Emerging market equities: India on the ascendency

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Portfolio Manager Daniel Graña explains why India's favorable demographics, pro-growth policies, and innovative companies all contribute to the country being among the most promising future sources of excess returns within emerging market (EM) equities.

Key takeaways

- Demographics, corporations' desire to diversify supply chains, and geopolitics are causing investors to recalibrate their EM equities allocations.
- India's young work force, pro-growth economic policies, and strong equities culture are characteristics that should command EM investors' attention.
- A wave of capital investment, along with innovative products and services aimed at solving EM-specific frictions, have the potential to unlock much of India's unrealized productivity.

As has been the case with other asset classes, the investment environment for emerging market (EM) equities has evolved considerably over the past few years. In the wake of the COVID-19 pandemic, the trend toward deglobalization has accelerated. Companies are now seeking to reconfigure supply chains and the cost of capital has reset to levels harkening back to the 1990s. All the while, the inescapable forces of demographics march on and geopolitical tensions have added an additional layer of complexity to allocating capital.

EM equities investors must process how these shifts will impact corporate earnings growth and, thus, returns for the asset class. Many of the past decade's return drivers are waning, especially as China's central government prioritizes *national service* at the expense of profitability within the private sector and authorities struggle to identify the right mix of contributors to economic growth. The confluence of these developments has led investors to seek alternative sources of returns within the EM equities universe. One potential destination that, in our view, is rightfully garnering investors' attention is Asia's other giant economy: India.

The subcontinent's dominant economy meets many of the criteria that we consider conducive for generating excess returns over a multi-year horizon. India has favorable demographics, with the benefits inherent in a young workforce magnified by the trend toward urbanization. The country is rapidly improving its historically subpar infrastructure with the aim of unlocking productivity. Furthermore, the government is championing a reform agenda that seeks to increase the private sector's role in propelling economic growth.

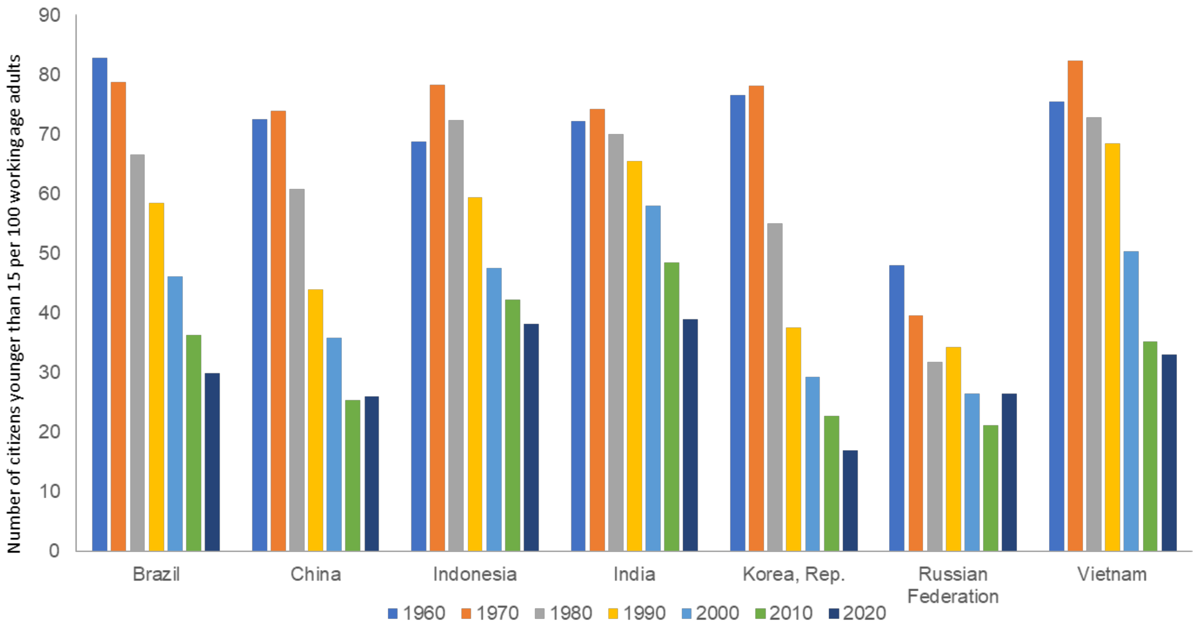
India through the looking glass

We believe that an effective way to view the EM equities landscape is through the complementary lenses of *country*, *company,* and *governance*. Country analysis matters when investing in emerging markets because it is rare to find attractive investment opportunities in jurisdictions that are hostile to the private sector and that have unsound national finances and poor demographics. Instead, the potential for excess returns tends to be enhanced by the secular tailwinds associated with strong or improving macro fundamentals and political governance.

They say demographics are destiny, and India's young population relative to other major emerging markets has it on the cusp of becoming the world's largest country. While on the surface, India and China have similar dependency ratios[1], their composition reveals diverging demographic paths. In 2020, India counted roughly 10 citizens older than 65 for every 100 working-age adults. For China, the ratio was a far grayer 18. Perhaps more importantly, during the era of China's one-child policy, the ratio of youths per 100 working-age adults slid from 61 in 1980 to 26 by 2020. For 2020, India's youth dependency ratio stood at a much healthier 39.

Exhibit 1: Youth dependency ratio in major emerging economies

India's population is far younger than many emerging market peers, which bodes well for economic growth as its citizens enter their most productive years.



Source: World Bank, as at July 2023.

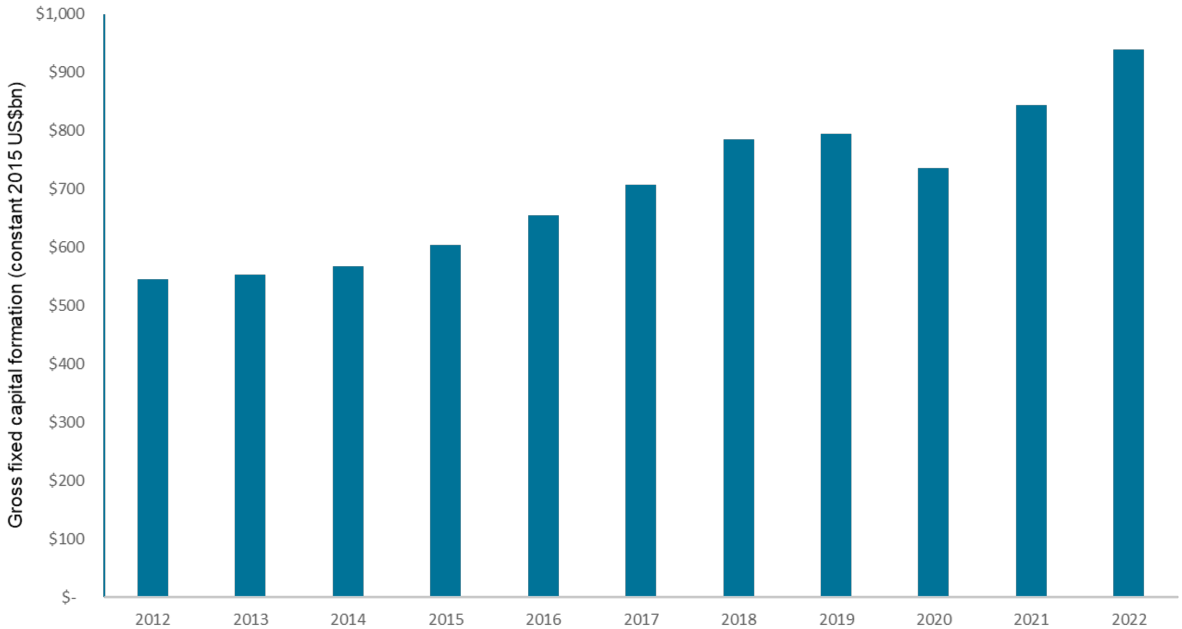
Complementing India's younger demographics is the country's push toward urbanization. The shift from rural areas to cities was a major impetus for China's period of double-digit economic growth as workers churned out manufactured goods and required adequate housing. India is perhaps a generation behind China in this respect as its urbanization rate was only 36% in 2022, compared to 64% in China and even 58% in Indonesia.

Urbanization requires infrastructure, and in recent years, upgrading India's ports, roads, energy grid, and housing – from a notably low base – has become a priority for authorities. Improved infrastructure stands to facilitate both domestic and international trade and provide the needed services for India's growing population. The returns in these investments will be measured in unlocked productivity, which is a key ingredient to economic growth and a higher standard of living.

We believe India is now entering a multi-year capital expenditure cycle, with contributions from the housing sector, industry, and government. Given the undersupply in housing, residential construction has dominated Indian gross fixed capital formation in recent years. Rising government investment, meanwhile, is not only aimed at infrastructure projects, but also at incentivizing private-sector investment via its well-timed *Production-Linked Incentive Scheme*, which stands to benefit from multinational corporations' (and nations') desire to diversify supply chains away from China. For their part, Indian companies are seeking to modernize factories to increase utilization. To finance these initiatives, companies can rely upon both government incentive programs as well as borrowing, given the corporate sector's low level of aggregate leverage.

Exhibit 2: Growth of Indian gross fixed capital formation

Fixed capital investment has increased by an approximate 5.0% annual rate over the past decade, with housing comprising the largest portion.



Source: World Bank, as at 31 December 2022.

Elevating the private sector

Another way in which *country matters* when identifying attractive regions for investment is the degree to which governments champion a reformist agenda that prioritizes economic growth led by a thriving private sector. This has largely been the case under the government of the Bharatiya Janata Party (BJP), led by Prime Minister Narendra Modi. India's government has taken steps to simplify the tax code, streamline – and decrease – regulations, and lower the barriers for the foreign direct investment that can elevate the productivity of the recipient's industrial base. These policies stand in contrast to the state-led, highly regulated, and largely protectionist economy of India's past.

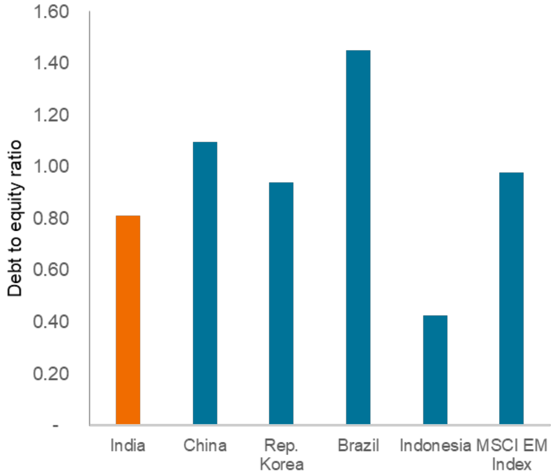
It should also be noted that India is a democracy. And while the negotiations and compromises inherent in parliamentary chambers can be messy, they tend to provide a level of transparency and accountability that reassures investors.

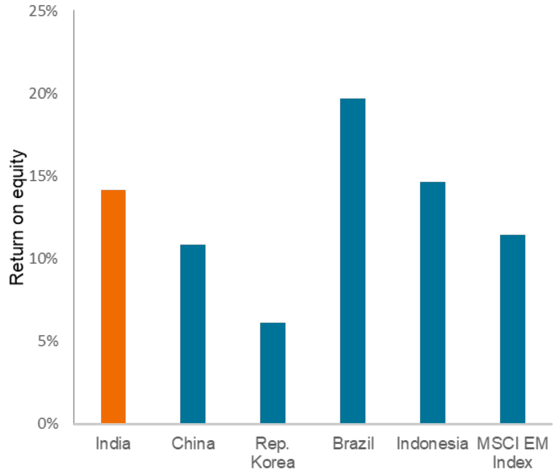
Good governance is not only requisite on the sovereign level, but also in corporate boardrooms. India possesses a strong equity culture where the interests, roles, and rights of minority shareholders are recognized. This is not always the case in EM regions. This equity culture also presents an opportunity for capital market growth, as we expect some of India's high level of household savings to find its way into stocks. Currently, property comprises roughly half of Indian household assets, while equities account for less than 5.0%. Equities' share is likely to rise as household wealth grows over the coming years. Domestic ownership of stocks would provide a potentially resilient counterweight to less sticky international capital flows.

Country- and boardroom-level priorities create the environment for companies to succeed; it's up to management teams to execute. Indian companies have a history of delivering, with aggregate returns on equity higher than many EM peers. Equity returns, in our view, have the potential to climb further, given large Indian companies' low levels of aggregate debt. Increased borrowing can either finance capital investment, leading to additional productivity gains, or, for companies with steady cashflows, it can be deployed to magnify earnings.

Exhibit 3: Corporate returns on equity and debt ratios

Large Indian companies tend to generate returns on equity higher than those of many EM peers, while their use of leverage falls below the aggregate EM average.





Source: Bloomberg as at 1 August 2023.

India is also well positioned to participate in the trend of future EM equities returns being increasingly driven by innovation. For much of the past two decades, EM economic growth was premised on economic and income convergence with more developed markets and the trend toward global outsourcing. As those themes have matured, the contribution to growth from productivity-enhancing innovation has risen. Rather than importing novel technologies and services from more advanced economies, EM innovation is becoming more home grown and aimed at solving EM-specific frictions, whether it be in financial services, cleaner energy supply and transport, more efficient retail, or improving various aspects of healthcare delivery.

Understanding the risks

Despite a notable level of reforms and improvements in corporate governance, EM equities remain among the riskier asset classes. India faces a unique set of risks that investors considering increased exposure to the country should properly assess.

As a hydrocarbons importer, India is exposed to imported inflation should energy prices rise. This would, in turn, decrease the Reserve Bank of India's ability to lower interest rates and could therefore diminish the magnitude and duration of the expected capital expenditure upcycle. Similarly, higher fuel prices for consumers and businesses could compel the government to channel funds from infrastructure investment toward subsidies.

Politics also informs the risks behind the government's desire to restrain budget deficits. As elections approach, many EM governments find it difficult to avoid the temptation of increasing spending. That is a possibility with elections looming in 2024. The 2024 elections present another risk: the prospect of the BJP losing seats – if not its majority – which could endanger the continuity of its pro-market, reformist agenda.

Lastly, investors must be mindful of equity valuations. India's equity multiples have recently traded higher than many of its EM peers. Part of this is due to investors cooling on China. Yet, we view India's valuations within the context of its clear potential for long-term – and structural – economic growth. While valuations have drifted above their long-term averages, we believe that, given India's reform agenda, impending capital expenditure cycle, and innovative corporate sector, earnings over a multi-year horizon have the potential to exceed what's currently priced into the market.

[1]A country's age dependency ratio is the number of citizens younger than 15 and older than 65 per 100 working-age citizens.

Important information

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