As Australia’s RBA cuts rates, here are the swap opportunities

We're taking a snapshot of the Aussie interest rate swap curve and identify a c.50bp pa gap between the 10yr rate and our projected profile for 3mth bills. Comparing the US curve, we identify a choice price in short tenors in terms of rates and a positive carry opportunity of some 60bp in the 10yr, all while with the RBA still in rate-cutting mode

Assessment of current Aussie swap curve

We identify a neutral Reserve Bank of Australia rate at around 3.6%. The theory here is centered on a tolerance for CPI inflation up to 3%, with a moderate real rate added to that. It is also in line with the average RBA rate over the past three decades, a period long enough to back out numerous cycles and extremes on both ends. It’s against the 3.6% area reference rate that we confront the current curve against. The vision ahead is for an RBA move down to 3.35%, and then a subsequent reversion to 3.6%.

This implies a bottoming for the 3mth bills rate at around 3.5%. It's currently at 4.1%. On a two-year view, the 3mth bill rate heads back up to the 3.7% area. The current swap curve is illustrated below (1), showing an inversion out to the 2yr area which dips just below 3.7%. And then an upward sloping curve out towards 4.4% on the 10yr.

We think that the approach of 4.4% on the 10yr is a reasonable fair level versus a future 3mth bills rate at 3.7%. But likely with upside potential should US Treasury yields get forced higher in the months ahead.

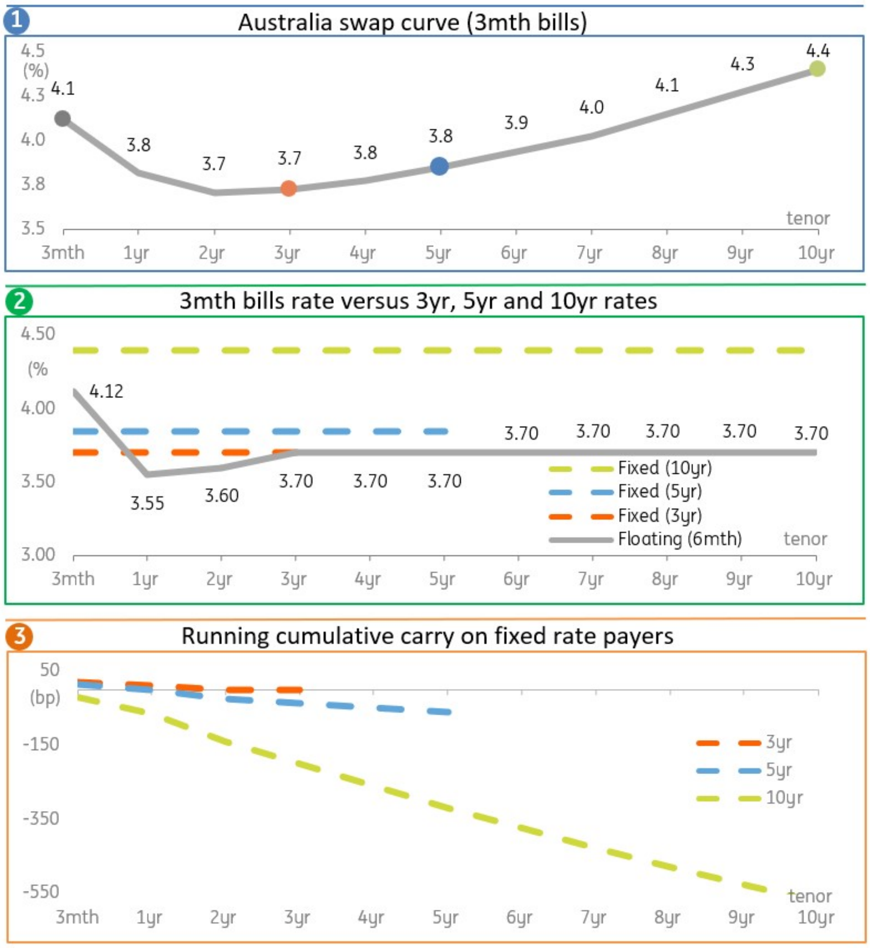
The three-decade average spread from the RBA rate out to the 10yr government yield is 60bp as a guide for an average curve. Currently the 10yr swap rate is some 15bp below the 10yr government yield, as has become thematic in many developed markets. However, we view this as a less compelling thing for Australia. The more conventional setting has the swap curve sitting above the government curve.

The Fixed versus Float analysis

In terms of the fixed versus float setting, the chart below (2) compares the projected movement in the 3mth bills rate relative to selected 3yr, 5yr, and 10yr fixed rates. The one in the middle (2) shows the cumulative carry outcome from setting fixed rate payers. The 3yr payer is broadly balanced, the 5yr payer has an average cost of some 10bp per annum, while the 10yr payer has an average carry cost of some 50bp per annum.

Both the 3yr and 5yr payers are impact positive in carry, but that dissipates as the RBA cuts (final (3) above). The 10yr has cumulative negative carry of some 500bp (average 50bp pa). This may seem like a lot, but it's actually fitting with a normal upward-sloping curve and of course pays interest rate certainty.

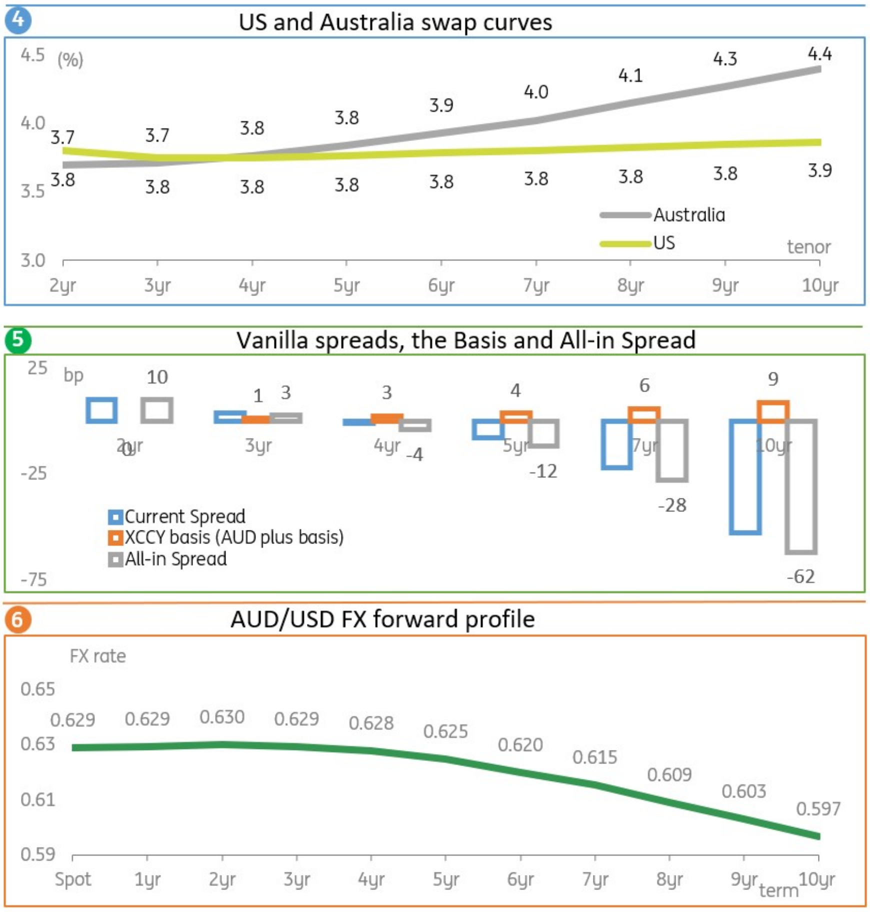
The Aussie swap curve and Fixed versus Float Simulation



The Australia versus US spreads environment

Turning to Australia versus the US, both swap curves are flat in the 3.7% area in the 2yr to 3yr tenors (although from a pure credit perspective the bank bills reference for the Aussie curve should sit above the risk free rate SOFR curve, other things being equal). Beyond that, the contrast between the two curves is a progression steeper for the Australian swap curve versus a much flatter to moderately inverted in places, to an only moderately upward sloping SOFR curve. That in turn opens up progressively wider spreads between the two on extensions out the curve.

Aussie rates versus SOFR, and the cross currency setup



The Cross Currency Analysis

The two curves are shown above (4), and below that, the breakout of the spreads between the two by maturity (5).

In the 10yr tenor, the 9bp basis premium attached to the AUD leg acts to push the all-in spread out to 62bp. The positive carry play then is to receive AUD and pay USD for that rate pickup (or reduction in interest rate costs for liability managers). Having generated a synthetic USD liability, the risk then is the AUD/USD FX rate falls (USD appreciation) by more than implied from the FX forward profile (6).

In contrast, in shorter tenors there is a choice price as the rate differential is in single digits, and in fact flipping the other way on the 2yr. As a consequence, the implied FX forward breakeven rates are broadly flat to spot. On a 2yr forward view, we, in fact, forecast 0.65 compared with 0.63 on the 2yr FX forward, pointing to a preference to pay Receive AUD 2yr and Pay USD 2yr.

> Bottom line, on the vanilla Aussie swap curve, lock-ins on 3yr to 5yr tenors have mild moderate flat to negative carry; it's more on the 10yr, circa 50bp pa. On a swap to floating in the 10yr, that's 50bp pa in positive carry.
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> Versus the SOFR, a swap from Aussie 10yr swap comes with c.60bp in positive carry (or

reduction in interest rate costs), or there is broadly a choice price between SOFR and Aussie swap in shorter tenors, but with upside on the FX exposure.

The macro underpinning for Australia

From a macro perspective, we see a weakening trend of full-time employment, wage growth, and a modest rise in the unemployment rate which should give the RBA comfort to ease further. Wage growth slowed to 3.2% in the fourth quarter of 2024 from 3.6% in 2Q and 4.1% in 1Q. Also, headline CPI corrected meaningfully from 3.8% in June 2024 to 2.4% in the fourth quarter and remained within the bank's CPI target of 2-3% in the month of January as well.

However, the recent bounce back in GDP growth in 4Q suggests that growth might be bottoming. Hence, for the RBA to continue the monetary easing as per our forecasts, we'll need to see continued progress on CPI inflation with greater certainty that it remains in the target range for the RBA. This is likely to create uncertainty on the pace and timing of rate cuts. The market currently discounts a bottoming in the area of 3.4% for the RBA. We're okay with that, seeing a bottom at 3.35%.

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