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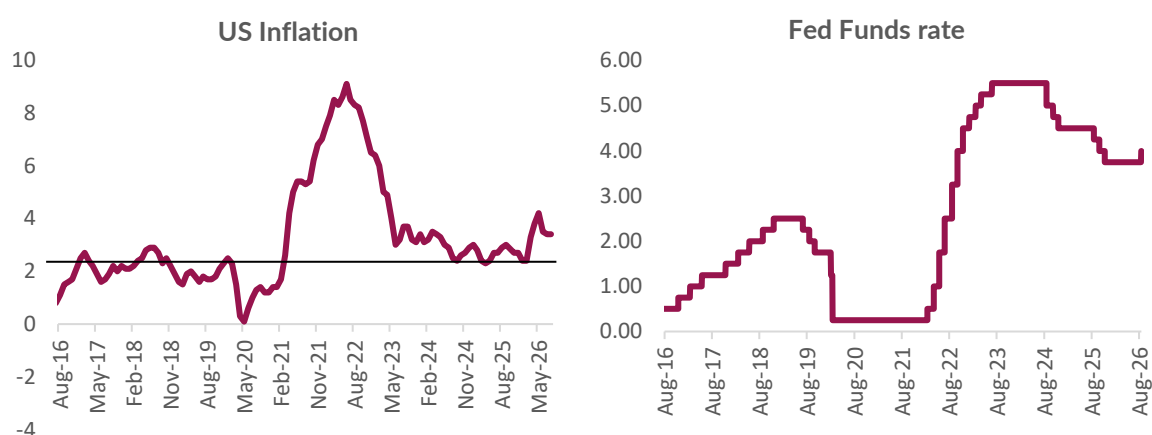
AXIS ASSET MANAGEMENT

For investors, the bigger question is not the hike itself. It is whether the world is entering a new phase of "higher for longer" interest rates, just as energy prices, geopolitical risks and inflation concerns are resurfacing globally.

At the same time, inflation is proving far stickier than policymakers had anticipated. Even after an extended period of elevated interest rates, price pressures remain well above the Fed's 2% target. While inflation had shown signs of moderating earlier in the year, the recent surge in crude oil prices has raised concerns that progress could stall or even reverse, forcing the Fed to keep policy restrictive for longer. Reflecting this backdrop, the Fed revised its 2026 inflation forecast higher to 3.7%, while also raising its real GDP growth projection to 2.3%.

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US Inflation has stayed above Fed's 2% target post Covid



Source: Bloomberg

Is the Fed rate hike timely or is it already behind the curve

While the Fed has raised rates, the pertinent question is whether it is already behind the curve given that other central banks moved ahead of it to tighten policy. The European Central Bank began raising rates in June, the Bank of Japan tightened in June and again in September, while the Reserve Bank of Australia delivered three increases between February and May.

Central banks that raised rates so far

Economy / central bank	Operative policy rate now	Rate increases in past 12 months	Hikes expected in next 12 months
US Federal Reserve	3.75%–4.00%	25 bps	Additional 25-50 bps of rate hikes expected could take the operative rate towards 4.5%
European Central Bank	2.50%	50 bps	Additional 50-75 bps of rate hikes expected
Bank of Japan	1.25%	50 bps	Additional 25-50 bps of rate hikes expected
Reserve Bank of Australia	4.35%	75 bps	Additional 25-50 bps of rate hikes expected

Source: Bloomberg

The US has faced persistent inflation post covid where it has remained above Fed's comfort range. For investors, the conventional response to a Fed hike is straightforward: higher US rates tend to keep bond yields elevated, support the dollar and attract global capital towards US assets.

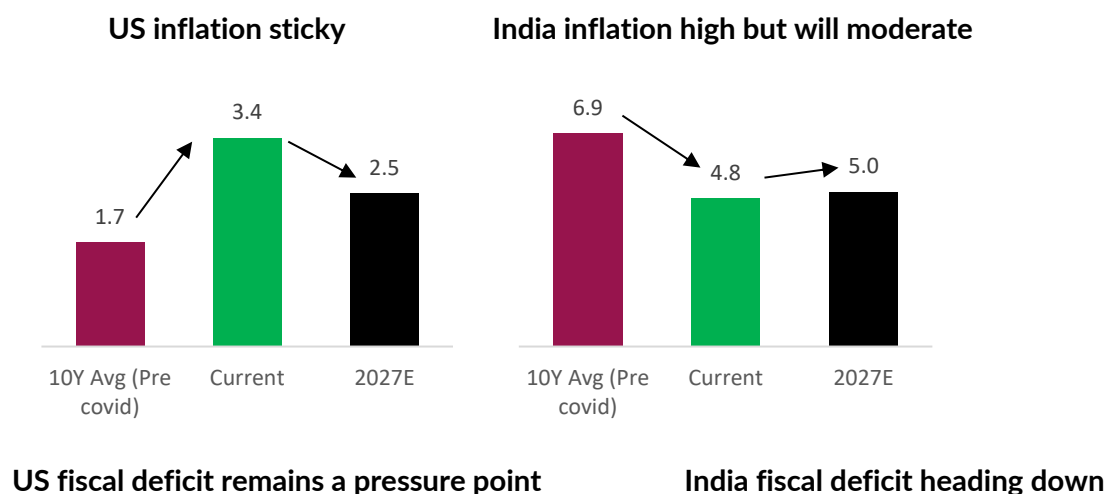
However, this cycle could be different for three reasons. 1) Reciprocal tariffs have not yet produced the broad manufacturing revival that was expected. Despite several reshoring announcements, US manufacturing construction spending has declined from its 2024 levels,

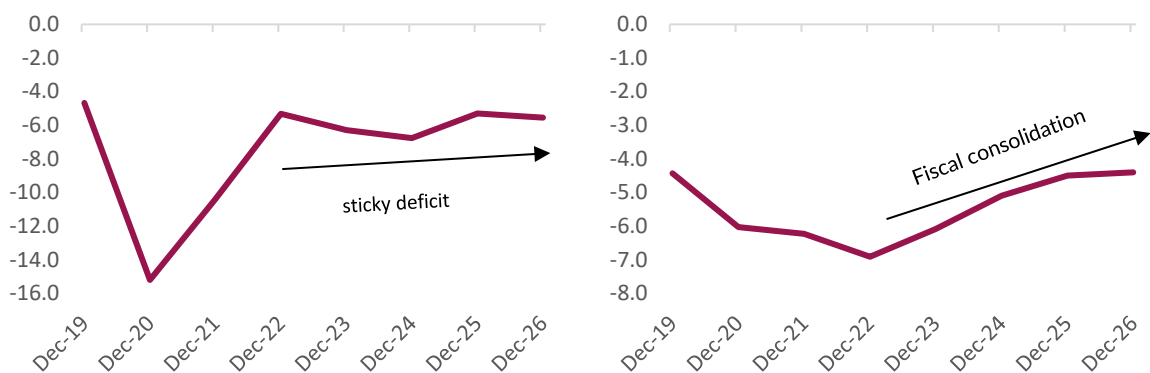
while the more visible investment boom has been in data centres and power infrastructure. 2) The US is carrying a significantly higher fiscal burden. Higher interest rates therefore come at an increasingly meaningful cost to an already indebted economy. 3) A significant investment impulse is currently coming from AI-related spending, particularly data centres, computing infrastructure and the associated power ecosystem. This has helped support US investment even as the broader manufacturing response has been more measured. The key question is whether the broader economy can remain resilient if this extraordinary AI investment cycle begins to moderate.

Against this backdrop, we view the Fed hike as an important signal of institutional credibility in its fight against stubborn inflation. In our view, another two to three hikes may be required, potentially taking the operative policy rate towards 4.5%, after which rates are likely to remain higher for longer. The key risk to this view is a sharp slowdown in AI investment. If that were to materially weaken US growth, the Fed's ability to continue hiking would become constrained. For investors, therefore, the more important debate is no longer simply whether the Fed is behind the curve, but how far it can raise rates before growth begins to become the binding constraint.

What does it mean for India?

Historically, a Fed hiking cycle has transmitted to India through three channels: pressure on the rupee, higher domestic bond yields and greater external vulnerability. We are seeing some immediate market reaction this time as well, with the rupee moving beyond 96/US\$ and the 10-year government bond yield moving above 7% following the Fed hike. But the starting point for India today is very different from earlier episodes. Importantly, the US and Indian macro cycles are beginning to diverge. US inflation remains elevated, while India's inflation dynamics are being driven increasingly by its own domestic and supply side factors. Similarly, while US fiscal pressures remain significant, India has been on a path of fiscal consolidation. This suggests that India need not mechanically follow the US rate cycle.





Source: Bloomberg

The same distinction is important for Indian bond yields. Global yields can create bouts of volatility, but we believe the more persistent upward pressure on Indian yields from here is likely to come from domestic factors rather than simply from higher US Treasury yields. India's CPI inflation has already risen to 4.82% in August, from 4.45% in July, while the repo rate currently stands at 5.25%. The domestic inflation risks are also becoming clearer: food prices could be affected by weather conditions, core inflation could broaden due to commodity pressures, while oil remains vulnerable to developments in West Asia. In our assessment, if CPI averages around 5% over the coming 12 months, an operative policy rate closer to 6% would be more appropriate. In other words, the case for an RBI hike would primarily be India's own inflation trajectory, rather than the Fed hike itself.

The second concern is the currency, but here too India has significantly more cushioning than in earlier tightening cycles. Foreign exchange reserves reached a record US\$785.7 bn in early September, while the special FCNR(B) window mobilised around US\$133 bn by its August 31 closure. These flows have materially strengthened the near-term foreign-exchange buffer. They also supported the balance of payments during July, when FCNR(B) inflows helped keep the overall BoP in surplus. Alongside resilient domestic growth, this makes India's external position considerably better cushioned against global volatility. We would therefore distinguish between currency volatility, which can persist as US rates and oil prices rise, and external vulnerability, where India today has substantially more buffers.

That said, global monetary tightening still matters for the RBI. If global central banks continue hiking while India holds rates unchanged, a narrowing interest rate differential could add to currency and capital flow pressures. The RBI therefore has to balance two considerations: domestically, the direction of inflation across food, core and fuel; and externally, the need to maintain sufficient monetary policy credibility to prevent undue pressure on the currency. Our view is that domestic inflation will ultimately be the stronger reason for the RBI to act. If inflation moves towards 5% and remains there, we see room for the policy rate to move towards 6%. The key difference from previous global tightening cycles is that India is not simply reacting to the Fed. Its monetary policy cycle is increasingly being determined by India's own inflation, growth and liquidity conditions.

Will the RBI hike rates?

Our view

We expect the RBI to undertake a measured tightening cycle of 50-75 bps over the next 6 months, taking the operative policy rate towards 6-6.25%. Policy normalisation, however, is

likely to extend beyond rate hikes. With substantial surplus liquidity in the banking system, we expect the RBI to continue withdrawing liquidity through measures such as OMO sales and VRRR operations, complementing rate action. This calibrated combination of higher policy rates and tighter liquidity should help address emerging inflation risks while balancing the need to support growth. For investors, near-term pressure on bond yields could create opportunities to gradually lock into attractive yields as the tightening cycle progresses.

What should investors do?

Overweight 1–3 year Corporate Bonds; cautious on Long SDLs. The fixed income opportunity remains attractive, but selectivity is key. **We prefer the 1-3 year segment of the curve**, particularly high-quality corporate bonds, where favourable carry, ample liquidity and limited CD issuance create an attractive risk-reward balance.

We remain neutral on government securities for now. The RBI's use of OMO sales to absorb surplus liquidity, alongside the deferment of Bloomberg index inclusion, higher fiscal slippage risks, could keep yields under pressure and limit the scope for a sustained rally. However, as the rate-hiking cycle progresses and yields repriced higher and with a view of a shallow interest rate hike cycle, **we would look for opportunities to tactically add duration.**

We remain cautious on long-duration SDLs. Elevated state borrowing and an unfavourable demand-supply balance could keep yields elevated and limit meaningful spread compression. Risks around the 8th Pay Commission, softer tax collections and subsidy pressures also warrant caution.

Thus, our preference today is to earn carry at the shorter end, stay patient on duration and use periods of yield repricing to gradually add duration when the risk-reward becomes more favourable.



Source: Axis MF Internal Research

The bottom line

The Fed's hike is a reminder that the global disinflation process may not be linear. In the US, sticky inflation and a rising fiscal burden support a higher-for-longer bias, although a sharp slowdown in AI investment would challenge that view. India is in a much better shape and is likely to run a more domestically determined rate cycle. For Indian fixed income investors, the appropriate response is a disciplined combination of quality, carry, liquidity and tactical duration.

Source: US Federal Reserve website, Bloomberg

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