EVIDENTIA GROUP

LIS LONSEC INVESTMENT SOLUTIONS EVIDENTIA PRIVATE Implemented Portfolios

# Portfolio Perspectives

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# Key Messages for Investors

- The fluid geopolitical backdrop due to the ongoing US-Iran conflict is complicating the outlook for inflation, growth and monetary policy.
- Global equity investors are largely looking through events in the Middle East, given the much bigger medium term thematic of AI capex. We maintain a balanced exposure to US equities.
- US earnings are growing a lot faster than nominal GDP growth would normally imply. The strength is real, but an unusual dynamic has propelled earnings growth to a rate we expect to slow before the capex cycle peaks. Expect larger swings in EPS than the macro backdrop would normally produce.
- Headwinds remain domestically and we retain our cautious stance on Australian equities. That is a view based primarily on the outlook for the macro economy.
- The sharp rally in emerging market equities over an extended period removed the valuation case for an overweight without creating one for an underweight. We have moved back to neutral.

**Macro Overview**

Global financial markets are navigating the cross currents of renewed geopolitical uncertainty, resilient US growth, the AI investment boom and the prospect of higher interest rates.

Despite an escalation in the US-Iran conflict and a resurgence in the price of oil, recent equity market volatility has been around its long run average. But global bond yields have shifted higher due to the threat of elevated inflation and central bank policy tightening.

From a portfolio perspective we maintain a neutral stance on US equities. The scale of the AI investment underway continues to support corporate profits, productivity and the broader economy. And as we set out below, the current strength in earnings has identifiable drivers. But that impulse will eventually fade and that could look more dramatic in the earnings data than in the economic data.

Our assessment of the domestic landscape has not changed and we remain cautious on Australian equities. With underlying inflation still above target the RBA needs a period of below trend growth to bring it back into the target band. That outcome is the objective rather than a by-product. Whether it comes from policy already at a restrictive setting or requires further tightening is secondary, though we lean towards the latter. Either way the economy needs to slow. And we expect subdued growth in FY27.

Housing is a further headwind. Higher rates are already weighing on prices. And the Budget changes to negative gearing and capital gains tax add to that by slowing the rate of credit growth. That in turn will weigh on bank earnings.

**Feature Article - Why are US earnings growing so much faster than the economy?**

This month we unpack why US earnings growth has been so much stronger than the underlying economy would imply. EPS growth has reached levels normally seen only coming out of a recession, driven by features specific to this investment cycle. The gap is wide enough that a reasonable investor might conclude the earnings cannot be real.

They are real. And the drivers can be identified. But they are not stemming from the typical economic cycle. Rather they are being driven by a unique investment boom that carries a second implication. The boost to earnings growth will eventually unwind, and that will not require the business cycle to turn. Put another way, investors should expect larger swings in earnings over the next few years relative to what the macro backdrop would normally produce.

**The earnings and GDP disconnect**

The US economy is in solid shape. The labour market is balanced, growth in consumer spending is robust and overall economic expansion is decent. But earnings are growing well beyond what that backdrop would normally produce.

Earnings across the economy should track nominal GDP as their natural anchor. And operating leverage amplifies that into faster earnings growth as a portion of the cost base does not scale one-to-one with revenue (i.e. it is fixed). That amplification is a normal and structural feature of the relationship.

But the gap today between nominal GDP growth and earnings growth is unusually large. For context, nominal GDP grew 6.1%/yr in Q1 26, which is an outcome that would normally be consistent with forward EPS growth in the high single digits to mid-teens. Instead, forward EPS growth is running at ~30%.

Consensus expectations for nominal GDP growth in the US are close to its current rate. So it is not a case that the US economy is anticipated to go through a period of abnormally high growth.


*Source: Bloomberg*

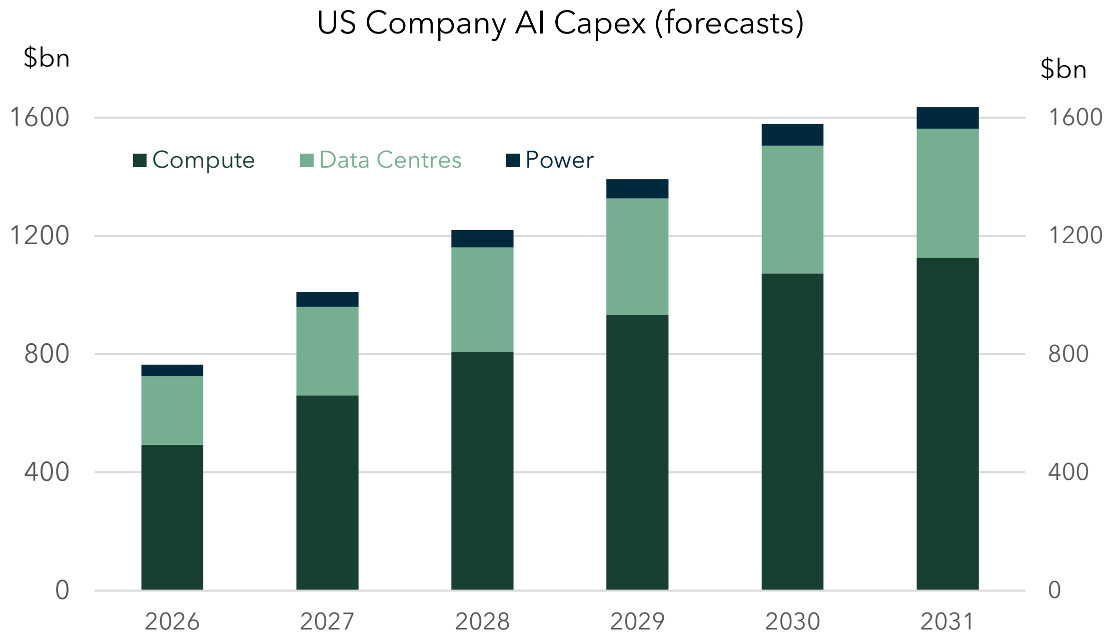
**Unpacking the disparity**

In our view, there are two genuine factors that explain the current disparity between earnings growth and the US economy. The first is that the S&P 500 is not a pure play on the US economy. And the second is the AI investment cycle, which impacts reported earnings through several channels at once.

On the first, approximately 40% of S&P 500 revenues are generated overseas. So US output does not bound revenue growth. But the more important point today is sectoral.

The S&P 500 currently carries a far higher weighting to tech than tech's share of output in either the US or the global economy. That gearing augments the effect of the AI cycle on index earnings relative to its effect on economic activity. It will also amplify the earnings unwind as capex growth slows. Composition is the channel. The AI cycle is the impulse.

What makes the AI rollout different from other large investment cycles is that much of it occurs within a single ecosystem. Hyperscalers are investing unprecedented amounts in AI infrastructure, while many of the suppliers of semiconductors and networking equipment are constituents of the same sector. Capital expenditure by one part of the sector becomes revenue for another almost immediately. The benefit is not confined to the US, flowing through to other tech-heavy markets, notably Japan, South Korea and Taiwan.




*Source: Goldman Sachs*

The timing of recognition on each side is not symmetric. Suppliers recognise revenue and profit immediately. But the hyperscalers funding the investment capitalise the expenditure and depreciate it over several years. This means that the cost does not hit the income statement at the point of spend. At the index level this opens a window in which the earnings benefit is recognised well ahead of the associated cost.

Because the spending circulates within the sector, the cycle surfaces in the earnings data in a few places. It shows at the top line, where the recent acceleration in index revenue growth is particularly strong in the supplier cohort. It shows in margins, where forward adjusted net profit margins are at a record 15.7% against a long run average of 10.4%. In contrast, the equal weight index sits at 10.7%, indicating the expansion is concentrated. The recognition asymmetry amplifies EPS and margin expansion because the revenue and profit arrive ahead of the matching cost.

**The capex cycle will dictate the earnings swing**

When capex growth slows, as it eventually must, supplier revenue growth decelerates just as the accumulated depreciation charge on the hyperscalers' expanding asset base builds.

Earnings respond to the growth rate of capex rather than its level, so the peak in earnings growth should coincide with the peak in the growth rate of investment rather than the level. Whether the slowdown in earnings growth is modest or substantial will depend largely on one question: how strong is the return on investment?

If AI generates sufficient incremental revenue, the depreciation flowing through hyperscalers' income statements will be offset and the slowdown in earnings growth should be modest. If not, supplier revenue growth will be fading at the same time depreciation is rising, amplifying the earnings slowdown.

It also matters where any adjustment lands. The suppliers have already banked their profits in cash. The hyperscalers carry the asset. If returns disappoint, the cost sits with the buyers of the equipment rather than the sellers, which is the reverse of where the earnings benefit has accrued so far.

**What this means for portfolios**

Strong US earnings growth is better grounded than a headline comparison with nominal GDP would suggest. The earnings are real. But reported earnings in the US tech sector, and by extension the S&P 500, currently flatter the underlying run-rate due to the AI investment boom. That story will unwind as the capex impulse fades.

Earnings have therefore become a less reliable guide to the macro cycle in both directions. The surge in EPS did not tell us the economy was booming. And the earnings deceleration, when it comes, will not on its own tell us the economy is softening.

A material slowdown in EPS growth from these levels could happen against a perfectly reasonable economic backdrop. That said, a genuine economic downturn would still show up in earnings, so the signal does not disappear. But it carries a much larger non-cyclical component presently due to the idiosyncratic impact of AI capex on earnings.

Our balanced stance on US equities takes into account the earnings story articulated above. The earnings are real, which is why we are not underweight. But with margins at record levels and US bond yields moving higher, earnings and valuations look more critical to the outlook for returns than the US macro story.

In contrast, our cautious stance on Australian equities is more aligned to our macro call, given the domestic economic outlook is where the pressure lies.

Finally, the AI-related rally in emerging markets over an extended period has removed the valuation case for an overweight without creating one for an underweight. We are therefore neutral.

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## Growth Assets Outlook

| Asset Class | Outlook<br>Negative ← → Positive | Comments |
|---|---|---|
| **Growth Assets** | | **The strength of earnings growth and the increasing demand created by the AI CAPEX boom are supportive of growth assets. We recommend remaining invested in growth assets in line with long term strategy.** |
| 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 | | We moved overweight in October 2025 acknowledging the AI capex boom as an opportunity for technology-focused emerging markets, particularly those integrated into the global semiconductor supply chain. This has now played out and take profits as memory and chip prices hit extremes. |
| 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. Driving value vs growth is the AI trade, with CapEx being spent by the hyper-scalers, and being received by the memory and chip producers, datacentre construction, critical minerals, and many other industries. Also remain neutral to Evidentia's AI Risk Measure. |
| 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 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. We recommend a modest exposure – depending on your SAA this may involve a modest overweight or neutral position. |
| FX Hedging (AUD view) | | At 70c 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. We expect medium term cash rate differentials to continue to fall based on our view of a weaker Australian economy, which would put further downward pressure on the AUD/USD. We remain neutral but with increasing caution. |

# Defensive Assets Outlook

| Asset Class | Outlook Negative ← → Positive | | | | | Comments |
|---|---|---|---|---|---|---|
| **Defensive Assets** | | | | | | |
| Australian Duration (incl ILBs) | | | | | | We recommend an overweight in Australian duration as it provides portfolio protection if our view of weaker growth plays out. |
| 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 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. |