
SURPRISE! INDIA'S EQUITIES HIT NEW RECORD HIGH

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On March 10, 2014, the [S&P BSE SENSEX Index](#) hit a record high—21,934.¹ Many U.S. investors might be surprised by this fact, in that the experience of a typical investor accessing India's equities has not been indicative of a market strong enough to surpass its own January 2008² and November 2010³ highs. **U.S. Record Highs vs. India's Record Highs** U.S. equity markets, such as the [S&P 500 Index](#), are performing well and continuing to trend toward periodic record highs. This is what investors expect when the term "record high" is used—a strongly positive performance. With India, the single word that comes to mind to characterize the current experience is [volatility](#). This equity market, at least from our perspective in the U.S., has been driven less by the [fundamentals](#) of the underlying stocks and more by macroeconomic sentiment regarding either India itself or broader emerging markets. **Currency Can Cut Deeply** The critical link that we've thus far left out is India's currency, the rupee. A U.S. investor typically accesses India's equity market with [valuation](#) or other fundamentally related factors in mind. However, as with any other foreign equity investment, the country's currency becomes a second position for the investor. Recall that whenever the purchase of foreign equities is involved, an investor has to sell U.S. dollars and buy a foreign currency—in this case Indian rupees—to buy the foreign stocks. The rupee has been particularly volatile and has behaved as somewhat of an economic barometer, reflecting changes in investor sentiment. **How Influential Has the Rupee's Performance Been?** Looking back to August of 2013, as the S&P BSE SENSEX Index was trending upward toward a record high, the rupee was actually diving to a record low—an exchange rate of nearly 70 per U.S. dollar⁴. At this point in time, investors were very concerned with India's [current account deficit](#), and there was also deteriorating confidence in India's fiscal and monetary policies. Since then, the rupee has strengthened back to a level closer to 60 per U.S. dollar, which is still approximately 50% weaker than the levels seen as recently as the end of July 2011.⁵ **Illustrating the Issue for U.S. Investors** We've set up a veritable tug-of-war between India's equities and its currency, and the currency has been dragging down market performance for U.S. investors. **Looking at Profitable Firms in India** WisdomTree created an [Index of India's equities](#) to measure the performance of the country's profitable companies. Its inception date was in December 3, 2007. What has the performance experience been over this period? **India's Currency Has Been a Major Headwind for Equity Returns**



Sources: Bloomberg, WisdomTree. Period from 12/3/2007 to 2/28/2014 is the since-inception period for the WisdomTree India Earnings Index. Past performance is not indicative of future results. You cannot invest directly in an index.

• **Volatility**

Clearly Evident – whether looking at the [WisdomTree India Earnings Index](#) measured in U.S. dollars or in Indian rupees, it’s pretty clear that the market has been very volatile. Generally speaking, India is a higher beta emerging market country, and the WisdomTree India Earnings Index is broadly inclusive of profitable companies, including even [small-cap](#) firms as constituents.

• **Large Currency Impact** – Given our inception date, the chart makes it clear that currency has been the primary factor leading to negative returns—as the equities in local currency terms are in net positive territory and close to all-time highs. Cumulatively, the rupee has depreciated nearly 36% against the U.S. dollar over this period. Measuring the performance of the WisdomTree India Earnings Index in rupees shows a cumulative return of over 7.5%, a positive figure. But accounting for the exchange rate depreciation brings this cumulative return down to a negative 31%.

Evaluating India as an Opportunity Today Given this illustration, we believe it is impossible to evaluate the case for India’s equities without also considering factors that could potentially influence the performance of its currency in a positive way. Even with the S&P BSE SENSEX Index hitting record highs, it’s just as important to think about the things that can keep the currency from sliding back in the future. Over the last seven months, several developments have enhanced the resiliency of the Rupee and create a stronger backdrop for US investors to allocate to Rupee denominated assets.

• **Renewed Central Bank Credibility** – The new central bank governor, Raghuram Rajan has helped restore market confidence in the inflation fighting credentials of the Reserve Bank of India, by pro-actively hiking rates to stem inflationary pressures. Additionally, the RBI has re-built [FX reserves](#) and re-anchored FX expectations, reducing volatility.

• **Reduced external vulnerabilities** – The current account deficit has improved dramatically. At close 2% of GDP, it is less than of last year’s 4.7% deficit. Solid export growth amid a curb in gold imports and a fall in non-oil imports triggered the improvement.

• **Less Heat from Inflation** – The pace of headline inflation has turned significantly dropping from double-digits to 8% for consumer price inflation (CPI). [Core CPI](#), however, remains sticky at 8%. Inflation expectations remain elevated, providing some underpinning to the RBI’s more hawkish stance.

• **Greater Fiscal Restraint** – The government has slowly worked to tighten the government’s belt in the last year. The recently proposed [fiscal deficit](#) of 4.6% of GDP exceeded expectations of 4.8%.

• **Building consensus for pro-business candidate** – Though elections do not start until April, a consensus in the polls is forming behind Narendra Modi and his opposition Bharatiya Janata Party (BJP). A growing number of strategists and business leaders feel that the prospects for change under the BJP could inject an immediate boost to investor confidence. The confidence is likely to be extremely supportive of the Rupee and Rupee-denominated assets. These developments have fostered investor sentiment that India is pro-actively addressing its vulnerabilities and unlocking the growth potential that has stagnated in recent years.

Conclusion: **Should We Have Been Hedging the Rupee?** As we consider all these factors, we hope that the divergence between the concept of record highs and the experience of U.S.

investors has become clearer. The astute reader might question one thing, however: Given WisdomTree's success with [currency-hedged equity](#) strategies, an obvious answer could have been to simply hedge the rupee. In a future blog post, we will address why this may not be the best approach to solving the disconnect between India's equity and currency performances. ¹Source: Bloomberg. ²January 8, 2008: SENSEX level at 20,873. ³November 5, 2010: SENSEX level at 21,004. ⁴Source: Bloomberg; refers to 8/28/2013, when it took 68.83 rupees to purchase 1 U.S. dollar. ⁵July 28, 2011: rupee vs. U.S. dollar exchange rate was 44.07.

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DEFINITIONS

S&P BSE SENSEX (S&P Bombay Stock Exchange Sensitive Index): A free-float market capitalization-weighted stock market index of 30 well-established and financially sound companies listed on BSE Ltd.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

volatility: A measure of the dispersion of actual returns around a particular average level.

Fundamentals: Attributes related to a company's actual operations and production as opposed to changes in share price.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Current account deficit: Situation where a country has a greater level of imports than exports.

WisdomTree India Earnings Index: A fundamentally weighted Index that measures the performance of companies incorporated and traded in India that are profitable and that are eligible to be purchased by foreign investors. Companies are weighted in the Index based on their earnings in their fiscal year prior to the Index measurement date, adjusted for a factor that takes into account shares available to foreign investors.

Small caps: new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

FX Reserves: assets held by central banks and monetary authorities, usually in different reserve currencies, used to back its liabilities.

Core CPI: Long run trend in the price level that excludes items frequently subject to volatile prices, like food and energy. Can also be known as, CPI ex-Food & Energy

Fiscal deficit: Situation where government spending exceeds government revenue.

Hedge: Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.