



Investor Insights

DECEMBER 2025 QUARTER



In summary

The fourth quarter of 2025 delivered strong returns for investors, driven by a rally in global equities. Notably, market participation broadened beyond technology, with gains across sectors and regions, including global banks, small caps, and emerging markets. Bond markets remained range-bound due to lingering inflation concerns.

Heading into the first quarter of 2026, with markets at or near all-time highs, our outlook remains positive as strong earnings forecasts are coupled with monetary and fiscal policy tailwinds. While supported by several positive factors, we retain a vigilant stance on specific risks such as resurgent inflation and geopolitical tensions that may impact portfolio positioning.



In this edition

In this edition of Investor Insights, we examine the prevailing economic forces and market trends to determine their likely influence on investment performance ahead:

- **The Australian economy has been slowly recovering**, but sticky inflation and an evolving interest rate environment pose potential risks to current economic momentum.
- US equity strategists **forecast positive momentum for the S&P 500 in 2026**, but the emergence of risks such as rising inflation or a slowdown in artificial intelligence (AI) capital expenditure (Capex) could trigger a recalibration of growth expectations.
- Global equity valuations may appear elevated, by some historical standards, but they are underpinned by **robust earnings expectations**. Domestically, the picture is slightly less optimistic.
- The continued growth in the **adoption of artificial intelligence (AI) across business sectors may provide positive catalysts** for both economic growth and shareholder returns.
- Australian residential property prices continue to rise as **market imbalances support prices but add to economic and social risks**, raising regulator concerns.

Global economic growth: steady but below trend

AI investment, resilient consumer spending and policy stimulus measures are currently driving economic momentum, acting as powerful counterweights to moderating global growth. While fiscal sustainability and inflation remain key structural risks, the overall environment supports a resilient, albeit modest, economic outlook.

Given these conditions, the most likely base case for the global economy remains a **'Below Trend Growth'** scenario.

In this scenario, global growth stabilises at below-trend levels. To stimulate activity, we anticipate the US Federal Reserve (Fed) will cut interest rates two to three times. However, domestic conditions tell a different story where the Reserve Bank of Australia (RBA) is expected to remain on hold, with the potential for rate hikes should inflation risks persist.

Bond markets will likely balance the support of softer economic growth against the pressure of sticky inflation. Concurrently, rising budget

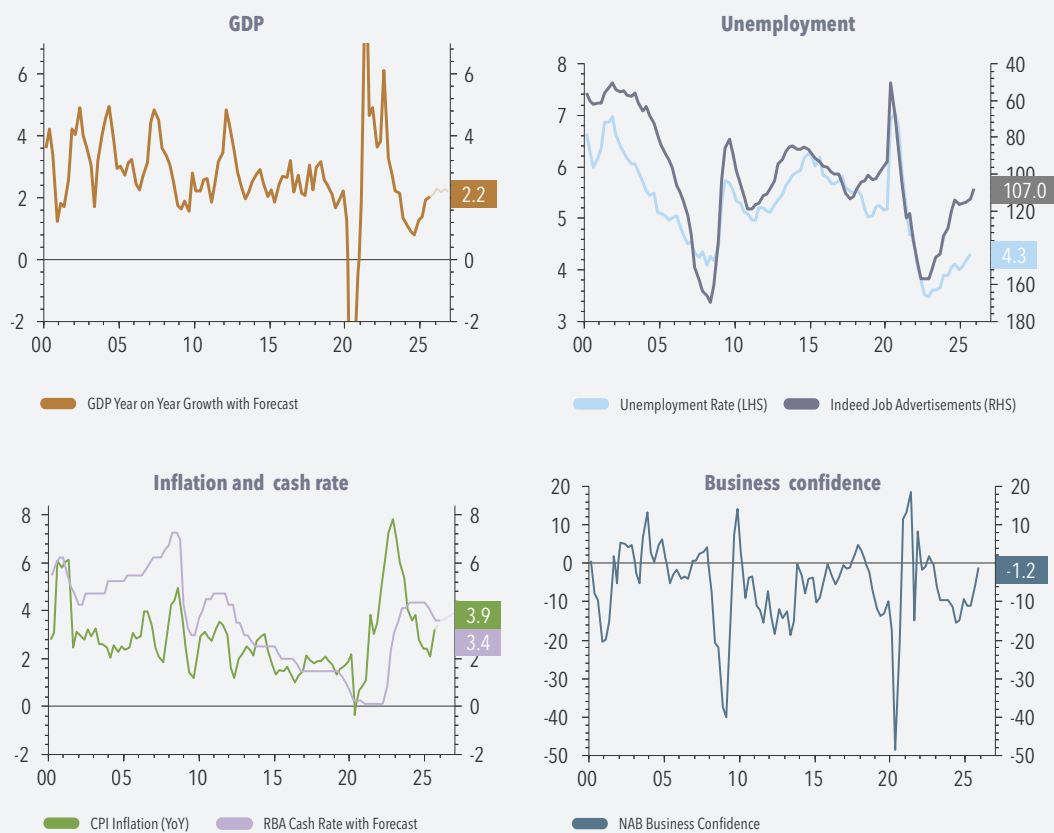
deficits and increased debt issuance to fund government spending are expected to lift longer-term yields, further weighing on government budgets.

Despite the headwinds facing tariff-hit sectors where earnings may be subdued, the broader market outlook remains constructive. Earnings are expected to improve, supported by pro-growth policies and structural themes such as AI. Furthermore, a trend toward a weaker US Dollar is expected to act as a tailwind, boosting emerging and non-US developed markets.

Australian economic snapshot

The economic outlook for Australia in 2026 reflects a complex balance between improving GDP growth and persistent inflationary pressures that have tempered expectations for RBA rate cuts. This backdrop suggests a gradual economic improvement, though one that warrants continued investor caution given the uncertain trajectory of monetary policy.

Chart 1 Key Australian economic indicators



Source: LSEG Datastream, Quilla Consulting

Chart 1 presents key economic indicators, highlighting the current state of the domestic economy.

Economic growth (GDP)

Economic growth has been improving, with GDP growth reaching 2.1% for the third quarter of 2025, with expectations for growth to remain steady, reaching 2.2% by late 2026. This progress is largely supported by strong public sector demand, particularly in infrastructure, and a rebound in private sector activity, which was supported by three interest rate cuts in 2025.

Labour market (unemployment)

Unemployment has risen to 4.3%, but has been relatively steady in recent quarters despite a slowdown in job advertisements. Other forward-looking indicators continue to point to a relatively stable jobs outlook.

Inflation

Prices are rising faster than the Reserve Bank of Australia (RBA) or investors expected. Recent data shows headline inflation has risen to 3.4%, well above the RBA's target range of 2-3%. Many components of the Consumer Price Index (CPI) basket are running above 3%, with most service prices rising closer to 3.5%. The largest contributor to inflation remains the 'Housing' sub-component, which makes up a large portion of the CPI basket and increased at a brisk 5.2%.

Interest rates (cash rate)

With inflation remaining high, hopes for lower interest rates have faded. Markets had previously expected two further rate cuts in 2026 following the three cuts in 2025. However, given the rising inflation dynamics, market expectations have shifted, now expecting at least one rate hike this year, which would lift the cash rate from 3.60% to 3.85%.

A drop in the cash rate is currently unlikely unless there is a sharp deterioration in employment or a moderation in inflation, of which leading indicators suggest neither is imminent.

Business sentiment

Corporate sector confidence has continued to improve, helped by improving economic growth and interest rate cuts. However, caution prevails among businesses as forward orders soften and the interest rate environment swings more hawkish.

Outlook

The economy is slowly recovering, with expectations of steady growth and a stable labour market. However, sticky inflation and an evolving interest rate environment pose potential risks to current economic momentum.

US equities: 2026 targets and risks

The majority of US equity strategists forecast positive momentum for the S&P 500 through 2026, but the emergence of key risks could trigger a recalibration of growth expectations.

Fund manager expectations for the S&P 500 in 2026

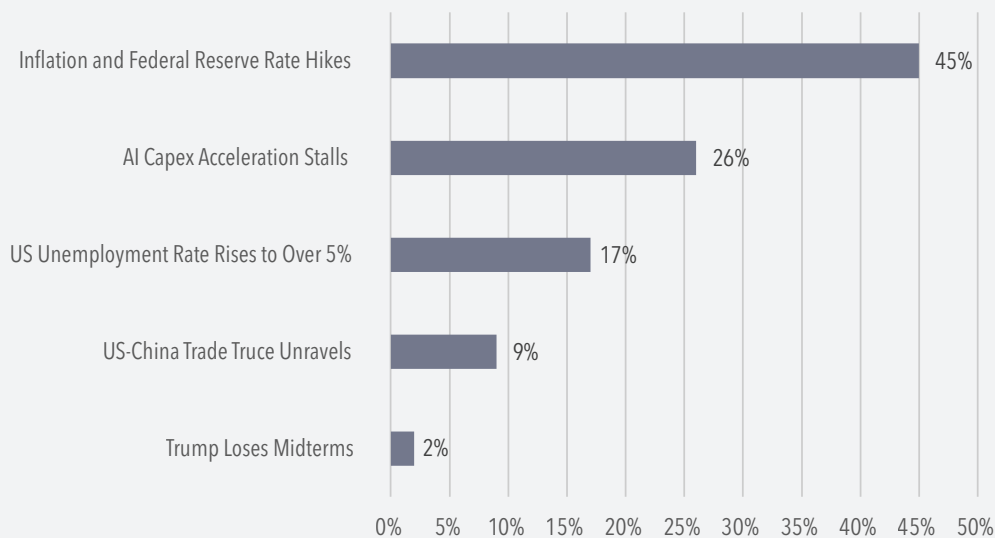
The Bank of America Global Fund Manager Survey (FMS) is a monthly report that tracks the sentiment and investment views of roughly 200-300 major institutional, mutual, and hedge fund managers around the world. The latest survey revealed that most market strategists forecast that the S&P 500 will deliver steady, moderate gains through 2026. While forecasts have a wide range, the majority of expectations sit in the low single to low double-digit range (roughly 5-12%), driven by earnings growth rather than rapidly expanding valuations.

Key risks to US equities according to fund managers

Several risks to the constructive US equity outlook have been identified by surveyed fund managers depicted in Chart 2, (on the next page) with the two most prominent risks being:

- **Inflation and interest rates:** The market is currently expecting 2-3 rate cuts over the next year in the US. If inflation unexpectedly rises, central banks may be forced to keep rates higher for longer. This could shock markets that are currently expecting a favourable easing environment.
- **Capital spending (capex) shortfalls:** Current bullish sentiment assumes companies will continue spending heavily on growth and infrastructure, particularly within the realm of AI. If businesses pull back on spending or moderate their expected future capex spend, bullish company forecasts may need to be downgraded.

Chart 2: Bank of America (BoA) Global Fund Manager Survey Factors that would be seen as the most bearish in 2026



Source: Bank of America Global Fund Manager Survey; Quilla Consulting

Emerging risks we are monitoring

- **AI profitability:** We are moving from the “hype” phase to the “results” phase. If heavy spending on AI fails to generate tangible profits, investor confidence could falter as positive earnings expectations disappoint.
- **Debt-funded AI development:** In the race to scale AI infrastructure, some companies are raising significant debt to fund development, often collateralising these loans with the very hardware, such as GPU chips, they are acquiring. While this is not currently a material risk, as major technology firms are funding capex through cash flows, it is an emerging trend that warrants investor attention.
- **Market breadth:** Earnings in 2026 are expected to improve more broadly across sectors. Should earnings growth fail to spread to other sectors as expected, the US equity rally may not be as sustainable as previously thought.
- **US debt and bond yields:** Concerns over US government spending and rising debt levels could drive up long-term bond yields. If safe government bonds start offering higher returns, risky assets like shares become less attractive, potentially causing market volatility.
- **Initial public offerings (IPO) exuberance:** A sudden rush of large technology companies listing on the stock market often signals a market peak. We view this “exuberance” as a potential warning sign that optimism has gone too far. Examples of this may include the anticipated listings of SpaceX, Canva, Stripe and Open AI.

Our view

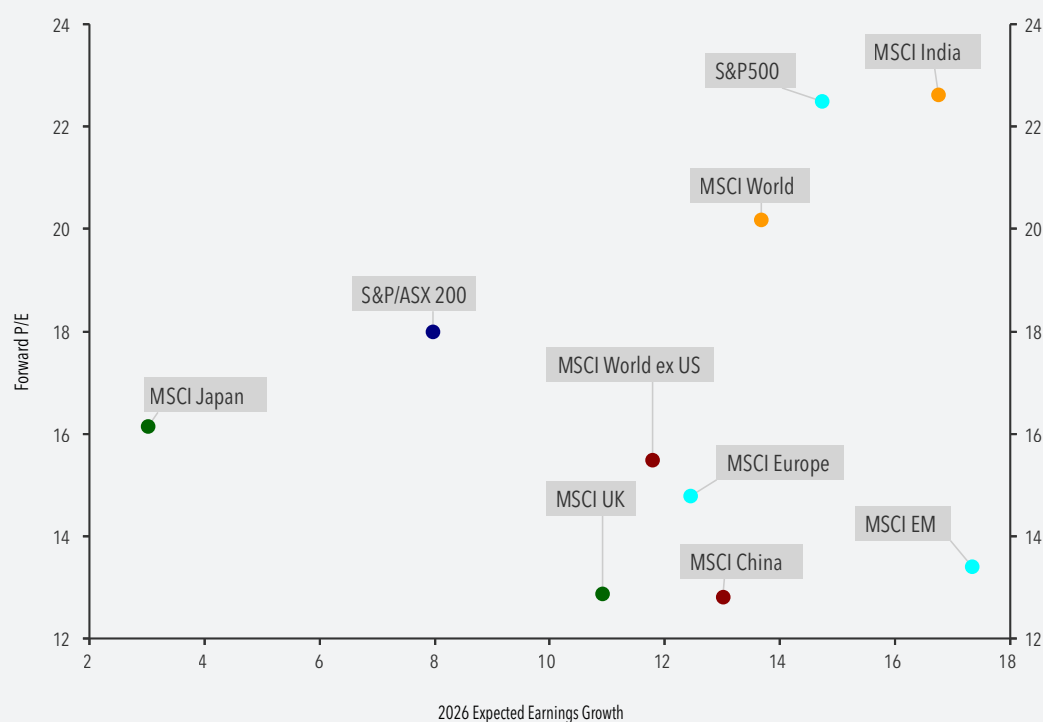
We are positive on the long-term factors driving US equities, but are aware of potential risks that may introduce volatility. We still favour US shares over Australian shares and are comfortable maintaining current allocations to US equities.

Equity valuations and expected earnings growth 2026

Navigating markets through 2026 requires a careful analysis of equity market valuations and expected earnings growth. Chart 3 illustrates where global equity market valuations, measured by the forward price to earnings ratio (P/E), sit relative to the earnings growth expected from each market in 2026.

While headline equity valuations appear elevated, by some historical standards, they are increasingly underpinned by robust earnings expectations. The critical task for investors is distinguishing between markets where higher valuations are justified by real growth and those that are simply mispriced, signalling either a risk or a buying opportunity.

Chart 3: Global market forward price to earnings ratios (P/E) vs expected 2026 earnings per share (EPS) growth



Source: LSEG Datastream, Quilla Consulting

Note: The price to earnings ratio (P/E) is the price an investor pays per dollar of earnings. A higher number suggests a higher implied valuation and a lower number suggests a cheaper valuation.

Global outlook: earnings as the anchor

Current global equity valuations are supported by a buoyant outlook for corporate profitability. As Chart 3 shows, the MSCI World Index is projected to deliver nearly 14% earnings growth in 2026. The higher P/E multiple likely reflects investor confidence in fundamental growth rather than irrational exuberance.

The growth premium (S&P 500 & MSCI India)

These markets offer the strongest expected earnings growth. While valuations are commensurately higher, the premium is supported by superior earnings visibility and structural tailwinds, specifically the AI and technology cycle in the US, and demographic-led economic modernisation in India.

A compelling divergence (MSCI EM)

Emerging Markets present a compelling combination of strong earnings growth for 2026 while trading at attractive valuations. This disconnect signals the market is pricing in macro uncertainty rather than fundamental corporate weakness. This creates a potential upside scenario where prices re-rate to Emerging Market fundamentals that are also underpinned by a structurally weaker US dollar.

The domestic headwind (S&P/ASX 200)

The Australian market currently faces a challenging risk-reward dynamic characterised by a relatively high valuation compared to its modest 8% earnings growth, which is one of the lowest in the peer group. This could result in limited scope for further valuation expansion and more modest returns relative to other global markets.

Non-US markets (MSCI World Ex-US)

Markets outside the US (such as Europe and the UK) offer a middle ground of respectable growth (~12%) at modest valuations. However, uncertainty regarding the quality and persistence of future earnings, as well as lower levels of technology and AI exposure, contribute to the valuation discount.

Positioning for 2026

Our asset allocation preference within equities remains tilted offshore, favouring the earnings momentum of global and emerging markets over Australian equities. The domestic market's combination of modest large-cap earnings growth and full starting valuations presents a less attractive proposition for capital appreciation.

Growing artificial intelligence (AI) adoption

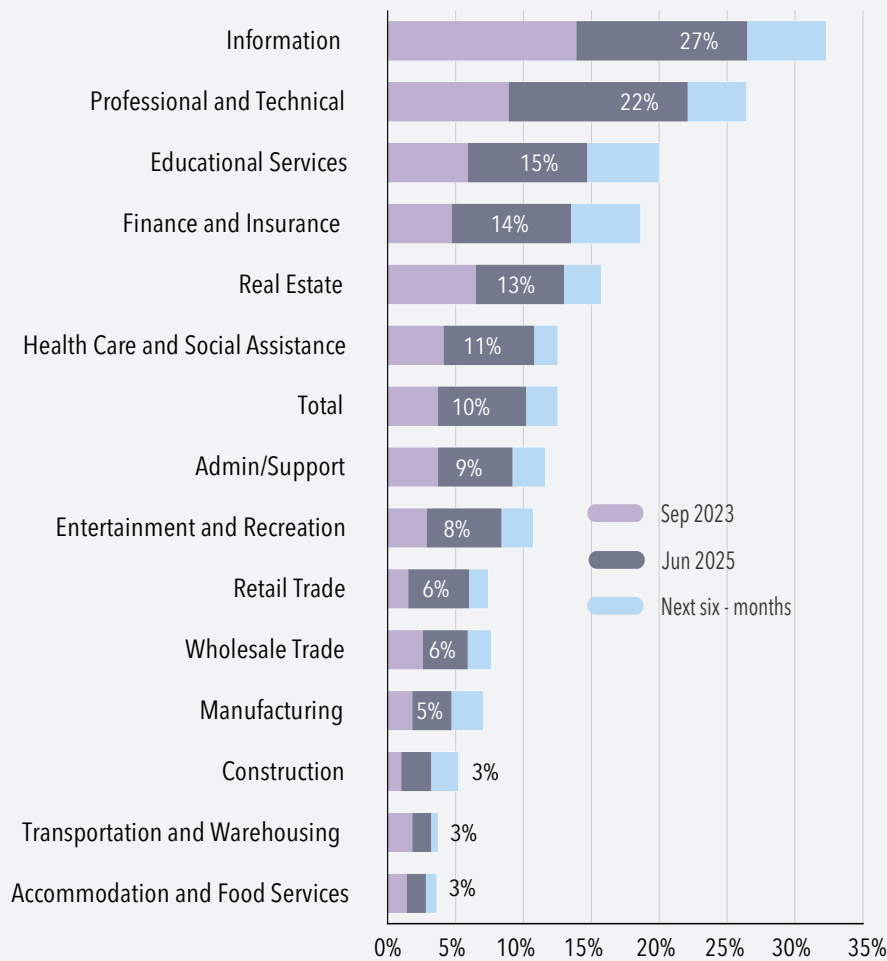
Since ChatGPT's public debut in 2022, Artificial Intelligence (AI) has become a primary engine for economic growth and investor returns. To date, this momentum has been concentrated within the foundational layers of the AI ecosystem, spanning cloud computing platforms, data centres, hardware developers, and chip manufacturers.

The rally has also extended to physical infrastructure, benefiting data centre developers, component manufacturers, and the energy companies required to power these energy-intensive systems.

Looking ahead, we expect the benefits of AI to ripple across the broader economy. As AI tools and services become standard,

the impact will move beyond just technology companies to the wider business landscape. Chart 4, (on the next page) illustrates this momentum as the percentage of firms utilising AI has risen sharply since 2023, with expectations that this adoption will accelerate further across all industries.

**Chart 4: Businesses using AI to produce goods and services -
% of all firms reporting use of AI in applications**



Source: JP Morgan Asset Management

We view AI integration as a significant tailwind for corporate earnings and economic activity over the long term. We believe the broad adoption of AI is not just a trend, but a structural shift that will create value for shareholders in two main ways: by making companies more efficient and by helping them grow faster.

Efficiency:

- **Operating leverage (doing more with less):** AI allows companies to automate routine tasks and optimise complex processes.
- **Productivity gains:** Employees can focus on higher-value work rather than administration or mundane tasks, leading to higher output per person.
- **Cost savings:** As efficiency improves, companies spend less to generate each dollar of revenue. This “margin expansion” means a larger portion of sales converts directly into profit.

Sales growth:

- **Revenue acceleration (new ways to grow):** Beyond just cutting costs, AI is a powerful engine for new sales.
- **Faster innovation:** AI speeds up Research & Development (R&D) cycles, allowing companies to bring new products to market much faster than before.
- **Pricing power:** By embedding “smart” AI features into products, companies can offer more value to customers, often allowing them to charge a premium price.
- **Higher capacity:** AI tools allow businesses to serve more customers simultaneously without a drop in quality.

Recent evidence

We are already seeing these benefits materialise in financial data. In the latest reporting season, US companies reported record-breaking profit margins, largely driven by the Information Technology sector, which has been the fastest to adopt AI.

The tech sector is likely a “preview” for the rest of the economy. As other industries adopt these tools, we expect their profit margins to also rise.

Companies at risk (who gets left behind?)

Not every company will win in this environment. Investors need to be selective.

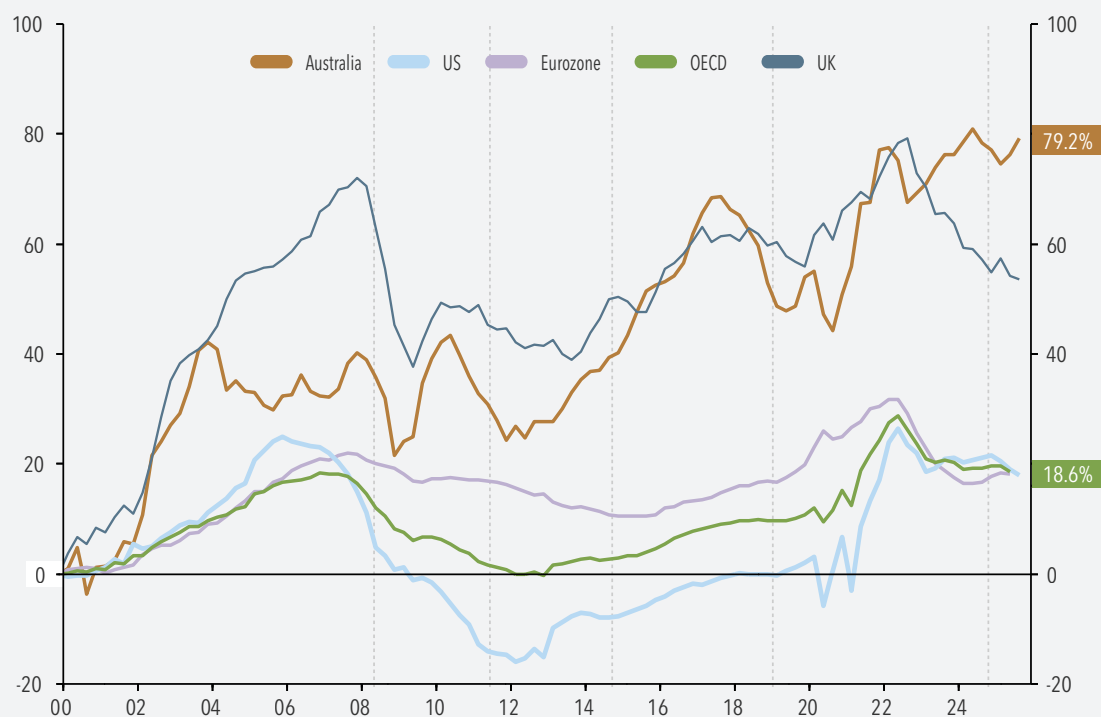
- **Disintermediation:** Companies that act as “middlemen” (particularly in software or services) risk being bypassed if AI can perform their function directly.
- **Failure to adapt:** Businesses that underinvest in AI or fail to use it effectively risk losing market share to more efficient, high-tech competitors.

Over the long term, we view the integration of AI as a significant tailwind. It supports stronger corporate earnings and broader economic activity, creating a favourable environment for the companies that successfully navigate this transition.

Australia's property dilemma: wealth, risk, and regulatory response

Australian residential property markets continue to demonstrate remarkable resilience, with prices reaching new record highs that have significantly decoupled from fundamental wage growth. This divergence has pushed the house price to household income ratio from 5x to approximately 9x, a significant 79% increase over the past 25 years. This marks the fastest deterioration in affordability among developed peer nations (Chart 5).

Chart 5: Percentage change in house price-to-income ratios



Source: LSEG Datastream, Quilla Consulting

Housing supply and demand dynamics

The Australian housing market has been underpinned by demand-supply mismatches driven by several factors:

- **Monetary policy influence:** As illustrated by the grey vertical lines in Chart 5, historical interest rate cuts have acted as a catalyst for demand, consistently preceding periods of widening affordability gaps.
- **Structural imbalances:** Beyond the cost of credit, the market is underpinned by a supply-demand mismatch. Record net overseas migration and government stimulus initiatives have bolstered demand while the expansion of money supply continues to support asset price inflation despite broader economic headwinds. Concurrently, housing supply has been unable to keep pace as home construction lags despite government and industry plans and support.

Regulatory response targeting systemic risk

The Australian Prudential Regulation Authority (APRA) announced limits to high Debt-to-Income (DTI) lending as a pre-emptive “guardrail” to protect the financial system from the risks of rising household debt.

- **The cap:** Effective 1 February 2026, banks will be restricted in their high-leverage lending. New residential mortgages with a Debt-to-Income (DTI) ratio exceeding 6x must be capped at 20% of total new lending portfolios.
- **Intent:** These measures are designed to address rising household indebtedness and reduce bank exposure to higher-risk borrowers.

Economic implications

The rising property market has both positive and negative consequences for the Australian economy.

- **The wealth effect:** Rising asset values technically create a ‘wealth effect,’ bolstering consumer balance sheets, sentiment and spending.
- **Housing risks:** The current dynamic creates a fragile equilibrium. While asset owners benefit, worsening affordability exacerbates socio-economic inequality. Furthermore, the capital required to purchase a home increasingly cannibalises discretionary income, which places downward pressure on household consumption. Simultaneously, rising housing costs contribute to sticky inflation, keeping the cost of living stubbornly high.

Conclusion

Structural property market imbalances are likely to support near-term prices, frustrating broader efforts to cool aggregate demand and inflation. This dynamic reinforces the view that the RBA will maintain a restrictive stance, with risks skewed towards a further cash rate increase this year.

A constructive outlook for 2026

We enter the new year with a positive outlook for global markets. While global complexities persist, the underlying data suggests resilience across major economies. We anticipate that the global economy will maintain its sound footing, providing a stable backdrop for companies to expand earnings throughout 2026.

Our constructive stance is driven by several supportive factors. Fiscal and monetary tailwinds are set to sustain business confidence, while improving clarity around global trade should further lift sentiment. Corporate fundamentals appear robust, characterised by solid balance sheets and strong earnings growth. Furthermore, the ongoing capital expenditure and adoption of AI will likely act as a structural tailwind for both economic output and profitability.

However, we remain realistic about current valuations and the potential for downside risks. With asset prices higher than historical norms, we anticipate bouts of volatility that may test investor resolve. While equity returns in 2026 may be more modest compared to the exceptional strength seen in 2024 and 2025, we view this as a broadening of opportunity rather than a signal for concern, finding value across a wider range of regions and asset classes.

To capitalise on this environment, a disciplined approach is essential. We believe that a robust, diversified portfolio remains the superior strategy for navigating this landscape. By balancing exposure across various asset classes, investors can effectively manage short-term fluctuations while positioning themselves to capture attractive, real returns over the medium to long term.