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ADVISORY

# Diverging Paths

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Our weekly view on asset allocation.

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# The US May Still Support Domestic Markets Despite Local Challenges

After a year adapting to major policy changes in 2025, the latest Federal Reserve projections anticipate the US economy emerging on track for stronger growth and lower inflation in 2026.

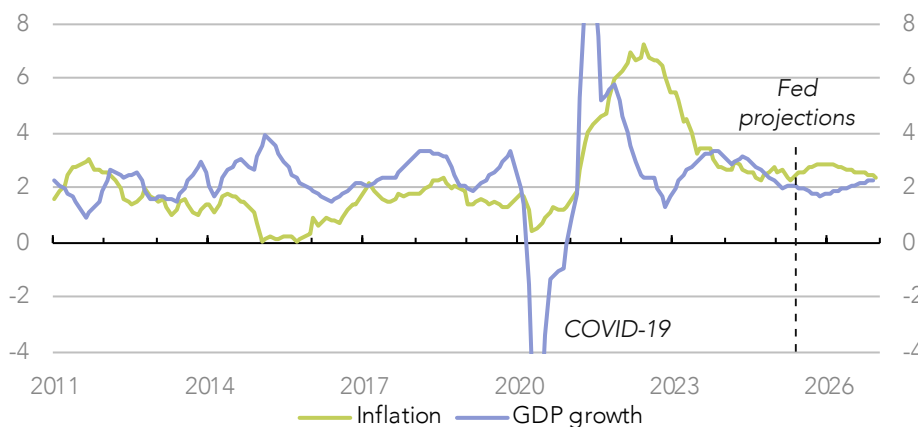
In contrast, the latest assessment from the RBA sees risk of signs of a broad-based inflation pick up and the potential need to raise interest rates again next year.

Here we consider the potential implications for markets before discussing the differing outlooks in more detail.

- **Recent market performance has factored in some divergence in the outlooks.** We have commented in the past few weeks on the sensitivity of markets to shifting interest rate expectations, which have created choppy US markets but left equity indices and bond yields little changed in the past month and half; while generating weaker markets in Australia, with equities down around 5% and bond yields up as much as three-quarters of a percent, as rate expectations have swung around. In the past week, the Fed and the RBA tended to validate these moves, with the Fed cutting again and projecting more easing, but the RBA on hold and discussing conditions that could require a hike next year.

- **In reality, the Fed may be close to pausing, though an improving economic outlook could remain supportive of markets.** At the past week's press conference, the Fed Chair noted that, after the three, one quarter percent rate cuts in recent months, policy was now within the range of estimates of neutral, leaving the Fed well placed to "wait and see" how the economy evolves. Moreover, the median projection of committee members was for only one further quarter point cut next year, and there were two dissenters from cutting at the past week's meeting. But the projections also envisage an easing in inflation and pickup in growth next year, conditions that could continue to support equity and bond markets (Figure 1).

**Figure 1: US inflation and growth (year ended % change)**



Source: Fed, Refinitiv, Canaccord Genuity.

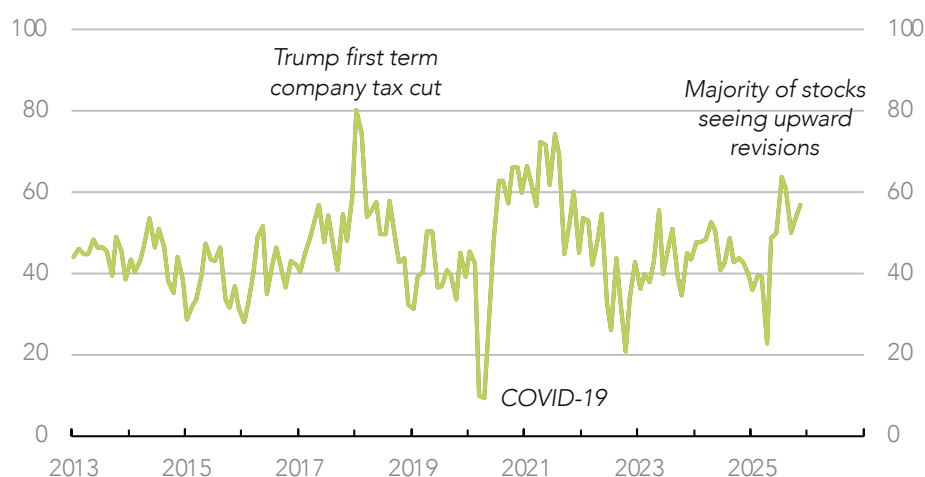
- **Domestically, markets have now priced in a significant change in the direction of rates, and the RBA may not need to go beyond that.** After the past week's meeting, the Governor indicated the board is assessing how much of a persistent rise in inflation may have occurred and how restrictive policy may or may not be. On the indications so far, including underlying inflation only at or slightly above the target range, any adjustment in rates might not need to exceed the half a percent rise markets have factored in. Consumers may also be sensitive to the change in outlook for rates, from cuts to hikes, given cost of living pressures, and a stronger AUD could also contribute. Thus, after what's been priced in, further headwinds to domestic markets could be less, and continued gains in the US could remain a positive backdrop.

## Getting Back On Track

The past week's Fed meeting had the added interest of offering an official view of the US economy after a couple of months of little government data and difficulties judging conditions. The assessment provided turned out to be more positive than expected and projected both a significant easing in inflation and pickup in growth in 2026. It suggested the US economy would emerge from a challenging year of major policy changes in 2025, particularly in relation to trade and immigration, on track for sustainably stronger growth again in 2026.

The median projections of the policy setting committee members anticipated the Fed's preferred measure of inflation, based on the PCE price index, easing from 2.9% at the end of this year to 2.4% by end next year, and GDP growth picking up from 1.7% this year to 2.3% next year. These favourable projections were founded on, in the case of inflation, continued decline in inflation in services, and a peaking and decline in inflation in goods, the latter as the effects of higher tariffs passed; and in the case of GDP growth, on sustained consumer spending, continued business investment in AI, and fiscal stimulus from the recent federal budget.

**Figure 2: S&P 500 stocks with upward earnings revisions (% of total stocks)**

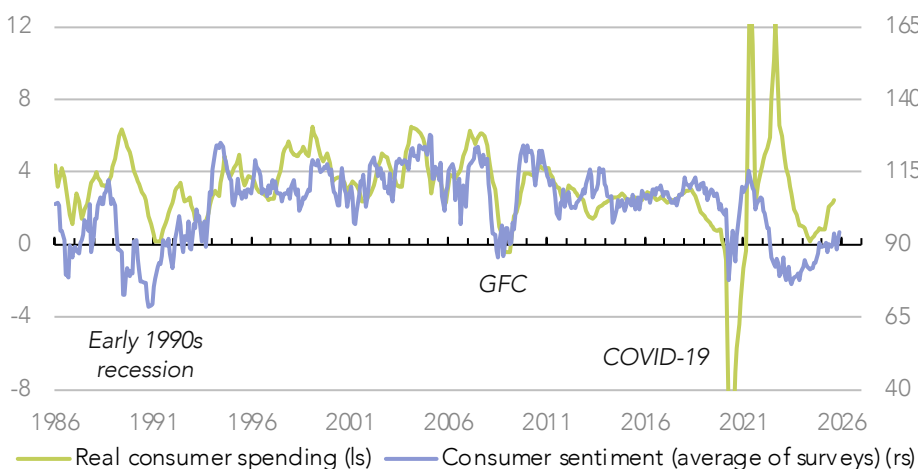


Source: IBES, Refinitiv, Canaccord Genuity.

Part of the more subdued growth this year and pick up next year was attributed to the disruption of the government shutdown, causing a reduction in growth this quarter and bounce back next quarter. Abstracting from this, GDP growth would have been projected to be 1.9% this year and 2.1% next year, less of an underlying pickup but still one nonetheless.

Based on available data, the Fed considered that growth had remained moderate over recent months, though positive corporate earnings guidance and upgrades to earnings forecasts by analysts indicate business conditions have been favourable and the Fed's economic projections suggest that continuing next year (Figure 2).

**Figure 3: Australia consumer sentiment and spending (year ended % change)**

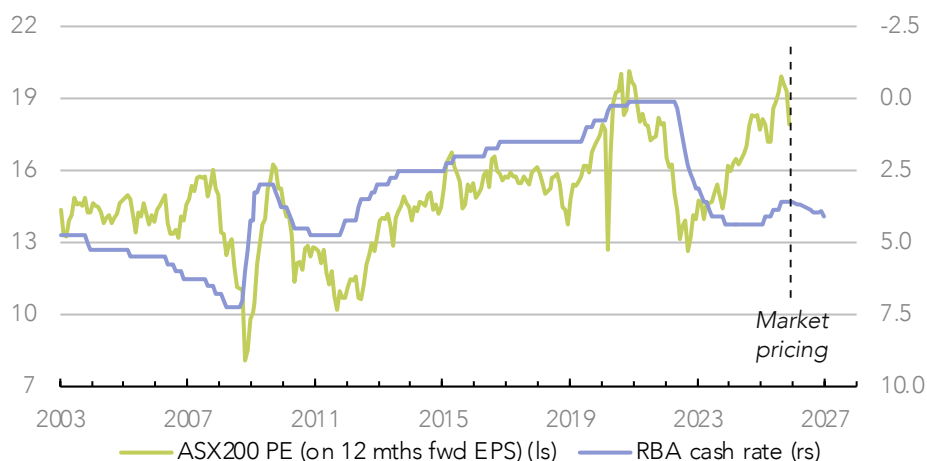


Source: ABS, Roy Morgan, Westpac/Melb. Insitute, Refinitiv, Canaccord Genuity.

## Moving A Little Off Course

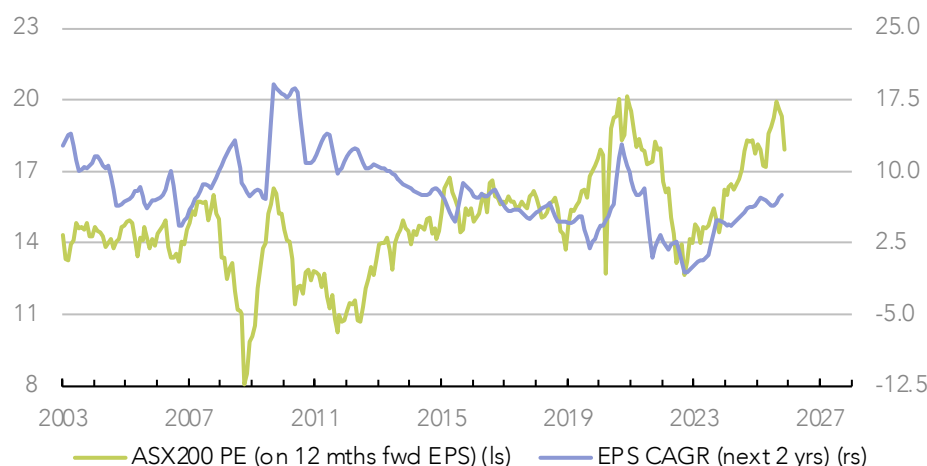
The RBA meeting also provided an official view on the domestic economy, after the first comprehensive monthly figures for inflation in October and the recent GDP figures for the September quarter. The assessment was a bit more hawkish than after the prior board meeting, reiterating that both temporary and persistent factors could be contributing to the rise in underlying inflation, but noting the risk of signs of a broad-based pickup. The GDP growth of around 2% over the past year was in line with the RBA's forecasts and close to potential growth, but the pickup in private demand growth to 3% had been stronger than expected.

**Figure 4: ASX200 PE ratio and the official cash rate (%)**



Source: RBA, Refinitiv, Canaccord Genuity.

**Figure 5: ASX200 PE ratio and consensus forecast EPS growth (%)**



Source: IBES, Refinitiv, Canaccord Genuity.

The board had been left of the view that the risks to the outlook had tilted to the upside, having been judged more to the downside at mid-year, partly due to global developments at the time. And so, while wanting more information to assess how much of a persistent rise in inflation had occurred and how restrictive or not policy is, the Board discussed conditions that might warrant a rate hike next year; and the Governor interpreted the market's swing from pricing a further half of a percent of cuts only two months ago to half a percent of hikes now, as trying to judge the RBA's potential reaction to developments, without wanting to comment on the scale of adjustment.

However, on the indications so far, including underlying inflation only at or slightly above the target range and policy appearing little if at all easier than neutral, and with consumers likely sensitive to the change in rate expectations given cost of living pressures, as reflected in still relatively low consumer sentiment, any policy tightening by the RBA might not go beyond that now priced into markets (Figure 3). This might limit further market weakness, as a significant change in rate expectations seems to have been absorbed in the equity market's recent de-rating, particularly given earnings growth forecasts have still been rising (Figures 4 and 5); and gains in the US market could still provide a positive backdrop in the coming year.

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### Wilsons Advisory contact

[tbrennan@cgf.com](mailto:tbrennan@cgf.com) | +61 2 9258 8939

[dcassidy@cgf.com](mailto:dcassidy@cgf.com) | +61 2 8247 3149

[www.wilsonsadvisory.com.au](http://www.wilsonsadvisory.com.au)