TenCap

Letter from the CIO

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2026: Outlook Intact

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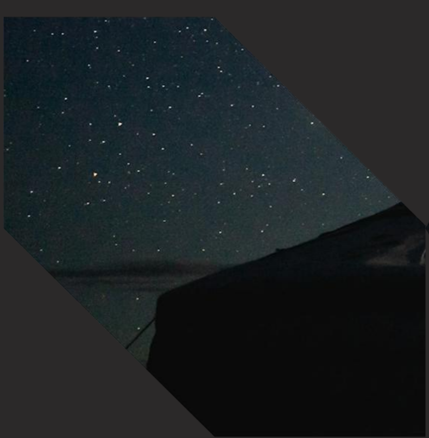
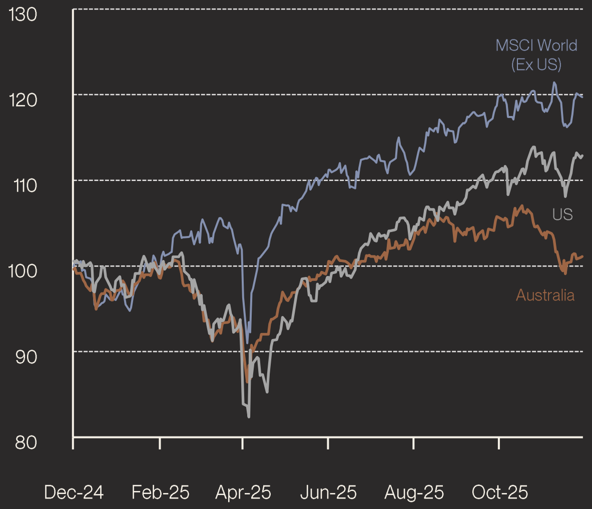


2026 – Outlook Intact

For most of 2025 the consensus was on the wrong side of a stronger than expected global economic and market outlook. It was only 8 months ago that US economic recession was the consensus call and that US exceptionalism had ended. In the following months, everything reversed. The US economy proved resilient to trade driven uncertainty and the magnificence of the Mag-7 made it costly for anyone who took the early bet against the US.

US vs Australia vs World (ex US)

Daily price performance (indexed to 100 as at 4/12/25)



Source: Bloomberg

In truth, the extent of economic upside has been modest and narrowly focused. The same can be said for the US equity market where AI driven earnings surprises have dominated and the US has underperformed both European and Asian equity markets (particularly the peripheral nations within these regions). However, there was enough momentum (and enthusiasm) behind both developments to drive US risk assets, and by association global risk assets, considerably higher.

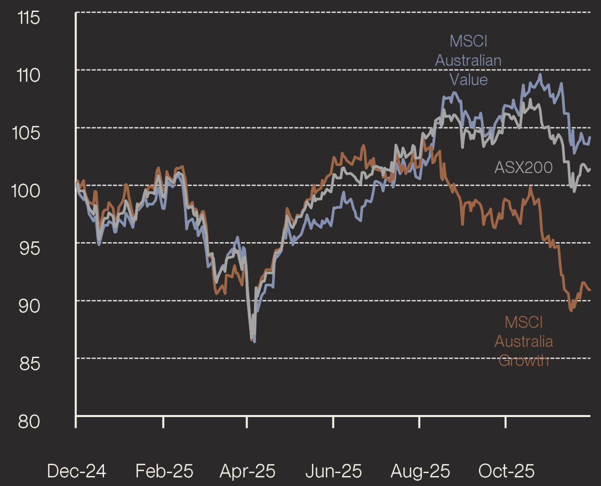
After a strong year for equity markets, its equal parts worrying and encouraging that the sell-side consensus view is for another solid year. It's highly unlikely that the consensus will be right - it rarely is - but it's hard to throw shade on what seems like a broadly sensible outlook for 2026. We don't think the balance of probabilities is high enough to go against a broad backdrop where the US leads global growth higher, global inflation measures remain stagnant if not fall modestly, the Fed provides more stimulus for markets at the short end while also backstopping any emerging liquidity concerns and where the AI thematic continues to be a key structural driver for markets (albeit more selectively given where valuations sit).

Solid is how we rate the outlook in general, but in particular, individual countries and markets will dance to their own tune, but the broad tailwinds of stronger economic growth, moderating inflation, lower policy rates and solid earnings growth will be defining trends for the global economy and equity markets. While 2025 has been a year of rising imbalances as AI / tech driven capex has come at the expense of a weakening labour markets across several key developed economies, there remains enough positive drivers to keep the global expansion alive while also pushing equity markets higher. This will come despite bouts of scepticism.

For Australia, the economy is expected to grow around trend in 2026, supported by solid fundamentals - steady labour income, strong immigration, and improving global conditions. However, the removal of the RBA's easing bias will soften sentiment and limit price gains across rate sensitive areas. Fiscal policy remains supportive but is shifting toward revenue reform, which could introduce volatility for certain sectors. Nevertheless, we think the Australian market will exceed "trend" expectations of 8-10% underpinned by an improved earnings and a further re-rating rather than de-rating of the average PE multiple.

"Growth" has underperformed in 2025

Daily price index (indexed to 100 as at 4/12/25)



Source: Bloomberg, MSCI

The Global Backdrop – Intact

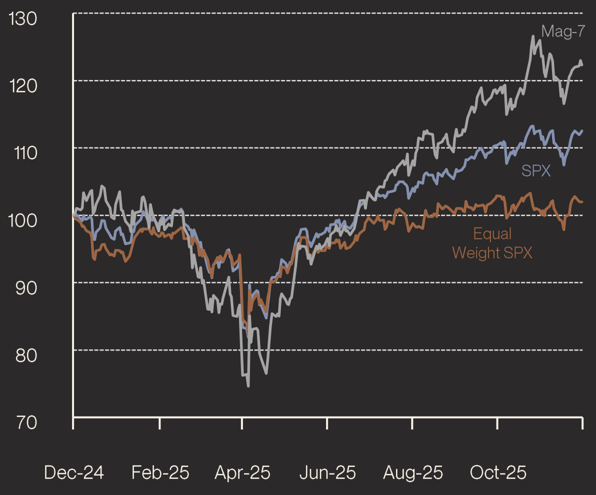
Growth is expected to consolidate with most major developed economies converging towards trend growth rates (or slightly above) as policy easing begins to seep its way into the global economy and consumer & investment spending broadens. This is not a synchronized global boom, rather, it is a patchwork recovery shaped by regional divergence and structural shifts.

The upside scenario is clear: faster diffusion of AI productivity and a clean hand-off from capex to hiring could lift growth and tame inflation without derailing policy. Stronger labour markets would reinforce consumption, while easing supply frictions would allow central banks to maintain a steady glide path.

On the other hand, there are risks to this view. A US-led slowdown - triggered by sticky inflation, weaker labour income, or a policy misstep - would ripple globally. A disorderly rise in long-end yields could tighten financial conditions abruptly, while China's struggle to reflate poses a persistent drag on emerging markets. Add to this the latent risk of private-credit stress and geopolitical flare-ups, and the margin for error narrows considerably.

US equity performance highly skewed

Daily price performance (indexed to 100 as at 4/12/25)



Source: Bloomberg

In addition, central banks are now in the final stages of policy easing with liquidity conditions expected to remain favourable, but not improve dramatically from this point forward. The Federal Reserve is expected to cut rates by another 50-75 basis points through mid-year, nudging policy toward neutral before pausing to assess labour market dynamics.

Europe and the UK follow with modest reductions, while Japan continues its slow march toward normalization. China, by contrast, leans on targeted fiscal measures and incremental monetary easing to stabilize growth. These moves set the stage for a yield curve that bull-steepens in the first half - front-end yields falling as central banks ease - before re-steepening later as term premia and supply concerns reassert themselves.

Australia – resilient but imbalanced

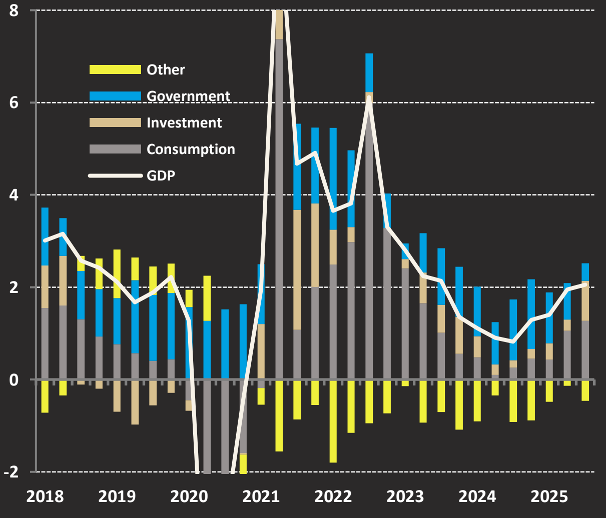
Australia's economic outlook is defined by a delicate balance between domestic resilience and global uncertainty. Our base case is constructive, but the margin for error is narrowing, and the policy environment is finely poised. Australia is set to grow at or slightly above trend, with GDP expected to expand by around 2.0–2.2%. The engine of this growth is overwhelmingly domestic. Household consumption remains robust, buoyed by strong labour income, a rebound in population growth through immigration, and the wealth effect from elevated asset prices. Business and consumer confidence are improving, and credit growth is picking up, further supporting spending and investment.

A notable feature of the outlook is the anticipated uplift in business investment. The capex pulse is being driven by lagged effects of earlier rate cuts, a pipeline of government infrastructure projects (including the Olympics, defense, energy transition, and data centers), and a broadening of private sector investment. The mining sector, in particular, is a key swing factor, with strong commodity prices and volume growth underpinning both profits and capex.

Government spending remains a tailwind, though the fiscal stance is gradually shifting toward revenue reform and longer-term sustainability. Externally, while China's growth is slowing, demand for Australian commodities remains robust, and the AUD should rise steadily through the year.

Australian economic growth to stabilize

Contribution to GDP Growth (%)



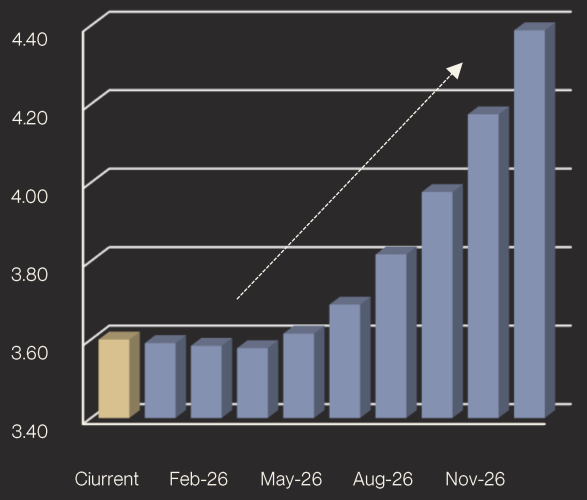
Source: ABS, Morgan Stanley Economics

Domestically, imbalances are building. Equity valuations are elevated, and household debt remains high. A correction in asset prices or a shock to employment could amplify downside risks. The housing market, while supported by policy and migration, is sensitive to interest rates and credit conditions.

Similarly, inflation remains sticky, with services and wage inflation still elevated. If inflation persists above target, the RBA may be forced hike rate cuts, tightening financial conditions. Fiscal sustainability is a medium-term risk, with government spending high and revenue reform politically challenging.

Market pricing in RBA hikes

RBA cash rate – Futures pricing as at December 2025



Source: Bloomberg

The RBA is expected to remain on hold through much of 2026, with further rate cuts looking increasingly unlikely. This would mean the RBA is finished cutting rates after just 75 basis points and could by year end 2026 see policy rates just 25bps off the most recent cycle high.

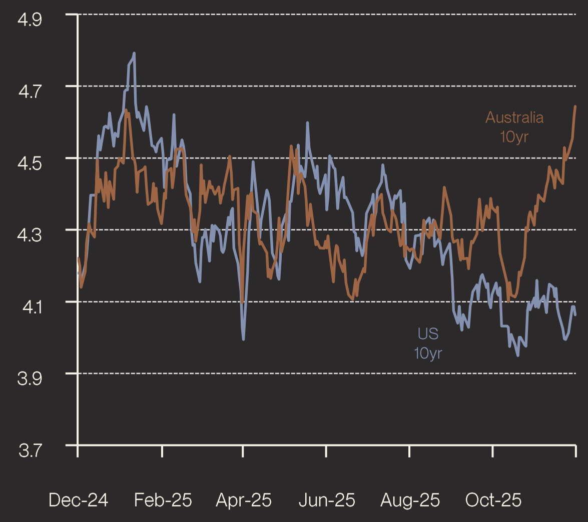
The rationale for higher policy rates would be persistent inflation - especially in services and wages - or further house price inflation alongside improving domestic demand. Conversely, if there is further slowing in the labour market that pushes the unemployment higher, or inflation falls back into the target band, the RBA would have scope to cut rates to support demand. At this stage the RBA faces a classic dilemma - balancing the need to support growth and employment against the risk of entrenching inflation and financial imbalances. The base case is for the labour market to soften further, but not enough to push the RBA to prioritize rate cuts. At best the RBA stays on hold for an extended period. At worst, its raising rates again in 1H26.

Markets in an unstable balance

Markets reflect this delicate equilibrium. AI should remain a defining theme regardless of (periodic) bubble fears. This will drive further corporate investment and shape sector leadership, but valuations demand increased selectivity. Credit faces heavy issuance, particularly in investment grade, as companies fund infrastructure and refinancing needs against a favourable macro backdrop and tight spreads.

US bond yields well behaved

US and Australian 10-year government bond yield %



Source: Bloomberg

Private credit bears watching for stress signals as liquidity tightens, but we are unfazed by fears of systemic failure, and we don't see an end to the demand from investors who are seeking equity-like returns. Gold remains a favoured hedge as geopolitical uncertainty lingers, and real yields oscillate but any potential good news on the Ukraine/Russia conflict will remove a tailwind.

We think equities will post solid gains but with much greater differentiation between high-and low-quality growth stocks as liquidity tailwinds slow. In the US, the cyclical backdrop remains supportive for broad based equity gains, but this is less likely in Australia should the RBA tighten rates faster than expected – in which case we will see a more dramatic rotation towards late cycle cyclicals.

Equities will look through downside risks

Equities enter 2026 on an optimistic footing. While the Australian market appears fully valued at 20x earnings, we doubt this will prevent the market from moving higher as earnings growth broadens. Investors will simply have to accept that higher valuations are the price to pay when liquidity is plentiful and FOMO is high.

2026 earnings 'g' looks strong

Consensus earnings estimates for ASX200 (%)

Source: UBS Strategy, Refinitiv

However, we think 2026 will see some key trends emerge at the stock and sector level that will define performance. It is possible to argue that Australia is still early cycle given we have not seen a prolonged cyclical upswing post the COVID downturn and with the RBA only 12 months into its easing cycle. However, sticky inflation suggests this is not the case and that its possible the RBA's next move is raise policy rates. But, either way, it will take some time for clarity on the outlook, and this means rates are at worst on hold through most of 1H26.

For now, we think the key market drivers that have prevailed throughout 2025 still holds with stocks well supported by low policy rates and early cycle cyclicals (consumer discretionary) and rate sensitive areas (property)

Still feeling the tailwinds from recent rate cuts. However, as we move further into 2026, and rate hikes become more likely, we expect outperformance to gradually favour late cycle cyclicals (materials / miners) and offshore cyclicals (particularly the US). Tightening liquidity also acts as a headwind for richly valued growth stocks although we don't see "bubble" risks like many others do.

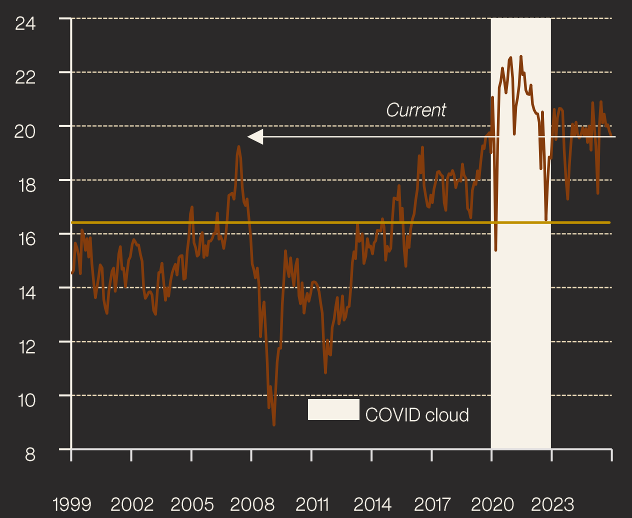
An "average" year for Australian equities is between 8-13%

Since 1900, the average total return for Australia equities has been 13% pa. Over the past 20 years it has been 8% and over the past 10 years it has been 9%. This means, depending on the time horizon, that the range for Australian equities in an "average" year is between 8-13%.

We think domestic equities will surprise on the upside again in 2026 but not because the relative or absolute outlook is strong, but rather because the market has the pre-conditions to simply produce an average year return, supported by modest domestic cyclical tailwinds, a (still) favourable liquidity backdrop even if less so than in 2025, corporate earnings that are higher than in 2025 (with 2026/27 outlook statements continuing this momentum), and as investors continue to upweight risk allocations – before the end of the cycle.

ASX200 PE multiple is not restrictive

ASX200 ex resources median forward PE ratio (x)



Source: Bloomberg, Ten Cap

Don't get overly defensive in 2026

We do not think 2026 will be characterised by the need to be overly defensive or to favour large/liquid stocks over small/mid cap cyclicals. A solid economic backdrop, slightly lower policy rates, a recovering consumer and structural thematics are all positive drivers – offset only by valuation concerns. However, liquidity conditions will remain strong, risk-taking behaviour will continue, and investors will not chase private markets at the expense of public markets because of value.

We think the Australian market will exceed "trend" expectations of 8-10% upside, underpinned by an improved earnings outlook and a further "re-rating" rather than "de-rating" of the PE multiple. It might appear contentious to think that the PE multiple can continue to rise from elevated levels, but we think this will be driven by the materials sector alongside a broadening out of performance into value laggards (including healthcare). We don't see a lot of de-rating risk for the bank sector if they can deliver on earnings expectations and this should provide downside protection for the aggregate market.

Earnings growth is returning after a period of contraction, and we expect this to broaden beyond resources into select areas of financials, industrials, and high-quality domestic franchises. We expect to see a wide dispersion of returns within sectors as was the case through 2025. We are focused on companies with strong cash flow generation, pricing power, and the ability to execute on operational efficiency or restructuring. Thematic opportunities remain in sectors exposed to infrastructure, energy transition, and digital transformation.

In this environment, we like sectors and companies that can benefit from domestic demand, commodity tailwinds, and structural change (AI), while maintaining a cautious stance on those areas most exposed to global volatility, higher domestic rates and/or valuation risk. The Australian equity market still offers opportunities for those willing to be selective and disciplined. The outlook is constructive, but the margin for error is narrowing. Remaining agile matters as does a greater focus on fundamentals. Investors should ensure portfolios are robust to a range of scenarios as we navigate the year ahead.

Thank you to our readers and those who have supported Ten Cap through its maiden year. We are excited for what is to come in 2026. We wish you a happy holiday season and a safe and prosperous new year.

Jason and the Ten Cap team

Thank you for reading our ***"Letter from the CIO – 2026 – Cyclically and Structurally Intact"****. At Ten Cap, we are excited to share with you our unique insights. Please subscribe to our Ten Cap newsletter at www.tencap.com.au and/or at https://www.linkedin.com/in/jatodd/*

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