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What to watch: Markets and the Talion law, expectations for the Indian elections, and the depreciation of the renminbi still ‘under control’

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Executive summary

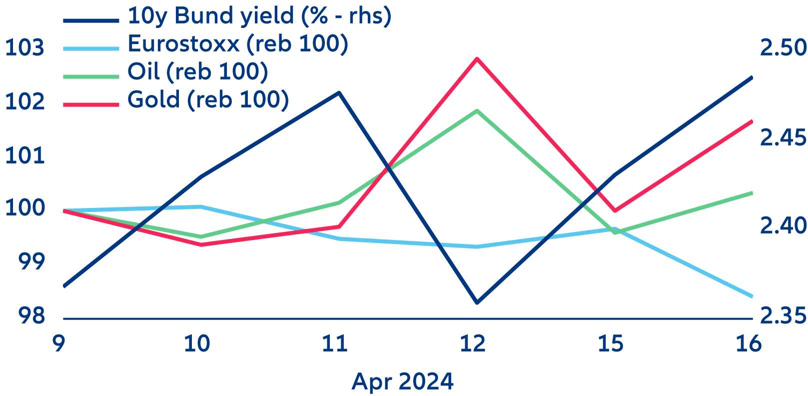
This week we look at three critical issues:

- **Is the Talion law driving markets?** The conflict in the Middle East is fueling market pessimism, a flight-to-safety, and a shortened investment horizon visible in “W-shaped” market volatility patterns. Indeed, investors seem to continuously adjust to the shifts between geopolitical escalation and relaxation, or a form of Talion law – the “eye for an eye” principle. Current oil prices, at USD90, appear to include a geopolitical risk premium of USD5 to USD10. It also appears that the current geopolitical scenario is likely to prompt a slightly dovish stance from central banks. Significant intraday volatility in equity markets, influenced by technical and fundamental factors, will likely amplify short-term market volatility, regardless of the news source (be it political, geopolitical, or financial earnings).
- **Indian elections: continuity is critical.** India will conduct parliamentary elections from 19 April to 1 June, with results expected on 4 June. Narendra Modi is poised for a third term with his Bharatiya Janata Party leading the coalition government. The continuation of reforms should focus on regulations, infrastructure, the labor market and the manufacturing sector to sustain fast-paced growth and position India as a prime destination for foreign investment. The government aims to elevate India’s infrastructure and trade logistics to rank among the world’s top 25 countries by 2030. India could become the second-largest economy in the Asia-Pacific region and the third-largest globally by 2030, yet downside risks remain.
- **PBOC’s strategy to control the depreciation of the renminbi.** Despite global pressure, notably from strong US data, the onshore Chinese yuan (CNY) has shown remarkable stability, with a slight depreciation of just -0.1% this month. The People’s Bank of China (PBOC) aims to contain this pressure, likely accepting modest, controlled depreciation but keeping the USDCNY onshore rate below 7.34. Policy measures to support the economy such one more cut in both the reserve requirement ratio and the one-year loan prime rate can still be anticipated, although implementation may be delayed. The controlled depreciation of the renminbi could benefit other Asia-Pacific currencies strongly correlated to the renminbi.

Is the Talion law driving markets?

The conflict in the Middle East is fueling market pessimism. The growing instability in the Middle East is now significantly influencing market valuations. Investors are reducing their decision-making timelines drastically, often responding to news developments within the same trading day. This shortened investment horizon has led to "W-shaped" market volatility patterns, as investors continuously adjust to the shifts between geopolitical escalation and relaxation (Figure 1).

Figure 1: European market variables

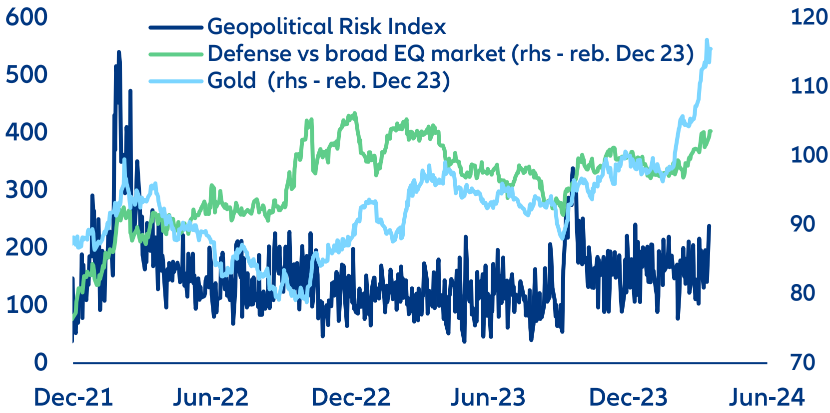


Sources: LSEG Datastream, Allianz Research

Current oil prices, at USD90, appear to include a geopolitical risk premium of USD5 to USD10. With our projected anchor for the next two years around USD80, the current pricing already accounts for considerable geopolitical uncertainty. Moreover, global excess production capacity could avert any fundamental shift in crude oil market trends. Consequently, the current situation is expected to have little impact on oil-based economic projections in the mid-term.

It appears that the current geopolitical scenario is likely to prompt a slightly dovish stance from central banks, influenced by stable commodity prices and potential declines in consumer spending due to heightened fears of conflict intensification. We anticipate periodic market shifts towards safe-haven assets (such as the defense sector, gold and bonds from developed markets) driven by the ongoing "eye-for-an-eye" principle – Talion's law – in the region. Although we expect increased market volatility, we do not foresee the situation spiraling into extreme risks, such as a full-scale war or a complete disruption of oil supply through the Strait of Hormuz, which accounts for about 17% of global oil production (Figure 2).

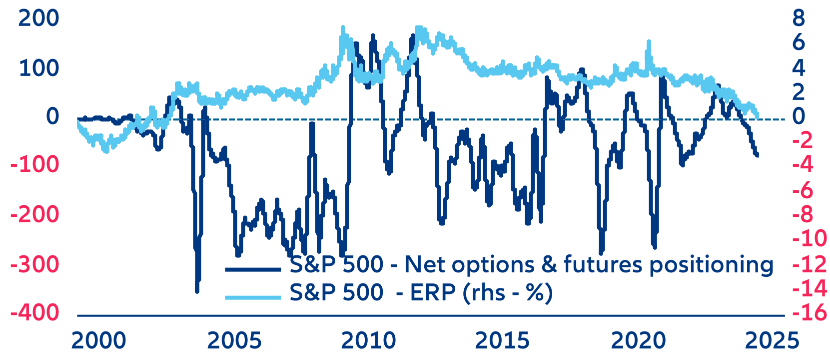
Figure 2: Market variables and Geopolitical Risk Index



Sources: LSEG Datastream, GPR Index, Allianz Research

Significant intraday volatility in equity markets can largely be attributed to high valuations and extreme market positions. Focusing on the US markets, the influence of major stocks, often referred to as the Magnificent 7, has reduced the equity risk premium, resulting in a market trend heavily leaning towards short positioning. This indicates that both technical and fundamental factors are poised to amplify short-term market volatility, regardless of whether the news is political, geopolitical or financial earnings (Figure 3).

Figure 3: S&P 500 net options and futures positioning and Equity Risk Premium



Sources: CFTC, LSEG Datastream, Allianz Research

Indian elections: continuity is critical

The largest democratic election in the world: Parliamentary elections will take place in India from 19 April to 1 June, with official results expected on 4 June. Approximately 970 million eligible voters are called to the polls, representing more than 10% of the world's population. This exceeds the combined total of all other top ten most populous countries, excluding China. The logistics are immense, with 1 million voting stations, 1.7 million electronic voting machines and 15 million poll workers in action to enable the voting process.

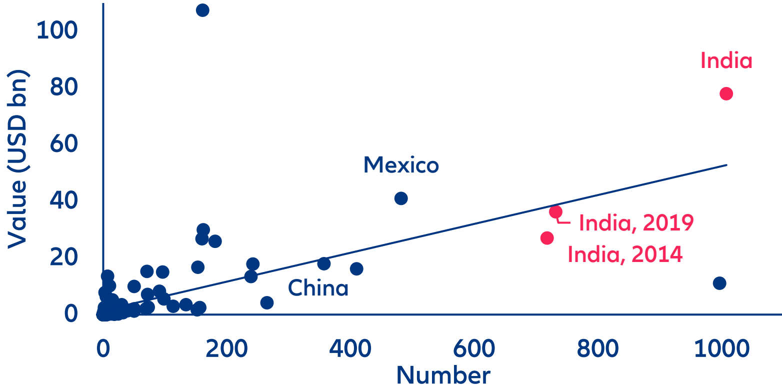
Narendra Modi will likely enter his third consecutive five-year term, with his Bharatiya Janata Party (BJP) leading the National Democratic Alliance (NDA) and the coalition government. Modi benefits from high approval ratings. According to Morning Consult, 78% approve of Modi's work – substantially higher than global counterparts such as Meloni (43%), Biden (39%), Macron and Scholz (22%). Despite Modi's age – he will be 78 years old at the end of his third term, the NDA is still expected to secure 330 of the 543 parliamentary seats, or around 60%, a slight decrease from 352 in 2019. Although Modi's election campaign emphasizes socio-cultural issues, the post-election focus is expected to shift towards economic and growth-promoting initiatives.

With the NDA securing another majority in parliament, the reform momentum is set to continue. An efficient government is crucial for further structural reforms, essential for India's long-term growth prospects. Achievements in recent years suggest another government led by the BJP could lead to continued development of the financial sector, increased infrastructure spending, labor market reforms and policies to strengthen the manufacturing sector.

Continuing the reform momentum in the context of fast-paced growth will keep India attractive to foreign investment. Recent data highlights India's leading position among developing economies for greenfield investment projects, with 1,008 projects announced in 2022 amounting to USD78bn – equivalent to 2.3% of India's GDP (see Figure 4). While India's foreign direct investment (FDI) regulatory restrictiveness aligns with many Asia-Pacific peers, there is room for improvement in regulatory quality, which lags major ASEAN economies. Enhancing transparency in market regulations and predictability in law enforcement, such as tax inspections and fines, could further boost investor confidence. In the insurance sector, the "Insurance for all by 2047" policy, launched in 2022, aims that every citizen has appropriate insurance cover, that every firm is supported by appropriate insurance solutions and that the Indian insurance sector becomes globally attractive. Additionally, the Indian government will focus on boosting the functioning of the country's still underdeveloped capital markets, where foreign investors still play a minor role. Critical areas for policy improvements include enhancing market liquidity, especially in the bond market, improving

currency convertibility, simplifying regulatory complexity (including taxes and cross-border investment regulations) and preventing the disorderly growth of markets that could lead to financial (and real estate) bubbles or erode foreign investor confidence.

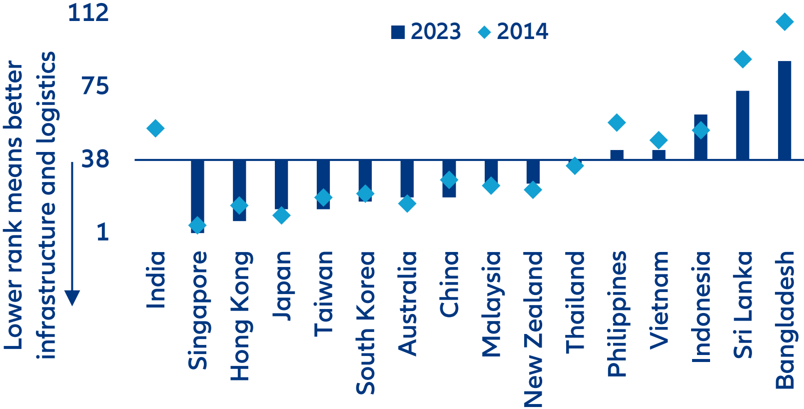
Figure 4: Announced greenfield foreign direct investment projects (total number and value), developing economies, 2022 unless otherwise mentioned



Sources: UNCTAD, Allianz Research

The government aims to elevate India's infrastructure and trade logistics to rank among the world's top 25 countries by 2030. According to the World Bank's Logistics Performance Index, India improved from 54 in 2014 to 44 in 2018 and to 38 in 2023 (see Figure 5). This advancement is largely attributable to major initiatives such as the Bharatmala project, which focuses on developing cross-country roads and highways, and the Sagarmala project to build port infrastructure. Both projects were initiated in 2015. Despite these improvements, India's logistics and transport infrastructure still underperforms many regional peers (see Figure 5). In the near future, several other major infrastructure projects will become operational, including the Delhi-Mumbai and Bengaluru-Chennai expressways, the Navi Mumbai and Noida airports and the Mumbai Coastal Road Project. Additionally, the National Logistics Policy, announced in 2022, aims to support India's logistics efficiency by developing digital systems. Efficient domestic transport networks and port logistics would improve India's productivity and make the country even more attractive to foreign investors.

Figure 5: Ranking based on the World Bank's Logistics Performance Index, main Asia-Pacific economies (x-axis crosses at 38th, which is India's ranking in 2023)



Sources: World Bank, Allianz Research

India benefits from a vibrant and growing labor force, but there is room to unlock its potential further. Demographics support India's long-term economic outlook, with the working-age population (ages 15 to 64) expected to surpass the 1bn threshold in 2026 and maintain this level until 2075, peaking at 1.1bn in 2048. Despite this, India's demographic dividend faces several challenges. These include high youth unemployment (around 23%

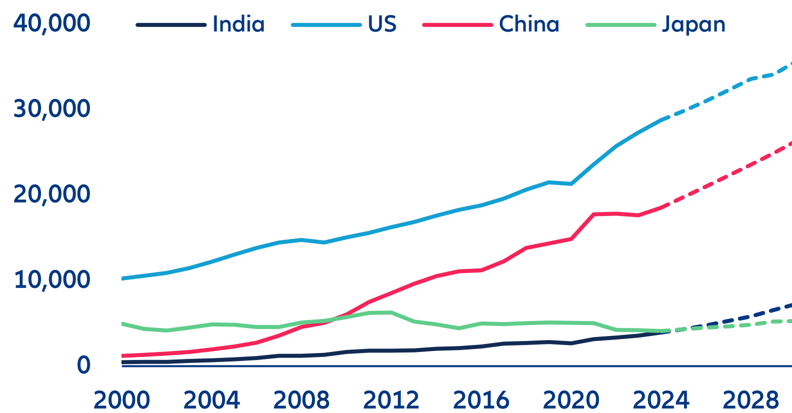
in 2022), low female participation rate (30% in 2022, the lowest among major Asian economies) and an education attainment, where only 50% of the population aged 25 and older have completed a lower secondary level of education as of 2022. Labor market reforms are often controversial. However, a government with a strong majority could implement vital measures to unlock the workforce's potential. These could include reducing bureaucracy, easing restrictions on overtime, fostering greater female labor force participation and reducing the share of informal jobs. The latter is particularly relevant in the agriculture sector and supporting the manufacturing sector could significantly increase the share of formal employment.

Strengthening the manufacturing sector: doing the domestic groundwork to seize the opportunities offered by global supply-chain diversification. The government aims to increase the manufacturing share of the economy to 25% by 2025, up from 13% in 2022. This would align India more closely with regional peers like China (28%), Vietnam (25%) and Indonesia (18%). Critical focus sectors include electronics, electric vehicles, information technology, renewable energy and pharmaceuticals. While the 2025 target is probably too ambitious, it serves as a catalyst for enhanced policy support. To achieve this, essential domestic groundwork is necessary, such as infrastructure spending, labor market reforms and labor force upskilling. Additionally, a significant area for government action is trade policies. India remains one of the most protectionist emerging economies, with average customs duties on imports more than double those of its peers. Efforts to correct this have been seen in recent years, with India actively negotiating bilateral free trade deals beyond its traditional Asian partners. Since 2021, India has secured more free trade agreements than its peers in ASEAN and Mexico, indicating a willingness to leverage geopolitical shifts as multinational firms seek alternatives to China.

We expect the Indian economy to grow by +6.4% in 2024 and +6.5% in 2025, following +7.7% in 2023 (calendar years). These projections position India as the fastest growing major economy globally. This growth is driven by robust household consumption, investment supported by government spending and improving confidence as interest rates peak. We foresee the Reserve Bank of India (RBI) beginning to reduce its policy rate in the second half of 2024 (after increases amounting to +250bp between May 2022 and February 2023) as inflation returns towards the RBI target (we forecast 4.6% in 2024 and 2025, after 5.7% in 2023). India's dynamic growth is particularly notable against renewed concerns over the Chinese economy since 2023, positioning India as the next bright spot among emerging markets. Consequently, Indian capital markets have performed well and could be poised for further gains. The inclusion of Indian sovereign bonds in global indices in 2024 should attract further inflows and support the currency. While short-term currency performance may be influenced by external factors, such as US monetary policy expectations, a continued path of mild depreciation is likely in the medium term due to persistent current account deficits.

By 2030, India is projected to become the second-largest economy in the Asia-Pacific region and the third-largest worldwide (see Figure 6). We expect India's annual economic growth to average around +6.6% from 2026 to 2030. This growth will be supported by strong macroeconomic fundamentals, an improving business environment, robust investment and consumer spending. India's increasing prominence on the global stage is further evidenced by high-profile events such as its G20 presidency, successful lunar missions and Modi's state visit to the US. These developments help position India as a distinctive and influential voice, bridging West nations and the Global South.

Figure 6: Nominal GDP, USD bn



Sources: IMF, Allianz Research

What could go wrong? While there is ample reason for optimism about the Indian economy in the short and long term, it is important to remain vigilant about the key downside risks that could jeopardize its growth path.

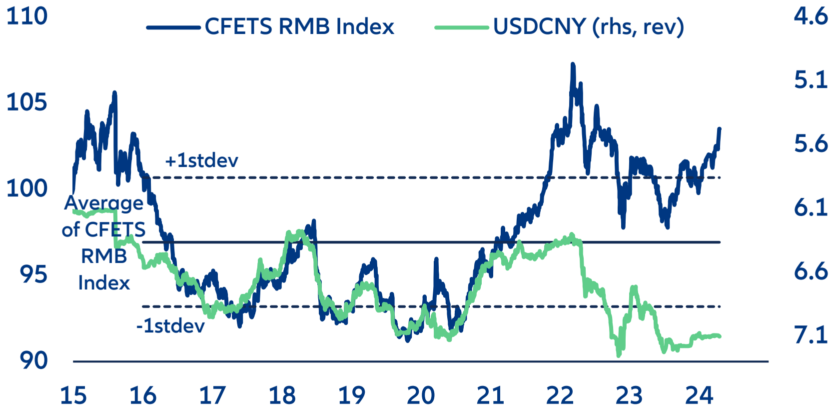
- **Return of a trade war.** In the short term, an external factor is the potential risk of a renewed trade war under another Trump administration[1]. In a scenario where the US raises tariffs on non-critical dependencies to 60% on China and 10% on the rest of the world, and trading partners respond in kind, economies around the world would suffer. Our estimates indicate for the Indian economy's growth a potential -0.2pp in the second year and -0.3pp in the third year of such a trade conflict.
- **Banking sector vulnerabilities.** Despite improvements in the banking sector, such as a declining non-performing loans ratio (from 6.9% in Q3 2021 to 3.2% at the end of Q3 2023) and ongoing reforms, the banking sector has areas needing vigilant oversight. The rapid rise in credit (particularly, unsecured loans) coupled with inadequate regulatory supervision means continued close monitoring is necessary.
- **Reform momentum.** Sustaining the reform momentum is crucial for unlocking India's growth potential and maintaining investor confidence, as detailed previously in this note.
- **Climate change impacts.** Climate change poses significant risks to the Indian subcontinent, potentially curtailing growth through decreased labor productivity and increased (food) inflation. By 2050, labor-productivity losses due to climate change could reduce India's GDP by an average of -7%. To limit the global temperature rise to 1.5°C, it is estimated that India will need to invest USD143bn by 2030.

PBOC's strategy to control the depreciation of the renminbi

Robust US data are putting pressure on currencies worldwide. Economic indicators, including a stronger-than-expected inflation rate and resilient retail sales, are cooling expectations of the Federal Reserve's monetary easing. Consequently, major currencies have depreciated against the USD. The Dollar Index (DXY) rose by +1.6% so far in April and +4.8% year-to-date. In contrast, Asian currencies like the Korean Won and Indonesian Rupiah experienced depreciation of -2.7% and -2.4% against the US dollar, respectively, this month. Meanwhile, the CNY onshore rate has shown remarkable stability, depreciating by just -0.1% so far this month. This has resulted in appreciation of the Chinese currency in trade-weighted terms, with the CFETS RMB Index rising by +1% (see Figure 7).

[1] *See our report Trumponomics : the sequel*

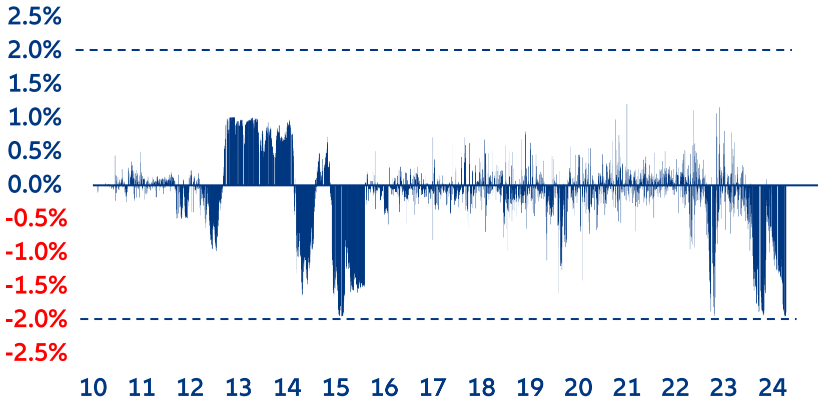
Figure 7: CFETS RMB Index and USDCNY mid-rate



Sources: Bloomberg, Allianz Research

The People's Bank of China (PBOC) wants to contain pressure on the renminbi, aiming for modest, controlled depreciation. The PBOC is striving to keep the USDCNY onshore rate from exceeding 7.34, recognizing that a weaker renminbi can undermine domestic confidence and prompt outflows of foreign funds. Recent stability in the Chinese currency was driven by the PBOC refraining from setting the daily mid-rate higher (see Figure 7), even when the USDCNY onshore rate neared the 2% spread limit (see Figure 8). We believe the PBOC could follow strategies used during last fall's bout of depreciation: after exceeding 7.2 during two days (8 and 11 September 2023), the mid-rate was consistently capped below that level to prevent the USDCNY onshore rate from rising beyond 7.34.

Figure 8: Spread between USDCNY mid-rate and onshore rate (%)



Sources: Bloomberg, LSEG Datastream, Allianz Research

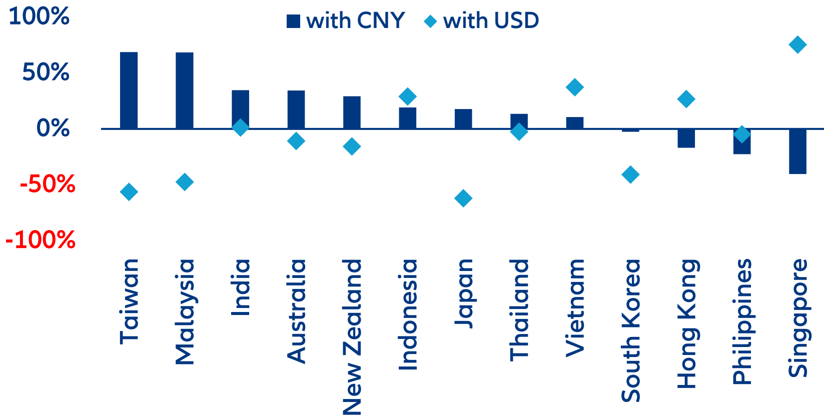
Chinese policymakers seek to balance currency stability and monetary easing. Since late 2021, the PBOC's monetary policy has diverged from global trends by cutting policy rates by -40 basis points, while the Fed has hiked rates by +525 basis points. This policy divergence has resulted in the China-US government yield spread turning negative in 2022, a first in twelve years (see Figure 9). Despite the depreciation pressure on the renminbi, which may constrain further rate cuts, we still anticipate one additional cut in both the reserve requirement ratio and the one-year loan prime rate. However, the PBOC may delay these cuts to the second half of the year. Even though recent data releases in China suggest that the economy still needs policy support, there are also signs of a stabilizing economic base, reducing the urgency for immediate further policy easing. The PBOC might wait for depreciation pressures on the renminbi to ease before delivering further rate cuts.

Figure 9: Sovereign yield spreads vs. USDCNY

Sources: LSEG Datastream, Allianz Research

Controlled depreciation of the renminbi could support other Asia-Pacific currencies. Recent trends show a growing influence of the Chinese Yuan (CNY) over other Asia-Pacific currencies, shifting away from the traditional dominance of the USD. Analysis of real effective exchange rates shows that over 2022-2023, the New Taiwan Dollar has a 69% correlation with the CNY (see Figure 10), a significant increase from 31% between 2012-2014. Similarly, the Malaysian Ringgit's correlation jumped from 1% to 68%, the Indian Rupee from -25% to 35%, the Australian Dollar from -32% to 34% and the New Zealand Dollar from 12% to 29%. This suggests that controlled depreciation of the renminbi could help support these currencies in the context of a strong US dollar.

Figure 10: Correlation with CNY and USD (based on REER indices), monthly averaged over 2022-2023



Sources: Bruegel, Allianz Research

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