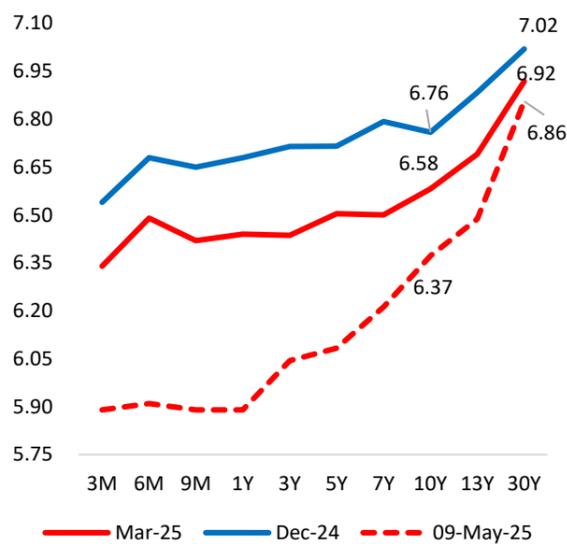
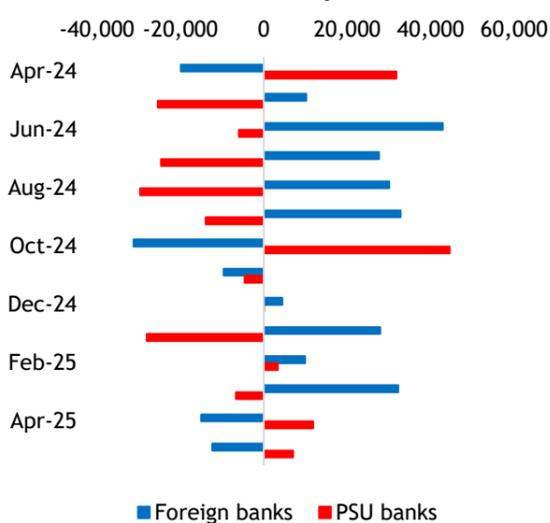


Fig.1: Yield curve shifting downwards with flat bias upto 1 year



Source: Bloomberg, UBI Research

Fig.2: Foreign Banks & PSU Banks on opposite sides in Bond market activity



Source: Bloomberg, UBI Research

It is a known fact that during periods of uncertainty and rising growth concerns, fixed income as an asset class continues to benefit. However, during war periods, expectations of fiscal profligacy caps the decline in yields on concerns of spike in supply pressures. Consequently, while the Indian yield curve traded way below Mar-25 levels (Fig.1) despite the spike in the 10-year benchmark in last one week to 6.44% zone due to rising tensions between India and Pakistan. However, the liquidity flush by the RBI continues to support the shorter end of the curve with T-Bills cut off coming in at 5.88%, lowered from 5.91% zone in last week auction. More importantly, the Indian Rupee slipped on Thursday this week due to escalation in military actions between the two neighbouring countries. The INR depreciated to Rs.85.71/\$ from Rs.84.8250/\$ falling by over 1% in a single day and 1.72% over the week (most in over two years). The strengthening of Dollar too created sentimental bias towards depreciation. Globally, the FOMC has stay put on holding Fed rates as the Fed Chair Jerome Powell stating that there will be no rush in adjusting current monetary policy. On the other hand, Bank of England (BoE) has cut its bank rate by 25bps to 4.25% as projected.

**FOMC kept put on rate decision**

- The Federal Reserve decided to keep the funds rate steady at 4.25% 4.50% for the third time in May 2025, consistent with market predictions, as officials opt for a wait-and-see strategy amid worries that President Trump's tariffs could elevate inflation and impede economic expansion.
- Policymakers have observed a further increase in uncertainty regarding the economic outlook, along with heightened risks of rising unemployment and inflation. During the standard press briefing, Fed Chair Powell remarked that it is too soon to decide which issue, inflation or unemployment, will be of greater concern, asserting that the Fed should not feel pressured to swiftly alter interest rates. The central bank is capable of adopting a patient stance, monitoring new data and maintaining a wait-and-see strategy.
- The yield on the US 10-year Treasury note decreased to 4.28% yesterday following the Federal Reserve's decision to maintain interest rates, as anticipated, while indicating a growing uncertainty regarding the US economic outlook. The dollar index rose to above 99.7 as traders digested the latest FOMC decision.
- Fed Chair Jerome Powell signaled that rising tariffs could stall progress on inflation and growth, cautioning that the central bank cannot act pre-emptively amid ongoing uncertainty over their scope and scale. As per CME FedWatch Tool, the rate cut cuts probability in CY2025 has decreased from 4 to 3.

**10-year benchmark hardened amid rising cross border tensions**

- The RBI on behalf of the GoI, issued a new 10-year paper for a coupon of 6.33%. The new paper was launched on 02<sup>nd</sup> May'25 and was the second most traded security.
- While the old benchmark, 6.79% GS 2034, has moved from a low of 6.31% to high of 6.44% during the week, while closed at 6.38%. This moved occurred to the escalating cross border tensions between India and Pakistan.
- Usually, Foreign Banks and PSU Banks have remain on opposite sides barring a few months in FY 2025. Again during Apr'25 and May'25 till date, they have remained on opposite fronts with PSU Banks buying on yield hardening days aggressively.

**System is flushed with liquidity with transmission as block on the road**

- RBI has flushed the system with surplus liquidity in Apr'25 which continued to spill over to May'25 as well. However, the surplus liquidity is finding its way back to Central Bank via SDF deposits. In terms of transmission, the loans & advances get adjusted immediately being linked to EBLR, deposit rates however, shall be moved down slowly by banks as they are already in the knock-out ring for deposits.
- In the money market segment, the WACR has majorly remained within the policy corridor. Even the T-Bills cut off came in at 5.88%, lowered from 5.90% zone in last week auction. Meanwhile the 10-year benchmark yields hardened to 6.44% after hitting a low of 6.30%, post cross-border tensions escalated.
- While there is limited data on the impact of past war incidents on macros and markets, a preliminary analysis shows that the impact of past cross border wars incidents lead to:
  - mixed impact on GDP growth: Kargil war saw growth outperformance on fiscal profligacy while it came under sharp pressure in the 1965 and 1971 wars,
  - inflation also eased despite notion that wars are inflationary except for period post 1971 war that saw global oil price spike;
  - paradoxical impact on markets during Kargil war (for which data is available) with bond yields easing despite fiscal boost, equities clocking a sharp surge while Rupee saw limited weakness.

That said, markets may see higher volatility this time round as we are fighting two wars simultaneously: one across the border and second, global trade war.

War year (marked in red)	GDP (% YoY)	Inflation (% YoY)	Combined govt fiscal deficit (% GDP)	FX reserves (\$ bln)	BoP (\$ Bn)	Import cover	USDINR (end period)	10yr bond yield (%)	Sensex (% change)
Kargil war (3 May 1999 - 26 July 1999)									
1998-99	6.18%	13.11%	7.00%	31.586	-47.54	6.88	42.44	12.07%	-3.92%
1999-00	8.85%	3.38%	8.70%	38.036	-55.38	8.20	43.61	10.79%	33.73%
2000-01	3.84%	3.74%	9.10%	42.256	-57.91	8.24	46.64	10.07%	-27.91%
Indo Pakistani war (3 Dec 1971 -- 16 Dec 1971)									
1970-71	5.16%	-	-	9.75	-2.44	-	7.50	-	-
1971-72	1.64%	3.20%	-	11.94	-2.76	-	7.28	-	-
1972-73	-0.55%	7.80%	-	12.19	-2.80	-	7.66	-	-
Indo-Pakistani War (5 Aug 1965 -- 23 Sep 1965)									
1964-65	7.45%	-	-	5.24	-2.98	-	-	-	-
1965-66	-2.64%	-	-	6.26	-2.87	-	-	-	-
1966-67	-0.06%	-	-	6.38	-2.84	-	-	-	-

Source: CEIC, RBI, UBI Research

By: Kanika Pasricha  
[kanika.pasricha@unionbankofindia.bank](mailto:kanika.pasricha@unionbankofindia.bank)

Dhiraj Kumar  
[dhirajkumar@unionbankofindia.bank](mailto:dhirajkumar@unionbankofindia.bank)

Banking Research Team	
Kanika Pasricha Chief Economic Advisor	kanika.pasricha@unionbankofindia.bank
Suneesh K	suneeshk@unionbankofindia.bank
R Gunaseelan	gunaseelan@unionbankofindia.bank
Nidhi Arora	nidhiarora@unionbankofindia.bank
Rajesh Ranjan	rajeshranjan@unionbankofindia.bank
Jovana Luke George	jovana.george@unionbankofindia.bank
Amit Srivastava	asrivastava@unionbankofindia.bank
Rohit Yarmal	rohitdigambar@unionbankofindia.bank
S. Jaya Laxmi	s.jayalakshmi@unionbankofindia.bank
Dhiraj Kumar	dhirajkumar@unionbankofindia.bank
Akash Deb	akash510@unionbankofindia.bank
Shreyas Bidarkar	shreyas.bidarkar@unionbankofindia.bank

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