A Review and Outlook for Indian Equities

Returns for the Indian Equity Market vs Other Key markets in 2018

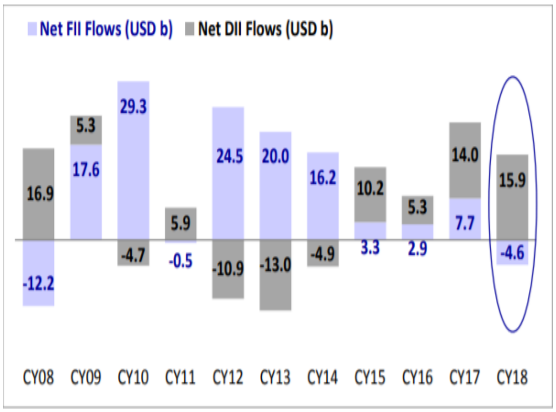
It was a year where benchmark indices representing Indian equity markets performed quite well relative to their emerging market and developed market peers. Three regions to fare particularly poorly in 2018 were China, Australia and Emerging Markets (which China dominates). Australian investors should be wary of having a heavy concentration in their investment portfolios to the thematic of China, Australia, residential housing and AUD in 2019.

It was the BRIC's ex-China that did well in 2018, with Brazil, Russia and India producing positive returns in AUD and local currency terms. It's easy to forget that the AUD behaved liked an Emerging Market currency. The table below illustrates returns (in Australian Dollars) for accumulation indices of relevant equity markets.

AUD Returns	*3 months*	*6 months*	*12 months*
MSCI India	5.33%	5.22%	2.82%
MSCI China	-8.30%	-13.32%	-10.02%
ASX 200	-8.24%	-6.83%	-2.84%
NZSE	-2.07%	2.53%	10.08%
S&P 500	-11.16%	-2.21%	6.06%
MSCI World	-11.06%	-4.57%	1.26%
MSCI EM	-4.95%	-3.93%	-5.25%

For NZD returns simply reduce returns by 3.5-4% over 3 & 6month periods and 4.5% over 12 months as the NZD appreciated by around 5% relative to the AUD in 2018.

Why did Indian equities perform well in 2018 relative to other competing equity market investments? We can attribute this to the usual fundamentals we know, such as being the fastest growing major economy and improving corporate earnings growth (with low volatility in this earnings growth and high ROE). Earnings are expected to be between 15-20% p.a. (next 3 years[1]).



Source: Motilal Oswal – Bulls and Bears Report

Additionally, local investors in India came to the party, buying US$17bn worth of Indian equities (compared to foreign investors selling US$4.6bn in CY18). Local investors invested mainly in the format of monthly investment plans into mutual funds (US$1.1bn per month vs US$750m the prior year). Despite foreign perception of India looking overvalued and being burdened with rising oil prices and the resulting weakening currency as well as an upcoming National Election (May-19), local investors continued to increase their participation in equities to accumulate long-term wealth. This is an interesting development as it has served to reduce the volatility of India's markets and reduce the dependency on foreign investors. Remember the fluctuations of the Rupee do not have an impact on local investor sentiment!

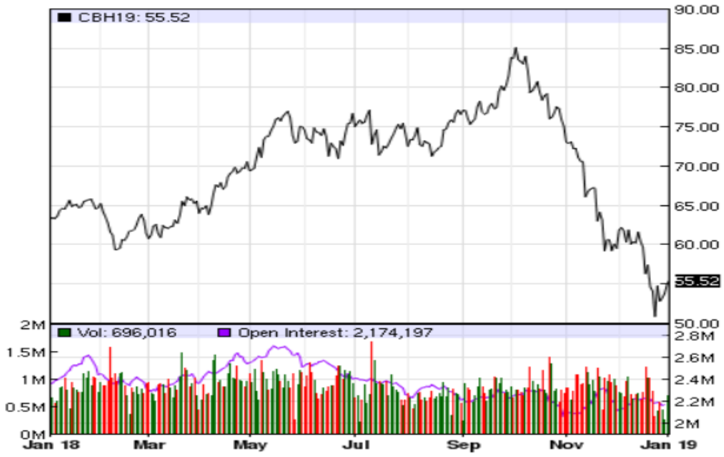
[1] Broker consensus expectations

Source: XE Corporation

In reference to the currency, we can see that the INR appreciated against the AUD over the year! This is despite the weakening of India's currency relative to the USD on issues such as rising oil prices. However, the AUD continues to operate in a similar ilk to the EM currency basket (0.9 correlation). It remains a risk-on currency. We expect the INR to hold its own and potentially appreciate against the AUD in 2019.

Indian Market Risks

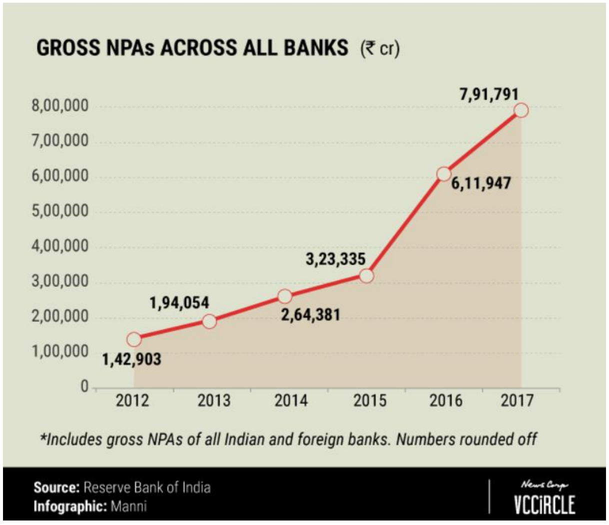
India's equity market performance is remarkable given the number of headwinds faced over 2018:



Rising oil prices impact the current account position and destabilise the currency. This led to the use of open market operations and accumulated foreign reserves to defend the currency.

However, since the peak price of US$85 per barrel on October 2, 2018, oil has retraced significantly, providing breathing room to India's macroeconomics and corporate profitability.

Source: Nasdaq



Question marks over the strains on the banking system remain, given the significant non-performing loans (estimated now at US$200bn). The Bankruptcy Code Reform and effort by the RBI to clean up lending and the financial system brought to bear pressures on the system when liquidity was tight due to rising bond yields (Sep-Oct 2018). This led to a default by one of India's largest infrastructure in IL&FS, before the Government and Central Bank stepped in to assure investors and inject liquidity.

A sum of Rs.791791 crores in the chart above equates to approximately AUD$160bn (reported at end of 2017). Most recently Banks have reported better recoveries from stressed assets owing to the implementation of the Insolvency and Bankruptcy Code two years ago. Total recoveries stood at ~US$6bn from disputed loans of ~US$42bn in FY17-18. For example, steel companies which borrowed significantly in the surge of investment activity during 2003-2007 that turned into bad loans over the next decade are now being resolved or closer to resolution e.g. Bhushan Steel and Essar Steel.

PM Modi and his BJP Party's fading popularity, given poor perception of reforms like Demonetisation and GST (which we put together hastily), has generally been at the lower socio-economic levels. Anti-incumbency is common in India amongst this group and the BJP have encountered this in 2018, leaving investors questioning if they can repeat their strong win of 2014 and if indeed, win at all. The BJP and its alliances form the National Democratic Alliance (NDA). The NDA won 336 seats out of 545 in 2014 in the Lower House for India's first political majority in 24 years (BJP won 286 seats on its own accord). It is unlikely to secure the same outright majority in 2019, but likely to win nevertheless.

Are Index Returns a true measure of market performance?

Index returns can be very deceiving and can paint a very different picture to broad market performance. In 2018, it was the top 5 stocks by market capitalisation that drove the MSCI India to positive returns. Investors sought large and liquid stocks, with foreign revenue generation (IT companies benefitting from a weaker currency) which were less likely to be impacted by currency devaluation and rising oil prices. The top 5 stocks by market cap are over 33% of the weight in the Index.

In fact, when comparing the performance of the Nifty (local Index - top 50 by market cap) to Nifty Mid Cap 100 and Nifty Small Cap 100 the difference is alarming. Nifty returned 3.1% for CY18, whilst Nifty Mid Cap and Small Cap returned -15.4% and -29.1% respectively. This indicates the dispersion in the broad market as risk-off behaviour was illustrated in India, but not evident in large-cap market indices.

Typically, active management in India is related to a high level of market inefficiency and trading and primary research on undiscovered companies. India's stock markets after all have close to 6,000 company listings, which is the most of any in the world.

Most active managers investing in Indian markets, local or foreign based, suffered underperformance relative to their passive market-capitalisation orientated benchmarks, due to the "mega cap effect" in 2018. Our performance was also similar, which we have kept you up to date with in our fact sheets. Our year end fact sheet will be out on January 15th.

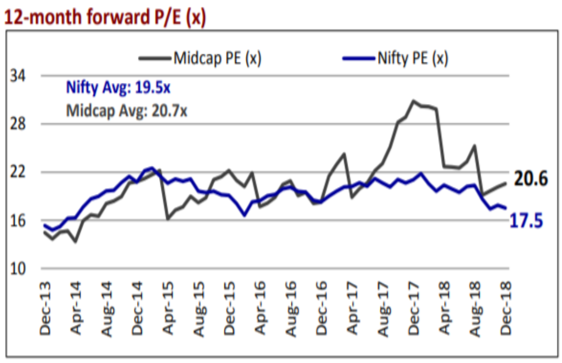
India Avenue's Proposition

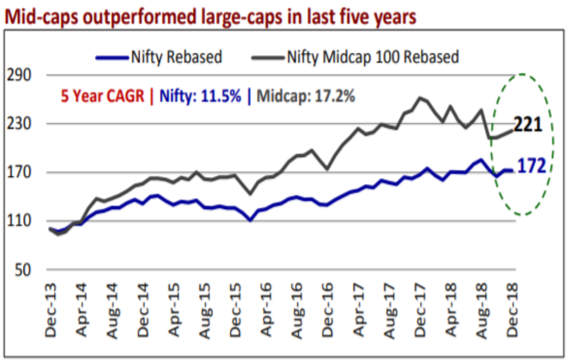
Our proposition revolves around our philosophy that India is going to be a high growth region given its significant and youthful population and a very low base of GDP per capita. With some economic and market reforms, significant bottlenecks can be reduced to create even higher sustainable growth.

Additionally, it is our view that the best way to invest for growth in a market like India is to adopt an active approach that focuses on depth in stock picking. Primary research and the local knowledge advantage we believe can produce significantly better results than passive market-capitalisation based investing over the long-term.

Our assessment and knowledge of locally based investment managers / advisers in India provides evidence that active management and investing with depth is a winning strategy in the long-term. In 2018, given significantly higher valuations for mid and small cap stocks (after a 4-year bull run over 2013-2017), we saw a reversal of this trend as investor sentiment was impacted by cyclical weakness induced primarily by rising oil prices.

We had been adopting a relatively cautious approach to mid and small cap investing, given the significant valuation differential between mid and small caps vs large caps, particularly at the end of 2017 (see below). However, as the valuation premium of mid and small caps have tapered significantly by the end of 2018, we have used the opportunity to increase our exposure from 20% to 40% of our portfolio (to mid/smaller cap companies) over the course of the year.



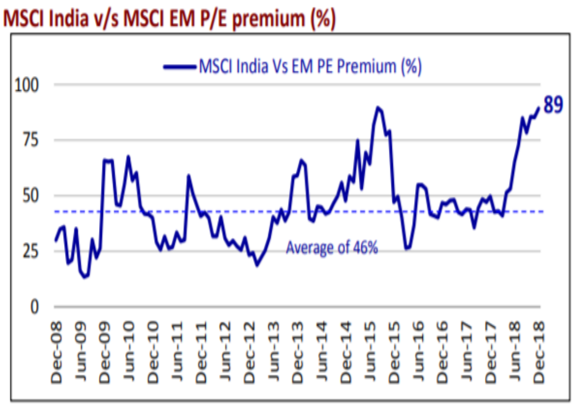


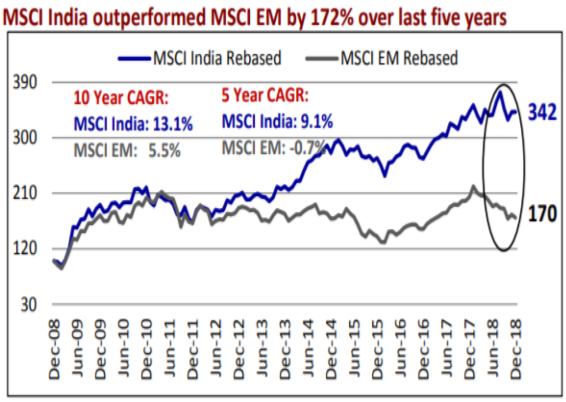
Source: Motilal Oswal – Bulls and Bears Report

Valuations

One can look at India's one-year forward P/E and feel that it appears over-valued relative to other cheaper EM countries. However, this incorporates the lower run-rate of earnings India has experienced over the past 5 years compared to an expected pick up in earnings from FY18-22 (in the positive business cycle earnings growth averaged over 20% p.a.).

With GDP growing at over 7% p.a. and corporate earnings about to strengthen, it is evident why investors are increasingly seeking independent exposure to India's economy. Its P/E premium to Emerging Markets P/E is telling us that India is decoupling from being wrapped up in an EM trade (particularly given the Chinese economy appears to be in an economic slowdown). Whilst the P/E premium (one-year forward) has blown out, we don't see this mean reverting any time soon given India's earnings growth trajectory and domestically insulated economy (trade-wars less likely to impact).





Source: Motilal Oswal – Bulls & Bears Report

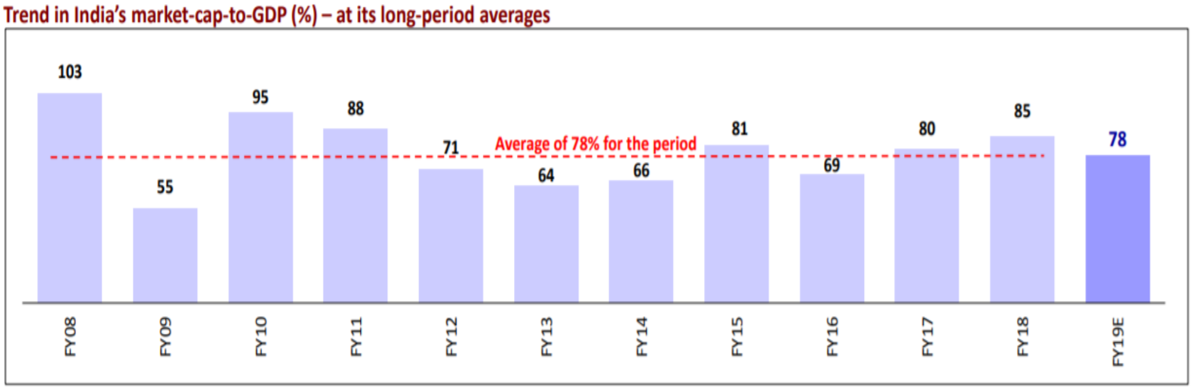
If you are asking, why India should trade at such a hefty premium to other EM's, then the answer is in its low volatility, sustainably strong earnings and higher RoE, equating it rightfully to the status of a quality stock and with a premium multiple.

MSCI Index	*Std Dev of EPS growth since 2002*	*Avg ROE growth since 1996*
India	13%	18%
China	19%	13%
Brazil	44%	13%
Russia	45%	13%
Emerging markets	27%	13%
All Country World Index	34%	12%
US	33%	15%
Developed markets	35%	12%

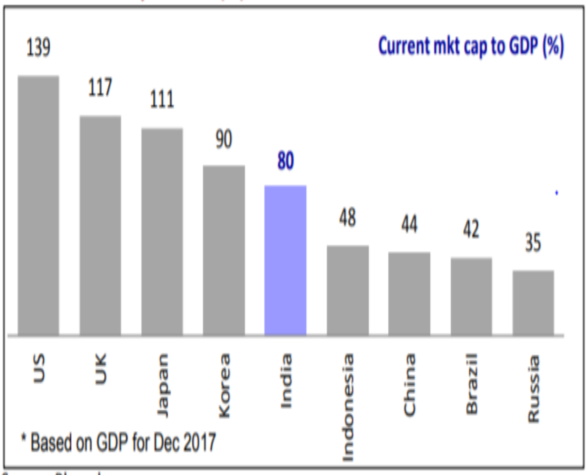
Source: Morgan Stanley research

With local investors in India discovering equities as a form of wealth accumulation, we expect a new premium to EM to be established. In our opinion, looking at India's valuations through market-cap to GDP provides a more sanguine view. Market-cap to GDP is frequently used by investors like Warren Buffett, especially in assessing opportunity rather than today's stock price relative to current earnings.

Trend in India's market-cap-to-GDP (%) – at its long-period averages



Global market-cap-to-GDP (%)



Source: Bloomberg

In this chart we can see that India's stock market may not be the cheapest relative to some other emerging markets. However, as alluded to earlier, it doesn't have the cyclicality of earnings experienced by Russia or Brazil. China is in a slowdown, but also appears attractive from a long-term structural perspective.

The key point here is that India's highly investable, deep and liquid market offers a far more attractive valuation compared to developed markets. The steep ascent of its GDP will continue to provide a fertile hunting ground for stock pickers.

Outlook for 2019

The key risk and opportunities we see in 2019 are as follows

- Markets to remain somewhat volatile leading up to the National Elections in May 19
- The Government to provide further hand-outs to rural India as the key voters in the election. Will have to monitor fiscal discipline and observance of it
- Likely reduction in interest rates via monetary policy, given benign inflation and receding threat of currency weakness
- Newly appointed RBI Governor to be far more "market friendly" in terms of interest rates and more pro-active on dealing with bad loan issues
- Signs that we have reached the bottom of the provisioning for bad loans
- An increase in capacity utilisation and capex, particularly in 2H2019
- Improving earnings growth as we see improving contribution from the finance sector and less impact from higher input costs from rising oil prices

We expect companies in the Banking, Consumption and Industrial companies to outperform in the first half of 2019. Provisioning in Banks have bottomed out and we expect earnings to improve significantly from here, particularly given credit growth. Our top picks here are ICICI Bank, HDFC Bank, Kotak Bank, State Bank of India, IndusInd Bank and Axis Bank.

Consumption will also remain a dominant theme as interest rate cuts are delivered, retail credit growth increases and the benefit of handouts to rural India (Government initiatives, populist measures and farm loan waivers) lead to a pick-up in spending. Our top picks here are Mahindra and Mahindra (autos/tractors), Dabur (consumer health products), Britannia Industries (biscuits, milk and basic foods), Crompton Greaves (consumer products) and Sun TV (media/television).

We expect markets to remain volatile over the first half of 2019, with good stock picking opportunities, particularly in banking, consumption and capex related industries. In the second half we are likely to see the resumption of India's nascent business cycle, which should last till 2022-23 (according to the World Bank). ***The next 6 months should provide an opportune time for investors to start or add to building wealth in the world's fastest growing major economy!***

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