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of RBC Dominion Securities

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Market Update

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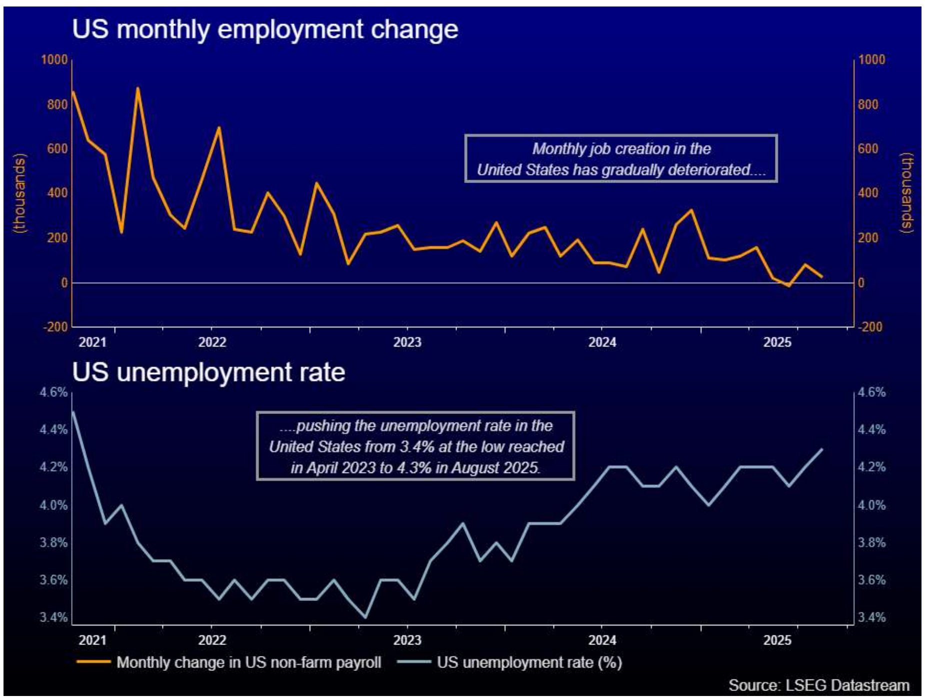
Defying all expectations, stock markets around the globe have made remarkable progress so far in 2025. In a climate of profound economic uncertainty tied to the trade war the United States has waged against the rest of the world, investors could have rightly expected a much weaker performance from the stock markets. Nonetheless, despite the impressive returns seen up until now, the journey has not exactly been smooth sailing. The stock markets went through an intensely volatile period in the spring, especially in the week after the Trump administration declared “Liberation Day” on April 2, 2025, the date that marked the official launch of its tariff offensive. Between February 19 and April 8, the S&P 500, America’s bellwether index, fell by almost 19%, and this correction could have been even sharper had it not been for the U.S. government announcing a 90-day pause on its “reciprocal” tariffs. In addition to that timely break, the strong rebound in stock market indices since the April low can also be attributed to the resilience of the U.S. economy, which continues to surprise most economists. While many experts did acknowledge that the risks of a recession were very high last April, the possibility of a soft landing for the U.S. economy is a scenario that has been gaining traction in recent months. Despite the uncertain climate, the economy’s resilience had a positive impact on companies’ performance, with financial results exceeding analysts’ expectations, particularly in the second quarter of 2025. Keep in mind that, again this year, profit growth and index performance have been heavily driven by tech companies, which continue to ride the AI wave. More recently, the change in tone from U.S. Federal Reserve Chair Jerome Powell has boosted investor enthusiasm. After taking a break in December 2024, the U.S. central bank resumed its monetary easing cycle on September 18, 2025, cutting its key rate by 0.25%. In the wake of this decision, financial markets responded strongly and are now discounting several more cuts in the year ahead. The most bullish believe that the easing of the Fed’s monetary policy, combined with the passage of Donald Trump’s “One, Big, Beautiful Bill” on July 4, could stimulate enough economic activity in 2025 and 2026 to largely offset the damaging effects of the ongoing tariff war.

While this scenario is plausible and desirable for investors, it still seems fairly optimistic at this stage. Let's not forget that the Federal Reserve has a dual mandate: promoting stable prices and maximum employment. In the current economic climate, however, reconciling these two objectives is no cakewalk. On the one hand, the job market is clearly deteriorating. As we see in Chart 1 below, the latest statistics show that job creation is stagnating and the unemployment rate is climbing back up from the low reached in April 2023. What's more, in light of the annual revisions announced by the U.S. Bureau of Labor Statistics (and not reflected in Chart 1), the state of the job market over the past few years has not been as rosy as we might have thought. In fact, between April 2024 and March 2025, job creation was revised considerably downward, dropping by 911,000 jobs versus the original estimates. This weakening employment is the main driver of the Federal Reserve's recent pivot to a more accommodative policy stance.

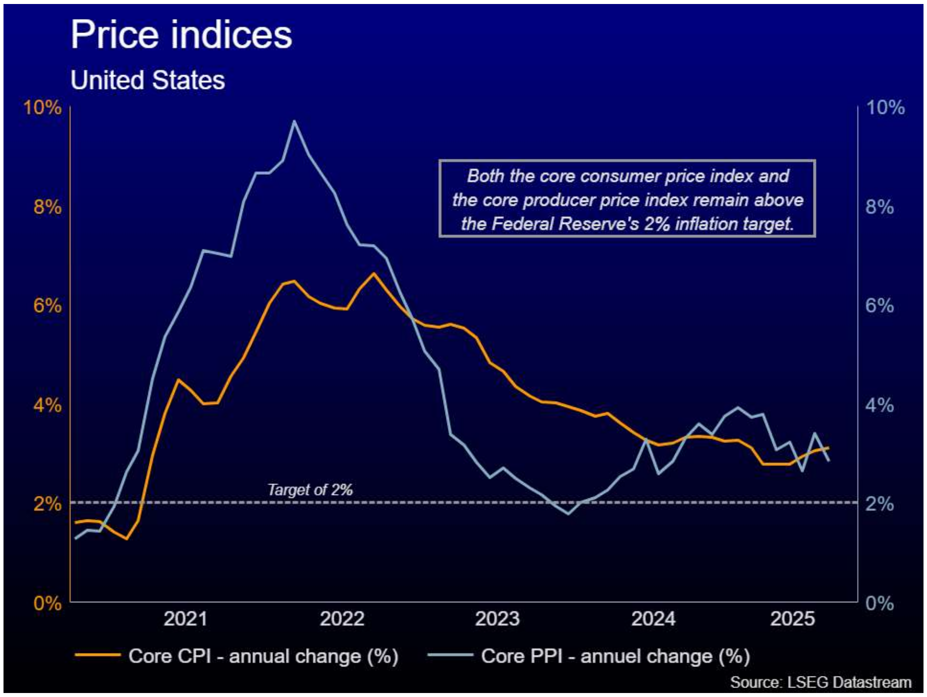
Chart 1



On the other hand, the battle for stable inflation is far from over. Indeed, inflation remains doggedly above the Federal Reserve's 2% target, as we see in Chart 2 at the top of the next page. The annual rise in the consumer price and producer price indices remains too high, a situation we find just as worrying as the soft job market. As it stands, all signs point to the slowdown in job creation being the Federal Reserve's bigger priority.

In our March newsletter, we expressed our concerns about the tariff policies being considered by the United States at the time, and the risk of retaliatory measures being taken by countries that found themselves in the Trump administration's crosshairs. That situation could have deteriorated, creating difficult conditions in which global economic growth stagnates while inflation accelerates. There are several reasons why the more pessimistic outlook has been avoided for the time being. First, an analysis of U.S. tariff revenues indicates that the average tariff on imports is around 10.5% of the value of the imported goods, the highest it's been since the 1930s. Although this percentage is up sharply from the roughly 2% average at the start of 2025, it remains well below the initial estimates of 17% to 19%. Importers have therefore managed to adapt their supply chains to minimize the cost of tariffs. Beyond that, many products were exempt from the U.S. tariffs, including the vast majority of products covered by the United States – Mexico – Canada Agreement (USMCA). These exemptions have obviously helped to limit the increase in tariffs.

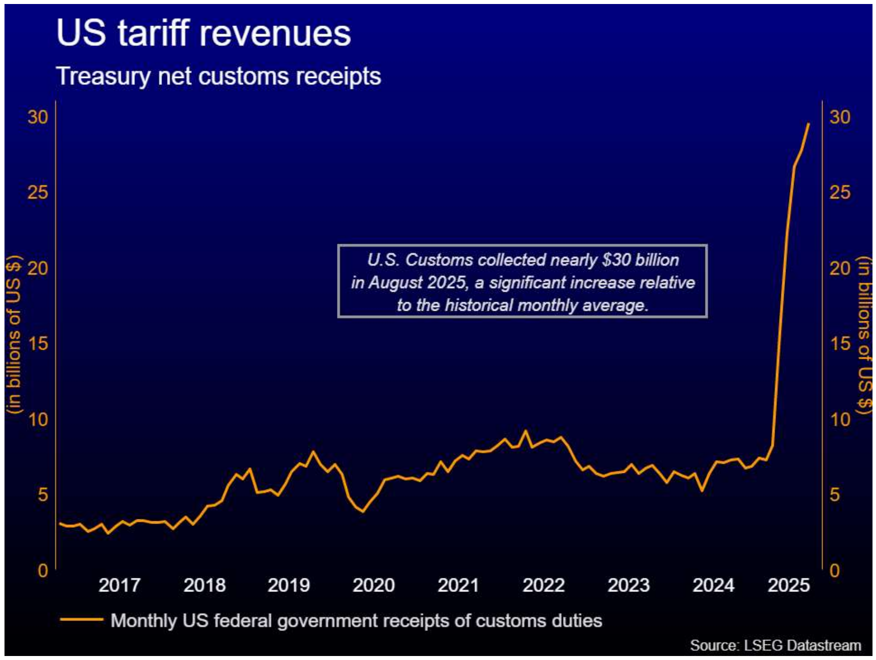
Chart 2



Another reason why the global economy has fared so well amid this trade war is that most countries have shown restraint and refrained from imposing retaliatory measures on the United States. Rather than taking an adversarial stance, many countries opted to negotiate agreements with the United States, which has helped lessen the uncertainty for the various economic players. Lastly, several foreign governments announced budgetary measures to stimulate their economies and support the sectors most affected by the U.S. tariffs.

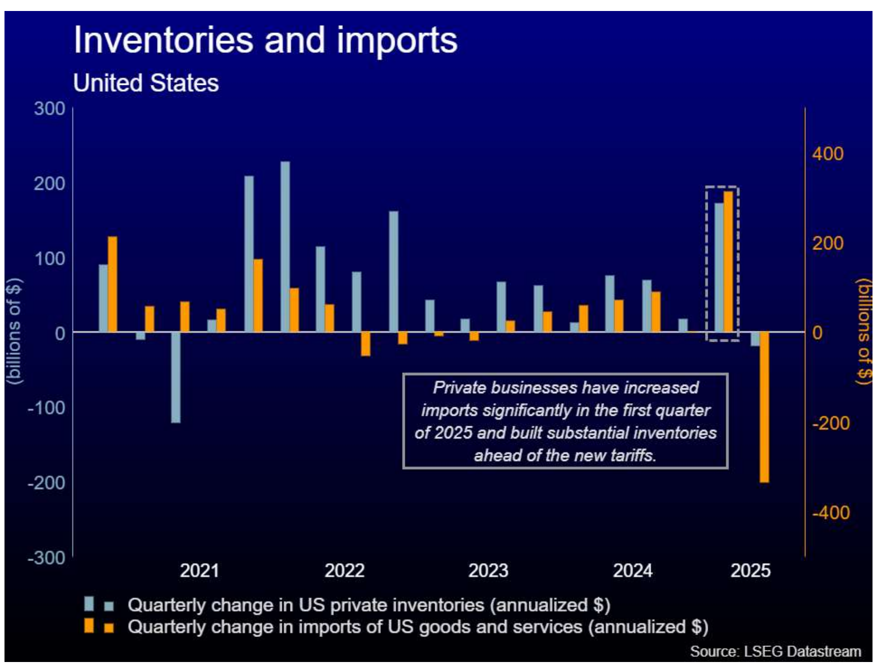
Despite tariffs being less steep than anticipated, the fact remains that this tax is an economic burden that cannot be ignored. As we see in Chart 3 at the top of the next page, U.S. Customs collected nearly $30 billion in tariff revenues in August 2025, or around $354 billion at an annualized rate. The question is, then, who will bear the cost? In theory, tariffs can be absorbed by foreign exporters reducing their prices to remain competitive, by importers cutting into their profit margins or by American consumers paying more at the checkout. If the statistics for the prices of imported goods are any indication, foreign exporters have conceded virtually nothing thus far. And on the U.S. consumer front, fears of a significant acceleration in inflation have yet to be realized. So, for the time being, we have every reason to believe that U.S. import companies are the ones absorbing the lion's share of the additional tariffs imposed by the Trump administration.

Chart 3



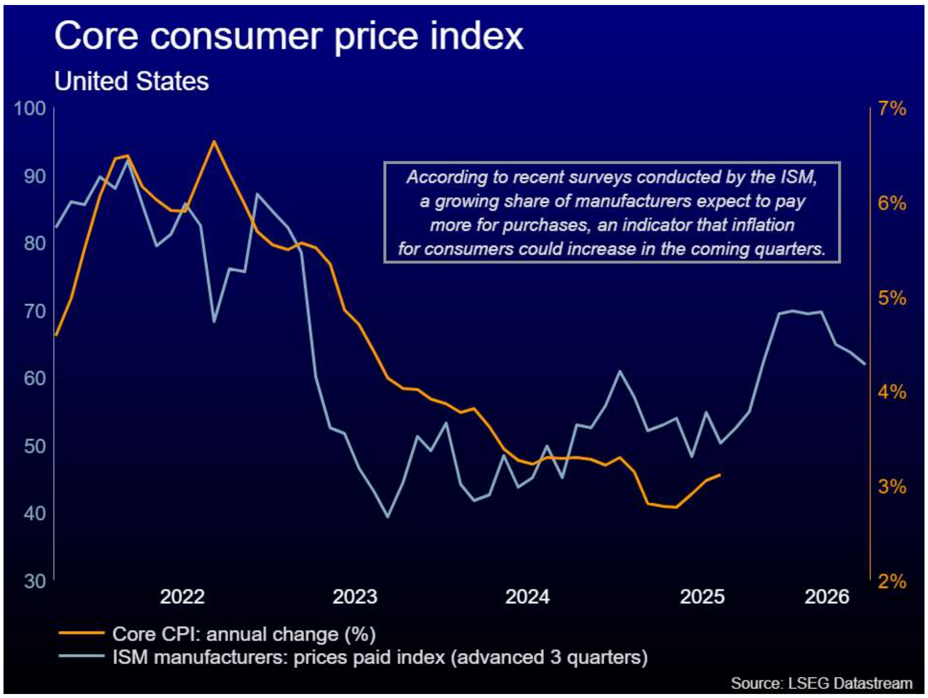
Companies' ability to absorb the tariffs could be short-lived, though. Indeed, as we see in Chart 4 below, businesses appear to have built up substantial inventories in the first quarter of 2025, in an attempt to get ahead of the new tariffs. It's safe to say that, once the lower-priced stock runs out, those companies may consider increasing prices to reflect the additional tariffs and protect their profit margins.

Chart 4



Moreover, according to the ISM survey of U.S. manufacturing purchasing managers, a growing proportion of respondents anticipate having to pay more for inputs in the months ahead, a leading indicator that inflation could rise for consumers over the next few quarters, as illustrated in Chart 5.

Chart 5



For now, investors are enthused that the Federal Reserve has resumed its monetary policy easing cycle, and are already counting on the central bank's key rate falling significantly by the end of 2026. A significant cut in Fed interest rates has generally proven to be a boon for financial markets in the past. In fact, not only do rate cuts drive economic activity and corporate profits, they also provide a tailwind for the valuations of investments held in portfolios. However, we believe that such optimism from investors is premature, and that the risk of inflation accelerating in the near future could leave the Federal Reserve—which is in a fairly delicate position—with little leeway. In addition to the cost of the tariffs potentially translating to higher price tags for consumers in the coming months, the Trump administration's immigration policies are shrinking the labour supply, which could keep inflationary pressures on wages alive. Given the country's aging population and declining labour force participation, the U.S. government's more restrictive immigration policies do not bode well for a return of inflation to its 2% target in the near future. We believe that the risks of inflation accelerating again are very real and should not be overlooked.

Financial markets

We've been monitoring and analyzing the financial markets for over 30 years, and rarely have market conditions been so disconcerting. Currently, the risks are many. Not only might inflation accelerate, but tariff policies are constantly shifting, U.S. political discourse has grown alarmingly polarized, geopolitical tensions show no sign of abating, the independence of the Federal Reserve is under threat, and the U.S. budget deficit remains very high, and these are just some of the forces at play. Despite all these uncertainties, stock markets around the world continue to rally to record highs. Signs of exuberance abound nonetheless. Low-quality stocks are all the rage, especially those related in any way to AI or cryptocurrencies. It is hard not to draw parallels with the dot-com bubble of the late '90s. Although Internet traffic has exploded since the early days of the web, the players at the time built far too much fibre optic capacity in the early years, which led to the ensuing crash.

As we can see in Chart 6 below, the S&P 500 is trading at about 22.6x expected earnings over the next 12 months, well above the average valuation of the index over the past 20 years. The high price-earnings ratio of the S&P 500 is partly attributable to the tech sector, whose weight represents more than 40% of the total market capitalization of the index. With the exception of that sector, the valuations seem more reasonable, and several non-tech S&P 500 stocks still offer good potential for returns.

Chart 6

It's not just the S&P 500 that's showing signs of speculation. We are also seeing a certain appetite for risk in the Canadian market. Indeed, much of the S&P/TSX's performance since the start of 2025 has been due to an unprecedented boom in the metals sector, especially gold, which now accounts for nearly 12% of the Canadian index. With the shock caused by the Trump administration's tariff policies, the role of the U.S. dollar is being called into question, and many investors, including foreign central banks, have turned to gold, the price of which has surged. Despite the sector's significant weight, we are unlikely to start adding gold producers to our portfolios. Not only are mining companies generally much riskier than the average listed company, their shares don't meet our quality criteria. In the 20 years prior to 2025, the gold sector saw very low returns, and all the evidence suggests that these mining companies are creating very little long-term value. Outside the mining sector, several Canadian stocks continue to offer excellent growth prospects at reasonable valuations.

Internationally, major regional indices have finally outperformed the U.S. stock market after years of lagging far behind the S&P 500. For the time being, this shift in leadership seems to have more to do with massive capital flows linked to the uncertain economic climate in the United States since Donald Trump's election. After years of outperformance by the U.S. economy and its companies, many investors likely found themselves overexposed to S&P 500 stocks, and many deemed it prudent to reduce their exposure. We have been limiting our direct exposure to international markets for years, preferring to focus on successful North American multinationals with a presence in all the world's economic regions. Although we are not yet sure there is a need to invest directly in international companies, we continue to assess the situation and are trying to determine whether recent developments will lead to fundamental changes over the longer term that would justify revisiting our position.

Portfolio management

Since the beginning of the year, we have maintained a cautious approach centred on the quality of the investments in the portfolio and have avoided speculative stocks. We believe that uncertainty remains high in the current climate and that stock markets are at levels that suggest the risks are being underestimated. In terms of asset allocation, we maintained a good exposure to equities in the portfolios, but without exceeding the strategic target of our mandates. In fact, after several years of strong equity returns, we had to reduce our exposure on a few occasions to stay close to our target, which will result in slightly more capital gains this year than in previous years. In terms of our exposure to fixed income securities and high-quality alternative investments, we are very close to the overall target for these two asset classes combined. Lastly, we kept liquidity at levels slightly higher than the target.

In the coming months, we will be keeping a close eye on inflation, the resilience of the U.S. economy and growth in corporate profitability, and will be ready to reduce risk further if these elements deteriorate significantly.

Equities

For some years now, we have gradually been reducing the risks in our equity portfolio. We have less exposure to sectors that are more sensitive to the pace of economic growth, such as base metals and the oil and natural gas sector, and good exposure to more resilient ones, such as the health sector. Moreover, in keeping with our philosophy, we are focusing on companies that post strong returns on invested capital, that generate significant cash flows and that have low debt levels. Market weakness earlier in the year gave us an opportunity to increase our exposure to some of our existing portfolio holdings, such as Toromont, Canadian Natural Resources, Fortis, Nutrien, Manulife and NextEra. Then, solid gains by certain stocks prompted us to reduce our exposure as valuations appeared closer to fair value, namely Dollarama, National Bank, Thomson Reuters, Enbridge, Abbott Labs, JP Morgan, Apple and the U.S. Energy Index Fund.

As for the new positions added to the portfolios in the past year, the following is a summary.

Capital Power (CPX)

Capital Power is a power producing company operating in Canada and the United States. The electrification of the economy and the construction of new data centres required for the development of the AI sector will support solid growth in electricity demand over the next few years, and we believe the company is well positioned to take advantage of this.

US Bancorp (USB)

We decided to initiate a position in this high-quality regional bank while the valuation of its shares seemed attractive compared with the other banks in the sector. In addition, deregulation of the financial services sector in the U.S. could potentially be favourable to bank valuations in the longer term.

Zoetis (ZTS)

A leader in the animal health sector, this company develops a variety of products (medicines, vaccines, diagnostics, etc.) used to care for pets and livestock. Prospects for growth are excellent, and the valuation of the stock is below its historic average. The company is in good financial health, posting strong returns on invested capital and generating high cash flows.

Thermo Fisher (TMO)

Thermo Fisher offers a wide range of products and services for the life sciences sector, including analytical instruments, laboratory equipment for research and diagnostics, and prescription drug research and manufacturing services. We added this stock that meets our criteria for quality and whose valuation is well below its historic average while the outlook for the sector is starting to improve.

Palo Alto (PANW)

This company is one of the biggest players in the field of cybersecurity, a high-growth sector. Threats to corporate and government IT networks and data are becoming increasingly sophisticated, and Palo Alto offers a wide range of solutions to meet these needs. We took advantage of a correction to the price of the stock earlier in the year to initiate a position.

Xylem (XYL)

Xylem’s products and services are used to transport, treat, test, and monitor water, and return it to its natural environment in an efficient and responsible manner for various sectors such as building, industry and agriculture. With aging water infrastructures, a population that continues to grow, and rising needs in developing countries, the outlook for growth in this sector is good and Xylem is well positioned to participate and gain market share. In addition, we like the fact that Xylem has low levels of debt and that it generates significant cash flows.

Uber Technologies (UBER)

Many people are seeing the arrival of self-driving cars as a threat to Uber. We believe instead that the company’s expertise and its enormous network of users make it a worthwhile partner. The company is in good financial health and will see its cash flows grow significantly in the coming years. We think that the company could see the valuation of its shares increase as fears around self-driving vehicles dissipate.

Killam Apartment REIT (KPM.UN)

Killam is a real estate investment trust that focuses on the multi-residential segment of the real estate industry. With a high occupancy rate of over 97% for its units and an average rent of around 15% less than comparable rents on the market, Killam should be able to grow its revenues at a decent pace over the next few years. We believe that the valuation of the stock is attractive and we like the stability of the multi-residential sector in Canada.

Telus (T)

Telus has completed the roll-out of its fibre optic network and we are therefore anticipating a significant drop in its capital expenditures, which should enable the company to generate much higher cash flows in the coming years. In addition, we are seeing more discipline from telecommunications sector players following a period of intense competition around the pricing of bundles for customers.

Generally speaking, we sell stocks when the potential for return is limited (fully valued), the fundamentals are deteriorating or our quality criteria are no longer being met. Over this past year, we eliminated Crown Castle, KBW Financial Services index fund, CVS, Diageo, Honeywell, Corteva, Home Depot, First Capital, Bombardier and BCE.

Fixed income securities

Since the beginning of 2025, our positioning in this part of the portfolio has remained more or less unchanged. Nevertheless, we recently decided to reduce our exposure to corporate bonds, as the yield premium offered by this segment of the bond market is historically low and insufficient to make up for the added risk. We are therefore replacing maturing corporate bonds with less risky government bonds while sacrificing very little in the way of yield. We are also continuing to lean toward bonds trading at a discount for the tax advantage they offer. Moreover, some of the discount bonds purchased in recent years are maturing and will increase the capital gains realized in portfolios in 2025. Lastly, we maintained a healthy allocation to preferred shares, a segment that continues to perform very well. Although they are riskier than corporate bonds, we believe that the return potential of higher-quality preferred shares remains sufficiently high to maintain our exposure.

Alternative investments

Over the past year, we have continued to inject capital into private alternative investments. The majority of new investments were made in infrastructures, through the RBC Global Infrastructure Fund. The aim of this alternative strategy is to offer a diversified access to quality infrastructures and the assets sought by this fund generate substantial cash flows while offering attractive longer-term growth potential.

We continue to believe that this asset class is appealing to investors. Not only does it offer attractive potential returns, it also helps to further diversify portfolios and reduce risk.

We hope that this account of our management has been useful to you, and we invite you to contact us for any questions or clarification. We also want to take this opportunity to thank you for your trust in us.