Omba Advisory & Investments Limited

India Outlook & Analysis – April 2019

Join us as we delve into an analysis of

"the world's fastest growing large economy".

"When I was growing up, my parents told me, 'Finish your dinner. People in China and India are starving.' I tell my daughters, 'Finish your homework. People in India and China are starving for your job."

- Thomas Friedman, political commentator and Pulitzer Prize winner

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Contents

1. INTRODUCTION 2

2. ECONOMIC OUTLOOK 4

2.1. STRONG, CONSUMPTION-LED GROWTH 4
2.1.1. India economic composition 5
2.2. THE GOOD, THE BAD, AND THE UGLY OF INDIAN GROWTH 6
2.2.1. The Good: Robust consumption continues to drive growth 6
2.2.2. The Bad: Sluggish manufacturing and investment growth 7
2.2.3. The Ugly: Weak credit and export growth 7
2.3. RECOVERY FROM THE TWIN POLICY SHOCKS 8

3. ASSET PRICES AND VALUATIONS 10

3.1. A WORD ON THE GLOBAL CORRECTION OF 4Q 2018 10
3.2. INTO 2019: RECENT LAG PROVIDES SCOPE TO OUTPERFORM 11
3.3. EQUITIES AND ETFS 13
3.3.1. Non-bank liquidity crisis led 3Q 2018 Equity weakness 13
3.3.2. Indian Equities – Looking Ahead 14
3.3.3. Investing in India Equity ETFs 15
3.4. GOVERNMENT CREDIT (FIXED INCOME) 19
3.4.1. Recent trends in government bonds 19
3.4.2. Key risk: Inflation surprise from rebounding food prices 22
3.5. CORPORATE CREDIT (FIXED INCOME) 22
3.5.1 Comparing corporate and government credit 23
3.5.2. Key risk: Slowdown in shadow bank lending 24
3.6. RUPEE OUTLOOK 25

4. IS INDIA THE NEXT CHINA? 27

4.1. CHINA'S SUCCESSES AND INDIA'S CHALLENGES 28
4.2. COMPARATIVE DATA 31

5. INDIA'S GROWTH: THE PAST, THE PRESENT, THE FUTURE 31

5.1. 1991-2003: CRISIS CAUSES CHANGE 33
5.2. 2003-2008: "BOOM YEARS" 34
5.3. 2009-2017: POST-GFC NORMALISATION 34

CONCLUSION 36

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1. Introduction

The Republic of India, the second most populous nation in the world, is often heralded as **"the world's fastest growing large economy"** after overtaking China in 2015 (with Indian year-on-year GDP growth averaging 7.3% in 2018). The nation of 1.3 billion ethnically diverse people spans 29 states, multiple religions, and 22 official languages (as well as 122 unofficial). Balancing domestic as well as international interests, it walks a fine line in managing long-term regional tensions with fellow nuclear-power Pakistan; a key issue in the current Indian general election in April/May 2019.

India's economic backdrop is robust and annual GDP growth is likely to remain above 7%, as strong consumption continues to drive growth while a nascent recovery in exports and domestic investment gains traction. **We are net positive towards Indian asset prices assuming a market-friendly election outcome,** whereby the incumbent Bharatiya Janata Party ("BJP") led by Prime Minister Narendra Modi remains in power. Recent opinion polls suggest a BJP win, although by a tight margin. We expect that the 2019 year-to-date underperformance in equities and FX, relative to Emerging Market ("EM") peers, could improve amid renewed foreign investment appetite. India is uniquely diverse in its composition and has had an interesting economic growth experience.

Growth in India really began to accelerate after the 1991 balance of payment crisis forced economic and trade liberalisation as part of a deal for monetary aid from the IMF and World Bank. Since then, India has chartered a new path of economic growth as it defied the tried-and-tested exports and manufacturing focused growth strategy employed by China and the Four Asian Tigers (Singapore, Hong Kong, South Korea, Taiwan), which favoured industry over services. While China grew quickly, India grew steadily with 60% of GDP growth stemming from improvements in productivity in the services sector as opposed to traditional manufacturing or simple factor inputs (labour and capital)[1]. Manufacturing and industry are well-known to have faster growth potential than the services sector but are not considered to be as robust - the hallmark of a developing economy. In 2015 markets grew concerned over a slow-down in China. Whilst China demonstrated very typical patterns in the economic developmental process of moving jobs out of manufacturing and into services, India remained more robust and continued its fast and accelerating growth. Although we do not believe that India will be able to mimic China's unprecedented export-driven growth any time soon, due to recent trends in automation and factory mechanisation, we cannot ignore the structural demographics that point toward greater future growth.

As a consequence of India's increased share in global trade, it is increasingly dependent on the health of international markets. We see the single greatest risk to Indian growth as being a broader global economic slowdown. Recent sluggishness in proprietary growth indicators from the Brookings Institution suggest a "synchronised slowdown" across the global economy, with prominent figures such as Christine Lagarde of the IMF sounding warning signals as fundamental data suggests a moderate slow-down in momentum (as opposed to an outright global recession). Professor Prasad of Brookings noted that "globally, only India stands out as an exception to the slowing trend", as summarised by the Financial Times[2]. Additionally, **a return of higher crude oil prices would put pressure on India's net trade deficit** (as an importer it sells Rupees to fund US Dollar-based oil purchases). Imminently however, a market-unfriendly election outcome remains a key concern as it would hurt growth and increase risks of further fiscal slippage from the estimated 3.4% of GDP budget deficit for the fiscal year ended 31 March 2019 (the target being 3.0%). India's dual-deficits in exports (trade deficit) and the government budget (fiscal deficit) remain in focus.

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Through 2019, India could benefit from a broader theme of investment flows into EM assets which would support the **Rupee (INR)**. In 1Q 2019 the US Federal Reserve ("Fed") abruptly reversed their policy outlook of higher interest rates, suggesting that the strong 2018 performance of the US Dollar was a possible overextension from fundamentals. EM equities also enjoy a more favourable outlook given a recent trend in policy reversals, as a slew of EM central banks cut interest rates after tightening in 2018 in efforts to protect currencies from the strengthening US Dollar. We note that 13 different EM central banks have cut interest rates year-to-date whilst only 4 have increased - a stark contrast to 2018 when 35 different EM central banks hiked policy rates[3]. As such, we expect both EM monetary policy easing and EM and DM central bank policy convergence to be themes in 2019.

The Reserve Bank of India ("RBI") is just one of the many central banks making a policy U-turn as it changed its stance from one of "calibrated tightening" to "neutral" and surprised many economists by cutting benchmark rates 25bps in February 2019. In line with revised market expectations, the RBI cut rates a further 25bps to 6.0% at the recent 4 April 2019 Monetary Policy Committee ("MPC") meeting. **Indian bond markets will be supported by expectations of further policy easing** amid tepid inflation, a narrower trade deficit after the 4Q 2018 drop in oil prices, and a tighter supply of government debt as the RBI continues bond purchases through Open Market Operations ("OMOs").

Although the Nifty 50 and BSE Sensex 30 indices - India's two main equity benchmarks - trade at a premium to EM peers in terms of Price/Earnings and Forward Earnings metrics, **we see upside potential to Indian equities post-election on renewed investment interest**. We believe the 2019 year-to-date underperformance relative to EM benchmarks has been a result of curtailed investment flows due to the election event-risk. [*Picture below:*[4]]

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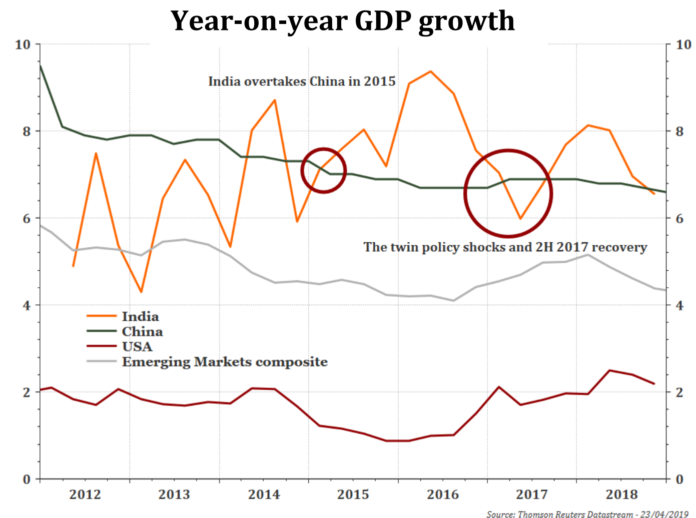
2. Economic Outlook

2.1. Strong, consumption-led growth

We expect nominal economic growth to remain on a robust trajectory in excess of 7%, with potential to accelerate if India can address key systemic issues. Underperformance in export growth continues to persist as the manufacturing sector remains sluggish in comparison to services and capacity utilisation remains low at 74.8%. The RBI also noted the current negative output gap at the latest MPC meeting on 4 April 2019. The Indian economy, as measured by GDP, is the 5th largest in the world and 3rd largest in Asia. It is unique in its history, diversity, and composition. Although it is much larger than most of its regional peers, it has lagged in terms of growth performance since World War 2. Mainland China, along with the Four Tigers, have followed a well-known recipe of economic liberalisation and investment in manufacturing, with the end goal of boosting trade flows and increasing global participation. India has followed a different route as it has primarily relied on growth in the services sector; both domestic services and services-exports (a.k.a. "invisibles" or invisible revenue) such as call-centres and IT services.



Although we are optimistic over future growth, India has faced structural limitations in scaling-up productivity in the manufacturing sector (see how China outsmarted India) which has followed through to a chronic lack of export-competitiveness. Weak credit growth, due to systemic issues in the banking sector exacerbated by the Global Financial Crisis ("GFC"), has followed through to weak investment growth. Poor investment has limited manufacturing, which inherently implies the production of fewer goods that can be exported. When we talk about poor performance in Indian industry (relative to services), we refer to the investment-manufacturing-export complex that lies at the heart of industrialisation and the economic development process.

As we discuss later, the Indian banking system has been plagued by soured loans that were granted during the pre-GFC credit bubble and underpinned the credit tightness that hurt investment, manufacturing, and ultimately exports.

India is well known for its lagging industrial sector and we want to highlight the strong potential for growth if the economy can fire on all (or more!) cylinders. "[It is the Indian] services leg doing all of the walking, the economy can only limp along... For a more rapid transformation, India must walk on two legs. That means more rapid growth of the labour-intensive manufacturing"[5].

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2.1.1. India economic composition

Indian economic growth has been limited by the fact that the services sector grows slower than manufacturing. Services sector growth is less volatile in nature, and more insular, as it is primarily driven by domestic demand as opposed to cross-border trade (making India better protected from risks of a global slowdown). Emerging market economies grow faster than Developed Market ("DM") counterparts because exports can be scaled up quickly, as cheap labour makes exports internationally competitive. As economies develop, wages typically increase, and we see a natural shift away from manufacturing-orientated growth into services-orientated growth.

For average 1Q-4Q 2018	Private consumption as % of GDP	Goods exports (excl. services) as % of GDP	Invisibles exports as % of GDP*	Year-on-year GDP growth
India (EM)	**59.0%**	12.3%	**7.1%**	**7.3%**
South Korea (DM)	48.6%	**38.7%**	5.3%	2.7%
China (EM)	38.6%	17.8%	1.7%	6.6%

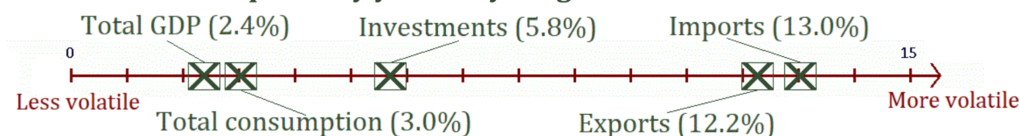
** Inferred from source.* ***Source:*** *Oxford Economics*

While DM economies grow slower than EM counterparts, they are also better protected from trade risks and international growth concerns. A global slowdown greatly hurts commodity exporting countries but will unlikely deter the reader from buying a coffee at a local cafe. The table above suggests that the Indian economy is, in some respects, more similar to South Korea than China. Private consumption comprises 59.0% of Indian GDP, which is remarkably high, even compared to its highly developed regional peer South Korea where private consumption only contributes 48.6% of GDP. Private consumption contributed a "mere" 38.6% to Chinese GDP, more than a 20% differential to India.

In terms of economic sensitivity to goods-exports (i.e. exports excluding services), merchandise exports account for 12.3% of Indian GDP versus 17.8% in China. Although these percentages may appear closer than many would expect, China is still a much larger global exporter as it has a GDP of US$ 12.24 trillion compared to US$ 2.59 trillion for India[6]. The scope for India's economy to improve goods exports remains meaningful, particularly in terms of market share of global trade. Total exports as a percentage of GDP, including both goods and services, are comparable between India and China (19.4% and 19.5%, respectively) as India compensates by being a stronger exporter of services. We discuss the exact reasons that led to India's unique industrial composition later in the section "Is India the next China?".

GDP growth comes through a variety of contributing factors, including private and government consumption, investments, and net trade (exports less imports). To illustrate why consumption is more robust than exports or investments, we calculated the observed variance in year-on-year growth rates across Indian total GDP, combined private and government consumption, investment, exports (seasonally adjusted), and imports (seasonally adjusted) – shown below.

Standard deviation of quarterly year-on-year growth rates between 1981 and 1Q 2019



Source: *Oxford Economics, constant 2011 INR prices*

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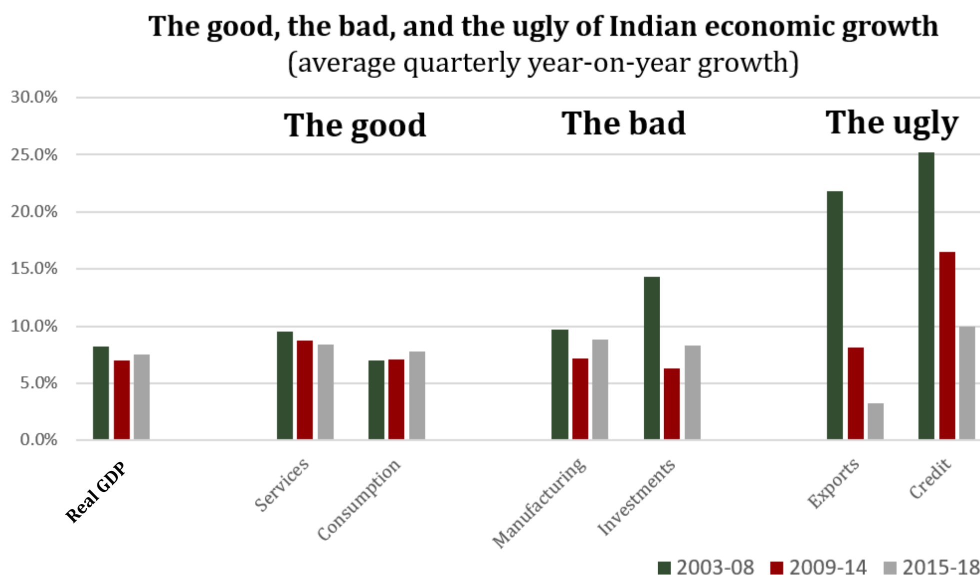
2.2. The Good, the Bad, and the Ugly of Indian growth

The Indian economy has only ever been able to sustain expansion above the elusive 8% year-on-year GDP growth rate for seven periods since the 1950s and was only once able to maintain it for more than 2 years. This occurred in the 2003-2008 pre-GFC "boom years", when GDP grew at an average annual rate of 8.2%. This period of unparalleled growth was the result of unsustainably easy global liquidity that facilitated huge investment and export growth. The chart below shows the incredible growth experienced during the boom years (green bars), as measured by average year-on-year growth.

To understand India's economic make-up, and to highlight the areas that need improvement, we compare the pre-GFC boom years that enjoyed 8% growth, to the periods from 2009 to 2014 and 2015 to 2018. We look at **the Good** (services, consumption), **the Bad** (manufacturing, investments), and **the Ugly** (exports, credit) of the Indian economy. Data in the below section references the accompanying chart.



2.2.1. The Good: Robust consumption continues to drive growth

Domestic consumption, closely related to the services sector, has long been the main driver of growth in India. The well-known characteristics of a services-focused economy can be clearly seen when comparing growth over different periods.

Services growth is more robust, yet slower, than the manufacturing sector in that:

(1) it **cannot be inflated (and is slower)** by factor inputs. Even in the face of unprecedented global liquidity, India's services sector "only" grew at an average annual rate of 9.5% - slow compared to the 21.8% and 14.3% rates experienced by exports and investments, respectively.

(2) it is **better protected (and more robust)** in an economic downturn. After the boom years ended and global liquidity tightened, the services sector growth fell only 0.8% points to 8.7% for the period 2009-2014. Export and investment growth rates fell 13.6% and 8.1% points, respectively.

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Driver: Strong domestic consumption

Although total consumption growth (private and public) was down 1% in 1Q 2019, relative to the strong average year-on-year growth of 8.3% over 2018, it remains the largest driver of the Indian economy and reflects the strength of the domestic services sector.

Although **private consumption** remains the largest and most robust driver, an increase in **government consumption** also supported the pick-up in growth since July 2017. National and state authorities increased public sector salaries in 2017 after approving the 7th Pay Commission, which benefitted both private and public consumption.

Urban consumption has been supported by a drawdown of household savings and steady retail credit. **Rural consumption** has fallen recently but remains strong overall, although faces downside risks that are linked to poor crop performance and weak rural wage inflation (due to a sustained labour surplus).

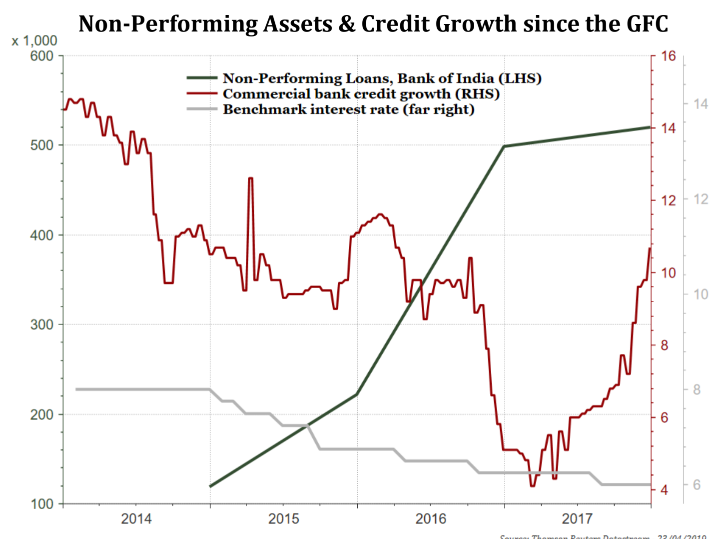
2.2.2. The Bad: Sluggish manufacturing and investment growth

Manufacturing and investment growth have been sluggish since the GFC but show signs of improvement. During the 2003-2008 boom years, investments grew at an average of 14.3% but fell to 6.3% between 2009 and 2014. Investment is also "bad" due to the volatility of its growth as shown by the chart on the previous page.

We remain optimistic for further improvements in the investment environment but see **[ugly]** credit growth as a major limiting factor. There are, however, signs of improvement in the credit environment as the health of the banking system improves.

2.2.3. The Ugly: Weak credit and export growth

The long-suffering banking sector saw an epidemic of Non-Performing Assets ("NPA") after the GFC; a period in which large numbers of risky loans were granted amid a climate of unsustainably easy credit. Poor banking practices of "evergreening" continued to exacerbate the inefficient allocation of capital in the banking system well after 2009, although progress has been made in containing these bad, pre-GFC loans. "Evergreening" is the practice of persistently granting extensions to poorly serviced debt, preventing it from being identified as non-performing.



The situation for NPAs became dire in 2014 after a temporary dip in economic performance sparked an accelerated rise in defaults as credit conditions tightened despite rate cuts by the RBI.

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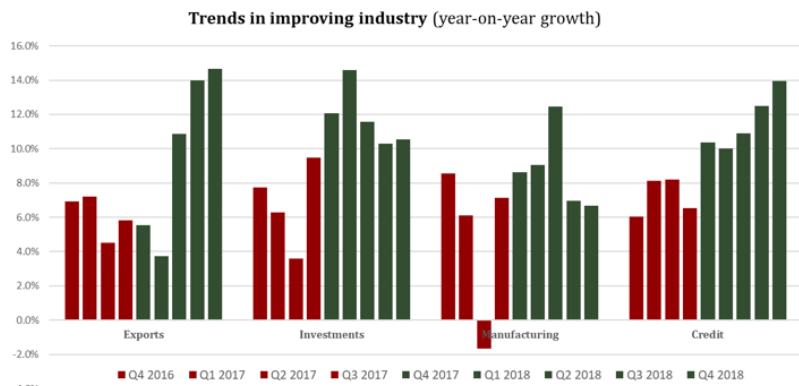
It is interesting to note that until 2017, credit growth decelerated despite a climate of consistently declining interest rates. However, since then, credit growth has accelerated sharply whilst non-performing loans have stabilized.

Today the Indian domestic credit climate is supported by:

- **(1)** the containment of the late-2018 domestic liquidity crisis in the non-bank lending space;
- **(2)** a central bank which continues to support government bond prices through debt buying in Open Market Operations ("OMOs"), and will do so through 2020;
- **(3)** recent accommodative monetary policy (i.e. rate cuts);
- **(4)** government-led bank recapitalisations as well as a variety of other policy reforms which help alleviate structural balance-sheet stress.

Driver: The nascent recovery in credit gains traction

As we previously suggested, and will further elaborate on when analysing "India's recent growth cycles", disappointing credit growth has been the main limitation in unlocking faster economic growth given the pass-through to investments and manufacturing. We are optimistic that the observed pick-up in year-on-year credit growth will continue to gain traction after improving for the last 6 consecutive quarters. The commercial banking sector, the largest provider of credit, is bolstered by lower Non-Performing Asset ratios, less leverage, and improved business practices due to the Insolvency and Bankruptcy Code of 2016 ("IBC").



The Modi government has presided over a variety of reforms, such as the Revised Framework for the Resolution of Stressed Assets, which forces debt to be identified as stressed immediately after a single missed interest payment and which can also force bankruptcy proceedings of a company if debt is not serviced for over 180 days. The banking sector has been further supported by government-led bank recapitalisations announced in October 2017, amounting to US$ 32 billion and to be released in traches until 2020. Commercial banks still require an estimated additional US$ 23 billion to the already-granted provisions to sufficiently meet Basel III capital standards and achieve a 65% Non-Performing Loan cover ratio[7] - suggesting there is still more to be done despite recent progress.

2.3. Recovery from the twin policy shocks

The Indian economy has made a strong recovery since the twin policy shocks of the 2016 banknote demonetisation and the introduction of the Goods and Services Tax ("GST") in 2017, which resulted in year-on-year GDP growth dropping to a low of 6.0% in 1H 2017. These two reforms had a clear and measurable negative impact on asset prices and economic growth, although we have seen a full recovery and expect the policies implemented to support long-term growth. The strong average year-on-year GDP growth of 7.3% experienced in 2018 can partly be attributed to a bounce from the low 2017 numbers.

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The 2016 Indian demonetisation of large banknotes saw high value denomination paper currency taken out of circulation as part of a clampdown on black market activity. The GST, which was implemented on 1 July 2017, is a nation-wide indirect tax (consumption tax) code that replaced multiple state and central government levies. Although the GST will help to formalise the economy and increase the tax base in the long term, poor implementation saw highly disappointing indirect receipts in the first few months and greater costs and complexities for businesses. However, overall, the indirect tax base expanded 65%[8] in the 12 months after the GST roll-out and is expected to allow for greater, and more efficient, tax collection.

Demonetisation has been called a failure, and we can see why!

Demonetisation was intended to wipe "black money" out of the economy as it required large denomination paper notes to be physically deposited into the banking system and the source declared. The government opined that black money could not be easily deposited into conventional banking institutions and estimated that approximately 20% of outstanding notes would never be accounted for. However, 99.3% of the value of demonetised cash eventually found its way into the banking system, effectively forcing the laundering of the black money and having the opposite of the desired effect.

The run-up to demonetisation resulted in the development of new black market activities, as large notes were physically traded at discounts, physical gold sales spiked 30% with multiple establishments being caught making backdated entries, and the emergence of professional brokers who dispatched low-income Indians to wait in line to make fraudulent deposits.

The Indian economy, and in particular rural business, slowed due to the frictions of implementing the restrictive policy of demonetisation. Consumption and lending both tightened as money moved less freely. The Indian economy is highly dependent on cash as it has a less developed banking infrastructure. Domestic business sentiment was hit particularly hard as Composite PMI fell from 55.4 in October 2016 to 47.6 in December 2016. A measurement above 50.0 indicates "optimism" - below suggests "pessimism".

Asset prices echoed the negative outlook as the Nifty 50 fell 6% on the day of the announcement of demonetisation. The GST also hurt business sentiment in the month of implementation (July 2017) as Composite PMI once again fell below "neutral" (50.0) to an all-time low of 46.0.

The detrimental impact on growth persisted from late-2016 to 3Q 2017. After GDP had grown by 7.4% year-on-year in 4Q 2016, GDP growth slowed by 1.1% to an average of 6.3% over the next 3 quarters (1Q to 3Q 2017).

1. **Credit growth fell significantly** from 12.3% in 2Q 2016 to 6.0% in 3Q 2016 and remained supressed throughout 2017.
2. **Consumption, investments, and manufacturing growth all dropped over 1H 2017** as credit tightness and producer destocking hurt the economy. Manufacturing growth, which is closely linked to investment and credit, turned negative for the first time since 2009.

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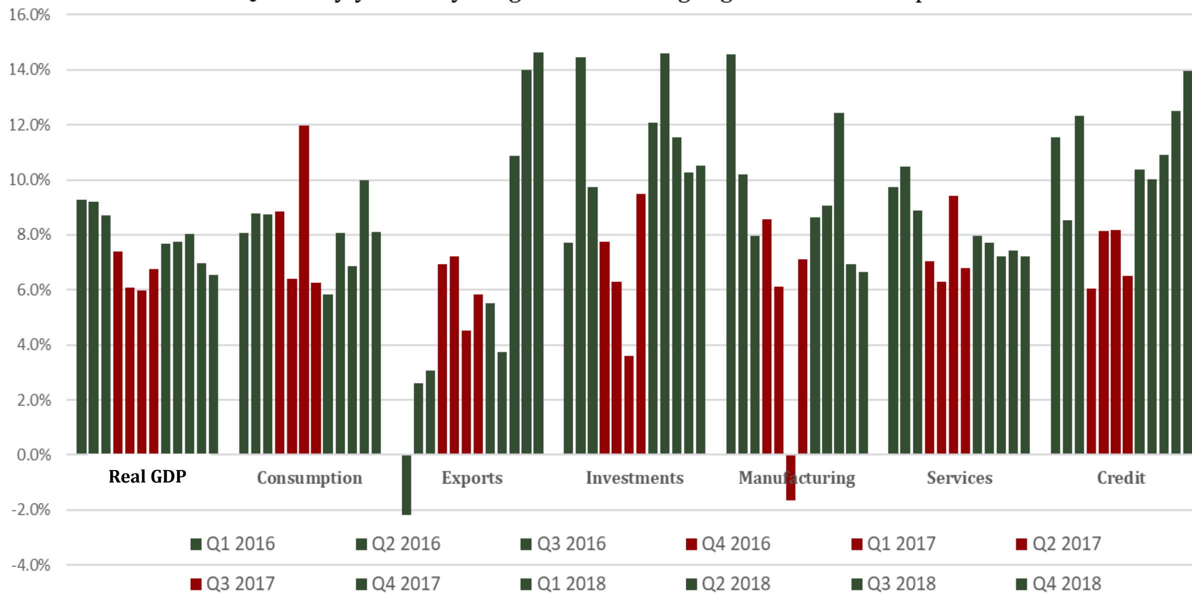

3. Asset prices and valuations

3.1. A word on the global correction of 4Q 2018

The second half of 2018 saw a global repricing of risky assets as an equities-led sell-off reverberated across the world and caused widespread panic in both emerging and developed markets. Developed markets, such as the US and Europe, saw equity benchmarks finish the year near their lows. Emerging markets sold-off more aggressively than their developed counterparts, given a greater sensitivity to global trade concerns and higher export-dependence. Almost no asset class was left unharmed. Although safe-haven assets like the US Dollar and gold were strong (and even closed 2H 2018 higher), many other currencies dropped in value while industrial commodities such as crude oil fell over US$30/bbl from the highs.

Nifty 50 Outperformance	Developed Market	Emerging Market
Regional	Korean Kospi **15%**	Shanghai Comp. **15%**
International	S&P 500 **10%**	MSCI EM Index **12%**

Despite a more globally integrated India having a stronger correlation to international trends in terms of GDP growth, trade growth, and equity performance, the sell-off in 4Q 2018 was an opportunity to showcase some of the virtues of the robust nature of the Indian economy. Over the correction, India's benchmark index, the Nifty 50, beat various regional/ international and DM/EM peers **(as shown in the accompanying table over 2H 2018)**. The chart on the next page rebases a collection of equity benchmarks to 100 at the beginning of 2H 2018. Note how the Nifty 50 **(orange price line)** is the top performer over 2H 2018 following a strong recovery post the non-bank liquidity crisis and broader equity sell-off.

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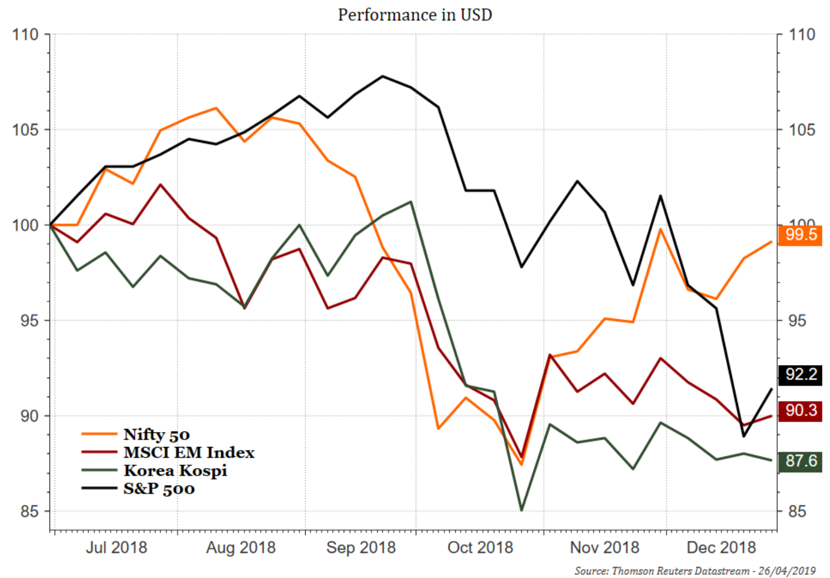
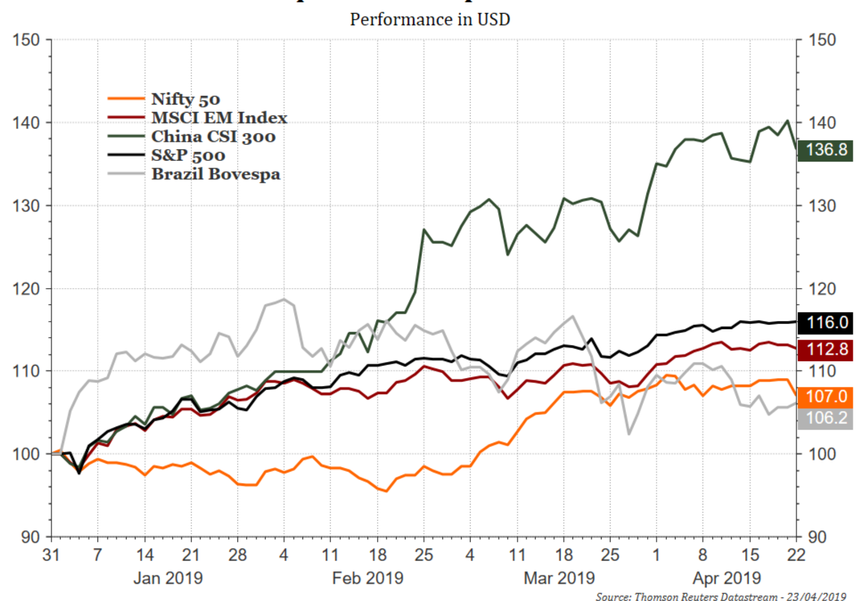
The Nifty 50 outperformed regional peers thanks to robust domestic growth and its consumption-led economy. **The unique make-up of India's services-focused economy allowed it to be less impacted by export-related trade-war concerns that hurt many other EM economies.** Additionally, its demographic composition allowed GDP to grow faster than DM economies. **India is unique in that it demonstrates an industrial composition similar to developed economies, while enjoying growth rates only seen in emerging economies.**



3.2. Into 2019: Recent lag provides scope to outperform

As we moved into 2019, global risk sentiment began to recover mainly due to an abrupt change in the Fed's policy guidance allowing monetary easing by many EM central banks. Additionally, lower oil prices started to act as a tailwind for economic growth, and international investment flows shifted towards EM assets as investors saw the EM-complex in a more favourable light. Many EM equity benchmarks and currencies have been the greatest beneficiaries of the renewed optimism in global growth. The more positive global sentiment was further supported in India by favourable domestic inflation data, positive momentum in GDP growth, and subsiding risks in domestic credit markets (read about the Non-Bank Financial Company liquidity crisis of 2018).

The chart on the right shows strong 2019 year-to-date performance across global equity markets, although India has clearly underperformed EM peers. We believe this is largely due to risks surrounding the general elections which are being held between 11 April and 19 May 2019. While recent polls suggest a market-friendly election outcome, whereby the incumbent BJP remains in power, the event risk has limited investment flows into Indian assets. The outcome of the election and its impact on the economy has become increasingly uncertain as recent polls have tightened. While the recent flare-



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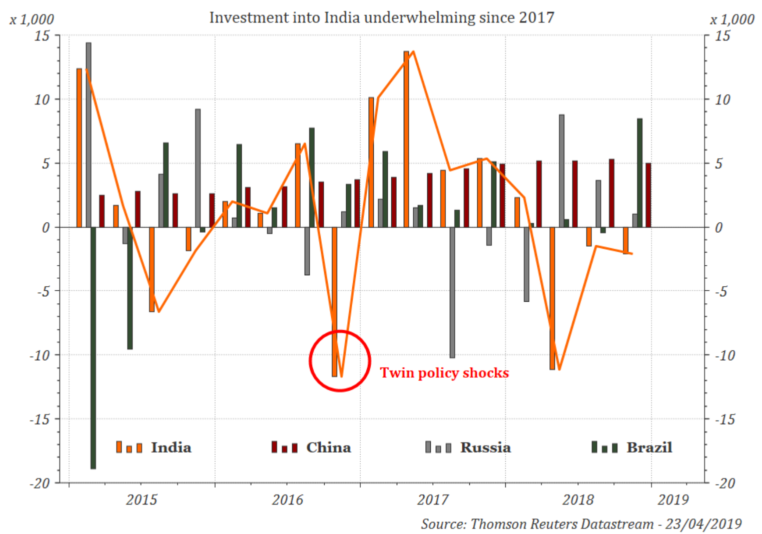
up in tension between Pakistan helped rally support for the hard-line PM Modi, there is a sense of disappointment held by many voters over the government's failure to deliver on key 2014 campaign promises such as improving youth unemployment.

We believe the risks are low for a severe or prolonged election-driven equity correction as no political party has signalled a full U-turn in economic policy. The BJP is considered more market-friendly as it has demonstrated consistent fiscal discipline since the 2014 elections and has presided over a variety of important structural policy reforms. The centre-left opposition National Congress ("Congress") is more populist in tone and is therefore more likely to incur fiscal slippage (i.e. budget overspend) if elected.

Foreign portfolio investment into BRIC economies in USD



We observe that foreign portfolio investment into India has been tepid relative to other BRIC economies, with net flows being outright negative since early 2018. Given the strength in Indian equity prices and robust economic growth, this is likely unjustified and may reverse amid new investment interest post-election. In summary, the outlook for Indian equities remains net positive due to robust economic growth, positive momentum in EM investor flows, and a variety of improving domestic indicators such as strong consumption growth and a nascent structural recovery in credit and investments. Of course, the greatest risk to equity prices remains global economic health, which is significantly impacted by the Fed's policy as well as the state of global trade. As is often said, "when the US sneezes, the rest of the world catches a cold".

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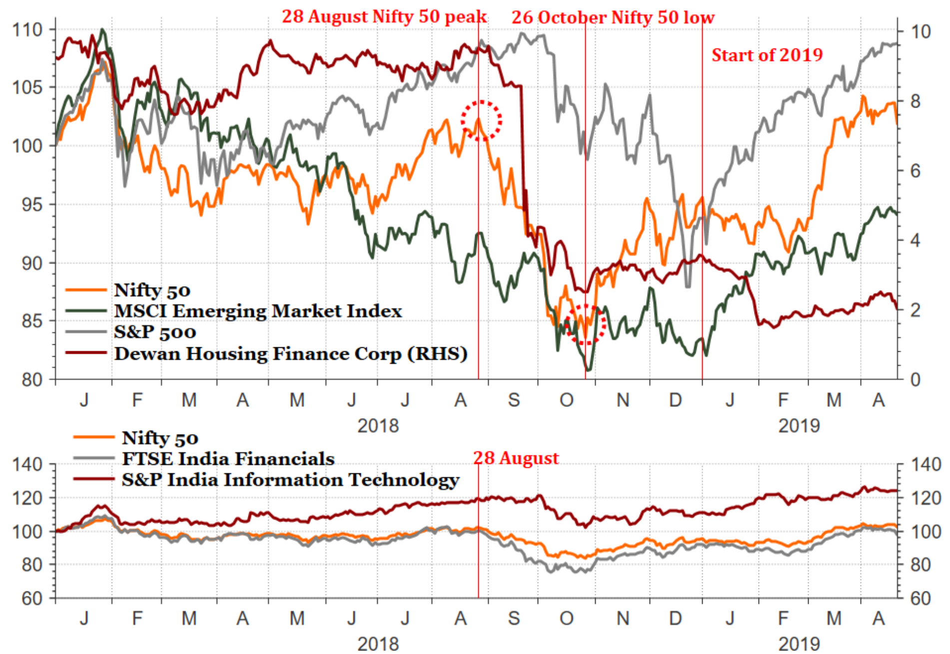
3.3. Equities and ETFs

3.3.1. Non-bank liquidity crisis led 3Q 2018 Equity weakness

Although global equity prices dropped notably in 4Q 2018, **Indian markets started falling months earlier** after the Nifty 50 peaked in late August. The fall across domestic equity prices was driven by a **Non-Bank Financial Companies ("NBFC") liquidity crisis that was sparked by defaults in the non-bank lending space**. As expected, the Financial Services sector was the worst affected as it is more dependent on broader credit conditions, whereas other sectors such as Information Technology were relatively less impacted. The Dewan Housing Finance Corporation was amongst the worst performers and fell over 73% from peak to trough.

Indian Equities sold-off before Developed Markets (in USD)



Source: Thomson Reuters Datastream - 23/04/2019

Other EM-related equity risks such as Sino-US trade tensions also weighed on Indian equity performance during the broader EM sell-off, although the Nifty 50 proved to be more robust than other indices such as the MSCI Emerging Market Index.

Over the last 5 years (using monthly data) correlation has been relatively low between the Nifty 50 and the S&P 500 (at 0.44). India also has relatively low correlation against Chinese equities (0.42) and the broader MSCI EM Index (0.57). With China representing approximately a third of the MSCI EM Index, its correlation to this index is expectedly high. Indian equities lower correlation with the S&P 500 highlights the potential diversification benefits of Indian equities in a developed market equity portfolio. However, as shown, the diversification benefit of bonds when combined in an equity portfolio are far greater but comes at a cost of lower potential return.

	iShares China Large-Cap ETF	S&P 500	iShares India 50 ETF	MSCI EM Index	iShares US Treasury Bond ETF
iShares China Large-Cap ETF	1.00	0.63	0.42	0.84	-0.11
S&P 500	0.63	1.00	0.44	0.65	-0.17
iShares India 50 ETF	0.42	0.44	1.00	0.57	0.30
MSCI EM Index	0.84	0.65	0.57	1.00	0.05
iShares US Treasury Bond ETF	-0.11	-0.17	0.30	0.05	1.00

***Source**: Refinitiv, 2019*

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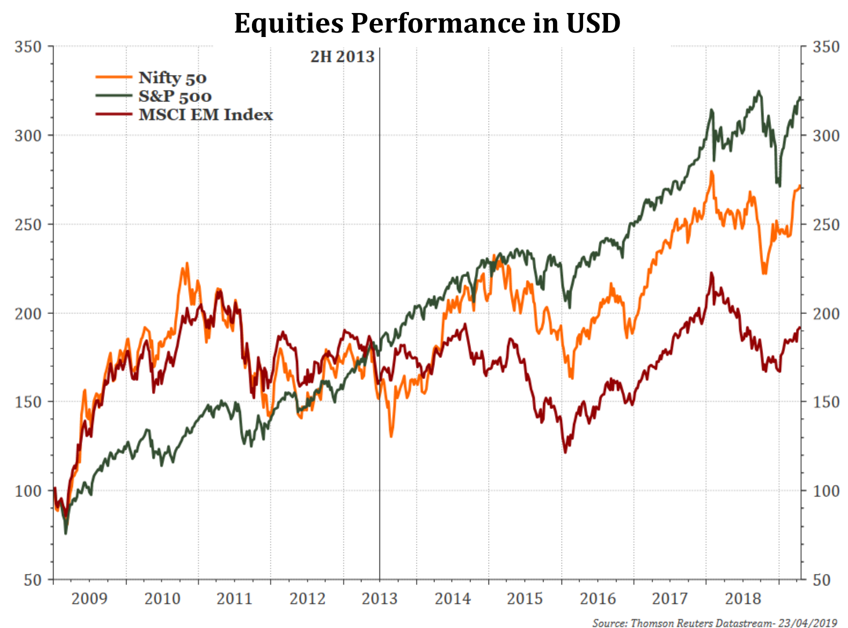
3.3.2. Indian Equities – Looking Ahead

Our outlook for Indian equities is positive, and supported by a variety of market focused, short-term factors, which complement the more structural, demographic-driven, long-term factors.

In the **short-term,** the EM complex has benefitted from renewed portfolio investment flows. Indian equities have underperformed other EM benchmarks such as China's CSI 300 on **tepid investment demand ahead of the general elections**, suggesting that any positive result or alleviation of event-risk fears could act as an upside catalyst to equity prices. India's more insular, consumption-focused economy also supports the outlook for equities, as earnings should be better protected from global risks such as Sino-US trade tensions. An outright trade war between the USA and China may even support some Indian industries, such as textiles, although would likely be a net headwind to asset prices given risk-off investor sentiment (which is more pertinent to asset prices).



In the **medium-term**, Indian equities show good price momentum, and have been a clear outperformer relative to the broader MSCI Emerging Market Index since 2013. Equity performance has been underpinned by **robust economic growth, a central bank which has been highly proactive in injecting liquidity into domestic markets** through multiple channels, and **new policy reform which will continue to improve credit conditions** and growth. Economic policies will also likely continue to support the fiscal health of the government and lead improvements to the state of the banking sector. These fundamental factors may help India continue to demonstrate superior economic growth relative to peers, which would support earnings and the performance of asset prices.

In the **long-term**, we see a healthy growth story arising from **structural demographic trends of improving average wealth**, the implementation of **productivity-improving technology**, and **improvements in business practices** due to better corporate governance and economic liberalisation (increasing in rank by 56 places since 2009, to be the 77th rated country for ease-of-doing-business in 2018). With over 47% of the working population employed in full-time agriculture in 2012, it is undeniable that structural trends in education and technology suggest *future growth*, whereas the low-base from which India is starting suggests *fast growth*.

Indian equity markets, as represented by iShares MSCI India ETF, is comprised of 23% Financial Services, 18% Technology and 14.7% Energy. These sectors, being higher-beta and more cyclical in nature, would be the biggest beneficiaries of a post-election rally and will provide better upside

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exposure in the context of a tactical equity buying opportunity moving into 2H 2019. Financial Services, the biggest single sector, is also well positioned for future growth due to policy reforms.

However, despite the positive outlook, expensive valuations on both a relative and historical basis remain a key concern for investment at this juncture. Other longer-term issues, such as currency controls, concerns over central bank independence, and restrictions to FDI due to infrastructure limitations all hurt foreign investment into physical domestic assets.

3.3.3. Investing in India Equity ETFs

Although the Indian domestic ETF industry hosts a wide variety of products, spanning various sectors and strategies, we have selected five offshore ETFs (all domiciled in the USA) which we believe provide an easy way to gain exposure to India for non-domestic investors. All the below ETFs have large Total Net Assets and are relatively liquid instruments. The first three on the list focus on Large-Cap stocks, while the bottom two are more Small-Cap focused.

Instrument Description	Ticker Symbol	Physical vs Synthetic	Total Expense Ratio (%)	Total Net Assets (USD)	Number of Instruments	Price Earnings Ratio *	Forward Price Earnings Ratio *	Top Ten Holdings % of Total Net Assets
WisdomTree India Earnings ETF	EPI	Physical	0.84	1,333,860,000	347	21.11	18.56	41.15
iShares MSCI India ETF	INDA	Physical	0.68	5,015,790,000	83	27.68	23.17	51.68
iShares India 50 ETF	INDY	Physical	0.92	824,837,500	56	27.50	22.67	57.07
VanEck Vectors India Small-Cap Index ETF	SCIF	Physical	0.80	185,498,601	198	24.53	16.45	16.84
iShares MSCI India Small-Cap ETF	SMIN	Physical	0.77	276,289,500	265	34.61	24.00	15.91

Instrument Description	Income Distribution Indicator	Dividend yield %	% Change from 52-week High	% Change from 52-week Low	Std Dev 5-yr	Drawdown 5-yr	Year-to-Date Performance
WisdomTree India Earnings ETF	Paid	1.03	- 4.96	19.37	18.81	- 28.89	5.72
iShares MSCI India ETF	Paid	0.90	- 3.17	21.20	17.14	- 26.82	6.60
iShares India 50 ETF	Paid	0.55	- 2.40	21.62	17.45	- 28.12	7.45
VanEck Vectors India Small-Cap Index ETF	Paid	0.12	- 28.44	15.93	28.62	- 43.80	1.02
iShares MSCI India Small-Cap ETF	Paid	2.84	- 20.81	17.97	22.48	- 32.19	1.86

** Price Earnings and Forward Price Earnings Ratios of greater than 200 were excluded as outliers in the above calculation.*

***Source:** Refinitiv, 25 April 2019*

Indian equities trade at a slight premium in terms of current Price/Earnings ("PE") ratios relative to the S&P 500. Valuations indicate that investors are willing to pay approximately 30x current earnings for the Nifty 500 (the larger, more diversified counterpart of the Nifty 50), whereas investors currently pay about a 20x multiple for the S&P 500.

In addition to being **expensive relative to EM peers, both forward and current Price/Earnings ratios are high relative to historical multiples, excluding the extreme pre GFC levels**. Forward Price/Earnings ratios have clearly increased, while dividend yield has been relatively stable.

Despite these comparatively expensive valuations, Indian equities have demonstrated strong medium-term performance. Since the GFC, Indian price returns have beaten the broader EM Index but underperformed the S&P 500. The Nifty 50 demonstrated its most stark divergence from EM prices after 2013, when China started to lag.

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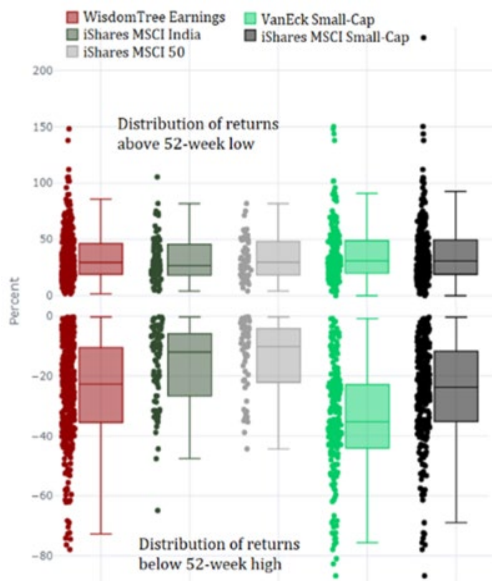

When assessing the distribution of returns relative to 52-week highs and lows across the various holdings of ETFs, it is clear that Small-Caps have more extreme performance than Large-Cap stocks (as seen by a greater variation in distribution). Comparatively, Small-Cap stocks have performed worse than larger cap stocks as the distributions of returns shows a greater negative mean below their 52-week highs and a similar positive mean above their 52-week lows.

For greater granularity, we look at 21 most prominent single stocks held across the three Large-Cap focused ETFs. This basket of stocks accounts for 52% of the WisdomTree Earnings India Fund, 60% of the iShares MSCI India ETF, and 71% of the iShares India 50 ETF.

Valuation Metrics for our basket of 21 Prominent Stocks (simple average)

It is also worth noting that **only about 50% of revenues of these stocks (where data was available) originates from within India.** India's strong invisibles sector is demonstrated by the fact that the two largest IT companies in our basket, Infosys and Tata Consultancy, only generate 3.2% and 6.4% of revenue from domestic sales, respectively. The data on the next page suggests that Indian equities are relatively unattractive from the perspective of yield generation when compared with the S&P 500 and the iShares China ETF.

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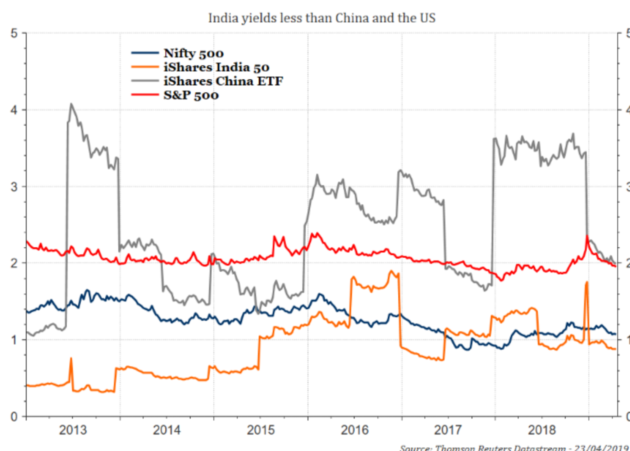
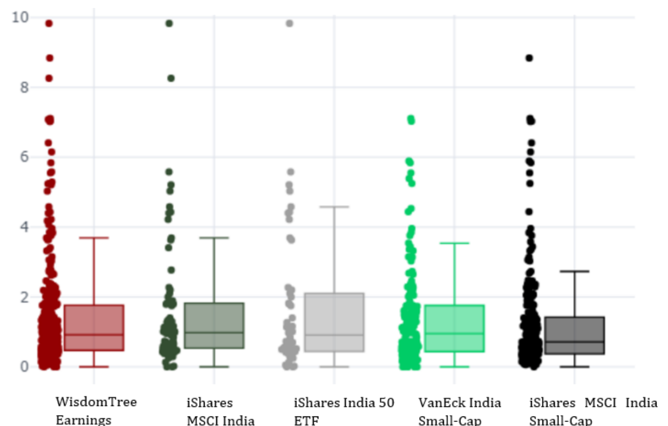
Single stock	Sector	Percentage holding of each stock by ETF			
		WisdomTree India Earnings Fund	iShares MSCI India ETF	iShares India 50 ETF	Domestic revenue as % of total
Reliance Industries Ord Shs	Energy	9.64	11.07	9.74	49.0
Housing Development Finance Corp	Financials	8.49	9.48	7.01	n/a
Infosys Ord Shs	Information Technology	7.74	8.09	6.45	3.2
Tata Consultancy Services Ord Shs	Information Technology	3.31	5.63	4.82	6.4
ICICI Bank Ord Shs	Financials	2.25	2.63	5.21	n/a
ITC Ord Shs	Consumer Staples	1.31	2.98	5.47	87.0
HDFC Bank Ord Shs	Financials	-	-	8.11	n/a
Hindustan Unilever Ord Shs	Consumer Staples	1.12	3.55	2.86	96.0
Larsen And Toubro Ord Shs	Industrials	0.88	1.94	3.69	67.0
Maruti Suzuki India Ord Shs	Consumer Discretionary	1.37	2.28	2.10	93.0
Kotak Mahindra Bank Ord Shs	Financials	1.39	-	3.74	n/a
HCL Technologies Ord Shs	Information Technology	1.90	1.80	1.36	3.9
Mahindra And Mahindra Ord Shs	Consumer Discretionary	1.34	1.52	1.39	64.0
Indian Oil Corp Ord Shs	Energy	2.38	0.86	0.81	100.0
Oil And Natural Gas Ord Shs	Energy	2.30	0.66	1.06	100.0
State Bank of India Ord Shs	Financials	-	1.51	2.33	n/a
Tech Mahindra Ord Shs	Information Technology	1.11	1.23	1.20	5.8
Wipro Ord Shs	Information Technology	1.20	1.32	0.97	9.3
Yes Bank Ord Shs	Financials	1.24	1.25	0.99	n/a
Power Grid Corporation of India	Utilities	1.23	1.06	0.97	n/a
Vedanta Ord Shs	Materials	1.83	0.69	0.73	58.0
Summarised		**52.00**	**59.56**	**71.03**	**53.0**

We see scope for Small-Cap stocks to outperform Large-Caps amid a recovery in domestic credit conditions and improvements in higher frequency indicators such as PMI readings. However, we remain aware of the key risks as discussed throughout this report.

Dividend Yields between Countries



Dividend Yields of Indian ETFs



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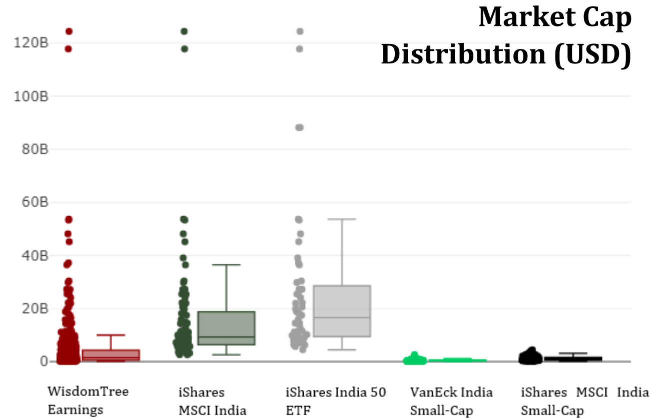

In our view one of the better ETFs to own to get broader Indian exposure, which includes both large, mid and smaller cap stocks, is the WisdomTree India Earnings Fund. It has a larger number of constituent holdings (>300), with its top 10 holdings representing 41% of the total assets (comparatively less than the two Large-Cap focused ETFs). It has experienced a slightly higher standard deviation and drawdown over the past 5 years. The WisdomTree India Earnings Fund is also less exposed to the financial services sector (24% compared with 39% for the iShares India 50 ETF) but does provide higher energy sector exposure at 20% compared with 13% for the iShares India 50 ETF. A downside to this ETF is the Expense Ratio which is quite high for an ETF at 0.84%.

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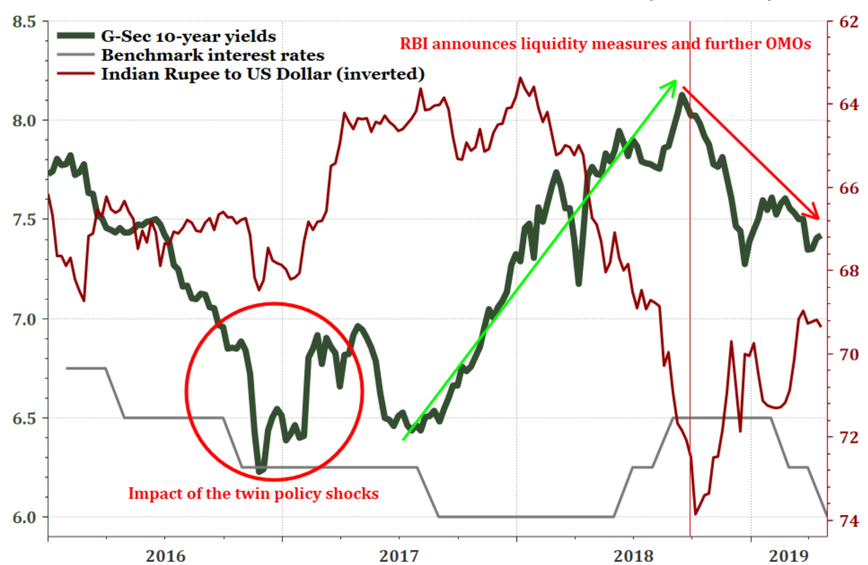
3.4. Government credit (fixed income)

3.4.1. Recent trends in government bonds

With INR 83.8 trillion (c. US$ 1.2 trillion) of outstanding debt in the form of bonds, the Indian central government enjoys an Investment Grade Baa2 rating from Moody's, a BBB- rating from Fitch, and a BBB- (stable) long-term rating from S&P for both foreign and domestic credit i.e. right on the cusp of "junk" but still Investment Grade and has been around this rating for many years. India has maintained a stable 41% debt-to-GDP ratio since 2010 and has been able to raise an increasing amount of external debt in global capital markets.

Indian government bond ("G-Sec") yields have been steadily falling since 3Q 2018 as bond prices have risen. Bond prices move in an inverse relationship to yields. We expect G-Sec yields to continue to fall, along with a broader flattening across the term structure. The fall in government funding costs (i.e. yields) started in September 2018 and was supported by the actions of the RBI, such as the unlocking of approximately INR 2 trillion worth of liquidity in the banking sector through a 2% cut in reserve requirements, the announcement of further Open Market Operations, and a rescue plan for the distressed IL&FS non-bank lender.

Lower Yields since RBI intervention (2H 2018)



Source: Thomson Reuters Datastream - 23/04/2019

Prior to the recent fall, G-Sec 10-year yields experienced a 13-month rise from 6.4% in August 2017 to a peak of 8.13% in September 2018. The move saw the biggest quarterly increase in yields since 2013 and was precipitated by **(A) <u>a spike in headline inflation expectations</u>** on higher oil prices (fuel inflation) and **(B) <u>fears of fiscal slippage</u>** on poor indirect tax collection after the introduction of the Goods and Services Tax. Slippage in the fiscal deficit would imply greater G-Sec bond issuances and higher government borrowing costs. Bond prices fall as the total supply of debt increases, while yields would need to rise (i.e. the market-priced cost of borrowing) in order to encourage the marginal creditor to fund the debt expansion. A few months into the trend, yields were further boosted by **(C) <u>interest rate hikes by the RBI in a bid to protect the strength of the Rupee</u>** in the face of **(i)** tighter US interest rates; and **(ii)** INR selling pressure due to the trade burden of importing expensive US Dollar-denominated oil. The RBI hiked rates by 25bps in each of the June and August 2018 meetings, the first two consecutive rate hikes since 2013. It is worth noting how the 2016 twin policy shocks of demonetisation and the Goods and Services Tax drove a temporary spike in yields in 4Q 2016.

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We expect lower yields due to the reversal of the previous 3 factors (A, B and C) and OMOs

(1) **Lower inflation:** Consistent underperformance in headline inflation since November 2018 will give the RBI scope to cut interest rates further.

(2) **Fiscal slippage:** Improvements to indirect tax collection combined with continued government spending discipline will limit fiscal slippage and mitigate government debt expansion.

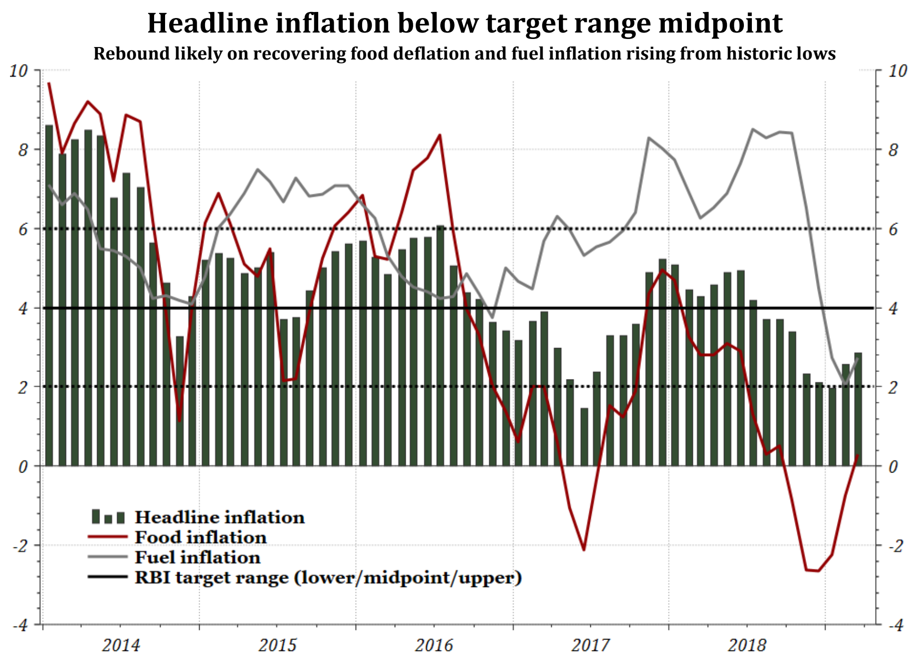
(3) **Loose Monetary Policy amid a stable Rupee:** A more stable Rupee reduces the need for the RBI to use monetary policy to protect the exchange rate given **(i)** a policy reversal by the US Federal Reserve and **(ii)** lower oil prices which reduces the import burden of selling INR to fund US$ oil purchases. Recent upticks in the oil price due to US sanctions on Iran could pose a risk.

(4) RBI's commitment to continue buying government debt in **Open Market Operations ("OMOs")** in a bid to inject liquidity into the banking system.

Driver 1: Headline inflation remains below RBI target range midpoint

Despite the 2018 concerns which drove yields higher, headline inflation is now well below the RBI's 2%-6% target range midpoint of 4%, at just 2.57% for February 2019. Persistently disappointing inflation numbers were cited as one reason for the February and April 2019 rate cuts, although we expect a modest recovery through 2019. The unusually soft inflation has been driven by structural food disinflation (decreased inflation) since 2014 which recently moved into outright deflation (falling prices).

Food prices, and thus headline inflation, could recover through 2019 given adverse weather conditions towards the end of 2018 which impacted planting of crops. The IMF opines that 60% of the recent fall in headline inflation can be attributed to weak fruit, pulses, vegetable, and sugar prices. Studies show that rural Indian consumers may spend 60-80% of income on food[9]. Although the rural economy has been supported by a boost in private consumption thanks to lower food costs - as well as the broader economic benefits of lower funding rates given RBI rate cuts - weak agricultural prices act as a net headwind to GDP growth due to the detrimental impact on farmer productivity and rural wage growth. Headline inflation has also declined due to moderating oil prices in 4Q 2018.



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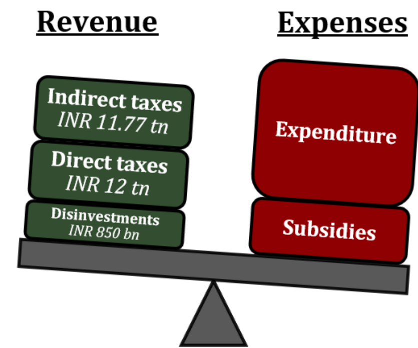
Driver 2: Indirect tax recovery proved fears of fiscal slippage were overstated

In the budget equation for the 2018-19 fiscal year, fears of fiscal slippage arose primarily from indirect tax (consumption tax) concerns. We expect minimal slippage from the 3.4% of GDP deficit guidance.

Indirect tax growth improved significantly in the fiscal year finishing 31 March 2018 on record high collections of INR 11.77 trillion (vs. a target of INR 11.44 trillion). Indirect tax growth has been more volatile as businesses adjusted to the new GST tax code.

Direct tax receipts (income tax, corporate tax) are healthy and exceeded budgeted expectations at INR 12 trillion (vs. a target of INR 11.5 trillion).

Government **disinvestments**, such as the partial privatisation of state-banks, underperformed slightly relative to budgeted targets but are not a key concern.



**Not to scale, excludes other contributors*

Sensitivity of bond yields to fiscal slippage

Bond markets have a high degree of sensitivity to any risk of fiscal slippage, as observed on 1 February 2019 when 10-year yields rose +13bps (the biggest daily rise in 2019) after the announcement of the interim budget proposal. The interim budget[10] was populist in nature and included relief for farmers and middle-class individuals. The support measures were partly intended to provide aid to rural regions that have been struck by persistent weakness in food prices, although cynics suggest the populist move was an attempt by the Modi government to canvass support ahead of the general elections. The interim budget proposal was later passed by the Lok Sabha (lower house) but has been met with mixed reviews.

Driver 3: Further Reserve Bank of India interest rate cuts

The RBI surprised economists by shifting its policy outlook from one of "calibrated tightening" to "neutral" earlier in the year and has since cut the benchmark rate twice by a total of 50bps to 6.0%. The RBI claimed the policy change was due to growth concerns and persistent disappointment in headline inflation. Markets anticipate another 25bps cut at the next MPC meeting in June 2019, after the conclusion of the general elections. Forecasts suggest a total of three 25bps cuts in 2019 – "front-loaded" over the 1H 2019 – but with possibilities of a fourth cut later in the year if growth concerns worsen. A tighter trade deficit due to lower oil prices helps to support the Rupee by alleviating US Dollar import costs, giving the RBI more scope to cut as it reduces the need to protect the exchange rate through higher interest rates.

Driver 4: The RBI to continue Open Market Operations

G-Sec bond prices are further supported by the RBI's commitment to continue buying government debt in Open Market Operations ("OMOs") in a bid to inject liquidity into the banking system. As of January 2019, the RBI had already purchased INR 1.9 trillion (US$ 27.4 billion) worth of debt over the 2018-19 fiscal year[11]. The tight supply of government debt helped drive a rally in bond prices which translated into lower yields. The RBI committed to extend OMOs to at least INR 3.38 trillion (US$ 48.9 billion) over the 2019-20 fiscal year, which will further support the supply/demand dynamic and continue to provide relief to domestic credit markets.

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3.4.2. Key risk: Inflation surprise from rebounding food prices

Any surprise to headline inflation above the RBI's target range would almost guarantee expectations of tighter policy rates. Although all economies are sensitive to inflation risks, India is especially exposed to spikes due to the volatile nature of food prices as it is the largest single component of rural CPI. We also note the disparity between headline inflation and core inflation. "Headline" inflation encompasses all goods and services while "core" inflation excludes more volatile components such as food and energy.

Core inflation measured 5.4% in January 2019[12], which is close to the upper limit of the RBI's target range, despite headline inflation being much lower. The central bank stated that it will focus on the more volatile headline inflation due to the broader impact on the rural economy. We expect headline and core inflation rates to converge as headline inflation recovers to 4%.

Indian food prices are exposed to the unpredictable, and potentially severe, impact of bad monsoon seasons (July-to-September) due to the geographical location of the country and the country's dependence on domestic production.

3.5. Corporate credit (fixed income)

While corporate credit benefits from falling yields on G-Sec bonds, the spread between corporate and government debt reflects various domestic risks. Recent financial reforms and liquidity provisions by the RBI have supported lending and credit growth, and we believe that improvements in the domestic banking sector will permeate the economy to the benefit of corporate borrowers.

Highly relevant to corporate borrowers is India's shadow banking sector as non-bank lenders accounted for 28% of corporate debt holdings as of July 2018[13]. Much of this credit is supplied by so-called Non-Bank Financial Companies, which have been systemically important to Indian economic growth over the last three years. To provide some context, 41% of total Indian domestic credit growth came from NBFCs in the fiscal year ending 31 March 2018. Nearly a third of shadow banking loans are for the financing of home ownership[14], although other industries have become increasingly reliant on NBFCs. Non-bank lenders have acted as a substitute for India's large state-owned banks which have been plagued by an epidemic of NPAs and balance sheet stress for the past four years.

The table below shows the average yield-to-maturity (%) on outstanding debt for some of the largest Indian corporates. Below, 7 of 8 of the selected names had outstanding debt in excess of INR 300 billion (US$ 4.3 billion) that was almost exclusively issued in INR (below shows only INR bonds).

	S&P rating*	2019	2020	2021	2022	2023	2025	2026	2027	2028	2032
Axis Bank Ltd	BBB+			8.00	8.00	8.10	8.20	8.30		8.50	
Reliance Industries Ltd	BBB+		7.70		7.90					8.60	
ICICI Bank Ltd	BBB-	7.00	5.40	4.80	8.00	8.50	8.20				
Kotak Mahindra Prime Ltd	BBB-	8.10	6.40	7.60					8.60		
State Bank of India	BBB-			7.10	7.30		8.10			8.30	
Mahindra and Mahindra Financial Services	NR	8.40	8.30	9.30		9.30			9.50		9.50
HDFC Bank Ltd	NR				7.30		8.50	8.40	8.40	8.40	
Housing Development Financial Corp Ltd	NR	7.90	8.00					8.60		8.60	

*Domestic long-term issuer rating

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The next table shows the average yield-to-maturity (%) for all (excluding outliers) Indian corporate bonds issued in US Dollars for issues sizes in excess of US$ 100 million. Most were natural resources companies. When comparing these two tables, you can see that the yield-to-maturity of US Dollar denominated debt is approximately 4% lower than those of Rupee denominated debt - reflecting the differential in short-term interest rates and the implied cost to currency hedge INR bonds for US Dollar-based investors.

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2035	2045
Investment Grade	3.23	3.50	3.56	3.88	3.84	3.97	4.31	4.65	4.40	4.58	4.61	4.53	4.75
High Yield	4.74	4.50	5.92	5.24	4.97	6.13		5.60	5.72				

3.5.1 Comparing corporate and government credit

Since the GFC, Indian credit markets have grown at an average annual rate of 34%, increasing in market size faster than equities, with the combined growth rate of the two markets in excess of 24% for the same period. Credit markets have benefitted from the relaxation of restrictions on foreign capital (particularly in 2014 and September 2018) although much is still to be desired. Reflecting its greater liquidity and attractiveness to foreign investors, government debt comprises the largest single segment of the Indian fixed income market. Government bond and bills accounted for 45.9% of the INR 135.6 trillion (c.US$ 1.95 trillion) Indian debt market as of January 2019, while corporates only accounted for 29.2%, and State and Municipalities accounted for 18.3%[15].

Government and corporate bond markets are quite different in terms of issuance trends. The majority of government debt exists in the form of longer-term, fixed-rate bonds, with INR 56.6 trillion (c.US$ 813.6 billion) outstanding, as opposed to the smaller sub-segment of short-term government bills, with INR 5.7 trillion (c.US$ 81.9 billion) outstanding.

Meanwhile, trends in the corporate bond market are quite different and are hallmarked by the issuance of a vast number of smaller-valued bonds, almost always through private placements (95.7% of outstanding bonds were privately placed). **Corporates have issued over 12,000 bonds and have an average outstanding amount of INR 3.7 billion (c.US$ 53.2 million), with 77.5% having a maturity greater than one year. The median issue amount for corporates is about INR 500 million (c.US$ 7.2 million) – quite different from much larger, more liquid government bond issuances**, as observed in the FTSE SBI Bond Index, which tracks 70 government bonds at an average value of INR 754 billion (c.US$ 10.84 billion). As such, a mass influx of investment into corporate bonds remains unlikely as the fragmented, opaque, and concentrated nature of the market makes it relatively unattractive for foreign portfolio investment.

Corporate borrowing is also hindered by credit ratings, as very few listed companies have enjoyed Investment Grade ratings. Of the 27 firms rated by Standard and Poor's, only Tata Consultancy Services, Infosys, Wipro, and Reliance Industries (all included in our basket of 21 most prominent stocks previously noted) are rated higher than Indian sovereign debt.

Given the current state of corporate credit markets, the Indian government has been outspoken in its desire for greater economic liberalisation and more open issuance practices. For example, the Securities and Exchange Board of India ("SEBI") now expects listed companies with over INR 1 billion (c.US$ 14.4 million) of outstanding borrowings and a **domestic rating** of AA-or-higher to raise a minimum of 25% of new debt through corporate bond markets[16] - expected to amount to INR 400-500 billion (c.US$ 5.75-7.2 billion) of additional issuances over the next five years[17]. It is important and interesting to note that the domestic ratings in India are substantially different to the more well-known credit ratings from

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Moody's, S&P and Fitch. The RBI also placed new, although relaxed, restrictions on foreign investment into corporate bonds in May 2018 - only to completely remove them in September 2018 in a bid to contain the domestic liquidity crisis through the allowance of greater foreign liquidity.

The RBI currently limits aggregate foreign ownership to 6% of outstanding government debt for the fiscal year 2019-20[18]. Other rules were relaxed in May 2018, such as the removal of a ban on foreign buying of any government bond with a maturity of less than 3 years. Currently, no more than 20% of a portfolio of Indian debt can be invested in bonds with a maturity of less than one year and no single security can account for more than 30% of the total portfolio value. Prior to 2014, overseas investors were not allowed to hedge currency risk on Rupee-denominated government bonds through onshore means and were limited to the use of offshore Non-Deliverable Forwards markets.

3.5.2. Key risk: Slowdown in shadow bank lending

India's fixed income markets have developed significantly, supported by a number of factors including increasing financial literacy and demonetisation, which resulted in a significant rise in retail investment into savings products and mutual funds. The large influx of capital into mutual funds was deployed by managers through investment in domestic money markets – pushing down short-term lending costs amid an abundance of liquidity. This huge amount of liquidity in short-term debt instruments allowed NBFCs to borrow cheaply and effectively act as a substitute for conventional banks which had been hamstrung by bad debt. As discussed earlier, defaults by non-bank lenders prompted the 3Q 2018 liquidity crisis in Indian credit markets, which resulted in a 14% fall in the Nifty 50 (peak-to-trough). The debt market squeeze began in September 2018 when IL&FS, a large real-estate-focused NBFC, began defaulting on the US$12.6 billion[19] debt carried by the AAA-rated (by Indian standards) credit company. Less than four weeks after the event, IL&FS credit was downgrade to "D" for Default. The liquidity crisis spread through the shadow banking sector and resulted in a string of non-bank defaults. NBFCs were the worst affected as they carried the most risk, operating in a deregulated space. However, publicly traded banks were also hurt, as **ICICI Bank Ltd** (India's largest non-state-owned bank) and **Housing Development Finance Corp** fell 8.95% and 7.52%, respectively, over September 2018. **Housing Development Finance Corp** and **ICICI Bank Ltd** are two of the largest holdings in the iShares MSCI India ETF at 9.48% and 2.63%, respectively. Credit conditions tightened as 4Q 2018 saw the largest quarterly rise in 10-year G-Sec yields since 2013 and year-on-year growth in *net bank credit to the commercial sector (M3)* fell 15.9% between 3Q 2018 and 4Q 2018.

Proactive government intervention in the form of direct support to IL&FS, and liquidity injections into debt markets, contained the crisis but sluggish NBFC lending could be a drag on the economy. As part of the rescue plan, the finance ministry invoked Section 7 of the act governing the RBI for the first time ever, which **permitted the government to give direct instructions to the central bank**. **This, along with a large dividend payment from the RBI directly to the Modi government, and the abrupt resignation of the former central bank governor in December, has raised concerns regarding the issue of central bank independence.**

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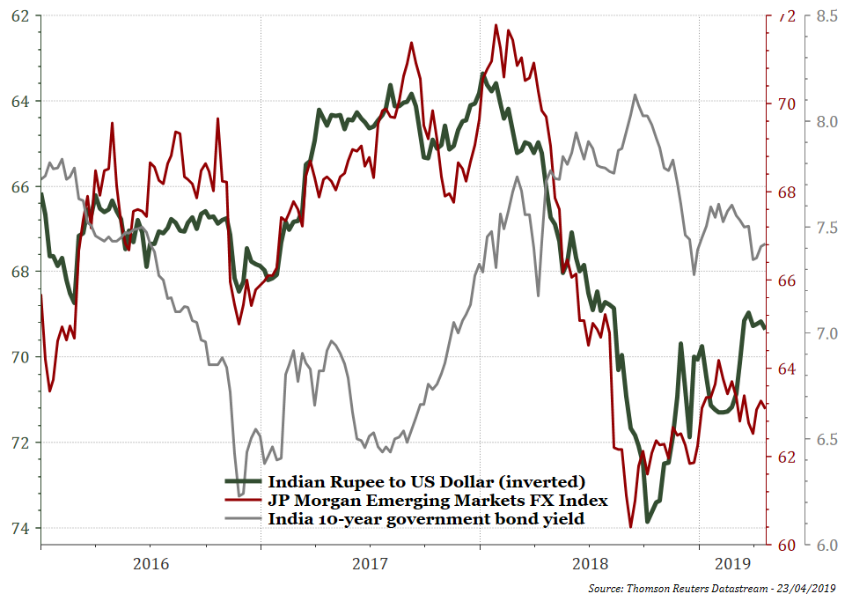
3.6. Rupee Outlook

The Indian Rupee, like many EM currencies, has experienced long-term depreciation against the US Dollar in line with traditional economic models of Purchasing Price Parity and Inflation Parity. The Rupee touched all-time lows of 74.5 to the US Dollar in November 2018 and was the worst performing Asian currency in 2018. The Rupee has since recovered to around 69.2 to the US Dollar, a 7.07% appreciation from the November 2018 low.

Indian Rupee strength since 4Q 2018



Although we see Fed policy and global economic conditions as the main driver supporting the appreciation of EM currencies vs. the US Dollar, the general election remains the greatest isolated risk to Rupee appreciation. USDINR implied volatility covering the April-May 2019 election dates, indicates higher event risk being priced in, also partly explaining the recent Rupee underperformance to EM peers. We expect the Rupee to appreciate further although the RBI may limit upside in 2019 through tactical selling as it attempts to replenish its foreign currency reserves.

The Rupee is not an easily convertible currency as it is subject to strict exchange controls, a policy which often hinders foreign investment into physical assets. The government increased restrictions on moving Rupees out of India after concerns of capital flight in 2013, and Indian firms are limited in the amount they can invest overseas. Although it is a free-floating exchange rate, the RBI frequently intervenes in order to dampen USDINR volatility. Thus, the majority of Rupee speculation occurs through Non-Deliverable Forward ("NDF") markets, which are over-the-counter trading venues that help bridge the gap between onshore and offshore markets, where pairs are settled in the non-Rupee currency. Part of the recent Rupee strength can also be attributed to an INR short position squeeze as the USDINR NDF market adjusted for expectations of less Rupee selling given a smaller trade deficit and lower oil prices. The largest hubs for INR NDF trading are London and Singapore. The INR NDF market was estimated at over US$ 16 billion in 2016, with 35% of all NDF trading stemming from BRIC currency pairs.

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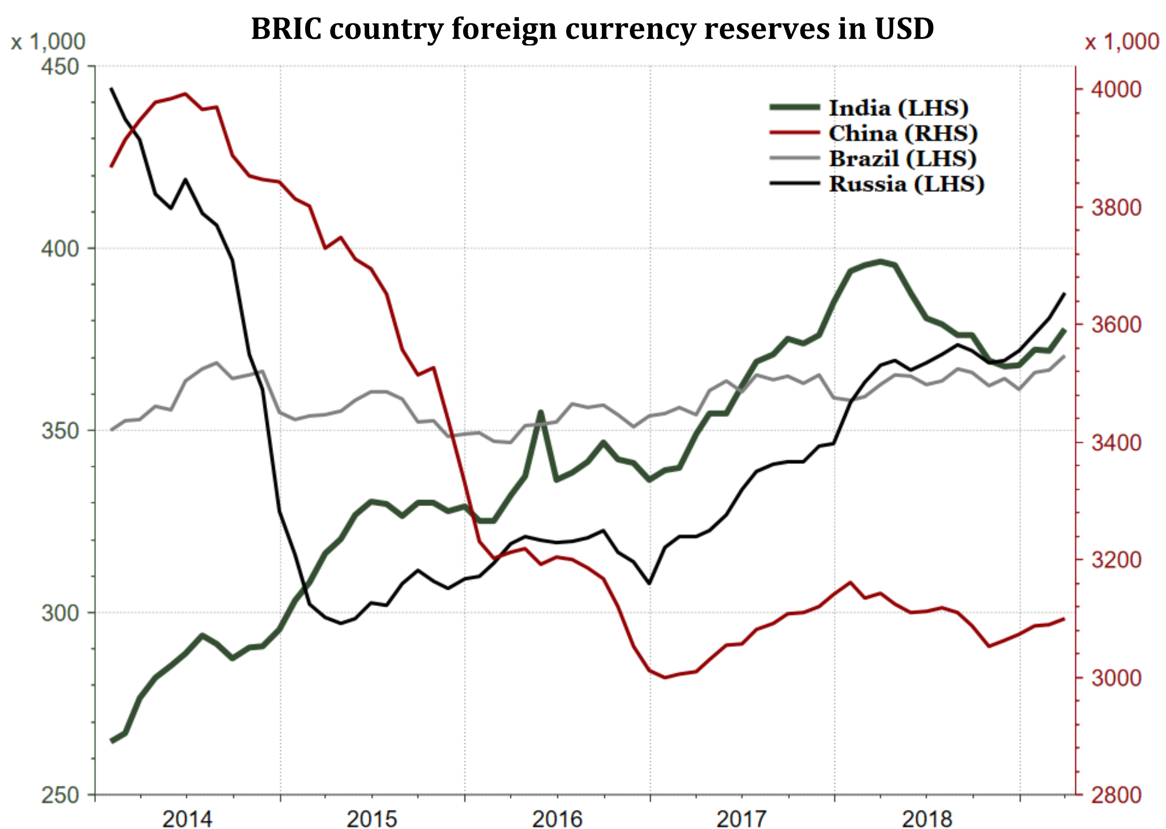
Driver 1: International investment flow into EM currencies

A 28 March 2019 Reuters poll of FX positioning[20] suggests that investors have been net long Rupee against the US Dollar for the past two months, after being net short since at least October 2018. The Rupee outperformed the JP Morgan EM FX Index by 2.08% year-to-date, as renewed foreign investment lifted the Rupee from being the worst performing Asian currency in 2019 to the best over the course of only 5 weeks. Moderate relief to election anxieties supported Rupee performance in India to the extent that borrowing US Dollars to fund Rupee purchases earned 3.8% in March 2018 and was the best carry-trade in the world over the past month[21]. EM currencies will likely benefit from a more optimistic global growth outlook, whereas a slowdown would drive investment into assets domiciled in more developed economies. Thus, a global de-risking environment would likely weaken the Rupee along with other EM currencies.

Driver 2: The RBI will likely limit Rupee upside

The RBI may use Rupee strength as a tactical opportunity to replenish foreign currency reserves through selling INR and buying USD. Foreign reserves are an important policy tool in protecting the exchange rate, as the RBI has demonstrated through recent actions. As the RBI sold US Dollars from its foreign reserves in a bid to protect the Rupee in the 2H 2018 slide, reserves fell by about US$ 30 billion (to December 2018) after peaking at an all-time high of US$ 396 billion in March 2018. Indian foreign reserves are comparable to other BRIC countries, except for China, where foreign reserves exceed those of India by more than 7x.



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4. Is India the next China?

Comparisons between China and India are frequent - the two bordering, emerging economic powerhouses share many similarities, yet are worlds apart in many respects. Since the end of World War II, regional peers in South East Asia have all grown at different rates and have experienced a divergence in socio-economic structures. India shared GDP per capita levels similar to those of the "Four Tigers" (South Korea, Hong Kong, Singapore, Taiwan) in the 1950s and even exceeded that of China until 1984. However, today, China's GDP per capita is 4.6x that of India. Unfortunately, India has simply not been able to match the pace of the best Asian economic performers.

Between 1961 and 2017, GDP per capita expanded by the following multiples for these Asian countries: China 51x, *Singapore 15x, Hong Kong 10x, Thailand 9x,* ***India 5x,*** *Indonesia 5x, Japan 4x, Pakistan 3x, Philippines 2x.*

China, now the world's second largest economy, is exemplary in terms of how a government is able to engineer unprecedented wealth growth and pull hundreds of millions of people out of poverty. Although global trends point to higher average wealth, better levels of education, and industrialisation in all nations, there are still remarkable differences between the effectiveness of differing growth strategies. It is in this area that India and China remain dissimilar. In this section, we look at the starting inputs, socioeconomic factors, and the government and societal structures that resulted in such different performances between the world's two most populous nations.

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Although we are sure of the direction in which India is moving, given the capacity of millions of citizens who are likely to head towards middle class status, there is a good chance that it will never be able to enjoy the same growth rates experienced by China. Trends in mechanisation and factory automation could mean that India may have missed the opportunity to replicate China's growth story and it will now need to find its own path to greater economic prosperity.

4.1. China's successes and India's challenges

India was unable to increase agricultural efficiency like China

If you want a country to grow quickly, you need to provide productive jobs. Jobs in manufacturing are the most profitable and can be relatively low in capital intensity and easy to develop. However, before deploying the investment capital to pay for the factory, you need to make sure you have the human capital to operate it. The first thing China did far better than India was to move large numbers of workers out of full-time agricultural jobs and into factories.

India has benefitted from several agricultural reforms which decreased rural poverty, such as the elimination of the "Zamindar" intermediaries between rural farmer and state. However, despite making dramatic improvements in reducing rural poverty, much was left to be desired as policy implementation in India was never able to increase farming productivity at a rate comparable to those achieved in China. One of the main reasons for this is that Indian farmers have faced structural limitations to competition and productivity due to long-term agricultural subsidies provided by the Indian government.

China was able to effectively reform agriculture through the launch of the Household Responsibility System (HRS) in the early 1980s, which replaced the egalitarian communal farming teams with individual households. The policy gave increased autonomy to individuals, aligned individual incentives with higher farming efficiency, and was introduced alongside marketisation that allowed the sale of crops in a more free-market. The incentive of competition forced some farmers into new lines of work, while improved labour allocation subsequently pushed down food prices and wages. The benefits of this reform have been widely documented in literature and helped to sharply reduce the number of full-time agriculture labourers. Annual increases in Chinese agricultural productivity averaged 7.7% between 1978 and 1984.

The ratio of the Chinese population in full-time agricultural work was 54.3% in 1994 compared to 60.5% in India. In the following 18 years to 2012, China reduced its agricultural labour ratio by approximately 20% while India's reduced by 13%. Only 34.8% of Chinese workers were employed in full-time agriculture in 2012 compared to 47.2% of Indian workers[22].

China is also more self-reliant on food production than India, as it has enjoyed a production-consumption ratio of roughly 1.0 for grains since the mid-2000s, whereas India has become increasingly reliant on rice imports. Major grain exporters like the US have a production-consumption ratio of grains between 1.5 -1.7[23].

India never increased competition (hence export competitiveness) like China

India's tightly controlled protectionist government prior to the 1991 economic liberalisation introduced a systemic lack of competition in the manufacturing sector. The centrally planned economy shielded manufacturing from international competition through systems of quotas, import tariffs, and complex licensing regulations which prohibited private companies from producing most goods.

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Similarly, China's experience with a centrally planned economy (like that of most nations) was highly disappointing. The experiences of the "Four Tigers" helped prompt economic liberalisation in China in 1978 (13 years before relaxations started in India). Although China boasted average annual growth rates of 5.8% from 1952 to 1978, many people remained under the US$ 1 per day (using purchasing power parity) poverty line. Due to agricultural marketisation and the HRS reform, China began to see large growth in so called "Town and Village-owned Enterprises" (TVE) as part of the economic liberalisation. TVEs are small, privately-owned businesses which grew in prominence by providing a new organisational structure for agricultural workers amid the HRS reform. TVEs were, importantly, allowed to go bankrupt and they often did so regardless of any partial state ownership[24]. Survival of the fittest resulted in much higher efficiency and was reflected by the fact that, between 1979 and 1991, TVEs grew at an average annual rate of 25.3% relative to State-Owned Enterprises ("SOEs") at 8.4%.

TVEs grew in size due to increased productivity (i.e. efficiency improvements) and only secondarily due to greater capital or labour input. It was efficiency, as opposed to direct investment, that was driving growth. In other words, investors were getting greater return on investment in China. The opposite was true in India, as studies show that productivity actually decreased in manufacturing due to poor incentive structures and lack of competition.

Chinese policy towards TVEs resulted in a more efficient allocation of resources over time. Increased efficiency of labour and capital allocation helped push TVEs from a small subsidiary of the agricultural sector into one of the largest sectors of the economy[25]. While industry size in India may have still risen over time, a long-term structural misallocation of capital has prevented India from being competitive in the export market relative to its regional peers. In stark comparison to India's globally uncompetitive merchandise export sector, the value of Chinese TVE exports amounted to US$ 94 billion in 1999, which was 48% of total exports[26].

Despite government intervention still being a key theme to Chinese industry, the notable shift in productivity trends between SOEs and TVEs resulted in government withdrawing from medium sized industries while remaining in "key, strategic industries". The Chinese government reduced barriers to entry for small business as it pursued a policy of "grasping the big and letting go of the small" – a stark difference to the Indian "License Raj" where government directly regulated all production. The overly complex economic policy framework in India resulted in huge amounts of business-hostile red tape and was aptly described as the "Byzantine system"[27]. As part of the divergence in policy, China began to formalise private enterprise as early as 1988 although private legal status was only officially established in 1998. Chinese liberalisation began years before liberalisation in India, which only gained real traction after the 1991 crisis.

China's industrial composition was more scalable than India's

The third area in which China outsmarted India was in creating manufacturing jobs that employ the greatest number of people and have the largest impact on national wage growth. As mentioned before, not all manufacturing jobs are created equal. Some pay more, others are more labour intensive. Some are more capital intensive - such as expensive, high-tech electronic factories. Low capital-intensive industries are easier to set up and can employ a large number of people, but they do not typically pay as well as higher-tech firms.

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Indian industry is much more polarised than China was at the height of its growth[28]. **Indian manufacturing is characterised as having 55% of all industrial sector employees working for low-tech, low capital-intensive, low labour-intensive and low productivity efficiency firms, of less than 10 people[29]. Dichotomously, while there is a large gap in employment in the space of medium-tech firms, India also has a greater proportion of large firms who employ over 500 people, and which operate in highly capital-intensive business areas. Notably there is a huge gap in the middle and is known as "the missing middle in India's manufacturing"[30].**

India's small companies are limited in scalability as they are just not labour-intensive enough, while larger firms face scalability issues often linked to higher capex needs and a lack of funding. High-tech firms face additional headwinds in India amid infrastructure concerns, which have restricted industry growth. Despite high-tech firms employing more people and paying more, they have just never reached the critical mass in India as seen in China.

High-tech manufacturing now amounts to 38.5% of Chinese export trade, while low-skill merchandise manufacturing such as cheap toys and leather goods accounted for less than 10% of exports in 2013. In contrast, primary commodities, precious stones, and non-monetary gold (like jewellery) accounted for 47.4% of India's total exports in 2013. Due to contemporary trends in mechanisation, historical limitations in improving efficiency in the industrial sector, competition from regional peers, and issues with infrastructure, it will be extremely difficult for India to achieve growth rates akin to China during its boom period.

Cultural diversity and Political framework

Another factor which continues to limit effective policy in India is the social diversity of the country. Policy implementation in democracies is a compromise between parties, and risks arise when a lack of political continuity occurs during leadership changes. India is "the world's largest democracy", and as one can expect there are substantial difficulties in balancing the concerns of 1.34 billion ethnically diverse people who speak 22 official languages and are defined by several castes and sub-castes. India is measured on the Goren cultural diversity index at 0.64 relative to China's 0.14[31].

To touch on the power of the Chinese government in policy implementation, it is of interest to remind readers of the "Up to the Mountains and Down to the Countryside Movement". This was a Chinese reform instituted in the 1960s and 1970s which "rusticated" approximately 17 million urban dwelling children and resettled them – often through coercion - into rural villages as part of planned reallocation of regional labour. These 17 million children are known as "the lost generation" in China.

Essentially, China has greater control over its people than India due to the way in which the country is run and its political structure.

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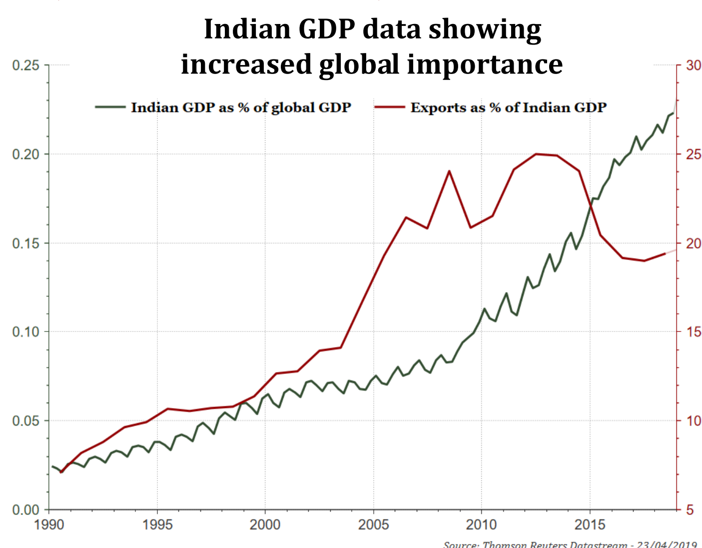
4.2. Comparative Data

	China	India
Capital City	Beijing	New Delhi
Government Type	Single-Party States	Parliamentary Republics
Population *(2015)	1,397,830,000	1,310,955,000
Total GDP (2018) in US$ trillions	10.80	2.73
GDP per Capita (2018) in US$	7,627.34	2,011.54
GDP % Chng Y/Y (2018)	6.58%	7.31%
Debt/GDP Ratio (2017)	16.42%	45.58%
S&P long-term issuer rating (foreign)	A+ (Sep 2017), STABLE (Sep 2017)	BBB- (Jan 2007), STABLE (Sep 2014)
Exchange Rate Regime	Managed	Floating
Labour force (millions)	776.4	527.42
Life expectancy (years)	76.25	68.56
Births per woman (2016)	1.62	2.33
Population growth rate, annual change (2016)	0.50%	1.15%
Primary education rate	99.50%	95.0%
Secondary education rate	95.03%	75.2%
Tertiary education rate	51%	27.5%
Literacy rate (over 15 y/o)	96.40%	69%
Gini coefficient	42.20%	35.10%
HDI ranking	91	135

Source: *Refinitiv, 2019*

5. India's Growth: The Past, The Present, The Future

Despite the previous comments, when compared to China, India is in the midst of a transformation; it is becoming more urbanised, industrialised, and globally integrated. It must be pointed out that prior to the 1991 Indian balance of payment crisis, national policy was totally averse to developing international trade relations or opening the economy to global markets. Policies were highly nationalistic, with great emphasis being placed on self-sufficiency. India showed low integration with the rest of the world, which limited economic growth given little trade openness and high barriers to entry for foreign investment and business.



After a slew of watershed policy reforms in the early 1990s, India's GDP growth rapidly accelerated as it gained market share of global trade. As the chart shows, Indian GDP rapidly broke above a 0.05%

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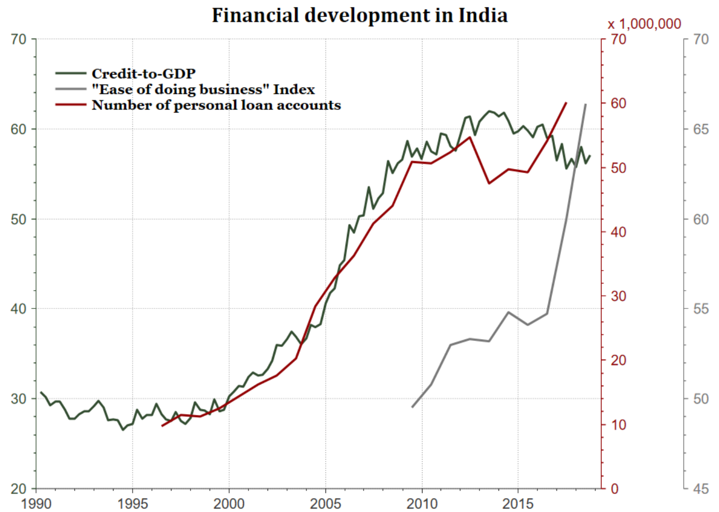
share of global GDP after decades of sluggishness. It must also be noted that exports contribution has since quadrupled, from accounting for less than 10% of Indian GDP in the previous decades.

Studies have shown a strong causal link between trade openness and GDP growth[32], and the rapid expansion of the Indian economy can largely be attributed to increased global integration. The chart shows that the 1990s were also an inflection point for Indian financial development, as measured by the credit-to-GDP ratio and number of personal loans. India is now highly integrated with the global economy and the correlation between domestic GDP growth and global GDP growth has increased from less than 20% to above 60% since the year 2000.



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5.1. 1991-2003: Crisis Causes Change

After imports began to swell in 1985, India began to run both a trade deficit and a large government fiscal deficit. A lack of fiscal discipline by the government saw Indian foreign exchange reserves dwindle to less than the value of three weeks of imports. The financial health of the government was so poor that it almost defaulted on financial obligations, although it never did. Domestic uncertainty and lack of confidence from the international investment community sparked a depreciation of the Rupee, which increased the challenges of the government in financing the trade deficit. After a failed attempt by the government to pass a new budget, Moody's downgraded the nation from Investment Grade and international lending to India almost completely dried up while even the IMF and World Bank temporarily stopped assistance. The Indian government was ultimately forced to airlift national gold reserves as a pledge in exchange for a US$ 500 million conditional bail-out provided by the IMF and World Bank to avoid defaulting on its balance of payments debt.

The early 1990s balance of payments crisis, which was triggered by the 1990 Gulf Oil shock, meant that the need for change became critical. A combination of domestic instability, the assassination of the Prime Minister, and a subsequent change in leadership ushered in ground breaking policy reforms relating to industrial deregulation, reducing restrictions on foreign investment, and reductions to import tariffs (which fell from an average of 300% to 15%)[33]. Although the new government was successful in permanently maintaining a more global outlook, the initial impetus behind the reform in policy came with conditions imposed by the IMF and World Bank in providing emergency aid to India.

As the chart above shows, Indian growth averaged almost 6% pa from 1990-2002, and also accelerated. Growth became more stable and more globally dependent. Business practices improved, political stability increased, and better corporate governance standards were implemented. Although India was certainly "late to the party", with economic liberalisation starting much later than in China, growth started from a lower base and thus currently has more capacity for improvement.

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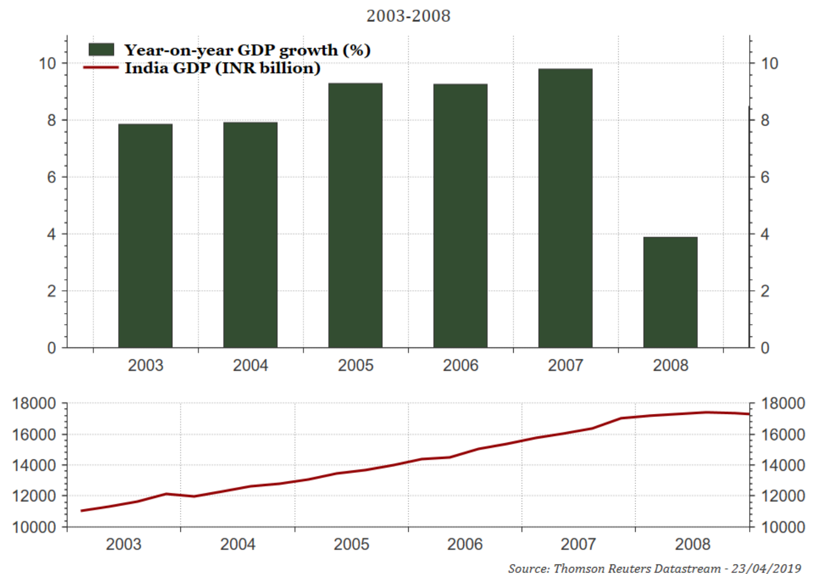
The abolishment of "License Raj"

Economic liberalisation after 1991 gradually saw the abolishment of "License Raj" (meaning license rule), which was an elaborate framework of licenses, regulation, and red tape which applied to all business in India. Under License Raj, a business would require approval from up to 80 different government agencies in order to produce a new product. The cumbersome system was the result of the post-independence government's vision of a centrally planned economy – in a similar fashion to that of the Soviet Union.

5.2. 2003-2008: "Boom years"

The second growth cycle, and the fastest of the three in recent decades, occurred from 2003 until the Global Financial Crisis. As you can see from the chart, average annual economic growth exceeded 8% over the period 2003-2009 and exceeded 9% for each of the three years from 2005 to 2007.

Indian GDP growth during the pre-GFC "boom years"



The years of economic liberalisation and government reforms implemented prior to 2003 made India ripe for growth as it removed structural policy headwinds. The more supportive business environment (being more globally-facing) benefitted from unusually high global liquidity, foreign investment, and a boom in credit. Although consumption remained relatively flat over this period, India saw a large increase in contribution of manufacturing and exports to GDP growth. Growth in investments exceeded 18% p.a. over 2003-2008. After the global credit tightening in 2009, there was a marked slowdown across the Indian economy which was most severe in areas such as investments, exports, and manufacturing – areas which had previously benefitted the most from the inflated and unsustainable credit conditions. As credit growth and capital flows reversed, Indian GDP growth was revised lower to a more sustainable pace. The years of annual growth sustained above 8% were over, at least for a while.

5.3. 2009-2017: Post-GFC Normalisation

As you can see from the following chart, post-GFC Indian GDP growth has recovered to a trend rate between 7%-7.5% p.a., averaging an annual growth rate at just over 7% between 2008-2017. If the economy was to return to the >8% growth in the boom years we would need to see a recovery in the key areas of credit, investment, and exports. **While consumption has grown at a faster rate since the GFC than during the preceding 2003-2008 boom years, growth rates in investments and exports unsurprisingly never returned to the same highs.** The GFC initiated a slowdown in investment and export growth which has been more pronounced in India than in other EM countries.

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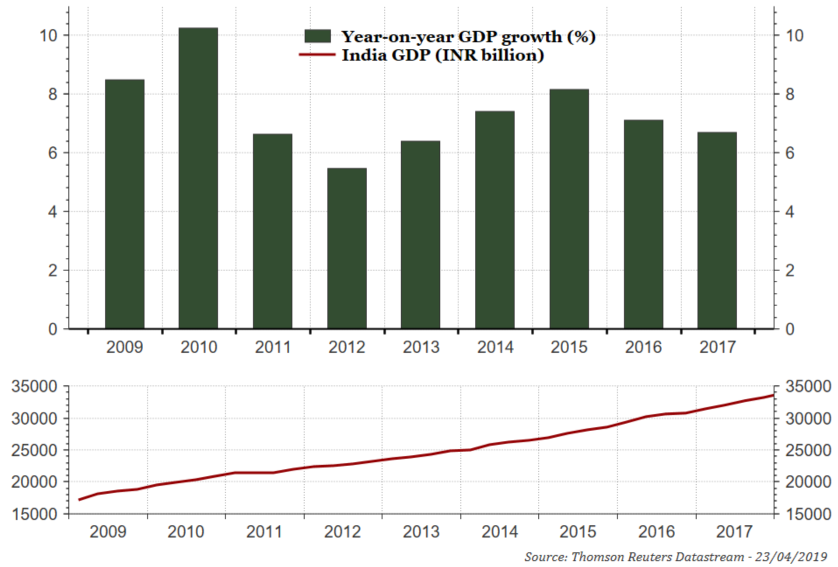
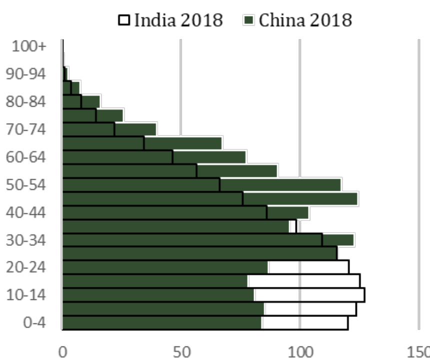
Despite the legacy issues of the credit markets and banking system, the central government has been highly supportive in dealing with structural growth issues. **Since the GFC, we have seen the implementation of a variety of breakthrough reforms such as a new inflation targeting framework, an overhaul in energy subsidies which has reduced government costs, containment of the fiscal deficit and the installation of new guidelines, an improvement to the quality of government fiscal expenditure, and a host of other market reforms. Credit markets have also been strengthened by new insolvency rules and a bank recapitalisation.** The proactive measures taken by the central government provides a strong foundation for India's next growth cycle. India is fundamentally well positioned for another wave of growth, or a "fourth" growth cycle, albeit with the broader risk of a global slowdown.

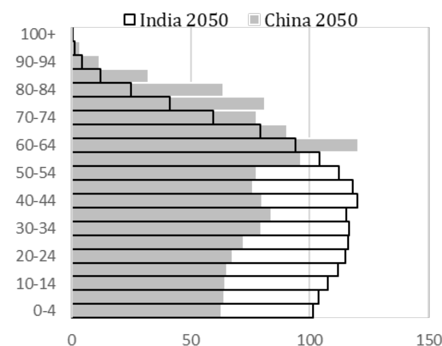
Post GFC growth has been slower



2018 Population



2050 Population Estimate



One of the key factors supporting the Indian growth story is its favourable population demographics. When considering growth, they are in fact better than those of China, which is predicted to suffer from an ageing population by 2050 - partly due to its one child policy. India is expected to become the world's most populous nation by the end of next decade. A challenge for any populous region or country is also the need to educate and provide healthcare for the population which imposes challenges on the respective state, and thus a large and growing population can be as much of a benefit as a burden.

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Conclusion

India is a country with immense opportunity and scope for growth and an opportunity to further its influence in the world. It has structural challenges to overcome but is making good headway in passing positive reforms. From an investment perspective we like the government bond market as we think yields will compress and the carry compensates well for currency risk. The challenge for many investors is accessing the bond market. We like the equity market too but feel valuations are a little stretched at the moment, so prefer to wait for a more attractive entry point. A BJP win in the 2019 election will provide political stability and likely be a boost for capital markets.

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