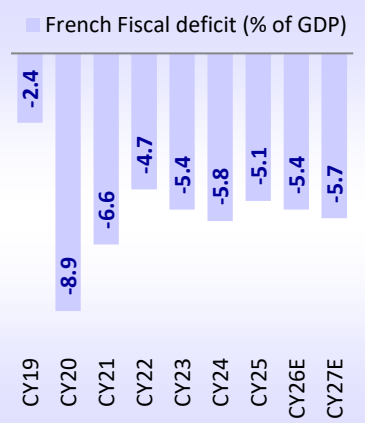
Economy | Macro-Cap

Global markets at a crossroads!

Global markets are facing a growing divergence between economic fundamentals and financial-market performance. France's persistent fiscal deficits, rising debt, and widening sovereign spreads are reviving concerns over eurozone stability, while resilient US activity, elevated bond yields, and the AI investment boom continue to attract global capital toward dollar assets. However, the AI-led sell-off that has begun raises questions about the sustainability of this concentration and the returns on massive technology investments. Despite strong domestic growth, India has faced foreign portfolio outflows and currency pressure as global capital remains concentrated in US assets. In the sections below, we examine these global risks, the outlook for the dollar and US interest rates, and how a potential shift in global capital allocation could shape India's market prospects.

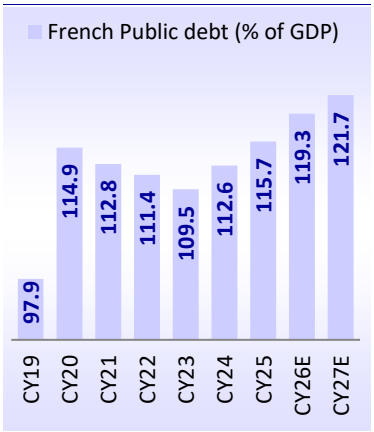
French fiscal deficit at 5.1% of GDP in CY25; projected to rise to 5.4% in CY26



Let's talk France

- **France's fiscal problem has been building for decades, but rising borrowing costs and political uncertainty are making it harder to ignore.** The fiscal deficit has exceeded the EU's 3% of GDP limit in around 20 of the 26 years since 2000. The deficit widened to 7.4% of GDP in 2009 (from 2.7% in 2007) during the GFC and 8.9% in 2020 during Covid-19 (vs. 2.1% in 2019), but France struggled to bring it sustainably under control after these shocks passed. The deficit stood at 5.1% of GDP in 2025 and is expected to widen to 5.4% in 2026. Public debt rose from ~64% of GDP in 2007 to 84% in 2009 during the global financial crisis (GFC) and further mounted to 115% in 2020 (vs. 98% in 2019) amid the pandemic. **The debt burden has continued to mount, reaching 119.3% of GDP (EUR3.6t) in 2QCY26 from 115.6% in 2025, and is projected to rise further to 121.7% by 2027.**
- **High debt, weak growth (projected at 0.6% in 2026), and rising interest payments—which are projected to increase from EUR79.2b in 2026 to EUR91.2b in 2027—are leaving less room for public spending**. French 10-year government bond yields have approached 5%, their highest levels since 2002, while the spread over German bonds has approached 140–160bp (the first time since the 2011–12 eurozone debt crisis), reflecting growing investor concerns over France's fiscal outlook and political stability.
- **Austerity is now the political flashpoint.** Prime Minister Sébastien Lecornu's proposed 2027 budget envisages a total fiscal adjustment of around EUR54b, including EUR43b of measures in the draft budget, to bring the deficit down to 5.0% of GDP. **These measures include restraining pension increases, freezing public-sector pay, tightening sick-leave rules, reducing healthcare costs, limiting selected tax concessions, and curbing public spending.** They are unpopular because households, workers, and businesses are being asked to bear the cost of correcting years of overspending through lower real benefits, tighter services or higher taxes. With a divided parliament and opposition from unions and political parties, passing the budget remains uncertain. This creates a difficult cycle: France needs fiscal restraint to reassure bond investors, but political resistance could dilute or delay the measures, keeping borrowing costs

French public debt at 115.7% of GDP in CY25; projected to rise to 119.3% in CY26



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elevated and making debt reduction even harder. The central risk is no longer simply high debt, it is whether France has the political capacity to control it.

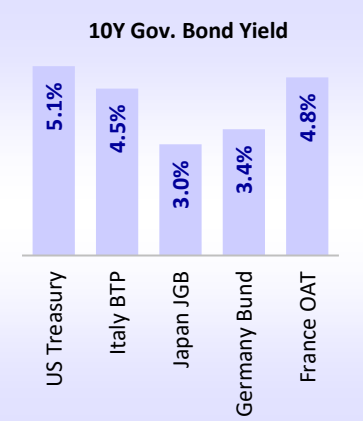
The problem extends beyond France

- Italy and other more indebted eurozone economies have also faced pressure, with the Italian–German 10-year spread approaching 100bp during the recent sell-off. Europe's common monetary policy coexists with nationally determined fiscal policies, leaving countries with different debt burdens and growth prospects exposed to diverging borrowing costs. **The ECB faces a difficult trade-off: persistent inflation argues for restrictive policy, but tighter financial conditions could weaken growth and increase sovereign financing stress.** A full-scale eurozone debt crisis is not inevitable, but prolonged fiscal uncertainty and elevated sovereign risk premiums could tighten credit conditions across the region and complicate the ECB's policy response.
- ***The euro's sharp depreciation is an important channel through which European stress is affecting global markets*. EUR/USD fell to approximately USD1.112 in early October, its weakest level in around 17 months.** The decline reflects concerns over French fiscal credibility, political fragmentation, weaker relative growth prospects, and Europe's exposure to higher energy prices. The dollar has benefited from this weakness, alongside relatively attractive US yields and demand for liquidity. **The US Dollar Index (DXY), which assigns the euro a weight of approximately 57.6%, climbed to an 18-month high near 102.9 in mid-Oct'26 before easing toward 101.84 on 16th Oct'26.** This composition matters: the dollar can strengthen substantially because the euro is weakening, even without an equivalent appreciation against every other currency.

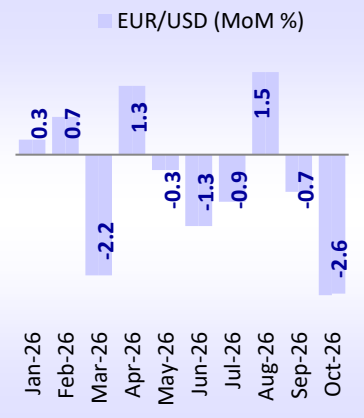
US: The dollar's safe-haven appeal

- **The dollar's rally reflects persistent inflation, resilient economic activity, and expectations of interest rates remaining higher for longer.** The US manufacturing and services PMIs remained in expansionary territory in Sep'26 at 54.5 and 54.9, respectively. However, inflationary pressures have intensified: CPI accelerated to 3.7% YoY in Sep'26 from 3.4% in Aug'26, while core CPI rose to 2.6% from 2.4%. Although headline inflation remains well below the 9.1% peak reached during the 2022 inflation shock, the renewed acceleration is complicating the Fed's policy outlook. Producer price inflation also surged to 1.3% MoM in Sep'26 from 0.5% in Aug'26, marking its largest monthly increase since Mar'22, led by a 10.8% rise in energy prices. The labor market is also sending mixed signals: payrolls increased by just 29k in Sep'26, well below the average monthly gain of 45k over the preceding 12 months. Nevertheless, the Fed lowered its median unemployment forecast for 2026 and 2027 to 4.1% from 4.3% earlier, indicating that unemployment is likely to remain broadly stable.
- Following its September hike, the Fed's policy rate stands at 3.75–4.00%. **Markets expect a pause at the 28th Oct'26 meeting, with a 72.3% probability of no change. However, expectations point to further tightening by Dec'26: the market-implied probability of at least one 25bp hike at the 9th Dec'26 meeting stands at 89.3%, including a 23.6% probability of a cumulative 50bp rate hike.** Our view is that the Fed will pause in Oct'26 and deliver a 25bps hike in Dec'26, allowing more time to assess incoming data ahead of the US midterm elections

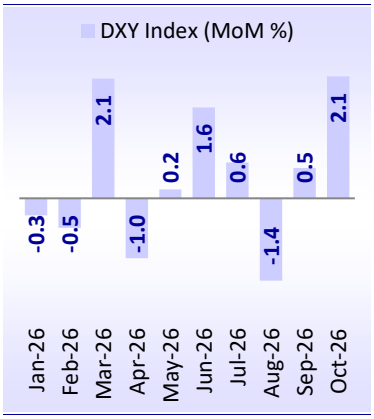
Global bond yields have spiked



EUR/USD contracted 2.6% in Oct'26



US DXY Index jumped 2.1% MoM in Oct'26



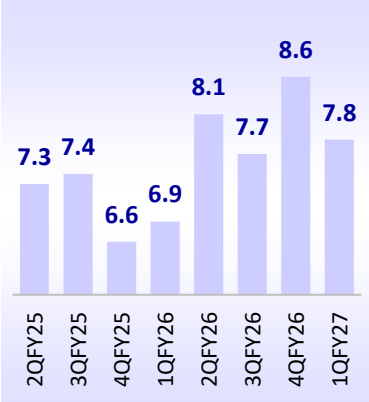
on 3rd Nov'26, while persistent inflation keeps further tightening on the table. The US 10-year Treasury yield reached around 5.1% in mid-Oct'26, supporting the relative returns available on dollar assets while raising global borrowing costs. The combination of sticky inflation, expectations of further Fed tightening, and continued AI-related investment has supported the dollar, although a deeper AI-led sell-off could weaken risk appetite and pull Treasury yields lower.

- **The current environment fits the Dollar Smile theory. The dollar tends to strengthen at both ends of the economic spectrum: when the US outperforms its peers and attracts capital through stronger returns, and when global uncertainty drives investors toward liquidity and relatively safe assets.** Both forces are operating simultaneously. On the right-hand side of the smile, resilient US activity, AI investment, and relatively high yields support demand for dollar assets. On the left-hand side, French fiscal stress, widening European sovereign spreads, geopolitical uncertainty, and higher energy prices encourage defensive positioning. The prospect of a further 25bp Fed rate hike in Dec'26 strengthens the case for a firm dollar. While this expectation is partly priced in, persistent inflation and the prospect of US rates remaining higher for longer could sustain dollar strength, particularly if economic and fiscal risks elsewhere continue to mount. **A sustained dip in US yields, stabilization in European sovereign spreads, and improving global risk appetite would move markets toward the middle of the smile, creating a more supportive environment for emerging-market capital flows.**

India: Strong growth, but capital is flowing elsewhere

- **India's problem is not growth; it is global capital allocation.** Real GDP grew 7.8% YoY in 1QFY27, prompting the RBI to raise its FY27 growth forecast to 7.1% (from 6.7%). Further upside surprises are possible if domestic demand, services activity, and investment remain resilient. Yet strong growth has not translated into equivalent equity-market outperformance, because foreign investors are comparing India's returns with opportunities elsewhere. Higher US yields increase the return hurdle for emerging-market assets, while a stronger dollar and elevated crude oil prices put pressure on portfolio flows and the rupee.

India's Real GDP grew 7.8% in 1QFY27



Source: CEIC, MOFSL

- **A potential rationalization of LTCG tax and STT could improve India's competitiveness for global capital by raising post-tax returns and lowering transaction costs**. The government's willingness to hear investor feedback ahead of Budget 2027-28 is a positive signal, although no tax changes have been announced. However, scrapping these taxes would entail a significant fiscal cost through lower government revenue. **Our calculations suggest that a complete waiver of LTCG and STT taxes could put an estimated INR1.8–1.9t* of annual government revenue at risk on a static basis**, adding to the fiscal trade-off at a time when consolidation remains a priority. Further, tax cuts alone are unlikely to offset higher US yields, dollar strength, and the concentration of global capital in AI-related investments. Tax reform could strengthen India's ability to capture the next wave of global inflows, but the timing of that rotation will still depend on global market conditions, especially when the global AI cycle turns.
- **The global AI investment cycle has intensified this divergence.** The US benefits from its technology platforms and AI infrastructure businesses, while Taiwan and South Korea have captured substantial demand through semiconductor

manufacturing and memory chips. These markets are capturing earnings benefits from AI infrastructure spending. India's listed market has comparatively lower direct exposure to advanced semiconductor and memory-chip supply chains.

Our view: India's Opportunity and risks

- **Our view is that India's opportunity depends on how the global AI cycle evolves.** The AI sell-off has already begun, with investors reassessing stretched valuations, the sustainability of massive AI infrastructure spending, and the ability of companies to generate adequate returns on capital. The correction has spread from AI-linked equities to semiconductor manufacturers and companies financing data-center expansion. The global semiconductor index has fallen for seven consecutive sessions, losing more than 11% and ~USD1.6t in market value over the last six sessions. South Korea's KOSPI fell 7.6% on 15th Oct'26, while Japan's Nikkei dipped 4.9%, reflecting the heavy concentration of these markets in AI-linked stocks. The sell-off reflects a combination of hotter-than-expected US inflation, rising interest-rate expectations, concerns over debt-funded data-center investment, and growing competition from China**. If the sell-off remains orderly, US yields moderate, and the dollar weakens, capital could gradually rotate towards India's domestic-growth story, supporting foreign portfolio inflows, equity-market performance, and currency stability. However, an outright AI bust or global recession would initially be negative for India, as investors seek dollar liquidity and emerging markets face further outflows.**
- **India's medium-term fundamentals remain strong, but near-term market performance will continue to be determined by global yields, the dollar, crude oil prices, and the concentration of capital in AI-related assets.** France's fiscal stress and the wider eurozone sovereign repricing reinforce the importance of global financial conditions in determining currency and portfolio flows. A sustained recovery in Indian markets is more likely when US yields moderate, the dollar softens, and global capital allocation broadens beyond a narrow group of technology and semiconductor beneficiaries—not simply when India delivers another strong GDP print.

Note: **Indicative calculation: INR1.29t of equity LTCG tax collections (AY2025–26) + INR521.97b of STT receipts (FY2024–25 actual) to INR636.70b (FY2025–26 revised estimate), implying INR1.81–1.93t of potential revenue exposure. Figures cover different reporting periods and represent a static estimate, not an official assessment of revenue foregone.*

STORY IN CHARTS

France's fiscal problem has been building for decades

Exhibit 1: French fiscal deficit at 5.1% of GDP in CY25; projected to rise to 5.4% in CY26

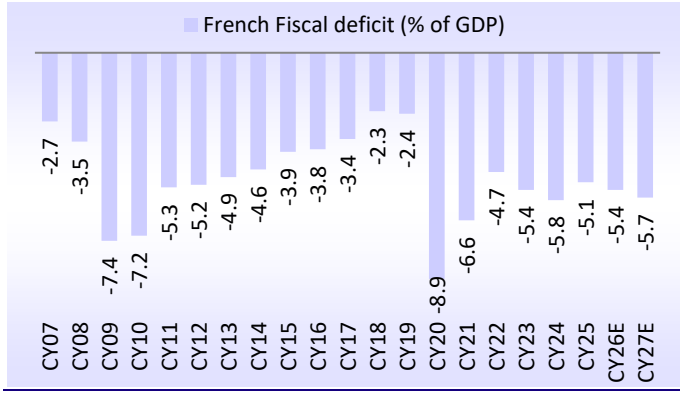
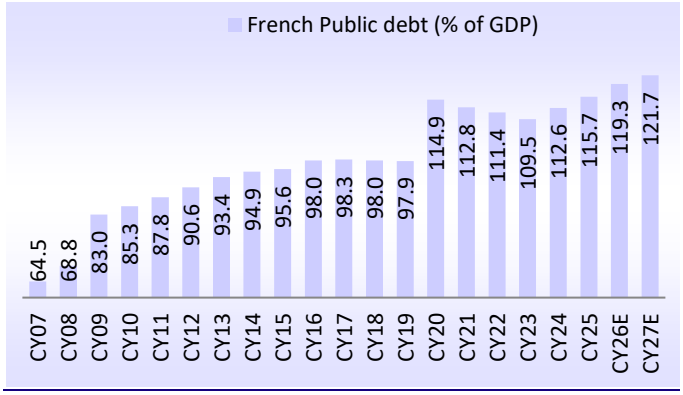


Exhibit 2: French public debt at 115.7% of GDP in CY25; projected to rise to 119.3% in CY26



Source: CEIC, MOFSL

Exhibit 3: France's non-financial sector debt stood at 324% of GDP in CY26*...

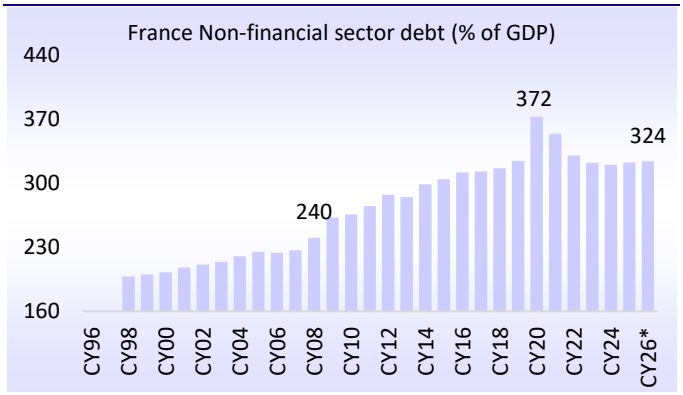
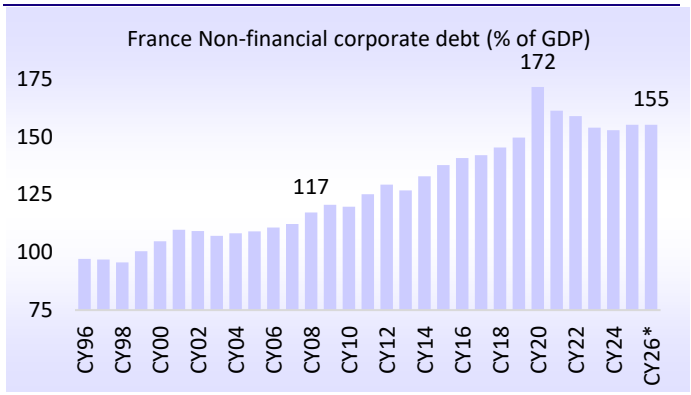


Exhibit 4: ...while that of France's non-financial corporate debt stood at 155% of GDP in CY26*



Source: CEIC, BIS, MOFSL; Note: CYTD*: Data till Mar'26.

Exhibit 5: France-Germany 10Y yield spread have widened to 130-140bp

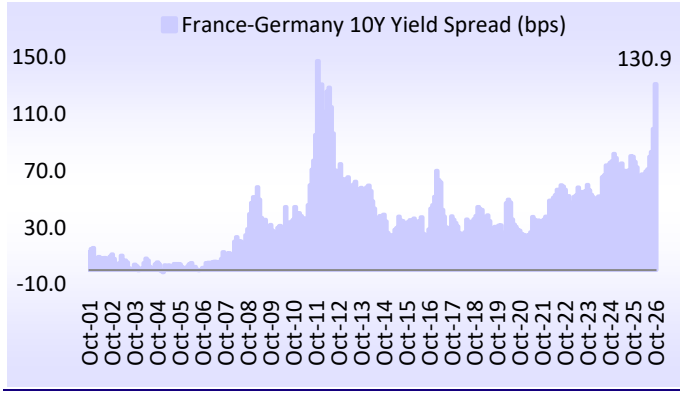
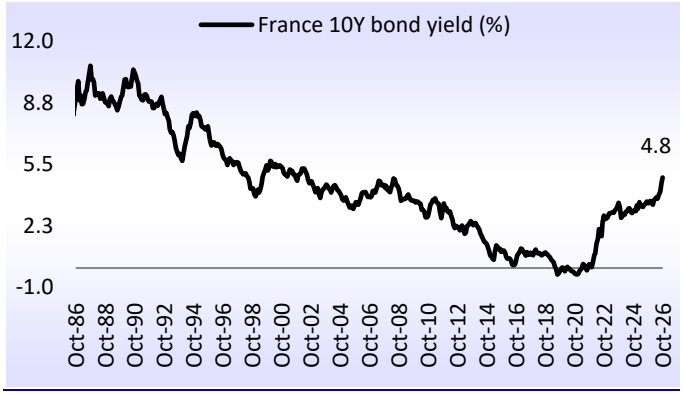


Exhibit 6: France's 10Y bond yield has accelerated to 4.8% on deficit and debt fears



Source: CEIC, MOFS; Data as of 19th Oct'26

The problem extends beyond France: Euro has fallen across the board

Exhibit 7: Germany-Italy 10Y yield spread edged up to 100bp in Oct'26

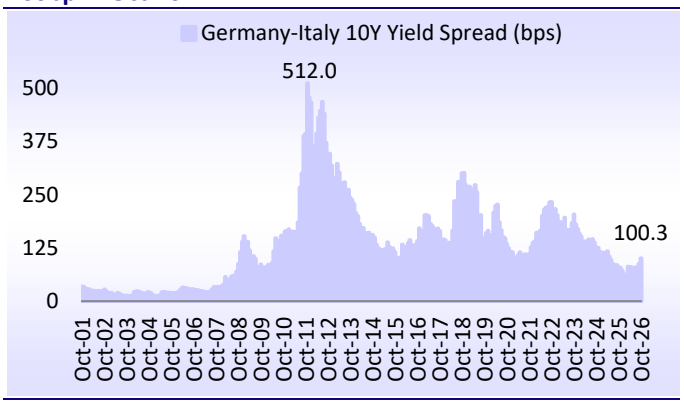
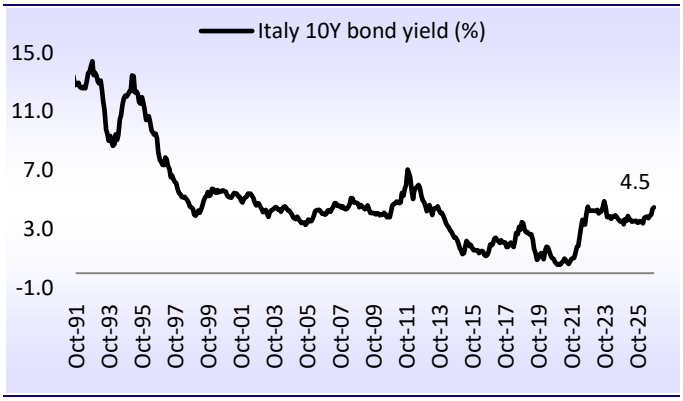


Exhibit 8: Italy 10Y bond yield has accelerated to 4.5% as of 19th Oct'26



Source: CEIC, MOFSL; Data as of 19th Oct'26

Exhibit 9: EUR/USD slides down to 1.13 in Oct'26

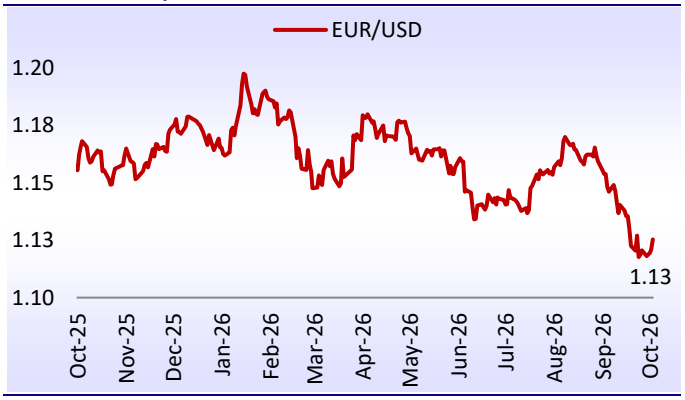
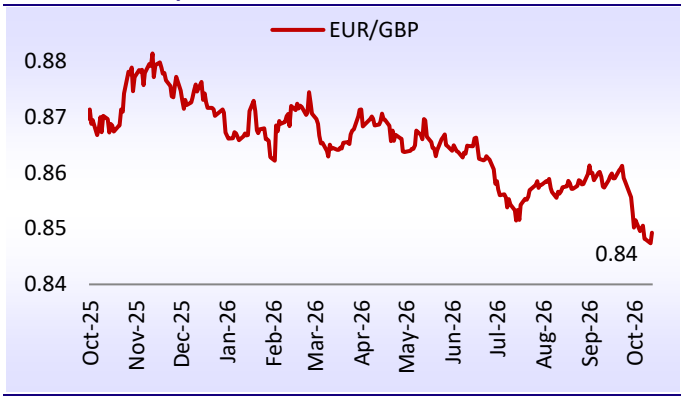


Exhibit 10: EUR/GBP decelerated to 0.84 in Oct'26



Source: CEIC, CBO, MOFSL; Data as of 19th Oct'26

Exhibit 11: EUR/JPY dropped to an 11 month-low at 177.82

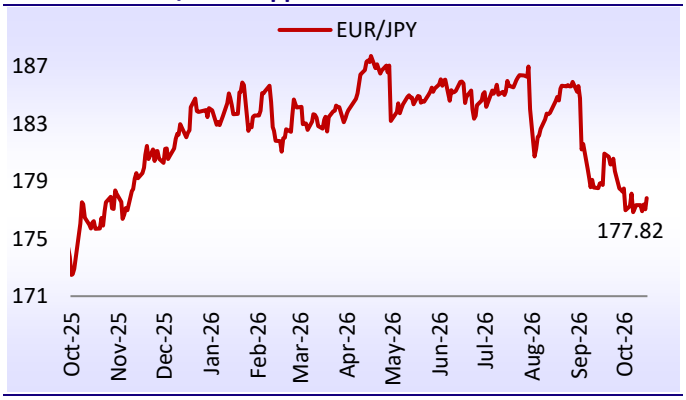
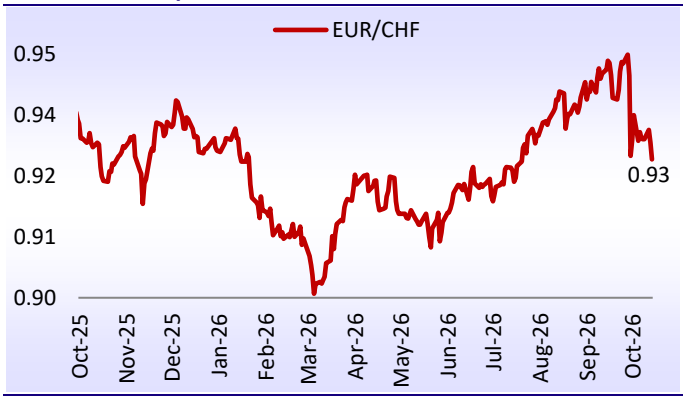


Exhibit 12: EUR/CHF slides down to 0.93



Source: CEIC, CBO, MOFSL
Data as of 19th Oct'26

Exhibit 13: EUR/USD contracted 2.6% in Oct'26

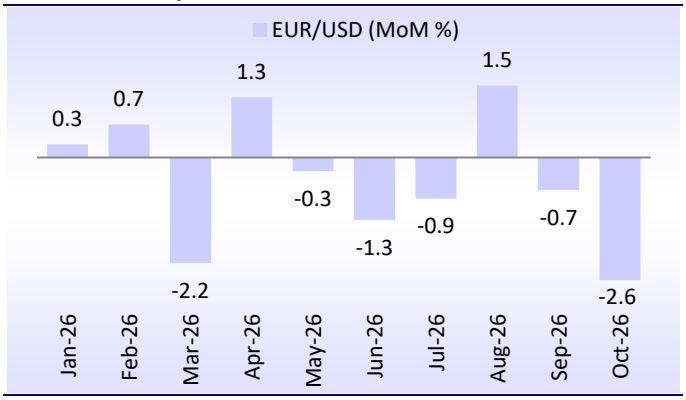
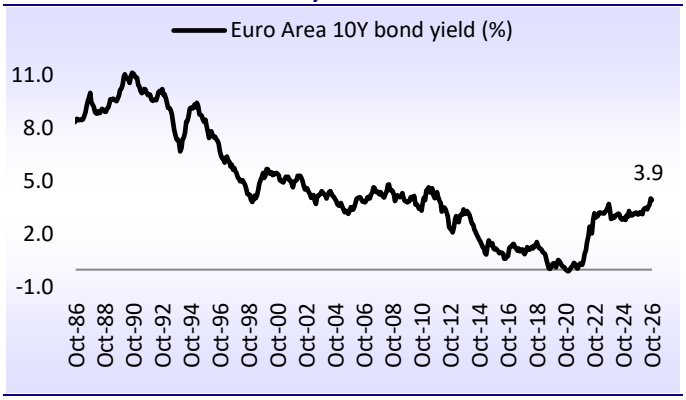


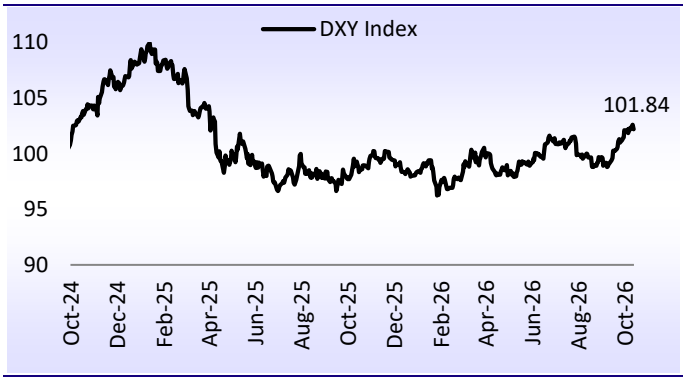
Exhibit 14: Euro Area bond yield stood at 3.9% in Oct'26



Source: CEIC, CBO, MOFSL; Data as of 19th Oct'26

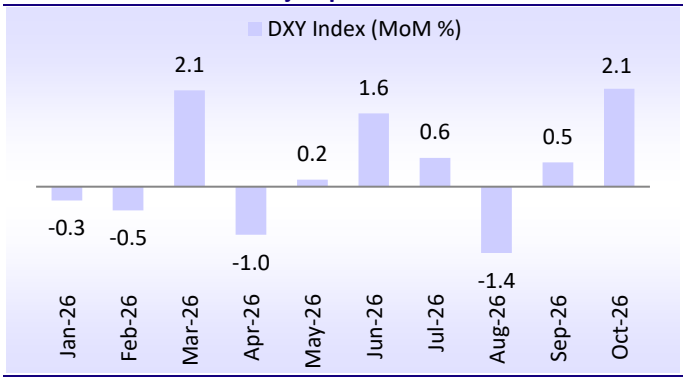
US: The dollar's safe-haven appeal

Exhibit 15: DXY Index accelerated to 101.8 in Oct'26



Data as of 19th Oct'26

Exhibit 16: US DXY Index jumped 2.1% MoM in Oct'26



Source: CEIC, MOFSL

Exhibit 17: US 10Y bond yield surged to 5.1% in Oct'26

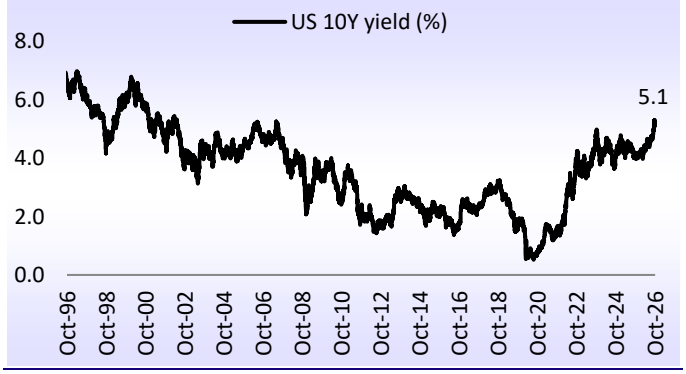
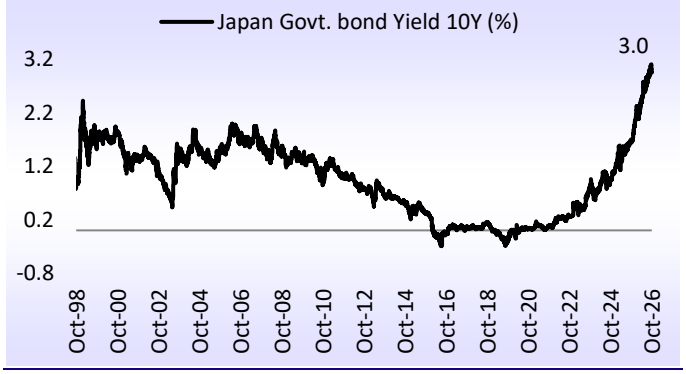
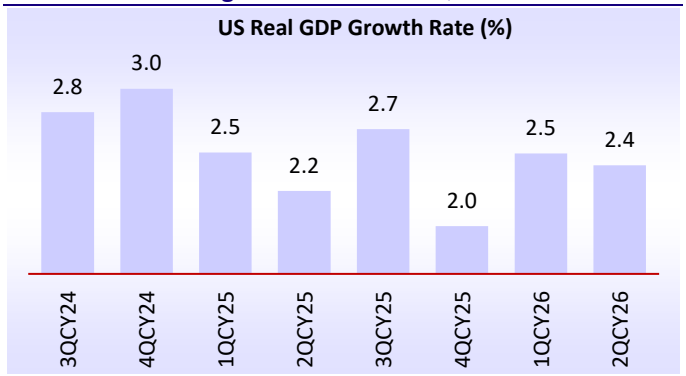


Exhibit 18: Japan 10Y bond yield accelerated to 3.0% in Oct'26



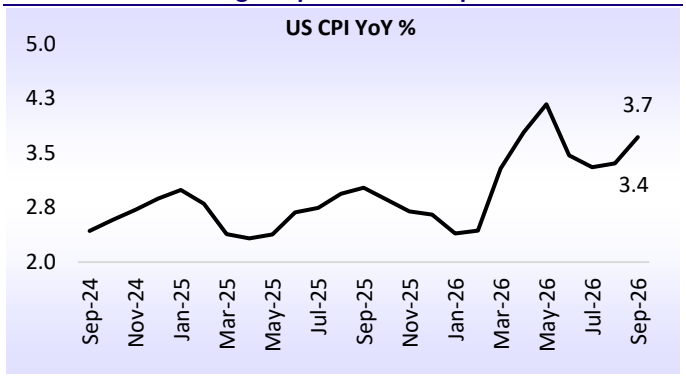
Source: CEIC, CBO, MOFSL, **Data as of 19th Oct'26**

Exhibit 19: US GDP grew 2.4% YoY in 2QCY26



Data as of Sep'26

Exhibit 20: US CPI edged up to 3.7% in Sep'26



Source: CEIC, MOFSL

Exhibit 21: US – Key economic indicators

Indicator	Latest reading	Previous reading
Real GDP growth	2.2% annualized, Q2CY26	2.5%, Q1CY26
Headline CPI inflation	3.7% YoY, Sep'26	3.4%, Aug'26
Core CPI inflation	2.6% YoY, Sep'26	2.4%, Aug'26
Headline CPI, MoM	0.6%, Sep'26	0.4%, Aug'26
Core CPI, MoM	0.3%, Sep'26	0.3%, Aug'26
PPI inflation, MoM	1.3%, Sep'26	0.5%, Aug'26
Manufacturing PMI (ISM)	54.5, Sep'26	54.6, Aug'26
Services PMI (ISM)	54.9, Sep'26	55.4, Aug'26

Source: FRED, MOFSL

Exhibit 22: Markets place a 72.3% probability on the Fed holding interest rates steady at the next meeting

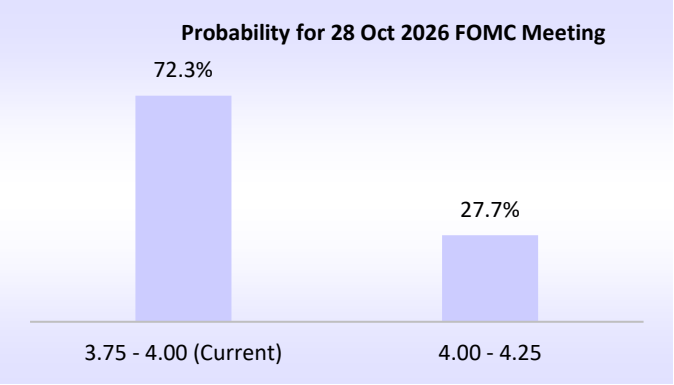
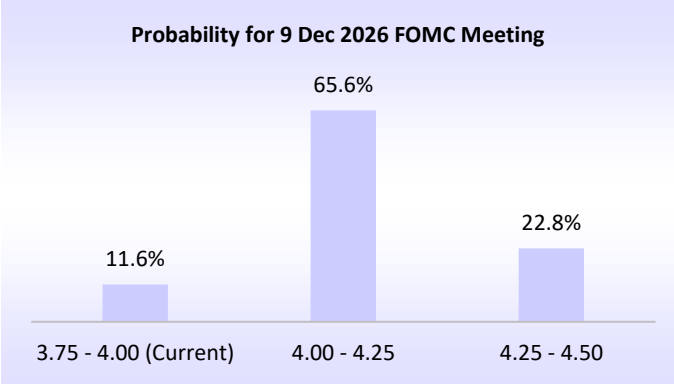


Exhibit 23: Market odds shift toward a rate hike with 65.6% probability for Dec'26 FOMC



Source: CME Fedwatch, MOFSL

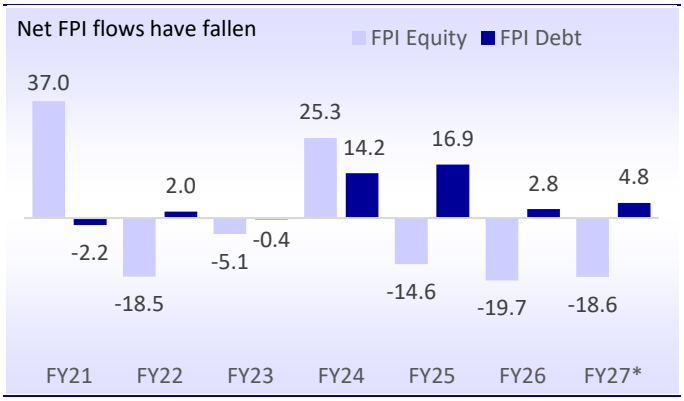
Exhibit 24: The FOMC revised its growth and inflation projections higher: Median Fed macroeconomic projections

Month	2026	2027	2028	Long Term
GDP (% YoY)				
Sep 2026	2.3	2.4	2.2	2.0
Jun 2026	2.2	2.3	2.2	2.0
Mar 2026	2.4	2.3	2.1	2.0
Dec 2025	2.3	2.0	1.9	1.8
Sep 2025	1.8	1.9	1.8	1.8
Unemployment Rate (%)				
Sep 2026	4.1	4.1	4.1	4.2
Jun 2026	4.3	4.3	4.2	4.2
Mar 2026	4.4	4.3	4.2	4.2
Dec 2025	4.4	4.2	4.2	4.2
Sep 2025	4.4	4.3	4.2	4.2
PCE Inflation (% YoY)				
Sep 2026	3.7	2.3	2.1	2.0
Jun 2026	3.6	2.3	2.0	2.0
Mar 2026	2.7	2.2	2.0	2.0
Dec 2025	2.4	2.1	2.0	2.0
Sep 2025	2.6	2.1	2.0	2.0
Core PCE Inflation (% YoY)				
Sep 2026	3.4	2.5	2.2	
Jun 2026	3.3	2.5	2.1	
Mar 2026	2.7	2.2	2.0	
Dec 2025	2.5	2.1	2.0	
Sep 2025	2.2	2.0	NA	
Median Fed Funds Rate (%)				
Sep 2026	4.1	4.1	3.9	3.2
Jun 2026	3.8	3.6	3.4	3.1
Mar 2026	3.4	3.1	3.1	3.1
Dec 2025	3.4	3.1	3.1	3.0
Sep 2025	3.4	3.1	3.1	3.0

Source: FED, MOFSL

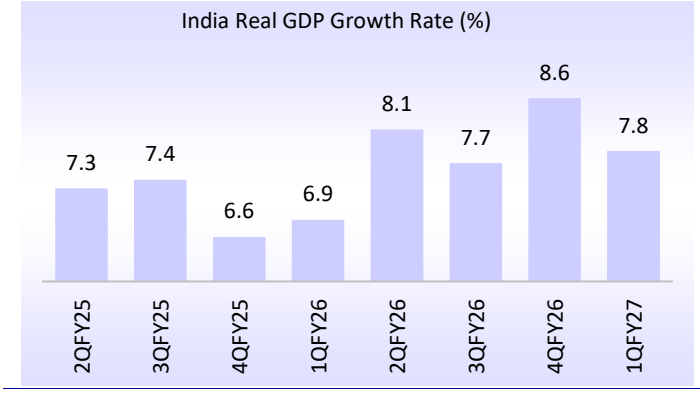
India: Strong growth, but capital flowing elsewhere

Exhibit 25: Net FPI flows have contracted 18.6% in FY27



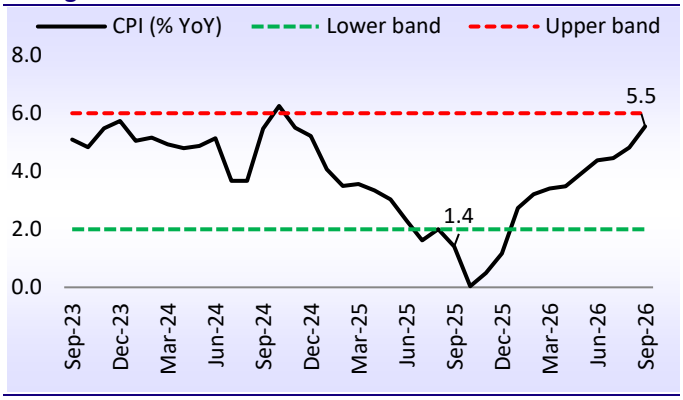
*Data till Oct'26

Exhibit 26: India's Real GDP grew 7.8% in 1QFY27



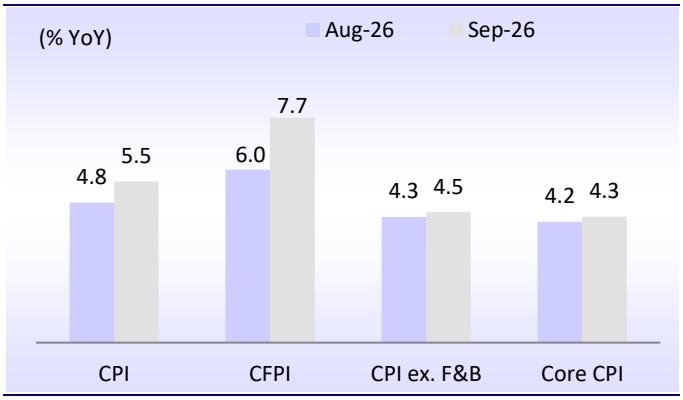
Source: CEIC, MOFSL

Exhibit 27: Inflation increased to 5.5% in Sep'26 from 4.8% in Aug'26



Data as of 12th Oct'26

Exhibit 28: Food inflation increased to 7.7% in Sep'26; core inflation stood at 4.3%



Source: CEIC, MOFSL

Exhibit 29: India's bond yield increased to 7.4% in Oct'26

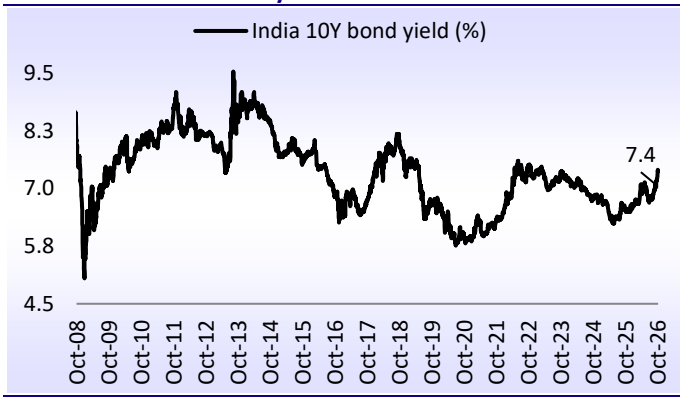
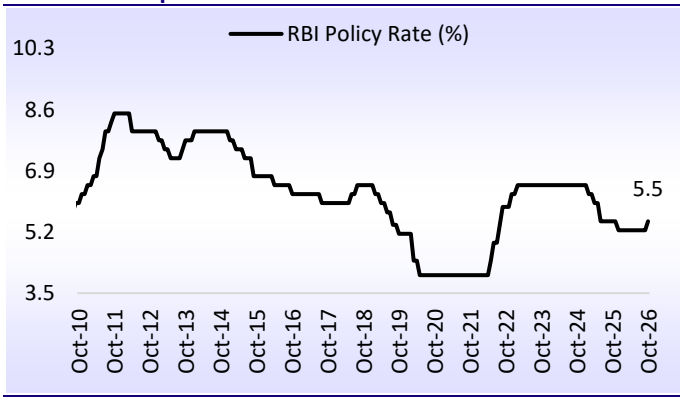
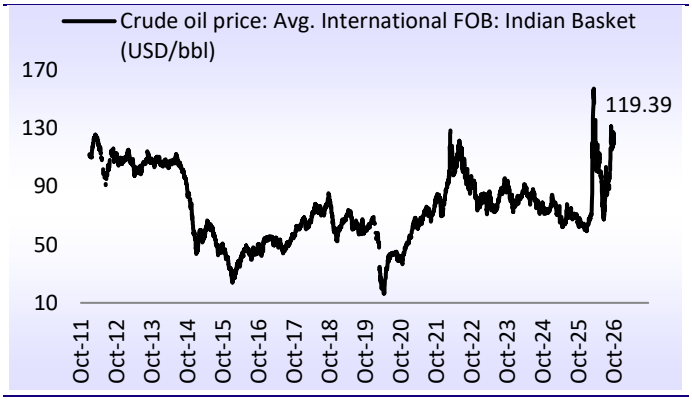


Exhibit 30: Repo rate was hiked to 5.50% in Oct'26 MPC



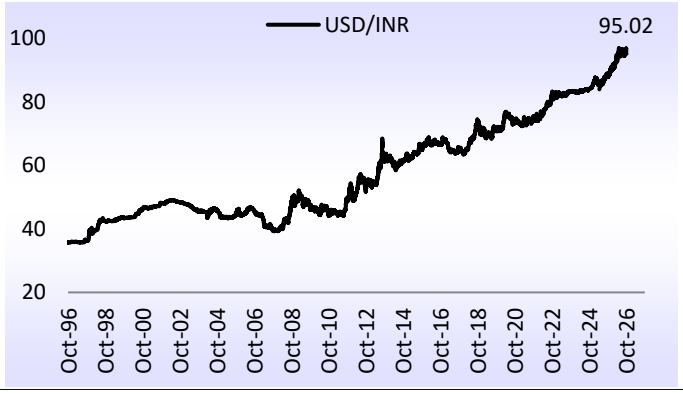
Source: CEIC, MOSPI, MOFSL

Exhibit 31: Crude oil price increased to USD119.4/bbl



Data as of 19th Oct'26

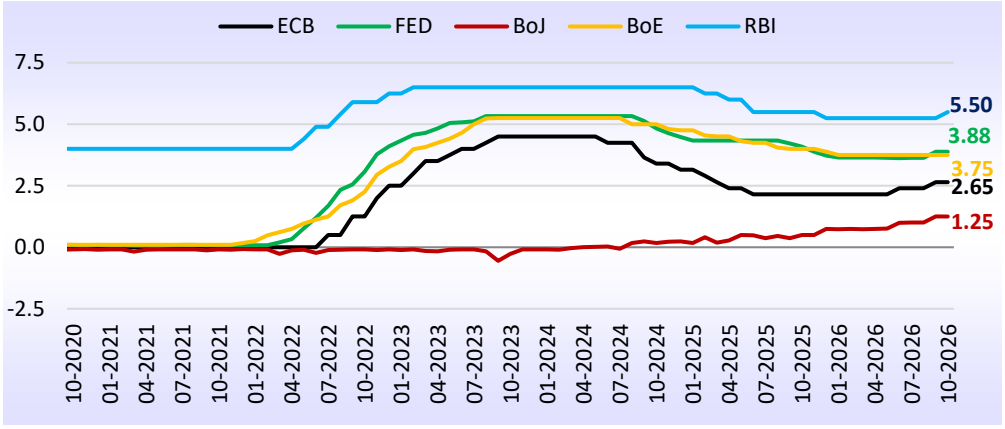
Exhibit 32: USD/INR stood at 95.02 in Oct'26



Source: CEIC, MOFSL

Global central banks have shifted from easing to tightening

Exhibit 33: Rate hike cycle has begun



Source: CEIC, MOFSL

Exhibit 34: US Federal funds rate stood at 3.88% in Oct'26

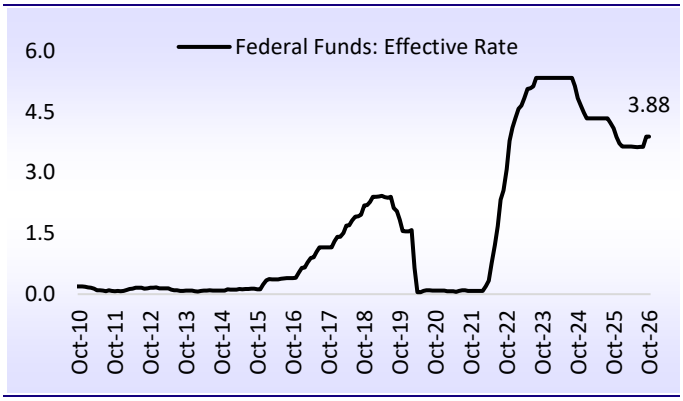
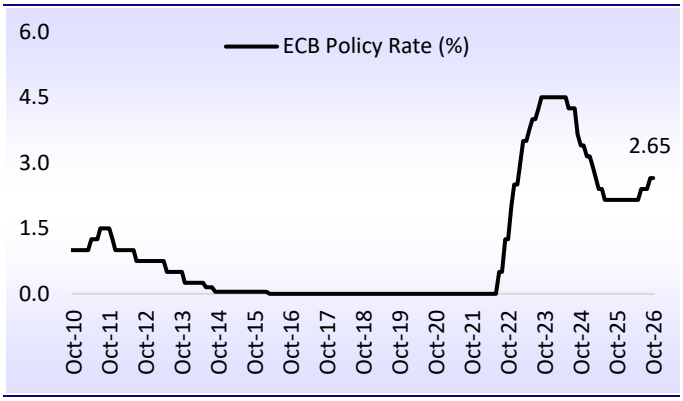


Exhibit 35: ECB policy rate was hiked for the fourth month in Oct'26



Source: CEIC, MOFSL

Exhibit 36: BoJ policy rate remained at 1.25% in Oct'26

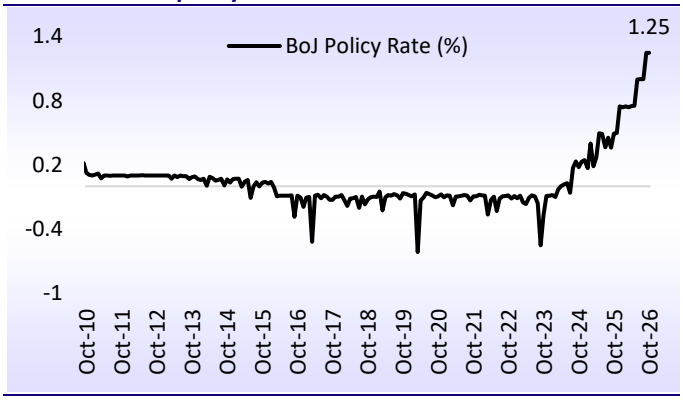
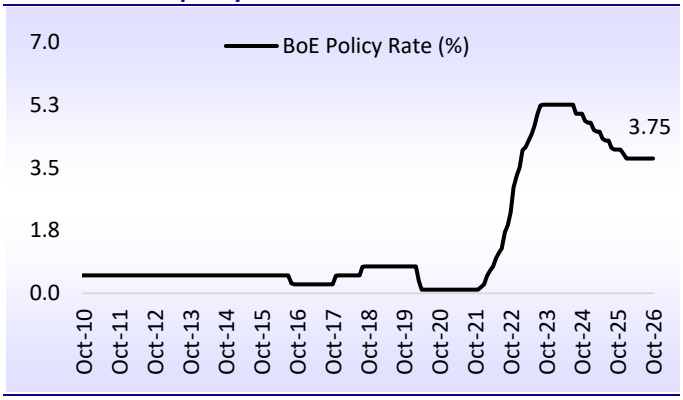


Exhibit 37: BoE policy rate held at 3.75% in Oct'26



Source: CEIC, MOFSL

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