

SRRF Commentary: Will equities yield?

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Global bond yields have spiked, putting pressure on asset prices across the board. But will higher yields cause equity markets to crack?

Market Review

All eyes were on bond markets in September, with yields backing up over 50 basis points in the US, with the 10-year government bond yield rising to 5.3% by the end of the month. Strong domestic growth, continued upward pressure on the oil price, a resumption of the US hiking cycle and a more hawkish tone from the US Federal Reserve (Fed), caused markets to price in four more rate hikes this cycle. This is a far cry from the 3 rate cuts priced at the end of last year. Other bond markets outperformed, but were no less impacted, with countries like Australia, UK and Germany seeing their 10-year bond yields rise around 30 basis points. This had ramifications across asset classes, the US dollar rallied, credit spreads widened, and equity markets wobbled. The US dollar was up 2% on a trade weighted basis, the Australian dollar fell 3% and the Japanese yen rallied 1.5%. Investment grade credit spreads widened between 5-10 basis points, but high yield widened almost 50 basis points. Despite weakness in equities, the overall global equity market fell a subdued 0.7%, with the S&P 500 only falling 0.35%. This remarkable outcome hides damage under the surface, given a handful of technology companies kept the index buoyed, whereas more cyclical stocks suffered. The Nasdaq rallied over 3% but the equal weight S&P 500 fell 5%, and less technology heavy countries like Australia and Europe saw their markets fall around 2.4% each. Brent crude oil rallied over 14% to hit \$103.5, whereas gold fell over 6% to around \$4150 at month end.

Market Outlook

Bonds have once again become the risk asset, selling off aggressively in September. We have been warning about structurally higher inflation and the inability for government bonds to protect your portfolio in a strategic asset allocation sense for some time now. This month our fears became reality as bond market yields backed up across the world. The market started pricing rate hikes on fear over higher inflation driven primarily from the rise in oil prices. Brent oil rose from US\$90 a barrel last month to almost \$110 in September, after increased tension in the Middle East after the Houthis in Yemen attacked the Saudi East-West pipeline and shipping facilities. Tensions remained after Washington rejected Iran's seven-day peace proposal. This pushed up inflation fears, which put upward pressure on bond yields.

At the same time US economic growth remained resilient. September saw a powerful upward revision in final sales to private domestic purchasers to 4.6%, which was heavily fuelled by a 3.8% surge in consumer spending and a 9% annualized jump in non-residential investment. S&P flash PMIs beat expectations, with manufacturing coming in at 57 and services at 58.7. Retail sales rebounded sharply, up 6% year-on-year, showing continued household spending despite higher inflation. The job market also recovered, with non-farm payrolls coming in at 162k, well above the expected 55k. This gave the new Federal Reserve Chair Kevin Warsh the cover to hike interest rates by 25 basis points in September, taking the target rate to 4%. The market was surprised by Warsh's hawkish tone, stating he

was removing accommodation as opposed to tightening. This caused the market to price in another 4 rate hikes to come. This pushed the 10- and 30-year yields to their highest since 2007 and 2004, respectively, with the 10-year closing at 5.28% and the 30-year at 5.63% on 30 September.

The US was not alone. The European Central Bank (ECB) lifted its deposit rate to 2.50%, its second hike this year. The Bank of Japan (BOJ) raised rates to 1.25%, a level last seen in 1995, while 10-year JGB yields pushed toward 3.1%, a high not seen since 1996. The Reserve Bank of Australia (RBA) raised rates by 25 basis points to 4.60%, with markets now pricing in a peak near 5.15%. Australian 10-year yields closed at 5.35%, up 27 basis points for the month, after touching post-2011 highs in a global selloff led by US Treasuries. The front-end was just as dramatic: on 10 September alone, 2-year yields jumped 19 basis points to 4.93% as the entire curve hit its highest levels since May 2011.

The fact that equity markets haven't broken given the aggressive repricing in bonds is noticeable. However, the headline returns of the S&P 500 obscure the damage under the surface, with technology companies rallying on capex spend whereas cyclical companies fell 5% over the month. It's not that the market isn't reacting to higher rates, it's that the market is concentrated in AI linked names which continue to see strong earnings off the back of \$800bn of capex being spent in 2026 and \$1tn p.a. in the years to come. The fact that bond yields were mainly moving due to strong growth, as opposed to worry over fiscal spending, kept equities somewhat insulated. It would be very different if we were looking at a liberation day flight from treasuries.

For the past few months, we have been bearish on bonds as we believed that the market was not correctly pricing rate hikes for 2026. Now, we believe the market is likely pricing too many hikes than what central banks will actually deliver. For the first time in years, bonds are well positioned to do their job again. With 10-year yields above 5% in both Australia and the US, government bonds now offer serious income and real upside if growth stumbles. If central banks try and deliver the number of cuts priced, economic growth will slow, and the risk of a policy mistake will grow. Central banks are tightening into an oil supply shock, yet pass-through to underlying inflation remains limited. If hikes lead to a growth slowdown, bonds will likely protect equities. However, our base case is that worries over oil subsidies, inflation remains sticky but below the current fears, and rate hike expectations get priced out of the market. This would see both bonds and equities rally. We don't think the hiking cycle is over, but that it will be less than the market is pricing. Despite all our bearishness around energy supply through the Strait of Hormuz, it has surprised many to see how much oil is actually getting through. JP Morgan has regional oil exports only 11% below pre-war levels, which is a remarkable recovery for a region still at war. This could help see recent worries over even higher inflation normalise.

We have therefore moved more positive on bonds. Our base case is that bonds and equities will rally together in the coming months, as opposed to central banks causing a growth slowdown from excessive tightening. We do not believe higher bond yields will crack the equity market, but acknowledge risks remain, especially leading into the US mid-term elections. We therefore keep our equity exposure but increase our hedges to protect from any short-term volatility.

Portfolio Changes

Our equity allocation was cut 2% from 37% to 35% by the end of September. We sold equities at the start of the month, given worries over bond yields and energy prices in the short-term, rather than any strong fundamental concerns. This was primarily through reducing our exposure to European equities, which subsequently underperformed over the month. We reduced our position to the US equal weight and reverted back to the standard S&P, given our concern that rate hikes will impact cyclical stocks more than technology stocks. We also took profit on our US energy sector position, which subsequently fell

almost 4.5%, and rotated into health care which then rallied 1.7%. At the end of the month, we sold a US 10-year treasury strangle to profit on elevated bond market volatility. We used the premium to fund a 5% notional S&P 500 7300 put option out to December, to protect the portfolio during this heightened bond volatility and the upcoming US mid-term elections.

Fundamentally, we continue to like equities and US equities in particular. US economic growth remains supportive, both from consumer spending and continued corporate capex. The job market appears to have rebounded, and retail sales has resumed its strength. Valuations are becoming more attractive, particularly on the recent three-year comparison and increasingly on a longer-term basis as well. Positioning is also no longer a headwind, with investor positioning back around neutral. However, our equity crash model is suggesting heightened risk. US earnings momentum appears to have peaked, which has historically acted as a headwind for forward equity returns, while our EPS growth forecast has fallen from close to 20% to around 14%. This still points to positive earnings growth, but the impulse is no longer as strong as it was in prior months. We therefore remain long equities but increased our protection with put options.

European earnings momentum remains strong, with Spain, Germany, Italy and France all improving, but our EPS model suggests the growth impulse could fade as base effects become less supportive, and the euro is expected to strengthen. Positioning in equity markets across the Eurozone are stretched by 1-2 standard deviations. Macro surprises are also near the top of their range, suggesting the recent improvement may be difficult to sustain. We continue to see some support for the periphery and European banks, but after strong performance and richer valuations, we took profit on Europe. The fundamental backdrop for Japan has improved, with earnings momentum still strong and moving higher. Our EPS model points to some moderation in earnings as earlier support from PMIs, the Tankan survey and yen weakness fades. We prefer to take our Japan allocation through the more tech-heavy Nikkei than Topix at this stage. EM valuations look attractive, particularly on forward P/E, and earnings momentum has moved back into positive territory for broad EM.

We remain negative on Australian equities. The macro backdrop remains poor, our earnings model is still negative, and earnings momentum continues to deteriorate, even though the profit margin backdrop has started to improve from trough levels. Valuations remain expensive on a longer-term basis, and there is not yet enough technical support to justify adding exposure. While Australia may eventually benefit if the market shifts focus from inflation risk towards growth downside and future easing, that is not enough to offset the current earnings and valuation headwinds.

Credit spreads widened over the month, more in high yield than in investment grade. High yield widened around 50 basis points over the month, both in cash bonds and credit default swaps. High yield credit default swap spreads improved to almost neutral levels, with the US approaching the 34th percentile and EU hitting 46th percentile, from a mix of spread widening and new composition underlying after the roll to the new contract. We shifted our 2% European credit position from investment grade to high yield and also added another 2% to US high yield, both through selling protection on credit default swaps. This resulted in a net increase in credit of around 2% and an increase in high yield of 4%. While we are not out of the woods and there is plenty of room for further widening if the economy slows, we believe we can take carry in credit and that we should see credit default spreads tighten back once bond volatility subsides. We continue to hold most of our credit allocation in Australia. Spreads remain relatively wider and the index continues to have better quality than global corporates. We continue to favour the BBB space in Australia, which includes allocation to infrastructure and utility corporates who benefit from higher inflation. We continue to let our Australian real estate private debt allocation to roll off, falling from 4% at the start of the year to 1.4% as deals are successfully repaid. We have been warning about this

sector all year, given rising cash rates, a weakening economy, weaker house prices, the removal of negative gearing and falling immigration rates, coupled with rising construction costs. We expect this exposure to continue to fall and fall to zero by the second quarter next year. The fund continues to hold around 0.7% in Australian corporate private debt (non-property). We reallocate this capital to Australian higher yielding BBB corporates.

We have been very active in duration this month. In the first week, we moved 0.1 years from the back-end of both Australian and German curves to buy the front-end given worries the yield curve might steepen. We also added around 0.15 years to US front-end break evens on fears inflation would rise. In the second week of the month, Australian bonds sold off dramatically, with the 3-year government bond yield rising 30 basis points in a few days after the market started pricing a more aggressive rate hiking cycle from the RBA. We added to duration in Aus at the front-end as we don't believe the RBA will be able to hike that aggressively, given the slowing economy, increase in taxation and falling house prices, which will hinder consumption. In the third week, global bonds followed suit, starting to rise dramatically. We added to Germany as we saw relative value there, where more hikes were being priced than we anticipate. We sold our front-end US inflation linked bonds and bought Australian 10-year inflation linked bonds, which at the time of purchase had a real yield of 2.9%. We stayed away from US duration mostly throughout this period. At this time, only Aus, EU and UK markets were pricing in more hikes than our views.

Then finally, in the fourth week, we have started adding to US duration. With one rate hike delivered and four more being priced, we believe the market is too hawkish. We took profit on our short positions in the back-end of the US curve, closing our shorts in 10- and -20-year bond futures. We also continued to add to the front-end of Australia, after the RBA delivered another hike, as well as the UK. This resulted in a net increase of 1 year of duration at the fund level over the month, ending September at 3 years duration. We also sold US 10-year volatility. We believe duration will deliver over the coming months as inflation comes down and the market prices in less hikes.

We added 2% to the US dollar (USD), funded from reducing our emerging market currency allocation by the same amount. We continue to expect US growth to outpace other developed markets, and now with more rate hikes being priced in the US treasury market, we expect these rate differentials to support the USD, especially given our view of less rate hikes than expected in the EU, UK and Australia. We added 1% to the Japanese yen (JPY), funded from selling the Euro (EUR). The JPY has rallied as the market prices in more hikes over the next year, while currency volatility has also surged. If the relationship between USD/JPY and rate differentials re-establishes itself, there remains significant further upside. However, we still prefer to stay on the sidelines given previous rallies have not been sustained, while carry remains negative, and a sharp appreciation of the JPY will hurt the export industry / overall economy of Japan. Funding the yen from Euros helps reduce the negative carry. In Europe, in the short-term rate hikes are fully priced, while longer term structural concerns remain. We remain short the British pound (GBP). While weak growth and fiscal concerns are fundamentally negative, these have not had any sustained material impact on GBP, but we will wait out the UK budget in October before considering any changes. We continue to like select emerging market currencies that have high real yields and provide carry in portfolios but have reduced our positions in favour of the USD in the short-term. We continue to hold 2% in gold and 3% in broad commodities. Within our broad commodities exposure, the team went from long oil to neutral by the end of the month.

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