Phew? Sort of, for now.

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In our previous quarterly outlook, we predicted an interesting year ahead for Canadian investors. In hindsight (and in keeping with the character of the 2020s), perhaps we should have said, “Let the chaos begin.” Through a multitude of executive actions, the second Trump Administration has been breaking (or at least threatening to break) radically with the global trade and military order of the past 60-to-80 years while also articulating territorial ambitions reminiscent of the late nineteenth and early twentieth centuries. Heading into the “Liberation Day” announcement on April 2, we hadn’t seen any large economic or market dislocations, but economists and other observers understandably were concerned about potential impacts on the Canadian and global economies as well as financial markets. In this paper, we’ll recap the current state of the trade war, discuss potential impacts, and try to identify some under-the-radar risks.

A sigh of relief, but hold your breath

We think “chaos” is a fair characterization of Trump’s executive orders, as even their ardent supporters acknowledge they aim to massively reshape longstanding global trade patterns. In his executive order signed April 2, Trump announced the imposition of broad 10% tariffs against over 130 countries as well as higher reciprocal rates on countries that Trump views as being the worst offenders in terms of trade imbalances.[1] Surprisingly, both Canada and Mexico were left off the list entirely.

While that’s certainly a positive, corks should be left in the champagne bottles. Canada’s exports to the U.S. are still subject to higher trade barriers, including 25% tariffs on aluminum, steel, and goods that are not compliant with 2020’s United States-Mexico-Canada Agreement (USMCA), as well as 10% on energy goods. Canada is fortunate to have escaped additional Liberation Day tariffs, but these existing measures still pose significant risk. As multiple observers have now noted, the United States’ cumulative in-force and announced tariffs are now at levels last seen in the 1930s.[2]

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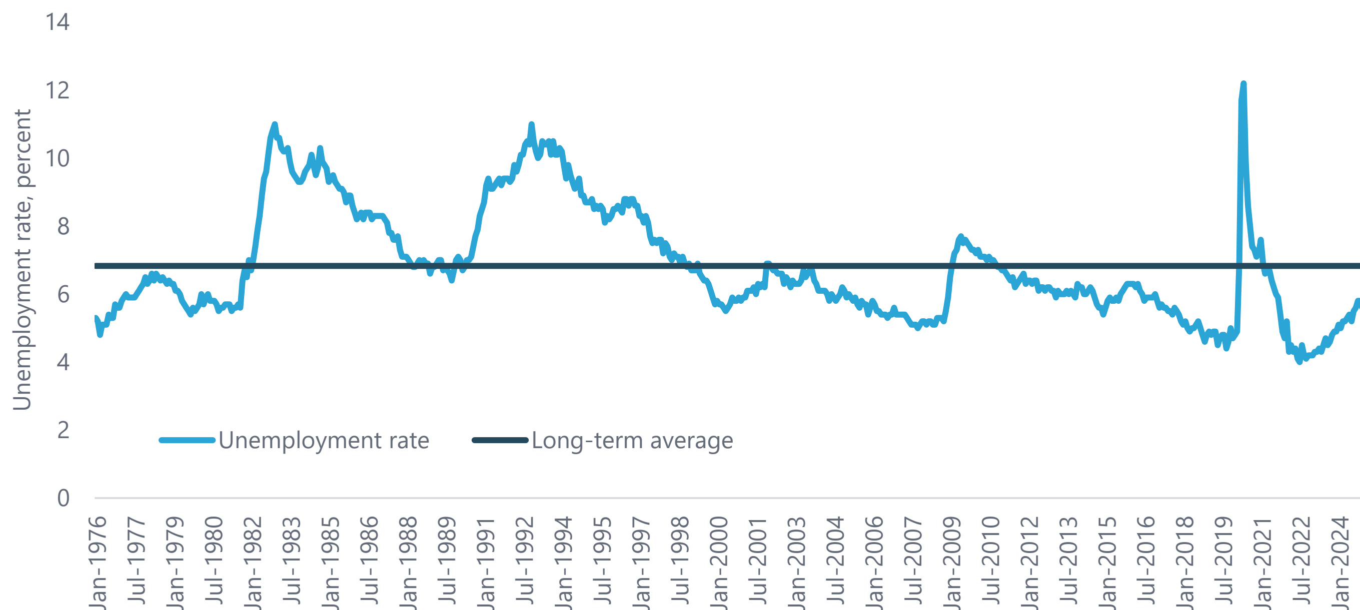
Furthermore, Trump has promised to pursue additional tariffs on strategic sectors such as lumber, pharmaceuticals, and semiconductors (the first two are especially relevant in terms of potential impact to Canadian industries).

Finally, in addition to these impending and potential headwinds, Canada's economy is quite exposed to any global or U.S. economic slowdown precipitated by Trump's trade war and any subsequent retaliation from other countries.

In short, the intermediate-term outlook is now quite concerning. Sentiment measures have been worsening in Canada and the U.S., and while the domestic labour market was still in reasonable shape as of the latest report (Exhibit 1), it's quite possible we'll begin to see some more meaningful deterioration in hard economic data in the months ahead.

Exhibit 1: The unemployment level is OK, but the trend is poor and could get worse



Monthly data from January 1976 through February 2025. Sources: Statistics Canada, SEI.

A difficult spot for central bankers

What shape might that economic deterioration take? It's subject to multiple behavioural forces and thus impossible to predict with any precision. However, we can identify several general points of adjustment: volumes of tariffed goods imported by the U.S.; substitute goods available domestically in the U.S., absorption or pass-through of tariff costs by importers and other businesses and resulting impacts on margins (an area of concern for creditors and investors); and prices (a concern for downstream businesses and consumers) and so on.

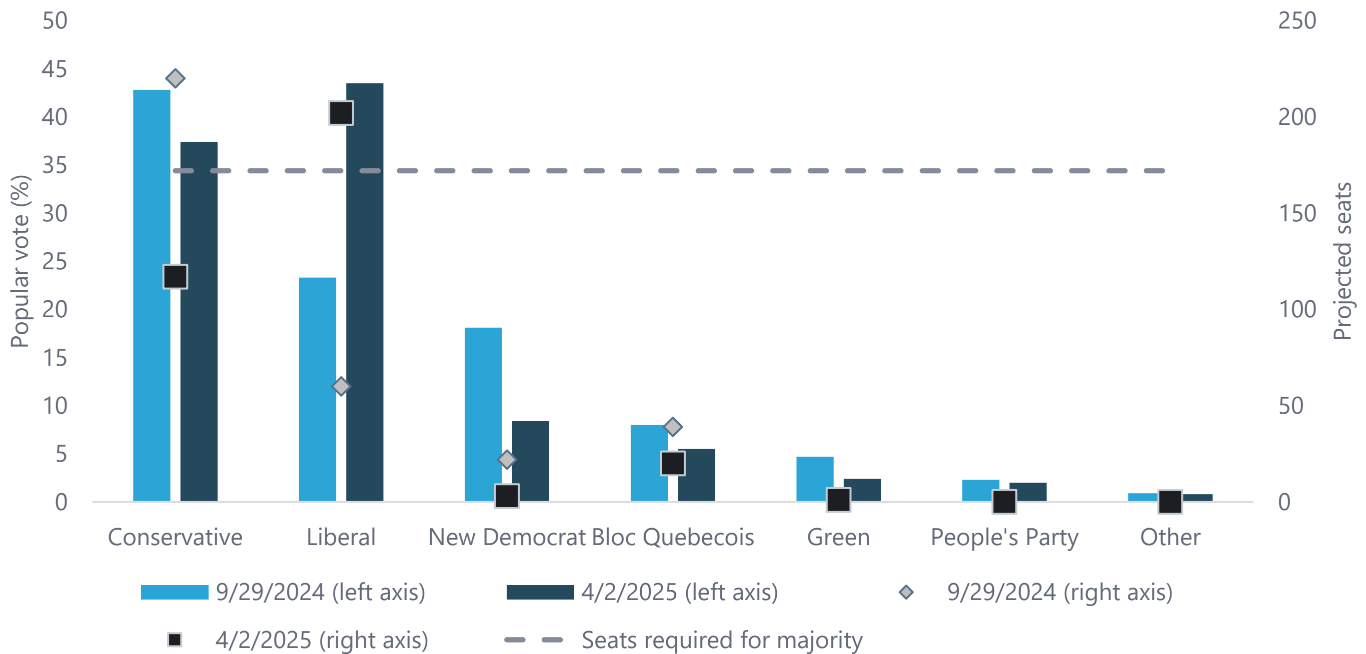
The critical component for recession risk is employment impacts—if lower overall activity and/or margin compression cause unemployment to rise meaningfully, recession is almost certain to follow. While the U.S. is *relatively* insulated from this given it is a massive net importer with an overall economy that is not heavily trade-dependent, it is not immune.

In addition to lowering overall economic activity, U.S. tariffs also risk exacerbating inflation[3], which raises the dreaded specter of *stagflation*, the bane of central bankers' existence (stagflation is stressful for households, too, although they don't have to explain monetary policy decisions to an anxious public). While the Bank of Canada (BOC) has continued to lead the way in interest rate-cutting among advanced-economy central banks, stagflation could put it into a difficult spot. From that standpoint, Canada being left out of Trump's April 2 order could make the BOC's job slightly easier than was feared. The same might not prove true for its American counterpart, the Federal Reserve. And if Trump's trade war raises the global price level, the BOC and other central banks might all find themselves boxed in by difficult policy choices eventually.

An upended political chessboard

While the first few months of Trump's presidency have had a wide array of impacts, one of the most astounding has been the shift in Canada's electoral outlook. In a recent quarterly outlook, we observed that polls indicated the Conservatives were almost certain to assume power in 2025. That has reversed dramatically, as shown in Exhibit 3. At the end of September 2024, it looked as though Conservatives would garner 43% of the popular vote and 220 out of 343 seats in Parliament (172 seats are required to form a majority). By April 2, this had declined to 37% and 117, respectively, while the Liberals, under the new leadership of former BOC and Bank of England head Mark Carney, saw its figures rise from 23% and 60 seats to 43% and 202 seats.

Exhibit 2: Make Liberal great again?



Aggregated polling results and seat projections as of September 29, 2024, and April 2, 2025. Sources: Canadian Broadcasting Corporation, Oxford Economics, SEI.

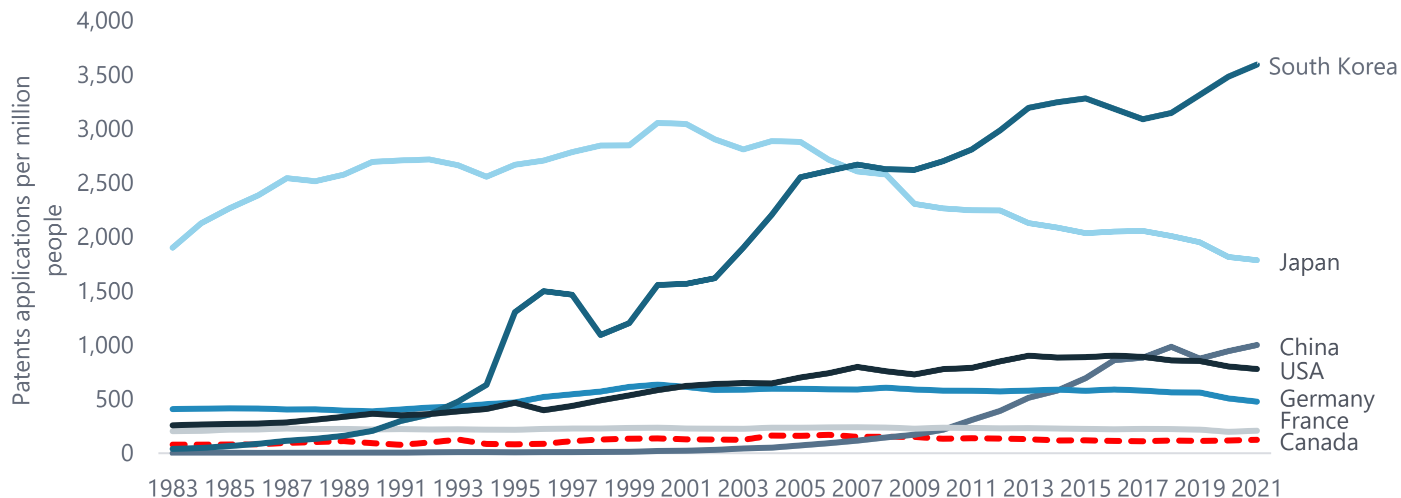
While roughly a quarter of the shift to the Liberals was at Conservatives' expense, half of it came from previous New Democrat supporters and the remainder from the Bloc Quebecois and Green. According to CTV/Nanos polling from late February through early March, "dealing with U.S. President Trump" has surpassed "the economy" as voters' most important issue.[4] Based on the shift in polls, voters in aggregate seem to believe that Carney and the Liberals are best-positioned to do this. The Conservatives could regain some ground between now and the election, but its current leader, Pierre Poilievre, seems to be fighting a two-front battle against both the incumbent Liberal government's record and a tariff-happy Trump. A more decisive focus on the trade war might help, and there are rumours of internal disagreement over current messaging.[5]

What can policymakers do?

Whichever party (or parties) assumes control of Canada's government after the April election, it will certainly have its work cut out for it. To the extent the BOC's hands are tied by stronger inflation pressures in coming months and given that the tariffs implemented thus far are likely to put pressure on domestic activity, employment, and incomes, policymakers may need to get more comfortable with the possibility of concerted federal fiscal easing. Both Carney and Poilievre have embraced this idea in different ways and to varying extents, but it's not clear from their initial campaign promises that either party is fully prepared—to borrow a phrase from the former head of the European Central Bank Mario Draghi—to do whatever it takes to support a worsening labour market, much less encourage significant domestic business investment. (The latter is an issue we and others have pointed to well before Trump won the 2024 U.S. election.) Tariff-induced inflation could make fiscal easing more challenging, as it's difficult to enact significant fiscal measures without impacting inflation (see the U.S. circa 2021-2024). It would be somewhat ironic if a Carney-led government enacted policies that made the BOC's job even more difficult, given that he was governor of the BOC from 2008 through 2013. But the fact is that, as things currently stand, a more concerted level of fiscal support is likely to be required.

On the issue of business investment, the BOC released an interesting study in December 2024 comparing long-term growth in gross domestic product (GDP) per capita between Canada and the U.S., finding that most of the gap could be explained by differences between the top 10% of earners in each country. Those differences also helped explain the gap between both countries' rates of productivity growth. The authors concluded, "these differences can help identify which explanations of the difference in Canadian GDP and productivity are symptoms versus causes of the gap. Our analysis suggests that selective emigration of high-ability people could be a key factor in accounting for both persistent cross-country income differences and lower innovation in Canada compared to the United States." These findings also raise important questions about possible distortions in productivity measurement, but the innovation aspect still seems relevant. While just one piece of a much larger mosaic, a comparison of patent applications per capita across countries (Exhibit 3) indicates that Canada has significantly lagged more technology-focused economies in Asia as well as the U.S. and Germany.

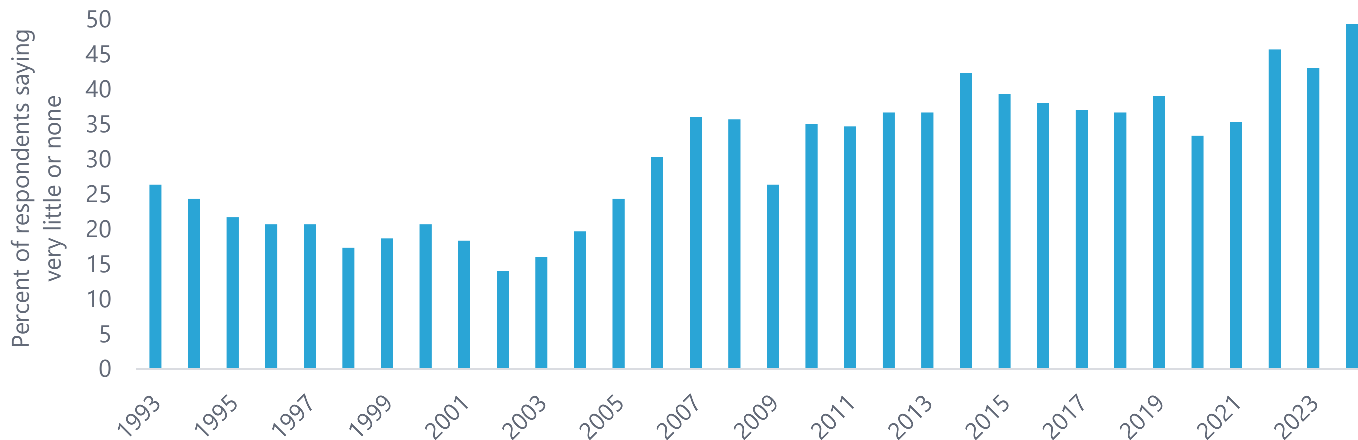
Exhibit 3: Patent applications per capita



Annual data from January 1983 through 2021. Sources: Our World in Statistics, World Bank, United Nations, SEI.

Trump's trade war makes Canada's productivity and innovation challenges more pressing, in our view. While plenty of lip service is being paid to the importance of domestic investment, creating a conducive environment for it is a complex and long-term challenge. Canadians' trust in public institutions, although wavering some in recent years, may still be at high enough levels to get such a process underway. Otherwise, there's a risk that Canada finds itself in a situation like the U.S., where rising mistrust in political institutions (Exhibit 4) has led to a deep and growing political divide with much higher policy volatility and uncertainty.

Exhibit 4: Eroding trust in U.S. political institutions



Annual survey data from 1993 through 2024. Average sum of "very little" and "none" responses to whether one trusts the Supreme Court, Congress, and the presidency. Sources: Gallup, SEI.

What can/should investors do?

It's clearly going to be an extremely challenging environment for Canadian policymakers, but what about Canadian investors? Anecdotally, some Canadian consumers have decided to protest Trump's trade measures by cancelling or curtailing travel to the U.S. and buying products "made in Canada." Should investors take similar measures with their portfolios, for example, by selling their U.S. equity holdings? The sentiment is understandable, but we would counsel against it. First, it's not clear at all what the longer-term impacts will be on relative performance between the U.S. and the rest of the world; and in our view, investors shouldn't make large bets on such outcomes with their portfolios. Secondly, diversification is a bedrock principle of successful investing. No matter how one might feel about the current U.S. administration's posture towards Canada and the rest of the world, U.S. companies contribute by far the largest country allocation to global equity indexes such as the MSCI ACWI (Exhibit 5). Divesting from the U.S. would represent a meaningful retreat from diversification at a time when heightened geopolitical and economic uncertainty make it as important as ever.

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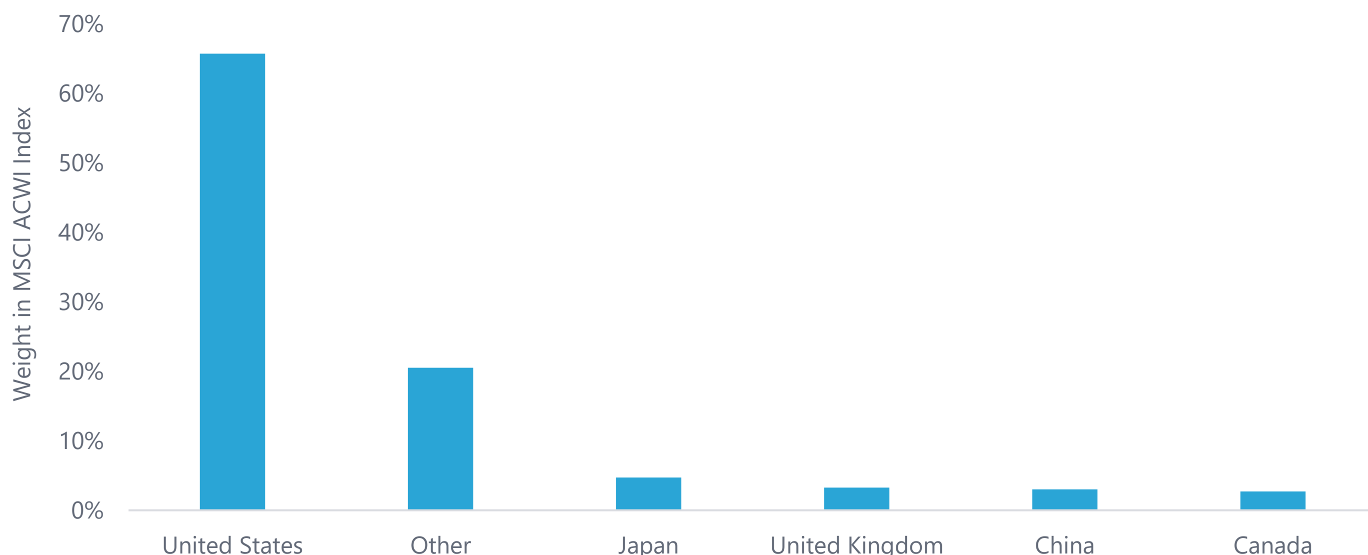
Exhibit 5: Avoiding the U.S. is a massive bet



Market-capitalization weights as of 28 February 2025. Sources: MSCI, SEI.

Grey swans for which to keep an eye out

The trade war is likely to dominate news headlines for the foreseeable future, but it's always a good practice to keep an eye out for potential surprises, as the better prepared we are for them, the more likely we are to stick with an investment strategy. While we won't spend a lot of time on them in this report, two recent ones seem worth a read, and who couldn't use a brief distraction or two at this moment? Utility-grid fragility was highlighted by the Heathrow Airport transformer explosion[6] and fears of a "liquidity mirage" in foreign exchange markets were raised in a recent Bloomberg article.[7] The liquidity mirage concept is not new—researchers associated with the New York branch of the Federal Reserve were writing about it 10 years ago in regards to U.S. Treasury markets, for example[8]—but it's one to watch given today's intense and chaotic geopolitical and policy environments.

Index definitions

The MSCI ACWI tracks the performance of large and mid cap segments across Developed Markets and Emerging Markets countries. The index covers approximately 85% of the global investable equity opportunity set.

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[1] The “reciprocal tariffs” were derived using an unusual and controversial approach based on each country’s trade surplus with the U.S. divided by its total exports. While China was the highlight, this approach also threatens severe harm to some smaller countries.
[2] Investors are likely to hear frequent references to the Smoot-Hawley Tariff Act of 1930 and its proximity to the onset of the Great Depression. While relevant to the current situation, we would caution investors not to consider those tariffs as the sole and proximate cause of the Great Depression. Monetary policy likely played a much more important role in the severe global downturn of the early 1930s. See, for example, Douglas Irwin’s 2010 paper, “Did France Cause the Great Depression?” Available at: https://www.nber.org/system/files/working_papers/w16350/w16350.pdf.
[3] The full impact of tariffs on inflation is subject to contentious theoretical debates, but for discussion’s sake, let’s concede that one of the initial impacts is to raise the overall price level.
[4] “Canadians say Trump and the economy are top issues influencing federal election vote,” CTV News/Nanos, available at: https://nanos.co/wp-content/uploads/2025/03/2025-2795-CTV-Feb-Populated-report-PP.pdf.
[5] See, for example, “Second week of campaign underway as Poilievre faces criticism, leaks within Conservative ranks,” Toronto CityNews, available at: https://toronto.citynews.ca/2025/03/30/second-week-of-campaign-underway-amid-criticism-leaks-within-conservative-ranks/.
[6] See, for example, “Heathrow is a wake-up call for utilities,” https://www.bloomberg.com/news/newsletters/2025-03-30/heathrow-is-a-wake-up-call-for-utilities, “Widespread power failures demonstrate the fragility of our electrical grid, and the perils of privatization,” https://www.halifaxexaminer.ca/morning-file/widespread-power-failures-demonstrate-the-fragility-of-our-electrical-grid-and-the-perils-of-privatization/, and “From Fragility to Flexibility: The Path to a Resilient U.S. Energy Grid,” https://picus-capital.medium.com/the-path-to-a-resilient-us-energy-grid-e85546d242db.
[7] “Traders fear global FX market may be less liquid than it appears,” https://www.bloomberg.com/news/features/2025-03-30/wall-street-fears-liquidity-problems-creeping-back-into-currency-market.
[8] Liberty Street Economics, “The liquidity mirage,” https://libertystreeteconomics.newyorkfed.org/2015/10/the-liquidity-mirage/.

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