



Global Investing: Can Indian Equities continue outperforming over the next decade?



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September 23, 2024

I recently visited India and the city of Mumbai, where I spent 18 formative years. Over the past seven years, my frequent visits to India have allowed me to observe the country's transformation and evolving economic engine closely.

Each visit offers a nostalgic trip down memory lane and a firsthand glimpse of India's rise as an economic powerhouse. Much has been written about the tremendous opportunities for global investors in today's fastest-growing large economy. After sensing widespread optimism about India's future, I wanted to offer a balanced macro perspective on the factors that will likely drive India's equity market performance over the next decade.

The Current State of the Indian Economy and Capital Markets¹

¹ Statistics from Wikipedia regarding size and composition of India's economy



India's economy is currently the fifth largest in nominal terms, with an estimated 2024 GDP of \$3.95 trillion. India's impressive growth rate – 8.3% in 2023 and an estimated 7% in 2024 – leads the world's major economies. With 70% of GDP driven by consumption, India is the fourth largest consumer market in the world after the United States, the EU, and China. These are impressive numbers, albeit for a relatively small base. India also has a world-leading population of 1.4 billion people and a per-capita income of about \$3,000, well below the global average of \$13,000.

Several other facts offer more context. India evolved from an agrarian economy to a services-oriented economy without a significant manufacturing sector. The fastest-growing sector – the Indian service sector – accounts for more than 50% of GDP, while the industrial and agricultural sectors employ most of the labor force. India's rural population comprises 65% of the total population and about 50% of India's GDP.

The Bombay Stock Exchange and National Stock Exchange are some of the world's largest stock exchanges by market capitalization. Over the long run, India's stock market performance is comparable to that of the United States, the world's largest equity market. This is particularly impressive because most investors consider the past two decades a period of US economic and capital markets exceptionalism.

Benchmark Returns	1 year	5 years	10 years	20 years
MSCI USA	28%	15.1%	12.8%	10.3%
MSCI Europe	20%	9%	5.6%	6.6%
MSCI Emerging Markets IMI	15%	5.1%	3.1%	8%
MSCI India	36%	17.6%	9.7%	12%

As of Sept 17, 2024, Source: MSCI, Bloomberg, Gross Annualized Returns

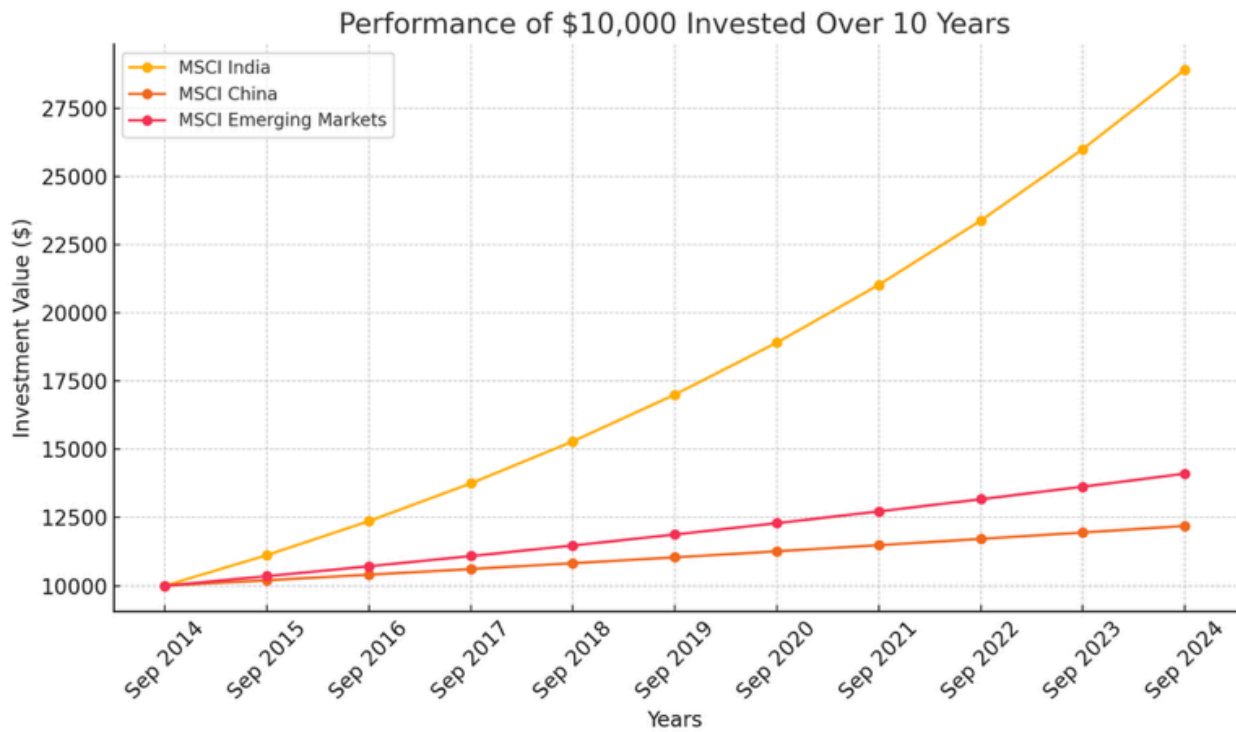
Equally impressive is that the volatility of Indian equity returns, as measured over the past ten years, is comparable to broader emerging and developed markets, indicating consistent relative outperformance on a risk-adjusted basis.



Volatility	India	US	Europe	Emerging Markets
10-year annualized	15.91%	15.48%	16.78%	14.91%

Source: MSCI as of August 30, 2024

Indian equities have also significantly outperformed Chinese equities over the past ten years, even though India’s economy is 1/4th the size of China’s economy. This performance gap partially stems from China’s economic uncertainty, regulatory changes, and global trade tensions. However, a big reason for this relative outperformance is the Indian economy’s tailwinds over the past decade.



Source: BlackRock, Bloomberg

Tailwinds



Three key factors have supported the outperformance of Indian equities. Barring a fundamental change in governmental policy or prolonged global recession, these factors will likely contribute to the growth of India's capital markets in the coming decade.

1. Robust Economic Growth: India has maintained a high GDP growth rate compared to other emerging and developed markets. A young and growing population, an expanding middle class, and increased consumer spending have driven domestic demand. Economic growth in India has raised living standards for millions and fueled the expansion of the country's capital markets. Traditionally, India has been a nation of savers, with annual savings amounting to approximately 20% of GDP². At current GDP levels, this equates to around \$800 billion in savings yearly, roughly half directed into banking and capital markets. Of this, about \$200 billion is invested by Indian residents in domestic capital markets yearly. As India's GDP continues to grow, this figure is expected to rise, further strengthening the capital markets and enhancing their appeal to international investors.

India has attracted significant foreign direct investment (FDI) and portfolio investments, especially in technology, telecommunications, and pharmaceuticals. The government's efforts to improve the ease of doing business and implement structural reforms have made India a more attractive destination for global capital.

Key economic reforms – such as implementing the Goods and Services Tax (GST), digitalization through initiatives like "Digital India," and efforts to formalize the economy-- have bolstered market sentiment. Additionally, policies to improve infrastructure and rural development have provided growth momentum.

2. Tech Sector Growth³

India's booming tech sector, including its rapidly growing business outsourcing services (BPO) industry, has significantly bolstered stock market performance. The BPO industry has remained the world's premier destination for outsourcing everything, from R&D to finance, marketing,

² CFA Society of India, Wealth Management Conference, Aug 2024

³ The Rise of the Indian Elite, Asia Society, Saurabh Mukherjea, July 2024



sales, customer services, and human resources operations. Assuming the addressable market for India's business process outsourcing from the developed countries is \$1.5 Trillion annually, which is 10% of the total services-led GDP in the developed world, India's BPO industry can grow 500% in the next decade from its current level of \$300 Billion annually.

India is also leveraging its high-tech culture to automate relatively early in its economic development. This is most evident when you visit India's airports, which provide a super rich customer experience driven by high-tech automation. Additionally, India's widely adopted mobile network and payments infrastructure have proven their high scalability while driving down transaction and data costs to the lowest in the world.

3. Finance Sector Expansion

In parallel, India's financial sector has significantly expanded, driven by banking reforms which have improved credit access and boosted investment in infrastructure and other key industries.

India's financial sector growth has significantly supported the rise of equity and other capital markets through several key mechanisms:

a. **Increased Access to Credit:** Banking reforms have provided businesses, especially SMEs, better access to credit, driving profitability and demand for equity financing.

b. **Diversified Financial Instruments:** The development of new products like derivatives and corporate bonds has deepened markets, attracting both domestic and international investors. The introduction of infrastructure and real estate investment trusts has provided alternative funding sources, contributing to the overall market expansion.

c. **Rising Retail Participation:** Digital platforms and financial inclusion initiatives have expanded the base of retail investors, adding liquidity and stability to the markets.

d. **Enhanced Corporate Governance:** Despite some alleged high-profile corporate governance controversies in India recently⁴, more robust regulations and corporate governance reforms have generally enhanced investor confidence, making equity financing more attractive for companies.

⁴ Hindenburg Research report on Adani, January 2023.



Together, these developments have deepened India's equity and capital markets, enabling businesses to raise capital and attract global investors.

Headwinds

From a capital market perspective, India's healthy levels of economic growth are likely accounted for in the current price of Indian equities. Indian equities are also trading at a substantial premium compared to other markets.

Fundamentals	India	US	Europe	Emerging Markets
Forward P/E	24x	21x	12x	12.5x

Source: S&P, MSCI

India will require additional growth drivers to justify its relatively high forward valuation multiples. These drivers present opportunities and risks for investors in Indian equities over the next decade.

Addressing three key factors can support and even expand the current premium valuation multiples attributed to Indian equities.

1. Manufacturing

The COVID-19 pandemic has created a significant opportunity for India and other emerging markets, as global players are looking to diversify supply chains away from China. Major international companies like Apple and Merck are actively shifting their supply chains from China to India. The production of knowledge-intensive goods such as semiconductors, pharmaceuticals, and electric vehicles could potentially create an annual opportunity equivalent to 10-15% of India's 2024 GDP.



Despite initiatives like the government-sponsored “Make in India” program, India has not successfully accelerated manufacturing efforts. Despite having a substantially educated workforce, India may not possess the necessary infrastructure to expand manufacturing and effectively compete with China and other historically strong manufacturing economies.

India's ability to secure manufacturing projects in knowledge-intensive sectors will largely depend largely on its capacity to rapidly modernize its infrastructure, including world-class ports, a scalable electric grid, and a modern transportation network. These improvements would instill confidence that India can produce high-quality goods quickly and cheaply.

2. Youth Jobs

India may be the world’s fastest-growing major economy, but despite this, it is simply not creating enough jobs for its massive population of 1.4 billion. Half of India’s population is considered below the age of 35, and unemployment rates among Indian youth between the ages of 20 and 24 are estimated to be as high as 40%, according to some estimates⁵.

India is also struggling to create enough high-quality jobs for its educated workforce. About 15 million graduates enter the labor market each year, but there are not enough jobs available. Even graduates from top universities are facing challenges in finding employment. This situation could lead to political instability and hinder economic growth.

Additionally, climate change and the rise of Artificial Intelligence (AI) can exacerbate these labor market challenges. As climate change continues to lead to extreme heat events across many parts of India, labor productivity for outdoor work, especially related to much-needed infrastructure development, could suffer. Further, while many people are currently migrating from rural India to urban India, AI is simultaneously eliminating many lower-skilled jobs in India’s booming business process outsourcing sector.

⁵ Source: Bloomberg



While the government is taking steps to address the jobs crisis, much more needs to be done to stimulate job creation.

3. North vs. South India Economic Disparities⁶⁷:

India is composed of 28 states and eight union territories. The western and southern Indian states have experienced faster growth compared to the northern states, which has significant implications for India's long-term economic and demographic future.

Southern states like Tamil Nadu, Karnataka, Kerala, Andhra Pradesh, Telangana as well as Maharashtra, Gujarat, and Goa in the west, have displayed robust economic growth, often surpassing the national average. These states make significant contributions to India's GDP and have higher per capita incomes than many northern states. The southern states have a diversified economy, with strong growth in IT, manufacturing, biotechnology, and services sectors. For instance, Bengaluru in Karnataka is a global IT hub, while Tamil Nadu is a leader in automobile manufacturing. Southern states also tend to have better infrastructure, higher "Ease of Doing Business" rankings, and higher human development indices (HDI) compared to northern states like Bihar and Uttar Pradesh.

The southern states have achieved lower fertility rates, resulting in a faster stabilization of their population compared to the northern states. Conversely, northern states, particularly Uttar Pradesh and Bihar, continue to have higher fertility rates, leading to faster population growth. With lower birth rates, the southern states face the challenge of an aging population, which could lead to a future decline in the working-age population. On the other hand, the northern states will continue to see a younger, growing workforce.

This trend has significant implications for India's long-term growth potential. Regional imbalances may lead to further economic inequality and increase migration from northern to southern states, thereby straining resources in the aging South. This also increases the risk of fiscal and political disputes due to regional disparities.

⁶ South vs North : By Nilakantan R.S.

⁷ The Rise of the Indian Elite, Saurabh Mukherjee, Asia Society, July 2024



Balanced investment and regional cooperation are crucial for sustainable growth in India. The federal government is aware of these gaps and is looking to address them by boosting infrastructure, manufacturing, and jobs across the country.

Conclusion

While India has experienced impressive tailwind-driven economic growth and strong stock market performance, future outperformance will depend on addressing significant headwinds. The country's ability to attract global companies to manufacture in India, create jobs for its young population, and resolve regional economic disparities will be critical.

Without these factors, the current high valuations of Indian equities may not be sustainable over the long term. However, some of the world's most sophisticated investors – including large asset owners – have invested significant time on the ground in India, sending teams to gain a deeper understanding of its economic and cultural landscape. These investors are displaying confidence in India's long-term potential. If the headwinds are managed effectively, India could continue to offer attractive opportunities for global investors.

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