MACRO OUTLOOK

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How the Interaction of Credit Spreads and Yields Shape Bond Market Opportunities

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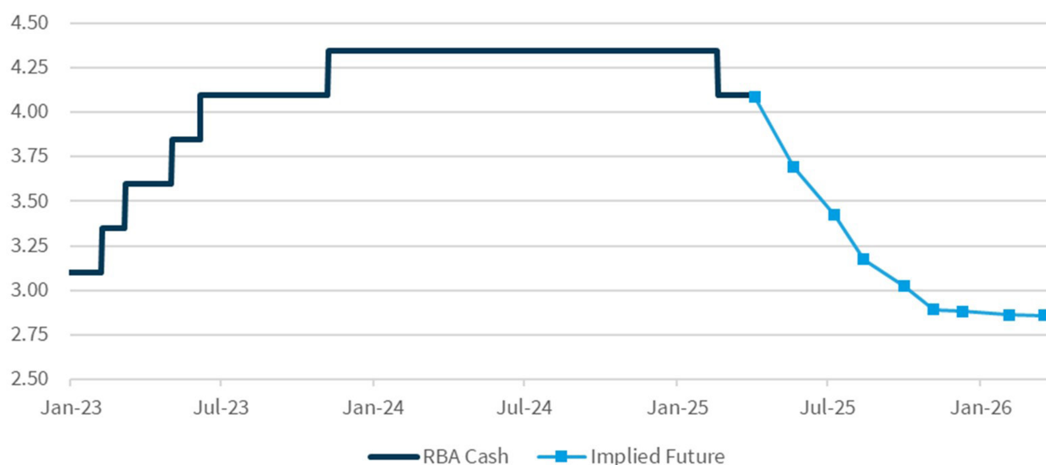
The Interaction of Credit Spreads and Outright Yields

As the tide of global news washes over us, we need to keep an eye on the fundamentals, too. The RBA has started to lower interest rates and seems at this point – assuming international disruptions don't derail the outcome - to be likely to achieve the almost mythical soft landing. Inflation has come down materially and now sits comfortably inside the target band at 2.7%, according to the most recent monthly trimmed mean result. Meanwhile, the unemployment rate has meandered around just above the 4% level, suggesting we are somewhere near full employment. It's only been a few months, but if the RBA manages to maintain the current status quo, then they will have played a part in something extraordinary. Namely, the taming of inflation without triggering a material slowdown.

The recent volatility in markets caused by tariffs has seen the expected trajectory for the RBA drop, and an elongated RBA cycle is now anticipated; there's even a decent prospect for a 50bp rate cut in May currently priced, but that could vanish as quickly as it appeared. Australia is lucky that our current position allows us to cut rates freely if that proves to be necessary.

Figure 1: Expected trajectory of the RBA



Source: Bloomberg, FIIG Securities. Correct pricing as at 7 April 2025.

Other similar countries have not been so lucky. Canada has seen a material rise in the unemployment rate to 6.6%. New Zealand has seen the unemployment rate rise to 5.1% and some fairly appalling GDP results like the (revised) -1.6% over the year to September 2024. So even though the 2022 outbreak of inflation and the associated RBA rate rise cycle hasn't been fun to live through as a consumer, Australia has come through very well compared to global peers.

Our overall understanding of the domestic Australian economy has not changed much since we published our BOLD strategy in January. The RBA cut rates in February, rather than May, as we had thought most likely, but the RBA's severe reticence and hawkish commentary accompanying the cut suggest they would have been happy waiting had other factors not been at play. The market has started to change the medium-term assumptions. Previously, only a short, mild rate cut cycle was expected by the market, while we have long argued that a slower, elongated rate cut cycle is more likely as our base case. As we've explained before, we think the labour market is showing clear evidence that the true rate of full employment occurs at a lower unemployment rate than the RBA currently believes. If that's so, then the feared bout of wage inflation won't materialise in coming years, and the RBA will feel comfortable gently lowering the cash rate periodically in search of even higher employment. All in all, the domestic economy is looking fairly good at present – as long as we're not derailed by offshore moves.

That doesn't mean the future is without economic risks. In fact, thanks to President Trump, the current global economic outlook is probably more dangerous than it has been since COVID. Inflation was a problem over the past couple of years, but a problem we could identify and deal with. The solution to high inflation is to raise interest rates. It hurts, but it works. On the other hand, a complete knockdown and reorganisation of global trade flows was not something that planners or forecasters had been anticipating. I'm writing this shortly after the Chinese retaliation to President Trump's "Liberation Day" new tariffs. A complete reorganisation of major trade flows now seems fairly likely.

This reorganisation will likely be very painful. The world of trade is splintering. The US appears to want to dominate global trade and set parameters that are very beneficial to itself only. But that's not how mutually beneficial trade works, so other countries are fighting back. It seems likely that by seeking hard power and domination, the US will find itself with much weaker soft power. That will matter in the long run.

It's easy to point to the individual losers from a globalised trade system, particularly in countries like the US. Manufacturing is now mostly done in places where the cost of labour is lower, simultaneously providing work for the truly low-paid (in a global sense) and cheap goods for the well-off (again in a global sense) to enjoy. This trade relationship caused material improvements in the standard of living for both Americans and residents of lower-paid countries. By seeking to ensure that manufacturing takes place in America, this nexus is broken. It creates a situation where the manufactured goods are no longer as freely traded. This will cause reductions in the standard of living in both countries.

The economic situation in the United States looked very good going into the Presidential transition, and the official data, which lags the developments, of course, continues to hold up surprisingly well. There has been just the odd sign that cracks are appearing recently. Given the new announcements and terrible share price performance, it seems a given that confidence will weaken even further.

Whether this very unusual state of affairs of terrible confidence and reasonable data is going to continue is the million (multi-trillion?) dollar question. A sharp drop in confidence and fears of a recession can easily become self-fulfilling if consumers start to pull back on spending because they're uncertain about the future. The same applies to large companies investing in new production facilities since they are uncertain about the future rules for trade.

Tariffs are taking most of the headlines, but the up-ending of the US civil service also matters and is, for the most part, not holding the attention of markets. That could change in the future, however. Some recent headlines suggesting a USD 500bn shortfall in US Government revenue due to upheaval at the IRS have broken through and demonstrate the problem neatly. It's easy to demonise the Government as slow and inefficient – because it's often true. But it's also often true that the Government delivers services that the private sector can't or won't. As a consequence any hard-and-fast cuts to the Government tend to simultaneously end up cutting inefficiencies and cutting necessary services at the same time.

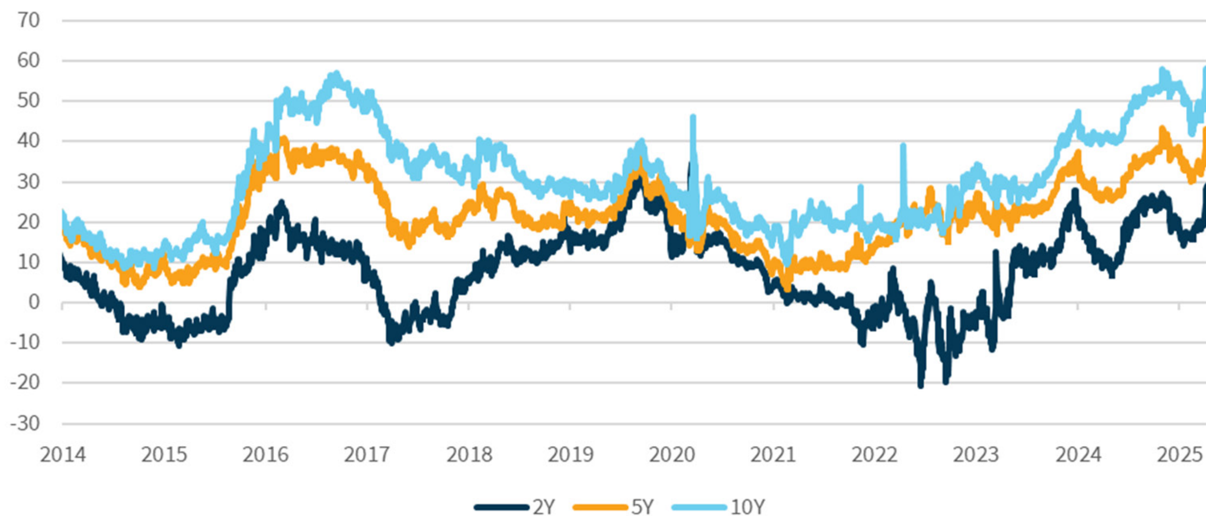
The experiment the US is currently running in real-time is whether you can slash the less efficient parts of Government – or the parts that the President has a political opposition to - without fundamentally damaging the long-term core parts of the Government that provide services you want to preserve. Some measure of deficit reduction was needed in the US, and we were initially hopeful that the spending cuts might achieve that, even if they achieve it via a painful mechanism. However, if the IRS is losing efficiency the spending cuts won't be enough to restore health to the US budget deficit. There is also still the question of possible tax cuts sitting in the background, which is likely to come to the foreground relatively soon as the Republicans in the Senate begin staking out a position on the Budget.

The other risk – still faint but more substantial than is comfortable – is that a global realignment of alliances is taking place alongside the global realignment of trade flows. If it is, that will see trade and capital flows materially change. After around 50 years of global politics being, by and large, in favour of free trade the US is now openly hostile to the concept. Free trade can be damaging to domestic industries that are no longer competitive but is, overall, the most efficient way to structure the global economy. In fact, free trade is often given as one reason for lower inflation taking hold across the 1990s, 2000s and 2010s.

Tearing up that structure and restarting with a new premise for global trade would create very difficult environments in many economies, Australia included. In the short-term, the process would be inflationary, both directly via tariffs raising prices and indirectly, because onshoring processes is neither efficient nor cheap.

Australia is mercifully remote from the direct impacts of the tariff war, but our economy would not be immune from a global problem. At present, Australia has been subjected to a 10% overall tariff as part of the new baseline arrangements. Canada has been bearing the most direct and imminent risk for the last couple of months, but the focus on China is growing and, given their recent retaliation, we expect China to be the focus for the next little while. But remember that China is both a trade partner and capital provider to the US. The notion that there could be a capital flight from the US as the global alliances reform is still relatively remote – but also uncomfortably real. One way to measure this is to look at the difference between a 10Y US Government bond yield and the US 10Y cash rate expectation. This is a form of credit spread for the US Government. This spread has been rising materially for a while, with a sharp spike wider in recent days.

Figure 2: US Government "Credit" spreads



Source: FIIG Securities, Bloomberg. Note: defined as UST less OIS for given maturity.

In total, the current situation is one where the (lagging) official US data looks mostly benign, but the confidence surveys are terrible and the geopolitical backdrop has much more risk than it used to.

Bonds are a good investment in times of high risk, but they are also a very broad category, and the performance of bonds during a bout of risk-off movements in equity markets depends crucially on what sort of bonds you choose.

This quarter's Macro Outlook will look at how credit risk interacts with interest rates when investing in bond markets. The idea that "during a period of calamity the RBA will cut interest rates, and bond yields will fall, causing bond prices to rise" is broadly true and very much applies to government bonds and other low-risk bonds. That's what makes bonds a good investment at times of high risk. However, it's also true that "during a period of calamity, the risk in any individual company will rise, so the credit spread implicit in a risky bond will rise and the risky bond will not perform as well as government bonds during a period of market stress".

Not all bonds are created equal, and not all bonds will react in the same way during a period of economic difficulty. The key for bond investors is to make sure you understand how the bonds you own will behave should we experience a prolonged period of economic turbulence.

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The interaction of duration risk and credit risk

The components of a bond yield.

Before we can talk about how the components of a bond yield interact, we must define what the different components of a bond yield are.

One way of decomposing a bond's total yield is to think of the yield as the sum of:

The risk-free rate	being the expected compounded cash rate to the maturity date.
The term premium	being the extra yield asked by investors to lock their investment in for a longer time period over and above the expected risk-free rate.
The credit spread	being the extra yield demanded to compensate for the risk the company defaults.
The liquidity premium	being the extra yield demanded to compensate for the extra costs of exiting the bond early.
Technical factors	being any short-term dynamics that relate to who wants to buy or sell that bond at that particular time.

Different sorts of bonds have different proportions of these different components of a yield.

For example, a 5Y Government bond would be comprised mostly of the risk-free rate. There is usually only a small amount of term premium at five years. There is very little credit spread for the Australian Federal Government, meaning this component is effectively zero. Government bonds are very liquid, so the liquidity premium is also exceptionally small. The technical factors for a Government bond are complex, but they typically amount to no more than a handful of basis points, and even then, only at very specific times of year. As a result, the 5Y Government bond is almost entirely made up of the risk-free rate and term premium.

The interaction of duration risk and credit risk

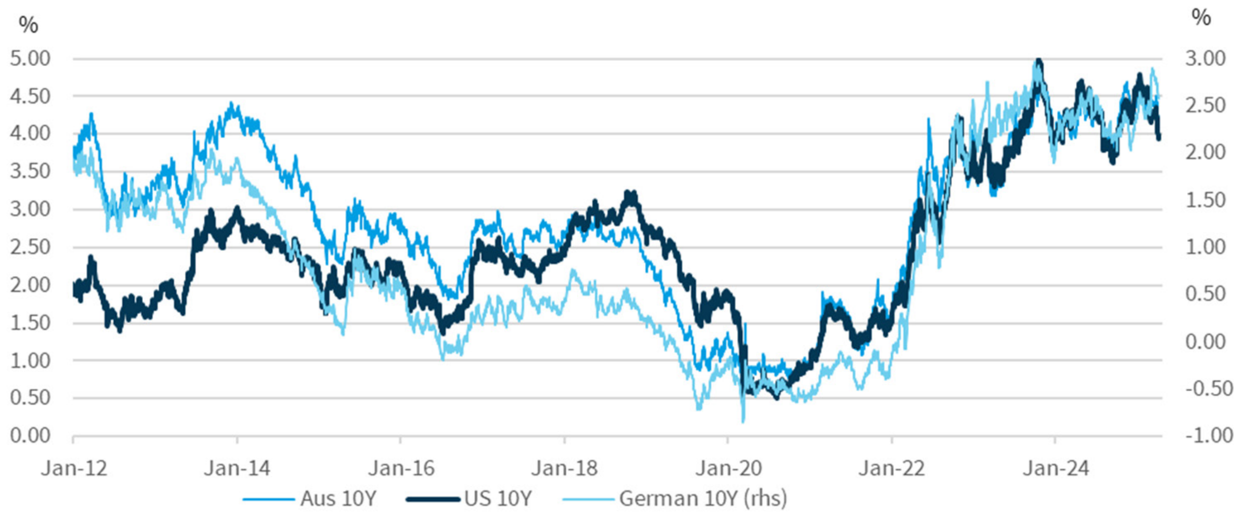
In contrast, a 5Y investment-grade corporate bond would generally be higher than the 5Y Government bond rate. The 5Y risk-free rate and term premium components are identical, of course. However, the corporate bond would have a much higher credit risk premium and also is very likely to have a higher liquidity premium because even the most liquid corporate bonds are less liquid than the government bonds.

It is important to remember that although each of these proportions displays patterns and general tendencies, none of the components is set in stone. Most are cyclical. The expected risk-free rate moves up and down as the expectations for the RBA change, for example. The credit cycle also sees the amount charged as a credit spread rises and falls over time in reasonably predictable ways as the likelihood of default changes.

A fundamental point, though, is that while all of these components vary, they tend to be correlated with each other. The most important correlation is that when markets are anticipating very poor economic growth outcomes – even recessions – the expectations for the cash rate fall, but the risk of default rises. So, the risk-free rate falls, but the credit spreads tend to widen (get larger) at the same time.

The recent tariffs announced by the US and by China have seen sharp falls in the stock market and moderate falls in bond yields. Despite the drops in bond yields, the overall level of yields remains relatively high by longer-term assessments.

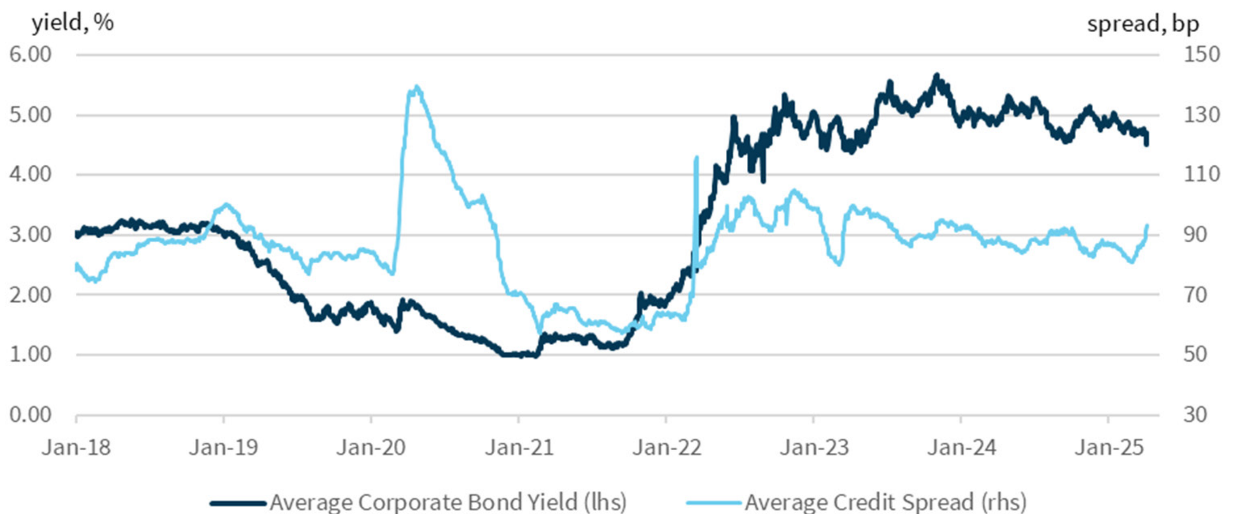
Figure 3: Government Bond Yields in Australia, US and Germany



Source: FIIG Securities, Bloomberg

At the same time, there's been a widening in credit spreads, but one that still leaves credit spreads within the recent ranges or only marginally higher. This interaction of falling yields and rising credit spreads is actually quite common. It makes intuitive sense that in a period where markets expect generally weak economic outcomes that the level of the risk-free interest rate would fall while the level of the risk in a credit spread would rise.

Figure 4: Australian Corporate Bond Yield and Average Spread



Source: FIIG Securities, Bloomberg

But this interaction also contains the seeds of a problem. For investors who have bought bonds to protect their overall investment portfolio in a time of market stress, this tendency for credit spreads to rise during periods of stress is undermining the reason bonds were purchased in the first place.

This is not merely an idle speculation. During "stress" events, credit spreads widen significantly, often undoing most – if not all – of the gains from falling risk-free rates.

Figure 5: The negative interaction of credit spreads and yields in the US

Source: FIIG Securities, Bloomberg

Notice that during the start of the pandemic (early 2020) and to a lesser extent during 2016, there were material widenings in credit spreads during the periods when overall yields, represented by the 5Y US Treasury, were falling. The correlation holds in reverse, too. The period around 2012 and 2013 saw rising overall yields and falling credit spreads.

We have frequently compared the current period and likely upcoming behaviour in rates with the 2012-2015 period in Australia. That time frame was actually a great example of the dynamic I'm discussing, but unfortunately, the best data only begins during 2014. However, even during that window, there was a material widening of credit spreads that coincided with a significant drop in risk-free interest rates.

The net result was that during a period of falling interest rates, credit bonds underperformed other forms of bonds because the falling risk-free rate coincided with a widening of the credit spreads.

This needs to be kept in proportion, though, and kept in proportion with what happens in other types of investment markets. What tends to happen is that during periods of significant risk-off movements, like the current tariff episode, the price of comparatively risky credit bonds remains relatively stable. That's because the risk-free rate falls and the credit spread widens which, largely, cancel out. The details will depend on the exact bond considered, of course. This relative stability in the price of credit bonds occurs even as the price of government bonds rises (because risk-free rates are falling) and the price of equities are falling incredibly quickly (because there's some calamity happening).

When positioning portfolios for such a period, bond investors need to consider what they are attempting to achieve with their bonds. Bonds are often thought of as a great diversifying asset to hold alongside an equity portfolio. Bonds, as an asset class, provide both consistent income and an asset that tends to outperform when equity markets are falling.

But it's not the same sorts of bonds that provide these two features. Credit bonds provide higher consistent income. Government bonds provide the best chance of actual capital gain during a downturn.

This is neatly shown in just the last few days by comparing the CBA Nov-34 call tier 2 subordinated bond, with the ACGB Dec-34 maturity bond and the CBA share price. In just the last few days, the equity price has fallen 4.02%. The credit bond has edged up 0.44%, and the Government bond has risen 2.37%.

	31-Mar-25	7-Apr-25	Change (%)
CBA Equity Price	150.93	144.86	-4.02
CBA Tier 2 Bond Nov-34 Call	102.405	102.859	0.44
Government Dec-34 Bond	93.059	95.263	2.37

The fixed-rate credit bond has performed much better than the equity during this bout of volatility and continues to do what it says on the tin. The coupon has not changed and the price didn't move very far – fixed rate it is. For those who are trying to use the bond market to actively hedge their equity holdings, however, will need to take into account their credit exposure, too. Only the least risky bonds, like government bonds, have this negative correlation with equity markets.

The fundamental properties we've described here are likely to continue through the remainder of the tariff war – however short or long that proves to be. Unfortunately, we suspect the tariff war will be ongoing as Trump does not appear to be a man likely to take a backward step or admit an error. The recent performance shows that purchasing credit bonds, even when spreads are expected to widen, can be the right choice. During periods of significant volatility, credit bonds may initially benefit from falling interest rates, but some of those gains are typically offset by widening credit spreads. However, the net result can still be positive.

At present, the market is highly volatile, with prices moving significantly. We continue to like many of the trades first described in our original BOLD strategy, particularly the switch into Government and State Government bonds, though we acknowledge that we have probably missed the best entry point on that. But, even so, if the RBA is forced to cut rates hard because the tariff war destabilises the global economy and prompts a global recession, then the movements in bond yields so far, while large, may just be the beginning.

On the other hand, if the needless, self-inflicted tariff damage ceases, then bonds will likely rise in yields.

As we discussed in the BOLD strategy and at other times, in periods of volatility you need to be decisive, even as you diversify your investments. There's been a fall in risk-free rates, but the credit bonds available still have very attractive yields – which may look even better with hindsight if the tariff situation continues to worsen and the entire yield curve falls.

In line with our original BOLD strategy, we recommended using bouts of volatility to take judicious risks. It is still a little too early to be selecting market bonds, but it is very likely that as the market calms and more liquid pricing returns there will be bonds available at attractive prices.

All spreads are moving wider. Provided below are some indicative movements in different types of bonds.

	April 1 credit spread (bps 5 year)	April 9 credit spread (bps 5 year)	Change
AAA Gov	-10	-15	-5
AA Semi Gov	25	40	15
A- Major Bank snr	85	105	20
A- Major Bank sub	160	205	45
BBB Corporate	125	150	25
BBB Corporate sub	200	265	65
BBB Regional Bank snr	110	130	20
BBB Regional Bank sub	175	225	50
BBB Offshore Bank snr	160	180	20
BBB Offshore Bank sub	210	260	50

Source: FIIG Securities

*illustrative purposes only - please contact your RM for more detailed bond pricing and availability

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