India: Will the economy get its mojo back?

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Key points

- India's economy is currently grappling with cyclical challenges due to reduced public spending following elections and persistent inflation. The stock market has experienced a 13% decline since its peak, fuelled by foreign investor withdrawals.
- With a young population and low urbanisation rates, India remains one of the fastest-growing economies and is projected to surpass the eurozone in terms of its global GDP contribution by 2025. India also benefits from a shifting geopolitical landscape.
- Cyclical support is emerging, with a less restrictive budget designed to boost consumption through tax exemptions and increased infrastructure spending. Meanwhile, the Reserve Bank of India initiated a rate-cutting cycle in February.
- Although we lowered our GDP forecast for 2025 to 6.25%, our 2026 forecast remains unchanged at 6.6%. Despite expectations of a recovery in the months ahead, investors should remain mindful of forex risks and elevated valuations.

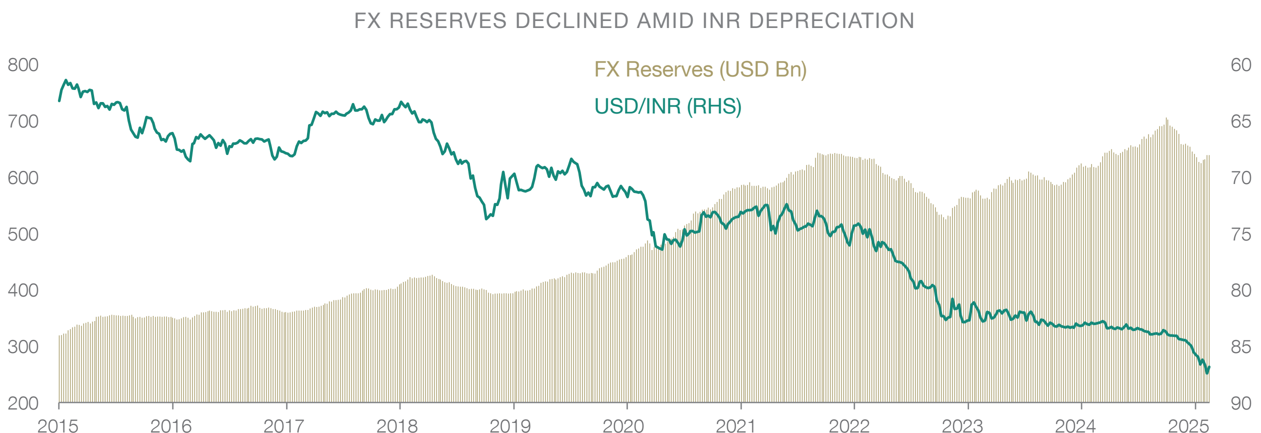
Much-needed cyclical support is finally under way

The Indian economy is currently facing cyclical challenges stemming from reduced public spending following elections in 2024 and persistent inflation. These factors had prevented the Reserve Bank of India (RBI) from lowering interest rates, putting pressure on earnings and investment. Consequently, growth momentum in Q3 2024 slowed more than expected, coming in at 5.6% year-on-year, down from 6.9% in Q2. The primary contributor to this decline was private consumption, which fell to 6.0% year-on-year, down from 7.4%. This slowdown can be attributed to a spike in food inflation, which has eroded households' purchasing power. Additionally, investment decreased to 5.4% year-on-year, down from 7.5%, owing to higher interest rates. The Ministry of Statistics and Programme Implementation (MoSPI) expects gross domestic product (GDP) to slow to 6.4% in the fiscal year starting in March 2024 (FY25), marking the slowest pace of expansion since 2019; however, we think this lull will only be temporary. Although we have lowered our GDP forecast for FY25 to 6.25%, our FY26 forecast remains unchanged at 6.6%.

The Indian economy has lost some of its mojo, so it is not surprising that India's stock market has experienced a 13% decline since its peak in September 2024. This drop has been fuelled by foreign investor withdrawals amid weaker corporate earnings and the economic slowdown. According to India's Central Depository Services, net foreign investment in both bonds and equities fell by approximately USD 950 million in Q4 2024. Additionally, the persistent weakness of the Indian rupee (INR), which has depreciated by approximately 3% against the USD since September 2024, has compounded these pressures, driving away investors.

For several years, the RBI has carefully managed the pace of the Indian rupee's depreciation, contributing to macroeconomic stability in a world still recovering from the aftermath of the Covid-19 pandemic. However, this rigidity has started to create challenges, leading to calls for the RBI to permit a stronger depreciation to ease liquidity constraints and alleviate economic pressures. Since October 2024, the RBI's foreign exchange reserves have declined by USD 70 billion (11%), partly due to efforts to support the rupee.

FX RESERVES DECLINED AMID INR DEPRECIATION



Sources: RBI, Bloomberg Finance L.P., UBP

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This situation has resulted in tighter domestic liquidity, even with a 50-basis-point reduction in the cash reserve ratio in November and collateralised lending against government securities. This mercantilist approach appears to contradict the RBI's official position that the rupee operates under a managed float, where interventions are meant solely to address significant volatility.

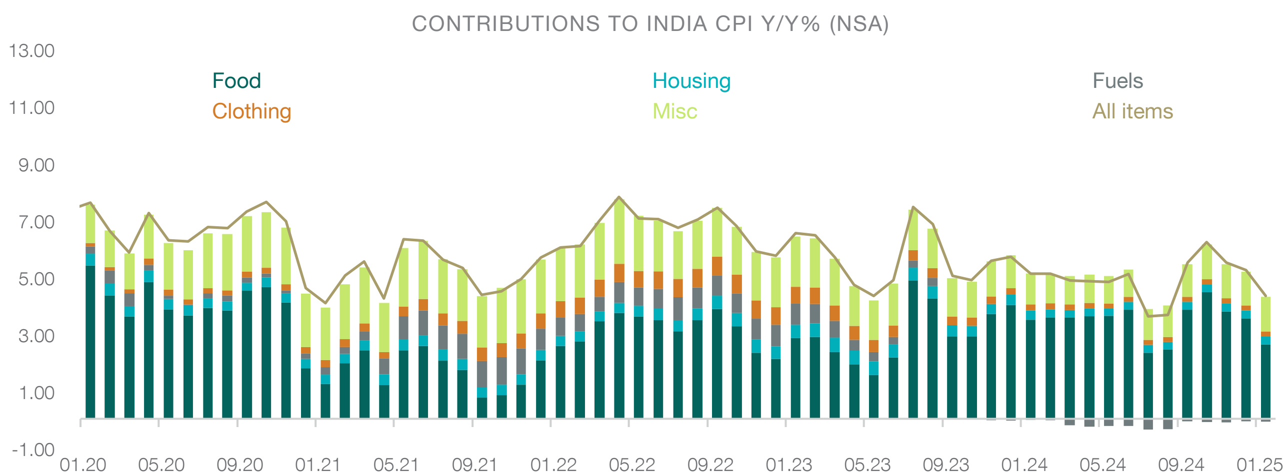
On a positive note, cyclical support is finally under way, underpinning our more constructive view for FY26. On 1 February, Finance Minister Nirmala Sitharaman unveiled a less restrictive budget, including significant changes to income taxes that will exempt an additional 10 million middle-income households from tax liabilities. Given the prominent role of consumption in India's economy – the sector constitutes roughly 60% of GDP – it makes sense for the government to focus on boosting consumer spending. By freeing up disposable income and enabling middle-income households to spend more, policymakers can help to enhance corporate earnings and stimulate the economy. Urban consumption in particular has struggled from high inflation and stagnant wages, so the rationale for tax cuts should be justified in our opinion.

Government spending on major infrastructure projects has also been a crucial driver of India's economic growth since 2020. Despite an unexpected contraction in actual spending during the first nine months of the current fiscal year, the government has raised its infrastructure expenditure target slightly from INR 11.1 trillion to INR 11.2 trillion (USD 129.18 billion), entailing a slightly less restrictive approach to public investment. Additionally, the government plans to offer interest-free loans for individual states to enhance their capacity for infrastructure development.

Opposition leaders have criticised it for overlooking the needs of the poor and for cutting funding in crucial sectors like education and health. It is important to highlight that the government is positioning for a more constructive medium-term outlook by adhering to a policy of fiscal austerity. The finance minister underscored the ongoing need to reduce the budget deficit in order to avoid potential downgrades by ratings agencies, which might jeopardise India's long-term goal of attracting foreign direct investment (FDI). Therefore, the finance ministry will aim to reduce the fiscal deficit from 4.8% of GDP this year to 4.4% by end of FY26. The government also intends to lower its debt-to-GDP ratio from 60% currently to 50% by 2031. Prime Minister Narendra Modi, from the Bharatiya Janata Party (BJP), was re-elected for a third term in 2024. However, the BJP only won 240 seats in the Lok Sabha (the Indian parliament's lower house), falling short of the 272 needed for a majority. As the leader of a broader coalition government, Modi will need to make compromises on spending, resulting in a more gradual approach to fiscal consolidation.

The good news is that the RBI has taken measures to support the economy, offsetting any slack from a slightly less restrictive fiscal stance. As expected, on 7 February, the RBI initiated its easing cycle with a 25-basis-point cut – a vital step aimed at addressing some cyclical challenges. We believe this move will help mitigate economic headwinds, with the effects likely to be more pronounced in the second half of 2025. However, the RBI did not provide forward guidance on the timing or extent of future rate cuts during its February meeting, indicating that future decisions will depend on inflation.

Fortunately, the ongoing normalisation of food prices could strengthen the case for additional support. In January, the Consumer Price Index (CPI) fell to 4.31% year-on-year, landing within the lower half of the RBI's target range of 2–6%. Notably, annual food price inflation decreased to 5.68% y/y, with the MoSPI reporting a significant drop in vegetable inflation. This trend is expected to continue in the coming months. We anticipate inflation will slow to 4.0% in 2025, with the possibility of it falling below this level in H1 2025. Our House View assumes that the RBI will continue to cut interest rates by at least 25–50 basis points in the remainder of 2025.



Sources: CSO, Bloomberg Finance L.P., UBP
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Long-term drivers and geopolitical tailwinds

Although the economy has encountered cyclical challenges, it is slowing from a record-breaking pace of around 8% post-pandemic. India is still one of the fastest-growing economies in the world and is expected to surpass the eurozone as the third-largest contributor to global GDP in 2025, behind only China and the US. Over the past ten years, India has averaged real GDP growth of 6.0% and this growth rate has translated into equity returns comparable to those of the US, with the MSCI India delivering annualised total returns of 9.9% over the same period.

Additionally, India surpassed China to become the most populous country, boasting a population of 1.4 billion people. India is a relatively young economy, with an average age of 32.4 years. Despite the advantages of a large population, India's urbanisation rates are still low, at around 36% compared with 65% in China. The transition of millions of people into urban environments will necessitate substantial investments in infrastructure and housing in the coming years. This ongoing urbanisation should also benefit the emergence of the world's largest middle class, which currently comprises only about 30% of India's population.

As a key member of the US-led Indo-Pacific alliance and the Quad, India is well-positioned to benefit from geopolitical shifts, providing an alternative market for companies diversifying away from China. Although the US has a USD 50 billion trade deficit with India, making it among the key targets for Trump's reciprocal tariffs, the country's response has been swift and assertive. During a recent trip to the US, Prime Minister Modi met with President Trump to discuss strengthening bilateral relations. On 13 February, just one month after Trump took office, they issued a joint statement outlining plans to enhance trade, increase defence cooperation, boost technological collaboration, and address global challenges such as terrorism and energy security. A key takeaway was the establishment of a 'Framework for the US-India Major Defence Partnership in the 21st Century', under which India will import more weapons from the US over a ten-year period.

The statement also set an ambitious goal to double bilateral trade to USD 500 billion by 2030, with plans to negotiate a bilateral trade agreement by the end of 2025. This follows India's recent measures to lower tariffs on US exports of bourbon, motorcycles, ICT products, metals, and agricultural products. Despite India's efforts to leverage the China-Plus-One strategy, FDI was down by 51% and 8% in 2023 and 2024, respectively. The joint statement announced plans to increase US investment into new technologies in areas like nuclear energy, defence, artificial intelligence, semiconductors, quantum, biotechnology and space.

Implications for investors

The International Monetary Fund (IMF) projects GDP growth of 6.0–7.0% in the coming years, supporting a constructive long-term outlook. After a 13% pullback since reaching their peak in September 2024, valuations have adjusted somewhat but remain elevated by historical standards at 23x P/E, in line with the asset class's 10-year average. High valuations have long been a hallmark of Indian equities, often justified by strong earnings and a significant presence of high-growth SMID-cap companies; this makes the earnings outlook particularly relevant. Earnings are expected to remain above global averages at 17% in 2025; however, momentum has turned less positive since September 2024, with an increasing number of analysts downgrading their forecasts for 2025.

VALUATIONS IN LINE WITH LONG-TERM AVERAGE

Sources: Bloomberg Finance L.P., UBP
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While cyclical support has emerged, some uncertainty remains. It may take months for monetary and fiscal stimulus measures to boost real demand and earnings. Additionally, US inflationary risks could restrict the RBI's ability to deliver rate cuts. The real rate differential between India and the US (10-year yield adjusted for inflation) remains negative, while the 2-year spread has narrowed to 65 basis points; this will restrict the RBI's ability to provide support without stoking further depreciatory pressures. Although the RBI intervened to slow the rupee's decline in February, this does not change the fundamentals. Investors should expect ongoing volatility in the rupee, which may affect sentiment and demand at least through H1 2025.

INDIA'S YIELD CURVE FLATTENED SHARPLY IN 2024

Sources: Bloomberg Finance L.P., UBP
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In 2024, the yield curve flattened significantly and shifted lower, primarily due to a sharp decline in the 10-year bond yield (bull flattening). This shift reflects the government's fiscal discipline and the inclusion of Indian debt in global indexes, which increased global demand. Investors were also anticipating the start of the domestic rate-cutting cycle in 2025. Authorities should take prompt action to support growth, manage currency weakness, and inject liquidity before expectations of slower growth become entrenched.

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