

Q3 MACROECONOMIC UPDATE

THE WEIGHT OF EXPECTATIONS

**WHEN EXPECTATIONS CARRY THE MARKET,
EVEN SMALL SHIFTS MATTER**



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Late-cycle markets are a lot like suspension bridges: they can hold incredible weight right up until the moment the tension becomes visible.

From a distance, everything looks calm and stable, but beneath the surface, every gust of wind, every additional load, every shift in the structure matters more.

Today's market is priced for perfection, but standing on uneven ground. Valuations are elevated, credit is tight, and AI-fueled narratives are doing much of the heavy lifting. Fiscal excess, rising tariffs, and early labour market weakness don't break the cycle overnight, but they do bend it and when expectations are these heavy, even small shifts can tip the scale.

It raises the question, if perfection is already priced in, how well is your portfolio positioned for imperfection?

PRESSURE POINTS IN THE MARKET

WHERE THE PRESSURE IS BUILDING BENEATH THE SURFACE

01. Growth Tailwinds vs. Structural Friction

Global fiscal and monetary stimulus are setting the stage for stronger activity into 2026. But that momentum will have to overcome some opposing forces: rising tariffs, early labour-market weakness, persistent inflation, and elevated debt loads all have the potential to bend the cycle before it accelerates.

02. Equities: Strength Built on a Narrow Base

Equity markets remain strong, but the foundation is increasingly concentrated. A handful of mega-cap names, the “Magnificent 7” and the AI trade continue to dominate returns. AI capex momentum has driven high valuations, and though this could certainly persist, cracks in the AI spending narrative could have large implications given risk premiums. Given the elevated valuations, the market is offering very little room for disappointment.

03. Credit: Supported by Policy, Priced for Perfection

Softening labour data in Canada and the U.S. has opened the door to rate cuts, potentially providing a meaningful tailwind to credit markets. Strong inflows and a healthy new issue calendar have kept spreads tight and returns solid, but with valuations already stretched and fiscal pressures building, this strength is increasingly dependent on policy remaining supportive.

04. Short-Term Caution: Innovation Meets Friction

AI is driving a powerful wave of investment and optimism, but it’s unfolding against a more complicated macro backdrop. Stagflation-like pressures, sticky inflation, and policy uncertainty could test market resilience in the near term, leaving less room for markets to absorb negative surprises.

MARKET POSITIONING

Positioning Is Getting Extended

Investor exposure in U.S. equities is already nearing the danger zone

Source	Prior 3 Months	Prior 2 Weeks	Current Positioning						Next 1 Month Est.
Retail			L					H	
CTA			L					H	
Vol Target			L					H	
Buybacks									
HF			L					H	
Pension / Insurance									
Vol / Hedging Flows			L					H	
CB / Macro Liquidity									



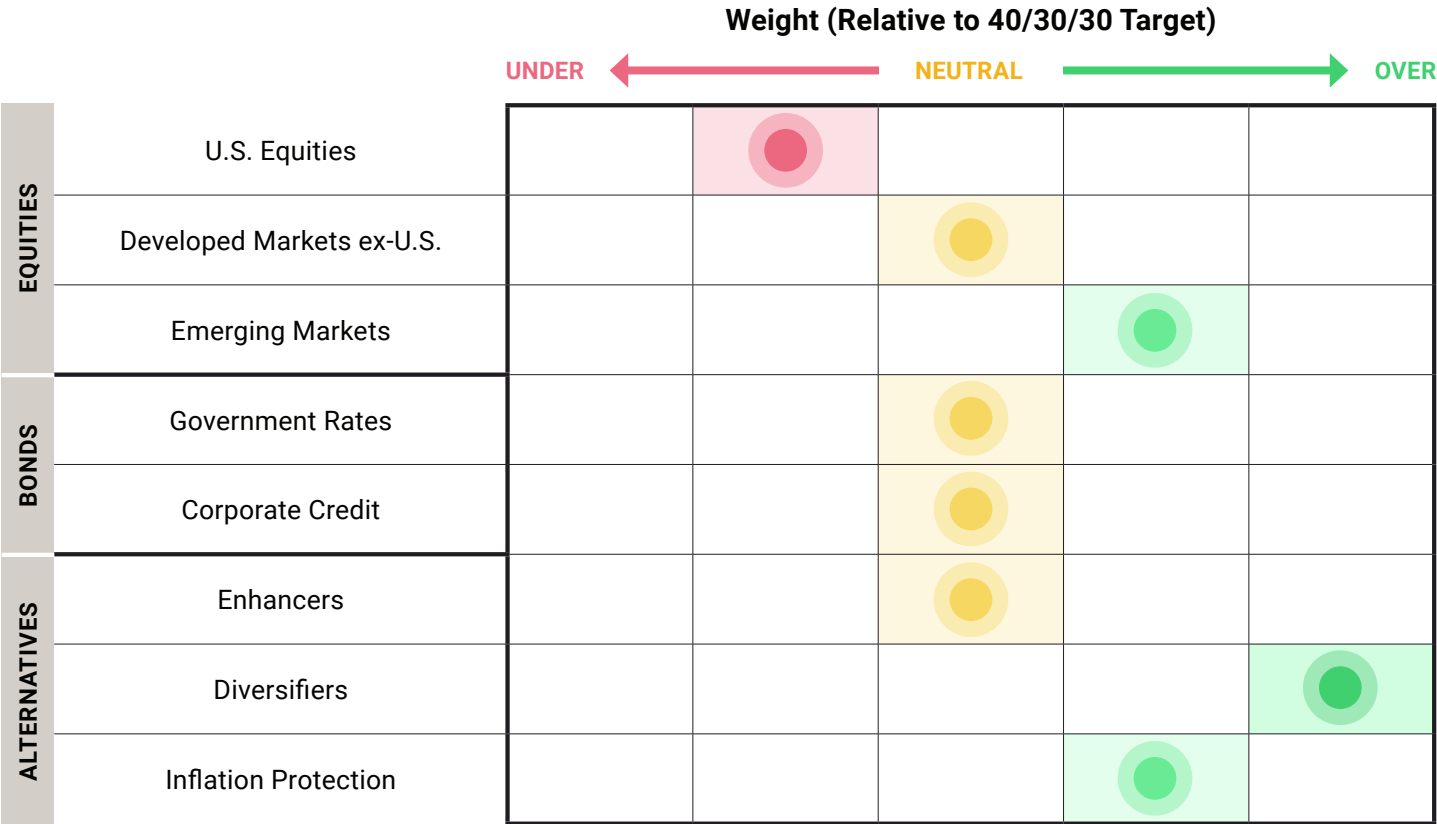
Q2 - 2025



Q3 - 2025

Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. As of Sep 2025.

Positioning for What Comes Next



QUESTIONS ADVISORS SHOULD BE ASKING

SHARPER QUESTIONS, LEAD TO BETTER POSITIONING

Late-cycle markets don't reward complacency. They reward clarity. In an environment where expectations are stretched and concentration is rising, we believe the right questions can matter more than the right forecasts.

The Questions That Matter Now:

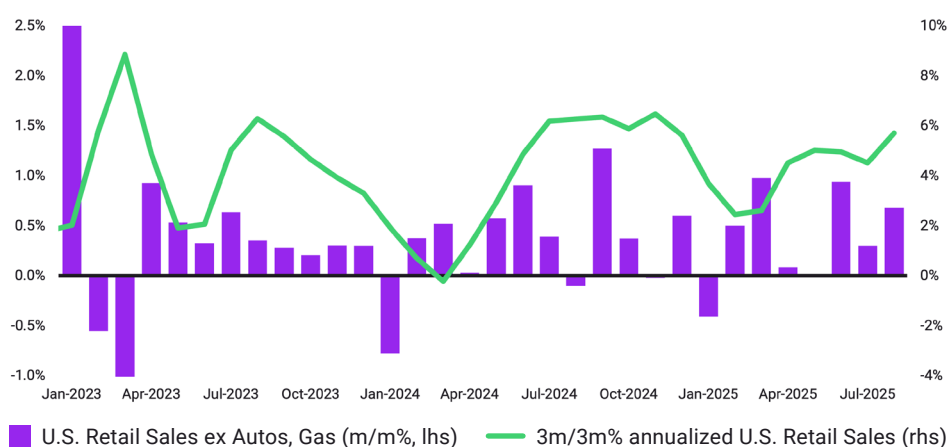
01. If a handful of mega-caps are driving returns, how much of my portfolio is truly diversified?
02. With equity risk premiums near record lows, am I being adequately compensated for taking risk?
03. If long rates continue to rise, where does my portfolio find a genuine ballast?
04. How dependent is my return profile on the durability of the AI trade?
05. Are alternatives a marginal allocation or a structural one?

01. GROWTH TAILWINDS VS. STRUCTURAL FRICTION

Q3 2025 was characterized by the contrast between near-term favourable economic conditions combined with positive business environment expectations, and a multitude of potential global fiscal and economic headwinds looming over the horizon.

Near-Term Support for Equity Markets

In the near term, the backdrop for risk assets remains constructive. Easing financial conditions are beginning to filter through the system, setting the stage for an incremental pickup in activity. In addition, retail sales have picked up over the last three months after a more concerning start to the year.

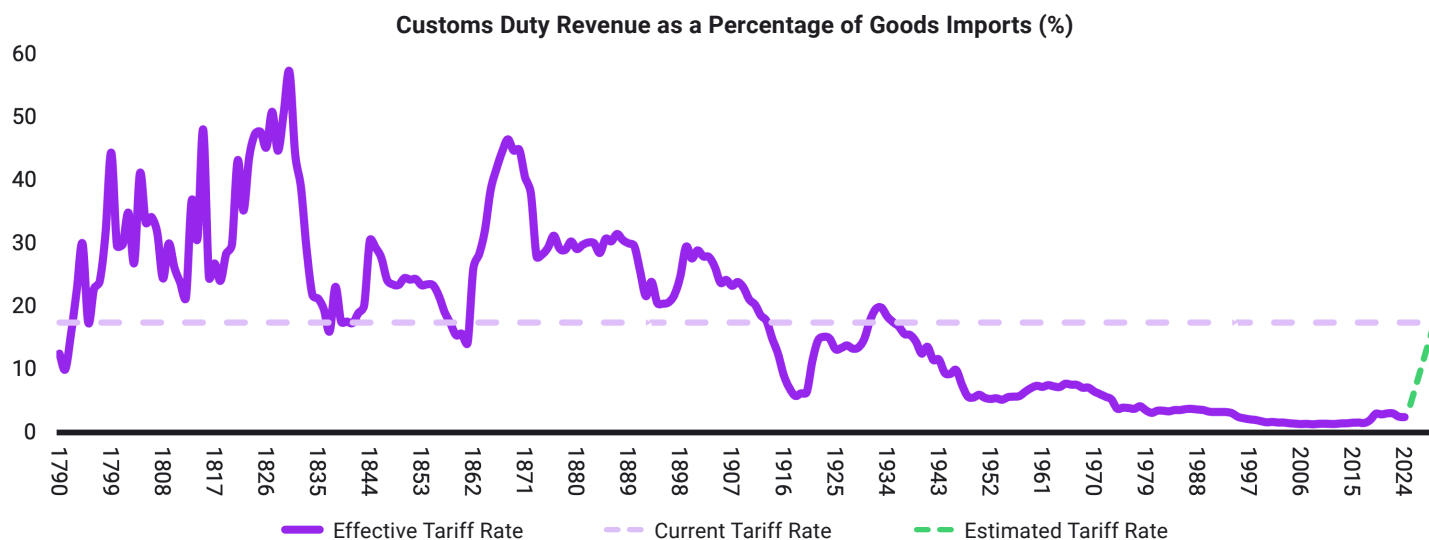


Source: Bloomberg L.P., Picton Mahoney Asset Management Research. Jan 2023 to Aug 2025.

Further support is coming from targeted fiscal measures, including the recently passed **One Big Beautiful Bill Act**, which is expected to provide a meaningful near-term boost to economic activity while easing some of the burden on **Federal Reserve System (the "Fed")** policy over the longer horizon.

Monitoring Tariff and Weakening Economic Data

On the other side of the ledger, the most visible economic headwind is the **tariff shock**. U.S. tariffs have surged to 17.4%, the highest sustained level since the 1930s, introducing a clear inflationary impulse and a meaningful drag on growth expectations.

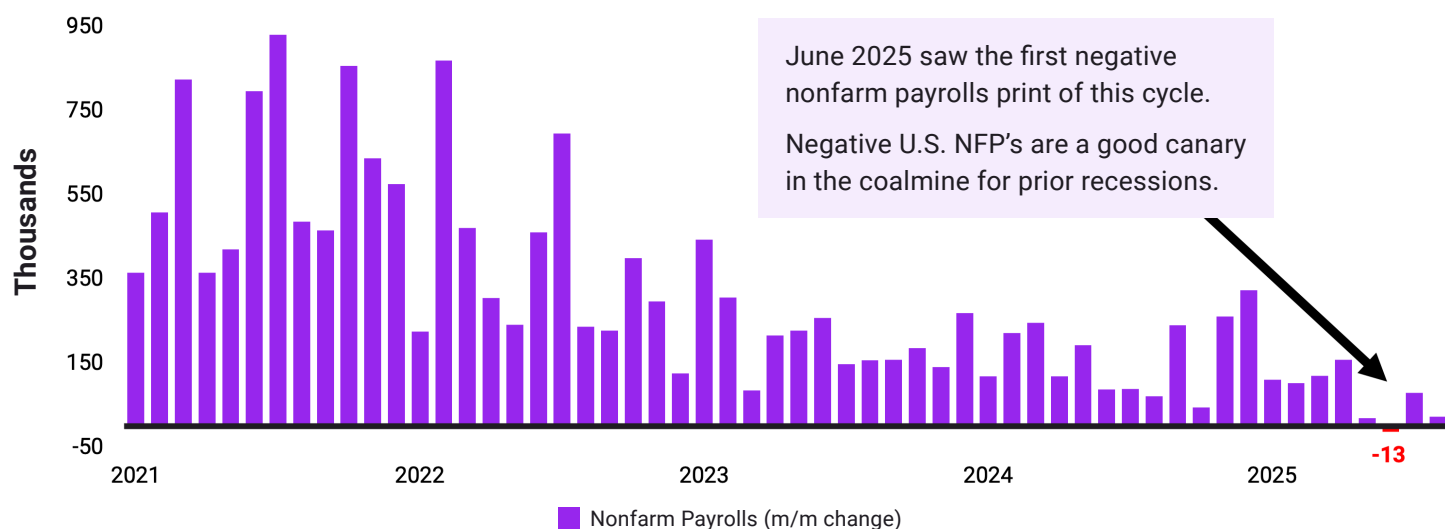


Source: Yale Budget Lab. Sep 2025. <https://budgetlab.yale.edu/research/state-us-tariffs-september-4-2025>

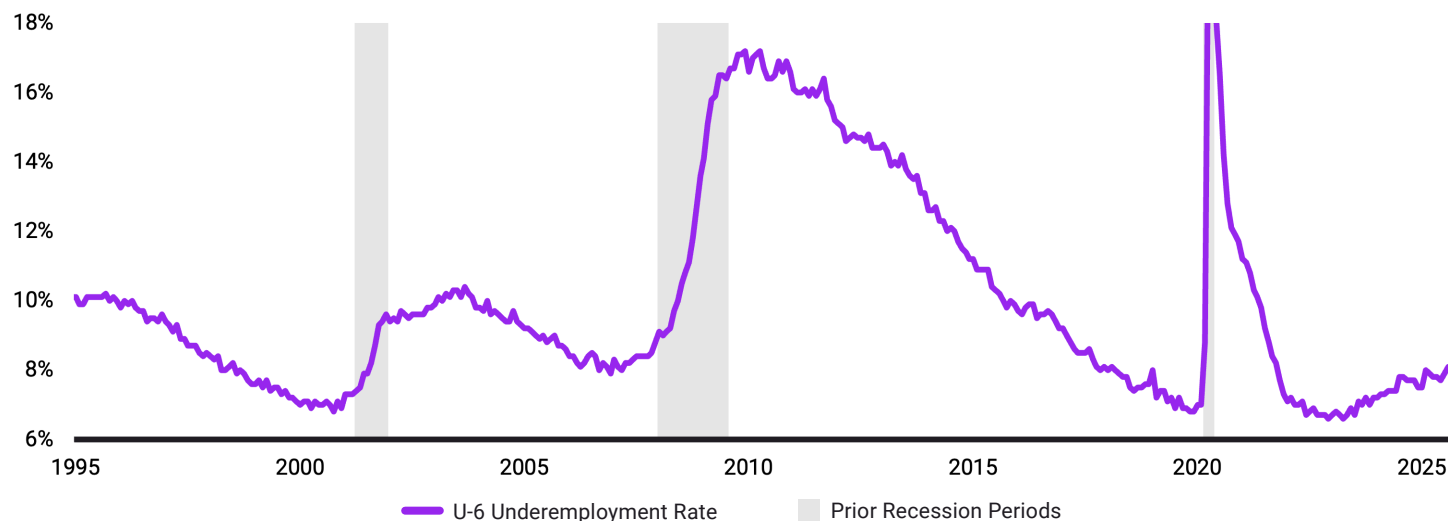
The inflationary impact of tariffs is now clearly feeding through the system. Higher input costs are contributing an estimated **1.7 percentage points** to consumer price inflation — effectively translating to a **\$2,300 loss in average household purchasing power** in 2025 U.S. dollars. If sustained, these tariff levels are expected to **shave roughly 0.5% off U.S. real GDP growth** over 2025 and 2026, creating a material headwind to economic expansion. Globally, the risk is reflexive: trading partners are likely to respond, raising the probability of broader trade frictions that could further disrupt global flows.

Labour data is also beginning to show early signs of strain. **U.S. Nonfarm Payrolls** have trended lower since the start of the year, with June marking the first negative print of this cycle — a pattern that has historically preceded downturns by several months. Meanwhile, the U-6 Underemployment rate (which takes into account all persons marginally attached to the labor force, plus total employed part time for economic reasons) reached a multi-year high of 8.1%. This softening may push the **Federal Reserve System** to lean more dovish, even as inflationary pressures persist.

Meanwhile, the Fed's latest **Beige Book** highlights that **consumer spending is flattening**, as wage gains struggle to keep pace with rising prices. Taken together, these signals point to an economy still resilient, but carrying more weight beneath the surface.



Source: Bloomberg L.P., Picton Mahoney Asset Management Research. Jan 2021 to Aug 2025.



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1995 to Aug 2025.

While inflation has eased meaningfully from its post-COVID peaks, it remains stubborn beneath the surface. Disinflation in goods has ended, and service-sector inflation — as reflected in the **Institute for Supply Management Services PMI Price Index** — has proven far more resistant, now hovering near 2023 levels.

Alternative data sources are reinforcing these trends. For example, Harvard's Data Lab shows imported and domestic goods across a number of categories are experiencing price increases. This may also indicate that there are more impacts of the tariffs that aren't showing up in official data sources. With tariff policy still in flux, there could be additional impacts if Trump goes back to a harder stance on China.

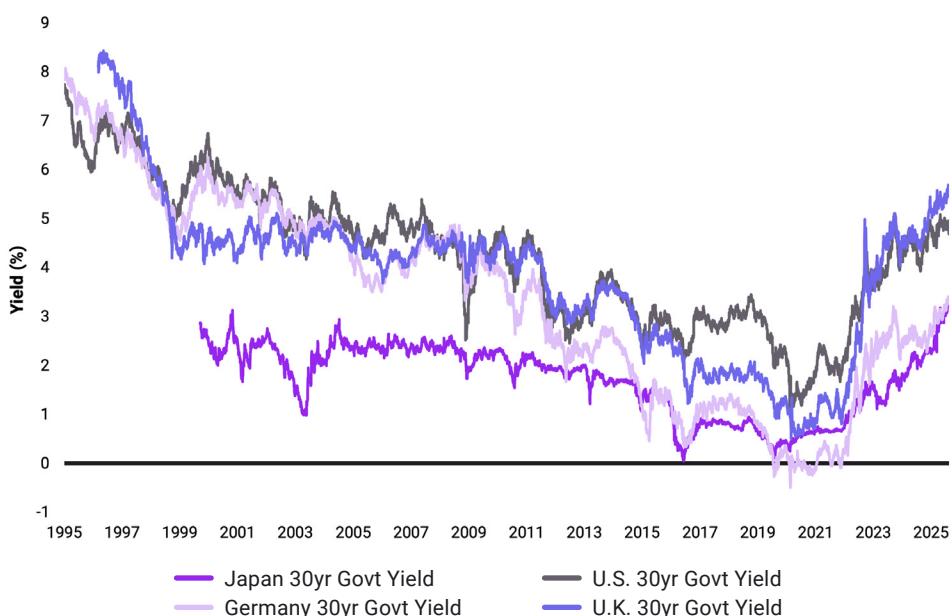
This dynamic has left the **Federal Reserve System** in a classic late-cycle policy bind: cut rates too quickly, and risk reigniting inflation; hold rates too long, and risk slowing growth further. Markets are watching closely, fully aware that how the Fed manages this balancing act will shape the trajectory of both risk assets and the broader economy.

Fiscal Policy and Political Challenges Weigh on U.S. Dollar

On the fiscal front, the U.S. deficit remains a critical consideration. The federal debt burden continues to rise, with interest payments now among the largest components of government spending. This dynamic is crowding out resources that could otherwise support growth in the near term and risks becoming a persistent structural drag over the longer horizon. Recent budget legislation has only deepened this trajectory. Projections show net interest costs climbing sharply by 2035, underscoring the growing urgency of addressing fiscal imbalances to preserve economic stability.

The combination of fiscal excess and political pressure on the **Federal Reserve System** is beginning to show up in markets. Gold prices are moving to new highs, and long-dated yields continue to drift upward, clear signals of investor concern over the potential erosion of U.S. fiscal credibility and, by extension, the U.S. dollar.

Importantly, these fiscal pressures are not confined to the United States. Elevated debt burdens in Japan, Europe, and the U.K. are prompting similar investor reactions. The rise in 30-year sovereign yields — with the U.K. reaching a 27-year high — reflects growing resistance to prolonged fiscal expansion and signals a more challenging funding environment globally.



The rise in yields reflects a clear market signal around fiscal sustainability and the growing risk of higher borrowing costs over time. Bond markets are effectively pricing in the consequences of “run it hot” fiscal policies, pointing to a more volatile and less forgiving environment for major sovereign borrowers in the quarters ahead.

Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1995 to Sep 2025.

Consequences of Covid-Era Policies Resurface

Moderate funding stress in overnight lending markets has emerged, which may push monetary policy to become even more accommodative. This could mean an immediate end to quantitative tightening, or something more drastic like a new quantitative easing program. Some consequences of historic monetary and fiscal largesse from years ago may yet to be felt in the plumbing of the financial system.

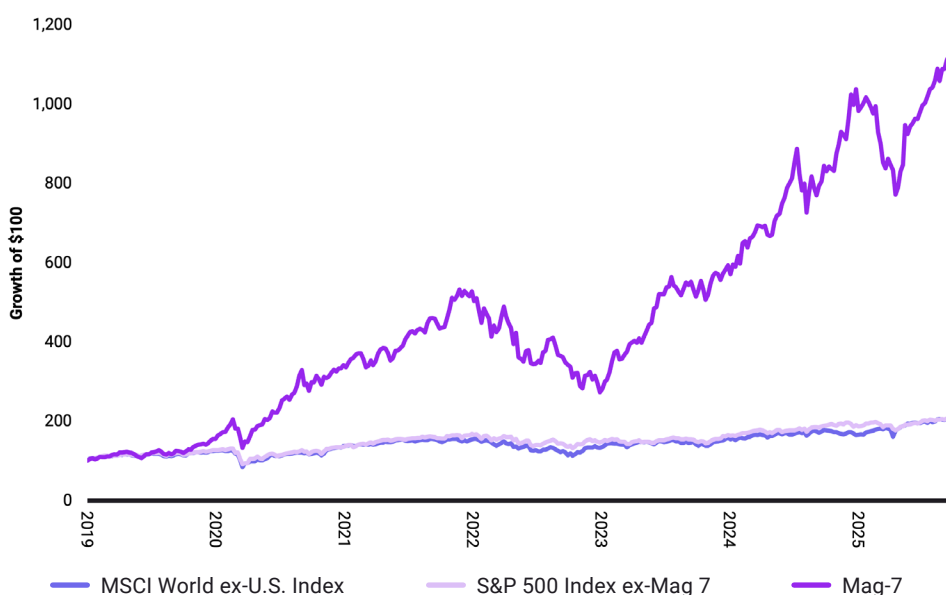
The heavy fiscal pace since 2020 required an enormous amount of government funding, mostly in the form of Treasury Bill issuance. Post-pandemic, the Fed dramatically expanded its balance sheet and has been slowly running it down via quantitative tightening since 2022. Both of these measures (quantitative tightening and net issuance) effectively pull liquidity from the financial system.

In the post-Covid era, there was so much excess liquidity that QT and net issuance impacts were easily absorbed, given the Reverse Repo Facility usage was as high as \$2.5T USD in '22-'23 and banks had excess reserves. Now that this offset has since been depleted and U.S. bank reserves are back to 2022 levels (\$3T USD) despite a larger economy, it is possible that the Fed will be forced to react (and perhaps too late) to funding stress as we approach the end of the year.

There are no shortage of tools, both existing and yet to be concocted, that the government has at their disposal to address concerns about stress in overnight lending markets. However, this approach risks adding more fuel on the fire that could open a new chapter in the global debasement trade.

02. EQUITIES: STRENGTH BUILT ON A NARROW BASE

U.S. equities posted strong gains over the past quarter, but performance remains highly concentrated. Returns continue to be dominated by the so-called “Magnificent 7” (“Mag 7”) — **Alphabet Inc., Amazon.com, Inc., Apple Inc., Microsoft Corporation, Meta Platforms, Inc., NVIDIA Corporation, and Tesla, Inc.** — effectively splitting the market between a narrow group of mega-cap leaders and everything else.



This narrowing breadth raises questions about the durability of the current rally, particularly as growth becomes increasingly concentrated in a single segment of the market.

Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2019 to Sep 2025.
Past performance is not indicative of future results. Returns are presented for informational purposes only and are not guaranteed.

AI Remains the Defining Market Narrative

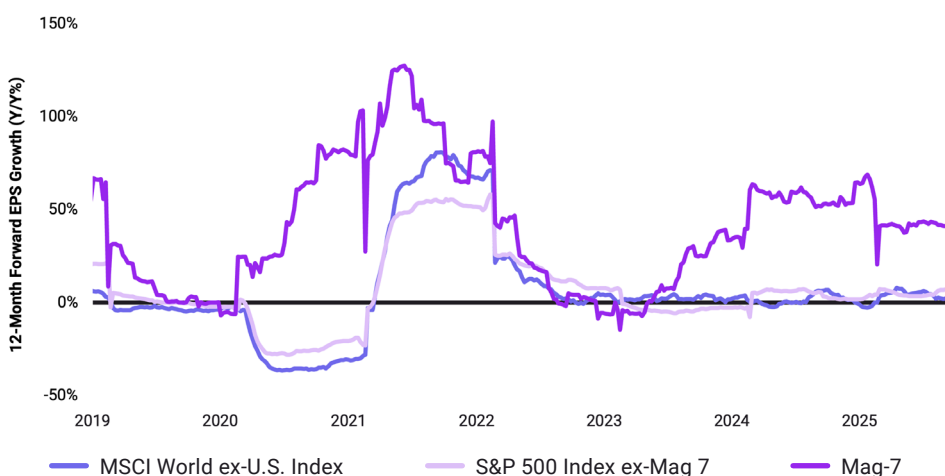
Additionally, the AI theme continues to drive performance across multiple sectors, including technology, industrials, materials (notably uranium), and even utilities. This can certainly be viewed as a positive structural trend; however, the risk of concentration needs to be kept in mind.

Valuations remain at historically elevated levels on several measures:

- **Cyclically Adjusted Price-to-Earnings (CAPE)** sits around 39 — among the highest readings on record. Historically, CAPE levels in this range have tended to precede lower long-term return profiles.
- **Equity Risk Premium (ERP)** is at approximately 0.7%, a multi-decade low. This indicates that investors are being compensated only marginally for assuming equity risk relative to risk-free assets.

Together, these factors signal a market environment where expectations are stretched and the margin for error is increasingly narrow.

Looking beneath the headline strength, earnings momentum tells a different story. The **S&P 500 Index** excluding the Magnificent 7 and the **MSCI World Index ex-U.S.** show **nearly flat year-over-year 12-month forward EPS growth**, reflecting a broader backdrop of muted fundamental improvement.



This divergence increasingly positions the Magnificent 7 as a **de facto asset class of their own** — one where growth expectations and market behavior are decoupled from the rest of global equities.

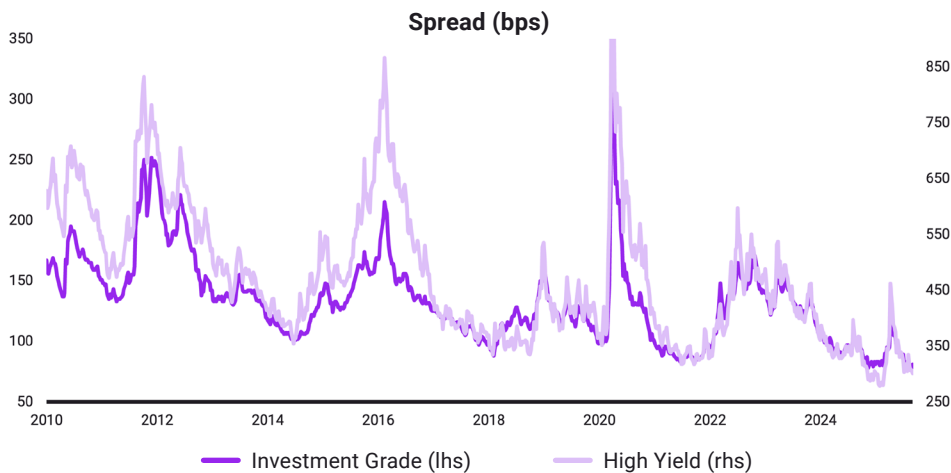
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2019 to Sep 2025.

03. CREDIT: SUPPORTED BY POLICY, PRICED FOR PERFECTION

Credit markets delivered strong returns in the third quarter, supported by a meaningful decline in policy uncertainty and a dovish shift from central banks. As labour data softened in both Canada and the U.S., the **Bank of Canada** and the **Federal Reserve System** found sufficient room to cut policy rates for the first time in six and nine months, respectively.

However, this easing bias, combined with sticky inflation and elevated fiscal deficits also increases the likelihood of further steepening at the long end of the curve.

Credit inflows remained strong through the quarter. While primary issuance was healthy, investor demand continued to outpace supply, leaving excess cash on the sidelines. This dynamic pushed spreads tighter across both investment-grade and high-yield markets, returning to levels last seen in the first quarter of 2025.



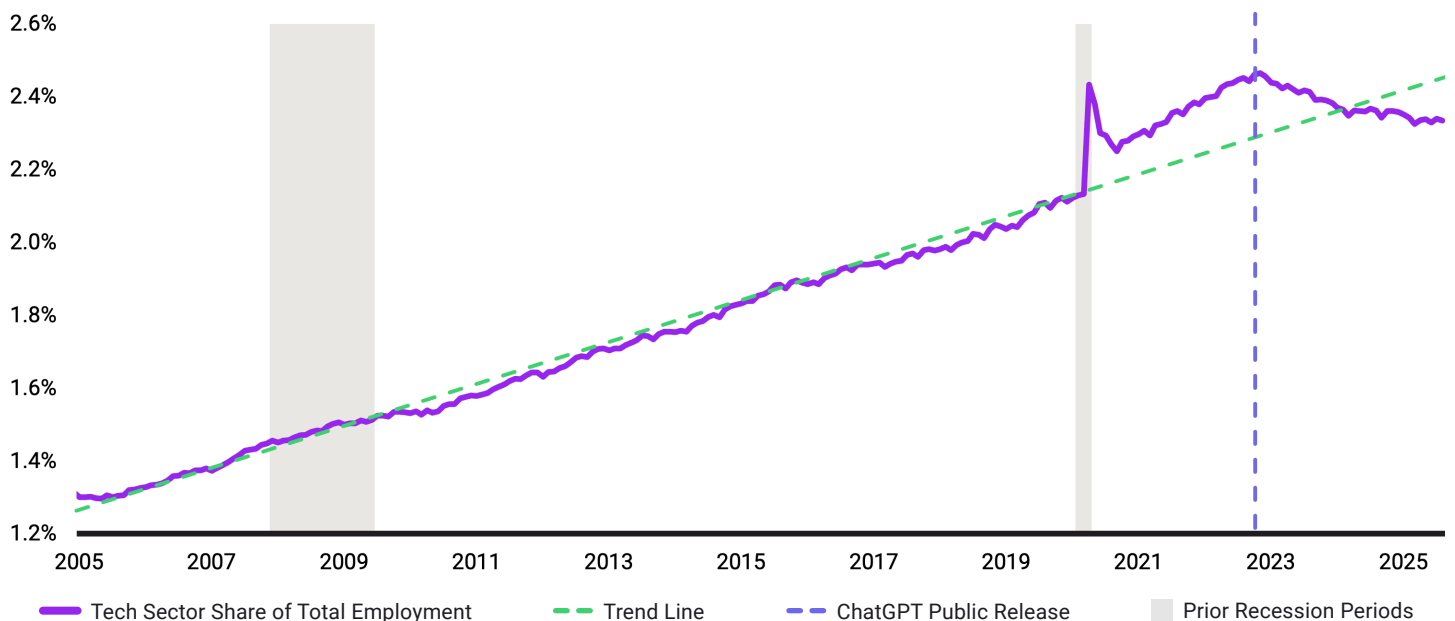
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2010 to Aug 2025.
Investment Grade is represented by the ICE BofA US Corporate Index.
High Yield is represented by the ICE BofA US High Yield Index.

Nonetheless, credit valuations remain expensive, and macroeconomic risks are building. Against this backdrop, a more defensive posture appears warranted. With the path for rates still uncertain — particularly at the long end of the curve — shorter-duration credit continues to offer a more attractive risk-reward profile.

04. SHORT-TERM CAUTION: INNOVATION MEETS FRICTION

The impact of AI on global markets has been substantial and is expected to remain a powerful driver of growth. AI-led capital expenditure in data centers and information processing has surged in recent quarters. In the first half of 2025, this wave of investment **matched household consumption in the U.S.**, marking the first time in history that technology investment has contributed as much to GDP growth as consumers.

At the same time, the rapid diffusion of AI is creating a **potential structural labour shock**. Estimates suggest that roughly **20 million U.S. jobs or about 10% of the workforce, could be at risk of displacement** within the next five years, particularly in warehousing, delivery, and trucking. For context, that scale of job loss is comparable to the **peak of the COVID-19 downturn** and could exceed losses during the **global financial crisis**. Unlike cyclical layoffs, these shifts are more likely to be permanent, with early signs of pressure already visible in segments of the tech labour market, particularly among younger workers.



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2005 to Sep 2025.

Q3 2025 reflected a clear tug-of-war between **short-term economic strength** and **emerging long-term risks**. Easing financial conditions, improving manufacturing data, and targeted fiscal support have provided a constructive near-term backdrop. But rising tariffs, sticky inflation, and early labour-market softening are clear signposts that the cycle is carrying more weight beneath the surface.

U.S. equities have rallied strongly, powered almost entirely by the “Magnificent 7,” leaving broader markets stagnant and valuations stretched. CAPE ratios sit near historic highs, and equity risk premiums remain compressed, offering little margin for error. Meanwhile, the AI boom is driving investment and productivity, but it also carries the potential for significant structural labour disruptions over time.

Against this backdrop, **short-term caution is warranted**, even as global fiscal and monetary stimulus could provide a tailwind into late 2025 and 2026.

Disclosure

**The Beige Book is a report produced and published by the Federal Reserve. The report, referred to formally as the Summary of Commentary on Current Economic Conditions, is a qualitative review of economic conditions. The Beige Book is published eight times each year before meetings held by the Federal Open Market Committee (FOMC) and is considered one of the most valuable tools at the committee's disposal for making key decisions about the economy.*

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