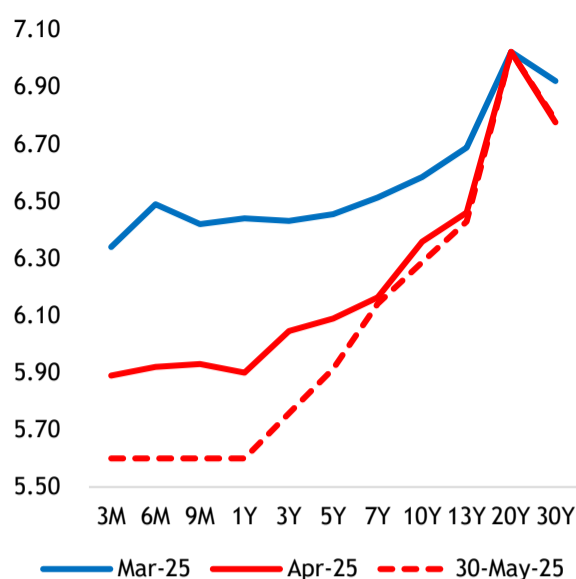


Fig.1: Surplus system liquidity and rate cut expectations keeping yield curve below 1 year flat



Source: Bloomberg, UBI Research

Global bond markets experienced significant turmoil in May 2025 due to escalating US fiscal risks, a downgrade from Moody's, and persistent inflation, which caused the 30-year US yield to surpass 5%, marking its highest level since 2023. The yield spread between India and the US for 10 years plummeted to a 20-year low of 177 basis points, indicating an increasing confidence in India's fiscal responsibility amidst growing global uncertainty. Additionally, Japan's bond market faced pressure, with the 10-year JGB yield reaching 1.5%, the highest it has been since 2009. In the midst of this volatility, the Reserve Bank of India (RBI) delivered an unexpected positive surprise by announcing a record dividend of Rs.2.69 lakh crore, despite increasing its contingency buffer, thereby providing a boost to liquidity and a fiscal safety net. Initially, G-Sec yields decreased to 6.24%, supported by ample liquidity and subdued inflation; however, they surged following India's Q4 GDP growth, which exceeded expectations at 7.4%, diminishing the likelihood of more substantial rate cuts. The announcement of a Rs.25,000 crore G-Sec buyback at the end of the month, along with the forthcoming Monetary Policy Committee (MPC) meeting scheduled for June 4-6, are now crucial in shaping the near-term direction of the market.

Global bond yields on upswing:

- The Federal Reserve maintained the federal funds rate in the 4.25%-4.50% range for the third time in May 2025, consistent with market expectations. The decision reflects a cautious stance amid inflationary risks from President Trump's tariffs and concerns about potential economic slowdown. Policymakers cited heightened uncertainty, particularly around rising inflation and unemployment. Fed Chair Jerome Powell reiterated that policy decisions will remain data-driven and not rushed.
- Moody's downgraded the US sovereign credit rating from AAA to Aa1, citing the continued rise in federal debt levels and growing interest payment obligations. The downgrade underscores increasing concern about the long-term sustainability of the US fiscal path.
- Fiscal policy uncertainty intensified as the US House of Representatives narrowly approved a major tax and spending package expected to increase federal debt by \$3.8 trillion over ten years. The bill extends 2017 tax cuts, removes various green-energy incentives, and tightens eligibility for social support programs.
- These developments triggered a sharp rise in US Treasury yields, with the 30-year yield surpassing 5%—its highest level since 2023. The broader global bond market sold off, with Japan and Germany particularly affected due to rising investor uncertainty.
- The US dollar index rose above 100, marking its third straight session of gains, following a federal court ruling that President Trump exceeded his authority in imposing reciprocal tariffs. The US Court of International Trade declared the tariffs unlawful, ordered them to be vacated, and permanently prohibited them.
- In FOMC minutes released on May 28, the Fed indicated it may cut rates once or twice by 25 basis points later in 2025, while awaiting clearer data. Policymakers noted that they may face difficult trade-offs in the coming months, as inflation and unemployment risks rise.
- The US 10Y Treasury yield held near 4.4% last Friday as markets weighed renewed trade tensions and steady macro data. President Trump accused China of breaching its trade deal, while a federal appeals court reinstated his tariffs, reversing a prior ruling. Inflation data (PCE) remained benign, with both core and headline up 0.1% MoM and easing YoY. Personal spending rose 0.2%, aligning with expectations. The data kept alive hopes for a Fed rate cut later this year. Overall, the 10Y yield ended May down over 20 bps, reflecting a cautious risk environment.
- In May 2025, Japan's government bond (JGB) market experienced significant stress, marked by rising yields, declining demand for long-term bonds, and changing investor preferences. The 10-year JGB yield rose to 1.5%, the highest since 2009. A 40-year bond auction on May 28 drew the weakest demand since July 2024, with a bid-to-cover ratio of 2.21. Contributing factors included regulatory changes affecting life insurers, reduced quantitative easing by the BOJ, and concerns over fiscal sustainability. Volatility in JGB yields can influence global borrowing costs and investor behavior across markets.

India US yield spread narrowed to two decadal low

- As of May 28, 2025, the India-US 10-year bond yield spread narrowed to 177 basis points, the lowest in over 20 years, due to a surge in US yields and a dip in Indian yields. Historically wider spread reflected higher risk premiums on Indian debt while the current compression signals improved investor confidence in India's macroeconomic and fiscal stability, amid growing concerns over the US fiscal outlook and inflation risks.
- Several factors have contributed to this trend:
 - US fiscal policy: Aggressive stimulus and tax cuts have driven US yields higher.
 - Debt metrics: US debt-to-GDP is ~121% vs. India's 83%, impacting risk perception.
 - Monetary stance: The RBI's cautious policy has helped anchor Indian bond yields.

RBI dividend bounty curtailed on expanded CRB

- The Reserve Bank of India's balance sheet grew by 8.2% to ₹76.25 lakh crore in FY 2024-25, reflecting an increase in assets such as foreign currency reserves, gold, and government securities. Net income rose by 27%, primarily driven by higher global interest rates—which boosted returns on RBI's foreign investments—and gains from active foreign exchange operations amid rupee volatility.

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- RBI announced its dividend payout to Centre on 23rd May'25 after market hours, amounting to Rs.2.69 lakh crore, in line with our estimate of Rs.2.5-3.0 lakh crore (Our Report: [Drop in domestic yields amid global headwinds](#)). However, it is still higher than the FY26 budgeted figures and last year's dividend of Rs.2.11 lakh crore.
- We believe that the revision in ECF with hike in buffers to 6 +/-1.5% is very prudent during times of global and domestic economic uncertainty. Despite the ECF revision and raising of contingency reserve buffer to upper end of threshold limit of 7.5% from 6.5% last year, with an absolute impact of ~Rs 75,000 crore, the RBI has been able to announce a strong dividend number. With the number higher versus budgeted by ~ Rs 60,000 crore (0.15% of GDP) the RBI has managed to provide fiscal leeway to the central government.

Liquidity, Money market and G-Sec yields

- The banking system remained in surplus for the month of May'25 averaging Rs.1.47 lakh crore higher than previous month average of Rs.1.40 lakh core. The WACR averaged 5.77%, below the repo rate, due to surplus fund in the system.
- As per RBI weekly data, the Govt. balance has jumped to Rs.4.3 lakh crore on account of transfer of RBI dividend of Rs.2.69 lakh crore on 23rd May'25. This has led to a sharp increase in Core liquidity to Rs.6.01 lakh crore, which is c.2.7% of NDTL. In Jun'25 we may witness further increase in banking system liquidity as high govt. balance spills over to banking system.
- The latest 364D T-bill cut off remained bullish at 5.62% down by 28bps from 30th Apr'25 showing comfort in lower tenures due to surplus liquidity.
- At the start of rate cutting cycle in Feb'25, the 364D T-Bill cut off as of 05th Feb'25 was 6.54% which has lowered to 5.62% as of 28th May'25. Even with MPC cutting down repo rate by 50bps since Feb'25 the 364D T-bill was down by 92 bps on the basis of surplus system liquidity.
- The 1 year CD-Tbill spread which squeezed to below 80bps at the start of FY 2026, has again expanded to 90bps & above in May'25 while it is still lower than Mar'25 of more than 100bps. Even with surplus banking system liquidity, the money going back to SDF showing the gap between Haves & Have-nots, with weaker Have-nots commanding the pricing thereby leading to higher CD-T-bill spreads.
- Credit growth trends reveal that the overall advances of the banking system have experienced a 9.8% increase, while deposits have seen a growth of 9.96% as of May 16, 2025. This expansion in the gap between credit and deposit growth (-16 basis points from -6 basis points in the last fortnight) indicates that banks are actively working to gather deposits.
- The 10-year benchmark yields moved to a low of 6.24% on easing liquidity further with RBI dividend announcement of Rs.2.69 lakh crore and easing inflation (CPI) numbers providing room for further rate cuts. However, the better than expected Q4FY25 GDP data has spoiled the momentum of the G-Sec market.
- India's Q4 FY25 GDP recorded a growth rate of 7.4%, exceeding expectations and highlighting the strongest quarterly performance of the fiscal year. This growth was largely attributed to robust activity in the construction sector, complemented by a significant rise in net indirect taxes (For Q4FY25 - 12.7%) on favorable base effect. For the full fiscal year, FY25 GDP growth moderated to 6.5%, down from 9.2% in FY24, reaching a four-year low. Despite this slowdown, India continued to be recognized as the world's fastest-growing major economy. In the future, market anticipate FY26 growth to fall within the range of 6.3% to 6.6%, driven by possible monetary easing and resilient domestic demand.
- Prices of G-Secs slumped after India's GDP growth of Q4FY25 was notified as 7.4%, higher than market consensus of 6.8%. Traders sold because the trajectory of rate cuts during 2025 has become uncertain, while 25bps cut remaining on table. Few market participants expectation of 50bps cut in June also diminished. However, in our view, we continue to expect 25bps cut in upcoming MPC meets of June and August.
- Post market hours on 30th May'25, RBI announced a buyback auction of Rs.25,000 crore which was unforeseen. Also, no provision was made for such buybacks in FY26 budget. The buyback securities having maturity of 2026 & 2027, thus, further steepening of yield curve may be expected.
- On the market activity front, PSU Bank led the buying along with Private Banks, Mutual Funds & others, whereas Foreign Banks sold G-Secs along with PDs during the month of May'25.
- Going ahead, MPC meeting due from 4th to 6th Jun is likely to be the driver of G-Sec market.

Table 1: Drivers of Liquidity

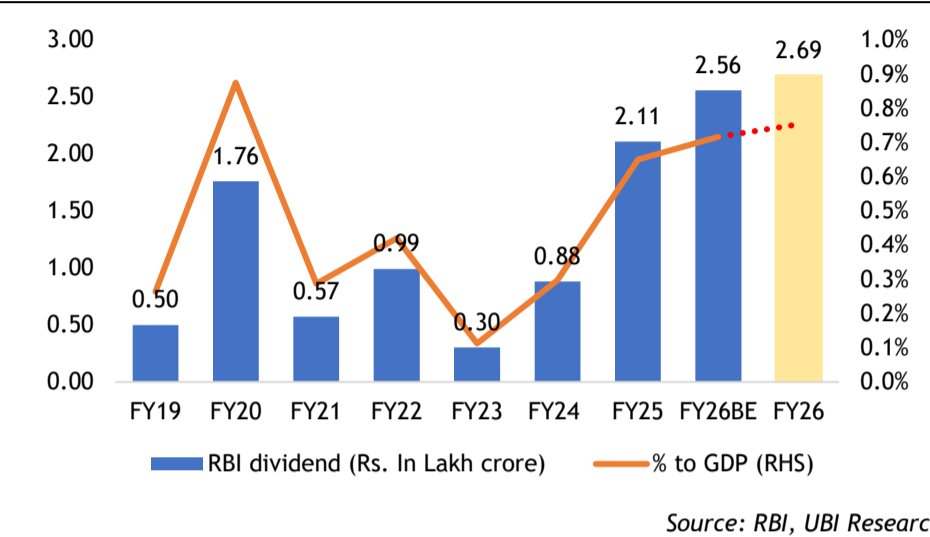
INR Lakh Crore	Systemic Liquidity Balance	Govt. Balance with RBI	LTRO	Core Liquidity	Spot Fx Intervention	LT SWAP (USD/ INR)	OMOs	LTROs	RBI Dividend	CIC	CRR
FY22	7.18	0.35	0.87	8.40	1.35		2.14	0.55	0.99	2.77	2.01
FY23	1.51	-0.49	0.73	1.76	-2.17		-0.35	-0.14	0.31	2.43	1.65
FY24	0.54	2.00	0.07	2.61	3.40		-0.19	-0.66	0.87	1.33	1.28
FY25 YTD*	0.11	1.96	1.83	3.91	-5.20	2.18	2.59	1.76	2.11	2.09	-0.21
FY26 YTD^	1.64	4.37	-	6.01	-1.91	2.18	2.39	-1.83	2.69	1.22	0.20
Q1FY26 Est.	3.92	2.70	-	6.62	0.30 to 0.50	2.18	2.45	-1.57	2.69	1.00	0.25

*upto 28th Mar'25 ^upto 23rd May'25
Source: RBI, CEIC, UBI Research

Table 2: Market Snapshot		Yield (May 30)	Monthly Change
10 Year G-Sec (6.79% 2034)		6.29%	-7 bps
1 Year T-Bill		5.60%	-30 bps
WACR (avg.)		5.78%	-16 bps
US 10 year Yield		4.40%	+24 bps
Credit Growth (%)		9.8%	-48 bps
Deposit Growth (%)		9.96%	-20 bps
Credit Deposit Wedge (bps)		(16)	-29 bps

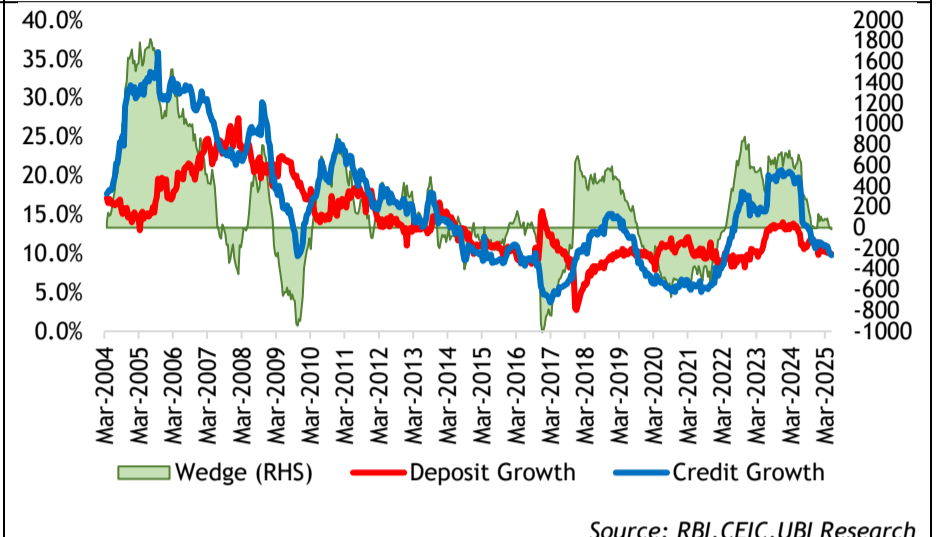
Source: RBI, CCIL, UBI Research

Fig.2: RBI dividend exceeded the FY26BE opening up scope for Fiscal leeway



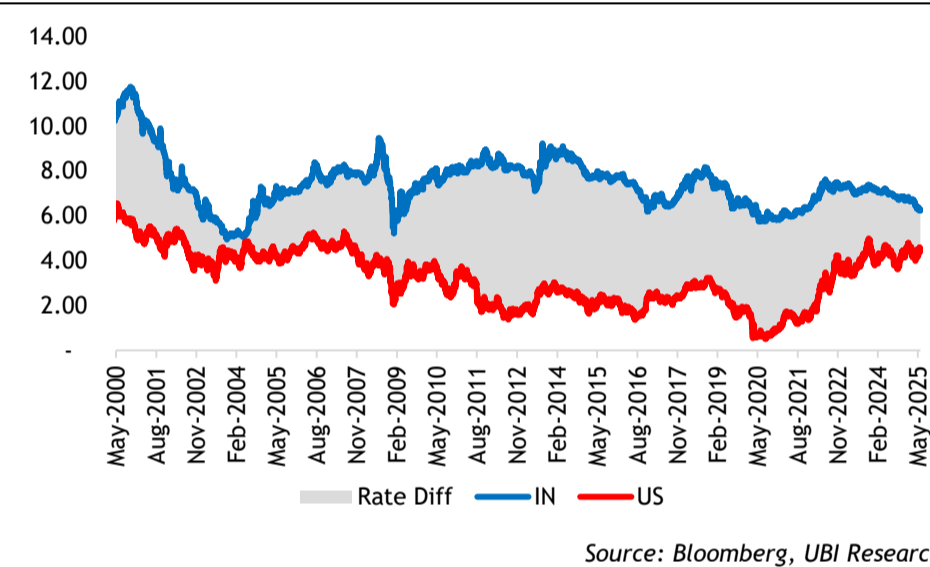
Source: RBI, UBI Research

Fig.3: Credit Deposit growth gap merged again showing banks' greater intent towards mobilising deposits



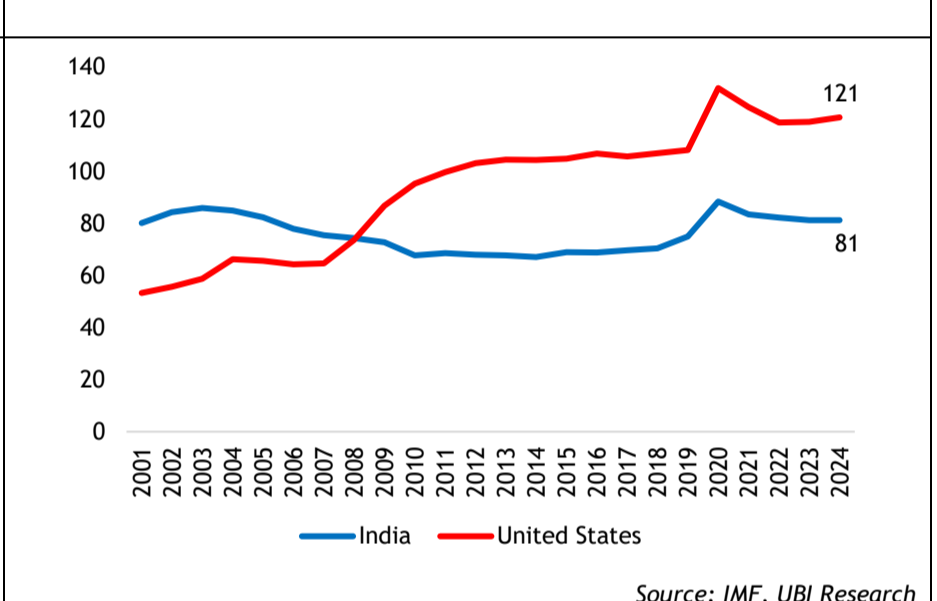
Source: RBI, CEIC, UBI Research

Fig.4: India US 10 year benchmark interest rate differential at two decadal low



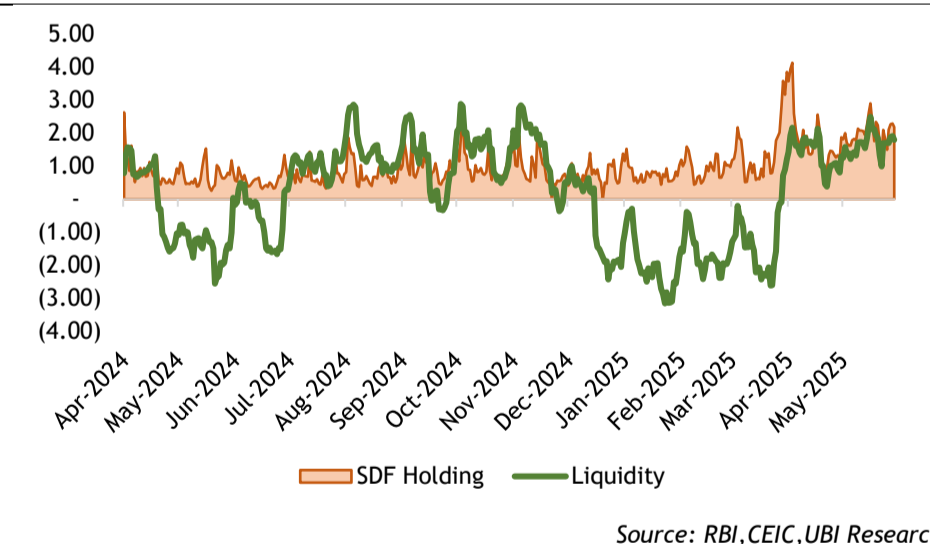
Source: Bloomberg, UBI Research

Fig.5: Debt-GDP ratio of US is far higher than India



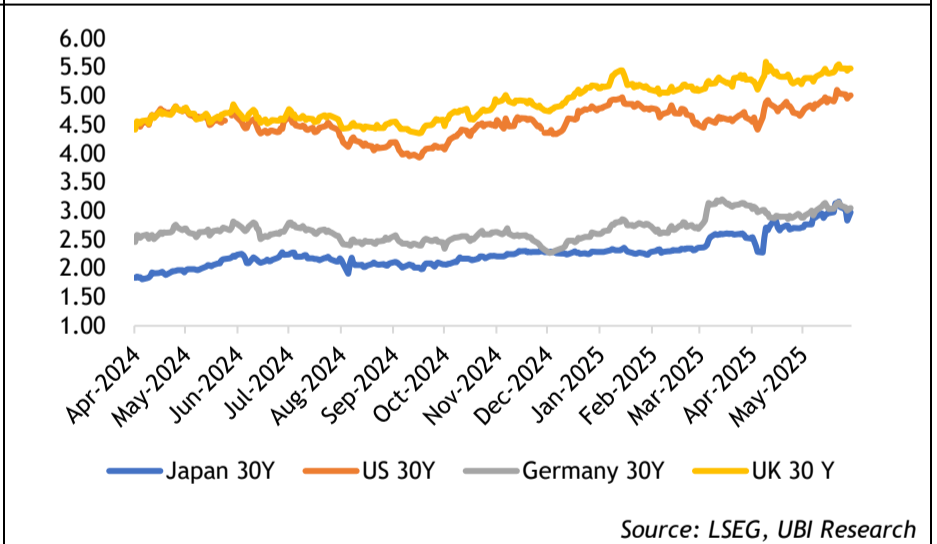
Source: IMF, UBI Research

Fig.6: Surplus liquidity making its way back to SDF



Source: RBI, CEIC, UBI Research

Fig.7: Global longer tenure yields on upswing



Source: LSEG, UBI Research

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