Monthly Macro & Strategy

February 2025

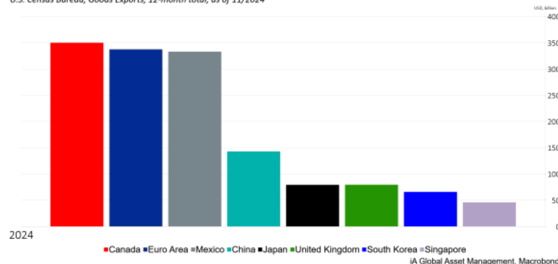
iA Global Asset Management

Across the Murky Waters

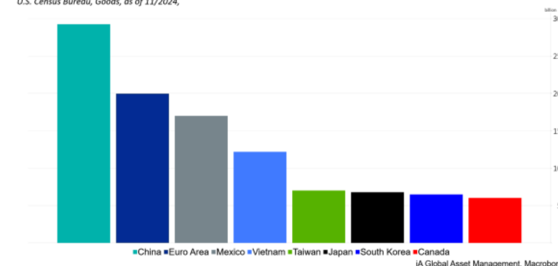
Section I: Free trade begins at home

Donald Trump's return to the U.S. presidency has reignited concerns about protectionism and its implications for global trade.

Canada and the United States are each other's most important trade partner in nominal terms and have the tightest trade relationship in the world. Their trade is also fairly balanced, with the United States' ratio of exports to imports sitting at 0.85, by far the closest to balance among its main trade relationships. And it is even more balanced if energy is excluded from the picture.



But, with early signs pointing to heightened scrutiny of trade imbalances and the possibility of tariffs targeting key U.S. trading partners, Canada must once again brace for potential disruptions. External pressures of this kind demand attention but also underscore the need to address internal inefficiencies within Canada's own borders. A key opportunity lies in reducing internal non-tariff trade barriers (NTBs), which continue to stifle productivity and economic potential across the provinces.



Highlights

- Reducing internal trade barriers could significantly boost Canada's GDP per capita by up to 4%, enhancing economic resilience in the face of tariff threats.
- Despite the prevailing bearish sentiment, Europe's low expectations set the stage for potential upside surprises in 2025.
- We remain overweight on equities, focusing on U.S. and Canadian markets due to favourable earnings and the positive impact of deregulation.

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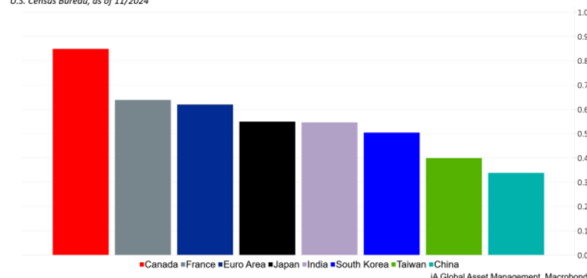
ASSET CLASSES					
Money Market			■		
Fixed Income		■			
Equities				■	
Alternatives			■		
RELATIVE EQUITY					
Canadian Equities				■	
U.S. Equities				■	
International Equities*			■		
EM Equities			■		
RELATIVE FIXED INCOME					
Government Bonds			■		
IG Corporate Bonds			■		
HY Bonds			■		
OTHERS					
Oil			■		
Gold		→	■		
USD (trade weighted)			■		
CAD/USD			■		

* Japan



The hidden cost of internal trade barriers

Canada's economic structure is heavily reliant on international trade, but its internal trade framework remains fragmented. NTBs—including dairy quotas, trucking regulations, and differing professional licensing requirements—impose significant costs on businesses and consumers. These regulatory inconsistencies hinder labour mobility, limit consumer choice, fragment markets, stifle competition, and constrain economies of scale. In short, the cumulative effects of the barriers have stunted Canada's productivity growth.

According to a report by the International Monetary Fund[1], the average tariff-equivalent cost of non-geographic internal barriers in Canada for 2015 was estimated at 21%, with significant variation across provinces and sectors. Services, heavier metals, food products, and manufacturing goods face particularly high barriers, with some sectors experiencing effective rates exceeding 27%. Manitoba, Nova Scotia, and Newfoundland and Labrador are especially affected, exhibiting some of the highest non-geographic trade barriers, even after geographic factors are accounted for.

Interprovincial trade: A stagnant engine

Even though international trade volumes have grown significantly since the 1980s, interprovincial trade has stagnated. In the early 1980s, the combined volume of interprovincial and international trade (the value of exports and imports combined) accounted for roughly 55% of Canada's GDP. In the following decade, however, interprovincial trade declined steadily to less than 40% of GDP, where it has remained ever since. In contrast, international trade surged, peaking at more than 80% of GDP after the introduction of the Canada-U.S. Free Trade Agreement (1989) and NAFTA (1994).

This growing reliance on international trade has left Canada vulnerable to external shocks, such as tariff threats and shifting trade policies in key markets such as the United States.

A greater focus on liberalizing internal trade could mitigate these risks, reducing dependency on volatile external markets and fostering stronger economic integration within Canada.

An easy solution? Look within

Canadian politicians and diplomats should continue to work overtime to convince the Trump administration that the logic behind the 25% tariff threats is off-base (the rhetoric about a "vast number of people and Fentanyl coming in" does not factually apply to the Canadian border). But at the same time, we see an obvious path forward that can reduce our reliance on trade with our neighbour and, quite likely, provide easy solutions to Canada's productivity problem: reducing NTBs.

According to IMF estimates, fully liberalizing internal trade in goods could increase GDP per capita by about 4%, with gains as high as 16% in smaller provinces such as Prince Edward Island. The Atlantic provinces stand to benefit, with projected increases in real GDP per worker of up to 8%. The numbers are significant, given that in 2019 the Bank of Canada estimated a 3.1% hit to long-run real Canadian GDP in a scenario where the U.S. administration imposes a 25% blanket tariff on all imported goods, and every country in the world (including Canada) retaliates symmetrically.

The IMF report also estimates that liberalization would drive a 15% increase in internal trade volumes as a share of GDP, bringing them back in line with levels last seen in the early 1980s. Employment would be reallocated to provinces with the largest productivity gains, reducing regional disparities and fostering a more balanced economic landscape.

Lessons from abroad

Canada's fragmented internal trade regime contrasts sharply with the more integrated frameworks of countries such as Australia and blocs such as the European Union. Australia's success in reducing internal trade barriers has been attributed to cooperative federalism whereby the federal and state governments worked together to streamline regulations. The European Union has adopted a more centralized approach, enforcing the free movement of goods and services through legal harmonization and mutual-recognition mechanisms.

These models offer valuable lessons for Canada. A coordinated effort involving federal, provincial, and territorial governments could replicate these successes, building on the existing framework of the 2017 Canadian Free Trade Agreement to tackle the remaining barriers. Strong federal leadership will be essential to harmonize regulations and to ensure all provinces remain committed to liberalization.

1.International Trade in Canada: Case for Liberalization", IMF Working Paper, July 22, 2019

Bottom line: Help yourself first

With Canada facing potential external disruptions during Trump 2.0, reducing internal trade barriers offers a strategic path to greater economic resilience. By fostering greater integration within its borders, Canada can unlock substantial productivity gains, reduce regional disparities, and mitigate its dependence on foreign trade. This strategy is not merely defensive but also proactive; it would be a step toward a more competitive and dynamic economy—one better equipped to navigate domestic and global challenges alike.

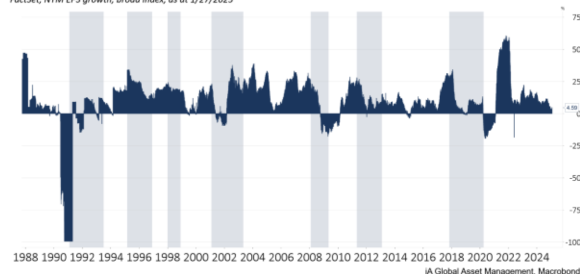
Section II: Does Europe rock or roll over?

The European economy and its markets enter 2025 under a dark cloud but with the potential for positive surprises. Even though structural challenges and geopolitical risks loom large, we suspect that selective opportunities for growth and sectoral outperformance may be hiding in plain sight. Let's look at market sentiment, the macroeconomic backdrop, sector outlooks, and the policy implications shaping Europe's investment landscape.

Market sentiment and expectations

The European markets are grappling with a stark divergence between sentiment and potential. The market consensus remains excessively bearish, with euro zone equities reflecting levels of pessimism even deeper than during the initial stages of the Russian invasion of Ukraine in 2022.

The outlook for equities is also gloomy. With expectations for earnings-per-share growth over the next 12 months on the broad European equity market plummeting to a lowly 2%, it appears that investors have already written off 2025.



The bearish outlook is also evident in the sharp increase in euro/U.S.-dollar short positions, driving the currency to its lowest point since the war's onset. We can safely argue that pessimism has reached extremes, with valuations suggesting that substantial negativity is already priced in.

Adding to the negative outlook is the widening gap in equity flows, with the United States continuing to attract disproportionate investor interest. Over the past year, U.S. equities have seen consistently stronger inflows than their European counterparts, a trend that accelerated after the U.S. election. The divergence is not surprising and underscores investors' preference for the U.S. market, which has consistently outperformed over the past 15 years.

Performance of Euro vs Major Currencies, as at January 31, 2025

	-3M	-6M	-12M
EURCAD	0%	0%	3%
EURUSD	-4%	-4%	-3%
EURJPY	-2%	-2%	1%
EURGBP	1%	0%	-2%
EURAUD	1%	1%	1%
EURCHF	1%	-1%	1%
EURMXN	-1%	6%	16%

Source: Bloomberg

The case for optimism

Despite the prevailing negativity, Europe's low expectations have set the stage for asymmetric upside risks. A series of potential catalysts could drive a re-rating of European equities and improve economic sentiment.

First and foremost, policy and fiscal adjustments could be the low-hanging fruits of 2025 in Europe. For example, Germany's potential loosening of fiscal policies and increased defence spending could provide a much-needed boost to domestic demand. Also, broader euro zone fiscal consolidation, which acted as a drag in 2024, subtracting 1.1% from GDP, is expected to ease in 2025, creating a more supportive environment for growth.

Second, 2025 could bring some geopolitical stabilization to the continent. A peaceful resolution to the situation in Ukraine, for example, could alleviate market concerns and revive investor confidence. Or the EU's potential (forced or unforced) alignment with U.S. geopolitical priorities, including increased defence spending and reduced reliance on Chinese imports, may strengthen transatlantic relations and reduce trade uncertainties.

Third, opportunities for reforms and structural improvements abound. For example, the Draghi report, though largely dismissed by markets, includes actionable recommendations that could improve policy coordination, reduce bureaucracy, and enhance competitiveness. If backed by key leaders such as French President Emmanuel Macron, these reforms could gain traction.

Fourth, a few key macroeconomic indicators, such as credit-easing measures and inventory-cycle improvements, are likely to support a mild recovery in euro zone PMIs, which remain at depressed levels. The signs of progress are timid, for now, but they certainly warrant monitoring for signs of improvement.

The case for caution

Europe is not without challenges, which remain significant and deeply entrenched. The region continues to face structural issues, such as an aging population, low productivity, and the lack of a cohesive fiscal union. These factors limit the euro zone's ability to respond dynamically to external shocks.

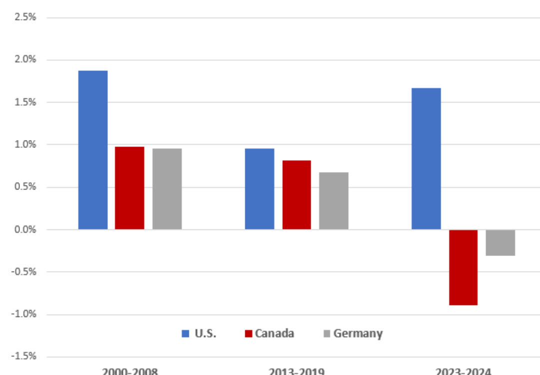
Geopolitical risks also persist, particularly the potential for U.S. tariffs on European goods. Such measures would disproportionately affect export-dependent countries, such as Germany, further straining growth prospects. Rising energy costs and uncertainty surrounding the green transition add another layer of complexity, weighing heavily on industrial competitiveness.

Europe's trade dynamics are increasingly influenced by its alignment with U.S. geopolitical priorities. Many ongoing EU trade investigations target Chinese imports, reflecting a shift toward greater defensiveness. In response to potential U.S. tariffs, Europe may increase liquefied natural gas imports and military spending to appease Washington, while also exploring retaliatory measures, such as higher import duties on U.S. consumer goods.

The pace and scale of Europe's fiscal adjustment will be critical to the trajectory of trade tensions. A proactive approach could mitigate risks, while delays may exacerbate economic vulnerabilities.

The euro bloc is also suffering from the Canadian disease of falling productivity, making it particularly vulnerable to a tariff salvo from the Trump administration.

Inflation dynamics also remain a concern. Even though the ECB's sequential inflation indicators show signs of moderation, underlying pressures could prompt further policy tightening, exacerbating the challenges posed by quantitative tightening and a record-high bond supply.



Inflation and monetary policy

Inflation trends in the euro zone remain mixed. Even though sequential underlying inflation ticked higher in December 2024, the ECB's core metrics point to subdued momentum. With quantitative tightening in full swing, the European bond market faces a record-high net supply creating potential downward pressure on prices. Even so, strong demand during recent syndications indicates that robust investor interest could act as a stabilizing force.

Will the ECB be positioned to deliver the much-needed 100 basis points of rate cuts priced in for 2025? Although markets haven't adjusted the expected path forward despite the renewed inflationary pressures of recent months, the balance of risks has clearly shifted to a less obvious rush-to-neutral stance from the central bank.

Bottom line: balancing risks and opportunities

The European economy and its markets present a complex picture. Even though significant challenges persist, the potential for positive surprises driven by policy reforms, geopolitical stabilization, and easing of fiscal constraints cannot be ignored. For investors, this context creates a nuanced opportunity set: undervalued equities in defensive sectors, improving credit conditions, and an underappreciated euro.

That being said, the region's structural weaknesses and exposure to external shocks necessitate a cautious approach. Our focus is on weighing the asymmetric upside potential against the risks of further deterioration as we continue to evaluate the prospects of European assets. Even though we are on the sidelines for now, we acknowledge that European equities and the euro could offer substantial opportunities for contrarian trades in the near future.

Positioning

Despite the noise and risks surrounding tariffs and trade tensions in the second Trump administration, we remain overweight equities. Much of the market's attention has been on the risks related to trade and immigration policies, but there has been less focus on the positive supply-side shock from deregulation. Since much of the deregulation is carried out via executive orders, its impact on the U.S. economy can be quicker than the lengthy process of getting Congressional approval for policy changes.

Although headlines about trade wars and tariffs will most likely continue to generate market volatility, we think the primary trend for equity markets will remain upward owing to the positive impacts of deregulation on a growth and earnings environment that is already favourable for U.S. companies.

Our overweight equity position is focused on U.S. equities but also on Canadian equities. Despite tariff risks, Canada has a relatively favourable earnings backdrop stemming from a bottoming-out of the macro cycle and the delayed impact of previous Bank of Canada easing. Moreover, with inflation receding to levels slightly above the 2% target, the Federal Reserve and the Bank of Canada have ample room to cut rates in the event of an unforeseen growth shock in 2025. We will therefore continue favouring equities in our asset mix.

Even though we appreciate the role that fixed income can play in portfolios as a more effective hedge to equity risks, we are more tactically cautious on the asset class. We think equities will continue to offer a better risk-reward. We will continue to monitor growth and inflation conditions to assess when a shift to a more positive view on fixed income will become appropriate.

As for currencies, we are generally overweight the U.S. dollar versus European currencies, such as the euro, the Swiss franc, and the Czech koruna. Much of the market's attention has been centred on Trump's desire to impose tariffs on Mexico, Canada, and China, but Europe finds itself in a difficult position regarding its role in global trade.

With Germany in a political no-man's land before its federal election on February 23, it is difficult to implement policies that would respond to the threats facing the country's industrial sector. Chinese overcapacity in industries such as electric vehicles threatens the euro zone's global export market share for goods, making growth for goods-exporting countries in Europe challenging.

Thus, we think the European Central Bank is likely to continue easing, and currencies with beta to the euro are likely to depreciate against the U.S. dollar.

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Market Performance

Total returns as of January 31, 2025, in $CA

	MTD	QTD	YTD	1Y
EQUITIES (LOCAL CURRENCIES)				
S&P 500	2.8%	2.8%	2.8%	26.4%
S&P/TSX	3.5%	3.5%	3.5%	25.2%
NASDAQ 100	2.2%	2.2%	2.2%	25.3%
MSCI World Net	3.5%	3.5%	3.5%	23.0%
MSCI EAFE Net	4.8%	4.8%	4.8%	13.7%
MSCI EM	1.6%	1.6%	1.6%	19.7%
COMMODITIES (USD)				
Gold	6.6%	6.6%	6.6%	37.2%
CRB	1.0%	1.0%	1.0%	3.9%
WTI	1.1%	1.1%	1.1%	-4.4%
FIXED INCOME				
FTSE Canada Universe	1.2%	1.2%	1.2%	6.9%
FTSE Canada Long Term	1.4%	1.4%	1.4%	6.2%
FTSE Canada Corporate	1.1%	1.1%	1.1%	8.8%
CURRENCIES				
DXY	-0.1%	-0.1%	-0.1%	4.9%
USD/CAD	1.1%	1.1%	1.1%	8.2%
USD/EUR	-0.1%	-0.1%	-0.1%	4.4%
USD/JPY	-1.3%	-1.3%	-1.3%	5.6%
USD/GBP	1.0%	1.0%	1.0%	2.4%

	MTD	QTD	YTD	1Y
SECTORS S&P/TSX				
Financials	2.7%	2.7%	2.7%	34.0%
Energy	0.2%	0.2%	0.2%	22.3%
Industrials	3.4%	3.4%	3.4%	11.1%
Materials	10.2%	10.2%	10.2%	42.8%
Information Technology	10.0%	10.0%	10.0%	42.2%
Utilities	-0.3%	-0.3%	-0.3%	14.8%
Communication Serv.	2.3%	2.3%	2.3%	-21.6%
Consumer Staples	-2.7%	-2.7%	-2.7%	13.6%
Consumer Discretionary	0.2%	0.2%	0.2%	10.6%
Real Estate	0.4%	0.4%	0.4%	5.6%
Health Care	-2.7%	-2.7%	-2.7%	9.5%
SECTORS S&P 500				
Information Technology	-2.9%	-2.9%	-2.9%	27.3%
Health Care	6.8%	6.8%	6.8%	6.3%
Consumer Discretionary	4.4%	4.4%	4.4%	40.9%
Financials	6.5%	6.5%	6.5%	34.3%
Communication Serv.	9.1%	9.1%	9.1%	45.7%
Industrials	5.0%	5.0%	5.0%	23.9%
Consumer Staples	2.0%	2.0%	2.0%	14.6%
Energy	2.1%	2.1%	2.1%	8.3%
Utilities	2.9%	2.9%	2.9%	31.0%
Real Estate	1.8%	1.8%	1.8%	12.5%
Materials	5.6%	5.6%	5.6%	9.8%

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A magnet for top investment talent, iA Global Asset Management is one of Canada's largest asset managers, with over $100 billion under management across institutional and retail mandates. We help investors achieve their long-term wealth creation goals through innovative investment solutions designed for today's complex markets. We are building upon our historic success, supporting the growth of our core strengths, and exploring innovative ways to meet investor needs. We are rooted in history and innovating for the future. Our experienced portfolio managers use a proprietary investment methodology, rooted in iAGAM's unifying commitment to strong risk management, analytical rigor and a disciplined, process-driven approach to asset allocation and security selection.

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