Market View
India's election may weigh on structural reform

Date 14 June 2024

Author Sanjay Rijhsinghani

At a glance

- Prime Minister Narendra Modi's unexpected loss of majority caused a market sell-off and swift recovery as he formed a new coalition government.

- Modi's reduced power may slow structural reforms but enhance social stability, with a focus on infrastructure development.
- Despite short-term volatility, India's strong economic fundamentals and continued foreign investment support long-term growth prospects.

We are halfway through an election year when more global voters – some 49% of the world's population – are heading to the polls, the most ever.[1] In India, after a marathon 7-week election, the results came in on Tuesday, 4 June. Forecasts and polls were defied as Prime Minister Narendra Modi lost his outright majority for the first time in a decade, with his opposition (known by its acronym INDIA, and overseen by the Congress Party) re-emerging as a political force. Perhaps India's election serves as a warning not to rely too heavily on polls. This means that Modi will need to cobble together a broader alliance to form the next government. Whilst there is no doubt he will be successful, passing important reforms will be more challenging.

The shock result came as rural voters want more government relief. In the West, there is concern over Modi's hard stance on Hindu nationalist ideology. However, the reality is that domestic voters are more focused on issues like subsidies and inflation. Rural voters, in particular, are seeking greater support at a time when Modi has helped propel India to new heights by generating one of the fastest GDP growth rates globally.

Market reaction

After the election outcome, Indian assets sold off sharply, with equities losing 5.85% in a single day,[2] as Modi's Bharatiya Janata Party (BJP) failed to secure a majority. However, once markets realised that BJP's pro-growth stance would continue under Modi, who was named the head of a new coalition government, they swiftly recovered their losses to near all time highs.

Whilst the implications of the election result will unfold in the coming months, especially as budgets are announced and the new government is formed, Modi's initial task will be to resist popular demands for more welfare benefits. At the same time, his diluted power base may weigh on growth, as it will be more difficult to liberalise agricultural land and labour markets. However, this could potentially make the country more secure socially if it prevents the BJP from pursuing Hindu nationalist policies.[3]

Apple's expansion

If India can achieve real annual growth of 6-7% in the next five years, its economy will surpass Germany and Japan to rank third globally.[4] To accomplish this, India will need to invest heavily in infrastructure to enhance the competitiveness of its transport and logistics sectors; expand the manufacturing sector to create more jobs; and attract more foreign direct investment (FDI).

FDI flows have been strong in recent years, driven by geopolitical tailwinds such as Apple's contract manufacturer Foxconn expanding in India,[5] as money continues to be diverted from China to India.

Economic fundamentals solid

In the short-term, markets may experience increased volatily due to this political shock, which may potentially weigh on fiscal policy and economic reform. However, in the medium term, we feel that the economic fundamentals in the country remain solid. Domestic demand may soften this year compared to last year, and we may witness a rebalancing of expenditures in favour of more revenue and less capital expenditure, which would likely support consumption. The new government will likely maintain a more market-driven approach, and it's possible some of the government's previous capital expenditure plans may be diverted to support welfare and subsidy spending.[6] The BJP had considerable losses in Uttar Pradesh, India's most populous, but relatively poor, agriculture-dominated state. Therefore, it is possible some spending will be diverted here towards lower-income groups and the rural population. Nevertheless, infrastructure development will remain a key focus of the budget.

Policy reforms

Leading up to the election, BJP members maintained that labour, land and capital regulation reforms would be priority, reforms that historically faced backlash. Economists said these reforms would provide greater labour market flexibility, incentivise investment and promote job creation. However, relaxing rules around firms' firing policies faced criticism from unions. Land acquisition was another reform aimed to expedite infrastructure projects whilst facilitating setting up manufacturing sites to promote domestic manufacturing growth. Some government advisors now believe there is an increased likelihood reforms will go through with greater dialogue and collaboration across multiple stakeholders.[7]

As mentioned, equities have rebounded since the near 6% single day drop. While a potential derating of Indian assets is possible, it is worth noting Indian assets have performed well in past collation governments. The MSCI India Index gained 200% in 2004-2014, like performance under Modi's first two terms.[8] A resetting of prices could represent an opportunity for investors, especially as equity valuations are quite high compared to other emerging markets. Ultimately, we believe it is more likely policy continuity will broadly continue, with some less-contentious infrastructure investment a new focus for the government.

[1] Time, https://time.com/6550920/world-elections-2024/

[2[FactSet

[3] Gavekal Daily

[4] Gavekal Daily

[5] Time, https://time.com/6318369/apple-iphone-factory-india/

[6] Oxford Economics

[7] Oxford Economics

[8] Gavekal Daily