Andersen Canadian Economic Report

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HOW LONG WILL TARIFFS LAST?

Tariffs could take the worst-case direction. There may be no further delays or phasing-in. The carve-out is limited. There is a 10% tariff on Canadian exports of oil, natural gas and electricity. The rest face a 25% rate. Also President Trump is threatening reciprocal additional tariffs for any retaliatory tariffs.

Canadian business confidence is badly shaken. Americans are not as worried. Consumer confidence is down in the US, but business sentiment held up through February. No one knows how long the tariffs will last. At this point it seems that it will be until after Canada's spring 2025 federal election (if there is one).

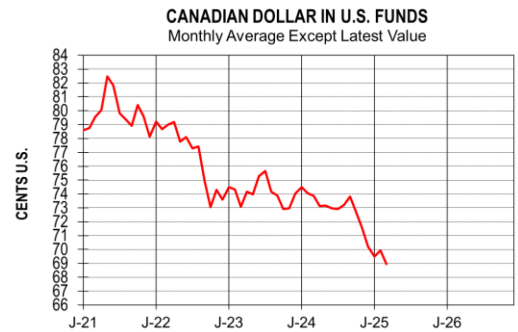
Canada could possibly suffer through 3 to 6 months of US tariffs. It would be painful but may not be fatal. However, a longer-lasting tariff shock would deliver a severe blow. Canada would likely slip into a deep recession. We don't think that this would happen because the negative feedback on the US economy would not fit with a rational US game theory approach.

It would help if we knew what President Trump's tariff objective really is. Is it to give a negotiating advantage, and force other policy changes on Canada? Is it an attempt to boost US government revenue to pay for tax cuts? Or is a longer-run attempt to bring back manufacturing to the United States?

Let's hope it is the first one – a negotiating tool. Canada has hardly been a manufacturing offshoring threat to the United States. If it is viewed as a new source of government revenue though, this would be a problem. It would mean that tariffs could be a long-term fact of life.

Cash will be king for Canadian businesses. Efficiencies and cost-cutting will be the name of the game. This does not have to mean immediate layoffs though. Canadian CEOs remember the pandemic-related labour shortages.

Skilled workers were still in short supply in 2024. While hiring plans for full-time workers will probably be shelved, demand for part-time workers may pick up. Canada's unemployment rate will increase, but not sharply until later in the summer (if tariffs last that long). In addition, a much lower CAD will soften the blow. At its current level of around 69 cents (US) it is already down by 16% from its 2021 peak. A decline to 66 cents would give a 20% decline.



UNITED STATES

- **Economic worries exaggerated**
- **Real GDP increase of 2.3% in 2025**
- **Potential growth rate is 2.1% (CBO)**

- **Corporate & personal tax cuts coming**
- **2 Fed rate cuts in 2025 (June & Dec.)**
- **Year-end 30-yr mortgage rate down to 6.5%**

- **Tariff inflation add-on of under 0.5%**
- **A tariff offset from services disinflation**
- **CPI 2025 forecast increase of 3.2%**

- **Business surveys are still positive**
- **Regional Fed survey expectations stable**
- **Job market can absorb federal layoffs**

CANADA

- **Recession risk from tariff shock**
- **Tariffs to last 3, 6 or 12 months?**
- **Over quickly or on for a long time**

- **Business sector on defense**
- **End-game is unpredictable**
- **Objective to survive until 2026**

- **Business sector belt-tightening**
- **Focus on business efficiency**
- **Corporate liquidity a top priority**
- **Investment plans put on hold**

- **Beware of detailed point forecasts**
- **They give false impression of accuracy**
- **No models can predict economic outcome**
- **But GDP declines likely (Q2/25 and Q3/25)**

- **Big rate BOC cuts are coming**
- **CAD expected to head much lower**
- **Fiscal measures take longer to act**

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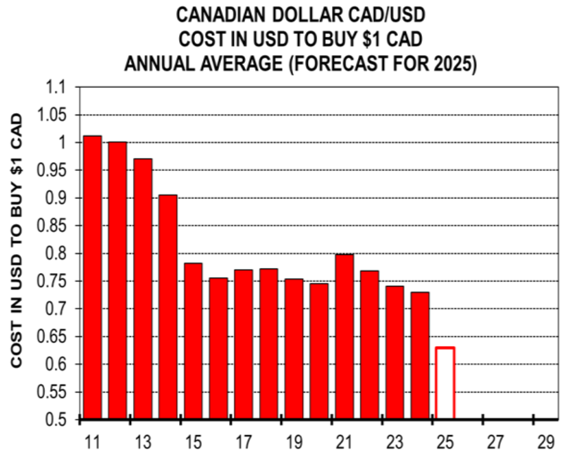
COVER PAGE CHART STORY



The CAD is headed lower.

This will help offset the tariff shock.

It has traded below 69 (cents US).

The tariff news is pushing it down.

The Bank of Canada is probably buying to give it temporary support.

It cannot continue to do this for long.

The CAD peaked at 82.47 in May 2021.

At around 69 cents now, it is down by 16% from then.

Currencies are notoriously hard to predict.

However, we expect additional big interest rate cuts by the Bank of Canada very soon.

We are penciling in an annual average of 63 cents (US) for the CAD in 2025.

This is not so much a forecast as a best guess.

If that happens, the devaluation will amount to about 24% from the 2021 peak.

Looking back further, the CAD averaged around 100 cents (US) in 2011 and 2012.

A 63 cent CAD in 2025 would mean a 37% devaluation from those years.

If the CAD moves much lower in 2025, as we expect, Canada’s exporters should be able to survive a 25% tariff shock.

They would be receiving much more in Canadian dollars from US dollar priced exports.

At 63 cents (US), a devalued CAD would produce 1.59 Canadian for one USD of export sales.

At 81.50 cents (US) it would produce 1.23 Canadian for one USD of export sales.

A lower BOC interest rate and currency devaluation are likely to be Canada’s first policy response to tariffs. Fiscal help (tax cuts and government spending) takes too long to work. In addition, fiscal help may have to wait until after the next election, which may be in May.

TARIFF UNCERTAINTY
The US Needs Canada

Peter R. Andersen, Ph.D.

NEGOTIATIONS TAKE TIME: The end result for Canada will in all likelihood not be as bad as it looks now. The US needs Canada's supply chains. President Trump does not want higher inflation. The situation is still fluid. It looks like Canada will not face the full 25% tariff that is threatened. In addition, the tariffs on auto products now appear to be delayed until April. This gives time for more negotiations. Our working assumption is that the tariff disruption for Canada will not be as severe as currently expected. President Trump likes to operate in an unpredictable way. He thinks that this gives him a negotiating advantage. Looking through this uncertainty, we expect the eventual outcome to be one that is consistent with stable inflation in the United States. This means that US tariffs on Canada's key exports will be scaled back to manageable levels, if not eliminated completely.

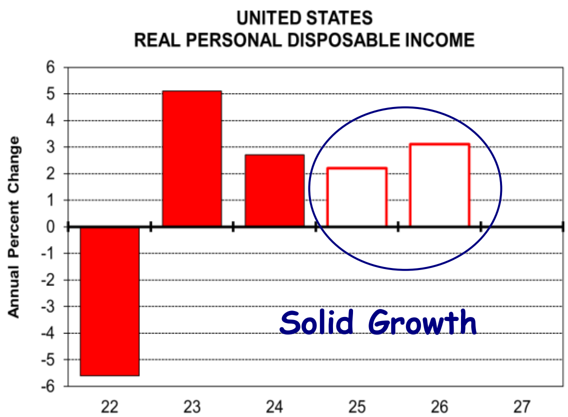
WILL CANADA FOLLOW THE US LEAD ON SOME THINGS: Parts of the he Trump Agenda (lower corporate tax rates, 100% annual depreciation, deregulation) are an attempt to take a more business-friendly approach. Could Canada be shifted into a more tax-competitive response? Is it possible that a rollback of regulations could also find a counterpart in Canada. It is too early to tell, but it could happen. Personal income taxes will decline further in the US as well. They appear likely to be made retroactive to January 2025. There is already talk that Canada is becoming uncompetitive on the personal tax front for individuals. There have been some worries expressed on the possibility of a "brain-drain" of Canadians to the United States. This is a controversial subject, but it is being discussed.

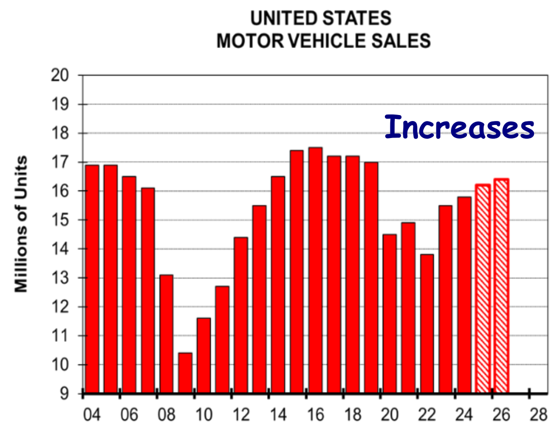
THE RETURN TO OFFICE: This is another development that could move across the border from the US into Canada. A number of US corporations and universities mandated a full (or increased) return to office, before the November US elections. Since than the movement has grown. In addition, President Trump is requiring federal employees to return to their offices. The RTO momentum is picking up speed in the United States. At this point this is not as evident in Canada. However, many US companies are located in Canada, and they are likely to bring RTO requirements with them. This will impact Canada's commercial real estate markets. There have already been signs of a transition in Canada's office market. It is beginning to recover.

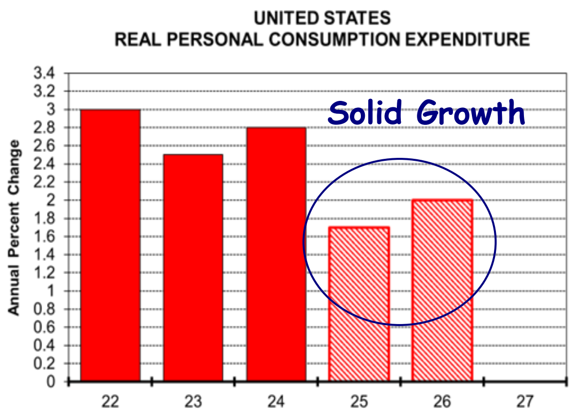
CANADA'S OFFICE MARKET: Liquidity in Canada's office market is slowly improving. Lenders are cautiously returning to the market. Leasing activity has picked up. Physical occupancy is also higher now in downtown locations. However, occupancy in class B and C buildings is still a problem. Suburban office valuations are still abnormally low. If the US shift to a return to office begins to catch on in Canada though, 2025 and 2026 could see the beginnings of a fundamental recovery in Canada's office market.

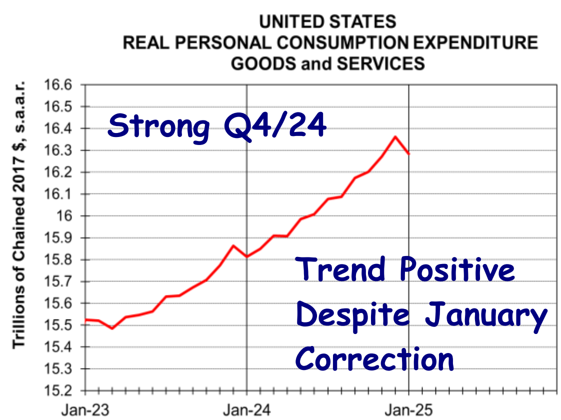
TARIFFS, SUPPLY CHAIN SHORTAGES AND PRIVATE SECTOR LAYOFFS: Tariffs and retaliatory counter-tariffs, if they happen, will likely produce layoffs for Canadian workers. CEOs will initially be reluctant to do this as memories of labour shortages are still very fresh. Layoffs will be delayed as long as possible. Hiring plans could be shelved though. In addition, employers could opt for part-time instead of full-time hiring. Counter-tariffs on US imports coming into Canada would increase production costs for Canadian companies and squeeze profits. For some companies, profits will decline. Cash will be king. There will be pressure to economize and lower costs. Some private sector layoffs are likely this summer.

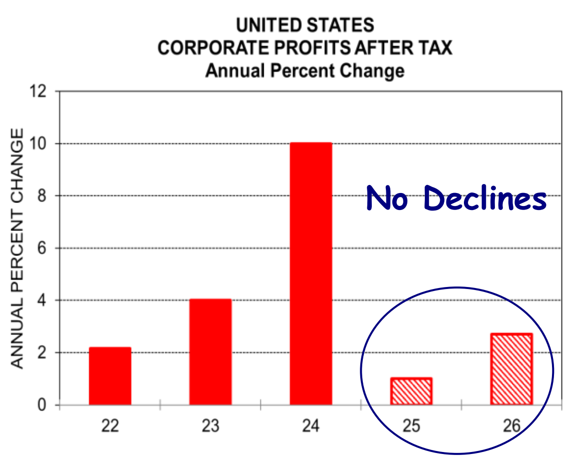
We are counting on the consumer to keep the US economy going. Fortunately the job market is strong enough to absorb the impact of federal government downsizing, and the tariff shock of higher foreign supply chain prices. The 6-month trend in non-farm payroll employment growth has picked up to 178,000 per month. This is the strongest since the spring of 2024. Job growth is expected to slow this spring and summer, but not by enough to push the unemployment rate significantly higher. It is currently at a level consistent with a fully employed US economy. Business confidence surveys continue to show stability and generally upbeat sentiment. A healthy job market will be the key to a growth contribution from consumer expenditure. Real personal disposable income is expected to show a solid increase in 2025, and then accelerate in 2026. Motor vehicle sales (a discretionary purchase) will be higher in 2025.

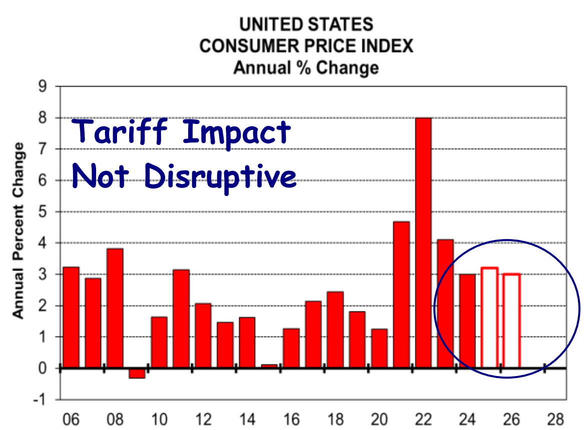




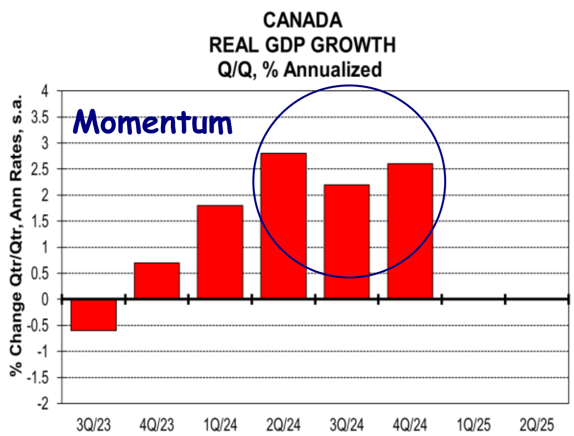


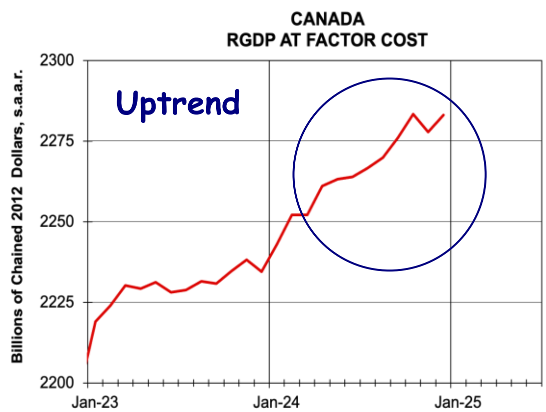


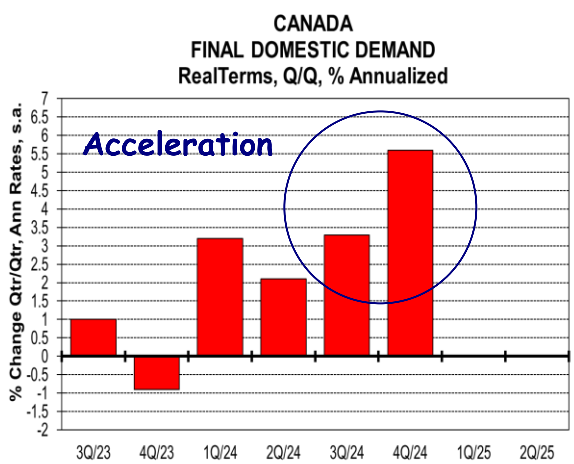


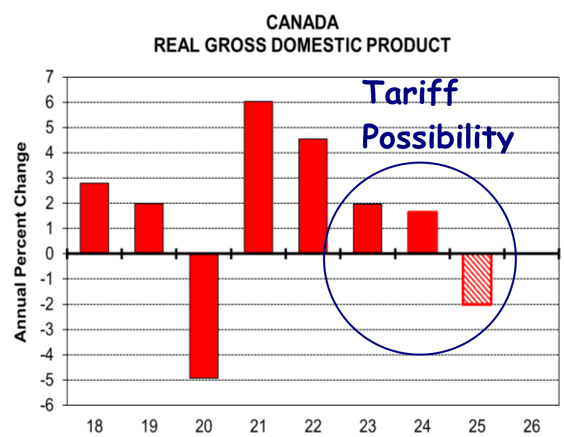


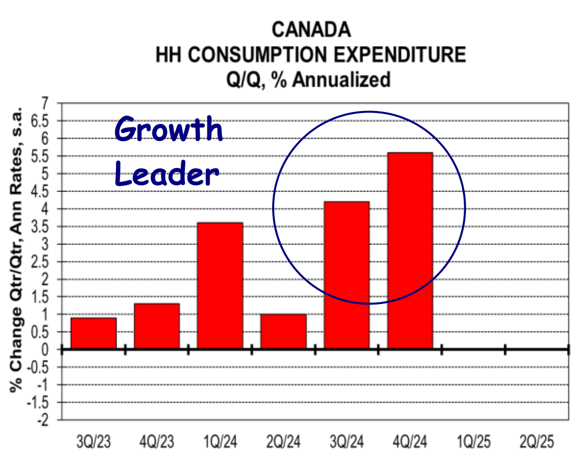
Canada's economy showed impressive growth momentum at the end of 2024. This will spill-over into early 2025, despite the tariff uncertainty. The details of the 4th Quarter GDP report look good. Strength was well distributed across economic sectors. The increase in final demand caught companies by surprise. There was a big inventory burn, with customers' orders being met by warehouse supplies. Household consumer spending growth in Q4/24 was the strongest since the 2nd Quarter of 2022. Business investment in non-residential structures shows a 1.8% annual decline for 2024, but there was a pick-up in the 4th Quarter. Investment in machinery and equipment surged in the 4th Quarter, increasing at a double-digit annualized rate. Consumer and business confidence have been shaken by the tariff threat though, and we expect much slower GDP growth in the 1st Quarter of 2025. A worst-case outcome, with an extended period of US tariffs, would probably cause a series of real GDP declines in Canada, starting in the 2nd Quarter.

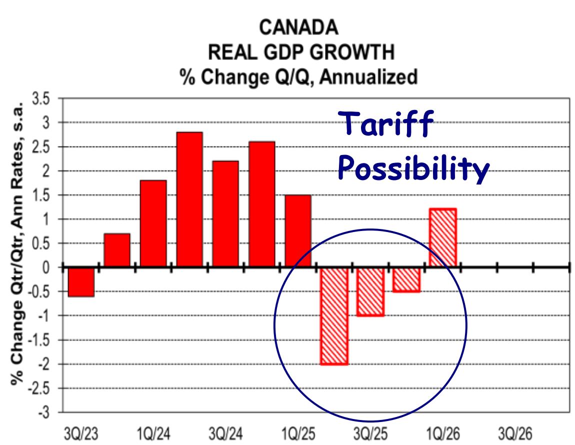




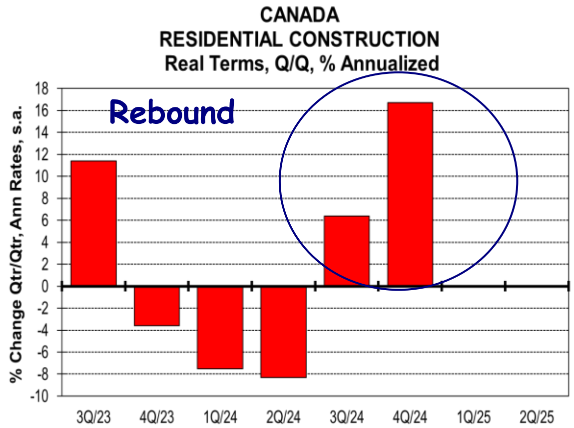


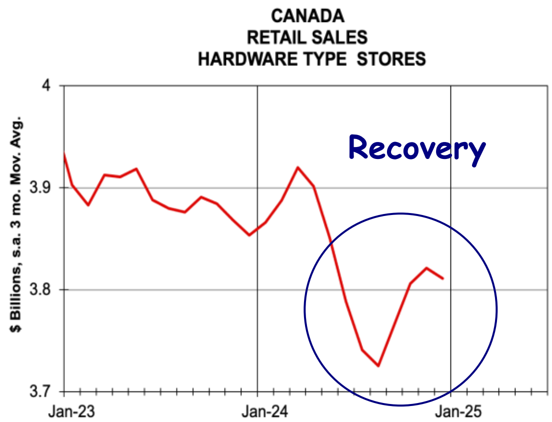


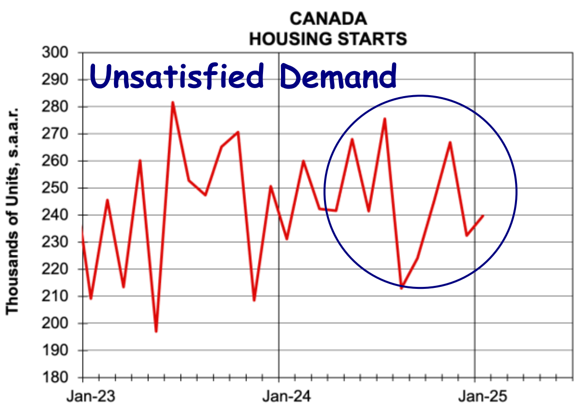


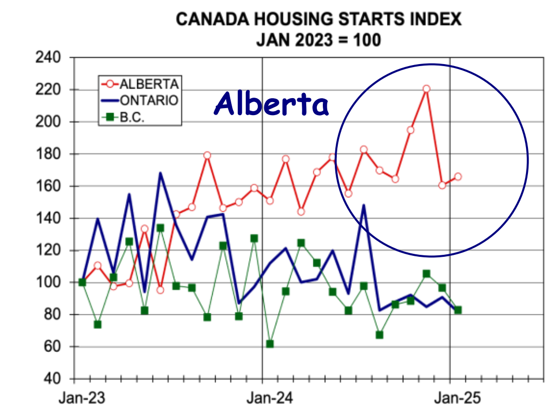


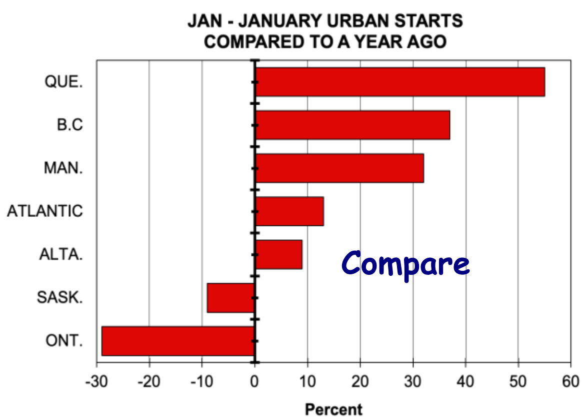
There was a surprise pick-up in residential construction in Canada in the final Quarter of 2024. It was the largest Q/Q increase in almost four years. Ownership transfer outlays were up sharply, reflecting increased resale activity. Single-family homebuilding in Ontario shows a noticeable increase. In addition, renovation activity has picked up. Real spending on residential alterations and improvements were up by 6% Q/Q annualized in Q4/24. This is a good sign, as weakness in previous quarters caused an annual decline in renovation spending in 2024. Canadians were back in the mortgage market at the end of last year. Lower mortgage rates are having an effect. Looking ahead, we expect further mortgage rate declines, as the Bank of Canada attempts to offset the adverse effects of tariffs. Employment growth has picked up in recent months, especially in Canadian manufacturing. This is an important precondition for homebuyer demand. If tariff uncertainties can be resolved, the outlook would be positive for the spring selling season.

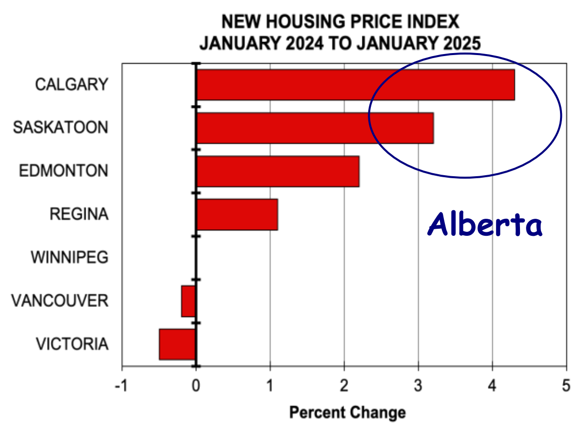












The meeting between President Trump and President Zelenskyy altered the geopolitical risk landscape. The Ukrainian outcome seems more complex now. The rift between the US and Ukraine could add to the difficulties with global trade negotiations. International tariff risk is high. The EU seems likely to be hit with 25% US tariffs. A retaliation response is likely. The outlook for the global economy has therefore worsened. The outlook is negative for many commodity prices. Gold is the traditional investment safe haven. After the Trump-Zelenskyy confrontation, the USD has weakened. This is also positive for gold, which has increased to over $2,900 per ounce. In addition, if peace talks resume, there is a possibility that sanctions on Russia could be partially lifted. This could mean an increase in global oil supply, at a time of global economic weakness. OPEC+ also announced today that it will go ahead with its planned April oil production increase. The price of WTI crude has now declined to around $66 per barrel.