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7 July 2026

Investment Strategy Note

Global Outlook – Improving Sentiment with Robust & Persistent AI Investment

Global growth momentum is on track to be 3.0% (YoY) for 2026 with upside revisions given the very resilient US economy year-to-date. The recent run of better-than-expected data (particularly from the US) implies the downgrades in economic outlook following the beginning of the US-Iran conflict will continue to be reversed in the second half of 2026. We anticipate global GDP upgrades towards 3.3% for 2026 given the current run of positive US economic data, which is higher compared to many current estimates. Of note, the forecast range by many economists has been wide due to geo-political uncertainty. This range has been between 2.4% through to 3.5% (IMF, OECD and various private sector bank research).

As with the persistent and robust upgrades to US earnings, ongoing improvements in US partial economic data continue to support global growth momentum. For global equities, price targets have been consistently revised higher, despite the lag in investor sentiment, driven mainly by strong US earnings upgrades that reflect resilient US economic conditions and the sustained, persistent and powerful growth of AI.

Our outlook for global equity markets remains constructive for second half of the year and we prefer the cyclical trades that are linked to the global economic cycle. Further, the recent fall of energy prices will reduce pressure on headline inflation but will also support the growth outlook by partly unwinding the squeeze on household real incomes. This dynamic should leave only modest and selective cash rate rises across developed market (DM) central banks. The end of the Middle East conflict, despite ongoing uncertainty around the details, is also a positive for sentiment.

Monetary Policy and Central Banks:

The outlook for central bank monetary policy (MP) globally is marginally more synchronised than just a few months ago. That is, more alignment in either tightening bias or remaining on hold. We anticipate further selective rate hikes before year-end for the ECB, BoJ and BoE, stubborn core inflation measures, and in the case of the ECB, they are behind the curve and have very low cash rates combined with stubborn core inflation, compared to other key developed economies.

For the US, the Fed is now expected to remain on hold with the possibility of raising rates within the next six to nine months. This is a notable change to the expectation of a lower US Fed Funds rate just a few months ago.

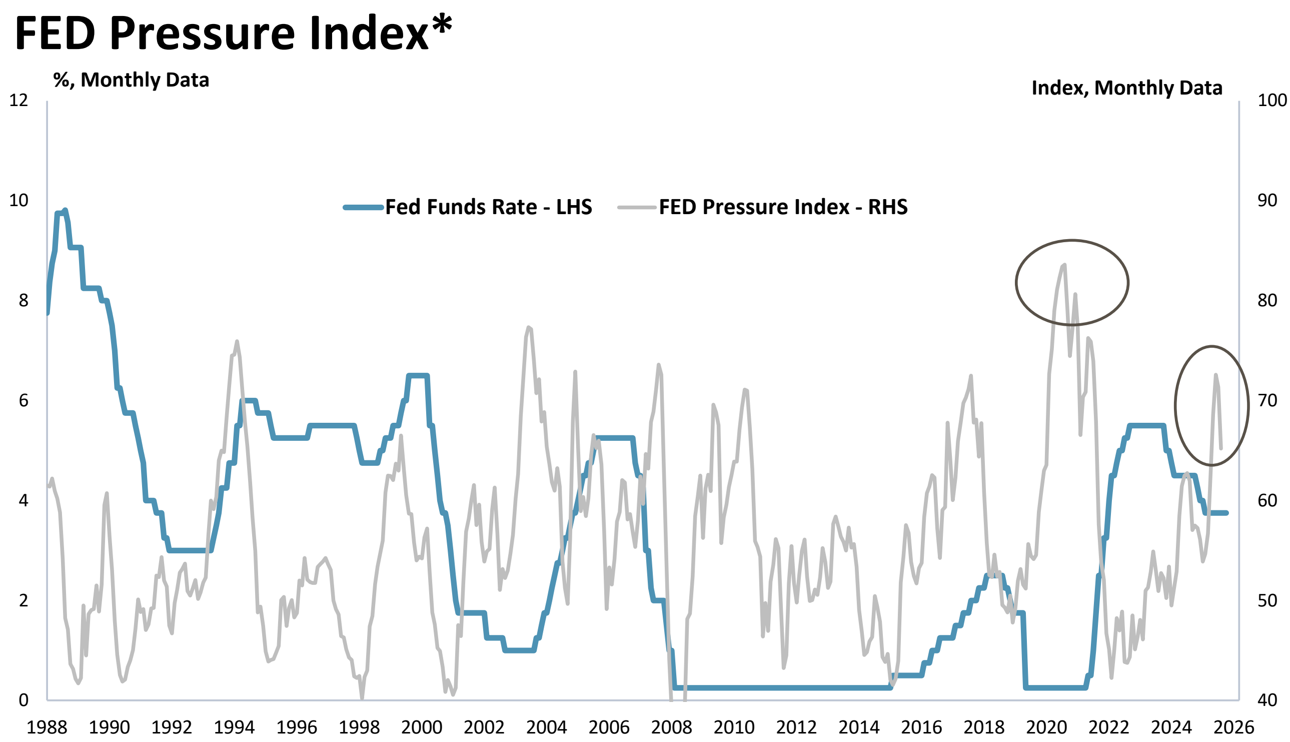
Chart 1 shows the Fed Pressure Index (ISM Prices Paid & Deliveries data) compared to the Fed Funds Rate over time. This suggests with the current data pulse that the current Fed Funds Rate is appropriate and mildly restrictive. Historically, particularly over the past twenty years, many have estimated a 0.75% Real Fed Funds Rate target which broadly implies a 2.5%-2.75% neutral target. Given the higher price pressures (both headline and core) in both developed and emerging economies since the pandemic induced inflation shock, an upgrade towards 1.0% Real Fed Funds

Target would be more appropriate. Looking at the current inflation pulse, which remains at the higher end and in many cases above target, this implies the current neutral Fed Funds Rate is more towards the 3.0%-3.25% range. This suggests a higher neutral rate for the cycle ahead compared to the past few cycles. Both households and companies will need to be able to adjust to this higher discount rate going forward.

A US Fed rate cut expected by some in the market does look a little too ambitious at this stage, given inflation expectations (US 5-year break-evens) remain in line, and some productivity gains are coming through. Further, the significantly lower energy prices over recent weeks will be a positive for inflation. On the current trajectory of core inflation and US data, remaining on hold looks appropriate given the restrictive MP settings. The core inflation (particularly core PCE) will dictate the need to remain on hold or tighten further. The key however is the current Fed Fund rates are restrictive (mildly), notably higher than the ECB, and a tightening or hawkish bias appropriate given underlying economic conditions and earnings have been expanding and resilient.

Chart 1: US Fed Pressure Index

The Fed Funds Pressure Index is a broad guide to the future direction of the Fed Funds Rate. This is a data dependent measure of the ISM Prices Paid & ISM Deliveries Index that complements the implied Fed Funds Rate (probability of future rate moves). The current FED pressure index suggests the current rate is appropriate.



Source: Bloomberg, ISM, K2 Asset Management

*Fed Funds Upper Band. Index consists of ISM Deliveries & ISM Prices Paid equal weighting

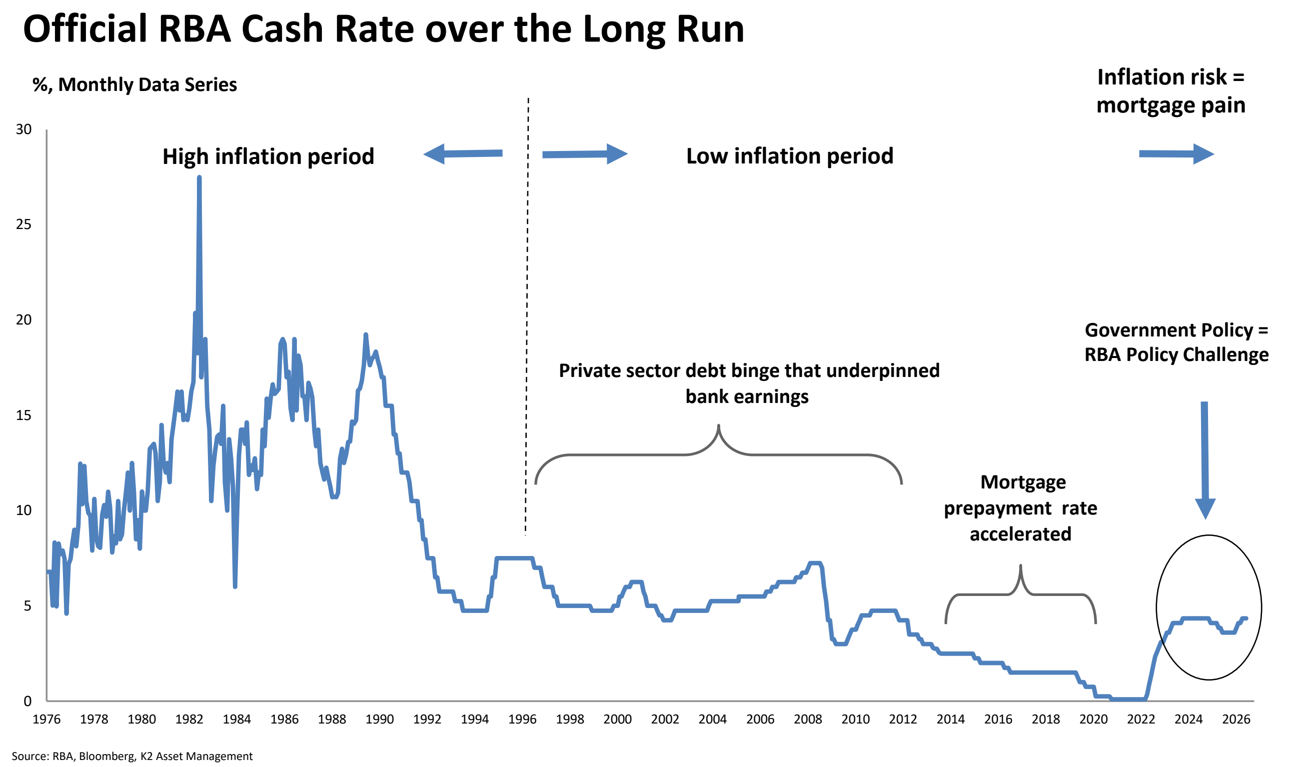
With regard to the new incoming Fed Chair, Kevin Warsh, financial markets are in good hands despite some misinformed headlines. A quality CV and a good existing working relationship with the past three Fed Chairs. Further, he has a long history with multiple parts of The Fed operations, particularly during, and after the GFC. There will be some recalibrations regarding communication and process that is welcomed. The phasing out of the "Dot" plots for example reinforces what the market already knows. It has little useful objective applications for market guidance. The recent 180-degree switch between the March and June meetings by nine members is a good example that this has little to offer investors and can now be seen as a political protest.

The RBA does have a more challenging policy dilemma. Persistently higher inflation (some of the highest in the developed economies), no productivity upside for the foreseeable future and very low consumer (generation lows) and business sentiment (cycle lows) which has been amplified by a very regressive Federal Budget that delivers even more headwinds for investors and corporate Australia.

Chart 2 illustrates the long run RBA Cash Rate over the past fifty years. It clearly shows the significant downside of high inflation for investors. The pursuit of price stability is key to be able to blend in additional policies that should improve productivity. The RBA is addressing the sticky inflation outlook and remains challenged by government policy settings.

Chart 2: RBA Cash Rate

The RBA Cash Rate over the long run is clearly impacted by inflation which is a major detriment for households and the private sector business. "Higher for longer" funding rates compared to recent history are anticipated. Government policy remains a challenge for the RBA.



Of note, the recent falls in Australian house prices are doing some of the required recalibration for the RBA and indeed the government (although they are limited in how they discuss this sensitive topic for Australian households). Compared to other key global economies Australia has pushed the boundaries of housing affordability that can be difficult to reconcile. Hence the underinvestment of our banking sector by global active investors. The lower house prices imply that MP is working, and no more rate rises are required for now.

Given the recent strong RBA response to deal with stubborn core inflation and challenging sub-optimal federal government policy (particularly the sentiment draining Budget) it would appear too early to signal lower cash rates next year. The key signal for markets on the next cash move will be the direction of property prices over the remainder of the year and our core inflation which remains uncomfortably high for any independent central bank.

Global Macro-Economic Outlook:

Global growth has held up year-to-date by a very resilient and broad-based US economy. The various key economic variables have consistently beaten expectations as the world's largest economy. This includes a recovery in the US labour market this year, improving service and manufacturing surveys (PMIs), and ongoing strong consumption, primarily via the US tax benefits to households (particularly the no tax on overtime and tips from April) and lower US corporate taxes that began to roll out from last year. The historically strong AI capex spend has been able to hold up US real GDP and has been supportive for US earnings year to date.

The recent cheaper energy prices will reduce pressure on headline inflation but will also support the growth outlook by partly unwinding the squeeze on household real incomes (both developed and emerging economies). This dynamic should leave only modest and selective hiking across developed market central banks. With regard to many emerging economies, there is a large disparity of policy challenges that partly reflect weaker currencies and their USD debt servicing obligations.

Core EU economies continue to struggle following many years of negative economic growth from the key major economy Germany, and an improving but challenged French economy. The broader EU GDP contribution has consistently come from the Mediterranean economies including Spain, Italy and Greece since 2022. Ongoing defence spending commitments, additional infrastructure and energy investment, particularly from Germany, will continue to be the key potential driver of EU upgrades. The market clearly needs to see a reliable commitment to this significant fiscal spend to better understand the magnitude of the impact on EU earning upgrades.

The economic outlook for China is one of slowing domestic economic growth with a strong export sector. The uneven recovery is set to continue. Challenging domestic demand conditions continue to impact households as the unforgiving property price correction in recent years has impacted their wealth accumulation ambitions. However, China has one of the most advanced export sectors and continues to be a low-cost producer and exporter of EVs and key energy transition infrastructure, particularly to the EU. The AI Capex spend is also towards historical highs as they aim to compete with the US. This is supportive for some emerging market (EM) equity indexes including the Hang Seng and other tech driven equity markets, including South Korea (Kospi) and Taiwan (TAIEX).

Domestic Australian Economic Outlook:

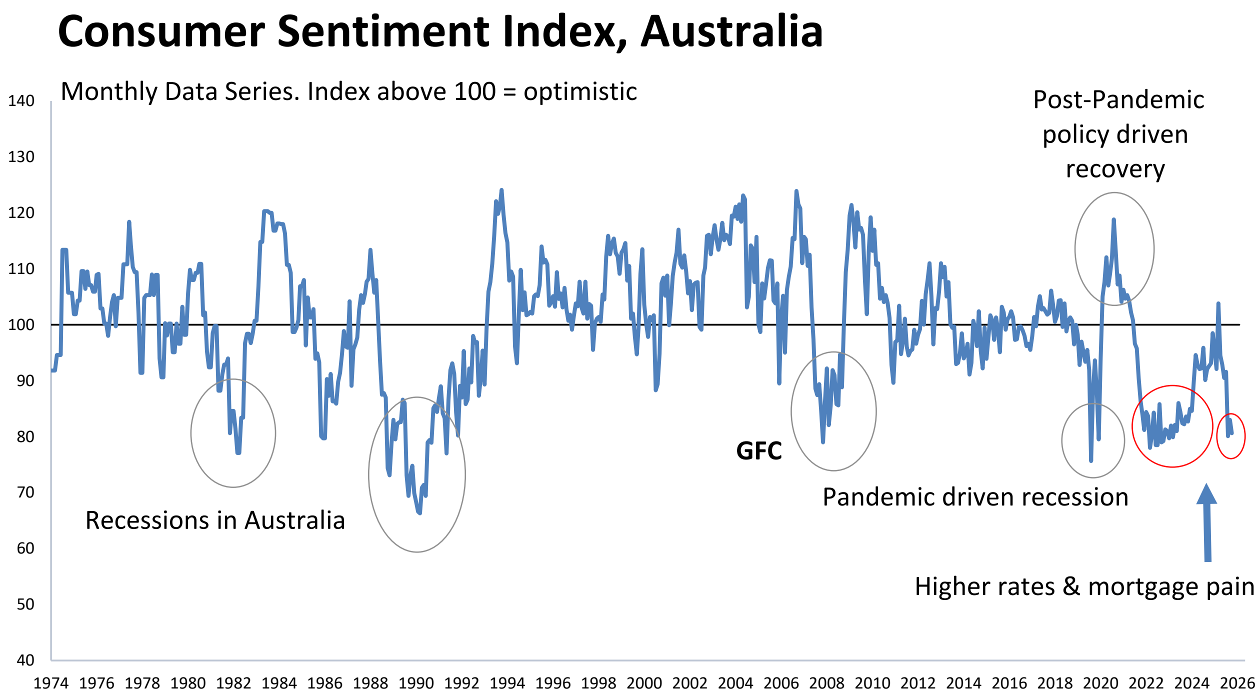
Australian economic momentum continues to slow, combined with stubborn core inflation, creating a policy dilemma for the RBA. Expectations are for GDP to continue to weaken from the mid to low 2.0% towards 1.5% in late 2026, early 2027. Unfortunately, economic activity is well below our long run average. The combination of slow domestic demand, a challenged private sector, low productivity metrics combined with stubborn and high inflation will continue to be a challenge for the RBA to navigate.

The current cash rate settings are mildly restrictive and appropriate given the balance of risks to address stubborn persistent inflation. Employment conditions remain tight, which has led to the continued growth of housing credit up to 30 June. However, a combination of the restrictive cash rate, recent Federal Budget measures impacting private sector investment and the uncertainty for investors has severely impacted sentiment.

Chart 3 illustrates the challenges for Australian households as higher mortgage rates, and a slowing and challenged private sector have led to near 50-year lows in sentiment. The fall in house prices in recent months will continue to challenge household sentiment. Globally, investors have found it difficult to reconcile the logic when it comes to our housing sector valuation, particularly when compared to our debt servicing levels relative to incomes. However, lower house prices are in effect a silver lining if they remain limited as this should lead to less need to raise rates further, reducing some of the RBA's workload.

Chart 3: Consumer Sentiment, Australia

The combination of higher cash rates leading to an increase in mortgage repayments, a challenging Federal Budget and persistent core inflation has impacted household sentiment, which is near 50-year lows. Household finances continue to be challenged.



Source: Melbourne Institute, Westpac, Bloomberg, K2 Asset Management

Equities:

We continue to remain constructive for the remainder of the year with a preference (overweight) for developed market (DM) equities compared to emerging market (EM) equities (neutral). The AI upstream theme should remain a steady pillar of growth as the strong capex cycle continues to broaden and extend. This will lead to a more broad-based recovery of earnings in other sectors including healthcare, transport, utilities, materials and energy. The strong upward revisions in US earnings are anticipated to continue but not at the same robust pace seen year-to-date.

Expanding US earnings (in aggregate) have been driven by the historically strong AI capex cycle, resilient US consumer spending and the first half 2026 upgrades to materials and energy sectors following higher prices. Further pullbacks within the energy and material sectors are an opportunity for additional accumulation. We anticipate further M&A within these sectors in 2027, particularly given the very strong demand for electricity generation that is required. Uranium, for example, is a clear winner to be able to meet some of this insatiable demand.

The consensus outlook for the US has been upgraded once again for 2026 and 2027. Indeed, one year forward S&P 500 EPS looks set toward around $400. With a reasonable 20x multiple, we can see an 8,000 target in the second half of 2027. Of course, markets are volatile by nature and markets do not rise in a linear manner. Equity markets are inherently volatile given the constant change in investor sentiment and changes to expectations. The core theme remains that any notable market drawdown is an investment opportunity for growth investors on a three year plus investment horizon.

The overweight to some key developed markets (US, EU, Japan) remains our preferred portfolio recommendation through to year-end. The higher dividend equity indexes that include Australia and the UK are a neutral weighting at best with materials, energy and financials remaining key contributing sectors.

For emerging markets (EM), there is a key divergence as the tech / semi-conductor sectors are contributing significantly to the surge in these markets. Investors need to be cognisant that these EM are primarily technology driven and very different to many other smaller EM that have little or no technology sector.

Overall, in terms of global equity outlook, we are looking for broader market participation from the current and recent historical AI capex investment (both debt and equity).

Fixed Income and Credit

It is very clear that government debt obligations have continued to worsen since the pandemic induced debt binge. Markets have so far been broadly forgiving given the magnitude of the obligations. There has been little structural reform to rein in future debt obligations across many developed economies. The spending trajectory for many in the out years continues to indicate that additional debt issuance is required at an increasing rate.

Looking at some broad guidance, the OECD Debt Report (2026) indicates a record USD 29 trillion in debt issuance is anticipated this year. This is a significant increase on recent years (increase of 17%)

and more than double the levels from just a decade ago. Of this debt issuance, circa 78% of sovereign government debt will go to refinancing.

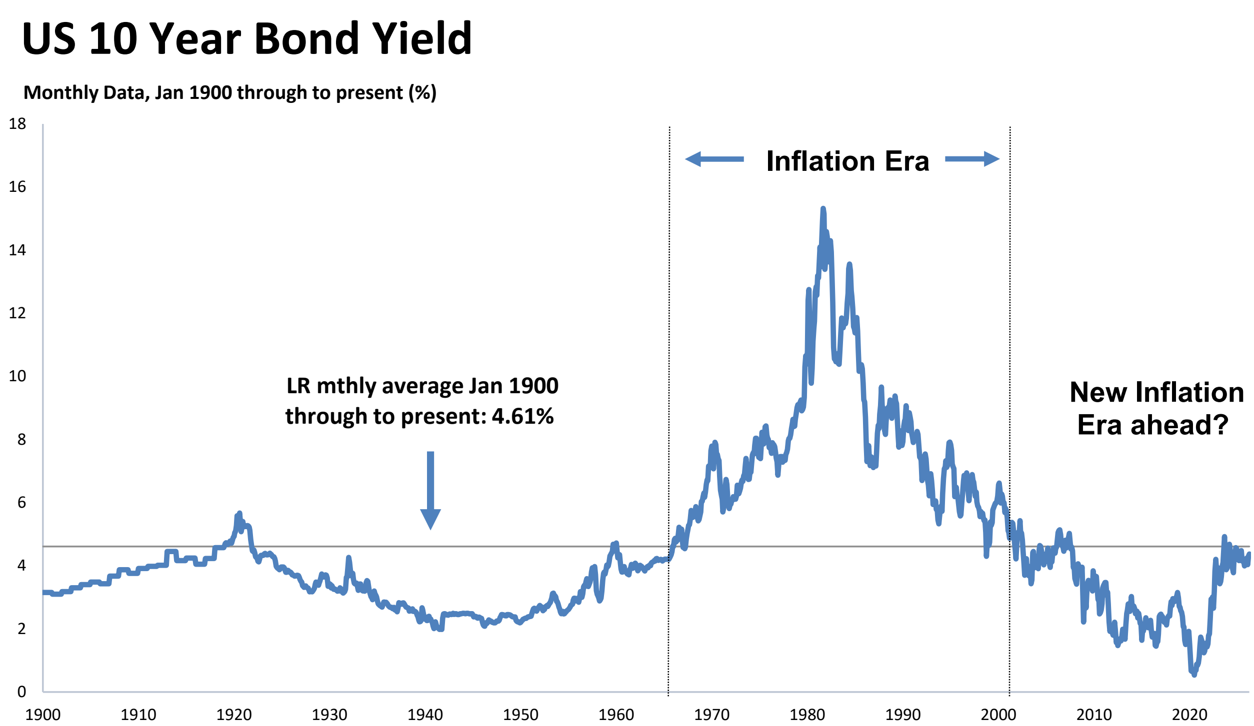
It is true that a higher inflation environment helps the issuer of debt (government borrowers) as it effectively lowers their real debt obligations and improves some debt metric indicators. However, once inflation is managed towards the key central bank target levels, bond markets will become a little more demanding. The bond vigilantes will increasingly begin to test some government borrowing programs.

Chart 4 shows the US 10-year nominal bond yield for the past 126 years. It illustrates periods of low and high inflation over this long period. Current bond yields remain at levels seen 25-years ago and the period of low inflation and ultra-low financially engineered long bond yields by central banks is behind us. A higher discount rate across the curve should be anticipated. For some investors this is simply going back to a more normalised investment framework.

Emerging economy sovereign debt is in a more precarious situation. Alignment and assistance with the OECD and the various other supra-national issuers (Asian Development Banks, Inter-American Development Banks) are pre-conditions to attract foreign investors. With regard to corporate debt issuance, this is also approaching near record levels given the surging issuance of AI led issuance to fast-track infrastructure build out. Similar to the large-scale equity issuance, there is some crowding out of other sectors that require debt to meet this demand.

Chart 4: The US Long Bond Yield Over the Long Run

The US bond market is the most liquid debt market globally and a key driver of capital markets. Over the past 126 years extreme inflation events have not been standard.



Source: Bloomberg, Yale, K2 Asset Management

* Latest Data Point July 2026

Broadly, the corporate balance sheet and credit conditions for investment grade credit (senior unsecured) remain positive, particularly in the US. The surge in corporate bond issuance (in line with the record levels of equity being raised) for the AI sector will impact the sector for years to come.

For the long-dated liability matching insurance sector, they are just “buy and holds” and remain a different marginal investor compared to the fixed income credit manager.

For the active manager, there will be better secondary market opportunities (i.e. higher spreads) and a focus on the 2-5 year part of the curve given the short swap rates are attractive enough with some limited duration and credit risk compared to longer date debt. Some securitised debt obligations (US RMBS) also offer some relative value. For high yield debt (sub investment grade) there are also opportunities for investors, particularly any distressed assets. However, our preference remains in investment grade.

Summary:

In general, global conditions have held up year-to-date compared to expectations. A very resilient US has been the key driver. Cash rates look set to remain higher for longer with some scope for selective rate rises across many developed economies. A higher discount rate across the curve is anticipated compared to the past 15-years. Geo-political tensions will come and go. These will impact the headlines, but an objective mindset is also key. What is the impact of key data, and what are the key leading indicators suggesting? The Socratic method stands the test of time. Always ask questions, look at the evidence (data) and evaluate the risks.

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