

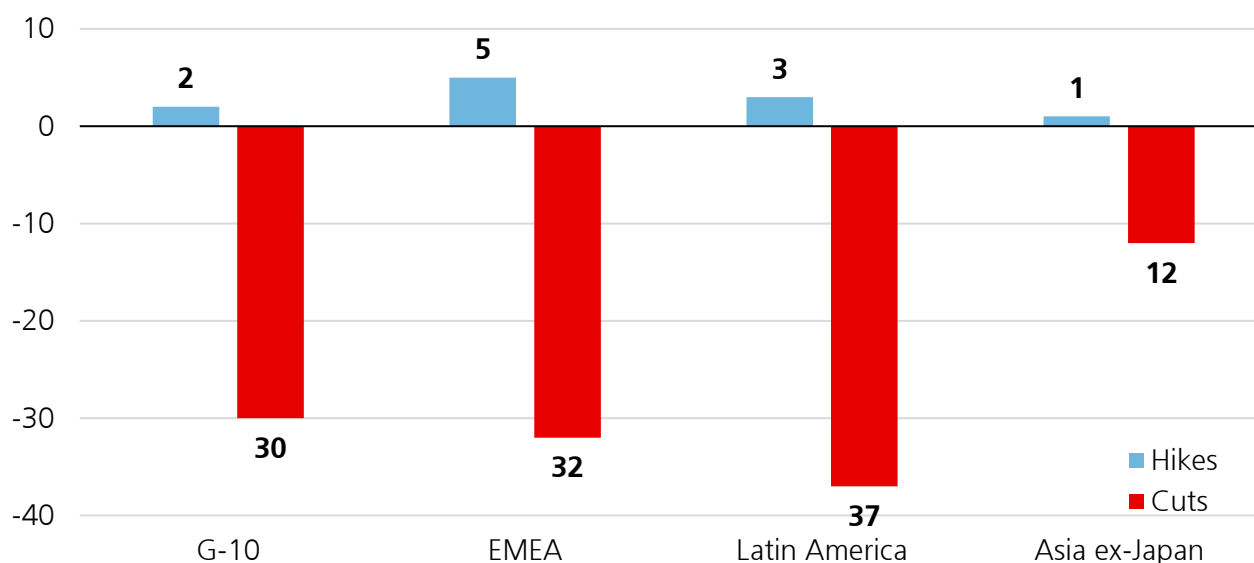
Bonds in 2025: Home bias



Cricket can be a cruel game. There's the physical discomfort of being struck by a projectile launched at speeds of up to 150kph or from toiling away for days on end in the heat of summer. Then there's the psychological pain. Any opening batsmen will know how it feels to be dismissed for a duck only to watch on from the confines of the pavilion as others make hay. Viewed through this cricketing lens, one should have empathy for the RBA who failed to get off the mark while the rest of the world notched up a century of rate cuts last year (Chart 1).

1. The RBA watched on as 111 rate cuts were delivered last year

Central Bank Policy Rate Changes in 2024*



Source: UBS Asset Management, BIS, *number of moves based on sample of 37 countries. As of January 2025.

Thankfully as active bond managers, we have not been confined to the pavilion waiting for the runs to come. We often talk with clients and consultants about the vast global platform that we operate on at UBS Asset Management and the unique perspectives that this enables us to bring to the Australian market. We cannot recall a time like 2024 when it paid so well to have this global approach to our Australian fixed income funds. It has been the appreciation of the breadth and depth of the global easing cycle that has helped us to deliver strong investment outcomes for our clients across both credit and interest rate strategies, even as the RBA failed to trouble the scorers.

First, expectations of global easing calmed fears of a recession benefitting our overweight in credit as spreads contracted to their tightest levels since 1997. Second, we exploited a raft of opportunities in anticipating central bank action around the world allowing us to deliver strong alpha across a number of global rates strategies. This is the investing equivalent of the all too elusive "away win" in cricket.

A global approach has even been helpful in navigating the volatility in domestic rates. Our own analysis as well as our regular dialogue with portfolio managers across UBS's global network kept bringing us to the same conclusion – there is nothing particularly unique about the position that Australia finds itself in. From an economic perspective, we seem to have much more in common with "the cutters" such as those in Europe, North America and New Zealand than the likes of Russia, Turkey and Japan who went against the grain and raised rates.

This meant that while others predicted confidently that the RBA would need to hike again or pushed their rate cut forecasts further into the never ever, we have been trading our positions with a long duration bias, seeking to benefit from a drop in bond yields as the RBA’s cycle turns towards easing.

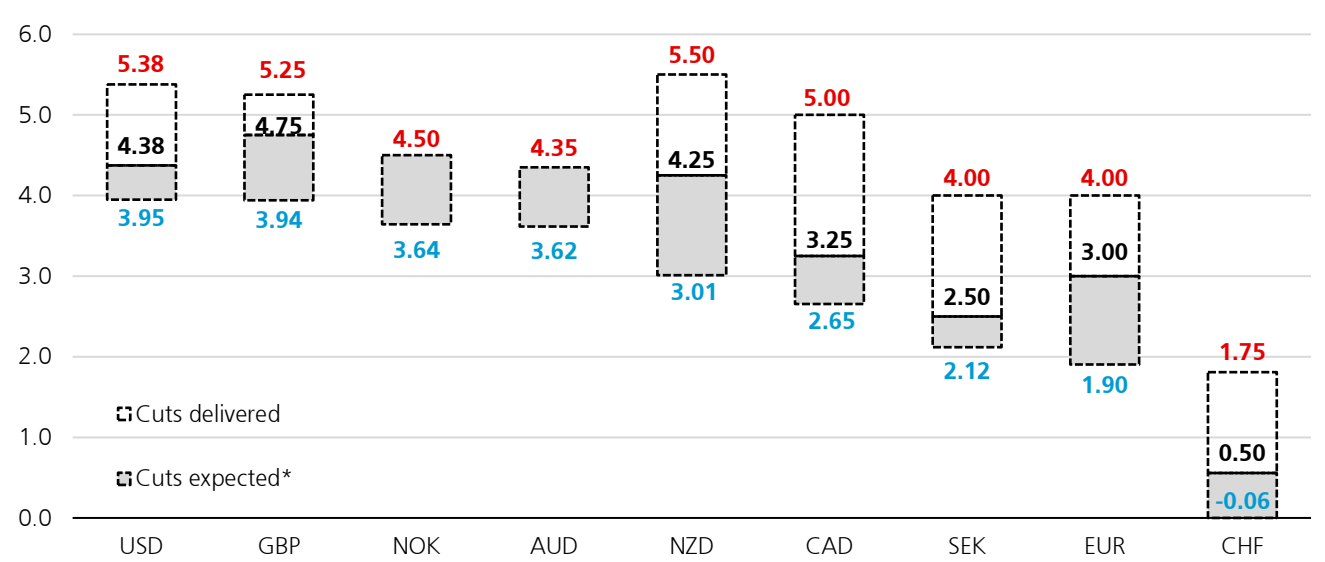
The case for a “home win” in Aussie bonds

Which brings us to today.

The RBA finished 2024 by laying the groundwork for an easing cycle which we have for some time thought could start as early as February. The formbook looks set to be flipped on its head going into 2025: the RBA is poised to break its rate-cutting duck and, in our view, should outperform lowly expectations, whereas the global easing cycle is showing signs of becoming more uneven given the divergent economic performance across regions.

2. Australian bonds price in a high structure of interest rates, similar to the US

Global policy rates (%): The journey from peak to trough



Source: UBS Asset Management, Bloomberg, as of 8 January 2025. *Note: Based on lowest point of forward rate curve over the next two years. For illustrative purposes only.

To see this, look to the US at one end of the global interest rate spectrum. Economic exceptionalism dominates with productivity and investment trends the envy of the developed world while the economy’s resilience to higher interest rates has led many to speculate that the “neutral” interest rate is higher than the 2.5% level widely assumed prior to the pandemic. Last year’s “red wave” has turbocharged this narrative and now the Federal Reserve is expected to stop cutting rates close to 4%, which would represent the highest terminal rate in the G10 (Chart 2). This exceptionalism has weighed on US Treasuries with 10-year yields entering the new year close to their cycle highs of 5%.

European markets are at the other extreme with economic performance seeming to revert towards the lacklustre pre-COVID mean. Yet this is well understood and the bond market has already moved to price in a policy rate with a 1-handle on for the European Central Bank and even a possible return to negative rates for the Swiss National Bank.

US exceptionalism, Australian mediocrity

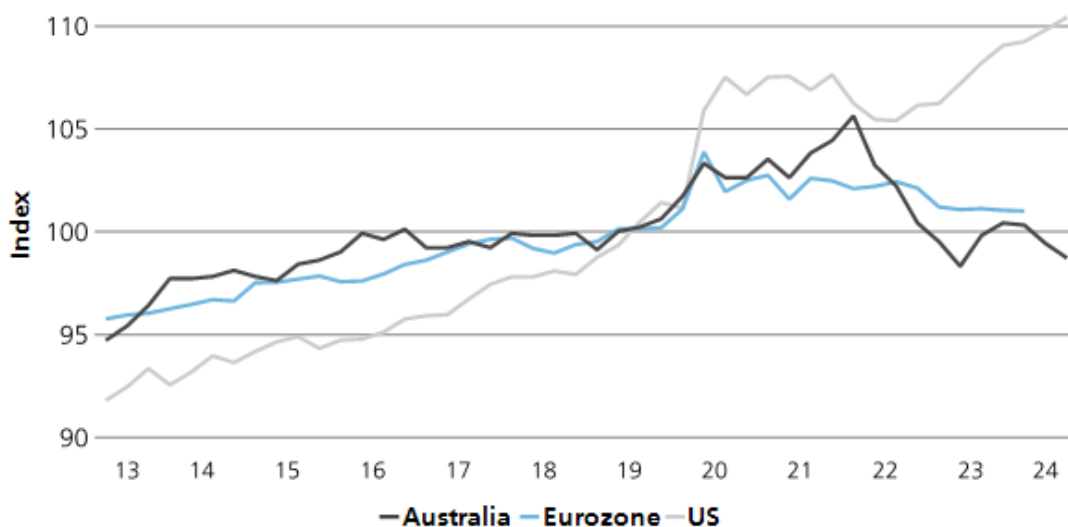
Scouring the globe, the best buying opportunities are likely to come from looking between the extremes to those bond markets that have been swept up in the US's higher-for-longer narrative but whose economies are not showing the same exceptional signs. Under this framework, Australia would be at or close to the top of the list.

Valuations help explain our "home bias". The market expects the RBA's cutting cycle to be shallow, with the cash rate bottoming out at 3.62%, not far from the US Fed at 3.95%. This terminal rate is also above both the 3.5% level that the RBA's models deem as "neutral" and more than 1%-pt above the average cash rate of 2.5% that prevailed in the last decade. In other words, the market anticipates a permanently higher structure of interest rates.

Expected future performance information or capital market assumptions are not indicative of future performance.

3. Australia operates a low productivity economy, even more so than Europe

Labour productivity: GDP per hour worked



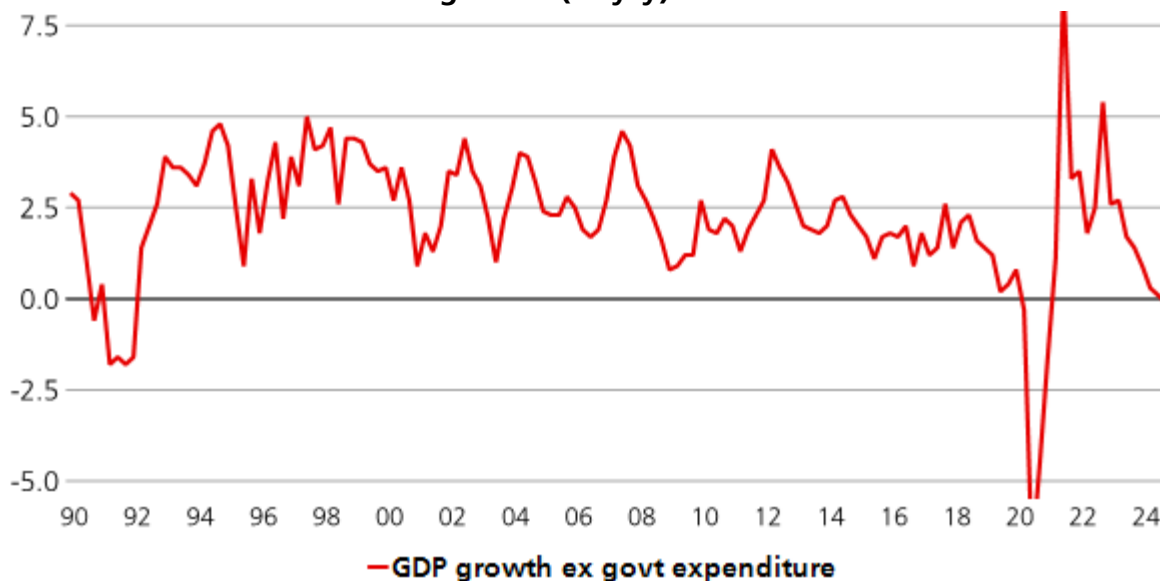
Source: UBS Asset Management, Macrobond as of 2024 Q3. Expected future performance information or capital market assumptions are not indicative of future performance.

Yet the evidence that interest rates should be structurally higher is much more limited in Australia than in the US. First, there are no signs of a capex or productivity boom to raise potential growth (Chart 3). Economists' warnings that this could prolong inflationary pressure misses the bigger picture: we are on the same low productivity trajectory as prior to the pandemic. Absent any meaningful reform, the economic growth model will continue to be skewed towards growing the labour force (e.g. through migration or childcare policy). This sounds like a reversion to the pre-COVID mean where wages growth disappoint expectations and any lingering inflationary pressures will dissipate.

Second, the market (and the RBA's models) likely underestimate just how restrictive monetary policy settings are. A deeper dive into the data shows that it is only record government spending and unusually high employment in non-cyclical sectors such as health and social care that has kept the economy out of recession (Chart 4). This is starting to be better appreciated in the public debate, yet what is less widely discussed is what happens when the public sector tailwind fades. After all government spending must keep increasing at the same pace to be additive to growth, which would seem unlikely if the global trend against incumbent governments extends to this year's federal election. The need to cut rates should become even more obvious in this case in order to provide rapid relief to the interest rate sensitive private sector.

4. The private sector is in desperate need of interest rate relief

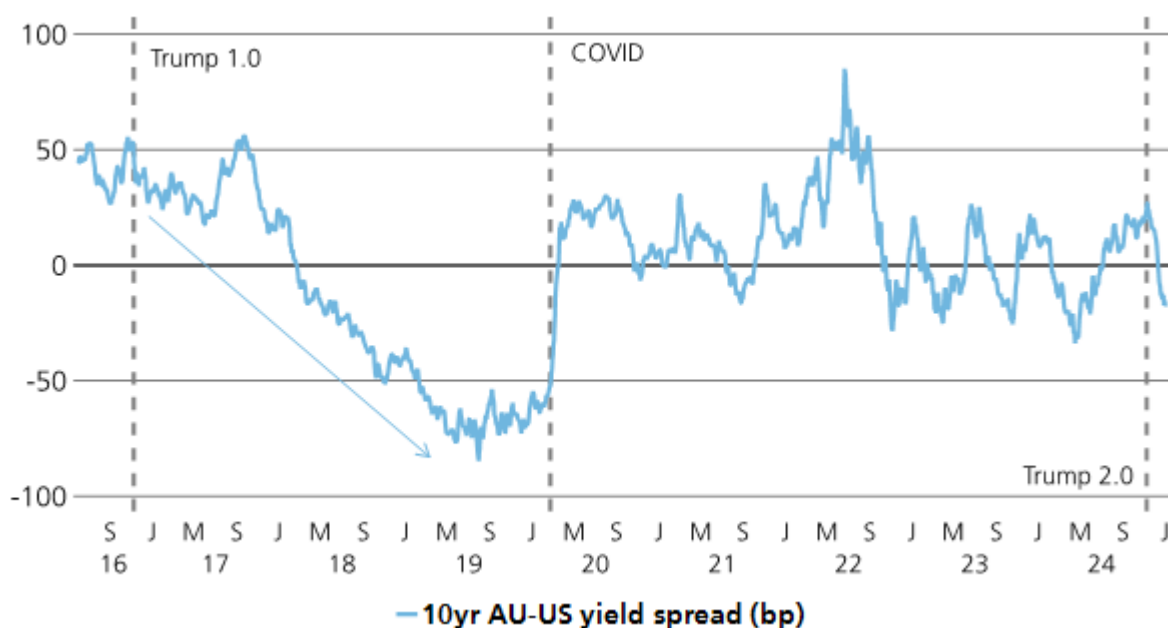
Australia: Private sector GDP growth (% y/y)



Source: UBS Asset Management, Macrobond as of 2024 Q3.

Third, the change in the White House should reinforce the trend towards Australian bond outperformance at the margin. The lesson from President Trump's first term was that hawkish trade policy undermined business confidence in most trade sensitive economies, including Australia. What's more, Australia imports a very similar basket of goods from China as the US does. This means aggressive tariffs on China from the US could see more imported deflation as discounted Chinese imports are diverted to Australia instead.

5. History rhymes: Aussie bonds have started to outperform Treasuries again



Source: UBS Asset Management, Macrobond as of 10 January 2025.

2025 investment themes

Putting cricket analogies to one side, we think this investment landscape has a number of key implications as we head into 2025.

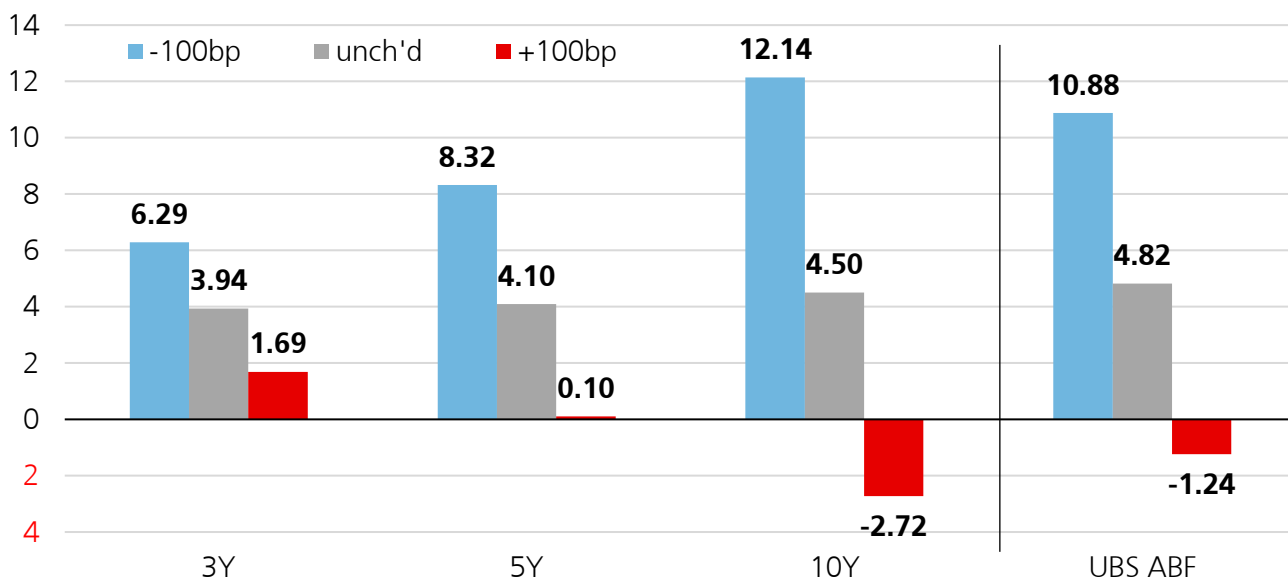
- 1) **Strong case to be long domestic interest rate duration.** Our central expectation is for 100bps of rate cuts which is more than what the market currently prices in. If anything, we see risks skewed towards a more protracted and deeper easing cycle if policy is kept too tight for too long. The better opportunity is likely to be in the front-end of the curve and we expect three-year government bond yields to ultimately trade down to 3-3.5% (currently 3.9%). 10-year yields may be more impacted by higher global term premium but still offer value for long-term holders at or above 4%.
- 2) **Cross market relativities.** When we look around the globe, Australia's bond market scores at the top of the buy list. We have already seen strong outperformance versus US Treasuries at the end of 2024 but we would not be surprised to see this extend further, similar to the 2017-18 period (Chart 5).
- 3) **Decade high all-in yields remain the key to the appeal of credit.** The fundamental backdrop is supportive for investment grade credit with recession risk seeming to have lessened. While spreads are tight, all-in yields are close to decade highs providing an attractive prospective total return and continuing to drive strong inflows to the asset class. Australia remains one of UBS Asset Management's favoured credit markets given the higher average credit quality and shorter duration nature of the market.
- 4) **Money to flow into traditional fixed income assets.** Australian investors have historically been underweight traditional fixed income often favouring a mix of term deposits and major bank hybrid securities (AT1s) instead. There are a number of shifts that suggest that 2025 will see flows being reallocated back towards fixed income funds.

First, holders of major bank AT1s will need to find a new home for their cash given last year's announcement by the Australian regulator that these securities will be phased out altogether. Second, the relative return profile looks much better for bonds vs term deposits as the cash rate falls. Whereas term deposit balances will be hit by a lower re-investment rate, capital gains in long duration bond funds could see double digit gains in even a modest easing cycle (Chart 6). Finally, some investors are still scarred by the negative returns in 2022 where bonds did not provide their usual insurance role against falling share prices. However, our analysis has shown that the crucial negative bond-stock correlation is set to kick back in when inflation is sustained below 3%. Given this is more or less where inflation is today and given the rich valuations in other asset classes, we expect investors to re-discover the diversification value of bonds in their portfolios.

This is not guaranteed by UBS.

6. Even a modest easing cycle could see double digit returns in long duration funds

AU Bonds: 1yr total return from parrallel yield shift (%)



Source: UBS Asset Management, Bloomberg, as of 8 January 2025. Note: UBS Australian Bond Fund (ABF) calculation is indicative only and does not take into account fees or other transaction costs; other tenors are government securities. Past performance information is not indicative of future performance.

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Tom Nash is a Portfolio Manager in the Australian Fixed Income team and is responsible for the management of short and long duration portfolios.

Tom contributes to the analysis and research of the fixed income markets. He specialises in generating investable strategies in Australian and global interest rate markets based on macroeconomic trends.

Tom joined UBS Asset Management in May 2021. Prior to that, he spent nearly a decade at HSBC Global Research in Sydney and London. This role included setting HSBC's view for rates and foreign exchange strategy across Australia, New Zealand and Japan.

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Note: as at March 2024

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