

Episode 16 - 50% Tariffs or TACO Tuesday?

John Pagliacci

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If you thought President Trump was going to turn down the temperature on his highly unpopular policies heading into the November midterm elections, so far, you would have been sorely mistaken. In this episode of Guardian Capital LP's "Buy The Way" podcast, we address one such unpopular policy, specifically tariffs on Canadian goods. And we ask, should you care? Is this just the latest in a long line of TACO incidents? And just to be clear, for those of you that may have been living under a rock the past 18 months, the acronym TACO is a popular one that stands for Trump Always Chickens Out, and it was coined last spring when the President first introduced his sweeping Liberation Day tariffs, only to walk those back after harsh criticism. My name is John Pagliacci, and I am joined by a powerhouse panel today to get insight into these new 50% tariffs from numerous perspectives. Our regular guests, David Onyett-Jeffries, VP of Economics and Multi-Asset Solutions is back with us, alongside Aubrey Basdeo, Head of Canadian Fixed Income, and Sam Baldwin, Senior Portfolio Manager of Canadian Equity. Guys, thank you so much for joining me today. Like I said, we have seen so many instances of the President sort of thumping his chest with these outlandish claims or threats over the past a number of years. That he then walks back and it's really hard to take anything he says all that seriously. But I can understand why people, particularly here in Canada, might be worried. 50% tariffs does sound like a big deal, and on the surface, seems like it would seriously hurt the Canadian economy by stifling our exports into the US. So to kick things off, maybe I'll start with you, David, you're obviously our macroeconomic expert and keep your finger on the pulse of what's going on with this stuff. So can you give us a quick history lesson, I guess, on how this trade relationship between Canada and the US has evolved since Trump started his second term in office.

David Onyett-Jeffries

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Well, the relationship historically has been a positive one and a very strong one. And that's why the vast majority of Canadian exports go to the US. But since the President has come into office, this relationship has become rocky to say the least. So if we go back to the President's first term, there were threats of withdrawing the US from the North American Free Trade Agreement, which the President called one of the worst trade deals ever. But it had been enforced and beneficial, mutually beneficial since 1994. So, the threats to remove that. And in response, there were negotiations and all parties agreed on the new US, Mexico, Canada agreement or the USMCA in 2020, which for pretty much all real purposes was largely the same as NAFTA. There were just some added rules related to autos and digital trades and things related. You know, so that was put in place and has been in place for the last six years. In July of this year, the President announced that the US would not be renewing the USMCA, because he feels that the US doesn't need anything from Canada or Mexico and that he views Canada and Mexico need to treat us better right now. Importantly, pulling out of the agreement or not renewing the agreement more specifically, doesn't actually have any direct impact right now. As it stands, the trade agreement was in place for 16 years, so it means it doesn't actually expire until 2036, or until one party gives six months notice that they're withdrawing from the agreement or terminating it.

David Onyett-Jeffries

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You know, but the idea that even down the road and with this increased threat that they're going to withdraw from this agreement, obviously that is not a positive. So rather than pushing towards increased free trade across this continent, the US is pushing for greater barriers or even, just restricting the amount of free trade. And that also coincides with additional threats of tariffs. So we had tariffs on Canadian goods that are not covered under the USMCA. So there was obviously a few initial slates that were introduced that were shot down by courts. But we have these new tariffs being introduced, which are under section 338 of the Tariff Act that have a little bit stronger legal standing. And they have, this is the discussion right now, this is how everything has developed and this is how we are right now.

John Pagliacci

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Okay. So you mentioned that acronym there that goes by a couple of different forms depending on where you sit across the border. But CUSMA or USMCA as they call it in the US. Like you said, the free trade agreement that Trump signed in his first term, it's kind of ambiguous here. Like, is that still in place today, is it not, and what sort of the scope of these new 50% tariffs.

David Onyett-Jeffries

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So it is in place today. And again it's in place until, it is formally in place until 2036. But one of the conditions of this is that there's a mandatory review every year. And that is what was starting in July. And that sort of led up to this discussion about, pulling or not renewing the agreement. But, for the next decade of this, this plan is in place, and it does cover the vast majority of trade between Canada and the US, Mexico and the US, and Mexico and Canada. The vast majority of the goods, so it's roughly about 80% of goods are covered under this, right, so it doesn't impact that. These new tariffs that are put in place are on goods that aren't covered by this agreement. And so that 50%, it varies across ranges, but it can be up to 50%. And it covers roughly 5% of Canadian exports to the US, which translates to roughly \$20 billion. And these are on goods that were previously duty free. So to be clear, you know that 50% doesn't cover everything. It's just a small, sort of smallish sliver. But it is important to realize that, it's not nothing. But at the same point, it's not huge either. Like it doesn't change the game. And it suggests that the impact is going to be, relatively small. So we're talking tenths of a percent on growth rather than percentage, right. Like as long as the USMCA remains in place. So this does have significant impacts on the industries impacted. And if you look broadly, this does roughly double the effective tariff rate that the US charges Canada on Canadian goods. And it's still roughly, one of the lower ones with US trade partners. So the average effective tariff rate is roughly 7%, but Canada is no longer at the lower end of the spectrum. It's now more consistent with other G7 countries. But again, I think one of the big things about this, and you mentioned TACO Tuesday, and this tendency to backtrack on things that tend to be not the best economic policy, with the benefit of some hindsight. I think one of the key things to realize is that some of these tariffs aren't actually slated to come into effect until January 1st. Right. And those ones are specifically tied to auto tariffs and steel. And as we've seen, the longer sort of the runway that we've had before something comes into effect under this

current administration, the less likely it is actually to see the light of day. It's something that could just be kicked down the road. But at the same point, there are areas in industries that in Canada that are going to be impacted by this. When these do come into effect, and we have to operate on the assumption, and we've seen this time and time again over the last decade that by assuming something's going to go forward, we tend to be I don't know if we're disappointed, but it doesn't end up materializing. Right. But because this is the information we have in hand, this is what we have to work with.

David Onyett-Jeffries

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So when we're drilling down to what these tariffs impact, it's largely on manufactured goods. So if we look at the natural resources, they're largely not impacted. There are some things on metals in lumber, but it tends to be sort of the fabricated stuff. Right. So it's after that fact. But these do represent prohibitively high tariffs. Right. So adding the 50% to the cost of something creates a huge disincentive to buying those Canadian goods. And that's going to impact areas specifically talking like apparel and textiles, fabricated metals, plastic, wooden paper products, electronics and electrical equipment, machinery. And then obviously the autos that are going to be the most impacted by tariffs. And as a result of sort of that industrial makeup, these tariffs are likely to have a larger impact on the more industrial-focused economies. So if we're talking largely Ontario and Quebec, whereas if you look at Saskatchewan and Alberta, Newfoundland, which tend to be more natural resource tilts, are going to be relatively unaffected. Right. But even if over or above these tariffs and whether or not they come into effect, this resumption of a trade war after we had a little bit of a lull of it for a period of time, really has the impact of ramping up this uncertainty. Right. The trade policy uncertainty. And again, Canada historically has been highly reliant. You have a lot of companies and industries that have worked to integrate supply chains across this continent. And suddenly you're having their ability to do business on a day to day basis with the added uncertainty about whether or not they're going to be able to go forward. Now, and there's two ways that this can sort of manifest right now. The near term is, uncertainty means that anybody who's looking to expand production they're maybe going to be more hesitant, right. They're maybe not going to hire those added bodies, or maybe you end up cutting payroll hours if demand takes a big enough hit. They're not looking to expand their property, plant and equipment. So, the CapEx side can get a drawback. And, just the general uncertainty means that people are going to be more hesitant to spend. And the negative spillover effects is that, that's going to impact consumer spending decisions and business investments and everything that can go on that, because it's not just the direct industries, it's in ancillary industries as well. The alternative, though, and this is over the more medium term, is it's going to force Canada, and we've seen this in over the last year in particular, and a lot of government initiatives to look beyond the US and increase partnerships, which could, in the medium and longer term, support investment to establish the infrastructure needed for trade. It's just this is not an immediate impact. And one of the issues with the uncertainty is the fact that we don't know if these are actually going to be in place a week from now, a month from now, six months from now, means that sometimes you don't want to give up on that low hanging fruit and start changing direction, if you know that, you know there's a definitive likelihood that this is not going to happen. But in terms of what we are seeing from the economic impact, while this impacts the private sector and has concerns about restraining growth there, it does create this possibility and likelihood, and we've already seen some of it play out, that you're going to see more expansionary policy put in place by the federal government or provincial governments as well.

David Onyett-Jeffries

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And, it could have implications on monetary policy, which I'll touch on briefly, because I know we have Aubrey on the call to keep a little bit more of a nuanced view on it. But the reality is, so we've already had, in association with the announcement of the retaliatory tariffs this week by the federal government, there was a, what, \$1 billion support package that was launched by the federal government that is designed to support the affected industries. And we have the fall federal budget coming up in the next couple of months. So last year it was presented in early November. And so we're likely to see that timeline. And that can represent an opportunity to introduce added initiatives designed to stimulate trade with other economies outside the US and also like prop up the areas that are most impacted domestically. And from an interest rate perspective, the likelihood that the Bank of Canada is going to start, the expectations especially in the start of this year, was that the inflationary backdrop was and the growth backdrop were going to be sufficient, that Bank of Canada was going to start raising interest rates. This added uncertainty, this added potential economic hit, definitely raises the possibility that the Bank of Canada can lean on this hit to growth as impacting the output gap, which puts disinflationary pressure on the broader economy. And they can argue that either through the direct impact on industry and exports or the indirect impact on those confidence channels, this negative trade policy will have the impact of delaying the closure of this output gap, which means that there's going to be more disinflationary pressures for longer, which would therefore, reduce the need near-term to hike interest rates, right. So that's sort of the broad viewpoint of sort of this policy.

John Pagliacci

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Right, wow, okay, that was that was very fulsome, lots to digest there. But I appreciate sort of 30,000 foot view of everything there that you covered, David. I think there's a lot to pull out of that for our listeners. I do want to turn maybe to Sam now to drill down a little bit more specifically on what all of this could mean for the Canadian equity market. So he talked about the economic side, but specific to investment opportunities in the market. Sam, you obviously run a number of Canadian equity strategies and conduct research on a wide range of companies here at home. What's your initial read here in terms of potential impact?

Sam Baldwin

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So, tariffs, quite frankly, have been a discussion point for coming up on a couple of years now. And so, while it's not a new risk, it's been a source of constant uncertainty. And as we just talked about, there have been tariffs that have been put on and had impact, despite being illegal, and having been pulled back. And so part of the strategy all along on the part of the US has been to create general uncertainty and to essentially push back on this idea that, okay, if the Canadian currency is low, and you think you want to build a factory in Canada to re-export to the US, think again. And so really encouraging the investment to go directly into the US at Canada's and other countries expense. So the strategy has been very clear when we talk to companies, quite frankly, a lot of them that do business north and south of the border are just not willing to do acquisitions in Canada because, yeah, that's where the greatest uncertainty lies. And the business environment has been sort of having this dark cloud of

uncertainty over it, much prefer to do US acquisitions where it's very clear that the arrows are pointing in that direction. So there's been this uncertainty, there's been this lack of appetite to invest in Canada relative to invest in the US. I guess we had this headline of a technical recession, over Canada. But if you look at the market, we're at all time highs. So there's a lot of mixed signals out there. But it is fair to say that on the ground in Canada, it's not a normal situation. And there is this sort of overhang of, what are the rules of the game, and therefore, how should we deploy capital? Now when it comes to these most recent tariffs, one of the interesting things we've learned is that the timing or the duration of the implementation of tariffs is very uncertain, because Trump could change his mind at any point in time. We've even seen headlines this week that some of the key issues that caused Canada to walk away, we've been pulling back on some of those after seeing a little bit of give from the US side.

Sam Baldwin

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So even already, there's sort of, I'd say reasons for optimism that negotiations at some point can resume. So we don't know how long this will last. And as David just said, it's on a small part of the Canadian economy. It matters a lot for jobs in those areas. So one of the things that we did was look at the performance of the bank stocks when these announcements came out, because they're a barometer of cross cap size small business up to largest business, and across the economy, both in the US and Canada, in many cases. And quite frankly, the reaction of bank stocks to this news was as if there's nothing to see here. And it's probably because capital markets have been trained to be aware that the possibility of a TACO or pulling back on the threats is there. And the incentives, if you think about it, looking at the politics in the US right now, where the states in the midterm elections are breathing down our necks, and Maine is a state that could switch hands, and it's very unpopular, what the tariffs are doing for that state and Michigan as well. So one of the reasons for doing tariffs is obviously financial in terms of the fiscal situation and the long term investment picture in the US. But there's also this notion, I think, in Trump's own mind, that it's popular, but there's a lot of voices coming up saying that it's not popular. And so it's fair to say that tariffs are not popular in Canada. They're not popular in the US at the grassroots ground level, and certainly business is not a fan. Although there are some sectors that are benefiting and cheering on certain actions, like if you're a steelmaker in the US, for example. But what I would say in summary is that this is a known risk. A lot of the tariff impacted stocks, this threat is priced in, and at the very high level, the impact on the Canadian economy, which has already been there for a while in terms of slowing growth and creating that uncertainty, the best barometer being the bank stocks is not seeing a massive threat from these most recent announcements. And back to something that David said as well, that we're kind of an indirect beneficiary of the situation in the Middle East because the oil prices are high and it creates a fiscal windfall for Canada. And we will be able to put dollars to work where some of the tariff impacted industries, are suffering and not have it be overly onerous fiscally. So, wait and see, but it seems like a manageable situation right now, and the stock market has moved on.

John Pagliacci

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Yeah, I appreciate the comments there. You did mention obviously the tariffs, we've been dealing with it for a number of years now. Even with perhaps the headline-grabbing 50% number, I'm almost hesitant to ask if this news is all that noteworthy. I mean, I don't want to downplay, you said and David said that there will be some acute impacts for sure, and it will

impact jobs in certain areas, but overall, it seems like it isn't that meaningful. Does it, from your portfolio management standpoint, does it really change how you're approaching stock selection here at home?

Sam Baldwin

[00.19.22]

So we've like I mentioned, we've been thinking about tariffs for a good couple of years. And there was a bit of pricing in as we've gone through particularly from the fall of 2024 through to Liberation Day, in particular. There is great sensitivity and the market would treat and apply more volatility as opposed to the more tariff impacted stocks. So these are being known risks. And so I think one of the areas where I could highlight that in a tariff impacted situation, there's an ability to avoid. So I think part of your question is saying, oh, with the tariffs in the backdrop, would you change the portfolio? Implied in there, are there some things that are off the table that you don't want to engage with? But I'd say on the flip side, there's also some businesses that are tariff impacted, but it's priced in. And we had a situation like this late last year, early this year with the company that we own in the focus strategy called Mattr, where they were getting hurt by a more commodity, wire and cable part of their business due to tariffs, being less economic. And essentially they made a decision to exit that business, which put revenue pressure downward. But essentially, other parts of the business were doing very well. And so what this meant for us is that as the price of the stock came down to essentially price in a very adverse outcome, yet the future that we saw was quite a bit better than what was priced in. That allowed us to position into that company's stock at a very favorable valuation. As we've seen since then, the company has outperformed expectations. The stock has produced good gains, and yet there is still a looming potential tariff exposure. The company quantifies it as being a cost of \$10 million, for example, to move some of their plant equipment south of the border. And this is for a \$1.5 billion revenue company looking a year out. So, these are the types of things where the companies themselves could adapt to the tariff backdrop, or we could make adaptations. But for us, it's all about expectations versus reality. And if there's nothing priced in because the valuation is implying hunky dory rosy conditions and we see danger. Then we'll avoid those pockets. But if we see punitive valuation because of an apoplectic outcome being priced in, but we don't actually think it's that bad, then we could see that as a potential opportunity. So there are examples out there of both. But that's what I would say is we're constantly as active managers trying to ascertain expectations versus reality and position accordingly.

John Pagliacci

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Good stuff. Appreciate it, Sam. Aubrey, last but not least, I did want to round out our read on these tariffs with your from a fixed income standpoint. Now, obviously it goes without saying any tariff amount, regardless of the rate should in theory have a negative impact on economic growth. So aside from potentially lower bond yields here in Canada reflecting maybe some slowdown in growth, what else do you think investors can expect if these tariffs do remain in place for any meaningful length of time?

Aubrey Basdeo

[00.22.59]

Well, I think, trying to get a read in terms of how the actual impacts, to get back to Sam's point about what's reality and what's the assumptions or what's priced in, and there could be

a pretty big gulf between those two things. But let's just focus on what we think the bank is likely to offer up next week. It's going to sound redundant because David, I think, covered it, quite succinctly. This is an aggregate demand shock to the economy. So you would expect that demand to cool, the potential for some level of layoffs or slower job growth, if you want to put a positive spin on it, to manifest itself over the next little while. Coupled with the uncertainty factor, because you're not going to make any, if you're planning on an investment now, you're going to have to delay that. So it relates to the output gap to the Bank Canada, which is their measure of whether they have to start to worry about, increased inflationary pressures. I think they'll cover that and suggest that the output gap is likely wider than they would have assumed without this latest round of tariffs, so that delays them from doing anything at the moment. The market going into this was pricing in, or prior to this was pricing in a potential for the bank to raise interest rates early next year, I would say. Begrudgingly so though, because there's still this sort of turbulence on our growth outlook. So that potentially delays it even further to the extent that things start to pick up significantly. So I think that trend is still in place in terms of, the next move is more apt to be a nudge upwards in rates rather than a nudge downward in rates. And why do I say that? Well, we're at two and a quarter in the overnight rate, inflation is two kind of pointing upwards, I would say from here. And I think that gives you very little wiggle room in terms of a real overnight rate, trying to maintain some semblance of that, to the extent that you get excessively accommodative. I think you're starting to enter into a danger zone here where inflation story, you know, globally is one that suggests that the skew is to the upside, not not to the downside at this point. And so we don't see the bank suggesting that there would have to be or there would look to be accommodative in order to absorb the shock. And if you go back to where the bank thought the range for neutral is, it's two and a quarter to three and a quarter, sorry, at the lower end of that range. If on the other hand, you do end up with a more significant aggregate demand shock than we're anticipating, then they might think about reacting to that. So there is, I would point out, that there's a fat-tail skew on the left side to this outlook. And you have to always, if you're thinking about probability distribution, there's this fat thing hanging out on the left side that you would want to recognize and that things could get go sideways, if you're not careful, and you have to be able to absorb that. But I think, you're attentive to that, the data as of Q2 would suggest that there is some momentum in the economy that will carry through. And I also think that monetary policy is probably not the right thing here, given where we are, in part, in terms of the overnight rate, and that fiscal policy is, by far the better tool to address these shocks that we need to absorb. And we're already seeing a recognition of that. And that's coming into play faster than otherwise we would have thought. So what's the setup going forward? Again, we don't see the Bank of Canada doing anything for potentially a little longer than we were anticipating, so late next year is probably when we would have to think about, at least from today's perspective, price of Bank of Canada move. So the trajectory of rates is still upwards, not downwards there. And that suggests to us that when we think about positioning, the better outcome would be think about durable income as how you try to think about your investments in fixed income. And that's in the shorter end to the middle part of the curve, where in credit exposure, even though credit is very expensive, the all-in yield from a spread level, they're very expensive. But from an all-in yield, they're very attractive. And that's how we think about positioning, still going forward with the caveat that, it's more about worrying about the downside risks than the potential upside risks on inflation at this point.

John Pagliacci

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So maybe one last question I had as it relates to the positioning and sort of, we've all in our own way talked about the pricing and things being priced in. You know, if you're looking at the short and mid end of the curve, do you see that the tariff stuff right now has been priced in and there's potential opportunity to get some upside, if we again have a TACO Tuesday incident and we sort of pull back or is that fully sort of there, and you still recommend sort of the shorter exposure in the bond space?

Aubrey Basdeo

[00.29.25]

Yeah so, when you look at the reaction, to answer that question I'd say look at the reaction to when we came in on, I think it was Monday and the market, rates fell about nine-ish basis points across curve on that day. And the next day they backed up. We are trading in a global, I mean we're an open market subject to global forces, the trend for bank rates is not down in the G10, if you like, it's up. And so our market is going to reflect, outside of the overnight rate, is going to reflect what is happening globally to rates. And so it's still suggesting that there's an upward bias at the margin in spite of the tariffs that we're going to have to deal with. And again you know, the thing I would say is, if we do get that fat-tail outcome on the left side, then all bets are off at that point because I think we'll recalibrate to something that is somewhat unique to Canada at this point. But outside of that we're trading in a relative value global context.

John Pagliacci

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All right, guys. That was excellent, I think we're at time here. Really good round up from different perspectives. And if I tried to sort of distill it down, yes, it matters as I said, be some acute pain in certain areas. But overall, people shouldn't be freaking out over this announcement. We certainly don't know if it'll come in fast. And even if it does, it is fairly limited in its scope and its impact. Sounds like really not a lot changing at all from a portfolio construction standpoint on our side as well here. So, hopefully that leaves our listeners with a bit of confidence. And again, it's a very fluid situation, we're trying to put something out here, but things could change and we'll try to stay on top of it and keep you informed going forward. But again, thank you so much for your time, gentlemen. Thank you for listening everybody that's tuned in. If you are enjoying the podcast, feel free to follow us so that you don't miss any episodes. And of course, we do always welcome your questions or your feedback, if you email Insight@GuardianCapital.com, that will come directly to me. So, fire away. I'm looking forward to seeing what comes back. And, I guess with that, I will wrap this up today. Take care everybody. We will catch you next time.

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