CI GLOBAL ASSET MANAGEMENT

Capital Insights

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HOPE FOR THE BEST, PLAN FOR THE WORST:
Economic Implications and Considerations for Canadian Investors

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Hope is an emotion, but investing requires pragmatism. As Canadians, we feel uncertainty about the future and hope that the tariff dispute is short-lived. But tariffs are now a reality, although duration and broader implications remain unclear. While U.S. policies could shift at any time, the Canadian and global economies are facing structural changes that will reshape business activity, trade flows, and overall economic health. Investors must reassess risks and adjust accordingly.

At the same time, signs of slowing are emerging in the once 'exceptional' U.S. economy. Retail sales and housing activity have softened, and a significant inventory build-up has occurred ahead of tariffs just as demand appears to be rolling over. Cuts to public-sector spending are also weighing on sentiment, contributing to job losses and reduced activity among businesses serving government contracts.

Financial markets are reacting. U.S. assets have outperformed in recent years, but with trade uncertainty mounting and growth moderating, investors are reconsidering their exposure. This potential investor rotation combined with a softening economy could push U.S. interest rates lower and weaken the U.S. dollar.

While the Trump administration may welcome a weaker currency, the implications for Canada are mixed. A weaker loonie would help offset the squeeze on exporters facing higher tariffs, while importers would feel additional pressure from rising costs tied to Canada's own retaliatory measures.

For the U.S., tariffs add complexity to an already delicate balance. While growth is slowing, trade-related inflationary pressures could complicate the Federal Reserve's ability to respond. The U.S. economy is less reliant on global trade than others, but tariffs will still weigh on growth at a time when momentum is seemingly fading. Investors should be prepared for heightened volatility and remain flexible as the situation evolves.

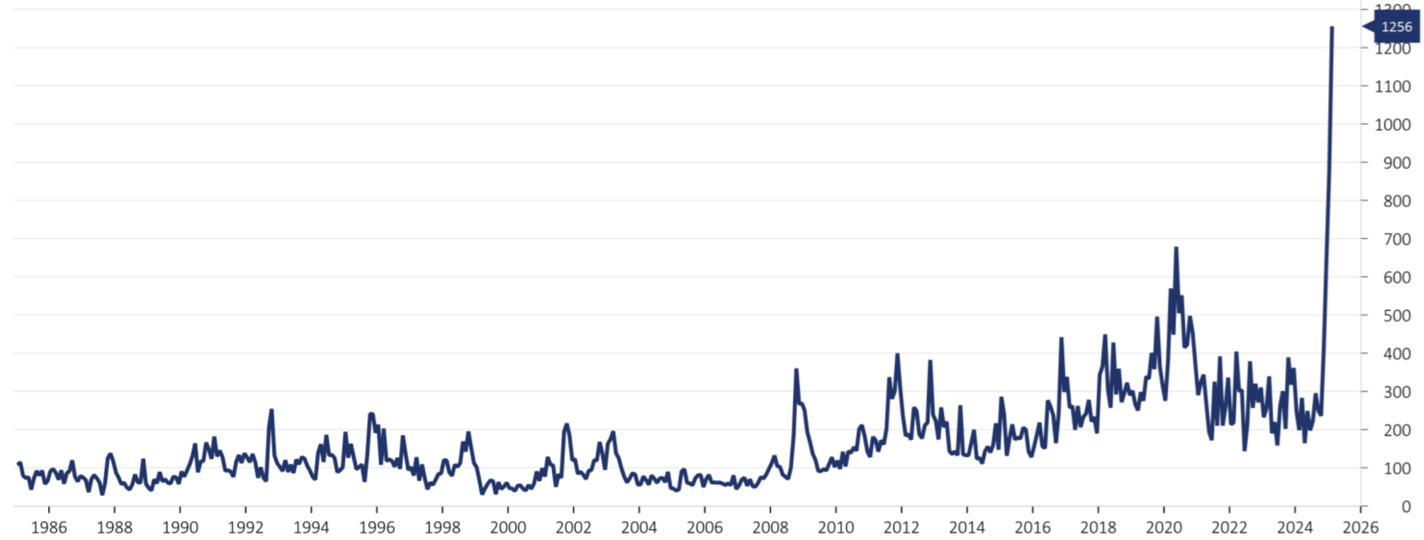
What Happened?

Over the past month, heightened uncertainty has loomed over the future of trade between the United States and Canada. After the signing of the Executive Order on February 1 and a subsequent delay on February 3, the U.S. has officially imposed a 25% tariff on all non-energy exports from Canada, while Canadian energy exports will incur a lower 10% tariff.

Mexican exports to the U.S. also face a 25% tariff, while China's exports are now subject to a 20% tariff, combining the 10% tariff applied on February 4 with the new 10% tariff applied today.

One slightly positive development is that President Trump signed a new Executive Order on March 2, extending the exemption for low-value shipments under $800 from Canada and Mexico, which had been set to end with the new tariffs. This extension provides short-term relief to e-commerce businesses, though the exemption is expected to be removed once the adequate systems for revenue collection are in place.

CANADA ECONOMIC POLICY UNCERTAINTY INDEX



Source: Bloomberg Finance L.P., Macrobond, as of February 28, 2025.

How Has Canada Responded?

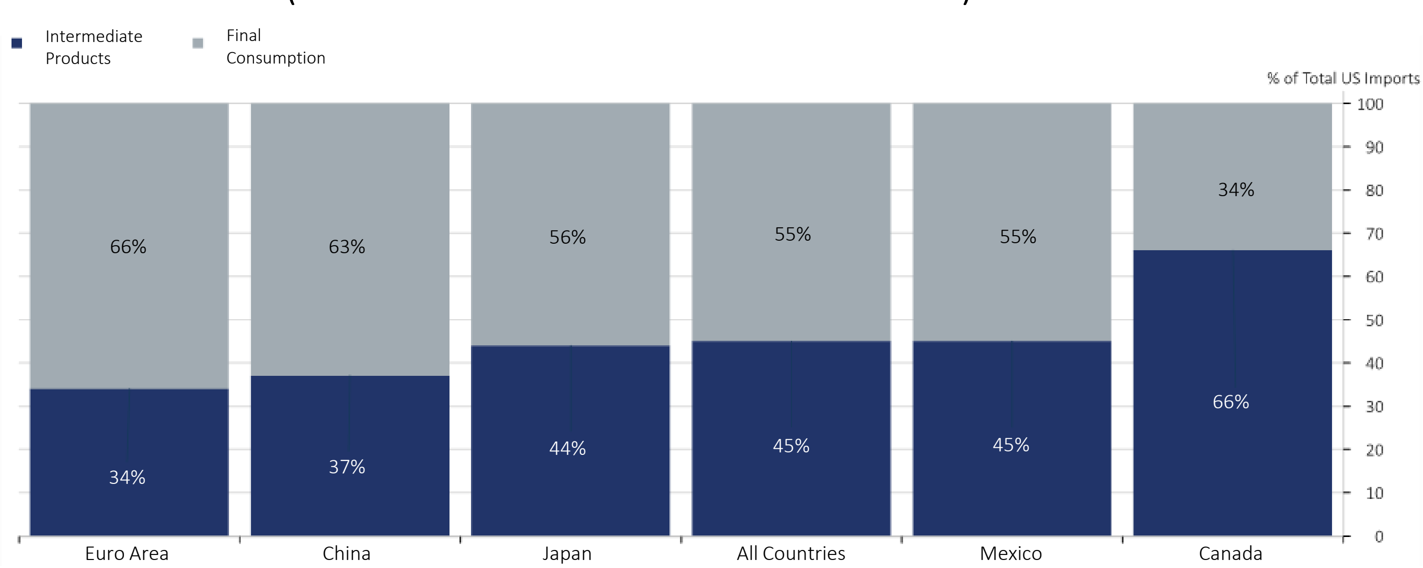
As we highlighted in our Capital Insights note on February 4, the Canadian government has already announced retaliatory tariffs of 25% tariffs on $155 billion of U.S. goods, with the first phase – covering $30 billion of final consumer items, including about $10 billion in food and beverage products – taking effect today.

As the Government of Canada outlined in early February, the second phase of retaliatory tariffs will cover $125 billion of U.S. goods and will likely be made available in the coming days for a 21-day comment period prior to implementation. This list will include products such as passenger vehicles, trucks and buses, steel and aluminum, certain fruits and vegetables, aerospace products, and more.

Taken together, tariffs on $155 billion of U.S. goods represents roughly 40% of Canada's imports from the U.S. and may largely avoid intermediate inputs, which will mitigate some of the damage to Canadian manufacturers.

U.S. manufacturers will not enjoy the same privilege. Notably, two-thirds of U.S. imports from Canada are intermediate products. This is significantly higher than that of other countries. Importantly, President Trump's February 1 Executive Order indicates that if Canada retaliates, the U.S. may increase or expand the scope of duties.

SHARE OF U.S. IMPORTS (INTERMEDIATE PRODUCTS VS. FINAL CONSUMPTION)



Source: FRBSF, Macrobond, as of February 24, 2025.

Long-Lasting Tariffs Will Derail Canada's Economic Improvement

The Bank of Canada's 200 basis point reduction in interest rates was leading to an improvement in economic activity. Fourth quarter GDP data, released last week, revealed Canada's economy ended 2024 on solid ground and momentum was also evident in the beginning of 2025. The labour market exhibited very strong jobs growth in December and January and consumer spending had also picked up.

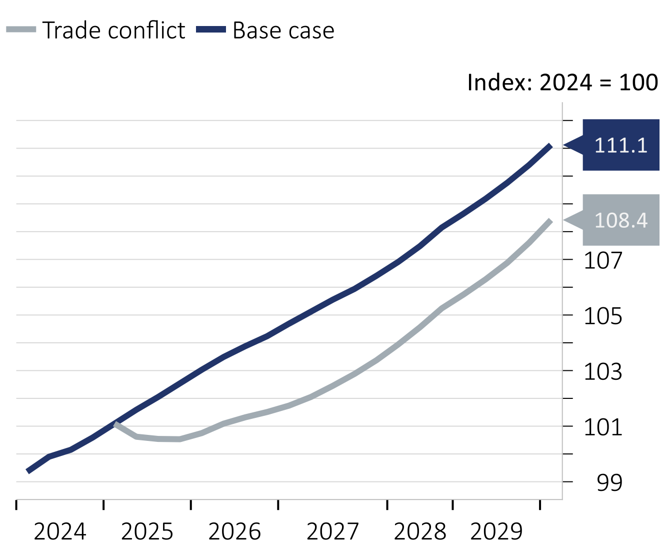
That said, tariffs already appear to be weighing on activity given the looming uncertainty over the past month. Canadian home sales declined in January, with most of the weakness apparent toward the end of the month. Consumer sentiment has also declined since the rhetoric surrounding tariffs on Canadian exports intensified, with a significant drop in February. Business surveys suggest nearly two-thirds are pausing capital investment plans until there's clarity on trade relations.

On February 21, Bank of Canada (BoC) Governor Tiff Macklem presented an illustrative scenario of the economic impact based on the tariffs that were implemented today, plus Canada's announced retaliatory tariffs.

Based on this scenario, real GDP growth would decline immediately and stabilize by 1Q 2026, the peak impact would equate to a -2.9% hit to GDP relative to the BoC's baseline forecasts. Notably, as Governor Macklem highlighted in his accompanying speech, the economic consequences of a protracted trade conflict would be different than the COVID shock.

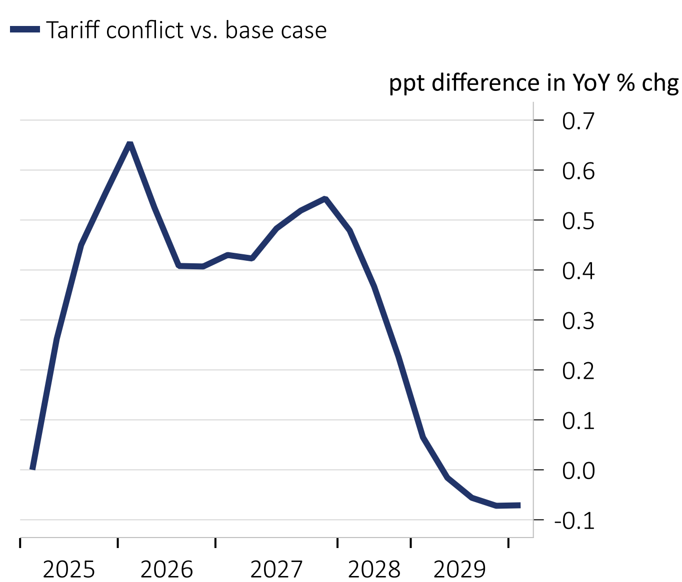
Unlike the sharp recession of 2020 that was followed by a rapid recovery as the economy reopened, long-lasting tariffs would prevent a rebound, leading to a permanent reduction in output compared to what would have been the case in a non-tariff world.

BOC'S GDP PROJECTIONS: DIMINISHED OUTPUT POTENTIAL



Source: Bank of Canada, Macrobond, as of February 21, 2025.

BOC'S INFLATION PROJECTIONS



Source: Bank of Canada, Macrobond, as of February 21, 2025.

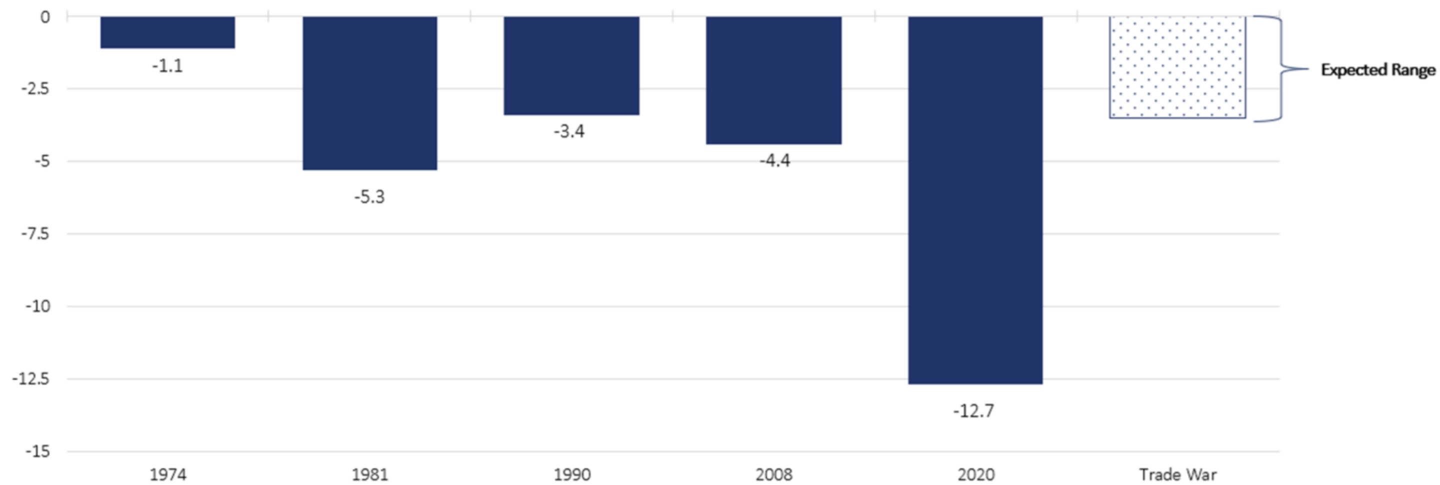
In the BoC's tariff scenario, factors pushing prices up more than offset the downward price pressure from weaker demand, so inflation rises. Their analysis suggests that headline inflation would likely head toward 2.5-3.0% YoY vs. the BoC's baseline projection of closer to 2% over the next 2 years.

It is important to highlight that models are imperfect at the best of times. The lack of historical precedent and uncertain path forward make them even less reliable. As such, while these projections provide us with an idea of the impact of tariffs, the precise impact will ultimately depend on the duration of the tariffs and the fiscal and monetary policy response.

There are also other positive offsets that may come from an eventual reduction of interprovincial barriers, policies that improve tax competitiveness and ultimately attract business investment, and development of infrastructure to support the domestic energy sector.

Make no mistake: while these efforts may mitigate some damage to the Canadian economy, the BoC's current projections suggest that today's tariffs will likely lead to a recession, with a decline in activity similar to previous downturns.

REAL GDP GROWTH (PEAK TO TROUGH % CHANGE)



Source: Bank of Canada, Macrobond, as of January 29, 2025.

What Could Canada's Fiscal Support Look Like?

Governments across Canada are already publicly exploring financial support options to offset U.S. tariffs. Existing programs such as Employment Insurance (EI) and the EI Work Sharing (WS) program, which helps firms avoid layoffs during downturns, can be activated quickly without the need for new legislation. The EI WS was previously used during the 2018 steel and aluminum tariffs, extending agreements from 36 to 76 weeks, streamlining processes, and broadening eligibility to include related industries and those affected by retaliatory tariffs.

Other options, such as wage subsidies (CEWS) or expanded EI (CERB), may also be considered but would require Parliamentary approval. That said, support is likely to be more targeted and time-limited, even if tariffs are in place for several months. As experienced during the pandemic, pro-longed support could result in unwanted inflationary pressures.

What is the BoC's Likely Response?

With the BoC's next meeting just over a week away, attention is turning to what their next move might be. The market implied probability of a 25-bps cut has sharply risen following the implementation of tariffs and currently sits at nearly 95% (previously 50%).

Moreover, a total of 75 bps of cuts are now expected this year. This would take the overnight rate to 2.25%, the bottom end of the BoC's range for its neutral rate estimate. Further cuts beyond this may be warranted but will depend on the severity of the decline in activity and the fiscal policy response.

In making this assessment, the BoC will also be closely watching and assessing whether the downward pressures on inflation from the weakness in the economy offsets the upward pressures from higher import costs, a weaker Canadian dollar, and inevitable supply chain disruptions. If the latter is the stronger force, monetary policy would be constrained given the BoC's inflation mandate.

One thing is clear, as Governor Macklem highlighted in his most recent speech, the response is unlikely going to look like a "COVID type response" as the BoC wants to ensure "that the tariff problem doesn't become an inflation problem".

The Long and Bumpy Road Ahead

The current situation and path forward remain fluid. The U.S. administration has threatened tariffs on other exports that would amplify the impact on the Canadian economy. Next up are 25% tariffs on steel and aluminum imports due on March 12. Please see our Capital Insights publication for more details on the impact of these tariffs.

Reciprocal tariffs and a further 25% tariff on all non-US origin automobiles, pharmaceuticals, and chips may also come into effect as early as April 2. More recently, tariffs on agriculture products and softwood lumber have also emerged. Additional tariffs would presumably be in addition to the tariffs implemented today, i.e. tariffs on Canadian steel and aluminum exports would amount to 50%.

In recent days, members of the Trump administration have proposed the idea of Fortress North America, suggesting that tariffs on Canadian and Mexican exports to the U.S. may eventually be lifted, although the criteria for what objectives must be met to achieve a resolution remain unclear.

While various avenues to challenge the legality of the Executive Order exist, particularly given existing trade deal in place with Canada (USMCA), this is unlikely to be practical. Any challenges would be symbolic and take months to resolve, while the tariffs continue to inflict economic damage.

PRESIDENT TRUMP'S TARIFF THREATS AND ACTIONS

Target Nation	Implementation Date	Target Goods	Tariff Rate
Canada and Mexico	March 4, 2025	Total goods exports	**25%** on non-energy; **10%** on Canadian energy
China	March 4, 2025	Total goods exports	**20%** (including 10% implemented on February 4, 2025)
Most nations	March 12, 2025	Steel and aluminum	**25%**
	April 2, 2024	Reciprocal tariffs	**TBD**
	April 2, 2025	Automobiles, pharmaceuticals and semiconductors	**~25%**
	April 2, 2025	Agriculture products	**TBD**
	TBD (likely November 2025)	Softwood lumber	**TBD**
	TBD (likely November 2025)	Copper	**TBD**

Investment Implications: Managing Risk While Identifying Resilience

Investors should be prepared for heightened volatility and remain flexible as the situation evolves, making disciplined risk management essential. Sectors most exposed to U.S. tariffs - particularly manufacturing and export-driven industries - face mounting pressures. However, some businesses will adapt, whether by restructuring supply chains, expanding into alternative markets, or leveraging government incentives to sustain domestic production.

Navigating this environment requires a measured, long-term perspective. While risks are in focus, market adjustments will create opportunities as businesses reposition. The coming months will be pivotal in determining whether tariffs persist, shift, or ease. Our focus remains on protecting capital while identifying areas of resilience, ensuring portfolios are well-positioned for an evolving trade landscape.

For more information, please visit ci.com.

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