

INVESTMENT STRATEGY AND INTEREST RATE ANALYSIS

Are We There Yet?

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COMMENTS

The closure of the Strait of Hormuz for almost four months is a reminder that the global economy's most efficient supply chains are often the most fragile. The world has not simply become less connected—it has become more aware that connection creates leverage. For decades, markets rewarded global integration because it improved efficiency. But sentiment is shifting. Resilience, redundancy and control are becoming more valuable in a geopolitical environment where chokepoints can quickly become sources of macro risk. For investors, this means regional diversification is no longer enough. Portfolios need to be screened not only by geography, sector and factor exposure, but also by where assets sit relative to critical networks and chokepoints. While commodity exposure remains key, network dependence is becoming just as important.

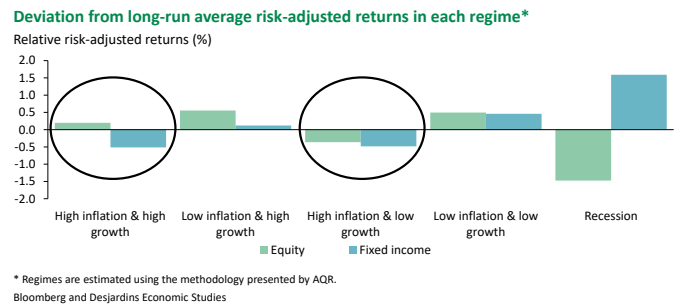
In that sense, “Are we there yet?” isn’t simply a question about whether the energy shock has peaked, it’s a question about whether markets have fully priced the cost of moving from efficiency to resilience. The answer, in our view, is not yet.

ECONOMIC TRENDS AND INTEREST RATES

Resilience is not free, and that makes the implications of this shift uncomfortable for fixed income. A world built around efficiency was disinflationary at the margin. The transition to a world built around resilience may be inflationary. Redundancy requires higher inventories, duplicated supply chains, strategic reserves, defence spending, energy security investment and infrastructure buildout. While these may reduce vulnerabilities over time, they will be expensive and they add to a growing list of concerns facing fixed income. The result is a growth and inflation mix that is less favourable for bonds, making a return to the pre-pandemic regime unlikely (graph 1).

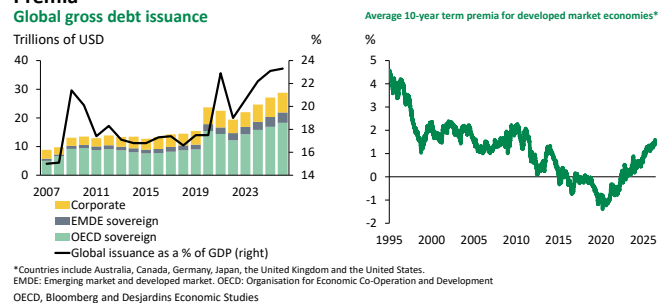
Increased issuance is contributing to a structural rise in term premia. 2026 is expected to bring a record amount of gross bond issuance (graph 2, left). Governments are also

Graph 1
Higher Inflation Regimes Tend to Weigh on Fixed Income Returns



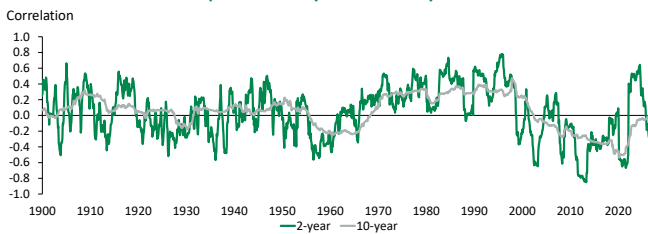
adjusting original funding plans in response to changing financing needs and shifting demand dynamics. At the same time, central banks are absorbing a smaller share of supply, leaving more duration for price-sensitive investors. As supply rises and central banks step back, markets are likely to put a higher premium on sovereigns that can fund resilience without raising fiscal sustainability concerns. These forces should continue to put upward pressure on term premia and make long-term rates less likely to follow movements at the front end of the yield curve (graph 2, right).

Graph 2
Rising Debt Issuance Should Put Upward Pressure on Global Term Premia



Fixed income still serves a role in portfolios, but that role has shifted. Long-term bond investors are being asked to absorb surging supply, inflation uncertainty and growth shocks simultaneously. Which risk dominates depends on the macro regime, helping explain why the correlation between stocks and bonds has become less stable (graph 3). The traditional hedging properties of fixed income should return in a sufficiently large growth shock, but in a world of more frequent supply constraints the size of the shock needed is likely larger today than it was before the pandemic.

Graph 3
Stock–Bond Correlations Have Been Much Less Stable in the Post-Pandemic Period
 Correlations between US equities and 10-year US Treasury returns



Yale University and Desjardins Economic Studies

This more complicated fixed income backdrop is contributing to central bank divergence. The energy shock is global, but the pressure points are local. Inflation and monetary policy starting points, energy import dependence, currency sensitivity, fiscal capacity and domestic slack all differ across jurisdictions. That has pushed some central banks like the RBA, Norges Bank and the ECB to raise rates proactively.

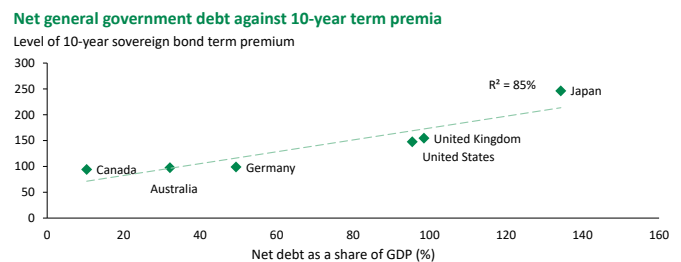
Others have been more willing to wait. The Bank of Canada held rates steady in June, pointing to weak domestic activity and limited evidence of broad-based pass-through from higher energy prices to underlying inflation. The Federal Reserve is undergoing more structural shifts but also appears more inclined to remain on hold. Our expectations are unchanged that both the Bank of Canada and Federal Reserve make no changes to their policy rates this year.

Monetary policy divergence may be more persistent barring a large growth shock. Before the pandemic, central banks were often pulled in the same direction by common demand shocks. In the current environment, common supply shocks can push central banks in different directions because the transmission mechanism varies by region, as does the fiscal response. Put simply, investors need to be more selective about which countries' bonds they own. For fixed income, the question is no longer just about growth, but also which economies are most exposed to critical chokepoints, and which have the credibility, fiscal capacity and strategic flexibility to reduce those

vulnerabilities. That means looking at whether institutions can deliver on their mandates, governments have room to spend if needed and countries can adapt by finding new trade partners and alternative sources of energy and materials.

Has the fixed income market fully priced these nuances? Not yet. Investors have become more attuned to fiscal capacity, and countries with less of it tend to carry more term premia (graph 4). Foreign flows also suggest investors are behaving in a way that is consistent with fiscal capacity becoming a key variable, particularly where lower debt levels and stronger institutional credibility make it easier for markets to absorb incoming bond supply.

Graph 4
Term Premia Are Higher in Countries with Larger Net Debt Levels



Net debt as a share of GDP estimates for 2026 from the IMF Fiscal Monitor.
 Level of term premia as of June 2026.
 IMF, Bloomberg and Desjardins Economic Studies

EXCHANGE RATE

That distinction between fiscal vulnerability and strategic relevance matters most when thinking about US assets.

American markets are the largest and most liquid in the world, but Treasuries are being evaluated through a less forgiving lens. Larger deficits, heavy issuance and US dollar-related sanctions are some reasons why foreign investors are shying away from US Treasuries (graph 5 on page 3, left). Central bank reserve diversification, including the rising role of gold, reinforces that point. But on the other side, the dollar is still being supported by capital flows into US equities (graph 5 on page 3, right). While some foreign investors have reduced enthusiasm for US duration, their appetite for US assets overall remains strong.

So, are we set for further US dollar weakness? Not in the short term. Official accounts, which include central banks, public pensions and some sovereign wealth funds, may be diversifying away from Treasuries at the margin, but global investors are still allocating toward US equity exposure because the US remains central to AI networks. Until that support for stocks fades, another decisive leg lower in the greenback may be difficult to sustain. It is more likely that the US dollar trades in a range throughout the summer before weakening further next year.

Table 1
Retail Rate Forecasts

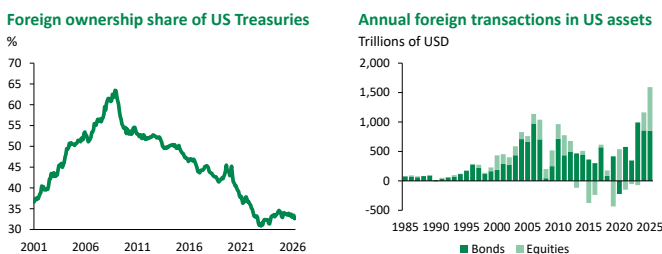
%	Discount rate	Prime rate	Mortgage rate			Term savings*		
			1-year	3-year	5-year	1-year	3-year	5-year
Realized								
<u>End of month</u>								
November 2025	3.00	4.95	5.84	6.05	6.09	2.45	2.45	2.75
December 2025	2.75	4.70	5.84	6.05	6.09	2.45	2.52	2.75
January 2026	2.50	4.45	5.84	6.05	6.09	2.45	2.52	2.75
February 2026	2.50	4.45	5.84	6.05	6.09	2.45	2.45	2.75
March 2026	2.50	4.45	5.49	6.05	6.09	2.45	2.52	2.75
April 2026	2.50	4.45	5.49	6.05	6.09	2.70	2.75	2.75
May 2026	2.50	4.45	5.49	6.05	6.09	2.70	2.75	2.75
Forecast								
<u>End of quarter</u>								
Q2 2026	2.50	4.45	5.49	6.05	6.09	2.70	2.55	2.75
Q3 2026	2.50	4.45	5.45	5.85	5.95	2.70	2.55	2.80
Q4 2026	2.50	4.45	5.40	5.65	5.85	2.70	2.55	2.85
Q1 2027	2.50	4.45	5.35	5.75	5.75	2.70	2.60	2.90
<u>End of year</u>								
2026	2.50	4.45	5.40	5.65	5.85	2.70	2.55	2.85
2027	3.00	4.95	5.20	5.40	5.60	2.70	2.75	3.05
2028	3.00	4.95	5.10	5.20	5.40	2.70	2.75	3.05

* Non-redeemable (annual).

NOTE: Retail rate forecasts are based on the historical relationship between retail rates and the borrowing costs of Canadian financial institutions and do not reflect the pricing strategies of Desjardins Group.

Bank of Canada and Desjardins Economic Studies

Graph 5
Foreign Investors Are Stepping Away from US Bonds and Buying Stocks



TIC, U.S. Department of the Treasury and Desjardins Economic Studies

EQUITIES AND CREDIT

If bond markets are starting to price the cost of resilience, equity markets are paying for its winners. In fixed income, investors are demanding more compensation for a myriad of factors tied to resilience. In stocks, investors are more willing to accept concentration risk when that concentration is backed by strong earnings projections and exposure to critical networks. This is most obvious in the US, where technology-related ecosystems continue to dominate index-level earnings and prices (graph 6 on page 4). But this setup comes with risk. Equity gains remain highly concentrated, and while valuations have improved, there isn't much room for disappointment.

For the Canadian dollar, the biggest risk remains the CUSMA negotiations this summer. With the July 1 deadline unlikely to deliver an extension of the agreement, negotiations could persist for some time. That should keep the loonie under pressure over the summer. But if negotiations eventually move toward a more stable framework, the Canadian dollar should be able to finish the year stronger.

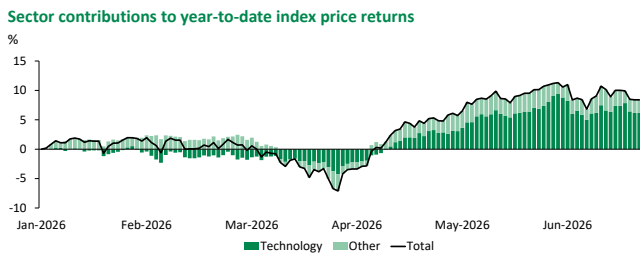
Table 2
Currency Forecasts

End of period	2024		2025				2026				2027
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	Q1f
C\$/US\$	1.35	1.44	1.44	1.36	1.39	1.40	1.37	1.38	1.39	1.38	1.34
US\$/C\$	0.74	0.70	0.70	0.73	0.72	0.71	0.73	0.72	0.72	0.72	0.75
C\$/€	1.51	1.49	1.55	1.60	1.63	1.62	1.62	1.59	1.60	1.63	1.63
US\$/€	1.12	1.04	1.08	1.17	1.17	1.16	1.18	1.15	1.15	1.18	1.22
US\$/£	1.34	1.25	1.29	1.37	1.34	1.32	1.34	1.28	1.30	1.30	1.35

f: forecast

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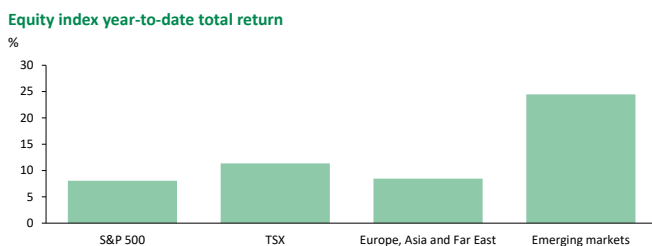
Graph 6
The Technology Sector Is Driving Returns in the S&P 500



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But this is not only a US story. Taiwan and Korea have helped drive emerging market (EM) outperformance because they sit at the centre of the AI hardware cycle, while China remains strategically important through its dominance in rare earths, batteries and industrial supply chains (graph 7). Emerging markets increasingly offer exposure to critical nodes in the global investment cycle rather than generic market exposure, which reduces some of the diversification benefit. EM has outperformed, but that outperformance has become more dependent on the same AI capex cycle supporting US equities.

Graph 7
Emerging Market Indices Are Outperforming This Year



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Europe is not the best place to get exposure to companies at the centre of today's most important global networks, but it still serves as a useful hedge. The region is more exposed to the energy shock and has less direct exposure to the AI hardware and platform networks that investors are currently rewarding. But this is also where the diversification trade-off becomes important. Europe can provide a ballast if concentration risk becomes a problem. Parts of the European market still benefit from the resilience theme through expanded infrastructure spending, and those sectors have been attracting capital.

Canada also serves as a hedge, but not a clean one. The TSX's heavy exposure to financials, energy and materials gives it a different return profile than US or North Asian equity markets. The market benefits from many of the inputs needed to build resilience, including energy, metals and financial intermediation. But those advantages do not fully insulate Canadian equities from soft domestic growth or US trade uncertainty, both of which could inject volatility over the coming months.

Credit markets are telling a similar story. AI-related issuance has already surpassed last year's total, and while technology spreads have underperformed relative to other sectors, they remain historically tight. Investors are still willing to absorb supply when it's linked to the AI infrastructure buildout (graph 8).

Graph 8
Tech Sector Bond Spreads Have Been Rangebound Despite Increased Issuance



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In Canada, hyperscaler issuance has pushed corporate supply well ahead of last year's pace, while provincial borrowers have continued to issue more abroad, reducing their share of outstanding Canadian dollar supply. We remain relatively neutral on corporate spreads more broadly.

So, has risk sentiment reached a tipping point? We aren't quite there yet. Speculative rallies typically end when growth disappoints, issuance becomes excessive or monetary policy tightens enough to challenge the underlying narrative. None of those conditions fully describes the current environment. Growth has slowed but not to concerning levels, issuance is rising but not yet extreme, and central banks are cautiously hawkish rather than turning aggressively restrictive. Still, each risk looks closer than it did a few months ago. The network premium can continue to support equities, but the cushion is thinner. Investors are still being rewarded for owning critical networks, but the market is becoming more vulnerable to disappointment if AI expectations are cut, fewer companies see their profit outlooks improve or growth slows more decisively.

Table 3
Asset Class Returns (%)

End of year	Cash	Bonds	Canadian stocks	US stocks	International stocks	Exchange rate
	3-month T-bill	Bond index*	S&P/TSX Index [^]	S&P 500 Index (US\$) [^]	MSCI EAFE Index (US\$) [^]	C\$/US\$ (% change) [†]
2014	0.9	8.8	10.6	13.7	-4.5	9.4
2015	0.5	3.5	-8.3	1.4	-0.4	19.1
2016	0.5	1.7	21.1	12.0	1.5	-2.9
2017	1.1	2.5	9.1	21.8	25.6	-6.4
2018	1.7	1.4	-8.9	-4.4	-13.4	8.4
2019	1.7	6.9	22.9	31.5	22.7	-4.8
2020	0.1	8.7	5.6	18.4	8.3	-2.0
2021	0.2	-2.5	25.1	28.7	11.8	-0.8
2022	4.3	-11.7	-5.8	-18.1	-14.0	7.2
2023	5.1	6.7	11.8	26.3	18.9	-2.2
2024	3.1	4.2	21.7	25.0	4.3	8.6
2025	2.5	2.6	31.7	17.9	32.0	-4.6
2026 forecast	2.3	2.8	14.5	15.0	11.0	-0.7
Range	1.5 to 3.0	1.0 to 5.2	0 to 20.0	0 to 22.0	-3.0 to 16.0	-5.0 to 1.0
2027 forecast	2.6	4.2	13.0	13.0	9.4	3.0
Range	1.8 to 3.5	2.0 to 7.0	-5.0 to 20.0	-5.0 to 20.0	-5.0 to 18.0	-3.0 to 4.5

* FTSE Canada Universe Bond Index

[^] Dividends included

[†] Negative = appreciation, positive = depreciation.

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