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Special report

Navigating US policy dynamics

Anticipated effects of the new trade tariffs

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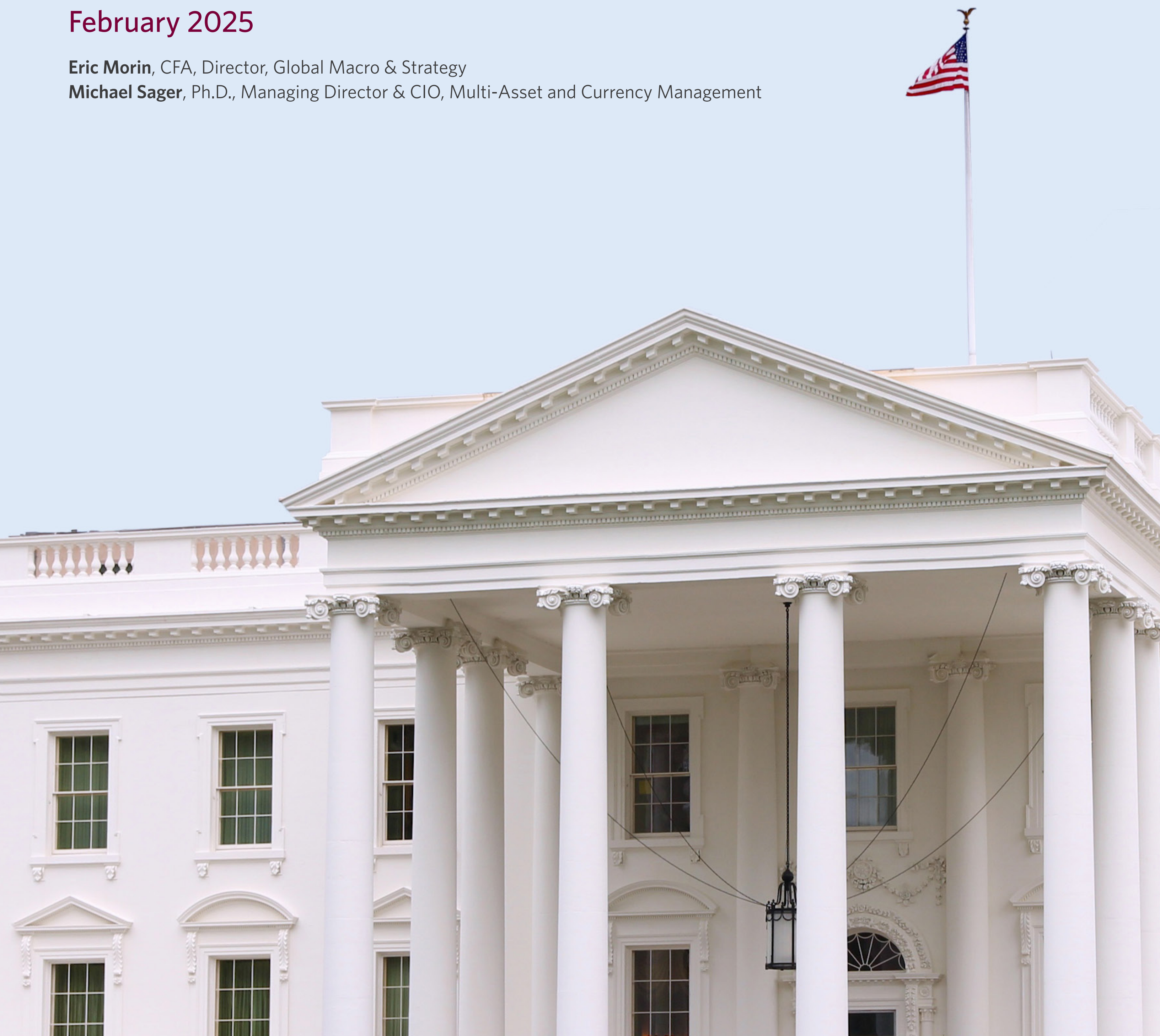

Key takeaways

1. In an uncertain outlook, we expect that the newly imposed US tariffs on Canadian goods will be temporary, with expectations of a resolution through negotiations that could lead to their removal within a quarter. That said, the balance of risk is skewed to the downside as tariffs could last more than one quarter.
2. Prolonged tariffs could significantly impact the Canadian economy, potentially leading to a 2-3% reduction in GDP, while also causing the Canadian dollar to depreciate further against the US dollar.
3. The integration of US and Canadian supply chains means that an extended period of tariffs will likely also inflict economic pain on the US, including auto producers and consumers, which may have political repercussions for the Republican party in upcoming mid-term elections in 2026.
4. Considering the tariff uncertainties, investors should focus on maintaining a well-diversified portfolio across asset classes and geographies. Staying disciplined and avoiding attempts to time the market will be crucial for achieving long-term investment objectives amidst fluctuating economic conditions and political risks.

Baseline economic outlook

Our baseline outlook for the global economy and markets has been cautiously constructive. We had expected resilient US GDP growth in 2025 and a notable recovery in Canadian economic growth in the second half of the year, supported by large interest rate cuts from the Bank of Canada since June 2024. Embedded in this outlook was the view that Canada would avoid large, blanket US tariffs. Instead, our working assumption was tariffs on Canadian goods would be targeted to a subset of exports that excluded oil and autos.

Given recent developments, our adjusted baseline outlook today is that comprehensive US tariffs on Canada (and retaliatory Canadian tariffs imposed on the US) will be short lived. But the situation is highly uncertain, and risks around this revised view are skewed to tariffs remaining for a longer period—or that they could resurface after initial removal.

What happened this weekend?

US President Trump announced tariffs of 25% on goods imports from Canada and Mexico, and 10% on imports from China. Canadian oil exports to the US faces a lower tariff rate of 10%. This outcome is a lot more punitive than we had expected, and has potentially important implications for growth, inflation, and market volatility. The duties will come into effect on Tuesday, February 4th. President Trump has also indicated that additional tariffs focused on Europe and specific sectors, including pharmaceuticals and commodities, will be announced in the future.

- Canada has announced reciprocal tariffs, equivalent to a levy of 25% on American imports worth C$155bn ($107bn) with a staggered implementation, and targeted on Republican states to maximize economic pain in the most politically sensitive parts of the US.
- Mexico has also announced its intention to reciprocate, but without details as of Sunday Feb 2.
- The additional 10% tariffs announced on China augment tariffs already in place, but are less stringent than the 60% level previously threatened by President Trump.

Why is the US imposing tariffs on its three largest trading partners?

They have been positioned by Trump administration as a response to the failure of all three countries to stop the flow of fentanyl into the US. For Mexico and Canada, they are also being positioned as a response to a perceived failure to prevent illegal immigration into the US.

How long could tariffs remain in place?

The outlook surrounding tariffs is highly uncertain. **With this important caveat, we expect tariffs on Canada to be relatively short lived.** In the next few days, there is a risk that the US could respond more forcefully to the announced Canadian retaliation. But the most likely scenario is Canada reaches a deal with the US in a reasonably short time period by committing to comprehensive measures to better secure and control its borders. The baseline scenario of our senior analyst covering US politics is that US and Canadian tariffs levied on one another will remain for no more than one quarter.

Tariffs levied on Mexican goods exported to the US are also likely to be short-lived, but the outlook is more uncertain than for Canada due to more significant border problems.

The new tariffs on China are likely to remain in place longer, perhaps becoming permanent. This reflects a bi-partisan US consensus in favour of efforts to emasculate Chinese economic development in order to minimize its growing global economic and geo-political standing.

What is the likely economic impact from short-lived tariffs?

Even assuming tariffs last no more than one quarter, the already-weak Canadian dollar is likely to weaken further against the US dollar. Depending on how tariff rhetoric evolves in the coming days, USDCAD could certainly move above CAD $1.50 in near future (spot price on Sunday February 2nd = $1.4721; source: Bloomberg). We also expect much more volatility. Currency weakness, as well as targeted fiscal support that we expect will be forthcoming to help impacted businesses cushion some of the impact of tariffs, will buy some time for the Bank of Canada (BoC). We had already expected the BoC to cut its policy rate by 25 bps at each of its next two scheduled policy meetings in March and April. A more forceful response should be expected if US tariffs remain in place longer than the one quarter we expect.

Assuming the removal of tariffs within one quarter and a cumulative interest rate cut of 50bps in the intervening period, we can expect a sizeable Canadian growth recovery in the second half of this year. Short term pain, but better days ahead.

Why do we expect tariffs on Canada to be short lived?

- **Cost-benefit argument for Canada.** In isolation, US tariffs could reduce Canadian GDP by 2-3% compared to a counterfactual of no tariffs. Canada has all the incentives to beef up control of its borders.
- **Canada is not at the core of the fentanyl problem.** The Economist reports that just ~1% of US seizures of fentanyl and encounters with illegal migrants occur on its northern border.
- **The US needs Canada to compete with China.** The US is in geo-strategic, commercial, and technological competition with China. From an economic and geopolitical standpoint, Canada complements US supply chains, while China rivals US interests. The US—which is currently facing important domestic supply constraints—needs Canadian oil and natural resources, as well as its manufacturing potential.
- **US tariffs on Canada will bring targeted pain** to US auto producers, refiners, and consumers, for instance via higher gas pump prices. Auto supply chains are particularly integrated between the US and Canada, implying significant economic pain for American auto firms located in Michigan, a key political swing state. As a result, the impact of tariffs that last longer than the one quarter could be politically costly for Republicans at the 2026 mid-term elections. A majority of Canada's exports to the US are crude oil (~US$100bn), followed by transportation equipment (including motor vehicles), machinery & parts (~US$50bn).

What if we are wrong and tariffs stay in place longer than we expect?

As mentioned above, the current situation is highly uncertain. If tariffs remain in place for longer than we expect the economic costs would become much larger for Canada (and the US). We currently assign a 15% probability that US tariffs on goods imported from Canada could last more than two quarters.

In this scenario, it is likely that the Canadian dollar would experience a much deeper depreciation. The level of GDP would likely decline by a cumulative 2-3% over the course of four quarters relative to a counterfactual without tariffs. In this scenario, and despite higher transitory inflation, we would expect the BoC to cut its policy rates by at least an additional 100 bps (25bps at each of the next two meetings, plus several more cuts thereafter). The cushion from currency depreciation, lower interest rates and bond yields, and targeted fiscal relief to impacted businesses would cushion some of the GDP shock and smooth the negative impact across several quarters. If punitive blanket tariffs remain in place for several quarters, Canada would flirt with a recession. This compares to the notable recovery we had previously expected.

For the US, its own tariffs and retaliatory measures from the likes of Canada, Mexico and China could reduce GDP growth by 1-2% in the next four quarters. Overall, the self-inflicted negative shock for the US economy from long-lasting tariffs is about four times larger than the impact of the 2018-2019 trade war between the US and China. In this scenario, and with a delay of a few quarters, the US Federal Reserve (Fed) would likely cut its policy rate more than priced (as at February 1, markets expected a little less than two 25bps reductions) and 10-year government bond yields would likely fall below 3.75% (from 4.53% on February 1). While

tariffs bring higher prices, they also bring weaker growth. And over time, the negative growth impact is likely to outweigh the one-off shock to prices.

What should investors do?

As we have emphasized in this note, the situation is very uncertain. In the context of heightened uncertainty, it's important for investors to stay disciplined and focused on long-term objectives. Attempting to time exposure to markets often proves to be unhelpful for long-term investment results. In periods like these, we expect to benefit from having prepared portfolios by maintaining a well-diversified mix across asset classes, geographies and styles in our strategic asset allocation.

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