Strategic case for investing in India in the current business cycle

- India – the best structural growth story in Asia and EM for the next 10 years.
- India will become a source of outperformance in the global equity portfolio.
- The weight of India in global portfolios will increase as the country makes its way to becoming the 5th largest economy within 5 years and the 2nd or 3rd largest economy in the world within the next 8-10 years. In size, India's economy will overtake France in 2022 and the UK in 2023.
- Indian financial markets - a safe haven in the next 2-3 years?
- 7.3% 10Y government bond yield in currency, set to appreciate over a 3 to 5-year period, is a good option for placing cash in volatile times.

A combination of powerful forces will transform India's economy over the next decade, changing the balance of power in Asia. Technology breakthroughs, energy transition, and geopolitical shifts are creating new opportunities for the country. Economic growth this year of 7.5- 8% will be the highest among big countries, according to the IMF. A massive single national market is being created, where the companies grow through economies of scale, and where both companies and consumers use the modern financial system instead of "grey" economy schemes. A consumer class, one of the largest in the world, is being born. Financial reforms have made it easier to float new companies and bankrupt bad ones. Local business leaders see a government that is more consistent and less corrupt than its predecessor.

Overall, what convinces me most about India's future is how Indians worship education as the path to progress. From village schools to evening tuitions to Indian Institutes of Technology (IITs), this devotion to education is the main accelerator of the country's economic growth. Almost every Indian family places education for children as the number one priority.

A new pattern of growth is visible. Domestic tech effort is a key driver.

- India is becoming a technology and science powerhouse in the most advanced fields of technology: IT, Fintech, Biotech, AI applications, etc.
- As the cost of technology has dropped, India has rolled out a national "tech stack": a set of state-sponsored digital services that link ordinary Indians with an electronic ID, payments and tax systems, and bank accounts. The rapid adoption of these services has forced the old, inefficient, "grey" economy based on cash payments to evolve into the 21st century. Digital services push consumers to make transactions efficiently in the official economy (even if their jobs remain in the grey economy), raising productivity and channelling funds into the banking system. As a result, India has surpassed every nation including China and the US in digital financial transactions. India made 48.6 billion real-time online payments in 2021, more than 2.6 times more than China. All this is taxed, allowing the government to redistribute funds using the direct welfare system to support a great mass of under-skilled and underemployed people.
- Today, India is the 3rd largest destination for VC/private equity flows after the US and China. A rich venture-capital system can finance firms throughout their life cycle, from angel funding to public offerings (which financial reforms have made easier). Local VC professionals estimate there is a pipeline of 10,000 real, credible start-ups created each year.
- India's IT services and outsourcing industry has doubled in size over the past decade. Its annual revenues are now $230bn.

Indian financial markets - a safe haven in the next 2-3 years?

India's stock market is the 5th biggest in the world with a market capitalization of USD 3 trillion. It is also liquid.

Indian equities have been relatively resilient in 2022 with the Nifty 50 Index down 1.1% (in local currency terms) as of 29 July 2022. Foreign investors have sold around USD 34.5 billion out of USD 625 billion of foreign equity holdings in Indian equities. Deterioration in the Goldman Sachs US Financial Conditions is the main factor (correlation 80% +) influencing the performance of emerging market (EM) assets over the last 25 years. The index covers the main aspects of US economy and monetary policy: USD (U.S. Dollar Index DXY), the 10Y Treasury yield, inflation, and the performance of the S&P 500. All the components of the index were in the red in 2022, which resulted in outflows from India and all major emerging markets and negative performance of the major EM asset classes.

There are clearly short-term tactical risks in India. On 4 May India's central bank kicked off the tightening cycle in line with other central banks, raising interest rates from 4% to 4.4% in response to rising inflation. Another interest rate hike is expected in August or September. But such a move is fully discounted by the bond market, which has seen the 10-year government bond yield rising from 5.82% at the start of 2021 to 7.32% on 29 July 2022.

The Indian rupee has been holding better than other currencies and depreciated 6.5% YTD. The rupee's decline partially mirrors decline in several other global currencies against the U.S. dollar (DXY index) which has appreciated 10.61% in 2022 (as of 29 July 2022).

India's foreign exchange reserves have fallen by around $53 billion this year to $580 billion as of 8 July. India's central bank has been selling dollars to try to keep the rupee from sliding sharply, which is one of the reasons for the decline in foreign reserves. Reserves are particularly important for India as it is an import-dependent country. Any spike in commodities prices will deteriorate the situation with the current account deficit, add pressure to inflation, and might result in further rupee depreciation.

These are important but short-term risk factors.

The Reserve Bank of India (RBI) is one of the most respected central banks in the world. RBI has built and maintained its credibility by pursuing prudent, conservative monetary policy. It has never used new, unconventional monetary tools based on negative interest rates, nor uncontrolled money printing and debt accumulation, which have been actively used by western central banks.

Following Russia and China, the RBI also issued a notification to set up a mechanism for settling imports and exports in rupees rather than in a foreign currency. This will support the rupee in the long term.

We have confidence in Indian currency, equities, and government bonds in the long run, with a 3 to 5-year horizon. We think that despite the high volatility the Indian rupee will appreciate versus the USD in the long run and Indian equities will outperform major world equity markets. In addition, Indian government bonds are a great place to hide during the time of uncertainty, chaos, global recession. We would use any string correction in rupee as an opportunity to buy Indian government bonds.

Inflows in Indian domestic equity funds continue. A growing pool of domestic investors offer resilience should foreigners feel forced to flee. There is increasing evidence of a secular shift into equities from a growing pool of household savings. Indian households had only 4.8% of their total assets allocated to equities at the end of FY21, though this was up from 2.2% in 2014. This compares with 49.4% in property. We are confident that in the future the Indian stock market will be increasingly driven by domestic flows into the mutual fund industry where assets totalled close to USD 500 billion at the end of April 2022.

We think Indian equities offer a better risk/reward opportunity than developed western markets in the next decade. Western markets will drift through a low-return environment which will be based on a long-term bear market, global recession, a much higher level of inflation than the majority of investors expect, the collapse of corporate earnings, structural de-rating of equity valuations, and financial repression. Foreign institutional investors will be anxious to increase weighting in India during any meaningful correction because most of them believe in the power of the long-term story. We would use any strong correction as an opportunity to increase positions in Indian equities.