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Fundamental Fixed Income

Market update: India

Smart Beta • Fixed Income

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India – sovereign debt upgrade reinforces the quality story

India may have taken a knock recently as a result of a number of awkward policy moves, but we think its quality shines through and we are not alone. Yet many investors will miss out on the potential this growing and strengthening economy offers if they focus on traditional investment approaches.

A welcome upgrade

The recent upgrades of India's local and foreign government debt by rating agency Moody's have provided some welcome daylight between the nation's credit rating and the high yield (junk bond) threshold.

India's first rating upgrade by Moody's for 14 years, the increase from Baa2 to Baa3 signalled a timely nod of approval towards Prime Minister Modi's institutional reforms and their positive long term impact on the nation's already strong fundamental profile.

Resilient in the face of home-grown challenges

On the back of the government's somewhat controversial drive last year to withdraw all high-value currency notes from circulation ('demonetisation'), along with the implementation of a national goods and services tax (GST), India has seen a steady decline in annual GDP growth levels over the past 18 months. Growth fell from 9.1% in Q1 2016 to 5.7% in Q2 2017 as the reforms negatively impacted economic activity. Despite this, the easing of monetary policy by the Reserve Bank of India (RBI) has helped to stabilise macroeconomic conditions, with inflation floating around a sustainable 2-4% level over the last 12 months. And with the IMF forecasting India to be the largest BRIC and ASEAN growth nation (excluding Myanmar) in 2018, it would appear as though the economy has weathered the temporary hit from the controversial policies, emerging on the other side with a more shock-absorbent structure. Indeed, Moody's press release cited the positive long-term growth outlook resulting from the structural policy changes as a key driver for the rating upgrade, whilst acknowledging the recent slowdown was a side effect of the clunky initial implementation.

A strengthening governing party

The upgrade brings an additional benefit to the Modi government, as it is likely to provide a boost the party in the upcoming polls in Modi's home state next month and create positive momentum ahead of a national vote in 2019. It is possible that in strengthening the government's position, the upgrade could provide a multiplier effect of sorts in terms of stability, consistent fiscal policies and solidified fundamentals.

Risk factors to consider

It is, however, important to provide context. An improvement in India's debt position is greatly reliant on a number of factors, the most obvious being the continued success of the fiscal reforms.

The government's initiative to combat the nation's non-performing loans problem by recapitalising banks to the tune of USD 32 billion was warmly received by credit agencies and economists alike and was long over-due. However, this will further increase debt levels in the short term, and if benefits fail to translate into increased demand on the ground level, the outlook may well shift in the opposite direction.

Secondly, and perhaps more importantly, the rally in oil prices could scupper the Central Bank's plans for further rate cuts. And if the oil price increase persists, inflationary pressures will take their toll on India's energy-dependent manufacturing sector, particularly if export data fails to pick up to compensate.

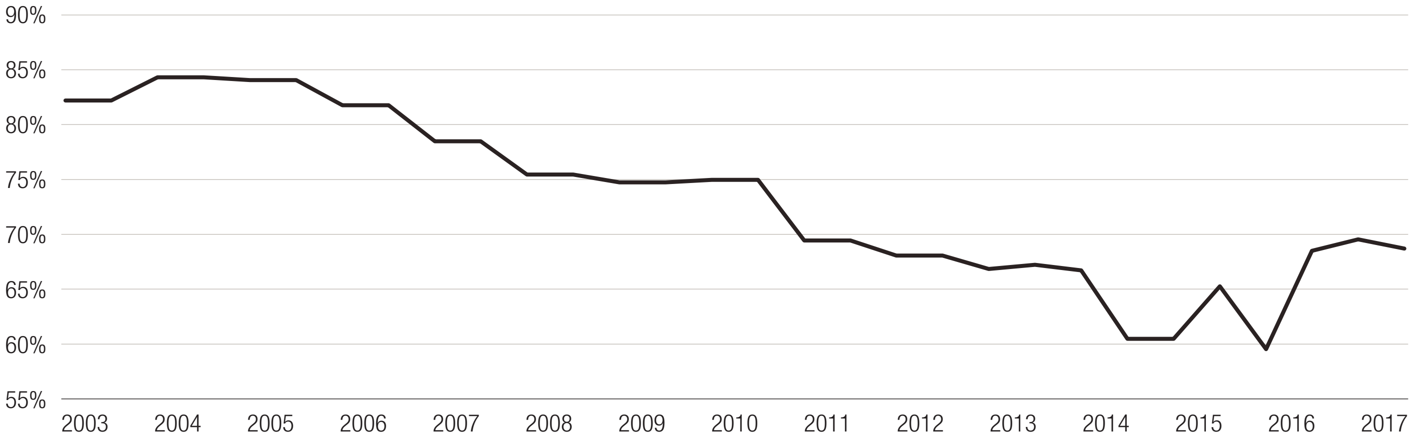
Furthermore, the upgrade is yet to be matched by Moody's peers, S&P and Fitch, as they are likely awaiting news from the upcoming fiscal budget next year. Both agencies have cited weak fiscal balance sheets as the key stumbling block for any potential upgrade.

Credit where it's due

We believe the move by Moody's was justified and deserved.

As Figure 1 shows, India's gross debt to GDP figures have been steadily declining for the past decade to much more sustainable levels than seen previously. With the IMF forecasting 7.4% GDP growth in 2018, in conjunction with the effects that new reforms should have in terms of reducing the likelihood of a sharp increase in debt, in our view, India seems well placed to further improve this metric in the coming years.

Figure 1 – Gross debt-to GDP of India since 2003



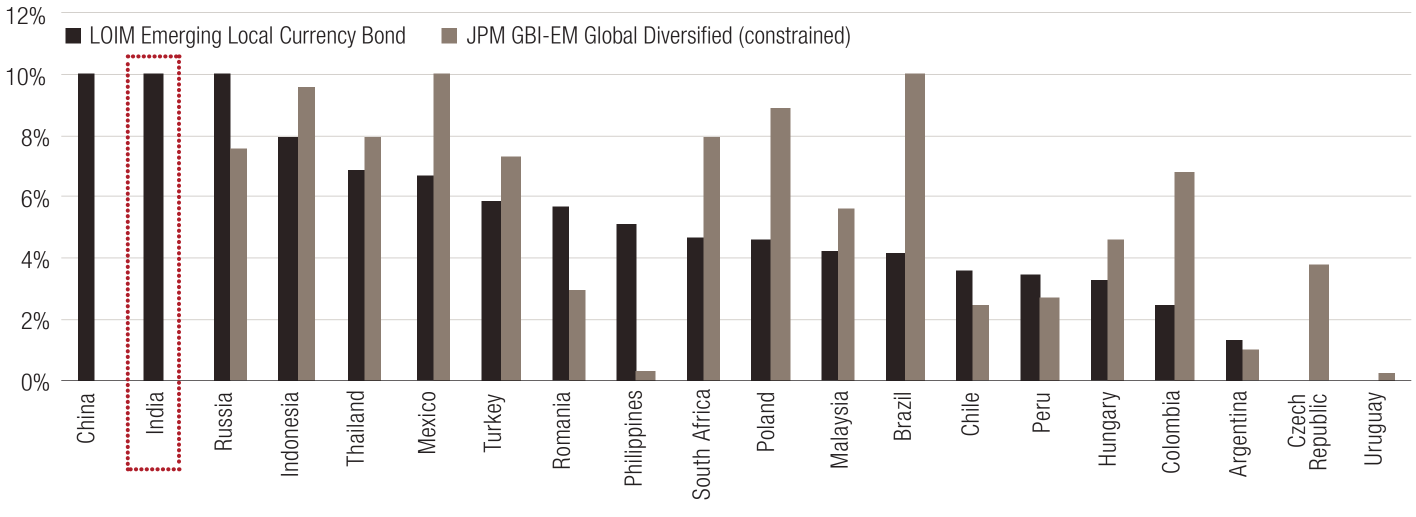
Source: Bloomberg, IMF World Economic Outlook October 2017.

The importance of a fundamental-based investment approach

When it comes to portfolio construction in emerging markets space, India's case underlines the importance of a rigorous country-by-country fundamental analysis of emerging markets to ascertain where quality lies as opposed to the leverage-rewarding embedded in the traditional market cap approach.

Figure 2 shows the country allocation of LOIM's fundamentally-driven emerging market local currency index against the relevant market cap index.

Figure 2 – Country allocations of the LOIM Emerging local currency bond strategy compared to the traditional market-cap benchmark



Source: LOIM, JPM. For illustrative purposes only. November 2017.
Holdings and/or allocations are subject to change.

Our fundamental-based approach to portfolio construction results in an allocation of 10% to India. Conversely, as access to local bonds is subject to government auction, the Indian market is not eligible for traditional market-cap indices. We believe that India merits a significant allocation in a quality-based emerging market debt portfolio and should be a core holding that is well suited to today's fractured liquidity environment.

Best regards,

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Client Portfolio Manager

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Graduate Analyst

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Emerging markets securities may be less liquid and more volatile and are subject to a number of additional risks including, but not limited to, currency fluctuations and political instability.

Source of the figures: Unless otherwise stated, figures are prepared by LOIM.

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