The China Conundrum

The comparison is inevitable. In the post Covid era, numerous calls for rotation from Indian to Chinese equities have hit the tape, often authored by star strategists. These centred around rotational momentum or outperformance, mean reversion calculations or the overenthusiasm amongst the cerebral types to call the next big move in the markets. The common outcome has been that the calls have all fallen flat. Now we have views which suggest that India may have decoupled, and mean reversion will not work for India as the country is going through a massive transition to become a big economy.

First of all, while it is clear that India is executing well as an economy and the delivery record is at its best over the last three decades, the transformation is mere work-in-progress. If free markets have created unprecedented wealth, they need to be their true self from time to time. Mean reversion is one of the mechanisms by which free markets find equilibrium. The debate could be about a new and maybe a higher mean being discovered. Mean reversion cannot be expunged from the debate on markets.

First a look at some basic numbers. In the midst of the fresh peaks we are scaling frequently, let us try to remain grounded by numbers.

Key Indicators	India	China	USA
Nominal GDP (USD Tn) - CY23	3.5	17.8	27.4
Per Capita GDP (USD) - CY23	2,500	12,514	81,632
Market Cap to GDP (%)	138	57	219
Corporate Profits as % of GDP	6.2	5.9	11.8
Bank Credits as % of GDP	56.3	48.3	205.3
No of companies with > USD 10 Bn market cap	127	223	653
PE(x) Ratio of the above	26.7	12.8	27.6
Median PB Ratio of the above	6.6	2.0	5.0
Median ROE of the above (%)	17.7	11.4	17.2

Note:

1) *PE, PB, ROE- India (FY24), GDP and other data - CY23.*
2) *PE, PB, ROE are calculated for profit making companies.*
3) *Market cap is on Price as on September 30, 2024. The data pertains to CY23 for China and USA while for India, FY24 has been used.*

Source: World bank, IMF, Bloomberg, Spark Fund Research

CAGR (%)	Nifty 50 India	Shanghai Composite China	S&P 500 USA
4Yr Market Performance	23.1	0.9	14.4
5Yr Market Performance	17.6	2.8	14.1
10Yr Market Performance	12.5	3.5	11.3

Note: Data as on September 30, 2024, Returns in respective currency.
Source: Bloomberg, Spark Fund Research.

By any reckoning, India is punching above its weight. The question is whether that is justified. The answer is simple in that the water has found its level out of its own free will. The fact is also that India always traded at a premium to emerging markets. India is performing and that is for real. Yet some perspectives on the facts are in order lest we get carried away.

False equivalence between EM weight and market heft

India's weight has crossed that of China in the leading emerging market index even as the Chinese economy is about five times the size of India. Be that as it may. The weight of emerging markets in global markets is only about 10% or so. Not all pools of capital investing into India follow EM weights. Therefore, many factors need to be considered before jumping to conclusions. In the past, many smart India investors were hugely overweight India when India's weight was 5-10%. They made a lot of money. In fact, a veteran India strategist was triple overweight on India when India's weight was comfortably lower. There is little elbow room left for the bull trade to be rewarding at this point. **India's current EM weight is no good lead indicator on flows or performance.**

Let us understand how and why the India premium came about in the first place.

The following factors contributed to India turning out to be the best performing large market in the world over the last decade or so, save the NASDAQ perhaps.

1. An economy that fired despite policy (for most part)
2. High cost of capital
3. Consistent scepticism, particularly from the media
4. An under-rated Central Bank
5. Positive feedback loop from good examples
6. Anglo Saxon legal system and regulations
7. Easy money and dissolving barriers for global capital flows

Some of the above may well be counter intuitive. The first two factors ensured that Indian businesses never had it easy. They had to perform under adversity and capital discipline was necessary to evade extinction. The markets ended up rewarding the outcome. India was not a fancied market for most part and the media spotlight was always on China's success. At least for Indian markets, this worked well.

While many of these factors continue to provide tailwinds, the relentless run-up in prices is about to tire out the virtuous cycle. That is or should be the nature of free markets. Let us see how some of the factors above turned India into a market that investors have fallen in love with.

Lack of ease of doing business

This is what Indian businessmen have been up against even after liberalization and reforms. Public borrowings crowded out private investments and inflation was often an easy pawn for policy to trade away. India ended up having a high cost of capital as a result even as end markets for goods got freed up.

CPI (%)	India	China	USA
2001-04	3.9	1.2	2.3
2005-08	6.2	3.5	3.3
2012-14	9.0	2.4	1.7

10Yr G-Sec Yield (%)	India	China	USA
2001-04	7.0	4.4	4.4
2005-08	7.6	3.6	4.3
2012-14	8.3	3.8	2.2

Note: Data as on CY basis, Yields are average for the specified period.
Source: World Bank, Bloomberg, National Bureau of Statistics of China, Spark Fund Research

India presented an interesting middle class and therefore a lucrative end market. In contrast, China presented a bigger end market and whatever said and done, the government made it possible for business to flourish. There were some Trojan horses but when capital was looking to rush in, a red carpet was there.

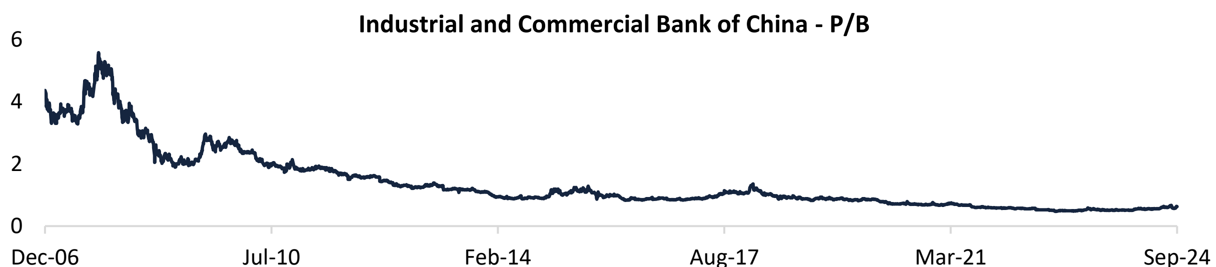
In India, entrepreneurs learnt the hard way the importance of capital allocation during the mess emanating from the Asian crisis and the period of political instability. Further, great examples came about from the IT services sector where the lesson was reinforced as to how markets can reward shareholders and entrepreneurs if they pay attention to capital allocation and corporate governance.

This was followed by a highly sagacious Central Bank and consistently improving market infrastructure/regulations.

The invisible Central Bank Put

India's Central Bank has deftly managed the monetary system in India over the last three decades. Even as government policy has gone through its mini cycles, the RBI remained like a rock at most times. Not just that. Even as the private banks gained share from the PSU banks (note that the foreign banks were not given a level playing field for various reasons), the RBI stepped in to avert accidents which could have tripped the system. Those were the invisible Puts that worked well for the banking system and the best in class navigated this well. Global Trust Bank, Yes Bank, IL&FS and several others failed without causing a systemic meltdown.

On the other hand, Chinese monetary policy broadly worked overtime to act as an extension of governmental push to keep the economy going gangbusters even as risks in the system were building up. For instance, not many people may be aware that Chinese policy set lending targets as a pivot and got interest rates to dance to that tune. This is not what happens in the Anglo-Saxon free markets where the Central Bank uses interest rates as a tool to balance extremes. There was enough exuberance on China's banks as the chart below shows but that has been waning relentlessly.



Source: Bloomberg, Spark Fund Research

The point to note that around 2007, any logic offered against the high valuation of Chinese banks never found favour. You were met with the same disdain with which people questioning steep valuations for India are facing right now. The consequences are visible.

Confluence of positives

More recently, the Indian financial system managed to dodge most bullets when the worst crisis in a century hit the world in the form of Covid. Even against an economic sudden stop that the modern world never knew how to handle, the system did not break down. The policy-making framework in India has also gone through an iterative improvement no doubt. Institutional structures around infrastructure build-out have become robust with time and the government seems to have pressed the right buttons during Covid, the one occasion when Indian policy has scored a one-up.

It stands to reason that India's weight has gone up and Indian market has been rewarded. The problem is that you can't keep rewarding the best boys in class again and again for passing the same exam with flying colours. The market will need more catalysts. It is well-nigh impossible to sustain high growth with everybody enjoying high returns on capital. In China, the high growth was achieved in the backdrop of fierce

competition which benefitted consumers. Producers had to let go of returns on capital to keep pushing the pedal on growth.

In India, the stress signs are visible in the start-up or unlisted world where balance sheet returns have been reserved for life after listing and it is not acceptable to ask questions about this earlier. In public markets, future arrives faster when the tables are turning. Which is why we need to keep comparing with situations such as China, Japan, Nasdaq and whatever is appropriate as a reference benchmark. Such comparisons may be deemed as inappropriate given India's newfound reputation as the sole star in a growth-starved world. One should listen to such selective logic only at one's own peril.

The one point that we need to recognize is that it has seldom been rewarding to be negative on Indian market. What are the caveats against the cautionary note that we are sounding?

Timing

Markets can remain overheated longer than we can afford to keep calling this out. Fundamental analysis involves some level of scenario-building on certain amount of mean reversion. Liquidity can occupy pole position for long periods. It is momentum that will determine the timing of the turn. All we are saying is that a lot of stuff that talks about the great Indian decoupling is a product of positive momentum and that usually does not go on forever. But it can carry on for some more time. We need to be cognizant about this.

Extent

Sizing the extent of excess is also a difficult task. The new mean could well be higher than the existing or old mean. To the extent mean reversion is a factor to consider, it has to be accepted that the new normal may well be a matter of discovery and we need to be aware of this.

However, the more the process gets delayed because of liquidity, collective reinforcement of momentum or policy props, the more difficult the shape of reset will become. Nasdaq had a violent reset which was swift, short and steep. For a while, the market was in denial but when the correction happened, it was a complete clean-up act. On the other hand, Japan refused to read the writing on the wall and suffered from chronic and severe anaemic conditions. China looks going the way of Japan or so it would appear. India could well be entering that phase when choices will be forced upon the market. That is the food for thought we wanted to lay out.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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