



**[00:00] [Kevin Minas] [KM]** In this episode of The Art of Boring, I sit down with Stu Morrow to go over what happened in Q2. Markets were hit by geopolitical shocks, diverging central bank signals, and a rally that looked strong on the surface but was driven by a very narrow set of themes underneath. We unpack what happened across Canadian markets and in the global context, and more importantly, the implications for investors' portfolios.

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**[00:48] [KM]** The end of another quarter, certainly a lot of volatility. Nice to see you, Stu, looking forward to the conversation.

**[00:54] [Stu Morrow] [SM]** Yeah, me too. Lots going on, lots to talk about.

**[00:56] [KM]** Why don't we start with Canada? We saw a decline for two straight quarters in growth, so technically a recession, maybe not a true recession, but nevertheless we did technically trip the recession wire.

The TSX, I should say, did quite well but did lag global peers. Commodity producers sold off a bit. Why don't we start with what's going on in Canada, if you could walk us through what happened in the quarter?

**[01:21] [SM]** Yeah, sure. It's the definition of a technical recession. In the first quarter, GDP contracted for the second straight quarter but did rebound in the April numbers with about 0.5% month-over-month growth, which was on the stronger end of the last nine months. You had seen 14 out of 20 industries expand. So by quarter end, and a little after that, the recession label was a bit backward-looking. If you dig underneath the surface, the headline GDP, if you looked at it on a per capita basis—adjusting for some deflation in population—GDP actually grew on a per capita basis, 0.9%. That shows there's still some underlying demand there that's intact. It may have met the technical definition of a recession, but it doesn't exactly look or feel like a typical one. So maybe closer to a stall-speed economy than a contraction.

And on the TSX itself, in the quarter, in Canadian-dollar terms, it returned about 7%. So I'd say a fair absolute return for just a three-month period, but that certainly paled in comparison to some of the global equity markets, which were powered ahead by the AI theme, which we'll talk about. The TSX didn't have a lot of that exposure. It has more exposure to the materials side, and, as you mentioned, gold and mining stocks did give back a bit. The price of bullion came back from its high in the prior quarter. So, back to your question: how can stocks rally



while the economy looks like it's stumbling? We wrote a paper on that last September. It was titled [Deciphering the Disconnect Between Markets and the Economy](#). We explained how markets can be forward-looking, usually pricing in that recovery or downturn before it shows up in the macro headlines, whereas some of the data, like GDP itself, is backward-looking.

One other thing I'd say is that the makeup of a stock market index could look different than the composition of the industries that contribute to GDP and the economy. In Canada's instance, on the index side, we're pretty heavy on financials and energy, which dominate the index. And in the real economy, it's real estate and healthcare. Those are meaningful parts of GDP, but they barely register on the TSX. So often, when there's a disconnect, it's sometimes a reflection of just what the index does and doesn't capture.

**[03:36] [KM]** I hadn't really thought about that on the real estate side. I guess a lot of private investment, and on the healthcare side, a lot of government spending, which contributes to GDP but isn't going to be reflected in the stock market. It is good to hear, at least, that we had some GDP per capita growth, which from what I recall had been on a pretty poor downturn for quite a while. So it's nice to see there was at least a bit of an uptick there, although, to your point, it was probably more a function of the number of people as opposed to growth. But at least it was moving in the right direction.

**[04:02] [SM]** And some of those numbers, too, they're within some margin of error. The technical definition of a recession—down 0.1%—is within that margin of error, so it may not be. Keep an eye on that going forward, for sure.

I was going to say, I woke up this morning, I was driving to work, and I noticed the price of gasoline changed right before my eyes. It really prompted me to turn on CNBC and turn off the music I had on. And lo and behold, it seems like the war is back on.

We've seen the price of crude back up a bit higher this morning, at least at the time of recording. Thoughts on how this has been playing out? We've probably gained some insights on how to think about positioning for geopolitical risks in the last six months, but there's a lot going on. I don't know what your thoughts are on the latest developments.

**[04:48] [KM]** Yeah, up until this morning I would have said there have been two phases of what we've seen in terms of the geopolitical issues in the Middle East between Iran and the U.S. As you alluded to today, there's arguably already been three phases, and I'm sure by the end of this conversation we'll already be in a fourth. So let me give a summary of what's happened over the last few months, and then we can get into what's changed.

The first big phase was the shock: the initial outbreak of war, around late February. That certainly impacted markets in Q1, but it really did spill over into April.

As far as it relates to commodity prices, oil in particular, you had a spike. I think it peaked around \$120 a barrel, so a very big move there. The Strait of Hormuz, this bottleneck for global energy and a bunch of other commodities too—but certainly energy being probably the most important—was effectively being shut down.

And so that fed into inflation expectations. At the end of the day, energy itself, the price of the commodity, is



highly impactful for inflation, but it's also feedstock for other goods and services being produced. And so, to your point earlier about the market looking ahead and trying to factor things in, the market moved pretty quickly to a more hawkish expectation on interest rates.

In other words, an expectation for greater volume and faster interest rate hikes by central banks. In Canada's case, that's a tough position for the Bank to be in, because—as we've talked about in the last few quarters, and certainly the conversation you had about the technical recession—things are weaker here. And you've got inflation.

I think we talked a lot last quarter about stagflation as a risk, and this is a potential realization of that risk. So that was the first phase.

The second phase was really the reversal: towards the end of the quarter, you've got odds of a peace agreement.

Odds were starting to improve, with this memorandum of understanding between the U.S. and Iran to have a 60-day ceasefire—which, as of this morning, is potentially in question now with some of the statements President Trump has made, and I think a re-engagement on the military side. Nonetheless, at the time in June that was seen as pretty constructive for the markets. Oil really sold off, going from that \$120 a barrel to around \$70.

That's moving around a lot today. I think we're at around \$75, maybe a bit higher than that. So it has moved off the lows, but still quite a bit lower than peak.

And so you had a big unwinding of that inflation fear. Gold, to your point as well, gave back some of those gains. It tends to be an asset that, when there are a lot of inflation concerns, is usually seen as a safe haven.

For us, the big takeaways—and this one's almost dated in some ways, but in some ways it's also been reinforced—is really that the risk has not disappeared. It's eased. This conflict is not done, even when it does hopefully come to some conclusion.

There's always the risk of re-engagement, whether it's here or in another area of the world. So that, I think, is the first takeaway, and we're seeing it this morning. The second is a good reinforcement of some of the benefits of having commodity exposure in portfolios.

I know we're sometimes seen as being less inclined to invest in commodities, and I think that's a fair assessment from clients and others in the industry. But we certainly do have some exposure. And maybe the nuance people sometimes miss is that there are periods where we have a lot of exposure, even more than the benchmarks.

Over the last couple of years, we've ticked up our exposure, both on the energy and the mining side, in most of our portfolios. And I think the role that it plays—whether you think about geopolitics, but even inflation concerns, fiscal strains, that global fragmentation we're seeing, not just in the last few quarters but really over the last number of years—that still holds.

So, we need to make sure we're looking at stocks from a bottom-up perspective. But when you're doing that bottom-up work, these macro themes do ultimately feed into commodity producers when you're doing your



assessments of them. That, I think, was really reinforced.

And the last one is that geopolitical risk is looking increasingly like a baseline condition investors have to consider. I certainly would have said, and maybe you would have as well, that these are tail events we're seeing right now. But when you keep seeing them happen, quarter after quarter or year after year, it's not necessarily all that much of a tail position anymore.

So, we're certainly not getting into the forecast of trying to call the outcomes of these things—when exactly they'll start or end, or what the situation will be. I don't think we have any special edge there. But we need to factor in that this is more of a potential reality, and there's a wide range of outcomes.

When we're constructing portfolios, it's important to make sure we have some exposure on the commodity side. Assuming the valuation works and the quality of the business and management team is there, there are certainly some portfolio construction benefits, I think, to commodity exposure.

**[09:21] [SM]** It's not easy. The de-escalation, escalation, like you said, could be different by the time we finish recording this. For central banks, it must be even more difficult to drive changes in levels of interest rates, or changes in expectations of interest rates, or to guide markets.

You mentioned the Bank of Canada, and there have been other central banks moving on interest rates, some of them potentially diverging from what the Fed is doing. I don't know what your perspective is on that and on the Bank of Canada, but maybe some background on what other central banks have been doing at these crossroads.

**[09:57] [KM]** Yeah, it's definitely been a quarter of divergence as far as central bank activity. To your point, they've certainly been moving in different directions. In Europe, the ECB did raise rates in response to some of these inflation concerns.

They're a bit more sensitive to energy prices, given that a lot of the energy inputs they use come from the Middle East and other regions. They're not necessarily large producers across Europe generally. The Bank of Japan also continued normalizing rates in the quarter, as they have been for the last little while, which is a pretty big shift from the decades preceding the last few years.

Domestic conditions have continued to support higher rates—basically a return of some level of inflation and decent growth. And in the U.S., they stood pat. The bigger news there was less around rate movements and more the new Fed chair, Kevin Warsh.

His initial message was arguably a bit more hawkish in tone: more of a focus on fighting inflation, making sure it's not persistent, less reliant on forward guidance. But I think it's probably understandable that he would come out hard out of the gates. There's a perception of potentially some political overtones to the appointment.

Would he be soft on rates, because that's what President Trump wants? So you could understand why he'd come in a bit heavier on the hawkish side, notwithstanding what's going on. But I do think the current circumstances warrant that approach he's using right now.



So I think that's fair game, but ultimately the Fed didn't move. And similarly, the Bank of Canada didn't move either. There were two meetings, April and June. They had cut rates quite a bit at this point, so the economy was already relatively supported in terms of monetary policy.

And as I was alluding to earlier, you have, on the one hand, these inflation concerns or fears that we saw earlier in the quarter, offset against this softening economy. That's a really tough spot to be in if you're a central bank.

In terms of how we were positioned, or how we were thinking about all this in our Canadian bond strategy: ultimately, we were naturally concerned that higher energy prices would feed into inflation, all else equal. That would force the Bank of Canada off the sidelines.

At the same time, though, as energy prices were going up—and if they stayed up for a sustained period of time, which obviously they haven't now, but if they had stayed relatively high—that has a bit of a knock-on effect, or a disinflationary force potentially. If it's enough inflation to actually slow down growth, because you ultimately crowd out other spending, you can only cut your energy consumption so much, so you only have a certain amount of dollars at the end of the day.

If you're spending more on energy, maybe you have to spend less elsewhere. And so that can have a disinflationary impact. Governments around the world stepped in and did have some sort of relief policies, basically to give some relief to consumers.

In Canada, we saw that in the form of relief on the gas taxes. And ultimately, we thought that was a reasonable response. With that bout of inflation, you saw yields moving all over the place.

As yields sold off—in other words, yields went higher—we tactically added some duration to the portfolios. And then as yields came back in, when markets thought, OK, the inflation figures have gone away again, we took off the duration position. So, a good example of where there are opportunities to tactically trade around some of these things, especially on the fixed income side. The more volatility you get in the rate space, the more you can make some of those adjustments in the portfolio.

**[13:10] [SM]** The new Fed chair—I took away from some of that, at least the first press conference, that there are a lot of task forces, many tasks to do. It's kind of interesting. But there's also this underlying tone of changing the communication style, the tone of the Fed to the market. Is the bond market figuring that out? Or have they figured it out?

**[13:30] [KM]** I think it's pretty early still to say that there's a good read on it. That's certainly the message that was delivered. But I think it's pretty early to say, as I was alluding to earlier, how much of this is just jawboning, or wanting to set a precedent now, especially with all the political undertones that have been focused on the Fed and the previous chairman.

That's my read. Frankly, I think we need more evidence before we can have a more conclusive say at this point.

So we've spent quite a bit of time on the fixed income and macro side of things. Why don't we talk a bit more about the equity landscape? I feel like we'd be remiss having a podcast over the last couple of years without



talking about AI and the CapEx.

And I feel like we should probably cover that now. In the quarter, we saw a lot of announcements about continuations of that CapEx spend by the hyperscalers, memory stocks doing very well, and emerging markets putting up their best quarter in the last 15-plus years. So, what's your read on what's happened there?

What's the team thinking around this AI buildout? Are we getting to the point where there are maybe concerns around overcapacity? And then EM specifically. What's been going on there, particularly given the level of exposure to semiconductors?

**[14:42] [SM]** Yeah, an extraordinary period, where we've gone through this capital-light period in the economy to now more capital-intensive. And the numbers that are thrown out there—you take a look at Amazon, Alphabet, Meta, Microsoft, and Oracle at \$750 billion-plus this year, up from \$400 billion or so last year, headed towards \$900 billion in 2027—are extraordinary numbers. A real shift from what was asset-light to capital-intensive.

And I don't know if you can draw a line today between what's going to be a transformative buildout and what's overcapacity. I'd be skeptical if anyone says they could. But the CapEx is real. We know this. The earnings behind it are real, being funded by cash-generative businesses, not just leverage and hope, which is different than past cycles. But at the same time, there's this widening gap between the performance of those names along the stack: those who are spending on the AI buildout and those who are capturing the revenue side of the buildout.

There is a risk of overcapacity; at the same time, there's a risk that this could be very early days and still has a lot more to go—call it a cycle or super-cycle. That's the framing we used on the last [Art of Boring podcast with Paul](#): you can't just eliminate those risks, you can choose which ones you're going to tolerate.

And memory specifically—memory stocks are one example. Where you think about what's priced in, or what the price-to-earnings ratio is today, the risk isn't necessarily in the P, it's rather the cyclicity of the E. In other words, the earnings themselves might not be as durable as the current pricing models assume. And that's the real risk or question mark—not really what multiple you're paying, whether it's cheaper or more expensive today.

So for us, it's trying not to call a top or a bottom, or get into that debate, but to continue to measure that overall net AI exposure in portfolios, so we're not levered to one side of that potential outcome. And practically, that's meant trimming names over the quarter. Like the headline memory names, which have run pretty far, pretty fast, and some other businesses—trimming those, hitting those businesses where we think the valuation has gone beyond, or the current price is beyond the current valuation, and staying invested in those where we still see value. I think it all goes back to: yes, there have been some real short-term winners and perceived losers, but for us, given the portfolio, given the volatility in the market, there's a tension that exists between being concentrated and overexposed and being diversified.

Those two things are quite different right now. And we're in this market being driven by this narrow set of AI-linked winners—semiconductors and memory stocks, like you said, in the last quarter or last six months—versus this diversified portfolio going against a benchmark or an index. I don't think it means diversification is wrong.

I think there's a trade-off there. Concentration does help relative returns in a rally like this, and diversification



helps resilience, maybe when those names pause or reverse. And maybe we've seen a bit of that in the short term in the last few days, in the first part of the third quarter. We can't get both, which is why we stress that risk management can look disappointing in the short term in a quarter like this, perhaps just on a relative basis—trimming names, rebalancing, all of those right decisions that you do, holding names outside of the hot theme that are on the field, but on the bench as substitutes.

All of that can feel like it's costing you in the short run, but it's really valuable over the cycle, which is important for investors to keep in mind. And it's not us ignoring what's changing in markets—it's really building portfolios that can survive multiple outcomes. We've talked about a lot of things: AI enthusiasm, geopolitics, inflation, rate changes, sentiment change. It's a lot of uncertain days, so I think portfolio construction and process matter quite a bit right now. One thing leading off of that—talking about hyperscalers and names around the technology stack—they've, of course, been borrowing to build out this infrastructure they're going through. Not just what we've seen on the equity side, but also on the debt side.

Thoughts from you on the quarter? Anything that stood out in credit markets? How have spreads behaved? How is this supply being absorbed?

**[18:57] [KM]** Overall, it was a constructive quarter for the credit markets. Returns were generally solid. Spreads stayed quite contained, at least from the beginning to the end of the quarter. There was obviously some volatility in between, given the geopolitical issues we talked about earlier, but beginning versus end, spreads were quite tame. You got your coupon. It was a pretty healthy backdrop overall. But to your point about hyperscalers, that was certainly noteworthy in the Canadian market. We saw both Amazon and Google come to the Canadian investment-grade bond market for some pretty sizable issuances—actually record-breaking, particularly in the case of Amazon, where they did a \$14 billion five-tranche deal.

Both deals were well-subscribed or oversubscribed, which means there was a much bigger order book than there was available debt being issued. In the case of the Amazon deal, investors got close to full fills, meaning there was only just slightly more of an order book than there was supply. That's not totally surprising, given the size of the deal. But it also came after the Alphabet deal, which perhaps indicates that there is a boundless appetite for new credit, especially given the size of the deals. But they were both quite attractive. We participated in both. The spreads were decent, I think, considering the quality of the businesses—they were single-A-high and AA credits. There's not a ton of that exposure in Canada, particularly not in IT.

So you're thinking, okay, you get decent spread, you've got high-quality businesses with very strong balance sheets. Yes, there's a lot of CapEx being spent and the revenues aren't necessarily all there yet. So that would obviously be the main counterpoint, but certainly very good businesses with lots of liquidity. We thought the deals were still quite attractive ways to diversify the portfolio. That was really the big theme in the quarter for credit markets. That was certainly newsworthy. But ultimately, credit continues to chug along. Spreads do remain very tight. I know we've been talking about that for years at this point, but it remains true. So investors aren't necessarily getting a ton of compensation for going out the risk curve. We participated in relatively shorter-dated positions.

And to the extent we have a small overweight in credit in our Canadian bond strategy, and then of course global credit, which is predominantly credit, we tend to be in higher-quality, shorter-dated securities. We continue to



have that positioning just because you're not getting paid to take on incremental risk, but the all-in yields are still relatively attractive in the shorter end of the curve. So that's where we're at today.

**[21:19] [SM]** Nice. Yeah, it's a good rundown.

**[21:21] [KM]** We've covered equity, we've covered fixed income, we've covered the macro. I think a nice thing to always end with is what we did on the asset allocation side within the quarter. Lots of turbulence in the markets, as we've talked about already, given some of those concerns and volatility—and perhaps there was opportunity as well. What did we do on the asset allocation side in the quarter?

**[21:40] [SM]** Yeah, so briefly, a few deliberate shifts stood out in the quarter in the balanced strategy. As we talked about, equity markets ran pretty hard.

We trimmed some of that strength back into fixed income to bring portfolios back to where their intended asset mix should be, rather than letting that equity strength passively drift higher. We kept a preference for international equities and emerging market equities over the U.S., given still more reasonable relative valuations, and given where our U.S. equity strategy is actually positioned with a lower weight towards the most concentrated AI leaders at this point. That acts as a partial hedge if that group of stocks does start to lose momentum or steam going forward.

Within each strategy, as we've talked about a bit here, we've been actively trimming positions that had run pretty hard, very fast—those that are ahead of our valuation bands—and taking that capital and recycling it back into names that have better risk-reward.

Overall, positioning strategies back towards more of a neutral stance in the quarter.

**[22:46] [KM]** Awesome. More of the somewhat boring approach to asset allocation, where you trim your winners, redeploy, and keep your risk relatively balanced. I think it's a proven approach over the long term. I think that's a good point to leave off on. Nice talking to you again, Stu, and looking forward to the conversation next quarter. Thanks again.

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#### **Companies Mentioned:**

Amazon

Alphabet (Google)

Meta

Microsoft

Oracle