Rotation, Recovery, and a More Nuanced Policy Landscape

Recent market moves have been far more about rotation than deterioration. The ASX 200 has only pulled back around 4% from its peak and the S&P 500 just 3% before its sharp rally late last week, hardly the stuff of genuine risk-off positioning. Instead, what we are seeing is the market responding to a new phase in the investment cycle: one where the extraordinary investment in AI by the US hyperscalers is reshaping industry dynamics, supporting near-term growth, but also challenging some of the very companies that led the last decade of tech disruption.

This surge in AI capex now approaches 2% of US GDP and is underpinning a broader industrial recovery. Last week's ISM numbers made that clear. As that recovery builds, it naturally supports cyclical sectors, and in the Australian market, commodities remain the cleanest way to express that theme. For resource companies, AI represents a productivity tailwind rather than a competitive threat, unlike what we're seeing across parts of the software universe where the business models themselves risk being disrupted. The result is that value continues to outperform, and should continue to do so while the global cyclical upswing remains intact. Still, investors should be ready to step back into some of the better quality growth names that have experienced significant de-rating.

Reporting Season: Australia Rejoins the Global Earnings Recovery

Australia has been late to the global profits rebound. The US, Europe and Japan saw earnings expectations begin to turn higher back in late 2022, while Australia endured three consecutive years of EPS contraction. That trend is now finally reversing. Expectations for ASX 200 EPS point to growth of almost 9% through June 2026 and a further 10% in FY27. The early phase of this recovery has been almost entirely driven by Commodities, where forecasts swung sharply from a 5% contraction to a 21% expansion for FY26. Financials and Industrials are improving too, though at a more modest pace.

There is lingering scepticism about how long the commodity momentum can last, which is why the 2027 earnings contribution shifts meaningfully toward Industrials, with companies like CSL, Wesfarmers and ResMed expected to pick up the baton. At the same time, some of the big mining names, including BHP and Fortescue, are forecast to see EPS contraction that year.

As we move into the February reporting season, three themes stand out. First is the ongoing pressure on the so-called "faded-grandeur" names – companies that were once market favourites but have struggled with profitability, competitive dynamics, or industry shifts. CSL, Ramsay, Reece, ASX, Seek, Sonic, Domino's and Treasury Wine all fit that description, and while consensus still expects a recovery by FY27, that timeline looks optimistic for several of them.

Second, New Zealand, which was a material drag in the August reporting period, is now stabilising. GDP has moved back into positive territory after four quarters of contraction, PMIs and job ads are lifting, and building permits are rising. For companies like Wesfarmers, BlueScope, GWA and Super Retail, this could shift NZ from a headwind to a tailwind over the course of 2026.

The third theme is the emerging FX headwind. Roughly 40% of ASX 200 earnings come from offshore, much of it USD linked. The recent strength in the Australian dollar has already eroded some of the earnings tailwind of the past two years and could become more challenging if it holds at current levels into the June half. Names such as Amcor, CSL, James Hardie and Reece look the most exposed unless they can offset the translation impact with stronger operational performance. That said, currency impacts tend to matter far more for near-term earnings than for long-term profitability.

Buybacks will be a prominent feature again this season. Historically, buyback programs have delivered strong performance, though with so many companies undertaking them now, investors will need to be more selective. Among the names best placed to conduct meaningful buybacks this year are AMP, AUB, Challenger, Healius, The Lottery Corp and Worley.

Xero is worth mentioning separately. It has been one of the hardest-hit names in the Australian tech space due to broader fears around AI's impact on the SaaS business model. While its EPS downgrades appear to be stabilising, we remain cautious: valuations remain elevated relative to the uncertainty in its earnings outlook.

Australian Economics & the RBA: Strong Demand Meets Sticky Inflation

The Australian economy came through the December half far stronger than expected, with robust household consumption, firmer dwelling and business investment and stronger exports. The RBA now concedes it underestimated the speed and scale of the rebound in demand. This surprise on the upside is feeding through to higher inflation, particularly in housing, durable goods and market services, areas the Bank considers highly rate sensitive and central to its mandate.

Governor Bullock has made it clear the RBA is closely watching three-month rolling inflation. The Bank appears comfortable holding rates steady once that measure re-enters the target band, and then only cutting once it approaches the middle of the band. The RBA's own forecasts suggest this could take longer than markets would prefer. We think inflation may ease faster than the Bank expects, but even so, we now see policy remaining marginally tight through most of 2026, with a first rate cut likely in November. The risks lean toward either no cuts at all in 2026 or an additional hike if inflation proves stickier than expected.

A policy stance that is tight at the margin naturally limits the upside for domestic demand sectors such as retailers, retail REITs, housing-related stocks and domestically focused industrials. However, it's important to place this in context: the underlying economic backdrop is, as Bullock put it, "actually in a really good position." Household savings remain high and the demand pulse is strong enough to provide support, but without near-term rate cuts, investors will need to be selective.

US Economics & the FOMC: Policy on Hold, Earnings in Focus

The latest FOMC meeting held rates steady at 3.5% to 3.75%. Much of the press conference centred around political questions, including the Supreme Court case involving Governor Lisa Cook, which Powell described as the most important in the Fed's 130 year history. He emphasised repeatedly that the Fed remains an independent institution and should continue to operate that way.

Powell also noted that the economy had improved since the last set of projections in December, implying some FOMC members may scale back expectations for future cuts. He described policy as being "around neutral," highlighted the benefits of AI-led productivity improvements, and reiterated that no FOMC member sees the next move as a hike. Our US economists continue to forecast cuts, but we acknowledge the Fed has time on its side.

The more important shift for markets is that the powerful re-rating phase fuelled by falling interest rates is now behind us. With rates on hold for an extended period, equity markets will need earnings to do the heavy lifting. That helps explain why parts of the US economy, including the homebuilders, have not fully responded to the 175 bps of cuts already delivered.

The announcement of Kevin Warsh as incoming Fed Chair has added a layer of uncertainty. Warsh was historically the most hawkish candidate, having opposed QE during the GFC era. But markets shouldn't assume he will be reflexively hawkish in his new role. Warsh has argued that AI could be disinflationary and therefore supportive of lower rates, though for now, evidence is mixed. For example, the build-out of US data centres has pushed electricity prices higher in several states.

The US dollar has strengthened since the announcement, with gold pulling back and silver seeing heavier selling. This could create short-term softness in commodities such as copper, which we would view as a buying opportunity. We remain constructive on commodity producers, with BHP continuing to stand out as a preferred exposure.

AI's impact is also playing out unevenly across the equity market. While it supports macro-level growth, it is proving disruptive for parts of the software sector. Recent results from Microsoft and ServiceNow triggered meaningful share price declines, driven by rising capex for defensive AI positioning and defensive M&A activity. ServiceNow is down roughly 50% over six months. The pattern is similar in Australia: Xero has halved, though it still trades at a far richer valuation than its US peers.

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