Special Coverage

Union Budget provides a supportive backdrop for long-term growth

Key takeaways

- In the FY26-27 Union Budget, the government guided towards a slower pace of fiscal consolidation, and continued its thrust on capex and slightly higher-than-expected borrowing.
- The Reserve Bank of India (RBI) is unlikely to cut interest rates at the upcoming Monetary Policy Committee (MPC) meeting on 6 February, given that inflation seems to be trending higher towards its target range.
- The Budget was largely mixed for Indian equities. Commitment to fiscal consolidation and the announcement of taxation of buybacks at the capital gains tax rate are structural drivers. The hike in the Securities Transaction Tax (STT) is likely to be a negative for equities. We favour domestically oriented sectors, including consumer discretionary, financials and industrials. Indian local currency bonds continue to offer attractive absolute and relative yields, as well as diversification benefits due to their lower correlation with global bonds.

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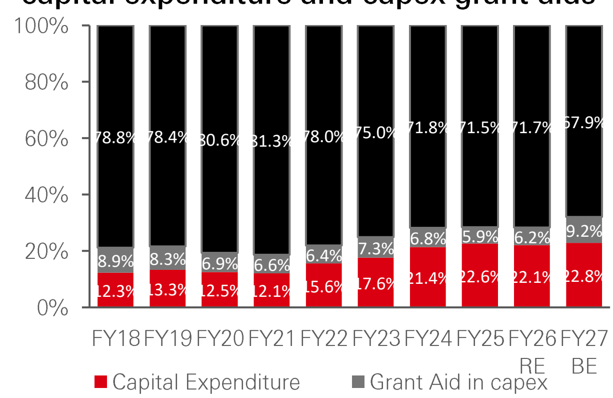
What happened?

- The highly anticipated FY27 Budget was greeted by a muted market reaction, as it appeared to prioritise long-term structural growth over a near-term boost.
- While the pace of fiscal consolidation slowed, policymakers retained their focus on high-quality capex, with increased spending on AI, semiconductors and rare earths, alongside continued support for the manufacturing sector. As a result, government spending is likely to be neutral for growth.
- The Finance Minister forecasted a fiscal deficit of 4.4% of GDP for FY26, in line with prior guidance, and 4.3% for FY27 (April 2026-March 2027), implying a slower pace of fiscal consolidation than our expectation of a fiscal deficit target of 4.2%. Nominal GDP growth is forecasted at 10%, with the debt-to-GDP expected to ease to 55.6% in FY27.

The government continues to allocate a higher proportion of spending towards capital expenditure and capex grant aids



Source: Bloomberg, HSBC Private Bank and Premier Wealth as of 2 February 2026. Past performance is not a reliable indicator of future performance.

- The government continued its thrust on capital expenditure, with FY27 spending set to grow at 11.5% y-o-y to INR 12.2trn. Overall, the budgeted capex spending was steady at 3.1% of GDP. The government also increased allocations for interest-free capex loans to states to INR 2.1trn (vs INR 1.7trn previously). The major categories for capex include defence, railways, roads and highways.
- The FY27 Budget focused on semiconductors, data centers for AI and increased incentives for self-sufficiency in rare earths. Key announcements included Semiconductor Mission 2.0, and a tax holiday for building data centers in India until 2047, and the development of rare earth corridors across multiple states, including Odisha, Kerela, Andhra Pradesh and Tamil Nadu.

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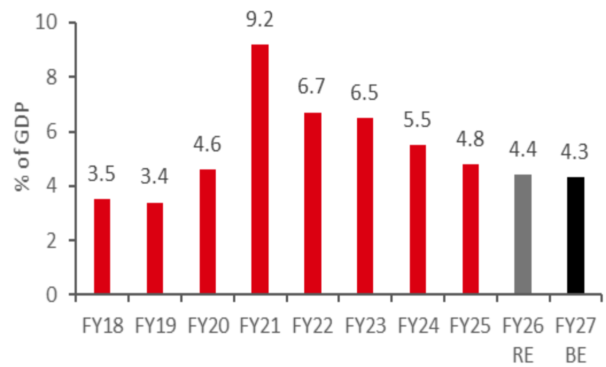
- The government also laid out support for areas such as biopharma, electronic components, chemical parks, container manufacturing and high-tech tools. In addition, Production Linked Incentive (PLIs) schemes for pharma, air conditioners, LEDs, electronics and autos are set to increase in FY27. The government also introduced an INR 100bn SME growth fund and a credit guarantee scheme for MSMEs to help mitigate the impact of US trade tariffs.
- While no major overall tax changes were announced, the government will increase the Securities Transaction Tax (STT) for futures and options to curb speculative trading by retail investors. Custom duties on select items have also been reduced.
- At a broad level, the assumption of 10% nominal GDP growth appears reasonable. The government is looking at 11.7% growth in direct taxes, led by personal income tax collections, while corporate taxes are projected to increase by 11%. Overall, tax revenues are budgeted to grow at 8% y-o-y.
- The government has guided towards non-tax revenue of INR 6.7trn, largely driven by RBI dividends and higher disinvestment proceeds.
- Gross market borrowing was projected at INR 17.2trn, while net market borrowing is expected to rise to INR 11.7trn. Both figures are slightly higher than market expectations.

Pace of fiscal consolidation to slow down



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- Corporate taxes are also projected to increase by 11%, which may be ambitious, while indirect taxes are projected to grow at a much slower pace following recent GST cuts, leading to a low tax buoyancy of 0.3.

Investment implications

- In our assessment, the FY27 Union Budget was largely mixed for Indian equities, with differentiation at the sector level. However, we may adopt a more constructive stance if there is evidence of a sustained uptick in earnings momentum and improved foreign investor sentiment.
- Commitment to fiscal consolidation and the announcement of taxation of buybacks at the capital gains tax rate are structural drivers. However, in the near term, the lack of relief on capital gains taxation, the hike in the Securities Transaction Tax (STT) on derivatives, and a lack of measures to attract foreign capital could weigh on market sentiment.
- We also expect investors to refocus on the fundamental drivers for equities, which are largely balanced in our opinion. We therefore retain a neutral stance on MSCI India.
- The macroeconomic backdrop remains broadly supportive for Indian equities, with nominal GDP growth projected at 10% for FY27. Over the longer horizon, Indian equities' performance has shown a close correlation with nominal GDP growth.
- We expect earnings growth in 2026 to be in the high single digits. However, we expect several other Asian equity markets to deliver substantially higher earnings growth relative to Indian equities.
- We prefer domestically oriented sectors and remain overweight on consumer discretionary, financials and industrials.
- Higher gross and net market borrowing is a modest negative for Indian bond markets in the near term. Nevertheless, we retain a bullish stance on Indian local currency bonds over a 6–12-month horizon.

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