

Deflator lift, tariff drift: India's balancing act

Bottom line: India's economy remains one of the fastest-growing globally, with real GDP growth buoyed by deflator effects and resilient domestic demand. Recent GST reforms aim to boost consumption; though fiscal space remains tight. Tariff escalations from the US pose downside risks to exports and sentiment, while inflation remains subdued, paving the way for further RBI easing. Equities may rebound on policy support and earnings recovery, especially in consumer and financial sectors. Fixed income offers value amid steep curves and expected rate cuts. However, FX remains vulnerable to trade tensions and seasonal outflows, warranting caution and hedging strategies.

Cycle and the macro outlook

Growth for the quarter ending in June was recorded at 7.8% YoY. Part of this increase can be attributed to distortions from the GDP deflator, particularly prevalent when commodity prices decline. However, even after adjusting for these effects, growth remained solid at 6.8% YoY. The upcoming two quarters are expected to reflect opposing influences from the recent tariff hike and tax reductions (both discussed below). We think that the real GDP growth will remain robust in the current fiscal year, partially due to statistical support from the deflator; though, this effect is anticipated to diminish over the next two years, resulting in somewhat lower but still healthy growth rates. In contrast, nominal GDP growth – which is unaffected by deflator anomalies – is projected to moderate from 11% in the previous two years to 9.5% over the coming two years, which may affect corporate earnings and credit expansion. However, worth noting that these growth rates are still very high in global comparison. Consumer price inflation dropped to 1.6% YoY in July. While some worry that low current inflation could mean higher YoY inflation next year due to base effects, monitoring sequential momentum offers a clearer picture. Ample grain supplies and low global oil prices are holding food and core inflation down, despite volatility and weaker growth. With these factors in mind, we expect the RBI to cut rates again in Q4 2025, reducing the repo rate to 5.25%. Overall, while near-term risks include uncertain external demand, weather-related inflation, and global financial tightening, India's economy is still one of the fastest-growing worldwide with steady government policy and investment supporting medium-term stability.

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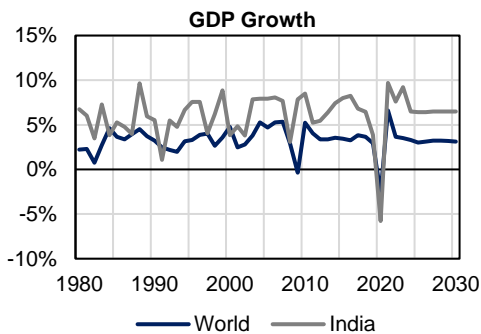
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Exhibit 1: India's growth is expected to outpace the rest of the world through the remainder of this decade



Source: IMF World Economic Outlook Database, LSEG Workspace, and ADCB Asset Management

Exhibit 2: India's inflation has cooled substantially allowing room for the central bank there to cut rates



Source: Reserve Bank of India, LSEG Workspace, and ADCB Asset Management

GST reforms and implications

India shifted its GST system from five slabs to a two-tier structure starting September 22, keeping separate rates for luxury and "sin" goods. The rate cuts on commonly used items aim to boost affordability and consumption, though the overall fiscal space will be limited as reduced revenues are expected to total about 0.2% of GDP in FY26. While revenue losses will be partly offset by compensation cess collections and fund surpluses, decreasing transfers to states may constrain their budgets unless revenue growth rises. We expect the net effect on economic growth to be neutral. Lower indirect taxes and phasing out the compensation cess could raise consumption and GDP by around 0.2%, provided companies pass savings to consumers. However, any increase in consumption is likely to be counterbalanced by lower government capital spending, maintaining a stable fiscal impulse. Headline inflation should see a temporary decrease, mainly from lower prices on core goods like food and medicines, with CPI likely falling by 0.3–0.4ppt in the next year. This disinflationary impact is expected to fade by Q4 of 2026.

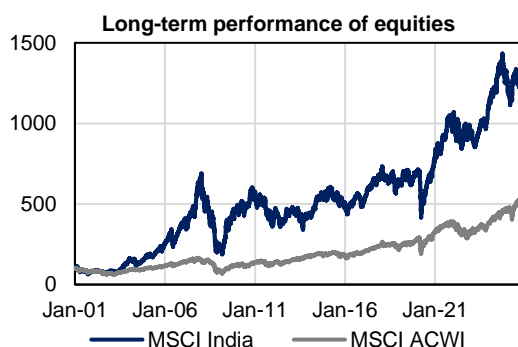
US tariffs on India and implications

On August 6, President Trump used IEEPA authority to impose a 25% secondary tariff on India for continuing to import Russian crude oil. Effective August 27, total tariffs on Indian goods reached 50%, affecting about one third of India's US exports (USD29.5bn), including pharmaceuticals, electronics, and petroleum products. Overall, nearly USD58bn of exports are now subject to these higher tariffs, with steel and aluminium already facing a 50% rate. The impact on India's trade, current account deficit, and GDP is uncertain and depends on how long tariffs last and whether a new trade agreement is reached. If exports decline, lower intermediate imports may partially offset negative effects. However, job losses and weakened confidence could amplify GDP impacts, making government intervention crucial. Our best-case estimates suggest a USD17bn export loss (c0.4% of GDP) if India diverts trade and boosts domestic demand, while the worst case projects USD46.3bn in lost exports (c1.2% of GDP) in the event of an "effective embargo" with minimal trade diversion or policy effectiveness.

Equities outlook (positive)

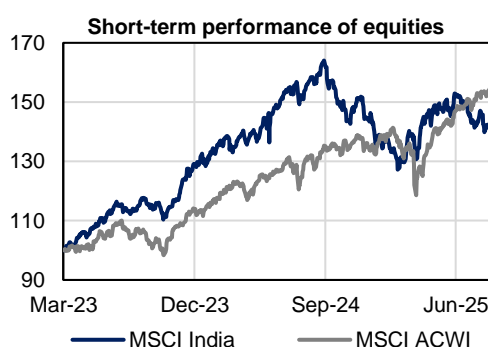
Indian equities have come under pressure over the past year due to disappointing corporate earnings, subdued domestic consumption, higher valuations, adverse tariff developments, and a depreciating currency. Policymakers have taken steps to support domestic growth since the beginning of this year, including tax reductions in the budget, monetary policy easing (total repo rate cuts of 100bp and a CRR cut of 150bp), and a significant Goods and Services Tax (GST) overhaul. The introduction of a two-tier GST structure is expected to stimulate consumption, which may encourage increased demand and reduce inflationary pressures. Directly affected groups include consumers (especially in durables, apparel, and footwear), automobiles, insurance, healthcare (notably diagnostics, hospitals, and eye care/dental chains), and the cement industry. In terms of growth, non-bank financial companies and retail banks may also benefit. The impact from GST 2.0 may offset some negative effects of US tariffs in upcoming quarters. Although uncertainties may limit market movement in the immediate future, improving macroeconomic indicators and projected strong earnings from the latter half of FY26 may contribute to future market performance. Sector wise, we prefer consumer sectors and financials over IT and pharma.

Exhibit 3: Indian equities delivered substantial outperformance in USD terms over the long-term ...



Source: MSCI, LSEG Workspace, and ADCB Asset Management

Exhibit 4: ... but have underperformed their global benchmarks over the past year

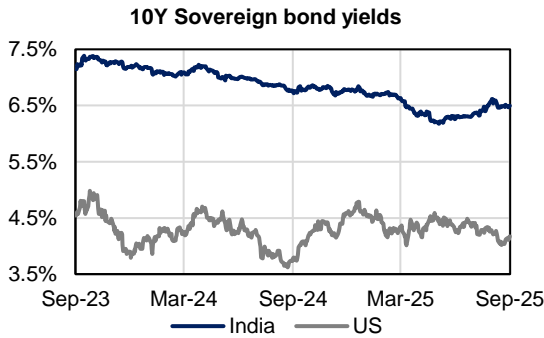


Source: MSCI, LSEG Workspace, and ADCB Asset Management

Fixed income outlook (positive)

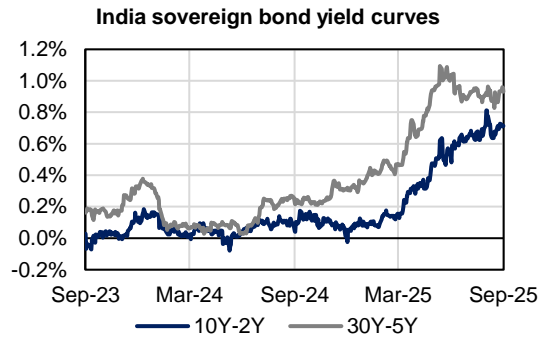
The RBI is anticipated to cut policy rates by 25bp, reflecting market pricing. Long-end yields increased by 30-40bps in August, influenced by fiscal concerns, personal income tax outcomes, and GST rationalization. Market borrowing is projected to align with budgeted figures, as the central government aims to achieve the fiscal deficit target through expenditure management and reprioritization. The sell-off in Indian Government Bonds in August has resulted in increased value compared to earlier in the year, in our view. Both swap and bond curves are currently steep relative to fundamentals, indicating a greater risk premium in the mid and long segments of the curve compared to the front-end, particularly when compared to other high-yielding Asian markets. We recommend building exposure to Indian bonds on an FX hedge basis because, absent a turnaround on tariffs, we see the INR underperforming peers.

Exhibit 5: Yields on 10Y India Government bonds rose considerably during August ...



Source: LSEG Workspace, and ADCB Asset Management

Exhibit 6: ... while yield curves have steepened remarkably over the past year

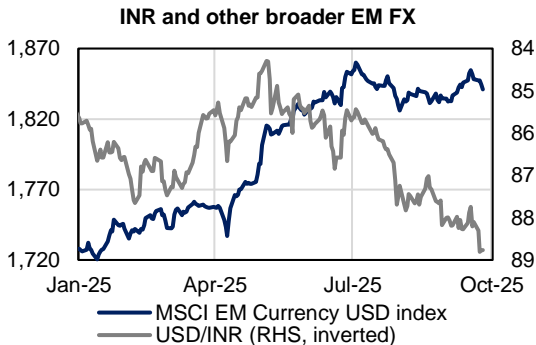


Source: LSEG Workspace, and ADCB Asset Management

Currency outlook (negative)

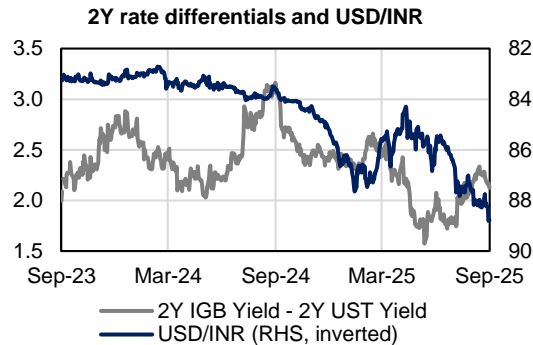
Trade talks and tariffs continue to play a significant role. Negotiating a trade agreement with the US has been challenging for India, whose economy is primarily domestic, and the Russia-Ukraine conflict has resulted in secondary tariffs affecting the country. While goods present a moderate risk for an economy focused on domestic markets, potential tariffs on services exports could have a notable effect on the current account. Portfolio flows are being affected by seasonal patterns. Since the beginning of July, foreign investors have sold USD7.9bn of Indian equities, reversing gains seen after Liberation Day. This trend may contribute to the usual seasonal decline in flows, particularly as the core trade balance experiences increased pressure from higher imports during the festive period leading up to Diwali.

Exhibit 7: INR has underperformed other EM FX since mid-April this year ...



Source: LSEG Workspace, and ADCB Asset Management

Exhibit 8: ... and may have further downside against the USD if 2Y yield spread between IGBs and USTs narrows further



Source: LSEG Workspace, and ADCB Asset Management

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