Investors must re-examine assumptions about India

By Shiv Puri

WHILE global liquidity lifted all boats like a rising tide during the boom of 2003-2007, that scenario is un-likely to be repeated again. So, investors need to be more careful now than they might have been before. One mistake they should avoid is to paint all emerging markets with the same brush. As we look into 2015 and beyond, the potential divergence among growth rates and equity market performance will become starker. In the Asian context, many global investors look at China and India as the two big potential opportunities. China is far ahead in terms of overall infrastructure devel-opment, manufacturing competency, the size of its foreign exchange reserves and its sheer scale. However, India has so far won hands down when it comes to making money for investors in the equity markets compared with China. Despite the economic slowdown and policy missteps in India over the past few years, the BSE Sensex (Bombay Stock Exchange index) is only about 10 per cent below its 2007 peak in dollar terms and well above its peak in local currency terms. The Shanghai Composite Index is still down more than 50 per cent from its 2007 peak in US dollar terms. The reason for this is clear – India has many world-class entrepreneurs, quality companies, more transparent accounting and, most importantly, a healthy respect for the cost of capital. These are the main tenets for investors to make money – not GDP growth by itself. It is possible that Chinese stock markets will rise because they are down a lot, but a case for secular returns in equity markets can-not be made unless the fundamental tenets mentioned above are addressed. China's best-case scenario for the next couple of years is a gently slowing economy while it transitions from investment-driven to consumption-driven growth without any serious accidents. China faces risks: history is littered with examples of economic troubles caused by overinvestment. But, where India is concerned, rarely does a functioning country ever suffer a serious economic problem when basic demand is more than supply – as is the case in virtually every sector. India is in the midst of a cyclical and structural upturn. The combination of stabilising macroeconomic outlook, a business cycle up-turn and political change has happened in 1984, 1991, 1999 and 2004. Each time the stock market moved up more than 100 per cent over the next few years. The "low hanging fruit" in India is enough to get real GDP growth to the 6-7 per cent range very quickly. Last quar-ter, GDP growth jumped to 5.7 per cent with just a slight easing of bureaucratic bottlenecks and improved sentiment. The infrastructure seg-ment of the economy has not even started to show up in the numbers and will probably add one to 1.5 percentage points to GDP growth in 2016. Concerns by naysayers about the lack of "big bang" re-forms are misplaced.

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The new administration under Prime Minister Narendra Modi is first trying to make existing things work better. That would be enough to get India's growth rate up. Also, why make big bang announcements which will potentially raise the political temperature when they can-not be acted upon immediately anyway? It's easier and smarter to reform, when the economy is already in the upturn. But, that said, re-cent actions such as the Bill for simplifying labour laws and rolling back subsides on diesel are serious reforms. Diesel subsidies alone cost India about 1.2 per cent of GDP in 2013. They have now gone. If this is not an example of a major reform, then what is? While India is getting the attention of foreign investors, which is usually a leading indicator of inflows , most investors are afraid of "pulling the trigger", given the 30 per cent rally in the markets this year so far. Foreign in-flows to India in 2014, at about US$13 billion, are about half the inflows of last year.

However, the conditions in India are similar to those that existed in 2004 – a business cycle upturn along with political change. At that time, the markets went up 180 per cent over the next four years, excluding the sharp rally towards the end of 2007 when valuation multiples got stretched. The rally from 2003 started after the preceding five or six years of zero returns in the equity market. The rally in 2014 has also started after a six-year period of zero return in the equity market.

As Mark Twain said, "History may not re-peat itself but it does rhyme." That is likely to be the case here. Despite the disappointment in In-dia's country growth rates over the past few years, the country is moving decisively in a new direction. It is likely that there will be a signifi-cant opportunity cost to investors who wait for all the evidence to come in over the next 2-3 years. A recent tailwind that should not go un-noticed is that the decline in oil prices, from US$110 to below US$80 a barrel, is equivalent to a US$20 billion stimulus for the Indian con-sumer. As Warren Buffet wisely said, "in the business world, the rear view mirror is always clearer than the windshield".

Global investors who pick and choose their spots and concentrate their investments in specific countries are likely to significantly out-perform those who rely on a top-down approach using the MSCI Emerging Market Index or any such comparable benchmark. As regards India, investors must reexamine their assumptions, re-test old hypotheses and up-date their knowledge on the essence of the changes taking place.

Stock-market corrections in India will be a certainty but inflection points are exciting times. India could meaningfully stand out in a world where countries – both developed and developing – are facing the challenge of slow or no growth. One of my favourite Chinese proverbs is: "When the winds of change blow, some build walls, while others build windmills." The time to build is now.

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