Letter n°100

Should you invest in India, the world's 4th largest stock market?

"When a tree falls, it makes a lot of noise, but when a forest grows, no one hears it," Gandhi.

India is now the 5th largest economy in the world with a GDP of 3.7 trillion dollars, and will probably become the 3rd largest by the early 2030s. But, like the forest Gandhi spoke of, few observers were aware of this take-off.

- ***The weight of the past***:

India, according to Maddison's calculations, represented 22.6% of the global GDP in 1700 but only 3.8% in 1952. Was this decline the result of colonisation as some claim? One may doubt it. While it's evident that the primary ambition of the British was not economic development, without them, India might not have avoided decline, as the industrial revolution remained predominantly European. Following Subrahmanyam, let's acknowledge the British contribution of liberal institutions, the spread of democratic political culture, access to language, and the prevention of fragmentation into smaller states.

- ***The take-off of the last thirty years***:

Certainly, India remains a poor country with over 70% of workers lacking any social coverage, a country classified among lower-middle-income economies, with a GDP per capita of $2200, far behind China, classified among upper-middle-income countries, with a GDP per capita of $12500.

However, economic growth is the strongest among all major powers, at 6.5% in 2024-2025 according to the IMF, 400 million Indians have lifted themselves out of extreme poverty in 15 years, demographic momentum persists, and the stock market is booming.

These are all reasons to take interest, with this Letter n°100, in the future of India. In the interest of balance, we will begin by recalling the persistent obstacles, then we will assess India's attractiveness, and conclude with an analysis of the Indian stock market.

Persistent obstacles:

Lack of capital:

Domestic savings, even with the substantial influx of money from the diaspora, $125 billion, which amounts to 3.4% of GDP according to the World Bank, is insufficient to cover investments, and the government faces a budget deficit of 5.8% of GDP in 2024. Bank credit to small and medium-sized enterprises is also insufficient.

While China's development in the 1990s and 2000s may have been facilitated by abundant foreign investment, around 6% of GDP, foreign direct investment in India represented less than 1.5% of GDP in 2022, or $50 billion.

These amounts struggle to increase because some large companies, such as General Motors, Ford, Holcim, Metro, Walmart, Vodafone, have faced setbacks in their development in India. Some have been discouraged by regulatory hurdles, others by insufficient infrastructure, and still others by the mismatch of a workforce often lacking in qualifications. Of the 11,000 companies that entered this market between 2014 and 2021, a quarter are said to have withdrawn.

However, others, such as Apple, General Electric, Boeing, Harley, and Samsung, are strengthening their presence. And in the coming years, Saudis could invest $100 billion in infrastructure, and the Emirates $70 billion.

Weaknesses of the industry:

The industry, a key difference with China, remains controlled by a few large oligopolistic and family conglomerates, and the weight of the public sector is low.

Despite the government's exhortations, industrial development remains slower than in Vietnam or Mexico. This is due to deficiencies in education, as one-third of 25-64-year-olds have no elementary education, and among the others, 78% have not progressed beyond secondary education.

The second weakness is regulatory barriers to business concentration.

The third weakness is persistent protectionism, insufficient openness to exports, and a structural trade deficit.

The fourth weakness is research spending as a percentage of GDP does not exceed 0.6% and benefits primarily the space and defence sectors. The number of researchers as a percentage of the population is low, 26 per 100,000 compared to 170 in China and 450 in the United States.

There is development in the petrochemical and finance sectors, but few job creations accompany these developments.

Manufacturing industry represents only 14% of GDP compared to 17% two decades ago according to the World Bank. This is insufficient to absorb the 12 million young people who enter the job market each year, and it is estimated that between 2011 and 2018, even before the COVID pandemic, the manufacturing sector destroyed 3.5 million jobs and employed only 65 million people.

A GDP economic growth rate of 7 to 8% per year translates to approximately 6 million new jobs. Also, the labour force participation rate is low at 41% compared to 62% in the United States, the workforce is surplus, and productivity is low.

An unproductive agriculture:

It still employs 44% of the workforce, 280 million poorly paid individuals, yet contributes only 17% to GDP, whereas in Nigeria, for example, with a similar contribution to GDP, only a quarter of the active population is employed in agriculture. This abundance of labour hinders mechanisation and the consolidation of agricultural land.

A service sector with low job creation:

As a percentage of GDP, the service sector is more developed than in similar economies, with a positive export balance of nearly $30 billion, but the creation of skilled jobs is low.

An attractive country:

Of all the large countries, India benefits from the highest demographic growth. The workforce is expected to grow by 80 million by 2030, and the median age is 11 years younger than in China. This represents an unparalleled potential for consumption growth.

A political counterbalance to China:

India aims to be both the voice of the "Global South" and a partner of the United States in containing China's influence, as it participates in the Quad alongside Americans, Japanese, and Australians and seeks to counter China's growing closeness with Pakistan.

India stands in solidarity with South-South countries but has been participating in the G7 for over five years.

Since Nehru's visit to Moscow in 1955 and the Treaty of Peace and Cooperation in 1971, India has had defence and space relations with Russia. However, in recent years, even though India has not condemned Russia's aggression in Ukraine and remains Russia's top military supplier, it has diversified its purchases, buying more from the Americans and the French.

Political relations with China have never been simple, but in 2013, 2014, 2017, and in 2020 in Galwan, armed incidents occurred along the 3500 kilometres of the Line of Actual Control, not the border, between the two countries, and India lost some territory. India distances itself somewhat from the Shanghai Cooperation Organization, dominated by China, refuses to participate in the Belt and Road Initiative, and while criticizing the dominance of the $, it does not want to replace it with the Yuan.

Nevertheless, it is worth noting the importance of trade relations between the two countries, since China is the second-largest partner, clearly to the advantage of the Chinese, because although trade amounts to $115 billion, India's trade deficit exceeds $80 billion.

A potential growth driver amidst China’s slowdown:

- 3 notable improvements:

Infrastructure was lacking, nowhere near China's standards, but Mr. Modi's government has adopted a $1.4 trillion investment plan for the period 2020 to 2025, equivalent to 7 to 8% of GDP, and has, for example, opened over 70 airports. This year, the country is expected to allocate over $130 billion for infrastructure development.

Modi has improved the business climate as per the World Economic Forum, with the country jumping from 142nd place in 2014 to 40th. The corporate tax rate is moderate at 25%, and even lower at 17% for manufacturing companies. While starting a business remains challenging, significant progress has been made in obtaining construction permits, accessing credit, and bankruptcy procedures. Access to electricity, once problematic, has seen significant improvement.

The government is taking numerous actions to promote digital development in payments and industry, focusing on sectors such as electronics, medical equipment, telecommunications, and solar energy.

- Strong growth:

In 2000, the nominal GDP was less than $500 billion, today it stands at $3.7 trillion. Apart from China, few countries have shown such performance. Since 2004, the percentage of people living in poverty has dropped from 40% of the population to 12%. The GDP is at the level of China's in 2007 but could more than double in the next decade.

GDP growth was 8.4% in the fourth quarter despite a relatively weak private consumption at 3% and public investments at 3%, and despite a 0.8% contraction in the agricultural sector in the fourth quarter due to drought. However, there is strong growth in private investment and credit. In 2024, growth could reach 7.6%.

The United States, now India's top trading partner, is strengthening its bilateral relations with over $200 billion in trade.

- Satisfactory financial situation:

At $620 billion, foreign exchange reserves represent 11 months of imports and are equivalent to the amount of external debt.

While this year the $ has appreciated against the majority of currencies, the Indian Rupee remains stable against the $.

The current account deficit is limited, barely exceeding 1% of GDP.

The inflation rate, at 5%, and core inflation at 3.6%, is not excessive considering the strong economic growth. The 10-year interest rate, at 7.1%, and the official rate at 6.5%, are reasonable.

The situation of banks is solid, with both a decrease in non-performing loans and an increase in profitability.

A developing but expensive stock market:

Market capitalisation:

India now has a market capitalisation exceeding $4.6 trillion, vastly surpassing the less than $200 billion mark in 2000, and significantly higher than the Hong Kong market. India is home to 4,000 companies, including around 250 with a capitalisation of over $1 billion, constituting 17% of the MSCI Emerging Index, trailing behind China + Hong Kong at 25%.

For comparison, the US market capitalisation exceeds $50 trillion, China's market is at $11.5 trillion, Japan stands at $6.7 trillion, France at $3.3 trillion, and other markets are considerably smaller.

In the past five years, the Indian market has seen a 50% increase in performance, while China's has declined by over 20%.

Market appreciation:

Over the past thirty years, the average annual appreciation of the Sensex index has approached 12%, or 8% after accounting for currency depreciation against the $. In rankings among major markets, India ranks second only to the United States.

In the past five years, market appreciation has primarily benefited real estate, a sector with low representation, and then, unsurprisingly, the tech sector, ahead of industrial and healthcare sectors.

The appreciation in recent years has been driven both by disappointed international investors in China and by a larger number of domestic investors. Ten years ago, foreigners accounted for 60% of the market, whereas today it's 40%.

The attractiveness of the Indian market has been bolstered by corporate deleveraging in recent years, often high margins due to protectionism (import taxes close to 20%), and a growth in consumption.

Market valuation:

In terms of valuation, the Indian market, at over 21 times expected earnings for the Nifty50, is now more expensive than its average of the last ten years, more expensive than the US market, and even more so than the Chinese market at 9 times earnings due to well-known political uncertainties. However, profit growth, at +15%, surpasses that of these different markets and exceeds the average of the last thirty years, which was 12%.

Alongside the large caps - Tata, $360 billion - there has been a flowering of start-ups. 180 companies out of 2,800 now have a market capitalisation in excess of $1 billion, a higher figure than in other countries.

The Indian market accounts for almost 24% of financial stocks, a percentage comparable to that of Brazil, but higher than the weight of finance in developed countries.

Tech stocks represent 12% of the market capitalisation, double the percentage of China, but obviously much lower than what they can represent in smaller countries like Taiwan or South Korea.

Next are discretionary consumer stocks at 13%, and communication services at 8.5%.

However, materials, industrial, and energy stocks are less represented, at 7.5%, 6.5%, and 5.5% respectively.

The same goes for consumer staples, at 5.5%, and healthcare stocks, at 3.6%.

Another reason for high valuation is the low floating shares of companies because they are often family-owned and held by a stable core of over 50%.

Conclusion: ***"What does it matter that we take different roads so long as we reach the same goal?" Gandhi.***

Gandhi's statement about religions applies to economics as well. Certainly, India's chosen path for its take-off differs from China's, but India has entered a catch-up phase, and investors cannot ignore it.

- ***Strong growth but a two-speed economy***: Undoubtedly, since coming to power in 2014, Modi has endeavoured to stimulate economic development, and India is an economy in take-off phase, even though it remains a two-speed economy.

  There's low geographic mobility between the five southern states, which, with 20% of the population, contribute to 30% of GDP, receive 35% of foreign investments, and account for two-thirds of the country's technological exports, compared to the poor northern states like Rajasthan or Bihar.

  There's also low social mobility, with very high social inequalities, as 1% of the population holds 40% of the national wealth, a concentration higher than in the United States or Brazil.

  The disadvantaged classes benefit little from economic take-off. 10% of the population lives on less than $2.1/day, and 90% of the population has less than $3500/year to live on. Thus, overall private consumption is expected to grow by only 4.4%. However, due to inequalities, certain sectors will continue to experience strong growth. Car sales are expected to reach 4.1 million this year, a record despite a 50% price hike since 2019. The luxury market is growing by around 20%, and this trend is expected to continue.

- ***Environmental challenges***: The country faces an environmental challenge, as it is home to 40 of the 50 most polluted cities on the planet and has water resource issues.

- ***Increasingly illiberal democracy***: One cannot ignore the decline of democracy, media control, and the repression of religious minorities in favour of Hindu nationalists.

- ***Stock market in a consolidation phase***: Modi, 73, is expected to win the elections starting on 19 April, with 970 million voters and results expected by 1 June. The market is expected to consolidate until this date but will offer potential beyond it.

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