The Auto Sector Rallied Strongly on the Announcement of Yesterday's U.S.-Mexico Trade Deal, But I'm Cautious: Here's Why

Description

It was a good day for stocks tied to the auto sector on Monday, as the bulls rallied on the back of what appears to be a tentative trade deal reached between the U.S. and Mexico.

While the details of a deal have yet to be formally announced, U.S. president Donald Trump reported on Monday that the two countries had reached an understanding on an agreement that would most likely replace the current North American Free Trade Agreement.

Following the news, auto stocks were green across the board, including sizable gains in key names like **Magna International** (TSX:MG)(NYSE:MGA), up 4.24%, **BorgWarner Inc.**, up 3.38%, **Linamar Corporation**, up 6.57%, and **Martinrea International**, up 6.18% on Monday.

It's reasonable to understand the bull's reaction on Monday, as a tentative deal between the U.S. and Mexico should, at some level, be expected to ease any fears about a possible worst-case scenario that could have prevented any type of sensible trade deal from being reached between the United States and its two closest trading partners, Mexico and Canada.

But while Monday's announcement might have done enough to release a little steam out of what has been, for the most part, a tense season of trade negotiations, I'm remaining cautious on the sector for now.

Why's that?

Granted, stocks of companies like BorgWarner are trading at valuations that would, in most cases, make them seem like attractive investments, but I tend to think this time it may be a little different.

For one, the main narrative playing out in the mainstream media surrounding the current round of U.S. trade negotiations is that Trump and his administration are convincingly intent on delivering on their campaign promise to bring manufacturing jobs back to the United States.

There's no question that bringing those jobs back to the U.S. would be a welcome change for the millions of American workers who have found themselves victims of the choices made by large corporations that have opted to outsource their labour in recent years.

However, the fact remains that the wages of those working at automotive assembly plants in the United States are considerably higher than those of the Mexican wages that they would purportedly be supplanting, and, simply speaking, someone is going to have to foot that bill.

One could make the argument that the impending tariffs that Trump and the U.S. administration are proposing on certain Canadian and Mexican imports could help to offset the higher costs, but at theend of the day, those tariffs too, without question, will come at their own cost as well.

Someone is going to get squeezed here — at least, that's how it looks to me at this point.

It could turn out that it's Canada that ends up paying the price — by way of lost jobs in the auto sector — which, mind you, could also have severe knock-on effects for other parts of the economy.

Or, it could be that smaller manufacturers, like the Martinreas of the world, are forced to pony up to larger OEMs, like **Ford** and **General Motors**, the next time their respective supply agreements are due for renewal.

Bottom line

If more manufacturing jobs are imported to the United States, it's difficult to envision a scenario where this wouldn't result in higher costs across the entire auto industry — an outcome which would not only threaten to shrink the bottom line of manufacturers, but also likely lead to a higher overall cost borne by the consumer.

And that shouldn't come as welcome news for anybody.

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