

THE REAL ECONOMY

VOLUME 44



TARIFFS:
ASSESSING THE
ECONOMIC IMPACT

FEDERAL RESERVE'S BEIGE BOOK
SHOWS TARIFFS BEGIN TO BITE

TARIFF IMPACT BY INDUSTRY



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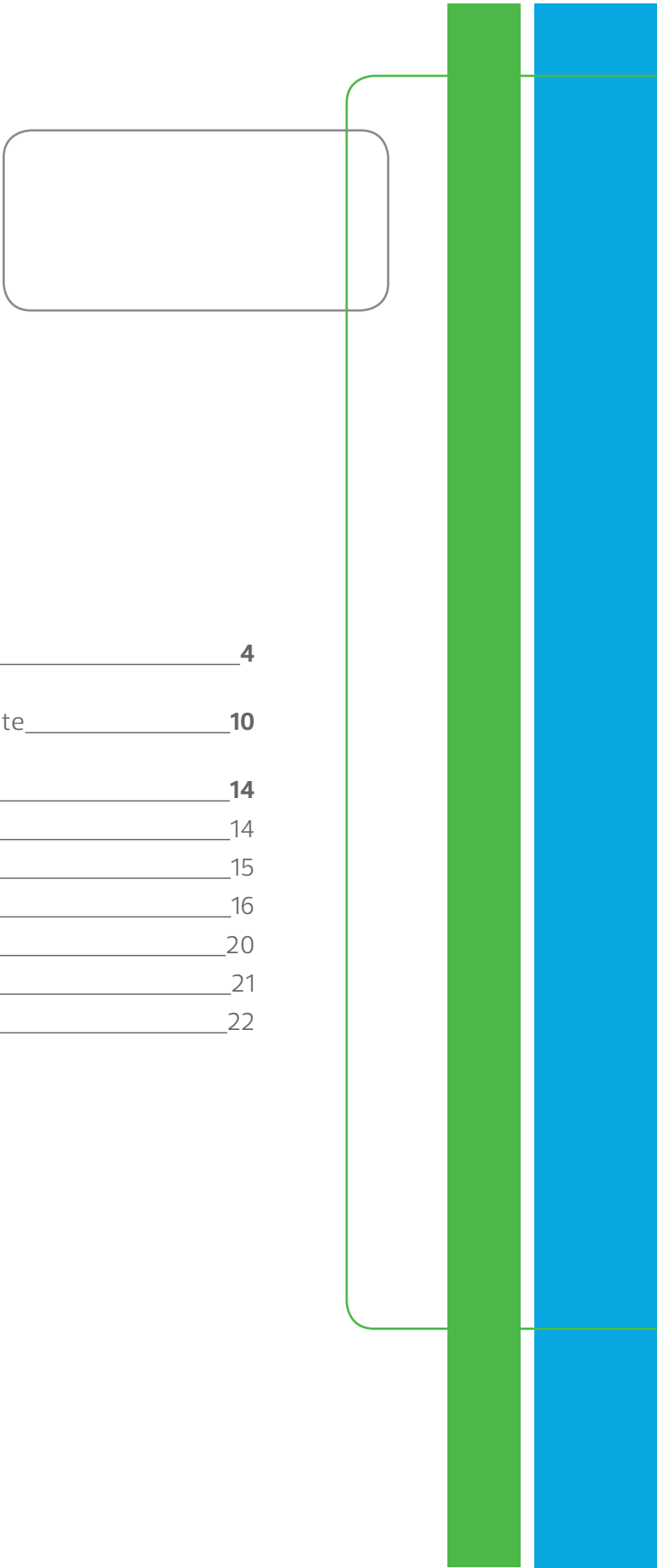


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TARIFFS: ASSESSING THE ECONOMIC IMPACT

MIDDLE MARKET TO BEAR DISPROPORTIONATE BURDEN OF ADJUSTMENT

By Joseph Brusuelas
Chief Economist, RSM US LLP

As the United States inches perilously closer to a three-front trade war with its NAFTA trading partners, the EU and U.K., China, Japan and most of the economies situated along the Asian supply chain, the initial costs of the first few rounds of the prolonged trade spat are coming into view. Those costs will be concentrated in a number of critical industrial ecosystems. If the tariff policy is fully implemented, the costs will likely exceed \$1.3 trillion with risk of a much greater hit to the U.S. economy than many are currently anticipating, and a premature end to the business cycle.

To date, the Trump administration has imposed roughly \$105 billion of import taxes across the three large trade blocs and supply chains. Since retaliation in the early portion of the trade spat has been tit-for-tat, the additional \$105 billion in global retaliation brings the early total hit on the U.S. economy to \$210 billion.

So far these estimates have yet to show up in the hard economic data and have appeared only as anecdotal evidence in industry sentiment surveys and soft data. Even so, the impact of trade policy will begin to appear in the September and October U.S. economic data, especially in manufacturing, durable goods and retail, as well as in the third-quarter gross domestic product (GDP) report to be published on Oct. 26—just days before the U.S. congressional election.

If the administration follows through on all currently available tariff lines for import duties, the hit to the U.S. economy would be closer to \$655 billion. Assuming continued in-kind retaliation, this would bring the total estimated impact to the economy to \$1.31 trillion, excluding the possible effect of currency fluctuations and competitive currency devaluations. Our base case presented last year indicated that setting tariffs on all available imports is the demarcation point when a trade spat becomes a full-blown trade war.

Large, active multinational businesses are better prepared to endure the first few rounds of a trade spat than middle market companies. They typically have government affairs, customs and trade employees on their payrolls.



MIDDLE MARKET INSIGHT:

If a negotiated trade settlement isn't reached soon, middle market businesses should begin to prepare for a price shock, driven by large businesses passing their rising input costs downstream. As the tariffs on imported goods begin to bite, the middle market will bear a disproportionate burden of adjustment.

On the brink of a trade war

If a full-blown trade war breaks out, the hit to the U.S. economy will be large and difficult to quantify, given uncertainty over how financial markets would react to the use of financial weapons and competitive currency devaluations. Recent depreciation in the value of the Chinese yuan, either due to the inability or unwillingness of the Chinese government to support the value of its currency, implies we may be closer to a trade war than is commonly acknowledged by the government, the corporate sector or investors.

In our core scenario—a limited trade spat that ends before a spillover into the financial sector—the costs to the United States are limited to near 0.4 percent of GDP between now and 2020. If the alternative scenario unfolds, involving an intensification of the trade spat and what in the 1930s were deemed *beggar thy neighbor* currency devaluations, the hit to the domestic U.S. economy would be closer to 1.8 percent of GDP with some risk of an even larger drag, and a possible premature end to the positive U.S. business cycle.

This forecast is based on our research that indicates an optimal tariff regime (the level of tariffs that maximize an economy's welfare) is near 70 percent for the tradeable sector if a trade war occurs. While that percentage will

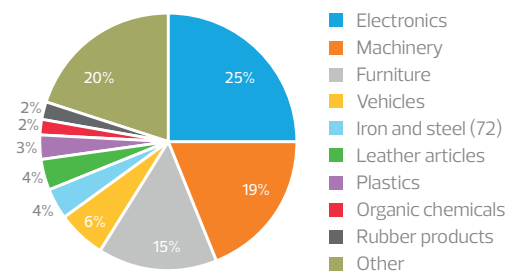
vary across different industrial ecosystems, based on our interaction with U.S. federal agencies, we are confident our estimates are conservative. In the agricultural industry, for example, the optimal tariff rate is likely near 65 percent, an underlying concern for such a capital-intensive sector.

For example, China has slapped an additional 15 percent tariff on imported American-made wine, bringing the total tax to 65 percent. We anticipate retaliatory U.S. action on a range of Chinese imports to equal or exceed that level, which would cause damage to the U.S. economy and associated industrial ecosystems.

Event or nonevent?

Importantly, as it stands, the present trade spat will not lead to a major *macroeconomic* event. Rather, it will produce a profoundly *microeconomic* supply shock as supply and value chains are disrupted and ex-post renegotiation of contracts between large and middle market businesses becomes the norm as prices increase. The potential microeconomic effects of the trade conflict are impossible to quantify for two reasons: first, the U.S. economy has not engaged in a trade war since the 1930s, when the United States passed the protectionist Smoot-

Tariff list (2017 values) as of July



Source: RSM US LLP



Hawley Tariff Act. Given the advent of today's global supply chains and deep integration of global financial markets, it is impossible with precision to predict the overall microeconomic impact. Second, damage to the economy will depend upon the relative elasticities (sensitivity to changes in prices) on both the supply and demand sides due to the tariffs, associated movements in currency valuations and overall financial conditions. If the current conflict escalates to a full-blown trade war, businesses should expect financial conditions to tighten noticeably.

The hit to the economy caused by the taxes on imports and exports will spread asymmetrically across the industrial ecosystems that make up the domestic economy. The major damage in the first phase will occur primarily in so-called A3 ecosystems: aerospace, agriculture and autos. More modestly hit will be the petrochemical industries—plastics, rubber, chemicals, mineral fluids

**RECENT DEPRECIATION
IN THE VALUE OF THE
CHINESE YUAN, EITHER
DUE TO THE INABILITY
OR UNWILLINGNESS
OF THE CHINESE
GOVERNMENT TO
SUPPORT THE VALUE
OF ITS CURRENCY,
IMPLIES WE ARE MUCH
CLOSER TO A TRADE
WAR THAN IS COMMONLY
ACKNOWLEDGED BY
THE GOVERNMENT,
THE CORPORATE
SECTOR OR INVESTORS.**

MIDDLE MARKET INSIGHT:

The impact of tariffs on the job market will be noticeable over time. If the trade spat is contained primarily to the aluminum and steel markets, for every one job created, five will be lost. It will cost roughly \$1.3 million to save each of those jobs. Should the tensions escalate to a full-blown trade war, 11 jobs will be lost for every one job saved across U.S. industrial ecosystems.

and apparel—as well as the prepared food and beverage industries. In a second, more robust round of a trade war, all of those ecosystems would suffer, with the apparel and footwear industrial ecosystems likely to suffer a more significant supply shock.

In our previous work on a possible withdrawal of the United States from NAFTA, we noted that a disruption to the North American auto supply chain would result in an effective tax on all autos produced and purchased in the United States, Canada and Mexico of about \$4,000 per vehicle. The Petersen Institute for International Economics estimates that if the administration follows through on its threat to impose a 25 percent tariff on all auto imports and parts, that amount would be about \$4,400 per car, with a total cost to American consumers of roughly \$83 billion dollars.

To put it in perspective, the average individual taxpayer received a tax cut of roughly \$2,000 dollars following the 2017 Tax Cuts and Jobs Act. The imposition of such a significant levy on the import of

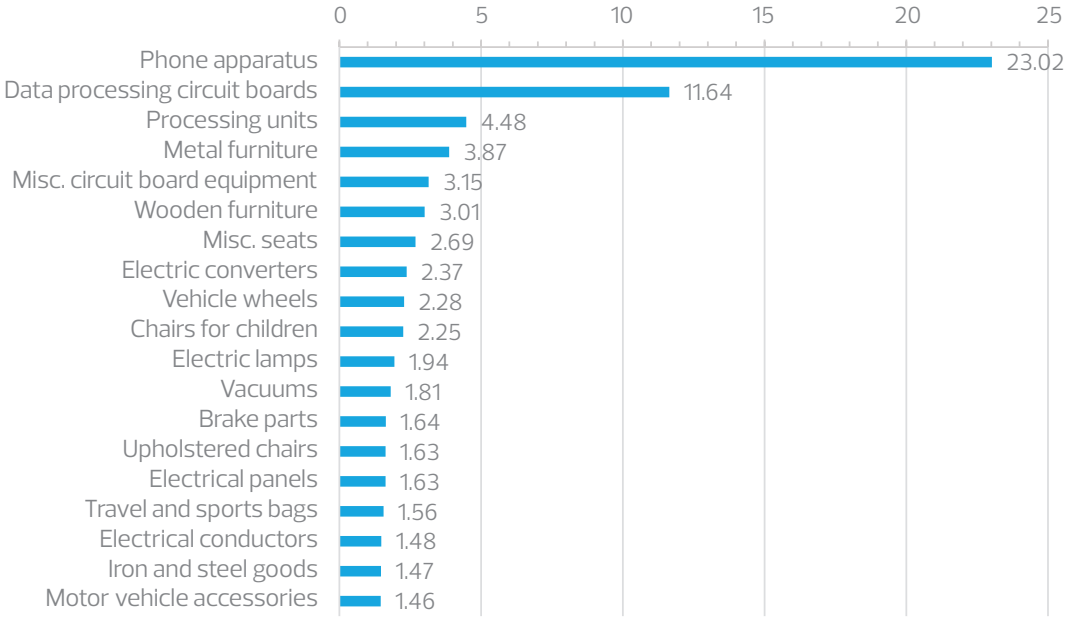
all vehicles and parts would completely erase the gains in disposable income associated with the administration's fiscal policy for the roughly 16.5 million auto purchases likely to take place in 2018 and 2019.

Based on our discussions with agency and administration officials over the past two months, it was strongly suggested that businesses with direct or even indirect exposure to the capital-intensive agricultural sector should begin thinking about aggressive mitigation efforts. This was

before the administration announced recent plans to pay as much as \$12 billion in relief funds to farmers hurt by the tariffs. Even so, the message of mitigation remains the same.

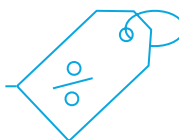
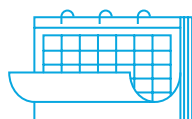
Officials also communicated that middle market businesses overall should begin to prepare for a protracted trade conflict. Currently, there is no strategic road map for the current trade spats and no easily identifiable offramps that would signal an end to the increasing trade frictions.

Tariff breakdown (billion)



Source: RSM US LLP

TRADE TIFF TIMELINE



2017	
Jan. 23	President Trump requests the USTR formally withdraws from the Trans Pacific Partnership.
March 5	20.8 percent tariff imposed on the import of Canadian softwood lumber, a major component in U.S. homes.
March 29	USTR announces that the United States intends to initiate negotiations on NAFTA.
April 20	Trump requests U.S. Department of Commerce initiates a section 232 investigation of steel imports to determine impact on national security.
April 26	Trump announces he will not pull out of NAFTA.
April 27	Trump requests a section 232 investigation of aluminum imports.
May 23	Robert Lighthizer, USTR, sends formal notice to Congress on renegotiation of NAFTA.
July 18	U.S. House Ways & Means Committee holds hearing on NAFTA modernization.
July 19	Canada and Mexico announce the intent to work on fast track to conclude negotiations in early 2018.
Aug. 14	Canada publishes its summary of objectives in NAFTA talks.
Aug. 16–20	Round one of negotiations in Washington, D.C., commences.
Sept. 1–5	Round two takes place in Mexico City.
Sept. 23–27	Round three is in Ottawa. The parties announced they intend to engage in seven rounds of talks.
2018	
Jan. 23	Eleven remaining nations announce the establishment of the Trans Pacific Partnership, with Japan and Canada taking the lead with an expected agreement date of March 8.
Feb. 26–March 6	Round seven of NAFTA talks takes place in Mexico City.
March 6	Trump announces plans to impose tariffs on aluminum and steel.
March 8	Trump signs proclamation on aluminum and steel tariffs, temporarily exempting Canada and Mexico.
April 30	Trump extends exemption on Canada and Mexico.
May 9	Speaker of the House Paul Ryan announces drop dead date for NAFTA of May 17.
May 11	Mexican government indicates it is unlikely that an agreement will be reached by May 17.
May 17	No NAFTA agreement reached.

May 23	U.S. Department of Commerce initiates section 232 investigation on auto imports: Report due in February 2019.
May 29	Vice President Mike Pence demands any new NAFTA agreement contains an automatic expiration after five years.
May 31	Canada's PM, Justin Trudeau, says he will sign no agreement that has automatic sunset component.
June 1	Tariffs on aluminum and steel imposed on Canada, Mexico and the EU.
June 1	Canada announces it will impose tariffs on over 100 products beginning July 1.
June 5	Mexico imposes retaliatory tariffs on U.S. imports of specific types of steel, lamb, cheese, port, apples, grapes and cranberries.
June 5	Trump announces he wants to negotiate separate bilateral agreements with Canada and Mexico.
June 7	White House Council of Economic Advisors issues report stating that tariffs will harm U.S. economy.
June 22	EU imposes \$2.5 billion in retaliatory tariffs on U.S. goods such as bourbon, motorcycles and orange juice.
June 29	Report leaked from White House that Trump is considering withdrawing from the World Trade Organization.
July 1	Mexico holds presidential election and Canada imposes \$12 billion of retaliatory tariffs on the United States.
July 1	Trump indicates he will not sign revised NAFTA agreement until after the U.S. midterms.
July 5–6	U.S.–China trade spat formally begins. United States imposes additional 25 percent tariff on 818 product categories of Chinese imports, and subsequently adds more. China responds with tariffs on U.S. goods, including soybeans, select farm crops, dairy products and autos.
July 6	USTR publishes process to request exclusions from tariffs.
July 9	Trump administration plans to impose a 10 percent tariff on an additional \$200 billion worth of goods imported from China with tariff lines exceeding 10,000 individual products. A two-month review begins with public hearings in August.
July 19	Trump indicates a willingness to impose tariffs on all \$500 billion-plus worth of Chinese imports.
September	Earliest possible presentation for a NAFTA modernization agreement.
Nov. 6	U.S. congressional election.
Dec. 1	Inauguration day for new Mexican president.
2019	
Oct. 21	Canadian federal election.

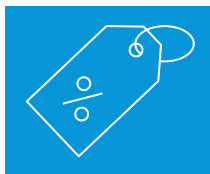
FEDERAL RESERVE'S BEIGE BOOK SHOWS TARIFFS BEGIN TO BITE

By Kevin Depew, Deputy Chief Economist, RSM US LLP

U.S. hard economic data has yet to catch up with the initial round of tariffs amid widening trade spats. But the U.S. Federal Reserve's Summary of Commentary on Current Economic Conditions, known as the "Beige Book," reveals anecdotal evidence of rising input costs and general trade anxiety among businesses surveyed in the report, which was released on July 18.

Tariffs contributed to price increases for metals and lumber. However, the extent of the pass-through from input to consumer prices remained slight to moderate. Movements in pricing of agricultural commodities were mixed across products and banking districts. Pricing pressures are expected to intensify further moving forward in some districts, while in others, the outlook is stable price increases at a modest to moderate pace.

Below is a summary of recent commentary from the most-recent Beige Book:



Boston Federal Reserve Bank (FRB): Tariffs

Contacts expressed concerns about tariffs, but none cited trade issues as affecting demand or hiring and capital

expenditure plans.



Boston FRB: Software and information technology services

Firms across the sector expressed concern about acquiring and retaining talent in the tech industry. Further,

contacts unanimously expressed anxiety about shocks to the broader economy, such as the potential for changes in trade, tariffs, immigration, war and the stock market.



New York FRB: Manufacturing and distribution

A number of manufacturing contacts remarked that tariffs had raised their costs. Moreover, uncertainty about

future trade policy was cited as a major concern, particularly in parts of upstate New York, where there is substantial trade with Canada.



Philadelphia FRB: Manufacturing

The makers of chemical products, paper products, fabricated metal products and electronic equipment noted gains in new orders and shipments; the makers

of lumber products, primary metals and industrial machinery reported mixed results. One machinery manufacturer said that effects of the steel tariffs have been chaotic to its supply chain by disrupting planned orders, increasing prices and prompting some panic buying.



Philadelphia FRB: Consumer spending

Auto dealers in New Jersey and Pennsylvania reported year-over-year sales flat to up slightly in May and June. Year-to-date sales appear to be holding

even with 2017's high levels. However, dealers noted greater downside risk than normal for the second half of 2018, including disruptions from tariffs, volatile markets and rising interest rates.



Cleveland FRB: Prices and tariffs

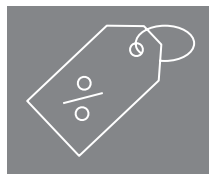
Business activity in the 4th District grew moderately during the survey period. Demand was strong in many sectors, but hiring continued at about the same pace as in the previous survey period, as a dearth of qualified workers constrained hiring. Wages rose moderately, and increases were in line with recent trends. Upward pressure on input costs was strong, notably for fuel and metals. Contacts widely attributed the cost increases to import tariffs.

Manufacturers and builders commented widely that import tariffs were lifting steel and aluminum prices. In some cases, manufacturers noted a rush to purchase metals in anticipation of additional price increases. To a lesser extent, construction contacts also noted lumber price increases. Aside from the manufacturing, construction and transportation sectors, contacts noted moderate cost increases consistent with recent trends.



Richmond FRB: Manufacturing

Manufacturing remained fairly strong. However, several manufacturers reported that while sales increased, profits dipped as price increases could not offset the rising costs of materials and transportation. Manufacturers also expressed concern about potential adverse effects of rising trade tensions. For example, a 5th District foam manufacturer reported growth in business but growing costs of raw materials resulting from tariffs. Additionally, a Maryland can manufacturer said it could not get the quality of steel needed domestically and anticipated losing business to foreign competitors not faced with steel tariffs.



Atlanta FRB: Tariffs

On balance, reports from 6th District business contacts indicated that economic activity continued to expand at a modest pace from mid-May through June. Although a number of contacts' sentiment declined due to uncertainty related to the impact of tariffs and tariff rhetoric, the overall outlook among businesses remains positive as most expect an increase in activity for the second half of the year. District firms reported some increases in nonlabor input costs, particularly for steel, aluminum and transportation, with limited accounts of an ability to pass along these increases. Expectations of rising costs related to tariffs continued to contribute to vendor price increases for commodities.



Chicago FRB: Prices

The pace of price increases edged up in late May and June, but remained modest overall. Contacts expected prices to continue to rise modestly over the next six to 12 months. Retail prices increased slightly overall. Producer prices rose modestly, reflecting in part the pass-through of higher costs for labor, materials, energy and freight. Contacts in the agricultural sector noted heightened price volatility related to uncertainty over U.S. and foreign tariff policies.



Chicago FRB: Agriculture

The outlook for agriculture income dimmed some over the reporting period, as prices for most commodities fell. Crop farmers reported that, in

general, field conditions were excellent and better than last year. Both corn and soybean prices fell, reducing expected profits from the upcoming harvest. Livestock farmers continued to struggle overall, with some reports of asset sales by hog producers and closures of dairy operations. Contacts throughout the 7th District expressed heightened concerns over the impact of trade disputes and tariffs on the agricultural industry.



St. Louis FRB: Labor and shipping

Economic conditions improved slightly. Labor market conditions remained tight and wage growth was modest. Local contacts reported robust increases in

shipping costs across all sectors due to higher fuel prices and driver shortages. Reports from businesses on the impact of tariffs varied by industry.



St. Louis FRB: Prices

Tariffs and trade restrictions have had a mixed effect on prices. U.S.- imposed tariffs raised prices for steel and aluminum, increasing input costs for

several business contacts. Construction contacts lamented that rising prices pressured their industry before tariff-induced inflation of metal costs. In contrast, proposed tariffs by China have led to an overall downturn in agricultural commodity prices, particularly the price of soybeans. These lower commodity prices have been passed on to food retailers, which reported that lower food prices have more than offset increased freight costs.



St. Louis FRB: Manufacturing

Manufacturing activity rose at a moderate pace since the previous report. Overall manufacturing activity was stronger than one month earlier in

both Arkansas and Missouri, and expansion, new orders and production increased in both states. Several companies that manufacture motor vehicles and parts reported plans to expand facilities and increase production. Contacts in paper packaging reported running at nearly full capacity. Similarly, those in the recycled metals noted record volumes, while those in mining equipment manufacturing reported experiencing backlogs. On the other hand, a maker of plastic products for appliances indicated lower sales. Several manufacturers noted increases in input prices, which they linked to tariffs.



Minneapolis FRB: Prices

Pricing pressures increased moderately relative to the previous report. Manufacturing contacts reported steep increases continued in

aluminum and steel material input costs in reaction to tariff announcements. Construction materials costs continued to increase briskly. A June survey of purchasing managers indicated that inflation expectations were elevated, but had decreased slightly from the previous month. Retail fuel prices as of late June were mixed across 9th District states relative to the previous reporting period; Montana and the Dakotas saw prices increase slightly, while prices in Minnesota and Wisconsin fell. Prices farmers received for corn, soybeans, wheat, hay, chickens and eggs increased in May, compared with a year earlier.



Dallas FRB: General outlook

Expansion in the 11th District economy continued at a solid pace. Manufacturing output increased, and loan demand and retail spending rose.

Broad-based expansion in the energy and service sectors continued. Home sales rose modestly, while apartment markets softened slightly. The ongoing drought negatively affected crop and grazing conditions. Hiring remained strong, and widespread labor shortages continued putting pressure on wages. Price pressures stayed elevated largely due to increases in input costs, particularly steel and aluminum. Although outlooks remained fairly optimistic, tariffs and trade-related concerns were creating uncertainty.



Dallas FRB: Prices

Pricing pressures remained elevated. Input costs increased for energy, manufacturing and construction firms, in part due to rising freight costs and

new tariffs on steel, aluminum and lumber. Auto dealers reported higher new vehicle prices and financing costs, while transportation service firms noted climbing fuel prices. Many other retailers and service firms also cited increasing costs for inputs and services such as health care. A number of contacts planned on increasing selling prices to offset higher costs. West Texas Intermediate oil prices rose to their highest levels since 2014, driven by falling inventories, rising geopolitical risks in the Middle East, U.S. policy on Iran and other oil supply concerns.



San Francisco FRB: Prices

Price inflation increased moderately over the reporting period. Recent oil price increases spurred inflation in a variety of sectors. Pricing pressures

strengthened for freight costs at lumber businesses in California and Oregon and for petroleum-based products like asphalt. Across the 12th District, contacts noted a pickup in price growth for finished steel and for metal inputs for manufactured products. A few contacts in manufacturing attributed recent inflationary pressures for metal products and declines in the duration of price guarantees to the implementation of tariffs.

Solid construction sector activity continued to exert upward pressure on prices for building materials. Contacts in California reported moderate price inflation for cherries, nuts and raisins after yields fell due to poor growing conditions. A few contacts reported that grocery stores passed increased food-safety costs on to consumers, somewhat lifting retail food prices. Excess capacity in power generation and low input costs continued to limit increases in electricity prices in southern California. Generic drug prices continued to fall modestly following a relaxation in regulation and heightened competition among the largest drug sellers.

TARIFF IMPACT BY INDUSTRY

MANUFACTURING

Tariff impact shows in manufacturing soft data

The Federal Reserve's July 18 Beige Book showed U.S. economic expansion continuing, even as manufacturers across the country expressed concern about tariffs. Many districts attributed higher prices and supply disruptions to the new trade policies. All showed signs of a tightening labor market, with respondents indicating an inability to find workers that constrained growth.

Several districts reported upticks in inflation. Prices for key inputs, including fuel, construction materials, freight and metals, continued to rise; a few districts described input price pressures as elevated or strong. While the impact of tariffs is not yet visible in hard data, the producer price index is already showing inflationary pressures building.

Tariffs were specifically identified as a major contributing factor for increases in metal prices, but the extent that price hikes in these inputs were passed through to

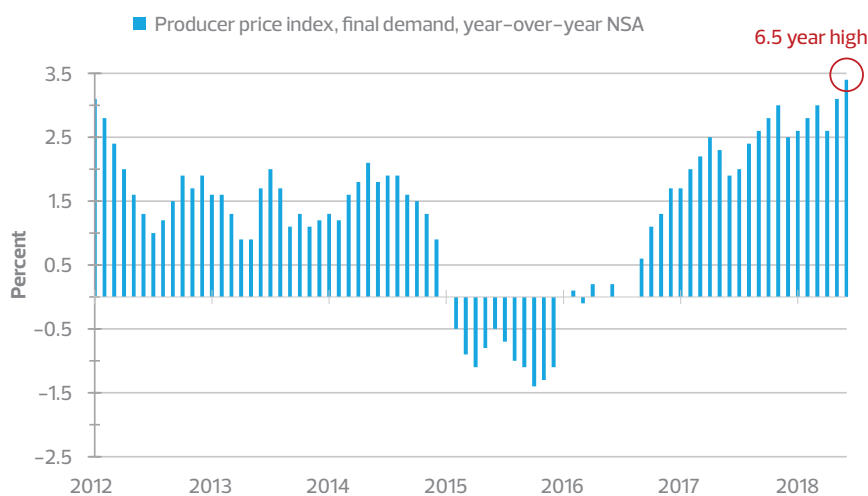
consumers remained slight to moderate. Some districts also noted that pricing pressures are expected to intensify in the near-term, while others noted the outlook is for stable price increases at a modest to moderate pace moving forward.

Ultimately, tariffs will hit U.S. manufacturers with higher costs in the fall. Beyond the 8.7 percent decline in the price of aluminum and the 29 percent drop in the price of steel, the real risk to the industrial ecosystem lies ahead.

Should the administration choose to impose 25 percent across-the-board tariffs all vehicle and auto parts imports, the cost would be prohibitive (a mid-priced \$35,000 car would tack on another \$4,400 to its sticker price, according to the Peterson Institute for International Economics).

Jason Alexander (industrial products)

Producer prices hit 6.5-year high



Source: Bloomberg, RSM US LLP

HEALTH CARE

Regional health care providers not immune from trade spats

The health care ecosystem is one of the U.S.'s largest, representing nearly 20 percent of GDP. Some of the items on the United States Trade Representative's list of products subject to the tariffs directly affect the health care ecosystem supply chain. Pharmaceuticals, medical devices and components that are used for equipment and construction material could be affected. If tariffs are imposed on these items, the costs could end up impacting providers of health care services that already operate on very thin margins, and are constrained by reimbursement models that may not take into account the tariffs.

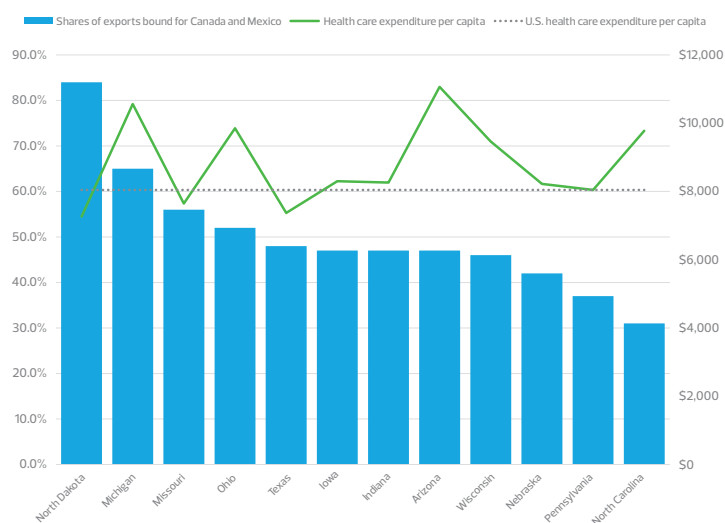
Meanwhile, health care providers face significant downside risk, even if indirectly, from United States trade policy, as everything from health care delivery systems to the

construction of new hospitals and medical-care facilities could face pressure from rising input costs.

For example, a university health care advisor told us it was facing a \$14 million cost overrun due to rising costs for construction materials currently subject to tariffs (steel, aluminum and wood). The provider said it would hold back a year of routine capital investment to pay for the cost overrun.

Health care delivery is still driven by geography, and some jobs may be on the line if the NAFTA talks do not end favorably and other proposed tariffs begin to affect the broader economy. Local job losses would decrease patients' ability to pay—particularly those with high-deductible plans.

Health care expenditure per capita in states most affected by potential NAFTA withdrawal



Health care is a highly fragmented and local industry. No single provider accounts for more than 5 percent of industry revenue, and the top four providers barely account for 10 percent, according to IBISWorld, an industry research firm. One study conducted by the state of Washington estimates the majority of people there do not travel more than 10 miles to receive health care. Many rural areas have only a single acute care provider.

Some localities are more exposed to risk than others in trade with Mexico and Canada. For example, almost 40 percent of Michigan's gross domestic product (GDP) is tied to trade, and 65 percent of that state's goods are exported to the other NAFTA members. Louisiana, by comparison, exports only 17 percent of its goods to Mexico and Canada.

Matt Wolf and Rick Kes (health care)

RETAIL, FOOD AND BEVERAGE

Consumer products companies illustrate divergent effect of tariffs within one sector

One of the difficulties in understanding the effect of tariffs in the middle market is the widely varying impact they can have on companies in the same industry. Consumer products companies need to examine their specific supply chains and review the list of tariff items to understand how those tariffs might affect their businesses. Goods subject to tariffs do not have to be bought or sold directly by a company in order for them to impact the business.

In a recent discussion with RSM, one prominent fashion retailer highlighted how difficult it can be to identify the impact of tariffs. In the company's initial analysis, executives believed that because inventory was being sourced from two large distributors, the company would be insulated from significant impact. However, upon a deeper analysis, they identified some problems.

First, they found that both distributors were sourcing a great deal of inventory from outside the United States. But that wasn't the only challenge. They then realized

that neither they, nor the distributors, had a thorough understanding of the comprehensive tariff list and whether or not their products contained listed items. They also struggled to definitively state whether their clothing contained a specific type of cotton on the list.

Companies should consider reaching out to their relevant trade organizations to understand how others in the industry have been impacted by tariffs and what changes they've made to their business practices to mitigate the impact.

Below are some of the key performance indicators for the apparel and accessories sector for the last two years, as well as pre-tariff estimates for 2018 and 2019. Based on the current list of tariff items, we expect the 2018 actual performance results and the future estimates to be negatively impacted.

Victor Kao, Alex Monahan and Chris Shaker
(consumer products)

S&P 500 consumer discretionary sector-income statement					
12 months ending	CY 2016 Dec. 30	CY 2017 Dec. 29	Current July 23	CY 2018 Est. Dec. 29	CY 2019 Est. Dec. 29
Income and expenses per share					
Sales	442.41	457.78	477.33	504.09	533.92
Gross margin percent	33.66	35.16	34.83	24.86	25.37
EBIT	48.05	51.50	50.20	57.70	63.42
Margin percent	10.82	11.12	10.43		
EBITDA	67.88	73.78	74.00	82.15	89.21
Margin percent	15.34	16.12	15.50		
R&D expense	9.23	10.91	11.85		
Earnings	33.44	34.07	34.59	40.85	45.82
Earnings before extraordinary items	30.58	37.39	37.40		
Diluted earnings from cont. ops	33.43	34.07	34.59		
Earnings, positive	33.44	34.28	35.11	40.98	45.82

Source: Bloomberg

S&P 500 consumer discretionary sector-balance sheet

12 months ending	CY 2015 Dec. 31	CY 2016 Dec. 30	CY 2017 Dec. 29	CY 2018 Est. Dec. 29	CY 2019 Est. Dec. 29
Assets per share					
Cash and equivalents	42.08	45.08	52.92		
Current assets	154.82	166.79	179.19		
Goodwill	60.89	71.58	78.27		
Total assets	456.35	517.48	564.35		

Liabilities and equity per share					
Current liabilities	124.84	137.69	149.04		
Total debt	168.49	199.42	229.76		
Total liabilities	326.30	373.08	407.38		
Retained earnings	-5.81	-10.35	-3.04		
Book value	126.95	137.88	150.22	163.60	183.46
Tangible book value	18.31	1.97	-3.66		
Total equity	130.05	144.40	156.97		

Reference items					
Enterprise value per share	708.33	757.33	915.38	1,017.44	1,007.86
Number of employees	6,458,687.00	6,225,813.00	6,369,633.00		

Source: Bloomberg

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S&P 500 consumer discretionary sector–cash flow					
12 months ending	CY 2016 Dec. 30	CY 2017 Dec. 29	Current July 23	CY 2018 Est. Dec. 29	CY 2019 Est. Dec. 29
Cash flow items per share					
Cash from operations	55.46	58.91	58.23	64.05	71.29
Cash flow from investing	–41.88	–38.17	–42.74		
Cash from financing	–13.82	–15.03	–14.47		
Capital expenditures	–20.16	–22.30	–24.18	–26.59	–26.29
Free cash flow	35.26	36.89	34.35	37.71	45.00
Dividends	10.22	10.44	10.80	11.28	12.27
Dividends, gross	10.22	10.44	10.80		
Dividends, net	10.22	10.44	10.80		
Reference items					
Free cash flow yield	5.44	4.70	3.85		
Dividend yield	1.58	1.33	1.21	1.27	1.38
Dividend yield (gross)	1.58	1.33	1.21		
Dividend yield (net)	1.58	1.33	1.21		

Source: Bloomberg

S&P 500 consumer discretionary sector–leverage and equity					
12 months ending	CY 2015 Dec. 31	CY 2016 Dec. 30	CY 2017 Dec. 29	CY 2018 Est. Dec. 29	CY 2019 Est. Dec. 29
Current ratio	1.24	1.21	1.20		
Net debt to EBITDA	1.34	1.50	1.63	1.50	1.38
Total debt to EV	0.24	0.26	0.25		
Total debt to total equity	129.55	138.10	146.38		
Total debt to total assets	36.92	38.54	40.71		

Source: Bloomberg

S&P 500 consumer discretionary sector-valuation

12 months ending	CY 2015 Dec. 31	CY 2016 Dec. 30	CY 2017 Dec. 29	CY 2018 Est. Dec. 29	CY 2019 Est. Dec. 29
Price/earnings	20.83	19.37	23.05	21.81	19.45
Price/earnings before XO	21.61	21.18	21.00		
Price/earnings, dil. cont ops	20.83	19.38	23.05		
Price/earnings, positive	20.83	19.37	22.91	21.75	19.45
Price/cash flow	13.14	11.68	13.33	13.91	12.50
Price/sales	1.52	1.46	1.72	1.77	1.67
Price/EBITDA	9.98	9.54	10.64	10.85	9.99
Price/book value	4.89	4.70	5.23	5.45	4.86

EV/sales	1.73	1.71	2.00	2.04	1.92
EV/EBITDA	11.39	11.16	12.41	12.50	11.51

Dividend yield	1.56	1.58	1.33	1.27	1.38
Dividend yield (gross)	1.56	1.58	1.33		
Dividend yield (net)	1.56	1.58	1.33		
Free cash flow yield	4.59	5.44	4.70		

Source: Bloomberg

S&P 500 consumer discretionary sector-profitability

12 months ending	CY 2015 Dec. 31	CY 2016 Dec. 30	CY 2017 Dec. 29	CY 2018 Est. Dec. 29	CY 2019 Est. Dec. 29
Gross margin	33.47	33.66	35.16		
EBITDA margin	15.19	15.34	16.12		
Operating margin	10.98	10.82	11.12		
Profit margin	6.84	6.93	7.90		

Return on assets	6.40	6.25	6.51	6.09	6.19
Return on common equity	22.19	22.87	24.88	22.51	18.60
Return on capital	11.19	11.51	12.90		

Dividend payout ratio	40.14	39.28	34.95		
Sales per employee	435,424.25	445,265.13	470,033.78		

Source: Bloomberg

REAL ESTATE

Trade policy threatens to shorten current real estate cycle

The U.S. real estate sector has enjoyed a long post-recession recovery with ample capital, cheap debt and strong fundamentals. Since the end of the Great Recession nearly a decade ago, these factors have driven a surge in construction. Homebuilders have doubled housing starts to 1.2 million since 2012, while developers during that time added 138 million square feet of new office space; 84 million more is expected by the end of 2019.

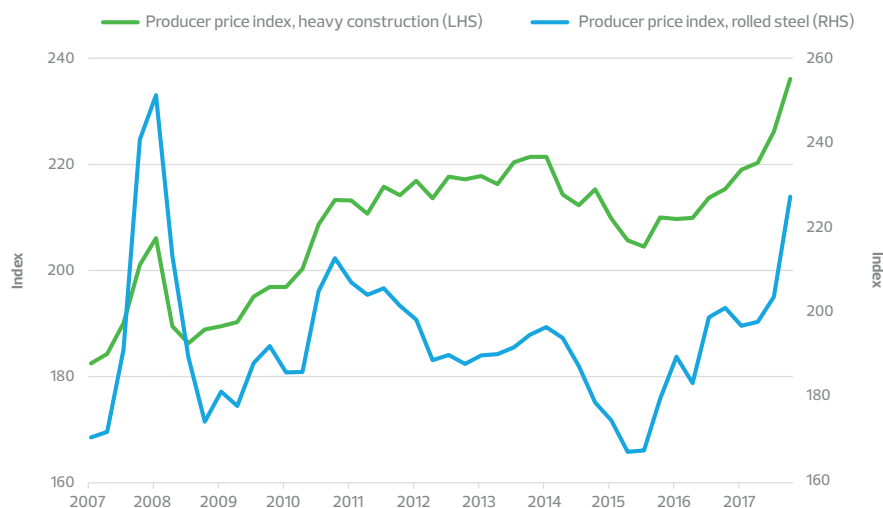
Recent U.S. trade policies, however, have placed increasing uncertainty on the cost of materials. A newly enacted 25 percent tariff on steel will curb the development of office, retail, industrial and multifamily building (steel generally accounts for 14 percent of building costs). Meanwhile, a 21 percent tariff on Canadian lumber enacted in 2017 adds additional pricing pressure to homebuilders (lumber

accounts for 5 percent of the average sale price of a new single-family home and 9 percent of total construction costs, excluding labor.) The lumber tariff, along with a reduction in lumber supply because of rail slowdowns, tree disease and forest fires, has led to a 36 percent increase in lumber costs since last summer.

Increased material costs due to tariffs, along with labor shortages and permitting challenges, present significant headwinds. The lack of new development will continue to increase the values of existing real estate assets and limit the ability of developers to meet demand, in particular, in the multifamily and housing markets, which continue to be undersupplied.

Laura Dietzel and Troy Merkel (real estate)

Rising construction material prices present headwinds for real estate developers



Source: Bloomberg, RSM US LLP

TECHNOLOGY

U.S. and China deploy technology tariffs in race to be global tech leader

The U.S. technology sector has remained largely unscathed by the first three rounds of global trade conflict. If tensions escalate into a full-blown trade war, U.S. firms will suffer as China seeks suppliers in Southeast Asia to reduce its import of complex American components such as semiconductors.

U.S. tech companies capture value primarily through research and development, software and brand ownership—measures not shown in trade statistics. Nevertheless, both Chinese and U.S. technology companies are concerned about their global supply chains as the two countries compete for the world's top technology ecosystem.

Historically, China has focused on low-value final assembly and is heavily reliant on other developed countries such as the United States for high-value components (see below figure). The new tariffs will result in rising costs for both Chinese and U.S. tech manufacturers. To the extent possible, U.S. tech makers whose products are created in China will look to pass on any additional costs resulting from the tariffs to their customers.

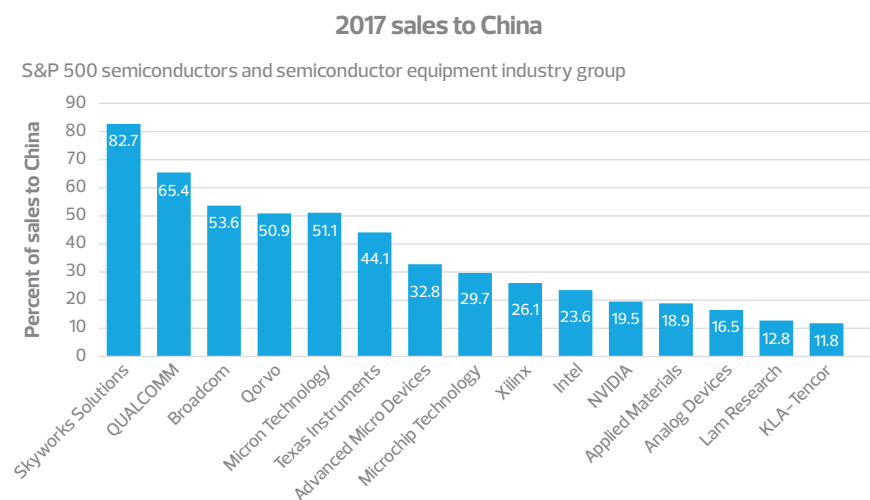
Besides imposing tariffs, China can pull other levers to disrupt U.S.-based technology companies; it can deny facility permits and approvals in Chinese plants and impede pending acquisitions. China failed this month to

grant regulatory approval for the \$43 billion takeover of NXP Semiconductors by U.S. telecoms equipment maker Qualcomm, resulting in a failed deal that forced Qualcomm to pay a \$2 billion breakup fee. Meanwhile, large multinationals like Apple, which counts China as its third-largest market for sales, have assembly plants and suppliers in China, making them vulnerable to escalating trade tensions. On an earnings call, Apple CEO Tim Cook said the tariffs were “a tax on the consumer.”

One of the aims of the U.S. tariffs is to slow Chinese initiatives like “Made in China 2025,” a program designed to comprehensively upgrade Chinese manufacturing. China also has stated a desire to surpass the United States as a world leader in artificial intelligence by 2030. Though the current international reach of China's technology ecosystem is not as extensive as that of the United States and is heavily reliant on semiconductors and other advanced materials, China has aspirations to become the preeminent global hub for technological innovation.

U.S. tariffs may delay China in the near-term, but in the long run continued innovation by U.S. tech giants and innovative middle market tech companies will be pivotal in keeping China from becoming the global tech innovation leader.

Kurt Shenk (technology)



Source: S&P, Bloomberg, RSM US LLP

PRIVATE EQUITY

Global trade spat could be a boon for M&A

Many dealmakers fear an all-out trade war could severely slow M&A activity; in fact, it could have just the opposite effect. An intensifying global trade war will result in disruptions to pricing and reduced global trade. Less trade means less competition, more barriers to innovation and suboptimal deployment of labor and capital. In effect, it becomes more expensive to bring products to market, so overall economic output declines—bad news for most companies, but good news for private equity (PE) firms on the hunt for bargains.

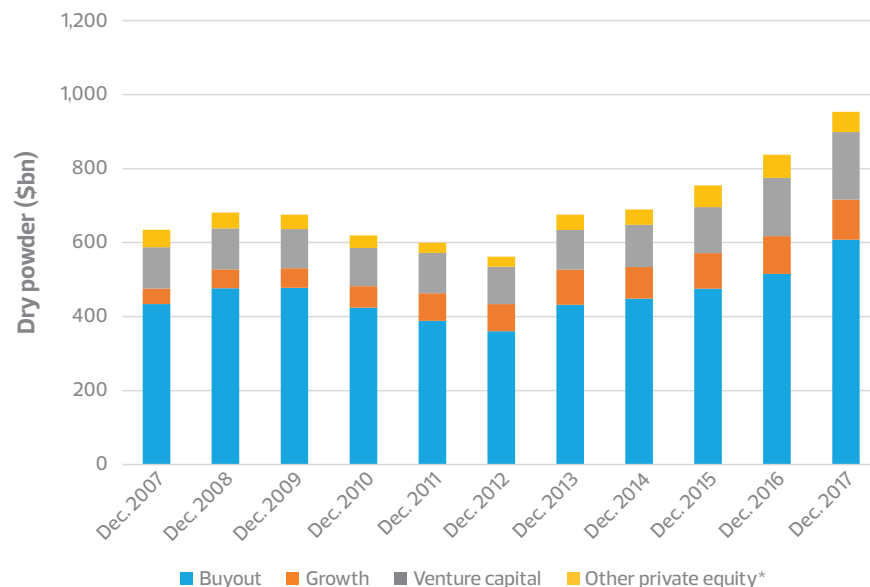
Softening margins are expected for middle market private companies suffering from trade inefficiencies. This may encourage PE buyers to adjust their operating agendas and deploy more capital to exploit volatile financial conditions. Companies that are unable to adjust quickly

for changes in their supply chains may be forced into bankruptcy. The manufacturing and autos sectors are especially exposed during the trade spat.

According to research firm, Preqin, approximately \$1 trillion of unused PE commitments, or so-called dry powder, is ready for managers to deploy. Recent high company valuations have made many managers slow to act, and this, along with the outperformance of the private sector over public markets, may accelerate M&A through the end of 2018. Further, the expected continuation of interest rate hikes by the Federal Reserve results in a good time for PE to invest in undervalued assets.

Anthony DeCandido and Jason Kuruvilla
(financial services)

Private equity dry powder by fund type, 2007–2017



Source: RSM US LLP

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