Indian equities: Where to next?

Following a period of sustained gains, Indian equities have experienced a correction in recent months. In this note, Rana Gupta, Manulife Asset Management's India Equities Specialist outlines the factors that are likely to continue to support the Indian equity market. Rana concludes that despite recent volatility, the medium to long term outlook remains promising, as a result of continuing government reforms and improving corporate profits.

Since reaching an all-time high during the first week of March, Indian equity markets have retreated by around 14%. In assessing market prospects over the medium to longer term, we believe that the pace and progress of reforms implemented by the Modi-led government and an improvement in corporate profitability are two key factors that are likely to be supportive for Indian equities going forward.

Government reforms to drive economic growth

Since coming to power in May 2014, the Modi government has undertaken a number of reforms that we believe will drive economic growth in the years ahead. These include:

Reforming government bureaucracy and promoting cooperative federalism: The Modi-led administration has removed the bottlenecks in administration and streamlined the government decision making process. Bureaucrats and ministers with reform credentials have been appointed to key ministries while states have been given more independence, including a higher degree of fiscal autonomy.

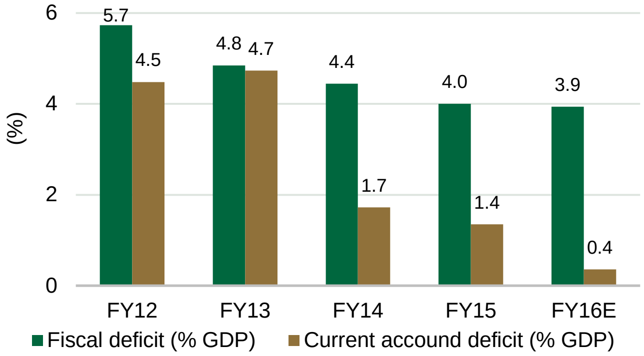
A transparent auction driven policy for the allocation of natural resources: Following the Supreme Court decision to cancel licenses allocated to private companies in September 2014, the Modi government has moved swiftly to develop a transparent, auction driven process to allocate natural resources. This is likely to end the arbitrary allocation of natural resources and reduce the scope for corruption and subsequent legal uncertainties, which have stalled projects and held back new investment. We also expect to see a pickup in investment in the natural resources sector following this clarification in regulations.

Arresting leakages through a direct benefit transfer (DBT) system: The Indian government spends around 2.2% of GDP on various subsidies and transfers. However the method of distribution has long suffered from leakages. The government plans to transfer all subsidies onto a DBT platform, in a phased manner. This will reduce the overall subsidy burden (by plugging leakages, thus reducing corruption) and ensure subsidies will go directly to recipients.

An efficient indirect taxation system to be rolled out from FY17: The current administration has laid substantial groundwork for the roll out of a goods and services tax (GST), which requires an amendment in the constitution and is currently before parliament. The GST will subsume a complex myriad of indirect central government and state taxes, improving tax compliance and increasing tax revenue.

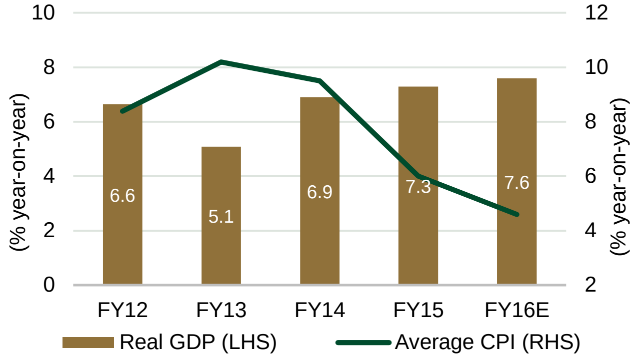
Fiscal reforms: Arun Jaitley, India's finance minister aims to reduce the fiscal deficit to 3% of GDP by FY18 from the current 4.0% (see Figure 1). This is expected to be achieved by moderating growth in entitlement schemes, reducing subsidy leakages and adopting a DBT scheme. An increase in revenue from the GST and government auctions of natural resources is also expected to help reduce the fiscal deficit. The minister has also committed to simplifying and lowering basic rates of corporate tax from the current 30% to 25% over the next four years.

Figure 1: Declining fiscal and current account deficits



Source: Reserve Bank of India, Centre for Monitoring Indian Economy, CLSA, Ministry of Finance, June 2015.

Figure 2: Improved economic growth and moderating inflation



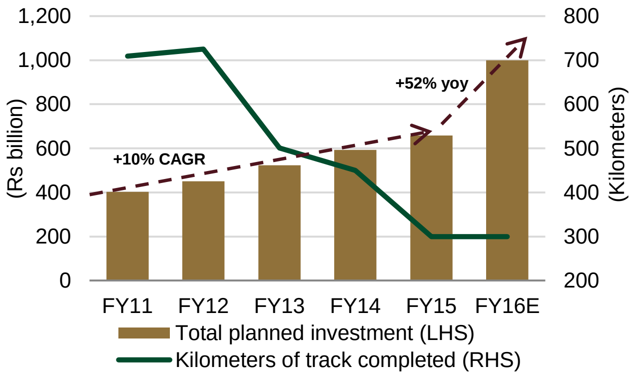
Source: Reserve Bank of India, Centre for Monitoring Indian Economy, CLSA, June 2015.

Inflation has also been curtailed significantly, from around 10% in FY13-14 to an expected 4.6% in FY16 while GDP is expected to increase to 7.6% in FY16 (see Figure 2). Fiscal reform, lower inflation and a decline in commodity prices have also helped to reduce India's current account deficit, which is expected to fall to 0.4% of GDP in FY16. This reduction in inflation and improvement in external accounts has increased the scope for the Reserve Bank of India (RBI) to reduce policy rates during 2015. The RBI has already reduced policy rates by a total of 0.75% to 7.25% in the year-to-date and we expect another 25 - 50 basis point reduction in the remainder of 2015 or in early 2016. The RBI has also accumulated significant foreign exchange reserves (around US$350 billion) to achieve its twin objectives of a stable but competitive currency and an improvement of external accounts.

Revival of infrastructure investment

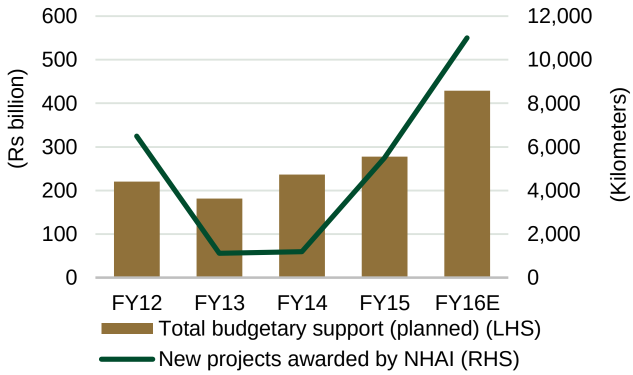
The government is also undertaking reforms which are expected to help revive investment in India. Allocation to infrastructure investment was increased in the February 2015 budget, with capital expenditure budgeted to increase by 25.5% year-on-year to US$39 billion. Allocations that have been increased the most are roads (US$14 billion, an increase of 126% year-on-year) and railways (US$16 billion, an increase of 52% year-on-year). We expect a significant pick up in the laying of new lines and increased investment in existing lines by Indian Railways (see Figure 3) and a substantial rise in road orders from the National Highway Authority of India (see Figure 4). In addition, the government is working to resolve bottlenecks in coal production, with production expected to double by 2019 from current levels.

Figure 3: Increased investment in railways



Source: Indian Railways, CLSA, Manulife Asset Management, March 2015.

Figure 4: Increased investment in roads



Source: National Highway Authority of India, Ministry of Finance, CLSA, June 2015.

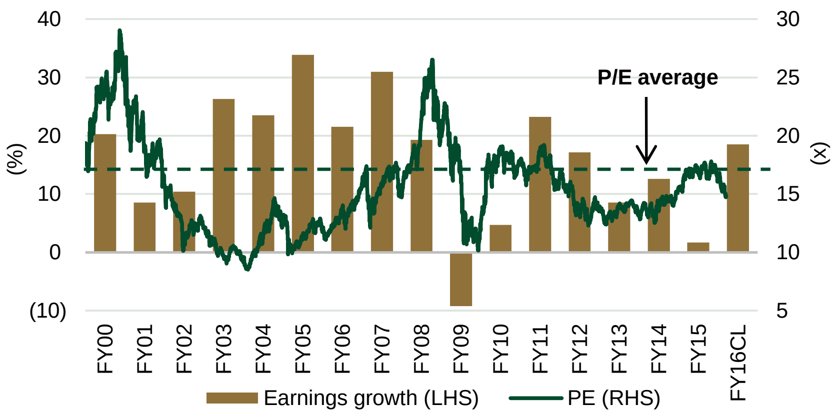
To revive domestic manufacturing, the government is expected to focus on improving manufacturing exports and encouraging import substitution. Defense and railways are likely to be the government's two major focus areas. In addition, we expect to see more multinational companies invest in India (through joint ventures with domestic companies). In our view, investment in infrastructure will have a multiplier effect and lay the foundation for future growth.

Improvement in corporate profits

Indian corporate profitability has plummeted to multi-year lows in FY15, while corporate profit as a percentage of GDP has slipped from 7.1% in FY08 to 4.2% in FY15[1]. With an improvement in domestic demand and a substantial decline in commodity prices, we expect profit growth to bounce back in FY16 and FY17. As the government undertakes reforms to transform the economy into one that can sustain higher growth rates over the longer term, near-term growth and earnings are likely to be gradual and uneven. However, the medium- to long-term outlook is brighter.

The expected increase in growth should translate into better earnings. Revenue and margins estimates are currently at low levels and earnings are expected to surprise on the upside over the next 12 to 24 months. The acceleration in earnings is likely to occur at a time when valuations are in line with the long-term average. Historically, price-to-earnings ratios have typically re-rated along with sustained earnings acceleration. Although we expect to see a significant pickup in growth, the Indian equity market remains reasonably valued, currently trading at around 15x price-to-earnings based on one-year forward estimates[2].

Figure 5: Earnings growth and P/E ratios



Source: CLSA, June 2015.

Additionally, while domestic investor participation in equity markets has significantly improved, equity ownership among Indian households remains low, at 2.7% versus 4.5% in March 2008[3]. We expect inflows from domestic investors to steadily increase along with more inflows from foreign investors following a pickup in corporate earnings and on any earnings surprises along the way. We also expect to see increased liquidity as savings shift from unproductive non-financial assets, such as gold, to more productive assets such as equities as a result of better economic growth prospects and lower inflation.

[1] Centre for Monitoring Indian Economy, RBI, CLSA, June 2015
[2] Bloomberg, 23 June 2015
[3] CLSA, June 2015

Potential risks

Despite our overall constructive outlook, it is important to flag potential risks that we are watching. These include: any global event which could reduce risk appetite and flows to emerging markets; lower-than-expected rainfall during the monsoon season which could stress rural and agricultural incomes, increase food prices and lead to a rise in overall inflation; and a sustained rise in global commodity and crude prices which is likely to have a negative impact on the current account (unless domestic fuel prices keep pace with international prices).

Our view on Indian equities

We continue to believe that public capital expenditure on infrastructure and further monetary easing are likely to spur GDP growth going forward and the overall market environment is likely to be supportive for Indian equities. Over the short term, the recovery process is likely to be gradual and uneven with more potential for market volatility. However, the medium- to long-term picture looks decisively better.

We will continue to focus on domestic cyclical stocks with high quality management teams that are likely to benefit from reform measures. We believe the transportation and industrial sectors are likely to benefit from the government's increased spending on roads, railways and other infrastructure projects once spending gets underway. We also expect privately-owned banks to play a role in the revival of economic growth and are also positive on the auto sector. We maintain a neutral view on export-oriented sectors such as information technology and pharmaceuticals. We have remained underweight in sectors such as consumer staples, due to regulatory uncertainty in tobacco and high valuations elsewhere in the sector. We are also underweight global cyclical sectors such as metals and energy due to the uncertain outlook on crude and commodity prices and we continue to remain underweight on utilities and telecommunications due to regulatory uncertainty, increasing capital expenditure and limited visibility for earnings progression.