

# Mr. Trump’s trade wars – Opening the Mexican front

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**Gabriel Casillas**  
Chief Economist and Head of Research  
gabriel.casillas@banorte.com

**Delia Paredes**  
Executive Director of Economic Analysis  
delia.paredes@banorte.com

## Fixed income and FX Strategy

**Alejandro Padilla**  
Head Strategist – Fixed-Income and FX  
alejandro.padilla@banorte.com

**Santiago Leal Singer**  
Fixed-Income and FX Strategist  
santiago.leal@banorte.com

**Leslie Orozco**  
Fixed Income and FX Strategist  
leslie.orozco.velez@banorte.com

- **President Trump has threatened to impose 5% tariffs on all imports coming from Mexico starting June 10**
- **These tariffs could escalate up to 25% by October 2019**
- **Mexican President Lopez Obrador reacted sending a letter seeking for a cooperative solution**
- **In our view, it is unlikely that tariffs will ultimately be applied as the trade relationship between the US and Mexico is far too deep**
- **Nonetheless, if they are applied, we expect negative consequences for both countries in terms of growth and inflation**
- **Moreover, we would expect central banks to alter course while USMCA ratification process could be compromised**
- **Risk premium soaring following President Trump’s trade threats**

**Tariff threat.** President Trump threatened to impose a 5% tariff on all imports coming from Mexico starting June 10. The tariffs would be removed if the “*illegal immigration crisis*” is tackled through “*effective actions taken by Mexico*”. The tariffs would increase by an additional 5% on the first day of each month up to 25% by October 1 if Mexico does not act “*to dramatically reduce or eliminate the number of illegal aliens crossing its territory into the US*”. Tariffs would remain at 25% “*unless and until Mexico substantially stops the illegal inflow of aliens coming through its territory*”.

### Tariff schedule announced by Mr. Trump

Date of application	Tariff level
June 10, 2019	5%
July 1, 2019	10%
August 1, 2019	15%
September 1, 2019	20%
October 1, 2019	25%

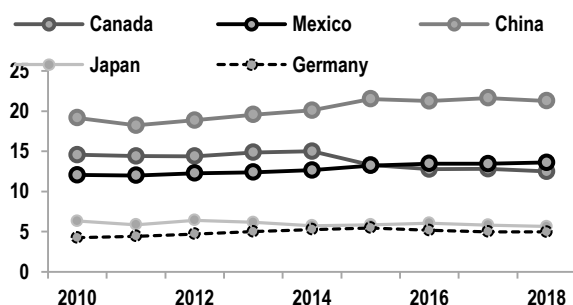
Source: Fox Business

**Mexico’s government reaction.** The administration of Mr. Lopez Obrador has responded with a letter in which he offers dialogue, hoping for a long-term cooperative solution to the problem of migration. He has also sent Foreign Relations Minister, Marcelo Ebrard, and Deputy Minister, Jesus Seade, to Washington D.C. to negotiate. We welcome this strategy although we cannot rule out retaliation from Mexico’s government as US measures would be violating not only WTO rules but mainly current NAFTA agreement.

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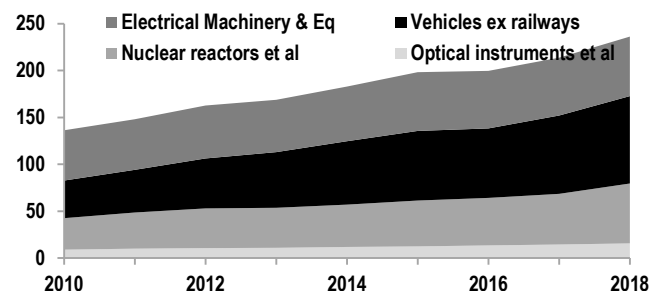
**Negative impact on already cooling down economies.** The US imported about US\$347bn from Mexico in 2018, representing around 15.9% of total imports. By product, the main imports come from the auto-industry, electronic equipment, etc. as shown below. We consider that value chains are more entrenched with products crossing the border several times along the production process, so that the 5% tariffs imposed would not only disrupt production but also productivity with the consequences on growth not only in the short term but also in the medium term as it could lead to relocation of firms. Meanwhile, Mexico imported about US\$228.8bn from the U.S., 46.5% of total imports. By products, main imports include nuclear reactors and other machinery, electrical machinery and equipment, among others. The Mexican economy has already been decelerating in 1Q19 on the back of temporary negative shocks and moderation from the fact that there is a new administration in government. Moreover, we expect softness to have extended to the second quarter while we believe that the balance of risks is biased to the downside. In the case of the U.S., even though consumption has rebounded in the second quarter, manufacturing figures continue pointing to a moderation of economic activity while we expect a much softer second half as fiscal stimulus continues to fade away. Finally, inflation in both countries is also likely to be negatively affected.

**US Imports by country**  
% total



Source: USITC

**Top 5 US Imports from Mexico**  
US\$bn



Source: USITC

**Central banks could alter course.** Once again, even though we do not expect tariffs to be applied at the end, if they are, we would expect both the US Fed and Banxico to alter course. In the first case, Chairman Richard Clarida said yesterday that the US economy is in good shape but that central bank officials would consider interest-rate cuts should economic data reveal a material risk of a sharper slowdown than they currently expect. In terms of Banxico, this week's communications pointed to a prudent stance as the members of the board were quite concerned about the high degree of uncertainty surrounding the outlook. In this context, even though Banxico might change its bias towards interest rate hikes -as it has done in the past few years to smooth the peso depreciation vis-à-vis the dollar-, Governor Díaz de León's comment on the FX Commission being ready to act point is a signal that Banxico might prefer to use FX instruments, rather than hiking the reference rate this time. After all, Mexico already has the highest reference rate in the EM universe (excluding Argentina and Turkey).

**What now in terms of USMCA?** The escalation of trade wars has complicated the USMCA ratification process, despite encouraging news this week of the three countries sending the USMCA to their respective legislatures for ratification. Nevertheless, we still believe that sense will prevail and that USMCA would be in place by the end of the year.

**We do not expect Mr. Trump to follow through but stakes are high..** Evidently, market reaction has been negatively as investors have taken this as a global threat given that if the US is doing this to Mexico, one of its main trading partners, how far can he go regarding China and even the UE and Japan in terms of tariffs to the auto industry. Moreover, they fear that Mr. Trump is taking damaging stands that will be hard to back down from, fostering a global recession sooner rather than later. In our view, this threat could eventually be empty given the importance of production chains between the two countries and it is yet another strategy from President Trump to secure its path to reelection. The announcement comes after the recent letter sent by Robert Mueller regarding its investigation on Trump's involvement in Russia's meddling in American election. Moreover, it seems that the president's decision has no support within his own government with press reports suggesting that U.S. Trade Representative, Robert Lighthizer, and Treasury Secretary, Steven Mnuchin, not agreeing with the president's announcement. Also, Texas and Arizona's state governors have reiterated their opposition to Trump's administration actions and have urged Congress to approve USMCA.

**FX impact at the beginning, inflation and growth could follow.** Our models suggest that a 3.5% depreciation of the Mexican peso vis-à-vis the US dollar could offset any effect of a 5% tariff. Even though we do not believe this would escalate more than a 5% level, a 25% tariff could foster an 18% depreciation. Unfortunately, FX will not be able to absorb the whole shock with high probability of the unexpected threat itself affecting confidence levels to invest in both the U.S. and Mexico. This could have a likely negative impact on GDP.

**Mexico potential smart retaliation.** While the U.S. might implement a 5% tariff across the board, it is our take that Mexico could retaliate with 8%-10% tariff on certain goods, instead of an overall tariff. Mexican authorities would target goods that are important for the U.S., in the Midwest -where Trump's voters are-, but that could have only a marginal effect on growth and inflation in Mexico (e.g. wheat, tobacco, *Tennessee* whiskey and bourbon).

*From our Fixed income and FX strategy team*

**Risk premium soaring following President Trump's trade threats.** The peso immediately reacted after President Trump announced his threat to impose a 5% tariff on Mexican exports to the U.S. starting June 10<sup>th</sup>, depreciating 2.5% towards USD/MXN 19.65 (reaching 19.80 earlier this Friday). In a similar fashion, interest rates of sovereign bonds have increased by 12bps in peso-denominated Mbonos and 8bps in foreign-currency-denominated UMS. In our view, the soar of the current risk premium embedded in local assets could extend in the following sessions. In an initial stage, the peso could portray an effect of 5% in competitiveness-adjusted basis, which suggest the next relevant level towards USD/MXN 20.00, with a relevant convergence of a Fibonacci retracement figure of 19.98, a psychological effect and short-term options' strikes. This could decrease the implied probability of rate cuts by Banxico currently priced in the yield curve and increase local rates by an additional 10-15bps magnitude. In the aftermath of this landscape we hold a cautious stance in terms of Mbonos, waiting for better entry levels and market conditions for new long positions. In the same way, we have a more negative assessment for the MXN. For more details please refer to our research notes: "*Fixed-Income, FX, and Commodities - 2Q19 Outlook*", [pdf](#), published on April 10<sup>th</sup>, 2019 and "*Fixed-Income and FX Weekly*", [pdf](#), published on May 27<sup>th</sup>, 2019.

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**GRUPO FINANCIERO BANORTE S.A.B. de C.V.**
**Research and Strategy**

Gabriel Casillas Olvera	Chief Economist and Head of Research	gabriel.casillas@banorte.com	(55) 4433 - 4695
Raquel Vázquez Godínez	Assistant	raquel.vazquez@banorte.com	(55) 1670 - 2967

**Economic Analysis**

Delia María Paredes Mier	Executive Director of Economic Analysis	delia.paredes@banorte.com	(55) 5268 - 1694
Katia Celina Goya Ostos	Senior, Global Economist	katia.goya@banorte.com	(55) 1670 - 1821
Juan Carlos Alderete Macal, CFA	Senior Economist, Mexico	juan.alderete.macal@banorte.com	(55) 1103 - 4046
Miguel Alejandro Calvo Domínguez	Economist, Regional	miguel.calvo@banorte.com	(55) 1670 - 2220
Francisco José Flores Serrano	Economist, Mexico	francisco.flores.serrano@banorte.com	(55) 1670 - 2957
Francisco Duarte Alcocer	Analyst, Global Economist	francisco.duarte.alcocer@banorte.com	(55) 1103 - 4000 x 2707
Lourdes Calvo Fernández	Analyst (Edition)	lourdes.calvo@banorte.com	(55) 1103 - 4000 x 2611

**Fixed income and FX Strategy**

Alejandro Padilla Santana	Head Strategist – Fixed income and FX	alejandro.padilla@banorte.com	(55) 1103 - 4043
Santiago Leal Singer	FX Senior Strategist	santiago.leal@banorte.com	(55) 1670 - 2144
Leslie Thalía Orozco Vélez	Fixed Income and FX Strategist	leslie.orozco.velez@banorte.com	(55) 5268 - 1698

**Equity Strategy**

Manuel Jiménez Zaldivar	Director Equity Research – Telecommunications / Media	manuel.jimenez@banorte.com	(55) 5268 - 1671
Victor Hugo Cortes Castro	Technical Analysis	victorh.cortes@banorte.com	(55) 1670 - 1800
Marissa Garza Ostos	Equity Research – Conglomerates / Financials/ Mining / Petrochemicals	marissa.garza@banorte.com	(55) 1670 - 1719
José Itzamna Espitia Hernández	Equity Research – Airlines / Airports / Cement / Infrastructure / REITs	jose.espitia@banorte.com	(55) 1670 - 2249
Valentín III Mendoza Balderas	Equity Research – Auto Parts/ Consumer Discretionary / Real Estate / Retail	valentin.mendoza@banorte.com	(55) 1670 - 2250
Jorge Antonio Izquierdo Lobato	Analyst	jorge.izquierdo.lobato@banorte.com	(55) 1670 - 1746
Itzel Martínez Rojas	Analyst	itzel.martinez.rojas@banorte.com	(55) 1670 - 2251

**Corporate Debt**

Tania Abdul Massih Jacobo	Director Corporate Debt	tania.abdul@banorte.com	(55) 5268 - 1672
Hugo Armando Gómez Solís	Senior, Corporate Debt	hugo.gomez@banorte.com	(55) 1670 - 2247
Gerardo Daniel Valle Trujillo	Manager, Corporate Debt	gerardo.valle.trujillo@banorte.com	(55) 1670 - 2248

**Wholesale Banking**

Armando Rodal Espinosa	Head of Wholesale Banking	armando.rodal@banorte.com	(55) 1670 - 1889
Alejandro Eric Faesi Puente	Head of Global Markets and Institutional Sales	alejandro.faesi@banorte.com	(55) 5268 - 1640
Alejandro Aguilar Ceballos	Head of Asset Management	alejandro.aguilar.cebillos@banorte.com	(55) 5268 - 9996
Arturo Monroy Ballesteros	Head of Investment Banking and Structured Finance	arturo.monroy.ballesteros@banorte.com	(55) 5004 - 1002
Gerardo Zamora Nanez	Head of Transactional Banking, Leasing and Factoring	gerardo.zamora@banorte.com	(81) 8318 - 5071
Jorge de la Vega Grajales	Head of Government Banking	jorge.delavega@banorte.com	(55) 5004 - 5121
Luis Pietrini Sheridan	Head of Private Banking	luis.pietrini@banorte.com	(55) 5004 - 1453
René Gerardo Pimentel Ibarrola	Head of Asset Management	pimentelr@banorte.com	(55) 5268 - 9004
Ricardo Velázquez Rodríguez	Head of International Banking	rvelazquez@banorte.com	(55) 5004 - 5279
Víctor Antonio Roldan Ferrer	Head of Corporate Banking	victor.rolan.ferrer@banorte.com	(55) 5004 - 1454