TD Asset Management

Market Perspectives 10 Minutes

From the Desk of the Public Equities Team

That Bears Watching – Narrative Confusion, Market Prognostications & Portfolio Rotations

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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.

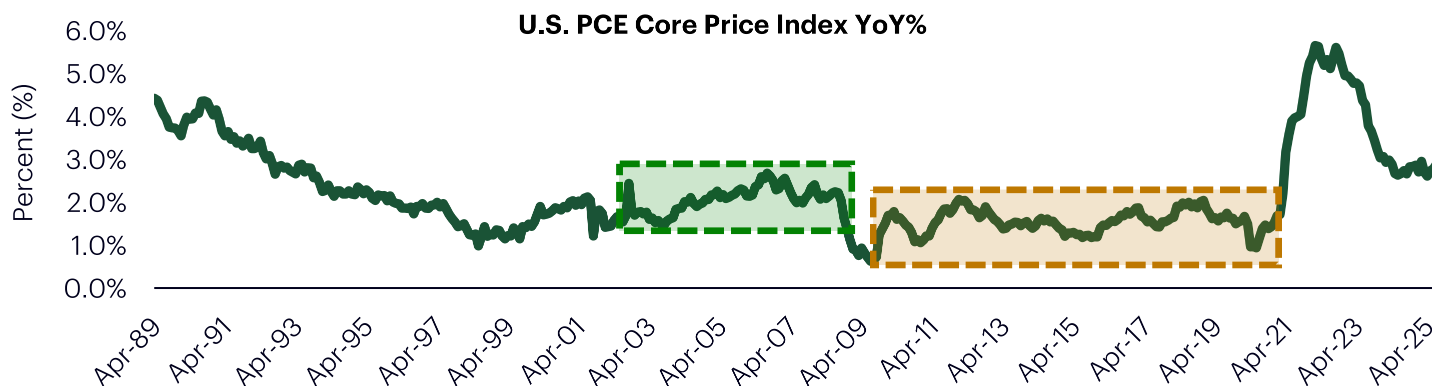
The Paradox of the Information Age – Narrative Confusion

Late summer always brings a reflective mood, be it the anticipation of heightened volatility that September usually brings, or the anxiety that the current relaxation is about to morph into potentially furious activity, both in markets (U.S. Federal Reserve (the Fed) rate cuts, inflation prints, third quarter earnings season), and life (kids back to school, year-end deliverables etc.).

Now, we have repeated this ad nauseam in prior commentaries but will repost for emphasis – data drives decisions in our investment process, not biased opinions coloured by our social media feeds. And in our view, the data currently looks fine.

In fact, evaluating macroeconomic variables, Personal Consumption Expenditures (PCE) Price Index Inflation (the Fed's preferred metric) has fallen from 5.7% three years ago to 2.9% (as at July 31). Granted, it is higher than recent history, but not alarmist in the grand arc of history. Our view is that the (dis)inflation experience of the 2010s (highlighted in yellow) was the anomaly, and clients should skew to 2000s inflation (highlighted in green) as potentially the new base case scenario **(Exhibit 1).** Similarly, Initial Jobless Claims, the best warning sign of labour market deterioration remains at six-decade lows, the Atlanta Fed GDPNow Estimate is tracking at a healthy 3.5% for the third quarter, and other high frequency measures of economic activity remain benign (if not positively biased).

Exhibit 1: Adapting to a New Inflation Regime



Source: Bloomberg Finance L.P. As of September 4, 2025.

If we turn to fundamentals, with second quarter (Q2) earnings season wrapped up, in aggregate, companies reported 6.3% sales growth and 12.4% earnings growth. The underlying trends were also healthy with Q2 earnings per share (EPS) revised up 6% through the earnings season, with every sector posting positive sales surprises (so revenues grew despite tariffs concerns), and excluding the Materials sector, every sector posting a positive EPS surprise (investors were too

bearish on the outlook). Earnings are forecast to grow 9% in 2025. Barring a collapse in activity, we would take the over on that estimate.

As we reflect on what has transpired so far this year, we remain satisfied that we kept our wits about us, especially with regards to the hyperbolic panic in the aftermath of "Liberation Day", but also more broadly, for not falling prey to the never-ending fascination from the media and 'expert' class about impending disasters – it seems we have been in a perpetual state of doom for quite some time. We keep coming back to a pet hypothesis of ours – in the age of endless information, humans may have lost some ability to discern objective facts from information.

In actuality, the evidence never supported economic recession, accelerating inflation, collapsing earnings, Middle East war, China-U.S. geopolitical escalation, or any other worry. **Essentially, the market kept pricing in negativity, and reality kept surprising to the upside – this has benefited client portfolios.**

The Bad, The Better, and The Beautiful

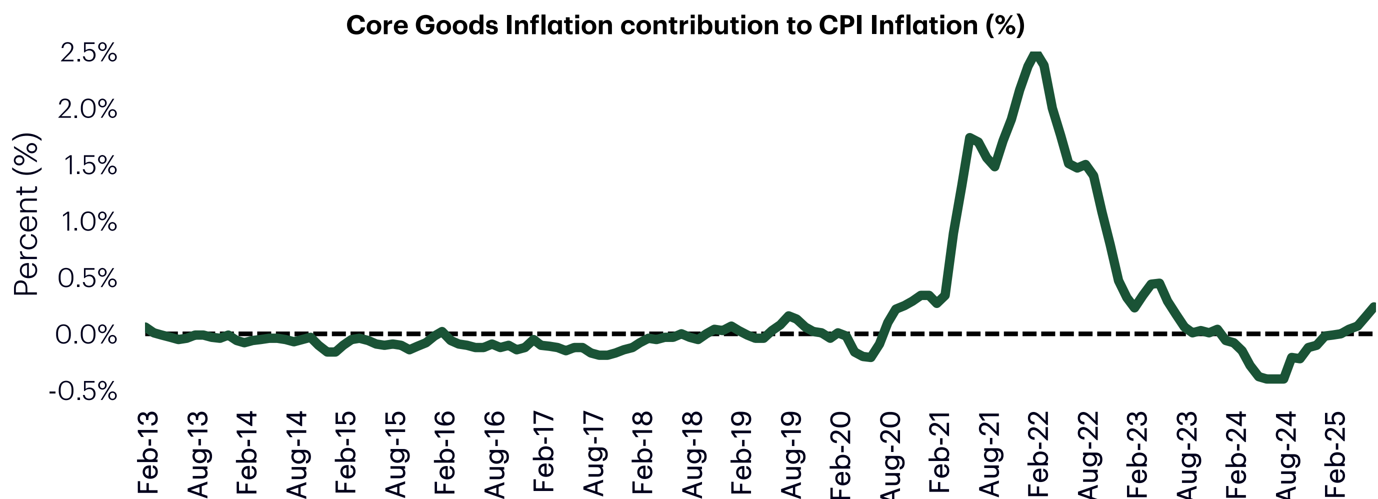
A query we often get from investors is what could go wrong from here? Curiously, rarely do we get questions about what could go right. But we figure that it's consistent with studies of investor behaviour showing a bias towards loss aversion. So, let's take a look at a few scenarios – the Bad, the Better, and the Beautiful.

When 'good' news is 'bad' news – Here is a thought experiment to elucidate. Given the sharp slowdown in job growth (average three-month payroll growth is just 35K), the Fed is biased to cut preemptively to ease financial conditions and provide economic support. But what happens if the unemployment rate remains at very low levels because immigration policies have arrested labour supply and economic growth doesn't slow? What if tariffs at the margin, start adding to inflation and the Fed doesn't have to be as accommodative because employment is fine?

With Fed Chair Jerome Powell seemingly waving the white flag as well, the market is now pricing in more than five 25 basis points (bps) rate cuts to the end of 2026. So, from our vantage point, the real risk isn't that the economy slows precipitously impacting earnings estimates – it's that artificial intelligence (A.I.) spending continues, consumption and income remains firm, and with economic activity running above trend, we don't get inflation subsiding, which is a key tenet for rate cuts. In this scenario, rate cuts that are priced in may have to be walked back. Financial conditions will then tighten, and both multiples and credit spreads will be negatively impacted.

As mentioned above, jobless claims remain low, earnings are forecast to grow double digits, and there is a bounty of stimulus measures announced globally. We are following the contribution of goods price increases and how they interact with inflation. We had the stimulus and supply shock of the COVID-19 pandemic that ignited goods inflation, but then as economies and supply chains reopened, it's been a cycle of goods deflation for quite some time. This trend has reversed and is showing early signs of reflation in goods pricing (**Exhibit 2**) and we are closely watching to see how this evolves.

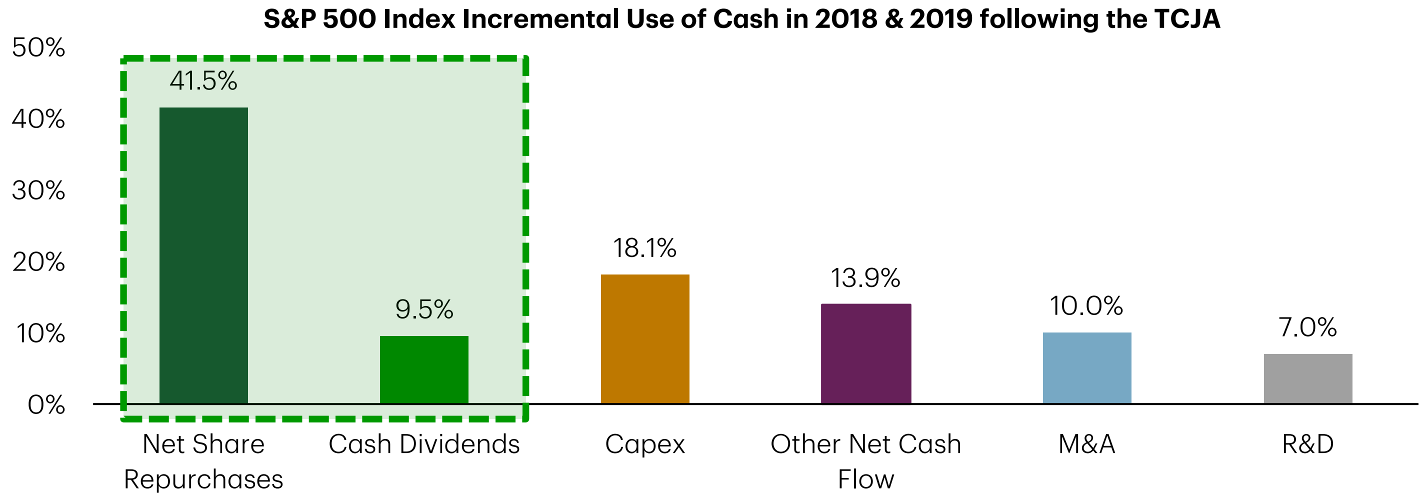
Exhibit 2: Post-Pandemic Pause Ends: Goods Inflation Rises



Source: Bloomberg Finance L.P. As of September 4, 2025.

More cash is always 'Better'– By our estimates, the passage of the One Big Beautiful Bill Act (OBBBA) is forecast to increase Free Cash Flow to S&P 500 Index companies by approximately 9% for both 2025 and 2026 (mainly due to expensing of Research and Development and investments in structures). When we look at what happened after the 2017 Tax Cuts & Jobs Act (TCJA) was passed in President Donald Trump's first term, over 50% of the tax benefit was returned to shareholders in the form of share buybacks and dividends (**Exhibit 3**). If history is a guide, a similar outcome is expected this time around as well. Increased cash returns are always supportive of equity prices (higher buybacks = price indifferent buyer).

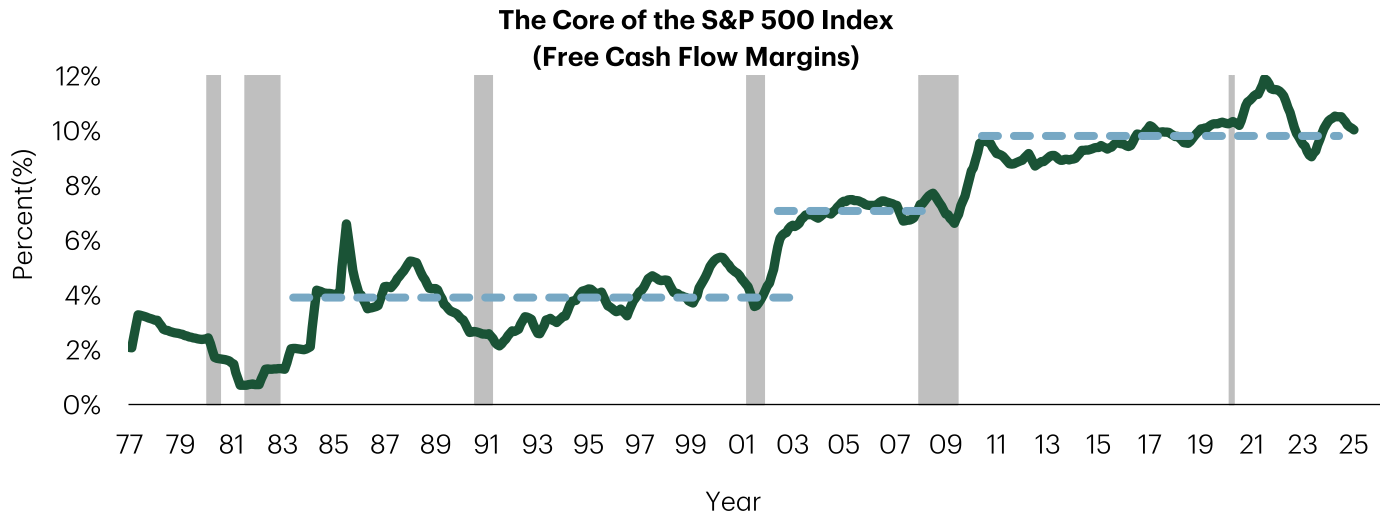
Exhibit 3: Cash Flow Trends: Lessons from Past Playbooks



Source: TD Asset Management Inc. As of September 4, 2025.

The 'beauty' of operating leverage – And finally, what does blue-sky scenario look like? Time for a bullish thought experiment. What happens if A.I. capital expenditures (CapEx) from the hyperscaler moderates (so CapEx falls) they keep earning a tangible return on A.I. (revenues accelerate), and reduce costs by substituting labour (expenses fall)? In that scenario margins will likely head higher and if the S&P 500 Index continues to return cash at its historical rate, that could justify even higher multiples from current levels.

Exhibit 4: Why U.S. Equities Command Higher Valuations



Note: Excluding financials, real estate, utilities, and energy. Free Cash Flow Margins measured in aggregates; based on trailing four-quarter data and smoothed on a trailing three-month basis. Source: Empirical Research Partners Analysis. As of March 31, 2025.

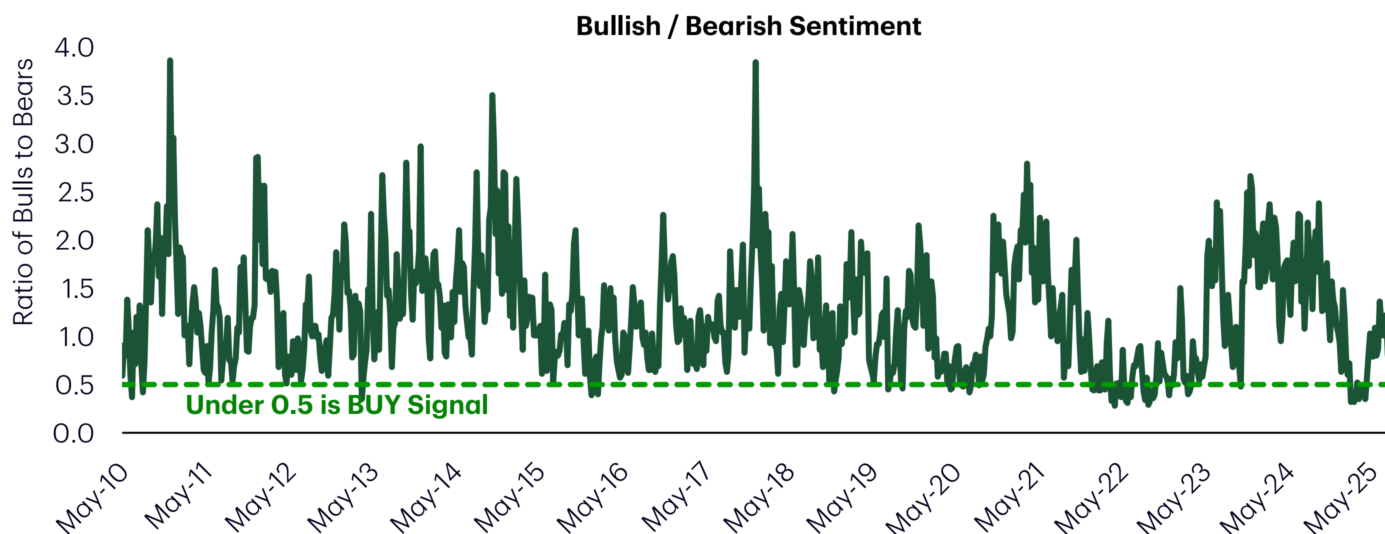
Looking at the exhibit above – notice how margins broke out of their historical range (2 to 6%) in the early 2000s, enabled by the outsourcing of manufacturing, and then took a similar step-up after the Great Recession of 2007 due to the rise of capital-light, monopolistic business models **(Exhibit 4).** A.I. could power the next leg up for margins. Investors could win both ways in this scenario – better fundamentals with increasing margins, free cash flow growing high-single digits, and with the S&P 500 Index returning >50% of that cashflow back to shareholders in buybacks and dividends, this could also justify premium valuations. Not our base case, but also not an unlikely possibility.

So, Risk-On, Eyes Closed or Balanced Positioning – What are We Doing Within our Portfolios?

The returns experienced in 2025 have been characterized by negative sentiment crashing against a wall of still solid economic and earnings growth – a bullish backdrop. But, as we step into the last third of the year, the investing backdrop is fairly mediocre, not the "back up the truck, buy anything situation" from a few months back.

Sentiment has recovered and is no longer a screaming buy – our custom bulls divided by bears ratio below has a great tactical hit rate when below 0.5 (two bears for every bull). It currently sits at 0.88 **(Exhibit 5).** September seasonality also remains ominous. Not only is September a negative average return month, but the skew is also left leaning (more bad months than good), with fatter tails (higher propensity for large drawdowns).

Exhibit 5: Bulls Return Slowly—Animal Spirits Still Dormant



Source: Bloomberg Finance. As of September 4, 2025.

These trading realities, coupled with positive year-to-date returns, valuations being at the higher end, and outstanding earnings beats being met with indifference – all lead us to express moderation. Cash balances in funds are sitting a little north of 3%, and we have taken some profits in the A.I. datacenter trade and reoriented technology exposure within the sector (rotating away from software which is going through a rough patch). We have added to some procyclical themes, (for example U.S. Housing, Euro financials, Global Industrials and Materials). We have made some rotations within sectors as well (Health Care, Communication Services, Consumer Discretionary), seeking to reallocate capital to higher conviction names. Ultimately, our equity portfolios remain balanced with diversified allocations across themes.

To be clear, we are not bearish – this is still a bull market. We just don't want to be sitting on the sidelines with our positioning and also want to have dry powder to exploit any potential market volatility. We are also open to the possibility that the next leg higher in this market may have new leadership (a late cyclical feel if we had to venture a guess).

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

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For further information, please contact your TDAM Representative.

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