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INSIGHTS & VIEWS

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Equity Markets Save the Day: Analyzing the Impact of Equity Markets on the Macroeconomy

EXECUTIVE SUMMARY

- **Equity markets have performed very well in recent quarters. Their performance has provided significant support to economic activity in the U.S. and Canada since 2023.**
- **We find that the surge in equity prices of the last few years raised the level of Canadian and U.S. real GDP in 2025Q3 by just over 1% relative to the level in late 2023.**
- **A significant pullback in equity markets would have damaging impacts on growth, eliminating a key support for economies that are adapting to a high-tariff world. Our simulations suggest a 20% decline in U.S equity markets that leads to a 10% decline in Canadian equity values would lower the level of real GDP by 0.8% and 0.5% in 2027 in the U.S. and Canada, respectively, relative to our base case.**

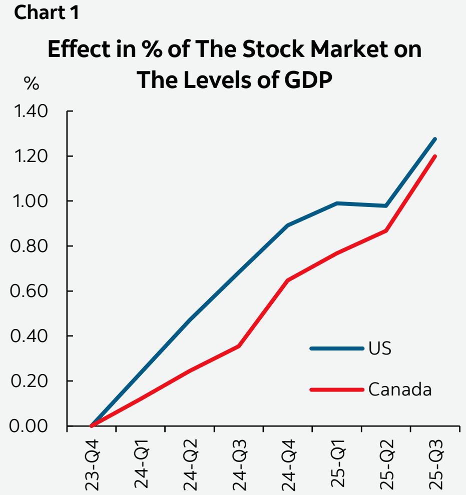
CONTEXT

Equity markets have risen by about 40% since 2023. This surge has boosted financial wealth and supported household spending in both Canada and the U.S. We find it has been an important source of growth in the last few years and will continue to support activity going forward. However, these elevated valuations imply high expectations for continued earnings growth in AI-linked sectors, expectations that may not materialize, raising concerns about potential overvaluation. This represents a downside risk to our outlook. This note examines the impact of past movements in stock markets on the current level of economic activity and draws out the implications of a potential equity correction on the way forward.

1. A LOOK BACK: EQUITIES PROVIDED SIGNIFICANT BOOST TO GROWTH

We use our macroeconometric model to assess the impacts of the equity market surge since late 2023. In isolation, the rise in equity values supported the U.S. and Canadian economies through stronger household balance sheets and easier financial conditions. Our simulations indicate that the equity rally boosted GDP levels in the United States by approximately 1.2% in 2025Q3 relative to late 2023. The effect in Canada is similar in magnitude but differed in its composition with most of the effect coming from positive trade spillovers (chart 1). Indeed, wealth effects are smaller in Canada since households have a smaller proportion of their wealth in equities, which means that the Canadian equity price surge had a smaller effect on household spending. In contrast, the strong exposure of Canadian exports to U.S. economic activity implies a strong reaction of Canadian GDP to movements in U.S. stock prices.

Chart 1



Source: Scotiabank Economics.

These simulations show that the surge in equity prices over the past few years had a significant impact on economic growth. On its own, it accounted for roughly 30% of U.S. growth and 40% of Canadian growth between 2023 and 2025, and almost entirely explains investment dynamics in the U.S. This reflects the fact that U.S. investment is quite sensitive to the cost of equity capital, and the rise in valuations lowered the cost of capital. While other factors contributed during this period, overall growth would have been markedly weaker without this support.

2. RISK SCENARIO: VALUATION CORRECTION

The support coming from elevated valuation is expected to remain over our forecast horizon, but a possible market repricing introduces a risk to our outlook. In our scenario analysis, we assume equity prices (S&P 500) decline by 20% from 2025Q4 to 2026Q1, to a level last seen in mid 2024, with a U.S.-led correction pulling the TSX lower by an assumed 10% (chart 2).[1] We also assess the impact of a worst-case scenario where equities drop by 40% in the U.S., and 20% in Canada. We use our macroeconometric model to simulate the economic impact of this adjustment. The use of a macro model here is critical, as it captures the general equilibrium effects of equity market movements, and reflects the deep commercial and financial integration between the two economies.

In our model, a repricing of equity valuations would be transmitted through the economy via three main channels:

1. **Wealth Effects: Household Spending**

   As equity prices fall, the value of household wealth also falls, leading to lower spending. U.S. consumers are particularly subject to this effect, where equities make up of a large portion of their wealth.

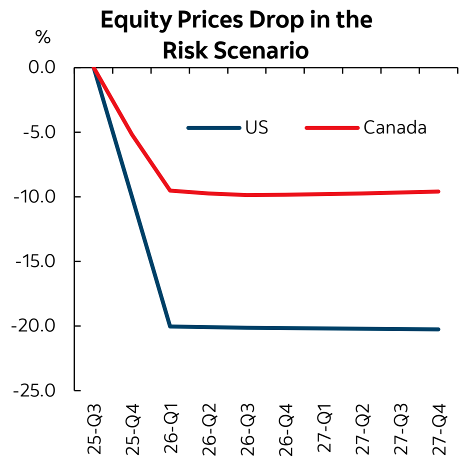
2. **Financial Conditions: Investment**

   A broad market pullback would tighten credit spreads, reduce corporate issuance appetite, and weigh on investment intentions.

3. **Trade and Financial Spillovers: Additional Impact on Canada**

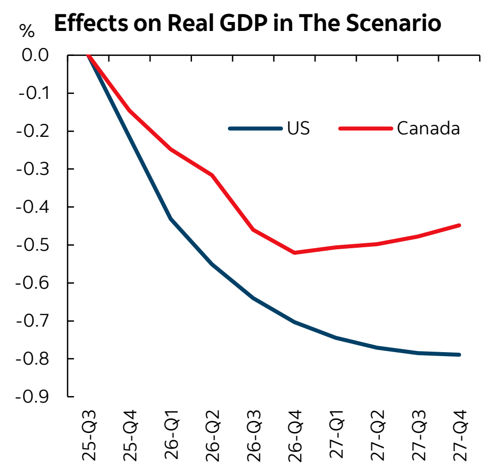
   On top of the direct effect of equity prices on Canadian household spending, Canada's trade integration with the U.S. business cycle amplifies these spillovers. This is in fact the most important channel for the Canadian economy

Chart 2



Source: Scotiabank Economics.

Chart 3



Source: Scotiabank Economics.

THE FED AND BOC CUSHIONING THE IMPACT

Overall, a broad pullback in equity markets would weigh on consumption and investment in both the U.S. and Canada, with Canada additionally exposed via trade. It would lower the level of GDP by 0.8% in the U.S., and 0.5% in Canada (chart 3), and lower inflation by 0.2 p.p. to 0.1 p.p., respectively. This weaker economic activity would also mean weaker job growth, reducing the level of employment by about 500k in the U.S. and 35k in Canada, relative to our baseline. The macro impact would be about double in the worst case scenario (table 1).

Such a negative impact would be sufficient to prompt a monetary policy response, though not large enough to fully offset the economic impact. Our model-based simulations suggest the FED would lower the fed fund rate by 60 bps relative to baseline, while it would be slightly smaller from the BoC at 50 bps, because of the relatively smaller impact on GDP.

Table 1: Macro Impact of an Equity Market Pullback (in Deviation From Baseline)

Scenario		Stock Market Decline (%)	GDP (%)	Inflation (p.p.)	Employment (000s)
Scenario 1	US	-20	-0.8	-0.2	-500
	Canada	-10	-0.5	-0.1	-35
Scenario 2 (Worst Case)	US	-40	-1.6	-0.4	-1000
	Canada	-20	-1.0	-0.2	-70

Source: Scotiabank Economics.

[1] The smaller impact on Canadian equities reflects the historical passthrough imbedded in the model between the two markets. It also reflects the fact that Canadian stock market is less exposed to AI.