Quick Take

CIO Office | February 3, 2025

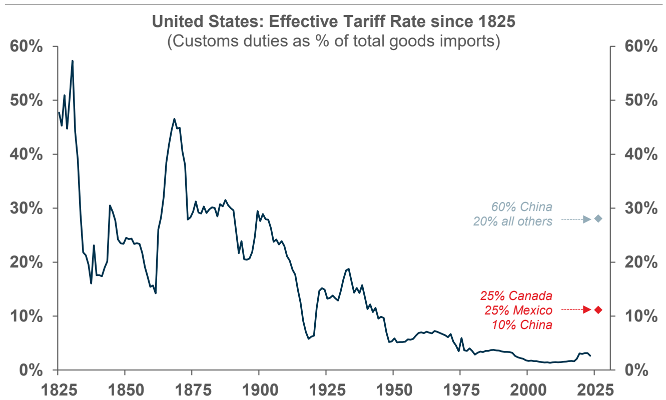
Five reference points in the fog of a tariff war

February 3 update (initial document published on January 31)

On February 1st, the new U.S. administration moved ahead with its threat to impose 25% tariffs on imports from Canada and Mexico, with the exception of energy products and critical minerals, which will be taxed at 10%, as will imports from China.

Technically, this isn't the most aggressive threat the American President made during his election campaign, Mr. Trump having occasionally evoked a universal tariff of 20% bonified to 60% for China. However, if maintained, it would still represent the highest effective tariff rate since 1943, as well as the highest annual increase since the “Morrill Tariff” of the early 1860s (**Chart 1**).

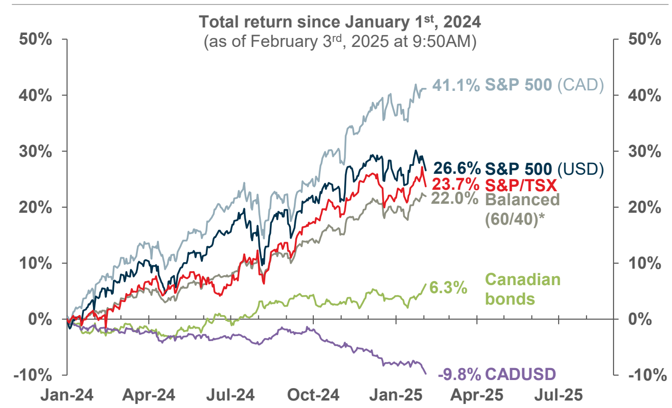
1 | The U . S. moves forward with one of its threats



CIO Office (data via Refinitiv, U.S. Census Bicentennial Edition).

Until recently, financial markets had greeted any news about US tariff policy with relative indifference. Today, the reaction is more significant, for the U.S. stock market (S&P 500, -1.7%), the Canadian stock market (S&P/TSX, -1.7%), the Canadian dollar (CADUSD, -1.0%) and Canadian bonds (FTSE Universe, +0.9%)[1]. Nevertheless, these movements remain rather contained compared with the performance recorded over the past year (**Chart 2**).

2 | Markets react, but don't panic



CIO Office (data via Refinitiv). *30% S&P/TSX, 30% S&P 500, 40% ICE BofA Canada Universe, all in CAD.

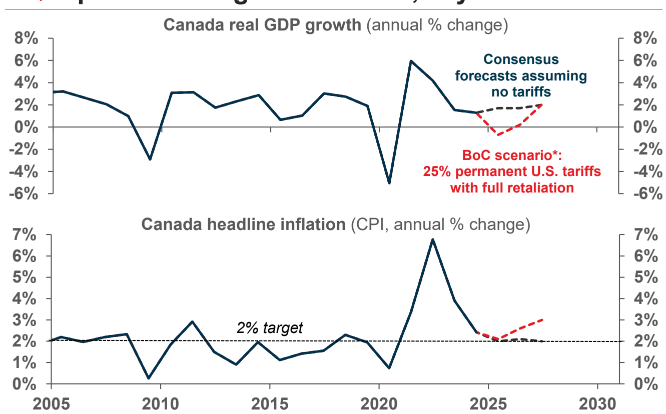
The President of the United States chose to strike at the global and Canadian economy, driving everyone into a thick fog of trade war. When visibility is low, projections are tricky, but reference points are always useful. Here are five of them.

[1] Daily fluctuations quoted are as of February 3, 2025, 9:50AM.

#1: While the economic impact is likely to be significant, beware of doomsday scenarios. Some headlines suggest that a severe recession is inevitable in Canada, with some mentioning something worse than the 2008[2] crisis and others drawing comparisons with the pandemic.

Now, while the Bank of Canada's recent study[3] on the matter suggests that a recession is indeed conceivable in the short term, with an inflationary impact in the medium term (**Chart 3**), let's not lose sight of the fact that their model assumes an extreme scenario in which the U.S. imposes (and receives in retaliation) a permanent 25% tariff on its imports (exports) with all its trading partners. The situation could always get worse, but for now, we're not there[4].

3 | 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.

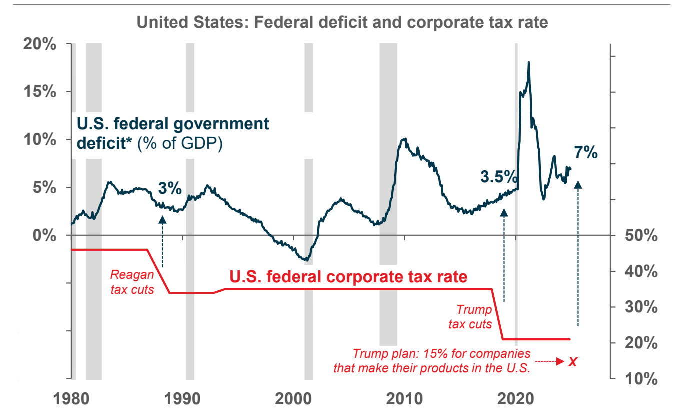
Moreover, let's not forget that the economy doesn't always react as one might expect – especially in extreme scenarios... as recent years have shown – while measures to support growth in Canada are likely to be announced very soon, potentially including a further reduction in interest rates.

#2: In principle, the most aggressive tariffs are primarily a tool to gain concessions, but permanent tariffs are to be expected. For instance, remember that in May 2018, the Trump administration imposed tariffs of 25% on Canadian steel and 10% on Canadian aluminum that remained in effect for a year, the time it took to complete the renegotiation of the North American Free Trade Treaty[5].

This time, we're obviously facing a much more aggressive American administration, which is apparently looking for a victory on the border. However, there is another major difference.

At the time of Reagan's tax cuts in 1986 and Trump's in 2018, the U.S. budget deficit was 3% and 3.5% of GDP, respectively. Today, it stands at 7%, a major constraint if Mr. Trump wants to lower the corporate tax burden again this year (**Chart 4**).

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



CIO Office (data via Refinitiv).

In principle, this suggests that there are two types of tariffs, as Secretary of Commerce Lutnick actually argued in his Senate hearing[6]. Those aimed at securing concessions from its trading partners (~25%, temporary), and those that will come once the full review of U.S. trade policy that Trump has

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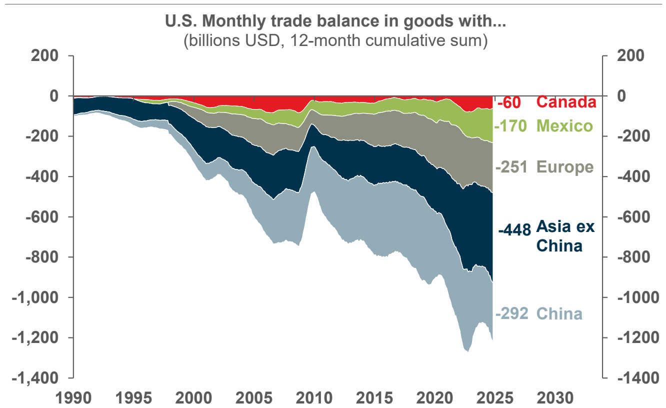
2 B.C. premier says U.S. tariff could hit harder than 2008 recession, backs pandemic-style relief, CBC, January 28, 2025.
3 Evaluating the potential impacts of US tariffs, January 2025, Bank of Canada
4 For example, the 25% retaliatory tariffs on $155 billion worth of goods imported by Canada from the U.S., announced by the Canadian government, represent about a third of Canadian imports. For the Americans, the tariffs announced for their effective tariff rates at around 11%, compared with 25% in the case of the Bank of Canada's extreme scenario.
5 Trump's tariffs on Canadian steel and aluminum: A timeline of key events since 2017, Global news, August 7, 2020.
6 See the Youtube clip here.

commissioned is completed in late March/early April (<25%, permanent) [7], which will serve as a source of revenue to fund a pro-growth fiscal agenda and as an incentive to attract foreign investment to the U.S.

In practice, it remains to be seen whether Mr. Trump will stick to the game plan drawn up by his economic team.

#3: There are arguments in favor of a relatively better outcome for Canada, provided the U.S. administration is ultimately guided by reason. Not only is the U.S. merchandise trade deficit with Canada insignificant compared to other trading partners, but it has also 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 other countries, a sign that many goods produced in China have simply found another tariff-free gateway to the U.S. (**Chart 5**) [8].

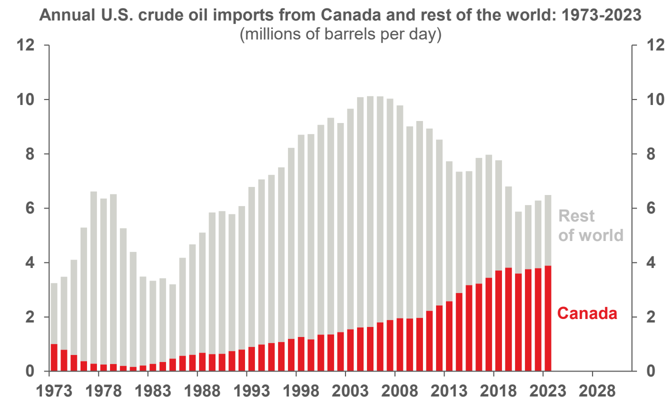
5 | The U.S. trade deficit with Canada is minimal...



CIO Office (data via Refinitiv).

What's more, their deficit with Canada would in fact be a surplus if we exclude Canadian oil, which the Americans buy to the tune of almost 4 million barrels of oil a day, or around 60% of their oil imports (**Chart 6**), 24% of all that is refined in the

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



CIO Office (data via Refinitiv).

United States[9], and the vast majority of what is refined in the Midwest, where converting refineries to accommodate light American oil would potentially take several years[10].

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” [11], he might want to reach an agreement with his neighbor to the north.

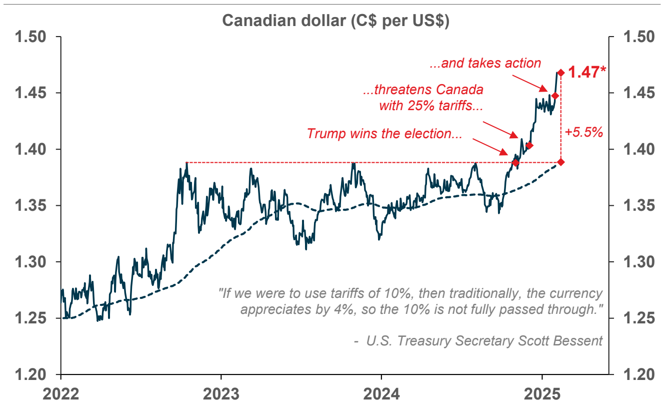
[7] America First Trade Policy memorandum, White House, January 20, 2025.
[8] For more details, see this article : In U.S. trade war with China, Mexico is emerging as the big winner, CNBC, September 20, 2024.
[9] Canada's crude oil has an increasingly significant role in U.S. refineries, U.S" Energy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

#4: Currencies were already discounting tariffs, which they are helping to offset, at least in part. Indeed, this was emphasized by new Treasury Secretary Scott Bessent at his Senate hearing, when he stipulated that the U.S. dollar could appreciate by 4% in response to a hypothetical 10% tariff[12].

In reality, it's difficult to isolate a single factor behind currency movements. Moreover, what happens next for the Canadian dollar will depend above all on how our respective economies and central banks react to all the factors at play – which is far from obvious.

However, it should be noted that since the election of President Trump, the US dollar has appreciated by 5.5% against the CAD. According to Mr. Bessent's rule of thumb (which has some academic basis[13]), this could mean that currencies are discounting permanent tariffs of around 14% against Canada (**Chart 7**).

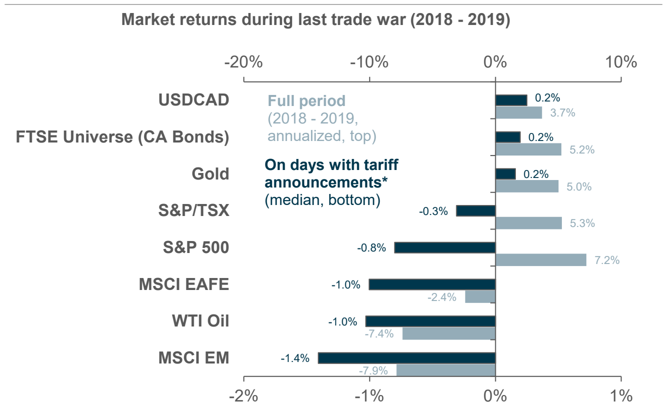
7 | The Canadian dollar adjusts continuously



CIO Office (data via Refinitiv).* As of Feb 3, 2025 at 9:50AM.

#5: If the latest trade war is anything to go by, stocks will experience tougher days and bonds better ones, but it will be important to keep a cool head as investors. On the 16 days of concrete tariff announcements (including retaliatory measures) that we tracked between 2018 and 2019, Canadian bonds and the US dollar posted a median gain of +0.2%, compared with a median decline of -0.8% for the S&P 500. But by the end of two years of trade war, North American stock markets had still managed to deliver annualized gains of between 5% and 7%, performances not far off those of bonds and significantly better than those recorded by international equities (**Chart 8**).

8 | 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)

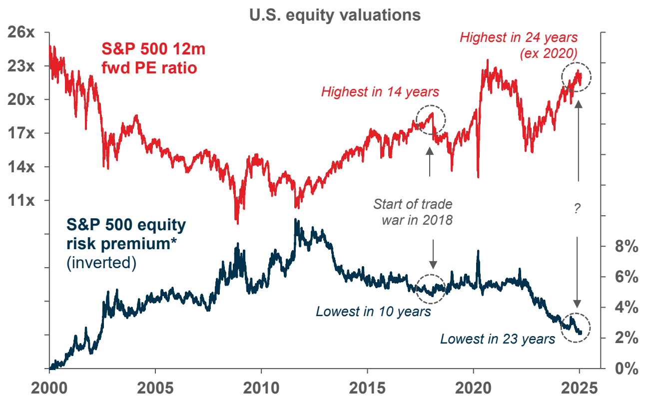
Then again, 2018 is anything but a perfect comparison for the current situation. On the positive side, the U.S. manufacturing cycle seemed rather on the way to rebound at last count, while central banks have considerably more room to cut rates if necessary. However, the brutal approach of the U.S. administration and high stock market valuations – with the risk premium at its lowest in 23 years (**Chart 9**, next page) – are aggravating factors, as are inflationary fears that could constrain the scope of accommodative measures in the short term.

One thing's for sure: it's in situations like these that diversification really comes into its own. This is true in portfolio management, and we will continue to

[12] Transcript of Scott Bessent's confirmation hearing.
[13] To what extent are tariffs offset by exchange rates? National Bureau of Economic Research, December 2021.

ensure that it remains the case in these unprecedented times. And it's also true in terms of trade relations, as Canada is witnessing today.

9 | 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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