

Restating risks from term premium

We have for months been indicating the combination of neutral rates and term premium taking the 10y G-sec to a 'fair' value of 7.25%. With higher underlying inflation, benchmark rate recalibration appears to have been hastened. Emergence of fiscal dominance in a tight savings environment has also pushed up global term premium faster than expected. These appear to be taking rates to levels we projected, but fresh risks are emerging in terms of shocks to inflation, as well as the concept of fiscal*. This states a structurally higher fiscal deficit to achieve balance. Were these to be achieved, risks on rates are higher.

September 02, 2026

Interest rates

Monthly update

Exhibit 1 - Projections of India benchmark rates

	1y OIS	5y OIS	2y IGB	10y IGB
Mar'27	6.15	6.35	6.60	7.00
Jun'27	6.20	6.55	6.60	7.25
Sep'27	6.20	6.35	6.60	7.25
Dec'27	6.20	6.20	6.60	7.25
Mar'28	6.20	6.20	6.60	7.25
Jun'28	6.20	6.20	6.30	7.25
Sep'28	6.20	6.20	6.30	7.25

Source: Axis Bank Research

MPC minutes, FCNR closure, liquidity concerns, data push yields up (Figs 1-2)

India rates were lower early on, with markets seeing the MPC meeting as further postponing rate hikes (not our view), despite continued geopolitical developments. Lower crude oil demand forecasts in the second week led yields lower still. The third week saw yields rise back with the RBI announcing an early end to the FCNR scheme, while MPC minutes were seen as hawkish (matching our view). The last week saw yields rise further on fears of liquidity measures, stronger than expected India GDP & IIP, and Jackson Hole comments of Fed chair Warsh seen as implying openness to hiking rates.

Rate recalibration hastened, term premium and fiscal* are risks

Inflation prints continue to show transmission of input shocks – our work shows a 4 month lag with 18% transmission (Fig 4) of imported WPI. Adding fresh shocks from the Monsoon and global developments, we see the path to reaching 6% neutral (Fig 5) as hastened. We have written about this many times, showing how global neutrals are transmitting to India. Mixed India GDP growth numbers (Figs 6-7) forestall hikes above neutral for now, though risks do exist. However, there are greater risks from transmission of high global term premium to India, where domestic levels have been suppressed by heavy OMOs (Figs 8-9). There is also a larger question around the overall public sector borrowing need (or fiscal*) being higher (Figs 10-11), potentially indicating longer-term supply risks.

Our rate views so far have been base cases, but upside risks might be emerging

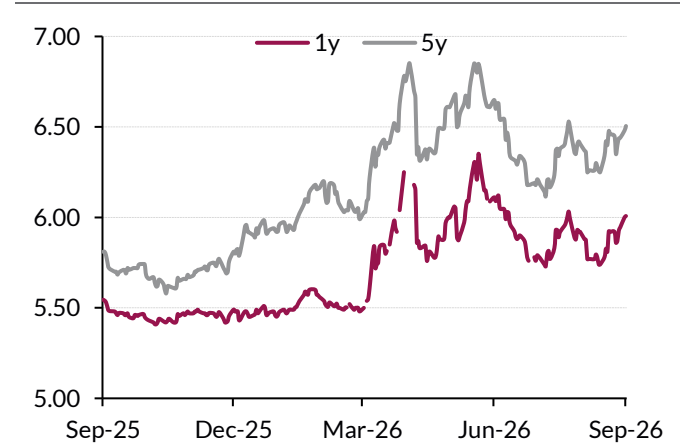
We have been pencilling in 75 bps rate hikes in OIS with steepening of term premium for months now. While conditions are finally beginning to approach this, there are risks developing. The first is to the inflation forecast, with potential pump price hikes, higher gold, food prices and telecom subscriptions. These can push our 4.7% FY28 inflation forecasts also to the upside, requiring rates to rise above neutral. Second, global term premium is likely to increase further, forcing India premia to increase just as increased fiscal spending is seen as more appropriate. We continue to see 7.25% on the 10y G-sec as fair, but the above factors could push these higher.

Tanay Dalal

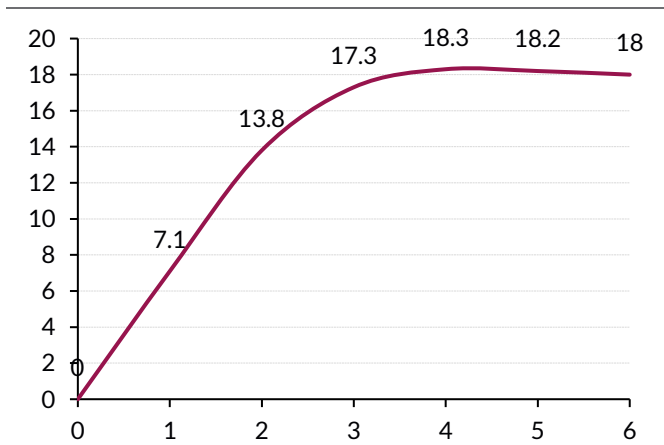
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Exhibit 2 - G-sec yields rise with oil, USTs, data

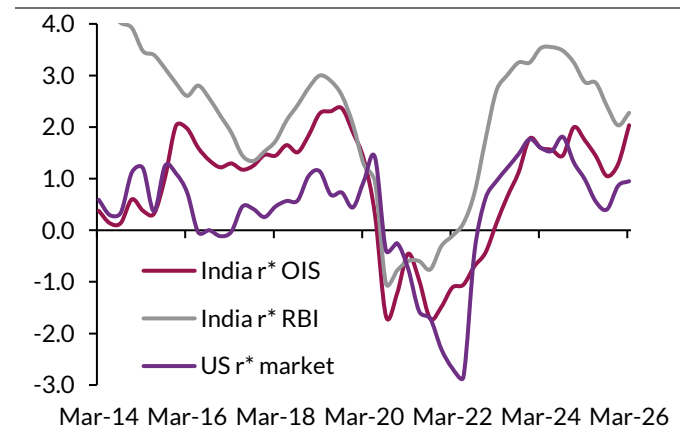

Source: Bloomberg, Axis Bank Research

Exhibit 3 - OIS also higher on the same dynamic


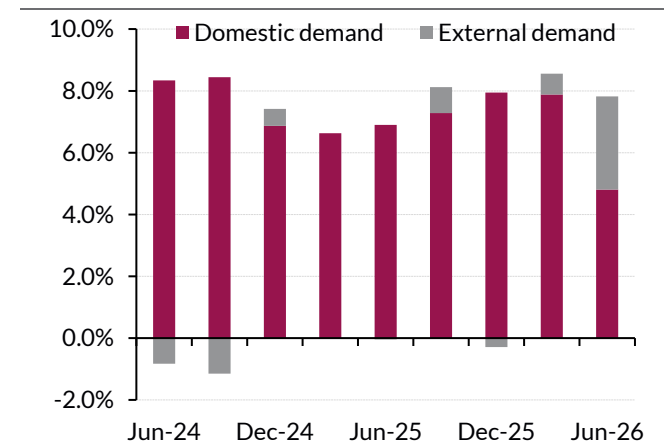
Source: Bloomberg, Axis Bank Research

Exhibit 4 - Transmission of shocks from WPI to CPI imported inflation is of 18% in 4 months' time


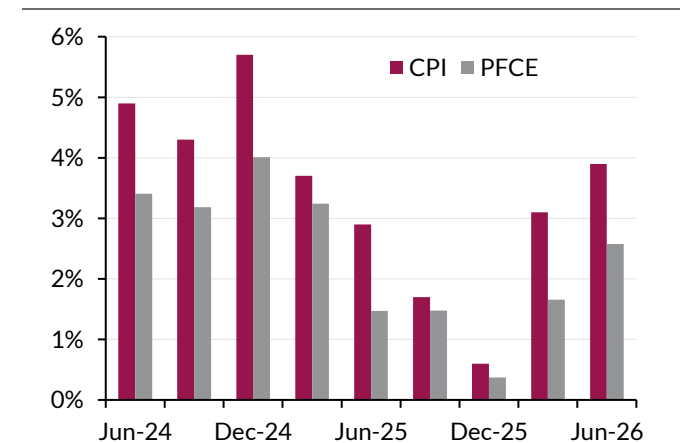
Source: Office of the Economic Adviser, MOSPI, Axis Bank Research

Exhibit 5 - India neutral rates have risen with global trends – seen at a 2% real rate


Source: RBI, MOSPI, Bloomberg, Axis Bank Research

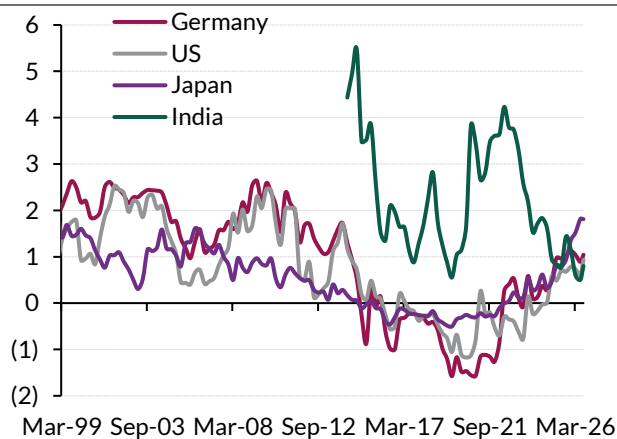
Exhibit 6 - The latest print shows a chunk of growth on iffy external demand


Source: NSO, Axis Bank Research

Exhibit 7 - PFCE inflation lags CPI inflation – like in the past, high price periods lead to demand substitution


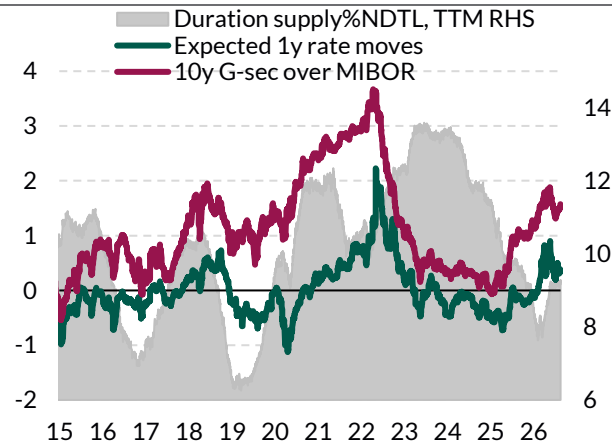
Source: NSO, MOSPI, Axis Bank Research

Exhibit 8 - Global 10y term premiums are higher – but is India too low??



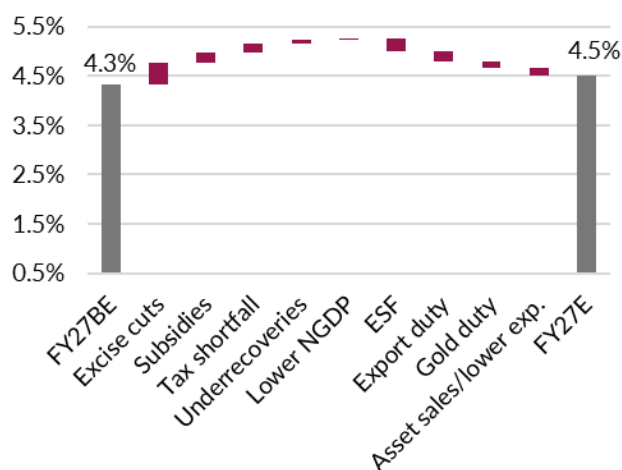
Source: Bloomberg, RBI Axis Bank Research

Exhibit 9 - With low duration supply – but this is now reversing



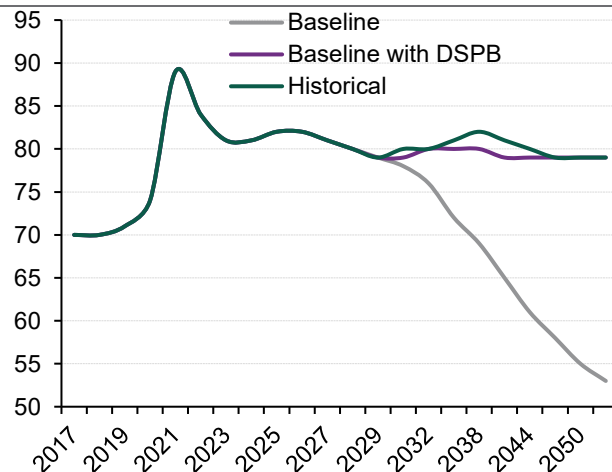
Source: RBI, Bloomberg, Axis Bank Research

Exhibit 10 - A 20-30 bps fiscal slippage is the base case, unlikely to increase supply this year



Source: CGA, Axis Bank Research

Exhibit 11 - India's IMF DSA study – the do nothing scenario preserving debt questions whether fiscal is too tight



Source: IMF, Axis Bank Research

MPC minutes, FCNR closure, liquidity concerns, and stronger data push yields up

India rates were lower early on, with markets seeing the MPC meeting as further postponing rate hikes (not our view), despite continued geopolitical developments. Lower crude oil demand forecasts in the second week led yields lower still. The third week saw yields rise back with the RBI announcing an early end to the FCNR scheme, while MPC minutes were seen as hawkish (matching our view). The last week saw yields rise further on fears of liquidity measures, stronger than expected India GDP & IIP, and Jackson Hole comments of Fed chair Warsh seen as implying openness to hiking rates.

Doveish interpretation of MPC pulls yields down in 1st week

India rates opened August higher with the 10y benchmark yield at 6.8481, the 2y yield at 6.2057, the 5y OIS at 6.3720 and the 1y OIS at 5.8875, following chatter of disruption to shipping in the Strait of Hormuz and with stronger Eurozone inflation. This was also added to by disappointment over the deferral of inclusion of India paper in the Bloomberg GAI. However, cancellation of planned US attacks on Iran and lower oil prices led this to reverse. Moves lower continued with Qatar indicating draft language on a US/Iran deal ready, as well as with the MPC being seen by markets as doveish (we did not agree with this interpretation, please see our MPC note). The end of the week saw yields rise back with reports of explosions in the Strait of Hormuz and reports of Fed chair Warsh preparing for a rate hike. The week closed with the 10y benchmark yield at 6.7651, the 2y yield at 6.1173, the 5y OIS at 6.2613 and the 1y OIS at 5.7700.

Second week sees yields tick lower, with geopolitics, lower oil demand forecasts

The second week saw yields trade flat with lower global yields after softer US payrolls was offset by higher crude oil with Iran seen attempting to shift the goalposts on compensation. Geopolitics then pushed yields higher, though this was capped by positive comments from Qatar and Pakistan around developments in Iran talks. This was further boosted by chatter of US/Iran MOU extension, though offset by slightly higher than expected India CPI inflation. Comments from US and Iran indicating continued conflict was offset by lowering of crude oil demand forecasts by the OPEC and IEA, keeping yields low. The last day of the week saw long positions being squared with higher crude oil prices amid tanker attack reports. The second week closed with the 10y benchmark yield

Exhibit 12 - G-sec yields rise with oil, USTs, data



Source: Bloomberg, Axis Bank Research

Exhibit 13 - OIS also higher on the same dynamic



Source: Bloomberg, Axis Bank Research

at 6.7578, the 2y yield at 6.1397, the 5y OIS at 6.2500 and the 1y OIS at 5.7400.

Early end to FCNR scheme, MPC minutes drive yields back up

The third week saw the curve open 2-3 bps higher after the RBI announced early end of the FCNR scheme, as well as with crude oil after US president Trump indicating he could bomb Oman. Further upside was driven by oil prices with Mr. Trump ruling out an Iran ceasefire and with Iran indicating a fully offensive position. Some exhaustion was seen with yields ticking lower midweek, though MPC minutes being seen by markets as hawkish (agreeing with our preliminary thinking) led yields up. Comments from Iranian president Pezeshkian on it being better to exit the war with dignity pulled yields lower at weekend, even though this comment was reinterpreted after market hours. The third week closed with the 10y benchmark yield at 6.8495, the 2y yield at 6.2523, the 5y OIS at 6.4600 and the 1y OIS at 5.9150.

Liquidity measures, higher GDP/IIP and Jackson Hole take yields up at month end

The last week saw yields rise early on amid higher oil given reports of tankers being targeted in West Asia, but reversed as US sanctions turned financial (implying military action less likely). Yields fell with reports of fruitful Iran/Pakistan discussions, and with a US proposal. However, incremental CRR chatter given easy liquidity led yields higher – this was also helped with caution ahead of Jackson Hole. Stronger than expected IIP and Jackson Hole comments from Fed chair Warsh seen as being open to rate hikes led rates higher still at month-end. August closed with the 10y benchmark yield at 6.9509, the 2y yield at 6.2765, the 5y OIS at 6.4812 and the 1y OIS at 6.0000.

Rate recalibration hastened, term premium and fiscal* are risks

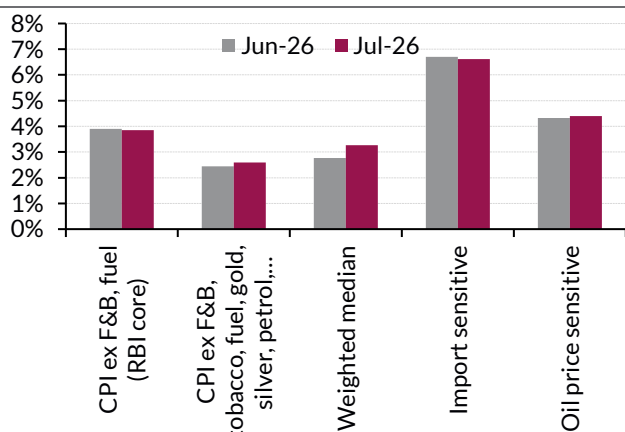
Inflation prints continue to show transmission of input shocks – our work shows a 4 month lag with 18% transmission of imported WPI. Adding fresh shocks from the Monsoon and global developments, we see the path to reaching 6% neutral as hastened. We have written about this many times, showing how global neutrals are transmitting to India. Mixed India GDP growth numbers forestall hikes above neutral for now, though risks do exist. However, there are greater risks from transmission of high global term premium to India, where domestic levels have been suppressed by heavy OMOs. There is also a larger question around the overall public sector borrowing need (or fiscal) being higher, potentially indicating longer-term supply risks.*

Recent inflation prints and MPC minutes bring forth tightening

The latest India CPI inflation print of 4.45% was suppressed by a high base in tomatoes and moves lower in gold prices - barring this, underlying inflation internals have been creeping higher. Of especial significance is the passthrough of increased globally transmitted prices - petroproducts, memory, agriculture into both domestic goods and services. Our research shows a direct link between global prices and WPI import inflation (this is because WPI indices take global prices as inputs) feeding into imported CPI inflation. The lag for this is around 4 months, with 18% of the imported WPI impulse transmitted into CPI in this period. This means that initial shocks until May have passed through, but further shocks resulting from higher prices of metals, further increase in memory prices and increase in crack spreads will continue to pass through. Add to this a potential 10%-15% increase in mobile phone tariffs.

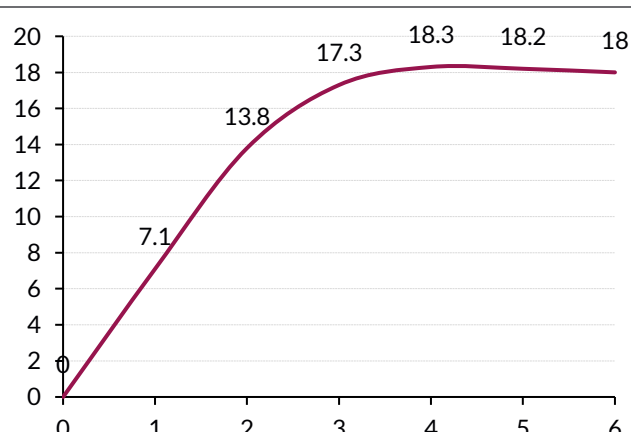
There are indications that these price increases have impacted demand. Though GDP PFCE remains steady at 7.1% in the Q1 reading, this is with the contribution of discrepancies at -3.2% the highest in the series – comparable with the 4% contribution of PFCE itself. Taken together, domestic demand is at a growth of 4.6%. This might also be seen in terms of weaker air traffic growth, along with potential cross-substitution towards lower priced items seen in the PFCE deflator dipping below the CPI deflator. At the same time, consumer confidence prints are also meaningfully lower, and retail credit offtake has picked up.

Exhibit 14 - Underlying inflation measures are beginning to rise



Source: MOSPI, Axis Bank Research

Exhibit 15 - Transmission of shocks from WPI to CPI imported inflation is of 18% in 4 months' time



Source: Office of the Economic Adviser, MOSPI, Axis Bank Research

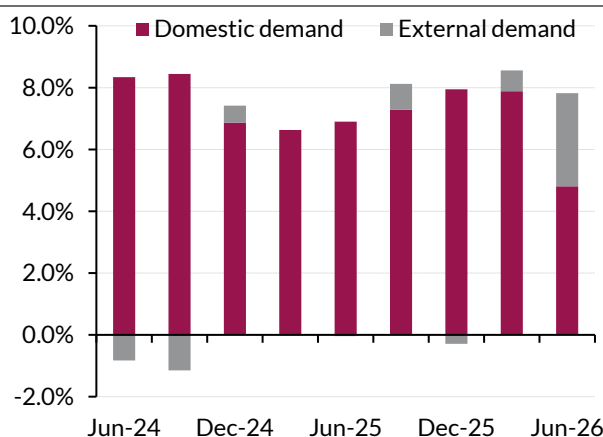
Rate hikes have been expected for some time, but low inflation prints have created space for caution until now. However, reading into the lines around recalibration of rates given normalisation of inflation bring up rate hikes in the medium term. This is likely to be somewhere towards neutral, reducing the level of policy accommodation, rather than a strict rate hike cycle.

Nominal neutral rates likely around 6%

India tightened fiscal conditions in the post-pandemic period, and has not yet reversed on this. Many countries have indeed begun to spend more fiscally. This has created a shift in global savings that we have often brought up, resulting in higher global costs of capital. Domestic costs of capital however, remain low. This means that the internal economy consistent neutral rate might be somewhere below 6% on a nominal basis. However, given open financial borders, we are being forced to accept higher global neutral rates of around 2% - witness steady financial outflows as a consequence of this, bringing de-facto rates higher. These de-facto rates are still below global levels, but likely push the equilibrium neutral rate closer to 6% on a nominal basis - potentially even above.

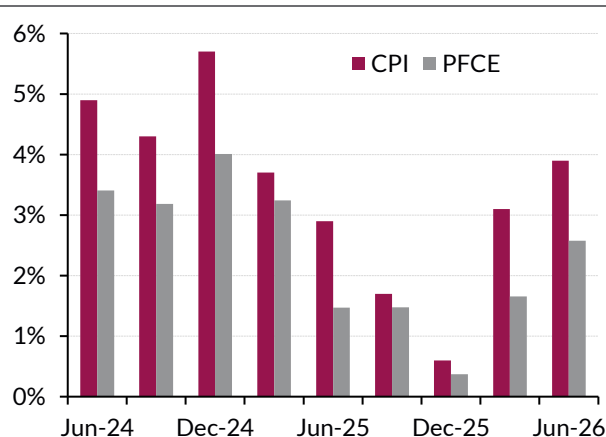
The MPC is likely to approach this level in the next 9-12 months with rate hikes potentially starting in October, but most likely in December. This is also likely to be accompanied by less easy liquidity conditions, pushing up the curve.

Exhibit 16 - The latest print shows a chunk of growth on iffy external demand



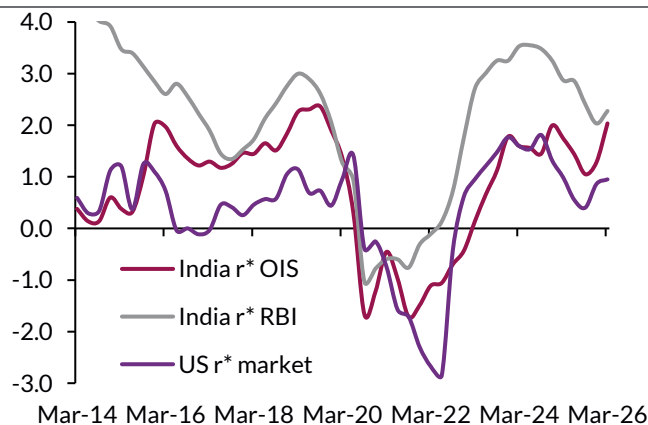
Source: NSO, Axis Bank Research

Exhibit 17 - PFCE inflation lags CPI inflation - like in the past, high price periods lead to demand substitution



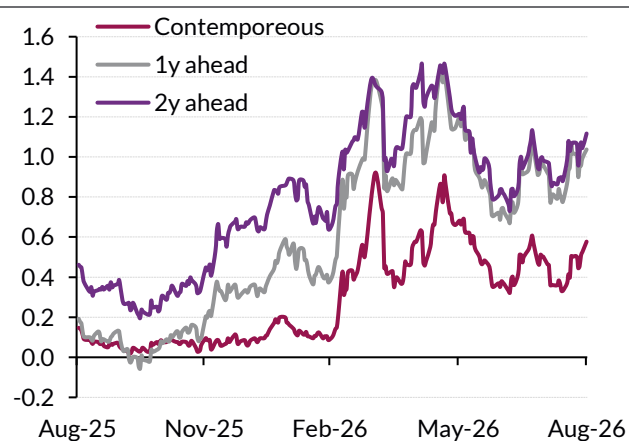
Source: NSO, MOSPI, Axis Bank Research

Exhibit 18 - India neutral rates have risen with global trends - seen at a 2% real rate



Source: RBI, MOSPI, Bloomberg, Axis Bank Research

Exhibit 19 - OIS markets pricing in terms of bps rate hikes - 100 bps is the base case, commensurate with neutrals



Source: Bloomberg, Axis Bank Research

Even with higher neutrals, term premium likely to increase further

Global term premium is set to continue to increase - this is a consequence not just of increased uncertainty, lower savings and higher fiscal. Rather, moves towards fiscal dominance seen in Japan and expected by us for the US drive this view. We have been arguing that steady fiscal expansion has historically only been managed by keeping rates lower than required by strict inflation targeting through history. This now appears to be coming true for the US as well, especially with the comments increasing the cap on long-end treasury buybacks to USD 4 bn per operation, then increasing this number, and then indicating that these could take place through direct buybacks rather than just twist operations. In the near-end a source of demand for securities might be created by stablecoin issuance and use, limiting increase in yields at this point. However, keeping interest rates too low will likely cause rapid money expansion, leading to eventual hikes - translating to a steeper curve.

India term premia are low in comparison - likely to rise

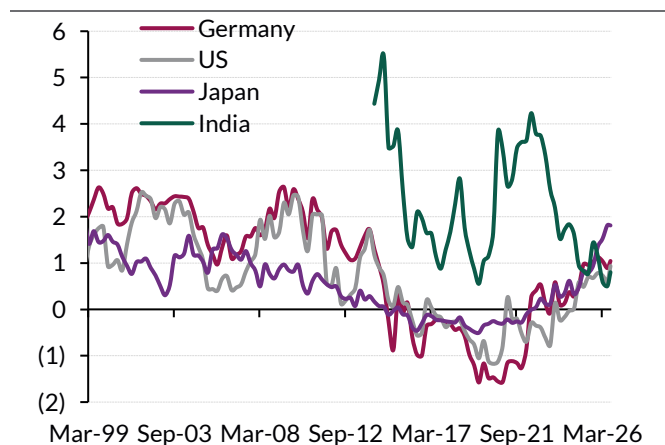
India 10y G-sec yields at 6.87% translate to 3.90% in USD terms - this is also what might be expected with unhedged carry, with 3% annual INR depreciation at the lower end of base cases. In contrast, yields of other countries across the EM and DM space have yields that are considerably higher. This fits the overall theme of India rates being too low, and potentially needing to rise. This implies expansion of term premium above 100 bps, targeting a 10y yield of around 7.25% - this has been our base case for a few months now. Absence of OMO purchases and moves to a tighter liquidity situation also imply this move.

A larger question on fiscal*

The dichotomy between costs of capital in India and elsewhere is also a reflection of fiscal policy being too tight. In the past decade, a tighter fiscal policy stance was desirable. Easier stances stuck out amid consolidation elsewhere, leading to higher inflation and current account deficits, while creating limited efficiency gains. However, in an environment where fiscal policy is now domestically tight, increased de-facto rates mean monetary policy is no longer effective, i.e. we are paying the price of a higher fiscal deficit but not reaping the gains. This brings about potential arguments around increased fiscal spending and supply, leading to further increases in term premium - this might also bring rates higher on a risk-adjusted basis, potentially crowding in foreign inflows. This is still speculative, but is being watched closely.

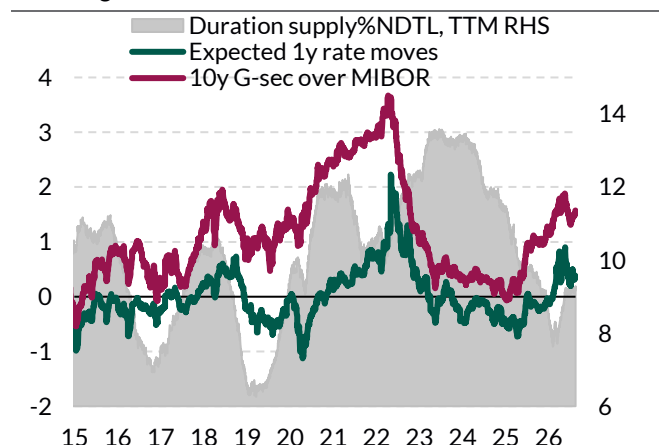
We therefore continue to expect rate hikes to a neutral of 6%, with OIS pricing this in in the near-end. Longer-end OIS might appear aggressive, but this potentially prices in

Exhibit 20 - Global 10y term premiums are higher - but is India too low??



Source: Bloomberg, RBI Axis Bank Research

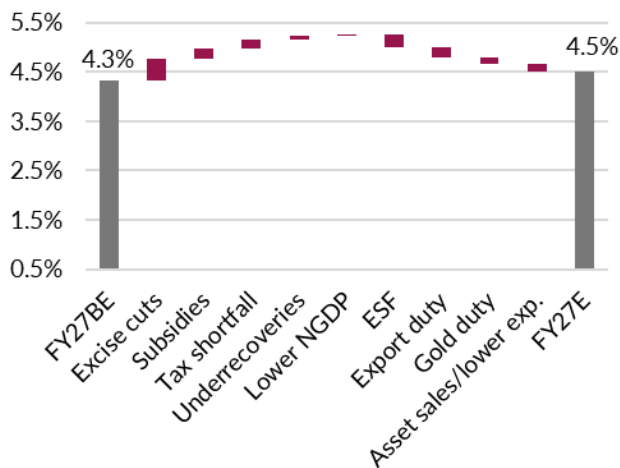
Exhibit 21 - With low duration supply - but this is now reversing



Source: RBI, Bloomberg, Axis Bank Research

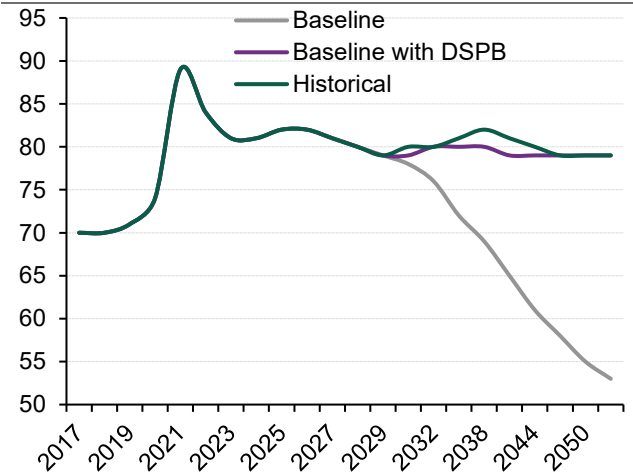
uncertainty or term premium. Higher levels might make for good received positions. We continue to see the 10y benchmark yield reaching 7.25%, especially if the US is unable to halt moves in 10y yields towards 5%.

Exhibit 22 - A 20-30 bps fiscal slippage is the base case, unlikely to increase supply this year



Source: CGA, Axis Bank Research

Exhibit 23 - India's IMF DSA study - the do nothing scenario preserving debt questions whether fiscal is too tight



Source: IMF, Axis Bank Research

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