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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Emerging Markets Spotlight

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"The Reserve Bank of India has asked banks to initiate bankruptcy proceedings against 12 large loan defaulters, accounting for a quarter of nearly [INR 9trn] that the banking system has piled up in bad loans." *Hindustan Times, 7 August 2017*

Our top-down process looks at a broad range of top-down drivers of emerging equity markets. One market that we have been positive on for several years has been India, with a preference there for domestic cyclical stocks. Both of those views have contributed positively to the performance of the portfolio. Since September 2013, the MSCI India index has delivered a total return of 56.6%, in US dollar terms, well above the MSCI Emerging Markets Index total return of 20.0%. That is not to say, however, that all of the drivers have played out as we expected. In particular, we have been revisiting our positive view on the banking and credit cycle in India.

We had expected an upswing in the credit cycle, which would be supportive of economic growth, both through consumption and investment. Inflation has come in substantially below expectations and both private sector credit/GDP and the loan/deposit ratio of the banking system have declined in recent years, in contrast to the ramp-ups of credit seen in some other emerging markets. Yet despite the apparent opportunity, growth has not come through. In the year to Q1 2017, we estimate system loan growth at 6.2%, compared to a 10.2% increase in nominal GDP. This is both negative for banking sector stocks and also for other cyclical stocks in India. Where were we wrong?

Looking into the reports from the banks, it is clear that there is a three-tier structure to growth in the Indian banking system. We have focused on the year to Q1 2017, but where Q2 2017 results are available, the pattern is the same.

The good news is in retail credit, particularly consumer and mortgage finance. Overall, we see loan growth of specialist mortgage lenders at 18.3% and that of consumer finance institutions at 16.9%. This pattern is mirrored within the loan books of more diversified private sector banks. Private sector banks did well (loans +14.7%) but were generally held back by weaker growth in corporate lending departments. In the portfolio we own HDFC Bank (loan growth +19.4%, led by retail), ICICI Bank (retail loans +18.5%, corporate +5.8%), Axis Bank (retail loans +21.0%, led by home loans; corporate loans flat) and Yes Bank (loans +34.7%, with the retail business growing 140%).[1]

With the very strong consumer and mortgage growth and the moderate growth in corporate loans from private sector banks, it is the state-owned (PSU) banks where the real disappointment comes in. PSU banks saw loans grow just 2.5%, with heavyweight State Bank of India at 7.3% and weaker growth elsewhere.[1] It is particularly in the PSU banks where the much-reported non-performing asset (NPA) problem sits. The clean-up is positive for India in the long run, but the write-off of NPAs eats into both loan growth and capital of the banks, and has been a drag in the short term. We continue to be believers in the Modi administration's reform process, but see the PSU banks being a problem for some years yet.

In this three-tier structure the private sector banks (including those we hold) have been able to do well, particularly from the retail sector, and this has benefited the portfolio. However, we have not yet seen the broad increase in lending that would lift overall growth in the Indian economy. We continue to see opportunities in the banking system, but recognise that a broad credit recovery may still be some way off.

[1]Source: Bloomberg/JOHCM as at August 2017.

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