

THE REAL ECONOMY

VOLUME 56



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AND THE END OF
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MIDDLE MARKET TREND WATCH:
CYBERTHREATS ARE UBIQUITOUS

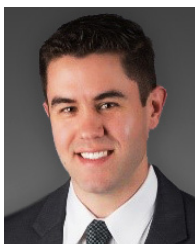
RSM AND UCLA ANDERSON FORECAST PARTNER TO BOOST
MIDDLE MARKET INTEL

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IS THIS **THE END?**

WAGE GROWTH
AND THE END
OF BUSINESS CYCLES



MIDDLE MARKET BUSINESSES SHOULD PREPARE FOR ECONOMIC SLOWDOWN

BY JOSEPH BRUSUELAS

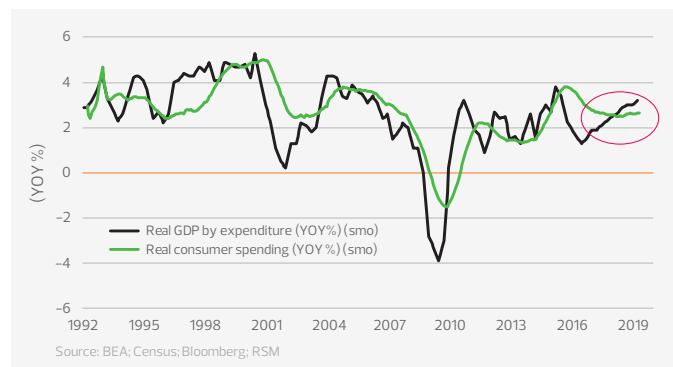
WAGE GROWTH DURING the current business cycle has been weak compared to the past several economic expansions. The May U.S. employment report implied a growth rate in wages of 3.1%, which was accompanied by a 2.73% three-month average annualized pace, pointing to broader deceleration in the growth of overall wages. Both metrics have declined for the past three months, and it's likely that wage growth has peaked in the current business cycle, which strongly suggests that the U.S. economy has entered the latter stages of the economic expansion.

Eyeing economic turning points

In the U.S. economy, the consumer sector plays an outsized role in the level of overall economic activity (see Figure 1). Therefore, the health of household balance sheets and the willingness of consumers to purchase goods and services and to invest in homes are key determinants of the direction of the business cycle.

Figure 1

Real GDP growth and real consumer spending



However, as illustrated in Figure 1, the pivot points of consumer spending tend to lag behind the turning points of gross domestic product growth. Expectations of sustained robust growth in the wholesale and retail sectors, as well as strong demand for the provision of services, often result in erroneous business decisions by middle market firms that do not have the resources and data analytics to identify turning points in the business cycle. This is one reason why these businesses lean toward excess in hiring, as well as mergers and acquisitions or overexpansion near the end of business cycles. In our estimation, employment growth and wage growth offer a better real-time assessment of where we are in a business cycle. While sales and new orders appear to remain solid, middle market businesses should proceed with caution as hiring, wages and economic growth decelerate.

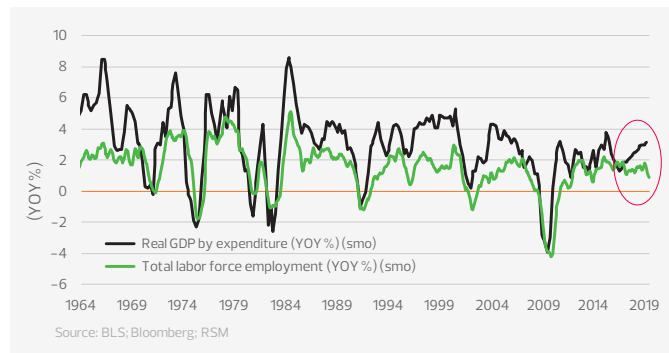
WAGE GROWTH continued

At the end of a business cycle expansion, we expect the labor force participation rate to increase noticeably and the growth rate of employment to decelerate as the pool of available labor decreases, particularly in the absence of large increases in wages. In the current post-crisis-recovery period, employment growth peaked at 2.25% year-over-year rate at the end of 2014 and has declined in recent months to less than a 1% rate (see Figure 2).

Figure 2

Real GDP and total employment growth

LABOR FORCE SURVEY



Wages are also showing signs of peaking in recent months. Weekly payrolls in the goods-producing sector decelerated from a 6% year-over-year growth rate in mid-2018 to a 4% rate in the spring of 2019 (see Figure 3). In the service sector, which exhibits a smaller range of growth, payroll growth has dropped from 5.7% in the third quarter of 2018 to 5% in May 2019 (see Figure 4).

Figure 3

Real GDP growth and growth of average weekly payrolls in the goods producing sector

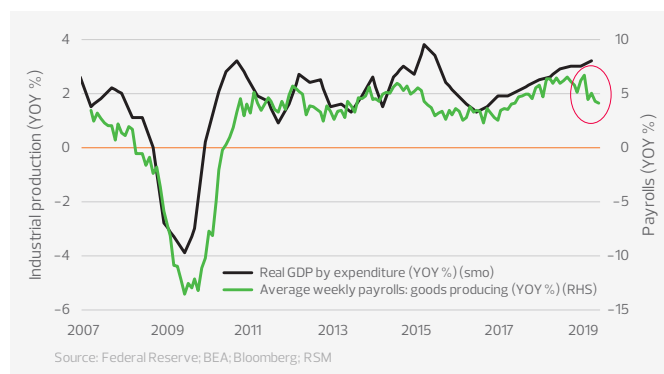
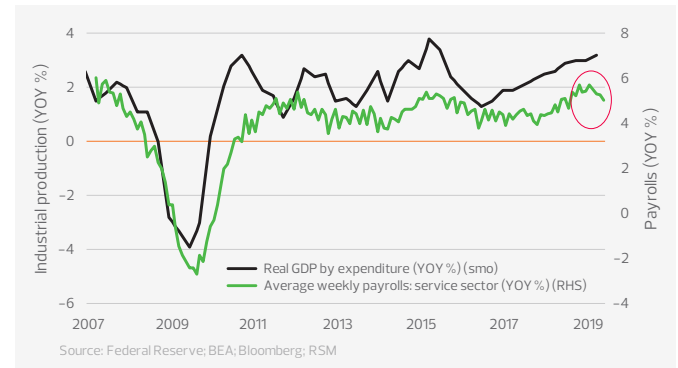


Figure 4

Real GDP growth and growth of average weekly payrolls in the service sector



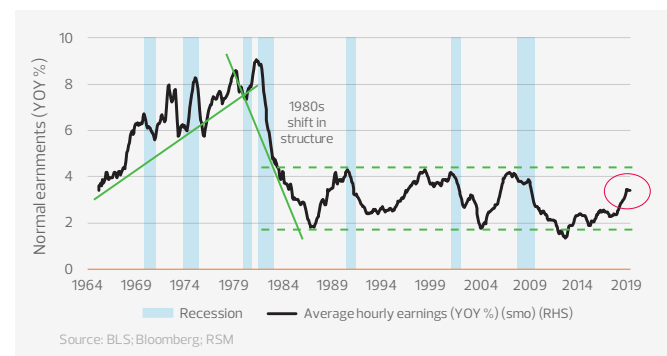
Earnings signals

So, can we use the growth rate of earnings to signal the end of a business cycle upswing and the presence of an impending recession? Our research indicates that, yes, we can. Note that Figure 5 is suggesting a shift in the structure that occurred in 1981, as companies began to substitute technology for labor, labor unions lost their political clout, and traditional manufacturing began to migrate to right-to-work, low-wage states as well as lower-cost offshore locations. The wage growth gains throughout the 1960s and 70s collapsed overnight from 9% increases per year in 1981 to less than 2% a year in 1985.

Figure 5

Growth of nominal average hourly earnings at the onset of recessions

PRODUCTION AND NONSUPERVISORY EMPLOYEES



IN OUR ESTIMATION, EMPLOYMENT GROWTH AND WAGE GROWTH OFFER A BETTER REAL-TIME ASSESSMENT OF WHERE WE ARE IN A BUSINESS CYCLE. WHILE SALES AND NEW ORDERS APPEAR TO REMAIN SOLID, MIDDLE MARKET BUSINESSES SHOULD PROCEED WITH CAUTION AS HIRING, WAGES AND ECONOMIC GROWTH DECELERATE.

In the 50 years of available data, and keeping the 1981 structural shift in mind, Figure 6 indicates that the rate of wage growth has tended to decelerate at the onset of a recession and then throughout the recession and beyond (the exceptions occurred in the 1973–1975 recession and the 1980 recession). In the three recessions since the shift of structure, the average of year-over-year growth rates of wages before a recession had been a 4.1%, which drops down to 4% during the first three months of the recession, then 3.8% in the following three months and to an average of 3.3% growth at the end of the recession.

On average, the growth rate of hourly earnings decreased by only 0.7–0.8 percentage points during the recession, but as we show in Figure 5, that deceleration tends to continue beyond the limits of the recession as employers are able to offer reduced wages to an increased supply of willing employees. It has been shown that the effects of underemployment endure far beyond the duration of the initial recession, as the labor force loses its ability to keep up with technology or lacks the means to move to where the jobs are. This results in workers sliding into lower-paying jobs and households adjusting their spending accordingly. Thus, waiting for a slowdown in wholesale and retail sales, and demand for services, may appear to be a risk-averse method of assessing the end of business cycles; however, doing so runs the risk of businesses overexpanding. It is also one of the primary reasons why middle market businesses tend not to be aware of the end of business cycles until six to nine months after they begin.

Figure 6 implies that wages likely peaked at 3.43% in the current cycle, which should be a signal to firms that a broader slowdown is in train. On a three-month, average annualized pace, wage growth slowed to 2.73% in May, implying a much slower trend than the top line, and down

for three straight months. With hiring data indicating an addition of only 10,000 jobs over the past three months, it is likely that the unemployment rate will begin to rise in coming months.

The policy-sensitive yield curve (10-year yield less three-month yield) has inverted due to a decline of roughly 115 basis points in yields on the U.S. 10-year Treasury; it is now pointing to much slower economic activity ahead.

Figure 6

Average growth rate of hourly earnings at the end of business upcycles, in the first quarters of recessions and at the end of recessions

Business cycle peak	Business cycle through	Average wage growth				Acceleration (+)/ deceleration (–) in wage growth (PPT)
		Quarter prior to recession (YOY%)	1st quarter of recession (YOY%)	2nd quarter of recession (YOY%)	At the end of the recession (YOY%)	
Dec 1969	Nov 1970	6.60	6.10	6.10	5.60	–1.00
Nov 1973	Mar 1975	6.13	6.00	6.27	8.07	1.93
Jan 1980	Jul 1980	7.47	7.33	7.83	7.80	0.33
Jul 1981	Nov 1982	8.97	8.87	7.70	4.77	–4.20
Jul 1990	Mar 1991	4.23	4.17	3.77	3.27	–0.97
Mar 2001	Nov 2001	4.13	4.07	3.87	3.47	–0.67
Dec 2007	Jun 2009	3.90	3.80	3.77	3.10	–0.80
1969–82 average		7.3	7.1	7.0	6.6	–0.8
1990–2009 average		4.1	4.0	3.8	3.3	–0.7
Current period (for reference)		as of Dec 2018	Jan–Mar 2019	Apr–May 2019		
		3.20	3.43	3.40	0.20	

Source: NBER; BLS; Bloomberg; RSM

While low wage growth is not a perfect predictor of a recession in the immediate future, it does signal there are elevated risks of a recession over the next 12 to 18 months as employment growth slows, unemployment rises and wage growth decelerates. The time for middle market businesses to stress test their balance sheets, engage in more rigorous evaluations of potential acquisitions and increase efficiencies has come. ■



BUSINESS DECISIONS AT THE END OF ECONOMIC EXPANSIONS: TELLTALE SIGNALS OF CHANGE

BY JOSEPH BRUSUELAS

THE U.S. ECONOMY is signaling that the decadelong business cycle upswing following the global financial crisis, and the Great Recession is nearing—or might have already reached—its apogee. This should be recognized as neither good news, nor a surprising development, given the proliferation of risks to the outlook. The monetary authority appears to have shifted the focus of policy from responding to a growing economy (and the effects of unconstrained fiscal policy) to responding to spillover from a global economic slowdown, as well as further disruption to a domestic and foreign enterprise brought on by continual threats to the global supply chain linked to trade policy. We now anticipate that the Federal Reserve will move to cut the federal funds rate by 50 basis points before the end of the year in an attempt to provide a cushion for an economy that is decelerating amid slower hiring and wage growth.

Timing is everything

It's safe to say that inertia is almost always a factor when forecasting economic cycles and when making investment decisions based on those expectations. After all, it's human nature to make personal or business judgments based on past experience, extrapolating the future from the current environment.

Unfortunately, a business decision to expand capacity can take years to implement, only to find that technology and tastes have moved on or that the demand for additional goods has been dampened by unforeseen events such as the oil shortages or financial crises that have distorted economic growth in the modern era. Invest in the face of a downturn, and capital will be underused and unprofitable. Fail to invest in the face of an upturn, and risk losing market share and potential profits to competitors. This is a sustained management challenge for businesses of all sizes, including the middle market.

The current business-cycle expansion is just days shy of becoming the longest in the modern (post-World War II) era. That alone lends to the adage that all good things must come to an end. But there are also indications in the financial markets and the real economy that conditions for a downturn are falling into place.

The following sections explore some of those signals, the estimated probability of a recession, and how it might affect expectations of further investment.

INVEST IN THE FACE OF A DOWNTURN, AND CAPITAL WILL BE UNDERUSED AND UNPROFITABLE. FAIL TO INVEST IN THE FACE OF AN UPTURN, AND RISK LOSING MARKET SHARE AND POTENTIAL PROFITS TO COMPETITORS. THIS IS A SUSTAINED MANAGEMENT CHALLENGE FOR BUSINESSES OF ALL SIZES, INCLUDING THE MIDDLE MARKET.

Signal #1: An inverted yield curve

Financial markets have been anticipating a slowdown for the past seven months. The government bond market yield curve has become inverted since the third quarter of 2018, with money market rates moving higher than the yield on 10-year Treasury notes (see Figure 1). While not necessarily forecasting a recession in the months ahead, the bond market is signaling that the conditions necessary for a downturn are in place. The bond market is now anticipating that the Federal Reserve will seek to avert the onset of lower growth by cutting short-term interest rates in hopes of stimulating investment and consumption.

Signal #2 – A downturn in the leading economic indicator

In the real economy, recent data releases suggest a climate of slower growth. The Conference Board's Leading Economic Indicator, a composite of trends in manufacturing orders, labor-market activity and consumer spending (as well as the financial sector), has been trending down since the third quarter of 2018, suggesting a pivot point for the economy (see Figure 2).

While the economy is far more complicated than the 10 components that comprise the leading indicator, it is a useful tool to ascertain where the economy is going. While the intent of The Conference Board is to provide estimates of the turning points in economic activity rather than to present a forecast of future growth, we can, nevertheless, argue that the leading indicator is pointing toward gross domestic product growth centered on a 1% rate.

Figure 1

Changes in the U.S. Treasury yield curve since Q4 2018

TREASURY YIELDS AS OF NOV. 7, 2018 AND JUNE 10, 2019

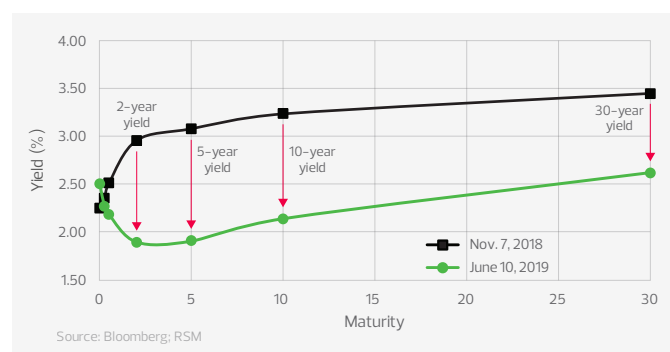
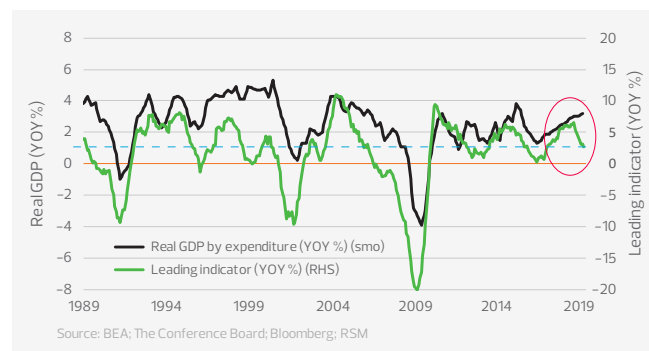


Figure 2

Real GDP and leading economic indicator

YEAR-OVER-YEAR PERCENT CHANGES



Signal #3 – Reduced wage growth

Wages likely peaked at 3.43% in the current cycle, which should signal to businesses that a broader slowdown is in train. On a three-month, average annualized pace, wage growth slowed to 2.73% in May, which implies a much slower trend than the top line, and is down for three straight months. With hiring in the household survey, which is used to estimate the unemployment rate, having only added 10,000 jobs over the past three months, it is likely that the unemployment rate will begin to rise in coming months.

Figure 3

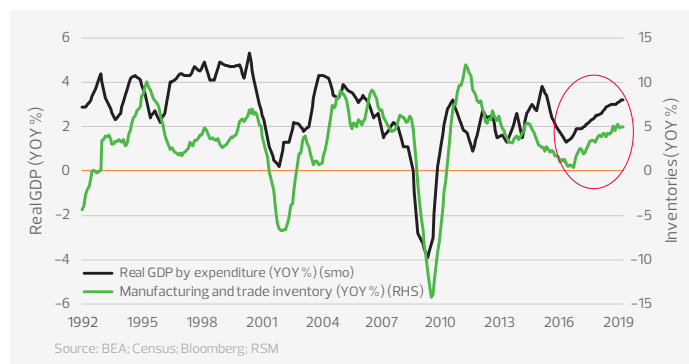
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Source: NBER; BLS; Bloomberg; RSM

Figure 4

Real GDP growth and manufacturing and trade inventories

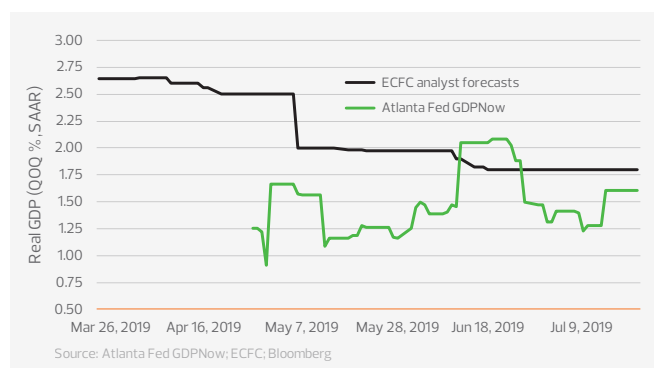


Signal #4 – Slipping into a low-growth profile

Real GDP in the first quarter increased by 3.2%, arguably a robust rate of growth so late in a business cycle. But there is lots of room for interpretation, with about two-thirds of that increase due to “a huge inventory buildup, a substantial decline in imports, surprising strength in exports and a bulge in state and local spending due to road repairs associated with this winter’s storms,” according to professor David Shulman in a June 2019 report by the UCLA Anderson Forecast.

Figure 5

Evolution of forecasts for U.S. Q2 real GDP growth



The consensus among analysts was that the 5% first-quarter inventory growth rate was outsized (see Figure 4), and we would argue perhaps transient, with inventory stockpiling leading to reduced production in coming quarters if future consumption outlays are reconsidered. Disregarding the one-off surges in inventories and other sectors listed above, the UCLA analysis suggests the core economy grew by only 1.2% in the first three months of the year. This supports our call and the interpretation of the leading economic indicator that the real economy is decelerating in a manner not reflected by top-line growth.



Looking forward, the Federal Reserve Bank of Atlanta's GDPNow estimate for second-quarter real GDP growth jumped from 1.4% on June 6 to 2.1% as of June 14 and then back down to 1.6% on July 16–17 on slow residential construction data (see Figure 5). Note that the GDPNow model reacts to the staggered release of economic indicators and will, therefore, move as the quarter progresses and new data becomes available. Also note that the range of estimates from the Bloomberg survey of economic analysts has moved lower from 2.65% early in the quarter to a median forecast of 1.6% for second-quarter growth. Initial government estimates for Q2 growth will be released on July 26 as we go to press.

Slipping into a 1% growth range appears to be a significant threshold. Like the inverted yield curve we discussed above, 1% growth suggests a climate ripe for an economy to slip into recession. As shown in Figure 6, economic growth leading into a recession can often be at high rates, like garbage time at the end of a basketball game, with benchwarmers jacking up threes and tomahawk jams.

Figure 7

Real GDP growth at the end of business cycle uptrends

Business cycle uptrends	Business cycle peak date	Business cycle through date	GDP growth in 1st quarter of downturn (YOY%)	GDP growth in 2nd quarter of downturn (YOY%)
Post-Kennedy/Great Society boom	Dec 31, 1969	Nov 30, 1970	2.0	0.3
Post-Vietnam boom	Nov 31, 1973	Mar 31, 1975	4.0	0.6
Post-Stagflation boom	Jan 31, 1980	Jul 31, 1980	1.4	-0.8
1980s Double-dip/Volcker recession	Jul 31, 1981	Nov 30, 1982	4.3	1.3
Post-Reagan/Bush expansion	Jul 31, 1990	Mar 31, 1991	1.7	0.6
Post-Dot-com boom	Mar 31, 2001	Nov 30, 2001	2.3	1.1
Post-Housing global financial crisis	Dec 31, 2007	Jun 30, 2009	2.0	1.1
Average growth rates			2.5	0.6

Figure 6

Real GDP growth at the end of economic booms/recoveries

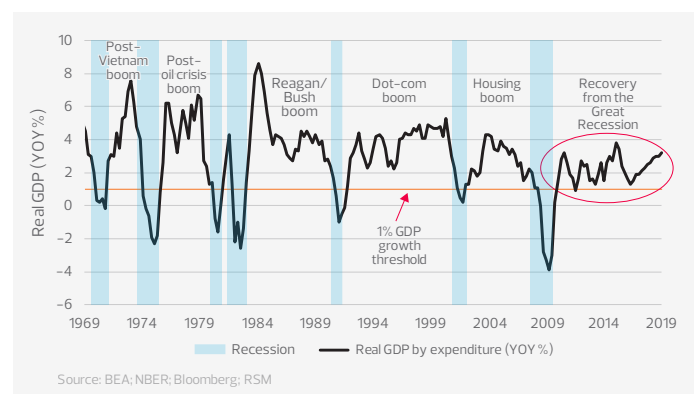
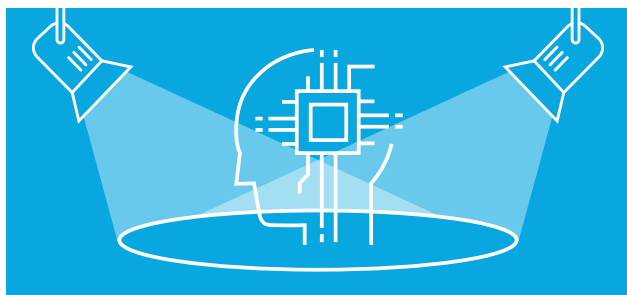


Figure 7 shows that average growth rate during the first quarter of modern-era downturns was 2.5%, with a range of 1.4% to 4.3%. But growth in the second quarter of the downturn has averaged only 0.6%, with a range of -0.8% to 1.3%. So if the core economy grew by only 1.2% in the first quarter, and if the overall economy were to grow by only 1.4% in the second, then the table would be set for an event (Brexit perhaps, or repercussions from the U.S.-inspired trade war with its allies and with China) to push the economy into outright recession. ■



TECHNOLOGY

INDUSTRY SPOTLIGHT

SLACK IS ANYTHING BUT IN ITS NYSE DIRECT LISTING

BY KURT SHENK

A NUMBER OF HIGHLY anticipated tech initial public offerings took place in the first half of 2019. But Slack, the workplace chat company debuting on the New York Stock Exchange last month, chose a direct listing. Is this approach, also taken by online music platform Spotify in 2018, becoming a trend?

IPO vs. direct

With high rates of cash burn, executives of emerging technology companies have historically chosen the IPO route, which offers a chance to raise capital with newly issued public shares and replenish the coffers. Slack, however, chose a direct listing approach, giving its early private investors liquidity and the opportunity for a premium from the public market.

At this point, the strategy seems like a good bet. Slack, trading under the ticker WORK, closed at \$38.62 recently, a premium of nearly 50% over the company's listing reference price of \$26 a share on the NYSE, as reported by the *Wall Street Journal*. In comparison, Spotify's direct listing reference price was \$132, but the stock opened north of \$165 per share.

Unlike a traditional IPO, a stock that launches through a direct public offering arrives on a public exchange without the pomp and circumstance of a roadshow to woo would-be investors. No investment banker is enlisted to determine how much stock to sell and at what price—something that can cost a company about 7% of its IPO proceeds. There is no risk of dilution of the stock, since no additional shares have been issued.

Executives of technology companies generally have not had difficulty raising late-stage capital in recent years, so a direct listing also offers the chance to increase market capitalization over time, as the markets have typically sent tech shares higher. (Stock in Apple, which went public in 1980 at \$22 a share, is now valued at nearly \$200 a share, with a total market capitalization of nearly \$918 billion.)

A direct listing is not without risk, however, and could result in significant volatility in the listing company's stock price. That's why technology company leaders are keeping a close eye on Slack's performance.

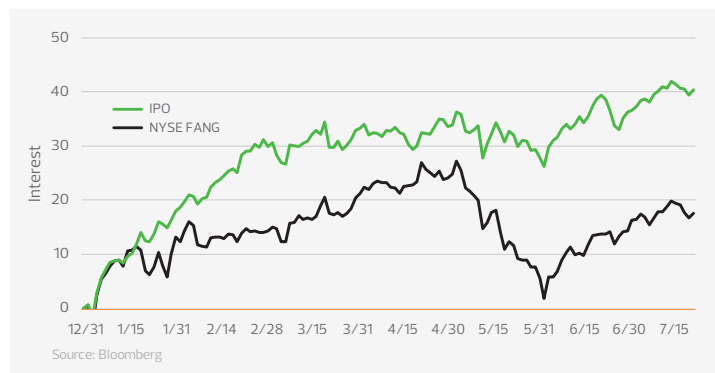
A good year to date for tech offerings

After the government shutdown in the first quarter, which delayed some IPOs, a number of technology unicorns appeared on the public markets. Uber, Lyft, Pinterest, Zoom Video Communications and CrowdStrike—all with valuations in excess of \$100 billion—have made it a good year to go public so far.

Zoom Video Communications and CrowdStrike have fared the best, doubling their share prices since their market debuts. Recently, the IPO of the cybersecurity firm CrowdStrike performed particularly well; after debuting at \$34 a share, it is now trading around \$75.

Figure 1

U.S. IPOs vs. NYSE FANG stocks



So far this year, Bloomberg's Renaissance IPO index, which tracks IPO performance, is greatly outpacing the NYSE FANG Index, which measures performance of well-known tech giants (see Figure 1). If the uncertainties plaguing big tech companies around trade and privacy continue, however, it's possible the new tech darlings will widen this spread.

The unicorn song

So what's behind Slack's \$15 billion valuation? In five short years, the company has been able to sign 600,000 customers onto its communication platform; in the last four quarters, it has had customer growth of 49% (see Figure 2). In addition, according to Bloomberg, Slack's premium valuation may be due to its higher sales growth expectation versus their software peer group. In July, Slack had traded at about 20 times enterprise value to fiscal 2021 consensus sales multiples.

And while the public market paths of Slack and Spotify may not yet signal a trend, it is possible that other tech unicorns could go public through direct public offerings, particularly if Slack's entrance to the NYSE is well-received by the capital markets. Established tech companies like online lodging platform Airbnb that have had access to private capital over many years and enjoy a strong brand reputation, are undoubtedly considering the possibility of a direct listing as well. Time will tell. ■

Figure 2

\$M	2018	2019	2020	2021	2022
Paid DAUs	3.5	5.2	7.3	10.2	13.8
Annualized growth	83%	48%	42%	40%	35%
Revenue (\$)	401	599	859	1,214	1,656
Annualized growth	82%	49%	43%	41%	35%
Revenue per DAU (\$)	115	116	117	118	120
Inflation	1%	1%	1%	1%	1%
DAU growth	83%	48%	42%	40%	35%

Source: Slack; PitchBook

MMBI FINDINGS INDICATE BUSINESSES ADJUSTING TO SLOWDOWN IN GROWTH

Middle market business sentiment staged an impressive recovery in the second quarter, as the proprietary RSM US Middle Market Business Index rose to 132.3 from 124.1 in the prior period. The positive outlook was bolstered by robust revenue and earnings expectations along with a modest economic upturn and strong rebound in equity prices.

However, MMBI findings also indicated businesses are in the process of adjusting to a deceleration in growth as the economy comes down from the high that followed 2018's federal tax cut. In the special questions portion of the MMBI survey, which focused on labor issues, companies denoted a reluctance to engage in aggressive hiring, in part due to the reduced supply of willing and available workers.

Learn more in the [full report](#).



MIDDLE MARKET TREND WATCH



CYBERTHREATS ARE UBIQUITOUS

WE'RE KEEPING an eye on the biggest issues affecting the middle market. For this issue, we examine the threat of cyberattacks on middle market businesses. Data provided from RSM US Middle Market Business Index Cybersecurity Special Report. For more, download the [full report](#). ■

Over one-third of middle market executives know someone that has suffered a ransomware attack, compared to **31%** in 2018, while **20%** have suffered an attack themselves.

Fifteen percent of middle market companies experienced a data breach in the last year, up from **13%** in 2018 and a significant jump from **5%** just four years ago.

Larger middle market organizations continue to be most at risk for cybercrime, as many have high volumes of valuable data but don't have the robust security resources of their large-cap peers, making them exceedingly attractive to cybercriminals.

Social engineering has also become prevalent, with **42%** of executives reporting social engineering attempts on their organizations.

More than half of middle market executives believe that an attempt to illegally access their company's data or systems is likely in 2019, an increase from **47%** in 2018.

KEY TAKEAWAY: The growing confidence of middle market leaders over their companies' cybersecurity measures conflicts with research that shows they need to remain diligent. While the number of reported breaches has tripled over the last five years, the majority (**93%**) of executives are confident in their organization's security measures.

RSM AND UCLA ANDERSON FORECAST PARTNER TO BOOST MIDDLE MARKET INTEL



BUSINESSES CAN EXPECT to gain enhanced economic insights thanks to a new partnership between RSM US LLP and UCLA Anderson Forecast, a quarterly economic outlook for California and the nation. As a strategic partner, RSM will provide essential support for the Forecast conferences, publications and research, and help maintain important connections to the business community.

Topics covered by the Forecast span city growth and the cost of living, the state of the retail industry, economic growth amid political volatility and the lower corporate tax rate. The Forecast's quarterly conference typically draws more than 300 prominent decision-makers from business, government and academia. Speakers have ranged from Peter Guber, the CEO of filmmaker Mandalay Entertainment to California Governor Gavin Newsom.

"This strategic relationship will not only expand the reach of our own economic insights," says RSM's

Chief Economist Joe Brusuelas, "but it will also allow us to glean information from other economic and business professionals."

RSM will gain exposure to the quarterly Forecast and have the opportunity to meet with a cross section of influencers from across the nation to discuss economic trends, furthering the reach of the firm's own economic analysis, while gaining valuable insights to help clients anticipate and address issues facing their businesses.

To kick off the partnership, RSM sponsored the UCLA Anderson Forecast's June 2019 Economic Outlook at the UCLA Anderson School of Management, which focused on interest rates, housing, homelessness and employment.

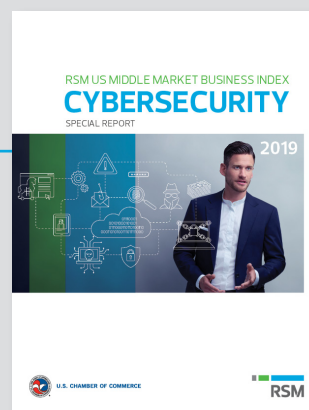
Stay tuned for future issues of The Real Economy as we share relevant Forecast data and insights, as well as what it means for middle market businesses. ■

RESEARCH SHOWS MIDDLE MARKET CYBER-RISK

Nearly 50% of midsize companies expect they will face unauthorized users attempting to breach their data or systems this year, according to executives RSM surveyed. Despite incidents of rising cybercrime, just half of the businesses surveyed carry cyber insurance policies to protect against internet-based risk. Our study shows that many of those policies may fall short of comprehensive coverage.

Meanwhile, the C-level executives we surveyed may be overly confident in their firms' internal abilities to thwart an attack. Some 93% of respondents were confident in their organizations' ability to safeguard customer data. The reality—based on actual incident reports—is proving that confidence may be misguided.

Learn more in the [full report](#).



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