RJL PCS: INSIGHTS & STRATEGIES

FEBRUARY 12, 2025 | 1:27 PM EST

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February 2025 Insights & Strategies: Tariffs Continue to Cloud an Otherwise Good Outlook

Macro Highlights for January

- In Canada, we saw data for November, which was the weakest month of the year, but included one-time events such as multiple labour disruptions. We are expecting an offsetting rebound in December, helped in part by the tax holiday, which stretches to mid-February. Longer-term expectations are for 1.8% GDP growth in each of 2025 and 2026, up from 1.3% growth in 2024. The inflation picture continues to improve, with headline inflation at or below the 2.0% target for five months, enabling the Bank of Canada (BoC) to continue its rate easing cycle.
- In the U.S., the economy remained remarkably strong, with the estimated real GDP up 2.8% in 2024, after a 2.9% gain in 2023. We expect slower, but still above-potential growth of 2.4% in 2025 and 2.2% in 2026. Headline CPI was 2.9% in December, up from 2.7% in November, although core CPI declined slightly to 3.2% from 3.3%. The Fed has pushed out its timeframe for returning to 2.0% inflation from 2026 to 2027, with a more cautious approach to easing interest rates.
- Labour markets have shown slight softening, but the U.S. unemployment rate remains low at 4.0% and the Canadian unemployment rate had recently declined slightly to 6.6% as population growth has slowed. Immigration reforms are occurring on both sides of the border, that could put pressure on the unemployment rate, although disruptions from tariffs may increase layoffs and defer hiring decisions, more so in Canada.

Financial Markets in January

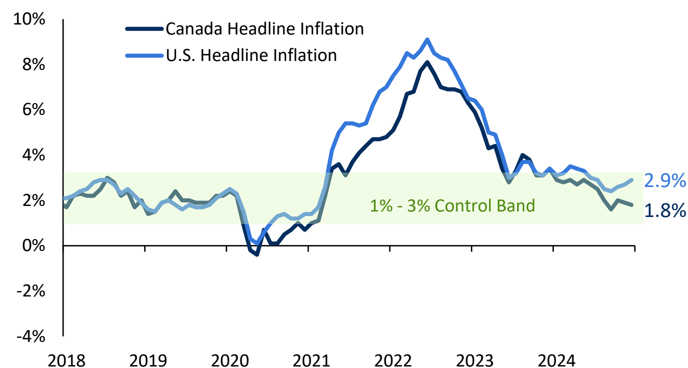
- In January, the TSX Composite, Canada's main stock market index, achieved a 3.3% price return and a 3.5% total return, outperforming the U.S. large-cap benchmark, the S&P 500, which recorded a 2.7% price return and a 2.8% total return in local currency.
- The TSX Composite's gains were mainly driven by the Materials and Info Tech sectors. In contrast, the S&P 500's performance was weighed down by the semiconductor industry due to threats from DeepSeek (a cheaper-to-train A.I. tool, using less advanced chips).
- We're now more than halfway through the 4Q24 earnings season, and the visibility remains promising. The S&P 500's forward-looking EPS grew by about 12% year-over-year in 4Q24, marking the highest growth rate since 4Q21.

Upcoming

- We expect further threats of tariffs throughout the year as President Trump addresses various issues, and certainly through to the renegotiation of the USMCA trade agreement, which we would expect to be advanced from its current mid-2026 timetable.
- Notwithstanding the disruptive aspects of tariffs, our overarching expectations are for equity markets to move higher in 2025, on the back of the economic and corporate profit backdrop, but with more muted gains than the 20%+ returns of the last couple of years. Also expect heightened volatility, which could include multiple pullbacks along the way. Our (U.S. Investment Strategy Group’s) S&P 500 target to the end of 2025 is 6,375 using 23.5x EPS of US$270, with a preference for Technology, Industrials, and Health Care. For the TSX Composite, we forecast 26,300 by year-end for an 8.5% total return.
- We expect the BoC to continue cutting interest rates by 25 bps at each meeting until achieving a policy rate of 2.25% at the June meeting. The Fed is likely to cut more slowly while economic growth remains strong and the unemployment rate remains low. We expect to see 25 bp cuts mid-2025 and towards the end of the year, to bring the policy rate down to 4.00%.

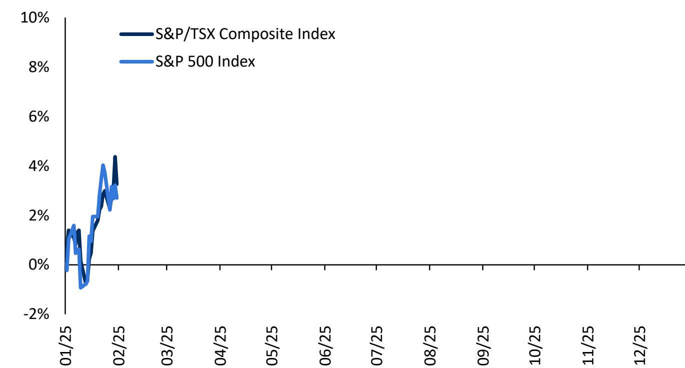
Please read domestic and foreign disclosure/risk information beginning on page 16

Chart 1 - Canada and U.S. Headline Inflation



Source: FactSet; Raymond James Ltd.; Data as of December 31, 2024. Not seasonally adjusted.

Chart 2 - S&P/TSX Composite and S&P 500 2025 Performance



Source: FactSet; Raymond James Ltd. Data as of January 31, 2025. Price return in local currency.

Executive Summary

With the activity in the last couple of weeks, it's hard to believe we are only just a little over a month into 2025.

In the following pages, you can read our thoughts and predictions on multiple metrics, with a focus on the following themes:

- **Tariff threats overhang everything.** While we make forecasts based on macroeconomic drivers, tariffs threaten to upend many of our assumptions. Canada and Mexico have negotiated a reprieve against the tariffs that were supposed to start on February 4, and based on conversations and actions so far we are relatively optimistic that the fentanyl-driven tariffs may be avoided. However, we expect President Trump to again use tariff threats for other issues, including defence spending and trade imbalances. For Canada specifically, our hope i s that an early renegotiation of USMCA terms, currently expected mid-2026, will bring some finality to threats and certainty to the trade relationship with the U.S. Investors should be prepared for volatility and high-pressure negotiations in the meantime.
- **Economic growth to continue.** While the U.S. seems poised to continue its significant growth rate, we do expect some slowing to 2.4% for 2025, from 2.8% in 2024. In Canada, we are starting to see benefits from the aggressive rate cutting cycle; growth is expected to improve to 1.8% from 1.3%, notwithstanding any significantly negative impacts from tariffs.
- **Stock market returns will likely be positive**, but much more muted that the 20%+ returns of the last two years, and investors should be prepared for **significant volatility**, including significant pullbacks as P/E multiples remain at stretched levels and many stocks are pricing in optimal conditions. It is possible that companies could end up beating earnings expectations that support their share price valuations, but underwhelming against exaggerated expectations, leading to more median-like valuation multiples.

January Recap

Aside from the escalating tariff drama through the end of January and into February, the Bank of Canada (BoC) also continued easing its policy interest rate, by 25 bps, to 3.00%, as the Consumer Price Index (CPI) inflation rate dropped to 1.8% for December 2024, from 1.9% in November, and the core measures of CPI-trim and CPI-median similarly declined to 2.5% and 2.4%, respectively, from 2.6% for both, with shelter continuing to be the most problematic component, although it is improving gradually. The January Monetary Policy Report (MPR) update stressed the heightened uncertainty from the volatile political landscape and tariff threats. Baseline expectations are for the global economy to continue growing by about 3% over the next two years. The rate cuts in Canada, which began in June, have started to boost the economy, with strengthening in both consumption and housing activity, although business investment remains weak. Following growth of 1.3% in 2024, the BoC is now projecting GDP growth of 1.8% in both 2025 and 2026, absent the potential impact of tariffs. Job growth has improved recently while the labour market remains soft with the unemployment rate at 6.6% in January, but the good news is that wage pressures are starting to show some signs of easing, which helps to bring down inflation.

In the U.S., the Federal Reserve (Fed) paused its campaign to lower interest rates, as economic growth remained solid and inflation remains somewhat elevated above the 2.0% target. In its January update, the Fed also pushed out its timeframe to achieve the 2.0% target from 2026 to 2027, acknowledging that this will be a longer than previously expected process. Headline CPI rose to 2.9% in December, from 2.7% in November, and the Fed's preferred measure, the Personal Consumption Expenditure (PCE) price index, increased to 2.6% in December, from 2.4% in November, while Core PCE remained unchanged at 2.8%. The economy remains solid as real GDP grew by 2.8% in the 4Q24, employment growth was much stronger than expected, and the rate of unemployment declined to 4.1% in December, from 4.2% in November. However, the U.S. economy also faces a degree of uncertainty from potential tariff wars with multiple trade partners.

Economics

The threat of tariffs will continue to overhang the Canadian economy for the immediate future. We expect that an early renegotiation of the USMCA trade agreement, that is currently planned for mid-2026, could bring some level of confidence and certainty to consumers and businesses in Canada, but until that is achieved, we can likely look forward to multiple rounds of tariff threats and negotiations premised on various issues. Most of our forecasts are based on the assumption that each round of threats can be managed with negotiations and various accommodations that do not create undue stress on the economy, other than limiting upside potential.

Tariffs — what to expect

According to President Trump's February 1 executive order, the 25% tariffs announced on Canada and Mexico (with a reduced 10% tariff on Canadian energy) were primarily justified as addressing the issue of the influx of fentanyl into the United States. Both countries managed to secure a one-month delay in these tariffs by assuring continuing efforts to improve border security. Likewise, Canada put a pause on retaliatory tariffs on $155 billion on targeted U.S. goods. Looking ahead, Canada and Mexico will likely need to demonstrate the effectiveness of their enhanced border security measures to provide President Trump with enough of a win to potentially further delay or remove these specific tariff threats. We are also advancing towards an April 1 deadline for various U.S. federal agencies to provide their recommendations on trade policies and trade relationships to the President. If Canada and Mexico make continued border security progress, we can imagine this first tariff round to be further delayed for final judgement against the April 1 reports.

Latest tariff threat on steel and aluminum

Now, even before the ink had dried on the 30-day delay, Trump threw another tariff into the mix. This one, on steel and aluminum imported into the U.S. from any country in the world, with no exceptions (except maybe an exemption for Australia due to the U.S. trade surplus position) would carry an incremental 25% levy, slated to come into effect on March 12, as the 30-day reprieve expires on March 4. This tariff threat seems similar to a June 2018 action where Trump enacted a 25% tariff on steel and 10% tariff on aluminum in his first term and may therefore be more likely to be implemented. That round resulted in Canadian exports to the U.S. falling approximately 20% over the following year before rebounded after the USMCA ratification in May 2019. Canada is the most exposed economy to this specific tariff as it represents approximately 20% of such U.S. imports and 90% of Canada's exports of these goods, equivalent to approximately US$24.4 billion, or roughly 1% of Canada's GDP. China, by comparison, is already subject to a 47.5% tariff on steel and 32.5% tariff on aluminum and so any incremental tariff there would be of negligible impact, although that country still sold US$15.4 billion of steel and aluminum into the U.S. last year.

Expect more tariffs

It is likely that further rounds of tariff threats will arise, driven in Canada by issues such as defence spending, immigration, and trade deficits. The U.S. holds a significant advantage in negotiations due to Canada's heavy reliance on trade with its southern neighbour, which accounts for nearly 20% of Canada's GDP. This reliance gives the U.S. considerable leverage in ongoing and future trade discussions.

One possible good news event surrounds recent commentary on reciprocal tariffs, whereby the U.S. could essentially just match tariff levels on any U.S. export that is taxed entering other countries. If this approach replaces the 25% tariff threat against Canada and Mexico, Canada would surely find itself in a better situation, aside from any impact in certain industry-specific tariff actions such as in steel and aluminum. Plus, we hope to see many or all these issues addressed in the USMCA renegotiation in mid-2026 (unless otherwise advanced), at least resetting the playing field for Canada and allowing some certainty and confidence to return.

Trade deficit likely to increase frustration

We know that trade deficits are a particular sore point with President Trump. Unfortunately, the U.S. trade deficit with the world reached a record US$122 billion in December — as imports to the U.S. surged by US$10.8 billion to US$289.6 billion, while exports fell by US$7.8 billion to US$167.5 billion. We can probably attribute some of this increase to businesses rushing to front-run expected tariffs while USD strength has made U.S. exports less attractive. We doubt these considerations will soften President Trump's frustration, and expect these numbers to further increase his urgency to address his view of this being a transfer of wealth out of the country that needs to be stopped.

President Trump has thrown around various figures of what he perceives to be the U.S.'s trade deficit with Canada, which he also expresses as the U.S. subsidizing Canada. He has most recently indicated that the U.S. pays "hundreds of billions of dollars to subsidize" Canada. According to the U.S. Census Bureau, in 2024, the U.S. exported US$349.4 billion of goods to Canada, while importing US$412.7 billion of goods, leaving a trade deficit of US$63.3 billion. A much cited adjustment to the goods trade number is the energy that Canada supplies to the U.S. The structure of Canada's pipelines results in 97% of exported crude being directed to the U.S., or roughly 4 million barrels per day. In 2023 this represented approximately US$92 billion, and so excluding oil, we can rationalize that the U.S. has a sizeable trade surplus with Canada (Chart 3). This heavy, sour crude oil is directed to U.S. refineries that are specifically tuned to refine this oil into gasoline. Alternative sources of this heavy crude are Mexico, Venezuela, and Colombia, which would make switching somewhat problematic. This captive supply chain and the type of oil Canada produces also results in allowing the U.S. to export a roughly equivalent 4.1 million barrels per day of its light, sweet crude, for which it achieves a higher price, representing US$117 billion, making this a profitable trade for the U.S., that we would otherwise expect the President to not upset.

Defence spending likely to enter the discussion soon

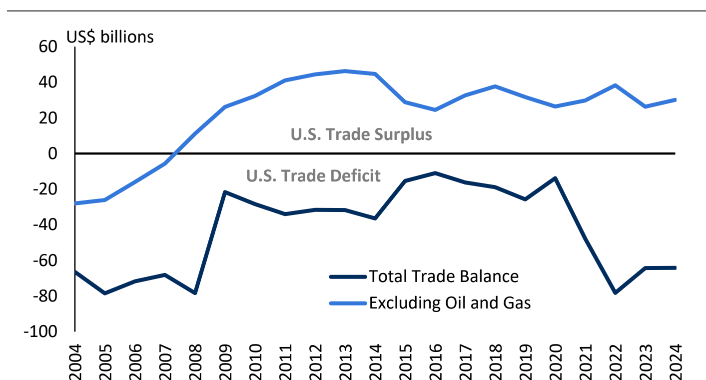
Another frequently quoted concern by President Trump is defence spending. He has been vocal about pushing all NATO countries, including Canada, to increase defence spending. He has even gone to the extent of suggesting that NATO should set a target of 5% of each member country's GDP, as opposed to the current target of 2%. Canada is among eight NATO allies out of 30 that are estimated to be falling short of this target and has faced persistent criticism from allies. According to a NATO report, Canada was estimated to spend roughly 1.37% of GDP on defense in 2024. This could be another issue where President Trump might threaten tariffs to gain greater negotiating power in pushing Canada to increase its military spending.

Possible GDP impacts

As long as the threat of tariffs hang over Canada, there will be uncertainty that drives new manufacturing capacity to be added in the U.S., rather than in Canada, and it could lead to investments being deferred in both countries until the future playing field is better defined. The Bank of Canada (BoC) provided a report, as part of the January Monetary Policy Report, on the potential impacts of U.S. tariffs. Its benchmark calibration puts the first-year impact of 25% across-the-board tariffs at a 2.5 percentage point negative adjustment, meaning that a previous forecast of 2.0% growth for the year — along the lines of what we were trending to — becomes a contraction of 0.5%. In the second year, the benchmark calibration is 1.5% lower, and by the third year, GDP growth would be expected to return to normal. Different scenarios put the cumulative impact at 3.4% to 4.2% negative adjustment to GDP from the baseline forecast, over the time period (Chart 4). While the impact of tariffs on growth rates is temporary, they cause a permanent reduction in GDP, reflecting a long-term decline in Canadian productivity due to the distortion created. On the other hand, as the cost increases from Canada's retaliatory tariffs are gradually passed on to consumer prices over three years, CPI inflation faces sustained upward pressure during this period. In the first year, considerable excess supply and declining commodity prices largely offset the direct impact of tariffs, but as excess supply is gradually absorbed in subsequent years, inflation begins to rise. Overall, different scenarios could lead to a cumulative impact of 0.7% to 2.7% increase in annual average CPI inflation. Overall, if we get a sustained 25% country-wide tariff that lasts more than six months, we could see Canada subject to at least a mild recession. However, we are somewhat optimistic that of the many tariff threats,

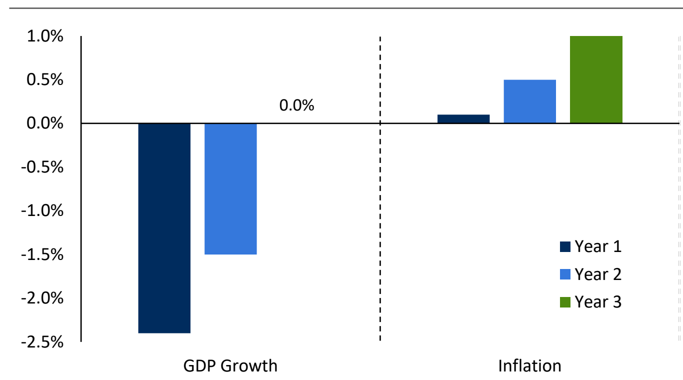
relatively few will be implemented, and over a relatively short period of time, with a USMCA renegotiation resetting the playing field allowing some confidence and certainty for businesses to recalibrate their operations and expectations. Some businesses and industries will likely have less of an advantage at the end of this process, but that is all the more reason for investors to remain diversified and invested within their risk tolerance.

Chart 3 - U.S. Trade Balance with Canada



Source: US Census Bureau; Raymond James Ltd.; Data as of December 31, 2024.

Chart 4 - Impact of 25% Tariff on Canada (BoC's Benchmark Calibration)



Source: Bank of Canada.

Canada — Looking a little brighter for 2025, but with caveats

Notwithstanding the potential short or long-term impacts of tariffs, the Canadian economy has been showing signs of better growth, likely prompted by the faster and more aggressive reduction in the BoC policy rate. We caution that the government's immigration reforms could have a slightly negative impact on economic growth, but that the largest risk to continued improvement in Canada comes from tariff uncertainty. Not only can enacted tariffs have the potential to slow economic growth, but uncertainty can cause businesses to delay investment or expansion plans until the environment is more certain. Potential adjustments to our outlook here can be found in the previous section above, specifically on tariffs.

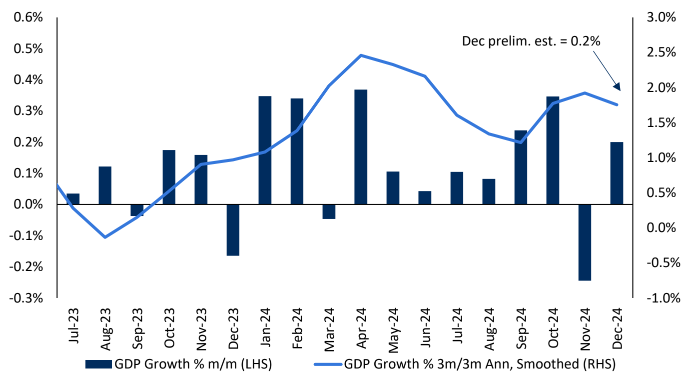
GDP contracted in November, but is expected to rebound in December

The Canadian economy was weaker than expected in November. Monthly GDP contracted by 0.2%, which was slightly lower than the BoC's preliminary estimate of a 0.1% contraction. This marks the weakest performance in nearly a year (Chart 5). That being said, we must recognize the temporary shocks that impacted the economy during this period. Labour disruptions in postal services and at major Canadian ports hindered economic performance, as reflected by a 1.3% decline in the transportation sector. However, preliminary data from Statistics Canada suggests a potential rebound of 0.2% in December, aligning with the BoC's forecast of a 1.8% annualized growth rate for 4Q24. Real GDP growth is forecasted by the BoC to be 1.8% in both 2025 and 2026 (down from 2.1% and 2.3%, respectively, in the October outlook), but up from 1.3% in 2024. The overarching risk in these forecasts is of an unfolding tariff war over an extended period of time.

Headline inflation below target, yet core measures still need to come down

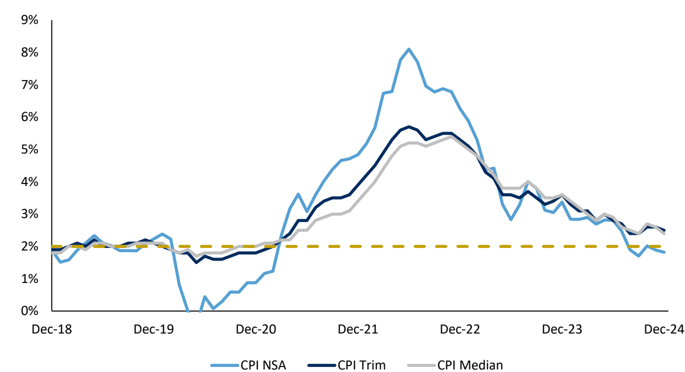
Headline CPI came in at 1.8% in December 2024, down from 1.9% in November, and marked its fifth consecutive month at or below the 2.0% target. This was partially helped by the temporary tax holiday that runs through mid-February. Looking at the BoC's preferred core measures of CPI-trim and CPI-median, inflation remained slightly higher at 2.5% and 2.4%, respectively, but with both down from 2.6% in November (Chart 6). These measures have also been within the 1-3% comfort zone since April 2024.

Chart 5 - GDP Contracted More Than Expectations in November



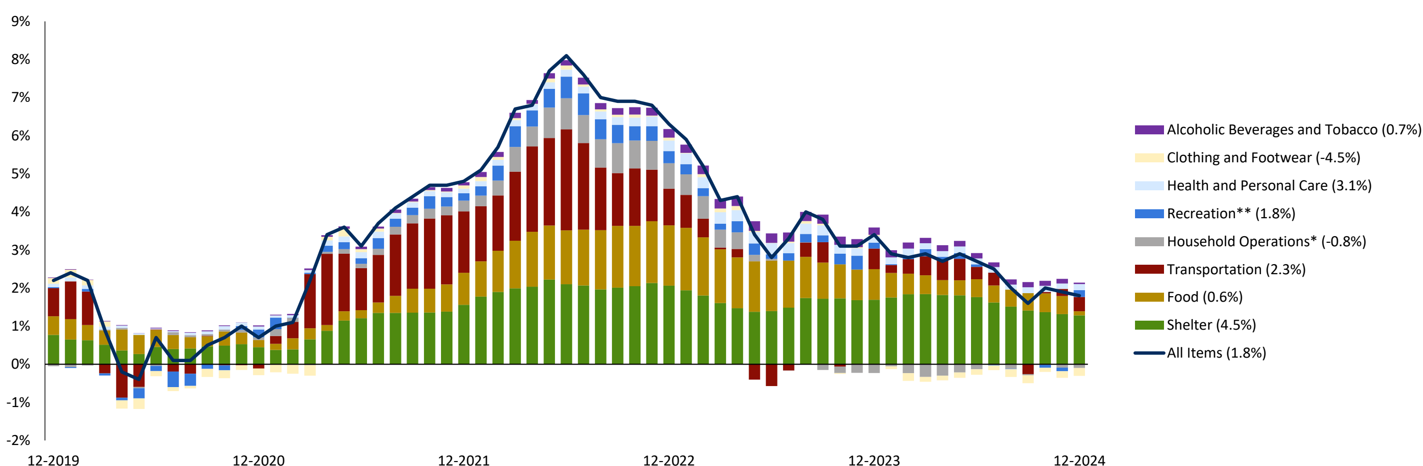
Source: Statistics Canada; Raymond James Ltd.; Data as of November 30, 2024.

Chart 6 - Core Inflation Measures Remain Slightly Elevated



Source: Statistics Canada, Raymond James Ltd.; Data as of December 31, 2024.

Chart 7 - Major Components' Contributions to Canada CPI (Stacked Bars) and Latest Monthly CPI (Bracket Beside the Legend)



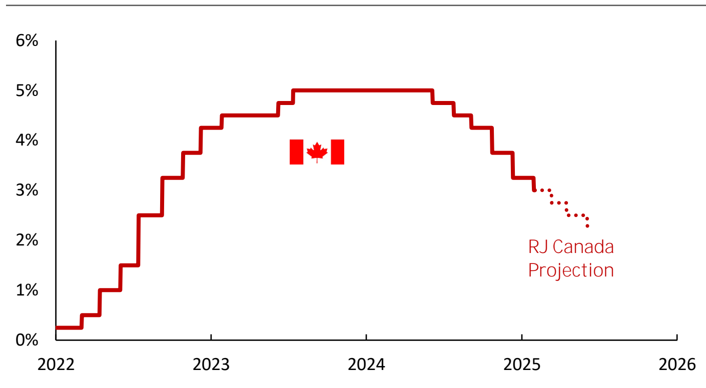
Source: Statistics Canada; Raymond James Ltd.; Data as of December 31, 2024. *Household operations, furnishing and equipment; **Recreation, education and reading.

Interest rates to continue declining

On January 29, the BoC continued its easing program with another 25bp cut, bringing its policy rate down to 3.00%, marking the sixth consecutive decrease since easing began in June 2024. The Canadian economy continues to be in excess supply and needs a more accommodative environment to boost household spending and business investment to help bring this into balance (Chart 9). Of course the threat of tariffs can create uncertainty that pushes both households and businesses to defer sizeable purchases, so the sooner we have more certainty of these risks, the better. The Bank also plans to end Quantitative Tightening (QT), which was an extra tool to remove liquidity and tame inflation, and to restart asset purchases in March 2025 towards increasing liquidity and lowering longer-term rates.

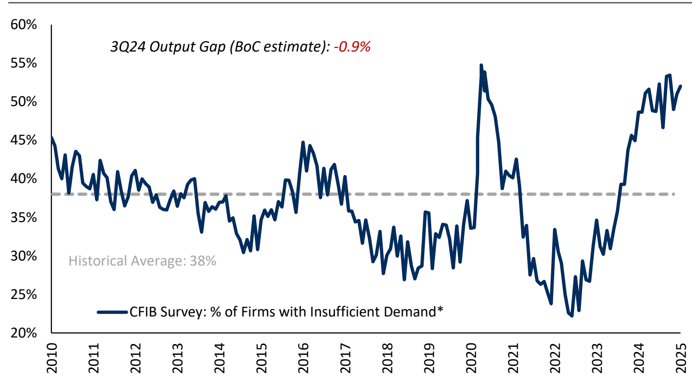
The BoC started cutting its policy rate earlier and more aggressively than many anticipated in 2024. Despite the widening spread between Canadian and U.S. policy rates, we expect Canada's interest rates to continue declining to 2.25%, the low end of the BoC's nominal neutral interest rate range, by mid-2025. This expectation is based on Canada's below-potential GDP growth, projected flat to negative population growth in 2025 and 2026, and concerning productivity growth. Although it's not our base case, Canada's policy rate may face additional downward pressure if tariff threats from the U.S. are enacted and more stimulus is needed.

Chart 8 - Interest Rates to Continue Declining



Source: FactSet; Raymond James Ltd.; Data as of January 31, 2025.

Chart 9 - Excess Supply Continues to Grow in the Canadian Economy



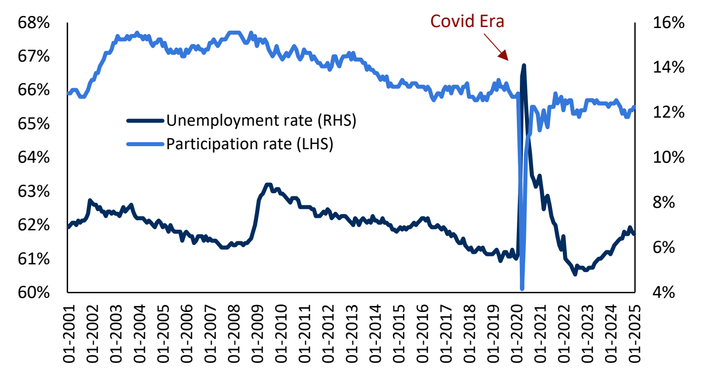
Source: CFIB, Raymond James Ltd.; CFIB survey as of January 31, 2025. *Domestic demand prior to 2024, domestic and foreign demand from January 2024 onward.

Labour market improving

The Canadian economy showed a large gain in employment in January, with a 76k increase, primarily driven by a 57k rise in private sector employment. The country's population grew by 56k, the smallest increase in two years and the fourth consecutive month of slowing growth. With the population increase, and some people coming back to the labour force (either as becoming employed or actively looking for work), the labour force grew by 61k. With a larger rise in jobs than in labour force growth, the unemployment rate declined to 6.6%, from 6.7% in December and 6.9% in November. Given the still high unemployment rate and fewer job openings, hourly wage growth, on an annual basis, slowed down to 3.5%.

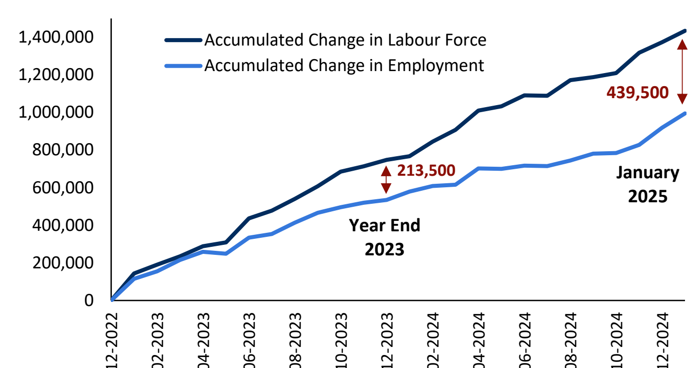
If the immigration reforms continue to slow population growth, and employment growth can continue, we could see a further slight improvement in the unemployment rate throughout this year. Unfortunately the reality, or just the potential, of tariffs can lead to layoffs and deferrals in adding workers, so overall we are not expecting any significant improvements in this metric over the short-term. Employment in manufacturing may be particularly susceptible to changes in tariffs and foreign demand, as the sector has the largest number of jobs dependent on U.S. demand for Canadian exports. An estimated 641k or 39.4% of jobs in manufacturing depend on U.S. demand for Canadian exports, and the sector overall accounts for 8.9% of total employment in Canada.

Chart 10 - Long-term Participation Rate and Unemployment Rate



Source: Statistics Canada; Raymond James Ltd.; Data as of January 31, 2025.

Chart 11 - Labor Force Growth Has Outpaced Job Additions



Source: Statistics Canada; Raymond James Ltd.; Data as of January 31, 2025.

The U.S. — Still strong

The U.S. economy continues to power ahead and the unemployment rate remains low. This led the Fed to hold its policy rate unchanged at its January 29 announcement, as was generally expected. The biggest change was likely in the Fed's expectation for when inflation will get down to its 2% target, as the disinflationary process seems to have further slowed, or even stalled. The expectation is that it will now take until 2027, rather than 2026 as previously expected, and rumblings are growing that we may not be far from the Fed starting to consider raising rates. President Trump's tariff and immigration plans are injecting further uncertainty into forecasting, forcing more caution.

Economic growth indicators are positive

GDP in 4Q24 came in at 2.3% quarter-over-quarter, annualized, and 2.8% for the full year, down only slightly from 2.9% in 2023 (Chart 12). This is a very solid growth rate and continues to be supported by the U.S. consumer. We expect this above-average growth to continue, but at a slightly weaker pace, at 2.4% for 2025, and then 2.2% for 2026. Government investments are expected to further support that growth as the majority of the stimulus money committed under various programs (IRA, IIJA, CHIPS) has still yet to be spent.

The Institute for Supply Management (ISM) Manufacturing Purchasing Manager's Index (PMI) also came in stronger than expected and crossed the 50 level, entering expansionary territory (50.9 in January, up from 49.2 in December) for the first time in 27 months. Some of this strength in New Orders, Production, Employment, and New Export Orders, might have been from a rush to head off potential tariffs, so we will need to watch this going forward.

Inflation still sticky, but moving in the right direction over the longer-term

Headline CPI was 2.9% in December, up from 2.7% in November, although core CPI declined slightly to 3.2% from 3.3% (Chart 13). Higher energy prices at the end of the year pushed the Fed's favoured Purchasing Power Index (PPI) up to 3.3%. While this shows some stickiness, real-time rent measures such as the Cleveland Fed's New Tenant Rent Index, which was down 2.4%, suggest that inflation will continue to trend down overall. Rent is the largest component in CPI and so real-time measures suggest that lagging official numbers will show further disinflation and leave the Fed open to continue easing its policy rate, albeit at a slower rate.

Interest rates coming down, but more slowly than in Canada

Our U.S. economics team continues to forecast two rate cuts from the Fed in 2025, as the economy has continued to grow well without needing stimulus from lower rates and unemployment still remains low at 4.0%.

On January 29 the Fed did as expected and kept its policy rate at 4.5%. The focus for the market was any changes in the messaging on the outlook. The most notable change was the removal of acknowledgement that inflation had made progress towards its 2% target and saying that the unemployment rate has stabilized. The overall interpretation is that the Fed might proceed even more slowly with further rate cuts. The Fed is very cautious about commenting on anything political and has previously indicated that it reacts to enacted policies and not to tariffs or other policies that may or may not end up being enacted, but we have to imagine that uncertainty around these measures, and their possibly inflationary effects tilt the Fed towards caution on further cuts at this time.

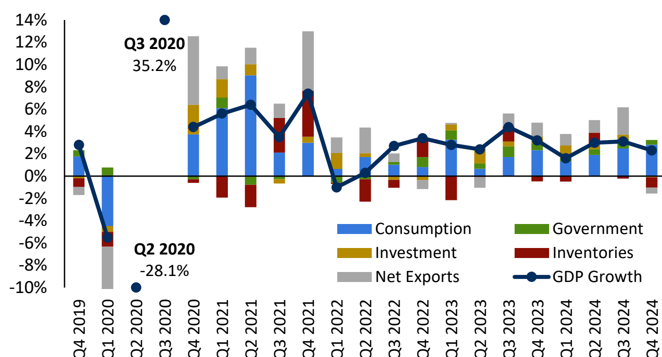
It's worth noting that in December, the Fed moved its target for hitting its 2.0% inflation target, as measured by the PCE price index, out from 2026 to 2027.

Labour market still strong

Job openings (from the JOLTS report) decreased by 556k in December to leave 7.6 million postings at the end of 2024, down 1.3 million for the year, compared to 6.9 million unemployed people. This indicates that the labour market is softening somewhat but remains strong overall as 5.5 million people were hired in December, while 5.3 million people were either laid off, quit, or separated from their jobs some other way.

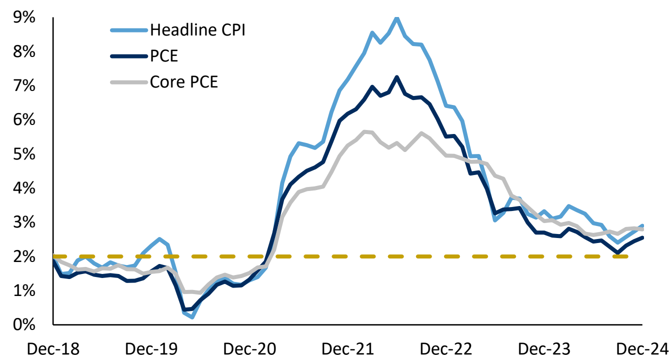
In January, the U.S. labour market continued to demonstrate strength, despite a smaller-than-expected payroll employment gain of 143k, compared to the consensus of 170k, after a revised 307k increase in December. The unemployment rate ticked down slightly to 4.0%, compared to 4.1% in December. On an annual basis, wage growth remained elevated at above 4.0%. With strong jobs growth and an unemployment rate steady around 4.0%, there's not a lot of pressure for the Fed to lower rates.

Chart 12 - US GDP Annualized Quarterly Growth



Source: Factset, Raymond James Ltd.; Data as of December 31, 2024.

Chart 13 - US Inflation (Y/Y Percentage Change)



Source: Factset, Raymond James Ltd.; Data as of December 31, 2024.

Consumer confidence is getting weaker

In January, the Consumer Confidence Index experienced a decline for the second month in a row, reversing the gains made since September 2024. The index fell by 5.4 points to 104.1, with both the Present Situation Index and the Expectations Index showing significant decreases (Chart 14). There was a notable drop in assessments of current labour market conditions and business prospects. This decline indicates a softening in consumer confidence and a weakening optimism about future business conditions and incomes.

U.S. debt level remains a concern

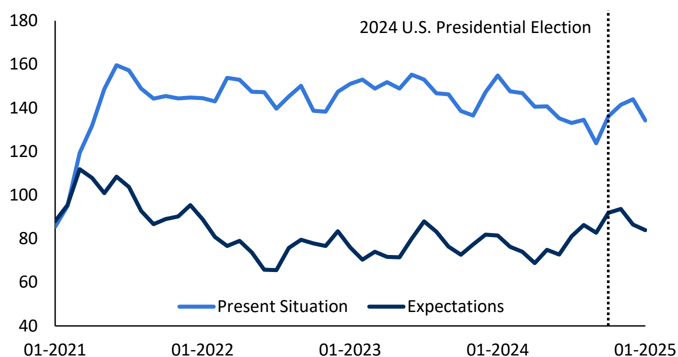
The Congressional Budget Office released a 10-year budget outlook than forecasts the federal debt held by the public to reach a record high of 107% of GDP in 2029, up from 98% currently. There are some optimistic assumptions in this forecast, including the 2017 tax cuts expiring and the 10-year Treasury yield falling below 4.0%. When adding in intragovernmental debt, the total debt to GDP measure is currently 120%. (By comparison, Canada's debt to GDP is approximately 69%.)

We expect a lot of debate over the debt in 2025 as the President looks to pass tax cuts. As it stands, the national debt stands as a record US$36.2 trillion (Chart 15). This is exacerbated by the annual deficit, which continues to grown and is now at 6.2% of GDP, with no signs of any political will to change course and campaign pledges from Trump that would likely only increase that divide.

The U.S. debt ceiling was just reinstated on January 1 at the level at that date, which means that the U.S. will not be able to add any additional new debt (although it can still roll over existing maturing debt) until a new debt limit is set and approved. While suspended, over the last 18 months, the national debt increased by US$5 trillion, or 16%. The debt limit is one of the items that needs a 60 vote majority in the Senate, and so there will have to be some negotiation to gain the additional Democratic votes to pass. Mechanisms such as 'extraordinary measures' will likely extend this negotiation into mid-2025 before the urgency reaches its climax. The Treasury currently has a cash buffer of US$620 billion, which will be topped up in April by tax receipts, to get it through this period. As we have written before, the chances of this causing the U.S. to default is essentially zero, but there will likely be much discussion and negotiation around that time. Net interest expense will be the second biggest government expense in 2025, after Social Security, and slightly more than Medicare, Income Security, National Defense, and Health.

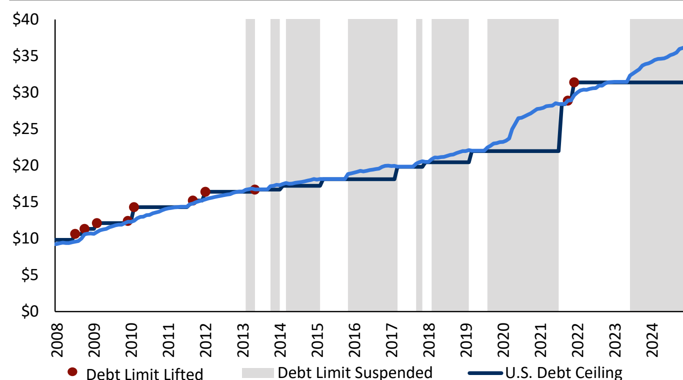
Once the debt ceiling limit has been addressed, the U.S. will need to issue more debt, likely steepening the yield curve, as investors look for better yields as the increased supply becomes available. The good news is that demand for U.S. Treasuries has not yet wavered. According to the U.S. Department of the Treasury, the Fed is no longer the main buyer of government debt due to massive quantitative tightening (QT). However, there has been a significant increase in private investors, who are more price-sensitive, picking up the slack. Foreign demand for U.S. Treasuries has been tepid due to the stronger USD leading to higher FX-hedging costs, but it has still increased over the past 12 months.

Chart 14 - Softening Consumer Confidence



Source: FactSet; Raymond James Ltd.; Data as of January 31, 2025.

Chart 15 - U.S. Government Debt Has Exceeded $36 Trillion

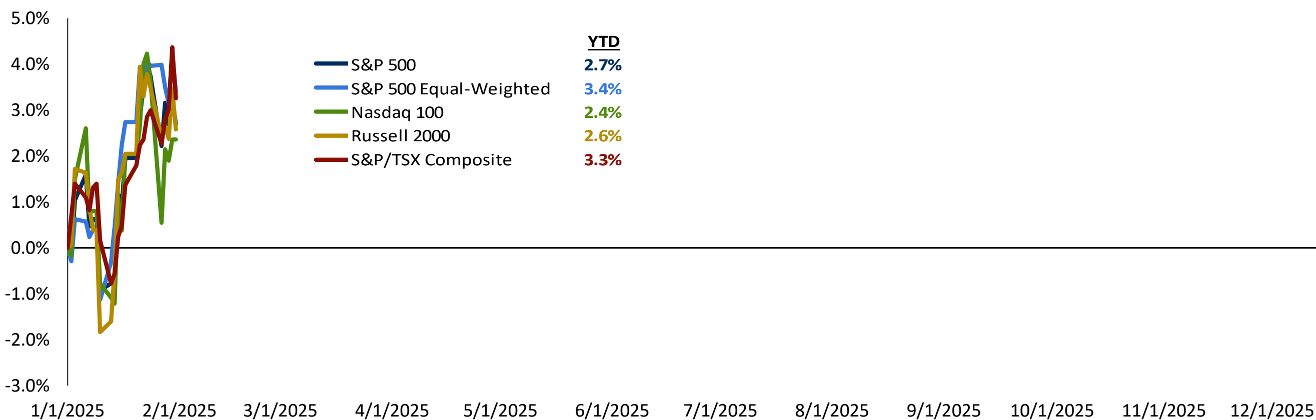


Source: Bipartisan Policy Centre; FactSet; Raymond James Ltd.; Data as of December 31, 2024, in trillions of U.S. dollars.

Financial Markets

In January, the TSX Composite, Canada's main stock market index, achieved a 3.3% price return and a 3.5% total return, this outperformed the U.S. large-cap benchmark, the S&P 500, which recorded a 2.7% price return and a 2.8% total return in local currency. The TSX Composite's gains were mainly driven by the Materials and Info Tech sectors. In contrast, the S&P 500's performance was weighed down by the semiconductor industry due to threats from DeepSeek (a cheaper-to-train A.I. tool, using less advanced chips). Excluding the semiconductor industry, the S&P 500 would have generated a total return of around 3.9%. Among major equity indices, the S&P 500 equal-weighted index delivered the highest return in January, reflecting a broad-based strong fundamental backdrop during this earnings season (Chart 16).

Chart 16 - Selected Indices Price Returns



Source: FactSet, Raymond James Ltd; Data as of January 31, 2025. Price return in local currency.

A.I. and the impact of DeepSeek

Before we delve into the equity markets by region, we would be remiss if we didn’t address the January 27 tech selloff prompted by the announcement of the availability for a new A.I. Assistant from a Chinese company named DeepSeek. This announcement upset the current narrative on U.S. dominance in A.I. and assumptions that A.I. advancements are dependent on larger and larger capital expenditures on A.I. infrastructure and advanced Nvidia chips, and forecasts for more and more power needed to support A.I. data centres. DeepSeek claims to have developed its open-source large language model (LLM), with comparable performance to leading models such as OpenAI’s GPT-4o and Claude 3.5 Sonnet, after less than two months of training, using ~2,000 Nvidia H800 chips, at a cost of ~US$6 million. The implication is that A.I. can be much more efficient, come at a lower cost, and have less power requirements than previously thought. More experienced technology analysts will have to validate these claims, but the revelations sent shockwaves through the technology sector, and in one day wiped almost US$1 trillion dollar of market capitalization off the NASDAQ index, and almost US$600 billion (~17%) off Nvidia alone.

DeepSeek: Catalyst for Market Broadening

The good news around this event was that the equal-weighted S&P 500 index was up very slightly on the same day, suggesting that despite the outsized impact of the Magnificent Seven over the last couple of years, the broader stock market can still survive and thrive based on broader economic and corporate strength. If claims about less expensive and more efficient A.I. tools are supported, it indeed could be beneficial for many other companies to adopt A.I. tools and to monetize the technology. An increasingly cited economic effect is called the Jevons Paradox, named after the English economist William Stanley Jevons. In 1865, he noted that when technological advances resulted in higher coal efficiency, coal use increased, rather than an expected decrease. The net increase was a result of skyrocketing adoption of coal as a source of fuel. In today's context, we could see these technological advances in A.I. actually accelerating its adoption.

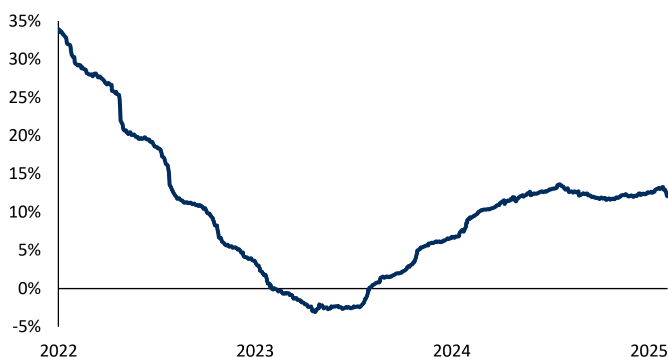
The key takeaway from the DeepSeek news and corresponding market reaction should be that diversification remains potentially more important than ever in what we have already cautioned will be a volatile year. While the market-cap-weighted S&P 500 index fell by 1.46% that day, the equal-weighted S&P 500 index (where all constituents have a 0.2% weighting, regardless of market cap) was actually up slightly (+0.02%) that day. Equity investing is not just about sticking with the largest companies. As we see a broadening out of the market, and previously overlooked stocks gain more attention, we can have a healthier and more balanced environment. Diversification remains key to maintaining the right risk/ return mix for each investor.

U.S. Equity Markets

We're now more than halfway through the 4Q24 earnings season, and the visibility remains promising. The S&P 500's forward-looking EPS grew by about 12% year-over-year in 4Q24, marking the highest growth rate since 4Q21 (Chart 17). For us, a sign of healthy growth will be seeing earnings growth extend beyond the Magnificent Seven stocks to non-tech industries and sectors. Encouragingly, we've observed this in the 4Q24 earnings surprises, with nine out of eleven sectors posting positive earnings surprises, which means analysts have revised their earnings projections upward (Chart 18).

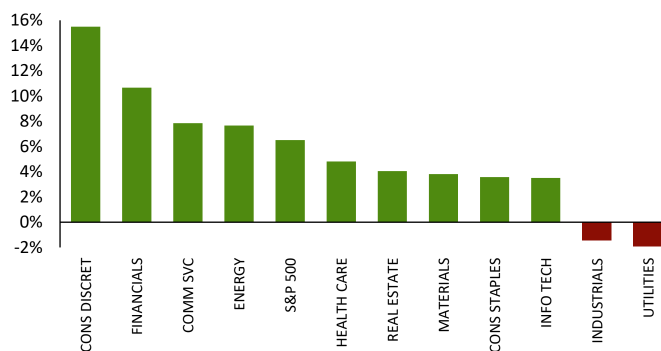
Economic fundamentals continue to provide a tailwind to equities, and we maintain our outlook for gains in 2025, although more modest returns than the 20%+ returns of the last two years. We have also cautioned that rising 10-year Treasury yields could put downward pressure on valuation multiples and increase the attractiveness of fixed income at the expense of equities, but we expect that as long as they can remain in the 4.2-4.8% range, equities will likely continue to benefit as corporate earnings remain strong.

Chart 17 - S&P 500 NTM EPS Growth (YoY)



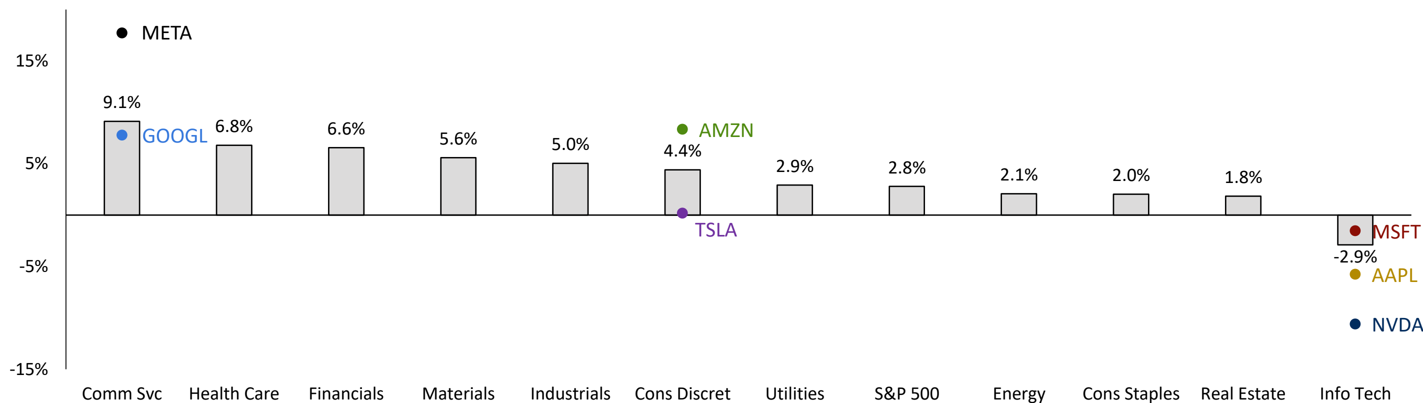
Source: FactSet; Raymond James Ltd.; Data as of February 7, 2025.

Chart 18 - Earnings Surprise by Sector - S&P 500



Source: Bloomberg; Raymond James Ltd.; Data as of February 10, 2025.

Chart 19 - S&P 500 Sector and "Magnificant Seven" Year-to-Date Total Returns



Source: FactSet; Raymond James Ltd.; Data as of January 31, 2025.

Canadian Equity Markets

The TSX Composite's gains in January were primarily driven by the Materials and Info Tech sectors, with cyclical sectors outperforming defensive ones overall. The rally in gold prices benefited the Materials sector, while the absence of the semiconductor industry and the potential for more affordable and efficient A.I. tools inspired by DeepSeek boosted the TSX Composite's Info Tech sector. The strong performance of cyclical sectors also reflects investors' optimism about Canada's economy, which is showing more signs of turning the corner.

Nevertheless, the recent economic improvement could easily be wiped out by the impact of tariffs or even just the threat of them, as discussed in the Economics section. Industries such as auto parts and consumer goods, which are the second and third largest components of Canada's exports to the U.S. after energy products, are likely to be hit the hardest by potential tariffs. This was evident in the market reaction on February 3, right after Trump signed an executive order initiating sweeping tariffs on Canada, with Consumer Discretionary and Industrials experiencing the largest declines (Table 1). Regarding the newly-announced 25% tariffs on all steel and aluminum imports into the U.S., however, we do not anticipate a substantial negative impact on the TSX Composite. This is because a country's economy is not the same as its stock market, and the index has minimal exposure to these industries. During the 2018-2019 period, when Trump first imposed such tariffs, the TSX demonstrated relative resilience.

In the longer term, the rolling tariff threats and strained relationship between Canada and the U.S. could also raise concerns about foreign direct investment (FDI). The U.S. accounts for over 40% of total FDI in Canada, with investments spread across various industries through holding companies. Manufacturing, finance and insurance are among the other main sectors receiving FDI from the U.S (Chart 20).

Top 3 Sectors (January 2025):

- **Materials**: Despite the delay in implementation, the increasing uncertainty around tariffs has been a key factor driving the gold price rally. As a result, the Materials sector, with about half of its exposure in gold, became the best performer in January.
- **Info Tech:** Unlike the S&P 500 Info Tech sector, the absence of the semiconductor industry in the TSX Composite Info Tech sector largely shielded it from the significant drawdown during the DeepSeek shock in late January. The sector's strong growth has been relatively broad-based. As the focus of A.I. development gradually shifts from hardware to applications (such as A.I. for e-commerce, retail, and business intelligence), the benefits of leveraging A.I. seen in the recent performance of software and IT services companies have been quite encouraging for the market. The quick and strong rebound after the initial DeepSeek shock also indicates that the potential for more affordable and efficient AI tools is welcome news for TSX Composite's Info Tech companies.
- **Industrials:** The gains in this sector were primarily driven by a few leading companies. The outperformance of these companies may be attributed to their significant exposure to the U.S. market or the boosted earnings driven by front-loading of orders before potential tariffs are imposed. However, many companies in this sector continue to struggle. With ongoing tariff threats and high valuations, the sector's outperformance does not seem sustainable.

Bottom 3 Sectors (January 2025):

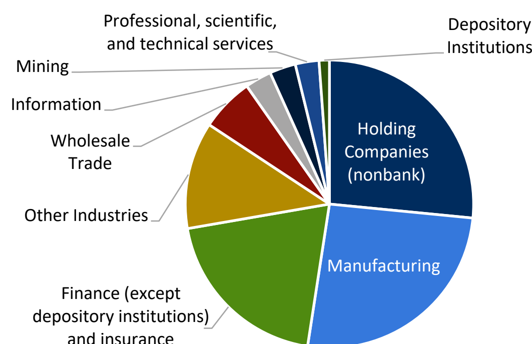
- **Consumer Staples:** This sector is experiencing a broad-based decline. With inflation stabilizing, it's becoming harder for companies to justify price hikes for everyday goods. Consumer spending is now driven more by discounts and promotions, which could hurt companies' pricing power and profits. Additionally, as the economy improves, capital tends to shift from defensive sectors to cyclical ones.
- **Utilities:** This sector's underperformance is mainly due to the Independent Power and Renewable Electricity Producers industry. The industry was shocked by DeepSeek, as the market quickly assumed that the demand for power might be lower than expected due to more efficient A.I. models. However, according to Jevons Paradox, the market may have overreacted, and this view could change over time.
- **Consumer Discretionary:** This sector was flat in January, with performance dragged down by the Automobile Components and Leisure Products industries. The underperformance of these industries may be partly due to tariff threats.

Table 1 - % Change of Capped Sector Index from Jan 31 Close

S&P/TSX Sector	at Feb 3 Open	at Feb 3 Close
S&P/TSX Composite	-2.2%	-1.0%
Consumer Discretionary	-3.6%	-1.8%
Industrials	-3.5%	-2.5%
Financials	-3.1%	-1.8%
Health Care	-3.0%	-2.1%
Real Estate	-2.5%	-1.5%
Consumer Staples	-2.0%	-1.2%
Utilities	-1.8%	-0.7%
Energy	-1.7%	-0.4%
Information Technology	-1.7%	-0.3%
Communication Services	-1.7%	0.3%
Materials	0.7%	0.8%

Source: FactSet; Raymond James Ltd.

Chart 20 - Breakdown of U.S. Foreign Direct Investment (FDI) into Canada



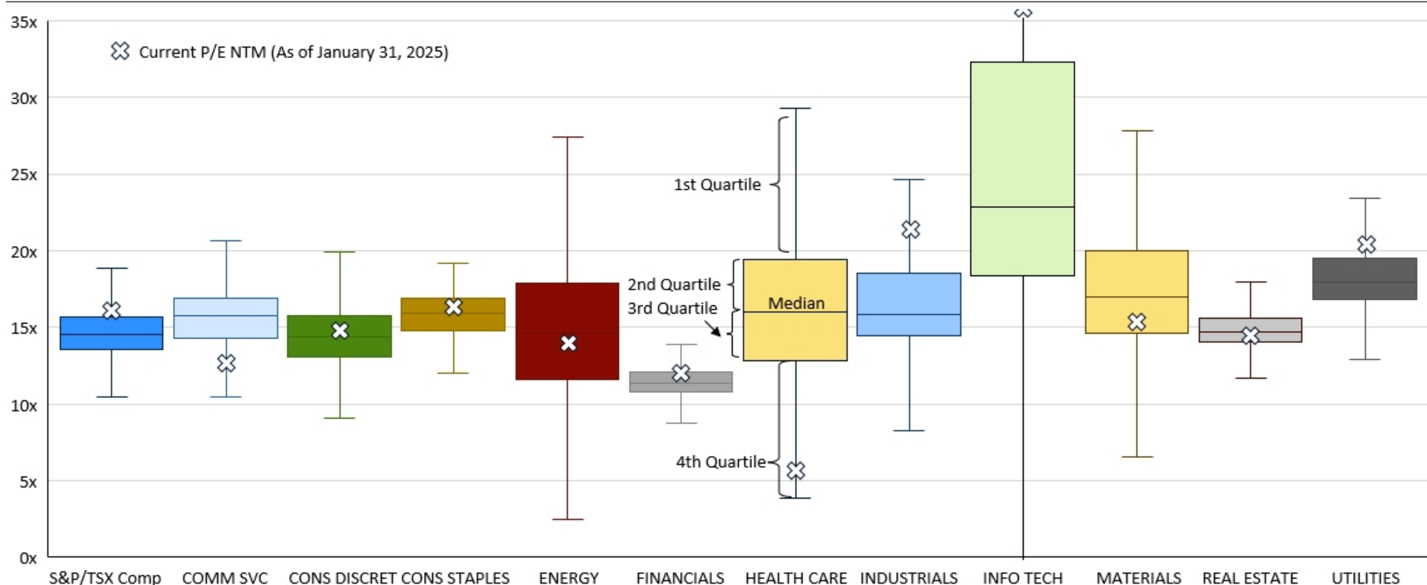
Source: U.S. Bureau of Economic Analysis; Statistics Canada; Raymond James Ltd.; For the year 2023.

Table 2 - S&P/TSX Composite Sector Performance and Valuations (Ranked by Quarter-to-Date Total Return)

Sector Name	Sector Weight	YTD Total Return	QTD Total Return	1M Total Return	Current P/E NTM	Historical P/E NTM
Materials	12.2%	10.2%	10.2%	10.2%	15.5	17.0
Information Technology	10.8%	10.0%	10.0%	10.0%	38.4	22.8
S&P/TSX Composite	--	3.5%	3.5%	3.5%	15.4	14.5
Industrials	12.6%	3.4%	3.4%	3.4%	21.9	15.9
Financials	32.7%	2.7%	2.7%	2.7%	12.1	11.4
Communication Services	2.3%	2.3%	2.3%	2.3%	12.5	15.7
Real Estate	1.9%	0.4%	0.4%	0.4%	14.2	14.7
Energy	16.6%	0.2%	0.2%	0.2%	14.2	14.6
Consumer Discretionary	3.2%	0.2%	0.2%	0.2%	14.9	14.4
Utilities	3.7%	-0.3%	-0.3%	-0.3%	20.2	18.0
Consumer Staples	3.7%	-2.7%	-2.7%	-2.7%	16.6	15.9
Health Care	0.3%	-2.7%	-2.7%	-2.7%	5.2	16.0

Source: FactSet; Raymond James Ltd.; Data as of January 31, 2025. The S&P/TSX Healthcare sector has been excluded from the performance commentary due to its minimal representation in the S&P/TSX Composite Index.

Chart 21 - S&P/TSX Composite Sector Current vs. Historical P/E NTM



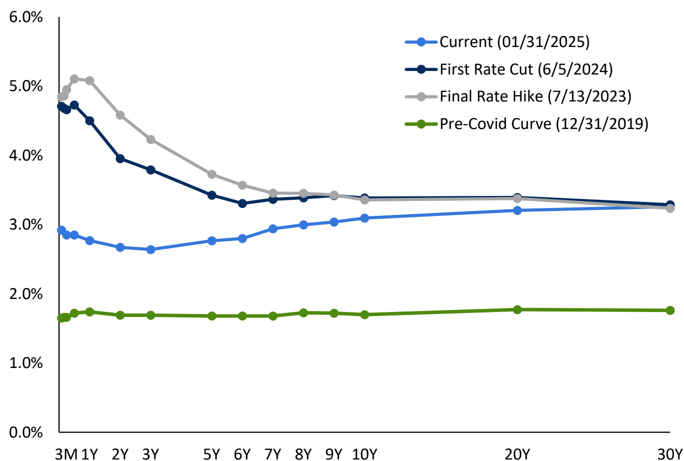
Source: FactSet; Raymond James Ltd.; Data as of January 31, 2025. Historical P/E: 1/1/2000 – 01/31/2025. Excluding outliners.

Fixed Income & Treasury Yields

Since late 2024, the treasury yield curves of both the U.S. and Canada have followed their respective trends. With the anticipated 25 basis point rate cut on January 29, Canada's curve continued its bull-steepening normalization. Looking ahead, Canadian bonds are expected to be heavily influenced by Trump's tariff policies. We anticipate further declines in yields, particularly in the short and mid-term segments of the curve. However, given the substantial 200 basis point cut already in place, the upside potential for bond prices may be limited.

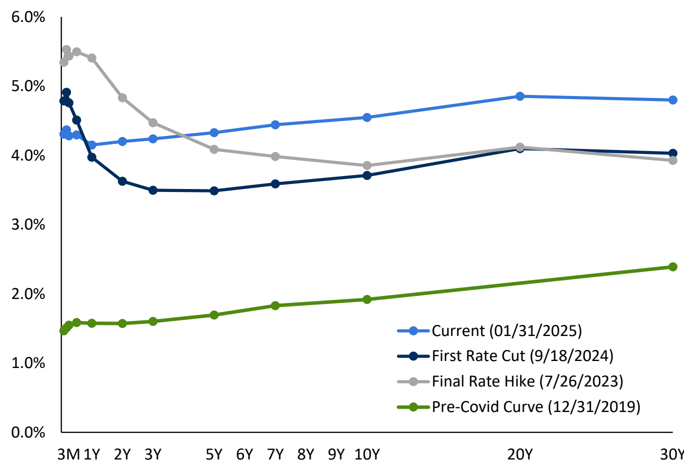
On the other hand, the U.S. yield curve barely moved in January, reflecting the strong economic backdrop and concerns about Trump's inflationary policies, as Fed Chair Powell put it, "the range of possibilities is very, very wide." The ten-year government bond yield, hovering around 4.5%, still appears quite attractive. Although the past two years have shown that the yield may take longer to come down and may not do so smoothly, the conditions for the ten-year yield to stay at this level are becoming stricter. Any weakness in the economy could cause the rate to drop. Historically, when the ten-year yield is at or above 5%, the subsequent five-year annualized return of the U.S. aggregate bond index is greater than 5% about 90% of the time, and greater than 10% about 30% of the time. With the U.S. stock market priced for perfection and expected to be more volatile this year, it may be beneficial to add some U.S. treasuries in the portfolio to reduce overall risk.

Chart 22 - Canada Government Yield Curves



Source: Factset, Raymond James Ltd.; Data as of January 31, 2025.

Chart 23 - U.S. Treasury Yield Curves



Source: Factset, Raymond James Ltd.; Data as of January 31, 2025.

International Equities

European markets outperformed North American markets in January, with capital inflows into European stocks reaching the second-highest level in 25 years. This outperformance is partly due to the DeepSeek shock, which had a greater impact on the tech-heavy indices. Additionally, European earnings are improving, and their valuation metrics are more attractive compared to the U.S., which is priced for perfection. Moreover, the market expects the European Central Bank (ECB) to cut rates more aggressively than the Fed. These factors helped European stocks step out of the U.S.'s shadow in the first month of 2025. Investors with the right risk tolerance and timeframe might find opportunities in this diverse basket. However, we don't believe the A.I. trend is over yet. North American markets are expected to be more volatile, but as more companies demonstrate benefits from A.I. applications, and together with strong earnings, the market could reach new highs.

In terms of emerging markets, we continue to watch for signs that a rebound in growth in China can be sustained. The Chinese government tried to deploy unused budget funds at the end of 2024 to help stimulate activity and property sales appear to be lifting slightly from depressed levels. Further loosening of monetary and fiscal policy could lead to further improvements, but concerns are that the measures will be short-lived and too small to make any serious dent in the structural issues (high savings rate, low consumption, and heavy reliance on investment and exports) weighing on the Chinese economy. Although the additional 10% tariff imposed by Trump on Chinese goods is expected to have a modest impact on China's economy, any future escalation to a trade war could exacerbate these structural issues. On the bright side, investors may become more optimistic about its Info Tech and other A.I.-related sectors, encouraged by DeepSeek.

Table 3 - Global Equities Performance

Select Global Equity Indices	Jan (in LCL)	Jan (in USD)	Jan (in CAD)	3 Mo (in LCL)	3 Mo (in USD)	3 Mo (in CAD)	YTD (in LCL)	YTD (in USD)	YTD (in CAD)	Current PE NTM	Historical PE Median	Premium (RED) / Discount (GREEN)
Major Aggregates												
World (Global)*	3.4	3.4	4.2	5.3	5.3	9.4	3.4	3.4	4.2	19.5	15.9	3.6
EAFE (DM ex U.S. & Canada)*	4.9	4.9	5.7	1.7	1.7	5.6	4.9	4.9	5.7	14.3	13.5	0.8
EM (Emerging Markets)*	1.9	1.9	2.6	-1.7	-1.7	2.2	1.9	1.9	2.6	12.1	11.7	0.3
Selected Developed Markets												
Nikkei 225 (Japan)	-0.8	0.7	1.4	1.4	-0.3	3.6	-0.8	0.7	1.4	18.0	16.8	1.2
Euro STOXX 50 (Europe)	8.1	8.4	9.2	9.9	4.9	8.9	8.1	8.4	9.2	15.2	13.2	2.0
FTSE 100 (U.K.)	6.2	5.3	6.0	7.6	3.4	7.4	6.2	5.3	6.0	11.9	12.4	-0.4
CAC 40 (France)	7.8	8.3	9.0	8.5	3.9	7.9	7.8	8.3	9.0	15.6	13.4	2.2
DAX (Germany)	9.2	9.3	10.0	13.9	9.1	13.3	9.2	9.3	10.0	14.6	12.6	2.0
Hang Seng (Hong Kong)	1.2	0.9	1.0	0.1	-0.1	3.1	1.2	0.9	1.0	9.2	11.9	-2.7
Selected Emerging Markets												
CSI 300 (China)	-2.8	-2.3	-1.6	-1.5	-3.5	0.3	-2.8	-2.3	-1.6	14.5	13.7	0.8
Nifty 50 (India)	-0.5	-1.6	-0.9	-2.7	-5.6	-1.9	-0.5	-1.6	-0.9	21.4	18.5	2.9

Source: FactSet; Raymond James Ltd; Total returns, data as of January 31, 2025. LCL: listed in local currency. Historical P/E Median: 1/1/2000 – 1/31/2025. *Indices are represented by their corresponding iShares ETFs, serving as proxies.

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