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USMCA – the new NAFTA

A new deal, with a new name, but hardly a rewrite.

The United States-Mexico-Canada Agreement, or USMCA, is a new deal, with a new name, but is hardly the major rewrite that warranted so much wasted time over a 13-month long period of negotiations.

With that said, its fruition has avoided a worst case outcome – which could have occurred had Canada caved to the harshest U.S. demands or if the country had been slapped with auto tariffs – and this is undeniably positive for the broader economy since it removes a key source of overhanging uncertainty.

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In terms of concessions, giving up access to 3.6% of the domestic dairy market (up from about 1%) would be the largest. However, it is worth pointing out that the U.S. had already negotiated access of 3.25% in the Trans-Pacific Partnership before ultimately withdrawing. Add to this the fact that dairy production only totals $6.6 bln per annum (or 0.3% of GDP), so 2.6% of this figure (3.6% minus 1.0%) amounts to just $172 million, or less than 0.01% of Canada's GDP.

Another obvious concession is that the patent protection for biologic drugs has been extended to 10 years from 8 currently – a win for U.S. pharma, but a negative for Canada since it means higher drug costs down the road.

Finally, the copyright period has been lengthened – to 70 years from 50 previously – bringing terms in line with the U.S. and Europe, but ultimately creating another source of higher costs for Canadians.

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As for the more positive aspects, the auto industry should be the largest beneficiary. The requirement to have higher automotive content (minimum 40%) in high wage jurisdictions (making at least US$16 per hour) benefits the U.S. and Canada at the expense of Mexico. Furthermore, in the event that the U.S. imposes tariffs on auto imports under Section 232, Canada will be able to export 2.6 million passenger vehicles per annum tariff-free (well above current levels of 1.8 million).

Another key feature is that the new deal will last for at least 16 years (though it requires a review after 6 years at which time it can be extended). This is much more favourable than the earlier demand from the U.S. that the agreement include a sunset clause – which would have forced all parties to recertify the deal every 5 years. All else being equal, this is a positive for business investment – good news for machinery, industrial construction and engineering.

In addition, there are mixed implications from the increase in the de minimis levels for cross border e-commerce transactions (from C$20 to C$150 for the duty exemption, and from C$20 to C$40 for the sales-tax exemption). While these developments represent a slight negative for domestic retailers, consumers stand to benefit from lower costs.

Lastly, and perhaps most importantly, Canada won out in keeping Chapter 19 and Chapter 20 (involving dispute settlement procedures) effectively unchanged in the new deal. Dispute resolution was a key sticking point for Canada, and the U.S. was ultimately forced to cave in order to cement the new deal.

So ultimately, there are no major changes that will meaningfully impact the trajectory of the Canadian economy. The parting of clouds may result in a capex pick-up, but one must also consider that the Bank of Canada is also now less likely to be dovish, at the margin. This means higher interest rates, which should weigh more on housing/interest-sensitive spending than would otherwise be the case.

From an investment perspective, we expect this deal to be positive for the Canadian equity market, and in combination with the recent rise in oil prices, has the potential to entice foreign investors back into Canadian stocks. The signing of the new agreement has removed significant

uncertainty for both domestic businesses and foreign companies looking to invest in Canada. This should ultimately help our economy and our competitiveness, as well as restore investor sentiment and confidence given how poorly the Canadian stock market has performed year-to-date.

From a currency perspective, we expect this deal to be moderately positive for the Canadian dollar near-term. There remain other impediments in the way (pipeline frustrations, tax rate differentials), but we could get a moderate rally in the loonie as the Bank of Canada keeps better pace with the interest rate hikes south of the border. (Note that there are still almost 18,000 net speculative short contracts on the CME ripe for a short squeeze.)

In terms of our Premium Income Portfolio, our focus has been more towards companies that generate service-related revenues rather than on capital goods that move across the US/Canadian border. Nonetheless, the bad press related to NAFTA discussions year to date has kept a lid on valuations of Canadian securities as a whole, including securities in our portfolio. We believe our portfolio is well positioned to benefit from a potential revaluation in Canadian securities as the market digests the USMCA trade deal and its positive longer-term implications.