MONARCH GLOBAL STRATEGIES

Monarch News

Inaugural Edition – August 2017

Welcome to Monarch Global Strategies!

On August 1, 2017, we were proud to announce that ManattJones Global Strategies is now *Monarch Global Strategies*. Monarch has separated from its parent firm and is now an independently owned and operated strategic consulting firm. Our core team, our values and our commitment to excellence will not change. Nor will our clients, all of whom will be following us to the new Monarch platform. We will remain a truly bi-national, bi-literate and bi-cultural team that is deeply committed to the success of our clients and to doing business ethically and without compromise. You can learn more about us and our transition in our press announcement, here. Our new name, "Monarch" comes from the iconic Monarch Butterfly, which annually migrates to and from Mexico and Canada, traversing the United States. It is, in our view, an elegant image of North American integration, which is at the core of our firm's values. Over the coming weeks and months, you will see some changes—in more than our name. Our new website, www.monarch-global.com, while still in the final stages of development, will showcase our evolving business model, our keen focus and insights on the development of the NAFTA renegotiations, and other initiatives we are pursuing. We are as confident as ever in the long-term economic benefits of investing and doing business in Mexico and North America, and we welcome your input and feedback as we build this new company.

…And Welcome to *Monarch News*

As we begin this new phase of our operations, we are pleased to continue with our monthly report, now rebranded *Monarch News*. Our goal is to provide our clients and friends of the firm with meaningful insights on developments in the U.S.-Mexico relationship, the Mexican economy and domestic Mexican politics on a monthly basis. We aggregate the most important news but also add our own analysis and insights. In time, look for us to broaden our focus to the greater North American region, including NAFTA news related to Canada. As of now, this is a free service that we hope you enjoy. *If you do not wish to receive this newsletter, please follow the directions below to unsubscribe, and we will promptly remove you from our distribution list.*

CEO's Executive Summary for August: The Essentials

Mexico and the United States are preparing for the August 16 start of the NAFTA renegotiation. The U.S. Trade Representative's Office formally released the core U.S. objectives in the upcoming trade talks, while the Mexican objectives were leaked to the press. Although the U.S. document emphasized the need to address U.S. trade deficits and modify the agreement's dispute resolution mechanisms, it also called for maintaining reciprocal duty-free market access, and the bulk of the document identified areas where regional trade can be expanded. The Mexican document emphasized market access, labor mobility and the energy sector—see more below. Further encouraging news included a good meeting between the U.S. and Mexican presidents on the sidelines of the G-20 summit in early July, a welcome juxtaposition to the leaked transcript of the January phone call between Donald Trump and Enrique Peña Nieto. The Mexican economy generally and the peso specifically both exceeded expectations during the first half of 2017, but analysts still expect a slowing of growth, a weakening peso and a gradual reduction in inflation during the second half of the year. In the energy sector, the successful licensing of oil and gas fields to private actors was punctuated by Mexico's first private oil discovery in 80 years. And despite the likely annulment of the June gubernatorial election in Coahuila, Mexican political attention is firmly focused on the 2018 presidential campaign.

I. U.S.-Mexico Relations

Following three months of consultation with Congress and three days of public hearings in late June, the Office of the U.S. Trade Representative (USTR) released its objectives for renegotiating the North American Free Trade Agreement on July 17. As anticipated, the document focuses on the need to address "America's persistent trade imbalances in North America." This is reflected in proposals to restrict market access through a buy American, hire American provision and stricter rules of origin. The USTR also proposed eliminating the Chapter 19 dispute resolution mechanism (which allows disputes to be settled in a supranational tribunal rather than national courts) and the exemption for Mexico and Canada from global U.S. safeguard measures such as the imposition of tariffs or quotas on an industry when imports have caused serious injury.

But the document also specifically calls for maintaining the "existing reciprocal duty-free market access" for agricultural and industrial goods. The bulk of the document emphasizes improving market access for U.S. exports through new rules governing e-commerce, financial services, telecommunications, intellectual property rights and energy. It proposes provisions to create more flexible labor markets, ensure environmental protection and bring both into the core of the agreement where they will be subject to dispute resolution mechanisms. And it proposes customs and trade facilitation and regulatory transparency.

Unsurprisingly, U.S. democrats and labor panned the USTR document while republicans praised it, and the business community breathed a sigh of relief at the ultimately moderate set of U.S. negotiating positions that seem to have internalized the U.S. Chamber of Commerce's bottom line–do no harm. In his initial comments regarding the document, Mexican Economy Secretary Ildefonso Guajardo called the focus on the trade deficit worrisome and repeated the oft-stated positon that Mexico is ready to discuss reduction of trade deficits through trade expansion, not through trade restriction. Mexico (and the U.S. auto industry) is also likely to be hesitant about adopting stricter rules of origin out of concern they could prove disruptive to regional supply chains on which its manufacturing sector thrives. And the Mexican Congress vocally supported the Canadian position that eliminating Chapter 19 was unacceptable, although Mexico did not echo the Canadian promise to abandon the negotiations over this issue. That said, the only clear red line for Mexico is its refusal to accept increased tariffs or quotas, or an outcome that is not mutually beneficial.

The Mexican objectives for the negotiations leaked to the press on August 1 and were formally released two days later. They emphasize expanded market access and greater labor mobility—something which merits more careful consideration. The Mexican document also calls for incorporating energy, the digital economy, financial services and telecommunications into the agreement, finding ways to include small and medium-sized firms into regional trade and modernizing—not eliminating—NAFTA's dispute resolution mechanisms.

The two sides also named their chief negotiators–John Melle for the United States and Kenneth Smith Ramos for Mexico. Both are experienced trade negotiators and NAFTA policy experts. Melle, currently assistant U.S. trade representative for the Western Hemisphere, has worked at USTR since 1988. Smith Ramos, currently the director of the NAFTA office in the Mexican Embassy in Washington, served as a junior member of the Mexican team during the original NAFTA negotiations and later as the chief of staff to the deputy trade minister.

The first round of negotiations will be held August 16-20 in Washington, D.C. Ensuing rounds are expected to take place at three-week intervals, allowing for 6-9 rounds if the negotiations are to be completed in late 2017 or early 2018 as proposed.

Beyond the NAFTA renegotiation, the past month included a series of high level meetings between U.S. and Mexican officials. Most significant was the July 7 meeting between Presidents Trump and Peña Nieto on the margins of the G-20 summit. The presidents agreed that a revised NAFTA must bring "tangible benefits" to all three NAFTA countries in a meeting the Mexican foreign secretary characterized as a "positive sign for the relationship".

While the U.S. and Mexican executive branches gear up for NAFTA negotiations, the White House and Congressional Republicans penned an agreement on a framework for tax reform which excludes a border adjustment tax that would have imposed a 20% tax on U.S. imports, including those coming from Mexico. The House of Representatives also approved $1.6 billion in funding for the border wall. Its fate in the Senate is unclear, however, since the measure is attached to a military spending bill that many Senators want to approve despite their opposition to spending for the wall.

Finally, on August 3, *The Washington Post* published the transcript of the January 27 conversation between Presidents Trump and Peña Nieto. In the conversation, Trump repeatedly insisted that the best, and his preferred, solution to the U.S. trade deficit with Mexico would be a tax on Mexican imports, although he would be willing to give negotiations a try. He expressed personal affection for "Enrique" while pressing Peña Nieto repeatedly to stop insisting publicly that Mexico would not pay for a border wall, even though Trump argued that the wall was "the least important thing we are talking about." And he offered to send the U.S. military to Mexico to help deal with drug traffickers whom he described as "some pretty tough hombres" that the Mexican military could not defeat. Peña Nieto responded in formal diplomatic language, successfully encouraging "Mr. Trump" (or "Mr. President") to address the trade issue through negotiations and to agree that they both simply stop talking about the wall. He also noted the U.S. role in a drug market that fortifies organized crime in Mexico and agreed that the two countries should work together to deal with the problem.

II. Mexican Economy

The Mexican economy exceeded expectations during the first half of 2017, holding up well despite the highest inflation in years and the uncertainty generated by the unpredictable behavior of the Trump Administration. The economy expanded 2.8% in the first quarter and 2.3% during the first half of the year, driven by consumption spending and record high exports. The stock market notched its best performance since 2012 and unemployment reached its lowest since 2003. This led the Mexican government, the IMF and private actors to increase their estimates for expected growth in 2017 to about 2%, estimates which suggest a gradual economic deceleration during the second half of 2017. This is apt to reflect a softening in consumer confidence despite record remittance flows and weak investment due to uncertainty associated with the renegotiation of NAFTA and the September 1 official start of the 2018 presidential election process. Annual inflation rose to the highest level in over eight years in June before appearing to stabilize in July. In part this reflects the behavior of gasoline prices which, after the January price increase that initially measured about 20%, now are up just 2% for the year. More significant is the recuperation of the peso, which reflects reduced concerns about the

NAFTA renegotiation and monetary policy set by the Bank of Mexico. After raising interest rates to 7% on June 22, Bank of Mexico President Agustín Carstens suggested that the recent series of rate increases is likely over, but the bank is unlikely to lower rates before the end of 2018.

The combined impact of high domestic interest rates and the assumption that U.S. interest rates will remain low for the foreseeable future has also ignited a carry trade in Mexican pesos that has driven capital inflows and strengthened the peso 15% in 2017, reaching 14 month highs before slipping back to an August 1 rate of 18.15 pesos to the U.S. dollar. The peso's value further reflects the surprisingly robust inflow of capital associated with the government's January tax repatriation offer, whose success convinced the government to extend its original July deadline until October. Nevertheless, the volatile nature of the carry trade, the low price of oil and uncertainty surrounding both the NAFTA renegotiation and Mexican politics together suggest that the peso volatility is apt to continue and the currency is likely to lose value in the coming months.

This economic performance helped inform Standard & Poors' decision to lift Mexico's credit rating from negative to stable. It was quickly followed by Fitch, and analysts expect Moody's to follow suit. More important to the rating agencies, however, was reduced Mexican government spending. Mexico generated a budget surplus in the first half of the year for the first time since 2008, which reduced the expansion of debt despite serious concerns about debt levels in ten states. This reflected both 2017 spending cuts and the possibility for more in 2018 and the annual transfer of the Bank of Mexico's unrealized foreign exchange gains. This year the gains reached 1.5% of GDP and so improved the government's fiscal position that it will not need to issue additional debt for the rest of 2017.

A final encouraging note on the economy: Mexico has displaced Brazil as the Fintech leader in Latin America.

Sector Focus: Energy

The implementation of energy reforms continues to make impressive strides. Despite low natural gas prices and fields located in regions associated with organized criminal activity, on July 12 Mexico auctioned off 21 of 24 blocks containing mostly natural gas reserves at high royalty rates. At almost the same time, a private exploration and production consortium announced Mexico's first private oil find in 80 years, and it was a big one. Nearly 70% of the profits from this 1.4 to 2 billion barrel field will be paid to the Mexican government as royalties. This led the government to postpone the next auction of deep water fields a month until January 2018, in anticipation of increased interest and the desire to give bidders more time to evaluate the implications of the recent find on the value of the blocks up for auction. Although Pemex did not participate in the July 12 auction, it plans to seek out alliance partners in 2018 for drilling and refinery modernization projects. Pemex also successfully placed $5 billion in long-term bonds, which will cover the firm's financing needs through 2018.

III. Mexican Domestic Politics

Mexican political parties were unable to come to an agreement on the timing and content of a special summer session of the Mexican Congress. As a result, Mexico's anti-corruption system began to operate without a budget, a new Attorney General's office or an anticorruption tsar and 18 anticorruption magistrates. Still, firms can now be fined or closed for making bribes, falsifying data, misappropriating government funds or colluding with government officials.

After weeks of heated discussions about the election results for the governor of Coahuila State, the National Electoral Institute (INE) concluded that the PRI (winner) and the PAN (second place) candidates had both exceeded campaign spending limits by more than 5%. According to the law, the INE must annul the election result should the judiciary confirm its findings.

With polls continuing to show very weak support for President Peña Nieto and a slight lead in early presidential election polling for the leftist candidate Andrés Manuel López Obrador, the President's PRI party will hold its national assembly in early August to determine the rules for its candidate selection. A likely change that allows non-party members to become the PRI candidate will be a sign that President Peña Nieto will retain control of the process and personally select the candidate. Meanwhile, the conservative PAN party and the left-leaning PRD party agreed to discuss the formation of a broad opposition front for the 2018 election with the aim of defeating both the PRI and López Obrador. But building a joint platform between these two traditionally opposition parties will not be easy, and harder still will be finding a candidate both parties can agree to support.

On the security front, the 30% increase in homicides during the first half of 2017 has placed the murder rate on pace to become the most violent year on record. Indeed, the Bank of Mexico's private sector poll points to insecurity as the factor most likely to hinder economic growth. And the Mexican Navy's special forces undertook an operation in Mexico City and captured the leader of a criminal organization in the city's Tláhuac neighborhood.

IV. Monarch Events, Speeches, Publications

June 15: MGS President and CEO Michael Camuñez was elected to the board of directors of Edison International and Southern California Edison (NYSE: EIX).

July 2-4: Camuñez joined a delegation of U.S. West Coast Consuls General and opinion leaders on a visit to Baja California, sponsored by the Mexican Foreign Ministry, to strengthen ties between Mexico and U.S. West Coast civic and business leaders. Read about the visit here.

July 11 & July 19: MGS Partner Luis Ricardo Rodriguez spoke about the proposed changes to NAFTA at the Fiscal Studies Academy in Tijuana and at the American Chamber in Monterrey respectively.

July 21: MGS Chairman Ambassador James R. Jones commented on Mexico's rising homicide rate in the Inter-American Dialogue's *Latin America Advisor*.

July 27: Camuñez was the opening speaker at the U.S.-Mexico Border Mayors' Association 2017 Binational Summit. His remarks focused on the urgency for cross-border municipal leaders to rally together and speak up with one voice on the importance of NAFTA and the overall U.S.-Mexico relationship so the border community's interests are not overlooked. Read about the event here.

July 31: With the active involvement of MGS, the American Chamber of Commerce in Mexico installed its NAFTA task force led by Francisco de Rosenzweig of White & Case and Adrian Correa of FedEx.