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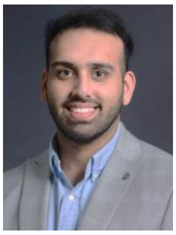
Marketing Material

# Investing in India: Bridging the allocation gap with passive market access



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## IN A NUTSHELL

— In the June 2024 index rebalancing, J.P. Morgan incorporated Indian government debt into its largest emerging-market bond index, the J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM).

— This development alters market dynamics, index compositions and renews global investors' interest in both equity and fixed income markets in India.

— The inclusion could potentially amplify global investment in Indian debt by an estimated $20 to $40 billion as emerging market investors recalibrate their portfolios.

— Portfolio considerations for India extend beyond mere tracking error considerations, as India offers attractive risk-return characteristics.

— ETF flows towards India are evolving and benchmark aligned market access may serve as a valuable tool to bridge the emerging allocation gap.

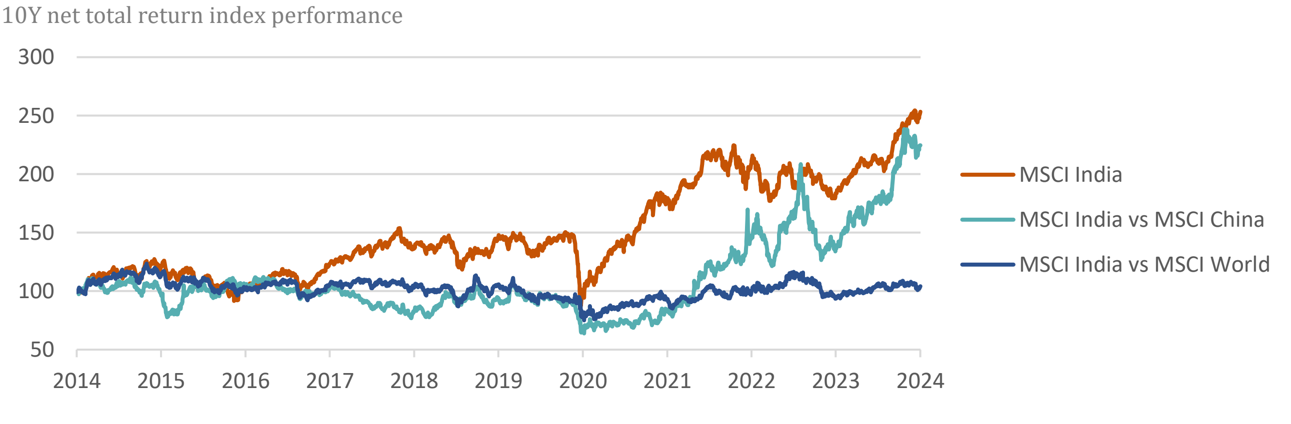
# 1 / The India story: A poorly kept secret

The macroeconomic investment case for India is becoming increasingly compelling, as a recent DWS CIO View publication outlined in detail.[1] A decade ago, India was part of the "fragile five", but it has since transformed into a favoured destination for Emerging Market investors. India's demographic advantages are well recognized, stemming from a combination of the world's second-largest labour force, with approximately 694 million people (second only to China), and a relatively young population with a median age below 30. This "demographic dividend" could provide a significant boost to what is already the world's most populous country.[2] The Indian government's capital expenditure strategy, growing exports, and the partial liberalization of the bond market are fuelling robust momentum for markets.

Especially India's strategic focus on digitalization continues to impact key sectors. Service exports have seen a surge and now cover an array of high-tech services, R&D, analytics, robotic process automation and cloud computing. These reflect 4.5% of global services exports, a significant leap compared to goods exports, which constitute 1.8% of global goods exports. The so-called Global Capability Centers play a pivotal driver of this robust rise in service exports. They have evolved from offering simple call, IT, and back-office services for multinational corporations to providing research and development, process automation, machine learning, and cloud computing.[3]

On the macro risk side, India's reliance on oil is declining. While oil remains the key source of energy, efforts are ongoing to diversify its energy sources and enhance energy efficiency. With approximately 85% of India's oil consumption needs being met through imports, oil however is still the country's major import. Meanwhile, fiscal policy has become more prudent, and overall rising exports support the improvement in the current account. This positive economic trajectory has not gone unnoticed. In May 2024 S&P Global signalled that it might upgrade India's credit rating over the intermediate term. For now, the outlook on India has been revised to positive from stable, and the investment grade rating at BBB- has been affirmed.[4]

Figure 1: India vs. China return comparison




Source: DWS GmbH, Bloomberg as of June 2024. Past performance, actual or simulated, is not a reliable indicator of future results

[1] See the CIO View publication India – a poorly kept secret for more details
[2] Source: UN DESA Policy Brief No. 153: India overtakes China as the world's most populous country | Department of Economic and Social Affairs
[3] Source: DWS Macro Research, Reserve Bank of India - RBI Bulletin What Drives India's Services Exports?, June 2024
[4] Source: India Outlook Revised To Positive On Robust Growth | S&P Global Ratings (spglobal.com)

# 2 / Changing market realities: China + 1

Unlike some other Emerging Markets, India's equity market performance has historically been closely associated with its economic performance, posting 30-year returns in line with the MSCI World Index, and outperforming the MSCI EM Index over the same timeframe by about 3 percentage points per year in USD terms. On shorter horizons, the performance differences appear even more significant; over the past three years the MSCI India Index has seen a gain of close to 40%, while the MSCI EM Index has lost 15%, mostly driven by the MSCI China Index which lost more than 45% in USD terms.[5]

This shift already impacts allocation realities. An investor benchmarking against the MSCI EM index will now find that almost 20% of their allocation is in India, trailing China by only about 8 percentage points. This is a significant change over index weights in late 2020, when Chinese stocks made up nearly half (43%) of the EM index, while India comprised only 8%, a gap of 35 percentage points.[6] This serves as a powerful reminder that broad-based benchmark investing allows investors to participate in changing long-term trends. More importantly, India is emerging as the second country, after China, that investors may wish to manage on a stand-alone basis.

When it comes to implementation, investors can take advantage of a straightforward index landscape. The Nifty 50 and MSCI India indices are broadly aligned and relatively tied to domestic consumption. The MSCI India Index, as any MSCI large and mid-cap index, represents 85% of India's total market capitalisation. The Nifty 50 offers similar exposure to financials (34%) and IT (12%) but is slightly more top-heavy, with the top ten holdings representing about 56% of the index's value, compared to just below 35% for MSCI India. While Indian investors may be focused on the Nifty, foreign investors often benchmark to indices created and maintained by MSCI, which include an adjustment for foreign ownership room. The slightly broader coverage of MSCI has historically allowed the index to outperform by about 30bps per annum since 1999.[7]

Table 1: India index comparison

| | MSCI India | Nifty 50 | MSCI EM |
|---|---|---|---|
| **Number of constituents** | 146 | 50 | 1,335 |
| **Top 10 total weight** | 34.72% | 56.16% | 26.39% |
| **Diversity (top three sectors)** | Top three sectors: 48.61%<br><br>Financials 24.79%<br>Cons. Dis. 13.21%<br>Info. Tech. 10.61%<br>Other 51.39% | Top three sectors: 59.30%<br><br>Financials 34.69%<br>Info. Tech. 12.48%<br>Energy 12.14%<br>Other 40.70% | Top three sectors: 59.39%<br><br>Info. Tech. 25.22%<br>Financials 21.75%<br>Cons. Dis. 12.43%<br>Other 40.61% |

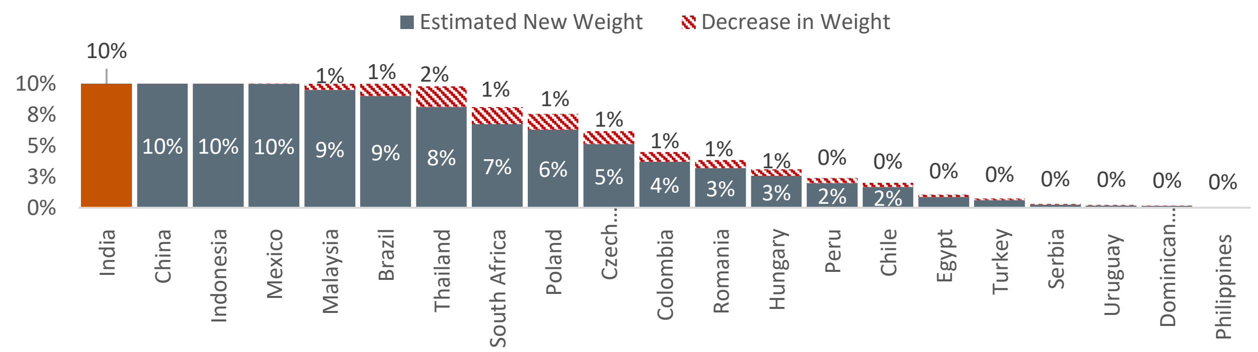
Source: DWS International GmbH, Aladdin BRS, as of 23/06/2024.

[5] Source: Bloomberg, based on net total return indices, 07/1994 – 07/2024 and 05/2021 – 05/2024, respectively. Past performance, actual or simulated, is not a reliable indication of future performance.
[6] Source: DWS, MSCI, June 2024
[7] Source: Bloomberg, June 2024

# 3 / Portfolio representation: An allocation gap?

Given the established and growing role of India in EM equity indices, foreign ownership of the Indian market is well established and currently stands at about 18%[8]. Looking beyond Equities however, the representation of India in portfolios is scarce. With a mere 1% foreign ownership[9], the Indian bond market is significantly under-owned by international investors. The inclusion of Indian Fully Accessible Route government bonds into J.P. Morgan's flagship local government bond indices may change these market dynamics fundamentally. 35 bonds with a combined notional value of about $450 billion have now become eligible and will be phased in over the next ten months at roughly 1% weight per month, up to a maximum weight of 10%. This inclusion is estimated to translate into an influx of foreign capital of over $20 billion. If the inclusion of China into fixed income benchmarks from 2019 onwards, which attracted over $250 billion in foreign portfolio investment, serves as any guide, this might just be the beginning[10]. In the longer term, India may be included in other major benchmarks.

Figure 2: Projected EM index comparison




Source: J.P. Morgan estimates, using index composition as of December 2023 for illustrative purposes only

India will transform the face of the index, with 10% being allocated to a country with investment grade rating and yielding close to 7% on its 10-year debt, which lies above the index average. While this closes a representation gap, with INR bonds formerly excluded from all major global fixed income indices, this might open an allocation gap for investors. Benchmarked EM investors may face a growing tracking error risk, especially towards the later stages of the inclusion. The most common implementation concerns for investors are operational hurdles, which has been the reason the India inclusion did not take place earlier. This may render ETFs a suitable tool to fill allocation gaps.

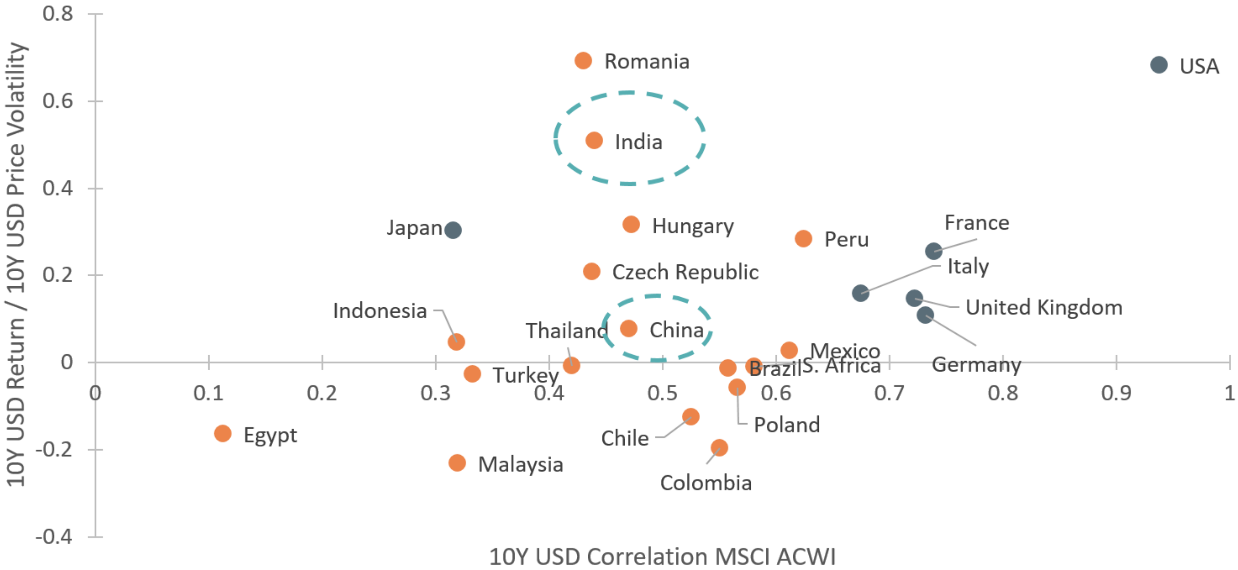
The incentives of allocating to India however extend beyond tracking risk mitigation. Historically, investors have benefited from a distinct risk-reward profile that mirrors India's increasing independence from broader EM developments. As depicted in Figure 3, India can be viewed as both a source of returns and a means of diversification for equities and fixed income portfolios. The prerequisites for a continuation of this trend may already be in place. In the equities market, expectations of double-digit earnings growth and a unique sector composition render India a distinctive allocation option. For fixed income investors, high levels of yields and their potential longer-term decline provide the basis of the investment case[11]. Provided that currency headwinds remain moderate and interest rate cycles continue to diverge from developed countries, India may serve as a robust diversification strategy considering overall rising developed sovereign allocations.

[8] Source: National Stock Exchange of India "India Inc. Ownership Tracker", Reserve Bank of India, as of April 2024. t
[9] Source: Reserve Bank of India as of April 2024
[10] Source: DWS International GmbH, J.P. Morgan estimates as of April 2024. China data is inclusive of all local currency bonds including CGBS, FBs and NCDs
[11] Source: DWS International GmbH, Bloomberg as of April 2024
Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

## Figure 3: India historic risk and return characteristics

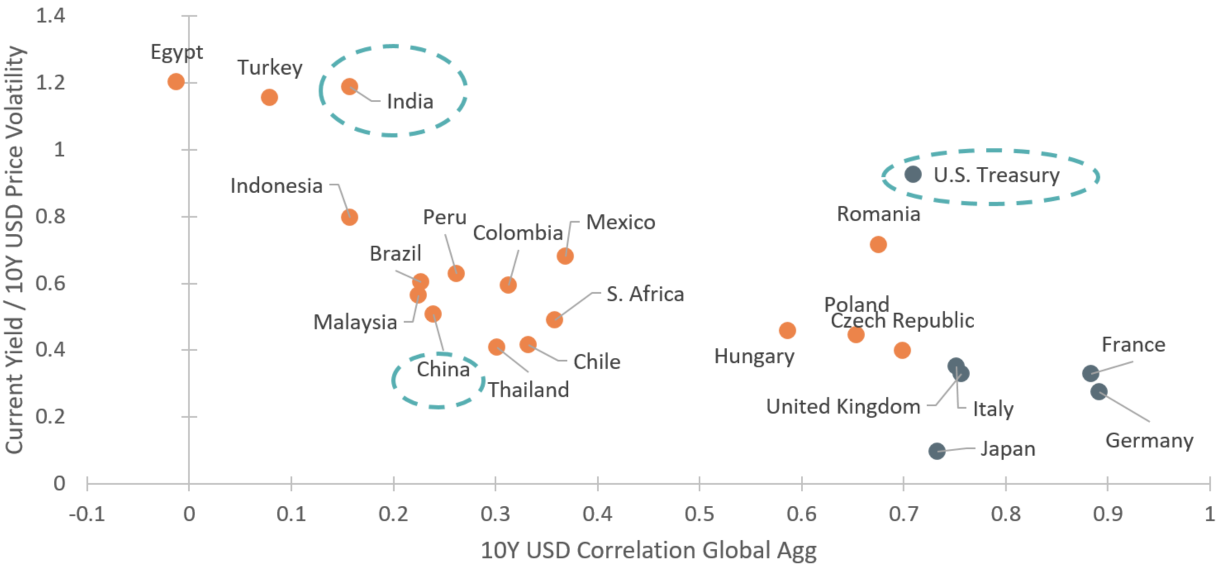
Equities: 10Y USD risk-adjusted return and correlation with Global Equities

Based on MSCI Large & Mid Cap indices




Fixed income: 10Y Risk-adjusted yield and correlation with Global Bonds

Based on Bloomberg EM Local Bond index components




Source: Bloomberg, DWS International GmbH, Past performance, actual or simulated, is not a reliable indicator of future results. April 2024.

## Disclaimer



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