WEEKLY ECONOMIC COMMENTARY

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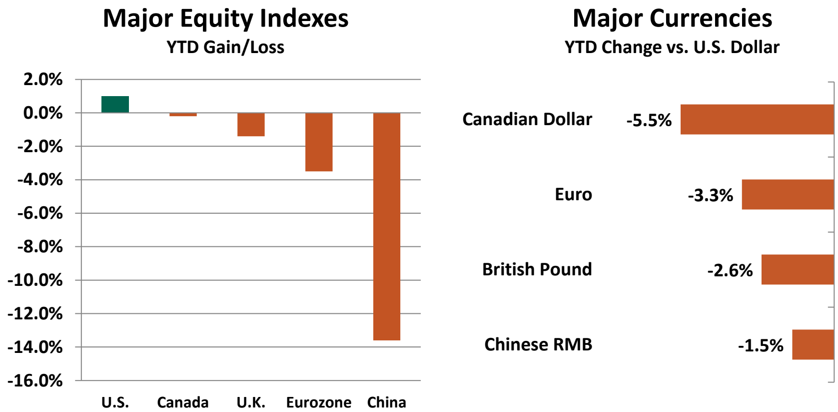
When my children were smaller, we would occasionally have staring contests at the kitchen table. I always won, because I was able to distract them with jokes or funny sounds while sustaining eye contact.

The tussles between the United States and just about every one of its trading partners may come down to who blinks first. Each round of new tariffs has been designed to inflict maximum discomfort, and the constant stream of new threats has been designed to create economic and political uncertainty.

The effect on specific businesses and industries has been mixed. While those most disadvantaged garner headlines, others are quietly benefitting. Simulations considering current and threatened tariffs do not produce a substantial economic retreat for the United States, Europe or China.

But the most sensitive gauge of the growing trade conflict may be the financial markets. Stock and currency values are often the first to reflect the prospect of changing fortunes. Leading world equity indexes are composed of global firms with international sales and supply chains. Foreign exchange serves as a medium for trade in goods and services.

So far this year, equity market performance has diverged considerably across countries. The U.S. market is the only one that has advanced so far in 2018. And the U.S. dollar has gained strength.



Source: Bloomberg

This relative resilience may be feeding the sense among U.S. trade negotiators that America is in a position of strength, and can withstand more discomfort than others can. This perception informs the aggressive posture taken by Washington.

The question is: how long this can be sustained? Collectively, members of the S&P 500 derive 43% of their sales from foreign countries and use global supply chains to bring output to market. Trade barriers could damage both, leading investors to revisit their valuations.

My staring contests at home always ended with laughter. Unfortunately, I suspect the current round of trade standoffs will not end with such amusement.

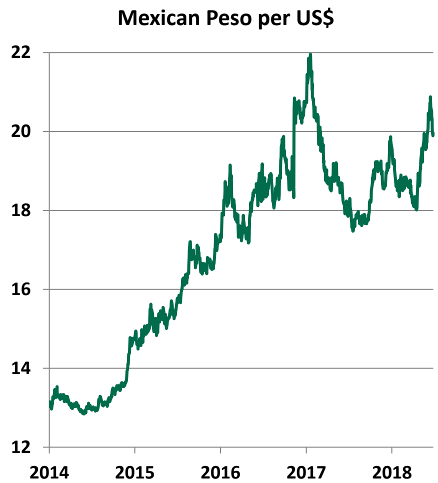
Una Elección Importante

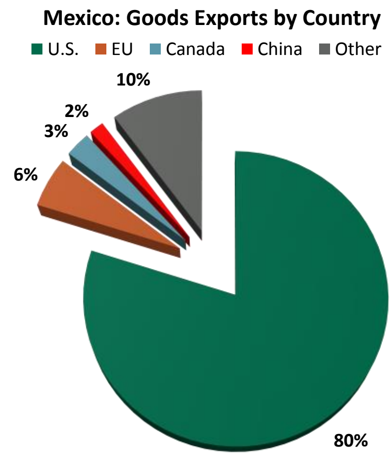
There is little doubt that the relationship between Mexico and the U.S. under President Trump has been a roller coaster. Uncertainty over the future of the North American Free Trade Agreement (NAFTA) hovers over Sunday's elections in Mexico, which will be watched closely.

If the opinion polls are to be believed, the leftist candidate Andrés Manuel López Obrador (AMLO) looks set for a comfortable victory in the race for the Mexican presidency. With voter support of 51% (as per the last Reforma newspaper poll ahead of the election), AMLO is well ahead of his challengers Ricardo Anaya (27%) and José Antonio Meade (19%).

Mexico's recent surge in violence and endemic corruption surrounding its entrenched political parties are the most prominent issues for voters. But the brewing trade war with the U.S. and a languishing currency (close to historic lows against the dollar) are also important factors. The Mexican peso is regarded as one of the most liquid currencies in the emerging market (EM) space, yet it is also among the most vulnerable during rapid shifts in market sentiment. Despite robust Mexican economic fundamentals, the peso has been hit particularly hard by the wider deterioration surrounding EMs, dropping 10% in just over two months.

In spite of good fundamentals, Mexico faces economic uncertainty.





Sources: Bloomberg, Oxford Economics

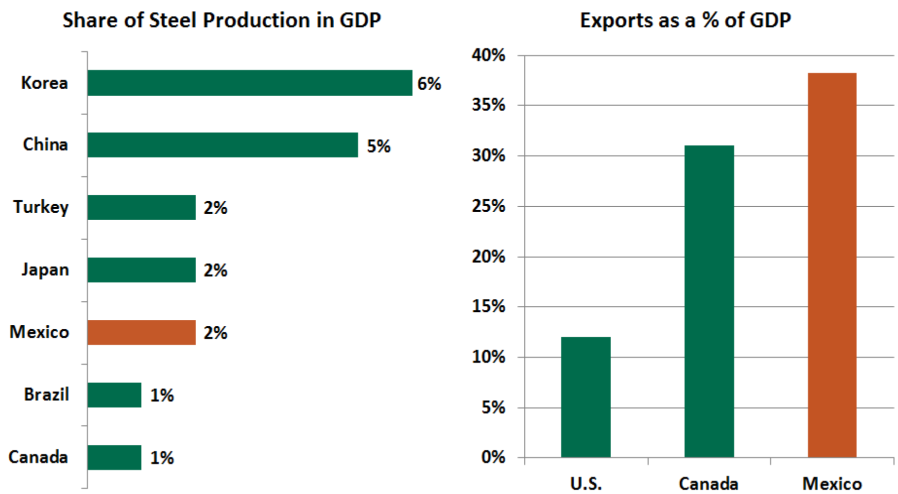
Mexico has a reasonable track record on the fiscal policy front, and a moderate current account deficit, largely financed by foreign direct investment flows. Those are strengths. However, the U.S. is Mexico's most important trading partner, accounting for 80% of exports and 50% of imports. That makes Mexico particularly vulnerable to any additional trade barriers in North America.

Mexican steel exporters are heavily exposed to the increase in U.S. steel tariffs, as 77% of Mexico's steel exports go to the U.S. However, steel production accounts for only 2% of Mexico's gross domestic product (GDP), and 83% of Mexican-made steel is consumed domestically. These factors should shield Mexico's broader economy from the brunt of the U.S. steel tariff.

However, any intensification of broader global trade tensions or a unilateral U.S. exit from NAFTA would put the peso under additional stress.

Mexico's imposition of "equivalent retaliation measures" on selected U.S. products (including laminated steel, lamps, pork, fruit and cheese) has only added to the anxieties. Mexico, the biggest beneficiary of NAFTA, will suffer the most in the case of U.S. withdrawal. Not long ago, Oxford Economics estimated that a U.S. exit from NAFTA would reduce Mexico's real growth by 0.9% in 2019 and would cost the Mexican economy around 4% of its GDP over the next five years.

Leading presidential candidates have treaded lightly on the subject of NAFTA.



Sources: Oxford Economics, OECD

American industries with globally integrated supply chains, particularly in the automotive and manufacturing sectors, would also suffer in the case of a withdrawal by the U.S. administration. Under those circumstances, U.S. firms would have to reassess their Mexican and Canadian operations.

Against this backdrop, AMLO's subdued reaction to the breakdown in NAFTA talks is certainly helping to de-escalate tensions. Mr. López recently urged the government to "respond firmly to the U.S., but at the same time, avoid falling into the trap of a trade war."

Mr. López is attempting to shake off his populist reputation and has made overtures to markets and investors. The independence of the central bank, often a key concern for investors in EMs, does not appear to be at risk. Carlos Manuel Urzúa Macías, AMLO's economic advisor, has given reassurances on maintaining a freely floating exchange rate and pursuing a "zero-deficit" budget.

Despite this being an election year, the current government has been pressing on with its fiscal austerity efforts and targeting a primary surplus of 0.8% of GDP this year. Speaking recently in Mexico City, AMLO promised cuts in government expenditures, including a reduction in the president's salary and selling the executive air fleet.

In Ruchir Sharma's book *The Rise and Fall of Nations*, Chilean president and billionaire Sebastián Piñera observed of "the long history of Latin America" that "when times are good, countries turn to the left, and when times are bad, they turn to the right."

Going by this narrative, one would suppose the Mexican economy is looking at good times, but the times may be changing.

The Sun Sets on LIBOR

The London Interbank Offered Rate (LIBOR) has been a part of the financial system for decades. Thousands of market participants rely on it, and the index is referenced in financial contracts worth trillions of dollars. Unfortunately, LIBOR is also fatally flawed and facing retirement.

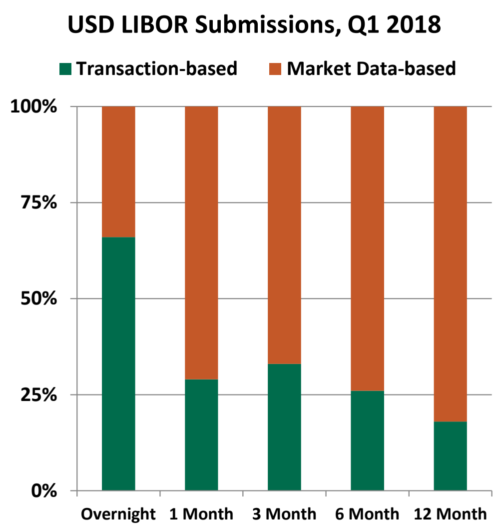
LIBOR is created through a daily data aggregation from select global banks. Historically, LIBOR submissions responded to the question: "At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size, just prior to 11am?"

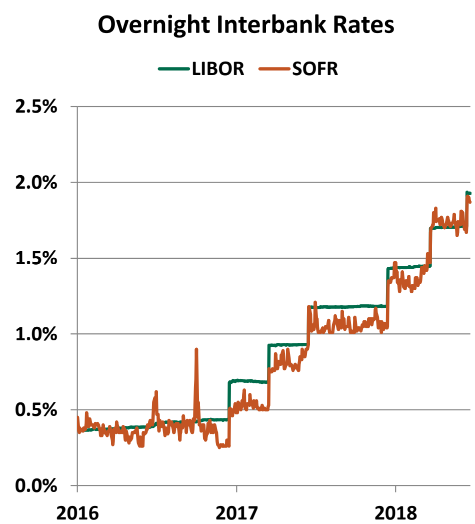
The problems with that approach were legion. First, the question was hypothetical: the contributing banks did not have to support their submissions with any real transactions. Second, the controls around the submissions were left to each bank, making them subject to manipulation. While high and low submissions were discarded to limit any one bank's ability to move the average, if a collection of banks inflated or deflated their rates, the average could move. Lastly, each bank's submission was visible to the market. Managers feared a high LIBOR submission would signal poor health, creating an incentive to state rates below actual borrowing costs.

Once discovered, LIBOR's faults proved irredeemable.

Starting with academic research and demonstrated in litigation, banks were found to have manipulated LIBOR during the 2008 financial crisis. Fines were paid to settle past misconduct. LIBOR moved to a new administrator, which worked with contributing banks to implement strict controls and derive rates from actual transactions. This effort uncovered a new wrinkle: banks are not conducting enough transactions in all of LIBOR's tenors and currencies to have a firm basis, and substantial subjectivity is required to this day.

As a result, market confidence in LIBOR has waned, and the rate will soon be replaced. But given LIBOR's many permutations and widespread adoption, this is no small task.





Sources: Intercontinental Exchange, New York Fed, Haver Analytics

LIBOR is published in five currencies: the U.S. dollar, the British pound, the euro, the Japanese yen and the Swiss franc. Each of these regions has assembled its own working group to determine a replacement benchmark. In the U.S., a consortium of banks and regulators known as the Alternative Reference Rates Committee (ARRC) convened in 2014. The group's key benchmark rate is the new Secured Overnight Financing Rate (SOFR). The SOFR is published daily, derived from actual transaction data provided by clearing agencies.

SOFR is not LIBOR. First, it is secured, based on banks' overnight repurchase agreement ("repo") borrowing costs, in which a seller agrees to sell a security and repurchase it from the borrower the next day. In contrast, LIBOR reflects the higher risk activity of unsecured borrowing, rendering LIBOR generally higher than SOFR.

Second, SOFR is an overnight rate. LIBOR, however, was published in tenors of up to 12 months. The ARRC does not plan to expand into a similar set of tenors. Rather, as adoption of SOFR grows, a market for longer-dated SOFR derivatives will form, using the overnight rate as a basis for pricing longer-term risks.

The LIBOR replacement committees for other currencies are following a similar approach. Overnight reference rates are agreed with the expectation that a swap market will grow to price longer tenors. Moving away from LIBOR will therefore require significant research and testing.

Migration away from LIBOR is not as simple as swapping one rate for another.

The publication of SOFR began in April of this year, with historical data made available as far back as August 2014. The historical view is useful but limited. SOFR has not yet been battle-tested by enduring an economic downturn, and underwriters may hesitate to use a rate for which behavior has only been demonstrated during benign economic circumstances. LIBOR, for its faults, has a nearly 50-year history.

The transitions, however, are mandatory. The U.K. Financial Conduct Authority has asked all contributing banks to continue submitting LIBOR postings through year-end 2021. After that date, it will not compel banks to submit the rates required to calculate LIBOR. It is prudent to assume the rate will be gone starting in 2022.

The clock is ticking for market participants to adopt new benchmarks. The greatest challenge is a legal one: Many borrowing agreements implicitly assumed LIBOR would always exist, and lack provisions to use any other benchmark rates. Identifying and modifying the language of existing LIBOR-dependent contracts will be a significant effort.

LIBOR appears fated to join trading pits, Christmas clubs and charge card imprinters in the history books of banking. Parties that rely on LIBOR have some work to do in the transition, but we expect the change to lead to an era of more reliable benchmark rates.

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