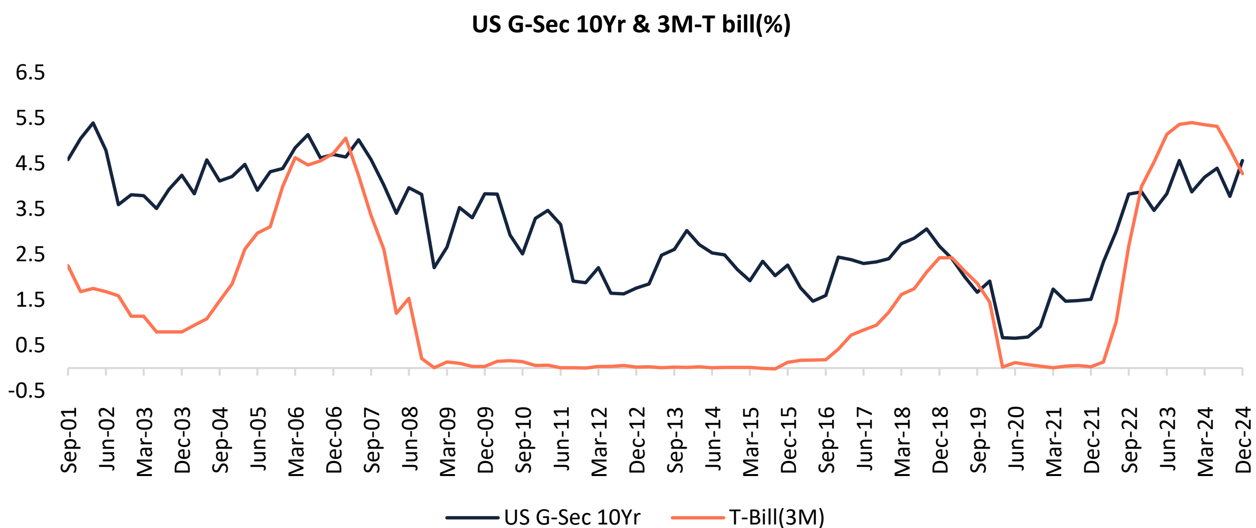
MY NAME IS BOND. US BOND

"But now, I want to come back as the Bond Market "– James Carville, Political Advisor to Bill Clinton in 1993 when he was moving on from his powerful role.

The reference was meant to stress the power that the bond market wields over investor psyche. What is significant about it? What has changed? Why should we in India worry?

These are some questions we need to debate.

First of all, the yield curve in the US which was inverted after Covid, has straightened up. The short-term yields are primarily set by the central bank. The long-term yields usually trade at a premium. The premium is meant to cover the cost of capital which needs to factor in the uncertainties in lending money when the tenor is longer.



Source: Bloomberg, Spark Fund Research

When the market signalled that the long-term rates can be lower than the rate set by the Fed, what it was implying was also that the cost of money or capital will remain lower for longer (or forever and that is how the markets twisted this and began to read this). The unintended consequence of the low rates was an unprecedented quantum of asset price inflation across many asset classes. The low rates were themselves caused by massive injection of liquidity from Central banks led by the US Fed. Over time, the causes were relegated to the backburner, but the consequence has been celebrated as the new normal.

What has changed now?

From 2021 onwards, the cult status of the US Fed in the markets is under a cloud. The massive stimulus in the aftermath of Covid led to inflation and the US Fed had to pivot from its "lower for longer "stance and raise rates in 2022. Towards the end of 2024, the Fed seemed to suggest that it had inflation back in the bottle and began to lower rates. **The market revealed a mind of its own and the long-term rates started going the other way**. The yield curve straightened up and the long-term yield hit a 20 year high. This means one or more of the following.

1. The market is not willing to believe that the inflation can head lower from the 3% levels (The long-term goal of the Fed is 2%) and stay there.
2. Capital has a cost (which was all but forgotten). In other words, money cannot grow on trees.
3. The debt that leading nations had accumulated is unsustainable and the market is not willing to finance more of the borrowing binge without extracting a price.

4. Growth could be higher than projected. While this can be conveniently singled out as a reason, there is no corroborating evidence that there are growth impulses alive in most economies. While the US has been in a no-landing scenario for the last two years, growth outlook has not been great.

Government (Gross) Debt to GDP (%)	CY24
Japan	251
Italy	137
United States	121
United Kingdom	102
China	90
Brazil	88
India	83
Germany	63

Source: International Monetary Fund, Spark Fund Research

Most likely, what we are seeing is a signal coming from the US Bond markets, which is a large and liquid market. The signal is that the days of ever-reducing rates and cheap money on tap are over. Rate movements in UK and Europe point to the same. Even in Japan, the tree on which money grows for free is seen withering.

This is bound to have far-reaching consequences for the whole world in months and quarters to come. We want to limit to the consequences for India and the potential implications for India and its stock market.

What gives in India?

Unfortunately, a lot.

First and foremost, equity valuations in India could face headwinds. Mind you, the comment is on equity valuations and not on equities as an asset class. The comment is also on equity valuations on a relative basis – relative to what we have come to witness in recent years.

The above assumes importance because whenever valuations have been questioned, the defenders of the sacred right of Indian equities to keep going up all the time have responded by saying things like

1. PE ratio is a bad measure.
2. We have SIP.
3. Indian growth is superior.
4. India is a compounding story.
5. India is a stock-pickers market.

No one seemed to accept or even hint that India may have been an unintended beneficiary of the historic bull market in valuations. If the US Bond trades higher for a few more months (not even for higher for longer), a lot of these comments will start coming back to bite. Maybe, it is beginning to happen. Maybe, we are seeing the signs of what happens to a house of cards when it happens. Maybe, this is why FPIs are persistent sellers in Indian equity.

What complicates the scene for investors is that it is not just about the PE ratio or about the power of positive thinking which we in India are advised to wear on our sleeves all day and all night. The higher yields and higher cost of capital have other implications.

1. The pressure on INR

   The US Dollar has strengthened despite the US being a debt-ridden nation. This is because there is no real alternative for the USD. If the 10-year bond in the US returns 4.5-5%, that is a damn good deal. All currencies have tanked against the USD. INR is fundamentally vulnerable as India imports far more than it exports (unlike China and the ASEAN) and uses flows into equity markets to pay for the difference. We know what is happening to those flows. INR is facing the heat and

given past experience; devaluation has always been the cost that India has paid for the exuberance it has shown in better times. We need to be prepared for another round of INR devaluation and consequences thereof.

2. The pressure on fiscal deficit

   Indian budget is a tough balancing act, and it doesn't balance anyway. India keeps borrowing. In better times, growth seems to take care of the debt concerns. When times are bad (which they are with a highly unpredictable US administration breathing down a hapless unipolar World), the pressure on the deficit can look magnified.

3. The pressure on rates

   Indian interest rates were supposed to start going down meaningfully this year. The optimism on that count may need to be tempered a bit. Even if the RBI creates the room and conjures up a rate cut, the market rates may not fall much.

4. The pressure on prices

   A costly US Dollar will pinch the pocket of the consumer. While inflation expectations are broadly muted, it does not take much time for inflation to flare up in India.

What are we staring at?

1. Delay in growth recovery.
2. High risk of earnings disappointment for FY26. (FY25 is a gone case)
3. Continued and enduring pain in small/midcaps.

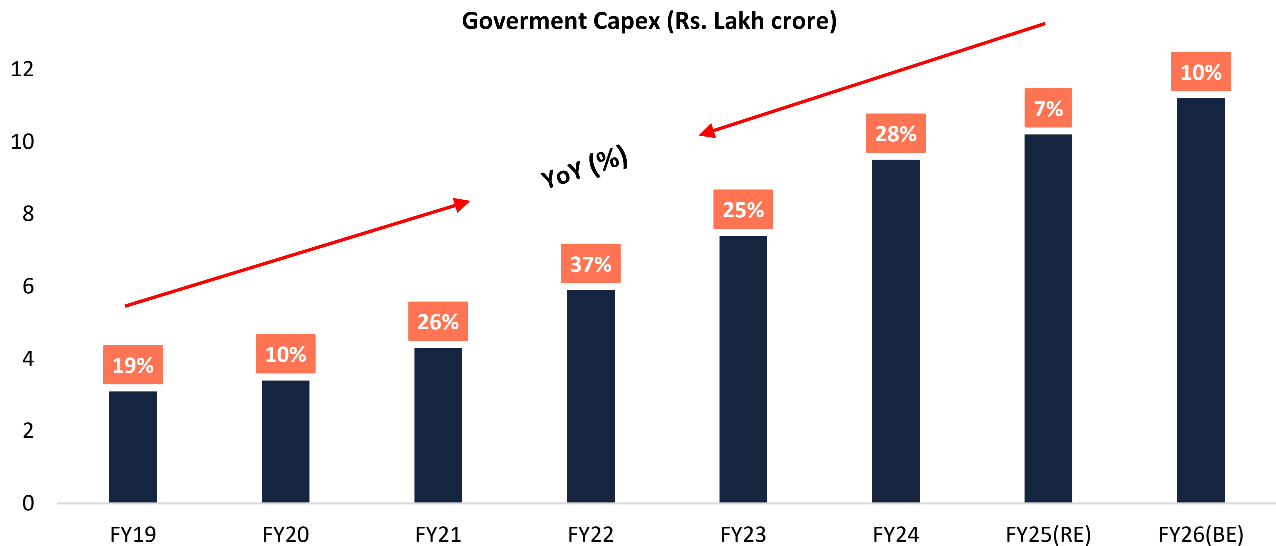
We are in a much better situation on the economy as compared to previous occasions when India ran into rough weather. However, the market positioning has become so extreme in recent years that investors at large insist that markets should give positive returns all the time. Volatility is defined as a phenomenon where other people will be shaken out, but the "believers" will come out unscathed. The experience in several other seemingly exciting market situations across geographies and time suggest that the markets are seldom very kind to such convenient posturing.

We do believe in the long-term story of India and its equities. However, there are times when reality bites. There will be a time to buy, and we are sanguine that we will get such opportunities as we go forward. But these are also times when discretion should take precedence. We should remember the time-tested adage about who rushes in where and when angels fear to tread.

Postscript – Excitement over the Union Budget

The 2025 Union Budget has created more excitement in the media than any other in recent memory. The tax cuts will put more disposable income in the hands of the taxpayer and that is a clear positive. Even as the encomiums for the stimulus pour in, we list out a couple of facts which merit attention.

1. Capex spending shifts into slow gear



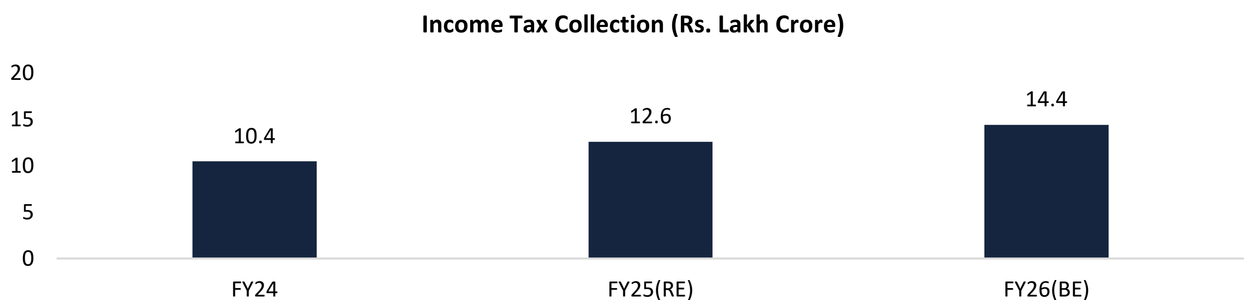
Note: RE – Revised Estimate BE- Budget Estimate. Data labels denote the YoY (%) change in government capex.

Source: Ministry of Finance, Spark Fund Research.

1. It is a fact that India's economic recovery post 2020 outpaced the world – at an aggregate level or on a comparison with any meaningful and relevant economy in the developed or developing world.
2. It was fired by capex spending and the persistence with the same. The chart above unambiguously proves the point. Most other countries did not (or could not) follow this script. Needless to add, the multiplier effect from accelerated spending on infrastructure is something that does not need explaining.
3. In FY25, the capex spending faltered. We know the impact to growth.
4. In FY26, the budgeted amount is the same as what was planned for FY25 earlier on.
5. There is a clear course correction away from the huge emphasis on capex spending.

This cannot be growth positive for India in today's context, whatever the spin.

2. Personal Income tax projections need to add up



Note: RE – Revised Estimate BE- Budget Estimate.

Source: Ministry of Finance, Spark Fund Research.

1. The budget explanation talks about a revenue loss of Rs 1 lakh crore due to the tax cut. Like-to-like, the personal tax collection would then start at a base of Rs 11.6 Lakh crores for FY26 as the collection in FY25E is Rs 12.6 lakh crores. The projection of Rs 14.4 Lakh crores for FY26 represents an effective growth of 24%. This kind of growth has never happened.

2. Apart from the tax cut, the personal income tax collection in FY25 includes a handsome contribution from capital gains tax emanating from all-time high market indices. The implications are clear. The revenue expected from personal income tax for FY26 is a spot of bother.

In 2025, the market will have its hands full navigating the rough waters and the turmoil created by the new US administration. Meanwhile, the optics around tax sops is appealing and creates a feel-good. The taxpayer will get the extra money to spend only from April and progressively from then. Let us keep a keen eye on the consumer and the choices that she makes.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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