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**13 August 2024** **Fixed Income**

# Patience on Rate Cuts – Maintaining Our Bullish view for AUD Fixed Income.

## Opportunity Ahead for AUD Bonds

The Reserve Bank of Australia (RBA) is notably behind other major central banks in reducing rates (see Chart 7 below). This delay is due to persistent wage growth and inflationary pressures in Australia.

Will wage growth and inflation decrease in the future? It is likely, given the recent softening of service sector PMI data and job market conditions. Additionally, the RBA has not consistently provided accurate forward guidance. Persisting with its current stance, while major central banks are easing, could have significant repercussions.

Forward-looking investors have a prime opportunity to buy ahead of the anticipated rate cuts. Those who wait for market direction confirmation may miss out. Additionally, the recent weakness of the AUD currency enhances the appeal of AUD bonds.

**From a risk management perspective, including AUD fixed income in your portfolio enhances diversification and offers a buffer against negative growth surprises and geopolitical uncertainties.**

## Our FTV Framework

Our framework shows three compelling reasons to be bullish on AUD bonds:

**Fundamentals: (1)** The RBA lags in its easing plan due to ongoing wage growth and inflation pressures. Although the easing cycle is delayed, it remains inevitable as other central banks are already responding. This presents an opportunity to buy AUD bonds before the RBA pivots.

**Technicals: (1)** The 30-year Australian government bond yield shows a short-term uptrend (50 and 100-day MAs), but the long-term trend (200-day MA) is reversing and declining. This indicates market caution about near-term inflation risk, with the 30-year yield potentially rising to 4.60%-4.80% before a long-term decline.

**Valuations: (1)** AUD investment-grade corporate bond yields are nearing 10-year highs, presenting attractive opportunities. These bonds are poised to benefit from the expected easing cycle. Moreover, Australian government bonds, despite their top-tier credit quality and safety, offer the highest yield among AAA-rated countries (see Chart 11).

## The Sweet Spot on the AUD IG Yield Curve

Given the slight unevenness on the AUD investment-grade yield curve, the sweet spot is in the 7-year to 10-year segment (see Chart 13).

Historically, AUD corporate bonds have performed well during rate cut cycles (see Chart 10). We expect this trend to continue in the current cycle. Additionally, investors may benefit from potential capital gains during the expected rate cut cycle by increasing their exposure to long-duration Australian government bonds.

## Top Client Questions:

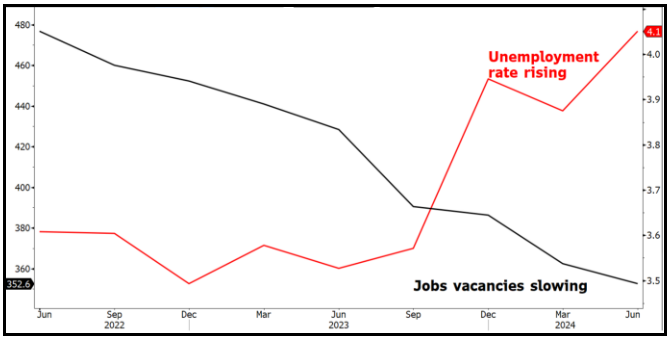
### 1. Will the RBA pivot?

**The Australia economy is not immune to global economy softness**

The RBA is currently hesitant to hike rates due to persistent inflation, high household debt and the housing market's sensitivity to rate changes.

Will the RBA maintain high rates for longer? Given the softer global economy, weaker commodity markets, and sluggish recovery in China, there are compelling reasons for the RBA to consider rate cuts to support long-term growth in near future, particularly with the softening of Australia's labour market and the manufacturing and service sectors

**Chart 1: Evident softening in the labour market.**

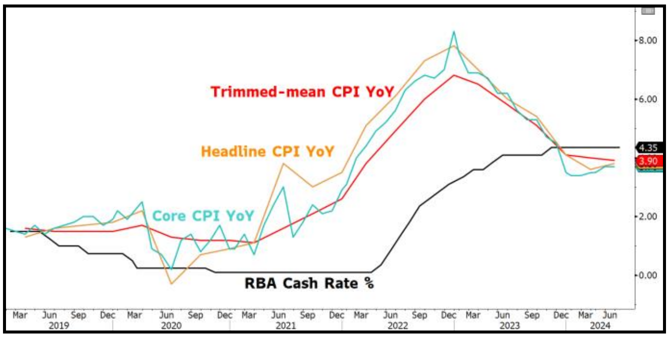



Source: Bloomberg, CIMB Chief Investment Office

Australia's economic activity grew 0.1% QoQ in Q1, the slowest since the pandemic. Investment fell 0.9% QoQ, offsetting a 0.4% rise in domestic consumption. Inflation dropped from 8% in 4Q22 to around 4% since February, due to persistent housing, food, and transport prices. The RBA's target is 2%-3%.

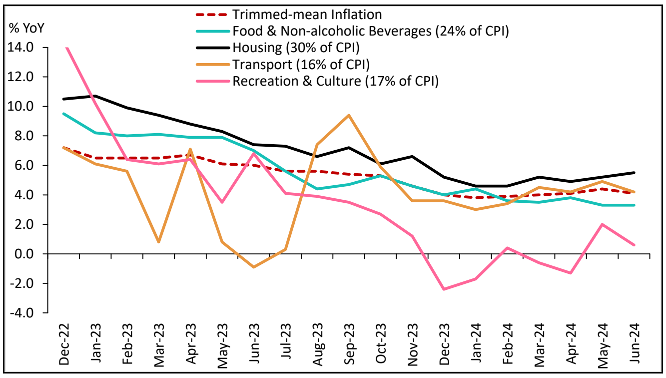
The labour market has weakened, with unemployment rising to 4.1% in June and job vacancies declining since the end of 2022. Although wage growth has decelerated, it still surpasses inflation, posing a significant challenge to the RBA's decision to ease rates.

**Chart 2: Disinflation decelerated, will it pick-up?**



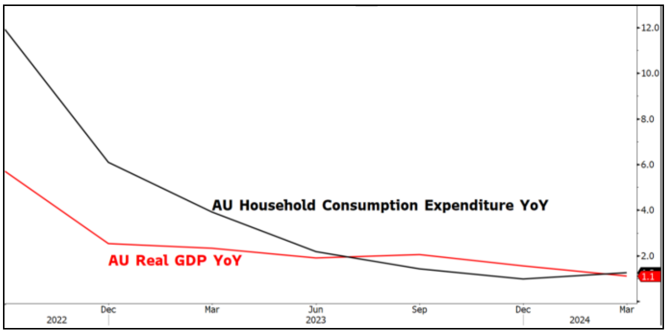

Source: Bloomberg, CIMB Chief Investment Office

**Chart 3: Most CPI components are easing, housing prices remain an exception.**



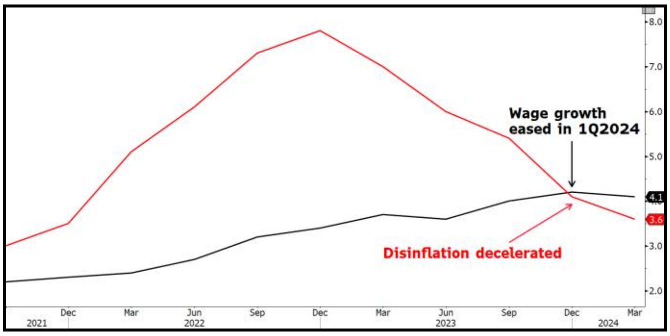

Source: Australian Bureau of Statistics, CIMB Chief Investment Office

**Chart 4: Real GDP and household spending have been easing since Q4 2022.**




Source: Bloomberg, CIMB Chief Investment Office

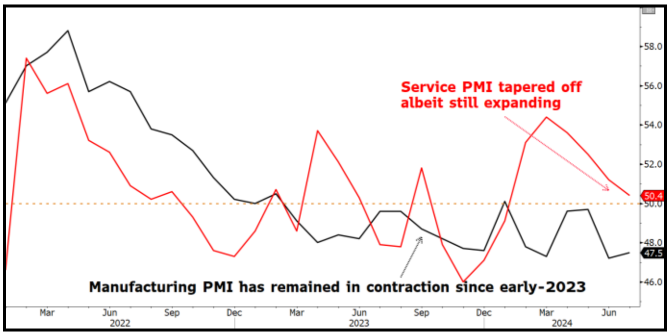
**Chart 5: Wage growth decelerated but is now outpacing inflation.**




Source: Bloomberg, CIMB Chief Investment Office

The manufacturing PMI has been in contraction since early 2023, except for January 2024, due to sluggish demand, supply constraints, and cost pressures, leading to weak employment and a poor sector outlook. Meanwhile, the services PMI has remained above the expansion threshold in recent months, but high interest rates may be starting to weigh on the sector.

**Chart 6: Manufacturing sector remains sluggish; services sector is slowing.**




Source: Bloomberg, CIMB Chief Investment Office

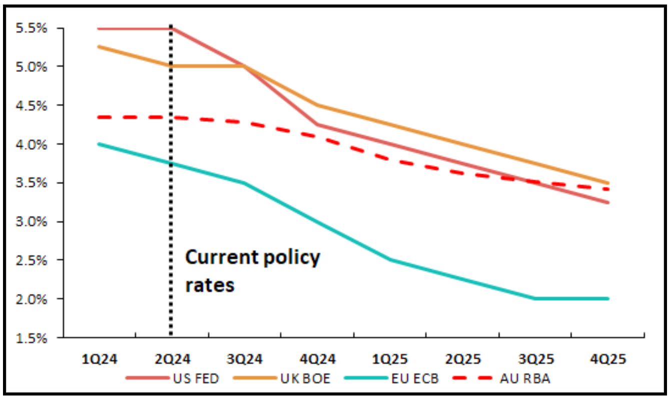
## 2. What is the RBA's stance on monetary policy? Is the RBA lagging in the easing cycle?

RBA officials have shifted from actively considering a rate hike to maintaining high rates for longer due to cooler inflation and a weaker labour market, with no indications of immediate easing. Their goal is to balance returning inflation to target while achieving a soft economic landing.

The Australian cash rate futures market expects at least a 25bps cut in 2024 and up to 92bps of cuts by 2025. However, these expectations could be premature, as current conditions do not support significant rate adjustments without risking inflation and an overheating housing sector.

Nonetheless, the prevailing consensus is that an easing cycle in Australia is inevitable. However, it is expected to lag behind other major central banks, as indicated by the flat trajectory of rate expectations below.

**Chart 7: The RBA lags behind major central banks in easing.**

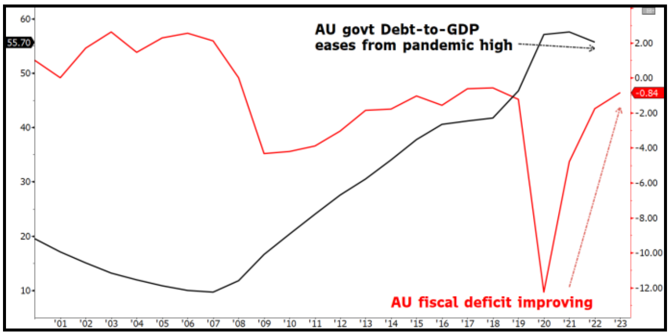



Source: Bloomberg, CIMB Chief Investment Office

## 3. Are fiscal policies supportive of the AUD bond market?

They are. With a slowing fiscal deficit increase and continued, though declining, GDP growth, Australia remains fiscally strong. The IMF's latest fiscal monitor ranks Australia's budget balance as the second strongest among G20 nations, at -0.9% of GDP in 2023, just behind Canada.

**Chart 8: Fiscal deficit and debt levels have improved since the pandemic.**




Source: Bloomberg, CIMB Chief Investment Office

## Actionable Ideas

In the coming months, fixed income instruments are poised to become a central focus of the market. Our selection of AUD corporate bonds (see table below) offer investors attractive income generation opportunities while providing hedging benefits against an uncertain economic and geopolitical environment. Investors should take opportunity of recent AUD currency weakness to invest into AUD bonds.

**Table 1: Our high conviction AUD bond ideas.**

| Issuer | Bond Type | Currency | Coupon | Rating | Maturity / Call | Indicative Yield |
|---|---|---|---|---|---|---|
| Australian Govt Bond | Government Bond | AUD | 4.750% | AAA | 21-Jun-2054 | 4.50% |
| Pacific National | Senior | AUD | 5.400% | BBB- | 12-May-2027 | 5.60% |
| Westpac Banking | Tier-2 Subdebt | AUD | 7.199% | A- | 15-Nov-2033 | 5.83% |
| ANZ Banking Group | Tier-2 Subdebt | AUD | 6.124% | A- | 25-Jul-2034 | 5.90% |
| National Australia Bank | Tier-2 Subdebt | AUD | 6.342% | A- | 6-Jun-2034 | 5.86% |
| AusNet Services | Senior Unsecured | AUD | 5.981% | BBB+ | 16-Mar-2034 | 5.48% |
| Brisbane Airport | Senior Unsecured | AUD | 5.900% | Baa2 | 8-Dec-2033 | 5.45% |

Source: CIMB Chief Investment Office

## Buy 30-year Australian Government Bond Ahead of RBA Pivot

Our goal is to exit at a yield of 4.10% by the end of 2025. This would translate to an unleveraged holding period return of 12.8% (annualized 9.0%), for a 30-year Australian government bond purchased at a 4.50% yield. This target exit yield is derived by averaging the consensus estimated yields of the 10-year Australian government bond, the RBA cash rate, and the 3-month Bank Bill Swap rate, plus a spread.

Rate cuts have yet to be fully priced in, and valuations are compelling for the 30-year Australian government bond. We believe this presents a good buying opportunity and recommend purchasing the 30-year bond when the yield reapproaches the 4.60% to 4.80% range.

While technical indicators suggest a short-term uptrend (50 & 100-day moving averages), the long-term trend appears to be reversing and declining (200-day moving average). As illustrated in Chart 9 below, Australian government bond yields have historically anticipated and moved ahead of RBA easing decisions. This has yet to occur, as the RBA maintains its hawkish stance. However, this may soon change as growth continues to soften in Australia.

## Appendix

**Table 2: Key consensus forecasts.**

| Indicator | 2023a | 2024f | 2025f | 2026f |
|---|---|---|---|---|
| Real GDP Growth | 2.0% | 1.2% | 2.1% | 2.4% |
| CPI YoY | 5.6% | 3.4% | 2.8% | 2.6% |
| Unemployment Rate | 3.7% | 4.2% | 4.5% | 4.5% |
| AUD/USD | 0.68 | 0.68 | 0.70 | 0.71 |

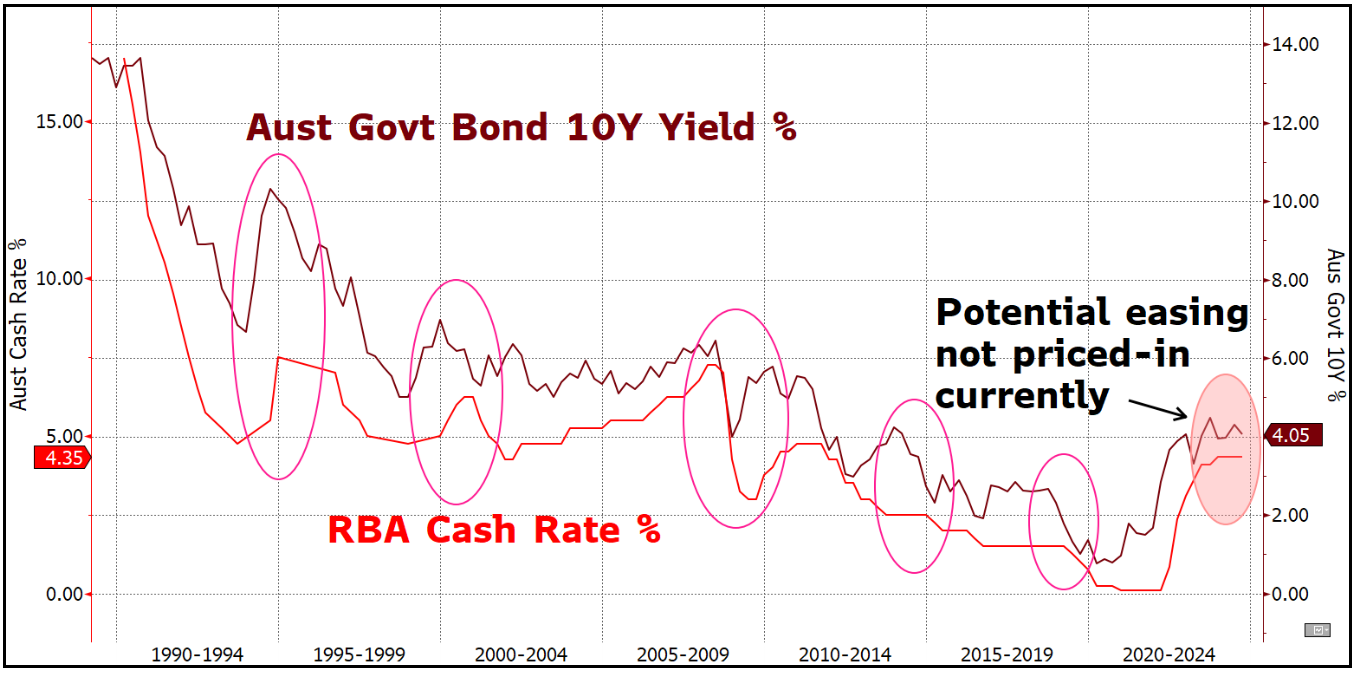
Source: Bloomberg

**Table 3: Implied policy rate path by the Cash Rate Futures market.**

| Policy Rate | 3Q24 | 4Q24 | 1Q25 | 2Q25 | 3Q25 | 4Q25 |
|---|---|---|---|---|---|---|
| RBA Cash rate | 4.29% | 4.09% | 3.80% | 3.62% | 3.51% | 3.42% |

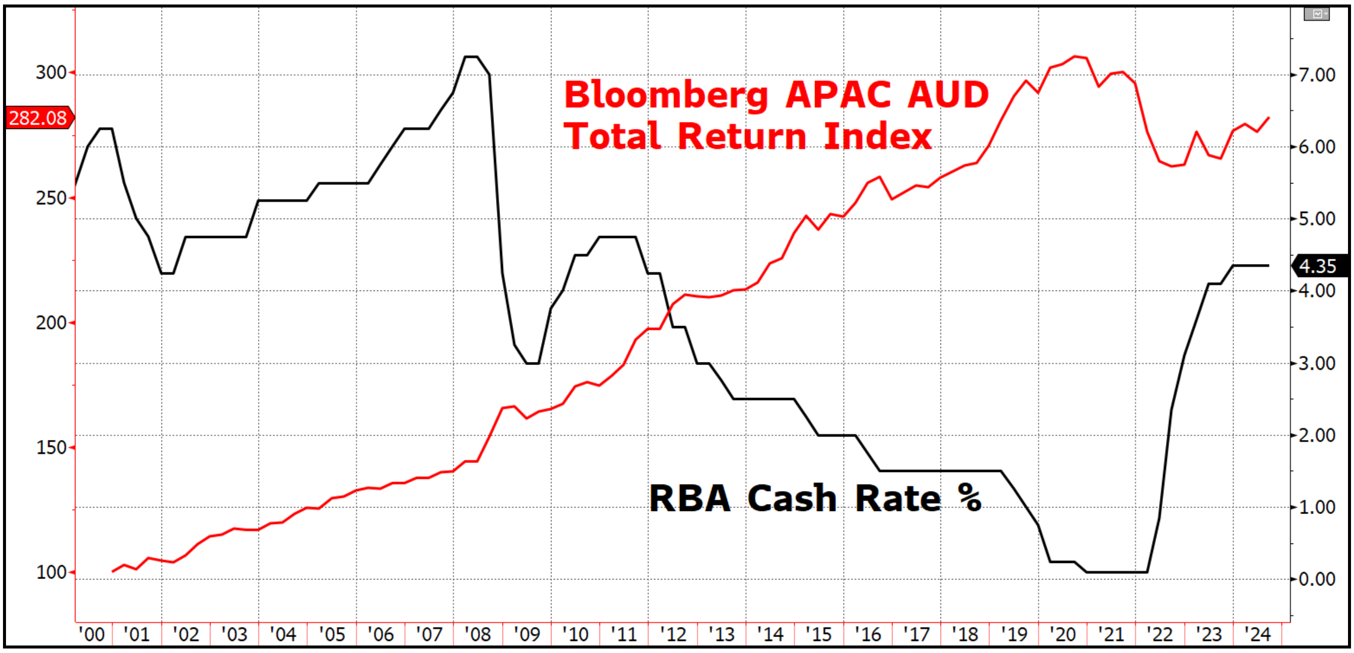
Source: Bloomberg, CIMB Chief Investment Office

**Chart 9: Australian government bond yields have historically moved ahead of RBA easing decisions.**



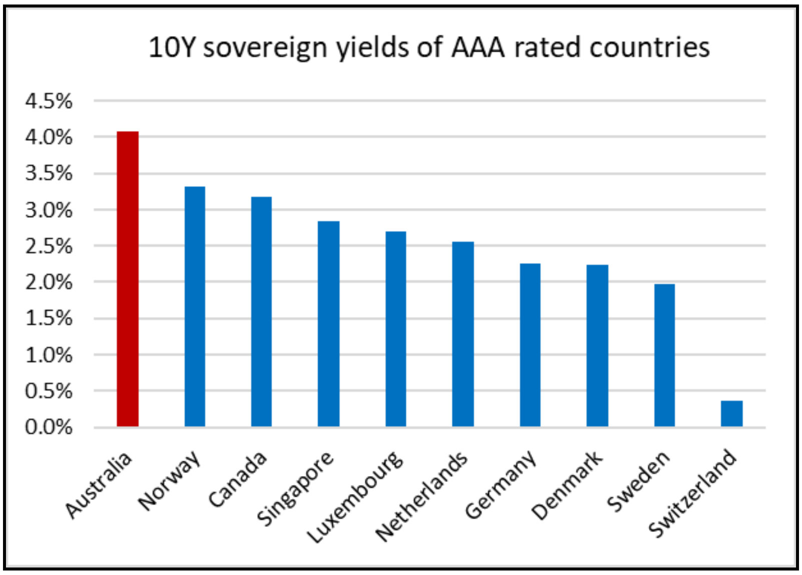

Source: Bloomberg, CIMB Chief Investment Office

**Chart 10: Historically, RBA monetary policy has had a significant impact on AUD corporate bond performance. Investors are advised to purchase AUD bonds before the RBA pivots.**



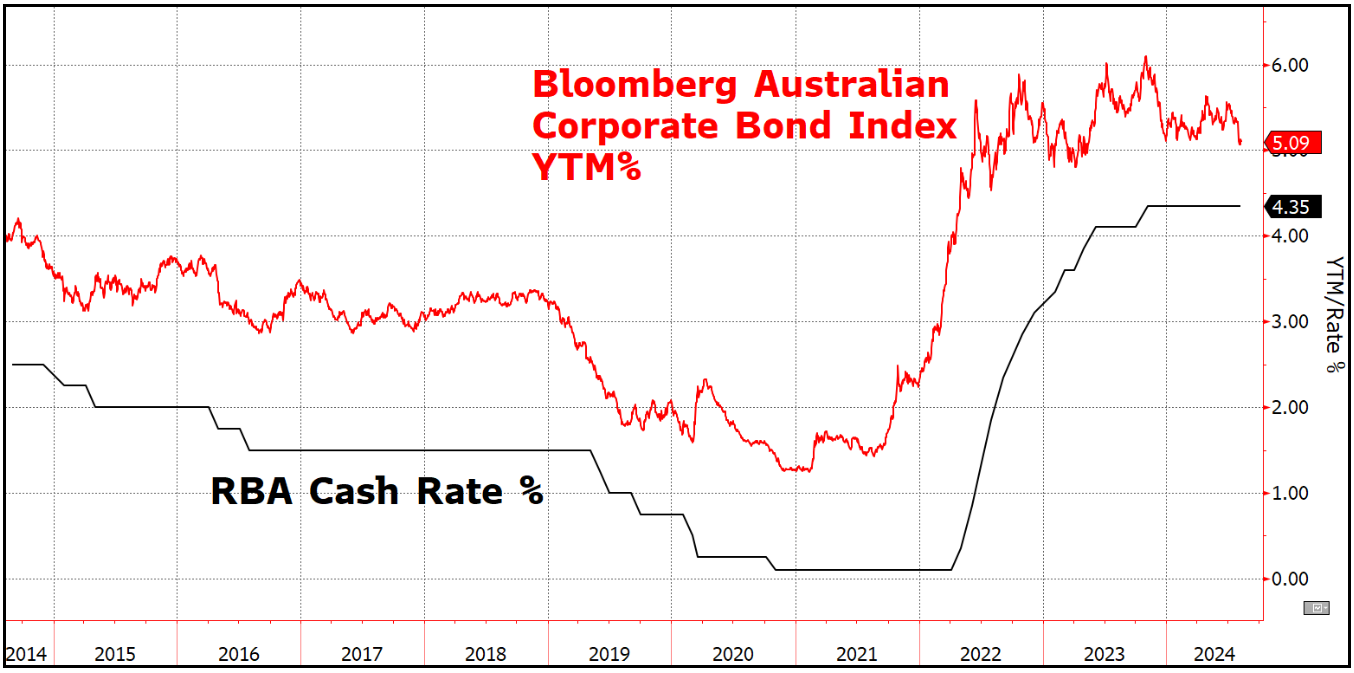

Source: Bloomberg, CIMB Chief Investment Office

**Chart 11: Australian government bonds offer highest yield among the AAA-rated countries.**



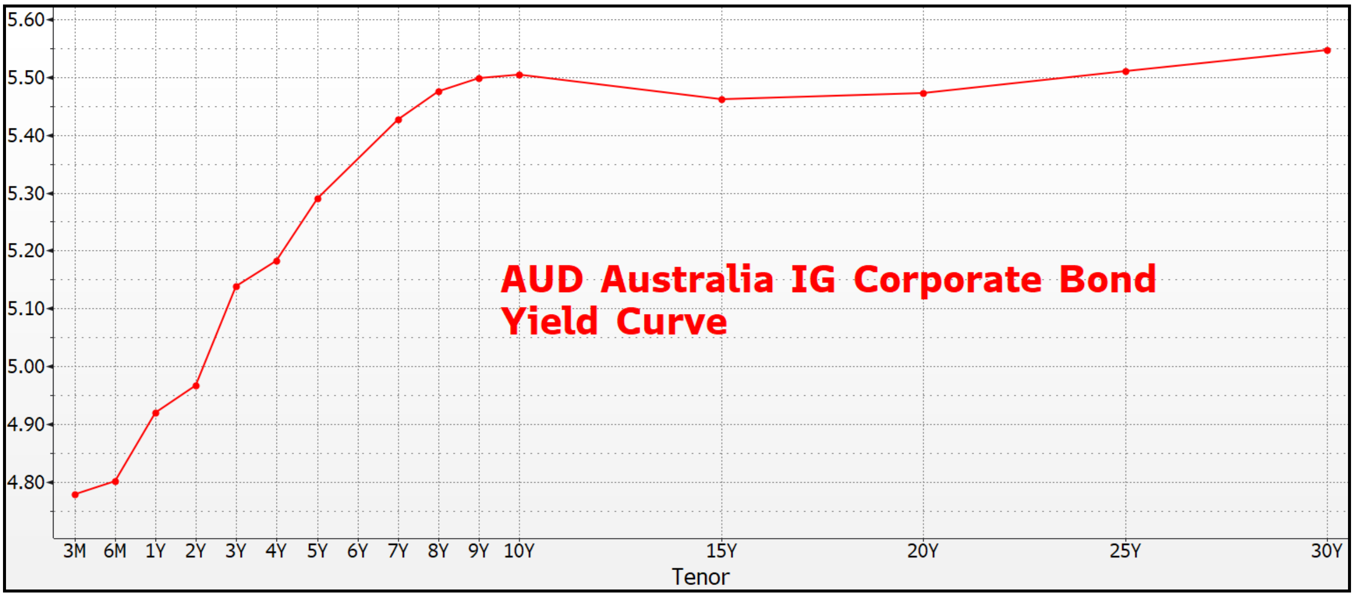

Source: Bloomberg, CIMB Chief Investment Office

**Chart 12: AUD corporate bond yields remain near 10-year highs, with potential rate cuts yet to be fully reflected in the yields.**




Source: Bloomberg, CIMB Chief Investment Office

**Chart 13: The AUD IG corporate yield curve is upward sloping; The sweet spot is in the 7y-10y segment.**




Source: Bloomberg, CIMB Chief Investment Office

**Chart 14: 30-year Australian government bond yield – uptrend in short-term, but long-term trend appears to be reversing.**


Source: Bloomberg, CIMB Chief Investment Office

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