

Special Coverage:

Indian Elections – PM Modi likely to return to power with smaller majority

Key takeaways

- ◆ PM Modi's party – BJP – won 240 seats but fell short of the 303 seats won in 2019. The BJP-led National Democratic Alliance (NDA) won 293 seats, falling short of the 353 seats won in the last elections. The opposition INDIA alliance, led by Indian National Congress (INC) were the main beneficiaries, gaining more than 100 seats.
- ◆ Prime Minister Narendra Modi is highly likely to be invited by the President of India to form a government for the third consecutive term. At a broad level, we expect continuity in policies and key priorities for the government. Public capex, infrastructure and support for hi-tech and new emerging manufacturing sectors is likely to continue.
- ◆ Given the likelihood of near-term volatility, we favour large-cap equities as their more defensive nature could benefit from rotation from investor flows away from mid-and small-cap equities. India's long-term fundamentals, especially the strong GDP growth of 7.8% in the last quarter, remain supportive. We stay bullish on INR government bonds given the sizeable index inclusion flows over the next 12-18 months. We also think RBI rate cuts later this year would be a more pertinent factor in driving yields lower. S&P's recent announcement to place India's sovereign ratings on a "positive" outlook for a potential upgrade should also lead to improved investor sentiment.



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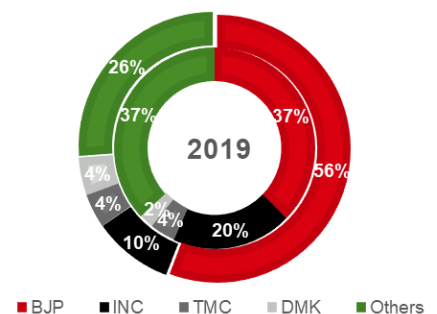
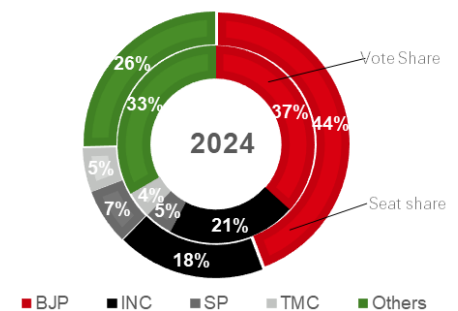
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What happened?

- The Election Commission of India announced on 4th June 2024 that PM Modi's party –BJP– won 240 seats but fell short of the 303 seats won in 2019. The BJP-led National Democratic Alliance (NDA) won 293 seats, falling short of the 353 seats won in the last elections. The opposition INDIA alliance, led by Indian National Congress (INC) were the main beneficiaries, gaining more than 100 seats.
- Indian parliament's lower house or Lok Sabha has 543 seats up for elections, which translates into a requirement of 272 seats to win a majority and form the government. Assuming that major parties in NDA alliance do not switch over to INDIA alliance, it is highly likely that the incumbent Prime Minister Narendra Modi will be invited by the President of India to form a government for the third consecutive term.
- Heading into the elections in April and even shortly after the end of voting a few days ago, most of the private exit or opinion polls had projected that NDA would win a larger number of seats compared to 2019 elections.

BJP saw a large decline in seat-share despite largely similar vote share



Source: Election Commission of India, HSBC Global Private Banking and Wealth as of 5 June 2024. Past performance is not a reliable indicator of future performance.

- Hence, while the return of PM Modi to power was in line with expectations, the margin of victory was substantially smaller than what most pollsters and investors were expecting. Unsurprisingly, Indian equity markets reacted sharply, as Nifty index declined more than 8% intraday while internationally tradeable MSCI India index fell over 9% intraday, before recovering some of the losses.
- While the knee-jerk market reaction has been sharply negative, we believe that even with a slimmer majority, the return of an NDA government is likely to point towards policy continuity and stability.
- At a broad level, we expect public capex, infrastructure and support for hi-tech and new emerging manufacturing sectors to continue. However, more challenging farm and labour reforms are unlikely to be enacted in the upcoming term, as the potential NDA-led government does not appear to have the political capital to push those through. However, in a way, the presence of a strong opposition could be a long-term positive for India's structural reform outlook as it should lead to better checks and balances. The focus will also shift to the upcoming union budget and the guidance for future fiscal trajectory.

Investment implications

- For the bond market, the narrower victory increases the risk of an increase in spending on welfare and populist schemes, which could lead to slower fiscal consolidation and greater debt issuance. However, at least in the near term, we see limited risks to supply-demand balance.
- Firstly, the recent buybacks of government securities and reduction issuance has led to a favourable demand-supply picture. Secondly, the recent large profit transfer by the RBI to the government provides further fiscal space. Thirdly, the ongoing inflows for INR bonds on the back of index inclusion provide a sizeable source of foreign demand for INR bonds.
- Hence, we believe the markets should be able to easily absorb any modest increase in supply over the next 6-12 months. However, we acknowledge that there is incrementally greater degree of uncertainty around the medium-term supply-demand dynamics and look towards the union budget announcement for more information regarding future fiscal consolidation path.
- Lastly, we believe the RBI is currently at the peak of its interest rate cycle and expect the central bank to cut rates later in the year. The potential upgrade of India's sovereign rating to BBB by S&P could lead to reduction in term-premium for Indian government bonds and further decline in yields. Overall, we continue to like INR bonds owing to the attractive yield of around 7% and their low correlation with other major bond asset classes.
- We find the performance of Indian equities around the 2004 election cycle as the closest historical comparable. Indian equities fell sharply after the incumbent NDA government unexpectedly lost the elections but ended up modestly outperforming global equities 6 months after the results.
- Compared to 2004, we believe the Indian economy and equities benefit from (i) stronger domestic investor base from both institutional and retail, (ii) light positioning from foreign investors, (iii) strong GDP growth trajectory powered by buoyant demographics and structural shift in global supply chains.
- India's economy continues to grow at a robust pace, with the GDP growth in the last two quarters surpassing consensus growth expectations. Indian equities are expected to deliver c. 36% earnings growth in 2024 and double-digit growth in 2025.

MSCI India P/E ratio is only modestly higher than its 5-year average



Source: Bloomberg, HSBC Global Private Banking and Wealth as of 5 June 2024. Past performance is not an indicator of future returns..

- While valuations (P/E ratio) are elevated relative to other Emerging Market counterparts, they are only slightly more expensive relative to their own 5-year average.
- We maintain overweight on Indian equities and favour large-cap equities as they could benefit from the near-term uncertainty. We would not rule out some rotation out of small and mid-cap equities into the more defensive large-cap segment, owing to the latter's more defensive characteristics.
- From a sector perspective, we continue to favour Industrials which should benefit from the continued government focus on infrastructure development. Any welfare schemes also have the potential to boost the earnings outlook for the consumer discretionary and staples sectors. Lastly, we continue to like Financials as they continue to benefit from tailwinds of cheaper valuations relative to the broader market, improving asset quality and strong credit growth.
- We expect USD/INR to be largely stable in the near term as the heightened uncertainty over the next few days may increase the incentive for the RBI to use its sizeable FX reserves to curb excessive INR volatility.

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