MONARCH GLOBAL STRATEGIES

Monarch News

May 2018

CEO Executive Summary

As we go to press, the fate of the NAFTA re-negotiations is looking quite grim. Despite being faced with a Congressionally-imposed May 17 deadline to meet the requirements of the Trade Promotion Authority guidelines and the U.S. congressional calendar, the U.S. has, according to our sources, shown a remarkable lack of flexibility in getting to a final deal. Several contentious issues remain outstanding. Despite solid work at the technical level, as of this writing, no deal appears to be imminent. Our analysis of what happened can be found below.

In the broader bilateral relationship, another rhetorical scuffle over Central American migrants set off last month by President Trump was defused, but there are also clear signs that the President's rhetorical excesses are having a negative impact on bilateral cooperation.

In Mexican politics, Ricardo Anaya, the candidate of the PAN/PRD alliance, clearly won the first presidential debate on April 22. This enabled him to inch closer in the polls to Andrés Manuel López Obrador (AMLO), but post-debate polls still give AMLO an average lead of 16 points. Following the debate, PRI candidate José Antonio Meade has been relegated to a distant third place, motivating a revamp of the PRI party leadership to reinforce party unity and strengthen Meade's position. In early May, sparks flew between AMLO and some of Mexico's leading businessmen, members of the Mexican Business Council, when the Council published a newspaper ad condemning AMLO for his sharp campaign critiques of them. AMLO initially returned the favor by doubling down on his charges that they are backing Anaya in order to block his election before literally waving a white handkerchief and toning down his rhetoric. Meanwhile, the Mexican legislature closed its spring session unable to address key pieces of pending legislation due to electoral politics.

The Mexican economy continues to grow faster than expected with falling inflation, which convinced Moody's to upgrade its outlook for Mexico. Peso volatility persisted, but market participants still expect the Mexican currency to finish the year at 18.3, well below where it is currently trading. Events in the energy, telecommunications, and infrastructure sectors also caught our attention this month, but the most notable event was AMLO's public statement on May 7 that he would be willing to consider a concession model for Mexico's new international airport rather than cancel the project.

I. NAFTA WOES

So far, we have been promised a renegotiated NAFTA by the end of 2017, by the end of March, in time for the mid-April Summit of the Americas, by the end of April, by May 4, and now by mid-May. This time, however, the deadline appears to be firm. Even as President Trump says that the United States is in no rush to complete the NAFTA renegotiation, his Trade Representative insists that an agreement must be reached by mid-May if it is to have a chance of being approved by the current Congress given the time lines laid out in U.S. trade law. Speaker of the House Paul Ryan added a specific date: May 17. And Commerce Secretary Wilbur Ross has made it clear that if there is no agreement by the end of May there is likely to be no agreement before the end of the year.

The three countries' technical teams have been working virtually non-stop and the principal negotiators met repeatedly during April and early May. As a result, at least 70% to 80% of the new treaty has been completed. But what remains are the most challenging topics including auto rules of origin, sunset clause, dispute resolution, government procurement, the seasonality of Mexican produce, and protection for the Canadian dairy sector. This situation allowed Mexican Foreign Minister Luis Videgaray to announce on April 26, after four consecutive days of meetings among the principal negotiators, that the three countries were reasonably close to an agreement, while on the very same day Economy Minister Ildefonso Guajardo noted there are still many pending issues to iron out.

The following day, U.S. Trade Representative Robert Lighthizer, Canadian Foreign Minister Chrystina Freeland, and Guajardo announced a 10-day break in their meetings, necessitated by a trip to China by a U.S. trade delegation that included Lighthizer, even as the technical teams continued to talk. After the delegation returned, five consecutive days of talks among the three principals did not generate an agreement. Despite public reports that Mexican Economy Secretary Guajardo had brought to Washington "two weeks' worth of suits," he unexpectedly returned to Mexico after discussions on Friday May 11 with time running out.

What happened? Has there been a breakdown in the talks?

Inside U.S. Trade has reported (*subscription required*) that the key to reaching a NAFTA agreement is auto rules of origin. The most recent U.S. proposal calls for a minimum 75% regional value for vehicles and 75% for "core" auto parts and a requirement that 40%-45% of vehicles be produced by workers earning at least $16 per hour, all of which would take effect within four years.

As expected, Mexico has balked at the wage requirement, but is reported to have countered with a compromise proposal. This proposal would set a 70% minimum of North American content, compared with the United States' 75% demand, for tariff-free treatment in the auto sector. Insiders said the proposal also would allow for some higher-wage content but includes a ten-year phase in instead of the four years the United States is demanding.

Monarch's discussions with trusted sources close to the negotiations suggest a few dynamics are worth noting. First, the Mexicans appear to be the adults at the table, making good faith efforts to accommodate what most agree are very difficult and often unreasonable U.S. demands. The Mexican counteroffer on auto rules of origin was not easy for them to make, and in return they reasonably expected some flexibility on the part of the United States—none of which it has seen to date. Moreover, the traditional maxim in trade negotiations is that "nothing is done until everything is done." It is the ultimate art of compromise, big and small. And yet the U.S. appears to be taking the approach that issues must be addressed and fully resolved one at a time, expecting the Mexicans to finalize the rules on ROO without knowing how other highly sensitive issues will be resolved (like dispute resolution, the so-called sunset provision, agricultural seasonality, and other issues). This approach almost guarantees the negotiations will fail, and it's hard to criticize the Mexicans for their objections to this approach.

Meanwhile, despite heretofore strong relations and cooperation between the Canadians and Mexicans, the U.S. approach has effectively allowed Canada to opt out of some of the most challenging issues on ROO, leaving Mexico to carry the water on its own this last week. It's unclear what's behind Canada's approach—whether it prefers that if the talks break down so they can duck blame and assign it to the Mexicans or whether they are simply keeping powder dry to fight the U.S. on the forthcoming battle over IP and dairy market access. Whatever the case, this week has revealed some discordance in the negotiations, according to our sources.

We take no comfort in observing that the NAFTA talks appear to be going off the rails. But we also are quite clear about where responsibility lies: the U.S. has, from the beginning, taken a U.S.-centric approach to the negotiations that is at odds in many cases with the interests of its own industry, farmers, and workers. It must therefore own the result if the talks breakdown.

That said, we must remember that, as of today, NAFTA still exists and will remain in full force and effect. If President Trump decides to attempt to withdraw from the agreement, there will undoubtedly be many legal challenges to his authority to do so. Thus, while we may continue to see storm clouds on the horizon for some time, business will continue under the status quo for the foreseeable future. We are obviously monitoring this space very closely…

In other trade news, the United States extended Mexico and Canada's exemption from steel and aluminum tariffs for another 30 days, but with a promise that these exemptions would be the last. Mexico and the European Union finalized the update of their free trade accord, and Mexico became the first country to ratify the revised Trans-Pacific

Partnership among the eleven countries that remained after the U.S. withdrawal. Meanwhile, China expressed its interest in developing closer trade relations with Mexico, and analysts note a good chance for improved trade relations between Mexico and Brazil. All of this points to the fact that Mexico is, wisely, not waiting around to see where the U.S. ends up. It will continue to embrace its commitment to free trade and to deepened ties to world markets. ***While the U.S. faces lost market share in Mexico as a result (a self-inflicted injury), Mexico will remain a very attractive place to invest and do business in the coming years.***

II. U.S.-Mexico Relations

President Trump's rhetoric and actions in the immigration space continue to complicate bilateral relations. Following Trump's decision to order the National Guard to the U.S.-Mexico border in response to a feared surge of Central American migrants, Mexican President Peña Nieto ordered his government to undertake a review of all cooperation agreements Mexico currently has with the United States to determine if they continue to be in the Mexican national interest. According to the U.S. government, whether intentionally or due to risk-averse bureaucrats concerned about collaborating too closely with the United States in these circumstances, this review has undermined bilateral cooperation in a number of areas.

At the same time, both governments took actions to reduce bilateral tensions. Mexico announced that it would send Federal Police to its southern border to reinforce security there, Mexican Foreign Minister Luis Videgaray and U.S. Homeland Security Secretary Kirstjen Nielsen agreed to high level talks with their Central American counterparts to deal with the migration issue, and the Trump Administration has somewhat toned down its rhetoric. When the caravan of Central American migrants reached the U.S. border at the end of April, the United States quietly began processing small numbers of asylum seekers. For his part, President Trump tweeted that weak U.S. laws rather than Mexico are to blame for the situation. Trump also has not called on Mexico recently to pay for the border wall, nor has he engaged in Mexico-bashing despite appearing in campaign-style rallies where such rhetoric is red meat for his supporters.

This is the state of the bilateral relationship that will greet a new U.S. Ambassador. Ambassador Roberta Jacobson returned to the United States on May 5, leaving behind a softening of U.S. rhetoric while the two countries try to nail down a final NAFTA accord and deal with an increased flow of Central American migrants fleeing violence and poverty. She left the embassy in the hands of the Deputy Chief of Mission, William Duncan, who is slated to become the Consul General in Monterrey in June. Our sources indicate that he will be replaced as DCM by John Creamer, another highly respected career foreign service officer who spent most of his career in Latin America. For the past two years Mr. Creamer has been the Deputy Assistant Secretary of State for Cuba, Mexico, and Central America. Meanwhile, incredibly, there still has not been any formal nomination for the open post of ambassador.

III. Mexican Domestic Politics

The first debate in the Mexican presidential campaign took place on April 22 in Mexico City. As expected, by all accounts the winner was Ricardo Anaya, the candidate representing the PAN/PRD alliance, who is known to be a talented debater. The consensus is that the PRI's José Antonio Meade, an accomplished technocrat who is finding it difficult to differentiate himself from a party the majority of Mexicans oppose, perhaps fared the worst. Somewhat surprisingly, the left-leaning Andrés Manuel López Obrador (AMLO) held his own, largely by refusing to debate with the other candidates on the stage and by instead sticking to his campaign script. Post-election polls confirm this. The newspaper *Reforma* shows AMLO's lead over Anaya shrinking slightly with Meade relegated to a clear third position. After including the *Reforma* poll, the May 3 Oraculus poll of polls gives AMLO an average lead of 16 points (AMLO: 45%, Anaya: 29%, and Meade: 18%).

Unsurprisingly, anti-AMLO commentators called on the less well-positioned candidates to throw their support behind Anaya as the only way to defeat López Obrador. The likelihood of this happening, however, seems slim. Under campaign law, it is now too late for any of the candidates to have their name removed from the ballot. Beyond that technicality, the feud between Margarita Zavala and Anaya caused by his refusal to allow her to challenge him for the party's candidacy is apt to keep her in the race. Jaime "El Bronco" Rodríguez was brought in the race to siphon votes from AMLO so is unlikely to join ranks of an anti-AMLO front. And the PRI needs a strong presidential candidate to motivate the base to come out on election day and vote for PRI legislators and governors. To this end, the PRI replaced Enrique Ochoa as party president with René Juarez, a traditional politician whose task is to revive Meade's flagging campaign by uniting the party behind him. Juarez immediately rejected the notion that the PRI would step aside for anyone. **The next presidential debate will be in Tijuana on Sunday, May 20.** Monarch CEO Michael Camuñez will be in attendance so look for his live tweets during the debate **(@michaelcamunez)**.

In late April, the presidential candidates visited Tecnológico de Monterrey where they were interviewed by a trio of students. In his remarks, AMLO promised to rid government of corruption, to produce more of what Mexico consumes, and to "cancel" education reform but "review" energy reform. He referred to NAFTA as "necessary" while insisting that the bilateral relationship should be one of mutual respect. And he again reacted negatively to the new Mexico City airport project that is now under construction.

In early May, sparks flew between AMLO and the Mexican Business Council (CMN). In his campaign, AMLO has repeatedly insisted that a small number of business leaders have historically benefited from a cozy relationship with the government, have prevented real democracy in Mexico, and are backing Ricardo Anaya in order to block AMLO's election. In a May 3 announcement published in Mexican newspapers, the Mexican Business Council (CMN) condemned AMLO for his "personal attacks" and "baseless accusations" arguing that they undermine business confidence and thus investment in Mexico. In response to the announcement, AMLO accused five business leaders, including Mexico's second and third richest men, of being part of a plot to prevent his victory on July 1. He also doubled down on his rhetoric, referring to the business elite as thieves who have "captured institutions, kidnapped the government" to benefit themselves at the expense of the nation.

In the ensuing days, AMLO toned down his rhetoric, literally waving a white handkerchief at one campaign event. On May 7, apparently as part of this effort to calm private sector concerns about an AMLO presidency, López Obrador announced that he would consider a concession structure for Mexico's the new international airport rather than cancel the project outright. That same day, another business organization, the Business Coordinating Council (CCE), distanced itself from the CMN.

The relationship between AMLO and the Mexican private sector is a tortured one, but one that seems to be giving off signs that at least some business leaders are beginning to confront and accept the possibility of an AMLO sexeño. Certainly the reports of major Wall Street leaders like BlackRock's Larry Fink having constructive meetings with AMLO suggest the same of the international investment community.

The Mexican legislature closed its spring session on April 27, leaving behind a record number of bills approved on the final day of the session. Legislators approved a law regulating government advertising, but remained unable to name the anti-corruption prosecutor called for in the 2015 legislation creating Mexico's National Anti-corruption System, or to address the proposed creation of an independent Attorney General. And although the Chamber of Deputies passed a bill denying all public servants their historic immunity from prosecution while in office, this initiative was blocked in the Senate by the PRI despite it being part of the campaign platform of their presidential candidate. The PRI has suggested the possibility of calling an extraordinary legislative session to deal with these pending bills, but not until after the July 1 presidential election.

IV. Mexican Economy

The Mexican economy grew at a faster than expected 2.4% and formal employment expanded at a 4.2% annual rate in the first quarter of 2018. Meanwhile, the consumer price index fell 0.34% in April bringing annual inflation to 4.55%, its lowest rate since December 2016 and edging back toward the Bank of Mexico's target rate of 3%. This has some market participants predicting that the Bank will hold rates steady for a time, as long as the exchange rate remains around 19 pesos per U.S. dollar. We still suspect that, given the cautious signals emanating from Banxico, the benchmark rate will inch up another 25 basis points to 7.75% before the election should the NAFTA negotiations fail or López Obrador sustain his lead.

This resilient economic performance, despite delayed investments caused by the NAFTA renegotiation, coupled with a low probability that the next Mexican presidential administration will weaken macroeconomic and fiscal trends, convinced Moody's to upgrade its outlook for Mexico. Given López Obrador's strong backing for balanced budgets and a reduced national debt, this analysis seems more on point than Citigroup's recent argument that deficits will balloon and inflation increase under an AMLO administration.

The Mexican peso, after rising 4.7% from mid-March to mid-April on news of a potentially quick resolution to the NAFTA negotiations, gave up these gains and more in late April and early May. This depreciation paralleled that of other emerging market economies driven in part by expectations of rising U.S. interest rates, but also by post-debate polls showing a sustained double-digit lead for AMLO in the presidential race. Still, the Bank of Mexico's measure of private bank sentiment has the peso closing 2018 at 18.3, backstopped by the possible signing of NAFTA, the carry trade which motivates peso buying when the currency slips, rising oil prices, and record high remittance flows into Mexico.

Sector Focus: Energy

While AMLO talks of reviewing the energy reform and boosting the role of Pemex as a state-owned petroleum company, Pemex's current CEO expressed his support for a future IPO for the firm. In addition, Pemex moved forward with plans to launch a tender for private sector partners to help it explore 14 onshore blocks that it was awarded in Round 0, which could occur before the end of President Peña Nieto's term.

Meanwhile, a poll carried out by *El Financiero* newspaper and the Brookings Institution puts AMLO's proposed referendum on the energy reform in sharper focus. It shows that public opinion about the energy reform is divided, with 41% saying the reforms were necessary and 47% saying they were not necessary.

Sector Focus: Telecom

The courts agreed to hear Telcel's challenge to the Federal Telecommunications Institute (IFT) ruling that would divide its fixed line unit, Telmex, into two separate entities. However, since IFT rulings cannot be suspended while they are being challenged, Telcel must move forward with the breakup of Telmex while its challenge is being heard.

In the cellular market, AT&T's market share continues to expand, reaching 13% in the first quarter of 2018, but this expansion is coming at the expense of Movistar as much as market leader Telcel whose market share remains over 63%.

Sector Focus: Infrastructure

The debate over the future of Mexico's new international airport project (NAIM) heated up a bit in April when Mexican business titan Carlos Slim, who rarely participates in political debates, directly challenged AMLO's opposition to the project. Slim insisted that the airport is essential for Mexico's future growth. AMLO, meanwhile, demanded that the federal government stop construction on the project immediately should he win the July 1 presidential election, threatening legal action if they do not comply. In private, however, AMLO's tone has been less strident, reportedly suggesting that a private concession to finish the project would be acceptable as long as no public funds are used, a proposal he made public on May 7 as we noted above. Still, all the uncertainty has undermined the value of the bonds floated to finance the airport project.

V. Monarch Events, Speeches, Publications

April 23: Monarch published *NAFTA News – Volume 7*, a periodic newsletter from MGS, Manatt, Phelps & Phillips, and TACTIX, jointly offering information and insight on NAFTA renegotiations from experts in the three NAFTA national capitals. For this edition of NAFTA NEWS, our partners in Ottawa, Mexico City, and Washington provided a snapshot of the political pressures facing an agreement in each of the three NAFTA nations.

April 24: MGS President & CEO Michael C. Camuñez spoke to the *Washington Examiner* about the current state of NAFTA negotiations, the need to act quickly given the political calendar, and the importance of solidifying the North American partnership to enhance U.S. competitiveness with China.

April 27: Michael Camuñez was a featured panelist in a public discussion of President Trump's trade policy hosted by Zócalo Public Square and the UCLA Anderson School of Management.

April 29: Michael Camuñez spoke to the *Los Angeles Times* about the chances of a renegotiated NAFTA being supported by President Trump and approved by Congress.

May 2: Michael Camuñez spoke to CNNMoney about the chances of a breakthrough in U.S.-China trade negotiations in advance of Secretary Mnuchin's visit to China.

May 9: Michael Camuñez was interviewed by Andrew Ross Sorkin on CNBC's *Squawk Box* about the fate of NAFTA as trade negotiators enter a critical stage.