Confidence must be earned

Amundi ASSET MANAGEMENT

INVESTMENT TALKS

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Indian elections: political continuity is positive but reform is what matters most

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- ***Election results:*** *Prime Minister Modi led the National Democratic Alliance (NDA) to a sweeping victory, with a full majority in Parliament and therefore significant political capital. We expect the second term of the NDA government to display continuity on the broader reform agenda (fiscal consolidation, support for infrastructure spending and a strong social security net).*
- ***Economic situation:*** *Indian economic activity has been showing signs of moderation in recent months. As the election is now over, we expect policymakers to address the slowdown in growth. With a reform-friendly government at the helm, confidence among the business community and investors should return.*
- ***Political reforms:*** *Reforms are needed to help the economy make a smooth transition. Reforming the agriculture and financial sectors, increasing investment in physical and social infrastructure, creating a strong social security net and increasing the ease of doing business by leveraging digital technology should all be on the table.*
- ***Trade and oil themes:*** *India may be a beneficiary of the potential supply chain shift due to the US-China spat. The country has done well in a few sectors and may benefit from its large pool of skilled and English-speaking manpower. Furthermore, the government has been focusing on energy efficiency, as well as developing and strengthening the renewable energy sector to reduce its dependence on oil imports, a dependence that makes India highly vulnerable to oil price movements.*
- ***Fixed income and FX view:*** *The election outcome is positive from an investment perspective in that it means there will be policy continuity. While we are still waiting for more clarity on the fiscal front, the removal of the election uncertainty should still be modestly positive for local bonds in the short term. On the currency front, the Indian Rupee has already outperformed its peers in the past month, however, we believe some inflows into the equity market are still possible and this should mean the Indian Rupee continues to outperform its peers, especially if oil prices remain anchored.*
- ***Equity view:*** *Overall, it is quite a comfortable environment for equity investors and we expect premium valuations to be sustained or even increase. We maintain our preference for the financial sector, both banks and insurance. We also think companies benefitting from infrastructure or consumption spending may be attractive. At the moment, valuations in the equity market are high and should remain that way as India appears relatively isolated from concerns over a global trade war.*

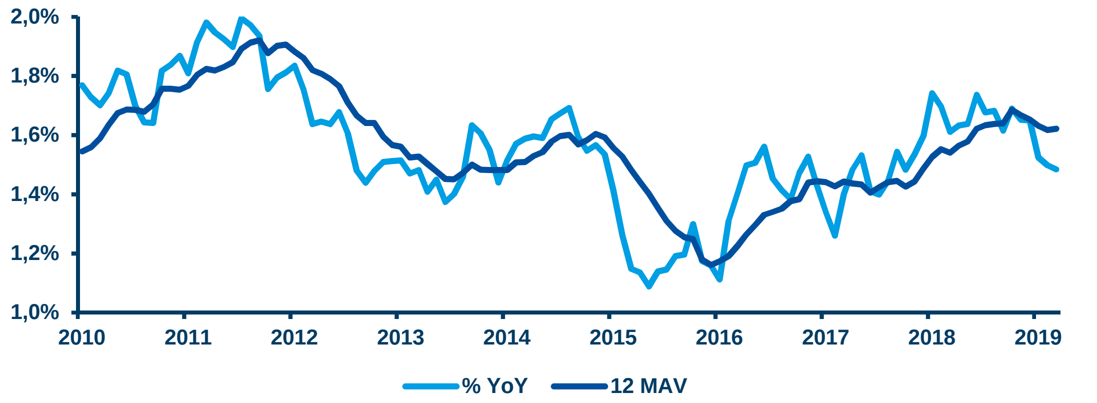
What are your post-election considerations and are the results going to have any implication upon your outlook for the Indian economy?

Prime Minister Modi led the NDA to a sweeping victory, with a full majority in Parliament and therefore significant political capital. There was some apprehension in the market ahead of the election and a clear majority will certainly soothe nerves. During the NDA's first term from 2014 to 2019, some of the key reforms seen were in the areas of foreign direct investment (FDI) liberalisation, the implementation of a goods and services tax (GST), banking sector reform (the implementation of the Insolvency and Bankruptcy Code), regulation in the real estate market and the setting up of the Monetary Policy Committee.

"The favourable election outcome should ensure continuity on the broader reform agenda and help the government to undertake some of its unfinished tasks."

Further, t**he government has been focused on fiscal consolidation, has displayed fiscal prudence and has stayed away from populist spending activities at large**. Its policies were aimed at spurring infrastructure activity and easing the conditions for doing business in India. We expect the second term of the NDA government to display continuity on the broader reform agenda. The government is likely to continue with its agenda of fiscal consolidation, support infrastructure spending and provide a strong social security net. We also think that barring the natural course of inflation mean reversion, the inflation scenario should remain broadly well behaved. **The favourable election outcome should help the government to undertake some of its unfinished tasks**, such as enforcing GST compliance and bringing about tax buoyancy. India's economic activity has been showing signs of moderation in recent months. In part, this was due to election-related factors (slowdown in government infrastructure-related orders ahead of the election and the postponement of business capital spending plans). As the election is now over, we expect some of the shelved spending to be revived. However, policy support is also needed to address the slowdown in growth. There have been some liquidity issues in the financial sector since the middle of last year. We expect the government, in coordination with the Reserve Bank of India, to **focus on easing financial and monetary conditions in India** and take measures to spur real estate and infrastructure activity. With a reform-friendly government at the helm, confidence among the business community and investors should return.

Economic activity indicator shows deceleration in the first half of the year



Source: CEIC, Amundi Research. 12 months moving average (MAV). Data as of 20 May 2019.

What potential key reforms could be on the priority list for the new government?

"The new government will have to focus on a host of reforms, helping the economy to make a smooth transition."

As highlighted above, the government, during its previous term, successfully pushed some very key reforms in the areas of taxation (unified goods and services tax), banking (the Insolvency and Bankruptcy Code), inflation (monetary policy framework) and digitalisation. India's rank in the World Bank's Ease of Doing Business index has significantly improved, from 142 in 2014 to 77 in 2018. Some of the reforms, however, have brought disruption to the economy, as reflected in the slowing growth momentum. The new government will have to focus on a host of other reforms to offset the disruption, helping the economy to make a smooth transition. For instance, a sharp fall in inflation is positive for the economy but lower food prices have created distress among farmers. **Reforms are needed to ensure better income growth for the farming community.** The new government should also focus on increasing investment in physical and social infrastructure, creating a strong social security net and improving further India's ease of doing business by leveraging digital technology. **Next-generation financial sector reforms will also be on the table.** Legislative reforms and a mindset change were the major agenda items for the previous government. Execution will be the key for the next one.

Global trade and oil prices are both key themes for emerging markets. What could the threats and opportunities be for India in relation to these issues?

"India may be a beneficiary of the potential supply chain shift due to the US-China spat."

Exports (goods and services) account for less than 20% of India's GDP. Looking ahead, if global supply chains look for alternatives due to the US-China spat, then India may be a beneficiary. India has done well in a few sectors such as automobiles, chemicals and light industrials. The country is also an export hub of software services, benefitting from a large pool of skilled and English-speaking manpower. India is the third largest oil importer in the world. However, 86% of India's energy needs are met through imports and that makes the country highly vulnerable to oil price movements. The government has been focusing on energy efficiency, as well as developing and strengthening the renewable energy sector in India. It has recently signed the Paris Agreement, whereby the government has laid out plan to quadruple its renewable power capacity to 175GW by 2022**. Focusing on alternate forms on energy will help India to reduce its dependence on oil imports.**

What is your view on India's fixed income market and what could the implications of the election result be on it?

We see the election result, with the leading Bharatiya Janata Party (BJP) - led coalition having a comfortable majority, as a positive outcome from an investment perspective in that it means there will be policy continuity. We hope that the result will allow the coalition to have more momentum to push through the much-needed labour and land reforms in order to raise growth prospects over a medium term. While we are still waiting for more clarity on the fiscal front, the removal of the election uncertainty should still be modestly positive for local bonds in the short term, especially given: 1) their positive real yield; 2) their under allocation by global investors; 3) the so far well behaved inflation dynamics and the stable oil price; and 4) a dovish central bank.

"From an investment perspective, the election results are modestly positive for local bonds in the short term."

Where do you see the Indian Rupee headed in the foreseeable future?

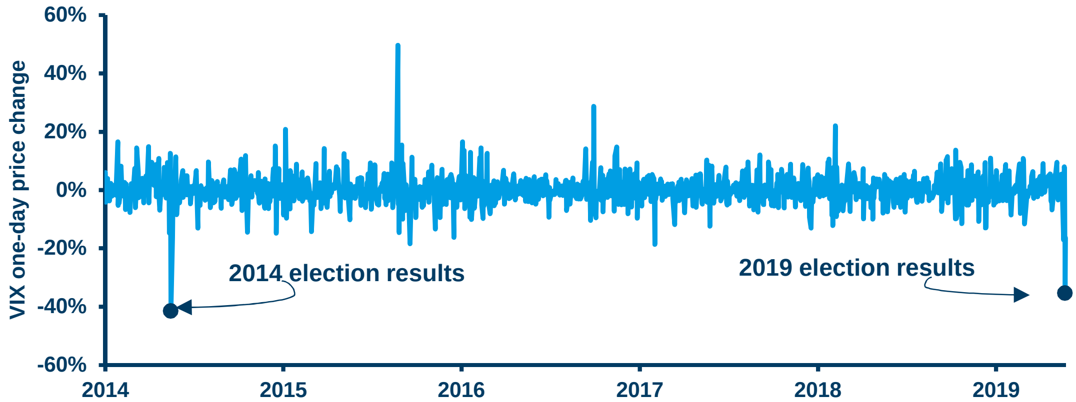
The Indian Rupee already outperformed its peers in the month leading into the election, so one could argue that most of the positive news is priced in. That said, we believe there are still investors that have held back their investments due to the election. Therefore, **some further inflows into the equity market are still possible** and this should mean the Indian Rupee continues to outperform its peers, especially if the oil price remains anchored and there's no negative surprise in the Monsoon.

What is your view on the Indian stock market in light of the result? Do you see any trigger in the horizon that might change your convictions?

In a world of political uncertainty, **the biggest positive of the Indian elections is the continuity** in the administration and economic policy. This is obviously welcome for equity investors given the focus on restoring macro fundamentals and implementing structural reforms in the previous terms. This means the government did not need to use extreme populism to win, it can continue its economic agenda and will likely start to benefit from past reforms. Overall, it is a comfortable environment for equity investors and we expect premium valuations to be sustained or even increased. **We think only a sharp disappointment in terms of economic policy would hurt valuation premiums, but this looks unlikely at present.**

"It is quite a comfortable environment for equity investors and we expect premium valuations to be sustained."

Indian equity volatility has plunged the most since 2014



Source: Bloomberg, Amundi. Data as of 24 May 2019.

"We maintain our preference for the financial sector. Companies benefitting from infrastructure or consumption spending may also be attractive."

Where do you see the best opportunities in the Indian stock market? Which sectors look the most compelling?

We expect macro stability to be maintained and the focus on infrastructure build-up and social spending on the poorest part of the population to be maintained. So overall, companies benefiting from infrastructure or consumption spending offer attractive investment opportunities. We believe investors should maintain strong discipline as valuations tend to be on the high side in general in these sectors. **Our biggest preference remains the financial sector, both banks and insurance**. Private banks continue to benefit from structural gains in terms of market share, with stronger balance sheets and better deposit franchises. Insurance benefits from lower interest rates and the structural shift from physical assets toward financial assets. We also expect increasing consolidation in the insurance sector as leading private players enjoy stronger capital, brands and distribution capabilities.

How do you see India in comparison to other EM countries in terms of market valuations?

There is no doubt that **valuations in the equity market are high but this should remain the case as India appears relatively isolated from concerns over global trade wars**. Its exports to GDP ratio is one of the lowest within EM, it is not part of the technology supply chain and it appears politically relatively close to the US and Europe. Assuming progress in terms of cost competitiveness, India could even become a key beneficiary of the current global trade war.

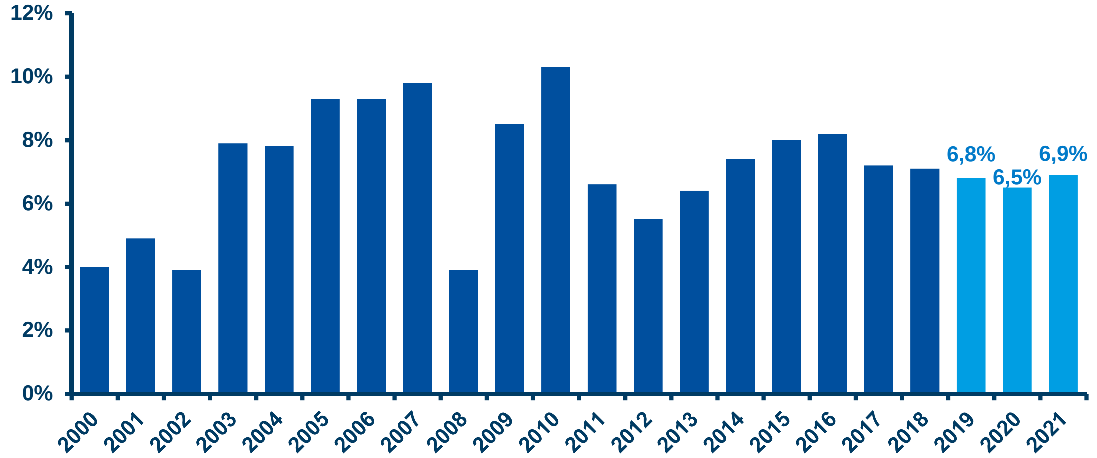
We keep a watchful eye on the balance of payment dynamics and oil prices, both of which could affect the currency and hurt returns for foreign shareholders. Longer term, the prospects remain bright as the government has the opportunity to continue its reforms. With a young and growing population, generating employment growth will be crucial. Any measures to improve labour laws, land access and overall manufacturing costs would be key positives.

"Compared with other EM peers, especially those which have more political instability, we may see India outperforming."

Do you consider India an appealing EM story for the long term? Why?

India is one of the few countries where growth is still decent, above 6.5-7.0%, and the labour market is dynamic. In addition, our stable outlook for oil should mean inflation remains relatively anchored. Compared with other EM peers, especially those which have more political instability, we may see India outperforming, especially if the BJP-led government can make more progress on the reform side to improve the country's growth potential. Over a longer term, there may be issues with the independence of the central bank. Moreover, India is still a twin deficit country even though the current account deficit has improved a long way.

India real GDP growth



Source: IMF, Amundi estimates for 2019, 2020 and 2021. Gross domestic product corresponding to fiscal year. Data as of 24 May 2019.

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Unless otherwise stated, all information contained in this document is from Amundi Asset Management and is as of May 26, 2019.

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