Trump, Tariffs, and Trade: A Preliminary Comment on Canada

On Saturday, U.S. President Donald Trump announced tariffs against Canada, Mexico, and China. Many Canadians and investors had hoped he would exercise some moderation, as some news reports had suggested, but that hope proved misplaced. President Trump imposed two general tariffs on Canada: a 10% tariff on oil and gas and a 25% tariff on all other goods, effective tomorrow. Later on Saturday, the Canadian government responded with a two-phase tariff program. Phase 1, beginning tomorrow, covers $30 billion worth of goods, including groceries, consumer discretionary products, and commodities. Phase 2 is due to occur in about 21 days and will expand the retaliatory measures to an additional $125 billion in goods.

What Is a Tariff?

A tariff is a surcharge applied to goods when they enter a country. The importer of record—the company responsible for importing the product—pays the tariff to the federal government.

Once the importer pays the tariff, they must decide how to absorb the cost. They may pass it on to consumers by raising prices or absorb it themselves, depending on market conditions. In some cases, tariffs are entirely passed on to consumers, while in others, importers bear the cost.

The Potential Impact on Canada

The impact of these tariffs on Canada will depend on several factors, making it too early to draw definitive conclusions. However, three key elements will determine the severity of the trade war:

- **Depth:** The percentage increase in tariffs (e.g., 10% or 25%).
- **Breadth:** The number of goods affected.
- **Duration:** The length of time the tariffs remain in place.

We now have clarity on the first two factors, but the duration remains uncertain.

If the trade war lasts for months, Canada could enter a recession, leading to higher unemployment, lower aggregate demand, and increased inflation due to tariffs. In response, the federal and provincial governments may offer financial support to impacted workers, similar to COVID-era assistance. Additionally, the Bank of Canada could lower short-term interest rates to mitigate economic strain.

A prolonged trade war would impact all Canadian companies. Although the initial tariffs target goods rather than services, the Canadian government has hinted at limiting service contracts with U.S. firms, signaling a possible expansion of the dispute.

Industry-Specific Effects on Canadian Public Companies

It is difficult to imagine any Canadian company remaining unaffected by this trade war. The U.S. tariffs appear overwhelmingly negative, with some key risks:

- **Industrial Manufacturers:** Companies with integrated North American supply chains, such as auto parts and steel/aluminum producers, may face higher costs and supply chain disruptions.
- **Commodity Companies:** Energy and natural resource firms could experience declining demand and lower margins.
- **Banks:** Given their ties to the broader economy, banks may suffer if a slowdown or recession leads to rising unemployment and higher loan losses.

However, there are some potential offsets:

- **U.S. Operations:** Canadian companies with U.S. businesses may see benefits. For example, the Bank of Montreal has substantial U.S. operations, and a weaker Canadian dollar increases the value of U.S. earnings.
- **Commodity Inelasticity:** Tariffs often drive inflation. If applied to commodities with inelastic supply, prices may rise. Since the tariff announcement, oil prices have been climbing, a development which benefits Canadian energy firms.
- **Exchange Rate Effects:** Most commodities are priced in U.S. dollars. A weaker Canadian dollar improves margins for Canadian producers selling in U.S. dollars while incurring costs in Canadian dollars.
- **Stimulated Domestic Demand:** A weaker Canadian dollar encourages local consumption, benefiting domestic retailers such as Canadian Tire, Sobeys, Dollarama, and Loblaw.

We would also note that we believe the 10% tariff applied to Canadian energy is a positive development. This is a modest tariff and we believe that this is easily absorbed. Given that Mexico didn't get the same favourable treatment for its oil, this 10% tariff encourages, at the margin, more Canadian heavy oil demand.

How Might This Be Resolved?

President Trump remains unpredictable, making it difficult to forecast how or when this trade war will end. However, historical examples provide insights:

- In 2018, U.S. tariffs on Canadian steel lasted for 11 months before both countries lifted the restrictions.
- The U.S. government has granted industry-specific exemptions in past trade disputes, particularly in steel. There is already speculation that U.S. firms may seek exemptions for Canadian potash given Canada's dominant market share.

Investment Strategy for a Trade War

Our portfolio strategy is built around high-quality companies - those with diversified businesses, strong balance sheets, and experienced management. We also emphasize reasonable valuations, as overpriced companies tend to suffer disproportionately from market shocks.

As part of our overall process, we conduct scenario analysis for our investments. We assess what factors are of the greatest importance and how things could evolve. Each sector is unique and has factors that could increase or decrease earnings. There are a lot of variables at play, and it's our task to identify how each company's earnings could be impacted.

In addition to understanding the pluses and minuses for each company, we must also take into consideration valuation. Valuation is critically important because as the valuation decreases, a greater degree of risk is theoretically considered, and the margin of safety is greater.

As we look at scenario analysis, earnings impacts, the quality of our companies, and their respective valuations, we have not made any significant changes in our portfolio holdings but have been making modest changes in holding weights. We believe our portfolio is solidly positioned for a multitude of scenarios.

Furthermore, investment decisions need to be taken prudently and thoughtfully as this situation is very fluid. Given the news from this morning that Mexico may have received a one-month tariff pause, this situation is evolving rapidly, reinforcing our belief that the best course of action is our disciplined, long-term investment approach.

Over the past three decades, our strategy has navigated the dot-com bubble, the global financial crisis, and the COVID-19 pandemic. While market shocks often induce fear, history shows they also create opportunities. Our focus remains on long-term resilience, and we continue to avoid overreacting to short-term volatility.

We remind our clients that when markets experience sudden disruptions, investors often assume the worst. However, with uncertainty comes opportunity, and with resolution comes reward. **Stay invested for the long term. Stay calm and carry on.**

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