

India

Money, Military & Markets-XII

Pahalgam: Currently, India is controlling escalation ladder

- India is currently managing the escalation dynamics after the targeted killing of Hindu tourists in Pahalgam.
- Unlike the post-Balakot scenario, the IAF now possesses superior BVR missile capability with Meteor and Astra, outmatching Pakistan's AMRAAM missiles.
- Pakistan is ill-equipped for a sustained conflict. Any Indian strike could lead to symbolic Pakistani retaliation, but the likelihood of a full-scale war is low.

India is controlling the escalation ladder

The recent targeted killing of Hindu tourists in Pahalgam, India—after proper identification—has significantly heightened tensions between the two arch rivals, India and Pakistan. In response, India has suspended the Indus Waters Treaty, a historic agreement that had withstood three wars and decades of hostility. From Pakistan's perspective, this move marks a serious escalation. **What lies ahead?** A likely scenario is an Indian strike on the terror infrastructure of Jaish-e-Mohammed and Lashkar-e-Taiba within Pakistan (more specifically Pakistan-occupied Kashmir or PoK and Muridke). India's armed forces may operate under the principle that "there is no shame if shamed in private," which means any response must be verifiable and clearly visible to maintain credibility. Such a move could provoke a reaction from Pakistan, potentially escalating tensions further. The sub-continent now stands on the brink of a limited conflict. The stock market may initially react with a sharp correction, but it's important to remember that Pakistan, in its current economic and political state, cannot afford a full-scale war. Moreover, nowhere else in the world do military generals run a country the way they do in Pakistan. After any Indian retaliatory strike, there will likely be symbolic retaliation—some bombing of Indian territory, perhaps—but nothing that spirals into a major conflict. If markets correct sharply after an Indian strike, it may present a strong buying opportunity.

Unlike a post-Balakot scenario, PAF doesn't have missile superiority

The Pakistan Air Force (PAF) dared to venture near the Line of Control or LoC and attacked India because they knew that the Indian Air Force (IAF) had no answer to 110km AAMRAM BVR missile. This same macho air force was chickening out during the Kargil war against M-29s and Mirages because their F-16s had no BVR capacity at that time. They watched their soldiers die in Indian bombing and due to the fear of loss didn't venture to save them. As of now, India's Rafales have Meteor and Sukhois have Astra BVR missiles. While Astra's range is equivalent to AAMRAM; however, Meteor has a range of 160km, which is 50km higher than that of AAMRAM. In a most likely scenario after the Indian air strike, PAF will use long-range ground attack missiles to attack Indian military infrastructure. However, If India releases conclusive evidence of destroying the terrorist hideouts and training centres, then Pakistan would not have any face to show to the world.

Pakistan doesn't have economic strength to fight a war

Pakistan faces several economic challenges that would constrain its ability to support a full-scale war: Its debt-to-GDP ratio is high, and it relies on International Monetary Fund or IMF programs and bilateral support (from China, Saudi Arabia, the UAE, etc.) just to keep its economy afloat. Its foreign exchange reserves have often hovered at dangerously low levels, sometimes covering just a few weeks of imports. Sustaining military logistics in war time — particularly with imported fuel, arms, or technology — would be near-impossible without reserves. War could destabilize the economy further, leading to public unrest. Unlike countries with strong industrial and technological bases, Pakistan's defence manufacturing is limited. It relies heavily on imports or Chinese support — both of which are hard to scale up quickly in war time without money. While historically, strategic importance helped Pakistan secure support from its allies (e.g., during the Cold War or the war on terror), there's rising donor fatigue, and conditionalities are stricter now. Even China, a key ally, is unlikely to bankroll a full-scale war that could destabilize the region, especially with its economic ties to the West and its own slowing economy.

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The Pahalgam terror attack - ISIS style execution of Hindu tourists

On 22 Apr 2025, terrorists attacked tourists in Pahalgam, a popular tourist location in the Anantnag district of Jammu and Kashmir, killing at least 26 and wounding a dozen others. The Resistance Front, a little-known militant group, claimed responsibility for the attack on social media. Like ISIS executions in Syria and Iraq, many of the tourists were killed at point-blank range after identification. The effort appears to perpetrate instability in India by inciting violence against Indian Muslims. Pakistan's army would also be hoping that by diverting home audience attention from Balochistan and KPK, they can regain some of their lost ground in the eyes of the Pakistani populace.

ISIS-like execution of tourists in Pahalgam ➤

On 22 Apr 2025, a brutal terrorist attack occurred in the Baisaran valley near Pahalgam, Jammu and Kashmir, resulting in the deaths of at least 26 tourists and injuries to over 20 others. The assailants affiliated with a group called 'Kashmir Resistance', executed the attack in a manner reminiscent of ISIS tactics. Survivors recounted that the militants demanded victims to recite Islamic verses, sparing those who complied and executing those who did not. Additionally, the attackers checked for circumcision to identify Muslims, whom they spared, while targeting non-Muslims for execution.

The attackers were dressed in military-style uniforms and emerged from nearby forests to open fire on the tourists. Witnesses reported that some victims were shot at close range, and at least one survivor was deliberately spared to relay the horrors of the attack to Indian Prime Minister Narendra Modi.

The group 'Kashmir Resistance', which claimed responsibility for the attack, is believed to be a front for Pakistan-based terrorist organizations such as Lashkar-e-Taiba and Hizbul Mujahideen. Their stated motive was opposition to the settlement of "outsiders" in Kashmir, which they perceive as an attempt to alter the region's demographic composition.

It appears to be a diversionary tactic by the Pakistan army to deflect the attention of common people, who are reeling under severe economic hardship ➤

The Pakistan army and its affiliated intelligence networks have often been accused of using Kashmir-centric escalations or proxy operations as tools to:

1. **Divert domestic attention:** When Pakistan faces internal crises—whether economic, political, or social—externalizing blame or creating tension with India has served as a unifying rallying point. The recent economic strain, with record inflation, IMF-imposed austerity, and growing public discontent, fits that backdrop.
2. **Reassert control:** The military in Pakistan has historically wielded significant power, and during periods when civilian governments or dissenting voices gain momentum, orchestrated conflicts or security threats are used to reassert military dominance over national discourse.
3. **Project relevance:** Attacks like the one in Pahalgam allow the Pakistan military to justify its budgetary demands and continued control over foreign and defence policy, especially at a time when economic mismanagement is under intense scrutiny.

This attack—gruesome, symbolic, and targeted at tourists—also serves a strategic communication purpose: undermining India's narrative of normalcy and tourism revival in Kashmir, while also possibly provoking a domestic or international reaction that shifts media cycles.

India's response and options

India has taken a slew of diplomatic measures and, notably, has placed the Indus Waters Treaty in abeyance. While this is a non-kinetic move, it signifies a serious escalation. The Indus Waters Treaty had withstood the test of time, surviving three India-Pakistan wars—making this step by India particularly significant.

That said, true to form, the Pakistan army is unlikely to respond to this directly. The concept of nation building and long-term national interest is largely alien to the Pakistani military establishment. Most of its top generals retire into comfortable lives in Saudi Arabia or Western countries.

However, if India conducts strikes on terror camps in Pakistan-occupied Jammu & Kashmir, a response from Pakistan becomes almost inevitable. The concern is that Pakistan, given its precarious financial condition, cannot sustain even a week of conventional warfare. As a result, its nuclear threshold may now be lower than before.

Indian strategic planners must consider this carefully. It is crucial that India maintains escalation dominance—acting first and decisively to control the escalation ladder, while minimizing the risk of unintended consequences

India has put Indus Waters Treaty in abeyance ➤

India has suspended its Indus Waters Treaty (IWT) with Pakistan after a deadly terrorist attack in Jammu and Kashmir's Pahalgam region on 22 Apr 2025.

What is Indus Waters Treaty? ➤

The **Indus Waters Treaty (IWT)** is a landmark **water-sharing agreement** signed between **India and Pakistan** in **1960**, brokered by the **World Bank**. It governs the use of the waters from the **Indus river system**, which originates in the Himalayas and flows through both countries before emptying into the Arabian Sea.

Key provisions of the treaty

The treaty divides the six major rivers of the Indus River system into two categories:

1. Eastern rivers – *allocated to India*

- Ravi
- Beas

- Sutlej

India has exclusive rights to use the waters of these rivers for irrigation, power generation, and domestic use.

2. Western rivers – allocated to Pakistan

- Indus
- Jhelum
- Chenab

Pakistan gets unrestricted use of these rivers, although India is allowed limited use, such as for:

- **Non-consumptive use** (like generating hydroelectricity).
- **Irrigation under strict conditions.**
- **Run-of-the-river projects**, provided they don't obstruct flow.

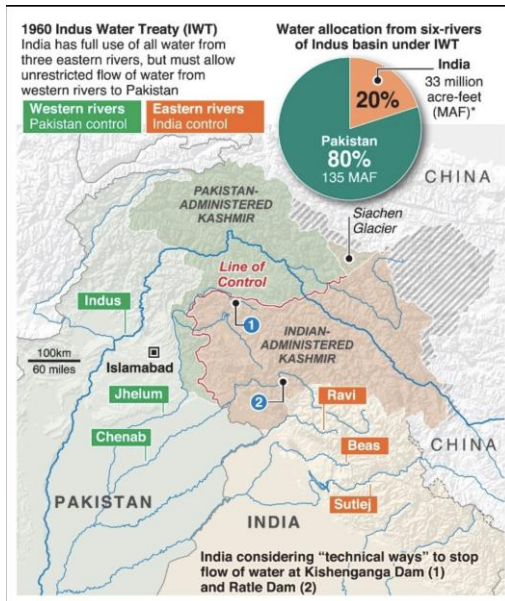
Implementation mechanism

- **Permanent Indus Commission:** A joint body with commissioners from both countries, which meets regularly to:
 - Exchange data.
 - Resolve disputes.
 - Inspect projects.
- **Dispute resolution mechanism:** Involves neutral experts, World Bank mediation, or arbitration if disagreements arise.

Why water from Indus river is important for Pakistan? ➤

- **Lifeline of agriculture** - agricultural dependence: Over 90% of Pakistan's agriculture relies on irrigation, and about 80% of that irrigation comes from the Indus river system. Pakistan is an arid to semi-arid country with very little rainfall, so river-fed irrigation is essential for crops like wheat, rice, and cotton — the backbone of its economy.
- **Major river system** - The Indus river and its tributaries (Jhelum, Chenab, Ravi, Beas, and Sutlej) form one of the largest irrigation systems in the world, called the Indus Basin Irrigation System (IBIS). This system supports two-thirds of Pakistan's population, either directly or indirectly.
- **Urban & industrial use** - Cities like Karachi, Lahore, Multan, and Islamabad rely on water from the Indus River for drinking, sanitation, and industrial processes. Industries like textiles and food processing need consistent water supply — most of which comes from the river.
- **Energy security** – The Indus river is central to hydropower generation in Pakistan. Major dams like Tarbela and Mangla on the Indus and Jhelum rivers supply a significant chunk of Pakistan's electricity. Without Indus river water, Pakistan would face energy shortages, especially given its dependence on hydroelectric power.
- **Environmental stability** – The Indus river supports wetlands, forests, and ecosystems along its course. It helps prevent desertification in vast areas of southern Punjab and Sindh.
- **Strategic and political significance** - The Indus Waters Treaty (1960) between India and Pakistan is a key element in regional water diplomacy. Pakistan gets rights over the three western rivers (Indus, Jhelum, Chenab). The river is not just a source of water, but also a symbol of national security and sovereignty for Pakistan.

Figure 1: The flow of Indus river



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 2: Ravi, Beas and Sutlej river water remained with India



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Can India stop the flow of water to Pakistan? It cannot be done immediately (only 5–10% on the western side is feasible), but even the threat of doing so could bring all development work in Pakistan to a standstill ➤

India's decision to hold the treaty in abeyance doesn't mean an immediate halt to water flowing to Pakistan. This is so because India presently doesn't have the infrastructure to stop the flow of water from the Indus river into Pakistan or divert it for its own use. At the most, India can cut water flow by 5-10%.

The treaty restricts India from building reservoir dams on Indus, Jhelum, and Chenab rivers. India could, however, develop hydroelectric 'run-of-the-river' projects. This means that these projects cannot alter the flow of water or obstruct it.

Suspending the treaty means India may not adhere to these restrictions and begin constructing reservoir dams to plug water flow.

However, building large reservoirs on these rivers will take years, if not a decade. It would require extensive surveys and funding for such a thing to fructify considering the ecological impact. Thus, at this point, India's move is more of a pressure tactic on Pakistan to rein in terror groups and stop infiltration.

These are the dams which have been built on the western rivers, namely Jhelum, Chenab, and Indus:

1. River Kishanganga HEP (a tributary of Jhelum) water ready for diversion via a 23-km tunnel in 2018 itself.
2. Ratle HEP (on Chenab river) already revived in 2021. Tulbul Navigation Project (on Jhelum river) already revived in 2016 & is ready to regulate flow.
3. Work on Shahpurkandi dam (on Ravi river) is in progress since 2018 to block surplus water from flowing into Pakistan.
4. Ujh Multipurpose Project (a tributary of Ravi river) in progress since 2020 to stop water flow into Pakistan.

The Kishanganga project alone can store 6.1bcm of water, which is about 4% of the total flow to Pakistan. However, India can strategically time this storage during periods when Pakistan needs the water the most.

Once the flow is regulated by India—contrary to the provisions of the treaty, even if it's in abeyance—the funding of developmental projects, irrigation, and other critical activities in Pakistan would be at risk ➤

Even a perception that India might regulate or weaponize water from the Indus river system — contrary to the treaty — has serious downstream implications for Pakistan's:

Developmental funding & economic planning

- International donors (World Bank, Asian Development Bank or ADB, etc.) need water security as a baseline assumption before funding large-scale irrigation, hydropower, or agricultural projects.
- If India disrupts flow, even temporarily or as a political signal, Pakistan's credibility and feasibility for such projects could be questioned.
- Investors might view this as a sovereign risk, reducing funding or increasing borrowing costs.

Agricultural sector's stability

- The Indus Basin Irrigation System is the world's largest contiguous irrigation system. It irrigates 80%+ of Pakistan's cultivated land.
- Any reduction or unpredictability in water flow, especially during key sowing or harvesting periods (rabi/kharif), could:
 - Slash crop yields.
 - Disrupt food security.
 - Spike rural unemployment and discontent.

Power generation (hydropower projects)

- Major dams like Tarbela and Mangla are on western rivers (Jhelum, Indus), whose flow depends on treaty-bound Indian cooperation.
- Interference or even delay in upstream flow could:
 - Reduce electricity output.
 - Trigger blackouts.
 - Stress an already fragile energy grid.

Macroeconomic impact

- Agriculture contributes ~20% to Pakistan's GDP and employs about 40% of its workforce.
- Disruption in irrigation affects:
 - Rural consumption → Slows down the broader economy.
 - Export earnings (e.g., textiles from cotton) → Worsens trade deficit.
 - Inflation and food prices → Political fallout.

Diplomatic & legal repercussions

- Pakistan could argue before international courts or World Bank arbitration that India's actions breach international obligations.
- But proving intentional treaty violation requires technical evidence, which can be complex and time-consuming.
- Meanwhile, economic and project uncertainty persists.

Psychological and strategic deterrence

- Even if India doesn't breach the treaty, talk of regulating water can be used as a diplomatic tool to apply pressure.
- This causes planning paralysis in Pakistan's water strategy, delaying:
 - Dams.
 - Canals.
 - Water management reforms.

Given the widespread repercussions, Pakistan army has to act one way or the other ➤

In Pakistan, the **army isn't just a defence institution** — it's a **central player in strategic planning**, especially where existential risks are concerned. If India were to **disrupt the flow** of Indus river water, even subtly, the Pakistan army would likely feel compelled to act.

1. For Pakistan, the Indus river system is a non-negotiable national lifeline. Any perceived interference by India — even short of treaty violation — could be seen as economic warfare, triggering military recalibration. This includes forward troop movement, diplomatic escalation, or even coercive signalling (e.g., missile tests, troop exercises).
2. First response: Diplomatic protest + engagement of World Bank (treaty arbitrator). Next steps (if unresolved): Tactical military deployments in Kashmir. Heightened patrols along Line of Control (LoC). Strategic coordination with China or OIC nations to put pressure on India. In extreme cases, water could become a *casus belli* (justification for conflict), especially if timed with broader political tensions.
3. Psychological warfare and domestic legitimacy: The army has long projected itself as the guardian of Pakistan's sovereignty. A perceived failure to respond to Indian water pressure could undermine its standing with the public and invite criticism from rival political parties. So, even symbolic show of strength becomes necessary for internal legitimacy.

However, remember all these were possible if Pakistan has the resources to fight a war and, as of now, it doesn't. **A big LoC skirmish and then coming to the diplomatic table is the most likely solution.**

Can Pakistan hand over Hafiz Saeed and the top LeT leadership to India in exchange for the Indus Waters Treaty? It's unlikely ➤

1. Handing over Hafiz Saeed or other top LeT figures to India would be seen by many in Pakistan as capitulating to Indian pressure. Given the deep-rooted support for Hafiz Saeed from certain Islamist groups and segments of the political establishment, this move could provoke serious domestic unrest.
2. Groups like Lashkar-e-Taiba or LeT have long been seen as "strategic assets" by Pakistan's military and intelligence services, especially for operations in Kashmir. Surrendering them would cut deep into Pakistan's long-term strategic doctrine vis-à-vis India.
3. Giving up Hafiz Saeed would signal a major strategic and ideological shift—essentially admitting that Pakistan harboured terrorists acting against India. This sets a precedent that Pakistan's establishment has consistently tried to avoid.
4. Such a deal would be hard to frame positively for Pakistan on the international stage. It risks appearing as if Pakistan is trading terrorists for water, which would undermine its long-standing narrative of "moral support for Kashmir" and further expose its links to terror groups.

What if, in addition to suspending the Indus Waters Treaty, India also launches strikes on terror camps in PoK? Pakistan army would then be compelled to retaliate against India

As India has already suspended the Indus Waters Treaty and added to it if it launches strikes on terror camps in Pakistan-occupied Kashmir (PoK), the situation would escalate very quickly, and the Pakistan army would likely feel compelled to retaliate for several key reasons:

1. The retaliation doctrine would be triggered: The Pakistan army has established strategies to respond to any Indian military action on its soil, and PoK holds significant strategic and symbolic importance.
2. The army leadership would be under immense pressure to show strength, and failure to respond could lead to political fallout within Pakistan and criticism from its military establishment.

After the induction of Rafales and S-400s, India has gained aerial superiority over Pakistan ➤

Thirty-six Rafales equipped with Meteor, Hammer, and Scalp missiles are more than sufficient to neutralize the PAF's crown jewel, the F-16. Our experience during the Kargil War shows that F-16s were so intimidated by MiG-29s that they didn't venture near the LoC. At that time, India had BVR missiles with a range of 30km, whereas the F-16s had no BVR capability. The PAF could potentially lose 100 F-16s if they are hidden, but if they are exposed publicly, their 'macho' image in the eyes of the Pakistani people would significantly diminish. Additionally, Su-30s are armed with Astra-1 missiles, which have a range equivalent to the AAMRAM on the F-16. Therefore, all the aerial superiority Pakistan had during the Balakot skirmish is now gone.

India needs to control the escalation ladder and hence, it needs to strike on terror camps asap ➤

India needs to control the escalation ladder and that's why it needs to up the ante. As of now, Pakistan has not reacted in any kinetic way because of the Indus Waters Treaty being held in abeyance. India needs to find military/terrorist targets and eliminate them before they change places. The easiest target for Indian Air Force will be attacking the terrorist camp in PoK. Remember, LoC is the cease fire line and not the international border.

Uptill now, the reaction of Pakistan has been timid ➤

Pakistan's military and political response to Indian actions in recent years has often been more cautious and restrained, particularly when it comes to the Indus Waters Treaty and military operations in Kashmir. Let's dive into why this timidity exists and what factors shape Pakistan's reaction:

Avoidance of full-scale war: While Pakistan's military doctrine emphasizes defence and retaliation, the country's leadership is aware that a full-scale war with India could lead to catastrophic consequences. Thus, Pakistan often opts for limited, calibrated responses to avoid crossing thresholds that would provoke total war.

International pressure: The international community, particularly the US, China, and Russia, often exerts significant diplomatic pressure on Pakistan to avoid escalating tensions with India, particularly given the potential for regional destabilization. In recent years, China-Pakistan ties have provided Pakistan with some strategic leverage, but even China doesn't want its ally involved in a full-blown war with India, particularly because of its own regional interests.

Internal political and military constraints-domestic stability and legitimacy: The Pakistan army, though highly influential, operates under the broader political framework of Pakistan. Civilian leadership has often been wary of overly aggressive military actions, fearing that domestic stability could be compromised. Moreover, internal issues, such as economic challenges (inflation, debt, poverty) and political fragmentation, often push Pakistan's leadership to avoid military escalation, especially when it involves the risk of a war with India.

Public sentiment and international opinion: While the Pakistani public generally supports a strong defence posture, there is also a recognition that a total war with India is not in the national interest. The economic and human costs would be severe, and Pakistan is already dealing with a fragile economy.

Economic constraints: Pakistan's economy is highly dependent on global trade and aid, particularly from IMF and World Bank. Escalating tensions with India could hurt Pakistan's economic prospects, leading to sanctions or diplomatic isolation, especially from the West. A military escalation would likely trigger sanctions or at least diplomatic backlash from global powers, exacerbating Pakistan's economic crisis.

However, an air strike against terror camps in PoK or in Muridke would likely provoke a response from Pakistan ►

An air strike targeting terror camps in Pakistan-occupied Kashmir (PoK) or Muridke (which is associated with the Lashkar-e-Taiba terror group) could indeed escalate tensions significantly. Such an action would likely provoke a strong military and diplomatic response from Pakistan, given the sensitive nature of these regions and their strategic importance to Pakistan.

Pakistan might consider various retaliatory actions, including military escalation along the Line of Control (LoC). Additionally, Pakistan could use the incident to rally domestic support and consolidate the narrative of defending its territorial integrity. The international community, including powers like the US, China, and Russia, could also become involved in urging restraint or potentially mediating tensions.

Remember though that uptill now, India is controlling the escalation ladder and that's reassuring ►

As of now, India is controlling the escalation ladder, and logically, India knows when to back off. Public humiliation of the Pakistani army or air force would be the last resort for India. Indian planners understand the Pakistani army is the only military in the world that has a whole nation behind it, and they thrive on their carefully cultivated macho image. This is reflected in Pakistani textbooks, where it is taught that Pakistan won the 1965 war. Additionally, it's important to remember that while General Amir Abdullah Khan Niazi was surrendering in Dhaka, *Dawn*, the leading newspaper of Pakistan, published a front-page article declaring how Pakistan would fight until the end of time in the 1971 war with India.

Figure 3: Pakistan always lives in a self-made delusional world; seen below is the first page of *Dawn* newspaper a day after General Niazi surrendered with 93,000 soldiers in the 1971 war



SOURCE: INCRED RESEARCH, COMPANY REPORTS

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Recommendation Framework

Stock Ratings

Definition:

- Add** The stock's total return is expected to exceed 10% over the next 12 months.
- Hold** The stock's total return is expected to be between 0% and positive 10% over the next 12 months.
- Reduce** The stock's total return is expected to fall below 0% or more over the next 12 months.

The total expected return of a stock is defined as the sum of the: (i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.

Sector Ratings

Definition:

- Overweight** An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
- Neutral** A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
- Underweight** An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings

Definition:

- Overweight** An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
- Neutral** A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
- Underweight** An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.