Questions? We've Got Answers

Addressing Issues Impacting the Economic and Financial Outlook

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Our December forecast entitled "2025: The Fast and the Furious" has gone from screenplay to real life! In just four weeks since assuming office, President Trump has issued a record number of executive orders (EOs) and is spinning markets with new tariff announcements by the day. No surprise, this quarter's Q&A is dominated by discussions on potential impacts. We have changed our forecasts for interest rates and economic growth, most notably for Canada. These headline-grabbing developments have obscured the fact that both the U.S. and Canadian economies started 2025 with better-than-expected momentum, to the credit of consumers. This means forecast alterations are coming off a higher watermark. Canada will still absorb the greatest uncertainty and potential scarring to

Q1. How has the global economic outlook changed in light of recent tariff developments?

Acting on his campaign promise, President Trump immediately leveraged far reaching tariffs on Day 1. He directed the secretaries of Treasury and Commerce as well as the U.S. Trade Representative to open an investigation into "unfair and unbalanced" trade practices with the U.S., with a deadline of April 1st for specific policy recommendations. Why wait? On February 1st, the President announced a universal 25% tariff on Canada and Mexico, as well as a 10% tariff on China. In what may become a trademark of this administration, eleventh-hour negotiations permitted a 30-day delay in implementation. The same was not true for China, where tariffs came into effect

How to forecast in this environment?! This is where assumption-based scenario analysis is best applied, making them susceptible to more frequent reviews. Here's our opening baseline assumptions on the U.S.:

> President Trump implements further tariffs on China, the European Union and other major trading partners by early-April.
>
> The U.S. effective tariff rate is assumed to rise from today's level of 3% to a peak of 7.5% by Q3.
>
> The tariffs are assumed to remain in play for the remainder of this year, before being largely phased out by mid-2026.
>
> Some retaliation from trading partners is incorporated.
>
> International governments will lean into supporting businesses and households.

From a global scale, the impact is small. Growth is held back by only 0.1 percentage point. China is one of those economies where we expect government stimulus measures to offset some of the drag. Special borrowing to the tune of roughly 2% of GDP is already underway, and authorities will likely step that up to sustain economic momentum near the 5% mark. In Europe, some fiscal offset could come from Germany, depending on the result of upcoming elections. Its economy is one of the most exposed to international trade and tolerance for further economic stagnation will be limited after several years already (see report). In contrast, the U.K. and France have limited fiscal space, making it challenging to buffer the economy from tariffs.

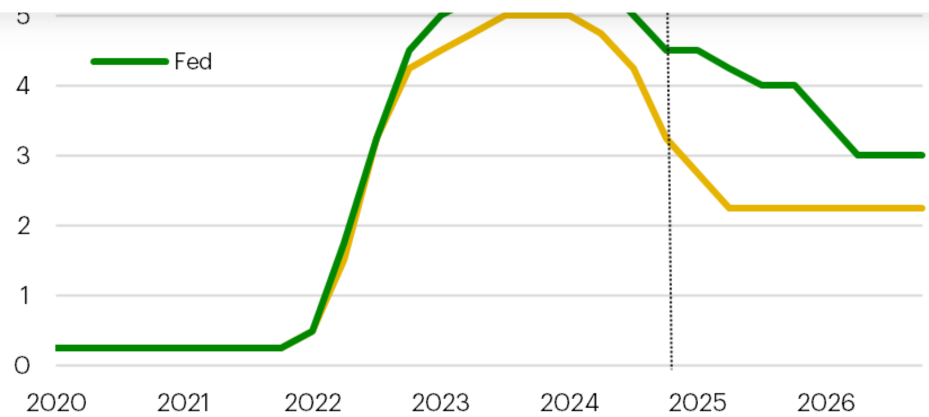
From Canada's standpoint, provincial and federal government levels are united on fiscal supports and tariff-retaliation. However, we've assumed that whether tariffs proceed or not, persistent and unstructured threats from the President will

Q4 2024 to Q1 2025 (for more details on Canada's trade relationship with the U.S. see our recent report).

As for the U.S., economic momentum will be pinched by 0.2-0.3 percentage points in 2025, as further tariff announcements lead to some tightening in financial conditions, while the passthrough to inflation results in a modest erosion in consumer purchasing power.

Returning to the concept of scenario analysis, we review what could happen if Canada and Mexico fail to head-off the 25% economy-wide tariffs set to come into place on March 4th. We do this on a “time lapse” basis, if full tariffs remain in effect for 6-months, 1-year and 2-years (see Table 1). We chose 6-months as the initial starting point to run the scenarios because that’s when the Canadian economy would tip into recession with an unemployment rate peaking at 7.7% by the end of the year. The passage of time serves to worsen the outcomes. The scenarios also include Canada's outcomes with and without fiscal supports. Additional government spending amounting to 2% of GDP in the worst-case scenario provides some offset for the economy. This would also have an inflationary impact. In terms of the labour market, the impact of fiscal supports will depend on the type of measures the government elects to implement. For example, resurrecting wage subsidy programs from the pandemic period would reduce the impact on the unemployment rate (for more details see question 9). For the U.S., annual average growth is reduced by an additional 0.2 percentage points in the 6-month scenario, while the unemployment rate would peak at 4.6% in the fourth quarter, before improving once tariffs are removed.

Q2. How would central bankers react to trade war scenarios?



Source: BoC, Fed, TD Economics.

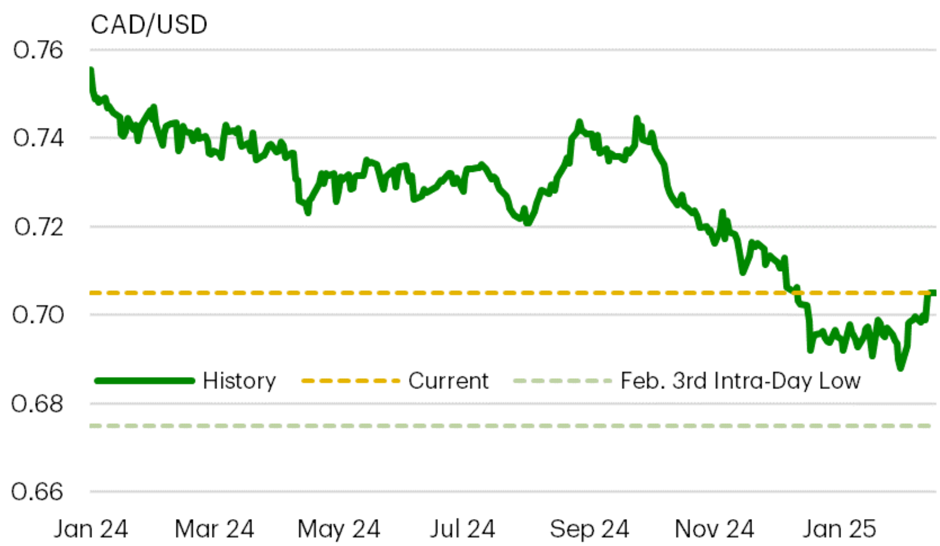
Trade wars introduce huge uncertainty for central bankers. How the Federal Reserve and Bank of Canada respond depends on how they weigh the importance of the negative economic growth shock versus the permanence of higher inflation.

Central bankers should (in theory) look through the immediate inflation increase, as it would be a supply-side shock that can't be addressed with higher interest rates. This would mean that the downside risk to growth should be the focus. However, life is rarely that simple. Even a temporary inflation boost can lift longer-term inflation expectations, particularly when households are already displaying high price-sensitivity. In this case, sitting on the sidelines may not be an option. The pandemic offers insight into this thinking. Central bankers initially looked through the rise in inflation as "transitory" due to one-time pandemic re-opening effects. But eventually had to aggressively raise rates to re-anchor inflation expectations. This is why some Federal Reserve speakers have already noted that they can't ignore a tariff-induced inflation shock. In our baseline assumption, we expect the Fed to remain on pause in the near-term. This presumes the summer will bring greater clarity on tariffs that will be absent “blanket” approaches. Likewise, this would help anchor inflation (and expectations) and allow the Fed to resume modest rate cuts. We expect the policy rate to end the year at 4.0% (Chart 1).

spring. This widening in the policy rate differential between the two central banks is likely to add to the Loonie's downside pressure, or limit a sustained lift beyond 70 cents until 2026.

Q3. How have markets reacted so far to tariff threats?

Chart 2: Canadian Dollar Near Year-to-Day High



Source: Wall Street Journal, TD Economics.

So far, financial market reaction has been controlled and relatively benign to tariff developments. However, this is more a by-product of timing than outright indifference. With the exception of steel and aluminum, President Trump has made large-scale, official tariff announcements over the weekend, when most asset markets are closed. In addition, the significant policy measures were subsequently suspended in short order via negotiations with the targeted countries. This means limited active trading hours for financial participants to react.

Market reactions were strongest between the February 1st executive order on fentanyl, which threatened tariffs on Canada, Mexico and China, and the February 4th implementation date. At this time, markets began to price in the risks of an aggressive timeline was short. By 10am, movements were already reversing as Mexican President Sheinbaum announced a one-month tariff suspension for its country. Similar news was announced by Canadian Prime Minister Trudeau later in the afternoon. North American markets fully reversed the post-announcement moves over the following week, even though the 10% additional tariffs levied against China went into effect as announced.

The Canadian dollar is currently fluctuating near its year-to-date high, undeterred by tariff risks, but still weighed down by monetary policy differentials (Chart 2). We expect the Canadian dollar to remain below 70 U.S. cents through the year due to historically wide policy rate differentials, and presuming tariff risks don't fully leave the landscape. Should President Trump's economy-wide 25% tariff threat be imposed, brace for the CAD move to the mid-60 U.S. cent level, and possibly lower.

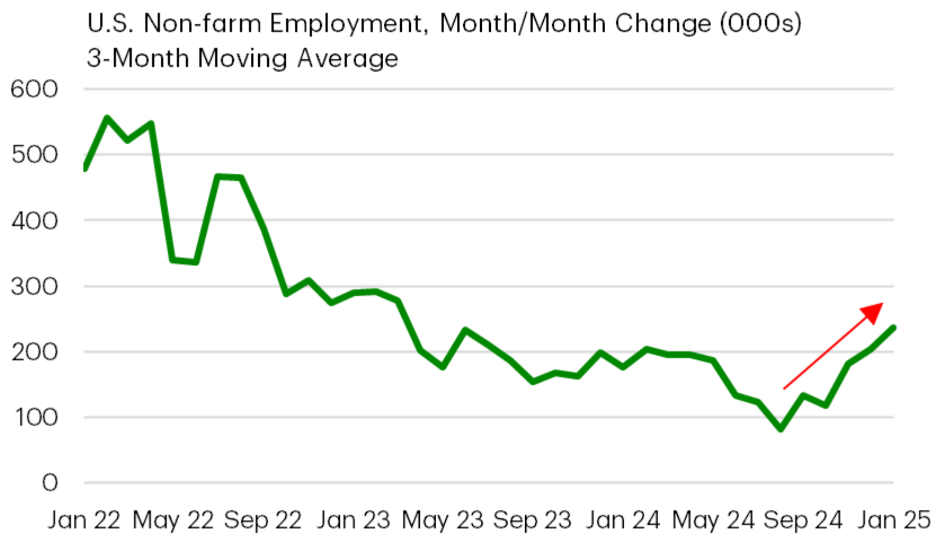
Financial markets have since returned their attention to company earnings reports and macroeconomic developments, but with multiple tariff threats still on the horizon, this respite may prove to be short-lived.

Q4. Executive Orders are flying, how will they get captured in the U.S. outlook?

President Trump has wasted no time signing over 70 executive orders (EOs) in the last few weeks. The actions have been far reaching, touching on everything from national security, climate & energy, immigration, the economy, and cost cutting controls within the Federal government.

From an outlook perspective, we applied judgement on tariffs (see question 1), assumed Congress will maintain TCJA tax cuts, imposed a significant scaling back in immigration and labor force flows, and applied a positive growth-impulse from

Chart 3: U.S. Hiring Has Been Gaining Momentum



Source: Bureau of Labor Statistics, TD Economics.

One thing is for certain – the U.S. economy is starting the year on a solid footing. Economic growth expanded by a healthy 2.3% annualized in Q4, with all the strength coming from domestic drivers, including consumer spending, residential investment, and government. Further evidence of the ongoing momentum was underscored in the January employment figures. Annual revisions showed an even stronger pace of hiring to end 2024 and in January 2025 (Chart 3). With monthly employment gains still averaging north of 200k, it's no wonder consumer spending remains resilient. Even as tariffs bite, the consumer is likely to remain a key driver of growth in 2025 (see question 5).

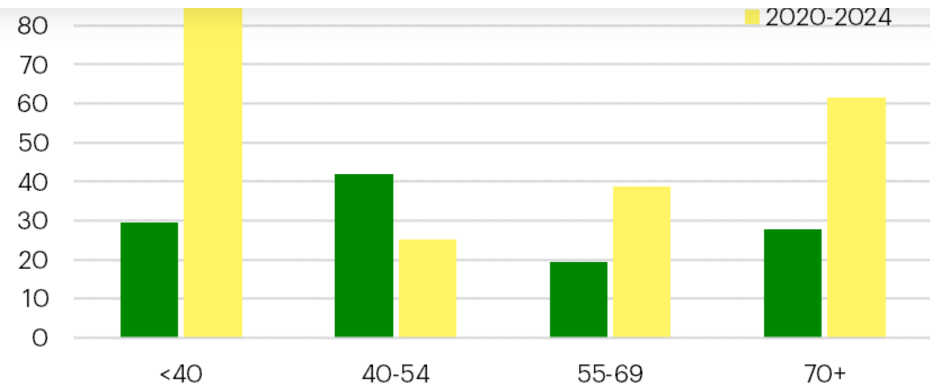
Business investment is also likely to get a lift from rising animal spirits. Several large tech companies, including OpenAI, Meta, and Alphabet, have announced big investment commitments to further expand AI infrastructure over the coming years. Investments in data centers have increased three-fold since 2021, while construction spending on semiconductor facilities has increased over 16-fold during that same time. Investments across these two industries accounted for over 20% of CRE manufacturing sector could see many projects put on hold and production interrupted until there's stability on the new administration's imposition of tariffs on trading partners. For instance, following the 25% tariff announcement on steel and aluminum, the United Steelworkers of America called for efforts to contain global overcapacity by targeting bad actors, like China, while distinguishing trusted trade partners, like Canada.

The combination of executive orders incorporated within the baseline forecast described above nets out to shaving only a few tenths from GDP in 2025. From an inflation perspective, near-term trends are likely to drift higher by Q2, as producers pass on some of the tariff costs. This will keep the Fed on hold for longer than previously expected, which means less reprieve in longer-term yields.

This puts in jeopardy our view that the housing sector may finally turn the corner in the second half of this year (see question 6). It's still too early to throw in the towel on that call, but the risks will shift to the downside with the passage of time of ongoing tariff uncertainty. For now, the economy is predicted to expand by 2.4% this year. The theme of U.S. exceptionalism is still alive and well, although this pace is a stepdown from recent years that averaged 2.8%.

Q5. American consumers bolted out of the gate, will this be another expectation-beating year?

Despite massive policy uncertainty, the one thing going for the U.S. outlook is its consistent ability to surprise on the upside. Once again, consumers were off to the races last year. Spending growth accelerated from an annualized rate of 1.9% in Q1 to a blow-out 4.2% in Q4. Spending growth outpaced disposable income in ten of twelve months, a remarkable performance given high interest rates and an easing in wage growth.



Source: Federal Researve Board, TD Economics.

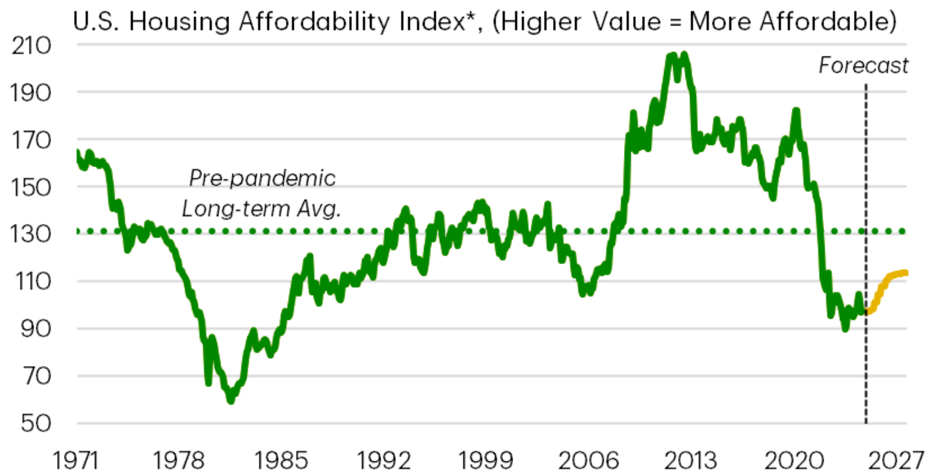
Given the strong momentum from last year, as well as some lingering replacement demand for goods due to the wildfires in Los Angeles and hurricanes in various parts of the country, we have upgraded our outlook for consumer spending in 2025 by 50 basis points to 2.4%. However, there could be further room for gains, particularly if the labor market remains resilient and Congress delivers on an array of lower taxes for households that boosts disposable income. One of the biggest of these would be eliminating taxes on social security.

Another source of upside risk to consumer spending stems from the continued strength of household balance sheets since the pandemic. Household net worth has increased by 44% over the last five years, with nearly every cohort benefiting from stronger gains relative to the five years prior (Chart 4). Higher levels of wealth could be one reason why the personal savings rate in December at 3.8% was lower than prior to the pandemic, when it averaged near 7% in the two years prior. Given its already low level, it is hard to see the savings rate declining much further. Outside of the pandemic, this last occurred during the housing market frenzy prior to the subprime crisis.

While the backdrop for consumers holds solid, the risks around the forecast are considered balanced. The potential inflationary boost from tariffs is a downside risk. And the restart of student

U.S. real estate stage a lasting revival?

Chart 5: U.S. Housing Affordability Still Well Below Historic Norms



Source: NAR, Census Bureau, TD Economics.
*Seasonally adjusted data, existing single-family home, fixed rate 30-year mortgage.

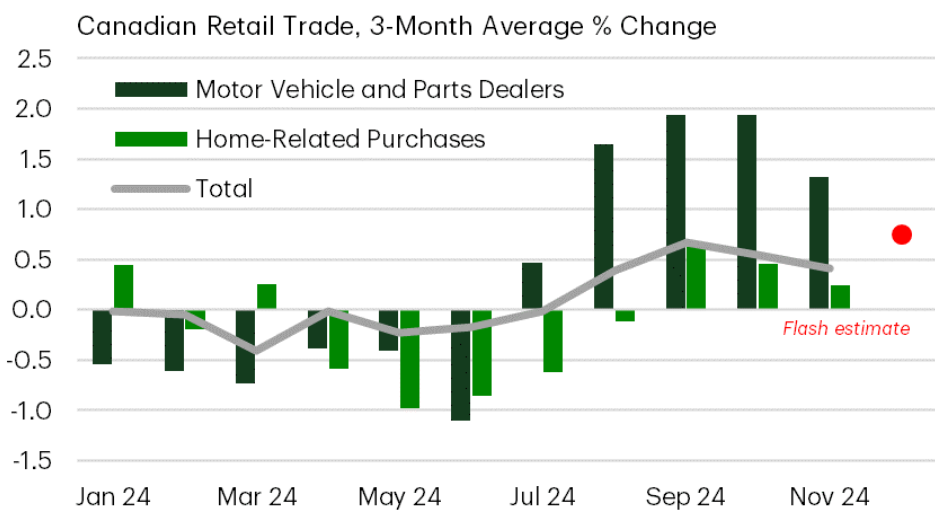
Lower mortgage rates in the spring and summer of last year delivered a late-year boost to residential investment. However, the backup in bond yields is likely to slow the sector's momentum in the near term. Pending home sales and weekly mortgage purchase applications have started to pull back. Thirty-year mortgage rates are hovering around 7%, 80 basis points higher than when the Fed first cut the funds rate in September. Meanwhile, existing home prices have not let up, with the median price up 6% y/y in December. At these levels, the typical mortgage payment for an existing single-family home is close to $2200 – more than double the pre-pandemic average. Over the same period, median family incomes have risen 23%. This would normally be a great result, but in the current environment, it still reflects badly stretched housing affordability (Chart 5).

The outlook for inflation and interest rates has higher than usual uncertainty due to policy shifts in Washington (see question 1).

homebuilding trends – aided by a lower interest rate environment and perhaps reduced regulation – can suppress home price growth and allow incomes to catch up. However, this will likely be a long-term process. For the near-to-medium term, other risks dominate, including import tariffs on lumber and other inputs combined with immigration restrictions that can create labor shortages.

Q7. How is Canada's economy performing in the face of elevated uncertainty?

Chart 6: Canadians Ramp Up Discretionary Spending



Source: Statistics Canada, TD Economics.

Canada's economy ended 2024 on a solid footing, with momentum carrying into the early days of 2025. The labour market has been a pillar of strength. Job growth has averaged 35k per month over the last year, but the past three months, that pace accelerated to 70K. The unemployment rate has also started to fall (from a 6.9% peak to 6.6% in January). Job growth is now outpacing labour force growth, with early evidence that the Federal governments' population policy is starting to have an effect. More Canadians are working, hours worked are rising, partially offsetting the drag from slowing population growth. And then there's the extra kick from a cumulative two-percentage point reduction in the overnight rate that is still in the early stages of easing debt-servicing pressures.

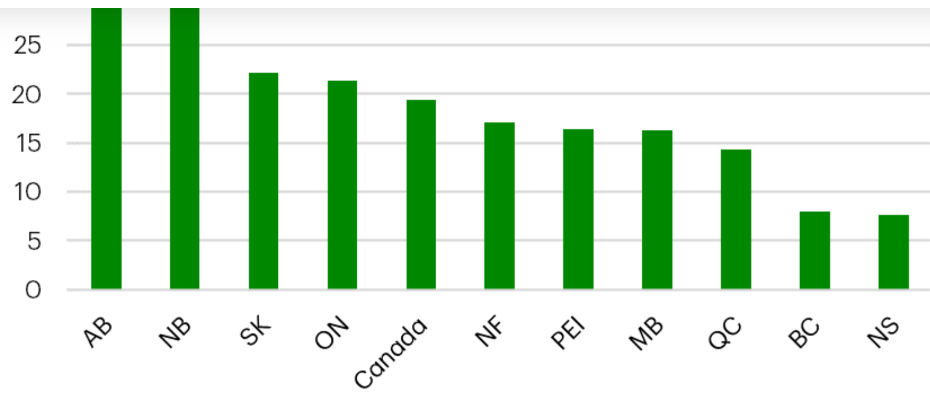
Concerns over mortgage renewal shock are fading, lifting the confidence and security of households. At the same time, many Canadians have built up precautionary savings, pushing cumulative 'excess deposits' (those above the pre-pandemic trend) to an estimated $153 billion, some of which will be funneled back into the economy.

Rate cuts have also revived Canadians' favourite past time – home shopping (Chart 6). Other discretionary spending has also rebounded, with strong demand for cars, entertainment, and recreation. Government stimulus, such as the GST tax break, has likely offered a tailwind to spending on restaurants, although the jury is still out on the full impact.

All told, consumer spending is poised to reclaim its role as a key driver of economic growth – so long as employment and income growth remain intact. We expect personal consumption growth to reach 2.6% (annualized) in Q1 2025 before moderating to an average of 1.3% over the final three quarters of the year (see question 1 for details on the GDP outlook). Naturally, uncertainty on potential tariffs and retaliatory measures pose a risk to our outlook for consumer spending.

Q8. How are different provinces exposed to tariff risks?

U.S. exports make up about one third of GDP in Alberta and New Brunswick, the largest tally across provinces, driven by the energy sector (Chart 7). Ontario and Saskatchewan also count on the U.S. in a comparatively large manner. Saskatchewan ships energy, potash products, uranium, and agricultural



Source: Statistics Canada, TD Economics.

products south of the border. In contrast, Ontario pivots from resources to the auto industry in a deeply integrated North American supply chain.

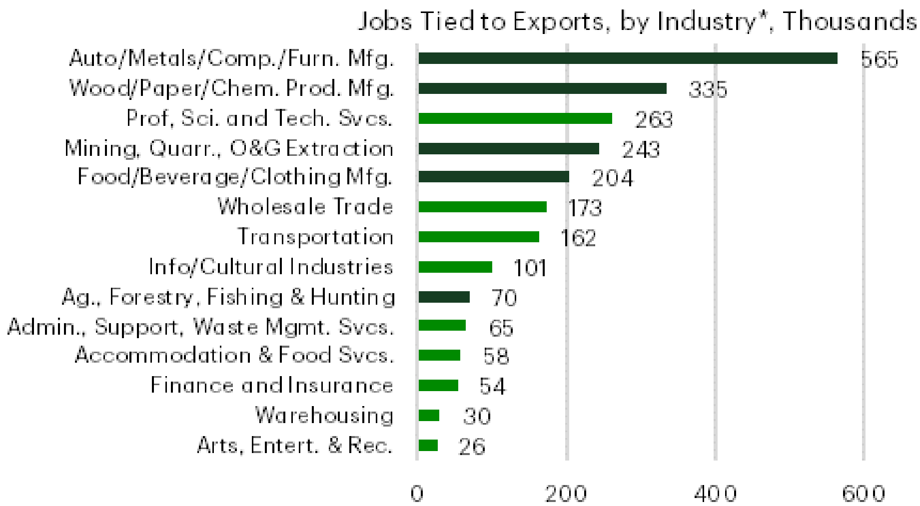
The Atlantic regions have lower exposures, albeit the figures are still material. Interprovincial exports play a more prominent role in the region, as does large public sectors. The latter is also a cushion for Quebec to a degree, while interprovincial markets feature prominently for Manitoba's exporters. To the West, B.C. is directly shielded through its larger reliance on the Chinese market, although that economy may start to reflect weaker demand under the new 10% tariffs placed on them by the U.S.

These are the exposures. However, how the situation plays out for the provinces is fluid and depends on what ends up tariffed. For example, 25% levies on Canadian steel and aluminum products would impact Ontario (steel) and Quebec (aluminum) the most, although these exports only account for 2-3% of GDP. Singlehandedly, both economies could withstand this blow, as they did in 2018 under Trump's his first term (although the tariff rate was only 10% for aluminum). Back then, Ontario and Quebec mustered very strong economic growth despite the individual industries suffering under the weight of the tariffs.

The story doesn't end there, however. On the opposite side of the ledger, imports from the U.S. equate to 23% and 11% of GDP in Manitoba and Saskatchewan (representing a diverse array of

Q9. How could the government pivot policy to provide insulation to Canada?

Chart 8: Tariffs Will Disproportionately Impact Jobs in Canada's Goods Sector



*Includes only industries with more than 20K export related jobs; dark green bars indicate the goods sector. Source: Statistics Canada (Table: 12-10-0100-01) , TD Economics.

Governments across Canada are publicly discussing large financial supports to cushion the impact from potential U.S. tariffs. There are existing programs that don't require new legislation, which means they can be implemented quickly without recalling parliament. This includes Employment Insurance (EI) and the EI Work Sharing (WS) program. The latter is designed to help businesses and workers avoid layoffs during temporary downturns. This program was used during the steel and aluminum tariffs in 2018. The duration of WS agreements was extended from a standard 36 weeks to 76. The application process was streamlined, and eligibility was expanded to include not just firms impacted directly, but those in related supply chain industries, as well as firms affected by retaliatory tariffs.

Beyond EI, some other areas government may consider including pandemic-programs, such as wage subsidies (Canada scratch. Plenty of time and analysis has transpired since the pandemic to help with program selection and decisions. For example, a CEWS-style program, which provided subsidies to businesses in hard-hit industries, is more likely than CERB, which supported workers directly, including some who were ineligible for traditional EI.

No matter the chosen programs, governments won't have the financial leeway of the pandemic period because debt levels are much higher. Caution must be employed on scope and the duration applied to any program, even if tariffs turn out to be permanent. Based on previous Statistics Canada tariff-related estimates[1], if goods-sector exports decline by a third due to tariffs roughly 640k jobs would be lost (Chart 8). Providing a CEWS-style wage subsidy to these workers would cost the government approximately C$2.6 billion per month. This is less than the C$4.2 billion monthly average during the pandemic but certainly not sustainable on a medium-term basis.

And, if there is one thing we learned during the pandemic, it is that the greater the income supports to insulate Canadians, the higher the possibility that inflationary pressures linger.

Removing the knee-jerk reaction, governments must sharpen Canada's competitive position in the global economy with or without tariffs. The end-goal must be to make Canada the preferred destination of businesses, high valued labour and a magnet for foreign investment. As outlined here, actions should focus on tax competitiveness, reducing regulatory layers and complexity, and ensuring responsible development of energy and critical mineral resources within reasonable timeframes. The more tax dollars that are spent on supporting near-term initiatives, the less that may be available to truly pivot the economy to a brighter and more resilient future.

The stars have been aligning for at least a moderate advance in home sales activity in 2025. Positive factors include pent-up demand, looser mortgage rules, a rising share of Canadians in their prime home buying years, continued economic growth and falling interest rates. At the same time, average home price growth is likely to lag, given supply/demand balances that favor buyers in B.C. and Ontario.

That assumes no major curve ball from tariffs that would derail momentum. Indeed, even the threat of U.S. tariffs already appears to be weighing on homebuying confidence. Sales slumped in January while new listings surged, as buyers were anxious, and sellers hurried to list their properties ahead of potential economic softness. The imposition of steep tariffs would hurt job markets and dampen consumer moods, negatively impacting housing demand and home price growth. These impacts would be exacerbated by poor affordability in several regions, an oversupplied GTA condo market, and rapidly slowing population growth. However, the Bank of Canada is also likely to cut interest rates faster in a tariff scenario, providing some offset to the housing market.

Table 1: Economic and Financial Forecast Scenarios

	Baseline Forecast (Annual Average)		Duration of Trade War					
			6-Months		1-Year		2-Year	
	2025	2026	2025	2026	2025	2026	2025	2026
Real GDP (% Change)								
U.S.	2.4	2.1	2.2	2.1	2.1	2.0	2.1	1.6
Canada	1.8	1.6	1.1	1.6	1.0	1.2	1.0	0.3
Canada with Fiscal	1.8	1.7	1.2	1.8	1.2	1.7	1.2	0.8
CPI Inflation (% Change)								

Canada	6.5	6.1	7.2	6.7	7.3	7.2	7.3	8.0
Policy Rate (%, EOP)								
U.S.	4.00	3.00	4.25	3.00	4.50	3.25	4.50	3.50
Canada	2.25	2.25	2.25	2.25	2.00	1.75	2.00	1.50
10-Year Yields (%, EOP)								
U.S.	4.10	3.75	4.25	3.75	4.35	3.90	4.35	4.00
Canada	3.00	3.00	3.00	3.00	2.90	2.75	2.90	2.65
USD per CAD (EOP)	0.71	0.74	0.68	0.71	0.62	0.67	0.62	0.65
WTI (USD/BBL, EOP)	72	78	65	75	63	71	63	60

Note: Forecasts for interest rates and exchange rates are end-of-period (EOP).

Source: TD Economics.

End Notes

1. Assuming a weekly subsidy of $847 and an average reduction in jobs as estimated by Statistics Canada. See Facts on Select Canadian Industries Impacted by Tariffs.

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