TD Wealth

Tariffs and other inevitabilities

Monthly Perspectives
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15 minutes

Tariffs and other inevitabilities

Brad Simpson, Chief Wealth Strategist | TD Wealth

I will always remember Saturday, February 1, 2025 — the day that President Donald Trump placed tariffs on Canada, Mexico and China — and the following days as some of the most remarkable times in my career.

It was surreal. For months we'd been writing about tariffs and pontificating on their potential impact on the economies of major trading nations and financial markets. The Sunday after, I spent three hours reading about tariffs. I then spent two hours on conference calls listening to different views on the same. Then, on Monday, I got up at 3:45 a.m. (on the West Coast) and participated in my first call about tariffs — something I did three more times that day, for a total of around three hours.

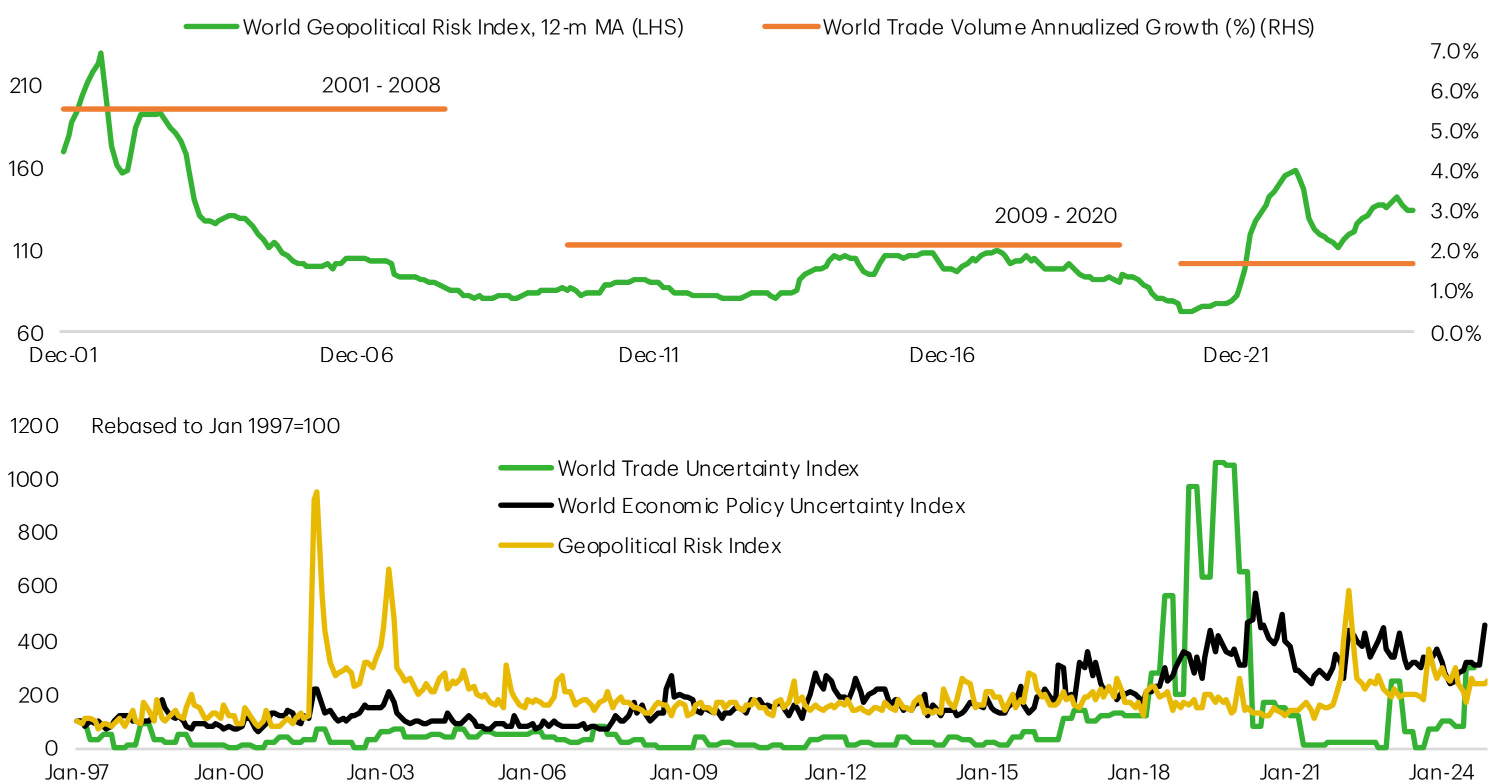
Then, at one point in the day, I checked into cable media to see their perspective — and was promptly subjected to a litany of hyperbole about markets, all displayed on red banners in all-caps.

I thought perhaps I had missed something. Had I lost my way? Was I out of touch? I double-checked my FactSet monitor, and then my Bloomberg Terminal as well, and to my wild-eyed amazement, what I saw across equity markets that day was, in relative terms, a whole lot of calm. Sure, on average the major indices were down 1% to 2%, but "plunging" they were not. We live in such extreme times. People take extreme positions and make preposterous statements, often cocooned within the safety of internet anonymity. Things are either good or bad. Right or wrong. Best or worst.

In the days that followed, I have thought about that time, and the same question keeps repeating in my head: How could anyone have been surprised? Now, I'm not saying that because I have some great predictive ability; I don't. Those of you who have read my columns know my strong view that we live in a world where predicting outcomes is difficult at best. But I thought there was no doubt there would be tariffs, and I've written about it numerous times.

At our annual conference on January 20 (coincidentally, President Trump's inauguration day), I put Figure 1 on the screen and asked the rhetorical question: "Has the discount mechanism disappeared?" For non-market people, that's finance-speak for asking, "Has the market's ability to price the most likely outcome vanished?" After all, it's not like we were all caught off guard by the threat of tariffs. Global trade volume growth has been slowing since the 2010s, when President Trump was first elected.

Figure 1: Has the discount mechanism disappeared?



Source: Economic Policy Uncertainty, Matteo Iacoviello, Macrobond, as of January 17, 2024

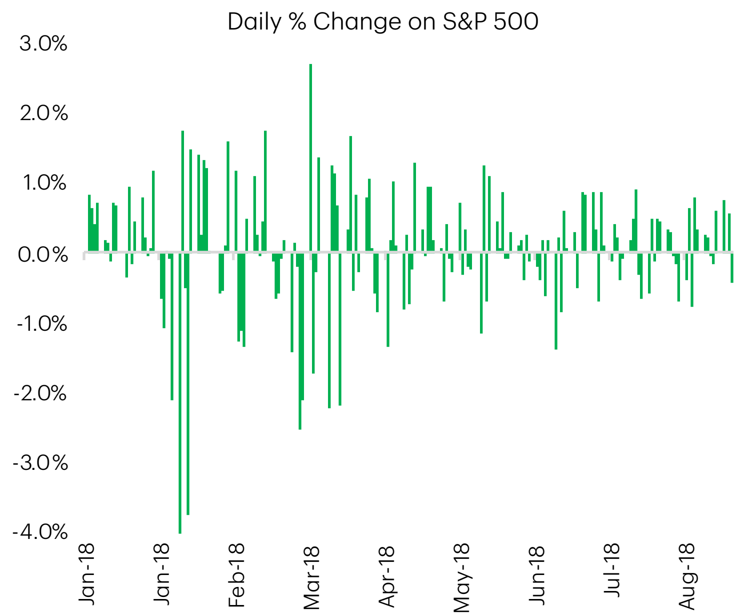
Now, for clarity, I'm not making light of this. In Canada, on a national scale, the threat of painful tariffs from our largest trading partner is a really big deal — it threatens thousands of jobs and has the potential to push our economy into a recession. The same is true for other nations, but what I was trying to get at is the how financial markets reacted. How did the pricing mechanism function in the aftermath of the tariff announcement?

The answer is, it worked just as expected. The market reaction that day was really very calm. The reason for this is that the vast majority of investors were already well aware of the likelihood that tariffs were coming.

Figure 2 categorizes the daily returns of the S&P 500 going back to 2000. Simply put, it shows the likelihood of the market being up or down a certain percentage for the past 25 years. As it happens, almost 35% of the time, the S&P 500 moves 25 basis points or less on any given day. The Monday after tariffs were announced, the index moved between 75 and 100 bps (76 bps), something that the market has done 10% of the time over the past 25 years. My point: The market by and large expected this, and it was business as usual. Sure, it was a little hectic, but not out of the ordinary.

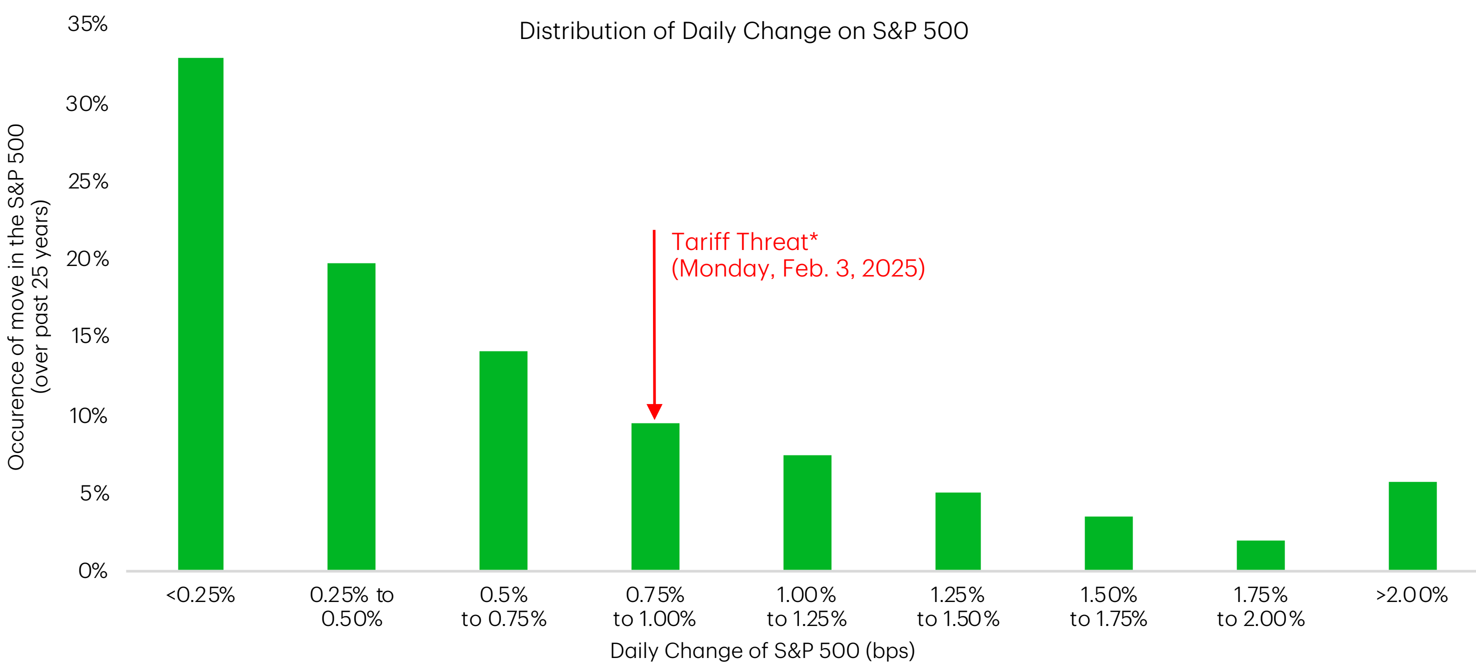
Figure 3 compares the market reaction on the week of February 3 to the trade-war escalation that occurred during President Trump's first administration, between January and August 2018, when both U.S. and China imposed tit-for-tat retaliatory tariffs. Daily market swings in excess of 2% were much more common back then, given that investors had not yet priced in the impact of the trade war. Simply put, back during the first Trump administration, financial markets didn't know what to expect. Now they do. Markets have become less extreme, while views about how markets are reacting have become more extreme. It's quite the dichotomy.

Figure 3: 2018 Tariffs: New and unexpected leading to pain



Source: FactSet and Wealth Investment Office as of February 6, 2025

Figure 2: 2025 Tariff Monday: Was just another day



*S&P 500 moves between 75&100 bps 10% of the time. Source: FactSet and Wealth Investment Office as of February 6, 2025

Things have changed

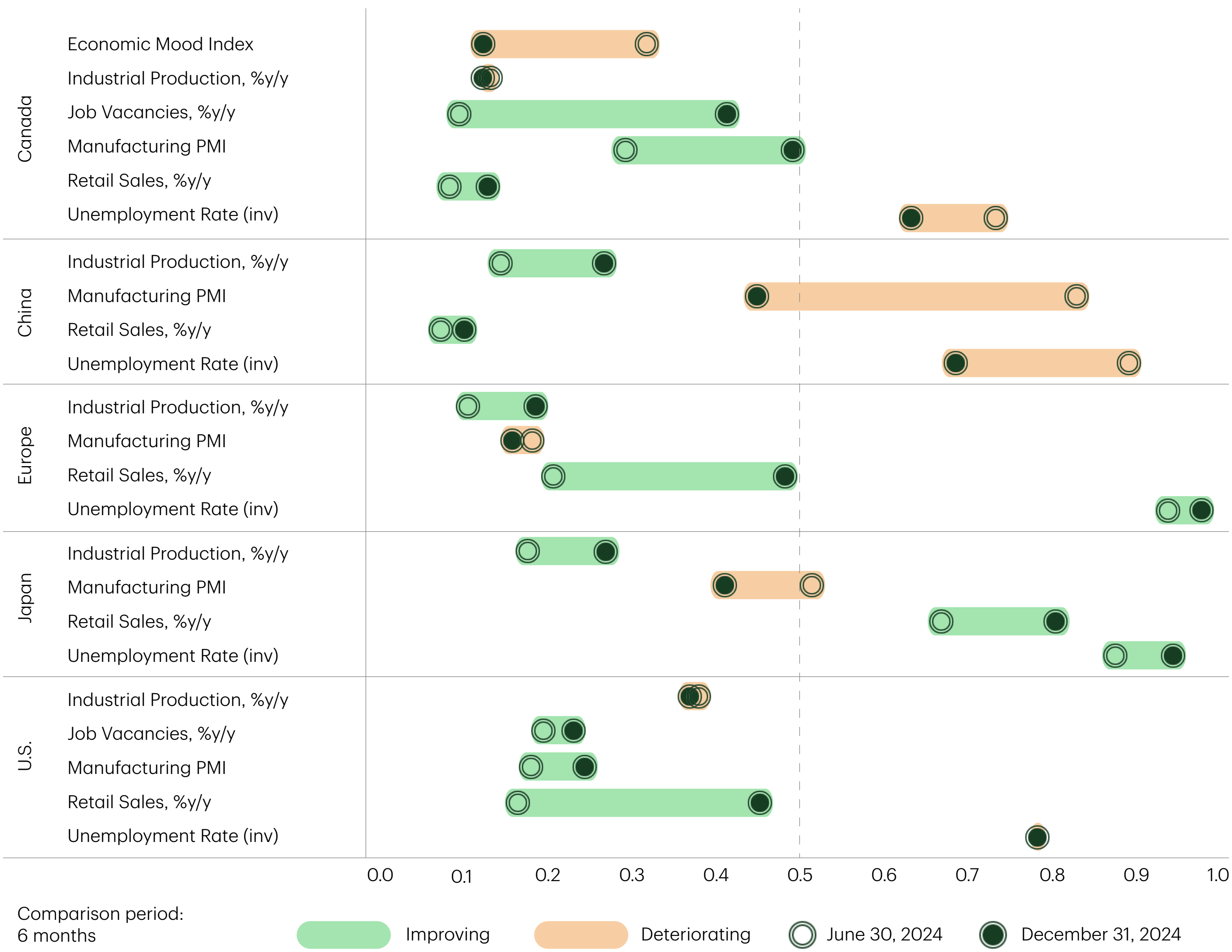
Our theme for the quarter is “Things have changed.” What we mean by that is, we now live in a very different environment than we did in the past. As investors, it’s imperative that we come to terms with that and make decisions for the environment we’re in — not the one that we wish we were in. The facts are the facts, which is why we at the Wealth Investment Office have a philosophy, called Risk Priority Management, with tenets and universal principles that guide our long-term strategies. So, to help our readers keep grounded, I’m going to construct a consistent way of looking at things that we can come back to over and over again, as this new world unrolls itself to make a new carpet in this partially constructed home.

Tariffs: how to measure and manage their impact

First of all, there are going to be tariffs. Go back and read that out loud to yourself. It’s okay, there will be tariffs. How much and how broad they will be, we don’t know, but we know they are coming.

Okay, now that we’ve resigned ourselves to the inevitability of tariffs, how are we going to monitor all of this? A good place to start is the economy. Remember, the performance of equities is driven by the prospect of corporate earnings, which over the long term are derived from the strength of the economy. Similarly, the performance of fixed income is driven by interest-rate expectations, which are also derived from the strength of the economy. Figure 4 is our global cycle indicator. It considers, for the five most important regional economies, the big measurables that we use to assess economic health: industrial production, job vacancies, manufacturing, the service economy and the unemployment rate.

Figure 4: WIO Global Cycle Indicator



Source: Macrobond, FactSet and Wealth Investment Office as of February 1, 2025

What this chart is showing us, from a cycle perspective, is that we are potentially entering a mid-cycle expansion phase in most developed countries, with the exception of Japan. Manufacturing PMIs have stabilized, and services remain strong. We define this phase of the business cycle as a period of recovery in the cyclical sectors following a non-recessionary slowdown (i.e., similar to the U.S. economy in 2013 and 2016).

The ongoing monetary-policy easing by the Fed, Bank of Canada, European Central Bank and People's Bank of China is a tailwind for growth and should help activity. As the old saying goes, don't fight the Fed. These central banks all understand that we are in an uncertain environment.

Our Outlook

The macroeconomic backdrop remains supportive for risk assets, especially in the U.S., where growth is still running around trend while inflation remains relatively stable. So, if we view tariffs as a certainty, and we frame where we are in the economy and how we can update our view on an ongoing basis to assess the impact of future tariffs, we can start thinking about how to invest.

Fixed Income – Modest Underweight

We believe returns going forward will largely be composed of the coupon. We hold a neutral view on domestic government bonds given that yields, while potentially volatile, are attractive. After the strong performance of the past few quarters, the outlook for Canadian government bonds is now more balanced over the medium to long term, and therefore we encourage everyone to take a risk-managed and opportunistic view of government bonds and yields.

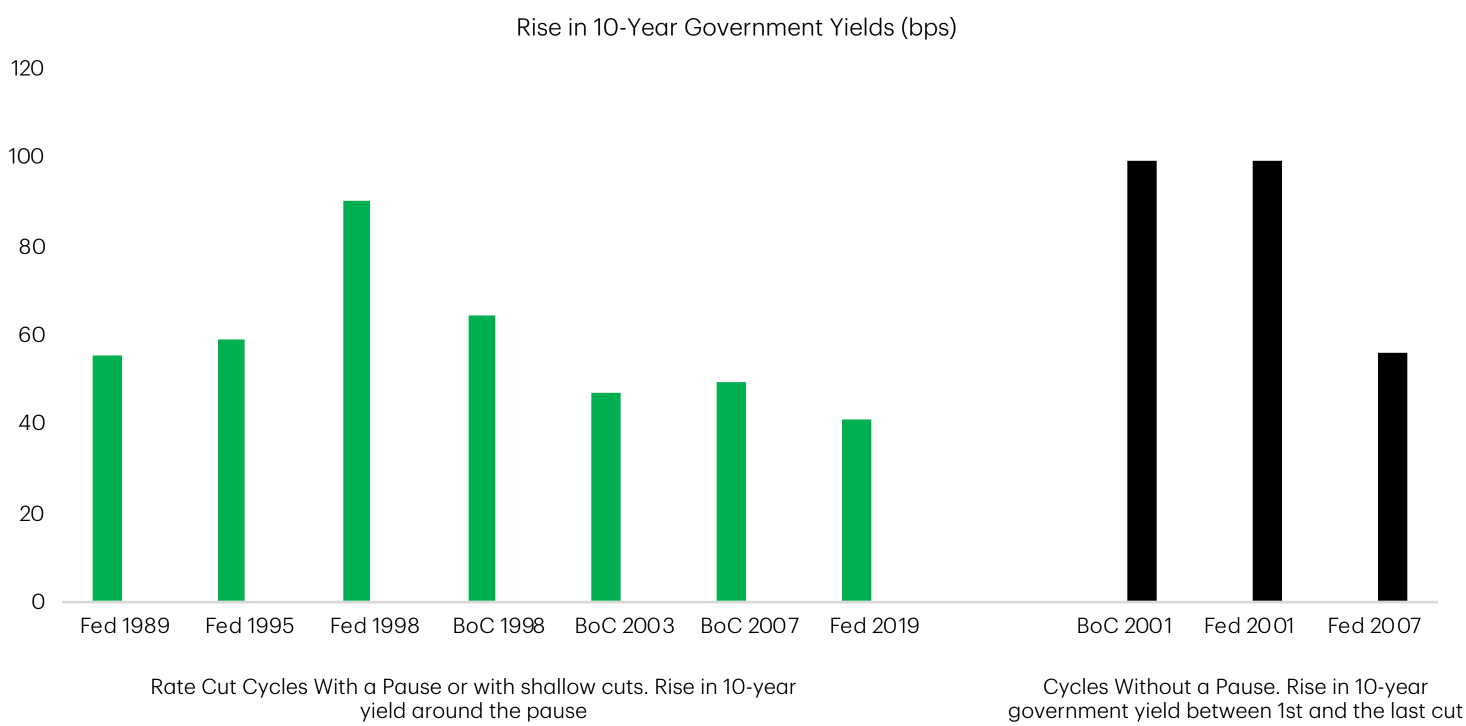
As we highlighted in the Q4/24 edition Portfolio Strategy Quarterly (entitled "U-Turns"), the notion that government yields only fall when monetary policy is easing is misplaced. Government yields can be highly volatile, irrespective of the type of easing cycle we are in. In the seven instances where the central bank paused after only a handful of initial cuts, bondholders suffered painful drawdowns around the pause. On the other hand, when there was no pause in the cutting cycle, government yields jumped between the first and last cut. In a few cases, cuts were unable to prevent a hard landing (Figure 5).

Any investor who commits to a particular outcome in the current cutting cycle is merely rolling the dice. Successfully navigating this period requires someone with an adaptable approach and flexible framework that's capable of adjusting on the fly as the economy reacts to policy changes and shocks.

We remain modest overweight on investment-grade credit. IG spreads are still tight, and we believe Canadian IG bonds, with their slightly wider spreads, are more attractive than U.S. IG.

We hold a neutral view on high-yield credit. HY spreads are extremely tight, reflecting their rich corporate valuations, and have little room to tighten further.

Figure 5: Expect continued volatility in bond yields



Source: FactSet, Wealth Investment Office as of December 31, 2024

Figure 6: Don't ignore U.S. stocks just because of the high S&P multiple

Source: FactSet, Wealth Investment Office as of January 17, 2024

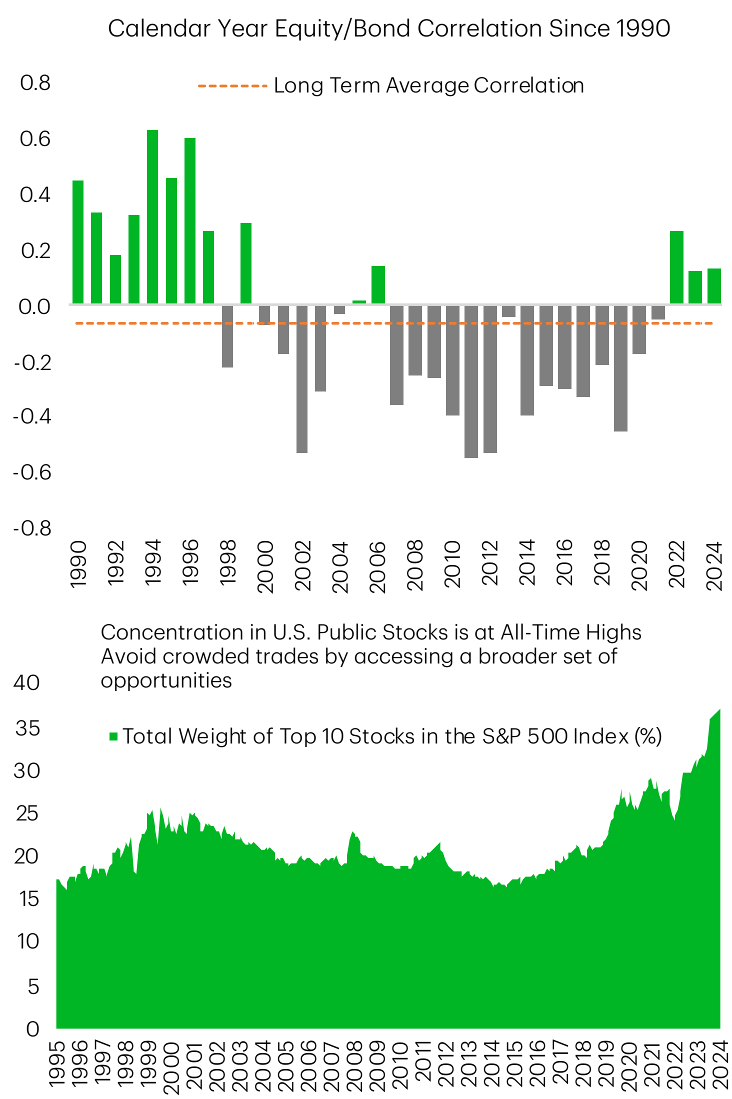
Equities – Modest Overweight

We are modest overweight U.S. equities given that the S&P 500 Index is expected to generate 14% to 16% earnings growth in 2025. Further, the equal-weighted S&P 500 tends to outperform in a mid-stage economy. This bodes well for companies in the small- and mid-cap tiers as well.

Stagnant economic activity and tariff threats, however, cloud the prospect of a recovery for international and emerging markets. As such, we maintain a modest underweight position in these equities.

We think this is a market that's tailor-made for active and long/short strategies. Following two years of multiple expansion in U.S. stocks, investors can also de-risk their portfolio by substituting beta exposure with alpha strategy. Another challenge for traditional diversification are sporadic periods of higher-than-usual stock/bond correlations. Directional hedging strategies and investments with less correlated factor exposure make a lot of sense here (Figure 7).

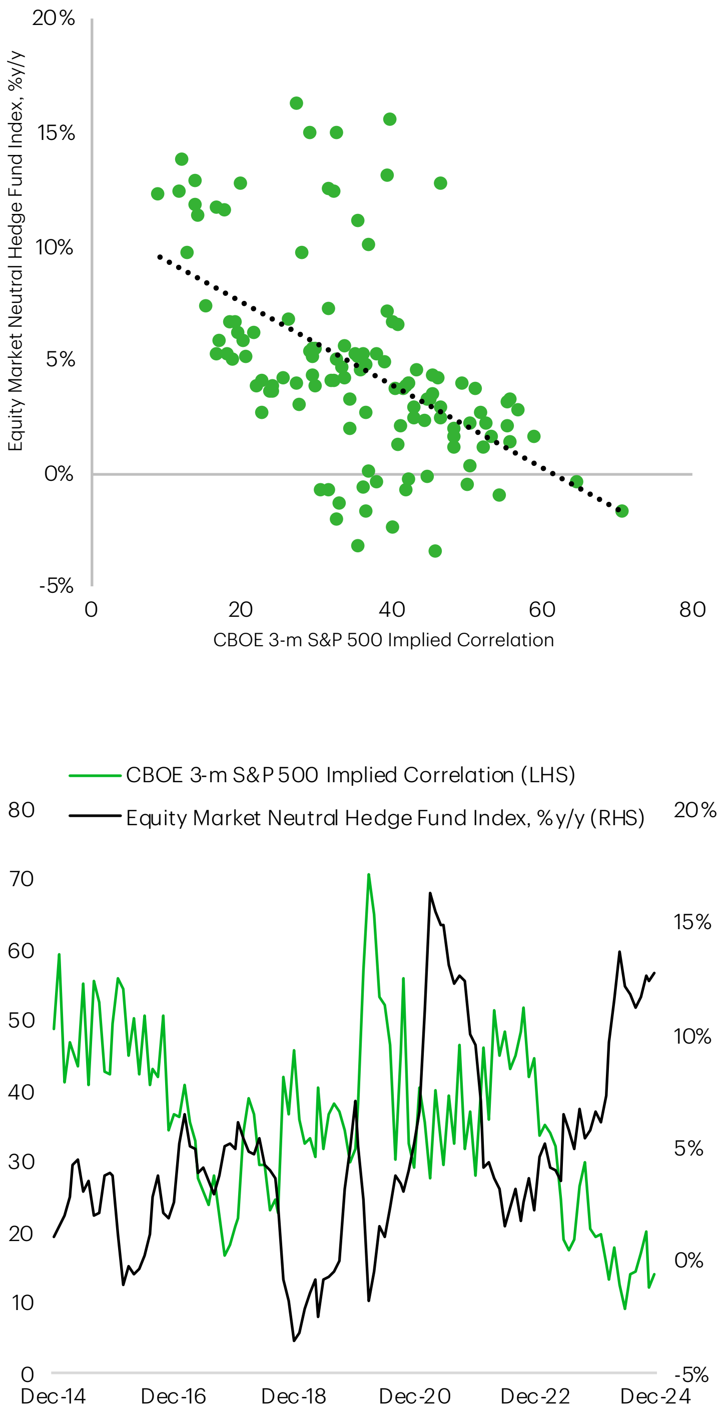
Figure 7: Traditional investment correlations are higher; public equities are more concentrated



Source: Wealth Investment Office, FactSet as of December 31, 2024

Long/short and market-neutral strategies tend to perform better during periods of declining and low correlation within the equity market, as had been the case in 2024 (Figures 7 & 8). If the equity market broadens this year, as we expect, stock prices will increasingly be driven by idiosyncratic company factors rather than macro forces — a boon for active managers.

Figure 8: Environment favours active and directional (hedging) equity strategies



Source: FactSet, Wealth Investment Office as of December 31, 2024

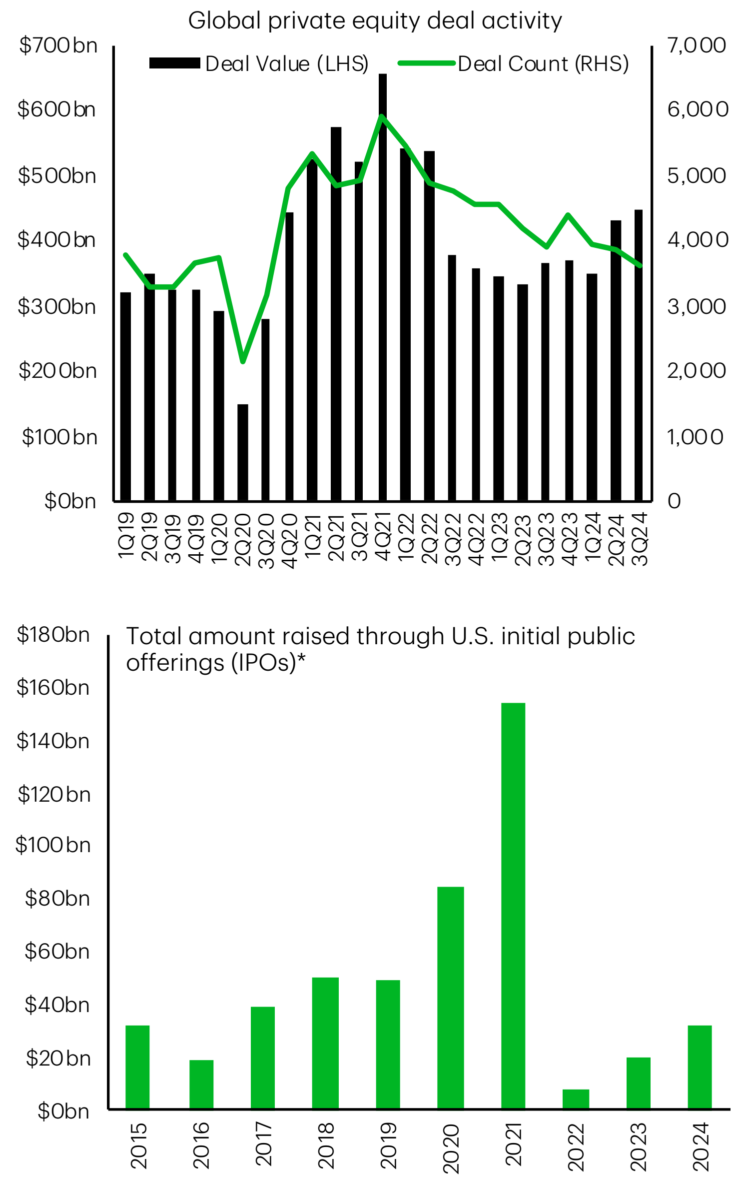
Alternatives – Modest Overweight

We are modest overweight infrastructure, with a shift in focus from core infrastructure assets to core-plus and value potentially providing greater growth and higher return potential.

M&A transaction activity has signalled green shoots of recovery, and continued monetary-policy easing should provide a tailwind for private-equity buyouts.

We are neutral domestic real estate and believe a significant portion of the value adjustments in the Canadian commercial real estate space have been made. Moving forward, we see more reason for confidence in the multi-unit residential, retail and industrial spaces.

Figure 9: Green shoots in deals market generate a tailwind



Source (top): Preqin, Wealth Investment Office, UBS Asset Management as of September 30, 2024. Source (bottom): Wealth Investment Office, FactSet as of December 31, 2024 *Data excludes SPACs

Commodities – Modest Overweight

We live in a world where geopolitical competition continues to increase, military spending is growing, the energy transition is unfolding, and where inflation is more volatile than it has been in decades. This is a world where commodities and gold — which tend to have minimal correlation with stocks and bonds — should fare well, providing strong diversification benefits to portfolios.

Through 2024, the Bloomberg Commodity Index (BCOM) returned 4.7% (CAD-hedged), helped by a late-year rally that has continued into 2025. Concern about renewed inflation risk, combined with supportive economic data, have been a tailwind for commodity prices (Figure 10). During the weakness in equities and fixed income seen in late December, almost every commodity was higher, attesting to the benefits of including commodities in a portfolio. On the micro front, commodities have found support from better-than-expected fundamentals.

We continue to believe that commodities are in the early innings of an investment supercycle, which should lead to above-normal returns. Continued economic growth should keep inventory balances tight as the lagged impact of inadequate capex over the past decade highlights supply challenges.

How to not get lost in the noise

First, we have to acknowledge that the outlook for global economies, trade and monetary policy have become increasingly uncertain. Economic- and trade-policy uncertainty have spiked amid the threat of U.S. tariffs, while the growth outlook outside the U.S. remains downbeat. Inflation in Canada has fallen to below the Bank of Canada's 2% target, but in the U.S. various measures of inflation show a more gradual decline amid stronger economic growth and a tighter labour market.

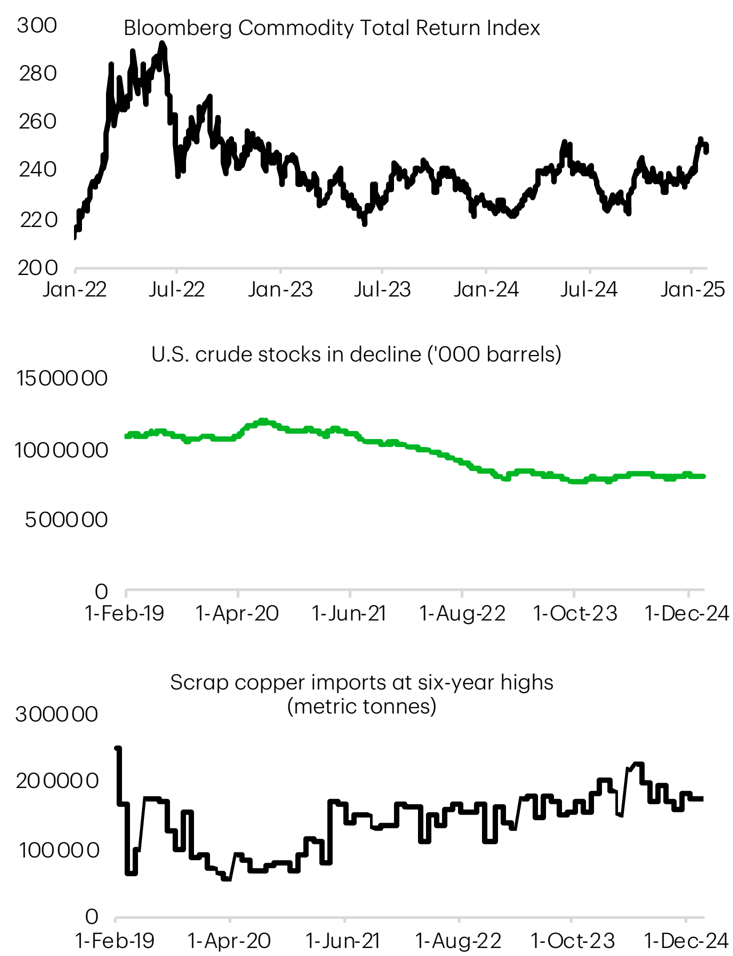
Second, several post-pandemic trends remain intact, including heightened geopolitical risk and deglobalization. These trends pose downside risk to traditional asset classes, such as equities and bonds, but could be mitigated through greater portfolio diversification. The good news is that buying portfolio insurance today is cheap, and similar to buying an insurance for your house, the best time to buy is before an accident actually happens. The falling intra-equity correlation is conducive for long/short and market-neutral equity managers to harvest alpha.

Third, tariffs can be seen from three different angles: (1) as a source of raising fiscal revenue and as an offset to the potential extension of 2017 tax cuts; (2) as a means of protecting national security and bring manufacturing back to the U.S.; and (3) as a negotiation tactic to force concessions from trade partners. The market has become desensitized to tariff news over time as investors increasingly dismiss the threat of trade-war escalation. We think that, although the probability of broad-based tariffs on U.S. trade partners is low, tariffs are likely for goods deemed strategic and important for national security, including semiconductors, pharmaceuticals and commodities such as steel, aluminum and copper. To some extent, the market is already pricing this in, with COMEX copper delivery in Chicago trading at a 6% premium over the LME (London delivery), which implies a 60% probability of 10% tariffs.

Certain segments of the market have priced in the threat of a trade war more than others: the U.S. dollar has risen and will likely continue to do so; inflationary pressure could also push up bond yields; commodities could go higher in the inflationary environment; and equities, meanwhile, are likely to be volatile in this envirnment.

Our theme for the quarter is "Things have changed." They always do. We believe in the concept of "consilience" — the linking together of principles from different disciplines — in seeking to understand, profit and manage risk in a complex physical, biological, social, cultural and technological world. We think strong diversification is the best way to tackle the quarter ahead and the ones that follow.

Figure 10: Almost every commodity is higher in the tense geopolitical environment



Source: TD Asset Management as of January 20, 2025

Market Performance

Canadian Indices ($CA) Return	Index	(%) 1 Month	(%) 3 Months	(%) YTD	(%) 1 Year	(%) 3 Years	(%) 5 Years	(%) 10 Years	(%) 20 Years
S&P/TSX Composite (TR)	105,785	3.48	6.47	3.48	25.19	9.97	11.45	8.96	8.33
S&P/TSX Composite (PR)	25,533	3.26	5.70	3.26	21.46	6.57	8.07	5.70	5.23
S&P/TSX 60 (TR)	5,218	4.19	7.42	4.19	25.44	9.90	11.90	9.44	8.81
S&P/TSX SmallCap (TR)	1,515	0.65	-0.04	0.65	20.05	4.75	9.71	6.03	4.17
S&P/TSX Preferred Share(TR)	2,155	2.25	7.30	2.25	20.50	3.43	6.97	3.76	3.09
U.S. Indices ($US) Return									
S&P 500 (TR)	13271	2.78	6.22	2.78	26.38	11.91	15.17	13.76	10.64
S&P 500 (PR)	6041	2.70	5.87	2.70	24.66	10.18	13.37	11.72	8.50
Dow Jones Industrial (PR)	44545	4.70	6.66	4.70	16.76	8.23	9.53	10.01	7.50
NASDAQ Composite (PR)	19627	1.64	8.47	1.64	29.43	11.29	16.49	15.53	11.92
Russell 2000 (TR)	12376	2.62	4.47	2.62	19.09	5.62	8.67	8.45	8.16
U.S. Indices ($CA) Return									
S&P 500 (TR)	19112	2.86	9.87	2.86	35.89	16.70	17.13	15.18	11.48
S&P 500 (PR)	8699	2.78	9.51	2.78	34.04	14.91	15.30	13.11	9.32
Dow Jones Industrial (PR)	64149	4.78	10.32	4.78	25.55	12.87	11.40	11.38	8.31
NASDAQ Composite (PR)	28265	1.72	12.19	1.72	39.18	16.06	18.47	16.97	12.77
Russell 2000 (TR)	17823	2.70	8.06	2.70	28.06	10.15	10.52	9.80	8.98
MSCI Indices ($US) Total Return									
World	17968	3.55	5.55	3.55	21.94	10.07	12.61	11.11	8.86
EAFE (Europe, Australasia, Far East)	11745	5.26	2.33	5.26	9.20	5.66	6.77	6.20	5.68
EM (Emerging Markets)	2905	1.81	-1.93	1.81	15.35	-0.26	3.45	4.16	6.46
MSCI Indices ($CA) Total Return									
World	25876	3.63	9.17	3.63	31.11	14.79	14.53	12.49	9.68
EAFE (Europe, Australasia, Far East)	16914	5.34	5.84	5.34	17.42	10.18	8.59	7.52	6.47
EM (Emerging Markets)	4183	1.89	1.44	1.89	24.03	4.02	5.22	5.46	7.26

Currency									
Canadian Dollar ($US/$CA)	1.45	1.09	4.36	1.09	8.23	4.59	1.90	1.34	0.80
Regional Indices (Native Currency, PR)									
London FTSE 100 (UK)	8674	6.13	6.95	6.13	13.67	5.13	3.55	2.54	2.95
Hang Seng (Hong Kong)	20225	0.82	-0.45	0.82	30.61	-5.28	-5.13	-1.90	1.96
Nikkei 225 (Japan)	39572	-0.81	1.26	-0.81	9.06	13.59	11.27	8.39	6.43

Benchmark Bond Yields	3 Months	5 Yrs	10 Yrs	30 Yrs
Government of Canada Yields	2.86	2.73	3.07	3.24
US Treasury Yields	4.29	4.33	4.54	4.79

Bond Indices ($CA Hedged) Total Return	Index	1 Mo (%)	3 Mo (%)	YTD (%)	1 Yr (%)	3 Yrs (%)	5 Yrs (%)	10 Yrs (%)
FTSE TMX Canada 91-day Treasury Bill Index	474	0.34	0.96	0.34	4.79	3.92	2.52	1.73
FTSE TMX Canada Universe Bond Index	1183	1.20	2.19	1.20	6.94	0.95	0.45	1.72
FTSE TMX Canada All Government Bond Index	1107	1.24	2.05	1.24	6.30	0.30	-0.08	1.31
FTSE TMX Canada All Corporate Bond Index	1455	1.06	2.61	1.06	8.84	2.85	1.98	2.84
U.S. Corporate High Yield Bond Index	306	1.26	1.74	1.26	8.61	3.49	3.68	4.53
Global Aggregate Bond Index	260	0.27	0.44	0.27	2.94	-0.62	-0.29	1.47
JPM EMBI Global Core Bond Index	535	1.22	0.59	1.22	7.81	-0.86	-1.07	2.28
S&P/TSX Preferred Total Return Index	2155	2.25	7.30	2.25	20.50	3.43	6.97	3.67

Source: TD Securities Inc., Morningstar®, TR: total return, PR: price return, as of January 31, 2025

Wealth Investment Office, TD Wealth

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