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India and China: a divergence in market performance

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Taken from start of the second quarter of 2020 – roughly the point at which markets bottomed after the Covid-induced panic of February and March that year – the performance differential of India and China could not be more stark. While India has rallied 90% in US dollar terms since that date – the index now sits well above the level seen just prior to the market sell-off – China has fallen 25%, well below pre-Covid levels and at a level not seen since 2016. The extent of this performance diversion is unprecedented in the last 20 years. What can explain such a significant relative divergence in performance?

Perhaps the most obvious answer is the differing policy approach to the Covid pandemic. Although China was initially praised for its rapid and aggressive response to lockdowns and as a result limiting the spread of the virus, this has given way to a seemingly endless 'zero-Covid' policy that has hampered any meaningful economic recovery. To the present day, even a relatively small number of cases – even less than 50 – can cause lockdowns to be re-enacted in response. Travel in and out of the country remains extremely challenging.

Contrast this to India where, although initial lockdowns were relatively comprehensive, we have seen a steady opening up of the economy throughout 2020 and 2021. India was, somewhat unexpectedly, spared the worst of the first Covid wave (on an epidemiological basis at least) and, although famously was hit much harder in the second wave of March 2021, this had a relatively insignificant impact on an economic and corporate earnings basis and hardly derailed the ongoing recovery.

Although these specific policy factors have clearly had a significant impact on the relative fortunes of the two emerging markets, it is also true that the fundamental position of these major economies was extremely different before the disruptive arrival of the Covid-19 virus. If we cast our minds back to 2013, when India was one of the so-called 'fragile five' emerging market economies that were buffeted by the Taper Tantrum (an interest shock that threatened those economies viewed as vulnerable to external macroeconomic shocks), we see an economy considered extremely vulnerable.

Following the ascent to power of Narendra Modi and the business-friendly BJP Party, we have seen a period of fiscal repair going hand in hand with necessary, and occasionally painful, structural reforms. In particular, the banking sector had become gummed up with bad loans from the last boom and bust cycle and thus unable or unwilling to lend. The last five years have seen a wholesale cleaning up of bank balance sheets, leaving the financial sector in excellent health and able to lend to and support a recovering economy.

In many sectors, the overcapacity apparent from the previous cycle has now been worked off – most notably perhaps in the housing sector, where inventories have finally fallen to levels consistent with price increases and affordability is at record highs. A recovery in the housing sector has been a critical missing link in recent economic cycles in India and has the capacity now to spark a wider capex recovery after more than a decade of excess capacity.

China, by contrast, has struggled to efficiently clear the excess capacity created in the post-financial crisis boom in infrastructure spending, and nowhere has this been more acutely felt than in the property sector, which continues to haunt asset quality of the financial sector. The creditworthiness of key property players continues to cause concern in the Chinese market. Moreover, whilst India has proceeded with a more expansionary fiscal policy − enabled by the previous decade of semi-austerity and credibility of a well-respected and independent Central Bank - China has resisted any impulse to add stimulus to the economy given the existing overcapacity on the investment side of the economy and the reality that consumption is currently restricted by zero-Covid policies.

India has also benefited from a more benign geo-political backdrop, seen by the US as a democratic bulwark to China in Asia, whereas relations between the US and China have continued to deteriorate. The latter has been exacerbated due to tensions reflected in tit-for-tat trade disputes and restrictions on China's access to vital semiconductor equipment needed to develop a competitive internal chip-manufacturing industry. In terms of domestic politics, China has focused on the "common prosperity" agenda that has targeted companies, especially in the previously fast-growing tech industry, not seen as patriotic enough. Meanwhile, India has continued to welcome foreign investment.

Given this extreme divergence in economic pre-conditions, Covid reaction-function, domestic and international policy, it is perhaps not surprising that we have seen such a stock market performance differential.

The question of course from this juncture is are we likely to see this Indian outperformance continue or reverse. The most compelling argument for a reversal in Chinese fortunes are to be found in the relative valuation picture, in which India now trades at extended valuations compared with history, China offers historical low valuations. This is a set up that − with the addition of a meaningful catalyst − could prove a powerful driver of Chinese outperformance.

What could provide such a catalyst? The most obvious would be an easing of zero-Covid policies − and there is some degree of hope that the development of Chinese-produced mRNA vaccines will provide cover to do so. The 20th Party Congress is currently underway (at the time of writing) and there are some hopes that this event could provide much needed clarity on economic growth plans.

For India's part, we believe a multi-year structural investment phase beckons and with a stable political backdrop, we see relatively low domestic risks to this agenda. A potential external risk to Indian outperformance is always to be found in high oil prices especially were energy prices to rise substantially above $100 per barrel.

Given the valuation and sentiment disparity that has developed between these two markets, it is certainly possible that China will manage to stage something of a recovery in the final quarter of this year. However, over the medium term, we still believe the domestic policy environment and growth potential remains a more compelling proposition in India, which we argue remains the most structurally compelling long-term investment opportunity within emerging markets.

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