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Portfolio Perspectives

May 2026

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Key Messages for Investors

- It is important to distinguish between the cyclical and the structural. Markets will remain more volatile than usual while uncertainty around the conflict in the Middle East persists, but the structural outlook is constructive.
- The US reporting season has been exceptionally strong, the AI capex boom continues, and the consumer remains resilient. Reflecting this, US equities have outperformed and pushed to record highs.
- Domestically, the picture is more complicated. A cyclical slowdown is underway as inflation is too high and the RBA has tightened policy quickly, placing pressure on consumers. Australian equities have consequently underperformed.
- Even so, Australia's structural outlook remains positive, underpinned by balance sheet strength and a globally significant resource endowment.
- There are investment opportunities in this environment and pragmatic portfolio optimisation is warranted. But radical changes are rarely rewarded over the long run. We continue to expect near-term underperformance in Australian equities, while opportunities to add domestic duration should emerge over time.

Overview

The conflict in the Middle East has been a daily focus for global financial markets since late February. The duration of the war will determine its impact on the real economy and central banks' policy responses.

Tail risks are hard to price. Financial markets have been caught between solid underlying fundamentals, particularly in the US, and the risk that a prolonged closure of the Strait of Hormuz could materially disrupt global supply chains.

So far, the US equity market has focussed on the former, while the bond market is placing more weight on the latter.

The Australian story is more complicated, given elevated inflation before the war and the RBA's three 25bp rate increases so far this year. The 2026 Federal Budget added another layer of complexity, particularly given its likely implications for housing activity, credit demand and household confidence.

In this edition of Portfolio Perspectives, we look at the divergent performance of the US and Australian economies, the implications for markets, and the likely path over the period ahead.

US exceptionalism continues

The performance of US equities over the past month has been remarkably strong. During the first-quarter reporting season, 84% of S&P 500 companies that reported results beat analysts' estimates. To put that in perspective, that is higher than the five- and ten-year averages.

Earnings leadership was firmly tied to the AI ecosystem. Information technology and communications services delivered the strongest results, but financials also made robust contributions. Health care and energy were comparatively weaker.

Consumer discretionary earnings were mixed but generally stronger at the top end of the market.

The US economic data also supports the price action in equities. Retail trade was better than expected in April, despite consumers paying more for fuel. The labour market remains in good shape.

The Trump administration's immigration policy means the US labour force is growing much more slowly than before. The upshot is that the break-even level of job creation

required each month to keep the unemployment rate steady is lower.

In recent months, US employment growth has been healthy, and the US Fed's previous concerns about a loosening labour market have not materialised. The US unemployment rate ticked down by 0.1ppt to 4.3% in April, on a three-month average basis. Average hourly earnings were robust, up 3.6% over the year.

Looking ahead, the net fiscal impulse of the 'One Big Beautiful Bill' is estimated to be ~1% of GDP in 2026 and about half that in the following two years. Put simply, there is a fiscal tailwind for the US economy.

A solid income boost is flowing through to households from both labour income and tax cuts. This is supporting consumer spending and, by extension, corporate earnings.

From an equities perspective, this dynamic is constructive. In addition to the hyperscaler capex boom, a robust consumer supports a range of corporates in the US.

It's not quite the Goldilocks scenario, however, as inflation pressures have become less benign in the US. Both input and consumer prices are rising at a pace in the US that is inconsistent with the Fed's inflation target. This dynamic warrants close monitoring.

Over the past month, US money markets have shifted from pricing no change in the US Fed Funds rate to pricing one 25bp hike within a year. This move largely reflects the run of economic data and the balance of risks. Notwithstanding, most analysts still expect the US Federal Reserve not to increase the policy rate.

The US bond market has sold off over the past two months. The key 10-year Treasury yield has risen by ~50bp since early March and is now oscillating around 4.5%. The back-up in the US 10-year yield has not been

solely a Fed repricing story. Term premia have risen, reflecting investors demanding greater compensation for duration risk. In addition, the move reflects a broader repricing of fiscal sustainability and the unresolved oil-related inflation risk.

The US bond market looks fairly priced at this juncture, in our view, given the variety of forces feeding into current pricing.

Finally, we note that the new Federal Reserve Chair, Kevin Warsh, is now at the helm, and his first meeting as Fed Chair will be in June. Markets will closely watch any signals on the Fed's tolerance for inflation above target and the balance between inflation and growth risks under the new leadership.

In summary, our base case is that the US economy will continue to perform well in 2026 and that equity prices will remain well supported. The key downside risk is that the conflict in the Middle East drags on, oil takes a material leg higher, and that drags equities lower and pushes bond yields higher.

Australia

As my colleague Deanne Baker noted in the April edition of Portfolio Perspectives, the domestic picture is less comfortable.

That observation has so far been reflected in the recent run of domestic economic data, further RBA tightening, and the underperformance of Australian equities.

The tax reforms around negative gearing and capital gains tax in the 2026 Commonwealth Budget added to this discomfort, largely because of their impact on credit demand and the outlook for home prices. But we aren't concerned about the impact of the Budget reforms on the treatment of capital gains themselves from an equities valuation perspective (more on that below).

Australian equities, as measured by the ASX200, have been essentially flat over the

past month. However, sector performance has been markedly divergent. Resources stocks have significantly outperformed, thanks to higher commodity prices. Consumer-facing stocks have struggled, as have financials.

Another way to look at it is that stocks more exposed to domestic demand have been under pressure. In contrast, our exporters, which are largely commodity-based, have fared well.

The reasons are straightforward. The RBA's three 25bp rate increases so far this year will slow domestic demand by moderating consumer spending growth, which will weigh on earnings. In contrast, elevated commodity prices are supporting earnings growth in our export sector.

The RBA is currently in inflation-fighting mode, and monetary policy is restrictive. This means the domestic economy will grow below trend this year, and unemployment will rise.

A loosening in the labour market contains wage pressures, and higher mortgage repayments constrain households' ability to consume. Real household disposable income growth ultimately slows, limiting firms' ability to raise prices. In time, inflation falls and the RBA achieves its inflation objective.

But the process is somewhat protracted, meaning 2026 will be a tougher year for the Australian economy than the prior year. The war in Iran and the resultant oil shock have simply made the RBA's job harder and created additional uncertainty for households and businesses.

Further rate increases by the RBA at this juncture will accelerate the return of inflation to the target band. But it will mean greater economic hardship in the short term. It is unclear at this stage how much more tightening the RBA will implement and at

what pace. The money markets currently have one more 25bp rate hike priced, though this has been pared back over the last few weeks as a softer tone in domestic economic data has become apparent.

We stress that this process of moving monetary policy into restrictive territory is cyclical. Monetary policy will not remain restrictive indefinitely, and economic growth will return to a trend-like pace of around 2% per year once the RBA is in a position to start loosening policy again. But at this stage, that looks like a story for 2027.

The Australian bond market looks attractive further out on the curve. The 10-year bond yield is hovering around 5%, offering a ~50-bps spread to the US. There is likely to be a good opportunity for investors to add duration over time. But we would caution against moving too early, given the risk that the conflict in the Middle East drags on and oil prices push higher.

The Federal Budget and equity market implications

The 2026 Budget's tax reforms were primarily revenue-raising measures. The changes to capital gains tax and negative gearing make housing less attractive as an investment (although new builds will still be eligible for negative gearing). Over time, these changes improve the Budget's bottom line.

Will they help first home buyers? Yes, at the margin, as they should place modest downward pressure on house prices relative to no policy change. But the broader mismatch between underlying housing demand and supply will remain, driven by strong population growth relative to the economy's capacity to deliver new housing.

From a credit perspective, there will be less new lending to investors, which will keep overall growth in system credit and broad money lower than otherwise. Slower credit

growth weighs on bank earnings, and this has pushed our domestic bank share prices lower. Additional provisioning for bad loans has also contributed.

There has been discussion that changes to CGT could increase investor preference for stocks with franked dividend streams relative to growth stocks, potentially altering relative valuations. On that basis, there should be some form of price adjustment, either in the short run or over time.

We believe that rationale is flawed, however, because it implicitly assumes the Australian equity market is closed, with all investors facing the same taxation regime. Our market is not. Capital flows freely, and a tax distortion affects only one investor cohort. If there are unconstrained investor cohorts – notably foreign investors and super funds – relative prices should adjust until after-tax returns equalise.

In practical terms, unless domestic investors affected by the tax changes dominate marginal pricing, the long-run valuation effects should largely wash through. That is, it looks beyond the first-order impact to the equilibrium effect, where foreign capital, super funds and other investors not subject to the tax changes partially or fully offset shifts in domestic household behaviour.

The upshot is that we do not think the tax changes in the Budget, outside the banking sector, affect relative valuations. They may simply shift the composition of ownership across the market at the margin.

Concluding thoughts

Periods of heightened uncertainty often create the greatest temptation to become overly defensive. History suggests that approach is rarely rewarded over the long run. While cyclical risks remain elevated, particularly amid uncertainty in the Middle East, we continue to believe that disciplined

diversification and selective portfolio positioning remain the most appropriate strategy for long-term investors.

It is important to look beyond the first order of events and be cognisant that the role of policymakers is, among other things, to solve problems and restore economic balance.

Markets can shift and reprice very quickly, which is why we do not believe investors should attempt to time the market aggressively. At present, we remain cautious on Australian equities while continuing to monitor opportunities to add duration as the inflation and geopolitical outlook becomes clearer.

Portfolio Perspectives

May 2026

Growth Assets Outlook

Asset Class	Outlook Negative ← → Positive				Comments
Growth Assets					Despite geopolitical risks, the broader macro backdrop remains supportive, particularly in the US. We recommend remaining invested in growth assets but adjusting portfolios for improved inflation resilience if the dispute drags on.
Australian Equities (incl. Australian Smalls)					Restrictive monetary policy is weighing on the outlook for Australian equities and earnings. Changes announced in the Budget around negative gearing and capital gains tax will slow credit growth. And elevated inflation is a key risk that could result in further RBA tightening.
Global Equities					We remain neutral global equities with strong earnings momentum offset by rich valuations. Sector opportunities within are nuanced by the risk of inflation as conflict continues in the Middle East, and the question of AI disruption to business models over the medium to long term.
Emerging Markets Equities					Earnings growth continues to accelerate across emerging markets. The AI capex boom is increasingly providing a tailwind for technology-focused emerging markets, particularly those integrated into the global semiconductor supply chain.
Property					Global Listed Property valuations are attractive in comparison to global equities. The challenges on growth and supply are fading.
Infrastructure					Structural tailwinds exist leading to an expansion in the asset base. Increased capex sets the sector up for a lower dividend yield but higher growth outlook. We maintain our overweight with the view the sector has further outperformance potential.
Value vs Growth					Remain neutral, valuations on growth companies have become closer to fair, however higher rates and the AI disruption theme may provide further downside.
Quality vs Cyclical					We observe superior long-term risk adjusted returns from quality companies. The recent underperformance of quality style managers may offer an attractive entry point. An economic slowdown in Australia would see quality outperform. We remain positive Quality.
Global Small vs Large					Small Caps represent attractive relative value, have historically delivered strong trend EPS growth, and the recent broadening of earnings growth are all supportive. A higher inflation and rates environment represents a risk, in an otherwise supportive setup for small caps.
FX Hedging (AUD view)					At 72c the AUD is near long term PPP. A firmer terms of trade due to higher commodity prices is supportive of the Australian dollar. But that is offset by a relatively weaker growth outlook for Australia vs the US and narrowing in interest rate differentials.

Defensive Assets Outlook

Asset Class	Outlook					Comments
	Negative ←		→	Positive		
Defensive Assets						
Australian Duration (incl ILBs)						Australian duration offers attractive value at near 5% YTM. A slowdown in Australian growth would likely see Australian Fixed Income outperform, particularly if the unemployment rate is on a clear upward trend.
Global Duration (incl. TIPS)						Once AUD hedging is included, the all in yield on global fixed income has become attractive. While risks remain for global inflation volatility and lack of fiscal discipline a concern, a YTM of 5.5% for Global Aggregate as fair compensation for these risks. We are neutral.
Australian IG Credit						Credit spreads remain tight. Excess returns are at the lower end of historical ranges. We remain neutral in recognition of more modest forward looking return expectations.
Global IG Credit						Global spreads are at extremely tight levels. We acknowledge less 'spread risk' in IG compared to High Yield and therefore are comfortable to remain at neutral.
Global High Yield Credit						High yield credit spreads are at near all time lows. Historically at spreads this tight, high yield bonds have underperformed cash in the following 1-2 year period.
Absolute Return (Fixed Income)						With cash rates and bond yields above multi-decade averages, we see less need to pursue returns via absolute return strategies.
Cash and Enhanced Cash						Cash can serve as a useful short term tactical defensive exposure while credit spreads are tight.

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