

# Investment Strategy and Interest Rates Analysis – Diverging Fortunes

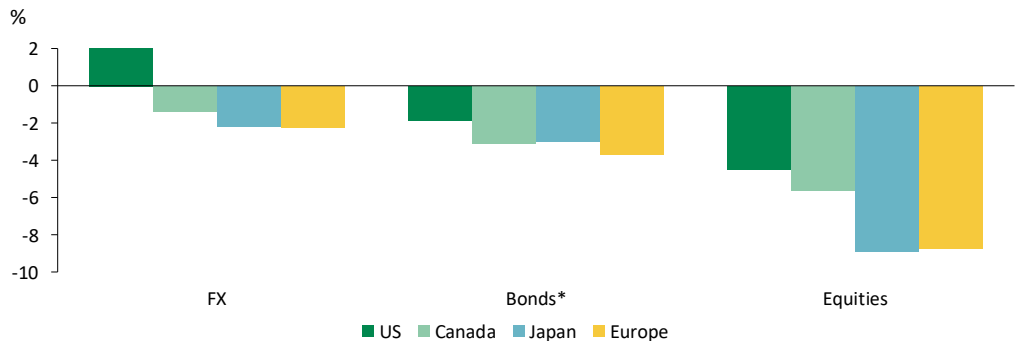
by **Jimmy Jean**, Vice-President, Chief Economist and Strategist,  
**Tiago Figueiredo**, Macro Strategist and  
**Oskar Stone**, Macro Strategy Associate



**Today’s increasingly shock prone world is delivering the volatility we anticipated, albeit for different reasons than expected.** The latest surge in energy prices hit assets and regions unevenly. Markets are reading it through a terms of trade lens—rewarding energy exporters and penalizing energy importers. North America, with ample domestic supply, has held up better, while Europe and much of Asia, which rely more on imported energy, have lagged (graph 1).

**Graph 1**  
**North American Assets Have Outperformed in March**

Cross-asset performance since escalation in the Middle East



\* German bonds are used for Europe.  
 Bloomberg and Desjardins Economic Studies

**The market is trading on inflation and under-pricing growth risks.** Across jurisdictions, front end rates have repriced sharply—led by Europe—as investors have moved from expecting cuts to pricing in multiple hikes later this year. While the first order effects are inflationary, a longer lasting disruption would increasingly threaten economic growth through higher costs and tighter financial conditions. Our base

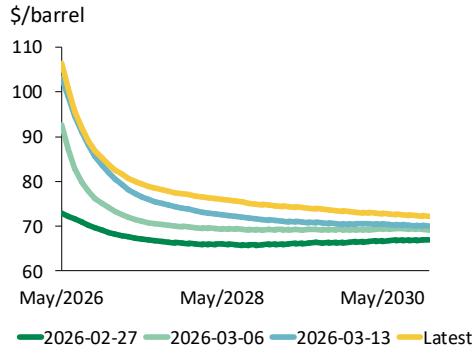
case still leans toward de escalation, but recent strikes on Gulf energy infrastructure raise the possibility that disruptions extend beyond shipping through the Strait of Hormuz (graph 2).

**From here, the paths forward are varied and wide ranging.** To anchor our views, we introduce a regime classification framework and compare risk adjusted returns across assets against their long run averages (graph 3). What comes next is uncertain. But with recession risks rising, we see asymmetric downside in equities and upside in fixed income.

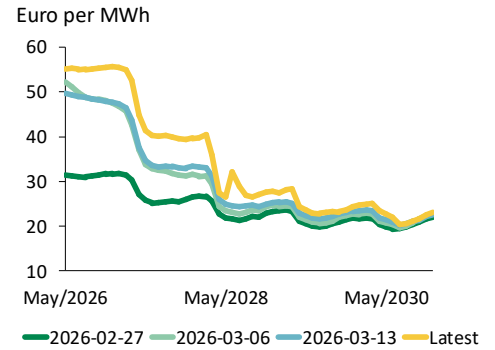
### Graph 2

#### Futures Are Now Pricing in Longer Disruptions in Energy Markets

##### European Brent crude futures



##### Dutch TTF natural gas futures

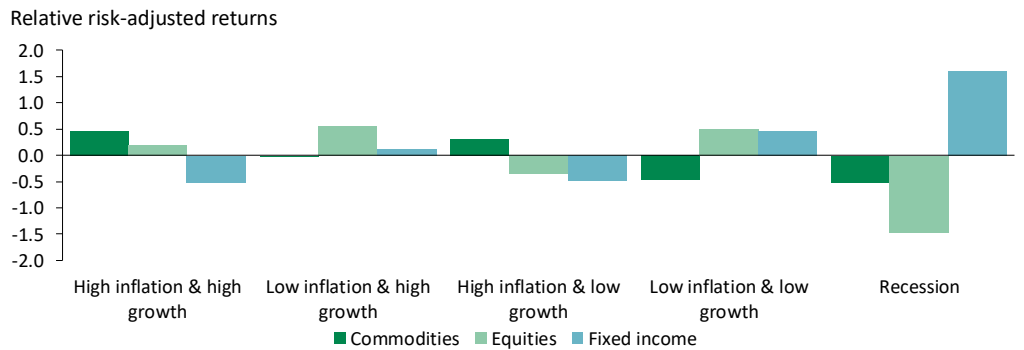


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### Graph 3

#### The Path Forward Is Unclear, but Risks Skew in Favour of Fixed Income

##### Deviation from long-run average risk-adjusted returns in each regime\*



\* Regimes are estimated using the methodology presented by AQR.

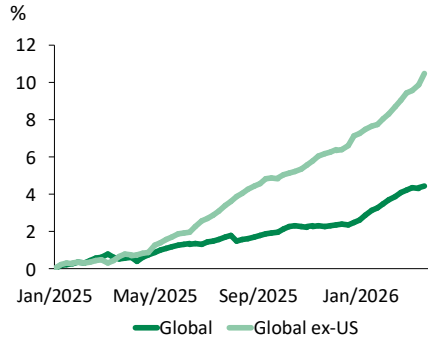
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What hasn't changed is our view that investors continue to diversify away from US assets. Indeed, global ex US equity and bond funds continue to attract capital (graph 4). That said, Europe now faces stiffer headwinds, and further disruptions in energy may delay the ongoing rotation.

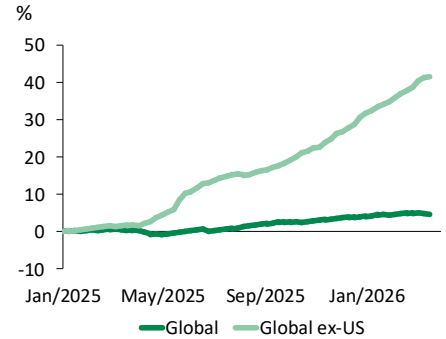
### Graph 4

#### The Rotation Away from US Assets Is Still Underway

Equity fund flows as a share of AUM



Bond fund flows as a share of AUM



AUM = Assets under management  
EPFR and Desjardins Economic Studies

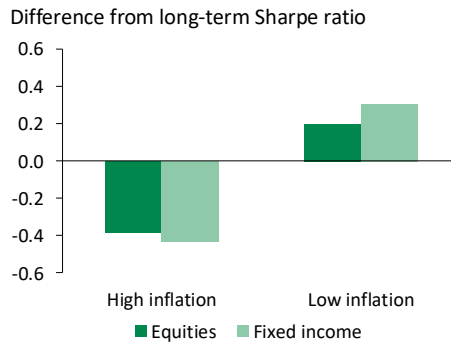
## FROM FRONTIER TO FABRIC: A BRIEF MODERN SUMMARY OF EMERGING MARKETS

Longer-term bonds are a good hedge for any future growth shock. Inflation led episodes can weigh on bond returns, but when the growth impulse weakens, fixed income typically outperforms (graph 5). Absent further escalation, the bias is for yields to drift lower from their currently high starting point. If tensions do escalate, the path won't be linear. In fact, an initial inflation pop can cheapen bonds. But as growth concerns build, we believe that fixed income should ultimately outperform.

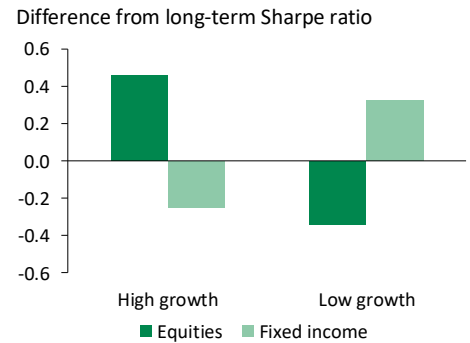
### Graph 5

#### Negative Growth Shocks Tend to Pull Fixed Income Higher

Positive correlation between stocks and bonds



Negative correlation between stocks and bonds

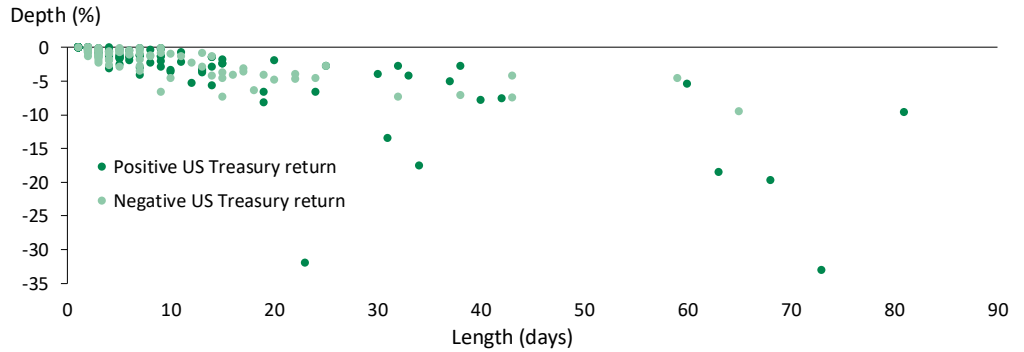


Regimes are classified using the AQR methodology.  
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**The role of bonds in portfolios has shifted:** stock-bond correlations are no longer reliably negative, and yields are higher and provide more income. More importantly, duration still provides an offset to steep drawdowns in equities (graph 6).

### Graph 6 Large and Sharp Stock Selloffs Result in Positive Bond Returns

Maximum drawdown vs. length of drawdown – S&P 500

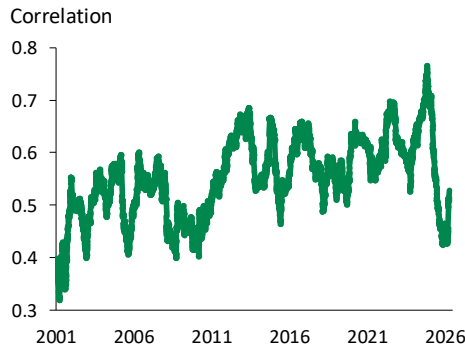


The colours indicate whether US Treasury returns over that period were positive or negative.  
Datastream and Desjardins Economic Studies

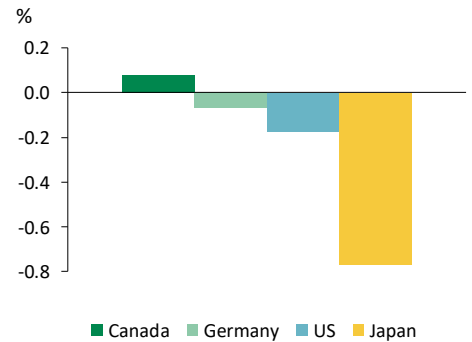
**A common global factor is driving rates, but diversification within bonds remains important.** Since the Iran shock, major yields have moved in tandem and curves have flattened (graph 7). Energy prices will likely dominate the near term path for duration, but as the shock fades, markets should re sort fixed income by fundamentals, creating more cross market dispersion even if geopolitical noise persists.

### Graph 7 Correlations Within Fixed Income Are Rising

12-month rolling correlation of 10-year rates\*



Year-to-date returns on bonds (USD)



\* Average pairwise correlation across Japan, the UK, the US, Canada and Germany.  
Bloomberg and Desjardins Economic Studies

**A re-steepening of yield curves is likely, but it will be uneven and non linear.**

The extent will vary by region. Europe's high inflation pass through will keep its front end stuck higher, whereas North America is more energy independent. As a result, fixed income markets here can pivot sooner as growth risks emerge.

**The Bank of Canada has the greatest flexibility among major central banks.**

With headline inflation close to target, economic activity weak and energy holding a lower-than-average weight in Canada's CPI basket, the risk of broader inflation spillovers is limited, allowing Canadian policymakers to remain patient. The market is pricing in more than two rate hikes this year, which we believe is too many (graph 8).

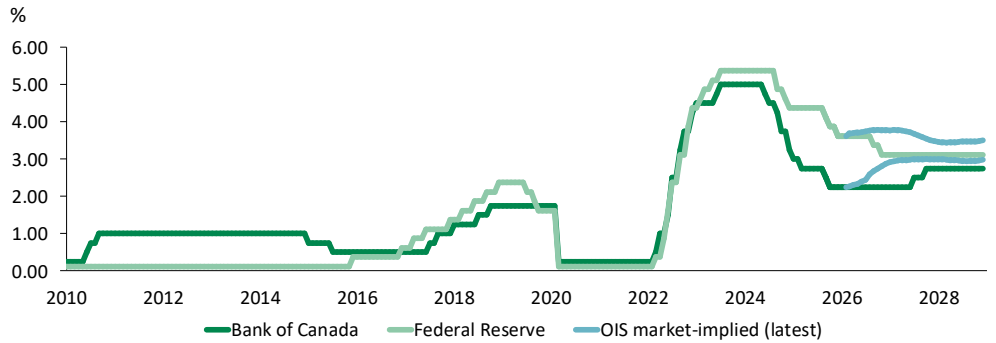
**The Federal Reserve faces a very different backdrop.**

US inflation has remained sticky above the central bank's target, and current conditions risk further delays (graph 9). While rate cuts later this year remain our base case, they are contingent on a near-term de escalation in geopolitical tensions (graph 8).

### Graph 8

#### Market Pricing Has Changed Drastically Since the War in the Middle East Began

##### Overnight policy rate forecasts and market pricing

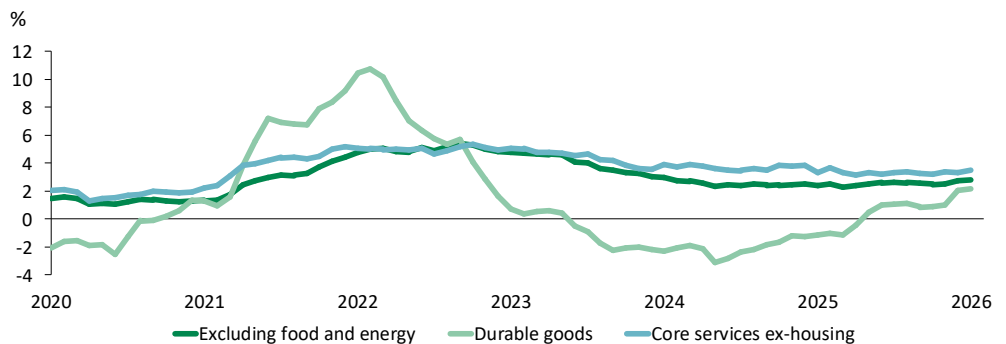


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### Graph 9

#### US Inflation Remains Sticky and Above the Fed's Target

##### US PCE inflation



Bureau of Economic Analysis and Desjardins Economic Studies

## EXCHANGE RATES

**The US dollar continues to benefit from the global squeeze in energy prices.**

The broader US dollar index has reversed year-to-date losses and is now roughly flat. Most of that strength has come against European currencies (graph 10). Our revised forecasts now see more weakness in the currencies of energy-importing countries.

**Policymakers are watching FX closely.**

Authorities have hardened intervention rhetoric—notably the Swiss National Bank, which has flagged a greater readiness to act against rapid CHF appreciation, and Japan, where USD/JPY is hovering near 160 and keeping Bank of Japan/Ministry of Finance intervention risk alive.

**Against this backdrop, the Canadian dollar has been the top performing currency.** Our base case had already baked in some volatility in the Canadian dollar, and our forecasts remain unchanged as a result. Looking forward, the CUSMA review remains a key headwind to business investment in Canada and a risk that markets appear to be somewhat complacent around.

## EQUITIES AND CREDIT

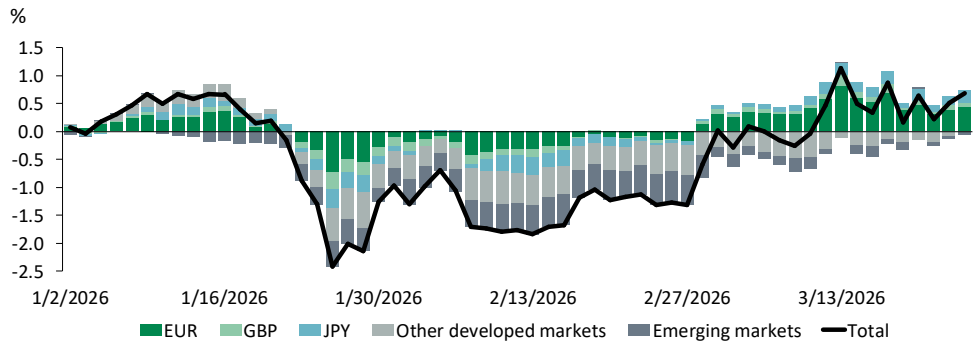
**Equity investors were well hedged going into this shock.**

Relative to the sharp moves in energy, equity drawdowns have been limited, paling in comparison to those seen during the “Liberation Day” chaos last year (graph 11).

**Graph 10**

**Weakness in Europe Is Driving Most of the Recent Strength in the USD**

Contribution to Bloomberg US Dollar Index return (year to date)

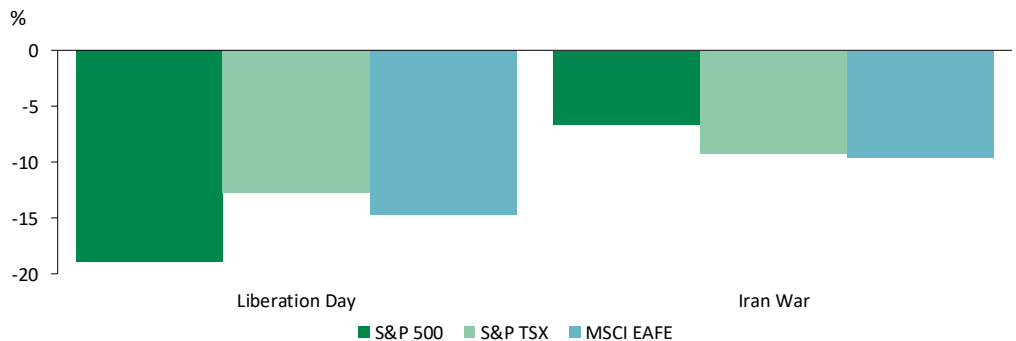


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**Graph 11**

**Equity Market Reaction Has Been Limited So Far**

Equity index maximum drawdown

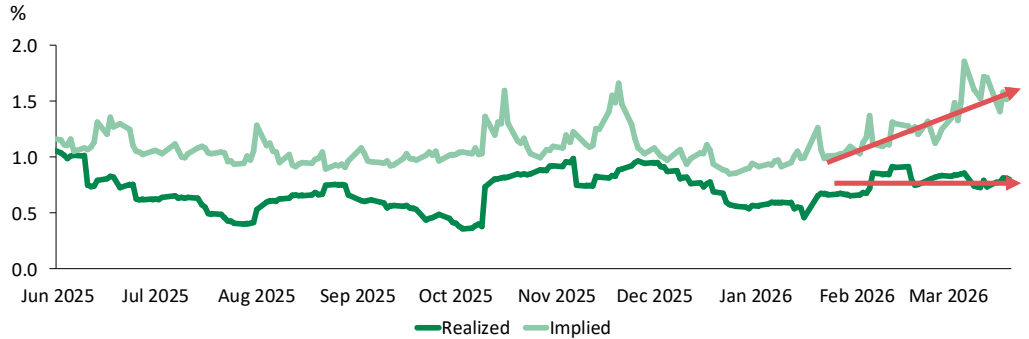


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**With bonds a less reliable hedge in inflationary episodes, many investors sought protection in listed options/volatility markets.** Absent a more pronounced equity correction, those hedges will drag on performance as premium costs accrue. Investors are still paying up for protection, and for good reason (graph 12). But many of these listed options expire at the end of March, which could give equities more freedom to move on new information thereafter.

**Graph 12**  
Investors Are Paying Up for Protection

Average daily move in the S&P 500 – Realized and implied volatility\*

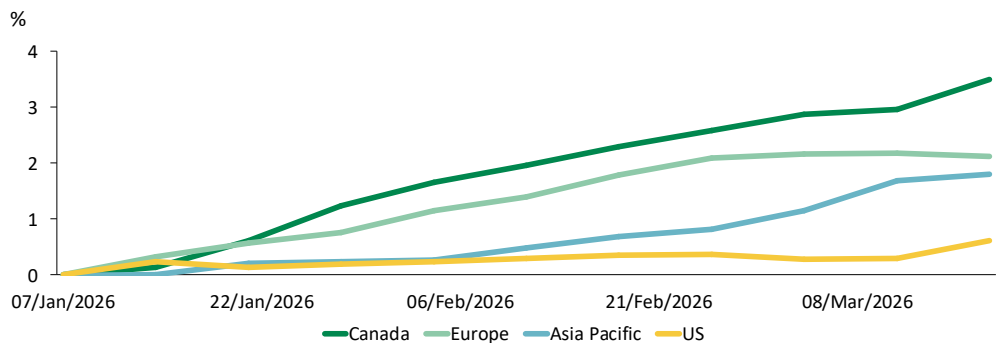


\* The VIX Index is converted into an average expected move in the S&P 500. Note that an increase in implied volatility typically indicates higher risk aversion in markets.  
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**Selectivity across regions is rising.** US equity flows continue to lag equity flows into other jurisdictions. During the first few weeks of the war, investors were rotating out of the US and into Asian and Canadian stocks (graph 13). Flows into Asia were likely opportunistic given the unusually large volatility and recent drawdowns. That said, it's clear that demand for European equities is waning. That's not surprising. Earnings growth was already slower in Europe than in North America, and the impact from sharply higher energy prices will likely temper expectations further.

**Graph 13**  
Flows into European Equities Are Clearly Stagnating

Year-to-date equity fund flows as a share of AUM



AUM = Assets under management  
Bloomberg and Desjardins Economic Studies

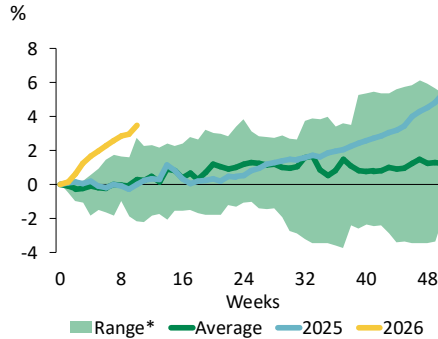
### Canada still stands out.

Fund flows year to date have outpaced anything we've seen since this data started being collected (graph 14). At the end of last year, foreign investors had begun shifting into Canadian stocks, and we believe that has continued into this year. Canadian stocks remain under-owned relative to their global market cap (graph 14), and we see scope for foreign demand to rise further.

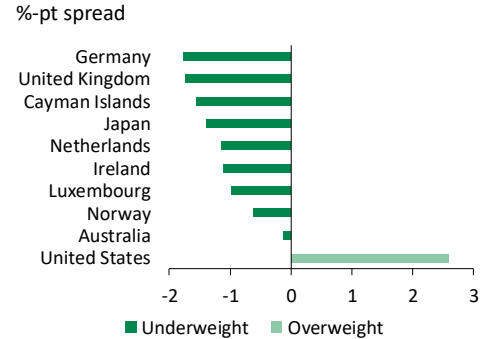
### Graph 14

#### Foreigners Are Still Likely Underweight Canadian Stocks

Canada yearly equity fund flows as a share of AUM



Foreign equity allocation to Canada relative to Canada's market share (as of 2024)\*\*



\* 10th to 90th percentile range.  
 \*\* Top 10 largest foreign holders of Canadian equities ranked by distance from Canada's share of global market cap excluding the domestic market.  
 IMF, Bloomberg and Desjardins Economic Studies

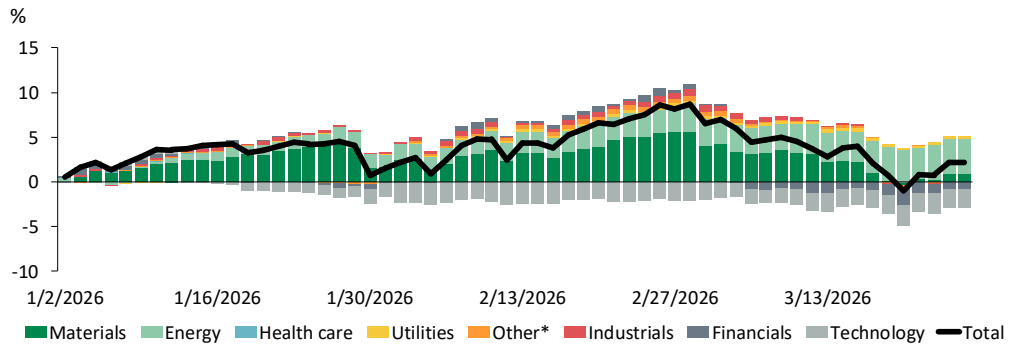
### Our TSX forecast is unchanged, but we've revised our projections for the US and EAFE indices lower.

Higher commodity prices should feed through to higher EPS growth in Canada over time. While the TSX has underperformed the S&P 500 since the onset of the conflict, nearly all of that underperformance has come from the materials sector, which had an incredible run leading up to the conflict

### Graph 15

#### The Weakness in the TSX Since the Iran Conflict Is Mostly Tied to Materials

Sector contributions to year-to-date TSX Composite Index returns



\* Other includes communication services, consumer discretionary, consumer staples and real estate.  
 Bloomberg and Desjardins Economic Studies

(graph 15). In a more dangerous and uncertain world, we believe there's room for gold prices to increase again. In the US, the S&P 500 now faces more headwinds, with rate cuts potentially off the table. Capex monetization tied to AI also remains a concern. Outside of North America, rising energy costs are likely to blunt earnings growth, and we expect lower returns as a result.



### **Jimmy Jean**

*Vice-President, Chief Economist and Strategist*

Jimmy Jean is Vice-President, Chief Economist and Strategist for the Desjardins Group. He directs research, analysis and forecasting and makes positioning recommendations on a variety of issues, including monetary policy, macroeconomic developments and the outlook for interest rates. Jimmy manages a team of economists in both Québec and Ontario.

Before joining Desjardins, Jimmy Jean held the position of Senior Strategist at the Caisse de dépôt et placement du Québec. He also worked as an economist at Moody's, RBC and Statistics Canada.



### **Tiago Figueiredo**

*Macro Strategist*

Tiago Figueiredo is a macro strategist part of the Desjardins macro strategy team based in Toronto. He has been with Desjardins for over 3 years and previously worked as a cross-asset analyst at the Bank of Canada where he was responsible for briefing department heads on market developments. He holds a Masters in Economics from the University of Western Ontario and a Bachelor of Arts from the University of Waterloo.



### **Oskar Stone**

*Macro Strategy Associate*

Oskar Stone is an Associate on Desjardins' Macro Strategy team based in Toronto. He has been with Desjardins for two years, having previously worked in investor relations for North America-based private equity funds and earlier in the treasury department of a European technology company. He holds a Bachelor of Arts and a Master of Science in Economics from University College Dublin.