WEALTH MANAGEMENT INTERNATIONAL, LTD.

Proactive Investment Management & Financial Planning

Global Perspectives, October 2018: NAFTA, and the Wreck of the *Edmund Fitzgerald*

When suppertime came, the old cook went on deck,
He said, "Fellas, it's too rough to feed ya . . . "
At 7 p.m., the main hatchway gave in,
He said, "Fellas, it's been good to know ya . . ."

For those of us living in Arizona, basking in the warm autumn sunlight or enjoying a pleasant dinner on our patio, it can take real imagination to conjure up the gloomy Midwestern skies and cold, biting wind that met the sailors of the *S.S. Edmund Fitzgerald* as they set off on their final, fateful voyage across Lake Superior in November 1975. Like myself, most of those who will read these words are of the "investing" or "retiring" class. We work or worked in safe, comfortable offices as professionals and business owners, so we can never really know the grinding monotony, the dirt, the exhausting physical labor, or the danger involved in the blue-collar work of the 29 men who went down with the *Fitzgerald* as she sank in a storm that November 10. But as difficult as it may be, I think a true understanding of today's world and how it's changing requires that we all try for a moment to step into those men's shoes.

Pride of the American Side

Famous among the U.S. and Canadian freighters hauling iron ore and other goods on the Great Lakes, the *Edmund Fitzgerald* really was the "pride of the American side," just as Gordon Lightfoot wrote in his ballad. When she was launched in 1958, the *Fitzgerald* was the biggest ship on the Great Lakes. She was 730 feet long and 75 feet wide. With a draft of 25 feet, she could carry 26,000 tons – usually iron ore from mines in Minnesota to steel mills in places like Detroit, Toledo, and Cleveland. In their own way, the strong men who crewed the *Fitzgerald* were also the pride of the American side, as were the crewmen on countless freighters and tankers running up and down the East Coast, or the sailors manning the oil rig tenders and shrimp boats plying the Gulf of Mexico, not to mention the mill workers and assembly line hands and the countless other soldiers of the American industrial army as it was just beginning to pass its zenith.

If the seamen of the *Edmund Fitzgerald* had survived to today, many of them would have endured a painful industrial transition. From the mid-1970s onward, the mighty U.S. industrial sector seemed to be gradually disintegrating and dying away. Factories closed, especially in the Midwest, or they were moved to locations with lower wage costs in the South or abroad. In reality, U.S. industrial strength remained robust. Much of the old industrial activity was simply replaced by the production of new, higher-technology products like aerospace goods and information processing equipment, usually in the Sunbelt or on the coasts. Nevertheless, there was a palpable decline in opportunity in many parts of the country. In small Midwestern towns, where perhaps only one modest factory accounted for the majority of local employment, the impact was especially devastating. The causes of this erosion were many, but a significant part of it was "globalization," i.e., the increased international competition that arose from factors like reduced transportation costs, easier international communications, economic reforms abroad, and, importantly, new free-trade deals like the North American Free Trade Agreement (NAFTA), implemented by the United States, Canada, and Mexico in the early 1990s.

Figure 1.

The S.S. Edmund Fitzgerald (Source: Wikepedia).

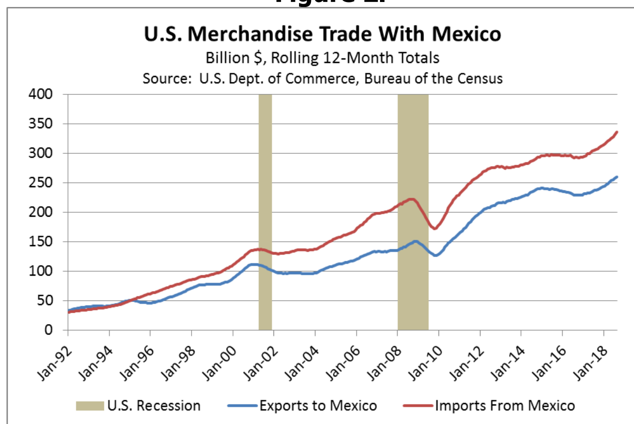
Broad Gains, Concentrated Pain

By most accounts, NAFTA performed pretty much as expected. It sparked a huge increase in international trade among its signatories. It encouraged a wholesale revamp in many companies' approach to manufacturing,

© Wealth Management International, Ltd.
23131 North Lake Pleasant Parkway | Peoria, AZ 85383 | 623-875-5204 |1-888-91-ASSET
To find out how we use our research in an effort to build better investment strategies, see our website at www.wealthadv4u.com.
Advisory services offered through Wealth Management International, Ltd. (WMI), or AdvisorNet Wealth Management (AWM), SEC registered investment advisors. WMI and AWM are not affiliated.

with the result that supply chains have become increasingly complex and international. In North America, producing a complex product like an automobile can now involve dozens of suppliers scattered from Quebec to Queretaro. Free or nearly free border crossings have encouraged firms to source each part or component from wherever it can be made most economically. The result has been to encourage highly efficient production that has benefited wide swaths of consumers in all three countries and even abroad. The problem is that these "broad gains" have been accompanied by "concentrated pain," at least for those workers who were left with far fewer and less lucrative opportunities when their factory closed or relocated, or for those workers who had their wages and benefits cut.

Figure 2.



It's important to remember that even as economists, businesses, and politicians promoted free-trade deals such as NAFTA from the 1980s onward, they understood that many U.S. workers would lose their jobs in the face of foreign competition and the shift of production to lower-cost countries. The promoters offered two basic forms of reassurance: First, they promised that U.S. businesses would soon transition to the more lucrative production of technologically complex, high-value products that less advanced countries can't produce, so displaced workers who upgraded their skills could shift to better-paying jobs in the new growth industries. Second, they promised the government would provide temporary financial assistance to cushion the blow of unemployment and cover the cost of learning new skills.

The problem was that the workers' transition into the new growth industries was much harder than anyone admitted, especially since the promises of government assistance were only partially kept. Could a displaced steel mill laborer or deckhand on an ore freighter really become an aircraft technician or nurse? And even if he could, how easy would it be to move to where the new jobs were? How easy would it be to leave family and friends, or to sell a house in a small town that was collapsing after the closure of its sole factory, or to rent an apartment in an expensive city on the coast as you looked for your first job in a new career? Although the economic and social issues are complex, it seems obvious now that those who suffered from the disruptions of globalization and the lack of meaningful assistance gradually revolted against free trade. They finally found their voice in President Donald Trump, who was a critic of such trade deals long before he ran for president. In any case, the Trump administration has now scored an important victory against the status quo with a preliminary agreement among the NAFTA countries to update and modernize the free-trade agreement. The deal still has to be finalized and approved by all countries, but it might be useful to review its broad contours to see how things might now change for the North American economy and its financial markets.

Figure 3.

Shuttered steel mill in Warren, Ohio (Source: NPR).

NAFTA 2018

Most big trade agreements between major countries are long, complex documents, as is NAFTA 2018 (although the Trump administration refers to the deal as the "United States-Mexico-Canada Agreement," or USMCA, the actual legal text calls it NAFTA 2018). It would be much too difficult to review every element of the deal, but we think the key provisions are as follows:

Autos and Auto Parts. In our view, the most important provisions in NAFTA 2018 may be those related to cross-border shipments of light trucks, autos, and truck and auto parts. Those goods make up a big share of North American trade, and they're politically sensitive. Under the new deal, shipments of trucks, autos, and parts from one NAFTA member to another would not be subject to import tariffs (taxes on foreign goods) if at

© Wealth Management International, Ltd.
23131 North Lake Pleasant Parkway | Peoria, AZ 85383 | 623-875-5204 |1-888-91-ASSET
To find out how we use our research in an effort to build better investment strategies, see our website at www.wealthadv4u.com.
Advisory services offered through Wealth Management International, Ltd. (WMI), or AdvisorNet Wealth Management (AWM), SEC registered investment advisors. WMI and AWM are not affiliated.

least 75% of their value was created in North America. That compares with the original NAFTA deal requiring North American content of 62.5% (the increase will be phased in over five years). In addition, an entirely new provision would require that by 2023, at least 40% of the product's value must be created by workers earning at least $16 per hour – a requirement that effectively limits how much of a vehicle can be produced in low-wage Mexico. Finally, if the United States imposes import tariffs against trucks, autos, and auto parts for ostensibly national security purposes, Canada would be granted an exemption from the tariff for up to 2.6 million vehicles per year, and Mexico would be granted an exemption for up to 2.4 million vehicles.

Textiles. The new agreement reduces the amount of non-North American fiber, yarn, and fabric that can be used in textiles traded tariff-free among the signatories. For example, a factsheet provided by the U.S. Trade Representative touts the provision as "requiring that sewing thread, pocketing fabric, narrow elastic bands, and coated fabric, when incorporated in most apparel and other finished products, be made in the region for those finished products to qualify for trade benefits."

Other Manufactured Goods. The agreement similarly tightens and updates the rules of origin for a wide range of other traditional manufactured goods, such as steel products, glass, optical fiber, and chemicals. As with autos and textiles, the changes generally require that products have a higher level of North American content in order to qualify for tariff-free trade among the signatories. Market access rules have also been updated to discourage non-tariff trade barriers such as import licenses, requirements to use local distributors for imports, and restrictions on re-manufactured goods.

Agriculture. In addition to maintaining tariff-free access for most agricultural products, the deal includes new measures to prohibit the use of export subsidies or World Trade Organization safeguards for products sold to other signatory countries. Canada also agreed to give U.S. producers greater access to its dairy and poultry markets, while Mexico agreed not to apply discriminatory grading standards against U.S. food and agricultural goods.

Digital Trade and Intellectual Property. In one of the least controversial aspects of the deal, the agreement establishes new rules to protect intellectual property and many types of digital trade that didn't even exist when the original NAFTA was negotiated. For example, the agreement includes ten years of patent protection for "biologic" drugs, lengthens copyright protection to an author's life plus 70 years, and requires each signatory country to treat copyright holders from other signatory countries no differently than domestic holders. An entirely new chapter on digital trade would prohibit tariffs and other discriminatory measures from being applied to digital products distributed electronically, such as e-books, videos, music, software, and games.

Labor Standards. The agreement includes a new Labor chapter that requires each signatory to adopt, and maintain in law and practice, the labor rights recognized by the International Labor Organization. This provision is largely intended to push the Mexican government toward stronger enforcement of labor standards and greater protections for workers trying to organize unions. The idea is that those measures would tend to raise Mexican labor costs and undercut Mexico's current cost advantage versus the United States and Canada.

Dispute Resolution. The new deal maintains much of the original system for handling trade disputes among the signatories. For example, the United States gave in on its demand to scrap an arbitration process available when one signatory wants to challenge another over anti-dumping tariffs. Meanwhile, Canada agreed to scale back a provision that allows companies to sue a signatory foreign government over its trade rules.

"Sunset Clause." Under the new deal, NAFTA 2018 would automatically expire in 16 years unless it is actively renewed or renegotiated. The signatories to the deal would meet every six years to decide whether to renew it or renegotiate it. Each time they decide to renew it, the "clock" would reset to a new 16-year term.

Does anyone know where the love of God goes
When the waves turn the minutes to hours?
The searchers all say they'd have made Whitefish Bay
If they'd put fifteen more miles behind her . . . .

Implications and Conclusion

Like many observers, we believe the new changes in NAFTA 2018 are too limited to create either a major improvement or a significant problem for North America in general or for the United States in particular. From an economic standpoint, the main change is that the tightened rules of origin and higher labor standards will create a modestly greater incentive to manufacture in the United States, especially when it comes to trucks and autos. Since U.S. workers and other inputs are relatively expensive, that alone would tend to push up the cost of vehicles. In addition, certain low-priced models currently produced in Canada and Mexico would be especially unlikely to meet the higher North American content requirements, and their manufacturers may simply decide to pay the default 2.5% tariff instead of shifting production. Either way, the risk over the longer term is

© Wealth Management International, Ltd.
23131 North Lake Pleasant Parkway | Peoria, AZ 85383 | 623-875-5204 |1-888-91-ASSET
To find out how we use our research in an effort to build better investment strategies, see our website at www.wealthadv4u.com.
Advisory services offered through Wealth Management International, Ltd. (WMI), or AdvisorNet Wealth Management (AWM), SEC registered investment advisors. WMI and AWM are not affiliated.

that vehicles available for purchase in the United States will likely become more expensive for consumers and/or less profitable for carmakers, while less competition from abroad will reduce the incentive for firms to innovate. We would expect similar dynamics of modestly increased U.S. production and higher U.S. prices for many other products covered by the agreement. We worry that the resulting pullback in consumer demand and weaker growth could well offset any benefit for U.S. factory workers.

Figure 4.

For investors, the fact that NAFTA 2018 ended up changing so little of the North American trade system was a major relief. Financial markets initially seemed to respond well to the deal. More recently, however, it appears that investors have realized that even the deal's limited changes play into many of the negative trends developing in the economy and markets. For instance, corporate earnings growth was already expected to begin slowing in the coming year. With many global manufacturers now facing costly supply-chain shifts and a requirement to increase production in more expensive locations, the threat to profitability is even greater. Likewise, recent strong economic growth and rising inflation had already made the Federal Reserve more amenable to continued interest-rate hikes. To the extent that the new deal threatens to push inflation even higher in the coming years, the policymakers at the Fed might become inclined to raise rates faster or farther than previously planned, which could disrupt both the bond market and the stock market. Finally, if investors decide the new agreement will substantially cut the U.S. trade deficit, they could drive the value of the dollar even higher. While an even stronger dollar could help limit today's uptrend in inflation, it would also be an additional headwind for corporate profit growth.

Finally, what are the implications of the new trade deal, and others that may follow, for the industrial workers who make up so much of the political support for the administration? Does requiring 75% of a car to be made in North America, versus 62.5% previously, really create vast numbers of new jobs, higher pay, or better working conditions for those who in an earlier epoch might have found work tightening lug nuts on an auto assembly line in Detroit, or manning a freighter like the *Edmund Fitzgerald* as it hauled supplies to a factory across Lake Michigan? Despite the new agreement's nostalgic focus on industries like autos and textiles, it seems inescapable that modern production efficiencies and market dynamics will probably preclude any major improvement in their lot. In today's world, we still believe the advantage will go to those with advanced, specialized skills and those who work with their mind rather than their body. If you count up all the money that companies are about to spend on production shifts, and the money consumers are about to spend on more expensive products because of NAFTA 2018, it's a valid question whether those funds would be better spent on worker retraining, increased equipment and infrastructure investment, and other programs to help workers compete better in global competition – just as was originally promised by the promoters of free trade. Only time will tell whether the new deal truly honors the men and women toiling in today's industrial complex to provide a better life for us all.

In a musty old hall in Detroit they prayed,
In the Maritime Sailors' Cathedral.
The church bell chimed till it rang 29 times
For each man on the Edmund Fitzgerald . . . .

Patrick Fearon, CFA
Chief Investment Officer

© Wealth Management International, Ltd.
23131 North Lake Pleasant Parkway | Peoria, AZ 85383 | 623-875-5204 |1-888-91-ASSET
To find out how we use our research in an effort to build better investment strategies, see our website at www.wealthadv4u.com.
Advisory services offered through Wealth Management International, Ltd. (WMI), or AdvisorNet Wealth Management (AWM), SEC registered investment advisors. WMI and AWM are not affiliated.