

The Transformation of India

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The world is undergoing an historic power shift, according to the World Bank, with India and other emerging markets commanding a greater influence on global events. This is borne out by the recent ascendance of the G-20 as the premier world economic council, in place of the exclusively developed-market G-8.

Along with China, India has been one of the few economies to survive the global downturn without sinking into recession. India's strength and resilience reflect decades of astounding progress, including higher living standards, better health conditions and its emergence as a global player in industries such as telecommunications, pharmaceuticals and information technology.

India is now the world's fourth-largest economy, based on purchasing power parity, and one of the fastest growing. Although significant challenges remain—rural poverty, lack of infrastructure and continued low levels of basic literacy, for example—this huge democracy offers tremendous long-term potential as a world economic power. In fact, India is one of the key drivers of the current global economic recovery, and we expect an even greater contribution to world growth as it tackles the problems that suppress the aspirations of its people.

Continuing Economic Growth

The Indian economy averaged over 9% annual growth for the 2005-2007 calendar-year period as the export market exploded and domestic spending increased. Like every country, however, India felt the impact of the global financial crisis, despite a stable banking system and strong sovereign and corporate fundamentals. Economic growth slowed to 7.5% in 2008 and continued to weaken into 2009 as exports fell 25-30% and local demand declined.

India's economic pullback—concurrent with negative growth across the developed world—was mitigated by government stimulus programs, including interest-rate reductions, tax cuts and federal spending programs, together representing more than 12% of GDP.

Thanks to these stimulus efforts, Indian GDP rose 7.9%, year-on-year, for third quarter 2009, far beyond the median forecast of 6.3%. The economy benefited during the period from upticks in services and manufacturing, offsetting the effects on the agricultural sector of the worst drought in decades. In addition, while 60% of Indians work in agriculture, its import in the economy has been waning, dropping from 30% of GDP in 1990 to 18% today. The services sector currently accounts for more than 50% of GDP.

With signs of an economic upswing, the Reserve Bank of India may withdraw its stimulus measures sooner than anticipated—starting with an interest-rate hike in early 2010—as it refocuses its attention on inflation. Following the poor monsoon season, food-price inflation has skyrocketed to 17.5%, potentially driving the overall inflation rate to 6% or higher by the end of the fiscal year. In the meantime, government officials have announced that India will be able to restore 9% annual GDP growth in the medium term. The country's objective is to double the level of exports by 2014 and its share of world trade by 2020, supported by a series of proposed financial and social reforms.

Long-Awaited Reforms

For many years, reform in India was hampered by a lack of consensus within a broad coalition of political parties. That changed in May 2009, when Indian voters shocked pundits by handing Prime Minister Manmohan Singh a resounding victory, making him the first full-term prime minister in almost 40 years to be re-elected. Mr. Singh's Congress Party also had a sweeping win, nearly capturing a majority and enabling him to form a coalition much more easily than in his previous term.

The decisive election results signified national stability—leading to a stronger position on the foreign policy front—as well as an endorsement of Mr. Singh's reformist agenda. Among his proposed initiatives are substantial tax reforms to simplify corporate regulations, boost federal revenues and open the door to greater foreign investment, which has been somewhat hindered by government regulations. Reforms in the pension and insurance sectors are also anticipated, including the privatization of government-owned financial institutions. Implementation of reforms could begin as early as 2011.

Reducing poverty, particularly in rural areas, is another key focus for Mr. Singh's government. More than one-third of the world's poor live in India, whose economic future depends in large part on inclusion and greater opportunity. Rural communities generate over half of India's domestic demand.

Government plans to upgrade education, health care and social services are reflected in the federal budget for fiscal year 2009/2010, which calls for a 36% increase in spending over the previous year, including allocations to massive infrastructure development. While economists agree that radical changes are required for continued economic progress, some critics fear that the resulting higher budget deficit—estimated at a 16-year high of 6.8% of GDP—could subdue India's long-term growth.

The country's debt burden has already dampened economic expansion. It also creates a measure of economic volatility while reducing the number of options available to policymakers during an economic crisis. We believe that the deficit needs to be corralled quickly for India to increase its growth trajectory.

India vs. China: Better Long-Term Prospects?

India lags only China in terms of rapid growth, and the term "Chindia," used often in the press, aptly conveys their developing synergy. The two countries have forged a trade partnership based on their complementary strengths—raw materials and information technology in India, for example, and manufacturing and technology users in China. A major trade agreement implemented in 2006, focusing on information technology, energy and agriculture, aims at doubling their total bilateral trade to \$40 billion by next year. This agreement has been a positive step in the midst of ongoing trade disputes.

China currently holds the economic edge over India, with a higher growth rate and deeper government pockets to build infrastructure and foster a more consumer-oriented society. Yet India's longer-term prospects—looking out 20 years or more—are stronger than those of China. India has time and demographics on its side, with a much younger population than in China, implying steadily rising consumption of goods and services. In the words of one corporate leader, "India will become richer before it gets older, and the Chinese will become older before they get richer." The balance should also shift as the Indian manufacturing sector continues to develop, diverting the country's raw materials toward domestic use, and as the Chinese service industry expands.

Favorable Investment Outlook—Today and Tomorrow

With its sound financial structure, growing economy and established global presence, India is well positioned to benefit early from the world economic upturn. This is already evident from an investment standpoint. Net equity inflows from foreign institutional investors (FII) were the second highest ever during second quarter 2009, even as GDP continued to weaken. Indian equities have soared, with the MSCI India Index up 100.5% year-to-date through December 1, 2009.

Stock prices often rise toward the end of a recession in expectation of a recovery, yet many observers worry that the Indian market has overheated and outrun fundamentals. Indian stocks currently trade at 18x forward price-to-earnings—on the higher side, but far from bubble valuations. In addition, the consensus 22% one-year earnings growth estimate seems to be on the conservative side. We suspect that growth will be strong, surprising most investors, although it is often difficult to establish conclusively how much of it is being discounted.

History shows that no market climbs in an uninterrupted straight line. India, like other developing countries, is still a relatively high-beta market, and we may see additional volatility until the global recovery is on firmer ground. The amount of liquidity that has been pumped into the world economy is unprecedented, and it will take time for it to work its way through to the real economy.

During this process, the Indian market should continue to move upward, albeit with some corrections along the way. For example, we believe that the central bank's initial interest-rate hikes will have a negative effect on equities. However, we also believe that these hikes will constrict inflation rather than squeeze economic growth. This can be expected to increase the length of the economic cycle and dampen its amplitude, which will be positive in the longer run for India's economy and stock market.

In our view, correction periods should be used to add exposure to India and other emerging markets. A substantial market correction can provide a valuable opportunity to purchase fundamentally attractive stocks at very favorable prices. This approach has typically benefited long-term investors in India and other developing countries, whose continued progress in the coming years should reward them over time.

Important Information

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