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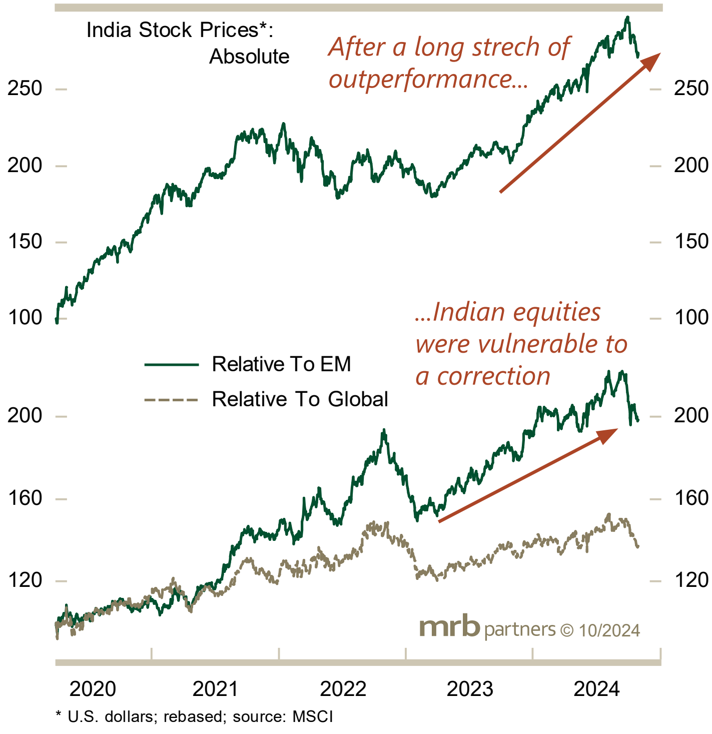
Independent Investment Strategy
RESEARCH HIGHLIGHT
INDIA
October 30, 2024

Why We Are Still Overweight Indian Equities

- After several years of outperformance, slowing earnings momentum and China's stimulus announcement have recently weighed on India's equity market.
- However, earnings momentum will firm anew, and a continuation of China's equity market rally is by no means assured. This should help Indian equities resume outperformance over the next 6-12 months.
- Still, stretched valuations imply that upside (absolute and relative to EM) over the next 12-24 months will be limited compared to the gains seen over the past several years.

India's equity market has been on a tear since the low in 2020, rallying 190% in absolute U.S. dollar terms and strongly outperforming the EM and the global equity benchmarks (**chart 1**). More recently, however, investor sentiment has shifted, and Indian equities have shed 7% in absolute terms and have underperformed their EM and global counterparts by 8%.

Chart 1 Recent Underperformance Should Reverse



* U.S. dollars; rebased; source: MSCI

While further consolidation in relative performance could occur, the recent headwinds that have held back relative performance are temporary, and India's equity market should outperform over the next 6-12 months.

Still, India's valuations are stretched by most measures, so future returns and outperformance are unlikely to match the averages seen over the past several years. The cyclical and structural outlook remain positive for Indian stocks, but investors should temper their return expectations for the for the next 1-2 years.

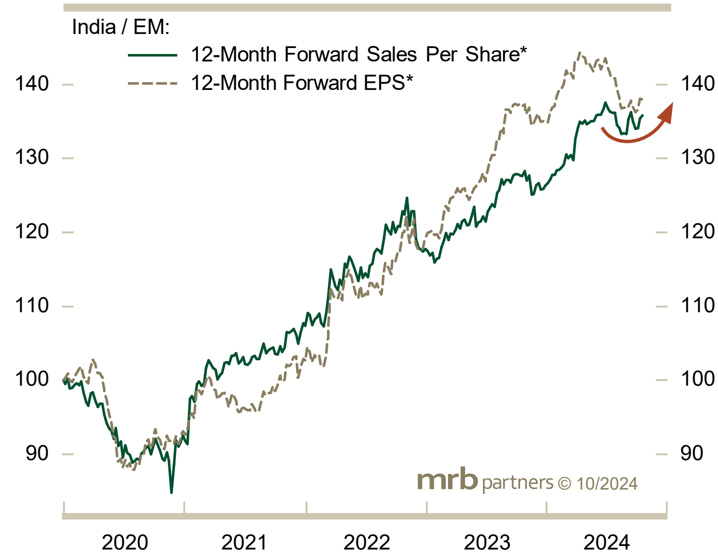
Earnings

Earnings in India have handily outperformed their EM counterparts over the last several years, and the outperformance was broad-based across sectors. This was driven largely by the outperformance of revenue (**chart 2**), although a modest improvement in profit margins relative to the EM equity benchmark also contributed positively to the earnings outperformance.

This long stretch of outperformance, in combination with India's structural economic tailwinds[1], propelled relative stock prices higher, but also led to lofty earnings growth expectations and stretched valuations (see page 4), leaving the market vulnerable to any economic/earnings growth disappointments or shifts in sentiment. Indeed, as GDP growth recently moderated, earnings estimates were revised lower and have recently weighed on relative performance.

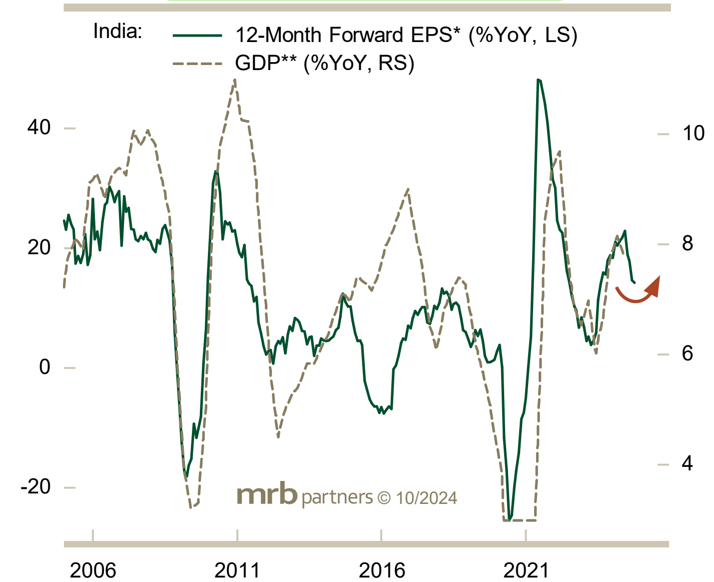
Although most economic forecasts (including the IMF's most recent projections) show India's GDP growth slowing in 2025, we are more upbeat, which bodes well for equity market earnings because of the close correlation between the two (**chart 3**). If our constructive outlook on global growth and trade pans out, then India's exports of goods and services should firm along with manufacturing activity, while at the same time the agriculture sector should rebound on the back of above-normal rainfall and robust reservoir levels, which should reignite rural demand. The RBI will likely cut its policy rate next year as core inflation is benign and headline CPI is likely to follow.

Chart 2 The Worst Has Passed For Relative 12-Month Forward Earnings



* U.S. dollars; rebased; source: I/B/E/S Global Aggregates

Chart 3 Earnings Momentum Will Firm Along With Economic Growth



* Local currency; source: I/B/E/S Global Aggregates
** Four-quarter sum

The implication is that economic growth and earnings are poised to firm in the next two years, with upward revisions to consensus earnings expectations. Indeed, 12-month forward earnings and sales relative to the EM benchmark are now showing signs of recovery, having underperformed in recent months. Furthermore, EPS and sales forecasts for 2025 (FY2) are also beginning to recover compared to EM peers (**chart 4**).

[1] **MRB:** "*Webinar: Investing In EM: China? India? Or Neither?*", April 26, 2023 and "*Webinar: EM ex-China Behind The Wheel, China In The Backseat*", November 29, 2023

The caveat is that emerging market earnings will also recover[2], with China now showing signs of an earnings turnaround, albeit narrowly based[3]. While this does not preclude further outperformance of India's earnings, it does imply that ***relative*** earnings upside will be more limited on a 6-12 month view.

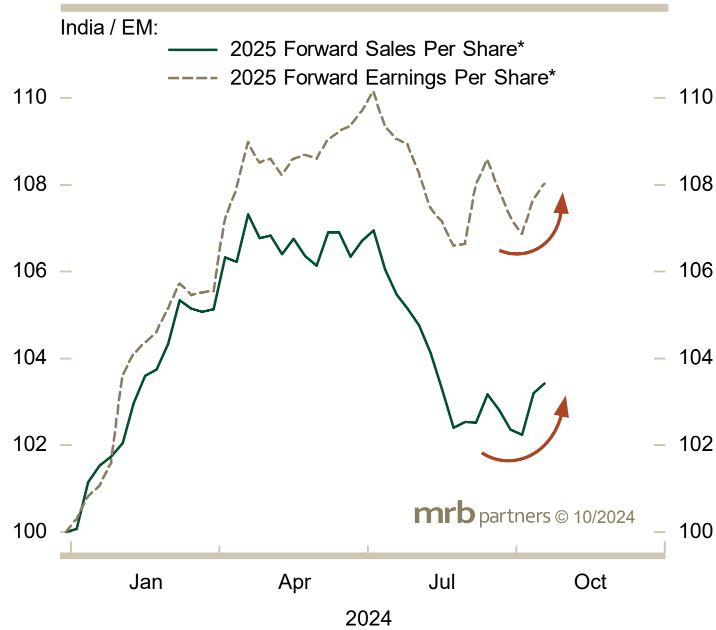
Positioning: India Versus China

Investors had rotated out of Chinese equities in recent years for various structural and cyclical reasons, and India was one of the main beneficiaries, in part due to widespread optimism about its long-term growth outlook and because of the large size of its equity market, which now rivals China's.

It was our assumption that some of these flows would reverse and India would temporarily underperform once investors warmed up again to Chinese stocks. Indeed, the announcement of China's stimulus measures has coincided with heavy net selling of Indian stocks by foreign investors (**chart 5**) and a sharp reversal in the relative performance of Indian versus EM and Chinese stocks. The outflows from India and corresponding underperformance were exacerbated by stretched valuations and the speed and scale of China's stock market recovery.

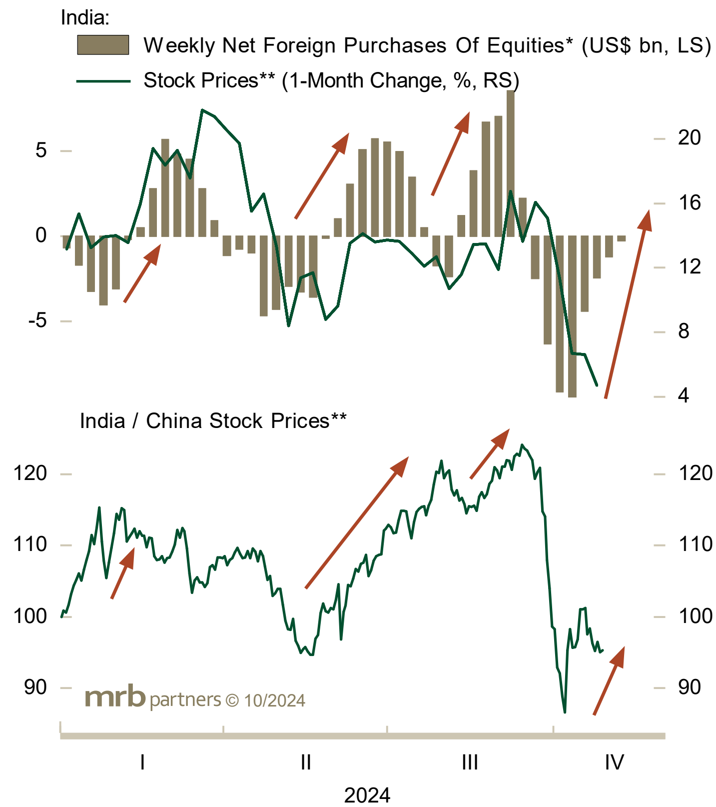
However, there are two reasons why we think this rotation from India to China will ***not*** last. First, China's stimulus will not have as much of an impact

Chart 4 2025 EPS Estimates Are Firming Relative To EM Pears



* FY2 estimates; U.S. dollars; rebased; source: I/B/E/S Global Aggregates

Chart 5 Capital Outflows Are Subsiding



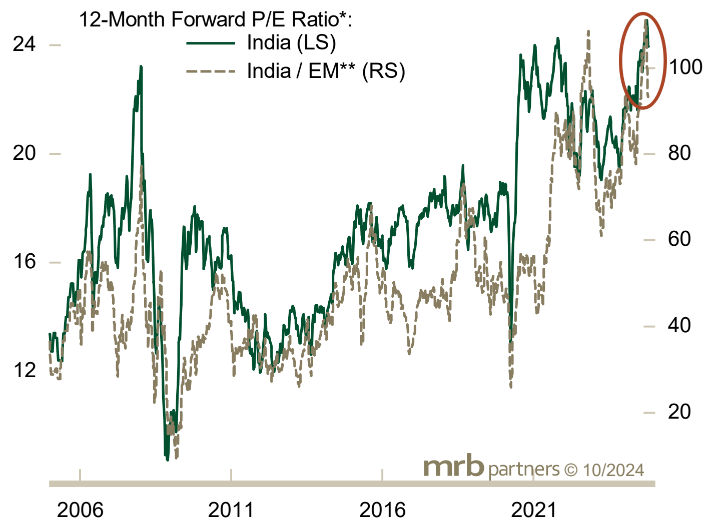
* Source: Securities and Exchange Board of India
** U.S. dollars; source: MSCI
Note: Panel 2 is rebased

[2] MRB: "*Emerging Market Equities: Earnings Are Outperforming, Prices Will Follow*", September 10, 2024

[3] MRB: "*China: Equities Are Riding The Dragon's Tail*", October 10, 2024

on economic/earnings growth as the aggressive moves in stock prices are suggesting and the impact on bank earnings may even prove negative[2]. This implies that the recent ***outperformance*** of China (and therefore outflows from India) should fade at a time when India's earnings estimates will be upgraded again. This, in turn, should provide support to Indian relative performance over the coming months.

Chart 6 **A Lot Of Good News Already Priced In**



* Source: I/B/E/S Global Aggregates
** Percent premium (+), discount (-)

Second, the competition for capital flows between China and India will likely weaken. When capital flows to EM are scarce, investors tend to view them through a zero-sum lens, where one market's win is another one's loss, as has been the case since 2021 as total EM capital inflows dried up. However, to the extent that global growth conditions improve, and broad-based DM monetary policy easing continues, then overall EM capital flows should improve, providing support to most EM equity markets, i.e. the tide will lift all boats. In this context, both India ***and*** China can outperform a global equity benchmark.

Implications Of Stretched Valuations

Valuations are still stretched…

…and future returns and outperformance are unlikely to match the averages seen over the last several years

India's positive structural outlook is well known and has a played a large role in propelling its equity valuations higher in the post-pandemic era (**chart 6**). Stretched valuations can last for some time, and in the case of India can be justified by the structural improvement in India's economic landscape and high return on equity. However, there are two important implications for investors.

First, the likelihood of a further meaningful re-rating is relatively small, and so over the next 6-12 months, the expected outperformance of India's stock prices will be driven by earnings outperformance. Thus, stock price outperformance will be broadly in line with the moderate upside of relative earnings.

Second, while India's structural tailwinds and positive long-term outlook will remain intact, India's equity market is not immune to cycles. Indian equities are clearly more vulnerable than most EMs to any cyclical economic/earnings disappointments or other shocks because of stretch valuations, as was demonstrated over the past month.

Final Word: *Strong and consistent outperformance versus EM and global peers left Indian stocks overbought and valuations stretched. The market was thus vulnerable to the recent slowdown in earnings momentum and the shift in sentiment resulting from China's stimulus announcement, both of which took a toll on share prices.*

However, the worst has passed for economic and earnings growth, and China's outperformance is likely to fade over the coming weeks. As a result, we see further upside for Indian stock prices in absolute terms and relative to EM peers, although still-stretched valuations will limit upside going forward.

While further consolidation in relative performance could occur, India's equity market should outperform over the next 6-12 months

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