

Inflation, Policy Shifts and a More Fragile Cycle

An Inflationary Expansion — For Now

The global industrial recovery continues to broaden, supporting a resilient tone across risk assets. At its core is the extraordinary surge in AI-related capital expenditure, with hyperscaler investment now expected to exceed US\$700bn in 2026 and approach US\$1 trillion by 2027.

This investment cycle is feeding directly into earnings, with global EPS revisions running at their strongest pace in decades. However, it is also contributing to a more subtle but important shift in the inflation regime.

Recent US inflation data highlights this tension. While headline inflation remains relatively contained, the composition is becoming more concerning. Core CPI has re-accelerated and, notably, software prices are now rising materially after decades of deflation. This reflects the monetisation of AI functionality across corporate software stacks.

This dynamic is critical. While AI should ultimately be disinflationary, the initial phase is clearly inflationary, via:

- Higher capex intensity
- Increased pricing power in technology
- Stronger labour demand in high-skill sectors

Bond markets are beginning to reflect this shift. Long-end yields are rising, and inflation expectations remain elevated, reinforcing the view that this is an “inflationary boom” rather than a disinflationary recovery.

The implication is clear: the bar for central bank easing remains high, and the peak in the capex cycle may arrive sooner than markets currently expect.

The Iran Conflict: The Largest Macro Risk

Overlaying this cyclical recovery is a highly unstable geopolitical environment. The Iran conflict, and specifically the closure of the Strait of Hormuz, remains the most immediate macro risk. Around 14mb/day of oil supply has been disrupted, with prices thus far contained near US\$100–110/bbl due to inventory drawdowns. However, these inventory buffers are finite.

If the Strait remains closed, the risk is for a sharp oil price spike toward US\$150/bbl, which would:

- Reignite global inflation
- Tighten financial conditions materially
- Weaken growth across developed markets

Energy markets therefore remain the key transmission channel to broader macro outcomes. As Hasan Tevfik at MST has highlighted, fiscal subsidies and reserve releases can only offset supply shocks for 1–2 quarters at current drawdown rates.

The central case remains a negotiated resolution and gradual normalisation. But conviction is low, and market resilience should not be mistaken for stability.

Australia: Strong Surface Data, Fragile Foundations

Domestically, the headline economic data presents a picture of resilience:

- GDP growth: ~2.6%
- Unemployment: ~4.3%
- Wage growth: ~3%



However, this masks a more fragile underlying picture. Inflation remains above target and is proving persistent, driven by:

- Supply-side shocks
- Weak productivity
- Tight labour markets
- Strong nominal demand

The RBA has shifted to a more assertive stance, with markets now pricing further tightening. Bond markets are signalling this clearly, with Australian 10-year yields around 5% and potentially moving higher. At the same time, there are early signs that domestic demand is softening, particularly in housing activity and forward indicators.

This leaves the RBA in a difficult position. A faster resolution to geopolitical risks could re-ignite demand and force further tightening, while a prolonged energy shock would simultaneously weaken growth and lift inflation, a classic policy dilemma.

Federal Budget: A Structural Shift for Housing

The Federal Budget introduces a meaningful change to the housing investment framework, centred on:

- Removal of negative gearing on existing properties
- Changes to capital gains tax
- Increased scrutiny on trusts

From a market perspective, the key takeaway is simple: the cost of capital for residential property has risen. History provides a useful guide. During the 1985–87 removal of negative gearing:

- Rents rose strongly
- Real property prices declined
- Rental yields rose to ~8%

This adjustment reflected a supply shock, compounded by rising interest rates. Today, the dynamics are somewhat different:

- Negative gearing remains for new builds
- Vacancy rates are near historic lows
- Dwelling supply is lagging population growth

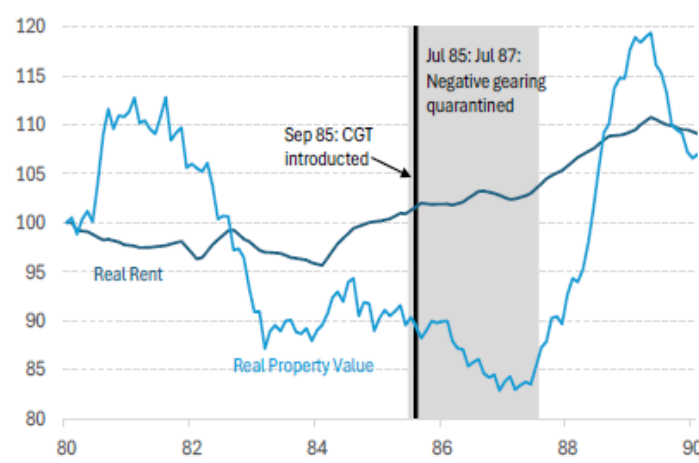
This suggests the adjustment may be skewed more toward higher rents than falling prices. However, some decline in real housing values still appears likely, particularly if interest rates move higher. CBA analysis suggests a modest base-case impact (~3% lower house prices over three years), but sentiment effects could drive a larger adjustment, especially in investor-heavy segments.

The broader macro implications include:

- Slower investor credit growth (negative for banks)
- Higher housing turnover (positive for platforms like REA and PXA)
- Continued upward pressure on rents

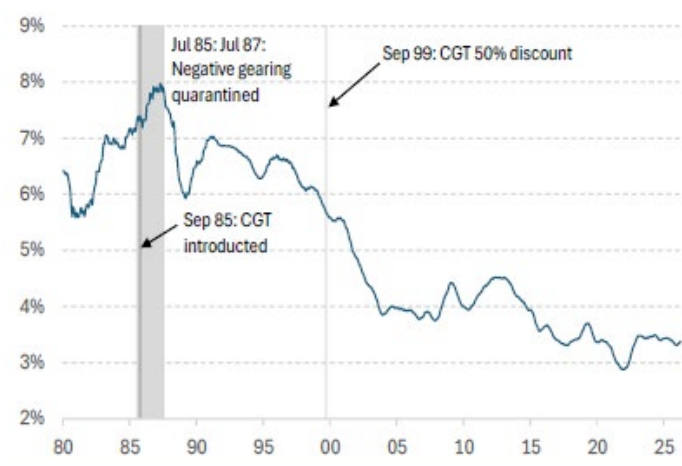
Real rents rose and prices fell in 1985-87

Australian real rents & property prices 1980-90



Australia's highest rental yields were in 1987

Australia Gross Rental Yield



Investors should therefore remain cautious on property-exposed sectors during this transition.



Markets: Resilient, But Cracks Are Emerging

Despite the growing complexity of the macro backdrop, markets have remained remarkably resilient:

- US equities continue to reach new highs
- Earnings revisions remain strong
- Risk appetite is supported by the AI theme

However, several warning signs are emerging beneath the surface:

1. **Rising Bond Yields**
Higher inflation expectations and increased bond issuance are pushing yields higher, compressing equity multiples and reducing valuation support.
2. **Narrowing Equity Risk Premiums**
With bond yields rising, equities require continued earnings upgrades to justify current valuations.
3. **Private Credit Stress**
Early signs of stress are appearing in global private credit, with rising defaults and redemption pressures, though systemic risks remain contained for now.
4. **Policy Constraints**
Central banks are increasingly constrained, with limited flexibility to respond to either inflation or growth shocks.

Investment Implications

We are operating in a more complex and less forgiving environment. Several key themes dominate:

1. **Stay Constructive on AI — but Aware of the Cycle**
The AI capex boom remains a powerful earnings driver, but it is also:
 - Inflationary in the near term
 - Sensitive to the cost of capital
 - Ultimately cyclical
2. **Expect Higher Volatility**
Markets are entering a phase of episodic volatility, driven by:
 - Geopolitical risk
 - Policy uncertainty
 - Shifting inflation dynamics
3. **Be Selective in Domestic Exposure**
Australia faces tighter monetary conditions and structural housing adjustments, limiting upside for:
 - Domestic cyclicals
 - Property-exposed sectors
4. **Watch Energy Markets Closely**
Oil remains the key macro variable. A sustained spike would materially alter the inflation and growth outlook.
5. **Position for Optionality**
Given the binary nature of several key risks (Iran, inflation, policy), maintaining flexibility and liquidity remains critical.

Conclusion

The global economy is navigating an unusual combination of forces:

- A powerful investment-led upswing driven by AI
- Persistent, structurally higher inflation
- Rising geopolitical risk
- Meaningful domestic policy shifts



While the base case remains one of continued expansion, the range of outcomes has widened considerably. In this environment, discipline, selectivity and risk management will be critical, as markets transition from a liquidity-driven cycle to one increasingly shaped by inflation, policy and geopolitics.



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Sources: MST Financial, Hasan Tevfik. MST Sandstone, CBA Global Economics