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NAFTA renegotiations risk and main implications for investors

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- *The North American Free Trade Agreement (NAFTA) is a trilateral pact between the U.S., Canada and Mexico that has been in force since 1994. Negotiations to revamp and modernize it, requested by the U.S., started in August 2017 and are now encountering some issues.*
- *From a US perspective, withdrawal from NAFTA would have significant impacts on domestic industries and jobs. Trade, foreign direct investments flows among the three partners, and jobs would be affected. Moreover, a withdrawal from NAFTA would not only have economic effects but it would combine with an intense political agenda (elections in Mexico, midterms in the US). Hence, in the short-term, we see the risk of a pull-out from the U.S. as decreasing, but we acknowledge the topic could resurface once elections took place.*
- *As far as the development of US trade policy in general is concerned, in the short term, we think that the current administration is not likely to take broad disruptive actions in an attempt to align the principles of "fair and reciprocal trade" with "America first" rhetoric.*
- *From a multi-asset perspective, a halt in NAFTA renegotiations could affect commodity prices and sector rotation in US equities, but we believe that it is premature to take a position on these issues, given the current high level of uncertainty.*
- *In the US equity market, the agriculture and automotive sectors could be the hardest hit in the theoretically unlikely event of a US withdrawal from the agreement.*
- *The global economy should aim for balanced development: the accumulation of massive trade surpluses may become unsustainable at a certain stage and protectionist policies to preserve such surpluses may undermine the strength of the recovery and of the stock markets. If trade policies are designed to encourage balanced development of different economies, they are in general positive in the long term.*

What is NAFTA and how are the renegotiations proceeding?

A.U. The North American Free Trade Agreement (NAFTA) is a trilateral pact between the US, Canada and Mexico that has been in force since 1994. Currently, it is the world's largest trade agreement. Negotiations to revamp and modernize it, requested by the US, started in August 2017. Tensions have increased regarding the agreement, with the new US administration's focus on nationalistic "buy American" proposals and pushing on issues considered hardly receivable by the counterparties. This has cast a shadow on the negotiations, resulting in a lower likelihood of the parties coming to an understanding, with a raised threat of a unilateral withdrawal by the US frequently being mentioned by US officials and President Trump. The last round of negotiations was more constructive, with progress being made even if at a very slow pace. All participants declared their commitment to working towards reaching an agreement, with a new round of talks announced for late February, to take place in Mexico.

What are the major challenges ahead?

A.U. We need to keep in mind, however, that a number of sticky issues remain on the table yet to be solved, including: stricter rules for North American and US-specific content; a new NAFTA review process; and a new dispute settlement system. The process to reach agreement may be slower than previously expected and bumpier: the US busy agenda of specific investigations in the months to come will offer the opportunity for more targeted and unilateral trade actions by the US, with the risk of increasing tensions. Upcoming Mexican elections and US mid-terms could result in domestic and international political blowback. The rhetoric used by the counterparties which have made clear they are preparing for all possible outcomes in response to the increased uncertainty relating to the US trade policy stance will be used as a powerful negotiating tool. In the short-term yet, we may see the parties keeping negotiations to proceed without yielding a breakdown.

Could you provide a cost/benefit analysis for the US associated with the different scenarios? What are the incentives for the US to stay in the trade agreement?

"The impact of withdrawing from NAFTA on domestic industries and jobs would be significant, especially in agriculture, manufacturing and auto manufacturing".

A.U. Looking at this problem only from a US perspective, the potential impact on domestic industries and jobs of withdrawing from NAFTA would be significant. Opposition from strong lobbying forces has been building over the last months to make clear the serious impact that a NAFTA withdrawal would have, especially on agriculture, manufacturing and the auto industry. Trade, foreign direct investment flows among the three partners, and jobs will be affected. Moreover, withdrawal from NAFTA would have not only an economic impact, but would also result in a strong political backlash in an election year. As an example, in 2016, US exports of goods and services to Canada amounted to more than US$321Bn, and to Mexico more than US$261Bn (nearly 15% and 12% of US total exports, respectively). Imports amounted to US$313Bn and US$324Bn, respectively (approximately 12% of total US imports each). Canada and especially Mexico are key markets for many agricultural products grown in the US: in 2017, Canada was the second-largest export market for the US, at approximately 15% of total US agricultural exports, while Mexico was the third-largest agricultural partner, accounting for almost 12% of US agricultural exports. In addition, over the years, car manufacturing has developed an integrated production chain that would be put at risk should the agreement cease; the US Chamber of Commerce has repeatedly expressed concerns about the state of negotiations. That's why now we do not see the US to rush to a unilateral move in an election year.

How do you expect future trade policy in the US to evolve this year?

A.U. The agenda is quite busy over the next few months in terms of events that could have an impact on the perception of the US stance on trade, including the outcomes from investigations regarding steel, aluminum and Chinese intellectual property expropriation, with outcomes all due sometime during the first half of 2018. All of these issues could potentially offer the US the opportunity for more targeted and unilateral trade actions, thus increasing tensions. In the short term, we think that the current administration is not likely to take broad disruptive actions and that the preferred path would be to use targeted actions to send messages and test trade partners while aligning the principles of "fair and reciprocal trade" with the "America first" rhetoric. However, we need to pay attention to how every single targeted action would combine into a broader picture that may change the market perception of the country's long-term stance on free trade (i.e., how likely are further unilateral moves or retaliation from trade partners, and will protectionist tensions across the world be heightened or exacerbated?).

Do you see the "NAFTA withdrawal" risk currently priced in the US stock market? Which sectors could be the hardest hit?

"Agriculture and automotive industries could be the hardest hit in the (unlikely) event of a withdrawal".

M.P. NAFTA withdrawal is highly unlikely but with this administration this possibility cannot be completely ruled out. While in the long term we will have some kind of a trade agreement in North America, it may or may not be NAFTA. After the elections (Mexico and US Mid- term), we think the US could withdraw to renegotiate two separate bilateral agreements, not necessary worse than NAFTA.

The market does not expect this but it is possible, maybe even likely, given the hard negotiating tactics of this administration. Ultimately both Canada and Mexico have huge trading surpluses with the US and a lot to lose. Agriculture and automotive industry could be the hardest hit but it could be an excuse to justify a broader correction that the market would need anyway.

More generally, do you believe that the Trump administration's stance on trade policy could undermine the strength of stock markets globally?

"Global stock market growth will be more robust if export-driven economies decide to open up to imports, opting for a more balanced development".

M.P. President Trump's stance on trade could damage those economies which do not understand that global growth with massive trade imbalances is not a sustainable model. We point, for example, to the US merchandise trade deficit with China, which for the past several years has been significantly larger than with any other US trading partner. The Trump policy of more trade but less imbalance could end up being positive for the stability of the global economy. On the other hand, change comes with risks. The export-driven economies may decide to open their markets to more imports or continue their protectionist policies (see China or Europe on agriculture as examples). The first option would be a very positive development. The second could potentially prove disastrous.

From a multi-asset perspective, what are the implications of NAFTA renegotiations and, more generally, the rise in talk of protectionism?

"From a multi-asset perspective, we expect to see effects on commodities and sector rotations in US equities, but we believe that it is too early to take a specific stance, given the high level of uncertainty".

F.S. It's difficult to assess the opportunities for multi-asset investors coming from the next round of negotiations, especially regarding some of the most contentious issues, including rules of origin, agriculture and sunset clauses. There is, at present, intense farming and industrial lobbying activity going on in the US to keep the trade agreement in place. We sense developments may affect commodity markets, thereby driving stocking dynamics (inventories, acreage allocated) over the next few years or, certainly, at the stock-picking level in sectors such as lumber and softwoods, and in energy as well. We believe that the ongoing lack of clarity regarding the US stance, in combination with an overlapping with other important reforms (such as the US corporate tax rates) could generate some positive momentum in some US equity sectors (energy, fertilizers, agriculture) and we are in the process of assessing which negotiating stance will prevail in order to form a definitive view. We currently view it as premature to take a hard position, given the uncertainty. At a macro strategy level, clearly, the potential breakup of NAFTA is the most significant downside risk for rather large economies such as Canada, where investments are expected to be down by 2% by 2019 as a result of uncertainty on trade and the possibility that companies reallocate spending to the US to benefit from lower corporate tax rates. Mexico will be affected too, although assessing the net final effect is even more complicated. As to the rules of origin, for example, we will carefully monitor the Mexican auto sector. Mexico may be able to cope with an increase in the NAFTA content, given its low-cost advantage.

What could be the impact of the NAFTA renegotiations on the Mexican peso (MXN) and the Canadian Dollar (CAD)?

"NAFTA renegotiations could impact currency dynamics".

G.A. Since the start of the year, President Trump's positive tone on the progress of negotiations has helped the MXN to appreciate by around 5% against the US$, and the currency seems to be pricing in diminishing risks of a NAFTA withdrawal. The MXN could still appreciate marginally by end-2018, however, the uncertainties and news flow on local Mexican presidential elections set for 1 July will keep MXN volatility high, with the Mexican central bank (Banxico) maintaining a 'cautious' stance in 1H18.

R.F. We note that, for the time being, the CAD has mostly reacted to the Bank of Canada (BoC) monetary policy, while the NAFTA negotiations rounds have been largely neglected. That said, if negotiations around NAFTA begin to be more tense, such a political factor could certainly come to play a major role. The matter is already affecting the communication tone from the BoC, which shifted during its last monetary policy meeting from hawkish to neutral due to the uncertainties about the trade agreement.

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