MULTI-ASSET

How Safe Is NAFTA?

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With US-led trade skirmishes opening up on multiple fronts, it's natural to wonder if the North American Free Trade Agreement (NAFTA) is in jeopardy. Here, Franklin Templeton Multi-Asset Solutions' Stephen Lingard explains why he thinks NAFTA is not likely to be canceled—at least not outright.

As 2018 has progressed, we've seen global trade conditions continue to deteriorate. China recently announced tariffs of 25% on more than 100 US products in retaliation to earlier announced US steel and aluminum product tariffs and the threat of additional ones. Also, Donald Trump's administration has said it plans to invoke Section 301 of the US Trade Act of 1974, which could significantly increase the number of products and trade subject to higher tariffs to the tune of $100 billion.

With trade skirmishes opening up on multiple fronts, we think the United States may feel increased pressure to get a NAFTA deal done ahead of this summer.[1] That's when the Mexican presidential election and US mid-term election campaigning will be in full swing. Otherwise, the United States risks attempting to win a trade war on multiple fronts, which tends to end badly if history is any guide.

We've already seen the United States drop one of its more contentious demands during a recent round of NAFTA negotiations that called for 50% of auto components to be made in the country. This demand was a "non-starter" for the Canadian and Mexican auto industries. Perhaps this concession signals a US desire to get a NAFTA deal done soon so the country can turn its attention to the real elephant in the room on trade—China.

Impact on the Canadian Economy and Markets

On the other hand, in the event NAFTA goes away there is a probability that trade could revert to the 1989 US-Canada bilateral free trade deal, which shares similar trade rules with NAFTA in many areas. In our view, this possibility can't be ruled out. It seems to us that Trump likes to negotiate bilaterally and has so far eschewed multi-lateral trade or other policies.

The economic impact of reverting to the previous US-Canada trade deal would be minimal in theory. However, investment would likely be held back until more certainty emerges.

There is also a small probability that if NAFTA dies, trade would revert to World Trade Organization rules. Under this agreement, tariffs on most products could rise to around 4%, although select products could have tariffs of 25% or more.

The bottom line is unpredictability often reigns with the current US administration. Trump's personal negotiating style seems to favor creating chaos, often leading to changes that can be positioned as "wins" for his political base.

Should NAFTA be removed, this could have a negative impact on Canadian stock valuations and the Canadian dollar—at least initially. Based on our analysis, the market is currently pricing in a low probability of NAFTA being canceled. In our view, investors who believe otherwise should consider raising the foreign component of their portfolios.

What's Next for NAFTA?

We think the consensus has it right that NAFTA is not likely to be canceled outright. However, we do expect to see changes (maybe significant ones) so that a deal may be viewed as a win for the US president.

In fact, we think a new NAFTA agreement seems more likely, as the temperature has increased on China-US trade relations, the key for the US trade deficit. Trump has often cited the US stock market as a key metric of "success" for his administration. We believe this political stance supports the view of changes as opposed to putting globalization fully into reverse.

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All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments.

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1. NAFTA is an agreement between Canada, Mexico and the United States to eliminate barriers to trade and investment between the three countries. The agreement came into force on January 1, 1994.