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After the elections, Modi loses political power. Will he maintain his dream of India as a superpower?

Electoral Results and Initial Market Reaction

On the first trading day after the elections in India, the Indian market experienced a significant drop, closing the session down by 5%. Why? The election results slightly diminished Modi's political power, unsettling investors who no longer view Modi's BJP as an omnipotent and reassuring political force. On the second market day, with 100% of votes counted, India's Sensex Index rose by 3.2%. The BJP ultimately won 240 seats, down from the 300 seats Modi secured in the previous elections, but still allowing Modi to form a government majority of 292 seats with his traditional allies from the National Democratic Alliance, enabling him to govern India for another term. Where does the market risk now lie? Although the BJP is expected to keep its coalition intact, Modi will need to appease his allies. Yesterday, there were rumors that two of his partners, controlling a total of 28 seats, could switch sides to join the opposition alliance, potentially forcing a change in government—a scenario the market would likely disapprove of. However, at the time of writing this note, it is being announced that Modi has secured the crucial backing of key allies in this coalition, allowing him to form a government. The consensus is that Modi will maintain the unity of the coalition.

Market Assessment and Projections

On the first trading day following the elections, the Indian market experienced a 5% drop. On the second day, the market rose by 3.2%

In the short term, markets might react negatively to the challenges now faced by Prime Minister Modi, who will need to make some concessions. If these concessions undermine fiscal discipline and the continuity of the reform agenda, investors will take note, and we might see capital outflows from this market. However, in the medium term, we believe investors are more likely to conclude that India's economic fundamentals remain solid. In the long term, this constructive outlook will depend on the government avoiding unproductive populist policies, diverting funds from infrastructure investments to more popular social subsidies, in order to reverse the political setback. That is the risk. On the positive side, Modi has aptly signaled his intentions over many years, leading a program based on the idea of transforming India into an international manufacturing hub; a goal that requires attracting a significant volume of foreign capital, installation capacity, and simultaneously, a strategic objective that is incompatible with economic populism.

Our Strategic Approach to This Market

Modi must ensure the continuity of his economic and political legacy by maintaining average annual real growth rates of 6-7%.

Going forward, we will focus on identifying what we consider Modi's government needs to do to maintain investor interest in this market, and monitor what it does. In this regard, we understand that Modi must ensure the continuity of his economic and political legacy, maintaining average annual real growth rates of 6-7% for the next five years. By doing so, he will fulfill the market's estimate that India will surpass Germany and Japan to become the world's third-largest economy by 2030. This will require (i) sustaining the investment agenda in infrastructure to improve logistics competitiveness, (ii) expanding the manufacturing sector to create jobs and accommodate hundreds of thousands migrating from rural to urban areas; and (iii) keeping foreign direct investment flowing into India through effective FX and debt risk management. Indeed, India's superior performance in recent years has been based on the government's dual ability to keep an economy advancing while maintaining fiscal rigor. If Modi can continue resisting the temptation to alter public spending to reverse his recent poor electoral performance, then we can ensure that advancements in domestic logistics costs will continue to decrease to developed world levels over the next few years, resulting in a situation of sustained and differential economic development.

According to investors, key government priorities should include investment in infrastructure, improving logistics costs, expanding the manufacturing sector, and managing foreign exchange and fiscal risks effectively

In general, Modi must continue focusing on improving infrastructure. Only then can the superior growth of domestic markets (manufacturing and services) be maintained. This is supported by recent evidence, which shows that improvements in infrastructure in India over the last five years have led to an 80% jump in India's share of global service exports (from 2.5% to 4.4%). This path must continue as only through better logistics can the goal of turning India into a real alternative for global supply chains be achieved. The path so far has been correct, and this has been endorsed by the strong foreign direct investment inflows into India in recent years.

Avoiding Rash Decisions

There is no need to panic over the electoral outcome and the prospect of a coalition government. Indian asset prices performed well under previous coalition governments. The MSCI India Index returned 200% in 2004-2014 when a volatile group led by Congress governed the country. This result was similar to the market performance under Modi's government during his first two terms with a single-party majority, although it is true that his gains occurred with less volatility. Therefore, if asset prices were to significantly readjust downward in the coming weeks, it could represent a buying opportunity, as subsequent returns on Indian assets could surpass those of the last two decades.

Another favorable aspect, albeit little noticed by investors, is that the electoral result makes it much harder for Modi's BJP to impose aggressive policies to consolidate Hindu primacy. A policy that stirred India's multicultural democracy and had the potential to be socially explosive. Something that would be unfavorable for the investment environment.

The Indian equity market performed well under previous coalition governments..

Conclusion

Having said all this, I must admit that asset holders in India now face a risk-reward equation that is negatively skewed. In our role as managers of discretionary investment mandates, a medium and long-term perspective prevails (we are not traders). And as far as India is concerned, our outlook remains intact and favorable. We will maintain our direct exposure in this market while monitoring the movements of the new government.