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Bonds Wrap

Global yields are showing significant upward momentum. The major driver has been the direction of US 10Y yield which is now trading at its highest since 2007. This comes in the wake of elevated inflation data which has led Fed to embark on its rate hike cycle. FOMC projections suggest steeper rate hike path, going forward. We believe the northward bound of global yields to persist, taking cues of direction of US yield. Further, domestic conditions in terms of inflation inching up and rising gap between India and US 10Y yield redirecting FPI debt flow especially towards developed markets (US treasury), all point towards a steeper yield curve for India. RBI's OMO sales are also likely to put pressure on yields, as seen historically. However, the quantum and timing of the same remain crucial.

With Fed's rate action, market is pricing in further tightening by major central banks. ECB has already signaled accelerated pace of tightening to control inflation. Japan's yen movement has solidified expectations of a steeper rate hike cycle by BoJ. RBI's Oct'26 decision will be closely watched under this changing global backdrop.

Weighing all the factors, we expect India's 10Y yield to trade in the range of 6.95-7.12% in the remaining part of Sep'26, with risks tilted to the upside.

Global yields trading with a sharp upward bias:

- Global yields are showing considerable upward momentum in Sep'26. Among advanced economies, the sharpest increase was seen for US, UK and Germany. The Bloomberg Barclays EM USD aggregate index also shot up by 20bps in Sep'26. EM yields except for China also saw significant increase this month till date (16th Sep 2026).
- The narrative of global yields centered around US yield. Albeit US government's effort to buyback securities, yield witnessed upsurge. This was primarily on account of escalated military tension between US and Iran since Aug onwards after the initial agreement of an interim truce. Further in Sep'26, situation worsened with renewed attacks on oil infrastructure in Saudi Arabia, ports of Kuwait and Bahrain. Apart from this, US macro indicators also showed strength with factory orders (+0.9%, SA, MoM, in Jul'26, compared to -0.2%, last month) and core durable goods firming up, labour market conditions remaining buoyant, non-farm payrolls surged by 162k in Aug'26, largest gain in past 5 months, following 21k additions seen in Jul'26. Jobless claims data especially the 4-week moving average claims softened (206K, for the week ending 5 Sep 2026). The current PPI print remained elevated at 5.4%, core PPI at 4.6%. CPI was elevated at 3.4%, core CPI at 2.4%, especially the sequential momentum in CPI was strong. This has prompted Fed to go for its first rate hike since Jul'23. FOMC forecast also shows a steeper Fed Fund rate trajectory. 16 FOMC members now expect another 25bps rate hike in CY26, where in Jun'26 only six members were expecting the same.
- The repercussion of rise in US 10Y yield and anticipation of a tighter path of Fed fund rate also led selling across major fixed income classes. UK's 10Y yield rose at the sharpest pace. BoE

Chief Economist has also pointed out that waiting too long to take a call on rates might let inflation become embedded in the economy. However, the Sterling Overnight Index Average (SONIA) Rate is not pricing any immediate rate action on part of BoE. On macro front, indicators showed better performance such as new car registration, BRC shop price index and new consumer credit. However, labour market conditions have weakened. CPI inflation edged up to 3.1% in Aug'26 from 2.9% in Jul'26. However, both core and services inflation held steady at 2.6% and 3.4% respectively, which would give some headroom to BoE to keep policy rates at the same level.

- Germany's 10Y yield also rose considerably. Post ECB's recent rate hike, Germany's 10Y yield inched up by 6bps. This is the second hike by ECB after the Jun'26 hike, amounting to total 50bps hike in the current cycle. The path is likely to be steeper to get inflation under control, with market anticipation of another three rate hikes, going forward. It is to be noted that ECB started the restrictive cycle much earlier compared to major global central banks.
- Among major EMs, S. Korea and Thailand showed sharp increase in 10Y yield. For S. Korea, the recent 25bps increase in policy rate was the major factor driving yields. For Thailand, elevated inflation print kept yields higher.

Domestic 10Y yield after firming up by 11bps in Aug'26, rose by another 10bps in Sep'26, in line with global yields. The sharp jump was seen in the last few sessions buoyed by expectations of rate hike by Fed.

Table 1. 10Y Yield movement globally

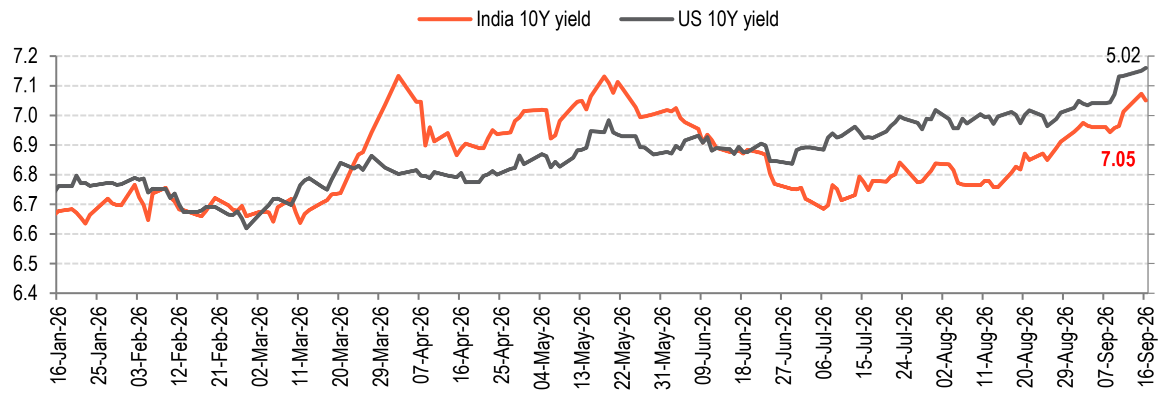
Countries	10Y sovereign yield, 31 Jul 2026	10Y sovereign yield, 31 Aug 2026	10Y sovereign yield, 16 Sep 2026	Change, 16 Sep/31 Aug, bps
US	**4.73**	**4.75**	**5.02**	**27**
UK	5.05	5.06	5.30	24
Thailand	2.05	2.13	2.36	23
S. Korea	4.26	4.31	4.54	23
Germany	3.21	3.32	3.51	19
Singapore	2.34	2.34	2.49	15
Indonesia	7.34	7.03	7.16	13
India	**6.84**	**6.95**	**7.05**	**10**
Japan	2.81	2.96	3.01	5
China	1.72	1.69	1.68	-1

Source: Bloomberg, Bank of Baroda Research

India-US yield gap: A factor to closely watch for:

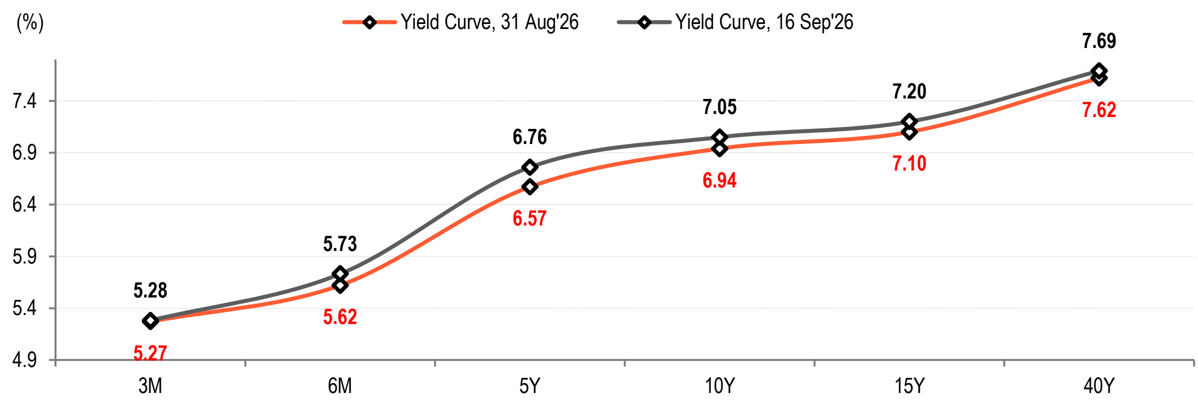
- There has been certain degree of consonance in India's 10Y yield movement and US 10Y yield movement in CYTD26. The correlation coefficient between the two is also higher at 0.50 in CYTD26 compared to 0.12 in CY25. Hence a considerable rise in India's 10Y yield can be attributed to the direction of US 10Y yield as seen in Fig 1. The 10Y yield gap (India-US) is also at multi-year low level of 212bps currently (Sep: 16 days average). For US, unless the war situation resolves, yields are likely to trade with an upward bias. The buyback announcement of US government also could not cap its yield. Further with US President announcement of no near-term resolution of the war even with the US midterm elections in sight, yield gap is likely to show some upward correction. Fed has already embarked on its rate hike cycle before RBI. The FOMC projection also implies a steeper rate hike cycle for Fed. Hence a lot hinges on what RBI's action will be to get a cue on yield gap between India and US. Any delayed response from RBI might lead to widening yield gap between India and US.

Fig 1: Movement of India and US 10Y yield



Source: Bloomberg, Bank of Baroda Research

Fig 2: Evolution of India's yield curve



Source: Bloomberg, Bank of Baroda Research

Yield curve has witnessed upward shift especially for 5Year and above part of the curve. On the other hand, short end part of the curve got support from abundant domestic liquidity conditions. Going forward as well, we expect short end part of the curve to trade with a downward bias unless RBI comes up with frequent and more long-term absorption of liquidity to sustain it at the 1% NDTL surplus level. Long end part of the curve is expected to mirror the direction of global yields. We expect steepness in yield curve to continue this month as well. The gap between 3M and 10Y part of the curve is currently at 177bps, higher compared to 167bps, as seen on 31 Aug 2026.

What do auctions in the domestic market reflect?

In Sep'26, cut-off yields for State government securities have risen sharply. Even for 182 and 364-day Tbill it rose on an average basis, in Sep'26 compared to Aug'26.

Table 2. Cost of borrowing

Type of Papers	Avg. Cut off yield, Aug'26	Avg. Cut off yield, Sep'26*
Central Government Securities	6.99	7.02
State Government Securities	7.58	7.69
Tbills		
91 days	5.27	5.25
182 days	5.57	5.68
364 days	5.74	5.95

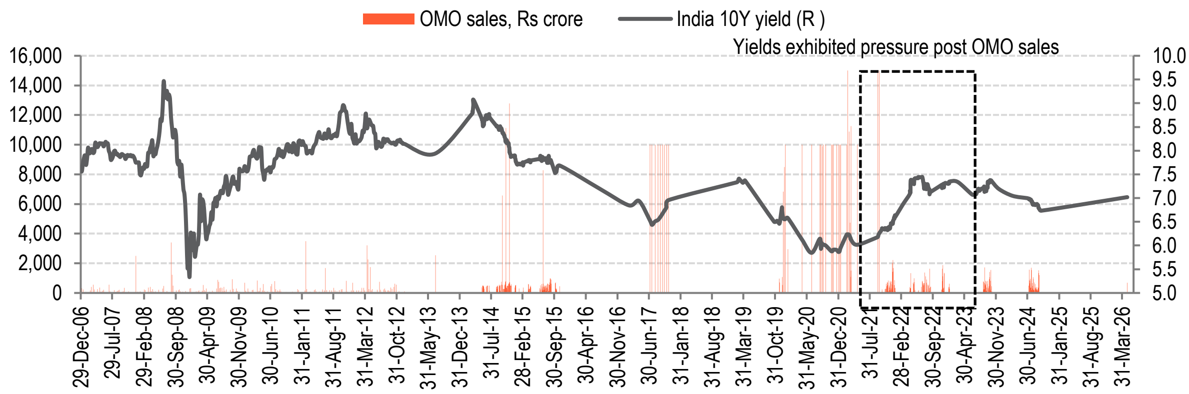
Source: Bank of Baroda Research, Note: Average cut off yield of auctions for the month have been accounted for, *Sep'26 is average till current available information.

- As per Bloomberg data, foreign banks and MFs were major sellers in Sep'26 (till 16 Sep) whereas private banks and PSBs continued to be buyers.

System Liquidity is far above the 1% NDTL level:

- Average system liquidity surplus shot up to Rs 10.2 lakh crore in Sep'26 (first 16-days) compared to Rs 3.7 lakh crore surplus in Aug'26. Net durable liquidity is also significantly higher at Rs 10.7 lakh crore as of 31 Aug 2026. So, the question is how long RBI will allow system liquidity to remain above the 1% NDTL surplus level. Current level is around 3.4% of NDTL. However, RBI's fine tuning through the LAF window has been less impactful especially for the longer tenor VRRR (26 days and 30 days saw tepid demand). It is to be mentioned that the outstanding VRRR is already at Rs 3.2 lakh crore. Hence, this expresses unwillingness of the market participants to park funds at a time when credit demand is strong.
- To withdraw liquidity on a durable basis, RBI has announced OMO sales of Rs 1 lakh crore. Historically, we have seen that OMO sales have a bearing on yields if not immediately, but it tends to put upward pressure on yields. Hence, we believe a more calibrated approach might be taken by RBI to withdraw liquidity on a durable specially when credit demand is high and rate hike cycle is anticipated.

Fig 3: OMO sales and movement of India's yield



Source: Bloomberg, Bank of Baroda Research, Note: OMO sales data is RBI OMO sales in the secondary market

- Banking liquidity i.e. the difference between deposits and borrowings net of investment and credit stands at Rs 5 lakh crore in Q1FY27. This is on account of faster pace of accretion in incremental deposits of Rs 16.4 lakh crore (accretion between 31Mar 2026 till 31 Aug 2026), attributable to the higher level of FCNR (B) flows. Credit accretion during the same period is Rs 10.3 lakh crore. We expect some normalisation in banking liquidity in line with system liquidity on account of CIC (currency in circulation) leakage due to festive demand and persistent buoyancy in credit demand due to strong underlying growth indicators.

Outlook on India's 10Y yield in the current month:

- India's 10Y yield is expected to face upside pressure in the near term. A lot of it is dependent on the direction of US 10Y yield. The rhetoric is now of a steeper rate hike by Fed as seen from the projections of Sep'26 policy. Globally as well, interest rates are likely to be elevated taking cues from US yields. We believe for India, the yield gap with the US is likely to show some correction. There might be some downside pressure on FPI debt on account of the same as flows might be tilted towards safe-haven US treasury security in the rising interest rate cycle.
- Other key upside risks to domestic yield emerge from the trajectory of inflation. Core inflation is also gaining momentum. Abridged core which excludes pan, tobacco, gold, silver and precious metals is also picking pace. In Aug'26, it has inched up to 2.8% which was 2.5% in Jul'26 and much lower at 2.1% in Apr'26. Thus, RBI is likely to be mindful of the same in the upcoming policy. However, we believe, Dec'26 will be the opportune time for any rate action as RBI's inflation forecast peaks during that quarter. Any unanticipated rate action might push domestic yield higher.
- On FPI debt side as well, pressure started building up with aggravating war situation and higher international oil prices. Through the debt route, net FPI outflows in Sep'26 have been US$ 1.1bn (till 15 Sep) compared to outflow of US$ 152mn in Aug'26. If similar run rate continues there will be upside pressure on yields.

Table 3: OIS rates did not show much momentum

	As on 31 Aug 2026	As on 16 Sep 2026
OIS Rates		
1M	5.30	5.30
2M	5.37	5.39
9M	5.85	5.92

Source: Bloomberg, Bank of Baroda Research, Note: data as on the mentioned time point

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