

Investment Management

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The Tariff Man Strikes Again

The Through Line: Over the weekend, it was announced that U.S. President Donald Trump intended to institute a blanket 25% tariff on all goods imported from Mexico and a similar 25% on all imports from Canada except energy which will be levied at 10%. An additional 10% tariff on all Chinese imports was also announced. While the use of tariffs was a frequent campaign trail promise, applying them in a blanket fashion – and to two primary trading partners was a surprise. Equity, fixed income, commodity and currency markets are likely to react sharply over the next few days as last-minute negotiations are sought and/or counter tariffs announced. This remains a highly fluid situation and we urge patience and calm as details evolve.

And the trade wars commence

No one wins in a trade war. This has become axiomatic in economic and financial circles over the last century for good reason: tariffs can lower economic growth and increase prices, two undesirable outcomes which could impact all three North American economies (and several others) to varying degrees if the tariffs that newly inaugurated U.S. President Donald Trump announced over the weekend become reality.

On Saturday, President Trump signed an order imposing 25% tariffs on goods from Mexico and Canada, and a 10% duty on Chinese imports, due to start on February 4. Energy resources from Canada will face a lower 10% tariff presumably to contain gasoline and heating oil inflationary pressures. As expected, Canada immediately announced retaliatory measures. (For those who enjoy American wine and bourbon, Monday might be a good day to stock up.)

In the event of a protracted trade war – which is not a foregone conclusion since President Trump has quickly reversed course several times in the past – Canada and Mexico could see a material impact to GDP growth this year. American consumers, on the other hand, could theoretically bear the brunt of higher costs to the extent that they are passed along. This is not a given due to recent revolts around higher prices. If absorbed by importers, manufacturers or others in the distribution chain, for example, an import levy could be absorbed in their margins rather than passed along directly. In some industries (autos, food distribution) margins for distributors are thin and costs could indeed be pushed along, though ultimate unit price increases are varied.

Not your typical tariffs

It is important to note the nuance in these tariffs: they were invoked by President Trump under the International Emergency Economic Powers Act (IEEPA) and are not trade based tariffs per se. The intent is to stop illegal immigration and fentanyl coming from Mexico and Canada. Blanket tariffs are a unique and largely untested use of the IEEPA law so there may well be legal challenges from various industry groups protesting the lack of direct connection between their assessment and the issues at hand (illegal drugs and immigration).

How will markets react?

The tariffs are slated to take effect at 12:01 EST on Tuesday, perhaps to gauge the market's response on Monday. President Trump cares about the reaction of his base and how markets react to his policies. Should markets continue their Friday afternoon unwind and/or industry lobbying pleas intensify, perhaps some sort of compromise solution could be worked out. President Trump's press secretary noted on Friday afternoon that tariffs – similar to many of the other early administration

moves – fell under the “promises made, promises kept” vow of the campaign trail.

At this point, we fully expect an initial negative reaction for risk assets and especially equities.

While Canadian public companies in the TSX derive about a third of revenues from the U.S., the share of sales coming from goods as opposed to services is actually much smaller. Ultimately, steel and aluminum, chemicals, aerospace, autos parts, machinery, clothing, agricultural and forestry companies appear to be most directly exposed. Oil and gas companies will also face a headwind but at a lower tariff rate, at least initially.

What will happen to the Canadian economy?

In response to the tariff announcement, BMO Economics revised their estimates for GDP growth and various other indicators. With admittedly limited information at this point (and assuming revocation after a year), they estimate that the tariffs will reduce real GDP growth by about 2% to roughly zero in 2025. This reflects reduced demand for Canadian exports to the U.S. (which account for about a fifth of GDP), disrupted supply chains impeding business activity and consumption, and heightened uncertainty that reduces business investment. It also reflects a reduction in domestic demand due to higher prices stemming from retaliatory tariffs and a weaker Canadian dollar. On a slightly more positive note, inflation pressures should remain subdued, allowing for some moderation in 2026.

Partly limiting the economic pain will be a weaker currency, lower interest rates and an expected government relief program for jobless workers and affected businesses. These supports should lead to a modest recovery in real GDP growth to about 1% in 2026. All told, they expect the economic impact to hit hardest in Ontario and the rest of Central Canada; significantly impacting some concentrated industries in Atlantic Canada and B.C., while dealing a lesser immediate blow in oil-producing provinces.

Implications for major assets

Canadian dollar – the Canadian dollar has already depreciated approximately 10% since January of 2024. BMO Economics forecasts CAD\$1.49 by autumn. This helps to offset some of the tariff impact allowing Canadian exporters to lower prices as they end up with more Canadian dollars after converting the U.S. dollars received.

Equities – tariffs are a tax and a drag on economic growth, with the attendant uncertainty potentially impacting the “animal spirits” of capitalism. For investors, parsing out the combined impacts on corporate earnings is the bottom line. There are far too many unknowns to draw any conclusions, but directionally, the impact is negative and global equity markets are poised to open down about 2% on February 3. However, global equity markets enter this period of uncertainty on decent footing. Earnings growth expectations are solid and recent reports are surprising to the upside across much of the world. Valuations in non-U.S. equity markets aren’t overly onerous, some are quite low (China).

Tariffs are a disruption; and disruption has been the name of the game for five years or more. Corporations have become quite skilled at navigating challenges, particularly supply chain challenges, including the 2018 trade war, COVID shut down and reopening, and the war in Ukraine. Add on cracks in the U.S banking system (Silicon Valley Bank failure), inflation’s spike and retreat, coupled with a coordinated global central bank tightening cycle. All of this has made businesses hardened and more resilient and better able to meet this new challenge.

Bonds – we expect bond yields to decline as demand increases for their perceived status as a safe haven investment, relative attraction amidst an economic slowdown, and expectations of the stepped-up Bank of Canada easing.

Rely on diversification

Discipline, patience and balance are key to navigating periods of heightened uncertainty and market volatility. Well diversified investors need to remember the role various assets play in their portfolios under the current circumstance. Other ways to think about creating resiliency in your investments are outlined below.

U.S. equities exposure brings U.S. currency exposure. The investments remain compelling on their own merits, with the additional benefit of a currency offset to Canadian investors at a time when the Canadian dollar is under pressure.

The Canadian stock market is not the Canadian economy. Tariff threats conjure up images of steel, forest products, food stuffs and auto parts. While these are important to the Canadian economy, their weighting on the Canadian stock market is minimal. These industries combined are a low-single-digit weight of the S&P/TSX. The big weightings are metals and mining at 12%, energy 17%, and financials 33%. Resource companies are seeing a lighter tariff impact; while financial services face none.

Even Canadian companies in industries subject to tariffs have significant plants, facilities and operations inside the U.S. – none of which are subject to tariffs.

We see Canadian medium- and longer-term bond yields falling, bringing price appreciation to high-quality bond positions. This is the role these bonds play in balanced portfolios.

Bottom line

As mentioned in last week's Weekly Strategy Perspectives ([Weekly Strategy Perspectives: Navigating Volatility - BMO Private Wealth](#)), equity markets have a historic ability to weather external shocks including wars, terrorist acts, pandemics and other assorted economic calamities. Sharp reactions in the short-term as new information is assimilated into valuations and outlooks is to be expected, but it is important to not let fear or emotion drive decision making.

Our advice is to remain calm – panicked, knee-jerk reactions to any market calamity are never the best course of action. This is evermore the case given the level of uncertainty and the pace and fluidity of the current situation.

As always, maintaining a well-diversified portfolio across asset classes, sectors and individual issuers is the best defense against bouts of market volatility. Please contact your BMO Private Wealth professional if you have any questions, and to discuss your portfolio and specific securities.

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