TenCap

Letter from the CIO

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Stocks behaving badly

Jason Todd, CFA
Founder / CEO

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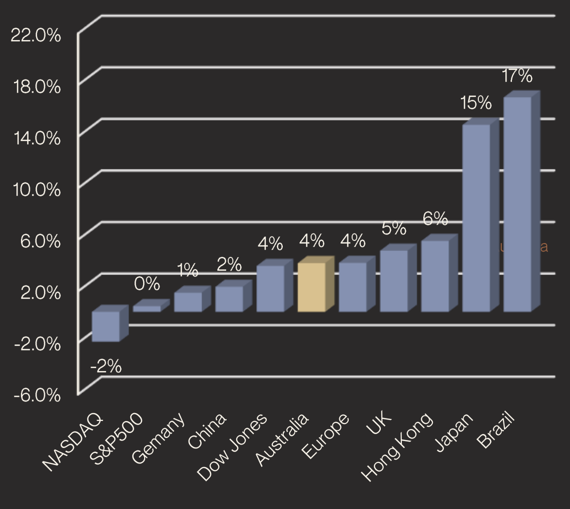
Markets are tough. You wouldn't think so if you looked at headline index returns for the year. Most key indices are firmly in the green and many are already up in the high single digit if not low double-digit ranges. Unfortunately, this is not where Australia sits with year-to-date gains at a lackluster 4%. What's more, the skew to returns (dispersion) has been significant at the stock level. For instance, the Info Tech sector is down 19% while Materials and Energy are up 13% and 11% respectively.

Equity index returns remain strong

Daily price performance (Year to date)



Source: Bloomberg

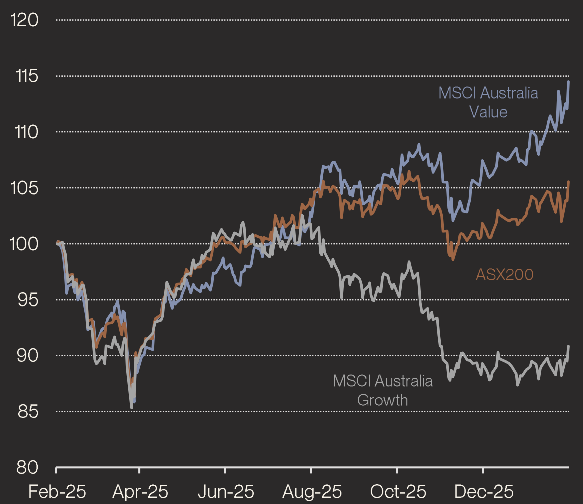
We think a lot of the price moves can be explained with some simple yet broad reasoning. Energy is up because Mid-East geopolitical tensions are high. Materials are up because there are structural tailwinds for certain commodities. Tech stocks are down because of concerns around software and AI overinvestment. Real Estate and Consumer Discretionary are relative underperformers because of rate rise fears. And there is rotation out of anything with "risk" and into perceived safety – the extent of which depends on the day in question.

So far good and nothing controversial in these statements. The problem is that the market is constantly flip-flopping. One day it's buying energy and selling tech. The next day it's selling energy and buying tech. Today it's buying value stocks, yesterday it was buying growth stocks. Last month the hottest trades were gold and silver, this month they are both radioactive and so on and so forth. The volatility is undermining investment decision that are based on fundamentals, which is a large reason why so many active managers across both value and growth have struggled in recent months – Ten Cap no exception.

Despite this stomach-churning volatility, there is some good news. First, while the market is fixated on daily news flow, it is not having a lasting market effect. And second, money is rotating within equities and not out of equities. In other words, investors are making relative bets within the same asset class rather than across asset classes. This is a sign that they are comfortable with underlying equity market fundamentals even though they are uncomfortable with fundamentals for certain stocks and sectors.

"Growth" continues to underperform

Daily price index (indexed to 100 as at 13/2/25)



Source: Bloomberg, MSCI

Don't lose sight of the big picture

It is easy to lose sight of the big picture and in your conviction bets when the market is volatile and stocks are behaving badly. It would have been impossible to think that Commonwealth Bank would rise 6% in a day or CSL would fall 13% in a day just a few years ago, but this type of volatility – even for our largest market cap stocks – is not far from a daily occurrence.

The question for investors is what has been driving this volatility, does it continue and how do you navigate this against an underlying trend in the headline index? It is hard not to be swayed by short term moves, but it is equally as important to zoom out and focus on the bigger picture. When doing this, we maintain our view that equities, while volatile, are on a path higher supported by an improving cyclical backdrop, ongoing easy monetary conditions, strong corporate earnings, structural tailwinds in key sectors such as tech and unrelenting desire by investors to chase returns and buy the dips. However, it's impossible to focus on the long run when there is so much uncertainty around the short run. We discuss both in the following sections.

Why are stocks so volatile?

We believe several factors are contributing to the volatility within the equity market.

1. A changing policy rate outlook: At the highest level, the RBA has short-circuited the policy easing cycle. Heading into 2026, the narrative was low rates, a weak AUD, multiple expansion and a broadening economic recovery. By January the narrative was for rising rates, a stronger AUD, more targeted economic growth and a headwind for valuations. From a market perspective, we don't think the shift by the RBA is enough to offset the positive tailwinds for equity markets in general. But it is enough to drive a divergence in relative performance across rate sensitive vs non-cyclical sectors, particularly if fine tuning policy is not enough, and the RBA is forced to take a more aggressive policy stance.

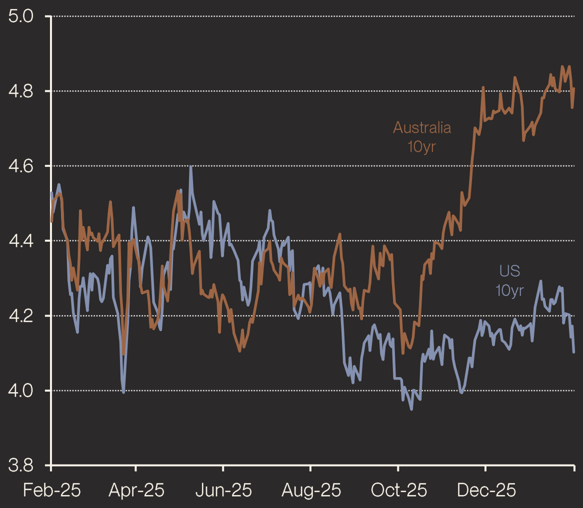
2. Elevated valuations and wide valuation dispersion: We don't think valuations are a constraint to equity market upside but the skew within the equity market is causing investors to rotate from higher valued stocks into areas where there is more valuation cushion. In other words, the extent to which some stocks have rallied also works in reverse as profit taking takes course and as investors seek more valuation protection. Accentuating the rotation is the rapid price discovery that is taking place in areas impacted by AI (software, insurance and wealth management to name a few over recent weeks).

3. **Heavy positioning with deteriorating confidence:** Performance of the Mag-7 stocks through 2024 and the start of 2025 illustrates how narrow the market rally has been at a global level. Because investors have funneled into a very narrow sub-set of stocks, positioning has been very heavy. When sentiment turns, the unwind of very concentrated positions work in reverse. In addition, there is a "reduce at all costs" mentality fearing that there will not be any natural buyers to support share prices if you are not out early.

On top of these factors is the corporate reporting season, which is now in full swing. We label it as a "deliver or die" update where the upside surprises are being rewarded but not as heavily as the disappointments are being discounted. It is notable that there is a rotation towards some of the more domestically defensive areas – banks in particular – but Materials have also been a beneficiary of the unwind in areas under pressure such as software and selected consumer cyclicals / rate sensitives. We don't think the extent of volatility is a permanent feature of the market, but it will take time for positioning to normalize and for greater transparency to emerge on the broader macro backdrop.

Bond yields remain well behaved

US and Australian 10-year government bond yield %



Source: Bloomberg

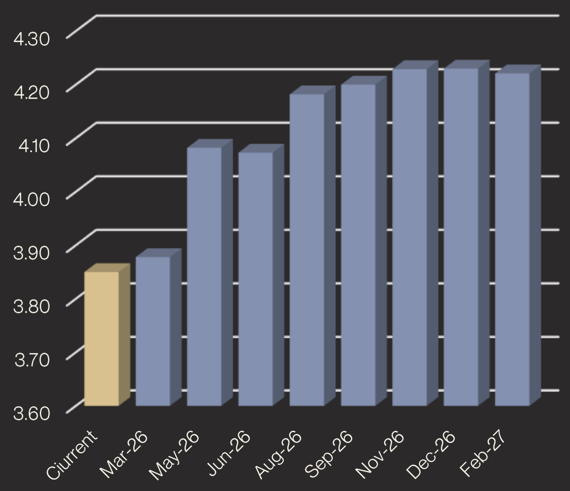
Can the market look through recent concerns?

Yes, is the answer. Despite pockets of notable weakness at the stock level - particularly in software and other high-valuation names – we think the Australian equity market can look through this softness and still move meaningfully higher into year end. The broader macro and liquidity backdrop remains supportive, especially in the US, where policy is biased toward easing, economic and earnings growth are solid, inflation is contained, and global capital continues to concentrate in large, liquid growth franchises. These forces matter far more for index direction than isolated drawdowns in crowded or expensive parts of the market.

What we are seeing is not a warning signal for a broader sell-off – supported by a rotation within equities. AI driven weakness has not translated into broad-based tech stress, let alone cross-asset de-risking. Market breadth remains healthy, indices are making new highs even as many stocks correct, and earnings expectations are largely intact. This divergence - strong index performance alongside falling individual stocks - is consistent with investors reallocating capital rather than existing the asset class altogether. Importantly, volatility remains contained, cash continues to be deployed, and sentiment continues to favor buying dips rather than selling rallies.

Market pricing in further RBA hikes

RBA cash rate – Futures pricing as at February 2025



Source: Bloomberg

Australia's relative underperformance reinforces this point. It reflects a relative macro and policy disadvantage, not a collapsing equity outlook. Australia is facing a more restrictive policy environment, a highly leveraged consumer, a housing-sensitive economy, and an equity market skewed toward value and old-economy sectors, with limited exposure to global growth themes. In contrast, the US benefits from liquidity tailwinds, a more supportive policy cycle, and index leadership from sectors still attracting capital inflows.

In short, recent stock-level weakness does not yet challenge the broader equity thesis. For that to change, we would need to see tightening liquidity, a sustained rise in volatility, earnings downgrades, or weakness spreading decisively across major sectors—particularly broader technology. Until then, the market's ability to look through idiosyncratic weakness remains intact, and current price action is better characterized as rotation and consolidation, not the early stages of a broader correction.

Are positive drivers for equities intact?

The key positive drivers for equity markets remain firmly intact, and recent bouts of volatility have done little to undermine the broader investment case. Economic growth is showing signs of improvement across major developed markets, with activity proving more resilient than feared and downside risks continuing to recede. At the same time, inflation has moved decisively lower, giving central banks confidence that the next phase of policy is one of easing rather than further restraint. Falling policy rates, or at least the clear prospect of them, remain a powerful support for risk assets.

Corporate fundamentals are reinforcing this backdrop. Earnings growth has held up well, margins have proven more resilient than expected, and balance sheets remain strong. Importantly, this is not an environment where equities are being supported purely by multiple expansion—there is genuine earnings delivery underpinning market performance. In parallel, liquidity conditions remain easy by historical standards, with financial conditions supportive and capital readily available for both investment and risk-taking.

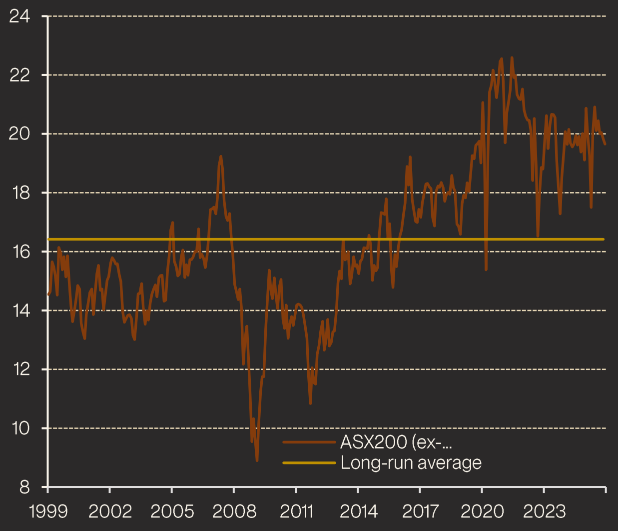
A further structural tailwind is the growing impact of AI-driven productivity gains. While still uneven across sectors, the efficiency, revenue, and margin benefits from AI adoption are becoming increasingly visible at the corporate level. This provides a medium-term earnings support that sits alongside cyclical improvement, rather than replacing it. Markets continue to reward companies that can demonstrate credible exposure to these productivity gains, reinforcing leadership rather than undermining it.

Taken together, improving growth, falling inflation, an easing policy outlook, solid earnings, supportive liquidity, and structural productivity benefits suggest the positive drivers for equities remain very much in place. Periodic stock-level or sector-specific weakness should be expected in this environment, particularly where valuations have become stretched, but these episodes look more like rotation and consolidation than a challenge to the broader equity thesis. As long as these macro and fundamental supports remain intact, markets should be able to look through near-term noise and maintain a constructive medium-term outlook.

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%.

ASX200 PE multiple is not restrictive

ASX200 ex resources median forward PE ratio (x)



Source: Bloomberg, Ten Cap

Despite rising uncertainty as to what will take and/or maintain equity market leadership, we think the equity market will traverse a very bumpy road higher and ultimately surprise on the upside again in 2026. This is not because the 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) favorable 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.

As the current reporting season shows, 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. The Australian equity market still offers opportunities for those willing to be selective and disciplined. The outlook is constructive even if the ride remains stomach churning.

Jason and the Ten Cap team

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Let's Keep Talking

Sydney

Level 4, 151 Macquarie Street,
Sydney
NSW 2000, Australia
+61 2 7241 4388

Investor Relations

info@tencap.com.au
tencap.com.au