Escaping the crowds

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Equity markets remain buoyant as we wind our way into the final quarter of 2025. The intense fear that accompanied "Liberation Day" back in April is a distant memory, replaced by enthusiasm surrounding corporate spending on AI related technology. Reflected in the growing concentration of the US equity market (Figure 1), the AI theme has become increasingly crowded. While we respect the transformational nature of the underlying technology, neither ultimate effects of AI on productivity nor the eventual winners from its adoption are fully clear at this point. Moreover, concentrated markets are not diversified markets. And maintaining diversification is of paramount importance for the funds we manage for Canadian investors. As a result, we have been reluctant to chase this rally and continue to hold a broadly neutral allocation to total equity. From a regional perspective, we have also maintained our underweight to US equities while becoming more constructive on the outlook for Canada.

Figure 1: Record concentration in the US market

Top 10% of US companies as a share of total US equity market cap

Source: Fama French Data Library, FMR. As of June 30, 2025

Seeing the forest from the AI-generated trees

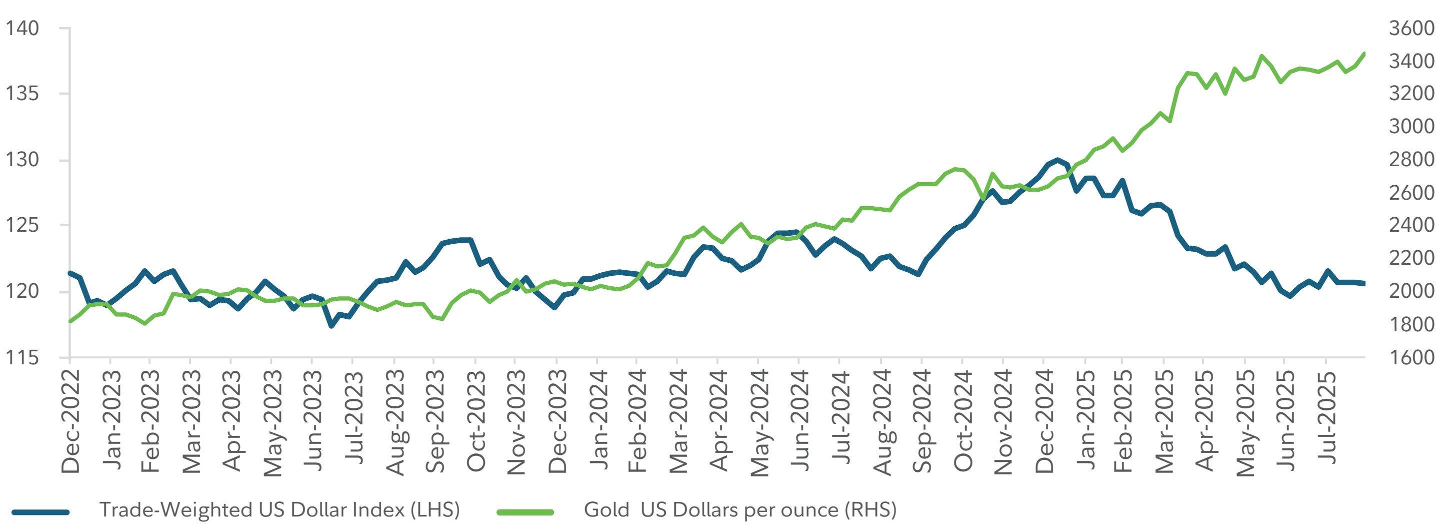
The near-singular focus on AI-related spending has obscured several less constructive developments in the wider US economy. [In our last Thought Leadership piece], we outlined how the isolationist polices of the current US government have raised the potential of a new global investment regime. In this new regime, global investors may demand a higher risk premium to hold US assets, thereby challenging the traditional safe haven status of

US markets. Actions taken by the government since that time have only strengthened that thesis. Notably, the increased politicization of the Federal Reserve and the Bureau of Labor Statistics threaten the independence and credibility of these critical US institutions.

We are also mindful of the economic impact of additional fiscal and monetary stimulus expected over the remainder of the year and into 2026. While the pace of hiring has cooled in recent months, an indicator that has historically signaled caution, we have seen a commensurate decline in the supply of labour, helping to maintain relative balance. Dynamics in the labour market are supportive of durable consumer behaviour, an important factor contributing to robust economic growth. Taken together, the probability of recession remains low. Given this backdrop, additional stimulus will raise the risk of resurgent inflation and even larger budget deficits. This could push longer-dated government yields higher as investors price in a larger fiscal risk premium and anticipate tighter monetary policy down the road to once again bring inflation back under control.

The continued softness of the US Dollar (USD) is a product of these concerns as investors navigate this potentially new global investment regime. The risk that the USD continues to weaken forces us to disentangle the investment opportunities that exist within the US from the return measured in Canadian dollars. On the former, our actively managed US equity building blocks are well positioned to invest in profitable companies across AI and other investment themes. Using a combination of actively managed building blocks with portfolio managers that have different investment styles also helps to diffuse the concentration risk that would otherwise come with a passive index exposure. And on the latter, we have taken further steps to reduce our USD exposure, diversifying into other currencies as well as into gold – whose recent strong rally reflects both the weaker USD trend and the questions about US policy that underpin it (Figure 2).

Figure 2: Gold shines as the US Dollar falls



Source: Bloomberg, As of August 31, 2025

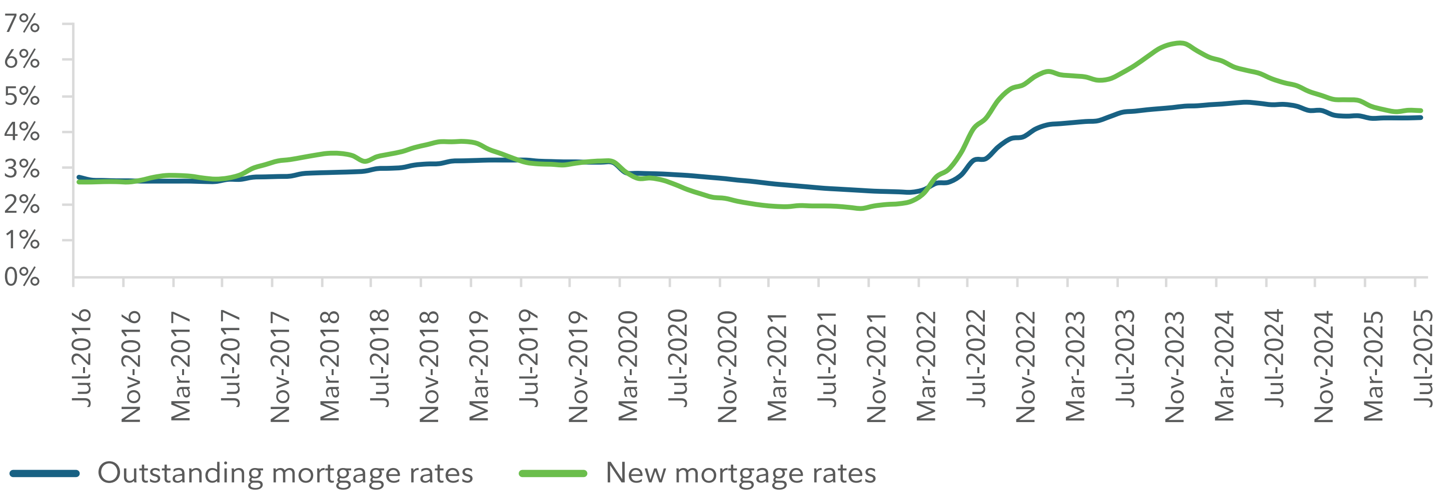
Darkest Before Dawn in Canada

As our concern over the US deepens, we think the long-struggling Canadian economy may be in the process of troughing. This might be surprising to read on the heels of the Q2 GDP report showing an annualized decline of 1.6% in economic output, which was the worst number since COVID struck. But this report reflected dynamics that were visible long ago and well discounted in markets. First, it was always clear that the tariffs introduced in early 2025 would deliver an immediate blow, and indeed the 27% annualized drop in exports in the second quarter was the largest drop in 40 years outside of the 2008-09 recession and COVID. Second, as we've discussed for years, the combination of high Canadian household debt and looming mortgage resets from the ultra-low rates five years ago was always going to be challenging for consumer spending and the housing market. Third, it's long been clear that the reversal in immigration flows that began late last year, regardless of one's view on its desirability, would leave something of a near-term hole in GDP.

All three of these weights are likely to lift somewhat ahead. The political rhetoric on the trade war has since cooled and there have been signs of a rapprochement ahead of the scheduled review of the CUSMA next year; while it is far too early to anticipate the results of the review, the trading relationship is unlikely to be as disadvantageous to Canada as it was earlier this year. The 'pig in the python' of adverse mortgage renewals will pass in coming years, so long as rates stay near current levels (Figure 3). And population growth will eventually stabilize at a rate that better matches the economy's ability to support it.

Figure 3: Less sticker shock at rate renewal

Aggregate uninsured mortgage rates



Source: Macrobond, Bank of Canada. As of July 1, 2025

In addition, there are glimmers of hope on productivity growth over the longer term. The federal government has announced ambitious plans focused on infrastructure and natural resources development, along with aspirations to reduce the interprovincial trade barriers and bureaucracy that have long weighed on the efficiency of the Canadian economy. While the successful implementation of these policies will not be easy or fast, there is a visible path to improvement for the first time in many years.

To be clear, the economic situation in Canada right now is not good. Based on our analysis, the economy has been flirting with recession for the better part of two years and may continue to struggle in coming quarters. But the medium-to-longer-term outlook is getting better, even as the reverse seems to be true in the United States. As always, we are looking to where the puck is going rather than where it is now, seeking exposures with positive prospective change that may be underappreciated by the market. In that context, earlier this year we filled in a large portion of the underweight we have long held in Canadian assets. We are broadly neutral Canadian equity today and the modest underweight we have to the Canadian dollar is against an overweight to non-USD developed and emerging market currencies. A larger allocation to Canadian assets will depend not only on headwinds fading further but as well on emergent tailwinds that strengthen the recovery thesis.

The growing concentration in the US equity market reflects the undeniable appeal of investing in a transformation technology like AI. But it is also important to place an investment theme like AI into a wider market context and against competing opportunities. Guided by the goal of diversification, we will continue to adjust our positioning to balance the momentum of the crowd with roads less traveled.

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