Longer term outlook for India remains highly positive, an expected Modi win bodes well for secular economic and capital market outlook

By Jay Kumar, Adithy Mula, Deepika Veeraragavan

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Key Insights

- The USD$2.6 trillion Indian economy is expected to grow by 7% in 2019, placing it amongst the fastest growing economies in the world.
- India's economic growth is underpinned by structural drivers of private consumption, fixed asset investments and public expenditure and is unlikely to be deterred by the outcomes of the current election.
- BJP and Modi are predicted to win the upcoming election but may not gain the same majority sitting in the Lok Sabha that was achieved in 2014.
- Since Modi's win in 2014, the Indian economy has increased by USD 1 trillion, the Indian stock market has outperformed the Global emerging market index by a notable margin, and the Indian Rupee appreciated 15% against AUD.
- Longer term outlook for Indian investments remains very positive for patient investors.

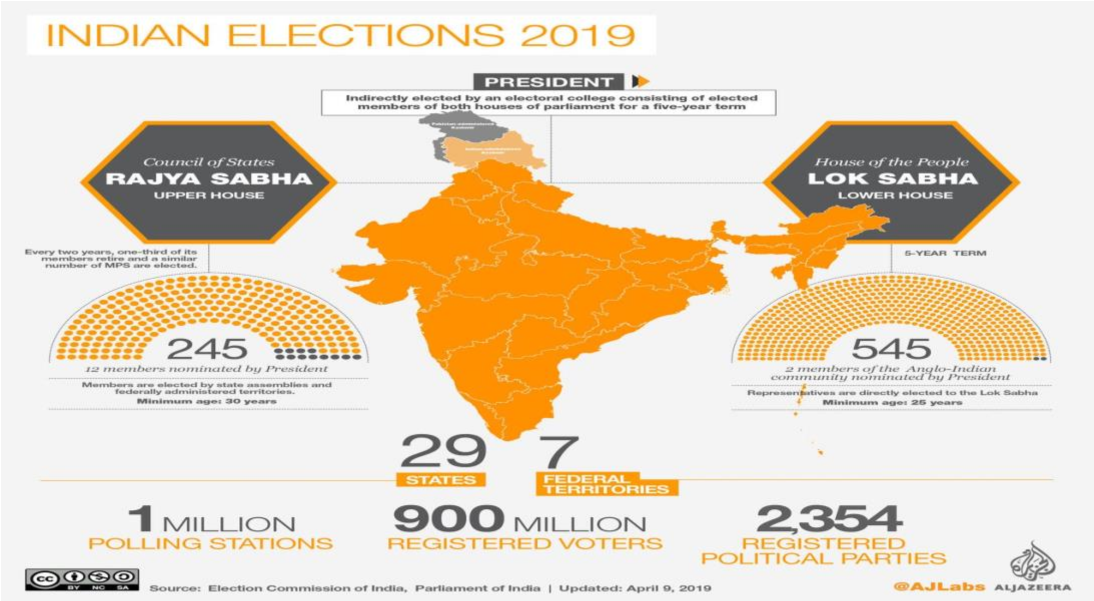
Introduction

The Indian economy has transformed into one of the fastest growing on the global stage with private consumption, fixed investments and government consumptions as key pillars for secular growth. The longer-term outlook for these key drivers remains very positive. That said, the trend GDP growth remains susceptible to cyclical headwinds from various economic reforms that have a longer-term payoff, political uncertainty, exogenous shocks and policy mistakes. The outcomes from the upcoming elections will no doubt remove the uncertainty around the political system and likely pathway for fiscal and monetary policies. Notwithstanding this shorter term uncertainty, capital markets have remained positive and buoyant with a wide expectation for Modi government return.

Structure and predictions for India's national election

In the current political climate, Bharatiya Janata Party (BJP), one of India's two major political parties, is predicted to win the election. However, unlike its majority victory in 2014, poll predictions show that BJP will face difficulty in regaining a majority sitting in India's Lower House. This will result in Narendra Modi, leader of the BJP, to resort to a coalition-based policymaking approach with the National Democratic Alliance. However, under this new government structure, the BJP's pro-business policies and land and labour market reforms are at risk of being stalled or executed with sub-optimal structures. India's multi-stage national election started on April 11 and will end on May 19. The result, due on May 23, will decide who governs the world's biggest democracy for the next five years. Exhibit 1 shows the breadth and depth of this democratic process.

Exhibit 1: Indian Elections – the single largest political event on the planet



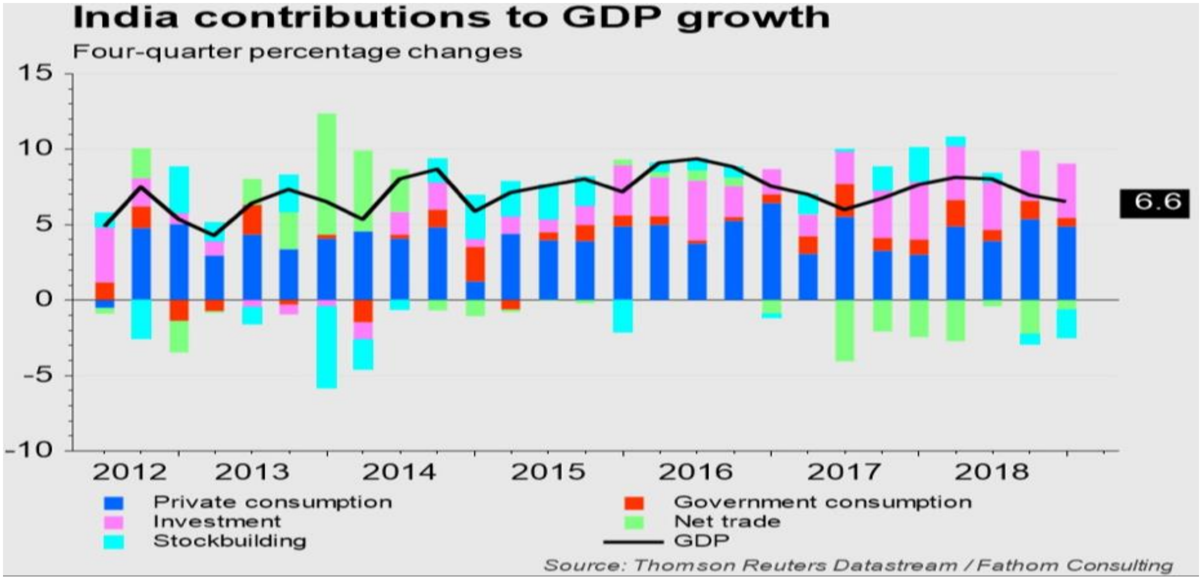
Above 7% GDP growth of India places it as a top-economy

GDP growth in India is forecasted to reach 7.2% over 2019[i] which places the Indian economy as one of the fastest growing economies in the world. India's GDP growth has recorded an impressive annual rate of 7.5% in recent years[ii] with the entire economy now sitting at $2.6 trillion. Since the last elections (2014), India's economy has increased by almost $1 trillion[iii].

Exhibit 2 shows the key structural drivers of GDP growth. As the data shows, private consumptions emerge as the most significant contributors to GDP growth followed by a gradual long-term increase in fixed investment. Fixed asset investments such as infrastructure have substantially increased since 2014 as Modi's government implemented a range of economic and infrastructure policies which in turn have eased the barriers of entry for foreign investors across manufacturing, retail and aviation sectors.

The removal of these barriers has generated significant foreign investment inflows. For instance, flows increased to $45 billion in the last fiscal year compared to $25 billion in 2014[iv].

Exhibit 2: Private consumption and Fixed investment are the key drivers of India's GDP



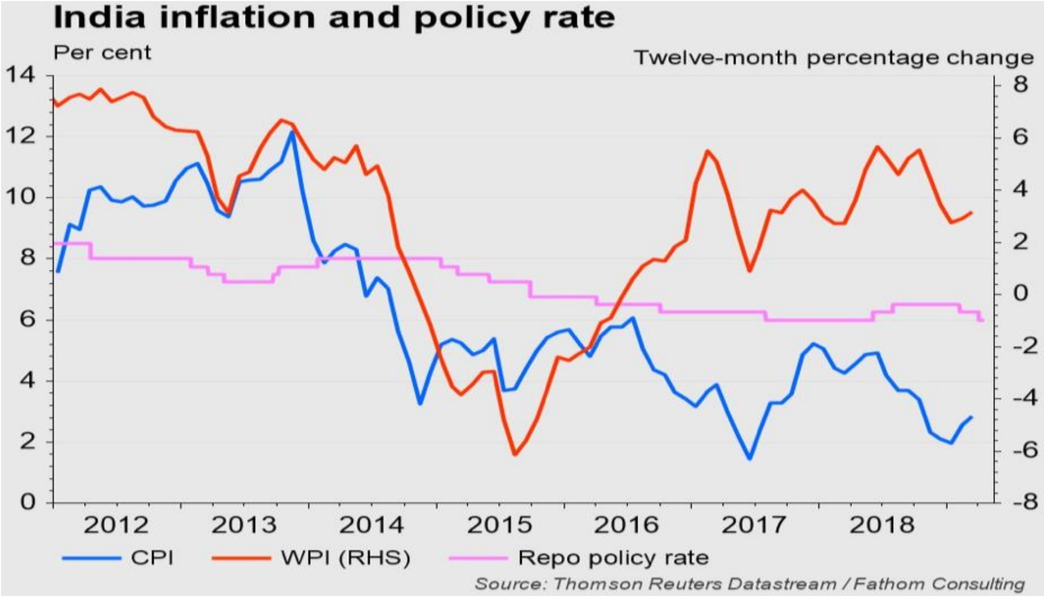
Fiscal Policy

Government spending has also been a key driver of GDP growth. Since Modi's appointment, the increase in government spending has been evidenced by the expansion of the gross fiscal deficit. Some of these expenditures have focused on income support schemes for farming families, income tax rebates and pension schemes for unorganised sector workers. The Reserve Bank of India (RBI) projects a federal fiscal deficit of around 3.4% in the 2018-19 financial year. However, the RBI is expecting this figure to level off at 3% by 2020-21[v]. The government is also expecting an increase in gross tax revenue to 12.1% of GDP in 2019-20[vi] which is expected to assist in the management fiscal deficit.

Monetary Policy

The RBI cut its short-term lending rate for commercial banks by 25 basis points to 6.25% in February 2019 and then again in April 2019 by 0.25%. RBI's accommodative policy has been instrumental in easing financial conditions as well as support growth whilst simultaneously achieving the medium-term inflation objective of 4%. RBI's monetary policy decision was underpinned by a moderate level of inflation that has been closer to the lower bound of the MPC's target range of 2-6%. Further easings are expected in the upcoming months in response to cyclical economic and financial headwinds.

Exhibit 3: The repo policy rate currently sits at 6% after the short-term lending rate cut by RBI.



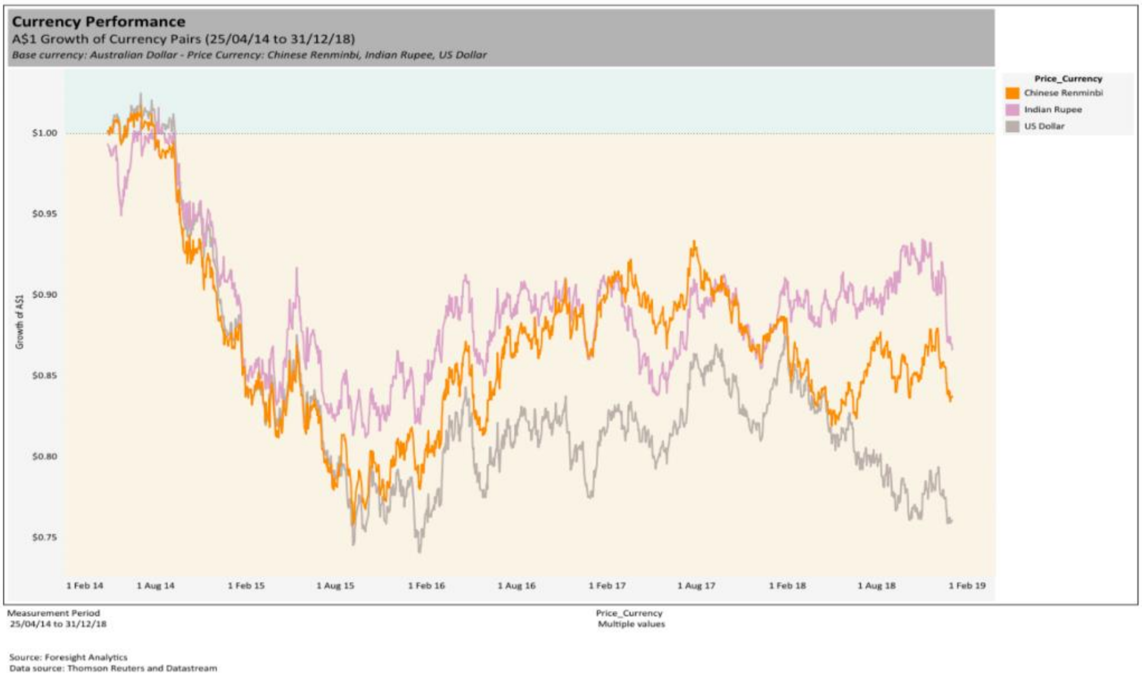
Financial markets to benefit from a stable economy under BJP

Currency

The Indian Rupee (INR) has fared quite well against the AUD since Modi came into power in 2014. Figure 4, shows a sharp depreciation of AUD against INR between 2014 and early 2016. Despite some recovery of AUD/INR over the past two years, the AUD is still down some 15% against INR. The weaker AUD/INR has been positive for Australian investors with unhedged exposure to Indian equity or bond markets over this period.

Most of the AUD weakness can be distilled down to differences in real interest rates, inflation and economic growth. The Australian economy has been growing at below trend growth for some time with much lower levels of inflation. India's inflation has been underpinned by higher economic growth as well as rising oil prices which have contributed to higher fuel costs for Indians. Stability of the INR's performance is dependent on the maintenance of the status quo and hence a majority win and appointment of the BJP is the most ideal outcome for the currency. However, in the circumstance of a BJP defeat in the election, the INR could experience high levels of volatility.

Exhibit 4: AUD/INR depreciation has been positive for investors with unhedged exposure to INR



Equity Market

India's equity market has been one of the best performing Emerging markets in the past 12 months. Exhibit 5 shows that since Modi's appointment in 2014, the Indian equity market (as measured by MSCI India Index) has outperformed the all cap Emerging market index (MSCI EM) as well as MSCI Asia Index.

While the predicted Modi and BJP victory continues to signal a positive outlook for the Indian equity market, investors could take a breather after the recent sharp rally. Election outcome-related uncertainty has failed to dent market sentiment, with the S&P BSE Sensex and the Nifty50 hitting new highs in April 2019. In the medium term, monetary policy stances of global central banks are bigger variables driving flows into emerging markets generally and India specifically, than domestic political news.

In an unlikely event, where the "worst-case" scenario of a hung Parliament and/or a government formation by a disorderly coalition of parties, the equity market could face some turbulence and potentially de-rating risks (Indian equity market trades at a premium to other Asian markets) at least from a cyclical perspective. The longer-term outlook for the Indian equity market is likely to remain very strong regardless of the election outcome. The current consensus earnings forecasts for Indian companies is around 18% which is quite healthy.

Exhibit 5: Indian equity market has outperformed EM Index and Asia Index since Modi's appointment in 2014

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