Investment Insights

September 2025

Smarter Investment Solutions

Quilla.com.au

Key messages

- **Broad expectations for slowing global economic growth.** Consensus estimates suggest weakening global GDP trends. This aligns with our base case for a slower global economic growth outlook over the next 12 months.
- **Earnings misses punished in a solid Australian reporting season.** The reporting season concluded with a net earnings beat, driven by improved corporate margins, though large-cap companies that missed estimates experienced significant sell-offs.
- **Active Australian equity managers' underperformance at the extremes.** A large proportion of active Australian equity managers have significantly underperformed the ASX 200 by a historically wide margin. This trend is expected to reverse.
- **Surprisingly reasonable global equity valuations combined with strong earnings growth expectations.** Expectations for stronger earnings across global equity markets, combined with valuations close to longer-term averages, provide a supportive backdrop for equity markets.
- **Japanese companies are improving capital allocation decisions.** The Tokyo Stock Exchange's (TSE) corporate governance initiative is successfully compelling companies to improve capital efficiency, unlocking shareholder value, and potentially creating a positive structural catalyst for Japanese equities.

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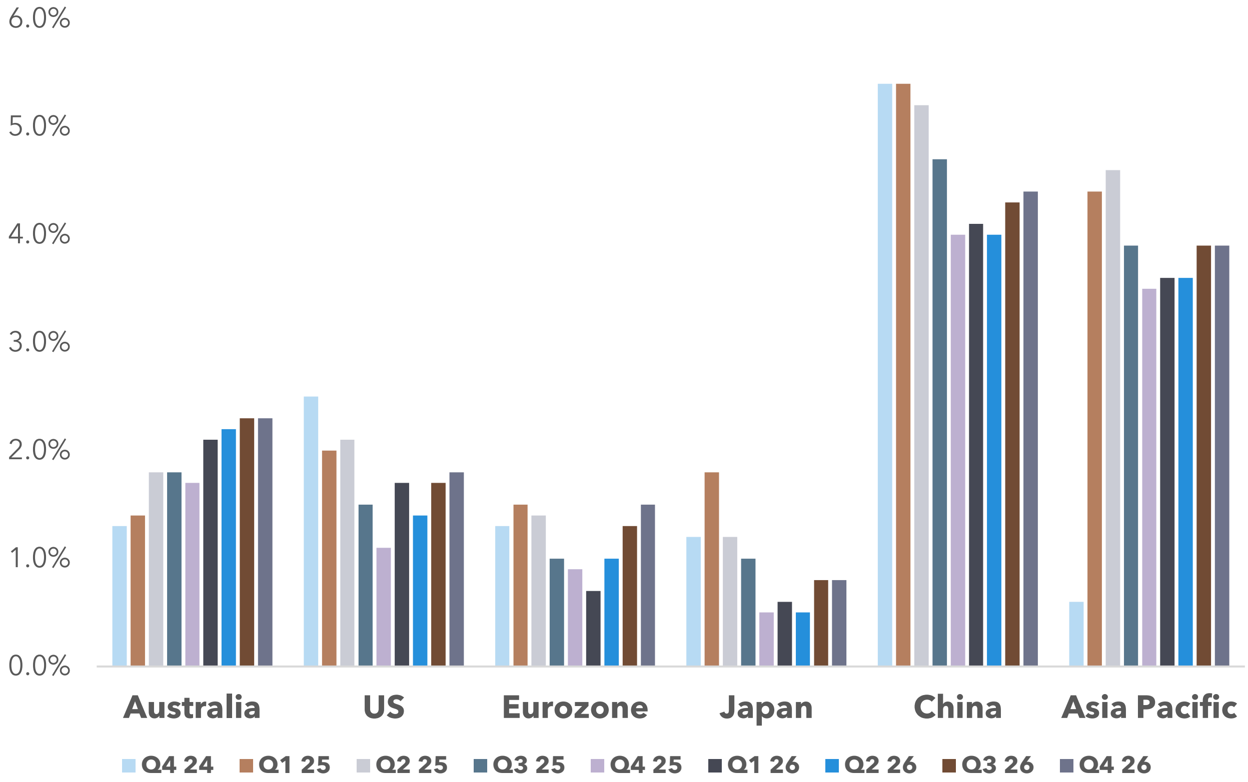
Global economic scenarios

	Scenario 1: Tail Risk/Recession	Scenario 2: Slower Economic Growth	Scenario 3: Growth Stabilisation
Probability	**10% (Unchanged)**	**60% (Unchanged)**	**30% (Unchanged)**
Detail	• Most major economies' growth slows meaningfully, leading to recession. • Inflation rises temporarily as large tariffs are broadly implemented. Inflation could, however, remain unexpectedly sticky, limiting the magnitude of rate cuts. • Central banks view inflation as transitory and continue to cut interest rates, but less than the market expects. • Global bond yields fall. • Potential for an unexpected escalation in geopolitical risk (China, Iran, Russia, Taiwan). • Companies' earnings per share (EPS) contract.	• Growth slows with a small possibility of a mild/technical recession. • Inflation rises temporarily as tariffs are broadly implemented with a moderate number subject to downward renegotiation. Base tariffs of at least 10% remain in effect. Inflation remains stubborn. • Global central banks, including the RBA, implement several (1-3) rate cuts to stimulate growth. • Global bond yields balance lower growth with risks of rising inflation. Higher fiscal spending leads to larger budget deficits and rising debt leading to a steeper yield curve. • Unemployment rises and consumer spending comes under pressure. • Tariff affected sectors experience earnings downgrades. Other sectors earnings stabilise with room to surprise to the upside. Smaller US focused companies may struggle under weaker economic conditions. • Structural themes like AI support the economy and equity markets.	• Growth rates stabilise and economies avoid recession. • Inflation picks up marginally as effective tariffs are negotiated meaningfully lower, with the possibility of the tariffs being blocked by the US Supreme Court. • Central banks implement minor interest rate cuts. • Global bond yields remain rangebound, while longer dated bond yields are pushed higher by larger deficit spending. • Pro-growth policies are implemented, such as fiscal spending and tax cuts, to support economic growth. • Earnings are revised higher as sentiment improves. • Structural themes like AI drive productivity gains, leading to both economic growth and higher equity returns from improved corporate earnings.

Broad expectations for slowing global economic growth

Quarterly real GDP growth forecasts (year on year)



Source: Quilla Consulting, Bloomberg Financial LP

Global real GDP growth is forecast to slow in the coming quarters amid economic and trade uncertainties. A modest reacceleration is expected in 2026 as the effects of monetary policy easing and fiscal stimulus measures take effect.

The Australian economy appears more resilient, evidenced by a better-than-expected 1.8% year-on-year GDP growth in Q2 2025.

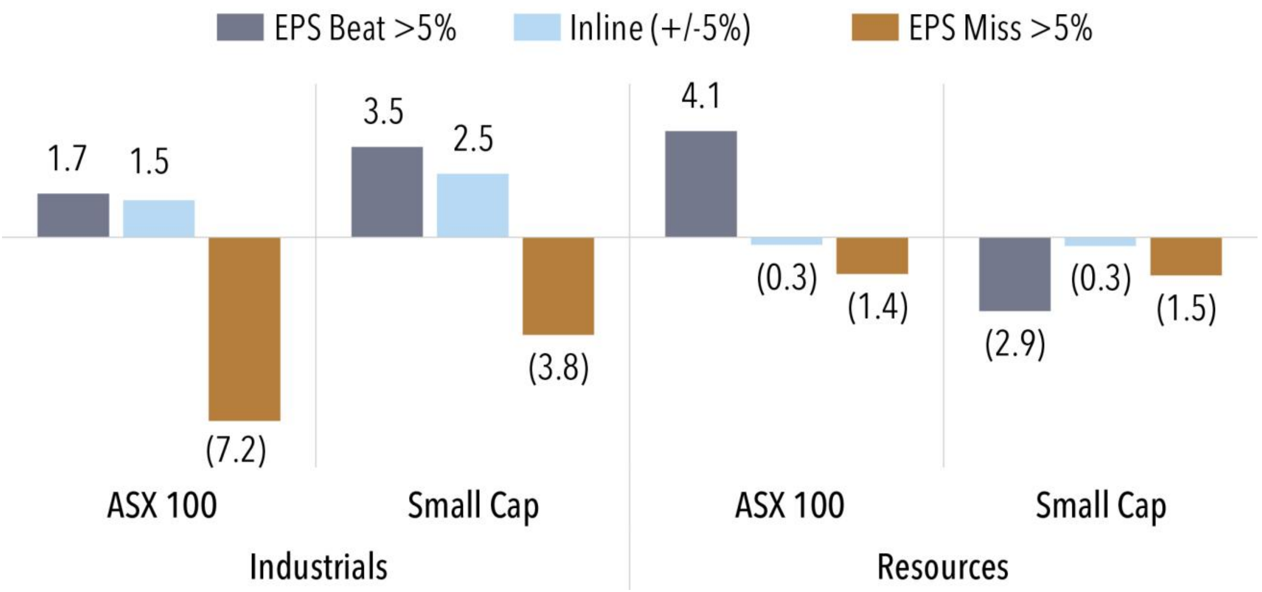
While a brief slowdown is forecast for Q4 2025, growth is expected to trend higher in 2026, supported by a continued rise in government spending and stronger household consumption driven by interest rate cuts and rising consumer confidence.

The current projections for global GDP growth support our base case for a period of slower, below-trend economic growth over the next 12 months.

Earnings misses punished in a solid Australian reporting season

Volatile market reactions to large-cap earnings misses

2-day relative % return by market cap group



Source: Factset, Visible Alpha, Macquarie Research

The Australian reporting season saw Materials and Consumer Discretionary companies post resilient results. Firms with US exposure gave downbeat forecasts, while tech-related companies generally produced solid earnings growth. FY26 guidance was generally conservative, while dividends and share buybacks positively surprised.

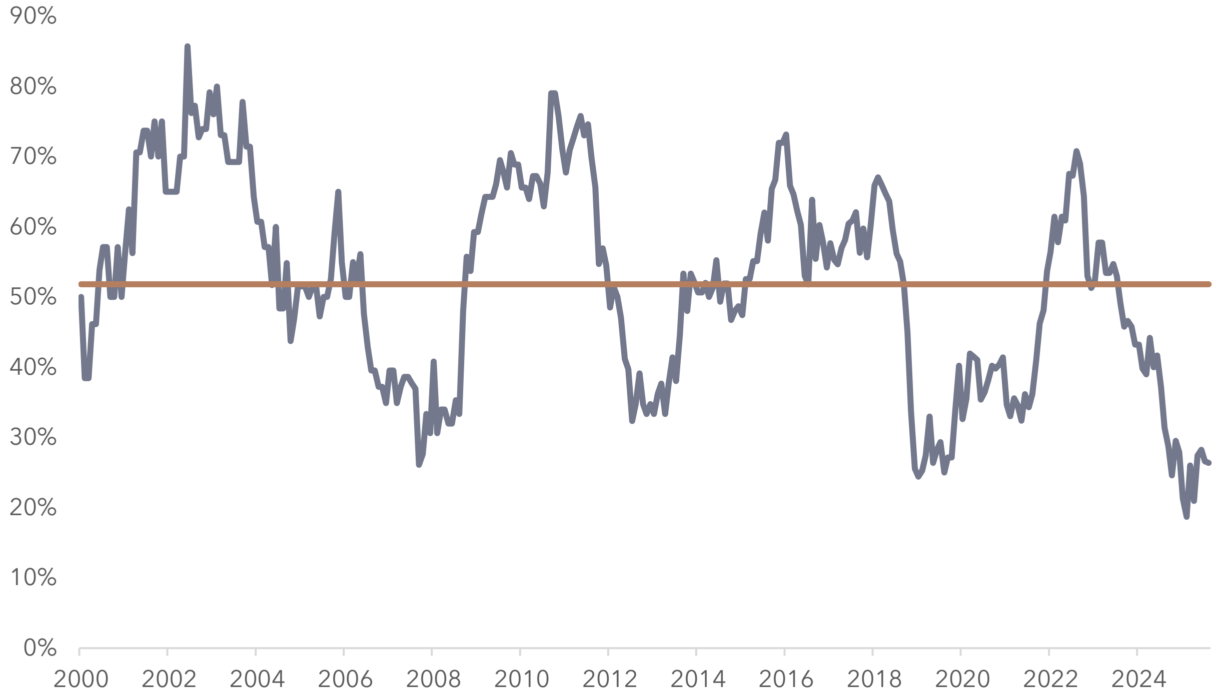
CSL: The biotech giant suffered its largest single-day sell-off in decades after its results, guidance, and a major restructuring plan all disappointed the market.

Consumer Staples: Woolworth's results led to its heaviest one-day sell-off since 1994. The company is facing a challenging year and appears to be losing market share. Conversely, Coles rallied, beating earnings expectations due to a sharp rise in e-commerce sales and a strong operational performance in its supermarkets division.

Financials: Commonwealth Bank reported steady profit growth and a record dividend. Major banks' results highlighted the health of Australia's financial sector despite rising arrears.

Active Australian equity managers' underperformance at the extremes

Percentage of managers outperforming the ASX200 (3-Year rolling)



Source: Quilla Consulting, FE Analytics

A significant share of active Australian equity managers have underperformed the ASX 200 over multiple time frames.

This trend has become particularly notable over the last three years, with less than 30% of active managers outperforming the ASX200. benchmark.

This degree of underperformance is also at an extreme, with the average active manager underperforming by 2.4% annually.

A major cause is the high concentration of the ASX 200, where a few large-cap stocks, such as Commonwealth Bank and Wesfarmers, have driven a significant portion of the index's returns, despite valuations appearing to be stretched. This structurally disadvantages more diversified active portfolios.

We view this underperformance as cyclical and expect active manager outperformance to mean-revert. A broadening of market leadership will improve the environment for stock pickers, allowing skilled active managers to narrow the performance gap.

Reasonable global equity valuations & strong earnings growth expectations

Regional annual earnings growth expectations and relative valuations

	2025	2026	2027	Valuation Premium / Discount	PEG Ratio
MSCI World Index	8.76%	10.88%	10.69%	5.4%	1.79
ASX 200 (Australia)	0.20%	6.22%	8.99%	13.7%	3.13
S&P500 (US)	8.48%	11.89%	11.16%	3.4%	1.81
S&P500 Equal Weight (US)	4.68%	11.37%	10.44%	-11.5%	1.46
STOXX 600 (Europe)	-1.98%	11.19%	9.42%	-9.7%	1.25
FTSE 100 (UK)	-3.77%	8.96%	9.46%	-9.2%	1.42
Nikkei 225 (Japan)	7.50%	5.29%	12.58%	-0.9%	3.80
MSCI India	5.05%	17.32%	11.89%	-8.5%	1.18
MSCI Emerging Markets ex China	17.50%	14.12%	11.91%	-3.4%	0.92
MSCI China	2.09%	14.15%	12.46%	-7.3%	0.83
MSCI Asia Pacific ex Japan	7.76%	12.94%	11.88%	-2.6%	1.10

Source: Quilla Consulting, Bloomberg Financial LP

Note:

- Valuation Premium/Discount refers to the percentage above or below that the 2026 price-to-earnings ratio trades at compared to the 10-year historical average.
- PEG Ratio: (Price/Earnings-to-Growth ratio) is a valuation metric that divides a company's price-to-earnings (P/E) ratio by its earnings growth rate, providing a more comprehensive view than the P/E ratio alone by factoring in future growth. A figure below 1 is deemed good value. Values starting with a 1 are close to fair value.

While global uncertainties have created a mixed earnings outlook for 2025, forward earnings growth is expected to improve materially in 2026 and 2027. This recovery is supported by fiscal stimulus, easing monetary policy, and resilient corporate and consumer fundamentals.

Based on 2026 earnings forecasts, global equity valuations do not appear stretched compared to their 10-year averages.

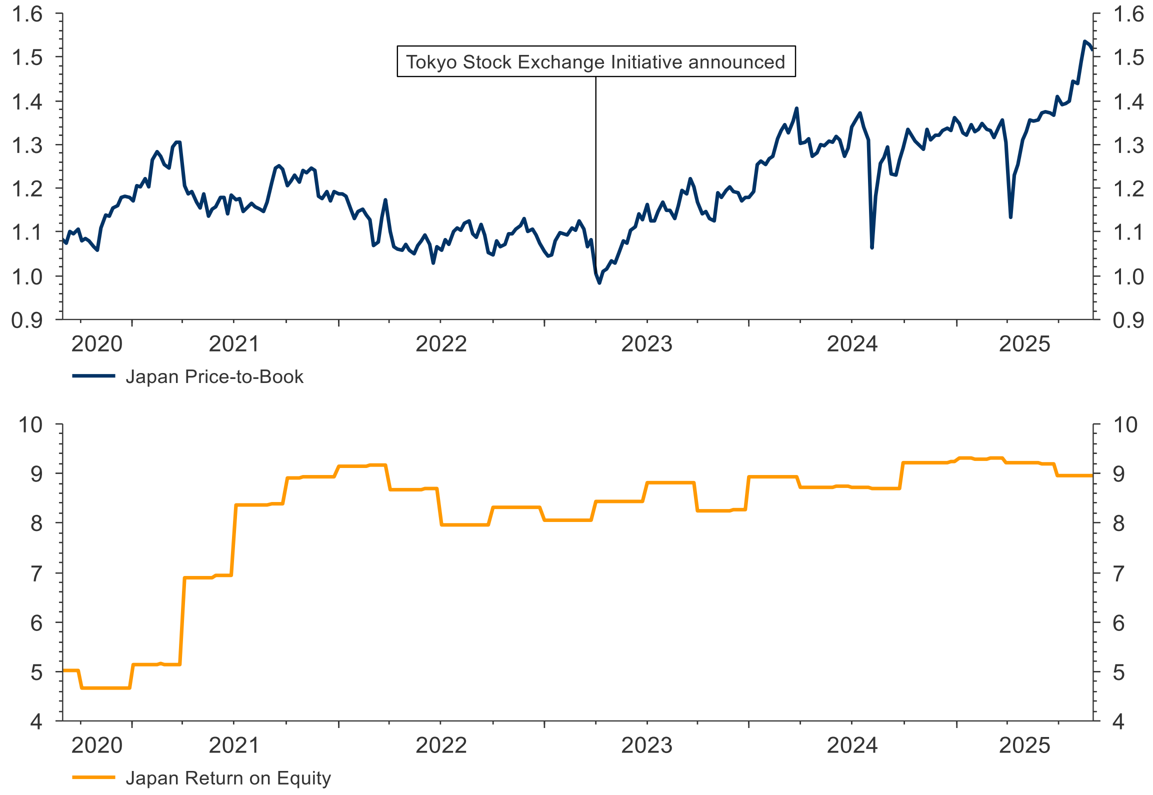
The S&P 500 is only 3.4% above its average. Stripping out the effect of mega-cap valuations, the S&P 500 Equal Weight Index trades at a meaningful discount. The ASX 200 shows the largest valuation premium at 13.7%.

Incorporating 2026 growth, using the Price/Earnings to Growth (PEG) ratio valuation measure, emerging markets seem most attractive with the lowest PEG ratios, while Japan and Australia appear the least attractive.

Overall, the strong earnings outlook combined with reasonable valuations provides a supportive backdrop for equity markets. The key risk remains a failure to meet these future earnings estimates.

Japanese companies improving capital allocation decisions

The TSE Initiative has had a meaningful impact on Japanese corporate fundamentals



Source: LSEG Datastream, Quilla Consulting

The TSE Corporate Governance and Capital Efficiency Initiative was launched in March 2023 to address persistent undervaluation and weak governance among Japanese listed companies.

The TSE's reforms include encouraging companies to reduce cross-shareholdings, deploy excess cash into dividends and share buybacks, as well as tracking firms trading below book value on a public 'name and shame' list.

The initiative has shown positive progress, with total dividends and buybacks increasing to ¥25trill in 2024 (up 7% year-on-year) and are expected to increase to ¥29trill in 2025 (up 16% year-on-year).

The Price-to-Book ratio of the Nikkei has increased from 1.0x in 2023 to 1.5x in 2025, driven by a rerating in large cap companies. 39% of companies still trade below book value (which are mostly smaller companies comprising 24% of the index).

We are currently investigating this opportunity further.

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Quilla asset class views: summary

Key themes	Rationale
Modest exposure to government bonds	Real yields are currently attractive with the potential to provide protection and returns in a recessionary environment. A reasonable move lower in yields, to the lower end of the current trading range, would be an opportunity to reduce duration exposure. Preference for Australian over US government bonds. Underweight duration relative to the benchmark given the risks on the longer end of the curve.
Preference for investment grade credit over high yield and government bonds	Yield pickup in credit compared to government bonds and lower credit risk compared to high yield. Overweight Australian credit versus US credit where spreads are historically tight levels.
Prefer global equities compared to Australian equities	We remain overweight global equities, which provide more favourable return opportunities compared to Australia, where weak earnings growth is likely to restrain market returns. Within global equities, we are underweight US equities following a period of strong returns and an uncertain US economic outlook. Australian equities are, however, still preferred for equity income strategies.
Maintain global small cap exposure	Global small caps have recovered strongly but still lag their large-cap counterparts. While relative valuations remain attractive, the earnings outlook is uncertain under more challenging economic conditions. We maintain some selective exposure but have actively reduced positions into strength.
Positive view on private assets	A positive outlook due to the potential for higher long-term returns while reducing portfolio volatility and increasing diversification. Improving IPO and exit activity suggests a more favourable environment for private equity realisations.
Constructive view on gold	Gold provides an insurance policy against potential geopolitical tail risks. Gold will likely be supported by global central bank purchases and investor flows, which have experienced positive momentum in recent months.
Positive on Indian equities	Several structural economic tailwinds exist within the Indian market, supporting the medium and long-term outlook for Indian equities. The lower correlations to other global equity markets also make Indian equities attractive given the uncertain investment climate for developed market equities.

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