Market Bulletin

July 29, 2015

India and Mr. Modi: A progress report

In brief

Market reaction to the Modi government's reform program has cooled. After a strong 2014, India's equities market have grown only moderately this year, with the MSCI India gaining 4.5% in dollar terms (USD) and 5.6% in local currency[1].

- Nevertheless, the government has made much progress in the past 12 months, implementing measures to encourage foreign direct investment (FDI) and a more friendly business environment for foreign companies and promoting energy, coal and mining reforms, as well as implementing enhanced social welfare programs.
- Some reforms are still works in progress, however, and have not yet met market expectations. Manufacturing growth has been disappointing and the tax system is still unfavorable for foreign companies. Both the Goods and Services Tax (GST) and land reforms have been delayed, casting doubt on the government's ability to push ahead with reform.

While we believe India's reform agenda is progressing at a steady pace, clearly more remains to be done—and to judge from the market's reaction, more will be expected in 2H 2015.

A HALF GLASS OF REFORM

It has now been over a year since Prime Minister Narendra Modi and the Bharatiya Janata Party (BJP) came to power in India. As an update to our January white paper: "*India and Mr. Modi: After the honeymoon*," we review the progress that the government has made to date. As we previously wrote, while the Modi government has met or exceeded expectations, in our view, further progress will depend on the pace at which Mr. Modi can implement his agenda and how his policies have an impact over the medium term.

[1] Source: FactSet, J.P. Morgan Asset Management. Data are as of July 23, 2015.

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For equity investors, the key near-term issue will still be how long it will take before corporate profits and margins start to respond to the improving economy. Initial market expectations may have been overly positive. Reforms have neither been as bold nor as fast as investors had hoped. Earnings have disappointed, and the economy has yet to take off. As a result, India's equity performance, year to date, has fallen short of 2014.

Our own view has been, and still is, that Mr. Modi is taking a long-term approach to dealing with India's structural problems. We expect the pace of reforms to be steady and incremental. The past year has seen a number of initiatives. We consider most have turned out more successful than not, but there have been some letdowns.

What has worked?

FDI REFORM

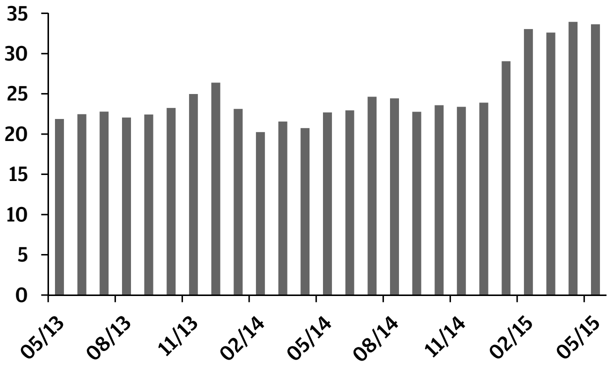
Market-friendly regulatory changes have relaxed restrictions and have allowed more FDI into the insurance, railways and defense sectors. By raising the limit on foreign participation in defense and insurance investment from 26% to 49%, the changes have enabled more foreign flows. New rules have opened railway projects to full foreign ownership and reduced both FDI limits in construction and minimum project size as well as budget thresholds for foreign participation. Altogether, the measures have created opportunities for infrastructure improvement, and indeed 12-month rolling FDI inflows increased 48.3% in May, compared with a year ago.

ENERGY SECTOR REFORM

Energy sector reforms have moved forward as a means of improving efficiency and pricing mechanisms. The collapse in oil prices gave the government the opportunity to deregulate diesel prices, which it has taken to free itself of expensive subsidies.

India's growing FDI inflows

EXHIBIT 1: FDI INFLOWS, ROLLING 12-MONTH (USD BILLIONS)



Source: Reserve Bank of India, J.P. Morgan Asset Management. Data are as of June 30, 2015. The chart above, and the charts, graphs and tables herein, are for illustrative purposes only.

While politically and publicly unpopular, shifting to market-driven prices and cutting oil subsidies has greatly reduced the fiscal deficit and freed up spending for other sectors. Gasoline pricing mechanisms have also been revised to align domestic prices more closely with global market prices. The government has already relied on the new mechanisms twice to adjust prices in India's markets.

COAL AND MINING REFORM

Coal and mining reforms aim to increase transparency, reduce corruption and cut bureaucratic red tape. The issue of coal mining rights dogged the previous government, causing a scandal when it was revealed that certain entities benefited from the government's allocation systems, which was ultimately declared illegal. No longer do public sector companies have the exclusive right to mine coal and sell to the market. Allowing private participation has boosted supply, providing an incentive for greater investment in the sector.

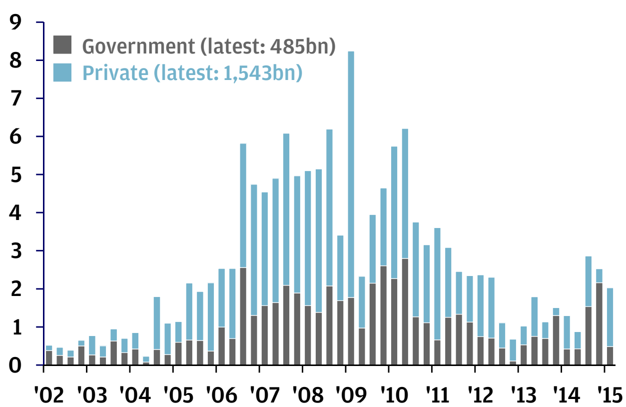
Similar changes have been pushed through for mining and mineral concessions in general. Previous rights were granted by discretion, but a new auction system should increase transparency and reduce corruption.

PROJECT MANAGEMENT REFORMS

In a bid to revitalize capital expenditures and the investment climate, the government has devoted much effort to ridding India of its reputation as a difficult place to do business. It has rolled out an online e-business portal that consolidates several government services and cuts the time required to legally establish a new business entity and attract investment. Rules for environmental approvals have also been eased and another new online system speeds up project approvals. The combined changes have already produced results, with new project announcements accelerating after a long period of stagnation **(Exhibit 2)**.

Positive results seen in new project announcements after period of stagnation

EXHIBIT 2: ANNUAL NEW PROJECT VALUE (RUPEE TRILLIONS)



Source: Centre for Monitoring Indian Economy, J.P. Morgan Asset Management. Data are as of June 30, 2015.

Related to these attempts at turning the industrial environment around have been changes in labor laws to increase business flexibility while still protecting workers. As an example, the apprenticeship policy has been made more flexible, reducing punishments for violations and encouraging worker training. Smaller businesses now have incentives to improve labor force skills and will see less harassment from authorities.

SOCIAL WELFARE PROGRAM REVAMPS

Financial inclusion programs to provide bank accounts for Indian households, as well as new pension and insurance programs, are intended to reduce poverty and encourage household savings. The government has rationalized subsidies and adopted price stabilization measures to help check food-price inflation in the event of poor monsoons. Direct transfer of benefits has greatly improved the efficiency and administration of programs helping the poor, while also saving the government money by removing the old, poorly administered subsidy system.

What could have gone better?

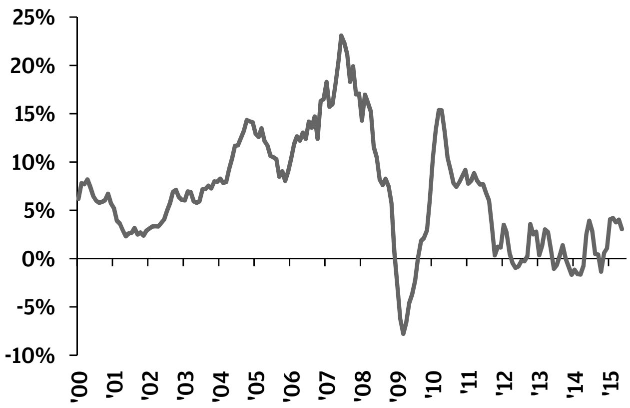
“MAKE IN INDIA”

Our previous market bulletin on India made mention of the “Make in India” drive. As we noted, the “Make in India” campaign is not inward looking. Rather, it seeks to supercharge manufacturing growth from 12% to 14% per year by attracting more overseas businesses to set up global manufacturing operations in India. So far, we have seen only marginal changes in manufacturing activity. As shown in **Exhibit 3**, there has been no dramatic improvement yet, with manufacturing growth stuck at single-digit levels as electricity shortages and congested ports hold back growth.

Attempts to boost manufacturing take time, however, and it is still relatively early into the campaign. India still has plenty of opportunity to turn itself into a manufacturing hub and meet the government’s target.

Manufacturing merely stable

EXHIBIT 3: MANUFACTURING GROWTH, % YEAR-OVER-YEAR, 3-MONTH MOVING AVERAGE



Source: Ministry of Statistics & Programme Implementation, J.P. Morgan Asset Management. Date are as of June 30, 2015.

UNPREDICTABLE TAX COLLECTION

As part of trying to improve its image, the government has tried to turn what has been seen as unpredictable tax enforcement into a more consistent tax collection system. When the courts found for the defendants in tax cases against several major foreign corporations, the decision from the government not to appeal seemed to signal that it was serious in its effort to improve India's business climate. Then, in late April, it levied a retroactive tax bill on foreign investors, much to their surprise. This has led many to question once again the government's intention to improve the tax regime.

GST AND LAND ACQUISITION BILLS

The two biggest disappointments in reform hopes—the failure to date to pass the GST and Land Acquisition bills—illustrate the legislative difficulties the government still faces, despite the BJP's control of the lower house. The GST policy would have combined different state and central tax systems in an attempt to simplify tax codes. It appeared to have support from both the Congress, the principal opposition party, as well as the BJP. It has nevertheless been delayed. The Land Acquisition bill would have made it easier for land to be used for certain categories of projects, speeding up negotiations with owners and subsequent development. The opposition has thwarted passage of the bill by portraying it as overly favoring big businesses.

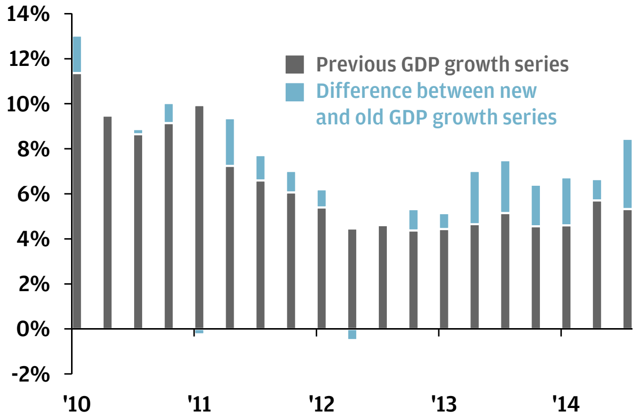
Although failure to pass the GST and Land Acquisition bills has cast doubt on the government's ability to push ahead with reform, we still believe it is a matter of when, and not if, the revision in the GST will go ahead.

NEW GDP GROWTH CALCULATION

India's new GDP growth figures have been a source of much confusion. The new methodology should have put it in line with more generally accepted standards, but the results do not seem to line up with other indicators or the general public's perception of India's growth rate. The new numbers show growth increasing at a faster pace than China, despite most other measures indicating a sluggish economy. **Exhibit 4** shows the significant difference between the two GDP growth methodologies that has caused uncertainty over how to interpret the data.

Significant difference between new and old GDP growth series caused uncertainty over new GDP figures

EXHIBIT 4: GDP GROWTH SERIES COMPARISON



Source: Ministry of Statistics & Programme Implementation, J.P. Morgan Asset Management. Data are as of June 30, 2015.

INVESTMENT IMPLICATIONS

Despite policy setbacks that have caused some loss of faith in the Modi government, we still believe reforms are moving at a steady pace, even if more has to be done. The large scope of reforms initiated bodes well. A pickup in investment and the positive impact of reforms should eventually turn markets around. Our medium- to long-term outlook is still highly positive on India.

While valuations are a bit stretched and trading above historical averages,[2] the key headwinds for India equities are weak 1Q15 earnings and negative earnings revisions. Yet, within the overall constrained outlook, we are noting diverging sector performance, with some sectors performing relatively well—for example, financials—in response to the government's bank account reform for rural population. In order for markets to respond positively and re-rate valuations more extensively, however, the Modi administration will have to deliver even more effectively on what it has promised.

[2] MSCI India's forward P/E trading at 16.6x vs. 10-year historical average of 14.8x. Source: MSCI, IBES, J.P. Morgan Asset Management. Data are as of June 30, 2015.

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