FI Monthly: Dovish MPC Keeps lid on Yield amid Global volatility; Fx Inflow leads to Liquidity Management on Close Watch

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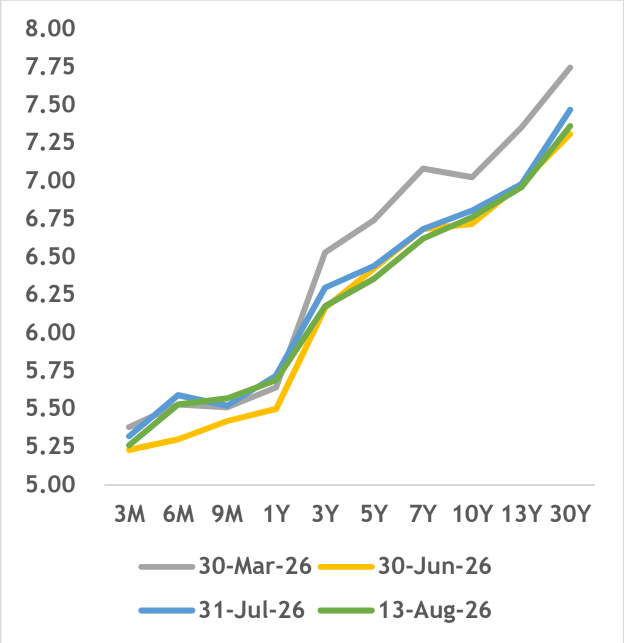
Fig.1: Yield Curve: steepening at longer duration



Source: Bloomberg, UBI Research

July was a challenging month for Global fixed income markets as the earlier optimism around disinflation and monetary easing was increasingly tested by renewed geopolitical and energy-price pressures. For India, the domestic rate market remained relatively resilient, but the combination of higher crude oil prices, a weaker rupee and elevated global bond yields limited the scope for a sustained rally in duration. The Indian 10-year benchmark yield started July around 6.76% and ended the month at 6.84%, representing a rise of roughly 8 bps. The move was not linear: yields initially declined towards 6.69% as de-escalation in west Asia War Crisis, improving monsoon conditions and foreign buying supported sentiment, before reversing higher as oil prices rose, the rupee came under pressure and global yields firmed. The global backdrop was equally important. The US 10-year Treasury yield ended July at approximately 4.75%, while the US 2-year yield was around 4.28%. The Federal Reserve kept the Fed Funds target range unchanged at 3.50%-3.75% at its July meeting, but the decision was accompanied by three dissenting votes in favour of a 25 bps hike, highlighting the persistence of inflation risks. The biggest global macro shock during the month came from energy. Brent crude rose around 21% during July, driven by renewed Middle East supply concerns, with Brent trading around $90/bbl towards month-end. For India, this translated into pressure on the external account and the currency. The rupee ended July at around ₹95.38/USD, declining approximately 0.7% during the month, despite strong intervention by the RBI and state-owned banks. Overall, July reinforced a key message for Indian fixed income: the domestic rate cycle remains constructive, but the path to lower yields is likely to be gradual and increasingly dependent on global rates, crude oil and currency stability.

Month of August has somewhat fared better comparatively, with improved market sentiments on continued diplomatic efforts towards a negotiated resolution, coupled with recovering OPEC production. Market closely watching development in negations across the board, hoping normalization of flows rather than a confirmed reopening through Strait of Hormuz. 10Y UST yield improved to 4.61% before helped by decline in Crude oil prices. However, the decline was short lived which saw upward making UST to trade in the range of 4.65% to 4.70%. Story was no different for 10Y Domestic Benchmark except not much of the upward movement seen helped by dovish MPC tone, while trading in the narrow range of 6.76% to 6.79%.

US Treasury Market: The Global Anchor:

- ✓ The US Treasury market continues to be the key global driver of duration and risk sentiment. The 10-year Treasury yield ended July at approximately 4.75%, while the 2-year yield ended around 4.28%.
- ✓ Treasury yields moved higher amid persistent inflation concerns, elevated geopolitical risks and uncertainty around the Fed's future policy path.
- ✓ FOMC in its July meeting maintained the Fed Funds target range at 3.50%-3.75% by a 9-3 vote. Three FOMC members — Beth Hammack, Neel Kashkari and Lorie Logan — dissented in favour of a 25 bps rate increase.
- ✓ The Fed acknowledged; economic activity remained solid, while inflation continued to run above its 2% objective, partly reflecting supply-side and energy-related pressures.
- ✓ July US CPI provided some comfort, with headline CPI at 3.4% YoY and core CPI at 2.5% YoY, both broadly in line with expectations. The inflation data reduce the immediate risk of a renewed upside surprise, but are not sufficient to establish a sustained disinflationary trend.
- ✓ The Fed is likely to remain highly data dependent, with employment, inflation and growth data determining the timing of any policy change.

Indian G-Sec Market: Early Rally, Late-Month Reversal:

- ✓ The Indian government bond market began July on a positive note, with the 10-year benchmark yield declining from 6.76% to around 6.69% during the first week. The initial rally was supported by improving monsoon conditions, foreign investor buying and expectations of manageable domestic inflation.
- ✓ The rally subsequently reversed as West Asia tensions intensified, crude prices increased, the rupee weakened and US Treasury yields moved higher. The 10-year benchmark ultimately ended July around 6.83%-6.84%.
- ✓ The yield curve experienced a meaningful shift over recent months, with March-June characterised by a broad decline in yields, particularly across the 3-year to 30-year segment.
- ✓ The subsequent move into August represents a partial reversal, reflecting higher global yields, crude-related risks, currency pressure and greater uncertainty around the future monetary-policy path.
- ✓ The market has therefore moved from pricing a more supportive domestic rate environment towards a more cautious and selective duration stance.
- ✓ Inflation, food prices drives the uptick; core remains comfortable:

Inflation - Food Prices Drive the Uptick, Core Remains Comfortable

- ✓ India's July CPI inflation increased moderately to 4.45% YoY from 4.38% in June in line with our expectation, marking the second consecutive month above the RBI's 4% medium-term target. Food inflation increased to 5.52% from 5.32%, indicating that the recent increase in headline inflation remains significantly concentrated in food prices.
- ✓ The persistence of the monsoon deficit and the possibility of uneven rainfall remain key upside risks to food inflation.
- ✓ Comfort to the MPC, since core inflation remained broadly stable at 3.90% for the third consecutive month,
- ✓ Contained core inflation suggests that underlying price pressures remain manageable, despite higher food and headline inflation.
- ✓ In US, July headline CPI rose 3.4% YoY, moderating from 3.5% in June, while core CPI remained at 2.5% YoY.
- ✓ Softer US employment data, combined with the July CPI and flat PPI, have reduced expectations of an immediate Fed rate hike.
- ✓ Markets are currently pricing 40% probability of a September Fed hike, according to CME FedWatch, although the probability remains sensitive to incoming inflation and employment data.

Crude Oil; The Most Important External Risk

- ✓ Crude oil remains the most important external risk, given its direct impact on inflation, the current account and the rupee. Brent crude crossed US$100/bbl during July before settling around US$88/bbl towards month-end. Sharp movement was primarily driven by geopolitical developments and concerns around disruption to crude flows through the Strait of Hormuz.
- ✓ The risk remains relevant in August, with the possibility that disruptions to Middle East production and transportation could persist.
- ✓ For India, a sustained Brent price above US$90-$95/bbl would be inflationary, particularly if accompanied by further rupee weakness. Conversely, a meaningful geopolitical de-escalation could lead to a rapid reduction in the oil risk premium, supporting both the INR and Indian G-Secs.

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Monsoon, a key risk remained to be mitigated:

- ✓ The southwest monsoon remains a critical variable for India's growth and inflation outlook.
- ✓ Rainfall improved materially during July and helped narrow the cumulative deficit. However, the improvement needs to be viewed cautiously, with the IMD indicating a below-normal rainfall outlook for August.
- ✓ The strengthening El Niño risk remains an important concern for the second half of the monsoon season.
- ✓ Monsoon critical for food inflation, agricultural output, rural consumption, water availability, power generation and overall economic activity.
- ✓ Around 70% of India's annual rainfall is received during the southwest monsoon, while nearly half of India's agricultural land remains dependent on rainfall.
- ✓ As of 10 August 2026, cumulative monsoon rainfall was 12% below normal, according to the IMD.
- ✓ Any further deterioration in rainfall could create upside risks to food inflation and reduce the scope for aggressive monetary easing.

RBI MPC; Dovish Policy pause reinforces data dependency:

- ✓ MPC maintained the repo rate at 5.25% and retained its neutral stance, broadly in line with our and market expectations.
- ✓ The MPC revised its FY27 CPI inflation forecast lower to 5.0% (same as UBI projections) from 5.1% projected in June, risks being evenly balanced. The higher inflation is mostly on account of food and fuel inflation with little sign of generalisation so far. The downward revision in core inflation forecast from 4.7% to 4.3% is reassuring of the benign underlying price pressures.
- ✓ With the RBI comfortable with the current policy setting, the near-term direction of bond yields is likely to be driven more by inflation data, global rates, liquidity and currency movements rather than expectations of an immediate policy-rate change.

RBI aims to provide sufficient liquidity:

- ✓ As per RBI Governor, Excess liquidity to be naturally absorbed through the seasonal increase in currency in circulation and the maturity of the RBI's forward positions. The central bank further indicated that the liquidity injected through FCNR(B) inflows would also be absorbed over the medium term.
- ✓ Our analysis shows that the current system liquidity has risen from near-neutral levels in the third week of June to ₹3.34 lakh crore as of 11th August 2026, already exceeding 1% of NDTL.
- ✓ While the RBI Governor did not show much concern on liquidity management of FCNR(B)/ECB flows, we firmly believe that proactive policy approach may be require as persistent liquidity surplus of more than 1.5% of NDTL could be inflationary as stated in report by RBI on Currency and Finance dtd 29.04.2022.
- ✓ **We believe RBI is likely to use market neutral tools like VRRR (long/short term), forward maturities and reverse FX swaps rather than using market sensitive tools like OMO sales, CRR hike etc.**
- ✓ As per our analysis, looking at strong response to Reserve Bank's Swap Facility, the system may get S80 Bn by end Aug'26 whereas flow may touch $100 Bn, end Dec'26, core liquidity may rise from Rs 6.78 lac Cr. as of 31st of July to double-digits by Q3-FY27. ***(as per RBI notification dtd 14.08.2026, Swap facility for FCNR(B) deposit will be available till 31st Aug, 2026 with swap available till 11th Sept, 2026 and ECB and OFCB will be continued till 31st Dec, 2026)***

Table 2: RBI's FX FWD maturity profile

Period	Fwd Maturity profile at the end of	
	Jun-26	May-26
Up to 1 month	-8.97	-19.82
1-3 Months	-5.73	-8.86
3 months- 1 year	-24.42	-21.9
More than 1 year	-64.21	-56.07
Total	-103.33	-106.65

Table 1 Expected core liquidity position on account of Fx inflows (In Rs. Lakhs Crore)

From	To	Core Liquidity (From Date)	FX Impact	CIC	CRR	Core Liquidity (From Date)
30.06.26	31.07.26	4.94	1.80##	0.18	-0.15	6.79
31.07.26	15.09.26	6.79	4.57#	0.48	-0.16	11.68*
31.07.26	31.12.26	6.79	6.47#	-1.00	-0.41	11.85*

Source: CEIC, RBI, UBI Research

* It does not include any impact of RBI's forward maturities (Table 2) and Fx spot Interventions; # assumes $ 85 Bn received till end-Sep, and $ 100 Bn by end-Dec under swap facilities

Inspite of receiving $40 Bn by 31st July, RBI forward position of $13 Bn helping in offset the Fx-impact in the month of July'26

Table 3: Fx inflow in Swap Facility by 13th Aug, 26

Type	Amt (USD Bn)
FCNR (B)	52.30
OFCBs	2.81
ECBs	1.74
Total	56.85

Conclusion: *July was a month where in-spite of external risk Indian Fixed Income market has fared better on account of domestic fundamental backdrop remains reasonably supportive, resilient growth, fiscal collections are healthy, core inflation is manageable and the Indian bond market is gradually becoming more accessible to global investors. However, crude oil, the rupee and US Treasury yields have emerged as the three key risk variables. The key trigger for a sustained Indian bond rally would be a combination of lower crude, a stable rupee, softer US yields and continued moderation in domestic inflation. Until that combination emerges, the preferred strategy is to focus on high-quality credit and selective duration, rather than aggressively extending duration at every decline in yields. For August, therefore, the broad stance is cautiously constructive on Indian fixed income, with a preference for quality and a staggered approach to duration.*

Fixed Income Outlook – August 2026:

- ➢ **Global rates:** With static inflation print and poor employment data, Fed rate hike is on hold for now, but timing is uncertain. The Federal Reserve's July decision demonstrates that the path is not very clear as of now, though the three dissenting votes for a rate hike highlight the degree of sensitivity to inflation risks. With Next FOMC on Sept 15-16, hold on rate may continue some extended period.
- ➢ **Liquidity**: A potential near-term headwind: The expected increase in system liquidity from FCNR(B)/ECB-related flows is an important development. While abundant liquidity is generally supportive for short-term rates and credit markets, an excessive and persistent surplus could eventually require sterilization. The RBI's choice of liquidity-management instruments will therefore be closely watched.
- ➢ **Rupee to remain weak but broadly range-bound**: Rupee to trade sideways rather than a sharp and sustained recovery in the near term. Continued rupee weakness would make the RBI more cautious on monetary easing and hence may impact yield on G-Secs.
- ➢ **GDP data on watch:** The upcoming GDP releases in India and the US are likely to be important near-term catalysts for global and domestic fixed income markets. For India, the focus will be on the Q1 FY27 GDP data due on August 31, while in the US, the second estimate of Q2 2026 GDP is scheduled for August 26.
- ➢ **Crude, direction important**: The direction and persistence of crude prices are likely to matter more than short-term fluctuations in the absolute price. A gradual decline towards US$80/bbl would be materially more constructive than crude remaining around US$90/bbl for an extended period.

Our take: In absence of any key trigger till GDP data, We expect range domestic benchmark to trade range bound with mild downward bias. We expect 10Y Benchmark to trade between 6.70% to 6.80%. We expect longer duration to hold steady for now with mild downward bias. We also propagate a Steepener Trade.

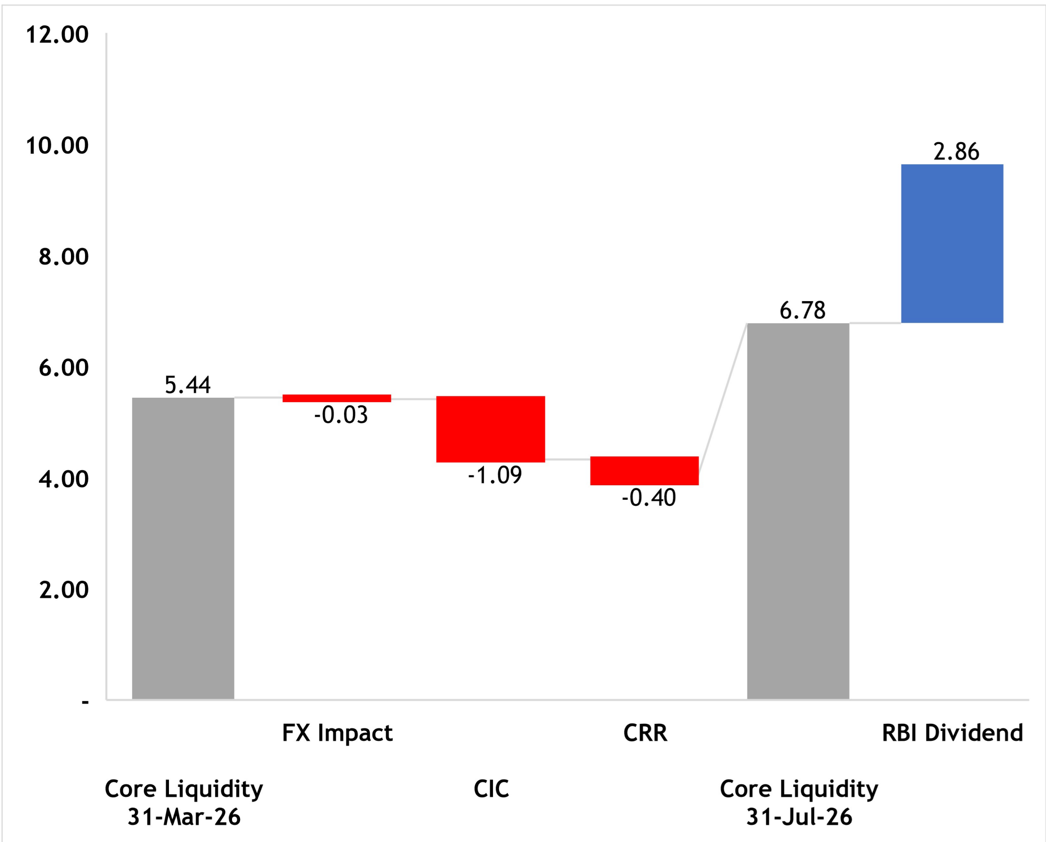
Key risks: Sustained higher crude oil prices, increasing trend in food inflation, stronger-than-expected growth, global Treasury yields and reduced foreign portfolio flows may trigger sell-off. On the positive side, easing inflation, softer global yields and clearer evidence of economic moderation could support a further decline in Indian bond yields.

Table 3: Market Snapshot	Yield (31st Jul)	Monthly Change
10 Year G-Sec (6.94% GS 2036)	6.84%	+09 bps
1 Year T-Bill	5.71%	+09 bps
US 10 year Yield	4.75%	+29 bps
Credit Growth (%) (as of 31st July'26)	19.3%	+70 bps*
Deposit Growth (%) (as of 31st july'26)	15.4%	-207 bps*
Credit Deposit Wedge (bps) (as of 31st July'26)	395	-137 bps*

*fortnight changes

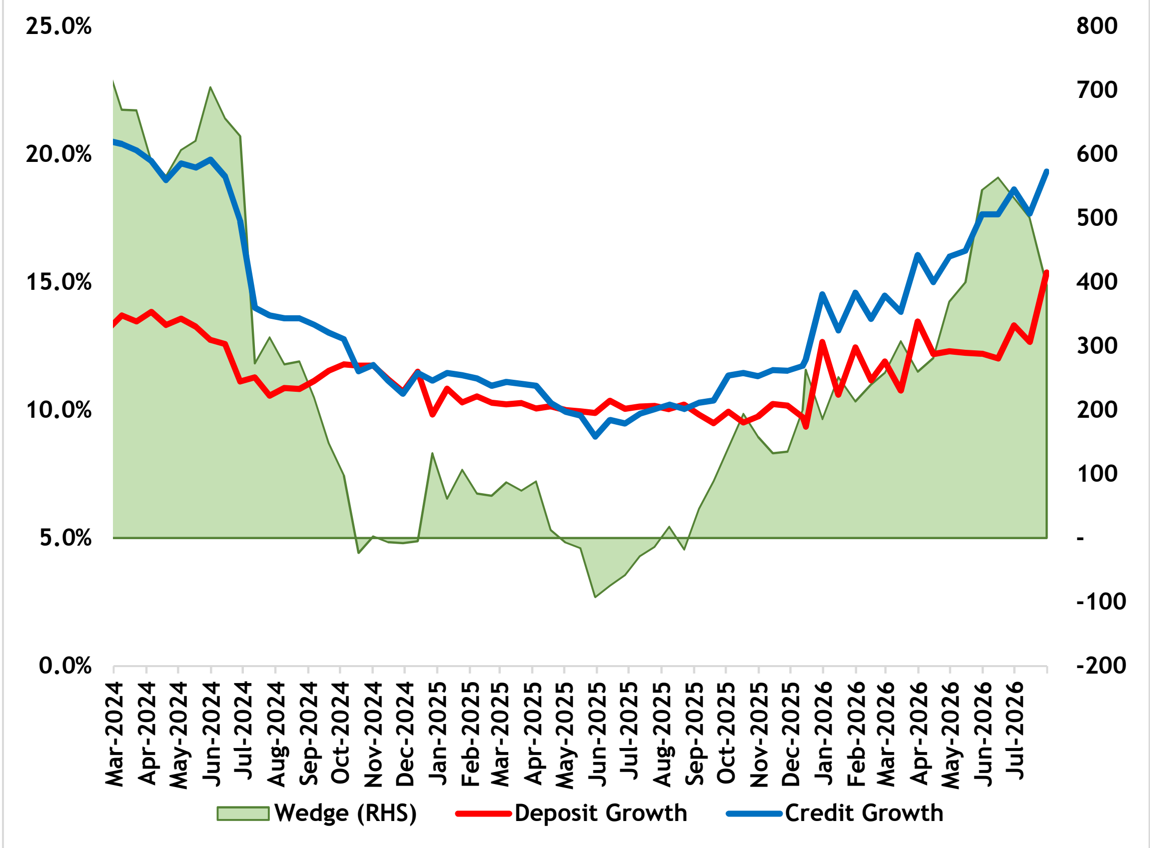
Source: RBI, CCIL, UBI Research

Fig.2: Core liquidity on rise



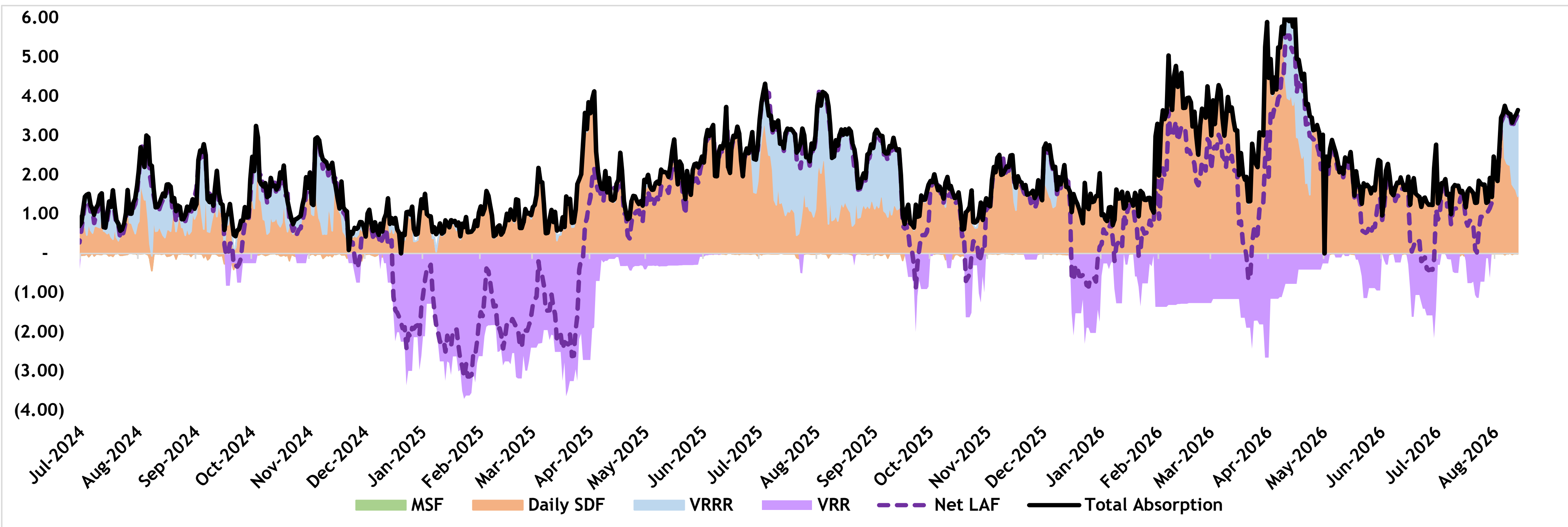
Source: Bloomberg, UBI Research

Fig.3: Gap narrowing, but Credit still ahead of Deposits



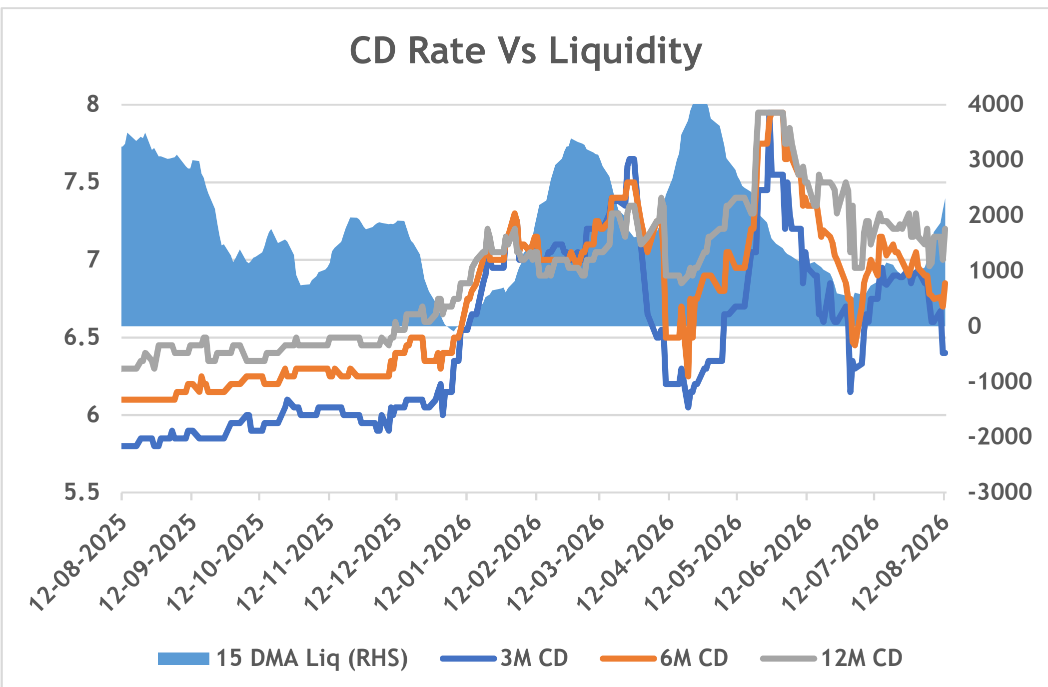
Source: RBI, CEIC, UBI Research

Fig.4: In Liquidity Components again placement of SDFs taking the centre spot; Rs in Lakh Crore



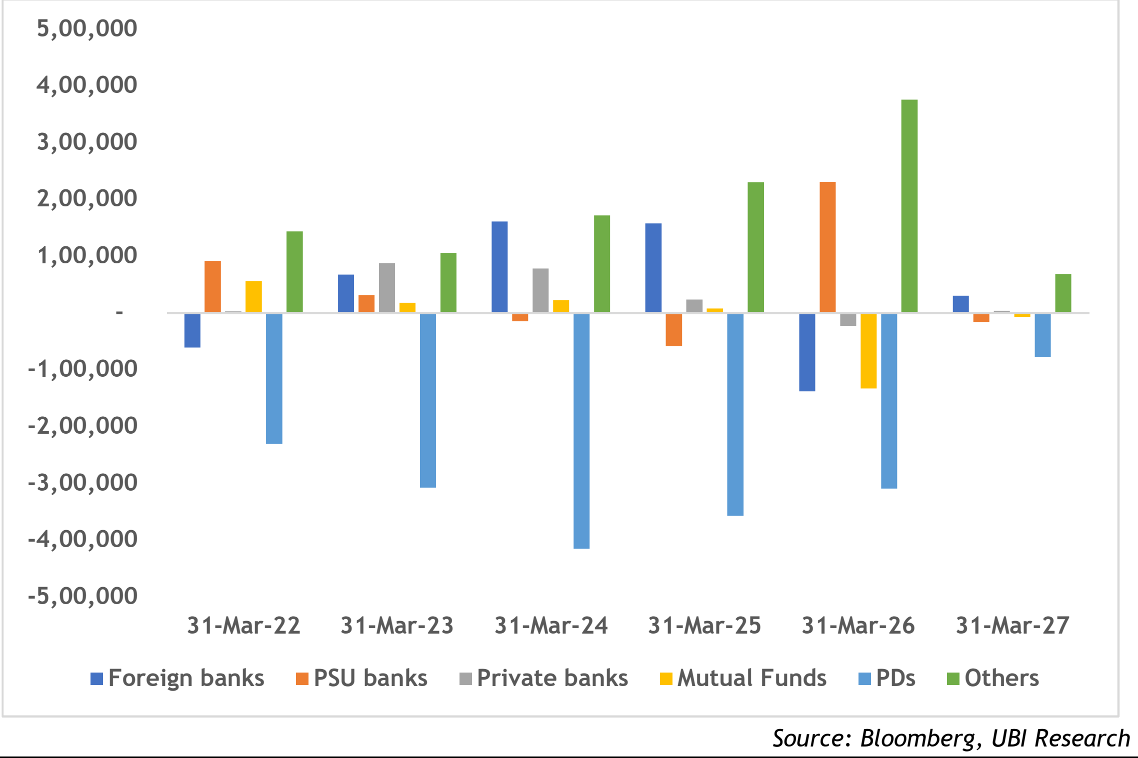
Source: RBI, CEIC, UBI Research, For Aug-2026 data is till 13th Aug 2026.

Fig 5: CD rate Declining with rise in liquidity



Source: Cogencies, UBI Research

Fig 6: PSU Banks on short side in current financial year; (Rs. In Crore)



Source: Bloomberg, UBI Research

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