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Global Perspective

NAFTA 2.0: The impact is unlikely to be contained to North America

Asset Management

September 2017

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The second round of the North American Free Trade Agreement (NAFTA) renegotiations is concluding with little sign of progress and no shortage of tension. How much is at stake and how relevant is this for the rest of the world? Here we consider the risks surrounding this crucial accord.

The discussions started with the US administration seeking to make major changes to an agreement that it views as fundamentally flawed and damaging to the US economy and workforce. President Trump goes as far as to threaten to leave NAFTA if the US doesn't get the amendments it is seeking. The current level of tension suggests that the renegotiation will be difficult and complex and is likely to take longer than anticipated. All parties were hoping to complete the renegotiation process by the end of this year or early next, leaving enough time for the agreement to be sealed into law before the Mexican elections next summer.

A background to NAFTA

NAFTA was created in 1994 when Mexico joined the US-Canada Free Trade Agreement signed in 1989. It has been credited for the creation of one of the most well-integrated cross-border supply chains, especially in the automobile industry. The importance of NAFTA for the Canadian and Mexican economies is well-understood, with the US accounting for approximately 65% of the countries' external trade flows. However, while most investors grasp that both countries are major suppliers to the US, many seem to forget that they are also major export markets for US products. Almost 20% of US exports go to Canada and 15% to Mexico, much higher than the 8% going to China, and 4% to Japan and the UK (exports to the EU are 18%). As a result, the economic health of its immediate neighbours can matter for US growth and a hit via NAFTA could reverberate in the US. For example, the decline in Canadian investment in the Oil and Gas industry in 2015 was the main culprit for the decline in US manufacturing activity that year.

Trump's agenda

President Trump views trade as a zero-sum game, where countries having trade surpluses are winners and those with trade deficits are losers, rather than a symbiotic relationship where both parties stand to gain. This might explain his constant complaints of unfairness in the trade relationships with China, Germany, Mexico and others. So the ultimate objective of the NAFTA renegotiation for the US administration seems to be to reduce the US trade deficit, as expressed by Robert Lighthizer, the US trade representative, when he said NAFTA's failure was symbolised by the US trade deficit with Mexico and what he described as an unbalanced relationship in recent years with Canada.

What's on the table?

The main objectives supported by all parties are to:

- Maintain reciprocal duty-free market access for good and services
- Preserve and strengthen investment and market access in the Energy sector to support the security and independence of the North American Energy sector
- Further open up the Financial and Telecom sectors to cross-border competition
- Strengthen property rules
- Upgrade and modernise the rules of origin, which determine the eligibility to tax-free trade

However, the US has some demands that are less acceptable for Mexico and Canada, as discussed below.

Main points of contention

In addition to pursuing a reduction in its trade deficit, the US would also like to eliminate the Chapter 19 dispute settlement mechanism which, the US argues, undermines its sovereignty. This is a big sticking point for both Mexico and Canada; both countries have said that the exclusion of Chapter 19 would be a deal breaker, as both have successfully used it in the past to push back on US protectionist measures. Another goal of the US is to get Canada and Mexico to open up government contracts to US suppliers, but the US is also seeking to close its government contracts to Canadian and Mexican companies; something Canada and Mexico have understandably taken issue with. Canada and Mexico would like to modernise NAFTA - to broadly follow the Trans-Pacific Partnership (TPP) by covering some of the service industries, ecommerce, environment, labour protection, data gathering and sharing, etc. All three countries accepted the broad outcomes of the TPP negotiations before President Trump ultimately refused to sign it.

Implications of the renegotiations

The key in the NAFTA negotiation will be for Canada and Mexico to propose changes to the agreement that President Trump can claim as **his** victory but that do not disrupt too much the flow of trade within North America. This is most likely to come from reshaping NAFTA so that it discriminates against non-NAFTA countries, especially China and other countries with a big trade surplus with the US.

One way to achieve this would be to have more stringent rule-of-origin provisions, i.e. a higher minimum share of a product's NAFTA content in order to qualify for tariff-free trade, together with a closer control of compliance with these rules. The NAFTA countries might also launch investigations and retaliation against third countries' unfair practices and "trade dumping" (exporting at a loss in order to gain market share). We believe such measures are most likely to be aimed at China, especially regarding steel and intellectual property. However, it is not clear whether Canada and Mexico would want to alienate China.

Such changes to the agreement could provide the US President with claims that the revamped NAFTA had created a trade agreement that protects Americans workers against the unfair practices of China. However, this puts the US, and its NAFTA partners, on a collision course with China, raising the risk of a trade war with all its negative implications for global trade growth.

Conclusion

The renegotiation of NAFTA will be complex and the early comments for the negotiation teams suggest that reaching an agreement will be difficult and protracted. These renegotiations are a major risk to the economies in North America. However, we believe that a greater risk may be that NAFTA could set the stage for greater trade disruption and a clash between the US and China, with much bigger consequences for the global economy.

It is important to stress that while these are risks that investors need to bear in mind when investing, ultimately they do not change our views. We continue to believe the broad outlook for emerging markets remains positive. Fundamentals have improved quite broadly and valuations remain attractive. Moreover, emerging markets are less sensitive to the fortunes and monetary policies of developed markets than they were at the time of the 'taper tantrum'. However, not all emerging market economies have progressed at the same rate and on all measures, and not all are at the same stage in their economic cycles. Furthermore, not all emerging economies have solved the governance issues of the past. We believe the attractive positioning of the asset class is very real, but given the issue of heterogeneity in emerging markets – particularly in light of evolving risk factors - we believe that a quality-driven, fundamentals-based approach remains key. And with bond market liquidity fractured, we also believe investors should seek low-turnover investment approaches.