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Special report

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Canada confronts U.S. protectionism

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Joseph Wu, CFA

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Special report

Canada confronts U.S. protectionism



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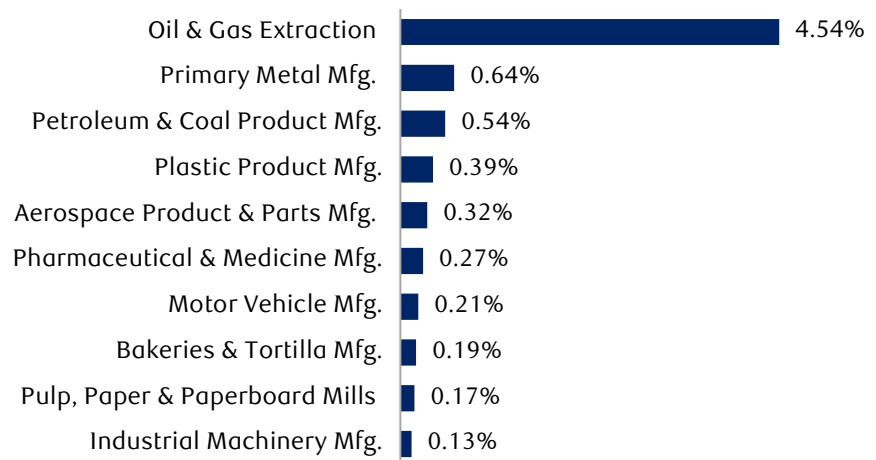
U.S. trade policy is taking a more restrictive turn with potential implications for Canada's economy and equity market. For investors, we believe maintaining a disciplined approach and resisting knee-jerk reactions to headlines will be the best way to navigate through what could be repeated bouts of market volatility.

Bracing for U.S. protectionism

The spectre of U.S. tariffs has cast a shadow over Canada's economy, with potential consequences across several key sectors where cross-border trade plays a critical role. With merchandise exports constituting roughly 25 percent of GDP, the Canadian economy is deeply tied to the U.S., its largest trading partner. Nearly three-quarters of Canada's exports flow south of the border, predominantly within sectors such as energy, metals, and auto manufacturing (see chart below).

Tariffs would almost certainly lead to a decline in exports and dampen economic growth. RBC Global Asset Management estimates that in the worst-case "North America-focused scenario," U.S. tariffs could cumulatively reduce Canadian GDP by as much as 4.5 percentage points after two years, assuming 25 percent tariffs remain in place throughout—a scenario we deem unlikely (see table on next page). RBC Global Asset Management anticipates that any U.S. tariffs on Canada are likely to be limited, as pragmatic considerations are expected to temper the scope of protectionist measures. Under the more probable "Substantial but temporary" and "Partial tariffs" scenarios, the drag on Canadian GDP

Canadian industries exposed to U.S. trade, by share of GDP



Based on 2023 GDP. Includes industries with export/GDP ratios above 100% and a trade surplus with the U.S. of at least \$1 billion.

Source - Statistics Canada, Industry Canada, RBC Economics

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is estimated to range from 0.3 to one percentage point. More broadly, economists generally see tariffs as a “lose-lose” policy, imposing economic costs not only on trading partners but also on the countries that implement them. In addition to potential inflationary effects in the short term, tariffs are often met with retaliatory measures.

Economic implications of U.S. tariffs

Estimated maximum cumulative effect on economic output after two years, assuming reciprocal tariffs

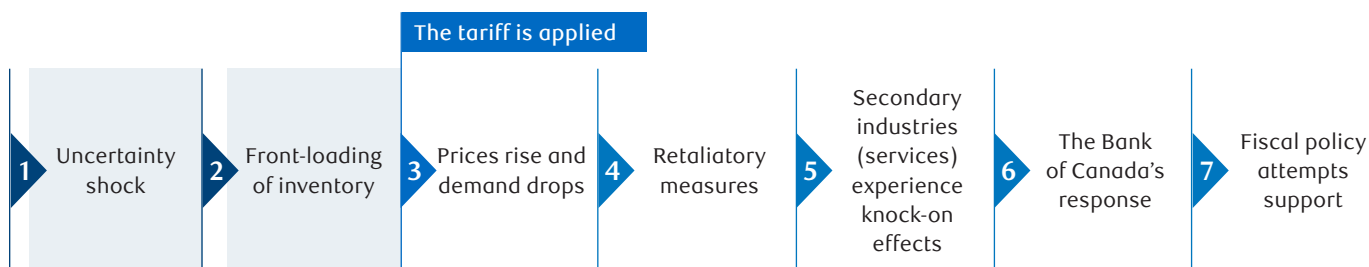
Scenario	Likelihood	Detail	Effect on economic output							
			Global	Canada	U.S.	Mexico	China	Japan	Eurozone	UK
Original tariff plan	10%	60% China 10% rest of world	-1.0%	-1.9%	-1.2%	-1.5%	-1.4%	-0.6%	-0.9%	-0.6%
North America-focused tariffs	10%	25% Canada 25% Mexico 10% China	-0.8%	-4.5%	-1.5%	-4.0%	-0.6%	-0.2%	-0.4%	-0.2%
Substantial but temporary tariffs	25%	One of the above scenarios, but tariffs withdrawn after several months	-0.3%	-1.0%	-0.4%	-0.9%	-0.3%	-0.1%	-0.2%	-0.1%
Partial tariffs	45%	Smaller tariffs on targeted sectors and countries	-0.2%	-0.3%	-0.2%	-0.2%	-0.3%	-0.1%	-0.2%	-0.1%
No tariffs	10%	No significant new tariffs	0% for all							

Source - Oxford Economics, RBC Global Asset Management; data as of 1/24/25

While these projections provide useful context for assessing the possible range of economic outcomes from U.S. tariffs, the various assumptions behind them are subject to significant unpredictability—including how the Bank of Canada (BoC) and Canadian government may choose to respond, the Canadian dollar’s reaction, and the scope, size, and duration of tariffs. Meanwhile, the Canadian government recently signaled it is prepared for “dollar-for-dollar” countermeasures to any U.S. tariffs, adding another layer of complexity.

In a [recent report](#), RBC Economics pointed out that “the reality of a tariff shock is trickier” than can be neatly estimated in a single figure hit to jobs or growth. Beyond specific forecasts, another approach for thinking about how tariffs could ripple across an economy is through a broad-based framework (see graphic below).

How a U.S. tariff flows through the Canadian economy



Source - RBC Economics

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In the short term, the prospect of tariffs can boost economic activity as firms and consumers make preemptive purchases in anticipation of higher costs. However, this initial flurry of activity often gives way to an output “air pocket,” as:

- demand falls off following the pre-implementation front-loading of purchases;
- higher post-implementation prices erode buying power; and
- retaliatory measures dampen export prospects.

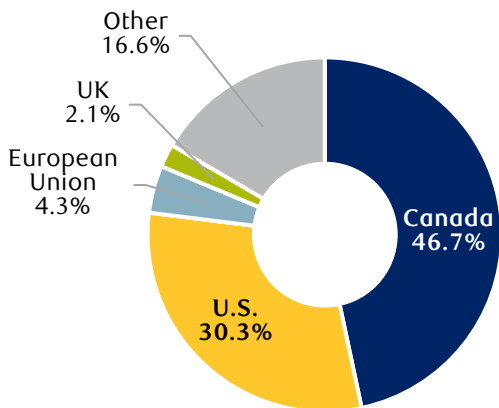
As the macro effects of tariffs take hold, we believe the policy responses from the BoC and the federal government—interest rate policy, counter-tariffs, and support measures for impacted industries—will play a crucial role in shaping the near-term trajectory of the Canadian economy.

Equity market fallout likely manageable

Despite the anxiety around U.S. trade strategy, the broad Canadian stock market may weather the storm better than investors expect, if we assume that a non-recessionary economic headwind from temporary or partial tariffs is the most likely path forward. While approximately 30 percent of the S&P/TSX Composite Index’s revenue is sourced from the U.S., only about a quarter of that exposure is tied to firms in goods-producing industries (see charts below).

S&P/TSX Composite revenue exposure by geographic region

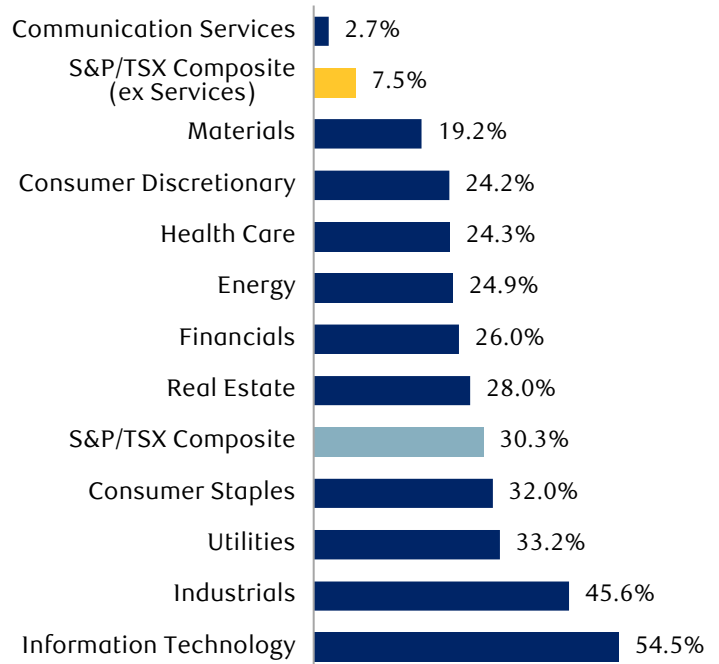
Market cap weighted



Source - RBC Wealth Management, FactSet; data as of 12/31/24

S&P/TSX Composite U.S. revenue exposure by sectors

Market cap weighted



“Services” includes Communication Services, Financials, Health Care, Information Technology, and select industries in the Consumer Discretionary, Consumer Staples, and Industrials sectors.

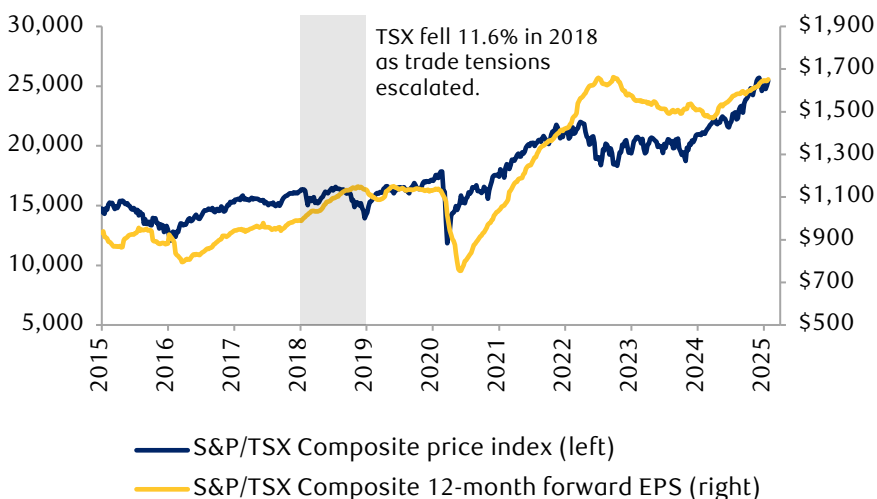
Source – RBC Wealth Management, FactSet; data as of 12/31/24

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Sectors such as Industrials, Energy, Materials, and Consumer Discretionary appear relatively more vulnerable to punitive U.S. tariffs, in our view. By contrast, despite their material U.S. revenue exposure, we think services sectors such as Information Technology, Utilities, and Financials are likely more insulated from the direct impact of trade policy, which tends to focus on merchandise. Still, the knock-on effects from any tariffs—ranging from diminished business investment and dampened consumer confidence—could weigh on the broader Canadian economy and filter through to services sectors.

While U.S. policy uncertainty will likely amplify market volatility intermittently, we think the potential earnings impact for the S&P/TSX Composite from tariffs should be manageable. Canadian companies are no strangers to navigating trade-related uncertainties, most recently the U.S.-Mexico-Canada Agreement, or USMCA, which was negotiated over a span of 14 months in 2017–18, during which the U.S. imposed temporary steel and aluminum tariffs on Canada. The S&P/TSX Composite endured an 11.6 percent price correction in 2018 amid trade anxieties and concerns about the U.S. Federal Reserve’s interest rate trajectory, before rebounding 19.1 percent in 2019 as tensions eased. Beyond the short term, a steadily growing economy and rising corporate profitability remain the most important fundamental drivers for the equity market, in our opinion (see exhibit). FactSet consensus sees earnings for the S&P/TSX Composite rising by roughly 12 percent in 2025, accelerating from just over four percent in 2024.

The equity market follows the direction of earnings



Source - RBC Wealth Management, Bloomberg; data through 1/24/25

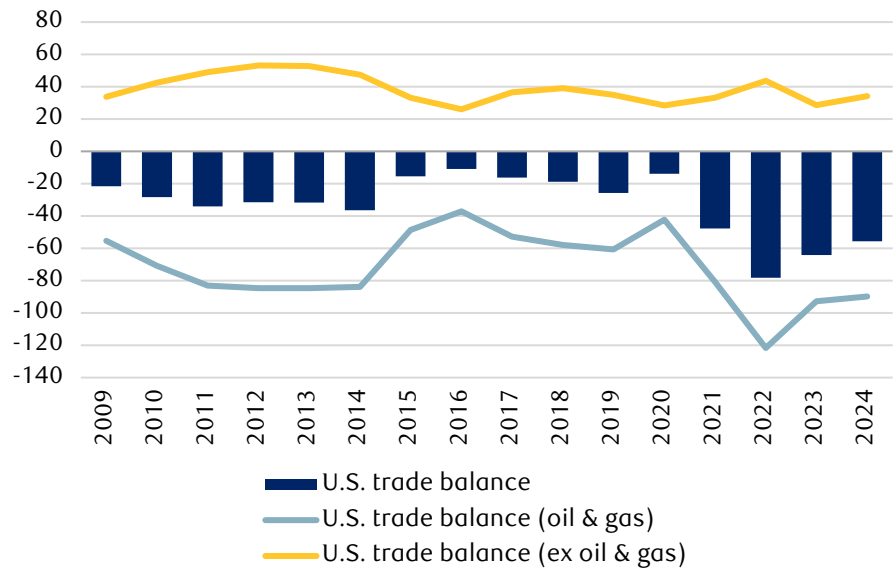
Wait-and-see limbo

The imposition of steep U.S. tariffs by the Trump administration poses a genuine threat, in our view. However, extreme rhetoric can differ meaningfully from actual policies because of real-world constraints on policymakers, including tightly integrated North American supply chains and political sensitivities around inflation.

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Tariffs on oil and gas imports from Canada, for instance, would undermine the Trump administration’s stated goal of lowering energy prices and inflation for U.S. households and businesses. The feasibility of imposing tariffs on Canadian energy seems questionable to us, given the potential lack of viable short-term substitutes to the more than four million barrels of oil that the U.S. imports daily from Canada—roughly 20 percent of U.S. oil consumption. The widely cited U.S. trade deficit with Canada also obscures a more nuanced trade narrative, which shifts markedly when cross-border trade is segmented into energy and non-energy categories. Excluding energy trade flows, the U.S. runs a trade surplus with Canada (see chart below).

U.S. trade balance with Canada



In billions of U.S. dollars; 2024 annual data through November.

Source - RBC Wealth Management, Bloomberg; data through 11/30/24

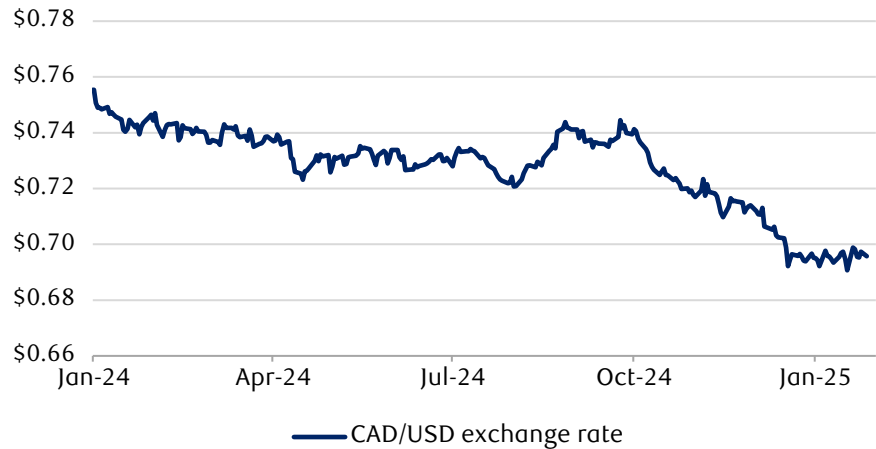
Lessons from how past trade disputes unfolded during the first Trump administration suggest that tariffs may serve as a lever for negotiation rather than a permanent fixture. During his first term, Trump raised tariffs on many trading partners, a tactic that paved the way for new or revised trade agreements—including the USMCA and the “Phase One” agreement with China—that eventually led to the reduction or removal of tariffs.

Financial market reactions will differ widely depending on the specific implementation details of tariffs and how policymakers in Canada choose to respond. The Canadian equity market, for now, remains mostly unperturbed. The S&P/TSX Composite trades at 15.5x forward 12-month consensus earnings estimates, modestly above the 20-year average of around 14.5x, indicating little immediate anxiety among investors. Despite the current calm, we think the events of 2018 are a reminder that trade frictions and concerns about their secondary impact on growth can result in downside price volatility for the Canadian stock market, at least for a time, even if the direct impact of tariffs on earnings turns out to be relatively contained.

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Currency markets, by contrast, have already shown signs of adjustment, with the Canadian dollar weakening by roughly four percent and the trade-weighted U.S. dollar strengthening correspondingly since November’s U.S. presidential election (see chart below). If tariffs are announced, a cheaper Canadian dollar may partially offset the increased costs created by the tariff for U.S. importers, according to RBC Economics.

The Canadian dollar has weakened further



Source - RBC Wealth Management, Bloomberg; data through 1/27/25

In what is likely to be a volatile period for Canadian equity portfolios, we believe maintaining a disciplined investment strategy focused on the long term while avoiding knee-jerk reactions to near-term headlines is the most prudent approach. Diversifying across a range of high-quality companies with durable business models, resilient cash flows, and strong balance sheets provides an effective defense against any trade policy shocks to come, in our view. Firms with these characteristics are typically well-equipped to weather more challenging operating environments and adapt to economic shocks.

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			Count	Percent
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