



Commonwealth
Private



October 2026

Market Outlook.

Positioning matters in a
world of structural shifts.

CIO Foreword

Earlier this year Commonwealth Private's Investment Research Team (IRT) highlighted the possibility that investors were underestimating the risk of a renewed rise in interest rates. Since then, that risk has become reality. Across Australia, the US and much of the developed world, policy rates, bond yields and borrowing costs have moved higher as central banks confront an inflation pulse that's proven more persistent than many expected. While these increases are beginning to bite households, businesses, and asset prices, we believe the adjustment isn't complete. The forces pushing rates higher remain in place, and further tightening over the remainder of the year is likely.

What's notable about the current environment is that interest rates aren't rising in isolation. As we discuss in this Outlook, monetary tightening is occurring alongside a significant increase in capital demand from governments, infrastructure projects and, increasingly, artificial intelligence (AI). AI continues to be one of the most important drivers of the US economy, with recent AI-related investment contributing approximately 0.5 percentage points to US GDP growth over the past year, or around one-fifth of total growth.

The investment opportunity is substantial, but so too are the questions. Financial markets have become increasingly dependent on assumptions that AI investment will continue to accelerate, delivering real productivity, and that today's AI market leaders maintain their competitive advantages. As we've noted previously, technological revolutions rarely progress in a straight line. The emergence of increasingly capable low-cost models has the potential to place pressure on incumbent developers, challenge pricing power, and alter expected returns on the enormous capital being deployed across the AI ecosystem. Meanwhile, instances of autonomous AI systems acting in unintended ways, including within government and enterprise settings, highlight that the technology's governance challenges remain unresolved.

These risks have prompted increasing calls for tighter regulation of advanced AI systems. Some of these concerns are entirely legitimate. Investors, governments and society all have an interest in ensuring powerful technologies operate safely and transparently.

However, it's also worth asking whether every call for regulation is motivated purely by public interest. Throughout history, incumbent industries have often supported regulatory frameworks that, intentionally or otherwise, reinforce existing competitive positions. As AI evolves, distinguishing between sensible risk management and barriers designed to protect market share may become increasingly important.

For investors, the lesson is not to reject AI, nor to blindly embrace it. The lesson is the same one that has applied throughout every major investment cycle: *maintain discipline, diversify sources of return and remain focused on long-term outcomes rather than short-term excitement*. Higher interest rates, greater competition for capital and rapidly evolving technologies create both risks and opportunities. They also reinforce the value of diversified portfolios that aren't dependent on a single economic outcome, policy decision or technological narrative.

While much attention remains focused on interest rates and AI, investors shouldn't lose sight of broader themes shaping markets. Fiscal sustainability, energy security, private capital deployment and the growing competition for global savings are becoming increasingly important drivers of returns. In our view, these forces are likely to remain relevant well beyond the current market cycle and deserve as much attention as the headlines that dominate today's news flow.



Paul Stevenson,
Interim Chief Investment Officer
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Central banks move together

What's going on here:

- Persistent inflation and resilient growth are driving a globally synchronised reassessment of how restrictive monetary policy needs to be.
 - Simultaneous global policy tightening raises borrowing and refinancing costs, amongst increasing competition for capital.
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What does this mean?

For years, the world's major central banks forged their own paths. Now, monetary policy is becoming increasingly synchronised and when central banks tighten together, the effects can be greater than the sum of the individual rate hikes.

Investors have become accustomed to central banks moving at different speeds and, at times, in opposite directions. Today, that divergence is narrowing. Across many developed economies, the conversation has shifted from questioning when rates will fall to whether policy is restrictive enough.

The US Federal Reserve (the Fed) joined that shift in September raising rates by 25 basis points (bps), following earlier tightening by the Reserve Banks of Australia and New Zealand, European Central Bank and Bank of Japan. CBA Economics¹ expects at least two further 25bp increases over coming months.

The world isn't experiencing a perfectly synchronised hiking cycle. But something potentially more important is occurring: a global reassessment of how restrictive monetary policy needs to be.

Why should I care?

The immediate problem is inflation. Renewed energy-price pressures have complicated the inflation outlook at a time when underlying inflation was already proving persistent. At the same time, economic activity has been more resilient than expected. Increasingly, monetary policy is responding not simply to inflation, but to strong economic growth.

The US illustrates the challenge. Growth remains strong, unemployment is around 4%, and inflation remains above the Fed's 2% target. The

Fed expects the economic expansion to continue, while core inflation is projected to remain above target through 2028. That combination matters. If higher inflation were accompanied by rapidly deteriorating demand, central banks would have greater scope to look through temporary price shocks. Instead, resilient growth gives policymakers both a reason and room to remain focused on inflation.

There's also the possibility that the interest rate required to keep key economies in balance is simply higher than before the pandemic. The Fed has again increased its estimate of the longer-run neutral rate, while stronger non-inflationary growth suggests economies like the US may be able to sustain higher rates than previously thought.

When monetary conditions tighten across several major economies simultaneously, borrowing and refinancing costs rise together, and discount rates increase across markets. This is occurring as governments and businesses compete for substantial amounts of capital. Many governments are now pursuing/running large fiscal deficits which require commensurate government borrowing, while investment in AI, data centres, energy and infrastructure is generating significant private-sector financing demand.

Greater competition for global savings is likely to result in longer-term bond yields staying elevated, even after central banks eventually stop raising policy rates.

How does this impact investors?

Higher rates are not universally negative for markets. *For fixed-income investors*, higher yields have restored meaningful income after the extraordinarily low-rate environment that followed the global financial crisis.

For equities, the distinction is increasingly about the ability to absorb a higher cost of capital. Companies capable of delivering strong earnings and productivity growth can potentially offset higher discount rates. Highly leveraged businesses, or those dependent on cheap refinancing, face a more challenging environment.

As we argue below, this is unlikely to become another aggressive 2022-style tightening cycle. However, the larger question isn't necessarily how high rates go, but how long the global cost of capital remains elevated and how different asset classes would be impacted.

¹ CBA Forecast update; 23/9/26

What does the rise in bond yields mean for fixed income investors?

What's going on here:

- September saw an acceleration in the rise in global bond yields.
- To limit return volatility and income erosion, IRT's firm preference for absolute return fixed income funds that actively manage their low-moderate interest rate exposure is unmoved.
- Resulting high portfolio yields of 6-7% give sound compensation, are supportive for forward-looking return potential, while providing greater defence

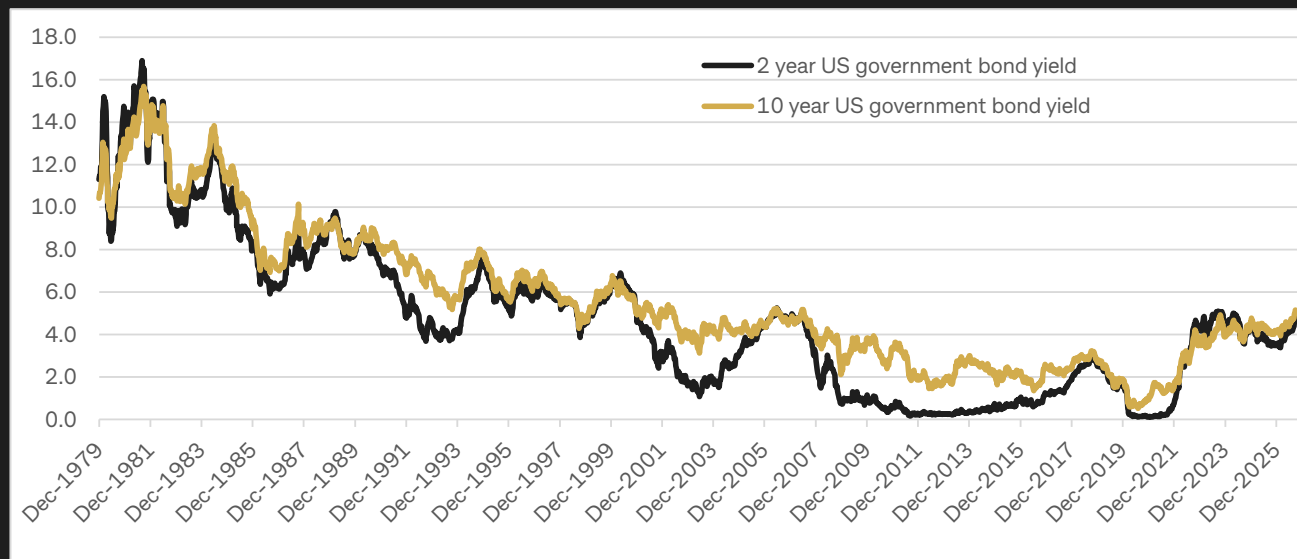
- Higher inflation from global oil/supply chains from the Iran conflict and the reciprocal US tariffs,
- A solid US economy,
- Concerns on government fiscal positions and fiscal credibility,
- Resultant rate hikes across the US, Europe, Japan, NZ, and Australia (most recently, this week), and
- Competition for capital from the hyperscalers using corporate bond markets to fund AI-related capex.

What does this mean?

September ushered in a renewed global hiking cycle and an acceleration in the ascent of government bond yields. This saw the US Treasury (UST) 10 year yield briefly top 5.1% for the first time since 2007 and its AUD counterpart also reach 5% - its highest level since 2011. Shorter-dated UST yields were under more pressure as investors priced in a September hike and the risk of further tightening.

In September, we noted that the drivers for the march higher in global/US bond yields (which started in late February), were a mix of inflation and non-inflation factors, including but not limited to:

US government bond yields since 1980 (percentage)



While these bond yield moves have been significant, we provide some historical context on these conditions and what they mean for fixed income investors.

Post GFC, following an extended period of central banks suppressing yields, these moves are partly a return of the term premium. Some investors are concerned this synchronised re-hiking cycle is a repeat of 2022 when global and US bond yields spiked from historical lows. We don't share this concern as:

1. In 2022, the post-COVID core inflation peaked at 5.4% in the US. While the current level of 3.3% is still above the Fed's 2% per year target, it is well down on the post-COVID peak, and other key inflation readings have roughly halved since 2022, and;
2. Back in 2020, the USD two-year bond yield was a mere 11bps. Late last month, this was just under 5.0%. With monetary tightening now well underway in both the US and Australia, as hikes are delivered and credibility bolstered, notwithstanding the difficulty of forecasting in the current environment and noting we are still in capitulation phase, CBA² now thinks yields are nearing their peak and should start to ebb in 2027, albeit they will remain structurally higher.

Key risks that would reinstate the severe version of the higher inflation (and even higher rates) scenario include: (1) a re-acceleration in the US economy, and (2) a spike in the oil price (from a re-escalation of the Iran conflict and/or a marked decline in global oil inventories). We do note that, historically, the Fed has shown a willingness to act should bond markets/yield levels become dislocated. Also, while not discussed widely, the forming of a potential super El Nino event in the Pacific may have a material impact on food/other input prices in Australia.

Overall, however, with policy rates substantially higher compared to 2022, central banks have rebuilt the capacity to ease rates in a downturn should that eventuate. A case in point may be Australia later in 2027 given that growth, dwelling prices, consumer confidence and business conditions are all materially weakening.

Why should I care?

For standalone fixed income, this environment reinforces the case for unconstrained, absolute return managers. To limit volatility and protect today's higher coupon income, investors are better served by funds keeping duration low to moderate, with active management within that range. This is the domain of absolute return-based managers and how Commonwealth Private's standalone fixed income funds (that aren't part of a diversified portfolio) are structured.

Looking ahead, for these lower duration funds that have risk managed through the recent rate yield rises, high portfolio yields of 6%-7%+ provide sound compensation and are constructive for fixed income return potential - noting that the starting yield is not the whole story - it's total returns. To this end, should a catalyst emerge, such as a resolution in Iran or a moderation in the market's expectations for further policy tightening - these funds may benefit from potential price appreciation on their moderate interest rate exposures, on top of an already attractive income stream.

From a defensive viewpoint, higher for longer portfolio yields also provide a meaningful cushion against adverse: (1) credit spread moves historically amid low credit spread levels, especially in the USD and EUR credit markets, and (2) any unexpected further spikes in interest rates.

² CBA Market Strategy & Rates Research Weekly Strategy Research:
25 September 2026.

Margin of safety?

What's going on here:

- Equity markets are strong, ahead of the US midterm elections.
 - But valuations are rich with little room for error: this is not the time to take concentrated bets.
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What does this mean?

Warren Buffett's quote "be fearful when others are greedy and greedy when others are fearful," advocates being contrarian and buying when prices drop due to panic and selling when hype drives prices too high, and IRT believes this applies to market concentration and diversification within equities too. There are times when portfolio concentration will reward investors (think over-indexing on AI) and times when it's best to sit back and let diversification do its thing because you simply don't know. We are in one of those times today.

On the plus side, most global equity indices have provided positive year to date performance. Focussing on the US, because it tends to lead the world, according to investment manager Clearbridge, since 1950 the S&P 500 has delivered a calendar year to end-August performance above 10% 28 times. When the return has been over 10%, in 25 of these years the index has delivered a positive performance over the remainder of the year, with the average of those 28 cases returning 5.3%. This year, the market rose 13.1% to the end of August. In addition, equity markets have a strong tendency to rally around US midterm elections. The fourth quarter of midterm years and the subsequent two quarters have a very high frequency of positive returns. Again, going back to 1950, in the second year of every President's term, the index has produced an average Q4 return of 7.5% followed by average returns of 8.2% and 5.9% in Q1 and Q2 of the following year.

The next cause for optimism is corporate strength. Balance sheets are in great shape and reported S&P 500 second-quarter earnings delivered year-on-year EPS growth of more than 50%! A handful of AI oriented mega-cap technology companies contributed heavily to this result, but it's nevertheless remarkable. Finally, markets have largely been

willing to look through geopolitical risk: the response to the US-Iran conflict has broadly followed a typical pattern: down initially on uncertainty and an overpricing of risk, then back up as the parameters become clearer. However, oil prices across both crude and the product complex remain elevated, presenting economic headwinds.

But here's where we are cautious. As earnings-per-share (EPS) rose more than 50% in Q2, markets barely moved, already largely at all-time highs. As has been covered in these outlooks regularly, the AI trade and the winners and losers remain a divisive argument. Where will the market rotate next? Is it the semiconductors, hyperscalers or software?

Which leads us to our last and most critical point. Rates. If interest rates remain elevated for longer than expected, this could become a big issue for investors, as extensively covered in the two sections above. The S&P 500 price-to-earnings ratio is trading on 21x, equating to an earnings yield of 4.8%. One could argue the equity risk premium isn't just zero, it's negative. While this is a very simplified comparison, it highlights how much future earnings growth is already embedded in current valuations. Typically, the equity risk premium is around 3-4%. At the moment, company earnings growth can justify valuations, however, were AI-driven EPS growth rates to falter, there is more than a little air pocket waiting below valuations. Perhaps the S&P 500 Equal Weighted Index, which trades around four PE points lower at 17x and has a lower weighting to information technology, makes more sense?

As we can't see interest rates dipping anytime soon, the infrastructure and compute-capacity investment programs of the hyperscalers, along with AI labs, data-centre operators and the broader AI ecosystem, will run into the trillions of US dollars and only add to the demands of debt holders.

Why should I care?

If this all sounds complicated, it's because it is. This really isn't a time for concentrated bets in equities. Hindsight is a wonderful thing and one day everything will have seemed obvious. But unless everyone knows something we don't, we recommend trading carefully, maintaining perspective and staying diversified. Selecting the right active investment managers can also help cushion returns during turbulent times.

High-yield Credit: different fruit

What's going on here:

- While high-yield (HY) credit investments can be volatile, well-chosen investments can still provide enhanced returns.
 - Investors need to understand the return drivers, be tolerant of return volatility, and have a long-term investment horizon that aligns with the underlying asset liquidity.
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What does this mean?

As global interest rates continue to push higher, with expectations that this higher rate environment will prevail over the near-to-medium term, investors are asking whether HY credit will be able to withstand what may be a more challenging macroeconomic regime.

The immediate consequence of higher rates is the increased debt servicing burden for corporates and consumers. While this will prove challenging for some weaker credits, aggregate credit quality within the liquid high-yield universe has improved in recent years, with higher interest coverage ratios and sound equity buffers providing a foundation for resilience.

However, the persistence of higher rates introduces a second-order challenge. If higher interest rates persist, or inflation continues to rise, it'll increase the difficulty of corporates refinancing existing debt, due to both the impact on serviceability and increased caution from lenders. This is especially true for those HY issuers that haven't undertaken interest rate hedging strategies prior to the current hiking cycle. While this will have the greatest impact on the lower quality segments of HY, it would potentially result in credit spread widening across all high yield credit (and to a lesser extent, investment grade credit as well).

Some of this dynamic has already played out across global high-yield bond and broadly syndicated loan markets, with secondary market index level credit spreads for CCC and below rated issuances having widened significantly over the year-to-date relative to their B-rated market segments. However, at an absolute level, aside from CCC rated credit spreads, HY index level credit spreads

tightened rapidly from their peak widths in March this year that coincided with the outbreak of hostilities in Iran and continue to sit at historically low levels despite the rise in rates over the past six months.

The potential for this higher interest rate regime, or other events, to trigger another round of spread widening remains. Any such widening would be mirrored in lower valuations of already-issued debt, resulting in downward pressure on high-yield assets and net asset values of funds investing in them.

What happens if credit spreads don't re-compress so quickly if there's another bout of volatility? Paradoxically, while changing market dynamics can challenge investment returns in the short-term, they can also lay the foundation for improved long-term returns: higher base rates, wider credit spreads, and the pull-to-par of discounted asset valuations increase the prospective yield on both existing and new assets, thereby providing a more fertile environment for both opportunistic and longer-term HY investments. The critical caveat to that is that defaults need to be contained.

Why should I care?

In a higher-rate, higher-spread, environment, the dispersion of outcomes between HY borrowers is likely to increase, pushing default rates higher. Avoiding defaults, and minimising credit downgrades, is paramount. This reinforces the importance of deep fundamental credit analysis and active portfolio monitoring. As such, Commonwealth Private prioritises high-yield managers that: (a) have the necessary resources to conduct such analysis, (b) have experience in navigating stressed environments successfully, and (c) provide well diversified portfolio exposures. Ultimately, we seek to work with managers that are capable of delivering below-system default rates across a range of credit conditions, thereby allowing them to capitalise on the potential for return enhancement from high-yield investments.

It's also essential that investors align their expectations with the characteristics of the asset class. That is, investors need to understand, and be comfortable with, the potential for return volatility, and have the discipline to "hold the line" and invest over a full market cycle to capture the returns available from this asset class.

Things you should know:

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