Invesco Fixed Income Investment Insights
"Modi-nomics" creates new inflection point for Indian bonds

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India is finally pursuing a clear mandate of economic reform following three decades of coalition government. Invesco's Ken Hu and Sujoy Das explain which initiatives are having an impact, how key challenges are being addressed and where India's future growth potential ranks globally. They also provide context on the current inflection point for Indian bonds, examining the latest trends in macro indicators and real interest rates.

Emerging market bonds stand out in the current environment for their high yields and diminishing currency risks, presenting a compelling alternative as fixed income markets in developed economies start to grapple with rising interest rates and a pull-back from quantitative easing support. Despite the positive upside, Indian bonds are still under-owned by global investors. Improvements in the country's economic picture are starting to gain recognition though, punctuated by Moody's upgrade on India's credit rating in November 2017 for the first time since 2004.

With general elections due in 2019, India's path to continued structural improvement will come under increasing scrutiny. Lowering debt levels, increasing foreign investment, keeping a lid on inflation and generating job opportunities for India's booming young population will all be critical success factors.

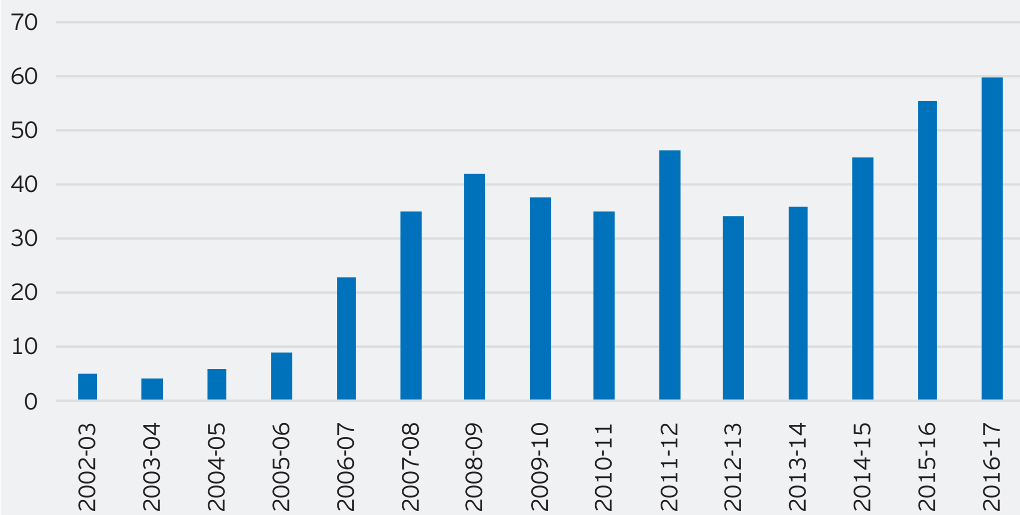
"Modi-nomics" is having an impact
In May 2014, Narendra Modi was sworn in as Indian Prime Minister after leading the Bharatiya Janata Party (BJP) to a sweeping victory that restored single-party rule to India for the first time since 1984. Making history as the only Indian Prime Minister to be born since the country's formal establishment in 1950, Modi has promised to usher in a new wave of prosperity by implementing a wave of supply-side economic policies. Known as "Modi-nomics," the approach is intended to increase productivity by attracting foreign investment, expanding capacity, improving infrastructure and reducing government red tape.

Optimism remains high within the country that this plan will translate to positive results. Modi held a 78% approval rating in 2013 before taking office. Since then, it has ranged between 81% and 88%[1].

Recognizing the positive early impact of "Modi-nomics," Moody's upgraded India's sovereign credit rating for the first time in 13 years, raising it from Baa3 to Baa2. The ratings agency said it expected recent initiatives and reforms would increase India's revenue base and thereby ultimately shrink its debt obligations. In 2014, S&P raised its outlook on India from "negative" to "stable" following Modi's election. It has not yet changed its credit rating of BBB-, however, which is the lowest level of investment grade.

Key initiatives and reforms generate increasing foreign investment
Among his campaign promises, Modi pledged to make India an easier place to do business. Global investors appear hopeful on this new economic direction. India received a provisional US$60 billion in foreign direct investment in 2016-17, marking the fourth consecutive year of increasing inflows (Figure 1).

Figure 1: Foreign direct investment flows into India (USD billions)



Source: Department of Industrial Policy & Promotion. Data listed for 2014-17 is provisional.

Their optimism is pinned in part on the "Make in India" initiative launched in 2014 to promote investments in 25 different sectors including food processing, railways, automobiles and thermal power. The new scheme streamlines the investment process and relaxes foreign ownership rules. It has already generated positive results. In 2017, India jumped 30 spots in the World Bank's Ease of Doing Business rankings, rising from 130th to 100th out of 190 countries[2]. Meanwhile, India ranked eighth in the 2017 A.T. Kearney FDI Confidence Index, ahead of Spain, Sweden and Brazil[3].

1. "Three years in, Modi remains very popular." Pew Research Center 15 November 2017.
2. "Doing Business." The World Bank, retrieved 2 February 2018.
3. "The 2017 A.T. Kearney Foreign Direct Investment Confidence Index." A.T. Kearney, retrieved 2 February 2018.

Since taking office, Modi has also launched key reforms to formalize India's economy. In November 2016, the Reserve Bank of India (RBI) announced it would demonetize the Rs 500 (US$7.70) and Rs 1,000 currency notes to clamp down on black money circulating outside the banking system. That accounted for about 86% of cash in use[4]. The long-term effect of steering some of that money back into the public domain and toward bank deposits should ultimately boost the government's balance sheet and lower overall debt levels through higher tax revenues. It also improves the trail for the tax authorities for all financial transactions from within the banking system. There is ample room to expand this revenue source, given that only 3.5% of the population filed an income tax return in the 2015-16 year[5].

The other major reform is the Goods and Services Tax bill (GST) implemented from July 2017. The GST streamlines the levy process by replacing a complex set of state and federal taxes with a single indirect charge. Previously, a car produced in the southern city of Chennai would incur multiple costs and processing delays as it crossed over state borders on the way to an end-user in New Delhi, for example. Simplifying this procedure with a single national tax should create a mutually beneficial situation for the government, private enterprises and consumers alike.

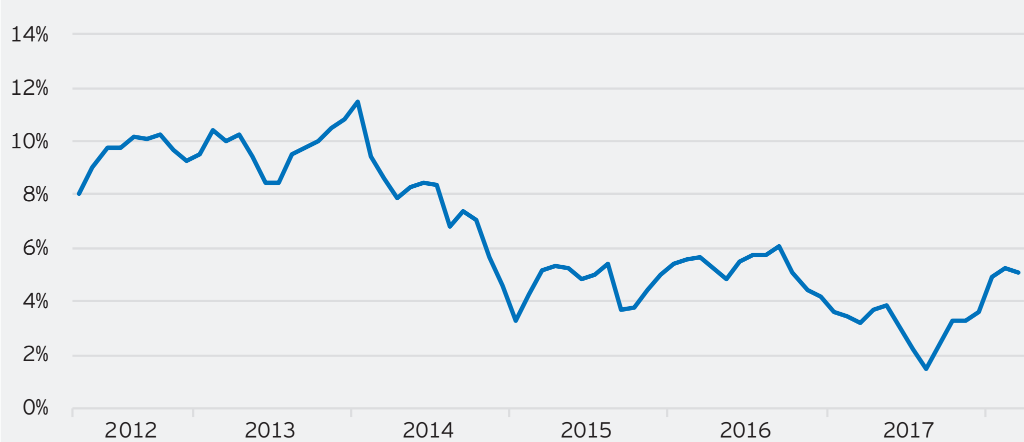
Meanwhile, biometric mapping is another major project that puts India on the path to a more formalized economy. This effort predates Modi's administration but has ramped up since he took office to the extent that more than 1 billion Indians are now enrolled in the "Aadhaar" unique identification program. This is the single biggest exercise to link the population with bank accounts and mobile phones and bring about an efficiency in terms of improving transparency and transferring financial benefit directly to the people.

India's improving economic fundamentals

Structural improvements in the Indian economy will take time to develop fully given the country's immense size and the legacy of a decentralized economy. There are early signs of improving macro indicators, however, as recent positive developments start to have an impact.

Inflation has declined, for example, trending under 6% during the past three years (mostly under 5%) after previously hovering around 10% or higher (Figure 2). Traditionally, rising prices in India have stemmed in large part from food wastage due to systemic delivery problems. In 2013, India's agriculture minister revealed that upward of 40% of total produce was wasted annually[6]. New reforms like the GST bill aimed at reducing logistic and regulatory bottlenecks should expedite food transport and significantly reduce spoilage. Going forward, this could introduce further structural downward pressure on inflation.

Figure 2: Consumer price inflation in India



Source: Bloomberg, Invesco

4. For more details, read "Talking points: India's demonetization - A long-term positive" available on Invesco's Asia-Pacific Institutional website.
5. "Income tax return statistics assessment year 2015-16." Income Tax Department, retrieved 2 February 2018.
6. "India wastes more farm food than China: UN." Hindustan Times 11 September 2013.

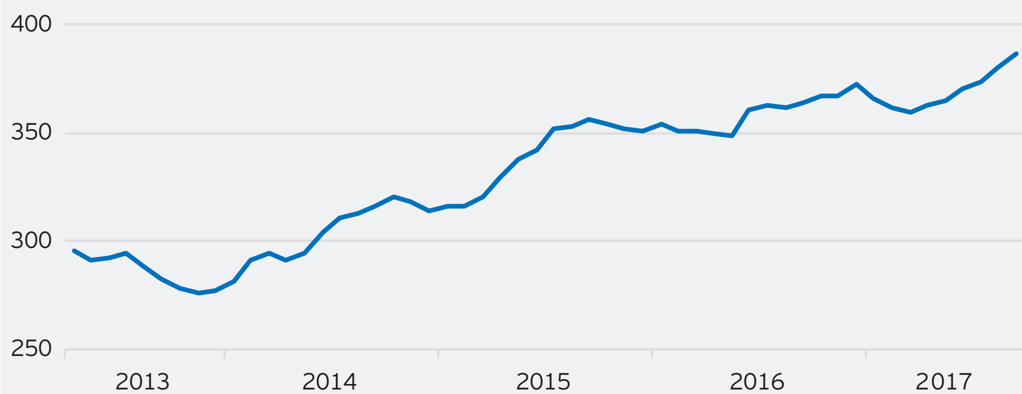
Stabilization in consumer prices has enabled the RBI to lower the benchmark interest rate to 6% from a high of 8% in early 2015. The central bank has signaled a neutral inflation target of 4% with an error margin of +/- 2%, suggesting it has further room to reduce the key lending rate if inflation falls further below the upper bound on a durable basis. In an interest rate reduction cycle, fixed income securities denominated in Indian rupees could potentially generate capital gains.

India's currency has also been experiencing a period of stability since Modi took office. Following a sharp loss in value in 2013 that predated his administration, it has traded within a band of 60-70 rupees per US dollar (Figure 3). A closer look at India's considerable foreign reserves suggests that the rupee even has room to strengthen. To this point, the RBI has been adding to a record reserve position, tamping down any meaningful appreciation in the currency (Figure 4).

Figure 3: USD/INR exchange rate

Source: Bloomberg, Reserve Bank of India Handbook of Statistics on the Indian Economy

Figure 4: Foreign currency reserves (USD billions) in India

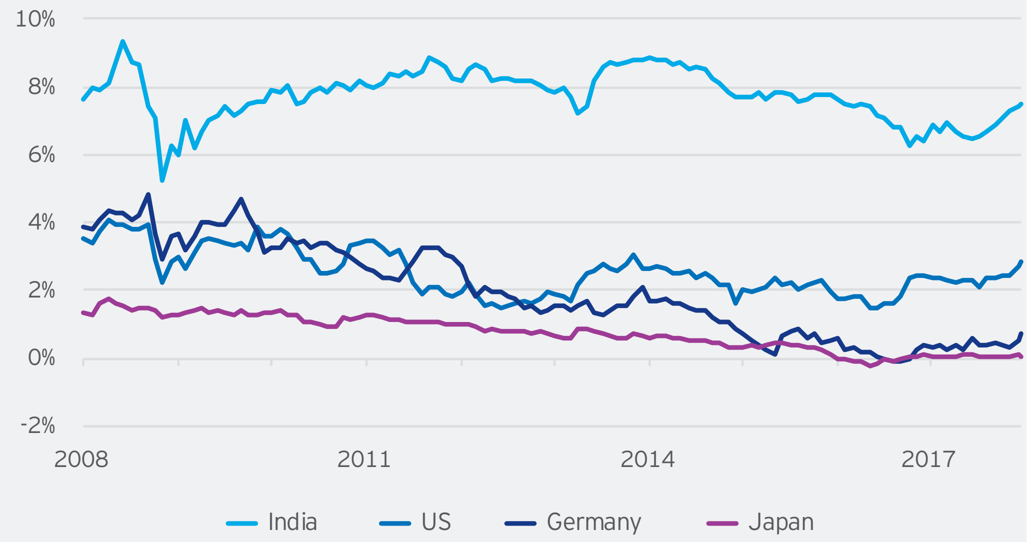


Source: Bloomberg, Reserve Bank of India Handbook of Statistics on the Indian Economy

Positive inflection point for fixed income

Indian rupee-denominated government bonds currently yield close to 8%, providing a significantly higher return versus comparable issues from the US, Germany and Japan (Figure 5). High yields have not been uncommon in India, but the recent drop in inflation has also translated to high real interest rates, which ranked second among 10 global regions[7]. Resiliency in the rupee has also protected the value of local currency-denominated assets for global investors. The combination of declining inflation and improvements in external deficits has created positive support for the rupee.

Figure 5: Government bond yields



Source: Bloomberg, Invesco. Data from 29 February 2008 to 9 February 2018.
India: Government Bond Generic Bid Yield 10 Year; US: Generic Government 10 Year Yield; Germany: 10 Year Bund Auction Average Yield; Japan: Generic Government 10 Year Yield

Aside from return potential, Indian bonds also provide a diversification benefit. They are not closely correlated with any major global asset classes like commodities, developed market equities or real estate (Figure 6). One explanation for the divergence is that there are limitations on foreign ownership of Indian fixed income securities. Foreign investors must register with the Securities and Exchange Board of India and are capped by an investment quota. Allotments have been regularly increased following high demand, however. The quota for government bonds was increased by 80 billion rupees (US$1.2 billion) to 2.5 trillion rupees for the October-December 2017 period, for example[8].

7. "Real interest rates show room for a rate cut." Economic Times 18 July 2017.
8. "RBI increases foreign investment limits for debt." Reuters 28 September 2017.

Figure 6: Correlation between asset classes

	M2	Inflation Linked	Gold	Oil	US Treasury	Real Estate	S&P 500	Euro Stoxx	US High Yield	India Bond	Em Govt & Corp in USD	EM Govt in LC (Since 2006)
M2	1	0.04	-0.03	0.01	0.06	0.00	0.00	0.01	-0.05	0.04	-0.05	0.04
Inflation Linked	0.04	1	0.12	0.01	0.05	-0.08	-0.05	-0.03	-0.05	-0.01	-0.02	-0.01
Gold	-0.03	0.12	1	0.01	-0.08	0.01	0.04	0.05	0.04	0.06	0.00	0.02
Oil	0.01	0.01	0.01	1	-0.13	0.10	0.21	0.20	0.22	-0.08	0.16	0.28
US Treasury	0.06	0.05	-0.08	-0.13	1	-0.15	-0.33	-0.38	-0.09	0.08	0.19	0.03
Real Estate	0.00	-0.08	0.01	0.10	-0.15	1	0.70	0.56	0.44	0.03	0.38	0.52
S&P 500	0.00	-0.05	0.04	0.21	-0.33	0.70	1	0.83	0.50	0.00	0.35	0.54
Euro Stoxx	0.01	-0.03	0.05	0.20	-0.38	0.56	0.83	1	0.49	0.01	0.36	0.55
US High Yield	-0.05	-0.05	0.04	0.22	-0.09	0.50	0.50	0.49	1	-0.04	0.59	0.50
India Bond	0.04	-0.01	0.06	-0.08	0.08	0.03	0.00	0.01	-0.04	1	-0.03	0.14
Em Govt & Corp in USD	-0.05	-0.02	0.00	0.16	0.19	0.38	0.35	0.36	0.59	-0.03	1	0.68
EM Govt in LC (Since 2006)	0.04	-0.01	0.02	0.28	0.03	0.52	0.54	0.55	0.50	0.14	0.68	1

Source: Bloomberg. Data is from July 2000-January 2018.

Foreign investors are still relatively under-invested in Indian bonds despite a recent pick-up in demand for the asset class. In November 2017, non-residents only accounted for a small share of India's local currency government bonds (4.6%), compared with much larger ownership in other emerging market bond markets such as Malaysia (44.3%), South Africa (41.4%), Indonesia (39.3%) and Thailand (15.8%)[9]. If investment quotas continue to ease and foreign investors right-size their Indian bond positions, it will provide a wave of liquidity that could significantly boost values.

Future growth prospects remain strong

India has a prominent position on the world stage given its population size of 1.3 billion people and long history spanning thousands of years. Its potential as a future global economic growth engine was proclaimed in 2001 after being named together with Brazil, Russia and China as a member of the BRIC acronym used to designate powerful emerging markets[10]. Since then, India's economy has delivered on its promise, increasing from the 13th to seventh largest in the world[11].

Continued growth rests on the shoulders of India's dynamic population. While other major economies grapple with aging populations, India will continue to enjoy a so-called "demographic dividend" in which the size of its labor force outnumbers its dependents. By 2050, it is expected to trail only South Africa among BRICS countries in the share of people aged 15-59 years old (Figure 7).

9. "Emerging Markets: Non-residents' holdings in local currency government bonds." Credit Suisse, retrieved 5 March 2018.
10. BRIC was later modified to BRICS to include South Africa as a fifth member.
11. "World Economic Outlook Database." International Monetary Fund, retrieved 2 February 2018.

Figure 7: 15-59 year-old age group as percentage of total population

Country	2015	2050
Brazil	65.2	55.7
China	67.6	50
Germany	59.5	48.3
India	62.3	61.5
Japan	54.1	45.1
Russia	63.2	53.5
South Africa	63	63.3
United States	60.4	54.7
World average	**61.7**	**57.2**

Source: United Nations Department of Economic and Social Affairs/Population Division, 2015

This large swath of India's future population base also stands to be better educated than their predecessors. The youth literacy rate has nearly caught up to global standards, for example, rising from 76% in 1995-2004 to an estimated 90% in 2015. By contrast, the world average increased from 87% to 91% during the same span[12]. Prioritizing an improvement in educational standards will help ensure that the workforce has the necessary skillset to participate in India's evolution to a more dynamic and inclusive economy. To that end, Finance Minister Arun Jaitley reportedly used the word "education" a record number of times during his speech outlining the Union Budget 2018[13].

Challenges are being addressed

With a general election due in 2019, Modi will look to extend structural improvements in the Indian economy. While key factors like debt levels and inflation will require further monitoring, there are signs in many areas that challenges are being meaningfully addressed.

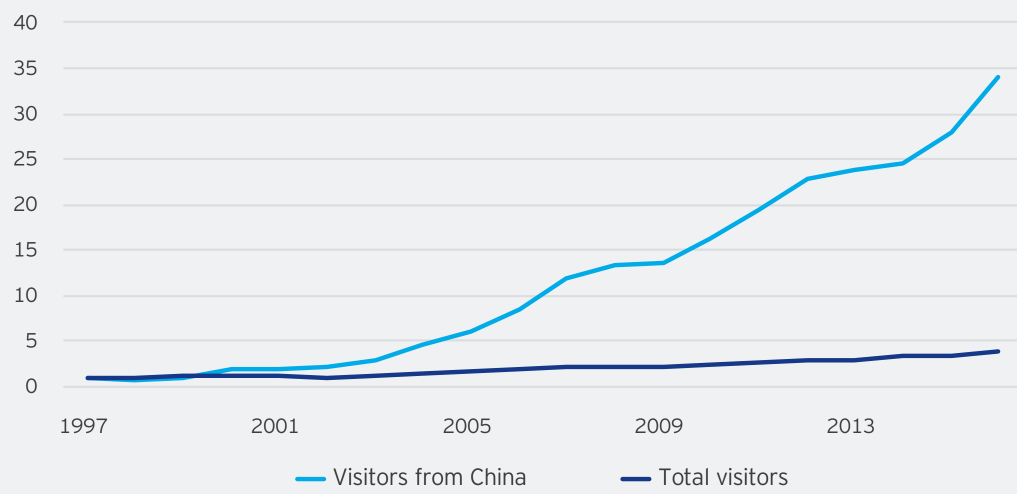
Improving the country's infrastructure has been one key focus area. A ready, reliable means of transporting people and goods is essential, particularly as India looks to stimulate domestic consumption and accelerate its economic development. To that end, it launched a US$17 billion high-speed rail project with Japan set to finish in 2022 that will link the two financial hubs of Mumbai and Ahmedabad[14].

India has also made strides in improving its digital infrastructure. Upon taking office, Modi said, "Our ancestors used to play with snakes, we play with mouse." In 2015, he launched the Digital India campaign with stated goals of creating a knowledge economy and bridging the technology gap between the country's urban and rural populations. The initiative has already made a positive impact. Internet users in India jumped 23% in January 2017 versus a year ago, for example, ranking behind only Indonesia, Philippines and Mexico for the world's largest percentage increase[15].

12. "Education for all 2000-2015: Achievements and challenges." UNESCO, retrieved 2 February 2018.
13. "Budget for health, education: Challenge to walk the talk." The Times of India 1 February 2018.
14. "Japan's Abe to launch $17-billion Indian bullet train project as ties deepen." Reuters 12 September 2017.
15. "Digital in 2017 Global Overview." Hootsuite, reserved 2 February 2018.

Geo-political risks have also started to ease. Modi invited Pakistan's then prime minister Nawaz Sharif to attend his inauguration ceremony, signaling a new era of improved relations between the two countries which have been involved in four armed conflicts since 1947. Relations with China, India's other powerful neighbor, also seem to be on the upswing despite a two-and-a-half-month territorial dispute that ended without incident in August 2017. Just a week later, Modi met with Chinese President Xi Jinping for bilateral talks in Xiamen, China for the 9th BRICS summit. Meanwhile, Chinese tourism to India has increased at a rapid rate, as cultural ties between the two countries continue to grow (Figure 8).

Figure 8: Visitor arrivals in India



Source: Ministry of Tourism in India. Each data set is normalized at a starting value of 1 for comparison purposes.

On the financial side, India has also embarked on a significant recapitalization plan to ensure healthy credit markets. The government unveiled a 2.1 trillion rupee scheme in October 2017 to fund public sector banks. Combined with a push to simplify antiquated bankruptcy laws, this is one of several measures intended to reduce bad debt.

Since taking office in 2014, Prime Minister Modi has pursued a clear mandate of reform after three decades of coalition government in India. He will look to extend key initiatives and build on the strengthening economy ahead of general elections in 2019.

Political stability along with structural improvements combined with attractive bond yields and a stable Indian rupee provides a unique entry point for foreign investors to tap into future upside in the Indian fixed income market.

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