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**THE FED'S INDEPENDENCE IS GONE: SHORT-TERM GAINS, LONG-TERM PAINS**

For much of the past three decades, markets operated under the assumption that monetary policy was largely independent of government influence. Even during extraordinary times—the Global Financial Crisis, the European debt crisis, and the COVID-19 pandemic—central banks coordinated with governments but ultimately acted under their own mandates. That independence gave investors confidence: once they built models for growth and inflation, they could compare their views with central bank frameworks and position accordingly.

This framework is now under strain. President Trump has reshaped the Fed's Board of Governors, tilting it toward members aligned with his view that rates should be materially lower. With U.S. employment data softening, the Fed cut rates in September and is expected to cut twice more before year-end. From a purely economic standpoint, these moves are defensible and did not require any political interference. They are also likely to support equities in the near term.

However, the longer-term implications are more concerning. Inflation, while subdued, has not fully returned to target in most developed economies. Once rate cuts filter through and growth reaccelerates, inflationary pressures are likely to resurface. At that point, the Fed should raise rates, but political pressure may keep policy looser than warranted. The result could be higher long-term yields, unanchored inflation expectations, and a significantly more volatile environment for risky assets.

In the meantime, we remain constructive on markets. Rate cuts, combined with a powerful wave of AI-driven capital expenditure, should continue to support equities into year-end. Yet the seeds of a more challenging backdrop have been planted. By the second half of 2026, we expect the tension between what the Fed should do and what it will do to emerge as a defining challenge for markets.

In short: investors can enjoy the near-term gains but should recognize they will likely come at the cost of longer-term pain.

# ASSET ALLOCATION OUTLOOK



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SVP, Co-Head of Multi-Asset



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## KEY SUMMARY POINTS

- Despite sustained U.S. market highs, earnings growth, policy support, and liquidity suggest markets remain fundamentally healthy.
- Non-U.S. markets may continue to outperform, with China particularly attractive as earnings and valuations reconnect.
- We recommend overweighting equities, gold, and cash. Within fixed income, we continue to find selective opportunities in corporate and emerging-market bonds.

U.S. markets, as measured by the S&P 500 Index, have reached new highs multiple times in 2025. This has raised concerns about a potential market bubble and the risk of a global market correction, as U.S. markets tend to lead global markets. However, there are several reasons to believe that markets remain fundamentally healthy.

Corporate earnings have grown in line with market performance, consistently exceeding investor expectations. In addition, the S&P 500 has posted double-digit earnings growth in each of the last three quarters. Equities are not the only asset class experiencing growth; money market fund assets have also expanded significantly, now totalling U.S. \$7.5 trillion.

## U.S. MONEY MARKET FUND ASSETS VS. S&P 500



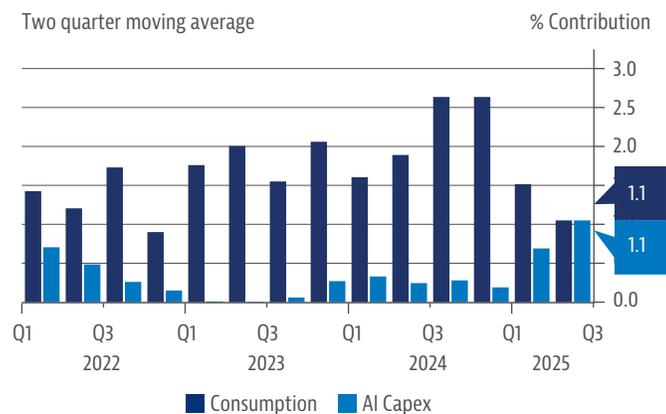
Source: U.S. Securities & Exchange Commission, Macrobond, Bloomberg. Data as of September 9, 2025.

(Chart 1 highlights the growth of S&P 500 market capitalization and money market fund assets.)

Although the U.S. job market has shown some signs of weakness, it remains unclear whether this is seasonal or a developing trend. The Federal Reserve resumed interest rate cuts in September, which should support the domestic economy and improve investor sentiment, as stocks typically rise when rates decline.

Consumption has weakened, largely due to low consumer confidence stemming from job uncertainty and tariffs. However, strong capital expenditure—particularly in AI—has more than offset the decline in consumer spending.

### U.S. REAL GDP GROWTH—CONSUMPTION VS. AI CAPEX



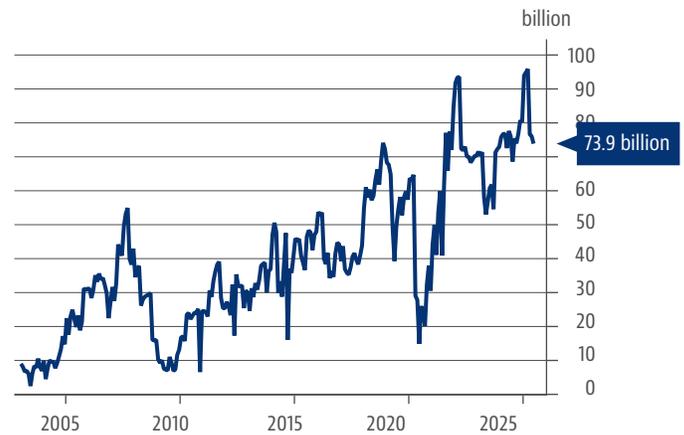
Source: U.S. Bureau of Economic Analysis (BEA), Macrobond. Data as of September 25, 2025.

(Chart 2 illustrates how slowing consumption has been more than offset by increased capital expenditure, particularly in AI.)

The perceived slowdown has given central banks and governments reason to unleash stimulus. Around the world, money supply is expanding, central banks are cutting interest rates, and governments are increasing fiscal spending—all of which support asset prices. It is also worth noting that the OECD recently raised its global economic growth forecast for 2025 from 2.9% to 3.2%.

The supply of investable U.S. equities is declining, as the dollar value of share buybacks consistently exceeds new issuances.

### S&P 500 INDEX BUYBACKS MINUS ALL IPOs



Source: S&P Global, SIFMA (Securities Industry & Financial Markets Association), Macrobond. Data as of September 17, 2025.

(Chart 3 highlights the persistent gap between buybacks and IPOs.)

Meanwhile, sovereign wealth funds, such as Saudi Arabia's Public Investment Fund, have been actively buying assets to support initiatives like "Vision 2030," which aims to diversify their economies away from oil.

Investors are asking questions and challenging the thesis, but this suggests the market is fundamentally healthy. We believe equity markets have limited downside risk overall and could continue their upward trajectory into 2026. While non-U.S. markets typically do not drive risk sentiment, they may continue to outperform the U.S., supported by stimulative policies and attractive valuations. China remains notable in this regard. For a while, earnings and valuations have diverged due to macro events, and that divergence has likely gone too far.

We recommend overweighting equities, gold, and cash, while underweighting fixed income. Within equities, we favour emerging markets and have recently upgraded our outlook on small-cap stocks, driven by declining interest rates and attractive valuations. Although we remain underweight fixed income overall, we continue to find value in corporate and emerging-market bonds.