Current Market News

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Michael P. Stritch, CFA, Chief Investment Officer, BMO Wealth Management - U.S.
Yung-Yu Ma, Ph.D, Chief Investment Strategist, BMO Wealth Management - U.S.

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NAFTA update: Deal, or no deal?

The Monday, August 27, 2018 announcement from the White House that the U.S. and Mexico have reached the framework of a new trade deal is potentially good news for Mexico and the U.S., but raises more questions than answers for Canada. The U.S. will begin negotiating with Canada "immediately", and Mexican President Pena Nieto was relentless on today's call with President Trump in making sure that Canada was kept front and centre in the discussion. However, Trump was much more focused on ending NAFTA as we know it, dropping it in both name and openly stating that it will now be "terminated' to make way for the new deal—whether that includes Canada or not. Still, financial market reaction has certainly been positive, with the Mexican peso rising nearly 1%, and trade-related equities powering ahead, while the Canadian dollar has also managed to rise nearly 0.5%. Let's dig deeper into what exactly has been agreed to, what issues remain unresolved, what Canada now faces, and what are the implications of the deal.

1. What did the U.S. and Mexico Agree To?

First, here's what the U.S. and Mexico have actually agreed to so far:

- Overall, several bilateral issues that would remake NAFTA, perhaps the most important of which is on **autos**. The deal would require 75% auto content made in the NAFTA region versus 62.5% currently. It would also require 40-45% of auto content made by workers earning at least $16 an hour.
- The U.S. backed down on a 5-year **sunset clause**. Instead, the deal will be reviewed every six years and will only be eligible for expiration after 16 years. The deal can then be extended for another 16 years if there are no irreconcilable issues in the review process. If a key issue is identified after the six-year review, the deal would be reviewed every year until that key issue was resolved.
- Mexico will double its **de minimus duty-free shipment** values to $100.
- To practice **labour rights** recognized by International Labor Organization (which should improve working conditions in Mexico).
- Ten years of data protection for **biological drugs.**
- Retain duty-free access for **farm products**, and retain dispute rights for energy and telecom industries.
- Stronger **rules-of-origin** for industrial products, such as chemicals and steel-intensive products.
- Stronger rules governing the **textile industry** that would promote U.S. fabric products and limit the use of non-NAFTA inputs.
- Address non-tariff barriers for re-manufactured goods.
- Mexico agreed to immediately start purchasing as many **U.S. farm products** as possible.

Of note, Trump proposed to **change NAFTA's name**, but no word on whether Mexico agreed. Trump's preferred choice, "The United States Mexico Trade Agreement", suggests Canada will need to make concessions to remain part of the deal.

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2. What issues are still outstanding?

There's uncertainty as to whether NAFTA's **Chapter 11** (investor-state) and **Chapter 19** (anti-dumping and countervailing duty) dispute settlement mechanisms have been modified in the new US-Mexico deal. On Chapter 11, reports say that there were no changes for the energy or telecom sectors... something the incoming Mexican Administration was pushing for. This suggests that Chapter 11 -- and possibly Chapter 19 -- might have made it through to the new deal relatively unscathed. The USTR had been pushing for both chapters to be scrapped in any new NAFTA deal.

Also unclear is the fate of the USTR's push for more restrictive **government procurement** practices. It's possible the U.S. has simply dropped this demand, which Canada also objected to strenuously.

Note that U.S. Trade Representative Lighthizer said that the Section 232 tariffs on Mexican **steel and aluminum** will not be lifted.

3. What does Canada now face?

Clearly, the pressure now falls entirely on Canada. A senior U.S. trade representative said that there are hopes that a deal can be reached by Friday, suggesting that the demands on Canada cannot be overly complex. Yet, President Trump specifically highlighted his long-standing issues with Canada's supply management system during his press conference, seemingly indicating that any deal would need to include some movement on that front. As well, Trump's comment that *"I think with Canada, frankly, the easiest we can do is to tariff their cars coming in"* is a pretty strong indication that the Administration, at least, believes it has the leverage to force Canada to accept U.S. demands—the proverbial take it, or leave it. Suffice it to say, that hardly sets a positive tone for what could be intense negotiations in the next few days.

Along those lines, one of the first comments from a Canadian Foreign Affairs spokesperson was that Canada would only sign a deal that was good for the country, and Prime Minister Trudeau has been oft-quoted suggesting that he wouldn't sign "any deal" and/or that "no deal is better than a bad deal". Of course, besides the pressure to compromise on dairy and supply management more broadly, the **issue for Canada was maintaining the dispute settlement mechanism** (Chapter 19), which could become another lynchpin in this week's discussions. Recall that this was the issue that almost prompted Canada to walk away from the initial Canada/U.S. Free-Trade Agreement negotiations way back in 1987, and is widely viewed as an ultimate red-line in Ottawa.

Depending on what the U.S. now asks of Canada, the **Mexico-U.S. agreement on autos is a potentially positive development for Canada**, since Mexico had been securing the lion's share of recent new investments in the North American auto industry. However, we still openly wonder whether this is a net positive for Canada as things stand right now—it is not yet obvious that a deal agreeable to Ottawa can be reached, and the President's tone today was far from encouraging on that front. In other words, while we are cautiously optimistic, we would not change any Canadian forecasts until Canada is officially part of the deal—or isn't, as the case may be watchful of other risks (e.g. inflation and interest rates, foreign currency) but view them as manageable for now.

4. What happens to the deal if Canada can't be brought on board?

Canada now appears to be in a near-take-it-or-leave-it situation with respect to spinning the U.S.-Mexico deal into a broader agreement on a revamped NAFTA. Should the circumstances dictate that they "leave it" (Mexico is still openly hoping for Canadian participation), a possible 25% tariff on auto production looms, as threated again by President Trump today (through the Section 232 process). But, the fact that a number of Republicans in Congress have expressed the need to keep Canada in any deal could be a chip in Canada's favour. Indeed, should the U.S. and Mexico be relegated to a bilateral deal, the ability to push it into law is unclear, and likely won't be nearly as swift. Technically, the Administration only has negotiating authority to do a trilateral deal, although Lighthizer asserted that current Trade Promotion Authority does allow a bilateral deal. Meantime, a hard deadline to get a deal done by Friday is driven largely by two factors: First, it allows the 90-day notice window (to Congress of a pending trade agreement) to end just in time for outgoing Mexican President Nieto to sign it. And, it would allow Congress to act before any changes resulting from the midterm elections.

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