William Blair

February 2015

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Prospects for the Indian Economy in 2015 and Beyond

Growth drivers behind the current market rally

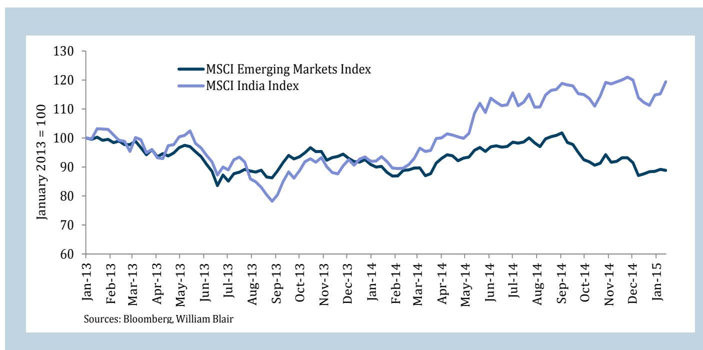
Behind India's recent equity market rally is the resurgent optimism about the country's improving economic prospects, fuelled by the belief that recently elected Prime Minister Modi can return the country to its high growth path of the mid-2000s. To the extent that the government is able to sustain low inflation and channel fiscal savings into productive investment, India can become one of the most rapidly growing Emerging Markets. The country's large number of high quality listed companies offers ample potential opportunity for international equity investors to participate in the country's economic resurgence.

As of mid-January 2015, Indian equities, as measured by the MSCI India Index, registered a 19% gain in the last two years, even as the MSCI Emerging Markets Index remains 11% below its January 2013 level (Figure1).

Behind India's 2014 stock market rally is the resurgent optimism about India's economic prospects, ramped up by a belief that recently elected Prime Minister Narendra Modi can return the country to its high growth path of the mid-2000s and trigger Chinese-style transformational development.

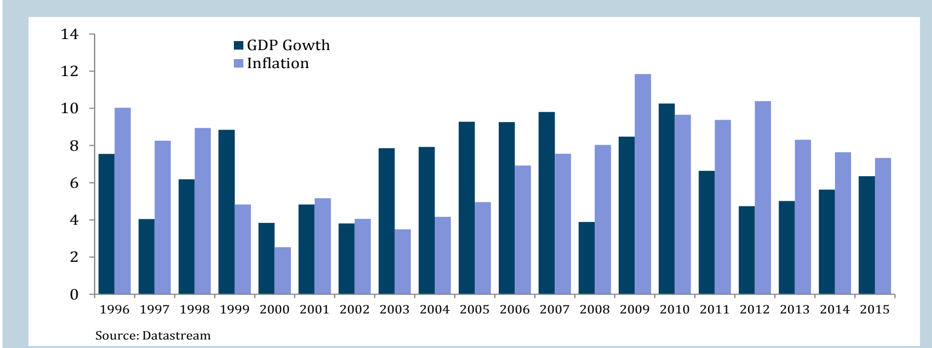
For these expectations to materialize, the mix of growth and inflation needs to change.

Fig. 1: Equities Markets Performance – MSCI Emerging Markets vs. MSCI India Indices



In the years preceding the financial crisis, India experienced strong growth coupled with relatively low inflation (Figure 2). Over the past five years, the mix has completely reversed, with prices growing at or near a double-digit pace, while the economy expanded at half the pace of the early 2000s.

Fig. 2: Growth and Inflation Performance



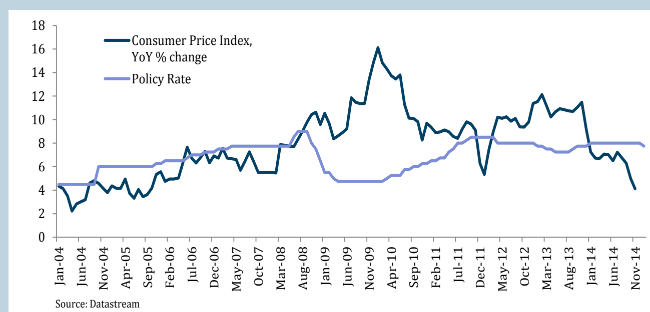
The impact of high inflation has been to suppress real deposit rates. Unsurprisingly, deposit growth cratered as savers sought out stores of value such as gold. In 2014, inflation has fallen below the main policy rate for the first time in two years.

Lower inflation to support growth

By focusing on the fairly new CPI as its target variable, the Reserve Bank of India (henceforth RBI), with Raghuram Rajan as the central bank governor, has resisted calls to cut rates in a dash for growth. To be sure, the policy rate was just reduced by 25 basis points, and further cuts will be determined based upon the next government budget and continued inflation performance (Figure 3). As inflation continues to decelerate and RBI regains domestic credibility, real deposit rates have swung positive. As a result, the savings rate is likely to grow. As savings flow into liquid financial assets such as bank deposits, they will provide the means for increasing capital spending without upsetting the recently achieved macroeconomic balance.

As importantly, sustainably low inflation supports real income growth, thereby facilitating increased consumption. In a country where about 60% of the population lives on less than US $2 a day, and where propensity to consume is high, lower inflation makes a significant contribution to real incomes and consumption growth

Fig. 3: Real Interest Rate – Difference Between Inflation and Policy Rate



Fiscal consolidation to support investment

The result of India's macroeconomic stabilization is an improved fiscal situation, although most fiscal consolidation over the past two years has been achieved by cutting back public investment in order to meet ever growing subsidy bills. Fuel subsidies have accounted for as much as 10% of Indian public spending in recent years. Diesel alone has taken up to 60% of those fuel subsidies. The current government's stated intention is to lower the subsidy bill to under 2% of GDP. In line with this objective, a phased series of hikes in the administered price in the second half of 2014 means that diesel is now priced at market levels, and the government has announced "full deregulation" of the diesel market.

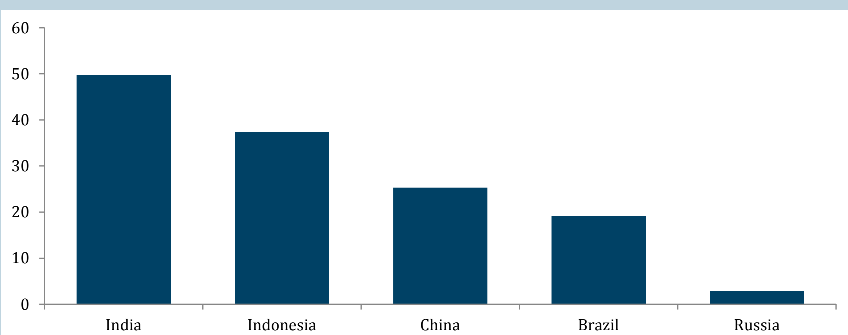
As importantly to the outlook for structural inflation is this year's once-a-decade pay review of the civil servants. Not only does India have 3.5 million civil servants whose jobs tend to be the most secure and best rewarded in the country, but they dictate wage bargaining across the rest of the Indian economy. India's inflation and fiscal woes since the late 1990s have coincided with 10 yearly civil servant pay deals. In the past, the bureaucrats have secured simple inflation-linked raises. The current administration in New Delhi is unlikely to allow this in 2015, but it is a material risk to monitor.

Under the mantra of "less government, more governance" Modi's government is prioritizing the digitization of permits requests and the centralization of subsidies distribution. Over time, this is likely to lessen bureaucratic burden and streamline the provision of services. To the extent they are implemented, these reforms are disinflationary, as is the eventual introduction of the Goods and Services Tax (GST). The extent to which improvement in fiscal accounts is channeled into public investment will be a key determinant of higher sustainable economic growth and expanding equity multiples.

A broad opportunity set

India's low starting point, coupled with increasingly credible promise of significant economic reforms, are, in our view, all the more exciting for international equities investors because India has a large number of high quality, publicly listed companies, as compared to other major Emerging Markets economies (Figure 4). As a consequence, we believe the Indian market offers plenty of opportunities to participate in the country's accelerating economic growth.

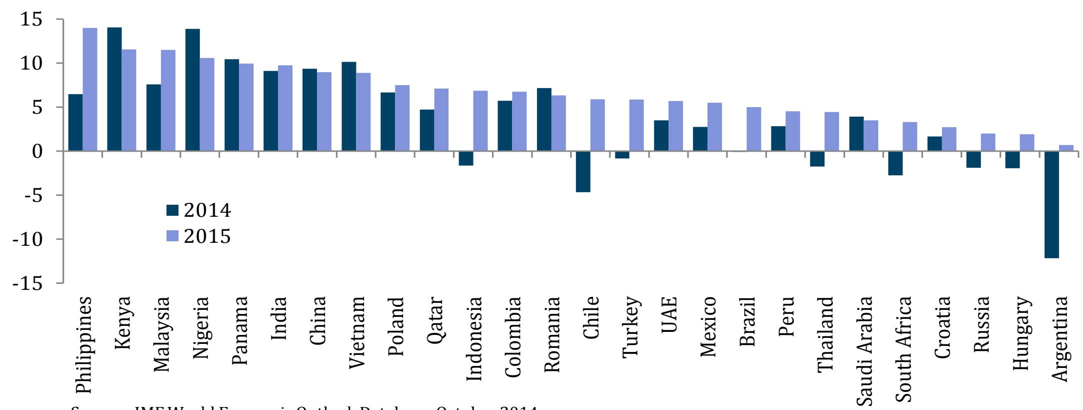
Fig. 4: Number of High Quality Publicly Listed Companies Per US $1 Million GDP



Sources: IMF World Economic Outlook Database, October 2014; William Blair

Robust growth in Emerging Markets has historically been highly correlated with strong equity markets performance. According to the latest projections from the International Monetary Fund (IMF), not only is the Indian economy expected to be among the fastest growers this year, but its pace of expansion is expected to accelerate in 2015 as compared to 2014 (Figure 5).

Fig. 5: Actual and Expected Nominal GDP Growth, Select Countries.



Source: IMF World Economic Outlook Database, October 2014

Good growth prospects, coupled with scarcity of growth elsewhere in emerging markets, support the relative valuation premium embedded in Indian equities. Ultimately, we expect sustaining low inflation and channeling fiscal windfall into investment will pave the way for enduring economic growth, robust corporate earnings, and handsome stock market returns.

About the Author

Olga Bitel joined William Blair & Company in 2009. She is responsible for economic research across all regions and sectors. Prior to joining the firm, Olga was a Senior Economist at the National Institute of Economic and Social Research in London, U.K., where she was responsible for macroeconomic forecasting and thematic research projects for international organizations and government bodies. Education: B.A., University of Chicago; M.Sc. Economics, London School of Economics and Political Science.

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