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FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Emerging Markets Spotlight

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We think getting the country calls right is the biggest driver of successful investment in emerging markets. Currently India is one of our two favourite emerging markets, with both a strong trend growth rate as well as the potential for a cyclical recovery in the Indian economy. The near-term potential is from an upswing in the credit cycle combined with fiscal support.

In recent years both private sector credit/GDP and the loan/deposit ratio of the banking system have declined as the Indian economy has delevered, most notably through an undershoot of private sector capital investment and restrained consumption growth. This decline in leverage stands in marked contrast to the ramp-ups of credit seen in some other emerging markets. More recently, inflation has come in below expectations, giving the central bank policy flexibility. We feel that the Indian economy resembles a coiled spring waiting to be released.

We have also been expecting the government to provide fiscal support for both consumption and investment ahead of the 2019 election. In addition, we consider the Modi administration to be the most pro-reform government in any emerging market right now, and see some of the policies (e.g. tax reform, infrastructure investment and improvement, switch to cash benefits for the poorest citizens) as providing direct and visible uplift to economic growth. Government can be the trigger that unleashes the spring.

A double helping of good news

Recently we saw two major developments in India that only add to our optimism over the Indian economy and, by extension, Indian equities. The first was the announcement of a recapitalisation of the state-owned banks of approximately US$32 billion over the next two years (US$20 billion through recapitalisation bonds sold by the government to the banks and then reinjected as equity, cleverly avoiding any liquidity impact, and US$12 billion directly from the fiscal budget). This is by far the most significant move of any recent Indian government to tackle the under-capitalisation of the state-owned banks. Banking sector stocks reacted accordingly with sharp upward moves.

The second, which has received less attention than the bank news, was the announcement the same day of a US$105 billion five-year road-building plan to improve transport infrastructure to allow the economy to more fully benefit from the liberalising effects of the national goods and services tax (GST). These steps, we feel, are indicative of a government keen to ensure that the positive effects of its reforms are felt before the election.

Above-average valuations justified

Whilst Indian equities are not cheap in an absolute sense, the premium they attract over the average for emerging markets is slightly below its normal level, and we feel that the very strong growth opportunity and the prospects for further reforms justify current valuations. We remain heavily overweight Indian equities, with a focus on domestic sectors including, notably, banks.