India's Domestic Engine

The Highest-Conviction Structural Story in Asia

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Abstract

India enters 2026 as the fastest-growing major economy, expanding near 6.5% on the strength of a domestic-demand engine that is largely insulated from the global trade war paralysing exporters across Asia. In a year when WTO merchandise trade volume growth stalls at roughly 0.5%, China slides deeper into deflation, and Korea claws back from a 1.1% collapse, India's growth is generated at home: consumption, a maturing public and private capex cycle, and a financial system in its healthiest state in a decade. A 36% effective US tariff and a deliberately tight 2025 fiscal and monetary stance drove equity underperformance and, in our view, manufactured an attractive entry point. With S&P having upgraded the sovereign to BBB from BBB-, an India-EU trade agreement broadening market access, and a median age of 28, we hold India at Overweight and rate it our single highest-conviction structural allocation in Asia-Pacific. We are most constructive on financials and domestic-facing consumption.

1. The Structural Case: Growth Made at Home

The defining feature of the 2026 Asia-Pacific landscape is the divergence between economies that sell to the world and economies that sell to themselves. The house baseline places regional growth near 4.4%, still comfortably above the global average, with Asia contributing roughly 60% of world GDP growth. But that headline masks a brutal bifurcation. WTO merchandise trade volume growth is projected at only about 0.5% in 2026, down from above 2% across 2024 and 2025. China's export machine is fading against a 47.5% US effective tariff, Korea remains hostage to the memory-chip cycle, and Thailand and Malaysia are exposed to Chinese oversupply. India stands apart because its growth is not imported. Private consumption accounts for close to 60% of GDP, and net exports are a modest share of output. This is the rare large economy where a synchronised global trade slowdown is a second-order concern rather than the main event.

India is on track to grow near 6.5% in fiscal 2026, retaining its status as the fastest-growing major economy. The IMF's most recent World Economic Outlook and the World Bank's India Development Update both frame this as durable rather than cyclical, anchored by three reinforcing structural drivers: favourable demographics, a broadening capital-expenditure cycle, and the deepening of domestic capital markets. Crucially, these drivers are domestic in origin, which means the transmission of external shocks, whether a tariff escalation or a China demand air-pocket, is far weaker than for the region's trade-geared economies.

> **Our view:** India is the cleanest expression of the domestic-demand theme we have argued all year. In a world of 0.5% trade growth, an economy that manufactures its own 6.5% is not merely a growth story, it is a diversification asset. We hold India at Overweight and treat it as the highest structural conviction call in our Asia-Pacific book.

2. The Demographic Dividend and the Digital Layer

India's median age of 28 is not a talking point, it is the raw material of two decades of demand. Roughly one million Indians enter the working-age population every month. The dependency ratio is still falling, which historically correlates with rising savings rates, rising household formation, and rising discretionary consumption. Contrast this with the demographic cliff facing China, Japan, and Korea, where ageing is now a structural drag on both growth and fiscal sustainability. The demographic dividend is only monetised, however, when the labour force is productive and formal, and this is where India's digital transformation becomes decisive.

2.1 Digital public infrastructure as a growth multiplier

The India Stack, comprising the Aadhaar identity layer, the Unified Payments Interface, and account aggregator frameworks, has quietly become one of the most consequential pieces of economic infrastructure in the emerging world. UPI now processes well over 18 billion transactions a month, formalising commerce that was previously invisible to the tax base and the credit system. This matters for the macro case in two concrete ways. First, formalisation widens the tax net and improves the trajectory of the fiscal deficit without punitive rate increases. Second, the digital credit rails allow banks and non-bank lenders to underwrite tens of millions of first-time borrowers and small enterprises using verifiable digital footprints, extending the credit cycle into the long tail of the economy.

There is a second, quieter export story that sits underneath the demographic argument and is frequently missed because it does not travel in containers. India's services exports, led by software, business process management, and the fast-growing footprint of global capability centres run by multinationals, now rival merchandise exports in scale and are structurally more resilient to tariffs, which are levied on goods rather than on cross-border services. Global capability centres alone employ well over a million high-skill workers and are expanding their mandates from back-office processing into research, product engineering, and financial analytics. This flow of high-value services income cushions the current account, supports urban wage growth, and feeds directly back into the domestic consumption engine. In a year when the goods-trade channel is throttled to 0.5% growth, the services channel is the part of India's external account that keeps compounding.

> **Our view:** Digital public infrastructure is the underappreciated compounding force in the India thesis. It simultaneously lifts productivity, broadens the formal tax base, and deepens credit penetration. We see it as a structural tailwind to both nominal GDP and to the earnings of the financial sector we favour.

3. The Capex Cycle: Public Priming, Private Ignition

For most of the past decade India's investment cycle was carried by the public balance sheet. Central government capital expenditure roughly tripled over five years, funding highways, dedicated freight corridors, ports, and renewable capacity. The signal we have watched for is the handoff to the private sector, and in 2026 the evidence is finally convincing. Capacity utilisation in manufacturing is holding above 75%, the level at which fresh private investment historically becomes economic. Corporate balance sheets are the least levered they have been in fifteen years, and the banking system has the capital to fund the next leg.

Three vectors are drawing private capital. The production-linked incentive schemes are pulling electronics, pharmaceuticals, and component manufacturing onshore, partly as a China-plus-one hedge by global supply chains. The energy transition, with an installed renewable target that requires sustained annual investment, is a multi-year capex sink. And the property upcycle, after a long post-2013 hangover, is now supporting a broad construction and building-materials recovery. J.P. Morgan and Societe Generale both flag India's investment-to-GDP ratio as being in the early innings of a multi-year climb toward the mid-30s percent range.

Metric	2025 (est.)	2026 (proj.)	Structural read
Real GDP growth	6.3%	6.5%	Fastest major economy; domestic-led
CPI inflation (avg)	4.6%	4.3%	Inside RBI 4% target band
RBI policy repo rate	6.00%	5.50% to 5.75%	Easing bias as fiscal loosens
Central fiscal deficit / GDP	4.8%	4.4%	Consolidation with capex protected
Manufacturing capacity use	75%	76% to 78%	Above private-capex trigger
Investment / GDP	~31%	~32%	Early innings of multi-year climb
10Y sovereign yield	6.6%	6.3% to 6.5%	Anchored by upgrade and easing

Sources: IMF World Economic Outlook, World Bank India Development Update, RBI, and Darmine Capital estimates. Fiscal years India basis. Figures rounded and indicative.

> **Our view:** The public-to-private capex handoff is the swing factor that converts India from a good growth story into a great one. Deleveraged corporates, healthy banks, and above-trigger capacity utilisation are aligned for the first time in a decade. This is the multi-year engine we are underwriting.

4. Insulated From the Trade War: Tariffs, Deflation, and Divergence

India was not spared the 2025 tariff shock. A 36% effective US tariff, layered on during the Liberation Day escalation, is a genuine headwind for specific export lines, notably textiles, gems and jewellery, and some engineering goods. But the macro damage is contained precisely because goods exports to the United States are a small fraction of Indian GDP. Where a 47.5% effective US tariff is an existential threat to China's 1.2 trillion US dollar surplus and its factory base, a 36% tariff on India dents a handful of sectors while leaving the domestic engine untouched. The relative, not absolute, tariff position is what matters for capital allocation, and on that measure India screens as a defensive growth asset within Asia.

The contrast with China is the crux of our regional stance. China faces persistent deflation, an export impulse that is fading under tariffs, and a property overhang that continues to suppress household confidence, forcing the PBoC into a moderately loose stance. India faces the opposite problem set: inflation is comfortably inside the RBI's target band, credit demand is healthy, and the policy debate is about how much to ease, not how to escape a liquidity trap. We are Underweight China domestic demand and Overweight India domestic demand, and the two positions are the mirror image of one another.

4.1 The India-EU trade agreement

The conclusion of the India-EU free trade agreement is a strategic offset to US tariff friction. It broadens preferential access for Indian goods and services into the European market, supports the China-plus-one supply-chain reallocation, and diversifies India's export destinations away from a single, now-hostile, trade partner. We do not model the FTA as a near-term growth accelerant, its gains accrue over years, but it materially improves the medium-term export optionality and reduces the tail risk of the US tariff regime.

> **Our view:** India's tariff exposure is real but survivable, and its relative position within Asia is a source of strength, not weakness. The India-EU deal reinforces the diversification case. We treat India as the defensive growth allocation within a region where most economies are trade-fragile.

5. The Sovereign Upgrade and the Entry Point

S&P's upgrade of India's sovereign rating to BBB from BBB-, the first notch of movement in nearly two decades, is a validation of the fiscal consolidation and growth durability we have described. The upgrade is not merely symbolic. A higher rating lowers the sovereign's cost of capital, compresses spreads for Indian corporates borrowing offshore, and, importantly, raises India's weight and eligibility in global bond indices, drawing structural passive inflows into the local debt market. Combined with India's inclusion in major emerging-market bond indices, the upgrade deepens the domestic capital market and reduces reliance on volatile portfolio equity flows.

5.1 Why 2025 underperformance created the opening

Indian equities underperformed the broader Asia ex-Japan complex in 2025, and we read that underperformance as the source of the current opportunity rather than a warning. Three forces converged. The RBI and the government ran a deliberately tight fiscal and monetary stance through much of the year to defend the currency and squeeze inflation, which slowed nominal growth and compressed near-term earnings momentum. The 36% tariff shock hit sentiment in export-facing sectors. And rich starting valuations, India habitually trades at a premium to the region, left little cushion for disappointment. The result was a de-rating that has taken forward multiples back toward their longer-run averages even as the structural growth outlook is, if anything, improving.

That combination, a strengthening structural story meeting a cyclical policy-induced de-rating, is the classic setup for a favourable multi-year entry. With inflation now inside the target band, the RBI has room to ease toward 5.50% to 5.75%, and the fiscal stance is turning more supportive while protecting capital expenditure. The policy headwind of 2025 is becoming the policy tailwind of 2026.

> **Our view:** We interpret 2025's equity underperformance as manufactured, not fundamental. Tight policy and a tariff scare de-rated a structurally improving market back to reasonable multiples. With the policy mix now turning supportive and the sovereign upgraded, we see an attractive multi-year entry point.

6. Sector Strategy: Overweight Financials and Domestic Demand

Our preferred expression of the India thesis is financials. The sector is the highest-beta play on everything we have argued: it captures the credit cycle, the capex handoff, the formalisation dividend from digital infrastructure, and the demographic rise in household credit penetration, which remains low by emerging-market standards. Bank asset quality is the strongest in a decade, with gross non-performing assets down sharply from their mid-2010s peak, provisioning coverage healthy, and system capital adequacy well above regulatory minimums. Net interest margins may compress modestly as the RBI eases, but volume growth and falling credit costs more than offset this over the cycle.

6.1 Where we lean in

- Private-sector banks and larger non-bank lenders, geared to the credit cycle and best positioned to use digital underwriting rails.
- Domestic consumption: staples, discretionary retail, autos, and building materials that ride rising incomes and the property upcycle.
- Capital-goods and industrials leveraged to the private-capex ignition and public infrastructure pipeline.
- Insurance and capital-market intermediaries, structural beneficiaries of financialisation of household savings as flows rotate from gold and property into equities and mutual funds.

6.2 Where we are cautious

- Export-facing sectors most exposed to the 36% US tariff, notably textiles and gems and jewellery, until trade terms clarify.
- The most expensive pockets of the mid and small-cap complex, where retail-driven flows have kept valuations stretched relative to earnings delivery.
- IT services, which face soft global discretionary tech spending in a 0.5% trade-growth world and are a global rather than domestic play.

> **Our view:** Financials are our top-conviction sector across all of Asia-Pacific, and India is where we express it most aggressively. Healthy balance sheets, low credit penetration, an easing tailwind, and the formalisation dividend make Indian banks the purest way to own the domestic engine. We pair them with domestic consumption and industrials.

7. Risks to the Thesis

No structural call is without vulnerabilities, and intellectual honesty requires naming them. First, valuation: India rarely trades cheap, and even after the 2025 de-rating the market is not statistically inexpensive versus the region, so returns will need to be earned through earnings delivery rather than further re-rating. Second, execution risk on the capex handoff: if private investment stalls and the burden falls back on an already-stretched public balance sheet, the growth premium narrows. Third, tariff escalation: a widening of the 36% US tariff to additional sectors, or a breakdown in trade negotiations, would deepen the export drag and dent sentiment.

Fourth, the external account and the rupee: India runs a structural current-account deficit, funded historically by portfolio flows that can reverse quickly during global risk-off episodes, though the sovereign upgrade and bond-index inclusion are steadily improving the quality of that funding. Fifth, oil: as a large net crude importer, India is exposed to any supply-driven spike in energy prices, which would pressure both inflation and the external balance simultaneously. We judge each of these as manageable rather than thesis-breaking, but they define the variables we monitor most closely.

Two further risks deserve mention even though we rank them lower. The first is political and reform continuity: much of the structural case rests on the state protecting capital expenditure through the fiscal-consolidation path and on the steady, unglamorous work of implementing land, labour, and logistics reforms at the state level, where execution is uneven. A durable slippage in reform momentum would slow the manufacturing formalisation we are underwriting. The second is global financial conditions: because India habitually trades at a valuation premium, it is sensitive to a sharp repricing of the US term premium or a stronger-for-longer dollar, either of which can drain portfolio flows from premium-priced emerging markets regardless of local fundamentals. We would treat such an episode as an opportunity to add rather than a reason to exit, but it can extend the period over which the thesis has to prove itself and is the most likely source of interim drawdown.

> **Our view:** The primary risk is that we are early to price growth that must still be delivered, not that the structural story is wrong. Valuation and capex execution are the two variables that would make us trim, oil and a tariff widening are the two exogenous shocks we hedge against.

Portfolio Positioning Summary

Overweight: India, our highest structural-conviction market in Asia-Pacific. Within India, Overweight financials (private banks, larger NBFCs, insurance and capital-market intermediaries), domestic consumption (staples, discretionary, autos, building materials), and capital goods and industrials geared to the capex ignition. India is a domestic-demand diversification asset in a 0.5% global trade-growth world.

Market weight: Indian IT services, a global rather than domestic play facing soft discretionary tech spending. Export-linked engineering goods that are only partially tariff-exposed. Balance direct equity with the local bond market, where the S&P upgrade to BBB and index inclusion support a structural inflow story.

Underweight: Textiles and gems and jewellery and other sectors most directly hit by the 36% effective US tariff until trade terms clarify. The most stretched mid and small-cap pockets where retail flows have decoupled valuations from earnings. Broadly, this sits alongside our Underweight China domestic demand as the mirror-image regional pair.

Key catalysts to reassess: Reassess on: RBI easing path and whether the repo rate reaches 5.50% to 5.75%; evidence of the private-capex handoff in order books and capacity utilisation; the FY2026 union budget's fiscal-consolidation and capex mix; progress on implementing the India-EU FTA; any widening or de-escalation of the 36% US tariff; the trajectory of portfolio and bond-index inflows post-upgrade; and Brent crude, given India's crude-import sensitivity.

Conclusion

India is the clearest embodiment of the single most important idea in our 2026 Asia-Pacific framework: in a world where merchandise trade growth has collapsed to roughly 0.5% and the trade war is reshaping every export-led economy in the region, the economies that generate demand at home will compound while the economies that sell to the world stagnate. India grows near 6.5% not because the world is buying, but because 1.4 billion people, a median age of 28, a deleveraged corporate sector, a healthy banking system, and a maturing capex cycle are building an economy for themselves.

The 2025 underperformance, engineered by tight policy and a tariff scare, has handed patient capital a favourable entry into a structurally improving market, now validated by an S&P upgrade to BBB and broadened by an India-EU trade deal. We hold India at Overweight, our highest structural conviction in Asia-Pacific, and express it most forcefully through financials and domestic demand. The risks are of being early and of paying up for delivery, not of the engine failing. We are comfortable owning that trade-off.

Sources and Further Reading

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