India on the Rise: The South Asian Nation Overtakes China as Growth Leader

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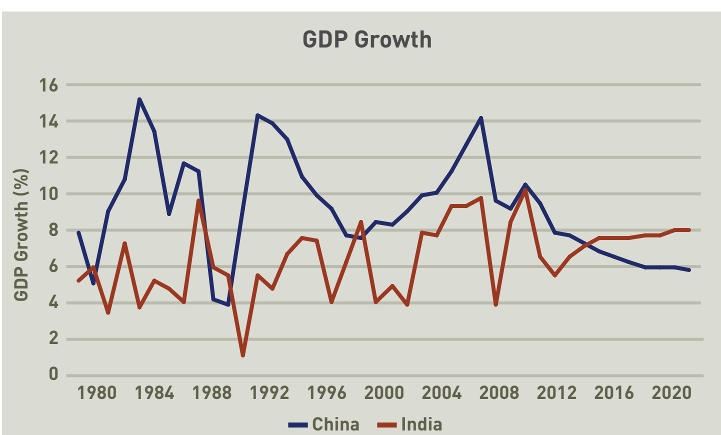
For the last quarter century, China has been the main story within the emerging-market paradigm. The nation developed into an export and economic powerhouse focusing its centralized efforts on urbanization and massive infrastructure investment. China has consequently been the lead success story among large developing countries. That's possibly about to change, however, as another Asian country is poised to take its place. And that country is India. After years of disappointments and false dawns, India is in a demographic sweet spot and under the spell of its brash and reform-minded Prime Minister Narendra Modi. With nominal gross domestic product (GDP) of $2.25 trillion, India, the world seventh-largest economy, is on the cusp of potentially altering the global economic landscape forever.

While it may not become the "next China," India holds great promise. Unlike the manufacturing prowess developed by China and its 1.37 billion people, India is a more decentralized but politically stable and service-oriented economy. While traditional village farming still serves as the livelihood for most of the 800-plus million people in the rural areas, the South Asian country of 1.28 billion has taken great developmental strides the past few years: Modern agriculture, industries, and services now represent thriving and growing sectors of its economy. India's large and well-educated English-speaking population has helped it become a major provider of information-technology services, pharmaceutical manufacturing, business-outsourcing operations, and software workers. Today, services are the major source of economic growth, accounting for nearly two-thirds of India's output.



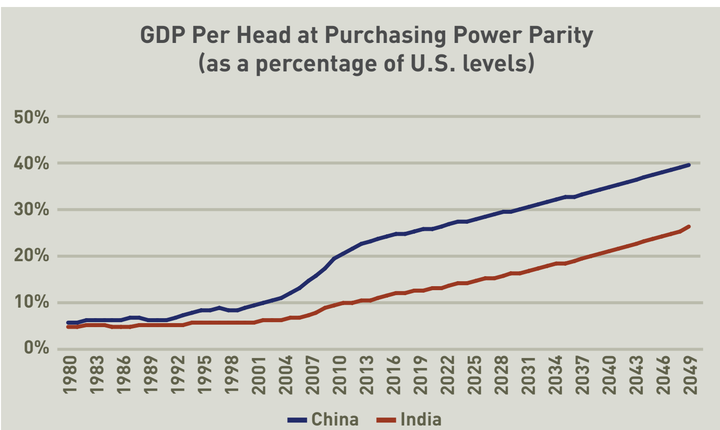
Source: International Monetary Fund

India does have its challenges. These include a lack of infrastructure, a slow-moving banking crisis, corruption, pollution, stifling bureaucracies and excessive regulations, unskilled workers, and slumping capital spending. Its urbanizing economy hasn't created enough jobs. It also has significant strengths, however, which lie in its favorable demographics, a rising and educated middle class, an established democratic government, and an improved current account position. Importantly, the South Asian giant is being now led by a true and active reformer, one who is keenly focused on making India a better place to do business.

We've been traveling to India for over 20 years and have invested our clients' money there for well over a decade. It is a country of great contrasts – linguistically, socially, economically, geographically, and in terms of religious diversity. We have been keenly aware of the enormous challenges and the extraordinary changes that have taken place. On our most recent trip, we had a chance to meet with corporate leaders, government officials, academics, and journalists. We sensed a sea change in the mindset of the people. The country has generally moved from a more socialized orientation to a greater reliance on the private sector and is more open to the capital markets and trade. While skepticism is warranted based on years of false starts and structural headwinds, India is finally in the position to determine its own future.

INDIA RISING – BUT JUST NOT FAST ENOUGH

Like China, India began to open up its economy in the early 1990s, introducing measures to deregulate industries, privatize state-owned enterprises, and reduce controls on foreign trade and investment. While China clearly outpaced its neighbor, India held its own. From 2003 through 2010 (with the exception of 3.8% in 2008, the year of the global financial crisis), India's GDP growth was 7.9% or higher each year. Unlike China, however, India fell further behind. Expansion began to slow in 2011 due to a decline in investment caused by high interest rates, rising inflation, lethargic world growth, and investor pessimism about India's commitment to making further economic reforms. Annual GDP growth declined to 5.6% in 2012 and 6.6% in 2013, modest by India's standards. In the 2014 general election, the Hindu nationalist Bharatiya Janata Party (BJP) and its leader Modi consistently pushed a business-friendly, anti-corruption agenda as it hammered the ruling India National Congress party. In a decisive victory for Modi, the BJP won an absolute majority in the Lok Sabha, the lower house of India's parliament.

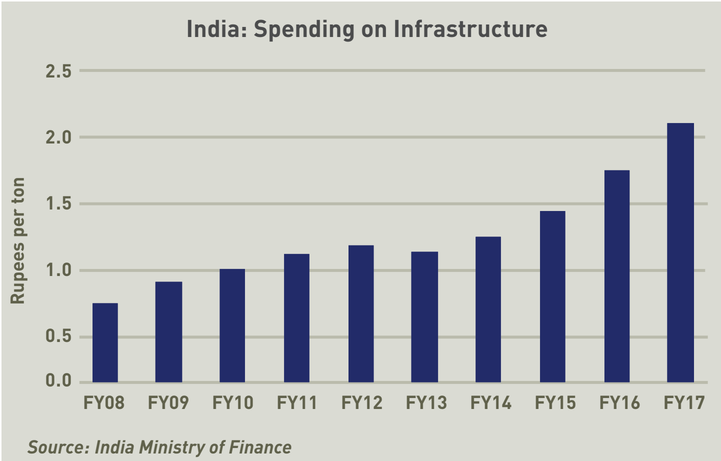


Source: International Monetary Fund

Modi's party's main political support emanates from the upper castes, but his political message resonated with an electorate demanding change, upward mobility, and a revival of growth. Indians are furious over the pervasive culture of corruption at every level of government. Its electorate is young: Half the nation's 815 million voters are under 35 and eager for reforms that will help them secure meaningful employment. Business projects are hard to launch – India ranks 130 out of 190 economies in the World Bank's measure of ease of doing business – and crumbling roads and ports, along with inadequate electricity supply, bedevil commerce and the average citizen alike.

Investors' perceptions of India began to improve due to expectations of post-2014 election economic reform and a reduction of the current account deficit, which resulted in a surge of inbound capital flows. Since late 2014, a halving of global oil prices has further boosted economic activity in India, lowered inflation, and improved its trade position. The current account deficit fell sharply from 4.8% of GDP in 2012 to about 1.1% of GDP in 2016 and it is expected to remain compressed. Near-term inflation is projected to be below 5%, in line with the Reserve Bank of India's inflation target and a dramatic decline from 10.9% in 2013. The government fiscal deficit was reduced to 3.5% of GDP in the most recent fiscal year, down from 4.5% two years earlier.

India's GDP growth rebounded to 7.2% in 2014 and 7.6% in 2015. GDP figures released by India show that the country grew 7% in the fourth quarter of 2016 in spite of demonetization and would expand 7.1% in the 2016-2017 fiscal year. It must be noted that the International Monetary Fund (IMF), citing a temporary negative consumption shock induced by India's demonetization initiative (more on that later), estimates that 2016 GDP grew 6.6%.



India's future is all about increasing urbanization, jump-starting job creation, and enhancing job skills in order to exploit its powerful demographic dividend. Its biggest challenges for the government are to increase economic growth, multiply employment opportunities for the burgeoning young population, increase female labor participation, improve infrastructure, and increase domestic capital investment.

MODI'S REFORM AGENDA – FROM TEMPERED TO SHOCK AND AWE

Enter Prime Minister Modi. His modernizing reforms include efforts to attack corruption, reform the central bank, liberalize the debt markets, increase manufacturing and construction, ease foreign direct investment (FDI) rules, and reform the bankruptcy code to streamline processes to make India an easier place to do business. To combat the weak central government and lack of Indian competitiveness, he instituted a policy of "competitive federalism" to stimulate greater competition among the 29 Indian states. India has consequently jumped more than 30 spots in the World Economic Forum's Global Competitiveness Index. Similarly, the central bank, the Royal Bank of India, now has a more formal policy to target inflation and is considered more centralized under its monetary policy committee, less politically driven, and more independent. In addition, the bankruptcy code, enacted in May 2016, enables banks to more quickly recover funds and replaced a mishmash of outdated regulations. While still small and undeveloped, the debt market has been liberalized to rely less on bank funding by allowing pension funds and insurance companies to buy corporate debt and banks to offer credit enhancements. While progressing more slowly than some investors had hoped, these efforts are certainly helpful for the economy going forward. So far, so good.

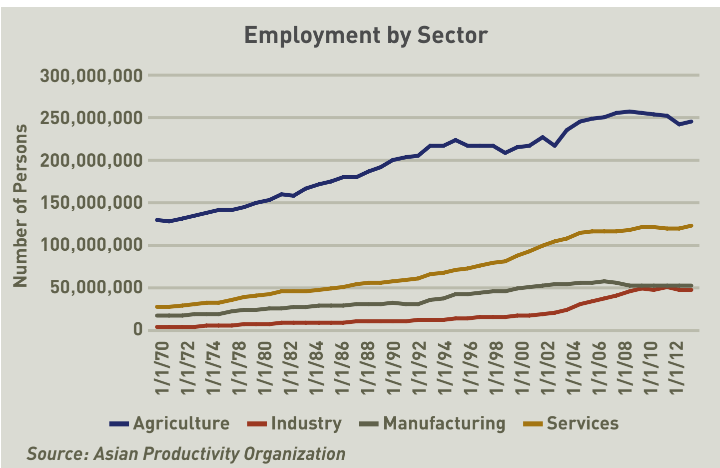
The most significant initiative since 2000, however, involves tax reform. Taking its confusing patchwork of local and regional government taxing authorities and revamping India's overly complex tax system and bringing India into the 21st century would be a monumental achievement. The government expects to broaden the country's tax base, improve business efficiency, and slash the size and influence of the black market. The government is replacing all indirect taxes levied on goods and services by individual states and various taxing authorities with a pan-India Goods and Services Tax (GST). While initially slated to commence in April, implementation will now likely be in July 2017. The GST will enhance economies of scale, efficiency, and competitiveness, and rekindles the hopes that Modi will continue to deliver on his reform agenda. It is expected to have a dramatic effect on the economy by creating a single, common market, simplifying the tax regime, and reducing the cascading effect of taxes on the cost of goods and services. It is estimated to add one to two percentage points of economic growth going forward.

Other significant reforms include plans to open up more sectors of the economy to foreign direct investment and initiatives to replace the expensive, corrupt, and inefficient welfare system with simple cash transfers. Of note is India's Aadhaar program, the world's largest biometric identification system. The government uses the Aadhar network to ensure that individuals who require assistance gain access to these resources directly, eliminating the need for middlemen and reducing fraud and waste. While the Aadhaar program began well before he took office, Modi can reap its efficiency benefits.

Unlike the GST plan which was announced years in advance, demonetization is another of Modi's reforms, one that many would argue has suffered through a bungled implementation. In November 2016, Modi declared without warning that all 500- and 1,000-rupee notes – which make up 86% of the entire cash in circulation in India – could no longer be used in transacting business and had to be exchanged for new bills. The sheer boldness was breathtaking, and it took the markets and the Indian public by complete surprise. The underlying rationale for Modi's demonetization plan was straightforward enough: The vast majority of transactions in India take place in cash, which helps the black market and organized crime, and curtails tax collections. The government hopes to improve the functioning of the economy, move the country into the digital future away from cash, and boost tax revenues by cracking down on the shadow economy and placing more citizens on the tax rolls. Indians were told to swap their useless bills for new ones. Those who don't have the paperwork to account for their cash are expected to receive unwanted government attention and big tax bills.

Unfortunately, the rollout of demonetization was botched. New bills were slow to be circulated, and the cash-dependent Indian economy suddenly found itself without enough currency. People lined up for weeks around ATMs that didn't work, and even simple everyday transactions came to a halt. Although the pain is expected to be temporary, the widespread cash crunch and severed supply chains have been disruptive. Many of the negative effects from the effort did not come to pass as GDP has held steady. Most banks have noted that their recovery has been V-shaped, indicating that the effects were not as deleterious as first feared. While some parts of the economy have returned back to their cash-central ways, time will tell if demonetization's goals were successful.

India knows it must take advantage of its demographic tailwinds to grow the economy and upgrade its infrastructure. India's biggest problem remains the lack of private sector investment due to strained balance sheets. With many of the public sector banks, which provide three-quarters of India's domestic credit, hamstrung by high non-performing loans, capital spending has slumped as banks have reduced lending. The government's budget has increased 22% year over year, but it can't cover all of the road, rail, water, sewer, power, and airport projects that are needed. The ultimate goal of the government is to get the private sector to invest in infrastructure.



Modi certainly has farther to go in getting his reform agenda in place – the Center for Strategic and International Studies identifies 30 major reform proposals in varying stages of implementation. Nonetheless, he appears tireless and undaunted in his quest to shape India's future according to his vision. His popularity remains high even after the demonetization misstep. In March, the BJP won control of the legislature in Uttar Pradesh, the country's most populous state with over 220 million people – a population that is larger than Germany and France combined. With over three-fourths of the seats in the state assembly going to the party, it was an emphatic endorsement of Modi and his policies. In spite of the headaches caused by demonetization, the focus on economic development coupled with a crackdown on corruption appealed to poor voters across different castes. Although Modi still needs to make progress toward taking a majority of the upper house of Parliament, the landslide victory underscores that the effort to reduce the costs of doing business, attack corruption, and create a friendlier environment for business were not in vain. India's reform project is definitely still on track. Voters have given him more time to pursue reform at least until the next national elections in 2019. And in some ways, this recent election defined the shape of the country for many years.

MODI AND TRUMP: POPULIST BROTHERS IN ARMS

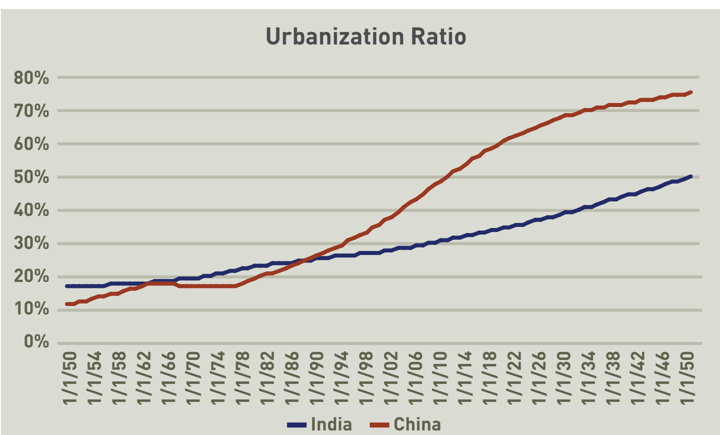
The similarities between Prime Minister Modi and President Trump are striking. Each rose to power as populist outsiders willing to disrupt entrenched political elites. Like Trump, Modi can be brash, and he is an ardent Twitter user. He is all about power politics. He has a deep distaste for traditional media and frequently bypasses news outlets in communicating to the public. He also wants to ramp up manufacturing, although his goal of raising the sector from 16% of GDP to 25% will be extraordinarily tough. And Modi presaged Trump with his promises of a new growth era for his nation driven by pro-business, anti-corruption governance. He is looking for three terms in order to reorder and fix India into his world view.

On our recent trip to India we had the opportunity to discuss the prime minister with the editor and chairman of a major newspaper. “Modi is the first genuine leader of India’s nationalist right wing,” he said. “He is quite possibly the strongest political figure the country has ever had, and that includes Gandhi. Modi has a big personality and will do whatever he wants. For example, he probably knew that the approach to the demonetization scheme was flawed, but he pushed it though anyway. Modi is hyper-narcissistic and fancies himself as a decisive, tough leader. At his core, he is a statist. He wants to make the government work better, not become smaller. I believe Modi’s goal is to turn our patchwork country into something more like the Singaporean model: a highly developed free-market economy with a strong corruption-free central government.” Recent election results bear out that the Indian people continue to support his efforts in spite of the growing pains. The risk is that the BJP becomes too nationalistic and anti-Muslim and India’s successful democracy is upended by Modi becoming too powerful for his own good. Emulating China can only go so far.

THE BENGAL TIGER VERSUS THE RED DRAGON

For most of human history, India and China accounted for roughly half of the world economic activity. After the industrial revolution, they became insignificant. After the 1990s their combined rise began, but it was mainly China that outstripped its neighbor. Today, China’s economy is nearly three times the size of India’s. Going forward, it may change. In some ways, it’s the “old” economy versus the “new” economy. Led by export-driven manufacturing, China has long been the growth champion of the large, developing countries. However, the leadership baton is now passing to India, which sports a world-class information technology services industry. China’s GDP grew 6.7% last year – its slowest rate of expansion in a quarter of a century – barely edging out India’s growth of 6.6%, using the IMF’s estimate. As mentioned, India’s growth was hampered by its mismanaged demonetization launch in the fourth quarter, the effects of which are temporary. The IMF forecasts that India will grow 7.2% and 7.7% in 2017 and 2018, respectively, while China will expand by 6.5% this year and 6.0% in the following year.

While population growth alone does not ensure economic success, India’s advantages over China clearly start with decidedly more favorable demographics. While China’s one-child policy has officially ended, the long-term effect will result in fewer entrants into the labor force for decades to come. In fact, the working-age population in China is already shrinking. China must skillfully manage an aging population with demands for increased productivity. In contrast, India’s demographics favor growth. Its population of 1.3 billion is second only to China’s, and it is on track to become the most populous nation in the world by 2022. With half of its population 25 or under, India is a young country. Approximately 12 million people join the workforce each year, and India will reach 900 million people of working age by 2020. As a result, the dependency ratio – the number of children and seniors relative to the working-age population – will decline in India as it rises in China. India’s population is projected to surpass China by 2030 and be around 1.7 billion by 2050 versus China’s 1.3 billion.



Source: United Nations Database

And India’s middle class continues to grow rapidly. The number of households with a disposable income of more than $10,000 leapt from 2.5 million in 1990 to nearly 50 million in 2015, according to Euromonitor International. By 2027 India’s middle class population will over overtake that of the United States, Europe, and China, according to the World Economic Forum). Urbanization will keep the middle class development train going. And India has fallen behind. In 1990, India was slightly more urbanized than China at approximately 25% versus 20%, but by 2015 China was more than 55% urbanized while India’s urbanization ratio was only around 35%. Like China, India needs to take its rural workers and employ them in construction and manufacturing to further increase wealth and prosperity. Interestingly, Xiaomi, China's largest smartphone seller announced an assembly plant in India. Currently however, its urbanization rate is still too low when compared with other emerging markets of a similar size. India has no shortage of megacities with three cities ranking in the global top 20, but its inferior infrastructure and poor public services hamper its ability to maximize efficiency and growth.

Finally, India has a democratic form of government – the world's biggest – which over time may offer advantages over China's more centralized, one-party regime. Along with a belief in a free and competitive press, India inherited a legal system from the British and its rule of law is well entrenched. Use of English is widespread in India, a significant plus in a business world that accepts English as a common language. English usage also serves as a unifying force in a country with hundreds of languages and dialects. Whether Modi likes it or not, India is not China or Singapore.

These advantages have helped produce more service-oriented companies with global scale – think Infosys, Tata, and other large, sophisticated companies that compete globally. China, on the other hand, is hampered to some degree by a command economy and huge, inefficient state-owned enterprises. China is also struggling to transition from an export economy to one with greater consumer demand, while India already has a functioning consumer market.

EMERGING MARKET RESILIENCE AND RESURGENCE? INDIA WILL BE AN INTEGRAL PART.

Overall, we are becoming more constructive on the emerging markets. After several years of underperformance and failing to deliver due to weak commodity prices, U.S. Fed hike concerns, weaker economic growth, compressed corporate margins, and a stronger U.S. dollar, emerging markets are starting to stabilize and selectively may be poised to outperform their developed-market peers. We believe that 2016 was an inflection point for emerging markets. Subject to a potential risk-off growth scare or U.S. border tax adjustment fueled correction later this year, the developing-markets rally looks to be self-sustaining. We also believe that we are closer to a U.S. dollar peak, if we haven't already seen its top. And inflation does not pose the threat it once did.

We believe that developing-market equities may be in an early stage of a multi-year rally. It used to be that political risk emanated primarily from emerging markets. Now, we are seeing a reversal. While we continue to like Europe based on compelling valuations and its cyclical growth prospects, emerging markets don't carry the relative, outsized political risk we are witnessing in the developed markets. In addition, emerging markets have generally accumulated sizeable foreign currency reserves as a buffer against debt default and their currencies are no longer overvalued. Many emerging-market economies can take advantage of the current synchronized global recovery, especially firms with high operating leverage.

Current valuations remain attractive increasing potential returns and earnings per share growth is stabilizing and expected to rise much faster than in the developed world. The long-term potential of developing-market consumers is well known. Finally investment flows have returned. Our PNC Capital Advisors International Equity team has taken notice and we are further expanding our product offering and investment footprint in the emerging markets. Our disciplined approach of purchasing great growth companies and investing in markets with compelling valuations and the least amount of risk will likely mean that India will be a destination for us for the next several years. While the Indian market is currently overbought and expensive, we will be looking to add to this consumer-driven, growth market going forward. India has some of the highest expected earnings growth in the world. It is one of the few markets that is undergoing real, structural reform changes, and, we believe, is best placed among the developing markets. With its reform efforts, India is playing the long game.

Will India become the next China? Probably not. Its influence on the global economy will likely be less significant, but will be important nonetheless. India presents a bright spot for the global economy. We expect that the next decade should see the ascendancy of India. But India does have its challenges. Dense bureaucracies, a weak central government, inadequate capital spending, cumbrous regulations, corruption, inefficient and wasteful social spending – these are all headwinds and areas that need attention. India's banks face mounting bad debt, placing a restraint on credit growth, while female participation in the workforce remains low. A lack of good infrastructure, especially in transportation and power generation and distribution systems, is an area where India takes a huge back seat to China. During

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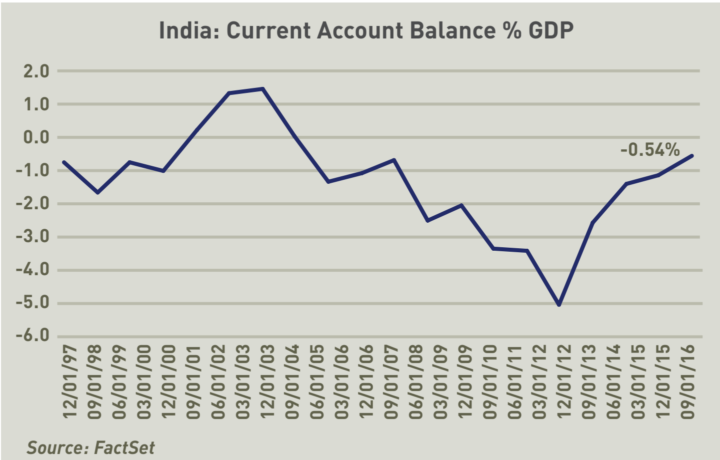

Source: FactSet

our recent trip to India, we experienced first-hand the extraordinary challenges in traffic and pollution. In Mumbai, the air quality index was over 350, well into the hazardous range. And while high-caliber education is available for those who are better off, many Indians have difficulties securing good, basic schooling, especially in rural areas. Other longer-term risks include further technological advancements and automation, which may short-circuit India's attempt to put its rural population to work in manufacturing.

Even with these obstacles, however, India has a bright future due to a burgeoning young population and low dependency ratio, healthy investment rates, declining inflation, and an improved current account position. Approximately 10 million Indians are joining the workforce every year. Its non-performing loan cycle has likely peaked. It is a beneficiary of low oil and commodity prices. Its people are free to compete economically and express themselves politically. When you add a strong-willed reformer to the mix, the case for India's economic future is compelling. The recent election victories vindicated Modi and should further energize the reform agenda. Modi is definitely a leader who takes risks. His banknote initiative to accelerate change was highly unorthodox, but he has successfully reached across traditional caste divides and delivered what voters wanted. He has become the most consequential leader in India since independence. Modi's reforms are gaining traction. If he can encourage greater capital investment, improve education and job creation, and increase manufacturing and construction, he can hit his target of 8% GDP growth, and India will surely be on its way. The implementation of the GST and consequent creation of a unified tax system – similar to what Europe accomplished in the 1950's – is a sure way for India to leapfrog into the 21st century with a single market. And international investors should take note.
