



Commonwealth  
Private



October 2025

# Market Outlook.

Exploring the importance of  
fiscal dominance.

# Foreword

Equity market sentiment has remained buoyant, despite the S&P/ASX 200 spending the last month slightly below its record highs. Australia's economy is benefiting from lower interest rates, coupled with renewed confidence from the local consumer, which is leading to improving growth prospects. At the same time, employment growth in the US has slowed enough to facilitate a further loosening of interest rates. The Nasdaq and S&P 500 equity indices each closed at a series of record highs during the month of September, despite persistent questions over the independence of the US Federal Reserve and the spectre of fiscal dominance, a topic we discuss below.

The widely anticipated 0.25% September cut to the US cash rate was delivered in response to the growing signs of US labour market weakness. Several downward revisions suggest the US jobs market has seen a slowing compared to the strength witnessed during its recovery in the aftermath of the pandemic. Part of this cooling is likely due to tariff-related uncertainty from earlier in the year, especially as employment data tends to be a lagging economic indicator. Immigration policy has also played a role in the supply of labour in the US, which has served to keep unemployment rates lower. One silver lining from the post-pandemic inflation outbreak was interest rate settings in most countries were bought back to more normal levels. With US cash rates at 4.00% to 4.25%, there remains ample room to cut if the US economy deteriorates substantially (albeit this is currently not our base case).

The latest US rate cut comes amid questions about whether the US economy is heading towards a regime characterised by fiscal dominance. Fiscal dominance occurs when monetary policy is influenced by the government's fiscal needs, rather than controlling inflation. High levels of government debt and/or large budget deficits, coupled with weak governance, are common features of those countries that have subordinated monetary policy needs. Fiscal dominance has typically been an issue for certain emerging markets. Under a scenario of fiscal dominance, the central bank may not meet its inflation

goal because the priority is to keep interest rates for the government low, which has significant negative consequences for the economy.

A key risk with fiscal dominance is that inflation expectations rise as consumers, businesses, and markets lose faith that the central bank will achieve its inflation goal. Therefore, fiscal dominance can result in higher, rather than lower, borrowing costs. This is somewhat consistent with the current easing cycle in the US, where longer-term bond yields have remained elevated in the face of falling cash rates. This dynamic has occurred despite a stated preference from US Treasury Secretary Scott Bessent that long term borrowing costs remain sustainable.

If we were to enter a regime of outright fiscal dominance in the US, then equity markets would likely perform well in a "run it hot" scenario and the US dollar would likely come under continued pressure. Yield curves have already steepened, and would steepen further, if central bank credibility was severely undermined. Even still, we would still expect short to medium bond yields to fall in a scenario where the economic backdrop darkens materially, meaning bonds still have scope to play their traditional role in portfolios, centred around diversification potential and income generation. The base case assumption from the CBA Global Economic and Markets Research team is that the Federal Open Market Committee (FOMC) maintains its independence in relation to its mandate, although new appointments are likely to see it adopt an easing bias. However, we do acknowledge the risk of fiscal dominance in the US is growing and we are closely monitoring this issue.

As it stands, equity market valuations have become full in pockets, especially in countries like the US and Australia. However, not all assets are in this category, e.g. global real estate investment trusts (G-REITs). Valuation differentials (measured by dispersion) within and across equity markets remain elevated. Dispersion is constructive for future alpha, or excess return, potential, because portfolios

can be deployed into areas with more attractive risk/reward prospects. We continue to believe diversification is key to be able to prepare for a range of scenarios to play out across markets. That means combining assets with different growth and inflation drivers such as alternatives (including hedge fund exposure), real assets, fixed income and local and global equities.

James Foot, Chief Investment Officer  
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# Global Economics:

## Rate cycle back in focus

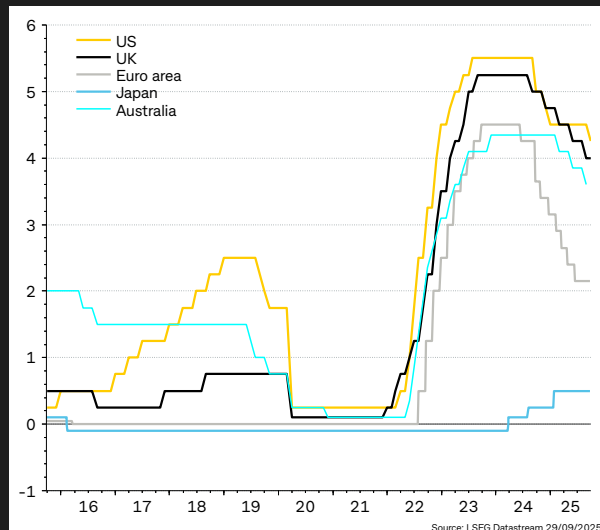
- Central banks managing dual mandates
- Policy divergence becoming more evident

September was a pivotal month for the US as the Federal Reserve (the Fed) initiated its first rate cut this year, lowering the policy range by 25 basis points to 4.00% to 4.25%. The decision was justified by a sharp loss of momentum in the labour market, with August nonfarm payrolls rising by only 22,000 and unemployment edging up to 4.3%. Inflation continued to moderate, with Consumer Price Index (CPI) at 2.9% year-on-year, still above the Fed's 2% target, but consistent with a gradual disinflation trend. The move was framed as a risk management step, rather than the start of an aggressive easing cycle. But this also leaves scope for one to two additional cuts by year-end if labour market weakness accelerates.

In Europe and the UK, monetary authorities took a more cautious stance. The European Central Bank left rates unchanged, highlighting the persistence of services inflation and the resilience of domestic demand despite slowing trade flows. Similarly, the Bank of England maintained its rate at 4.0%, citing concerns premature easing could reignite wage and price pressures. The hesitation to follow the Fed reflects domestic inflation dynamics and the vulnerability of Europe's terms of trade. Both the euro area and the UK remain heavily reliant on imported energy, leaving them exposed to renewed inflation if their currencies depreciate significantly. With geopolitical risks still affecting energy markets, policymakers view currency stability as essential to containing imported price pressures, even at the expense of weaker growth momentum. This divergence underscores a central theme for global investors. While the Fed is moving to cushion demand, Europe is constrained by the risk policy easing could worsen its external price position and delay further progress on inflation.

### Global central bank rates

Percent per annum



China's policy stance reinforced this picture of divergence. The People's Bank of China kept the loan prime rate unchanged for the fourth consecutive month, opting instead for targeted credit and fiscal measures aimed at boosting services consumption. Economic activity remains patchy, with industrial production, fixed asset investment and retail sales showing only moderate growth, slowing from the previous month. At the same time the external environment has become more challenging. China's terms of trade have deteriorated as export growth slows and import costs for commodities remain high. With capital outflows already a concern, authorities have prioritised currency stability and financial system resilience over broad-based rate cuts. This approach highlights China's limited policy space compared to the US, where the combination of reserve currency status and domestic energy production provides greater flexibility.



# Australia Economics:

## Reserve Bank of Australia (RBA) easing close to the end

- Rate cuts are having the desired effect on the economy, with further evidence of rising economic activity, but also a firmer inflation pulse.
- CBA is forecasting one more rate cut this cycle, but this is data dependent and not guaranteed.
- The rising dispersion of economic activity among key developed countries has key implications for their equity, currency and bond markets, providing opportunities for our active global fund managers.

Recent data flow since the RBA's rate cut in August has reinforced the view the local economy is recovering. Notably, as flagged in our previous Market Outlook, this includes the consumer, with annualised growth in the latest quarterly Westpac Consumer Sentiment data accelerating to 17.7% from 13.1%, consistent with further nominal consumption growth.

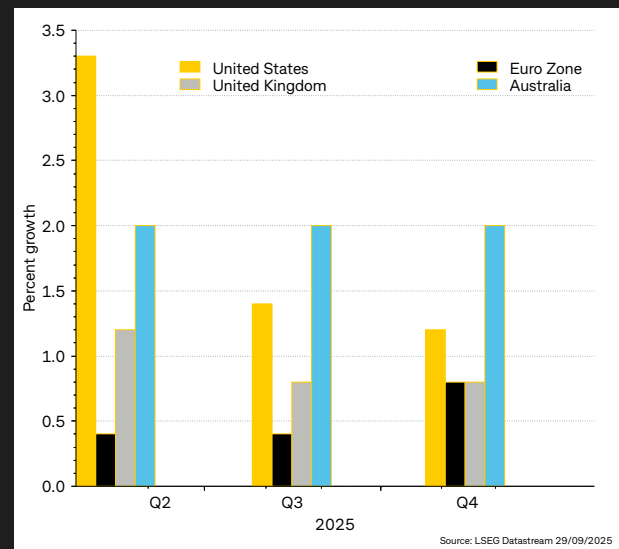
Meanwhile, as the first significant increase since the third quarter of 2022, the NAB Business Conditions Index was also stronger in August. This suggests domestic demand is increasing, while raising the risk of renewed inflation, as noted below.

While the S&P Global Purchasing Managers' Index (PMIs) for September showed a slight softening after a strong two months, over the quarter, these PMIs indicated economic activity remained solid in the third quarter of 2025. This implies expansion in real GDP growth in coming quarters and follows the June 2025 quarter GDP surprise to the upside, rising by 0.6% for the quarter to be 1.8% higher annually.

Another reason for a muted rate cutting forecast from here is the unemployment rate remains low historically. This was again confirmed in August with the rate holding steady at 4.2%, albeit there are further signs of softening with employment falling by 5,400 people compared

### Dispersion of GDP growth increases

#### GDP growth & expectations



to market expectations for a 21,000 gain.

In addition, the latest headline monthly CPI data was stronger than consensus at 3.0% a year in the year to August, compared to CBA expectations of 2.7% a year. With key subcategories firmer than expected, including market services and housing, this indicates the inflationary pulse in the economy has firmed.

Given the above, CBA expects the RBA to cut the cash rate once more in February 2026 to 3.35%, although this cut is not guaranteed. Importantly, as of late September, short- to mid-dated interest rate markets have fully priced in this RBA interest rate cutting cycle.

While the domestic economy is recovering, that's not the case in other developed countries. New Zealand recently saw a drop in quarterly GDP, while in Canada its central bank cut rates last month to 2.5%. There has also been tepid quarterly GDP growth in the euro area, amid decent economic fundamentals in the US.

This has implications for the equity, currency and bond markets, providing plenty of interesting opportunities for active global fund managers.

# Equities:

## Active management looking attractive

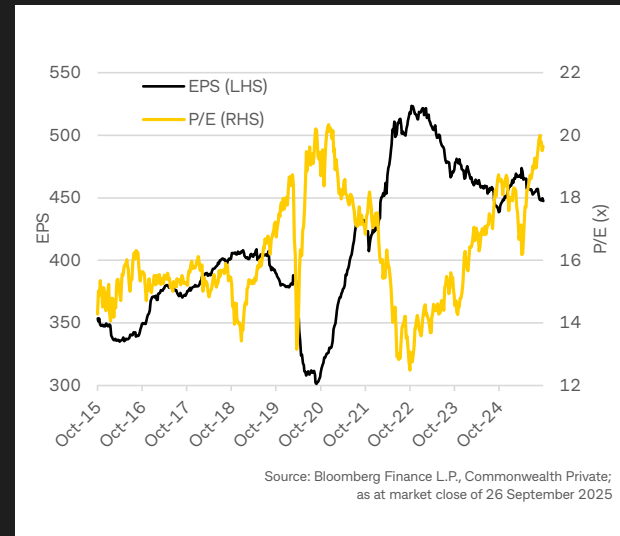
- Active management is our preferred way to access Australian equities today.
- Mid caps and small caps have an attractive risk reward set up relative to large caps.
- Style neutral portfolios are the most prudent approach to portfolio construction for the period ahead in Australian equities.

Australian and US shares have experienced strong returns from their April lows, but we still see select opportunities within these broad markets. Starting with Australia, financials have compounded at 21% over the last three years to the end of August 2025, just behind the information technology sector at 25%. The strength exhibited by financials has seen their allocation in the ASX 200 grow to 34% of the index. At the same time, our market continues to trade on higher-than-normal valuations. The ASX 200 presently sits on a one-year forward price-to-earnings (P/E) ratio of almost 20 times, versus a long run average of 15 times, with earning growth for the next 12 months expected to fall to low single digits. Despite this, there are some neglected areas for active investors, namely in domestic mid and small cap equities.

Mid caps are a subset of the ASX 200 and represent stock numbers 51 to 100 in the index, or 12% of the total market capitalisation. Mid caps often have a long runway of growth driven by product innovation, growing market share and/or global expansion. Since 2013 to the end of July 2025, mid caps have delivered an average three-year earnings-per-share (EPS) compound annual growth rate (CAGR) of 7.9% compared to 2.4% for the ASX 20 (our largest companies). Looking forward, earnings growth is expected to compound at approximately 11% for the next three years, compared to the ASX 20 at 3%. Relative to their growth potential, mid cap valuations remain reasonable and an alpha-rich area for active managers.

### S&P/ASX 200 Index 12-month forward P/E vs EPS

Elevated multiples on soft earnings



Similarly, domestic small cap stocks struggled post the COVID pandemic, which saw interest rates rise rapidly, inflation spike and tepid domestic GDP growth. Small companies tend to be more sensitive to the economic cycle and more reliant on debt, which means higher rates hurt. However, with interest rates having trended lower and the economy generally on an even keel, this bodes well for small caps. Earnings growth for the Small Ords is expected to compound at 15% over the next three years and is an area where active management consistently beats the index.

The opportunity is similar in the US, where small caps offer superior relative value. In the US, small caps have 70% of their revenue derived in the US, compared to 50% for large caps. This enables greater exposure to the US economy and better shelter from erratic tariff policy. Small caps are also more diversified with industrials, health care and financials well represented alongside information technology. With the US Fed on the interest rate reduction path, a greater focus on domestic growth for fiscal policy, less regulation and solid valuations, US small caps are equally well positioned.

# Fixed Income:

## Late cycle easing aids low credit spreads

- The resumption of Fed rate cuts and easier financial conditions has supported credit spreads, which are low, especially offshore.
- Our recent review meetings with our active managers highlighted they are generally still sanguine on risk assets, but with their portfolio positioning a bit more defensive given credit spread levels.
- By design, the funds in the liquid, IG-based Yield Managed Account (Yield Model) from CPL have return and capital-related objectives, with a low weighted average portfolio allocation to private assets of 5% as of 30 June.

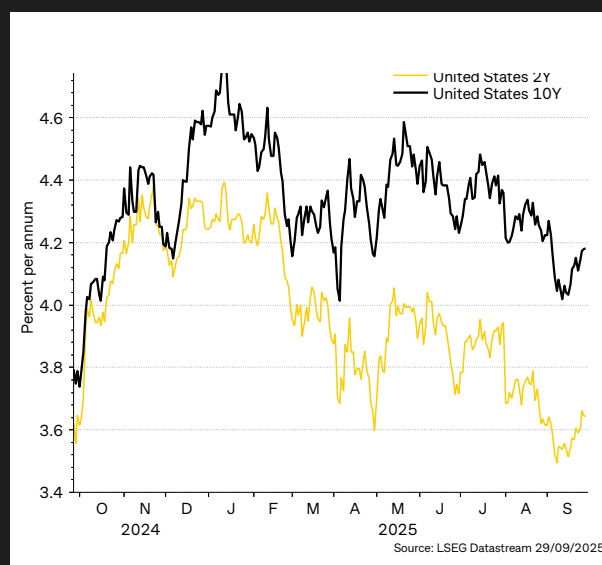
US dollar bond yields generally declined over September as the Fed resumed late cycle rate cuts. The resultant easier financial conditions provided further support to global credit spreads last month and drove US dollar investment-grade credit spreads at the index level to the tightest level since 1998 (albeit on a duration adjusted basis, US dollar investment-grade spreads were mildly tighter in 2021). Euro investment-grade spreads are now at 14-year lows. Australian dollar investment-grade credit spreads are not as tight but are still below long-term averages.

As a result, in our recent due diligence review meetings with managers, a key focus has been on the positioning of their credit portfolios given low credit spreads. Pleasingly, our meetings have confirmed that while these onboarded managers are still generally sanguine on risk assets, they have turned a bit more defensive into their portfolios, while remaining active and selective.

While credit spreads are tight, notably offshore, given: (1) all-in yields are much higher compared to 2020, (2) demand for fixed income continues to be strong (with reports that assets in money-market funds recently reached a record US\$7.7 trillion), and (3) credit and macroeconomic fundamentals continue to be satisfactory, we

## US Treasury yields decline in September

US 2-year and 10-year Treasury yields



remain constructive on fixed income, but with a strong preference for liquid, shorter-dated, IG-based investments, funds that are actively managed, and a focus on issuer and sector selection. For these reasons, the managers/funds in CPL's Yield Model have a focus on capital and/or risk-adjusted returns, as well as seeking to deliver a medium-term return target, while the majority of assets in the portfolio are IG-rated (83% as of 30 June on a weighted average basis), as noted in our August special report "Navigating the Shifting Tides: Australia's Fixed Income Investment Landscape". Similarly, the weighted average exposure to IG assets in CPL's Core Managed Account was 88% as of 30 June.

Finally, a brief note on the Australian Securities and Investment Commission's (ASIC) interim report into Australia's private credit market, as it pertains to CPL's yield model. Consistent with the requisite criteria sought for this fund-of-funds portfolio and its liquid and investment-grade-oriented asset base, the weighted average allocation to private assets at 30 June is low at 5%. Also, these modest private asset exposures comprise the likes of pre-public asset-backed warehousing, and not higher risk real estate construction/development finance, where ASIC sees areas for improvement for investor protection and market integrity.

# Real Assets:

## Real assets build on solid foundations

- Real assets such as property and infrastructure can provide long-term investment stability.
- It can also provide a hedge against the inflationary-based erosion of asset value.

While equity markets pushed to new all-time high points in September, led by the US, the performance of listed real estate and infrastructure indices were weaker.

We have previously shared our positive outlook for listed global real estate in the form of G-REITs, according to a combination of fundamental factors. Overall, G-REITs are trading at implied discounts to underlying asset values, underlying real estate valuations have stabilised and are now showing signs of growth, interest rates are declining and contracted rental income is increasing over time. As such, we continue to have a positive outlook on this market segment.

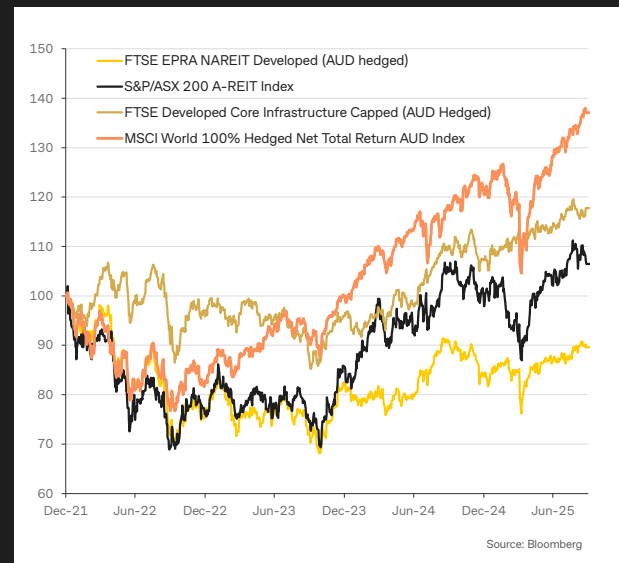
We also maintain our positive outlook for infrastructure investments. After a more difficult period of fund raising in from late 2021 through to the first half of 2024, when rising interest rates dampened investor demand, both long-term and short-term interest rates are now trending downwards to create a more constructive environment for infrastructure investment.

We also expect the shortfall in projected infrastructure investment requirements compared to current available capital such as the infrastructure funding gap to provide strong support for investment returns over the medium to long term.

Drivers of this infrastructure funding gap range from chronic government underspending in developed market core infrastructure over the last ten years, new emerging market infrastructure to meet the demands of rapidly maturing countries, for example across Asia, as well as new technology drivers.

### Real Asset investment returns

AUD Hedged (Indexed to 100 at 31/12/2021)



In addition to core infrastructure such as utilities (traditional electricity generation, water and gas), transportation (road, rail, airports and marine), all of which require ongoing capital investment, this asset class continues to evolve, as social demand places additional importance on new infrastructure sectors. These new infrastructure sectors include energy transition (renewable energy generation and storage), digital infrastructure (mobile towers and data cable networks), social infrastructure (hospitals, schools and universities), and waste recycling. Further, the adoption of new technologies is driving a considerable increase in energy demand, for example from data centres, machine learning and broader artificial intelligence (AI) applications.

Supporting our positive outlook on infrastructure, we expect returns from infrastructure investments to typically be less volatile than listed equity markets. This is due to market factors and long-term and/or regulated cash flows. They also provide some protection from asset value erosion that can be caused by inflation as some cash flows are indexed to inflation.

Together, we believe ongoing demand for infrastructure capital will provide a sound base for investment returns over the decade to come.



# Alternatives:

**While fundamentals remain sound, manager and investment selection continue to be imperative**

- Hedge funds aim to provide absolute returns with low correlation to traditional asset classes.
- Alternative credit offers enhanced yields.
- Private equity offers access to value-added opportunities and participation in developing businesses and technologies.

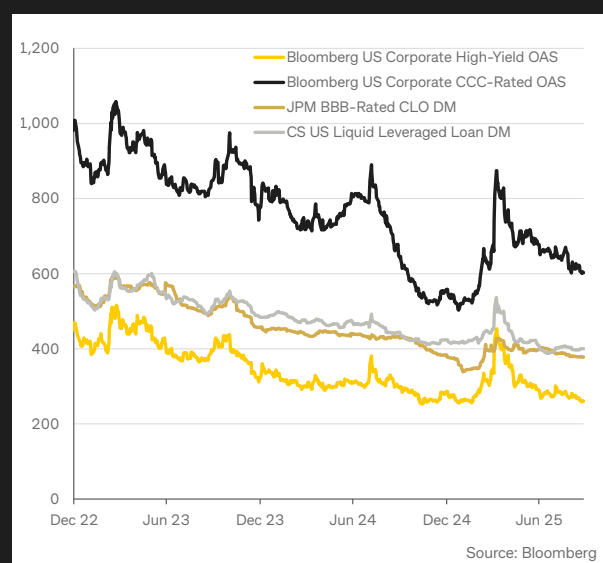
In late September, ASIC provided a progress update regarding its review of public and private markets in Australia, including the release of its interim report into Private Credit in Australia (REP-814). REP-814 is a summary of the work conducted to survey market participants (both borrowers and lenders), market practices, and compares Australian private credit markets to those offshore.

On the positive side, this report concluded the growing availability of private capital in Australia has met a real need, complemented the banking system and provided further opportunities for innovation, employment and growth. It also identified positive credit practices. We note the sector has, overall, provided investors with positive investment returns.

However, on the negative side, ASIC called out some practices by some market participants that it regards as concerning, including valuation practices, a lack of transparency through to underlying loan exposures, opaque fee structures, questionable related party transactions, governance, as well as the inconsistent use of investment terminology across the industry. ASIC also noted certain aspects of the Australian private credit market compared unfavourably to international practices.

## High-Yield spreads and discount margins


Basis points



In ASIC's view, the shortfalls in disclosure could potentially impede investors' full understanding of potential investments. As such, ASIC has called on Australian private credit industry bodies to lift their standards. ASIC also confirmed it will continue to take action where it sees practices that are inconsistent with current financial services laws.

Good governance and transparency are essential to every investment, regardless of the asset class and whether in public or private markets. We support ASIC's ongoing efforts to continue to improve practices in the Australian private credit market. The issues outlined by ASIC are ones we consider regularly when conducting due diligence on investment managers and this highlights the importance of undertaking such diligence.

Overall, we maintain our preference for experienced specialist credit managers. We look for managers who actively manage a diversified portfolio of investments, have a strong focus on risk assessment and can demonstrate ongoing below-system asset downgrades and default rates. In the current market context this includes preferencing companies that have high-quality stable cash flows and consideration of the additional risks posed by sectors that are more exposed to changing economic and policy drivers.



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