HSBC Mutual Fund

Debt Market Review

India rates bear the brunt



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October was a month of two halves: a record-setting early rally fuelled by AI optimism, followed by a sharp reversal as mega cap earnings exposed the unsustainable cost of the AI buildout. The divergence between tech and the rest of the market widened and it also led to fall in bond yields as investors sought safe-haven assets. The global AI/tech rout put India in the spotlight and there was renewed interest in Indian markets as an opportunity, with its non-AI-heavy market attracting rotation flows and posting its best month since July. Across major economies, the common overhangs were geopolitical developments, oil prices, and inflation worries. *Despite the cooling in US rates, Indian rates edged higher, bearing the brunt of oil prices, Brent oil ended at ~US$118/bbl end-Oct, the MPC's policy pivot and tighter banking-system liquidity.*

An important update on the global economy was the release of the IMF's economic outlook, which described the current backdrop as resilient global economic activity that is nevertheless running out of room, with difficult policy choices likely to be needed. IMF estimates global growth at 3.1%, a modest upgrade from July, but the distribution of that growth is narrowing with fewer economies accounting for most of the global expansion. The Middle East war and the closure of the Strait of Hormuz are the defining macro shock, acting as a persistent oil-price tax on the global economy. Within the G7, the US continues to be a growth engine; Europe is recovering but shaky, with the situation in France being a notable headwind. India is the WEO's brightest spot, the largest major-economy upgrade at 60bps to 7.0%; but given its oil dependence and overall external sector vulnerability, macroeconomic headwinds could persist if conditions in the Strait of Hormuz deteriorate or fail to improve from here. The IMF's message is unambiguous, i.e., policymakers must rebuild fiscal buffers to withstand future shocks.

For India, the upswing in oil prices has altered the macro dynamics and policy choices. Producer prices are reflecting the energy shock; retail prices are starting to broaden despite the limited direct pass-through of higher oil prices to automotive fuels. While Indian State oil marketing companies continue to absorb most of the price pain, pass-through may become inevitable if oil prices remain elevated. India's oil import bill has also risen since the start of the conflict, averaging at least US$5bn more per month than pre-West Asia conflict. Foreign flows too have been volatile; with an outflow of US$2.2bn, mainly from equities, while debt inflows turned marginally positive. The momentum of FPI equity outflows slowed in Oct'26 vs Sep'26 - while this can be attributed to rotation to non-AI heavy markets, it may also be owing to stability returning to the INR.

In October, the RBI MPC hiked the Repo rate by 25bps to 5.50% with a change in stance from neutral to calibrated tightening; the MPC minutes clearly signalled a tightening bias to contain inflationary pressures. A few days after the MPC meeting, the RBI announced a few regulatory FX measures to arrest the depreciation pressure and curtail speculative activity. INR in October gained almost 2% from its intra-month lows of 96.79/$ and ended the month at 94.96/$. While the RBI's measures did arrest rupee's slide, the stringent FX measures also impacted the forward premia curve, effectively increasing the cost of hedging. Forward premium levels have since moderated as the currency has stabilised. On the flip side are the implications of FX intervention and seasonal factors that led to a rapid drop in banking system liquidity. So far, the liquidity surplus has dropped rapidly during Oct'26, down from +2% of NDTL to ~0.8% of NDTL and in absolute levels sits at a surplus of ~INR 1.5tn down from ~INR 5.5tn at the start of Oct'26. Resultantly, overnight rates hardened and started to settle near the upper bound of the policy corridor before moderating closer to the Repo rate towards end-Oct. RBI's OMO sales of 1.25tn too drained durable liquidity from the system.

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In summary, elevated oil prices, a non-AI trade, cooling-off in global yields and a US Fed pause were developments that unfolded in the latter half of Oct'26; thereby changing India's market backdrop. Meanwhile, in terms of macroeconomic data, the inflation outlook has changed modestly, but the risks of inflationary pressures are intensifying and beginning to broaden, which led to a policy pivot in early Oct'26. In terms of a rate-hike cycle, the markets appear to be a bit more divided. For now, market expectations are pricing in at least another couple of 25 bps rate hikes over the course of next six months. The rate expectations could swiftly change depending on how crude oil prices behave and how the pass-through starts to spill over into retail prices, currency & rates. In the last few days, a swift drop in oil prices has definitely eased pressures on FX & rates.

One reason domestic rates markets may have reacted as they have to the sharp drop in oil prices, nearly US$15 per barrel from recent peaks, is that in a recent interview the RBI Governor signalled that interest rate defense can be deployed to ensure financial stability; raising the prospects of aggressive rate hikes. Although the odds of a 50 bps rate hike at the December policy are rising, our base remains that of a 25 bps rate hike on the 4-Dec policy meeting. For debt markets, how the liquidity situation is managed also remains important to monitor. Any sign that the RBI intends to keep liquidity deliberately closer to neutral or in deficit would indicate a desire to maintain tight financial conditions.

Fund positioning

Markets saw a sharp sell-off across segments on the back of increased geo-political tensions, higher crude prices, commencement of rate hikes and OMO sales conducted by the RBI. The yield curve flattened with RBI commencing rate hikes. During the month, 3 yr G-Sec sold off by around 40 bps while 10 yr G-Sec was higher by around 22 bps. With RBI removing liquidity from the system, 1 yr CD levels rose by 65 bps while 2-3 year corporate bonds sold-off by around 50 bps and are currently trading around 8.30% levels.

There has been some cooling off in rates after the sharp sell-off with crude prices easing closer to USD 100-105/bbl. While current market sentiment has turned a bit positive, we believe risks pertaining to global markets and energy prices remain. Further deterioration in Rupee can push RBI to use interest rates as a defense for currency. In that case, RBI might have to continue to hike rates to allay any pressure on currency. While we have remained underweight on duration versus peers across our funds, yields from a valuation perspective are becoming favourable. We will keep evaluating incoming data and look to opportunistically add duration across our funds on any signs of sustained moderation of US Treasury yields or easing on the geopolitical front.

Investors with a short-term investment horizon can look at the less than 1 year bucket, i.e. Ultra Short Duration, Money Market Fund and Low Duration Fund as they offer pick-up over the Liquid category.

For investors with a medium-term investment horizon, Corporate Bond category can be an investment opportunity as it provides reasonable accrual in a lower duration product.

For investors who can look at tactical allocations with a medium-term horizon, Short Duration and Banking and PSU categories can also be possible avenues.

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Abbreviations:

RBI: Reserve Bank of India
MPC: Monetary Policy Committee
SDF: Standing Deposit Facility
MSF: Marginal Standing Facility
VRRRs: Variable Rate Reverse Repos
CRR: Cash Reserve Ratio
OMO: Open Market Operations
GDP: Gross Domestic Product
CPI: Consumer Price Index
SDL: State Development Loans
G-Sec/IGBs: Government Securities

Past performance may or may not be sustained in future and is not a guarantee of any future returns.

Note: Views provided above are based on information in public domain and subject to change. Investors are requested to consult their financial, tax and other advisors before taking any investment decision(s).

Source: Bloomberg & HSBC MF Research estimates as on November 4, 2026 or as latest available.

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