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Australia Rates Viewpoint

Three reasons to buy AUD bonds: pay 3y AUD invoice spreads

28 May 2025 Corrected

Rates Strategy
Australia

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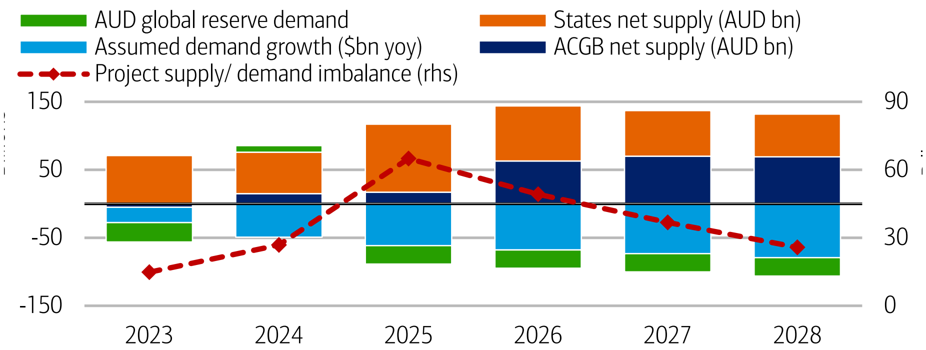
Buy 3y bond futures, pay 3y swap

We see three tailwinds for AUD bonds: (1) possible bank deregulation; (2) superannuation (super) funds' rapidly growing footprint in AUD fixed-income markets and (3) a rising share of AUD claims in global, official reserves. We recommend buying 3y bond futures, paying 3y (q/q/) interest-rate swaps (i.e. paying 3y swap EFP). Entry: -9.5bps, target 10bps, stop: -19bps. Risk: a global sell-off in bonds, which drags invoice spreads lower.

Exhibit 1: AUD bond demand to outstrip supply by 2028
Higher supply/ demand imbalance = higher excess supply



Source: IMF, AOFM, State Funding Agencies,

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Regulatory change on the horizon?

Potential regulatory change could see net stable funding ratio (NSFR) requirements loosened, possibly reducing the regulatory burden for banks purchasing bonds on asset swap and encouraging greater private-market repo activity. We see change as likely in part because Australia's regulatory settings are out-of-sync with major markets, but also because it could set the stage for the RBA to shift to a symmetric policy corridor (+/-25bp) by reducing the remuneration rate paid on bank reserves. See discussion below.

Rapidly growing super funds to bid for AU bonds

Australia's rapidly growing super funds, which manage Australians' retirement savings, have increased AUD fixed-income holdings at an average annual growth rate of 15.8% since 2022 (Exhibit 7). Assuming their asset allocation remains broadly stable and AUD fixed-income investments mirror the AUD debt market index, domestic demand for AUD bonds should outpace combined ACGB and semi supply by 2027/28 (see Exhibit 1).

Global reserve manager demand to increase

Since 2014, the share of global official reserves denominated in AUD has more than doubled, increasing from <1% to >2%. Most of the growth has occurred in the past few years. Investor feedback and AOFM data on foreign ownership of ACGBs suggests most of this growth has come from Asia ex-Japan, which we see as a durable trend.

q/q = quarterly/ quarterly or 3m bank bill swap rates, paid quarterly

EFP = exchange of future for physical

RBA = Reserve Bank of Australia

AOFM = Australian Office of Financial Management

QTC = Queensland Treasury Corporation

TCV = Treasury Corporation of Victoria

NSWTC = NSW Treasury Corporation

APRA = Australian Prudential Regulatory Authority

For a list of open and closed trades over the past 12 months, see the most recent Global Rates Weekly.

Timestamp: 27 May 2025 04:00PM EDT

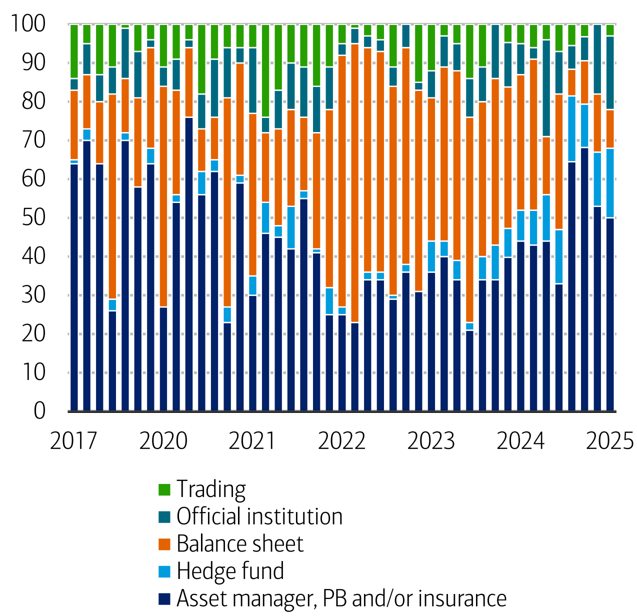
Admittedly, global reserve managers' demand for AUD-denominated assets was slightly lower in Q4 2024 and our assumptions could yet prove audacious. Yet similar quarter-on-quarter falls in 2018-20 proved short-lived and global investor feedback suggests a durable bid from reserve managers is a function of steep AUD yield curves, a general safe-haven bid for Australia and the decline of China property bond complex. All of these trends look set to endure (if not intensify) in the coming years.

Offshore AUD demand: rotation from North to South Asia

Although State data is a little sparse, we aggregate ownership by investor type from the three largest issuers, QTC, NSW Treasury Corporation (NSWTC) and TCV. The data suggests a steady pick-up in official institutions' share of purchases in 2025, alongside robust growth in asset managers' share of purchases (Exhibit 2). More fundamentally, an increase in demand for ACGBs from investors (likely official reserve managers) in South and South East Asia has more than offset a decline in investments from North Asia (likely life insurers and banks in Japan) (Exhibit 3). We see this as a structural trend that is likely to continue for the foreseeable future.

Exhibit 2: QTC, TCV, NSWTC syndications by investor type

Official institutions & asset managers' shares picked up notably in 2025



Source: State funding agencies

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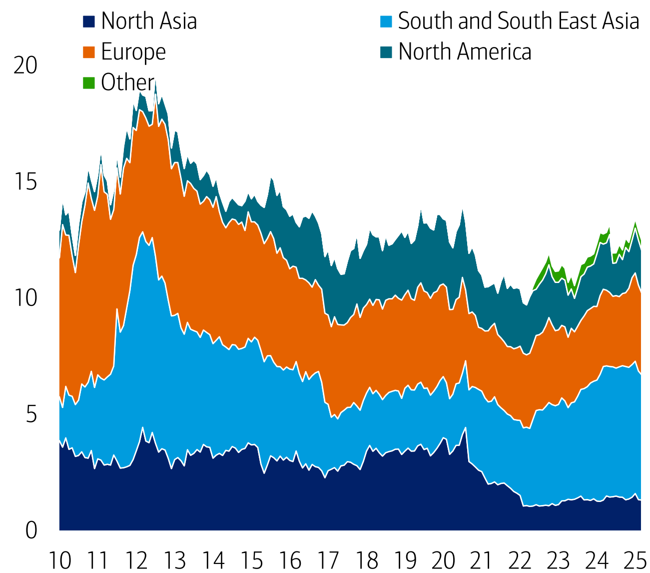
Exhibit 3: Identifiable ACGB ownership by country of origin

Unidentifiable ownership is likely offshore as well



Source: AOFM

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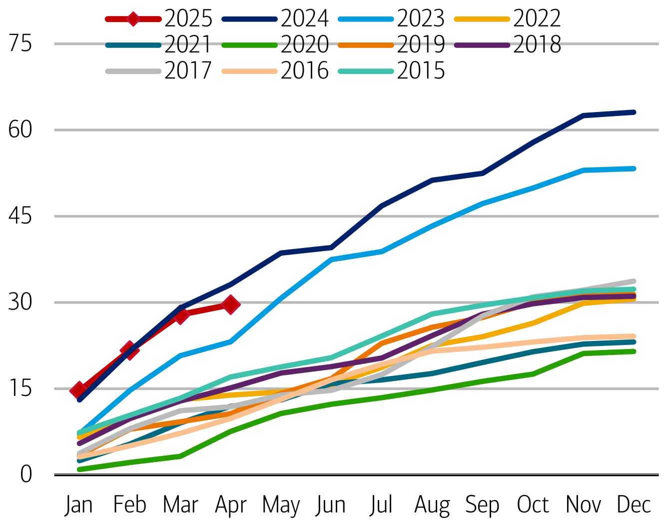
Domestic demand tailwinds for AUD bonds

Super funds' assets under management have expanded at 11-12% since 2023, far outpacing AU GDP. We have previously flagged super funds' large and rising footprint in foreign equity markets as a structurally bullish trend for the Australian dollar, but the impact on AUD fixed income has also been substantial (see Rise of the Super Funds 29 August 2024).

Although super funds' fixed income asset allocation has remained broadly unchanged around 12-13% of assets under management since 2014, rapid growth in super funds' total assets under management has meant their footprint in AUD fixed income markets has increased substantially. There are several indicators super fund demand might be outpacing the supply of new AUD debt: the percentage of bank term funding programs completed onshore by Australia's five largest banks has steadily increased from 20% to 30% over the past decade and Kangaroo bond issuance since 2023 has been substantially higher than in prior years (Exhibit 4, Exhibit 5).

Exhibit 4: Cumulative Kangaroo issuance by year
AUD SSA issuance programs skyrocketed from 2023 onwards



Source: Bloomberg
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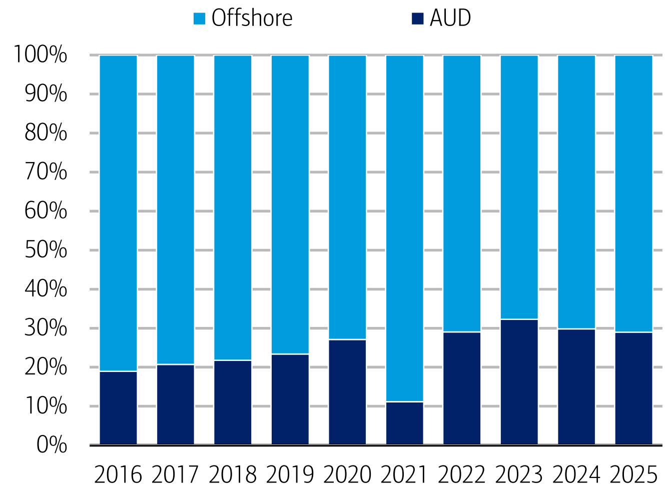
Exhibit 5: Annual bank term funding programs - AUD vs offshore (%)
For Australia's five largest banks



Source: Bloomberg
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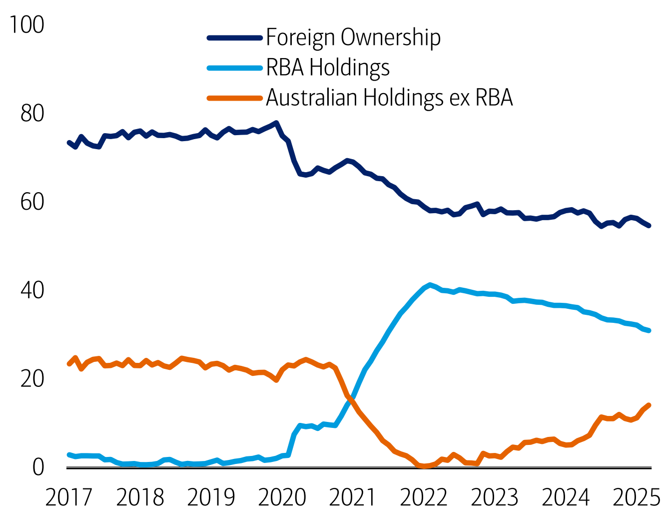
In Exhibit 1 above, we assume the super fund complex's AUD fixed-income allocation mirrors the Bloomberg Ausbond composite bond index. If this assumption (and our assumptions about reserve manager demand) hold, then demand for AUD bonds will outpace supply from 2027/28. In this forecast, we also assume bank balance-sheet demand remains stable and domestic holdings ex-RBA gradually increase as the RBA draws down its balance sheet (Exhibit 6).

In the latest quarter, banks' high quality liquid asset (HQLA) portfolios grew by 6.6% YoY after a period of consolidation following higher-than-usual, Term Funding Facility-related issuance in 2023/24. Our bank equity analysts note HQLA levels remain elevated and banks could look to reduce HQLA portfolios to manage downward margin pressures from competition and lower rates. Yet regulatory reform poses an upside risk to our static bank balance-sheet demand forecasts for ACGBs and semis.

Exhibit 6: ACGB holdings by investor type
Domestic holdings ex-RBA are steadily increasing as the RBA normalises its balance sheet



Source: AOFM *Note: we assumed unidentified holdings are held offshore
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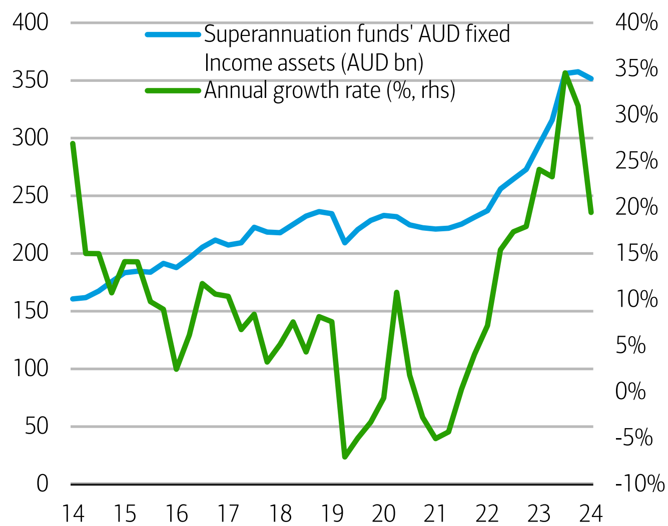
Exhibit 7: Super funds' fixed-income footprint has increased markedly
Super fund assets under management are increasing



Source: APRA
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Recommendations for regulatory reform

The Australian Financial Markets Association (AFMA), an industry association for banks, brokers, securities dealers and government funding agencies operating in Australia, has highlighted the unusually high funding requirement imposed on banks for engaging in short-term (<6 months) repo and for derivative liabilities, which include swap contracts used to hedge government bond purchases (see AFMA 09 May 2025). AFMA has called for regulatory alignment with major G10 economies like the UK, US, Japan and the Eurozone.

AFMA recommends changes to the net stable funding ratio (NSFR), which is a regulatory ratio that weights different assets and liabilities based on their perceived stability.[1] Available stable funding (ASF) is the numerator of the ratio and applies a higher factor or weight to funding that tends to be more stable over time and during periods of stress (like retail deposits). Required stable funding (RSF) is the denominator of the ratio: a higher factor or weight (i.e. funding requirement) is attached to assets that are likely to generate a funding gap in periods of stress. NSFR (%) = ASF/ RSF.

AFMA recommends aligning the RSF factor on derivative liabilities and short-term reverse repo transactions with international peers. 'Derivative liabilities' include swaps that banks pay (and receive floating-rate bank bill swap rates quarterly or semi-annually) to hedge their purchases of bonds issued by the Australian Government (ACGBs) and State Governments (semis).

Why is this change likely?

Although a submission from a peak body is not typically an indicator of future regulatory change, we see these changes as likely to gain traction given potential alignment with the RBA's reserve management regime.

The overall goal of the RBA's new reserve management regime is to encourage private-market activity (see Australia Watch 08 April 2025). If APRA reduced the required funding created by lending in the repo market (secured against HQLA 1 for a term of less than 6 months) to zero, it would likely facilitate higher interbank (secured) lending in the repo market and potentially set the stage for the RBA to reduce the ESA rate.

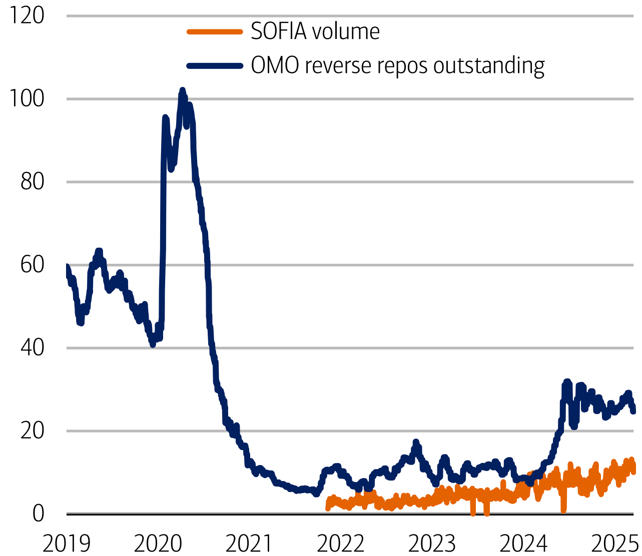
The ASX publishes the Secured Overnight Funding Index Australia (SOFIA), which measures General Collateral 1 (GC1) overnight repo transactions (i.e. overnight repos with semis/ ACGBs as collateral) where the RBA is not a counterparty. Although the dataset begins in 2022, volumes remain depressed vs RBA OMOs and suggest ample room for an increase in private-market activity (Exhibit 8). Regulatory change could spur this change and a lower ESA rate could provide an additional incentive, especially if markets are slower to react than the RBA would prefer.

Potential market impacts of regulatory change

The NSFR is more of a binding constraint on major banks than the Liquidity Coverage Ratio (LCR) because banks tend to operate with a NSFR closer to the regulatory minimum (Exhibit 9). Consequently, the market impact of lower RSF factors could be meaningful.

[1] For a full list and explanation of bank regulatory ratios, see report: Australia Rates primer on money markets and front-end rates in Australia.

Exhibit 8: SOFIA vs RBA OMO reverse repos outstanding (AUD bn)
Repo volumes remain low vs pre-pandemic



Source: ASX, RBA

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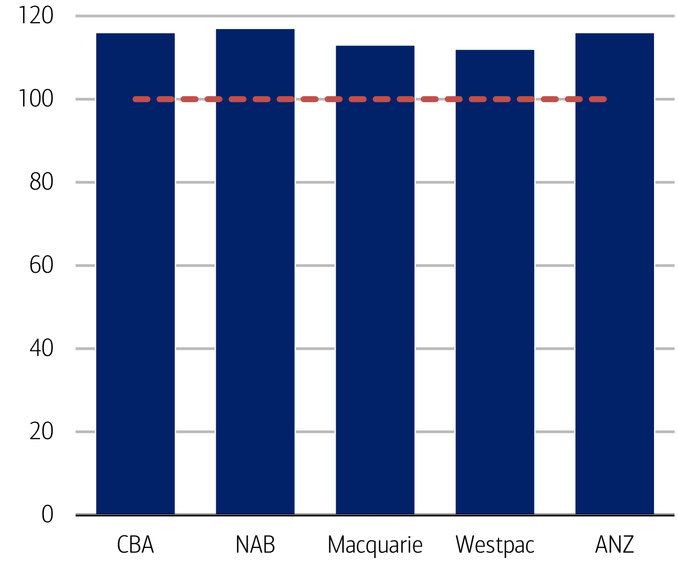
Exhibit 9: NSFR by bank (floor = 100%)
Bank NSFR requirements are more of a binding constraint than the LCR



Source: Bloomberg

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Specifically, we see three potential impacts: (1) higher demand for bonds; (2) wider swap spreads (i.e. cheaper bonds to swap) and (3) higher demand for T-notes if the RBA lowers the ESA rate.

We use Australia's five largest banks, Macquarie, CBA, ANZ, NAB and Westpac, which hold 78.5% of Australian bank deposits (and 76.5% of bank loans) as a case study for estimating the potential effects.[2] If APRA amended the RSF for derivative liabilities and HQLA level 1 reverse repos, the required stable funding for these banks would decrease by about 35bn. The lion's share of this fall (c. AUD 23bn) would be from HQLA level 1 reverse repos, which (all else equal) should be considered the most likely change given the shift would facilitate a reduction in the ESA rate and the introduction of a symmetric policy corridor (+/- 25bp), as well as aligning AU regulation with international peers.

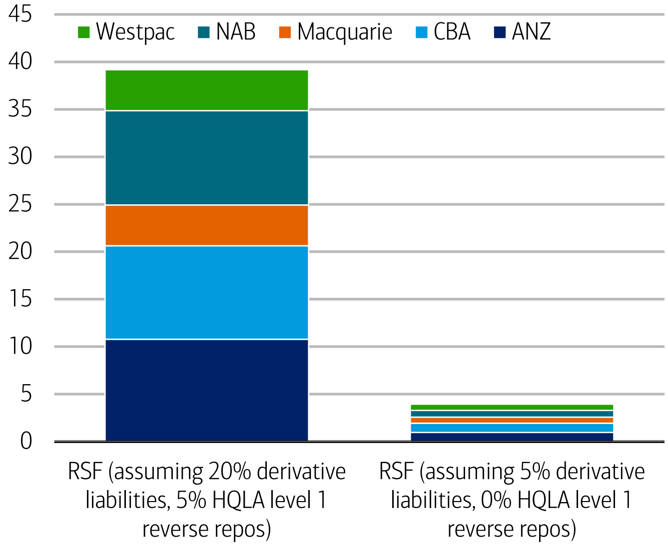
If APRA also reduced the RSF factor for derivative liabilities from 20% to 5%, the RSF for the five major banks would decline by a further 12bn. A reduction in derivative liabilities would also reduce the funding requirement created by interest-rate hedges (i.e. asset-swapping) on banks' bond portfolios. From the RBA's perspective, this shift could also be advantageous insofar as a move to encourage bond purchases should reduce banks' preference for holding cash at the RBA (although total ES balances can only be reduced through RBA QT – see Australia Rates primer on money markets and front-end rates in Australia.for a full explanation).

It is difficult to quantify the effects because it is not clear if banks would respond to higher regulatory ratios by reducing their funding programs or increasing their purchases of ACGBs or semis on asset swap. At current levels, the latter would provide some yield enhancement, especially if used to purchase semis. The bottom line, though, is that regulatory reform would likely be a tailwind for the bond market and see higher levels of asset-swap paying, which should see swap spreads move wider. If regulatory reform was

[2] Note: CBA's pillar 3 disclosures for Q1 '25 do not include NSFR data so we have used six-month averages for all five banks, including Q3 & Q4 '24 for CBA and Q4 '24/ Q1 '25 for all other banks.

coupled with a lower ES rate, we could also see a meaningful increase in demand for T-notes (AU equivalent of US T-bills) and the AOFM could choose to rely more heavily on short-dated funding to meet its annual funding task.

Exhibit 10: Impact of potential changes to NSFR requirements
Ali of c. AUD 15-20bn



Source: Bank Pillar 3 disclosures, BofA Global Research

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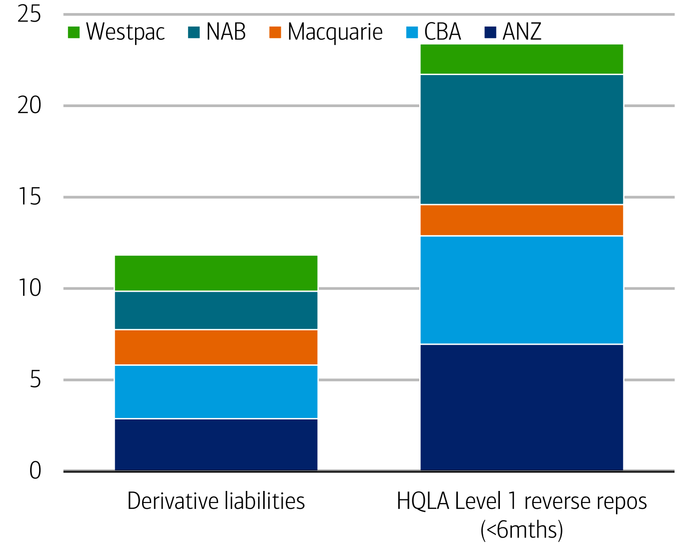
Exhibit 11: Potential reduction in required stable funding
No penalty for short-dated reverse repos = opportunity for lower ESA rates



Source: Bank Pillar 3 disclosures, BofA Global Research

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Pay 3y invoice spreads

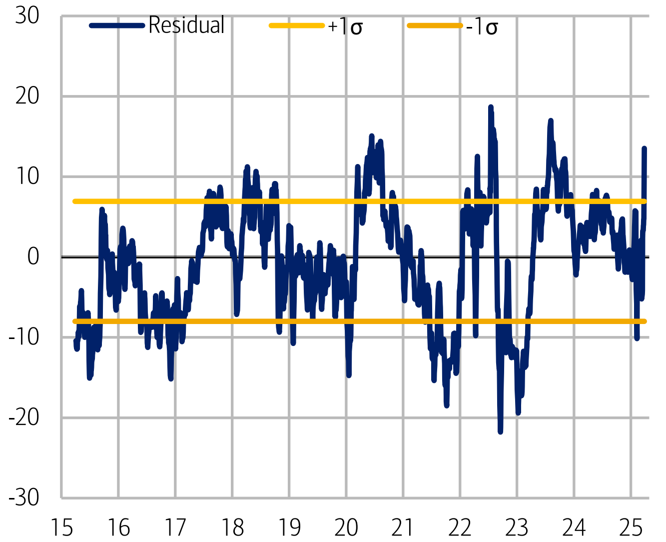
Given the multiple tailwinds for AUD duration, we are broadly constructive on swap spreads. We also see higher bills-OIS basis (BOB) as a downstream impact of the RBA's changes to its reserve management regime (Liquid Insight 01 May 2025). Given Australian swaps are still on the LIBOR standard, higher BOB should also mean bonds trade richer vs swap.

More fundamentally, though, the spread between 3y or 10y bonds and OIS are near all-time lows (Exhibit 15). Our swap spreads framework for 10y swap spreads suggests spreads are more than 1 standard deviation too tight (i.e. bonds are too cheap) vs fair value (Exhibit 12, Exhibit 13).

We generally prefer to buy 3y bond futures vs swap because the RBA owns 42% of the bonds in the 3y bond futures basket (Exhibit 14). The RBA will continue owning a high percentage of bonds in the 3y bond futures basket for the next few years, which should cap moves to the downside. Conversely, front-end swap spreads are more sensitive than long-end spreads to shifts in BOB so 3y swap EFP is better positioned to capture the upside from our forecast for higher spot BOB.

We specifically recommend paying 3y swap EFP (rather than buying cash bonds, paying swap) because 3y & 10y invoice spreads (i.e. swap EFP) are some of the most liquid fixed-income products in Australia. Entry: -9.5bps, target 10bps, stop: -19bps. Risk: a global sell-off in bonds, which drags invoice spreads lower.

Exhibit 12: AU swap spreads framework, residual
The framework is sending a pay signal (i.e. bonds are too cheap vs swap)



Source: Bloomberg

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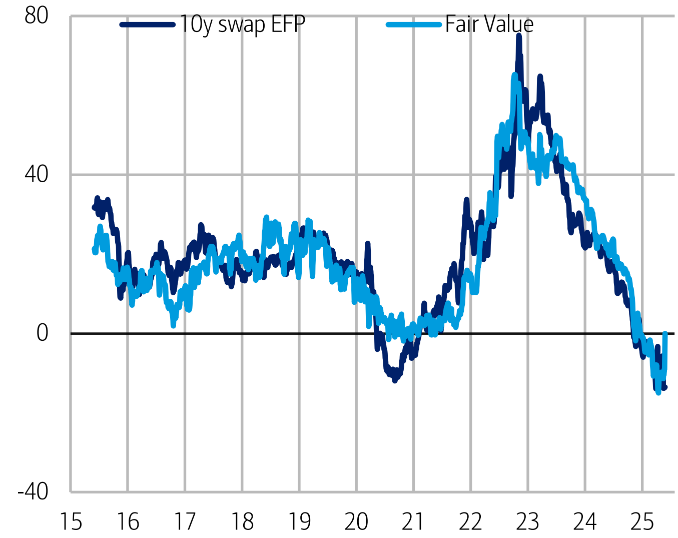
Exhibit 13: AU swap spreads framework
We see swap spreads as too negative



Source: Bloomberg

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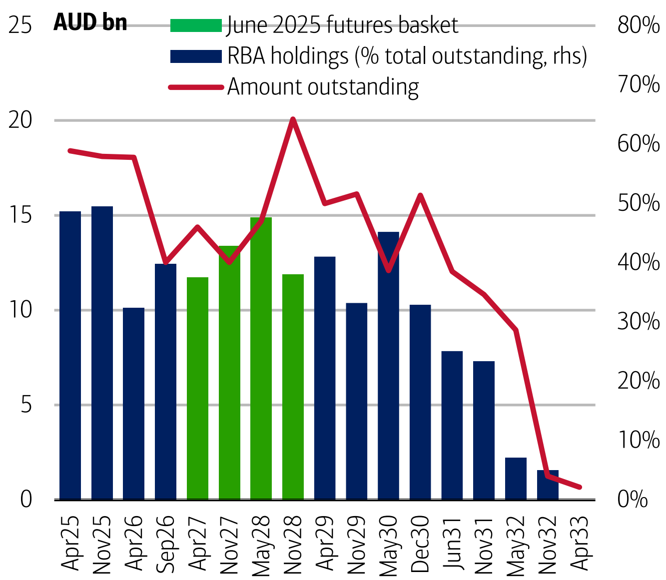
Exhibit 14: RBA ownership by bond line
RBA owns 42% of 3y bond futures basket



Source: ASX, RBA, AOFM

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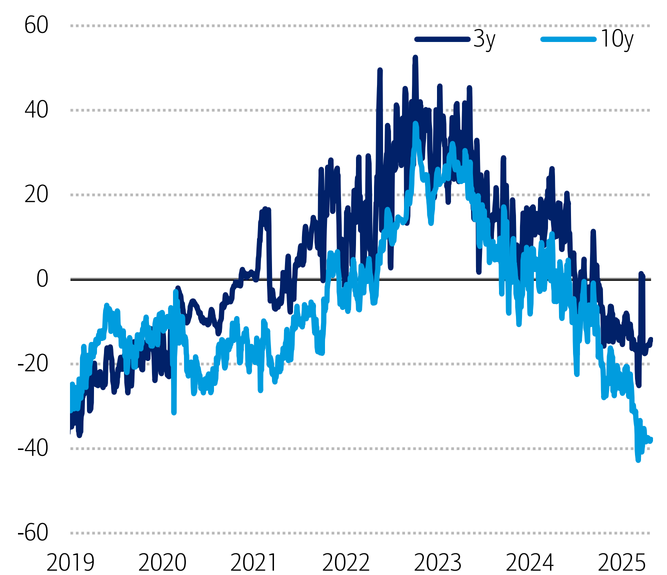
Exhibit 15: Bond-OIS spreads
Near all-time lows



Source: Bloomberg

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