



Wealth Management  
Dominion Securities

Cooper Wealth Management of  
RBC Dominion Securities

# Thoughts on the market

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RBC Dominion Securities Inc.

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## My Favourite Season



“It is possible for an old, overweight ball player to tag a fastball for a pinch hit home run, but you don’t change your lineup because of it.

- Warren Buffet, Legendary Investor

Fall is upon us, to the delight of nature lovers and North American sports fans. You can enjoy a drive to see the fall colours and watch baseball, basketball, football and hockey in the same weekend. It is also the time of our favourite season of all: third quarter US earnings season. The 3rd quarter earnings reports tell us two very important things: 1) Have companies continued to trend positively or has there been a setback and 2) the 3rd quarter report can provide vital clues to what is in store for year end. Here’s how it works. If a company’s 3rd or any other quarter was below expectations, there is a stronger possibility that the 4th quarter will contain all available write offs, a “kitchen sink “ quarter as it is known, and that earnings will likely disappoint for at least another quarter. This month, we will focus on US corporate earnings and our expectations moving forward.

One of the key performance measurements for any S&P 500 CEO is share price appreciation. The higher the stock price, the larger the payout, which usually comes in the form of stock options. However, if your company is having a bad year, why not clear up any potential problems on your balance sheet? This will lower analyst expectations for the coming year and therefore make it easier to attain your targets the next year. For the executives of the company, this strategy has paid off over time but for the shareholders, it often means 6-9 months of little to no returns, even longer if the business does not immediately improve. A weak third quarter can be a strong sell signal but there are other factors to evaluate.

An important consideration is the company's current valuation. Let's use the specific example of Canadian Natural Resources (CNQ). From a shareholder perspective, the stock has disappointed, down \$1.63 year to date, despite record production and increased profits. The chief source of weakness has been the price of oil, currently at \$62.10 US per barrel. The company has indicated it would still be profitable down to \$40, which indicates they currently have an over 50% profit margin on their products. If CNQ posted weaker 3rd quarter results, would we be sellers? The short answer is no. Trading at an 11x price earnings ratio and with a healthy 5.38% dividend yield, we would look to be buyers rather than sellers on any short-term earnings weakness.

The good news is that the earnings season is off to a fine start. JP Morgan led the way with an earnings beat and raised guidance, which is a great sign for the economy. So far, 86% of reported issuers have surpassed earnings expectations. Banks are definitely stronger when interest rates begin to decline, but for a better insight into the economy, we need to look at a company that sells big ticket retail items to see if the US consumer continues to spend. We need to look no further than General Motors quarterly report for our answer. GM posted their best sales and profit numbers in many years. Coca-Cola also beat analyst estimates, another good indicator that the US consumer is doing well and not yet switching to generic brands.

At the moment, earnings information from these companies is the only source of information available about the US economy as the US government shut down enters its fourth week with no end in sight. The Democrats are standing firm, seeking increased funding for healthcare and there have been no concessions from the Republicans. The US House of Representatives is not even in session, apparently unwilling to certify a new Democratic member. The situation remains a mess, but the US economy and the stock market have continued to prosper, despite the absence of US government data.

Fortunately, the Government of Canada is still in business and producing statistics. The annual inflation rate came in at 2.4%, driven higher by gasoline, travel and groceries. The economy generated a solid 60,000 jobs in September, which kept the unemployment rate at 7.1%. Canada's GDP grew by 0.2% in July, the first increase in four months as mining, energy and auto sales all improved. August fell back to zero growth, but September's data is expected to show improvement. The rising inflation did give the market a moment of worry as there was concern that the bank of Canada would pause interest rate cuts until inflation came back down. Given the anaemic economy at the moment, we expect the bank to continue cutting rates for now. Much of the Canadian economy seems to be holding its breath until a new Canada/US trade deal is announced, and once this happens, we expect the Canadian economy to improve. Canadian stocks have held up quite well, largely driven by financials and gold. Our preferred shareholdings continued to deliver above market yield while still having room for further price appreciation as interest rates come down.

Among our portfolio holdings, we don't see any major warning signs for this quarter's earnings. National Bank could experience a weaker quarter if ongoing integration costs of their Canadian Western Bank takeover are unexpectedly high. Our other bank holdings should again have strong earnings as loan loss provisions have been coming down. One area of potential profitability concern will be their mortgage businesses. As interest rates come down, variable rate

mortgage holders will be paying less and people who can renew their Covid era mortgages will be getting much lower rates. We expect this decline will be more than offset by other lines of business within the banks, but it will be something we are watching. Canada's energy stocks have been weaker than expected this year due to low price of oil. These stocks are in two categories: pipelines/midstream processors and producers. Generally, we own the pipelines for stable dividend income and producers for growth. As we highlighted earlier with CNQ, both categories have held their own, with share prices largely flat on the year due to the strength of their dividends. We expect both categories to rally in the coming year due to interest rate cuts, and hopefully a more stabilized world economy.

Another area that needs to be mentioned regarding US corporate earnings is the effect of the US dollar. During the second quarter, the US dollar fell from \$1.42 to \$1.36 Canadian. In the third quarter, the dollar climbed back to \$1.39. The US dollar moved similarly against all major currencies so we can use the Canadian dollar as an easy reference point. US multinational companies got a boost in the second quarter as international earnings translated into more US dollars and profit due to a weaker currency. The third quarter will be even more impressive than the last if the current pace of performance continues because companies will have had to overcome the currency headwind.

Our final quarterly discussion centres around stock repurchases. Stock repurchases by companies are now expected to reach a record \$1.9 trillion this year. Buybacks this year have already matched last year's total. This is the fourth consecutive year where the net supply of US stock has shrunk, given limited new issues and buybacks. This activity has been a tailwind for equity markets as companies have been using any weakness to repurchase their shares. On a further positive note, buybacks as a percentage of overall market capitalization are still below historical peaks, which suggests there is room for even higher level of repurchases, and therefore support for the market moving forward.

The weather may be getting cooler, but the third-quarter US earnings so far are keeping the market warm. As Fall moves on, we will continue to monitor earnings, and as year end approaches, we will be looking to realize any capital losses to offset capital gains and minimize taxes payable. Until next time, enjoy the Fall and stay well. Go Blue Jays!

As always, questions, concerns, comments, and feedback are always welcome.

Yours truly,

Walter, Trevor, Charles, and the Cooper Wealth Management team



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