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Why India may be investors' next port of call

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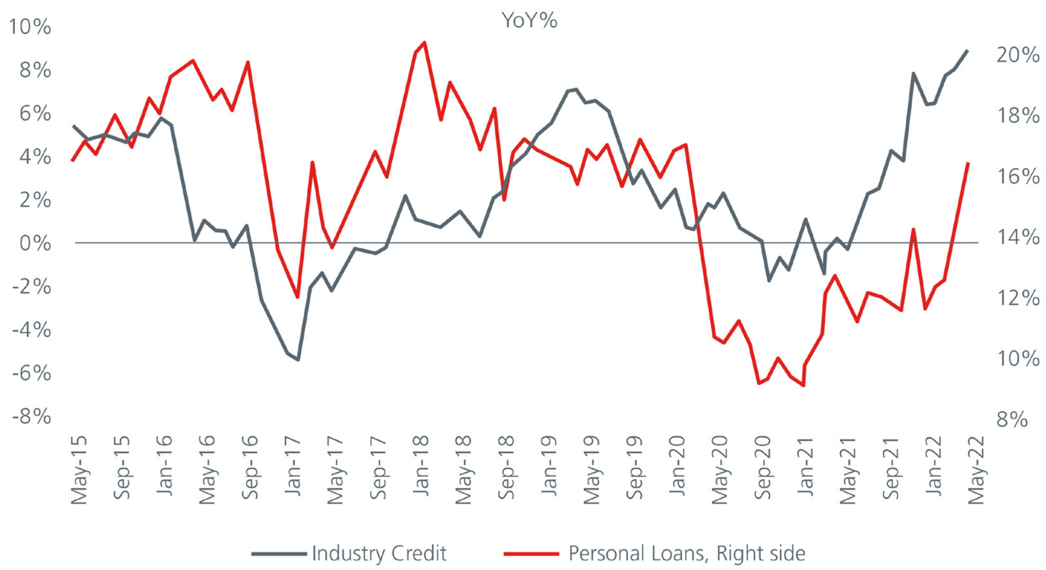
India is experiencing robust credit growth, rising private investments and resilient earnings. Beyond the positive cyclical factors, reforms are gradually bearing fruit, offering investors the opportunity to benefit from the demographic dividend, expanding manufacturing capabilities and rising digitalisation of a large democratic economy.

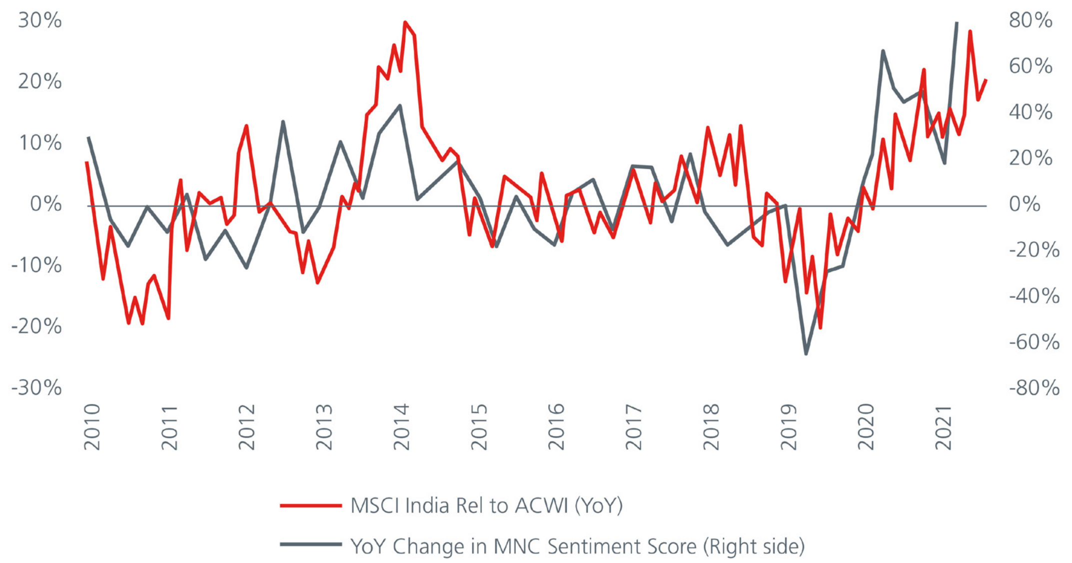
The Indian economy appears resilient as analysts mark down global growth forecasts and developed market economies slide into (unofficial) recessions. Credit growth is robust, corporates are reporting high confidence levels and private investments have recovered strongly. Fig. 1. and 2. Corporate debt currently stands at less than 50% of GDP and has fallen, not risen in recent years. This is important as India is expected to continue to normalise interest rates.

Fig 1: Credit growth picks up pace



Source: RBI, Morgan Stanley Research. July 2022.

Fig 2: Change in corporate sentiment



Source: RIMES, MSCI, Refinitiv, AlphaWise, Morgan Stanley Research.

Despite rising rates, the recovery in the real estate sector appears unabated. Affordability ratios, vacancy rates and inventory point to continued strength. Our bottom-up engagement reveals that there is pricing power within the sector despite the inflationary environment. In addition, despite the 50bps basis points rise in the repo rate in August 2022 to 5.4% from 4.9% in June, we note that real rates are still negative around -2%. This suggests that financial conditions are not yet overly restrictive to choke off the recovery.

India's economic resilience partly stems from the fact that exports currently make up less than 20% of GDP, making it less vulnerable to slowing global demand. It also helps that India's exports (excluding jewellery) has a smaller discretionary component and consists largely of pharmaceutical products and information technology services, which are unlikely to experience sharp falls in demand. In fact, India's exports of electronics and chemicals are growing at twice their historical growth rates[1].

This resilience has shown up in the earnings – India's earnings, compared to its Emerging Market peers, have held up better. Fig. 3. In fact, the operating margins of multiplex stocks within the communications sector are already above pre-COVID levels, reflecting the boost from India's re-opening and growing affluence. Given that Indian corporates have raised prices between February to June 2022 and the prices of commodity inputs have fallen since, earnings can potentially be revised up.

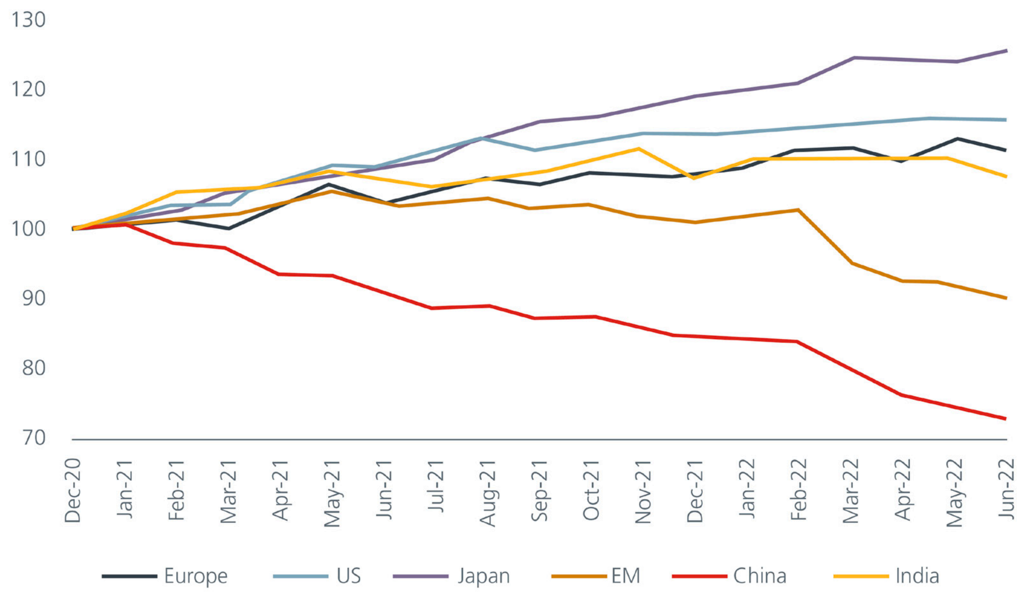
WHY INDIA?

Beyond the cyclical reasons mentioned above, there is also an increasing number of reasons why India is becoming a more attractive investment destination from a longer-term perspective.

India's still-growing population, its younger age cohorts and its expanding working-age group give it a significant advantage over the rapidly ageing populations in the western economies and China. India's population is estimated to reach nearly 1.5 billion by 2030 and 1.64 billion in 2047[2]. In 2020, 67% of the population was in the 15-64 working-age group, according to United Nations figures. Another 101 million will join by 2030 – when the proportion of working-age people is expected to peak – and a further 82 million will be added by 2050. Fig. 4. Meanwhile the median age in India currently is 29, well below China's 37 years and 38 years in the US. The surge in young workers, and a large and growing domestic

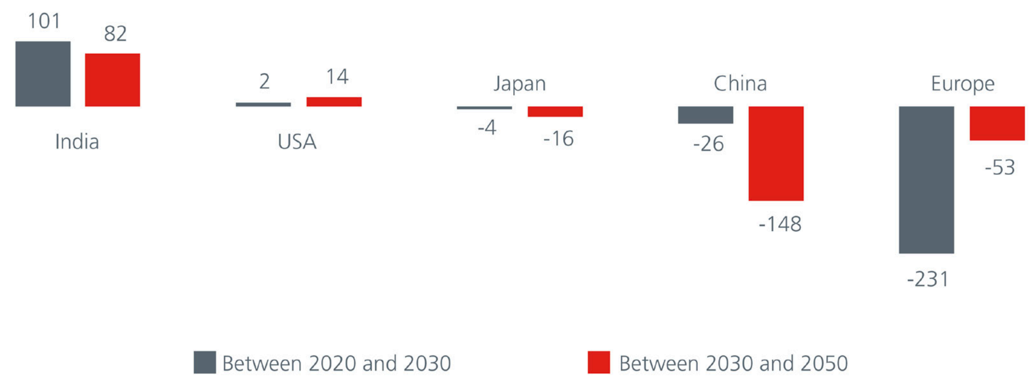
[1]Credit Suisse estimates. Ministry of Commerce. 11 January 2022. [2]Confederation of Indian Industry.

Fig 3: 2022 Earnings per share revisions (Indexed to 100)



Source: Goldman Sachs Research. July 2022.

Fig 4: Addition to working age (15-64 years) population (million) – Asia vs developed markets



Source: UN Population Statistics & Citi Research.

market could transform India into a USD40 trillion economy by 2047, according to the Confederation of Indian Industry. That said, India would need to train its workforce and create sufficient jobs to harness its demographic dividend.

The government's Production Linked Incentives (PLI) scheme, which is designed to encourage domestic manufacturing in India, can help to provide the jobs that India needs. The scheme offers eligible manufacturing companies incentives ranging from 4% to 6% on incremental sales over a 4-to-6-year period across 14 sectors including automobile and auto components, electronics and IT hardware, telecom, pharmaceuticals, solar modules, metals and mining, textiles and apparel, white goods, drones, and advanced chemistry cell batteries. The scheme was launched in March 2020, and to date, 327 companies have received approvals under the scheme which is expected to generate USD32.5 billon of additional capital investment[3].

[3]Morgan Stanley Research. Capex Monitor – Tracking Macro and Micro indicators. 11 July 2022.

India is also benefiting from the move by global corporations to diversify their supply chains. We see companies in the Electronic Manufacturing Services (EMS) and Electric Vehicle supply chain gaining market shares from competitors in the region. Gross Foreign Direct Investment inflows have stayed relatively stable at USD 82 billion in FY2021 and USD 83.6 billion in FY22, which can be viewed as an endorsement by global investors. Cushman & Wakefield's 2021 Global Manufacturing Risk Index, which assesses the most advantageous locations for global manufacturing among 47 countries in Europe, the Americas and Asia Pacific, ranked India 2nd in its baseline scenario. According to the report, India's established manufacturing bases in the chemicals, pharmaceuticals and engineering sectors are advantages as these sectors remain the focus of US-China trade tensions. India's ability to meet outsourcing requirements has also helped to establish its credibility. Going forward, further reforms to land and labour laws are critical to India's continued success as a global manufacturing hub.

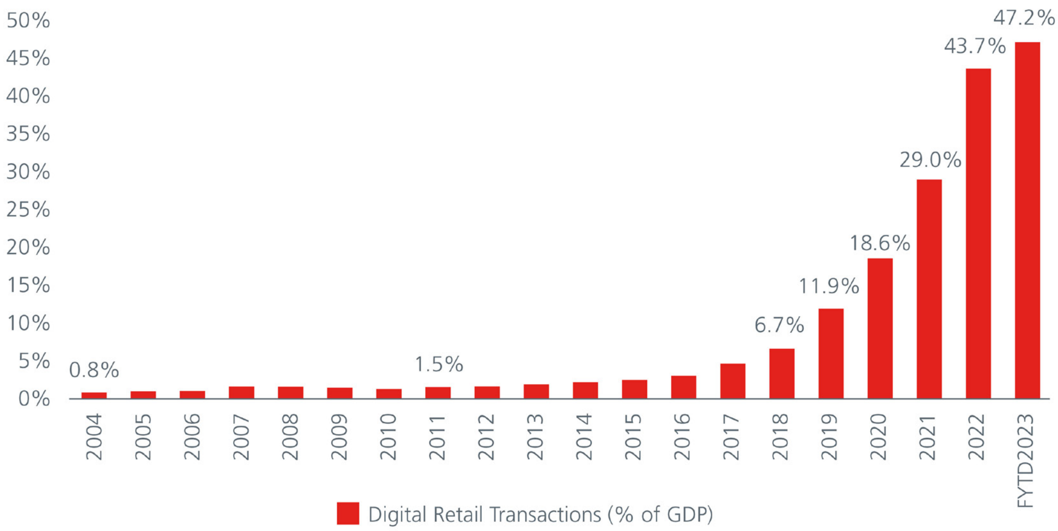
ADDRESSING THE CHALLENGES

India's consumer price index (CPI) was 6.7% in July, down from 7% in June. Some moderation in commodity and domestic food prices could improve the near-term outlook for inflation. We think it is underappreciated that Indian policy makers and consumers have significant experience dealing with high inflation. This is unlike the US for example, where headline inflation reached a 40-year high in July. The impact on India, therefore, may be more manageable.

The rise in e-commerce in India may help to mitigate inflationary pressures. Digital payments have grown exponentially in India in the last few years, which is also a reflection of the rapid transformation that is taking place in the informal sector. Fig. 5. It has been observed that the rise of e-commerce had a deflationary impact on prices in the western economies. In the US, Oxford Economics observed that digital deflation was strong in the US in 2006-2008, receded in the following years but was still around -2% p.a. in 2015 and 2016.

India's trade deficit hit a record recorded an all-time high of USD31.02 billion in July 2022 on the back of elevated commodity prices and the falling rupee. The trade deficit also widened because petroleum exports fell 37% from the prior month after the government announced a windfall tax on oil companies. The trade deficit may moderate in the coming months as global crude oil prices soften on the back of weakening global demand. India's status as a net exporter of food and agricultural products also helps to soften the impact from rising soft commodity prices. Meanwhile, robust foreign exchange reserves can be used to stabilise the rupee if required.

Fig 5: Digital retail transactions (as a % of GDP)



Source: Morgan Stanley Research. July 2022.

[6]Asia Bond Monitor. March 2022. [7]Asia Bond Monitor. March 2022.

A NEW PORT OF CALL FOR INVESTORS

India may traditionally not have been investors' first port of call when considering a standalone country allocation in Asia. However, with reforms gradually bearing fruit, the Indian equity market offers investors opportunities to benefit from its demographic dividend, expanding manufacturing capabilities and rapid digitalisation of a large democratic economy. In an earlier article, we had highlighted that India is the most diversified equity market in Asia where experienced active investors can add significant alpha from non-benchmark bets. In view of India's economic resilience and favourable longer-term drivers, investors may want to rethink their next port of call.

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