SFIF Commentary: Divergence Over Direction - How we're positioned for a fractured global rates cycle

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August forced central banks apart rather than together - the Reserve Bank of Australia edging toward one more hike into a slowing economy, the US Federal Reserve's new Chair refusing to commit to a path, and the Bank of Japan signalling it won't wait. We've traded the near-term divergence tactically while holding firm on our structural view: Australian duration and credit are set up to outperform once growth catches up with the data that's already turning.

Market Review

Australian Rates: RBA holds, but the market has already moved past it

The Reserve Bank of Australia (RBA) left the cash rate unchanged at 4.35% at its August meeting, a unanimous decision following three hikes earlier in the year (February, March, May). RBA Governor Bullock was careful not to characterise the hold as a foregone conclusion to the tightening cycle, noting the Board was not ruling out further increases and wanted additional data before confirming the disinflation path was intact. The accompanying Statement on Monetary Policy assessed inflation risks as skewed to the upside, citing both domestic capacity pressures and cost pass-through from the Middle East conflict.

That caution was validated within weeks. The July Consumer Price Index (CPI) release at the end of August showed trimmed mean inflation of 0.5% for the month against a 0.3% consensus - materially above expectations even as headline inflation eased to 3.5%. RBA minutes published mid-month confirmed the Board had debated a hike at the August meeting before opting to wait for more data. The combination repriced the front end sharply, with market pricing moving from an outside chance of a September move to a near fully priced hike by either the September or November meeting. Ten-year Australian Government Commonwealth Bond (ACGB) yields closed the month at 5.08%, up 10 basis points (bps) over August and 75bps over the year.

Australian growth: a deteriorating backdrop beneath a hawkish inflation print

A more consequential development this month is the widening gap between the inflation data driving rate expectations and the underlying growth picture. Housing has cooled more sharply than the RBA anticipated, with national dwelling prices down approximately 1.5% from their March peak and investor loan demand declining noticeably. Labour market conditions have softened by more than forecast, and the RBA's own central projection has unemployment rising gradually to 4.8% by end-2028. Governor Bullock also flagged persistent weakness in productivity growth as a structural constraint on non-inflationary growth capacity.

This creates a material policy tension. The inflation impulse driving current rate expectations is substantially supply-side and externally sourced - Middle East-related cost pass-through and the roll-off of the fuel excise reduction - rather than demand-driven. Meanwhile, the domestic demand indicators the RBA also monitors (housing, employment, productivity) are showing clear signs of deceleration. A further hike delivered primarily in response to the CPI print, without adequate weight given to the accumulating growth signals, raises the risk of policy tightening into an economy that is already losing momentum - a sequencing error that historically tends to produce a sharper subsequent downturn than would otherwise have occurred.

Global Rates: An opaque Fed and a fragile long end

There was no scheduled Federal Open Market Committee (FOMC) meeting in August, though the policy narrative moved considerably. Minutes from the July meeting showed three regional Fed presidents dissenting in favour of a hike, the most hawkish dissent count since 2016. US Federal Reserve (Fed) Chair Kevin Warsh delivered his first Jackson Hole address on August 28, declining to offer forward guidance or articulate a reaction function, and stating that "we should not indulge a regime in which market participants are looking primarily to the Fed for their next trade." He further noted that despite improved summer inflation readings, underlying trends had not shown meaningful improvement. Markets responded by lifting the priced probability of a September hike from roughly 34% to 56% within the session, with the 2-year note rising close to 10bps.

Long-end Treasuries were the more structurally significant story. The 30-year yield reached its highest level in nearly 20 years amid sustained pressure from fiscal deficit concerns, total public debt surpassing $40 trillion, and elevated corporate issuance competing for investor demand. Treasury Secretary Bessent responded by more than doubling the size of long-dated buyback operations to at least $4 billion per operation. The initial market reaction was a meaningful yield decline on the 10- and 30-year bond but this was fully reversed within a single subsequent session, underscoring the limited durability of the intervention against the underlying supply-demand imbalance.

Oil remained the principal cross-market variable throughout the month. Brent crude ranged between approximately $83 and $90 per barrel as Strait of Hormuz developments alternated between de-escalation signals and renewed disruption to shipping. Every major central bank's near-term inflation forecast remains materially exposed to this single geopolitical variable.

Global Credit: valuations offer minimal margin for error

Credit spreads remained historically tight through August. US high yield closed the month near 275bps, in the richest decile of its historical range against a long-run median of approximately 450bps; investment grade valuations are trading around 80bps. The HY/IG ratio of roughly 3.5x is broadly consistent with its long-run average, indicating the tightness is market-wide rather than concentrated in lower-quality credit. Supportive conditions included an easing policy bias from the Fed, a re-steepened yield curve, subdued rate volatility, and contained default rates.

Australian Credit: resilient and largely uncorrelated with the rates move

Spread levels showed limited sensitivity to the sharp repricing occurring in rates markets over the same period, consistent with the view that August's volatility was a rates-driven rather than credit-driven event. Primary issuance activity remained robust despite the volatility in government bond yields.

The standout event was Alphabet's inaugural Kangaroo bond - a A$5.5 billion, four-tranche deal, the first Australian-dollar issuance from a major US tech company since Apple in 2016, and the first from an AI hyperscaler. Demand was overwhelming: over A$18 billion in bids for A$5.5 billion on offer, reflecting how starved local investors are for tech-sector exposure. Amazon is widely tipped as the next hyperscaler to follow. The deal sits within a broader wave of foreign issuance into AUD - Kangaroo volumes are running at roughly A$60 billion year-to-date, up over 40% on 2025 and on track for a record year.

The size of the transaction had knock-on effects: as investors made room in portfolios to fund the deal, spreads on other high-quality AUD paper - major bank senior, subordinated and broader high-quality agencies - saw modest widening pressure. This is a normal technical response to a jumbo single-name print, not a sign of deteriorating fundamentals - if anything, it shows the market's growing capacity to absorb large, diverse issuance without disorderly repricing.

Market Outlook

Australian Rates: September is live, and so is the policy-error risk

The RBA's August minutes confirmed that a hike was seriously considered, without disclosing the closeness of the vote. Combined with the July CPI surprise, the September meeting now represents a genuinely two-sided decision rather than a formality. Q2 GDP and labour force data due ahead of the meeting will carry significant weight in the outcome.

The central risk to monitor is not simply whether the RBA hikes, but whether it does so against an economy where the underlying growth signals - housing, employment, productivity - are already deteriorating. A further tightening move driven primarily by an inflation print with substantial external and transitory components could compound existing demand weakness rather than address genuine excess demand, increasing the probability of a more pronounced subsequent downturn.

Global Rates: the next six weeks carry elevated event risk

Fed Chair Warsh's deliberate withholding of forward guidance means incoming data will be amplified in market pricing ahead of the September FOMC meeting. The structural pressure on long-end Treasury supply is unlikely to be resolved by a single buyback announcement, as evidenced by the full reversal of the initial yield relief within 24 hours. A further escalation in Middle East tensions would simultaneously pressure inflation expectations across multiple major economies, representing the principal tail risk across the global rates complex.

Global Credit: technically vulnerable, fundamentally sound

Current spread levels leave limited room to absorb negative surprises. September will also bring a heavy issuance calendar, providing the first meaningful test of demand at current valuations. The primary risk channel is not credit fundamentals but a spillover from rates volatility — historically, a breakout in rate volatility has been the leading indicator for credit spread widening, rather than fundamental deterioration in issuer quality.

Australian Credit: stability likely to persist

AUD credit markets are expected to continue absorbing supply without material spread widening even as the RBA's tightening bias reasserts itself, consistent with the limited contagion observed during August's rates volatility. Two factors warrant monitoring into the fourth quarter: the market's capacity to digest long-duration issuance at current levels as yields remain elevated, and any pass-through of further rate increases into bank funding costs at the front end of the curve.

Portfolio update

The combination of factors outlined above supports a constructive medium-term view on Australian government bond duration. The current inflation impulse is substantially externally sourced and transitory in nature, while the underlying domestic growth trajectory — housing, labour market, productivity — is already showing clear signs of deceleration. Should the RBA proceed with further tightening in response to near-term inflation data without adequately weighting the accumulating growth evidence, the probability of a sharper subsequent slowdown increases materially. Historically, such sequencing tends to compress the timeline to the following easing cycle rather than extend it. A curve currently priced for further hikes may be under-pricing the speed with which the policy conversation could shift toward easing once growth data converges with what housing and labour market indicators are signalling - a dynamic that would favour Australian duration outperforming global peers into an early-2027 cutting cycle.

Tactical Shift: Short Australia versus long US

That medium-term view sits alongside a tactical repositioning we made through the back half of August. Having run long Australia vs US through July, we flipped to short Aussie rates vs long US rates by month-end, looking for near-term AU underperformance as the hot July CPI print and the RBA's own admission that a hike was debated forced a hawkish repricing the market hadn't fully caught up to. This isn't a reversal of the medium-term duration thesis above - it's the tactical corollary of it. We expect the RBA to hike into a slowdown before it's forced to reverse course; the trade captures the hike leg first, with the intention of flipping back to long AU duration as evidence of the growth deceleration builds toward year-end and into the 2027 cutting cycle we're positioned for structurally.

The long UK rates position remains in place and continues to perform as intended – growth and inflation in the UK have stayed persistently soft, and we see no case for the Bank of England validating the term-premium-driven back-up that's lifted yields globally.

Europe is where we've taken risk down. We've moderated the long duration position built earlier in the year, on the view that the term-premium move hitting global rates has less clean a growth-divergence story behind it in Europe than in the UK or Australia. We're now only holding short-duration European credit, keeping the carry exposure without the duration risk while that repricing plays out.

Long US and European breakevens have been the standout performer of the month. Both positions benefited as breakevens widened alongside the broader back-up in nominal yields - consistent with our read that the term-premium move is being driven at least in part by genuine inflation-risk repricing (Middle East cost pass-through, sticky underlying inflation) rather than purely a growth or supply-technical story. The US leg continues to double as a Fed-credibility hedge: Chair Warsh's Jackson Hole refusal to commit to forward guidance, while flagging that underlying inflation trends haven't "meaningfully improved," reinforces the case that this exposure pays off regardless of how the September FOMC decision breaks.

Short Japan rates and a curve flattener round out the month's changes. We're short the front end, positioned for the Bank of Japan (BOJ) to pull forward its tightening cycle - consistent with the BOJ's own July summary of opinions showing policymakers see room for further hikes as underlying inflation nears target. We're long the back end, on the view that the Ministry of Finance's efforts to encourage greater domestic buying at the long end will keep a lid on term premium there even as the front end continues to reprice higher. The net effect: a flattening position that expresses BOJ policy normalisation without taking on the long-end supply risk that's weighed on other sovereign curves this year.

High-quality carry in credit continued to do its job through the volatility. Spread levels showed limited sensitivity to the sharp repricing occurring in rates markets over the same period, consistent with the view that August's volatility was a rates-driven rather than credit-driven event. Primary issuance activity remained robust despite the volatility in government bond yields - Alphabet's record Kangaroo debut being the clearest evidence of that. We continue to hold Australian credit for carry, and are looking to diversify further into US credit given the underperformance in US rates has pushed all-in yields to attractive levels, with the added benefit of a positive hedge back to A$ - a dynamic that also supports our European credit preference. Within US credit we continue to like agency mortgages specifically: high quality, attractive spreads vs corporates, and high all-in yields, in a segment well supported by resilient US growth.

Diversifiers: Securitised and EM unchanged

US securitised assets over Australian mortgages and emerging market debt as a diversifier carry forward unchanged - we remain comfortable avoiding Australian housing exposure given the cumulative effect of this year's RBA hikes on borrowers, and EM continues to earn its place on genuinely high real yields, with the usual caveat that it remains the position most exposed to a reversal in the US dollar.

Nothing that happened in August changes the core thesis: markets are increasingly demanding evidence over guidance, and that shift favours positioning for divergence - across regions and across time horizons - rather than for a single global rates direction. Oil and the Strait of Hormuz remain the key swing factor for the US inflation and Fed-credibility story. On the Australian side, the tactical short into September sits comfortably alongside our structural conviction that the case for Australian duration and credit outperformance keeps building the longer the RBA leans on a CPI print that the growth data underneath it doesn't yet support.

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