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By Perpetual Corporate Trust
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Risk assets charted a volatile course through November from sharp sell-off earlier in the month to partial recovery towards month-end. Drivers of the volatility included competing views about the likely investment return from the vast money spent developing artificial intelligence to whether there is any leeway for central banks to continue cutting official interest rates in the face of inflation becoming sticky above their respective targets. The issue of inflation running above targe came to the forefront in Australia with inflation pushing above 3% on all measures in October raising the possibility that the RBA might have to consider not a rate cut, but a rate hike down the track.

Share markets were down sharply through much of November, but the late-month rally helped some to push just inside positive territory for the month. The US S&P 500 and Europe's Eurostoxx 50 index each rose 0.01% and were the best of a month of losses elsewhere, albeit pared back from much bigger falls mid-month. Losses in November ranged from 0.2% for Hong Kong's Hang Seng to 4.1% for Japan's Nikkei. Australia's ASX 200 fell by 3.0% as views about the future course of the RBA's cash rate shifted from more cuts ahead, to no more cuts and even the possibility of a hike next year to deal with inflation pushing up close to 4%.

Credit markets were softer in November reflecting weakness in risk assets in general. Australian credit spreads over yields on government bonds marked higher, but the local market continues to look relatively safer than the US market. Australian households are still in a very strong position to meet their debt servicing, even though debt levels are high. The unemployment rate dipped to 4.3% in October from 4.5% in September and employment growth firmed in the month. Rising household disposable income, helped by rising real wages, and earlier reductions in mortgage interest rates in 2025-, and lower-income tax through 2024-25 are enabling households to meet their high debt servicing requirements.

Government bond yields in the US and Australia diverged in November, falling in the US but rising in Australia. The divergence in bond yields in the two countries reflects the likely next changes in official interest rates by the US Federal Reserve and the RBA. The market sees the Federal Reserve cutting the Funds rate at the FOMC

meeting this month by 25bps to 3.75% and with some capacity to cut rates further early next year. The market's view of more US rate cuts is based on expectation of softer US growth data starting to show, and the Federal Reserve wanting to prevent unemployment rising too high, rather than dealing with inflation looking sticky around 3% y-o-y on all measures.

The RBA in contrast, admitted early in November, in the quarterly Monetary Policy Statement, that demand is shaping up more strongly than previously forecast and with it, inflation too. After the early-November monetary policy meeting that left the cash rate unchanged at 3.60% and the release of the RBA's latest economic forecasts revising upwards demand and inflation forecasts, data releases showed even more upward pressure on demand and inflation as well as evidence of a very tight labour market and annual wage growth stuck at 3.4% y-o-y, too high for an economy with persistently poor productivity.

The impact of the different economic forces facing the US Federal Reserve and the RBA during November showed in bond yields falling in the US, but rising in Australia. The US 2-year bond yield fell by 8 basis points(bps) to 3.49%, and the US 10-year bond yield fell by 7bps to 4.01%. In contrast, bond yields rose in Australia in November with the 2-year yield up 25bps to 3.80% and the 10-year bond yield up by 22bps to 4.51%.

Our view is that the market is over-estimating the capacity of the US Federal Reserve to continue cutting US interest rates with US inflation stuck near 3%. We also see the market needing to build-in one or two RBA rate hikes in 2026 to temper inflation that now seems likely to top 4% y-o-y over the next few months, well above the RBA's 2-3% target band. We see the RBA's policy meeting next week sounding more caution about the inflation outlook and while holding the cash rate at 3.60%, warning of the possibility that the next rate move could be a hike if inflation does not settle.

In early February next year, the RBA will produce updates to its economic forecasts in the quarterly Monetary Policy Statement. After the substantial increases to its inflation forecasts in November another set of inflation forecast upgrades is in prospect. If that occurs, as we suspect it may, that would oblige the RBA to hike the cash rate in February, or soon after.

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