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The Trade War Begins

By Stéfane Marion & Team

Despite hopes that Washington could negotiate with its trading partners to delay tariffs and prevent a global supply shock, the President announced on **February 1** the imposition of **blanket tariffs** on **Canada, Mexico, and China**, set to take effect on **February 4**.

For **Canada**, the tariffs include a **25% duty on all imported merchandise**, except for **energy products and critical minerals, which will face a 10% levy**.

In response, **Canada has announced retaliatory tariffs** of **25% on $155 billion worth of U.S. goods**, rolled out in two phases:

- February 4: A 25% tariff on $30 billion of U.S. imports.
- February 25: An expanded 25% tariff covering an additional $125 billion in goods.

The following summarizes a revised baseline forecast, constructed as at February 2nd and assuming tariff implementation and retaliation proceeds as currently threatened/promised. **We have attempted to simulate impacts of a lasting trade war, but caution that impacts and policy reactions are uncertain.** The geopolitical situation remains fluid and much could change in the coming days

Assumptions on U.S. tariff policy:

We assume that the **initial wave of high tariffs** is a strategic move to pressure trading partners into addressing border-related issues. Once progress is recognized, we expect **tariffs to be reduced but not eliminated**.

Given the new administration's protectionist stance, we anticipate that **tariffs will settle at 10%**, aligning with the **lower bound imposed on Canadian energy goods**. This policy would serve two key objectives:

1. Encouraging domestic investment in the U.S.
2. Generating a stable revenue stream to fund additional tax cuts for U.S. businesses.

Canadian Economic Outlook

We now forecast **GDP growth of 0.4% in 2025**, down from our previous estimate of **1.4%**, and **0.9% in 2026**, compared to the previous baseline projection of **1.5%.**

The economic slowdown will be driven by:

- **Weaker exports and investment**, as trade disruptions and higher tariffs weigh on business activity.
- **Slower consumer spending**, as labour market conditions deteriorate and terms of trade become less favorable.
- **Tighter financial conditions**, leading to **higher capital costs** for businesses and a **negative wealth effect** for households.

Labour Market

As economic conditions weaken, the **unemployment rate** is now projected to **average 7.4% in 2025**, up from **7.0% previously**. A further increase to **7.6% is expected in 2026**, compared to the previous forecast of **6.7%.**

Inflation

While **domestic inflationary pressures** will be more subdued due to weaker demand, overall **inflation is expected to be slightly higher**, driven by:

- **Tariffs**, which will raise import costs.
- **Currency depreciation**, making foreign goods more expensive.

We now expect **CPI inflation to rise by 2.3% in 2025** (compared to **2.2% previously**) and by **2.3% in 2026** (up from 2.1%).

Interest rates and the stock market:

As it stands, the policy rate at 3% is still in the upper half of the assumed neutral range (2.25% to 3.25%). To lessen the fallout on Canada's real economy and to simultaneously buttress financial conditions, we believe there would be **a strong argument for an emergency or inter-meeting interest rate cut by the BoC**. Note that an emergency action would argue for a larger-than-normal cut of at least 50 bps. Beyond a near-term inter-meeting action, additional relief at the scheduled March and April meetings (25 bps each) would **quickly lower the policy target rate to 2% by spring**.

Given that we foresee relatively less economic damage accruing to the U.S., it is unlikely that the FOMC would feel compelled to act as quickly/aggressively as the Bank of Canada. Thus, an already significant degree of monetary policy rate divergence could extend further. Still, we assume the U.S. outlook deteriorates in a trade war, creating scope for roughly 100 bps of FOMC policy rate relief in 2025. Given that financial markets had been discounting only a modest and gradual amount of FOMC easing, longer term Treasury yields would be supported in our revised baseline scenario. We forecast **U.S. 10-year yields** to reach approximately **4.15% by mid-2025** and **3.9% by year-end**.

This decline would help cushion the impact on equity markets, which we anticipate will undergo a **15-20% correction.**

Canadian dollar

The widening **interest rate differential between Canada and the U.S.** (expanding to **200 basis points**) has significantly impacted our **currency forecast**.

We now expect **USD/CAD to reach 1.55 (65 cents US) by H2 2025**, up from our previous estimate of **1.45**.

This revision also reflects a **downward adjustment in our WTI forecast**, which we have lowered from **$65 to $60 per barrel**.

For **year-end 2025**, we forecast **USD/CAD at 1.50**, assuming **tariff reductions and U.S. monetary accommodation**.

Conclusion

The escalation of tariffs and potential trade restrictions is expected to weigh on economic growth and disrupt labour and financial markets as the global economy adjusts to the fallout from a supply shock originating in the world's largest economy. Though the situation is evolving, Canada's status as a small, open economy makes it particularly vulnerable, with the effects likely to be more pronounced on this side of the border.

That said, we continue to believe that Canada remains a vital part of the U.S. economic strategy, which supports the case for a more measured and less punitive tariff structure. At the same time, current developments provide an opportunity for Canadian policymakers to mitigate the impact of trade uncertainty through a combination of lower interest rates, tax reforms, deregulation, and reductions in interprovincial trade barriers.

The transition may involve two years of below-trend growth, but this is a necessary adjustment to enhance Canada's economic sovereignty.

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