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Update on India Investment Thesis

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In the last few years, India has received increasing attention from investors. Following a strong 2014 performance, India-focused exchange-traded funds (ETFs) received more than $1 billion in inflows during the first quarter of 2015. For context, the entire 2014 inflow was $2.8 billion.

India has always held vast potential for growth. India is the second most populous nation (population 1.2 billion) in the world and boasts a stable democracy. While India is the fourth-largest economy in the world, income is low on a per capita basis. If Indian growth can be sustained, there should be a long runway for progress. India's mortgage debt made up just 9% of GDP in 2012, versus 20% for China, according to IIFL Research. India also has a significant middle class, a large English-speaking population, and well developed technology and financial services companies. Despite this potential, poor infrastructure, arbitrary taxation and significant government interference have put off investors.

So why the sharp increase in interest? The answer is the election of a strongly pro-business government that could unlock this potential. A landslide win for Narendra Modi and his party, the Bharatiya Janata Party (BJP), in May 2014 brought both the support of the people and a clear majority in Parliament. India hasn't had a single party with this kind of majority since 1984.

The election of Modi has sparked hopes for a virtuous cycle of increasing business confidence, accelerating growth, deficit reduction and increased foreign investment. Modi has helped clear 176 projects valued at $105 billion, according to Morgan Stanley, and is focused on welcoming foreign investment. Examples include $2 billion of transmission works and four new power projects with 16,000 MW of capacity for India's notoriously poor power grid. Reform efforts include cutting subsidies on diesel prices, a budget that improves fiscal balances and a number of efforts to facilitate the ease of doing business in India.

Another important factor has been the selection of Raghuram Rajan as chief of the Reserve Bank of India. Under Rajan's watch, inflation is coming down, real interest rates have turned positive and the currency has stabilized.
A stronger foundation provided by non-political, credible central bank policy could help stabilize the Indian currency.

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India's economy is now at an inflection point: economists expect GDP growth to accelerate to about 7% annually in 2015 and beyond, driven by implementing half-finished projects, business formation and increased domestic demand. Risks include a re-run of the 2013 disruption in emerging markets on fears of U.S. rate hikes. India fiscal balances are in better shape today, but the country is still dependent on external funding.

In our opinion, we think the recent pullback in Indian shares is an opportunity. Equity valuations are reasonable, especially in light of expected earnings momentum and larger participation of domestic investors in the stock market. GDP acceleration should translate into compounded annual corporate earnings growth in the mid-teens in the next few years, up from a post-crisis average of 8%. Many analysts have yet to factor this into their individual company estimates.

The most recent selloff has been a combination of a sympathy move with U.S. markets and fears about a retrospective tax on capital gains. After inheriting a minimum alternative tax (MAT) from the previous administration, the Modi administration revoked the tax, effective April 1. But what spooked the market is that foreign investors have been asked to pay MATs of close to $100 million for capital gains in India back to 2009. Despite this controversy, the Modi administration has been extremely market friendly since coming into power. This was put on display this week when the Indian finance minister wrote an op-ed piece in Financial Times, explaining the MAT. In the piece he said, *"Even though it is only the legacy issues that haunt us, we recognise that we must put a quick end to them."*

In addition to the fundamental story, the models BCA uses continue to rank Indian shares highly. Despite the current weakness, India's stock market continues to be in a very strong longer-term trend. India also continues to have good valuation again given strong earnings growth trends. Both the IMF and World Bank have upgraded their expectations for India's GDP growth and expect the country's growth to overtake China this year. Additionally, the Reserve Bank of India has cut rates twice this year, showing its willingness to stimulate the economy. We argue the current weakness should be seen as a buying opportunity, especially for investors with a long-term time horizon.

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