WEEKLY STRATEGY

# Perspectives

BMO Private Wealth

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## Tariff-ied

"I am a tariff man, standing on a tariff platform."
– 25th U.S. President William McKinley

**The Through Line:** Markets were pleasantly surprised that incoming President Donald Trump did not include overt tariff actions among the many executive orders signed on his first day in office. However, he responded to a reporter's question late Monday evening by saying tariffs remain a front-burner issue for his administration. We expect many trial balloons will be floated on the way to hammering out individualized deals with specific companies, industries and countries. Expect these negotiations to unfold in blow-by-blow accounts via the media, quite possibly causing short-term volatility in markets, rates and currencies. Stay calm and patient as details sort themselves out.

### Tariff announcements noticeably absent

On the campaign trail, President Donald Trump repeatedly emphasized that a core goal of his election bid was to rebuild and strengthen U.S.-based production. Large U.S. trade deficits were anathema to his "Make America Great Again" agenda, with tariffs and America-first trade policy foundational pillars. Markets anxiously awaited Day One pronouncements, bracing for blunt-edged and potentially sweeping levies against friend and foe alike. However, the absence of notable tariff policy in the initial round of executive orders seemed to imply a more nuanced stance on the hot-button topic.

### The what, why and how of tariffs

Tariffs have long been a regular part of global trade policy. In the U.S., they were specifically authorized by the Constitution, supported by Alexander Hamilton – the first U.S. Treasury Secretary – and deployed as a primary method of government funding for well over 100 years. Tariffs are a duty on goods coming into the country, levied to:

- correct for perceived inequities created when a trading partner's industrial policy unfairly subsidizes a specific product or industry (e.g., Chinese solar panels or speciality steel)
- protect nascent industries or those deemed to have national security importance within the U.S.
- raise revenue and/or
- punish a specific trading partner believed to be acting counter to U.S. interests as an incentive to course correct (e.g., President Trump's threat of across-the-board tariffs on EU nations that don't spend adequately on their military or purchases of U.S. oil and gas)

### Assessing the knock-on impacts

In 2018, during President Trump's first term, the U.S. imposed 10% to 50% tariffs on nearly $300 billion worth of goods. Trading partners around the world inflicted retaliatory tariffs averaging 16% according to a study conducted by the National Bureau of Economic Research (NBER).[i]

**Tariffs are typically assessed on a company importing a particular good into a country – not on the exporting country itself.** While economists and business leaders agree that tariffs raise consumer prices for the importing country to some extent, BMO Wealth U.S. CIO Yung-Yu Ma, Ph.D., points out that the percentage of a tariff passed on to consumers depends on a variety of factors: market power of the importing company and country; availability of substitute products and suppliers; and the extent to which higher prices would result in demand erosion.

**Studies on the 2017 to 2019 tariffs found full pass-through of tariffs to consumer prices for many products. They also concluded that tariffs on steel in particular resulted in exporting countries bearing about half of the tariff.[ii] In the current situation, Dr. Ma believes that approximately two-thirds of aggregate tariff levies will be passed on to U.S. consumers, with substantial variation depending on the specific good.**

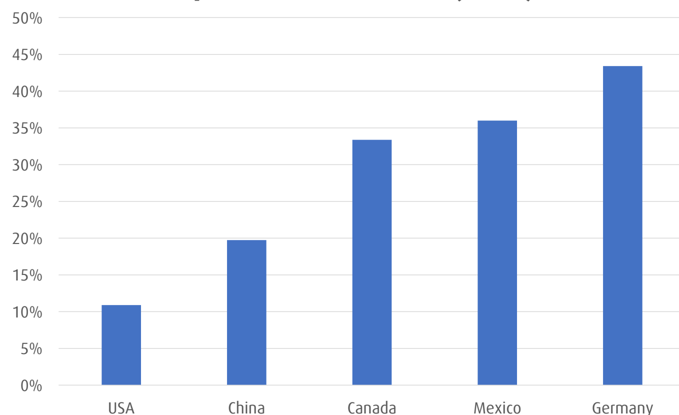
Additionally, we saw tangential impacts. China diverted a huge proportion of its soybean and corn purchases to non-U.S. producers in response to tariffs placed on Chinese solar panels. This dealt such a heavy blow to U.S. farmers that the government stepped in with subsidies.

## Let's make a deal

President Trump has selected a variety of Wall Street types to help shape and implement economic policy in the new administration, including hedge fund manager Scott Bessent for Treasury Secretary and Cantor Fitzgerald CEO Howard Lutnick as Secretary of Commerce. These individuals are well respected among market participants and are widely expected to bring market-sensitive perspectives to the deal-making table. **Our House View has long held that tariffs are more likely to be used as negotiating tactics for extracting desired outcomes and cutting deals with trading partners rather than blunt weapons –** a view reinforced by both the selection of the individuals who will lead policy / implementation and by implication since tariff policy didn't appear in early executive orders.

## Handicapping the endgame – "heads I win, tails, you lose"

While markets breathed a sigh of relief that tariffs were not on the Day One agenda, we fully expect the topic to remain in the headlines as goals for specific trading partners are floated and negotiated. The timing and magnitude of the response from countries and industries impacted by the tariffs will depend in part upon the timing and magnitude of the tariffs themselves. As the chart illustrates, the U.S. economy is largely self-contained, despite the significant quantity of goods imported in whole or in part. Many trading partners, including Canada, Mexico and Germany, are substantially more export dependent than the U.S. This gives President Trump a strong negotiating stance that he fully intends to use.




Source: World Bank Group (2024), Federal Reserve Bank of St. Louis (2024), Bloomberg L.P. (2024), BMO Wealth Management (2024)

- **The EU** – Tariffs could be across the board and/or aimed at key industries with the largest high-dollar-value trade surpluses in the U.S. (autos, luxury goods). The President wants more manufacturing shifted to the U.S. – not "end run" through Canada or Mexico. He has also repeatedly stated he expects all NATO member countries to step up their military spending. More recently, he has noted he expects the EU to increase its purchases of U.S. energy.
- **China** – Rhetoric has focused on large double- or triple-digit tariffs applied across the board, theoretically designed to jump-start negotiations. The final U.S. position(s) will almost certainly be much more nuanced and could well involve insistence on technology transfer (China to the U.S. in categories such as EVs or advanced manufacturing), prohibition against the transfer of militarily-sensitive technology to Chinese companies, and China's removal of subsidies on items deemed to be "dumped" (semiconductors, steel, critical infrastructure-build items). Focus will be on protecting and enhancing key U.S. industries, including semiconductors, AI, robotics, medical devices and other areas demanding highly skilled manufacturing. Interestingly, even the EU is amping up its trade-negotiating status. It recently demanded that China agree to technology transfer relative to EVs in order to receive European subsidies to sell them on the continent.[iii]
- **Mexico** – In addition to wanting concessions on the flow of illegal drugs and immigrants coming across the border, the President is intent on shutting the back door that enables Chinese goods to flow through Mexico and avoid tariffs.
- **Canada** – We had hoped that Canadian business would initially be left alone. According to Statistics Canada data, Canada's merchandise trade surplus with the U.S. hit C$108 billion in 2023. Primary exports to the U.S. consist of mission-critical minerals, four million barrels per day of heavy crude that U.S. refineries are geared for, and parts for U.S. auto makers. We suspect President Trump is pressing the front-foot advantage, given the lame duck status of Prime Minister Justin Trudeau and the knowledge that Canada's exports to the U.S. have more impact in aggregate on its GDP versus Canadian imports on U.S. GDP.

## Implications for Investors

Markets are clearly reacting – both up and down – to fresh tariff news. Even so, net moves have been muted and other factors such as interest rates, central bank cut/hold prospects and company fundamentals are more significant. As always, we suggest you keep calm amidst the headlines as the short-term narrative invariably shifts. Stay focused on strong underlying fundamentals.

## Partner Spotlight
## Doug Porter's 10 Tariff Truths

In a recent client update, Doug Porter, BMO Financial Group's Chief Economist, made the following compelling points regarding potential U.S. tariffs on Canada:

- **Canada is America's single biggest export market** while Mexico is #3. Combined, these two countries absorbed nearly $700 billion of U.S. goods and services.
- **Total trade between Canada and the U.S. is much better balanced (meaning flows going both ways) than U.S. trade with most other industrialized partners.**
- **The total deficit of goods and services between the two countries amounts to less than 0.1% of U.S. GDP.**
- Excluding energy, the U.S. runs a large trade *surplus* with Canada as well as a substantial services surplus.
- Excessive import tariffs on Canada and Mexico could cause unintended consequences for the U.S. including substantial supply chain disruption as imports are diverted to other markets. It could also nudge Canada and / or Mexico to strengthen ties with other countries, weakening U.S. alliances.

Additional core points and a wealth of great tables can be found here: Ten Tariff Truths

**Additional BMO Insights:**

- BMO Capital Markets' Chief Investment Strategist Brian Belski (BMO Capital Markets - Canadian Strategy...)
- Private Investment Counsel's Chief Strategist Brent Joyce (2025 Capital Markets Outlook: Bunches and Punches - BMO Private Wealth)
- Wealth Management webcast: President-Elect Donald Trump's Tariff Threat is Too Big to Dismiss - BMO Private Wealth

# In focus in North America

*Jon Borchardt, Sr. Analyst*
*George Trapkov, CFA, VP and Portfolio Manager*

## This week

**A flurry of executive orders –** During his first 48 hours in office, President Trump issued 27 executive orders and rescinded 78 from the prior administration. Core focus of the announcements centered on **energy** (boosting conventional energy and critical materials production while declaring a national energy emergency); **immigration; social priorities** (ending diversity, equity, and inclusion initiatives; freezing hiring; converting thousands of workers to "at will" hires; and issuing a return to work order for all government employees); and the **environment** (withdrawing from the Paris Climate Accord).

An executive order is a legally binding directive but can also take the form of a press release promoting non-binding ideas and aspirations. An example of the latter, the "Unleashing American Energy" executive order called for freezing spending from the Inflation Reduction Act and the bi-partisan Infrastructure Investment and Jobs Act while sparing concerns about infrastructure spend. They later clarified that this directive only applied to "green new deal" spending on EV infrastructure and appliances. Examples such as this highlight the challenge of balancing bold policy ambitions and effective governance.

**U.S. stares down another debt ceiling –** On January 21 the U.S. Treasury Department initiated extraordinary measures to constrain spending in an effort to avert a government debt default which could come as soon as March 14. House Speaker Mike Johnson is now in the unenviable position of needing to rally Republicans around the idea of a temporary debt ceiling increase/suspension or working out a deal with Democrats. He will likely face an even steeper climb to meet his stated goal of putting a comprehensive reconciliation package, addressing both the debt ceiling and Trump policy priorities, to a vote by the end of April.

**"Drill baby drill" is the new proclamation President Trump made in his inaugural address –** while outlining a plan to lower energy prices through increased supply. **U.S. oil production is at record highs and broadly speaking companies don't have a strong desire to "drill, baby, drill."** Trump also expressed an intent to fill the strategic petroleum reserve to the top and advance liquid natural gas (LNG) projects, both of which would shrink domestic supply and likely prove inflationary. Oil prices have rallied off the lows of 2024 with traders focused on tighter U.S. sanctions enforcement, anticipated economic stimulus in China and solid OPEC+ output cuts which have helped deplete global inventories. Prices at the pump have also shifted higher in response. During Trump 1.0, growing U.S. production led to a price war, the impetus for low gasoline prices but bad news for U.S. producers. **Trump's ability to forge deals with Russia and Iran, tariff policies and Chinese demand growth are the key wild cards for oil price as we drive into 2025. Gasoline price risk in the coming months is skewed to the upside.**

**Canada housing starts slowing –** Canadian housing starts fell to 231,000 annualized in December, which leaves the full-year total at 245,000 – little changed from the prior year. While more purpose-built rental stock continues to break ground, other corners of the market (e.g., homeownership and condos) have pulled back alongside weaker market conditions and little investor appetite. **BMO Economics sees a continued gradual ratcheting down of housing starts as immigration caps slow the rate of household formation in the coming years, closer to levels seen before the pandemic.** If the starts data are any indication, the construction sector has already begun responding to softer market conditions by taking its foot off the gas on Toronto condos.

**Canadian consumer prices –** CPI fell 0.4% month over month in December bringing the inflation rate down to 1.8%. There were a lot of moving parts in the month, but the biggest was the sales tax holiday (took effect December 14, 2024). Food from restaurants fell 4.5% month over month, while alcohol was down 4.1% and toys/games fell 7.1%. The dip from the GST holiday will help again in next month's reading for January...but then reverse over the next two months. **Recent economic numbers are good enough to allow the Bank of Canada room to trim interest rates next week for risk management purposes.**

**U.S. earnings season rolls on –** last week kicked off earnings with a host of positive comments about the macro and deal making outlook and beats by the largest U.S. banks. More bank, credit card and consumer goods companies reported this week, also with a positive tone. According to FactSet's early Earnings Insight report (only 12% of the S&P 500 results are in so far), the blended earnings growth rate is running at 12.5%. The first of the Mag 7, Netflix, reported solid results – including subscriber growth that far exceeded analyst expectations. Other core tech names (Apple, Tesla, Meta, Microsoft, Amazon) will report next week.

## Next Week

More earnings on the docket plus central bank decisions in both Canada and the U.S. on Wednesday. Expect plenty of questions at the FOMC press conference relative to indications of policy adaptation subsequent to Trump 2.0 executive orders, tariff plans and other policy initiatives. The U.S. Fed's preferred inflation measure, Personal Consumption Expenditures, is not due until Friday.

- **Tuesday 1/28** – U.S. Consumer Confidence
- **Wednesday 1/29** – U.S. FOMC interest rate decision and press conference | Canada Bank of Canada policy meeting and rates decision
- **Thursday 1/30** – U.S. Initial Jobless Claims and GDP for 4Q2024
- **Friday 1/31** – U.S. PCE, Personal Income and Spending data | Canada GDP

## Data scorecard as of January 22, 2025

| Equity Market Total Returns | | | | | | |
|---|---|---|---|---|---|---|
| | 1/22/2025 Level | WTD | YTD | 2024 | 2023 | 2022 |
| S&P 500 | 6,086 | 1.5% | 3.5% | 25.0% | 26.3% | -18.1% |
| NASDAQ | 20,009 | 1.9% | 3.6% | 29.6% | 44.7% | -32.5% |
| DOW | 44,157 | 1.6% | 3.9% | 15.0% | 16.2% | -6.9% |
| Russell 2000 | 2,304 | 1.2% | 3.3% | 11.5% | 16.9% | -20.5% |
| S&P/TSX | 25,312 | 1.0% | 2.5% | 21.7% | 11.8% | -5.8% |
| MSCI EAFE | 8,340 | 2.0% | 3.2% | 3.8% | 18.2% | -14.5% |
| MSCI EM | 578 | 1.1% | 0.7% | 7.5% | 9.8% | -20.1% |
| **Bond Market Total Returns** | | | | | | |
| | | WTD | YTD | 2024 | 2023 | 2022 |
| Bloomberg U.S. Treasury | | 0.1% | 0.1% | 0.6% | 4.1% | -12.5% |
| Bloomberg U.S. Aggregate | | 0.2% | 0.1% | 1.3% | 5.5% | -13.0% |
| Bloomberg Canada Aggregate | | 0.2% | -0.5% | -4.6% | 9.5% | -17.3% |
| Bloomberg U.S. Corporate | | 0.3% | 0.2% | 2.1% | 8.5% | -15.8% |
| Bloomberg U.S. High Yield | | 0.3% | 1.1% | 8.2% | 13.4% | -11.2% |
| Bloomberg 1-10 Year Munis | | 0.3% | 0.3% | 0.9% | 4.5% | -4.7% |
| **Government Bond Yields** | | | | | | |
| | 1/22/2025 | Last Month End | Last Quarter End | 2024 | 2023 | 2022 |
| U.S. 10-Year Treasury | 4.61% | 4.57% | 4.57% | 4.57% | 3.88% | 3.88% |
| Canada 10-Year Government | 3.30% | 3.23% | 3.23% | 3.23% | 3.11% | 3.30% |
| U.K. 10-Year Gilt | 4.63% | 4.56% | 4.56% | 4.56% | 3.53% | 3.66% |
| German 10-Year Bund | 2.53% | 2.36% | 2.36% | 2.36% | 2.02% | 2.57% |
| Japan 10-Year Government | 1.19% | 1.09% | 1.09% | 1.09% | 0.61% | 0.41% |
| **Currencies & Real Assets** | | | | | | |
| | 1/22/2025 Level | WTD | YTD | 2024 | 2023 | 2022 |
| USD Index | 108.17 | -1.1% | -0.3% | 7.1% | -2.1% | 8.2% |
| CAD:USD | $0.70 | 0.7% | 0.0% | -7.9% | 2.3% | -6.7% |
| Bitcoin | $104,071.31 | -0.5% | 11.1% | 120.5% | 157.0% | -64.3% |
| Gold | $2,756.48 | 2.0% | 5.0% | 27.2% | 13.1% | -0.3% |
| Oil (WTI) | $75.44 | -3.1% | 5.2% | 0.1% | -10.7% | 6.7% |

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[i] NBER 2018 Tariff Study

[ii] Who's Paying for the US Tariffs? A Longer-Term Perspective | NBER, https://www.nber.org/papers/w26610

[iii] EU to demand tech transfers from Chinese companies, FT reports | Reuters