Fundamentals continue to favour fixed income market post general election results

June 2024

General elections 2024 are over now and as the results fell short on expectations, it triggered an adverse knee-jerk market reaction on June 4, 2024 on fears of Government instability and more particularly, concerns on fiscal policies.

Since then, fixed income market has recovered more than half of the losses as NDA has formed the Government under the leadership of Shri Narendra Modi with support of alliance partners.

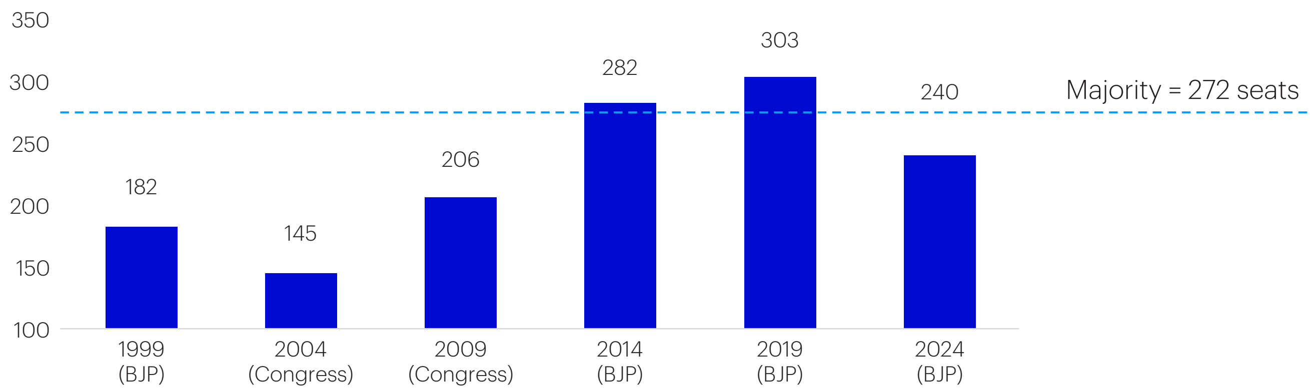
As we delve more into the implications of election outcome, **we continue to remain constructive on domestic rates and duration. We see limited impact of election results on** domestic yields given the **favorable demand – supply dynamics for G-sec and expected easing of global as well domestic monetary policies over next few months.**

NDA coalition with sizeable seat share of BJP is expected to provide a stable Government

In the current NDA, BJP alone stands at 240 seats which is close to the majority 272 mark. In past also, various coalition Government have completed their 5 year term even with much lesser seat share of the single largest party. As of now, our base case is that NDA will be able to form a stable Government at the Centre which gives some relief in terms of continuity of political landscape over the next 5 years.

Despite no majority in 2024, largest party has much higher seats than other coalition governments in the past - providing high stability to government

Seats (Largest Party)



Source: Election Commission of India

India has already been riding on various strong fundamental factors; not expected to get derailed due to the election results

Over the last few years, India has emerged as one of the strongest country on macro stability factors and has clearly shown its resilience against the global turmoil. As of now, Indian factors are characterized by robust GDP growth, steady decline in headline as well as core inflation, strong balance sheet of banks & Indian corporates, manageable current account deficit, rapidly declining fiscal deficit, surplus Balance of Payments, record high forex(Fx) reserve, relatively stable currency and inclusion of G-sec in global bond indices. Many of these fundamental improvements are structural in nature and are not expected to be meaningfully impacted by the outcome of election results.

For more detailed assessment of favorable factors, kindly refer our previous published notes on Active duration strategies poised for outperformance in June and Tug of war which are available on our website.

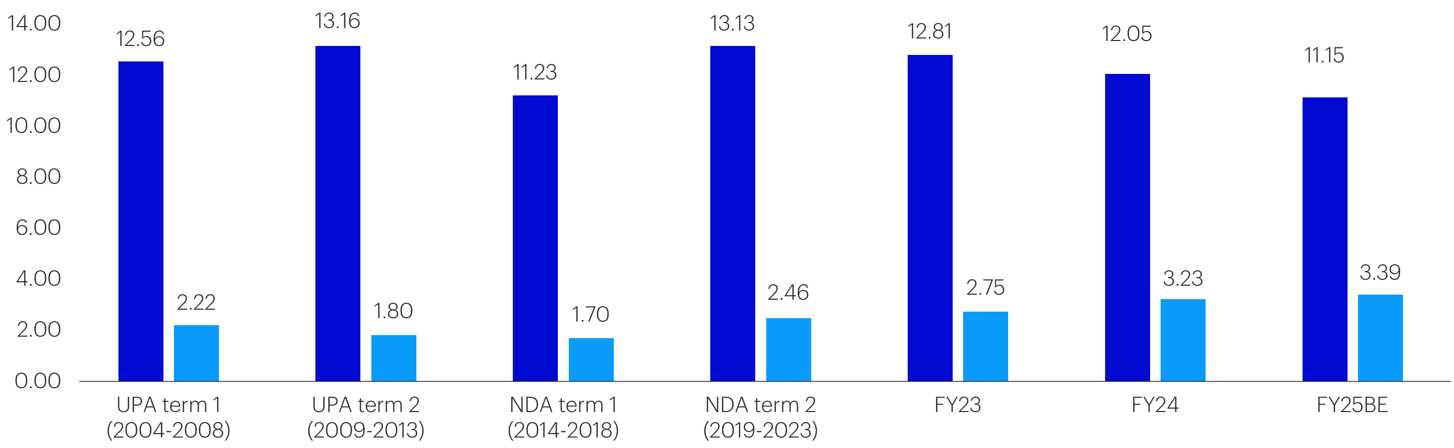
Still, policy continuity on fiscal consolidation is critical for domestic fixed income market

While we believe the Government will continue with its well-articulated fiscal consolidation approach over next few years as it is in line of achieving better macro-stability, one cannot rule out the likelihood of Government taking more populist measures under current political compulsion. We will try to address these concerns by analyzing various cushion factors available with the Government to undertake populist measures while still continuing with the fiscal consolidation.

1 Mix of fiscal deficit; room for some rebalancing between Capex and Revenue expenditure

The Government over last few years had given special emphasis on infrastructure spend while keeping revenue expenditure under check by maintaining a tight leash on subsidies. This has helped in addressing various structural issues especially in improving roads & railways infrastructure. Higher capex spends by the Government was also the need of the hour as private capex had slowed down due to global uncertainty post Covid and tight monetary policies. For FY25, Government has targeted to reduce fiscal deficit by a sharp ~70 bps and still has managed to budget a record high capex spend of ~3.39% of GDP, as against the average of 2.46% for last 5 years. It is to be noted that for FY24, Government had downscaled its budgeted Capex by ~Rs 50,000 crore as it was unable to spend the entire allocated amount. Given the current political landscape, we believe there is a room to re-align the mix of fiscal spend to some extent from Capex to Revenue expenditure without meaningfully impacting the growth. Marginal 0.2% realignment of capex can release Rs 50,000 – 75,000 cr to revenue expenditure (read consumption-oriented populist measures).

Average Revenue and Capex as % of GDP



Source- CMIE

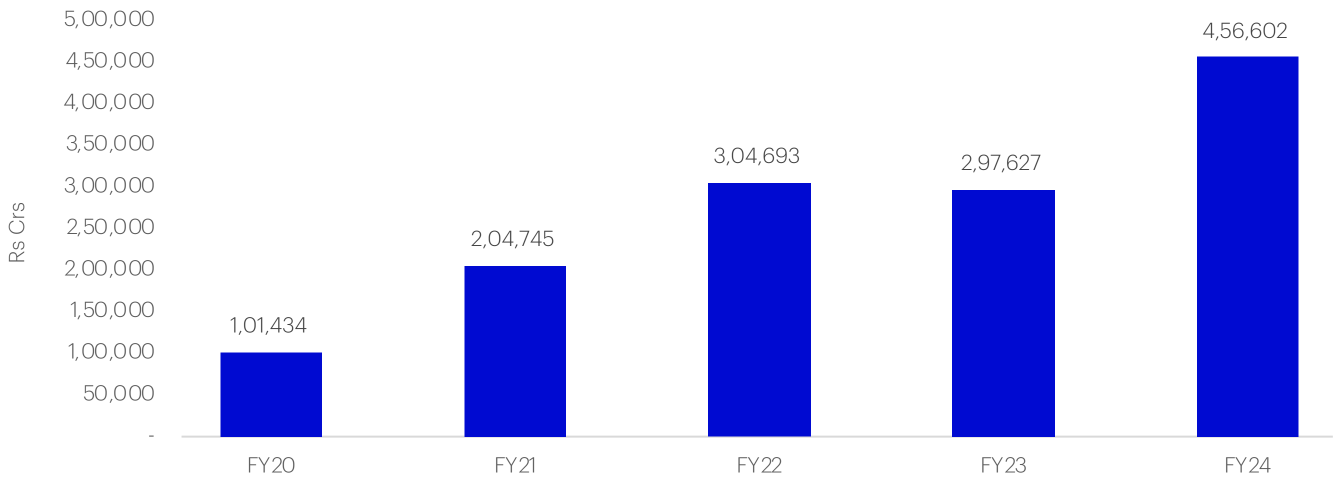
2 RBI dividend in FY25 provides healthy cushion

RBI announced a record high dividend of Rs. 2.1 lakh crore to Government for FY25 on the back of higher interest income on foreign securities and lower provision requirement. It is substantially higher than the budgeted Rs. 1.02 lakh crore of public sector financial institutions (including RBI dividend). This RBI dividend alone gives the extra cushion of 0.35% - 0.40% of GDP which was expected to be used by Government to expedite the fiscal consolidation. Now with the changed political dynamics, we believe Government may partly use this for supporting populist measures while still keeping overall fiscal deficit within the budgeted 5.1% for FY25.

Additionally, dividend from Public Sector Undertakings (PSUs) and Public sector banks (PSBs) is also expected to be higher than budgeted numbers as they have reported a record high profit in FY24 for which the dividend to Government will be paid in FY25.

Profits of PSUs and PSBs have shown a strong growth in FY24 - providing additional cushion for providing dividends

Profits (PSUs + PSBs)



Companies included are constituents of S&P BSE PSU.

Source- Ace Equity

3 Actual Fiscal deficit of 5.6% against the budgeted 5.8% in FY24 provides room to keep FY25 G-sec borrowing under check

Government achieved a fiscal deficit of 5.6% in FY24 as against the revised budget estimate of 5.8% resulting in a lower fiscal deficit by ~Rs 81,000 crore in absolute terms for FY24. In our assessment, this saving on account of lower fiscal deficit in FY24 has resulted in higher opening cash balance of Government for FY25 at ~Rs 2.27 lakh crore as against the opening cash balance for FY24 at ~Rs 1.07 lakh crore. Now, while this higher cash balance may not lower the fiscal deficit of FY 25 by itself, but it will still be helpful in funding the fiscal deficit without resorting to higher market borrowings through the dated G-sec. In very simple terms, ~Rs 81,000 crore of additional fiscal deficit in FY25 can be funded by cash surplus available with Government as on 1st April 2024 without altering the budgeted G-sec borrowing numbers for FY25.

FY25 seems to be comfortably placed on fiscal front, key monitorable will be the fiscal consolidation in FY26 and onwards

Based upon the assessment of above factors, we believe that the Government will be able to maintain fiscal deficit within the budgeted 5.1% for FY25 and will not resort to any additional G-sec borrowings than already budgeted for FY25. Not to forget the major milestone event of Indian G-sec getting included in global debt indices from June 2024, which is expected to fetch ~USD 25-30 bn inflows in FY25 thereby making the fiscal demand – supply dynamics favorable.

In addition of a favorable demand – supply dynamics in FY25, global Central Banks are also expected to start the rate cut cycle in CY2024 paving way for rate cuts by RBI as well, as the domestic inflation continues to maintain its downward trajectory.

Accordingly, for now our constructive outlook on duration remains a high conviction call supported by favorable demand supply dynamics working in the backdrop of rate cut cycle beginning at some point in time.

More critical will be to watch out for the fiscal consolidation in FY26 and onwards when we may not have the benefit of factors like record high RBI dividend. The performance of BJP / NDA in critical State assembly election of Maharashtra & Haryana in Oct / Nov 2024 will also play an instrumental role in designing fiscal policies for FY26. Any major political loss in State elections will force the Central Government to take more aggressive populist measures resulting in fiscal slippages. Accordingly, we will keep a close watch on evolving political landscape and keep reassessing our interest rate views.