

MULTI-ASSET

A View from Canada on the New USMCA

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After more than a year of tense talks, Canada, Mexico and the United States have replaced the North American Free Trade Agreement (NAFTA). Franklin Templeton Multi-Asset Solutions' Stephen Lingard gives his take on the new trilateral trade pact and explains why it could benefit select Canadian companies.

On September 30, Canada and Mexico reached a last-minute deal with the United States to replace the 1994 North American Free Trade Agreement (NAFTA).

We think the new United States-Mexico-Canada Agreement (USMCA) averts the worst fears of a breakdown in trade relations between the three countries and potential disruption to regional supply chains. As we mentioned in a previous [article](#), the protracted renegotiation process posed threats to the North American auto market in particular.

The chart below shows some of the main differences we see between NAFTA and USMCA.

How USMCA Differs from NAFTA

- Tighter country of origin rules—especially tough on the auto industry.
- Minimum level of input from factories paying workers US\$16+ an hour.
- Deal will be reviewed in six years and will take effect for 16 years.
- Improved access to the Canadian dairy industry, but on terms similar to those of the Trans-Pacific Partnership and Comprehensive Economic and Trade Agreement.
- Overall, balanced, with restrictions on trade and investment in some areas (autos) but relaxation in others such as agriculture and technology.

Sources: Office of the United States Trade Representative, Export Development Canada.

In our view, the new North American trade deal is neither especially good nor bad for Canada and Mexico. But the fact that it clears away some of the uncertainties is positive, in our eyes. This new deal may support capital expenditure and remove a headwind from future growth.

However, the path to this agreement included threats, tariffs and sanctions, which are not generally part of the normal course of negotiations.

Where was the collaboration within established institutions? The lasting damage to trust and mutual respect have created a challenging environment. We think this will heighten concern in Canada and Mexico about being so dependent on one trading partner. And it may push those countries to start looking at trading opportunities further afield.

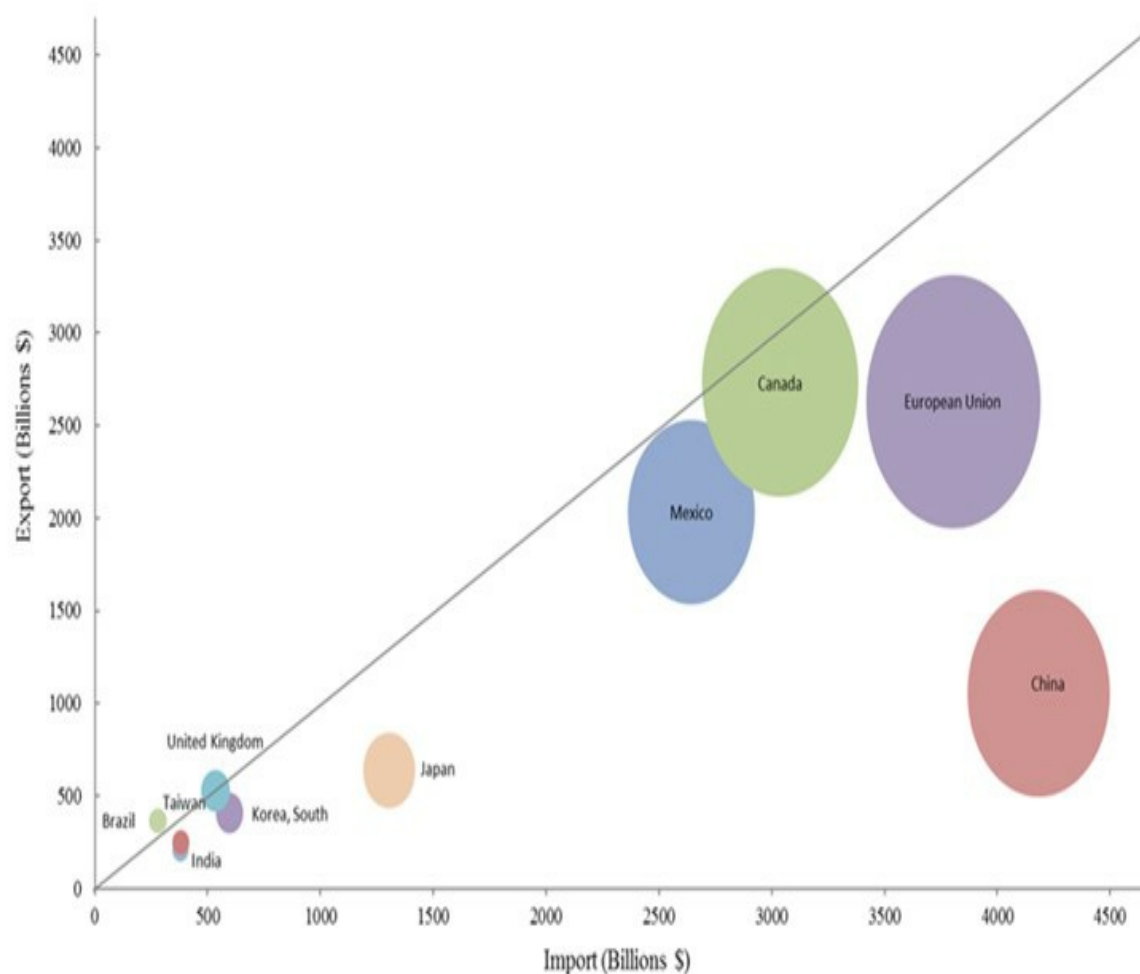
Who won in the stand-off? Canada initially stepped back from the negotiations. After the United States agreed to a deal with Mexico, Canada came back to the table. But would a US-Mexico bilateral deal have ever passed in US Congress? The depth of the integration of the United States and Canada supply chains seems to have been enough to persuade the United States to make critical concessions at the last minute.

Or was it just that the United States decided to narrow the trade war, and fight on one front (at a time)? Initiating talks with other long-term allies such as Japan and the European Union suggests that the United States is summoning all its energy for the bigger fight, with China. As the chart below shows, these countries and the European Union have been the top US trading partners over the past 10 years.

Top US Trading Partners



Total Sum of Import and Export Goods 2008-2017



Source: United States Census Bureau. Data as of June 18, 2018. Size of the series indicates the US total trade with the country from January 2008 until December 2017.

Investment Implications

We think the conclusion of trade negotiations is a positive for Canada as it removes a cloud hanging over the economy and adds to other shorter-term tailwinds supporting cyclical activity. However, some deceleration in the pace of Canada's gross domestic product growth is still anticipated in 2019.

For global portfolios, we maintain slightly cautious toward Canadian bonds.

The uncertainty around trade had previously been cited by the Bank of Canada. With that uncertainty removed, we expect that it will continue to raise interest rates.

We see select opportunities in Canadian stocks, with financials likely benefiting from a rising interest-rate environment and the energy sector benefiting from higher crude oil prices.

The Canadian dollar might benefit from these trends as well.

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