TenCap

Letter from the CIO

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Absorbing risks is not ignoring risks

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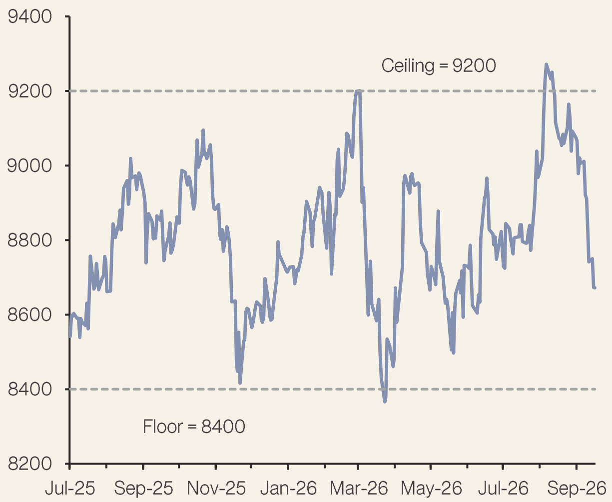
Absorbing risks is not ignoring risks

There is a growing belief that the equity market is ignoring downside risks. We disagree. Markets are absorbing downside risk and these two are very different things. The dispersion of sector returns across and within the Australian market and the broad decline in valuation ratios is ample evidence of this.

How else can you explain the return spread between Energy and Info Tech which sits at a massive 55% year to date if investors were ignoring risks associated with the US-Iran conflict on energy prices or the structural risks from AI confronting technology stocks (software in particular)? Why is Real Estate down 18% if risks around housing were not being incorporated into the outlook, or how can you explain meaningful outperformance from Consumer Staples (defensive) versus Consumer Discretionary (cyclical) if the market were ignoring risks posed by further rate hikes?

ASX200 rangebound for 15 months

Price Index



Source: Bloomberg

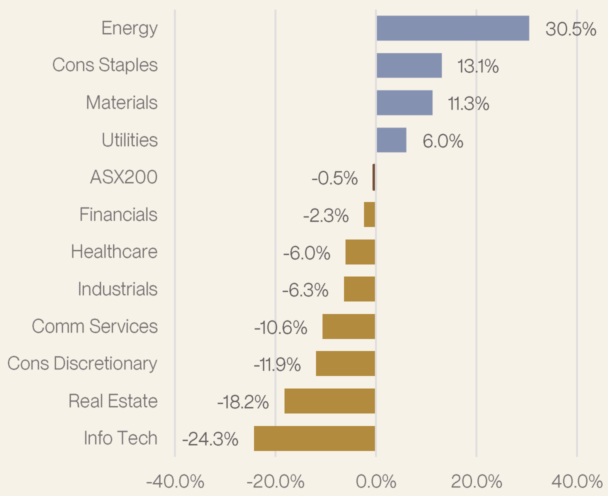
I am not suggesting that there is not more downside (or underperformance risk) or that every stock and/or sector has accurately priced each and every risk. But I am arguing that the lack of a market "correction" does not mean the equity market is not incorporating risks or that it is being complacent. I would even go as far as suggesting that outside of a global correction that takes Australia down with it, the Australian market can continue to bounce within the 8400-9200 trading range which has persisted since mid-2025.

Why is the market not weaker?

Looking at where the ASX200 is trading paints a confusing picture. How can the ASX200 be within 6% of its all-time record high when it is being confronted by a litany of headwinds? Inflation is problematic, the RBA is about to hike rates for the fourth and likely fifth time, house prices are in free-fall, bond yields are at multi-decade (and for many investors) generational highs, corporate earnings are softening without any input cost reprieve and there are mounting problems brewing for the AI trade.

ASX200 sector return skew is large

Year to Date Price Returns – ASX200 Sectors



Source: Bloomberg

I think it's because economic growth, despite all the headwinds, has remained far more resilient than base-line models would have suggested and this has led to corporate earnings also coming in ahead of expectations. Take for example the most recent Australian reporting round. It recorded the highest number of beats for many years with profit margins surprising positively and guidance – while negative – not nearly as bad as feared. This resiliency has given some comfort that economic growth and corporate earnings are not at risk of collapse even if geopolitical and economic uncertainty is extremely elevated.

I am in no doubt that markets will reach a breaking point if some of these risks do not begin to settle. Energy prices are not far from levels hit during the initial stages of the US-Iran conflict and long bond yields have continued their relentless climb higher and this is a bad combination.

But the rise in bond yields, which would have traditionally caused significant angst for risk assets – equities in particular – has been absorbed reasonably well because they are not only rising for "bad" reasons. As Gerard Minack (Minack Advisors) points out:

"Policy makers eased rates through 2024-25 because inflation seemed to be on a glide path to target and policy was restrictive. Inflation hasn't returned to target and it's not clear that policy is restrictive, so policy makers and markets are revising up their estimate of the neutral rate. For central bankers that means tightening policy, for rate markets it means higher long-end yields, for equities it means a headwind for valuation"

A rising neutral rate (higher rate of growth before generating inflation) has meant a large proportion of the rise in bond yields is because real rates are rising. There are other reasons which are not so good - including elevated inflation and fiscal spending concerns. But US 10-year yields have risen 100bps YTD and 450bps since 2020. That would have normally caused significant carnage.

Bond yields have not crushed equities

%

Source: Bloomberg

But in reality, the first 300bps has been a normalisation and we now think US long bond yields are somewhere in the middle of a trading range (potentially 4.00% - 6.00%) which does not necessarily mean they need to drive a large correction in equity markets. Similarly, if policy makers had underestimated the neutral rate, then policy is not as restrictive as expected and so the first few rate hikes need not be major headwinds for risk assets. Once again, this is markets absorbing rather than ignoring risks.

Others may argue against this view. I think that's the easy call. At some stage, and if risks continue to build, you'll get a correction. But that's not insight, that's just logic. Of course, if the market continues to go higher and risks continue to build that a breaking point will emerge. But I think the trading range may persist for some time even if the narrative becomes even more negative. It's much easier to talk about downside for the market when the market is near peak and the only new developments are negatively tilted.

Why stock / sector weakness over a broad correction?

Get a bunch of Australian economists together and none of them will talk about an imminent Australian recession. If the Australian economy is not on a path to economic recession, despite a further tightening in financial conditions, then it also stands to reason that corporate earnings should avoid the same fate.

In July's *"Letter from the CIO – Volatile and Rangebound"* we argued that the ASX200 was unlikely to sustainably break out of the 8400 – 9200 trading range that it has sat in since mid-2025. We argued that there were enough headwinds to prevent a breakout on the upside while there were enough tailwinds to prevent a breakout on the downside.

ASX200 PE is well off its highs

12-month forward price earnings ratio

Source: Macquarie Strategy

We have not changed this view. The extreme performance skew is how you gauge whether the market is factoring in risks and not whether the ASX200 has corrected from highs. We think this is a market where risk-reward is best played out in how you position within the market rather than positioning out of the market. You can be negative on consumer discretionary and real estate without being negative on the market. You can be long energy as a play on rising oil prices without selling the market or you don't have to sell the domestically based AI "picks and shovels" because global AI stocks are wobbling.

This may mean leadership continues to be volatile and that does make investing difficult. But broad-brush comments which highlight Australia's lack of aggregate earnings growth or that it (still) trades expensively are somewhat superficial observations given a market that over the past 2 years has traded as a *"sum of its parts"* rather than the *"whole"*.

We think a number of factors will support the broader market and allow it to absorb the headline risks:

- Performance skew has driven valuation skew: The ASX200 may still trade around 17x forward earnings, above its ten-year average of 16.4x, but that headline multiple disguises a large collection of stocks that have been dramatically de-rated.

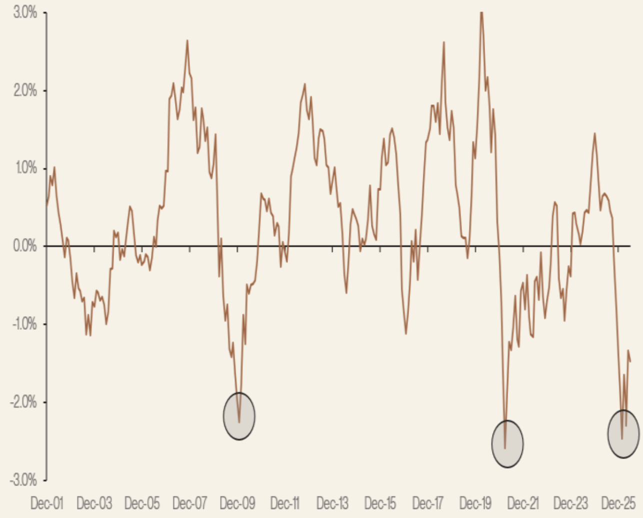
- Growth & Quality is at "fire-sale" valuations: In the past 26 years, there have only been two other periods of underperformance from Australian growth / quality stocks that match the current episode (in 2008 during the GFC and in 2020 during COVID). The economic and earnings backdrop is not approaching crisis conditions, and we think this will be a significant support for stocks.

- Bond yields have risen for good reasons as well as bad, and equities have absorbed it. While yields have risen significantly over the past 4 years, we think three-quarters (~300bps) of the move higher was a reversion to normal levels a large part of the remaining increase driven by higher growth expectations. While equities are not impervious to higher yields, the sensitivity to higher yields is more robust than in previous cycles.

- The Australian outlook is softening, not breaking, because the consumer still has ballast. Growth is slowing and the RBA still has work to do, but the labour market has held up better than feared, and net household debt to disposable income is down to 20-year lows, meaning households are carrying this tightening cycle from a stronger starting position than in prior cycles. Add several years of accumulated wealth gains - in housing before the recent slowdown and in superannuation and listed equities through this cycle's bull market - and the consumer has more of a buffer than the growth data alone would suggest.

Growth Compounders are at multi-decade performance lows

Excess rolling 12-month returns



Source: Macquarie Strategy

- The AI thematic still has room to run, and for Australia it shows up as bricks and mortar rather than the hyperscalers. HSBC estimates Australia's data-centre investment pipeline at around US$97 billion, roughly 3.4% of GDP. As PIMCO's Adam Bowe put it, "at the end of the day, this is just real-estate investment in Australia... we rent the space out." That's a different, and arguably more durable, way for the local market to participate in the AI cycle than trying to pick the next software or chip winner: it shows up in industrial land, power and grid infrastructure and data-centre landlords, rather than in a handful of crowded global mega-caps.

- Australia retains more policy optionality than most developed markets. Federal debt is on track to peak near 35% of GDP, a fraction of levels in the US and elsewhere, leaving the RBA and Canberra more room to manoeuvre than most developed-market peers if conditions deteriorate. That's not a reason to relax about further hikes near term, but it is a reason the downside case doesn't have to be as severe here as in a more fiscally constrained economy.

Ultimately, I don't know when the breaking point for the equity market is reached. I would ask why there has to be a breaking point. It's quite possible that risks diminish. It's also possible that the Australian economy and corporate earnings continue to show better resiliency than expected (just as they both have over the past 2 years). It's also quite possible that risks don't become systemic and that "isolation" of risks remains the best way to play the market.

I think market experts have exhibited rubber arms in recent years. Wherever the wind is blowing, that's the easy narrative to take. I think the Australian equity market can keep doing what it's doing. Corrections are inevitable but that doesn't mean we are on the cusp of one simply because there are risks and the headline index is at a puzzling altitude. Tell that to Nick Scali or Harvey Norman, which are already down 40% year to date, the collection of real estate names that are down 30% plus or the WiseTechs, Xeros and Life360s of the world that are down between 40-50%.

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Let's Keep Talking

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