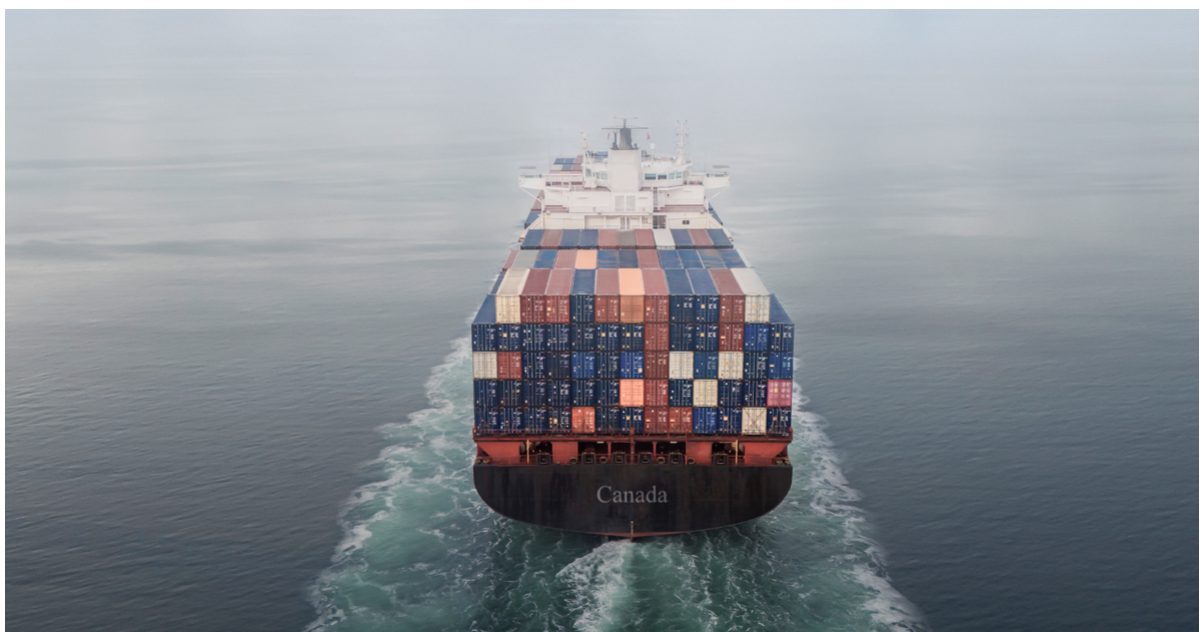


February 3, 2025

Rising uncertainty amid tariff threats—what does it mean for Canadian investors?

Whenever the threat of tariffs raises its ugly head, market volatility is never far. On Saturday February 1st, the Trump Administration announced that the United States was imposing significant tariffs on its largest trading partners: 25% on Canadian and Mexican goods and 10% on Canadian energy products. China also faces a 10% export tariff.



On Monday, in a demonstration of how fluid the situation remains, Mexican President Claudia Sheinbaum announced that after a conversation with the president, the U.S. had agreed to wait a month before the Mexico tariffs take effect.

Canada appeared unlikely to get a similar reprieve. Prime Minister Justin Trudeau announced 25% counter-tariffs on \$30 billion worth of select American imports, with similar levies on an additional \$125 billion worth of trade to come 21 days later. Canada, Mexico and China are the United States' largest trading partners, and a protracted trade dispute would negatively impact all three.

The reaction from investors was no surprise. Markets opened Monday morning with the S&P 500 (US), Nasdaq (US), and S&P/TSX (Canada) down 1.5%, 1.9% and 2.8%, respectively. The MXSE IPC (Mexico) was closed Monday for a holiday. The Canadian dollar dropped to 0.68 CAD\USD, down 1.6% since Friday. Crude oil was up 1.4% to US\$73.77. While most investors know not to make knee-jerk investment decisions, it isn't always easy to do so. Might lessons from 2017/18 provide some insight? We take a closer look.

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Donald Trump's victory in last November's U.S. Presidential election made headlines around the world and generated countless analysis and pieces. Among them, the view that the new U.S. administration was looking to introduce tariffs of up to 25% on Canadian exports to the United States.

Speculation heightened in the lead up to the inauguration ceremony on January 20, but few could've anticipated the turn of events that followed. The morning brought relief as news outlets reported that in place of a tariff announcement, a broad memorandum would be issued, directing U.S. government agencies to study the country's trade deficits and evaluate U.S. trade relationships. The evening, however,

brought news that Washington could impose 25% tariffs on Canadian goods from February 1. That deadline has now passed and the Trump Administration stayed true to their word.

Unsurprisingly, this has caused some angst among Canadians. While tariffs in any form are likely to have a negative impact on Canada's economy, as investors, it's worth bearing in mind that the economy is distinct from the markets.

It's impossible to predict how Washington's policies will evolve over the coming months. Will the Trump administration quickly pivot if gasoline prices begin to rise materially, or inflation increases due to the likely extra cost of tariffs on the US consumer? Or will this become a long, drawn-out battle? For now, any discussion around quantifying the impact on the economy would amount to, at best, false precision, and at worst, pure speculation. That said, it's important to understand the economic relationship between Canada and the United States as well as the investment landscape that we were operating in the last time we experienced tariff uncertainty, i.e., in 2017 and 2018.

Historically, Canada and the United States have enjoyed one of the most extensive and mutually beneficial bilateral relationships in the world, characterized by deep economic, cultural, and political ties. Here are some key aspects of their interdependence.

Trade: the world's most comprehensive trading relationship

It's no coincidence that Ottawa and Washington describe trade between both countries as "the world's most comprehensive trading relationship." Goods and services worth nearly \$3.6 billion (US\$2.7 billion) cross the border each day in 2023. It shouldn't surprise anyone that Canada and the United States are each other's largest export markets. Similarly, the United States is the single largest investor in Canada while Canada returned the favour by being the biggest source of foreign direct investment to its neighbour to the south at the end of 2023.¹

Energy: a key component of U.S. energy security

Canada is a major supplier of energy to the United States, including oil, natural gas, and electricity. In fact, it's the United States' single largest foreign energy supplier,¹ thereby making the country a crucial component of U.S. energy security. Canada exports nearly four million barrels of crude oil to the United States every day, powering some six million U.S. homes. U.S. refineries, particularly those in the Midwest and around the Gulf Coast, are set up to process Canadian crude as opposed to crude from the Middle East or Venezuela.

Supply chains: state of interdependence

It's common knowledge that the two nations have highly integrated supply chains. Infrastructure that connects both countries have been built over decades, linking industries such as automotive, aerospace, and technology. Parts and materials often cross the border multiple times during the manufacturing process. In 2023, a hefty 72% of U.S. freight with Canada was transported by land—the old-fashioned way using truck and rail. The extent to which the two economies are dependent on it was laid bare last August when a labour dispute led two rail companies to shut down freight traffic on Canada's two largest railways. Cue numerous headlines on how the shutdown would roil North American supply chains and inflict damages to both the U.S. and Canadian economy.

Canada-United States: the best of friends and the closest of allies

It's clear that the United States and Canada rely heavily on each other for economic prosperity, energy security, and regional stability. It's why the two nations have often been described as the best of friends and the closest of allies.

While tariffs are in place in the near term, we believe it's unlikely that significant tariffs—the variety that which would have a materially adverse effect on both economies—

will be in place by the end of the year. Retaliatory tariffs have been announced, but ultimately, most would agree that neither side stands to benefit from a prolonged trade dispute. As such, we think investors should ignore the short-term headline noise as it's unlikely to impact investment returns over the long run.

That said, the curious mind wants to know how a trade dispute between Canada and the United States might affect investment returns.

Comparing then and now

For much of the first two years of the first Trump administration (2016–2018), the U.S. equity market, as measured by the S&P 500 Index, fared well—until around the last quarter of 2018 trade disputes between the United States and [China](#) escalated. The index subsequently dropped nearly 20%, hitting a bottom on Christmas eve that year.

As we've mentioned earlier, the stock market is distinct from the economy; however, some market commentators see it as a forward-looking indicator where the economy might be heading. In this instance at least, it proved prescient: in 2019, a year after tariffs were implemented, the United States lost as many as [43,000 factory jobs](#) and domestic [business investment declined](#).

The S&P 500 Index hit a bottom in Q4 2018 but recovered in 2019



Source: Macrobond, Manulife Investment Management, January 29, 2025.

Unsurprisingly, investors are concerned that history could repeat itself. Their fears are perhaps accentuated by the market environment in which we find ourselves—lofty stock valuations. Looking back to 2018, however, it seemed clear to us that there was much more going on behind the scenes that could have influenced market performance—tariffs were only one part of the equation.

In 2018, the U.S. Federal Reserve (Fed) was in the process of getting its policy rate back to their target levels following a prolonged period of low interest rates in the wake of the global financial crisis. The Fed began its rate-hiking cycle in December 2015, when the target range for federal fund rate was 0.25%–0.50%. By September 2018, the target range had risen to 2.00%–2.25%.²

At the time, the fear was that the tariffs would result in a global economic slowdown and that the U.S. economy might be more negatively impacted as a result of the Fed's tightening bias. U.S. equity market valuations declined amid economic and earnings uncertainty. The global equity markets also experienced a significant drawdown, derailed by the prospect of a global recession.

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Compare that with today, where the Fed has arguably exhibited an easing bias, having already cut rates by 100 basis points since September 2024.² What this tells us is that in the event the U.S. economy shows signs of weakening as a result of heightening trade disputes, the Fed has much more room to stimulate the economy through further rate cuts than it did in 2018.

While we think a repeat of 2018 is unlikely, we believe it makes sense for investors to be proactive and take steps to insulate their portfolios from the threat of tariffs.

In this environment, we favour taking a balanced approach to portfolio construction. We believe investors' focus should be on security selection—in both equity and fixed income—rather than on broad index allocation. In our view, there's also an opportunity to identify areas of the equity markets that are less sensitive to potential trade disputes. U.S. mid-cap companies, for instance, is a way for investors to gain exposure to procyclical/"America First" policies. From a sector perspective, industrials form the biggest component of this segment of the market. This is significant because it's the group that's highly likely to benefit from onshoring initiatives and have the ability to provide some protection against further U.S. dollar appreciation (potentially more so than their large-cap peers since a larger portion of their revenue is earned domestically.)

Navigating uncertainty

Following the material pullback in the U.S. equity markets in the fourth quarter of 2018, investors were eventually rewarded with a strong recovery the following year. To us, this is yet another proof point showing that short-term trade skirmishes may not

have a long-term impact on market returns. As such, it's critical that investors do not make impulsive investment decisions on the back of unsettling news headlines.

It's impossible to eliminate uncertainty—it'll always be a part of the investment journey, albeit with varying triggers. What's important in times of heightened uncertainty is to retain objectivity and clarity of thought, adhere to established principles of investing, and focus on our individual investing goals.

¹ Government of Canada, January 22, 2025. ² U.S. Federal Reserve, January 29, 2025.

Important disclosures ▼

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