A Turbulent Start, but Rate Cuts Still Likely in 2026

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We are merely a fortnight into the year and if you thought geopolitics was the primary source of the financial market volatility in 2025, then we appear to be taking things to a whole new level in the early days of 2026.

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The capture of the Venezuelan president for trial in the US for narcotics crimes – followed by clear warnings to others in the region that they could be next – was an interesting way to commence the year. Not too many people are going to be overly concerned about the removal of an illegitimate president overseeing a brutal regime, but many are disquieted by the precedent that it sets and whether it brings forward China's plans for Taiwan into the 2026 year.

It is not clear that the US's plan was always to capture President Maduro or to force a regime change. At the moment there doesn't appear to be a clear plan of how the US would run the country, particularly given virtually all of the old regime remains in place, and the complexity of local politics and well-armed militias with strong vested interests makes for a very uncertain future.

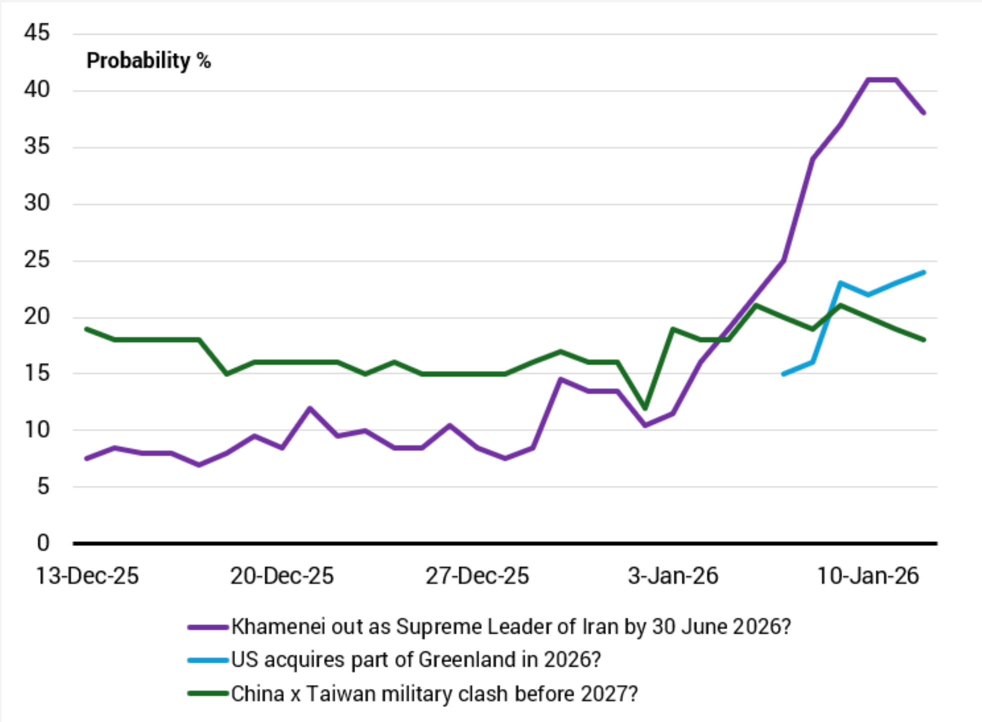
Stepping back, the broader objective appears to be the same thematic that we were discussing this time last year. The US Administration seemed intent to claim the Western hemisphere for itself and exclude China and Russian influence on both economic and national security grounds. In this context, it is worth noting that Venezuelan oil takes just four days to transport to the US and has been a crucial source of supply for the US in prior major conflicts. So, we perhaps shouldn't be too surprised Venezuela was a priority.

Of course, economic security in the modern era is as much about critical minerals and certainty of trading routes as it is about oil. As much as one would like to dismiss the US ambitions for Greenland as clickbait, it is difficult to ignore that Greenland does fall into the Western hemisphere, does have ample supplies of critical minerals (even if the local people desire that it remains in the ground) and the retreat of arctic ice has opened up access routes that could prove vital to trade and military interests.

Naturally, this puts the US on a collision course with another NATO power, which only further complicates what appears to be a rapidly fraying alliance.

In the background we may also be witnessing in real time the most important event for Iran since 1979 as demonstrations across the country appear to be ongoing and the regime under clear threat. What the Middle East would look like should the regime fall is anyone's guess (refer market odds in Chart 1). But it is easy to imagine both benign and dangerous scenarios depending on who fills the power void and how long it takes.

Chart 1. Market odds of major political events in 2026



Source: Polymarket.

All of this is to say that, while most of us were on holiday, a lot has already happened in 2026 and it is only just getting started.

We have previously framed our views on the US and financial markets more broadly around what we believe will be a furiously contested mid-term election in November 2026. President Trump can clearly point to some important wins: border security, strong equity markets and a solid economy being the key factors likely to have broad appeal. However, even the President acknowledges his polls are low, and the Administration is somewhat concerned that its policies are not resonating with the electorate as hoped.

Weak employment growth, ongoing affordability concerns and evidence that much of the economic growth has been coming from relatively few wealthy households – rather than the numerous average households – are all part of the problem.

The Administration's plan has long been to get oil prices as low as possible, for the Fed to be easing interest rates consistently and for bond yields to be declining sharply, all of which would see Main Street feeling much better about life well ahead of the mid-terms. To be fair much of this could still happen: US petrol prices are falling, Powell will soon be replaced with a dovish new Chairperson and depending what happens with the court case of Fed board member Lisa Cook and other Fed board member retirements, it is feasible that Trump may get to appoint up to three new members to the Fed Board in 2026. This could tip the balance to the Fed embarking on further easing in coming months and we still expect three rate cuts in the US this calendar year.

The fly in the ointment is that US Financial Conditions continued to ease into late 2025 and early 2026 which suggests that the Fed easing could be delayed. It is worth noting that the easing in financial conditions over the past seven months has all been due to strong equity markets and low credit spreads. That is, we have very loose financial conditions for the corporate sector.

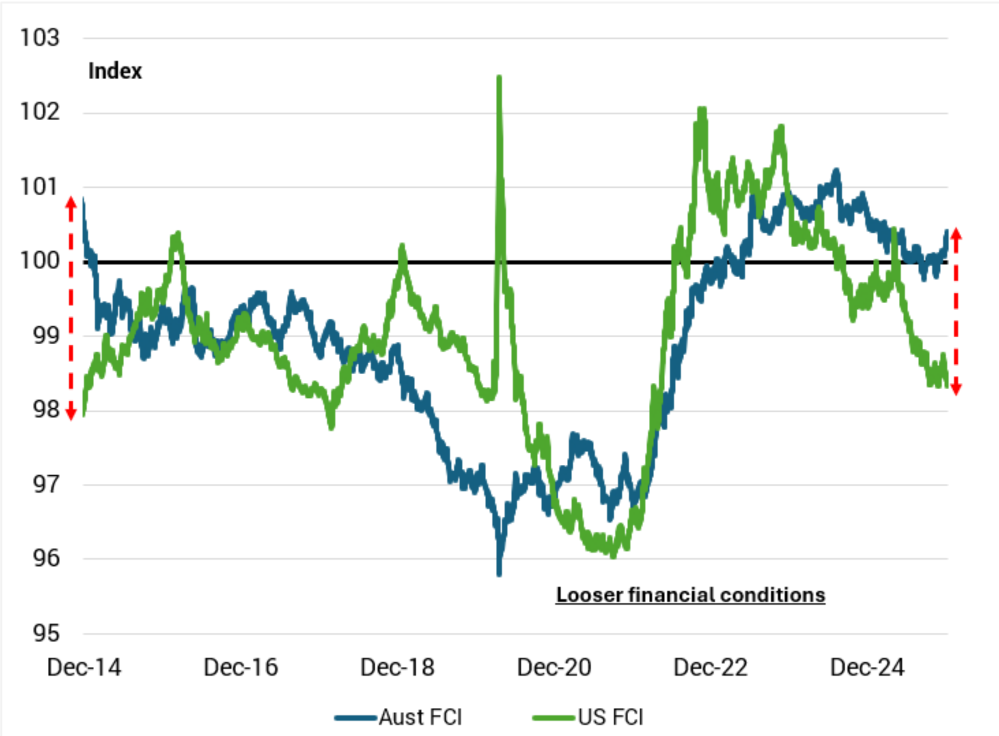
However, given bond markets are still concerned about escalating US government debt – and it is long dated bonds that matter for households – there has been little relief for indebted households. In other words, financial conditions are easy, but not for everyone.

The additional complication is that Chair Powell has now been served a subpoena by the Justice Department threatening a criminal indictment over his testimony relating to the cost of Federal Reserve construction renovations. Powell's response has been to post on the Fed's website that this is an attack on Fed independence and its unwillingness to bend policy to the whims of the President.

If Powell was inclined to bow to Trump's pressure and ease interest rates in early 2026 prior to the subpoena, then he will almost certainly not be now.

It is fair to say that Powell may now not even make it to his final meeting in May. If Powell is replaced with someone more willing to implement Trump's will before May, then my call for three rate cuts in the US is suddenly looking very good.

Chart 2. The spread between Australian and US Financial Conditions now the greatest in more than a decade



Source: Yarra Capital Management.

Switching to Australia, it has been particularly interesting that the defining shift that impacted financial markets to the greatest extent in Australia in recent weeks has not been the economic data per se. Indeed, the data has largely panned out as we had hoped.

It wasn't even the official market communication from the Reserve Bank of Australia (RBA), which remained reasonably even handed. It was the RBA Governor's Q&A in the November RBA meeting that set the rabbits running.

In an unusual turn of events, the RBA Governor was clearly perturbed by high annual inflation readings and chose to rule out further interest rate cuts in the near term and flagged the next move could be an increase. As expected, a host of financial market economists abruptly shifted their forecasts to rate hikes as early as February and sought to outdo themselves as to who could be the first and who could have the most hikes in their forecasts.

Suddenly I find myself in the position of having the most dovish view on Australian interest rates in the market.

I still have rate cuts in my baseline view in my forecasts for five simple reasons:

1. **Economists and the RBA appear to be confusing annual base effects and sequential inflation pressures.** If we were to trust the new monthly CPI data, and maybe we shouldn't, inflation has averaged 0.1% (m/m) since August 2025 – an annualised

rate of 1.1%. The annual rate slowed from 3.4% in October to 3.2% in November but we note that a large 0.7% (m/m) rise in December 2024 will fall out of the annual calculation on the next release. This means a 0.2% (m/m) rise in December 2025 will be enough to see inflation back in the RBA's band as soon as later this month.

2. **Much of the recent rise in inflation has been the impact of taxes and subsidies.** In terms of electricity, our contention was that the inflation surprise in Australia came via some states using up their annual allotment of electricity subsidies which saw a spike in August and September, only for catchup payments to be paid in October and November.

   Given the peak amount of the subsidy was paid to households in the year earlier, the shifting of the payments from August and September 2025 generated a significant base effect. This will work its way through over coming months and although the Treasurer has ruled out further subsidy extensions, electricity futures have been in retreat suggesting electricity price increases may be less than many fear.

   Separately, the impact of the mismeasurement of tobacco has also been significant. Tobacco prices have increased more than 40% over the past three years in response to sharp increases in excise taxes. Yet, retailers and industry reports suggest that illicit tobacco sales are now between 25-30% of the market.

   Yet while the ABS has gradually reduced the weight of tobacco in the CPI basket over time, reflecting a reduction in smoking rates, there has been no explicit attempt to account for illicit tobacco sales. For instance, if illicit sales were 10% of sales in 2022 and this has lifted to 30% in 2025 and the average price for a packet of illicit cigarettes is closer to $20 compared to $50 for a legal packet, then it is likely that the CPI has overstated tobacco inflation in the past three years by approximately 23% and headline inflation would be 0.2% lower in each of the past three years.

   In short, if we exclude the distortions of electricity and tobacco, the annual rate of inflation is currently running at 2.8% – well within the target band.

3. **There are also some one-off increases that appear somewhat noisy in the data** such as strong gold and silver prices resulting in high inflation contributions from fashion accessories. For such high inflation contributions to continue would require gold and silver prices to keep accelerating at the same rate as 2025's historic surge, which is possible but unlikely.

4. For those concerned about a lack of spare capacity, we would caution against using the NAB survey as your guide given the hospitality sector is clearly distorting the survey at the moment. Our preference is the actual GDP data and on that basis **our estimate is Australia is operating at -0.5% output gap, the equal largest output gap alongside Canada, compared to the G7 peer group and significantly greater than the USA**. More importantly, labour productivity appears to have commenced an upcycle, and we expect productivity to trend higher in coming quarters supported by the recovery in private demand and the embracing of AI and related technology.

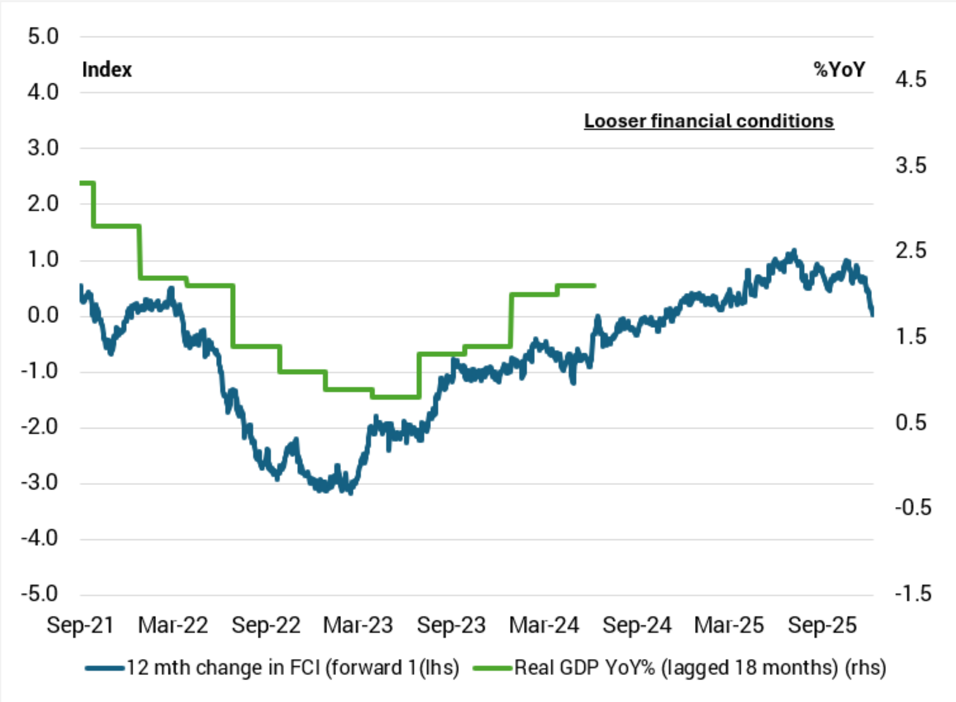
   So, with: (i) wage inflation undershooting RBA expectations, (ii) the labour market indicators still in slow retreat with a real lack of full-time employment growth, (iii) import prices moderating and (iv) productivity in the early stages of uptrend, there is little rationale to genuinely fear the risk of an inflation breakout.

5. **The US$ downtrend may have stalled in 2H25, however, likely Fed easing and a messy lead into the US mid-terms is likely to see investors again move to allocate outside of the US through 2026**. In concert with what we still regard as strong building blocks for Emerging Market demand growth, there is a strong prospect that the A$ will appreciate significantly in 2026.

   This is highly relevant for the RBA which has been down weighting the role of 'cash flow effect' of monetary policy and upweighting the role of the 'exchange rate effect'. All else equal, a materially higher A$ would encourage the RBA to ease interest rates to prevent an unplanned further tightening in financial conditions.

It is this final point that could be somewhat problematic for those looking for interest rate hikes. Indeed, our measure of Australian Financial Conditions has tightened noticeably since the RBA Governor's more hawkish comments (refer Chart 3).

Chart 3. Recent tightening in Australian Financial Conditions will weigh on future economic growth



Source: Yarra Capital Management.

Financial conditions are now consistent with real economic growth of 1.75% (12 months ahead) which is down from a suggested 2.5% last quarter. The last thing Australia needs in an uncertain global backdrop is for a central bank to embark on a rate hiking cycle on a misread of some inflation dynamics and into an environment where broader financial conditions are already tightening and likely to continue to do so as the A$ rises in 2026.

In terms of broader financial markets, it is clear that equity markets have gotten off to a good start in 2026, and we expect that 2026 may well feel a little like an echo of 2025. A weaker US$, a steeper yield curve and a long Emerging Market trade appear likely to be the dominant themes again in 2026. The key difference is that the gloss is coming off the 'Trump-trade'. So, backing tariff winners, crypto, financial deregulation and all things AI/Tech may well feel a little bit more 2025 by mid-2026.

We are somewhat loath to make economic and asset class recommendations based on the likely outcome of US mid-term elections, but we do suspect that financial markets will become more volatile as the mid-term election approaches.

I'm expecting a bumpy but positive ride for equities in 2026, with a total return of +9% for the US, +12% for the Emerging Markets, and around 10% for Australia. Given our expectation that US economic growth and earnings will undershoot expectations, and the Fed will cut interest rates more aggressively than consensus currently forecasts, it is likely that Growth will outperform Value and any mean reversion in the poor performance of Quality during 2025 may be somewhat delayed. We still like the prospects for commodities, with metals likely to outperform gold in 2026.

Within rates, we expect yield curve steepening to be in vogue again in 1H26 in anticipation of a dovish Fed outlook and stubbornly high US government debt to contain the back end from participating proportionately.

In short, in 2026 Emerging Markets should be well-placed to outperform and Australia should prove an increasingly attractive destination for foreign capital seeking to capitalise on EM resilience, a rising A$, effective monetary policy stimulus, stable fiscal finances, and Australia's robust economic growth trajectory.

Contact us

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We still expect interest rate cuts from the RBA in 2026.

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