EXECUTIVE SUMMARY

At a time when weak commodity prices and concerns about global growth have dampened investor appetite for emerging market risk assets, India is a rare focus of investor optimism, in large part because of a change in political leadership driving hopes of reforms and domestic investment unlocking growth. On the other hand, investors are punishing Turkey – a market that, like India, is a beneficiary of low energy prices – for its persistent current account deficits and perceptions of heighted political risks.

This analysis argues that the new Bharata Janata Party (BJP) government of Narendra Modi in India has underwhelmed both in terms of actual achievements and details of future policy direction, and that India stands to offer further incremental disappointments going forward because of the political calendar and broader structural issues. By contrast, Turkey stands to benefit from a reduction in macroeconomic headwinds, positive political catalysts, and a geopolitically-driven energy windfall that helps hedge against a rebound in oil prices.

Investors should favor Turkish equities (trading at a forward PE of less than 10.5x) over Indian equities (trading at more than 16x). The Borsa Istanbul 100 index trades at a level 2% below its July 2014 peak, even though Brent crude oil fell more than 47% in the same period and the Indian Sensex rose 10% (6% in USD terms). As investors look past the June elections and price in improving inflation dynamics, a Turkish equities re-rating to a still-reasonable (relative to India and history) 13x forward multiple, implies **upside of nearly 25% in Turkish equities within 9-12 months**, with the potential for a kicker from favorable earnings revisions. Turkish CDS spreads currently at 208bps could easily fall to December 2014 levels of under 160bps, potentially seeing lows below 120bps visited in 2013.

Investors should see India as a rate cut story fueled by falling inflation rather than buying into the story of a Modi revolution, seeing the recent selloff in bonds as an opportunity, and underweighting equity exposure to the financial and infrastructure sectors hyped by Modi mania. Banks offer an unappealing choice between weak balance sheets in the case of PSU banks and rich valuations of as much as 3x book value for private sector names. Meanwhile, infrastructure plays are likely to continue to disappoint from an earnings standpoint. **Indian equities overall will be bolstered by lower inflation, incremental rate cuts, and Modi mania, so investors should not have an outright short on the asset class, but avoid sectors seen as levered to Modi's investment plans, which are likely to disappoint.**

THE EMERGING MARKETS BARBELL OF POLITICAL RISK

The fall of Egypt's Hosni Mubarak in early 2011 reinforced the importance of political risk in the minds of emerging markets investors. Since then, events such as the Bolotnaya Square protests in Moscow in 2011, the Gezi Park demonstrations in Istanbul in 2013, have lead to periods of heightened volatility and the application of sustained political risk discounts on the part of emerging market investors in certain markets. On the other hand, the prospect of political change has been a powerful driver of upside in other emerging markets, as seen in the (misguided) rally in Brazilian equities ahead of the 2014 presidential polls, and especially the Modi mania currently gripping investors in Indian equities.

The paradox is that just as investors are more conscious of politics as a driver of returns, they are inconsistent in how they conceive of political risk and opportunities – some markets are being heavily punished, whereas in other markets, political risk is being underappreciated.

One example I highlighted in January, and which persists broadly is in the CDS markets for oil-producing countries such as Russia and Iraq, where the spread on the former is still 334bps (after having been more than 500bps when first flagged), while the spread of the latter – a country with no appreciable control over its borders – is only than 345bps. Given the underlying geopolitical dynamics and their implications for public finances, the spread should be wider.

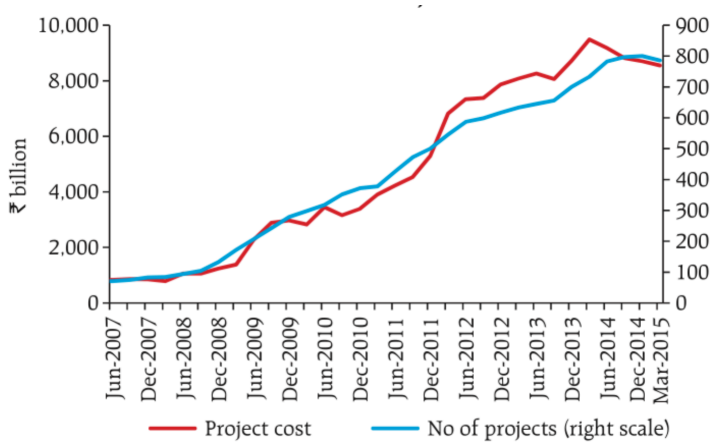
The disconnect in investor perceptions regarding political risk carries through to commodity-importers. **In particular, the comparison of India and Turkey suggests that markets are overly optimistic about the prospects for the former, while being overly negative on the prospects for the latter.**

MODI'S FIRST 10 MONTHS IN OFFICE: UNDERWHELMING SO FAR

Since the formal announcement by the Bharata Janata Party (BJP) of its selection of then-Gujarat Chief Minister Narendra Modi as its candidate for the post of Prime Minister on 13 September 2013, the benchmark S&P Sensex Index has rallied more than 45% in both local currency and dollar terms. Much of this investor euphoria actually took place before election results were announced. **The rally between Modi's anointment as BJP candidate and the announcement of election results in May 2014 accounts for more than 33 percentage points of the 46% dollar return in the benchmark index from September 2103 to date.** Since the election results were announced, the index has risen more than 12% in USD terms.

The record of the Modi government since taking office should give investors pause. Most recently, the government's budget was an underwhelming affair insofar as the finance minister pushed back the goal of achieving a fiscal deficit target of 3% of GDP from two years to three. In spite of the government's declared aims of boosting growth through investment, it has barely managed to dent the massive backlog of stalled projects – in both private and public sectors.

Figure 1: Modi has thus far failed to break the backlog of stalled investment projects



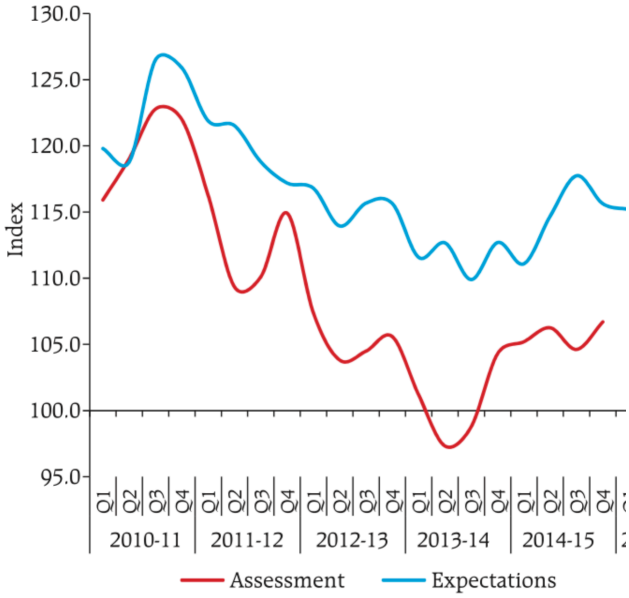
Source: RBI, Centre for Monitoring Indian Economy (CMIE)

Modi's legislative agenda has suffered major setbacks. The main obstacle to his legislative plans was that in spite of his control over the lower house (Lok Sabha), he lacked the votes needed to push key bills through the upper house (Rajya Sabha), whose members are indirectly elected by the state legislatures. True, he has passed laws in favor of opening the coal sector to commercial development. Nevertheless, in other matters, Modi has relied on controversial ordinances to compensate for his inability to pass bills in Parliament. **A major legislative failure is Modi's Land Acquisition Bill, aimed at facilitating the acquisition of rural land for infrastructure and industrial development.** Failing to secure the votes necessary for passage in the legislature, even after watering down the bill, Modi has resorted to a series of temporary ordinances. The strategy is counterproductive insofar as the nature of ordinances fails to provide the confidence in regulatory continuity that promotes investment while simultaneously hurting Modi politically insofar as he appears to be ruling by decree rather than consensus.

State elections, too, have proven to be a headwind rather than a tailwind. After wins in state elections in the northern regions of Jarkand, Jammu & Kashmir, and Haryana, the ruling NDA coalition suffered a devastating defeat in the Delhi state elections earlier this year, winning a mere 3 seats out of 70, with the remaining 67 going to the Aam Aadmi or "Common Man" party led by Arvind Kerjiwal. The loss in the capital district was notable for several reasons – it was overwhelming, at the hands of a relatively new upstart party, and took place in the north of country in a state where the BJP has done well in the past (if not a dominant force in Delhi, the BJP did win the Delhi state elections of 1993 and 2013 and were polling well before the current election). **The Delhi defeat has now centered attention on the upcoming Bihar elections, due before 29 November 2015.** At a time when the nearly 70% of Indians that live in rural areas are already under strain due to the negative impact of rains on crops, and with the opposition is seizing on the land acquisition bill as a way to paint Modi's government as anti-farmer and pro-corporate, elections in an overwhelming rural state like Bihar will be particularly challenging for Modi.

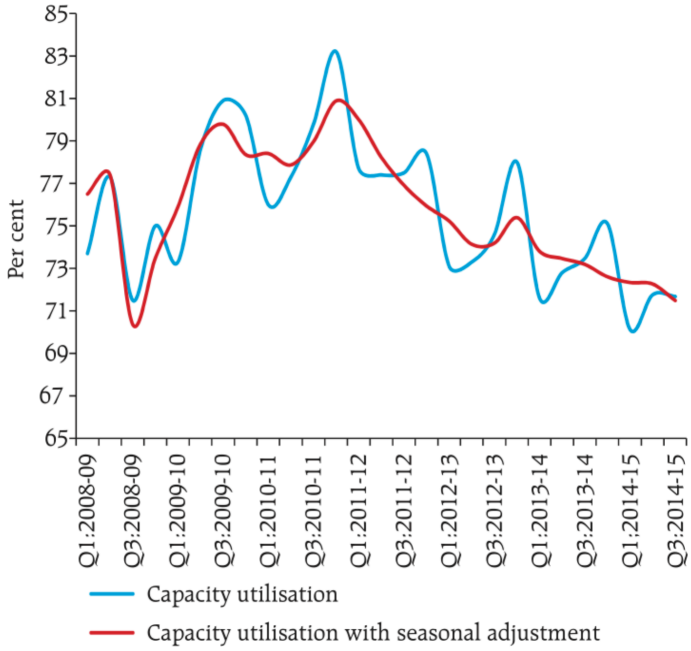
Meanwhile, Modi Mania seems to have escaped corporate India. Notwithstanding investor optimism and mantras about reform and infrastructure investment, corporate earnings have consistently disappointed investors. The banking system remains under pressure, loan demand from the corporate sector remains weak, suggesting that in spite of their dutiful public praise of the government's reform agenda and the optimism of portfolio investors, India's corporate leaders are not buying into the Modi boom.

Figure 2: RBI Business Expectations Index suggests flagging optimism



Source: RBI

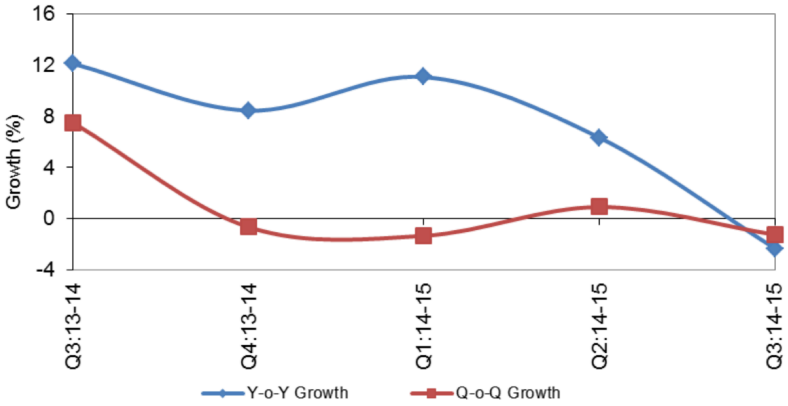
Figure 3: Capacity utilization continues to fall in Modi's India



Source: RBI (April 2015)

In considering business confidence measures, it is particularly notable that, according to the Reserve Bank of India (RBI), falling costs (and growing margins) are the main driver of optimism, while weak top-line drivers are the key reasons behind incremental pessimism. Data reports of falling capacity utilization and flagging order books are manifestations of these phenomena.

Figure 4: Growth in new orders (%) has only weakened



Source: RBI Quarterly Order Books, Inventories and Capacity Utilisation Survey (latest; Oct-Dec 2014)

With key items of legislation stuck in parliament, embarrassing defeats in state elections, which are at risk of continuing through year-end, and with a lackluster corporate response in terms of both earnings and new investment, Modi's first 10 months in office have failed to deliver on the pre-election hype. More worrying, from the standpoint of a market that in aggregate trades at a forward PE of more than 16 with some banks trading at more than 3x book value, is the difficult road ahead.

RAILWAYS: THE DEVIL IN THE REVEALING DETAILS

One of the cornerstones of Modi's plan for reviving India's economy is an ambitious program of $137bn in spending on the country's railways over the next five years. Railways are one of the least controversial aspects of India's economy – many of Modi's political opponents have actually praised his desire to invest in railway infrastructure even as they fight him on other fronts.

At first glance, Modi's focus on railways as an engine of growth is logical. Not only does increasing railway capacity unlock growth potential in manufacturing and lower barriers to trade and broaden labor markets, but capital expenditure on railways has a large multiplier effect – of at least 5x according to estimates in the government's latest *Economic Survey*. Moreover, with railways accounting for only 33% of freight transport (lower than even in the road-heavy and more energy independent US), the potential for efficiency gains from modal shift of traffic in favor of railways is large.

Modi's plan, however, fails to acknowledge that the railroad problem in India is one of software, not hardware. According to the *Economic Survey* prepared by Modi's own chief economic advisor, India's freight rates are the highest in the world, largely in order to subsidize passenger traffic at rates that, over the course of 20 years, have risen at a rate far below inflation. The average revenue yield on passenger traffic in India is now 85% below that in Russia, whereas the average yield for freight traffic is more than 33% and 72% higher than the yield in Russia and China, respectively. Meanwhile, according to government estimates, freight demand is far more sensitive to price than is passenger demand, with the price elasticity of demand for the former standing at 55%, while the elasticity of demand for the latter is less than 15%.

Whereas railways are a more efficient form of transport than road for both freight and passenger traffic, the energy savings for freight are 75-90%, but only 5-21% for passenger traffic. This dramatic difference in energy savings is explained by the need to move passengers at faster rates and along more direct routes, while freight trains are most efficiently operated at low speeds and frequently in lengths as long as 2 miles. Given that freight and passenger trains share the same track in India, and that the latter are given priority for speed reasons, it is not surprising that **65% of network capacity is used by passenger service** according to the *Economic Survey.*

The Indian passenger rail service is a handout to the urban rich at the expense of industry and farmers. According to the *Economic Survey*, the top 20% of households account for 72% of passenger rail traffic in India. Thus not only does passenger traffic tie up valuable network capacity, but it does so to cater to the subsidized travel of the richest 20% of the population.

Modi's railway program in India is doing little to tackle the fundamental problem with the system. A network that allocates 65% of its capacity to service the top 20% of (overwhelmingly urban) households at a subsidized rate while denying access to industry suffers from a misallocation of existing resources rather than the need for capital. Throwing capital at the system will do little to fix the underlying problem, which is at root one of political economy, and which requires political will and the spending of political capital to fix.

Far from using his win to enact visionary reforms in the rail sector, Modi is being remarkably squeamish. Rather than rationalizing a perverse system of prices that punishes industry and subsidizes wealthy urban households, Modi has actually reinforced it in the aftermath of his party's humiliation in the Delhi elections by pushing a budget that is seeing hikes in freight rates by 3.2% but no material increase in passenger fares. **While Modi's rail proposals may play well with voters, investors should be wary of plans to spend more on a system that represents a massive and poorly-targeted subsidy, and they certainly should not think of a politician willing to enact such plans as a politically brave reformer of the system.**

THE FLAWS WITH "MAKE IN INDIA"

Another cornerstone of Modi's recipe for economic success lies in his "Make in India" campaign. The idea is to use India's "demographic dividend" to turn the country into the workshop of the world along the lines of China's recent experience. The problem with this campaign is manifold.

Firstly, the campaign assumes the generalizability of a model "proved" only in Gujarat. According to the government's own estimates, only in Gujarat has the peak share of manufacturing in GDP exceeded 20%, with even relatively advanced and prosperous states like Tamil Nadu and Kerala seeing peak rates of only 18% and 10%, after which they underwent a process of deindustrialization.

Indeed, the campaign ignores the reality that India's peculiar path may be one better suited to rural and urban services development. In both Tamil Nadu and Kerala, the economy moved on from a brief flirtation with industrial production to a more service-focused economy, rooted in part on the IT and outsourcing economy. This trend (seen in other provinces) reflects the reality that in India, job-creation from manufacturing is limited. Research by the prime minister's own chief economic advisor suggests that this phenomenon is due to the dependence of registered manufacturing on skilled workers rather than the unskilled labor that is abundant in India. As the *Economic Survey* concludes, "the skill intensity of the [registered manufacturing] sector is not quite aligned with India's comparative advantage."[1]

Insofar as "Make in India" seeks to absorb the youth bulge in the country, it is misguided. Not only does it depend on a reduction in bottlenecks in labor, capital, and land markets that are severe – and which the government's problematic approach to railway reform will do little to

[1] See in particular, "What to Make in India? Manufacturing or Services?" *Economic Survey of India*, Vol. I, 2015; 102-116.

alleviate – but it fundamentally caters to urban skilled workers, who are a minority of the workforce, and who in any case may be better utilized in the services sector that has been a major driver of growth in the past.

Even assuming that Modi is able to implement key programs vis-à-vis railways and manufacturing, the government's own research into these sectors raises serious questions about the wisdom of such plans. While investing in transportation infrastructure and manufacturing capacity may superficially put India on a Chinese-like path, the particularities of the Indian situation may warrant a different approach.

THE POLITICAL CALENDAR: A CATALYST FOR INDIA-TURKEY CONVERGENCE?

The political calendar in both India and Turkey suggests potential catalysts for convergence. In the case of India, the recent Delhi state election was a stunning defeat for the BJP – a party with roots in the north, which has in the past had some success in Delhi – that saw the upstart Aam Aadmi Party ("Common Man Party") win 67 seats, leaving the BJP with the remaining 3. **The upcoming Bihar state elections, due before 29 November 2015, will be a key test for the BJP.** The Delhi results were a reminder that pre-election polling in India is notoriously unreliable, but Modi faces an uphill battle given the perceived anti-rural tinge to his reform program. **The BJP is caught in a dilemma: water down the reform programs to improve chances with Bihar's rural voters and risk disappointing investors, or push on with reforms-by-ordinance at the risk of losing Bihar, not to mention other states (e.g., Kerala, West Bengal) in 2016, where the BJP has been historically weaker.** In the latter case, implementation of reforms would become increasingly difficult given the unprecedented devolution to the states that is taking place in India.

The upcoming Congress protest on 19 April against Modi's Land Acquisition bill is a sign of things to come. Congress is merely acting out an old tradition in Indian politics that has led to negative market shocks in the past (notably in 2011-2012, when the BJP opposed reforms in the retail sector) and which underscore the difficulties Modi is having in implementing a China-inspired program in the context of India. Particularly in light of data showing disinflation and even outright deflation in rural India (still the majority of the country), the prospects of opposition- and farmer-led protests over efforts to free up rural land markets to promote investment are not encouraging from a sentiment standpoint.

Meanwhile, in Turkey, the political calendar offers the prospects for positive market catalysts. While many commentators see an authoritarian streak in Erdoğan's vocal remarks about central bank (CBRT) policy, he is no doubt sensitive to the **upcoming 7 June Turkish general election.** Heading off a potential challenge for leadership of his bloc from former foreign minister and current prime minister Ahmet Davutoğlu, Erdoğan hedged himself. By setting a target for winning 400/550 seats in the parliament he has at once set a very high bar for Davutoğlu. If the latter delivers, Erdoğan will have the necessary votes to turn Turkey into a presidential system. If Davutoğlu fails, Erdoğan's position as ultimate leader of the AKP will be vindicated. **Either way, barring any surprises, the summer should see Erdoğan emerge with a renewed electoral mandate and with the political capital to curb his recent populist remarks that have led to so much investor concern.** Indeed, Erdoğan's recent meeting with CBRT head Erdem Başçı and Deputy PM and economic tsar Ali Babacan and subsequent

conciliatory remarks is evidence of a more statesmanlike approach to the inflation and interest rate debate.

THE SELECTIVE READING OF INDIAN AND TURKISH POLITICAL HISTORY

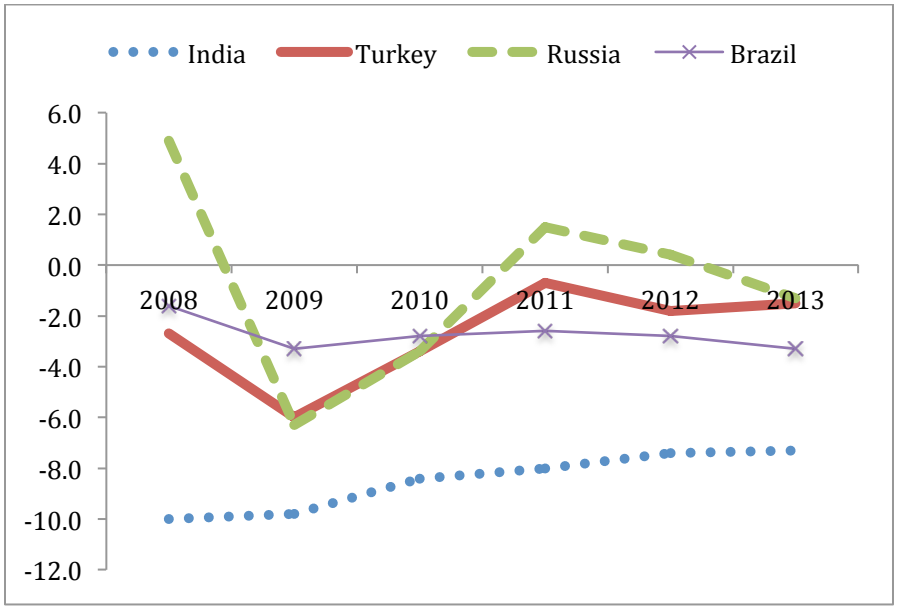
A striking feature of much of the commentary about Modi and Erdoğan is the cognitive dissonance in dominant narratives about both leaders.

In spite of recent concerns, Erdoğan's track-record is actually quite good. Erdoğan's record is a stark contrast to some of the more critical commentary in the political and financial press about his populist stances. On the socio-political front, Turkey under the ruling Justice and Development Party (AKP) has made huge progress. True, recent ham-fisted attempts by the government to control social media and the press backfired, but they occurred in a country with long-standing restrictions on the press. Erdoğan did not invent the practice of restricting speech of jailing journalists in Turkey. If anything, on subjects ranging from the legacy of Ataturk to the Armenian genocide, discourse is freer than ever before in modern Turkish history.

In other areas, the increasing liberalization of Turkish society is also tangible. It was under the AKP that construction of the first new church in Turkey since 1923 has started, while Kurds enjoy greater freedoms than ever before in modern Turkish history. Indeed, in the pre-AKP era it was inconceivable to have a Kurd of humble origin appointed as finance minister, and for him to speak in Kurdish in public on an official overseas visit to Iraqi Kurdistan. That Turkish officials will mention the word "Kurdistan" at all in conversations is another sign of the liberalization and pragmatic attitude the AKP has introduced in Turkey, as is the heavy involvement of Turkish businessmen in developing Iraqi Kurdistan.

On the economy, detractors frequently argue that the AKP's supposed success is really due to the country's 2001 program with the International Monetary Fund (IMF). Yet the successful implementation of a program and the discipline to stick to it are rooted in political will – something that has been all-too-lacking in other emerging markets. At a time when Modi's government is being applauded by foreign investors for targeting a fiscal deficit of 3% of GDP, even as it pushes back its timeline for doing so, Erdoğan has kept Turkey's deficit below 2% for years. Whereas India and other markets are being praised for removing costly fuel subsidies, **Turkey – a country even more dependent on fossil fuel imports than India – has for years not only refused to subsidize fuel, but has the second-highest gasoline prices in the world due to taxation**, according to Bloomberg. Investors concerned about Erdoğan's pressuring the CBRT on interest rates should also consider that he has resisted the temptation to play to his political base by lowering fuel taxes and resorting to other analogous fiscally irresponsible measures.

Figure 5: Populist Erdoğan? (Fiscal deficit as % of GDP)



Source: IMF Fiscal Monitor (latest, April 2014)

True, Turkey's current account deficit is about more than just energy. Turkey's savings rate of 12.6% is amongst the lowest in the emerging world, and is in strong contrast to India's (falling) rate of c. 30%, if not much lower than South Africa's 13.2% and Brazil's 15.8%. Far from driving or encouraging such a low savings rate, Erdoğan and the AKP have been actively seeking to raise it. The AKP's overhaul of the pension system in Turkey was an effort in part to deepen the domestic institutional savings pool to help reduce a reliance on foreign capital. Speeches by Erdoğan and other senior AKP leaders frequently call on Turkish consumers to restrain spending. Beyond just trying to talk up savings, the government has taken political risks by introducing macro prudential measures, including restrictions on installment and credit card payments, including particularly severe restrictions on purchases of popular consumer items such as mobile phones. **The willingness of the AKP to take such unpopular actions stands in stark contrast to the Modi government's unwillingness to spend political capital on railway subsidy reform.**

More broadly, Modi's political history is considerably more checkered than that of Erdoğan. Whereas Erdoğan has been accused of intimidation of journalists and political opponents, Modi has been associated with outright murder – to such a degree that he was denied a U.S. visa while heading the Gujarat government. Although such accusations were not proven in court, officials in his government and BJP politicians were implicated in inciting and aiding anti-minority pogroms that led to the deaths of thousands as well as subsequent cover-ups. More recently, militant wings of Modi's political bloc have disturbingly continued to be associated with violent acts – witness the church destruction in Haryana last month. There is a large gulf indeed with such violent crimes and the behavior of which the AKP and Erdoğan are accused.

On the economic reform and fiscal responsibility front, too, the record of Modi and the BJP is questionable. While in opposition, the BJP frequently opposed reform efforts, notably in 2011-2012 when it encouraged popular protests against the then Congress government's efforts

to liberalize restrictions on FDI investment in the retail sector. Such moves led to investor disappointment at the time, and ironically investors in the Modi story now face similar risks from a Congress-led opposition.

More recently, the aforementioned backtracking on previous promises about the speed of fiscal consolidation and the avoidance of serious overhaul of subsidies in the railways brings into question the narrative of Modi as free market and economically responsible revolutionary. **As a party, the BJP's record of being a consistently reformist voice is weak; as a leader, Modi's own reformist record over the last 10 months is ambivalent, partly because of his unwillingness to spend political capital on the really tough decisions, and partly because of the questionable efficacy of the plans he is pushing.**

STRATEGIC TAILWINDS AND HEADWINDS

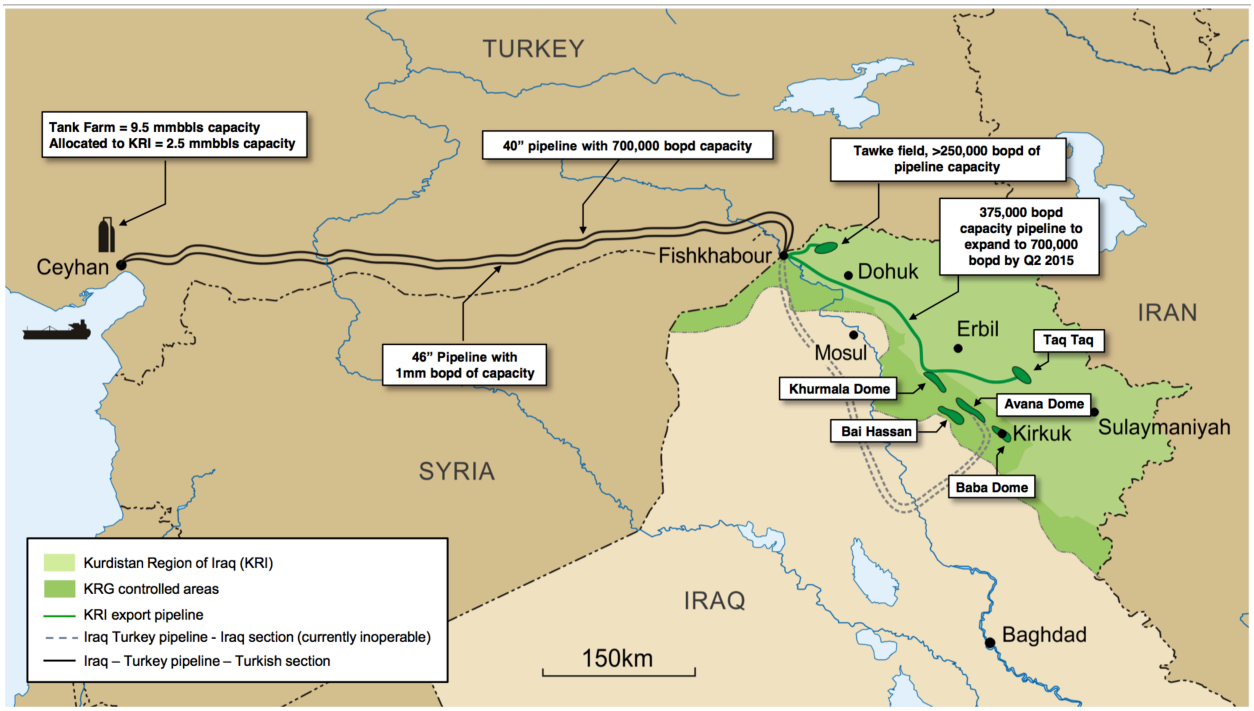
Longer-term structural and strategic issues also suggest marginal upside for Turkey and roadblocks for India relative to investor expectations.

In the long-run Turkey stands to benefit from a geopolitically-driven energy windfall. The broad consensus – shared even by the CBRT in its most recent inflation report – is that geopolitical dislocations in Ukraine, Syria, and Iraq are net losses for Turkey insofar as they hurt trade with key partners in Russia and the Middle East. As recently as 2012, Iraq was Turkey's largest Middle Eastern export market and overall second only to Germany, accounting for 7% of Turkish exports. Yet the consequence of the deteriorating relations between Russia and the West and the beginnings of the partition of Iraq is the creation of two major distressed sellers of energy in Turkey's neighborhood.

The Russian energy reorientation stands to more than double the gross supply of Russian gas to Turkey. In 2014, Turkey sourced 56% of its gas, or 27bcm from Russia. The recent reorientation of the erstwhile "South Stream" Europe-bound pipeline into the Turkey-bound "Turkish Stream" route stands to bring an incremental 63bcm of gas into Turkey. While most (47bcm according to some estimates) of this incremental gas flow may well be re-exported, the favorable impact on Turkey from these developments is evidenced by recent reports in Russian media about **discounts of as much as 10.25% on future Russian gas shipments to Turkey.**

The turmoil in Iraq, too, has a silver lining for Turkey on the energy front. A consequence of the de-facto partition of Iraq since the fall of Saddam Hussein has been the emergence of an autonomous Kurdish state in the north of the country, bordering Turkey. Turkish companies have been aggressively involved in the development of Iraqi Kurdistan, and the Turkish government – and Erdoğan in particular – have actively cultivated the Iraqi Kurds through overtures vis-à-vis the peace process, and through cooperation on infrastructure projects. A key component of the latter has been the development of pipeline capacity facilitating the export of Kurdish oil via the Turkish energy hub of Ceyhan, with capacity having reached 425,000 bpd as of 1Q15. When completed, this capacity will increase four times to 1.7mm bpd.

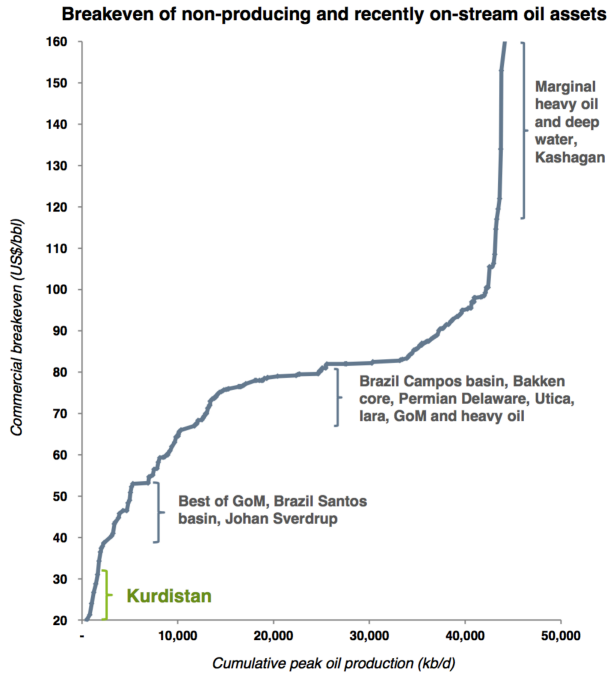
Figure 6: Turkey will be the key export route for oil from Iraqi Kurdistan



Source: Genel Energy

Moreover, Kurdish oil production is likely to continue under almost any reasonable price scenario, given that it is amongst the cheapest to extract globally (see Figure 7 below).

Figure 7: Kurdistani oil would remain economical even if oil prices were to fall further



Source: Genel Energy

Whereas the geopolitical dislocations in Turkey's neighborhood have paradoxically produced an energy windfall on its doorstep, India enjoys no such advantage. In the event of a sustained rebound in oil prices, this divergent energy trajectory may well drive a differentiation in investors' views on both markets.

Structural and institutional factors also suggest an advantage to Turkey over India. Three major obstacles on an institutional front confront Modi. The notoriously change-resistant Indian bureaucracy remains a formidable obstacle to his reform and investment program. In this sense, it is telling that the government's own analysis of the drivers of stalls in public sector investment projects found that the failure to secure bureaucratic regulatory clearances was a major factor explaining holdups even in public sector projects.

The Central Statistics Office's poorly executed overhaul of the country's growth indicators is perhaps the most striking evidence of bureaucratic headaches in Modi's India. Both the PM's chief economic advisor and the governor of the RBI have confessed their own puzzlement over the new data series. More importantly, **the RBI has explicitly stated that the inconsistencies in the data have materially complicated policymaking, citing it as one reason for the decision to hold off on further rate cuts this week.** The tendency of the Indian bureaucrat to, in the words of one major EM investor, "take something that is not broken and fix it until it is" is more than a headache for the ordinary citizen or businessman – it has quite likely delayed growth-boosting rate-cuts.

Secondly, having dissolved the once powerful Planning Commission that was a cornerstone of Indian economic policymaking since the 1950s, Modi has deprived himself of mechanism that was once a powerful tool for central control over the states. True, the body was inspired by Soviet socialism, but in the last 25 years, it became a key institutional center of reformist thinking – its last head, Montek Singh Ahluwalia, was one of the key architects of the reform program India implemented in the 1990s. At a time when states may well fall to the opposition, Modi may come to regret his push for decentralization insofar as it has deprived him of a tool to push the centre's will onto the states.

The Supreme Court represents a third, underappreciated, obstacle to Modi's program. A key aspect of Modi's plans to streamline and better target subsidies is the use of the so-called "JAM Number Trinity" seeking to leverage bank accounts, Aadhar (Unique Identification) cards, and mobile phones to facilitate direct cash transfers from the state to individual citizens. The first problem with this push to modernize the subsidy transfer system is that in a country that is still overwhelmingly rural and where illiteracy is still high, and disproportionately so amongst the poor, extending the payment infrastructure is a formidable challenge. As of April 2015, only 2/3 of the population had Aadhar numbers in the Union overall, with coverage rates particularly low in poorer and more rural states like Bihar, where the rate was less than 40%. The larger problem for Modi is that even if he manages to somehow extend JAM coverage to 100% of the country, the Supreme Court has recently reiterated that is finds the payment of subsidies contingent on having Aadhar numbers unconstitutional.

In contrast to Modi's India, one of the advantages of the more centralized and politically unified nature of Erdoğan's Turkey is that such bureaucratic and judicial barriers are easier to overcome. While investors and emerging market commentators fret about authoritarianism in Turkey, these concerns are inconsistent with a lack of attention to such factors in far more autocratic markets like China, the GCC, etc. Of course, Modi's and India's above-referenced record on minority rights and other issues, including press freedom, itself suggests the simplistic dichotomy between Indian democracy and Turkish autocracy is a false one.

CONCLUSION AND INVESTMENT IMPLICATIONS

With the Indian equity market trading at a forward PE of more than 16x overall, at 2.6x book value, and with some private sector banks trading at more than 3x book value, investor expectations about the potential for change in India are extraordinarily high. The record of Modi's first 10 months in office, the difficult political calendar confronting his party, the questionable efficacy of key proposals of his, and deeper structural and institutional impediments to his plans all suggest greater investor caution is warranted.

To the degree that lower energy prices lead to a deceleration in inflation, driving rate cuts by the RBI, investors should see India as a conventional rate cut story rather than buy into the narrative of a reform and investment driven secular growth market. Buying Indian fixed income (especially after the recent selloff) and broad baskets of equities that are not tied to the banking or infrastructure stories would give investors positive exposure to the core rate cut trend, while allowing them to avoid overpriced banks and potential setbacks on Modi's reform and investment program.

In contrast to India the Turkish market trades at a relatively undemanding forward PE of less than 10.5x and at less than 1.5x book value. Like India, Turkey benefits from lower energy prices. In contrast to India, Turkey enjoys a political calendar that offers the prospect of positive rather than negative catalysts, fewer institutional barriers to growth, and the prospect of a secular improvement in its energy import dynamics.

The Borsa Istanbul 100 Index still trades below its July 2014 peak, even though oil has fallen by more than 47%, in part driving a 10% gain in the Indian Sensex (6% in USD terms). Conservatively assuming that Turkish equities will re-rate to a PE of 13x forward earnings as investors look beyond the June elections and see continued improvements in inflation dynamics, **the Turkish index could see upside of nearly 25% from current levels over the next 9-12 months**, with the potential for earnings upgrades driving even more upside. Turkish CDS spreads of 208bps could well revert to lows below 120bps visited in 2013 in the second half of this year.

Recognizing that India is currently in a classic reflexivity up cycle driven by the optimism of foreign investors about Modi and by lower commodity prices, investors should not aggressively short India, but rather underweight it relative to Turkey, which offers more sustainable upside at a less demanding valuation.

DISCLAIMER

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