WHY INDIAN TIGER COULD ROAR AS CHINESE DRAGON COOLS

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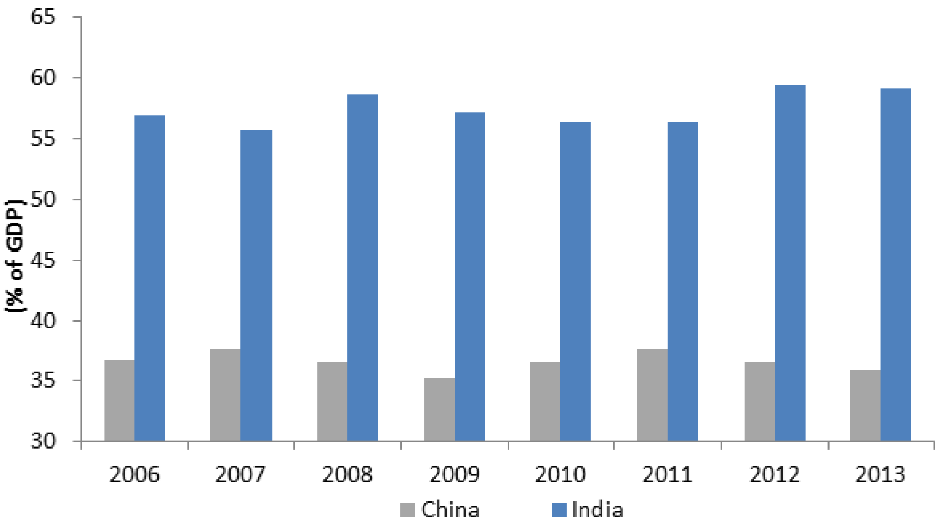
Back in mid-August when I was in India, markets world over were rattled by concerns of a Chinese slowdown and yuan devaluation. Though a Chinese slowdown may bring some headwinds for global markets in general, some emerging market (EM) economies can withstand this turmoil better than others. Below I highlight why the Indian tiger could roar at a time when the Chinese dragon's fire cools. **Indian Model: Sustainable Debt Levels with Demographics & Households Driving Consumption-Led Growth** • **At the Fiscal Level:** Chinese debt has been steadily increasing, and years of state-driven investments have created excess capacity in several sectors. While Chinese gross domestic investment (as a percentage of gross domestic product (GDP) for years has been above 40% and as of 2013 stood at 47.6%, India has always been below 40% and as of 2013 stood at ~32.5%.[1] This could imply that China has much less space for further state investment. India, on the other hand, could easily invest billions of dollars in its public infrastructure without having to worry about overcapacity. • **Demographics:** India has a much younger population, and with an economic size equal to the number of workers times their productivity, this bodes well for economic growth. By 2050, India is projected to have a staggering workforce (i.e., people between the ages of 15 and 59) of 940 million, growing from the current 674 million, compared to the Chinese workforce, which could shrink from 930 million to 817 million in the same time frame.[2] This could potentially also drive up labor costs in China—a dent to its competitiveness. • **India Has Most-Local-Consumption Economy:** One of the economic stories of the times is China trying to rebalance its economy from a massive state-controlled infrastructure and investment-led economy to more consumption led. This is exactly the type of economy India is today. Household consumption as a percentage of GDP is much higher in India. India's ~60% consumption-expenditure-to-GDP ratio (compared to ~39% of China)[3] indicates an economic model hugely influenced by local consumption (see chart below), providing potentially better insulation from global headwinds.

External Debt and Household Consumption Expenditure (12/31/06–12/31/13)



Source: World Bank.

• **GDP:** It is no secret that China, after more than a decade of stellar GDP growth rates, is slowing down, while India continues at a more sustained ~7.5% growth rate,[4] on track to not only surpass China but possibly be one of the world's fastest growing economies. Decelerating Chinese investment also implies a downward pressure on commodity prices, bad news for commodity exporters like Brazil, Indonesia and even Russia. However, for a big importer like India, it's a windfall and helps in cooling inflation. Bottom line: Factors such as sustainable debt growth, domestic consumption driven by favorable demographics, cooling inflation supported by falling commodity prices and a decelerating China could make India much better positioned in the current macro backdrop. **Excellent Central Bank Policy—Taming Inflation for Cheaper Credit to Expand Economic Activity** • Under the excellent leadership of Raghuram Rajan, the Reserve Bank of India (RBI) has clearly established itself as an inflation-fighting central bank. After successfully lowering inflation (compared to 2013 double-digit numbers, July 2015 inflation was 3.78%)[5], RBI has so far engaged in three consecutive rate cuts, with another one widely expected to happen this year. At a time when we are staring at an imminent rate hike in the U.S. (which could put downward pressure on all EM currencies), a rate cut by RBI speaks volumes of forward-looking stability and strong fundamentals of the rupee. • Economic policies often work with a lag, and we believe the economic benefits of RBI's rate cuts could be fully realized over the course of the next year. HDFC Bank (India's second largest private sector bank by assets) cut its base rate by 35 basis points (bps) on September 1; other large players like ICICI (India's largest private sector bank) and SBI (India's largest bank) are likely to follow. • Cheaper credit is good news for the automobile sector, which can easily be termed the mother of the manufacturing sector in India. Growth of the Indian automotive industry could provide an impetus to the manufacturing sector, propelling prime minister Narendra Modi's "Make in India" campaign (which we covered in our previous blog on India). Under the scheme, Modi's government aims to increase manufacturing's share of GDP to 25% from its current 16%. Encouraged by local demand and cheaper production, a slew of automakers, including General Motors, Toyota Corp. and Mercedes-Benz, have already either opened or expanded manufacturing operations in India in the recent past. • Should there be any heightened volatility in currency markets, RBI with its all-time-highest $380 billion foreign exchange reserves,[6] is now much better positioned to intervene and stabilize its currency—something already validated by governor Rajan in his recent speech in Mumbai. Overall, there are risks involved in investing in general, and India is no different. However, for investors willing to take moderate to aggressive risk with a medium- to long-term horizon, we believe India offers unparalleled opportunity in the current global economic backdrop. [1]Source: World Bank. [2]Source: World Bank. [3]Source: World Bank. [4]Source: World Bank. [5]Source: Reserve Bank of India (RBI). [6]Source: Reserve Bank of India (RBI).

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DEFINITIONS

Headwind : challenges to performance or expectations of performance.

Fiscal budget : is a period used for calculating annual budget requirements for a country or an organization or company.

Gross domestic investment : Consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Inflation : Characterized by rising price levels.

Basis point : 1/100th of 1 percent.