WEEKLY MARKET UPDATE

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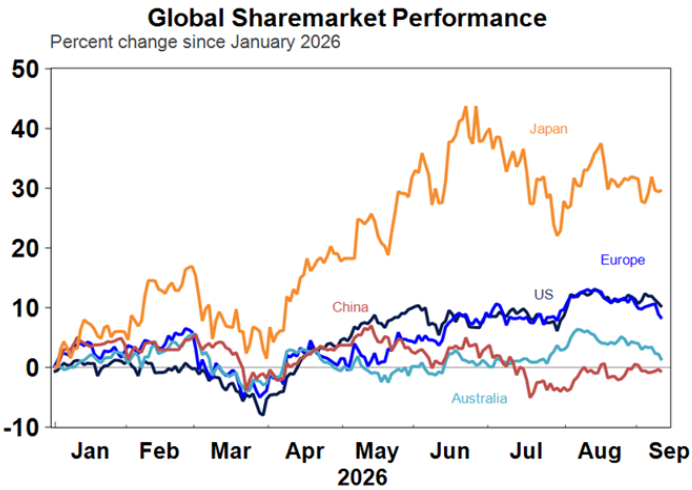
DR SHANE OLIVER

Head of Investment Strategy and Chief Economist, AMP

Investment markets and key developments

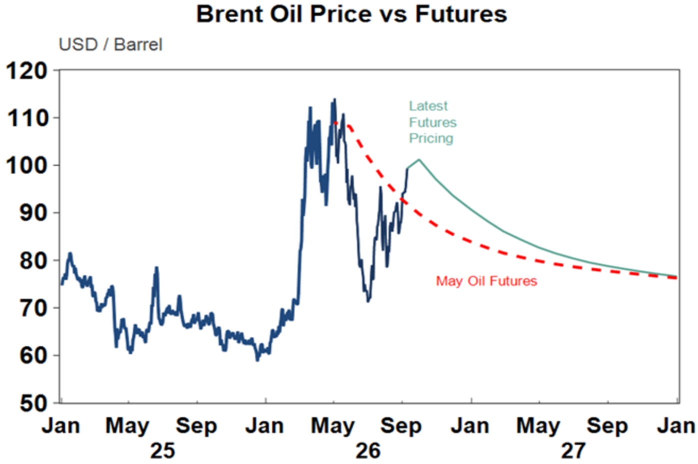
Global share markets fell again over the last week as both oil prices and bond yields pushed higher with more upwards pressure on central bank interest rate expectations. The Australian share market was particularly hard hit with around a 3% fall not helped by talk of back to back hikes by the RBA on top of worries about the impact of rising oil prices, rising bond yields which act as a drag on share market valuations and falling property prices. Energy shares rose but this was offset on the ASX 200 by big falls in IT, retail, property and mining shares.



Source: Macrobond, AMP

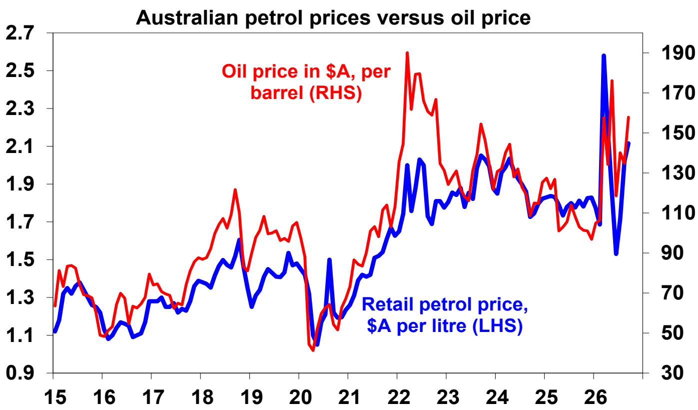
Bitcoin and gold both fell as rising bond yields and rising expectations for Fed rate hikes reduced their relative attractiveness. So far Bitcoin is holding above its 200-day moving average which is a positive sign, but gold has fallen back below its 200-day moving average. Metal and iron ore prices fell as did the $A despite a slight fall in the $US.

Oil prices are heading into a danger zone with Brent pushing near $US110 a barrel for the first time since May as the US-Iran conflict escalated further with more attacks on ships in the Strait of Hormuz, more US strikes on Iran, more retaliatory action by Iran on neighbouring countries and new Houthi attacks on Saudi Arabia. With Hormuz effectively remaining closed the risk to global oil supplies is rising as global reserves can't be run down indefinitely. With oil now above the top of our $US70-$US100 range Trump is likely to do something – another TACO anyone? – to get them back down but the risk of a further rise is high. The hardline Iranian leadership may want to keep it going to inflict more damage on Trump politically and run the risk of what he may do after the midterms.



Source: Macrobond, AMP

Particularly at risk are gas prices - with very little gas gettig out through the Strait at all and few diversions from Qatar and very low European gas stockpiles as the northern winter approaches - and refined product prices especially for diesel given a hit to Russian refineries and exports. **Petrol prices in Australia at around $2.1/litre have already retraced around half the fall from their March high but are likely heading even higher with the rising global oil prices**.

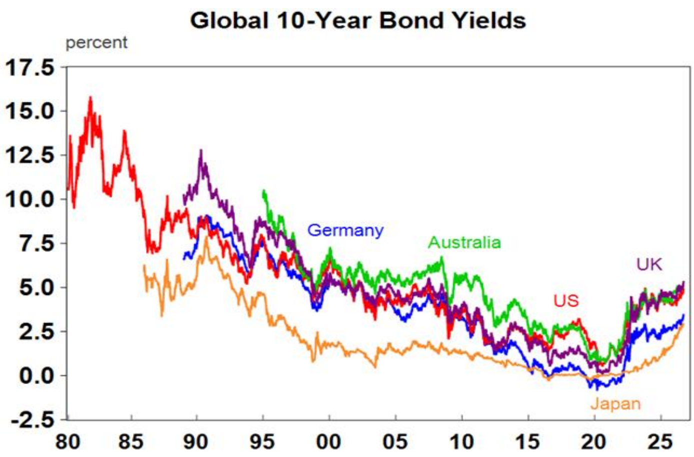


Source: Bloomberg, Motormouth, AMP

The past week saw another surge higher in bond yields reflecting concerns about big budget deficits in the US and elsewhere, increased corporate borrowing to fund data centre investment, worries about higher for longer inflation partly flowing from higher oil prices, a related need for central banks including the RBA to run higher interest rates for longer and a rising trend in Japanese bond yields leading to a reversal of the so-called carry trade. This is being compounded by US Government actions:

- While US Treasury Secretary Bessent tripled the size of the long-term bond buyback operation to $6bn this was largely ignored by the bond market and adds to fears that the US will monetise its debt and threatens to make the US Treasury a more erratic issuer of bonds demanding a higher risk premium. While he's talking of reducing the budget deficit it's hard to see it happening given the inability of DOGE to do much last year and given that Congressional approval will be required.
- Trump's offer of $US5000 per adult if the Republicans retain the House and Senate underscore that the risk is a further deficit blowout not consolidation. That said, his election bribe is unlikely to be passed by Congress.
- Trump ramped up tariffs on Canada even further in response to Canadian retaliation, adding more to costs.
- And of course, the Trump's War with Iran is adding to energy costs which is adding to inflation.

Bonds are starting to get oversold suggesting a short-term rally, but the risk is skewed towards a further rise in yields longer term. As US bond yields are the base for global yields their rise has continued to flow through to rising Australian bond yields made worse by strengthening expectations for RBA rate hikes.

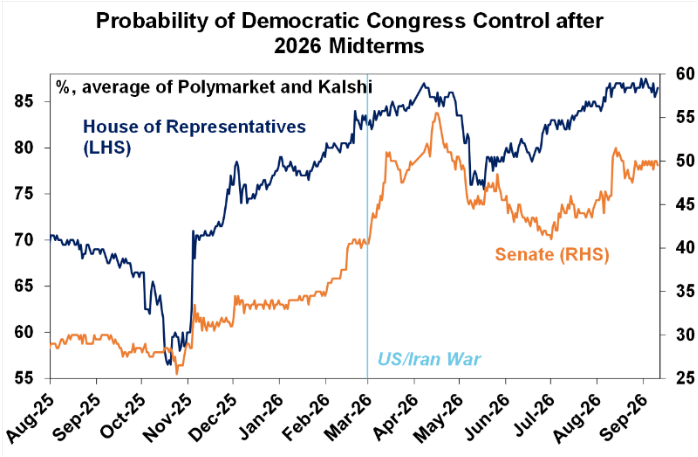


Source: Macrobond, AMP

The rise in bond yields points to: higher fixed mortgage rates; pressure on share market valuations; threats to commercial and residential property; and pressure on Federal & state budgets as borrowing costs surge.

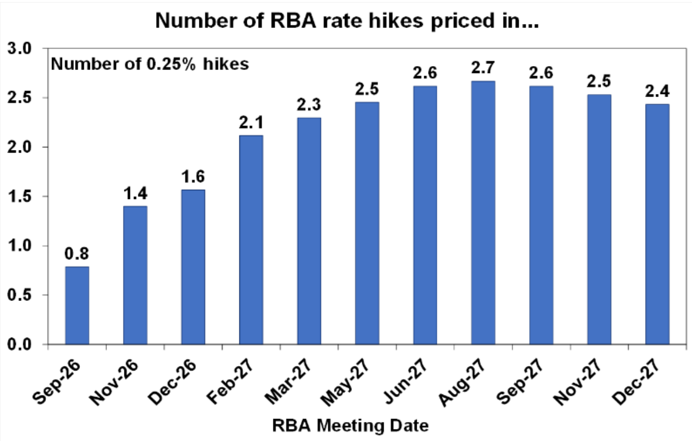
The back up in public debt interest costs at a time when stamp duty revenue is falling due to the slump in the property market comes at a difficult time for state governments with Queensland seeing its credit rating downgraded from AA+ to AA by Standard and Poors. S&P also cited large infrastructure spending programs in Queensland including for the Olympics. The downgrade to AA could add another 0.1 to 0.15 percentage points to Queensland's borrowing costs pointing to further pressure to cut spending for a state government philosophically averse to hiking taxes. While some of the reasons for the Queensland downgrade were beyond the state government's control, this arguably could have been avoided if it had focussed more on containing spending after the last election. That said I am not sure that cutting its rating to the same as Victoria's is warranted! NSW moved from AA+ (negative watch) to AA+ (stable).

Trump's election bribe should be seen in its wider context as a sign of desperation. If the US had the "tremendous strength and success" he claims, then the bribe would not be needed. But things are going the wrong way – the Iran war is an unpopular disaster, oil prices are surging again, the hardline Iranian government may want to keep it going, tariffs are on the way up again and the Fed is at high risk of hiking again. And the mid-terms are just two months away. Betting markets put Democratic control of the House at over 85% and the Senate is back to around 50%. The risk for markets may be that a Democrat win (particularly for Democratic Socialist candidates) will fuel fears of tax hikes after the election.



Source: Bloomberg, AMP

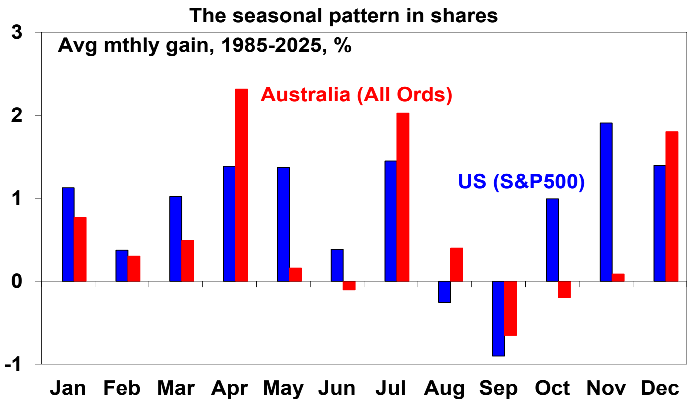
The RBA is looking like its seen enough bad news on inflation and will most likely hike this month, so we have moved forward our expectation for the next hike from November to September. Since before the July CPI release, we had been expecting another rate hike this year, most likely in November. The high CPI and okay GDP data released in the last three weeks then suggested its 50/50 as to whether its September or November, but RBA communication over the last week suggests its likely to be this month. Comments by RBA Assistant Governor Hunter and Deputy Governor Hauser were decidedly hawkish – despite both coming after soft consumer and business confidence data. The clear message was that the RBA sees growth around trend, unemployment as still low and is not too fussed about the fall in home prices as they are still up 3%yoy and 50% this decade but that inflation is too high and upside risks to it appear to be materialising. As a result, according to Hunter "inflation is top priority right now" and according to Hauser "people are furious about inflation…[and] want us to do our job and bring inflation down". So, while there is a rising risk of recession with a renewed surge in oil prices and a negative wealth effect from falling home prices the more pressing issue for the RBA is inflation. And with inflation on track to be above target for five of the last six years including the current year, waiting till November to hike risks further damaging RBA credibility in terms of its commitment to getting inflation back to target. And once that credibility is lost it will be even harder to return inflation to target. **As a result, we now expect the RBA to hike at its next meeting late this month and retain a tightening bias**. A hike this month is not inevitable – as it could still be blown around by global developments or a very weak jobs report the week before the RBA meeting – but we would see it as odds on with a 75% probability. A second hike in say November would probably be overkill as it would risk tipping many households with a mortgage over the edge risking in turn a crash in property prices, much higher unemployment and a deep recession. That said, the probability of a second high is probably 50/50, and a third hike would definitely be overkill. Interestingly the money market now has nearly three hikes priced in by October next year – but that looks like an overreaction to the surge in oil prices.



Source: Bloomberg, AMP

Proposals to allow access to super to cover living costs may be popular but like other "cost of living" relief measures is not the way to address the "cost of living" crisis and could make it worse. A common approach offered by all sides of politics over the last few years to the cost-of-living crisis has been to offer support via things like energy rebates, fuel tax cuts, low home deposit schemes and access to super with another proposal on the super front from a minor party in the last week. The problem with all these schemes is that they don't solve the underlying cost of living/inflation problem and by putting more money into the hands of people could make it worse by boosting demand in the economy adding to the inflation problem and leading to even higher RBA interest rates and then leave people with less in retirement and not much to show for it. Rather, the focus should be on reducing government spending to make more room for private spending in the economy and boosting productivity with deregulation and tax reform to expand the capacity of the economy to supply goods and services without adding to inflation.

The risk of a correction in shares is high. September has been the weakest month of the year on average over the last 40 years and shares are already down – with US shares down 2.7% from their high last month, global shares down 2.8% and Australian shares down around 5.8%. There are plenty of triggers for a further correction including: rising bond yields at a time when equity risk premiums are low; potential Fed and RBA rate hikes this month; rising oil prices; worries about an AI bubble; and political uncertainty ahead of the US midterms with a Democrat win potentially flagging the risk of US tax hikes. That said, with strong earnings growth we would see any pullback as a correction rather than the start of a new bear market.



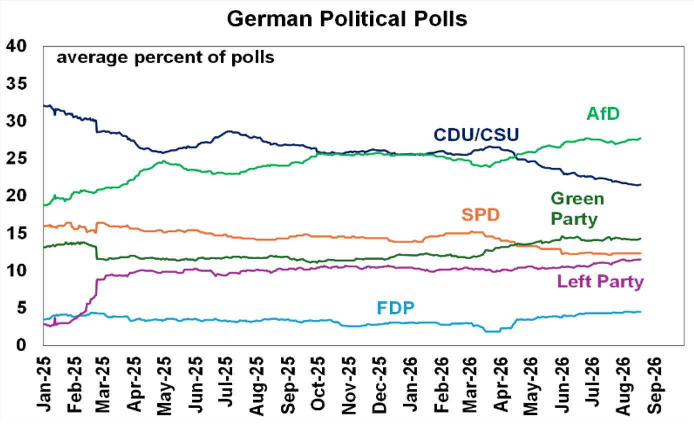
Source: Bloomberg, AMP

Major global economic events and implications

US producer price inflation data for August was in line with expectations at 4.6%yoy for core PPI, but key components that feed into the core private final consumption (PCE) deflator were a bit higher than expected adding to upside risks to the core PCE and hence to the odds of the Fed hiking in the week ahead. Of course, CPI data tonight will be key. Jobless claims remained low.

The ECB hiked rates as expected by 0.25% taking its deposit rate to 2.5% with more hikes likely. Its messaging was hawkish seeing "inflation well above target for an extended period" with inflationary pressures from the Iran War still building and it revised up its inflation and growth forecasts. Another hike is likely by year end.

The success of the far-right populist Alternative for Deutschland in the German state of Saxony-Anhalt highlights the ongoing rise of the populist right but is not a sign of another Eurozone crisis being on the way…well not yet anyway. The AfD is clearly continuing to rise in popularity reflecting cost of living issues and a backlash against high immigration levels. But it needs to be put in context: the AfD is not a Nazi party; Saxony-Anhalt is a middling east German state with East German resentments; the AfD failed to win a majority in the election; it was founded as an alternative to the Euro but around 90% of Germans support the Euro; while the current German government is unpopular the next federal election is not till 2029; the government is likely to respond with more fiscal easing and a further tightening in immigration rules which along with any economic recovery will tend limit support for the AfD more broadly in Germany; and even if the AfD does attain German government it will likely moderate its views a bit like Meloni in Italy. Next year's French election poses a bigger risk regarding threats to the EU and Euro with Le Pen of National Rally being the front runner, but again if she forms government, she will likely soften her views albeit there could still be tensions with the EU in terms of reducing France's budget deficit.



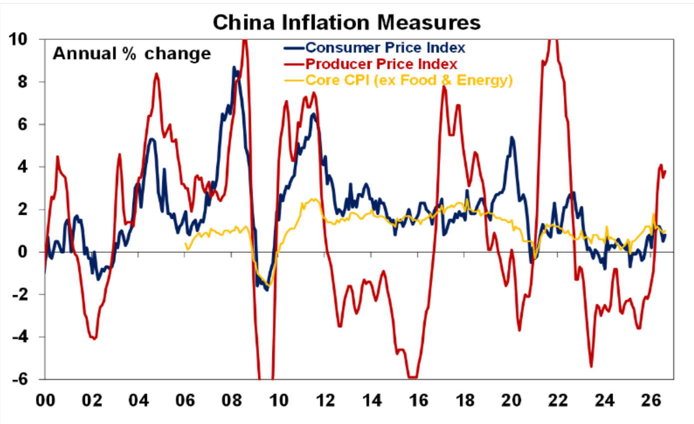
Source: Bloomberg, AMP

Japanese wages growth accelerated to 4.7%yoy consistent with more rate hikes from the BoJ.

Chinese import and export growth remained strong in August. The strength of import growth is surprising given that it would normally suggest strong growth in domestic demand whereas weak retail sales and fixed asset investment suggest softness.

Source: Bloomberg, AMP

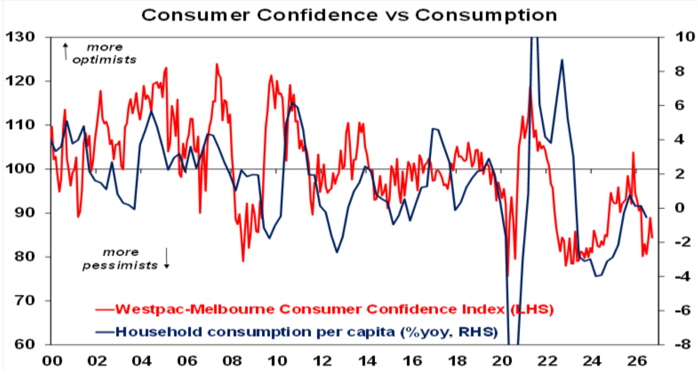
Chinese inflation rose slightly in August largely on the back of higher energy prices, but core CPI inflation also rose but only to 1%yoy.



Source: Bloomberg, AMP

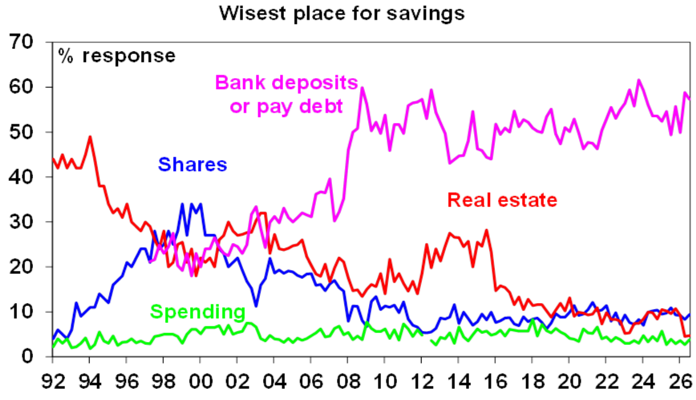
Australian economic events and implications

Consumer confidence fell 5% in September on the back of rate hike talk and higher fuel prices, with the Westpac/Melbourne Institute consumer sentiment index back to a weak level of 84. All components fell with mortgage holders being the group with the biggest fall. Weak confidence is consistent with a slowing ahead in consumer spending.



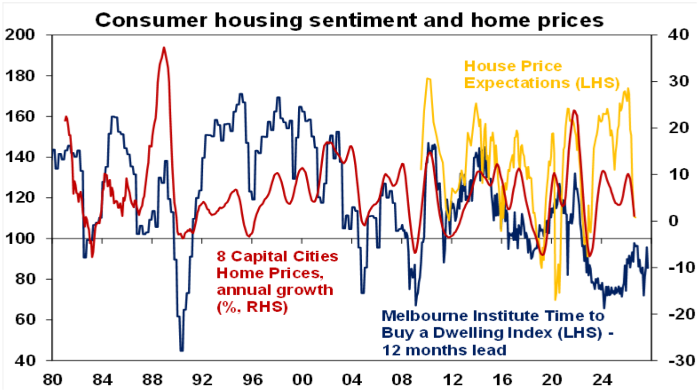
Source: Westpac/Melbourne Institute, AMP

The Westpac/MI consumer survey also showed that consumers remain cautious with their savings preferring paying down debt and bank deposits, with real estate being a less popular destination for savings than shares.



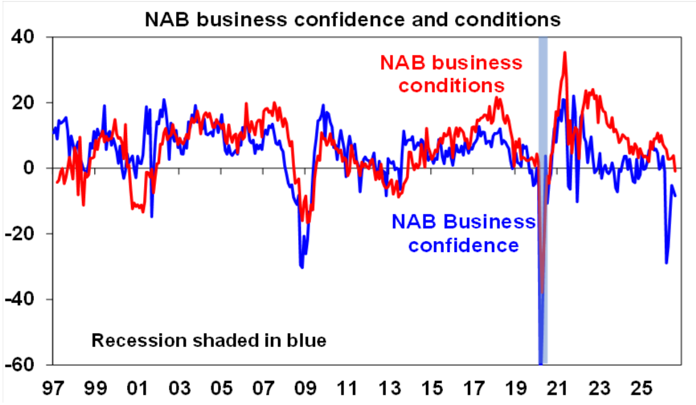
Source: Westpac/Melbourne Institute, AMP

Consumers' expectations for home prices gains fell further as did perceptions as to whether now is a good time to buy a property – albeit it's still up from its lows.



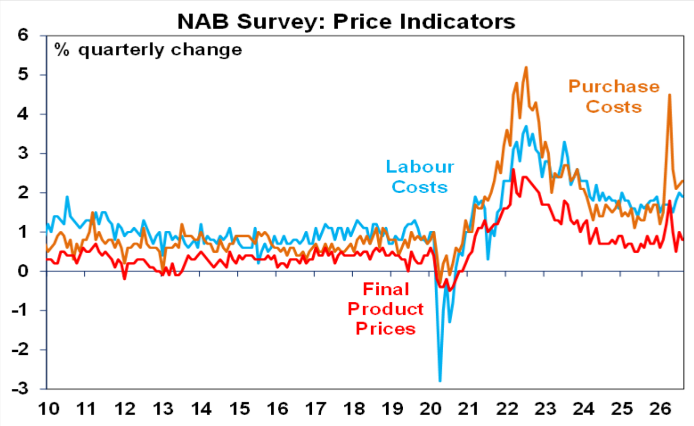
Source: Westpac/Melbourne Institute, Cotality, AMP

The August NAB business survey saw conditions fall to their lowest since the pandemic.



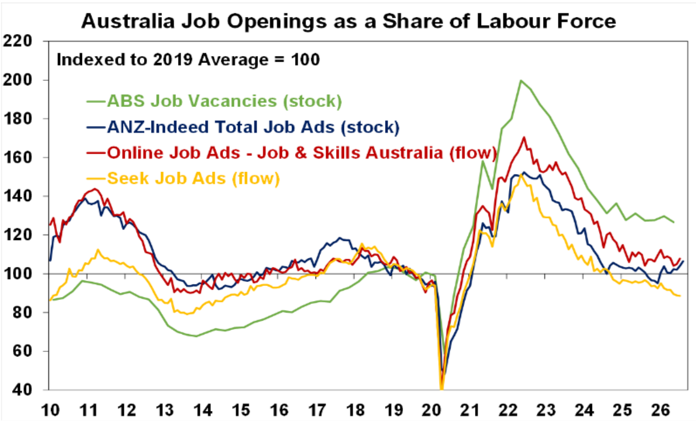
Source: NAB, AMP

Meanwhile, the NAB survey showed that selling prices fell but purchase and labour cost pressures remain elevated posing risks for inflation.



Source: NAB, AMP

Data released over the last week wasn't all weak with ANZ Indeed job ads up again in August and looking like they are on the rise again – which is a bit hard to believe.



Source: Bloomberg, AMP

What to watch over the next week?

Interest rates will likely be the focus over the week ahead with three major central banks meeting: the Fed, the Bank of England and the Bank of Japan.

In the US, the Fed (Wednesday) is likely to hike interest rates by 0.25% taking them from 3.5-3.75% to 3.75-4% on concerns that sticky inflation. But it's a close call depending on August inflation data (to be released this Friday night). Fed officials have been signalling that they need to see a downtrend in inflation to be able to leave rates on hold. In this regard a 0.2%mom rise or less would likely see a hold as it would be consistent with a downtrend in inflation. But 0.25%mom or more rise wouldn't be consistent with a downtrend and would likely result in a hike. Either way the Fed is likely to lean hawkish. On the data front, expect the New York and Philadelphia regional manufacturing indexes to soften but remain solid, retail sales (Wednesday) to show a solid rebound, housing starts (Thursday) to bounce after sharp fall in July & production (Friday) to show a small rise.

Canadian core inflation for August (Monday) is likely to show the underlying measures remaining around 2%yoy.

The Bank of England (Wednesday) is expected to leave rates on hold at 3.75%, although it's likely to warn of upside risks to inflation flowing from ongoing high energy prices. Meanwhile, CPI inflation for August (Wednesday) is likely to remain around 2.9%yoy with core inflation around 2.6%yoy.

The Bank of Japan (Friday) is expected to increase its policy rate from 1% to 1.25% and indicate that further gradual increases are likely with inflation around target. Inflation data for August (Friday) is likely to show a rise in core inflation to 1.4%yoy.

Chinese activity data for August (Tuesday) is likely to have remained soft with industrial production up 4.8%yoy, but retail sales up just 0.8%yoy and investment down 7.3%yoy.

In Australia, parliamentary testimony by RBA Governor Michele Bullock (Friday) will likely reiterate the hawkish signalling from other RBA officials recently with the implication that another rate hike is likely.

Outlook for investment markets

Global and Australian share markets are at risk of a correction given the lack of any resolution to the Iran War and rising oil prices, rising bond yields and stretched valuations, sticky inflation, political uncertainty associated with Trump & the midterm elections and worries about the impact of AI and whether there is an AI bubble. However, returns should still be okay for the next 12 months as a whole thanks to continuing economic growth with recession avoided and strong global profit growth and likely rate cuts next year.

Bonds are likely to see subdued returns.

Unlisted commercial property returns are likely to be solid helped by strong demand for industrial property associated with data centres.

Australian home prices are expected to fall around 10% top to bottom, of which they have already done 3.6%, out to the June quarter next year as a result of poor affordability, RBA rate hikes, reduced investor demand flowing from the winding back of negative gearing and the capital gains tax discount and poor confidence.

Cash and bank deposits are expected to provide returns around 4-5%.

The $A is likely to rise reflecting the wider interest rate differential to the US, although a move to Fed hikes may limit this. Fair value for the $A is around $US0.72.