U.S. Tariffs

March 4, 2025

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The United States imposes a 25% tariff on its USMCA partners Canada and Mexico, and doubles the tariff on Chinese imports from 10% to 20%

1. What happened?

U.S. President Donald Trump stated that there was "no more room" for Canada and Mexico to avert or to delay a 25% tariff on exports to the United States included in an executive order tabled in early February; therefore, he implemented the tariffs at midnight on March 4. The tariffs were announced in February but delayed until March 4 because Canada and Mexico agreed to implement tougher measures at their borders to address Trump's perceived problem of illegal immigrants and drugs entering the United States. Canadian energy imports will be taxed at 10% instead of the general 25% rate. This move is most likely part of a broader strategy to address perceived trade imbalances, to protect domestic U.S. industries and to redraw the geopolitical map of U.S. alliances with various countries.

Trump also doubled the tariff on Chinese imports from 10% to 20%. He further announced that there would be tariffs on agricultural products coming into the United States, with details to be released in April.

One key difference from the February announcement was an amendment to the original executive order to reinstate the de minimis exemption for imports valued at less than $800. Such imports can continue to enter the U.S. on a duty-free basis until "adequate systems are in place to… collect tariff revenue" on them.

2. What do we know so far?

Canada and Mexico have announced retaliatory tariffs that will go into effect at the same time as the U.S. tariffs.

Canada's response consists of a 25% tariff on $155 billion worth of U.S. goods. The first tranche of $30 billion takes effect immediately and targets mainly food products. The second tranche of $125 billion targets automobiles, steel and aluminum and is set to take effect in a few weeks. China is also considering retaliatory tariffs on U.S. agricultural and food products, a response similar to what it did in the trade war during the first Trump administration.

What we do not know, and what will most likely be the most important variable, is the duration of the tariffs. Commerce Secretary Howard Lutnick said that Canada had done "a good job at the border" and that tariffs may not remain in place forever.

Most analysts think the tariffs will remain until a broader, more comprehensive trade deal is agreed to with Canada and Mexico.

That being said, there is no specified timeframe for lifting the tariffs, which creates significant uncertainty that may hinder corporate investment.

3. What are the most direct impacts for Canada and the United States?

In Canada, the tariffs will most likely reduce the competitiveness of Canadian goods in the U.S. market, resulting in job losses, particularly in sectors heavily reliant on exports to the U.S., such as manufacturing and agriculture. Alberta's oil and gas sector will also be affected because the U.S. is a major destination for Canadian energy exports.

In the United States, consumers are expected to face higher prices for goods imported from Canada, Mexico and China, as well as for gasoline. Supply chains could be disrupted. Job losses may occur in industries that depend on Canadian imports or that export to Canada, given Canada's retaliatory measures.

On both sides of the border, the imposition of tariffs and the retaliatory measures are expected to weaken economic growth and fuel inflation, complicating life for central bankers. The trade war is also taking place as U.S. growth appears to be slowing markedly in the first quarter of 2025.

The auto industry, given the integration of its U.S. and Canadian supply chains, is particularly susceptible to price pressures. Higher vehicle prices will most likely reignite inflation in the short run.

We estimate that the 25% tariff on Canada and Mexico, and the extra 10% tariff on China, if sustained, could boost U.S. inflation by a non-trivial 0.5-0.8% in the coming four quarters.

Overall, in the United States, this additional inflation will boost the effective tariff rate by about seven percentage points, which is non-negligible and is a hit to U.S. consumers and businesses.

4. What are the broader implications for other U.S. partners?

The imposition of tariffs on major U.S. trade partners, such as Canada, Mexico, China, and the euro zone, could trigger a global trade war because other countries will probably retaliate in kind. Such a trade war could disrupt global supply chains, reduce growth, increase costs for businesses and consumers alike, and sustain economic uncertainty worldwide.

Moreover, the United States' relationships with traditional allies and partners have been damaged. That the trade dispute is taking place during a rapprochement between the United States and a traditional adversary such as Russia is increasing the level of distrust between the U.S. and its traditional partners.

5. Is there a path to resolution?

Even though President Trump has taken exception to the U.S.-Canada trade balance, the evidence and the data show that the trade relationship is in fact well balanced, especially if one excludes energy from the picture. Moreover, the reasons cited for the imposition of tariffs—immigration and drug flows—are highly dubious in the case of Canada.

Any resolution of the trade dispute will most likely involve negotiations to reach a new trade agreement, which could include some concessions to the U.S. on issues that have long bothered President Trump, such as Canada's supply management system for agricultural products. We also expect Canada to take additional measures to secure the border and to increase military spending, because its defense budget has failed to reach the level agreed upon as part of NATO membership.

6. How will the trade dispute affect Canada's coming election?

The trade dispute may increase the likelihood of a spring election in Canada. Even though the Conservative Party, led by Pierre Poilievre, held a large lead earlier in the year, tensions with the United States and the resignation of Prime Minister Justin Trudeau have led to a complete reversal of Canadian political polls. The Liberals, who will most likely be led by former central banker Mark Carney, have enjoyed a massive boost in popularity. An election is likely to be called earlier rather than later because dissolving Parliament quickly could give the incumbent party an advantage.

Either way, trade and political tensions with the U.S. have made the Canadian federal election a tight race that is difficult to predict.

7. Which provinces would be more affected?

Alberta and New Brunswick: The provinces at the core of the oil and gas industry will be affected significantly by the tariffs, because the U.S. is a major market for Canadian energy exports. Exports to the U.S. account for about a third of the GDP of Alberta and New Brunswick, an amount significantly higher than the Canadian average of 19%.

The initial impact will be seen in the widening spread between the prices of Canadian and U.S. oil, but demand for Canadian oil could be sustained, given that U.S. refineries in the Midwest are designed for Alberta's heavy crude and lack any short-term alternative.

Ontario and Quebec: The two Eastern provinces, with their large manufacturing bases, particularly in automotive, aluminum and steel, will also be heavily affected.

8. Is a recession guaranteed?

Even though a recession is not guaranteed, the risk is high owing to the economic disruptions caused by the tariffs. The overall impact will depend on how long the tariffs last. The economic consensus is that any prolonged trade dispute could lead to a recession in both Canada and the United States According to the Bank of Canada, the long-run impact on Canada's economy would be equivalent to a 3% loss of GDP.

Whether a recession takes place also depends on the nature and the speed of the policy response by Canadian authorities, with both the Bank of Canada and the federal and provincial governments likely to adopt special measures that would counterbalance the negative impact of the tariffs.

Given the nature of import tariffs, the economic impacts will probably be gradual as importers react to higher prices by cutting new orders, negotiating lower prices from exporters, taking a hit on their profitability and passing on some of the cost increase to consumers. If the situation turns out to be sustained, then a reshaping of the supply chain would lead to more severe, and most likely durable, economic consequences.

9. How many jobs are threatened?

It is hard to provide a precise figure, but tens of thousands of jobs in both Canada and the U.S. are at risk, particularly in the manufacturing and agricultural sectors. The exact number will depend on the duration and extent of the tariffs. We expect the federal and provincial governments to decide quickly on measures to cushion the blow, such as by accelerating access to employment insurance benefits or by allowing businesses in hard-hit sectors to defer their tax payments.

10. What about oil prices?

The tariff on Canadian oil is likely to disrupt the North American oil market, especially because the refineries in the U.S. Midwest, accounting for about a quarter of the country's refining capacity, are geared to processing Canadian crude. U.S. consumers will most likely see an increase in gasoline prices at the pump. If Canada and Mexico curtail shipments of crude oil to the U.S., the effect will be amplified.

We can expect the spread between the prices of U.S. crude oil (West Texas Intermediate) and Canadian crude oil (Western Canada Select) to widen initially, adversely affecting Canadian oil producers. As well, the profit margins of U.S. refiners will most likely be negatively affected.

11. What about the Canadian dollar?

The Canadian dollar has already weakened by about five cents since October in anticipation of the tariffs. At the loonie's current level (about 68 cents to the U.S. dollar), the foreign exchange market is expecting the issue to be transitory. There is still skepticism in the foreign exchange market as to whether the tariffs will be permanent. If the tariffs become permanent, we foresee the Canadian dollar trading closer to the low end of the 0.60-0.65 range against the U.S. dollar. If an offramp materializes in the short run (which appears unlikely from Trump's most recent comments but is not impossible given the man's frequent about-faces and sometimes unique negotiating tactics), the Canadian dollar should bounce back.

That being said, if a resolution is slow to arrive, we think the Canadian dollar will fall toward the low sixties against the U.S. dollar. Despite the high degree of uncertainty, we are leaning toward the latter scenario.

12. What about the equity markets?

In the United States, even though most of the economic growth is generated domestically by its outsized domestic consumer, U.S. companies are exposed to earnings from foreign sources, which exposes them to retaliatory actions by the country's trade partners. Moreover, foreign investors have generally invested significant amounts in the U.S. stock market in recent years, as the "U.S. exceptionalism" theme gathered strength. Such flows could reverse themselves in a trade war. This context, combined with more generalized risk-off sentiment, exposes U.S. equities to risks.

In Canada, a more generalized macro impact may be priced in initially. Whether it is a lasting shock, or a one-off bout of volatility will depend mainly on the fiscal and monetary mitigating measures, and whether the trade war persists or fades quickly.

13. What about interest rates and bond markets?

The first impact will be on economic growth. On both sides of the border, the effect on economic growth will be unambiguously negative. Economists' consensus sees a hit of at least 3% to Canadian GDP if the tariffs are sustained; as for the United States, they estimate that the combined tariffs on Mexican and Canadian imports will subtract close to 0.5% from GDP. Although the negative impact is much greater in Canada, both countries are set to feel pain, which will lead to lower interest rates as central banks respond to lower growth.

IThe second effect will be on prices and inflation. Tariffs do not contribute to ongoing inflation (they are essentially a one-off price shock, and they do not lead to a continued upward trend in prices), but they do contribute to higher price levels. The Federal Reserve has hinted it is likely to look beyond the initial price shock, dismissing it as transitory and focusing on the underlying inflation trend. In Canada, the retaliatory tariffs will also surely lead to higher prices. Because higher inflation generally leads to higher interest rates, this second effect runs contrary to the first one detailed above.

Overall, we think the negative growth shock is likely to outweigh the price increases, and that the Bank of Canada's reaction could be tilted toward more easing. In other words, rate cuts could be warranted to provide stimulus to the Canadian economy, and Canadian rates might fall more than U.S. rates.

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