J O Hambro Capital Management Group

News

Keeping Positive but Realistic

As India revels in its growth, will high valuations prove resilient amidst the shifting landscape?

James Syme   Paul Wimborne   Ada Chan

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Because the emerging market universe is made up of countries at different stages of their economic and market cycles, there will be times when an individual country is doing well when many others are struggling. That has been particularly true of India in recent quarters, but we have a smaller overweight to the market than to other countries where we see strong top-down conditions. This piece discusses why that is.

The Indian economy is undeniably strong at present. GDP growth in 3Q23 was 7.6% YoY, and November PMIs were 56.0 for the manufacturing sector and 56.9 for the services sector (by comparison, the most recent manufacturing PMI surveys were 50.0 in Korea, 48.3 in Taiwan and 50.0 average for the two Chinese surveys). Consumption is strong, with passenger vehicle registrations up 17.3% YoY in October; construction is strong, with cement production up 17.1% YoY in October; exports continue to grow, up 6.2% YoY in October.

Part of this is the business cycle that is inherent to all economies. After seeing a broad, extended economic slowdown from 2013 to 2019, and then a recovery disrupted by Covid, India is now seeing 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 that we are currently seeing. These growth cycles in emerging markets tend to extend for multiple years, and the bright prospects for India and Indian companies are partly from this cycle.

At the same time, India is benefiting from some powerful secular shifts that support economic growth. One of these is the combination of digital identities, the UPI payments interface and mobile internet, which is driving a huge uplift in financial inclusion and economic activity as people who could previously not save, borrow or easily make payments are enabled. A second is the legacy of the GST tax simplifications combined with a huge public sector investment in transport infrastructure, which is increasing internal trade in India, allowing both economies of scale and economies of specialisation to be achieved. And a third is the combination of 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 pivots away from China.

In equity market terms, this success has been steadily recognised through performance. MSCI India has outperformed the MSCI EM 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 rising global bond yields and oil prices were a headwind to global equity markets.

Given this, why are we more cautious than in other markets? The weakness in the investment case for India is valuation. Indian equities are expensive: in an absolute sense, relative to India's own history, relative to other emerging markets, and relative to local bond yields.

However, market-level valuation is merely the aggregate of stock-level valuation, and it is here 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 of 108x. 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 means that the growth boom will have to continue for many years to bring valuations at some future point to a rational level. 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. Inflation for now seems benign, with CPI inflation to October of 4.9%, but the October trade deficit of USD 31.5bn is by far the largest on record. The overall current account balance is not yet a problem, expected to be around 2.0% of GDP in the year ahead, but India's investment-driven growth model means that growth that cannot be funded by domestic savings will be funded from abroad, which inherently drives the current account deficit. We have a high confidence that the Indian growth boom will suck in imports funded from overseas, which will expand the trade and current account deficits and eventually put pressure on the currency, interest rates and eventually, growth. That is how the last boom ended and how we expect this one to end.

We do not expect that within our two-year investment horizon: we are overweight India in 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. This is, we feel, an example of the disconnect that can occur between bottom-up investors and top-down conditions and which we seek to avoid.

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