Manoj Pradhan Manoj@talkingheadsmacro.com
Patryk Drozdzik Patryk@talkingheadsmacro.com

Does President Trump Secretly Love Mexico More than America Inc.?

January 20, 2017

SPEED READ: US equities are priced for perfection, Mexico for destruction. The general consensus for the US is that capex will create jobs, infrastructure will generate productivity, and corporate profitability from capex will be protected by a combination of border taxes and corporate tax cuts. We struggle with this monochromatic view. The way we see it, only unconditional, profit-maximizing capex will raise productivity and profitability. Capex born out of rent-seeking will do the opposite. And infrastructure? That's a disaster-in-waiting. **If border taxes were to become the predominant strategy of the new administration (it probably won't, and we ourselves have flagged economic tailwinds), US equities would be a short.**

A broader question is: Why would you *want* to force manufacturing to return to America?

By contrast, the peso is down some 15% since Mr. Trump's win, acting as an automatic stabilizer, and Mexico has options to consider (export cars much like Germany does to Russia, offer a subsidy, route through Brazil). **The structural outlook for Mexico isn't bad either.** Border taxes will mean a painful adjustment that the markets are pricing in. However, the end result is less reliance on the US, a weaker currency, lower inflation and more rather than less manufacturing.

Market implications: Should border taxes become an important tool of the new administration, downgrade parts of the US stock market that have rallied on the border tax rationale. In Mexico, play for falling inflation and sell *peso* vol**.**

US – PRICED FOR PERFECTION

US equity markets will be shocked if some of Mr. Trump's policies turn out to have an adverse impact on the corporate sector. But why would this happen?

Why would the US corporate sector be adversely affected?

USD strength would resume - hurting corporate America. Onshoring by itself would still pull capital into the US or keep it from going outside. Mr. Trump's attempts to talk the dollar down stand at odds with the economic position of the US and his own policy intentions as well.

Cost hit, even if it is transferred to the fiscal balance. We're surprised to find ourselves in agreement with Mr. Summers for once (not on secular stagnation). He's quite right when he says Mexico is being handed an advantage. The other side of the coin is that the US corporate sector has seen an increase in costs - border taxes will make that permanent. Yes, corporate tax cuts can offset this, but it simply means the higher costs are simply transferred to the US Treasury.

Supply side disruption. Suppose border taxes are imposed tomorrow. Is the US manufacturing complex ready to step up and replace existing supply chains? Until that transition happens, either US manufacturing slows down and takes a substantial cost hit, or the fiscal side absorbs that cost hit.

Why would you *want* to force low-end manufacturing onto the US economy?
Very simply put, moving the US back towards a manufacturing economy would be a step backwards.

Low-end capex onshoring has already happened - endogenously. We have highlighted the endogenous recovery of the low end of US manufacturing for over five years now. Auto production, electrical machinery, metals - all very low-end activities from the point of view of the US that had already turned itself into a competitor for EM rather than the traditional consumer. This was the manufacturing that the US prematurely lost to China, and has since regained to a large extent.

Capex based on rent-seeking from border taxes will cause capital misallocation. Even unproductive and unprofitable capex would seem attractive when border taxes are in place - that's not what the corporate sector

needs. It is only capex that results from an unconditional profit-maximization decision that would unambiguously raise productivity along with profitability.

There is a trade-off between productivity and employment-generation. The kind of capex that the corporate sector would choose (with an eye on future demography and weaker prospects for immigration) would be capital-intensive to reduce reliance on labour as much as possible.

MEXICO – PRICED FOR DESTRUCTION

The *peso* is down a good 40% since late 2014 and has been a widow-maker for many an EM position. Such persistent underperformance and domestic concerns are also driving the pessimism surrounding Mexico. Had the US economy seen a manufacturing revival under normal circumstances, Mexico would have received a much-needed shot in the arm. Instead, most are seeing a divorce from its traditional partner as almost inevitable now. But is it?

Let's say a 35% border tax is imposed on autos coming from Mexico. Automotive exports are roughly a third of total exports to the US. The *peso* response to the border tax threat should amount to about a 10% depreciation (to balance off the 35% hit to 30% of exports). That will help the Mexico auto sector only partially, but provide a good lift for the remaining 70% of exports to the US. But what happens then? Keep in mind that the *peso* is already down more than 15% just since Mr. Trump's election.

What can Mexico do?

Besides the *peso's* automatic stabiliser effect, Mexico is not bereft of options. Here are just three to ponder:

- *Do what Germany does to get around Russia's border tax:* German auto manufacturers builds their cars as usual. Then they dis-assemble them completely, ship them to Russia and re-assemble them there. Believe it or not, assembling is a very small portion of the cost of manufacturing.
- *Provide a 20% subsidy and other incentives - what's to stop Mexico from doing a 'Trump' itself?* Perhaps the response would be a 60% border tax, but surely it gets ridiculous at some point
- *Take a stopover - ship them via Brazil:* Add some innocuous amount of value in Brazil and then ship them over to the US.

The structural end-game isn't bad at all for Mexico

Manufacturing will remain competitive for longer, attracting capex from other destinations at least: Regardless of what happens, many will be circumspect about using Mexico as a destination for exports to the US. But this will also keep wages under control, and Mexico can exploit its attractiveness as a manufacturing base thanks to the free trade agreements it has with more than 40 countries.

The macro balance is likely to be better too: The currency will show a one-time permanent drop, and real interest rates will move higher to keep inflation under control (with wages helping in that regard). The deficit could be under a bit of pressure if subsidies are handed out, but oil reforms should be in the money again, given commodity price dynamics.

Keep in mind, this isn't a binary event like Brexit or the US election - how high tariffs are set will matter

Mr. Trump (and Brexit for that matter) has shown scant regard for probabilities and what markets have conjectured. Though we started by asking what if a high border tax is introduced, it may not turn out to be that high. We are cautious though, knowing full well that nothing conservative will fit the agenda of someone who may want to leave a legacy of action without a thought of re-election.

In summary, investors are far too convinced that Mexico will bear all the pain and the US will reap all the benefits. That too when US markets are priced for perfection and Mexico for destruction.

We'd be much happier if his economic agenda was dominated by positive incentives for the US corporate sector via tax breaks, regulatory relief and administrative grease using the business-friendly team he has assembled.

On the other hand, if border taxes were the only story in play, the structural end-game would play out better in Mexico than in the US. It might even seem that Mr. Trump secretly loved Mexico more than America Inc. all along.

Disclosure:

This report is a piece of research ("Talking Heads Macro") provided by Talking Heads Macro Limited, a private limited company registered in England and Wales, company number 10314617 ("Talking Heads Macro Limited").

Talking Heads Macro research is provided only to investment professionals. Each piece of Talking Heads Macro research is intended for the use of the person to whom it is addressed (the "Addressee") and the colleagues affiliated. If you are not the Addressee or an Additional Addressee, please delete this piece of Talking Heads Macro research and destroy any copies. Please also email or telephone Manoj Pradhan at Talking Heads Macro Limited +44 7596 212 710 or manoj@talkingheadsmacro.com so that Talking Heads Macro Limited can take steps to see that you do not receive further Talking Heads Macro research.

Talking Heads Macro research is not an offer to buy or sell any specific investment. Talking Heads Macro research is and is intended to be a general market view. It is not and is not intended to be general or specific investment advice nor a personal recommendation concerning a specific investment, investment product or investment service. Talking Heads Macro Limited expects that all investment decisions taken by Addressees or Additional Addressees will be decisions made by the Addressee or Additional Addressee based on specific advice or specific recommendations made by an investment adviser or taken by an investment manager. Since Talking Heads Macro Limited does not provide investment advice nor carry on any other investment business it is not regulated by the U.K Financial Conduct Authority nor by any other regulator of investment business.

Research by Talking Heads Macro Limited is based on publicly available information, obtained from sources that Talking Heads Macro Limited considers to be reliable. However, Talking Heads Macro Limited does not represent that it is accurate and it should not be relied on as such. The opinions and conclusions expressed in any piece of Talking Heads Macro research are current as of the date of publication and Talking Heads Macro Limited does not accept any responsibility to update any such opinions or conclusions in the light of developing events or circumstances. All forward looking statements, even if they appear to be presented as fact, must be treated as opinions or judgements, and Talking Heads Macro Limited accepts no liability or responsibility if any opinion or judgement proves to be inaccurate in whole or in part. Without limitation of the foregoing, Talking Heads Macro Limited shall not be not liable for any loss or damage of any kind resulting in any way from or alleged to result in any way from Talking Heads Macro research or the use of Talking Heads Macro research by any Addressee or Additional Addressee or by any other person.