HSBC Asset Management

India fixed income – Elections, inclusion and allocation

May 2024

Key takeaways

- India is now towards the end of its six-week long general election process, with markets discounting a third consecutive win for the Modi-led NDA. Though there is a possibility of market volatility during election time, India's bond markets operate against a strong macro framework that has been strengthened by continuing reforms over the last three decades

- The RBI will likely hold off any rate cuts until the headline inflation has trended below the mid-point of the target band. We do not expect the RBI to ease policy rates until the last quarter of FY2025

- India bonds' index inclusion by JPMorgan and other potential index providers is expected to not only bring about significant passive inflows into the market but could also become a catalyst for strategic allocations

- Flows from index inclusion should contribute to increasing demand for India government bonds, while a declining fiscal deficit should lead to decreasing supply. As a result, with the demand-supply wedge widening, bond yields are expected to move lower

- We believe India bonds merit a standalone allocation in a global portfolio, given their strong historical risk-adjusted returns, low correlations with other major asset classes, relatively high yield, stable currency outlook and macroeconomic support

Source: Bloomberg, HSBC Asset Management, May 2024.

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Macro backdrop

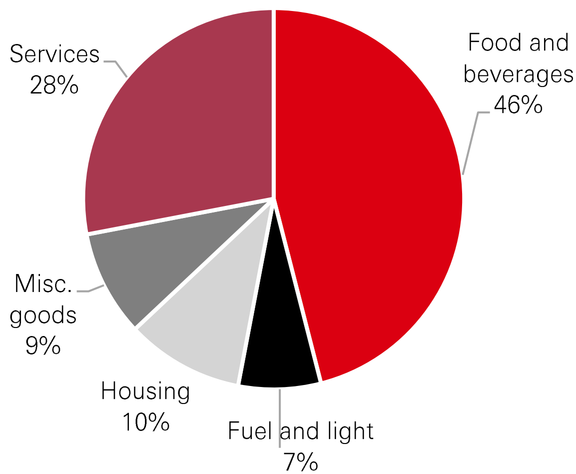
The election factor

India is now towards the end of its six-week long general election process. The 543 Lok Sabha seats, along with the mandates of four state governments, are subject to change, with the election results to be finalised on the 4th of June. The policy platforms of both the incumbent governing coalition, the National Democratic Alliance (NDA), and its major opponent, the Indian National Developmental Inclusive Alliance, are both more reformist and forward looking. Apart from the possibility of one of these two parties winning absolute majority, there is a third possible election outcome of a mixed mandate, which could bring about uncertainty in the political scenario. Markets as of now seem to be discounting a third consecutive win for the Modi-led NDA.

Historically, Indian election results tend not to impact bond markets in a significant manner, though it is possible that we may see some volatility in currency and rates around election time. India's bond markets benefit from a macro framework that has been strengthened by continuing reforms over the past three decades – some recent examples include the Goods and Services Tax, digitalisation of payments, establishment of the Monetary Policy Committee (MPC) and its inflation-targeting regime, and an increasing fiscal emphasis on infrastructure development. Given the strong macro backdrop, any volatility in markets can be an opportunity for a consolidation of positions.

Fig. 1: Food is a major component of inflation

CPI inflation components



Source: MoSPI India, May 2024.

Inflation trending lower

There are some favourable signs indicating that inflation is already trending lower. A notable encouraging factor is the Indian Meteorological Department's prediction of an above-average monsoon rainfall in 2024, estimated to be 106% of the long-term average, which brightens up prospects for good harvest and is thus helpful for food inflation. Also, the El Nino and La Nina effects of the current year might not be as disruptive as previously projected. As seen in Fig. 1, food and eatables are the most substantial component of consumer price inflation.

Oil and energy prices is another component that is crucial to inflation numbers, given India's current reliance on imports to meet 80% of its national oil demand. To note, is India's focus on expanding its renewable energy capacity to fulfill 50% of national electricity demand by 2030, potentially reducing its reliance on oil imports in the longer-term.

Given that the RBI projects that inflation will be around 4.5% for FY2025, we expect the Indian central bank to remain watchful on the inflation trend. We expect the RBI to hold off on any rate cuts until headline inflation has trended below the mid-point of the target band. Core inflation (excluding food and fuel) has already been trending below 4%. The RBI is expected to remain patient on rate easing and may only act in the last quarter of FY2025.

Source: Bloomberg, HSBC Asset Management, May 2024.

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Index inclusion flows – a catalyst for strategic allocations

JPMorgan's index inclusion is a pivotal event for India's bond market, which is expected to result in about USD 25 billion of inflows into the asset class through index tracking passive funds.[1] Bloomberg Emerging Market Local Currency Government Index is also confirmed to add India in early 2025, leading to another estimated USD 5 billion of inflows. We believe the potential inclusion of India bonds by Bloomberg Global Aggregate Index could also materialize in the next few years and lead to another USD 20-25 billion of inflows.

Apart from these passive inflows, we are seeing more interest from active investors in India bonds as increasingly more investors are discovering an under-explored market. This may easily match the passive fund activity and we expect to see similar (about USD 50 billion) flows into active funds as well. Thus, the increased interest in India bonds from both passive and active investors may add another USD 100 billion of flows into the asset class over the next 3-5 years. From the perspective of a global investor, index inclusion of India bonds could become a catalyst for strategic allocations.

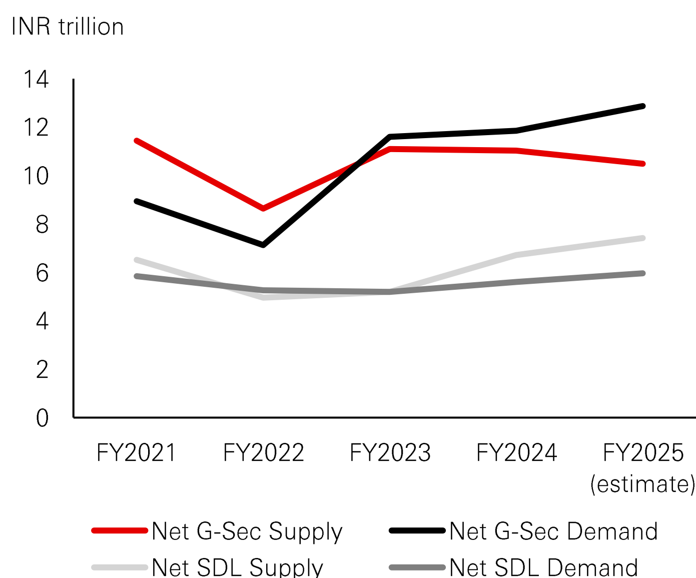
We believe that there is a strong case for strategic allocations into India bonds. The asset class offers portfolio diversification benefits and value. The India bond market is adequately large – in fact, India's government bond market, sized at USD 1.4 trillion, is amongst the largest within emerging markets[2] – and is also reasonably liquid, with daily liquidity varying from USD 2-4 billion of market volume for government bonds. Importantly, the market operates against a backdrop of macroeconomic stability and conducive monetary policies.

While this inclusion is only applicable to government bonds, it should be noted that the large positive inflows are expected for the rest of the bond market. Since the index inclusion announcement in September 2023, the India bond market has already attracted USD 11 billion of net foreign inflows[3] – well before the official start date of index inclusion. Index inclusion should bring about medium-term support for various segments, including corporate bonds.

Index inflows are also expected to benefit the demand and supply dynamics of India government bonds. The demand supply equation has shifted towards more demand (ex of RBI) than supply in FY2024 and FY2025. We estimate that the demand supply wedge has widened due to index related bond demand as well as lower fiscal deficit (lowering the supply of bonds). This should lead to a downward move in bond yields.

In the **HSBC India fixed income strategy**, we have increased duration in our India government bond holdings, which we believe will be the first among India bonds to reap the benefits from the widening demand-supply gap. We have also added to our position in USD bonds out of the expectation that US rates may ease in the medium term from the recent spikes. We have not increased our position in corporate bonds as spreads in this space are relatively unattractive.

Fig. 2: Net demand and supply of government bonds (ex of RBI)



G-Sec refers to government securities, SDL refers to State Development Loans.
Source: Reserve Bank of India, February 2024/ FY 2025 is HSBC estimate.

Note 1: India bonds will be included in JPMorgan's emerging market indices, including EMBI, GBI-EM and CEMBI series, starting June 2024. India is expected to reach the maximum weight of 10% in the GBI-EM Global Diversified Index (GBI-EM GD), and inclusion will be staggered over a 10-month period. Only fully accessible route (FAR) securities will be eligible. Source is JPMorgan, March 2024.
Note 2: Source is Bloomberg, March 2024. Note 3: Source is NDSL, 21 May 2024
Source: HSBC Asset Management, May 2024.

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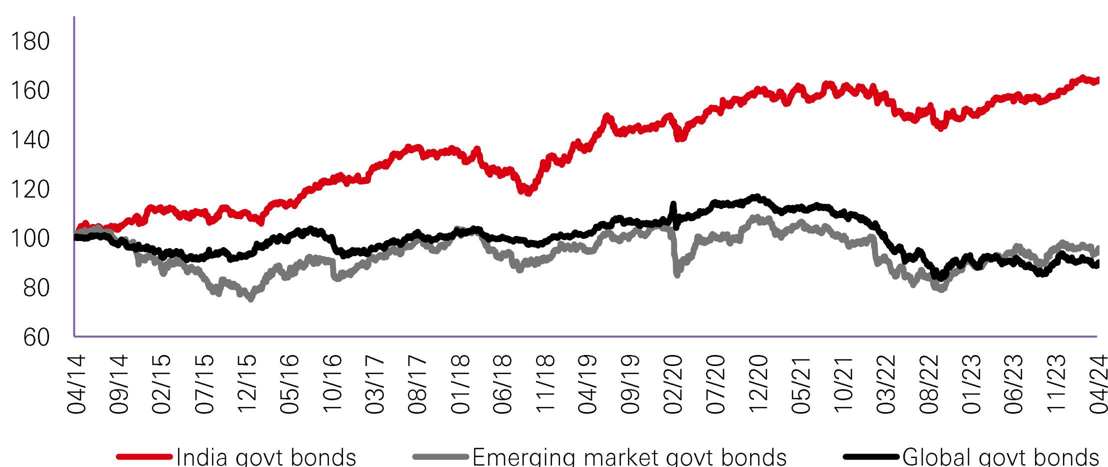
Compelling case for standalone allocations in India bonds

Policy credibility leading to rates trending lower: The investment case for India bonds remains compelling over the medium to long term. While in the period between 2010-2016, India 10-year government bond yields traded above 8% with occasional spikes into the 9% plus range, the recent 7-year period since 2017 has seen yields hardly move even above 8% – in contrast US 10-year government bonds moved from 0.5% to 5% in the same period.[4] Hence, the spread between India and US 10-year government bond yields has drifted down to about 265bp now.[4] In our view, this is a trend that is here to stay and can be ascribed to increased policy credibility.

Performance: With the index inclusion around the corner, it is noteworthy to compare the performance of India with emerging market bonds as well as global bonds. India has meaningfully outperformed both of these markets on a USD unhedged basis, in the past 10 years (Fig. 3).

Fig. 3: India bonds have outperformed global and EM bonds (unhedged USD)

Index performance: 30-Apr-2014 = 100[5]



Source: Markit, JPMorgan, FTSE, Bloomberg, 30 April 2024.

Low correlations: An advantage that India bonds offer is that of portfolio diversification, as they exhibit low correlations with other asset classes – all the more valuable in the heavily correlated world we are in. India bonds' correlation against global bonds in the past 10-year period is only 0.11.[6]

Relatively high yields: India government bonds yield 7%-7.50% and are among the highest yielding bond markets, barring a few markets such as Brazil.

Stable currency outlook: The other critical leg of the value proposition is the currency. Our outlook on the Indian rupee is positive, supported by a strong macroeconomic environment and healthy FX reserves buffer. Moreover, the increasing prevalence of manufacturing and continuing strong services exports, along with growing investment flows (including those driven by index inclusion), will lend long-term support to the strength of the rupee. In the more immediate time horizon, the RBI has shown proactiveness in stabilizing the rupee, using its ample FX reserves.

We believe that these factors combined with macroeconomic support and robust regulatory framework form a strong investment case for standalone and strategic allocations into India bonds.

Note 4: Bloomberg, May 2024. Note 5: Indices used for India govt bonds: Markit ALBI India TRI Hedged USD; Emerging market govt bonds: J.P. Morgan GBI-EM Global Diversified Composite Unhedged USD; Global govt bonds: FTSE World Government Bond Index Unhedged USD. Note 6: Using FTSE WGBIUnhedged USD and Markit ALBI India TRI Unhedged USD indices as of April 2024.
Source: HSBC Asset Management, May 2024.

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