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By Perpetual Corporate Trust
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Risk assets rose strongly again in August assisted by hope that the US Federal Reserve might restart rate cuts this month. Another factor helping to keep US technology stocks at the leading edge of the rally this year is belief in the huge earnings growth potential that may come from the increasing adoption of artificial intelligence, AI, in business practices. Hopes for lower interest rates and the potential of AI are for the time being trumping the costs to US and global growth and inflation prospects from President Trump's chaotic upending of low-protection international trading arrangements that have served to bolster global economic growth and to help lower inflation over the past three decades and more. Markets may continue to look through the damage from President Trump's economic program providing central banks have some cause to lower official interest rates and hopes about the benefits from AI do not sour.

We see some risk building that central banks may call an end to interest rate cuts over the next few months amid signs of rekindling inflation. Our view is at odds, for the time being, from the latest guidance from the US Federal Reserve that the time is approaching for a rate cut. It is also at odds with indications from the RBA that after cutting the cash rate in August it may be able to cut rates further over the next year.

Essentially, the reason we are at odds with guidance from the US Fed and the RBA is our sense that demand is showing signs of running more strongly than forecast by both central banks and with that stronger demand comes rekindling inflation. The data relating to growth and inflation over the next few months will determine whether the central banks or we will be changing view.

Returning to what happened in August, it was for the most-part a very strong month for major share markets with several markets again making record highs, including the US and Australian share markets. Gains in July ranged from 1.3% for Britain's FTSE 100 to 10.9% for China's share market, Shanghai's CSI. China's share market has risen very strongly over the past two months amid signs of a trade deal in the making with the US and less damage to China's growth prospects than thought likely a few months ago from the continuing struggle with the lengthy decline in property

prices as well as the newer threat to China's exports from President Trump's tariff proposals. The already richly valued US share market made another strong gain in August, up 3.6%, making new record highs several times along the way. Australia's ASX 200 also rose strongly, up 3.6%, and traded above 9,000 for the first time during the month.

Credit markets in August also had a strong month with spreads closing in on the lowest margins over government securities seen over the last quarter century and more. There are signs, mostly in the US, that investors have been prepared to chase yield on high-risk securities. The Australian credit market looks attractive and relatively safer than the US market. Australian households remain in a strong position to meet their debt servicing, even though debt levels are high. Rising household disposable income, helped by rising real wages, falling mortgage interest rates and lower income tax through 2024-25 are enabling households to meet their high debt servicing requirements.

Investors' strong appetite for risk assets in August did not come at the expense of government bonds. US government bonds rallied mostly in August, especially shorter-dated bonds as the Fed indicated a change in policy stance towards restarting rate cuts. The 2-year bond yield fell by 34 basis points (bps) to 3.62% while the 10-year bond yield fell by 14bps to 4.23%. The long 30-year Treasury yield was an exception to the rallying trend, lifting by 3bps to 4.93%.

While the Fed could ease the Funds Rate 25bps to 4.25% at the September policy meeting, signs of firmer US economic growth and stickier inflation may limit the chances of rate cuts beyond September. We see US bond yields moving higher over coming months not only because of stronger growth and inflation reports, but also on concerns about high and rising US government debt and whether President Trump will try and limit the rate-setting independence of the Federal Reserve.

In Australia, government bond yields were mostly steady in August, notwithstanding the RBA's delivery of a 25bps cash rate cut to 3.60% at the August policy meeting with guidance of potentially more cuts to come. The 2-year bond yield fell by 2bps to 3.33% while the 10-year yield rose by 1bp to 4.27%.

The RBA's guidance of more rate cuts to come, albeit slowly, over the next year is contingent upon their August economic forecasts of slow economic growth over the next two years and with it a less tight labour market with inflation, after a near-term blip upwards, slipping back to mid-2-3%-target late 2026 and in 2027.

Data releases since the August RBA meeting seem stronger than is consistent with the RBA's economic forecasts. The unemployment rate in July at 4.2% was a shade below the 4.3% the RBA is forecasting through the second half of 2025. Wage growth in Q2 2025 at 3.4% y-o-y was a shade higher than the RBA had slotted in. More concerning, the latest monthly CPI for July with a jump to 2.8% y-o-y from 1.9% in June is indicating a bigger upward blip in inflation developing in the second half of 2025 than the RBA's forecasts allow.

Adding to the pressure on the RBA's August economic forecasts, there is a risk that Q2 GDP growth out this week may be a touch firmer than the RBA has slotted in. Stronger than forecast growth added to a bigger-than-forecast blip in inflation would make it less likely that inflation slides back to mid-target from late 2026. It will take more data to confirm a stronger drift away from the RBA's growth and inflation

forecasts, but at this stage early warning signs are showing. It is the reason why we stick with our view that there may be one more 25bps cash rate cut, at most, to 3.35% late this year and then a lengthy pause. Our cash rate view leaves little room for Australian government bonds to rally and risk that higher bond yields develop over coming months.

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