Emerging Markets Spotlight

India's Election Surprise Shakes Up the Market

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KEY POINTS

- India's general elections delivered surprising results, giving Prime Minister Narendra Modi a rare third term and bringing forth a new coalition government following his party's loss of the supermajority.
- In a first for Modi, the Prime Minister will have to make concessions to the emerging coalition to retain their support, which could spell trouble for the implementation of much-needed economic policy reforms.
- Uncertainty following the election spooked Indian markets and pushed the Rupee plunging before regaining stability, underlining our confidence in holding an underweight position in our portfolios.

This week, India was delivered a shocking election surprise when incumbent Prime Minister Narendra Modi failed to secure a supermajority in his Bharatiya Janata Party (BJP). For the first time under Modi's rule, a new coalition government will take the stage after he is sworn in for a rare third term following a narrow victory.

Support for Modi's BJP-led National Democratic Alliance fell well short of previous election results and earlier polling widely predicting a landslide. In 2019, the NDA won 321 of the 543 seats in the lower house of India's Parliament, with the BJP alone securing 303 seats. Following this year's election, the NDA won just 240 seats to the BJP with coalition partners picking up an additional 53 seats — roughly half of which were cobbled in by two smaller regional parties.

Since coming to power in 2014, Modi will now lead with concessions to alliance partners in a bid to retain their support. The two regional parties have often switched sides over the years and only re-joined the NDA in the leading months before the 2024 election. While Modi has publicly declared confidence, this weaker coalition government will make it tough for Modi and the BJP to push through deeper economic reforms or policies in support of their Hindu nationalist agenda.

The uncertainty rocked India's emerging markets. Indian equities have experienced high volatility throughout the election cycle, culminating in a period when the local currency-denominated Sensex[1] index rose 3.8% on Monday, fell 6.3% on Tuesday, and rebonded 3.4% on Wednesday. Politically exposed and policy-driven stocks have led the market shake-up, sending the Rupee plunging into volatility, though stability has been regained.

We do not see this election result ending India's policy-led economic boom. Still, brewing government tensions seem likely to make it harder to drive public sector investment or push privatisations and much-needed economic reforms over the next five years. Against the backdrop of expected fiscal tightening, there is also a heightened risk of the coalition collapsing before the next general election rolls out in 2029.

We have been underweight India in our portfolios, having reduced our position in recent months. Despite the election result and concerns about tight liquidity in the banking sector, the primary driver behind this decision has centered on valuation. At a time when many emerging markets are trading on cheap valuations, India has rerated to historically high valuations. The 12m/f P/Es[2] of our preferred MSCI country indices are 7.5x for Brazil, 8.5x for UAE, 12.5x for Mexico, and 13.0x for Indonesia, but 22.7x for India.

While we are not value investors, we view valuations as an important component of forward returns and, more importantly, as a downside reduction against disappointment. With political and policy letdowns now a material risk in India, we are confident in our underweight position and are actively reviewing any remaining holdings to ensure our existing weights flux with the nation's unfolding economic environment.

Source: Bloomberg/MSCI/JOHCM.

[1]Stock Exchange Sensitive Index (Sensex) is the benchmark stock index of India's economy. It represents 30 of the country's largest and most well-capitalized stocks list on the Bombay Stock Exchange (BSE).

[2]12 month forward price-to-earnings ratios