19|19 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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Euphoria Lost!

Following a brief fit of euphoria, investors began to rethink the investment climate. After an exuberant welcome to the announcement that the United States, Mexico and Canada had come to an agreement in renegotiating and renaming NAFTA, realities began to set in and the equity markets swooned. The Dow Jones Industrials fell 0.04%, the S&P 500 fell 0.97% and the NASDAQ took the brunt, falling 3.21%. What happened?

An examination of the new accord between the U.S, Mexico and Canada revealed that perhaps it is not the greatest U.S. trade agreement in history. Interest rates took a sharp turn upwards and the Fed spoke about deregulation. Economic reports were not really bad, but far from upbeat. Emerging markets will bear the brunt of the current economic climate, and what about China?

NAFTA, of course, has been on the minds of investors for a while and there was great relief when an agreement was reached. There really should not have been much question whether an agreement between these three countries would come about. Mr. Trump staked a lot of personal prestige on its completion. Both Mexico and Canada are dependent on trade with the United States and are Lilliputian in comparison. Seventy-eight percent of Canada's exports go to the United States. It was clear from the beginning that the U.S. held almost all of the cards. Three questions beg to be answered. What did it do or change, are the consequences good, bad or indifferent and is it over?

The changes are mostly cosmetic; it remains very much as before. The name has changed so the United States comes first. Rules of origin for the auto sector have changed, more about that later, and the Canadian dairy market allows for more U.S. participation. Canada wanted, and got to keep, the dispute settlement procedure and kept most of the agricultural protections. The United States, at least in the short run, got more than its trading partners, but at what cost? Our allies are questioning whether the age of soft power is over and what does this do to our long term interests? One thing it certainly does do is bring a sense of relief that the negotiations are over.

Will there be a great economic benefit? Not likely. As Jeffrey Schott, of the Peterson Institute for International Economics, writes, "NAFTA's benefits had always been primarily through the strengthening of economic integration of the economies. It is the first free trade agreement negotiated by the United States that raises rather than lowers trade barriers."

It does improve wages and working conditions for Mexican workers. It will certainly raise the price of cars in the United States. This will occur as car sales are slowing and interest rates are rising. This might do the opposite for the U.S. auto worker than hoped for.

The game, of course, is not over. It still must be ratified by Congress and there is certainly a decent chance that it will be in the hands of a democratically controlled House. More to come!

Weekly Market Insights (cont'd)

Interest rates are indeed rising and the Fed is showing plenty of resolve to follow through with their earlier view that they will continue to raise rates through 2019. As we wrote earlier, rising rates are beginning to make an impression on investors. As interest rates go up, so does the U.S. dollar. A strong dollar has a tendency to increase imports and dampen exports. This, of course, increases the Trade Deficit. There is also talk from the Fed about deregulation of the banking industry. This does not seem to make a whole lot of sense. It was a banking crisis that created the "Great Recession" in the first place. Banks are doing just fine. As we have written in the past, banks are such an important foundation to a market economy that they are almost a public good. As such, the consequences of banking failures is so great that a higher degree of regulation is justified.

Interest rates are moving up and that has international consequences. These consequences are often transmitted through relative currency prices. Much of Emerging Market debt is denominated in U.S. dollars. Any increase in the value of the dollar versus their currency means paying the debt and interest is much more onerous. Adding to that problem is many vital commodities are priced in U.S. dollars. The most important is oil. Not only is the cost of debt going up for them, but the cost of a vital commodity is also going up.

Finally, China continues to show an apparent slow down. It is a bit dangerous to make a call on the Chinese economy, but if this is true, it just adds to our concerns.

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