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# Digital dreams and fiscal realities

The third quarter of 2025 marked a turning point, with monetary policy easing across Canada and the U.S., and artificial intelligence (AI)-driven optimism fuelling equity markets to new highs. While momentum remains strong in markets, we turn attention to fiscal dynamics that will be critical in shaping the long-term sustainability of economic growth.

**Canadian budget:** The federal government's upcoming fall budget is expected to introduce a structural shift in fiscal planning by permanently moving budget announcements from spring to fall (November 4 release date for 2025), allowing provinces more time to plan projects. A new framework is also being proposed to separate capital and operating budgets in hopes of improving transparency and accountability between long-term investments and day-to-day spending. The government aims to "balance" the operating budget within three years (meaning operating revenues should cover costs), achieved through automation and attrition efforts. Meanwhile, capital budgets would be allowed to run in deficits if required, and the estimated deficit of $68.5 billion in next year's budget is planned to be funded with long-term debt. This strategy signals a prioritization of growth-oriented investment, while maintaining a discipline on recurring expenditures. The yearly federal spending is projected to rise 6.8% driven by health care (notably, elderly benefits), infrastructure, housing and clean technology. These targeted investments have the potential to stimulate growth in the industrials, materials and technology sectors – though impacts will be gradual rather than an immediate boost. Against a backdrop of rising deficits, aging demographics and productivity challenges, the government faces a delicate balancing act: foster resilient economic expansion through high-impact spending while ensuring long-term fiscal stability.

**U.S. shutdown:** South of the border, the U.S. government faces political dissent over their federal budget, driven from Medicaid cuts, healthcare subsidies and foreign aid recessions, which have resulted in a temporary government shutdown. While markets have yet to price in any major risks, prolonged delays could disrupt federal operations, trigger furloughs and weigh on consumer spending. These disruptions have caused the Department of Labor to pause on releasing the September jobs report, which leaves the Federal Reserve navigating policy without key data. The timing is particularly challenging amid broader employment strain from AI disruption, immigration crackdowns and tariff pressures. A sustained shutdown could potentially elevate market volatility and impede economic momentum.

Globally, fiscal policies are following a similar path of increased spending and deficits that are planned to be financed with higher debt loads. The result has been currency debasement (especially with a weaker U.S. dollar), uncertainty about fiscal sustainability and higher inflation expectations. Consequently, investors and central banks seeking stability have flocked to gold as the "safe haven" asset, causing it to rally almost 50.0% this year and reach new all-time highs.

## KEY TAKEAWAYS

AI-driven optimism and easing monetary policies continued to propel equity markets in the third quarter.

Canada's upcoming fiscal budget marks a turning point for technology and infrastructure expansion.

Rising fiscal deficits across global economies have contributed to the rally in gold as a safe-haven asset.

Strong benchmark performance this year could influence investor behaviour, potentially leading to increased market activity in the fourth quarter.

## Canadian equities

Canadian equities continued their impressive rally as the S&P/TSX Capped Composite Index gained 12.5% in the third quarter and 23.9% year-to-date in CAD terms. The index has outperformed most benchmarks and U.S. equities this year. The rally was led by the materials sector, which soared 37.8% in the third quarter, driven by gold prices reaching all-time highs and marking gold's best annual performance since 1979. Other commodities, like silver and uranium, also posted significant gains, fuelled by rising demand linked to AI-driven energy consumption and data centre expansion. The economy showed signs of strain in August, with inflation ticking up to 1.9%, driven by seasonal spikes in apparel and household goods, though it remains below the 2.0% target. Unemployment rose to 7.1%, while GDP contracted to 1.6%; this slowdown follows an expected whiplash effect, in which anticipatory export surges that occurred earlier now give way to a tariff-driven pullback. A tripling of the Canadian trade deficit from May to August underscores the impact of tariffs, which may continue to persist in the absence of new trade agreements. Consequently, the Bank of Canada (BoC) cut its policy rate by 0.25%, bringing it to 2.50% to support growth amid labour market stress and rising trade imbalances.

## U.S. equities

U.S. equities also built on their momentum, fuelled by AI-driven optimism, with the S&P 500 gaining 8.1% in USD terms and 10.3% in CAD terms for the third quarter. Information technology and communication services led the charge, posting returns of 13.2% and 12.0% respectively, in USD terms. Investor enthusiasm is backed by rising profits from AI-powered productivity and over $350 billion in planned capital deployment by top technology firms in 2025 alone. While this capital spending is exciting for many AI-focused investors, some market participants are drawing parallels of current state investments to the dot-com bubble, raising caution around valuations of these technology companies. Meanwhile, the economic picture in the U.S. remains mixed. GDP grew at a solid pace of 3.8% in the second quarter, but economists remain widely contentious over third quarter GDP estimates. Inflation in August increased to 2.9%, while the unemployment rate edged higher to 4.3%. More notably, job creation slowed sharply, as companies appear to pause hiring and firing amid shifting immigration policies, tariff pressures and early signs of AI-driven displacement. In response, the Federal Reserve enacted its first 0.25% interest rate cut of the year, aiming to recalibrate policy, but remaining data-dependent.

## International equities

International equities also continued their momentum. Developed markets, as measured with the MSCI EAFE Index, posted a 6.8% return in CAD terms for the third quarter, as investors rotated into opportunities outside of the U.S. While the U.S. has established a clear lead with AI innovation, investors sought broader diversification across other regions and sectors offering lower valuations and cyclical exposure. Steady policy and regulatory environments in Eurozone economies supported capital flows, though leadership transitions in France and Japan could now introduce short-term fluctuations. Emerging markets outperformed their developed counterparts, with the MSCI EM Index rising 12.8% in CAD terms for the quarter. Easing global interest rate expectations and a softer U.S. dollar provided tailwinds, as many emerging economies benefited from reduced pressures on their debt that is typically denominated in the U.S. dollar. Rising commodity prices, attractive valuations and broader risk-on sentiment further fuelled capital flows into these higher-growth and higher-risk regions.

## Fixed income

Fixed income also rebounded in the third quarter as FTSE Canada Universe Bond Index increased 1.5%, while the Bloomberg U.S. Aggregate Bond Index (CAD-Hedged) rose 2.6% in CAD terms, respectively. The recovery was driven by interest rate cuts across key markets shifting monetary policy to be more accommodative for economic growth. The Bank of Canada's rate cut supported a cooling in shelter-related inflation and a decline in 3- and 5-year treasury rates, which could offer relief to households facing upcoming mortgage renewals. However, long-term rates in Canada have moved higher, reflecting long-term inflationary concerns expected from the government's spending plans. On the corporate side, lending conditions remained healthy, buoyed by earnings growth and prudent debt management. However, consumer sensitive sectors could face headwinds from trade policy and declining savings rates, reinforcing the case for active management and selective positioning over a broad market exposure.

## Outlook

Canada's fiscal strategy shows promise, with an emphasis on accelerating AI adoption. Interestingly, while the country excels in academic research for AI, its enterprise adoption for the technology remains limited. Recognizing this gap, the government has introduced a new cabinet role of Minister of AI, who will drive national strategy, legislation and industry uptake.

In capital markets, while the third quarter has historically been prone to periods of market volatility, this year saw continued positive momentum. It is worth noting that most benchmark indices have posted strong gains and outpaced many active investors. As year-end approaches, underexposed investors may feel pressure to chase returns, which could amplify market momentum but can also increase the risk of frothy valuations and subsequent abrupt reversals. Our investment strategy remains anchored in fundamental research and geographic diversification, with a disciplined approach that helps us stay focused – especially in those market environments where emotions can run high and disconnect from company fundamentals.

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