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INVESTMENT MANAGEMENT

Tales From the Emerging World

Emerging India in a Multipolar World

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When the 15-nation UN security council hastily called for a vote in February to condemn Vladimir Putin's invasion of Ukraine, India joined China and Qatar to abstain. It was a difficult balancing act. Delhi didn't want to alienate Russia, an important historical friend, which supplies 46% of its military equipment,[1] without also antagonizing the U.S., its largest trading partner.[2] India also depends on Russia's diplomatic support at the UN for its claims over Kashmir. After all, the Soviet Union has used its veto six times at the Security Council on India's behalf.

For Delhi, though the abstention vote was an embarrassment, the clear and present dangers come from a prickly Pakistan and a muscular China. India is forging its own geopolitical path in this multipolar world and focusing on its strategic interests. That means siding both with Russia and joining Western alliances, such as the Quadrilateral Security Dialogue, alongside the United States, Australia, and Japan. From Brussels to Tokyo to Washington, governments are determined to lower their dependence on Beijing. At a time of when investability in China is being questioned, shifting geopolitical realities offer India an opportunity to shine.

Coupled with its geopolitical stance, India's economic condition is looking favorable for the rest of this decade. India has not been able to realize the kind of industrial transformation that turned countries like China and South Korea into miracle economies by building their manufacturing capabilities. Instead, India's economic growth was led by services unlike the Asian tigers. Recently there has been a change in the mindset from the Gandhian principles of small is beautiful, to actively incentivizing large scale manufacturing capacities through production linked incentive (PLI) schemes.

These schemes have attracted interest across 14 sectors including automobiles, solar panels, and advanced batteries. Buoyed by the government's PLI scheme, India now is an exporter of mobile phones. Delhi is also focusing on

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[1] Bloomberg, Haver, SIPRI.

[2] World Trade Organization, COMTRADE, Haver.

import substitution in manufacturing to enhance domestic capacity and reduce external dependence. As firms everywhere reconfigure supply chains to lessen their reliance on China, India has an opportunity to increase its manufacturing, helped by a $26 billion subsidy scheme.[3]

Emerging sectors such as aerospace, semiconductors, and renewables should help increase youth employment. The reform measures are starting to pay off. The "Make in India" initiative encourages both foreign and domestic investment in the manufacturing sector; "Smart Cities" aims to eradicate urban squalor and "Digital India" targets an overhaul of government services with electronic identity, digital payments, and bank accounts. Additionally, the government has launched its Open Network for Digital Commerce (ONDC) in an attempt to deepen e-commerce penetration and foster innovation by start-ups with a special focus on small merchants and rural consumers. Each of these are enhancements in efforts to improve the country's infrastructure. India has backed the "tech stack" and direct welfare and persevered with the painful task of shrinking the informal economy. Financial reforms have made it easier to float young firms and bankrupt bad ones.

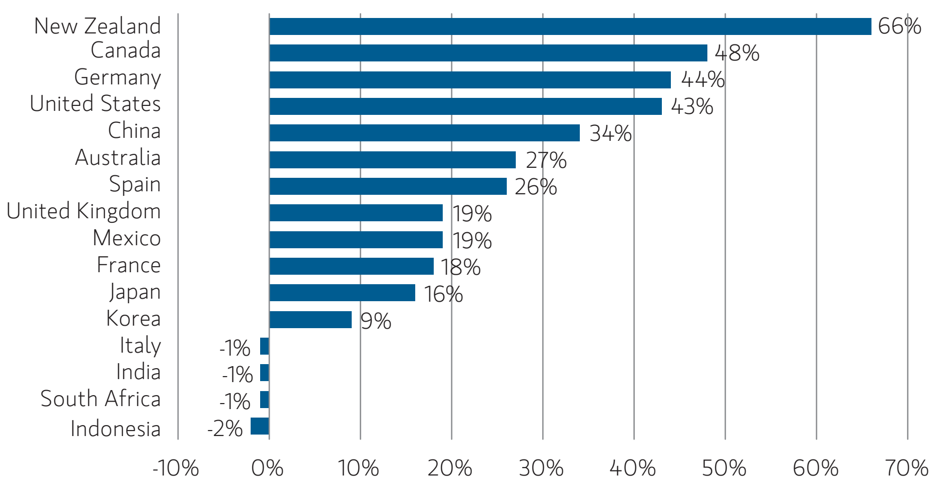
In contrast, China continues to focus on transitioning its economy away from investment to consumption. China's economy is slowing down, faced with a shrinking workforce, industrial overcapacity, a floundering property market, a mountain of debt and renewed COVID lockdowns. A serious downturn in the property market, a key engine of GDP growth, has eroded confidence in the economy. Real estate lies at the heart of an investment cycle. While investment to GDP ratio in India hovers at 30%, China's has peaked at 45% and a big share of that is real estate investment. The real estate sector accounts for around 29% of GDP in China, more than double the ratio in India, according to IMF economist Yuanchen Yang.[5] Excessive supply is dragging down China's heavily indebted property sector. The working-age population in China is now shrinking,[6] which will further erode the demand for housing over the coming years hurting future growth.

The reverse holds in India. After being in doldrums for the past 3 years, India's real estate sector is set to recover. As more of India's population heads to the cities, demand for housing increases. India's young work force stands to benefit from affordability at almost unprecedented levels in terms of mortgage payments relative to income growth, that has declined to 28% in Q1 2022 from 53% in 2012.[7] House prices

DISPLAY 1

India Missed the Global Real Estate Party

Real House Price Appreciation: 2015 – 3Q21

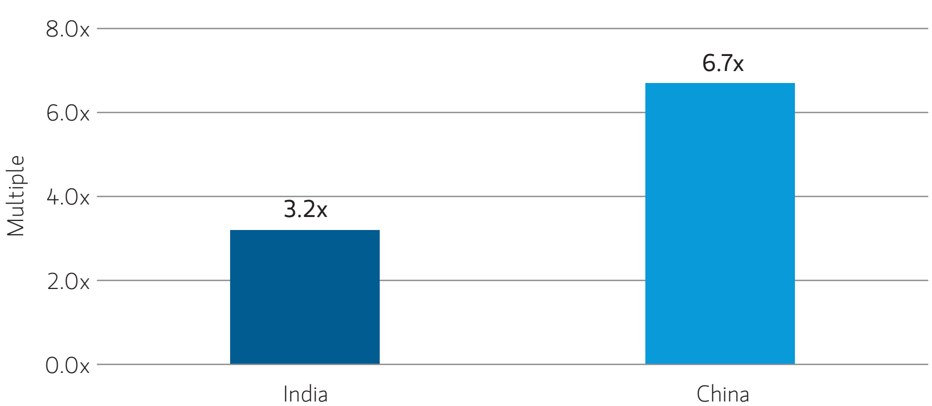


Source: OECD as of 3Q21.

DISPLAY 2

India Beats China on Housing Affordability

Home Price to Income Multiple



Source: MSIM, JPM, NBS, HDFC.

[3] Reuters, Bloomberg.

[4] MSIM, Bloomberg, FactSet, Haver.

[5] VoxChina, Haver.

[6] BCA Research, Rhodium Group.

[7] HDFC, SBI, Jefferies. Note, data for Q1 2022 represented by fiscal year ended March 31, 2022.

are 3.2 times average income in India compared to 6.7 times in China.[8] In fact, the five biggest cities in the world, with the lowest rental yields, are all in China, making it one of the most expensive countries in the world.

Residential inventory levels have declined to a nine-year low of 24 months of sales for the top seven cities in India.[9] Nominal wage growth of around 8% should fuel demand just at a time when supply has declined.[10]

China's economy is also more levered, with total debt to GDP at 300%.[11] Chinese property developers have excessively high debt levels. Goldman Sachs expects a third of China's property firms to default this year and a massive chunk of onshore and offshore bonds are maturing by the end of 2022.[12] Two of the largest have already defaulted on their offshore bond repayments. Corporate bonds of property developers are trading at less than 50 cents to the dollar.[13] Household debt has risen from almost nothing in 2007 to 62% of GDP today, mainly on account of rising mortgage debt.[14] China's households are refusing to pay mortgages in 50 cities.[15]

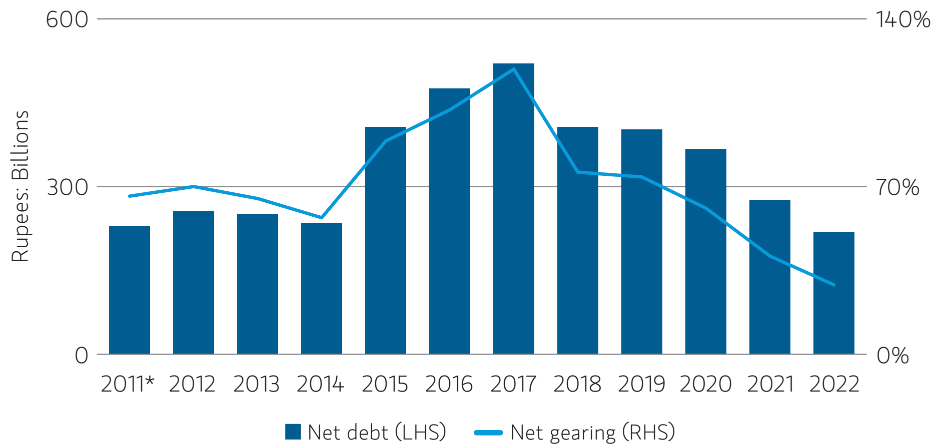
Chinese property firms are facing debt deflation, falling asset prices with high debt burden, whereas property markets in India have healthy debt ratios and in our view, a high probability of increasing asset prices. India's real estate sector has been cleansed of weak players. Developers have been prudent with their finances and have cut their balance sheet debt by half over the last 3 years.[16] As Indian developers are not allowed by the Reserve Bank of India (RBI) to take loans from abroad, there are no dollar-denominated borrowings in the sector. The banking sector today stands much healthier with steadily improving nonperforming loan (NPL) ratios and no asset quality concerns as such.[17] According to the RBI, businesses have seen a steady net profit-to-sales growth over the past year and are sitting on piles of cash.

It is true that India will face headwinds from geopolitical uncertainties. Inflation and global supply chain disruptions will challenge the government's ability to smoothly manage the economy, however macro fundamentals today are stronger than that seen during the 2013-14 period. But unlike China today, Indians benefit from a healthy real estate market and global businesses seeking more resilient and cost-effective alternatives to China. The stage is set for Delhi to move forward with an investment cycle to create a path for growth. That way, India truly emerges from under the shadow of China.

DISPLAY 3

Declining Developer Debt: A Sign of Improving Property Markets

India Property Developer Borrowing



Source: MS Research. *All years reflect the fiscal year ending March 31 of that year.

[8] MSIM, J.P. Morgan, NBS, HDFC.
[9] Reserve Bank of India, Bloomberg.
[10] World Bank Data, Reserve Bank of India.
[11] Bank of International Settlements, Haver.
[12] Bloomberg.
[13] Bloomberg.
[14] Reuters.
[15] Bloomberg.
[16] Morgan Stanley Research.
[17] Reserve Bank of India Financial Stability Report.

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