

Successful end to NAFTA renegotiation

October 1, 2018

- **Late last night, Canada and the US reached an agreement in terms of NAFTA**
- **As a result, the three countries will be part of the new agreement which will be known as USMCA**
- **According to the Secretary of Economy, Ildefonso Guajardo, the new agreement could enter into force in the second half of 2019**
- **Now the agreement has to comply with each country’s legal procedures before starting to apply**
- **In our opinion, the agreement is positive as it reduces uncertainty to the Mexican economic outlook in particular**
- **We will publish a note with a more detailed analysis of the agreement reached shortly**
- **Local assets extend profits after the recently announced USMCA**

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US and Canada reach a last-minute deal. Late last night, the US and Canada reached a last-minute trade agreement, considering the US-imposed deadline of September 30th for the release of the full-text of the deal reached with Mexico on August 27th. From that date on, efforts were focused in resolving the differences between these two countries, in particular regarding access to the Canadian dairy market and dispute-settlement mechanisms.

In the first case, the US will be able to increase its exports of dairy products to Canada for an equivalent of about 3.5% of the value of its domestic market, slightly higher than the concession that had already been made in TPP negotiations, from which the US retired unilaterally in January 2017. In the second case, one of the dispute-settlement mechanisms was kept unchanged (Chapter 19), specifically the one related with anti-dumping and countervailing duties cases due to unfair trade practices. The permanence of this mechanism was a key demand of Canada in order to protect its lumber industry, among other sectors.

Main changes to NAFTA

Concept	NAFTA 1994	New NAFTA
Rules of origin for passenger vehicles and light trucks	62.5%	75%
Rules on wages for workers in the auto sector	Not included	40% of the work must be done in high wage areas (USD 16 per hour or more)
Sunset or revision clause	Not included	The treaty will last for 16 years unless it is revised, which can be done since year six
<i>De minimis</i> import of goods	USD \$50	USD \$100
Patent protection to medicines	8 years	10 years
Access to the Canadian dairy market	Not included	Access up to 3.5% of the market (US\$16bn per year)
Investor-state dispute settlement (Chapter 11)	Applicable to the three countries in several sectors	Eliminated between Canada and the US but prevails for Mexico in certain sectors

Source: USTR, Ministry of Economy

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NAFTA 2.0 will stay trilateral and will be renamed as USMCA. Now, the agreement has to comply with each country's legal procedures before starting to apply. In Mexico, the text has already been sent to the Senate for approval. In the US, it has to go through Congress and in Canada, the Parliament needs to ratify it. It is highly likely that the deal could be signed by the three presidents around November 30th, at the G20 summit in Argentina. In this context, Mexico's Minister of Economy, Ildefonso Guajardo, said that the new treaty could come into effect in 2H19.

Stricter rules of origin for the auto sector... In line with the agreement already reached with Mexico, new rules of origin for automobile and auto parts will need to comply with a minimum content of 75% of regional value. Moreover, the new *Labor Value Content Rule* requires that 40% of automobiles and 45% of light trucks content be made by workers earning at least 16 dollars per hour. It is worth noting that both rules include a phase-in period of four increases (one per year) starting from January 1st, 2020 or since the treaty comes into effect, whichever comes last. In this respect, these rules will be fully applicable until January 1st, 2023 at the earliest. In addition, it was also established that: (1) Steel and aluminum purchases by light-vehicle assembly plants should have at least 70% of North American content; and (2) seven auto parts were identified as "essential", meaning that they should be produced in North America to be compliant with the rules.

...but with protections from Section 232 tariffs. Moreover, the agreement includes tariffs exemption for the auto sector of Mexico and Canada if the US imposes tariffs under the Section 232 of the *Trade Expansion Act* of 1962 due to national security concerns. This measure shall exclude: (1) 2,600,000 passenger vehicles imported on annual basis; (2) all light trucks imported from Mexico and Canada; and (3) such quantity of auto parts amounting to US\$ 108 billion in declared customs value in any calendar year from Mexico and US\$ 32.4 billion from Canada. Moreover, the U.S. shall not adopt or maintain a measure imposing tariffs or import restrictions on goods or services for at least 60 days after imposition such a measure.

New and revised chapters. Among the main agreements, we highlight: (1) Modernization of the chapter related to Intellectual Property; (2) additional enforcement provisions for any trade agreement; (3) digital trade; (4) increased *de minimis* shipment value levels; (5) a commitment to liberalize financial services markets; (6) the inclusion of a chapter for macroeconomic policies, particularly regarding the exchange rate regime; (7) anti-corruption and environmental measures; and (8) changes in sanitary and phytosanitary rules.

From our Fixed-Income and FX team

Local assets extending the recent rally after the newly settled USMCA, however with limited room for additional gains. In this regard, we hold our defensive trade ideas of long positions in the CPI-linked Udibono Jun'22 and buying the USD in dips (with a key level at USD/MXN 18.60) ahead of Banxico's decision this week. Mexican sovereign bonds are extending the recent rally, but in a limited fashion, following the recent announcement of a new trade deal between the United States, Mexico and Canada (*i.e.* NAFTA 2.0, newly named USMCA). In our view, the news surrounding trade dynamics are supporting the decline of country-specific risk premiums embedded in local assets observed in the last two weeks, despite a challenging environment in EM.

The peso remains as the top performer in the EM landscape YTD (5.3%), also sustained by investors' optimistic view about the new administration in Mexico and the continuity of a strong macroeconomic framework. The defensive stance of the MXN has increased the likelihood of Banxico to stay put this Thursday. More details in "*We no longer expect Banxico to hike after NAFTA 2.0*" <[pdf](#)>, released earlier today. However, it is our take that the room for an additional appreciation of the Mexican peso and local rates is limited, given the current valuation. In this regard, we hold our year-end forecast of USD/MXN 18.60, with an expected trading range of 18.60-19.50 in a 6- to 12-month horizon. As a result, we hold our trade idea of buying the USD in dips, with a relevant support in 18.60.

In term of rates, we are maintaining our recommendation of long positions in the CPI-linked Udibono Jun'22. After some pressures observed in the first half of September, this security has rallied 16bps in the last two weeks (2bps this morning). In our view, this strategy remains appropriate given the current risks associated to the EM backdrop. This bond can continue benefiting from lower risk premia in Mexico, the possibility of stable monetary conditions (*i.e.* Banxico standing pat on October 4th), and an attractive UDI carry given the expected performance of inflation in coming months (1.66% for the remaining 91 days of 2018 or 6.58% on an annualized basis). These factors could compensate a 3-year breakeven trading at 3.99%, still 18bps above the 12-month mean and median.

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