

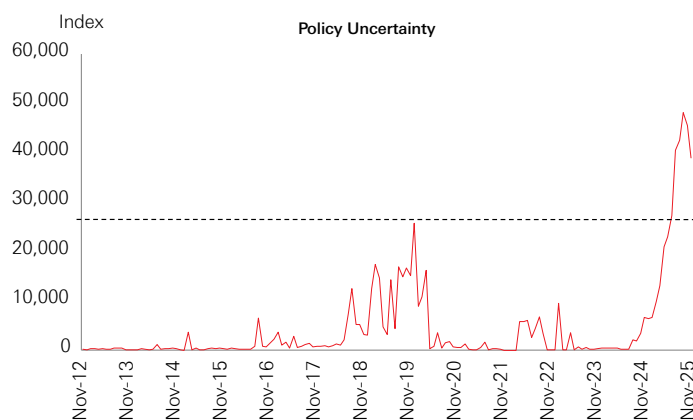
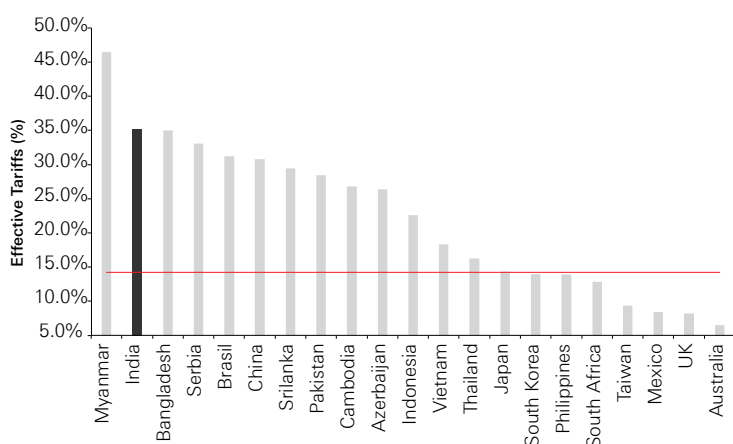
Fixed Income Outlook

2026 - A fine balancing act





2025 would be remembered as a tariff-ied year and 2026 may be the year of transition; transitioning into the orbit of a world of higher tariffs and disrupted global supply chains. 2026 may be the year of transition for many nations as they navigate the geopolitical developments and the first full year of a tariffed world. The average effective tariffs for the world stand at 14% and that on Indian exports to the US are almost at the top of the table at 35%! The global growth and world trade is likely to undergo tectonic shifts in the newly tariffed world and we think 2026 would be the first year where the implications on investments, growth, inflation, rates, and currency would start showing up. The increasing number of bilateral trade agreements between nations, and each country's equation with the US is likely to complicate the trade & commerce map – with the US becoming the north star in the navigational compass for trade.



Sources: RBI, Worlduncertaintyindex, Bloomberg

India's Macroeconomic Landscape

Look back at 2025:

2025 was clearly a tale of two halves as far as India rates and currency is concerned. The first half was marked by a largely stable rupee, recouping of forex reserves by the RBI to a peak of 703bn in end June, an aggressive 100bps rate cutting spree by the RBI MPC and a 50bps rally in 10-year government bond yields. All of this was broadly in sync with our expectations outlined at the start of 2025 and if anything, a positive surprise even versus our above consensus bullish expectations.

However, the darker tone for the second half of the year was set by the negative tariff surprise for India, which initially seemed like a short term blip, but as the year went by – the continuing negative impact started weighing on INR weakness, trade and BoP data and RBI's liquidity management as well. From 1st July, the INR weakened by ~4.2% - standing out as one of the weakest performers versus its EM peers, forex reserves started reducing – with RBI shifting the pressure from spot to the forward book and government bond yields starting moving higher by almost 25-30bps despite RBI reducing rates by another 25bps at its December policy; taking the total easing to 125bps in CY25.

While the domestic macro fundamentals suggest a golden period for our economy, with RBI's FY26 GDP growth estimates up to 7.3% (6.7% at start of the year) and average CPI at 2% (4.2% at the start of the year) – all eyes are instead on the external front where the wait for a “good” trade deal with the US is getting longer and more uncertain.

This policy uncertainty was visible in market volatility through the year; especially currency, which was the worst performing currency in Asia, down ~6% YTD CY25. Notwithstanding these headwinds, India has shown remarkable poise, due to domestic factors and policies with equity markets up YTD by ~9.5%, bond yields modestly down ~16 bps (CY25 data till Dec) with FX reserves showing an accretion of US\$ ~46 bn to US\$ 687bn (as of 5-Dec).

CY26 - A FINE BALANCING ACT

2025 was characterised by fiscal boost to growth, accompanied by monetary policy easing. The government has reduced personal income tax rates and rationalised indirect taxes under GST. Concurrently, monetary policy has become more accommodative, with policy rates lowered by 125 basis points to 5.25%, increased system liquidity through CRR cuts and OMO purchases, and FX Buy/Sell Swaps to manage currency volatility.

This coordinated approach is expected to support domestic growth in CY26, although policy options, hereon, would be limited. The focus shifts to navigating trade negotiations with the US, where progress has been delayed and continues to require careful footwork. After such an eventful year and with so much done on the fiscal and monetary policy fronts, the most immediate question becomes what more? We narrowed down on five key domestic drivers that shape our outlook for 2026.

1. Can India keep pushing on the growth pedal in 2026 without stirring up inflation?

In our view, yes. Despite sustaining 6.5-7% trend growth through the year, inflation is likely to average just 3.5% in 2026, well below the MPC target of 4% with structural factors expected to keep inflation well contained. All this is of course on the assumptions of a good monsoon and a stable global commodity regime. While US tariffs present headwinds to India's growth outlook, fiscal and monetary easing in 2025 provide offsetting support. The RBI's MPC faces a fine balancing act as it manages forthcoming base revisions to both CPI and GDP.

2. Is there more space on fiscal and monetary levers to further push on the growth pedal?

Following the expansionary measures in 2025, the government's fiscal capacity is now more restricted, particularly at the state level where resources are stretched. With recent tax incentives and sustained capital expenditure, there is limited room for additional fiscal intervention to support growth. As the government transitions its fiscal anchor from deficit management to a debt-to-GDP target of $50 \pm 1\%$ by FY31, fiscal policy will require careful calibration. State-level fiscal positions remain weaker than the Centre's and will be a key area for monitoring.

On the monetary policy front, while majority of the heavy lifting is already done, **we still ascribe a >50% probability to one last 25bps cut by the MPC at either the Feb or the April policies, before we settle at 5% rate for a prolonged period.** While it is natural to start worrying about the inevitable rate hike at the end of an easing cycle, we believe it is premature and do not expect any rate hike in 2026.

3. Would liquidity management and credit-deposit trends pose a challenge?

The unexpected FX intervention has been a drag on banking system liquidity in 2025. In our view, this is likely to be a key challenge for the economy and for the RBI to manage as we head into 2026, more so as credit growth is likely to move higher from 11% currently, while deposit growth remains stuck in a 10% range. The RBI would need to ensure adequate reserve money creation in the system, which is currently languishing at 1.5-2%. We expect the RBI to continue with their proactive liquidity infusing stance, ensuring the benefits of monetary transmission do not get frittered away similar to what we saw in the latter half of 2025.

4. What will arrest the INR's unidirectional weakening trend?

The elephant in the room undoubted is the rupee trajectory and the key hope there is for an early trade deal with the US, putting us on a favorable footing versus other peer exporters. Managing the rupee in 2025 has been a tough balancing act, with rising dollar demand, a widening trade deficit, and capital outflows all testing the RBI's ability to walk the tight rope. Historically, the currency tends to experience sharp depreciation every two to three years, typically driven by significant global developments—as observed in 2013, 2015, 2018, and 2022. After such periods, the rupee trajectory generally tends to stabilize over the next few years, tracking domestic macroeconomic fundamentals. While it is hard to predict exactly when the rupee weakening peaks off this time around, given the strong underlying macro fundamentals – **we do believe we are closer to the end of the sharp depreciation phase, after which it may settle into a more stable range through rest of 2026.** On a real effect exchange rate

basis, the rupee has weakened almost 10% making it cheap on long term valuations. **In an optimistic scenario, a sudden reversal in the rupee trajectory can also not be ruled out on a combination of a beneficial trade deal announcement, strong policy driven offshore investor inflows, along with potential confirmation of Bloomberg Global Aggregate Index inclusion.**

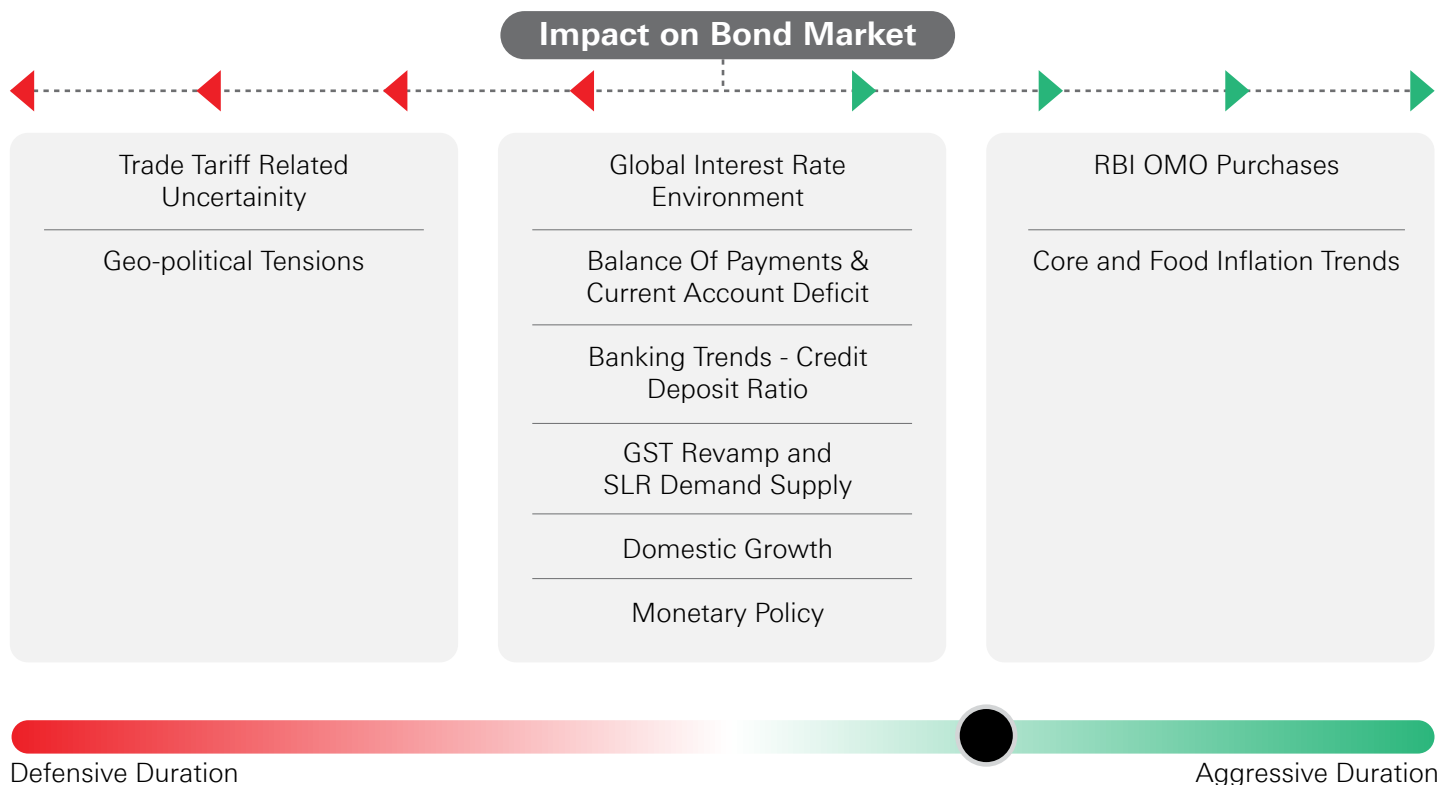
5. Will the demand-supply equation pressure yields higher in 2026?

The Centre is expected to walk a tightrope, balancing multiple objectives without increasing G-sec issuance. However, fiscal developments at the State level are likely to keep overall bond supply elevated year-on-year, particularly with a substantial pipeline of State Development Loans (SDLs) anticipated in CY26.

We expect 1.5-2.5 lakh cr of OMO in Q1 2026, with potentially another 2-3 lakh cr OMO in rest of the calendar year depending on the extent of accretion / depletion of FX assets on its balance sheet. This in our view, may tilt the demand-supply equation for central government securities in a favorable manner. The joker in the pack would be any confirmation of inclusion of Indian bonds in the Bloomberg Global Aggregate Index in Q1 2026, which could then lead to 15-20bn USD of FPI inflows, creating a very positive technical backdrop for Gsec. We remain wary of State Development Loans (SDLs), as the supply worries in that segment are likely to continue, pushing SDL spread over Gsec higher, even from the currently elevated 75-80bps.

Our top-down analysis indicates that the macroeconomic environment remains fairly conducive for rates to remain steady and lower for longer, with risks emanating from external sector & global developments. Accordingly, we expect the fixed income markets to consolidate, with wide trading ranges and higher volatility, as we approach the end of the easing cycle, and the markets shift focus on timing the reversal of the current loose monetary policy.

In the above backdrop, we think, it would be prudent to have an accrual strategy in portfolio positioning in 2026 along with some tactical calls on long-end of the curve. The below is a snapshot of what factors are in focus for the Indian Bond markets:



Investment Strategy: Staying Nimble Footed

On balance, amidst all the global uncertainty and the known unknowns, we are taking a neutral approach to the Indian bond market for 2026, favoring an accrual strategy, with the intent to remain nimble footed in our strategies and using overweight duration position as a tactical call to capture alpha, as and when such opportunity emerges.

As we start 2026 - We remain positive on 2-3 year corporate bonds, which has recently seen spread widening this month and remains at fairly favourable spread over IGBs.

As we ease into April 2026, sufficient liquidity is likely to provide an opportunity here for capturing spread compression. We also remain positive on 7-12 year segment in IGBs which may benefit from OMO purchases, while looking at 30-40 yr segment more as a tactical call. We continue to remain underweight on SDLs in duration products given likely higher supply in Q4.

Steady Footing Amid Global Shifts

The year 2025 came with its own twists and turns, keeping market on its toes as it navigated through tariff shocks, low inflation-high growth conundrums, a constant will they/wont they debate on rate cuts and finally the Rupee unfortunately hogging the limelight. Year 2026 will likely come with its own share of surprises and investors should take a nimble footed approach, as always. But amidst all this, India's resilient macroeconomic fundamentals offer a solid foundation to be able to deal with such challenges as we navigate through 2026.

Source: RBI, Worlduncertaintyindex, Bloomberg and HSBC MF FI Desk, Data as on Dec 15 closing, IST or as specified.

Note: World Policy Uncertainty (WPU) - The WPU is computed by counting the percent of word "uncertain" (or its variant) near a word related to policy and politics in the Economist Intelligence Unit country reports. The WPU is then rescaled by multiplying by 1,000,000. A higher number means higher uncertainty and vice versa.

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