The Encyclical

December Quarter 2025

To: Our Professional and Wholesale Investors - Not for Retail Distribution

Market Review & Strategy

International equity markets mostly finished the December quarter in the black. Momentum clearly supported European and emerging market stocks over US shares, the latter fatigued post the breakneck rally from the deferral of Liberation Day on April 9.

The US treasury yield curve steepened appreciably over the three months to December on expectations that the Federal Reserve had further rate cuts planned, coincident with a material expansion in ten-year bond term premia. This came about as bond investors began to discount recent heavy bond issuance, mounting concerns around Fed independence and an emerging 'higher-for-longer' rate narrative.

The FT reported the value of global dealmaking at USD4tn for 2025, the biggest since 2021 and the second highest in 40 years.[1] Worldwide M&A increased by +50% from 2024 levels the paper also offered.[2]

A risk-off mood pervaded in the early weeks of October with an upward spike in US credit spreads, coupled with freshly hiked China tariffs and new export controls on critical US software. Concerns around regional bank credit quality resurfaced and cryptocurrencies began their *bitcoin winter,* with outsized long liquidations and record digital asset ETF outflows (USD$3.5bn in November) being recorded.

Locally, the ASX annual general meeting season dominated news flow for much of the period in review. Most trading commentaries either met or modestly bettered expectations, resulting in net upgrades to earnings estimates for FY26 although membership of the much spurned *second-half club* (companies with a disproportionate H2 FY2026 profit skew) did swell. Share price volatility throughout the season was more extreme than normal.

Many of Australia's listed IT names fared poorly in the three months to December end, with the relatively new-fledged benchmark, the S&P/ASX All Technology Index, -20% for the period. The rub-off effect of US investor concerns around AI company valuations, AI capex intentions, voracious debt issuance and the growing prevalence of 'circular financing loops' (Chip makers funding AI start-ups to underwrite prospective sales) took their toll as did several dispiriting quarterly/interim results and AGM updates.

ASX corporate activity cooled somewhat from the prior two quarters pace. Macquarie Asset Management bid for **Qube Holdings**, Brookfield/GIC jointly bid for **National Storage** and **Helloworld** approached **Webje**t. **Credit Corp** made a $385m bid for **Humm Group** and **Embark Early Education** moved on **Mayfield Childcare** late in the quarter.

1 Financial Times 28 December 2025
2 Financial Times 28 December 2025

US pharma company Cosette's bid for **Mayne Pharma** (MYX) became a fiasco of epic scale. Cosette's attempts to withdraw their takeover bid post a disappointing MYX result, were blocked by the Takeovers Panel and the NSW Supreme Court. Artful threats to close plants and shed jobs by the suitor invoked the ire of politicians and FIRB, resulting in the bid being outlawed on national interest grounds.

On the ECM front, **Eagers Automotive** raised $502m to acquire CanadaOne, one of Canada's biggest auto groups and **Megaport** $200m to fund an acquisition, expanding its network into India. Development hopefuls in the resources space capitalised on improving sentiment. Most notably, **Arafura Rare Earths** raised $525m via a two-tranche placement and SPP ahead of FID for its Nolans Rare Earths project, supported by Hancock Prospecting emerging as a 15.7% shareholder post transaction. **Rox Resources** raised $200m for the development of its Youanmi gold project.

Orion Mine Finance progressively sold their 7.3% stake in **Capstone Copper Corporation**, the CSIRO sold down its significant shareholding in **Chrysos Corporation** and **Qualitas** cofounder, Andrew Schwartz sold a 5% stake in the company.

The initial public offering market remains fragile with only one in three recent debutantes trading above issue price at the time of writing. The quandary appears to be less about buyer participation and more about offer quality/pricing and thematic relevance. Take the unlisted **Firmus Technologies** as a case in point. Firmus develops and operates AI infrastructure assets and deploys various proprietorial energy/cooling technologies. The public market aspirant raised $330m in a series 1 equity funding round in September, marking the largest pre-IPO raise in ASX history. In December, Firmus backed up again and raised ~ $500m in a series 2 preference share offering. Lead brokers to the transaction report being besieged with interest. The company intends to come to market in early 2026.

Technical Summary

Stocks

Post meandering price action during the December quarter, but firmly in obeyance of the primary uptrend, the **S&P 500** seems poised for a mild retracement to ~ 6520. An unfolding *rising wedge* formation underway since November suggests as much. A similar set-up is also appearing for the **S&P 100**. A modest reset in stock prices would not be a bad thing but I am reminded of the *January effect* on US stocks of how January trades so goes the market for ensuing 12 months. CFTC data highlights a small net short position in S&P 500 E-mini futures, a little smaller than that seen at September quarter end.

Both the **NASDAQ Composite** and the **NASDAQ 100** saw historic highs struck in late October, with a recent run of lower highs suggestive of investor fatigue. Net long trader positioning, common for this contract since mid 2024, dropped sharply coming to the close of December, suggestive of profits taken by traders. It is worth recognizing the unsung hero of the NASDAQ market must surely be the biotech sector with the **NASDAQ Biotech Index**, trading at historic highs in December and a decisive year over year outperformer, +32% versus +20.4% for the general index. A similar showing on display among Russell small cap stocks with the Russell 2000 +11% versus +44% for biotech names.

The improving stock participation in the major indices advance is now widening to take in US mid and small cap companies and accordingly they have commenced 2026 strongly.

Emerging markets had a buoyant 2025 with the **MSCI EM Index** closing in on the historic highs of March 2021. It is interesting to see this rally extend without the backing of a US dollar sell-off. For China bulls it is exciting to observe the **Shanghai Composite Index** on the cusp of breaking clear of a downtrend line that has checked share prices decisively since December 2007.

Locally, the **All Ordinaries Index** chalked up all-time highs in early October only to yield to profit-taking quickly thereafter. Despite a creditable performance from ASX 20 names, the main area of investor interest continues to be in mid, small and micro-cap indices, with resource constituents dominating their performance.

The S&P/ASX Small Ordinaries is now within striking distance of 4176; its December 2007 high. The Williams %R oscillator has spent most of the year firmly camped in the extreme overbought 'red' zone, which should be read positively: One of *The Encyclical*'s most trusted sentiment indications (extreme overbought is bullish and vice versa). Index breadth is supportive at 51.5% of names above the 100 day moving average, well shy of the euphoric end of September quarter readings of 70%.

The **ASX Mid Cap 50 Index** rallied effortlessly to new highs during the period in review and its current corrective mode appears sticky-downward to the author. Our conviction remains high here.

ASX Emerging Companies Index continues to enjoy the updraft in micro-cap company stock prices and is now trading in unchartered waters.

Commodities/Currencies

The chart of the **AUDUSD** continues to gladden the heart following a noteworthy break of a valid downtrend line originating from February 2021, a line that has checked all attempts at rallying.

Regular readers of *The Encyclical* will recall my fondness for cross-rates when assessing the strength of a particular currency. In this case I reviewed the technical merit, or otherwise, of the AUD expressed in NZD, Yen, British pound, Singapore dollar and the Swiss Franc. In each instance the unit is either rebounding from long term support (in the case of the GBP), trying to clear a multi-year, hidebound base (against the Yen and Kiwi) or in the throws of challenging a multi-year downtrend line (in the case of the Singapore dollar and Swiss Franc). In summary, the technical set-up looks very enticing.

Aussie dollar Futures positioning on the CME remains net short but notably lower than previous quarters end, suggesting a progressive winding back of the bet against the *Pacific peso*.

Gold continues with its all-too-familiar price action, with occasional retracements presenting investors with opportune buy set-ups. Investor positioning is incrementally longer than it was at September quarter end (6.2:1 v 5:1 long) but well shy of 8:1 positioning seen in December 2024. It remains one of financial markets most powerful and enduring uptrends and must be respected. It is timely to mention that **Platinum** and **Palladium** found their feet during the quarter and outpaced golds performance.

For **silver** bulls your patience has been rewarded and in spectacular fashion. *The Encyclical* has proffered that a convincing break of the multi-decade highs of ~USD50.00/oz would make for a powerful move. By December end the metal had touched USD84.00/oz before settling back at USD71.66/oz. Technicians will have spotted the textbook *key reversal* pattern accompanying the late December surge. This sounds a cautious clarion to traders so managing positions here moving forward will require diligence. Silver equities have fared nicely with the trend channel breach of the **Global X Silver Miners ETF** in September validated in subsequent weeks.

It was amusing to read recently that the German Treasury has cancelled the issue of the eagerly awaited '3 Wise Men' commemorative silver coins because the rally in the price of silver renders the coins uneconomic for the government to proceed with the coinage.

The Log – Some thoughts on the active versus passive debate

In Sharpe's "Arithmetic of Active Management", he discussed the implications of this insight:

$$Market\ return = Passive\ return\ \ so\ Active\ Return < 0\ after\ costs$$

Put differently, if the market consists of two categories: passive and active, and passive returns are the same as the market, then the aggregate active return must be zero (and less than zero after costs and fees) for the arithmetic to hold. But some practical issues (also addressed in Sharpe's article) are 1) the index funds used to target passive returns do not perfectly replicate the market, 2) different types of active investors exist within the "active return" group, and 3) the size of each active investor matters.

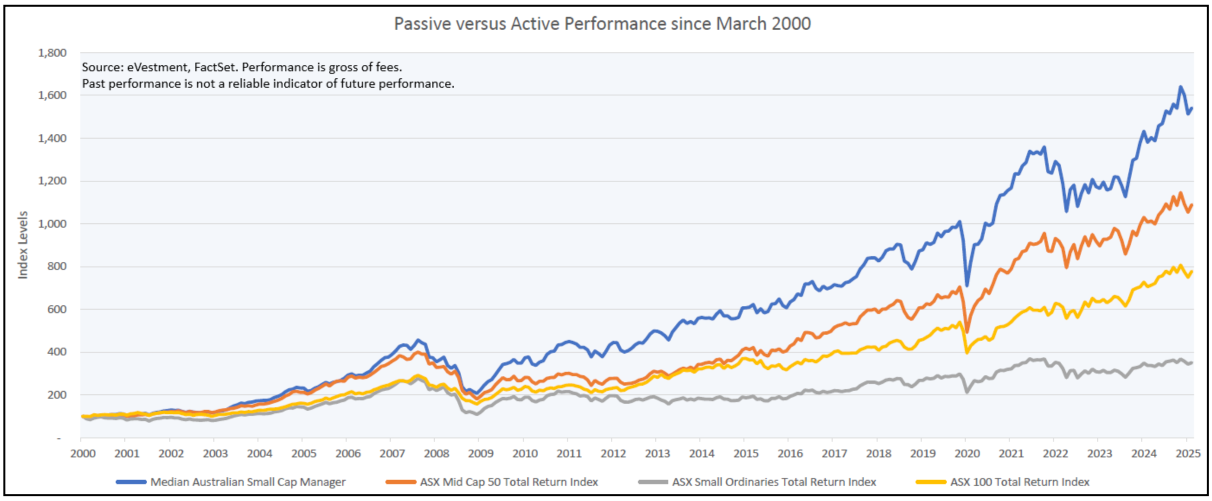
On #1, index funds follow index inclusion rules and typically do not have access to IPOs until they are added to the index. This limitation means passive investors will miss out on ex-index sources of return, like IPOs, which an active manager may be able to access.

On #2, we could expand on Sharpe's insight above (using weighted aggregate returns):

$$Active\ return = Delegated\ institution\ return + Non\ delegated\ institution\ return + Retail\ return$$

Research undertaken by Gerakos, Linnainmaa and Morse, found that **delegated** institutional capital (**mandates** managed by active managers for asset owners) earned a statistically significant positive net alpha over the sample period[3]. The point is to highlight that there are groups within the broader category of all active managers that have a history of outperforming. Future research may find it worth refining or redefining these categories further. This exercise could be done for different markets. For example, in Australia, the median small cap manager has significantly outperformed the Small Ords since its creation (see chart below).

[3] The sample period was January 2000 to June 2012. The implication is that non-delegated institutions and retail underperformed on a combined basis. One possible interpretation of this result is that delegated institutions may have more skill and/or a greater incentive to outperform.



On #3, the larger an active manager becomes, the more like the benchmark their returns will become because capacity constraints force them to hold larger more liquid stocks, which have more weight in a cap-weighted market index. Hence, another point is that an active manager that has not grown too large, is more likely to outperform the market than a large one.[4]

A great irony in the rise of passive investing is that it makes the market less efficient and thereby increases the opportunity for active managers to outperform. Indeed, in an article titled The Less-Efficient Market Hypothesis, Cliff Asness pointed out that he thought the market had become less efficient during his 30+ year career. The three main reasons he gave were very low interest rates (sustaining extreme valuations), tech/social media + gamified trading amplifying mispricing (e.g. meme stocks) and finally - you guessed it - the rise of indexing.

Outlook

"*It's always been best on these occasions to do what the mob do*". "*But suppose there are two mobs*?" suggested Mr. Snodgrass. "*Shout with the largest*" replied Mr. Pickwick, from Charles Dickens, The Pickwick Papers.[5]

That timeless exchange might easily sum up where investors find themselves right now in markets.

The bull mob will call out the US Federal Reserve as not yet done easing rates, with 0.75% expendable on the path to the neutral rate, theorized at around 3%.

FactSet consensus for 2026 S&P500 earnings growth sits around 15% with economic catalysts including imminent outsized tax refunds, trickle-down from the One Big Beautiful Bill and continuing AI capex with all its multipliers. Operating leverage should also enhance earnings outcome.

The bear mob will tell you that there are no Wall Street bears left, with the whole street shooting for higher stock prices in 2026 and with no less than 3 banks are now calling for the S&P500 to be 8000 by year end. Mid-term election years, where we now find ourselves, are traditionally problematic for stocks.

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[4] An important caveat is the manager has skill, or they are just as likely to underperform as outperform.

[5] Investing with Keynes, Justyn Walsh, 2021

The AI phenomena has rallied stocks into bubble territory, with comparisons with the late 1990's regularly featured in financial press. Famed trader Michael Burry has recently disclosed a short position in Nvidia because he believes AI Capex to be inherently unprofitable.

It is indubitable that the primary trend for US stocks is upwards with improving breadth (stock participation) and elevated (but not frenzied) investor animal spirits. Credit spreads, credit default swaps and the Morningstar Leveraged Loans Index are quiescent and provide the requisite backdrop for stocks to extend their rally.

The trade-off of stocks versus bonds, or the equity risk premium, is uncomfortably narrow but less of an issue if the S&P500 delivers 15% earnings growth in 2026 following on from two years of low teens growth.

Australian small caps continue to fare well, small resource companies especially so. The earnings outlook is more certain post recent AGM updates and largely inure to any modest upward adjustment to cash rates that might be ahead in 2026.

Investors are reminded to keep a *weather eye* on the Australian dollar for hints as to the vitality of small company outperformance.