



January 23, 2025

We hope that you are well and keeping warm as we transition towards an indeterminate future.

As we enter **the Trump presidency phase two**, there is one thing that we can take from the past. Donald Trump relies on symbolism rather than substance.

The Trump Administration is proposing that it will lower corporate tax rates and those for upper income earners. They are also looking to cut any regulations that in the past have slowed corporate growth. In the short term, this should boost profitability, lead to a wave of mergers and acquisitions, and lead to easier credit conditions. This could propel equity markets higher on both sides of the border as a change of the Canadian government will likely move in a similar direction to maintain a competitive stance.

It is important to remember that **deregulation** can lead to economic imbalances and become inflationary. This could unwind the momentum built by the Central Banks that propelled equity markets higher in 2024. It is also not clear how the U.S. government will make up for the shortfall in tax revenue. It can either increase deficits or cut services (Obamacare, veteran's benefits, food stamps, etc.). They might be looking for income generated by tariffs to make up the shortfall. Although the newly formed DOGE (Department of Government Efficiency) will be tasked to streamline programs, it is possible there will not be as much waste to trim as they think.

The biggest potential negative facing Canadian investors is **the proposed 25% tariff** on goods being exported to the US. It is unclear whether this is merely a negotiating tactic to wrest concessions. This would be consistent with President Trump's "Art of The Deal" mentality where demands are very high up front to manipulate discussions in his favour. The Trump Administration sees tariffs as a way to protect US industry, build revenue, and leverage negotiating power. They have a mandate to limit inflationary pressures and keep consumer costs down so any tariffs would likely be gradual and negotiated. Tariffs are charged by the Government taking in the goods. The result is typically an increase to the price of imported items for the consumer. Tariffs hurt both the exporting companies and those importing. For the exporters they may see sales slow , which cuts profit margins. There can also be relocations of production to avoid tariffs. For the importing companies, supply chains can get disrupted and imported parts and components as a result become more expensive. These costs get passed on to consumers which becomes inflationary. If the US puts tariffs on Canadian goods, it will hurt US manufacturers, especially the auto industry that have developed cross-border supply chains. There will also be **retaliatory tariffs** that would target US exporters to Canada. During the last Trump administration, Canada imposed about \$16 billion in retaliatory tariffs. Reports are that there could be \$150 billion of tariffs placed on US goods bound for Canada - about 1/3 of all trade - in a worst-case scenario.

These tariffs have been justified by a supposed \$200 billion **trade deficit** that the US is running with Canada, some of which might be justified (border security and military spending). It is important to note that the US runs a relatively small trade deficit with Canada of \$38 billion (2023). If you take out energy, the US runs a trade surplus of \$58 billion with Canada. Much of the energy shipped is **heavy oil** that would be difficult to replace for US refiners. This oil allows the US to be a net exporter of oil and oil products.

If the tariffs happen for an extended period, it is difficult to see how Canada will avoid a **recession**. The US economy will be damaged too. If tariffs against Mexico, China and Europe go through and there are counter tariffs, the US could also possibly go into recession. The theory that the income produced by the tariffs offsets the costs is controversial at best.

The likely outcome is that tariffs, if implemented, will be temporary, or limited longer term. Initially Donald Trump didn't sign these tariffs as an executive order. He has indicated that February 1st may be the date that he looks to begin implementation. He once again mentioned border issues as the problem and not poor trading relations. This seems to offer some **room for negotiations** and in the worst case to prepare a strong response. There are some positives to this approach as it will **force Canadian legislators to look inward** and make changes to our own provincial boundaries and internal trading practices. There will also be a renewed focus on Canadian industry competitiveness and lower barriers to international trade with non-US partners to be more competitive. Once the political uncertainty in Canada is resolved, it is likely that the incoming government will have a focus on business-friendly initiatives. More aggressive rate cuts stimulated by tariffs may also help **maintain strength in equities** because interest rates will likely have to decline further to offset any growth decline. This is good for financials, telecoms, REITS and utilities because as rates come down, they tend to do well because of their high relative yields. The weaker Canadian Dollar could also be good for domestic companies especially in travel and tourism and some industrials (air, rail). The TSX is a very rate sensitive market, and these types of equities make up a large portion of the index, so a decline in economic production may be somewhat muted as reflected by the index.

It is hoped that the full impact of tariffs will not be felt on either side of the border. Canada's proposed expenditure of \$1.3 billion in **border security** to target drugs, illegal immigration and guns will be welcome, as would a firm commitment to increase military spending. As the rationale for the tariffs were originally proposed to encourage Canada and Mexico to halt Fentanyl smuggling and illegal immigration, it could be an off ramp allowing the US to lower and/or eliminate tariffs altogether and still declare victory.

Equity markets have reflected all the uncertainty with **renewed volatility**. This has been partially driven by the harvesting of gains, especially in the technology sector, to avoid 2024 taxation and the increase of longer-term bond yields. The US 10-Year Treasury yields approached the 5% mark in early January, which is negative for the equity markets as it offers an alternative to investors looking for higher returns. This can partly be explained by the high deficits and the potential inflationary effect of tariffs. Rates are beginning to come down, however this needs to be monitored closely and may lead to a revaluation of fixed income strategies. We have also begun to see some **sector rotation** to energy, materials and healthcare, which lagged the market returns last calendar year. This is due to pension fund rebalancing and value-based buying. Markets will likely be headline driven for the foreseeable future as we digest the daily musings of the new President.

We are now at a period of the economic cycle where rates are still likely to decline, especially in Canada, however the pace will likely slow which removes some of the upside potential of equities. This makes **earnings** even more important and so far, we have seen positive results from US financials and increased guidance going forward. This bodes well for the coming year and will likely lead to a broadening out of the equity markets. The economic numbers continue to be solid. Financials, utilities, commodities, industrials, healthcare, and technology look poised for gains.

Even though we have an uncertain short-term outlook, history has revealed resiliency in the face of uncertainty and ultimately, we look to better times ahead.

As always, we are an e-mail or phone call away if you have any questions or just want to catch up.

We're here to help.

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