



Tariff Threats Hang Over Canadian Equities

February 5, 2025

Key Takeaways

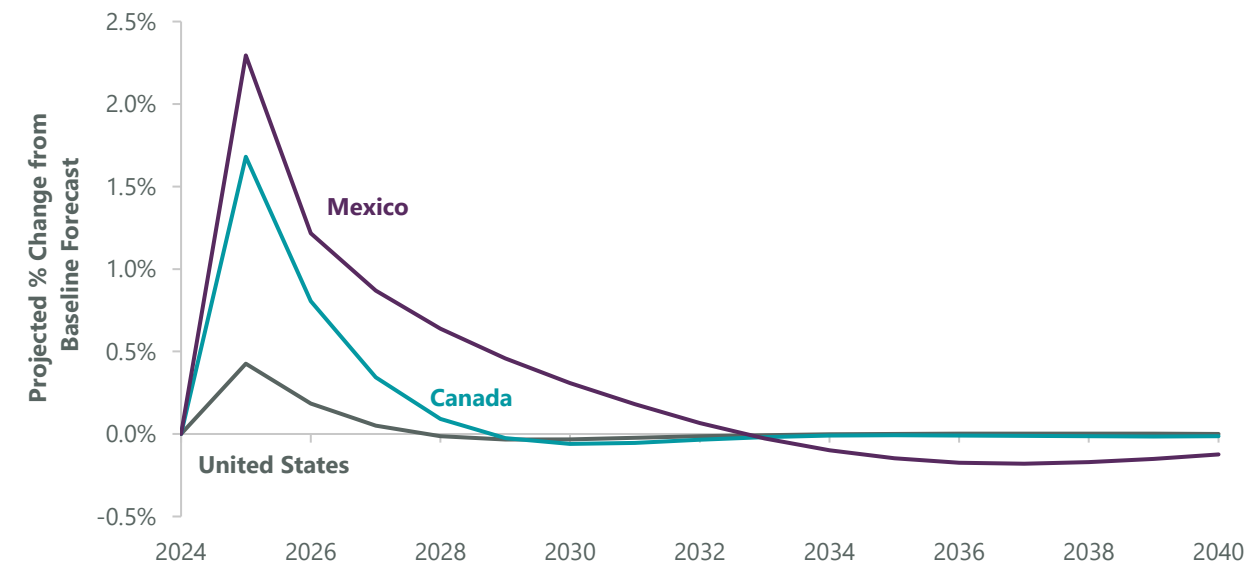
- ▶ Despite delays and ongoing negotiations over the Trump administration's planned tariffs on Canada, some damage was done to Canadian equities and the threat remains.
- ▶ A proposed 10% tariff on Canadian energy, although notably lower than levies on other goods and commodities, would still be a material headwind for Canadian energy companies, especially heavy oil producers reliant on U.S. refiners.
- ▶ Banks are one example of the impact of second-order effects, as the blow to the Canadian economy from tariffs and rising credit uncertainty could have material impacts on both growth and profitability.

U.S. Tariffs Would Carry Direct, Second-Order Impacts

The Canadian equity market tumbled on February 3 with the announcement of tariffs by U.S. President Donald Trump via executive order, threatening to snarl trade and abruptly hurl the already tepid Canadian economy into a recession. An announcement to delay implementation of tariffs for 30 days in the final hours of negotiations resulted in some recovery for Canadian equities, but some damage was done nonetheless, and the threat remains.

While vague and inconsistent threats of tariffs had been bandied about since prior to the U.S. election in early November 2024, the more concrete announcement included 25% tariffs on all goods and commodities from Canada except for Canadian energy resources, which would be subject to a 10% tariff. Trump's stated demand was largely to curtail illicit substances entering the U.S. on the northern border, but it does not seem to be a secret that the true concern remains the U.S.'s trade deficit with Canada. Tariffs were also imposed on Mexico for the same stated goal. Canadian manufacturing companies, particularly those in automotive parts and consumer discretionary industries that directly export to the U.S., would be most impacted by tariffs. However, the broad potential impacts to the Canadian economy and second-order effects would be much further reaching. In addition, uncertainty of this magnitude can be paralyzing for capital as companies deter investments and are less likely to proceed with the marginal ambitious project.

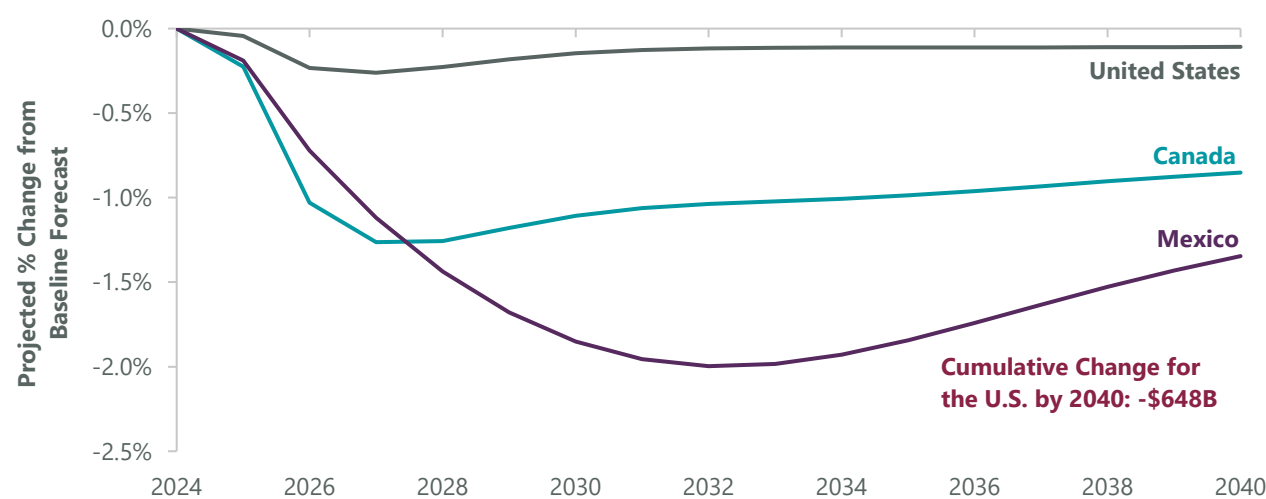
Exhibit 1: Projected Tariff Impacts on Inflation



Used by permission. Source: The Peterson Institute for International Economics © 2025. <https://www.piie.com/blogs/realtime-economics/2025/trumps-threatened-tariffs-projected-damage-economies-us-canada-mexico>

Banks in Canada provide an excellent example of the impact of second-order effects, as the blow to the Canadian economy from tariffs and rising credit uncertainty could have material impacts on both growth and profitability. The potential for a tariff-induced recession in Canada and the knock-on effects to Canada’s GDP, unemployment, inflation and interest rates would have material impacts on the credit environment in Canada. In turn, credit provisioning for Canadian banks would categorically increase, materially impacting profitability, reducing capital ratios and ultimately impacting returns. Although the banks are well-capitalized and have sufficient access to liquidity, a poor credit environment would erode relevant metrics. Furthermore, the possibility of tariffs would generally elevate the cost of capital for Canadian companies, increasing the required return on investment for projects. This could reduce the demand for capital and subsequently slow down loan growth in Canada.

Exhibit 2: Projected Tariff Impacts on GDP Growth



Used by permission. Source: The Peterson Institute for International Economics © 2025.

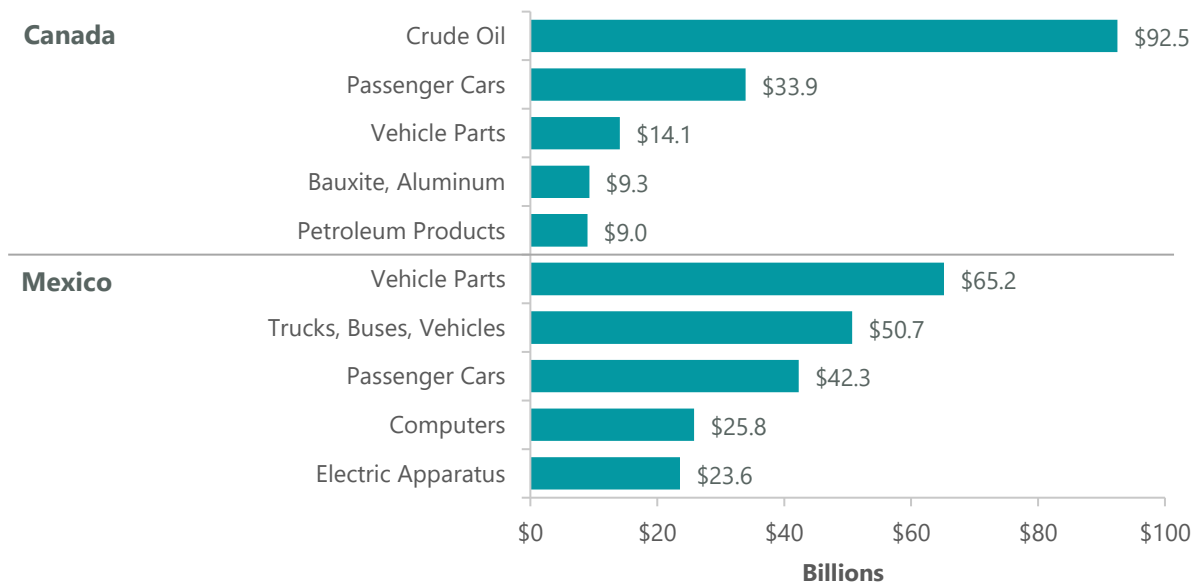
It is likely that even the uncertainty from tariff threats will be enough to warrant an increase in stage 1 (performing loan) provisions by the Canadian banks, a precautionary move similar to that experienced during the onset of the COVID-19 pandemic, albeit of a smaller magnitude. Canadian banks with larger U.S. exposure such as Bank of Montreal (BMO) and Toronto-Dominion Bank (TD) would be relative beneficiaries versus their more Canadian-concentrated banking peers such as CIBC (CM) and Royal Bank of Canada. Bank of Nova Scotia has exposure to both Mexico and Canada, which could lead to profitability impacts on both fronts. Periods of consternation and pessimism around these stocks, potentially induced by bouts of credit weakness, and particularly fears of peak credit losses, could create an opportune moment to add to banks.

Rails Stocks Have Exposure Across North America

Like the banks, the rails face a significant potential impact from tariffs. Canadian Pacific Kansas City (CP) and Canadian National Railway (CNR) vary in different ways depending on the tariff scope and structure. Although neither rail would have tariffs applied directly to their underlying businesses, customers in all three countries (Canada, Mexico and the U.S.) would be impacted, which would likely weigh on freight volumes.

For CP, approximately 40% of revenue is tied to cross-border flows, with 17% specifically linked to U.S.-Mexico trade. While only 5% of revenue currently originates from Mexico to the U.S., future growth heavily relies on this corridor, particularly for automotive and intermodal shipments. Tariffs on Mexican imports could threaten growth, though more severe tariffs on Chinese imports could still encourage near-shoring trends to Mexico. Key commodities like grain and petroleum products moving southbound to Mexico also represent critical revenue streams that could be disrupted under a more aggressive tariff regime where retaliatory tariffs are put in place by Mexico. For CNR, approximately 30% of revenue is tied to transborder Canada-U.S. trade, making it vulnerable to tariffs on specific commodities such as lumber and metals, including steel. Lumber is a significant driver as well, with almost all CNR’s lumber volumes destined for the U.S., while CNR also derives 13% of its revenue from international intermodal.

Exhibit 3: Top Five U.S. Imports by Value from Canada and Mexico



Note: Data from 2023; for Canada imports. U.S. goods returned and reimports are excluded. Source: U.S. Census Bureau, Bloomberg.

Although 10% of CNR's total revenue is tied to trade with China, a fraction is directly exposed to potential U.S. tariffs on Chinese imports. While CNR's diversified Canada-U.S. volumes provide some insulation, broad tariffs on Chinese imports could still pressure Canadian port volumes destined for the U.S., particularly affecting intermodal revenue. While tariffs would undoubtedly present challenges for both railways, CP's exposure to Mexico makes it more sensitive to changes in U.S.-Mexico trade policy, whereas CNR's risks are concentrated in its intermodal segment and certain commodities. Despite these potential headwinds, we believe the market has been overly punitive toward both names. Both companies' irreplaceable networks, strong pricing power and operational efficiencies make them compelling long-term investments.

Energy Tariffs Could Spark Global Diversification

The U.S. has proposed a 10% tariff on Canadian energy, notably lower than the tariffs on other goods and commodities. Tariffs of any size, however, would be a material headwind for Canadian energy companies, especially heavy oil producers reliant on U.S. refiners. The short-term impact would likely be wider Western Canadian Select (WCS) differentials (as we have seen so far), resulting in lower cash flows and weaker sentiment. Much of this was priced into the commodity since the U.S. election results. Longer-term, it could push Canada to accelerate diversification efforts to global markets, which has long been needed.

These policies would reduce Canadian energy competitiveness in the U.S. market by making Canadian crude more expensive, leading refiners to seek alternative sources such as U.S. domestic production or imports from other countries. Although this is difficult for refiners to do in practice, this would widen the WCS-West Texas Intermediate discount, further pressuring oil sands producers such as Canadian Natural Resources, Cenovus Energy and MEG Energy. To diversify exports to Asia and Europe, Canada may leverage the Trans Mountain Expansion, which came into service in May 2024, and LNG Canada, whose startup is due later in 2025. However, this shift will take time due to the current infrastructure's focus on the U.S. market. Ultimately, lower realized prices would reduce free cash flows, pressuring dividends, buybacks and reinvestment plans for producers. At current commodity prices, even with wider differentials, energy companies in good financial standing should be able to maintain dividends and move forward with prudent capital expenditure plans. However, the overall impact for the Canadian energy would undoubtedly be negative, weakening sentiment toward the sector and reinforcing the urgency for export market diversification.

About the Authors



Garey J. Aitken, CFA

Managing Director, Head of Canadian Equities

- 33 years of investment industry experience
- Joined firm in 1998
- MBA in Finance from the University of British Columbia
- Bachelor of Commerce in Finance from the University of Alberta



Timothy Caulfield, CFA

Managing Director, Director of Canadian Equities Research

- 24 years of investment industry experience
- Joined firm in 2007
- Bachelor of Commerce from the University of British Columbia

ClearBridge Investments

One Madison Avenue, New York, NY 10010 | 800 691 6960 | [ClearBridge.com](https://www.clearbridge.com)

Past performance is no guarantee of future results. Copyright © 2025 ClearBridge Investments. All opinions and data included in this document are as of the publication date and are subject to change. The opinions and views expressed herein are of the author(s) and may differ from other managers, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. This information should not be used as the sole basis to make any investment decision. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed. Neither ClearBridge Investments, LLC nor its information providers are responsible for any damages or losses arising from any use of this information.