Bright spots in North American trade opportunities

BMO recently sat with a group of cross-border experts to discuss the state of play for businesses regarding the economy, trade, tariffs, and even an evolving cannabis landscape. Although the topics covered were broad, one theme was consistent—the opportunity for North American trade is a bright spot in today's global climate.

Michael Gregory, BMO Capital Markets Deputy Chief Economist, noted economic growth has slowed in the U.S. from about 3.5% a year ago—fueled in part by tax cuts that have worked their way through the system—to about 2% today. "Business cycles don't die of old age, but they do show their signs of old age," Gregory said.

After the longest business expansion in U.S. history, those symptoms have included capacity pressures and labor shortages, the latter of which Gregory cited as "the No. 1 reason we hear why businesses can't grow as much as they'd like to."

Gregory also cited the ongoing trade war with China and trade tensions with Europe as critical areas of focus for businesses, with the potential to knock a half a percentage point off of future GDP growth despite increased government spending and a lift in the debt ceiling. "It's all about trade," Gregory observed.

A Closer Look at the USMCA

Enabled by the North American Free Trade Agreement currently in effect, the U.S. enjoys $1.4 trillion in annual two-way trade between both Canada and Mexico—trade with Canada alone accounts for more than half that amount ($721 billion), with about $2 billion of goods and services crossing the U.S.-Canada border every day.[1]

The recently negotiated successor to NAFTA, the USMCA, was signed by the three nations' leaders in November 2018. It does not become law, however, until it is ratified by each country's government. Mexico ratified it in June, but the U.S. and Canada have yet to follow suit.

Given the recent commencement of the Canadian election process, all pending legislation is terminated and will need to be reconstituted by parliament following the election in October. This doesn't mean the USMCA won't ultimately be ratified in Canada, but it will have to be done through a bill reintroduced in the next parliament, according to Joe Comartin, a former Member of Parliament and now the Consul General of Canada in Ohio, Michigan, Indiana and Kentucky.

As for the U.S., the political obstacles facing the legislation are no surprise. The Democrat-controlled House of Representatives has voiced four areas of concern—labor provisions, environmental protections, pharmaceutical interests and enforcement mechanisms—and their mark on the deal is widely considered necessary for the deal to be ratified. "The USMCA in Congress now will not be emerging as law," said Dan Ujczo, International and Regional Practices Group Chair with law firm Dickinson Wright.

Despite the USMCA being caught in political limbo, Gregory sounded an optimistic note. "Whether it's NAFTA or the USMCA, we do have some sense of trade certainty and tariff-free access to Canadian and Mexican markets, and that's massive."

Cannabis and Canada

The legal cannabis industry in North America is another dynamic cross-border topic. That's why Abigail Picotte, Legal Director with Hawthorne Gardening Company, a subsidiary of Scotts Miracle-Gro Company, and her team are closely following the evolving cannabis landscape. "When people are trying to grow things, Scotts Miracle-Gro is interested," Picotte remarked, addressing the company's entry into the segment and subsequent growth into the largest hydroponic distributor in North America via Hawthorne.

Participating in the industry, of course, raises the issue of operating within myriad and oft-changing regulations, particularly in the U.S. Given the mismatch of state and federal law—that is, despite legalization of either medical or recreational use in a growing roster of states, cannabis is still illegal under U.S. federal law—Picotte

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noted companies participating in the industry must balance legal considerations and the growth and success of their businesses. To that end, Hawthorne does not sell directly to any growers in the U.S. Company representatives are constantly aware of whom they are talking to, and they're cognizant of staying away from anyone not in compliance with both federal and state laws. Even "states [with some form of legalization] are still trying to figure out how to implement their regulations, and that unfortunately leaves a big market open for illegal operations, so we really err on the conservative side," Picotte said.

As Hawthorne cautiously expands in the U.S., it is, importantly, also expanding in Canada. Upon its formation, the business immediately looked up north, which even prior to the 2018 nationwide legalization of cannabis had legalized medical marijuana and licensed growers across the country.

"We can more freely have these conversations in Canada—conversations we've been having with growers for 150 years about how our products can help them grow their best product," Picotte said. In Canada, Hawthorne has enabled a sales force to work directly with growers and even partnered with pioneering Canadian cultivator, Flowr on a first-of-its-kind R&D facility in British Columbia.

"It's another opportunity Canada presents that we don't yet have in the U.S.," Picotte said. "That is, being able to conduct research and development of our products on the actual plant. It's a testing ground and it is also in its own right a really huge opportunity for us."

Canadian Trade Opportunities

Noting the opportunities that Canada presents for all businesses operating internationally, Comartin discussed the free trade agreements the country participates in. "We now have available to us, which the U.S. does not, access to 1.5 billion new consumers, via favorable trade agreements both in Europe [CETA] and in Asia [CPTPP]," he said. "We're talking 51 countries with which we have favorable trading arrangements with, including the U.S. and Mexico."

Comartin added that accounting firms and companies have expressed interest in using Canada as a gateway to gain free trade access to the European and Asian markets; with that being said, he emphasized the importance of product being sufficiently modified in Canada to meet valued-added thresholds and to satisfy trade and country of origin regulations.

Also, while Canada is going through a difficult period in its relationship with China, affecting some sectors of the bilateral trade, Comartin noted that most Canadian businesses continue to engage positively with Chinese business partners. "This is encouraging, and shows that Canada is committed to growing the economy and enhancing trade" added Comartin.

Canada's skilled workforce and immigration policies also create opportunities to meet labor demands. Many U.S. companies, particularly in technology, are expanding operations into Canada. Toronto is the #1 "brain gain" market for tech job growth, outpacing even the Bay Area, Seattle, Washington D.C., and New York City.[2] No wonder Ujczo, congenially dubbed by Gregory as the most-quoted lawyer on trade and the USMCA, said he's "very bullish on Canada."

A New Trade World

The evolution of the U.S. trade story in recent years—from uncertainty around NAFTA to the trade war with China—continues to impact North American businesses. Following Lists 1, 2, and 3 of tariffs affecting $250 billion of imports, the latest tariff escalation will affect the remaining $300 billion of goods imported from China. Virtually all trade with China is expected to be impacted by tariffs of either 15% or 30%.

Ujczo summarized his corporate clients' reactions over the past 18 months as falling within three groups:

- 20% of clients took no action in 2018—those are the clients keeping his team really busy.
- Another 20% began taking action to transform their supply chains—moving out of China into Vietnam, Thailand, Malaysia and Mexico, which has been a significant knock-on beneficiary of the China-U.S. trade war.
- The remaining 60% bought in bulk in advance of the tariffs coming into effect, making huge purchases in summer 2018 and carrying elevated inventories through Q1 of 2019.

Where is the 60% contingent now that the tariffs are still in effect and, as Ujczo contemplates, may to a large extent remain indefinitely? According to Ujczo, inventories have run out and companies are getting big bills from customs brokers. "We still haven't seen the full impact of the tariffs from last summer, and even if we get a deal there's going to be transformation," he said.

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Companies are now faced with choosing another course of action: pass the costs on to their customers, file for tariff exclusions or transform their supply chains. Although the China tariff exclusion process is working well, it's not a long-term solution. Ujczo noted that based on his view of the U.S. investigation into China's trade practices and subsequent negotiations, many List 1 and 2 items include sophisticated technologies and components the U.S. government largely doesn't want domestic companies importing from China anymore.

Ujczo also cautioned against oversimplifying the decision to move from China to Vietnam or other countries. Doing so, he said, is a significant effort still complicated by limitations in infrastructure and labor. He's also working with his clients on making product here in North America effectively and competitively, and using the Canadian platform and trade agreements to get it out to global markets.

Despite the various headwinds, Ujczo believes the outlook for North American trade is bright. "We will be in a transformed global economy within months, if we're not there already, and it's going to stay that way for the foreseeable future," Ujczo noted. "The light at the end of the tunnel is that North America is a safe harbor for global trade and the safest place to do business. The advantage is here."

To see more insights for U.S. companies that want to expand into Canada or grow their operations North of the border, visit bmo.com/XBorder.

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[1] U.S. Census Bureau

[2] CBRE Research