A macro view of India

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The change in leadership in India in the May 2014 general elections has put India back on the global map as an attractive investment destination. Focus on structural reforms from the current leadership, and the potential room for monetary easing by the RBI driven by a significant drop in inflation over the last six months provides a positive backdrop for India in the current global context. it is facing one of the strongest demographic waves in its history and will add approximately 125 million people to the working age population over the next 10 years. This is some 25% of the estimated increase in global working age population in the same period.

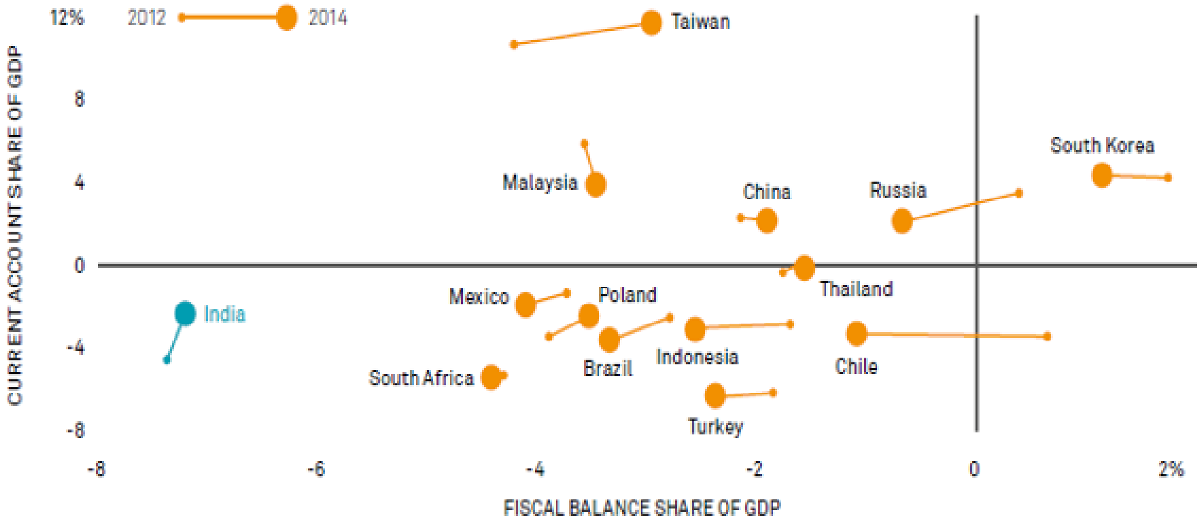
India's macroeconomic adjustment has been meaningful with the current account deficit (as % of GDP) shrinking significantly from ~4.8% in mid-2013 to ~1.5% currently. The incremental flows in onshore debt and equities are helping the RBI to strengthen FX reserves and build a war chest that can be used in a likely weaker global macro environment. The trade deficit has widened recently driven by gold and non-oil goods imports. However, we believe this is a temporary phenomenon. The capital account gained from strong Foreign Institutional Investor (FII) flows in debt and equity ($26 billion in debt and $16 billion in equities in 2014).

Low oil prices provide a significant tailwind benefitting India on multiple fronts – lower fiscal deficit, lower current account deficit (India imports ~80% of its daily oil consumption of 3.4 million barrels), lower inflation and higher consumption. The latter is a key driver of economic growth.

The growth turnaround is in the early stages and is more cyclical than structural at present, with some improvement in the PMI and industrial production (Dec 2014 PMI is at a two-year high). Structural reforms expected in the Budget in Feb 2015 will likely focus on increasing the growth momentum and reviving the capital spending cycle.

Figure 1: Rehabilitating twins

EM current account and fiscal balances, 2012-2014



Sources: BlackRock Investment Institute and IMF World Economic Outlook

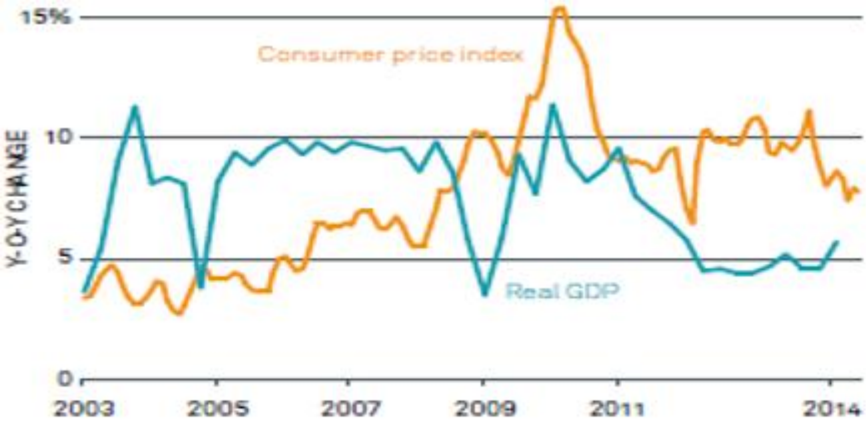
Notes: Fiscal balances represent general government deficits and surpluses, including state and local balances. 2014 is the IMF's forecast

The growth slowdown over the last few years was driven by a combination of collapse in investments (both public and private) and deterioration in the productivity dynamic. GDP growth in the last two years has averaged 4.9%, compared to a >7% average over the last 15 years. Inflation was elevated during the last few years, providing no room for any monetary easing by the RBI. There has been a shift in the last seven months with several major steps being taken including:

- Clear focus on unclogging the investment pipeline, in order to restart the investment cycle (India has projects equivalent to ~8% of GDP at different stages of completion)
- Manage fiscal deficit through a combination of revenue and expenditure side adjustments
- Focus on supply side factors impacting inflation
- Attracting FDI through reforms (defense, insurance, railways, etc.) and new initiatives (launch of “Make in India” campaign).

Figure 2: Stagflation no more

India GDP and inflation, 2003 - 2014



Sources: BlackRock Investment Institute, OECD, India Ministry of Statistics and Implementation, Oxford Economics and India Central Statistical

Notes: Consumer price data before March 2012 is based on OECD data

Ensuring an upturn in the investment cycle, as well as funding of long term infrastructure projects, remains a challenge given the low capitalization of state-owned banks (accounting for >75% of the outstanding loans in the country). There have been some recent discussions around setting up of a holding company structure for 27 state-owned banks in order to ease the capital deficit.

The government needs to continue with structural reforms in order to unlock the long-term growth potential of India. In order to build infrastructure and support the "Make in India" campaign, the government needs to focus on labour reforms to introduce flexibility in labour markets and improve ease of doing business.

Recent actions taken by the government provide a positive backdrop for the determination and will to implement significant reforms. The government introduced the Goods and Services Tax Constitutional Amendment Bill for consideration in the recent session of the Parliament. It has since also promulgated a few ordinances - Foreign Direct Investment (FDI) in the insurance sector, Coal Amendment bill and amendments to the Land Acquisition Act.

Figure 3: Modi's business plan

Selected India reforms, September 2014

INFRASTRUCTURE

- **Power:** Extending tax breaks, implementing $2 billion of transmission works and initiating four new power projects with 16,000 MW of capacity.
- **Land purchases:** The Land Acquisition Act is likely to be amended to streamline the process of buying land.
- **Transport:** Cleared $6.5 billion in road projects. Developing rail freight corridors at a cost of $13 billion. Proposing to award 16 new ports and set up airports in secondary cities.
- **Oil and gas:** Proposing 15,000 km of gas pipelines through private-public partnerships.
- **Rivers:** Inter-linking key waterways to better distribute water and setting a three-year target to clean up the Ganges.
- **Financing:** Proposing to set up real estate investment trusts and infrastructure investment trusts.

FISCAL

- **Goods and services tax:** Agreed in principle – but the timeline of implementation is still unclear.
- **Cutting subsidies:** Gradually increasing diesel prices to reduce subsidies.

EASE OF DOING BUSINESS

- **Streamlining projects:** Increasing the timeliness and transparency of approvals with the launch of an online portal to track progress. Scrapped the Planning Commission.
- **Labour laws:** Piecemeal changes such as increasing overtime limits. State-level changes include Rajasthan's move to raise the firm-size threshold for retrenchment rules.
- **Foreign direct investment (FDI):** Increasing FDI limits in defence, railways and insurance. Considering special economic zones.

FINANCIAL

- **Bank recapitalisation:** Potential holding company to recapitalise state-owned banks and accelerate credit growth.
- **Monetary policy:** The RBI targets CPI at 8% by January 2015 and 6% by 2016.
- **Bad loans:** New legal powers for banks to take charge of companies that wilfully default on loans.
- **Private banks:** New RBI guidelines on licensing of banks to encourage greater private sector participation.
- **Financial inclusion:** Push to provide the poor with bank accounts.

Source: BlackRock Investment Institute

In January 2015, the government outlined the creation of a new think-tank called NITI (National Institution for Transforming India), which will replace the erstwhile Planning Commission. NITI is expected to undertake both ad-hoc as well as long term development plans, and also help with the coordination between the Central and state governments. It will also monitor and evaluate the implementation of programs and focus on technology upgrades and capacity building.

Overall, with the government's strong resolve for initiating structural reforms, inflation decline leading to room for significant monetary easing, revival in the investment cycle and likely strong growth in corporate earnings, India will continue to remain an attractive investment destination for global investors.

INDIAN EQUITIES

India was one of the best performing equity markets in the region and globally with approximately 30% returns in 2014 (BSE Sensex in local currency). Although valuations for Indian equities remain expensive compared to other EMs or Asia, it is not expensive compared to its own history. Structural reforms in the near term could lead to significant growth acceleration over the next few years. This will contribute to robust growth in corporate earnings.

Investors will continue to focus on the data reflecting the upturn in the GDP growth rate, as well as progress in terms of structural reforms. The significant decline in inflation recently, with CPI below 5% and WPI at 0% provides room for the RBI to reduce the policy rate in 2015. RBI delivered the first rate cut on January 15th reflecting the turn in the rate cycle. The current policy rate post the rate cut is at 7.75% (10Y government bond yield is at ~7.7% as at Jan 21st 2014).

INDIAN FX AND DEBT

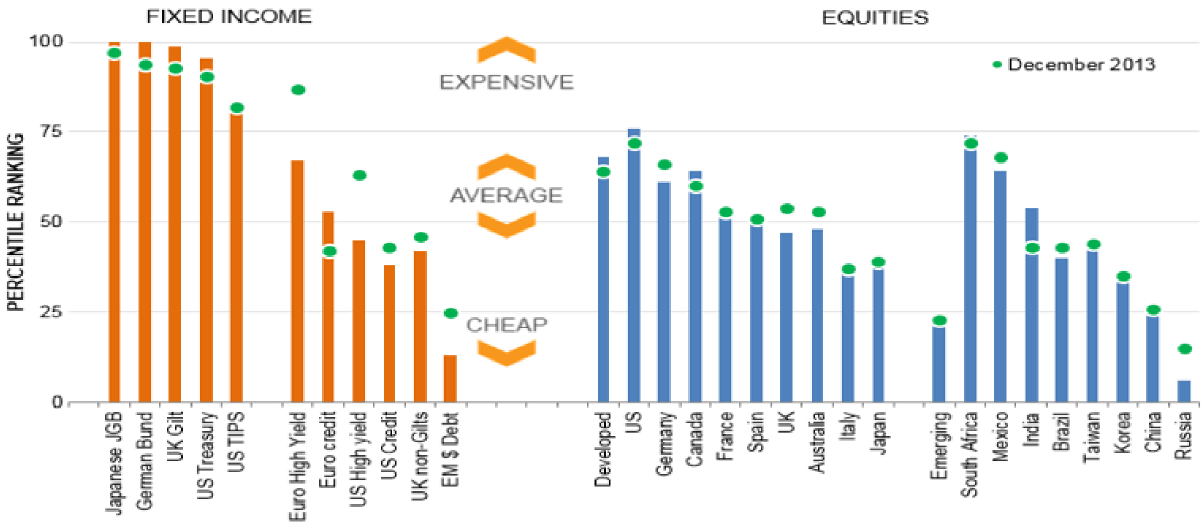
We are positive on the Indian Rupee, rates and credit. India is positioned well to benefit from a combination of structural reforms reviving growth, decline in inflation due to lower oil and commodity prices and the potential for interest rates to ease further.

The above mentioned factors caused S&P to upgrade the sovereign rating outlook from negative to stable in the last quarter of 2014. Although we do not expect any rating upgrade in the very near term (from the current rating BBB- / Baa3), we do expect it to be stable and potentially see upgrades in the medium term. Credit spreads have declined significantly during 2014 and we continue to remain positive on the Indian credit universe in 2015.

We are positive on Indian government bonds, and high quality INR credits with the expectation that the rate cut cycle will continue through 2015. Lower oil prices give the RBI room to positively surprise the markets. A positive macro backdrop, significant improvement in the current account and a stronger balance of payments continues to support the Indian rupee. We expect it to outperform most other EM currencies in the current environment.

Figure 4: Valuation of assets vs. historic norm

EM current account and fiscal balances, 2012-2014



Sources: BlackRock Investment Institute and Thomson Reuters

Notes: Percentile ranks show valuations of assets versus their historical ranges. Example: If an asset is in the 75th percentile, this means it trades at a valuation equal to or greater than 75% of its history. Valuation percentiles are based on an aggregation of standard valuation measures versus their long-term history. Government bonds are 10-year benchmark issues. Credit series are based on Barclays indexes and the spread over government bonds. Treasury Inflation Protected Securities (TIPS) are represented by nominal U.S. 10-year Treasuries minus inflation expectations. Equity valuations are based on MSCI indexes and are an average of percentile ranks versus available history of earnings yield, trend real earnings, dividend yield, price to book, price to cash flow and 12-month forward earnings yield. Historical ranges extend back anywhere from 1969 (developed equities) to 2004 (EM$ debt).

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