THE CHANGING ASIAN LANDSCAPE – PART 2
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NEUBERGER | BERMAN

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Can India Keep Up the Pace?

India has been a focus of investor interest on the back of multiple years of rapid growth, far-reaching reforms, and stable monetary and fiscal policy. The growing global diversification of supply chains has highlighted India's strategic role. In this context, we continue our series on *The Changing Asian Landscape* by interviewing three Neuberger Berman investors on the Indian success story from macro, equity and fixed income perspectives, and where they believe it may go from here.

What would you say are the key factors behind India's recent success?

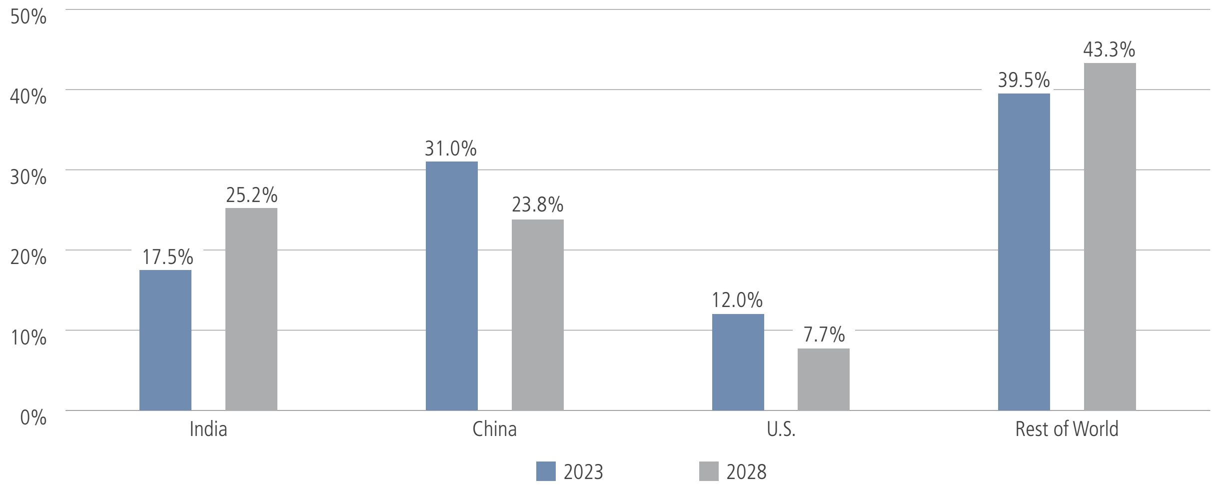
Conrad Saldanha: Over the past decade, the Indian government has executed on a variety of reforms that have had a profound impact on its economy. The government is emphasizing domestic production with its "Make in India" initiative, and is currently providing incentives for establishing local businesses, manufacturing and infrastructure spending. At the same time, a growing need by multinational companies looking to diversify their production base has given impetus to the domestic sector. While many are aware of India's demographic "dividend," with a population skewed toward youth, a subsegment that has greater discretionary income is also developing—including an estimated 100 million people who will have incomes over $10,000 by 2027.[1]

All of this has contributed to India's economic outperformance, with growth above 7% over the past three years and possibly in 2024 as well. Moreover, the pace of growth is widely expected to continue above peers in both developed and emerging markets.

[1]Source: Euromonitor, Goldman Sachs.

INDIA'S RISING ECONOMIC PROFILE

Contribution to Global GDP, 2023 Actual vs. 2028 Estimated



Source: Bloomberg Economics, as of April 2024. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

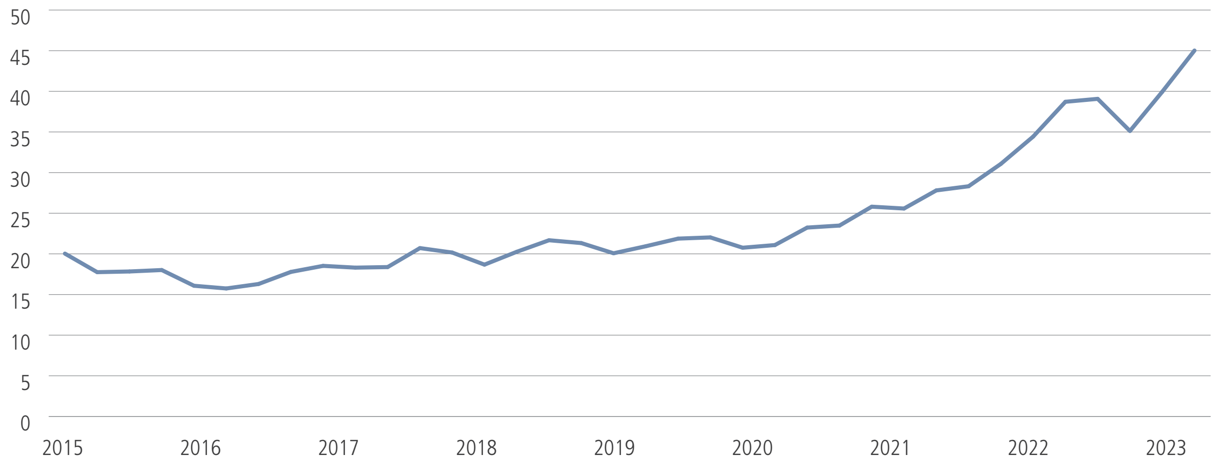
Prashant Singh: The level of change has been impressive. If you go back 10 years, India was infamously part of what were called the "fragile five" economies. External balances of trade were fairly weak, and it was clear that its capital markets and currency had trouble coping with externally driven stresses. As a result, we saw material volatility in Indian assets and periods of constrained and inhibited policymaking.

This has largely been corrected. The current account deficit, which at one time was at 3% to 4%, is now at 1% and could go lower; fiscal balances are on an improving trend; and FX reserves have risen meaningfully.

Looking at the current account, a key reason for improvement has been rising services exports, which have expanded from traditional outsourcing and call centers to include an array of "Global Capability Centres" providing services in areas like IT, business development, engineering and legal support, as well as research and development. Also important moving forward will be gains in onshore manufacturing, which is needed to employ the many young people in India—a demographic advantage as long as you have the job growth to sustain them. Here, we've seen gains in autos, defense and other areas, which is helping to attract investor capital.

SERVICES HAVE BEEN A KEY GROWTH DRIVER…

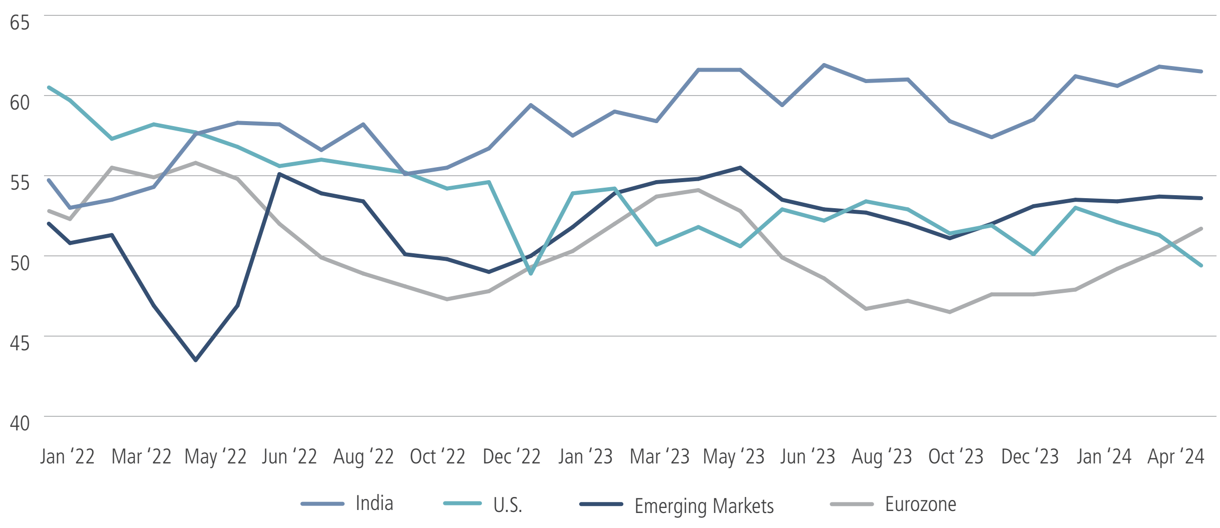
India Services Exports (USD Bn, Quarterly)



Source: CEIC, as of December 31, 2023. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results. **Past performance is no guarantee of future results.**

…BUT WE BELIEVE MANUFACTURING WILL BE CRUCIAL FROM HERE

Manufacturing PMI



Source: HSBC, Markit, ISM, Bloomberg. As of April 30, 2024. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

What reforms, in your view, have made the most difference to the country?

Conrad: In our view, the key reforms have included the digitization of the financial economy with real-time direct transfer payments and widespread banking access (now close to 100%), a harmonized national tax framework and collection, and government incentives for various industries. Fintech reforms specifically have helped to put money directly into the hands of the people who need it and have supported meaningful growth in consumer demand.

Gui Xiong Teo: The Goods and Services Tax put in place in 2017 created one value-added tax system for the whole country, which helped reduce complexity and delays in shipping, and encouraged development across regions. Also important was the Insolvency Bankruptcy Code (IBC). Not too long ago, India would go through frequent boom/bust cycles; the IBC, a framework to help the banks restructure bad debt, facilitated the transfer of assets to companies better able to manage them, which has helped banks to generate more liquidity for economic use.

Prashant: We have also seen the fiscal picture show real improvement, with the government willing to put fiscal discipline first and shy away from short-term populist measures. That has instilled a level of confidence regarding what's happening in India, which has been evident in reduced market volatility.

Inflation remains under control despite elevated growth rates—likely in part due to that growth being driven by investment rather than wages, which have lagged in rural areas. Moreover, work on infrastructure—the importance of which cannot be overstated—has certainly improved productivity, which may have also increased the potential neutral growth rate for the economy overall.

Do you believe growth is being supported by shifting economic relationships?

Conrad: Growth is coming from across the Indian economy. In our view, it is secular rather than cyclical in nature, supported by the reforms and infrastructure investments that we've discussed, as well as trends in global manufacturing supply chains that favor India. The country has navigated the current geopolitical situation well, maintaining good relations with both Russia and the West, while offering a strong domestic market, democratic framework and legal process that are conducive to long-term foreign direct investment.

The focus on domestic manufacturing has multiple benefits apart from "friendshoring"; the transition from being a net importer to net exporter of consumed products like electronics has had a big fundamental impact on the balance of payments and should support the rupee longer-term.

Prashant: Companies are increasingly diversifying operations to protect themselves from geopolitical and other risks. The "China-plus-one" trend has helped regional neighbors including Japan, Vietnam and India, which is taking full advantage by attracting foreign companies with tax breaks tied to production output—popularly known as the Production-Linked Incentive schemes. Obviously, no one likes tensions, which tend to divert resources from productive to nonproductive (i.e., defense) purposes. But they also can enhance cooperation among blocks of countries, which can improve economic dynamics.

Tell us about the fixed income space, particularly in sovereign debt.

Prashant: India does not issue dollar-denominated sovereign debt, given policymakers' relatively conservative bent and their worries about the potential for external pressures. However, on the local side, yields are reasonably attractive on a risk-adjusted basis, with the 10-year bond yield in excess of 7%. The market is very liquid, with an array of local institutions that trade bonds and a deep menu of derivatives to achieve portfolio goals. That said, although we see currency risk as relatively low given sound economic fundamentals, for those who wish to hedge out that risk, yields become less appealing. Tax rates are also an issue, and can be fairly punitive unless the investor fits under one of various tax treaties. In sum, investing in Indian sovereign bonds is doable, but can be complex.

India local bonds are set to become part of the JPMorgan BGI-EM Global Index. Do you anticipate any potential market impact?

Prashant: We view the addition of India to this index and others as a moderate positive for the local market. The timing will be gradual in the case of JPMorgan, with the India weight increasing over 10 months until the country represents 10% of the index by March 2025. In terms of investor composition, the sovereign market will remain dominated by local investors, with foreign representation of about 3 – 3.5% when the process is complete.

The transition has been widely signaled, with the investment community and the Reserve Bank of India being well prepared for what we expect to be $25 billion to $27 billion in additional flows, much of which may be already priced into the currency and bond markets. (The central bank will likely be a primary seller in addressing the new demand.) That said, the inclusion has symbolic benefit, solidifying India's presence among global indices, and should reinforce the degree of discipline that Indian issuers have already achieved.

How about on the corporate side? What sectors do you find appealing?

Gui Xiong: We are looking closely at renewable energy, where India's commitment and ability to execute are among the best in Asia. In our estimate, about $100 billion to $110 billion in capital alone will be needed to help achieve the country's 500-gigawatt clean energy installation capacity target for 2030. And substantially more capital investment is required to develop an array of emerging industries across the value chain, including solar components, more sophisticated grid equipment, hydrogen production, carbon capture and other areas.

More broadly, infrastructure has great potential. A key foundation of India's manufacturing ambitions is effective infrastructure, which in the past made large-scale transportation of goods across the country very challenging. The government has been spending big money on roads, airports, electricity, logistics and ports, and so there's been growing issuance from companies that are active in these areas. Importantly, credit quality has improved in a regulatory environment that is highly focused on protecting investors.

Unlike in the sovereign space, companies do issue foreign currency-denominated debt, but issuance from the high yield sector tends to be constrained due to the central bank's restrictions on issuance yield (no more than the U.S. floating benchmark plus 400 – 500 basis points) and tenor (seven-year minimum). However, given the country's growing investment needs for private sector capital, we believe high-quality foreign currency issuance from the corporate sector will continue to grow substantially in the coming years.

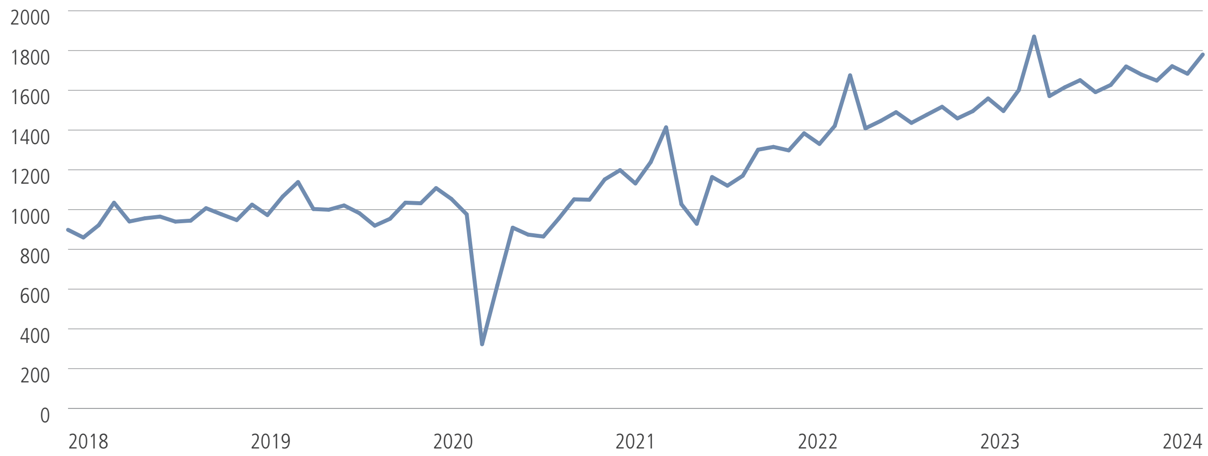
In equities, where are you seeing opportunity?

Conrad: It's worth noting the depth and breadth of the Indian equity market, which has close to 5,000 names in the small-cap space alone, most of which are under-researched. The result is a universe that affords extensive opportunity for fundamental research and stock-picking. Overall, we think the positive economic backdrop has many beneficiaries across the industrial, consumer, health care and financial sectors. The country has a variety of lenders from national private sector lenders that serve urban businesses throughout the country to regional housing and auto finance companies. We are currently circumspect on select consumer products and services subsectors where growth has been anemic and we find valuations rich. However, global competitive dynamics could benefit Indian consumer electronics manufacturing as multinational companies expand production outside of China.

In a recent trip to India, I saw exceptional interest on the part of the diverse group of foreign investors visiting from the West and East Asia, who were evaluating direct, private and public equity opportunities. This is in addition to local investors, who have continued to add to their equity exposures with an average of $2 billion pouring into the market every month. Overall, it's a very positive picture for the long-term health of the Indian equity market and economy.

TAX RECEIPTS POINT TO CONTINUED CONSUMER DEMAND

GST Revenues in Rupees



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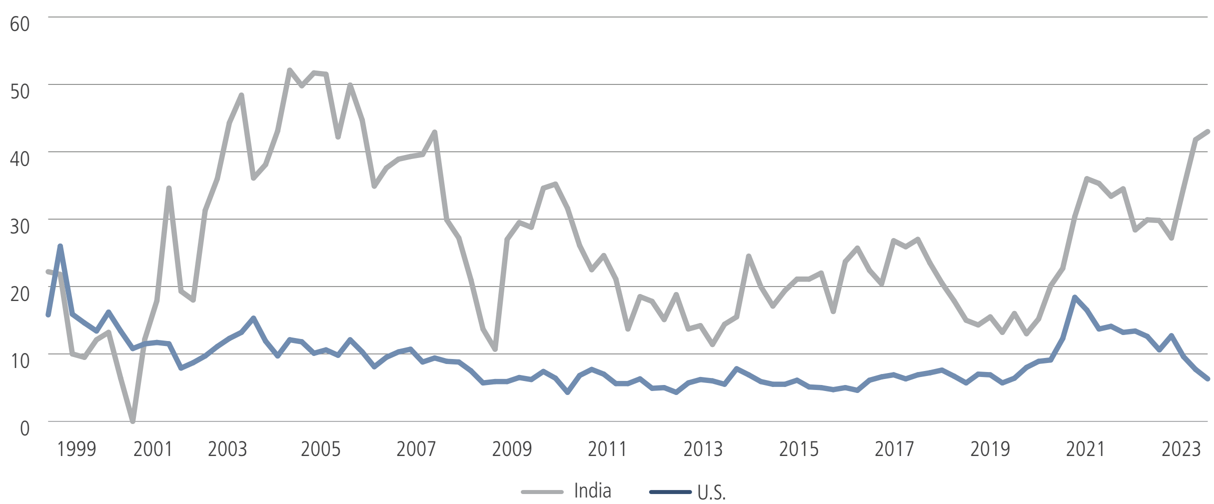
PREMIUM ON SECURITY SELECTION

Percentage of Stocks With No Sell-Side Coverage



Source: FactSet, Jefferies, as of December 31, 2023. Nothing herein constitutes a prediction or projection of future events or future market behavior. Historical trends do not imply, forecast or guarantee future results. Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed or any historical results. Investing entails risks, including possible loss of principal.. **Past performance is no guarantee of future results.**

How do you assess current political dynamics in India?

Conrad: Politics tend to drive volatility, although they have provided opportunity to buy into what we consider one of the best fundamental opportunities globally. With the incumbent party, the BJP, heavily favored in the current election, we anticipate that Prime Minister Naredra Modi will likely be afforded another five-year term. Moreover, we see a continuation of supportive government investment and a benign regulatory backdrop. One early positive signal was that the recent interim government budget did not include populist spending measures designed to win favor with voters. If the government can stay disciplined with its spending rules, that should help its credibility with foreign investors, who would have less fear of a depreciating rupee that might dent returns in hard currencies.

What other risks do you see?

Conrad: While government spending on infrastructure is helpful, the risk is that those investments cannot be scaled up with yields and costs that are competitive with China—making execution very important. Also, a broad swath of consumers—poorer, younger and more rural-based—are seeing a bigger toll from inflation on their disposable income. While the immediate shortcoming is reduced consumption, there could be longer-term consequences in terms of social stability and risks to growth expectations. Also, a strong showing by the BJP carries risk of the country becoming more nationalistic and marginalizing its minorities.

As for specific sectors, we think it's important to look past glowing projections and be realistic about what can be achieved. For example, IT services companies face various headwinds at the moment, given a slower global growth environment and the focus in technology toward artificial intelligence.

Prashant: From a tactical perspective, the investor consensus on India is currently *very* positive. So, there are a lot of bets in the same direction, which could lead to disappointment if we see weaker growth or other shocks to the system—and it calls for a degree of caution in investment approach.

More strategically, many of the positives we've discussed are built upon the reforms that took place in recent years. Therefore, a key risk for us is any break in policy continuity—whether based on politics or other reasons. India still has a long way to go toward achieving the kind of stability that an economy of its size should have. Signs are good, but no one should be complacent.

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