Active is: Navigating geopolitics

What's next for India's "improbable" democracy?

by Siddharth Johri | 16/04/2019

Summary

The world's second-most populous country has launched the world's biggest exercise in democracy – and reform is on the agenda. Regardless of the short-term noise from these elections, India's economy looks strong, particularly if the country can take advantage of opportunities arising from US-China trade tensions.

Key takeaways

- As India holds its month-long general elections, most political parties are talking about "development" and "reform"; this is good news for investors
- India's incumbent prime minister has been a partially successful reformer – the goods and services tax is his government's biggest achievement – but he will need to deliver more if he wins again
- We are optimistic about India's long-term economic growth, though infrastructure and employment need attention
- Long-term investors should consider Indian companies with good governance records, using an active, all-cap approach to access the potential structural opportunity that India represents

Some academics have called India's democracy an "improbable" one because of its low income levels and its vast racial, political, social and religious differences – factors that normally make it hard for democracies to function. Yet democracy is alive and well in India, and 900 million of its 1.3 billion citizens are eligible to vote in the month-long general election period that started on 11 April. This is the world's biggest democratic exercise, and the sheer diversity of peoples, languages and cultures involved makes this a spectacle like no other. Investors in particular should watch for India's equity markets to feature a potential pre-elections rally – similar to how markets performed as they grew more confident of Narendra Modi's victory in 2014, though on a smaller scale.

Reforms are a core issue in India's elections

Prime Minister Modi, leader of the incumbent government, led his Bharatiya Janata Party (BJP) to victory in 2014 on the back of a reform and development agenda. Since then, he has had some success delivering on his promises. If Mr Modi wins again, he will need to keep up his reforms with a specific focus on employment generation and rural India, which continue to need government attention.

Polls suggest that the BJP and its allies are comfortably placed to win – and that the only way for the opposition to spoil the party is to put together potent coalitions. Regardless, the ideas of "development" and "reform" are now part of the primary narratives of most of the political parties. This is good news for investors.

Recent reforms are already bearing fruit

The 2017 implementation of India's goods and services tax (GST) is probably the single biggest achievement of Mr Modi's government, even though the politics associated with launching such a large-scale reform have made it a slow process. There is now a common market with a simplified tax code, which has had a significantly positive impact on India's economy. Moreover, government finances will likely improve as compliance with the GST improves. This should enable the government to spend more on infrastructure, which the country needs.

The other major initiative from Mr Modi with significant long-term implications is bankruptcy-code reform. The banking system is saddled with bad loans, but we believe the new proposal offers a fair way to recycle capital out of unproductive assets. The support structure is still being implemented, but there is already one positive knock-on effect of the new initiative: many of the borrowers who once wilfully defaulted on bank loans now seem afraid to do so.

A positive outlook for India's economy

Aside from the short-term political noise associated with this election, the long-term prognosis for India appears promising. Over the last few years, consumption drove the economy as private capital expenditures slumped. But with capacity utilisation at a level where companies are poised to expand, this second growth engine seems likely to come back on line. Inflation continues to be quite benign, and the GST and bankruptcy code could provide tail winds for growth over the next few years.

Despite this progress, some issues must still be resolved – primarily employment. The large youth segment of the population and the rural-to-urban shift will require new jobs that India's services-oriented economy might not be able to generate single-handedly. We believe the answer lies in developing the manufacturing capabilities for products that India is either good at producing or imports too much of.

Can India capitalise on US-China trade tensions?

The US-China trade war presents India with interesting opportunities in areas that play to India's strengths – like auto components, chemicals and textiles. India's success at capturing these opportunities will depend on how well the government supports these sectors and develops its infrastructure to boost economic efficiency.

In terms of geopolitics, the US appears inclined to support India as a counter-balance to China, which is using its belt-and-road initiative to extend its influence throughout Asia. We expect to see stronger engagement between the US and India, both in terms of India's economy and regional security.

Opportunities for equity investors

The equity markets rallied before the 2014 elections as they grew more confident of Mr Modi's victory. This time around, we expect a shorter pre-elections run-up before market returns level out over the course of the year. India's small- and mid-cap equities have had 12 months of significant underperformance, and we believe that may turn around as 2019 continues.

Long-term investors should consider focusing on Indian companies with good corporate governance track records, aiming to identify high-quality franchises before buying them at points where expectations are reasonable. An active, disciplined, all-cap approach may be the best way to capitalise on the potential structural opportunity that India represents.

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About the author

Siddharth Johri

Portfolio Manager

Mr Johri is a Hong Kong-based portfolio manager with Allianz Global Investors. He joined the firm in 2015 and is responsible for providing Indian stock recommendations for regional portfolios.

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Active is: Diversifying portfolios

Emerging markets look strong in 2019

29/04/2019

Summary

Global growth continues to decelerate, but many emerging-market economies are presenting opportunities after a tough 2018. Domestic growth is being pushed higher by accommodative commodity prices, Fed support and easing trade tensions.

Key takeaways

- The macroeconomic environment is supporting emerging markets, creating a buying opportunity for longer-term investors
- Rising costs in China, coupled with increasing tensions with the US, have put pressure on company margins and created opportunities for other Asian emerging markets to grow
- Risks are inherent in emerging-market investing, so investors should aim to be active and long term; don't lump all emerging markets together, since each country faces its own risks and drivers
- Look for countries or companies with strong fundamentals and good balance sheets – and for firms that could benefit from long-term growth stories such as AI and demographic shifts
- When considering emerging-market bonds, the choice of funding currency is paramount; economic weakness in other regions could support the US dollar despite the Fed's dovish turn, so emerging-market hard-currency bonds are relatively safe for most investors

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