



Wealth Management
Dominion Securities

Cooper Wealth Management of
RBC Dominion Securities



Thoughts on the market

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The first cut is the deepest... Except for interest rates



“The first cut is the deepest.”

- *Cat Stevens' song lyrics*

Cat Stevens' emotional ballad is about lost love, but one thing remains true as it relates to the stock market: investors love interest rate cuts. This past week, both the US Federal Reserve and the Bank of Canada reduced interest rates by 25 basis points, both sighting concerns about a slowing economy and stagnating job growth. In the past, the market would've moved lower on weak economic news, but in this era where the focus is on growing areas such as technology, interest rate cuts are particularly good news because growth stocks are valued by estimating future earnings and calculating a present value, using the current interest rate. The simple explanation is the lower the interest rate, the higher the current stock price should be, as future earnings have a higher value.

So why is the first cut important? One interest rate cut does not make a trend as it is only a simple data point. However, if more interest rate cuts happen, a trend begins, and the market gains momentum. This month, we will focus on North American interest rates and their projected impact on both the market and the economy.

As we have written in the past, the US Federal Reserve is in a difficult position, having to fight inflation on the one side and keeping the economy out of recession on the other. With a weak job creation report, as well as sharp reductions to the previous two months of reports, the Fed was finally forced to act. The market reaction was immediately positive, but soon after, Fed Chairman Powell sought to cool market enthusiasm by publicly stating that he thought stocks were “fairly highly valued”. It did work for a couple of days, but the positive market trend continues. The market also began to price in two further rate cuts for this year.

Normally, interest rate cuts are only used when an economy is slowing or under stress. However, the US economy is even stronger than predicted with US Gross Domestic Product (GDP) growing at an annualized rate of 3.8% for the second quarter, a significant upward revision from the 3.0% initially reported. If job growth is significantly slowing, and unemployment is rising, how is the US economy growing so quickly? The answer is two-fold: first, 70% of the US economy is service based. Despite inflation, demand for services has continued to grow, particularly with the ageing population. The baby boomers are all reaching retirement age, and this will likely increase demand for a wide variety of services, particularly healthcare. The second, and even more important factor, is the ever-increasing input of artificial intelligence (AI). AI is having a profound positive impact on productivity. It is influencing many areas of our lives already. Whether it is the friendly artificial voice you talk to at the call centre of any major business, to the software guiding a manufacturing process, to Netflix helping you pick movies you might like or even help you write an essay (but not this one!). AI is changing the world around us. The long-term effects on productivity are impossible to measure at this point, but as technology continues to develop, we could easily see where the economy could continue to grow but unemployment continue to rise. This makes the Fed’s job that much more difficult as cutting interest rate rates tends to further stimulate the economy, which could lead to higher inflation, which is the other fight the Fed may have on its hands.

The August US inflation rate was 2.9% annualized, up from 2.7% over the previous two months. This upward price pressure is largely being attributed to US tariff policy, but while tariffs are not helping, our greater long-term concerns are concentrated in two areas: housing costs, which will need lower interest rate rates to solve and service inflation, as a reduced workforce and increased demand for services in everything from restaurants to healthcare could lead to higher wages and therefore inflation. While the Fed can help with housing costs, they can’t control service prices, and therefore, inflation will likely prove difficult to drag down to their target of 2%, barring a change away from tariffs and increasing immigration to support demand. As we do not expect a radical change in the direction of US public policy, potential help in these areas is unlikely over the next three years, without a change of heart for the American electorate at the midterm elections next year.

In Canada, the case for interest rate cuts is even stronger. Canada’s GDP shrank by 1.6% in the second quarter as the government struggles with US trade policy. While the economy is starting to weaken, the Canadian stock market is hitting new highs, driven by financials and high-yield stocks in general, as well as gold and base metal stocks. The index performance of the TSX can be misleading as it contains a heavy weighting in junior, below investment grade companies, particularly in the resource sector, where a small price move can represent a large percentage gain. Gold has been the leader in the commodity space as investors and governments have added to their reserves, once again due to global trade uncertainty. We have added Agnico Eagle and Newmont for gold exposure, as we expect strong earnings and cash flow performance from both. As Canadian interest rates head lower, we expect continued positive performance from Canadian equities.

In fixed income, the Canadian 10-year bond yield is down to 3.19%. Given that inflation is hovering around 2%, there is no compelling case for long-term bonds at this point. However, for those of you who own preferred shares, they have rallied considerably since the April lows and continue to offer decent yields of 5.6% on average with the potential for prices to move higher as Canadian interest rates decline.

One area where we have seen a positive impact on inflation has been energy prices. The benchmark West Texas Intermediate price is currently at \$63.39 US per barrel. With the US administration actively encouraging drilling and Russian oil still flowing through India and China, there remains downward pressure on oil prices. However, US shale drilling is not economical at current prices, so we expect to see a slowdown in US drilling. Also, Russia is the number three oil producer in the world and threatened US sanctions against Russia could lower their output. In 2022, international sanctions kept the price Russia could receive on any oil shipped by sea to \$60 US. This low price has encouraged China and India to purchase even more oil and has kept Russia funded for now. Ironically, for the sanctions to have worked, the price should've been set at say \$200 so Russia couldn't export any oil, but humanitarian concerns for the Russian people makes this a nonstarter. The good news for Canadian producers is that our production costs are low compared to other international producers and profit and cash flow margins are still healthy, even at today's price level. We are maintaining our energy holdings and collecting the dividends in the meantime.

From the overall portfolio perspective, our focus remains primarily on technology and financials, as they are the biggest beneficiaries of today's market environment. So far, share price appreciation in these sectors has been matched by earnings growth, and we will continue to hold as long as this is the case. We also continue to remain diversified across multiple sectors to help reduce market risk. Portfolio highlights for the last month include Apple (+9%), Uber up (+6%) and Couche Tarde (+6%).

Low interest rates will definitely help both the economy and the stock market. Time will tell how many cuts there will be, as it is impossible to accurately predict given ongoing global affairs. However, one thing seems to be coming increasingly clear: many of the largest and fastest growing global companies have little need to borrow, and this is becoming the widening separation point between the market in the economy. For now, interest rates and earnings are heading in the correct opposite directions and the market continues to perform. Until next time, stay well.

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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