Major Country Developments
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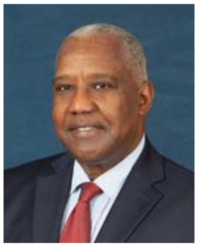

By Byron Shoulton

Overview

Global economic growth has been surprisingly upbeat of late. A broad uplift in activity had become a rare sight in the post-financial crisis world. But over the past year the global economy appears to have picked up steam. Indices for both developed and emerging-market countries have risen together into positive territory. A global manufacturing purchasing managers' index (PMI) for January came in at 52.7, pointing to continued expansion and matching December's 34-month high. The Institute for Supply Management reported U.S. factory activity accelerated in January to its fastest pace in more than two years. This picture could yet be disrupted. Political risk is on everyone's watch-list, as the new U.S. administration gets going and Europe eyes a heavy election calendar. Globalization is under scrutiny, and protectionism is a growing concern. Even stronger U.S. growth wouldn't necessarily be an unconditional good news story: by pushing up the dollar and U.S. interest rates, it could create renewed negatives for emerging markets. Markets have swung from deflation fears to embracing reflation, which started before the U.S. November 2016 presidential election. But they are now pumped up both by the legacy of many years of ultra loose monetary policy and hope for future growth. That is as much a cause for caution as celebration.

USA

U.S. President Donald Trump wasted no time (once he was sworn in) pursuing many of the main goals he campaigned on: fair trade, jobs, immigration reform, cutting business taxes and deregulation of financial services. The Trump administration within its first weeks in office set in motion policies to renegotiate the North American Free Trade Agreement (NAFTA), signed executive orders to withdraw from the Trans-Pacific Partnership (TPP) and to build a wall along the U.S. border with Mexico, halted the access to the U.S. for certain refugees, and warned that certain imports will likely face high tariffs going forward (as an incentive for companies to bring overseas production back to the U.S.). The new Administration also encouraged an early bilateral trade agreement with the UK as that country exits the European Union. Meanwhile, the U.S. warned China that it will move forcefully to curtail Chinese exports at below cost to the U.S., and signaled close monitoring of artificially low exchange rates which the Administration deems as disadvantageous to U.S. exports (specifically the Chinese RMB and the euro).

The Trump Administration blamed Germany's large trade surplus with the U.S. on the low euro exchange rate against the dollar and insists that Germany is deliberately keeping the euro exchange rate low to benefit its export oriented economy. The German finance minister has responded by blaming the European Central Bank (ECB) for setting monetary policy for the euro-zone, which he says is too loose for Germany and that the euro exchange rate is too low for the German economy's competitive position. Thus, he acknowledged that Germany's export surplus is a problem but one that has its origin in the ECB's expansive monetary policy.

The strident protectionist and anti-globalization posture taken by the new administration marks a dramatic departure for the U.S. from its approach toward cross border trade since World War II. The aggressive shift away from peaceful engagement with the rest of the world will force U.S. trading partners around the world as well as U.S. companies and financial institutions engaged in international trade, to reassess the impact on their businesses of the new rules that will govern U.S. trade relationships during the Trump presidency.

Business leaders, particularly those at companies that have benefited from globalization in the markets for goods, services, capital and people, are urgently debating how to respond to the protectionist bent of the new Administration. Their counterparts in Europe and Asia equally will be trying to seek ways to engage and find common ground with the Administration. Companies can either seek to evade the protectionist wrath by making production decisions based on the demands of the Administration. Or they can stand up for their right to make business decisions that are best for their customers, their staff and their stakeholders. Their combined responses will partly decide the future of globalization. The dominant position of multinationals in the world economy had started to look shaky even before President Trump took office.

The globalization push of the 1990's and 2000's, which saw supply chains snaking around the world and multinationals exercising labor cost decisions by placing production in China, Mexico, etc., appeared to be running out of momentum prior to the U.S. election. One example was plant closings in China, being relocated to Southeast Asia (because of rising labor costs in China). Or anecdotal cases of select companies moving some overseas production back to the U.S. due to technology advancements, tax incentives etc. There is nothing unhealthy about that: rather than reflecting 1930's-style protectionism, those examples simply involved business decisions based on wages, technology and productivity. They were not decisions taken in response to the policy dictates of any government.

Political opposition to multinationals were aroused and gained momentum in recent years because the off-shoring of production was blamed for the weakness in manufacturing job creation in advanced countries. Aggressive tax planning by multinationals, shifting headquarters overseas or creating complex legal structures to be able to declare earnings in

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low-tax jurisdictions aroused public anger and fed into an anti-corporate populism that became a powerful force which propelled President Trump's election. The best outcome for the global economy is for companies and consumers to make the case for why protectionism is ultimately a negative force that will significantly raise the prices we pay for goods and services. Those that have benefited from free trade and free markets must clearly articulate to the public and the Administration those advantages versus the disadvantages of protectionism. Failure to effectively make that case could lead to the beginning of vicious trade wars.

Euro-zone

The euro-zone PMI hit a 69 month high in January. A stream of recent positive economic data which exceeded expectations, have highlighted the strength of the euro-zone economy despite criticisms of the single currency block emanating from the new U.S. president and populous movements across the region. Figures for business sentiment, growth rates and unemployment for the euro area have all provided surprises during the start of the year, as business confidence proves resilient despite Britain's vote to leave the EU.

The euro-zone economy has posted 14 consecutive quarters of growth, unemployment has returned to single digits, and economic sentiment reached its highest level in six years. These numbers contrast with common depictions of the eurozone economy as stagnant and perennially underperforming. In January, job creation accelerated to near a nine-year record, while output growth maintained a 5 and 1/2 year high. The PMI Composite Output index-which measures purchasing managers' confidence - was firmly in positive territory at 54.4, registering the 43rd consecutive month of expansion.

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Despite continued deep concerns about the health of Italian banks and Greece's long-running financial crisis, euro-zone growth in the fourth quarter of 2016 was estimated at 0.5%. For 2016 as a whole, euro-zone growth was 1.7%. This compares with a 2016 growth rate of 1.6% in the U.S. The reason for the better than expected economic performance is that the financial crisis is now almost a decade old and there is plenty of slack in the labor force to absorb new workers without putting upward pressure on wages. It appears that so far, the UK's vote to leave the EU has not proved the shock that most feared. Furthermore, the European Central Bank's ultra-loose monetary policy appears to be finally working, encouraging households and companies to borrow and spend. Domestic demand has fuelled most of the recent growth.

The Trump Administration accused Germany of continuing to exploit other EU countries, but growth rates have improved across the euro-zone, with the important exception of Italy. Spain's GDP grew by 3.2% in 2016. In France growth advanced quickly during the 3rd and 4th quarters of 2016 from a contraction during the second quarter. Some analysts observe that Europe has been a victim of a pessimistic narrative about its performance relative to the U.S. without much recent substantial evidence. Over the past decade GDP growth per capita in the euro-zone averaged 1.9% a year compared to 2.4% in the U.S. Nevertheless, with fragmental financial markets and big problems remaining in some peripheral EU countries, such as Italy's and Portugal's weak banking sectors and high public debt, there are reasons to doubt whether Europe's recent improvements are sustainable. Research has shown that growth in credit has partly fuelled the surprising recent improvement – and since the credit growth began slowly towards the end of last year, it remains uncertain if the euro-zone's latest mini-upswing will withstand global negative trends including Brexit and growing U.S. protectionism.

Euro-zone officials are equally cautious, not wanting to highlight the improved prospects out of fear this will increase pressure, particularly on Germany, for tighter monetary policy. In addition, the current environment still falls short of a sustained adjustment in inflation closer to the 2% target over the medium term. The likely consequence of the ECB continuing to allow momentum to build in the economy, to boost inflation and reduce unemployment, is that it will also slowly raise interest rates. The ECB is keen to keep the eurozone economy humming and is mindful but circumspect about its recent surprisingly strong performance.

Meanwhile, the head of the European Council has ranked the arrival of the Trump administration alongside China's assertiveness and Russian aggression as some of the biggest global forces making Europe's future highly unpredictable.

China

Defaults have been rising in China as the government tries to restructure ailing state-owned enterprises (SOE's). According to new data, a flurry of defaults in just the last three months brought the accumulated non-performing loans to $8 billion. That's three times higher than at the end of last year. State-owned enterprises, once considered immune from defaults, accounted for a half of the total.

As part of its push to open its markets to international capital, China is keen to stimulate overseas interest in its debt market. While being the third-largest domestic bond market in the world (and growing rapidly), China's fixed income market totaling nearly $10 trillion is still less than a third of the U.S. market value. In an effort to grow, regulations regarding foreign investor access have been loosened. Last year the interbank bond market, which accounts for the majority of bond trading in China, was opened to qualified foreigners. Efforts to stimulate foreign appetite have so far been only partly successful. Overseas investor buying increased as the market rallied in 2016. Still, foreigners hold just 2% of the total debt. Disincentives abound. Credit risk and the absence of a transparent process to handle defaults is a deterrent. Poor quality issuer information and questionable local ratings (nearly all issuers are rated A+ or above) do not help. In addition, a period of renminbi depreciation hardly makes RMB assets attractive.

According to Fitch Rating defaults have added to recent disruption in the asset class. Tightening liquidity and the expectation of rising U.S. yields have led to a market sell-off; onshore corporate bond issuance fell one-third versus the previous year for the month of December as 82 deals were cancelled or delayed. In the long run, however, it notes that better capital allocation in China will help bring clearer rewards.

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Meanwhile, the Trump Administration appointed a number of key economic and trade advisers who hold China responsible for many of the U.S.'s economic woes. There is a real risk that the U.S. will impose high tariffs on Chinese imports as a first step. In addition, it appears likely that a series of anti-dumping and anti-subsidy cases will be brought against China, making it difficult for Chinese firms to export to the U.S. the way they have over the past three decades. Tensions between the two trading partners have escalated to a new high in a relatively short period. These are unlikely to deescalate soon.

Themes that are commonly held by the new U.S. policy team include the claim that China uses subsidies to support its state-owned companies. This is true. The U.S. believes that China's economic rise has cost it an enormous number of jobs, an assessment that has some support, although the effect is hard to separate from the wider trends of automation in manufacturing and the globalization of manufacturing supply chains. The Chinese opponents in the new Administration espouse the view that China has benefited from lower barriers to trade around the world without giving reciprocal access to foreigners wishing to enter its own domestic market. They also believe that Chinese companies have engaged in widespread theft of intellectual property, often with a degree of official state support. While these views emphasize the negative aspects of China's role in the global economy, they downplay the significant benefits of cheap Chinese products to U.S. consumers and the profits that American firms have been able to deliver to their shareholders as a result of globalization. Such negative views have been held by many, including the previous Obama administration.

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Elsewhere in the new Administration China is a target for a far more interventionist foreign policy. The notion that China poses a threat to U.S. interests in the South China Sea means that China will face increasing pressure in that arena. The long-held view in China that Taiwan is not an independent country (but a rebellious extension of the Chinese mainland), which has been tolerated, has now been thrown into contention as President Trump may not support the concept. Much to the chagrin of the Chinese government the new U.S. Administration appears inclined to use the Taiwan question as a bargaining chip. This could mean that in exchange for concessions from China [including a stronger currency or greater access to its market for U.S. companies], the U.S. would be willing to grant the People's Republic leverage over Taiwan or choose to adhere to the one-China policy.

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On the economic front, the new U.S. Administration has already abandoned the Trans-Pacific Partnership, which the previous administration saw as a cornerstone of economic efforts to strengthen regional alliances against growing Chinese influence. The Trump Administration may yet brand China a currency manipulator, despite abundant evidence that it is intervening to prevent the renminbi depreciation rather than to keep the currency undervalued. Much more worrying for China is the prospect that the U.S. could adopt a Border-Adjustment Tax, which forms part of the tax reform plan under consideration. This would have a significant impact on all companies that export to the U.S. While several large U.S. multinationals are frantically lobbying against the measure, its potential impact is such that firms and governments will need to keep a close eye on its progress.

Mexico

Mexico's public debt stock rose considerably in 2016, mostly as a result of peso weakening, which raised the local-currency value of its external debt. At over 50% of GDP (and excluding other liabilities such as state and local debt), Mexico debt is now at the highest level in decades. This adds an element of risk to the credibility of the government's economic management in what is set to be a particularly difficult year. The government exceeded its fiscal targets in 2016, but meeting its 2017 objectives will be harder as GDP growth is likely to be well below estimates of 2-3% set before the U.S. presidential election. Independent forecasts have downgraded 2017 growth estimates to 1.8%. This will require additional belt tightening to meet the current fiscal deficit target of 2.4% of GDP. As further weakening of the peso is set to continue, two of the three major credit rating agencies have placed Mexico on negative watch. With the combination of weaker GDP growth in 2017 and the expected negative impact of the Trump administration on Mexico's medium-term outlook, the country is well placed for a credit downgrade in the not too distant future.

Mexico has been on the hot seat since President Trump assumed office. The U.S. trading relationship with Mexico was a persistent target for the Trump campaign, which blamed Mexico's cheaper costs of labor and production for the loss of U.S. jobs. The Mexican economy will suffer if threats to impose high tariffs on Mexican exports to the U.S. are implemented. The warnings from the Administration to U.S. companies to bring back manufacturing now being done in Mexico would put thousands of Mexican jobs in jeopardy. In addition, the focus on illegal Mexican immigration and the decision to go ahead with the building of a wall to keep out illegal immigrants has soured the relationship between both countries to its lowest levels in decades.

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The already weak Mexican government is not in a position to retaliate effectively against the U.S. Some 80% of all Mexican exports are to the U.S. The U.S. can deal Mexico a body blow by ripping up NAFTA. President Trump has made it clear the agreement will have to be renegotiated as he regards the existing deal as one-sided. The President could choose to take the U.S. out of the agreement completely. However he would need a congressional vote, merely to give the other NAFTA partners six months' notice. The President has the authority and the power to impose fresh tariffs or quotas and does not need the backing of the U.S. Congress. However, this would almost certainly lead to legal proceedings against the U.S. through either the World Trade Organization or the U.S. courts. The more appealing option would be to renegotiate NAFTA on terms that all three countries (U.S., Canada and Mexico) agree to.

Revisiting NAFTA has potential benefits. The agreement is 23 years old and could be updated to include protections on labor standards and the environment, and to reduce red tape for workers in new industries like the digital economy. There are clauses that Canada would like to overturn, such as a mandate to sell a certain volume of oil to the U.S. Mexico could also seek greater protections for small agricultural producers and limited forms of nascent-industry protection, and also push for migrant rights. However, the U.S. will want to focus on local-content rules, with tariffs as a fallback.

Both the U.S. and Mexico have an interest in maintaining current cooperation between their respective security forces. This is especially relevant to drug trafficking and gang warfare. Mexican federal police exchange information with the U.S. Drug Enforcement Administration and the Bureau of Alcohol, Tobacco, Firearms and Explosives. This often leads to the capture of drug kingpins in Mexico. A Mexican law enacted last year allows armed American border patrol officers to inspect trucks on the southern side of the border. U.S. and Mexican intelligence agencies jointly monitor terrorist threats. It is not in the best interest of the U.S. to walk away from these accommodations.

Furthermore, under the so-called Merida Initiative, the U.S. provides Mexico with $139 million each year to fight gangs, strengthen the rule of law and improve border security. The money goes in part toward reforming the Mexican court system and to the provision of more than 400 drug-hunting sniffer dogs.

Left-wing political parties, particularly Morena [which is led by Andres Lopez Obrador] are the main beneficiaries of the current upheavals and uncertainty in Mexico. Mr. Obrador looks far more likely to benefit from the chaos resulting from the Trump victory. Obrador has demanded that the sitting government take a defiant stance against President Trump, which has earned him loud applause from potential voters. He has rallied in defense of NAFTA now that it's under threat. Ironically, the Mexican left were typically vocal opponents of free trade in the past.

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FCIA's Deals Of the Month

Bank's A/R Purchase Policy: Mid-eight figure policy limit of liability supporting the purchase of accounts receivable for buyers in industrial/construction equipment sector; U.S.

Political Risk Policy: $25,000,000 limit of liability in investment insurance coverage for Confiscation, Expropriation and Nationalization perils in the chemicals sector; Worldwide

What is Trade Credit Insurance?

If you are a company selling products or services on credit terms, or a financial institution financing those sales, you are providing trade credit. When you provide trade credit, non-payment by your buyer or borrower is always a possibility. FCIA's Trade Credit Insurance products protect you against loss resulting from that non-payment.