Analysis of NAFTA Renegotiations

Background

The current U.S. administration has adopted a foreign trade policy centered on narrowing trade deficits. Rhetoric has focused on manufacturing, which has been outsourced in recent decades from the United States to developing countries, notably Mexico and China.

In mid-2017, Donald Trump fulfilled one of his electoral promises of opening up the North American Free Trade Agreement ("NAFTA") for negotiation. Led by foreign affairs and trade ministers, Canada, the United States and Mexico are in the middle of seven rounds of negotiations around the almost 25-year-old agreement.

Figure 1: NAFTA Negotiation Timelines

Round	Date
Round 1	August 16-20, 2017
Round 2	September 1-5, 2017
Round 3	September 23-27, 2017
Round 4	October 1-5, 2017
Round 5	November 15-21, 2017
Rounds 6-7	Prior to March 2018

Source: National Post. Canadian Press. CNN.

Market reactions have been muted since the announcement to re-examine NAFTA and through the opening rounds of negotiations. While the Mexican peso tumbled with the prospects of renegotiation, Canadian equity and bond markets have witnessed minimal impact from NAFTA-related announcements.

In our client discussions, the most frequently posed questions have been regarding the impact to the Canadian economy in the event renegotiations fail and NAFTA is terminated.

Greystone's View

It appears that the renegotiation of NAFTA is the U.S. administration's opening salvo in pursuing more favourable terms of trade and narrower trade deficits globally. We do not believe that Canada is a primary focus for the United States; our view is that a possible overhaul of NAFTA is likely more focused on Mexico and may serve as a message to other global trading partners of the U.S. As seen in Figure 2, Canada has a fairly neutral trade balance with the United States. If you exclude energy, Canada runs a significant trade deficit. In fact, Canada is the largest customer for the U.S. and a key destination for exports from many rust-belt states that provided Trump with his Electoral College victory.

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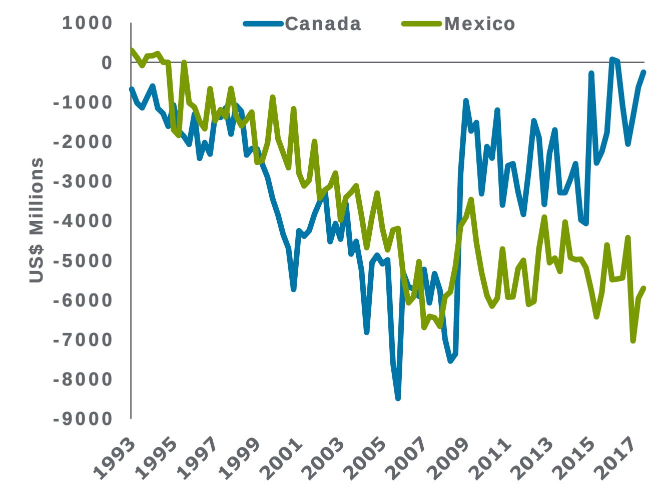
Figure 2: U.S. Trade Balance with NAFTA Countries



Source: Bloomberg. U.S. Census Bureau.

Figure 3: Potential GICS Sector Impacts

GICS Sector	NAFTA Impact
Consumer Discretionary	Seamless movement of auto sector products
Consumer Staples	Supply management of dairy and poultry industries
Materials	Softwood lumber and Chapter 19, dispute settlement mechanism
Technology	Impact of Buy American, Hire American on U.S. government contracts
Retail/Real Estate	Increase on duty free thresholds for online retail
Industrials	Impact of government procurement

Source: Greystone. CIBC World Markets.

If NAFTA were to collapse there are two likely structures under which trade would occur: tariffs as they exist for other countries in the World Trade Organization ("WTO") or pre-NAFTA trade agreements. Under the WTO, Mexico charges tariffs of 7% on average and the U.S. averages up to 3.5%. For Canada-U.S. trade this is a relatively minor issue as currency readjustment could balance out any adverse impact. Companies have had to regularly deal with, and adjust to, currency volatilities that have been a multiple of those potential tariffs. In all likelihood, Canada and the U.S. would seek bi-lateral trade terms similar to the Canada-United States Free Trade Agreement, which existed prior to NAFTA. This would further mitigate any sustained impact on the Canadian economy.

While broad economic impacts are expected to be minimal, we do see some sector and asset class specific challenges related to NAFTA renegotiations. From an investment perspective, a negative resolution will have knock-on effects across many different industries, sectors and asset classes. A 'Buy American, Hire American' approach would have an obvious impact on the large number of publicly traded companies that generate revenues in the U.S. We note in particular the potential impact on:

1. Auto Industry
2. Technology & Industrials
3. Retail/Real Estate
4. Interest Rates/Bonds

AUTO INDUSTRY

The auto industry relies on a global supply chain with parts often moving across borders multiple times before completion. According to Export Development Canada, the average motor vehicle assembled in Canada and shipped to the U.S. has almost half its parts originally manufactured in the U.S. It is notable that U.S.-based auto Original Equipment Manufacturers do not support changes to the current rules.

The major issue currently being discussed is the so-called 'Rules of Origin.' The rules determine what percentage of a product must be sourced within NAFTA to be considered duty-free. Currently, the rules require a minimum of 62.5%. In recent meetings, U.S. negotiators have proposed increasing this minimum to 85% and adding a new, U.S.-only content requirement of 50%.

Canadian companies, such as Magna International and Linamar, would obviously be impacted by any changes to the existing structure. While they would be able to shift some operations to their U.S.-based factories to appease 'Hire American,' any rule changes that lead to more 'Buy American' would have a negative impact.

TECHNOLOGY & INDUSTRIALS

Canadian tech companies and industrials, such as CGI or bus manufacturer New Flyer Industries, rely heavily on the U.S. federal and state government procurement markets. In recent meetings, the U.S. has asked for a 'dollar-for-dollar' reciprocity agreement for government procurement. Given that U.S. procurement is 10 times the size of Canada's, this would be an obvious disadvantage for Canadian companies looking to do business in the United States. Companies with substantial operations and revenues in the U.S. have already been subject to more stringent 'Buy American' regulations. New Flyer complies with a 60% U.S. content requirement for U.S. orders, which rises to 70% by 2020.

REAL ESTATE (RETAIL SECTOR)

U.S. negotiators have also focused on online duty-free limits, which could affect Canadian retailers. Currently, Canada imposes duties on goods bought online to protect its domestic retailers. Duties are applied if prices are more than C$20 (about US$16) — the U.S. is looking for this to change to US$800. As the popularity of online shopping grows, this change would only accelerate that trend. For real estate investors, we believe the potential for this change is minimal given the Canadian government's historical protection of retailers. That said, we have advocated for destination and experiential type retail to drive foot traffic and to be better insulated from headwinds facing the retail sector.

FIXED INCOME

The immediate risk of a breakdown in NAFTA would be a flight to safe haven assets due to uncertainty. This could include an initial drop in interest rates as investors seek bond exposure and price in the potential for more accommodative central banks. While the Bank of Canada may slow down or pause with rate hikes, we do not believe a NAFTA breakdown would result in cuts to the overnight rate. From a fixed income perspective, the lack of pundit dialogue around inflationary impacts of de-globalization is interesting. In our view, the demand on domestic economies for greater internal production would further tighten economic capacity utilization. While interest rates may fall initially, this could lead to tighter monetary conditions and higher rates in the long run.

Conclusion

Media attention has focused on the downside impact and negative tone of the negotiations. Our base case is that some form of free trade will persist, either with NAFTA or bi-lateral free trade between each country. While the risk is that aggressive negotiating tactics result in a non-agreement, we do not believe the worst-case scenario would materially alter the trajectory of Canadian growth rates. Sector and security considerations are of relative greater importance, particularly within auto, technology and industrial sectors.

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FIXED INCOME

- LDI
- Term
- Plus
- Sector

PUBLIC EQUITIES

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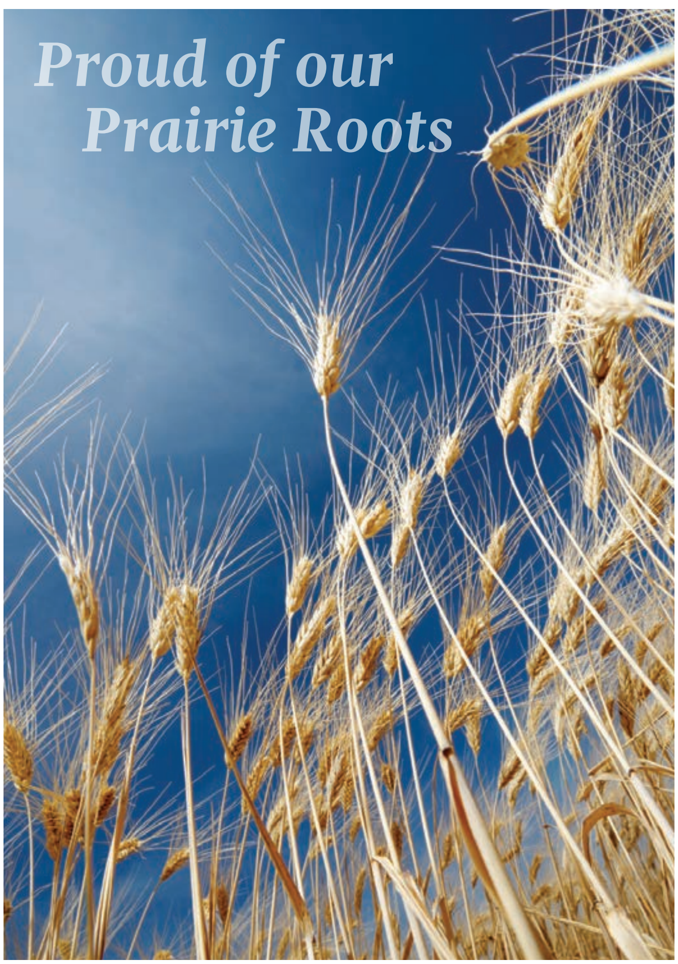
- International
- Global
- China



FOR FURTHER INFORMATION PLEASE CONTACT:

Jafer Naqvi, CFA
Vice-President, Fixed Income & Multi-Asset
416.309.2586 | jafer.naqvi@greystone.ca

REGINA (HEAD OFFICE)
300 Park Centre
1230 Blackfoot Drive
Regina, Saskatchewan S4S 7G4
Canada

TORONTO
77 King Street West
Suite 4510, TD North Tower
Toronto, Ontario M5K 1J3
Canada

WINNIPEG
201 Portage Avenue
Suite 1907
Winnipeg, Manitoba R3B 3K6
Canada

HONG KONG
Suite 1, 12/F
International Commerce Centre
1 Austin Road West, Kowloon
Hong Kong

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