MEKETA

Understanding India

WHITEPAPER
MAY 2024

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Key takeaways

- **India's unique economic fundamentals remain intact and continue to lift standards of living, expand the middle class, and increase domestic consumption.**
- **The demographic dividend will continue with family formation and increasing participation of women in the formal workforce.**
- **Prime Minister Modi's economic and market-based reforms continue to lay the groundwork for more financial openness and investment.**
- **Stock and bond market structures and regulatory reforms promise more access to global capital markets.**

Introduction

As the world's most populous country and largest democracy, India's growth story is gaining momentum. India is likewise attracting attention from equity and bond market investors, particularly those who might be interested in viewing India as an alternative or complement to China. India had grown to represent more than 17.7% of the MSCI Emerging Markets equity index,[1] making it the second largest country in the index behind only China.[2] As India's economy grows, its markets are well placed to become more important for a globally diversified portfolio.

In this paper, we take a closer look at India's demographic and macro-economic fundamentals, infrastructure, and market reforms. We also review the stock and bond markets, as these represent a substantial portion of the investable opportunity set.

Rather than examine India on its own, we have included comparative analysis relative to China. In stark terms, India's story is quite distinct from China's, but the two countries share some similarities that investors may wish to consider. China and India are among the fastest growing economies in the world, they dominate the MSCI Emerging Markets index in terms of market capitalization, they are the two most populous countries in the world, and their rapid pace of development is accompanied by rapidly growing companies. But their differences are significant and may increasingly factor into global capital allocation. India may not be the new China, but its own unique characteristics and increasing prominence in financial

[1] Data source: MSCI, as of March 29, 2024.

[2] Ibid.

markets warrant a closer analysis. As India's economy continues to grow and pursue market-based reforms, global investors may find India's attractive fundamentals increasingly compelling.

Macroeconomic fundamentals

In 2023, India's economy grew 7%, exceeding forecasts.[3] This continued a trend of economic growth accelerating from 4.4% on average in the 1970s to the 1980s to over 7.1% in the 2010s.[4] Over the coming decade, India is expected to grow at an annual rate of 6%.[5] Over that period, India is projected to become the world's third largest economy, displacing Germany and the United Kingdom.[6] Several factors have supported India's remarkable growth story and these include a broad and diversified economy, private and public investment, domestic consumption, and productivity gains. When compared to the long downward trend for China, India's annual growth rate has been relatively stable since 1990 (see Figure 1).

[3] Source: Rosenberg Research, January 2024.

[4] Source: World Bank Blogs; P. Gupta et al., "India's Remarkably Robust and Resilient Growth Story," April 12, 2018.

[5] Source: The Economist, "How Strong if India's Economy Under Narenda Modi?", January 15, 2024.

[6] Source: Rosenberg Research, January 2024.

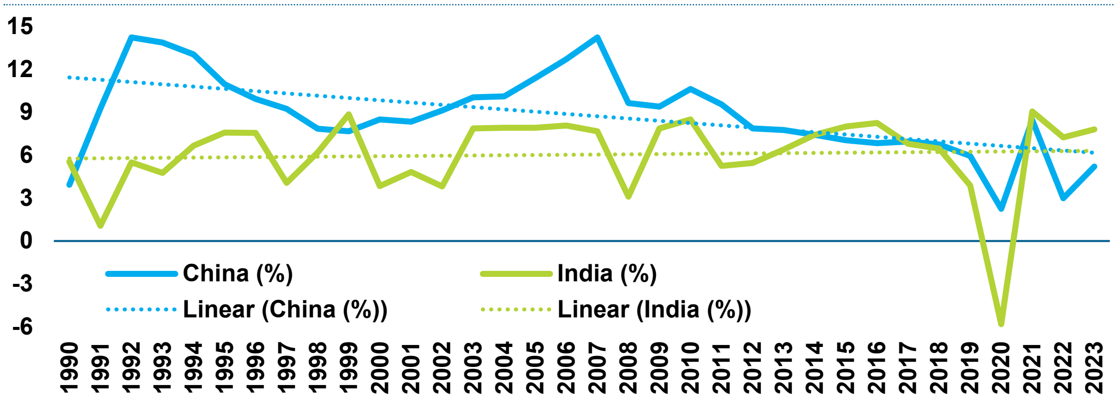

FIGURE 1
India and China Annual GDP Growth (%)

Source: World Bank data, December 2023.

Demographic structure

India is a true middle-income country, where the middle class is still emerging and increasingly impacting the demand for goods and services. Organizations like the IMF and the World Bank recognize that developing economies grow quickly but at a certain point they may fall into the "middle income trap."[7] Today, India is still quite far from the upper-middle income threshold where countries often suffer from growth stagnation without further economic reforms. China is an upper middle-income economy based on its per capita gross national income[8] (see Figure 2).

[7] Middle-income countries are countries where the per capita GDP rises sufficiently to allow for an emergent consumer class. The middle-income trap refers to the phenomenon where previously rapidly growing economies stagnate at middle-income levels and fail to ascend to the ranks of high-income countries.

[8] Source: World Bank In China, 2024.

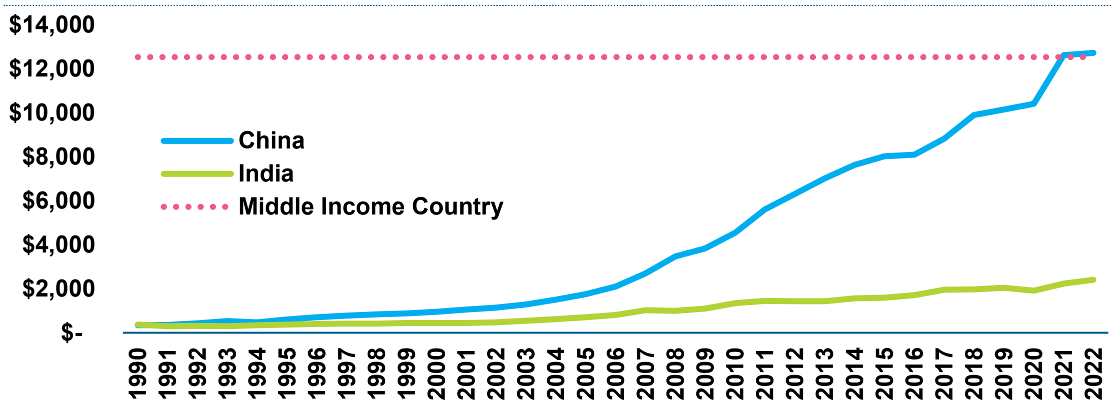

FIGURE 2
India and China Per Capita Gross National Income (PPP)

Source: World Bank, December 2022. Current international dollars. PPP is a econometric methodology looking at purchasing power parity (PPP) where price differentials among countries are taken into account instead of a currency based estimate.

While estimates on the size and wealth of the Indian middle-class range considerably,[9] one recent estimate put the size of the middle class at approximately 432 million people, or around a third of the population.[10] When economies move from subsistence farming to wage labor, urbanization, and interacting via a cash (rather than barter) economy, the ability to accrue savings and purchase consumer goods is a critical step in development. India is still largely a rural nation, with less than forty percent of its population living in cities, where China's urban population is around sixty-seven percent.[11]

In India, the growth of the middle-class in relative terms can help foster economic activity and the investment required to propel economic development, including investment in human capital (e.g., education).[12] But this process may be slow or uneven, especially if the pace of economic development stalls in a process called the middle-income trap.

At current PPP levels, the World Bank defines middle income countries as having per capita incomes between $1,036 and $12,535 a year.[13] With the average per capita GDP now around $8,000 a year,[14] the expansion of the middle class in India appears well underway.

GDP drivers

India's economy has evolved over the past two decades, most notably with exports rising from around fourteen percent of GDP to twenty percent of GDP (see Figure 3). But domestic consumption is the main driver of India's economic growth. Consumption accounts for seventy percent of India's GDP compared to China's consumption accounting for just fifty-three percent of its GDP.[15] Economic growth is typically understood to be a function of net exports, government spending, investment, and consumption. Over-reliance on any one driver can create vulnerabilities like those China is facing today where dependance on fixed-asset investment produced an unsustainable real estate bubble.[16]

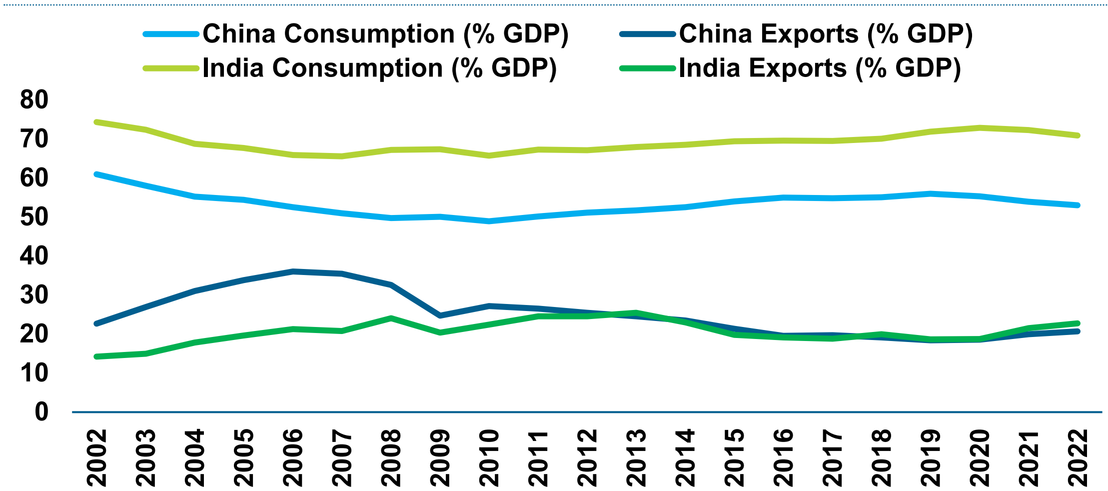

FIGURE 3
India & China Exports and Consumption as Percentage of GDP

Source: World Bank data as of December 2022. Exports and consumption do not total 100%; remainder would include investment. For example, China's domestic consumption is 53% of GDP and exports are 22.7%; the rest of GDP is linked to private and public investment at approximately 24.3%. Whereas India's public and private investment is near 6.3% of GDP.

[9] Source: The Economist, "India Has A Hole Where The Middle Class Should Be," January 13, 2018.

[10] Source: Financial Times, J. Reed, "Gauging India's Middle Class Opportunity," May 16, 2023. The lack of clarity is partly a result of the size of the informal sector in India. Only around 52 million people filed income taxes.

[11] Source: Oxford Economics, March 2024.

[12] Source: Asian Development Bank, N. Chun et al., "The Role of the Middle Class in Economic Development: What Does Cross Country Data Show?" ADB Working Papers, January 2022 No. 245.

[13] Source: World Bank definition of developing country categories.

[14] Source: World Bank data as of December 2022.

[15] Source: World Bank data as of December 2022.

[16] Source: Financial Times, M. Wolf, " The Economic Threats of China's Real Estate Bubble," October 5, 2021.

Debt dynamics

India's public debt level has risen since 2000 from around seventy percent of GDP to just over eighty percent of GDP at the end of 2022 (see Figure 4).[17] Over the same period, China's debt to GDP rose from thirty-two percent to nearly eighty percent.[18]

[17] Source: IMF data as of December 2022.

[18] Ibid.

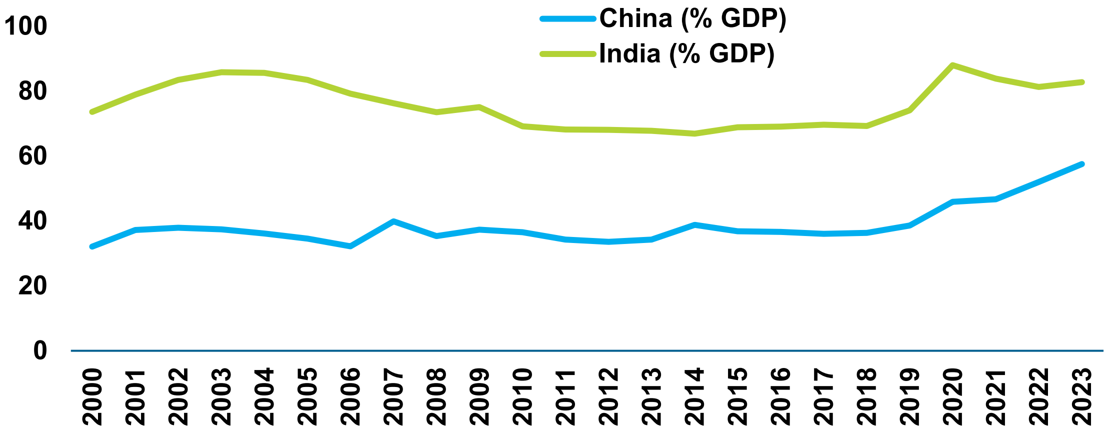

FIGURE 4

General Public Debt % of GDP (2000 – 2023)

Source: Oxford Economics December 2023. China's public debt statistics do not include public debt of provinces and municipalities. The Bank for International Settlements estimates that China's total debt to GDP is over 300%. IMF estimates total global debt for China is 272% of GDP in December 2022. IMF, " Debt Monitor" December 2022.

Demographic dividend

While accurate official census data from India and China may lead to different demographic estimates, it is generally agreed that sometime in 2022 or 2023, India surpassed China as being the most populous country in the world. Current estimates suggest a population exceeding 1.4 billion people (see Figure 5),[19] representing a twofold increase since 1950.[20] By 2050, India's population may peak around 1.7 billion people before declining. Meanwhile China's population may have already peaked and is projected to fall to around 1.3 billion people by 2050.[21]

[19] Source: World Bank Data October 2023.

[20] Source: Pew Research, L. Silver et al., "Key Facts as India Surpasses China as World's Most Populated Country," February 9, 2023. India's last census was in 2011 and demographic data has been calculated. Europe's population is currently around 744 million people and is less populous than either China or India.

[21] Source: United Nations, World Population Prospects as of 2022. Estimate of 1.7 billion people is derived from UN's medium variant projection through 2060.

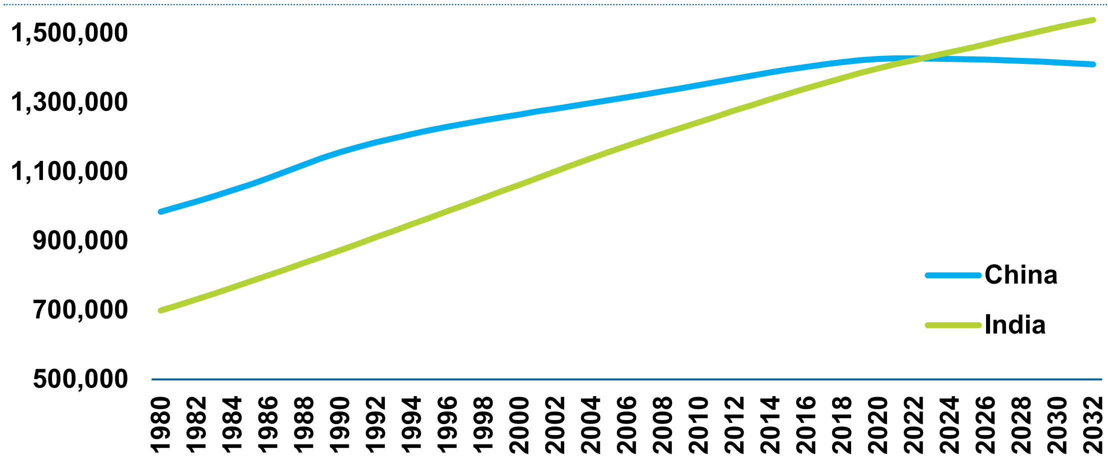

FIGURE 5

India & China Population (1980-2032)

Source: Oxford Economics data as of December 2023.

India's total population has followed a very different demographic pattern from China since the 1990s. On average, a woman in India is expected to have two children in her lifetime.[22] In China, the current fertility ratio of around 1.2 per woman is below population replacement thresholds.[23] Female participation in the work force in India

[22] Source: Pew Research, L. Silver et al., "Key Facts as India Surpasses China as World's Most Populated Country," February 9, 2023.

[23] Source: Financial Times, "China's Population Decline Accelerates as Economy Reaches Low Growth Target," January 17, 2024. See also United Nations, World Population Prospects as of 2022. In China there are 10 live births and 10 deaths for every 1,000 people.

was just twenty-four percent during the pandemic but has since risen to nearly thirty-three percent.[24] However, India's female participation is still quite low. For example, in China the female participation rate is over sixty percent.[25] Raising female participation rates in India could require more regulatory support for women in the workplace as well as changes in traditional cultural norms.[26]

Moreover, India's population is very young. Over forty percent of the population is under the age of 25.[27] India has a much lower dependency ratio, where young workers entering the workforce lower the ratio of workers to "dependents" (i.e., retirees, children, and unemployed) As shown in Figure 6, the ratio of over-55 to the total workforce is roughly twice as much in China than in India.

[24] Source: Wall Street Journal, V. Agarwal et al., "India Is Behind the Curve on Women in the Workforce," August 8, 2023. There is some disagreement on women's participation rate perhaps due to definitions. When self-employment is included women's participation rate reached nearly thirty-three percent after the pandemic. See Reuters, "Rising Women's Participation in India Workforce likely Led by Distress," September 20, 2023.

[25] Source: World Bank as of December 2023. India's female participation rate is lower than Saudi Arabia's at just over thirty-four percent.

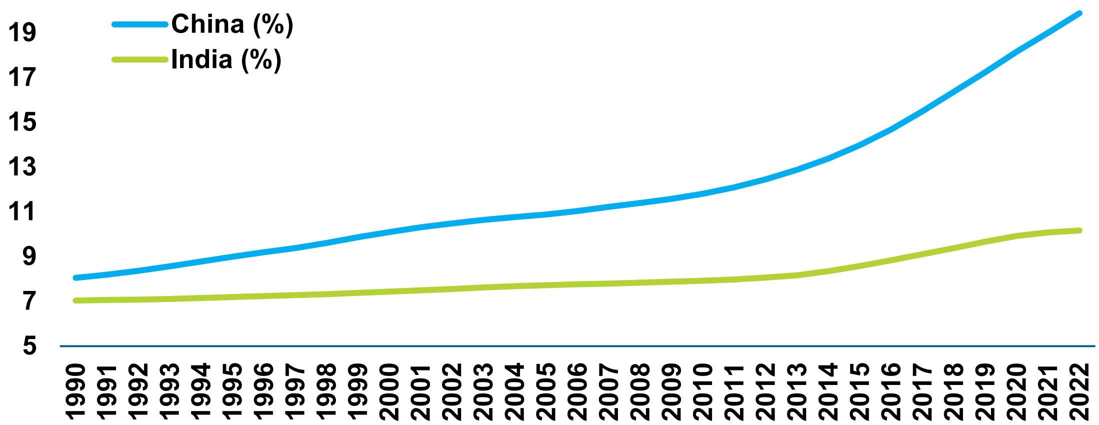

FIGURE 6

Percentage of Over-55 to Total Work Force in India & China (1990-2022)

Source: World Bank Data October 2023.

Younger countries tend to experience higher rates of household formation, demand for goods and services like education and healthcare, and over time, higher rates of consumption and investment. Over the long run, there appears to be a stable relationship between the ratio of middle-aged to young people and the performance of the stock market.[28] Conversely an older population has been connected with declining government fiscal multipliers as more of government expense is turned to social programs designed to support an aging population rather than productive investment.[29]

Smart phones, digital IDs, and connectivity

Between 2010 and 2019 the number of Indians with smartphones rose from one hundred million users to over six hundred million users.[30] Smartphones represent not only the first phone, but also first television, camera, alarm clock, and computer for many Indians.[31] During the same period, the Indian government enlisted the co-founder of Infosys - Nandan Nilekani - to help design and implement a national digital identification system. Known as Aadhaar, it is the world's largest biometric database, offering legal identity and access to government benefits to hundreds of millions of Indians.[32] Prior to 2010, approximately forty percent of Indian's did

[26] Source: See Reuters, "Rising Women's Participation in India Workforce likely Led by Distress," September 20, 2023.

[27] Source: United Nations, World Population Prospects as of 2022.

[28] Source: Journal of Financial & Quantitative Analysis, A. Gozluku, "Demographic Trends, the Dividend Stock Price and the Predictability of Long-Run Stock Market Returns," Vol. 46, No. 5 April 2011.

[29] Source: American Economic Journal: Macroeconomics, H.S. Basso et al., "The Young, The Old, and the Government: Demographics and Fiscal Multipliers," Vol. 13, No 4 October 2021.

[30] Source: Asia Society, R. Agrawal, "India's Mobile Revolution," May 2019.

[31] Ibid.

[32] Ibid.

not have a birth certificate and around sixty percent did not have bank accounts.[33] And only around three percent of Indians paid taxes.[34] By 2021, approximately ninety-percent of Indian adults of working age surveyed by the Indian government had access to a financial account.[35] Since its inception, Aadhaar has helped facilitate securing housing, education, and medical care, and transferred $310 billion in government benefits.[36]

The Indian government is also rolling out a digital public infrastructure system designed to connect micro, small and medium size business ("SMEs") with access to formal credit. Wireless networks and the increasing availability of smartphones will make it easier for SMEs to connect with lenders who may be located far from the SMEs. The project is expected to provide around $250 to $300 billion in credit to SMEs.[37]

Economic and market reforms

India's evolution from a more socialist form of government to a more market-based economy has taken several decades. Prime Minister Narenda Modi's high degree of popularity may have helped to create political stability, which has facilitated the implementation of reforms.

For example, in 2015, the government created a thinktank, NITI Aayog, that is designed to foster interstate cooperation and promote economic development through the centralization of national and state reforms.[38] Although Prime Minister Modi enjoys a substantial majority in government, the pace of reforms has been uneven.[39] When Modi won reelection in 2019, his government promised deep reforms, but some proved particularly difficult to implement (see Figure 7).[40] Each state in India has its own regulatory and government structure, so coordinating nationwide reforms can take time.

Many reforms are caught between political promise and meaningful implementation.[41] Some have been defined by executive order from the President's office, but parliament, ministries, and state governments have proved slow-footed in implementing legislative changes. For foreign investors, several barriers to foreign ownership of insurance, retail, finance companies, and land have been addressed.[42] In spite of some progress in privatization, state-owned banks still control sixty-two percent of deposits.[43]

[33] Source: Yale Insights, K. Sudhir et al., "What Happens When a Billion Identities are Digitized," March 27, 2020.

[34] Ibid.

[35] Source: The Economic Times of India, "Nearly 90% Adults Had Accounts with Financial Institutions in FY21," March 8, 2023.

[36] Source: World Bank Blogs, S. Dixit, "India's Digital Transformation Could Be A Game-Changer for Economic Development," June 20, 2023.

[37] Ibid.

[38] Source: NITI aayog, NITI aayog: Framework, 2024.

[39] Source: TS Lombard, A. Dubey, "Modi's Unfinished Reform Agenda," January 3, 2024.

[40] Source: TS Lombard, A. Dubey, "Modi's Unfinished Reform Agenda," January 3, 2024. Note that, as of this writing, Modi is up for re-election and is widely expected to win.

[41] Source: CSIS, India Reform Tracker as of December 2023.

[42] Ibid.

[43] Source: TS Lombard, A. Dubey, "Modi's Unfinished Reform Agenda," January 3, 2024.

Proposed Reform	Outcome/Description	Status
Allow more than 50% ownership for foreigners in insurance	Foreign ownership of insurance companies now capped at 74%	Done 2021
Reduce corporate tax from 30% to 25%	Effective corporate tax rate now 25.7%	Done 2019
End retrospective tax on cross-border investment	Cross-border investment no longer taxed	Done 2021
Privatize Air India	Government stake reduced to 49%	Done 2022
Pass major port authority bill	Reform & streamline shipping at ports	Done 2021
Allow more than 50% ownership for foreigners in defense	Foreign ownership in defense companies now capped at 74%	Done 2021
One stop shopping for government clearance	Takes 10 procedures for government clearance versus Asian average of 7.6	Incomplete
Increase ceiling for foreign holding of government debt	Increase cap to 30%	Not Started
Release all foreign direct investment data	FDI data to include country funding	Not Started
Stop forcing banks to lend to certain sectors	Ends ability of government to direct lending through banks	Not Started
End restrictions on foreign investment in multi-brand retail	Foreign investment in retail subject to tax	Not Started
Amend/replace Foreign Land Acquisition Act of 2013	Rule prevented foreign purchase of land without approval of 80% of state residents	Not Started
Deregulate pricing for natural gas & kerosene	Natural gas & kerosene pricing set by government	Not Started
Allow more than 50% ownership for foreigners in retail	Must meet requirements for local content, local labor, and single brand rules	Not Started
Simplify complicated goods & services tax (GST)	Proposal to streamline GST to three categories	Not Started
Write ten-year plan to privatize all state-owned enterprises	Currently govt pursues ad hoc privatization	Not Started
Privatize public sector banks	Currently govt pursues ad hoc privatization	Not Started
Raise foreign ownership ceiling on Indian companies	Foreigners' ownership capped at 10% for fast growing companies	Not Started
Establish rail development authority	The authority exists as cabinet position but without legislative backing	Not Started
Businesses to secure government permits in less than 10 days	World Bank estimates average 17 days for permit	Not Started

FIGURE 7

Proposed Economic and Market Reforms

Source: CSIS, India Reform Tracker as of December 2023. The table reflects a snapshot of some market-based reforms relevant to foreign investors. Other reforms include the judiciary and bankruptcy reforms.

Equity markets

India's stock market has grown rapidly. At the end of 2021 India was just 9.3% of the MSCI emerging market ("EM") equity index, yet by March 2024, it had become the second largest stock market in the EM index, representing 17.7% of the index.[44] Over the same period China's market share fell from 39.1% to 25.1%.[45]

[44] Source: MSCI data as of March 31, 2024.

[45] Ibid.

FIGURE 8

MSCI India Index in Context

	MSCI Emerging Market Index	MSCI India Index	MSCI China Index
Number of Companies	1,376	136	704
Top 3 Sectors	Financials (22.4%), IT (23.7%), Consumer Discretionary (12.4%)	Financials (24.8%), Consumer Discretionary (12.8%), IT (11.8%)	Consumer Discretionary (29.6%), Communication Services (20.1%), Financials (16.5%)
Market Weight of Top Ten Companies	24.1%	36.6%	42.0%
Top 5 Companies	TSMC (8.3%), Samsung (4.1%), Tencent (3.6%), Alibaba (2.0%), Reliance Industries (1.5%)	Reliance Industries (8.5%), ICICI Bank (5.3%), Infosys (4.7%), HDFC Bank (3.8%), Tata Consultancy (3.3%)	Tencent (14.2%), Alibaba (8.1%), PDD Holdings (3.8%), Meituan (3.4%), CCB (3.2%)
Top 3 Countries Revenue Exposure	China (47.7%), US (7.7%), India (7.4%)	India (77.6%), US (7.6%), China (2.6%)	China (84.7%), US (4.4%), Japan (0.8%)

Source: MSCI data as of March 29, 2024.

The Indian stock market is slightly less top-heavy than the Chinese stock market, though the largest ten companies comprise more than one-third of the MSCI India index. The Indian market also has a greater emphasis on the financial sector, and much less focused on consumer discretionary than China. Importantly, the vast majority of revenues come from within India.

Over the past two decades, Indian stocks have tended to perform similarly to the broad MSCI Emerging Markets index (see Figure 9), perhaps reflecting larger macro-economic trends rather than local conditions within India. However, over the last two years, the performance of Indian equities has started to diverge from the emerging market index and particularly from Chinese stocks which have underperformed.

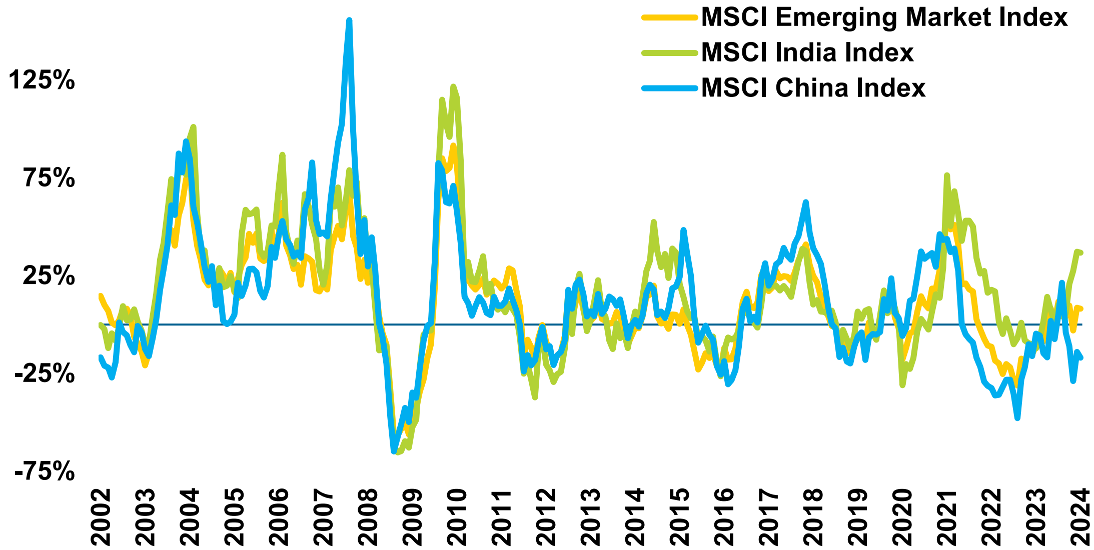

FIGURE 9
India, China, and Emerging Market Equity Rolling One-Year Returns

Source: Bloomberg as of March 2024.

Indian stocks have generally enjoyed a price premium over their emerging market peers for the past decade (see Figure 10), even as returns have largely tracked the emerging market index. With national election in India in April and May of this year, markets appear to be factoring in further market-based reforms with higher valuations for Indian companies.[46]

[46] Source: Bloomberg, A. Joshi, "India Market Value to Reach $10 T by 2030, Jeffries Says," February 22, 2024.

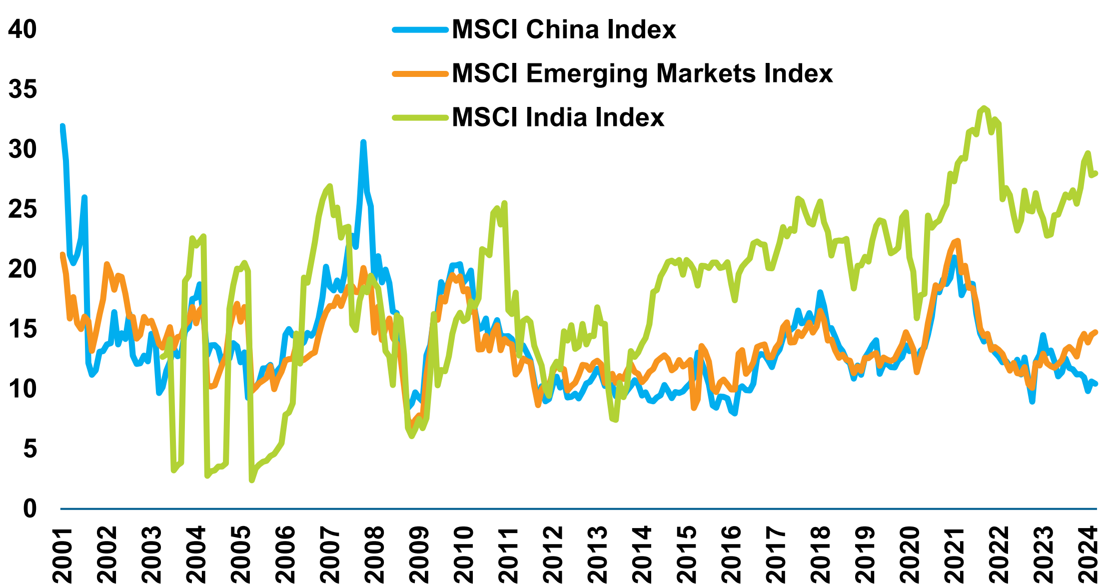

FIGURE 10
Price-Earnings Ratio for India, China & Emerging Market Equity Indices

Source: Bloomberg data as of March 2024.

Bond markets

Historically, foreign investors have had access to non-government debt, and both public and private entities have tapped global capital markets to raise debt (see Figure 11). However, the ability to invest in government debt markets in India has been constrained by foreign access and ownership limits. The creation of dedicated government bonds for foreign markets is changing this dynamic.

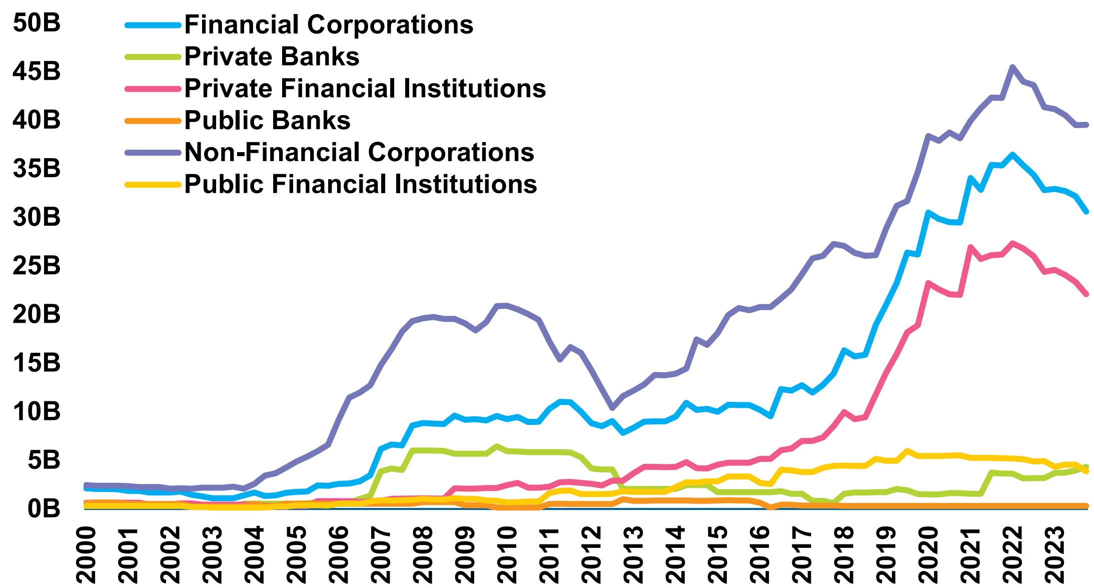

FIGURE 11
International Public & Private Debt Issuance (USD B)

Source: Bank for International Settlements as of December 2023.

In September 2023, JP Morgan announced that it would add India to its emerging market debt indices.[47] Starting in June 2024, JP Morgan will add twenty-three Indian government bonds with an estimated notional value of approximately $330 billion dollars in local and hard currency. Long anticipated by investors looking for access to India's government debt markets, this move will mark a late entry for India into JP Morgan's popular emerging market debt benchmarks.

In March 2024, Bloomberg announced the inclusion of Fully Accessible Route ("FAR") bonds in their emerging market local currency debt indices beginning in January 2025.[48] FAR bonds are government debt issues that do not have a ceiling for foreign ownership.[49] Starting in June 2024, FAR bonds will also be assessed for inclusion by JPM. While some emerging market debt managers have previously made ex-benchmark investments in India, the inclusion of India in these prominent benchmarks will likely open the door for further flows of institutional capital into Indian debt.

Summary

India is growing faster than most populous emerging market countries like Brazil and China, and its rapid pace of growth appears poised to continue for at least the next decade as the drivers for India's next phase of economic development will be carried forward on several fronts.

The government has expanded its infrastructure investments to improve transportation and trade. Prime Minister Modi's economic and market-based reforms continue to lay the groundwork for more financial openness and investment. Stock and bond market structures and regulatory reforms promise more access to

[47] Source: JP Morgan announcement September 2023. Indices that will include India government bonds include the EMBI, GBI-EM and CEMBI indices over time. JP Morgan will increase the country allocation to India to a cap of ten percent of the JPM GBI-EM index over a ten-month timeframe.

[48] Source: Bloomberg. The weight of FAR bonds will be increased in increments of 10% of their full market value every month through October 2025 when they will be weighted at their full market value in the indices.

[49] Source: HSBC, "India Bonds Included in Major Emerging Market Indices," September 3, 2023.

global capital markets. A young and dynamic labor force stands in stark contrast to many Asian peers with aging populations. And wireless technology should hasten connectivity, popular banking, retail consumption, and national integration through thoughtful development of governmental social spending programs through mobile payment apps.

The Indian economy does not depend on a single resource or source of revenue. Rather its economic fundamentals are balanced between domestic consumption and exports of goods and services. And in a young democracy, the popularity of the ruling Bharatiya Janata Party ("BJP") party has offered relative political stability. While Modi and the BJP have played a crucial role in India's economic trajectory, the continuation of reforms and sustained growth will also depend on various factors beyond their leadership, including policy decisions, global dynamics, and effective implementation.

After more than two decades where Chinese equities have dominated the MSCI emerging market equity index, it appears that markets are increasingly interested in other emerging market countries, most notably India. India is a large country in terms of geography and demographics, but its financial markets are still developing. India's stock and bond markets may well prove to be a stabilizing feature of emerging market equity and debt indices.

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