MONARCH GLOBAL STRATEGIES

Monarch News

June 2018

CEO Executive Summary

A month ago, we noted that the future of the NAFTA renegotiations was very uncertain and that the time to get a deal done in 2018, with the current Mexican government and the current U.S. Congress, was quickly evaporating. Regrettably, the situation has only worsened since then. It is now quite clear that there is virtually no chance for a deal in 2018, although none of the parties has yet formally abandoned the negotiation process and talks—for whatever they are now worth—continue. But we must be honest about the situation: it's not looking good. The Trump Administration has, at least until now, been unwilling to compromise on some of its key demands that the Mexicans and Canadians believe are non-starters. Mexican gestures of compromise on autos have been largely rejected. And President Trump, perhaps (wrongly) thinking he could gain some leverage in the negotiations, initiated a process on May 23 that could lead to a 25% tariff on all cars imported into the United States and, to the surprise of all, on May 31, terminated the Mexican and Canadian exemptions from the 25% steel and 10% aluminum tariffs imposed in March. Both countries retaliated, with Mexico imposing 15%-25% tariffs on a wide range of U.S. exports targeted to impact the districts of key Republican lawmakers. Mexico also challenged the legality of the U.S. tariffs in the World Trade Organization. Meanwhile, following the G-7 summit in Canada, an aggrieved President Trump and his White House advisors launched a blistering and quite personal attack on Prime Minister Trudeau, casting a pall over the NAFTA talks.

Adding insult to injury, after weeks of remaining silent, President Trump returned to his demand that Mexico pay for a wall, which elicited a tersely-worded response from Mexican President Peña Nieto stating that Mexico would never pay for a wall. In the midst of these tensions, it was presidential front-runner Andrés Manuel López Obrador (AMLO) who tried to play the peace-maker by calling on the Mexican government to act firmly in response to American taunts, but to not respond in kind to every affront for fear of starting a trade war that Mexico can ill-afford.

In Mexican politics, polls show that López Obrador remains the favorite to win the presidency, and his party is well-positioned to win a majority in the national legislature. This has Mexican business leaders very concerned. But the broader private sector and foreign investors have a more sanguine attitude about a potential AMLO presidency. They appear to have concluded that his primary concern is the market-distorting special treatment that key private sector participants have enjoyed for decades rather than capitalism in general.

Meanwhile, the Mexican economy continued to outperform expectations, and inflation continued to fall in May. But the peso sank throughout the month, reflecting problems in the NAFTA negotiations and concerns over an AMLO victory. Meanwhile, two Mexican business confederations demanded that the government do more to respond to a crime wave that has 2018 on path to be the most violent in recent Mexican history.

I. NAFTA Woes

NAFTA negotiators blew through what was supposed to have been the final May 17 deadline for completing a new trilateral trade agreement in 2018. U.S. Trade Representative Robert Lighthizer argued that "the NAFTA countries are nowhere near close to a deal." But the Mexican and Canadian negotiators continued to insist that a deal could still be concluded by the end of May. To get there, officials considered a "skinny" deal that would focus on auto rules of origin and other regulatory changes that would not require the approval of the U.S. Congress. Labor unions, some key members of Congress, and Mexico, however, all opposed the idea. For Mexico, this option meant they would have to give up a lot while getting little in return from the U.S.

In the wake of this breakdown in talks, U.S. Treasury Secretary Steven Mnuchin suggested the negotiations could now extend into 2019. For his part, President Trump turned up the pressure. Despite his own administration showing remarkably little flexibility, the President complained that Mexico and Canada were being very difficult in the negotiations and on May 23 threatened to impose a 25 percent tariff on imported cars. He ordered Commerce Secretary Wilbur Ross to begin a section 232 investigation into the potential threat to U.S. national security from automobile imports. The investigation will take months, but this is the same mechanism that led to the imposition of steel and aluminum tariffs in March, from which Mexico and Canada received a two-month exemption to give the NAFTA talks time to reach a conclusion. Despite the deep skepticism that auto imports could in any way pose a national security threat to the U.S., the administration has strained to remain straight-faced about the issue and is moving forward with the investigation. (As an aside, and beyond the scope of the bilateral U.S.-Mexico relationship, the United States' use of these pretextual national security provisions not only strains credibility but opens the door for copy-cat moves by other countries in the future that will undoubtedly harm U.S. interests. The contagion effect is very real.)

Despite these challenging circumstances, on May 25, Mexican Economy Minister Ildefonso Guajardo still estimated a 40% chance for a NAFTA deal before July 1. On the same day, Canada's Justin Trudeau proposed to President Trump a trilateral meeting with Mexico's Enrique Pena Nieto to personally discuss an agreement that seemed tantalizingly close to a breakthrough. But on May 29, Vice President Mike Pence called Trudeau to say the meeting was on, albeit with one condition: Canada and Mexico had to agree to the sunset provision that would terminate NAFTA in five years unless the three countries affirmatively agree to extend it. For Trudeau and Peña Nieto this was a deal breaker.

An apparently frustrated White House decided to increase the pressure further on its NAFTA counterparts. On May 31, Trump stated in reference to NAFTA that "The United States has been taken advantage of for many decades on trade. Those days are over." He went on to say that the U.S. would "agree to a fair deal, or there will be no deal at all." Secretary Ross then announced that the exemptions for Mexico and Canada (and the European Union) from the 25% steel and 10% aluminum import tariffs would expire at midnight. In other words, unless Mexico and Canada caved to U.S. demands, there not only would be no NAFTA 2.0, but also there would be high tariffs on their steel and aluminum exports.

Rather than making Mexico and Canada more willing to capitulate, this decision made it politically more difficult for Mexico and Canada to make additional concessions, and it elicited retaliation. Canada announced it would implement the same levies on U.S. steel and aluminum exports to Canada beginning July 1, and Mexico announced tariffs that took effect June 5 of an equivalent value on a wide range of U.S. exports carefully targeted to impact the districts of key congressional Republicans. Mexico also initiated proceedings to declare the U.S. tariffs illegal under the rules of the World Trade Organization. Still, both countries' leaders expressed their willingness to continue the NAFTA negotiations, even in this increasingly difficult context. The possibility of a successful conclusion of a NAFTA renegotiation this year, however, now seems a virtual impossibility.

Surprisingly, it was the Mexican Presidential front-runner, who has been painted as an anti-American nationalist by his Mexican opposition and by some in Washington, who called for cooler heads to prevail. Andrés Manuel López Obrador called on the government to act firmly, but to not respond in kind to every affront since this could cause the situation to deteriorate into a trade war that Mexico could ill-afford to enter. Instead, AMLO called on President Peña Nieto to meet personally with Trump to de-escalate the situation and promised, if elected, to request a meeting with the U.S. president in the first days of the transition to help sustain a friendly bilateral relationship based on partnership and mutual respect.

Meanwhile, during the first week of June President Trump made it clear that he would not accept a revised NAFTA that does not contain a five-year sunset clause, and he again spoke of the possibility of negotiating two separate bilateral agreements instead of the single trilateral accord that is taking so much time to conclude. Mexico and Canada immediately rejected both proposals.

As a final note, following the G-7 summit held June 8-9 in Quebec, Canada, President Trump, apparently feeling aggrieved by Canadian Prime Minister Justin Trudeau's comments in a post-summit news conference, tweeted an aggressive taunt targeting the Canadian leader. White House advisors Larry Kudlow and Peter Navarro added fuel to the fire with some unusually sharp and personal attacks that many felt crossed a line—so much so that Navarro later apologized. Although Trudeau held his tongue, Canadians were shocked and appalled by Trump's attack, casting a pall over U.S.-Canada relations and thus over the NAFTA negotiations.

Looking ahead, it's quite hard to see how the parties get out of their current rut unless the Trump Administration significantly changes its approach to the negotiations and begins to show some flexibility. The antagonism it has shown both Mexico and now Canada is generating substantial political opposition on Capitol Hill, and as the retaliatory tariffs begin to be felt in the heartland, we suspect the political pressure on Trump will mount further. That said, any deal at this point will have to be addressed by the new Congress in 2019 and by the new (most likely) AMLO administration. If the Democrats take the House, it's simply unclear how they might vote on a proposed new NAFTA deal. The biggest wild card by far is whether President Trump further escalates by announcing a withdrawal from NAFTA. It is not inconceivable that he would do so in an attempt to further animate his base before the mid-term elections. Regrettably, at this point, all we can say with any certainty is that we are in for a period of great uncertainty.

In the midst of all of this tension, some good news to celebrate: FIFA awarded the 2026 Soccer World Cup to the joint bid from North America – Canada, Mexico, and the United States. It seems FIFA and the world appreciate the strength and vision of North America far more than its largest occupant.

II. U.S.-Mexico Relations

The second Mexican presidential debate was held on May 20 in Tijuana, and it focused on international affairs, border security, migration, and, of course, U.S.-Mexico relations. Unsurprisingly, all four candidates said they wanted a good relationship with the United States but would demand more respect from President Trump. This unity of voices, and the fact that foreign relations are not a top voter concern, strengthens our position that Trump will not be a deciding factor in the July 1 election. Surprisingly, it was Ricardo

Anaya of the PAN/PRD alliance that laid out the most confrontational stance, arguing "you can't appease tyrants and bullies. You have to confront them." He also insisted that Mexico would be willing to put security and migration cooperation on the table to get a better NAFTA deal from the United States.

In an interview published in *Proceso* magazine in late May, AMLO's foreign minister-designate Héctor Vasconcelos argued that during PAN and PRI governments "there was an excessive focus on pleasing the U.S." But he insisted that the AMLO team does not desire nor expect a bad, much less a confrontational, relationship with the United States. U.S.-Mexico relations will instead be based on mutual respect, on working with allies in the business, legislative, and academic communities, and on building AMLO's hoped for "alliance for development."

After weeks of having refrained from speaking ill of Mexico or Mexicans in public, President Trump returned to form in a Memorial Day campaign-style speech in which he once again said Mexico will pay for the wall and like it. This, unsurprisingly, elicited a retort from President Peña Nieto via Twitter, but in surprisingly blunt terms (and in both English and Spanish), stating that "Mexico will NEVER pay for a wall. Not now. Not ever."

III. Mexican Politics

We are now barreling toward the July 1 presidential election in Mexico. Recent polls show a uniform and clear tendency in Mexican voter preferences – Andrés Manuel López Obrador has a large and growing lead that looks increasingly impossible to surmount.

Since our last publication, we have seen two additional presidential debates. Neither appears to have changed the basic dynamics nor trajectory of the race. AMLO has been able to remain largely unscathed by the debates; his opponents are simply not gaining traction. And at this point the gap is so large that it is difficult, though not impossible, to conceive of any outcome other than an AMLO win.

Two major polls taken after the second presidential debate, from the newspapers *Reforma* and *El Financiero*, also show AMLO breaking the 50% threshold. The second-place contender, Ricardo Anaya of the PAN/PRD alliance, fell back a bit, and support for the PRI candidate, José Antonio Meade who is currently in third place, remained largely unchanged. The updated Oraculus poll of polls gives AMLO 49%, Anaya 27%, and Meade 20%. Equally striking in the *Reforma* poll is the negative opinion voters have of Anaya and Meade, which far surpass AMLO's negatives (38%, 42%, and 24%, respectively). Meanwhile respondents qualified Meade and AMLO as almost equally likely to be a danger for Mexico, about 25% each, helping to explain why this line of attack against AMLO--which was successful in 2006 and 2012--has not worked well in 2018. Meanwhile, Mitofsky reports that 58% of Mexicans think the next president should make a drastic change in the economy.

AMLO's Teflon quality meant he gained ground despite another weak debate performance and even in the face of a stark accusation that one of his party's Senate candidates was a kidnapper during her time in one of Mexico's self-defense militias. Meade's strong second debate performance had minimal impact on his standing with voters, largely because he still refuses to distance himself from a widely unpopular president. And Anaya's support could fall further following the release of a video that appears to support the money laundering and corruption charges leveled against him earlier in the campaign.

Nor did the third debate appear to make much of a difference. Meade and Anaya once again attacked one another as much as they attacked AMLO. They each presented a litany of facts that seemed unlikely to convince voters or dent AMLO's position. Instead they seem to be battling for second place, all but ensuring that the anti-AMLO vote will be divided on July 1.

Recent polls also indicate that AMLO's party, Morena, is well-positioned to win a majority in the federal legislature as well as four to six of the nine governorships in play on July 1. This outcome would substantially strengthen AMLO's presidency and governance—an outcome that was almost inconceivable in the recent past. However, Morena is unlikely to have a two-thirds congressional majority and will not control a majority of Mexican state legislatures, which together are needed to change the constitution.

Most Mexican business leaders are clearly worried. Several have publicly insisted that an AMLO presidency would have a negative impact on the nation and have called on their employees to vote against him. AMLO's response has been consistent. He accuses these business leaders of unfairly attempting to influence the vote of their employees, of influence trafficking and of being part of Mexico's mafia of power. But he and his surrogates have also met with key private sector actors, both national and foreign, to explain their policy proposals, while regularly insisting that AMLO is not a threat to the private sector.

Put differently, AMLO's beef is not with the private sector per se. It is with the economic groups he argues have long benefited from a cozy relationship with government, and in the process have undermined competitiveness in the Mexican economy. It is time, he argues, "to separate economic power from political power."

Yet in a June 5 meeting with members of the Mexican Business Council (CMN), the entity representing business leaders across all sectors of Mexican economy, both sides pronounced the encounter to be productive. AMLO described the meeting as cooperative, stating that he expected to have a cooperative relationship with the private sector. For their part, the business participants made clear their willingness to work with AMLO and perceived in the presidential candidate a willingness to work with them as well.

Finally, the dissident teachers' union (CNTE) launched a strike and nationwide march that began on June 4 and culminated in several days of protests in Mexico City. The protesters will once again be demanding an end to education reform and the reinstatement of hundreds of fired teachers.

IV. Mexican Economy

The Mexican economy grew 2.4% in the first quarter, compared with the same quarter in 2017, led by agriculture and services. Inflation fell for the fifth straight month, albeit more gradually than in April, reaching an annualized rate of 4.51% in May, down from early April's 4.55% rate. This smaller than expected reduction in inflation reflects rising gasoline prices, despite a government effort to keep prices from rising through another cut in the gasoline tax. In this context, the Bank of Mexico held its benchmark interest rate steady at 7.5% for the second meeting in a row. Market watchers are now beginning to discount the potential that a López Obrador victory could have a negative impact on markets, and are thus looking for a possible interest rate cut in the second half of the year. In the meantime, however, the impact of the deteriorating trade situation with the United States on the peso could pressure the Bank of Mexico to raise its benchmark interest rate at its next meeting on June 21.

The peso experienced a steady slide throughout the month of May, reflecting a solidifying López Obrador lead in the presidential election race and the inability of NAFTA negotiators to reach a deal. As we had anticipated the ensuing June 1 tariff tit for tat between the United States and Mexico pushed the peso sharply lower. The Peso closed on June 8 at its lowest level in sixteen months, at 20.5 pesos per U.S. dollar. We remain concerned that uncertainty surrounding trade and a likely AMLO victory will continue to pressure the peso in the days and weeks ahead.

Mexico surpassed Brazil to lead the A.T. Kearney FDI Confidence Index in Latin America, albeit with a lower overall confidence rating. At the same time, J.P. Morgan warned of increased country risk while Mexico fell to its worst ranking in 21 years in the IMD 2018 Competitiveness Ranking, driven by corruption, insecurity, and a lack of transparency. Despite this, foreign direct investment set a first quarter record, jumping 19.6% in the January-March period, while the carry trade continues to draw in portfolio flows.

Finally, a cyberattack that targeted the country's internal banking payments system cost three Mexican banks $15 million dollars. The theft followed five earlier hacks and a failed January attempt to steal money from the Bank of Mexico, and it forced the central bank to announce new measures to protect its payments system and to create a cyber security unit.

Sector Focus: Energy

Private firms now control five percent of Mexico's total petroleum reserves, helping to push up Mexico's gas reserves even as oil reserves and production continued to fall. But regulatory requirements have hindered drilling on about two-thirds of Mexico's newly private energy projects. Energy firms are also expecting a López Obrador presidency to slow down implementation of the energy reform, a belief reinforced by the comments of AMLO's Energy Minister-designate and Senate candidate, Rocio Nahle who tweeted that 80% of all activity in the petroleum sector should be Mexican and that Pemex should once again be a fully Mexican firm. On June 12, AMLO's Finance Minister-designate, Carlos Urzúa told the *Financial Times* that while an AMLO administration would "open the door" to all foreign investment, "the only exception is there is going to be a halt to energy tenders."

It's difficult to know, at this point, whether AMLO plans a temporary pause in the exploration and production tenders—purportedly to assess potential corruption in the awarding of contracts (something, we should add, seems extremely unlikely given the very transparent process that government established)—or whether something more, and broader, is in store. We know, based on discussions with AMLO's team, that they strongly support Mexico's push toward sustainability and renewables, which will continue to draw substantial foreign investment and interest. Companies doing business in this sector will need to seriously evaluate their government relations strategies and capabilities to navigate this highly regulated sector.

V. Mexican Security

Two of Mexico's leading business confederations have called on the Mexican government to take action in response to a crime wave that has placed 2018 on path to becoming the most violent year in recent Mexican history. This year has also seen a sharp rise in truck and train robberies, and gasoline and auto theft, albeit coupled with a drop off in kidnapping. In response, some firms have cut operations and investment while others face higher transportation costs owing to extent of theft. Indeed, for business like for average citizens, rising insecurity is one of the chief complaints about the current government. Watch this space for further analysis of the next administration's efforts in this area.

VI. AMLO Transition Watch?

With the presidential election in two weeks, and AMLO seemingly poised to win, we have been approached by many firms about the possibility of providing deeper analysis on AMLO and his new team and priorities as he transitions to take office on December first. Accordingly, we will be preparing a subscription-based newsletter that focuses narrowly on the AMLO transition from July to December to help companies prepare for and understand what to expect in a new AMLO administration. The "AMLO Transition Watch" newsletter will include regular updates on transition and policy-related developments, personnel appointments and biographies, and political intelligence based on our own relationships with AMLO and his team. We will also provide access to Monarch principals for regular conference calls to address specific issues of interest to subscribers. **If you would like to sign up for and learn more about this new service, please let us know here.**

VII. Monarch Events, Speeches, Publications

May 10: MGS Managing Director Andrew Rudman discussed the deteriorating medical situation in Venezuela and its regional impact in the Inter-American Dialogue's *Latin America Advisor*.

May 17: Monarch CEO Michael Camuñez spoke to *The New York Times* about incongruent expectations between the U.S. and Mexico during NAFTA negotiations as the deadline to get Congressional approval in 2018 passed without a deal.

May 21: Monarch CEO Michael Camuñez spoke to *The Washington Times* about the chances for a breakthrough in U.S.-China trade discussions.

June 5: Monarch CEO Michael Camuñez spoke to The Associated Press about recent statements suggesting that President Trump wants to negotiate separately with Canada and Mexico rather than continue three-party talks to modernize NAFTA.

June 13: Monarch Chairman Amb. James R. Jones participated in the *Latin America Advisor* Q&A to express his opinion that presidential frontrunner Andrés Manuel López Obrador is a pragmatist who understands the need to grow the Mexican economy with help from the private sector.