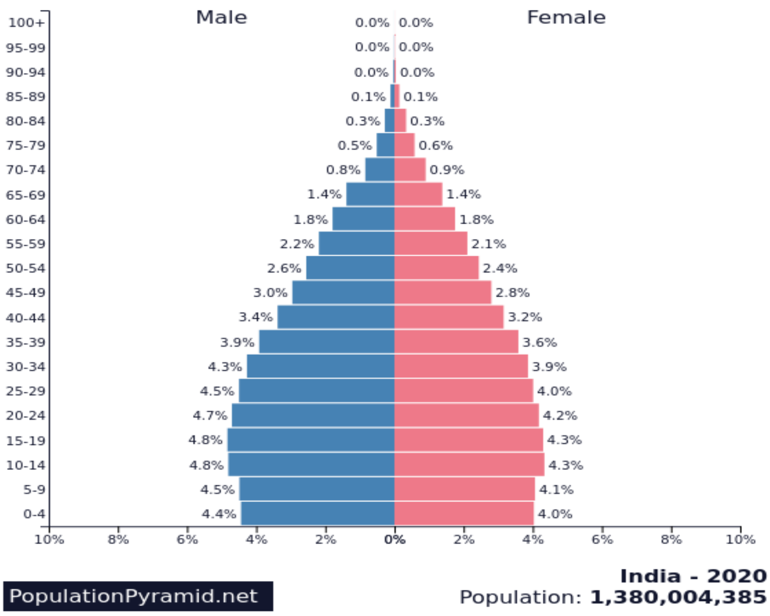
Great Expectations....of a new decade

- India's GDP is expected to grow to US$5trillion over the next 5 years as per Government of India goal with a delay incorporated for COVID-19, but a positive pivot to India in future
- Productivity and wealth gains will be made through reforms in taxation, labour and agriculture, manufacturing and export incentives and infrastructure spending.
- Corporate earnings which have been weak for the last decade will pick up pace from a low point, Commodity prices, lower interest rates, access to capital will assist margins
- The environment over the next 3 years should be ideally suited to solid market gains (e.g., 10% plus p.a.) with potential to add value through outperformance for active managers

India's fundamental tailwinds of a **SIGNIFICANT** (1.4 billion), **YOUTHFUL** (average age 28) and **ENTREPRENEURIAL** (over 6,000 listed companies and 30% of GDP contributed by MSME's) population, are expected to propel it to the third largest economy in the world by the end of 2030.

The growth in GDP is expected to be driven by the need for consumption and services driven by rising wealth and the need for improving infrastructure given the inevitable mass. To provide perspective, India's GDP per capita is currently at US$2,104 (where China was in 2003 and today is over US10,000 and likely to rise towards that of developed nations) and can rise substantially given nominal GDP is now likely to rise at 10-12% compared to population growth of 1%. This is because **India is approaching its sweet spot** of maturing population growth, a lowering dependency ratio (population of dependents relative to working age) and rising GDP.

India's Economic Fundamentals

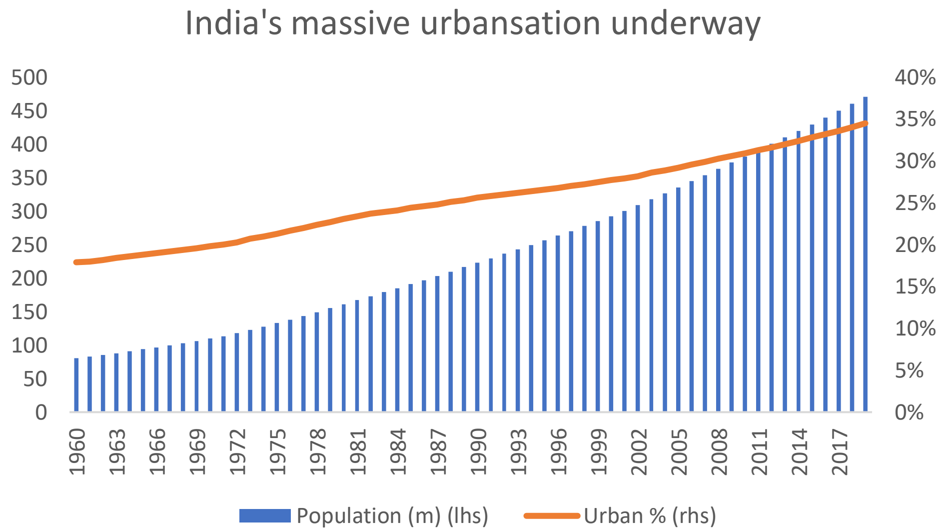


According to WORLDOMETER, India's population is currently 1.386 billion, which equates to **17.7% of the world's population**. 35% of India's population is urban and the average age is 28.4 years.

The population pyramid looks like that of China's prior to its growth explosion. Of course, India is not China and will grow at a different trajectory given different political regimes, different paths taken and different economic environments.

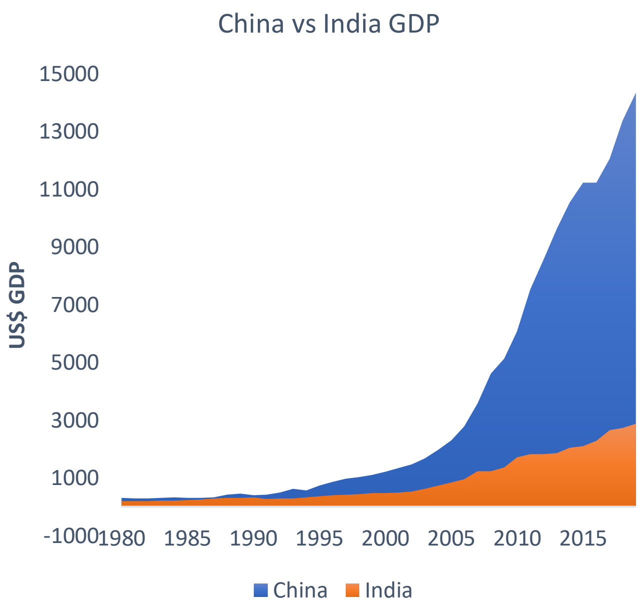
Urbanisation Underway

India’s population has shifted from 27% urban in 1955 to 35% today. **Over the next 30 years some 400m people are expected to shift to cities in the search of employment and lifestyle improvement**. This will create a significant need for infrastructure, consumable goods and services.



Source: Macrotrends

Dreaming of a US$5 Trillion Economy



In 2019 the Modi Government stated an aim of US$5 trillion for India’s GDP which would require a nominal rate of growth of 11.7% per annum. This would have been a lofty goal and was based on increasing productivity and the promotion of India’s manufacturing campaign to “Make in India”. However, this goal was set pre-COVID and given India’s GDP went backwards in 2020, it looks an unachievable task. It is more likely that **the aim of US$5tn will be achieved in 2026-27**.

Source: Tradingeconomics.com

We can see that way back in the 1980’s India and China almost had the same GDP. However, China went ahead in leaps and bounds given their chosen path of manufacturing and their low dependency ratio (number of dependents (0-14 + 65+ / working age). India’s dependency sweet spot looms over the next few decades.

GDP Composition – Manufacturing and Agriculture to join the party

Over time India's economy has shifted from agrarian to being driven by services. As we know China manufactured its way to growth, peaking at 33% of GDP in 2005 and currently still at 27%. Other larger economies which are significant manufacturers (above 20% of GDP) are Japan, Korea, Indonesia, Malaysia and Thailand.

After reaching a peak of 18% of GDP in 1995, India is now closer to the global average of 14-15%. Going forward manufacturing will become more important in improving an economy's health and self-reliance. **The Indian Government seeks to lift manufacturing to 25% of GDP contribution**. A recent slew of production linked incentives has been provided for the industry. The focus will be directed more towards value-added industries rather than high volume, low value. It is expected that industries like Auto and Ancillaries, Pharmaceuticals, Electronics and Chemicals will be the key comparative advantage sectors.

In November, the Indian Government provided **incentive schemes amounting to US$20bn for 10 sectors in enhancing India's manufacturing and export capabilities**. The focus being to increase India's self-reliance and its export competitiveness. The largest component of the spending is going to Auto/Components, Chemicals/Cell Batteries, Pharmaceuticals/Drugs and Tech/Telecom products.

Whilst the agricultural economy reduces in size in a growing industrialised economy, it nevertheless remains important, given close to two-thirds of India's population depend on it for a living (circa 14%, relative to global average of 6% of GDP). Typically, the farmers of India have relied on a minimum support prices from the Government for crops. However, recent proposed reforms will allow prices to be set by market forces with buyers directly dealing with farmers rather than slippages through a middleman. This is likely to **entice more private investment into the sector and create much less leakage and greater efficiency**. Inevitably it will also lead to removal of those operating with low productivity and most important contribute meaningfully to increasing India's GDP per capita.

Reform driving Financialisation, Digitalisation and Urbanisation

Reform / Initiative	Action Taken	Impact
Aadhaar Card	1.2bn people biometrically identified	Identity, audit, efficiency, trace and reducing slippages
Jan Dhan Yojana	400m bank accounts opened	Financialisation to link with national ID, mobile phones
Insolvency & Bankruptcy Act	Clean up of Bad Debts within the Banking System	Rules for lender recourse, resolution process
Demonetisation	Cleansing "black money" by withdrawing currency from the system	A shift to financialisation and digital payments, with a trail
GST	Introduction of national tax	Increasing tax revenues over time, less complexity
Corporate Tax Cut	Cutting corporate taxes from 30% to 22%	Globally competitive tax rates with other manufacturing locations
Labour Reform	Setting a standardised labour code	Transformed work environment and basic rights
Agri Reform	Removal of price setting and allowing market price determination for farmers	Increase private investment in agriculture and increased productivity

Make in India	Promotion of India's manufacturing capabilities	Greater importance in the global supply chain. Place to do business
Smart Cities	Expansion of Wi-fi enabled cities along major routes	Improving urbanisation and physical and digital infra
Digital India	Improve India's digital infrastructure via smart phones, National ID, internet	Improve the connectivity of India and enhance business and inclusion
Skills India	Training 400m people in different job skills in India	Create job opportunities for India's youth to capture the "dividend"
Swaach Bharat	Clean up of India via access to services and infrastructure	Improvement of livelihoods at lower socio-economic groups

Productivity Gains to Come

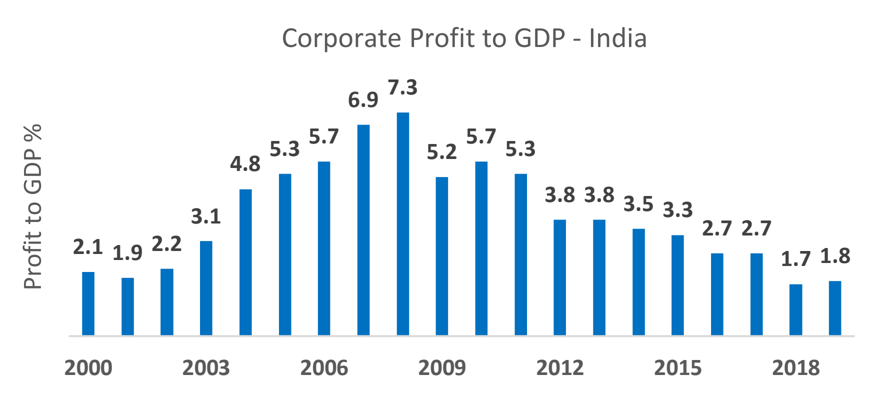
The impact of reforms and initiatives taken by the Modi Government is to create an improving and productive economy, minimising the slippages and increasing effectiveness and efficiency. Below we have highlighted some of the improvements which have either occurred, in the process of occurring or are set to occur.

Business is shifting towards organised from organised. Budding entrepreneurs now have more access to capital, are digitally enabled (mobile phone, internet, payments) and connected to clients.

An example of what can be expected to improve is **India's logistics cost to GDP of 14%, relative to 8-10% across the US and Europe**. India's supply chain and logistics is a significant industry of US$215bn growing at 10.5% p.a. With the Government now promoting infrastructure investment, it is likely that the growth of roads, ports, railways etc. will reduce logistics costs and make the corporate landscape more tenable for local and global businesses operating in the ecosystem. This has the potential to significantly improve productivity/profitability and reduce costs to 7-8% of GDP.

Corporate Earnings Landscape set to Improve

Whilst India's corporate earnings growth have averaged 10% p.a. over the last 25 years with minimal volatility, the last decade has been poor. Corporate profits to GDP have dropped from a peak of 7% to less than 2%. This has been driven by low private investment due to excess capacity and high cost of capital (a banking crisis has played a role) as well as flagging demand, particularly over the past 3 years.



Source: Kotak Institutional Equities

We can expect the next three years to see a rebound in corporate profits as capacity is available, corporates have cut back their fixed costs, taxes and interest rates are lower and access to capital is improving.

Outlook 2021 – 2023

- We estimate that India can achieve its **goal of US$5 trillion GDP by CY2026**.
- India's **Market-cap-to-GDP** has averaged 0.8 over the last 10 years, which we think **can move towards 1.0**. The US market is currently at 1.8x GDP. This would take India's market cap to US$4-5tn by 2026.
- **Flows towards Emerging Markets should rise** as the USD is expected to undergo some weakness. MSCI India is close to 9% of the MSCI EM Index.
- **Corporate profits are currently 2% of GDP and can rise towards 4%** (10-year average) through **increasing productivity and efficiency gains**.
- Excess capacity, lower oil prices and interest rates are in place. In a similar period of 2003-2007, India's corporate earnings grew at > 20% p.a.
- IPO's are set to rise as is a massive privatisation exercise of Government owned assets which should **boost investment and liquidity** for Indian markets.

1) We expect Index market returns in the vicinity of 10% p.a. over the next 5 years.

2) This will be driven by rising GDP and a significant catch up in corporate earnings.

3) Active management is expected to be able to add further to this return profile. India's active managers have typically thrived when GDP growth starts rising. Their skill set to identify winners in a growing economy has been proven over 2003-2007 and 2013-2017. This is at contrast to the period just witnessed between 2018-2020 when liquidity, narrow breadth and safety were at a premium for investors.

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