

NAFTA renegotiation– Breakthrough in US-Mexico bilateral issues paves the way to maintain the trilateral agreement

- Both Mexican and US authorities have announced an agreement between the two countries regarding bilateral issues in the NAFTA renegotiation process
- Once bilateral issues between Mexico and the U.S. were sorted out, now Canada will come back to the negotiation table
- According official information, an agreement was reached on the following issues:
 - (1) Rules of content in the auto-industry;
 - (2) *Sunset clause*;
 - (3) Controversy mechanisms;
 - (4) Seasonality in agricultural imports;
 - (5) Strengthening of IP provisions; and
 - (6) Digital trade
- Once this deal is approved by the three nations, it will have to go through a specific legal process in each country
- In our view, this development is positive and it is in line with our view that NAFTA will remain in place

US and Mexico sort out issues in NAFTA renegotiation. Both President Donald Trump and President Enrique Peña-Nieto spoke to the media about the agreement, congratulating both teams and inviting Canada back to the negotiating table. The US Trade Representative, Robert Lighthizer mentioned that it is a preliminary agreement, still subject to finalization and implementation. Here, it is worth noting that Mexico's Foreign Affairs Minister said that Mexico will sign the agreement, even if Canada stays out of the deal.

According to information from the USTR as well as the Mexican Ministry of Economy, an agreement was reached on the most controversial issues. This includes: (1) Rules of origin in the car industry; (2) the so called *sunset clause*; (3) controversy mechanisms; (4) seasonality in agricultural imports; (5) the strengthening of IP provisions; and (6) digital trade. In the first case, the rules of origin in the car industry would increase from current 62.5% to 75%. In addition, there would be a clause requiring that between 40% and 45% of the Mexican workers involved in auto production earn at least US\$16 an hour (around MXN\$300 an hour, up from current levels of about US\$4 to US\$8 an hour). Finally, already established plants along with the ones undergoing construction, MFN tariffs will be held until they manage to comply with these new requirements. In our view, even though this could eventually deter Mexico's competitiveness levels, it is worth noting that given technological revolution, repetitive tasks will be automated, with companies demanding more educated workers and thus offering better levels of wages.

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NAFTA to be reviewed each 16 years. One of the main issues where the negotiation stalled was the so called *sunset clause*, in which the US government wanted the agreement to be suspended every 5 years. Negotiators seem to have settled for a 16-year period in which parts would sit down every year as of year number six to agree on whether to extend it for another 16 years or suspend it by year 16, if an agreement is not reached. We highlight that Mexico was reluctant to accept a *sunset clause per se*, however having agreed a 16-year clause reduced the uncertainty surrounding investments, because it isolates it from the political cycle, as it goes beyond the six-year Mexican, and the four –and eventually eight-year–, US presidential terms.

Controversy mechanisms and seasonality in agricultural imports. In the first case, even though chapter 19, which refers to controversy solving, Robert Lighthizer said that Mexico will keep energy and telecom dispute rights. Moreover, the seasonality in agricultural imports clause that the US government wanted to introduced was ruled out. Under such clause, the US administration wanted to impose restrictions on Mexican agricultural exports, particularly on seasonal produce, *i.e.* whenever both countries were able to supply such goods, as if we had seasons different from those in the US (weather-wise).

IP provisions and digital trade. Some of the improvements to intellectual property protection are based of better enforcement of actual laws and more severe punishments for the violation of IP provisions. On digital trade, it is worth noting that it was added for the 1st time, reflecting changes from the original NAFTA.

Canada still has to approve this deal in order to maintain NAFTA. It is worth mentioning that Canada was mostly left out of this round of the renegotiation, which in part enabled the agreement between Mexico and the US. However, given the trilateral nature of the agreement, if Canada does not sign off on the changes agreed today, the renegotiation process might be extended or it could trigger a NAFTA breakup with bilateral trade agreements with the US. Nevertheless, we do not believe this to be the case, with the three parties reaching an agreement in the coming months after further discussions. On today's developments, Canada's Foreign Affairs spokesman mentioned that Canada is encouraged by the optimism between the two parties, and that this progress is necessary to finalize the renegotiation.

In our view, this development is positive and it is in line with our view that NAFTA will remain in place. It is worth noting that, even though we believe that the three countries are close to an agreement, there is still a long way to go. In the case of Mexico, the Senate –which resumes activities on September 1st with its new composition– has to approve the measures with a simple majority (50% +1 vote), which then can be signed by the sitting president. Depending on the timetable, it could either be signed into law by Enrique Peña-Nieto or by Andrés-Manuel López-Obrador. For the US, the proposal must be submitted to the US Senate, which will hold a 90-day consultation period with several stakeholders. Once this period is over, it can then be approved by this body also with a simple majority, to then be turned over to President Trump.

All in all, we consider that the most important victory for Mexico today is that we will be able to maintain a common legal framework, at least in terms of the relationship with the US, which in turn reinforces Mexican institutions.

From our fixed income and FX strategy team

Mexican assets rallied following the U.S.-Mexico trade deal announcement but with limited room for additional gains. The peso appreciated 0.9% to 18.75 per dollar (reaching up to 18.60 intraday), the best in EM, while local rates extended last week's gains rallying 4bps, following the announcement of a trade deal between the U.S. and Mexico. The country risk premium embedded in both assets has declined significantly in recent weeks, on the back of the results of July's elections and constructive news in terms of NAFTA. However, we acknowledge that there is limited room for additional strong gains going forward. Regarding the fixed-income market, we hold our trade idea of long positions in the CPI-linked Udibono Jun'22, taking into account the expected carry gains coming from inflation and the positive effects in terms of monetary policy coming from this trade news. It is worth noting that in spite of a complex inflation backdrop, the Mexican peso's performance in the aftermath of the local electoral process and some signals of a slowdown in economic activity could influence Banxico's Board to hold their reference rate unchanged for the rest of the year. In this respect, the Mexican yield curve is pricing-in 18bps of implied rate hikes for the rest of 2018, with the market following closely Banxico's *Quarterly Report* to be delivered on August 29th, in particular the update on the bank's inflation point forecasts (likely up) and the estimated range for GDP (slightly down). Considering this latter scenario, it is our take that current CPI conditions and dynamics are still supportive and favorable for our investment idea of long positions in the Udibono Jun'22. In terms of the FX market, the Mexican peso is near an attractive level to start building shorts, although momentum is strong as a result of this news. We have remained on the sidelines in directional positions since July 24th, when we took profit in tactical peso longs. We maintain our view that gradual dollar purchases look attractive at or below the 18.50 figure, which could be poised to test again for the first time since the beginning of the month, with the next relevant technical support below this at 18.40 per dollar. In case momentum extends towards 18.00, which could be in store in case of a quick resolution with Canada that leads to a trilateral agreement (as sought by Mexico even with a change in name) it is our take this latter level would flag the peso as expensive, both in absolute and relative terms. For a more comprehensive analysis of our fixed-income and peso forecasts please refer to our research note "*Fixed-Income, FX, and Commodities - 3Q18 Outlook*" <[pdf](#)>, published on July 24th, 2018.

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