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What We Think...

NAFTA & Canada-US Trade

One need not be an expert to have an "expert" opinion on the outlook for global trade – expertise doesn't give one any better insight into the kinds of political decisions coming out of Washington that are ultimately shaping the outlook. A year ago, we were led to believe that Canada was not going to be a major target of the White House's trade reforms - "We have a very outstanding trade relationship with Canada. We'll be tweaking it. We'll be doing certain things that will benefit both of our countries", President Trump said at a news conference following his first face-to-face meeting with Justin Trudeau. After all, in a world where trade deficits have become cause celebre, Canada, with its roughly neutral trade balance with the US (according to the Office of the United States Trade Representative) would appear to be small fry compared to China with its $375 Billion USD trade surplus (2017). In hindsight however, Canada was always unlikely to get off scot-free, given its involvement together with Mexico and its $71 Billion USD trade surplus with the US (2017), in NAFTA. Now, Canada finds itself front and centre, alongside other traditional US trade partners, in a tariff battle with the White House.

Since the departure of Gary Cohn and Ray Tillerson (reasonable and dovish voices) from the Trump administration, the White House trade team has been dominated by the trade "hawks" and confrontational personalities of Navarro and Lighthizer. They have enabled Trump's own confrontational tendencies to rise to the surface and produce a very aggressive negotiating style. It is a little surprising that confrontations have emerged between the US and its western allies, when Asia offers bigger targets. We still believe that the most important trade issue (imbalance) for the White House is with China and that this will ultimately be the government's priority.

We think a renewed NAFTA is mostly in the hands of Mexico, as they are the ones who will have to concede the most, on what we see is the US's most material NAFTA issue – the auto sector. It appears that Mexico is ready to make necessary compromises here, even with a newly elected government, but only time will tell. We see the issue of dairy supply management as the most provocative Canadian NAFTA issue, albeit mostly for its shock value as a negotiating tactic and for generating support amongst the US electorate, rather than for its US export potential – the total industry was $15 Billion USD in 2016 (0.08% of US GDP). We think the Canadian government will likely have to offer up some kind of adjustment to supply management, something we speculate they will be willing to do, broad federal political opposition notwithstanding.

Washington's desire for a "5-Year Sunset Clause" – meaning that NAFTA agreement would be subject to automatic cancellation unless agreed to by all parties, appears to be one of the most unresolvable NAFTA issue. We confess, that we find it hard to believe that the US will remain adamant on this issue, given that the current agreement implies that the US government is able to exit NAFTA at any time (within an existing process) anyway. And merely putting doubt over the future of NAFTA, is enough to alter trade and investment dynamics. We understand Lighthizer is particularly adamant that the clause be agreed too, but at the same time, we do think that Canada's position will remain insistent on a longer-term agreement, something that may be more palatable to the US in the context of bilateral agreements. (We note that the head trade negotiator of the newly elected Mexican government, appears to have accepted the reality of a bilateral trade deal outside of NAFTA.)

So, what are the prospects for a bilateral Canada-US trade agreement? We believe the general relationship with Mexico is very high on the list of issues for the White House, and consequently, Canada will remain embattled, so long as its stands by NAFTA and Mexico. Trump has clearly offered Canada a way out, through a "bilateral agreement", which, up until now the prime minister and Chrystia Freeland have been unwilling to consider, at least publicly. We reason that the

Gary Morris, CFA
President
T. 647.776.8111 E. info@loricaic.com www.loricaic.com

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government believes it has a stronger negotiating position as part of a Canadian-Mexican alliance. Nevertheless, we do think the White House ultimately has the power to enforce its will in this regard (by upping the heat through additional tariffs), but with the potential for significant damage to all parties, in the process.

We think, the Canadian government's strategy may have initially been to try and drag-out the NAFTA negotiations and perhaps outlive President Trump (and his congressional majority) – this will not happen. We think the most probable scenario for Canada is a renewed NAFTA or a bilateral agreement with adjustments in the auto sector and supply management. The removal of recent tariffs would follow, with an overall dampening of the Canada-US trade conflict. With an agreement in place, we see the medium-term impact to trade to be relatively benign. However, should an agreement contain a sunset clause, we would expect to see further erosion of foreign investment in Canada with negative consequences on trade longer-term.

Should NAFTA be terminated with no bilateral Canada-US agreement, all bets are off. Escalation of the trade war between the US and Canada and Mexico will include auto tariffs – with disproportionate damage to the Canadian and Mexican economies. Perhaps one salient point to remember, is that the US will also suffer an escalation of the trade conflict (autos is just one example that would have ramifications on all sides of the borders), which will not go over very well with many Americans, evidenced by the existing divisions within congress over NAFTA. Ultimately, disagreement inside the US could prove to be the constraint on the extent of a Canada/Mexico-US trade war.

US trade with China, Canada and Mexico represent the top three binational trading relationships (by $'s) in the world, with Japan and Germany also in the top ten. Disrupting any of these relationships will have a negative impact on global growth, although not necessarily shared evenly (of course the Trump administration is counting on strong US growth to distract from any fallout suffered by the US). We expect disruption to US-China trade to have a negative effect on near-term global growth. Disruption to other US trading relationships will similarly be problematic.

Trade & The Bond Market

So, what are the implications for the Canadian bond market? We are not surprised that investor expectations for a July rate hike from the Bank of Canada have been extremely volatile (See Figure 1) sitting at an 85% probability (at quarter-end according to the overnight indexed swap market). The Bank has deliberately eschewed forward guidance, so as to keep its policy options wide open, but has left itself exposed to sending mixed signals. Governor Poloz has affirmed that the Canadian economy warrants tighter monetary policy but has also highlighted that there are many uncertainties ahead. The most recent strong economic data has caused investors to increase the probability of a hike in July, but we are unconvinced. NAFTA has already had an impact on Canadian trade and investment, and we feel that, with the current level of antagonism, the Bank will opt out, preferring to err on caution.

Figure 1: Probability of Hike July – Last 12 Months

Source: Lorica Investment & Bloomberg; June 2018

US-Canada spreads have widened by roughly 35 bps across the yield curve since the beginning of the year,

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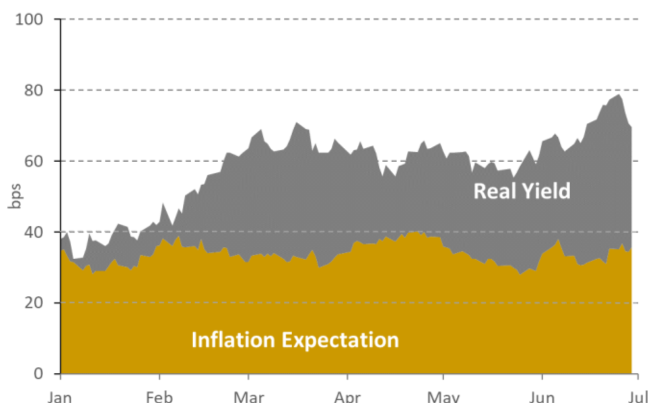
largely on the back of divergent growth forecasts and trade concerns. Real yields and inflation expectations represent close to 90% and 10% of the widening, respectively (See Figure 2). Since the beginning of the year, Canadian real yields have been basically stable, falling by a couple of basis points, in contrast to US real yields which have risen. The divergence of Canadian and US real yields reflects divergent growth expectations and monetary policies, and NAFTA fears. The Fed appears to have regained market confidence with consistent hikes, while the BoC has been deliberately non-committal. Nonetheless, Canadian real yields remain exceedingly low, and we would argue, inconsistent with the current growth profile.

Figure 2: US-Canada 10-Year Yield Spread – YTD



Source: Lorica Investment & Bloomberg; June 2018

We think a pre-emptive hike by the BoC, or a surprise resolution to NAFTA negotiations (with an implicit green-light to the Bank) would both lead to higher Canadian real yields. A July pass from the Bank, will not change yields much, as investors will most likely attribute the hesitancy to NAFTA uncertainty. Inflation expectations have been sticky on both sides of the border, albeit higher in the US, despite tight labour markets overall. We still believe that wage growth will lead to broader inflation increases in both countries and become a greater factor in nominal yields. Colouring the Canadian inflation outlook is the tariff actions and the weakness of the Canadian dollar which should both be inflationary. In summary, we feel that the risks to both real yields and inflation expectations in Canada are more heavily weighted to the upside.

What of the inverting yield curve? There is no denying that longer-term yields have not kept pace with central bank actions in both Canada and the US. The extreme flattening of both country's yield curves, (which many believe are headed for inversion) is more typical of late stages of a tightening cycle, ahead of a slowdown. Given the more measured actions of the Bank of Canada, as compared to the Fed, we find it surprising that the Canadian yield curve has flattened by 29 bps this year compared to 40 bps for the US yield curve (See Figure 3).

Figure 3: Yield Curve Slope – YTD

Source: Lorica Investment & Bloomberg; June 2018

Our portfolios have been positioned consistent with our fundamental outlook – for higher real yields and inflation with a cautious Bank of Canada. As we have mentioned before, both real yields and inflation expectations in Canada have lagged the increase in the US, largely because of NAFTA and trade. We have generally been optimistic, that the Canada-US trade dispute will be resolved before severe damage to the Canadian economy, but we recognize that the outcome could easily defy rationale.

Risks & Risk Management

The worst-case scenario would be a recession, due to destructive tariffs and the collapse of business

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investment in Canada. Under such a dire scenario, government yields would rally and corporate yield spreads would widen, with the worst performance reserved for the weakest credits. We would expect the Bank of Canada to respond, by aggressively lowering interest rates, thereby steepening the yield curve. Although recession is not our base case scenario, we have maintained an optimal balance between maximum exposure to credit, but with higher quality and shorter maturities, thus minimizing risk to spread widening. Should our expectations of recession increase, we would look to extend duration in government positions.

The biggest risk to absolute performance would be from higher or stable short-term rates and lower long-term yields - in other words, a likely inversion of the yield curve. The portfolio's concentration in shorter maturities would be exposed to tighter monetary policy from the BoC, while the dearth of long-term positions, would mean little benefit from falling long bond yields. While the Fed is on a consistent tightening schedule, we do not foresee similar policy from the BoC, so in our view, an inversion would have to take place with little movement from the Bank and with economic contraction in the horizon – a more improbable scenario. Ultimately, we don't see anywhere near the scope for policy error in Canada, that some see in the US – a view that we believe is partially responsible for the flattening of the US yield curve.

Risk management has always been fundamental to our approach to portfolio management – our investment process is a balance between return optimization and risk management. When we think of risks, we think of risks to the underlying value of the securities in the portfolio, generally influenced by yields and yield spreads, and creditworthiness. To manage the portfolio's exposure to risk, we consider term and weight (combined as duration weight) of every security, issuer, industry/province, sector and term.

The challenge of course is to know how different environmental factors will impact yields, spreads and credit. Some factors are more predictable than others; well down on the list of predictability are political factors; even further down are those related to political actors such as President Trump. Given the unpredictability of politics, managing risk related to political factors comes down to managing the portfolio's sensitivity to those factors, and not just relative to a benchmark, but in an absolute terms or dollars and cents.

We have made the point before that in an extremely low yield environment, it doesn't take much increase in yields to wipe out income, especially for longer maturities. Although Canadian yields have risen, on average, over the last 12 months, this has not been the case for long bonds. Consequently, yield break-evens – the amount yields can rise before income is wiped out – have become more attractive in short and mid-term bonds, but have remained inadequate for long bonds (See Figure 4). Maintaining an overall shorter duration with little long bond exposure, reduces the portfolios exposure to significant capital loss from higher long-term yields, albeit at the expense of more benchmark risk. We believe that political uncertainty is a significant factor embedded in the market, but in contrast to the post-election euphoria where optimism was rife, is relatively evenly balanced at this juncture.

Figure 4: Gov't of Canada 12-Month Break-evens

	Yield (bps)			12-Month Break-even (bps)		
Term	**Current**	**1yr Ago**	**Change**	**Current**	**1yr Ago**	**Change**
2	1.94	1.12	82	95	54	41
5	2.08	1.40	67	44	30	14
10	2.17	1.75	42	24	19	6
30	2.20	2.13	7	10	10	1

Source: Lorica Investment & PC Bond; June 2018.