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Outlook 2026: Politics to ‘Trump’ Economics

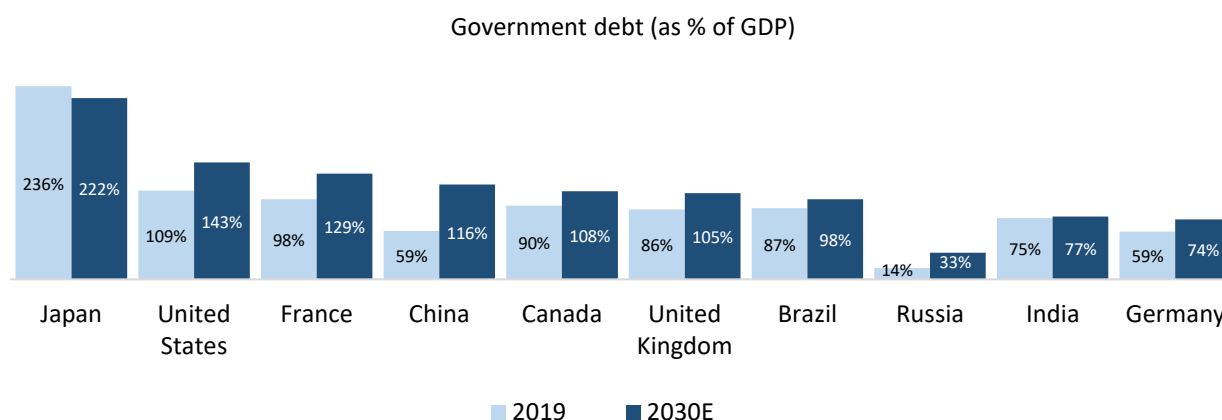
- Supportive fiscal and monetary measures, especially in developed economies, may sustain elevated global equity valuations. Nonetheless, worries about weakening macroeconomic stability, particularly due to mounting global debt, could re-emerge.
- Concerns about the overvaluation of AI-focused stocks are likely to persist, keeping market return expectations low. Optimism surrounding the possibility of a more accommodative stance from the new Fed chair and robust corporate balance sheets foster confidence in equities for 2026, as global economic expansion is likely to continue.

Recently India’s External Affairs Minister, Dr. S. Jaishankar made a comment that the world has entered an era where "politics increasingly trumps economics." This is a harsh reality where everything is being weaponized. From political and economic measures to outright military coercion, we have seen it all. But when times are tough, "short-termism" takes over strategic thinking, and the equity market is no exception. AI bubble or no bubble, resolution of the Russia-Ukraine war, or spike in Japanese bond yields will grip the investor sentiments in 2026. However, investors seem to be less concerned, as they have increasingly embraced the ‘too big to fail’ argument.

Expansionary fiscal policies may continue to support markets

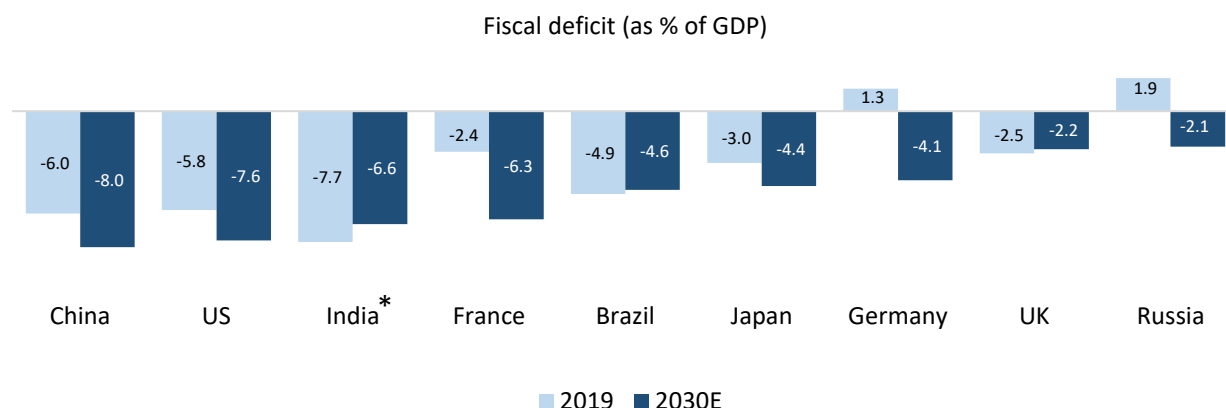
The prevailing mindset suggests that the US government will continue to bolster markets through expansionary fiscal and monetary policies in 2026, even if this requires additional money printing. Exhibit 1 shows that the top 10 largest economies may continue expanding their debt at an unprecedented pace, with debt-to-GDP ratios rising significantly—India being the notable exception. The IMF projects global GDP to increase by USD 6 trillion in 2026, while the US alone is expected to add USD 3 to 4 trillion in debt.

Exhibit 1: As per the IMF government debt to GDP to rise materially, India to focus on consolidation



Source: IMF

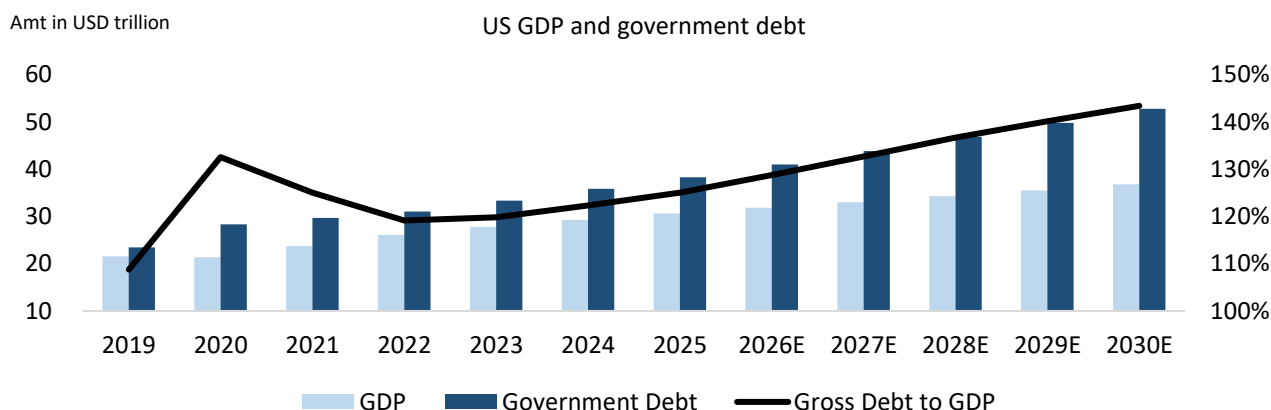
Exhibit 2: India stands out as one of major economies where the fiscal deficit is projected to decline below pre-pandemic levels



Source: IMF, Bloomberg

*Note: India's combined fiscal deficit, center plus states

Exhibit 3: US nominal GDP is projected to expand at ~4% p.a., while debt levels are expected to grow at ~7% p.a. The IMF predicts, the debt-to-GDP ratio could rise to over 140% by 2030E

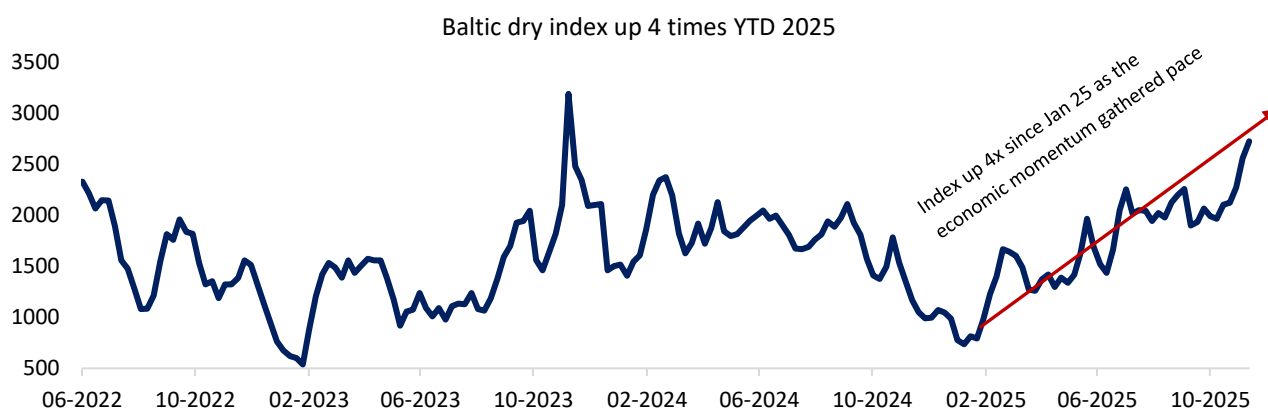


Source: IMF, Bloomberg

Global Inflation is expected to persist

The US Fed, BOE, and ECB have already cut rates in 2025, even though inflation remains high. Japan has begun raising rates, but real interest rates remain deeply negative. In 2026, further wage hikes in Japan could keep inflation elevated. Overall, we anticipate that monetary policy will remain supportive, alongside continued fiscal expansion in major economies.

Exhibit 4: Baltic Dry Shipping Index up 4x in 2025 as the recession worries abated



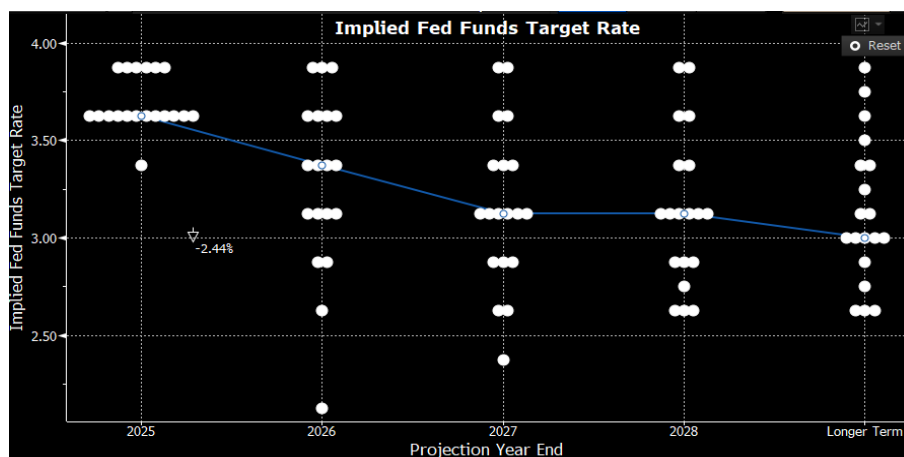
Source: Bloomberg

Last data point as on 10 December 2025

New Fed Chief could be more dovish; US cannot afford to keep interest rate higher for longer

Kevin Hassett, Director of the National Economic Council, has been dubbed as the front runner for the post of Federal Reserve chair. Hassett has endorsed Trump's policies and advocated for lower interest rates. Other top candidates include former Fed Governor Kevin Warsh and Christopher Waller. The market currently expects the Fed to cut rates twice in 2026, whereas the dot plot projects only one rate cut that year.

Exhibit 5: Fed dot plot indicates one rate cut in 2026 and 2027



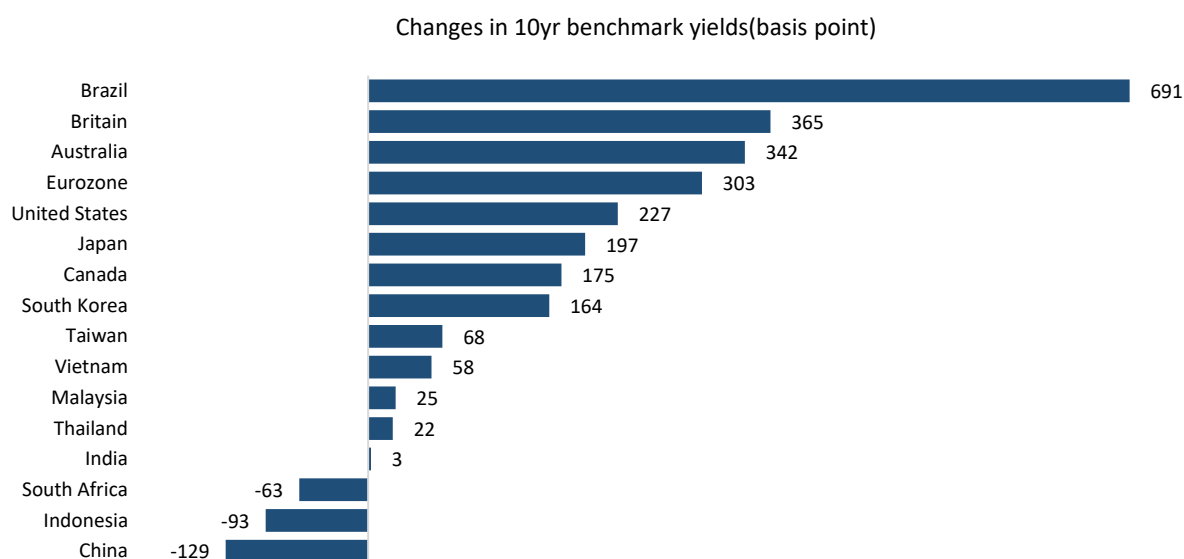
Source: Bloomberg

India has focused on macroeconomic stability and managed to keep bond yields in check

India has managed fiscal consolidation much better than other economies. This is clearly reflected in India's bond yields, which have remained well anchored at pre-Covid levels, with less volatility than even in developed economies. We expect the government to maintain fiscal discipline. That said, central borrowing is likely to remain within the INR 16–18 trillion band in the coming years, helping bond yields stay well anchored, in our view.

We will closely monitor the stance of global central banks in the coming years, which is expected to remain accommodative despite our view that inflation could stay above target. Japan, however, may prove to be an exception among the larger economies. Given India's macroeconomic stability, the RBI has ample room to ease not only policy rates but also liquidity conditions.

Should global inflation exceed expectations, concerns about macroeconomic stability may resurface. However, countries with stronger political mandates and fiscal and monetary buffers could outperform. India has exercised restraint in spending and boasts the strongest record of fiscal consolidation among major economies following the post-Covid expansion. The RBI has maintained tight control over interest rates and regulations, resulting in Indian inflation being much lower than in Japan or Europe. As shown in Exhibit 6, Indian bond yields have remained stable compared to pre-pandemic levels, while other markets have experienced significant increases in the cost of debt—except for China, Indonesia, and South Africa.

Exhibit 6: Stable bond yields in India suggest a lower risk premium for Indian equities


Source: Bloomberg

Last data point as on 17 December 2025

Indian Equities: From Perception to Perspective

- Many of the macro and political challenges that caused India's significant underperformance in 2025 could reverse in 2026.
- Resolution of the Russia-Ukraine conflict, trade agreements with the US and Europe, and a weaker dollar should help restore confidence in Indian equities, offsetting potential geopolitical tensions, in our view.
- Consensus corporate margin assumptions appear optimistic and may disappoint as private capex accelerates. The RBI has room to ease, and ongoing reforms should support volume-driven earnings, in our view.

India's ascent on the global stage will not go unchallenged

The world will not remain a passive observer as India strengthens its economic and political influence. In an increasingly adversarial environment, a nation with a fragile and sensitive socio-economic fabric has defied entrenched perceptions. As India transitions from a non-aligned posture to a multi-alignment strategy, its ability to navigate an evolving multipolar world order will be critical. With economic and political conditions deteriorating elsewhere, the onus lies on policymakers to reshape global investor sentiment through decisive reforms and strategic policy actions that can alter perceptions toward India. In our view, these efforts could be a defining factor for India's performance in 2026.

Indian equities underperformed almost all large countries; will it reverse?

The Indian equity market materially underperformed in 2025, with MSCI India posting a 2.5% gain in dollar terms versus 29.2% for the MSCI ex-Asia Japan Index. Developed markets such as the US, Europe, and Japan delivered returns of 16.8%, 37.8%, and 29.6%, as measured by the S&P 500, Euro Stoxx 50, and Nikkei 225, respectively, in CYTD 2025. Beyond concerns over overvaluation and excess equity supply, Indian equities came under pressure due to prolonged trade tensions with the United States. Corporate earnings entered a downgrade cycle, while government spending lagged the vigor seen in previous years amid elections. Furthermore,

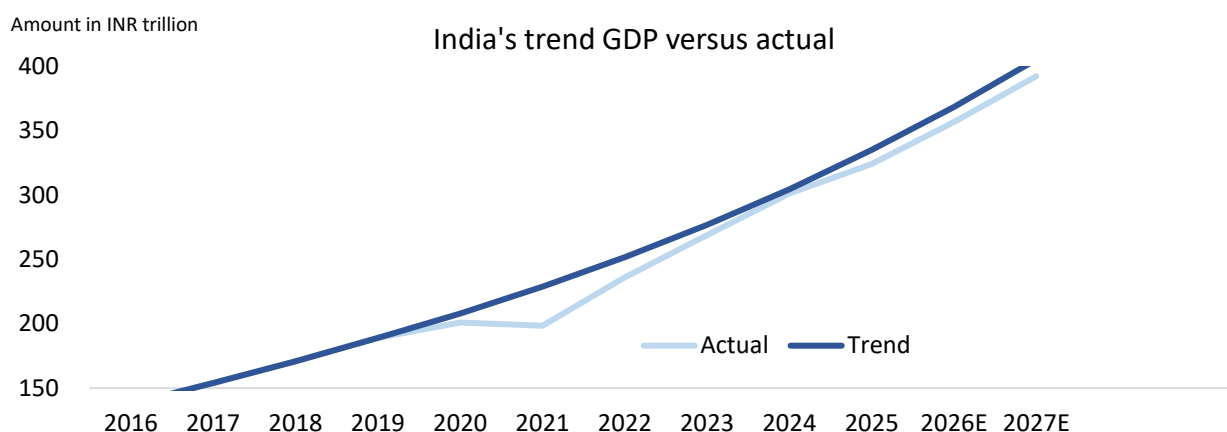
Indian equities offered limited exposure to the AI-driven boom that benefited Chinese (up 31.7% in CYTD), Taiwanese (33.6%), and Korean (85.6%) markets. Countries such as Thailand (9.5%), Vietnam (28%), Malaysia (12.3%), Pakistan (48.4%), and even Bangladesh (-8.3%) secured lower tariffs, while India remained isolated under the Trump administration.

Looking ahead to 2026, some profit-taking in AI-related stocks may occur, triggering rotation into Indian equities in our view. It is likely that India may eventually sign trade agreements with the US and Europe in the coming months. Domestically, we expect a better harvest and a pickup in consumption, supported by accommodative RBI policies, which should restore confidence in Indian equities. While we remain cautious about the corporate margin outlook, volume-led expansion could drive low double-digit earnings growth, in our view.

Trend GDP is still below pre-covid run rate

Structurally, the Indian economy continues to face slack—primarily labor-related—as nominal GDP remains below its pre-Covid trajectory. In March 2019, GDP stood at about INR 189 trillion, and assuming a minimum of 10% nominal growth (6% real and 4% inflation), the current level is expected to fall short by about INR 10–12 trillion by FY2026E. We believe the economy is poised to surprise on the upside and, over the next 2–3 years, surpass its trend growth rate. In our view, the Indian economy needs to grow at approximately 12% nominal growth annually.

Exhibit 7: India requires faster nominal growth to return to pre-pandemic trend levels. Current nominal GDP is short by INR 10-12 trillion compared to the trend growth

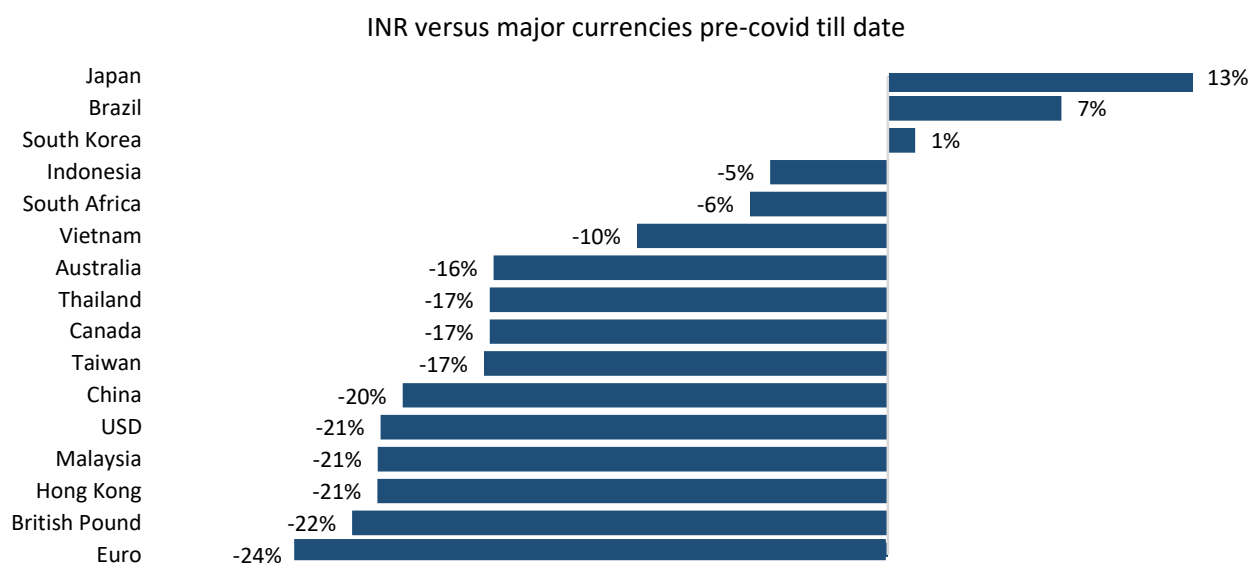


Source: Budget documents, Bloomberg, Bajaj Alts

INR depreciation should be viewed positively in the current context

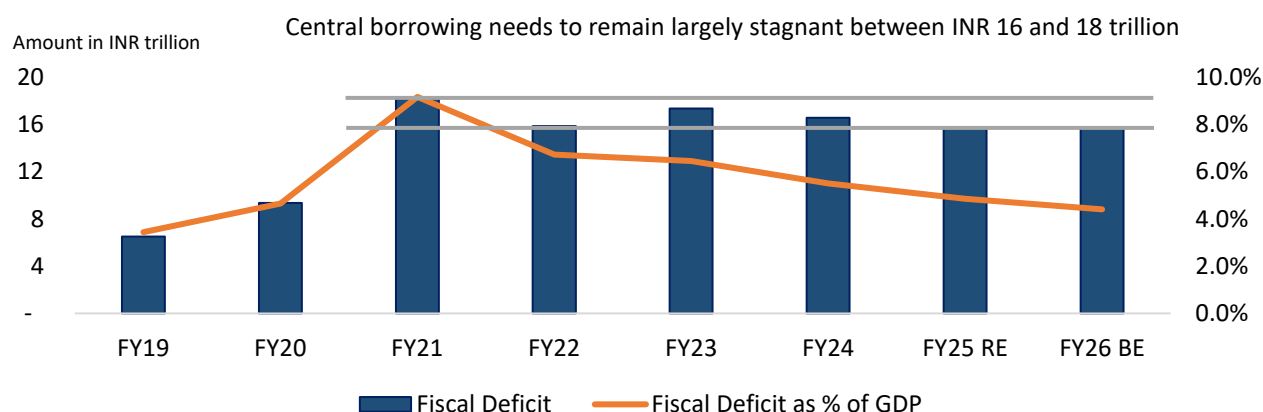
At a time when inflation in India is far lower than in even developed economies, the INR performed the worst in 2025 and post-covid outbreak as well. The precipitous fall in the currency in 2025 was also due to significantly higher tariffs on Indian goods as well as a surge in gold imports.

India's current account deficit has improved materially falling from about -2% in 2019 to about -0.5% of GDP YTD FY 2026. This resilience reflects strong growth in exports of services - particularly IT, consulting, and financial services - which has helped offset the rise in merchandise imports, especially gold and electronics. While goods imports have outpaced exports, the surge in services has narrowed the overall deficit, keeping India's external position manageable despite global volatility and rising import needs.

Exhibit 8: INR has been one of the worst performing currencies


Source: Bloomberg

Data from Dec 2019 till 17 December 2025

Exhibit 9: Central Borrowing peaked to INR 18 trillion owing to fiscal stimulus during Covid in 2021. Fiscal consolidation has been very steep leading to absolute borrowing dropping to ~ INR 16 trillion


Source: Union Budget Documents

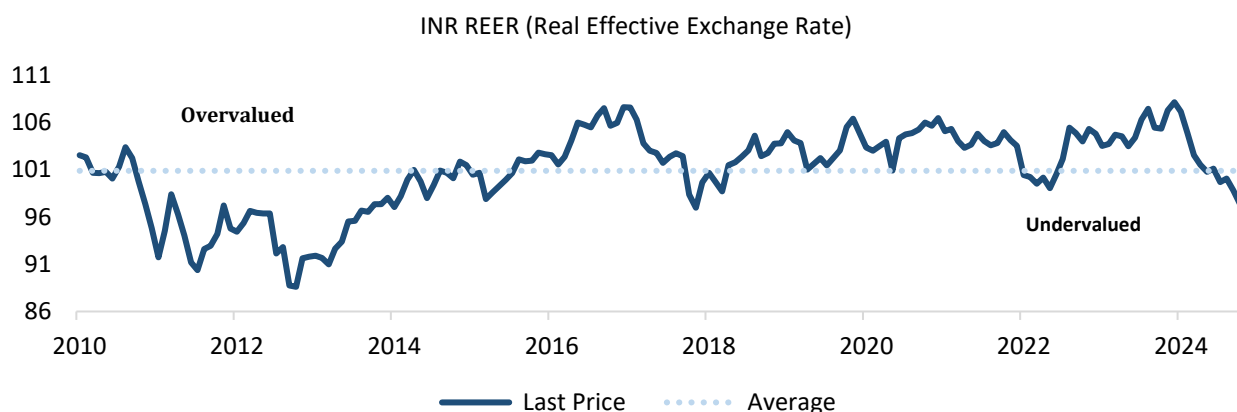
Nevertheless, the INR depreciation should be viewed positively in the current context when macroeconomic stability of India is far better compared to many other countries and compared to its own history. Most of the developed countries have been resorting to higher inflation to curtail debt accumulation. INR depreciation should encourage domestic sourcing and promote exports. MSMEs can benefit as they account for about 30% of our total exports and employ approximately 28 crore labor force in India. The government has recently rolled back Quality Control Orders (QCO) on 80 imported items, which will help reduce compliance burdens, ease supply chain disruptions, and improve imported input costs, especially for MSMEs.

Despite higher tariffs, India's merchandise exports from April to November 2025 grew by 2.62%¹. November recorded the highest exports in the last ten years for November month at USD 38.13 billion, (+ 19.4% YoY). We expect some upward pressure in the INR once the trade deal with US is

¹ MOCI, PIB release dated 15th Dec 2025

signed, however our central view is that the RBI is better off keeping the INR little undervalued compared to peers.

Exhibit 10: The INR REER remained largely overvalued since 2016, until recently when the INR precipitously declined against top 40 currencies



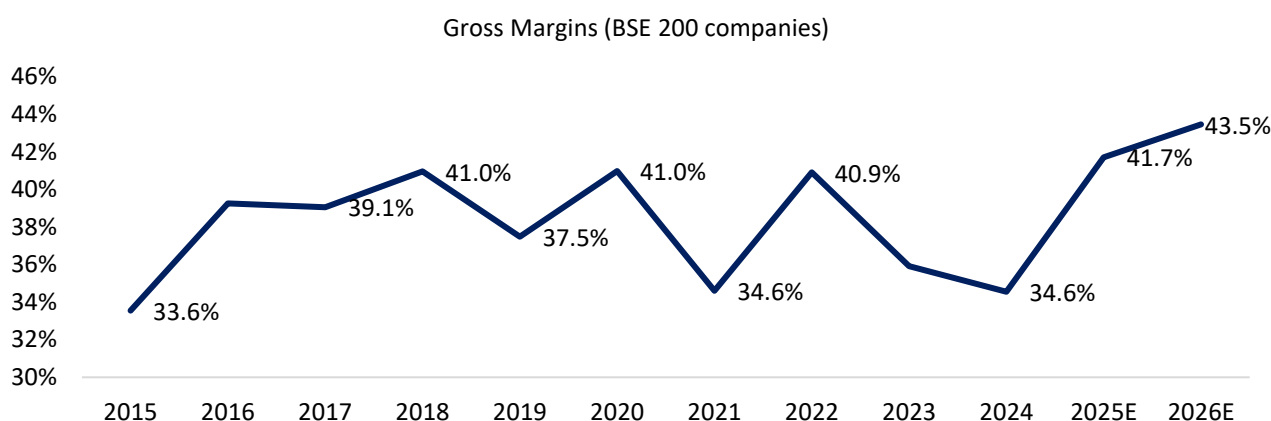
Source: Bloomberg

Last data point as on 17 December 2025

Growth Drivers: Supportive monetary policies and private capex

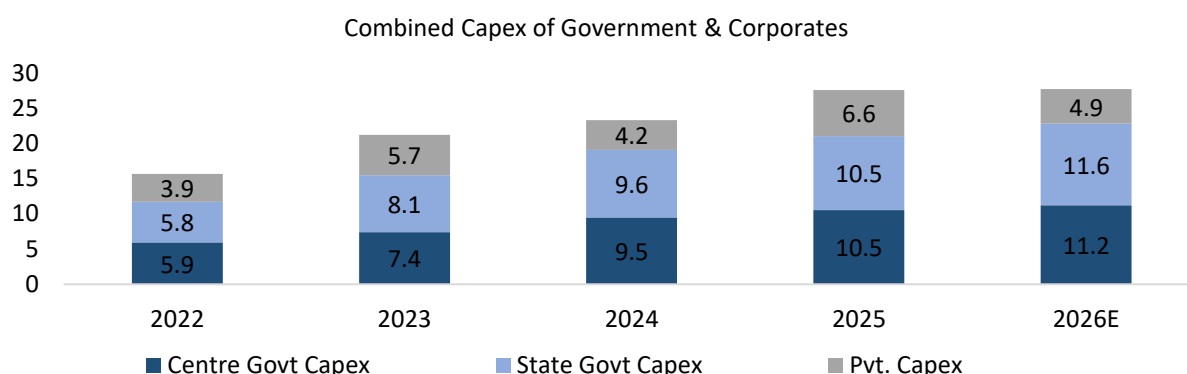
With fiscal headroom constrained by recent tax cuts, it is imperative that private capex and supportive RBI policies drive faster growth. Tax collections have fallen short of expectations, particularly after GST rate reductions, though the government retains some flexibility through higher dividends, asset sales, and PSU disinvestments. We estimate the revenue shortfall at the current run rate could be around INR 1–1.5 trillion in FY2026, which appears manageable while maintaining the fiscal deficit target of 4.4%. Looking ahead, as the government aims to reduce the debt-to-GDP ratio, it will need to carefully balance nominal GDP growth with fiscal consolidation. In our view, this calls for faster monetary easing and a generally weaker rupee.

Exhibit 11: Gross margins of BSE 200 companies are at record highs, even as consumption has slowed significantly



Source: Bloomberg

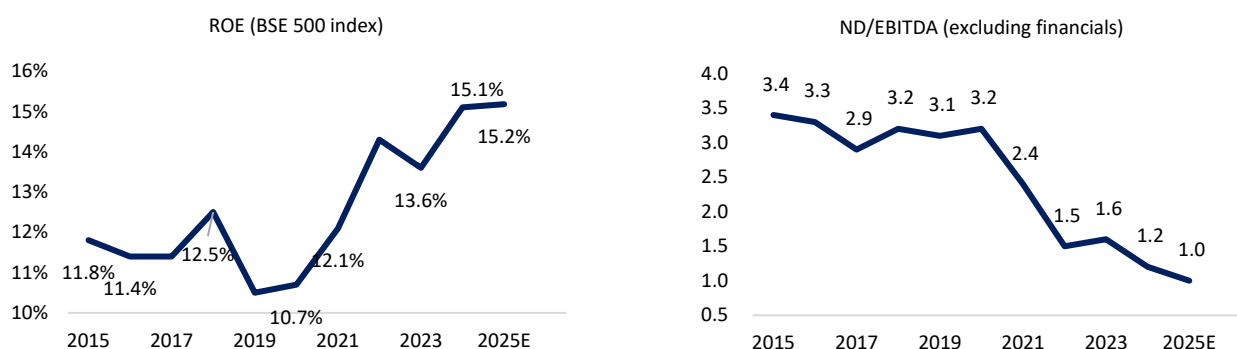
Last data point as on 17 December 2025

Exhibit 12: Total capital expenditure is projected to grow at a CAGR of 15%


Source: Union Budget Documents, MOSPI Survey

Indian corporates are at the pink of their health

BSE 500 companies have reported record profits of INR 16.30 trillion, with the corporate profit-to-GDP ratio nearing 5%. Given the significantly high ROEs of Indian corporates and a material reduction in leverage, we expect private capex to see some pickup in FY 2026.

Exhibit 13: Record ROEs and lowest Net Debt/EBITDA showing strength in corporate balance sheet


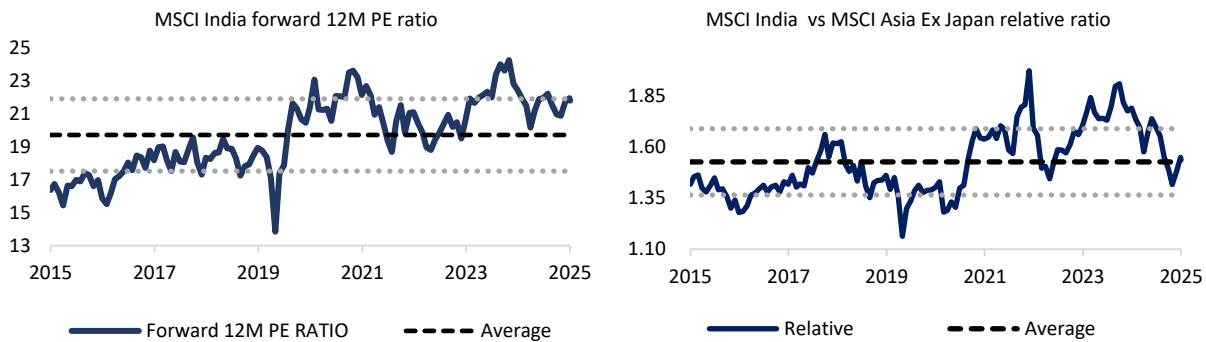
Source: Bloomberg

Last data point as on 17 December 2025

Valuations for Indian equities are expected to remain elevated

Indian equity valuations are likely to remain elevated, supported by high ROEs, strong balance sheets, and a favourable domestic macro environment. Record-high equity supply via OFS, QIPs, and IPOs is expected to continue, leaving little room for further valuation expansion.

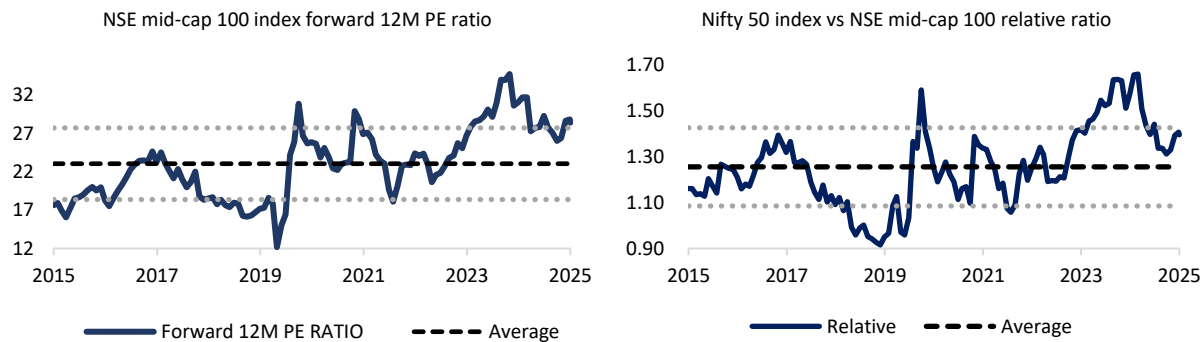
Relative to other markets, India's valuation froth has moderated following its underperformance in 2025. The valuation premium versus peers has eased; the MSCI India Index trades at a P/E of 21.7x compared with 13.9x for the MSCI Asia ex-Japan Index, representing a 56% premium—broadly in line with the 10-year historical average.

Exhibit 14: MSCI India vs MSCI Asia Ex Japan PE premium down to average levels


Source: Bloomberg

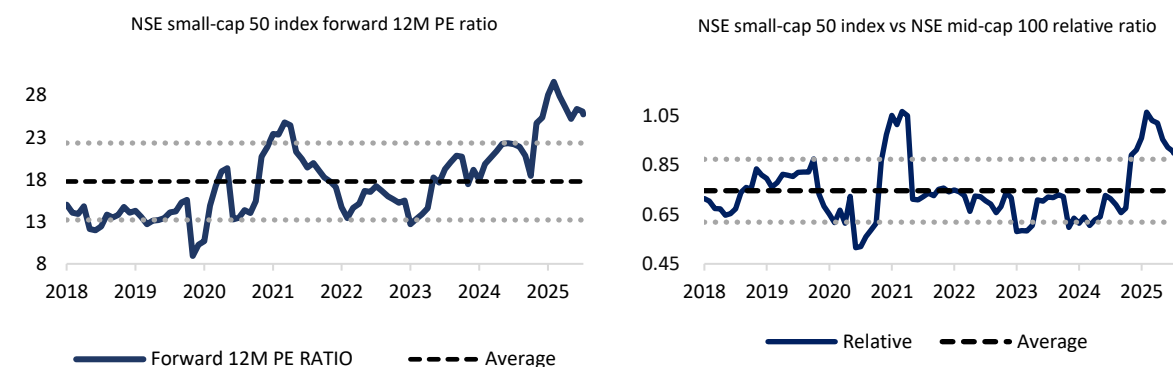
Last data point as on 17 December 2025

In terms of broader market, the Nifty Mid-cap Index valuation looks stretched with 12 months rolling forward PE of 27.9 times versus Nifty 50 Index PE of 20.3 times. On the other hand, the Nifty Small-cap versus Nifty Mid-cap Index PE premium has shrunk from its recent high, as shown below.

Exhibit 15: Mid-caps trading at a substantial premium to large cap


Source: Bloomberg

Last data point as on 17 December 2025

Exhibit 16: Small-caps to mid-caps premium is down from recent high


Source: Bloomberg

Last data point as on 17 December 2025

Asset class view

Equity: The Indian economy is expected to remain resilient and may even surprise positively. Higher nominal GDP growth in 2026 to accelerate corporate profits. We expect high single-digit to low double-digit returns in 2026 for the broader equity market, where sector rotation strategies can generate meaningful alpha. Earnings growth could reach the lower teens, compared with largely flat growth in 2025. While recent earnings growth has been margin-driven, competitive intensity and higher private capex may compress margins in 2026 and beyond, in our view. We prefer active investment management strategies over passive ones.

Preferred sectors include banking & financials, metals, and pharma. Credit growth is expected to surprise positively in 2026, though banking margins are likely to remain contained. Rural demand revival, growth in white-collar jobs, and anticipated salary hikes under the 8th Pay Commission should support consumer discretionary sectors—including autos, hotels, travel & tourism, and real estate—over the next couple of years. However, margins could come under pressure from record-high levels for consumer-facing companies as competition intensifies. The large-cap IT sector could see some near-term outperformance due to relatively low valuations and currency depreciation. Capital goods, particularly power-related and defense companies, offer long-term investment opportunities, and we recommend buying dips in these sectors.

Fixed Income: India's fiscal headroom has narrowed due to tax cuts, making major reforms, divestments, and disinvestments crucial for revenue growth. The upcoming budget will be pivotal in this regard. In our view, the RBI may deliver more monetary easing than currently anticipated. We expect the benchmark 10-year yield to remain range-bound and well anchored, with a slight downward bias in 2026.

Indian Rupee: A trade deal with the USA may help the INR recover to some extent, but our central view is that the RBI is better off keeping the INR slightly undervalued on a REER basis, as inflation is not a major concern for India at present and exporters need support against higher tariffs and China's dumping practices. We will also closely monitor the massive debt problem in the USA and how the new Fed governor addresses it. The USD appears overvalued, and there is a high probability that it may depreciate from current levels.

Commodities: We continue to maintain a bullish stance on precious metals such as gold and silver, given our view that central banks may continue diversifying their reserves away from the dollar. Bouts of volatility are expected following the precipitous rally. In our view, oil prices should remain well under control. A potential US invasion of Venezuela could lead to a near-term spike; however, in the long term, increased oil supply—and thereby a lower oil price environment—remains our central thesis.

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