HSBC Mutual Fund

Debt Market Review

Sovereign yields surge globally

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Geopolitically, renewed US-Iran military exchanges and the ongoing Strait of Hormuz standoff kept oil prices elevated and averaging ~US$88/bbl, with it currently hovering even higher at US$97/bbl; adding an inflationary tail risk into the month-end and persisting. Globally, there was a rise in hawks at major central banks, including India's RBI MPC which was revealed in its August policy minutes.

August was defined by two dominant themes, viz. rising global yields and escalating geopolitical risk. The long-end bond yields in the US, Europe, and Japan climbed to multi-year highs, driven by sticky inflation, heavy government borrowing, and a hawkish pivot in central bank rhetoric. Amongst all, the most notable was the policy signalling from the US Fed Chair at the Jackson Hole Symposium, where markets moved to price a September rate hike. The US Treasury Secretary's surprise bond buyback announcement provided a brief mid-month respite for fixed income, but analysts widely viewed it as insufficient to reverse the structural pressure on long-dated debt and overall, continued to keep US sovereign yields elevated. The US 10Y yield hovered near its highest levels since early 2025 through much of August, driven by persistent inflation concerns and rising global government debt. In August, the US was set to pay its highest cost on 30Y debt in roughly a quarter century, with a US$25 bn 30Y bond auction on Aug. 13; and the buyback announcement led gains were short-lived with the 30Y hovering at multi-year peaks.

Back home, the benchmark 10Y yield swung higher, following the MPC minutes which appeared far more hawkish than the RBI MPC's policy day. This coupled with the global bond sell-off and surge in oil prices all pushed the bond yields higher. However, even then, as compared to many global peers, the surge in India's 10Y yield has been far more measured in the last 3-6 months – thanks to the favourable macro environment. A slew of macroeconomic data releases continued to reflect India's strong fundamentals: the resilience in economic growth, the acceleration in credit offtake cycle, sharply improved balance of payments position, Centres' steady fiscal accounts. On the flip side, the risks emanate from a weaker monsoon (trailing ~14% of normal, so far) and the sharp uptick in oil prices. Alongside these external headwinds, particularly commodity-driven inflation pressures, a more hawkish tilt among major central banks is likely to increase pressure on India's policymakers to eventually shift towards policy tightening too.

The key highlight was RBI's decision to pre-maturely withdraw one of its FX measures it announced on 05-June-26. This announcement coupled with hawkish remarks revealed in MPC's August minutes, sent yields higher as markets started to price a policy exit as early as 07-October-26. The closure of the FCNR(B) deposit scheme one-month prior started to go down well with market participants once the RBI released the dollar mobilization data – which clocked US$ 136bn of which a whopping US$ 127bn was mobilized via the NRI diaspora (the FCNR(B) scheme). The massive dollar influx until 2nd September (from 8th June) has consequently led to a deluge of rupee liquidity in the banking system; bringing about a new challenge for the RBI to drain this excess liquidity. Resultantly, this has kept market participants on tenterhooks as it remains unclear and ambiguous as to what policy instruments the RBI would deploy to absorb this excess liquidity. Would the RBI use temporary tools from its toolkit, or would it rely on durable instruments. So far, the RBI has been using the Variable Rate Reverse Repo auctions, alas, the participation has been rather lukewarm which may compel the RBI to look at instruments which are more durable in nature.

When it comes to a potential policy pivot by the RBI's MPC, the key question is how the RBI would adjust and align system liquidity alongside any rate hike. In our view, the MPC's first rate increase is most likely in Dec'26. However, the hawkish tone reflected in the Minutes, together with external headwinds, particularly the West Asia conflict which has intensified inflation concerns, means the 7th October MPC meeting is now a "live" event, versus the earlier expectation that it would be a non-event before the Minutes were released. In parallel, markets are focused not only on the MPC's stance, but also on how the RBI handles the liquidity overhang from FX inflows, which has created a significant liquidity glut. System liquidity is currently running at around INR 11 lakh crore (as of 06-Sept-26).

Fund positioning

Markets are currently at a crucial junction with multiple factors at play. On one hand, the significantly higher than expected FCNR (B) deposit number will result in banks looking for assets to deploy, pushing yields lower. Additionally, the liquidity created due to these deposits has pushed short end rates sharply lower, amidst lack of CD supply. This higher than anticipated liquidity has put RBI in a situation where they need to withdraw excess liquidity from the system over the next few months. RBI has multiple tools at their disposal, vis-à-vis long tenor VRRR auctions, Cash Management Bills (CMBs), FX Sell Buy Swaps, Incremental CRR (I-CRR) and OMO sales. RBI will look to deploy some of these tools to remove excess liquidity from the system. Given that the recent MPC minutes were slightly hawkish than the policy itself, it might be imperative for RBI to withdraw liquidity before eventually raising rates. On the other hand, geo-political tensions continue to push crude prices higher and domestic inflation is expected to pick up. This, along with markets pricing-in a 60% chance of the Fed rate hike in September, will put pressure on domestic yields.

We believe it is important to be cognizant of the risks at play. Against this backdrop, we have reduced duration across our funds. We remain neutral in duration positioning across our short end funds. Across our bond funds and duration funds, we have turned underweight versus our peers by reducing exposure to G-Sec. We have maintained our allocation to corporate bonds as spreads of corporate bonds continue to remain favorable. We will keep monitoring incoming data to evaluate if we need to change our current positioning.

Investors with 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 a good investment opportunity as it provides reasonable accrual in a lower duration product.

Abbreviations:

RBI: Reserve Bank of India
MPC: Monetary Policy Committee
SDF: Standing Deposit Facility
MSF: Marginal Standing Facility
CRR: Cash Reserve Ratio
I-CRR: Incremental Cash Reserve Ratio
OMO: Open Market Operations
CMBs: Cash Management Bills
CD: Certificate of Deposits
GDP: Gross Domestic Product
CPI: Consumer Price Index
SDL: State Development Loans
G-Sec/IGBs: Government Securities
EMs: Emerging Markets
FX: Foreign Exchange
AEs: Advanced Economies
EM: Emerging Markets

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 September 7, 2026 or as latest available.

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