Asset Allocation Strategy

CIO Office | July 2025

After the stress test: a cool down?

Highlights

- Unprecedented tariff shock, growing budget deficits, turmoil in the Middle East: financial markets have been put through a genuine stress test in recent months.
- Despite the magnitude of the challenge, the picture remains positive for investors halfway through 2025, with markets buoyed by the relative resilience of the economy, low inflation, and a U.S. president in negotiation mode.
- What follows is not clear of risk, as economic growth is set to slow under the weight of tariffs and high interest rates, while the next chapter in U.S. trade policy remains to be unveiled. Nevertheless, there are encouraging signs.
- Besides, a certain wave of optimism seems to be benefitting Canadian stocks in particular, despite the current weakness of the domestic economy. What is going on?
- While the composition of the S&P/TSX explains part of the phenomenon, investors mostly seem inclined to place greater value on increasingly appealing long-term earnings growth prospects, a trend that has room to continue.
- To sum up, equity markets are likely to experience a period of consolidation in the face of somewhat weaker economic data this summer. However, the absence of a recession, the likely beginning of stabilization in U.S. trade relations, and a potential change in tone from the Fed should keep equity markets on an upward trend in the second half of the year.

Global Asset Allocation Views

Asset Classes	-		N		+
Equities				■	
Fixed Income		■			
Cash			■		
Alternatives				■	
Fixed Income					
Government		■		◇	
Credit		◇		■	
Duration			■	◇	
Equities					
Canada				■	
United States		■			
EAFE				■	
Emerging Markets			■		
Alternatives & FX					
Gold			■		
Uncorrelated Strategies				■	
Canadian Dollar			■		

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Bottom line: Although the economic backdrop remains fragile, our conviction in our base-case scenario of weak but positive growth has strengthened since the previous quarter, as the risks of recession have diminished. This backdrop calls for a moderately pro-risk stance, while maintaining room to adjust as the macro situation clarifies.

NATIONAL BANK INVESTMENTS

Market review

Fixed income

- The Canadian fixed-income universe ended the month virtually unchanged for the second consecutive time. The Canadian economy performed largely in line with expectations and the Bank of Canada kept its key interest rate unchanged, allowing bonds to trade without much movement.
- In the U.S., Treasury bonds posted gains as economic data was relatively disappointing, while some Fed officials surprised markets by opening the door to imminent rate cuts.

Equities

- The upward trend in equities persisted in June, as investors welcomed the easing of trade tensions between the U.S. and the rest of the world. In fact, Emerging markets and the U.S. posted the best monthly returns, while the EAFE region finished last for the first time this year.
- Within the S&P 500, June was marked by the outperformance of tech giants and the Energy sector, the latter benefitting greatly from higher oil prices resulting from the conflict between Israel and Iran.

FX & Commodities

- The U.S. dollar continued to depreciate in June, with the DXY index now down by more than 10% since the start of the year.
- Oil prices rose sharply following Israel's surprise air strikes against Iran, before falling back as tensions eased, leaving the barrel with monthly gains of around 8%.

Market Total Returns

Asset Classes	June	Q2	YTD
Cash (S&P Canada T-bill)	**0.2%**	**0.6%**	**1.5%**
Bonds (ICE Canada Universe)	**0.0%**	**-0.7%**	**1.3%**
Short Term	0.3%	0.5%	2.1%
Mid Term	0.2%	-0.4%	2.2%
Long Term	-0.4%	-2.4%	-0.7%
Federal Government	-0.1%	-0.9%	1.3%
Corporate	0.3%	0.4%	2.2%
U.S. Treasuries (US$)	1.3%	0.8%	3.8%
U.S. Corporate (US$)	1.8%	1.8%	4.2%
U.S. High Yield (US$)	1.9%	3.6%	4.5%
Canadian Equities (S&P/TSX)	**2.9%**	**8.5%**	**10.2%**
Communication Services	2.9%	2.6%	4.8%
Consumer Discretionary	3.7%	14.1%	13.9%
Consumer Staples	-2.1%	4.6%	4.1%
Energy	3.4%	1.3%	4.0%
Financials	3.6%	12.1%	10.7%
Health Care	9.4%	3.1%	-6.1%
Industrials	0.3%	8.1%	6.0%
Information Technology	4.9%	14.2%	5.7%
Materials	3.7%	8.1%	30.1%
Real Estate	1.4%	4.9%	3.2%
Utilities	0.2%	4.8%	10.0%
S&P/TSX Small Caps	6.2%	11.8%	12.7%
U.S. Equities (S&P 500 US$)	**5.1%**	**10.9%**	**6.2%**
Communication Services	7.3%	18.5%	11.1%
Consumer Discretionary	2.2%	11.5%	-3.9%
Consumer Staples	-1.9%	1.1%	6.4%
Energy	4.8%	-8.6%	0.8%
Financials	3.2%	5.5%	9.2%
Health Care	2.1%	-7.2%	-1.1%
Industrials	3.6%	12.9%	12.7%
Information Technology	9.8%	23.7%	8.1%
Materials	2.3%	3.1%	6.0%
Real Estate	0.2%	-0.1%	3.5%
Utilities	0.3%	4.3%	9.4%
Russell 2000 (US$)	5.4%	8.5%	-1.8%
World Equities (MSCI ACWI US$)	**4.5%**	**11.7%**	**10.3%**
MSCI EAFE (US$)	2.2%	12.1%	19.9%
MSCI Emerging Markets (US$)	6.1%	12.2%	15.6%
Commodities (GSCI US$)	**4.5%**	**-2.8%**	**1.9%**
WTI Oil (US$/barrel)	7.9%	-7.8%	-8.5%
Gold (US$/oz)	0.0%	5.1%	25.1%
Copper (US$/tonne)	5.3%	4.1%	16.2%
Forex (US$ Index DXY)	**-2.5%**	**-7.0%**	**-10.7%**
USD per EUR	3.4%	8.7%	13.4%
CAD per USD	-1.0%	-5.4%	-5.4%

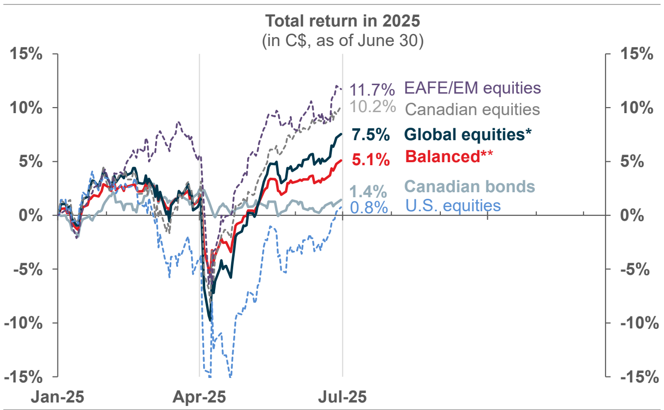
CIO Office (data via Refinitiv, as of 2025-06-30)

After the stress test

Unprecedented tariff shock, growing budget deficits, turmoil in the Middle East: financial markets and the global economy have been put through a genuine stress test over the past three months.

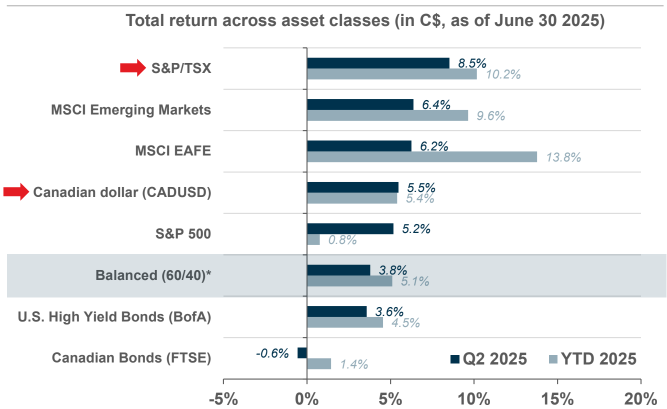
And yet, despite the high volatility generated by all these events, the health check remains positive for investors halfway through 2025 (**Chart 1**). This is particularly true for holders of Canadian equities which finished the last quarter at the top of the rankings in Canadian dollar terms, as overseas stock returns were tempered by a significant appreciation of the Loonie over the period (**Chart 2**).

1 | A positive picture for markets halfway to 2025…



CIO Office (data via Refinitiv). *35% S&P/TSX, 35% S&P 500, 20% MSCI EAFE, 10% MSCI EM, *60% Global equities, 40% FTSE Canada Universe.

2 | ...with a solid Q2 for Canadian assets...



CIO Office (data via Refinitiv). * 21% S&P/TSX, 21% S&P 500, 12% MSCI EAFE, 6% MSCI EM, 40% FTSE Canada Universe, all in CAD.

What follows is not clear of risk, with betting markets estimating the probability of a U.S.recession in 2025 at 27% and the chances of the Iranian government closing the Strait of Hormuz – through which nearly one-fifth of global oil consumption transits – at 16% (**Chart 3**).

3 | ... despite a tense environment, to say the least

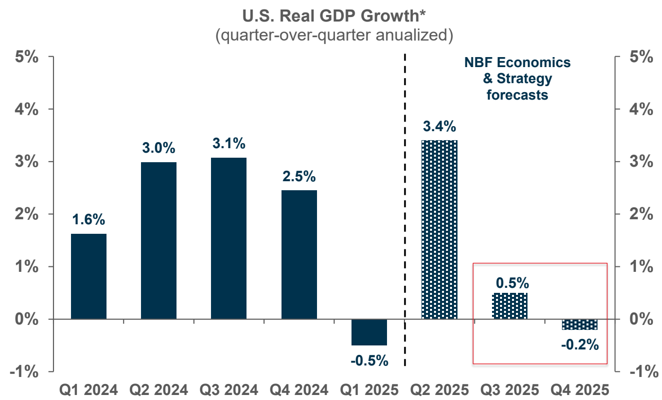
CIO Office (data via Polymarket).

Still, in both the medical and sporting worlds, the logical step after a stress test is typically a cool-down period. And this may also be what's next in the economic world over the coming months. Let's explore why.

A cool down?

For starters, we should expect growth to cool down in the second half of the year. After the significant fluctuations caused by trade imbalances in Q1 and Q2, the weight of tariff duties and elevated interest rates should lead to a period of relative stagnation in growth in Q3 and Q4, according to projections by our colleagues from NBF Economics and Strategy (**Chart 4**).

4 | The economy is set to slow down…



CIO Office (data via Refinitiv, NBF Economics & Strategy).

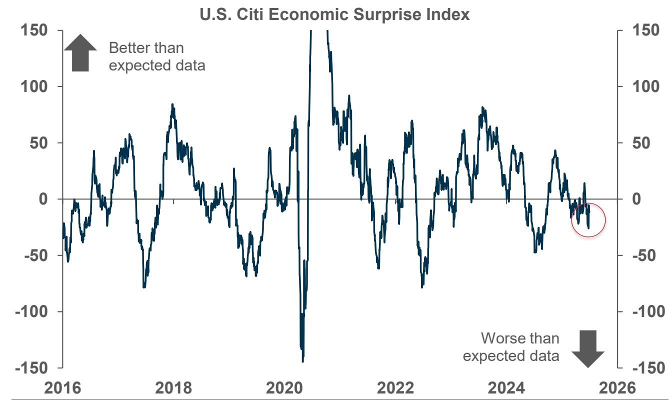
To some extent, this shift is already beginning to show in the latest economic data, which has often turned out weaker than expected as illustrated by the decline in the Economic Surprise Index in June (**Chart 5**).

Even so, the overall situation remains fairly positive, with the job market even showing a slight increase in the hiring rate compared to the layoff rate (**Chart 6**).

In the meantime, a cool down in geopolitical tensions is also conceivable, although nothing is ever certain or straightforward in this domain.

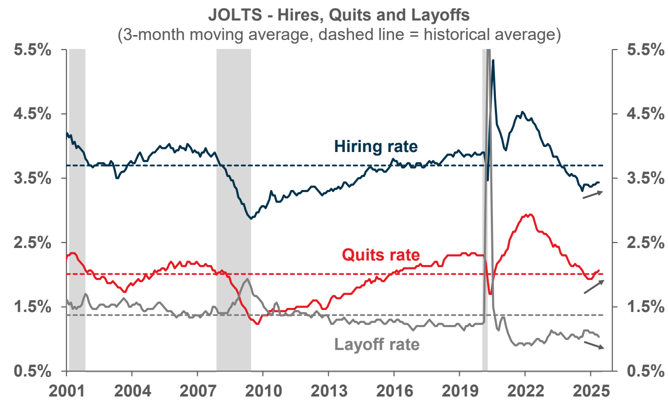
With regard to the Middle East, this is indeed the signal we are getting from oil prices, which quickly returned to their initial levels following the announcement of a ceasefire. It remains to be seen

5 | … as it's starting to become apparent…



CIO Office (data via Refinitiv).

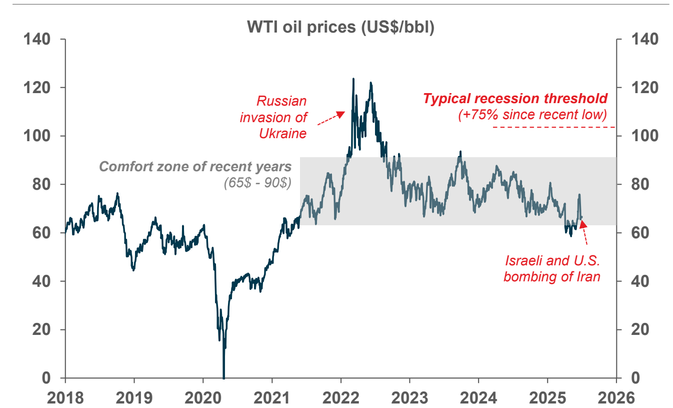
6 | … but the situation remains far from dramatic



CIO Office (data via Refinitiv).

whether this will hold. But, the experience of recent weeks has at least revealed that the bar for pushing oil prices to levels that are seriously problematic for global growth – typically 75% above a recent low (**Chart 7**) – is quite high.

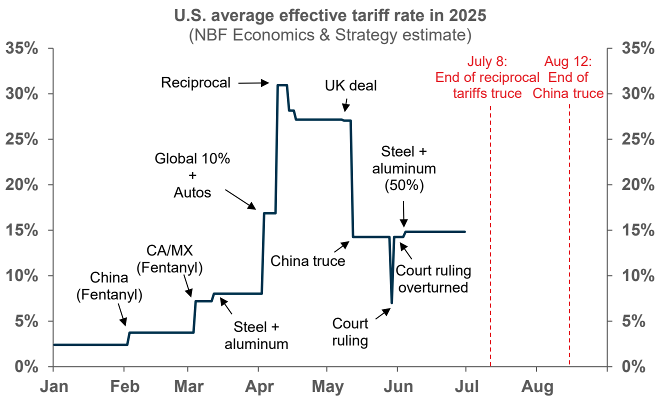
7 | Oil shock avoided



CIO Office (data via Refinitiv).

With regard to tariffs, things should clarify soon. In theory, the 90-day pauses in reciprocal and China-specific tariffs are set to end on July 8 and August 12, respectively (**Chart 8**).

8 | Tariffs are about to move again

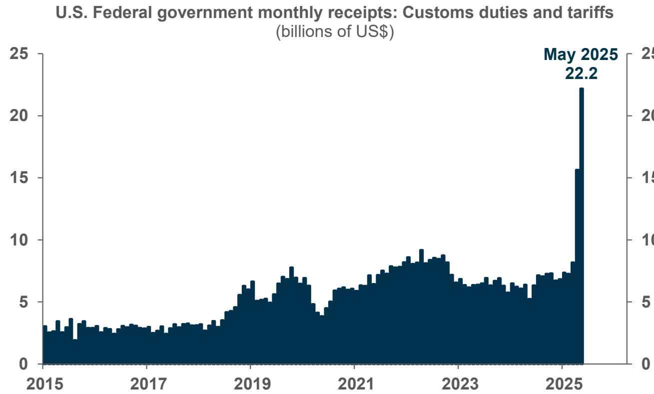


CIO Office (data via Refinitiv, U.S. Census Bureau, NBC, Bloomberg, NBF Economics & Strategy).

While there will undoubtedly be surprises, confusion, delays, and varying outcomes depending on the country, the only certainty is that it is in the United States' interest to remain on the path of de-escalation and trade agreements. This is indeed the signal sent by financial markets and U.S. voters in April, and echoes in recent months suggest that the message has been heard by President Trump.[1,2,3]Finally, one factor that may be underestimated is the possibility that the Fed will ease its monetary policy before the end of the year.

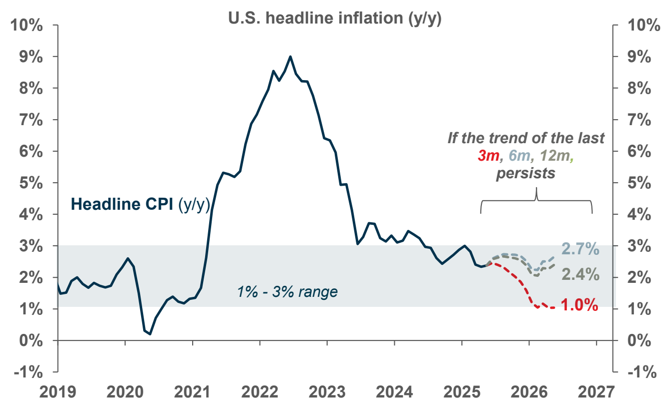
Of course, the official stance remains that rate cuts can wait until the impact of tariffs on inflation becomes clearer. However, tariffs have already been in place for several months (**Chart 9**) and inflation remains fairly low (**Chart 10**) which suggests that businesses (both exporters and importers) are absorbing much of the cost… for now.

9 | For now, the government is collecting tariffs...



CIO Office (data via Refinitiv).

10 | … but inflation remains contained



CIO Office (data via Refinitiv).

If this remains the case for another month or two, we are likely to see a more formal change in tone from the Fed this summer, similar to what Governors Waller[4] and Bowman[5] initiated in June.

This may seem trivial, especially since we are talking about simply shifting monetary policy from “slightly restrictive” to “neutral.” But, for markets which are by definition forward-looking, it is generally the signal sent by policymakers that matters most as we saw in January 2019, March

[1] Carney says he and Trump are aiming for a Canada-US deal inside 30 days, Reuters, June 16, 2025.
[2] Lutnick Says US-China Trade Truce Signed, 10 Deals Imminent, Bloomberg, June 27, 2025.
[3] Trump hails ‘positive’ step in U.S.-EU trade negotiations as markets hope for a deal, CNBC, May 27, 2025.
[4] Fed Governor Waller says central bank could cut rates as early as July, CNBC, June 20, 2025.
[5] Fed Governor Bowman favors July interest rate cut if inflation stays low, CNBC, June 23, 2025.

2020, November 2023, and even April 2025 (**Chart 11**).

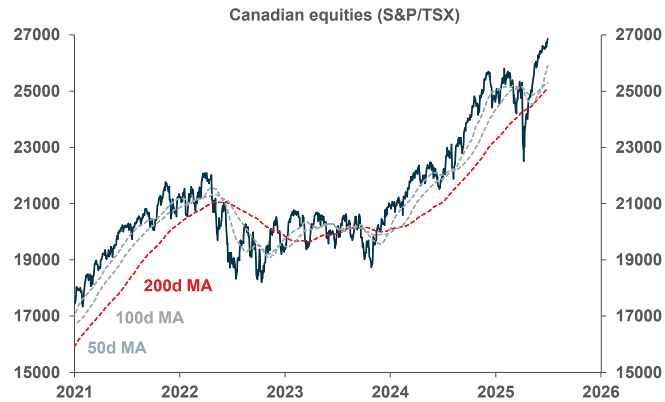
11 | Policy guidance is key to markets

CIO Office (data via Refinitiv).

O Canada

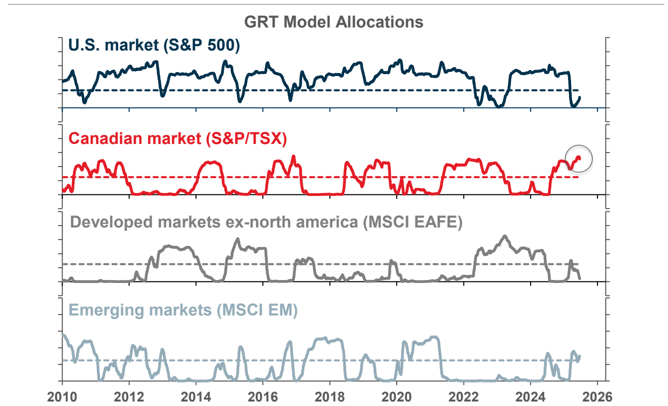
Clearly, the Canadian stock market is drawing interest as rarely seen in recent history, with the S&P/TSX reaching record highs without too much trouble since May (**Chart 12**), leading our relative momentum model to favour Canada over every other major stock market region (**Chart 13**).

12 | New high for Canadian equities...



CIO Office (data via Refinitiv).

13 | ... which stand out from the rest of the world...

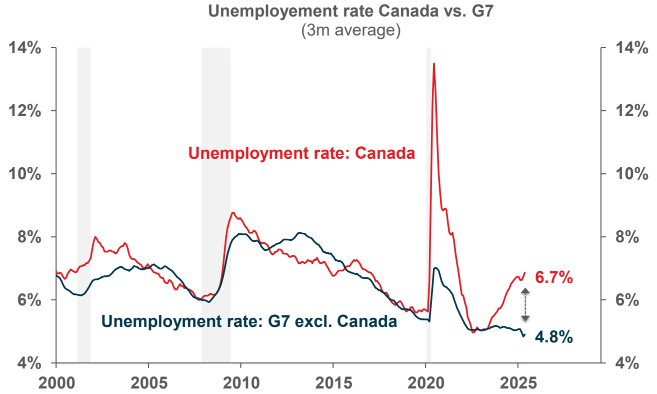


CIO Office (data via Refinitiv).

And yet, the cyclical backdrop in Canada is not particularly bright, with a sharp rise in unemployment contrasting with relative stable labour markets of the other G7 countries (**Chart 14**, next page). What is going on?

Two key elements explain the apparent dichotomy between equity markets and the economy in Canada: composition and time horizon.

14 | … despite a more challenging cyclical backdrop



CIO Office (data via Refinitiv).

In terms of composition, recall that the Canadian stock market is not solely dependent on the Canadian economy. In fact, around 55% of the revenues of the companies included in the S&P/TSX index come from abroad.[6] On the other hand, rising gold prices are a significant tailwind for the equity index, with the Materials sector – the S&P/TSX's third largest – thriving over the past year (**Chart 15**).

15 | CA stocks are more than just the CA economy

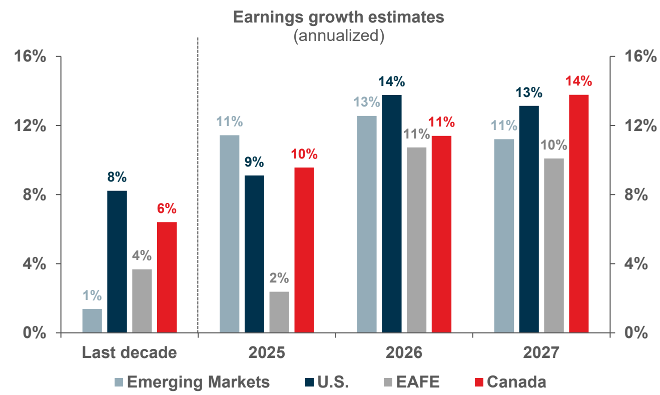
			Performance (total return)		
		Weight	**Q2**	**YTD**	**1-YR**
Canadian Equities	**S&P/TSX**		8.5%	10.2%	26.4%
	Financials	33%	12.1%	10.7%	38.1%
	Energy	16%	1.3%	4.0%	13.0%
	Materials	14%	8.1%	30.1%	39.0%
	Industrials	13%	8.1%	6.0%	8.4%
	Technology	10%	14.2%	5.7%	47.3%
	Utilities	4%	4.8%	10.0%	26.2%
	Consumer Staples	4%	4.6%	4.1%	14.3%
	Consumer Disc.	3%	14.1%	13.9%	23.7%
	Comm. services	2%	2.6%	4.8%	-6.4%
	Real Estate	2%	4.9%	3.2%	13.6%
	Health Care	0%	3.1%	-6.1%	5.4%

CIO Office (data via Refinitiv).

That said, a potentially even more important factor is the fact that equity markets are discounting machines. Thus, the cyclical malaise in which the Canadian economy finds itself is potentially already in the rear-view mirror for markets, which are instead looking at the country's economic potential the Carney government seems determined to activate rapidly.

To some extent, this phenomenon can already be seen in the earnings growth expectations for Canadian equities, which indeed improve the further out you look (**Chart 16**).

16 | A better future for Canadian earnings growth…



CIO Office (data via Refinitiv).

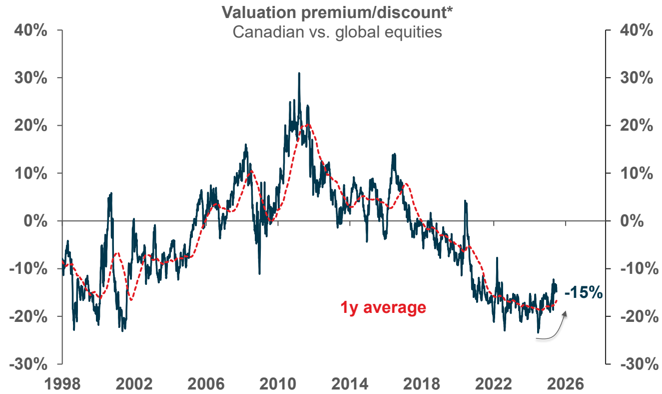
Considering that Canadian stocks have managed, despite every obstacle, to generate reasonable earnings growth over the past decade (only 2% less than the S&P 500 on an annualized basis), their potential for a brighter future is anything but theoretical.

If this were to happen, we could also expect Canadian equity valuations to improve relative to the rest of the world. This has been the case since the beginning of the year, and there is still room for this trend to build momentum (**Chart 17**, next page).

By extension, a growing interest in Canadian assets foreshadows upside potential for the Canadian dollar, as has been happening since the beginning of the year. How far the Loonie can appreciate remains an open question, but a Fed pivot combined with good news on the Canada-U.S. trade front could push markets to test the lower end

[6] Source: Factset

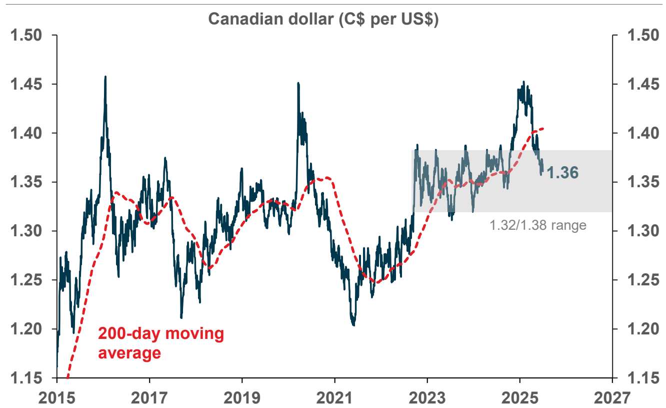
17 | … would likely justify higher valuations



CIO Office (data via Refinitiv). *Forward PE ratio of S&P/TSX vs MSCI ACWI.

of the 2022-2024 range on the USDCAD pair (**Chart 18**).

18 | The loonie has made it back home

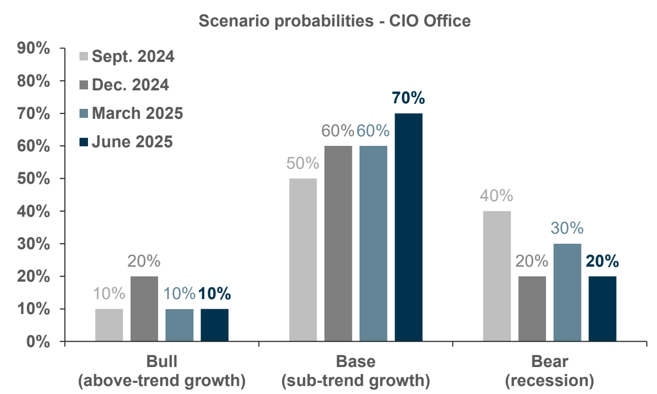


CIO Office (data via Refinitiv).

The bottom line

Although the economic environment remains fragile, our conviction in our base-case scenario of weak but positive growth has strengthened since the previous quarter as recession risks have diminished (**Chart 19**). Against this backdrop, we increased our equity allocation at the end of May and, again, at the end of June.

19 | A slowdown more likely than a recession

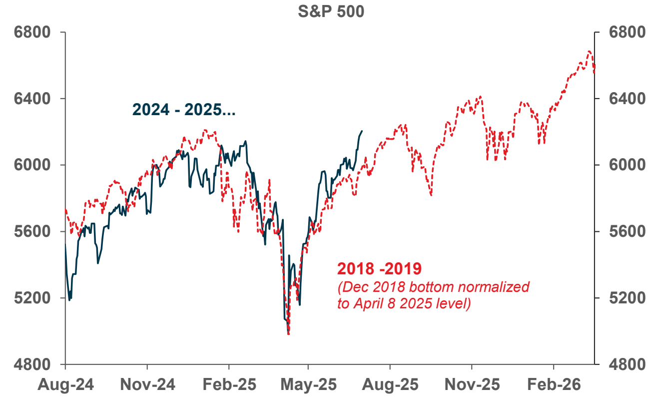


CIO Office (data via Refinitiv).

This summer, equity markets are likely to experience a period of consolidation in the face of somewhat weaker economic data. However, the absence of a recession, the probable beginning of stabilization in U.S. trade relations, and a potential change in tone from the Fed should keep stock markets on an upward trend in the second half of the year – much like we saw following the Fed's pivot in 2019 (**Chart 20**, next page).

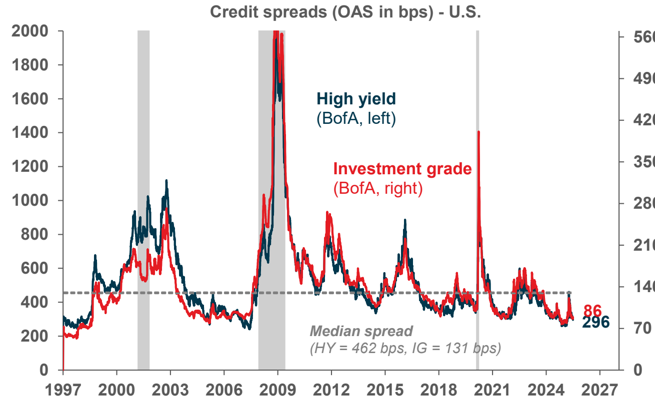
Within fixed income, the time had come to normalize the strategy, moving towards a less defensive positioning. Specifically, we brought duration back to neutral. Barring a recession, U.S. 10-year yields are likely to hover around 4.5%, which is consistent with the Fed cutting its benchmark rate three times over the next 12 months (**Chart 21**, next page).

20 | Equities are due for a consolidation period



CIO Office (data via Refinitiv).

22 | Spreads are tight and will probably remain so



CIO Office (data via Refinitiv).

21 | It will take a lot to push 10y yields much lower

CIO Office (data via Refinitiv).

For similar reasons, we are increasing the credit allocation to a slight overweight relative to government bonds. Far from being a bargain, corporate credit spreads are likely to remain stable in the absence of a major economic shock (**Chart 22**). However, we are keeping room to increase our allocation to corporate bonds should valuations improve.

CIO Office
CIO-Office@nbc.ca

Martin Lefebvre
Chief Investment Officer
martin.lefebvre@nbc.ca

Louis Lajoie
Senior Director
Investment Strategy
louis.lajoie@nbc.ca

Simon-Carl Dunberry
Senior Director
Portfolio Strategy
simon-carl.dunberry@nbc.ca

Nicolas Charlton
Director
Quantitative Strategy
nicolas.charlton@nbc.ca

Mikhael Deutsch-Heng
Director
Investment Strategy
mikhael.deutschheng@nbc.ca

Zaid Shoufan
Associate
Portfolio Strategy
zaid.shoufan@nbc.ca

Julien Gordon
Analyst
Quantitative Strategy
julien.gordon@nbc.ca

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