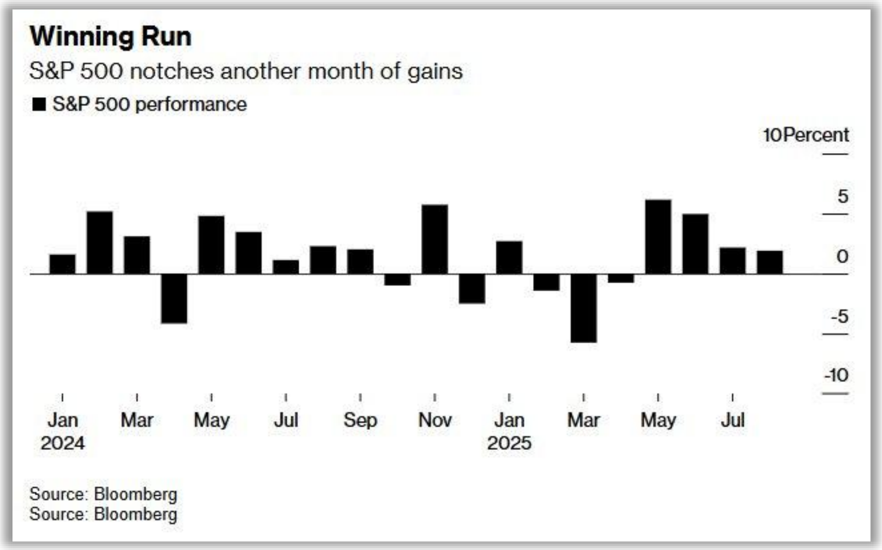
# **August Market Commentary** | Signals to Watch: Valuations, Fiscal Dominance Risks, and Gold's Warning Glow

Investors were rewarded with a quiet but profitable end to the summer. In August, the S&P/TSX gained +5.0% (total return, C$) and the S&P 500 +2.0%.  According to Scotiabank, only South Korea and India were in the red among major large-cap indices. For U.S. large caps, August marked the fourth straight positive month, bringing the S&P 500's four-month gain to +16.5%. While Canadian stocks are up "only" 16.0% over the same period year to date, the S&P/TSX is +17.6%, handily outpacing the S&P 500's 10.8% gain.

Not only are stocks performing well, but volatility is down – everywhere.  As highlighted by Société Générale, cross asset volatility has been declining for the past four months since peaking in May. Rising stock prices, falling volatility… just what vacationing traders want to see as summer winds down.

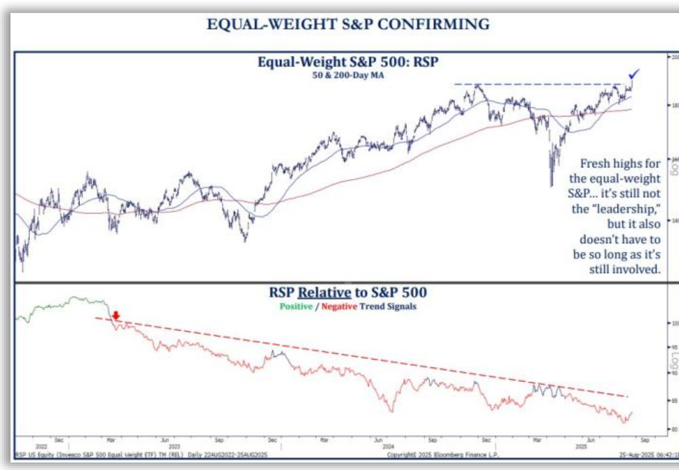


## Early signs of clouds on the horizon

As a recent Bloomberg headline warned, however, the summer calm may not last. August's returns were not driven by the usual leaders. Strategas notes that August was a month of rotation: the best performers through July were among the weakest in August.

The shift was confirmed by the outperformance of the equal-weight S&P 500 versus the cap-weighted index. This broadening could be good news, suggesting a more sustainable rally rather than the one driven by only a few big winners, like the Magnificent 7.

Investors appear less convinced, however. A late August survey conducted by the American Association of Individual Investors found there are more bears than bulls amongst the investing community.  Below, we look at some of the clouds forming on the horizon.


## AI and Big Tech under pressure

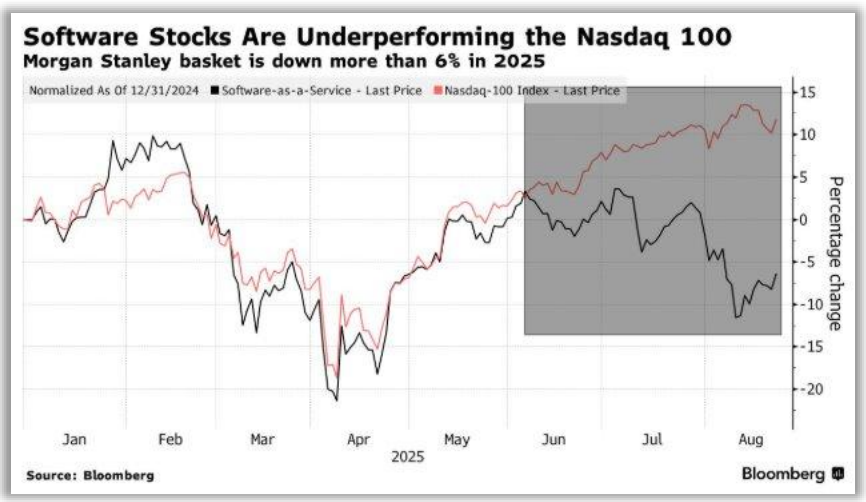
A change in market leadership can be healthy if it means more stocks are joining the rally – but it's more concerning if it reflects waning confidence in the leaders.

Technology, and artificial intelligence in particular, have been the drivers of market performance. But questions remain about how AI will evolve and what its ultimate impact will be.

Software stocks have come under pressure in 2025 as analysts worry that AI could disrupt their business models. AI itself is facing increased scrutiny: a group of MIT researchers recently found that 95% of organizations are seeing no return from their AI investments. Apollo also reports that AI adoption among larger firms is already starting to decline.

This is troubling news for the Magnificent 7 companies, which have invested billions in AI infrastructure. Societe Generale notes that big tech firms, once reliable free cash flow machines, are now becoming increasingly capital-intensive.

It's still early, but a lot is riding on the assumption that today's heavy capital spending will translate into higher productivity and profits in the near future.



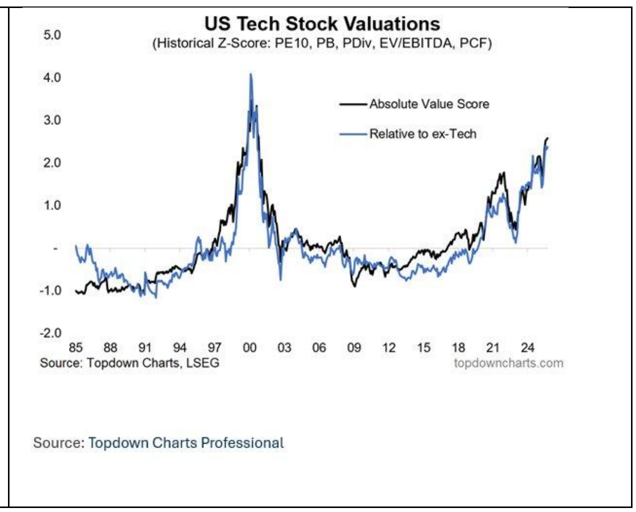

## Is market leadership about to shift?

Could we be seeing the beginning of a regime change?

Topdown Charts highlights that U.S. Tech has dramatically outperformed both Global Tech and U.S. Non-Tech. If leadership is set to change, the next market driver will have some very large shoes to fill.

From an earnings perspective, Strategas expects the gap between the Magnificent 7 and the remaining S&P 493 to begin narrowing over the coming quarters. However, it won’t be until the second quarter of next year that the broader market’s earnings-per-share growth is projected to match that of the Mag 7.

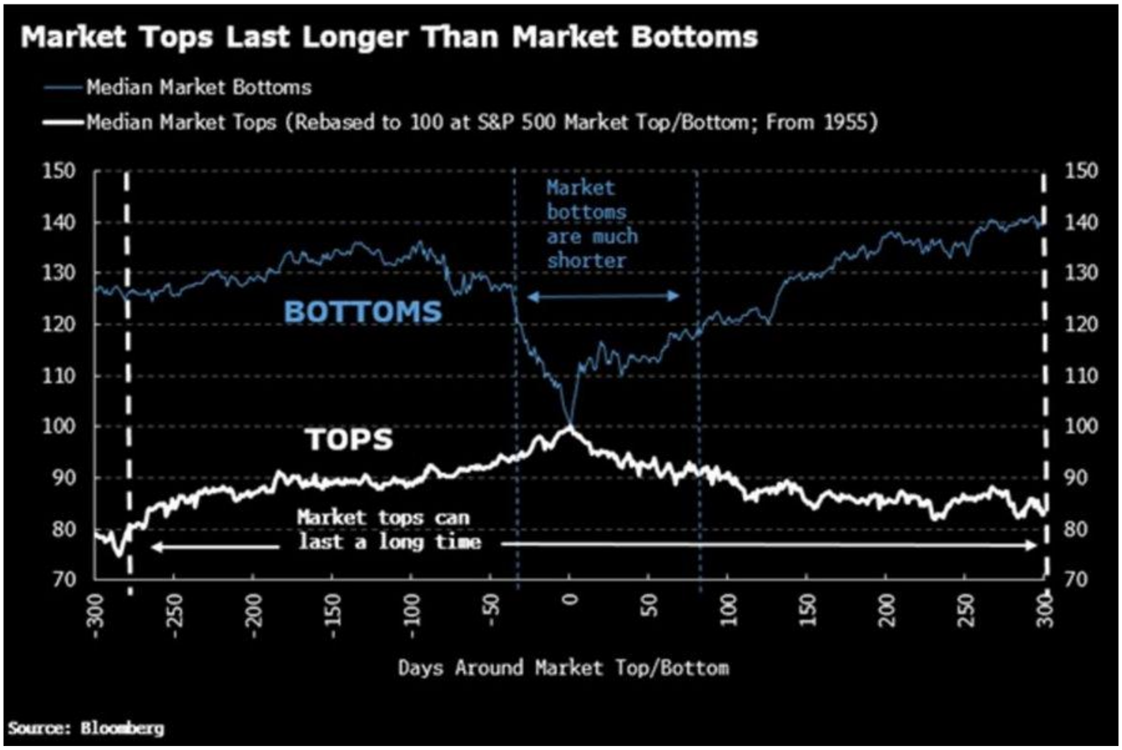
Valuations make a leadership transition plausible. U.S. Tech remains expensive relative to the broader market, which could open the door for rotation. The challenge is that, while the broader market may look cheap compared to tech, it is still expensive relative to its own historical range. Goldman Sachs notes that U.S. equities excluding Big Tech, as well as the All-Cap World and All-Cap World ex-U.S. indices, are all trading well above their historical averages.


## Valuations are elevated – but not necessarily a trigger

Stocks are expensive in general.  As highlighted by Bloomberg’s Cameron Crise, stock prices have overshot the rise in expected earnings. And, a recent Bank of America Fund Manager survey found 91% believe U.S. equities are overvalued.

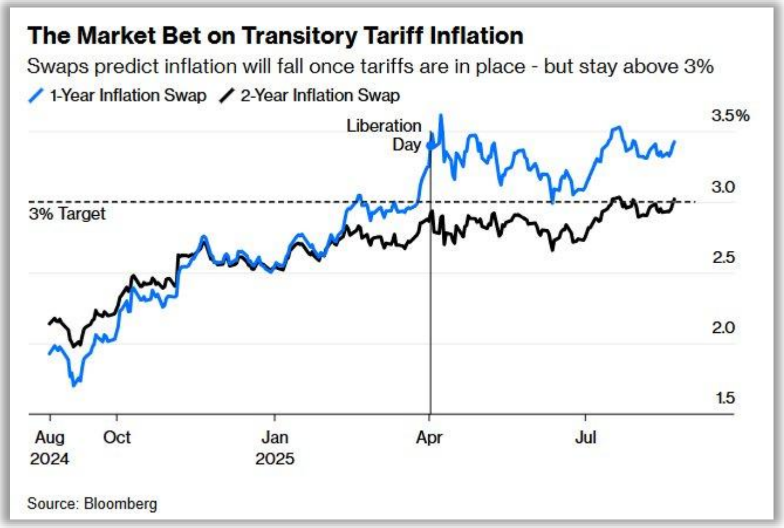
Valuations, however, have historically proven to be a poor predictor of returns in the short term. Markets can remain overvalued for extended periods.  According to Bloomberg, market tops have historically lasted much longer than market bottoms.




## Fed policy and the path for rates

Helping to extend this market top is the hope that the U.S. Federal Reserve will start to cut overnight interest rates.  It's been a bit of a tug of war for the Fed.  Concerns over rising inflation keep the Fed on hold, while a deteriorating job market is putting increasing pressure on the Fed to cut rates.

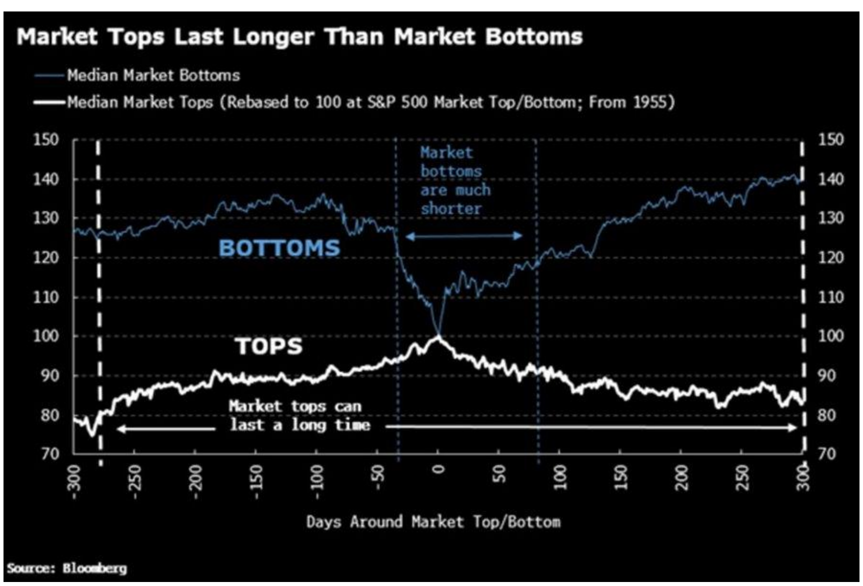
According to Bloomberg, Fed officials viewed inflation as the greater risk at the July FOMC meeting; however, declining employment numbers have driven two-year yields lower. Markets appear to be betting that tariff-driven inflation will be transitory, paving the way for rate cuts that extend the current rally.




## Global bond market signals

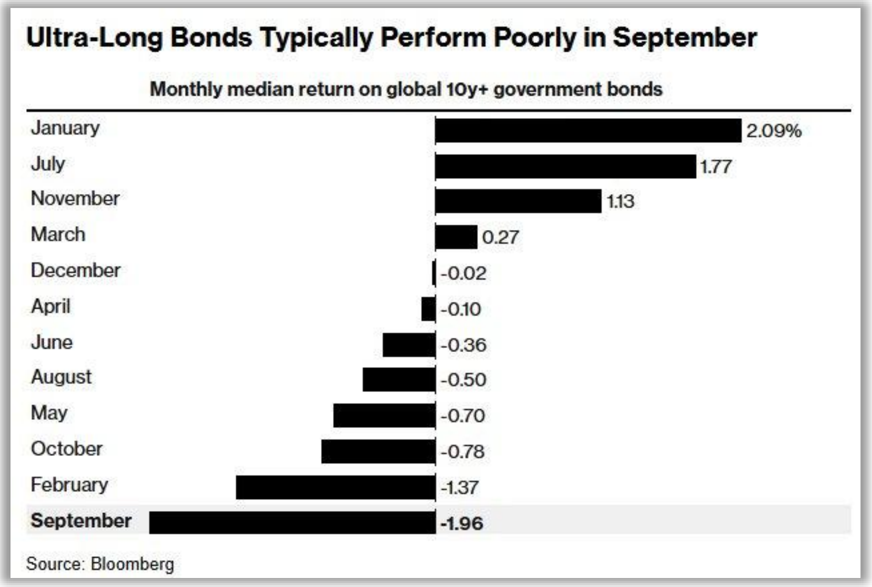
While short rates have been falling, longer rates moved higher in August. Bloomberg reports that 30-year yields climbed globally, steepening yield curves.

By global standards, the U.S. yield curve isn't actually that steep. Strategas notes that U.S. two-year yields have fallen as much or more than in other markets, while 10- and 30-year yields have declined less. Regardless, if short-term rates are falling due to concerns of a deteriorating job market, we would have expected longer-term yields to follow suit.



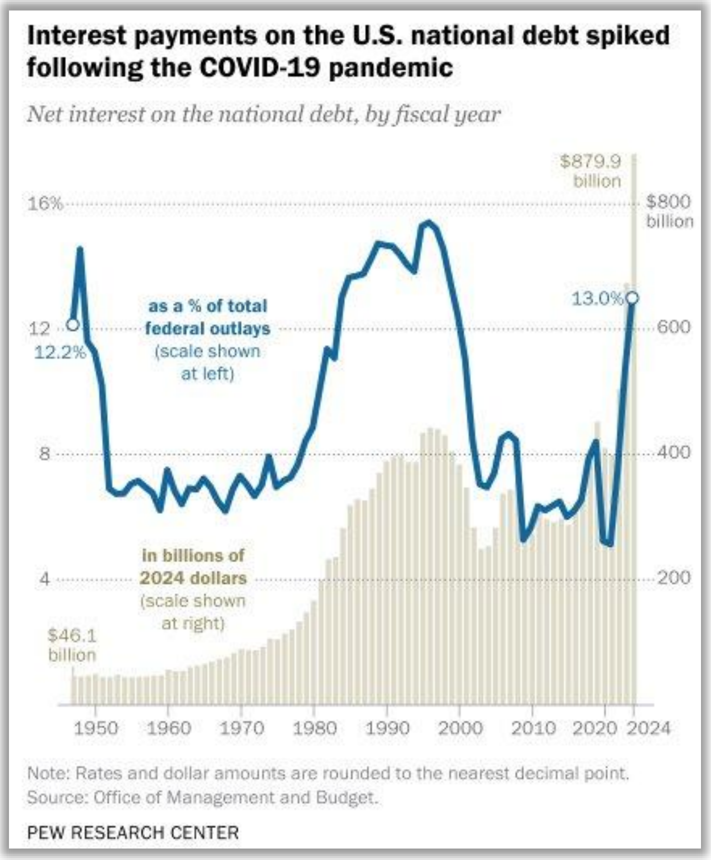
The U.S. 10-year government bond yield remains a key barometer for both the market and the economy. The Bear Traps Report estimates that, with U.S. GDP growth at +1.6% and the CPI at +2.7%, the fair value for 10-year yields is around 4.3%, very close to current levels. Strategas adds that 10-year yields are trading in a narrowing channel, which they believe will eventually break as rates become more volatile.

Seasonal patterns also warrant attention. Historically, ultra-long bonds have performed poorly in September, meaning yields tend to rise. Bloomberg recently highlights persistent deficits and inflation as factors that could keep long-term yields elevated.




## Fiscal deficits and structural risks

Inflation is closely monitored by the Fed, but deficits are more challenging to address. Pew Research highlights that U.S. interest payments have spiked post-pandemic due to higher debt levels and higher interest rates. America's current fiscal trajectory is unsustainable, raising concerns about investor confidence. Again, this is not just a U.S. issue, which is why long-term yields are rising globally.

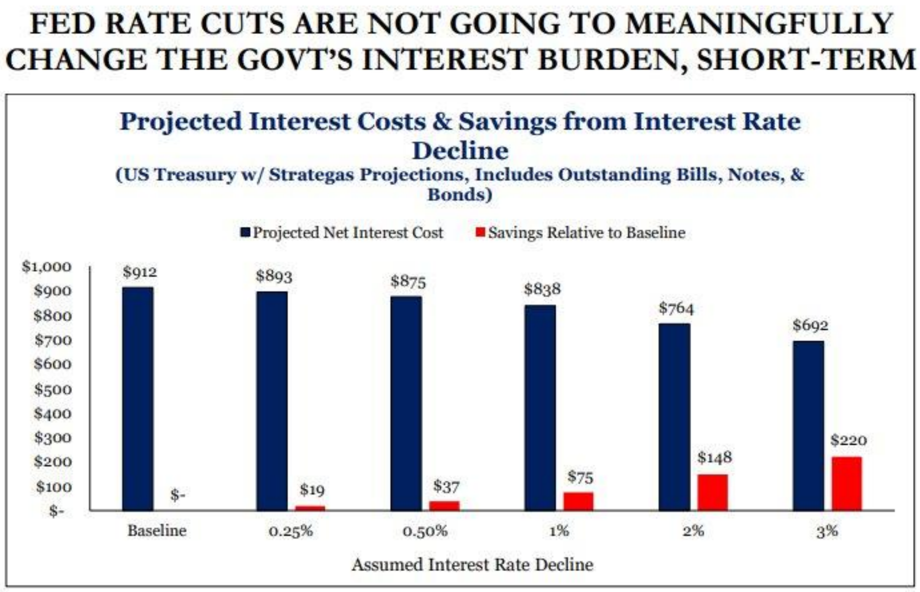



The U.S. treasury can help reduce the cost of servicing its debt by issuing more short-term paper, but the impact will take time, as not all outstanding government debt is short term.

This is why simply lowering the Fed Funds rate may not do as much to control interest costs as some expect. The Fed Funds rate has a significant influence on short-term rates – those with maturities of up to about two years – while longer-term yields are determined by the market through supply and demand.

Strategas estimates that even a 3% drop in the Fed Funds rate would reduce interest costs by only about $220 billion. As Bloomberg points out, shortening the weighted average maturity of outstanding U.S. government debt by issuing more short-term paper would likely steepen the yield curve, as buyers are diverted from buying longer-term government bonds.

This is what happened in 2024, when 10-year and 30-year yields rose even as the Fed Funds rate was falling.




## The rise of fiscal dominance

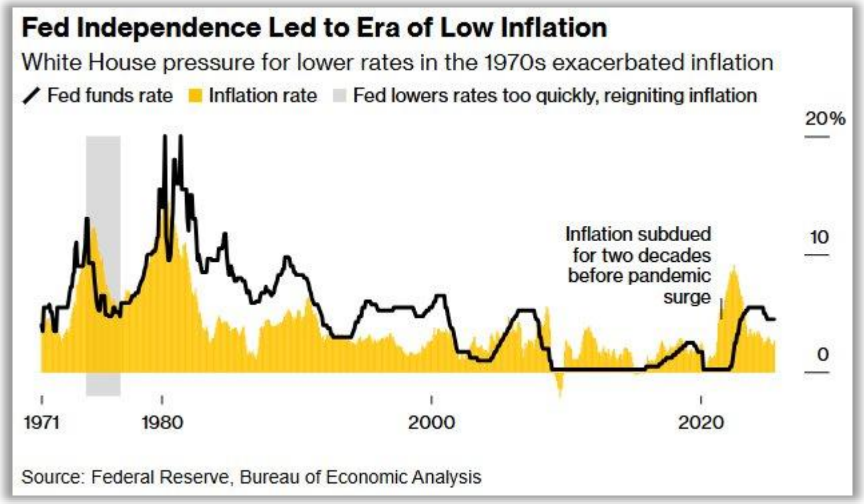
Along with cutting the Fed Funds rate, the Federal Reserve could also use its balance sheet to buy long-term debt on the open marketplace, thus helping drive yields down and flattening the yield curve. This approach, commonly referred to as Quantitative Easing or Yield Curve Control, is widely anticipated: a recent Bank of America fund manager survey found 54% of professional investors expect the next Fed Chair to do exactly this.

Interestingly, a recent Bloomberg Market Pulse survey found 59% of respondents believe this would actually be good for U.S. stocks. Perhaps – but there are no free lunches in finance. Expanding the Fed's balance sheet increases the risk of higher inflation. The Fed would then face a difficult choice: help President Trump control the cost of an unsustainable government debt, or risk allowing inflation expectations to become unanchored.

This dynamic is often referred to as Fiscal Dominance – an environment where central banks and monetary policy come under tremendous pressure, particularly from the President, to keep rates artificially low in order to help control the interest cost of government debt. President

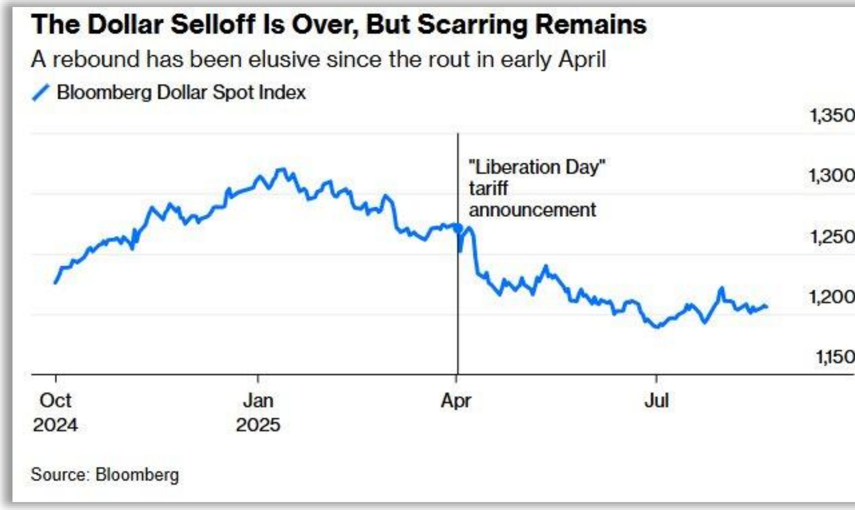
Trump has already threatened to fire Fed Chair Jerome Powell and Governor Lisa Cook, a move that would test the Fed's independence.

As Bloomberg has noted, the Fed's independence that followed the inflationary 1970s led to an era of low inflation. If President Trump succeeds in influencing the Fed and asserting fiscal dominance, we could be entering an era of structurally higher inflation.




The first place investors are likely to see the effects of fiscal dominance is the U.S. dollar. A cooperative Federal Reserve can buy government debt even if it results in inflation, but global investors, governments, and companies may hesitate to hold U.S. dollars if they believe its purchasing power is eroding.

U.S. stock valuations might remain elevated if interest rates are kept artificially low and earnings are strong. However, foreign investors may need to consider hedging their U.S. dollar exposure, as currency losses could offset any nominal gains. Earlier this year, long-term yields were moving higher, the yield curve was steepening, and the dollar was weakening. This was the first sign the market was becoming uneasy. The dollar has since stabilized, and dollar hedging has held steady, but a further decline could signal that the fiscal dominance era has arrived.

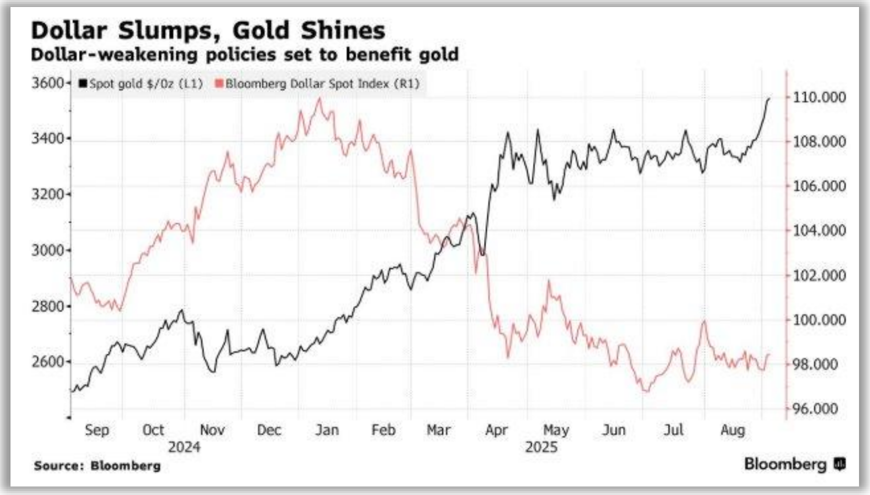



## Gold as a warning signal

Gold is another key indicator investors can watch to gauge the risk of fiscal dominance – and it's already flashing red.  While the U.S. dollar has stabilized, gold prices have continued to rise. A recent chart in the *Financial Times* shows that gold accelerated higher after President Trump called for Fed Governor Lisa Cook to be fired.

The Bear Traps Report clearly shows how hard assets like commodities tend to outperform – both in nominal and real terms – during inflationary periods. However, Goldman Sachs points out that the driver of inflation matters: inflation caused by supply shock is different from inflation driven by eroding institutional credibility.

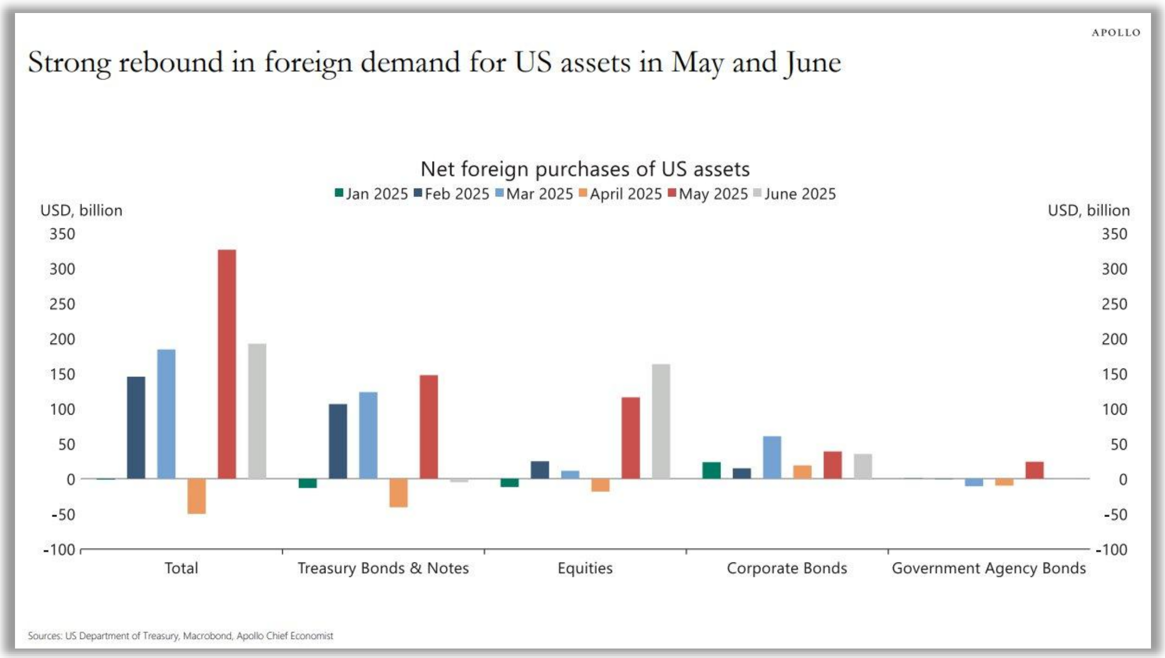
Gold is commonly viewed as an inflation hedge, but it is most effective when inflation is high and institutional credibility is weakening.  That appears to be exactly what gold's latest move is signaling.



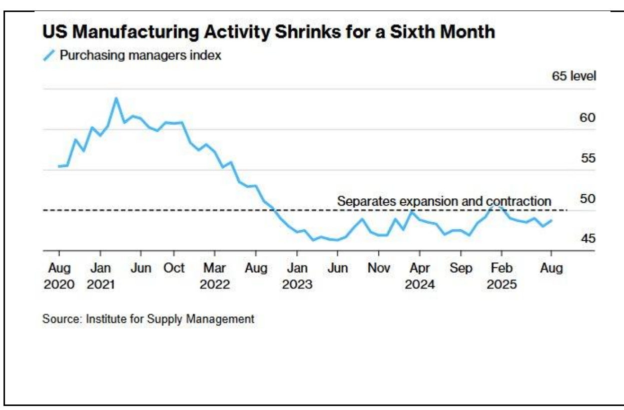

## Balancing warning signs with U.S. strength

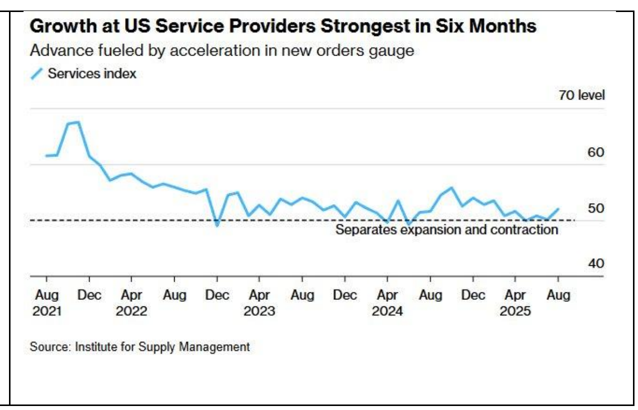
It’s not all bad news. While gold points to concerns over fiscal dominance, U.S. exceptionalism appears to remain intact. Apollo reports that foreign demand for U.S. assets rebounded strongly in May and June, with particularly strong interest in 10-year Treasury bonds outside of normal New York trading hours – a sign of robust international buying.

Morgan Stanley and Bloomberg’s Cameron Crise also highlight foreign demand for U.S. equities, especially in June.




Investors seem comfortable with the current "goldilocks" economic environment, where growth is slow enough to entice the Fed to start normalizing monetary policy through rate cuts, but not so strong that it hurts earnings. Bloomberg notes that economists expect U.S. growth to remain below 2% through 2026. For the past six months, most growth has come from the service sector, while U.S. manufacturing has been contracting.



NICOLA WEALTH

## Key risks on the horizon

The latest Bank of America Fund Manager Survey shows that the biggest perceived tail risk remains a trade war triggering a recession. A close second – and gaining quickly – is inflation preventing the Fed from cutting rates. A disorderly rise in bond yields also earns an "honourable mention."

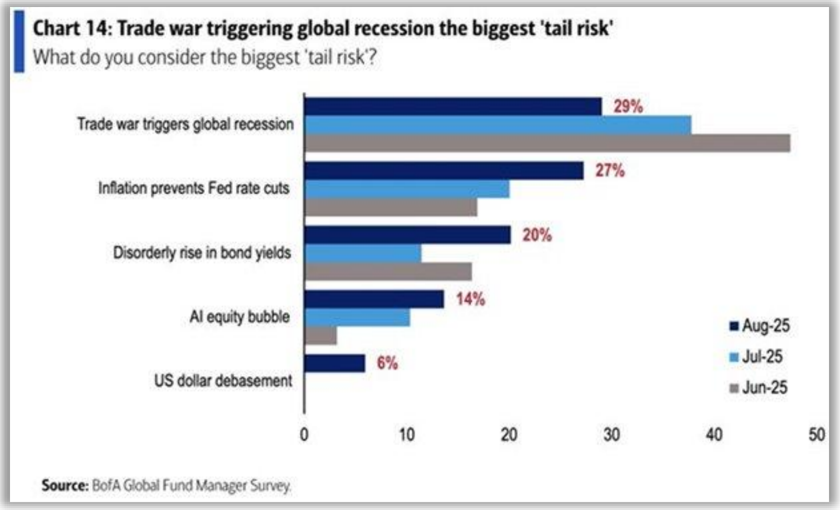
Markets currently anticipate a September rate cut, which could be positive for returns in the near term. Société Générale notes that, unless there is a credit event, S&P 500 valuations tend to rise when the Fed is cutting rates.

Fundstrats Tom Lee points to previous examples – notably the September 1998 and September 2024 rate-cutting cycles – where Fed easing drove the S&P 500 higher.

## Short- and long-term market risks

The risks?  In the short term, the market could correct if the Fed feels inflation is still too high to justify rate cuts.  Longer term, higher rates and the evolving risk of fiscal dominance could result in higher inflation and a weaker U.S. dollar.

The economy appears stable and earnings are relatively strong, supported in large part by robust AI-related spending. But if that AI spending slows or the bubble bursts, markets may find themselves without a clear growth driver, leaving stock prices and credit spending vulnerable.




*This material contains the current opinions of the author, and such opinions are subject to change without notice. This material is distributed for informational purposes only and is not intended to provide legal, accounting, tax or specific investment advice. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Information presented here has been obtained from sources believed to be reliable but not guaranteed. Nicola Wealth Management Ltd. (Nicola Wealth) is registered as a Portfolio Manager, Exempt Market Dealer, and Investment Fund Manager with the required securities commissions. All values sourced through Bloomberg, unless otherwise specified.*