

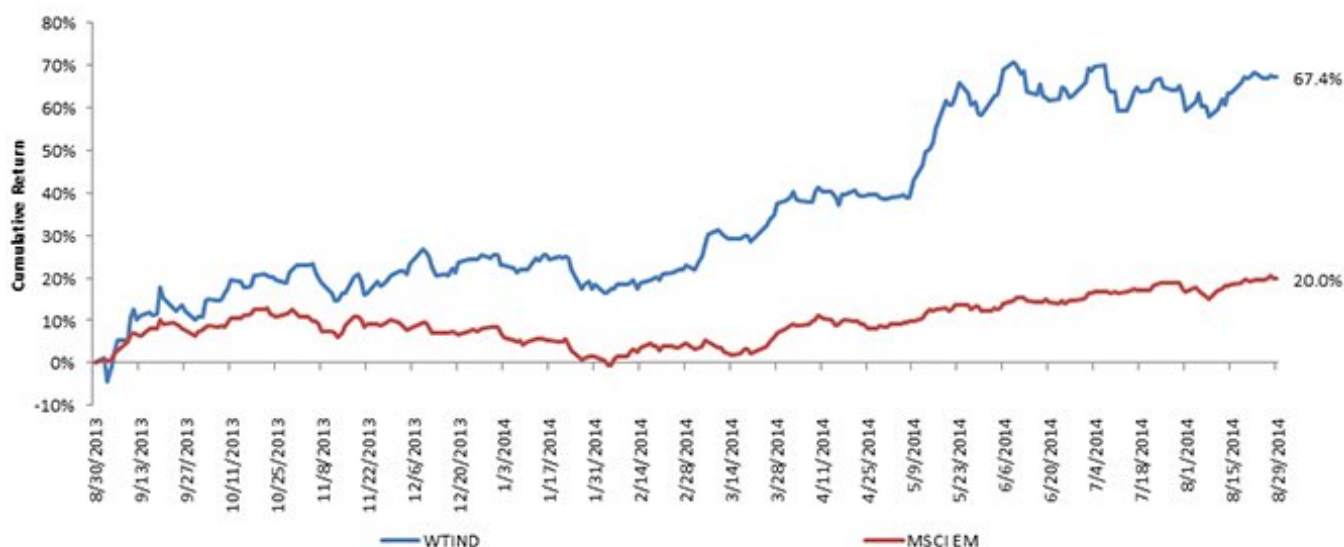
India: A Bright Spot in Emerging Markets

Published September 24, 2014

Christopher Gannatti, CFA

Global Head of Research

In 2013, emerging markets¹ were the laggards of the global equity markets². 2014 has seen some bright spots, but various uncertainties, most notably with respect to Russia, have tended to constrain equity rallies. However, there is one market that seems to have completely shrugged off 2013 concerns and emerge as an extremely strong performer thus far this year.³ That market is India. **Cumulative Performance of the WisdomTree India Earnings Index (WTIND) vs. the MSCI Emerging Markets Index (MSCI EM)**



Source: Bloomberg, with performance measured from 8/31/13 to 8/31/14. Period chosen to indicate performance from the 2013 WTIND Index screening date through the 2014 WTIND Index screening date. Past Performance is not indicative of future results. You cannot invest directly in an index.

For current performance of the WisdomTree India Earnings Index, [click here](#). The critical question: How has India been different from the broader emerging markets over the past 12 months to explain this nearly 50% outperformance? **Election of an Investor- and Reform-Friendly Government** Prime minister Narendra Modi, seen by many as much more investor and reform friendly than the previous administration, has been instrumental. Modi's Bharatiya Janata Party (BJP) swept into power with the biggest Indian election win in 30 years as voters sought change in a country saddled by slow economic growth and perceived to be thick with corruption.⁴ Modi's party has since made notable strides on the reform agenda, which includes the budget announcement (which encompassed the fast-tracking of projects), reining in India's fiscal deficit and promoting foreign direct investments (FDI) in sectors of the markets that have previously been closed to foreign participation.⁵ Markets rallied both in anticipation of the BJP coming into power

as well as after the election results were in.⁶ **Bringing Credibility to Monetary Policy** Since Raghuram Rajan's appointment as governor of the Reserve Bank of India (RBI), he has worked tirelessly to establish the RBI's reputation as an inflation-fighting central bank. Despite slower growth, the RBI has raised its key repo rates three times since May of 2013.⁷ Inflation has been a persistent problem in India, but whereas consumer price inflation had remained above 8% for the 28 consecutive months ending May 2014, the last two months have seen inflation prints below 8%.⁸ The RBI has since eased its inflation tone and maintained that monetary policy will be accommodative. **The Bottom Line:** The Indian rupee has become a much more stable currency after touching record lows in August of 2013.⁹ **Learning from 2013's "Taper Tantrum"** In 2013, one of the biggest discussions was about the U.S. Federal Reserve tapering its quantitative easing program. On the back of the "taper" discussions, many emerging markets—especially India—performed poorly as investors worried about the potential for poor liquidity and potentially even higher rates in the near future. India was particularly vulnerable with its twin deficit both in its fiscal and current account. Since that time, improvements have been made: • Current account balance went from -6.5% of gross domestic product in December 2012 to -1.7% of GDP in March 2014, contributing to a more optimistic view on the country.¹⁰ • The government's commitment to reduce its fiscal deficit from -5% of GDP to -3% of GDP over the next two to three years is highly encouraging. **Broad Exposure to India's Profitable Companies** The WisdomTree India Earnings Index was well positioned to take advantage of these recent events in India. First, it is the broadest measure of the performance of India's equities; since its inception it has had a minimum of 140 and a maximum of 270 constituents. Its average exposure to small caps (companies below \$2 billion in market cap) has been about 15% of its weight.¹¹ In a year like this, small-cap stocks have been very important performance generators. **Significant Exposure to Cyclical Sectors** In a [previous blog post](#), we discussed the industries that are poised to benefit from the Indian budget rollout. The key themes of the budget were centered around (1) ramping up local investment efforts, (2) encouraging foreign direct investments (FDI), (3) the fast-tracking of projects, (4) reining in India's government deficit, and lastly (5) overhauling India's complicated tax system. We believe the key industries that stand to benefit from these reforms are the Financials, Industrials and Energy sectors. It is thus unsurprising that cyclical sectors have led defensive sectors in the recent rally. It is worth noting that the cyclical sectors have averaged a return of 55.7% between the 2013 and the 2014 Index screening dates, while the defensives have returned only 27.8% during that period.¹² As of August 31, 2014, WTIND had nearly 85% exposure to cyclical sectors. **The 2014 Annual Rebalance** The most important single part of WTIND's methodology is its annual rebalancing process, which occurs with a screening date of August 31 of each year. This is where the approach seeks out India's profitable companies and then weights them according to their profits. The aggregate result tends to: • Trim weight from companies that have appreciated in price but whose earnings growth has not kept pace. Companies whose earnings have gone negative are deleted. • Add weight to companies that have seen earnings growth but whose share prices have not responded correspondingly. Companies whose earnings have become positive are added. After a year of WTIND's strong outperformance of MSCI EM, we think the importance of such a disciplined, rules-based process only increases. In future blog posts, we will explore how WTIND will be positioned after the 2014 rebalance, as well as for the potential for this process to mitigate the risk of exposure to overvalued stocks in India. ¹Refers to the MSCI Emerging Markets Index; performance

measured from 12/31/12 to 12/31/13. 2Refers to MSCI ACWI Index; performance measured from 12/31/12 to 12/31/13. 32014 performance is measured through 8/31/14. 4Andrew MacAskill & Unni Krishnan, "Modi-Led Bloc Wins Biggest Election Mandate in Three Decades," Bloomberg, 5/17/14. 5"India Budget: Arun Jaitley Unveils Reform Plans," BBC News, 7/10/14. 6Refers to WTIND's positive returns between 12/31/13 and 5/16/14, and then again between 5/16/2014 and 8/31/14. 7Source: Bloomberg. 8Sources: Reserve Bank of India, Bloomberg as of 8/31/14. 9Source: Bloomberg; refers to the rupee-to-U.S. dollar exchange rate of 68.8 on 8/28/13. 10Source: Bloomberg as of 8/31/14. 11Sources: WisdomTree, Standard & Poor's, with WTIND's constituents measured from 12/3/07 inception to 8/31/14. 12Source: Bloomberg, with performance measured from 8/31/13 to 8/31/14.

Important Risks Related to this Article

Investments in emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Investments focused in India are increasing the impact of events and developments associated with the region, which can adversely affect performance.