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Tariff update and implications

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Financial markets have been highly volatile as investors digest the potential impact of tariffs and weigh the various scenarios. With the situation rapidly evolving, uncertainty is elevated and the range of potential outcomes is especially wide.

Overview

The U.S. appears to be acting on its threat to implement large-scale tariffs. Markets have already responded, and the economic damage – if the current tariff path is fully pursued – would be significant, to the point of recession for Canada and Mexico. Additional tariffs appear forthcoming in Europe and elsewhere.

We would nevertheless flag the significant probability that the scale of these tariffs is lessened before too long. These tariffs run contrary to President Trump's goal of supporting domestic economic growth and reducing inflation, he has explicitly tied them to desired concessions from other countries, and tariffs have already been removed (Colombia) and delayed (Mexico and Canada) as those countries comply with U.S. policy objectives. Consequently, the most likely scenario in a year's time remains for tariffs, but of a smaller, more targeted nature that impose only minor market and economic damage.

New trade barriers

Following through on the tariff plan that he announced after his election victory in November, President Trump signed an executive order over the weekend, applying 25% tariffs on Canadian and Mexican goods, and a 10% tariff on Chinese goods. These are effective on February 4, 2025 for China, but the deadline has reportedly been delayed by a month for Mexico and Canada.

Canadian energy will only be subject to a 10% tariff, meaning that the average weighted tariff on Canadian goods exports to the U.S. is approximately 21%.

China has not yet responded with measures of its own, though it has complained that the new tariffs violate World Trade Organization (WTO) rules and is reportedly making additional plans to retaliate. Mexico has not yet released the details of its tariff plan, and may not ultimately have to based on recent discussions with Trump, but the expectation is that Mexico would impose 25% tariffs on a range of U.S. goods.

In response to the U.S. actions, Canada initially announced that it is levying tariffs against the U.S. in two stages. The first stage is a 25% tariff on C$30B of targeted U.S. goods. The second stage is much larger, applying 25% tariffs on a further C$125B of U.S. goods.

For context, Canada imported C$376B in U.S. products over the past twelve months, so the full C$155B represents tariffs on just under half – 41% – of Canadian imports from the U.S. As such, it isn't quite a tit-for-tat response, making for an average weighted tariff rate of 11% on U.S. products imported to Canada. Framed across Canada's entire trade landscape, the country's average tariff rate rises by approximately 5.5 percentage points (imports from the U.S. are almost exactly half of overall Canadian imports).

Canada is also considering imposing non-tariff barriers, though large-scale actions such as constricting oil exports to the U.S. do not appear to be in the immediate offing. Smaller actions like limiting the sale of U.S. alcohol and excluding American firms from penning government contracts are being implemented in patchwork fashion at the provincial level.

Canada's initial list of targeted U.S. products is extensive, spanning mostly discretionary consumer goods such as alcoholic beverages, fruits and vegetables, clothing, shoes, appliances, furniture, perfume and sports equipment. The longer list, to be applied at a later time, captures a much wider range of products, including a considerable range of vehicles, steel and aluminum, and meats and dairy.

Basic principles

The tariff threat in Trump's second term is indisputably greater than it was in his first term. It appears to be less aligned with resolving unfair trade practices (recall the greater focus on China from 2017 to 2020), and more as a means of inducing other countries to comply with U.S. wishes, as well as generate tariff revenue to finance tax cuts. Further increasing the scope for action, Trump has surrounded himself with more ideologically aligned politicians and policymakers this time.

But there are still some bounds as to what constitutes realistically sustainable tariffs. Tariffs will still increase U.S. inflation and reduce U.S. economic growth – see the estimates furnished later – limiting the extent to which they can be applied before there is significant macro-economic blowback. The business sector does not welcome tariffs, and the new Administration has many C-suite advisors.

It is also clear that the White House does not genuinely believe that tariffs are economically maximizing (at least in the short run) for the U.S., as otherwise they would have followed through with the original plan to implement large tariffs on a wide range of countries on President Trump's first day in office.

Instead, the White House has repeatedly delayed the tariffs. Optimists might note that tariffs on Canada and Mexico have already been delayed three times over the past two weeks – from January 20 to February 1, and then to February 4. Now, Mexican and Canadian tariffs are reportedly being delayed until at least early March. At this juncture, the implication is that the U.S. is a somewhat reluctant actor.

The U.S.-Colombia spat from last week provides a perfect example of this, with a 25% tariff threatened and then rescinded when Colombia bowed down to U.S. demands on migrant deportations. So, tariffs are, at least in part, a negotiating tactic designed to achieve other aims.

Scenarios from here

This report is being released before tariffs are implemented, leaving theoretical room for further delay or even cancellation, although we acknowledge there is considerable likelihood they will be applied, at least temporarily.

Concerningly, the dialogue between the U.S. and Canada appears to be quite limited, with the latest exchange on February 3 seemingly surfacing further U.S. grievances over American corporate access to the Canadian economy, as opposed to achieving incremental progress toward a detente. Perversely, to the extent Canada is not a major source of illegal immigration or drugs for the U.S., it may be harder to comply with U.S. border security demands than for Mexico.

Tariffs are still theoretically forthcoming against Europe and potentially elsewhere in the coming weeks, though the odds of this have surely also declined as North American tariffs are delayed.

We have calculated five tariff scenarios, depicted in Exhibit 1.

President Trump is currently pursuing a version of the "North America-focused tariffs" scenario. That happens to be the worst-case scenario for the U.S., Canadian and Mexican economies, and a fairly bad outcome globally. If sustained, it would induce a deep recession in Canada and Mexico.

Exhibit 1: Tariffs scenarios

Scenario	Detail	GDP effect		Inflation effect	
No tariffs	No significant new tariffs	0.0% for all		0.0% for all	
Original tariff plan	60% China 10% Rest of world	US: -1.2% CN: -1.4% CA: -1.9% MX: -1.5%	Global: -1.0% EZ: -0.9% UK: -0.6% JP: -0.6%	US: 0.5% CN: 0.6% CA: 0.8% MX: 0.6%	Global: 0.4% EZ: 0.4% UK: 0.2% JP: 0.2%
North America-focused tariffs	25% Canada 25% Mexico 10% China	US: -1.5% CN: -0.6% CA: -4.5% MX: -4.0%	Global: -0.8% EZ: -0.4% UK: -0.2% JP: -0.2%	US: 0.6% CN: 0.2% CA: 1.8% MX: 1.6%	Global: 0.3% EZ: 0.2% UK: 0.1% JP: 0.1%
Substantial but temporary tariffs	One of the above scenarios, but tariffs withdrawn after several months	US: -0.4% CN: -0.3% CA: -1.0% MX: -0.9%	Global: -0.3% EZ: -0.2% UK: -0.1% JP: -0.1%	US: 0.2% CN: 0.1% CA: 0.4% MX: 0.4%	Global: 0.1% EZ: 0.1% UK: 0.0% JP: 0.0%
Partial tariffs	Smaller tariffs on targeted sectors and countries	US: -0.2% CN: -0.3% CA: -0.3% MX: -0.2%	Global: -0.2% EZ: -0.2% UK: -0.1% JP: -0.1%	US: 0.1% CN: 0.1% CA: 0.1% MX: 0.1%	Global: 0.1% EZ: 0.1% UK: 0.0% JP: 0.0%

Note: As at 02/02/2025. Maximum cumulative effect on economic output. Presumes reciprocation. Source: Oxford Economics, RBC GAM calculations.

But it is not preordained that the White House continues down this path. We flag a high probability that the script flips within the coming weeks or months, pivoting to the “Substantial but temporary tariffs” scenario. That is to say, as a base case forecast, we don’t expect the large tariffs to be permanent. If correct, the economic damage would be considerably diminished. In this scenario, akin to undulations associated with a natural disaster, the economic damage would be considerable for a few months, but then bounce back as soon as the adverse pressure is lifted.

Perhaps stubbornly, our best bet in a year’s time is still the “Partial tariffs” scenario which envisions smaller targeted tariffs persisting into the future. This would balance Trump’s desire to extract concessions and generate tariff revenue, without overly damaging the U.S. economy.

In contrast to American blanket tariffs, Canadian and (likely) Mexican tariffs are targeted to exact maximum U.S. economic and political damage while minimizing pain to Canada and Mexico via the choice of products for which demand is elastic and/or substitutes exist. This theoretically pushes a disproportionate fraction of the economic and inflation damage onto the U.S. side of the border, though of course there will be significant pain on both sides, and the greater overall trade orientation of Canada and Mexico to the U.S. (as a share of their economies) still leaves the U.S. neighbours as the more vulnerable parties.

The most adversely affected countries are likely to deliver additional monetary easing and further fiscal stimulus, and their currencies – which have already fallen – are also capable of partially absorbing the macro aspect of the blow. But this does not shelter them entirely, and if tariff policy sticks to the most adverse scenario, the economic damage would be considerable.

An interesting thought is that to the extent concerns about the U.S. economy prior to these tariffs had been focused on the risk of overheating, tariff damage reduces the risk of this – at least from an output standpoint. Of course, tariffs also increase prices, which is especially unwelcome in the U.S. where inflation has been stickier than in most other markets and the central bank has already been in a difficult position.

From a long-term standpoint, an unanswered question is the extent to which these tariffs leave a legacy of structurally higher political and policy uncertainty, do reputational damage, induce malinvestment and/or possibly even encourage an enduring realignment of the global order in a way that could alter and subtly undermine economic growth prospects for years to come. This is not certain: it is important not to over-estimate these effects given the tendency for the world to snap back to normal once an economic shock has faded from view, but neither should they be ignored.

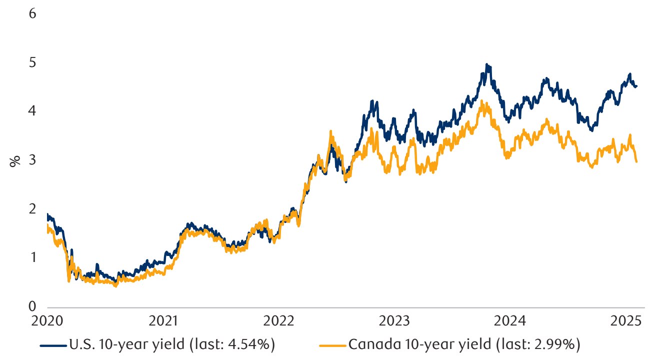
Market implications

We recognize that some of the tariff news is priced in, but not all, and it makes for a particularly challenging environment for investors. For those with a longer-term view, near-term market volatility tends to be noise within the bigger macro picture, but that noise can often lead to opportunities. So far, the market reaction over the weekend was fairly pronounced, although most asset classes have retraced a good amount of their overnight moves.

For government bonds, we have seen a significant adjustment in yields, most notably in non-U.S. markets. The Canadian 10-year bond yield fell by 19 basis points at one point last night. The drop to 2.88% represents an extension of the decline that began in mid-January from a high of 3.56%, although some of the decline was pared back as Monday's trading session progressed (Exhibit 2). This latest rally in Canadian bonds (i.e. drop in yields) reflects the looming challenges for the Canadian economy, pricing in an increased probability that the Bank of Canada may need to further lower short-term interest rates should tariffs weigh on growth. In contrast, the U.S. 10-year yield was little changed over the weekend, resting around 4.52%, as investors weigh the drag on growth from tariffs against potential inflationary implications. The spread in the U.S. 10-year yield relative to the Canada 10-year yield has widened to extremes, reflecting the diverging paths for both economies and the implications for monetary policy given that Canada will likely fare worse than the U.S. under a trade war scenario (Exhibit 3).

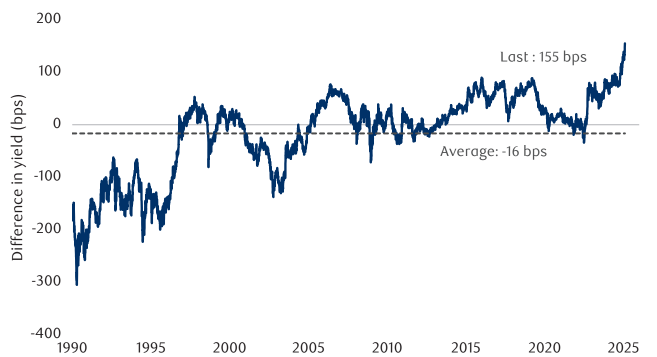
While short term fluctuations can be highly volatile and dependent on a variety of factors that are difficult to predict, we find comfort in relationships that have been relatively stable over long periods. One such example is the link between returns on 10-year bonds and their current yield to maturity. The chart in Exhibit 4 suggests the yield to maturity on 10-year Treasuries explains 96% of the return over the subsequent 10-year period, based on data going back to 1910. While that figure is close to 3% for Canadian 10-year

Exhibit 2: U.S. and Canada 10-year yield



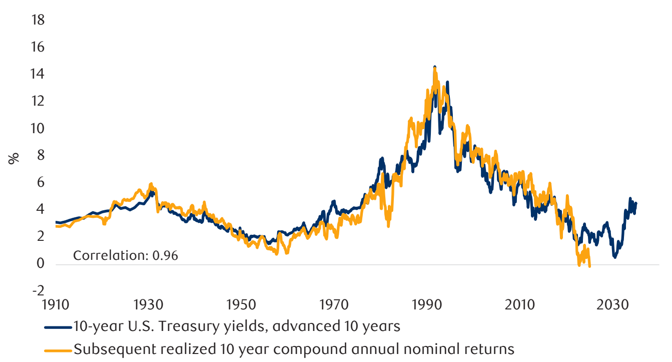
Note: As of February 3, 2025. Source: Bloomberg, RBC GAM

Exhibit 3: U.S. 10-year yield minus Canada 10-year yield



Note: As of February 3, 2025. Source: Bloomberg, RBC GAM

Exhibit 4: U.S. 10-year Treasury note and returns



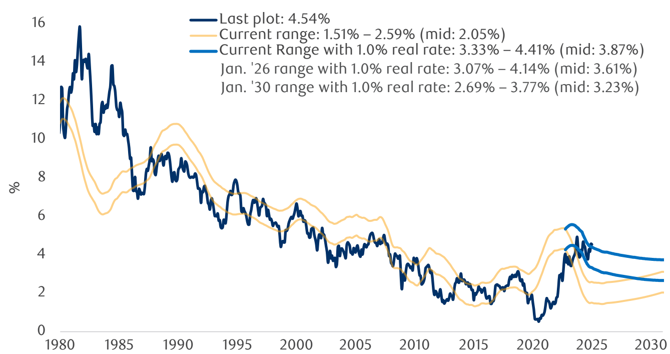
Note: January 31, 2025. Source: Deutsche Bank, Macrobond, RBC GAM government bonds, it remains an attractive 4.5% in the U.S. and, in our view, government bonds, particularly those in the U.S., offer decent return potential with modest valuation risk. This view is supported by our fixed income model that shows U.S. 10-year T-bonds are near the upper boundary of our equilibrium band (Exhibit 5).

In equities, the initial reaction to the tariff news was a steep sell-off across major global stock markets. The S&P 500 futures and tech-heavy NASDAQ futures were down as much 2.1% and 2.8%, respectively, in overnight trading, but recovered part of their losses as the day went on and with the news that the tariffs on Mexico would be delayed by a month. Note that many markets have been trading at or near record highs leading into this latest sell-off, so the elevated uncertainty with respect to tariffs is testing heightened investor confidence and the recent drops represent small declines in the context of the powerful rallies that we have experienced in the past two years.

From a valuation perspective, the U.S. remains the most expensive major market that we track at close to one standard deviation above our modelled estimate of fair value (Exhibit 6). But other regions, such as Canada's TSX Composite and MSCI Europe, are trading in the bottom half of their fair value channels, offering decent return potential should challenges fade or the damage from tariffs prove less severe than initially imagined (exhibits 7 and 8).

Exhibit 5: U.S. 10-year T-bond yield

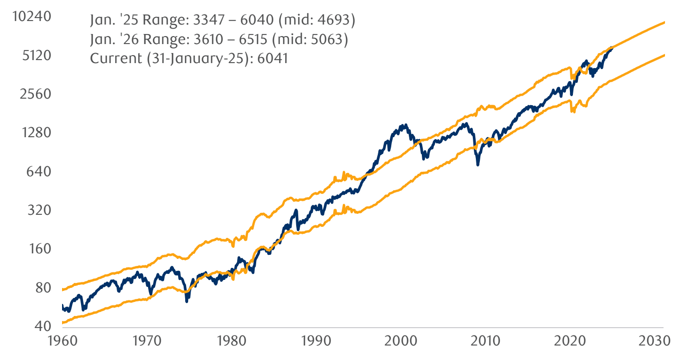
Equilibrium range



Note: As of January 31, 2025. Source: RBC GAM

Exhibit 6: S&P 500 equilibrium

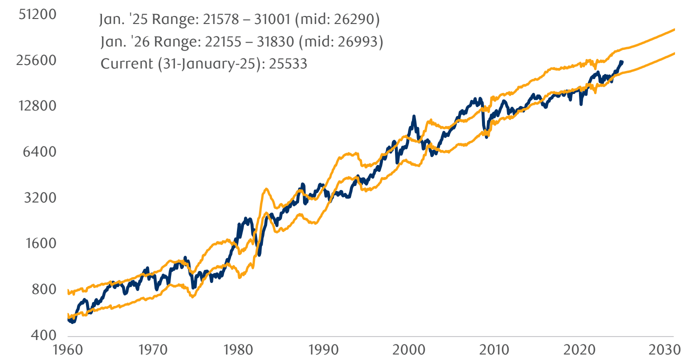
Normalized earnings & valuations



Source: RBC GAM

Exhibit 7: S&P/TSX Composite equilibrium

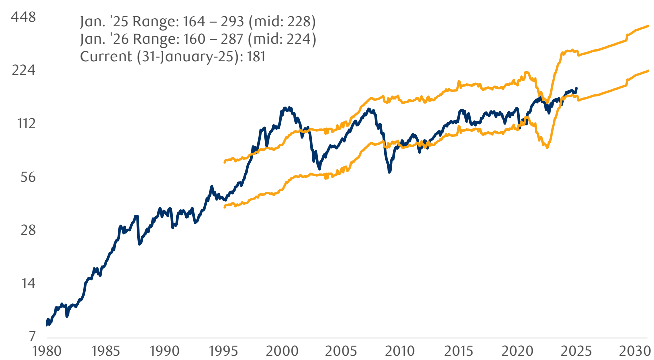
Normalized earnings & valuations



Source: RBC GAM

Exhibit 8: MSCI Europe equilibrium

Normalized earnings & valuations



Source: RBC GAM

That said, if tariffs are fully implemented to the extent that Trump has proposed, corporate profits would likely take a hit, while currencies can provide a partial offset. Tariffs are effectively a tax on international trade, resulting in less consumption and reduced business activity overall. Estimates vary widely depending on the possible scenarios, but earnings expectations could be reduced by as much as 3% to 10%, varying by region and/or sector. The full brunt of the tariffs may be partially offset by currency adjustments. For example, with the recent weakness in the Canadian dollar versus the U.S. dollar, domestic companies generating revenues in U.S. dollars would benefit. Ultimately, the damage to corporate profits will depend on the full scope of the tariffs, if implemented, as well as their duration.

From a currency perspective, prior to the tariff announcements, we had reviewed a variety of models and historic precedents. The caveat this time is that the U.S. currency is already extremely overvalued, and that the tariff news has not been a complete surprise. We came up with a few possible scenarios for the Canadian dollar:

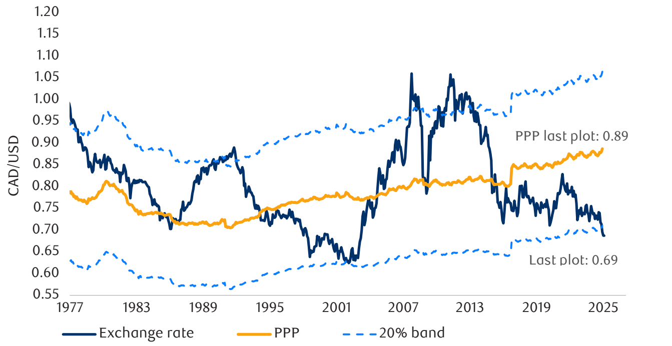
Exhibit 9: USD/CAD foreign exchange scenarios based on tariffs

Scenario	Impact on USD/CAD exchange rate	Projected USD/CAD rate (CAD per USD)
No tariff, indefinite delay	USD depreciates by 2-3%	1.41 - 1.42
10% universal tariff	USD appreciates 5%	1.52
25% universal tariff	USD appreciates 10%	1.60

Note: As of Feb 3, 2025. Source: RBC GAM

As a result, we expect the Canadian dollar to depreciate versus the U.S. dollar if tariffs ultimately go through, but we cannot rule out the possibility that Trump could backtrack on his initial proposal which would lead to increased volatility in currency markets. From the perspective of investors, we are talking about the Canadian dollar going from cheap to cheaper.

Exhibit 10: Canadian dollar & purchasing power parity



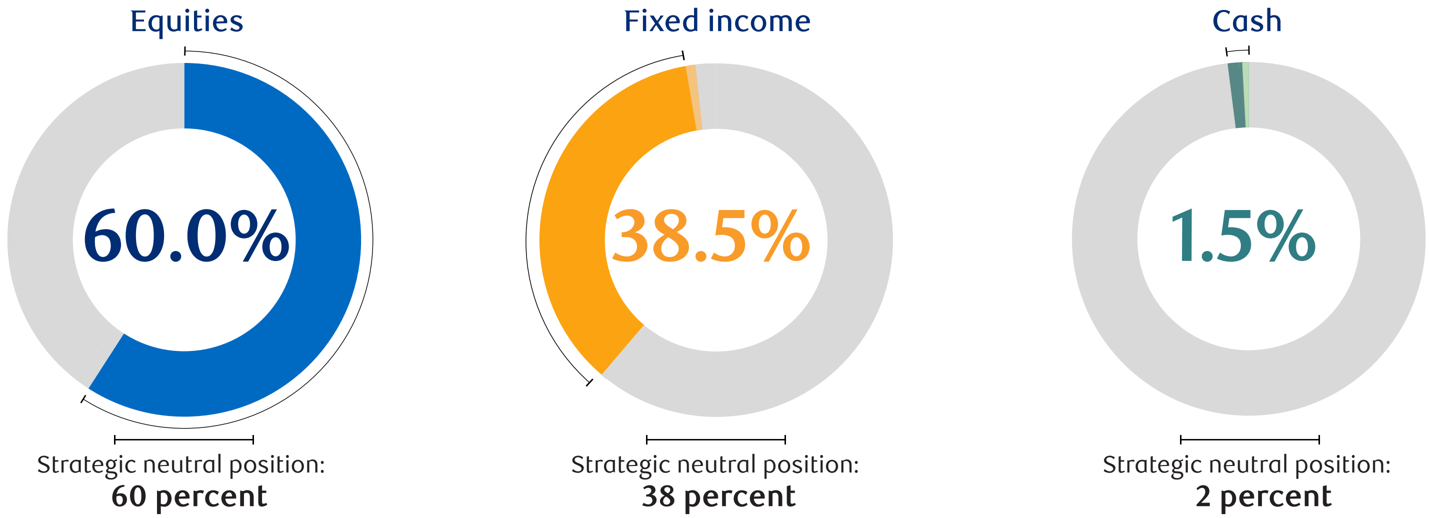
Note: As of Feb 3, 2025. Source: DB FX Research, RBC GAM

In the past, there have been opportunities for holders of Canadian dollars to take advantage of currency strength (for example 2007 to 2008 and 2010 to 2013), at which point Canadians had a chance to spend their expensive Canadian dollars on U.S. assets such as equities or real estate (Exhibit 10). For patient investors, even though the result was not immediate, these assets brought substantial rewards over the next 10 to 15 years. We believe we are at the opposite extreme now. While the turnaround may not be imminent, Canadian assets can be bought at attractive values with expensive U.S. dollars. Moreover, the short-term volatility gives investors in unhedged U.S. assets an opportunity to favour hedged investments.

Taking everything together, it is clear that if tariffs go through it will likely result in a major restructuring of global trade with the potential for significant impacts on financial markets. That said, we recognize that the pain is only severe if the tariffs last for an extended period, and that there are ways in which the tariff threat could be reduced or even eliminated, depending on a variety of factors such as lawmaker intervention or the result of negotiation between President Trump and other political leaders. With the situation evolving rapidly, we are reminded that, over the long term, investing success has less to do with the ups and downs of markets and more to do with how you react to that volatility.

Balancing the risks and opportunities, we are maintaining a recommended asset allocation close to our strategic neutral position, with a slight tilt toward fixed income. At higher yield levels, bonds offer attractive return potential and, importantly, are a critical ballast against equity-market volatility. Last month, we added to our fixed income exposure, boosting our allocation by 50 basis points to a slight overweight from a neutral position, sourcing the funds from cash. While there are significant challenges in the near term, we are maintaining a neutral stance in our equity exposure as we continue to believe that stocks offer superior return potential to bonds over the longer term. We believe our current tactical asset allocation puts us in a good position to benefit from the long term upside potential in stocks, while providing some protection against volatility in the near term, and giving us the flexibility to make adjustments should opportunities arise. For a balanced global investor, our current recommended asset mix is 60.0% equities (strategic: "neutral": 60.0%), 38.5% bonds (strategic "neutral": 38.0%) and 1.5% cash (Exhibit 11).

Exhibit 11: Recommended asset mix
RBC GAM Investment Strategy Committee



Note: As of January 31, 2025. Source: RBC GAM

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