

Rates outlook – The calm after the storm

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2025 has continued the run of extreme volatility in markets we have seen since the COVID outbreak. At the end of 2025, slightly higher inflation, stable unemployment and a lack of urgency from the Reserve Bank of Australia (RBA) to continue easing interest rates should help markets return to a period of relative calm in 2026.

Despite the turbulence we saw over the past year, the economy has held up better than we had expected. Inflation has eased, unemployment continues to remain well below its 20-year averages, and we saw the RBA deliver three rate cuts over 2025 which has taken some of the pressure off Australian consumers.

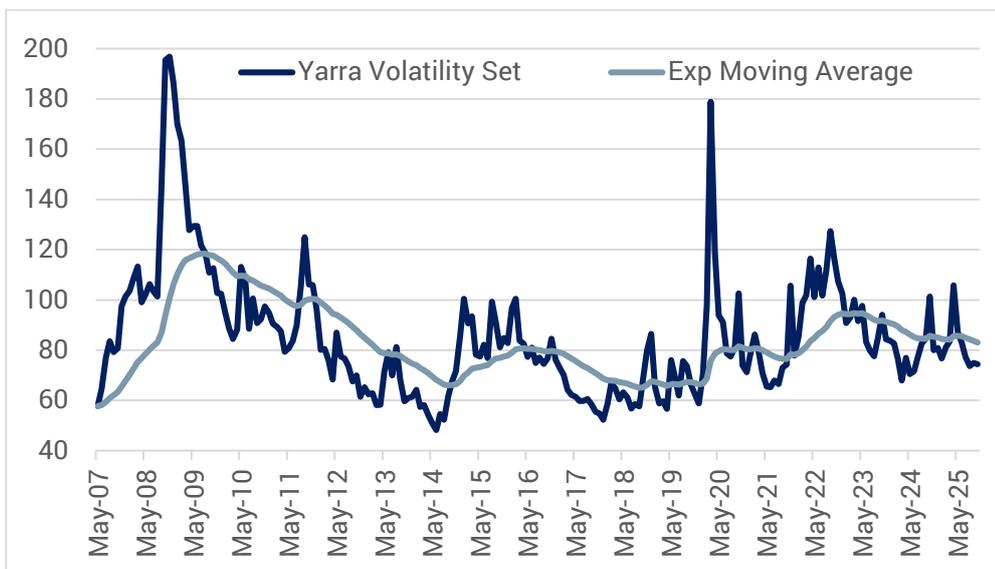
This all suggests the RBA can afford to be patient for some time and they have suggested they need more data and evidence that inflation is moving towards the midpoint of their 2-3% target band before considering further changes to policy. The one thing that might force the RBA's hand is if unemployment were to deteriorate rapidly. With the full monthly CPI available from November 2025, all RBA meetings may now be considered live.



the 2026
outlook
bonds

What stability means for investors

Chart 1. Monthly Market Volatility



Source: YCM/Bloomberg, December 2025.

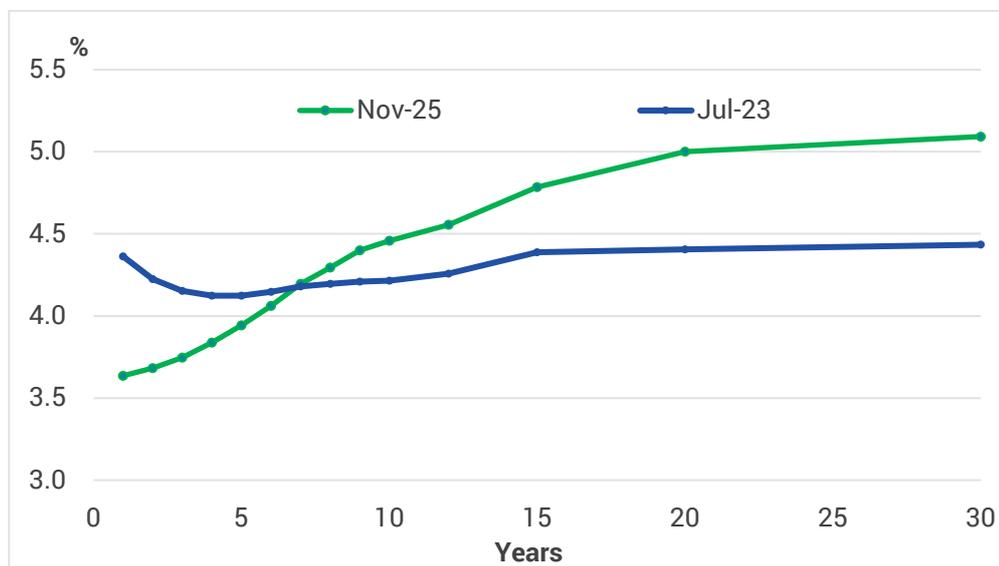
We expect market volatility to trend lower in 2026 and fixed income investors should rejoice at a period of stability, because it should make returns more predictable. Over the past two years, a large portion of returns have been generated due to market volatility and interest rate positioning. In lower volatility conditions, investors can rely on the surest thing in fixed income: a steady stream of income!

Big swings in interest rates could make or break performance, but in a more stable rates environment, we expect outperformance will come more from sector rotation, security selection and income. Less surprises and a rosy economy mean that income should dominate fixed income returns.

In terms of the cash rate, we think it could still be slightly lower in 2026, but more likely towards the back end of the year. We don't expect to see any more moves to interest rates in the near term while the RBA waits for more data – and they are probably inclined to wait as long as possible. Even if we don't see any further rate cuts, interest rate increases are probably a long way off and unlikely to be as destructive as in 2021 and 2022.

Steeper yield curves to play their part

Chart 2. Australian Government Bond Curve November 2025 vs July 2023



Source: YCM/Bloomberg, December 2025.

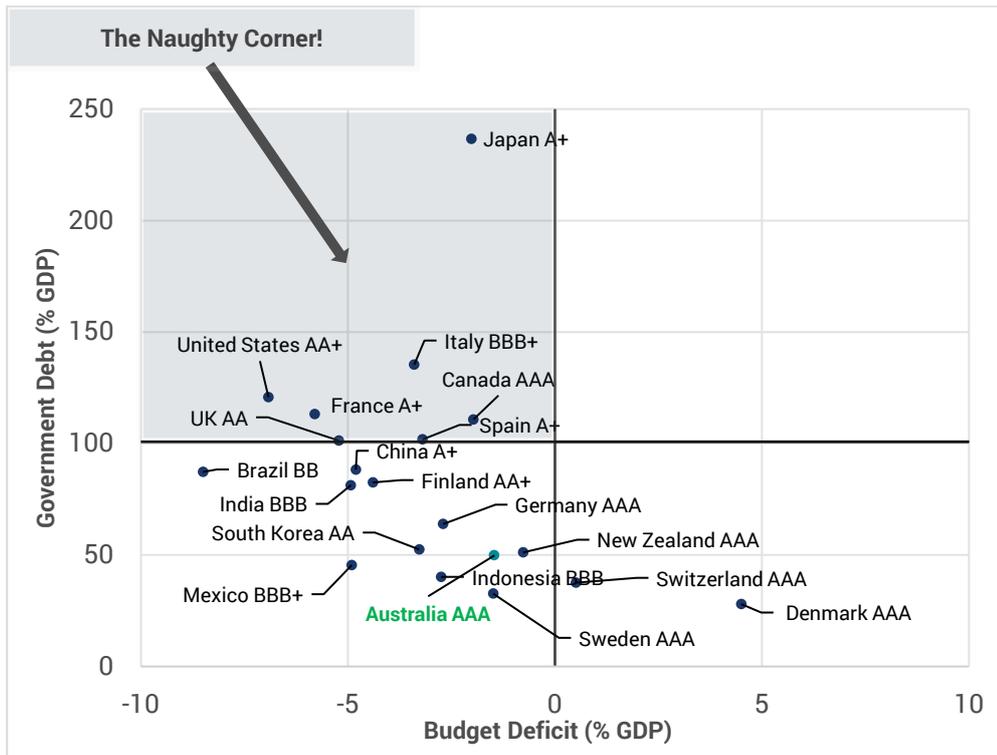
The shape of the yield curve also tells a more encouraging story for fixed income investors. In mid-2023, investors were barely compensated for taking on term risk (blue line). Today's curve is much steeper (green line), which means owning longer bonds once again compensates investors for taking term risk. A steeper curve offers higher income and better yields and creates more attractive opportunities for investors that were absent when yield curves were very flat. We expect the spread between the 3 and 10-year bonds to range between 0.60% to 1.00% in 2026.

Why we like Australian fixed income better than global

Global diversification plays an important role in portfolio construction, but it also introduces risks that are easy to overlook. Australia remains a AAA-rated sovereign with strong fiscal discipline and one of the most stable economic profiles in the world. Sadly, the same cannot be said for many of our global peers.

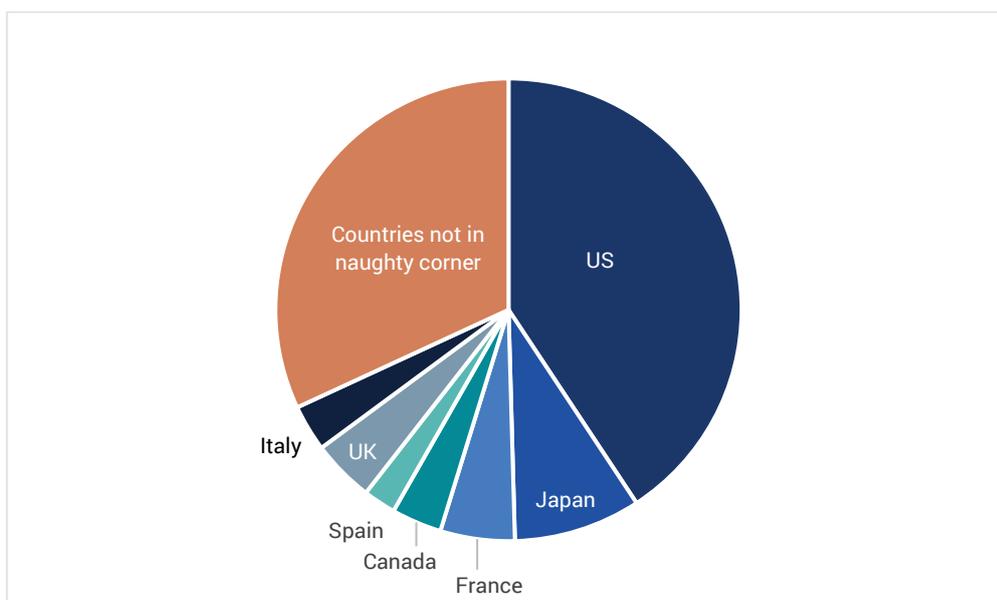
In Chart 3 we compare some of the major investment grade countries using two measures, budget deficit as a % of GDP (x axis) and government debt as a % of GDP (y axis). We define the countries that have government debt over 100% of GDP and is also in a budget deficit as being in the “naughty corner”. When we compare those countries to their allocation in the Bloomberg Global aggregate fixed income index¹, over 2/3s of the countries are suffering from outsized debt and extremely weak fiscal positions (Chart 4). How exposed do you want to be to those countries?

Chart 3. Government Finances and Ratings



Source: YCM/Bloomberg, December 2025.

Chart 4. Global Aggregate Index – Country of Risk



¹ One of the more commonly used Global FI benchmarks.

Source: YCM/Bloomberg, December 2025.

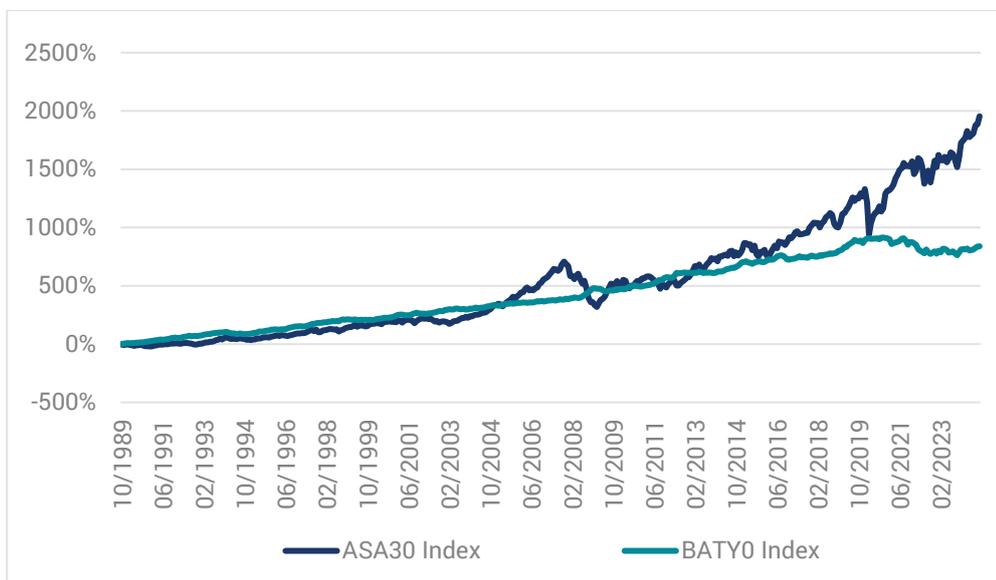
The Australian fixed income market looks much stronger in comparison, as Australia maintains a healthier budget position, lower debt levels and a more stable policy environment.

A key point for Australian investors allocating to global fixed income: hedging the currency risk back into AUD removes the impact of foreign interest rate movements. Once hedged, the portfolio is essentially taking on Australian interest rate risk and adding credit exposure to countries that have weaker fiscal profiles. The diversification has provided no real benefits given global bond indexes have largely underperformed domestic indexes in recent years.

We are not suggesting that investors allocate completely away from global fixed income, but understanding the trade-offs and the potential risks helps avoid any unexpected impacts. On this basis, Australian fixed income looks like a better place to be given the current global backdrop.

Bonds vs Equities: Mind the valuation gap

Chart 5: ASX vs Australian Government Bonds



Source: YCM/Bloomberg, December 2025.

Another theme to keep an eye on is the widening gap between equity and bond valuations. Since 2020, equity markets in Australia and the United States have continued to push higher even as interest rates rose sharply. Bonds repriced significantly during the hiking cycle, but equities have held on. Such a large gap is unusual historically and, in a world where fixed income now offers solid yields and lower volatility it should help to dampen any shocks from any reversal in equities should that occur.

With steeper yield curves, solid sovereign fundamentals and attractive valuations relative to equities, Australian fixed income stands out as a compelling choice. In a world where global peers face mounting fiscal challenges, Australia's AAA-rated profile offers security and opportunity. For investors seeking dependable returns and lower risk, 2026 could be the year income truly dominates



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As stability returns, will income take centre stage in 2026?

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