NORTHCAPE CAPITAL

Australian Equities

Market Outlook for 2026

The Australian equity market saw robust but uneven returns in 2025, driven by passive flows, AI-related exuberance, and strong performance in resources. Valuations appear elevated across most sectors, with notable extremes in technology and banking, but significant opportunities remain in quality companies at reasonable prices. Looking ahead to 2026, we believe disciplined, long-term investing in resilient businesses remains the clearest path to lasting returns.

Reflecting on 2025…

The Australian market is up 12% over the first ten months of the year, a respectable and fairly typical return by long-term standards. But the path has been anything but steady. Markets fell 15% earlier in the year on the back of US tariff headlines, only to recover to new highs just two months later. It is yet another reminder that sentiment can swing sharply, and reacting to the news of the day often proves more costly than staying the course.

The year-to-date return comprises 25% for the resources sector and 8% for the rest of the market. This has created a headwind for the relative performance of investors who focus on high quality companies, due to a lack of options at the cyclical end of the resources sector. The most significant commodity price move was of course gold up ~50%, but we have also seen substantial moves in copper, rare earths, uranium and lithium. In contrast, the iron ore price has been roughly flat and oil has fallen by close to 15%.

Commentators like to say gold's rally reflects worries about inflation, the dollar, or global tensions — but that story doesn't quite fit. Equity markets are hitting new highs, credit spreads are tight, the USD is strong, and inflation expectations remain tame. We won't pretend to know the next move in gold, but this looks less like a flight to safety and more like a rush of enthusiasm.

Exhibit 1: ASX300 Accumulation Index Performance (Source: Iress)

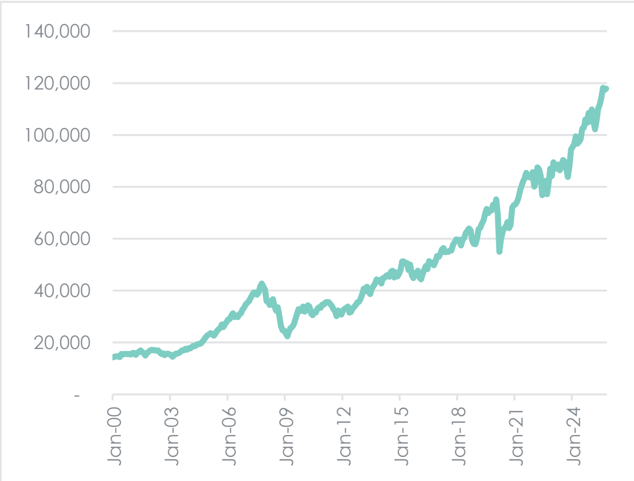
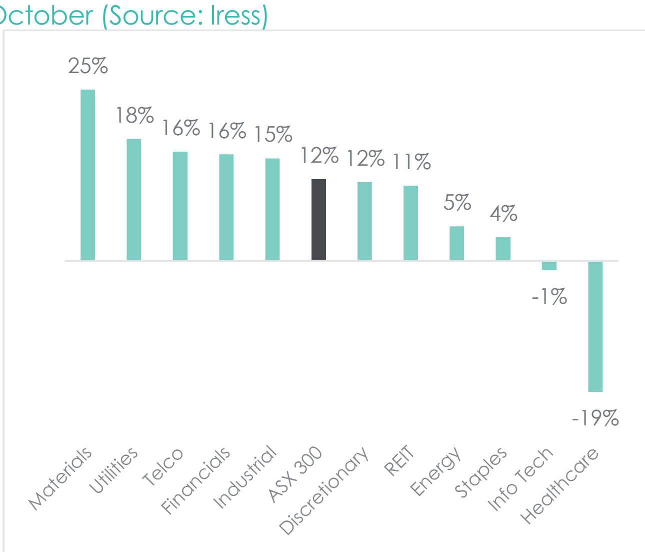


Exhibit 2: ASX Industry sector returns 2025 YTD at 31 October (Source: Iress)



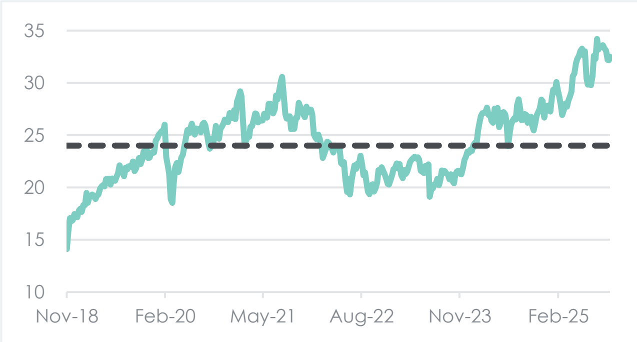
At the other end of the spectrum, the healthcare sector has taken a beating this year. This is mostly due to disappointing operating performance from CSL (-35%) but also includes weaker share prices for Cochlear (-1%), Ramsay Health Care (-5%), Fisher & Paykel Healthcare (-7%) and Sonic Healthcare (-18%). There are a few factors at play here including tariff uncertainty and government involvement in pricing, but the fact remains that this sector includes world-leading businesses that are heavily out of favour today, providing opportunities for patient investors.

Corporate governance came into focus this year with a series of scandals and controversial M&A decisions. Personal conduct of the CEO created problems at WiseTech, Mineral Resources, Santos and Steadfast, while aggressive offshore acquisitions made shareholders furious at James Hardie and Xero. Many companies deal with occasional missteps and scandals; in our view the key is to have a resilient structure in place where key people can be replaced, if necessary, without impairing the business, and where shareholder interests are respected. We are cautious of all the companies listed above (to differing degrees), for governance-related reasons.

The other key theme in the market this year has been the dominance of flows and momentum over fundamentals. Passive and quantitative investors are becoming increasingly dominant in markets, which is driving blatant valuation anomalies. For example, the staid retail and industrial conglomerate Wesfarmers normally trades at around 24x forward earnings, but re-rated this year to over 34x, (see Exhibit 3) causing the stock to rally 30% in a period when earnings revisions were negative.

We're often asked whether valuation still matters in an era of passive investing. The short answer is — absolutely. Markets may be getting noisier, but that's no reason to join the crowd. In the end, investors get paid based on the earnings of the companies they own, not from market sentiment. Prices can wander off course for a while, but the winning formula hasn't changed: buy good businesses at fair prices and give them time to work.

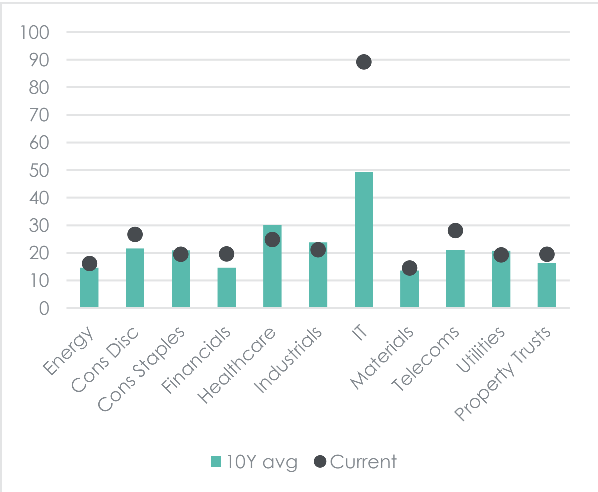
Exhibit 3: Wesfarmers forward PE ratio (Source: Bloomberg)



What are you paying for…

The market is trading on a forward PE ratio of 19.6x which is above its ten-year historic average of 16.5x. Most sectors are trading at the high end of, or above, their historic ranges.

Exhibit 4: ASX300 forward PE ratio (Source: FactSet)



Against this backdrop, we're seeing striking valuation extremes across the market - some sectors priced for perfection, others offering far better value. The IT sector, for instance, is trading on around 89x earnings versus a ten-year average of 49x. That suggests a growing number of lower-quality, less profitable names have joined the ranks.

Anything with even a hint of 'AI' seems to attract a premium multiple. There's also a clear herding effect at play, amplified by the structure of our market: technology represents just 6–8% of the ASX, compared to roughly 30–40% of the S&P 500. With fewer names to choose from locally, investor enthusiasm tends to crowd quickly into the same small group of stocks.

Until recently, consensus FY26 earnings forecasts for the Australian market had been steadily revised lower over the past year (see Exhibit 5). That trend has now turned, reflecting reasonable conditions in the domestic economy and higher commodity prices.

Looking forward one year, the market is expecting 5.4% growth for the ASX300 ex-Resources, which is a slight improvement on the 4.9% growth expected for this year, see Exhibit 6. At a sector level, Energy and Utilities are expected to see a decline, whilst Resources (or Materials) are expected to see the strongest growth in the coming year.

Exhibit 6: ASX300 forward earnings expectations (Source: Refinitiv, CLSA Research)

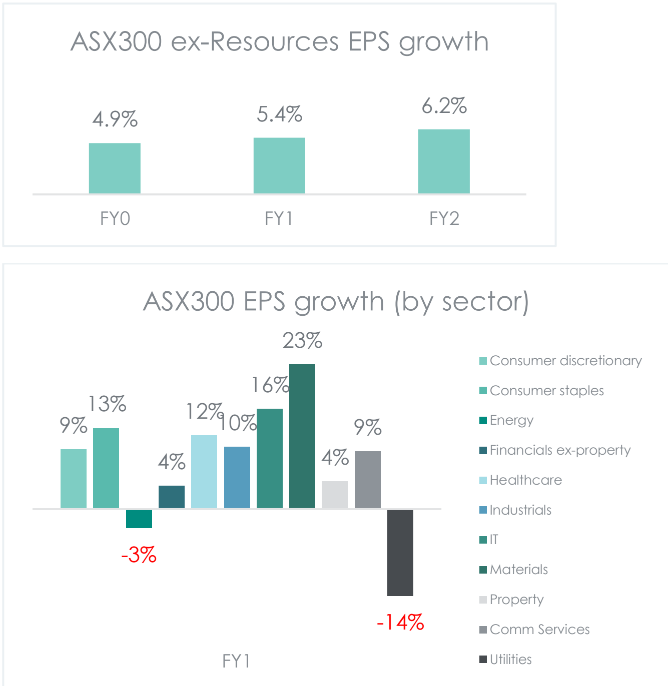
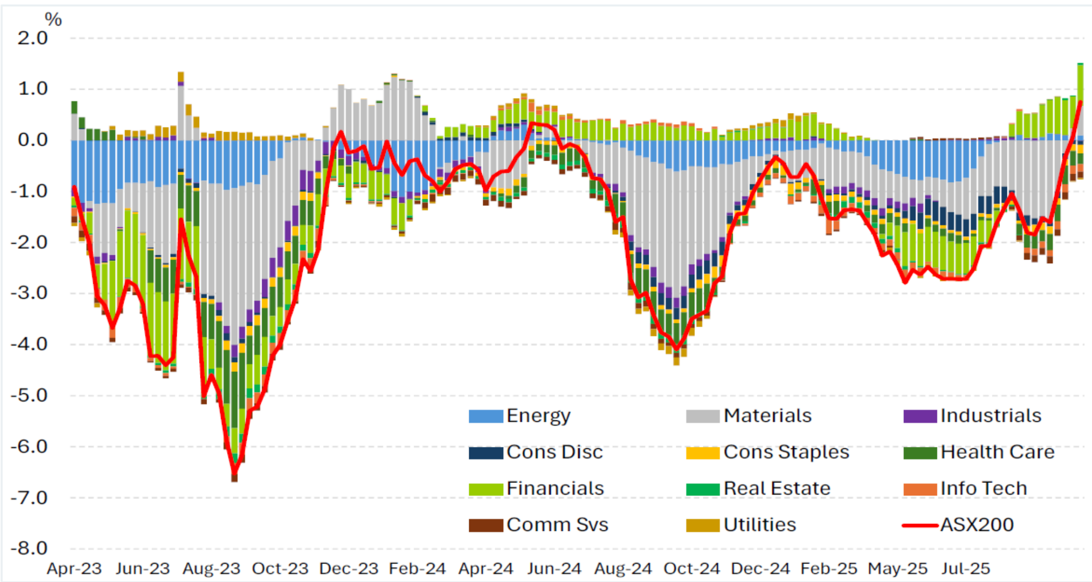


Exhibit 5: ASX200 weekly sector contributions to quarterly change in 12 month forward EPS estimate (Source: UBS Research)



The 2026 crystal ball…

The Australian equity market heads into 2026 after another year of strong, though uneven, returns. The question now is whether these same forces can continue to propel markets higher in the year ahead.

The Market of Momentum

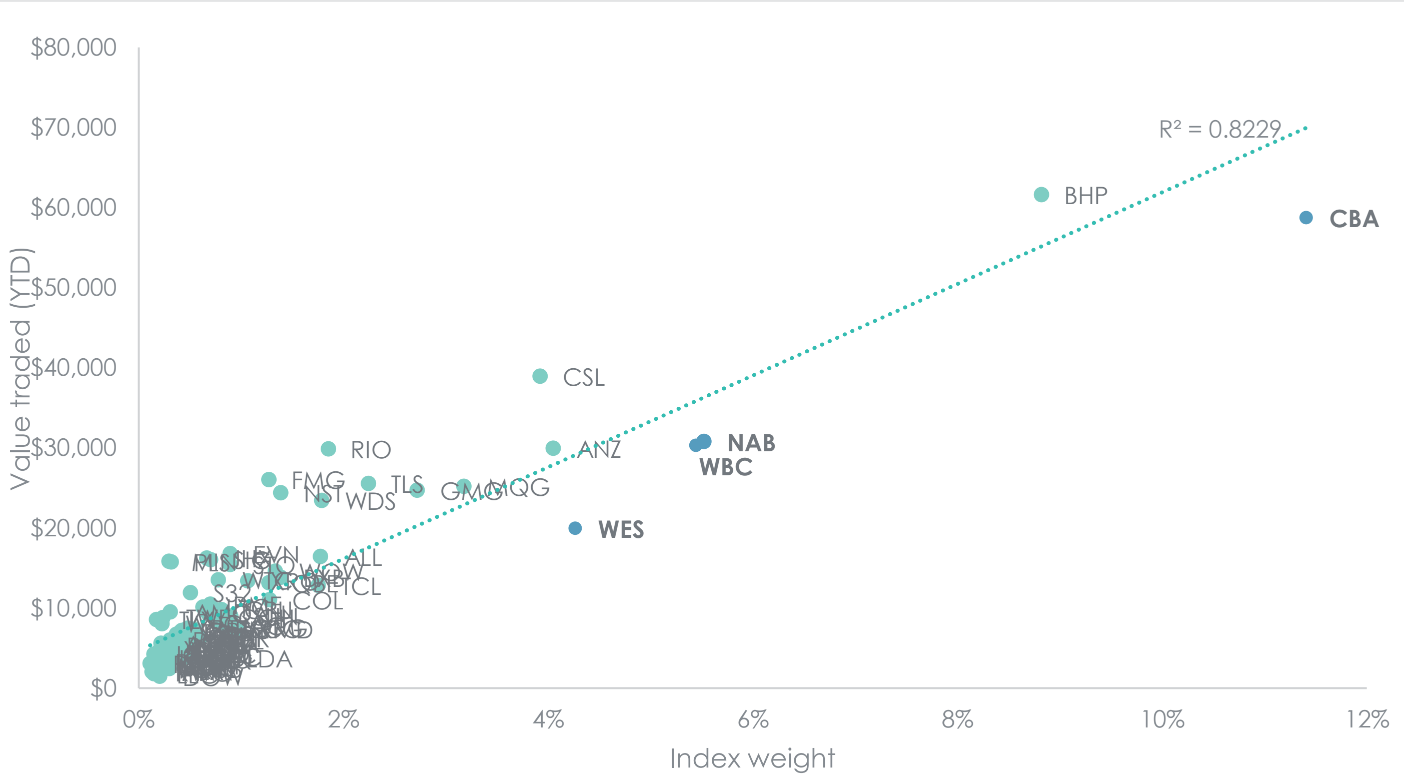
There's no doubt that momentum and passive flows have left a clear mark on equity markets. Alongside the global rise of ETFs and quantitative strategies, Australia's *Your Future, Your Super* framework has encouraged super funds to focus more on benchmark risk than capital risk. The result has been greater passive exposure to index heavyweights such as Commonwealth Bank, NAB, Westpac, and Wesfarmers — all now trading 25–35% above their long-term relative valuation norms (see Exhibit 7). In several cases, these stocks are priced at globally elevated multiples, despite only modest growth prospects.

Such has been the impact of these trends that a growing complacency has emerged — a belief that fundamentals no longer matter, and that it's safest to simply go with the flow.

So can anything break this?...

The thing to remember about momentum is that it's self-reinforcing not only on the way up, but also on the way down. It doesn't take much — an earnings downgrade, a shift in fund allocation, sentiment, or regulation… any number of small disruptions can snowball and cause the feedback loop to start running in reverse.

Exhibit 7: Value traded of ASX100 Index constituents versus their Index weight (Source: IRESS)



Market turnover versus. market size: Stocks with above average turnover for their size are typically those actively traded by market participants seeking alpha opportunities. Stocks with low turnover for their size (e.g. CBA, NAB, WBC, WES) are those where the scale of passive flows overwhelm the views of traders and investors.

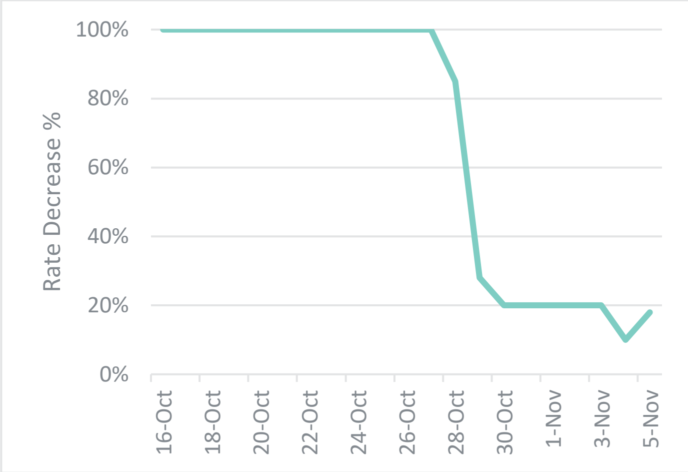
Sometimes the catalyst can start off further afield. One potential area to watch is the private credit sector. After years of rapid expansion, strains are now emerging globally. Rising defaults in U.S. private lending and concerns over asset-quality have drawn regulatory attention, including in Australia. Should credit stresses accelerate, super funds with significant private-market exposure may face liquidity pressure. In that event, there may be pressure to sell more liquid listed equity positions — which could disproportionately impact stocks where passive ownership is concentrated. Similarly, with the market at record highs, a broader sell-off or stress event could trigger member rebalancing or redemptions that expose liquidity vulnerability as we saw in April with the Liberation Day tariff announcements and APRA's involvement with a large industry super fund.

Structurally, the tailwind of inflows to industry super funds that has defined the last couple of decades may also start to come under more pressure as Australia's population ages and more retirees move from accumulation to pension phase and as wrap platforms take market share.

Higher for longer

The first eight months of 2025 brought three rate cuts, with markets confidently expecting further easing into 2026 on the assumption that the inflation battle had been won. As recently as late October, the implied probability of a November rate cut was 100% (see Exhibit 8). That confidence evaporated with the latest inflation data — a print high enough to erase expectations of another cut and even prompt some economists to suggest the next move in rates could be up, not down.

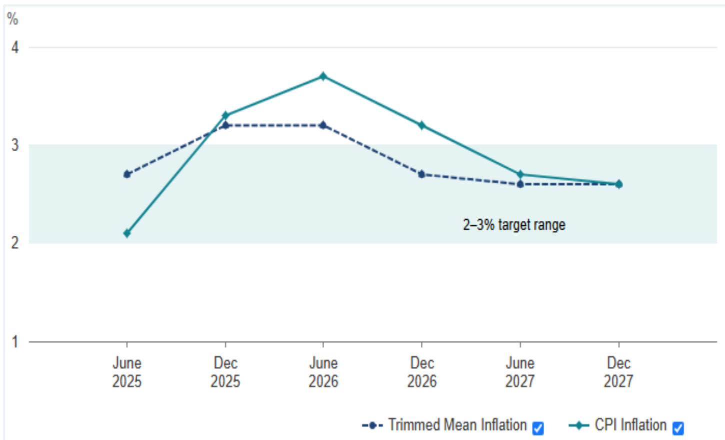
Exhibit 8: 30 Day Interbank Cash Rate target implied expectation of change (Source: RBA)



It's a timely reminder that inflation may prove stickier than expected. The RBA themselves now only see inflation falling to the middle of their target band in late 2027 (see Exhibit 9).

With the market previously betting on monetary easing support to help justify valuations, it pays to consider the alternative. Consumer discretionary names (e.g. Temple & Webster, Nick Scali, Harvy Norman +60-80%) and REITS (+~20-30%), which have risen strongly this year may find it more difficult in this environment, whereas general insurers may benefit, with pricing discipline and investment income helping to support margins.

Exhibit 9: RBA Inflation Forecast (Source: RBA)



Finding stock opportunities…

There are lots of factors to consider in the market today. Will gold keep rallying? Are data centres getting overbuilt, or still in critically short supply? Rather than making binary calls, we think long-term wealth is established by finding exposure to these themes through high quality companies with a competitive edge.

Gold

The gold sector offers plenty of options, but few miners have shown consistent discipline in capital allocation or operational excellence. One standout beneficiary of higher commodity prices and volumes, across gold, lithium and copper, is ALS, the global leader in minerals testing. ALS also operates in environmental and food testing, generating strong returns on capital and consistent growth. Encouragingly, the market has been slow to factor the benefits of firmer metals prices into its earnings outlook.

Data Centres

We're somewhat sceptical that 'this time will be different'; that every participant in the capacity race will emerge a winner. Many smart people in the industry disagree, but our preference is for businesses already sitting on unrealised gains from decades of investment in the sector. Macquarie's asset management arm has multiple datacentre platform investments that have advanced well beyond the concept stage. They have already begun realising profits through sell downs and have others at various stages of maturity. They are also involved in the power generation and distribution, and connective fibre optic cables that data centres need to operate. These investments are already contributing to earnings, and their success helps Macquarie's ongoing asset raising activities, providing fee income and profit growth for Macquarie investors consistently over the coming years.

Elsewhere, we see attractive value in companies offering reliable long-term growth and high operating margins, but outside the sectors the market has already crowded into.

Healthcare

Cochlear and Fisher and Paykel Healthcare have dominant market share thanks to product superiority built on decades of leading-edge research and development. An aging and wealthier global population leads to structural demand growth for hearing and respiratory support, driving earnings and dividend growth for these businesses. Compared to the rest of the market, these businesses remain attractively priced and look well placed to support wealth building for long term investors for years to come.

Infrastructure

On the theme of reliability, infrastructure-style businesses such as Transurban, Auckland International Airport and Brambles operate as near-natural monopolies. They can turn low-to-mid single-digit volume growth into much stronger profit growth through efficiency gains and inflation-linked pricing. With decades of runway(!) ahead, these companies offer something increasingly scarce in a fast-changing world — dependable growth without the threat of competition.

In an environment driven by momentum, narratives, and liquidity, it's easy to lose sight of fundamentals. Yet, as history consistently reminds us, the foundations of long-term wealth creation remain the same — owning high-quality businesses at sensible valuations, run by disciplined management teams that can compound through cycles. As we look forward to 2026 with the market facing as much volatility and dispersion of outcomes as ever, **quality remains the clearest path to lasting returns**.

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