# There's something about Rajan

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Asian markets are out of favour. A combination of Federal Reserve hesitation over when to raise interest rates and a Chinese economy that's losing momentum has cast a shadow of uncertainty over the region that is hard to dispel.

That's a shame because investors risk overlooking one of the most promising investment stories in the world right now – India. Before you start complaining about stalled reforms and the end of Prime Minister Narendra Modi's political honeymoon, there's a lot going on that has big implications for bond investors.

The story really isn't about Modi. This story is about the governor of the Reserve Bank of India, Raghuram Rajan, who is the first Indian Central Bank head to explicitly target inflation.

Rajan has helped restore credibility to Indian monetary policy. While inflation at some 4.4% may seem high to the rest of the world, this is a country where prices used to rise at double-digit rates when poor monsoon rains led to food shortages.

Some credit must go to cheaper oil (India is a major importer) but we think Rajan's role cannot be underestimated. He is probably the best central banker in the world right now.

As chief economist at the International Monetary Fund, he warned central banks of the growing risks that were in the global financial system almost three years before the collapse of Lehman Brothers in 2008. When our senior fund manager met him earlier this year (2015) he reported back that Rajan is even more impressive in person.

Rajan, the inflation buster, is targeting consumer price inflation of 4% (plus or minus 2 percentage points). He has Modi's full backing because this target is in line with the Prime Minister's desire to raise the real incomes of India's poorest people.

Our confidence in the Central Bank's ability to maintain its inflation target is strengthened by the structural reforms being pushed through by Modi, despite what you may have read in the newspapers about delays and setbacks.

The best example is the way food inflation has been kept under control, despite poor monsoons for two consecutive years. Modi's government has been very successful in getting grain supplies to areas in need and in deterring hoarding. All of this shows a remarkable degree of competence.

Why is this important for fixed income investors? Well, if Rajan manages to keep inflation at these levels, then investors must ask themselves why 10-year local currency government bonds yield more than 7.5%. If inflation expectations going forward are around 4%, this suggests the 10-year 'risk free' cost of money should be much lower.

The answer could simply be that the government needs to pay a high 'risk premium' because it's a risky borrower. Certainly, India was risky in the past because the government and the central bank lacked credibility and earlier reform efforts didn't go far enough.

Even now, Indian local currency government bonds are rated lower than their Chinese counterparts by both Standard & Poor's and Moody's, while Chinese 10-year government debt yields just over 3%, less than half the yield of bonds issued by India.

But India has come a long way since 2013 when the country's vulnerability to capital flight was exposed during the so-called 'taper tantrum'. That was after former Federal Reserve chairman Ben Bernanke had caused panic by talking about an end to central bank stimulus. Back then India was considered a weak link in the emerging markets, burdened with chronic deficits on both the fiscal and current accounts.

Today the country is the brightest star within the BRICs (Brazil, Russia, India and China) constellation as data show that economic growth may be faster than China's, government finances are in better health and the rupee has proven to be one of the more resilient emerging market currencies against a reinvigorated dollar.

That's why we think Indian country risk is massively mispriced. Rupee-denominated government bonds should not yield this much. The risk premium for India is too high and should fall.

If we're right – inflation is down for good and other low-key reforms bring benefits to the economy – there's a potential for the term structure of Indian interest rates to fall. Bond prices will rise as yields decline. Lower borrowing costs will help companies grow, which will raise earnings and share prices will also benefit. The combination of economic improvement and rising asset prices will attract foreign portfolio investment, and more capital inflows will strengthen the rupee.

Not much is certain going into 2016, but this is one of our fixed income fund managers' favourite trades regardless of whether they manage regional or global portfolios. That's because we feel quietly confident we're onto something special.

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**The value of investments and the income from them can go down as well as up and you may get back less than the amount invested**

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