India Strategy

Why Indian market returns are more sustainable than US's

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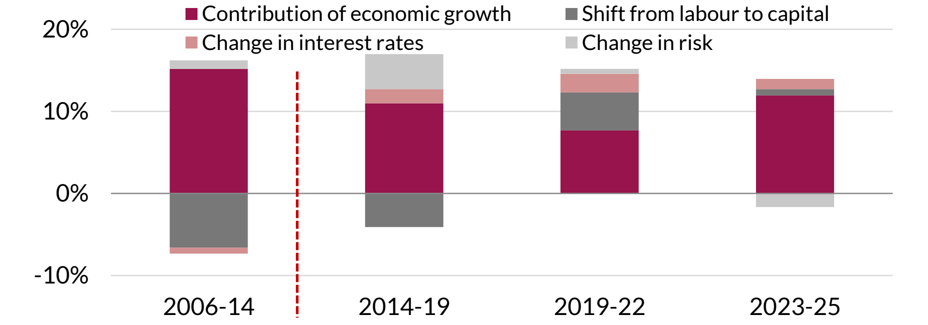
We deconstruct past market returns into: (1) GDP growth, (2) profit share of GDP, (3) risk-free rates, and (4) risk-premia. Over 2006-25, 80% of BSE500 index growth came from EPS growth (lagged GDP growth). This can be seen as a rising labor share of income but includes a fall in the BSE500 share of overall corporate profit. This reversed in 2019-25, and we expect the trend to continue. Valuations have seen a 2% CAGR – two-thirds came from lower risk-premia, a third from lower G-sec yields. We see both sliding lower, but global uncertainties could pressure risk pricing. India's returns contrast with the US's returns, which are driven by a distortive rise in capital share of income.

Exhibit 1: Market returns led mostly by higher economic growth and lower risk price



Source: Bloomberg, NBER, Axis Capital Estimates

Greenwald et al's 'How the Wealth was Won' (link) found that of the rise in US equity value over 1989-2017, 25% came from economic growth, 40% from shift of income from labour to capital, 21% from more risk, and 14% from lower rates. Over 1952-88, more than 100% came from economic growth. We try to break up Indian market returns into these parts.

80% of market returns in past 20 years driven by earnings, which lagged GDP

The BSE500 index has seen a 12% CAGR over FY00-25, in line with the nominal GDP growth. Market returns though are more volatile (Ex. 3): over 2000-06 returns exceeded economic growth, but then significantly lagged over 2006-19 (Ex. 4), before again growing ahead of nominal GDP in the past six years. In the past 20 years, for which we have more granular data, 80% of market returns have come from EPS growth (Ex. 5). Over longer horizons, EPS dominates returns (71-90%, Ex. 6), but P/E dominates over shorter 1-2-year periods (Ex. 7). In the past 18Y annual returns, P/E has declined only in four years (Ex. 8).

Corporate earnings driven primarily by economic growth offset by labor share

BSE500 EPS CAGR of 9% in the past 20Y lagged the 12% CAGR in nominal GDP growth. Through 2006-19, BSE500 EPS lagged nominal GDP growth by 5.5-6% annually, but saw 2.7% CAGR faster over 2019-25 (Ex. 9). We ascribe this to a shift from capital to labor in Ex. 1, while corporate profits as % of GDP did not change as much (Ex. 7). It meant gains for smaller firms: BSE500 share of overall corporate profits slid from 70% in 2012 to 45% in FY18 and was 49% in Mar'23 (Ex. 8). This has likely risen further over FY23-25, with 13% EPS growth exceeding nominal GDP growth of 12%. We expect this trend to continue.

Change in valuation mostly due to lower risk price

The above-mentioned factors drive EPS, and risk-free rates (yield on 10Y sovereign) and risk premia drive the P/E. 1-year forward P/E of the BSE500 has seen a 2% CAGR over 2006-19 (Ex. 11). One-third of the P/E expansion in the past 20Y (0.7%) was due to lower risk-free rates and the rest (1.4%) due to lower risk pricing. Over 2006-19, P/E expanded on lower risk premia, but over 2019-25, these have risen: G-Sec yields fell (Ex. 12). Going forward, falling risk-free rates should support P/E; but while low volatility and stable macro can help India's risk premium fall further, rising global uncertainties may offset that.

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