Bridgewater®
Daily Observations
September 4, 2018
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The US Flexes Its Trade and Dollar Muscles Again. The More Important Question Is How Other Countries Will Adapt.

The changes to NAFTA on their own won't matter, as the differences from the status quo are too small to matter for the US economy or global trade more broadly. What matters is that we have another instance of the US using aggressive tactics to force change and that the market action continues to illustrate that the US has considerable leverage—with the impact on foreign markets from US actions being much greater than the impact of other countries' retaliations against the US.

So far, even with the US breaking some of the rules of the game (e.g., using national security grounds to impose unilateral tariffs or unilaterally limiting access to SWIFT for companies trading with Iran), negotiations have mostly been limited to changes within the system as opposed to attempts at more fundamental changes that could undermine the system. And the US has been able to extract concessions because it has so much more leverage. The question is whether these wins will embolden the US administration to deploy similar tactics where the power balance isn't as uneven and where, if neither side blinks, there could be destructive outcomes for all sides that do threaten the system.

We are also closely monitoring the dynamics around the dollar as a global reserve currency. The rise of China and relative decline of US economic dominance have already created a longer-term incentive to move away from the dollar, and the risk is that the US's recent actions could accelerate it. So far, there has clearly been a ratcheting up of the rhetoric from major trading partners (not just from China and Russia but from more traditional allies like Germany), but there is no evidence of a material shift away from the dollar.

The tables below show the recent market action and betas of markets to our trade conflict gauge. The effects on US markets and even on those of Mexico and Canada have been smaller than the effects on China, Asian markets, or Europe. This is consistent with the idea that, at least in the short term, the US has less to lose, because trade isn't that big a share of output for the US, because the US has more leverage in any bilateral negotiation with most trading partners, and because the US has, in many cases, more tools to inflict harm.

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Market Sensitivity to Trade Conflict News

Equities	Beta
China	-1.37%
Philippines	-1.27%
Hong Kong	-1 20%
Poland	-1 04%
South Africa	-0 97%
Germany	-0 93%
Malaysia	-0 92%
Thailand	-0 84%
Japan	-0 69%
Portugal	-0.69%
Euroland	-0 69%
France	-0 65%
Norway	-0 63%
Singapore	-0 61%
Spain	-0 61%
Korea	-0 59%
Peru	-0 57%
Belgium	-0 54%
Ireland	-0 52%
Switzerland	-0 51%
Netherlands	-0 50%
Russia	-0 47%
Chile	-0 46%
Taiwan	-0 45%
United Kingdom	-0 45%
New Zealand	-0 38%
Hungary	-0 37%
Italy	-0.35%
United States	-0 33%
Canada	-0 28%
Czech Republic	-0 24%
Brazil	-0.05%
India	0.00%
Australia	0.10%
Saudi Arabia	0.11%
Mexico	0.14%
Colombia	0.15%
Turkey	0.17%
Bulgaria	0.24%
Greece	0.42%
Indonesia	0.45%

Chinese stocks look the most sensitive to trade conflict → China

Euroland also showing sensitivity (Germany through Spain)

Canada showing more moderate sensitivity → Canada

Interestingly, Mexican equities showing basically no sensitivity → Mexico

Nominal Bonds	Beta
Canada	0.34%
Euroland	0 25%
United Kingdom	0 24%
United States	0 24%
Australia	0 22%
China	0 20%
Switzerland	0 16%
Japan	0.01%

EM Spreads	Beta
Hungary	-0.13%
Malaysia	-0.13%
Poland	-0 11%
Russia	-0 09%
Philippines	-0 08%
Indonesia	-0 08%
China	-0 06%
South Africa	-0 04%
Korea	-0 02%
Saudi Arabia	-0 02%
Thailand	-0 02%
Peru	-0.01%
Hong Kong	-0.01%
Czech Republic	-0.01%
Singapore	-0.01%
India	0.00%
Colombia	0.01%
Chile	0.01%
Turkey	0.05%
Brazil	0.08%
Mexico	0.10%

Developed FX	Beta
Canada	-0.32%
China	-0.29%
Australia	-0.28%
Norway	-0 23%
New Zealand	-0 21%
United Kingdom	-0 19%
Euroland	-0 11%
Switzerland	-0 05%
United States	0.03%
Japan	0.23%

Canadian and Chinese FX are the most sensitive in the DW

EM FX	Beta
Russia	-0.50%
Korea	-0.47%
Turkey	-0 36%
Thailand	-0 27%
Czech Republic	-0 24%
Poland	-0 24%
Hungary	-0 23%
Taiwan	-0 23%
Singapore	-0 20%
Colombia	-0 17%
Bulgaria	-0 12%
Indonesia	-0 10%
Malaysia	-0.05%
South Africa	0.00%
Hong Kong	0.00%
Saudi Arabia	0.00%
Philippines	0.04%
Chile	0.06%
Peru	0.07%
India	0.10%
Brazil	0.24%
Mexico	0.64%

The peso has actually performed well against news over the period, partly because its pricing was so pessimistic to begin with (see chart on the next page) and the deal wasn't that negative for Mexico

Commodities	Beta
Copper	-1.16%
Oil	-0 88%
Aluminum	-0 65%
Iron	-0 48%
Soybeans	-0 45%
Silver	-0 44%
Gold	-0.07%

China-sensitive commodities have shown weakness

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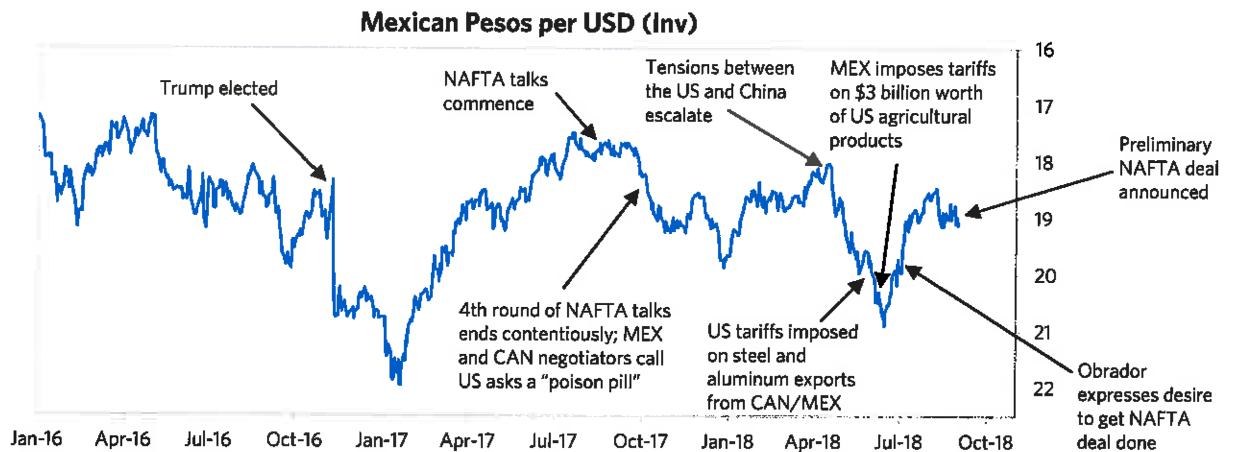
Looking a level down, it is also clear at the sector level that industries most directly tied to trade have been most negatively impacted in the US, but the impact has been more broad-based in China.

United States Stock Sectors	Sensitivity to Trade War News	China Stock Sectors	Sensitivity to Trade War News
Materials	-1.0%	Telecommunication Services	-2.2%
Energy	-1.0%	Information Technology	-2.0%
Industrials	-1.0%	Materials	-1.8%
Financials	-0.6%	Consumer Discretionary	-1.6%
Healthcare	-0.3%	Industrials	-1.4%
Total Market	-0.3%	Consumer Staples	-1.4%
Telecommunication Services	-0.2%	**Total Market**	-1.4%
Information Technology	-0.2%	Energy	-1.2%
Consumer Discretionary	0.0%	Utilities	-1.0%
Consumer Staples	0.1%	Healthcare	-1.0%
Utilities	1.1%	Financials	-1.0%

It is interesting that Mexico hasn't been impacted recently by the escalation of trade conflict, as shown in the table on the previous page. Of course, much of the hit to Mexican markets came early, once it become clear that NAFTA and trade with the US were at risk. Since the lows, Mexican markets have rebounded somewhat, and the recent market action (or lack thereof) is consistent with our preliminary read that the concessions are, at a minimum, much less negative than a material rise in tariffs. While the full details of the agreement aren't available yet, from what we have seen they don't appear to constitute a big hit to Mexico. Mexico may actually get some protection against competition from abroad via rules that increase domestic content of autos to Mexico and the US.



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The chart below shows a rough illustration of our estimated potential impact of a full-blown trade war within North America. The worst-case scenario for Mexico (including a broader set of tariffs) would be roughly a 4% hit to its trade balance. The impact for Canada would be roughly half of that. The positive supports for the US would be modest, at around 1% of GDP. The agreement that is on the table now appears to be consistent with modest changes (a small fraction of the worst-case scenario), and may even benefit Mexico in some ways (such as protection against trade from abroad).

Trade Balance Impact of a Significant Trade War (%GDP, Ann)

As we look across what's been agreed (which is still evolving, as we don't have the official text yet), the agreement looks moderately favorable to the US but likely to have far less of an impact on the trade deficit than the most serious measures that had been threatened (i.e., the 35% tariff). Some of the provisions may also help to protect Mexico from competition from others, including China (e.g., by upping the domestic content laws for autos). We list the key changes below and have a lot more detail in the appendix. Mexico has about five years to comply or face tariffs on autos of 2.5%, so it doesn't seem like these changes will materially impact the deficit in the short term.

1. Requires that 75% (up from 62.5%) of auto content be made in the United States or Mexico and that 40-45% of auto content be made by workers earning at least $16 per hour. This is protected by stronger rules for enforcement. Mexico gets some protection from the possibility of the US imposing high tariffs on auto imports.
2. Agreed to 16-year term with an opportunity after 6 years to renegotiate.
3. The agreement provides stronger intellectual property provisions, which may prove to be a template for other trade deals.
4. There are ongoing parallel discussions on immigration policy, which is likely to limit inflows into the US by immigrants from Central America, and on steel and aluminum tariffs.

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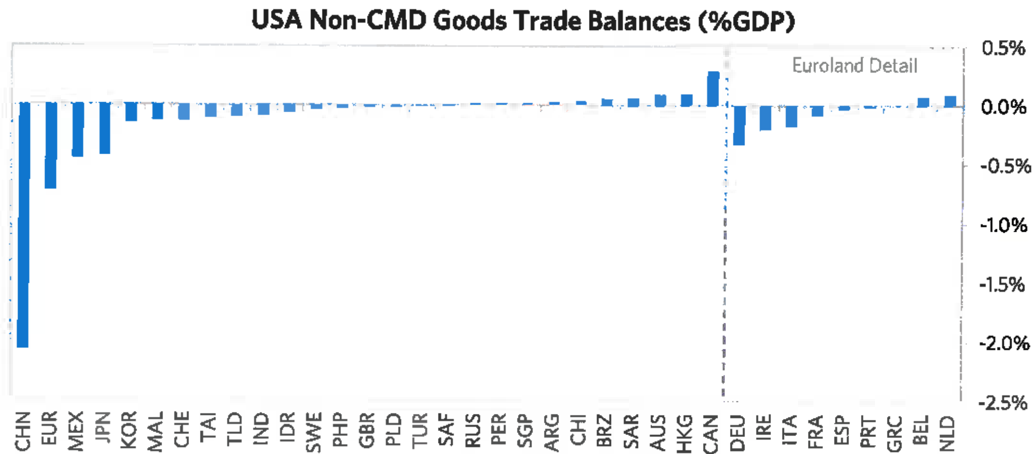
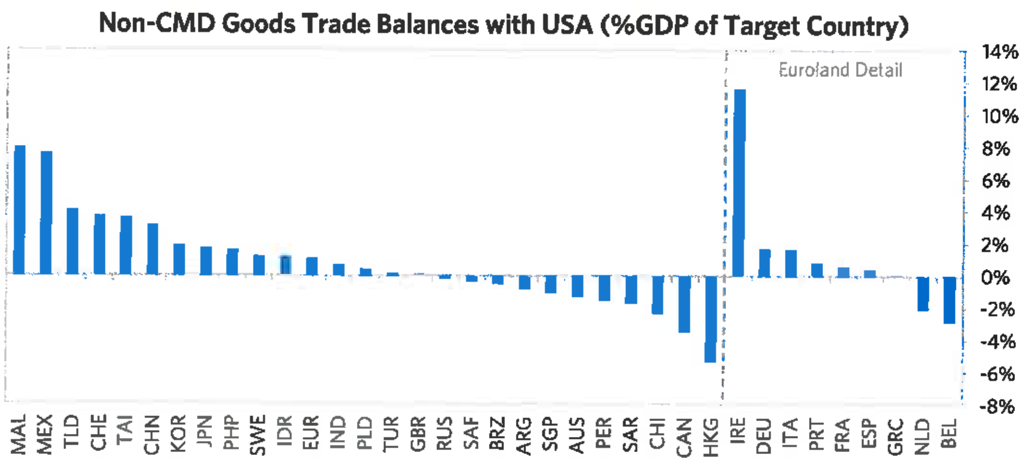
Some Perspective on the Largest Bilateral Goods Deficits

The Trump administration has been heavily focused on reducing bilateral goods trade deficits. As noted above, based on what we know so far, the deal with Mexico is likely to reduce the deficit but only to a modest extent. The much larger targets are obviously China and to a lesser extent Europe, and the deal may to some extent favor Mexico over these countries. The charts below are meant to provide some perspective on how large, relative to other countries, the deficit with China is. Of course, the importance to China of trade with the US is much smaller than it is for Mexico, and the conflict between the US and China is much more symmetric.





Something we are watching closely is whether the US's willingness to flex its muscle more broadly is leading to meaningful reactions that may ultimately undermine the US status in the global financial system. NAFTA negotiations are only a small dot within the context but are part of a pattern of US actions that puts other countries, including traditional allies, on notice. We give some perspective on the US dollar's status as a reserve currency below.

Perspectives on the Dollar's Status as a Reserve Currency

Given the US's centrality to the global financial system and the dollar's status as the world's reserve currency, the US administration has significant levers it can pull to pressure countries on the other side of the negotiating table. Indeed, this has been threatened against both Iran (after the collapse of the nuclear deal) and Russia, mainly through limiting its access to the SWIFT global clearing system. Over time, such tactics encourage major trading partners—competitors and allies alike—to find alternatives. Recently, global leaders have spoken about such a decentering of the dollar from global transactions:

> "As for the dollar as a reserve currency, we are not alone in talking about this problem, and it is becoming a problem...A great number of countries are talking about exactly this—the need to expand the capabilities of global finance and the global economy, and create new reserve currencies. This will make the global economy and global finance more stable." - President Putin

> "We need to gradually end the monopoly of the dollar once and for all by using local and national currency among us...Using the dollar only damages us." - President Erdogan

It isn't a surprise that Russia, Turkey, and China have a strong incentive to reduce their exposure to US actions. But even more traditional allies, such as Germany, have expressed concerns. The quote below by the German Federal Minister for Foreign Affairs was later somewhat watered down by Merkel, who did not advocate a break with SWIFT. But she still expressed the need to reduce reliance on the US.

> "[I]t is indispensable that we strengthen European autonomy by creating payment channels that are independent of the United States, a European Monetary Fund and an independent SWIFT system." - German Federal Minister for Foreign Affairs Heiko Maas

Few Tangible Signs of Diversification out of US Dollars Yet

Looking across the various measures of currency usage in trade and financial systems, the dollar has been the dominant currency (40+% share) across all measures for the last 30+ years. There are no signs of this share declining in the available data. In terms of central banks' reserves, they remain predominantly in dollars with some sign of the share rising recently. This is something we are watching closely for any evidence of a start of a more material shift.

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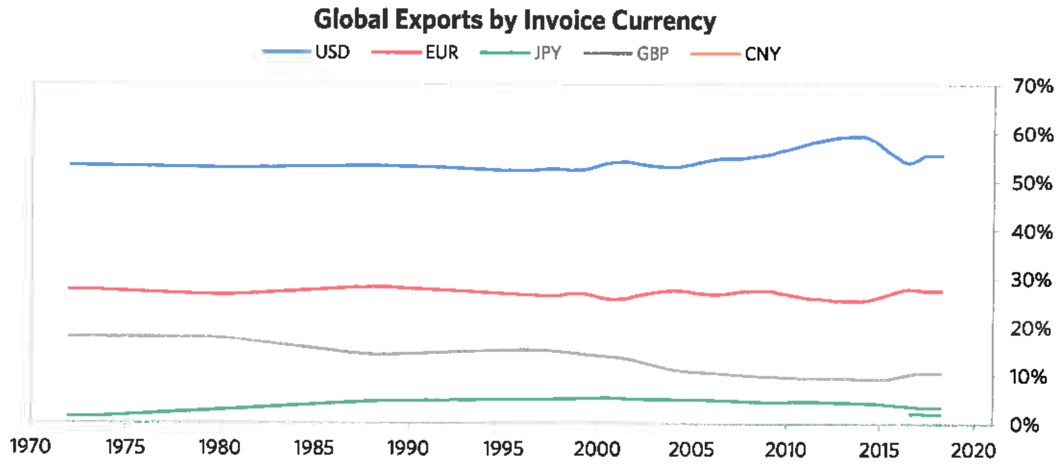
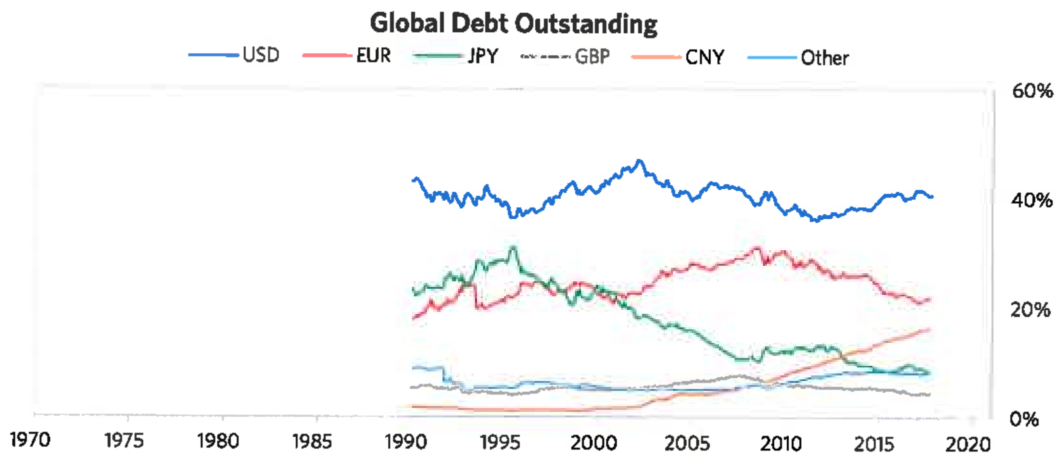
The dollar remains the dominant currency used for global trade invoicing and has been stable.



Global debt is also predominantly in dollars—the USD and CNY shares have risen in recent years, while euro and yen shares have fallen.



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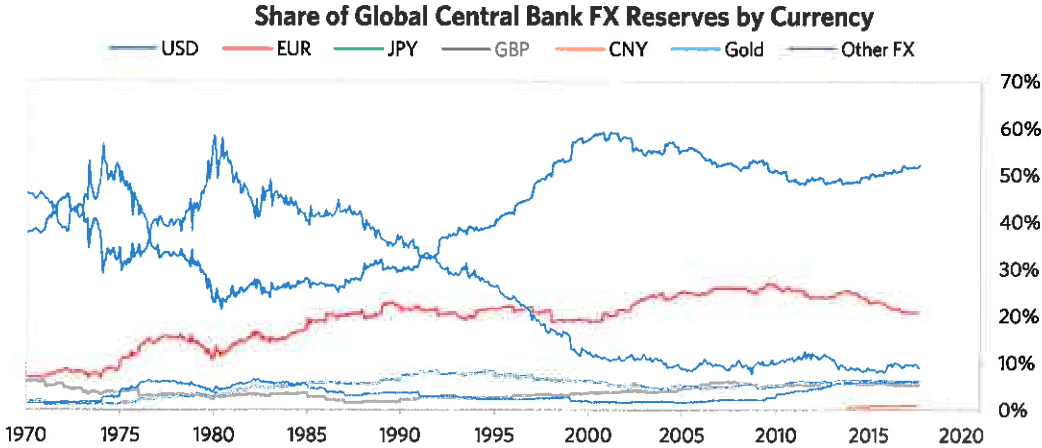
Additionally, central banks continue to hold the vast majority of their reserves in dollars.



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Appendix: Details of What We Know about a Likely Revision to NAFTA

What follows is preliminary, as full details haven't been released yet.

US-Mexico Bilateral Deal (Preliminary Agreement in Principle)

1. The US and Mexico reached a "preliminary agreement in principle" on August 27 on NAFTA 2.0. This permits Presidents Trump and Nieto (the current president of Mexico) to sign the agreement on November 29 per the Trade Promotion Authority (TPA) required timeline and before Andres Lopez Obrador (AMLO) assumes Mexico's presidency on December 1, 2018. To meet the December 1 deadline and the timeline required by the Trade Promotion Authority ("fast track"; requires 51 versus 60 votes in Senate and precludes amendments [up-and-down vote]), the US and Mexico had to reach an agreement by August 31 (the last possible date for Trump to notify Congress of his intent to sign a new agreement before December 1).
    a. The election of Andres Lopez Obrador brought momentum to the talks, as Obrador made clear he preferred that NAFTA 2.0 negotiations not encumber his presidency.

Trilateral Agreement Prospects

2. Canada rejoined the negotiations last week, also with aim of reaching a "preliminary agreement in principle" with both the US and Mexico by August 31, per TPA timeline. No agreement was reached. As the "full text" of the agreement must be sent to Congress by September 30, the negotiators have ~30 days to hammer out the "full text," improving the odds of a trilateral agreement (NAFTA 2.0).

US-Mexico Agreement: Meaningful Changes to NAFTA 1.0 Consistent with Trump Administration Goals

3. The US-Mexico agreement includes meaningful NAFTA revisions and additions consistent with the Trump administration's goals, including reducing bilateral goods trade deficits (autos and auto parts, the largest component in Mexico's surplus), incentivizing investment and production in US and Mexico/North America, protecting against transshipments (circumvention of antidumping and countervailing duties), and enhanced IP and digital trade in goods and services protections—i.e., NAFTA "modernization" provisions. The modernization provisions are hailed by the USTR as best-in-class (greater protection than TPP provisions) and are expected to be propagated by the US government through other trade deals, including potential reform of WTO rules and process.
4. The revisions and additions to NAFTA 1.0, in turn, appear designed not to induce significant trade, supply chain, or investment dislocations in the near and mid-term (see examples infra).

Side Agreements on Immigration, Steel & Aluminum, and Auto & Auto Parts Quotas

5. US-Mexico reportedly agreed to, or are still negotiating, a number of side agreements that also advance Trump administration objectives, including immigration flows and steel and aluminum imports.
6. One side agreement protects Mexico from a potential 25% tariff on auto and auto parts threatened by Trump (see infra). The protection is in place for up to 2.4 million of auto exports and $90 billion in auto parts exports from Mexico.
7. Another side agreement under discussion is to replace the Section 232 tariffs on steel and aluminum with export quotas—similar to those agreed to earlier by South Korea, Brazil, and Argentina.
8. Importantly, the US and Mexico have reportedly been in talks on naming Mexico a "safe third country" for migrants seeking to move from Central America to the US via Mexico. This designation would allow the US to legally bar asylum seekers arriving from Mexico to apply for refugee status in the US.

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Rules of Origin

9. To address trade in goods imbalance, protect against transshipments, and incentivize investment and production in signatory countries (the US in particular), the rules of origin for autos (effectively auto parts) and a number of other products were changed—increasing the share of content sourced from signatory countries. For autos (and auto parts), by far the biggest contributors to bilateral goods deficits, the increase was from 62.5% to 75%. Reportedly this increase is to take place over three years. R&D costs may be counted for up to 15% of content, and for exports not meeting this requirement, the tariff remains 2.5% (up to quota level; see infra) if Trump imposes 25% tariffs on auto and auto parts. These provisions are to reduce the negative impact of this change on primarily US manufacturers (whose largest producers already source above or near 75%).
10. The rules of origin provisions also create a stronger enforcement mechanism to "prevent duty evasion" and verify the origin of products. This addresses an important US consideration—reducing Chinese goods transshipped through Canada and Mexico as a means of evading antidumping and countervailing duties.

Wage Floor & Auto Export Quota

11. Mexico also agreed to an unprecedented wage floor—40% of auto and 45% of light truck content must be made by workers making at least $16 per hour (twice the average wage of Mexican auto workers and ~4x the wages of auto parts workers). The agreement was made easier as increasing workers' wages is an Obrador priority.
12. Mexico estimates that 32% of its current exports would not be compliant. However, reportedly a five-year transition period has been agreed to. After the transition, noncompliant autos and light trucks will be assessed a 2.5% tariff (US MFN tariff).
13. A side quota agreement ensures the tariff remains only 2.5%, even if President Trump imposes his threatened 25% tariff on all auto imports. The protection is in place for up to 2.4 million of auto exports and $90 billion in auto parts exports from Mexico.

Removing Incentives to Invest in Mexico

14. In order to reduce the incentive for investment and production in Mexico (at the expense of the US), the agreement repeals Chapter 11 of NAFTA investor-state dispute settlement mechanism protections for manufacturers, adds a sunset provision (with potential sunset in 16 years), and adds a labor provision (including worker participation in collective bargaining) with enforcement (reportedly).
    a. The new agreement guarantees NAFTA for 16 years, with a review in the next 6 years, along with the potential for a further renegotiation.

New Labor Provisions

15. New labor provisions include guaranteeing collective bargaining rights, in which Mexico specifically commits to passing new legislation strengthening collective bargaining. Signatory states are also required to recognize and keep laws in line with International Labor Organization recognized labor rights. According to the USTR, the agreement "brings labor obligations into the core of the agreement, makes them fully enforceable, and represents the strongest provisions of any trade agreement."

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NAFTA "Modernization" Provisions as Precedent for Other Trade Deals

16. One key goal of renegotiation was to update/modernize NAFTA. New chapters were added on digital trade in goods and services, state-owned enterprises, intellectual property protections, and environmental and labor protections. The USTR has characterized these provisions as best-in-class and is expected to advocate for them in other trade agreements, including the potential revisit of WTO rules and process.
17. The IP chapter, according to the USTR, provides for "strong and effective protection and enforcement of IP rights" and is the "[m]ost comprehensive enforcement provisions of any trade agreement." The agreement, according to the USTR, will be the first trade agreement to protect US IP from theft of trade secrets including by SOEs. The IP provision also includes state responsibility to stop counterfeited or pirated goods at a port of exit or entry, establish meaningful criminal procedures on piracy and counterfeiting, and strong protection of industrial trade secrets. The copyright provision accords full national treatment. These are all longstanding IP protection measures sought by the US government.
18. The digital trade provision prohibits customs duties and other discriminatory duties on digital products and ensures free cross-border transfers of data with limits on where data can be stored and processed "minimized." For the first time, the agreement includes a prohibition on local data storage requirements where a financial regulator has access to data it needs to fulfill its duties. It also limits a government's ability "to require disclosure of proprietary computer source code and algorithms."

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