November 24, 2017

Dear clients and colleagues,

On the campaign trail for the US presidency, candidate Trump frequently criticized the North American Free Trade Agreement (NAFTA), calling it "the worst trade deal" in US history and blaming it for the loss of manufacturing jobs in America's Rust Belt.

After taking office, President Trump decided to renegotiate the pact rather than cancelling it right away (note that experts still debate whether it's within the President's power to cancel the agreement).

Negotiations were originally scheduled to be finished by the end of 2017; however, this week's round of negotiations, scheduled to end on November 21, have not progressed much as senior representatives from the three countries were not in attendance. The reason given for their absence is the US is making demands that the other two countries can't possibly agree to. The talks are now scheduled to continue in the first quarter of 2018, although President Trump has again mentioned the idea of cancelling the agreement altogether.

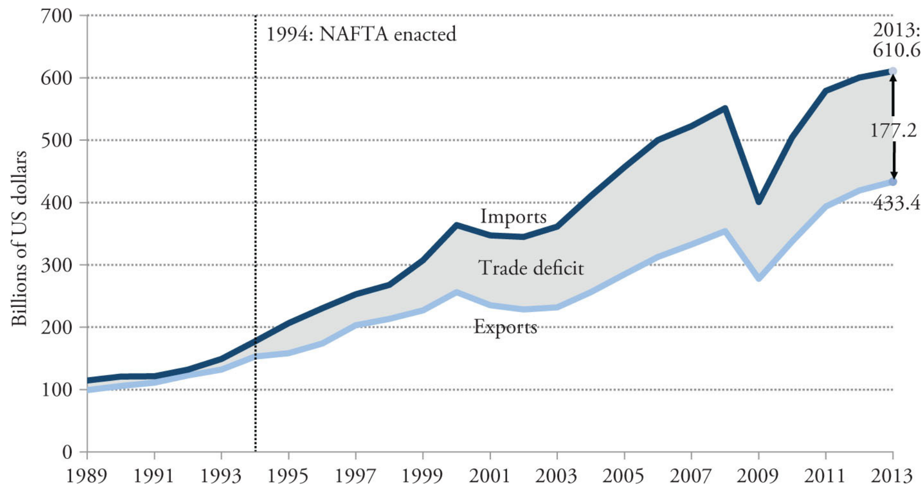
What is NAFTA? What has been the effect on the three countries? What could be the consequences of terminating it? We will try to address these questions in this week's commentary.

NAFTA is an agreement signed by Canada, Mexico and the United States that came into force on January 1, 1994. The idea was first raised by President Ronald Reagan and was negotiated by President George H.W. Bush. The US House of Representatives passed the agreement on November 17, 1993, 234 to 200. The agreement's supporters included 132 Republicans and 102 Democrats. The bill passed the Senate on November 20, 1993, 61 to 38. Senate supporters were 34 Republicans and 27 Democrats. President Clinton signed the agreement into law on December 8, 1993, and it went into effect on January 1, 1994.

Most economic analyses indicate that NAFTA has been beneficial to the economies and the average citizen of North America. They also conclude that withdrawing from or renegotiating NAFTA in a way that re-establishes trade barriers would adversely affect the US economy and cost jobs.

Since NAFTA took effect in 1994, trade between the three countries has more than tripled to over CA$1.3 trillion.

The following three graphs illustrate the growth and the interrelations between the countries.



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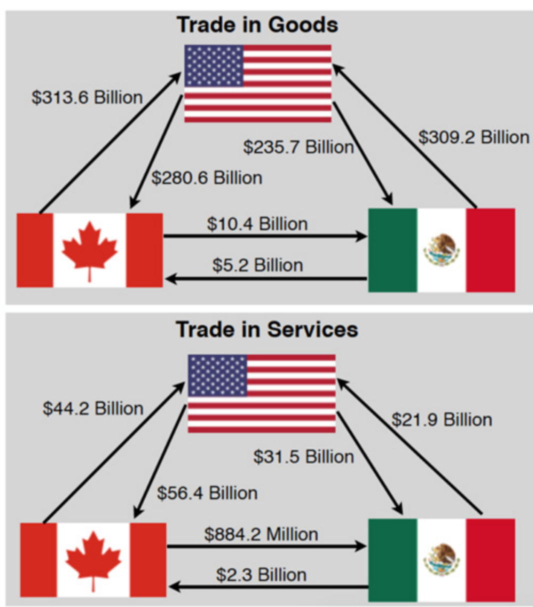


Intra-Regional Trade in NAFTA

Exports of Goods
$1.2 Trillion
Of Which Re-Exported Goods: $125.2 Billion

Exports of Services
$157.2 Billion

Total Exports of Goods & Services
$1.3 Trillion

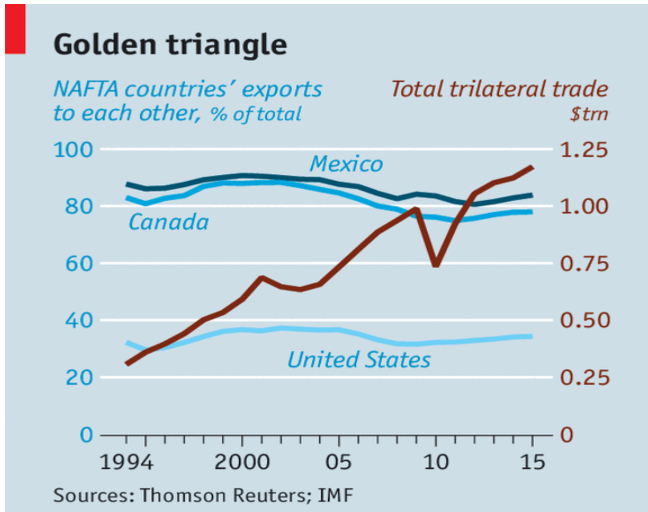
Bilateral Trade Balances in NAFTA

U.S.–Canada	U.S.–Mexico	Canada–Mexico
Deficit: $20.8 Billion	Deficit: $63.9 Billion	Surplus: $3.8 Billion

Leading Trade Partners of NAFTA Countries

	Exports		Imports	
CANADA	U.S.	76.7%	U.S.	53.3%
	EU	7.2%	China	12.3%
	China	3.9%	EU	11.5%
	Japan	1.9%	Mexico	5.8%
MEXICO	U.S.	81.2%	U.S.	47.4%
	EU	4.8%	China	17.7%
	Canada	2.8%	EU	11.1%
	China	1.3%	Japan	4.4%
U.S.	Canada	18.6%	China	21.8%
	EU	18.2%	EU	18.9%
	Mexico	15.7%	Canada	13.0%
	China	7.7%	Mexico	12.9%

Source: Google Search



Economist.com

Impact on the three countries

Canada has seen strong gains related to NAFTA; since 1993, US and Mexican investments in Canada have tripled. US investment, which accounts for more than half of Canada's fixed direct investment, grew from CA$70 billion in 1993 to over CA$368 billion in 2013. Sectors such as agriculture have tripled. Canada is the leading importer of US agricultural products. Canadian agricultural trade with the US has more than tripled since 1994, as did Canada's total agriculture exports to NAFTA partners.

Mexico's NAFTA experience has been more mixed. Between 1993 and 2013, Mexico's economy grew at an average rate of just 1.3 percent a year and per capita income rose at an annual average of 1.2 percent—far slower than countries like Chile, Peru and even Brazil.

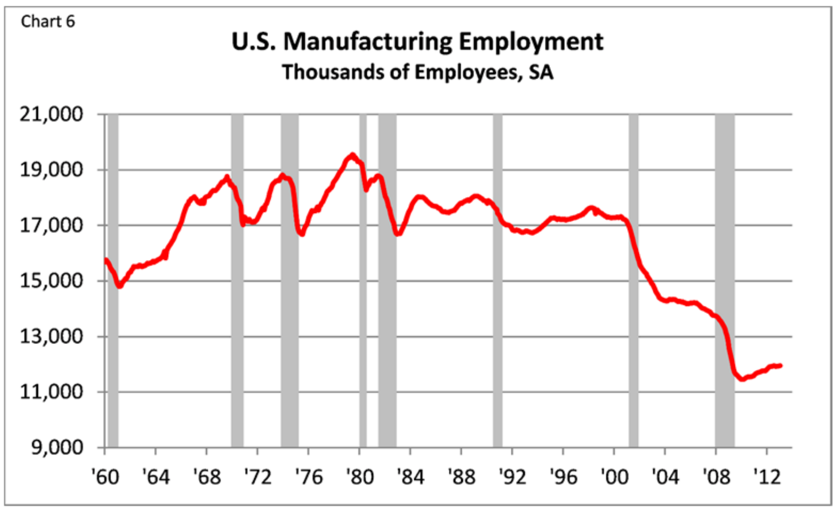
US trade with its NAFTA partners grew more rapidly than its trade with the rest of the world, and Canada and Mexico are the two largest destinations for US exports, accounting for more than a third of the total. However, most estimates conclude that the deal had a modest but positive impact on US GDP of less than 0.5 percent, or a total addition of up to $80 billion to the US economy upon full implementation, or several billion dollars of added growth per year.

However, and to President Trump's point, according to the Economic Policy Institute, California, Texas, Michigan and other states with high concentrations of manufacturing jobs were most affected by job loss due to NAFTA. EPI economist Robert Scott estimates some 682,900 US jobs have been "lost or displaced" as a result of the trade agreement.

The US auto sector has lost some 350,000 jobs since 1994—a third of the industry—while Mexican auto sector employment increased from 120,000 to 550,000 workers.

The US-Mexico trade balance went from a surplus of US$1.7 billion 1993 to a US$54 billion deficit by 2014.

However, many economists have concluded that manufacturing jobs were under stress decades before the treaty (see chart below), and that competition with China has had a much bigger negative impact on US jobs since 2001, when China joined the WTO. Technological changes such as automation have also had an important impact on the sector.



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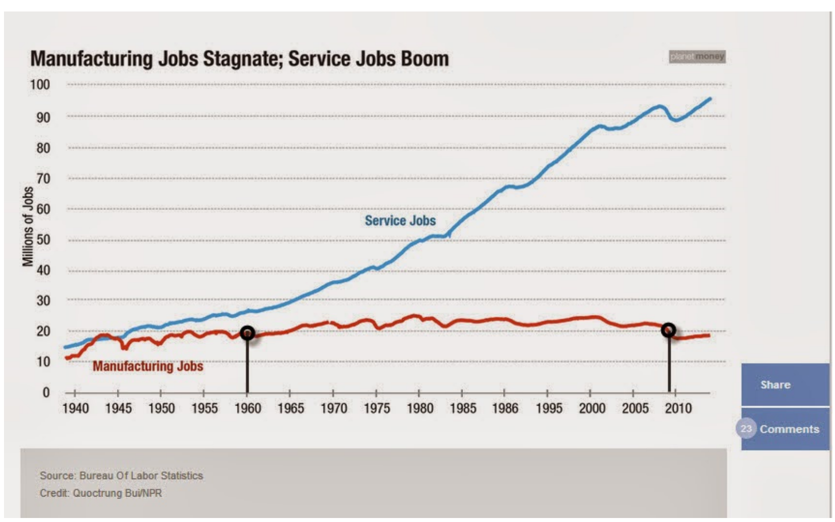
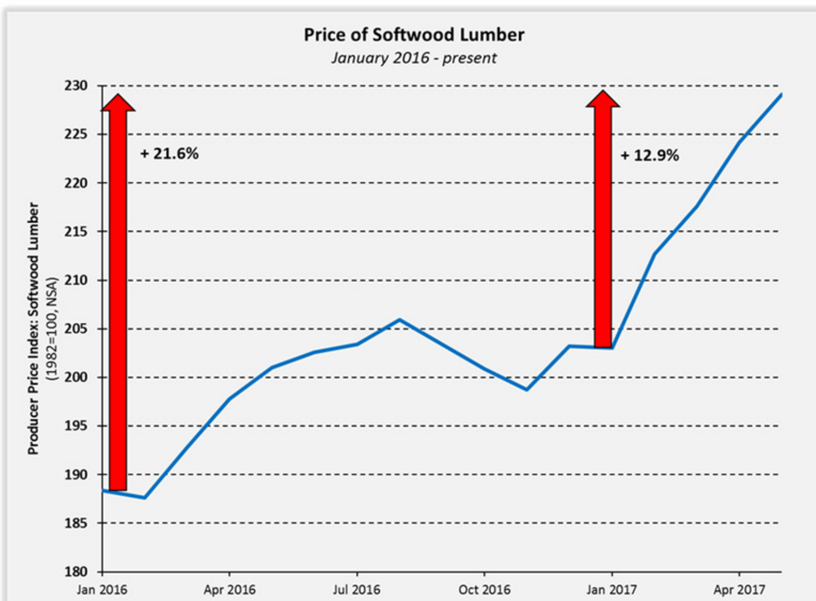


In fact, NAFTA probably helped the US auto sector compete with China. Moving production to Mexico allowed US auto companies to lower costs, just like European auto companies moved production to Eastern Europe. Breaking the complex supply chains now established would play to the advantage of European and Chinese auto companies.

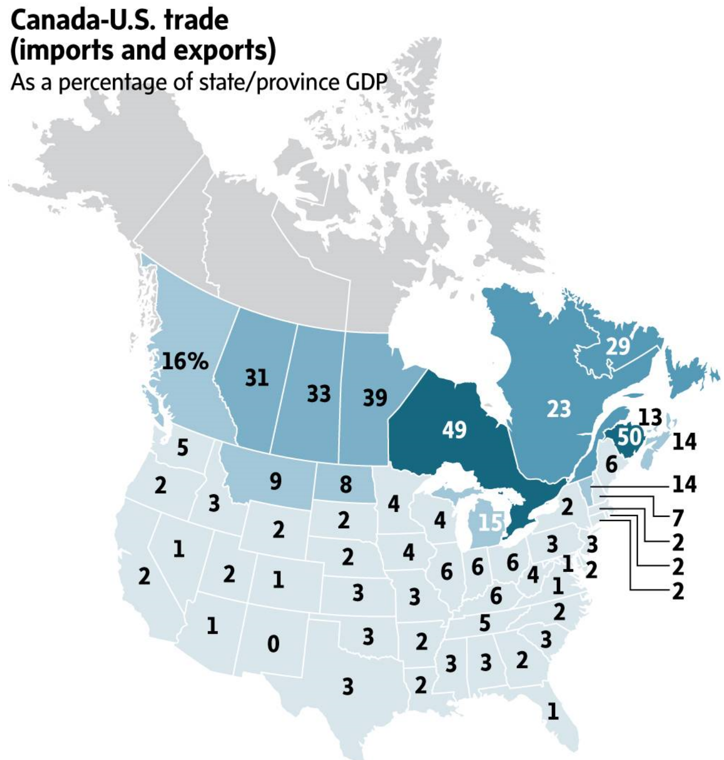
Pulling out of NAFTA would most likely have a range of unintended consequences for the US, including reduced access to its biggest export markets, a reduction in economic growth and increased prices for gasoline, cars, fruits and vegetables. The sectors most impacted would be textiles, agriculture and automobiles.

The chart below shows US lumber prices since the US imposed duties on Canadian lumber.



Source: Google Search

If NAFTA is cancelled, the US, aside from higher inflation, would probably be less impacted than Mexico and a lot less than Canada, the country most affected in our opinion.



Source: Google Search

For Canada, with the US out of NAFTA, experts say prices on everything from cars to groceries would be expected to increase. Unemployment would climb. The Canadian Dollar would weaken.

However, if NAFTA was eliminated, trade between the three countries would revert to the World Trade Organization (WTO), assuming the US stays in the WTO. Under the WTO's "most favoured nation" a 3.5 percent tariff would apply to all goods traded between Canada, Mexico and the US. For Canada, it means real GDP growth would be lower by about 0.5%.

The impact for the US could be more limited. The dozen American states that would be impacted the most from NAFTA's cancellation all happened to vote for Donald Trump, according to projections released in early November by the biggest business lobby in the US, The U.S. Chamber of Commerce.

Nobody knows what the final outcome will be, but it adds one more uncertainty to the markets and the global economy.

Our Global and International portfolios are not very affected by NAFTA. A few companies, such as Limoneira and Farmland Partners, in our Global Portfolio would probably benefit from higher agricultural prices as they produce in the US. Gentherm, an auto parts maker, would see its Mexican operations affected. Of its nine plants, three are in Mexico and one is in Canada. Ethan Allen has one of its nine plants in Mexico. LISI, a French aerospace component manufacturer, has important operations in Canada. THK, a Japanese industrial, has 3 out of 34 plants in Mexico or Canada, and OSG, another Japanese industrial, has 1 out of 17 plants in Mexico or Canada.

Overall, the direct impact would be minimal. That is not to say markets would not react negatively to the termination of the agreement.

Have a good week,

The Global Alpha Team