

Comfortably numb

Highlights

- After a more difficult start to the quarter, calm quickly returned to equity markets, which have comfortably consolidated their gains over the past few months. And yet, pressure in bond markets has continued to intensify, amid persistent chaos across the energy complex. How should we interpret this apparent disconnect?
- In the short term, a significant decline in energy prices would help ease tensions in bond markets. Interest rates have never been as closely correlated with oil prices as they have over the past year.
- However, that is not the whole story: behind the fog created by the energy supply shock may lie an economy with a more fundamental potential to overheat.
- Overall, our base case remains largely intact. Economic growth still appears solid, supported in part by strong capital spending, while moderate monetary tightening and some easing in geopolitical tensions should help avoid the worst on the inflation front.
- Nevertheless, the risks surrounding our outlook have necessarily increased recently, as the global economy and equity markets are being weakened by persistently high energy prices and rising borrowing costs.
- Meanwhile, movements in bond markets appear increasingly stretched from a technical perspective. The situation could still deteriorate before it improves but, at current levels, the risk-return profile is becoming increasingly attractive over a horizon of one year or longer.

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 environment remains supportive for equity markets, rising risks call for a somewhat more cautious stance as we enter the final quarter of 2026.

Against this backdrop, we took some profit on our equity overweight, reallocating capital to bonds, which have become oversold. We also further reduced our allocation to emerging markets, whose relative volatility had reached levels not seen since 2009.



Market review

Fixed Income

- September was a difficult month for the Canadian fixed income universe, as bond yields rose sharply amid renewed concerns over inflation and the path of monetary policy. The asset class declined 1.2% over the month, pushing year-to-date returns into negative territory.
- Conditions were even more challenging in the United States, where 10-year and 30-year Treasury yields climbed to levels not seen in several decades.

Equities

- Despite the widespread anxiety gripping bond markets, global equities ended the month with only slight losses. The United States and Emerging Markets outperformed Canada and the EAFE region on the back of strong returns for AI-related stocks.
- Within the S&P 500, gains were highly concentrated in technology-related sectors, while every other sector finished the month in negative territory.

FX & Commodities

- Oil prices continued their volatile swings in September, posting a substantial increase as an agreement between the United States and Iran remained elusive. Gold, meanwhile, came under pressure from rising real interest rates.
- The U.S. dollar appreciated significantly over the month, supported by resilient economic data and a Federal Reserve that struck a decidedly more hawkish tone than markets had anticipated in its approach to inflation.

Market Total Returns

Asset Classes	Sep	Q3	YTD
Cash (S&P Canada T-bill)	0.2%	0.6%	1.7%
Bonds (ICE Canada Universe)	-1.2%	-3.0%	-0.9%
Short Term	-0.6%	-0.9%	0.5%
Mid Term	-1.4%	-3.0%	-0.8%
Long Term	-1.8%	-6.4%	-3.2%
Federal Government	-1.2%	-2.7%	-0.9%
Corporate	-0.7%	-2.2%	0.0%
U.S. Treasuries (US\$)	-2.3%	-3.1%	-2.7%
U.S. Corporate (US\$)	-2.6%	-3.8%	-2.8%
U.S. High Yield (US\$)	-2.5%	-1.8%	0.0%
Canadian Equities (S&P/TSX)	-2.6%	1.6%	13.0%
Communication Services	-9.8%	-9.3%	-13.6%
Consumer Discretionary	-2.1%	-5.1%	-0.7%
Consumer Staples	-1.6%	-7.0%	1.3%
Energy	-3.7%	3.3%	27.7%
Financials	-1.1%	-3.0%	19.5%
Health Care	-0.6%	-5.4%	3.0%
Industrials	-1.2%	-3.2%	6.8%
Information Technology	3.5%	17.9%	-2.8%
Materials	-7.4%	12.9%	10.5%
Real Estate	-3.3%	-7.3%	-3.9%
Utilities	-2.5%	-7.2%	9.3%
S&P/TSX Small Caps	-1.8%	2.4%	20.8%
U.S. Equities (S&P 500 US\$)	-0.3%	2.3%	12.7%
Communication Services	4.3%	3.6%	4.5%
Consumer Discretionary	-5.8%	-5.1%	-5.8%
Consumer Staples	-3.3%	-1.9%	6.0%
Energy	-2.7%	17.2%	40.3%
Financials	-7.2%	-0.1%	-1.3%
Health Care	-0.9%	6.5%	10.2%
Industrials	-4.4%	-9.7%	8.5%
Information Technology	4.5%	7.2%	28.4%
Materials	-6.7%	-2.8%	8.8%
Real Estate	-6.1%	-5.6%	5.3%
Utilities	-5.9%	-12.4%	-5.7%
Russell 2000 (US\$)	-5.3%	-7.2%	13.7%
World Equities (MSCI ACWI US\$)	-1.1%	1.7%	13.4%
MSCI EAFE (US\$)	-3.0%	0.9%	10.8%
MSCI Emerging Markets (US\$)	-0.5%	-0.2%	23.7%
Commodities (GSCI US\$)	4.8%	25.1%	55.2%
WTI Oil (US\$/barrel)	11.7%	37.7%	69.7%
Gold (US\$/oz)	-6.2%	3.2%	-3.7%
Copper (US\$/tonne)	0.1%	8.3%	16.1%
Forex (US\$ Index DXY)	2.0%	0.3%	3.2%
USD per EUR	-2.2%	-0.7%	-3.3%
CAD per USD	2.7%	0.3%	3.7%

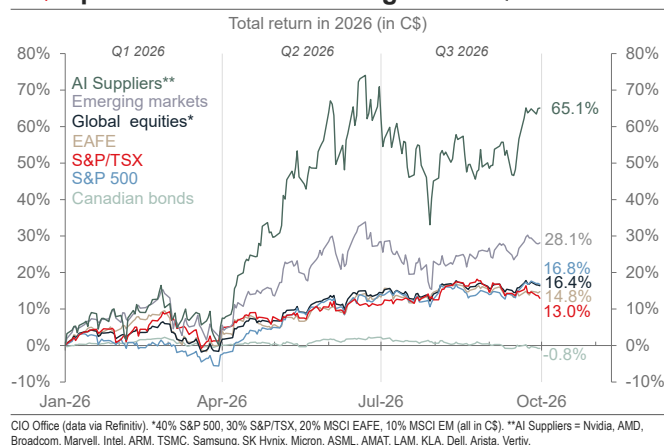
CIO Office (data via Refinitiv, as of 2026-09-30)



Comfortably numb

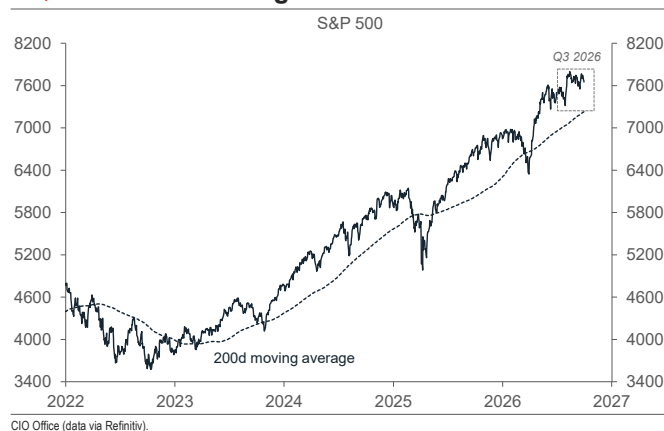
After a more difficult start to the quarter for equity markets — and particularly for the artificial intelligence theme — the situation stabilized quickly over the following weeks. Thus, after nine months, the overall picture for equities in 2026 remains broadly positive, with developed markets delivering comparable returns and emerging markets continuing to outperform (**Chart 1**).

1 | Equities consolidate their gains in Q3...



In itself, the relative calm of major equity indices during the third quarter is remarkable. At its worst, for example, the S&P 500 was down by barely 3% from its all-time high (**Chart 2**).

2 | ... near all-time highs...



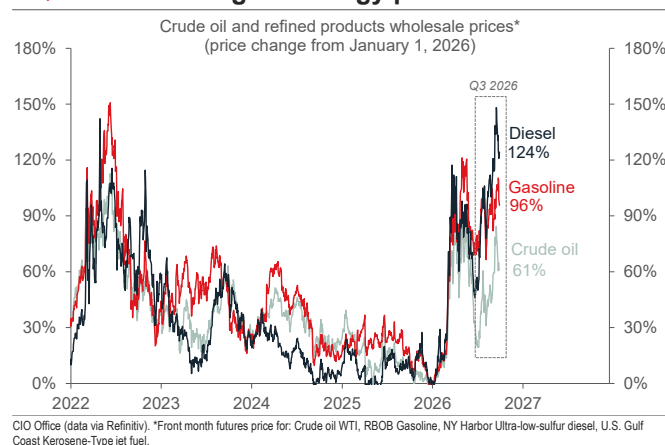
And yet, in bond markets, pressure intensified from one week to the next, with the U.S. 10-year yield breaking above its 2023 high in September and reaching its highest level since 2007 (**Chart 3**).

3 | ... unfazed by bond-market tensions...



All of this unfolded against a backdrop of persistent turmoil in the energy complex, affecting refined products in particular. Diesel prices have now surpassed the record levels observed in the aftermath of Russia's invasion of Ukraine in early 2022 (**Chart 4**).

4 | ... and the surge in energy prices



In our June report, entitled *The Uneasy Path*, we argued that it was important for investors to keep sight of the broader picture, which still appeared favourable for equity markets despite an uncomfortably long list of risks. That assessment

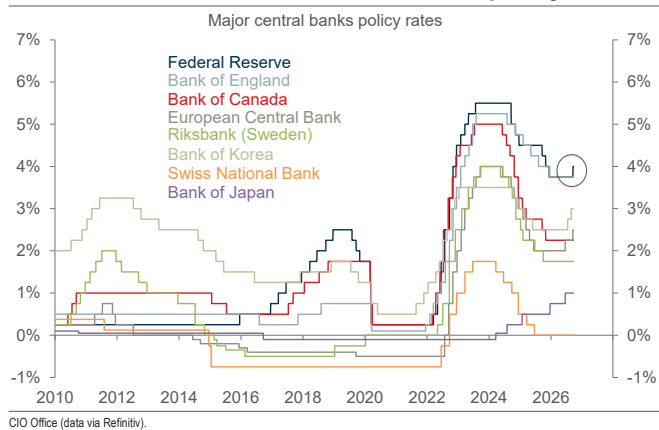


proved correct. But does it still hold? Let's take a closer look.

Another hike in the wall

Only four months after taking office, the new Chair of the Federal Reserve announced the first interest rate hike since 2023, joining a growing number of central banks that have adopted a similar stance (**Chart 5**).

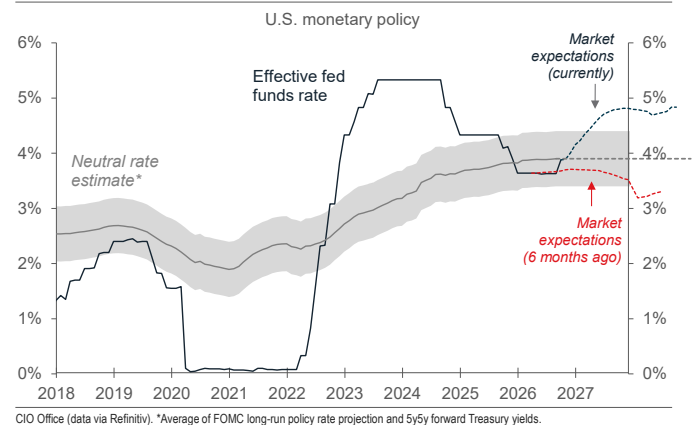
5 | The Fed follows suit and raises its policy rate



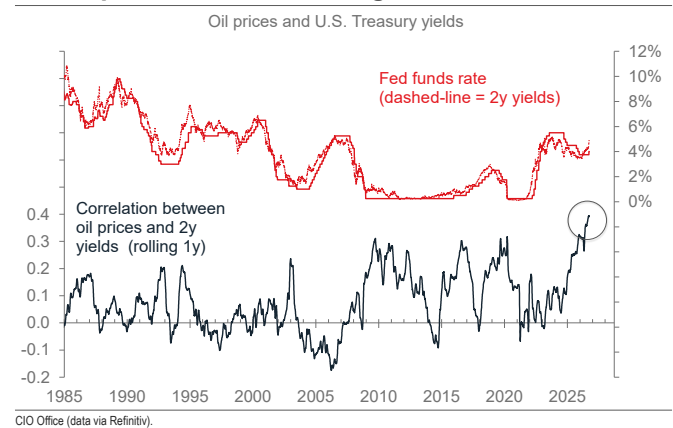
While this decision essentially settled the question of the Fed's independence from the White House, it reignited the debate over the appropriate level of interest rates. Whereas markets were still pricing in no change six months ago, they now expect four additional hikes over the coming year (**Chart 6**).

In the short term, a significant decline in energy prices would certainly prompt markets to lower their expectations for rate hikes. Indeed, interest rates have never been as closely correlated with oil prices as they have over the past year (**Chart 7**).

6 | Much has changed in six months!



7 | Oil prices take centre stage...

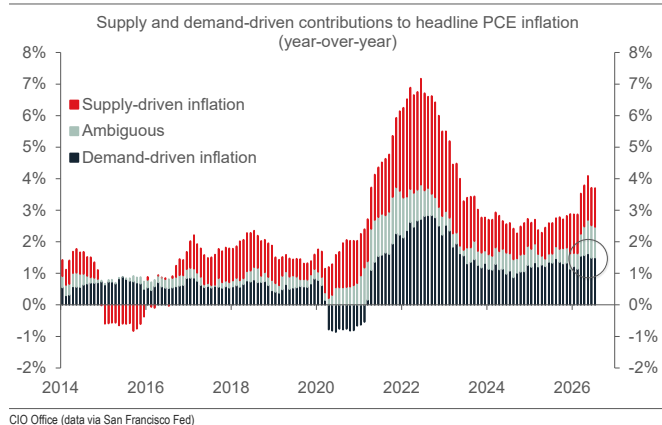


However, that is not the whole story. Behind the fog created by the energy supply shock may lie an economy with more fundamental overheating potential. After all, we are still seeing few signs of an economic slowdown, despite seven months of elevated prices at the pump. Moreover, according to analysis from the San Francisco Fed which seeks to distinguish supply-driven inflation from demand-driven inflation¹, some signs of renewed pressure appear to have emerged recently on the demand side (**Chart 8**, next page).

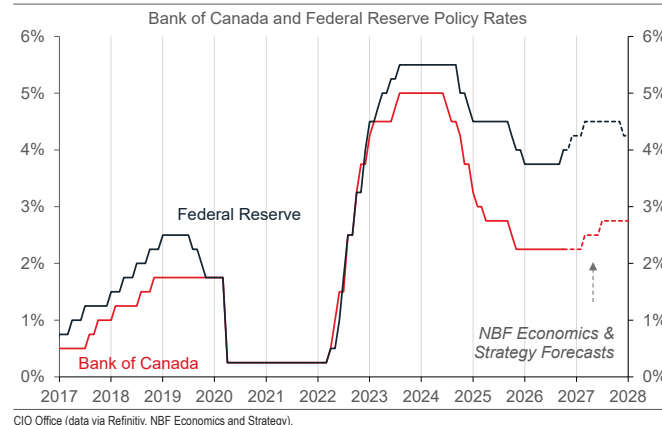
¹ Demand-driven inflation occurs when consumers are willing to purchase more despite rising prices — for example, during the post-pandemic reopening, when pent-up demand led to increases in both spending volumes and prices. This differs from a supply shock, such as a surge in oil prices, where prices rise while the quantity of goods or services available declines.



8 | ... but that is not the whole story

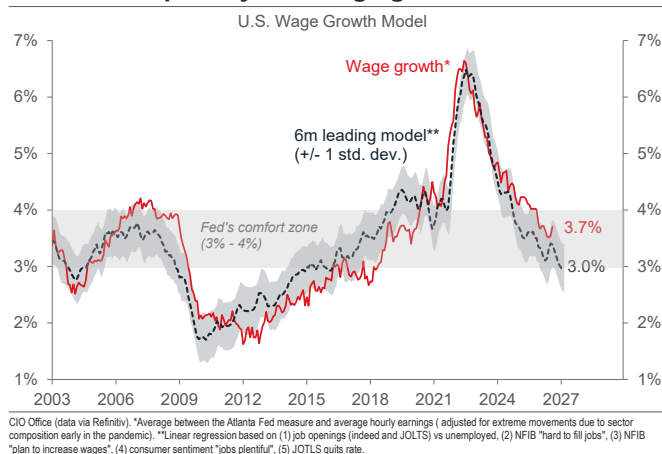


10 | Further rate hikes are looming

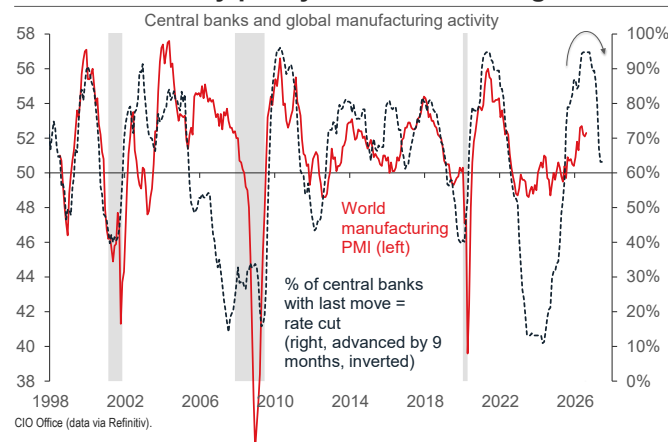


That said, we should be careful not to jump to conclusions. For the economy to enter a genuine overheating phase, wage growth would have to accelerate. While some indicators bear watching², the overall data still point to contained wage growth (**Chart 9**).

9 | Let's keep an eye on wage growth



11 | The monetary-policy winds are shifting



Against this backdrop, our economists' base case³ calls for two further rate hikes from the Fed. Two rate hikes are also possible from the Bank of Canada, although these may have to wait until early 2027 if some de-escalation in trade tensions with our neighbours to the south were to materialize (**Chart 10**).

² For example, wages for workers who change jobs have risen more sharply recently, a phenomenon that can sometimes signal broader pressures building in the labour market.

³ For more details, see the latest update of the Monthly Fixed Income Monitor from NBF Economics and Strategy.

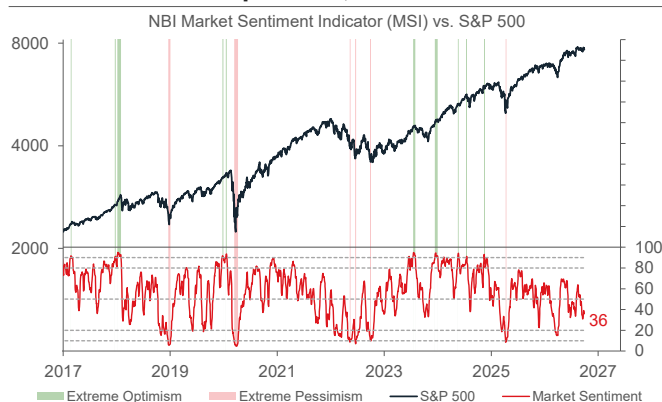


The bottom line for investors

Our base case — recently updated — remains largely intact. Economic growth still appears solid, supported in part by strong capital spending, while moderate monetary tightening and some easing in geopolitical tensions should help avoid the worst on the inflation front.

This backdrop remains supportive for equity markets. More specifically, following a quarter marked by a consolidation of the gains recorded earlier this year, investor sentiment still appears far from excessively optimistic (**Chart 12**).

12 | No excessive optimism, based on our indicator...

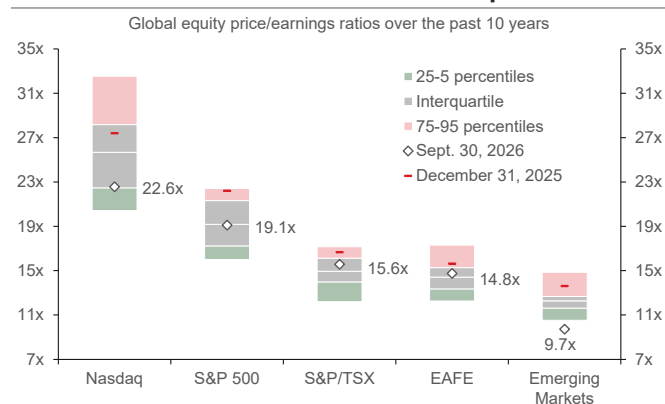


CIO Office (data via Bloomberg)

Moreover, while not necessarily trading at a discount, the major equity indices continue to exhibit lower price-to-earnings ratios than at the beginning of the year (**Chart 13**). The same is true of the heavyweights leading the race for advances in artificial intelligence, whose valuations are close to their lowest levels since ChatGPT emerged in late 2022 (**Chart 14**).

Admittedly, these ratios are based on earnings-growth expectations that may appear optimistic. However, such expectations have more often than not been underestimated in recent years. This encourages us to monitor them rather than dismiss

13 | ... with valuations well below their peaks...



CIO Office (data via Refinitiv).

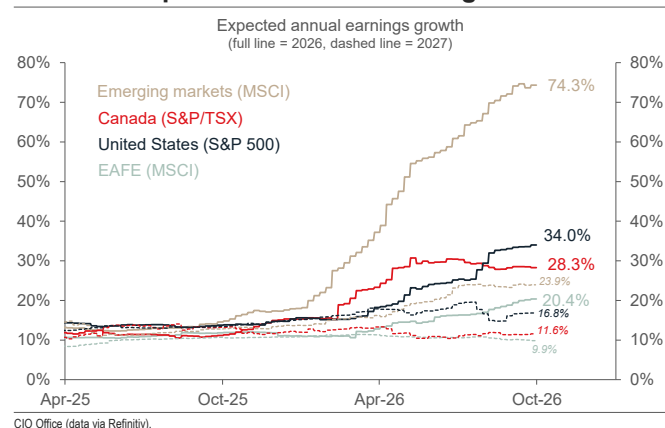
14 | ... including within the AI ecosystem



CIO Office (data via Refinitiv). 1. AI Suppliers = Nvidia, AMD, Broadcom, Marvell, Intel, ARM, TSMC, Samsung, SK Hynix, Micron, ASML, AMAT, LAM, KLA, Dell, Arista, Veriv. 2. Hyperscalers = Microsoft, Amazon, Alphabet, Meta, Oracle.

them and, for now, expectations remain relatively resilient (**Chart 15**).

15 | Profit expectations remain strong

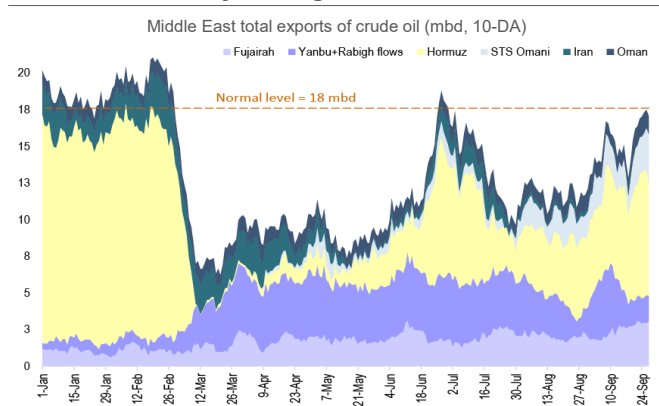


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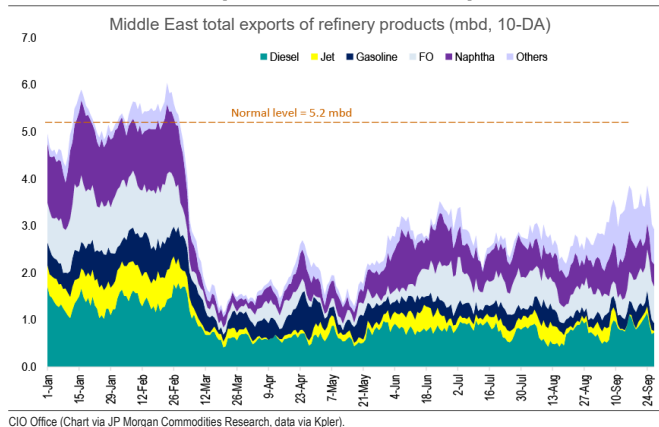


On the geopolitical front, although the situation remains highly precarious, a full-blown escalation still appears to be a secondary scenario. In fact, Iran even seems to be on track to lose a significant portion of its leverage over the Strait of Hormuz (**Charts 16 and 17**).⁴

16 | Oil finds a way through the chaos



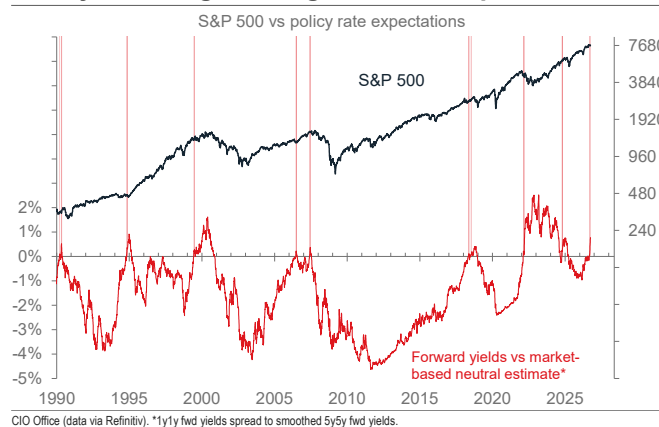
17 | It's more complicated for refined products



All of this is positive, but it comes with an important caveat: the cost to the global economy is considerable and is making it more fragile. This refers not only to the additional cost of transporting oil through the Strait of Hormuz and the pressure on refined products, but also to the resulting impact on borrowing costs.

To that end, an early indicator of restrictive monetary conditions that we monitor was triggered in September. This does not always signal imminent trouble for equity markets, but it certainly represents another yellow light that warrants attention (**Chart 18**).

18 | A yellow flag is being raised for equities



Against this backdrop, we took some profit on our equity overweight in September, thereby reducing the overall level of risk in our investment strategy. In turn, we reallocated capital to bond markets, where the sharp rise in yields over the past three months has significantly improved the risk-return outlook over a 12-month horizon (**Chart 19**).

19 | Bonds: the balance of risks is improving...

Expected 1-year total return from a change in interest rates ¹					
Rate Change	U.S. 10-year Treasury Note	U.S. 30-year Treasury Bond	Canada 10-year Bond	Canada Broad Universe ²	Canada Corporate Universe ²
100bps	-2.5%	-9.1%	-4.2%	-2.8%	-1.1%
80bps	-0.9%	-6.2%	-2.6%	-1.4%	0.1%
60bps	0.6%	-3.2%	-0.9%	0.0%	1.2%
40bps	2.2%	-0.3%	0.7%	1.4%	2.3%
20bps	3.7%	2.7%	2.4%	2.8%	3.5%
0bps	5.3%	5.6%	4.0%	4.2%	4.6%
-20bps	6.8%	8.6%	5.6%	5.5%	5.7%
-40bps	8.4%	11.5%	7.3%	6.9%	6.8%
-60bps	9.9%	14.5%	8.9%	8.3%	8.0%
-80bps	11.5%	17.5%	10.6%	9.7%	9.1%
-100bps	13.0%	20.4%	12.2%	11.1%	10.2%

1. Total return is measured as the sum of the starting yield, the roll yield, and the duration impact of the rate change (assuming parallel shifts in the yield curve).

2. For corporate bonds (representing approximately 30% of the Broad Universe index) we assume no change in their spread against government securities.

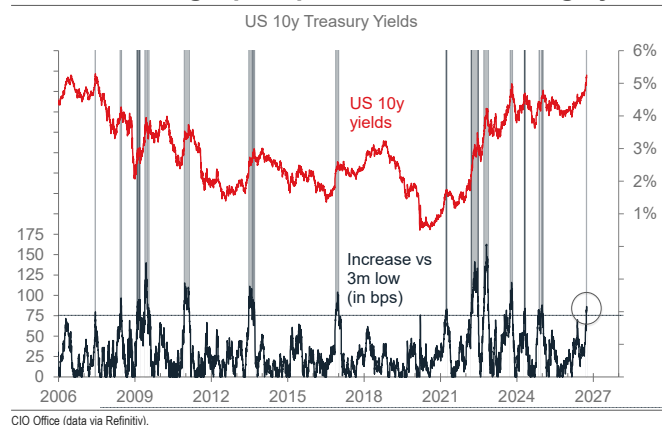
CIO Office (data via Refinitiv).

⁴ Middle East Oil Exports Rebound as Iran's Chokehold on Hormuz Breaks Down, Wall Street Journal, september 28, 2026.



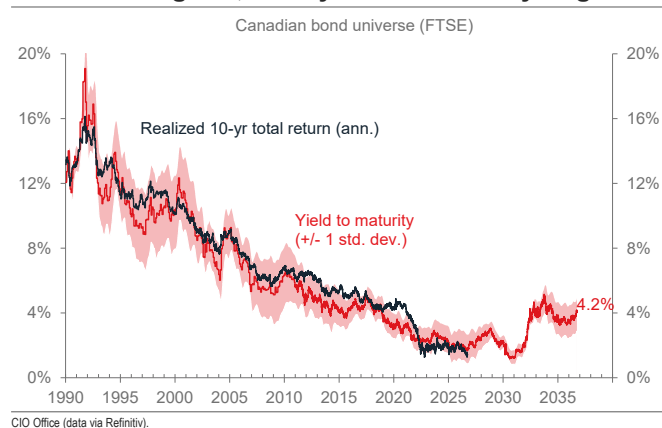
Of course, conditions could deteriorate further before improving for bonds. However, it increasingly seems unlikely that such deterioration could occur without consequences for equity markets. In any event, at current levels, bond yields would have to rise significantly to generate a negative return over the coming year, while their recent increase already appears technically stretched (**Chart 20**).

20 | ... following a precipitous rise in sovereign yields



Over a longer horizon — when the uncertainty surrounding fixed income diminishes — it is also worth noting that, after a disappointing decade, returns could potentially be three times higher over the next ten years (**Chart 21**).

21 | In the long run, what you see is what you get

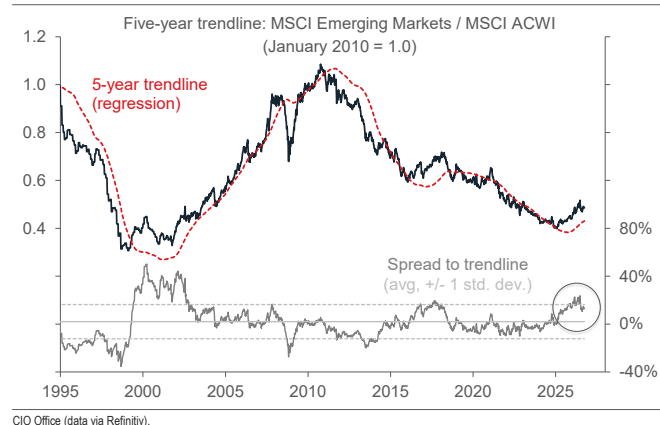


Finally, within equities, we further reduced our allocation to Emerging Markets (EM), bringing to an

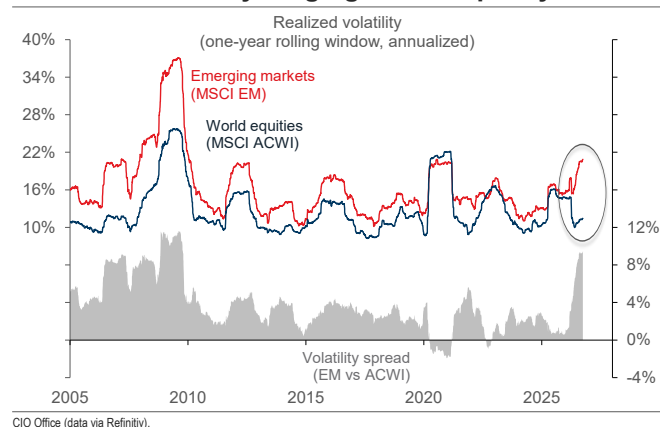
end a year-long overweight marked by significant outperformance, particularly driven by companies involved in AI infrastructure.

Although a favourable structural trend appears to be taking hold in the region, the bar is becoming increasingly difficult to clear in the short term (**Chart 22**). More importantly, from a risk perspective, the magnitude of the fluctuations observed in EM warrants reflection: volatility has reached its highest level since 2020 in absolute terms and since 2009 relative to the rest of the world (**Chart 23**).

22 | Emerging markets are struggling to keep pace...



23 | ... with volatility surging over the past year

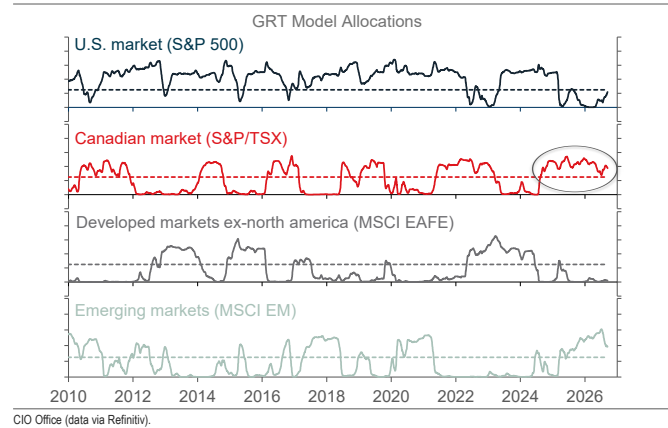


In turn, we increased our allocation to Canadian equities. Their greater exposure to commodities provides an attractive complement in the current



environment, while they also benefit from favourable market momentum (**Chart 24**).

24 | Canadian equities hold their ground





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General

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