Monthly Market Monitor

Data and opinions as of January 31, 2025

NEI perspectives

The Bank of Canada (BoC), and the European Central Bank (ECB) cut rates, extending the divergence from the Federal Reserve (Fed) who held rates unchanged and signalled caution: The Fed maintained its interest rate at 4.25%–4.50% through December and January, citing steady economic growth, solid labour market, and lack of progress on inflation. This widens the rate gaps with the ECB and BoC, as both cut rates by 0.25% to stimulate growth. **Bottom line**: *Growth and rate differentials will increase volatility in bonds, equities, and currency markets as investors assess policy shifts and impact on growth and inflation.*

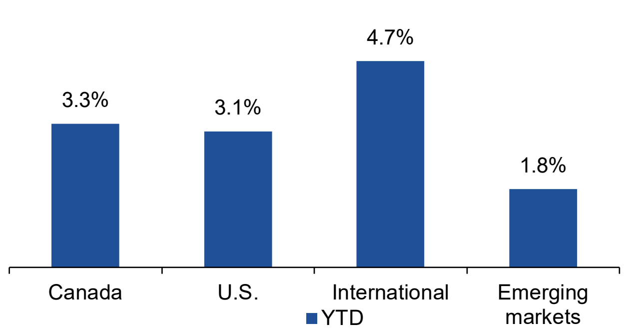
Earnings season and AI disruption in markets: Early 2025 earnings reports from major U.S. companies revealed mixed results, with tech firms facing increased pressure due to AI competition. The unveiling of DeepSeek especially sent shock waves through the AI, semiconductor, and infrastructure industries. **Bottom line**: *While earnings were mostly strong to start the new year, the AI sector remains a high-growth area but faces potential paradigm shifts from emerging competitors.*

Canada at the center of renewed tariff threats: President Trump has repeatedly threatened to impose a 25% tariff on Canadian imports, heightening economic uncertainty, impacting key industries such as automotive and energy. The Canadian dollar faced significant downward pressure, while the BoC remains cautious in its policy stance, balancing trade risks against inflation concerns. **Bottom line**: *Canada's trade-dependent economy faces increased volatility, requiring strategic policy responses to mitigate risks.*

AI disruptions, central banks walking a tight-rope, and Canada's tariff threat

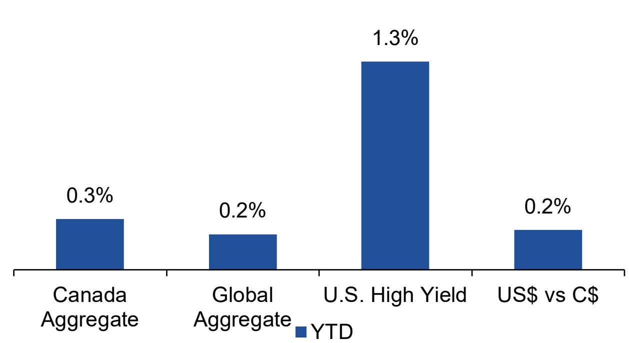
2025 started with gyrations between optimism and uncertainties, driven by significant developments in the AI and technology sectors, monetary policy decisions, and renewed trade tensions. The emergence of a Chinese AI competitor, DeepSeek, raised concerns about market dominance in the U.S. semiconductor sector and future demand on electricity, while the Fed's interest rate stance influenced broader market sentiment. Additionally, President Trump's revived tariff threats against the U.S.'s closest trade partners, including Canada and Mexico, added to economic uncertainty.

Equity returns (in C$)



Canada: MSCI Canada Index TR; **U.S.:** MSCI USA Index TR **International:** MSCI EAFE Index TR; **Emerging markets**: MSCI Emerging Markets Index TR. **Source: Morningstar Direct.**

Fixed income and currency returns (in C$)



Canada Aggregate: Bloomberg Barclays Canada Aggregate Bond Index; **Global Aggregate:** Bloomberg Barclays Global Aggregate Bond Index; **U.S. High Yield:** Bloomberg Barclays U.S. High Yield Index. **Source: Morningstar Direct.**

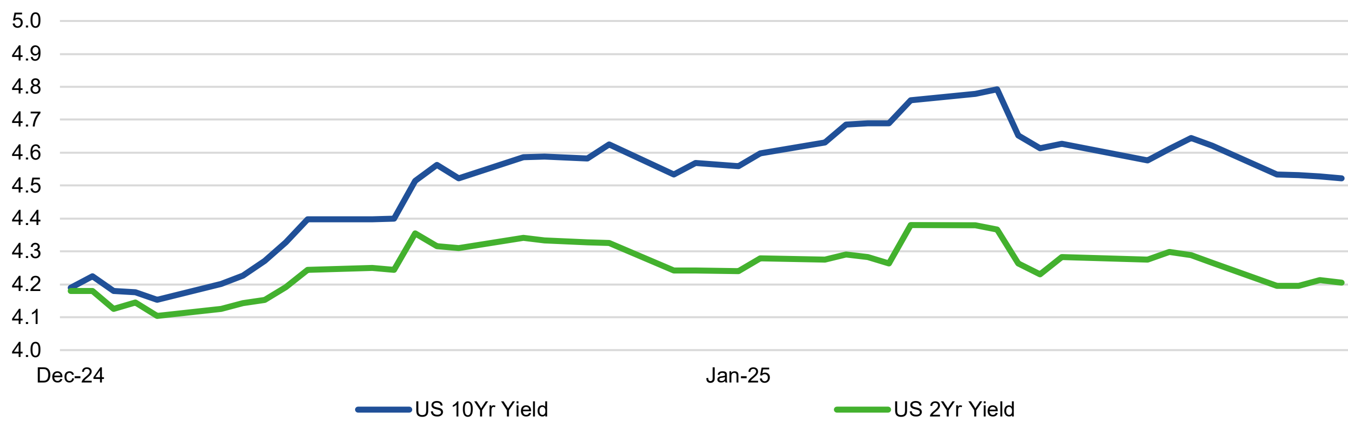
Central banks diverge on rates

In their January meeting, the Fed, the ECB, the BoC extended their divergence on monetary policy, reflecting differing economic conditions across regions. The U.S. Fed opted to maintain the fed funds rate at 4.25%–4.50%, while the ECB and BoC cut their rates by 0.25% to 2.75% and 3.00% respectively. Fed Chair Jerome Powell's remarks emphasized continued vigilance regarding inflation and economic stability. While the U.S. economy has demonstrated resilience, concerns over headwinds from global trade tensions, labour market cooling, and the impact of tariffs on the U.S. domestic economy, kept the Fed's tone cautious. The ECB and BoC, however, need to stimulate growth to combat weakening industrial activity, and sluggish consumer demand.

This divergence may lead to higher volatility across markets. The U.S.'s decision to hold rates higher could further strengthen the U.S. dollar relative to the euro and Canadian dollar, which could potentially boost European and Canadian export competitiveness, but could also amplify inflationary pressures from imported goods. This divergence is expected to widen further, as markets are expecting up to a single cut from the U.S., between 1-2 cuts in Canada, and between 2-3 cuts in Europe.

Since December the market saw the steepening of the yield curve during the lead up to Trump taking office, as long-term bond yields rose at a faster pace than short-term rates. This shift suggests that investors are anticipating inflationary pressures to re-accelerate in the medium term, which may prompt the Fed to adopt a more aggressive stance later in 2025. Inflation expectations have remained elevated, fueled by strong consumer demand, varying levels of tariffs on imported goods, and geopolitical uncertainties.

U.S. Yield Curve steepens into 2025:



Source: Bloomberg.

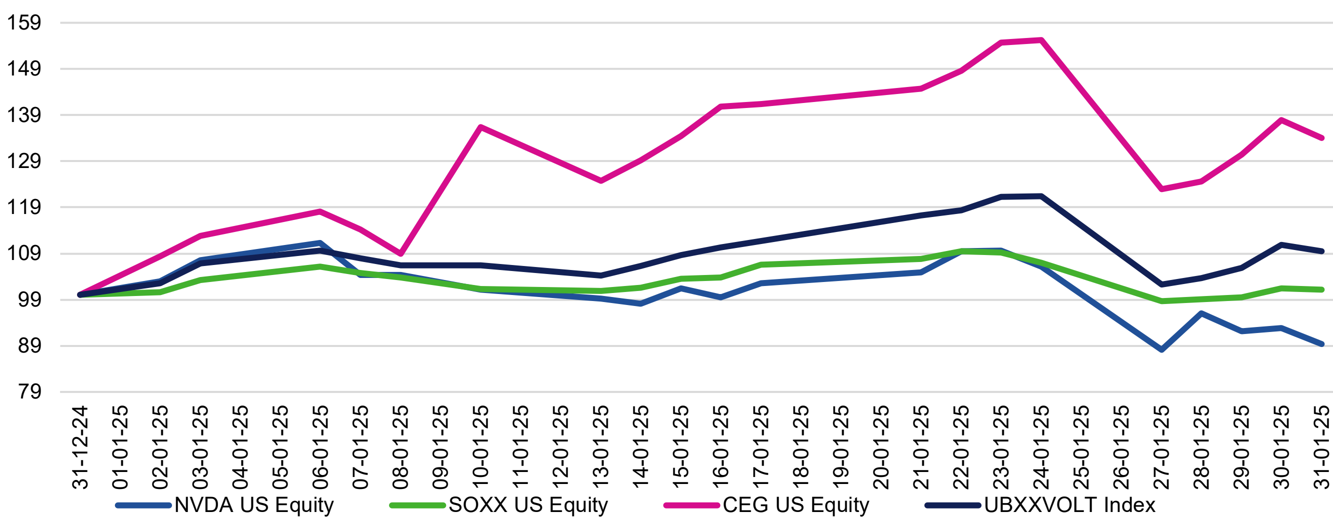
The decision to hold rates steady was met with mixed reactions. Financial stocks initially gained, as investors interpreted the move as a sign of stability. However, broader markets remained volatile, with concerns over potential rate adjustments later in the year. The Fed's wait-and-see approach suggests that economic data in the coming months will play a critical role in shaping monetary policy for the rest of 2025.

U.S. earnings season and AI disruption in markets

The bar is higher this earnings period: Consensus for earnings growth in the S&P 500 is 8% year-over-year. Out of the 78 companies who have reported Q4 results (~55% of market cap), 56% of companies reporting beat estimates, while 12% missed —earnings growth is currently tracking quite strong at 9% year-over-year. Financial and energy firms posted relatively strong and stable results, mostly beating consensus expectations. The technology sector struggled to deliver the growth that the market has come to expect. Tech giants, including Tesla, Apple, Microsoft and Meta, reported strong, but slightly disappointing results.

Nvidia, once seen as an invincible leader in AI computing, suffered an 18% stock decline following the emergence of DeepSeek, a Chinese AI competitor offering similar performance to state of the art models such as those from OpenAI, but trained at a fraction of the cost. Investors now fear that lower-cost AI solutions materially decrease the industry-wide demand for more chips, datacenters, and electricity usage. The rapid rise of Chinese AI models has also prompted discussions about potential regulatory responses and increased scrutiny of supply chain dependencies. The broader implications of this AI shake-up extend beyond individual companies. With Chinese firms advancing rapidly, U.S. tech giants may face greater geopolitical challenges, increased competition, and potential policy interventions. Investors will need to closely monitor AI sector developments to navigate this evolving landscape.

AI sensitive stocks hit hard



Source: Bloomberg.

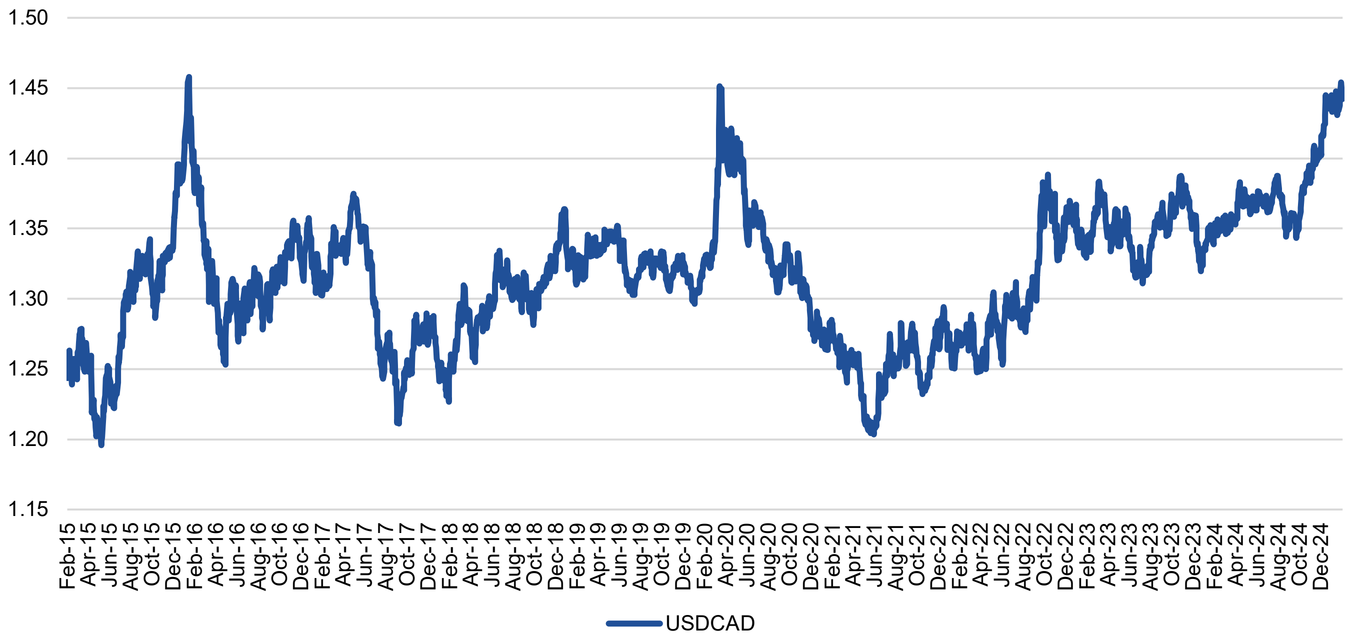
Canada at the center of renewed tariff threats

The new U.S. administration's relentless threats about imposing tariffs on U.S.'s closest trading partners including Canada, and Mexico, have hurt investor sentiment. President Trump repeatedly threatens to impose a 25% tariff on Canadian imports, particularly in trade-sensitive industries. The threat comes as part of a broader strategy to renegotiate USMCA terms ahead of its 2026 renewal deadline. Canadian industries, especially the automotive and energy sectors, are bracing for possible disruptions, with the Canadian dollar already exhibiting increased volatility. Economic implications vary depending on how the tariffs are structured — the magnitude, how broad-based, and duration. Ontario and Quebec are particularly vulnerable as they have significant exposure in steel, aluminum, automotive, and forestry exports to the U.S.

Market analysts estimate that a blanket 10% tariff on Canadian goods could lead to a 16% depreciation of the Canadian dollar if no retaliatory measures are taken. In the latest release of the monetary policy report, the BoC outlined the stagflationary impact of various scenarios of tariffs on Canada, estimating that a 25% blanket tariff can hit real GDP by -2.5% in the first year. They also estimate that the average impact to inflation to be 0.1% higher in the first year, 0.5% higher in second, and 0.75% higher in the third year following implementation.

The potential policy response to this trade conflict is further complicated by Canada's domestic political landscape. With Prime Minister Trudeau stepping down, the upcoming leadership transition adds another layer of uncertainty to trade negotiations. Additionally, the prorogation of Parliament until March limits immediate government responses to potential tariff actions. Despite these risks, the TSX has remained resilient, indicating cautious optimism or skepticism about full tariff implementation. Sectors such as energy, financials, and materials—comprising 70% of the index—are expected to be less impacted than the broader economy. Investors will be closely monitoring developments, as trade tensions remain a key factor in Canada's economic outlook.

Canadian dollar sharply weakens as tariff talks intensify



Source: Bloomberg.

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