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India: the emerging market outlier

Underlying economic factors make India an emerging market like no other.

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India is fast approaching a crucial inflection point. Around 2030, we believe it will become the world's third-largest economy,[1] and we expect it to gather pace in the decades ahead while the West's economic significance ebbs and China plateaus.

We believe the economic growth of the world's largest[2] democracy has been powered by a workforce well suited to the needs of an increasingly digitalised world.

But beyond the familiar growth narrative, what sets India apart? We believe its economy has several underlying structural features that are important for investors considering their allocations.

1. A large, relatively closed economy

India's growth trajectory belies a relatively closed economy that can provide domestic consumers with most of their needs. As a percentage of its GDP, India's exports plus imports comes to under 50%, compared with almost 75% for the Philippines and more than 80% for Mexico.[3]

In addition to relatively low trade openness, India has comparatively low financial openness, with international money largely absent from Indian markets. International portfolio assets plus liabilities stand at less than 5% in 2022, compared with almost 30% in China.[4]

Until very recently Indian government bonds (IGBs) didn't feature in major government bond indices, meaning foreign ownership of the asset class is below 2%, compared with 11% in China, 23% in Indonesia and 41% in Mexico.[5]

The effect of this economic self-sufficiency is that Indian assets have historically been less correlated with the world economy, potentially providing diversification.[6]

2. An atypical economic structure

Known as the back-office of the world, one of India's defining economic features is its high proportion of services exports. By way of comparison, China's services exports account for under 10% of the total, while in India services accounts for almost 45%.[7]

Unlike many emerging markets, India is not a large commodity exporter, at around 3% of GDP, compared with 15-20% for countries such as Russia or Chile.[8]

The effect of this atypical economic structure is that India has historically shown low correlation with emerging markets.

3. A relatively stable currency

FX is a major consideration for investors in local currency assets.

Similarly to other rapidly growing emerging markets, India has maintained a moderate current account deficit since 2013. However, due to India's attractiveness as a destination for FDI, the current account deficit is more than fully financed by FDI, leading to a positive balance of payments.[9]

Also notable is India's stock of FX reserves, the fourth largest globally,[10] which allows the Reserve Bank of India to limit rupee volatility.

4. The only real alternative to China

Only India can truly compete with China as a driver of global growth. Several important factors support bullish expectations.

First, population. India may account for a fifth of the growth in the global working age population by 2031.[11] As it moves closer to the East Asian growth model of export-led infrastructure investment, this virtuous circle may enable India to take China's place as the global growth engine.

Second, the country's manufacturing is ramping up, with output predicted to triple between 2022 and 2032.[12] This is in addition to the rise in services exports mentioned above.

Finally, thanks to India Stack – the country's open API solution for identity, data and payments – India is considered set to see consistent growth in consumer and business credit creation. This could ultimately translate into rising GDP per capita.

Indian government bonds come of age

We believe India's underlying macroeconomic strength provides a supportive backdrop for IGBs.

As well as being among the few emerging markets with an investment-grade sovereign debt rating, IGBs are now benefitting from inclusion in a major emerging market index.

Having been added to JPMorgan's widely followed GBI-EM Global Diversified Index at the end of June with an initial weighting of 1%, this will steadily be increased to reach 10% in March 2025 – putting India's importance to the index on a par with China's.

Momentum is growing, with Bloomberg recently announcing that it too will add IGBs to its emerging

market local currency government index from January 2025.

Accessing the market

Despite significant progress in opening India's capital markets to the world, investors looking to access IGBs still face some practical hurdles.

In our view, an ETF could therefore offer a straightforward, cost-effective and potentially tax-efficient[13] option, with potential benefits including:

- Easy access to a highly regulated market
- No need to deal with an additional restricted currency
- No need to onboard tax advisers and local brokers
- Potential tax benefits via the reduced withholding tax (WHT) rate applied to Irish-domiciled ETFs (10% WHT vs 20% standard rate)[13]
- The standard rate on capital gains is 10-30% for IGBs depending on how long the bonds have been held for, but Irish-domiciled vehicles are tax exempt[13]

Our L&G India INR Government Bond UCITS ETF is the first and largest ETF available to European investors[14] providing dedicated IGB exposure. It offers exposure to India's rapidly growing local currency bond market through a liquid, convenient and transparent fund structure.

Key Risks:

The value of investments and the income from them can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. It should be noted that diversification is no guarantee against a loss in a declining market. Tax treatment is dependent on individual circumstances and is subject to change.

[1]Source: Macrobond and LGIM calculations. As of May 28, 2024.
[2]Source: BBC, 10th June 2024 https://www.bbc.co.uk/news/world-south-asia-12557384
[3]Source: Macrobond. As of May 28, 2024.
[4]Source: Ibid, 2022.
[5]Source: Bloomberg, as at 30 May 2024.
[6]**It should be noted that diversification is no guarantee against a loss in a declining market.**
[7](2023 data) Source: Macrobond. As of May 28, 2024.
[8](2021 data) Source: Macrobond. As of May 28, 2024.
[9]Source: Bloomberg, as of 28 March 2024. Past performance is not a guide to the future.
[10]Source: World Bank, Bloomberg, Trading Economics, February 2022
[11]Source: Morgan Stanley, as of December 2022.
[12]Source: Morgan Stanley, as of December 2022.
[13]Tax treatment is dependent on individual circumstances and is subject to change.
[14]Source: ETFBook as at July 2024.
[1,3,4,7,8,11 and 12] **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**