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Portfolio Perspectives

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Key Messages for Investors

- We remain fully invested, while rebalancing the sources of interest rate risk across portfolios.
- Global growth has proven more resilient than many expected. Four major investment cycles are underway simultaneously: artificial intelligence, the energy transition, defence spending and onshoring. Collectively, they are underpinning global growth despite higher interest rates.
- Inflation and bond yields have risen. This investment boom is driving competition for constrained supplies of power, materials and labour. Global bond yields are now at their highest levels in well over a decade.
- Australia stands apart. Domestic monetary policy is now restrictive and economic activity is moderating. We expect these conditions to place downward pressure on Australian bond yields over 2027.
- We are increasing our allocation to Australian bonds and reducing global bonds. Overall fixed income exposure is unchanged; we have adjusted its composition.
- We are reducing exposure to the most rate-sensitive assets. Historically, global small companies and global listed property have underperformed following sharp rises in bond yields.

Macro Outlook

We see a world of firmer growth, stickier inflation and interest rates that stay higher than in the last cycle. Business and government investment has become the main engine keeping the global expansion on track. Manufacturing and services activity across major economies remains stronger than conventional economic models would predict, a sign that this cycle is being driven by structural investment rather than traditional consumer demand.

At the centre of this resilience is a surge of capital into four transformative, multi-year themes: artificial intelligence infrastructure, defence rearmament, energy transition and supply chain reshoring. Trillions of dollars are being committed across these areas. Because much of this spending is shaped by government policy and national security priorities rather than the cost of borrowing, it is less likely to be scaled back as interest rates rise. Notably, manufacturing is now expanding simultaneously in the US, Japan, Europe and emerging markets, a relatively uncommon alignment that has historically signalled a durable upswing.

Together, these forces are providing substantial support to global activity and employment, helping to offset a more mixed outlook for the consumer.

Consumer dynamics are defined by a stark K-shaped divide across households. U.S. consumer sentiment plummeted in September with the Conference Board index falling 6.7 points to 81.9, its lowest level since 2014. Headline spending has however, remained surprisingly robust, accelerating to a 3.8% annualized rate in Q2 (up from 0.7% in Q1). This apparent disconnect is driven by the upper arm of the K: asset-rich households buffered by wealth effects from equity markets, higher savings yields, drawn-down excess savings, and tax refunds are doing the heavy lifting to keep overall consumption resilient. Meanwhile, lower- and middle-income households in the lower arm face real strain under the weight of persistent inflation, elevated interest rates, and higher fuel costs with little financial buffer.

Consumption is roughly 70% of US GDP, so the key risk is whether spending by higher-income households holds up. If equity wealth effects fade or savings run down, aggregate demand could quickly reflect the weakness already felt by the rest of consumers. Corporate and government capex provides a solid foundation, but lower-income debt stress and high-net-worth spending are the two indicators to watch.

Inflation and interest rates

All four investment themes are competing for the same constrained inputs: electricity, copper, skilled labour and construction capacity. Higher oil prices, linked to conflict in the Middle East, are adding further pressure. Inflation has edged higher as a result, although long-term inflation expectations remain well anchored. Markets have nonetheless repriced the outlook for monetary policy, with a sharp rise in cash rate expectations across major economies as investors anticipate central banks will keep rates higher for longer.

The nature of the rise in bond yields is notable. In 2022, rising inflation prompted a rapid increase in cash rates, but long-dated yields remained below prevailing cash rates because markets expected the period of tight policy to be temporary. This time, yields have moved higher across the entire curve, including at the long end, which suggests forces beyond near-term inflation are at work. The increase has been driven primarily by higher real (after-inflation) yields, with US real yields now at their highest level since 2002.

A combination of forces lies behind this. Central banks remain firmly hawkish, pushing up the anticipated path of real policy rates. Robust investment, especially the funding needed for the AI build-out, is heightening competition for capital and may be raising the neutral rate of interest. Ongoing fiscal deficits, large volumes of government debt issuance, quantitative tightening and fewer buyers who are indifferent to price also play a role. Developments offshore are also feeding through, as higher yields on Japanese government bonds and UK gilts, together with the prospect of Japanese investors bringing capital home, lift yields in other markets. Volatile oil prices, tensions involving Iran and persistent underlying inflation add further upside risk.

The recent surge in sovereign bond yields is unlikely to fully reverse, and we expect yields to stay structurally higher than they were before the pandemic. Higher yields are not, however, producing a widespread economic slowdown. Instead, they are drawing a

clearer line between resilient businesses and those that are more exposed.

Australia: the outlier

Australia continues to present a noticeably more fragile macroeconomic picture compared to its global peers. The Reserve Bank has raised the cash rate to 4.6%, from 3.6% a year ago, and policy is now restrictive. The lagged and cumulative impact of these cash rate hikes, combined with severe cost-of-living pressures and recent structural changes to property tax settings, has placed significant drag on the Australian household sector. With household debt high relative to incomes, these forces are weighing on consumer spending and confidence.

Australia sits upstream of the global investment cycle rather than benefiting from it directly. As a supplier of copper, lithium, iron ore and energy, it captures some gains through export revenue and resources earnings, but these are concentrated in a narrow part of the economy and do little for household incomes. Meanwhile, Australia faces many of the same cost pressures driving inflation globally.

What it means for markets

Strong earnings expectations continue to support global shares, while higher bond yields create both a headwind for rate-sensitive assets and an opportunity in Australian bonds.

Global shares: strong earnings, full valuations and rate sensitivities

Strong earnings growth expectations and a capex cycle broadening beyond AI (energy transition, defence and fiscal spending) continue to support growth assets. Within the S&P 500, mega-cap tech firms and AI "hyperscalers" have shown remarkable resilience, leveraging strong balance sheets to comfortably handle higher interest rates. Valuations sit above their long-term averages but have moderated over the quarter, and we regard them as elevated rather than extreme. If corporates come close to delivering

earnings expectations, we think valuations are justified.

In contrast, rate-sensitive and lower-margin businesses face a tougher landscape as rising debt costs increasingly weigh on profitability.

Historically, global small companies and global listed property have underperformed following sharp rises in bond yields. Both asset classes are more exposed to higher borrowing costs than the broader market. US 10-year bond yields have risen about 1 percentage point in six months. Since 1998, after rises this large, global small companies have lagged the broader share market in about 80% of cases over the following 12 months. Global listed property has lagged in about 75% of cases since 1990.

Smaller companies typically carry a greater share of floating-rate and shorter-term debt, so higher rates flow through to interest expenses more quickly, and they generally have less pricing power to protect margins. They have also captured a smaller share of the AI-driven earnings growth that is supporting larger companies. Listed property faces a dual headwind: higher bond yields put upward pressure on capitalisation rates, weighing on asset valuations, while also raising financing costs and making property's income stream less attractive relative to bonds.

With yields likely to remain structurally higher, we see limited near-term relief for either, and prefer to hold our equity exposure in larger, more resilient businesses with stronger balance sheets and earnings momentum.

Australian shares: an expensive market with weak growth

Outside the major resources companies and a select group of the large banks, domestic earnings growth is tracking well below that of offshore markets. Valuations offer little cushion: even after adjusting for differences in sector composition, the Australian market trades on a price-to-earnings ratio of around 21.5 times, compared with 17.1 times for its global peers. The make-up of the ASX adds

to the challenge. Unlike the US, Australia has limited exposure to technology and the structural growth themes that can help offset the impact of higher discount rates and bond yields.

Bonds: Australia over global

Bond yields have climbed to their highest levels since 2011 in Australia and 2002 in the US. Starting yield has historically been the most reliable guide to a bond's return over the following years. Higher yields also provide a larger income buffer, giving investors more protection if yields move higher still before they peak. Historically, bonds have tended to rally once interest rates peak, as markets begin to price in the next easing cycle.

We believe Australia is closer to that turning point than other major economies. The Reserve Bank has lifted the cash rate to 4.6%, and with most mortgages on variable rates, tighter policy is feeding through quickly to household budgets. Consumer demand is softening, house prices are easing and growth is set to slow. Australian 10-year yields, at around 5.4%, already sit well above the cash rate, suggesting markets are pricing a prolonged period of tight policy that we think is unlikely to be sustained as the domestic economy slows. This creates scope for Australian yields to fall over 2027, delivering capital gains in addition to income.

The outlook for global bonds is less clear-cut. The US Federal Reserve raised rates in September, and US growth continues to surprise on the upside. Persistent government deficits, heavy debt issuance and elevated energy prices are keeping upward pressure on term premia, the extra return investors demand to hold longer-dated bonds. Until these pressures ease, global yields carry greater risk of moving higher, reinforcing our preference for Australian bonds within an unchanged overall allocation to fixed income.

Growth Assets Outlook

Asset Class	Outlook Negative ← → Positive					Comments
Growth Assets						Strong earnings growth expectations and a capex cycle broadening beyond AI (energy transition, defence and fiscal spending) continue to support growth assets. Rising yields and inflation are the key risk, so rather than reducing growth exposure we are lowering interest rate sensitivity within it. We recommend remaining invested in growth assets in line with long-term strategy.
Australian Equities (incl. Australian Smalls)						Australia continues to lag global markets and sits outside the key capex beneficiaries, with manufacturing back in contraction. RBA tightening, softening house prices, highly leveraged households and policy changes on property investment weigh on domestic demand. Resources remain a neutral look-through exposure.
Global Equities						Neutral with a positive bias. Strong earnings growth gives the most cushion against higher rates. Tilt toward large-cap, high-quality, cash-flow-rich companies that are less rate-sensitive. More work required before an outright overweight.
Emerging Markets Equities						Maintain our neutral position. Earnings growth is strong, but higher US bond yields, elevated oil prices and geopolitical risk are headwinds, particularly for energy-importing economies.
Property						Move to neutral. The most rate-sensitive growth asset: the GREIT cash-flow yield spread over US 10Y is near its thinnest since 2007 and cash-flow growth (~1.5% p.a. post-COVID) lags equities.
Infrastructure						Increased capex sets the sector up for a lower dividend yield but higher growth outlook. We view infrastructure as slightly less interest rate sensitive and more defensive than global listed property in a rising yield environment.
Value vs Growth						Remain neutral. The AI trade drives value vs growth: hyperscaler capex flows to memory and chip producers, data centres, critical minerals and more. Also neutral on Evidentia's AI Risk Measure.
Quality vs Cyclical						Remain overweight quality. Quality has delivered superior long-term risk-adjusted returns and recent underperformance may offer an entry point; an Australian slowdown would favour quality.
Global Small vs Large						Move to neutral. Small caps are rate sensitive. History tells us that small cap underperformance can continue for some time after an initial yield spike. Valuations are relatively cheaper, however we do not believe the discount offsets the risk of higher rates.
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 remain neutral but with increasing caution.

Defensive Assets Outlook

Asset Class	Outlook Negative ← → Positive					Comments
Defensive Assets						Defensive assets offer the most attractive yields in over a decade. We favour duration over credit: Australian duration is our highest conviction position, funded from global duration so overall portfolio duration is unchanged, while tight spreads leave credit offering limited compensation for risk.
Australian Duration (incl ILBs)				→		Domestic monetary policy is now restrictive and economic activity is moderating. We expect these conditions to place downward pressure on Australian bond yields over 2027.
Global Duration (incl. TIPS)			←			The rate cycle has further to run offshore, with the US Federal Reserve still hiking and growth continuing to surprise on the upside. We prefer to hold our fixed income exposure in Australian bonds, where the rate cycle is closer to its peak.
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						Spreads remain near historical tights, but the all-in yield-to-worst on high yield has risen to 8.4% - most of it reflecting higher government yields rather than credit compensation. Widening CCC spreads and heavy issuance (including AI-related debt) point to stress at the weaker end of the market. We remain underweight - with a potential to upgrade if we see all-in yields continue to improve
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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