SPECIAL REPORT
CANADA TRADE OUTLOOK

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Canada's Economy and CRE Market Face Uncertainty Amid Tariff Threat

Tariffs could derail economic and CRE outlook. As a small open economy with over 30 per cent of its GDP tied to a single large foreign buyer, the United States, Canada is highly vulnerable to trade barriers from its southern neighbour. The recently proposed import duties on Canadian goods, coupled with the nation's planned retaliation, have heightened domestic recession risks and could potentially disrupt the current recovery stemming from lower borrowing costs. A potential recession threatens to weaken near-term fundamentals across all commercial real estate property types. Uncertainty about the near-term political and economic outlook is expected to prompt additional investors to remain on the sidelines until the outlook becomes more clear. As a result, last year's rebound in the transaction market may prove to be short-lived, despite lower borrowing costs.

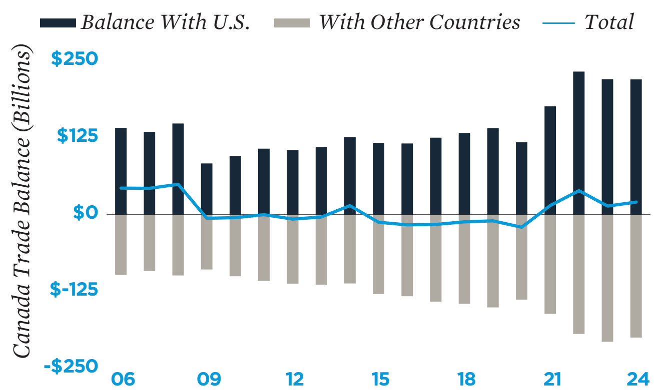
Canada depends on trade for economic growth. Trade with the U.S. has been indispensable to Canada's post-pandemic economic recovery. Between 2021 and 2024, strong demand for Canadian oil and other goods from U.S. consumers and businesses helped Canada shift away from the trade deficit, which had persisted since the Global Financial Crisis, to achieve a trade surplus. Exports of energy products contributed the most to this positive trade balance, with a significant portion consisting of crude oil produced in Alberta and transported to U.S. refineries in the Midwest, Rocky Mountains and other regions. At the same time, Canada's trade deficit with the rest of the world widened, reaching the highest level over the past two years.

Intertwined North American supply chain requires trade. The U.S. reliance on Canada's crude oil provides just a small glimpse into an interconnected supply chain between the two countries. Nearly 80 per cent of traded goods comprise intermediate inputs and capital goods used in production, while goods for final consumption make up the remaining 20 per cent. As a consequence of this trade pattern, some imports are re-exported to their originating country and can cross the border multiple times after being processed. From 2013 to 2022, nearly one-fifth of U.S. imports from Canada contained components that were originally sourced from the U.S. This underscores the reality that the more the U.S. imports from Canada, the more it exports to Canada. Additionally, Canada-U.S. trade volumes are also driven by the movement of goods within multinational firms operating in both countries. In 2023, intra-company trade and trade with related parties accounted for 52 per cent of Canada's exports to the U.S. and 47 per cent of its imports from the U.S.

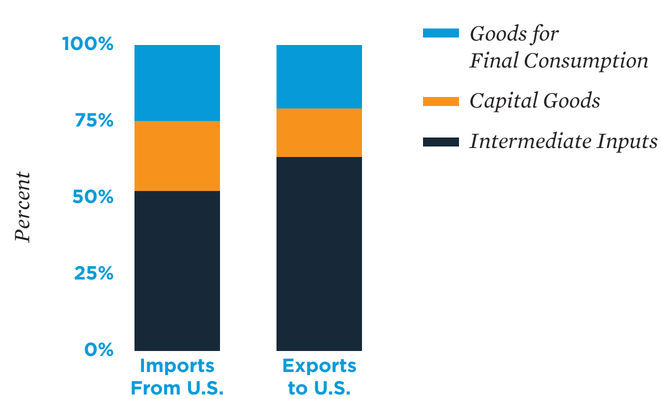
Key Takeaways

- Canada's heavy reliance on the U.S. makes it highly vulnerable to major trade policy shifts.
- Proposed tariffs could significantly disrupt trade flows, increasing recession risks.
- Once tariffs take effect, all CRE sectors in Canada are expected to face weakening fundamentals, weighing on investment activity despite easing financial conditions.

Canada Benefits From Trade With the U.S.



Canada-U.S. Trade Essential for Supply Chains



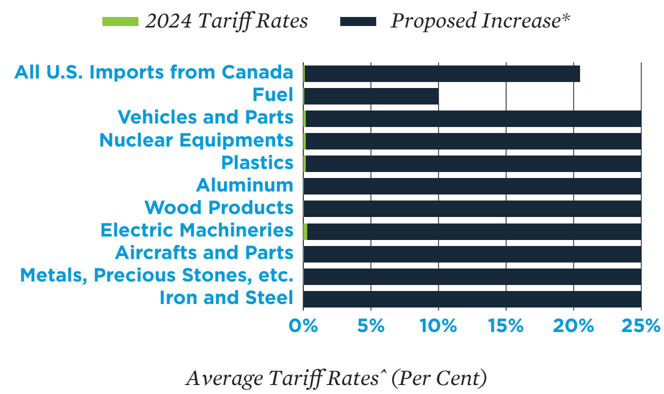
Sources: Statistics Canada; U.S. Energy Information Administration

Proposed tariff would pose a stagflation shock. According to U.S. Census data, the average U.S. tariff rate on Canadian imports was roughly 0.1 per cent in 2024. Under the newly proposed policy, a 10 per cent tariff on energy products and a 25 per cent tariff on all other imports are estimated to push the average import duty to 20 per cent. Combined with Canada's planned retaliatory measures, this substantial disruption will weaken demand for Canadian exports, leading to reduced production and investment. In response, businesses will lay off workers, which will push up unemployment and subsequently dampen consumption in non-trade sectors. Although this chain reaction weakens the economy and typically exerts deflationary pressures, rising import costs – due to a weaker Canadian dollar and retaliatory tariffs on U.S. exports – are poised to push inflation higher. The trade war will ultimately create a stagflationary environment, characterized by a contraction in GDP alongside elevated price growth.

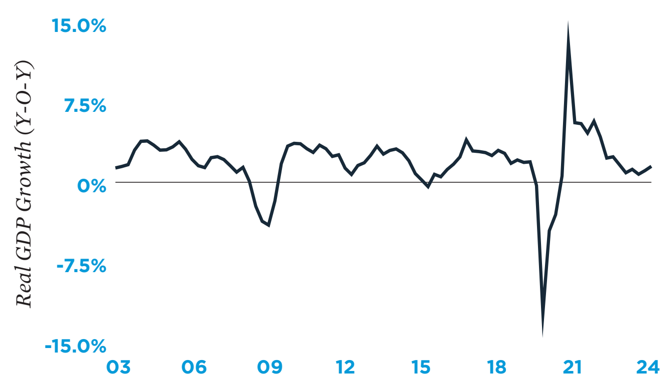
Proposed tariff rate would significantly impact Canada's GDP. While a precise assessment of the tariffs' impact on Canada's economy hinges on how trade policies develop – including the duration of potential tariffs and any escalation following retaliation – economists widely agree that a recession is imminent if tariffs of this magnitude are implemented. In its latest Monetary Policy Report, the BoC estimates that these tariffs could result in a permanent GDP loss of 3.3 per cent to 4.2 per cent and sustained upward pressure on inflation, ranging from 0.7 per cent to 2.7 per cent over the next three years. The Business Data Lab at the Canadian Chamber of Commerce projects a GDP decline of 1.8 per cent to 2.6 per cent, costing each Canadian an average of $1,300 to $1,900. Even if Canada manages to dodge U.S. tariffs, the blow to business confidence – elevated since late last year when the tariffs became more palpable – has likely already dampened investment decisions, weighing on economic growth in 2025.

Government and BoC to coordinate a strong policy response. Compared with U.S. tariffs imposed on Canadian steel and aluminum products back in 2018, which triggered a $2 billion government support initiative for affected producers and exporters, the new tariffs will warrant a far more aggressive fiscal stimulus. Even so, Canada's federal government is well positioned to provide it. Although the Bank of Canada must walk a fine line between supporting growth and maintaining price stability, Canada's current economic environment gives the Bank room for further policy easing. This will ensure that the economy is on as strong a footing as possible before potential tariffs hit. While higher inflation may emerge, the BoC will likely maintain a dovish bias. Hiking interest rates in the midst of a trade war this size would not only fail to address the root cause of inflation – an external supply shock – but it would also further penalize an economy already under strain from trade disruptions.

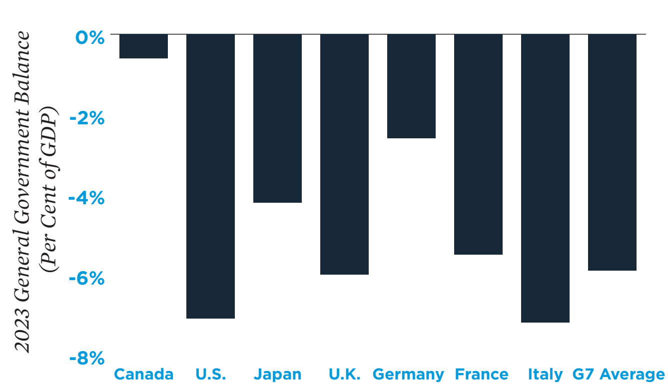
Tariffs Spike for U.S. Imports from Canada



Canada GDP Growth Trend



Canada's Fiscal Health Offers Room for Stimulus



** Increase in tariff rates measured in percentage points; ^ Calculated as total collected duty divided by total import value; the 2024 tariff rates are based on data from January to November*
Sources: Bank of Canada; Canadian Chamber of Commerce; IMF; Statistics Canada; United States Census Bureau

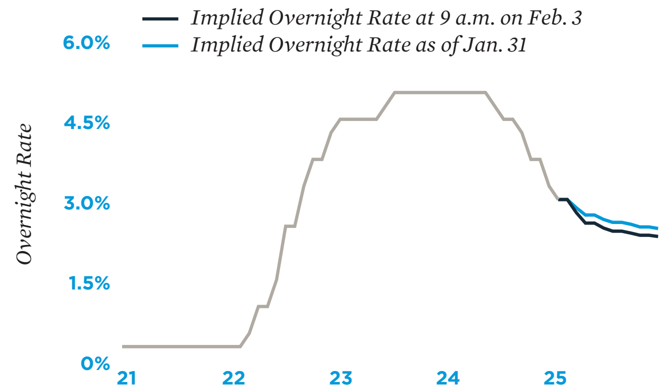
Impact on Commercial Real Estate in Canada

Trade tensions pose a material threat to industrial sector. As potential tariffs could dampen demand across the manufacturing, warehousing and transportation industries, the industrial sector will feel an immediate impact. If enacted, nationwide demand for industrial space will decline, with existing tenants considering right-sizing and potential lessees adopting a wait-and-see approach. Many development projects will likely be postponed or cancelled, but the immediate demand shock is expected to outweigh any longer-term supply-side adjustments. As a result, the national vacancy rate could rise to a higher level in 2025 than initially forecasted. By region, Ontario and Quebec are poised to bear the brunt of this on account of their large manufacturing presences and deep trade ties with the U.S. Alberta will be less affected, given the relatively lower duties on energy products. Meanwhile, British Columbia may mitigate some of the negative effects through its stronger trade connections with Asia.

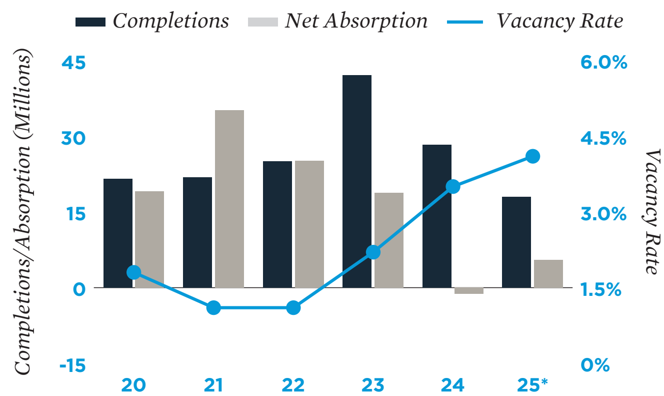
Near-shoring and export diversification to gain priority. With the U.S. administration also threatening to impose tariffs on other major economies, the global near-shoring trend is set to accelerate, even if the tariff threats prove less severe than they initially appear. In response, governments may introduce additional policies to bolster domestic manufacturing, mitigate supply chain vulnerabilities and attract investment in key industries such as advanced automotive, semiconductors and food processing, along with defense and aerospace. Canada is also expected to continue diversifying its energy export markets. Beyond the Trans Mountain Pipeline Expansion, major projects include multiple LNG initiatives for Asian and European markets, as well as hydrogen export agreements with Europe. These long-term projects will help broaden the sources of demand in the industrial sector, reducing exposure to external shocks in the future.

Tariff hikes dim retail sector outlook. Reinflation and lower personal incomes would pose a significant challenge for consumers. Although the BoC is expected to cut rates to cushion the impact, a trade war would ultimately hinder overall consumption. If enacted, demand for retail space will shrink, coinciding with a period of minimal consumer base expansion amid tighter immigration policies. The vacancy rate could rise notably after staying below 2.0 per cent for the past three years. During this downturn, however, spending on essential goods – particularly at discount stores and those sourcing domestic and local products – may stay more resilient while discretionary spending takes a bigger hit. Tariffs could also disproportionately affect smaller retailers, who tend to lack bargaining power due to thinner profit margins and less flexible supply chains. That said, this could present a favourable entry point for tenants who have faced challenges securing available spaces.

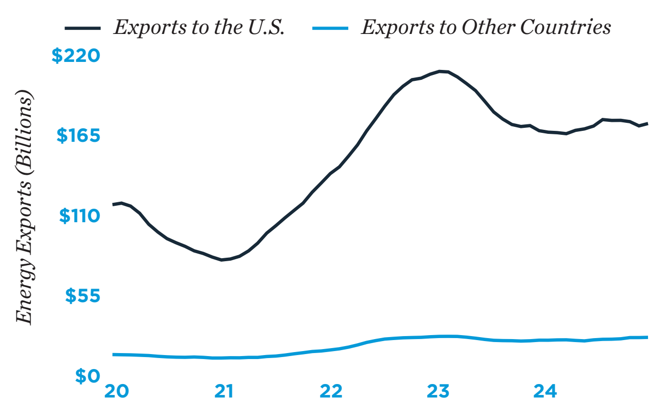
Market Expects More Easing for Trade War



Industrial Demand Softening Entering 2025



Energy Export Diversification Underway

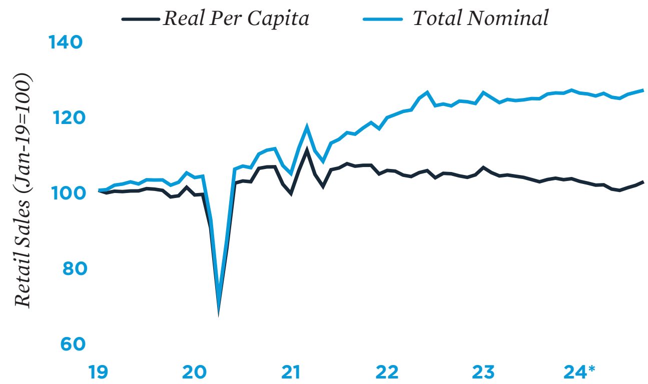


** Forecasts assuming no change from 2024 tariff duties*
Sources: Altus Data Solutions; Bank of Canada; Globe and Mail; Statistics Canada

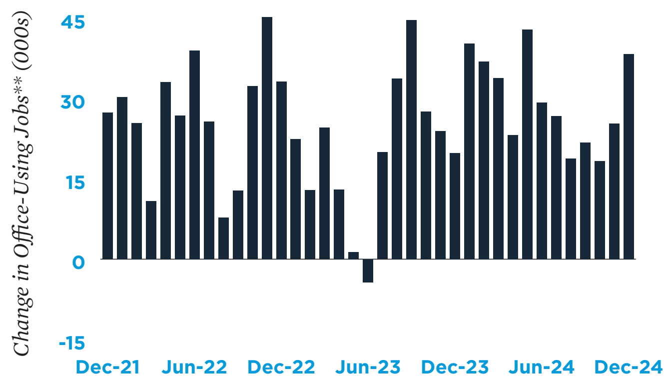
Office sector recovery could grind to a halt. If a recession takes hold, it would disrupt the ongoing recovery in the office sector. With post-pandemic hybrid work arrangements and governments' office divestment having already dampened office utilization, trade disruptions could drive vacancy even higher. This is on top of rising unemployment and cost-cutting measures tempering business expansion and leasing. While tariffs remain a primary downside risk, potential shifts in services trade with the U.S. could present an upside for Canada. For example, if the U.S. follows through on securing greater access to Canada's banking sector, which counts as an import of U.S. services, an influx of American financial institutions opening branches in Canada could drive more demand for downtown office space.

Investors brace for impact. Uncertainties surrounding trade tensions will be a dominating factor dictating the transaction market's performance in 2025. If planned tariffs do not materialize, a recovery in sales activity could still take shape, supported by a dovish BoC; however, the damage to investor sentiment will likely lead to a weaker rebound than initially projected. In the worst-case scenario where all proposed tariffs are implemented, a significant contraction in sales across all sectors is inevitable due to deteriorating fundamentals. The industrial and retail sectors would be hit the hardest, as they face the most direct impact from higher tariffs. Investors will likely gravitate toward properties with stronger insulation from trade disruptions, particularly those occupied by tenants with well-established domestic supply chains. That said, further easing of financial conditions could present attractive entry points for investors focused on long-term gains, especially if property values undergo a substantial adjustment.

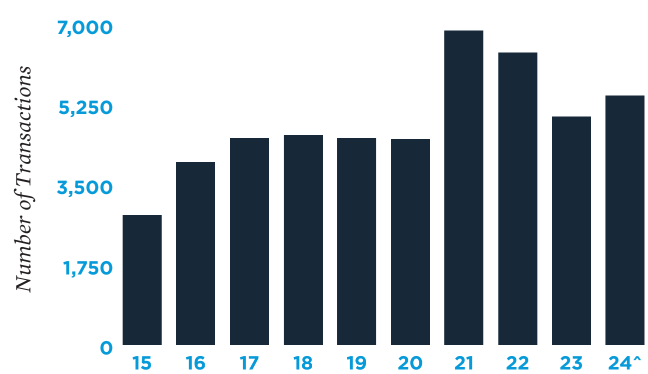
Real Per Capita Spending Already Stagnated



Creation of Office-Using Jobs at Healthy Pace



Investment Activity Began to Recover in 2024



* Through October; ** 3-month average; ^ Trailing 12-month sum through 3Q

Sources: Marcus & Millichap Research Services; Altus Data Solutions; Bank of Canada; Canadian Chamber of Commerce; Globe and Mail; IMF; Statistics Canada; United States Census Bureau

Price: $1,500

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