Equity Team commentary: Cyclical rotation continues

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Craig Jerusalim, CFA, MBA, Senior Portfolio Manager, Head of Global GARP
Tudor Padure, CFA, Portfolio Manager, Equities
Catharine Sterritt, CFA, CPA, CMA, Portfolio Manager, Opportunities Funds
Natalie Taylor, CFA, Portfolio Manager, Equities

Key takeaways

- Federal Reserve implements first rate cut of 2025, citing labor market softness.
- Teck Resources announces a merger of equals with Anglo American, creating a top-five global copper producer.
- Oracle delivers a standout quarter, with its stock surging on robust cloud infrastructure growth.
- Rotation from defensive to cyclical stocks continues, benefiting Canadian markets.
- High-quality Canadian stocks present attractive valuations amid market dislocations.

In September, the U.S. Federal Reserve executed its first interest rate cut of 2025, a highly anticipated and politically charged move prompted by signs of labor market softening. The path from here is less clear as the U.S. economy remains strong, the unemployment at 4.3% being historically low and further data points likely needed to gain comfort on the inflation path. Meanwhile, the Bank of Canada implemented its third 25-basis-point rate cut of the year, driven by economic pressures from U.S. tariffs impacting trade and labor markets. However, the Bank adopted a more hawkish tone, indicating a cautious approach to future rate decisions.

Prime Minister Mark Carney announced the creation of the Major Projects Office, headquartered in Calgary, to streamline approvals for nation-building initiatives. Key projects include LNG Canada Phase II and the Darlington New Nuclear project. The announcement boosted engineering and construction stocks on the TSX, which benefit from enhanced revenue visibility and potential new contracts.

In a significant M&A development, Teck Resources announced a merger of equals with Anglo American to form Anglo Teck, a top-five global copper producer. Despite the compelling industrial logic, the timing of the at-market offer raised concerns among investors, as Teck's shares had declined 17% year-to-date due to challenges at its QB2 mine. The combined entity will be headquartered in Canada, pending Investment Canada approval, with its primary listing in London.

Staying with materials, U.S. Energy Secretary Chris Wright advocated for expanding the U.S. strategic uranium reserve to reduce reliance on Russian supplies, driving a rally in uranium stocks. With U.S. uranium inventories relatively modest, this policy could exert upward pressure on spot prices, benefiting contract terms. Additionally, the International Atomic Energy Agency (IAEA) raised its nuclear power projections for the fifth consecutive time since 2021, further supporting positive sentiment.

Within our portfolios, we maintain exposure to uranium through Cameco and NexGen Energy. Cameco's vertically integrated operations and high-quality assets in key jurisdictions position it as an important player in the nuclear value chain. NexGen, a development-stage company, has secured contracts for 10 million pounds of uranium, advancing its Arrow deposit in Saskatchewan toward production at the end of the decade.

The biggest earnings event of the month was Oracle. The company reported a whopping backlog which grew 359% year over year to $455 billion as well as a five year guide for its Oracle Cloud Infrastructure business that blew past consensus estimates. This sent shares 36% higher on the day, though they have since taken a bit of a breather as the market digests the significant capex increase and evaluates growth sustainability.

Nvidia made headlines with a $5 billion investment in Intel (~4% stake) and a partnership to develop AI infrastructure and personal computing products. Intel's shares rose 25% following the announcement, which came shortly after the U.S. government acquired a 10% stake in the company. These developments strengthen Intel's competitive positioning and indirectly benefit our investment in Brookfield Infrastructure, which partnered with Intel on a $30 billion semiconductor facility in Arizona in 2022. This project is expected to generate free cash flow starting in 2026.

From a performance perspective, September saw a continued rotation from defensive to cyclical stocks, with MSCI U.S. cyclical sectors outperforming defensives by 4% (source: MSCI). Since April, cyclicals have outpaced defensives by 33%. In Canada, the materials sector surged 19% in September, significantly outperforming the TSX's 5% gain. The TSX's cyclical composition has driven its outperformance, surpassing the S&P 500 by 2% in September and 13% year-to-date, while also outpacing the NASDAQ by 8%, on a total return basis.

The TSX remains attractively valued, trading at a forward P/E ratio of 17x compared to 23x for the S&P 500 - a 25% discount, wider than the long-term average of 10%, despite similar forward growth projections and profitability for the two markets. This valuation gap, combined with the strength of high-quality Canadian companies, underpins our constructive outlook on Canadian equities. Despite recent market gains, the TSX offers compelling opportunities in high-quality companies across sectors.

Industrials: The rotation into cyclicals has weighed on waste management companies like GFL Environmental and Waste Connections, as their stable earnings profiles are less sensitive to economic cycles. However, we value their consistent double-digit earnings and free cash flow growth, supported by strong management teams. Additionally, President Trump's "Big Beautiful Bill," which reinstates bonus depreciation, is expected to enhance free cash flow for both companies by reducing tax burdens and supporting higher U.S. capital expenditure which could be accretive to volumes. We are increasing our exposure to these names to capitalize on current valuation dislocations.

Technology: Companies such as Constellation Software and Descartes Systems have underperformed recently due to concerns about generative AI's impact on software and SaaS business models. However, their scale, leadership in niche markets, and mission-critical software create durable competitive moats. These attributes, combined with proprietary knowledge of customer workflows, should position them to integrate AI effectively and maintain market leadership.

Constellation Software faced additional pressure following the unexpected resignation of founder Mark Leonard for health reasons. While Leonard's 30-year track record is unmatched, incoming CEO Mark Miller's multi-decade tenure and the company's decentralized structure provide continuity. We remain confident in Constellation's long-term execution.

Ultimately, we look for quality companies that earn high return on capital through the cycle which is indicative of distinct competitive advantages. We are especially excited when these companies trade at reasonable valuations.

About the authors

Craig Jerusalim
CFA, MBA, Senior Portfolio Manager, Head of Global GARP

Tudor Padure
CFA, Portfolio Manager, Equities

Catharine Sterritt
CFA, CPA, CMA, Portfolio Manager, Opportunities Funds

Natalie Taylor
CFA, Portfolio Manager, Equities

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