CIBC ASSET MANAGEMENT

Special report

Navigating US policy dynamics

Anticipated effects of the new trade tariffs

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March 4th update

What happened?

President Trump has imposed new tariffs: 25% on imports from Canada and Mexico (10% on Canadian energy) and increased the levy on Chinese goods from 10% to 20%. We underestimated Trump's willingness to risk a weaker economy by simultaneously threatening and implementing elevated tariffs on China, Canada, and Mexico, as well as potentially on Europe and Asia. These actions could bring US growth close to zero by 2026 and negatively impact earnings, posing political risks ahead of the US mid-term elections.

Why is this happening?

Tariff discussions, initially focused on border security issues like illegal immigration and fentanyl, have expanded, we believe, to include political matters such as access to natural resources, tariffs on China, urging Canada to increase military spending, and addressing perceived protectionism in Canada (e.g., lumber, dairy). The global geopolitical landscape is shifting as the US redefines its relationships to better compete with China as a long-term strategic rival and military threat.

What are our core views?

We view tariffs as a painful negotiation tool, with Trump applying maximum pressure to secure a successful deal with Canada. We anticipate a deal within 3-6 months with an 80% probability but see a 20% risk that it may take longer than 6 months to be reached. Our baseline assumptions include 30% tariffs on China and 25% tariffs on EU auto and agriculture. We expect a reduced version of USMCA that includes increased protectionism for the US auto sector and political conditions for Canada (such as imposing tariffs on China).

Why we expect a deal?

We expect a deal with Canada due to several key factors. First, the US cannot reshore all key supply chains because of resource constraints and costs; current supply chains with Canada are deeply integrated, reliable, and safe. US tariffs on Canada (and Canadian retaliation) will bring targeted pain to US auto producers, refiners, and consumers. Given that the US has a trade surplus with Canada, excluding oil, retaliation by Canada should also hurt the US. Trade war with Canada could reduce US growth by 0.5%. Additionally, Canada complements the US economy, unlike China and Europe where companies are competitors; approximately two-thirds of Canadian exports to the US are intermediate goods, while most other countries export final goods to the US. Finally, the US seeks to secure long-term access to natural resources, and Canada is uniquely positioned to assist in this regard, as most other countries cannot provide the same level of support.

Consequences of our outlook and risk scenarios

We anticipate greater short-term pain for the Canadian economy, with recovery potentially remaining weak at around 1% until a deal is reached within the next two quarters. If the deal takes longer to finalize, growth could turn negative, prompting additional cuts by the Bank of Canada (BoC).

What is the long-term outlook for Canada?

The long-term GDP outlook is favourable with a renewed trade deal. Canada is currently facing a housing shortage, which is expected to lead to the construction of more dwellings. Additionally, the country has a positive infrastructure outlook and is poised to benefit from the expansion of the US economy.

What are the implications for investors?

Given the unpredictability of the trade war, investors should maintain a balanced and diversified portfolio. In a tariff-risk environment, bonds may become more attractive than usual.

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