STONEBROOKE
ASSET MANAGEMENT

The Commentary

CommonSense Investing

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IN THIS ISSUE:

Trump's Tariffs, What Else?

President Trump's aggressive tariff strategy is potentially a major policy mistake with far-reaching consequences. By introducing sweeping tariffs and trade restrictions the Trump administration risks triggering supply chain disruptions, layoffs, and consumer backlash. In the next few months and quarters, as economic anxiety and inflation rise, there is bound to be a broader political fallout as well. This could lead to increased gridlock in Washington, undermining Trump's ambitious fiscal plans which include Congress passing legislation to extend and approve additional tax cuts.

The economic risks of imposing stiff tariffs are compounded by a misunderstanding of how trade deficits and capital flows function. Trump's zero-sum view ignores the fact that the U.S. benefits significantly from its capital account surplus. The surplus offsets the current account deficit in goods and services. Tariffs raise business costs and disrupt production. Unintended consequences will surely tighten financial conditions and undermine Trump's broader economic objectives. Moreover, his belief that foreign producers will absorb the tariff cost is unpredictable, and any assumption that consumers will gladly accept reduced purchasing power may be dangerously optimistic.

For Canada and Mexico, the two closest and large U.S. trading partners, the implications are particularly severe. North American manufacturing supply chains are deeply integrated, particularly in energy and auto production. Nearly 30% of all U.S. imports originate from Canada and Mexico, and many of those goods include substantial American-made content. The disruption of this system will ripple across borders, devastating sectors like transportation and industrials, and making any retaliatory response potentially even more damaging. Canada's economy is especially exposed, with the Bank of Canada estimating a -2.5% decline to our Gross Domestic Product (GDP) in the first year of a trade war - guaranteeing a recession.

The potential dire economic outcome would certainly prompt a strong policy response from Canada, including fiscal stimuli and interest rate cuts. The Canadian dollar would be vulnerable and likely to depreciate to offset the damage. A one percent cut in the Bank of Canada's policy rate, a substantial fiscal package, and downward pressure on bond yields are all anticipated responses to cushion the blow. These moves would help counteract the economic shock but will come at the cost of rising fiscal deficits.

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S&P/TSX : 24,918	90 Day T-Bills : 2.64%	Oil : $71.50 US	Cdn $: .699 US
S&P 500 : 5,612	10 Yr Cda Bond : 2.97%	Gold : 3,123 US	Euro : 1.55 Cdn

Bold Strategy or Mayhem

Trump's big and bold tariff policy is intended to shock trading partners into action. This will force negotiations for fairer trade with reciprocal tariffs in an effort to close the trade deficits. The U.S. maintains a strong strategic position given its minimal reliance on exports. Other nations are stepping up with concessions and cooperation. The stage is set for a rebalanced global trade environment that could ultimately benefit longer term American economic interests and manufacturing strength. Optimistically, the economic pain and disruption will be short lived.

For the Trump administration, closing the trade gap with China is the main objective. China imported $143.5 billion in goods from the US in 2024. The US imported $439 billion from China. The nations have a $295 billion trade deficit. The top US imports were electrical equipment ($127.1 billion), machinery ($85.1 billion), and toys/games ($32 billion).

While traditional statistics show the U.S. running persistent trade deficits, this narrative is oversimplified. When viewed through a corporate lens, many of the goods counted as imports, such as Apple iPhones or Tesla parts assembled in China, generate profits for American companies. These should not be equated, for instance, with imports from Chinese owned automobile firms like BYD, which benefit from subsidies and keep profits at home within their domestic economies. In reality, the U.S. trade "deficit" includes American value creation abroad.

The Trump administration has framed tariffs as an industrial strategy tool to rebalance trade and bring back manufacturing jobs. Tariffs on imported goods are designed to incentivize U.S. domestic production albeit they will increase near-term costs for both businesses and consumers. A 10 to 15% increase in Canadian car prices, for example, is significant but manageable. Over time, the permanency of tariffs is likely to force a structural pivot in global supply chains, bringing production back to the U.S. This shift in U.S. trade policy has been accelerated by the pandemic's supply chain disruptions. It is a deliberate move toward greater economic stability and security. For Canada, the U.S. policy shift will be a challenge as our domestic manufacturing becomes more expensive and less competitive.

While tariffs may yield concessions from America's trading partners, they also risk alienating key foreign buyers of U.S. debt. This is a strategic vulnerability and likely an unintended consequence. If U.S. deficits widen, it will be more difficult to finance government spending without the support of cooperative trade partners. Anticipated tax cuts together with monetary easing could potentially give the economy a boost. In the interim, managing the continuing mayhem and financial market volatility will be critical for investors.

Made In Canada Election

The Canadian Federal election is all about Donald Trump. The more inflammatory Trump gets the more it seems to help the Liberal Party, with Mark Carney being perceived as the better person to lead a nervous electorate.

For the Liberals, a fourth straight election win looked impossible just a few months ago. Pierre Poilievre however has not materially gained in popularity over the same time. Polls are never 100% reliable. The key battlegrounds in Ontario and Quebec will determine who will be Canada's next Prime Minister.

Whichever Party wins will be dealing with a significant economic challenge. By some measures, Canada's economy is heading for a slowdown/recession. Negotiations with the U.S. are not going to be easy. The White House is seeking major changes in our trading relationship. Canada cannot possibly pivot away quickly and establish better trade arrangements with European and Asian countries.

In the meantime, Canadians are displaying their patriotism and doing their part by shopping for Canadian products. Perhaps this will make a significant difference longer term and allow businesses in the country to restructure and become less dependent on the U.S. It is a tall order.

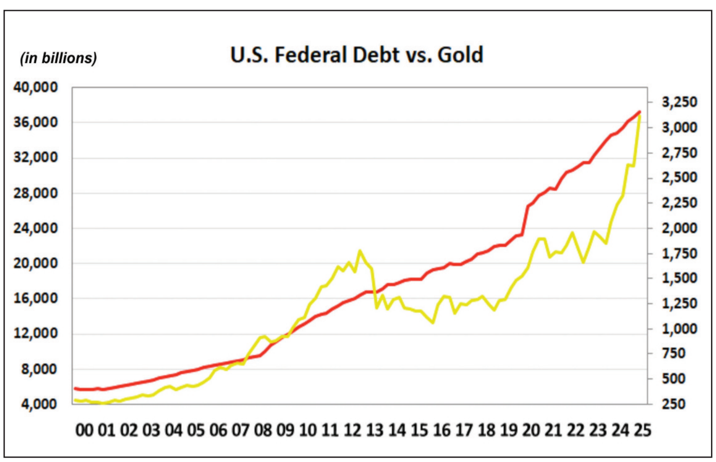
A New Regime

At a June 2024 speech at the Manhattan Institute, Scott Bessent, the current U.S. Treasury Secretary, described the current moment in geopolitics and economics as uniquely fragile and pivotal. His decision to enter public life was motivated by alarm over the size of U.S. deficits and fiscal spending, particularly given his background as an economic historian. Bessent warned that peace-time deficits of 6–7% of GDP are historically troubling and could signal deeper structural problems. Looking ahead, he anticipated a need for a global economic reordering akin to a "new Bretton Woods," and expressed a desire to contribute to shaping that future. He also voiced strong support for tariffs, emphasizing that a 10% baseline tariff is acceptable and necessary as part of President Trump's desire to reindustrialize the U.S. economy. At the time, Bessent made it clear that this strategy would be permanent and transformative.

Bessent noted that while a global recession might be required to secure favourable trade deals for the United States, Trump's approach—threatening harsh reciprocal tariffs to negotiate from a position of strength and ultimately settling for a 10% global tariff—is strategic. Bessent stressed that history shows financial crises typically bring Federal Reserve intervention to stabilize markets. He highlighted growing concerns over the U.S. dollar and national debt, noting that the U.S. twin deficits—current account and fiscal—now total -11% of GDP, an unprecedented non-war, non-recession low, with foreigners holding roughly 30% of U.S. marketable Treasuries. Bessent warned, investor confidence in U.S. Treasuries and the dollar could deteriorate further, accelerating a shift toward non-U.S. assets and gold—an era some believe has already quietly begun.

In addressing recent volatility, Bessent downplayed the bond market selloff and dismissed fears that foreign nations were aggressively divesting U.S. Treasuries. He reassured investors that the U.S. Treasury Department possesses the necessary tools to stabilize the market if conditions worsen. Furthermore, Bessent pushed back against the narrative that simultaneous declines in Treasuries and the dollar indicated the U.S. was losing its safe-haven status. "We are still the world's global reserve currency," he stated firmly, reaffirming the administration's commitment to a strong dollar policy despite the recent turbulence.

A Golden Hedge



Gold is still perceived as an inflation hedge. It is definitely a hedge against monetary instability. The rising level of government debt in the world is a concern for investors. In the U.S. the $37 Trillion treasury debt is at a level that many economists and market pundits believe is unsustainable. The adjacent chart compares the price of gold to the rise in U.S. government debt over the past twenty-five years. While the correlation is not perfect, over the longer term the two series track reasonably well.

Over the past two years, geopolitical uncertainty is likely the main reason the price of gold has advanced. JPMorgan projects prices could exceed $4,000 by mid-2026, citing continued economic uncertainty and strong central bank demand.

Additionally, the U.S. dollar has recently declined to a three-year low, diminishing confidence in its role as the global reserve currency. Persistent inflation and expectations of monetary easing by the Federal Reserve have bolstered gold's appeal. Investors are searching for and fueling the demand for uncorrelated assets. Gold, as well as Bitcoin, are benefiting.

The upward movement in gold prices reflects a complex interplay of factors, including economic policy decisions, market volatility, and geopolitical risks. As uncertainty persists, gold is likely to remain a key asset for investors seeking stability.

Monetary Policy on Hold

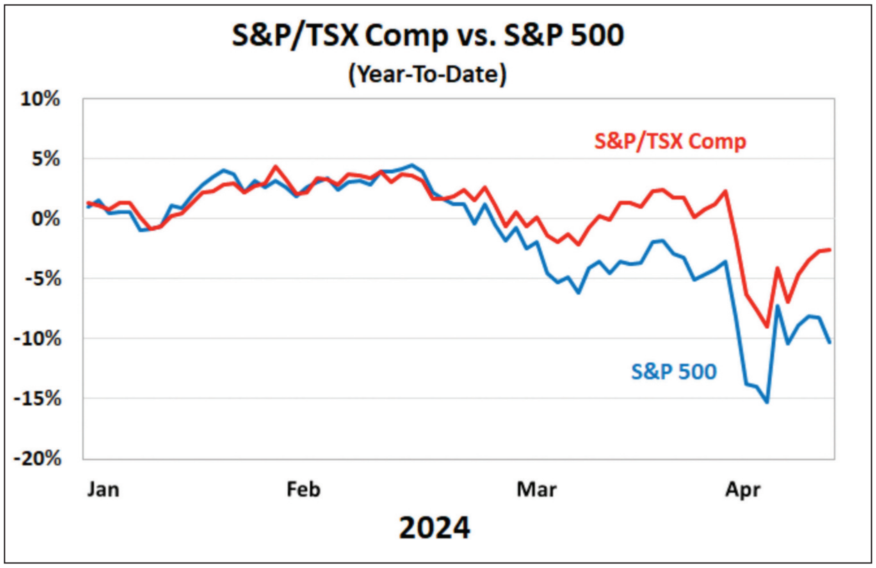
Federal Reserve Chairman Jerome Powell recently commented "labor market conditions remain solid," with wage growth outpacing inflation. That said, Powell didn't dismiss the possibility for rapid changes given tariffs and other factors: "Uncertainty today is unusually elevated," he said.

The market has moved quickly with short term interest rates down a full percentage point in the past month. Forecasts now project five or six rate cuts this year. While Powell maintained his neutral stance on anything political, he conceded that tariffs could get in the way of the ongoing inflation fight. "Inflation was running around 2.5% for some time," Powell said. "I do think with the arrival of the tariff inflation; further progress may be delayed."

Banking regulations are instrumental to the financial system. Tightening or loosening regulations is an important part of monetary policy, often more important than setting interest rates or buying treasury securities. The Federal Reserve has many tools to loosen policy. They are on hold for now however the "market" expects an accommodating Fed sometime later this year.

Equity Market

In the past several years, the U.S. stock market has dramatically outperformed the Canadian and major global stock markets. There has been an enormous rise in U.S. market valuations compared to the rest of the world. Importantly, it was largely driven by faster growth in U.S. corporate earnings, particularly in the technology and communications sectors. Net income for U.S. tech and communications companies has far outpaced the broader market. This earnings strength was propelled by massive capital expenditures from the so-called "Magnificent 7" tech giants. Datacenter spending has recently doubled, growing to $70 Billion in just the past quarter.



U.S. equity performance has attracted substantial investor capital both domestically and internationally. Household equity ownership as a share of U.S. financial assets has jumped from 25% to 43%, and foreign ownership of U.S. equities has grown from 30% to 56%. Meanwhile, many global economies continued to stagnate—most notably the Eurozone, which remained stuck in a prolonged period of low growth. However, since the beginning of this year U.S. outperformance is showing signs of strain. AI capital expenditures, while still significant, now face decelerating growth due to more cost-effective AI models like DeepSeek. Simultaneously, the sharp surge in government spending seen in 2022–2023 has faded, creating a difficult backdrop for sustained economic momentum.

Looking forward, both the U.S. and Canadian economies face many challenges. Geopolitical factors such as escalating trade tensions and tariffs are likely to further dent business confidence and growth. In contrast, regions like Europe are beginning to show signs of life, with Germany's DAX stock exchange index entering a bullish trend amid modest economic acceleration and increased defense spending. With the U.S. macro-outlook now more uncertain and credible international alternatives emerging, global investors are reconsidering their geographic allocations.

Shifting equity exposure toward sectors less sensitive to tariffs and more resilient in a low-interest rate environment makes sense. These include financials, REITs, communications, and utilities. These sectors are more defensive and should perform relatively better in the period ahead.

There is a great degree of uncertainty for investors. No one knows what the end game will be regarding trade policy and what the ultimate effects will be on the economy. Uncertainty will always drive emotions. With the distribution of possible outcomes very wide, we can expect more volatility in the months and quarters head.

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