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NAFTA bluff?

Reports that the Trump administration is considering an executive order allowing the United States to formally withdraw from NAFTA have sent a shudder through the markets. This order would give the United States the option to exit the trade agreement should attempts at renegotiation fail.

This threat has yet again renewed the debate over whether the President actually has the authority to withdraw from trade deals such as NAFTA without congressional approval. According to Gary Hufbauer of the Peterson Institute for International Economics, a leading scholar on the matter, the President can withdraw from them unilaterally with only six months' notice.

Regardless of whether he is right or wrong, we believe it is unlikely that President Trump will actually withdraw from NAFTA. This is because doing so would elicit an uproar in Congress, risk disrupting the activities of companies with supply chains spread across the hemisphere, hurt the economy and trigger a wave of lawsuits. Congress must also approve any new trade agreement. All of this would consume Trump's Presidency and prevent the administration from advancing other parts of its agenda (i.e. taxes, healthcare and infrastructure)

Even more importantly, President Trump does not have to resort to the nuclear option of ripping up trade agreements in order to implement protectionist measures. He has the legal authority to impose tariffs or quotas on virtually any sector of the economy without the approval of Congress. This is because, over the past century, Congress has relinquished much of its power to regulate trade to the executive branch. It has done so through such laws as the Trading with the Enemy Act of 1917, the Reciprocal Trade Agreements Act of 1934, the Trade Expansion Act of 1962, the Trade Act of 1974, and the International Emergency Economic Powers Act of 1977.

The only way for Congress to block this authority is to pass new legislation to repeal the powers it previously granted, but this would require a two-thirds majority in both the House and the Senate in order to override a presidential veto.

As a result, we feel that his threat to tear up NAFTA is merely a negotiating tactic to leverage greater concessions from Mexico, Canada and down the road China. It is also a signal to Trump's electoral base that he is following through on his promise to take a harder line on America's trading partners.

The government must give a 90-day notice to Congress before formally entering negotiations. The longer the administration waits, the more politically difficult it will become to formally renegotiate NAFTA. Mexico has an election scheduled for July 2018, which risks turning any concessions made to the United States into a campaign issue. These negotiations also run the risk of becoming a major issue in the upcoming U.S. mid-term congressional elections (November 2018).

While it is highly unlikely NAFTA will be revoked, it is certain the U.S. will continue to take an increasingly protectionist stance. This will be driven by the fact that opposition to free trade is one of the few things that unites an otherwise deeply divided U.S. electorate.

In this environment, investors must do more than simply analyze the balance sheets of companies. They must also look at any ongoing or potential future tensions with trading partners, since access to foreign markets should no longer be taken for granted. The lumber sector is a case in point.

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