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Investors have good reason to back India’s Modi miracle

India's stock market remains red hot despite its tepid economic policies

India's Prime Minister, Narendra Modi, has yet to make good on his promise to lift caps on foreign direct investment Photo: RAJESH KUMAR SINGH/AP

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1 Comment

When Narendra Modi was swept to power in May on a wave of new-broom optimism, I wondered whether investors would decide it had been better to travel than to arrive. The Indian stock market had soared in the months between last year’s “taper tantrum” and the election. It was reasonable to expect it to pause for breath.

That hasn’t happened. With both foreign and domestic investors continuing to bet on the Modi miracle, the Bombay market has remained red hot. This is despite the new Prime Minister taking his time about the change that investors are banking on. Secure at the head of India’s first majority government in 30 years, Modi has resisted the temptation to engage in a “first 100 days” blitzkrieg of new policy measures.

So, he has held off slashing fuel and fertiliser subsidies until a fresh report is completed on the measures that currently cost more than 2pc of GDP. He hasn't yet lifted the caps on foreign direct investment in areas like retail that arguably underpin the country's famed inefficiency. He is yet to introduce a national goods and services tax that would reduce barriers to trade between India's individual states.

In other areas, however, the scale of his ambition is more than evident. This week he launched a "Make in India" campaign which has the explicit aim of lifting manufacturing's share of the country's GDP from 15pc to 25pc. That compares with China, where manufacturing represents more than a third of economic output.

India's share of world exports has more than trebled since 1990, just before former Prime Minister Manmohan Singh's economic reforms kicked in. But at just 1.7pc this remains a fraction of the 11pc that China can claim.

Not everyone thinks that manufacturing is the answer for a country with a competitive advantage in services like IT and healthcare. However, successes in exporting cars and pharmaceuticals suggest that India has a future as the world's next workshop as China's wage costs become increasingly uncompetitive.

What are investors so excited about in India today?

The long-term structural growth story is certainly impressive. It took 50 years for India to get to a $1trn economy, just 10 to reach $2trn and the next trillion will happen even more quickly. GDP per capita rose from $463 to $1,430 between 2000 and 2010. Other positives include the fact that India's population is younger on average than the world's other leading economies. The median age is 27 compared with 37 in China, which needs to get rich before it gets old, and 38 in the US.

The shorter-term picture is also looking up. Economic growth slumped in the past five years from a level close to 10pc to less than half as much. That's expected to get back to 7pc by 2016 as half-finished projects are fast-tracked. Inflation is high but under control, which opens up the possibility of a rate cut in the first half of next year. That will help company earnings grow at around 15pc a year for the next three years.

There remain risks. India was one of the countries hardest hit by the threat of rising US interest rates last year. When that becomes a reality, probably in the middle of 2015, investors could well re-focus on India's continuing dependence on foreign capital.

India remains exposed to a slow-down in the global economy, just like any other emerging nation. Attracting foreign investment will require significantly better infrastructure, energy and logistics. Bureaucracy must be tamed so that it is easier to do business – more red carpet than red tape must be the mantra.

Those risks are largely in the price, however, while the upside of genuine structural reform may well not be. Compared to the long-term history, share prices are close to their average. Measured against asset values, they are still cheap.

Above all, India is a stock-picker’s market. Areas with the biggest opportunities include financial services and consumption-related businesses. There are some great IT companies. India has had a strong run but, with investors worrying about an increasingly mature bull market in the developed world, the Bombay market can still play catch-up.