

# INVESTMENT STRATEGY AND INTEREST RATE ANALYSIS

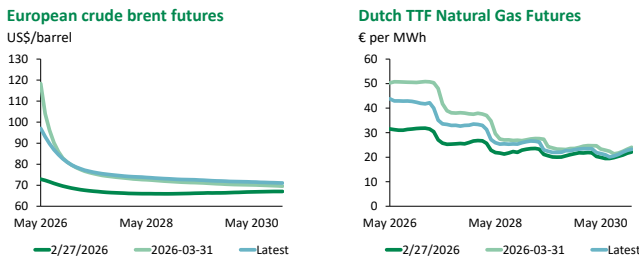
## Disruption Without Disaster?

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### COMMENTS

The war in the Middle East has evolved from a kinetic conflict into a contest of leverage. Military de-escalation has yet to translate into normalized maritime traffic, and while both sides appear open to negotiations, there's little chance that energy supplies recover quickly. Damaged infrastructure and shut-in wells will keep production constrained, extending shortages into next year and leaving energy prices elevated (graph 1).

**Graph 1**  
Energy Disruptions Expected to Persist for the Foreseeable Future

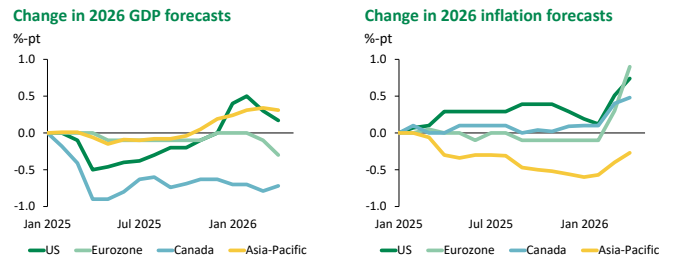


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Markets appear to be broadly priced for that outcome. The prevailing narrative effectively assumes a peace process alongside a mild inflationary impulse, rather than a severe hit to economic activity. That is consistent with lower growth expectations in Europe and Asia, and higher inflation across most jurisdictions (graph 2). It would likely take a few more months of complete closure for growth tail risks to turn acute, and gradual normalization is still the more likely path.

The ongoing energy shock will remain a key driver of cross-asset performance, amplifying regional differences through energy dependence. At the same time, this energy crisis has become the first true macro stress test of the AI

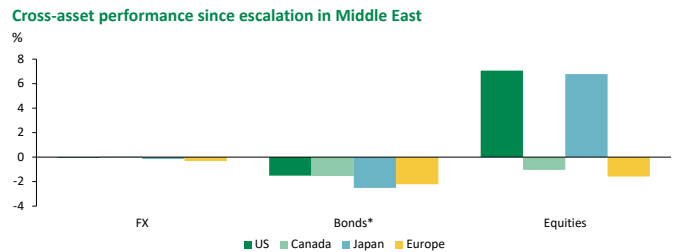
**Graph 2**  
Growth and Inflation Expectations Diverging Across Jurisdictions



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theme in 2026—a test which AI stocks have so far survived. Fixed income and FX markets, which are more closely tied to underlying economic conditions, are reflecting the ongoing growth and inflation trade-off more clearly than equities. While stocks are taking some cues from higher energy prices, the drag on future earnings is increasingly being counterbalanced at the index level by the growing tailwind from AI-related demand (graph 3).

**Graph 3**  
North American Assets Continue to Outperform



\* German Bonds are used for Europe.  
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**Diversification is therefore becoming more selective.**

Reducing exposure to US assets remains a strategic objective, but diversification is no longer as simple as distributing risk across regions. The rebound in AI stocks has raised the opportunity cost of underweighting US assets at a time when rising energy prices are dampening outlooks for European and several Asian economies. Overall, the US is well positioned against this backdrop. The sectors that dominate US indices are the very same ones that benefit from structural AI tailwinds while being less exposed to energy-related headwinds. This suggests that diversification away from the US must be narrower, with investors wanting exposure to markets/sectors that either share in the AI buildout or are less vulnerable to higher energy prices. Until energy markets normalize, there is a risk that a familiar TINA (There Is No Alternative) dynamic re-emerges and capital flows back toward the US.

**ECONOMIC TRENDS AND INTEREST RATES**

**Slowing growth is no longer sufficient to guarantee fixed income returns.** Ongoing supply shocks have become a fixture of the new macro environment and fixed income investors must contend with greater upside risks to inflation. As such, bonds have become a more convex asset class, one that only meaningfully pays off when a shock crosses into a disorderly or recessionary regime.

**The various starting points across regions further complicate the calculus.** In Europe and the more energy-sensitive parts of Asia, the bar for fixed income to resume its traditional hedging role is higher. Central banks in those regions are focused on credibility and second-round inflation effects in the face of imported energy shocks. That differs from North America, where central bankers have emphasized patience and a willingness to tolerate headline inflation as they gather more information about the fallout. These different approaches are most clearly seen in the diverging central bank expectations (graph 4).

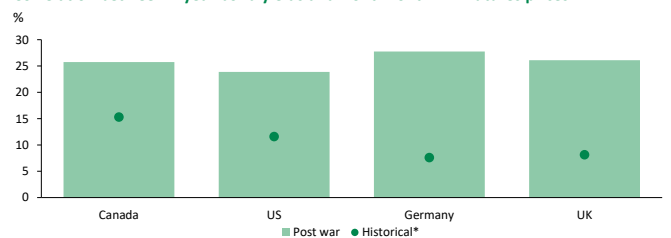
**Absent a recession, the more attractive opportunities in fixed income are likely to be relative rather than outright.**

The global economy is facing the same shocks filtered through different policy frameworks. Even if the Strait of Hormuz reopens soon, energy prices will take longer to normalize, keeping European and Asian yields stuck at higher levels. Once this shock passes, North American fixed income is likely to pivot to other fundamental factors, like downside risks to growth, more quickly than other energy-dependent parts of the world. As energy disruptions ease, correlations across global fixed income should begin to move lower.

**The Bank of Canada still appears to have the greatest flexibility, but the bond market is less convinced.**

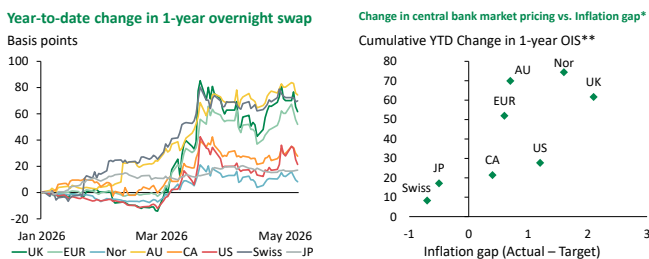
Policymakers have made clear that higher energy prices alone are unlikely to trigger action, unless oil prices remain elevated for a prolonged period and inflationary pressures broaden out. Yet Canadian fixed income continues to trade closely with oil prices (graph 5), suggesting that markets still attach meaningful weight to the single inflation mandate and terms-of-trade benefits. The risk of hikes later this year therefore cannot be ruled out, but it remains conditional. Canada may be best placed to absorb the shock, but its bond market is still trading as though oil is a cleaner macro positive than the Bank of Canada itself appears to believe. Our forecast continues to see the central bank on hold this year, which should bring mortgage rates down later in 2026.

**Graph 5**  
Market Is Assuming Greater Passthrough of Oil Prices to Canadian Economy  
Correlation between 2-year bond yields and front-month WTI futures prices



\* Historical data goes back to 2015.  
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**Graph 4**  
Change in Central Bank Pricing Reflects Starting Points on Inflation

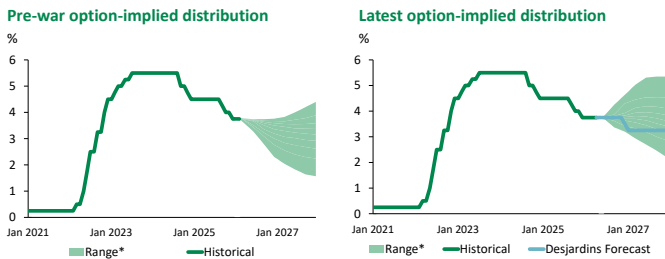


\* Inflation gap is the spread between actual inflation and central bank target; \*\* Overnight index swaps.  
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**In the US, there is a growing divide within the FOMC.**

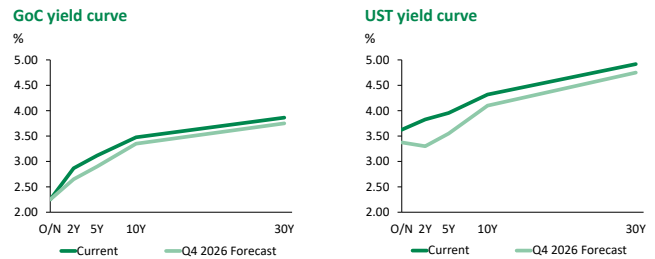
The April decision brought four dissents, the most since the 1990s, as concerns about upside inflation risks, fuelled by elevated energy prices, continue to build alongside a stabilizing labour market. Financial conditions have eased notably over the past month, largely reversing the tightening seen in March. While we still expect one Fed rate cut this year, that view remains highly conditional on the path of energy prices (graph 6 on page 3).

**Graph 6**  
Markets Now Pricing In Greater Risks of Rate Hikes in the US



\* 10-90th percentile range. Distribution on Fed Funds rate backed out from options on SOFR futures.  
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**Graph 7**  
US Yield Curve Likely to Steepen More, Relative to Canada



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**Conviction in a steeper US curve is also building.** A less predictable Fed communication regime, greater uncertainty around the reaction function, and a smaller Fed footprint in the Treasury market would all argue for elevated term premia, even if front-end yields don't move lower on additional cuts (graph 7).

**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 |      |
| <b>Realized</b>       |               |            |               |        |        |               |        |        |      |
| <u>End of month</u>   |               |            |               |        |        |               |        |        |      |
|                       | October 2025  | 3.00       | 4.95          | 6.09   | 6.05   | 6.09          | 2.45   | 2.45   | 2.75 |
|                       | 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 |
| <b>Forecast</b>       |               |            |               |        |        |               |        |        |      |
| <u>End of quarter</u> |               |            |               |        |        |               |        |        |      |
|                       | Q2 2026       | 2.50       | 4.45          | 5.50   | 6.00   | 6.10          | 2.70   | 2.75   | 2.75 |
|                       | Q3 2026       | 2.50       | 4.45          | 5.50   | 5.85   | 5.95          | 2.70   | 2.75   | 2.80 |
|                       | Q4 2026       | 2.50       | 4.45          | 5.40   | 5.65   | 5.85          | 2.70   | 2.75   | 2.85 |
|                       | Q1 2027       | 2.75       | 4.70          | 5.35   | 5.75   | 5.75          | 2.70   | 2.80   | 2.90 |
| <u>End of year</u>    |               |            |               |        |        |               |        |        |      |
|                       | 2026          | 2.50       | 4.45          | 5.40   | 5.65   | 5.85          | 2.70   | 2.75   | 2.85 |
|                       | 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).

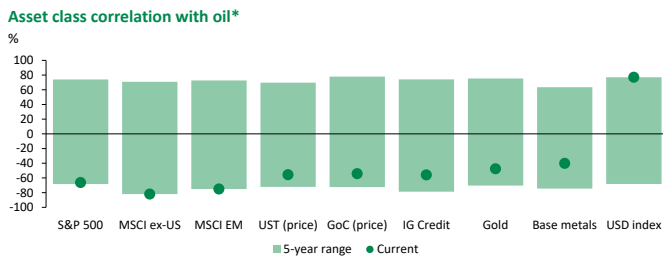
**NOTE:** Retail rate forecasts are based on the historical relationship between retail rates and the borrowing costs of Canadian financial institutions and do not reflect the pricing strategies of Desjardins Group.

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**EXCHANGE RATE**

**The US dollar has been one of the clearest liquid hedges against the surge in energy prices.** Since the start of the war, its relationship with oil has turned sharply positive, reflecting both safe-haven demand and the relative insulation of the US economy from the energy shock (graph 8). Even so, the dollar has failed to break decisively out of its recent trading ranges. Its path from here remains conditional on energy prices. Continued disruptions would likely support the dollar through a combination of safe-haven flows and reallocation toward US assets under the TINA dynamic described above, while a more durable normalization in energy markets would likely see the dollar weaken again over time.

**Graph 8**  
US Dollar Has Been the Clearest Liquid Hedge Against Rising Oil Prices



\* Rolling 1-month correlation with WTI oil prices. Bloomberg and Desjardins Economic Studies

**The Canadian dollar should retain a medium-term bias to appreciate, but with more near-term volatility.** CUSMA review risks are likely to inject noise over the coming months, yet tighter Canada–US rate differentials could still offer support if markets continue to price in some chance of Bank of Canada hikes later this year. As a result, the path to a stronger CAD is unlikely to be linear, particularly if trade uncertainty intensifies or oil prices retreat more sharply than expected.

**Table 2**  
Currency Forecasts

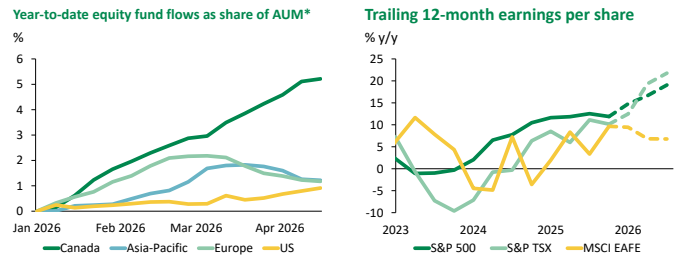
| End of period | 2024 |      | 2025 |      |      |      | 2026 |      |      |      | 2027 |
|---------------|------|------|------|------|------|------|------|------|------|------|------|
|               | Q3   | Q4   | Q1   | Q2   | Q3   | Q4   | Q1   | Q2f  | Q3f  | Q4f  | Q1f  |
| C\$/US\$      | 1.35 | 1.44 | 1.44 | 1.36 | 1.39 | 1.37 | 1.39 | 1.38 | 1.37 | 1.35 | 1.33 |
| US\$/C\$      | 0.74 | 0.70 | 0.70 | 0.73 | 0.72 | 0.73 | 0.72 | 0.72 | 0.73 | 0.74 | 0.75 |
| C\$/€         | 1.51 | 1.49 | 1.55 | 1.60 | 1.63 | 1.62 | 1.61 | 1.59 | 1.58 | 1.59 | 1.58 |
| US\$/€        | 1.11 | 1.04 | 1.08 | 1.18 | 1.17 | 1.17 | 1.16 | 1.15 | 1.15 | 1.18 | 1.19 |
| US\$/£        | 1.34 | 1.25 | 1.29 | 1.37 | 1.34 | 1.35 | 1.32 | 1.28 | 1.30 | 1.30 | 1.32 |

f: forecast  
Bloomberg and Desjardins Economic Studies

**EQUITIES AND CREDIT**

**Equity markets are balancing renewed AI momentum against the headwinds from higher energy prices.** The US has outperformed rest-of-world benchmarks, with investors recently selling European and Asian equities in favour of North American markets (graph 9, left). Strong earnings momentum and greater insulation from macro headwinds remain attractive features of North American equities (graph 9, right). While concentration concerns in the US have not disappeared, they have become easier to tolerate given the recent rebound in AI-linked leadership.

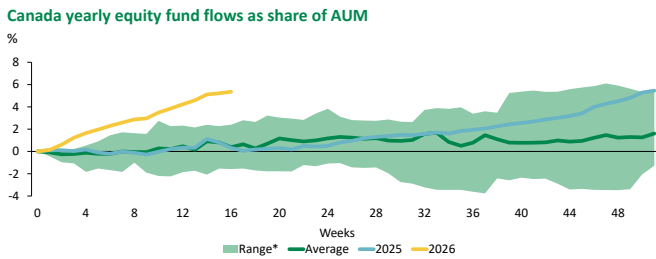
**Graph 9**  
US Outperformance Reflects Rising Earnings Expectations



\* Assets Under Management. EPFR, Bloomberg and Desjardins Economic Studies

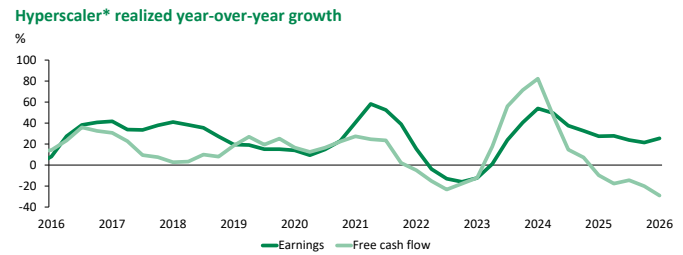
**The TSX should continue to outperform the S&P 500 this year, although the performance gap has narrowed.** TSX earnings expectations remain strong, driven predominantly by the materials sector. That linkage to hard assets remains a desirable feature of Canadian equities and has contributed to an unprecedented surge in buying (graph 10 on page 5). While the revival of the AI theme has forced us to lift our year-end targets for the S&P 500, our expectations remain tempered.

**Graph 10**  
Investors Continue to Pile Cash into Canadian Stocks



\* 10th to 90th percentile.  
EPFR and Desjardins Economic Studies

**Graph 11**  
Increasing Focus on AI Company Balance Sheets



\* Amazon, Alphabet, META, Microsoft and Oracle.  
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**The key risk to our equity outlook is that the AI-energy calculus stops working.** If elevated energy prices persist long enough to push growth tail risks materially higher, or if AI-related demand and monetization begin to disappoint, equity markets will likely become less willing to look past concentration and less forgiving of US leadership. That downside risk is amplified by the shift toward debt-funded CAPEX, which represents a structural change in the balance sheets of many AI-linked firms (graph 11).

**Credit markets are telling a similar story.** Corporate spreads tightened in April, in line with the loosening of broader financial conditions. While still wider than pre-war, spreads remain historically tight across the US and Canada, validating the broader theme of disruption without disaster.

**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 <sup>^</sup> | S&P 500 Index (US\$) <sup>^</sup> | MSCI EAFE Index (US\$) <sup>^</sup> | C\$/US\$ (% change) <sup>†</sup> |
| 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         | 13.0                       | 11.5                              | 7.0                                 | -1.5                             |
| Range         | 1.5 to 3.0     | 1.0 to 5.2  | -5.0 to 18.0               | -7.0 to 18.0                      | -8.0 to 12.0                        | -7.0 to 0.0                      |
| 2027 forecast | 2.6            | 4.2         | 14.5                       | 13.0                              | 11.0                                | -3.7                             |
| Range         | 1.8 to 3.5     | 2.0 to 7.0  | 3.0 to 21.0                | 0.0 to 20.0                       | 0.0 to 20.0                         | -7.0 to 0.0                      |

\* FTSE Canada Universe Bond Index

<sup>^</sup> Dividends included

<sup>†</sup> Negative = appreciation, positive = depreciation.

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