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Matthews Asia Perspective

Q&A: The Outlook for India's Stock Market & Economy

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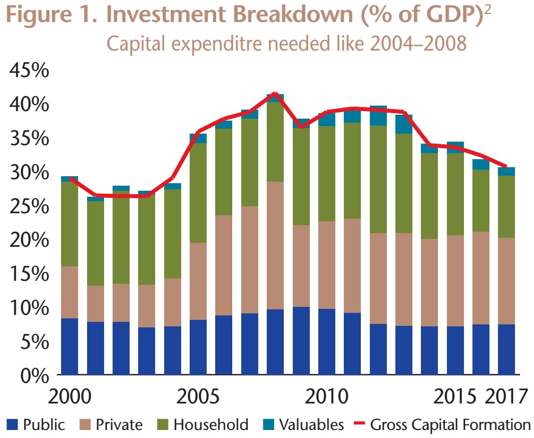
Q: The Reserve Bank of India is projecting GDP growth of 7.4% in 2018-19. Is that achievable?

Sriyan Pietersz: GDP growth expectations for fiscal year 2019 (the year ending March 2019) currently range from 7% to 7.5%. This sounds ambitious, but it can be supported as recent reforms pull informal activity into the formal sector. This year, private consumption is likely to be the main driver, though it will be funded partly by debt, as incomes in urban areas were hit by demonetization and the Goods and Services Tax (GST) while agricultural incomes still remain weak. Minimum support prices for both winter and summer crops should, however, provide some support for private spending.

Recovery in private investment will be slow. This is because some slack remains in the economy with capacity utilization at 74.1%[1], well below the threshold that is required to induce substantial fresh investment, and significant nonperforming assets (NPAs) still have to work through the banking system. With the national elections pending in 2019, many expect a meaningful recovery in investment to be visible only in fiscal year 2020. Public investment, meanwhile, is ramping up as the government expedites its priority infrastructure program on highways, railways, and affordable housing.

Figure 1. Investment Breakdown (% of GDP)[2]



Source: Central Statistics Office

Q: What are the risks to the economy?

Sriyan Pietersz: While growth indicators are improving sequentially, the principal risk, in our view, is the funding of the current account deficit, which is at present managed mainly via foreign direct investment (FDI) and long term portfolio flows. Rising external rates and oil prices could increase reliance on volatile short term capital flows, making domestic liquidity and confidence vulnerable to external events.

Q: Are you concerned about accelerating inflation?

Sriyan Pietersz: Headline inflation rose more than the market expected for the second consecutive month in April 2018, +4.6% year-over-year from 4.3% year-over-year in March 2018.[3] The upside surprise was the result of a jump in inflation excluding food, fuel, housing, gasoline, and diesel, suggesting that core prices are on a firming trend. The headline inflation trajectory is expected to rise above 5% in the second half of 2018,[4] primarily driven by supply factors such as higher oil prices and minimum support price increases for agriculture driving higher food inflation, but these could add further upside risk to core prices. So rising core inflation is a risk to achieving the RBI's headline inflation target of 4% over fiscal year 2019.

Q: Will the RBI need to hike rates soon?

Sriyan Pietersz: With the economic recovery still nascent, minimal corporate credit growth and the Modi government making growth a major priority ahead of the April 2019 elections, we believe the RBI is unlikely to move before the second half of 2018. However, the RBI's benign baseline inflation forecast for the second half of fiscal year 2019 does not factor in the possibility of likely minimum agricultural price supports for summer crops or potential retail fuel price hikes. In the event, a combination of high sustained inflation and solid economic activity may be viewed as criteria for an earlier rate increase.

1,2,3,4 Reserve Bank of India

Q: How has India's stock market performed so far in 2018?

Sunil Asnani: India's economic growth and corporate earnings seemed to be on a path to recovery during the first quarter of the year. Despite solid portfolio investment flows and an improving growth trajectory, however, India's market has corrected, led by cyclical stocks such as state-owned banks, metals and commodities, real estate, and automobiles, and by small and mid-cap companies, where valuations have been much higher than historical averages. The unearthing of a US$1.8 billion scandal at India's second-largest state-owned bank, the tightening of norms by the RBI for early recognition of bad loans and fears over the possibility of a rate increase weighed down market sentiment. The introduction of a federal government tax on long-term capital gains also was a setback.

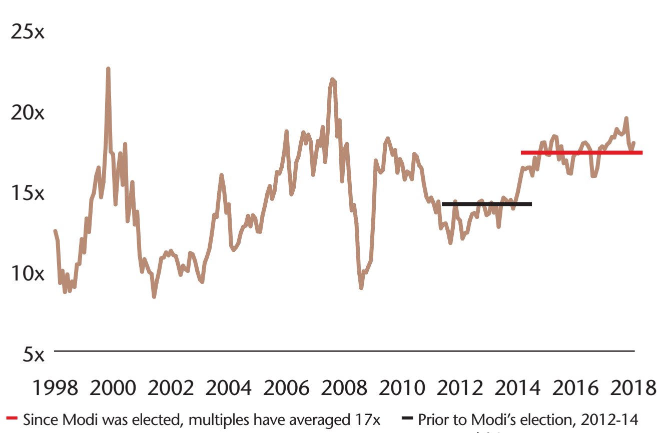
Q: What is the outlook for India's stock market?

Sriyan Pietersz: Underlying fundamentals for Indian stocks are showing signs of improvement. Aggregate revenues for nonfinancial public companies rose 11.3% year-over-year through the end of 2017, according to the RBI, and aggregate EBITDA was positive for the second successive quarter following implementation of the Goods and Services Tax (GST), as the impact of GST implementation fades.

Stock valuations appear inflated despite the fact that earnings have been depressed for almost four to five years. Valuations are currently around 18 times one-year forward consensus earnings, compared with average historical valuations of 15 to 16 times earnings. We see heightened volatility in India's equity market over the next couple of quarters as the national elections approach in 2019. Earnings growth expectations for this year (currently at 24%), also appear high, particularly in light of higher provisioning costs for banks in line with new RBI standards.

Overall, the broad market may face headwinds as expectations are reset to more realistic levels over the course of the year. Nonetheless, pockets of opportunity are likely for possible outperformance in various sectors and stocks, such as those exposed to government infrastructure spending and basic income recovery.

Figure 2. MSCI India:12 month FWD P/E Ratio



Source: Central Statistics Office

Q: What are you seeing in India this year from an investor's perspective?

Sunil Asnani: Our team visited India during the first quarter of 2018, meeting with a cross section of businesses, including many financial services companies. We learned that risks emanating from various reforms, including demonetization and the GST, seemed to be receding. Accordingly, we believe earnings for Indian companies have the potential to improve. At the same time, the macroeconomic outlook in India seems to have slipped. The federal budget deficit came in higher than the market expected, while a massive public sector bank scandal also came to light, dampening investor sentiment. The scandal was yet another reminder that state-owned banks historically have been poorly managed. As state-owned banks account for the bulk of India's bank deposit assets, they are unfortunately constraining overall growth. In contrast, well-run retail focused private sector banks, where we have our capital deployed, continue to do a better job of allocating capital, protecting against leakage, and delivering profitable growth.

Q. Where do you see the most interesting investing opportunities today in India's stock market?

Sunil Asnani: As active managers, we seek to buy stocks of companies that we believe have pricing power, which is not limited just to the consumer sector. Consider India's banking sector: If a bank is making small retail loans, it may achieve pricing power because small borrowers cannot dictate terms. Accordingly, we see opportunities in carefully researched retail-focused banks in this sector that concentrate on profitable growth. In contrast, if a bank is doing bulk lending, then borrowers have pricing power as they can shop around to find the best deals. We avoid investing in such banks.

By and large, we are looking for an edge either in terms of business model or management focus. Given the kinds of investment risks—macroeconomics, reforms, politics, currency, inflation, deficit, corruption, corporate governance—we believe that active management can help investors avoid a lot of these risks and find stocks that will do well over the long term. India's market is still not very efficient when compared with the U.S. stock market. Companies in India can remain expensive for a long time but eventually their true value will emerge, which is where active management helps to add value for long-term investors, in our view.

Q: What sectors seem attractive for long-term investors?

Sunil Asnani: Relatively depressed sectors such as health care look attractive right now. In addition, companies that exhibit pricing power and are better-governed can be found across diverse sectors such as consumer, pharmaceuticals, financial services and even materials. We are looking for quality companies that have a sustainable economic moat and are run by productive and upright management teams.

Definitions

Earnings Before Interest and Taxation, Depreciation and Amortization (EBITDA): Earnings Before Interest and Taxation, Depreciation and Amortization (EBITDA) is a measure of a company's earnings before considering the financing of that company (the share of equity capital and debt employed), and disregarding potential depreciation and amortization policies, which can be very different. EBITDA allows like-for-like comparisons between different companies' performance.

Forward Price-to-Earnings (P/E): Forward Price-to-Earnings (Forward P/E) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there still may be benefit in estimated P/E analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

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