Emerging Markets Spotlight

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India: Being Positive while Keeping Realistic

Navigating the delicate balance between optimism for sustained growth and cautionary considerations surrounding market valuations in India.

KEY POINTS

- India remains in a strong growth boom and boasts the most favourable growth conditions among the major Asian emerging markets.
- This boom is fuelled in part by cyclical recovery and partially by long-term secular supports.
- Indian equities look expensive overall, but that is because pockets of the market are priced at extremely high valuations. Despite growth prospects, the Indian economy is likely to face external constraints before those high valuations can be worked through with growth.
- While our stance is positive on Indian equities, we maintain a more conservative overweight position due to concerns regarding valuations.

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The emerging market universe is made up of countries at various stages of their economic and market cycles. Consequently, there will be times when an individual country is doing well while many others face challenges. That has notably been true for India in recent quarters. However, we maintain a more conservative overweight to the market compared to other countries where we see strong top-down conditions, and this piece explores the reasons behind that decision.

The Indian economy is undeniably strong at present. In the third quarter of 2023, GDP growth reached 7.6% YoY, and November PMIs were 56.0 for the manufacturing sector and 56.9 for the services sector. This contrasts with the most recent manufacturing PMI surveys reporting 50.0 in Korea, 48.3 in Taiwan and an average of 50.0 for the two Chinese surveys. Key indicators such as consumption, investment, and exports are strong with passenger vehicle registrations up 17.3% YoY in October, cement production up 17.1% YoY in the same month and exports continuing to grow, up 6.2% YoY in October.

Part of this is a result of the business cycle that is inherent to all economies. Following a prolonged economic slowdown from 2013 to 2019 and a recovery disrupted by Covid, India is now experiencing a broad and interlinked recovery in public and private sector investment, lending and credit extension and consumption. Having seen a period of disinflation, consolidation and stable credit to GDP, conditions were then in place for the cyclical upswing we are currently seeing. These growth cycles in emerging markets tend to extend for multiple years, contributing to the promising outlook for India and Indian companies.

At the same time, India is benefiting from some powerful secular shifts that support economic growth. The combination of digital identities, the UPI payments interface and mobile internet is driving a huge uplift in financial inclusion and economic activity enabling individuals who could not previously save, borrow or easily make payments. Another contributing factor is the legacy of the GST tax simplifications combined with a substantial public sector investment in transport infrastructure, fostering internal trade in India, allowing both economies of scale and economies of specialisation to be achieved. Additionally, India's great success in growing service exports (famously in IT services and call centres, but now increasingly also in business administration and back-office functions), combined with some pick-up in investment in export industries as global business pivot or diversify away from China.

In equity market terms, this success has been steadily recognised through performance. MSCI India[1] has outperformed the MSCI EM[2] Index over one, three and five-year periods, and was notable for outperforming (and rising in absolute terms) in the difficult third quarter of 2023 when global equity markets faced headwinds from rising global bond yields and oil prices.

Given this, why are we more cautious than in other markets? The weakness in the investment case for India stems from valuation concerns. Indian equities appear expensive, not only in an absolute sense but also relative to India's own history, other emerging markets, and local bond yields.

However, market-level valuation is merely the aggregate of stock-level valuation, and this is where the real distortion, as we see it, exists. The most expensive decile of the MSCI India index, by index weight, is priced at a forward price/earnings ratio[3] of 108x, with the second and third deciles are at 61x and 45x, respectively. Many of these companies have long-term earnings growth rates in the low- to mid-teen percentages. This implies that the ongoing growth boom must persist for many years to bring valuations to a rational level in the future. For example, one of the largest and most successful consumer staples companies in India trades at 55x forward earnings. Forecast growth will bring the P/E down to 38x for the year to March 2027, but at trend growth rates, the P/E will not fall to below 25x until about 2032.

Our concern is that we do not think the cyclical boom can continue that long. India still faces the constraints that brought the last boom to an end: inflation and external balances. Although inflation currently appears benign at 4.9% CPI inflation to October, but the October trade deficit of USD 31.5bn is by far the largest on record. While the overall current account balance, expected to be around 2.0% of GDP in the year ahead, is not currently a problem, India's investment-driven growth model implies that growth not supported by domestic savings will be funded from abroad, inherently leading to an expansion of the current account deficit. We have a high confidence that the Indian growth boom will attract imports funded from overseas, resulting in increased trade and current account deficits, ultimately pressuring the currency, interest rates and eventually, growth. This mirrors how the last boom concluded and how we expect this one will end.

Despite these concerns, we do not expect these issues to materialize within our two-year investment horizon. Currently, we are overweight in India within the portfolio and have benefited from that in performance terms. A significant part of the Indian equity market, however, is valued as though the slowdown will never come. We feel this is an example of the disconnect between bottom-up investors and prevailing top-down conditions— a divergence we aim to avoid

Source for all data JOHCM/Bloomberg (unless otherwise stated).

[1]The MSCI India Index is designed to measure the performance of the large and mid cap segments of the Indian market. With 122 constituents, the index covers approximately 85% of the Indian equity universe.

[2]The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,437 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

[3]The forward price/earnings ratio measures value by dividing a stock's most recent price by next year's earnings per share estimate for the entire year. If that estimate is not available, the estimate for the full current fiscal year is used.

RISK CONSIDERATIONS:
The Fund invests in international and emerging markets. International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. These risks typically are greater in emerging markets. Such risks include new and rapidly changing political and economic structures, which may cause instability; underdeveloped securities markets; and higher likelihood of high levels of inflation, deflation or currency devaluations.
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