RBC Economics & Thought Leadership

Financial Markets Monthly

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Fifty ways to leave your lover - sizing the impact of a trade breakup

Highlights:

- Employment data in early 2025 shows resilience in the U.S. labour market continuing, while the Canadian job market slowdown could be approaching an end sooner than expected.
- While domestic conditions improve, threats of trade disruptions are intensifying and clouding the outlook.
- We continue to expect some form of targeted measures on Canada and others from the U.S., like the planned revival of 2018/19 steel and aluminium tariffs, but not the more damaging 25% across the board U.S. tariff hikes threatened for March 1.
- Central banks are mostly refraining to commit to a response to tariff uncertainties. We think interest rate policy shouldn't be the first line of defence when a fiscal response is more suited, and expect the BoC will now skip the rate cut in March given early signs of past rate cuts supporting growth in the economy.
- **Issue in focus:** U.S. President Donald Trump backed away from imposing blanket tariffs on Canada at the 11th hour last week, but trade risks are not going away. We look at the impact to our base case economic forecasts, in the event of large and permanent 25% tariffs on Canada.

Overview

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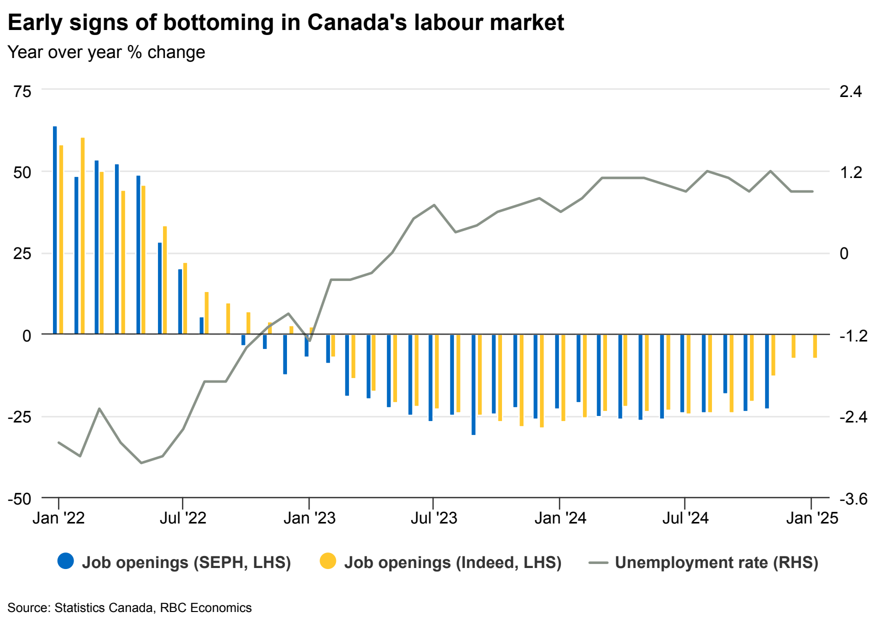
Forecast change: Canadian and U.S. near term outlooks adjusted higher

The first round of employment reports in 2025 suggest labour market conditions may be turning around faster than expected in Canada, and are still incredibly tight in the U.S.

Employment gains in Canada have surprised to the upside consecutively. Relative to slowing population growth, the gains were enough to push the unemployment rate lower again in January. On its own, the reports suggest the worst of Canada's labour market downturn may be in the past. But, we caution that it is too soon to give labour markets an all clear. Most indicators including job vacancies continue to point to softer hiring demand.



Business sentiment for hiring was still subdued in Q4 last year. Many recognized excess capacity in labour markets and expected wage growth to slow further in the year ahead. Risks tied to U.S. election at the time that's since morphed into international trade risks were also clouding the outlook. Even without actual tariffs in place, uncertainties are likely already weighing on business investment, particularly, in the goods producing side of the economy.

In the U.S., the tick lower in the unemployment rate to 4% in January was a clear sign of persistently strong hiring demand, and that additional rate cuts from the Federal Reserve are not needed at the moment. Trade risks are also front and centre. But we still think an all-out trade war is less likely as that will cost the U.S. economy more than what it can aim to reshore. Smaller and targeted tariffs are more likely instead.

Severe tariffs are too damaging for the U.S. economy

Trade uncertainty continues to be the bulk of questions we get around our economic outlook. Risks intensified after what was an ostensibly near miss in severe tariffs on Canada and retaliatory measures in early February. Read about the five things we learned from that week here.

Prolonged, severe blanket tariffs are too damaging for the U.S. economy to be likely for any significant length of time. If 25% tariffs are applied to Canadian and Mexican imports and last longer than six months, they could reduce gross domestic product growth in the U.S. in 2025 to close to zero. On top of that, any additional retaliation or expanded scope of tariffs from or on other countries or groups could push the U.S. into a recession this year.

Targeted measures that would hurt specific sectors are more likely, but that wouldn't substantially dent output growth this year. The recent announcement on steel and aluminum imports into the U.S. falls under this small scale, targeted tariff approach that's already assumed in our base case. Retaliatory measures from Canada may similarly be limited and targeted and wouldn't be significant enough to change our inflation outlook.

Bank of Canada's skips a March cut, waits for fiscal response before reacting to tariffs

Amidst the severe threatened tariffs in early February, the market's knee jerk reaction was for the BoC to cut interest rates on the premise that the central bank would focus on supporting a deteriorating growth backdrop in the economy while looking through the tariff impact to inflation in the near term.

The central bank didn't commit to a response in their latest meeting. We agree that the negative economic growth implications from tariffs should outweigh any near-term inflationary impact for the BoC, but also think there are limits to how much the blunt tool of monetary policy can help support the economy when the primary drag is weakening foreign demand for Canadian exports.

The initial weakness in production would likely be concentrated in a handful of sectors (especially in manufacturing) where fiscal support can have more impact, because it offers targeted and immediate relief.

Of course, the more severe the tariffs are, and the longer they drag on, the more likely it is that the BoC responds with rate cuts. But with those more severe disruptions not a part of our base-case, and the economy early in 2025 looking better than feared, we expect a more gradual path for BoC rate cuts than previously assumed.

Central bank bias:

<table>
<tr><th>Central bank</th><th>Current policy rate</th><th>Next decision</th></tr>
<tr><td>BoC</td><td>3.00%
-25 bps in Jan/25</td><td>0 bps
Mar/25</td></tr>
<tr><td colspan="3">In the January meeting when the overnight rate was cut by 25 bps, the BoC recognized that past rate cuts “have started to boost the economy,” but that the labour market is still soft. Governor TIff Macklem didn’t commit to reacting during a protracted trade conflict. With the most damaging tariff scenarios not in our base-case and domestic conditions proving better than feared, we expect the BoC will skip a cut in March.</td></tr>
<tr><td>Fed</td><td>4.25-4.50%
0 bps in Jan/25</td><td>0 bps
Mar/25</td></tr>
<tr><td colspan="3">The Fed held rates steady in January, citing policy and the economy are in “a good place,” and the committee remains data-dependent and is in no rush to make changes. The more important question on tariffs remains unanswered with Chair Jerome Powell merely acknowledging that there are “fat tails” in the economy. We think the resilience in domestic demand plus trade uncertainties will keep a cautious Fed on the sidelines.</td></tr>
<tr><td>BoE</td><td>4.50%
-25 bps in Feb/25</td><td>0 bps
Mar/25</td></tr>
<tr><td colspan="3">The Bank of England voted 7-2 in favour of a 25-bps cut in February (two members opted for a bigger 50 bps cut). The guidance was for “a gradual and careful approach” as the committee dismissed the near-term increase in inflation but cautioned uncertainties with longer-run trends stemming from supply constraints. We continue to think the BoE will cut in May, August, and November to leave the bank rate at 3.75%.</td></tr>
<tr><td>ECB</td><td>2.75%
-25 bps in Jan/25</td><td>-25 bps
Mar/25</td></tr>
<tr><td colspan="3">The European Central Bank lowered the deposit rate by 25 bps to 3% in January. President Christine Lagarde was optimistic about growth in the euro area and trends of moderating wage gains. Estimates of the neutral range were later updated to be at 1.75% - 2.25% in February. We still think there will be two more 25-bps reductions in the next two meetings before the deposit rate drops to the top end of neutral at 2.25% by April.</td></tr>
<tr><td>RBA</td><td>4.35%
0 bps in Dec/24</td><td>-25 bps
Feb/25</td></tr>
<tr><td colspan="3">A downside surprise in the Q4 consumer price index report is opening the door for the Reserve Bank of Australia to start its easing cycle as early as in February. We think the RBA will cut by 25 bps in February, May, and August for a total of 75 bps cuts this cycle, taking its target rate to 3.6%. Back-to-back cuts are less likely due to uncertainties with the inflation outlook tied mostly to persistent labour market strength.</td></tr>
</table>

Issues in focus: Sizing the impact of a trade breakup

The U.S. administration ultimately delayed the 25% tariffs on Canada and Mexico threatened at the start of February, but went ahead with hikes on imports from China roughly equivalent to the combined tariffs implemented during the first Trump presidency. This week, tariffs on all aluminum and steel products imported into the U.S., similar to 2018, were announced as well and are set to go into effect in March.

Targeted tariff measures could be painful for effected businesses but the magnitude of the shock on the broader macroeconomic backdrop itself is likely small. Threat of significant tariffs on Canada and Mexico is on an entirely different scale. And although those measures have been delayed, they're far from being dropped. As a thought exercise, here's how we think they would impact our base case economic forecasts.

Canadian unemployment rate would hit above 8%

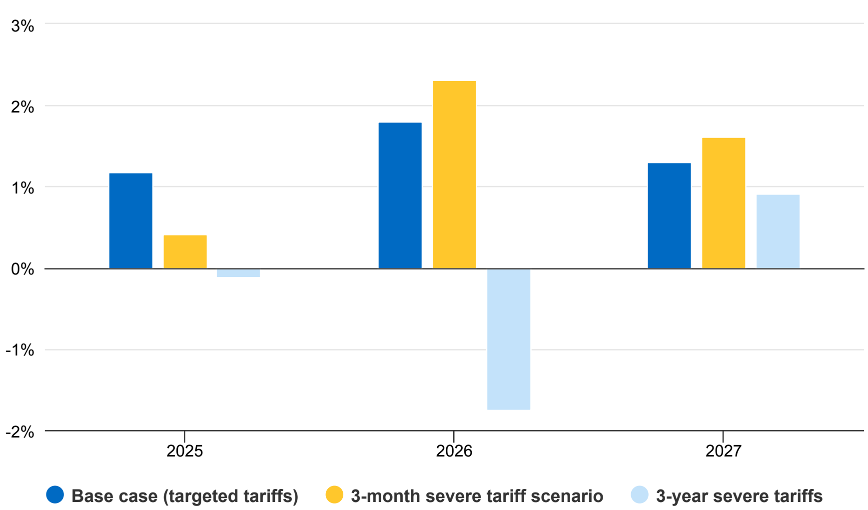
Cumulatively speaking, our assumptions are similar to modelled estimates from the BoC—that permanent tariffs of 25% across the board would lower Canadian GDP by 4% to 6% versus a no-shock baseline over the course of two to three years.

If tariffs were implemented in Q2 this year, we think real GDP growth in Canada would be reduced to zero in 2025 and then, contract by about 2% in 2026. The unemployment rate would rise and peak at about 8% at the start of 2027. That's roughly 2 percentage points higher than about 6% expected in a limited-tariff base case scenario, which assumes broad recovery in hiring demand starting in the second half of 2025.

Over the longer run, we assume structural damage to the economy as cross-border integrated production linkages break, severely damaging productivity growth in the manufacturing sector that accounts for close to 10% of the Canadian economy.

Impact on Canadian GDP from tariffs by scenarios

%, annual real output growth



Source: RBC projections *Base case assumes targeted tariffs similar to Trump 45; other scenarios assume 25% blanket tariffs start in Q2 2025

Tariffs for a shorter period would still be damaging

In the scenario that tariffs are imposed, but only last for three months before getting called off, we expect the growth impact would still be pronounced, but short-lived. Real output would essentially stop growing in nearby quarters with the economy recovering most of the losses after, once tariffs are reversed.

Our forecast for GDP growth in 2025 at 1.3% would be halved if tariffs last through Q2 this year. But growth would be stronger in 2026 and 2027 as trade and production activities resume. Labour market conditions would still soften in a shorter tariff scenario, but to a lesser extent. The unemployment rate would rise marginally to peak at just more than 7% over the second half of 2025 before dropping lower.

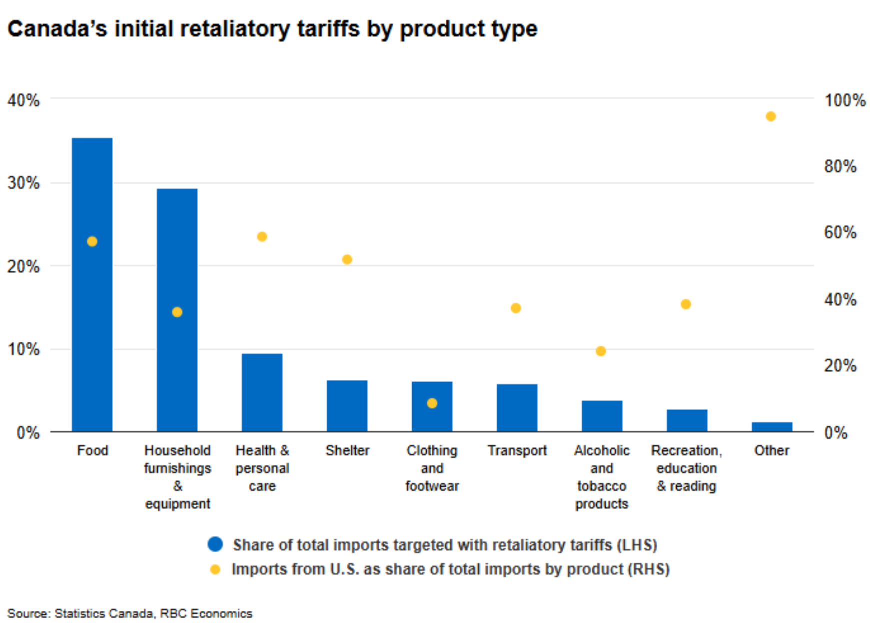
There would still be structural damage to the economy in this scenario as businesses cut back investment spending due to a lack of confidence in future trading relationships, lowering productivity growth. However, part of that's likely already playing out today as investment sentiment remains sluggish even with rates dropping.

Strategic retaliatory measures mean lower inflation in Canada

As noted in our tariff playbook, one key complicating factor when assessing the impact of U.S. tariffs on the Canadian economy would be the details of Canada's retaliatory measures. Last week, we got a sneak peak of what they could look like — partial and staggered.

The initial list contains $30 billion of imports targeted with details on the additional $125 billion set to follow. Of the $30 billion goods with more details, about a third were food products and another 30% are accounted for by home appliances and furniture.

To be sure, these measures would increase prices for Canadian importers. In a worst-case scenario, 25% tariffs on $155 billion worth of imports from the U.S. adds up to the equivalent of an about 2.5 % increase in consumer prices, assuming importers continue to import the same volume and are able to pass on the full cost increases to consumers.



But, the reality is the actual consumer price impact would be much smaller due to substitution at importers (to difference sources) and consumers (to different goods).

By our count, the initial $30 billion goods imports targeted in the list of retaliatory tariffs has an average U.S. import share of 35%. That's lower than the average U.S. import share of 50% among total Canadian imports, leaving importers room (at least partially) to diversify away from U.S. products.

Consumers will also have options to purchase alternative non-tariffed substitutes. For example, buying local instead of imported products or buying more apples and pears (not on the initial retaliatory list) and fewer oranges (featured prominently on the retaliatory list).

Overall, broader domestic demand in Canada is still weak, and the unemployment rate, despite signs of peaking earlier than expected, is still elevated. This has led to ongoing moderation in inflation and isn't likely to change with tariffs. Weak demand will continue to limit the extent to which importers can pass on cost increases to consumers, muting the impact of tariffs on inflation.

Interest rate outlook

Policy rates and government bond yields, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
Canada												
Overnight rate	4.50	4.75	5.00	5.00	5.00	4.75	4.25	3.25	3.00	2.50	2.25	2.25
Three-month	4.34	4.90	5.07	5.04	4.99	4.64	3.94	3.16	2.90	2.40	2.20	2.15
Two-year	3.74	4.58	4.87	3.88	4.22	3.99	2.92	2.93	2.75	2.40	2.30	2.20
Five-year	3.02	3.68	4.25	3.17	3.58	3.51	2.74	2.96	2.85	2.65	2.55	2.45
10-year	2.90	3.26	4.03	3.10	3.52	3.50	2.95	3.23	3.10	2.95	2.85	2.80
30-year	3.02	3.09	3.81	3.02	3.41	3.39	3.13	3.33	3.25	3.15	3.05	3.00
United States												
Fed funds midpoint	4.87	5.12	5.37	5.37	5.37	5.37	4.87	4.37	4.38	4.38	4.38	4.38
Three-month	4.85	5.43	5.55	5.40	5.45	5.48	4.73	4.37	4.28	4.33	4.38	4.46
Two-year	4.06	4.87	5.03	4.23	4.66	4.71	3.66	4.25	4.35	4.25	4.45	4.60
Five-year	3.60	4.13	4.60	3.84	4.28	4.33	3.58	4.38	4.40	4.30	4.50	4.60
10-year	3.48	3.81	4.59	3.88	4.27	4.36	3.81	4.58	4.60	4.55	4.70	4.75
30-year	3.67	3.85	4.73	4.03	4.41	4.51	4.14	4.78	4.80	4.75	4.90	4.95
United Kingdom												
Bank rate	4.25	5.00	5.25	5.25	5.25	5.25	5.00	4.75	4.50	4.25	4.00	3.75
Two-year	3.42	5.27	4.91	3.98	4.17	4.23	3.97	4.38	4.50	4.25	4.30	4.40
Five-year	3.33	4.66	4.53	3.46	3.84	4.03	3.85	4.35	4.60	4.40	4.50	4.60
10-year	3.47	4.39	4.46	3.54	3.95	4.17	4.00	4.57	5.00	4.75	4.80	4.90
30-year	3.82	4.42	4.92	4.14	4.49	4.67	4.54	5.11	5.50	5.35	5.40	5.55
Euro area*												
Deposit Rate	3.00	3.50	4.00	4.00	4.00	3.75	3.50	3.00	2.50	2.25	2.25	2.25
Two-year	2.66	3.27	3.20	2.40	2.83	2.82	2.09	2.09	2.30	2.25	2.30	2.40
Five-year	2.30	2.58	2.79	1.94	2.32	2.48	1.97	2.15	2.45	2.35	2.50	2.75
10-year	2.28	2.39	2.85	2.03	2.29	2.50	2.14	2.36	2.75	2.60	2.80	3.00
30-year	2.35	2.38	3.05	2.27	2.46	2.69	2.46	2.60	2.90	2.80	3.00	3.25
Australia												
Cash target rate	3.60	4.10	4.10	4.35	4.35	4.35	4.35	4.35	3.85	3.60	3.60	3.60
Two-year	2.96	4.21	4.09	3.71	3.76	4.17	3.64	3.87	3.80	3.75	3.85	3.90
10-year	3.30	4.02	4.49	3.95	3.97	4.31	3.97	4.37	4.15	4.15	4.20	4.15
New Zealand												
Cash target rate	4.75	5.50	5.50	5.50	5.50	5.50	5.25	4.25	3.75	3.25	3.25	3.25
Two-year swap	5.01	5.46	5.69	4.63	4.78	4.95	3.56	3.36	3.30	3.25	3.50	3.75
10-year swap	4.27	4.46	5.13	4.12	4.35	4.48	3.87	3.91	4.10	4.30	4.70	4.75

Sources: Refinitiv, BoC, Fed, BoE, ECB, RBA, RBNZ, RBC Economics, RBC Capital Markets | *German government bond yields

Economic outlook

Real GDP, quarter-over-quarter percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada*	3.5	3.8	2.4	-0.6	3.9	0.8	-0.6	0.7	2.0	2.2	1.0	1.5	1.1	1.2	1.1	1.2	6.0	4.2	1.5	1.3	1.3
United States*	-1.0	0.3	2.7	3.4	2.8	2.5	4.4	3.2	1.6	3.0	3.1	2.3	1.5	1.5	1.8	2.0	6.1	2.5	2.9	2.8	2.0
United Kingdom	0.7	0.3	0.1	0.3	0.1	0.0	-0.1	-0.3	0.7	0.4	0.0	0.2	0.3	0.4	0.4	0.4	8.6	4.8	0.4	0.8	1.3
Euro area	0.5	0.9	0.6	-0.1	0.0	0.1	0.0	0.0	0.3	0.2	0.4	0.0	0.2	0.3	0.3	0.3	6.3	3.6	0.5	0.7	0.9
Australia	1.0	1.0	0.4	0.8	0.5	0.3	0.5	0.2	0.2	0.2	0.3	0.5	0.7	0.6	0.7	0.7	5.4	4.1	2.1	1.0	2.3

*annualized

Inflation, year-over-year percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada	5.8	7.5	7.2	6.7	5.1	3.5	3.7	3.2	2.8	2.7	2.0	1.9	2.2	2.1	1.8	1.6	3.4	6.8	3.9	2.4	1.9
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.5	3.2	3.2	3.2	2.6	2.7	2.7	2.4	2.5	2.3	4.7	8.0	4.1	2.9	2.5
United Kingdom	6.2	9.2	10.0	10.8	10.2	8.4	6.7	4.2	3.5	2.1	2.1	2.5	2.6	2.4	2.5	2.3	2.6	9.1	7.3	2.5	2.6
Euro area	6.1	8.0	9.3	10.0	8.0	6.2	5.0	2.7	2.6	2.5	2.2	2.2	2.2	2.2	2.2	2.1	2.6	8.4	5.4	2.4	2.4
Australia	5.1	6.1	7.3	7.8	7.0	6.0	5.4	4.1	3.6	3.8	2.8	2.4	2.2	1.9	2.4	2.9	2.9	6.6	5.6	3.2	2.4

Sources: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics, RBC Capital Markets

Currency outlook

U.S. dollar cross rates, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
USD/CAD	1.35	1.32	1.35	1.32	1.35	1.37	1.35	1.44	1.43	1.45	1.42	1.40
EUR/USD	1.09	1.09	1.06	1.11	1.08	1.07	1.11	1.04	1.02	1.02	1.03	1.05
GBP/USD	1.24	1.27	1.22	1.27	1.26	1.26	1.34	1.25	1.24	1.23	1.23	1.24
USD/JPY	133	144	149	141	151	161	143	157	151	150	148	146
AUD/USD	0.67	0.67	0.65	0.68	0.65	0.67	0.69	0.62	0.63	0.61	0.60	0.60

Canadian dollar cross rates

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
EUR/CAD	1.47	1.44	1.43	1.46	1.46	1.47	1.50	1.49	1.46	1.48	1.46	1.47
GBP/CAD	1.67	1.68	1.65	1.68	1.71	1.73	1.80	1.80	1.78	1.78	1.74	1.73
CAD/JPY	98	109	110	107	112	117	106	109	106	103	104	104
AUD/CAD	0.91	0.88	0.87	0.90	0.88	0.91	0.93	0.89	0.90	0.88	0.85	0.84

Sources: Federal Reserve Board, Bank of Canada, RBC Economics, RBC Capital Markets