SBI RESEARCH

ECOWRAP

FIRST RATE HIKE OF 25 BPS IN OCTOBER AS COUNTER MEASURE TO TENACITY OF EXOGENOUS SHOCKS AND VOLATILITY AND PROPER COMMUNICATION: RBI RATE HIKE LIKELY TO BE INDEPENDENT OF ANY FORTHCOMING FED ACTION AS IN 2022 : EXCHANGE RATE MANAGEMENT REMAINS A MAJOR CONCERN

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Tempus fugit, or Time flies is a great saying since ages often accredited to Virgil. Seems, it just gets truer for financial markets going by the turn of events plaguing markets globally, with a panic like situation not far from the shores. Just one month back there were practically not much talks of rate hikes, and MOST (if not all) expected a "prolonged pause". But the situation has changed drastically since then. **Now we strongly advocate a 25-bps rate hike in the upcoming October policy (followed by another in December in quick succession), factoring the myriad evolving undershoots as detailed in this report. Out rate hike call is agnostic to August CPI inflation print that could comes around 4.8-4.9%. If oil prices remain at high levels, inflation print for October and November should move towards 6.5% or higher.**

First, crude prices recently crossed the $100/bbl mark amid heightened geopolitical uncertainties and our results from the quantile regression indicates that at 60th quantile over the next 15-days the prices can reach $123 / bbl.

Second, CPI inflation is showing incipient signs of generalizations. The risk of further generalization is particularly pronounced in sectors where input prices are currently rising faster than output prices, suggesting that the pass through has not been enough on producer's side, evident in Crude Petroleum & Natural Gas, beverages, pharmaceuticals, electronics etc. Going forward this could result in greater pass-through from producer prices to final prices especially in case of Crude Petroleum & Natural Gas as its imported share of 31.3%. **This provides a case for a rate hike now, followed by another in December (Total 50 bps as a moat).**

Further, globally, yields are inching past decadal highs surefootedly (we leave the pandemic disruptions for smoothening purposes) due to whirling synergy of multiple factors. A notable off-shoot is the vaulting US yields, 10Y within striking distance of 5% now (something unthinkable by majority of markets till a few days back) while 30Y has pulled back towards 5.40%, after a short lived reprieve emanating from the Treasury Department's tantrums to smoothen the longer end of the curve through elevated repurchases. Latest data shows tepid response to Treasury's first expanded buyback putting a question mark on efficacy and efficiency of policy tools to counter market mayhem (read: recent US Treasury Bond buybacks). **With US PPI up 0.4% in August (up 5.4% for the 12 months ended in August '26 while core PPI too is 4.6%), markets are reading between the lines of CPI (All Urban Consumers), which rose 0.4 percent, seasonally adjusted (SA), further having a bearing on Fed's rate hike probability (~71% now) though the Fed may still toy with other measures for now.**

An interesting, yet alarming analysis is that US increase has been dominated by the real-yield component, alongside a substantial rise in estimated term premium but other jurisdictions show more of local factors effects.

Back home, with benchmark Indian yields crossing 7% today (last seen on June 3 this year), we believe domestic liquidity can support the front end to some extent though not necessarily eliminating long-end pressure as an oil shock can work through several channels simultaneously. That essentially can checkmate the Mint Street strategy to keep volatility low and borrowing costs in check, signaling 10Y yields to travel some more miles (~10-15 bps), testing the May/March highs first but not limiting themselves there. **We believe 10 year yields should move up towards 7.15% or even higher tracking multiple cues.**

Against evolving scenario, this liquidity bulge looks more short-term in nature, tapering as we enter the festive season and should be absorbed optimally within the next 3/4 months rendering RBI to find it **less plausible to implement structural measures such as CRR or MSS/OMO (the last resort ideally going by today's numbers and response) operations**. **Also, going by the logic that RBI has concentrated more on OMOs targeting the short end of the curve, there is a fair likelihood of its tilting towards a possible rate hike should the brawl come to a fight.** Also, we estimate the liquidity to steadily taper through the remaining part of FY27 and it ideally should stand at ~Rs 6 lakh cr by March27 (sans accelerated OMOs).

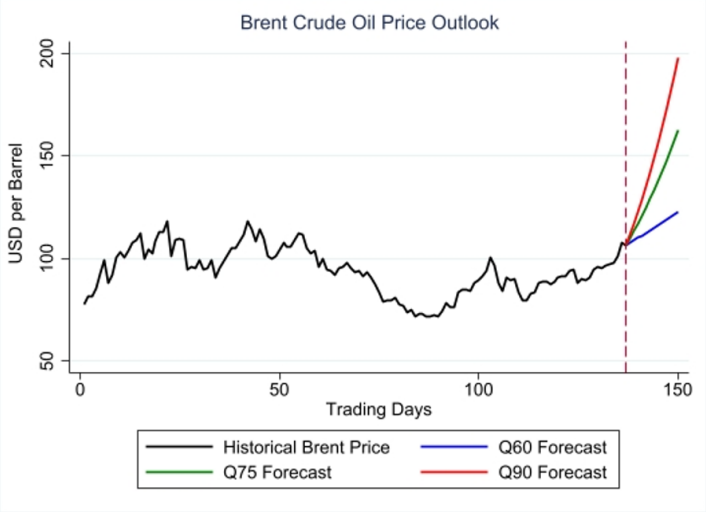
Clear, credible and consistent communication by the RBI is essential for anchoring inflation expectations, maintaining policy credibility and ensuring that temporary price pressures do not become entrenched in broader inflation dynamics. A shallow rate hike should serve many purposes at this juncture, most important building confidence in agility of the RBI. Also, it can go a long way in RBI leading the way in setting the course, and tone for others (read DMs) to follow!

OIL PRICE RISK AGGRAVATES

- **With intensification of conflict on both sides of the Arabian Peninsula, the risk of another spell of $100+ crude price looks real. The intensification of conflict in Straits of Hormuz has been further compounded by advances made by Houthis to exert control over the Red Sea and Bab-el-Mandeb**.
- As result, crude prices recently crossed the $100/bbl mark amid heightened geopolitical uncertainties. It becomes important to assess the potential persistence and magnitude of the ongoing upward price movement.
- **Our results from the quantile regression indicates that at 60th quantile over the next 15-days the prices can reach $123/bbl. While 60th quantile looks more realistic, higher quantile paths indicate worst-case stress, capturing the impact of sustained price momentum and elevated geopolitical risk, rather than a baseline expectation. An alternate specification using LTSM with 8 hidden layers indicate average price of $105/bbl for next 15- days**.

IS CPI INFLATION GETTING GENERALIZED?

- CPI inflation in new series has increased from 2.73% in Jan'26 to 4.45% in Jul'26. While inflation has increased considerably (though well-below RBI's upper target), the big question is about its generalization. Our research of data till Jun'26, indicate that the process of generalization has started. In Jan'26, 22 commodities explained 90% of CPI's weighted contribution. In July this number of commodities increased to 53.
- **Further, the top 25 commodities' (ex gold/silver), contribution has declined from 83% in Jan'26 to 75% in Jul'26.**
- **The risk of further generalization is particularly pronounced in sectors where input prices are currently rising faster than output prices, suggesting that the pass through has not been enough on producer's side. This is evident in Crude Petroleum & Natural Gas, beverages, pharmaceuticals, electronics etc.**



Weighted contribution of Commodities in overall inflation (No of commodities)

Share in overall inflation	Jan-26	Feb-26	Mar-26	Apr-26	May-26	Jun-26	Jul-26
25%	2	2	2	2	3	3	4
50%	4	7	8	9	9	10	10
75%	13	20	23	25	29	31	26
90%	22	35	41	48	57	61	53

Weighted contribution of Commodities in overall inflation (%)

Number of commodities (ex gold/silver)	Jan-26	Feb-26	Mar-26	Apr-26	May-26	Jun-26	Jul-26
25	83%	72%	71%	69%	66%	69%	75%
50	65%	55%	55%	54%	52%	55%	61%

Source: MOSPI; SBI Research

Items Group wise input Output spillovers

Item Group	Difference between input and output price (%)	Share in imported basket
Crude Petroleum & Natural Gas	0.72	31.30
Manufacture Of Beverages	0.10	
Manufacture Of Wood And Products Of Wood And Cork, Except Furniture; Manufacture Of Articles Of Straw And Plaiting Materials	1.07	
Manufacture Of Chemicals And Chemical Products	0.05	17.51
Manufacture Of Basic Pharmaceutical Products And Pharmaceutical Preparations	0.24	
Manufacture Of Fabricated Metal Products, Except Machinery And Equipment	0.83	
Manufacture Of Computer, Electronic And Optical Products	2.11	
Manufacture Of Electrical Equipment	3.99	
Manufacture Of Machinery And Equipment N.E.C.	0.12	
Manufacture Of Furniture	1.34	
Other Manufacturing	9.01	

- **Going forward this could result in greater pass-through from producer prices to final prices especially in case of Crude Petroleum & Natural Gas as its imported share of 31.3%. The sectors currently experiencing incomplete pass-through therefore constitute potential channels through which inflation could become more widespread.**
- **This provides a case for a October rate hike.** With inflation already becoming less concentrated and significant cost pressures yet to be fully transmitted, waiting for the entire pass-through to materialise in CPI would risk responding after inflation has become more entrenched. Restaurant inflation rose sharply as onions, edible oil, LPG became more expensive.

WHY CORE CPI HAS BEEN PERSISTENTLY BENIGN?

- While CPI inflation increased by whopping 172 bps during the July to Jan period, the core CPI increased by only 20 bps. One of the main reasons behind this benign increase in core CPI is due to contrasting change in "Restaurant & Accommodation" vis-à-vis "Personal care, etc.". While the inflation rate of former has declined during Jan-July period, it has increased in the latter category, thus nullifying the overall impact. Restaurant inflation rose sharply as onions, edible oils and LPG became more expensive, while higher transport cost and other operating costs added to more pressure. This came with lag due to menu cost frictions. Paan and tobacco inflation was driven largely due to the pass through of the higher taxes introduced in February 2026.

THE ELEVATED YIELDS CONUNDRUM

- With benchmark Indian yields slouching above 7% today (last seen on June 3 this year), we believe domestic liquidity can support the front end to some extent though not necessarily eliminating long-end pressure as an oil shock can work through several channels simultaneously, imported inflation, possible exchange-rate pressure, changes in the expected RBI response, and the compensation investors require for uncertainty. **That checkmates the Mint Street strategy to keep volatility low and borrowing costs in check, signaling 10Y yields to travel some more miles (~10-15 bps), testing the May/March highs first but not limiting themselves.**

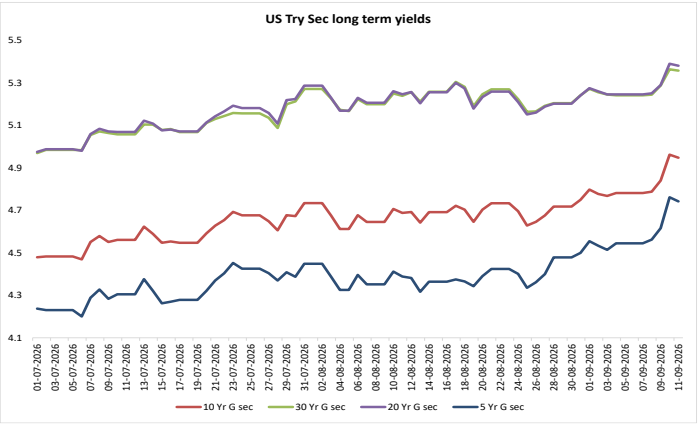
Weightd Contribution in Core inflation (%)

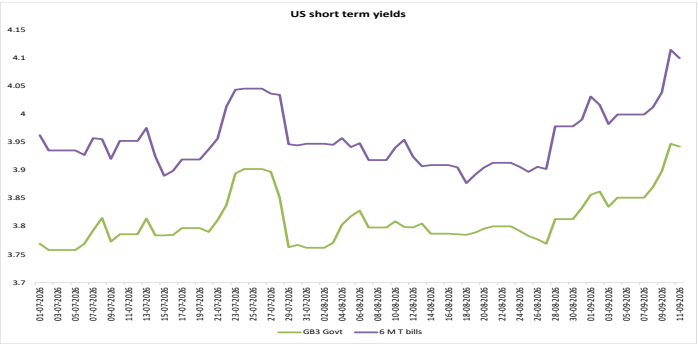
	Jan-26	Jul-26	Change in bps	Average	SD	% share in Core CPI Weight
Paan, tobacco and intoxicants	0.16	0.27	11	0.24	0.04	5.6
Clothing and footwear	0.36	0.41	5	0.36	0.03	12.0
Housing, water	0.46	0.51	4	0.48	0.01	23.2
Furnishings, household equipment and routine household maintenance	0.12	0.20	8	0.15	0.03	8.4
Health	0.25	0.15	-10	0.19	0.03	11.5
Transport excl Transport fuel	0.01	0.05	5	0.01	0.02	7.4
Information and communication	0.01	0.04	3	0.03	0.01	6.8
Recreation, sport and culture	0.07	0.05	-2	0.06	0.01	2.9
Education services	0.21	0.23	2	0.21	0.01	6.3
Restaurants and accommodation services	0.18	0.49	31	0.30	0.12	6.3
Personal care, social protection and miscellaneous goods and services	1.83	1.46	-37	1.74	0.14	9.5
Core CPI	**3.67**	**3.87**	**20**	**3.77**	**0.10**	**100.0**
Memo:						
Overall CPI Inflation	**2.73**	**4.45**	**172**	-		

Source: MOSPI; SBI Research

T-Bills Tenure, Schedule, and Borrowing Amounts

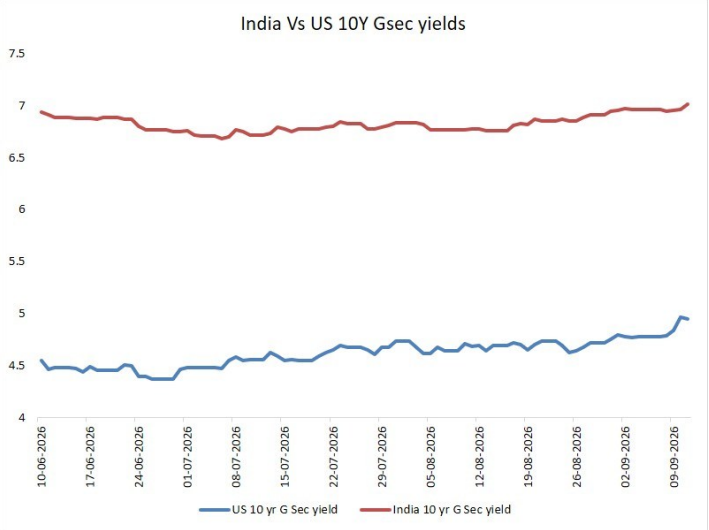
Tenure (Maturity)	Auction Frequency	Typical Announcement Day	Typical Auction Day	Average Borrowing Size (Per Auction)
4-Week (1-Month)	Weekly	Tuesday	Thursday	$70 Billion – $95 Billion
6-Week (CMB*)	Weekly	Thursday	Tuesday	$50 Billion – $65 Billion
8-Week (2-Month)	Weekly	Tuesday	Thursday	$70 Billion – $90 Billion
13-Week (3-Month)	Weekly	Thursday	Monday	$75 Billion – $95 Billion
17-Week (4-Month)	Weekly	Tuesday	Wednesday	$55 Billion – $65 Billion
26-Week (6-Month)	Weekly	Thursday	Monday	$70 Billion – $80 Billion
52-Week (1-Year)	Monthly	Every 4th Thursday	Every 4th Tuesday	$40 Billion – $50 Billion





GLOBAL YIELDS, US BORROWINGS, FED TRAJECTORY & BOND BUYBACK AND INDIAN YIELD MOVEMENTS

- Globally, yields are inching past decadal highs sure-footedly (sans the pandemic disruption that remains a Black Swan event), a nearly unseen phenomenon of late, more reminiscent of the panic laden early days of 2008 GFC, but looking firmer and broad based now, anchored by overlapping and whirling synergy of rapidly escalating oil prices, fractured supply security, persistent inflation fears, ballooning government debt, rise in debt mop up by Big Tech in its pursuit of 'AI's Kingdom of Dreams' and lurking credence of the rate hike by a host of Central Banks, even when a sharp sell-off in government debt is aggravating the situation.
- A notable off-shoot is the vaulting US yields, 10Y within striking distance of 5% now (something unthinkable by majority of markets till a few days back as chartists vetted 4.8% as the first significant barrier, and 4.9% the ultimate high)… the all-important 30Y, setting the housing ARM and other durable consumer loan benchmarks, has pulled back towards 5.40%, after a short lived reprieve emanating from the Treasury Department's tantrums to smoothen the longer end of the curve through elevated repurchases. However, latest data shows tepid response to Treasury's first expanded buyback, that mopped only $5.2 Bn against targeted $6 Bn ($10.5 Bn offered), putting a question mark on efficacy and efficiency of policy tools to counter market mayhem (read: recent US Treasury Bond buybacks). With US PPI up 0.4% in August (up 5.4% for the 12 months ended in August '26 while core PPI too is 4.6%), markets are keenly waiting for the CPI, whose deviation from estimates can be the kill switch. The probability of Fed rate hike in September has shot up to 71% now, up from pre-PPI 61% in its Sep 15-16 meet **though we believe the Fed may still side with other measures for now**.
- Analysing the yield movement since the onset of CY'26, ~80%+ of the year-to-date increase in the nominal 10Y yield is accounted for by the real-yield component, and about ~20% by inflation compensation (the caveat is the real-yield increase can also incorporate higher real-rate risk compensation and changes in liquidity conditions.)



- The Federal Reserve's Kim–Wright model decomposition shows that in CY26 (based on model's own dates and yield definition), ~53% of the increase came from term premium and ~47% from the expected future nominal short-rate path. Clearly, investors are demanding more compensation for holding duration, not merely revising the expected policy-rate path upward as inflation has not moved dramatically till now.
- Elsewhere, from Euro area to UK to Japan, near term expectations have been front loaded (EU), Inflation uncertainty, the future policy path and duration/ fiscal compensation often outweigh weak-demand signals (UK) and combining a higher expected nominal policy path with adjustment away from exceptionally low rates (Japan) is evident but remain at best a House of Cards if the oil price intensity gathers momentum and Yen carry trade slows down further.

FCNR (B) DEPOSIT MOBILIZATION

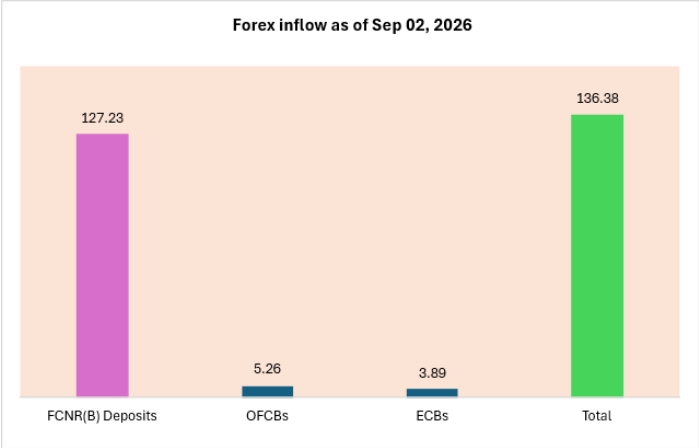
- As of Aug'31 2026, the total FCNR (B) deposit mobilization reached $127.22 billion. The realized mobilization has been almost twice the market anticipation doing rounds in June when the RBI launched the USD/INR Swap to beef up the reserves.
- The total mobilization including ECB and OFCB stand at a staggering $136.38 billion which will increase further given that SWAP window is still open for ECB and OFCB till December 2026.

EXPECTED DRAWDOWN OF SURPLUS FUNDS

- The FCNR (B) inflows have swelled the banks lendable resources while creating a surplus liquidity in the banking system.
- The expected future drawdown of the surplus fund in the banking system will be a function of currency demand as addressed above and the extent to which the FCNR (B) funds the fast growth in advances seen in current financial year.
- Timelines and expected trends become crucial. At the start of the FY27, the expected advances growth of banks was in the range of 16-17% and the deposits growth was expected in the range of 11-12%.
- Translated in nominal terms an anticipated funds gap for FY27 at Rs 12.5 lakh crore.
- **By design or by fluke, the mobilized amount of $127 billion almost matches the fund gap in banking system. This implies that the current spike will have a natural drawdown given the strong demand for credit supported by equally strong Q1 FY27 GDP growth figures.**
- **Thus, in all likelihood, the system liquidity will level out by the end of FY27 if the anticipated credit demand is met. The RBI Bank Lending Survey for Q1:2026-27 also indicates strong credit demand in H2 FY27.**

RBI POLICY OPTION FOR LIQUIDITY MANAGEMENT

- The policy option at the disposal of RBI has to be factored in the context of current surge in bank liquidity which is fundamentally different from the those seen during demonetization or COVID-19 pandemic.
- **Aggressive withdrawal of liquidity may create a deep deficit in Q3 and Q4 which are traditionally better month from the perspective of seasonal demand for credit and cash. Liquidity management may target a short horizon thus, adjusted as per evolving situation.**
- **Since FCNR has been exempted from CRR, use of CRR for liquidity management at this juncture does not look advisable. This leaves RBI with three options keeping in mind the short horizon, namely VVR, MSS and pre-emptively retiring the maturing short dollar positions.**
- **The current dollar show position in forward markets by RBI is $23 billion in 1-3 months bucket. Selective retiring of the position can also be an option.**



Incremental (Out /In) flow of funds in banking system (Rs Lakh Crore)

	Apr-26	Jun-26	Aug-26	Mar-27
Advances	36.3			
Deposits (Net CRR & SLR)	23.8			
Anticipated Gap	12.5			
FCNR (B)		12.1		
Anticipated Gap	0.4			

WAY FORWARD

- With the market filled with cacophony on possible usage of the liquidity gush (that is multi-faced), we believe exploring unconventional methods can be the genesis of a panic filled environment, creating a confidence conundrum.
- **Firstly,** against evolving scenario, this liquidity bulge looks more short-term in nature, tapering as enter the festive season and should be absorbed optimally within the next 3/4 months rendering RBI to find it **less plausible to implement structural measures such as CRR or MSS (the last resort ideally going by today's numbers and response) operations. Also, going by the logic that RBI has concentrated more on OMOs targeting the short end of the curve, there is a fair likelihood of its tilting towards a possible rate hike should the brawl come to a fight.**

- **Secondly,** RBI should continue to rely on Variable Rate Reverse Repo (VRRR) auctions to absorb surplus liquidity. To enhance market participants confidence, a calendar providing next 2-3 months operations with likely dates, tenors and some pre-fabricated drawdowns mechanisms to meet Banks' emergency needs, should encourage greater participation by banks, ceding their concerns on both fronts; meeting sudden liquidity requirements and able to front load growth against both proposals in pipeline (drawdowns) as also new credit growth.
- **Thirdly,** RBI should continue opting for early delivery of its buy/sell swaps maturing within 3 to 12 months but this strategy must be carried out very carefully lest the premia vaults out of the comfort zone, or the curve needs accelerated rebalancing later as INR remains subdued against the avalanche of incoming gloom.

- Chiefly, the outflows relating to advance taxes and GST (~Rs 4.5-5.0 lakh cr) should suck a sizeable portion. Additionally, committed loan disbursals should see banking system absorbing a good part of the liquidity, more so the onset of festival and rising corporate appetite for capacity addition. In fact, this liquidity gush can be an anchoring factor for sustaining the rising credit demand, simultaneously having a sobering effect on yields of various security types.
- With the RBI releasing the liquidity in the system in a calibrated manner (as evidenced through past FCNRB mop-up announcements and concomitant rise in systemic liquidity), we understand the liquidity can rise in the coming week if all the funds have not already become a part of the systemic liquidity.

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