

INVESTMENT STRATEGY AND INTEREST RATE ANALYSIS

Who's Got Your Back?

By Jimmy Jean, Vice-President, Chief Economist and Strategist,
and Tiago Figueiredo, Macro Strategist

COMMENTS

Investors have spent much of this year wondering who has their back. Central banks were expected to respond when growth weakened. Government bonds were supposed to rally when equities fell. And the US dollar was meant to strengthen when geopolitical uncertainty rose. These traditional backstops have not disappeared, but the global shift from prioritizing economic efficiency to building resilience has made their protection less consistent and more conditional. Investors may therefore need to build more explicit protection into portfolios rather than assume that yesterday's relationships will continue to hold.

ECONOMIC TRENDS AND INTEREST RATES

Fixed income markets ended the summer with what felt like a bonfire. Kinetic conflict in the Middle East was the main catalyst, further restricting the already limited flow of oil from the region. Seven months into the conflict, there is still no obvious path toward a durable resolution. Companies initially appeared willing to absorb the increase in energy costs, but the persistence of the shock has raised the likelihood that more of those costs will ultimately be passed on to consumers starting this fall.

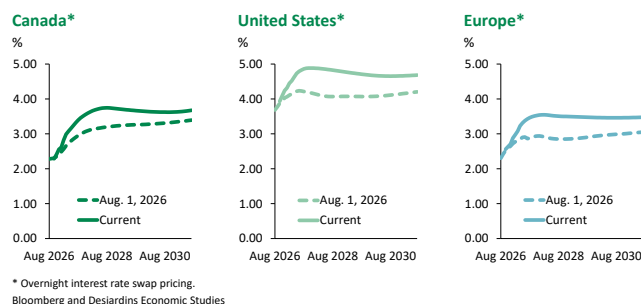
Central banks have adjusted both policy and guidance in anticipation of that pass-through. The ECB delivered its second rate increase of the year, while the Federal Reserve and Bank of Japan both came off the sidelines. Central banks that remain on hold have adopted a more hawkish tone, with the risks increasingly skewed toward tightening policy.

Interest rate decisions increasingly depend on oil prices. A return toward US\$80 per barrel this fall would likely unwind some of the expected tightening currently priced into markets. This remains our base case scenario, where additional non-Gulf production and some degree of demand destruction rebalance the market. Timing is uncertain, however. If oil remains near

current levels for longer, central banks may have little choice but to raise rates further. Even then, markets appear to have run ahead of themselves (graph 1). Short-term interest rate expectations now imply considerably more tightening than we believe the underlying economies can absorb, particularly if elevated oil prices continue weighing on household purchasing power and economic activity. At some point, central banks will need to consider the growing risks of an economic slowdown. Under our base case where oil prices move lower, both the Bank of Canada and Federal Reserve should remain on hold for the remainder of the year.

Graph 1

The Outlook for Monetary Policy Is Increasingly Driven by Oil Prices



Long-term yields remain increasingly disconnected from monetary policy and more heavily influenced by structural forces. Most of their recent increase has come from real yields rather than inflation compensation, pointing towards supply-demand imbalance as the dominant driver. The cost of building greater resilience is generating substantial issuance from governments and corporations, with debt issuance approaching levels normally associated with periods of economic stress. At the same time, central banks are buying less debt, leaving private investors to absorb more of the incoming supply. Those investors are generally more sensitive to price and may require higher

yields before stepping in. Together, these forces have been the main driver of recent bond moves, making it harder for country-specific advantages, such as stronger fiscal positions, to translate into clearer differences in bond market performance. Some countries have outperformed, but the dominant force has been that investors are demanding more compensation to hold longer-term bonds.

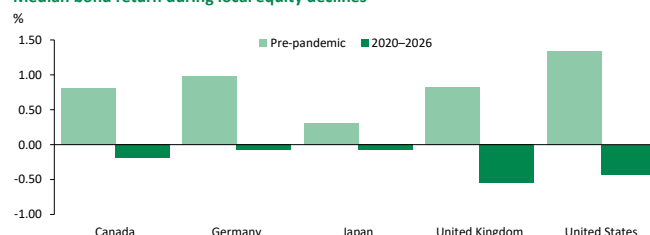
Although these structural headwinds limit the potential for a sustained decline in longer-term yields, the recent rise in yields has improved the opportunity to increase fixed income holdings. Speculative investors remain positioned for bond yields to rise, leaving them vulnerable to a decline in yields and a corresponding bond market rally. As with monetary policy, the outlook for interest rates at longer maturities remains conditional on oil. If energy prices move lower, front-end yields should fall more sharply than long-term yields, leading to steeper yield curves in both Canada and the United States.

Higher yields have improved the income available from bonds, but not necessarily their value as portfolio insurance. Before the pandemic, government bonds consistently

generated capital gains during equity market drawdowns (graph 2). That relationship has weakened considerably since then, with the deterioration concentrated at longer maturities. The results are even less favourable for unhedged foreign bonds for US investors, where currency movements have often compounded rather than offset equity losses. In the current environment, bonds are therefore offering more reliable income than downside protection.

Graph 2
Government Bonds Have Lost Their Hedging Edge Globally

Median bond return during local equity declines*



* Median weekly sovereign bond returns during the bottom 20% of equity drawdowns.
Bloomberg and Desjardins Economic Studies

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>								
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
June 2026	2.50	4.45	5.49	6.05	6.09	2.70	2.55	2.75
July 2026	2.50	4.45	5.49	6.05	6.09	2.70	2.55	2.75
August 2026	2.50	4.45	5.49	6.05	6.09	2.45	2.55	2.75
September 2026	2.50	4.45	5.49	6.05	6.09	2.60	2.75	3.00
Forecast								
<u>End of quarter</u>								
Q4 2026	2.50	4.45	5.40	5.85	5.90	2.60	2.75	3.00
Q1 2027	2.75	4.70	5.35	5.75	5.80	2.70	2.75	3.00
Q2 2027	3.00	4.95	5.30	5.55	5.70	2.70	2.75	3.00
Q3 2027	3.00	4.95	5.25	5.50	5.65	2.70	2.75	3.00
<u>End of year</u>								
2026	2.50	4.45	5.40	5.85	5.90	2.55	2.75	3.00
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

EXCHANGE RATE

The US dollar's ability to hedge equity risk has also become less reliable. Its correlation with equity returns has been unstable in recent years. However, the Iran conflict has worked in the dollar's favour thanks to higher expected US interest rates and America's relative energy security. This suggests the dollar's traditional safe-haven role has not disappeared but has become more dependent on the source of the shock.

For the Canadian dollar, the broad outlook remains largely unchanged. Improving prospects for business investment could eventually support the loonie, particularly as spending on energy, infrastructure and technology expands. For now, however, interest rate differentials remain the more important driver. Our rates forecasts imply a narrowing in the gap between Canadian and US policy rates next year, which should support a stronger Canadian dollar. The path is unlikely to be straightforward and is heavily dependent on a normalization in energy prices and no escalation in trade tensions.

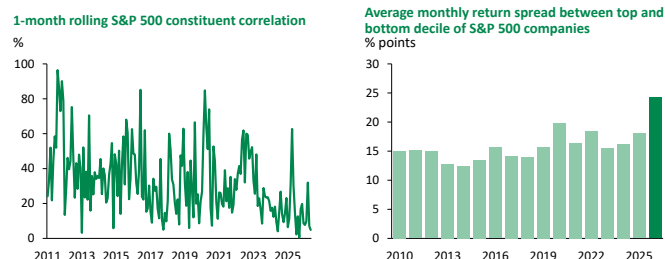
EQUITIES AND CREDIT

Equities have remained surprisingly resilient despite the sharp increase in bond yields. The AI investment cycle, tariffs, higher energy prices and geopolitical disruptions are affecting companies very differently. Rather than producing a broad decline in stocks, these shocks are creating distinct winners and losers. This is most evident in the US, where individual stocks are moving less in unison than at almost any point in recent decades, while the gap between the best- and worst-performing companies has reached its widest level in 16 years (graph 3). Similar trends, although less extreme, are also emerging in Canada.

For now, these offsetting moves are preventing elevated concentration from translating into greater index volatility. The larger risk is that a common shock causes the

Graph 3

The Index Is Calm. Stocks Are Not.



Bloomberg and Desjardins Economic Studies

market's biggest companies to fall together. Rising equity issuance, tighter financial conditions and slower growth are all factors that could lead to a decline. None appears likely to trigger an immediate selloff, but each risk is closer than it was several months ago. A sustained increase in real yields, weaker earnings, disappointment around AI returns or intensifying regulatory scrutiny could cause correlations to rise sharply, driving index-level volatility higher.

Strong earnings remain an important source of support, but the threshold for exceeding expectations continues to rise. With earnings growth expected to exceed 30% in the US, historical relationships point to weaker forward returns for the S&P 500 and TSX when expectations begin from similarly elevated levels (graph 4 on page 4). The current cycle has repeatedly exceeded those benchmarks, but that success has also left less room for disappointment. Even strong results may no longer be sufficient if they merely meet expectations already reflected in valuations.

Canadian equities continue to offer useful diversification from the most concentrated parts of the AI trade. Canada's exposure to energy, materials and financials provides access to many of the resources needed for the global investment buildout, while reducing direct dependence on the largest US technology

Table 2

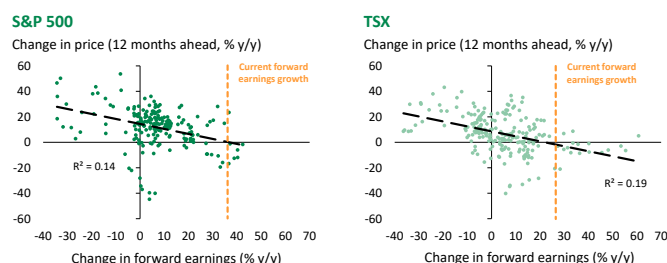
Currency Forecasts

End of period	2024	2025				2026				2027	
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4f	Q1f	Q2f
C\$/US\$	1.44	1.44	1.36	1.39	1.37	1.39	1.42	1.42	1.38	1.36	1.35
US\$/C\$	0.70	0.70	0.73	0.72	0.73	0.72	0.70	0.70	0.72	0.74	0.74
C\$/€	1.49	1.56	1.60	1.63	1.61	1.61	1.62	1.61	1.63	1.60	1.57
US\$/€	1.04	1.08	1.18	1.17	1.17	1.16	1.14	1.13	1.18	1.18	1.16
US\$/£	1.25	1.29	1.37	1.34	1.35	1.32	1.33	1.33	1.39	1.37	1.35

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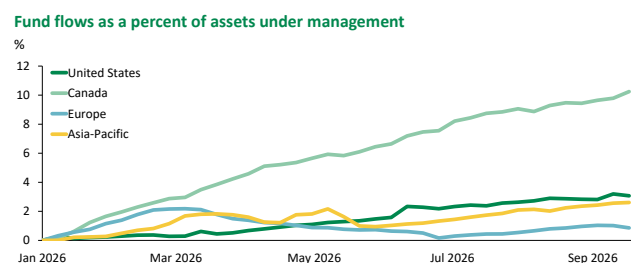
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Graph 4
Elevated Earnings Expectations Could Weigh on Forward Returns



Note: Data is monthly from 2008 until present.
Bloomberg and Desjardins Economic Studies

Graph 5
Canadian Equities Are Attracting Record Inflows



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companies. Against that backdrop, flows into Canadian equity funds have outpaced those into other jurisdictions (graph 5). Domestic investors have accounted for most of that demand, although foreign investors have also become net buyers over the past year. Canada remains an imperfect hedge, but its differing sector composition should continue to provide useful diversification. The recently proposed Productivity Mega Deduction has reinforced Canada's business-friendly policy shift. By allowing immediate expensing for a broader range of capital investment, the measure would lower the after-tax cost

of projects and further strengthen Canada's appeal to both domestic and foreign capital.

Overall, we remain constructive on equities, but the environment is becoming increasingly selective. Strong aggregate earnings and low correlations continue to support the major indexes, but neither should be mistaken for broad stability. We expect that investors will become more concerned about concentration risk going into year-end, but this is unlikely to materially derail any equity performance.

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	2.0	21.0	20.0	17.0	0.5
Range	1.5 to 3.0	0.0 to 4.0	10.0 to 25.0	10.0 to 27.0	5.0 to 22.0	-2.0 to 3.0
2027 forecast	2.6	4.0	12.0	12.0	9.0	-2.2
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	-4.0 to 2.0

* FTSE Canada Universe Bond Index

^ Dividends included

† Negative = appreciation, positive = depreciation.

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