

## CY2026 Outlook – Late Cycle

### The setup:

2025 surprised on the upside. We started cautious as PEs pushed fresh highs, but policy support, contained credit spreads, and AI momentum carried the tape longer than expected. Into CY26, the bull market isn't done, yet it's increasingly late-cycle: earnings need to show up to keep valuations in check.

### Macro & policy:

- Inflation re-accelerated in part due to tariffs; long yields stayed range-bound, helped by the resumption of QE in the U.S., which caps long-dated yields.
- Policy risk is elevated: a dovish-leaning Fed Chair arrives May 2026, and the U.S. mid-terms (Nov 3) may restore checks and balances—our base case is that markets will welcome this outcome.

### Markets:

- U.S. remains the dominant force, powered by fiscal and monetary support. AI is still a strong thematic, but proof of revenue will be crucial to sustain multiples.
- Australia is set for consolidation: modest EPS growth, some PE de-rating from ~19–20x toward ~17.5x, and dividends (~3.3%) doing most of the heavy lifting on total returns.

### Currency:

- Our earlier AUD call underestimated the impact of superannuation outflows to global markets. Even if U.S. rates fall faster than ours, super flows likely cap AUD upside at circa ~70c vs the ~75c implied by rate differentials.

### Late Cycle versus Early Cycle

2025 has been full of surprises. Many feared the White House's policy shake-up would derail markets, but so far, the global economy has held up better than expected. Yes, there are stress points—US migration cuts have slowed growth, and tariffs have pushed US inflation higher—but these same policies have strengthened trade ties elsewhere. Non-US markets have been the big winners: Korean equities are up 60%, Japan 20%, and even Europe has outperformed the NASDAQ.

Despite recession-like conditions in parts of the economy, US equities have delivered double-digit returns this year. Why? Corporate tax cuts encouraged companies to bring forward investment, and exporters benefited from tax breaks. Add to that a central bank cutting rates, even with inflation well above target, and liquidity has kept markets buoyant.

But here's the key question: Are we moving from early-cycle optimism to late-cycle risk? Several indicators say yes:

- Profitability is near 45-year highs, with RoEs around 18%.
- Capex is surging, up 20% in the past year, driven by hyperscalers betting big on AI. These firms, once light on capital, now have capex-to-sales ratios of 25%, funded increasingly by credit as lenders tighten.
- Valuations are stretched, with PEs at 22x, levels last seen post-pandemic.
- Leverage is climbing, with margin debt surging late-cycle style.

History tells us rapid capex booms often precede weaker returns. Combine that with peak profitability and high valuations, and the risk-reward for global equities looks less compelling. Monetary and fiscal easing could extend the cycle, but we're cautious.

Despite the headwinds from US policy, China's economy is proving resilient. Growth is tracking at its planned pace of around 5%, even as exports have softened since the Liberation Day tariffs. Interestingly, exports to Australia have picked up. What's missing? Residential construction, once 10% of GDP, has more than halved. Yet, commodity prices haven't collapsed as many feared.

China's latest five-year plan is ambitious: it aims to lead in new technologies, posing a real competitive threat to some of the biggest NASDAQ names. The plan also includes boosting exports, potentially helped by a weaker RMB. For Australia, that matters—given the close link between the AUD and RMB, a softer Chinese currency likely means a weaker Aussie dollar too.



Closer to home, Australia looks very different from the US. We're in the early stages of a recovery. Fiscal easing, rate cuts, and resilient households have supported demand. Inflation has ticked up, prompting the RBA to pause, but we think this is temporary. Our base case? Two more rate cuts in the second half of 2026—once inflation cools.

Corporate profits are improving after three years of contraction. So far, the gains are mostly from commodity producers, but we expect the recovery to broaden as domestic demand strengthens. Normally, that's great news for investors—except valuations remain expensive. The ASX 200 has de-rated from ~20x to lower levels, but still trades 15–20% above its long-term average. Supply-demand dynamics have shifted: institutional super demand has faded while equity issuance has picked up, pointing to lower valuations ahead.

We remain neutral on Aussie equities, generally ready to buy at cheaper levels or stock specific opportunities. We continue to focus on domestic stocks with income opportunities, Commodity-linked names and companies with positive EPS momentum or restructuring stories.

### The AUD\$

For years, interest rate differentials have been the go-to guide for currency moves. Higher rates usually mean a stronger currency. By that logic, the Aussie dollar should be closer to 75 cents, not circa 65 cents we see today. The RBA's survey of professional forecasters shows this has been the longest stretch of AUD forecasting errors in 20 years!

The old models still work for currencies like Sterling and the Euro, but not for the AUD. The big difference is superannuation. Australia's pension pool has become a major force shaping the balance of payments. As the superannuation guarantee (SG) rose from 9% in 2021 to 11% today, more money flowed into the system—and then out of Australia into global markets. Last year was a record for super inflows, and those outflows have dwarfed the foreign investment that interest rate spreads would normally attract. The result? A weaker AUD.

This isn't a short-term story. Treasury's MARIA model suggests super funds won't hit net outflows until after 2060. The RBA expects inflows until at least 2050. Until then, traditional AUD models will remain less reliable. Investors may need to apply a "superannuation discount" to their currency forecasts.

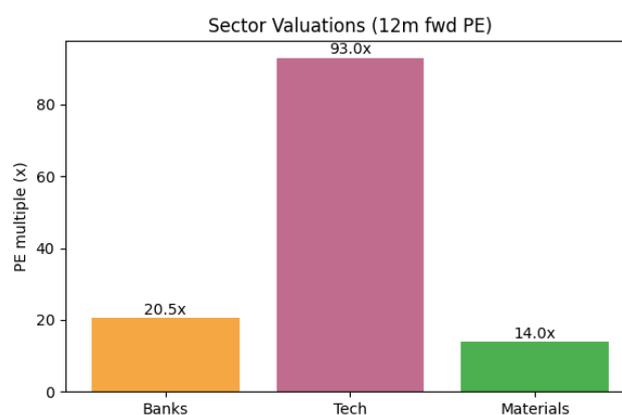
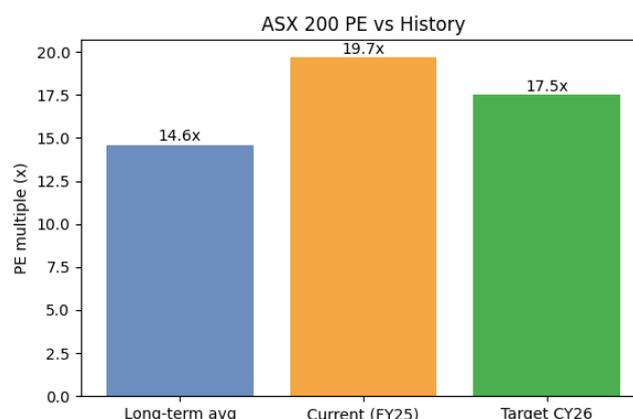
We still expect the AUD to appreciate as US rates fall faster than ours over the next 6–12 months. But the upside is capped by these super flows. Instead of 75 cents, strategists think 70 cents could be a more realistic target.

### Valuations: Still Stretched, Even as Earnings Improve

Analysts have finally started upgrading ASX 200 earnings forecasts after three years of downgrades. EPS growth for the year to June 2026 has jumped from 3% to 7.1%, and 2027 is now expected at 7.7%. Most of this upgrade comes from the big miners—BHP, Rio, Fortescue—and gold producers, thanks to stronger commodity prices and cost efficiencies. Financials and Industrials have seen modest improvements, but outside commodities, the picture is still fairly quiet.

Earnings are stabilizing but valuations remain expensive.

- The ASX 200 trades on ~20x forward PE, near the highest level in 40 years. Even if earnings grow as forecast and prices go sideways, we'll still be at 18.7x next year, well above the long-term average of 14.6x.
- Globally, valuations are also elevated. The S&P 500 trades at 23x, higher than its post-COVID peak, despite bond yields being 300bps higher now. NASDAQ is at 28x, though its strong EPS growth outlook makes it look less extreme.
- Aussie banks have been the biggest driver of the local re-rating—moving from 12.8x to 20.5x since early 2023. Tech is even more stretched, with forward PEs above 90x for some loss-making names. Materials remain the cheapest at 14x, despite solid growth prospects.





Dividend yields tell a similar story. The ASX 200 yield is 3.2%, close to historic lows. In past cycles, yields at these levels have normalized either through falling prices or rising payouts. Utilities offer the best income (around 5%), while banks sit at 3.6% with sluggish dividend growth.

One more concern: investor leverage. Margin debt in the US is up nearly 40% in 12 months, a pace seen only three times in 30 years—and those periods didn't end well for equity investors. Locally, the extraordinary re-rating was fueled by strong superannuation inflows and limited equity issuance. That demand-supply imbalance is reversing: super inflows have collapsed from \$50b p.a. to just \$5b, while equity issuance has surged to \$40b. This shift could be a catalyst for lower valuations ahead.

Earnings upgrades are welcome, but valuations remain rich. Without a stronger profit backdrop or policy stimulus, the risk-reward for Aussie equities looks challenging. We remain neutral, ready to buy at cheaper levels.

### Strategy Themes for CY26

We remain cautious on Aussie equities overall. Even with a potential profits recovery, valuations are still high, and rate cuts have been pushed out. MST Financial forecasts the ASX 200 year-end target is 8,600, assuming modest earnings growth and a PE de-rating to 17.5x—still well above long-term averages. This means strategists are expecting zero capital gain in 2026, meaning the 3.3% dividend yield will likely be the total return. Against this backdrop, we see rotation within the market: miners look set to outperform, while banks and expensive tech names could lag.

Here are our key themes:

#### 1. Domestic Focus

We have been increasing exposure to high-quality domestic stocks. Even without rate cuts, resilient household demand should support these names. We like Cleanaway, Temple & Webster, AGL, and Mirvac. At the same time, we're cautious on late-cycle US exposure.

#### 2. Commodities

Commodities have held up well as a hedge against US debt and inflation. Supply remains tight, and some producers are cutting costs. The sector is still cheap and could benefit as expensive parts of the market de-rate. Our preferred names include BHP, JamesHardie, Woodside, Viva Energy, ALS Ltd, and Orica.

#### 3. Income

Self-Managed Super Funds (SMSFs) own 15–20% of the Aussie market and remain focused on income. With concerns around private credit funds, we expect flows into equities to stay strong, or even accelerate, in 2026. Our income picks include BHP, AGL, AUB Group, and Mirvac.

#### 4. Restructurers

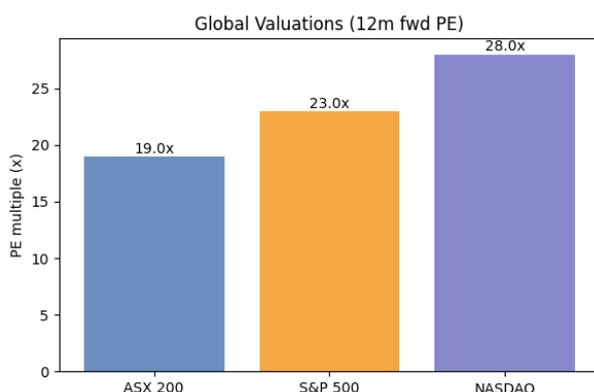
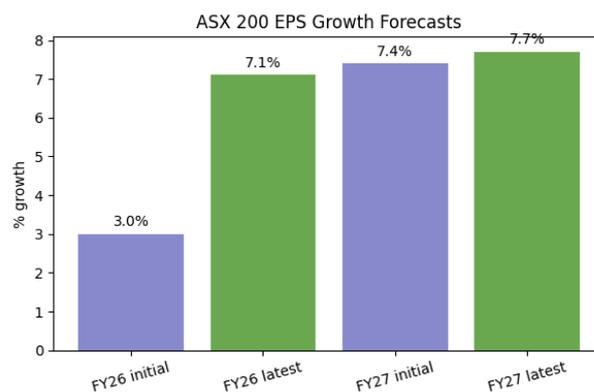
When we look for value, we want catalysts. We like companies restructuring through asset sales, consolidations, or buybacks. Our picks:

- CSL (buybacks and asset sales)
- Cleanaway (consolidation)
- Woodside (asset sales, de-risking)
- Viva Energy (consolidation)

We expect a period of consolidation for Aussie equities, but there are still opportunities, especially in commodities, income plays, and restructuring stories.

### Final Thoughts: From Goldilocks to Late-Cycle Caution

In CY24, we called for a “Goldilocks” scenario—moderate inflation, resilient growth, and steady markets—and that largely played out through 2024 and unexpectedly continued into CY25. Our caution heading into 2025 was based





on stretched valuations and the risk that the cycle was nearing its peak. In hindsight, we were too conservative too early. The bull market extended as fiscal stimulus, monetary easing, and strong thematic drivers like AI kept momentum alive.

Looking ahead to 2026, we believe the bull market still has room to run, but the backdrop is changing. Markets are searching for broader and faster global growth to justify current valuations. U.S. equities remain the dominant force, supported by policy stimulus and credit conditions that feel late-cycle. Earnings growth will be critical without it, elevated PEs risk a sharp correction. AI remains a powerful theme, but investors should demand proof of revenue to sustain lofty multiples.

Policy risks linger. Inflation has resurfaced, partly due to tariffs, yet long bond yields remain capped by renewed U.S. QE. The appointment of a dovish Fed Chair in May 2026 raises questions about independence and the potential for policy missteps. The U.S. mid-term elections in November could be a pivotal moment—our view is that Trump will lose some control, restoring checks and balances, which markets may welcome.

For Australia, the story is different. We expect a period of consolidation: modest EPS growth, expensive valuations, and limited capital gains. MST Financial have an ASX 200 target of 8,600 which assumes a PE derating to 17.5x, still well above historical norms. Dividend yield (around 3.3%) will likely be the main source of return. Rotation within the market should favor commodities and quality domestic names, while banks and high-multiple tech could underperform.

#### Key strategy themes for 2026:

- **Stay selective:** Focus on domestic resilience, commodity strength, and restructuring stories.
- **Income matters:** SMSF flows remain supportive, but yields are historically low.
- **Watch valuations:** Elevated multiples and rising leverage increase downside risk if earnings disappoint.
- **Global lens:** U.S. remains the growth engine, but late-cycle signals mean risk management is essential.

In short, the cycle isn't over but it's evolving. Quality, discipline, and selectivity will matter as we move into CY26.



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Sources: MST Financial, Hasan Tevfik; MST Sandstone "Tis the Season. 2026 Markets Outlook".