



FRONT WAVE FOCUS:

Narrowing India–US Bond Yield Spread: Brewing Macro Shifts and Equity Implications

The gap between Indian and U.S. 10-year bond yields has shrunk dramatically to multi-decade lows. Indian 10-year government bond yields have **fallen sharply** over the past several months – from around 7.3% late last year to nearly **6.22% recently**, the lowest since September, 2021. In contrast, **U.S. 10-year Treasury yields have climbed** to roughly **4.55%** in the same period, reflecting the Fed’s tighter policy. As a result, the **India–US 10Y spread has compressed to 1.8%(180 basis points)**, a level not seen in decades. This **historic narrowing** suggests something significant is underway in the macro landscape, breaking from the past when India’s bond yields carried a much larger premium over U.S. yields.

Such a **tight spread is unprecedented**—the spread was typically between **5-4%** pre-2020

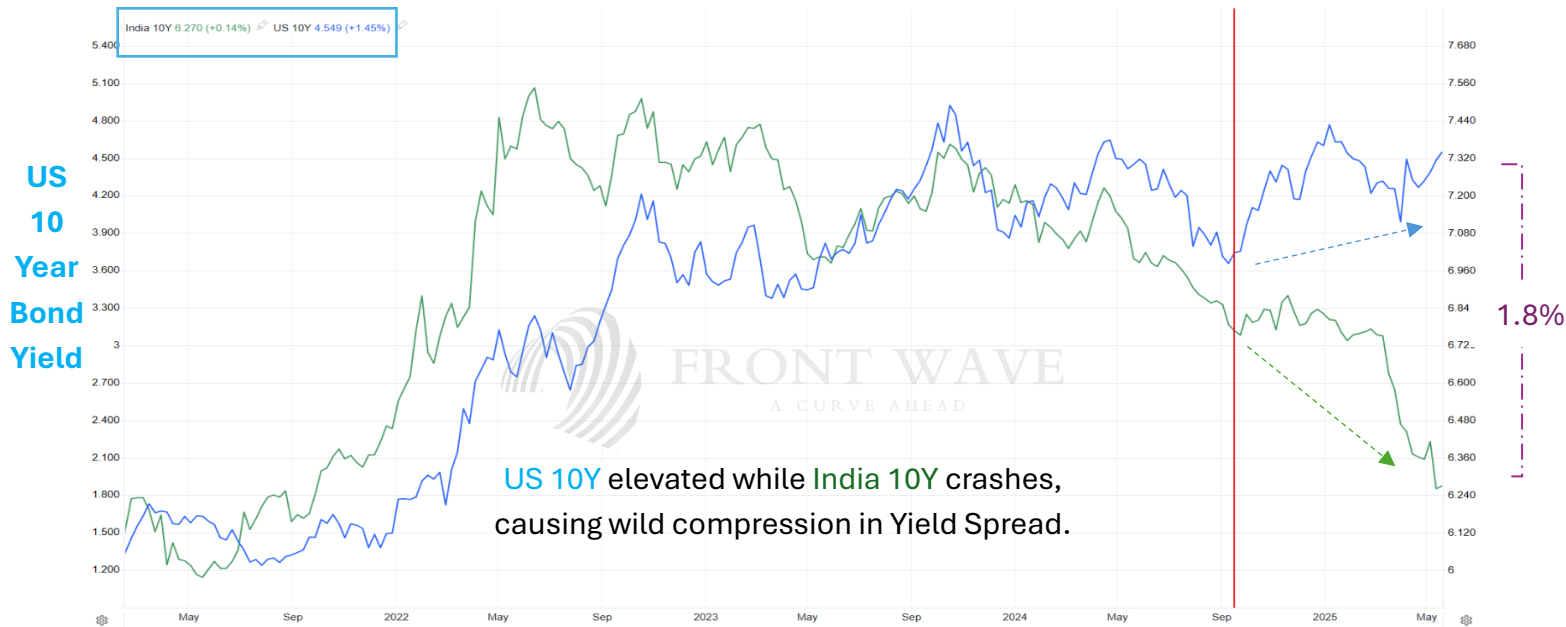
The Spread between US 10 Year and Indian 10 Year Bond Yields





Indian vs U.S. 10-year bond yields over recent years.

US 10Y on LHS; IN10Y on RHS



The Green line (India 10Y) has declined notably since late 2024, while the Blue line (US 10Y) has risen, compressing the yield spread to roughly 2 percentage points by May 2025.

This rare convergence in yields is **brewing a macro paradigm shift**. It indicates that investors now demand **far less extra yield** to hold Indian bonds versus U.S. Treasuries. The forces driving this shift – both **domestic (India's easing yields)** and **external (U.S. yields staying elevated)** – merit a closer look, as they carry important implications for liquidity, currency, and equity markets.

RBI's Liquidity Surge and Dividend Driving Indian Yields **Lower**

Abundant domestic liquidity is a key reason Indian bond yields are sliding. The Reserve Bank of India has been **injecting liquidity** into the banking system through bond purchases and repos. Crucially, the RBI's **hefty dividend to the government** – estimated at ₹2.75–3 lakh crore – is set to flood banks with fresh funds. Analysts project surplus system liquidity could jump to **₹5.5–6 trillion** on the back of this payout. This **surplus cash** is pushing short-term interest rates down and fueling demand for bonds, thereby **driving bond yields lower** across



the curve. Indeed, traders report the 10-year yield has fallen into the 6.2-6.3% range (a three-year low) amid the RBI's ongoing bond buys and liquidity ops.

The **macro implications** of this liquidity surge are significant. With cash aplenty, the RBI has gained **policy space to ease rates** without straining financing conditions. Market participants note that **ample liquidity ensures better policy transmission**, effectively **easing monetary conditions** even before official rate cuts happen. It's no surprise then that bond investors are **bullish**, expecting the 10Y yield to possibly break below 6.20% as the RBI sustains its infusions. In essence, the RBI's dividend and accommodative stance have created a **domestic liquidity wave** that anchors Indian yields lower, independent of global trends. This bodes well for borrowers and the government (lower funding costs), but it also means India's bond market is more **decoupled** from U.S. rate movements than in the past.

Global Yields and Shrinking Risk Premiums: **Capital Flow Implications**

While India's yields are falling, **U.S. bond yields remain high**, altering the calculus for foreign investors. Higher U.S. yields **increase the appeal of USD assets**, and the much **narrower India-US yield differential** makes Indian bonds (and other rupee assets) relatively *less* attractive. **Historically, a thinning yield spread triggers foreign outflows from emerging markets** as investors choose better risk-adjusted returns at home.

In early 2025, India did witness sizable FPI equity outflows amid global risk-off and **elevated U.S. yields, which made American assets more appealing**. Such outflows put **downward pressure on the rupee**, exacerbating the issue as a weaker rupee further erodes foreign investors' returns. On the flip side, some economists note that if the low spread persists in a stable environment, it could **reduce the rupee's depreciation bias – historically around 4–6% annually – down to ~2–3%**. That would mean less expected currency loss for holding rupee assets, partially offsetting the lower yield. **However**, this optimistic scenario hinges on steady inflows. In a **risk-off episode, rising U.S. yields and a strong dollar** tend to spur flight



from EM assets, so India could still see capital pulled out, pressuring both **rupee exchange rates and equity valuations**.

In summary, the **higher U.S. yield regime raises the global risk premium** and could cap foreign enthusiasm for Indian markets unless India's growth and liquidity story is compelling enough.

Implications for **Indian Equity Valuations** and Risk Premium

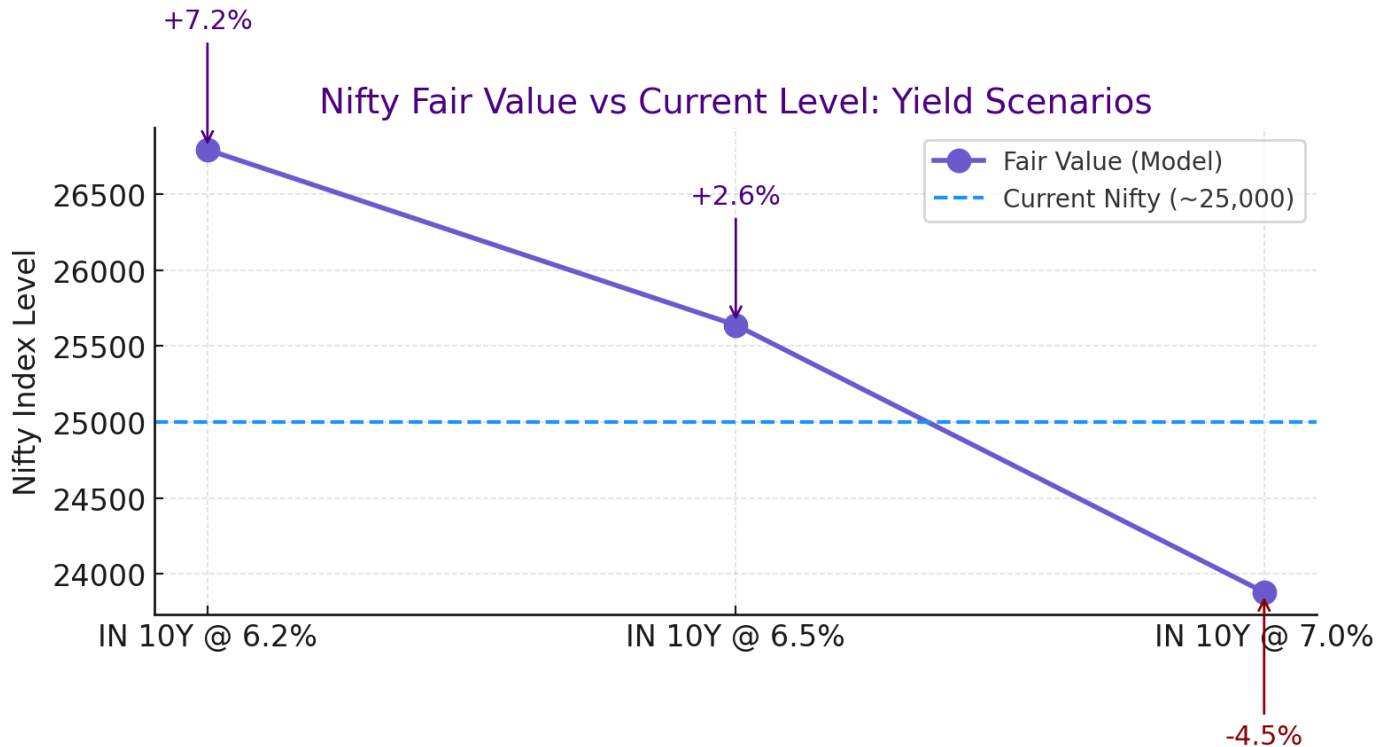
The bond yield shifts **directly feed into equity valuations** via the equity risk premium. In the Front Wave Research's valuation framework, the **Nifty50's fair value is modeled based on the spread between equity earnings yield and bond yield**, adjusted for growth.

Currently, the Nifty trades around **₹25,000** (having rallied strongly), with a trailing **earnings yield** of roughly **4.48%** (P/E ~22.3). Meanwhile, the 10Y bond yields **6.22%**. On the surface, this implies a **negative "yield gap"** – equity earnings yield is **1.74%** percentage points *below* the risk-free rate. Such a configuration normally signals **rich equity valuations** (investors accepting earnings yields below bond yields) **unless robust Earnings Growth is expected**.

Indeed, our model assumes corporate earnings will grow **~10%** annually, and it **requires at least a 0.75% equity risk premium** (ERP) over bonds to justify equity risk. In other words, investors should demand a **minimum 0.75% extra return** above the 10Y yield, after factoring in growth, to hold equities.



How does Nifty stack up on that measure today?



Scenario 1:

Plugging in current yields, a **0.75% Equity Risk Premium (ERP)** and **10% growth over 10 years**, the model estimates a **fair Nifty level around 26,794** (in index points). That is modestly **higher than the actual ~25,000**, suggesting Nifty is **not grossly overvalued** despite the High PE / Low Earnings Yield. In fact, by this calculation the market's pricing implies an **upside of 7.2% if these variables hold**.

Scenario 2:

If the 10 Year Yield rises and consolidates at 6.5%, the relative NIFTY fair value level will be **25,639**, only 2.6% higher from here. Thus, If the 10 Year Bond Yield starts consolidating around these levels over the next few months, **we see Nifty consolidating between 25,639 and 26,794 till the end of the year**. This is the most likely scenario, our Research House view.

Scenario 3:

However, if the US Yield spikes significantly towards 5.2%, we are of the view that the Bond



*Yield Spread can widen or in best case, stay the same – It doesn't have much room to go further down. **This scenario will cause major downside pressure on the markets as the Indian 10 Year Yield will implicitly go to 7% as compared to US at 5%, causing the implicit value of Nifty to be at 23,879 (4.5% downside).***

Caution: the model's output is highly sensitive to the assumed risk premium. A **superficial boost to fair value occurs when bond yields drop** (as we've seen, a lower 10Y yield mechanically raises the valuation for equities). However, if global conditions worsen and investors demand even a slightly higher ERP – say **1% instead of 0.75%** – the **“fair” Nifty value would fall sharply**, potentially well *below* current levels. In other words, **falling Indian bond yields can raise Nifty's justified valuations on paper**, but this scenario is at risk of **rising U.S. yields or increasing required India risk premium / widening spreads in the future.**

We saw a glimpse of this in early 2025 when foreign investors pulled out record amounts from equities, citing **high U.S. yields and a strong dollar** among the key factors. Thus, equity investors should not become complacent about low domestic yields alone – **the quality of liquidity and global risk sentiment matters** just as much for sustaining valuations.

Conclusion: Navigating the Future

For Indian equity investors, the **macroeconomic implications** highlighted by the narrowing India–US bond spread warrant careful attention. On one hand, **ample RBI-driven liquidity and falling local bond yields** are a tailwind – they ease financing costs, support economic activity, and, through valuation models, can lift the apparent fair value of equities. On the other hand, **rising global yields and a reduced yield cushion** introduce risks: they can tighten foreign capital flows, pressure the rupee, and force a higher equity risk premium. This tug-of-war will likely continue.

Investors in the Front Wave community should **keep a close watch on bond yield trends** (both Indian and U.S.), as well as **RBI's liquidity actions** and communications (e.g. signals on



further rate cuts or liquidity withdrawal). These will influence the interest-rate outlook underpinning equity valuations.

Finally, monitor the **equity risk premium** by tracking earnings yield vs. bond yield: if the gap turns decisively negative **without an offsetting growth upside**, it could flash warning signs of overvaluation. Conversely, a reasonable positive ERP would indicate a margin of safety. And of course, **global capital flow indicators** (FPI activity, dollar strength) and **risk sentiment** measures should remain on your radar – a scenario of U.S. yields stabilizing or falling would ease the pressure, whereas further spikes could spook investors across emerging markets.

In summary, the current narrow bond spread is a double-edged sword. It reflects India's improving macro stability and policy latitude, yet it also means **equities are more exposed to global rate swings**. Staying vigilant and responsive to these macro signals will be key for navigating the Indian equity market in the coming months.

For More Such Insights,

Join Our [Whatsapp Community](#) By Clicking Below:

[Click Here](#)

Disclosure Statement: This research report is issued by Front Wave Research LLP, a SEBI-registered Research Analyst entity (Registration No: INH000018407). The disclosures mentioned below are in compliance with SEBI (Research Analysts) Regulations, 2014, to ensure transparency and integrity.

Investors must perform their own due diligence before acting on any recommendations.

There are no outstanding litigations or disciplinary actions against Front Wave Research LLP as of the date of this report. Neither Front Wave Research LLP nor its associates or relatives hold any financial interest in the subject companies discussed in this report unless explicitly mentioned. Front Wave Research LLP or its associates do not own 1% or more of the securities of the subject companies as of the end of the month immediately preceding the publication of this report. Front Wave Research LLP, its associates, or relatives do not have any material conflicts of interest with the subject companies at the time of publication unless explicitly disclosed. Neither Front Wave Research LLP nor its associates have received compensation from the subject companies in the past 12 months for investment banking, merchant banking, or brokerage services. Front Wave Research LLP has not managed or co-managed public offerings of securities for any subject company in the past 12 months.

Front Wave Research LLP has not received any compensation or other benefits from any third party in connection with this research report unless specifically disclosed.

The research analyst(s) involved in the preparation of this report have not served as an officer, director, or employee of the subject companies.

Front Wave Research LLP has not been engaged in any market-making activities for the subject companies. Investments in the securities market are subject to market risks. This research report is not an offer to sell or a solicitation to buy any securities. Past performance is not indicative of future results. Investors are encouraged to seek independent financial advice and read all relevant offer documents before making investment decisions.

Front Wave Research LLP (SEBI Regd. INH000018407)

support@frontwaveresearch.com || www.frontwaveresearch.com || +91 9136990471

Registered Office: 214/215, Sagar Avenue, Lallubhai Park Road, Above ICICI Bank, Andheri West, Mumbai – 400058.