India's Market Pulse

From liquidity cycle to investment cycle

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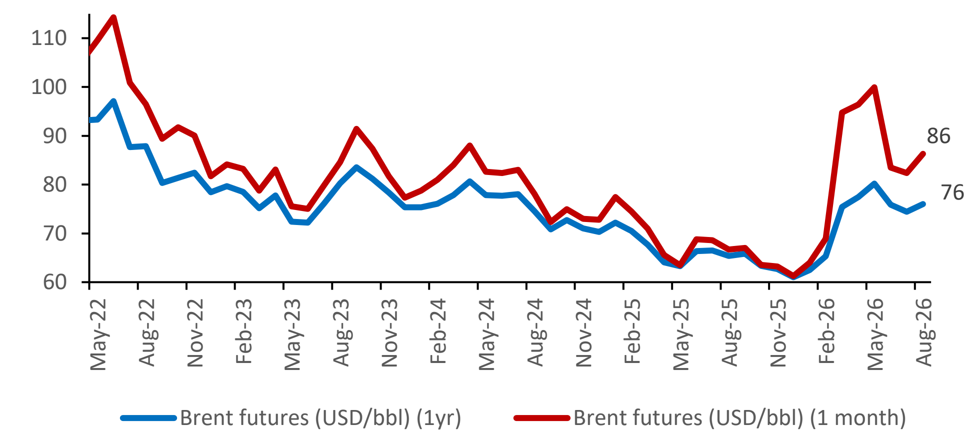
Even as fiscal dynamics and policy rate expectations keep global sovereign curves elevated and steeper, the ramifications of a prolonged conflict and supply disruption are gradually being visible in crude prices. Brent crude prices have rallied back to ~US$ 90/bbl. on an average in July and August 2026 vs ~US$70/bbl. by end June'26. In recent months, global bond markets are being driven by fiscal concerns and elevated energy prices impacting inflation outcomes. The prospect of inventory restocking and steady global growth should possibly keep prices elevated in the near term with ramifications on inflation expectations. Current CPI prints across most developed and emerging economies sit above their post GFC averages. Market yields across the Eurozone and UK have already priced in heavy tightening and look relatively better placed, whereas the US and Japan face more upside risks to rate hike expectations and hence yields. Term premium has risen because the macro backdrop is more uncertain. Fiscal deficit also matters for bond yields especially when stock bond correlation is positive. US Treasury supply has mostly grown through T bills, not dated securities, but at some point, given the refinancing risks, dated issuance will have to rise. Markets expect the BoJ to turn more hawkish soon, with additional rate actions.

Exhibit 1: Brent futures significantly higher than pre-war range



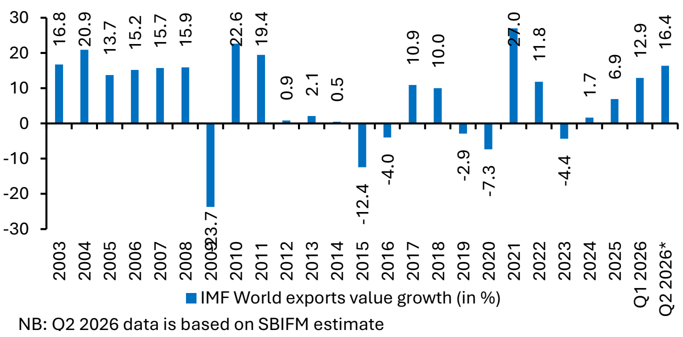
Source: Bloomberg, SBIFM Research

EQUITY

The global economy is moving from an era dominated by abundant liquidity to one shaped by higher investment. Capital spending is rising across defence, energy infrastructure, AI data centres, power systems and supply-chain reconfiguration. This supports nominal growth and capex-linked activity, but it also raises financing needs at a time when developed-market central-bank balance sheets are shrinking from their post-pandemic peaks. The result is that while on one hand the backdrop for valuations turns less forgiving for equities as inflation is proving sticky in several economies, bond yields are inching up, and the equilibrium cost of capital appears higher than in the previous decade, on the other hand the outlook for earnings improves as economy reflates. Therefore, earnings growth and not valuations should be the primary driver for equities going forward.

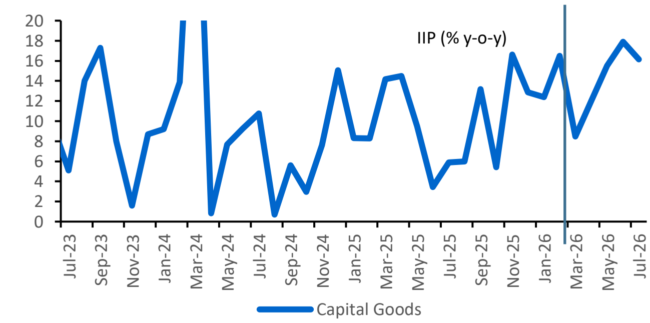
India's Q1 FY27 real GDP growth of 7.8% year-on-year was stronger than expected with composition better than the headline: real GFCF (gross fixed capital formation) and exports grew ~12% each against consumption at 7.1%. Investment and exports, rather than consumption, are emerging as the principal drivers of the current expansion. Three levers have driven the cycle so far: global investment and trade revival, domestic policy support (GST, income-tax, credit), and a wealth effect from equities, gold and land. Domestic policy support and the household wealth effect remain helpful, but their incremental contribution may moderate as the year progresses. Deficient monsoon rainfall stays a near term risk with rural economy and consumption likely to be impacted more. The investment cycle and global trade however stay strong and should do the heavy lifting on growth. As the confidence in economy grows, rate hikes should follow; however, calibrated hikes should not derail the economic momentum.

Exhibit 2: Global trade rebounds- underpinning the capex upturn



Source: Bloomberg, SBIFM research. Q2 2026 data is based on SBIFM estimate.

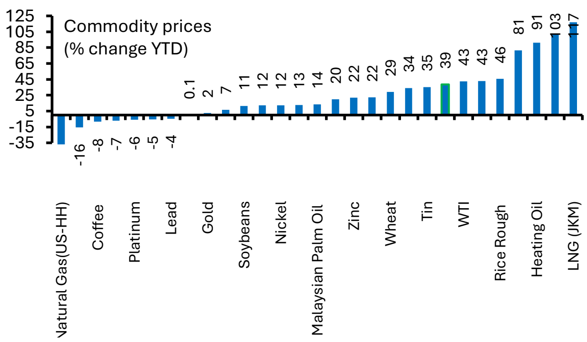
Exhibit 3: Capital goods momentum strong in India



Source: CMIE Economic Outlook, SBIFM research

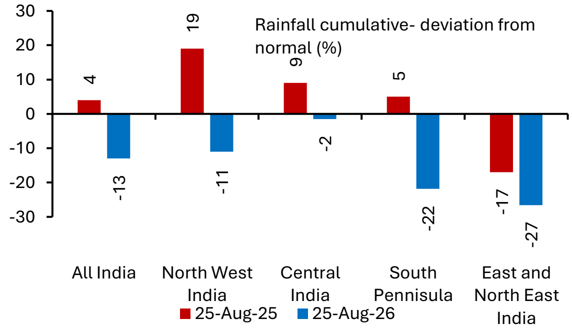
Energy, however, remains the most important macro swing factor. The prolonged Iran conflict continues to disrupt key shipping routes. China's earlier demand pullback and higher US petroleum exports helped contain the initial shock, but spot Brent averaged about US$90 per barrel in July and August, significantly higher versus about US$70 at June-end. Elevated energy costs and other commodities should test margins for most sectors. However, improved revenue growth and hence higher operating leverage can potentially offset some of the gross margin pressures.

Exhibit 4: High commodity prices pose headwinds



Source: Bloomberg, SBIFM research.

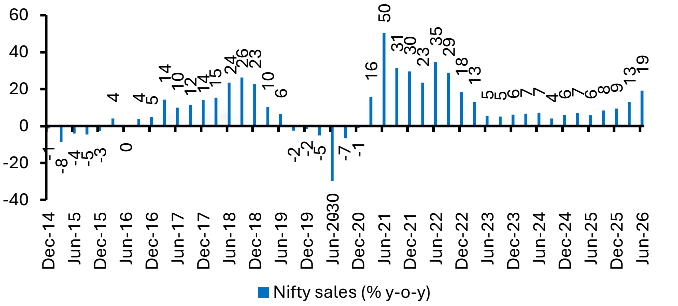
Exhibit 5: ...as does deficient monsoon rainfall



Source: CEIC, SBIFM research

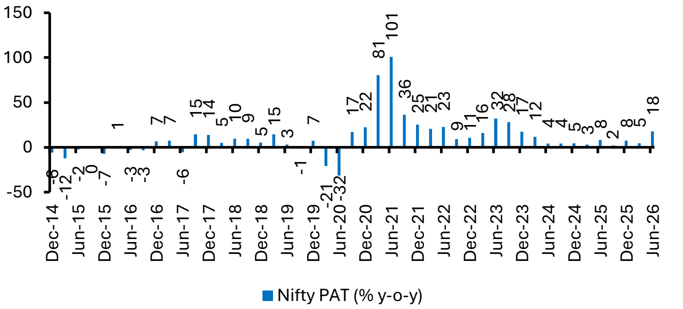
The earnings cycle is already showing signs of recovery after several quarters of subdued growth. Nifty revenue growth accelerated to 19% while profit after tax grew 18% year-on-year in Q1 FY27, compared with mid-single digits growth in the past many quarters, with strength across financials, metals, automobiles, chemicals and real estate. The path of earnings revisions is encouraging with an improving upgrade to downgrade trend, even as on an absolute basis, proportion of stocks seeing upgrades is nearly the same as proportion seeing downgrades.

Exhibit 6: Revenue growth improving



Source: MOSL, SBIFM Research. Results released for 50 NIFTY companies for June 2026 quarter.

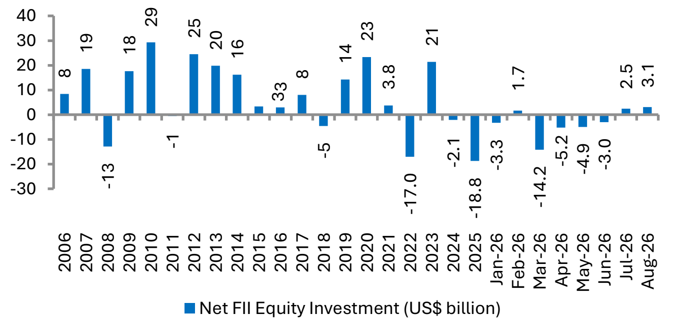
Exhibit 7: Profit growth trends improve as well



Source: Source: MOSL, SBIFM Research. Results released for 50 NIFTY companies for June 2026 quarter.

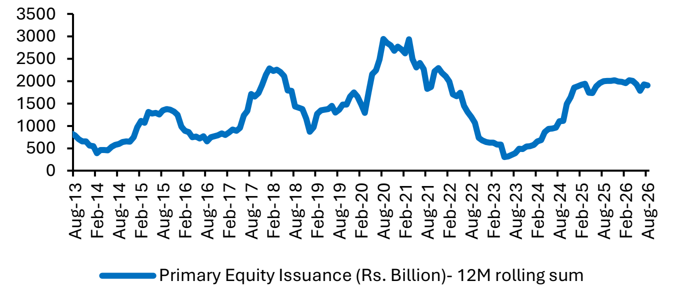
Large cap indexes, Nifty and Sensex, have been consolidating for over four months now. Indian equities softened in August, with Nifty and Sensex declining down about 1.1% and 1.3% respectively for the month and are down roughly 6.7% and 8.6 respectively year-to-date. Broader markets have been firmer- on a year-to-date basis, Nifty SmallCap 250 is up 10.7%, and Nifty MidCap 150 is up 6.4%. Foreign investors were net buyers for a second consecutive month, with approximately US$2-3 billion of purchases in each of July and August, while domestic systematic flows remained a stabilizing force. However, primary and secondary market equity supply stayed elevated providing a strong counter force to these inflows.

Exhibit 8: FPIs stay buyers for second month in a row



Source: Bloomberg, SBIFM Research

Exhibit 9: Primary market supply stays elevated



Source: Bloomberg, SBIFM Research.

Overall, the way forward is characterized by earnings being the primary driver for equities, as valuations face headwinds from rising yields. That said, valuations as measured through earnings-yield gap versus bonds have improved from the extremes of 2024, and India's relative underperformance has reduced some of its premium to emerging markets. The starting point is therefore much better, especially for large cap equities, even as elevated equity supply, higher global rates and geopolitical uncertainty may keep a lid on near-term index returns.

FIXED INCOME

July 2026 snapshot

Exhibit 8: FCNR(B)-led liquidity eases the short end; G-sec and corporate yields harden

Rates (%)		Jul-26	Aug-26	m-o-m (in bps)	YTD change (in bps)
Overnight	Repo rate	5.25	5.25	-	-
	TREPS	5.05	5.07	2	-18
	Overnight MIBOR Rate	5.41	5.24	-17	-43
Money Market	1 Yr T-Bill	5.74	5.80	6	26
	3M T-Bill	5.34	5.26	-8	1
	3M CD Yield	6.83	6.38	-45	51
	12M CD Yield #	6.89	6.70	-19	15
	12M CP Yield	7.33	7.51	18	67
Government bonds	3 year GSec	6.27	6.27	-	20
	5 year GSec	6.45	6.59	14	29
	10 year GSec	6.83	6.95	11	36
	30 year Gsec	7.47	7.56	9	29
	10 year SDL	7.55	7.50	-5	20
	30 year SDL	7.71	7.63	-8	7
AAA Corporate	3Yr AAA Corp bond	7.42	7.70	28	75
	5Yr AAA Corp bond	7.36	7.72	36	66
	10Yr AAA Corp bond	7.43	7.67	24	56
Swaps	1 Yr IRS	5.92	6.00	8	55
	2 Yr IRS	6.11	6.19	8	64
	5 Yr IRS	6.41	6.48	7	56
Others	INR/USD	95.39	95.17	0.2^	-5.9^
	Crude oil Indian Basket**	82.04	90.19	9.9	45.0

Source: Bloomberg, PPAC, RBI, CEIC, SBIMF Research; NB: *Corporate bond rate is for AAA rated bonds, **Crude oil price is average $/barrel for the month and INR, remaining data are % month end, ^INR and Oil price changes are % change, + denotes appreciation in rupee, -ve denotes depreciation, #data is for Mar'27 CD

Bond markets globally have witnessed material repricing in sovereign yields across most key jurisdictions. The evolving global context continues to be shaped by above target outcomes on headline inflation, weak fiscal metrics and the evolving large AI related borrowing that competes with sovereign long end supply. These dynamics continue to play out alongside the new normal of the US Fed eschewing specific forward guidance as in the past. Official interventions in currency and bond markets by key developed markets such as in Japan and the USA over the past month did not materially alter the dynamics of a steeper increase in yield curves.

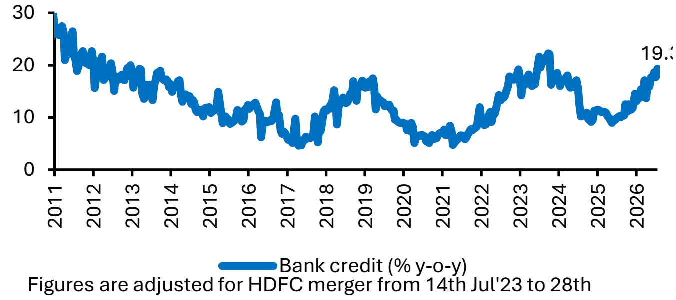
RBI August Policy review-

The minutes of the RBI August policy review gave a drastically different message than the dovish assessment given in the post policy briefings. During the month, the RBI also announced an early closure of the subsidised FCNR scheme. The August Monetary Policy minutes brought out concerns on inflation as well as need to recalibrate policy settings. This is in stark contrast to the policy statement and subsequent guidance wherein the RBI seemed to take comfort in various trimmed measures of inflation as against the legislated mandate of aligning headline CPI around the midpoint of 4%. The minutes seemed to confirm the likelihood that the policy stance could shift over the coming quarter, with even the October meeting likely to be a live event for policy action.

FCNR(B) Deposits

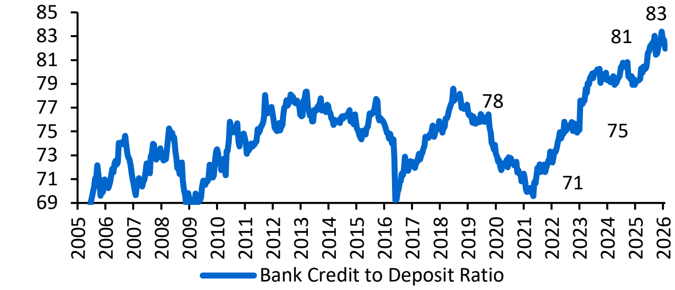
Much attention had been focused on the collections under the FCNR scheme. The final collection under the scheme at USD 127.2bn has been significantly higher than all estimates. Including the other 2 subsidised schemes for ECB and OFCB, the overall forex flows have been USD 136.37 bn. Additional flows are expected under the ECB and OFCB flows over the remaining months of this facility, that ends on 31st December. In the near term, these overseas deposits should normalise the gap between credit- deposit growth as well as aligning Bulk rates and CD rates lower.

Exhibit 9: Bank credit growth has been outpacing deposit growth…



Source: RBI, SBIFM Research

Exhibit 10: …pushing up the system-wide credit-deposit (CD) ratio to elevated levels



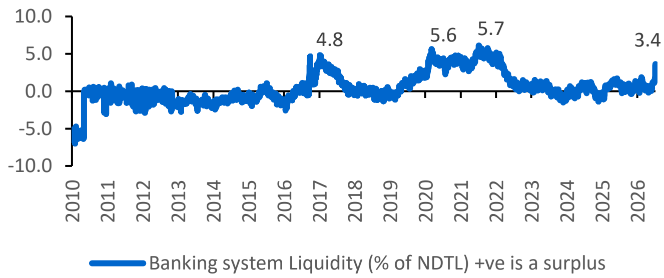
Source: RBI, SBIFM Research

Way Forward

The minutes of the RBI August policy, to the extent that it reflects the current thinking of the MPC should clearly point towards a policy normalisation to be initiated soon. The minutes reveal concerns on generalisation of price pressures, possible second order effects, real rates as well as the need to recalibrate policy rate settings. There has also been reference from the Deputy Governor with respect to policy rate hikes in the year. While all these risk factors were quite apparent at the time of the August review, surprisingly none of these concerns emerged during the policy briefing or in the policy statement. From a market angle, the evolving global context on rates and policy cycle sits alongside a more uncertain domestic reaction function of the central bank with respect to the liquidity management stance. Considering that policy transmission works through the liquidity channel, this clearly sets the stage for significant near-term volatility in domestic market yields, more so at the short end.

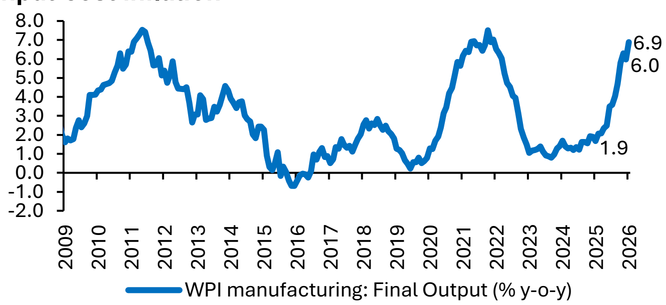
The larger than anticipated collections under the FCNR scheme has created a surge of primary liquidity overhang that is anticipated to be around 14 trillion+ at its peak over the coming days. In the absence of quick and adequate sterilisation of this to more sustainable levels, the policy rate recalibration would remain ineffective. Effective overnight settings currently remain way below the SDF rate, with even the operating target, i.e WACR (Weighted Average call rate) trading below 5%. The corresponding volatility in short end rates also warrants a more active liquidity policy that aligns with the intended policy rate settings.

Exhibit 11: Durable and banking liquidity surges



Source: CMIE Economic Outlook, SBIFM Research

Exhibit 12: Final output prices are firming up but still lag input-cost inflation



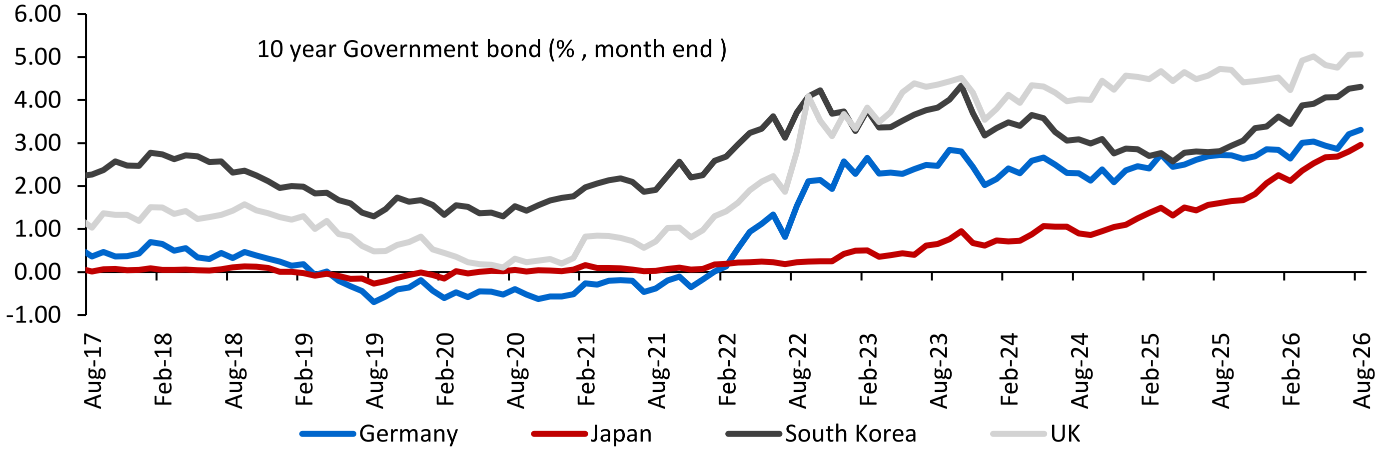
Source: CMIE Economic Outlook, SBIFM Research

From the entire gamut of likely options to sterilise liquidity, the RBI is clearly hamstrung by more effective instrument, i.e Market Stabilisation Scheme (MSS) that it doesn't have at its disposal. Short tenor VRRR (variable rate reverse repo) auctions remain ineffective, even as banks refrain from tendering at longer tenor auctions. Longer tenor VRRR auctions with early unwind flexibility as announced last week also would not address the issue of sterilising durable liquidity or aligning overnight rates near the policy rate. Market Stabilisation Bills/ Bonds issuance probably is the most effective instrument to deal with such episodic liquidity surges as they can be easily unwound as needed. However, the fiscal cost is directly borne by the government and the same remains unbudgeted as of now. In the absence of MSS, the RBI probably needs to resort to more blunt tools such as CRR hike, incremental CRR hike and Open Market Operation sales. Among all possible option to address surplus liquidity, OMO sales and Forex sell-buy swaps could be the most likely option as CRR and incremental CRR could penalise the wider banking system and these deposits were specifically exempted from CRR provisions.

Changing landscape of global rate cycle & Sovereign yield curves

The trajectory of global policy rates as well as yields provide less comfort. Weaker fiscal direction as well a prolonged period of above target inflation in most developed markets continues to support the case for higher global yields for a while longer. Recent gyrations in long term yields across most developed markets continue to provide a weaker setting. A flurry of central bank policy rate decisions including the FED are scheduled over the month. A relatively hawkish policy bias alongside additional tightening is broadly anticipated by markets.

Exhibit 13: Global Bond yields on a rising trajectory



Source: Bloomberg, SBIFM Research

From an investment perspective, the overhang of excess liquidity has clearly blunted pricing at the short tenor of the curve. With both liquidity absorption and rate normalisation overdue, there remains a case for remaining cautious leading into the policy meeting in October. Over the coming months as liquidity absorption and rate normalisation proceed, there could be a more appropriate entry point (from a timing angle) for other short -medium tenor bond products.