India: Is the recovery here?

Mike Sell – 28th May 2020

Summary

- Although economic growth was suboptimal in CY2019 at 5.3%, 2020 began strongly with PMI data in Q1 reaching 8-year highs
- Coronavirus has delayed this turnaround, but not destroyed the green shoots emanating from rural areas
- The government stimulus package remains underappreciated by the stock market
- Reform momentum has restarted
- Although there are risks to our thesis, we believe that they are well-managed at this juncture
- Our primary focus remains on companies that will benefit from domestic, particularly rural, opportunities providing exposure to an uncorrelated source of growth versus the expected recession in Developed Markets
- The increasing geo-political tension between China and USA could provide economic opportunities for India over the medium term
- Given the favourable structural characteristics of India (e.g. demographics, and the shift from the informal to formal economy), the positive near-term outlook and compelling valuations, we believe that this is an exciting, less-correlated opportunity for the long-term investor

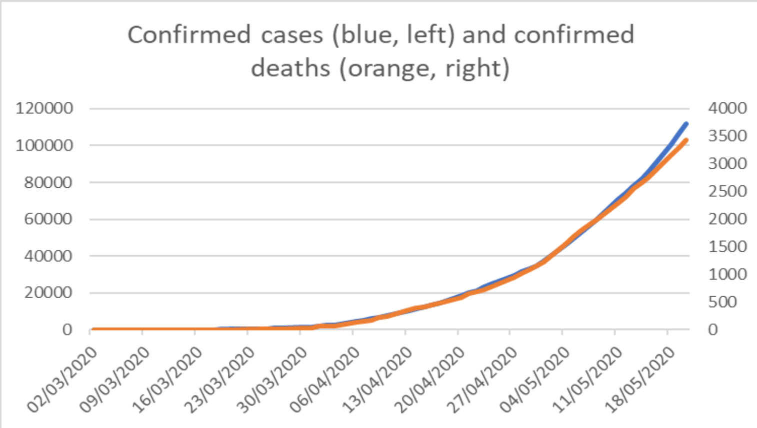
The coronavirus pandemic delays the recovery

India's real GDP growth peaked at 8.2% YoY in CY1Q18. However, as a result of stagnating construction and industrial activities due to the electoral cycle and lingering effects from the earlier non-bank finance liquidity crisis, the growth rate slowed to 4.7% YoY in CY4Q19. We had identified the signs of a subsequent recovery through our travels and interactions with company managements over 10 days in India in November and December, supported by 135bp of interest rate cuts during 2019. This premise was confirmed by signs of sequential improvement in the latest GDP data (driven by household demand and the restart of government spending post-election) followed by manufacturing PMIs reaching an 8-year high in January, at 55.3.

However, the cyclical recovery of the Indian economy as a whole was – temporarily – derailed by the measures taken by the government to contain the spread of the coronavirus, i.e. social distancing, the countrywide lockdown and restrictions on labour mobility. Thus, the latest economic datapoints paint a bleak picture of the Indian economy's state, for example manufacturing output was down 20.6% YoY in March, manufacturing PMI fell to 27.4, whilst the services PMI dropped to 7.2 in April.

Nevertheless, **India has coped better than earlier expectations**. The number of confirmed cases surpassed 112,000 on the 20th May with a mortality rate of 3.1% (see graph below for confirmed cases and deaths).

This is comparable with South Korea, with a mortality rate of 2.3%, where the government managed to contain the pandemic with drastic lockdown measures, whilst significantly lower than Brazil's 6.5%, where the government did not take decisive action to stop the spread. According to the Health Ministry, the doubling rate of the virus took 3.4 days when the lockdown started, which is now 13.3 days – a clear improvement, even accounting for under-reporting of the data. In comparison with other diseases, such as tuberculosis, the Covid-19 pandemic is less prevalent, as the number of tuberculosis cases was 2.69 million in 2018, according to the World Health Organisation's estimate. **Whilst the crisis is not over, India is increasingly trying to strike a balance between managing the virus and economic growth**.



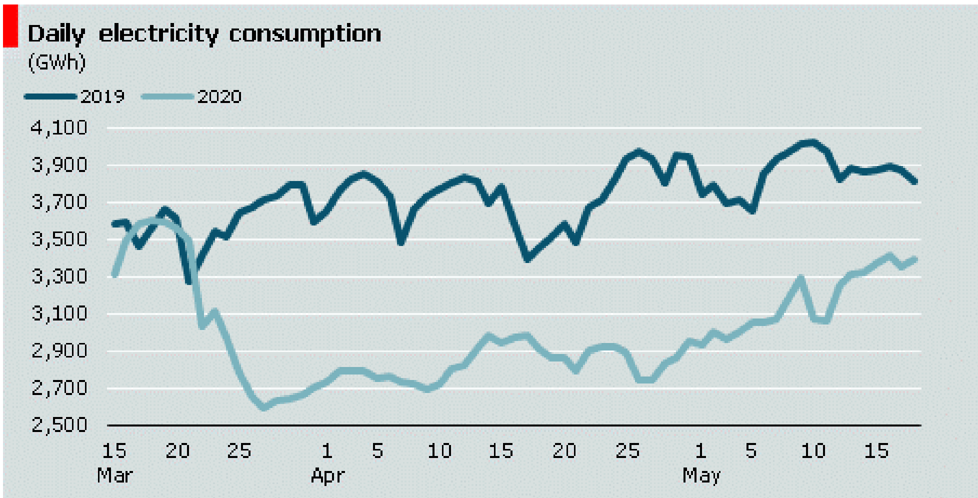
Source: Bloomberg

Perhaps uniquely, India also provides a recent reference point for a recovery from a sudden shock. We believe that there is a strong parallel with demonetisation in 2016, where the economy also suffered a significant and rapid jolt. In this case, expectations were that GDP growth would stagnate or contract for a couple of quarters, but the reality was much less severe, as India's real GDP growth was 5.8% YoY in 2Q17 at its lowest, and bounced back to 8.2% YoY by 4Q17

Selective signs of improvement

Over 800 million people are estimated to live in rural India and are responsible for generating about half of India's annual GDP. **Rural India moves to its own cycle**. The excellent monsoon last year (the highest amount of rain in the past 25 years) following on from two previous good has led to water levels in reservoirs reaching 85% of overall capacity (a 10-year high). This was positive for the Winter harvest and also provides a safety buffer in case of less strong monsoons in 2020. Fertiliser sales substantially improved in April (+47.4% YoY), which suggest that activity in the rural agricultural sector has already started to normalise. Meanwhile, cement prices strongly rose in May, by 6% MoM – again, a sign of **strengthening demand from rural areas**. The fact that the **mobility restriction measures were significantly less severe in rural areas also implies that economic activity fared better in those regions**.

Overall, as discussed above, we see green shoots in rural areas, outpacing their urban counterparts. In our view, **the rural recovery will represent a leading indicator and give a boost to the Indian economy as a whole**. Countrywide economic activity has been recovering gradually since lockdown measures were eased on the 4th May, as demonstrated by a **recovery in electricity consumption** (see graph below). **Positive signs can also be observed in the labour market**; according to the Centre for Monitoring Indian Economy, the unemployment rate fell to 23.8% in mid-May, from 27.1% at the start of the month. Although there remains a long road ahead, as the labour market tightens, the purchasing power of households will strengthen, which will be further boosted by declining domestic fuel prices, as crude oil prices remain very depressed. Employment at medium and large (predominantly state-owned) enterprises started to recover in March.



Source: Power System Operation Corporation Ltd, EIU

This recovery will be supported by selective easing of lockdown measures, as the government balances health and economic issues. On 24th April the central government issued revised guidelines allowing rural shops and stand-alone shops in urban areas to reopen, subject to staffing levels of around 50%, but with the mandatory use of masks and the observance of social distancing. On May 1st the Ministry of Home Affairs (MHA) extended the overall countrywide lockdown but providing relaxation to some areas as a part of efforts to restart economic activity. **The MHA has divided districts into green, orange and red zones to apply a graded relaxation of lockdown measures across India.** Green zones are defined as areas with no confirmed cases to date or zero new confirmed cases in the past 21 days. Red zones are defined by the Ministry of Health and Family Welfare based on the total number of active cases and the rate of growth in cases. Areas not marked as green or red zones are classified as orange zones. Even in the red zones, where restrictions are the most stringent, private offices can (depending on the individual State) allow 33% of their staff to work in the office whilst the rest works from home, shops (with the exceptions of malls) are allowed to be open, etc. According to the Health Ministry, 130 districts in the country were in red zone, 284 in orange and 319 in green zone at the beginning of May.

India's economic response to COVID-19

In a televised address to the nation on the 12th May, Prime Minister **Modi announced an economic package of about 10% of GDP**. Measures include providing liquidity to micro, small and medium-sized enterprises (MSMEs), non-bank financial companies (NBFCs), power and real estate companies. The government also created instruments, such as credit guarantees, in an attempt to boost bank lending towards MSMEs and NBFCs. The economic package also includes measures to support farmers, migrant labour and street vendors. The government will primarily rely on easily accessible and cheap credit facilities to aid them. In addition, there are steps to de-regulate agricultural activities by amending the Essential Commodities Act (allowing trade across states more freely, allowing farmers to sell to various buyers, etc.). Finally, the government delivered a number of measures as well, which will have a favourable impact on both the short-term economic prospects of India as well as its medium-term growth potential:

- budgetary expenditures related to the rural employment guarantee programme will increase
- insolvency rules for MSMEs will ease
- a new privatisation strategy
- rising borrowing limits for state governments

This economic relief package also includes the central bank's liquidity measures, which retains an accommodative stance to keep domestic financial conditions supportive of economic growth by keeping (real) interest rates low, whilst sustaining abundant amount of liquidity. In our opinion, **the Reserve Bank of India (RBI) will retain a very accommodative monetary policy stance for a prolonged period of time**, since the Monetary Policy Council expressed its preference towards policies conducive of economic growth through abundant liquidity. The RBI's key policy rate fell from 5.15% to 4% since the beginning of 2020, 115bp in total (and 250bp since the peak of interest rates in January 2019), which will further stimulate the economy.

The continuation of reforms

Since Prime Minister Modi assumed office in 2014, his government has delivered multiple comprehensive structural reforms, such as the Goods and Services Tax, the reduction of the effective corporate income tax to 25%, introducing the new Insolvency Code, etc. **The Prime Minister's reform agenda is now turning to the enhancement of the growth potential of the Indian economy by streamlining and relaxing the country's stringent and complex labour codes** (over 200 state laws and more than 50 central laws on wages, remuneration, social security, employment security, work conditions, etc.). At a state level, the relaxation of labour codes has already started in May 2020 (Uttar Pradesh, Madhya Pradesh, Gujarat, Karnataka, Punjab, Rajasthan and Odisha) in response to the economic and financial challenges brought about by the coronavirus. These states have suspended several labour laws including minimum wages, employment security and social security. Eventually, the central government will likely adopt national-level changes in 2020, which – in our opinion – **remains underappreciated by the stock market**. We have seen the first signs of this, with 44 national labour laws (of which 9 were passed in 1947) being replaced by 4 uniform codes, although details remain scarce. By increasing FDI flows towards India, the economy's current potential long-term growth rate of 5.5-6% p.a. could be lifted to or over 6.5% p.a. An increased amount of FDI driven by more flexible labour laws would also imply a more stable Rupee exchange rate, as the external funding needs stemming from the country's structural current account deficit would be covered to a greater extent than in the past.

On top of the reform of the labour codes, **the PM put emphasis on five aspects of India's current and future strength: economy, infrastructure, technology, demographics and demand**. In order to help to realise these strengths, Mr Modi pledged to continue reforming the Indian economy. The government is also redoubling efforts to attract investment in India's production capacity from **foreign companies seeking to relocate parts of their supply chain from China**. As examples, the government has also raised the foreign-ownership level in defence production from 49% to 74% on 16th May 2020. The government reiterated its commitment to liberalise coal mining for private-sector participation and to privatise the operations of more airports under a public-private partnership model.

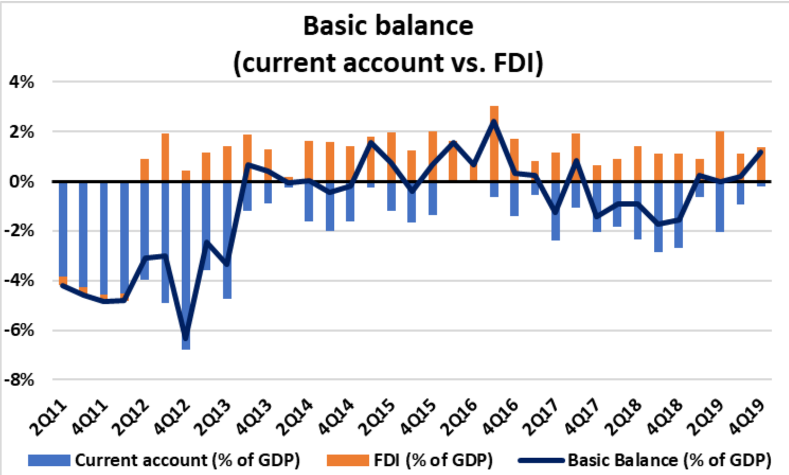
Furthermore, the renewal of the US-China tensions creates a great set of opportunities for India to attract FDI out from China. India is the only country, which has such a quantity of young labour, who could take over production from China at a lower cost. This is an area of future research focus for us, and a source of potential ideas in the portfolio in the medium term.

Low oil prices shield the currency

The external funding need of the Indian economy consistently and significantly declined throughout CY2019 (see graph below). Our in-house basic balance calculations show, that the external funding need (i.e. the current account deficit) narrowed to 0.2% of GDP in CY4Q19, in a period when oil prices were stable in the range of USD 50-60bbl. Meanwhile, net FDI inflows to India picked up in CY2Q-4Q19 due to the Modi government's landslide election victory as well as the 10ppt effective corporate income tax reduction, to 25%. As a result of a narrowing current account deficit and an increase in net FDI inflows, the external funding need of India significant decreased by CY3Q19 and ultimately became a surplus at the end of 2019.

Going forward, substantially lower oil prices at the beginning of 2020 will provide a further improvement. **The Indian economy is the third largest oil importer in the world** – with flows averaging a little over 4.5mn bbl/day in 2019 (vs. 10.12mn bbl/day in China). The total amount of oil imports was USD 143bn, about 30% of total imports last year or ca. 5% of GDP last year. **The lower oil price is actually a major positive for both the country and its financial markets** (unlike other EM countries, such as Malaysia, Mexico, etc.), since if oil prices stabilise in the range between USD 40-50bbl, the current account deficit could be lower than 1% of GDP, according to our estimates. Furthermore, we expect increasing net FDI inflows to persists as the government rolls out its reforms to attract foreign capital. Overall, in our view it is likely that the basic balance can remain positive throughout 2020, which in turn would serve as a shield against external shocks and it would limit the scope for rupee depreciation (vs. the USD).

From a growth point of view, **this economic crisis is different to previous global recessions. India's relatively weak linkage to the global economic cycle** (exports were 19.7% of GDP in 2019) **provides a shield, as does the fact that international tourism, which accounts for only 1% of GDP** (vs. 12% in Thailand, 6% in Malaysia, 6% in Vietnam).

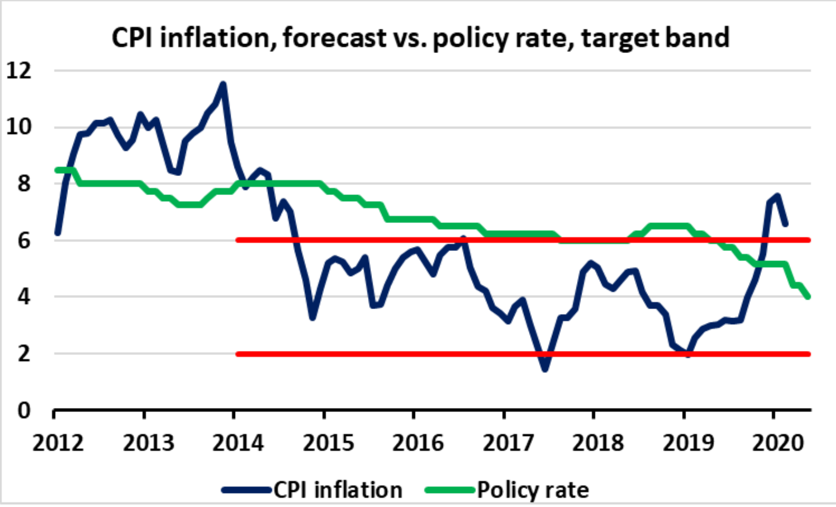


Source: Reserve Bank of India, official Indian statistical services, Bloomberg, Alquity calculations

Narrow current account and low inflation allow for greater monetary accommodation

Consumer price inflation in India sharply accelerated in September 2019 peaking at 7.6% YoY in January (see graph below). As the new harvest started to slowly come in the local market in February and March, food price pressure eased, which ultimately contributed to the deceleration of the headline figure – to 5.9% YoY in March. On a forward-looking basis, **we expect further and meaningful deceleration in inflation** (post-COVID disruptions), due to the favourable impact of increasing food supply as well as the drastic fall in crude oil prices which will translate into lower domestic fuel prices. Consequently, we expect headline inflation to return to around 4% YoY, i.e. to the mid-point of the central bank's inflation target range.

The combination of slowing inflation and narrowing current account deficit allow for additional room for monetary policy manoeuvre. This is further supported by a low gross central government debt to GDP ratio of 44.5% in 2019, and FX reserves of USD 477.5bn representing almost 13 months of imports at the end of April 2020, according to our in-house estimates. As a result, the Reserve Bank of India can opt for the reduction of the key policy rate (currently at 4%) as well as additional bond purchases to control the yield curve and to keep rupee liquidity abundant. This scenario would give a further boost to economic activity through lower debt service costs and increasing lending volumes.



Source: Bloomberg, Alquity calculations
Note: the red band represents the central bank's 2-6% inflation target range; the CPI print for April 2020 has not yet been released

Overall, real GDP could stagnate in FY2021 (ending in March) due to the six-week long nationwide lockdown period, with many factories and office buildings closed. The lower end of the consensus expects the Indian economy to contract by 5% in FY2021, which would be the deepest recession since 1979. This very pessimistic forecast builds on the idea that the lockdown will have a significant long-lasting negative effect on the productive capacities in India. In our opinion, that is unlikely at this point. The government's priority is to restart the economy as quickly as possible, whilst keeping a lid on the number of new coronavirus cases. **In our view, the resilience of the rural economy, the barrage of stimulus measures taken by the government and the central bank will help minimise the economic damage in FY2021 and will also ensure that economic activity will converge towards its 5.5-6% potential in FY2022.**

Modi's political position remains unchallenged

The Bharatiya Janata Party (BJP) won the majority of seats in the Lok Sabha (the lower house of parliament) in the general election that took place in April-May 2019, increasing their seats from 282 to 303 and giving Prime Minister Modi a second term. He remains the dominant figure in the government with no obvious challengers in sight. The next general election is expected to be held around May 2024. Thus, PM Modi still has plenty of time to carry on with his reform agenda without worrying about his popularity.

In the Rajya Sabha (the upper house), the BJP and its allies form the largest coalition with 104 seats out of the 245. Provided that the BJP retains control of key state assemblies and wins control of a few more in the next few years, the party and its allies within the larger National Democratic Alliance (NDA) coalition could potentially secure a simple majority in the Rajya Sabha. This outcome would enable the alliance to pass legislation with less opposition than currently.

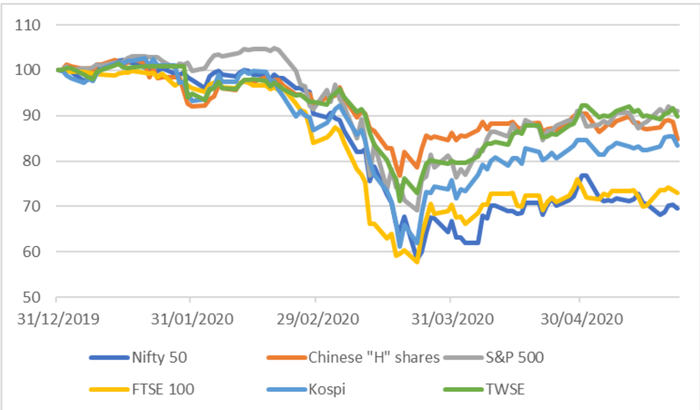
In the next 12 months, there are going to be state elections in Bihar, Assam, Jammu and Kashmir, Kerala, Pondicherry, Tamil Nadu and West Bengal. Out of the seven states, the BJP and/or the NDA coalition only controls Assam and Tamil Nadu. Therefore, the Prime Minister can take this opportunity to gain further political control.

From a geopolitical point of view, **India is not threatened by the renewal of the US-China tensions – in fact, India could be a beneficiary**. Given that labour costs have been consistently on the rise in China, there are a large number of manufacturers who have been considering relocating their capacities and we have seen selective signs of this. This provides an excellent opportunity for India to attract those companies and thus the country's manufacturing capacities would not only expand but would also climb higher on the value chain.

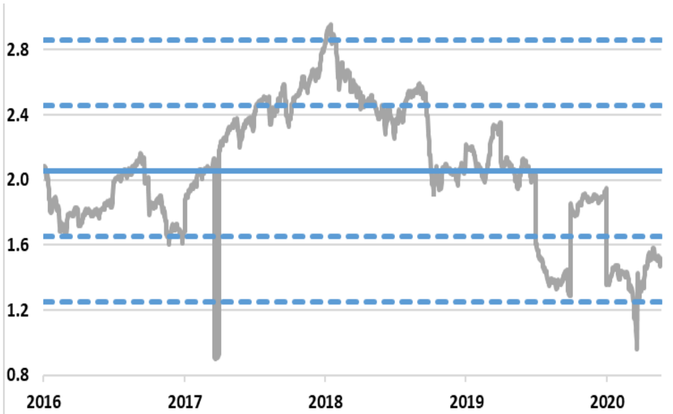
Valuation and market performance

Countries such as China, South Korea and Taiwan, where governments quickly introduced very stringent measures to contain the spread of the virus (e.g. a nationwide lockdown, shutting the borders, social distancing) were also the first ones to lift the restrictions and thus restart economic activity. Stock markets in these three countries have reacted appropriately, in our view, and have started to price in the eventual normalisation of the economy. As opposed to them, **the Indian stock market has largely ignored the impending lift of the lockdown in India**. In addition, the growth-boosting impact of the government's and central bank's stimulus measures and reforms have been ignored by markets so far. From a valuation aspect, the Indian stock market as a whole offers a compelling risk-reward trade-off at this juncture, as the **price-to-book value ratio remains very close to all-time lows**. The risk-reward characteristics of Indian small caps are very attractive in particular, and remain undervalued both on an absolute and relative basis on a price-to-book basis on a five-year historical horizon (see graphs below).

YTD performance of Nifty 50, Chinese "H" shares, S&P 500, FTSE 100, Kospi and TWSE indices in USD

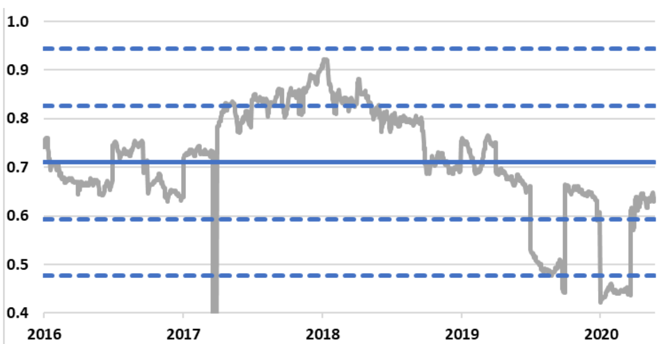


Relative P/BV valuation of the BSE Sensex



Nifty 50 index historical P/BV since 2000

Relative P/BV valuation of the BSE Sensex Small Cap Index to the BSE Sensex Index since 2016

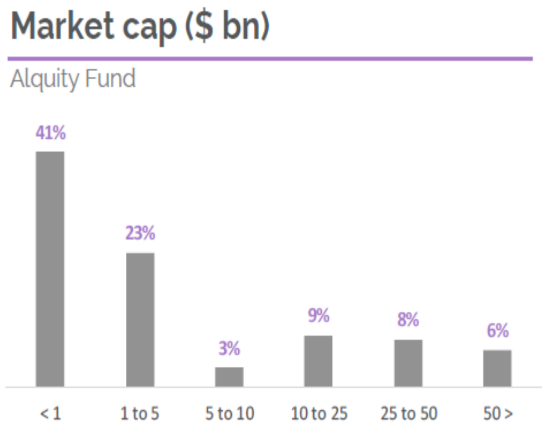


The Alquity India Fund is well positioned to benefit from the economic recovery

TOP 10 HOLDINGS

1.	HDFC	6.3%
2.	Amrutanjan	5.4%
3.	TCI Express	5.2%
4.	Heidelberg Cement India	5.0%
5.	Hindustan Unilever	4.9%
6.	Escorts	4.8%
7.	Hero Motorcorp	4.5%
8.	Ultratech Cement	4.4%
9.	TTK Prestige	4.1%
10.	Vmart	4.0%

Source: Alquity as of 30th April 2020



Source: Alquity as of 30th April 2020

The Alquity Indian Subcontinent Fund is comprised of quality companies with strong balance sheets, which benefit from the monetisable structural growth and exhibit cyclical growth characteristics. For example:

HEIDELBERG CEMENT

Heidelberg Cement (ESG rating 'C') is benefitting from the sustained excess demand for cement due to infrastructure development as well as the sustained structural growth of the rural economy, as new cement supply will remain constrained

Hindustan Unilever Limited

Hindustan Unilever (ESG rating 'B'), India's largest fast-moving consumer goods company, generates over 40% of its revenues in rural areas

Hero

Hero Motor (ESG rating 'B), the world's largest manufacturer of two-wheeled vehicles in the world with approximately 50% of sales from rural areas

AMRUTANJAN Since 1893

Amrutanjan (ESG rating 'C'), a health care company, benefits from domestic structural growth particularly in rural areas, and new product launches

Our ESG analysis assesses management quality, operational excellence and firm values. Our approach encourages responsible corporate behaviour that benefits not only investors but also the employees, communities and environment in which our holdings operate. This result **in "quality growth" focussed portfolios that monetise long-term themes via transparent companies, with effective management, who are aligned with all stakeholders**. Companies such as Heidelberg Cement publish their emissions monthly, Hindustan Unilever has targets to halve the environmental footprint of the making and use of its products by 2030 (e.g. the company reduced its water consumption in its manufacturing operations be 55% compared to 2008 baseline). Hero Motor across its portfolio of vehicles has worked to improve fuel efficiency, whilst investing in the development of electric vehicles. **The ESG quality of certain stocks** (but by all means not all of them) **is not appreciated by investors. We tend to find many of the best companies in the small cap space** (see graph above).

Over 50% of our portfolio holdings is predominantly exposed to rural India and thus the rural economic cycle, whilst we currently have zero exposure to software companies (16.3% of the index). In our view, the software sector is sensitive to the weak global economy and at risk of substantial cuts in IT spend by Western companies. **We prefer domestic exposure as we see a U-shaped recovery in India vs. an uncertain, volatile and W-shaped recovery for developed markets.**

The Indian stock market's correlation to developed markets is generally low, given the low percentage of exports in GDP and thus acts as a good diversifier. However, **Alquity India Fund's exposure, given our domestic and rural focus, is even lower** (see the matrix below) with a 27% correlation to the UK FTSE versus a correlation of 41% for the Indian market overall and 57% for H shares versus the FTSE.

Correlation matrix since inception

	Alquity India Fund	Relevant Indian stock index	FTSE 100	H shares	World stock market index
Alquity India Fund		90%	27%	26%	32%
Relevant Indian stock index	90%		41%	37%	49%
FTSE 100	27%	41%		57%	87%
H shares	26%	37%	57%		68%
World stock market index	32%	49%	87%	68%	
S&P 500	25%	42%	76%	59%	96%
Euro Stoxx 50	32%	45%	86%	49%	85%

Source: Bloomberg, Alquity calculations, data from 30th April 2014 to 28th May 2020

We believe that this is important for investors who are seeking diversification across equity classes.

Risks to the outlook

India's traditional Achilles heels are oil prices and the lack of political stability to pass legislation. We have discussed both aspects in previous sections stipulating that – currently – neither pose a material downside risk to India's economic cycle. Even if oil prices were to return to the range between USD 40-50/bbl, the current account deficit would remain low in a historical context. In this case, the cyclical upswing – as per our baseline – could continue, whilst the Rupee would remain stable enough so that the RBI would not be forced to take a U-turn on its current accommodative monetary stance. Meanwhile, the Prime Minister and his coalition are in a comfortable political position, where they comfortably have the ability to pass key reforms without needing to worry about the political costs, given that general elections are still distant.

The evolution of coronavirus cases now remains on top of the list of downside risks to the economy as well as to financial markets. The first Covid-19 case was confirmed at the very end of January and it was not until the 14th March until the number of cases surpassed a 100. Overall, the government's approach to containing the spread has proven to be efficient enough and at this juncture, two months later, we do not see any evidence that would suggest that the pandemic would spiral out of control in the near term as has happened in Brazil, where the identification of Covid-19 cases started to ramp up at a similar point to India.

There are always risks to GDP growth expectation. We foresee India's real GDP to stagnate in FY2021, due to the impact of the lockdown. **Given the available economic datapoints, we assign the highest probability to a U-shaped recovery**. However, if the government resorted to another round of lockdown later during the year, **there is a risk of a transition into a W-shaped trajectory**.

The Indian stock market suffers from volatility, as there is significant participation from heavy retail flows. **Although asset price volatility can be challenging to some, we see this as an opportunity for fundamental investors to buy excellent companies** – at compelling valuations – who are the beneficiaries of long-term structural trends, such as demographics and urbanisation.

Conclusion

Despite the adverse economic impact of the coronavirus in the short-term, we can see concrete evidence of a recovery in the rural areas. Furthermore, the concerted efforts of the Finance Ministry and the RBI will minimise the coronavirus-related damage to the economy as a whole and boost the pace of the recovery in the near term. Meanwhile, on a longer time horizon, the Prime Minister's reform agenda will enhance the growth potential of the Indian economy by streamlining and relaxing the country's stringent and complex labour codes. The outlook for a favourable reform and economic recovery outcome remains underappreciated by the stock market.

The Alquity Indian Subcontinent Fund is well-positioned to take advantage of the recovery in India given our domestic focus, and thus is largely unlinked to a global recession (exports are GDP) and a renewed US-China trade war. **This is also the case for the underappreciated rural recovery, which will have a positive impact on over 50% of our portfolio**. Although the Fund's recent performance has been impacted by weaker than expected Indian GDP growth, we expect this to reverse as the economy recovers.

Although there are risks, we believe that they are discounted by investors more than fundamentally justified, as price-to-book valuations hover around historical lows. In addition to the favourable backdrop for domestically focussed small and mid-cap stocks, the Alquity Indian Subcontinent Fund benefits from a **lower correlation to developed markets** than India overall. Given the favourable structural characteristics of India (e.g. demographics, and the shift from the informal to formal economy), the positive near-term outlook and compelling valuations, we believe that this is an exciting opportunity for the long-term investor.

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