

GRANT'S

INTEREST RATE OBSERVER®

Vol. 32, No. 06a

Two Wall Street, New York, New York 10005 • www.grantspub.com

MARCH 21, 2014

To India and back in just six days

If you, like your editor, had just returned from Mumbai, the hot and teeming port city formerly known as Bombay, you would know that the vast Indian electorate, 815 million strong, will be going to the polls starting on April 7 to elect a new prime minister; results are due on May 16 (it's a big country). You would further be aware that the front-runner in that marathon contest, Narendra Modi, a.k.a. NaMo, has vowed to put his vast, poor and comprehensively mismanaged country on the road to modernity.

Now under way is a financial travogue whose terminus is optimism. *Grant's* is bullish on India; on the values currently available in India, we are lukewarm. By the numbers, the Indian market is hardly bubbly—market cap to GDP stands at a reasonable 63.7%. The trouble, currently, is that foreigners love the place. On form, they will sooner or later decide to hate it (as they did last summer). In their flight, they will surface value.

If, as we believe, China is yesterday's growth story, India might be tomorrow's. We so speculate in full knowledge that, for the past dozen years, Mumbai's market has run rings around Shanghai's, even as India's GDP growth has drastically lagged China's. For the investor as opposed to the statesman, macroeconomic growth places a distant third to price and value on the scale of financial virtues. What's new in India is the possibility of stronger growth and less toxic politics.

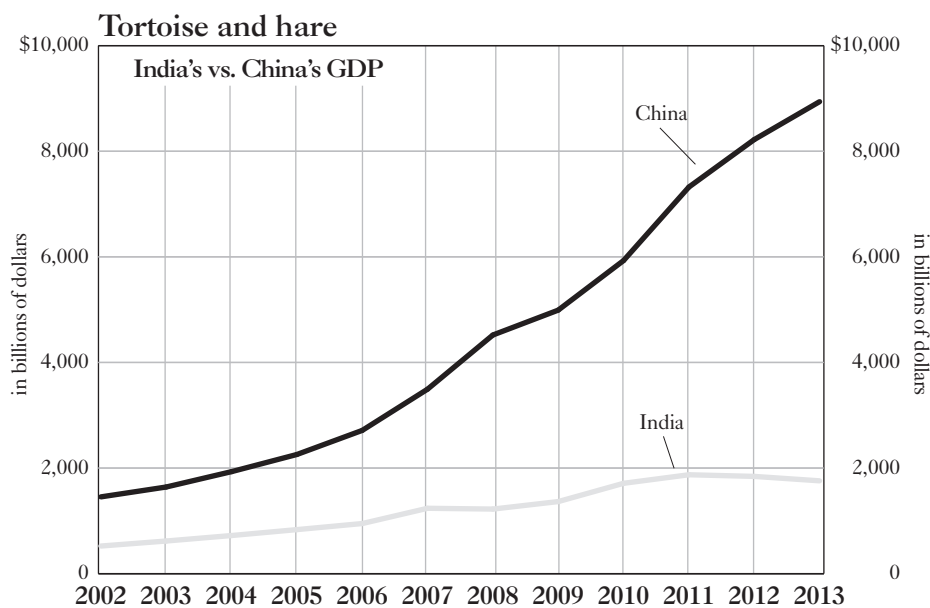
The oft-told Indian growth story would be a gift to the world if it finally did unfold—say, under a new leader who redirected the Indian bureau-

cracy away from its customary work of thwarting Indian enterprise. You know that crony capitalism has a foothold in a country when, as in India's case, the various contenders for and buyers of public office are expected to spend a combined \$5 billion (so says India's Center for Media Studies). This stupendous outlay would represent 0.28% of GDP, about seven times more, in proportion to GDP, than the \$7 billion American boosters spent on the 2012 U.S. elections.

The prospect of a business-friendly Modi government is the talk of financial Mumbai—except in the presence of an American, in which case the topic is steered as quickly as possible to Janet Yellen. Will she or won't she taper? If so, how quickly? This American

tried to redirect the conversation. Say, he asks, could India be on the verge of something wonderful? Perhaps, some say. Megh Manseta, private investor, genial host and—and—paid-up subscriber, demurs. "I have often been enthusiastic about India's immediate prospects, and have often been wrong," he says. He adds that, because of the volatility that the foreign herd brings to India's not very deep markets, it's always advisable to hold lots of cash, "so you can buy cheap."

Better if a financial traveler had landed at the Chhatrapati Shivaji International Airport during the August taper tantrum. Indian markets reeled then rallied. From the summertime lows, the rupee has leapt by 12.4% (measured against the U.S. dollar), the



source: International Monetary Fund

Sensex index of 30 stocks by 21.9%. On March 6, foreign institutional investors (“FIIs” in this land of acronyms) poured \$212 million into Indian stocks, the biggest single-day inflow of the year. The Sensex scored an all-time high, which level placed it at 14 times the consensus 2015 earnings estimate vs. a MSCI Emerging Markets price-earnings ratio of 10.3 times.

On Monday evening after the Friday in which the indices made their early-March records, a friendly group of fund managers finished a Mumbai dinner party with an impromptu exchange of investment ideas. Two of this company picked stocks that had jumped by 20% or more on that very day. It was enough to make the hair stand up on the back of a contrarian’s neck. Then, again, it is possible to lose the long-term scent. In the early 1950s, with the Dow still poised below its 1929 highs, a bullish American investor pronounced that “the market looks high, and it is high, but it’s not as high as it looks.” The Dow climbed much higher. Perhaps the Sensex today, although it looks high and is high, is not so high as it looks.

Indian investors—at least the ones encountered in this flying visit—revere Benjamin Graham, the father of value investing, but their functional muse is Phil Fisher, the guru of growth investing. More than deep value, growth is the Indian investment mantra. Successful Indian investors talk up the likes of Blue Dart Express, a micro-cap courier

service and integrated package-delivery company that, according to J.P. Morgan, is generating sales growth of roughly 30% per annum and is quoted just under 40 times’ trailing net income. The bulls’ frame of reference is wealth conferred on such visionaries as those who brought Infosys public in 1993. The buy-and-hold return to date on that especially satisfactory investment is 267,944%—before tax, if applicable.

As the law stands today, capital gains are tax-free after a year’s holding period. Dividend income is taxed at the corporate source and is free of tax to the recipient. Indian individuals seem unmoved by these blandishments. Indian fund managers report that the public is out of the market. You can set your watch by their ill-timed comings and goings, one of these fiduciaries relates. Expect them back when the Sensex P/E multiple tops the 20 marker. They buy at the highs.

If so, the Indian public is much like other publics. Its youth is what sets the Indian public apart. By 2015, according to United Nations’ projections, the median age of India’s population will stand at 26.9 years. China’s will be 36 years and Western Europe’s 43.7 years. Here is what the Indian optimists call their nation’s “demographic dividend.” In many more ways than one, India is a growth story.

Not that the chance to buy low is permanently foreclosed to the value-seeking investor. India busts as well as booms, as *Manseta* notes, and it’s es-

pecially prone to turmoil during election season. In 2004, when the Congress party confounded the experts by ascending to power, the stock market collapsed (*Grant’s* was bullish after the break: see “Up with India,” May 21, 2004). In 2009, Congress won in a landslide and the stock market—surprised again—rallied by 17% in a day.

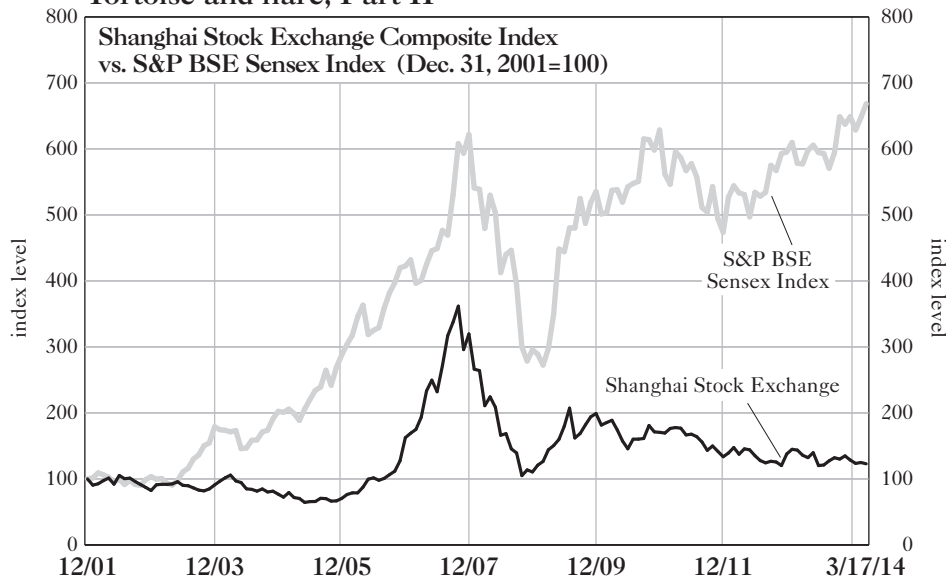
There was a little bust only last week in the market in inflation-linked Indian debt. In June 2013, the Reserve Bank of India issued 65 billion rupees worth of 10-year, rupee-denominated, inflation-indexed notes—at today’s exchange rate of 61.21 rupees to the dollar, \$1,062 million worth of debt. The coupon was 1.44%; the Wholesale Price Index was the indexation benchmark. The issue traded at around par until the RBI announced its intention to shift its policy-making focus away from wholesale prices to consumer prices. The WPI linkers promptly plunged to 80, at which level they commanded a yield four percentage points higher than the measured rate of wholesale price inflation.

Four percentage points of real yield—who could resist? According to “*Mint*,” the financial supplement to the *Hindustan Times*, investors resisted in droves. “Bond traders don’t trade on this bond any more,” the paper reported last week, “but there are some infrequent trades, mainly by [mutual] fund houses trying to accumulate it [individuals may buy Indian TIPs only through mutual funds]. Banks want to get out of WPI bonds, given the steady drop in prices. In the future, as everything gets measured in terms of consumer price-based inflation, this bond would likely become a dud and banks may not find buyers, they fear.”

No smile of cultural superiority will cross the face of any reader who recalls how few Western investors rushed to buy America’s leveraged loans, junk bonds, structured mortgage securities and other such (money-good, for the most part) assets at knockdown prices in the wake of the 2008-09 credit crisis. Greed and fear are human universals, like religion or the hamburger.

The average Indian has no bank account, let alone a brokerage account, but he or she knows enough about government-issue money to buy gold. It confounds the scholars at the Reserve Bank that the unlettered peasantry prefers shiny metal (despite stiff new

Tortoise and hare, Part II



source: The Bloomberg

import taxes levied on bullion) to compound interest. Since Raghuram Rajan was named governor in September, the Reserve Bank has raised its policy interest rate three times, most recently by 25 basis points to 8%. The CPI for February came in at 8.1%, the WPI for February at 4.68%, the latter being the lowest reading in nine months.

Striking recent improvements in inflation on the one hand, and in the current account deficit on the other, are prompting hopes of a virtuous circle of lower inflation and lower interest rates. It will take a circle of saintly virtue to wean the Indian public off gold, we conjecture. The rupee was quoted at seven to the dollar in the lifetime of middle-aged Indian savers; now, on a rally, it's quoted at 61 and change. Then, too, according to an analysis of investment returns over the past two decades as compiled in *The Hindu Business Line* of Feb. 9, gold in rupee terms generated an annual return of 12.6%. Lagging was the Sensex, at 11.4% per annum (a performance that was flattered by survivor and selection bias, as the paper noted); the Industrial Workers' Consumer Price Index was up by 7.9% a year.

"The current bull run," writes Rajesh Mascarenhas in the March 11 *Economic Times*, "will go down in history as one of the strangest ever. For one, the Nifty's rapid 27% climb [i.e., that of the CNX Nifty, a.k.a., the Nifty 50] from 2013 lows has not been accompanied by any major IPOs or public issues. Cash-strapped, debt-laden companies, usually among the first to jump at an opportunity to sell their overvalued shares in a bull market, are reluctant this time around. . . . Secondly, the economy continues to be in a deep funk. The current account situation may have improved, but industrial productivity is in the dumps and corporate investment is showing no signs of taking off. The previous bull runs were accompanied by strong earnings and decent economic fundamentals."

The bullish visitor ponders two distinct risks in Indian equities. The first is buying now at mediocre prices. The second is holding back too long from what could prove to be among the most significant economic events in a lifetime. Let us say that you, gentle reader, were not on board in America for the Reagan revolution, that you missed the post-World War II German miracle and

the Thatcher era in London. India—so we speculate—could represent another chance to participate in investment history. Here, though, we side with our friend Manseta: Buying low is the thing, always and everywhere. Bullish politics may afford almost as many moments of investment opportunism as bearish politics.

What do we know about the great white hope of Indian economic liberalization? Narendra Damodar Das Modi is a nationalist, a member of no Indian political dynasty (therefore, legitimately, an "outsider") and a Hindu. He is punctual! He is said to be incorruptible. Sixty-three years old, his face is framed with white hair and a neat white beard. He inspires strong feelings among fans and detractors alike. On the one hand, an Indian driver surprised his passenger last week with the ring-tone that issued from his cell phone; it was Modi's voice. On the other, the vice president of the incumbent Congress party, Rahul Gandhi, turned up in the newspapers comparing the challenger to Hitler.

Modi, the candidate of the Bharatiya Janata Party (BJP), has helped to deliver light, power and growth to the state of Gujarat, which he has governed since 2001. India's sizable Muslim population reviles him for his alleged complicity in a 2002 riot that led to the death of a thousand or more people, most of them Muslims. Modi denies the charges, and no court has found him guilty of a crime in connection with the killings.

If Modi gains power, how would he—as the press is wont to ask the question—"Modi-fy" India? He has pledged a new shake for enterprise and an end to the kind of corruption that freezes business decision making. Gurcharan Das, an eloquent voice for free markets in India—he is the author of the wonderful 2002 book, "India Unbound"—tells this publication by e-mail, that Modi, if elected, would improve the administration of the Indian state: "He would un-gum the system. He would give the bureaucracy a sense of purpose and improve the implementation of the laws—which is no small feat, indeed. This is what he did in Gujarat." What he gives no sign of intending to do is rolling back the suffocating Indian state.

The world's most populous democracy is among the world's least func-

tional nations. The World Bank reports that 21.9% of the Indian population lives below even the Indian poverty line, that 17.5% of the Indian people are undernourished and that more than 35% are illiterate. Inside a five-star hotel, say the opulent Taj Mahal overlooking Mumbai harbor, a tourist may feel as if the World Bank had exaggerated. He or she is likely to reconsider upon venturing even a few yards beyond the ferocious-looking Sikhs who stand guard at the hotel gate. Whizzing cars and motorbikes narrowly miss the pedestrians who amble down the middle of the street. Horns blare, stray dogs wander, beggars accost. Rama Bijapurkar's new book, "A Never-Before World," reports that in the six years till 2013, Mumbai added 51% more cars but next to no new roads. A visitor could have guessed it.

Under British colonial rule in the first half of the 20th century, India grew by an average of just 1% a year, according to Das in "India Unbound." Growth accelerated to an average of 3.5% a year between 1950 and 1980. "[B]ut so did population growth (to 2.2%); hence the net effect on income was 1.3% per capita (3.5 minus 2.2)—this is what we mournfully referred to as 'the Hindu rate of growth.'"

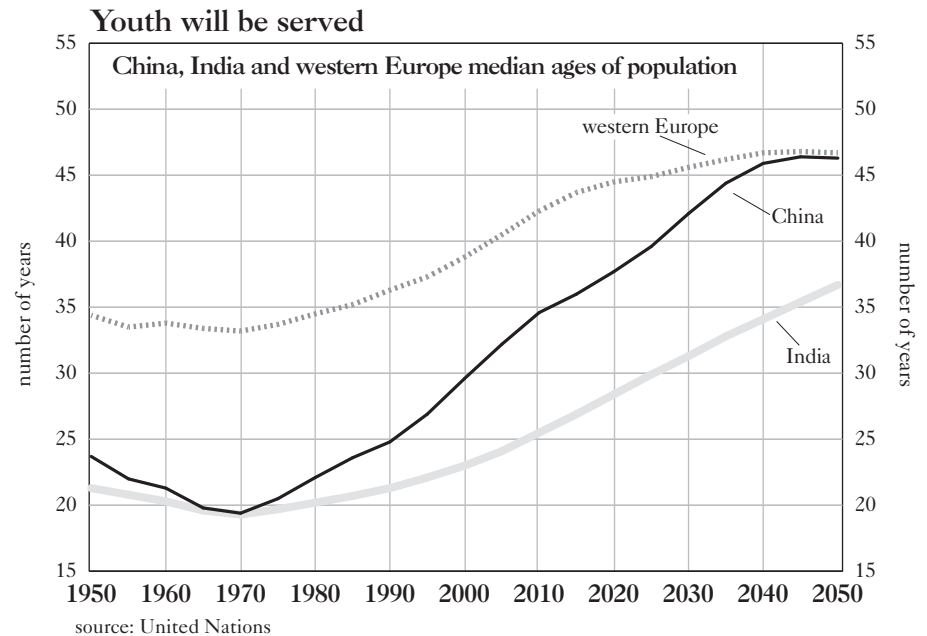
The British packed up and sailed away in 1947, leaving their socialism behind. High taxes and oppressive regulation were the watchwords of successive post-colonial governments. J.R.D. Tata (1904-93), one of the great Indian industrialists, was in a perpetual, losing struggle with the Indian state. In 1953, his pride and joy, Air India, was nationalized. And when, 15 years later, the government of Indira Gandhi accused him of wielding unchecked power as a corporate monopolist, Tata just shook his head. "No, dear boy," Das quotes Tata as addressing a friendly politician in the late 1960s, "I am powerless. I cannot decide how much to borrow, what shares to issue, at what price, what wages or bonus to pay and what dividend to give. I even need the government's permission for the salary I pay to a senior executive." By this time, Tata was paying a wealth tax on top of a 97% income tax. He sold assets to make ends meet.

A partial dismantling of the worst of the government controls in the 1980s ushered in a period of stronger growth: 5.6% on average for the decade. Great-

er liberalization in the 1990s delivered 10-year average growth of 6.3% (with population growth having subsided to 1.9% a year, real per capita income rose by 4.4% a year). With the government out of the business of licensing every proposed corporate strategic decision, foreign investment rose 30-fold, Das records. To counteract the rise of foreign banks, the Reserve Bank of India, in 1993, began to award private banking licenses, including one to what has become HDFC Bank, now the No. 7 bank in India by asset size; ICICI Bank, the No. 2 bank by asset size and the largest of the investor-owned institutions, came into the world in 1994.

Far and away the largest Indian bank is one that Indira Gandhi nationalized, the sprawling, accident-prone State Bank of India, now majority-owned by the government with a 41.4% stub in the hands of the public. State Bank, with assets of \$376.8 billion, 224,000 employees (most of them union members) and 15,297 branches and outlets (more than twice the number operated by America's most far-flung institution, Wells Fargo & Co.), accounts for roughly a quarter of India's bank loans. In the bad old days, politicians were the nationalized banks' de facto loan officers. Things have improved, though the public-sector institutions—controlling three-quarters of indigenously held Indian banking assets—have contributed more than their share to the industry's growing asset-quality problem. "Stressed" assets, which today constitute 11% of the total loans of Indian banks, will reach 14% next year, according to projections quoted in the "*Mint*" supplement in the March 10 *Hindustan Times*.

Though India's financial system is opening up to the outside world, it's still a ways from Wall Street. For one thing, Carl Icahn can stay home; there's no functional market in corporate control because most Indian public companies are majority-owned by their founding families. "They resist any restructuring that is dilutive to equity shareholders," a knowledgeable observer relates. Then, too, a visiting American will observe the absence of a market in distressed assets. "State-owned banks own 90% of corporate term loans," our source says. "They are corruptible and not very competent at recovering loans." The head of the workout department of the State Bank was recently quoted as comparing the



work of recovering bad debts to that of putting toothpaste back in the tube. Of course, toothpaste really doesn't go back in the tube.

The macroeconomic back story to the rise in NPAs is the deceleration in measured Indian GDP growth. In a snapback from a subpar 2008-09 (the fiscal year ends March 31), real growth vaulted to 9.3% in the 12 months ended March 31, 2011. Growth in the just-ending fiscal year is expected to register only half that much. Real growth on the order of 4½% to 5% would be America's dream come true. For India, it is worrisomely slow. That the stock market has been climbing in the face of such weak macroeconomic data presents Indian analysts with the age-old conundrum, namely: What (if anything) does the market know? A man with four full days on the ground in Mumbai has decided that the market knows that faster growth and stronger corporate earnings are in store no matter who wins the election. He judges that the market is correct in this divination.

You must understand, says an executive of a fast-growing Mumbai financial services company, that India is not one country but a union of 28 linguistically distinct states (there will soon be 29). Hindi is the most widely spoken language, but there are dozens of others. At the time of the 2001 census, not quite 1.2% of the population spoke Maithili, but that not-quite 1.2% represented 12.2 million people. India is a gigantic country.

China's GDP crossed the \$1 trillion line in 1998; India's in the same year measured \$429 billion. Now China stands at the threshold of \$10 trillion, India at almost \$2 trillion. For our part, we are prepared to accept that India has grown more slowly than China and that the Indian economy is smaller than China's. As to the details?

The International Monetary Fund "Consultation" report, released in February, makes a revealing confession. "There are longstanding deficiencies in employment data," the document acknowledges: "They are only available on an annual basis and with a substantial lag, and they only cover the formal sector, which accounts for a small segment of the labor market." The aforementioned "A Never Before World" relates that, as of 2009-10, "only 40% of urban working people and less than 10% [of] rural working people in India had a regular income. In urban India, 41% were self-employed and about 20% were casual labor (daily wage earners, usually). In rural India about 55% were self-employed, and close to 40% were casual labor."

Or—in the glass half-full vein—one might call them entrepreneurs. Indians have survived socialism, Gandhi-ism, Nehru-ism, confiscation and corruption. What remains to be seen is whether they can survive better government, if such lies in store. We're hopeful, jet-lagged—and bullish.