

India elections: likely no big “Modi-fication”

- India’s general parliamentary elections will run from the 11th April to the 19th May, with the final results scheduled to be announced on 23rd May.
- The 17th Lok Sabha elections will prove to be a litmus test for Prime Minister Narendra Modi whose popularity has been dented by slowing growth, increased unemployment and farmers’ distress.
- Opinion polls indicated that the ruling NDA coalition may be within a striking distance of forming a majority, though may not perform as strong as they did in the 2014 election.
- The BJP may struggle in the north-central and western states, based on their subdued performance at the state elections and consolidation of regional parties in India’s largest state-Uttar Pradesh
- National security issues and nationalist sentiment may overpower economic concerns and could influence the voting behaviour.
- Mr. Modi remains popular among the masses.

Macro outlook:

- We continue to argue, as we have always done, that the outcome of elections will not have a long-term impact on the country’s long-term structural reforms. See in particular our report [India, a giant on the move](#). Irrespective of the election outcome, we do not expect a major alteration in the reform agenda
- A second term of Mr. Modi’s government will reduce policy uncertainty and ensure policy continuity. The worst probable outcome could be in the form of “hung-parliament” situation which could put temporary brakes to the reform momentum

Fixed Income Strategy outlook:

- Irrespective of the election outcome, heavy bond supply concerns will continue to weigh on the long-dated local currency government bonds. However, on the monetary policy front, the RBI could reduce policy rates at least once more in 2019 and will continue to infuse more liquidity. As a result, *we maintain our tactical preference on short-dated local currency government paper*

Equity Strategy outlook:

- In the short-term the outcome of the elections could have a considerable impact on the equity markets. Having said so, it will not have a significant bearing on the long-term performance of equity markets as reform continuity will remain irrespective of the government in power, in our view. Overall, *we maintain our overweight position on Indian equities based on the long-term drivers of demographic growth and the rapidly expanding middle income class*

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The grand India election battle results to be announced on the 23rd of May

India is scheduled to hold its 17th Lok Sabha general elections in April-May to vote for the 543 seats in the Lok Sabha, the lower house of the parliament. Nearly 900 million voters will be eligible to vote for the 543 Lok Sabha constituencies, of which 15 million fall in the age group category of 18-19 years, requiring 1 million polling booths, up from 0.9million in 2014. The election will start on 11 April and end on 19 May and will be held in seven phases, down from nine phases in 2014, but more than the five phases in 2009. The final counting will take place on 23 May with the final results announced on the same day. Legislative assembly elections in the states of Andhra Pradesh, Arunachala Pradesh, Odisha and Sikkim will be conducted simultaneously.

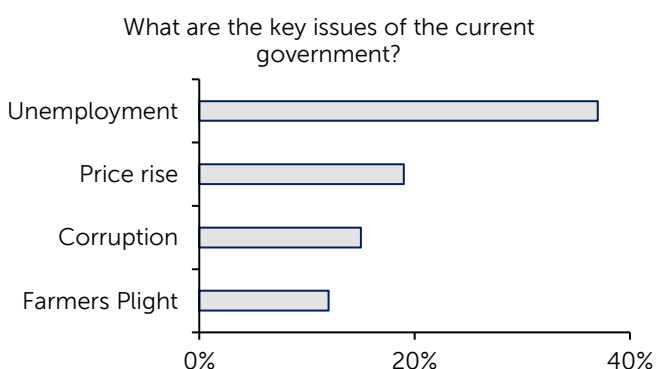
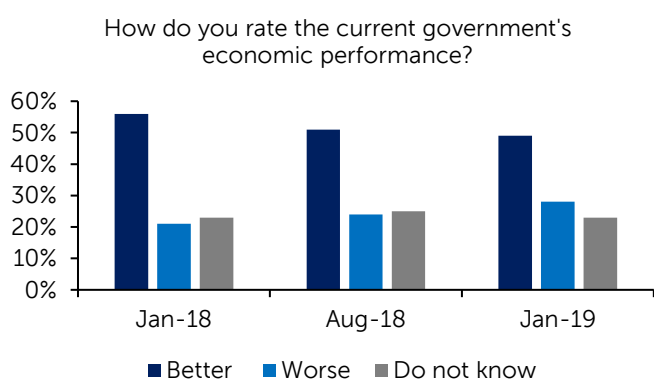
Phase	Date	Seats	States*
1	Apr-11	91	20
2	Apr-18	97	13
3	Apr-23	115	14
4	Apr-29	71	9
5	May-06	51	7
6	May-12	59	7
7	May-19	59	8

Source: Election Commission of India | *certain states could have elections on multiple dates

After the historic victory of 2014, Narendra Modi's appeal to the population has somewhat changed

The upcoming elections have increased concerns on political uncertainty and will ultimately prove to be a litmus test for the incumbent Prime Minister Narendra Modi and his ruling party. There are rising possibilities that the 2019 election result could be quite different than 2014. In the 2014 elections, Mr. Modi's BJP partly led the National Democratic Alliance (NDA) to win the majority in the lower house of parliament. But there was more to it. In fact, it was the first time that a non-Congress party (specifically Mr. Modi's BJP) managed to score a single majority in the Lok Sabha elections, i.e. without counting the seats of the other parties of the NDA. The 2014 elections resulted in a devastating defeat for the Congress Party and its United Progressive Alliance (UPA).

In 2014, the BJP's win was boosted mainly on account of 1) anti-Congress wave in the country which was hit by a series of corruption scandals 2) slowing growth 3) the popularity of Narendra Modi as a candidate for the Prime Minister. Over the years, the above-mentioned narrative has however changed. Opinion polls show that the perception of the government's economic performance has toned-down over past year. There has been rising criticism on the incumbent government's inability to boost jobs (one of the promises made by the BJP going into 2014 election), growth has slowed down (as against the 10% level guaranteed by the BJP) and, finally, farmers' distress has increased. As a result, we have also seen a change in the BJP's campaign narrative from "job creation" in the 2014 election being shifted to emphasizing more on the "Hindu Nationalism".



Source: India Today-Karvy January 2019 Mood of the nation poll

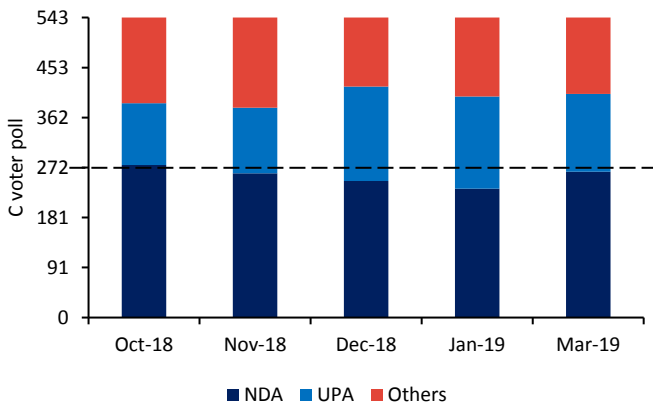
Opinion polls show that Mr. Modi's support had been coming down for a couple of years ...

Opinion polls have shown a steady decline in the NDA's consensus since early 2017, with the coalition losing the majority by the fall of 2018. This development should not have come as a surprise. After a strong reform momentum in the first two years of the NDA rule (including but not limited to relaxation of foreign investment rules, improvement of the country's ranking in "Ease of doing business", implementation of the goods and services tax), a perhaps inevitable slowdown kicked in as the economy adjusted to the after-effects of demonetisation and also to the complicated implementation of the goods and services tax. The cash crunch following the demonetisation severely impacted a large number of small business, leading to losses of jobs. The agriculture sector was particularly hit by the demonetisation.

.. but appears now to be rising again ..

However, in February, the Modi's government, taking into account the agrarian distress, unveiled a populist pre-election budget and also announced new cash transfer schemes for farmers. Further, the terror attacks on Pulwama on 14 February, which were followed with retaliatory attacks by India, stoked nationalist sentiment and might well have led to a rise in Mr. Modi's popularity. National security issues are thus becoming another important electoral factor, alongside economic and job issues. The recent opinion polls conducted in March and April, yet do not predict a major swing in results. The "ABP News-C-voter" poll, in January 2019, gave the NDA 233 seats, 39 seats short of a simple majority in the 543-seats in the lower house of the parliament. The polls conducted by the same agency in March 2019, which should account for the rise in national security issues, put the NDA tally at 264 seats, an increase of 31 seats since its previous poll, yet still 8 seats short of a simple majority. Similarly, other poll surveys also point to the possibility of the NDA coalition within a striking distance of forming a majority, but do not predict the same strong performance as seen in the 2014 general election.

A close call for BJP majority



		Opinion polls			
		Times Now-VMR poll (Apr-19)	IndiaTV -CNX (Apr-19)	Lokniti (Mar-19)	C voter (Mar-19)
	2014				
NDA	336	279	275	263-283	264
UPA	60	149	126	115-135	141
Others	113	115	142	125-165	138

Source: News sources, ADCB | Note: The dotted line at 272 is the number of seats required to form a parliamentary majority

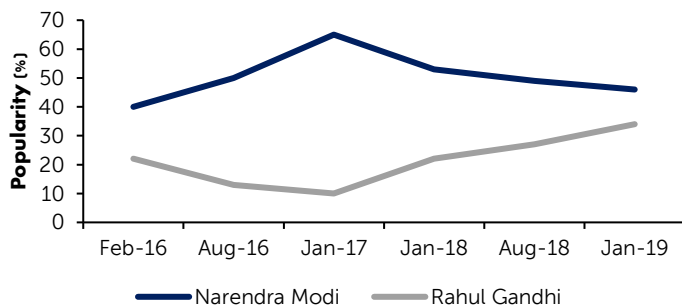
Needless to say one should read these opinion polls with caution. In the 2014 election, majority of the opinion polls were accurate in predicting the NDA win. However, the same was not the case in previous elections.

Ultimately, it's all about "Modi"

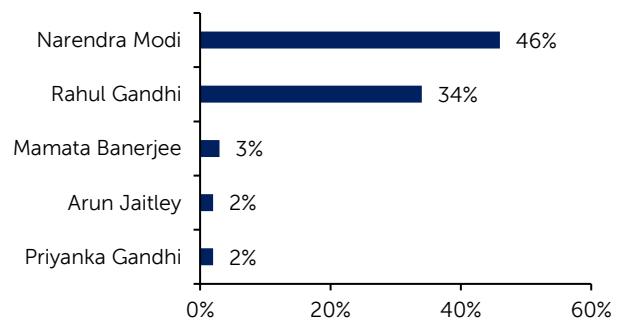
While India follows a parliamentary democracy, elections have become more "presidential" in nature. For most Indians, it's not about the ruling party anymore, but more about the popularity of the politicians. In 2014 elections, the "Modi wave" gained traction not only on account of the criticism of the Congress party but also on account of the lack of any alternative to Narendra Modi. In the upcoming election, the voters will be choosing between "Pro-Modi" and "not-Modi". Looking at the popularity graphs of Narendra Modi, the "pro-Modi" choice is looking increasingly evident. Even in most of the state elections post 2014 elections, the "Modi wave" played a crucial role in BJP's performance in the state elections, particularly in the state of Uttar Pradesh.

While there may not have been a drastic change in the NDA's score at the opinion polls conducted recently, the popularity of PM Narendra Modi, on the other hand, has risen. Until January 2019, based on the "India today-Karvy survey", the popularity gap between Narendra Modi and his opponent Rahul Gandhi had narrowed as economic concerns including growth hurdles, lack of jobs and farmer stress overshadowed the "Modi wave". However, Mr Modi's popularity has been rebounding recently and it appears that reservations for the weaker sections, new cash transfer scheme for farmers and the air strikes on Balakot post Pulwama terror act have to do with the revival of the "pro-Modi" sentiment.

The popularity gap between the incumbent and the opposition leader has shrunk



Who will be the next Prime Minister?



Source: India today-Karvy poll Mood of the Nation January 2019

Reforms will continue irrespective of the result

We believe that the NDA government coming back to power is the most probable outcome as Mr. Modi still appears to be a popular candidate. However, a weak majority could make it challenging for Modi's government to push through key reforms, thus slowing down the momentum of the economic reforms. This may lead to small bumps on the growth trajectory, but may not necessarily lead to a complete reversal of the economic reforms. The BJP may focus more on populist measures including mitigating rural distress, increase farmer's incomes, job creation, and land and labour reforms and may not be as dedicated to pushing through other economic reforms.

Irrespective of the election outcome, we believe that the reform momentum will remain, the only risk will be in the form of the speed and efficiency in implementation of economic reforms. As we have highlighted in our report [India, a giant on the move](#), India's reform process has always moved in the right direction, irrespective of the political party at play. The key economic policy aims of both the main parties (BJP and INC) are centered on higher economic growth, improvement in employment, more agrarian support and infrastructure development. As an example, some of the key reforms including GST and reductions in FDI limits were previously objected by the BJP when it acted as the opposition during Congress's rule. However, it was the Modi's government which later took over the same reforms and speed up their execution. As such, there could be slight alterations in policy priorities towards welfare programmes, but improving the business climate and pushing manufacturing activity will remain in the policy agenda. One of the key challenges will be to strengthen the financial sector. The non-banking financial corporations' financial stress has dragged down credit growth, given they contribute to almost 17% of the total credit in the economy. Introducing new reforms in restructuring and strengthening the financial sector will be key in pushing forward investment into infrastructure and in building business confidence.

Apart from elections, the economy is growing at a decent pace. After a volatile 2018, stability has returned in most of the Indian asset classes. Inflation pressures have subsided and settled within the central bank's inflation target. Growth could hit temporary bumps on the road in the near term, as typically seen before elections. But further economic stability is likely to return once there is clarity on government's economic policies post elections. The RBI's dovish stance is also supportive for the growth outlook. Overall, we believe that India's fundamentals still score strong and the country is likely to remain one of the fastest growing economies, even in the face of temporary slowdowns.

Fixed Income Strategy Outlook: short-duration gains

Indian local currency government bonds have been volatile since the beginning of the year, mainly on account of concerns on higher bond supply pressures and political uncertainty ahead of the elections. The bond yield curve has steepened significantly as the long-dated bond yields remain elevated on increase in bond issuances while the short-dated bonds have benefitted from the surprise RBI rate cut. We maintain our tactical preference for short-duration bonds with the likelihood of the RBI reducing policy rates at least one more time during the year and also focusing on infusing liquidity into the market. At the same time, it is important to monitor inflation pressures, particularly in light of the upward correction in global oil prices. Increase in inflation pressures in the second half could force the RBI to change its stance, signs of which were evident in the recent MPC meeting where the central bank highlighted potential upside risks to inflation.

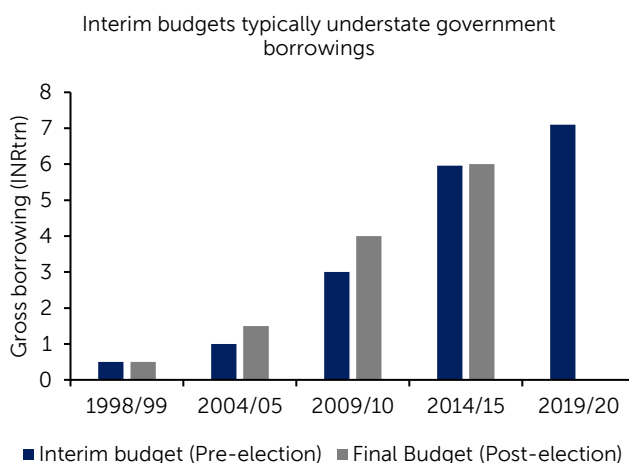
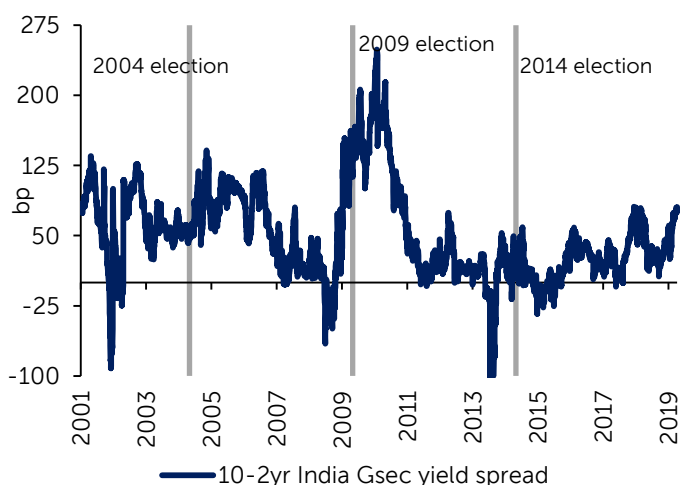
For government bond markets, the implications of political uncertainty ahead of elections may not be as significant as seen in the case of equities. However, historical precedents indicate that the volatility in the government bond market tends to rise ahead of the elections. This is mainly because the ruling government typically front-loads its expenditure ahead of the elections. This is then translated into higher government borrowing needs. The period ahead of the 2014 election was an exception with relatively less volatility visible in the government bond yields. One of the reasons for the relative stability in the government bond market was the absence of supply in the February -March 2014 period. However, as indicated in the interim budget (pre-election) presented earlier this year, the government failed to meet its fiscal deficit target of 3.3% in the FY18/19, thus leading to higher gross borrowing in the last two months of FY18/19 (February- March 2019). With an increase in bond issuance and lack of many open market purchases, the government bond yields, particularly the long-dated bonds have already been under pressure.

Offshore investments have been subdued and it's only recently that the net flows into the government bond market have turned positive. The recent jump in foreign interest has been mostly driven by the increase in the offshore debt investment quota limits and also fuelled by recent opinion polls indicating the possibility of a policy continuity. However, a significant rise in offshore demand looks difficult going into the elections. In the event of an unfavourable election outcome (hung parliament), one cannot rule out the possibility of increased volatility in the currency markets which could eventually impact offshore investments into government bonds.

Government bond issuance to add steepening pressure

So far irrespective of the election outcome, upcoming bond supply pressures will keep long-term bond yields elevated. The government has pencilled in a higher gross borrowing target of INR7.1trn for the FY19/20. Majority of the government borrowing is scheduled to be front-loaded i.e. more than 60% of the gross bond issuance will come in the first half of the financial year. In fact, the bond supply in the first half of FY19/20 is slated to be higher what witnessed in the first half of FY18/19. Further, relief from open market operations through government bond buybacks will also be limited given the RBI is more focused on inducing liquidity through FX swaps recently.

Separately, government borrowing needs have been understated typically in the interim budgets. Historically, looking at the interim budgets before previous elections, borrowing estimates are only revised higher later at the final budget once the new government takes charge. The 2014 election was again an exception where, in spite of the change in the government, the incoming government (BJP) focused on fiscal consolidation measures. However, with the recent resentment from the medium and lower income earners of the population, there is a strong possibility that the final budget (post-election), irrespective of the government, will be focused more on populist measures. In addition, it is also concerning that the interim budget has pegged in ambitious tax revenue targets, particularly from GST collections. As such, risk of further increase in government bond supply could only add further steepening pressure on the bond yield curve.



Source: Bloomberg, India's union budget, ADCB

Equity Strategy: it's a marathon not a sprint

Our equity overweight position on India is more structural and is based on long-term drivers of demographic underpin and rapidly expanding middle income class there. Corporate profitability and earnings growth trends are also superior when compared with other emerging markets. All these rightly justify higher valuations of Indian equities compared with their regional peers, in our view. We retain our structural overweight on Indian equities in our global asset allocation.

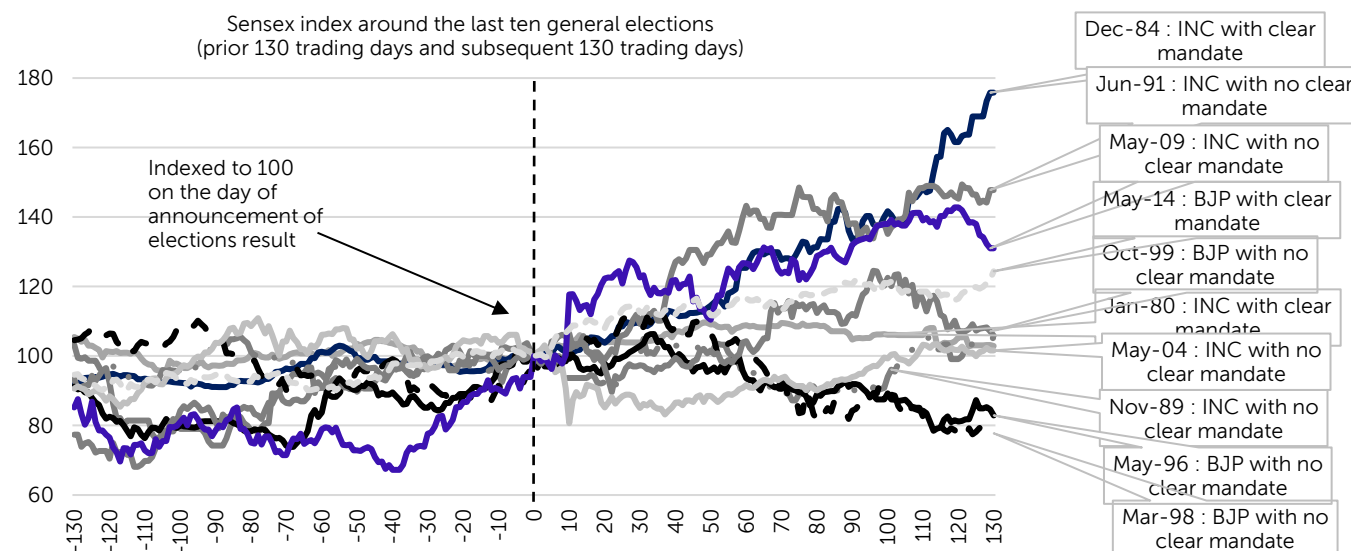
It's the elections, stupid

Indian equities recorded a sizable underperformance year-to-date as the focus was largely on the potential outcome of the general elections this year. As we held for a long time, whilst capital inflows are likely to be hesitant this side of the elections, they are likely to pick up soon after the election results are announced. In our view, the outcome of the elections is unlikely to have a strong bearing on the equity market performance for too long. Reform momentum is likely to continue irrespective of the party in power – this has been the case ever since the economic liberalisation in India in early 1990s. On the following pages, we analyse the equity market performance around the last ten general elections – those that helped convene all Lok Sabhas between 1980 and 2014. The chart below does make the point that the market movements are largely muted going into the elections but the subsequent performance is rather strong (based on average experience).

Whilst the outcome of elections does not impact the long-term performance of equity markets, there are two aspects however, that we think based on our observation of the recent market trends, can influence investor sentiment in the near-term (six month) horizon: 'who wins the elections' and 'how they win it'.

Does it matter who wins the elections? We think no. There seems to be a lot of concern about the incumbent Bharatiya Janata Party (BJP) losing the elections. Current Prime Minister Narendra Modi is seen as a reformist leader. Therefore anti-incumbency is being seen by the markets as anti-reform. However, we would argue that reforms in India have been on a constant progress ever since the economic liberalisation of the 1990s. For details on the India reform history see our report [India, a giant on the move, March 2018](#). Furthermore, as can be seen from the chart below, the three strongest performance episodes (out of the last ten) of Indian equities following general elections coincided with the win of Indian National Congress (INC), the current major opposition party.

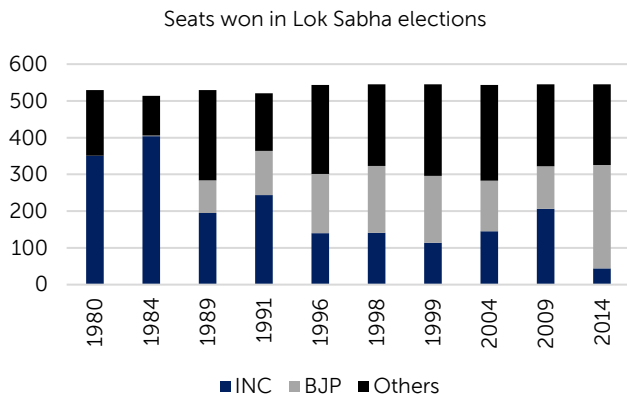
"Who wins the elections" doesn't matter much; but "how they win it" might impact to some extent



Source: BSE, Bloomberg, ADCB Asset Management

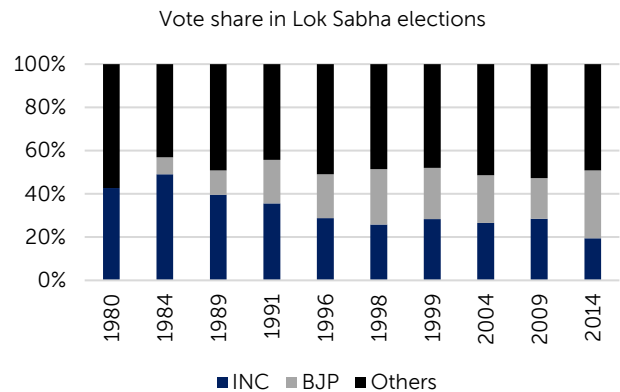
Does it matter how they win the elections? Well, 'yes' and 'no'. In our view, this question is more important than the previous one. The evidence from the previous episodes provides a mixed picture here. Looking back at the last ten general elections, we see only three instances of clear majority/mandate (going by the strict decision of the party winning more than 50% of the seats) given to either of the major political parties in India. Whilst 1980 and 1984 saw INC winning 66% and 79% of the seats respectively, 2014 saw BJP win 52% of the total seats. In all other instances, none of the political parties received a clear majority (see top left chart on the following page). In all these cases, the governments were formed and run with a coalition of political parties (while some coalitions were pre-poll there were many post-poll alliances too). Vote share data points to further dilution of the mandates. In fact in none of the last ten general elections did either INC or BJP receive a vote share of more than 50% (see top right chart on the following page).

Who won how many seats: INC and BJP



Source: Bloomberg, ADCB Asset Management

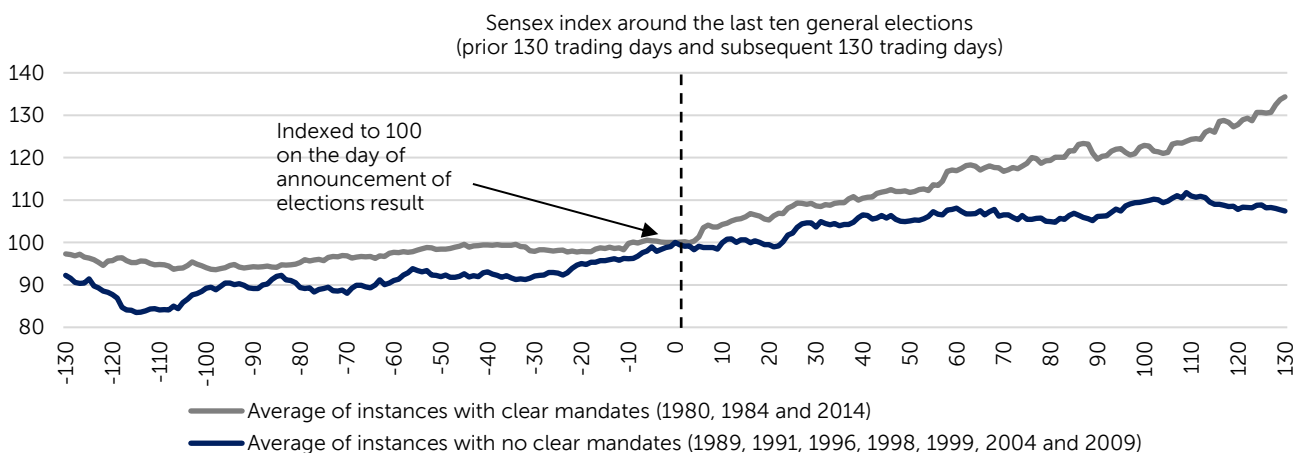
Who got how much vote share: INC and BJP



Source: Bloomberg, ADCB Asset Management

In terms of market response to the majority or lack of it for the winning party, we find mixed evidence. As can be seen from the chart on the previous page, on one hand two of the three strongest performances from the market came subsequent to INC winning (getting most number of seats than any other party) with no clear majority. On the other hand, both the episodes that saw equity markets fall six months after the elections coincided with BJP emerging the largest party with no clear mandate. Further the chart below shows the average experience of those cases when the largest political party receives an absolute majority (as in 1980, 1984 and 2014) compared with the average experience of those cases where the largest political party does not receive an absolute majority (1989, 1991, 1996, 1998, 1999, 2004 and 2009). As can be seen clearly, those instances when the winning party acquires absolute majority, were more positive for the equity market – on an average, equities returned 34% in the subsequent six month period. Even during those episodes where there was no clear majority for the winner, equity markets rose by c7% in the subsequent six month period. This brings us to a conclusion that while a clear mandate/majority to the winning party is good, the lack of it is not essentially bad. Of course markets seem to worry about a potential outcome with lack of clear majority in the current episode because what is on their minds is the decisive win of BJP in the 2014 general elections. The current pre-event performance trend points to the fact that market is oscillating between the two scenarios – absolute majority to the largest party and lack of any clear majority.

A decisive win (of either of the parties) could see equity markets perform even more strongly



Source: BSE, Bloomberg, ADCB Asset Management

Overall, we do believe that the outcome of elections is unlikely to have a bearing on the long-term performance of the equity markets in India. However, in the short-term the influence could be considerable. But what matters more for equity investors is whether the winning party gets an absolute majority or not. Even here, as we highlighted previously, the market performance was not negative when a clear mandate was not given to any of the political parties.

Other than elections?

Economic activity remains strong. PMIs continue to point to a robust growth in both manufacturing and services sectors. Strength in India's economic activity comes as a deep contrast to the weakness elsewhere in the region and across EMs broadly. Central Bank monetary policy has turned a lot more growth-friendly.

Issues around non-banking financial corporations (NBFCs) which have been a drag on the equity market performance since mid-2018 are discounted into the prices, in our view. At least, issues around NBFCs are unlikely to be a deterrent to the market performance going forward.

One other concern around the Indian financials space was the rise of non-performing loans (NPLs) for domestic banks. There are reasons to believe that the worst is behind us. The recent earnings season has already provided some evidence. For instance State Bank of India, the largest Indian bank already reported a moderation in NPLs and pick up in domestic loan growth. Stable CASA ratios (ratio of deposits in current and saving accounts to total deposits) and improvement in loan yields are likely to drive net interest margin expansions. Against this backdrop, valuations for banks in general might start to look attractive. Consolidation in the banking sector, something the finance ministry has been advocating, is likely to provide an upside catalyst.

Global fund managers have cut their exposure to market quite significantly over the past couple of years. However, this could very quickly change once the elections are out of the way. Earnings growth and return on equity remain strong too. I/B/E/S consensus expected earnings growth of c25% this year for MSCI India stands tall against the world earnings growth of c5%. Worth noting that the earnings estimates remain strong despite the correction in the stock prices. This hints at the potential for the valuations to expand from the current levels.

All in all, as we have argued before, capital flows into the market are likely to slow ahead of the elections but should resume strongly after that. The risks on the horizon include an escalating geo-political tension between India and Pakistan and also the potential for a trade skirmish between India and the US.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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