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Global Rates Viewpoint

Deficit divide: sell US 10y invoice spreads vs AU

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Rates Strategy
Global

Oliver Levingston
FX & Rates Strategist
Merrill Lynch (Australia)
oliver.levingston@bofa.com

Nick Stenner, CFA
Australia & NZ Economist
Merrill Lynch (Australia)
nick.stenner@bofa.com

Ralph Axel
Rates Strategist
BofAS
ralph.axel@bofa.com

EFP = exchange of future for physical

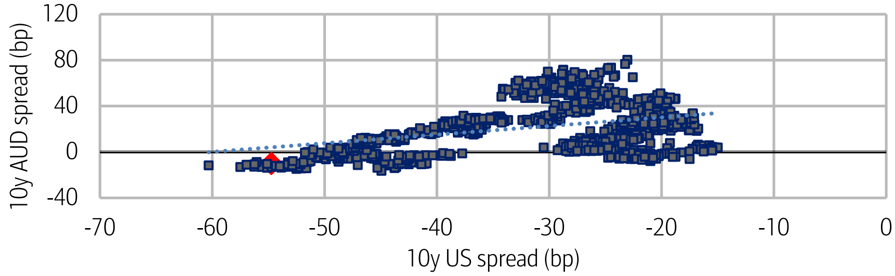
s/s = 6m AU bank bill swap rates, paid semi-annually

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

Deficit risks mispriced, spread of spreads looks stretched

We recommend selling US 10y invoice spreads (i.e. sell 10y UST future, receive 10y SOFR) and buying AU 10y invoice spreads/ swap EFP (i.e. buy 10y bond futures, pay 10y swap (s/s)). Entry 40bps, target 60bps, stop loss 25bps. Risk: more extensive US regulatory reform than we anticipate. In our view, there are higher downside risks for US deficits than for Australia. 10y AUD swap spreads also appear relatively tight (c. 7bps) on a regression versus 10y US swap spreads and on an outright basis in our AUD fair value framework (Exhibit 1, Exhibit 6).

Exhibit 1: 10y AUD spread is tight vs US 10y spread in the post-pandemic era
With 10y USD spreads at -55bp, history implies AUD 10y would be closer to 0bp.



Source: BofA Global Research, Bloomberg

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US: deficit expectations growing steadily

The US was recently downgraded by Moody's a single notch which we think underscores a trend of growing concern around US debt sustainability. The April 2 tariff announcement set off a 50bp rise in 10y rates even as the S&P declined. US 10y swap spreads tightened about 20bp in that episode as USTs underperformed swaps. These tightening episodes have become more common in flight-to-safety environments, and we like having upside exposure to future episodes.

AU: more constructive fiscal and spreads outlook

Government debt-to-GDP remains modest in Australia at around 50%, relative to 100% and rising in the US. Low government debt suggests fiscal headroom to respond to shocks and is a key factor supporting Australia's AAA rating. Projected deficits in Australia are also relatively modest around 1.5% of GDP, with near-term risks skewed towards smaller deficits, compared to US deficits c.6-7% of GDP.

We are constructive on AUD spreads for three reasons (1) possible bank deregulation could improve demand for AUD bonds, (2) robust demand for AUD bonds from global reserve managers and AU superannuation funds is likely to exceed supply by 2027/28 (3) LIBOR-OIS risk means AU spreads should widen in a risk-off episode (see report Australia Rates Viewpoint 28 May 2025).

US: deficit expectations growing steadily

The US was recently downgraded by Moody's a single notch which we think underscores a trend of growing concern around US debt sustainability. The deficit of course is a function of taxation vs spending. US govt spending is increasingly due to social welfare programs like health insurance and social security plus an interest rate expense component. These main components of spending comprise about 60% of total govt spending and are not easily controlled by Congress given the popularity of social welfare programs with voters and the inability of Congress to set interest rates. As a result, without substantial increases in tax rates over coming years, we see little scope for a reversal of the current trend.

In addition, the Treasury market has shown increasing sensitivity to flows. Most recently the April 2 tariff announcement set off a 50bp rise in 10y rates even as the S&P declined. US 10y swap spreads tightened about 20bp in that episode as USTs underperformed swaps. These tightening episodes have become more common in flight-to-safety environments, and we like having upside exposure to future episodes.

Budget talks in the US underway – expect late summer conclusion

The next few months will be key for the deficit narrative in the US. The debt ceiling raise and the federal budget will likely be passed together in a single bill that will set a 10-year budget plan. Earlier in the year, investors believed the incoming administration was determined to begin balancing budgets. The Department of Government Efficiency was seen as a sign of intention. But as budget talks developed, scope has increased for smaller spending reductions combined with larger tax cuts.

Much remains to be ironed out and we see the House bill as more of a symbolic gesture as the Senate bill will be much closer to actual legislation. If the Senate delivers even fewer spending cuts than the House, which is our expectation, it is possible that US swap spreads take another leg down as markets brace for bond vigilantes, potential additional downgrades, and increased concerns around the US commitment to fiscal sustainability.

AU: Deficits risks seem lower

Australia has a lower risk of unexpected deficit expansion than the US, in our view. Debt supply shocks have been a common theme of recent years in the US, and given current political openness to deficit spending, we think risks skew towards the US producing bigger deficit surprises than Australia. Australia's strong institutional frameworks and desire to keep it's AAA status implies a smaller risk of deficit surprises.

Australia's comparatively low debt suggests fiscal headroom

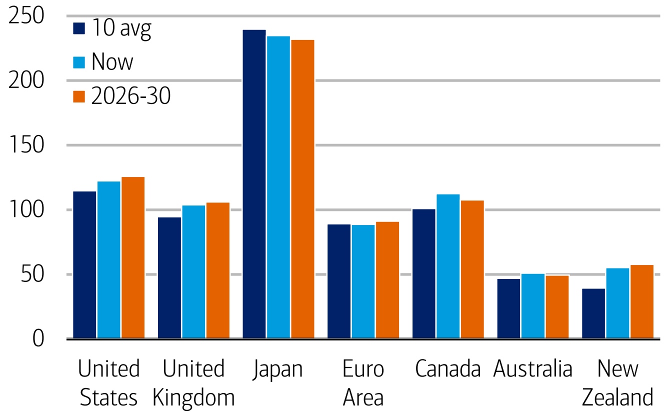
Australia's gross government debt remains modest relative to other countries at around 50% of GDP (Exhibit 2). Around 40% of Australian government debt reflects State governments, while gross Federal government debt is projected to peak at 37% of GDP in 2030 (net debt 23% of GDP). Low government debt suggests fiscal headroom to respond to future shocks and is a key factor supporting Australia's AAA credit rating.

By comparison, public debt-to-GDP in the US stood at 98% in FY 2024, which is up from 79% from FY 2019, and is set to rise further. Congress has been unfazed by fiscal sustainability concerns as the US recorded a deficit and primary-deficit to GDP ratios of 6.4% and 3.3%, respectively (see BofA - US Economic Viewpoint).

Two-sided risks to US deficits, while Australia's deficit may shrink in near-term

Our baseline expectation is for US deficit- and primary-deficit-to-GDP ratios of 6.9% and 3.5%, respectively, in FY26. We see two-sided risks to our baseline owing mostly to uncertainty over spending cuts. But even with more significant spending cuts, deficits should remain elevated compared to historical levels.

Exhibit 2: General government gross debt-to-GDP (%)
Australia government debt remains low relative to the US



Source: IMF WEO

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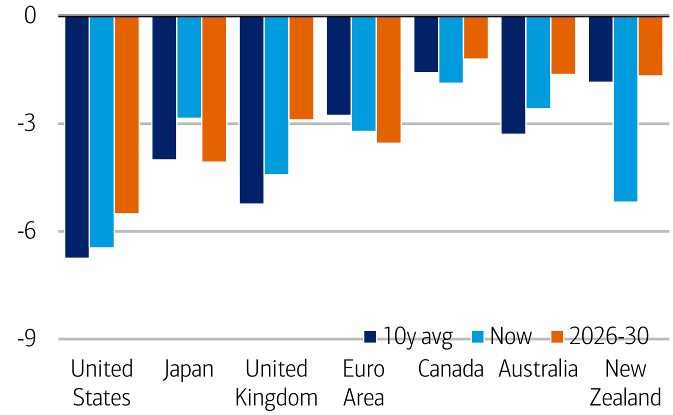
Exhibit 3: General government budget deficit-to-GDP (%)
Deficits set to decline, but Australia's is small relative to the US



Source: IMF WEO

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Australia's deficit-to-GDP is projected to average 1.6% of GDP to 2030 (Exhibit 3). Risks skew towards smaller near-term deficits, due to conservative commodity price assumptions. Iron ore is Australia's largest export by value (around 21% of total exports), and Budget forecasts assume a decline to US$60/tonne. This is well below our iron ore forecast of US$96/t in 2025 and US$90 in 2026 (BofA - Global Metals Weekly). A US$30/t upside surprise relative to Budget forecasts increases nominal GDP by $31bn and leads to A$6bn additional tax by 2028-29.

However, medium-term risks are skewed towards larger budget deficits given Budget projections hinge on no new spending initiatives, productivity growth rebounding to its long-term average, and no tax cuts to address bracket creep, all of which we view as unlikely (see Fiscal pulse: growth now, challenges ahead). Analysis by non-partisan think tank e61 shows the Budget deficit worsens by 2.6ppt of GDP in 2035 if productivity grows at 1% rather than the assumed 1.2%, defence spending rises to 2.5% of GDP from 2027, and governments give back bracket creep through tax cuts in line with historical patterns.[1]

Au spreads: 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 5). 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 4).

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 and an increase in demand for ACGBs from investors in South and Southeast Asia has more than offset a decline in investments from North Asia (likely life insurers and banks in Japan). We see this as a structural trend that is likely to continue for the foreseeable future.

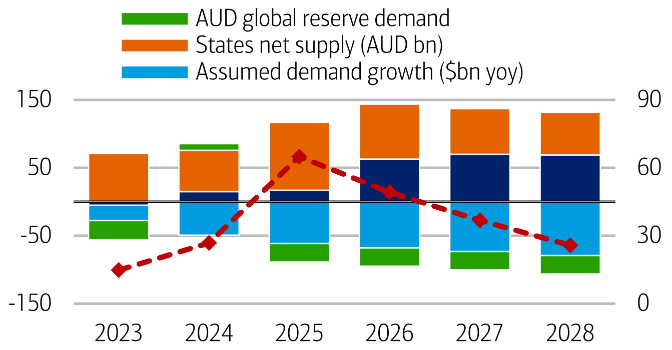
Regulatory change on the horizon?

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

[1] Assume a balanced Budget, Aaron Wong and Lachlan Vass, e61 Institute, 28 March 2025.

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 Australia Rates Viewpoint: pay 3y AUD invoice spreads 28 May 2025.

Exhibit 4: AUD bond demand to outstrip supply by 2028
Higher supply/ demand imbalance = higher excess supply



Source: IMF, Australian Office of Financial Management, State Funding Agencies,
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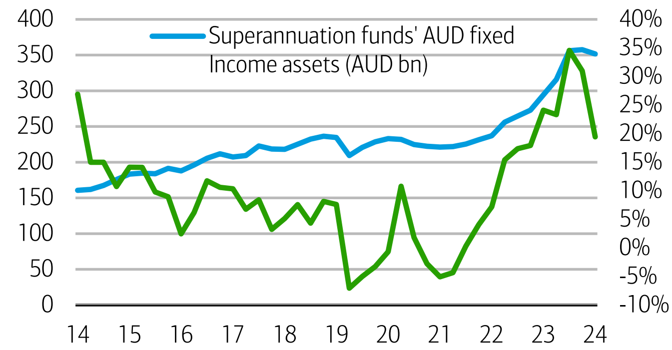
Exhibit 5: Super funds' fixed-income footprint has increased markedly
Super fund assets under management are increasing



Source: Australian Prudential Regulatory Authority
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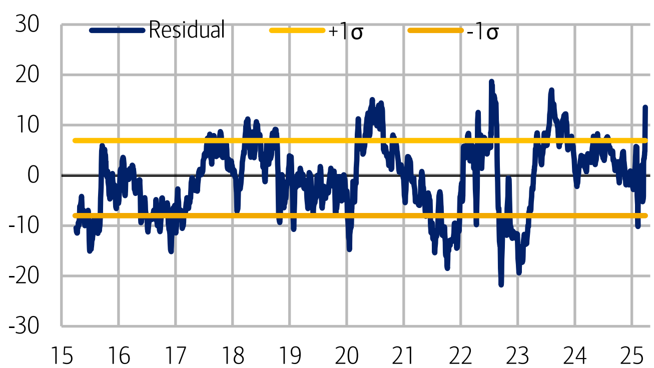
Fair value framework suggests paying spreads

Despite tailwinds for AUD bonds, the spread between 10y bonds and OIS is trading near all-time lows. 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, which is a pay signal (Exhibit 6, Exhibit 7). We specifically recommend paying 10y swap EFP (rather than buying cash bonds, paying swap) because 10y invoice spreads (i.e. swap EFP) are some of the most liquid fixed-income products in Australia.

Exhibit 6: AU swap spreads framework, residual (bps)
The framework is sending a pay signal (i.e. bonds are too cheap vs swap)



Source: Bloomberg
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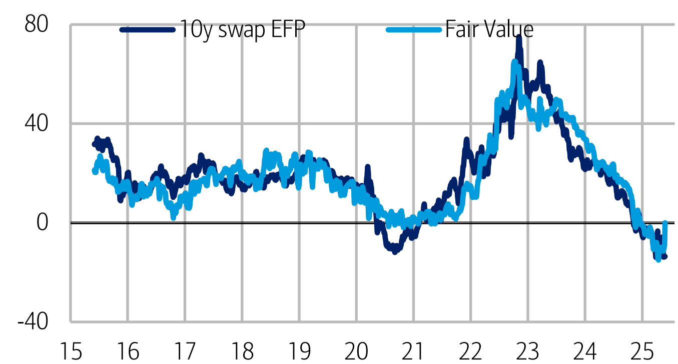
Exhibit 7: AU swap spreads framework (bps)
We see swap spreads as too negative



Source: Bloomberg
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