

SFIF Commentary: Bonds - The Comeback Asset

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With yields above 5% and central banks tightening into an oil shock, high-quality bonds are once again offering what investors need most: strong income and real protection if growth falters.

Market Review

For the first time in years, bonds are looking like they are well placed to do their job again. With 10-year yields above 5% in both Australia and the US, government bonds now offer serious income and potential diversification if growth stumbles. That hedge matters more than ever. Equity markets are crowded into a single AI trade, and any disappointment in earnings, capex returns or adoption could hit hard. Bonds at these levels offer the protection that simply wasn't there when yields were near zero.

The macro case is building fast. Markets are pricing around 100bp of further tightening across most developed economies. If central banks deliver it, growth will slow, and the risk of a policy mistake is rising. Central banks are tightening into an oil supply shock, yet pass-through to underlying inflation remains limited. Australia's August CPI says it all: headline inflation jumped to 4.0%, but trimmed mean slowed to just 0.2% for the month, below the 0.3% expected, with fuel and electricity driving the gap. Hiking rates to fight a supply shock that isn't feeding through to core inflation risks deepening the slowdown, and bringing the next easing cycle forward. The US is the exception, where strong growth gives the US Federal Reserve (Fed) room to keep going. That divergence sits at the heart of our positioning.

Australian rates: hike delivered, long end breaks out

The Reserve Bank of Australia (RBA) raised rates by 25bp to 4.60%, a unanimous decision and its fourth hike of the year, taking borrowing costs to their highest since 2011. Markets now price a peak near 5.15%. The Board kept its hawkish edge, warning that the upside risks flagged in August were materialising, from a broadening Middle East conflict to energy prices well above forecast and firms passing on higher costs, and left the door open to more hikes.

The bond market moved first. Ten-year Australian government bond yields closed at 5.35%, up 27bp for the month, after touching post-2011 highs in a global selloff led by US Treasuries. The front end was just as dramatic: on 10 September alone, 2-year yields jumped 19bp to 4.93% as the entire curve hit its highest levels since May 2011.

Australian growth: the cracks are widening

Beneath the hawkish headlines, the economy is losing momentum. June quarter GDP rose 0.4%, with annual growth slowing to 2.1% from 2.6% at the end of 2025, while per capita growth stalled. Productivity remains the Achilles heel, flat in the quarter and 0.2% lower over the year.

Unemployment climbed to 4.6% in August, a five-year high, even as employment rose a solid 39,500. Slack is building steadily, with labour supply outpacing demand. And housing is sliding, with the RBA

itself acknowledging falling prices in most capitals and a noticeable drop in new lending.

The picture is stark: the RBA has hiked into rising unemployment, stalled per capita growth and falling house prices, all to fight an inflation impulse driven largely by supply.

Global rates: the world tightens together

The Fed raised rates by 25bp to 3.75-4.00% on 16 September, its first hike since 2023, and this time the vote was unanimous after three hawkish dissents in July. Fed Chair Warsh pointed to a strong economy, a firm labour market, sticky inflation and Middle East tensions, and framed the move as removing accommodation rather than tightening. The median dot sits at 4.125% for 2026 and 2027: one more hike this year, and higher for longer after that.

The long end took centre stage. Strong US data and surging oil pushed 10- and 30-year Treasury yields to their highest since 2007 and 2004, respectively, with the 10-year closing at 5.28% and the 30-year at 5.63% on 30 September. The 5-year broke above 5% for the first time since 2007.

Tightening went global. The European Central Bank (ECB) lifted its deposit rate to 2.50%, its second hike this year. The Bank of Japan (BOJ) raised rates to 1.25%, a level last seen in 1995, while 10-year Japanese government bond yields pushed toward 3.1%, a high not seen since 1996.

And oil kept everyone on edge. Brent surged from around \$91 at the end of August to briefly top \$108 after Washington rejected Iran's offer to reopen the Strait of Hormuz, as the conflict spread to attacks on Saudi energy facilities. Some relief came late in the month as Saudi Arabia restored around 3.5 million barrels per day through its East-West pipeline, bypassing Hormuz.

Global credit: priced for perfection, then reality hit

Credit finally blinked. Higher yields, tighter financial conditions and a heavy supply pipeline began to test valuations priced for perfection. US high yield took the hit, with spreads blowing out 41bp in the final five sessions to around 342bp, while CCC spreads breached 1,000bp. Investment grade held its ground, widening only modestly. The backdrop offered little comfort: US job openings stayed elevated, and one-year inflation expectations jumped to 6.1% from 5.8%, putting higher-for-longer front and centre and squeezing weaker borrowers facing a refinancing wall.

Australian credit: calm on the surface, pressure beneath

Australian credit kept its composure. Corporate investment grade (IG) spreads ended around 110.5bp, just 4bp wider, though sellers dominated late in the month. Kangaroo financials saw client selling and Tier 2 showed signs of de-risking, while covered bonds and senior financials remained in demand. But the pressure is building. Australian financial conditions are now at their tightest since around 2013, driven by higher rates and yields, a stronger Australian dollar over the quarter and rising equity volatility. And the consumer is wobbling: household spending was flat in August after three strong months, a warning sign for discretionary retailers and retail REITs.

Market Outlook

Australian rates: The Hike Is Done. The Cut Is Coming.

With markets pricing a peak near 5.15%, we think the tightening cycle is fully priced. Our cash rate model peaked at 4.75% and is already turning lower as housing, jobs and sentiment weaken. August CPI backs this up, with headline inflation driven by fuel and electricity while underlying inflation has stalled at 3.6%. The September jobs data and September CPI will be important ahead of the November

meeting. As the inflation shock matures, we expect the story to flip from inflation to growth, with the RBA cutting in 2027.

Global rates: synchronised tightening, synchronised risk

The Fed, ECB and BOJ all hiked in September, a rare moment of global hawkishness in response to an energy shock. Even Warsh acknowledged that tightening abroad could help cool global inflation and limit the need for more Fed hikes. That's the dynamic to watch into year-end: coordinated tightening against a supply shock raises the odds of a sharper global slowdown. Oil remains the wildcard. A breakthrough on Hormuz could reprice curves overnight, while escalation would push inflation expectations higher everywhere.

This wasn't a full risk-off move, but the direction is clear. Higher yields and heavy supply are challenging rich valuations, and US high yield is feeling it first. With weaker borrowers facing a tougher refinancing wall, we favour quality carry over reaching for yield.

Australian credit: resilient, but pick your spots

Australian IG remains well supported by demand for high-quality financials, but restrictive rates demand discipline. We favour defensive real assets sectors such as infrastructure and utilities and are wary of sectors exposed to a fading consumer. The silver lining: softer spending could ease inflation and rate pressure, reinforcing our view that the RBA's next move is a cut.

Portfolio update

Australian rates: positioning for the peak

We turned more constructive on Australian rates over the month. Four hikes in, with markets pricing a peak near 5.15%, we believe the RBA is at or near the end of its cycle. As the inflation shock matures, downside risks to growth will take over the narrative. We added to front-end Australian government bonds, the part of the curve with the most to gain when the market pivots toward 2027 cuts.

Where central banks still have room to run, we're positioned for it. We are short US rates, expecting the Fed to push toward 4.35% on elevated inflation and strong growth. Unlike the RBA, the Fed has only just restarted its cycle. We are also short Japan rates, positioned for the BOJ to accelerate tightening as real growth picks up and inflation risks skew higher.

After a standout August, we cut our inflation breakevens and took profit. With central banks now moving decisively to get ahead of inflation, the easy gains are behind us.

Australian credit: from capital gains to carry

We've started trimming Australian credit. Restrictive rates, a slowing economy and heavy supply all weigh on spreads. We still like Australian credit for high-quality carry, but we're no longer banking on spread compression.

Rotating into government and semi-government bonds

We're making the portfolio more defensive by rotating into government and semi-government bonds. The curve now lets us earn the same yield further out in governments and semi-government bonds as in short-dated credit, without the credit risk. At this stage of the cycle, that's an easy trade to make.

Global credit: front-end yields too good to ignore

We added to short-duration US credit. US growth is holding up strongly, and with the Fed tightening, the front end once again offers real value for high-quality carry. We continue to hold short-duration European credit for the same reason: hedged front-end yields are exceptionally high across global markets.

We still hold no Australian RMBS given pressure on local housing. Emerging market debt stays in the portfolio for its high real yields and diversification benefits.

We've moved short the Australian dollar against the US dollar. The RBA is finding its peak after four hikes, while the Fed is just getting started. That divergence should favour the US Dollar.

Looking ahead: income and protection, finally together

With yields reset higher, the portfolio now offers a yield to maturity of 5.75%, compelling on its own. But the bigger story is what bonds can do for a portfolio again. With equities crowded into the AI trade and markets pricing around 100bp of further tightening across developed economies, the risk of central banks overtightening into an oil supply shock is real and rising. If that plays out, high-quality bonds deliver both income and protection. We've built the portfolio for exactly that moment: locking in high yields, moving up in quality, and staying ready for the market's focus to shift from inflation to growth.

Learn more about the Schroder Fixed Income Fund.

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