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Trade

Odds of NAFTA Withdrawal Executive Order 75% and Trending Up – Odds of Actual Withdrawal 25%

The Takeaway:

> *We think investors underappreciate the likelihood that President Trump issues an executive order (EO) triggering a U.S. withdrawal from NAFTA. We put odds of this event at 75%, most likely at some point in the mid-November / early-December time frame. This view is driven significantly by events of late last week that saw Trump take dramatic steps to unwind prior Administration's policies – even against the advice and wishes of others in the Republican Party. However, triggering NAFTA withdrawal and actual withdrawal are currently viewed as unified events and must be decoupled. We put prospects for actual withdrawal as still possible but lower, at only 25%. Reasons preventing actual withdrawal are aggressive lobbying by prominent Republican-aligned advocacy groups like the U.S. Chamber of Commerce and agricultural communities, combined with the popularity of NAFTA in Mexico and Canada – all of which will likely pressure negotiators from the three countries to ultimately reach some sort of modest alteration rather than dissolve the trade pact entirely.*

Why a Trump Executive Order Triggering NAFTA Withdrawal Has Become Highly Likely

- **The status quo is politically untenable**. Often when it comes to predicting policymaking, a good rule of thumb is that no change tends to be the easiest and often most likely outcome. However, events late last week demonstrate to us that Trump's anti-establishment agenda takes priority over anything else, and the status quo on major items (last week was the Affordable Care Act and Iran) is politically not tenable for this President. Trump came to Washington promising to "drain the swamp" and roll-back regulations from prior Administrations, and he has demonstrated that he will stick to that promise.

- **Details of a solution aren't necessary**. Events of last week also reinforce to us that, from President Trump's perspective, unwinding existing policy is enough. The unwinding itself is the end, not the means to something else. This Administration does not let the absence of a clear replacement policy path forward stop it from taking that initial, broad action (see: last week's ACA and Iran announcements, and repeal of the Clean Power Plan the week prior).

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- **NAFTA is not that popular among Republicans**. Only 30% of Republicans view NAFTA as good for the U.S. And 33% of Republicans believe NAFTA has been very bad for the U.S. So, the political risks to Trump for taking bold action on NAFTA may not be meaningful, again arguing for action rather than inaction when it comes to withdrawal.

- **NAFTA is not that popular among labor unions**. Labor unions are advocating for the Trump Administration to withdraw from NAFTA. This is an important constituency for the President's pro-worker, pro-U.S. / Make America Great Again Administration. Union members were more likely to support President Trump than candidate Hillary Clinton in the 2016 presidential race (56% to Trump vs. 37% to Clinton). This certainly gives the President a vocal and influential community of support should he trigger a NAFTA withdrawal.

- **The proposals being put forward by U.S. negotiators are too extreme for other countries to agree to, let alone the U.S. Congress to approve.** A list of proposals floated last week that we think are too contentious to be enacted in to policy either because they won't garner agreement by Mexico and / or Canada, and / or they will be too contentious to receive enough support for enactment by the U.S. Congress include a five-year sunset provision on a new NAFTA deal, and a requirement for automobile manufacturers to source 85% of the content (up from 62.5%) from the NAFTA region with a 50% minimum (up from no requirement) on U.S. content. While we think that 85% content requirement for the region could be part of a final negotiation, we think the five-year sunset and 50% U.S. auto content minimum are unlikely to survive future rounds of negotiations. If the President is unwilling to back off these and other contentious demands, the paths forward are few: either status quo or withdrawal – the latter for reasons above seeming more likely to us.

- **No countries in the negotiations have been given good reason to compromise**. For all the reasons listed above, the U.S. is likely not going to move off some of the tough positions it hopes to take in NAFTA negotiations. That would only work to avoid a withdrawal if Mexico and Canada were willing to acquiesce – which we don't see happening. Mexico's early 2018 Presidential election politics place pressure on Mexican negotiators to fight for the best deal they can get. And we think Canadian Prime Minister Justin Trudeau's trip to DC last week probably served to reinforce to him that Canada could continue to push for middle-ground solutions to renegotiations as well. Here's why: Trudeau met with House Ways and Means Committee Members who likely voiced to him their desire to make only modest adjustments to NAFTA going forward. And Congress must approve any new trade agreement the President enters. Trudeau likely left DC feeling like he could instruct Canadian negotiators to stand their ground against some of the more dramatic changes insisted on by Trump Administration negotiators. This outcome was reinforced to us by news later in the week that Trudeau and Mexican President Enrique Pena Nieto pledged unity on any renegotiated trade agreements (removing the option for the U.S. to cut one of the countries out as Trump threatened earlier in the week).

Why Actual NAFTA Withdrawal Is Far Less Certain

If President Trumps decides to withdraw from NAFTA, he can basically do so unilaterally and at any time. The mechanism for this would be an Executive Order (EO) providing official notice that he would trigger Article 2205 under NAFTA, which gives any of the parties the right to withdraw from the pact after providing at least six months' notice. This EO could be issued any day the President decides. And in theory six months later the U.S. could withdraw.

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There are a number of reasons we outline above that we expect will compel the President to ultimately issue that EO triggering NAFTA withdrawal. But triggering a withdrawal and actual NAFTA withdrawal are two separate events that must be decoupled in our view.

In the end, we think the most likely scenario sees the President trigger a NAFTA withdrawal, but sees negotiators reach an agreement before withdrawal officially occurs, an agreement that makes more modest changes to the underlying deal in the end for the following reasons:

- **The inevitable and extremely aggressive lobbying that would occur over those six months would pressure policymakers in Congress and the Administration to avoid actual withdrawal.** Unpopularity of NAFTA withdrawal by major, influential Republican industry and advocacy groups like the U.S. Chamber of Commerce, National Retail Federation, agricultural groups, and automotive industry groups (among others) will put urgency into finding a true solution ahead of the 2018 midterm elections where Republicans are already bracing for a fight over House and maybe even Senate majorities in Congress.
- **Canada and Mexico would also be incentivized not to walk away.** Public sentiment around NAFTA is far is more favorable in Mexico and Canada than in the U.S. – the trade deal polls at 51% that it benefits constituents in both countries, respectively. The pressures placed on U.S. negotiators to walk away with a deal we think will make them more likely to stand down from some of the tougher positions that are not tenable (such as a five-year sunset, for instance), meaning that in the end we think compromise will become more likely. Combine this with reasons why all three countries should remain at the negotiating table and a ticking six-month clock and we think a deal becomes more possible going forward.

What Comes Next

The fourth round of NAFTA renegotiations is wraps up tomorrow in Washington, DC. A fifth round is tentatively scheduled in Mexico City in early November. And a sixth round is tentatively scheduled in Ottawa in late November. *For full details of the renegotiation timeline, see our October 10 desk reference.*

As we write above, we are very bullish on prospects that President Trump issues an EO to trigger withdrawal (odds at 75%), thus starting a six-month clock. Trump could issue the EO at any time, but our best guess would be sometime in mid-November / early-December for this to occur (at least until after the next round of negotiations if not the round following).

The EO would technically trigger Article 2205 under NAFTA, which, as we write above, gives any of the parties the right to withdraw from the pact after providing at least six months' notice.

One other thing to note, however – once the President triggers withdrawal, we expect there will be lawsuits that emerge to challenge his authority to do so. Despite Article 2205 of the NAFTA agreement, the Commerce Clause of the U.S. Constitution places statutory authority with explicitly with Congress to "regulate commerce with foreign nations." Therefore, it is likely that if the President issues an EO to withdraw, advocacy groups and Democrats in Congress would sue the Administration, arguing they do not have the authority to take this unilateral action without Congressional ratification. This will add another element of complexity to those six months between the EO and the ability to withdraw, and could place additional pressure on the U.S. to compromise on a renegotiated agreement with Mexico and Canada.

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