

# PALOS

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## Palos Weekly Commentary

Issue No. 23 | JUNE 06 2019

### Macro View

*By Hubert Marleau*

### The U.S. Trade War That Could Include China, Mexico, EU and India Dominates the Headlines Forcing a Possible Tipping Point in Monetary Policy.

Just as the stock market was getting in a good buying zone, the Tariff Man upped the ante, turning against its third largest trading customer, imposing a 5% levy on all goods coming from Mexico on June 10, which will gradually increase to 25% until the illegal immigration problem is remedied. Actually, it results in an ultimatum---either block all asylum seekers fleeing poverty and violence in Central America from entering at the southern borders or accept responsibility for housing them. Clearly, a demand which is impossible for Mexico to satisfy.

The ghost of tariffs shattered the fragile calm that briefly descended across markets in the later days of May. It's a big deal. The US imports from Mexico \$350 billion worth of goods. That means that initially, the 5% tariff would, in round numbers, amount to \$20 billion, rising to as much as \$90 billion if the tariff rate ultimately rises to 25%. What is complicated is that almost 70% of all imports from Mexico are intra-company related, making the trade between Mexico and the U.S. part of the global supply chain. The enactment of these proposed tariffs would not only jeopardize the North American supply chains and dim the prospects for ratification of the USMCA but prevent many companies from operating in a country which has had long stable relations with the U.S. Its illogical, disruptive and costly. On the one hand, the administration is punishing Mexico with retaliatory tariffs and on the other hand asking Congress to approve a pact freeing up trade. It's therefore entirely reasonable to think that the USMCA deal could fall apart. It only adds concerns that the administration does not know how to deal with Mexico.

## Macro View cont.

*By Hubert Marleau*

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Regarding the tariffs, it's outrageous in that President Trump overruled his top advisers, opting to side with the hard-liners, by willingly violating Nafta and WTO rules of international trading. Thank God that Mexico is taking the high road. President Andres Manuel Lopez Obrador (ALMO) said that the Mexican Government will not act or respond in a desperate way, showing willingness to find an amicable and diplomatic solution. Almo has learned to take Trump's tariff threats with a grain of salt. But he was quite clear that Mexico doesn't deserve Trump's left-field broadside, cautioning that "America First" is a fallacy.

I'm not sure what we are supposed to think about this additional bombshell. Yet, I'm fully aware that immigration and trade issues got Trump elected and that he has in the past used the threat of tariffs to bring countries to the negotiating table. Once again, he has invoked the International Emergency Economic Powers Act, this time to justify stopping the flow of migrants from Mexico. The president said: "Mexico's passive cooperation in allowing this massive incursion constitutes an emergency and extraordinary threat to the national security and economy of the U.S.". I fail to understand how the across-the-board tariffs on Mexico are going to stop illegal immigration. The situation on the Mexican border has only worsened lately. Apprehension of illegal entrants is at its lowest level since the 1960s. In the judgement of a WSJ editorial, Mr. Trump is holding Mexico responsible for a mess which it cannot solve. "The cause of the illegal migration problem at the southern border is the lure of the U.S. asylum policy. Migrants know that if they cross the border with children, they can't be detained more than 20 days. They are then released into the US where they can work for years until their asylum hearing date; and most never show up."

It's bizarre in the opinion of the Council on Foreign Relations. This incongruous escalation is putting the fate of the updated USMCA trade deal into question, making it unlikely that the new version of Nafta will be ratified this year or at all. Canada and Mexico negotiated in good faith throughout the talks on the USMCA, including cooperation on migration. Many are questioning whether there is any point in negotiating with him. What utility is there, if one bends over backwards to renegotiate a trade deal only to find out that under any given pretense, Trump can impulsively decide on punitive actions at the speed of a tweet-- changing his mind on a dime. Is it not a misuse of Presidential authority and counter to Congressional intent? What would you do if you were a Head of State? ALMO did well to stay calm and try to pacify the situation, while knowing that any mitigation he may propose is unlikely to satisfy Trump's erratic demands. He knows that he must keep Mr. Trump happy. Mexico's proximity to the US puts his country in a promising position as a destination for businesses to locate their supply chains. Now issues unrelated to trade makes any cross-border supply chain inherently risky.

## Macro View cont.

*By Hubert Marleau*

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The reaction in the business milieu has been fierce, meeting resistance from business leaders and lawmakers. The US Chamber of Commerce said it's exploring legal options to respond to the Mexico tariffs, insisting that they should be quickly reverse. Baffled by the Presidential decision, several business groups were broader in their approach, discussing the possibility of suing the White House. An irate Chuck Grassley, Republican senator for Iowa, said that "trade policy and border security are separate issues". He's right it is an unrelated issue. Senate Majority Leader Mitch McConnell cited what he called a "humanitarian crisis at our southern border" but stressed the importance of economic ties with Mexico, saying "Any proposal that impacts this relationship deserves serious examination and I look forward to discussing this plan in greater detail with my colleagues and the administration." He should because mutual trust is obligatory for good relations when two neighboring countries share a very long border. This kind of trust has just taken a serious hit and the Mexicans will not forget the incident even after it gets cleared up. In this connection, Republican lawmakers are considering whether they should vote to stop the new tariffs on Mexican goods.

Moreover, the pronouncement that tariffs may be used for any given reason adds another layer of international complexity. Many nations must now believe that the U.S. negotiates in bad faith. The Mexican standoff is not escaping the attention of Germany and Japan who have large bilateral trade surpluses with the U.S.; it gave China an opportune moment to openly blame the mercurial President for abruptly reversing course on the China-US trade deal. It will, in the least, chill talks with all major trading partners because there is now evidence that Trump can resort to bullying practices if he does not get his way with China and Mexico not being the only victims. You might not have noticed but according to Trump, India is no longer a poor country. As of June 5, India's designation as a beneficiary developing country will terminate. It means that over 2000 Indian products will be subject to US tariffs. Indians are not happy. They succumbed to US pressure of not buying crude oil from Iran and yet suffered the loss of the special trade status. Perhaps, Xi Jinping didn't miscalculate the sincerity of the Trump's negotiating team. Jorge Guajardo, a former Mexican ambassador to Beijing and now a consultant in Washington with the firm of McLarty Associates, said; "Xi Jinping can make a point that there's simply no deal to be made with Trump." Robert Zoellick, the U.S. trade representative under George W, Bush and the World Bank, suggested that as Trump shreds international trust in the U.S., friendly countries must start preparing a Plan B: alternatives to relying on America.

## Macro View cont.

*By Hubert Marleau*

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This shift is already occurring, and the erosion is increasing rapidly. Grep Ip of the WSJ makes the point that the political trends which are weakening U.S. leverage with the world are compounded by economic trends. Since 1985, the U.S. share of global GDP has shrunk to 24% from 35%, while China's has grown to 16% from 3%. This means other countries have less to gain by cooperating with the U.S. and more to lose from antagonizing China.

Meanwhile, China wrote a white paper on the trade war called "China's Position on the China-US Economic and Trade Consultations". The 18-page paper is an appeal to the American people for cooperation concerning differences and frictions on the economic front and trade front. It goes on to say that China is willing to work with the U.S. to find solutions, and to reach a mutually beneficial win-win agreement based on principles that protects their best interest. It also emphasizes that what is at stake are the fundamental interests of two peoples, along with the prosperity and stability of the world. The authors go to some lengths to dismantle the notion that Trump's trade policies support making America great again. They make four headline points, verbatim:

1. The tariff measures have significantly increased production costs for US companies....
2. The tariff measures lead to domestic price hike in the US....
3. The tariff measures have an impact on US economic growth and people's livelihood....
4. The tariff measures lead to barriers to US exports to China....

The Heisenberg Report justly wrote that all four points are correct. That is not to say that there aren't intelligent counterarguments. It's the bottom line that counts---China wants the global supply chains to remain intact but is not ready in any circumstance to alter Chinese law in order to placate the U.S.

Timely, the Chinese white paper ends with a constructive message of hope just a few weeks before the G20 summit in Osaka. "It is hoped that the US can pull in the same direction with China and, in a spirit of mutual respect, equality and mutual benefit, manage economic and trade differences, strengthen trade and economic cooperation and stability for the well-being of both nations and the world."

## Macro View cont.

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Unsurprisingly, the Mexican peso and the Canadian dollar took an initial slide while risky assets like stocks and industrial metals stumbled. Yield on two- and five-year notes dropped below 2.00%. Expectations are building that there could be up to three rate cuts over the next 12 months. Many believe that the Fed will follow the market. Vice-Chair, Richard Clarida, pointed out that lower Federal fund yields were in the offing and St. Louis Fed President James Bullard gave his support to the idea of jump-starting stalling growth. The Atlanta Fed expects the Q2 GDP growth to slow down to 1.3%. Trade tension is knocking the economy off course and the Dias Fed is not about to make a policy mistake by not lowering its policy rate to 2.13%. The bond market has engineered an easing of financial conditions. The drop-in bond yields have happened without a decrease in inflation expectations. Long-term real yields have fallen, relieving pressure on the dollar and counterbalancing the inversion of the yield curve—ten-year bond yields are 20 bps lower than the policy rate. That tells us that the market wants a rate cut. The market's expected move has already started. Australia became the largest developed economy to cut interest rates in 2019 to offset the stressful effects of global trade wars. The U.S., Mexico and Canada will likely follow the Australian footsteps, perhaps as early as this summer...

I trust that the aforementioned bombshells won't explode. The occasion might give a chance for high-level diplomatic talks to identify a solution combined with some coordinated international action. To this end trade ministries of China and Mexico have said that progress is being made, and that talks with Washington are ongoing.

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# PALOS

1 Place Ville Marie, Suite 1670  
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188  
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504  
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110  
F. +1 (647) 276-0110

[www.palos.ca](http://www.palos.ca)