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L&G India INR Government Bond UCITS ETF

Is there a first-mover advantage in Indian bonds?

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LGIM

India Government Bonds

Market Landscape

India is the world's largest democracy, with over 1.4 billion people. Bloomberg recently highlighted India as the "world's fastest-growing major economy", with GDP growth expected at 9.2% for fiscal 2022. India is the sixth-largest economy globally and the second-largest among emerging markets (see graph 2), so why isn't India properly represented in investor portfolios?

Currently, Indian government bonds (IGBs) do not feature in any of the major government bond indices. Largely driven by historical quotas on foreign ownership and operational difficulties in accessing local currency IGBs, foreign ownership of the asset class is currently below 2% (source: Bloomberg, as at 31 December 2021). This is a stark difference when compared to 10% in China, 26% in Indonesia, and 47% in Mexico, especially when the nature of the asset class is considered.

Despite this lack of representation, the Indian bond market has experienced consistently strong growth over the past 10 years; we calculate the five-year average annual growth rate to the end of 2021 to be +17% for government debt issuance (see graph 1).

In addition to this growth in liquidity, India has historically provided strong correlation diversification against both global emerging and developed market countries. We find it to be one of the least correlated countries to the wider markets (see table 1).

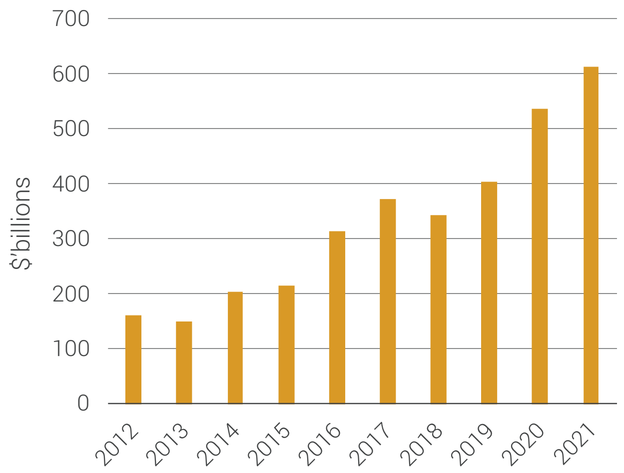
The landscape has similarly evolved on the FX side, as India's status as one of the most attractive emerging-market destinations for foreign direct investment (FDI) means that India runs a positive balance of payments and has built the world's fourth-largest FX reserve with the balance increasing significantly over the past few years (sources: World Bank, Bloomberg, Trading Economics, February 2022). India is also one of the few remaining emerging markets that possesses an investment-grade sovereign debt rating.

This lack of representation is about to change, in our view. India is liberalising its financial markets and is poised to join a range of major government bond indices in the near future. The country is already on the watchlist for JP Morgan's flagship local currency emerging-market bond offering, with inclusion into this index alone set to trigger $30 billion of inflows into the market (source: JP Morgan and LGIM, February 2022). One of the key aspects of this liberalisation has been the issuance of Fully Accessible Route (FAR) government bonds, free of quotas and more readily investible by foreign investors.

Even though Indian FAR government bonds only represent about 22% of overall IGBs by total notional amount, they represent over 57% of trading volumes (source: JP Morgan and LGIM, February 2022). In March 2020, the Reserve Bank of India communicated that all 5, 10 and 30-year issuances of government securities would qualify for FAR for foreign investors. To illustrate the appetite for this debt, the overall trading volume is split 57/43 in favour of Indian FAR-eligible debt (source: JP Morgan, CCIL, as at 31 December 2021).

Graph 1: India sovereign debt – market growth

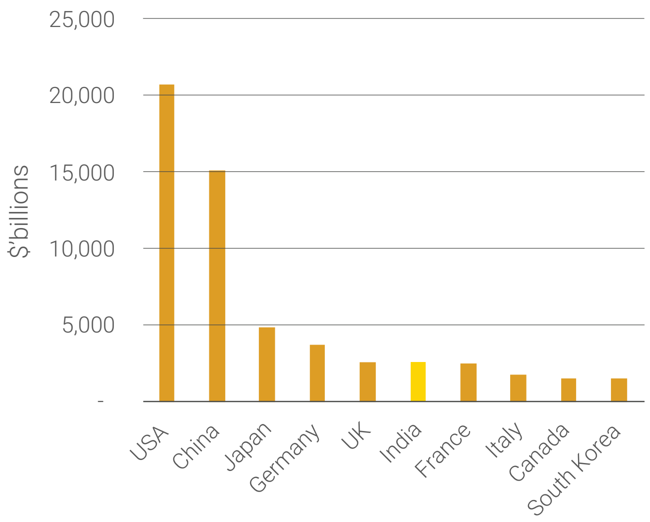
Ave ann. growth (2017-2021): +17%



Source: LGIM, J.P. Morgan, data to 31 December 2021.

Past performance is not a guide to the future.

Graph 2: 2020 gross domestic product – India ranks 6th worldwide and 2nd in emerging markets



Source: LGIM, World Bank, data for 2020.

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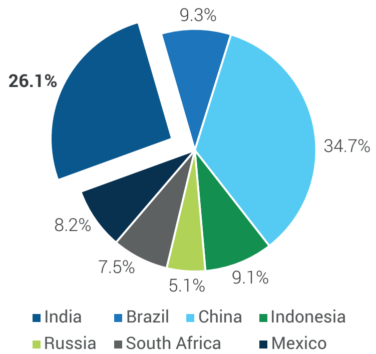
India Government Bonds

Relative to Other Government Debt Markets

India's local debt market currently exhibits very low levels of foreign ownership (see graph 3), contributing to its lower level of correlation to the wider global fixed-income markets.

Between 2019 and 2021, the Indian local debt market has accounted for a similar market value as China's local debt market, with India's local debt market value reaching $617 billion. Notably, this is a +290% increase since 2012 (source: JP Morgan and LGIM, February 2022).

Graph 3: Local-currency government debt market value – comparison of major emerging markets ($USD equivalent) 2019-2021



Source: LGIM, J.P. Morgan, data to 31 December 2021.
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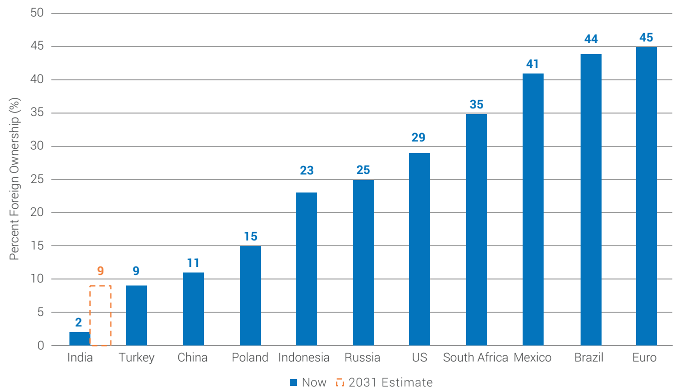
Graph 4: Foreign ownership share in local-currency emerging market



Source: Morgan Stanley, February 2022.
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India government bonds – Relative accumulative total return (USD)

Over the past three to five years, IGBs have outperformed single debt markets such as Mexico, China and even (quite significantly) Brazil. When compared with most of the below local debt markets, its performance also demonstrated a more stable pattern, with less significant volatility and drawdowns.

as of 31st January 2022	India accumulated relative TR performance (USD)						
	South Africa	Russia	Indonesia	China	Mexico	Brazil	US
1-year	-6%	10%	-3%	-7%	6%	2%	3%
3-year	13%	32%	-6%	-1%	-2%	41%	5%
5-year	-30%	-9%	-15%	22%	25%	5%	35%

as of 31st January 2022	South Africa	Russia	Indonesia	China	Mexico	Brazil	US	India
Daily annualised 5-year volatility	23.6%	16.2%	10.3%	4%	16.7%	19.3%	4.4%	6.4%
Max drawdown (5-year)	41%	31%	25%	8%	31%	33%	7%	14%

Source: JP Morgan and LGIM, data to 31 January 2022.
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Table 1: Monthly USD total return cross correlation matrix – five-year period to 31 December 2021

India has historically offered diversification benefits through low levels of correlation across a wide range of both emerging and developed-market issuers.

	GBI-EM Index*	USA	China	Egypt	India	Kazak.	Philip.	Ukraine	Brazil	Chile	Indones.	Serbia	S.Africa	Poland	Mexico	Thailand	Malaysia	Romania	Peru	Turkey	Uruguay
GBI-EM Index*	1.00	0.36	0.02	-0.08	-0.05	0.71	0.52	0.49	0.61	0.65	0.40	0.10	0.26	0.36	0.36	0.71	0.68	0.51	0.65	0.11	0.73
USA	0.36	1.00	0.37	-0.17	0.21	0.07	0.36	-0.23	0.18	0.36	0.30	-0.09	0.21	0.47	0.66	0.46	0.38	-0.03	-0.17	0.12	0.34
China	0.02	0.37	1.00	-0.07	0.14	-0.18	0.05	-0.28	0.18	0.22	-0.05	-0.04	0.12	0.43	0.26	0.34	0.23	0.05	-0.11	-0.07	-0.06
Egypt	-0.08	-0.17	-0.07	1.00	0.51	-0.10	-0.06	-0.04	0.07	-0.22	-0.16	-0.14	0.12	-0.03	-0.04	-0.10	-0.20	-0.07	0.10	0.02	-0.19
India	-0.05	0.21	0.14	0.51	1.00	-0.20	0.06	-0.22	0.08	-0.06	-0.14	-0.11	0.08	0.25	0.21	0.01	-0.07	0.02	-0.11	-0.02	-0.07
Kazakhstan	0.71	0.07	-0.18	-0.10	-0.20	1.00	0.41	0.76	0.30	0.33	0.38	0.17	0.26	0.15	-0.01	0.57	0.67	0.54	0.63	-0.06	0.79
Philippines	0.52	0.36	0.05	-0.06	0.06	0.41	1.00	0.27	0.20	0.30	0.24	0.16	0.19	0.20	0.44	0.23	0.32	0.14	0.25	0.16	0.50
Ukraine	0.49	-0.23	-0.28	-0.04	-0.22	0.76	0.27	1.00	0.15	0.29	0.17	0.17	0.16	-0.17	-0.09	0.32	0.34	0.38	0.64	-0.07	0.57
Brazil	0.61	0.18	0.18	0.07	0.08	0.30	0.20	0.15	1.00	0.20	-0.03	0.01	0.30	0.25	0.32	0.50	0.56	0.32	0.57	0.16	0.28
Chile	0.65	-0.17	-0.11	0.10	-0.11	0.63	0.30	0.64	0.57	1.00	-0.01	0.21	0.29	0.03	0.04	0.48	0.51	0.47	0.47	0.17	0.37
Indonesia	0.40	0.30	-0.05	-0.16	-0.14	0.38	0.24	0.17	-0.03	0.09	1.00	0.00	-0.14	0.09	0.08	0.19	0.20	0.08	-0.01	-0.04	0.53
Serbia	0.10	-0.09	-0.04	-0.14	-0.11	0.17	0.16	0.17	0.01	0.07	0.00	1.00	0.15	0.26	-0.06	-0.03	0.05	0.19	0.21	-0.22	0.09
South Africa	0.26	0.21	0.12	0.12	0.08	0.26	0.19	0.16	0.30	0.36	-0.14	0.15	1.00	0.34	0.30	0.38	0.42	0.25	0.29	0.22	0.11
Poland	0.36	0.47	0.43	-0.03	0.25	0.15	0.20	-0.17	0.25	0.31	0.09	0.26	0.34	1.00	0.27	0.51	0.44	0.53	0.03	-0.04	0.25
Mexico	0.36	0.66	0.26	-0.04	0.21	-0.01	0.44	-0.09	0.32	0.26	0.08	-0.06	0.30	0.27	1.00	0.31	0.21	-0.02	0.04	0.33	0.22
Thailand	0.71	0.46	0.34	-0.10	0.01	0.57	0.23	0.32	0.50	0.43	0.19	-0.03	0.38	0.51	0.31	1.00	0.81	0.59	0.48	0.07	0.59
Malaysia	0.68	0.38	0.23	-0.20	-0.07	0.67	0.32	0.34	0.56	0.42	0.20	0.05	0.42	0.44	0.21	0.81	1.00	0.55	0.51	0.02	0.66
Romania	0.51	-0.03	0.05	-0.07	0.02	0.54	0.14	0.38	0.32	0.27	0.08	0.19	0.25	0.53	-0.02	0.59	0.55	1.00	0.47	-0.20	0.48
Peru	0.65	-0.17	-0.11	0.10	-0.11	0.63	0.25	0.64	0.57	0.30	-0.01	0.21	0.29	0.03	0.04	0.48	0.51	0.47	1.00	0.11	0.50
Turkey	0.11	0.12	-0.07	0.02	-0.02	-0.06	0.16	-0.07	0.16	0.17	-0.04	-0.22	0.22	-0.04	0.33	0.07	0.02	-0.20	0.11	1.00	0.03
Uruguay	0.73	0.34	-0.06	-0.19	-0.07	0.79	0.50	0.57	0.28	0.37	0.53	0.09	0.11	0.25	0.22	0.59	0.66	0.48	0.50	0.03	1.00

Source: LGIM, J.P. Morgan, Bloomberg, data to 31 December 2021.
*J.P. Morgan GBI-EM Global Diversified Index. Where generic bonds are not available, the largest, most suitable proxy bond has been used from Bloomberg.
Past performance is not a guide to the future. It should be noted that diversification is no guarantee against a loss in a declining market.

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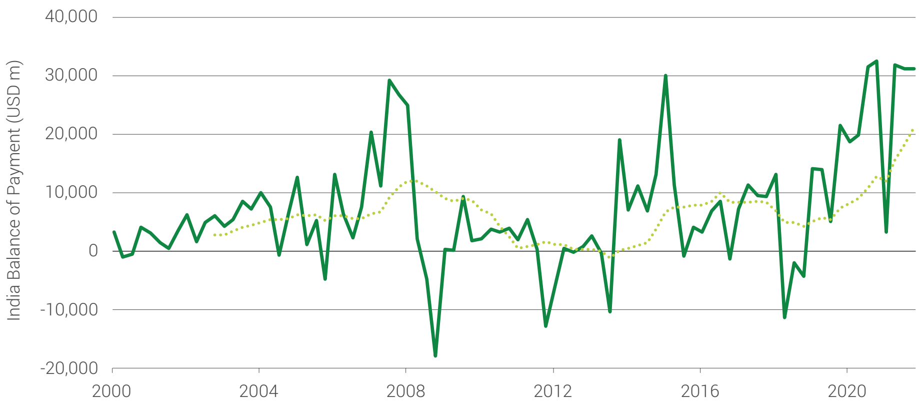
Evolution of the Indian rupee (INR) FX landscape

Graph 5: Positive balance of payments

Similar to other quickly growing emerging markets, India has maintained a moderate current account deficit since 2013. However, due to India's attractiveness as a destination for FDI, the current account deficit is more than fully financed by FDI, leading to a positive balance of payments that has meaningfully increased in recent years.



Source: Bloomberg, as of 31 January 2022.
Past performance is not a guide to the future.

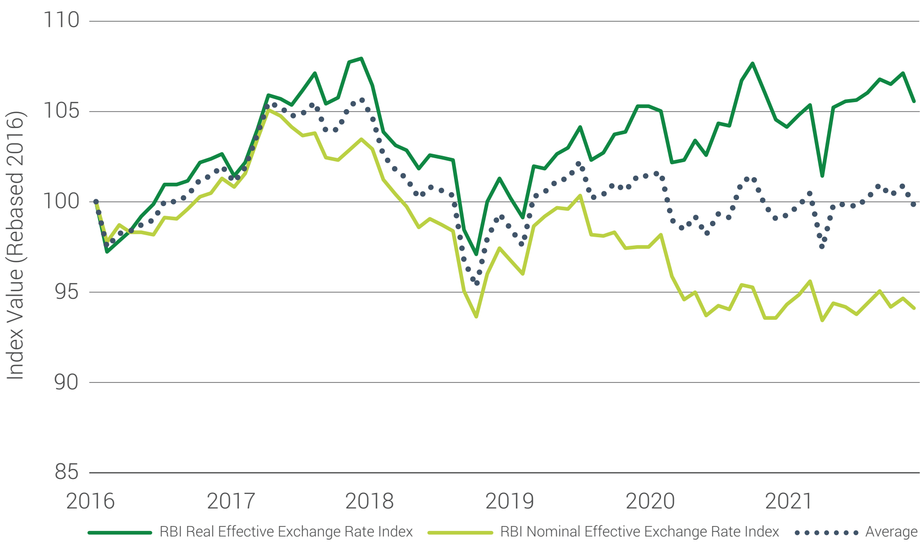
Graph 6: Increase in FX reserves

The positive balance of payments and sharp rise in FX reserves signals that the INR has been subject to appreciation pressure over the past few years. FX reserve levels are now the fourth highest globally, after China, Japan, and Switzerland.

Source: Bloomberg, as of 31 January 2022.
Past performance is not a guide to the future.

Graph 7: RBI measures of FX relative valuation

This sharp rise in FX puts the focus on the Reserve Bank of India's (RBI) outlook on the INR's relative valuation. The fact that the RBI's trade-weighted measures of real exchange rates show the currency is roughly fairly valued may go a long way to explain analysts' sanguine views around the currency's future direction.



Source: Bloomberg, as of 31 January 2022.
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India Government Bonds

The benefits of the ETF wrapper for accessing Indian bonds

The Fully Accessible Route (FAR) opened in April 2020, and the market value in USD of such bonds is now over $235 billion (source: JP Morgan, as of 21 February 2022).

FAR is a separate channel created by the Reserve Bank of India to allow non-Indian residents access to specified government securities. With direct investment in Indian bonds having been a challenge for global investors for many years, FAR avoids such trading issues and has facilitated access to the Indian debt market through a single ETF that can immediately provide full exposure to a basket of underlying bond securities rather than requiring investment in individual bonds.

The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

Potential benefits to the investor of the ETF structure

1

Easy access to a complex, highly regulated market

As opposed to many other countries, custody accounts in India are set up at a sub-fund level and not at an umbrella level, which can result in an expensive and lengthy regulatory approval process.

2

No need to deal with a complex currency

The rupee is deemed a restricted currency, which can limit its trading.

3

No need to onboard tax adviser and local broker

Our ETF is taxed as an Irish fund and is registered under the UK reporting fund status, which facilitates inclusion in tax calculations.

4

ETFs can provide meaningful liquidity, even in times of market stress

ETFs benefit from trading in both the primary and secondary markets.

India Government Bonds

Conclusion

This is a market we have been following closely for some time and where we continue to see positive developments. The Indian FAR bond market has now grown sufficiently to accommodate demand from foreign investors seeing access to India.

Given the fact that India is now aiming to recover from higher-than-projected pandemic costs, and local commercial banks are now having to reduce their holdings in local government debt (to satisfy statutory leverage ratio levels), we expect debt issuance to continue growing apace.

India's ongoing efforts to improve the ability of foreign investors to access its market have put the country on **a path to inclusion across major fixed-income indices**, including the J.P. Morgan GBI-EM Global Diversified index. This is a significant milestone for the country's ability to attract external sovereign debt financing, in our view. We expect these steps to set the tone for billions of dollars of international inflows into the world's sixth-largest economy (and second-largest emerging economy).

In addition to a current yield of ~6.4%, well distributed across the yield curve, the 17 India FAR government bonds offer a duration of ~6.5 years.[1] The local credit rating is investment grade, while offering what we believe is a compelling yield pickup of ~4.7% against its US 10-year investment-grade counterpart.[2]

Not only does Indian FAR government bonds' total market value in excess of $200 billion allow for improved liquidity, but the India debt market has historically provided strong diversification versus both emerging and developed bonds. We deem India to be one of the least correlated countries to the wider universe (see table 1).

We believe the L&G India INR Government Bond UCITS ETF offers global investors the opportunity to participate in these FAR sovereign bonds through a liquid, convenient and transparent fund structure.

1 Source: LGIM, Bloomberg, as at 21 February 2022.
2 Source: LGIM, Bloomberg, as at 31 January 2022.

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