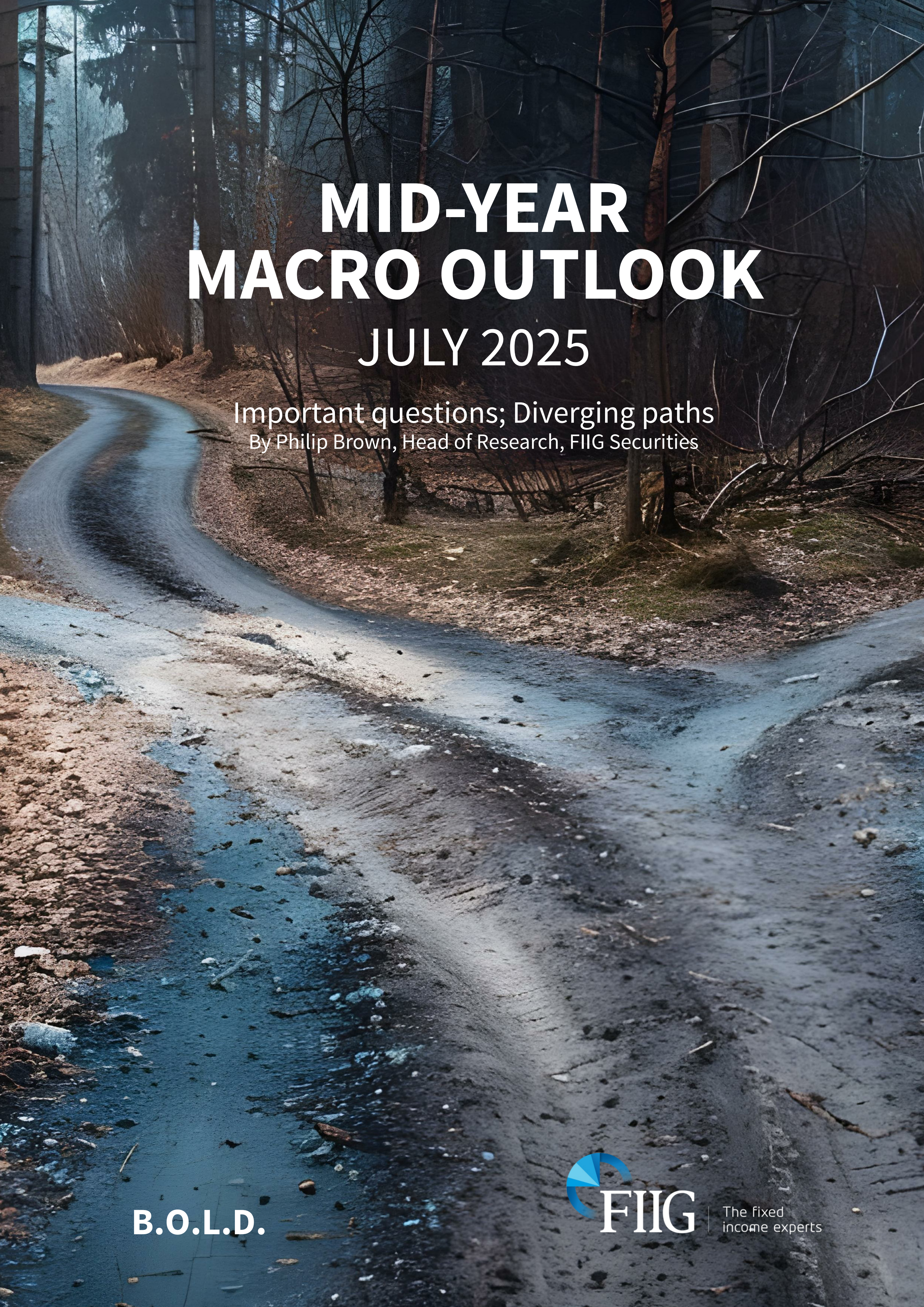

MID-YEAR MACRO OUTLOOK

JULY 2025

Important questions; Diverging paths

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B.O.L.D.

FIIG The fixed income experts

Important questions; Diverging paths

Executive Summary

The Macro Outlook in Australia, as seen by FIIG Research, is one of transition. There are big decisions and possibly divergent paths.

The war against inflation seems to be drawing to a close, and the new challenge in the coming years is likely to be stimulating growth. The RBA, however, seems to be quite late to pivot to a new understanding of the economic challenges of 2026 and 2027 and remains very focused on fighting inflation.

We expect the RBA is likely to change two key principles in their understanding of the economy relatively soon. First, the RBA is forecasting recent rate cuts and wage rises to trigger a major rise in the consumption side of the economy, but these instead seem to be showing as a rise in the savings rate. Second, the RBA continues to view the labour market as relatively strong and liable to trigger wages growth and inflation. After witnessing the economy over the last few years fail to deliver wages growth, we place much less emphasis on this risk.

FIIG Research expects a much slower, but much more elongated, RBA rate easing cycle that continues, slowly, into 2026 and possibly beyond.

For bond investors, that suggests owning longer-dated fixed-rate bonds is the clear strategy, but there are material risks there, too. The biggest risk is that the US Government's approach to debt and deficit is putting strain on global funding markets. We've already seen small wobbles in the US Government's ability to fund itself. Globally, interest rate curves are steepening, with the US 10-year and US 30-year bonds rising in yield noticeably, even as the FOMC has cut rates.

The US Government is also starting to crowd out other forms of borrowing. An obvious example is the high US 30-year bond rate putting pressure on 30Y mortgage rates, but the pressure is more widespread than that. The recently passed Big Beautiful Bill may well stimulate the economy in the short term, but the roots of a more long-term problem are clearly evident as the cost of funding these repeated bouts of stimulus hits home.

The risk of a major dislocation in US bond markets is real, though not high, but would cause a major rise in 10Y and 30Y bond yields. To balance these risks while also positioning for an elongated rate easing cycle, FIIG continues to suggest taking duration risk in the front and mid sections of the curve, with 5Y and 7Y bonds the recommended option. Credit risk is relatively well-behaved at present, but with so much risk in the system overall, it's important to remain vigilant on diversification to manage overall portfolio risk. Refer to the table on page 21 of this report for a list of 5Y and 7Y bonds that FIIG recommends for inclusion in a balanced portfolio.

Important questions; Diverging paths

The RBA has recently caused a bit of a stir by declining to cut rates at the July meeting despite being widely expected to. But for long-term investments, we prefer to focus on the underlying dynamics rather than the day-to-day headlines. Picking the exact timing for the RBA has proved difficult, but the overall shape of the RBA's actions has been very much in line with FIIG's expectations.

For the last couple of years, across multiple Macro Outlook publications, FIIG Research has been highlighting that the RBA probably wouldn't cut rates quite as early or as quickly as the market was pricing, but that the rate easing cycle, when it finally came, would likely be larger and more elongated than what was then understood. This assessment was a key part of why both the LOCK strategy in 2024 and the BOLD strategy in 2025 advocated using medium-term fixed rate instruments to prepare for a coming RBA rate-cutting cycle.

So far, the RBA has cut 50 basis points (bp) and another 75bp priced in. However, if market pricing is to be believed, the current RBA cycle is going to be complete by February 2026. We're not at all convinced of that. It's time to start thinking about how far the RBA cycle might go and how markets might react to that cycle, if it does prove to be a larger, but slower, cycle than currently assumed.

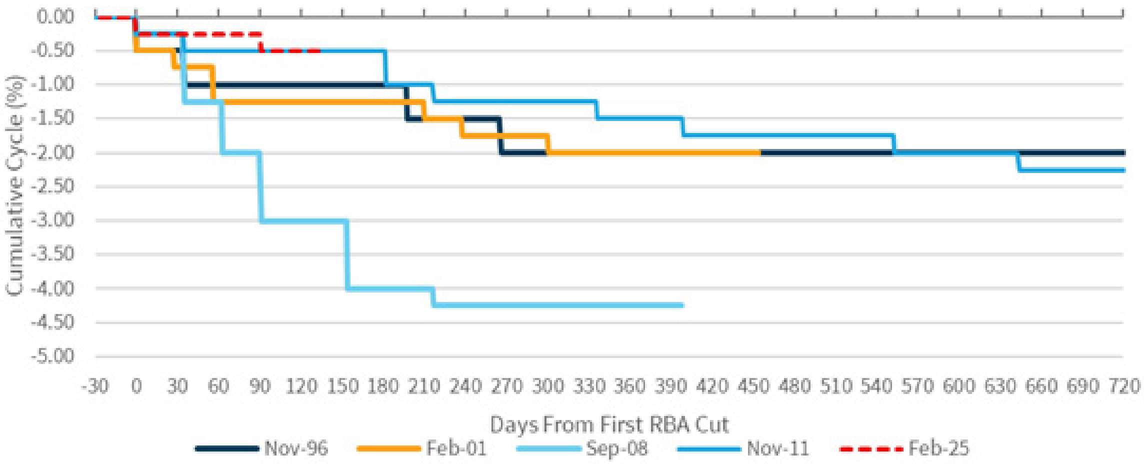
In our April 2024 Macro Update (Lucky 7), we highlighted that the RBA was approaching a rate cut cycle, but that this would be a "general economic slowdown" easing cycle, rather than in response to a catastrophe. That lack of a crisis meant (and continues to mean) the RBA has time to begin the rate cut cycle gently, but may well speed up once it has become clear that inflation is under control. That was what happened back in 2011-2012, and we've been highlighting the likelihood of a similar path this time around. So far, we've had a rate cut in February, then a pause, then a cut in May and another pause. At present, August looks very likely to be a rate cut too.

It is worth thinking about how the 2011-12 cycle played out. The rate cuts began slowly, then sped up, but the RBA never managed to really reignite growth, meaning the cash rate was then slowly edged down over many years.

The current cycle began even more slowly than the 2011-12 cycle. This slow start to the cycle is precisely because the RBA has both the need and the time to be careful in an economy that is slowly running out of steam, rather than one where things have actively "broken". The RBA was very careful not to raise rates too high during the rate hike cycle over 2022-2023, which bought them some time to be cautious at the start of the easing cycle. However, it's easy to get caught in the trap of fighting the last war, rather than preparing for the coming one. We think we are approaching the time for the RBA to stop thinking about fighting inflation at all costs, and turn their attention to the poor growth outcomes evident in Australia.

Important questions; Diverging paths

Figure 1: Different RBA cycles have different speeds



Source: FIIG Securities, Bloomberg

The RBA does appear to have made two key errors of late. First, they have assumed there would be a strong recovery in consumption driven by the rate cuts. Second, they seem inordinately worried about the risk that strength in the labour market might lead to an outbreak of wages growth. Neither of these scenarios seem to be coming to pass and will likely, eventually, need to be reconsidered by the RBA.

It's precisely this form of reassessment of the economy that could turn a very slow tentative shift back towards neutral from the RBA, into a more full-bodied cycle that takes rates all the way into expansionary territory. The RBA has some very important decisions to make in the coming months, particularly if the rate cuts so far fail to trigger much in the way of strengthening the economy. The RBA has elected to leave the cash rate at a restrictive level when many believe the inflation threat has passed. This will further slow an already weak economy later this year and into 2026.

At the same time, however, bond markets have not been behaving in a truly predictable way. A risk we have highlighted many times before – that of the US Government's growing indebtedness – has started to materially impact markets. This is keeping longer-term yields higher than they would otherwise be, both in the US and in Australia.

The higher yields give investors who haven't yet positioned for the coming rate cut cycle a final chance to do so, but also materially impact the slope of the interest rate curve and the likely returns from owning bonds. We'll go into this in more detail in later sections, but a steep curve makes the yield-to-maturity a slightly misleading measure. The yield to maturity is the average return over the entire life of the bond, but when markets are suggesting that the yield will move substantially over the life of the bond, the overall average yield may not be representative of the expected yield in the short term.

Section 1: The choices the RBA will have to make

"When events change, I change my mind. What do you do?" Dr Paul Samuelson, 1970 Nobel Prize winner for Economics. (This quote is also often attributed to John Maynard Keynes.)

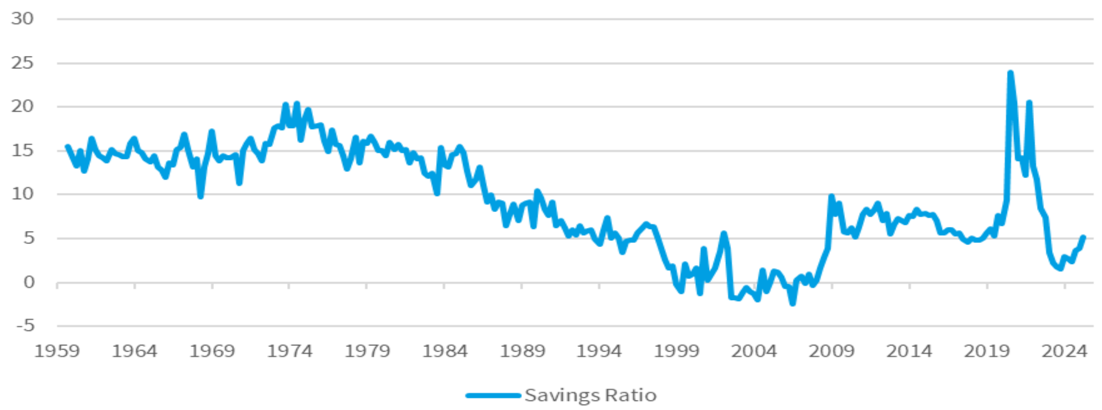
Economic forecasting is very difficult, and the RBA has a very difficult task in managing the economy in real-time. With the benefit of hindsight, we can see fairly clearly that the RBA was a little late to start raising rates in 2022. However, and better than many others, they did slow and then stop the rate hike cycle at a lower level than many comparable central banks in other countries. This restraint in 2023 allowed the Australian economy to perform well in 2024 and into 2025 and is a key reason why current economic outcomes in Australia are better than, for example, New Zealand or Canada.

However, the RBA's current understanding of the economy appears increasingly inaccurate. This is not meant as a harsh criticism – they have guided the economy well in the last few years - but events are changing. As the famous (and somewhat apocryphal) quote goes, when events change, I change my mind. Events are moving ahead of the RBA, and it seems quite likely that the RBA will have to change their reaction to those events soon.

There have been two key understandings that the RBA has used in their approach to policy-making that are becoming very hard to continue to defend.

First, the RBA was expecting a significant increase in household consumption over the middle and back part of 2025 as the impact of lower RBA cash rates and higher wages came to the fore. Instead, there seems to have been a significant increase in savings rates as households look to replenish the damage to savings done by the sharp rises in inflation. The savings ratio varies substantially over time, and that makes it hard to predict. The current level is above the true lows (see Figure 2), but the period of ongoing dis-saving seen in the late 1990s and early 2000s was exceptionally atypical. This time around, the savings ratio has rebounded much earlier and much harder than in the early 2000s, but this current experience is more consistent with theory and international practice. Nonetheless, this savings is money that would otherwise have gone to consumption and, potentially, triggered inflation. Instead, the money is being saved and is not contributing to inflation.

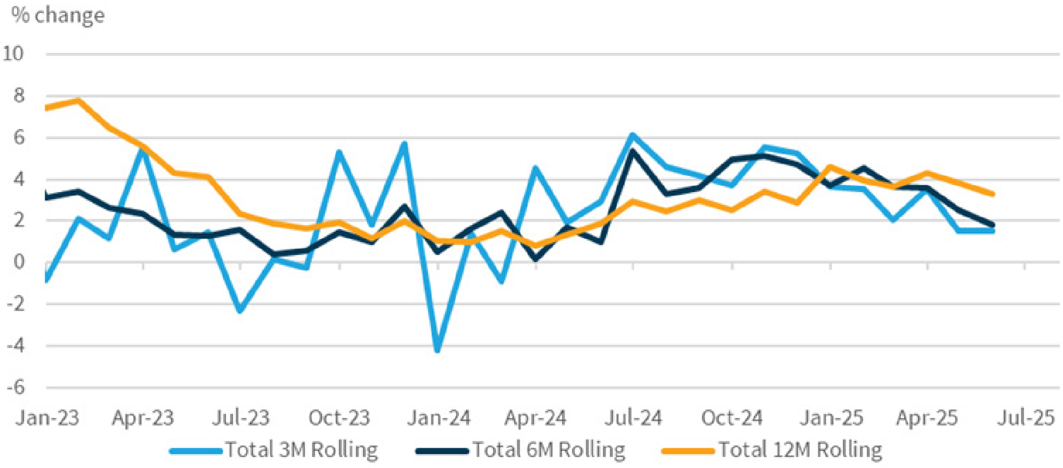
Figure 2: Savings Ratio (percentage of income)



Source: FIIG Securities, ABS

We also wonder why so few people are talking about the impact of the Stage 3 tax cuts as part of this consumption story. The strong rise in Retail Sales across the later part of 2025 coincided with the tax cuts, which started on 1 July 2024. That rebound in the second half of last year has since faded, but the economic commentariat seems hell-bent on refusing to acknowledge the impact of tax cuts on consumption. Obviously, there are lots of different inputs into a household budget and there appear to be lags involved, but the general patterns are evident. The 3-Month and 6-Month rolling changes (annualised) in retail sales all show peaks in both July 2024 and again slightly later in the year. Both these measures now show the weakness in retail sales into 2025 very clearly also. In the six-month period after the tax cuts there was a rise in retail sales, but this is now subsiding.

Figure 3: Retail Sales, rolling 3M, 6M and 12M changes



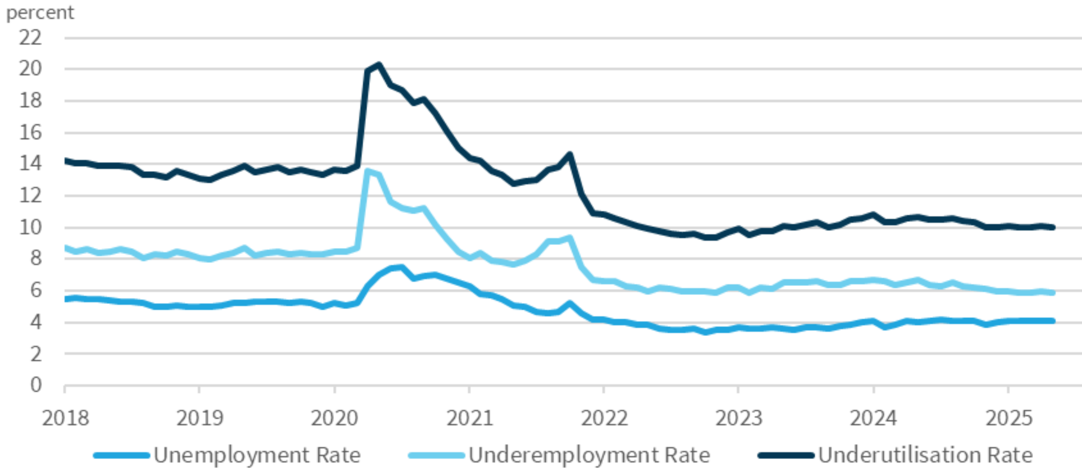
Source: FIIG Securities, ABS

The housing spending indicator showed a stronger picture, but nothing too dissimilar. Interestingly, though, the household spending indicator captured a large fall in clothing purchases in April that was then reversed in May.

Overall, the RBA's assumption of a strong increase in consumption putting upward pressure on inflation doesn't appear to be happening.

The second problematic assumption from the RBA concerns the condition of the labour market. This is a slightly strange one, but the RBA was concerned that the labour market was too strong and that any further demand for labour risked a wages breakout. As it has happened, since the RBA's May Statement on Monetary Policy (SoMP), the labour market has been slightly stronger than anticipated, with the unemployment rate remaining at 4.1% in May (released 19 June). Importantly, not only is the unemployment rate low, but the underemployment rate is low, too. This means that the overall level of underutilisation is very low by historical standards. On pretty much every measure, the labour market was stronger than anticipated in early 2025.

Figure 4: Unemployment and Underemployment

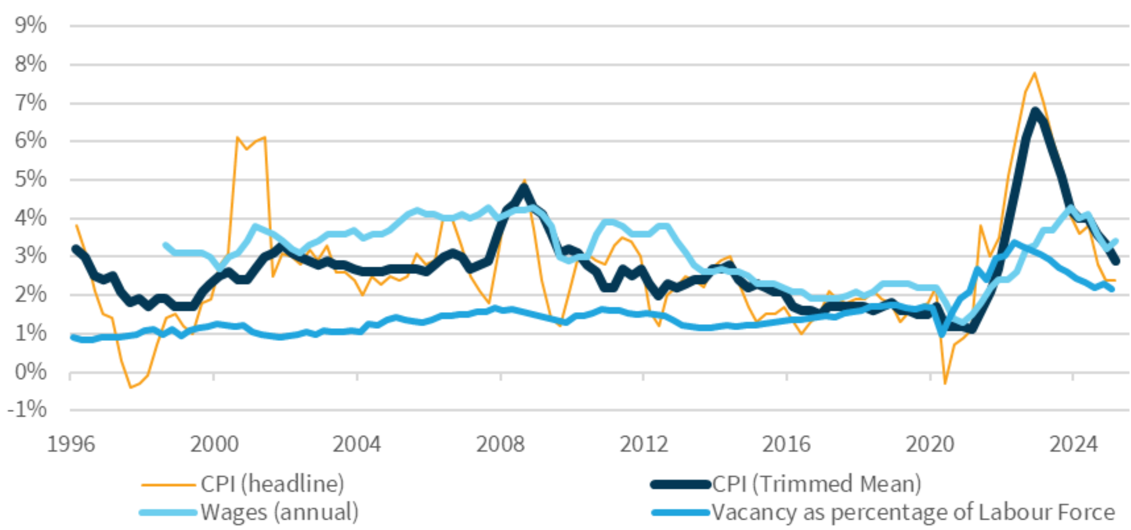


Source: FIIG Securities, ABS

It was, for a time, reasonable to fear that any unanticipated strength in the labour market might give rise to a wages spike and a generalised inflation response. However, this also doesn't appear to be playing out. In fact, despite the unexpected strength in the labour market, annual wages growth has barely been able to keep up with inflation, let alone suggest a general rise in wage levels. (Note, we prefer to use Trimmed Mean inflation for this analysis since that gives an understanding of how wages are moving against underlying inflation.)

It's quite easy to look at the short-term quarterly growth rates in wages and CPI and conclude "there's now wages growth". That's true, but the recent history of material reduction in real wages needs to be kept in mind.

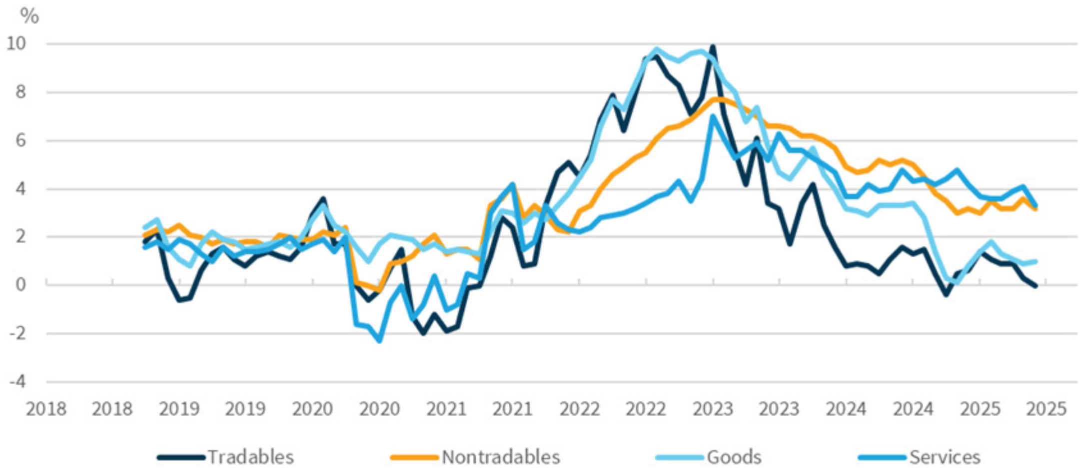
Figure 5: Wages are barely growing faster than inflation



Source: FIIG Securities, ABS

The generally weak response from wages over the last six months can also been seen in services CPI. The two are relatively strongly linked, since the prices of services, are to some extent, the prices of the wages of the people providing those services (give or take some lags).

Figure 6: The monthly CPI shows services inflation has turned downwards again

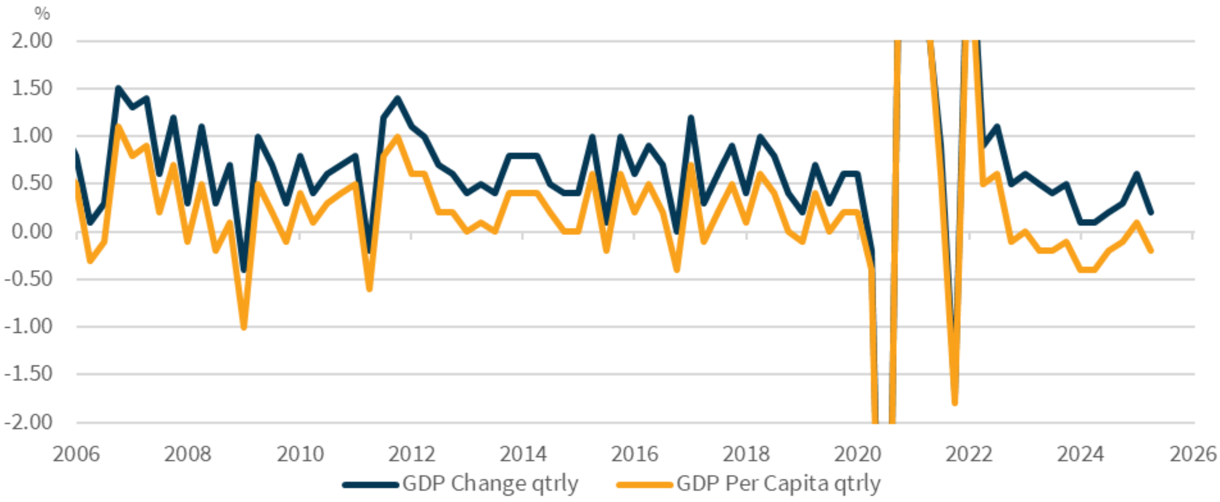


Source: FIIG Securities, ABS

The RBA's frequent warnings that any further strength in the labour market would trigger wage rises and reawaken inflation are starting to ring hollow. We've had a surprisingly strong labour market in the early part of 2025, but it hasn't triggered higher-than-anticipated inflation. In fact, the recent period of surprising labour market strength has coincided with a period where inflation fell faster than the RBA anticipated.

There are currently two elements of the RBA's understanding of the economy that could be materially revised relatively soon. If the RBA does start to change its mind on either of these things in the future (say, during the upcoming August SoMP forecast revisions), then the general premise for the rate cut cycle changes too. Instead of a measured cycle seeking only to soften the landing and finish at something like a neutral rate, the RBA will be facing a situation where the labour market is strong, but seemingly not strong enough to trigger inflation. The inflation rate is currently under control, and the existing forecasts suggest it will remain so even if the RBA cuts rates further in coming quarters. On the other hand, the GDP growth rates are currently quite poor, particularly on GDP per capita. There have been negative quarters on this measure before, both during COVID and during the GFC, but these sustained negative prints, quarter after quarter, suggest that the economy is being severely restrained by rates at current levels. This doesn't necessarily matter for the RBA in the coming three or six months, but it speaks to the level that rates are likely to settle at in the longer term.

Figure 7: GDP growth rates remain negative on a per capita basis



Source: FIIG Securities, ABS

The true neutral rate for the RBA is open to discussion, but it's worth understanding that the current level of interest rates has seen inflation drop materially and caused GDP per capita to be negative for multiple quarters in a row. That's a clearly restrictive rate. It suggests that, once the fear of inflation drops away, there will be scope for more rate cuts.

However, the RBA's natural conservatism was on display at the July meeting and will very likely prevent them from cutting the rate quickly. This is precisely the recipe for the sort of slow, elongated rate-cut cycle that was delivered across the 2010s and the sort of cycle we continue to expect. Indeed, other commentators are warning that if the RBA doesn't cut rates in a timely fashion now, they will end up needing to cut rates further in the future. We're not quite sure that the situation is quite that bad just yet, but that is certainly a risk.

We're not suggesting this cycle will last an entire decade, but if the economy is growing only very slowly and the inflation rate is under control, there is little reason to think the RBA will raise rates. As long as measured easing doesn't cause some unexpected problem (a housing bubble, for example), then there's plenty of scope for the RBA's 2025 easing cycle to slowly meander into 2026 and possibly beyond.

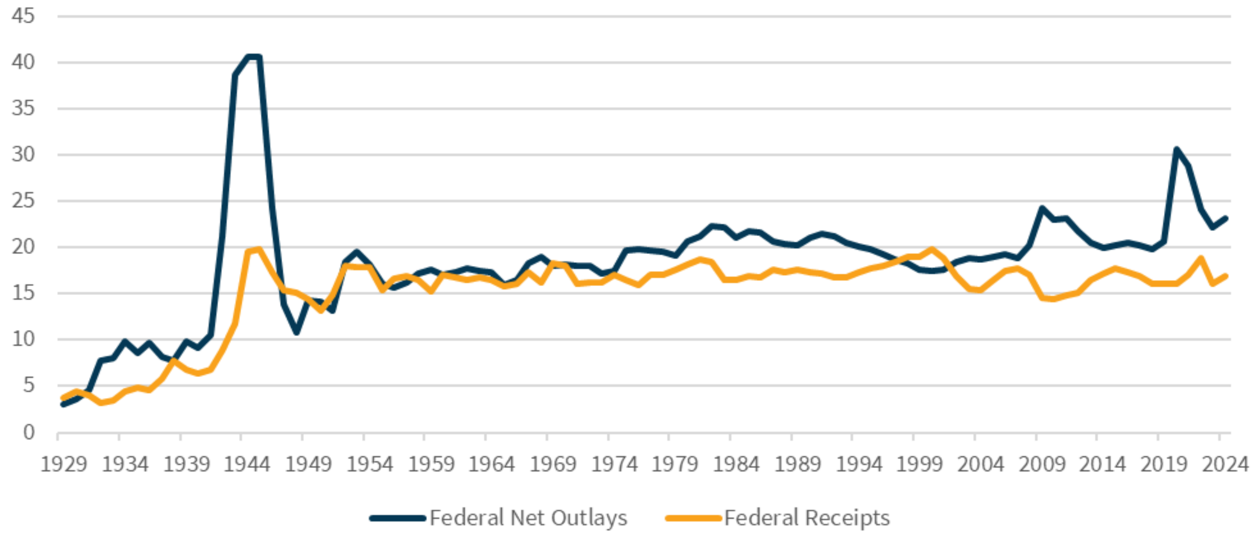
So far, from the domestic side of the equation, the RBA looks set to be forced to change their mind about the trajectory of the Australian economy, which may well change their approach to the RBA cash rate too. They have some big decisions to make about the domestic economy.

Unfortunately, global events are not giving the RBA clear air to make those decisions.

Section 2: The choices that US policymakers appear to have made

The two big active explicit questions for the US policymakers of late have been around tariffs and deficits, but there's been another implicit question bubbling under the surface. For the last three decades – and arguably more like the last five decades – the US has had a slowly increasing Government spend, while the Government revenue has been stable or marginally falling. The underlying question is what to do about this divergence.

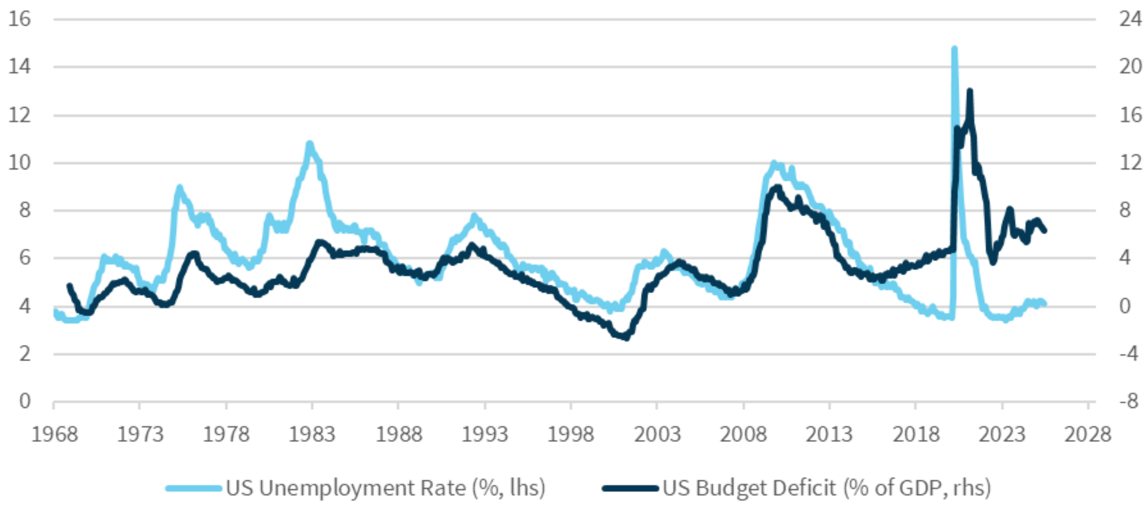
Figure 8: US Federal Government Outlays and Receipts, percent of GDP



Source: FIIG Securities, St Louis Federal Reserve

Rather than seeking to balance this underlying problem with either spending cuts or taxation increases, the so-called “Big Beautiful Bill” (BBB) has passed and worsened the situation. The US will increase their deficits despite already running a deficit that is exceptionally high by historical standards and even higher when you consider how strong the economy is at present. The following chart shows the US unemployment rate, indicating the strength of the economy, and the US deficit. The historical relationship used to be that, when the economy is strong, the unemployment rate was low and the deficit was low (or even a surplus). The current deficit is very large despite the US economy being very strong. That's very unusual, historically.

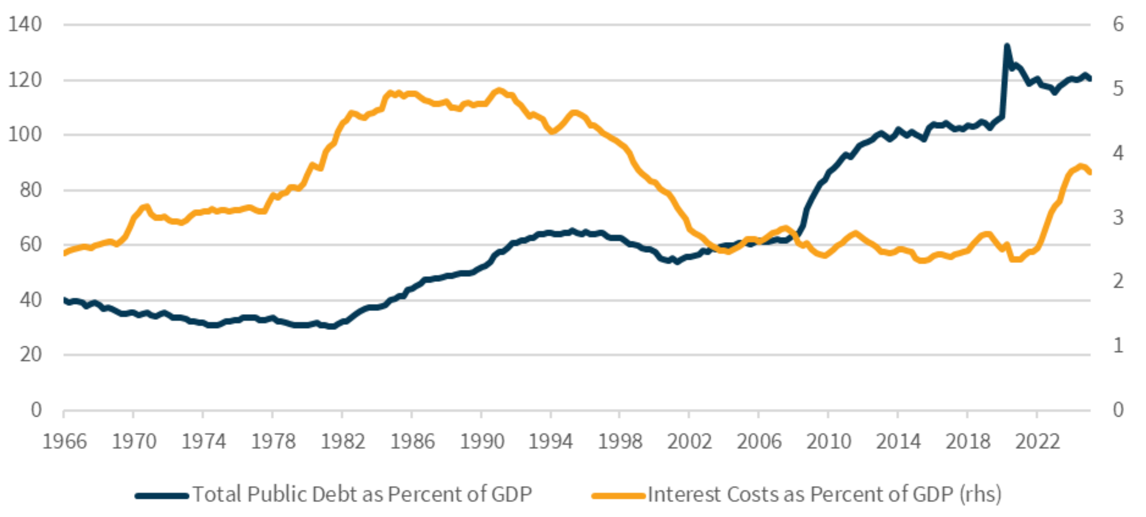
Figure 9: US Deficits and the unemployment rate



Source: FIIG Securities, Bloomberg

It's not just the deficit that is now causing concern. Both the US total debt and the US interest costs are now sitting uncomfortably high. The US is lucky that much of its long-term debt was issued during the 2010s and early 2020s when rates were very low. This makes the cost of their old debt relatively low and keeps the overall all-inclusive interest costs lower than they might otherwise be.

Figure 10: US Deficits and the unemployment rate



Source: FIIG Securities, St Louis Federal Reserve

Despite the signs that the bond market was uncomfortable with the US debt trajectory, the Big Beautiful Bill was passed and there is a new fiscal stimulus that will hit the US economy. This will come with strengthening for the US economy, too, though perhaps only a small effect given the size of the spend. Essentially, any debt-funded spending by the government improves the economy in the short-term.

The efficiency of this spending is a question of how often that money gets recycled through the economy. The best outcome, economically, is if the money gets spent multiple times, as each new recipient increases their own economic activity. Although slightly counterintuitive, the notion of money being spent multiple times comes from the observation that most expenses for one person are an income for someone else. In a stylised example, a tax break for a consumer allows that person to buy dinner at a local restaurant they otherwise could not have afforded, which prompts the restaurateur to buy produce from a local farmer, who in turn pays a local farm-hand to mend the shed, who spends their wages at the bakery, etc, etc, etc.

The US budget bill is not an efficient way to spend money. Most of the tax breaks go to exceptionally wealthy people, who are not likely to change their behaviour. Their propensity to spend is not actually affected by their wealth, which means that the wealth sits somewhat idly in the system as savings. There are some tax breaks in the bill for the less well-off, and those will contribute more, on a dollar-for-dollar basis, to economic growth. Unfortunately, many of these tax cuts to those on lower incomes are more about avoiding otherwise planned tax increases. The 2016 tax cuts were time-limited and due to expire shortly. Reversing those planned tax increases is beneficial to the economy compared to what might have happened, but it isn't necessarily beneficial compared to the current situation.

The US Congressional Budget Office noted that this Bill would increase the deficit by USD3.4 trillion. Most of the changes are in the form of lower revenues. In total, the expenditures fall, though not enough to cover the cost of the tax cuts.

Figure 11: CBO scoring of the Big Beautiful Bill

USD b	2025-2029	2030-2034	Senate Changes
Revenues	-2,129	-1,541	-20
Non-Interest Outlays	-373	-881	90
Increase in the Primary Deficit	1,756	660	110

USD b	2025	2025-2029	2025-2034
Direct Spending	-197	-176	-774
Revenues	-96	-2,094	-3,456
Change in Deficit	-101	1,918	2,773

Source: CBO

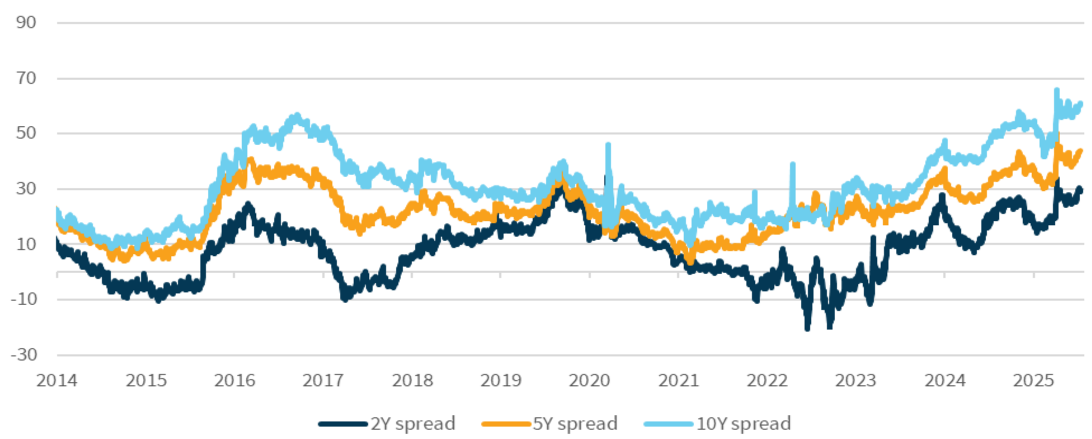
The Bill also includes very large spending for Immigration and Customs Enforcement (ICE). This is a two-edged sword, economically. More jobs and wages trigger repeated consumption loops and drive economic growth. Similarly, any construction work done on camps or holding facilities tends to put money through the system quickly. On the other hand, the behaviour of ICE itself may well have a chilling effect on the system as a whole. The clear and reasonably indiscriminate crackdown on immigration may cause workers without iron-clad proof of their legal status to withdraw their labour. The generally unsettled nature of the US might also see incoming tourist numbers fall, particularly as the main sources for US tourists are Canada and Mexico.

We should point out that our analysis of the economic impact of the Bill needs to be understood to be exactly that – the economic impact. The human and social impacts of this Bill are different aspects altogether. This Bill will do a great deal to reverse the trend of decades towards the government's share of the economy slowly growing as societal safety nets increase. By withdrawing healthcare from a large number of people there will be material ramifications – up to and including more deaths than would otherwise have occurred. Government policy is about making difficult decisions and balancing difficult choices. The US has chosen to prioritise lowering taxes and lowering government spending. That will probably make the economy more efficient, though it has a clear human toll as well.

We think a similar parallel here is to think about the policy choices made during COVID. The US never had the same level of health-related restrictions as other countries, and because of that many more Americans died (per capita) than in other similar countries like Australia, Canada or Europe. This lack of health restrictions protected the US economy, however. The US economy has done very well, even as the impact on overall health was poor. That's the choice the US government made at the time and the choice they appear to be making again. They are lowering the tax take and lowering the spending on healthcare.

Overall, the US Government is continuing to "juice" the US economy. They are borrowing money and using it to increase consumption in the short-term and hoping that the economy grows quickly enough to outpace the rising pile of debt. This is a dangerous approach. It can trigger strong growth, but does so at the risk of inflation and at the risk of rising government borrowing costs. We've already seen the market show some disquiet about owning US Government debt, and the policy decisions taken since then are unlikely to have helped assuage those fears.

Figure 12: Spread between US Government debt and US risk-free rate



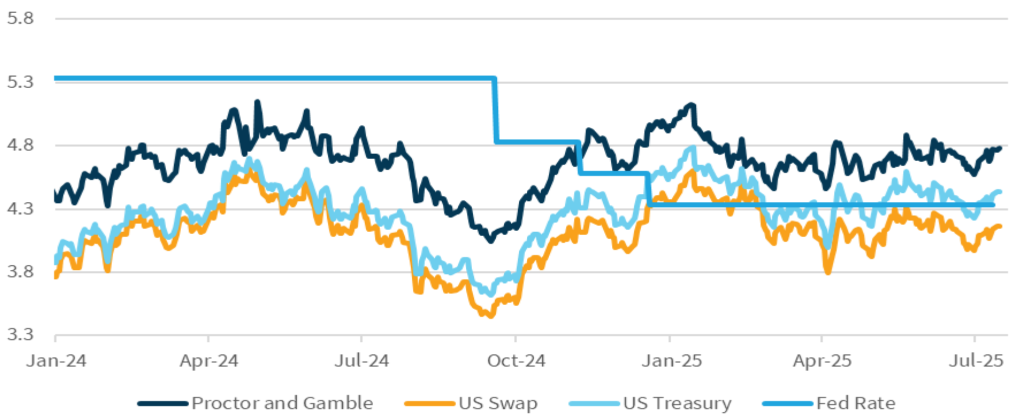
Source: FIIG Securities, Bloomberg

The purest measure for this is the spread between the US-Government Rate and the risk-free rate shown in Figure 12. This measure has been drifting wider for years, but spiked wider after Liberation Day. We must emphasise that although this looks like a credit risk, it perhaps shouldn't be thought of that way. Yes, the credit risk is rising, but not in a way that makes default likely. Instead, the interpretation we see is something more akin to an equalisation of the power balance between the bond seller (the US Government) and the bond investors. When rates were low, debt was scarce, and the Fed was buying lots of bonds, the government had things mostly their own way.

Now, with the Fed selling down debt and the US Government issuing a lot of debt, the investors have more of an upper hand and can extract higher yields from the US Government. This does also have the effect of crowding out other US borrowers, though. If the US Government is offering higher yields, then investors will move to that form of investment. This artificially increases the costs for other strong US borrowers.

As a case in point, Proctor and Gamble, the US mega-corporation, currently faces spreads above US Treasury that are very small, but spreads above US swap rates that are quite high. Higher US Government borrowing costs also mean that the total borrowing cost for companies in the US is not falling as quickly as it might, even as the Federal Open Market Committee (FOMC) is cutting rates.

Figure 13: US Government yields increasing costs to all borrowers



Source: FIIG Securities, Bloomberg

The other mechanism to consider is the US mortgage market. US mortgages are mostly set using the 30-year Treasury rate as the comparison point. When the US 30-year yield is rising the cost of a mortgage in the US is rising too – regardless of what the Fed is doing.

The medium-term consequences of this path are, as yet, unknown. A great deal depends on whether bond markets continue to fund the US Government with only the occasional grumble, or whether the current trajectories continue and the US Interest costs keep rising. We suspect there will be increasing instances of indigestion in the markets, and the general trend higher in US Government spreads will continue. That will cause a medium-term cooling of the US economy.

Global investors are discussing "de-dollarisation", which is the notion that markets will move away from the US dollar as the global reserve. This move needs to be understood as a change in emphasis, not as an absolute de-dollarisation. It's not that the markets would suddenly not fund the US Government at all, but it is quite likely that the US Government continues to be asked to pay higher and higher spreads to convince investors to bear the US risk that they would prefer not to hold.

The timelines here are very hard to predict, but it seems comparatively likely that US Government policy will not change in a meaningful way for another four years because of how the political system fits together. In turn, that means the overall cost of debt will rise for everyone in the US and constrict the economy. This constriction will likely, over time, show as reduced growth.

We expect a short-term improvement in the US economy from the tax cuts, but the longer-term impacts suggest a weaker economy.

We have not yet really analysed the US tariff situation. As we write, the market is currently blithely ignoring the most recent round of threats. We think that is dangerous. It's easy to look at the most extreme threats made – then withdrawn – and assume that not much has actually changed. That would be incorrect; the overall US tariff rate has increased materially. It hasn't increased anywhere near as much as threatened, but the change still matters. For the moment, the rise in tariffs hasn't unduly harmed the economy, but the changes are still working their way through the system, and new changes are being announced with some regularity. The direct and indirect impacts of the tariffs will both increase US inflation and further erode market confidence in the US dollar.

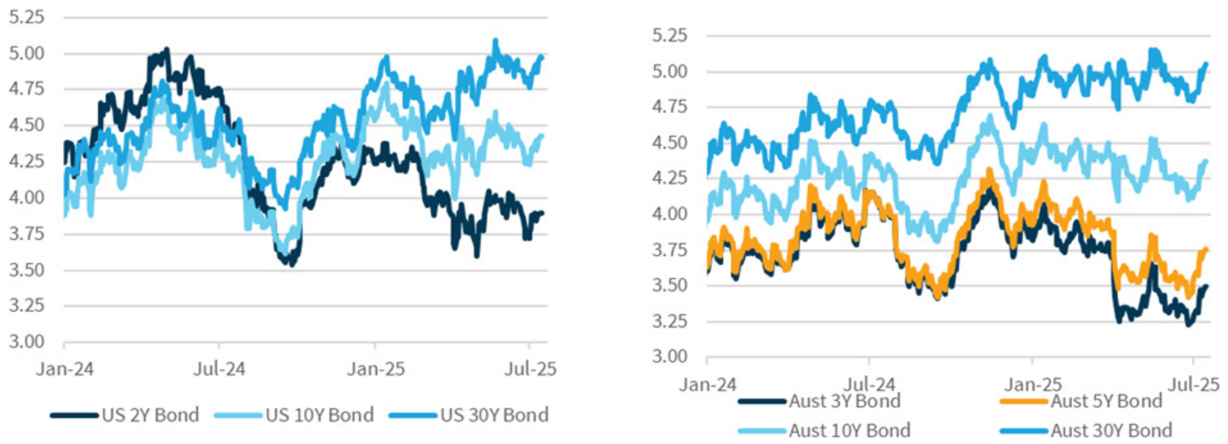
The US economy has a head of steam at present, but once the sugar rush of the BBB passes, there are growing difficulties lurking below the surface in the US.

Section 3: The choices investors must make in the Australian bond market

As we noted above, the US Government is doubling (trebling?) down on borrowing more to increase the spending. This will have short-term positive impacts on the US economy but will also likely have medium-term problems. For Australia, and particularly for the Australian bond market, the biggest impact of the US situation is that the Australian bond curve is steepening. That is, the reward for longer-dated bonds is rising compared to shorter-dated ones.

In both the US and Australia, the yield required for 30-year borrowing sits very high, even as short-term borrowing costs fall.

Figure 14: Curves steepening globally



Source: FIIG Securities, Bloomberg. Charts show yield in percent.

This has two important ramifications for Australian bond investors.

1. Be careful how and where you take duration, because 10-year bonds might not move the same way as the cash rate.

2. The expected return over a short period is not equal to the average return.

Lesson 1: Be careful how and where you take your duration.

Since the Lucky 7 piece published in April 2024, we have been suggesting that the 7-year was the right place to take duration risk. The growing risk in the US Government curve only reinforces that view.

So far, the rise in bond yields in the US has only been a rise in a relative sense. The US 10-year bonds are about the same yield (and therefore about the same price) as they were a few months ago. That might not always be true.

If the US government bond market starts to weaken aggressively, they could fall in price in an outright sense. This concern flows through to Australian bonds as well. Although we expect the RBA to cut rates over the coming 12 months and further out as well, the longer bonds will respond to global developments, not just to the RBA.

Lesson 2: The expected return over a short period is not equal to the average return.

Steep curves mean great things for those who rotate their investments. We've discussed forward rates before in our Macro note from October 2024, and that piece deserves revisiting. The key point to understand though, is that the yield advertised on a bond is the expected average return per year over the whole life of a bond. Generally speaking, the returns in the first few years of a bond investment are likely to be higher than average, while the last few years are likely to be lower than average.

When curves are steep, thinking of a bond return as its yield, which is the average return over the entire life, obscures the likely returns in the shorter term.

Imagine a very steep curve where you can buy a 5-year bond at 5% or a 4-year bond at 4%. You might expect a 5% return in the first year of the 5-year bond. Actually, the return is expected to be much higher if things go to plan.

As a short-hand, consider that a 5% return for 5 years suggests a total return of 25% over the life of the 5-year bond. Meanwhile, a 4% return for 4 years suggests a total return of only 16% over the life of a 4-year bond. That extra year, the fifth year, gains an extra 9% return. If you bought that 5-year bond and things developed largely as expected, you would probably earn about 9% in that first year. This is a stylised example in a very steep curve, but it does get to the crux of the matter. Steep curves mean that average returns over the life of a bond – captured as the yield to maturity - are not representative of the expected returns in the first section of a bond investment.

If the average return on a bond is a yield of 5% per annum, but the last couple of years, when the bond is very short, are going to have returns that are quite low, and much lower than the average, then it stands to reason that there must be some other years where the expected yield is much higher than the average. The return can't be below average every year!

This line of argument is very often true in bond markets, but the mathematical effect gets more extreme as the yield curve gets steeper. Investors are rewarded early for taking term risk, but the most common measure, the yield, is quoted as the average over the whole life of the bond. The steeper the curve, the more pronounced this effect is and the more beneficial rotating investments can become.

FIIG investors have achieved average returns of around 9 % for two consecutive years, mostly by buying bonds which yield in the mid 6% range. This demonstrates that the overall return for a portfolio can be much higher than the yield, consistently, for those who rotate their portfolio at opportune times and take advantage of the shape of the curve. This effect is already present, but will become even more noticeable if the curve steepens more, as we expect it will.

With the RBA likely to cut rates and benefit the short-end of the bond curve, but the 10-year sector exposed to vagaries of the US markets, buying bonds that sit between these two worlds seems the most attractive proposition to us. So, once again, we are suggesting that bonds in the 5 and 7-year section of the curve are the best options.

Credit Risk

We have not yet discussed credit risk because the credit markets, as a whole, have been very well behaved in recent months. There have been a few themes worth picking up on, though.

First, the growth of the use of subordinated debt is very noticeable. This form of debt is both higher yielding and higher risk. FIIG investors have been very active in these deals and they should have a place in most portfolios - but beware of concentration risk and make sure of diversification. Companies like Pacific National, for example, are offering very high yields, but subordinated debt in a risky company does come with substantial risk.

Second, the ESG-lockout on some companies has reversed. This was never an official thing, but the risk inherent in coal and other “dirty” industries prevented some issuers from taking the risk of accessing AUD markets in the past. Recent deals suggest that the market will still support these forms of investments, like for Port of Newcastle, for example. This suggests that clients who wish to make their own decisions on things like carbon, will need to pay closer attention to the details of some companies.

Third, the pickup for credit risk over and above the Government risk is smaller than the risk perhaps deserves. We’ve mentioned this in previous work and it remains true. This is an extension of the observations we made in this piece about the US government crowding out domestic borrowers. The higher US government borrowing rate is crushing up underneath the borrowing rates of US Corporates. Meanwhile, the impact of US government rates is pushing Australian government rates higher and causing a similar effect in Australia. Credit risk should still be taken, in our view, but cautiously and with an understanding of the duration of the credit risk involved.

Suggestions of bonds which look compelling at the current time

The bonds we suggest here are bonds that should fit nicely into most portfolios, but are not an exhaustive list. As we've laid out in this piece, we still like the BOLD strategy we described at the start of the year and are preparing for a slower, but more elongated, rate cut cycle, while being careful to avoid too much exposure to truly long bonds, because of the risk from the US.

This general understanding means bonds in the 7Y area (2030-2033 maturities) are preferred. We have both the Port of Newcastle and the Transgrid subordinated bond in that sector, while there's a 5Y Macquarie line too. These 5Y-7Y bonds shouldn't be your entire portfolio; however, diversification is still important. Diversification is needed both in the maturity of the bonds, but also on the type of bond. As such, our list includes shorter bonds, like Blue Owl, as well as an inflation-linked bond (Sydney Airport) and a floating rate option, too (Clearview).

Issuer	Ranking	Currency	Type	Maturity / Call	Coupon	Yield	Rationale
Port of Newcastle	Senior	AUD	Fixed	18-Jul-33	6.100	5.82	Strong safe yield in infrastructure sector. Some ESG concerns to be aware of.
Macquarie	T2 Sub	AUD	Fixed to call	20-Feb-30	5.603	5.03	Highest yield amongst 10NC5 T2 banks. Protected from longer-duration problems.
Westpac	T2 Sub	AUD	Fixed	4-Jun-35	5.815	5.42	Highest yield in the major bank space.
Sydney Airport	Senior	AUD	Inflation Linked	20-Nov-30	3.12	CPI + 3.21	Inflation protection still valuable, real yields haven't dropped as fast as nominal yields.
Nationwide	Jr Sub	GBP	Fixed to call	20-Dec-30	7.5	6.71	Higher risk, but higher yield.
BNP	Jr Sub	USD	Fixed to call	27-Jun-35	7.45	6.95	A second high-risk, high-return option. Also has currency risk.
Woolworths	Senior	AUD	Fixed	29-Nov-34	5.91	5.29	Safer bond providing sector diversification.
Blue Owl	Senior	AUD	Fixed	23-Oct-27	6.5	5.14	Shorter, safer bond that provides returns well above TDs.
Clearview	Sub	AUD	Floating	27-Mar-30	3M BBSW + 3.50%	6.31	Floating rate, but large margin offsets rate cut risk.
Transgrid	Sub	AUD	Fixed to call	11-Mar-33	6.277	5.8	Subordinated debt but well positioned for green transition.

Find out more

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*Please note that past performance isn't a guarantee of future returns. The median FIIG client rate of return for FY25 was calculated by using client portfolios with five or more bonds and a minimum portfolio size of AUD250K, excluding managed portfolios. The median return for clients over the previous five-year period (FY25-20) and three-year period (FY25-23) was 6.62% and 8.09% respectively, based on the same client criteria from the FY25 cohort. While the aggregated returns of FY25 are lower than FY24, this is a significant outperformance of the BB AusBond Composite 0+Yr Index, which focuses solely on the Australian debt market whereas FIIG clients may have international exposure and hold investments of varying credit rating. This index returned -0.10% over the same five-year period and 3.88% over the same three-year period.

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