SFIF Commentary: Seeing is believing

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Why bond markets stopped listening to central banks in July.

Market Review

Government bonds took a beating in July. Credit shrugged it off entirely. And the reason for both comes down to one theme: investors have stopped taking central banks at their word.

Kevin Warsh wants inflation expectations to do his job for him. Keep threatening future hikes, the logic goes, and you might not have to deliver one. July's US Federal Reserve (Fed) meeting was that playbook in action - a higher-for-longer message without an actual higher rate to back it up. Markets weren't buying the bluff. Three Federal Open Market Committee (FOMC) members dissented in favour of an immediate hike - the most one-directional dissent the Fed has seen since 2016 - and still, the committee held. Investors read that as jawboning, not action, and priced accordingly: September is live, but December is where the market now sits for the next Fed hike.

While the Fed talked, Australia delivered actual data - and it was good news. June quarter trimmed mean inflation came in soft, and the Reserve Bank of Australia’s (RBA's) tightening cycle now looks done. The market's read: next move is down, not up. That's the sharpest global policy divergence in months. The Fed can't declare victory. The RBA basically just did.

Here's the twist: even Australia's good news couldn't stop long-end yields from ripping higher everywhere. Investors are done giving central banks the benefit of the doubt on inflation risk, fiscal deficits and bond supply, and they're charging a premium for it. When the term premium moves, geography doesn't save you.

Just to keep things interesting, the Middle East reminded markets it hasn't gone away. Every US-Iran headline sent oil higher and risk appetite lower, layering fresh uncertainty on top of a bond market that already had plenty.

While government bonds were having a bad month, credit had a great one. Strong balance sheets, thin supply and yields that are simply too attractive to ignore kept spreads anchored - Australian investment grade especially. The one wrinkle: US tech-sector spreads wobbled as investors started asking hard questions about how hyperscalers plan to actually pay for the AI buildout.

The bottom line: central bank guidance is losing its grip on markets. Data is back in the driver's seat, and the data is telling two very different stories: Australia easing toward the exit, the US not yet allowed to leave the room. Oil is the wildcard that could rewrite either narrative overnight.

Market Outlook

The next quarter will be defined by whether economic data validates current market expectations. Investors are increasingly demanding evidence that inflation is returning to target rather than relying on central bank assurances, placing inflation, growth and labour market data firmly back in the driver's seat.

Australia appears best placed. The downside surprise in trimmed mean inflation has strengthened the case that the RBA has finished tightening, creating a more supportive backdrop for domestic bonds and credit. In contrast, the Fed remains wary of declaring victory on inflation, leaving US rates more vulnerable should economic activity and price pressures remain firm. We continue to expect Australian duration to outperform US Treasuries as this policy divergence plays out.

Europe and the UK face a different challenge. Growth is slowing, consumers remain under pressure and there is little evidence of the second-round inflation effects that would justify another meaningful leg higher in policy rates. That should help contain bond yields outside the US and support fixed income returns as markets increasingly shift their focus from inflation to growth.

Oil remains the key swing factor. Further easing in Middle East tensions would reinforce the disinflation narrative and support risk assets, while any renewed supply disruption could quickly revive inflation concerns and challenge market expectations for lower rates over time.

Credit fundamentals remain strong, but valuations leave little room for disappointment. We continue to favour high-quality credit, particularly Australian corporates and bank Tier 2 securities, where strong balance sheets, robust demand and the ongoing AT1 transition continue to provide support. With spreads already tight, carry and security selection are likely to be more important drivers of returns than further spread compression.

Portfolio update

July tested the parts of the book built for duration, and Europe and the UK bore the brunt of it. The broad-based government bond sell-off swept through those markets regardless of the more dovish policy backdrop underneath. It's a reminder that being right on the policy call and being right on the price action aren't always the same thing in a month like this, and we're taking it as exactly that: a timing headwind within a thesis we still believe in, not a reason to abandon it.

The offset came from credit, and it did its job well. High-quality carry - not spread compression, just getting paid to hold good balance sheets - was a good place to be while government bonds were being repriced. Australian investment grade, European credit, and select subordinated exposure all delivered the kind of quiet, dependable return that credit is supposed to deliver when rates markets are noisy. It didn't fully offset the duration drag, but it meaningfully cushioned it.

Long Australia versus US was the standout position again. June's pattern - Australian yields drifting lower even as US Treasuries broke to fresh highs - continued into July as the RBA's completed tightening cycle was reinforced by a below-expectations trimmed mean CPI print, while the Fed's hold-with-hawkish-dissent outcome kept US yields under pressure. The spread compression we've been positioned for is now playing out cleanly, and Australia's disinflation trajectory versus the US's stickier inflation backdrop gives us little reason to reduce this trade going into August.

Long EUR and UK rates was the one drag on rates positioning. Even though neither the European Central Bank nor the Bank of England shows genuine second-round inflation pressure, the month's broader theme - investors demanding more term premium everywhere for inflation risk, fiscal deficits, and rising supply - pulled European and UK yields higher alongside the US and Australia. We're treating this as a valuation-driven move rather than a change in the underlying policy divergence story, and we're maintaining the position; growth there continues to look too soft to justify a genuine tightening cycle.

Long US inflation breakevens did their job as a hedge on Fed credibility. With the Fed choosing to hold rather than validate the hawkish dissents outright, the market read that as a central bank that may be falling behind an inflation backdrop it's still calling a "supply shock." Breakevens moved higher over the month, consistent with that read, and the position continues to pay off whichever way the September decision ultimately breaks - a hike vindicates the short front end, a hold vindicates the inflation exposure.

Credit continued to grind tighter through the volatility in rates, and the portfolio's tilt toward Australian credit over global - particularly short-dated investment grade, subordinated debt, and supranational names - captured that carry cleanly, helped by limited new issuance and steady demand technicals. Our European credit over US preference also added value on relative valuation grounds, and US securitised over Australian RMBS held up as intended; we remain comfortable avoiding Australian housing exposure given the cumulative effect of this year's RBA hikes on borrowers and the recent round of budgetary measures.

The one area we're watching more closely is technology-sector spreads, where the market spent more of July scrutinising how hyperscalers intend to fund AI-related capital expenditure. It hasn't materially affected our positioning, but it's a theme we expect to keep generating idiosyncratic spread pressure through the rest of the year.

Emerging market debt continued to earn its place as a diversifier on the back of genuinely high real yields, though it remains the position most exposed to a reversal in the US dollar. We continue to view it as an appropriate offset against developed-market central bank divergence risk rather than a standalone directional call.Nothing that happened in July changes the core thesis: markets are increasingly demanding evidence over guidance, and that shift favours positioning for divergence rather than for a single global rates direction. Oil remains the key swing factor for the US inflation and Fed-credibility story - a further escalation in the Middle East would reinforce our short front-end and long-breakeven positions, while a de-escalation would test them. On the Australian side, the case for further outperformance in domestic duration and credit continues to build as long as the disinflation data keeps cooperating.

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