What we liked



- **Australia's economy kept growing in the June quarter, expanding 0.4% and a little better than expected:** helped by resilient household spending; it shows the economy holding up well despite higher interest rates and costlier fuel.

- **The US jobs market stayed strong, with employers adding 162,000 jobs in August, far more than the 53,000 expected:** while unemployment held steady at 4.1%; it reassured investors the world's largest economy is not heading into recession.

- **American shoppers kept spending, with retail sales rising 1.2% in August, well ahead of expectations:** and the strength was broad rather than just higher petrol prices; a resilient consumer helps keep the world's largest economy ticking over.

- **Europe's economy proved more resilient than feared, with overall business activity reaching its highest in almost three and a half years, led by its services sector:** the region is coping with higher energy costs better than many had assumed.

- **India remained the world's fastest-growing major economy, expanding at around 6 to 7%:** with strong local demand cushioning it from the global slowdown; alongside other emerging economies in Asia, it stayed a bright spot for global growth.

- **Japan's factories kept up solid output, helping stretch its economy's growth run to the longest in more than a year:** with production and new orders among the drivers; it shows demand there holding up even as the country manages higher interest rates.

What we didn’t like



- **The RBA raised the cash rate to 4.60% on 29 September, its highest since 2011:** a fourth increase this year, as underlying inflation remains stuck at 3.6%, above the 2 to 3% target; it means higher borrowing costs for households and businesses.

- **The US central bank raised interest rates for the first time since 2023 and signalled it may go further:** a rate-rising Fed removes the support that the prospect of cheaper money had been giving markets.

- **Longer-term US interest rates pushed to near 19-year highs, lifting mortgage rates to around 7.2%:** higher borrowing costs squeeze households and weigh on almost every kind of investment.

- **European inflation climbed to 3.3%, its highest in about two years, prompting the ECB to raise rates again:** the region is grappling with rising prices it cannot easily control.

- **Japan raised interest rates to their highest since 1995, in response to a very weak yen:** a faster pace of rate rises in Japan can ripple out into global markets.

- **China's economy stayed weak, with consumer spending barely growing and house prices still well down over recent years:** factory activity only just returned to growth in September (the official manufacturing survey at 50.1) after two months in contraction; soft demand in the world's second-largest economy is a drag on global growth.

BASE CASE

Our view of the most likely scenario for markets over the coming months.



75% Probability

The global economy remains on solid ground. Company profits have held up well, governments are still spending, and money is relatively easy to borrow. Encouragingly, we expect profits to keep growing into next year. That gives markets a firm base, and it is the main reason we stay broadly positive.

Even so, the risks are building. The conflict around Iran has pushed energy prices higher and disrupted the supply of essential goods such as fertiliser and industrial chemicals. The ongoing war in Ukraine adds further strain to global supply chains, the networks that move goods and materials around the world. When those networks are disrupted, costs rise and deliveries slow, which can eat into company profits. We have tilted our portfolios toward businesses with strong, lasting growth that are less exposed to these disruptions.

Inflation had been easing, but higher energy prices have pushed it back up. The difficulty is that much of today's inflation comes from these supply problems rather than from people spending too much. Central banks are fighting it with higher interest rates, yet rate rises mainly work by cooling demand, so they are a blunt tool against a supply-driven problem. If high prices persist, the bigger danger is that they force households to cut back their spending. The risk we watch most closely is the hard combination of an economy showing early signs of cooling while inflation stays high. That mix is tougher for policymakers than either problem alone, because the usual fix for one makes the other worse.

Central banks are walking a fine line. Most cut rates last year and those benefits are still coming through, but some have started raising again as inflation picked up. In the United States, new Federal Reserve chair Kevin Warsh has signalled he will keep rates higher for longer and gradually withdraw money from the financial system, a flow we watch closely because markets need it to function smoothly. We are also seeing long-term government borrowing costs, the interest rates governments pay to borrow for many years, rise around the world. Higher long-term rates lift borrowing costs across the economy and also lower the price investors are willing to pay for each dollar of company profit, a measure known as the price-to-earnings, or P/E, ratio. When that price falls, share prices can ease even if profits hold up, and we are already seeing P/E ratios come down across the market, with the most expensive companies feeling it most. Our base case is that policy stays tighter than markets had hoped, without derailing the recovery.

Looking further out, the big growth themes remain in place. Investment in artificial intelligence (AI), manufacturing and energy should lift profits across many industries over time. We are keeping an eye on the rising cost of building AI, as the specialised chips, power and data centres involved have become far more expensive, partly due to the same energy and supply pressures. Our base case is that this raises the bill without breaking it: the companies leading the spending can afford it, and competition may bring costs down, spreading the benefits to the many businesses that use AI rather than just those that build it.

In short, resilient profits, government spending and available credit give markets a reasonable foundation, though in a more volatile setting than in recent years. September and October are historically the choppiest months for shares, more so in a US mid-term election year, so we would not be surprised by a bumpier ride, and we do not read short-term swings as a change in the bigger picture. We remain positive but are holding a little extra cash for now, ready to act if that volatility creates opportunities.

BEAR CASE

Our worst-case scenario for the coming months.



13% Probability

The main risk is a real pullback in spending by households and businesses, especially in the United States, which has been the main engine of global growth and profits. If people tighten their belts, company revenues suffer at a time when share prices are already high relative to profits. If that were to coincide with a slowdown in the heavy spending now going into AI, the downturn could be sharp. Add in stubborn inflation and high interest rates, and both profit margins and share prices could fall together.

Large, sustained oil price rises would make this more likely, and worsening supply-chain disruption from the wars in Iran and Ukraine would add to the pressure. Because much of the inflation is supply-driven, central banks may be unable to cut rates to support the economy, while high government debt limits how much governments can spend to cushion the blow. Rising long-term borrowing costs around the world would tighten conditions further and squeeze valuations, lowering the price investors pay for each dollar of profit; in that case share prices could fall further even if company earnings stay strong. On the other side, if the cost of building AI keeps climbing while the payoff is delayed, investors may decide the returns will not justify the spending. Because the market's gains have leaned on a small number of expensive technology companies, a sharp fall in those leaders could drag the whole market down.

China adds another risk. If its property market weakens further and government support fails to restore confidence, Chinese growth could slow sharply. Because Australia relies heavily on Chinese demand for our resource exports, that would hit our national income and company profits directly. In this scenario, we would take a more defensive stance: more cash, less exposure to shares, and a tilt toward steadier sectors such as healthcare, essential household goods and utilities.

BULL CASE

Our most optimistic view for markets over the coming months.



12% Probability

In the bull case, tensions with Iran ease and the pressures on markets turn supportive. Falling energy prices, easing supply-chain strains, and better diplomatic relations, including progress in Ukraine, would support stronger global growth while keeping inflation in check. If trade disputes are also resolved, company profits could grow strongly as costs fall and consumers keep spending. Wider use of AI and other productivity-boosting technology would lift output and profits across many industries, without the widespread job losses many fear. At best, ceasefires hold, the key shipping route through the Strait of Hormuz reopens fully, and a period of recovery follows.

In this setting, the two pressures we are watching could turn in investors' favour. If markets trust that inflation will stay under control, long-term borrowing costs can fall even while the Fed holds rates steady. Lower long-term rates tend to lift the price investors will pay for each dollar of profit, so share prices could rise even if earnings simply hold steady, the reverse of the pressure now weighing on the market. At the same time, cheaper energy and rapid improvements in technology could bring the cost of building AI down faster than expected, spreading its benefits to the many companies that use AI rather than the few that build it. Government spending would add a further boost, and with strong household and company finances, both are well placed to respond as conditions improve.

For Australia, government spending and the end of the current run of rate rises would support stronger growth, and our relatively low public debt gives policymakers room to do more if needed. If interest rates stay below the rate of inflation, meaning money is cheap to borrow once rising prices are taken into account, conditions remain supportive for share and asset prices. Here we would favour a growth-focused portfolio with less cash and more exposure to the sectors that do well when the economy grows, such as industrials, materials and banks.

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