Global Insight Weekly

A closer look

NAFTA: Rhetoric vs. Reality

Kelly Bogdanov – San Francisco; Patrick McAllister – Toronto

The opening salvo in the NAFTA talks has brought with it predictable heated rhetoric and has unveiled a few sticking points between the U.S., Canada, and Mexico. We provide our take on the key provisions and broader trade goals.

It's no wonder aggressive U.S. rhetoric kicked off the first round of North American Free Trade Agreement (NAFTA) renegotiations. "It should be conceded that the U.S. is actually right in asserting that it is currently getting the raw end of the trade deal," said Eric Lascelles, chief economist at RBC Global Asset Management Inc. His data shows that U.S. companies tend to pay higher tariffs when conducting business in foreign markets than foreign firms do in the U.S. (see chart).

But trade is a delicate issue. Incentivizing or pushing trading partners to lower barriers is one thing; imposing new tariffs is another. The latter usually doesn't end well—especially between major trading partners.

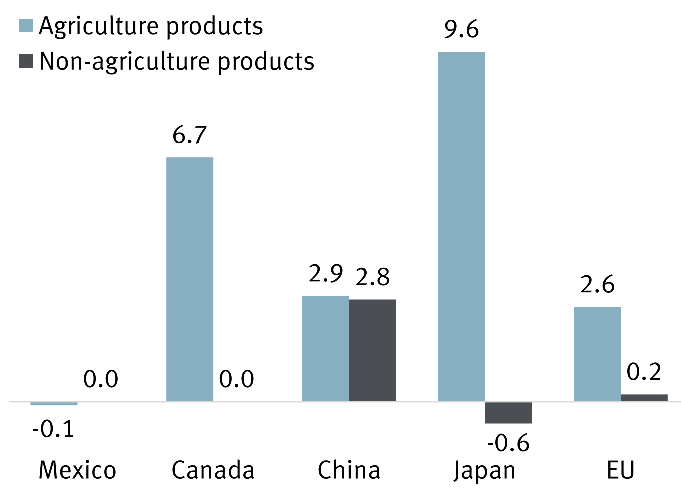
Sticking points

So far, global financial and currency markets are taking the NAFTA renegotiations in stride. Despite tough U.S. rhetoric, fears of tearing up the agreement have diminished considerably since the presidential campaign. There are, however, some sticking points to the renegotiations as the U.S. seeks changes to key NAFTA provisions:

Dispute settlement – The U.S. proposes to completely revamp the process so that disputes would be brought to domestic courts of the country that is being accused of violating a trade provision rather than to bi-lateral panels within NAFTA, which is the current structure. For example, if a Canadian or Mexican company/industry has a dispute with the U.S., it would be settled in U.S. courts rather than by a NAFTA panel. The Trump administration argues the current panel structure infringes on U.S. sovereignty. Canada strongly opposes this, as it believes it would be disadvantaged in U.S. courts and would increase legal expenses for Canadian businesses. Mexico is also opposed. Under NAFTA's current dispute settlement

U.S. pays higher tariffs than most major trading partners

Tariff rate differential between U.S. and partner countries (%)



Note: Data is the difference between tariff rates the U.S. pays on its exports to partner countries and rates partner countries pay on exports to the U.S. Source - RBC Global Asset Management, WTO/ITC/UNCTAD *World Tariff Profiles 2016*

Market pulse

Click here for authors' contact information.
Priced (in USD) as of 8/17/17 market close, EST (unless otherwise stated).
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RBC Wealth Management

structure, five-member arbitration panels are made up of representatives from both sides of a dispute. It is worth noting that the overwhelming majority of the rulings made by these bilateral panels have been unanimous.

Adopting a court-based dispute mechanism rather than using panels has long been a contentious issue for Canada in trade negotiations with the U.S. Indeed, Canada walked out of the Canada-U.S. trade talks in 1987 for a time on this very point. Canada recently threatened to withdraw from NAFTA talks if the U.S. continues to insist that the dispute-settlement panel provision be abolished. Should Canada feel compelled to follow through on that threat, it could prompt a bellicose reaction from a U.S. president that had previously threatened to unilaterally withdraw from the trade pact.

Safeguard exclusions – Canada and Mexico are currently excluded from American trade law provisions that allow the U.S. to impose tariffs or quotas to assist domestic industries that are seriously injured by foreign trade practices. The U.S. proposes to eliminate the exemption for Canada and Mexico. This change, combined with court-based dispute settlement panels, could open up a Pandora's Box of tariffs under the guise of safeguard exclusions, anti-dumping, and countervailing duties. Loss of safeguard exclusions for NAFTA partners could preserve the threat of trade tariffs and seemingly runs counter to the spirit of a free trade agreement. By our assessment, tariffs usually have negative consequences for both sides (see lower exhibit).

Rules of origin – The U.S. wants to decrease foreign content of freely-tradeable goods within the NAFTA zone, and it wants to increase the level of content produced in America. This issue has particular implications for an increasingly integrated North American automotive supply chain and is understandably meeting resistance from both Mexico and Canada.

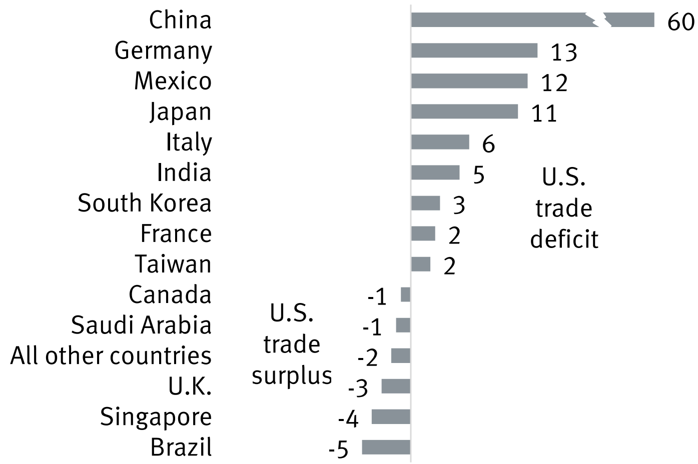
In this highly interconnected world—even more so since NAFTA was adopted 23 years ago—multiple countries are regularly involved in supplying parts, producing goods, and in various stages of product assembly. Parts move back and forth throughout the process with re-importing and re-exporting, within and outside of the NAFTA zone, until the product is finished. It's an elaborate, yet efficient web that brings products to consumers at low costs.

Striking a balance

The Trump administration has seemingly made reducing the NAFTA trade deficit the headline issue. On this measure, the NAFTA dispute is mainly about the trade deficit with Mexico, as the U.S. runs a trade surplus with Canada. Moreover, the concept of trade balance does not necessarily take into account the total value of trade and its coincident impact on economic growth in evaluating the merits of a trade pact. Not to mention, trade deficits are a reality when you have the world's reserve currency.

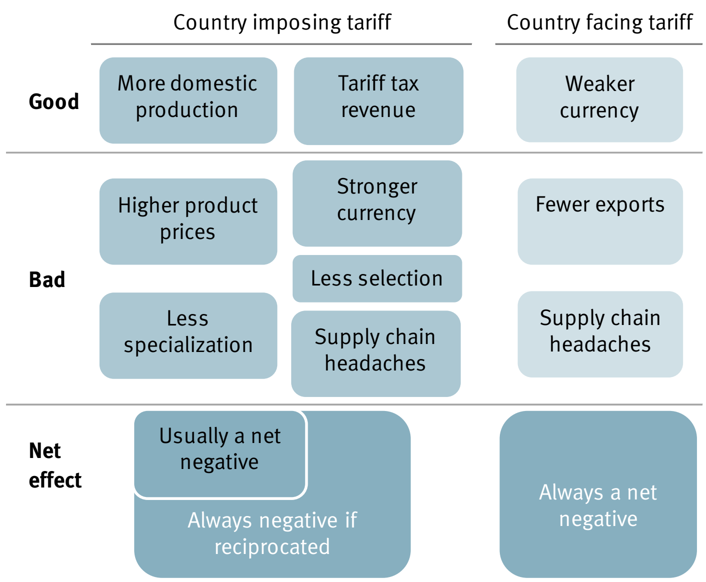
U.S. trade deficit with China tops the list

U.S. trade balance (% of total)



Source - RBC Global Asset Management, U.S. Census Bureau, Haver Analytics; cumulative 12-month trade balance to Q1 2017; China data is truncated so as not to distort the rest of the chart

What happens when tariffs are imposed?



Source - RBC Global Asset Management, RBC Wealth Management

With a general election in Mexico and U.S. congressional midterms looming in 2018, an aggressive timeline has been set to conclude the renegotiation of NAFTA with U.S. Commerce Secretary Wilbur Ross preferring to conclude talks by January. That compressed timeline could moderate the scope of renegotiation on the aforementioned sticking points, sharpen the focus on modernization and easy wins, and limit wholesale changes. However, given the complex nature of the negotiations and the U.S. trade representative's assertion that he will not be bound by an artificial deadline, NAFTA talks and the associated headlines may drag on into 2018.

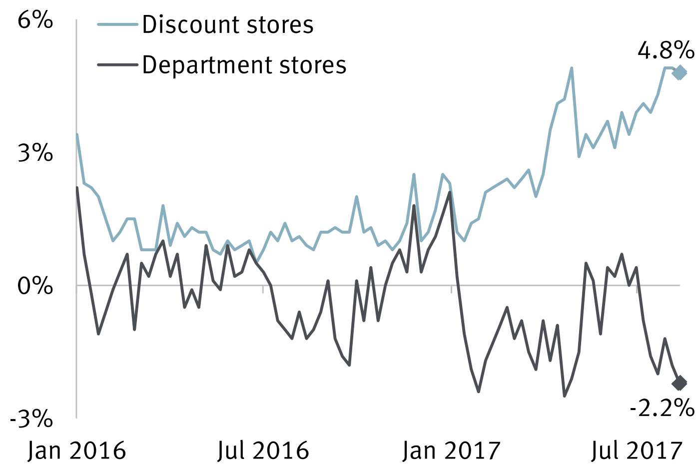
United States

Kelly Bogdanov – San Francisco

- As U.S./North Korea rhetoric calmed down, **the market turned back to basics** and focused on economic data and earnings reports. At first, the market mainly overlooked the controversy surrounding the president's Charlottesville comments and the breakdown of his business advisory councils. But as these developments and the larger political fallout were contemplated more by market participants, the S&P 500 declined 1.5% on Thursday.
- **Retail sales**, including the portion that feeds into GDP data, **rose more than expected in July**. This prompted the Atlanta Fed to raise its Q3 GDP tracking estimate to 3.85%. While that estimate will likely change and could even get dialed back as more data rolls in, it's an indication Q3 GDP could exceed economists' 2.1% consensus forecast.
- The retail sector's slew of earnings reports was in the spotlight. **Target, TJX, and Urban Outfitters** (Anthropologie and Free People brands) reported **better-than-expected quarters**. Target posted 32% y/y growth in digital sales, significantly higher than the consensus estimate. The TJX beat was helped by a 7% y/y rise in sales at its HomeGoods division, which benefitted from a boost in foot traffic by millennials. TJX is one of the few retailers with an aggressive plan to build new brick-and-mortar stores. This comes at a time when the **U.S. retail industry as a whole has an overabundance of stores compared to other developed nations**—said differently, the U.S. is "overstored." Urban's beat came from a combination of improved fashion offerings and low expectations following prior misses. **Many other retailers are still struggling**, including Macy's, J.C. Penney, Dick's Sporting Goods, and Advance Auto Parts.
- The retail industry is particularly challenged by pricing competition and heightened pricing transparency of the internet. **Competition from behemoth online retailer Amazon and digital sales strategies in general continue to be key themes** on many retailers' conference calls. For example, even though Home Depot reported a strong quarter and provided constructive forward guidance, the stock traded down as analysts peppered the management team with questions about online competition. From our vantage point, concerns about Amazon are unlikely to lift anytime soon. But over coming quarters, we should be able to better discern which traditional retailers can compete effectively online.

Not all retail sales are created equal

Johnson Redbook same-store-sales, y/y



Source - RBC Wealth Management, Bloomberg, Johnson Redbook; weekly data through 8/12/17

Canada

Patrick McAllister & Farazeh Mahboob – Toronto

- As discussed earlier in this report, **the first round of NAFTA renegotiations is underway** between Canada, the U.S., and Mexico. In light of this, RBC Capital Markets has addressed the potential adjustments that could be made to the current limit for duty-exempt purchases outside of Canada. The U.S. negotiating position is to have **Canada's limit increased to $800** from $20. RBC Capital Markets believes a compromise of $200 is possible with risk to the upside seemingly more likely than a lower limit. A higher duty-exempt limit **could have significant implications** for brick-and-mortar retailers and their landlords.
- **Competitive conditions in the domestic grocery market remain intense** at a time when the industry is confronting **multiple challenges**. Recent strength in the Canadian dollar could prolong the current period of food price deflation and the corresponding headwind to top-line growth. On the cost side of the equation, grocers are investing in e-commerce initiatives while facing **significant wage inflation** from proposals to increase the minimum wage in Ontario and Alberta. While we value the defensive ballast high-quality grocery positions offer a portfolio, we would **caution against overweight allocations** in light of these challenges.
- **The S&P/TSX Composite has tended to move higher** with sharp rallies in the Canadian dollar, yet the **latest rally** in the loonie has proven to be an exception, per RBC Capital Markets' analysis. Furthermore, **oil prices have also typically risen in tandem with periods of appreciation**

in the CAD; however, this **has not materialized** with the latest rally, which has been fueled by a change in tone at the Bank of Canada, higher interest rates, and previously bearish CAD investor positioning. As such, we would caution that past cycles may provide limited insight into the future path of the S&P/TSX.

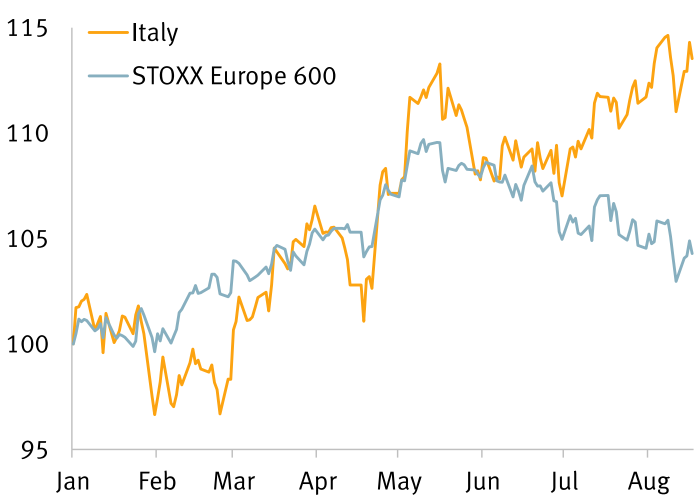
Europe

Frédérique Carrier & Thomas McGarrity – London

- With the reporting season now all but over, news flow is diminishing as the traditional August holidays are nearing in Europe. **Equity markets are in a consolidation phase**, though the Italian FTSE MIB Index is very close to an 18-month high, benefitting from the rerating of the country's banks. **Macroeconomic data** released both in the U.K. and Europe merely **reiterated recent trends**.
- In the U.K., **headline CPI was unchanged at 2.6% y/y**, in line with both the Bank of England's and RBC Capital Markets' forecasts. **Unemployment fell to 4.4% y/y** for the three months to June, the **lowest level since 1975**. The dwindling slack in the labour markets is an important consideration for the Monetary Policy Committee. It is not yet leading to inflationary pressures with the **average weekly earnings growth** continuing to hover at around 2.1% y/y for the three months to June. This suggests to us that real earnings are down 0.5%, so the **squeeze on earnings has not abated**. With RBC Capital Markets' expectations that CPI will pick up to 3.1% y/y later this year, the squeeze on real income is **likely to continue**, unless nominal pay starts to surge.

Italy avoids European pullback on the rerating of its banks

Year-to-date returns, indexed to 100



Source - RBC Wealth Management, Bloomberg; data through 8/17/17

- When commenting on its solid results in the H1 2017, U.K. insurer **Prudential** also announced that M&G, its U.K. asset management division, and Prudential's U.K. & Europe life assurance businesses, are being merged together, in another sign that the **U.K. asset management industry is being reconfigured**, as the wave of consolidation that has swept the asset management industry in the U.K. continues. Many observers commented that this could be a precursor for an eventual sale or spin-off (*Financial Times* August 10, 2017), a move which has been widely mooted since the financial crisis. However, Mike Wells, Prudential chief executive, would not comment on whether the decision to merge the two businesses was the first step on the road to a break-up.

Asia Pacific

Yufei Yang – Hong Kong

- Following strong second-quarter growth, **China's economy softened in July and missed expectations** due to exports and a housing slowdown. **Industrial output and fixed-asset investment grew at a slower pace** than in June. Retail sales expanded 10.4% y/y, but were lower than Bloomberg's 10.8% projection and the 11.0% in June.
- **The top two China internet giants reported better-than-expected results**. **Tencent Holdings** (700 HK) posted quarterly earnings that surpassed even the highest estimate on Bloomberg. **Sales rose 59%** to 56.6 billion yuan ($8.4B), and **net income surged 70%** compared to one year ago. Online games remained the largest contributor, accounting for 42% of total revenue. Driven by its hit game *Honor of Kings*, **mobile game revenue was up 54% y/y**, surpassing PC games for the first time. Launched in 2015, *Honor of Kings* has over 200 million registered users and 70 million daily active users. **Advertisements and other revenue** (including payments and cloud) **surprised on the upside**, increasing 55% and 177%, respectively.
- China's largest e-commerce firm **Alibaba** (BABA) also delivered strong growth. **Revenue rose 56%** to $7.4B, and **net income was up 67%**. Its core **e-commerce business grew 58%** in the last quarter, making up 86% of total revenue. Active buyers on its platform reached 466 million. Cloud business was another growth engine. Sales jumped 96% with paying customers exceeding one million for the first time. In June, Alibaba raised its expectations for full year revenue growth to 45%–49%. Alibaba and Tencent have gained 82% and 74% this year, respectively, outpacing their global peers.
- **Japan's economy grew for a sixth straight quarter**. GDP was up 4% in the three months ended June 30. Exports accelerated to 13.4% in July, compared with a 9.7% gain in June. Imports jumped again, a sign that domestic demand is recovering.

MARKET SCORECARD

Data as of August 17, 2017

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	2,430.01	-1.6%	8.5%	11.4%	15.6%
Dow Industrials (DJIA)	21,750.73	-0.6%	10.1%	17.1%	24.0%
NASDAQ	6,221.92	-2.0%	15.6%	19.0%	22.2%
Russell 2000	1,358.94	-4.6%	0.1%	10.7%	10.9%
S&P/TSX Comp	15,033.64	-0.7%	-1.7%	2.3%	5.5%
FTSE All-Share	4,052.37	0.2%	4.6%	8.6%	13.0%
STOXX Europe 600	376.87	-0.3%	4.3%	10.7%	-2.7%
EURO STOXX 50	3,461.97	0.4%	5.2%	16.2%	-1.0%
Hang Seng	27,344.22	0.1%	24.3%	19.9%	14.8%
Shanghai Comp	3,268.43	-0.1%	5.3%	5.1%	-18.2%
Nikkei 225	19,702.63	-1.1%	3.1%	17.7%	-4.5%
India Sensex	31,795.46	-2.2%	19.4%	13.5%	14.1%
Singapore Straits Times	3,268.88	-1.8%	13.5%	15.0%	6.6%
Brazil Ibovespa	67,976.80	3.1%	12.9%	14.6%	44.0%
Mexican Bolsa IPC	50,994.18	0.0%	11.7%	5.7%	16.0%

Commodities (USD)	Price	MTD	YTD	1 yr	2 yr
Gold (spot $/oz)	1,288.03	1.5%	11.8%	-4.5%	15.2%
Silver (spot $/oz)	17.03	1.2%	7.0%	-13.5%	11.1%
Copper ($/metric ton)	6,496.50	2.5%	17.6%	36.5%	27.2%
Oil (WTI spot/bbl)	47.09	-6.1%	-12.3%	0.6%	12.5%
Oil (Brent spot/bbl)	50.90	-3.3%	-10.4%	2.1%	4.4%
Natural Gas ($/mmBtu)	2.92	4.5%	-21.6%	11.5%	7.0%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	2.184%	-11.1	-26.1	63.4	1.6
Canada 10-Yr	1.848%	-20.9	12.7	79.4	47.6
U.K. 10-Yr	1.087%	-14.3	-15.2	52.4	-73.0
Germany 10-Yr	0.426%	-11.7	21.8	47.6	-20.1
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.48%	0.4%	3.1%	0.1%	5.6%
U.S. Invest Grade Corp	3.14%	0.1%	4.7%	1.8%	10.5%
U.S. High Yield Corp	5.72%	-0.5%	5.6%	8.6%	17.5%

Currencies	Rate	MTD	YTD	1 yr	2 yr
U.S. Dollar Index	93.7280	0.9%	-8.3%	-1.0%	-3.2%
CAD/USD	0.7890	-1.5%	6.0%	1.3%	3.2%
USD/CAD	1.2674	1.6%	-5.7%	-1.3%	-3.1%
EUR/USD	1.1720	-1.0%	11.4%	3.8%	5.8%
GBP/USD	1.2869	-2.6%	4.3%	-1.3%	-17.4%
AUD/USD	0.7883	-1.5%	9.4%	3.0%	6.9%
USD/JPY	109.5700	-0.6%	-6.3%	9.3%	-11.9%
EUR/JPY	128.4200	-1.6%	4.4%	13.4%	-6.8%
EUR/GBP	0.9107	1.6%	6.7%	5.2%	28.1%
EUR/CHF	1.1286	-1.4%	5.3%	3.9%	4.1%
USD/SGD	1.3665	0.8%	-5.6%	1.8%	-2.9%
USD/CNY	6.6755	-0.8%	-3.9%	0.6%	4.4%
USD/MXN	17.8474	0.3%	-13.9%	-1.6%	8.6%
USD/BRL	3.1755	1.6%	-2.4%	-1.0%	-8.8%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the German DAX and Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 8:38 pm GMT 8/17/17.

Examples of how to interpret currency data: CAD/USD 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 6.0% return means the Canadian dollar rose 6.0% vs. the U.S. dollar year to date. USD/JPY 109.57 means 1 U.S. dollar will buy 109.57 yen. USD/JPY -6.3% return means the U.S. dollar fell 6.3% vs. the yen year to date.

UPCOMING EVENTS

Fri, Aug 18
- U.S. Univ. of Michigan Sentiment (94.0)
- Canada CPI (1.2% y/y)

Sun, Aug 20
- U.K. Rightmove House Prices

Mon, Aug 21
- U.S. Chicago Fed National Activity

Tue, Aug 22
- China Conf. Board July Lead. Eco. Index
- Eurozone ZEW Surveys

Tue, Aug 22, cont.
- Germany ZEW Surveys
- U.S. FHFA House Price Index
- Canada Retail Sales

Wed, Aug 23
- Japan Nikkei Manufacturing PMI
- Eurozone Markit Manufacturing PMI
- Eurozone Markit Serv./Comp. PMI
- Eurozone Consumer Confidence
- Germany Markit Manufacturing PMI

Wed, Aug 23, cont.
- Germany Markit Serv./Comp. PMI
- U.S. Markit Manufacturing PMI
- U.S. Markit Serv./Comp. PMI
- U.S. New Home Sales (0.4% m/m)

Thu, Aug 24
- Japan CPI
- U.K. Q2 GDP
- U.K. Index of Services
- U.S. Existing-Home Sales (0.6% m/m)

Thu, Aug 24 – Sat, Aug 26
- Jackson Hole Central Bank Symposium

Wed, Aug 30
- U.S. Q2 GDP Revision (2.4% q/q annl'zd)
- U.S. ADP Employment Change
- U.S. Core PCE

Wed, Sep 6
- BoC Meeting

Thu, Sep 7
- ECB Meeting

The dates reflect North American time zones. All data reflect Bloomberg consensus forecasts where available.

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Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	826	52.01	293	35.47
Hold [Sector Perform]	657	41.37	144	21.92
Sell [Underperform]	105	6.61	7	6.67

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