What we liked

- **NAB Business Confidence:** Came in at 3, rising from 2, suggesting improving business sentiment, supportive for AUD.
- **US Durable Goods Orders:** Headline was +5.3% vs prior -2.1%, indicating stronger-than-expected manufacturing momentum. This is supportive for equity markets as indicates stronger spending and capital expenditure.
- **US Jobs data:** Stronger than expected jobs gains led the dollar to ease vs peers as markets repriced Fed rate expectations. While reducing the likelihood of interest cuts is not positive for markets on their own, the continued resilience of the US employment market remains supportive of a stronger economy and domestic demands.
- **China Industrial Profits:** Released late December; widely monitored as a gauge of Chinese industrial recovery. Signs of stabilisation were viewed as modestly supportive for commodities and Asia markets.
- **China Manufacturing Activity Rebounds:** Official PMI rose to 50.1, snapping an eight-month contraction. This boosted sentiment in Chinese equities and commodity markets and indicates incremental signs that Chinese manufacturing activity may have passed its trough.
- **Chinese leader Xi pledges "more proactive macro policies" for 2026:** President Xi Jinping announced fiscal and macro policy support to sustain growth, which bolstered market expectations for stimulus. While it remains piecemeal, we expect further pro-growth announcement over the coming months.

What we didn’t like

- **Australian CPI:** Annual inflation surprised higher (~3.8% YoY), above forecasts, pushing markets to price in a greater probability of RBA tightening in early 2026. According to the read, chances for a February rate rise increased to 70% in markets versus the previous expectation at 56% chance.

- **UK BRC Shop Price Inflation**: Reading came in at 1.5% vs 0.7% expected, indicating re-acceleration in retail inflation - pressured gilt yields and supported GBP.

- **Eurozone Manufacturing PMI:** PMI survey fell deeper into contraction (~48.8), highlighting slowing activity across major economies and weakening EUR sentiment.

- **Germany IFO Surveys:** Business Climate reading came in at 87.6 versus expectations of 89.5. Current Conditions came in at 85.7. This survey is a barometer of German business confidence. A broadly stagnant read continues to contribute to a generally cautious market tone on the German economy.

- **Japanese Core CPI:** Remained above the BOJ's 2% target in Dec 2025, keeping markets focused on future rate path and yen volatility.

- **China Services PMI Weakens:** In contrast to the manufacturing picture in China, its services sector expanded at the slowest pace in six months, highlighting soft domestic demand and dampening risk appetite. Disappointing for regulators who have made domestic demand growth a regulatory priority.

BASE CASE

Our view of the most likely scenario for markets over the coming months, for which our portfolios are currently positioned.

79% Probability

Markets enter 2026 with a cautiously optimistic tone. Global corporate earnings remain resilient, fiscal spending continues, and financial conditions remain relatively loose. However, elevated investor confidence and concentrated positioning in equities create vulnerability to short-term volatility from tariff developments, inflation surprises, central bank pivots, geopolitical shocks, or bond market stress.

Our forecast for subdued inflation in the first half of 2025 proved accurate. However, global inflation-excluding China-remains elevated relative to pre-pandemic norms. This uncertain inflation trajectory could spark volatility heading into 2026, particularly if tariff effects begin filtering through to consumer prices.

Fiscal expansion and manageable inflation have created a constructive backdrop for equities. The US tax and spending legislation appears more growth-supportive than initially anticipated, though sovereign debt accumulation remains a medium-term concern.

Central banks face a difficult balancing act. Lower rates support growth but risk currency weakness. Most major central banks cut rates over the past year, and we expect these cuts to become more visible in economic data over coming months.

Significant refinancing activity is expected throughout 2026, making continued access to liquidity and credit essential. This is one reason we maintain exposure to inflation hedges, such as precious metals.

We remain constructive on global activity and risk assets, but acknowledge our baseline is more vulnerable if US tariffs are fully implemented, or if expected support from the US Federal Reserve or Peoples Bank of China does not materialise in the short term.

Structural growth themes-particularly AI infrastructure and energy infrastructure buildout-should continue to support equity markets. Lower interest rates and sustained fiscal spending are expected to broaden earnings growth across sectors.

Our overall stance remains biased toward risk assets over the medium term, while accepting that short-term volatility is likely. We will use pullbacks to add exposure to sectors tied to economic and structural growth. Our asset allocation remains tilted toward growth, guided by macro developments, valuations, and central bank policy.

BEAR CASE

Our worst-case scenario for the coming months, which we are prepared to position for should conditions deteriorate.

8% Probability

Consumer spending weakens more sharply than expected, with the US economy slowing and limited signs of recovery elsewhere. A resurgence in inflation-or reduced support from the US Federal Reserve-would weigh on corporate earnings and compress valuations, particularly given current elevated levels.

Banking sector stress could re-emerge, echoing events of early 2023. Bond investors may demand higher yields amid concerns over sovereign debt sustainability, tightening credit conditions and threatening otherwise resilient labour markets.

Escalating geopolitical tensions could disrupt supply chains and energy markets, pushing inflation higher and forcing central banks to maintain restrictive policy settings. Persistent wage and housing cost pressures risk becoming embedded, squeezing corporate margins.

Central banks may find themselves unable to cut rates even as growth slows. Constrained fiscal flexibility-given elevated public debt-could further undermine consumer confidence and spending power.

In China, property sector fragility persists. If government support fails to stabilise prices and restore confidence, prolonged weakness could weigh on Australian resource exports.

In this scenario, we would shift to a more defensive posture: increasing cash holdings, reducing equity exposure, and focusing on resilient sectors such as healthcare, consumer staples, and utilities.

BULL CASE

Our most optimistic view for markets over the coming months.

13% Probability

Economic growth exceeds expectations as policy uncertainty clears. Easing supply chain pressures, resilient labour markets, and rising productivity-particularly from AI adoption-drive inflation lower. Diplomatic progress limits the impact and duration of trade tariffs.

Inflation falls without materially slowing growth. AI and emerging technologies boost worker efficiency and corporate profitability, supporting strong profit margins.

Governments increase spending to stimulate activity. While this may generate some inflationary pressure, nominal growth is expected to outpace inflation, creating a supportive environment for risk assets. Deregulation adds further tailwinds.

In Australia, increased government spending and rate cuts that began in 2025 support domestic activity. Globally, coordinated stimulus-including Chinas policy measures-and healthy corporate and household balance sheets drive a notable acceleration in growth.

If central banks maintain rates below inflation and expand liquidity support, markets could enter a renewed uptrend, boosting demand for growth assets in a low or negative real rate environment.

In this scenario, we would maintain a growth-oriented allocation with minimal cash, increasing exposure to cyclical sectors most sensitive to economic expansion.

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