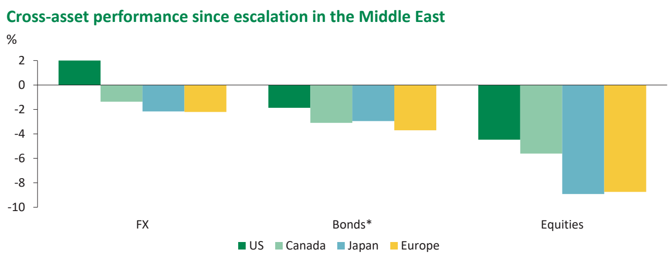
INVESTMENT STRATEGY AND INTEREST RATE ANALYSIS

Diverging Fortunes

By Jimmy Jean, Vice-President, Chief Economist and Strategist,
Tiago Figueiredo, Macro Strategist, and Oskar Stone, Macro Strategy Associate

Today's increasingly shock-prone world is delivering the volatility we anticipated, albeit for different reasons than expected. The latest surge in energy prices hit assets and regions unevenly. Markets are reading it through a terms-of-trade lens—rewarding energy exporters and penalizing energy importers. North America, with ample domestic supply, has held up better, while Europe and much of Asia, which rely more on imported energy, have lagged (graph 1).

Graph 1
North American Assets Have Outperformed in March



* German bonds are used for Europe.
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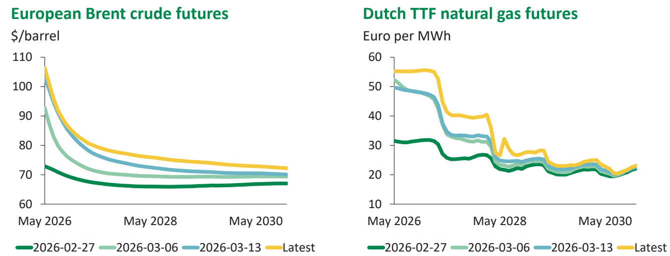
The market is trading on inflation and under-pricing growth risks. Across jurisdictions, front-end rates have repriced sharply—led by Europe—as investors have moved from expecting cuts to pricing in multiple hikes later this year. While the first-order effects are inflationary, a longer-lasting disruption would increasingly threaten economic growth through higher costs and tighter financial conditions. Our base case still leans toward de-escalation, but recent strikes on Gulf energy infrastructure raise the possibility that disruptions extend beyond shipping through the Strait of Hormuz (graph 2).

Graph 2
Futures Are Now Pricing in Longer Disruptions in Energy Markets



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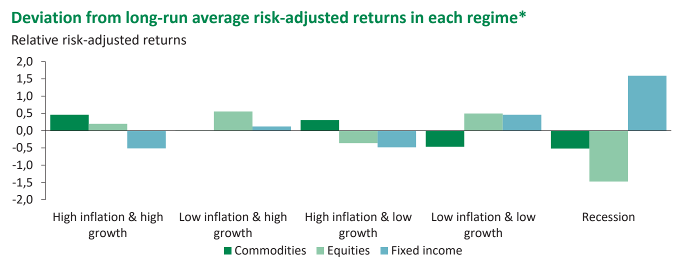
From here, the paths forward are varied and wide-ranging. To anchor our views, we introduce a regime classification framework and compare risk-adjusted returns across assets against their long-run averages (graph 3). What comes next is uncertain. But with recession risks rising, we see asymmetric downside in equities and upside in fixed income.

Graph 3
The Path Forward Is Unclear, but Risks Skew in Favour of Fixed Income



* Regimes are estimated using the methodology presented by AQR.
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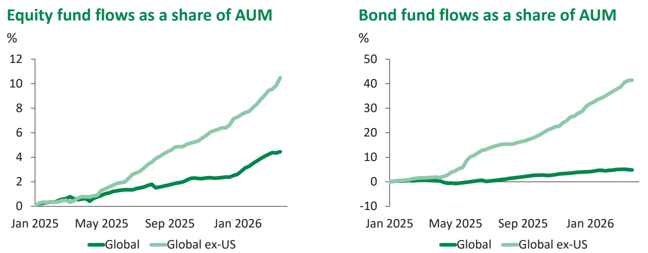
What hasn't changed is our view that investors continue to diversify away from US assets. Indeed, global ex-US equity and bond funds continue to attract capital (graph 4). That said, Europe now faces stiffer headwinds, and further disruptions in energy may delay the ongoing rotation.

Graph 4
The Rotation Away from US Assets Is Still Underway



AUM = Assets under management
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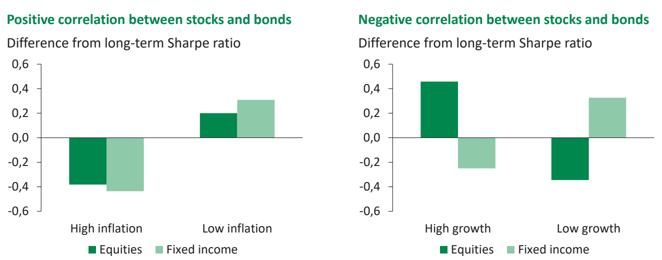
ECONOMIC TRENDS AND INTEREST RATES

Longer-term bonds are a good hedge for any future growth shock. Inflation-led episodes can weigh on bond returns, but when the growth impulse weakens, fixed income typically outperforms (graph 5). Absent further escalation, the bias is for yields to drift lower from their currently high starting point. If tensions do escalate, the path won't be linear. In fact, an initial inflation pop can cheapen bonds. But as growth concerns build, we believe that fixed income should ultimately outperform.

Graph 5
Negative Growth Shocks Tend to Pull Fixed Income Higher



Regimes are classified using the AQR methodology.
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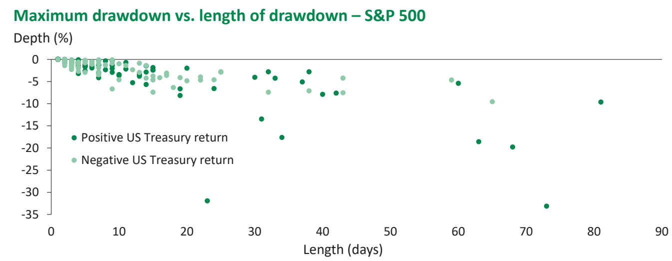
The role of bonds in portfolios has shifted: stock–bond correlations are no longer reliably negative, and yields are higher and provide more income. More importantly, duration still provides an offset to steep drawdowns in equities (graph 6).

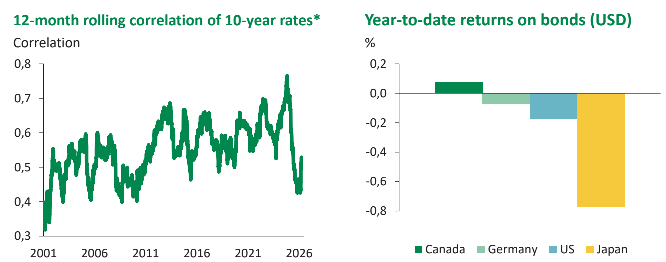
Graph 6
Large and Sharp Stock Selloffs Result in Positive Bond Returns



The colours indicate whether US Treasury returns over that period were positive or negative.
Datastream and Desjardins Economic Studies

A common global factor is driving rates, but diversification within bonds remains important. Since the Iran shock, major yields have moved in tandem and curves have flattened (graph 7). Energy prices will likely dominate the near-term path for duration, but as the shock fades, markets should re-sort fixed income by fundamentals, creating more cross-market dispersion even if geopolitical noise persists.

Graph 7
Correlations Within Fixed Income Are Rising



* Average pairwise correlation across Japan, the UK, the US, Canada and Germany.
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A re-steepening of yield curves is likely, but it will be uneven and non-linear. The extent will vary by region. Europe's high inflation pass-through will keep its front end stuck higher, whereas North America is more energy independent. As a result, fixed income markets here can pivot sooner as growth risks emerge.

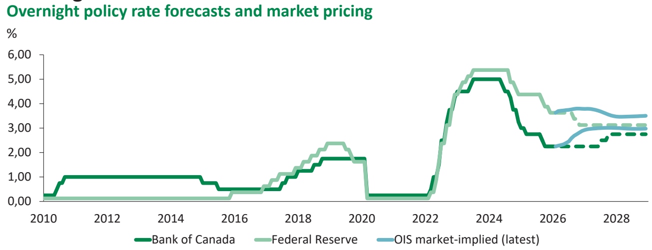
The Bank of Canada has the greatest flexibility among major central banks. With headline inflation close to target, economic activity weak and energy holding a lower-than-average weight in Canada's CPI basket, the risk of broader inflation spillovers is limited, allowing Canadian policymakers to remain patient. The market is pricing in more than two rate hikes this year, which we believe is too many (graph 8 on page 3).

Table 1
Retail Rate Forecasts

%	Discount rate	Prime rate	Mortgage rate 1-year	Mortgage rate 3-year	Mortgage rate 5-year	Term savings* 1-year	Term savings* 3-year	Term savings* 5-year
Realized								
End of month								
August 2025	3.00	4.95	6.09	6.05	6.09	2.62	2.67	2.90
September 2025	3.00	4.95	6.09	6.05	6.09	2.62	2.67	2.90
October 2025	2.75	4.70	6.09	6.05	6.09	2.62	2.67	2.90
November 2025	2.50	4.45	6.09	6.05	6.09	2.62	2.67	2.90
December 2025	2.50	4.45	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
Forecast								
End of quarter								
Q1 2026	2.50	4.45	5.85	6.05	6.10	2.45	2.50	2.75
Q2 2026	2.50	4.45	5.75	5.85	5.95	2.50	2.60	2.80
Q3 2026	2.50	4.45	5.65	5.75	5.85	2.55	2.65	2.85
Q4 2026	2.50	4.45	5.55	5.65	5.75	2.60	2.70	2.90
End of year								
2026	2.50	4.45	5.55	5.65	5.75	2.60	2.70	2.90
2027	3.00	4.95	5.20	5.40	5.60	2.70	2.80	3.05
2028	3.00	4.95	5.10	5.20	5.40	2.70	2.80	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 8
Market Pricing Has Changed Drastically Since the War in the Middle East Began
Overnight policy rate forecasts and market pricing



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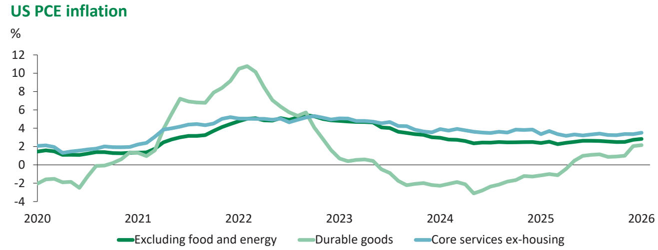
Graph 9
US Inflation Remains Sticky and Above the Fed's Target
US PCE inflation



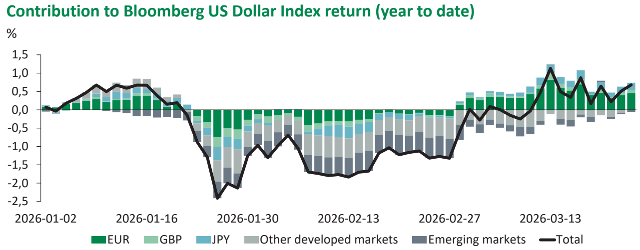
Bureau of Economic Analysis and Desjardins Economic Studies

The Federal Reserve faces a very different backdrop. US inflation has remained sticky above the central bank's target, and current conditions risk further delays (graph 9). While rate cuts later this year remain our base case, they are contingent on a near-term de-escalation in geopolitical tensions (graph 8).

EXCHANGE RATE

The US dollar continues to benefit from the global squeeze in energy prices. The broader US dollar index has reversed year-to-date losses and is now roughly flat. Most of that strength has come against European currencies (graph 10). Our revised forecasts now see more weakness in the currencies of energy-importing countries.

Graph 10
Weakness in Europe Is Driving Most of the Recent Strength in the USD



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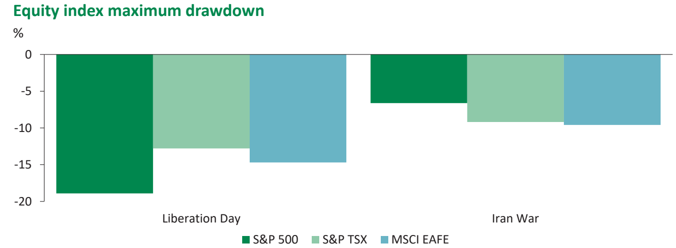
Policymakers are watching FX closely. Authorities have hardened intervention rhetoric—notably the Swiss National Bank, which has flagged a greater readiness to act against rapid CHF appreciation, and Japan, where USD/JPY is hovering near 160 and keeping Bank of Japan/Ministry of Finance intervention risk alive.

Against this backdrop, the Canadian dollar has been the top-performing currency. Our base case had already baked in some volatility in the Canadian dollar, and our forecasts remain unchanged as a result. Looking forward, the CUSMA review remains a key headwind to business investment in Canada and a risk that markets appear to be somewhat complacent around.

EQUITIES AND CREDIT

Equity investors were well hedged going into this shock. Relative to the sharp moves in energy, equity drawdowns have been limited, paling in comparison to those seen during the "Liberation Day" chaos last year (graph 11).

Graph 11
Equity Market Reaction Has Been Limited So Far



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With bonds a less reliable hedge in inflationary episodes, many investors sought protection in listed options/volatility markets. Absent a more pronounced equity correction, those hedges will drag on performance as premium costs accrue. Investors are still paying up for protection, and for good reason (graph 12 on page 5). But many of these listed options expire at the end of March, which could give equities more freedom to move on new information thereafter.

Table 2
Currency Forecasts

	2024		2025				2026				2027
End of period	Q3	Q4	Q1	Q2	Q3	Q4	Q1f	Q2f	Q3f	Q4f	Q1f
C$/US$	1.35	1.44	1.44	1.36	1.39	1.40	1.37	1.35	1.35	1.34	1.28
US$/C$	0.74	0.70	0.70	0.73	0.72	0.71	0.73	0.74	0.74	0.75	0.78
C$/€	1.51	1.49	1.55	1.60	1.63	1.62	1.62	1.58	1.59	1.61	1.56
US$/€	1.12	1.04	1.08	1.17	1.17	1.16	1.18	1.17	1.18	1.20	1.22
US$/£	1.34	1.25	1.29	1.37	1.34	1.32	1.34	1.32	1.31	1.30	1.35

f: forecast
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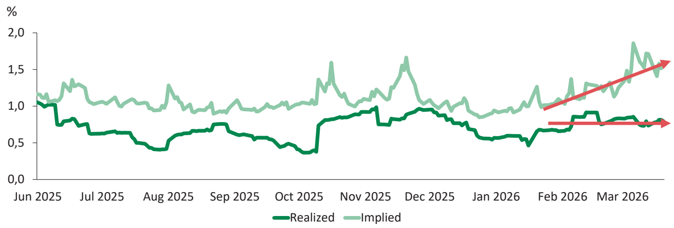
Graph 12
Investors Are Paying Up for Protection

Average daily move in the S&P 500 – Realized and implied volatility*

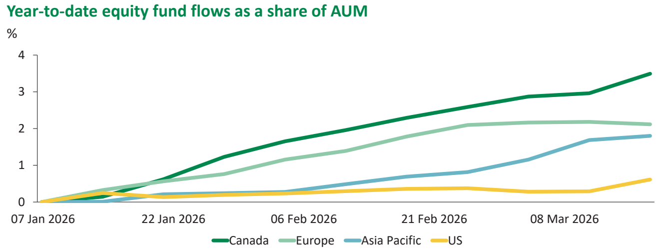


* The VIX Index is converted into an average expected move in the S&P 500. Note that an increase in implied volatility typically indicates higher risk aversion in markets.
Bloomberg and Desjardins Economic Studies

Selectivity across regions is rising. US equity flows continue to lag equity flows into other jurisdictions. During the first few weeks of the war, investors were rotating out of the US and into Asian and Canadian stocks (graph 13). Flows into Asia were likely opportunistic given the unusually large volatility and recent drawdowns. That said, it's clear that demand for European equities is waning. That's not surprising. Earnings growth was already slower in Europe than in North America, and the impact from sharply higher energy prices will likely temper expectations further.

Graph 13
Flows into European Equities Are Clearly Stagnating

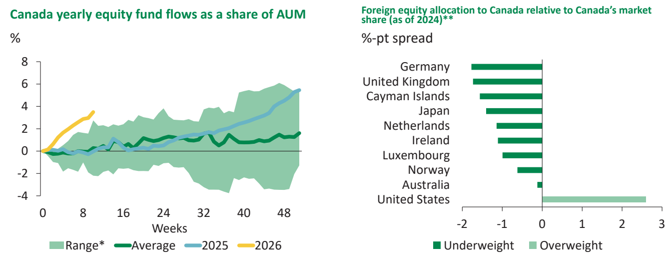
Year-to-date equity fund flows as a share of AUM



AUM = Assets under management
Bloomberg and Desjardins Economic Studies

Canada still stands out. Fund flows year to date have outpaced anything we've seen since this data started being collected (graph 14). At the end of last year, foreign investors had begun shifting into Canadian stocks, and we believe that has continued into this year. Canadian stocks remain under-owned relative to their global market cap (graph 14), and we see scope for foreign demand to rise further.

Graph 14
Foreigners Are Still Likely Underweight Canadian Stocks

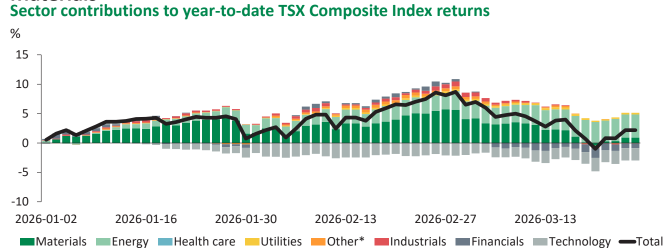


* 10th to 90th percentile range.
** Top 10 largest foreign holders of Canadian equities ranked by distance from Canada's share of global market cap excluding the domestic market.
IMF, Bloomberg and Desjardins Economic Studies

Our TSX forecast is unchanged, but we've revised our projections for the US and EAFE indices lower. Higher commodity prices should feed through to higher EPS growth in Canada over time. While the TSX has underperformed the S&P 500 since the onset of the conflict, nearly all of that underperformance has come from the materials sector, which had an incredible run leading up to the conflict (graph 15). In a more dangerous and uncertain world, we believe there's room for gold prices to increase again. In the US, the S&P 500 now faces more headwinds, with rate cuts potentially off the table. Capex monetization tied to AI also remains a concern. Outside of North America, rising energy costs are likely to blunt earnings growth, and we expect lower returns as a result.

Graph 15
The Weakness in the TSX Since the Iran Conflict Is Mostly Tied to Materials

Sector contributions to year-to-date TSX Composite Index returns



* Other includes communication services, consumer discretionary, consumer staples and real estate.
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Table 3
Asset Class Returns (%)

	Cash	Bonds	Canadian stocks	US stocks	International stocks	Exchange rate
End of year	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	12.5	9.1	6.3	-4.3
Range	1.5 to 3.0	1.0 to 5.2	-5.0 to 18.0	-7.0 to 15.0	-10.0 to 10.0	-8.0 to -1.0
2027 forecast	2.6	4.2	14.5	12.0	12.0	-4.5
Range	1.8 to 3.5	2.0 to 7.0	5.0 to 21.0	0.0 to 20.0	0.0 to 20.0	-8.0 to 2.0

* FTSE Canada Universe Bond Index.
^ Dividends included.
† Negative = appreciation, positive = depreciation.
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