Buy India, Sell China

Until recently, India saw itself as an emerging economic powerhouse, the next China so to speak. Those delusions of grandeur led to complacency and the end-result is that GDP growth has slumped to a ten-year low. Most investors are now writing India off as an economic and political basket case. For Asia Confidential,that spells potential opportunity. While India has many problems, they're unlikely to get much worse from here. At 13x forward earnings, with a cyclically low earnings base, the India market looks reasonable value.

India's rival, China, has far bigger problems, in my view. Current consensus suggests China's economy is recovering, its politicians will ensure this continues and stocks are poised to rebound. I think this will prove very wrong. To prevent a steep economic decline in the middle of last year, China's politicians effectively doubled down on the investment driven, debt fuelled growth strategy which got the country into trouble in the first place. That's led to spiralling asset bubbles and this week's news of likely further monetary tightening confirms the government is worried. It should be.

India's Budget Woes

15 years ago, it was difficult to generalise about anything Indian. It was a land of contradictions. Extreme wealth neighbouring extreme poverty, a deeply corrupt yet full-functioning democracy, an attachment to a welfare state despite recognition of its many limitations and a common national identity but every region having vastly different people, languages and tastes.

While things have changed a lot in India, many of the contradictions remain. I was reminded of this recently when the government handed down its budget. It's as if the government was trying to take several contradictory policies and meld them into a coherent document. It aimed to appeal to everyone, but pleased few in the end. In some ways, it was a microcosm of India's contradictions.

The government knows that it's spending beyond its means, but put forward more spending nonetheless, with expenditure forecast to rise 16% over the next year. That's despite threats by ratings agencies to downgrade India's sovereign rating to junk status.

More disturbing is the ongoing rural handouts. The budget announced a 22% hike in agricultural spending and 46% increase in rural development funds. The government is turning to the long tradition of buying rural votes. Even though all the evidence suggests that these subsidies are making farmers stay farmers, rather moving to urban areas. This means these workers are not moving up the value chain and becoming more productive workers, which is holding back the economy.

The government has a stated aim to encourage business investment. Yet the budget announced a 10% surcharge on citizens earning more than 10 million rupees a year. It appears India is copying the developed world's tax-the-rich policies.

The government knows that it needs further reforms to kick-start the economy, end the cycle of elevated inflation and keep the ratings agencies at bay. Yet, the budget provided no reform whatsoever.

It's clear that this was a budget framed with next year's general election front of mind. The government's betting that cash subsidies to voters will outweigh any negative fall-out for the overall economy.

Deeper Issues at Play

There's no denying India's problems. GDP at 4.8%, inflation stubbornly high at 10% and widening fiscal and current account deficits reflect this.

The key issue in the short-term is that the government is simply spending too much. The continued hike in rural subsidies is the best explanation for stubbornly high inflation, despite a slowing industrial sector. It's led to a blow out in the country's fiscal position. At the same time, the current account deficit has also widened, driven primarily by India's import of energy. This has put pressure on the rupee, which has created further inflationary pressure. All of this has meant the central bank has been hesitant to aggressively cut rates despite significant economic weakness.

I'd also suggest that there are deeper, structural explanations for India's economic malaise:

- The spending problems aren't new and reflect a dogged attachment to a welfare state that's ballooned since India became independent more than 60 years ago. A bloated government has led to deep-seated corruption, much of which has recently come to light.
- Geography remains India's chief structural weakness. As Winston Churchill once said: "India is just a geographical term with no more a political personality than Europe." India's states control more than 50% of all government spending. This de-centralisation of power means each state has a distinct identity and seemingly waning national consciousness.
- Demographics. I find it a little humorous that the "demographic dividend" is being touted as a significant advantage for emerging countries such as India. I suspect it's a term made up by stock brokers to sell the emerging markets story . After all, it was only a decade again that an alternative term, "population time bomb", was in vogue. The demographic dividend advocates suggest that an increased number of young workers means a more productive workforce and more productive economy. Unfortunately, the theory breaks down if there are no productive careers for the young population. And this is one of India's pressing issues.

All Seems Priced In

India's problems, both cyclical and structural, are well known. The key question for investors is what could change, for better or worse.

And it's here that I find some grounds for optimism. It seems to me that many of these issues are unlikely to further deteriorate from here. In fact, they may even show signs of improvement over the next 18 months. Consider that:

- At the start of each of the last four decades, India has undergone some form of fiscal crisis. Each period led to significant reform that propelled economic growth. The cycle of reform, then growth, then complacency, then crisis leading to reform, could well repeat itself this time around. History suggests Indian governments only reform in crisis.
- Even if there is little reform, there is likely to be a relatively tight rein on spending given threats of ratings agency downgrades. These threats will keep the government in check.

- Can Indian politics get much worse from here? It could certainly get more interesting given there's a distinct possibility of a new government coming in. The Opposition, Bharatiya Janata Party, has a good chance of defeating the incumbent Indian Congress Party at the next election. Particularly if it's led by the well-known economist reformist, Narendra Modi, the Chief Minister of Gujarat.

The other thing to consider is that a lot of the negative news appears to be factoring into the Indian stocks. At a 12-month forward earnings ratio of 13x, India isn't expensive compared with its 16x long-term average. Particularly when earnings are depressed due to the poor economic environment.

Given the potential for a turnaround in economic fortunes and favourable valuations, it seems to me that Indian stocks are worth accumulating at this juncture.

China: Double Trouble

China's problems dwarf those of India. Some of you may recall that in September last year, I thought the Chinese economy was heading for a so-called soft landing. This was premised on the view that the Chinese government had privately told investors that the 2009 stimulus of 4 trillion yuan was a mistake due to the asset bubbles which it had created. And it wouldn't be repeated.

Unfortunately, what the government said and what it did were two very different things. As China's economy started to deteriorate in the middle of last year, it turned to the same investment-driven, debt-fuelled strategy which led to problems in the first place.

From September, the central government announced 1 trillion yuan in investment spend while the local governments pledged a whopping 13 trillion yuan. How much of this has been spent hasn't been revealed, but given strong fixed asset investment and infrastructure spend data, there's little doubt much of the money has been put to work.

The resulting pick-up in economic growth has been hardly surprising. Neither has the accompanying asset bubbles.

These bubbles are even more dangerous this time around. The government spending has again focused on likely low return investments, particularly around infrastructure. And it's been funded primarily by the non-banking sector, or so-called shadow banking. The growth in this lightly regulated sector has been extraordinary. It's resulting in a sharp rise in China total debt, now equivalent to 200% of GDP.

It's clear that the government is concerned at asset bubbles and resulting inflation. Whether it can prevent a good old fashioned credit bust is the big question.

Markets Discounting a Hard Landing?

Since I suggested that it was time to sell China stocks two weeks ago, I've received pushback from a couple of different angles. There is a prevailing view that China's communist regime won't allow an economic crash landing. To put it politely, this is a bizarre notion. It ignores the many failings of communist regimes to prevent economic downturns. Think the Soviet Union and more recently, Vietnam. Not to mention that China itself has been through many economic downturns in recent times. It also ignores the larger issue whether politicians can really manage economic cycles (seemingly today's central bankers are yesterday's Soviet Union planners…). I'll leave that discussion for another day though.

Also, there is the continued argument that China has the money to throw at the problem. Particularly given its +US$3 billion in foreign exchange reserves. But most are illiquid assets. Moreover, they're highly unlikely to be used to fight an economic downturn as the consequences would be dire for the world's economies, including China.

As China and much of the rest of the world is discovering, credit busts are much harder to deflate in a gradual fashion than economic textbooks would have you believe.

Instead of just taking my word for being cautious on China though, you should perhaps heed the comments of China business leaders themselves. Recently Wang Shi, CEO of China's largest residential property company, China Vanke, told CBS that if the real estate bubble burst, the country may have its own Arab Spring – referring to an uprising against the current regime. He went on to say that he remained hopeful that China could prevent a bust. Nevertheless, it's an extraordinary statement given business leaders in China are usually paranoid about toeing the Communist Party line.

This week, China's richest man has been no less frank. Taking a different tack, Zong Qinghou, of privately listed beverage company, Hangzhou Wahaha Group, took aim at China's stock markets : "The capital markets suck in China."

This is not an uncommon view in China given the Shanghai Composite Index remains almost 60% below 2007 highs. With nine of the top 10 companies in the index being state-owned, stock market returns have significantly lagged economic growth. The chart below shows total returns from the Shanghai Composite Index of 67% from 2002-2012 compared with nominal GDP growth of 331% during the same period.

The question is whether China stock markets are already factoring an economic hard landing. I don't think they are, but perhaps we'll find out soon enough.