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EP 179 | Navigating Tariff Tensions in Canada: Risks and Opportunities

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[00:00:04] Andrew Johnson: Hey Mark, welcome back to the podcast. We're going to jump right into this one. We just had you on back in early January for an update on the Canadian equity portfolio. And at that time, you briefly spoke to the topic of tariffs, and since then, to say the least, things have escalated on that front. So what's the latest with all of this tariff talk?

[00:00:27] Mark Rutherford: Yeah, great to catch up and discuss, Andrew. It's certainly a topic we've discussed quite a bit, and as you mentioned, things have really heated up on that front. I think a little bit of historical context is important, and just kind of how did we get here in the first place? One bigger picture challenge that the U.S. has really been dealing with, going back probably 70 years now, is the decline of U.S. manufacturing and the hollowing out of manufacturing in the U.S. If you went back to 1950, manufacturing jobs were almost 50% of jobs back then in the market. Today they’re maybe 10% of all jobs in the U.S., or manufacturing jobs. And particularly post-World Trade Organization and in China joining that, and proliferation of free trade agreements globally, we've seen a really big decline in U.S. manufacturing jobs. So, what's happening with the U.S. economy is they're importing a lot of goods from countries like Canada, other countries around the world, so they're running a current account deficit. Their imports are greater than their exports. But then they also have a financial account deficit. They're borrowing a lot more and the government is spending a lot more than it's taking in. They're running this essential twin deficit.

They're also the world reserve currency. With that world reserve currency, there's arguments out there that that brings a lot of benefits to the United States—arguably brings a strong U.S. dollar, arguably lower U.S. borrowing costs. The U.S. is held in reserve by central banks and other large financial institutions globally to help manage their economies, maybe manage FX rates, facilitate global trade. But with that, there's an argument out there that it creates an artificially strong U.S. dollar because the U.S. is buying all these things, goods and services from other countries, and then they return to the U.S. in the form of financial investments—maybe it's buying treasuries, could be a foreign direct investment, buying financial assets. So, the owners of the financial assets are doing really well, but the people that are producing and the economic engine of that economy, they're getting hurt by this effect. Many governments have seen this longer-term trend, and we're at a point now where it's becoming unsustainable. It's a big political issue in the U.S., where they want to improve standards of living for that section of, for that proportion of, the economy so that everyone can participate, and they're looking at different mechanisms to do that. At the same time, they're looking at these deficits that they're running that are growing very rapidly, and that is arguably becoming unsustainable. A big risk, even globally, is the U.S. losing its reserve currency status. We can have long discussions on each of those topics, but what we're seeing now from our perspective could be just a reflection of this longer-term economic trend, and now it's coming to a head and it's

politically popular. So, governments are taking action and we’re seeing that with some of the announcements of the Trump administration announcing tariffs, additional tariffs on China, potential tariffs on Mexico, on steel, aluminum. So that's one mechanism that they think is a good tool to try to correct some of these imbalances that they're seeing in the economy. So that's where we are.

I think another thing that we're really thinking about as a team and within the Canadian equity strategy is really just revisiting some of the history and understanding some of the mechanics around how these trade flows can really impact global economies, because there have been big shifts in global trade before and economies and how they're structured. For us, as Canadians, most of the people in our lifetime have lived through really peaceful trading agreements. The further you go from a crisis, it's more likely that the pain of a prior crisis maybe becomes less over time, and as a country, maybe we were all lulled into complacency a little bit about how nice we've had it having this big trading partner to the south and able to freely trade most goods. If you actually go back prior to the Great Depression, there were actually significant tariffs put on previous U.S. governments. You could go to Fordney McCumber tariffs in 1922, there was 38% average tariffs across the board, and then Smoot-Hawley famously going into the Great Depression and following those tariffs saw significant decline in cross-border trade. So, what we're just being aware of and conscious of as we manage the portfolio and look for risks as well as potentially opportunities is just being aware of that volatility, how stark some of the history truly is relative to what maybe we've experienced in the last 30 to 40 years.

[00:06:54] Andrew Johnson: Yeah, certainly a lot history, a lot of variables that have led us here today and a tremendous amount of uncertainty about the way forward from here. You just mentioned risks and opportunities. How is the team thinking about risks and, if any, opportunities that something like this presents?

[00:07:15] Mark Rutherford: Yeah, it's probably the most important question. I think the first step when we're faced with any uncertainty, whether it's tariff risk or some other factor—maybe it's a company-specific factor—the number one step within the portfolio is just going to be diversification. That's a simple, easy strategy that we'll generally implement across the board. If we had a very concentrated 10 stock portfolios, that would be very concerning because that can work out very well, but that can create sharp edges as well, if you get just one single name wrong. So that's one first step. The next step that we really look at is within the portfolio, how are different companies positioned? Where could we maybe tilt the portfolio? Another thing, a mental model that we just have internally here is to think about, and just really look at, the policies that different governments are putting out, to be on the right side of City Hall, So, if there's particular areas—could be dairy, could be agriculture in the U.S. that are hot buttons, could be timber in Canada and softwood lumber that's been an ongoing dispute for decades now between Canada and the U.S.—those would be certain areas where at the bottom-up level we can identify, OK, this could be contentious. How are we positioned for that particular company? As we go through the portfolio, broadly speaking, companies that have more economic sensitivity, likely are going to be more exposed. So, is a bank directly exposed to tariffs? Less so maybe than an exporter to the U.S., but it could be that bank's customers that end up defaulting on a loan because maybe there's really high steel tariffs or auto tariffs, whatever it may be.

That's thinking through the first order effects. Another thing that we're doing internally, just from a process perspective, is fire-drilling, thinking about scenarios of, OK, what could happen? There's a number of questions we have: Are the tariffs going to be implemented? How long could they last? How big could they be? Following that, if there were tariffs implemented, say it comes in at 25%, how could governments respond and how do we

think they're likely to respond to those? One scenario may be, tariffs get applied, that causes economic pressure, but then maybe there's a more likely chance that there's economic stimulus and fiscal stimulus in Canada to help individuals or companies that are impacted by those. It's a combination of top-down thinking, but then also bottom-up thinking to identify positions that are directly exposed or indirectly exposed, and then maybe we want to tilt and adjust if needed.

[00:10:32] Andrew Johnson: Do you have any specific examples from either the portfolio or that broader market to showcase how tariffs may impact businesses or industries?

[00:10:44] Mark Rutherford: Probably the two most notable examples in the portfolio that would really be facilitating global trade and cross-border trade would be CP Rail and CN Rail. A significant portion of their business is through auto, minerals, other petroleum products, lumber, wood products. Then even international intermodal trade, there's a significant amount that is imported at each coast and shipped down into the U.S. They're probably very well-off over the very long-term. In the near-term, there could be some switching of customers in the U.S. if they're paying a higher tariff on goods coming from Canada. That could impact volumes in the near-term for a company like CP and CN Rail. Those would be two examples where we've made some small adjustments, just bringing the weight down. Discretionary sectors as well—specifically if you're importing a product from Canada.

Another example I would give, Andrew, for potential losers that we're cautious of on our weight would be banks. There it's more just broad exposure to economic weakness in Canada that could result from tariffs. That's one where we've lightened up exposure, too, recently; I still think very well-positioned, excellent-run institutions over the very long-term, but they could be hit, especially in this scenario where tariffs could escalate, we don't want to be leaning into that risk at the wrong time. If the information changes and tariffs are off the table and there's a new agreement in place, then we can adjust there as well.

On the winning side, there's a few other companies, too, that we tend to like more in an environment like this. You could think of service-based companies, so a company like Constellation Software, a company like Topicus that we own in the portfolio, which is partly owned by Constellation Software. Vertical market software companies are very well-positioned. Utilities within Canada, like Hydro One, are probably fairly insulated from international trade and what's going on—i.e., a long-term regulated return asset. And just broadly diversified firms, so even a business like Couche-Tard, that's selling convenience, gas stations, has a big portion—over half—of their business is actually in the U.S., a portion in Canada, so globally diversified. CGI, the consulting business, would also be another great example. Another one on the financial side that may be less impacted by banks would be a company like Brookfield Asset Management, a global diversified portfolio of assets under management. Their revenues are actually in U.S. dollars, so if there were Canadian dollar weakness, they could be impacted but can benefit from U.S. dollar strength. When we put all those together, number of contradictions across the portfolio so we're not overexposed, and then beyond that, we're going to be monitoring and assessing in real time as the facts change, because it's evolving quickly here.

[00:14:40] Andrew Johnson: I know our listeners are going to be very curious about those broader economic impacts, and you alluded to some of them already. Thinking when it comes to things like interest rates or currency, what are some of those fire drills that you guys are thinking about in that sense?

[00:14:56] Mark Rutherford: I think what we've seen and observed is that there could be higher odds of a recession in Canada. That would naturally lead to probably lower Canadian interest rates, a declining Canadian dollar. Another thing that we're seeing is risk havens or uncorrelated currencies, whether that be gold or even cryptocurrency, that we don't own in the portfolio, but assets like that performing well as maybe they're getting flows from other risk assets. Then in the near-term, we're observing more U.S. dollar strength, but we're also conscious of what the U.S. is trying to accomplish longer-term. It could be something like the Plaza Accord, where there's basically large meeting of countries globally, and they get together and decide to readjust currency valuations and significantly devalue the U.S. dollar. That's another scenario that we have to be mindful of. I'm not seeing signs of that yet, but that's very much just in the scenario book that we're mindful of at this point. I think overall, though, broadly, like the economic research that we see across the board, once tariffs are put up, there's a reaction by other countries, and that'll globally lead to higher prices, and that'll be offset by lower real volume of goods consumed, and that's lower economic output.

[00:16:42] Andrew Johnson: Yeah, obviously a time of turmoil, not just for the world, but in particular for Canadians in general and businesses here in Canada. Is there any silver lining in all of this for Canada in particular?

[00:16:57] Mark Rutherford: Definitely. I think if we're wearing our yellow optimistic hat, we definitely see—and I think we're already seeing some—signs by the Canadian government, work by premiers here to look at how we can knock down some of the trade barriers within Canada. There's been a pretty big shift, looking at some of the comments from the federal government ministers, as well as opposition leaders, about working together on different infrastructure or energy projects to diversify end markets. Even the BC premier was out recently noting a list of 18 projects that they're looking to accelerate within the U.S., so a combination of energy, utility, mining projects. Longer-term, those projects and those initiatives could take time, but if, as a country, Canada gathers the political and the social will to build more things and attract capital to Canada, there's massive opportunity to do that and create wealth and great jobs and economic growth. That can bring a lot of tax revenues longer-term that the government can use to help facilitate a number of social and political goals that the country has. So longer-term, this can cause Canada to come together and do a lot of really good things for the country on a longer-term basis. So, very early in that front or very early in that stage, but we're seeing some very good signs for the long-term benefit of Canada.

[00:18:46] Andrew Johnson: Well, certainly with a lot of worry out there, I do appreciate you throwing on the yellow hat and giving us some positivity with that. Finally, before we sign off, Mark, as a portfolio manager, what should investors keep in mind as we move forward?

[00:19:03] Mark Rutherford: I think one of the big things that we're trying to keep in mind at this stage is prepare, don't predict. We say it a lot internally, but also to clients. We also really try not to make huge swings in the portfolio. Looking at just the announcements that were made last week, we had very large intraday swings on the Monday where tariffs were supposed to be applied, and then there were agreements later in the day to delay them by a month. So, staying disciplined, really trying to run the process, and really taking time to do that, so that we're not making a rash decision quickly when markets are moving and the conversation between two political leaders can change the entire direction within a day. And just knowing the portfolio, monitoring exposures, thinking about portfolio offsets or companies that we don't own that we could go to if needed. Running all those things internally are helpful for us.

Finally, one thing we always try to do is just maintain that longer-term perspective and remember this could present some really good opportunities. When there's increased volatility and uncertainty because of this, what we sometimes see is higher risk premiums. Because investors in the market may not be sure what's going to happen, they demand a better return. That can be an opportunity to deploy capital and set up the following two to three years of good returns, so that's how we're thinking about it and planning on moving forward.

[00:21:00] Andrew Johnson: That's probably a great place to wrap this up, Mark. I really appreciate you coming on here, talking us through this. I'm sure our listeners do, too. A lot of us are going to be glued to the internet and the news sites to see how things unfold from here. Appreciate it, Mark.

[00:21:16] Mark Rutherford: Thanks, Andrew.