Portfolio Perspectives

July 2026

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Key Messages for Investors

- The geopolitical backdrop has improved materially given the US and Iran have signed a peace agreement. But it is premature to conclude that energy market risks have fully dissipated.
- The US Federal Reserve has taken a hawkish tilt under new Chair Kevin Warsh and the hurdle for policy tightening in the US appears to have been lowered.
- We remain constructive on US equities while earnings momentum holds, but the margin for disappointment has narrowed.
- Australian equities continue to face a less favourable macro mix given expectations of slowing demand, a softening housing market and a still-hawkish RBA. We are cautious on Australian stocks.
- Australian duration has performed well, but the valuation case has moderated and the spread to US treasuries has narrowed.

Overview

The geopolitical backdrop has improved materially following the peace agreement signed by the US and Iran. Oil prices have declined considerably, reducing the risk that a sustained energy price shock feeds into global inflation.

While this is clearly a positive development for central banks and financial markets, it would be premature to conclude that energy market risks have fully dissipated. Oil prices are likely to remain volatile in the near term given the potential fragility of the ceasefire as well as ongoing uncertainty around shipping, demining operations and the extent of damage to regional energy infrastructure.

In this edition of Portfolio Perspectives, we look at the outlook for monetary policy in the US under new Fed Chair Kevin Warsh and the implications for markets. We also take the pulse of the Australian economy and how it aligns with the outlook for domestic monetary policy and local equities.

The Fed enters the Warsh era

The 17th Chair of the US Federal Reserve, Kevin Warsh, wasted little time putting his stamp on the Fed's communication strategy in June. Indeed any speculation that Warsh would adopt a dovish stance because of his appointment by President Trump was quickly dispelled.

The FOMC's prior easing bias was dropped, as expected, but the first meeting under Warsh's leadership placed noticeably greater emphasis on price stability and less prominence on the employment side of the Fed's dual mandate.

The upshot is that market participants have assessed Warsh's resolute commitment to return inflation to the 2% target as hawkish. US money markets now fully price a 25bp increase in the Fed Funds rate by year-end and ~40bp of cumulative tightening over the next two years.

Shifts in expectations for the path of US monetary policy over the recent past have seen short end rates rise more than long end rates, otherwise known as a bear flattening move in the yield curve.

A flatter yield curve has historically made equity markets less forgiving of stretched valuations. We are very cognisant of that risk given the equity risk premium sits at very low levels. For now, however, strong earnings growth, historically high profit margins and a deep pipeline of capex continue to support US equities despite a more testing interest-rate backdrop.

The strength of US activity data also lends support to the stock market. Growth in employment has been robust and has kept pace with labour supply meaning the unemployment rate has been little changed in recent months at 4¼%.

Consumer spending has also been firm as proxied by solid growth in both real spending and nominal retail sales. Productivity growth is also strong.

The inflation data, however, has moved into territory that historically concerns the Federal Reserve. The core PCE deflator, the Fed's preferred measure of inflation, increased to 3.4%/yr in May. And the six-month annualised pace has lifted to 4.1% (the spread between six-month annualised and the annual rate provides a useful guide on the strength of the inflation pulse). A six-month annualised pace of core inflation with a 4-handle on it is unambiguously strong.

Context is always important. Elevated inflation is a more manageable problem for a central bank when activity growth remains firm. It means there is likely scope to slow growth in prices through tighter monetary policy if needed, whilst retaining positive momentum in the economy. That is the situation we believe the US economy is in right now.

Notwithstanding, US equities are priced for a benign outcome in which earnings remain strong, margins stay high and the Fed can tighten policy if required without derailing growth. The risk for market participants is that inflation remains sticky and earnings momentum fades. We don't see that risk materialising, but it warrants close watching given the valuation cushion is thin.

Warsh to take a 'less is more' approach to communication

The early indications from Chairman Warsh point to a communication strategy that will be more succinct and place less emphasis on forward guidance.

A lack of forward guidance raises the probability that rates markets will be more volatile to incoming economic data. That could have a knock-on impact to equity market volatility. It also increases the risk that the FOMC 'blind-sides' the market if the Fed's reaction function to the economic data is not well articulated and understood.

It is still very much early days for the FOMC under Chairman Warsh and we will learn more about his approach to the setting of policy and communication over the coming months.

The RBA faces a difficult policy choice from here

The Australian economy is pushing against the headwinds of restrictive monetary policy, elevated inflation, weak productivity growth and a quickly weakening housing market. But working the other way is a still tight labour market and decent growth in nominal income, which is supporting consumer spending. Indeed household expenditure in May was much stronger than expectations.

There is a big gap between how households feel about the economy, as measured by incredibly weak reads on consumer sentiment, and what they are doing. Words and actions are not aligned at this point. The local equity market already appears to be pricing some slowdown in domestic demand, but not necessarily the full adjustment the RBA may need to engineer.

The RBA left the cash rate on hold, as was universally expected in June. Recall that the RBA has previously increased the cash rate by 25bp in February, April and May (three consecutive meetings). A pause in that context was an orthodox move.

The June pause has reinforced the market's view that the tightening cycle is likely complete. But we are less convinced. Historically, pauses following a series of rate increases have not necessarily marked the end of a tightening cycle, particularly when inflation risks remain elevated. For context, since inflation targeting began, there have been only a handful of tightening episodes involving four or more consecutive rate increases.

We believe the RBA will need to engineer a material slowdown in demand growth in the economy to return inflation to the target band in an acceptable timeframe. We take that view because the supply side of the economy is constrained, productivity growth is low, government spending is high and labour costs are elevated. Indeed the margin of error for the RBA is small and the risks are two-sided.

If policy remains too restrictive for too long, growth could stall and unemployment rise materially. But if policy is not restrictive enough, inflation may fail to return to target, delaying the adjustment required to restore price stability.

The balance of risks faced by the RBA and their likely reaction function to the incoming data leads us to believe that another increase in the cash rate is more likely than not. But it's likely to be a finely balanced call.

The equity market implication is that domestically focused sectors remain exposed to further earnings pressure if policy needs to tighten further. And the demand for credit will be softer over the period ahead due to changes in the Budget around negative gearing and capital gains tax. The potential impact of further monetary policy tightening from the RBA on the bond market is more nuanced.

Last month we noted that the Australian bond market looked attractive further out on the curve given the 10-year bond yield was hovering around 5%, offering a ~50-bps spread to the US.

That spread has now narrowed to ~30bps, primarily because of a rally in the Australian 10yr bond yield to ~4.8%. The spread between the 10yr bond yield and the cash rate has also compressed since late April.

The re-emergence of term premium makes a materially inverted yield curve less likely, limiting the scope for long-end yields to rally unless the growth outlook deteriorates more meaningfully. Such an outcome could materialise if monetary policy needs to move further into restrictive territory. We are monitoring this dynamic closely.

Asset allocation implications

Our base case remains that earnings momentum outweighs valuation concerns. We note that valuation risk has increased due to low equity risk premium, but consider the macro and corporate environment to hold sufficient momentum at this juncture to support US stocks.

We see enough headwinds in the domestic economy to remain cautious on Australian stocks, particularly given our thoughts around the skew of risks for the RBA. But we are seeing some value in resources exposure as the war premium has now been removed from valuations. The depreciation of the exchange rate over the past month is also a tailwind for our export sector.

Australian duration provides portfolio protection if growth weakens, but the valuation case is less compelling than it was when the 10-year yield was near 5%.

In our view, the investment environment continues to reward selectivity over broad market exposure. Strong earnings, disciplined valuation analysis and an understanding of central bank reaction functions remain critical for portfolio construction.

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.
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 and the question of AI disruption to business models over the medium to long term.
Emerging Markets Equities		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		Stay neutral. Small Caps have historically delivered strong trend EPS growth, and the recent broadening of earnings growth is supportive. A higher inflation and rates environment represents a risk, in an otherwise supportive setup for small caps.
FX Hedging (AUD view)		At 69c the AUD is near long term PPP. The AUD has fallen recently due to a relatively weaker growth outlook for Australia vs the US and narrowing in interest rate differentials. If the RBA tightens policy again it will put upward pressure on the AUD given it is not currently priced.

Defensive Assets Outlook

Asset Class	Outlook Negative ← → Positive	Comments
Defensive Assets		
Australian Duration (incl ILBs)		We retain a slight overweight in Australian duration as it provides portfolio protection if growth weakens, but the valuation case is less compelling than it was when the 10-year yield was near 5%.
Global Duration (incl. TIPS)		Once AUD hedging is included, the all in yield on global fixed income has become attractive at a YTM greater than 5.0%. While risks remain for global inflation volatility and lack of fiscal discipline a concern, current yields offer 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 remain 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.