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India elections: Key reforms likely to continue amid coalition dynamics

Market update

Key reforms are likely to continue as India's new government navigates coalition dynamics. India's long-term potential remains intact, although the path to achieving its full potential may be bumpier. Staying disciplined on valuations and having a laser focus on earnings will be key to achieving sustainable returns going forward.

Narendra Modi's Bharatiya Janata Party (BJP) has won a historic third term, although with a much smaller majority than earlier predicted by exit polls. The BJP won 240 seats (down from 303 seats in the 2019 elections), falling short of a majority (272 seats) in parliament. As such, the BJP will form a coalition government with its allies, holding onto a total of 293 seats.

The return of a coalition government following 10 years of a single-party majority may introduce some uncertainty over the continuity of reforms needed to help India achieve its goal of becoming a USD5tr economy by 2030. We believe that many key reforms such as those linked to manufacturing, infrastructure and technology are likely to continue, although more contentious ones like those relating to land, labour and agriculture may be delayed. Investors may recall that it was a coalition government under the leadership of late Atal Bihari Vajpayee that had introduced important reforms such as The Fiscal Responsibility and Budget Management (FRBM) Bill in 2000.

With the India equity market valuations already rich compared to its Asian peers heading into the elections, the Nifty 50 Index fell 5.9% on Tuesday, 4th June, following the election outcome. The market has since regained some lost ground.

Investors will be assessing the government and cabinet formation in the coming days. The budget in early July should also provide greater clarity on the government's commitment to its fiscal targets. The new government may try to ensure that the dividends of high economic growth get more evenly distributed. On this backdrop, the newly elected government faces a delicate balancing act: adhering to the established fiscal consolidation path and stimulating economic growth at the same time.

Nevertheless, the long-term potential of India remains intact. The rebalancing in global supply chains has made India an increasingly important manufacturing location for global companies. The setting up of global capability centers by global firms to offshore tasks from data analysis to research and development (R&D) to India has also helped fuel a new wave of services-led growth. Meanwhile, the Indian consumer market is poised to become the world's third largest by 2027, presenting significant opportunities for investors who can tap into this potential.

As India's enhances its physical and digital infrastructure, and grows its renewable energy sector, its long-term economic outlook appears bright. India's presidency of the G20 in 2023 had already helped showcased its economic prowess and diplomatic finesse on the global stage.

There are however challenges to this rosy outlook. India's high unemployment threatens to derail its path to becoming a global economic powerhouse. With the construction sector being a major job creator, rising urbanisation may help to absorb the supply of lower skilled labour. High oil prices leading to higher inflation have also historically been a risk for India. On this front, India's increasingly diversified trade basket may help the rupee to better absorb oil price shocks going forward. India's new government will need to address these challenges while navigating coalition dynamics.

INVESTMENT IMPLICATIONS

According to **ICICI Prudential Asset Management Company (IPAMC)***, historically, election-induced volatility in the Indian stock market has proven to be short-lived. In the medium to long term, markets tend to be driven by potential earnings. The fundamental drivers of India's multi-decade growth story are still firmly in place: favorable demographic dividend, rising per capita income, under-control inflation, digital transformation, strong corporate balance sheets and consolidation of the central fiscal deficit. While investors await more clarity on coalition support, cabinet and ministry formation etc, it is nevertheless encouraging to note that the ruling National Democratic Alliance (NDA) party has ended up with a comfortable majority for the third consecutive term. This implies that there should be policy continuity with perhaps more focus on rural incomes and jobs. As such, the election outcome does not materially alter IPAMC's investment thesis. While the equity market may experience some temporary fluctuations, any further weakness could present a compelling entry point for long-term investors with a focus on fundamentals.

Likewise, **Yuan Yiu Tsai**, Portfolio Manager (Equities) at Eastspring Investments, continues to believe in the "India story", although the path to realise India's full potential may become bumpier. In the near term, he expects the Modi government to focus on rural consumption over capex spending because of upcoming state elections. On a brighter note, **Yuan Yiu** believes that market unfriendly reforms, such as the raising of the equity capital gains tax during the upcoming budget, are likely to take a backseat. The market may remain volatile in the near term as valuations of selected stocks/sectors get reset. Yuan Yiu is on the look out for opportunities as valuations become more attractive. Going forward, he believes that a disciplined, valuation-focused approach could be a less volatile proxy of the multi-year India growth story.

On the fixed income front, post the election, **IPAMC** believes that the path to fiscal consolidation may be put on the back burner as the focus shifts towards increased rural spending. Given the prospects of increased spending, long-term bond yields are unlikely to trend much lower and carry will continue to remain the main source of return for bonds. The compression in credit spreads indicates that there is high demand for investment grade corporate debt.

That said, demand for Indian government bonds (IGBs) is likely to remain supported as IGBs will be included in JP Morgan's emerging markets bond benchmark starting from 28 June 2024. IGBs will make up 10% of the index and with foreign ownership currently at around 1%, there is room for ownership levels to rise. According to **Goh Rong Ren**, Portfolio manager (Asian Fixed Income) at Eastspring, the inclusion of IGBs into the JP Morgan Emerging Market Bond Index could also encourage a similar inclusion by other leading bond index benchmarks. With a highly liquid USD 1 trillion sovereign debt market India and a growing economy, he believes that India offers attractive diversification for existing bond indices.

*IPAMC is the Investment Advisor for various India centric funds managed by Eastspring Investments.

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