Asset Allocation Strategy

CIO Office | May 2025

One step forward, two steps back

Highlights

- While the unveiling of hefty reciprocal tariffs at the beginning of the month sent U.S. equities close to bear market territory, a series of tariff reversals by the Trump administration allowed the S&P 500 to rebound and end April virtually unchanged, albeit still trailing overseas equities.
- In any event, the message sent by financial markets to Washington could not be clearer: the U.S. tariff strategy is misguided, and the policy reversal must continue.
- In March, betting markets estimated the risk of recession at around one in three. Today, it is two in three. For now, the economic damage remains mainly confined to sentiment surveys (consumers, businesses, investors), but more tangible signs of a slowdown are likely to multiply in the coming months.
- Fortunately, the Federal Reserve has room to support the economy should employment deteriorate further. The downside, however, is that the unpredictability of the U.S. administration is likely to force the Fed to be reactive rather than proactive.
- In the short term, a pivot away from disruptive tariffs—which must happen quickly with China—and toward more growth-friendly policies by the US government could continue to fuel hope in the stock markets. However, given current valuations, the downside risk remains non-negligible.

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: Against this backdrop, we reduced our allocation to U.S. equities relative to developed overseas markets in early April, seeing in market movements a signal that this rotation had room to run with the Greenback under pressure. Besides, our equity/bond allocation remains neutral, as we await more attractive risk/return prospects in equities.

Market review

Fixed income

- The Canadian fixed-income universe posted losses in April, especially in the long-term segments of the curve.

Equities

- April was a very volatile month for equities. The White House's big announcement of reciprocal tariffs resulted in severe stock market declines at the start of the month, but the U.S. administration's softening tone over the following weeks erased most of the losses.
- Geographically, EAFE equities continued to outperform significantly, thanks in part to the strong appreciation of the euro and the yen against the USD. Within the S&P 500, the energy sector stood out for its severe monthly losses caused by falling oil prices.

FX & Commodities

- Gold continued to benefit from the highly uncertain environment created by the White House, with gains of over 5% in April. At the other end of the spectrum, oil prices plummeted amid prospects of a tariff-induced global slowdown.
- In currencies, April was marked by a significant depreciation of the U.S. dollar, in a context where a trade war between the United States and the rest of the world would be a losing proposition for the U.S. economy.

Market Total Returns

Asset Classes	April	YTD	12M
Cash (S&P Canada T-bill)	**0.2%**	**1.1%**	**4.3%**
Bonds (ICE Canada Universe)	**-0.8%**	**1.2%**	**8.8%**
Short Term	0.0%	1.7%	7.5%
Mid Term	-0.3%	2.3%	10.3%
Long Term	-2.3%	-0.6%	9.4%
Federal Government	-0.5%	1.6%	8.1%
Corporate	-0.6%	1.2%	9.6%
U.S. Treasuries (US$)	0.6%	3.6%	7.6%
U.S. Corporate (US$)	0.0%	2.3%	7.8%
U.S. High Yield (US$)	0.0%	0.9%	8.7%
Canadian Equities (S&P/TSX)	**-0.1%**	**1.4%**	**17.8%**
Communication Services	-2.5%	-0.3%	-12.5%
Consumer Discretionary	1.8%	1.6%	9.7%
Consumer Staples	5.6%	5.0%	21.1%
Energy	-6.3%	-3.8%	4.3%
Financials	1.6%	0.4%	27.3%
Health Care	-6.8%	-15.1%	-18.1%
Industrials	-1.0%	-3.0%	2.0%
Information Technology	0.8%	-6.7%	30.4%
Materials	1.7%	22.4%	32.6%
Real Estate	-0.9%	-2.5%	8.5%
Utilities	2.6%	7.6%	28.1%
S&P/TSX Small Caps	-1.8%	-1.0%	8.9%
U.S. Equities (S&P 500 US$)	**-0.7%**	**-4.9%**	**12.1%**
Communication Services	0.7%	-5.5%	16.8%
Consumer Discretionary	-0.3%	-14.1%	11.3%
Consumer Staples	1.2%	6.5%	14.8%
Energy	-13.6%	-4.8%	-10.8%
Financials	-2.1%	1.4%	22.8%
Health Care	-3.7%	2.6%	1.9%
Industrials	0.2%	0.0%	9.8%
Information Technology	1.6%	-11.2%	13.8%
Materials	-2.2%	0.6%	-3.3%
Real Estate	-1.2%	2.3%	18.3%
Utilities	0.1%	5.0%	22.0%
Russell 2000 (US$)	-2.3%	-11.6%	0.9%
World Equities (MSCI ACWI US$)	**1.0%**	**-0.3%**	**12.3%**
MSCI EAFE (US$)	4.7%	12.0%	13.1%
MSCI Emerging Markets (US$)	1.3%	4.4%	9.6%
Commodities (GSCI US$)	**-8.4%**	**-4.0%**	**-6.0%**
WTI Oil (US$/barrel)	-17.1%	-17.8%	-28.7%
Gold (US$/oz)	5.9%	26.0%	44.1%
Copper (US$/tonne)	-5.6%	5.4%	-7.8%
Forex (US$ Index DXY)	**-4.6%**	**-8.3%**	**-6.4%**
USD per EUR	5.2%	9.8%	6.3%
CAD per USD	-4.1%	-4.1%	0.1%

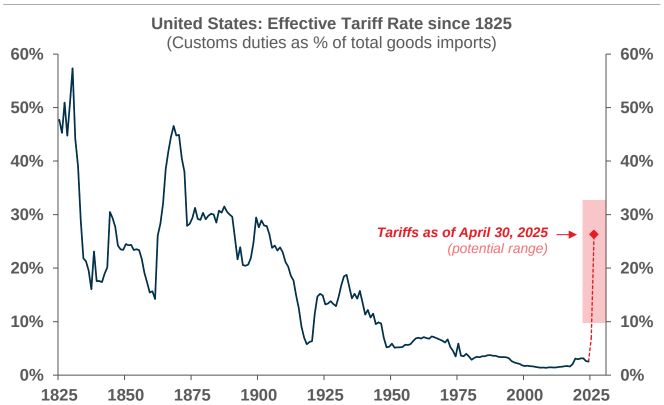
CIO Office (data via Refinitiv, as of 2025-04-30)

One step forward, two steps back

In 1904, Vladimir Lenin – the founding father of Soviet Russia – published a book entitled "One Step Forward, Two Steps Back: The Crisis in Our Party," in which he outlined the deep divisions between moderate and revolutionary factions within the Russian Social Democratic Party.

At present, in the United States, it is more a division between fierce opponents to free trade (led by Peter Navarro, senior advisor for trade and manufacturing) and those favouring a more nuanced approach (led by Scott Bessent, Secretary of the Treasury) that seems to be dividing the Republican Party. The result is constantly changing U.S. tariffs, which currently stand at levels comparable to those seen at the beginning of the 20th century (**Chart 1**).

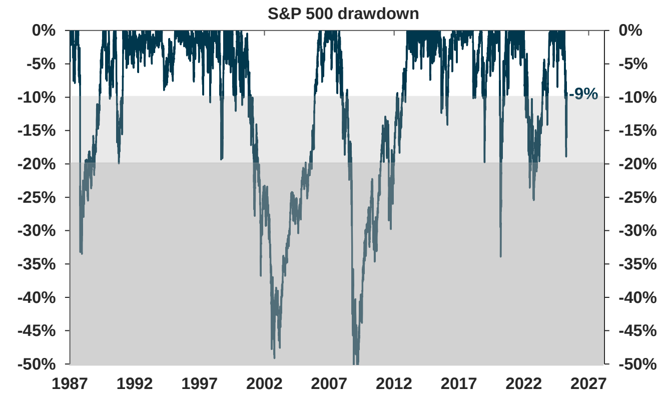
1 | Tariffs up...



CIO Office (data via Refinitiv, U.S. Census).

On the equity market front, while the reaction to monster tariffs announced on "liberation day" was severe – the S&P 500 edging close to the -20% mark from its recent peak – a series of reversals, including the announcement of a 90-day pause on reciprocal tariffs, allowed U.S. equities to recover almost all of the ground lost at the beginning of the month (**Chart 2**).

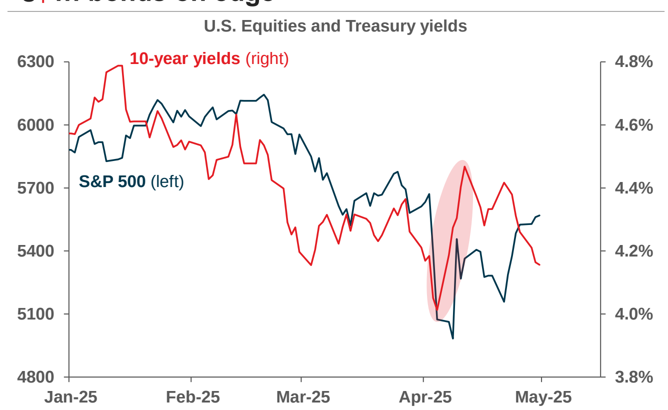
2 | … equities down…



CIO Office (data via Refinitiv).

However, it was movements in U.S. government bonds that caused particular concern in April, with 10-year yields rising by 46 basis points in just one week, prompting the U.S. president to refer to the market reaction as "yippy" [1] (**Chart 3**).

3 | … bonds on edge



CIO Office (data via Refinitiv).

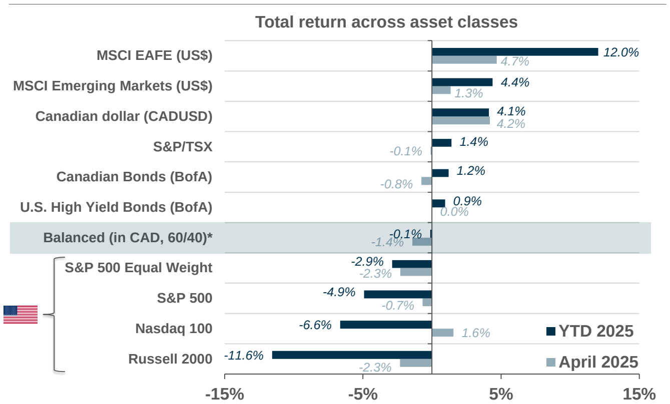
With hindsight, it seems that this phenomenon can mainly be explained by a forced deleveraging of large hedge funds in a context of extreme volatility[2] as was observed for several days during the equity downturn of March 2020. At the time, the Fed's massive intervention had calmed the markets. This

[1] Trump Says He Did Tariff Pause Because of 'Yippy' Reaction, Wall Street Journal, April 9, 2025.
[2] How the Treasury market got hooked on hedge fund leverage, Financial Times, April 25, 2025.

time, it took an announcement by the Treasury Secretary of a partial tariff truce.

In any event, the messages sent by financial markets are clear. First, a trade war pitting the U.S. against the rest of the world is not in the country's interest, which explains, at least in part, why the S&P 500 has underperformed since the start of the year. Second, for now, investors seem to be giving the U.S. administration the benefit of the doubt, even though it risks triggering a global recession if nothing changes. At least, that is what the relative resilience of stock markets would suggest, with overseas equities still showing gains in 2025 (**Chart 4**).

4 | U.S. markets coming in last



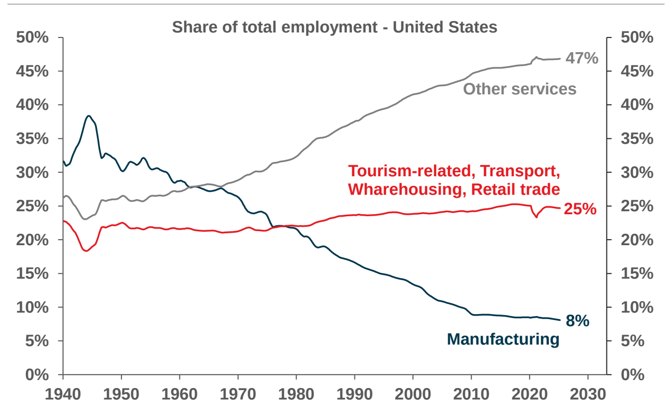
CIO Office (data via Refinitiv). * 21% S&P/TSX, 21% S&P 500, 12% MSCI EAFE, 6% MSCI EM, 40% ICE BofA Canada Universe, all in CAD.

But why?

To justify the use of import tariffs, the argument about bringing back jobs and factories to the U.S. manufacturing sector is regularly invoked.

While the proportion of Americans working in manufacturing has indeed fallen from a peak of 39% in 1945 to 8% in 2025, it should be remembered that this decline has largely benefitted the service sector, where conditions are often better. Furthermore, by paralyzing trade with China, whose imports are currently taxed at 145%, and alienating many potential tourists, other sectors are likely to feel the repercussions sooner rather than later. To put things in perspective, together, the tourism, transportation and warehousing, and retail trade sectors account for about three times as many workers as the manufacturing sector (**Chart 5**).

5 | It's not just the manufacturing sector...



CIO Office (data via Refinitiv). Tourism-related = Leasure and hospitality

However, the worst part of all this is that by disrupting global supply chains, the U.S. administration is jeopardizing the financial health of its very own manufacturing giants, as evidenced by the sharper decline in their stock prices (**Chart 6**, next page).

So, if the U.S. tariff strategy seems misguided, could it be mainly a matter of money? After all, with a deficit of 7.4% of GDP in 2024 – the worst of the

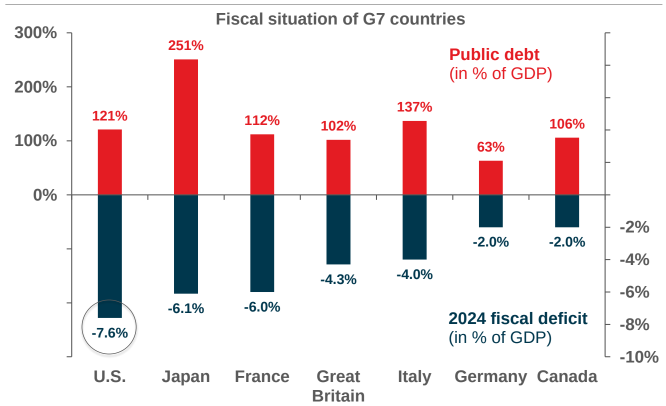
NATIONAL BANK INVESTMENTS

6 | ...which isn't looking too enthusiastic

CIO Office (data via Refinitiv).

G7 countries (**Chart 7**) – any additional source of revenue would be welcome for a U.S. president who promised to balance the budget in his speech to Congress on March 6.[3]

7 | Is the US gov. seeking new sources of revenue?

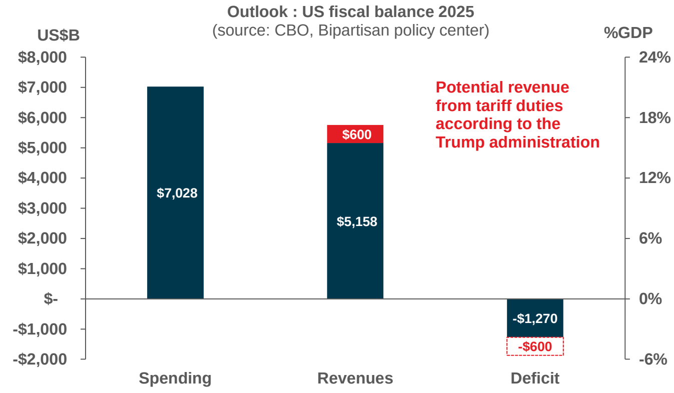


CIO Office (data via IMF).

Perhaps, but even in a highly optimistic scenario in which the U.S. government raises an additional $600 billion in 2025 through tariffs as claimed by the Trump administration[4], this would only represent a roughly 12% increase in revenue (**Chart 8**).

In truth, more realistic estimates taking into account the inevitable decline in trade volumes and retaliatory measures are closer to $200 billion in additional revenue.[5] All this in exchange for a significant risk of tipping the $30 trillion U.S. economy into recession.

8 | Yes, but no



CIO Office (data via CBO, Bipartisan policy center).

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[3] ***"****And in the near future, I want to do what has not been done in 24 years: balance the federal budget. We're going to balance it.",* President Donald Trump, March 6, 2025.

[4] Bessent Says Tariff Revenue Could Reach $600 Billion Annually, Wall Street Journal, April 4, 2025.

[5] Trump Tariffs: The Economic Impact of the Trump Trade War, Tax Foundation, April 11, 2025.

A risky game

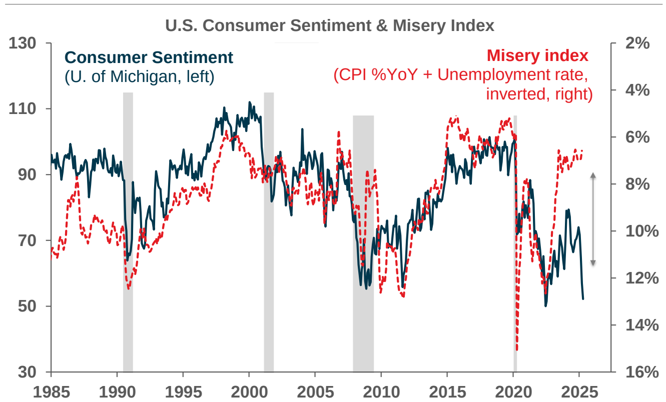
Before U.S. tariff policy was announced, betting markets estimated the risk of recession at around one in three. Today, it is two in three (**Chart 9**).

9 | The risk of recession has risen sharply

CIO Office (data via Polymarket).

For now, the economic damage is mainly reflected in consumer sentiment surveys which continue to weaken, unlike hard data on employment and even inflation which remain fairly positive (**Chart 10**). However, the gap between perception and reality is likely to narrow in the coming months.

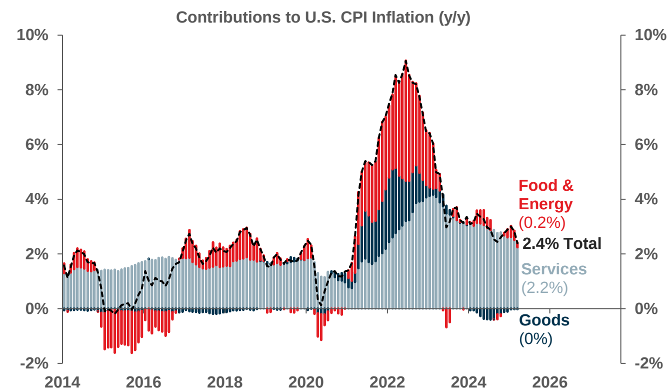
10 | Sentiment seems worse than the reality, for now



CIO Office (data via Refinitiv).

On the inflation front, while pressure on goods prices is inevitable given the added tariffs, the situation could not be more different from the inflation spike of 2021–2022 (**Chart 11**).

11 | Inflation: this is not a 2022 redux…



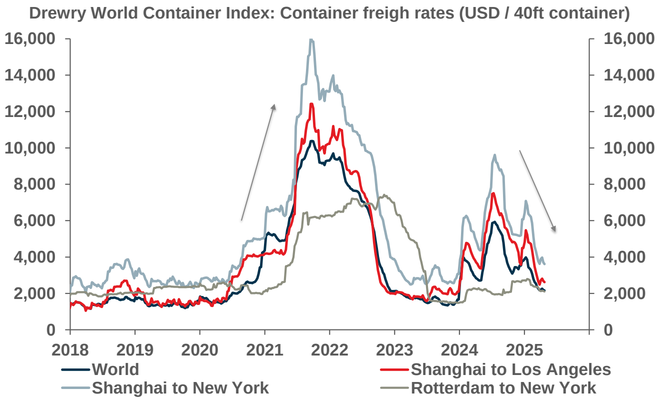
CIO Office (data via Refinitiv).

Back then, an economy thrown off balance by the pandemic and supercharged by extreme fiscal and monetary support measures had set the stage for a perfect inflation storm. This time around, while the economy is certainly disrupted by the reshaping of global trade, it is mainly being weighed down by tariffs that essentially function as taxes, on top of interest rates that are still considered restrictive. Case in point, the 15% drop in oil prices in April alone sends a clear signal to this effect, while the decline in global freight rates indicates that tariffs are significantly denting demand for goods – the opposite of what happened in 2022 (**Chart 12**, next page).

In sum, this context is likely to lead to significant volatility in the coming monthly inflation figures which, according to the latest projections from our economist colleagues[6], should ultimately remain slightly below 3% year-on-year for the overall index and slightly above 3% for the index excluding food and energy prices, in 2025.

[6] Monthly economic monitor – U.S., April 2025. NBF Economics and Strategy.

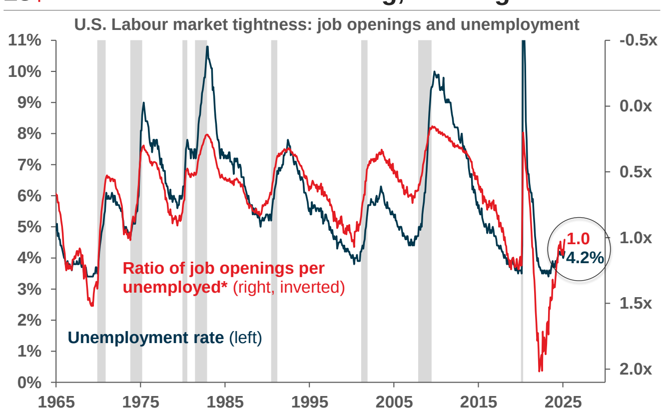
12 | … with global shipping rates heading south



CIO Office (data via Bloomberg, WCI).

With regard to employment, the situation could become more challenging. For now, the labour market is essentially balanced, with unemployment just above 4% and roughly one job opening for every unemployed person (**Chart 13**). This is excellent but, by definition, also means that it would not take much to tip the balance to the downside. And this is what our economists foresee, to some extent, with the unemployment rate ending 2025 at 4.8%.

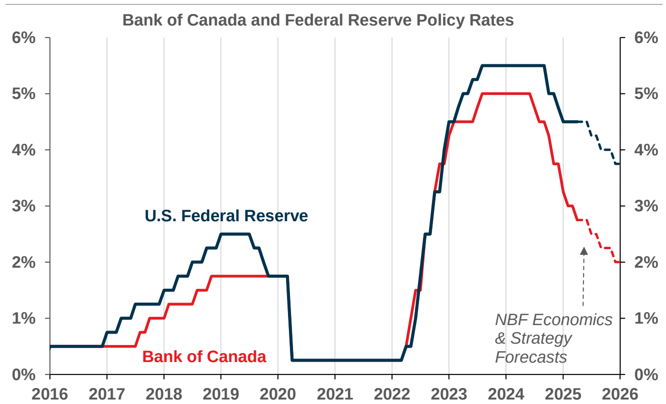
13 | The labour market is strong, but fragile



CIO Office (data via Refinitiv). *Job openings data before 2001 is based on the Help-Wanted index published by the Conference Board and the methodology outlined in Barnichon (2010).

Fortunately, central banks — and especially the U.S. Federal Reserve — still have room to support the economy in the event of a more significant deterioration in employment. Nevertheless, the unpredictability of the U.S. administration is compelling the Fed to wait and see the actual damage before acting, at the risk of doing too little, too late. Ultimately, the most likely scenario at this point, again according to our colleagues from NBF Economics and Strategy[7], involves three rate cuts in Canada and the U.S. in 2025 (**Chart 14**).

14 | There is room to cut rates, if required



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

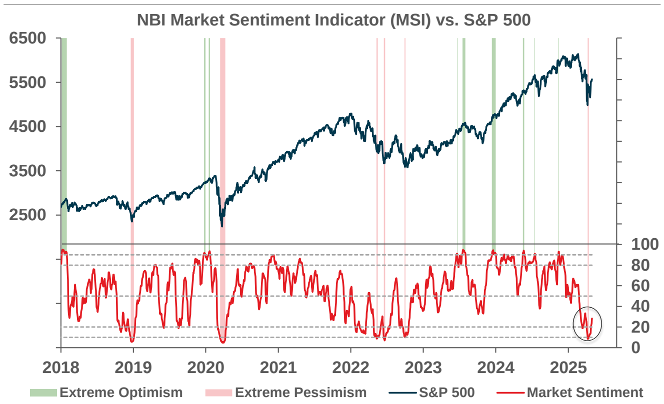
[7] Monthly Fixed Income Monitor, NBF Economics and Strategy, April 2025.

Signal chat

Reading markets that are trying to read the U.S. president is not easy but, if we filter out the background noise, a few signals and points of reference emerge.

On April 8, our market sentiment indicator hit the "extreme pessimism" threshold, a state from which even the slightest bit of good news can trigger a significant rebound in the short term. As such, when it announced a 90-day pause in reciprocal tariffs the next day, that's exactly what the U.S. administration delivered (**Chart 15**).

15 | After extreme pessimism, the rebound...



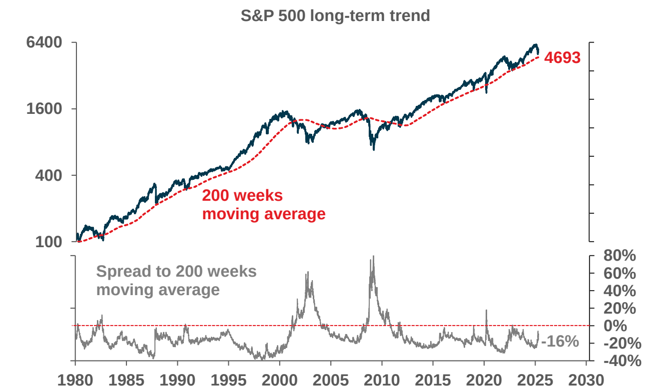
CIO Office (data via Refinitiv, Bloomberg).

However, by signalling a certain pivot on tariffs, the U.S. president has set expectations that de-escalation will continue over the coming months. And considering that the S&P 500 has already jumped 12% since its low on April 8, the hope seems to be that damage to the economy will be limited.

In the event that at least one of these two assumptions is tested, two important thresholds will need to be monitored for the S&P 500.

First, the 200-week moving average if worth paying attention to. With the exception of the financial crisis and the tech bubble, hitting this support level has often marked a point where bad news was largely priced in. Currently, this threshold is close to 4,700 or about 16% below current levels (**Chart 16**).

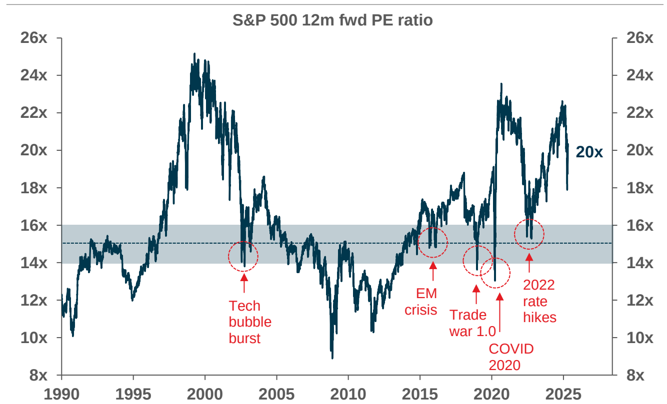
16 | … but downside risks remain…



CIO Office (data via Refinitiv).

Then, there is the forward price-to-earnings ratio to watch. Since the early 2000s, several major corrections have ended with valuations close to 15 times forward earnings. Compared to the current multiple of 20 times, and without taking into account earnings revisions, this would represent a decline of around 25% (**Chart 17**).

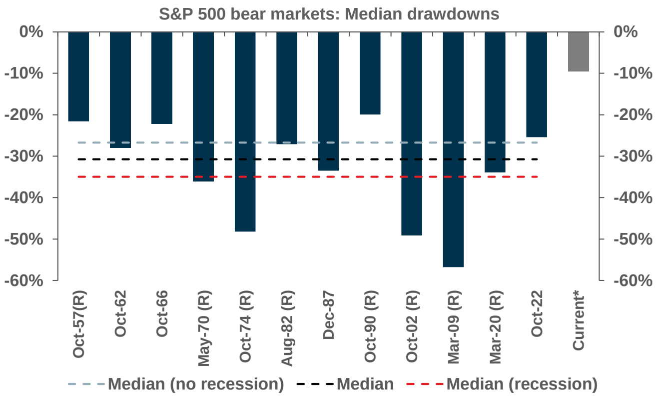
17 | … especially from a valuation perspective



CIO Office (data via Refinitiv).

In a pessimistic scenario, these two benchmarks therefore suggest a potential total decline in the S&P 500 from its February 19 peak of between 24% and 33%, a range not far from the median decline observed during a bear market without a recession (27%) and during a recession (35%) (**Chart 18**).

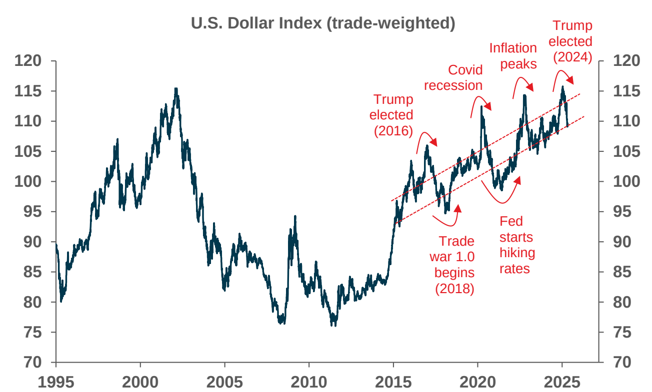
18 | Perspective on past equity market declines



CIO Office (data via Refinitiv, Bloomberg).

Meanwhile, as equities experienced significant volatility in April, the U.S. dollar remained firmly anchored on its downward trend of recent months – a strong signal considering that the Greenback typically strengthens when recession risks arise (**Chart 19**).

19 | The USD continues to decline

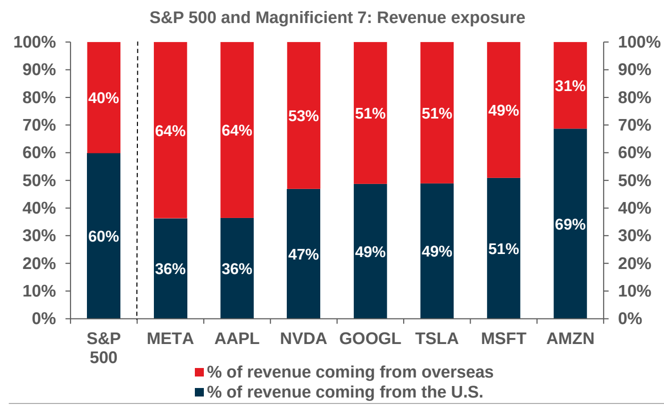


CIO Office (data via Refinitiv).

As discussed in our previous monthly report, the direction of the U.S. dollar is a key factor in stock market leadership across geographies. Seeing this trend persist, we reduced our U.S. equity allocation to underweight on April 7 (a first since 2021), favouring instead the EAFE region which has effectively continued to outperform in the ensuing weeks.[8]

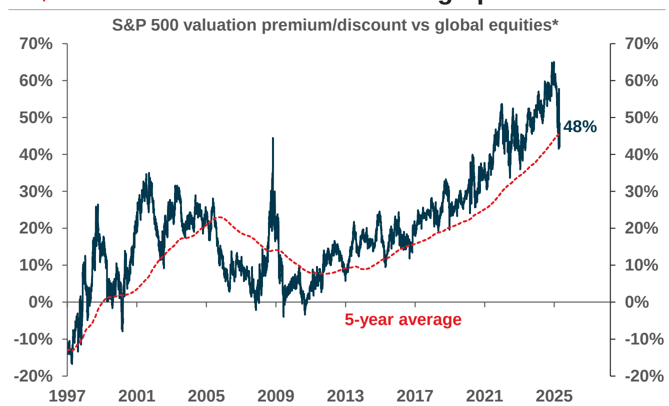
With 40% of S&P 500 sales coming from abroad – and more than half for several of its tech giants (**Chart 20**) – the U.S. government's resolutely isolationist policies are jeopardising both US equity earnings and their valuation premiums, which remain close to 50% relative to the rest of the world (**Chart 21**).

20 | U.S. equities, global revenues



CIO Office (data via FactSet).

21 | The S&P 500 still trades at a high premium



CIO Office (data via Refinitiv). *Average of the 12m fwd PE ratio of MSCI EAFE, MSCI EM, and S&P/TSX

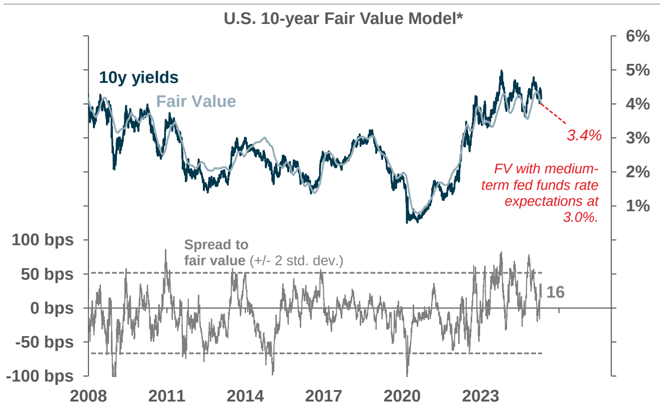
Finally, with regard to bonds, as long as the Fed does not open the door to supporting the economy, the asset class is likely to remain jittery. Nevertheless, we continue to believe that behind

[8] Since April 7, the EAFE region (EFA) is up 16%, compared with 10% for the S&P 500, in US dollars.

these concerns lies attractive return potential that does not necessarily require a severe economic slowdown to materialize.

For instance, according to our Fair Value Model, a convergence of the Fed's medium-term rate expectations toward what the institution now considers to be the neutral rate[9] could see Treasury yields fall to 3.4% (**Chart 22**). This would imply a gain of almost 10% over a 12-month horizon.

22 | Treasuries could provide decent returns



CIO Office (data via Refinitiv). *Based on (1) medium-term policy rate expectations and (2) long-term inflation expectations. **Function of conservative assumptions about the evolution of the two inputs to the fair value model.

A destructive tariff policy simply has no logical justification, which likely explains why the Trump administration has already started to backpedal and must imperatively do so — at least partially — with China.

In the near term, this “pivot” could continue to fuel some hope for equity markets. However, given current valuations, downside risk remains significant as the coming months should begin to reveal the extent of the damage inflicted on the economy.

Against this backdrop, we reduced our allocation to U.S. equities relative to developed overseas markets in early April, seeing in market movements a signal that this rotation had room to run with the Greenback under pressure. Besides, our equity/bond allocation remains neutral, as we await more attractive risk/return prospects in equities.

The bottom line

[9] Summary of Economic Projections, March 2025, Federal Reserve.

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