

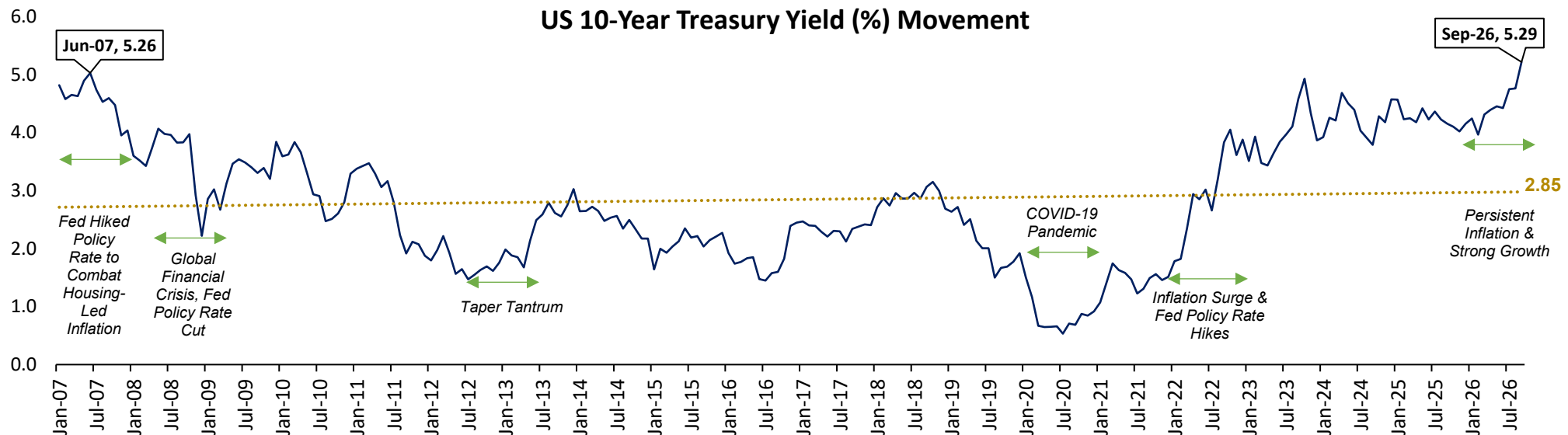
Hardening US Treasury Yields: Implications for Indian Economy and Financial Sector

Key Highlights

- The US 10-year treasury yield touched a high of 5.29% at Sep'26 end, its highest since July 2007 after the Fed's first hike of 25 bps on 16th Sep'26 since 2023 (to 3.75–4.00%), an oil-led inflation surge, heavy government and AI-related bond supply.
- As a direct spillover, India's 10-year G-Sec yield climbed to ~7.18% (a 2-year high), so the spread is ~189 bps against a 20-year average of ~450 bps. After hedging costs of about 3%, it offers foreign investors no pick-up over Treasuries.
- When US yields rise, they trigger a chain reaction across the Indian economy, dictated by foreign fund outflows, currency valuation, and the domestic cost of capital.
- The pressure runs through the rupee (trading at ₹96.0/\$ end Sep'26, RBI's forex reserves down \$14.9 bn in a week to \$765.9 Bn as of 18th Sep'26, imported inflation and a likely RBI repo rate hike in Oct'26 policy meet. Growth remains strong at 7.8% in Q1 FY27.

Forces Driving - US Treasury Yields

The benchmark US 10-year treasury yield climbed to around 5.29% on 30th Sep'26, its highest level in nearly two decades.



Source: Federal Reserve Economic Data | FRED

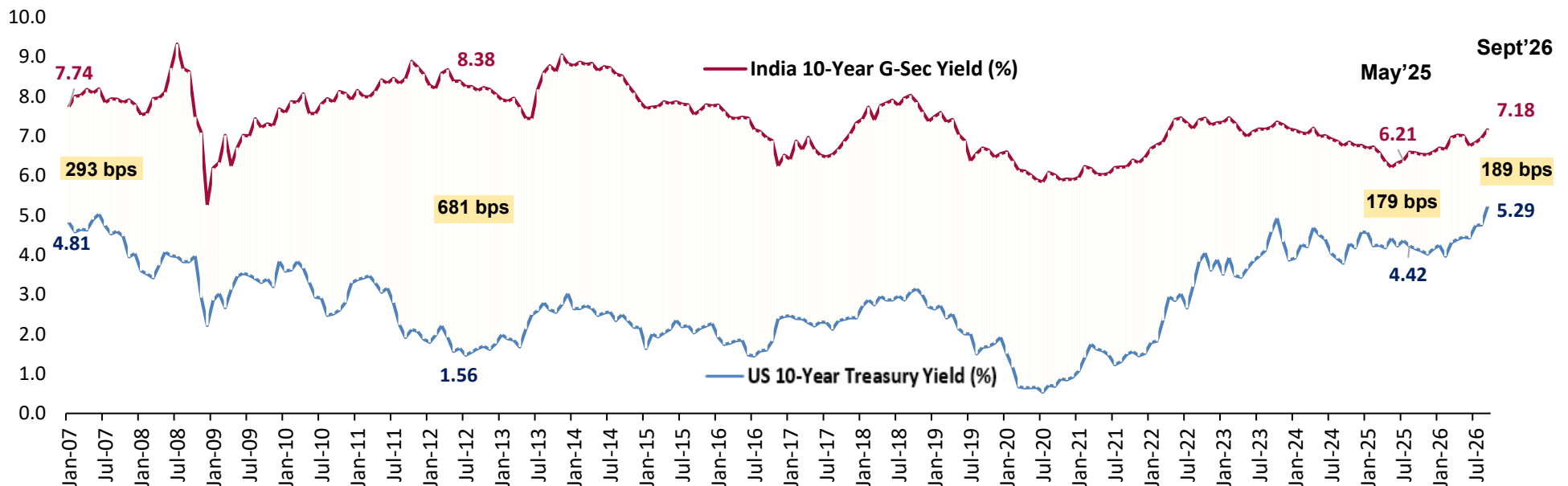
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This move has been driven by:

- I. **Energy-led inflation:** The West Asia conflict has kept Brent crude above \$100 a barrel and the Fed now projects 2026 PCE inflation at 3.7% (core 3.4%) and does not see 2% before 2029.
- II. **Resilient growth:** The AI investment boom is keeping US growth firm (the Fed projects 2.3% for 2026), which weakens the case for easier monetary policy.
- III. **Competition for capital:** Large sovereign deficits and a surge in AI-related corporate bond issuance are chasing the same pool of long-term savings. This is pushing up the term premium, the extra yield investors demand to hold long bonds.
- IV. **Fiscal Constraints:** The US fiscal deficit remains around 6% despite a resilient economy, debt-to-GDP continues to rise (125.8% by the end of 2026), and interest payments have surpassed defense spending.
- V. **Federal Reserve Policy:** On 16th Sep'26, the FOMC raised its policy rate by 25 bps to 3.75–4.00%, the first hike since July 2023, and the median projection points to one more hike this year. Chair Kevin Warsh said inflation is "too high and has been for too long."

Transmission Mechanism: From US Treasuries to Indian G-Secs

The yield on India's 10-year G-Sec rose to around 7.18% on 30th Sep'26, reaching its highest level in nearly two years. The spread between India's 10-year G-sec and the US 10-year Treasury has narrowed to ~189 bps (7.18% against 5.29% on 30th Sep'26) against a 20-year average of ~450 bps. The squeeze is coming mainly from the US side.



Source: US FRED, India CCIL

Thematic

The pass-through effect from US yields to Indian debt markets operates through relative risk-adjusted metrics rather than a strict formula

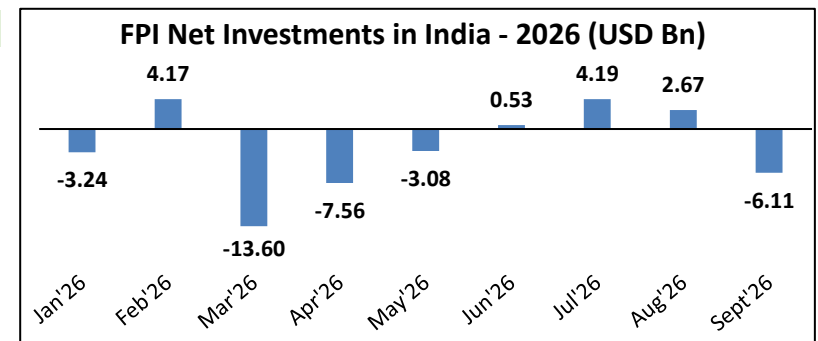
- **Yield Spread Compression:** Historically, Foreign Portfolio Investors (FPIs) demand a healthy buffer often around 250–300 basis points to hold emerging market debt like Indian G-Secs, compensating them for rupee volatility. With US yields near 5.3% and Indian yields hovering around 7.2%, this premium is even less than 200 bps, narrowest in more than two decades. It is below the 242 bps low of Oct'23 and the 224 bps low of Dec'24.
- **Capital Flight & FPI Retrenchment:** More attractive, risk-free returns in the US incentivize foreign funds to pull money out of emerging market equities and bonds, redirecting capital back to the United States.

Major Instances of US Yield Hardening & Its Impact

Major Instances	US 10-year Treasury Yield	Impact on Indian G-Sec, INR & Reserves
2007-08 Global Financial Crisis	It was around 5.0% (Jun'07) → 2.2% (Dec'08) US Fed cut policy rate to near-zero	India's 10-year G-Sec rose from 7.5% (Jan'08) to 9.3% (Jul'08) and then softened to 5.3% (Dec'08); INR depreciated from ₹39.5 (Jun'07) → ₹50.5 (Dec'08); Forex reserves fell from a peak of \$309.7 Bn (Mar'08) to \$252.0 Bn (Mar'09)
2012-13 Taper Tantrum	It was around 1.6% (Dec'12) → 3.0% (Dec'13)	India's 10-year G-Sec hit a record 9.53% (Aug'13); INR depreciated from ₹54 → ₹68.8; RBI's FCNR(B) swap window raised ~\$34 Bn
2018	It was around 2.5% (Jan'18) → 3.2% (Oct'18)	India's 10-year G-Sec grew to 8.2% (Oct'18); Indian rupee touched a record low of ~₹74.5 against USD;
2022	US Fed increased policy rate by +425 bps; 10-year Treasury yield climbed to 4.2% (Oct'22) from 1.8% (Jan'22)	India's 10-year G-Sec grew from 6.7% (Jan'22) to 7.5% (Oct'22) Indian rupee depreciated from ₹74 → ₹83 India's Forex Reserves fell by around \$118 Bn from its peak

Implications for the Indian Economy in Current Scenario

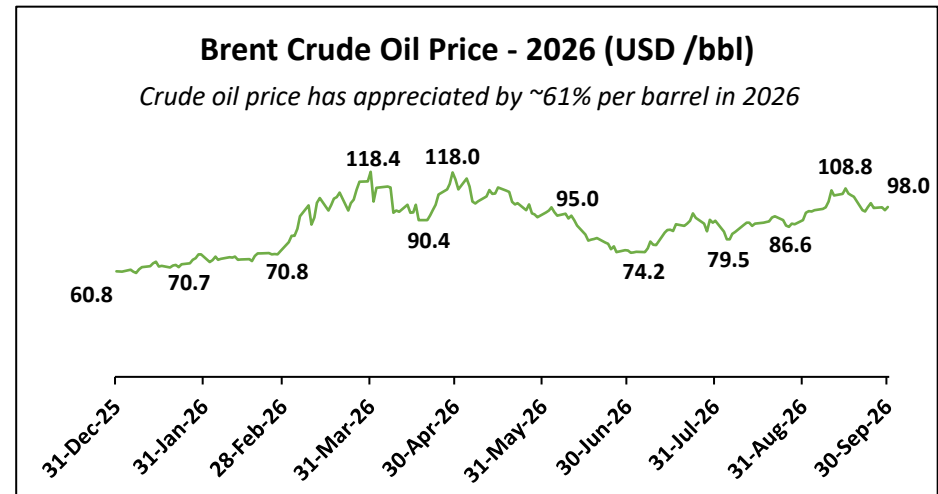
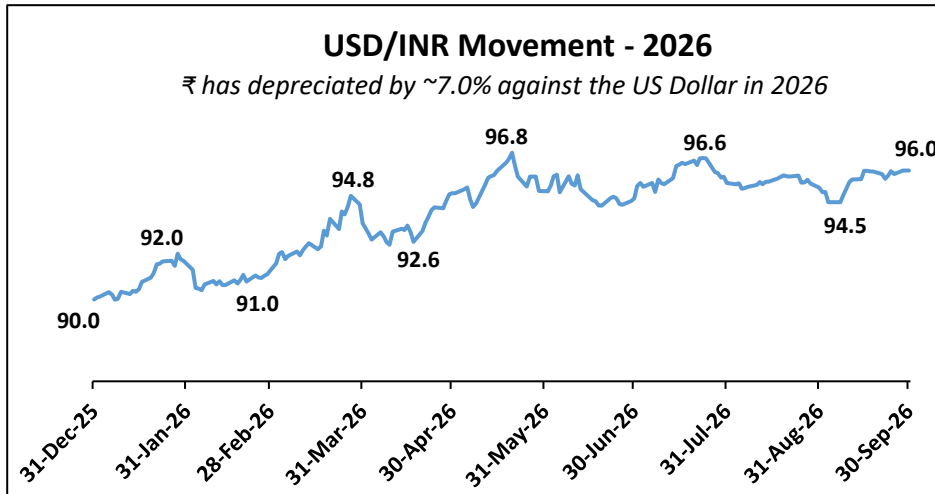
- **Capital Outflows:** When "risk-free" US government bonds offer high returns near 5.3%, the premium for investing in riskier emerging markets like India shrinks significantly. Consequently, Foreign Institutional Investors (FIIs) pull capital out of Indian equity and debt markets (\$22.0 Bn in Jan-Sept'26) to lock in safer, high-yielding US assets. This mass exodus triggers heavy selling pressure across Indian stock indices like the Nifty 50 and Sensex (down by 16% from its peak), driving down domestic equity valuations.



Source: NSDL

Thematic

- **Rupee and Forex Reserves:** The USD/INR is currently hovering around ₹96.0 (depreciated by ~7% in 2026) and the RBI is expected to be holding at the current level in the near term. As a result, RBI's forex reserves have fallen by \$19.8 bn to \$765.9 bn as of 18th Sept from its peak of \$785.7 (4th Sept), the sharpest drop in almost two years, yet they remain ~\$99 bn above the Jun'26 low of (\$666.9 bn). RBI's concessional swap window has mobilized \$143.6 bn (18th Sept), a far larger buffer than the ~\$34 bn raised in 2013.



Source: RBI, CMIE

- **Inflation and RBI's MPC Policy:** Currently the Brent is around \$100 /bbl (up by ~61% in 2026 till Sept) and a weaker rupee are pushing India's retail inflation i.e. CPI up (expected to cross 6.0% in Q3). A 25 bps repo hike is widely expected in the RBI MPC's Oct'26 policy meet. Further hikes are also expected under sustained oil shock. The RBI is also draining surplus liquidity (₹1 trillion of OMO sales, VRRRs, FX swaps).
- **Imported Inflation:** India relies heavily on imports, buying roughly 85-90% of its crude oil in US dollars. The double hit of a depreciating rupee and elevated crude prices creates a strong wave of imported inflation across the domestic economy. This places the RBI under pressure to sustain a hawkish monetary policy stance, leading to higher retail lending costs and elevated EMI rates for consumers.
- **Cost of Capital and Fiscal Deficit:** Higher sovereign yields directly affect the cost of financing for the govt. debt as they need to offer higher coupon rates on new debt issuances, expanding the interest-payment burden and fiscal deficit. Also, the G-Sec yields serve as the foundational pricing benchmark for commercial lending, banks and financial institutions face elevated funding costs. This pushes up the marginal cost of funds-based lending rates (MCLR), translating into pricier corporate loans, automobile finance, and home mortgages for retail consumers.

Thematic

Mitigating Structural Factors for India

While external vulnerabilities remain high, a few structural shock absorbers prevent a full-scale market rout:

- **Inclusion in Global Bond Indices:** The long-term structural inclusion of Indian sovereign paper in major indices (like J.P. Morgan's emerging market index) creates a steady baseline demand from passive global trackers, partly offsetting speculative capital flight.
- **Calibrated Sovereign Supply:** The Indian finance ministry has actively reduced the planned issuance share of 5-year and 10-year tenors for the latter half of the fiscal year (cutting 10-year supply down to 26.3% from 29%), which helps limit an absolute collapse in domestic bond prices.

Current Yield Hardening – Key Impact on Banks

- **MTM pressure:** Public Sector Banks generally carry larger sovereign bond portfolios than private lenders, making their income more vulnerable to sudden yield spikes. Rising bond yield results in valuation losses on Available for Sale (AFS) and Fair Value Through Profit and Loss (FVTPL) holding which are reflected in AFS Reserve and P/L Account respectively. This price drop forces banks to recognize immediate unrealized valuation losses, dragging down non-interest income and overall profitability.
- **Higher funding cost:** Banks may need to offer higher deposit rates, particularly for bulk/term deposits, putting pressure on their Net Interest Margin (NIM). To prevent savers from moving capital out of low-yield savings accounts and into surging debt mutual funds or corporate deposits, banks may face pressure to hike their domestic fixed deposit rates.
- **Credit risk:** Higher borrowing costs can affect repayment capacity, particularly of MSMEs and highly leveraged corporates.
- **Reinvestment opportunity:** Fresh investments can now be made at higher yields, improving future portfolio carry. Fresh SLR and surplus funds can be deployed at the present G-sec yields, and banks with strong NRI and trade-finance franchises are likely to earn more fees and FX income.
- Banks may require lesser provisions under AS 15 for employee benefits.

Yield hardening is a near-term challenge for treasury valuations and funding costs. However, it creates an opportunity to build long positions mainly in HTM at lower bond prices. Effective ALM and duration management will remain the key.

Outlook – 3 Scenarios for the Next 6–12 months

Our base case is that US yields stay high but stop rising sharply, keeping the India–US spread in the range of 170–220 bps.

Indicator	Base Case (Most Likely)	Adverse	Benign
Event	Fed hikes once more to 4.00–4.25%, then pauses; Brent \$90–105	Hormuz disruption pushes Brent above \$120; Fed hikes twice more	West Asia ceasefire; Brent below \$80; US inflation eases
US 10-year yield	4.9–5.4%	5.6–6.0%	4.4–4.8%
India 10-year yield	7.00–7.35%	7.40–7.80%	6.70–6.95%
India–US spread	170–220 bps	150–190 bps	220–260 bps
RBI repo rate	5.50–5.75%	6.00–6.25%	5.25–5.50%
USD/INR	95–98	99–103	92–95
FPI debt flows	Flat to mildly negative	Sustained outflows	Inflows resume

Estimates assume that historically, a 1 bps rise in the 10-Year US Treasury yield pushes India's 10-year G-Sec up by 0.4–0.5 bps, accordingly domestic inflation and policy actions.

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