

From the Desk of the Public Equities Team

## That Bears Watching – Probability Tails, Tariff Tantrums and 'One Big Beautiful Big Act' Takeaways

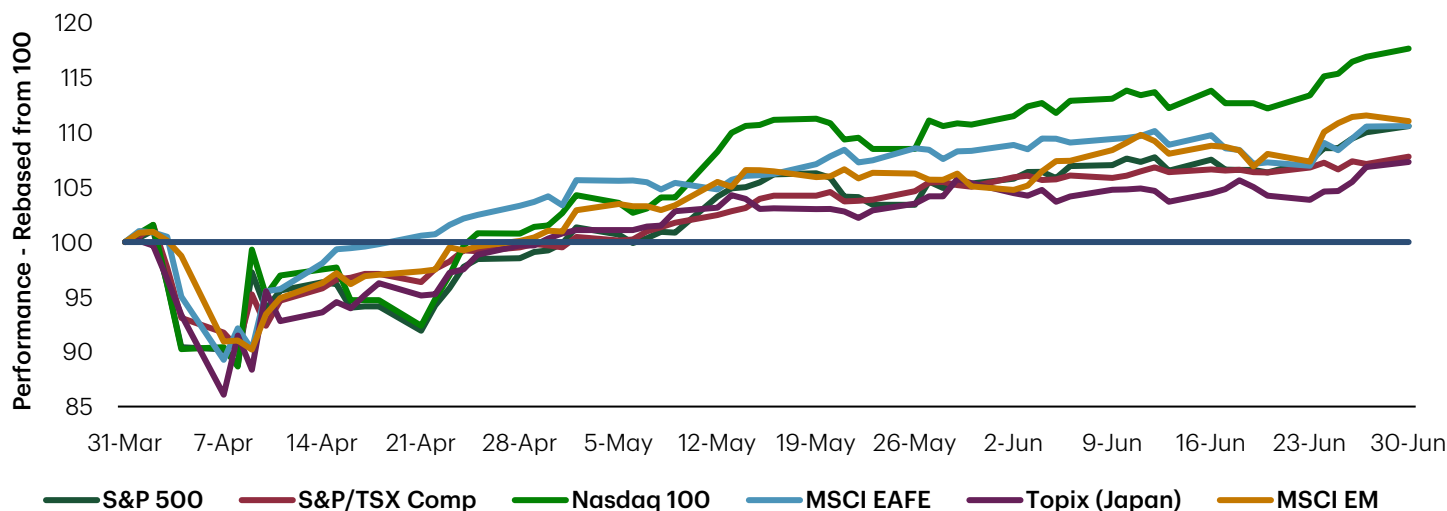
By Damian Fernandes, CFA, Managing Director, Portfolio Manager, TD Asset Management Inc. ("TDAM"), Jose Alancherry, CFA, Vice President, Client Portfolio Management and TDAM, Vitali Mossounov, CFA, CPA, CA, Managing Director, Head of Fundamental Equity Research, TDAM, as of July 2025.

*At TD Asset Management Inc., ("TDAM, we, our"), our business is about partnership with you – the investor and long-time unitholder. The better you understand the rationale for our decision-making, the more clarity you have on how our returns follow.*

### A Bounce Back for the Ages

Global markets celebrated U.S. Independence Day with fireworks, closing out what can only be described as a banner quarter for equities. Scores on the door for second quarter were 11% for the S&P 500 Index ("S&P 500"), 18% for the Nasdaq-100 Index ("NASDAQ 100"), 9% for the S&P/TSX Composite Index ("S&P/TSX"), 12% for the MSCI EAFE Index ("EAFE"), 7% for the Tokyo Stock Price Index ("TOPIX") and 12% for Emerging Markets ("MSCI EM"). If we take a long-term view, except for EM, all these markets have registered new all-time highs as seen in **Chart 1**.

**Chart 1: Markets Have Rebounded Sharply Worldwide Since the Bouts of Volatility in April**



Source: Bloomberg Finance. Data as of July 11, 2025.

### A Probability Distribution Has Two Tails

Naysayers and cynics have labelled this rally as rampant speculation (irrational exuberance), but like most prognostications made this year, the narrative does not follow the facts. Our hypothesis is that the corrosive impact of social media, coupled with a polarizing U.S. president Donald Trump, have led to an amplification of negative outcomes, and has blinded investors to what can go right.

Said plainly and recalling our Statistics 101 class, since 'Liberation Day' investors have been positioned for calamity – be it inflation spikes, economic slowdown, recessions, or collapsing earnings. What has actually transpired is a reduction of

left tail risks (particularly the worst outcomes of tariffs), renewed realization of the transformative impact of Artificial Intelligence ("AI"), an economy that continues to hum, albeit at a lower level, and the continued fall in inflation with stable yields.

Here is quick summary of right tail (positive) market outcomes that investors were potentially not positioned for:

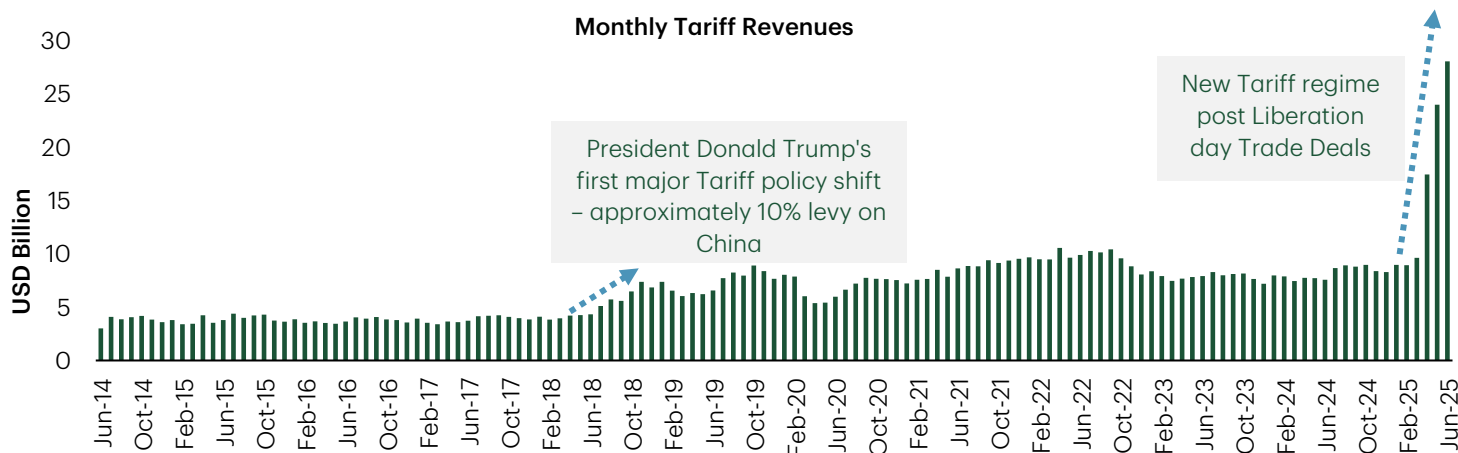
- **Flexible Deadlines as Part of Negotiating Approach:** The U.S. administration extended tariff deadlines to allow negotiation of deals that are materially less severe than the arbitrary and usurious rates proposed on the 'Liberation Day' whiteboard (for example, U.K. tariffs set at 10% with exceptions for automobile and aerospace parts; Vietnam tariffs reduced from 46% to 20%, amid ongoing extensions and more).
- **U.S. Economy that Remains in an Expansion:** Non-farm payrolls averaged 150,000 over the last three months with very little dispersion (158,000 in April, 144,000 in May, 147,000 in June). In addition, corporate earnings are expected to grow approximately 5% in second quarter year-over-year. This troughed at -15% in mid-April during peak tariff mania. These numbers are simply inconsistent with a recessionary backdrop.
- **Reduction in Geopolitical Risk:** Both the agreement among The North Atlantic Treaty Organization ("NATO") members to significantly increase defense spending to 5% over the medium to long term, and the decisive military operation to arrest (at least temporarily) Iranian nuclear ambitions, reduces geopolitical risk-premia.
- **Lower than Anticipated Crude Prices:** Steadily rising U.S. production, and The Organization of the Petroleum Exporting Countries (OPEC's) winddown of voluntary supply curbs have led to falling crude prices, with West Texas Intermediate ("WTI") crude prices closing at \$65.11 in June, -24% from last year. Stable to declining energy prices is supportive of falling inflation and consumer sentiment – consumers are happy when gas prices at the pumps do not bust budgets.
- **The Passage of the 'One Big Beautiful Bill Act' ("OBBA") Reconciliation Bill:** This defied most sceptics on the scope, concessions, and especially on timing projections. Our first pass is that this is growth (and cash-flow) enhancing, particularly for companies looking to invest and benefit from accelerated depreciation, and for individuals in reduced taxation on overtime and tips, with the added certainty that the 2017 tax cuts will be permanent.

Essentially, while investors were largely focused on the negatives and not pricing in right tail outcomes, reality has delivered upside surprises relative to expectations – and this has been the reason for the rapid bounce back.

## And...We are back to Tariffs

We do not want to talk about tariffs again, but at the margin it seems its back in vogue – and we may be stuck with related headlines for a while, especially as Trump's modus operandi is to start with an untenable position, and then negotiate from there. The 25% tariffs on Japan and South Korea (#5 and #6 in the country ranking of total goods traded with the U.S.) is evidence of that. **Chart 2** highlights data regarding tariff revenue collected by the U.S. Treasury. It seems access to U.S. consumer market matters more to its trading partners than tariffs.

**Chart 2: Parabolic Growth – Access to U.S. Consumer Market Matters More to its Trading Partners than Tariffs**



Source: US Treasury – Customs Receipts, Bloomberg Finance. Data as of June 30, 2025.

Two things are clear to us, one negative and one deliberate positive:

- **The Obvious Negative is that Extended Uncertainty is Counterproductive:** Ultimately it weighs on business and consumer confidence, directly impacting their hiring and spending decisions. There are some signs that the second quarter economic data was inflated by pre-spending (front loading orders) to avoid potential higher prices. If that persists, we could be in the early stages of an economic soft patch.
- **The Deliberate Positive is that Tariff Revenue is Coming in Significantly Higher than Estimates:** Chart 2 highlights a monthly series that is now sitting at \$28B/month in revenue, which does not even include the signed deals with Vietnam, or any future final settlements – we can state with reasonable confidence that it is headed higher. Our best guess is that tariff collection will come in around \$300 – \$400B annually, helping offset some of the blow out tax breaks announced in the OBBBA reconciliation bill.

## OBBBA – What's Potentially Hidden in the Fine Print?

Mainstream focus seems to be on the social spending cuts, funding for border security, tax cuts, and the usual greatest hits – but in our view, there are some provisions with huge implications that are not getting enough attention, both of which were key components of the Tax Cuts and Jobs Act ("TCJA") from the first Donald Trump Presidency.

- **Research and Development ("R&D") Deductibility (Section 174):** Domestic R&D is once again an immediate write-off while foreign R&D remains a 15-year amortization – this is designed to incentivize domestic investments.
- **Bonus Depreciation (Section 168):** 100% bonus depreciation is now reinstated. Eligible purchases range from excavators to server racks. As we understand it, even structures (e.g. factory with 39-year useful life for tax purposes) will be eligible for 100% depreciation through the end of the decade. This is unprecedented as the original TCJA did not have this – and again, designed to incentivize rebuilding America.
- **Federal Tax Deduction for State and Local Taxes ("SALT"):** No taxes on tips gets all the media attention, but this could be a more important tailwind for consumer spending. The TCJA capped SALT at \$10,000 per year while the OBBBA raises it to \$40,000.

## What Are Some Implications to Stocks that Stand Out to Us?

Our research team keeps a close eye on policy. Two of the provisions (R&D and depreciation) will translate into material upward revisions in free cash flows for many S&P 500 companies in 2025 and 2026. There will be no first-order implications for earnings-per-share ("EPS") as these are timing differences due to changes in accounting treatments (the companies would have received the cash from the internal Revenue Service ("IRS") in later years). Numerous companies stand to benefit with more than 10% FCF revisions, particularly in Technology, Telecommunications, Industrials & Pharmaceutical sectors.

## Where it Gets Interesting is the Second Order Implications?

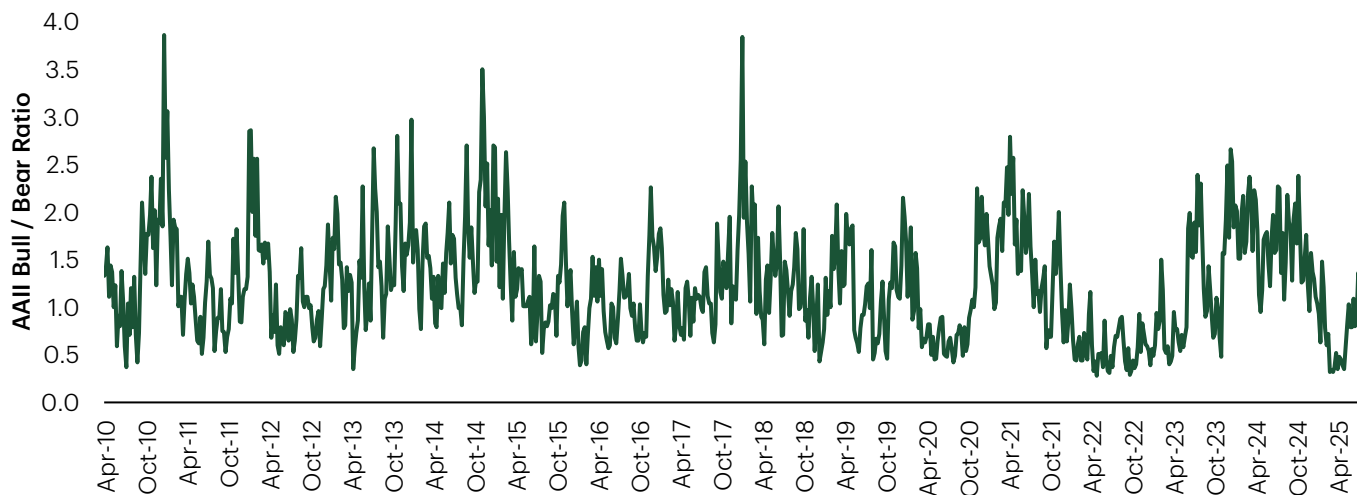
If companies have tax incentives to accelerate or pull-forward capex deployment, they are likely to do that. While the net present value ("NPV") impact to the market is modest, approximately 5%, FCF revisions will be positive over the next few quarters. We have been talking about Industrials for some time, and now you can add on another tailwind that's powering the sails of this sector – capex for every other sector is basically revenues for Industrials. America cannot re-industrialize without Industrials.

## Risk-on Appetite Seems to Be on the Rise

As we survey the economic landscape, the market is reasonably well balanced in our view. As shown in **Chart 3**, the sharp rebound in sentiment highlighted by the American Association of Individual Investors ("AAII") Bull-to-Bear Ratio, have lifted equity indices to where it is no longer an all-clear 'buy' signal from a risk-reward framework as stocks are not mispriced to the same degree as a few months back. But we also see the potential for upside catalysts such as global ex-U.S. growth accelerating due to significant stimulus measures, earnings surprising to the upside, and the U.S. Federal Reserve (the "Fed") providing support to financial markets with the restarting of its rate cutting cycle.

And so, with our portfolios, we have continued building positions in our high conviction ideas as evidence accumulated that the probabilities of worst outcomes were declining. The A.I. and datacenter theme has been featured prominently in the post 'Liberation Day' rebound, and we have added to names tied to this in recent weeks. There has been a strong rebound in Technology, particularly the U.S. mega-caps and semi-conductor complex. Looking at the big picture, we remain positive on a mid-cycle economic trajectory in the U.S. and positive inflections in many other regions. This is powering cyclical stocks across global markets – think Financials, Consumer Discretionary, and Industrials. These sectors remain in focus for us due to thematic tailwinds – defense, aerospace, consumer recovery, electrification, re-industrialization, rising capital market activity, among others.

**Chart 3: Sentiment Had Lifted off From the Troughs in April, Early Signs of Risk-on Investor Appetite**



Source: Bloomberg Finance. Data as of July 11, 2025.

At TDAM, we remain confident in our disciplined approach which has consistently guided us through shifting economic cycles. To repeat, with apologies for sounding like a broken record – we have no perfectly clairvoyant crystal ball, but we trust our process will continue to deliver superior, risk-adjusted outcomes for clients.

**Remain nimble to seize opportunities. Have balance in portfolio exposures. Keep Calm and Compound On.**

**Damian Fernandes & Jose Alancherry, and Team**

**For further information,  
please contact your TDAM Representative.**



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