IAM
INCOME ASSET MANAGEMENT

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Bond Opportunities in the Current Interest Rate Environment

By Matthew Macreadie

The threat of higher interest rates, slower economic growth, rising inflation and a deteriorating credit cycle is making investing very interesting. However, there are still many income opportunities available in investment-grade bonds which we have not seen for many years with 10-year Australian Government bond rates at low 4s. For investors looking to place capital into bonds at these better starting yields, a choice needs to be made on fixed and/or floating.

If today is your starting point, and you are trying to determine the outlook for interest rates, it's important to know that the markets' expectations are already priced in.

At this stage, I'd propose a balanced exposure to fixed and floating, or 50% fixed / 50% floating bonds for new investors with an overall duration of between 3-5 years. It is very hard to have any strong conviction/certainty over the inflation outlook which makes interest rate positioning especially challenging and the need to be appropriately hedged.

Investors can tinker around with the slope of the yield curve by taking a position on how overweight or underweight they would like to duration at the short, medium, or long end of the yield curve. In my view, keeping corporate maturities short to medium-term would be advisable. Government and semi-government bonds typically appreciate as economies enter recession; and whilst I don't believe this is a base case outcome for Australia, it could help offset other losses in your portfolio from equities and property. Thus, a small portion of short to medium-term government and semi-government bonds, maybe 10-20% is useful as a hedge.

A few things to keep in mind when considering the future direction of interest rates and inflation.

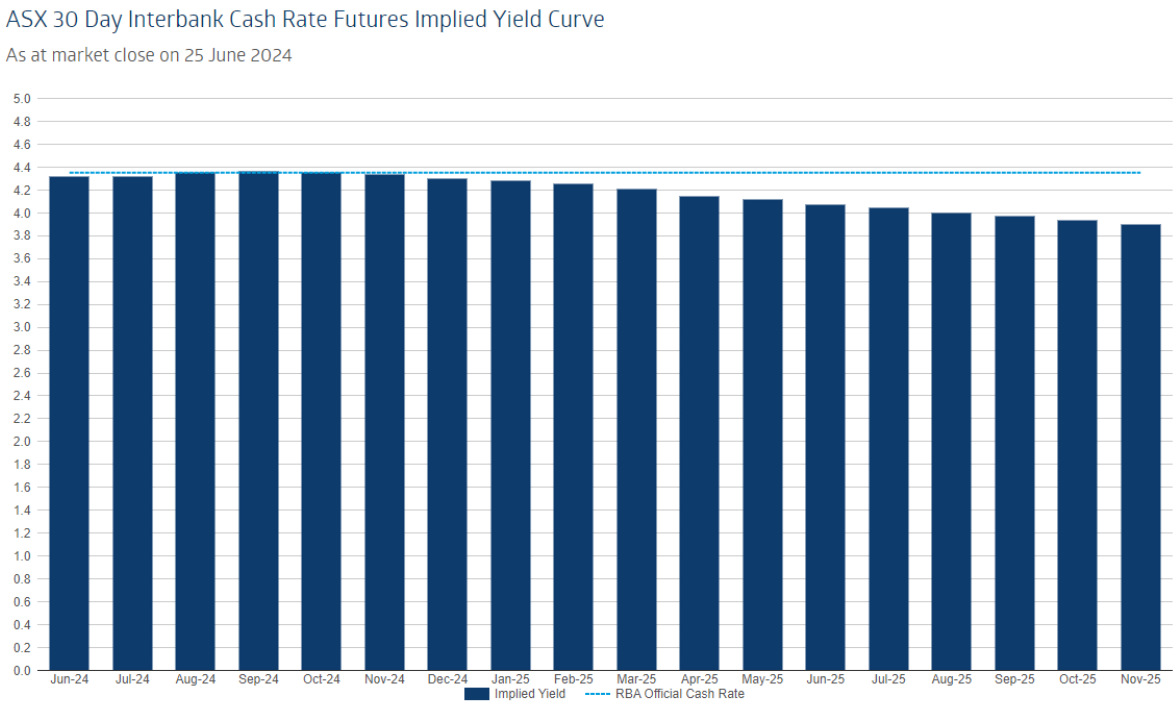
1. The latest RBA Monetary Policy Statement for June 2024 described: (a) Inflation remaining above target and proving persistent; (b) The economic outlook is highly uncertain; and (c) Returning inflation to the target band remains a priority. This is at odds with the fact the RBA will be cutting interest rates anytime soon.

Today's headline inflation materially beat expectations at 4.0% yoy, even though some items in the CPI bucket were inevitably volatile. The detail in the data however suggested a stronger underlying pace of inflation. Concerningly, when looking at other measures of underlying inflation – services, market goods and services, essentials and household services, it appears the stickiness of inflation is prevailing as a theme.

What this means is that an RBA hike is back on the table.

2. The chart below shows the 30-day cash rate futures curve until the end of 2024. At the time of writing, the market is expecting short-term rates (12 months) to reach 4.075% by June 2025, basically 1 cut of 25bps or 4.30% by December 2024 (no change).

If you think the market is pricing rates correctly or that rates will go higher from here, then you should have a bias towards floating. If you think the market has priced rates too high already, then you're better off buying fixed. Here in lies the challenge though, as the market will inevitably get this decision wrong.

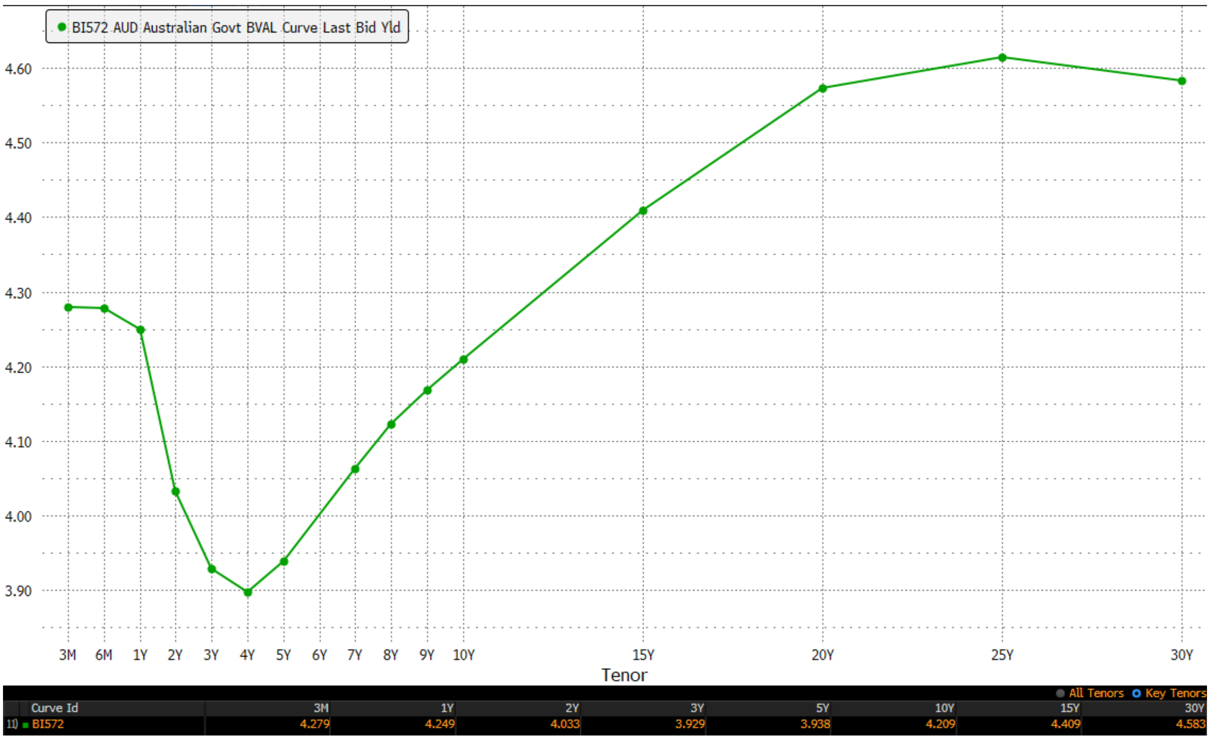


Source: https://www.asx.com.au/markets/trade-our-derivatives-market/futures-market/rba-rate-tracker

3. The chart below shows the yield on Australian Government bond curve. Currently,10-year Australian Government bond rates are at 4.209%. The yield curve shows the yields on Australian Government bonds across a range of different maturities. The slope of the yield curve reflects the difference between yields on short-term bonds and long-term bonds. The yields on short- and long-term bonds can be different because investors have expectations, which are uncertain, that the cash rate in the future might differ from the cash rate today. The yield curve is an important economic indicator because it is a source of information about investors' expectations for future interest rates, economic growth, and inflation.

For example, if an investor thinks rates will rise from here, they will shorten the duration of their book by allocating to shorter-term maturity dates. If an investor thinks rates have peaked, they could invest in longer maturity dates to build up duration.

At the time of writing, the market is interpreting that the current yield curve is a normal yield curve seen during periods of economic expansion. In this environment, investors demand higher yields on longer-term bonds as compensation for inflation and future rate rises.



Source: Bloomberg as at 26 June 2024

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