The Thompson Letter

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New deal – few surprises

Since the inauguration of President Trump, there have been concerns over Canada's ability to keep the United States in the North American Free Trade Agreement (NAFTA). The NAFTA accord promoted trade within Canada, the U.S. and Mexico by lowering or removing tariffs on a range of products. It was decided that the agreement, which was a quarter-century old, needed improvements and adjustments to reflect a new and evolving economy, and advancements like ecommerce.

Over the last year, negotiations intensified as the U.S. invoked tariffs on steel and aluminum. In the late summer, Mexico and the U.S. signaled that they had reached consensus on a new deal without Canada's involvement but would provide a window to September 30 for Canada to sign on to an updated agreement.

Canada joined a reworked, trilateral NAFTA replacement deal late on Sunday, September 30 after the U.S. finally relented, it appears, on a "five year out" clause. The new deal has been renamed the United States-Mexico-Canada agreement or USMCA. Like in all deals, there are some portions where it appears Canada won and some areas where it appears the U.S. won. On the following page, you'll find a breakdown from RBC Economics of what Canada conceded on and what we got in exchange.

New deal – few surprises
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What did Canada concede?

Rules of origin: As expected, Canada was OK with new auto rules of origin – agreed to bilaterally between Mexico and the U.S. – that upped required North American content and included a new "high-wage" component. Canada likely wouldn't have asked for the changes at the outset of negotiations, but the new rules will be more significant for Mexico than for Canada.

Sunset clause: The original U.S. demand for a five-year termination of the new deal softened into essentially a 16-year agreement with an option to extend after six-years. Given any party already has the option to terminate NAFTA with six months' notice, a 16-year "sunset clause" with high likelihood of extension probably doesn't change the calculus from a long-run business investment perspective all that much relative to the status quo.

Dairy trade: Also as expected, Canada made some concessions on dairy trade and will allocate to the U.S. approximately 3.5% of the Canadian dairy market – but leave the existing dairy supply management system largely in place. Canada had already made similar concessions in agreements with Europe (CETA) and partner countries in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership. As in past agreements, the government is likely to provide some compensation to Canadian farmers for this latest market share concession.

Biologic drugs and "de minimis" thresholds: Canada also gave in to demands to lengthen patent protection for biologic drugs to 10 years from eight years and will reportedly boost the amount of cross-border online purchases available for duty-free import to C$150 from C$20. The latter could cause some consternation among Canadian retailers, but probably will be welcomed by consumers.

What did Canada get?

Exemption from potential auto tariffs: Perhaps the most important measure for the near-term economic outlook was the inclusion of measures to protect the Canadian auto sector from potentially significant U.S. auto tariffs – along the lines of the 10% to 25% aluminum and steel product tariffs already implemented – pending the conclusion of an ongoing U.S. investigation into trade in the sector. Those tariffs against Canada were always viewed as unlikely because close industrial integration across the border means U.S. producers would also be hurt. Nonetheless, if implemented, they would probably have a larger near-term negative impact on the economy than a NAFTA tear-up itself.

Dispute resolution: In somewhat of a coup for the Canadian side, Canada was successful in keeping NAFTA's so-called Chapter 19 dispute settlement mechanism largely intact – a measure that the Canadian side had argued was indispensable, particularly given the seemingly erratic approach of the current U.S. administration to tariff actions.

Tariff cool-down period: Canada will get a 60-day exemption from any further U.S. tariffs or import restrictions imposed under Section 232 to allow the two parties to work toward a negotiated outcome.

Less uncertainty: Canadian business investment has been on the soft side despite low financing rates and production running close to capacity limits already. This agreement doesn't entirely eliminate uncertainty – new trade frustrations could yet emerge and broader U.S. trade tensions globally remain. Nonetheless, less uncertainty sets the stage for Canadian businesses to put more investment dollars to work.

While it's possible to conclude that the deal consists largely of tweaks to the old agreement, we believe reduced uncertainty about the U.S.-Canada trade relationship could prompt businesses to put more investment dollars to work and will support exports. Overall, however, the new deal doesn't much change RBC Capital Markets' base-case economic outlook for markets and the economy. And, we believe the USMCA won't alter the Bank of Canada's thinking on the pace and extent of future interest rate hikes.

In the end, it is great to get this overhang out of the way. Canadian markets have underperformed U.S. markets again this year and the uncertain trade outcome has been a central issue for investors. The deal will still need to be ratified by the U.S., Mexican and Canadian governments so a few more changes could happen before the final agreement is signed off on, but it is good to know that something that has worked so well will remain in place.

Has it been 10 years?

This past month marked 10 years since the demise of Lehman Brothers, a household name for investors and investment professionals alike. The bankruptcy set off a cascading effect that sent investors hurtling out of the market as share prices across all sectors crumbled. At that time, it felt like the capitalist system was on the verge of a collapse. The loss of Lehman's signaled the start of the greatest economic downturn since the Great Depression. While Canada's economy fared better in the aftermath than the U.S.'s, the uncertainty surrounding job security and savings had investors questioning their ability to maintain a desired lifestyle.

Thankfully, steps were taken (extraordinary steps) by governments and central banks around the world. Measures to promote liquidity in the economy so that commerce would begin moving again included the government dropping interest rates to extraordinary levels and putting backing in place to support the financial services sector.

I will never forget this period of my life, as it felt like there was nothing one could do to stop the erosion of wealth. As I look back on those fateful days, I realize I now count on a few lessons that I learned from the events of 2008 and 2009 that I believe should never be forgotten:

1. **Asset allocation is vital to maintaining your sanity with regards to your investment plan**. If changes in the short-term value of your investments are an issue for you, make sure you hold bonds and GICs to add buoyancy during rough markets so you do not "sell low."
2. **Diversification both by sector, geography and investment style are important.** While the more cyclical sectors were on fire going into the downturn, it was the old economy, high-dividend investments, that did best as we came out.
3. **Dividends are essential.** They provide income to your portfolio in tough market conditions. Also, it provides cash flow for lifestyle requirements or opportunity to reinvest when shares go on sale.

Sticking by your investment plan through the highs and lows of the investment cycle is essential to making progress toward your investment goals. Investors who chase the latest investment fad or try and be all in or all out of the market tend to make changes at counterproductive times.

Today, U.S. consumer confidence is the highest it's been in 18 years. The Conference Board's consumer confidence index increased to 138.4 in September from 134.7 in August. This is its highest level since it hit 144.7 in September 2000. Employment remains very full in North America, economies around the world continue grow in a synchronized fashion for the first time since the recession and corporations are producing sizeable profits.

But there are some concerns that we have to watch out for in the short term. Interest rates have moved up and will likely move even higher as global economies normalize. This is a normal situation as it signals the economy is growing on its own without government support. It will also provide central banks room to maneuver down the road when an inevitable economic slowdown develops.

Our U.S. Technical Analyst, Bob Dickey, believes we are in the middle innings of a longer-term secular bull market but that the bull market may have to digest the moves of previous years, especially in the U.S. That can lead to short-term market returns that pale to previous years.

He and our RBC Capital Markets strategist team do not see the dark days of 2008/09 being revisited any time soon. RBC Capital Markets continues to maintain that there is more upside to the markets, but that a return to a more normal level of volatility is likely. Present weakness, then, should not be surprising.

For myself, today's markets remind me of the early 90s when I started.

I will grow more concerned when consumer and investor optimism begin to move to levels that are unsustainable and at that time, I will once again remember the investment rules required to maintain my investment plan and live through the good and poor markets.

But what about wage growth?

The big story in the labour market is why haven't wages risen at a faster pace as employers compete for available talent? Canada's wage growth is below 6% and in the U.S. it has fallen even further. There are a few forces at work such as a demographic shift of older, higher-paid workers retiring and being replaced by younger, lower-paid workers, as well as the impact of technology in the labour force, allowing the same amount of employees to be more efficient and do a greater amount of work.

Another factor at play is that while wages are remaining under control, benefit compensation has been growing significantly faster.

Regardless, the subdued level of wage growth may work to keep a lid on inflation and allow the Fed to maintain a slow and gradual approach to raising interest rates.

Final notes and quotes

Moody's gives Canada's banks a "thumbs-up." This hit the wires on August 15, but in case you missed it, credit ratings agency Moody's Investor Services noted that Canada's largest lenders have boosted their capital enough in the past two years to withstand a 35% decline in housing prices in Ontario and British Columbia, and 25% in the rest of the country. According to Moody's, the lenders, which include Canada's six biggest banks and Quebec's Desjardins Group, have "materially higher" levels of regulatory capital, measured by the Common Equity Tier 1 ratio, that "would enable them to absorb marginally higher expected losses in their mortgage exposures," Moody's said. Canadian banks have been an integral part of Canadian's portfolios for a long time and it is nice to see the ratings agency provide us with some comfort that our lenders are well prepared for potential problems … U.S. household net worth just hit $107 trillion and in relative terms it is at an all-time high of 5.23x nominal Gross Domestic Product (that is huge!). What is significant about this is it is coming during a cycle that has been characterized by household de-leveraging. It took bubbles of epic proportions (like the ones in tech and housing) in the past to boost net worth/GDP significantly. This time around, we have a household balance sheet where liabilities relative to net worth are sitting at a 33-year low. Pristine balance sheets coupled with significant momentum from tight labour markets (firming wage growth) and tax reform (firming after-tax income) puts the consumer in a position to continue carrying this cycle for a while. Note that the last consumer cycle lasted 16 years (real consumer spending never declined in the 2001 recession). The current one is only the fourth-longest on record. Food for thought for those who think the cycle is long-in-the-tooth … **The Winnipeg community lost a great guy this September when Ab McDonald passed away. While he was well-known as a multiple Stanley Cup winner and the first captain of the WHA's Winnipeg Jets, I got to know Ab in a few celebrity golf tournaments years ago and found him to be a passionate supporter of charities across the province and a truly great person to be looked up too. I cannot say I knew him well and unfortunately I ran across him infrequently in these last few years, but always relished the opportunity to say hi to a true gentleman. The city will miss him …** Markets are once again displaying the October trends. More to the point, they have been rotten recently as interest rates make new highs. Be patient, rates are rising on economic growth and that is positive for the long term. To learn more about this, please turn to my client letter. If you are not a client but have questions, please give me a call.

Have a great fall.

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