# India: June a key month in focus

30th May 2024

*S&P's sovereign rating outlook changed to positive yesterday for the first time since 2007 following RBI's bountiful surprise last week has sharply improved the outlook for domestic asset classes. Going forward, the month of June is in focus given election results on the 4th and start of index inclusion flows by month end. We see a rise in flows once election related uncertainty fades boosting both G-sec and INR gains.*

**Dividend bounty from RBI has improved fiscal outlook duly acknowledged by major rating agencies**

- RBI has announced a surplus transfer worth INR 2.10 trn to the government, a 140% y/y jump from INR 874 bn in FY24 while it was budgeted to remain at similar levels *(Fig.1)*. This is a fiscal boost of 0.4% of GDP in FY25.
- This has led to expectations of a sharper fiscal consolidation (i.e. below 5.1% of GDP fiscal deficit targeted in Interim Budget) and borrowing cut for dated G-secs in the final budget for FY25. Meanwhile, our bias remains towards greater allocation of the improved fiscal space to capex.
- Post this, **S&P Global Ratings revised its outlook on India to positive from stable** for the first time since 2006. Notably, this upgrade is irrespective of the 2024 election outcome.
- As per media sources, the government is attempting to engage with all major rating agencies to make a case for a potential sovereign rating upgrade. This will only strengthen the cause of index inclusion.

**Election results in focus; polls signal continued political stability**

- The voting for the Lok Sabha is currently underway with results due on 04th June 2024. The poll of polls released before the start of election cycle in mid-April signalled that the current ruling party is likely to retain power, yet the actual seats retained by the same vis-à-vis 2019 results will be closely watched (*Fig.2*).
- Historical analysis of market moves during election result periods (*Table.1*) shows that:
    - *There is no clear trend in case of bond yields yet they saw sharp softening post 2014 & 2019 election results. Both periods witnessed strong boost from debt FPI flows with the impact way sharper in 2019 as it coincided with domestic rate cut cycle.*
    - *Similarly, in case of Rupee, the last two election result periods with a clear majority mandate for ruling alliance saw flows led appreciation of 1.0-2.5% one month after election results. This was followed by depreciation of c.2.0-3.0% after 3 months.*
- However, we acknowledge that the historical trends may not hold true this time if the ruling party does not get the number of seats as expected by markets. Despite this, expectations of enhanced flows due to bond index inclusion later in June is likely to have a positive impact on both G-Sec and INR.

**Balancing the bond inclusion flows**

- JP Morgan had, in September 2023, announced the inclusion of Indian government bonds in its GBI-EM Global index suite starting June 2024.
- The index inclusion is expected to attract \$25 to \$30 billion in inflows in the next 10 months till March 2025 according to estimates. Bloomberg Index also to add India bonds to its emerging markets index in January 2025, however flows may be limited to \$3-5 bn.
- As per NSDL data, FPI flows in Debt segment during Apr-Sep-23 totaled c.INR 257bn and nearly quadrupled to c.INR 955bn during Oct 23 - Mar24 (post announcement of Bond Inclusion in Sept-24). Since the start of FY 25, with the repricing of Fed rate cut expectations, there has been FPI outflows in Debt segment to the tune of c.INR 50bn till 29th May-24 (meagre ~5.2% of the inflows since announcement) (*Fig.3*).
- Interestingly, utilization of FPI limits through the general route has seen downward pressure while that through the FAR (Fully Accessible Route) has been picking up (*Fig.4*).

**Dollar may stay supported as uncertainty looms over timing of US Fed's rate cut decision**

- The US Fed has been indicating in recent meetings that interest rates need to remain restrictive for a longer period. US economic growth indicators continue to show strength while inflation numbers are turning sticky showing resistance to move towards the 2% target.
- Since the start of the year, we have seen market pricing of start of Fed rate cut expectations shift from March to September and now towards December. This has led to upward pressure on US yields and supported the Dollar.

**We are *Positive* on both G-sec and INR**

- With the rising expectations of reduction in dated G-sec borrowing program in the Final FY25 Budget following the cut in T-bill calendar by USDINR 600bn in Q1FY25, the outlook for India dated G-sec has improved further. An improved rating outlook on India by S&P along with increased demand from FPIs on index inclusion, are likely to give a cushion to rates from external volatility. On balance, we stay *Positive* on long duration G-secs since the Budget announcement in Feb'24 with a sharp improvement seen recently in demand-supply dynamics (*Fig.5*). The latter is likely to support bonds even if the expected start of a shallow rate cut cycle from Oct'24 gets delayed.
- Rupee is expected to see inflows driven appreciation in the near term. However, Dollar is likely to stay the key driver in medium term, with higher for longer rates theme by the US likely to drive FX to move back towards the current levels. Rupee is expected to see at least half the appreciation seen historically in the recent election cycles. However, RBI's persistent efforts to build FX reserves and limit FX volatility may cap Rupee gains in the near term in our view (*Fig.6*).


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*Table.1: Historical analysis of election results and impact on Gsecs & INR*

| Election Dates | Seats of single largest party out of 545 | India 10-year Bond yield | | | INR move | | |
|---|---|---|---|---|---|---|---|
| | | Before 1 month | After 1 month | After 3 months | Before 1 month | After 1 month | After 3 months |
| 06-Oct-99 | 182 | -7.00 | -7.10 | -37.30 | -0.26% | -0.40% | 0.19% |
| 13-May-04 | 145 | 9.80 | 14.60 | 148.40 | -3.36% | -0.25% | -2.31% |
| 19-May-09 | 206 | 0.60 | 49.30 | 67.60 | 4.19% | 0.92% | -2.49% |
| 17-May-14 | 288 | -2.00 | -18.60 | -31.10 | 2.50% | 2.35% | -3.38% |
| 24-May-19 | 303 | -20.00 | -36.70 | -66.50 | 0.49% | 0.09% | -3.29% |

*Fig.1: RBI's dividend bounty boosted FY25 fiscal space by 0.4% of GDP*

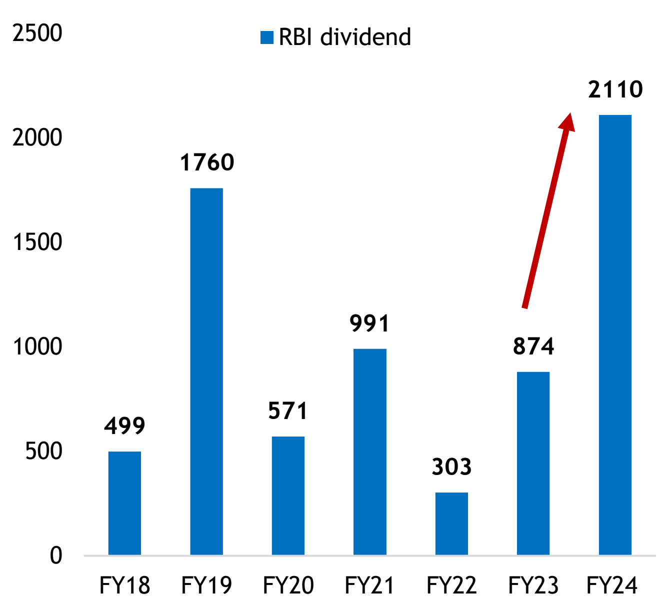



*Fig.2: Poll of polls for 2024 National Elections*

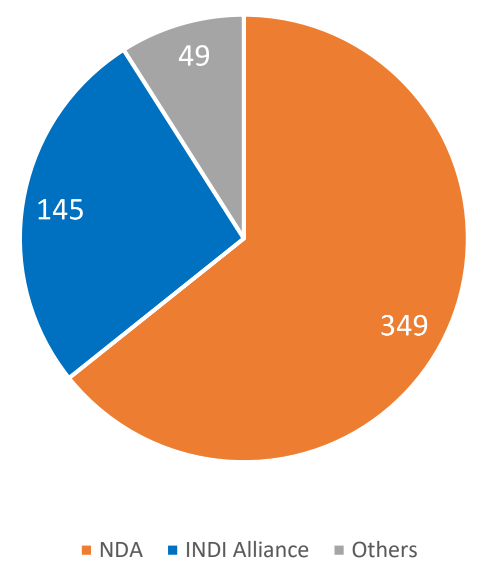



*Fig.3: FPI debt flows of c.INR 950bn clocked since index inclusion announcement in Sep'23; Debt FPI flows (INR bn)*

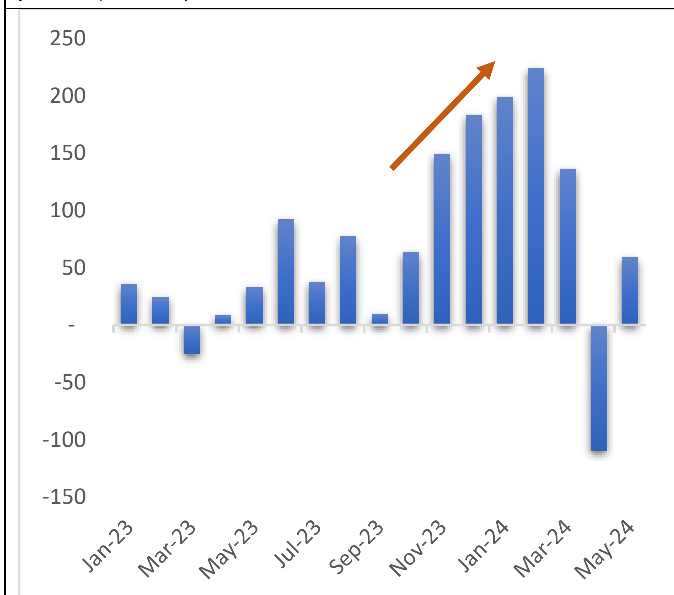



*Fig.4: FPI debt utilization limits in FAR on an uptrend while a drop seen in general route*

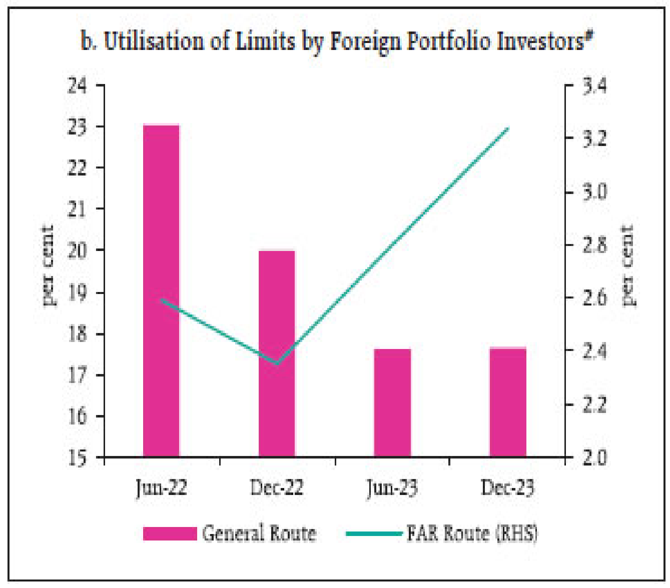
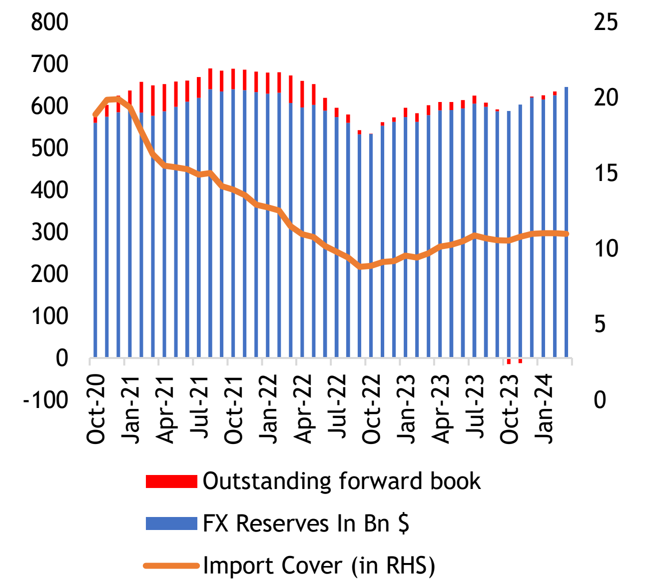



*Fig.5: Fiscal consolidation underway supports favourable demand-supply dynamics in Gsecs*

| Fiscal Indicators | | | | | | |
|---|---|---|---|---|---|---|
| Parameter | FY21 | FY22 | FY23 | FY24 (RE) | FY25 (BE) | FY26* |
| FD (% of GDP) | 9.2 | 6.8 | 6.4 | 5.8 | 5.1 | 4.5 |
| FD (Rs. Lakh Crore) | 18.2 | 15.8 | 17.4 | 17.3 | 16.8 | 16.3 |
| Net Market Borrowing (Rs. Lakh Crore) | 10.3 | 7.0 | 11.1 | 11.8 | 11.8 | 11.8 |

*Fig.6: RBI's reserve accumulation strategy likely to cap INR gains in the near term*




*assuming nominal GDP growth of 10.5% in FY26; Source - RBI, NSDL, Cogencis, Budget Documents and UBI Research

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