cio investment club

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China versus India: The Investment Case

The direction of travel for UK defined benefit (DB) schemes is towards safety. Investment strategies increasingly reflect a desire to get to the 'end game' with higher allocation to fixed income as trustees eye possible buy out opportunities with insurers.

Yet this flight to safety is not universal, and there are plenty of investors with an enthusiasm for risk, which includes increasing allocations to emerging market equities.

Russell Investments' UK Defined Benefit Market Insights[1] study published this May reveals a "small but growing appetite to re-risk into growth assets" with 15% of 115 DB schemes with over £270 billion in assets under management expecting to increase their allocations to emerging markets, up from 7% last year.

By way of example, the £40.3 billion Border to Coast Pensions Partnership launched a new £700m Emerging Markets Equity Alpha Fund last August which builds on the local authority's existing £1.2bn Emerging Market Equity Fund.

Two countries that are often central to emerging market strategies are China and India, boasting the largest populations in the world and, according to the latest figures from the IMF[2], offering real GDP growth rates of 4.6% and 6.8% respectively.

But where once China was the darling of emerging market funds, it is gradually being superseded by its Asian neighbour India, which in addition to offering higher growth rates, offers additional attributes that make for a compelling investment case.

Chulantha De Silva, client portfolio manager at GQG Partners, says: "We believe years of political stability in India have translated into a vibrant economy which is the fastest growing among large global economies. The country is benefiting from moderate inflation, positive real interest rates, and debt-to-GDP levels that are lower than those of many developed market countries."

Meanwhile China faces some significant challenges in terms of its demographics and some economists have pointed out that perhaps the country is getting old before getting rich.

Anthony Corrigan, a member of Vontobel's mtx Sustainable Leaders investment team: "China's beleaguered property market has prompted many to compare its situation to that of Japan in the 1990s. In comparison, many see India as the rising star in the world of emerging markets."

[1] https://russellinvestments.com/uk/insights/db-research

[2] https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD

Election impact

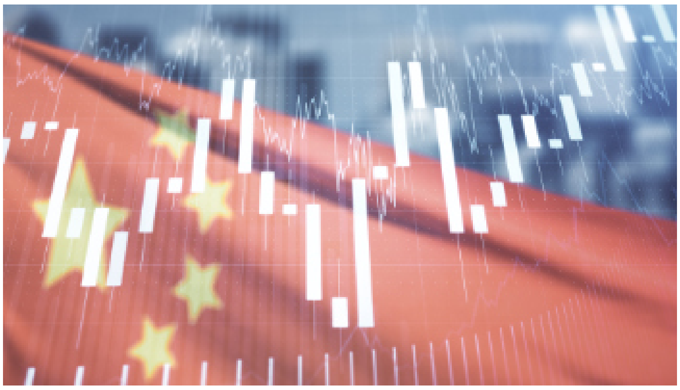
India's surprise election result this June, which saw incumbent prime minster Narendra Modi lose his majority having been widely expected to enjoy a landslide result, has created some uncertainty for the country however.

The Bharatiya Janata Party's failure to win an absolute majority for the first time in 10 years sent markets falling after a long bull market for Indian equities, leaving some fund managers questioning what this means for India.

De Silva says: "While the election upset undoubtedly created short-term market volatility, in our opinion, given the structural nature of the reforms over the last decade, even prior to Modi, and the progress that has been achieved in recent years, even this may not be a catastrophic event."

Ramiz Chelat, portfolio manager, Vontobel Quality Growth, says the big question mark for the country following the shock result is whether there will be a change in the broad push on infrastructure.

"We think that while there could be some marginal change, such as a certain amount of government expenditure directed towards subsidies, the broad momentum for infrastructure will continue. Coalition partners such as Nitish Kumar are also broadly supportive of infrastructure. We are seeing this as an opportunity for certain names that have pulled back on the election result," Chelat says.



Expensive equities

Moving from the macro to the stock level view, according to Catherine Yeung, Asian equities investment director for Fidelity International, historically, India has tended to be "one of the more expensive markets in Asia, with its valuation premium increasing versus the rest of region more recently. Notably, the small-cap index in India is now around 40% more expensive than Asian small-caps and 30% more expensive versus Indian large-caps".

The onus on investors then is to find what Raheel Altaf, manager of the Artemis SmartGARP Global Emerging Markets Fund, who invests 10.1% of his portfolio in India, calls "growth at a reasonable price".

However, he adds: "You have to look quite hard for that in India. You have to be very selective when you are buying Indian stocks; you want to tap into the growth story, but not pay too much to do so."

Driving this surge in Indian equity prices is a booming economy and growing consumer strength. At the same time, the strict capital flight restrictions rules in the country mean Indians have been largely forced to invest domestically.

This leads Altaf to observe that there are better-priced opportunities elsewhere in the emerging markets including China where he says "the gloom story has been oversold".

De Silva says the secret to investment success in India is to "delve deeper into the market" to identify what he believes are "very attractive investment opportunities across a variety of sectors".

"India is investing heavily in infrastructure as it positions its economy to become an alternative to China. We find appealing prospects in several sectors that have historically not fared well in India, such as energy, materials, utilities, and housing. In our opinion, there are companies with exceptional growth potential that are available at reasonable valuations."

Geopolitical tension

But what of China where, as Altaf notes, gloom stories may have been overblown.

Despite ongoing geopolitical tensions with the US and evidence that companies are diversifying their supply chains out of the country, according to the Kearny FDI Confidence Index 2024[3], China has jumped from seventh position to third most attractive destination for foreign investment.

De Silva says: “GDP growth does not always directly translate into stock market performance. However, the recent data has been more positive than expected, despite the relatively moderate stimulus measures. The economic data has not only stabilised to some extent, but there is also evidence that the government's heavy-handedness has softened.”

However, De Silva adds: “It is clear that China is not yet out of the woods; the country is still dealing with a significant property bubble, overcapacity in many industries, and increasing tariffs from both the US and Europe. Despite these challenges, we view the collective data as trending positively. Consequently, while we remain underweight relative to our benchmark, it is to a lesser extent.”

Also working in China’s favour is price to earnings ratio versus that of Indian stocks.

Vontobel’s Corrigan says investors “need to be very mindful of current valuations”, noting that based on figures from Factset as at 17 May 2024, India is trading at a P/E of 20.7x based on 2024 earnings, which is significantly higher than China which is trading at a P/E of 9.1x.

“It is important to note that earnings per share growth for India and China is predicted to be similar in 2024 – 15% in India versus 13% in China. Meanwhile China is predicted to grow earnings faster than India in 2025 – 12% in China versus 8% in India. In addition, Chinese companies can be incredibly profitable and innovative. This combination profitability, innovation and valuation makes China an attractive market for active stock pickers.”

[3] https://www.kearney.com/service/global-business-policy-council/foreign-direct-investment-confidence-index

The right mix

Taking into account the mixed picture for both China and India, the old adage of not putting all your eggs in one basket clearly applies to investing in the two emerging markets.

Border to Coast for example invests two-thirds of its latest fund on emerging markets ex-China equity mandates, whilst the remaining third will be concentrated on China equity mandates.

Corrigan says: "We believe there is a place for both China and India in a well-diversified global EM portfolio. The Vontobel mtx team have employs a bottom-up investment process that seeks to invest in companies that are industry leaders, have high levels of profitability, address their environmental, social and governance risks prudently and importantly where we can identify upside in terms of valuation. This last point regarding valuation is critical as we believe this is what ultimately drives our alpha over the long term."

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