



# Investment Insights

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Smarter Investment Solutions | [Quilla.com.au](https://Quilla.com.au)

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## Key messages

- **Navigating geopolitical and inflation risks.** The Iran conflict is expected to continue de-escalating, providing a more favourable outlook for risk assets.
- **The US stock/bond correlation has been rising.** This dynamic points to resilient growth but higher inflation expectations.
- **Anchored inflation expectations but rising stagflation risks.** Australian economic activity and price signals paint a stagflationary economic picture, but long-term inflation expectations remain anchored.
- **US earnings expectations accelerate.** Earnings revisions during the current reporting season have been materially positive, driven higher by the tech and energy sectors.
- **Commodity demand lifts Australian small caps.** Secular trends driving the global energy transition, coupled with accelerating demand for critical minerals, position Australian small caps for sustained growth.



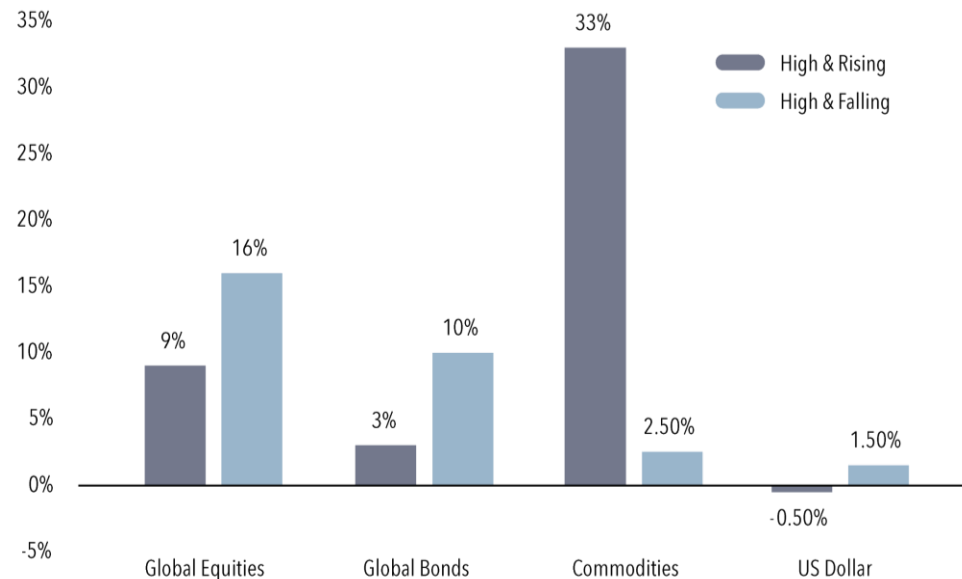
# Global economic scenarios

	Scenario 1: Tail Risks	Scenario 2: Below Trend Growth	Scenario 3: Growth Stabilisation/Acceleration
Probability	<b>15% (Unchanged)</b>	<b>50% (Unchanged)</b>	<b>35% (Unchanged)</b>
Detail	<ul style="list-style-type: none"> <li>• Most major economies' growth slows meaningfully, leading to recession and corporate earnings contraction.</li> <li>• The US-Israel war with Iran continues for longer than current expectations, driving energy prices higher, leading to broader inflationary pressures and a consumer slowdown, creating a stagflationary environment.</li> <li>• A broadening of the conflict in the Middle East destabilises relations across major economic powers. Eg: US and China.</li> </ul> <p>Other key risk factors:</p> <ul style="list-style-type: none"> <li>○ Material slowdown in AI capex.</li> <li>○ Expected AI earnings significantly disappoint.</li> <li>○ Inflation unexpectedly resurges.</li> <li>○ Substantial rise in bond yields leading to material revaluation of risk assets.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Global growth is uneven</b>; the US remains resilient while others stagnate. Economies that are net importers of petroleum products may face growth headwinds and inflationary pressures.</li> <li>• <b>Inflation remains stubborn</b> as oil supply disruption across the Middle East places upward pressure on short-term inflation expectations. This will likely subside as oil supply disruptions fade. Longer-term inflation expectations however remain anchored.</li> <li>• <b>The global policy landscape shifts more cautious.</b> The Federal Reserve holds rates steady for the remainder of this year, the Reserve Bank of Australia (RBA) remains hawkish, with potential further hikes as required towards the end of the year to combat stubborn domestic price pressures.</li> <li>• <b>Global bond yields balance lower growth with risks of rising inflation concerns.</b> Higher fiscal spending leads to larger budget deficits and rising debt, leading to a steeper yield curve.</li> <li>• <b>Labour markets remain steady</b>, sustaining modest consumer spending growth.</li> <li>• <b>Structural themes</b> like AI, as well as pro-growth government policies, support the economy, equity markets and corporate earnings. Continued energy price pressures may lead to downward earnings revisions.</li> </ul>	<ul style="list-style-type: none"> <li>• Global growth becomes more synchronised and improves as productivity gains support the global economy.</li> <li>• Inflation picks up marginally as aggregate demand lifts while productivity gains cap price rises.</li> <li>• Central banks hold rates steady. The RBA maintains a hawkish stance.</li> <li>• Global bond yields remain rangebound, while longer dated bond yields are pushed higher by larger deficit spending.</li> <li>• Pro-growth policies are implemented, such as fiscal spending and tax cuts, to support economic growth.</li> <li>• Earnings are materially revised higher as sentiment improves.</li> <li>• Structural themes like AI drive productivity, lifting economic growth and equity returns.</li> </ul>



# Navigating geopolitical and inflation risks

**Average asset class performance when inflation is rising or falling**



Source: BCA; Quilla Consulting

The Middle East conflict presents a dual challenge for global markets: geopolitical instability and the persistent threat of supply-driven inflation.

While peak US-Iran escalation appears to have passed in favour of diplomatic negotiation, the trajectory of inflation remains a key factor for asset class performance over the near to medium term.

Historical data suggest that the most favourable returns for equities and bonds occur during "high but declining" inflation regimes, a dynamic that makes the pace and durability of any ceasefire the critical variable to monitor.

Our portfolio strategy is guided by three distinct market scenarios:

**S1 - Near-term resolution (high probability):** A durable ceasefire and normalisation of energy markets eases inflation pressures, supporting outperformance across both equities and bonds, as the war premium unwinds in commodity markets.

**S2 - Extended disruption (medium probability):** Inflation remains elevated as energy costs bleed into core measures, though developed market GDP growth holds up as supply chains adapt. Financial markets remain relatively stable.

**S3 - Full escalation and stagflation (low probability):** A sharp escalation, characterised by critical infrastructure destruction and oil testing \$150-\$200 per barrel triggers demand destruction and a global recession. Risk assets de-rate alongside materially downgraded GDP forecasts and rising inflation, resulting in stagflation.

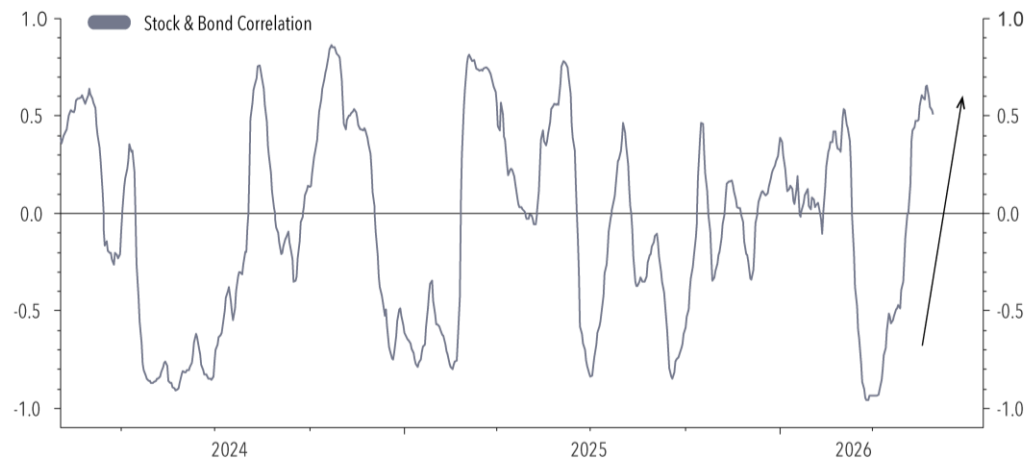
## Our view

The Iran conflict is expected to continue de-escalating. While we are maintaining our growth allocations, we continue to monitor the situation closely and stand ready to adjust portfolio positioning if the risk of adverse outcomes rises.



# Stock/bond correlation points to resilient growth and higher inflation

## The US stock/bond correlation is positive



Note: Rolling 30-day correlation of the S&P500 Index and US 10-year yield.

Source: LSEG, Datastream, Quilla Consulting

Amid recent Iran-driven volatility, the US stock-bond correlation has climbed. Equities remain resilient even as bonds soften and yields trend higher. This dynamic reflects:

- **Growth:** Financial markets are not pricing in a material deterioration in economic growth.
- **Inflation:** Bond markets are focused on energy prices, rising inflation, and central banks' capacity to contain a supply-side shock.
- **Rate expectations:** US markets have shifted from pricing 2-3 cuts to none; the BOE and ECB have pivoted from cuts to hikes.
- **Portfolio implications:** A higher stock-bond correlation weakens bonds as an equity hedge and reduces diversification in multi-asset portfolios.

This is consistent with the long-term pattern where stock-bond correlations remain positive in higher inflation regimes and turn negative in low inflation environments.

The correlation dynamic could reverse if energy supply disruptions extend well into the second half of 2026, weighing on growth expectations while bond markets concurrently price in lower yields.

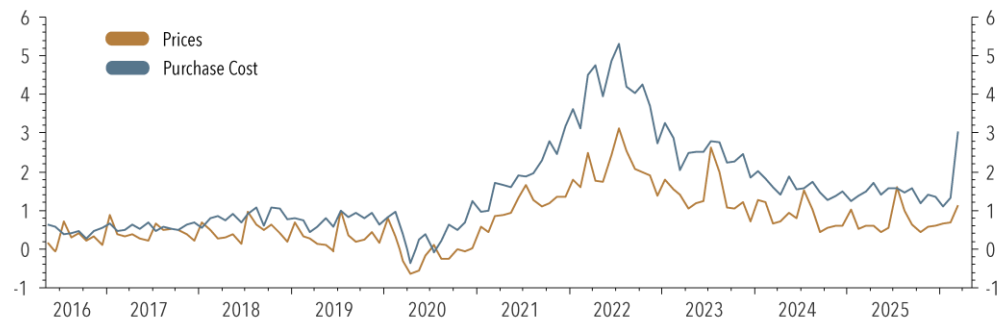
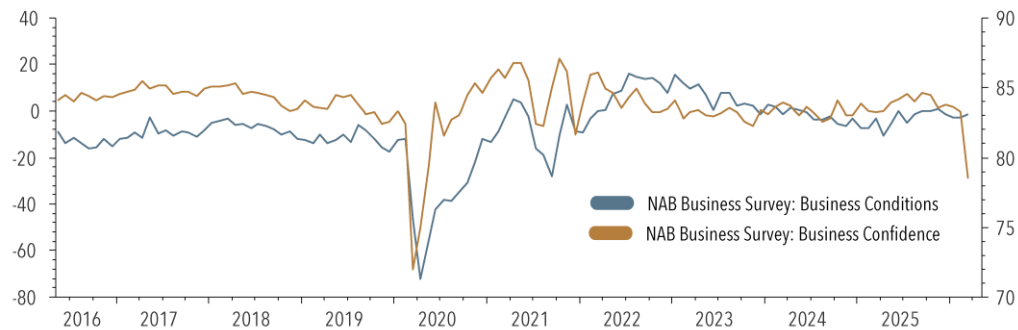
### Our view

Current market dynamics reinforce our view that the global economy remains resilient, underpinned by the AI theme, fiscal spending, and low unemployment. This supports our preference for credit over government bonds within fixed income. This may begin to shift as inflation decelerates or growth concerns emerge.



# Anchored inflation expectations but rising stagflation risks

**NAB Business Survey: activity and price signals paint a concerning economic picture**



Source: LSEG, Datastream, Quilla Consulting

Australia's pre-existing inflationary pressures are being intensified by rising energy and fertiliser costs. The latest NAB Business Survey captures the initial impact of energy market disruptions, with signals consistent with rising stagflationary risks:

- **Business confidence:** Collapsed to -29, the lowest reading since April 2020.
- **Business operating Conditions:** Held steady at +6, near the long-run average – suggesting underlying resilience.
- **Capacity utilisation:** Remains above historical averages, indicating the economy entered this period of volatility from a position of underlying strength.
- **Price dynamics:** Input costs are accelerating as are output prices, a dynamic visible in the bottom chart.

## Interest rates

Following three consecutive rate increases, markets are pricing a further 50bps of tightening by the RBA, a trajectory that would take the policy rate beyond the peak of the prior cycle.

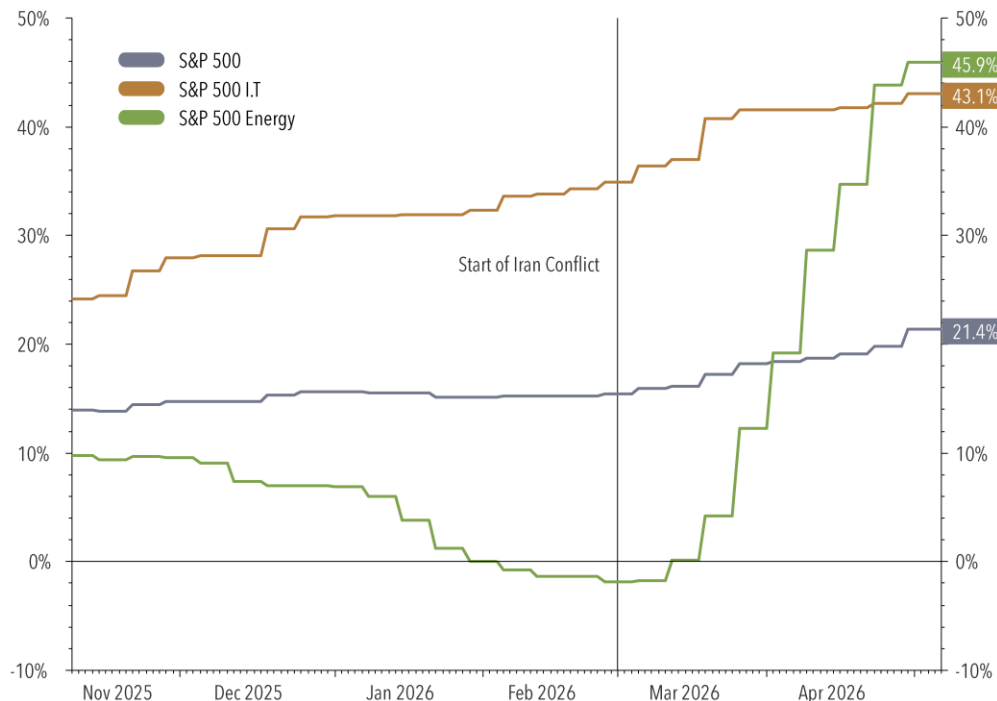
## Our view

Short-term inflation has spiked, but long-term indicators, including the 10-year breakeven rate, remain anchored near 2.5%. Further aggressive tightening beyond current expectations is only warranted if long-term expectations rise materially. Australian government bonds are becoming more interesting as rate hike expectations possibly peak, though domestic inflation remains a primary uncertainty.



# US earnings expectations accelerate

**2026 earnings growth expectations rise through earnings season**



Source: LSEG, Datastream, Quilla Consulting

US equity markets have reached all-time highs despite ongoing geopolitical uncertainty and oil market disruptions, supported by constructive fundamentals and strong earnings momentum.

Earnings (EPS) revisions during the current reporting season have been materially positive, the strongest since the Covid era, with EPS upgrades well above the average revision path.

Some of the key drivers of EPS upgrades include:

- **Technology sector:** Largely driven by semiconductor businesses such as Nvidia, Micron and Broadcom.
- **Hyperscaler capex:** Larger-than-expected capital expenditure announcements expected to flow through to AI-adjacent sectors.
- **Energy sector:** A positive earnings outlook for energy companies such as Exxon Mobil and Chevron, supported by current energy market dynamics.

S&P 500 EPS growth for 2026 is now forecast at ~21%, up from ~14% at the start of the year. The forward P/E of 21x is broadly in line with the 10-year average of 19x.

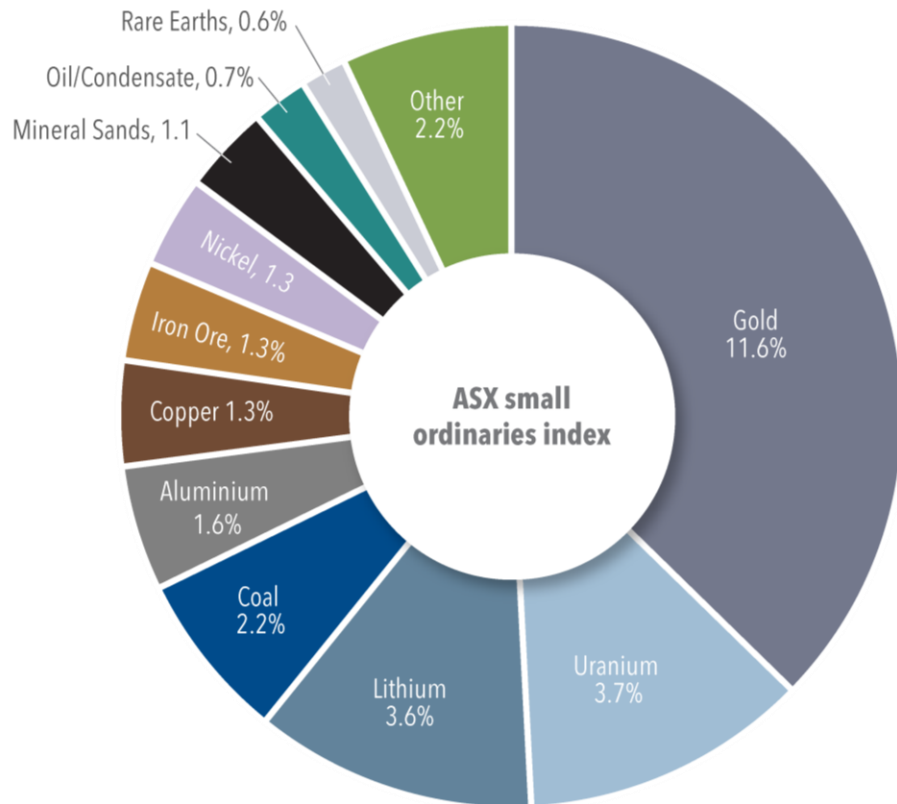
## Our view

US corporates remain in good health. The AI theme continues to drive revenue and profits, largely independent of energy market disruptions. We remain positive on US equity market exposures and the underlying secular themes supporting them.



# Commodity demand lifts Australian Small Caps

Australian small caps commodity breakdown (% of Index)



Source: Quilla Consulting

## Commodities have driven the small-cap market

- A sharp jump in commodity prices has benefited Australian small caps, with a more favourable commodity mix and price environment than larger companies.
- Small companies in the resources sector are expected to deliver 91% EPS growth in FY26 due to improved commodity prices.
- Resources and energy are responsible for 97% of the Small Ordinaries Index returns over the last year, with negligible returns coming from all other sectors.

## Our view for Australian small-cap resources remains favourable

- **Gold:** Continued appeal as a durable inflation and geopolitical hedge.
- **Energy transition:** Surging demand for lithium, nickel, and uranium driven by global electrification, EVs, and nuclear energy demand.
- **Traditional energy:** Australian coal and gas benefiting from substitution effects and a tighter global energy market.
- **Critical minerals:** Minerals, including rare earths, have become a geopolitical flashpoint. Australia stands to benefit as a trusted supplier to allied nations through preferential pricing.

## Ex-resources outlook is constructive

Despite a slowing macroeconomic environment, valuations are compelling, with the broader Small Ordinaries trading at historically discounted valuations.



Key themes	Rationale
<b>Modest exposure to government bonds</b>	Retaining diversified exposure to government bonds but remaining underweight duration relative to index proxies given the risks on the longer end of the curve. While we maintain a bias towards Australian credit over government bonds, we are becoming more constructive on Australian government bonds given the shift in the yield curve driven by inflation fears following the spike in energy prices.
<b>Preference for investment grade credit over high yield</b>	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 at historically tight levels. Monitoring global high yield bond spreads closely for potential opportunities.
<b>Prefer global equities compared to Australian equities</b>	A modest overweight to global equities where EPS growth has broadened out across regions. Australian EPS growth has improved but sustainability is uncertain given the cyclical nature of earnings in some sectors in the domestic equity market.
<b>Maintain global small and mid cap exposure</b>	Prior to the escalation of the US/Iran conflict, the macroeconomic backdrop was constructive and supportive for global small mid caps. Should the conflict be short lived, broader monetary and fiscal policy stimulus may continue to support the sector's performance.
<b>Positive view on private equity / venture capital</b>	A positive outlook due to the potential for higher long-term returns while reducing portfolio volatility and increasing diversification. Private equity/venture capital can provide exposure to the 'picks & shovel' of the AI Infrastructure build out and is less impacted by market sentiment.
<b>Constructive view on gold</b>	Gold remains a valuable hedge against geopolitical tail risks and concerns about government fiscal sustainability. Over the medium-long term we anticipate its price will be supported by continued central bank purchasing and strategic investor flows.
<b>Positive outlook for emerging markets</b>	We view the outlook for broader emerging markets more favourably, citing a constructive mix of cheaper valuations, strong economic growth, and supportive fiscal and monetary policy. A structurally weaker US dollar reinforces the case. We view this as complementary to Indian equities.





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