Letter From India

Standard Life Investments

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View From Above

Opportunities abound in India

This remains an interesting time for any investor to look at India and decide whether to invest. There are certainly a number of positive aspects. The country's economic growth is among the highest in the world. This looks set to continue thanks to its strong demographics, early stage development and an elevated savings and investment rate. The underlying business climate is also improving. As a result, India is attracting money from overseas, with foreign direct investment at a near-term high. Inflation – once a major impediment to the economy – has been brought under control, allowing the Reserve Bank of India (RBI) to ease monetary policy. Importantly, and somewhat under the radar, India's balance of payments profile is in fine shape – providing valuable investment opportunities in various Indian rupee 'foreign-exchange carry' strategies.

The key question for investors, of course, is how much of this news is already in the price? Indian equities, like their global equivalents, have endured a bumpy 2016. This is not surprising, given that companies on the Nifty, Sensex and MSCI India Indices derive around 50% of their profits from overseas customers. As such, these businesses are susceptible to swings in global risk sentiment, commodity price and currency moves, as well as foreign investor outflows.

So, what positive or negative news could help make up investors' minds? Some issues are as simple as the weather. Another failed monsoon could yet weaken the economy. Longer-term investors will look at political change and structural reforms. A key trigger would be the much-awaited Goods and Sales Tax. Market expectations are presently low on this issue, meaning there is a chance of an upside surprise if pragmatism ultimately prevails.

All in all, then, while there are challenges, we believe that as long as the Indian growth story stays intact there will remain a plethora of excellent opportunities for diligent investors.

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Market Overview

A bullish long-term outlook

Why are we relatively bullish on India over the long term? Examining the detail of the growth backdrop is a helpful indicator.

Real GDP in India jumped to 7.9% year-on-year in the first quarter of 2016, up from 7.3% the previous quarter and beating analysts' estimates. Admittedly technical questions have been asked about the accuracy of the statistical accounting, but this still looks impressive compared to the rest of the world. True, there were disappointments, not least from the industrials sector. Nonetheless, from a cyclical point of view, the economy is on an upward trajectory.

Another key issue is inflation. The CPI rate has ticked up modestly in recent months, back to 5% a year; however, this is a vast improvement on previous years – inflation was as high as 11% in 2013. Importantly, lower inflation has also allowed the RBI to cut interest rates.

Upper House of cards

Of course, politics will also play a sizeable part in India's growth story. It is fair to say that the euphoria that met Mr Modi's election win has since waned. Many have criticised his government's lack of 'big ticket' initiatives. While frustration is understandable, investors are missing the incremental – but no less important – progress that has been made. As an example, Mr Modi has introduced numerous market-friendly initiatives that have undoubtedly made it easier to do business in India. The new Bankruptcy Code is a welcome step in this regard.

Investment Insights

Mid-caps all the way

Valuations are a helpful signal for investors. The Indian equity market currently trades on a P/E of around 16.5x 12-months forward. This looks expensive on a global perspective, although this premium largely reflects India's superior long-term growth potential. It also appears fair from a historical point of view. That said, the near-term outlook is giving some investors cause for concern. given the global economic climate. Nonetheless, as we look towards next year, we would expect corporate earnings to pick-up again when the economy kicks into gear, against the backdrop of accommodative monetary policy. Base effects and a reduction in the year-on-year weakness in commodity-related profits will also play a part.

One area to highlight is the mid-cap equity sector. This market is huge and widely dispersed across regions and sectors, providing a multitude of excellent opportunities for active stock-pickers. Small and medium-sized enterprises are driving many parts of the economy in terms of corporate profits. This is because they are more domestically focused than large-caps and, therefore, are better sheltered from events overseas. Further, mid-caps tend to be held by more domestic investors, meaning they are less susceptible to external capital flight than their larger equivalents.

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"The economy is on an upward trajectory"

Banking on the future

Looking closer, we are seeing a number of companies that we believe can benefit from reform and increased infrastructure spending. For example, the RBI, with the tacit support of the government, has sought to clean up the banking sector. Many lenders have had to write-down bad loans as part of this process. This is creating winners and losers in the sector.

In the former camp, Yes Bank it seems has emerged from the process in fine shape, thanks to its robust credit processes, and our view is that it is now well-placed to capitalise as the banking sector recovers. Another name to mention is Axis Bank. Investors had rightly been concerned about its credit quality. However, the lender's recent willingness to open its books and write-down bad loans has allowed investors to draw a line under the issue as Axis moves towards a better growth trajectory.

Meanwhile, there has been a major focus on capital spending on roads, railways and ports by Mr Modi's government over the last 12 months. This has benefited the likes of Sadbhav Engineering and KNR Construction, both of which have seen their order books swell. With more projects up for tender in the coming years, we would expect these companies to benefit.

Currency matters

Outside of equity markets, there are also a number of intriguing investment opportunities linked to India's development. Take the Indian rupee for example. One of the key drivers of emerging market currencies is the balance of payments, while another is the amount of interest-rate spread or carry between one country and another. On the former, foreign direct investment into India now more than covers the current account deficit, which is a very healthy sign. On the latter, Indian interest rates of 6.5% compare very favourably in a global context, both in nominal or inflation-adjusted terms. This leads us to have a positive view on the Indian rupee over the medium term, and provides us with a range of rupee currency trade opportunities in global markets, both versus other emerging markets and also developed market currencies.

Overall, the outlook for India is encouraging. Economic conditions are improving, while monetary policy remains supportive. Much, of course, still depends on the successful implementation of political and economic reforms. Many obstacles remain and the task will not be easy. We will revisit these issues and more in our next Letter From India.

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"Stocks look expensive, although this reflects their long-term growth potential"

"We are seeing a number of companies benefiting from reform"

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