

QUARTERLY MACRO OUTLOOK

OCTOBER 2025

A glide path to a soft landing – but with
some risk of turbulence

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B.O.L.D.



The fixed
income experts

Executive Summary

Following the slightly elevated August 2025 monthly CPI result, the Reserve Bank of Australia (RBA) looks much less likely to implement a large near-term easing cycle. However, the weakening trend in the Australian labour market appears to keep surprising financial markets and commentators.

In contrast, FIIG has been pointing to the risk of a slow and elongated rate-cutting cycle for a long while now. This appears to be coming to pass. Our first section in this Macroeconomic Outlook will address the state of the Australian economy and the current RBA cycle, but our underlying expectation of a long, slow easing cycle has not changed. That also means that our key recommendation to bondholders to be slightly long duration, with a target of buying bonds around the 7Y point, is also unchanged – though timing a market entry point is also needed.

The fundamental observation driving this position is that usually when the RBA is moving rates, they are doing so against the backdrop of a serious problem. Whether it be a financial crisis, a pandemic or an inflation breakout, the result is an RBA trying to keep up with events. As a result, because the RBA is often moving quickly, this tends to give the impression that the RBA must always move quickly. It suggests that the RBA needs to move consecutively in meeting after meeting in the same direction whenever they are moving rates. However, somewhat unusually, while the current situation does suggest some further movement in rates is needed over time, there is no underlying crisis driving the RBA movement. In fact, despite the rise in the unemployment rate, the current Australian economic situation is nearly as good as the RBA could hope for and certainly much better than feared. There's no need to rush and no pressing emergency. This gives the RBA time to assess the data and pause in between moves, which is a luxury the RBA doesn't often receive. We expect this to play out as rate cuts interspersed with pauses.

The economic situation in Australia is currently good. The inflation rate is somewhere near the top of the 2-3% target band. The most recent quarterly results for CPI (Q2-2025) were 2.1% headline but 2.7% underlying over the year to the second quarter. Those are artificially reduced by the changes to electricity prices. The most recent monthly results (August 2025) were 2.9% headline or 2.6% trimmed mean over the year to August. These are a little higher than the RBA would probably like, but not disconcertingly so. They are nearer to the top of the RBA band than the centre, but that's a vast improvement from a few years ago. There are some hints of weakness around the edges in the labour market, and a slightly concerning medium-term trend. However, the overall position is still only a 4.5% seasonally adjusted unemployment rate. We have been anticipating a weakening in the labour market for a long while now, and this was specifically addressed in our July Macro Outlook.

Executive Summary (continued)

Put succinctly, the RBA's dual mandate is to achieve inflation within the band and as near as possible to full employment. It would be hard to argue that the RBA could achieve much better than the current situation. Inflation could be marginally lower, and it would be better if the unemployment rate were not rising quite so fast. However, even with the unemployment rate at 4.5%, compared to many international comparators, the RBA would be feeling quite satisfied. (The unemployment rate in New Zealand is 5.2% and rising, while the unemployment rate in Canada is 7.1%.)

That's not to suggest that things like housing prices, or the cost of living, or productivity are not material economic issues – they are. It's just that those problems are not really the RBA's to solve.

Within the scope of what the RBA can influence, there appears to have been a commendably soft landing for the Australian economy. The glide path at present looks very good. After applying the economic brakes relatively hard across 2022 and 2023, there has been scope to ease off on them in 2025.

However, although the domestic picture looks pretty good at present, there are a large number of risks that appear to be brewing, primarily though not entirely in the international arena. Our second section will look at some of the major risks that could upend markets in late 2025 or 2026. These are the possible sources of turbulence that could disrupt Australia's soft landing. The most material risks we see are a breakdown of the American economy based on political disagreements; a market reaction to the over-indebtedness in Europe, particularly France; or a reignition of domestic inflation driven by increased consumption. We don't view any of these risks as particularly likely, but it's still worthwhile to discuss how to position bond portfolios to protect yourself from those risks. Clients who judge these risks to be more pressing than we do should adjust their portfolios accordingly.

Our third and final section will look at the effect of rate cuts and steeper curves on the performance of bonds over time. As we discussed in July's Macro Outlook, the return on a bond is not constant over the course of the bond's life, but neither is it random. It is uneven, but predictable. Longer bonds, in particular, tend to make outsized gains in the first few years of their existence, assuming that bond markets overall stay comparatively stable. Using a Nelson-Siegel modelling exercise, we demonstrate how a 10-year Tier 2 subordinated bank bond can be expected to materially outperform in the first few years and outperform somewhat in years 4-7 before giving a lacklustre performance in the last few years of its life.

Section 1: Checking in with the Australian economy's calm glide

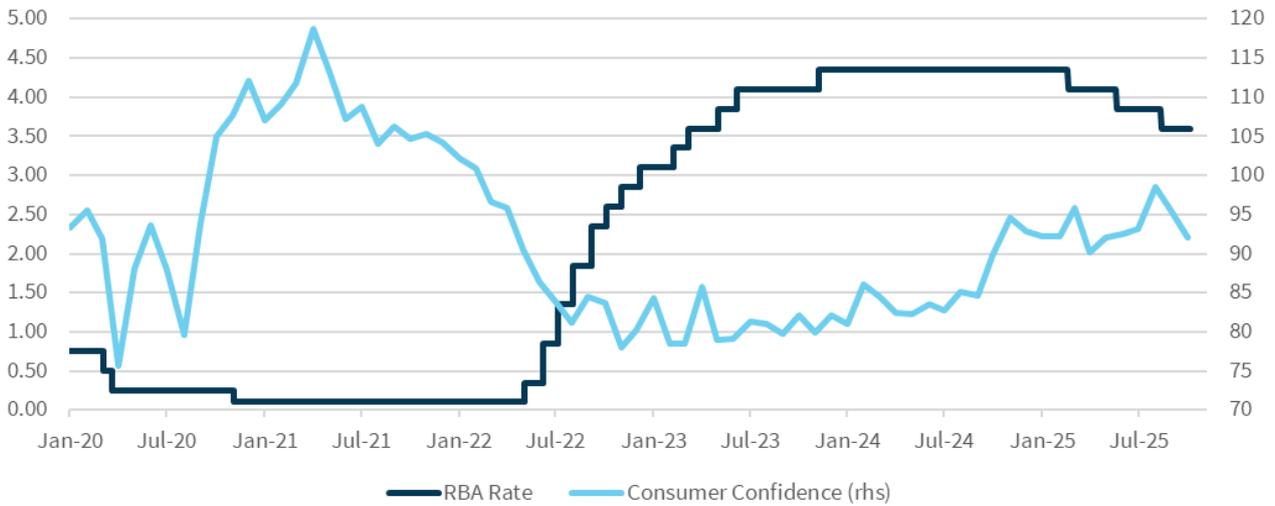
The Australian economy is mostly performing well at present, and the parts of the economy that the RBA could realistically try to influence are performing better than expected.

The RBA's dual mandate is to keep inflation between 2-3% (preferably near the middle of that band) and to achieve as close to full employment as possible. At present, inflation has been volatile within the band, thanks largely to the impacts of government policy for electricity subsidies flowing in and out of the data. Yet inflation within the band is a significant improvement on the exceptionally high rates seen in 2022 and 2023. Meanwhile, the labour market has been exhibiting a slow negative trend. That result is much better than in some other countries, where the trend has been clear and marked. We discussed in our July Macro Outlook the slow momentum towards weakening in the labour market. The two 4.2% prints in July and August (noting the August read was revised higher to 4.3%) flattered to deceive. They were worse than they looked. Reality has reasserted now with an increase to 4.5%, though that was only 4.46% to the second decimal place. As the two 4.2% results were slightly flattering, the 4.5% is somewhat unflattering. The truth lies somewhere in the middle, and we interpret it as a prolonged, slow weakening in the labour market.

Outside of the RBA's two mandated focus areas, there are some problems. For example, GDP rebounded to be up 0.6% in the second quarter, which was only 1.8% on the year. Given the relatively large population growth in Australia in recent times, GDP growth has been underwhelming. However, the RBA is not explicitly tasked with managing GDP and will only seek to improve GDP results if the other two measures are under control. Similarly, the current difficulties in housing affordability are real and troubling, but not really what the RBA was created to address. As such, there's not a great deal the RBA can do about housing affordability.

This set of circumstances creates a communication challenge for the RBA. The RBA is trying to point out that the areas they can control are looking reasonably good, while the overall "gut feel" for the economy held by most regular people is not particularly strong. It would be easy for the RBA to look out of touch by crowing too much about the strength of the economy while many people are still struggling with the aftermath of the cost-of-living crisis. This dichotomy can be easily seen in the consumer confidence data, which recently dropped back to only 92.1 points (the series is centred at 100). The data shows that people are not particularly confident at present, and the material improvement in confidence that accompanied the rate cuts earlier in 2025 evaporated when the general consensus was that the RBA was close to finished with its easing cycle. (Note that FIG Research never agreed with that consensus, but the overall assumption about the RBA is a little more undecided about November since the rise in the unemployment rate.)

Figure 1: Australian Consumer Confidence fell when the RBA looked likely to pause.

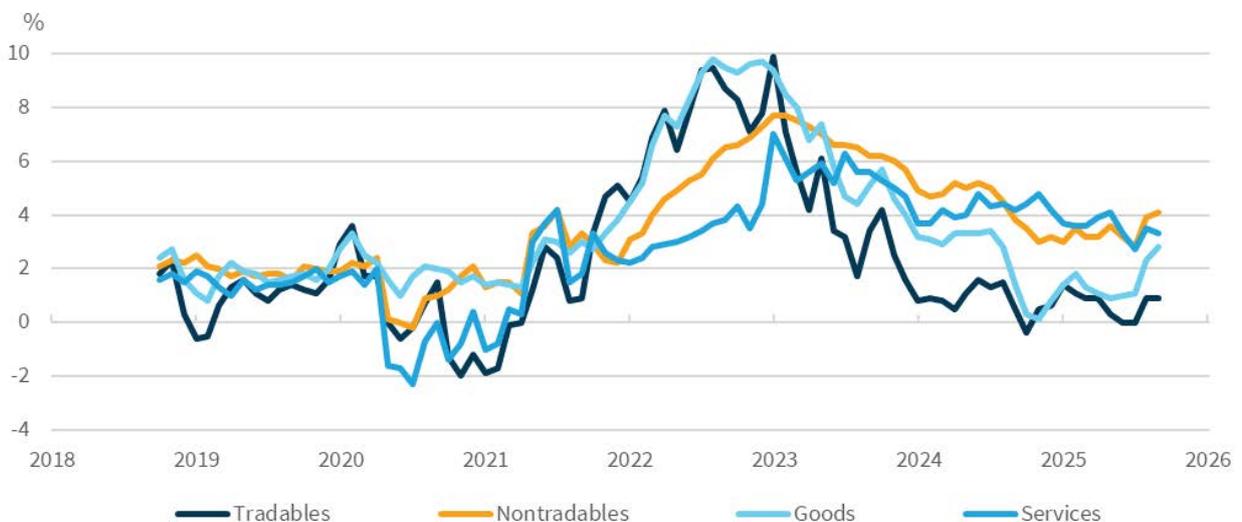


Source: Bloomberg, FIG Securities

While we think it is plausible that the RBA will pause for a period here, depending on what the Q3 CPI shows, we’re a long way from being convinced that the entire rate cycle is over. Instead, we think the data is suggesting a long-term momentum towards weakness that will see the RBA lower the rate more in 2026 and 2027, even if they don’t lower it more now.

The case to end the easing cycle rests very heavily on the increase in the CPI data in the August monthly result. That result did show a higher than anticipated inflation rate, but it was also only one month’s worth of data and, importantly, one month’s worth of data where there were a lot of oddities around the electricity prices. A common element of the analysis from various sources was that the stickier parts of the data, like services, were showing very high results, while the more volatile items were, coincidentally, all showing weaker results. There’s some truth to that line of argument, but it does miss the nuance a touch in our view. Although services inflation remains higher than goods inflation, it was actually goods inflation returning to a more normal level that caused the headline inflation rate to rise.

Figure 2: Australian Monthly CPI shows goods prices rising.



Source: ABS, FIG Securities

The other way to cut the data is into market services and non-market services (like healthcare, which is primarily a price set by the government). The market services data did show a somewhat higher set of results. The overall print is still one that is higher than fully comfortable for the RBA, but well short of panic stations. It was also only one monthly data print. We're still learning how the monthly CPI data series behaves, and it is quite possible that the coming two or three months show a different story. However, even if the current mild upswing in inflation continues, it is not a material problem.

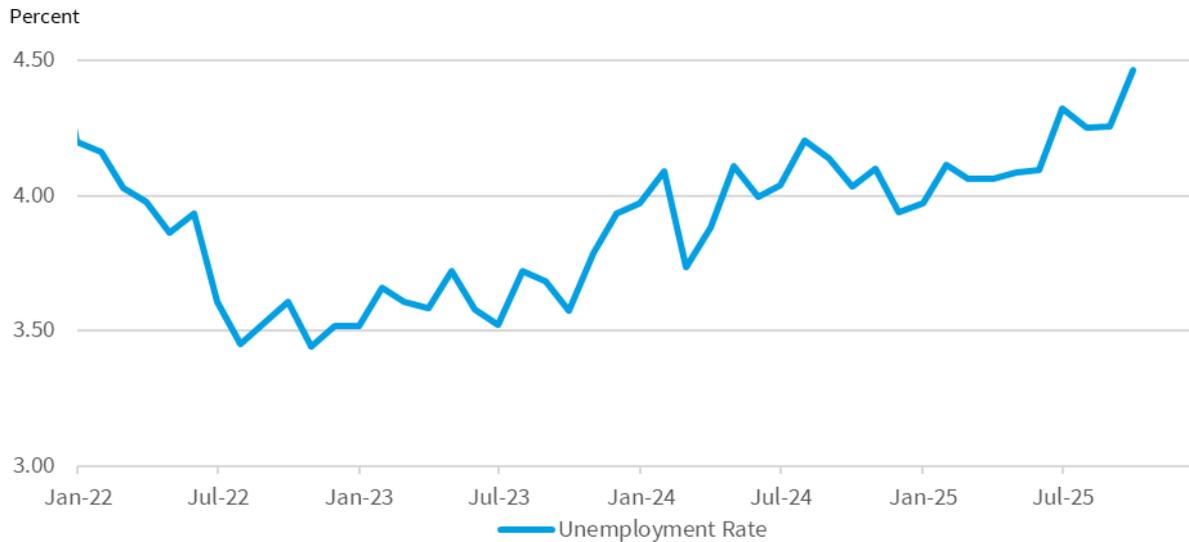
The current RBA rate is still above what most would regard as a neutral rate – meaning that simply by leaving the rate unchanged, the RBA can be leaning against any re-ignition of inflation. Certainly, leaving the rate unchanged while the unemployment rate is rising would be seen as quite a contractionary set of policies. We suspect the RBA will want to avoid raising the rate now if they possibly can, even if the inflation rate is a little higher than truly desired, because there are also a lot of suggestions that the rest of the economy is weakening, and the medium-term inflation appears under control.

One plank of the RBA's understanding of the economy was the assumption that household consumption would increase materially. Consumption has increased somewhat, but the most recent data suggest that the increase in household consumption is moderate at best. For example, the household spending indicator was expected to rise strongly in August and instead eked out a 0.1% rise to be up 5.0% on the year (that annual rate of growth is a fall from 5.3% in the year to July). We discussed the consumer confidence data above, but it is part of this story too. The consumer confidence fell in large part because the section devoted to the household finances in the 12 months ahead fell sharply. We assume that was driven by the removal of RBA rate cut expectations.

That creates something of a chicken-and-egg argument, though. If the RBA is expected to cut rates materially, the impulse to spend rises, but when those anticipated rate cuts are removed, suddenly the impulse to spend looks a lot shakier. That's a good thing, in a way, because it shows that the current RBA cash rate is roughly where it needs to be in the short term. If unbridled spending was continuing, whether the RBA raised rates or not, or if despondency was taking over despite an RBA rate cut or two, then that would strongly suggest the cash rate was well away from where it ought to be. The current cash rate is exerting a material effect on the marginal decision-making in the economy, which means it's roughly in the right place.

We're also still concerned that the labour market is weaker than the RBA gives it credit for. Noting the recent uptick to a seasonally adjusted rate of 4.5% is higher than the RBA's forecast of 4.3% by year-end. Moreover, there are also a lot of other pieces of secondary information that suggest weakness. The last two important pieces of data are ABS Job Vacancies (-2.8% on the quarter) and ANZ Job Ads (-3.4% on the month), and they both showed the slow-burning ongoing weakness we've pointed to before. Now, it's true that the labour market was previously very strong and remains in decent shape despite the weakening trend. The two unemployment rates released prior to this month have looked reasonable at 4.2%. However, the most recent print was revised higher to 4.3% and the prior one was really 4.24% when expressed to two decimal places (rather than 4.2% as it appears on the ABS website). That, combined with the fall in participation cushioning the last set of data and the weakness evident in both vacancies and job ads, makes us not surprised to see the seasonally adjusted unemployment rate jump to a 4-year high recently. As we pointed out in July, the general trend in the unemployment rate is still upwards.

Figure 3: Australian Unemployment Rate



Source: ABS, FIG Securities

Overall, we view the Australian economy, when viewed solely on domestic factors, to be in reasonably good shape. The inflation rate is slightly higher than desired while trending downwards overall. The cash rate is slightly higher than neutral, which should help to bring the inflation rate down in time. There are still some signs of weakness in the labour market, which we expect will see the RBA lowering rates again in the future, perhaps as soon as November. Our view that the most likely path for the RBA is a long, elongated and slow rate-cutting cycle remains in place. While there is some chance that the RBA pauses in November, and perhaps February also, there doesn't yet seem to be the strength in inflation that would cause the RBA to raise the cash rate.

For bond portfolios, our previous advice of maintaining a longer than normal duration but being wary of bonds that are too long and so exposed to the vagaries of international markets, remains our core position.

Section 2: The risks to our core understanding

We've explained our core position in Section 1, which sees a soft landing and relatively stable domestic economic outcome. That means our core recommendation to clients remains unchanged – namely, continue to buy fixed-rate bonds around the 7Y sector. Continue to pay attention to diversification because the credit spreads remain relatively tight. We'd add that the recent increase in infrastructure issuance allows clients to diversify away from banks into relatively attractive new issues.

However, we also want to underline the elevated level of risks in the current situation. We see three sets of risks that are worth discussing individually. They are all tail risks, in our estimation, and well short of likelihoods. However, each is real and needs to be considered. The key tail risks we see are

1. Slow breakdown of US political and social institutions.
2. A Sovereign debt crisis in advanced European countries like the UK and France.
3. A material re-awakening of inflation in Australia.

Again, we must re-emphasise that we do not see these as likely outcomes, but they are plausible enough to make us want to consider what happens if these risks did come to pass. Any clients who view these risks as more likely than we have assessed should consider changing their portfolios to protect against those risk sources.

Risk 1: A slow breakdown of US political and social institutions

The risk that the US is approaching a fundamental political breaking point is easy to overplay, but easy to underplay, too. We don't want to sound like Cassandra – but nor do we want to sound like Pollyanna. The risk from the degradation of US political and social institutions isn't about making judgments on left vs right, it's about how those institutions have served the US economy over generations and whether they will continue to do so. Externally, the US has benefited from a leading role in the world order that was made possible because of a deep commitment to independent institutions and to the rule of law. Domestically, the US has benefited from the creative spark of capitalism and meritocracy that are byproducts of solid institutions. Over time, there is strong evidence that [corruption causes an economy to operate less efficiently](#). The US political and legal institutions matter because they allow the creative spark of entrepreneurship to drive the US economy. As these US institutions come under pressure, there is a risk that one of the foundations of the US economic success might crack.

In the year since President Trump won the 2024 election, the US's place in the world has been radically altered. "Make America Great Again" has proven to be a very assertive American influence on international politics and trade – not always to the benefit of the system as a whole or even to the benefit of the US, as best we can see. The world was not ready for the maelstrom that was the start of Trump's second term, but they are starting to show a bit more steel now. In particular, China is starting to stand up against the US in calculated ways.

The US has benefited greatly from being at the centre of the international order over the last 80 years. This is often in the form of soft power that is buttressed by the US' commitments to institutions. This then leads to hard power, though. For example, in military terms, the US could build a "coalition of the willing" because other nations were prepared to accept the US position of leadership. Or in financial terms, the US dollar dominates the world's markets, and the position of "reserve currency" provides exceptionally cheap funding to the US Government. (And at a secondary level, the liquidity of the US dollar provides a leg-up for smaller US borrowers trying to access global capital markets.)

But we also cannot pretend that the structure of the US polity has remained unchanged. Corruption in the US has been increasing for a decade (sources [1](#), [2](#) and [3](#)), and the commitment to democracy appears less solid than before. The proportion of Americans saying that [violence may be necessary to get the country back on track has risen from 19% to 30%](#).

The US Government is also doing previously unimaginable things. In the last few weeks, the US Government has begun deliberately [attacking boats](#) because it asserts that the boats are carrying drugs. There's no evidence and no public hearings – just boats and sailors killed. Now, even if those boats were full of drug smugglers – and we reiterate that there's no actual evidence of that and in many cases [actual denials](#) – the change from using rules of law and international co-operation to simply killing enemies on sight is a major change in policy. It will have ramifications.

On the US domestic side, the FBI and other law enforcement are increasingly choosing who to prosecute based on political considerations. For example, [Fed Governor Cook](#), [Letitia James](#), [John Bolton](#) and [James Comey](#) are all currently under investigation for alleged crimes where the evidence seems flimsy at best.

The United States is starting, subtly, to lose the idea that the will of the people is the most crucial feature of choosing leaders – hyper-partisanship is causing loyalty to party to become the pre-eminent concern, sometimes overtaking things like loyalty to the institutions. For example, recently-elected [Adelitja Grijvela has not yet been seated in Congress](#) despite winning her race on 23 September. There's [no real reason for House Speaker Johnson to refuse](#), except political expedience. A few years ago, before January 6, the notion that the elected representatives of the people would not be allowed to take their places in Congress would have been unthinkable and caused an uproar. Now, I doubt many of the readers of this note would have heard about the Grijvela case.

This recent period of fragmentation of previously assumed democratic norms may self-correct thanks to the strength of US institutions, but we shouldn't assume that it will. US institutions have survived for centuries and are very strong – but they are also under pressure at present and there is no guarantee they will continue unchanged.

So far, this weakening of institutions has not impacted the US economy directly, but the US financial markets are starting to be affected. For example, TikTok was [sold for a price](#) much lower than previously assumed.

There is also material economic risk from changes to US immigration policy. The [Korean Factory worker case](#) is a prime example. There, the expertise needed to build the advanced factory was lost because the visiting workers did not want to stay. The US ICE is now deporting large numbers of people with [seemingly few restraints](#). This is presumably designed to dampen the desire of immigrants to come to the US, but that comes with two significant secondary effects, too. First, there is the lack of manual labour to perform unskilled jobs in industries like agriculture, but second, there is also the loss of the highly skilled immigrants who become the drivers of the economy. Sergey Brin, one of the founders of Google, came to America as an immigrant because his parents, both mathematicians, wanted to leave the USSR. Would his parents choose the US today, or would they choose Germany? Or Australia?

The risk implicit in the degradation of US institutions is a risk of undercutting the economic dynamism and growth of the US economy. This risk would not necessarily cause immediate impacts on financial asset prices, but the longer-term risk is substantial. A medium-term economic malaise driven by brain drain and a lack of economic entrepreneurship would see growing problems with US productivity.

The Federal Open Markets Committee (FOMC) would likely cut rates over time as the malaise continued. However, the US would find it difficult to create economic growth against such a backdrop. We would expect to see short-term rates in the US drop slowly over time, while the longer-end would notice the risks inherent in a country with a weakening political structure and may well sell off. This risk is, in economic terms, a medium-term and long-term risk, however.

The best solution for investors who fear this risk is to limit exposure to USD assets and to maintain a moderate duration exposure, since an economic malaise in the US probably causes economic slowdowns in most other countries.

For FIIG investors who are concerned about a degradation of US institutions, this means supplementing our general advice of long-duration and 7Y focus with an extra overlay:

- Selling USD assets and repatriating to Australia.
- Maintaining solid credit exposure to non-US names.
 - » Australian banks, both major and smaller, are good options, but beware of concentration.
 - » Infrastructure bonds, like ports and airports, offer good diversification.

Risk 2: A Government Debt Crisis in Europe

Unlike the slow-burning crisis that we outlined in US institutions, a European Government debt crisis would likely be explosive if it occurred.

As we saw in the 2010-2012 period with the European peripheral debt crisis, these events can become exceptionally fast-moving once they get started. The fundamental issue here is compound interest. Once governments start to face rising interest costs, the interest compounds. The higher interest costs raise the deficit, which increases the borrowing in the short-term, which raises the interest costs and so on.

We've written quite extensively about the European situation in our latest post-reporting season piece. However, the findings there are worth reiterating. The European countries most under pressure are the UK and France, with the US also deserving an (dis)honourable mention. In Figure 4, the best position to be in is the bottom-right, with countries in the top-left having large deficits and substantial debt stocks at the same time.

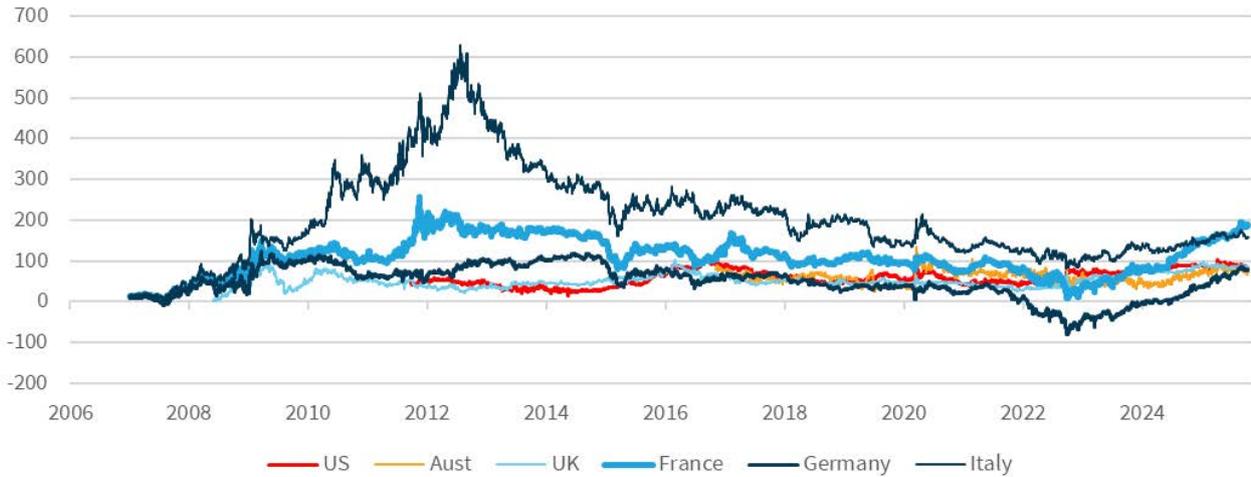
Figure 4: Deficit vs Net Debt



Source: IMF WEO April 2025, FIGG Securities

The spreads on European sovereign debts are already reasonably wide. The difference between the 30Y government bond yield and the 30Y OIS (Overnight Index Swap) is something to watch, as it functions as a canary in the coal mine. The OIS is a measure of the anticipated cash rate, so the difference between the government bond and the anticipated cash rate can be read as a measure of credit risk in the government bonds.

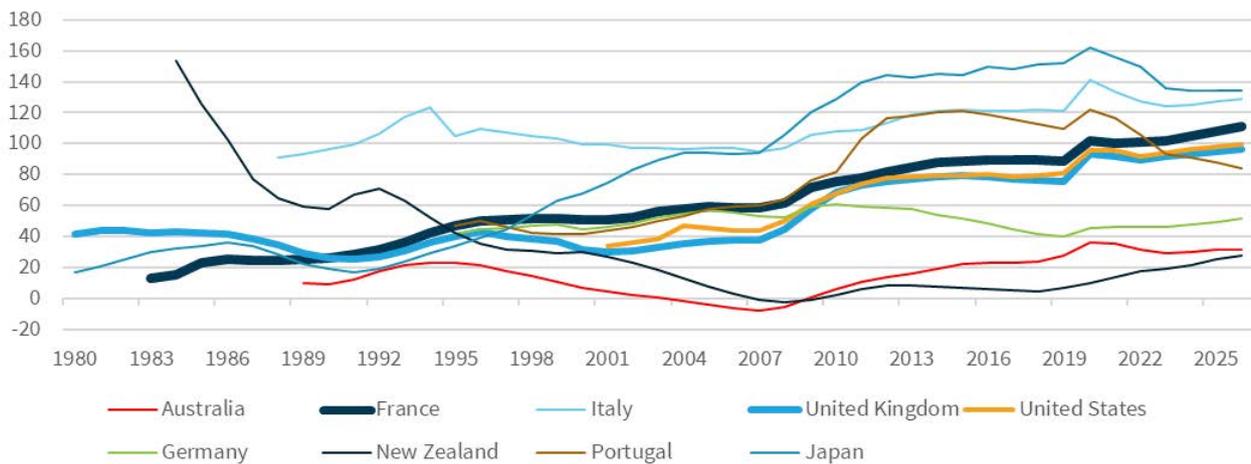
Figure 5: 30Y spreads to OIS



Source: Bloomberg, FIIG Securities

Notice that while the movement in French Government Bond spreads to OIS in Figure 5 is the largest in recent months, there has been a general movement wider in many names over the past few years. Part of that is a resumption of normality after the COVID years, but part of it is a general understanding that the indebtedness of many countries around the world has been rising for a long time – and might not be able to keep rising (Figure 6). This is particularly true in the “core” countries of France, the UK and the US. Notice we have included Australia on Figure 6 to highlight that although our debt is higher than it used to be, we are still well below the indebtedness of the problematic countries.

Figure 6: Government Net Debt to GDP ratios



Source: IMF WEO, FIIG Securities

For investors concerned about the European Sovereign situation, we would suggest reducing exposure to the European Sovereigns themselves (which most clients would not hold) or to the proxies like EDF (which some clients do hold).

We would not be particularly concerned about European banks, since many of the large European banks are, in fact, larger than the sovereigns now by many measures. The European banks, even the French ones, are relatively well diversified across the continent, too. There is some argument to be made to sell BPCE, which does have a strong exposure to France itself, but the other names like BNP Paribas and Barclays are well divorced from their respective sovereigns.

The risks here are actually tilted towards a “standard” recession as the most likely outcome. Take the French case – if they do manage to pass a new Government Budget that addresses the problem of the French deficit, it will cut spending and raise taxes. Much like the austerity years in the 2010s in the UK, this will cause an economic slowdown, perhaps economy-wide or even continent-wide, depending on which governments hew to the new path. In that sort of scenario, the specific governments that come under pressure will see rising yields and a bond sell-off, but the broader macroeconomic outcome is actually a rally for most bonds, including credit bonds – so long as you avoid the trouble spots.

For FIIG investors who are concerned about the risk of over-indebtedness in European sovereigns, this means:

- Considering exposure to sovereign-affiliated names like EDF.
- Ensure European bank holdings are diversified.
- Move towards Australian and US names within the portfolio.
- Lengthen duration in the low-risk names – though this is awkward, as sovereigns should not be considered low risk in this scenario. We like German utility names, like ENBW and E.ON.

Risk 3: The Australian economy does see a rebound in inflation

This is a risk that would see FIIG’s broadest advice – to be long duration and long in the 5Y-7Y sector – perform reasonably poorly, so it’s a risk case we pay attention to.

The most likely sources of a rebound in Australian inflation would be from strength in the Australian consumer sector, which seems doubtful if our understanding of the labour market is correct. However, that’s not the only way it could play out. Our general understanding also includes an assumption that the State Government infrastructure spending is now winding down and that migration into Australia is slowing. If any of these assumptions prove incorrect, you could also see increased demand and, from there, increased inflation.

The other two potential sources of inflation are different in that they are non-economic, or at least, not driven by the economy initially. These are changes to food prices because of climate change or an increase in military spending because of geopolitics.

If there is an outbreak of inflation driven by the consumer, the RBA will, at first, simply pause the rate-cutting cycle. However, there is a chance they will move back to raising rates. That would cause a sell-off in the 3Y-7Y fixed rate bonds.

If there is an external event driving inflation, the RBA is probably less likely to move rates in the short term than for a consumption-driven increase in demand. Raising the cash rate doesn't change the price of food in any way, nor does it end a drought nor put out a bushfire. (If the Prime Minister doesn't hold the hose, the RBA Governor most definitely does not!)

If you are concerned about this type of risk scenario, it might be time to start rotating your portfolio into the floating rate notes (FRNs) we have on offer. The relatively new RAM income notes are floating rate and have a high yield. They would perform well in the domestic-driven inflation scenarios since they offer floating coupons and are exposed mainly to the property market. If the Australian consumer is strong enough to drive up prices through demand, then it speaks to an overall strength in the housing market, too. Other floating rate bonds that might perform well are the AMP Oct-30 call and the Judo Oct-30 call. The Clearview Mar-30 call FRN is another option that is a floating rate and has a relatively high yield.

A burst of inflation driven by climate change or military spending is harder to prepare for since it might entail stronger inflation and weaker growth at the same time. To be fully protected from inflation, you need something with an explicit link to inflation, like an Index Annuity Bond (IAB) or a CPI-Linked Bond. The Sydney Airport Nov-30 ILB is tailor-made for this protection and still offers a solid yield of 3.23% plus inflation. If you are concerned about inflation being higher than anticipated, this bond performs very well, and doesn't even have too much duration left in it, which helps if the inflation burst triggers a sell-off.

For FIIG investors who perceive there is a risk of a material rise in inflation, this means:

- Consider selling fixed rate bonds in favour of FRNs
 - » RAM income notes, AMP and Clearview are good options.
- Directly take exposure to inflation via IAB or CIBs, like Sydney Airport

We wish to reiterate that the risk cases outlined here are exactly that: risks to our core understanding. Our core recommendation of expecting a slow elongated rate cutting cycle continues to hold, and with it our key recommendation to own 5Y-7Y fixed rate paper, with good credit diversification. This choice of the 5Y to 7Y sector is because the 5Y to 7Y sector is the steepest part of the credit curve and provides a good opportunity to own bonds that benefit from roll-down.

Section 3: Carry in a steep curve rewards active investors

A bond's great attraction is that the capital price is relatively stable, and the coupons are either fixed, or explicitly tied to an external variable. With fixed rate bonds, you know the annual cash flows exactly – but that's not quite the same as knowing the return. Bond prices are relatively stable, but not 100% unchanged. It's possible for changes in the bond price to influence returns, also.

The technical term for the return investors receive for holding a bond that comes from the passage of time is "carry". In wholesale markets, carry is usually assessed on a one-month or three-month basis. However, FIIG bond investors tend to have a longer time horizon, so we analyse one-year holding periods for our carry analysis here.

Carry is a combination of the interest earned and the change in the bond's capital price. It's a more advanced version of the Running Yield calculation.

When you own a bond from the start until its maturity date, the return you receive will be the Yield to Maturity, because that's what the yield to maturity is – and that's why it's calculated that way. However, if you sell a bond before the maturity date, you will get a different outcome. If you own a bond for one year, the annual return you get for that year might be higher or lower than the yield to maturity. However, that unknown return is not evenly distributed around the yield. It's not a random chance; there are predictable patterns. For most bonds, most of the time, the expected return in the first few years is much higher than the anticipated return of the last few years. Put simply, bonds tend to have front-loaded returns, not evenly spaced returns.

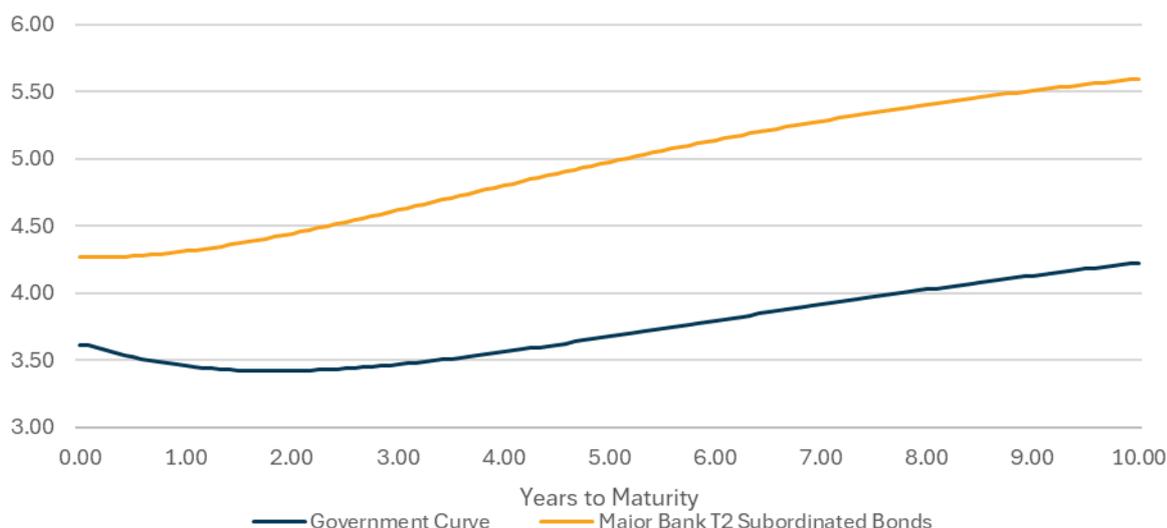
This outcome is driven by what's known as the slope of the curve. The slope is the observation that longer bonds tend to have higher yield than shorter bonds, meaning a chart of the yields will have a distinct upward slope. The shape of the different interest rates for various time points from the same issuer is known as the interest rate curve. Bonds at the short end of the curve are short bonds and usually have lower interest rates than bonds at the long end of the curve, despite being from the same issuer.

But a long bond, plus time passing, is a short bond. So, this consistent upwards-sloping shape means we can fairly reliably assume that the yield on a bond will fall over time. That's not 100% guaranteed, but it is a reliable and frequently true assumption. Given our expectation of the RBA lowering rates further, slowly, over the next year or two, it looks pretty likely that the yields on existing bonds will fall slowly over time over the next year.

The current slope of the curve is relatively steep and, if the RBA does continue to cut rates next year as we believe they will, the curve is likely to get steeper.

For this exercise, we have used two interest rate curves, one representing the Australian Government (which functions as the risk-free rate) and one representing Tier 2 subordinated debt from the major Australian banks (ANZ, CBA, NAB, Westpac). We have then used a modelling approach known as Nelson-Siegel curve fitting to create a smooth curve.

Figure 7: Government and Bank Curves are upward sloping

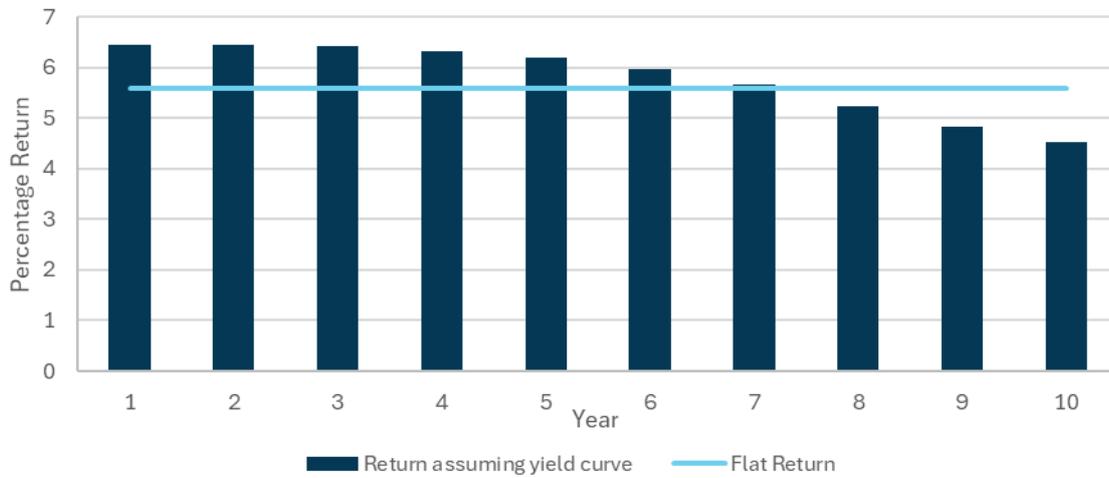


Source: Bloomberg, FIGG Securities. Model based on pricing of 15 October 2025. Curves shown are Maturity-based Nelson-Siegel fitted curves.

Figure 7 shows two upward-sloping yield curves. The important thing to notice about Figure 7 is that the model suggests a 10Y Bank Tier 2 bond has a yield of around 5.59%. However, because we now have a fully worked model, if we assume that the shape of the bond curve doesn't change shape, we can model what happens as time passes and any particular bond moves down the curve towards maturity. For this exercise, we use a 5.59% coupon 10Y bond.

Assuming the curve shape doesn't change, a bond we purchase at 10Y will move down the curve to have a yield of 5.49% one year later, when the bond is a 9Y bond. That fall in the interest rate implies a capital gain for the bond over and above the 5.59% coupon we will also earn in that modelled first year. If we repeat this process for each year, we find the following distribution of returns.

Figure 8: Modelled annual returns for a 10Y Tier 2 Subordinated bond as it rolls down the curve

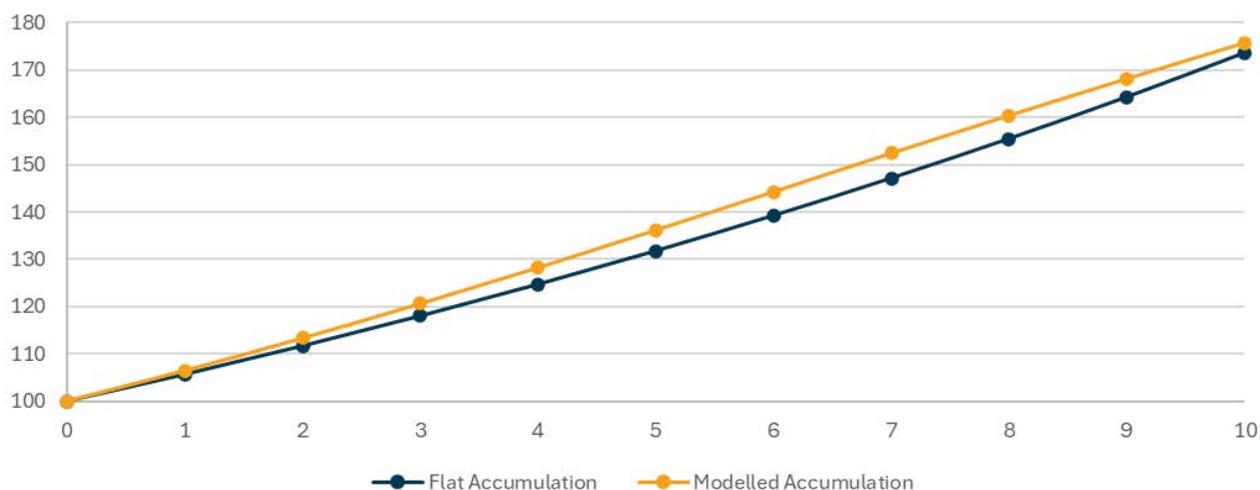


Source: Bloomberg, FIIG Securities. Model based on pricing of 15 October 2025.

Notice that under the assumption that the bond yield curve doesn't change, the 10Y Tier 2 bond makes returns well over 6% for the first two years and over 6% for the first five years of its life, even though the yield to maturity was 5.59%. This is the combination of the steep curve and the carry. It's also one mechanism by which FIIG managed to get median returns of around 9% for our clients over the past couple of years, despite the fact that bonds are generally yielding in the 5-7% range.

Notice also that when the bond has nearly matured, the bond has relatively poor return characteristics. The return in the last two years is only 4.8% then 4.5%, which is materially lower than the return of 6.45% seen in years 1 and 2. This dynamic is why FIIG Relationship managers will frequently tell clients that a strongly performing bond is probably not worth holding much longer. When the bond becomes too short, it's time to recycle that capital back into a new bond with better medium-term return characteristics.

Figure 9: Modelled accumulated returns for a 10Y Tier 2 Subordinated bond as it rolls down the curve



Source: Bloomberg, FIGG Securities. Model based on pricing of 15 October 2025.

As Figure 9 shows, the higher anticipated return for a bond in the early years means the bond will, on average, outperform the assumption of a compounding return of the yield to maturity. Assuming no change in the bond curve, the return to a bond assumed to roll down the curve outperforms the yield to maturity from the start of the modelling until year 7, where outperformance peaks as at \$5.31 per 100 original faces outperformance.

This outperformance of a bond early in its life compared to the yield-to-maturity is a predictable feature of bonds in an upward-sloping yield curve. We believe the curve in Australia will either remain around the current slope or get steeper, with a further steepening the more likely outcome. For bond investors, this means that understanding the dynamics of how bonds perform compared to their reported yields will become even more critical.

The key findings are that bonds will, on average, outperform their yields in the first few years, and underperform noticeably in the last few. The exact timing will be different for different sorts of bonds, but for Australian subordinated bank Tier 2 bonds, the outperformance is likely to peak when there is three years left to the call date. The current shape of the curve suggests that these 2 and 3-year bonds have already done their best work and it's time to move into new investments.

However, while we have only done the intensive modelling on Bank Tier 2 bonds, the general shape of the curve holds across many sectors. As the RBA lowers the cash rate, the need to recycle short bonds into longer bonds becomes stronger.

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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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