December 2025

Market Outlook.

Navigating AI-driven global equity markets with clarity.

Executive Address

The sell-off in US tech stocks during the first three weeks of November saw investors reassess their risk appetite and question the level of AI-related capital expenditure (capex). The interconnected nature of AI throughout the global markets served to further exacerbate moves in the tech sector. Diversification can be easily dismissed as being unnecessary when markets are moving rapidly higher by a concentrated set of thematics. The re-emergence of equity market volatility has served as a powerful reminder of the importance of having multiple return drivers across a portfolio. AI will take time to scale and see adoption throughout the real economy. But, as with all periods of major transition, there will be doubt and questions along the way. We do not expect the journey to be linear.

AI is becoming essential for many companies, but for investors, returns will vary based on who captures value. The investment selection process in relation to AI is not just about owning tech stocks. Rather, it involves identifying companies that can turn the promise of AI into real returns. Investors should be sure to understand how AI adoption is evolving and monitor which companies are turning innovation into measurable results. The coming decade will favour investors who analyse competitive positioning and understand the durability of cash flows.

We believe as AI moves from promise to performance, the pace of change could reshape entire industries. This will include areas as diverse as healthcare through to insurance and even the asset management industry, something we experience firsthand. AI is already serving as a tool to drive speed and efficiency within investment management by accelerating the collection and structuring of information for analysis. What could take hours can now be done in minutes. These are the easy wins. Whether AI can correctly and consistently make decisions regarding risk and reward is yet to be proven. Investors still need to use experience and judgement to investigate the most appropriate areas, ask the right question and interpret the results.

On the economic front, the Reserve Bank of Australia (RBA) held rates steady at the November meeting, as a sticky inflation picture has severely undermined the case for further rate cuts in Australia. This notable shift in the interest rate outlook supports the case for a spread of asset classes, including those with inflation-linked cash flows derived from real assets like property and infrastructure. Regulated assets can also serve to dampen portfolio sensitivity to economic growth. Our economic outlook remains broadly constructive, but the key to robust portfolio construction is maintaining exposure to assets with different cash flow drivers. This is especially important given the increasing AI related concentration flowing through markets. Australian equities, with its focus on materials and financials, may build out portfolio diversity with a relatively low exposure to the IT sector compared to global markets.

Diversification is also important because of the growing linkage between the US equity market and the US economy. This is due to the high US ownership of shares among the wealthy. According to Gallup, 87% of US adults with a household income of $100,000 or higher own stocks. Strong markets over the last few years have driven the wealth-effect despite overall consumer sentiment sliding. The implication being that a prolonged rise in the markets can be supportive for growth, but it also means the markets could lead the economy following any prolonged weakness. This further strengthens the argument for diversification to boost resilience across a broad spectrum of assets and strategies, including alternatives.

James Foot, Chief Investment Officer

AI: All In?

- AI dealmaking is creating complex interdependencies.
- Tech continues to dominate market weightings.
- Portfolio diversification remains essential.

As the artificial intelligence infrastructure buildout continues apace, key players have formed an interconnected system of reciprocal arrangements, the circular nature of which magnifies the risk of a market upset, should lofty investment return expectations not be met. Examples of such deals include Nvidia committing up to US$100 billion to help OpenAI build out data centres, with OpenAI also promising to fill those centres with Nvidia chips. This deal was closely followed by a US$300 billion tie-up between OpenAI and Oracle to build out data centres, with Oracle in turn promising to spend billions on Nvidia chips for those facilities. OpenAI anticipates infrastructure spending commitments of US$1.4 trillion over eight years. Meanwhile, OpenAI does not expect to be cash-flow positive until near the end of the decade. To put US$1.4 trillion into context, Amazon, Microsoft and Alphabet have spent less than US$1 trillion in capital expenditures over the past decade combined. Yet each new deal - Nvidia has made over 100 deals in the last two years - has seen share prices soar, which has been a major driver of market returns in recent months, notwithstanding the recent valuation correction.

Another development in 2025 has been the increasing use of debt. So far, approximately US$108 billion of debt has been raised across the largest AI spenders including Amazon, Alphabet, Microsoft, Meta and Oracle. Oracle's $18 billion debt raising to drive its foray into the cloud computing space, despite facing thin start-up margins caused particular concern. Debt only further increases the time pressure to generate acceptable returns for investors and while the absolute level of debt raised is not yet cause for alarm, the shift in behaviour is worthy of monitoring.

It is this network of dependencies, with capital, technology and demand flowing in loops, rather than via linear supply chains, and the rising balance sheet risk that make this an opportune time for investors to pause and critically consider the diversity within their portfolios. Indeed, many portfolios are now heavily exposed to the AI theme, even indirectly, through holdings in cloud providers, semiconductor firms or software companies whose valuations are influenced by AI optimism. Analysis by GQG Investment Partners shows technology and technology-related stocks now account for approximately 50% of the S&P 500, having risen from 20% post-GFC in 2010, while the once-dominant cyclical sectors (discretionary, energy, financials, industrials and materials) have fallen from 50% to 30% over the same period. Defensives (consumer staples, healthcare and utilities) have also decreased from 30% to 20%. Yet, history shows even the most dominant companies can see their fortunes reverse when expectations run ahead of investment returns.

Accordingly, diversification remains a critical portfolio construction tool, perhaps today more than ever. While AI is undoubtedly only going to grow more powerful over time and we do not dispute the world-class nature of the businesses leading the charge, the range of potential valuation paths and outcomes is immensely broad. We counsel investors to think outside the square and consider diversifying into areas that are more attractive from a valuation perspective, including companies down the market-cap spectrum (in both small- and mid-caps) where valuations remain attractive relative to history. Both our international and Australian active equity fund managers are finding strong opportunities in these areas. The value segments of the market are also appealing, as many of the defensive sectors cited above continue to trade cheaply on a relative basis. These are all great areas to round out a portfolio capable of performing across a range of market environments.

The oft-repeated phrase attributed to Nobel Prize-winning economist, Harry Markowitz, that diversification is the only free lunch in finance, remains true. AI may be changing the world day-by-day, but the tried-and-true tenets of portfolio construction remain the same.

The K-Shaped US Economy

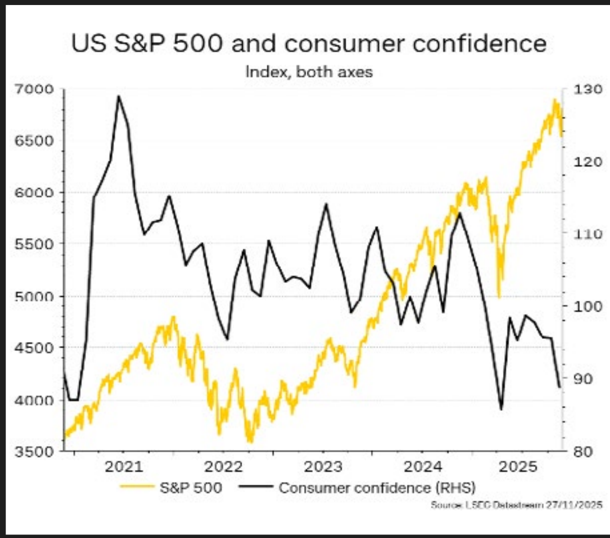
- The K-shaped economy metaphor describes a divergence in outcomes for different sectors and participants in the economy.
- Narrowing base of economic support introduces greater volatility risk more correlated with financial-market performance.

The US economy continues to expand, but growth has become increasingly uneven. The term K-shaped economy has emerged as a feature of the US economy, describing a recovery in which the upper arm of the K represents affluent households, asset-owners and capital-intensive corporations, continues to rise, while the lower arm, comprising wage earners, small businesses and lower-income consumers, faces mounting pressure. Corporate leaders such as McDonald's and Coca-Cola have noted this divergence in spending behaviour. Higher-income consumers remain resilient, sustaining demand for premium goods and services, while lower-income households are scaling back, shifting toward cheaper alternatives, or withdrawing from discretionary spending altogether.

For many lower- and middle-income households, the everyday experience has worsened meaningfully in recent years in line with the "lower arm" of the K-shaped economy. These households now face a combination of stagnant wage growth and sharply higher costs for essentials such as housing, utilities and food, eroding purchasing power and financial cushions. Signs of stress are increasingly evident. Credit card and auto-loan delinquencies have climbed to their highest levels since 2009, more families are living pay cheque to pay cheque and sentiment among lower-income consumers has deteriorated to multi-year lows. Conversely, the wealthiest households and large corporations benefit from appreciating asset prices, strong profit margins and AI and infrastructure investment cycles lifting capital returns more than payrolls.

From a macro perspective, this divergence represented by the K underscores the widening gap between Main Street and Wall Street.

US S&P 500 and consumer confidence



Corporate earnings and equity markets remain strong with S&P 500 profit margins back above pre-pandemic averages, while consumer sentiment, particularly among lower-income groups, has weakened to one of the lowest levels on record. The economy's resilience has become increasingly dependent on high-income spending and asset valuations. This dynamic creates both opportunity and vulnerability, corporate profits margins remain healthy, supported by secular capex in AI and data infrastructure and by premium-tier consumer demand but any correction in asset prices or erosion of upper-tier confidence could quickly expose any risks beneath the surface.

For investors, the implications are two-sided. On one hand, the upper part of the K favours sectors aligned with capital efficiency and scalable growth, notably technology, data infrastructure and high-margin consumer brands. Firms catering to premium segments, or positioned within secular investment themes such as artificial intelligence, digital transformation and reshoring, may continue to outperform. Sectors tied to broad-based consumption like mass-market retail, autos and certain services face sustained headwinds as lower-income households economise. A narrow base of economic support also introduces greater volatility risk, as high-income spending is more correlated with financial market performance than with wage growth.

For investors, while US growth appears resilient, it increasingly rests on a narrower foundation driven by the upper arm of the K. The question is whether this momentum can be sustained without renewed strength and participation from the broader base of the economy.

How do fixed income investors keep deriving risk-considered yield and income in 2026?

- Given interest market changes, attaining defensive yield and income via higher-for-longer portfolio yields is achievable in 2026 through careful fixed income investment selection.
- We favour active managers that operate liquid, investment-grade fixed income portfolios with measured interest and credit exposures.

Heading into 2026, with term deposit (TD) rates at recent lows and elevated equity valuations, attaining yield and income while maintaining a defensive bias remains at the top of fixed income investors' minds. Courtesy of some meaningful shifts in domestic interest rate markets, this can still be realised through careful investment selection.

Prior to the surprise Q3 inflation data in October, most market watchers, including ourselves, had forecast a continued easing bias from the RBA. Recent data has complicated the central bank's task. Improving economic growth, a resilient labour market, rising house prices and the latest quarterly and now monthly inflation data have taken rate cuts off the table and raised the risk of hikes later in 2026. Australian dollar market interest rates have swiftly moved to price this in, with yields for three-year government bonds and interest rate swaps rising around 0.5% over the last four weeks to 3.8% to 3.9% as of late November.

With income generation in fixed interest largely a function of the level of bond/portfolio yields, a higher for longer rate environment next year is beneficial for the potential returns for bonds and funds. According to PIMCO, the correlation between starting yields and bond returns is strong, with around 95% of expected returns from core bonds over the next three to five years explained by the starting yields (this dynamic assumes interest rate exposures are measured for standalone fixed income portfolios/investments not part of a diversified portfolio, explained below). Using a more extreme example to illustrate the opposite monetary policy outlook, if domestic interest rates swiftly and sharply decline by, say, 1.5%, following the one-off sugar hit from the capital gains associated with the fall in bond yields, the prospective portfolio yields and coupon income would be commensurately lower, with implications for their medium-term return potential.

Notwithstanding the above, with very tight offshore credit spreads, elevated equity valuations and re-emerging bond market volatility locally, in our view, this is not the time for investors with more defensive risk/return objectives to over-reach for yield, be it from giving up liquidity, and/or moving down the capital structure or credit curve (i.e. investing in securities with long duration).

As an example, with the phasing out of domestic bank hybrids, lately, several financial and corporate issuers have sought to tap strong investor demand for coupons/yields above 6.0%, by issuing 20-year bonds. With the sharp move higher in Australian dollar market interest rates last month, these long-duration bonds have declined by around $1.50 to around $5.00 in capital price terms and are trading below par as of late November. This is not a concern for investors who plan to hold these bonds to their 20-year maturity or call dates. However, for those that may unexpectedly need liquidity much earlier, a less favourable outcome may ensue, depending on the prevailing market conditions.

Heading into 2026, we retain our strong preference for liquid, absolute return and investment-grade-oriented fixed income managers and funds that are flexible and dynamic in their portfolio management and exhibit measured interest and credit exposures.

Will the robots rise or serve?

- Private equity (PE) firms are already using AI inhouse and within portfolio companies to achieve efficiency and accelerate growth.
- Whether AI can correctly and consistently make nuanced decisions regarding business and risk will need to be continually tested.
- AI will need to be guided to think outside the square. Humans need to understand AI as much as, or more than, AI needs to understand its given task.

Professional services business EY reported 84% of PE firms are already incorporating artificial intelligence (AI) into their deal screening and analysis. What is surprising is the number is not higher. Many large PE firms now have dedicated teams of data scientists working to implement AI assistance in their businesses.

These applications include the use of generative AI and large language models (LLM) to digest large data public data sets such as news reports, regulatory filings and website data, as well as private information regarding prior transactions and the performance of other companies. AI agents can use these inputs to identify investment themes and corporate acquisition targets faster and more efficiently than humans. Outputs can include drafting investment proposals, complete with risk analysis.

These processes and AI-assisted outputs will still need to be overseen by rational, experienced, risk managers. This includes that PE firms will need to recognise and avoid "groupthink" where the "group" is represented by AI engines trained on and prospectively reviewing similar data sets with similar objectives.

AI can also be applied to the analysis of complex PE portfolios being offered for sale on the secondary market. This requires the analysis of the financial statements and forecasts of potentially hundreds of private companies in a limited time. The contribution of AI in these transactions has the potential to open up PE secondaries to a broader pool of buyers, increase transaction velocity and accelerate returns from locked-up capital to investors demanding greater distributions.

Further AI applications within PE firms include monitoring portfolio company performance compared to their financial targets, as well as general business management functions including HR, CRM, legal and compliance.

Inhouse adoption of AI by PE firms builds their capability to implement AI models within their portfolio companies, with the objective of transforming and growing businesses and driving profitability.

Technology sector companies are the most obvious benefactors from AI, with PE portfolios allocating 30% of funds to tech, led by venture capital's 43% exposure (Source: MSCI). For example, in software development, AI-generated code takes only a fraction of the time to generate and test compared to human coding.

AI applications across other sectors continue to grow, including healthcare, consumer-facing businesses, financials and industrials, as well as communications services. For example:

- Healthcare: diagnosis, personalisation of care, pharmacological research into new compounds.
- Consumer businesses: personalised marketing that focuses on understanding customer needs and creating targeted messages and media, like virtual try-on options. Supply chain and inventory management and flexible pricing models.
- Financial: customer service, fraud detection, legal, compliance.
- Industrial and manufacturing: robotics and smart automation, accelerated design, workflow management.
- Communication services: network optimisation, customer service, cyber security.

Tactically, AI can assist fast followers to win market share. However, when competing for a piece of a finite-sized pie, not all can be winners. As such, we expect AI applications to expand beyond simple efficiency improvements and lead to the creation of new products, business models and markets in which new companies can quickly establish leading positions.

Moreover, private equity firms will continue to invest in AI technology to bring big returns. Some of the effects of this investment will be profound.