TenCap

Letter from the CIO

August 2025

The equity rally is durable

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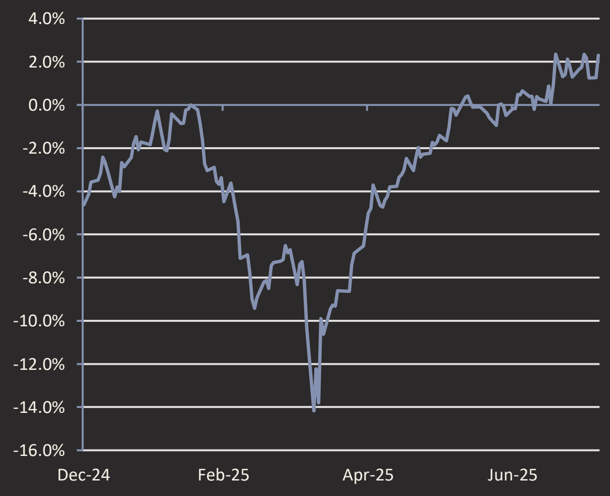
The equity rally is durable

Since the market lows in April, we have maintained a bullish view on equities, willing to buy the dips and look through the risks. Despite the recent rally, we maintain this positive view. We challenge the perception that markets are complacent, instead highlighting their resilience.

While valuations are elevated, we don't think they present a barrier to further upside, especially if policy rates continue to decline and a US recession is avoided. Furthermore, corporate fundamentals remain robust (as illustrated by the latest US reporting round) and should improve through 2H25. Finally, a "buy the dip" approach to equities persists despite some signs of market excesses.

ASX200 Price Index

Return from February 2025 Peak



Source: Bloomberg, Ten Cap

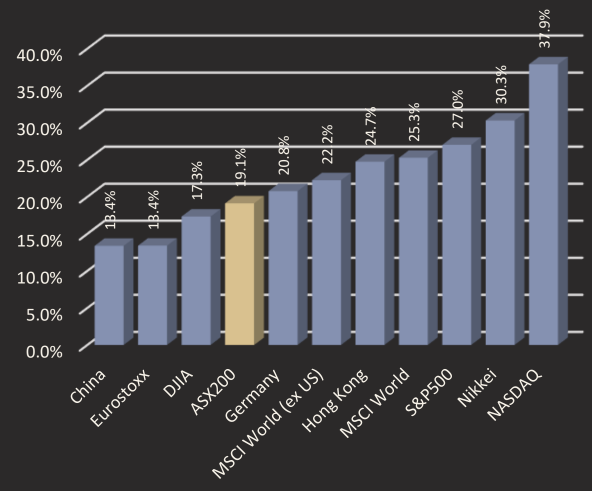
Our optimism does hinge on fundamentals keeping pace with market performance, or at least not deteriorating beyond the gradual slowdown anticipated in current economic and earnings forecasts. But unlike the prevailing consensus view which is fixated on downside risks, we believe the drivers of equity markets will strengthen in the coming 6-12 months as global liquidity conditions continue to improve as the U.S. Federal Reserve steps up the pace of rate cuts and macroeconomic uncertainty diminishes amid progress in major trade negotiations, especially with China and Mexico.

For Australia, provided global equity markets remain relatively stable, we think the local market will navigate reporting season uneventfully and begin to look towards an improving domestic outlook. With the RBA expected to resume interest rate reductions imminently, we are confident that domestic cyclical conditions are at or near their trough.

A stable labor market, rising real incomes, moderating inflation, and declining borrowing costs create a favorable environment for investors, assuming no unexpected external growth shocks. Should consumer confidence accurately reflect domestic sentiment, there is scope for upside surprises in cyclical sectors and risk assets as conditions gradually recover.

Equity Returns from recent Lows

% price return



Source: Bloomberg, Ten Cap

Five reasons we remain positive:

We expect the ASX200 to continue advancing, led by rotation into cyclicals, mid-caps, and rate-sensitive segments, marking a shift away from recent defensive growth leadership. We think this will mark the start of a more balanced and valuation-aware upswing that is likely to be more modest than recently seen, but broader from an index perspective. We think there are five major tailwinds for the equity market:

1. **Policy Rate Cuts:** We expect the RBA to resume its rate cut cycle in the coming week, with the cash rate likely falling to around 3% by year-end. We think it could be more given the RBA has always pushed real rates into negative territory during easing cycles. This trend provides strong support to rate-sensitive sectors, including property, retail, and discretionary consumer industries.

2 **Earnings Resilience and Margin Stability:** Despite macroeconomic volatility, earnings performance has been resilient, reflecting healthier-than-anticipated results through the first half of 2025. Although consensus projects a -1.7% contraction for FY25, outer-year growth expectations remain anchored around 5–8%, a range we consider achievable.

3 **Global Growth Slowing but Continuing:** While recent US payroll revisions have raised recessionary concerns, the base case still points towards a soft landing, given prevailing activity indicators. Mild economic weakness is anticipated in the US due to the unwinding of tariff-induced front loading of demand with some uptick filtering through to inflation. However, these risks are well-recognized by the market, suggesting a likely period of consolidation rather than a pronounced downturn. Furthermore, global equity flows continue to favor risk assets, demonstrated by sustained record foreign investment in US markets.

4 **Rotation into New Leadership:** Market momentum is shifting from large-cap defensives toward smaller caps and previously lagging sectors such as industrials, energy, and financials (excluding banks). We see stronger prospects for domestic cyclicals compared to global cyclicals, given the modest policy stimulus from China and persistent US housing sector weakness. Rotation is occurring with valuation discipline, enhancing the durability of this upswing.

5 **Tactical Trimming, Not Fundamental** Weakness: Recent profit-taking has been concentrated among outperformers, rather than indicative of fundamental market weakness. The move towards defensive stocks and bonds does not represent broad-based risk aversion. While data disappointments are possible, they are unlikely to result in recessionary conditions.

Reporting Season – Not a Catalyst for Correction

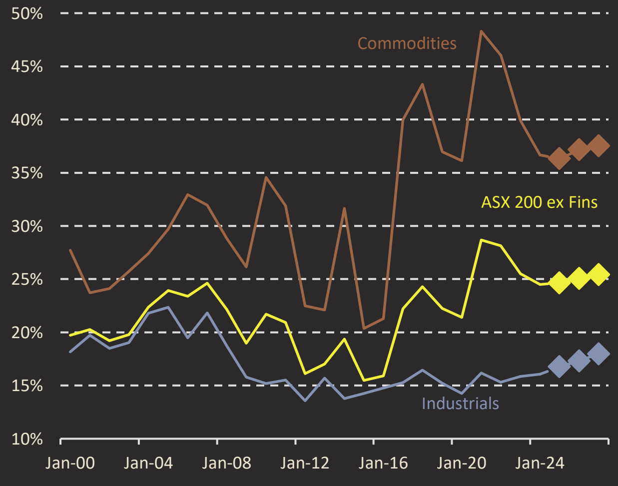
Given our constructive outlook, we approach the upcoming reporting season with pragmatism. Although downgrades have increased and a third year of negative growth is projected, these trends are consistent with recent reporting periods post-COVID. Investors should not read these headlines without calibrating their relevance for the equity outlook.

Negative earnings revisions leading into the reporting season is typical, as are downgrades to outer year forecasts. It's normal during cyclical turning points for valuations to rise and for fundamentals to have to grow into stock prices. It's also normal to have wide divergences in profit results depending on the stock, industry or sector.

In other words, we don't think we are set up to see anything drastically different to most other reporting seasons and we do not foresee aggregate results as a catalyst for widespread market weakness. If anything, incremental improvements in inflation and monetary policy should provide tangible benefits with a weaker A$ driving significant positive translation benefits. As was the case in February, when the market was willingness to look through weak result, we don't see why August will be any different if on the cusp of a recovery.

ASX200 profit margins expected to rise

MST bottom-up EBITDA profit margin %



Source: MST Strategy, Ten Cap

Downside Risks are Containable

Historically, equity market corrections are a regular feature of equity markets although their frequency and severity differ. In the US, a 5% correction happens almost twice a year while a 10% correction occurs once every second year. For Australia deep corrections are less common but it is subject to smaller and more frequent minor dips. These patterns underscore the cyclical nature of equity markets but also that the natural direction is higher. While not discounting risks, we think there are sufficient positive catalysts to absorb potential shocks. Nevertheless, several concerns merit attention:

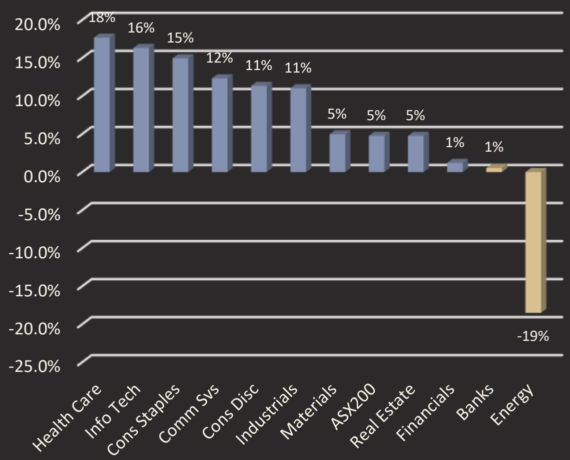
1 **Tariff Escalation and Trade Policy Uncertainty:** The most prominent and immediate risk is the re-escalation of tariffs. The US aggregate tariff rate is expected to rise above 20% later this year, with new reciprocal tariffs already announced and others pending - including potential 50% tariffs on copper and up to 200% on pharmaceuticals. This creates a supply-side shock that could lift inflation and compress margins, especially for exporters / global cyclicals.

2 **Fragile Earnings and Valuation Disconnect.** While earnings have held up in some sectors, the Australian market is facing its third consecutive year of EPS contraction. There is a growing disconnect between valuations and macro / corporate fundamentals which leaves markets vulnerable to earnings disappointments and guidance resets.

3 **Leadership Rotation and Style Risk.** The equity market is undergoing a leadership shift—from defensives and momentum names to high(er)-risk value and loss-makers. Normally this would be considered a "junk rally," consistent with historical recoveries but potentially unsustainable without earnings confirmation. If the rotation fails to deliver earnings support, it could reverse sharply, especially in crowded trades.

Australian EPS growth looking solid

ASX200 Consensus FY26 EPS Growth %



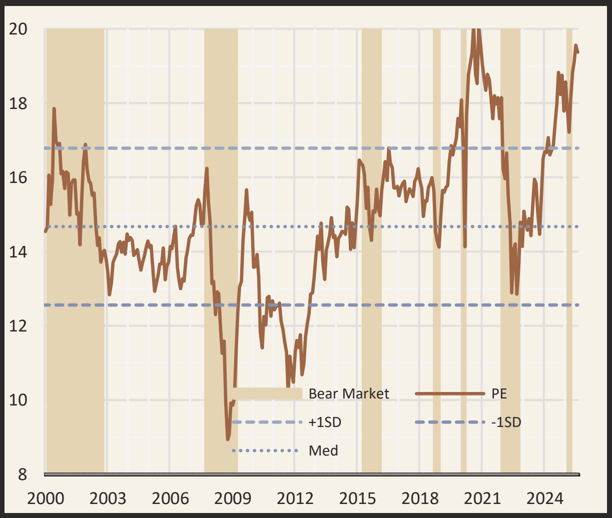
Source: UBS Strategy, Ten Cap

4 **Macro Volatility and Policy Missteps:** The US labor market is now showing signs of stress, with private payrolls shrinking outside healthcare. Medicare spending is decelerating, raising concerns about the sustainability of healthcare hiring. Meanwhile, bond market volatility is rising, and rate expectations are shifting rapidly. A misstep by central banks - either tightening too soon or failing to respond to inflation - could derail the recovery.

5 **Positioning and Sentiment Fragility:** Investor positioning remains light-to-moderate, and sentiment is lukewarm despite the rally. According to JPMorgan, this creates a "dual pain trade" scenario: if markets fall, investors are underexposed in defensives; if they rise, they're forced to chase cyclicals.

Equity Valuations not yet a constraint

ASX300 Forward PE Ratio



Source: Macquarie Strategy, Ten Cap

Summary:

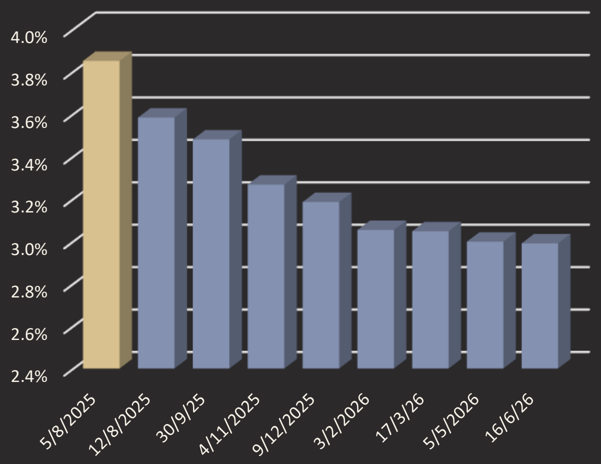
We remain positive on Australian equities. We believe the combination of supportive policy settings, resilient earnings, and evolving market leadership provides a durable foundation for further gains.

While risks persist - particularly surrounding earnings / economic delivery and political developments - the market has repeatedly demonstrated its capacity to adjust rapidly. The August reporting season, while important, is unlikely to be a pivotal test. Evidence of margin stability and incremental improvement in key sectors should be sufficient to sustain the rally toward year-end.

We recommend selective exposure to cyclicals and small-to-mid-caps while remaining cautious around crowded trades. We would use periods of weakness to raise domestic cyclical and interest rate exposures rather than becoming defensive. While our stance diverges from a more cautious consensus, we regard underlying conditions as broadly constructive with fundamentals solid enough to absorb non-recessionary economic challenges.

RBA rate expectations have collapsed

Market pricing for RBA: August 2025



Source: Bloomberg, Ten Cap

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Let's Keep Talking

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