Quick Take

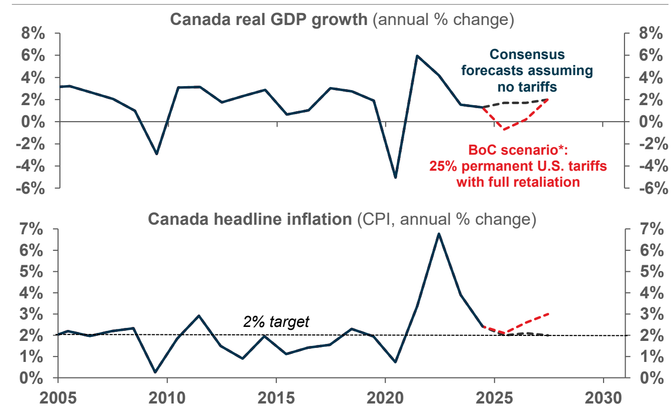
CIO Office | January 31, 2025

Trump's tariffs: 5 points to keep in mind

Since President Trump's inauguration just 11 days ago, the news surrounding the United States' trade policy has proved more volatile than the financial markets themselves, where relative calm persists. And yet, it appears that Donald Trump will go ahead with his most aggressive threat of a 25% tariff on Canadian imports as early as February 1st.

This backdrop raises many questions. Until things become clearer, let's highlight five key points for investors to keep in mind.

1 | A potential stagflation shock, says the BoC



CIO Office (data via Refinitiv, Consensus Forecasts, Bank of Canada). *From the Bank of Canada's January 2025 Monetary Policy Report.

First, the recession scenario recently published by the Bank of Canada in the event of U.S. tariffs is an extreme case[1]. Reading the headlines, one might think that a severe recession is inevitable in Canada, with some mentioning something worse than the 2008 financial crisis[2] and others drawing pandemic comparisons.

However, while the Bank of Canada's recent study on the subject does indeed suggest that a recession is conceivable in the short term, with an inflationary impact in the medium term (**Chart 1**), let's not lose sight of the fact that their model assumes an extreme scenario in which the United States imposes (and receives in retaliation) a permanent 25% tariff on all its imports (exports).

To be clear, this kind of study is not an exercise in precision, as the economy doesn't always react as you'd expect – especially in extreme scenarios… as recent years have shown – but we do seem a long way from a 2008 or 2020 environment.

Second, the most aggressive tariff threats (25%) are primarily a negotiating tool, but permanent tariffs are still to be expected. For instance, remember that in May 2018, the Trump administration imposed tariffs of 25% on Canadian steel and 10% on aluminum that remained in effect for a year, just long enough to complete the renegotiation of the North American Free Trade Agreement (NAFTA) [3].

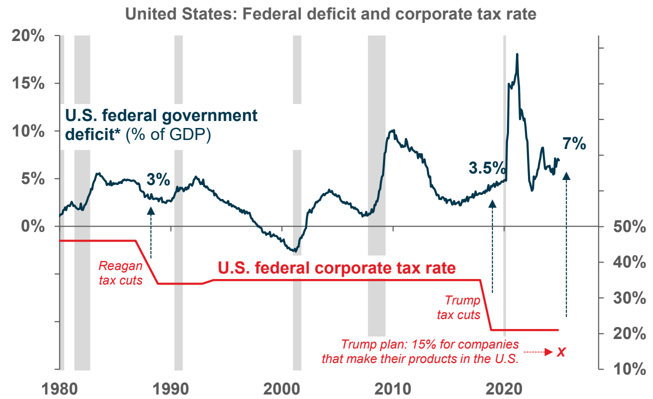
This time, the U.S. administration is clearly looking for a victory at the border, as well as paving the way for the renegotiation of NAFTA (or USMCA), which could well be pre-empted. However, there is an important difference today.

When Reagan cut taxes in 1986 and Trump in 2018, the U.S. budget deficit was 3% and 3.5% of GDP, respectively. Today, it's at 7%, a significant constraint if Trump wants to lower the corporate tax rate again this year (**Chart 2,** next page).

This suggests that there are two types of tariffs, as Commerce Secretary Lutnick effectively argued

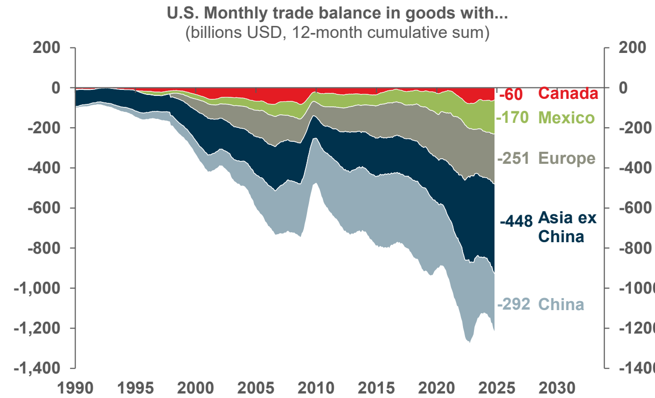
[1] Evaluating the potential impacts of US tariffs, January 2025, Bank of Canada.
[2] B.C. premier says U.S. tariff could hit harder than 2008 recession, backs pandemic-style relief, CBC, January 28, 2025.
[3] Trump's tariffs on Canadian steel and aluminum: A timeline of key events since 2017, Global news, August 7, 2020.

2 | The U.S. needs new revenues to cut taxes



CIO Office (data via Refinitiv).

3 | The U.S. trade deficit with Canada is minimal...



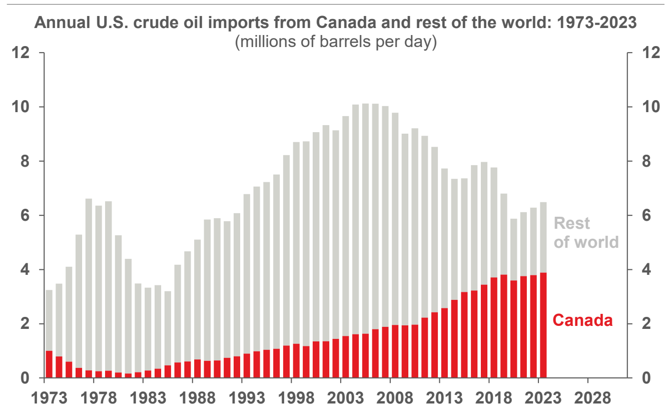
CIO Office (data via Refinitiv).

during his Senate hearing[4]. Those aimed at obtaining quick concessions from U.S. trading partners (temporary 25%), and those that will come once the full review of U.S. trade policy that the President has commissioned is completed in late March/early April (<25% but permanent) [5], which will notably serve as a source of revenue to finance the administration's pro-growth fiscal agenda.

Third, there are arguments in favour of a better outcome for Canada. For example, the U.S. merchandise trade deficit with Canada is not only minuscule compared to that with its other trading partners, but has been relatively stable for over 20 years. Conversely, while the deficit with China has decreased since the last trade war, it has greatly increased with the rest of Asia and Mexico, a sign that many goods produced in China have simply found another tariff-free gateway to the U.S. (**Chart 3**) [6].

What's more, this deficit between our two countries would in fact be a surplus if we excluded Canadian oil, which the U.S. buy to the tune of almost 4 million barrels of oil per day, i.e. around 60% of their oil imports (**Chart 4**), 24% of everything refined in

4 | … but U.S. imports of Canadian oil are significant



CIO Office (data via Refinitiv).

the United States[7], and the vast majority of what is refined in the Midwest, where converting refineries to process lighter American oil would potentially take several years[8].

In short, if Trump doesn't want to stray too far from his signature promise to "bring inflation down to levels you haven't seen in decades" by "cutting energy prices in half within 12 months" [9], he's probably better off getting along with his northern neighbour.

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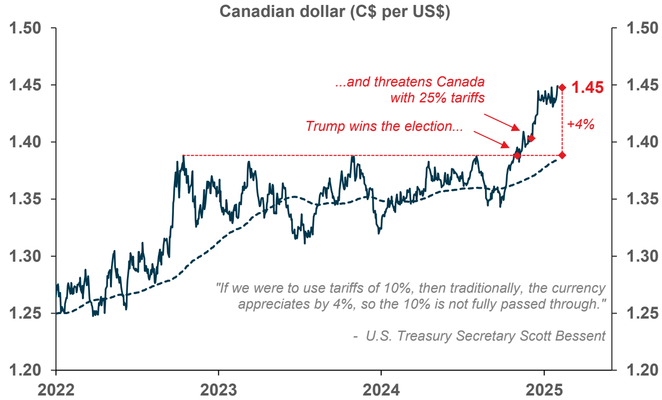
[4] Watch the clip on Youtube here.
[5] America First Trade Policy memorandum, White House, January 20, 2025.
[6] For more details, see this article: In U.S. trade war with China, Mexico is emerging as the big winner, CNBC, September 20, 2024.
[7] Canada's crude oil has an increasingly significant role in U.S. refineries, U.S" Energy Information Administration, August 1st, 2024.
[8] U.S. Refineries and Canadian Crude Oil, Institute for Energy Research, January 28, 2025.
[9] Former President Trump Speaks in Potterville, Michigan About the Economy, August 29, 2024.

Fourth, currencies already seem to be discounting major tariffs. Let's not lose sight of the fact that currency movements act in part as a balancing force against tariffs. This is what the new Secretary of the Treasury, Scott Bessent, said in his Senate hearing, when he stipulated that the U.S. dollar could appreciate by 4% in response to hypothetical 10% tariffs[10].

In practice, it is difficult to isolate a single factor behind currency movements, which do not necessarily respond to functions as precise as Mr. Bessent suggests. What's more, his assertion does not consider any retaliatory measures that Canada might impose on imports from the United States. However, it should be noted that since the election of President Trump and his threats of tariffs, the U.S. dollar has appreciated by precisely 4 % against the Canadian dollar (**Chart 5**).

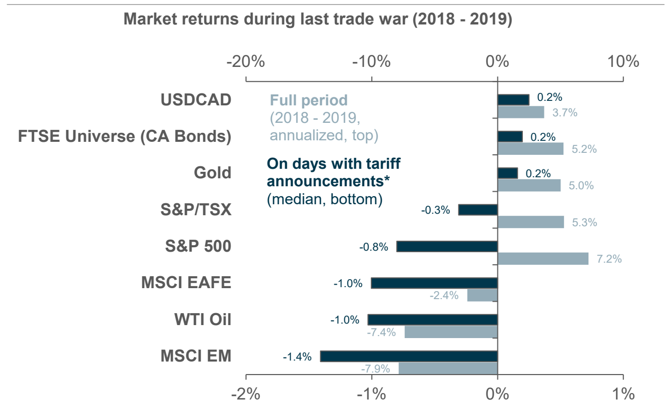
5 | The C$ is already discounting some tariffs



CIO Office (data via Refinitiv).

Fifth, if the latest trade war is anything to go by, equities could face tougher days and bonds better, but it will be important for investors not to overreact. On the 16 days of actual tariff announcements (including retaliatory measures) we tracked between 2018 and 2019, Canadian bonds and the U.S. dollar posted a median gain of +0.2%, compared with a median decline of -0.8% for the S&P 500. But after two years of trade war, North American equity markets had still managed to deliver annualized gains ranging from 5% to 7%, performances not far off those of bonds and significantly better than those recorded by international equities (**Chart 6**).

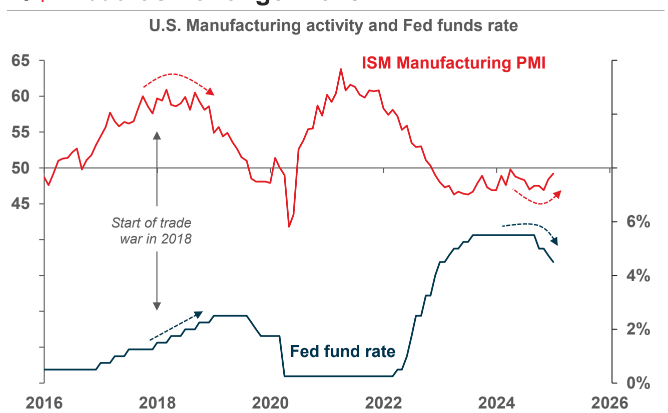
6 | Stocks weren't too keen on tariffs last time…



CIO Office (data via Refinitiv).
*Covers 16 days of tariff announcements (US, Chinese, other) between January 23, 2018 and December 2, 2019)

All that said, it will be vital not to lose sight of the bigger picture. In 2018, American offensive protectionism was completely new, the Federal Reserve was raising interest rates, and the manufacturing cycle was at a peak. Today, American protectionism is intensifying (as promised), the Federal Reserve is on a rate cutting cycle, and manufacturing activity looks poised to rebound (**Chart 7**). All this can change very quickly, and with the equity risk premium at its lowest level in 23 years, this is no time for complacency (**Chart 8**, next page). But perhaps that explains the relative calm we're seeing for now.

7 | ... but it's no longer 2018



CIO Office (data via Refinitiv).

[10] Transcript of Scott Bessent's confirmation hearing.

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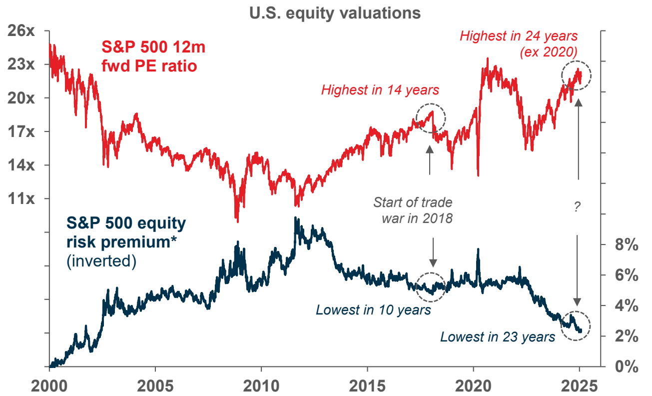
8 | Equities' expectations are even higher this time



CIO Office (data via Refinitiv). *S&P 500 earnings yield (1 / Fwd PE ratio) less 10-year real (TIPS) yields.

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