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**From:** Ed Devlin and Dane Rowlands  
**To:** Trade War Observers  
**Re:** ANALYZING THAT DAVOS SPEECH THROUGH A FINANCIAL MARKET  
MANAGER'S LENS

Mark Carney's China deal that sees tariff reductions on Canadian canola products, lobster, peas and crabs in exchange for allowing 49,000 electric vehicles to enter Canada, signaled a clear plan to diversify trade away from the United States.

The following week, his speech in Davos, Switzerland, furthered the notion of greater trade diversity and the need for counterweights to the world's large powers and the risks that they may violate trade agreements. This angered US officials who have asked pointed questions about the wisdom of substituting trade away from the United States.

An experienced fixed income derivatives traders, will apply counterparty risk management to reduce the risks in situations when there are concerns about the ability or willingness of trading partners to fulfill their obligations.

During the 2008 financial crisis, the collapse of Lehman Brothers forced the replacement of a large trading partner and required active risk management of large financial institutions. That episode underscored that every trading relationship is a bundle of mutual obligations, and that the failure of a large trading partner can cascade through the system. The Prime Minister's Davos speech extends that same logic of counterparty risk from the derivatives desk to the international trading system.

Mr. Carney describes a world that has moved from a rules-based order to one where great powers weaponize tariffs, financial infrastructure, and supply chains.

Middle powers like Canada, the EU, Japan, and Australia are no longer dealing with a benign "risk-free" hegemon; the reliability of their counterparties must now be actively managed in the same way financial markets had to adjust to the higher default risk of firms such as Lehman. His recommendation that middle powers build strategic autonomy and new institutions embodies a risk manager's instinct: Diversify exposures, strengthen terms, and never assume that yesterday's triple A counterparty is risk free forever.

Markowitz portfolio theory clarifies the Prime Minister's argument: In the Markowitz model, a decisionmaker constructs a portfolio of risky assets to maximize expected return for a given level of risk. For Canada, the "assets" are goods and services trade with other countries, each with its own risk-return profile. Historically, the United States was low-risk (highly reliable, politically stable) and high-return (proximate, wealthy), a safe anchor for Canada's economic architecture. Currently, the United States is now a higher risk trade.

When the United States threatens or imposes tariffs, quite possibly illegally, or otherwise breaches the spirit or letter of prior agreements, it effectively "defaults" on part of its trade obligations, lowering expected returns.

The new risk return tradeoff makes it less attractive to remain concentrated on US trade. Diversification, even towards countries with higher absolute risk than the United States, are part of the new optimal mix because the "safe" benchmark has changed. In this setting, engaging more with other countries, as well as China, for increased trade is not a rejection of the United States, but a rational response to an unstable large trading partner.

The Davos speech's call for middle powers to "act together" is meant to further optimize Canada's risk-return profile. By negotiating agreements with democratic, market-oriented middle powers, Canada can gain access to a large, diversified market that is less vulnerable to the behavior of any single member. Having undergone the costs of integrating with the US economy, Canada has left itself exposed to the asymmetric burden of disengagement, a vulnerability now being exploited.

Acting collectively improves each member's best alternative to a negotiated settlement, thereby strengthening their bargaining power. With credible collective alternatives, middle powers such as Canada can also motivate hegemonies (China and the United States) to become more desirable partners by being more reliable and predictable, and by moderating their demands for concessions.

Sovereignty means that countries can always renege on negotiated agreements, akin to the failure of a counterparty in financial markets.

How would financial markets deal with this possibility? The solution on the desk is not just to diversify, but also to tighten contract terms. Untrustworthy or lower rated counterparties are required to post collateral to offset the risk of violating contract terms. Economic integration has instead been weaponized, breaching both the spirit and the terms of economic agreements. In bilateral and multilateral trade deals, the credibility of dispute resolution mechanisms appears to be weakening, and without collateral offsets, it is unclear who may remain Canada's reliable partners.

Framed through the lens of a portfolio manager in financial markets, the Davos message points to a coherent strategy for Canada and other middle powers. The resulting policy prescription is clear: Diversify and rebalance the portfolio of economic partners rather than relying on single hegemon; organize and act collectively to resist coercive behavior, establish a fairer, rules based system; and consider ways to strengthen the commitments that our partners make in trade agreements.

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