Special Report

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A timely analysis of economic issues October 1, 2018

How Do You Spell Relief? USMCA

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Overview

After 13 months of sometimes fractious negotiations and waves of uncertainty for Canada's economy, policymakers and financial markets, we have an agreement to replace NAFTA. Talks nearly went down to last night's deadline for submitting an in-writing deal to Congress, but the **U.S. and Canada have agreed in principle on a new deal,** which both leaders have endorsed. Clearly, this is a major relief for Canada, lifting a heavy cloud of uncertainty from the outlook. **The one change we are making to our forecast as a result of the deal is one more Bank of Canada rate hike in 2019 (in January).** Accordingly, the Canadian dollar strengthened 0.7% in overnight trading to just over 78 cents (C$1.279), while the Mexican peso has popped a similar amount.

From Canada's perspective, the biggest concession appears to be giving up access to about 3.5% of the dairy market, in exchange for the preservation of some key areas (such as the dispute resolution mechanism) and some assurances, however technical, that Canada would not be hit by a 25% tariff on autos under Section 232. In a nutshell, **Canada has made concessions, but is coming out quite clean considering the array of potentially negative options or threats that were on the table**. Below are the major elements and key takeaways from Canada's perspective.

What's in the Deal, and Why It Matters

Here are the highlights of the agreement as we know them now:

- **Name and lifespan:** The deal will be called the **United States-Mexico-Canada Agreement**, or **USMCA**. **Canada is largely agreeing to whatever is in the U.S.-Mexico deal**, unless specified otherwise, including the six-year mandatory re-look. More specifically, the new bilateral deal will last for 16 years, with a review to be made at the six-year mark. At that point, the three countries can agree to continue on for another decade (10 years); or, if they are unhappy with how the deal is playing out, formal negotiations will begin. Then, negotiators will have 10 years to come to an agreement. But at least businesses know that they have 16 years of certainty, instead of the initial U.S. proposal of a five-year span, making it much easier to make investment decisions.
- **Chapter 19: The dispute settlement mechanism** for countervailing and anti-dumping duties, a.k.a. **Chapter 19** in the original NAFTA, which was not part of the U.S.-Mexico deal, is retained. (It will apparently now be known as **Chapter 10**.) This was a Canadian red line issue, and was the sticking point on bilateral negotiations as far back as the original FTA in the late 1980s. In other words, this was a big deal for Canada.
- The **state-to-state dispute resolution mechanism** (**Chapter 20**) was already retained in the U.S.-Mexico deal. The investor-state dispute settlement mechanism

(**Chapter 11**) will be eliminated between Canada and the U.S. (A scaled back version was retained with Mexico covering oil and gas, infrastructure and telecommunications.)

- **Dairy: U.S. dairy farmers** will get access to 3.5% of Canada's protected market, slightly above the 3.25% Asia/Pacific nations got under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Canada has agreed to eliminate its Class 6 and Class 7 milk categories within six months (the latter is for dried milk products, which was only recently introduced and raised the ire of President Trump). Given that Canada's domestic dairy market is growing by roughly 1% per year, and that the import quotas will be phased in over six years, Ottawa believes that the industry can gradually adjust to the changes. Even so, Ottawa intends to compensate dairy farmers.
- **Autos:** Higher automotive content (40%-to-45%) coming from higher wage jurisdictions (>US$16). The latter clearly helps Canada versus Mexico. There's a "side letter" guarantee that potential U.S. (Section 232) tariffs on **automotive products** will not be applied to Canada (same as Mexico). In return, Canada agreed to a quota: 2.6 million passenger vehicles per annum and US$32.4 billion in parts (light trucks are exempt). These are not binding constraints as Canada currently produces just under 2 million light vehicles for its domestic and export markets, and currently exports just over C$20 bln (or roughly US$16 bln) in parts. Effectively, this portion of the agreement is more of a safeguard that Canada will not become a high-volume producer in the future; given that Canada's vehicle production has been falling for more than 15 years, this was a low-probability likelihood. We would judge the overall effect of the agreement on autos with the U.S. and Mexico as a net positive for Canada.
- **U.S. steel and aluminum tariffs:** These remain in place for the time being. It looks like a quota here might also be the way out.
- **De Minimus threshold value on imported online goods:** The deal raised the minimum threshold value of Canadian imported goods purchased online (or via mail order) that qualify for duty-free access from C$20 to C$150. Imported goods valued at less than $40 also will be exempt from sales taxes (both the GST and provincial). The higher threshold value comes with both benefits (to consumers and businesses) and costs (to retailers). Canadian consumers will enjoy lower prices and faster delivery times due to less customs processing. Small and medium sized Canadian businesses that buy U.S. supplies online will save on administration costs and face fewer delivery delays, reducing uncertainty in their supply chain. However, Canadian retailers will lose out due to the relative loss of competitiveness.
- **Prescription drugs:** Canada will extend the patent protection for certain **prescription drugs** (biologics) from 8 to 10 years, matching what Mexico had already agreed to. This is the one portion of the deal that is a clear negative for Canada, since it will add to drug costs with precious little upside in return. In addition, Canada made concessions on copyrights (out to 75 years), which were beyond TPP proposals.
- **Cultural:** Previous protections for Canadian **cultural industries** are retained.

- **Timing:** A Trump administration official said Prime Minister Trudeau, President Trump and Mexican President Enrique Pena Nieto will **sign the USMCA at the end of November**. Unless the new deal can then be rushed through in the lame duck session in December, it will need to be ratified by the new U.S. Congress in 2019.

For a deeper dive, the text, as it stands now, was published by the Office of the U.S. Trade Representative here… *https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/united-states-mexico*

Implications for Markets and the Economy

- **The economy:** This deal was mostly about minimizing the negative impact on Canada's economy that could have resulted from the harshest U.S. demands. While Canada has made some concessions, the biggest positive from this deal is that it will remove a massive cloud of uncertainty for policymakers and businesses. **We had been assuming that an agreement would *eventually* be reached in our base case forecast, but the deal heavily reduces lingering uncertainty surrounding the 2019 outlook.** So, effectively, the **risk to our call of 2.0% GDP growth next year**—which we had just bumped up a tick last week, and following 2.1% growth this year—**is now to the upside instead of the downside**.

- **The Bank of Canada:** NAFTA and broader trade uncertainties have been a key issue for the BoC over the past year. Indeed, the September policy statement said *"the Bank is also monitoring closely the course of NAFTA negotiations and other trade policy developments, and their impact on the inflation outlook."* Suffice it to say that this deal, along with last week's solid run of data, all but cements a rate hike at the next policy announcement on October 24, barring something truly shocking over the next three weeks.

  Looking further out on the forecast horizon, a major downside risk to the outlook appears to have been cleared. On three separate occasions over the past year, the BoC downgraded their growth forecast due to trade uncertainty: by 2020Q4 business investment was 2.1% lower and exports 1% lower. It's unlikely the entire downgrade will be immediately reversed, as the Bank has previously said they want to see some evidence that conditions are improving before building it into their forecast. In addition, because the bulk of the downgrade was in business investment, any upward revision there would likely also mean increased capacity/potential growth. Those two factors suggest that Governor Poloz will maintain the *"gradual"* narrative—but that narrative may well change in the months ahead with a deal in hand.

  While rate hikes will likely stay gradual, the pace may pick up slightly more than previously expected over the coming year. **We are now calling for three rate hikes in 2019 (January, April, and July)**, which would keep Canada-U.S. overnight spreads at 37.5 bps, where we expect it to be at the end of October. Indeed, the BoC would be catching up with the Fed through mid-2019.

- **The loonie:** Accompanying the broad move higher in Canadian bond yields, the C$ has appreciated sharply. After trading around the C$1.30 (76.9 US cents) level for much of the past couple of months, the loonie rallied to C$1.28 (78.1 US

cents), for the first time in about five months. This is more or less the market scrubbing out risk of a negative outcome that was built into the market.

There could be modest further near-term currency strength as some of the negative sentiment around Canada unwinds, but the longer-term picture is still challenging for the loonie. Canada continues to struggle from a competitiveness perspective and the USMCA doesn't change that. Broader policy changes are needed to address this issue, meaning any further strength will be relatively limited. **Prior to the deal, we were looking for 78.5 cents ($1.275) for the end of this year and 80 cents (or $1.25) for the end of 2019. We remain generally comfortable with that call,** although similar to the growth outlook, there is now some upside bias to that forecast—especially if Canadian oil prices can better reflect the recent gains in world prices.

- **Stocks:** A limited TSX reaction to the deal likely reflects the fact that much of the index was never all that exposed to a negative NAFTA outcome to begin with (we often argue that the index is not an ideal reflection of the underlying Canadian economy). And, the deal does little to address other weights like the record oil price differential and slowing credit growth. As such, this will be more of a case-by-case basis for equities in the areas such as auto parts, some industrial products and dairy. The bigger picture is that Canadian equities are relatively cheap versus their U.S. peers, with the forward earnings yield gap recently trending around the widest level of the cycle—if this improves sentiment toward Canada more broadly, it could help narrow that gap.
- **Government finances:** Right off the bat, Ottawa made it clear that it will offer some support to the dairy industry as an offset to the concessions made in this trade deal. Look for an announcement in the Fall Economic Statement or Budget 2019, if not earlier. It remains to be seen what the dollar figure for any such support would be. In the wake of past CETA and TPP deals (which each opened up slightly less market share than the USMCA will), the prior government served up roughly $4 billion of support over 10-15 years, through income guarantee and quota value guarantee programs. The good news is that Ottawa's budget deficit is tracking somewhat better than expected in the current fiscal year (a surplus of $4.4 billion in the first four months of FY18/19, versus a deficit of $109 million in the same period a year ago), leaving some flexibility on this front without seriously denting federal finances.

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