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ON THE DRAGON'S TAIL:

Will India become the next China?

April 2015

China's economic dominance and rapid growth over the past decade has made it easy to overlook the potential opportunities in other emerging Asian powers like India. While India's growth has been undermined by hurdles like the lack of infrastructure spending and multiple levels of bureaucracy in the past, new reforms may be the catalyst India needs.

Duncan Robertson, Portfolio Manager, and Mike Jennings, Investment Director from TT International Ltd consider the opportunities these reforms may offer when balanced with the young Indian population, supportive markets and foreign investment. You can access TT International via the Advance Asian Shares Multi-Blend Fund and Advance Diversified Multi-Blend Funds.

Growth engines: the dragon and the elephant

The past growth of China and India has been reliant on differing drivers.

> China has been driven by infrastructure investment with the substantial tailwind of huge government spending.

> India has relied on growth through consumer spending.

Both countries are approaching a switch in growth drivers. China is encouraging its burgeoning middle-class to spend and move away from investment, while India's business-friendly government elected in 2014 is driving investment.

The struggle to rise

India's growth has been hampered by a number of factors.

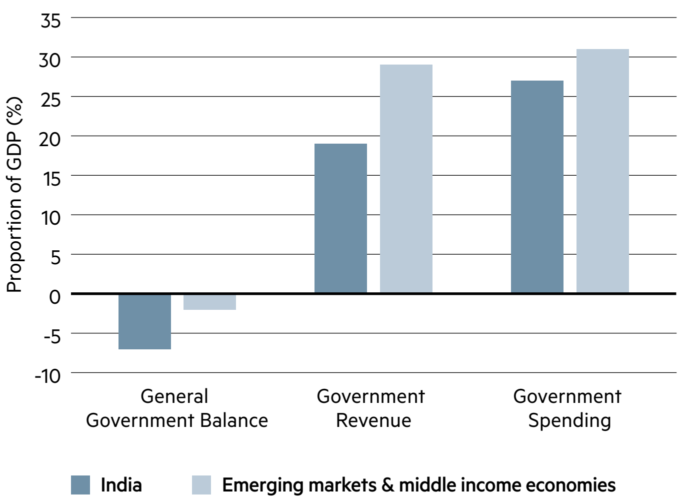
> **Lack of infrastructure spending:** existing infrastructure has been unable to cope with the volume of passengers, let alone freight traffic, which has discouraged foreign firms.

> **Inefficient labour markets:** India's labour laws are amongst the most rigid in the world and make restructuring extremely difficult. This has meant a sharp rise in contract labourers to the detriment of the broader labour force.

> **Excessive levels of bureaucracy:** the difficulty of managing the layers of bureaucracy has discouraged foreign investment.

These factors have resulted in a slowdown in India's rate of economic growth, as well as increasing the fiscal deficit. India's fiscal position compared to other emerging economies is shown below. The deficit has been exacerbated by a subsidisation culture. The effective tax rate after subsidies has meant government revenue is well below that of other emerging countries leaving little money to spend on reform.

Indian fiscal position versus emerging economies (% of GDP)



Source: CLSA, IMF

Changes in India: Modi magic

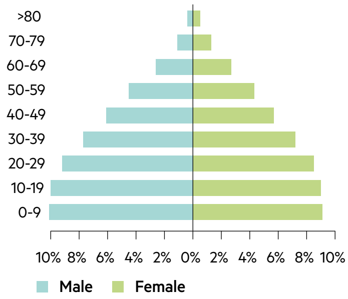
In 2014, Prime Minister Narendra Modi won a landslide victory and has since been a strong advocate of reform. His government has been responsible for a number of promising initiatives for India's growth.

- Tax reforms to boost government revenue and encourage foreign investment.
  - A reduction in fuel subsidies while oil prices have been low. Previously, fuel subsidies cost India $34bn, over 1% of GDP.
  - Removal of the wealth tax to be replaced with a 2% surcharge on the "super-rich".
  - Reduction of the corporate rate tax from 30% to 25% over four years.
  - Introduction of a Goods and Services Tax from April 2016.
- Labour market reforms in Rajasthan (India's largest state by area) which have allowed foreign multi-nationals to flourish.
  - Trade unions require larger membership before being perceived as representative of the workforce.
  - The definition of "factory" has increased from 10 people to 20 (reducing the regulatory burden on many small businesses).
  - Rajasthan's economic growth target is 12% which is being held as a model for other regions in India.
- Investment in infrastructure for greater efficiencies in speed and reliability both for citizens and foreign companies.
  - Indian railways carry 21 million passengers daily and 1 billion tonnes of freight are transported annually. That said, the infrastructure is unable to cope with the volume.
  - The government has promised to invest $137 billion over the next five years in its railway infrastructure for a 20% increase in track length and a dedicated freight corridor with the five year target of 30 million passengers to be transported daily and 1.5 billion tonnes of freight annually.

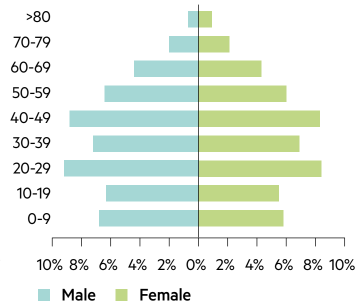
These reforms are expected to offer a boost for the domestic population but also encourage foreign investment, a crucial support to the government in developing a thriving business community, along with the opportunity to continue to enhance infrastructure in India.

India's opportunity for strong growth like China comes from the combination of these reforms with a young population compared to others, including China.

Indian 2014 population



Chinese 2014 population



Source: United Nations and Citigroup

A large and upcoming young population offers a large productive base which can in turn offer a surge in productivity and hyper-competition (source: RichesFlores Research). Considering an environment which is actively investing in infrastructure and increasingly encouraging for foreign investment, there is a great opportunity for India to thrive and grow going forward.

The new dawn of India

From an economic perspective, in the medium term, India's efforts to reform and grow are also supported by a collapsing oil price, strengthening economic data, lower inflation and lower interest rates. The combination of reforms and a strengthening economy may also insulate India from the risks to markets posed by a strong US dollar environment and likely US interest rate rises in the coming years.

Investors should be aware though that it may be a long process for India to generate the strong growth and success seen in China. Indian GDP per capita is only approximately 20% of that in China (and 3% of that in the US) but the reforms offer great potential for India longer term. Given the potential for growth, TT International is overweight in its strategic allocation to India, as well as China and Indonesia, which continue to implement market-friendly reforms.

Advance's monitoring has identified a number of opportunities in Asia for above-normal growth, particularly in countries like India, China and Indonesia. As a result, the exposure to Asian markets in the Advance Diversified Multi-Blend Funds was enhanced across the asset classes and increased in November 2014.

For more information on exposure to India in the Advance portfolios, please speak to your adviser.

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