Gyroscope Capital Management Group

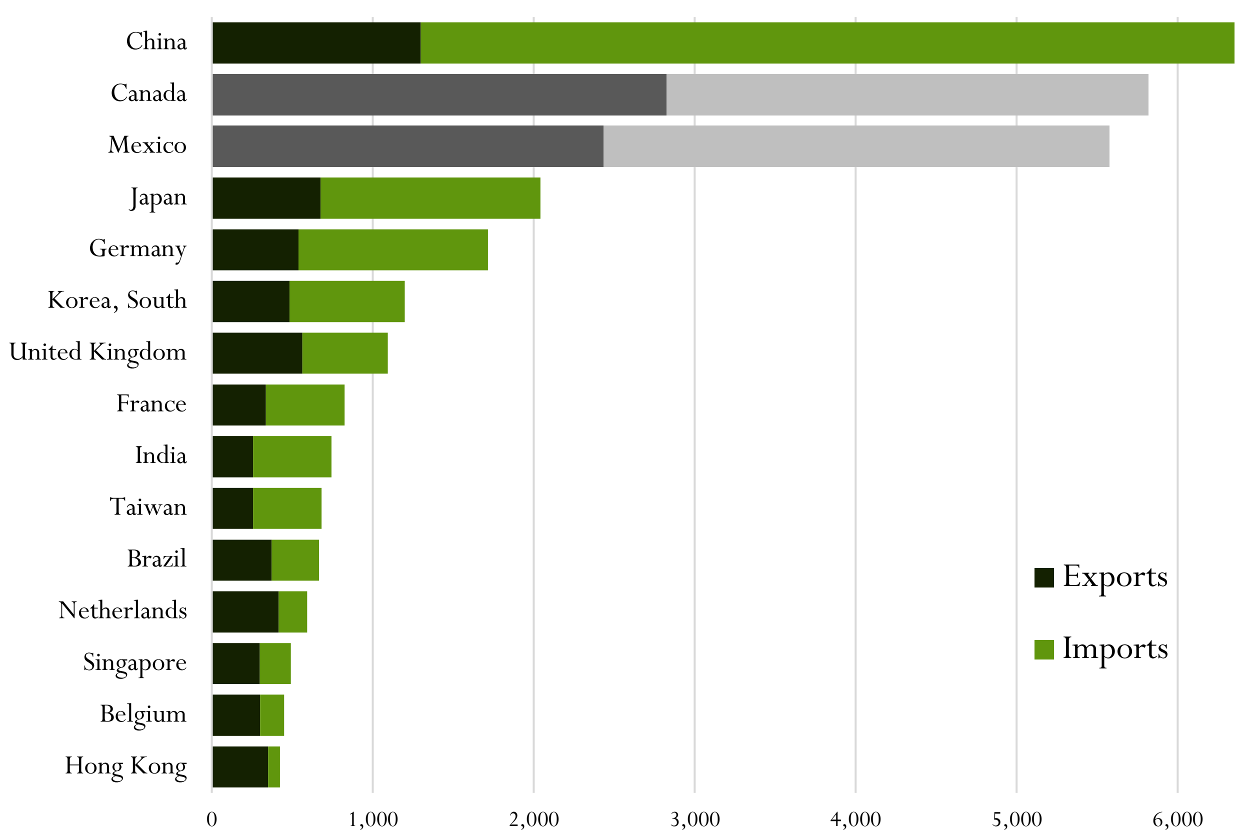
Wednesday, October 24, 2018

Quarterly Review and Commentary

On September 30th, the U.S., Mexico, and Canada came to terms on a new trade deal to replace the North American Free Trade Agreement ("NAFTA"). Negotiations came to a close after over a year of talks to renegotiate the decades-old agreement. The new United States-Mexico-Canada Agreement ("USMCA") seeks to create more equitable trade between the United States and its two North American neighbors. Despite the new name however, USMCA seems remarkable similar to the old NAFTA. The fundamental structure of the prior agreement remains intact, with some material revisions on autos, dairy, intellectual property, and digital commerce.

For the remainder of this piece, we discuss the changes to each of these topics and our take on the economic implications of each before drawing a conclusion of the deal as a whole and its potential impact on future trade negotiations.

Value of 2017 U.S. Trade in Goods by Country



Source: U.S. Census Bureau- https://www.census.gov/foreign-trade/balance/index.html

The chart above depicts Census Bureau data for 2017 exports and imports for America's top trading partners and clearly demonstrates the relative U.S. trade volumes covered by NAFTA.

NEW RULES FOR AUTO MANUFACTURERS

The most significant change for auto manufacturers pertains to Country of Origin rules. NAFTA had required 62.5% of car and truck components be manufactured in North America. USMCA increases this requirement to 75%. The motivation for this change is to force auto manufacturers to use parts from North America rather than cheaper parts from Asia. USMCA further requires that 40% of auto content be produced by workers earning at least $16/hr. Trump has labeled this requirement as a win for the U.S. as it is intended to limit the advantage of inexpensive Mexican labor and reduce the incentive for U.S. producers to relocate factories to Mexico. Further auto-rule changes come in the form of exemptions granted to Canada and Mexico to protect them from any future American passenger vehicle tariffs, granting the tariff-free export of 2.6 million vehicles per year.

OUR TAKE: We do not expect the new rules on autos to have a beneficial impact on economic activity in the U.S. or North America as a whole. We believe a 2.5% tariff may not be enough of a disincentive for car manufacturers to move production back to the United States. The requirement that more vehicle content be produced by higher-payed workers should reduce Mexico's labor-cost advantage and shift car making jobs to the U.S. However, this provision also entails cost increases and productivity losses that will make it more difficult for all three countries to compete with the likes of European and Asian manufacturers. Finally, the 2.6 million vehicle annual cap on exports to the U.S. may discourage capacity expansion in Mexico but current Mexican shipments are below this cap and Canada's shipments fall short by roughly one million vehicles. Thus, this cap is unlikely to prove consequential given the trend of stagnating U.S. auto demand.

GREATER ACCESS TO THE CANADIAN DAIRY MARKET

Canada employs a system of quotas and tariffs to control the flow of foreign dairy entering the country. As a result of USMCA negotiations, the U.S. has been granted access to 3.59% of the Canadian dairy market, which is marginally more than the 3.2% negotiated under the Trans-Pacific Partnership ("TPP"). The agreement also eliminates a dairy classification, "Class 7" milk, which U.S. dairy farmers have complained limits their ability to export to Canada.

OUR TAKE: Reducing trade barriers for U.S. dairy farmers to sell their products in Canada had been a sticking point for Trump, who commented that "dairy was a deal breaker" shortly after negotiations came to a close. While U.S. dairy farmers (and probably Canadian consumers) have reason to rejoice, U.S. dairy exports to Canada totaled $792 million in 2017, or roughly 0.30% of total U.S. to Canada exports. U.S. dairy farmers may benefit at the expense of their Canadian counterparts but USMCA dairy provisions will not move the dial on U.S. economic activity.

INTELLECTUAL PROPERTY AND DIGITAL TRADE

USMCA provides greater protections for copyrights and drug patents and addresses some issues that have arisen with the digital economy, which wasn't explicitly addressed when NAFTA was originally negotiated. The new agreement extends copyright terms from 50 years after the life of the author to 70 years. USMCA also provides greater protection for biologic patents, shielding these drugs from generic competition for 10 years instead of the eight provided by NAFTA. Also, USMCA provisions address issues pertaining to the removal of duties on electronically-produced products such as music and e-books while also providing protections for companies so that they cannot be held accountable for content their costumers produce.

OUR TAKE: We applaud the increase in intellectual property protections as they strengthen the incentive for U.S. individuals and companies to invest in the creation of new products, whether they be books or biologic drugs. We see the new provisions related to the digital economy as falling short of what's needed to address the complexities of modern digital trade (particularly as it relates to empowering consumers to enforce their rights across borders). However, we do view new digital trade provisions as a good start.

DISPUTE RESOLUTIONS AND SUNSET TERMS

Canadian negotiators succeeded in preserving NAFTA's Chapter 19, which set up an independent arbitration-like mechanism to resolve trade disputes outside of domestic courts. The elimination of this item was a deal breaker for the Canadians and its survival is commonly viewed as a win for Canada. Chapter 11, a provision in the original NAFTA, gave investors the ability to sue governments over environmental and health regulations that they claim would impact their profitability. This provision has been completely eliminated for the U.S. and Canada and substantially restricted in Mexico for all but a few sectors. A new sunset clause puts a 16-year shelf life on the terms of the agreement, which will expire if not renewed by all partners. The deal is also subject to review every six years at which time the partners can decide to extend the agreement.

OUR TAKE: We agree with keeping trade disputes out of domestic courts. Arbitration is a fair alternative that should help expedite resolutions and ensure the flow of goods across borders. The sunset clause and renewal terms may hinder capital investment in the North American market as firms may fear that the agreement terms could change.

USMCA APPROVAL

The deal has been struck, but it still must be signed and then ratified by each country. The three leaders are expected to sign the agreement prior to Peña Nieto leaving office at the end of November. It is plausible that the three leaders will do so at the upcoming G20 summit in Buenos Aires in November. Again, the signing of the agreement is the first step to implementation; it must then be ratified by all three governments.

While it is expected to be ratified by each country, there is potential political opposition to the deal in both U.S. and Canada. If the Democrats take control of the U.S. Senate, there is fear that they will oppose the trade agreement out of political spite. For Canada, resentment lingers over significant concessions related to agriculture and still-in-effect steel and aluminum tariffs.

PUTTING IT ALL TOGETHER

Tariff-free trade in most goods and services is a benefit for the U.S., Canada and Mexico. It is a valuable component of USMCA, but signatories already had this in NAFTA. USMCA certainly does have some improvements relative to NAFTA, but taken as a whole USMCA reduces free trade across the North American continent. The uncertainty caused by the possible total dissolution of NAFTA does not seem worth the concessions received in the dairy and automotive markets. To put the relative importance of each market in perspective, Canadians spent $11 billion on dairy in 2017; Americans spent $498 billion on automobiles and parts. Raising the costs of automobiles for all U.S. manufacturers and consumers in exchange for a marginal benefit to U.S. dairy farmers hardly constitutes a "winning" trade. Further, the use of national security law to protect specific U.S. industries and strong-arm U.S. allies is troubling. These types of tactics may provide a visible short-term benefit, but they damage valuable relationships that have taken many years to cultivate.

Some commentators note that USMCA demonstrated America's willingness to compromise and paves the way for a deal with the E.U. and China. While this may be the case, it's a certainty that European and Asian trade representatives were watching NAFTA negotiations very closely. Whether future U.S. negotiations with the E.U. and China will be fruitful remains to be seen. The USMCA sent these parties a clear message; the U.S. will use the threat of losing access to its markets in order to achieve a marginal improvement in an existing trade relationship so long as it can be touted as a win.

***DISCLOSURE:** *The information in this document is provided solely for illustrative purposes. While Gyroscope Capital believes this information to be accurate, the firm cannot guarantee its accuracy or the validity of the results presented.*