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Perspective from
**Franklin Templeton Emerging Market Equity**

# Exploring opportunities in emerging markets equity: China and India

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**Lirong Xu**
Chief Investment Officer
Franklin Templeton Sealand Fund Management Co.



**Murali Yerram**
Portfolio Manager, India
Franklin Templeton Emerging Market Equity



**Brian Freiwald**
Portfolio Manager
Putnam Emerging Market Equity




## Introduction

As investors consider opportunities across global equity markets, China and India both offer a combination of strong potential growth and independence from the US economic and market cycle. At the same time, investors should be aware of the important differences between these two large Asian economies. While China has achieved a higher long-term economic growth rate, India has a track record of delivering better equity returns. Also, India has accelerated its pace of development in recent years, while China has struggled with shifts in global trade patterns as well as from home-grown debt and deflation.

To compare current prospects for equities in China and India, we share perspectives from three Franklin Templeton professionals with experience investing in these markets.

Lirong Xu

## China's economy is recovering, and entrepreneurial spirits are rising

As China emerges from a sustained economic downturn, we believe global investors should take notice of its strong growth potential and reasonable valuations. The real estate market had a hard landing over the past two years, which caused worries that the overall economy would fall into outright contraction. Fortunately, real GDP growth has stayed positive. It turns out that China is more resilient than it was a decade ago. This is one reason we have optimism that, over the next three years, we could see a solid recovery for both China's economy and its stock market.


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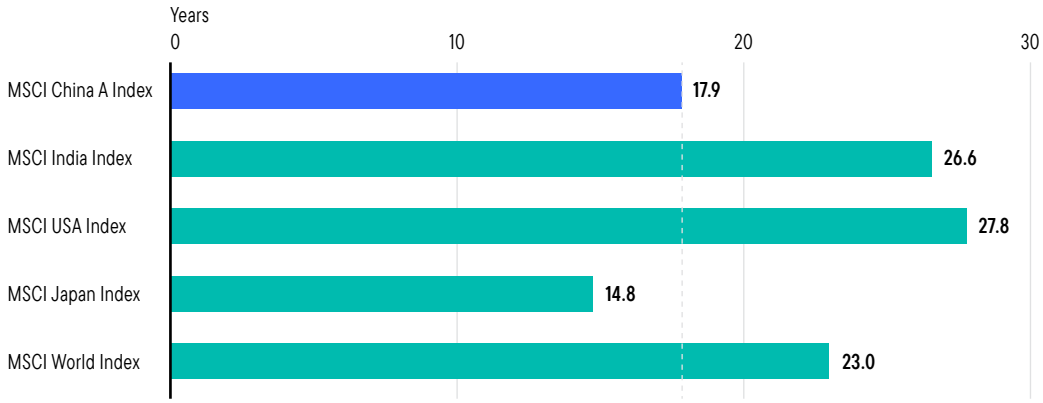
Our view differs from market consensus, as global investors continue to show caution about investing in China. Even with the brief rally in the third quarter of 2024, China has not followed the same late-year upward trend as the United States. Valuations in China have remained low (Exhibit 1), as have the correlations with global markets. We believe many global investors may be undervaluing Chinese stocks, but from our perspective, this reinforces the opportunity to invest at a potentially favorable time.

## Exhibit 1: China A Shares Offer Lower Valuations than India and Other World Markets

**Price-Earnings (P/E) Ratios of MSCI Index**

As of December 31, 2024




Source: MSCI. Data as of December 31, 2024. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not necessarily indicative nor a guarantee of future performance.** MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. See www.franklindatasources.com for additional data provider information.

## The road to recovery

While the short-term cyclical situation appears to be improving, China still faces risks that skeptical investors call the "three Ds"—debt, deflation and demography. The cyclical downturn since the COVID-19 pandemic and lockdown coincided with a collapse in property prices. Households carry heavy debt, and the currency remains weak, which limits spending at a time when the country is beginning to experience a decline in the share of prime-age workers.

Regarding the debt problem, there is some good news to report: We think one important factor to consider is that China's central government has relieved some of the debt burden on local governments, which play an important role in the economy. Local governments now appear to be in a better position to hire workers and pay suppliers, which is a method that China uses to help stimulate economic activity.

## The return of entrepreneurial spirit

We also believe we are seeing signs of the entrepreneurial spirit that can support further growth. During the September rally in China's equity markets, retail investors drove stock prices higher. We think this underscores the confidence of the local population in the economy's future. In past rallies, it was primarily Chinese institutional investors or global investors who were responsible for driving the markets, but now we are seeing stronger confidence from domestic retail investors.

We can also report examples of companies showing similar confidence. The leaders of these companies are trying to be creative with growth strategies in spite of economic challenges. There are many well-managed companies looking for ways to gain market share and even to expand overseas.

As investors, it remains important to be selective. We follow a patient, research-driven approach, applying our local expertise. Many of the most attractive companies in China, we believe, are privately held. In doing our research, we talk with private and public companies and with their suppliers, customers and even their former employees to determine which ones are well managed. We think firms such as these will have an advantage as the recovery gathers pace. Another area of good news for China is that policymakers are making progress on the debt and deflation problems. We think the economy will be on a better footing than in recent years.

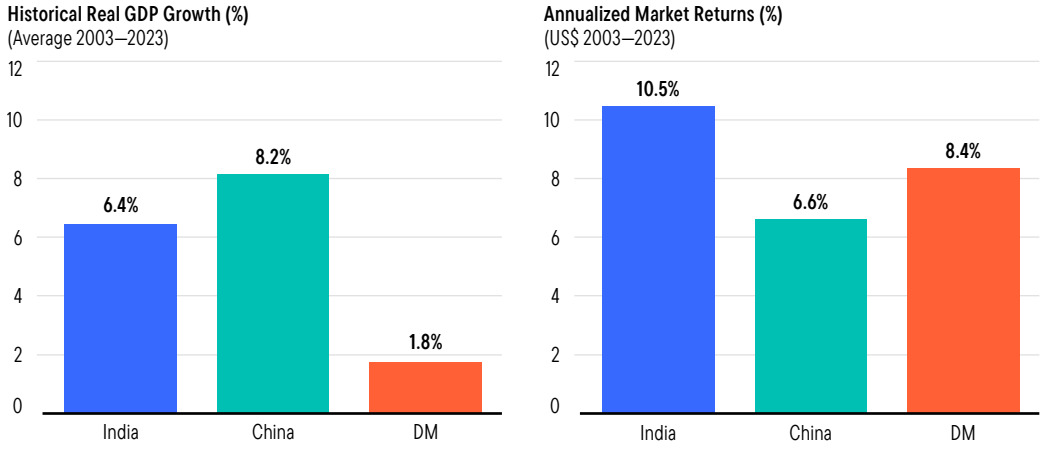
Murali Yerram

## Indian stocks benefit from multiple tailwinds

It is an interesting time to see how China and India stack up against each other. Over recent decades, China has significantly outperformed India in terms of economic growth, while India's market has delivered better returns to investors (Exhibit 2).

### Exhibit 2: India Led in Market Performance, China Led in GDP Growth

**Historical GDP Growth Versus Annualized Market Returns in India, China and Developed Markets**




Sources: Bloomberg, WEO, IMF, MSCI. As of 2023 (most recent data available at time of writing). Total returns are shown in US dollars, with India represented by the MSCI India Total Returns Index, China represented by the MSCI China Total Returns Index and developed markets (DM) represented by the MSCI World Total Returns Index. DM GDP growth rate is based on countries in the MSCI World Index excluding Hong Kong and Singapore, calculated based on weightings in their respective GDP based on purchasing power parity. India's GDP growth is based on fiscal years as forecasted by the IMF, with FY2022/2023 (starting in April 2022) shown as 2022. For illustrative purposes only. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.** MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. See www.franklindatasources.com for additional data provider information.

India's stock market is inherently different from many emerging markets and from China. One of the chief reasons is that government sector involvement in India is quite low, while, if you look at the MSCI China A Onshore Index, the proportion of government-owned companies was 47.7%.[1]

Another difference in India is that energy and basic materials companies also comprise a relatively low proportion of the market—about 15%.[2] Companies in these sectors create hardly any long-term alpha. Fortunately, in India these sectors have been less of a drag on returns when compared with other markets.

India has another advantage in that about 70% of its economic activity is consumption, and 65% of the economy is services oriented. This structure presents a great opportunity in India for entrepreneurs to set up capital-efficient businesses and grow by serving a large population without having to expand abroad. It's a distinctive advantage of India's model.

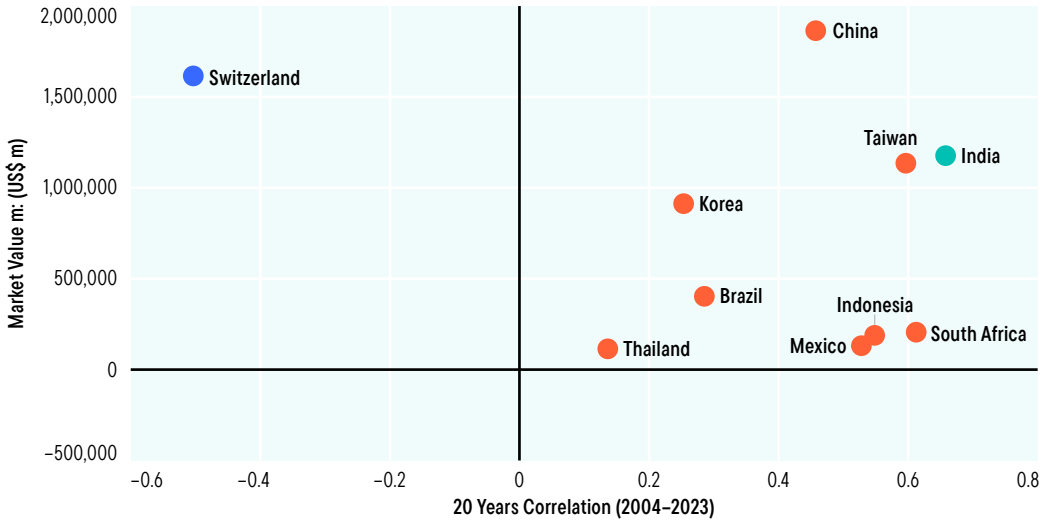
India also appears to benefit from good corporate governance. Several global corporations have established a culture of strong governance practices with an emphasis on delivering consistent results. This culture has influenced other companies. Global investors seem to appreciate that businesses have this focus and rewarded them well.

## India's outlook

While India's economy and market have a history of strong performance, we believe the best is yet to come. The nation held an election in 2024, and the policy framework is now settled for the near term, which is a tailwind for the market. The economy is growing, and Indian firms are typically able to convert GDP growth into earnings growth very well—the correlation between economic growth and earnings growth is about 70%, based on our analysis (Exhibit 3). Consumption is likely to continue growing at a steady level of about 6% to 7%, so this bodes well for earnings growth. This feature is another key differentiator from China, where consumption remains a weak point. Although India lags China in many measures of economic development, the gap in consumption is narrower.

### Exhibit 3: India Translates GDP Growth into Earnings Growth at a High Rate

**Correlation between GDP and Earnings Growth in the Following 12 Months**




Sources: Franklin Templeton, Bloomberg, MSCI. Data as of 2023 (most recent data available at time of writing). **Past performance is not an indicator or a guarantee of future results.**

Another contributor to our positive outlook is the government's capital spending. Indian tax collections are strong thanks to the digitization of the economy, and the government is using revenues prudently to invest in infrastructure.

In the private sector, the growth of home ownership and household formation is a beneficial trend. The housing sector in India is small compared with China, but it is growing because the desire for home ownership is strong—similar to China and even the United States. Capital expenditure on household formation in India is about 33% of total capital formation.[3] Private capital investment is also firm thanks to spending on the energy transition, the "Make in India" initiative, and higher capacity utilization. The consequence is that companies will likely need to invest to expand energy infrastructure to keep up with demand.

Aside from consumption and capital formation trends looking positive for India, we also regard the performance of the export sector as reasonably strong. Information technology services have been a bright spot for exports.

India is benefitting from a variety of tailwinds at this time, and it offers a very attractive structural opportunity to global investors.

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Brian Freiwald

## Bullish on India, cautious on China

We believe both India and China deserve attention for their growth potential relative to developed markets. Investing in either or both countries could help to expose a portfolio to different drivers of growth.

In comparing the two, we find India more compelling. Over the past 20 years, India's GDP growth has averaged about 7% per year, which for equity markets has translated into earnings per share growth of about 10% per year. We anticipate future growth rates will be near the same levels. India's equity market also offers attractive valuations, in our view. Many global portfolios are still what we could consider to be underweight in Indian equities.

## From airports to air conditioning

We have found opportunities in a variety of sectors, especially infrastructure and tourism companies. New airports have opened for the cities of Delhi and Mumbai, and many other cities around the country are building new airports. New high-speed rail lines also connect major urban centers.

Our team has also taken a big interest in the government's "Make in India" initiative to promote domestic production. On one of my recent research trips to India, I visited factories that produce air conditioners. India has a lot of hot weather, so it is somewhat surprising that the country traditionally imported air conditioners. Recently, however, local production has increased from about zero five years ago to 13 million per year currently. But that is just the beginning if you consider that China produces 230 million air conditioners annually. The executives of the Indian air conditioning company we visited were transparent in saying that unit costs are still higher in India, but as they add scale, the average costs should decline. Through the "Make in India" initiative, the government is helping pay for the costs of getting the industry to cost competitiveness.

## Earnings growth may be scarce in China

While we think China deserves a place in global equity portfolios, our outlook is less bullish than for India. We are concerned about the loss of manufacturing. Large global companies that in recent decades moved much of their manufacturing to China are now diversifying their supply chains and moving production to other countries. Even Chinese companies are opening more factories outside China. This key component of China's traditional growth model is in question. We will continue to analyze this trend for its impact on both economic growth and equity investment opportunities.

While China's economy is growing, we believe the earnings outlook for equities could remain lackluster for the foreseeable future. At the same time, we recognize that it's a large market, and there will likely be select opportunities for strong earnings growth. We consider China a stock-pickers' market that requires careful research and analysis. The opportunities in India may be more widespread, while in China a more selective strategy makes sense.

## Conclusion

Overall, our three investment experts believe that, while the economic and market dynamics are not equal, both India and China offer opportunities for global equity investors. The world's most populous nations are moving forward at different speeds, but both are likely to grow faster than developed markets. They offer different characteristics that warrant distinct strategies but also allow for attractive diversification potential. As described, one of the key differences is that India has resolved many of its policy questions in the wake of its election in early 2024, while in China, the policy picture is more complicated. The government has instituted several measures to overcome the challenges of debt and deflation and has achieved a degree of success, but it may also decide to do more. One possibility is to introduce reforms to stimulate stronger consumer demand. China's economy is growing, but investors may want to keep alert to future policy decisions that could have an effect on the nation's growth trajectory.

**Endnotes**

1. Source: Based on MSCI China A Onshore Index as of July 2024.
2. Source: MSCI India Index Factsheet. The energy sector represented 8.28% of the index and the Materials sector represented 7.3% of the index as of December 31, 2024.
3. Source: Ministry of Finance. July 22, 2024. Pib.gov.in.

### Index definitions

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1. The MSCI China A Index captures large and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges.
2. The MSCI China A Onshore Index captures large- and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges.
3. The MSCI India Index is designed to measure the performance of the large- and mid-cap segments of the Indian market.
4. The MSCI Japan Index is designed to measure the performance of the large- and mid-cap segments of the Japanese market.
5. The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the US market.
6. The MSCI World Index captures large- and mid-cap representation across 23 developed markets countries.

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