MACRO OUTLOOK

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By Philip Brown, Head of Research, FIIG Securities

B.O.L.D.

FIIG | The fixed income experts

Introduction

2025 begins with a large number of unanswered questions for the global economy and a great deal of uncertainty. To take just one example, “How will a re-elected President Trump behave?” That’s a broad question without a simple answer, but the US Government is a major influence on the world debt markets. He could spur significant growth with a large tax cut, or he might trigger a slowdown with an emphasis on cost-cutting and Government efficiency. (Or he could go to war against a long-standing ally because Denmark refused to sell Greenland – I’m fairly sure that’s hyperbole, but the fact that it isn’t 100% certain that it is hyperbole is a great example of the uncertainty Trump causes.)

Other questions can also be intertwined. To take a pair from closer to home, “Will the RBA cut rates in February?” and “Will inflation continue to fall?” are obviously linked questions. It’s not certain how much further inflation will fall, though the seeming inability for wages to respond to strong labour markets in 2023 and 2024 does suggest there is significant scope for a further decline. Meanwhile, the RBA decision scheduled for 17-18 February could go a number of ways: there is still important inflation data coming in late January, as well as the various labour market indicators. These two questions can only be answered together.

The key to successful investing, in our view, is not about knowing the answers to these and all other questions. To be candid, no one knows the answer to even half of these questions. Instead, successful investing comes from identifying which questions really matter in the medium- and long-term and which do not. For example, whether or not the RBA cuts rates in February – or instead waits for April, or May – matters comparatively little for bond prices over the longer term. When buying a medium-term investment like a bond, the exact month of the RBA rate cut quickly fades into history. What matters far more is how the RBA pricing develops over time. The answer to that question is much clearer, though. The RBA will be cutting rates relatively soon and will likely continue to do so, gradually, for some time. So the second question, about how inflation will behave over time, deserves a lot more thought, in our view, since it speaks to how far and how fast the RBA will lower rates.

We see risks on both sides of this inflation question, with domestic risks suggesting lower inflation but global risks suggesting higher inflation. We think the domestic argument will win out, though, and inflation will become tamer over time. Domestic growth has been very weak and almost entirely driven by the Government sector and population growth. But governments everywhere are starting to feel the pinch after a pandemic-induced increase in spending that has continued through the recent inflationary period. Australian governments (Federal and State) appear poised to cut back on spending (at least in a relative sense), while some other international governments are also reassessing their situation. Meanwhile, the recent boom in the population is now being actively suppressed by government policy.

Boldness in the face of uncertainty

Meanwhile, the local labour market hasn't delivered high wages growth even during periods of exceptionally strong demand, so we see private sector wages as very unlikely to drive ongoing inflation in 2025 and beyond. The risks towards higher inflation come from Climate Change (via food prices) and from Artificial Intelligence (via energy demand). In the long run, artificial intelligence (AI) might lower prices, but in the short-term, the use of power in AI is part of the global inflation move. Food and energy, combined, are a major part of the global consumer basket and the RBA cash rate has no impact on climate change or AI.

As we wrote in our outlook last year, we expect the RBA will be gentle with the initial parts of the rate cut cycle, but this cycle may well be more elongated and indeed larger in total size than currently understood. Depending on how the global inflation movement progresses, the next few years might resemble the mid-2010s, when the RBA repeatedly, but slowly, lowered the cash rate in an attempt to stimulate domestic growth.

If we're right about that medium-term trend, then purchasing bonds now, against an uncertain backdrop, should pay significant dividends in the long run. It does require a certain boldness, however, to purchase any investment against a backdrop with as many questions as the current situation.

We think investors should lean into this and have designed a strategy named BOLD, which emphasises the right ways to approach and execute bond trading in 2025 to set investors up for a profitable medium-term. Although the exact timing of the coming rate cut cycle is unclear, it seems very clear that the rate cuts are coming sooner or later. We recommend that clients prepare for that eventuality by being bold. Specifically, that is:

B **Buy duration ahead of a turn in the cycle.**

O **Outlast the short-term gyrations of the market.**

L **Look for opportunities in places not previously considered.**

D **Decisive action when the opportunities present.**

Contents

Global Backdrop Remains Highly Uncertain........................6

The United States and Trump's America First Policy.........................6
Government Indebtedness is a Pandemic symptom and is making government debt look cheap compared to corporate debt.............8
Inflation success and inflation risks: Climate Change and AI...........11

Local Dynamics Suggest Rate Cuts are Coming – Timing is the Difficulty..15

Understanding the RBA is about the trend, not the exact timing..15
Inflation is falling, but not that quickly...17
Labour market is a conundrum: Very low unemployment, plentiful jobs, but few pay rises...19
GDP growth will need to look beyond the Government sector and population growth in 2025...21

The BOLD Strategy for Bond Markets in 2025 and 2026..25

If the timing of the RBA is unclear, but the medium-term trajectory is for lower rates, investors must be bold when opportunities arise...25
Specific bond trade ideas for 2025...26

Global Backdrop Remains Highly Uncertain

Global Backdrop Remains Highly Uncertain

The United States and Trump's America First Policy

After spending much of 2024 with markets worrying about who would win the US Presidential election, we now get to spend a little longer worrying about what Trump might do with his regained power.

The Trump policy prescription is exceptionally vague, with an emphasis on "America First" about the only clear through-line that can be drawn. That more isolationist – even more selfish – US international policy will have ramifications for global markets. The most obvious arena is trade policy, where the quiet diplomacy of the Biden era will be replaced by a far more muscular, even bombastic, stance from Trump. It's not clear which is a more successful approach in the long run, but the change will definitely come with more global volatility in financial markets. During the first Trump Presidency, his Tweets (as they were then) used to move markets, so much so that other information sources began to stream his Tweets as part of regular financial market news.

The instability was significant and was actually the point, as best I can tell. By keeping your negotiating partners off balance, you can sometimes win concessions.

Trump's first term was unusual in that, for the most part, the largest threats turned out to be just that – threats and bluster. There are certainly diminishing returns to threatening tariffs and other more aggressive approaches. The risk is that the rest of the world will start to become a little deadened to the shock value of the threats and begin to treat them as the negotiating tactics we believe they are. However, that does possibly mean that Trump might be forced to follow through once or twice. The only way to prove it isn't a bluff is to follow through. That's the risk.

Interestingly, despite the increased volatility and fractiousness of the trade relationships under Trump, it is also undeniable that Trump mostly did not use direct military violence very often on an international level. Some of this reputation for non-violence is Trump's own spin, though far from all of it. Although trade wars were depressingly common in the first Trump Presidency, actual wars were infrequent in Trump's first term. In fact, many of the countries that might be considered the most likely opponents of the US in a dangerous war (e.g. China, Russia) see Trump as much more transactional and so much less war-like.

From a non-Western perspective, the Biden (and Harris) commitment to democracy and human rights means they are seen as much more ideological than Trump. From an international relations perspective, "ideologically committed" is seen as code for "relatively dangerous" since it causes countries to go to war on the principle of the matter even when the cost-benefit analysis suggests a different course of action.

Markets, however, should buckle in for a bumpy ride, as very few economic policies are off the table in the coming Trump administration. The one thing we can say with some certainty is that the second Trump presidency's economic agenda will not be a repeat of the first. It simply can't be, because the starting conditions are so different.

The economic success of Trump's first term was largely built on undoing the difficult economic work of deficit repair undertaken by the US Government as a whole (President and Congress) during the Obama era. During that period, the Federal finances were brought somewhat under control and the deficit was materially reduced. Obama had come to power during the aftermath of the Global Financial Crisis (GFC), of course, with massive deficits. However, by the end of Obama's Presidency, the deficit was "only" 2.2% of GDP. While still relatively sizeable, that marked a return to a healthy economic position with a long-term sustainable approach.

When Trump came to power in early 2017, he soon passed a significant tax cut which resulted in a sugar-hit to the economy. In the short-term, tax cuts trigger increases in growth, but the long-run effect is a material rise in the deficit. That process was underway when the pandemic began and effectively swamped any meaningful analysis of the tax cuts' more medium-term effects.

Although many are expecting a second round of tax cuts, the initial conditions in 2025 are very different from 2017. At present, rather than 2.2% of GDP, the deficit is far larger at 7.1% of GDP (at last count, which is the year to November 2024). There's simply no fiscal space to pass a second round of tax cuts like the first one. Instead, the commentary has been more around how large the reductions in spending will be. We've seen some commentators express a desire to return the deficit to 3.0% of GDP. While laudable, that's a very material cut in spending (4.1% of GDP) and would have real-world consequences for the US economy.

On one level, it's around the same improvement in the deficit that Obama achieved. But Obama was starting from a low base. Much of the improvement in the deficit across Obama's term was possible because the underlying economy improved as the GFC faded into history, and US Government revenues increased in line with that improvement. Now, however, the US economy is already running strongly, and a slowdown is in fact much more likely. So, while Obama was coasting downhill to reduce the deficit as the economy strengthened, Trump faces the uphill challenge of lowering the deficit as the economy, in all likelihood, slows.

Figure 1 is one of my favourite charts and illustrates the problem very neatly. It shows the US deficit on a rolling basis and the US unemployment rate, with the latter serving as a catch-all for the strength of the overall economy. Unsurprisingly, when the economy is strong, the unemployment rate is low, as is the deficit. There has been a very strong correlation between the two metrics over many decades. The problem now is not just that the deficit is high, but that the deficit is high during a period of very low unemployment and a generally strong economy.

Figure 1: US Government deficit (rolling annual) and US Unemployment rate

Source: FIIG Securities, Bloomberg.

There is no easy way to fix this deficit. It either involves painful cuts to services or painful increases in taxes. Neither is politically palatable, but sometimes there is no other course. There are plenty of possible delaying tactics, though. The big unresolved policy question for the Trump Presidency is whether he will tackle this problem head-on or continue to let it fester? Only time will tell.

Government Indebtedness is a Pandemic symptom and is making government debt look cheap compared to corporate debt

The US Government's increased indebtedness is a reasonably acute example of a broader disease, however.

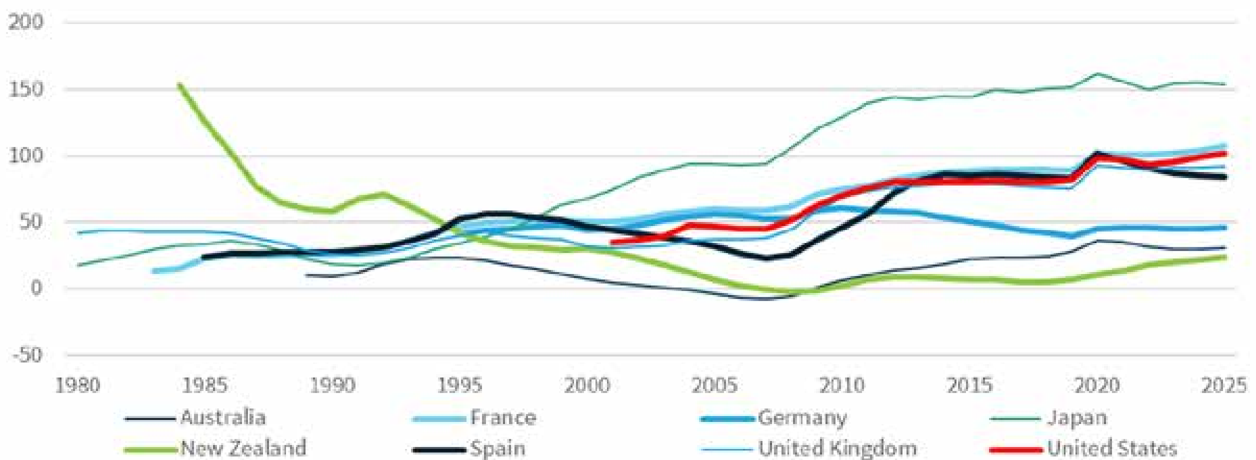
The US went into the pandemic with a relatively large deficit thanks to the Trump tax cuts and then, like every country globally, spent a good deal of money to deal with the pandemic. The current need for the US to control government spending is actually a common thread among many countries globally. Mostly, these pressures are faced quietly by bureaucrats and politicians, but there have already been episodes of public boilover in the UK (the Truss experience) and hints of the same pressures in France.

This particular problem is one with a sting in the tail. When inflation is high, debt-to-GDP ratios are normally fairly well-behaved, even if deficits are high. Yes, high deficits and high interest rates cause debt to rise sharply in dollar terms. But the high inflation rates cause nominal GDP to rise quickly in dollar terms too. Perversely, it is the time when the inflation problem is "solved" and inflation starts to fall, which is the most dangerous for debt/GDP measures. It is this period when the nominal GDP starts growing more slowly.

That is the situation that many countries around the world find themselves in right now. Inflation is falling and real GDP growth is moderating concurrently in many places (e.g. New Zealand). Countries that have high debt ratios now will find that debt harder to bear in 2025 as the rate of nominal GDP growth slows.

The list of problematic countries is changing, however. Thanks to the burst of inflation that accompanied the pandemic, many of the countries that were most exposed during the 2012 European Sovereign Debt Crisis have performed well. Instead, the pressure now sits with previous leaders, like the UK, US and France. The problem is not universal, however. Germany sits with a relatively low debt ratio as does New Zealand. Australia's debt ratio has risen from the lows around 15 years ago, but remains relatively low on a global comparison.

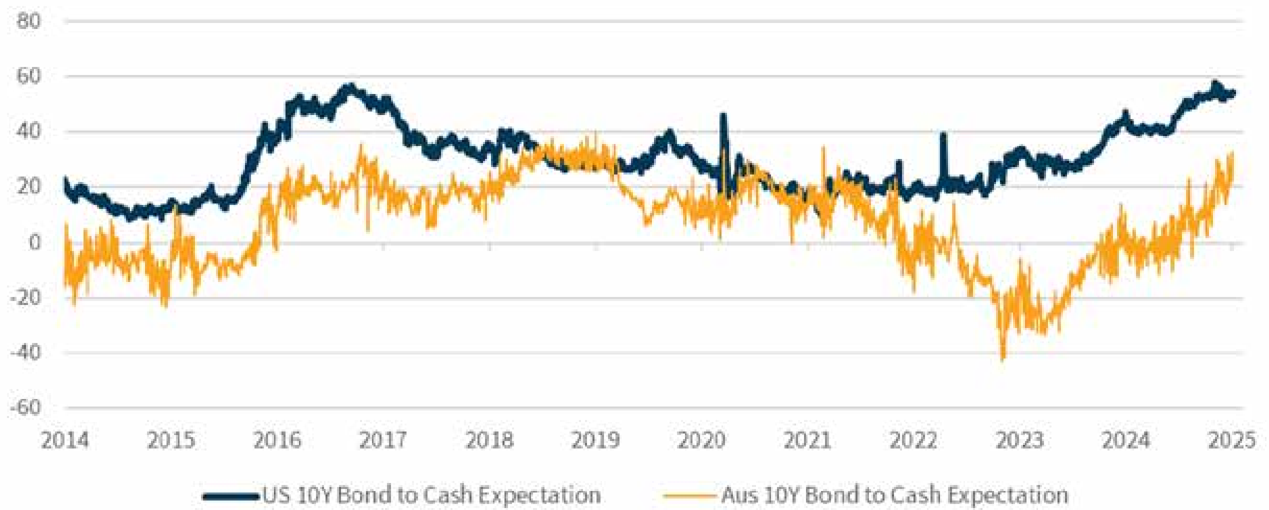
Figure 2: Government Indebtedness (% of GDP) across countries



Source: FIIG Securities, IMF World Economic Outlook.

This growing world indebtedness, particularly in governments that had previously sterling reputations, is causing identifiable ripples in global bond markets. Most notably, the result is an increase in the so-called “risk-free” government bond yields. It’s not credit risk exactly, since there remains very little risk that the Australian or US government would fail to pay. But as the volume of debt that governments collectively wish to issue rises, some extra inducement must be provided to convince investors to accept the comparatively low yield of risk-free debt. In essence, the risk-free yields of government debt are responding not only to interest rates; there is an element of supply-demand dynamics at play, too.

Figure 3: Spread between 10Y Government bond and 10Y expectations of cash

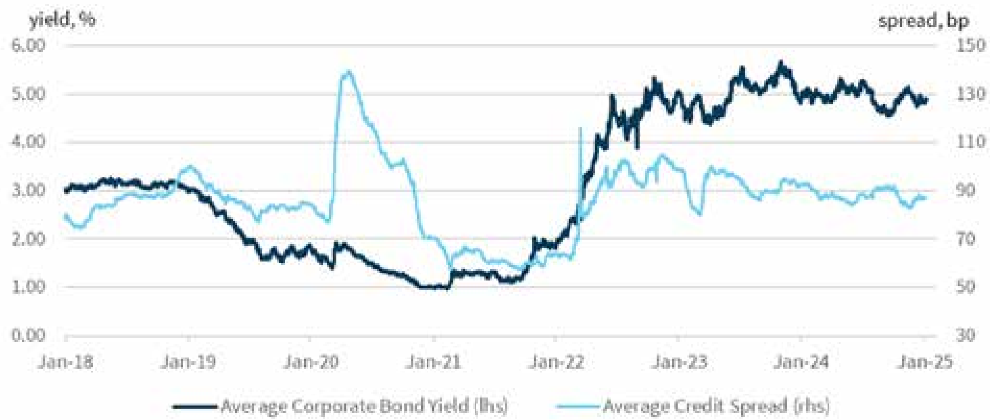


Source: FIIG Securities, Bloomberg. Measure is Bond yield over OIS, expressed in basis points.

As Figure 3 shows, the current spreads between government bonds and the expected cash rates are very high in both the US and Australia. This is an underappreciated aspect of current bond investing, where the Government credits (Federal and State) have reasonably high yields compared to expected cash rates. This nuance is underappreciated and unexpected, since corporate credit risk is currently at the exact opposite end of the spectrum.

Corporate credit spreads are currently quite low compared to historical patterns.

Figure 4: Spread between credit bonds and swap rates in Australia



Source: FIIG Securities, Bloomberg.

Many investors are currently concerned about the fact that corporate bonds have comparatively low spreads above government bonds. That tightness in corporate credit spreads can be thought about in two ways, of course. Is the yield on the corporate bond quite low compared to the government bond, or is the yield on the government bond quite high compared to the corporate bond? We tend to think the latter is the more accurate way to think about it.

Figure 5: Spread between Australian Government bonds and swap rates in Australia

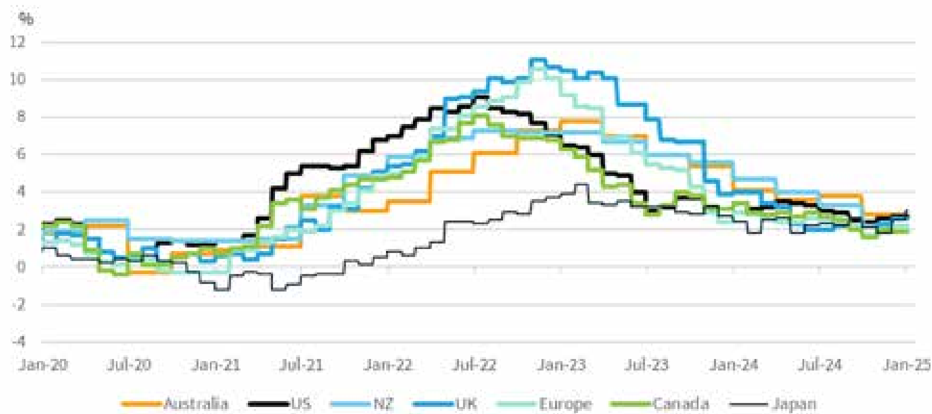
Source: FIIG Securities, Bloomberg.

Notice that the spread on the Australian Federal Government debt is being pulled higher by the dynamics in the US, rather than any particularly large risks in the Australian Federal position. This is also influencing the Australian state government bonds. There are nuances, but the global pressure causing government bond yields to rise in Australia is making the risk/return trade-off more in favour of investing in government debt. Yes, the yields are slightly lower than corporate debt, but the risks are materially lower.

Inflation success and inflation risks: Climate Change and AI

The world has seen great success in lowering inflation in 2024. The success was large enough that many counties were able to lower their cash rates, even though the RBA has not yet done so. In most countries, inflation is now sitting at around 2-3%. That's a little higher than truly desired (which is about 2% in most jurisdictions), but it is such an improvement from the highs of around 8-10% that the achievement shouldn't be overlooked.

Figure 6: Inflation rates around the world



Source: Source: FIIG Securities, Bloomberg. Charts shows annual percentage change.

The strong performance in lowering inflation up until now has largely been because:

- The immediate impact of the pandemic has faded.
- The initial financial-market impacts of the Ukraine war have faded.
- Central banks, almost everywhere, have raised rates significantly and helped lower consumption.
- Government spending has fallen in most places.

But the inflation rates now are still a little higher than they were in the 2010s and the downtrend seems to be faltering. Is this the end of the fall in CPI, or is it merely a pause in the overall downward move?

This is one of the great unanswered questions intriguing current central banks. Inflation rates seen in the 2010s were unexpectedly low. Many central banks, including the RBA, spent most of the 2010s consistently trying to spur inflation with repeated rate cuts because inflation was too low. So, the question of where inflation will settle in the post-pandemic era is incredibly important. We'll detail some of the reasons why we think inflation can keep dropping in a later part of this piece, but the reasons to be concerned about higher inflation than in the 2010s are as follows.

The 2010s period was the anomaly

Inflation had never been so low, for so long, as it was in the 2010s. A number of different reasons were posited, and many of them no longer apply. For example, during the 1990-2010s, the entry of Chinese labour into the global economy coincided with an influx of Chinese capital, too, meaning the world suddenly had access to cheap capital and cheap labour, allowing goods to remain low in price.

The Western world also experienced a period of underinvestment in physical assets across those decades driven by the prevailing political orthodoxy. The US government, in particular, though far from alone, allowed much of the physical infrastructure to atrophy, which saved money and reduced demand in the short-term, but caused inflation when the lack of investment could no longer be continued.

The 1990-2010s period saw a great improvement in technology. There was also a great deal of "low-hanging fruit" in the form of countries and systems that could be modernised with relatively little investment but resulting in a large positive outcome. This low-hanging fruit has now, largely, been gathered.

Under this understanding of the inflation discrepancy in the 2010s, the onus of the argument flips and a proactive case for inflation to keep dropping needs to be made. We think a case can be made, grounded in the behaviour of wages and industrial policy, though this will come later in the Australian section of our outlook.

Climate Change will cause a material lift in prices

One could write an entire article only about the impact of climate change on the economy, but we don't have time for that here. The bare bones of the argument are that every way you look at climate change, the impact is either to increase inflation directly or to lower productivity, and so raise inflation that way.

The first direct impacts of climate change on prices have already been felt in the insurance industry. However, we believe we aren't too far away from a time when the impact of climate change can be directly seen in food prices. In the short term, the impact of climate on food prices is not about simultaneous catastrophic failure, though complete failure can happen in some parts of the world. It has more to do with productivity and crop yields.

More unpredictable weather patterns will cause some parts of the world to experience atypical weather and declining production. This can be as extreme as storms and fire damage (we can't imagine California will have good crop yields this season), or more subtle as changing rainfall patterns, which encourage farmers to alter their growing patterns in ways that don't match the prevailing physical infrastructure of a region.

We have very little doubt that, over time, these factors will see a material increase in food prices. The bigger question is whether it will be felt soon enough to change the markets in 2025 or 2026 or impact inflation directly in this time frame. On that score, we don't think so. The longer parts of the bond markets are considering the state of the world in 2045 or 2055, and those are at risk from climate change. The area that most FIIG clients invest in, the 3Y-5Y sector, is probably safe for the moment, though we're not sure how much longer that will be true. This year is likely to be cooler than last given we're coming off an Niño cycle. That's a very small pushback against the overall warming trend.

That cooling will possibly calm the overall fear of climate change in the short term. On the other hand, the fires currently in California have both the impact and the global relatability to spur some changes.

Artificial Intelligence's demand for power is huge – but malleable

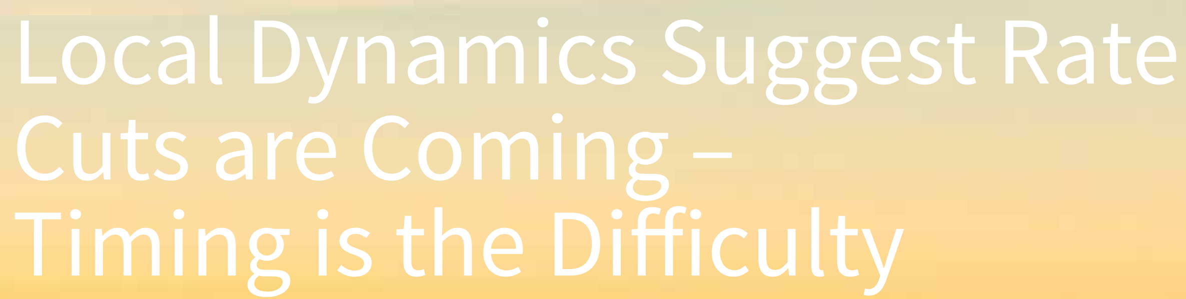
This is an interesting point. Many bank researchers breathlessly assure us that AI's demand for power is so large that it will drive up the price of energy.

While it is true that both AI and mining cryptocurrency use a great deal of energy, it is also true that advancements in hardware algorithms have materially increased efficiency. There is some sign that this uneasy truce might be about to break, with demand growing exponentially while advancements in efficiency are slowing down. We also found, however, that similar forecasts for massive increases in energy usage have been made by the US Energy Information Administration every year since 2006.

For the moment, this sits as an acknowledged risk but one that has not yet truly manifested. We do wonder, though, whether the prospect of AI being a marginal buyer of electricity prevents there being substantial drops in the cost of electricity.

The other thing to consider is the prospect of an incoming Trump presidency ramping up oil production beyond the current (record-high) levels. So, there are risks to both sides in the energy market in the coming years.

Local Dynamics Suggest Rate Cuts are Coming – Timing is the Difficulty



Local Dynamics Suggest Rate Cuts are Coming – Timing is the Difficulty

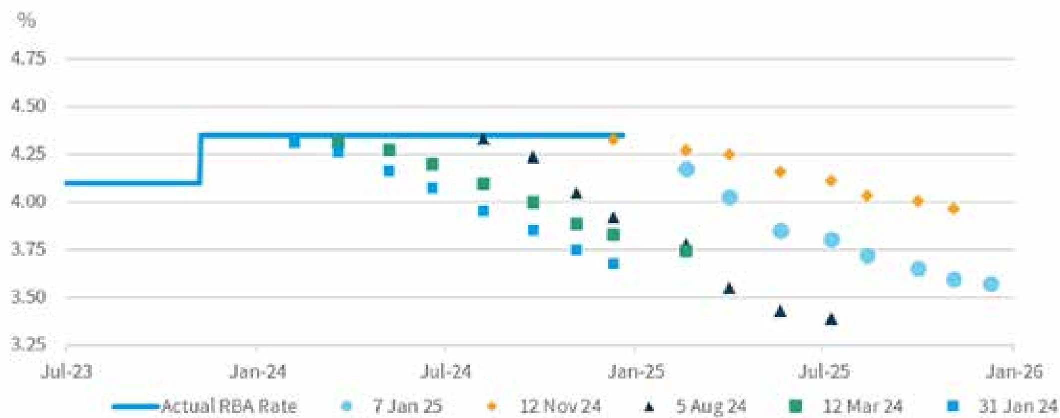
Understanding the RBA is about the trend, not the exact timing

The market is, once again, currently pricing an imminent RBA rate cut cycle.

If we sound slightly snarky, it's because the market does have a habit of pricing rate cuts far more often than they actually occur. In fact, those who read our first Macro Outlook in January 2024 will remember that a key theme of that first piece was FIIG pushing back on the idea of imminent rate cuts and suggesting that the end of 2024 was about as early as we could see a rate cut cycle commencing, and raising the fact that it might well be 2025 for the first cut.

The market priced an imminent rate cut cycle in January 2024, as well as March 2024, August 2024 and November 2024. None of these were delivered, of course.

Figure 7: Rates markets are not great predictors – rate cut cycles are frequently expected



Source: FIIG Securities, Bloomberg. Line is the actual RBA rate. Dots are the implied pricing on the date indicated.

This time around, we are still not convinced that rate cuts are quite as imminent as the market currently suggests, which is that a February rate cut is very likely (in the order of 75% chance of occurring). There has clearly been a change in tone from the RBA in recent communications, though, so the idea that a rate cut cycle might be coming in the not-too-distant future is much more plausible now than it was in early 2024.

At the December RBA meeting (and in the accompanying minutes), the board clearly changed tone. After forcefully pushing back on the idea of rate cuts in communications across the middle of 2024, the RBA now seems much more open to the idea of rate cuts once the data justifies them.

Specifically, the most recent RBA meeting minutes included this closing summary:

> [M]embers reiterated their earlier view that they had minimal tolerance to accommodate a more prolonged period of high inflation than currently envisaged. At the same time, if the future flow of data continued to evolve in line with, or weaker than, their expectations, it would further increase their confidence that inflation was declining sustainably towards target. If that were to occur, members concluded that it would, in due course, be appropriate to begin relaxing the degree of monetary policy tightness. If the data came in stronger, that process could take longer. They noted that, in making this decision, they would be guided by how the evolving data shaped the economic outlook and the associated risks.

Breaking through the jargon, the RBA is trying to make the following points:

- There is no tolerance for any indication that inflation might rise back to previous levels. Any signs of reaccelerating inflation would trigger a response.
- Inflation seems to be moving back to normal (i.e. target) and should be there soon.
- Once inflation is back to normal, in due course, then interest rates can move back to normal too (rates are currently quite high thanks to “monetary policy tightness”), in due course.
- Critically, this timing all depends on what the data says in the early part of 2025.

It’s that final point about the emphasis on the evolving data that makes us question whether the RBA is quite as close to cutting rates as the market seems to imply. We’ve said before that we think inflation being under control opens the door to a rate cut from the RBA, but that it is the labour force data that will see the RBA go through with it.

Now, while we don’t think the RBA is quite as likely to cut rates in February as the market seems to be implying, we do think the RBA will get to rate cuts relatively soon. The current FIIG forecast is for May 2025 as the first rate cut, with a risk that this comes earlier. We see no reason to change that forecast.

For bond investors, however, this difference between the first rate cut happening in February or May, or indeed at the intervening meeting in April, is not terribly important. The medium-term shape of the economy doesn’t change if the first cut is February, April, or May.

As a side note, it is also entirely possible that the RBA decides not to fight against the prevailing market belief and simply cuts rates a little earlier than intended but accompanies it with a hawkish statement. In the long run, the difference between a February cut and a May cut is very minimal, so the RBA may not wish to spend political capital fighting over the difference, even if their preference would be for a slightly later start to the cycle. Starting the cycle earlier, but more slowly, achieves broadly the same thing for the RBA.

Inflation is falling, but not that quickly

The headline inflation rate has dropped materially as of the most recent quarterly print, but Federal Government policies around electricity prices (along with a couple of extra things from states, like public transport in Queensland) were the primary driver. The RBA has drawn attention towards the Trimmed Mean inflation rate, which has also dropped, but not nearly so quickly.

Figure 8: Annual headline inflation has dropped, but the underlying measures remain higher

Source: FIIG Securities, Bloomberg, ABS. Quarterly data.

The annual results show a stabilisation of the underlying rates, but this is obscuring a divergence between services inflation and goods inflation. At present, goods inflation is dropping quickly while services inflation is still relatively high (or at least was still high in the September quarterly data). This is a very common outcome from an inflation spike. Goods prices are normally physical items where the prices can be changed very quickly (think about supermarkets or petrol stations). In contrast, services are much more likely to have prices that are much more sticky (think the cost of a haircut, or of having your taxes done).

As a result, essentially every time there is a large spike in inflation, the prices of goods rise quickly, and then, over time, the prices of services catch up to restore relativities. During the downswing in inflation, the prices of goods stop rising (or even fall) while the prices of services continue to rise for a little longer – they still have some catching up to do. While this process can make inflation seem sticky and last longer than initially thought, it does come to an end eventually. We are currently waiting for that final shoe to drop, namely that services prices should stop rising so fast. When that happens, inflation can really be considered safely on the path back to normal.

Figure 9: Goods inflation is now low, services is understandably sticky

Source: FIIG Securities, Bloomberg, ABS. Quarterly data.

Up until now, we've been looking at the more rigorous quarterly CPI data. The last few monthly CPI prints had shown a slight uptick on the services side, but the November print, which was released in early January, showed services CPI ticking back down again. This is very much a "back on course" kind of reaction, not a "pop the champagne" situation, though. The monthly CPI, measured as an annual change, rose 2.3% in November (up from 2.1% in October), while the Trimmed Mean monthly CPI, measured as an annual change, rose 3.2% in November (down from 3.5% in October, but equal to September's 3.2%).

However, the details of the print suggest that things are unquestionably moving in the right direction. The monthly data suggests that rental prices and home building prices are both starting to come much more under control, which will be very heartening for the RBA.

There will be another round of quarterly CPI data before the RBA's February meeting, with both the monthly and quarterly CPI being released on 29 January. This data is likely to show that the rate of inflation in the quarter was looking much more like what the RBA is hoping to achieve. Estimates are still preliminary, but forecasters I follow are currently suggesting a trimmed mean inflation rate somewhere near +0.5% in the fourth quarter.

That number is slightly impacted by the changes to the electricity rebates, but still looks very good compared to the RBA's expectations (around 0.7% on the quarter) and the overall target inflation rate of 2.5% per year. This will very likely be a "good quarter of CPI data".

The RBA famously said they needed more than one good quarter of CPI data before lower rates, though. At the time, this was interpreted as being that they would need two quarters of CPI data. However, the RBA later clarified that they meant that it could not be the CPI data alone that argues for a rate cut. The other parts of the economy must also be suggesting there is a need for the rate cut.

Labour market is a conundrum: Very low unemployment, plentiful jobs, but few pay rises

While the RBA sounded reasonably convinced the labour market was cooling in their statements around the December meeting, those statements pre-date the November labour force data which was released on December 12. This report showed a very strong result at a headline level, with the unemployment rate dropping to 3.9%, but was a little more mixed in the details. There's also been Q3 24 Job Vacancy data released on 8 January, which showed a rise in vacancies of 4.5% overall and, specifically, a solid 5.2% rise in Private Sector job vacancies.

So just when the CPI data is opening the door to a rate cut, the labour market data is (at present) suggesting there's no reason to step through.

We must say that while the current data suggests, on balance, that the labour market is strong, there is still the matter of the December Labour Force print scheduled for 16 January. The unemployment rate could be much higher, and the strength seen at present revised away – or not.

As the RBA said, the flow of the data will influence the decision in the short term. In the longer term, though, we are concerned that the labour market is not behaving in the way that it "should" and suspect this opens the way for the RBA's easing cycle to be both larger in total size and much more elongated than the market generally understands.

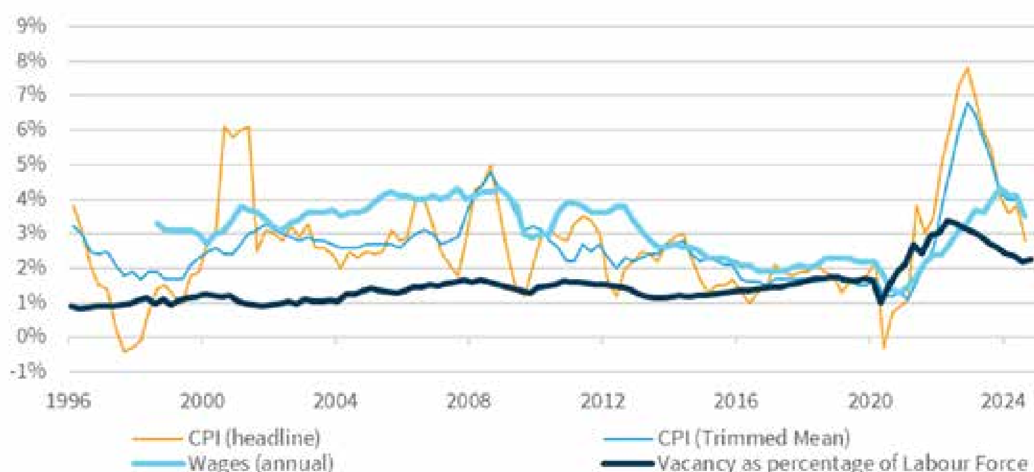
The labour market is simultaneously far more benign but also much more unsettling than the inflation data. Although most of the measures of labour markets look quite good (we reiterate that the unemployment rate is currently at 3.9%), the labour market is not behaving in the ways we would expect it to. Specifically, exceptionally strong labour markets have failed to produce wage rises in the way theory says they should.

The fact that the labour market is not behaving in the way the theory says it should stands in stark contrast to the inflation rate. The CPI data is looking much less problematic than it was a few months ago. Yes, there's a little more work to do on the inflation side, but the problem is improving along the lines of general understanding. So, although it's not great, the problem is a known problem (high CPI) with a known solution (higher cash rates), where the treatment is causing exactly the expected outcomes (reductions in overall CPI, with services CPI lagging). This isn't a great outcome overall, but it is both a significant improvement and perfectly understandable.

Importantly, the interaction between wages and the labour market does not seem healthy at all. Essentially, everyone has a job who wants one and participation is incredibly high. However, all the theory says that such a massive surge in demand for labour should have come with an increase in wages. But that part of the theory has broken down. There's been a moderate rise in wages of late that just about sees the most recent wages data growing at the same rate as annual trimmed mean inflation (and marginally higher than the headline CPI).

But that's coming after a major outbreak of inflation that leaves the real purchasing power of most salaries well below where they were in 2021 when the inflation outbreak began. Most consumers are being forced to consume less in real terms because their salaries are lower in real terms. It's not pleasant, but that is the solution to the excess demand that triggers high inflation. Namely, to convince the population as a whole to consume less. If this situation continues it is the unpleasant, but effective, solution to inflation.

Figure 10: Wages back above CPI – but only barely and only on some measures



Source: FIIG Securities, Bloomberg, ABS.

That is the nub of the medium-term question for the RBA. Are workers going to flex their muscles through widespread strike action and force salaries back up to their previous purchasing levels? Or are we going to see a return to more normal wage-setting behaviour from this point on, where wages grow more or less in line with CPI (maybe a touch higher, give or take a bit of productivity improvement now and again)?

Although there are some sectors where strike action is plausible (nurses, ambulance drivers, etc.) we don't see a widespread demand for major wage rises as particularly likely to be successful. After all, if there wasn't an ability for labour to demand higher wages when inflation was 7% and vacancies were three times higher than usual, we are not sure that there will be much of an argument that can be made for a wage breakout when inflation is closer to 3% (or even lower), and vacancies are back within a normal range.

Overall, the RBA is becoming more confident that things are on the right track, and they are very likely to lower rates at some point in 2025. Although that might be as soon as February, we don't think they are quite as raring to go as the market pricing seems to suggest. The RBA does seem very likely to get around to lowering rates at some point in the first half of 2025. It might be February, or April, or May. At this point, we think May is the most likely, but the rhythm of the data will tell the story.

Importantly, if the RBA leaves rates a little higher now to really ensure that inflation is brought under control, then it seems fairly likely to us that the RBA will have created conditions that allow for a more elongated trend lower in the cash rate over 2025 and into 2026 that ends up being larger than currently appreciated.

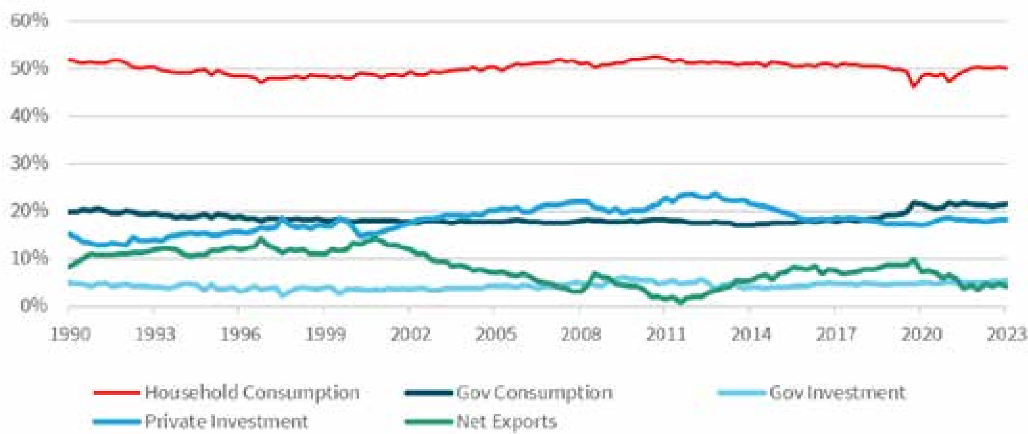
If goods prices are more stable (as they already are) and the wages component of the services basket is also under control, then inflation should be able to return to something that looks a little more like the 2010s than the early 2020s. There are differences, of course, and we mentioned many of these in our introductory section on global risks. Climate change as a contributor to inflation is the largest medium-term risk we see.

GDP growth will need to look beyond the Government sector and population growth in 2025

We discussed in previous outlooks the likelihood that the Federal and State government sector would be a significant addition to the overall rate of growth in 2024 and so it came to pass. The tax cuts didn't hit the economy in precisely the way we had envisaged, but they were close enough. We don't see it as a coincidence that the overall economy picked up when the tax cuts hit. Certainly, our forecast that the market pricing of rate cuts for late 2024 was premature turned out to be on the money.

The combined result of the increase in government spending (Federal and State) and the increase in population was that GDP growth was kept above zero. Government consumption is now a much larger proportion of the economy than it used to be.

Figure 11: GDP growth is leaning heavily on Government

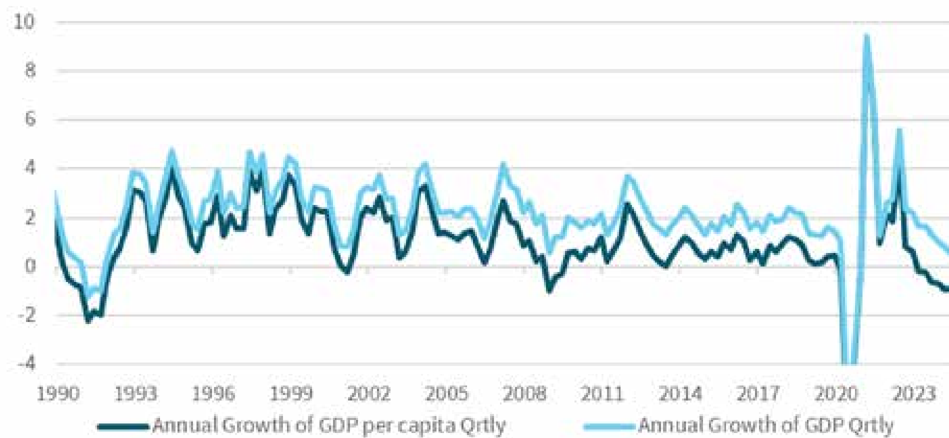


Source: FIIG Securities, Bloomberg.

The overall economy is still growing, but only because the population is rising. In fact, in per capita terms, the rate of growth in the economy in the last couple of years looks rather like the worst recessions in recent memory: the GFC and the early 1990s.

The Government has been trying to slow the population growth rate to ease pressures on the housing market. They have not yet succeeded, but changes to university visa approval processes suggest they might do so a little more effectively in 2025. Once the population growth rate fades as a source of GDP growth, the rate of growth in the economy will slow materially.

Figure 12: GDP growth is leaning heavily on population



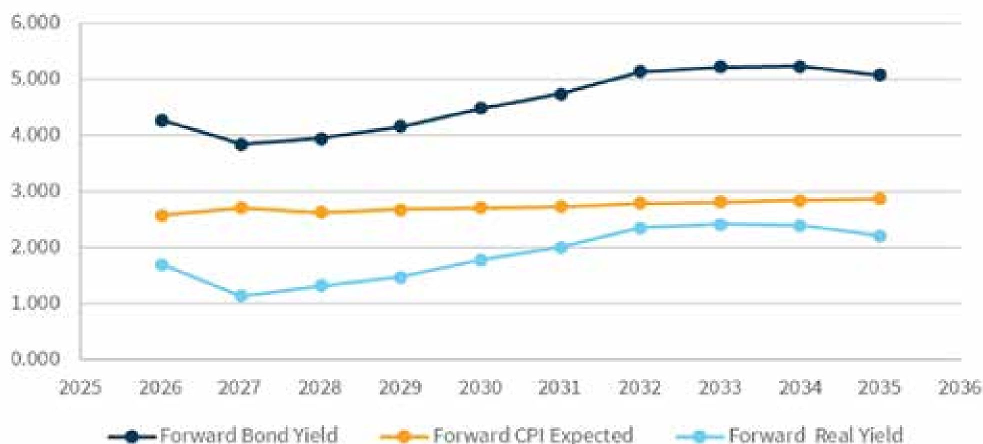
Source: FIIG Securities, Bloomberg, ABS. Per cent.

It is this reality of very weak growth that awaits the RBA later in 2025 and into 2026 once they have the inflation rate under control. There were good reasons to attempt to slow the economy via rate hikes in 2024 and this policy was incredibly successful, suggesting that the current level of interest rates is very contractionary. We won't need a contractionary policy for too much longer.

That's why we think that the coming RBA easing cycle might well be much larger in total basis point terms and more elongated than understood.

The dynamics of the wage market suggest there is no real sign of wage inflation, and the GDP growth rate is poor. Once inflation ceases to be front of mind, the RBA will need to lower rates to bring up both these measures. Yet the market pricing, at present, suggests something rather different. We discussed this in our Macro Outlook in October 2024, entitled "Rate Cuts and Steeper Curves", but much of it bears repeating. The market is currently pricing a fairly shallow RBA cycle, with the forward market interest rate expected to start rising again in only 18 months' time.

Figure 13: Annual forward Rate Expectations



Source: FIIG Securities, Bloomberg. Per cent.

Notice we say that the forward market interest rate is rising, not that the RBA cash rate is expected to rise. There's a subtle difference there. As we discussed in the section on the supply and demand dynamics in the Government bond market, the interest rate is simultaneously trying to capture many things. Here, a simplistic interpretation is that the RBA is expected to cut rates for 18 months, then raise them again. A more nuanced interpretation is that, in a situation with great uncertainty, the market is providing very high recompense to investors prepared to commit their money to bonds for more than a year or two. Notice in Figure 13 that the yield received rises sharply for moving from a maturity of 2027 to 2028 to 2029, yet the likelihood is that the RBA will be cutting rates, slowly, for much of that period.

We continue to like the 5Y to 7Y part of the curve for investors, where the extra duration is rewarded with higher yield. Once you move past 7Y, the extra duration does not come with rising yields (Figure 13, above).

The BOLD strategy for bond markets in 2025 and 2026

The BOLD strategy for Bond Markets in 2025 and 2026

If the timing of the RBA is unclear, but the medium-term trajectory is for lower rates, investors must be bold when opportunities arise

Last year, we suggested the LOCK strategy, arguing that investors should use 2024 to lock in duration because yields were relatively high, unlikely to fall in the near future, but very attractive on a medium-term basis.

In 2025, we think the fall in yields is much more likely to come soon, so the situation calls for a more BOLD approach. Specifically, we believe that bond investors should spend 2025 focusing on these four key approaches:

B Buy duration ahead of a turn in the cycle.

O Outlast the short-term gyrations of the market.

L Look for opportunities in places not previously considered.

D Decisive action when the opportunities present.

Although yields on most corporate bonds are not quite as compelling now as they were over the last few years, we think there is a good chance that yields will fall (and hence capital prices will rise) over the course of 2025. Hence the need to buy duration now ahead of a turn in the cycle.

However, with so much short-term volatility, bond prices are likely to fluctuate in the short-term. In particular, if the RBA doesn't cut rates in February but waits until May, there might be a rise in yields early in the year. This would very likely be temporary, though. Savvy investors will need to outlast these gyrations.

The change in the spreads between various asset classes means that government bonds, and even more so state government bonds, offer very good yields compared to the riskier asset classes. With a small extension in duration (which we recommend buying in of itself), a 5Y or 7Y state government bond often has a yield that's not too dissimilar to a shorter corporate bond, but with a lower risk profile. Many FIIG investors will not previously have considered state government bonds, but now is an opportune time to do so.

Finally, we suggest that clients lean in to the volatility and look to take advantage of unusual circumstances. If the RBA does push back against market pricing and delay the first rate cut, any rise in yields would be temporary and very likely a good opportunity to enter medium-term bond investments. It's part of the nature of markets that we can't be precisely sure what opportunities will come up over the year, but the clients who take bold, decisive action when those opportunities present themselves are the clients who are likely to do best from their bond investments.

Specific bond trade ideas for 2025

We have selected the below bonds as ones that fit naturally into our BOLD strategy. Obviously, each individual investor should choose the bonds that suit them, but this is a starting point for consideration.

Our Bank Analyst has suggested that Australian major banks remain exceptionally high quality and very good value. We'd place this in the "Decisive action when opportunities arise" strategy. Given the recent changes in how bank regulatory capital is calculated, it's very likely that Australian major banks will issue a lot of subordinated paper in the next few months. When those opportunities arise, we recommend that FIIG clients bid into the new lines.

Of the offshore names, Banco Santander, Lloyds and Nationwide look attractive. Credit spreads are relatively low at present for all names, so we are selecting the large banks which focus on lower-risk consumer lending rather than the more volatile investment banking offerings. These names have demonstrated more consistent returns over the years compared to the investment banks.

Of these names, Banco Santander stands out as the single best name. While it might have a higher risk due to its exposure to some emerging European and South American markets, its exposure to Spain, the UK, Germany, and the US markets remains above 60%. Earnings stability has been strong, reflecting a consistent focus on retail banking activities and better-maintained cost efficiency compared to peers. While Lloyds and Nationwide are also good options, they are highly exposed to the UK's macrocycle.

FIIG clients have holdings in several major French banks, including BNP Paribas, Crédit Agricole, Société Générale, and BPCE. While we believe these investment-grade names still offer decent risk/returns, Crédit Agricole is our preferred choice. Historically, Crédit Agricole has demonstrated more stable earnings performance compared to its peers. We attribute this to its strong market position as one of Europe's leading bank-insurance groups, benefiting from good business diversification and a dominant retail presence in France. A key factor that distinguishes Crédit Agricole is its favourable risk profile. Measured on a metric of the proportion of doubtful loans and coverage of doubtful loans, Crédit Agricole stands out among its peers. This aligns well with our strategy of selecting investments with favourable risk/returns, particularly in this challenging global economic environment.

Specific bond trade ideas for 2025

Issuer	Maturity/Call	Coupon	Yield	Rationale
Safest Bonds - lower yields, lowest risk				
SAFA	24 May 2032	1.75%	4.688%	State Government exposure. Duration in a nice part of the curve.
NSWTC	20 Feb 2037	4.75%	5.31%	State Government exposure. Long duration and low credit risk.
Low Risk – Infrastructure bonds and similar				
Sydney Airport	20 Nov 2030	CPI Index Annuity Bond	3.65% Over CPI	Strong asset with inflation protection.
JEM NSW Schools	28 Nov 2035	CPI Index Annuity Bond	3.71% Over CPI	Unusual name, but inflation protection and high yield. Now in stable mode.
ENBW	30 Oct 2034	6.048%	5.75%	European power provider. Green bond. Duration and diversification in a safe package.
Standard Risk – Corporate and Financial Bonds				
Santander	23 Jan 2031	6.499%	5.65%	Neatly in the 5-7 area. Simpler bank structure than peers.
Credit Agricole T2	16 Jan 2030 Call	3M BBSW + 205bp FRN	6.08%	Preferred banking name with good yield, note subordinated status.
Qube	11 Dec 2034	5.90%	5.95%	Logistics company with solid profile.
Blue Owl	23 Oct 2027	6.50%	5.87%	Not well known, but solid US credit company. High yield for the rating.
Higher Risk – Foreign Currency and High Yield Bonds				
Nationwide (GBP)	20 Dec 2030	7.50%	7.15%	Subordination gives high yield, some currency risk. Preferred name from the bank analyst.
Pacific National Sub	11 Dec 2029	3M BBSW + 385bp FRN	7.41%	Transport and logistics company, but subordinated status.

Pricing correct as at 13 January 2025.

Macro Outlook January 2025

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FIIG Securities was established in 1998 to provide investors with direct access to a broad range of fixed-income products and services. As one of Australia's leading independent fixed-income specialists, FIIG has grown to service over 6,000 clients with more than $4.5bn in funds under advice and locations across Australia in Brisbane, Sydney, Melbourne and Perth.

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About the Author

Philip Brown - Head of Research, FIIG Securities

Philip joined FIIG as Head of Research in late 2023 after a 20-year career working for the research teams of banks. He was most recently the Senior Fixed Income Strategist at Commonwealth Bank, but has also worked at Citigroup, Deutsche Bank and in the Federal Public Service. Philip was an integral part of the CBA team that won the KangaNews award for best research on Government and State Government Bonds for the last five years running.

Philip has a quantitative background including a degree in statistics, but prides himself on communicating in accessible everyday language. He was born and raised in Melbourne and works from the FIIG Melbourne office.

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Find out more

InvestmentStrategy@fiig.com.au
1800 01 01 81
fiig.com.au

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