NUS INVESTMENT SOCIETY

Global Macro Department – US (Neutral)

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Basic Information

GDP (Billions): 27,721

M2 (US$ Billion): 21,762

CPI: 320

GDP Deflator: 127

PPI: 147

Con. Confidence: 52.2

Key Levels:

S&P 500: 5,6840.00

Nasdaq Composite: 17,982

US 10Y: 4.3582

DXY: 100.424

Currency : USD

Source: TradingEconomics

Summary of events year to date

- The start of 2025 has been marked by growing anticipation around the re-election of Donald Trump and its potential impact on fiscal and economic policy. While campaign rhetoric has focused heavily on extending key provisions of the 2017 Tax Cuts and Jobs Act, actual legislative movement has been limited due to a divided Congress. Nonetheless, markets have begun pricing in the likelihood of wider fiscal deficits over the medium term, prompting a sharp focus on long-end rates and inflation expectations with long term yields peaking mid-January.

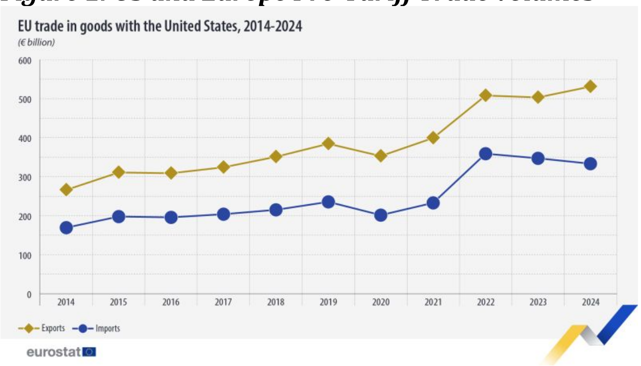
- Liberation Day brought forth unprecedented turmoil in the markets, which tariff rates far exceeding even the most pessimistic calls. It culminated with SPY entering bear market territory until a pause was called. Businesses front-runned tariffs, importing prior the implementation date, which contributed significantly to the USA's negative GDP print for the first quarter, -0.3% QoQ.

- Treasury markets similarly were in a mess, with the Fed Fund Futures (FFF) pricing in 5, 25 bp cuts in interest rates till end of year (EOY). Note that it meant 5/6 meetings with rate cuts till EOY. Such pricing would have been a good opportunity to short FFF considering inflation expectations are still high, labour market was resilient and Fed historically being (fairly) agnostic to stock returns.

- Growth was negative for the first Quarter at –0.3%, mostly thanks to the surge in imports prior to Libation Day. Consumer sentiment surveys such as Umich consumer sentiment however have shown growing pessimism. Trade policy uncertainty also has not encouraged more investments in the US. Until more data and clarity around trade policy must be seen for a precise estimate on growth, though safe to say at least for 2025 the US will be in a period of transition and can expect slower growth.

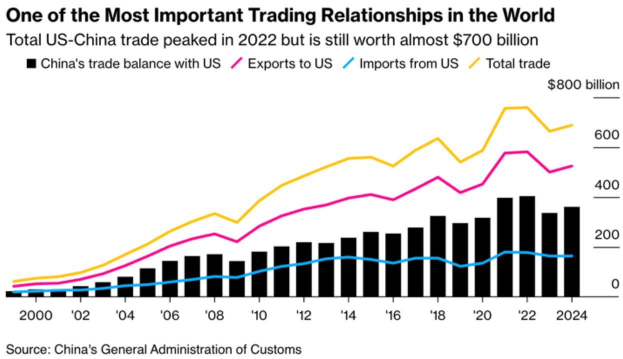
- Seasonally adjusted CPI is now down from January highs, 3% to 2.33%. The Fed's preferred gauge of inflation, PCE, has also lowered from 2.6% in January to 2.3% for March. However, these are figures before the implementation of broad-based tariffs. This is a concern of the Fed, and they have signalled that they are in no hurry to cut rates while current macro factors still point towards stick inflation alongside a tight labour market.

Figure 1: US and Europe Pre-Tariff Trade volumes



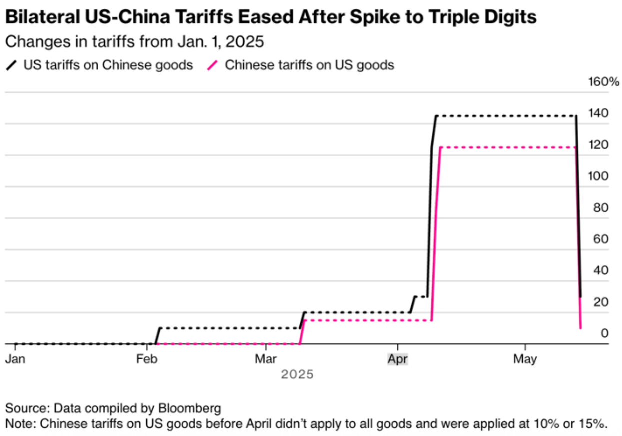
Source: Eurostat

Figure 2: China-US Trade Balance



Source: Bloomberg

Figure 3: US China Tariff Escalation



Source: Bloomberg

US Politics: Tantrum Turbulence

<u>EU tariffs: 50% threat and Ongoing Negotiations</u>

President Trump threatened to impose a 50% tariff on all European Union imports, citing a substantial trade deficit and accusing the EU of unfair trade practices. This move alarmed EU leaders, prompting emergency discussions. Following a call with Commission President Ursula von der Leyen, Trump agreed to postpone the tariff implementation to July 9, allowing time for negotiations. The EU proposed a "zero-for-zero' deal, aiming to eliminate tariffs on industrial goods. However, disagreement persists over issues like digital taxation and agricultural standards. The EU has also prepared retaliatory tariffs worth €21 billion, set to activate if negotiations fail.

<u>US -China Trade Deal: Temporary Easing</u>

After a period of escalating tariffs, the US and China reached a temporary agreement on May 12, 2025, to reduce reciprocal tariffs from 125% for 90 days. This truce is intended to facilitate further negotiations, with the possibility of tariffs reverting to higher levels if no long-term deal is minted by August 14. China has also agreed to suspend non-tariff countermeasures, signalling a willingness to engage in more constructive dialogue. Despite this, underlying tensions remain regarding issues like intellectual property rights and market access.

<u>The Mar-a-Lago Accord:</u>

The "Mar-a-Lago Accord" is a conceptual economic framework developed by President Trump's advisors, notable Stephen Miran and Scott Bessent. Drawing from the 1985 Plaza Accord, it aims to address the U.S. trade deficit by deliberately weakening the U.S. dollar. Key proposals include imposing tariffs and restructuring U.S. debt. Stephen Miran, who chairs the Council of Economic Advisers, published an influential paper advocating for significant changes in U.S. economic policy[2]. The paper lays out a policy blueprint that has proven prescient in several areas and contains strong hints about future policy direction from trump. Many of Miran's suggestions, such as the use of broad tariffs as a tool to fix systemic trade imbalance, has already been carried out in the markets, with 50% tariff threats on EU and the 125% to 10% tariff rollercoaster with China.

Moving forward, several policies may be proposed as outlined in the paper include currency-linked tariffs, security- for-trade access where allies get preferential trading terms. The result is either a unilateral or a multilateral currency approach to manage the revaluation of the dollar. Though a multilateral approach is preferred to coordinate the revaluation, both approaches are bearish for both the US dollar and Treasuries.

Monetary Policy: Holding Steady

Throughout 2025, the Fed has held the policy rate steady at 4.25-4.50%, maintaining and "watch and wait" approach, emphasizing cautious optimism to avoid premature easing despite cooling inflation. Since the last 25 bps cut in December 2024, inflation has remained slightly hotter than the 2% target, with CPI data ranging between 2.6-2.8%. Despite the year starting with 4 rate cuts priced into the SOFR markets, only 2 rate cuts are priced in for the rest of the year after consecutive delays.

In the January FOMC meeting, all FOMC members unanimously decided to hold rates at 4.25-4.50%, halting three consecutive

[2] A User's Guide to Restructuring the Global Trading System

2024 rate cuts. Powell emphasized the need for patience to assess lagged policy effects. He acknowledged that inflation remained "somewhat elevated" with no further progress toward the 2% target, removing prior optimism about inflation convergence. Powell noted the labour market resilience, with unemployment low, job gains "solid", but wage growth showing modest cooling.
The March meeting shared similar sentiment, as the Fed cited "heightened uncertainty" and upside inflation risks from fiscal policies and supply constraints as reasons for delaying rate cuts. The Fed slowed Treasury runoff[3] to $5B/month (from $25B) to address money market strains, while keeping MBS runoff at $35B/month. Also noted in the meeting was the increased uncertainty regarding the neutral interest rate[4]. Persistent inflation, changes in labour market dynamics and evolving fiscal policies were debated as factors which might have raised the neutral rate compared to pre-pandemic levels, requiring a higher policy rate. Despite these uncertainties, the FOMC maintained its median certainties, long-run estimate for the neutral rate remained at 3.0%,

In the May FOMC meeting, Powell noted moderating growth and persistent inflation as reasons for the rate cut. Q1 GDP dipped due to import swings linked to tariff fears but private domestic demand grew at 3%. With April expected and actual CPI at 2.6% and a surprise revised CPI at 3.0%, inflation was noted to be a key risk. Although unemployment was near its lows, Powell stressed that rising unemployment from the trade war was another key risk. The Fed reiterated confidence in current policy stance to address either direction of economic shocks.
Going forward in 2025, the market is pricing in 1-3 rate cuts, bringing the year-end policy rate to 3.50-4.25%. Another ~2 rate cuts are expected in 2026, with the 2026 year-end policy rate priced at 3.00-3.75%.

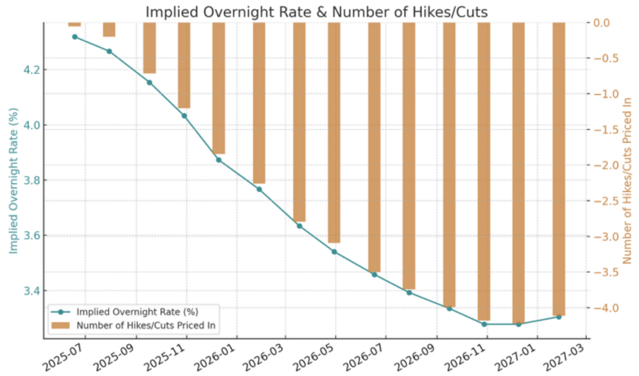
We believe that a base case of 2 cuts is a reasonable assumption, given that a 1% GDP slowdown is expected globally, and the Fed will have to make some progress in guiding the rate path back down to the neutral rate. The first rate cut is expected by September and the second one by December. The May 13th CPI print at 2.3% actual vs 2.4% expected supports this.

However, this is contingent on inflation staying cool under 3.0%. Supply chain disruptions or fiscal nonsense from the Trade war might upend this and up to 3-4 cuts may be repriced in.

<u>Trump vs Powell: Fed Independence</u>

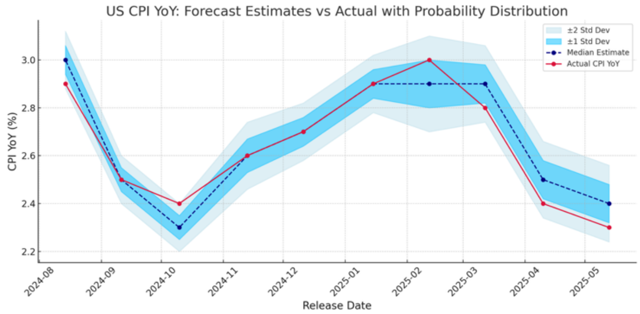
While the Federal Reserve is expected to be independent, Trump has been openly pressuring Powell to cut interest rates, repeatedly criticizing him for being too slow to lower rates. Trump has claimed that inflation is no longer a problem and that with energy and other prices falling, there is justification for immediate rate cuts. Other than taking to social media to pressure Powell, he has also floated the idea of removing Powell from his position as Fed chair, though legal and institutional barriers makes this difficult and unconstitutional.
Powell's priority of holding rates steady for price stability conflicts with Trump's short term political goal of cutting rates to offset economic headwinds from trade tariffs. We believe the Fed will continue to keep its cool and cut rates steadily. Furthermore, with the rollback of Trump's tariffs, we are likely to continue see

Figure 4: Fed Funds Target Rate (Insert Rate cut expectation and actual)



Source: FRED API

Figure 5: Inflation Cooling down

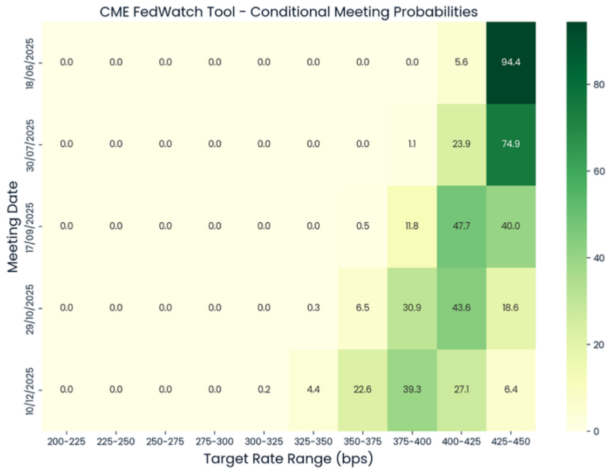


Source: Bureau of Labour Statistics, Bloomberg Economics

Figure 6: 94.4% Probability of 25 bps cut for June 2025 FOMC Meeting

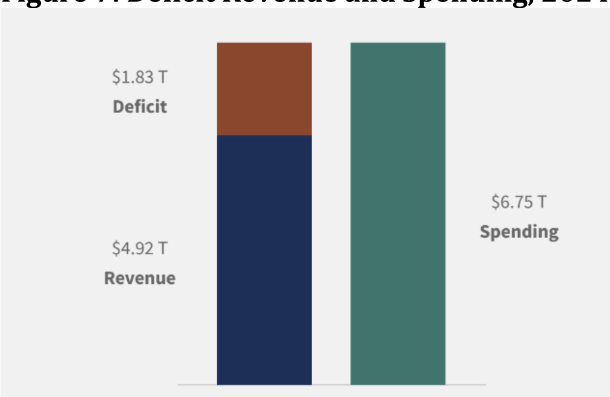
[3] The Federal Reserve lets maturing Treasuries and MBS leave its balance sheet without reinvesting the proceeds, gradually reducing its holdings and reducing liquidity in the financial system.

[4] The neutral rate of interest (r*) refers to the real short-term interest rate at which monetary policy is neither expansionary nor contractionary- supporting the economy operating at full employment with stable inflation. It is not directly observable and must be *estimated* from economic models. As a result, r* is inherently uncertain, making it a critical yet elusive metric for central bank policy decisions



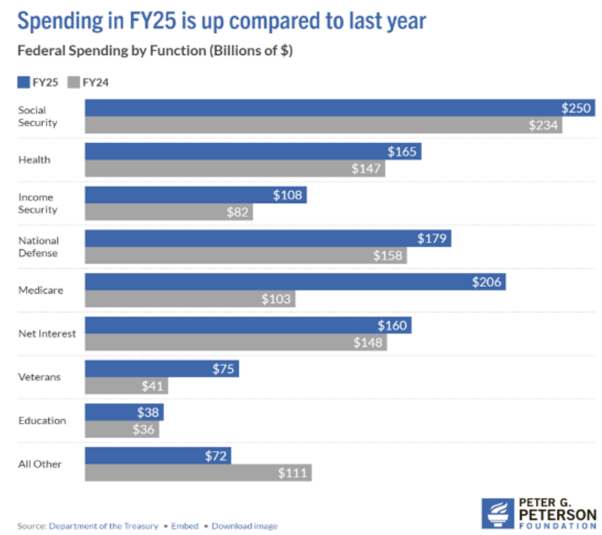
Source: CME FedWatch

Figure 7: Deficit Revenue and Spending, 2024



Source: FiscalData.Treasury.gov

Figure 8: Fiscal Spending in the US



Source: Department of the Treasury

upward revisions in growth estimates as more trade deals are minted, hence less rate cuts will be needed.

Fiscal Policy

Record Deficits and National Debt

As of November 2024, the federal budget deficit reached $367 billion, a 17% increase from the previous year. This surge is attributed to calendar payment shifts and increased government spending. Cumulatively, the deficit for the first two months of fiscal year 2025 stands at $624 billion, setting a record for the largest deficit to start a fiscal year. Consequently, the national debt has climbed to $36.13 trillion as of December 11, 2024.

Reducing the deficit requires the government to raise revenue through higher taxes or spending cuts. Tax increases are politically unpopular, and cutting spending is a challenge, given that mandatory spending on items like Social Security and Medicare rises along with an aging population. Discretionary spending has more wiggle room, but it's only about 25% of total spending—and about half of that is on military and defence.

The net interest paid on the US government debt burden is climbing too. According to the federal government, total interest payments were about 2.5% of GDP in 2021; today, they're just shy of 3.5%. We expect that bill to grow, given more debt and higher rates.

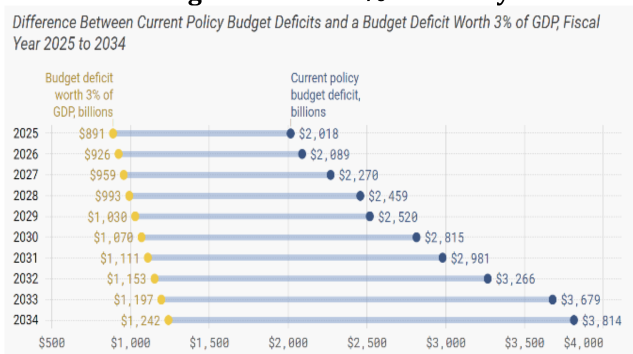
Spending in November 2024 was $80 billion more than in November last year, although the increase is entirely attributable to the timing shift. Controlling for that adjustment, outlays were down $2 billion compared to November 2023. Driving that decrease in spending was a $51 billion decline in outlays recorded by the Federal Deposit Insurance Corporation, as payments were made last year to resolve bank failures. Offsetting that decrease was outlay increases by the Environmental Protection Agency ($16 billion), which administers funds for a grant program established by the Inflation Reduction Act, Social Security ($8 billion), and net interest ($8 billion). Receipts were up $27 billion in November 2024 compared to last year, driven by a $21 billion increase in collections of income and payroll taxes.

Trump's Fiscal Agenda: Tax Cuts and Revenue Challenges

With the election of Trump, significant shifts in fiscal policy are anticipated. The administration plans to extend the individual income tax provisions of the 2017 Tax Cuts and Jobs Act (TCJA), maintaining lower tax rates and higher standard deductions. Additionally, there is a proposal to eliminate taxes on Social Security benefits, which aims to reduce the tax burden on retirees. Since most personal provisions in the TCJA were expected to survive regardless of the election outcome, the TCJA's personal income tax cuts are virtually guaranteed to remain. However, the fiscal cost of extending these cuts is quite formidable. The Joint Committee on Taxation estimated that an extension of the TCJA's personal income tax rates, combined with CTC provisions, would add a cumulative 3.3 trillion dollars to the primary deficit from 2025 to 2034 on top of an estimated baseline in which they expire of 7.4 trillion dollars (CBO 2024 report).

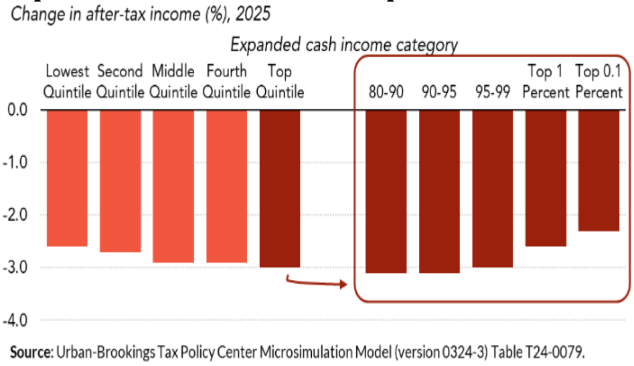
Import tariffs could offer some relief for federal revenues. Tariff revenue accruals surged by $50 billion from the fourth quarter of 2017 to the fourth quarter of 2018 at the start of the trade war with China, marking a 37% year-over-year increase—the largest jump in 35 years. Throughout the campaign, Trump frequently proposed imposing tariffs of 60% on all goods imported from China and 10% or 20% tariffs on goods imported from the rest of the world. If implemented, these tariffs could bring substantially larger revenue than in 2018–19, when tariffs were levied on about two-thirds of Chinese imports at an average effective rate of about 19%. However, given the scale of the proposed new tariffs, the subsequent repercussions could pose a drag on near-term growth, reducing potential tax revenues.

Figure 9: Over $2 Trillion in annual savings needed to stabilize budget deficit of 3% of GDP by 2034



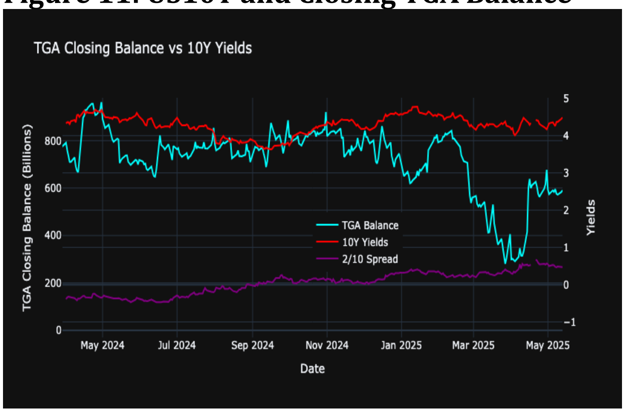
Source: Tax Foundation US, 6 Dec 2024

Figure 10: Effects of a 20% Tariff on Worldwide Imports and a 60% Tariff on Imports from China



Source: Urban-Brookings Tax Policy Center Microsimulation Model

Figure 11: US10Y and Closing TGA Balance



Source: TGA & Polygon API

Lastly, the Fiscal Responsibility Act of 2023 suspended the U.S. debt ceiling through January 1, 2025, after which the U.S. Treasury will start using extraordinary measures to keep the government open temporarily. With the fiscal 2025 budget unlikely to be finalized during the lame-duck session, we are reminded again that the nation continues to struggle to develop a clear plan to address both its short-term and long-term fiscal challenges. We expect this round of debt ceiling negotiations to proceed largely unnoticed, given single-party control of Congress and the Presidency.

FX

USD Summary

The US Dollar Index (DXY) has turned sharply lower from its 110 peak in a mix of growth concerns, fiscal uncertainty and trade policy volatility in Trump 2.0. Price action follows somewhat the same trajectory as in Trump's first term but with alternate macro and market drivers. Against the backdrop of Treasury market dislocations and foreign repositioning, capital has rotated away from USD assets and into European and Asian currencies. However, as trade headlines dissipate and market correlations normalize, FX markets ought to re-anchor to rate differentials.

USD Year to Date

The DXY peaked near 110 on the back of persistent US outperformance, higher-for-longer Fed messaging, and expectations of pro-growth tax cuts. But this was short-lived as Trump's aggressive trade rhetoric created uncertainty, with tariffs first imposed on Canada and Mexico — both valued trade allies.

The Atlanta Fed Nowcast suggested a negative Q1 print, which was realized at –0.3% QoQ. This triggered vicious Dollar and equity sell-offs. The article states that ES bottomed at 4832, levels not seen since January 2024, which was the nadir of the risk sentiment spiral. Interestingly, the dollar's correlation with long-end yields broke down, with DXY falling over 2.5% even as 10-year yields rose over 25 bps, an uncommon occurrence that's happened just three times in over 50 years.

The DXY correlation to long end yields also turned negative amid the sell-off (Figure 9). In-fact the week following Liberation Day was only the third time in more than 50 years that the Dollar declined more than 2.5% while the 10-year yields rose more than 25 bps. 10-year Treasuries also whipsawed aggressively from sub 4% yields to nearly 4.6% within a week., with speculators suggesting US trading partners selling-off US bonds. We are sceptical of that as naturally the values of foreign bond holders will have their investments erode significantly in the process. What is likelier is fast money selling-off bonds amidst the aggressive de-risking, including shorting bonds to cover over-exposed positioning.

Notably, currencies like the EUR and TWD surged the latter posting a 5% surge in a day (19 standard deviation move, Figure 10). While no particular reason has been identified for TWD, we believe large institutional players (e.g., life insurers) may have been rebalancing hedge ratios in response to higher volatility and collapsing Treasury liquidity.

Turning to US fiscal dynamics, we expect Scott Bessent to continue engineering easier financial conditions by anchoring long-end yields through strategic management of the Treasury General Account (TGA). A drawdown in the TGA typically signals net government spending, which injects liquidity into the banking system. This increase in reserves often supports demand for duration, particularly from domestic investors, placing downward pressure on long-term Treasury yields.

Since the start of 2025, the correlation between the TGA's opening balance and 10-year yields has been relatively strong at 0.63, reinforcing the link between fiscal operations and rate

Figure 12: DXY & US10Y Correlation Diverge

Source: Bloomberg

Figure 13: USDTWD tumbles

Source: Bloomberg

Figure 14: US Yield Curve

Source: FRED

Figure 15: Rising Term Premiums (ACM Model)

dynamics. If this trend continues, a lower TGA balance could help flatten the yield curve and restore stability to the bond market, an outcome that aligns closely with the Trump administration's policy priorities. As correlation between dollar pairs and long-term yields recover, in a period of what could be significant changes of treasury management, this could prove to be a chart to pay attention to.

Foreign investors who were long US equities were most affected by this drawdown, with the EUR surging on fiscal optimism from Germany and other pairs gaining on rotations away into non-US denominated assets. Notable example would be the TWD surging 5% in a day (19 SD move) against USD in recently. While there is no root cause identified, we suspect this might have been a collaborated move among huge money account managers such as lifers adjusting their FX hedge-ratio.

In the weeks following Liberation Day, Trump Put moments such as the initial 90 day pause on tariffs and the dialling back of tariffs on China have seen more capital flowing back into the states from dip buying, usually in the form of huge surges followed by gradual profit taking in the FX markets. This trend of headline trading the Dollar likely won't last much longer as more clarity around trade policy is achieved. Furthermore, as US equity and bond market recover from April 2nd induced rout, G10 FX markets should resume to trading closely in line with rate differentials again sooner rather than later.

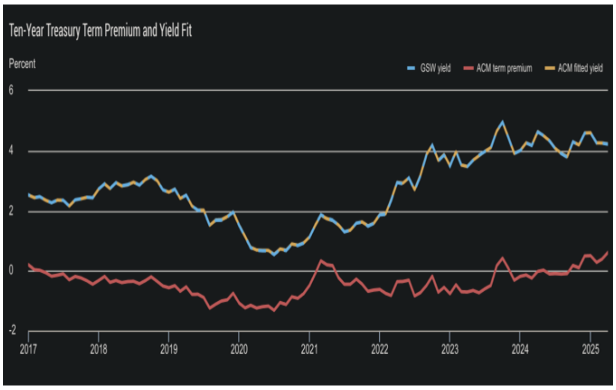
Fixed Income

U.S. Treasuries experienced significant volatility in the first quarter of 2025, with the 10-year yield beginning the year near 4.8% ahead of Trump's inauguration. Yields then fell sharply to sub 4.0% the days following Liberation Day, only to rebound swiftly to around 4.5% within a week. This has been ascribed to rising long term inflation expectations and expectations of debasement in the government budget over the long term. The reduced market pricing in terms of rate cuts have also pushed the yield curve up as a whole, raising (See figure X), though yields still have come down compared to the start of the year which Scott Bessent will be happy about.

Term premium, extra yield that investors require to hold a long-term bond vs shorter tenor, have also been on the rise due to the growing deficits of the US Government. This comes at a time when the deficit has grown to $2 trillion a year, or more than 6% of GDP. Such a path is clearly unsustainable which has been reflected in the NY Fed's Adrian, Crump, and Moench (ACM) Model (See Figure Y), with ACM at its highest in years.

Before the Trump administration have proposed what Trump calls the "Big Beautiful Bill" tax bill, Moody's have downgraded US Credit to AA1 from AAA, the last credit rating agency to do so, citing "decline in fiscal metrics". There are rough forecasts that Trump's tax bill is expected to cost $4 trillion over a decade, and with little fiscal consolidation coming from Musk's DOGE, more must be done else Scott Bessent faces a tough job executing his plan of refinancing through longer tenor US Treasuries.

The impact of Moody's downgrade has been immediate with 30-year yields touching 5% during the next Monday open. The level across the curve rose about 10bps. While there is a case of higher inflation that can push levels of yields higher, we believe term premium will remain the same for US Treasuries. The Basel regulatory framework has 0% capital requirements for government bonds rated between AAA and AA- for its standardized approach (See Figure 12). Furthermore, most primary dealers apply an exception for any investment-grade rated domestic government bond which automatically assigns them a 0% risk weight. Thus, this whipsaw in perceived risk-premium of UST is likely overblown.



Source: NY Fed

Figure 16: Sovereign Risk Weights

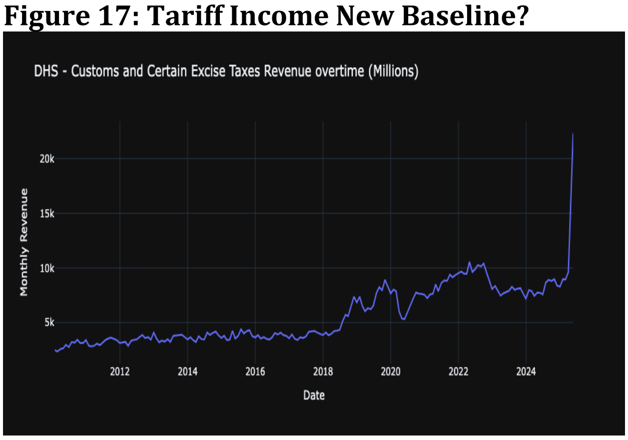
Table 1: Basel II standardized approach: Sovereign risk weights (in percentage)

Credit ratings	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk weights	0	20	50	100	150	100

Source: BIS (2013).

Source: Bank of International Settlements (BIS)

Figure 17: Tariff Income New Baseline?



Source: TGA

Figure 18: Investors Demanding Higher Yields

Funding the Fiscal Deficit

In a deeper dive on fiscal policy, a silver lining from tariffs is that they have already demonstrated to be quite a reliable source of income. The month of April and May brought in $17.4 and $22.3 billion respectively, up from $9.6 billion in March (See Figure 12). Considering the months leading up to April had plenty more exports due to importers front-running tariffs, the nearly 2 times increase in revenue is significant. If revenue remain the same, it would be over $200 billion a year and over $2 trillion in a decade. While not exactly close to the $4 trillion the TCJA renewal is expected to cost, paying greater attention to the revenue brought in from tariffs.

Around $9 trillion of Treasuries will need to be refinanced by the end of 2026, mostly long-end Treasuries. Around $3 trillion will need to be refinanced around the start of the year. As long-end yields rise rapidly, with the 30Y breaching the 5% level on 19th again, the bond market is growing concerned with the rising debt and how the US Treasury plans to refinance it. Rising long-end yields makes it more expensive for the US to borrow from the rest of the world. This is coupled with reserve banks around the world trimming US treasury holdings to diversify into after Liberation Day, reducing global demand for US Treasuries.

Apart from relying on Tariff revenue, the market is expecting the US to potentially lower the Supplementary Liquidity Ratio (SLR) to make it less costly and more attractive for large banks to hold more Treasuries. The SLR is a regulatory capital requirement that compels large banks to hold a minimum amount of Tier 1 capital relative to their total leverage exposure. When the SLR is binding (i.e., banks are close to the minimum ratio), it limits banks' ability to expand their balance sheets without raising additional capital. This constraint discourages banks from holding more Treasuries or providing liquidity in the Treasury market, especially during periods of large government debt issuance or market stress. Reducing the current SLR from the current 3% minimum and 6% for globally systematically important banks will free up balance for banks to increase Treasury holdings, improving domestic demand for Treasuries.

The market is potentially expecting US lawmakers to fund the fiscal deficit by increasing tax rates on certain foreign countries. Through Section 899 of the proposed "Defending American Jobs and Investment Act", federal income tax rates on income earned by non-U.S. persons would be significantly increased. The income taxes would be targeted against jurisdictions designated as "discriminatory foreign countries" that impose unfair foreign taxes on the US. Though this tax hike is explicitly retaliatory in nature, it does serve to generate significant tax revenues; marginal hikes from 5% to 20% on top of existing income taxes are projected to bring in over $116 billion in tax revenues over 10 years. On a more speculative note, targeted countries lose their existing tax exemption and the effective withholding tax on US Treasury interest rise from 0% to as high as 50%.

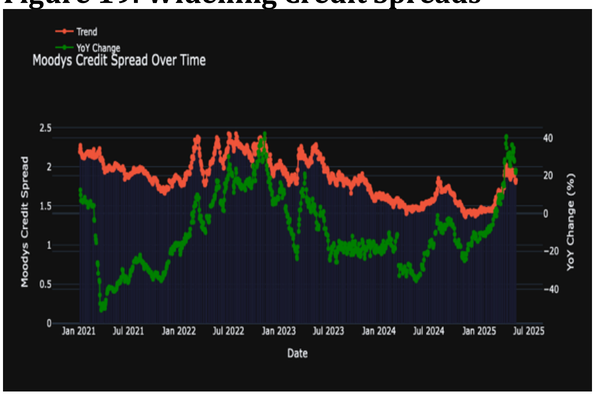
One way to decompose long end yields is growth expectations + inflation expectations + term premium. With growth expectations in the short term being muted in trade policy transition and term premium not likely to change, greater emphasis must be paid to reacting to changes in inflation expectation and the details of Trump's new tax upcoming tax bill. CPI figures have surprised markets with lower-than-expected figures despite the newly added tariffs. The next bout of volatility if at all for yields will most likely come when the tax bill comes next.

Credit Spreads

In the Corporates FI market, credit spreads have widened to their largest level, last seen in the inflation bear market of 2022. This is of course ascribed to Trump tariffs weighing down on the profitability of firms, especially the small and mid-caps like those on the Russell 2000. The latest spike in credit spreads we believe

Source: New York Fed

Figure 19: Widening Credit Spreads



Source: Moody's Credit Spread Index (FRED API)

is temporary. Calls for a recession have calmed significantly from Liberation Day, in part due to concessions by Trump. Though, there is also the renewal of tax cuts for firms to look forward to. Credit spreads tightened in Trump's first term leading up to the bill in part due to the TCJA, where spreads tightened from around 2.7% at election, to a low of 1.5% in January 2018. Our base case remains that unless significant turmoil unfolds from a breakdown in tariff negotiations, credit spreads should come down from here.

US Equity Markets

US Equities Summary

US equity markets were the envy of the world going into 2025. With the re-election of Trump and a red sweep cause markets to rally on optimism of a renewed Tax Cuts and Jobs Act (TCJA). This led to investors pricing in higher corporate earnings pushing US indexes such as the S&P 500 and NASDAQ to all-time highs. Such optimism began fading late in February when markets began pricing in major disruptions in trade if Trump tariff policies were to kick in.

SPY Futures fell from 6166.5 to 4832, entering bear market territory. With US equities performing so poorly it prompted Trump to announce a 90 day pause in tariffs, causing ESA to spike 10% in a day. This back-and-forth in trade policy announcements has become somewhat expected from Trump, or Trump-put moments. First with Canada and Mexico, pausing Liberation Day tariffs and latest with China.

US Equities Year to Date

U.S. equities have been predominantly carried by the performance of the Magnificent 7 stocks since the recovery from the inflation-driven recession of 2022. These tech-driven names now account for roughly 34% of the S&P 500's market capitalization, reflecting a level of concentration not seen since the dot-com era. Their outsized gains were underpinned by a powerful combination of earnings resilience, AI-driven optimism, and multiple expansion especially following the market-friendly expectations around a renewed Tax Cuts and Jobs Act (TCJA) after Trump's re-election.

Valuations, however, were increasingly priced for perfection, and momentum carried into early 2025 until macro concerns began to resurface. The first cracks appeared with weaker-than-expected GDP forecasts from the Atlanta Fed, suggesting that the economy might not be as robust as previously assumed. The tipping point came when 25% tariffs on imports from Mexico and Canada were announced.

Investors grew concerned about supply chain bottlenecks, input cost inflation, and retaliatory tariffs from trading partners, which threatened to erode corporate margins. SPY futures gapped down 2% on the Monday open following the announcement, with weakness in industrials, consumer discretionary, and even some of the Mag 7 names exposed to global revenue streams. The sell-off continued until Liberation Day, where broad-based tariffs were placed on every trading partner of the US with a baseline rate of 10%. Notable mentions would be China at 34% and the EU at 20%. This sparked a fierce sell-off which only really concluded following an announcement of a 90 day pause on tariffs.

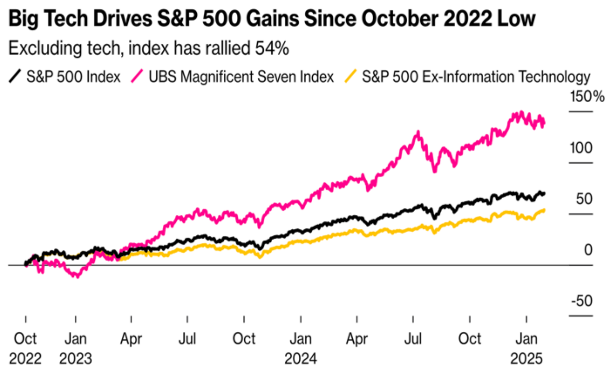
Since the bottoming out soon after Liberation Day, SPY Futures has started to inch back closer to ATHs, almost breaching the 6000 handle again. Whether ES can maintain such momentum remains to be seen as trade policy uncertainty is still unresolved. The current pause in tariffs last only until July. Negotiations with trading partners are nowhere near conclusion and is estimated to takes years to resolve for the many partners the US has.

Not the end of US Exceptionalism

Figure 20: US Equities vs Rest of World

Source: Bloomberg

Figure 21: Tech Driving gains entering 2025



Source: Bloomberg

Figure 22: Magnificent 7 YTD Performance

Source: Bloomberg

Figure 23: Not the end of US Exceptionalism: QQQ continues to outperform EM equities. Long EM basket Short QQQ poor YTD performance

Despite early-year calls from equity bulls proclaiming the end of US exceptionalism—a term used to describe the persistent outperformance of US equities driven by superior corporate earnings, tech leadership, and institutional depth—the NASDAQ composite continues to trounce EM equities. The long EM basket vs short QQQ trade has fared poorly year-to-date, underscoring the resilience of US markets relative to their emerging counterparts. The EM basket, constructed with estimated market cap weights, consists of equity indices from Europe, China, India and Brazil. The basket is down almost -10% YTD, while the QQQ is up slightly after recovering from the post-liberation day correction.

Contrary to the narrative at the start of the year The "End of US Exceptionalism" trade has performed poorly YTD, Rotating out of the *FAANG*-heavy NASDAQ ($QQQ) into a weighted basket of emerging market indices.

Trade Idea: US Yield Curve Steepener (2s10s/2s30s)

Thesis

Given the current fiscal situation, we expect curve steepener trades — long short-dated Treasuries, short long-dated Treasuries — to benefit from macroeconomic policy and structural dynamics driving a wider spread between short and long term yields.

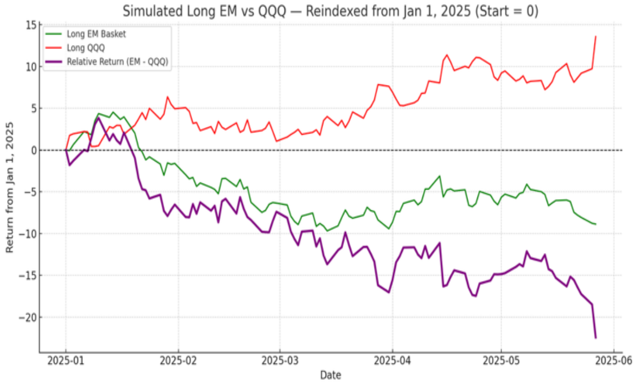
The Bear Steepener Case

A bear steepener occurs when long-end yields rises faster than short-end yields. This tends happen late in a cutting cycle or in the beginning of a hiking cycle, when long-end yields rises faster due to higher inflation or growth expectations, or rising fiscal deficits as is this case now. The entire long end from the 10Y to the 30Y has sold off significantly, with the 10Y and 30Y revisiting 4.5% and 5.0% respectively, testing the recent highs set at the end of last year.

While the 10Y is significantly more liquid[5] and is factoring higher term premiums, the 30Y has greater duration (sensitivity to interest rates) and its supply/demand dynamics is primarily affected by longer-term holders such as foreign central banks and pension funds. With rising fiscal deficit concerns and falling dollar

Bull Steepener Case:

[5] When implementing the yield curve through CME futures

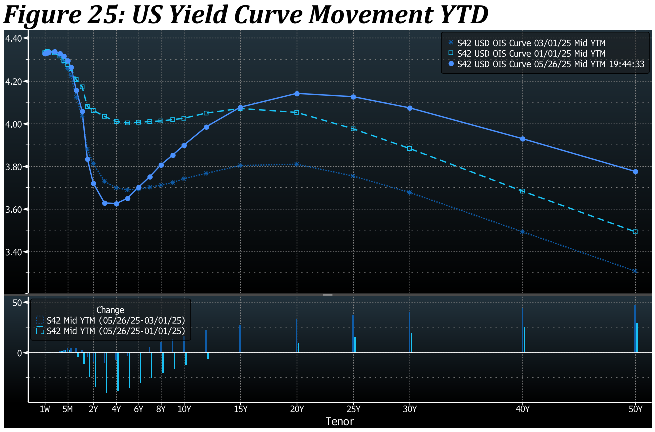


Source: Yahoo Finance

Figure 24: US Yield Curve Spreads[1]

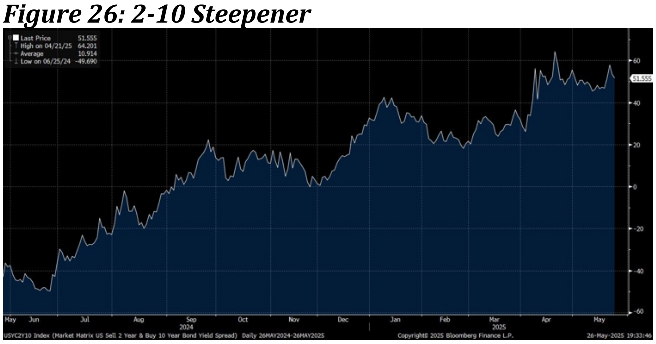
Source: FRED API

Figure 25: US Yield Curve Movement YTD



Source: Bloomberg

Figure 26: 2-10 Steepener



Given that we expect the long-end of the yield curve to continue selling off, it is unlikely that we will see a bull steepener. In such a scenario, where the Fed cuts rates fast and deep in reaction to rising recession risk, the short end of the yield curve will fall faster than the long-end, causing the yield curve to steepen.

<u>Twist Steepener Case:</u>

Should the Fed react to rising recession risk by cutting rates more aggressively (provided that inflation continues to cool), we could see a twist steepener in the yield curve, where both short-end and long-end rates move in opposite directions; Long-end Treasuries continues to sell off as real money managers trim portfolio allocations of US Treasuries due to shrinking fiscal/trade surpluses with the US and rising uncertainty, all while the short-end yields fall as the Fed cuts rates.

<u>Analysing US Curve Steepeners: 2s10s vs 2s30s</u>

In playing expectations of a curve steepening in US rates, either the 10Y or the 30Y can be selected as the long-end leg. Both tenors will likely continue to sell off and given that both tenors are DV01 neutral against the 2Y, both steepeners have performed similarly.

Granted, we slightly favour the 2-30 steepener as the 30y leg has higher duration and convexity, providing greater asymmetry in risk/reward, especially in a twist steepener case where the long-end sells off on fiscal concerns while the short-end rises.

The trade can be expressed through either the swaps or the futures market.

Trade Structure: 2-10 Steepener

Swaps:

- **Pay USD SOFR 2s10s**: Receive SOFR 2Y at 3.709%, Pay 10Y at 3.888%
- **Current Spread**: 17.9 bps
- **Stoploss/Take-Profit:** 7.9bps/47.9 bps (1:3 Risk:Reward)
- **1M/6M Carry + Rolldown**: 4.8bps/39.1 bps
- **DV01 for $1mm notional (Dollar Value of 1 bp change)**: ~$195 for near-leg, ~$850 for far-leg
- **Hedge Ratio (DV01 of 10y/ DV01 of 2y): =** 4.36

Futures:

- **USD 2y10y Treasury Futures Steepener**: Long 2Y, Short 10Y Treasury Futures
- **Current Spread**: 44.0 bps
- **Stoploss/Take-Profit:** 34.0bps/64.0bps (1:3 Risk:Reward)
- **1M Carry + Rolldown**: -3.3bps + -0.8 bps = -4.1bps/month
- **DV01 for $1mm notional (Dollar Value of 1 bp change)**: ~$193 for near-leg, ~$820 for far-leg
- **Hedge Ratio (DV01 of 10y/ DV01 of 2y): =** 4.25

2-30 Steepener:

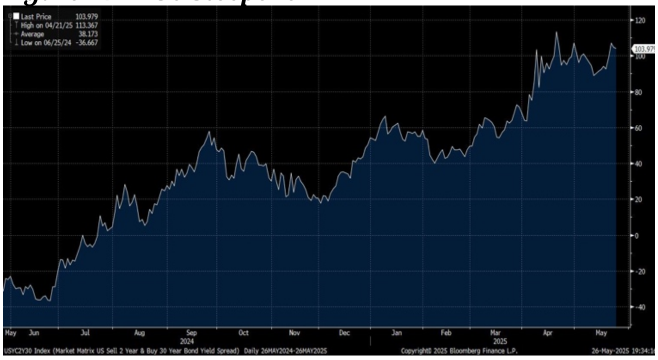
Swaps:

- **Pay USD SOFR 2s30s**: Receive SOFR 2Y at 3.709%, Pay 30Y at 4.603%
- **Current Spread**: 35.4 bps
- **Stoploss/Take-Profit:** 25.4bps/65.4bps (1:4 Risk:Reward)
- **1M/6M Carry + Rolldown**: 4.7bps/38.0 bps

[1] Constant Maturity Swap

Source: Bloomberg

Figure 27: 2-30 Steepener



Source: Bloomberg

- **DV01 for $1mm notional (Dollar Value of 1 bp change)**: ~$195 for near-leg, ~$1600 for far-leg
- **Hedge Ratio (DV01 of 30y/ DV01 of 2y)**: ~8.2

Futures:

- **USD 2y30y Treasury Futures Steepener**: Long 2Y, Short 30Y Treasury Futures
- **Current Spread**: 120 bps
- **Stoploss/Take-Profit:** 110bps/150bps (1:4 Risk:Reward)
- **1M Carry + Rolldown**: -3.4bp + -0.6bp = -4.0 bps
- **DV01 for $1mm notional (Dollar Value of 1 bp change)**: ~$193 for near-leg, ~$1600 for far-leg
- **Hedge Ratio (DV01 of 30y/ DV01 of 2y)**: ~8.3

Figure 28: 2-10 Steepener Carry-Rolldown

	Fwd	Carry	Rolldown	Total
1M	20.8	2.9	1.9	4.8
2M	23.9	5.9	3.8	9.7
Year-End 2025	39.5	21.6	17.5	39.1

Source: Bloomberg, OIS Curve

Figure 29: 2-30 Steepener Carry-Rolldown

	Fwd	Carry	Rolldown	Total
1M	38.7	3.3	1.4	4.7
2M	42.1	6.7	2.9	9.6
Year-End 2025	59.2	23.7	14.3	38.0

Source: Bloomberg, OIS Curve

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Basic Information

Real GDP (CAD)	4
M1 (CAD)	1.569 trillion
M2 (US$)	2.587 trillion
CPI	161.8
PPI	127.2
Con. Confidence	48.60
Stock Index	TSX Composite
Currency	CAD

Source: TradingEconomics

Overview of Canada's Economy

- Canada remains the world's 9th-largest economy, with CAD 3.13 trillion in nominal GDP (Q4 2024) and about US $2.24 trillion in 2024 (IMF WEO, April 2025)
- Real estate & rental and leasing (13.0% of GDP) and manufacturing (10.4%) are the two largest industry contributors.
- Canada is a top-10 global trader—the 10th-largest merchandise exporter (CAD 768.2 billion) and 11th-largest importer (CAD 770.2 billion) in 2023. Exports plus imports totaled CAD 1.54 trillion (2023), or roughly 48% of GDP.
- Energy products (crude oil, petroleum gas, refined petroleum) collectively account for ~18% of export value, followed by automotive & parts (11%), metals & minerals (10%) and consumer products (9%).
- The United States accounts for 77.4% of exports (CAD 594.6 billion) and supplies 49.5% of imports. China is a distant second destination at CAD 30.5 billion (3.97% of exports).
- Canada was the 6th-largest recipient of FDI in 2023, attracting US $50.3 billion of inflows and building a stock of roughly US $1.66 trillion.

Summary of Events in the Past 6 Months

Mark Carney Elected Prime Minister (April 28, 2025)

In a surprising political turn, former central banker Mark Carney led the Liberal Party to victory in the spring federal election, winning his Ottawa-area riding and securing a fourth consecutive majority government for the Liberals. Carney's campaign focused on leveraging his international economic credentials to navigate a fractious global trade environment and steer Canada through rising geopolitical uncertainty.

GST/HST Holiday (Dec 14, 2024 – Feb 15, 2025)

To cushion consumers against rising living costs, the federal government instituted a two-month "GST/HST holiday," suspending sales taxes on a broad range of goods and services. Retailers reported a surge in big-ticket purchases. Economists estimate that the holiday boosted real consumer spending by nearly 1% in Q4 2024, helping to sustain growth even as borrowing costs climbed.

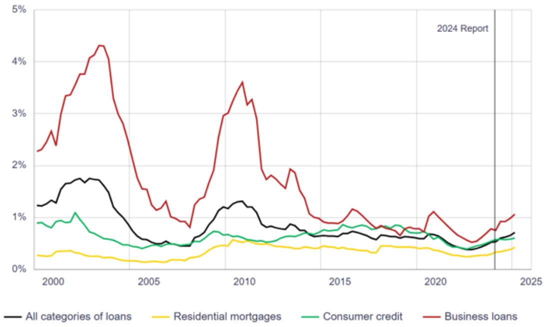
Removal of the Federal Carbon Tax (April 1, 2025)

In a major fiscal pivot, Ottawa eliminated the federal carbon levy, reducing fuel and heating costs overnight for consumers and businesses. Gasoline prices fell by an average of 10–12 cents per litre at participating pumps, and small manufacturers that rely heavily on natural gas reported immediate cost savings.

Bank of Canada Holds at 2.75% (April 16, 2025)
After a rapid easing cycle with 7 cuts amounting to 225 basis points since mid-2024, the BoC has paused its policy rate at 2.75%. Governor Tiff Macklem stressed that the Bank needed time to assess how recent tariff measures and the carbon-tax suspension were affecting both inflation and growth.

U.S.–Canada Trade War Escalation (March 11–13, 2025)
The U.S. has imposed 25% tariffs on Canadian steel, aluminium and auto imports in early March. Canada immediately retaliated with C$29.8 billion in counter-tariffs on U.S. goods. This exchange roiled commodity markets and hit manufacturing regions on both sides of the border. Canadian automakers have accelerated parts shipments before the tariffs took effect, contributing to a one-off spike in trade volumes but also a drag on Q1 growth as inventories swelled. They did this to brace for higher input costs.

Figure 1: Impaired loans at large banks, by credit category (share of total loan value)



Source: Regulatory filings of Canadian Banks, BoC (2025 Q1)

Canada Banking System

Credit Performance Remains Strong

Canadian banks remain well positioned to support the financial system and the broader economy, even through a period of financial stress. They have good access to funding through deposits and wholesale markets, and credit performance has been strong. They have increased their accumulated provisions (funds set aside for anticipated loan losses) and they maintain elevated levels of capital to absorb unexpected losses. They also continue to hold sufficient liquidity to meet their short-term obligations.

Prolonged and heightened financial stress on households and businesses would eventually spread to banks through higher credit losses. Banks could pull back on lending if losses affected their earnings and, at the extreme, their level of capital. That would add further stress on the economy and challenge overall financial stability.

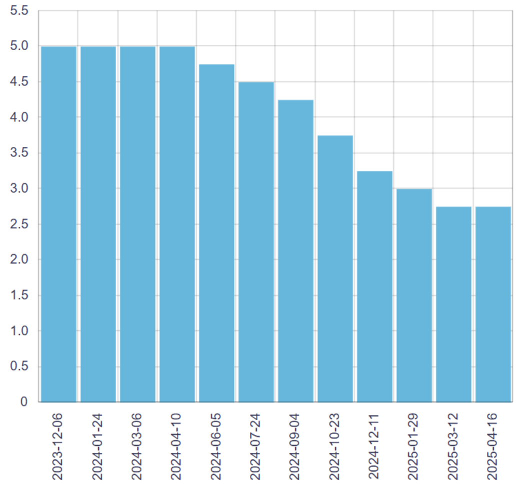
The two main sources of funding, customer deposits and funds borrowed through wholesale capital markets, have remained readily available over the past 12 months.

Bank deposits have continued to grow. Deposits at large banks grew 10% from March 2024 to March 2025. Yet the composition of bank deposits has shifted. In 2022 and 2023, when interest rates were elevated, households and businesses tended to prefer term deposits over demand deposits. The higher interest rates also increased competition for deposits. As interest rates have come down, deposit growth has been gradually shifting away from term deposits and back to demand deposits.

Investor appetite for bank debt remained strong in 2024 and the first quarter of 2025, hence, access to funding has been steady, and credit spreads for bank debt issued in wholesale markets have remained narrow (Figure 1).

Compared with their larger counterparts, medium-sized banks have seen a bigger increase in loan impairments, including on business and mortgage loans. This largely reflects their different business models, which can be centred around mortgage lending to higher-risk borrowers and business lending concentrated in specific industries or regions. Medium-sized banks account for only a small fraction of total lending by Canadian banks. For example, the total loan portfolio of

Figure 2: BoC Cutting Cycle Trend



Source: Bank of Canada, May 2025

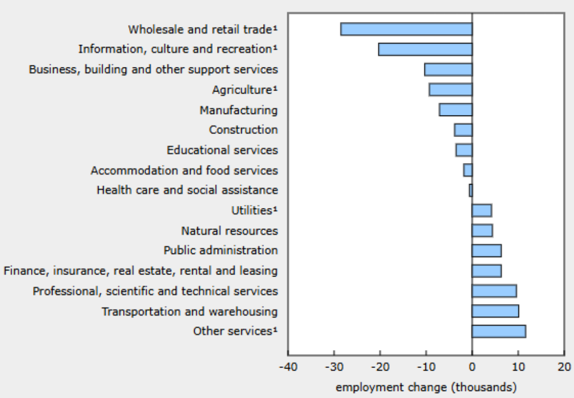
Figure 3: BoC Changes in Interest Rates

Date*	Target (%)	Change (%)
April 16, 2025	2.75	---
March 12, 2025	2.75	-0.25
January 29, 2025	3.00	-0.25
December 11, 2024	3.25	-0.50
October 23, 2024	3.75	-0.50
September 4, 2024	4.25	-0.25
July 24, 2024	4.50	-0.25
June 5, 2024	4.75	-0.25
April 10, 2024	5.00	---
March 6, 2024	5.00	---
January 24, 2024	5.00	---
December 6, 2023	5.00	---

*As of 2021, a change takes effect the day after its announcement.

Source: Bank of Canada, May 2025

Figure 4: Employment Change by Sector



1. Change is statistically significant.

Source(s): Labour Force Survey (3701), table 14-10-0355-01.

Source: Labour Force Survey, April 2025

Figure 5: Canada employment growth since June 2022 (%)

Canadian employment has stalled out in early 2025, with trade-exposed sectors like manufacturing seeing a sharp reversal. The chart shows total employment versus manufacturing employment growth (percentage change since mid-2022), highlighting the steep drop in factory jobs in April 2025.

medium-sized banks is only about $150 billion, compared with more than $4.3 trillion at large banks.

What's next for Canada's Monetary Policy?

Looking ahead, market pricing and analysts' expectations favor further easing in 2025, despite the April pause. With growth slowing and the trade war posing downside risks, traders in overnight index swaps anticipate as much as 75 bps of additional BoC rate cuts over the remainder of the year, which would bring the policy rate down near 2.0%.

Many economists similarly predict that the Bank will resume cutting rates by the June 2025 meeting, barring a swift improvement in conditions. Following the April jobs data, BMO's chief economist Douglas Porter stated that "the weak report clearly increases the odds of a 25-bp rate cut in June."

Forecasters highlight that labour market slack is building, and wage growth has cooled to a multi-year low, bolstering the case for more stimulus. Unless incoming data (including the next CPI release on May 20) show an unexpected inflation spike, the BoC is likely to ease policy further to cushion the economy.

Additionally, any further rate cuts will be delivered with an eye on inflation expectations. The BoC has noted a recent uptick in short-term inflation expectations as businesses anticipate higher input costs from tariffs. However, longer-term expectations remain well anchored, and the Bank's April statement stressed its commitment to keeping inflation controlled. The Governing Council will be "proceeding carefully" and will watch how tariff costs pass through to consumer prices, versus how much slack in the economy pulls inflation downward.

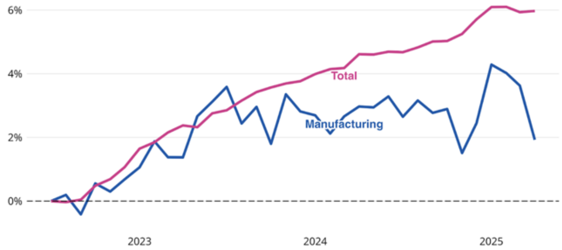
What this means is that the timing of the next cut is data dependent. A further deterioration in employment or spending could trigger a June rate cut, whereas any upside surprise in inflation or a de-escalation in the trade conflict might delay easing a bit longer. That said, the consensus baseline is that monetary policy will bias toward more accommodation in coming months. Furthermore, the Canadian 2-year bond yield (a strong indicator of policy expectations) has fallen to around the policy rate, reflecting these cut expectations.

Labour Market

Canada's labour market has fallen from resilient growth to a softer trend. After several years of solid job gains (and unemployment hovering near post-COVID lows), the tide turned in March 2025. Employment fell by 33,000 in March (the first monthly decline since January 2022) pushing the jobless rate up to 6.7%. The weakness initially appeared concentrated in consumer-facing sectors, with wholesale and retail trade shedding nearly 29,000 jobs in March as consumption slowed.

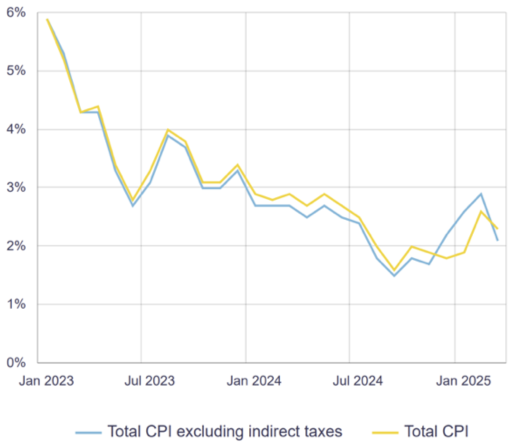
By April, however, the impact of the trade war became more plainly visible in the labour data. Thanks only to a surge in public-sector hiring, overall employment in April managed to stay flat. Public administration employment jumped by +37,000 (+3%) as temporary staff were hired for the spring election cycle. Excluding this one-off boost, April would have recorded another net employment decline on the order of –30k jobs. The unemployment rate rose to 6.9% in April (from 6.7%) and would likely have hit 7% without the election hiring distortion.

Total employment was little changed in April (+7,400), but the composition told the underlying truth. Manufacturing employment



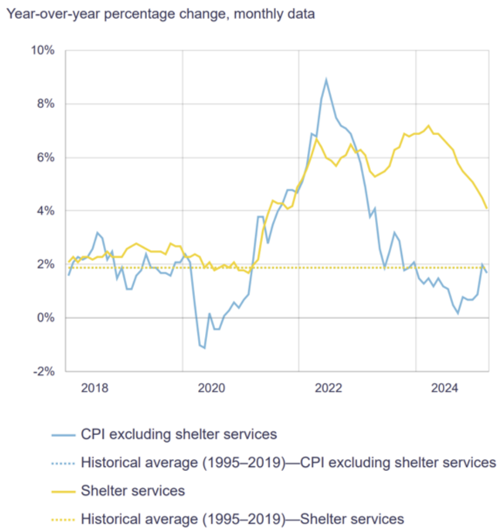
Source: Statistics Canada, April 2025

Figure 6: Year-over-year percentage change in inflation rate, monthly data



Source: Statistics Canada and BoC, March 2025

Figure 7: Inflation Data excluding shelter services has returned close to historical norm



Source: Statistics Canada and BoC, March 2025

Figure 8: Survey data of short-term inflation expectations for businesses and consumers

plunged by roughly 30,000 in the month, the largest one-month factory job loss Canada has seen outside of recessionary periods in decades. This drop in manufacturing (–1.6% month-on-month) was concentrated in Ontario and especially in the Windsor area, Canada's automotive hub, reflecting layoffs as U.S. tariff threats hit the auto supply chain. In addition to manufacturing, the wholesale and retail sector fell another 27,000.

This points to a cooling labour market that may be at a turning point after years of tight conditions. Leading indicators reinforce this shift, as we can see business surveys report scaled-back hiring plans going forward, and average hourly wage growth has eased to around +3.5% year-on-year – the slowest pace in three years. With labour force participation steady, the rise in joblessness suggests slack is emerging. This shows signs of demand softening. Should this trend persist, despite the chance of it alleviating wage-price pressures, but also decrease consumer spending power in the months ahead.

Inflation

Consumer price index (CPI) inflation has been volatile due to the GST/HST holiday. Excluding the tax holiday period, inflation has risen from 1.9% in November 2024 to 2.3% in March 2025 (Figure 6).

Total CPI inflation has increased because inflation excluding shelter services has rebounded to near its historical average, outweighing a steady decline in inflation in shelter services (Figure 7). While inflation in shelter services remains above its historical average, it is easing. Inflation in both rent and mortgage interest costs, despite still being high, is declining.

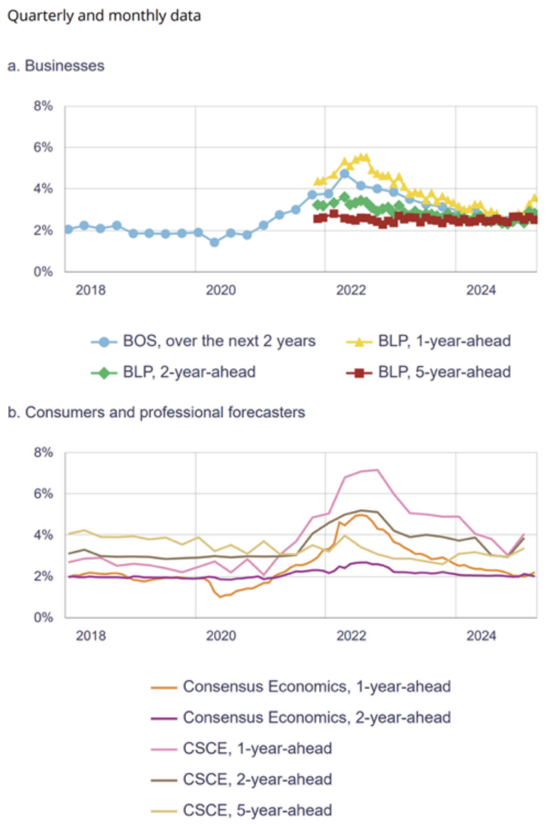
Goods prices were roughly flat before the GST/HST holiday, but inflation in goods prices reached 1.3% in March 2025, after the tax holiday ended. Inflation in goods prices has picked up and is broad-based. For example, inflation has risen in the prices of sporting and exercise equipment, clothing and fresh fruit. These increases stem partly from the delayed effect of the Canadian dollar decreasing in value in late 2024, which is making imports more expensive now. Additionally, some businesses have indicated that suppliers are proactively raising prices in anticipation of future tariffs.

Inflation in services prices was around 3.5% before the GST/HST holiday but fell to 3.1% in March 2025. The decline is mainly due to an easing of inflation in shelter prices. In contrast, inflation in services prices excluding shelter has been increasing, rising from 1.7% to 2.2% over the same period. The BoC's preferred measures of core inflation (CPI-median and CPI-trim) were 2.9% and 2.8% in March, respectively (Chart 5). These measures have remained in the 2.5% to 3% range since summer 2024, partly because elevated inflation in shelter prices continues to affect core inflation. However, higher goods prices are the main reason for the recent increase in core inflation.

Meanwhile, short-term inflation expectations increased in the first quarter (Figure 8). Both businesses and households expect the trade conflict to push prices up. Some businesses report that they have already seen an increase in costs and expect these increases to continue. Longer-term inflation expectations remain largely unchanged.

Fiscal Conditions and Trade Policy Disruptions

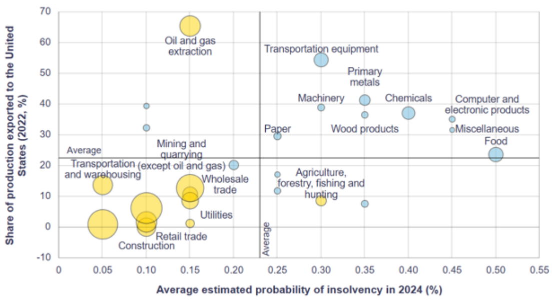
Canada's fiscal position entering 2025 is one of moderate deficits and a supportive stance geared toward economic resilience. The federal government has continued to run manageable budget deficits in the



Source: Consensus Economics, CSCE and BOS, April 2025

Figure 9: Dimensions of Business Vulnerability to Trade War with the US, by Industry

Each bubble represents industries in the North American Industry Classification System. The size of each bubble is proportional to the industry's outstanding debt balance in 2024.



Source: Statistics Canada and BoC, 2024Q4

Figure 10: Weekly Chart of USDCAD

C$40 billion range (roughly 1.3–1.5% of GDP). As of the first 10 months of the 2024–25 fiscal year, the deficit stood at C$26.8 billion, slightly higher than the prior year's pace.

Revenues have been growing solidly (up around 11% year-on-year, thanks to rising income tax receipts), but expenditures have also risen about 11%, keeping the deficit on a widening trajectory. Canada's debt burden remains moderate by international standards (federal debt-to-GDP is in the mid-40% range) and the government retains fiscal space to respond to shocks.

Importantly, fiscal policy has turned somewhat expansionary in response to current headwinds. In an election year (the next federal election is due by October 2025), the government is inclined to support growth and cushion households. It has already enacted certain tax relief measures that double as stimulus like the temporary GST/HST holiday mentioned earlier and the suspension of the carbon tax in 2025, both of which put money back in consumers' pockets and lower headline inflation.

The escalating trade dispute with the U.S. has prompted a targeted fiscal response as well. Businesses that export a large share of their production to the United States and have high leverage, low profitability and low cash reserves are particularly vulnerable to a lasting trade war. This applies mostly to firms in manufacturing subsectors (Figure 10).

Canada has rolled out support for affected industries and retaliatory measures calibrated to defend Canadian interests. The Finance Department announced in April new support for Canadian firms hurt by the tariff battle, which includes remission of certain Canadian counter-tariffs to reduce input costs. For example, the government introduced a performance-based remission for automakers that stated that if automakers maintain production and investment in Canada, they will be allowed to import a quota of U.S.-made vehicles tariff-free despite Canada's counter-tariffs.

Broader fiscal policy is also geared towards stability. The federal government's spring budget (tabled in March 2025) maintained a commitment to invest in funding for trade infrastructure and incentives to develop new markets beyond the US. If the trade conflict drags on, we can expect further fiscal stimulus in the form of extended tax relief or infrastructure spending to stimulate demand. Conversely, if a trade resolution is reached, Canada might revert to a path of gradual deficit reduction. The BoC's priority now is to buffer the Canadian economy from trade shocks even if it means temporarily higher deficits.

USD/CAD (loonie)

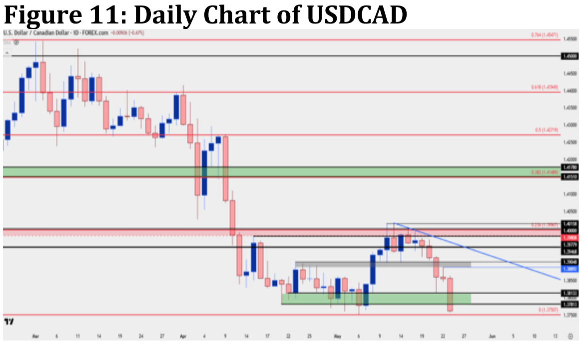
It's been a bearish outlay for the USD so far this year and that is in stark contrast to the strength that the currency was showing as it came into 2025. And at this point there's now the threat or possibility of a greater show of carry unwind in USD/JPY, which could drive more weakness into the currency.

If we do get that scenario of considerable USD-weakness, USD/CAD remains an attractive venue for bearish continuation, as the decade-long range remains intact even after the flare of strength earlier in the year (FIgure 11).

Notably – bulls couldn't hold the move above 1.4500 for long, and prices soon dipped down below 1.4000 in April. Since then, sellers have defended that price and the door remain open to longer-term range continuation in the pair.

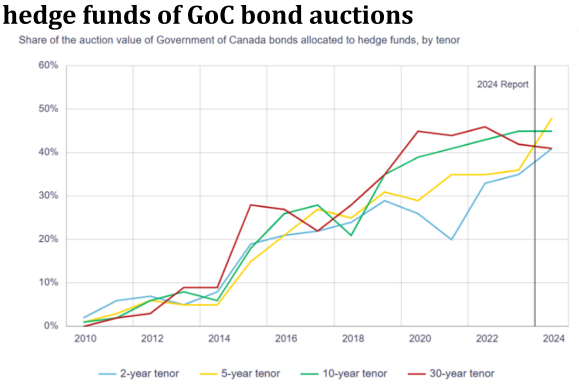
Source: TradingView, May 2025

Figure 11: Daily Chart of USDCAD



Source: TradingView, May 2025

Figure 12: Increasing trend of shares taken by hedge funds of GoC bond auctions



Source: Department of Finance, BoC, 2024

Figure 13: Bank of Canada Commodity Price Index

Last week, USD/CAD has traded lower every day on the heels of last week's resistance at the 1.4000 psychological level (Figure 12). This was a big zone that had resistance potential for some time. After the swing high on Tuesday the 13th, it produced a series of lower highs with the 1.4000 price holding the highs after, and this week sellers were able to stretch as short-term support was breached, and USD/CAD fell towards 2025 lows.

Our outlook for CAD remains two-sided. We expect continued volatility rather than a clear one-way trend. On one hand, the CAD could depreciate further if the trade conflict intensifies or if commodity markets stay weak. The CAD has lost ground against the safe-haven Japanese yen since the start of the trade tensions, reflecting the risk-off skew. In scenarios of extreme market stress, traditional havens like the USD, JPY, CHF currencies would have more demand than the CAD.

On the other hand, weaker oil prices and a dovish BoC stance are clear headwinds for the CAD. CAD could modestly appreciate if the Fed out-eases the BoC. Canada's improving current account (helped by earlier commodity price strength) and the possibility of US and Canada tariff negotiations could support the currency. We are likely to see CAD strengthen if we see a resolution or cooling of the trade war, and robust domestic data may also support it. For now, our base case is for USD/CAD to remain range-bound in the long term.

Fixed Income

In the near term, Canadian front-end yields (2-year and under) have the most room to fall if the BoC delivers the cuts that markets anticipate. Forward rate agreements are already pricing in at least 50–75 bps of easing over the next 6–12 months. If the June meeting brings a cut, one can expect 2-year yields to dip below 2.5%. Longer maturities will trade off a mix of global growth sentiment and inflation expectations. The 5-year sector (more important for mortgage rates) is around 2.9% and has dropped significantly, easing borrowing costs for households and businesses. This is directly reducing pressure on mortgage holders renewing loans.

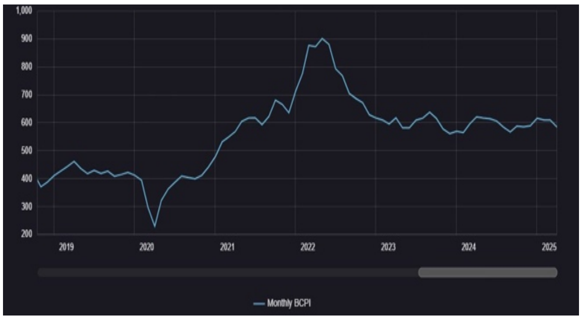
Hedge Funds have taken on a greater role in Canadian bond markets

Bond market intermediaries support liquidity by buying bonds at the time of issuance and then facilitating the trading of these securities in the secondary market. Historically, bank-owned broker-dealers have played that role in the Government of Canada (GoC) bond market. But while the total stock of GoC bonds has grown considerably since 2020, so has the amount being issued and traded. This has stretched dealers' capacity to intermediate, which is limited by factors such as financial regulations and their own risk management practices.

Hedge funds have taken on a larger role in these markets now than in the past. In GoC debt auctions, hedge funds now buy almost 50% of the auction volume in some tenors (Figure 14???). They also represent about 30% of the volume of trades between dealers and clients in the secondary market for GoC bonds. This is mainly due to the widespread use of leveraged strategies, such as the cash-futures basis trade .

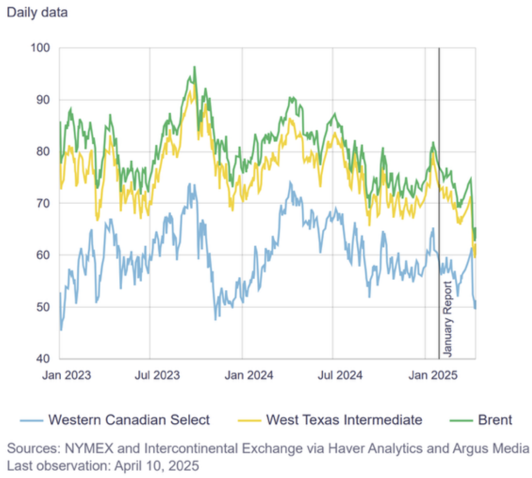
Hedge funds' increased participation in government debt auctions helps the market absorb the elevated level of debt issuance at competitive prices. And their active trading strategies add to the liquidity and efficiency of bond and futures markets.

However, hedge funds tend to finance their investments with leverage and do not face the same contractual obligations and regulatory requirements as bank dealers (e.g., minimum bidding obligations at auctions). They may be more likely than bank dealers to pull back from these markets in certain situations. In a period of stress, hedge funds



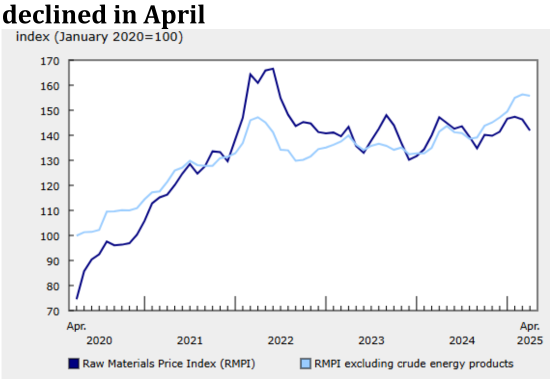
Source: Bank of Canada, 2024

Figure 14: Oil Prices declining



Source: NYMEX and Intercontinental Exchange via Haver Analytics and Argus Media, April 2025

Figure 15: Prices for raw materials in Canada declined in April



Source: Bank of Canada, April 2025

Figure 16: S&P/TSX Composite price June 2024 to May 2025

Source: Toronto Stock Exchange, May 2025

could find it harder to maintain their positions in GoC markets if, for example, they lost access to repo funding or if higher volatility in bond markets led to big margin calls. Foreign-based funds could also decide to abruptly reduce their exposure to GoC markets if trading in them became less attractive or riskier than trading in other markets, for example, due to an increase in funding costs or a sharp rise in volatility.

Commodities

Canada is a major player in the global commodities market, particularly in agricultural products and minerals. It's a significant exporter of various commodities like oil, gas, lumber, gold, silver, and copper.

Brent oil prices have fallen to around US$65, US$15 below the BoC assumption in its January 2025 Report. The decline reflects two main factors: concerns that the global trade conflict will reduce future oil demand and plans by members of the OPEC and some non-OPEC producers to increase production. The spread in prices between West Texas Intermediate and Western Canadian Select has narrowed from US$15 assumed in the January Report to about US$10. This is because traders now believe that US tariffs will not be broadly applied to Canadian oil, while Venezuelan oil exports are facing a pending decline and seasonal oil sands maintenance is restraining Canadian production. Lastly, natural gas prices have risen since the January Report due to colder-than-normal weather conditions.

The BoC's non-energy commodity price index remains roughly unchanged since the January Report. US tariff threats have led US metals traders to pull forward demand. This has caused the prices for some metals that are traded on US exchanges, such as copper, to increase. Gold prices have risen sharply as investors seek to protect themselves against geopolitical uncertainty and the trade conflict. In contrast, agricultural prices have fallen, partly due to tariffs on Canadian exports.

Equities

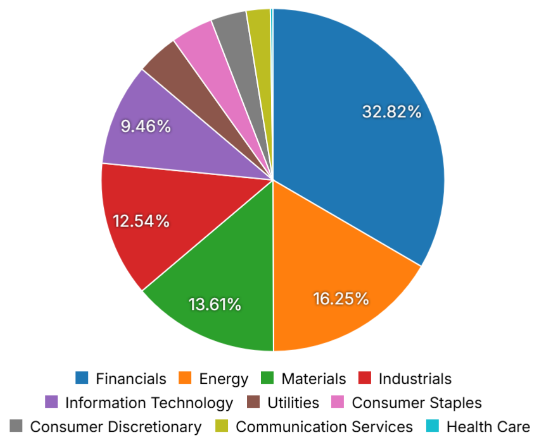
The Canadian equity market has experienced increased volatility. The S&P/TSX Composite ended 2024 at record levels, but performance in the first part of 2025 has been choppy, reflecting the tug-of-war between lower interest rates (a positive for equities) and trade uncertainty (a clear negative for certain sectors). A Reuters analysis noted that an index of "trade-sensitive" Canadian companies has lagged, with examples like BRP Inc. (a recreational vehicle maker) down 17% since the U.S. election that brought protectionism back to the forex. The TSX did see a pullback of a few percent in March when the initial tariff salvos were announced, and again in early April when global markets sold off on trade war fears. Financial conditions tightened briefly during these episodes, though the subsequent rally in bonds and dovish central bank tones helped stabilize stocks.

Financials (the largest TSX sector at 30% weight) have been middling since banks are navigating a mixed bag of lower interest margins (due to rate cuts) but also potentially lower loan losses due to a still-growing economy. The trade war by itself has limited direct impact on Canadian banks, but a domestic recession would hit loan performance. So far bank earnings have been stable and capital levels high, which has kept financial stocks range-bound. Industrials and technology have seen more pressure, especially any firms with U.S. exposure or global supply chains. Conversely, rate-sensitive sectors like REITs and Utilities have been relative bright spots, as the plunge in yields made their dividend profiles more attractive. Real estate investment trusts

Figure 17: Breakdown of sectors in the S&P/TSX Composite

Sectors

Sector	Weight %
Financials	32.82%
Energy	16.25%
Materials	13.61%
Industrials	12.54%
Information Technology	9.46%
Utilities	3.90%
Consumer Staples	3.89%
Consumer Discretionary	3.30%
Communication Services	2.23%
Health Care	0.24%

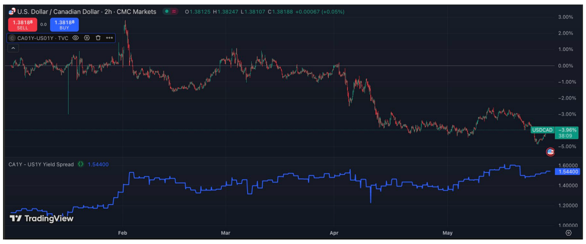


Source: Toronto Stock Exchange, May 2025

have also benefited from early signs that the housing market may be stabilizing.

Looking forward, Canadian equities face headwinds to earnings growth. The trade war is a key reason: tariffs raise costs and disrupt sales for many companies, eroding profit margins. Export-dependent companies see revenue declines if U.S. demand softens or if their products face tariff barriers. Uncertainty is prompting many corporate management teams to delay capital expenditures and expansion plans. However, with interest rates down and likely heading lower, equity valuations have a cushion. In addition, the TSX's heavy weighting in banks, pipelines, telecoms, etc means a large portion of the market is in relatively defensive, domestically oriented businesses. Energy and materials companies benefit from a weaker CAD (their commodities are priced in USD), and utilities/real estate benefit from cheaper financing.

Figure 18: USDCAD Daily Chart



Source: TradingView

Trade Idea: Long USDCAD

<u>Diverging Central Bank Policy; Slightly more cuts expected from BoC</u>

The Bank of Canada is currently pricing in 1.56 rate cuts (~39bps) by year-end. Rate cuts are expected to be front-loaded, with 25% probability priced for June, 44% in July and 47% for September. While the US Fed is expected to keep rates high amid strong US data and sticky services inflation, the Bank of Canada has the headroom to continue cutting, and slightly more cuts are likely to be priced in.

<u>90-Day Tariff Pause:</u>

The recent 90-day trade tariffs is only temporary and the market is uncertain what will happen next. Canada is more trade and export sensitive, particularly to auto and commodity flows. While its oil exports to the US are exempt from the 25% tariffs implemented on US imports from Canada. The eventual re-introduction of tariffs will stoke cost-push inflation which will hurt CAD more than USD.

<u>Risks;</u>
At the end of the 90-day tariff delay, Trump may offer Canada better than expected trade terms, but this is unlikely, as the current tariffs already provide exemption for Canada's most important export sectors. The current sentiment is also that US has the upper hand in current negotiations

Entry: 1.3838
Take Profit: 1.3974
Stop Loss: 1.3770
Reward Risk Ratio: 1:2

Carry:

3-month Forward Rate: 1.3771 (Spot-0.0065)

6-month Forward Rate: 1.3708 (Spot – 0.0130)

Disclaimer