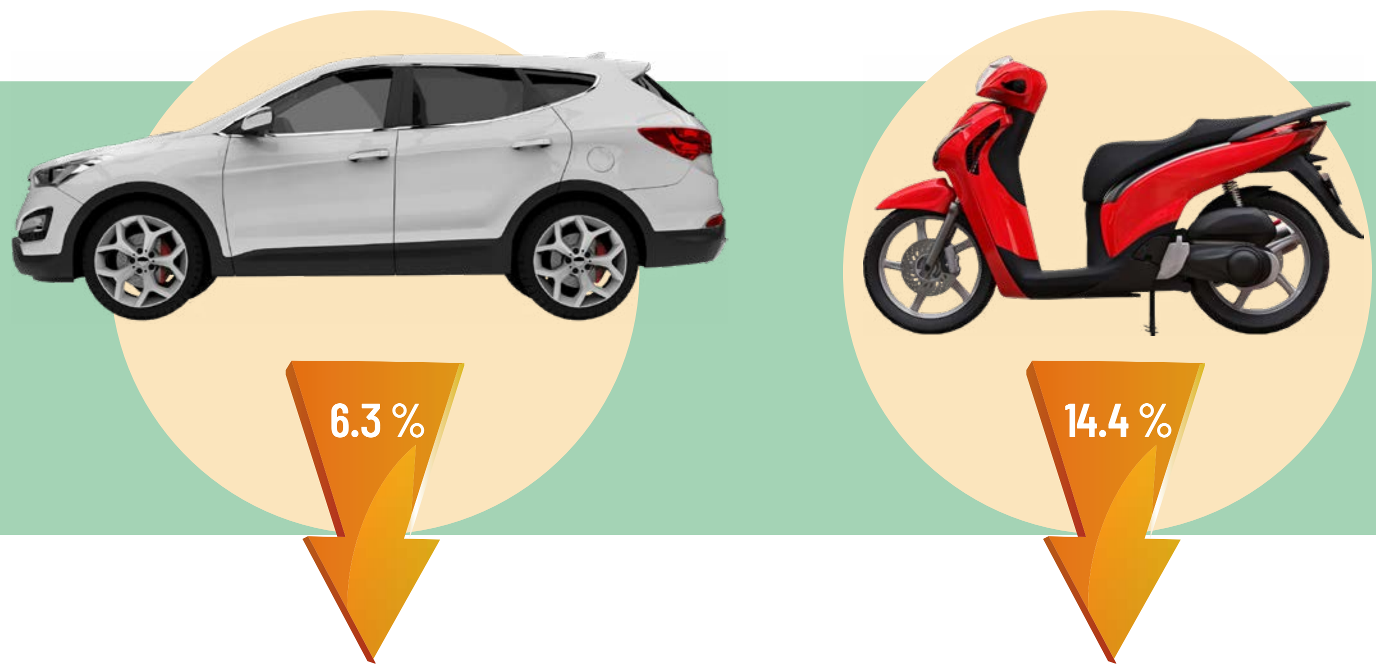
Domestic sentiment in the Indian economy is weak. Indian current affairs programs characterise the situation as a crisis. Could it really be that bad? For sure, the economic data is soft. Industrial production fell 3.7% in the third quarter, and the monetary system appears to have frozen over. Car sales fell 6.3% in October from last year, and motorcycle sales were down 14.4%, according to data released by the Society of Indian Automobile Manufacturers. The formal banking system has not been able to compensate for the marked deterioration of the shadow banking industry. Cuts in interest rates have had limited impact thus far because even if a company wanted to take advantage of the lower rates, it is a struggle to find a willing lender.

This is certainly not the greatest crisis the Indian economy has faced, and one suspects it will just take time for things to be righted. However, it will take the significant intervention of the government to make things better. The BJP government has been reform-minded from the start. Yet, the pace of government reform must follow the political cycle. As much as the Modi government may want to push ahead with reforms, they also realize that they must stay on the right side of the electorate. The BJP and partners still need to build a sufficient majority in the upper house to push ahead with more reforms. In the meantime, the central bank will be under pressure to provide further support for the economy.

Encouragingly international investors have stuck with the Indian asset markets. Late in 2019, foreign investor inflows into equities had reached $13.4 billion and $4.4 billion into bond funds. The hope amongst foreign investors is that in the wake of slowing growth, the government will provide a further stimulus package. The fact that the fiscal deficit is already at 3.3% and growing may limit the ability of the government to react. However, the government is expected to come back with measures to boost consumer spending potentially though tax cuts and/or payments directly to farmers.

Government hand-outs, however, only paper over more structural challenges to the economy. The country needs to encourage households to save inside the formal banking system and not in gold or under the mattress. Secondly, and most importantly, the banking sector needs to work out its bad debts, allowing an expansion in credit. Industrial India is starved of the capital required to grow and to become competitive.

If the government can relieve the credit crunch, this could provide a much-needed structural boost to the economy and then indeed the financial markets would have better grounds for high returns in the coming year.



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