RJL PCS: MARKET PERSPECTIVES

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Market Perspectives: Navigating the unfolding trade war

Navigating the unfolding trade war

As previously threatened, on February 1, President Trump signed an executive order initiating sweeping tariffs on Canada, Mexico, and China. This was initiated following the declaration of a national emergency, specifically related to the flow of fentanyl into the United States, which has contributed to the opioid epidemic sweeping the country. For context, fentanyl seized at the border with Canada last fiscal year was 19.5 kg vs. 9,570 kg at the Mexican border. A lethal dose of fentanyl could be as small as 2 mg. There were an estimated 107,500 drug overdose deaths in the U.S. in 2023, down approximately 3% from 2022, according to the CDC, with synthetic opiods such as fentanyl contributing to 69% of those cases.

The tariffs were originally planned to go into effect on February 4, with a 25% tariff on all Canadian goods, with the exception of energy, which would be subject to a lesser 10% rate. All goods from Mexico were to incur a 25% tariff, and goods from China were subject to an additional 10% tariff. Despite previously being the primary target of Trump's frustrations with threats of 60% tariffs, the lower rate was rationalized as being incremental to existing tariffs and therefore Chinese tariffs are starting from a higher baseline. Many Chinese products were already subject to 25-100% tariffs.

On February 3, after separate phone conversations with Mexican President Claudia Sheinbaum and Canadian Prime Minister Justin Trudeau, President Trump agreed to delay the start date of these tariffs by one month. This was accomplished by Mexico agreeing to send 10,000 National Guard troops to the U.S border to crack down on fentanyl and migrants specifically. In Canada, after committing $1.3 billion to border security measures in December, specifically targeting the fentanyl trade, Trudeau promised to invest an additional $200-million to fight organized crime and drugs, and to appoint a "Fentanyl Czar" and designate drug cartels as terrorists. A new Canada-U.S. Joint Strike Force is also planned to combat organized crime, fentanyl and money laundering.

Canadian retaliation planned

Prior to the Monday phone calls and establishing this detente, Prime Minister Trudeau had announced that Canada would impose 25% retaliatory tariffs on $30 billion worth of American goods on the same day as the U.S. tariffs were implemented (see list here), followed by further tariffs on $125 billion worth of American products in 21 days' time, to allow Canadian companies and supply chains to find alternatives. These retaliatory tariffs are presumably also similarly delayed.

Separately to these federally enacted retaliation plans, we have seen multiple provinces indicating that they would remove American products from provincially run liquor stores, cancel contracts with certain U.S. companies, and restrict new business with American organizations. For the most part, these actions seem to have also been put on hold pending further discussions and developments. Additionally, we have seen a wave of patriotic "Buy Canadian" campaigns sweeping the country.

What was the impact on Monday?

After digesting the Saturday announcement of the tariff implementation, politicians, citizens, and investors reacted to the impending deadline with only faint hope of the delay that eventually came. While there were multiple dramatic scenarios being scoped out on the economic and employment impacts, the financial markets immediately reflected their concerns.

Multiple economists have been publishing possible outcomes for weeks. The tariffs, as announced on Saturday, were close to the worst-case scenario. The Bank of Canada (BoC) provided a report as part of the January Monetary Policy Report, on the potential impacts of U.S. tariffs. It's benchmark calibration puts the first-year impact of 25% across-the-board tariffs at a 2.5 percentage point negative adjustment, meaning that a previous forecast of 2.0% growth for the year – along the lines of what we were trending to – becomes a contraction of 0.5%. In the second year, the benchmark calibration is 1.5% lower, and by the third year, GDP growth would be expected to return to normal. (Different scenarios put the cumulative impact at 3.4-4.2% negative adjustment to GDP from the baseline forecast, over the time period.)

The biggest variable was the length of time that these tariffs were expected to be maintained. For the most part, if maintained for six months or more, the expectation would be for at least a mild recession in Canada, with the potential damage growing over time if companies end up moving supply chains or even entire factories. We should also be mindful that even the overhanging threat of tariffs for an extended period of time can affect economic growth as both individuals and businesses might postpone spending, investment, and expansion decisions awaiting a more predictable environment.

Under the tariff scenario it is important to consider the potential reactions of the U.S. importer. If the importer, or ultimate payor of the tariff, expect the tariff to be short-lived, they would likely have to gauge the cost and effort is switching to a non-Canadian, or domestic supplier, against the time-limited costs of absorbing all or some of the tariff. Retail consumers, with multiple alternative options to the tariffed Canadian good might be quick to switch to a lower-cost product, but industrial product importers might not have such a luxury. Therefore, there might be less impact to the demand for certain Canadian goods, especially those involved in a complicated supply chain or requiring lengthy approval processes to replace.

Equities markets reacted swiftly on Monday, with the TSX Composite dropping over 2% at the opening, but recovering some of that ground over the next couple of hours and ending the day down just 1% (see Table 1). While the detente negotiated between Canada and the U.S. was not announced until after market close, we expect that the Mexican agreement, announced just after 10am EST, provided some optimism that Canada would be able to strike a similar deal.

As we have previously discussed, tariffs of this nature were likely to create further weakness in the Canadian dollar, beyond what we were already expecting with the weaker Canadian economy and growing differential between Fed and BoC policy rates. The Canadian dollar has hit a 22-year low against the U.S. dollar and consensus expectations seem to be that a return to the 25% tariff threat could put another 5-6% of pressure on the exchange rate, pushing the Canadian dollar down to the US$0.65-0.66 level. U.S. Treasury Secretary Bessent noted that for every 10% increase in tariffs, the opposing country's currency could fall by ~4%. Therefore, a stronger USD helps mitigate the impact of tariffs to Americans. The weaker Canadian dollar makes exports to the U.S. relatively more attractive, before factoring in the tariffs, and makes imports from the U.S. more expensive for Canadians.

What happens next?

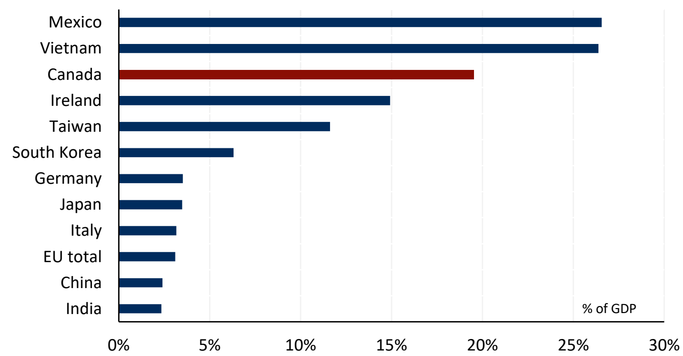
We expect that for the next month, Mexico and Canada will separately look to demonstrate the effectiveness of these enhanced border security initiatives and try to solidify such cooperation with more announcements. If Trump can declare a massively successful negotiation that has significantly improved border security, specifically related to the trafficking of fentanyl, we see the potential to further delay or remove this specific tariff threat.

Could this then be the end of tariff threats?

Unfortunately, we should anticipate subsequent rounds of tariff threats for various reasons over the next few months, at least. Even if we can avoid these fentanyl-driven tariffs, we should expect further grievances against topics such as Canada’s lagging defence spending, immigration, and trade deficits driving subsequent rounds of negotiations. We see Trump also likely focused on critical minerals and energy commodities that Canada can provide as he looks for better pricing and supply commitments. As a side note, President Trump is reportedly linking aid to Ukraine to the country supplying critical minerals such as lithium and uranium to the U.S. Canada is an important supplier of 13 of the 35 minerals that the U.S. has identified as critical to economic and national security. We should also expect pressure to increase defence spending, and given that Greenland is on the radar, we will likely see demands to allow a greater U.S. military presence in the arctic.

The U.S. retains a significant advantage in negotiations by leveraging the heavy reliance that Canada and Mexico have on their trade with the U.S. As shown in Chart 1, Canada’s export dependence on the U.S. is equivalent to almost 20% of its GDP. President Trump has no issues with using this reliance to his advantage.

Chart 1 - Export Dependence on the U.S. as a Percentage of Each Country's GDP



Source: Statistics Canada, U.S. Census Bureau, Raymond James Ltd.; For the year ending December 31, 2023.

Table 1 - % Change of Capped Sector Index from Friday's Close

S&P/TSX Sector	at Monday's Open	at Monday's Close
S&P/TSX Composite	-2.2%	-1.0%
Communication Services	-1.7%	0.3%
Consumer Discretionary	-3.6%	-1.8%
Consumer Staples	-2.0%	-1.2%
Energy	-1.7%	-0.4%
Financials	-3.1%	-1.8%
Health Care	-3.0%	-2.1%
Industrials	-3.5%	-2.5%
Information Technology	-1.7%	-0.3%
Materials	0.7%	0.8%
Real Estate	-2.5%	-1.5%
Utilities	-1.8%	-0.7%

Source: FactSet; Raymond James Ltd.

What can Canada do?

We have seen a strong united front from the federal government, provinces and territories through this crisis so far, and we are encouraged at the potential for this to be a catalyst to review interprovincial trade barriers. Dropping these trade barriers could provide a boost of several percentage points to Canadian GDP, which would partially offset any negative impact from U.S. tariffs. Additionally, we see this as bringing further discussions about energy and mineral development and distribution to the forefront in order to build up more resilience in the Canadian economy.

What can Canadian investors do?

Now that we have seen how the financial markets reacted on the first trading day after the executive order was announced, we have a good idea about market sensitivities to various sectors and companies. Overall however, the takeaway should be that investors need to work with their advisors to ensure appropriate diversification in their portfolios that address both return requirements and risk tolerance. Although we seem to have a reprieve in this trade war for the time being, we should recognize that the situation can change very quickly and investors need to ensure they are prepared and well positioned.

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