Higher for Longer – But Not Everywhere

The global economy continues to be shaped by two powerful and competing forces: a still-expanding AI-driven investment boom and a renewed tightening of financial conditions as central banks turn more hawkish.

While growth remains resilient on the surface, the underlying cycle is becoming more fragile. Inflation persistence driven by energy volatility and structural supply constraints has forced global central banks to adopt a more restrictive stance. In contrast, the RBA is increasingly an outlier, shifting toward a more neutral, and potentially even accommodative, bias.

In this environment, markets are recalibrating to a higher cost of capital rather than a deterioration in earnings. The implication is clear: volatility is likely to remain elevated, and selectivity will be critical.

At the same time, the AI investment cycle continues to act as a powerful tailwind to global growth and earnings, but evidence suggests we may be approaching a more mature phase of the cycle, with implications for both macro policy and asset markets.

Australia: Policy Divergence Emerging Post-RBA Decision

The domestic economy continues to present a mixed picture. Headline indicators remain resilient, but underlying momentum is softening, consistent with the “strong surface, fragile foundations” theme highlighted in previous updates.

GDP growth remains around trend (~2–2.5%), the labour market is still relatively tight, and wage growth is moderate. However, inflation dynamics are increasingly nuanced. Recent data shows trimmed mean inflation running at 3.6% year-on-year, still above target, but not accelerating sufficiently to justify further tightening in the near term.

Importantly, forward-looking indicators suggest inflation pressures are easing:

- Declining oil prices are reducing cost pass-through
- Slowing housing activity is easing labour demand in construction
- Vacancy data suggests capacity is gradually returning

As a result, the RBA’s tone has shifted. The latest communication marks a clear step away from its prior hawkish bias, with Governor Bullock explicitly noting that policy does not need to wait for inflation to return to target before easing.

This places Australia increasingly at odds with global peers. While most central banks are preparing for further tightening, Australia is likely entering a period of **extended policy hold**, with a growing possibility of a modest rate cut later in 2026 should inflation continue to undershoot.

From a market perspective, this implies:

- Slower credit growth and pressure on bank earnings
- Reduced importance of domestic rates for equities
- Greater sensitivity to global (particularly US) rates

In short, the RBA matters less; the Fed matters more.

United States: Resilient Growth, Hawkish Shift Under Warsh

The US economy remains the anchor of global growth, supported by strong AI-related investment, robust corporate earnings, and a still-resilient household sector. GDP growth is expected to remain solid through 2026 (c. 2.2–2.7%), even as consumption begins to moderate and non-AI investment weakens.

However, the policy backdrop is shifting. While Morningstar expects eventual easing through the cycle, near-term market pricing, and broader central bank commentary, suggests a more hawkish stance is emerging, consistent with efforts to maintain policy credibility.

Recent developments highlight this pivot:

- The FOMC has removed projected rate cuts from its dot plot
- Markets are now pricing a potential rate hike as early as September
- Policy tightening may increasingly shift toward balance-sheet reduction

This reflects both cyclical and structural factors. While inflation is expected to moderate once energy shocks fade, underlying demand, supported by AI-driven capex and fiscal policy, remains strong.

The US household sector remains in relatively strong condition. While savings rates are low and real wages are under pressure, balance sheets remain robust enough to absorb modestly higher rates.

The broader implication is that **global financial conditions are tightening through US policy**, not domestic developments. This has several consequences:

- Upward pressure on global bond yields
- A stronger US dollar
- Increasing stress in leveraged segments of markets

At the same time, the risk profile is evolving. Rising margin debt and leveraged positioning, particularly in bond markets and hedge funds, suggest that higher rates could trigger episodic volatility, even if the broader economic cycle remains intact.

Artificial Intelligence: From Tailwind to Cycle
The AI investment boom remains one of the defining features of the current economic cycle. As noted in prior updates, this is driving a significant uplift in global capital expenditure, earnings growth and productivity expectations.

Morningstar's analysis reinforces this view, while also challenging several common misconceptions.

1. AI is Already a Meaningful Growth Driver
AI contributed approximately **0.4 percentage points to US GDP growth in 2025**, with the true impact likely higher once measurement issues are accounted for.

More broadly, AI is exerting a powerful demand impulse through:

- Data centre and infrastructure investment
- Software and R&D spending
- Wealth effects via equity markets

2. The Investment Cycle is Real—and Ultimately Cyclical
The current phase of AI investment resembles previous technology booms. Capex is accelerating rapidly, led by hyperscalers, and is now feeding into global trade, commodity demand and earnings growth.

However, history suggests such cycles tend to peak within 4–5 years. By most estimates, the current cycle is already in its second or third year.

Morningstar similarly expects **AI investment growth to remain strong through 2026 before moderating**.

3. Productivity Gains Are Coming, But Not Yet
Despite the surge in investment, there is limited evidence that AI has materially boosted productivity so far. The recent uplift in productivity predates widespread AI adoption and reflects broader cyclical factors.

This distinction is critical:

- Near-term: AI is inflationary and demand-boosting
- Long-term: AI is likely disinflationary via productivity

4. Bubbles Can Still Be Economically Transformative
Even if elements of the AI boom prove excessive, this does not diminish its long-term impact. As with railways or the internet, periods of overinvestment can still generate substantial structural gains for the economy.

5. Markets Remain Sensitive to the Cost of Capital
The AI cycle is highly dependent on financing conditions. Rising real yields remain the most likely "circuit breaker" for the current investment boom.

This reinforces a key message: **AI is both the engine of growth and a source of instability.**

Markets and Commodities: Positioning Meets Policy
Recent market weakness reflects a repricing of interest rates rather than a deterioration in earnings.
Key dynamics include:

- Rising global yields compressing equity multiples
- Elevated leverage increasing sensitivity to funding costs
- Diverging commodity outlooks

Within commodities:

- **Gold appears vulnerable**, lacking fundamental support in a rising real yield environment
- **Industrial metals** (copper, aluminium) remain supported by the AI and industrial cycle, but positioning is stretched
- Any near-term correction may present selective opportunities

A further important development is the growing role of **stablecoins and non-bank financial institutions**, which are altering the transmission of monetary policy and potentially weakening traditional bank credit creation.

A More Complex, Less Forgiving Cycle

The global economy is entering a more complex phase of the cycle. Key features include:

- Diverging central bank policy (hawkish globally, neutral/dovish in Australia)
- A structurally higher cost of capital
- Continued but maturing AI-led investment
- Rising financial market fragility beneath resilient surface conditions

While the base case remains one of continued expansion, the balance of risks has clearly shifted.

For investors, the implications are consistent with prior guidance:

- Expect higher volatility
- Focus on quality and earnings durability
- Be selective in domestic exposure
- Maintain flexibility to take advantage of dislocations

The transition from a liquidity-driven cycle to one shaped by **policy, inflation and capital discipline** is now well underway.

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