

THE REAL ECONOMY

VOLUME 48



**ECONOMIC GROWTH
EXPECTED TO
MODERATE IN 2019**

ALSO IN THIS ISSUE:

UPDATES BY INDUSTRY

HOW TARIFF EXEMPTIONS WORK



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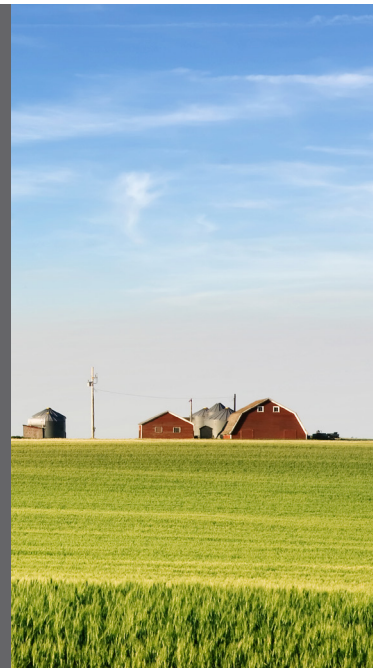
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MODERATE ECONOMIC
GROWTH EXPECTED
IN 2019 AS

URBAN-RURAL PROSPERITY GAP WIDENS



By Joseph Brusuelas

A hot U.S. economy will likely cool noticeably in 2019 as the combination of receding fiscal stimulus, higher interest rates and a rising annual operating deficit begin to increase the cost of doing business. We anticipate that a temporary 0.7 percent economic boost from the 2017 Tax Cuts and Jobs Act (TCJA) will diminish next year, pushing annualized GDP growth back toward 2 percent before returning to a long-term trend of 1.8 percent in 2020.

Economic activity, employment, wage growth and inflation remain uneven. The mounting urban-rural divide is likely to be exacerbated in coming years as cities closely linked to the new economy (with jobs and skills related to technology, life sciences, finance and trade) see growth, productivity and wages expand at a faster pace than rural areas that remain linked to the traditional economy of manufacturing and agriculture. While many sectors of the economy will experience hot growth in 2019, those that lag behind will have very different policy demands and expectations.

Economic growth in 2018 was largely defined by strong consumption fueled by a historically tight labor market. Next year, the defining economic narratives are likely to be continued trade tensions, more (possibly four) Federal Reserve interest rate hikes, a further decline in the unemployment rate to 3.4 percent and wage growth of 4 percent.

Our 2019 year-ahead forecast calls for a modest growth of 2.2 percent from our 2018 forecast of 3.1 percent. With 2019's impending deceleration comes the risk of a much more pronounced slowdown in overall economic activity due to the intensification of the U.S.-China trade spat despite a potential 90-day cease-fire agreed upon by the two governments.

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Our baseline forecast expects the consumer to be the primary driver of growth in 2019, as government spending eases significantly by midyear. We also anticipate a larger drag from the trade deficit on the back of a stronger dollar amid solid household consumption.

The alternative to our baseline forecast is a faster move back toward prior-trend growth of 1.8 percent as the Fed moves into a restrictive policy stance due to rising inflation risks linked to increasing wages and a potential full-blown trade war between the United States and China.

Government spending, which has been the second major driver of growth, will ease in 2019. By the end of the year, about \$126 billion in temporary expenditures linked to the TCJA and the 2018 federal budget will expire, weighing on economic activity in the final quarter before spilling over into 2020.

We do not expect a corporate-led boom in capital expenditures to [materialize](#). Rather, the lagged impact of the first phase of the trade spat via import prices diminished capital expenditures in the oil, energy and mining sectors. The likely expansion of the trade spat with China and possible tariffs on all auto imports will create an unnecessary layer of economic uncertainty during the year ahead that will result in a diminished investment outlook.

It is important to note that an intensification of the trade spat is a policy choice that could be reversed at any time, which would result in upgrading our growth forecast for the year.

Employment

Businesses shouldn't anticipate any relief on the hiring or wage front next year as the historically tight labor market continues apace. We expect the unemployment rate to fall to 3.4 percent by the end of the year and the economy to generate around 155,000 jobs per month. Supply challenges in the labor market will lead to faster wage growth during the next 12 months, culminating in a 4 percent increase in wages and salaries by the end of the year. Wage growth currently sits at 3.1 percent; however, the three-month annualized pace of growth is now 3.6 percent, and we expect that this late-2018 acceleration will become the primary economic narrative during the first half of 2019.

Financial conditions and interest rates

The Federal Reserve will increase its policy rate by 25 basis points at its Dec. 19 meeting, and likely raise rates four more times next year in increments of 25 basis points. The combination of rising wages, fiscal policy and inflation will lead the central bank to push the federal funds rate toward 3.5 percent by the end of 2019. While that may be neutral terrain for the large multinational firms, in our estimation, it is restrictive for the small- and medium-sized businesses responsible for the lion's share of job creation and growth during this cycle. Given growing global risks, we would not be surprised to observe a midyear pause in the Fed's normalization policy campaign. In fact, we think it would be in the best interest of middle market companies.

MIDDLE MARKET INSIGHT

Middle market businesses, which often self-finance or participate in the shadow banking industry, should expect a noticeable tightening of financial conditions in 2019 because of central bank policy.

U.S. financial conditions remain 1.3 standard deviations above neutral and are supportive of growth, but have tightened considerably since mid-2018. From a global

perspective, financial conditions in Europe are modestly supportive. In Asia, excluding Japan, they are 1.5 standard deviations below neutral, implying a net drag on growth in what had been the most dynamic region of the global economy. This will result in a sustained safe haven move into dollar-denominated assets, which will act to suppress the long end of the yield curve.

We expect the yield on the 10-year rate to end 2018 near 3.5 percent while trading in a range between 3.25 and 3.5 percent next year. If the Fed does not pause its rate hike campaign by midyear, the U.S. yield curve may invert in the second half of 2019. Because the term premium on the 10-year yield is negative, if global risks intensify, we expect a more pronounced safe haven move into dollar-denominated assets, further suppressing yields at the long end of the curve.

Inflation

The gyrations in oil markets that close out 2018 figure to be the major driver of inflation during the first six months of 2019. Inflation will likely ease in top-line estimates that include volatile energy prices, even as it increases for businesses. The U.S. consumer price index currently stands at 2.5 percent, the personal consumption expenditure deflator index at 2 percent and the core personal consumption expenditure (PCE) deflator (the policy variable used by the central bank), all point to general price stability. Even so, it is our contention that the Fed will look right through the easing of prices and continue its rate hike campaign in early 2019.

Over the past year, RSM US Middle Market Business Index participants have noted they have begun to pass prices downstream to customers. Given the risks that U.S. trade policy poses for price inputs, this is setting up as a central theme to monitor in 2019.

Autos and housing

The two most interest rate-sensitive ecosystems are autos and housing. Both have already reached their cyclical peaks. This is of paramount concern to policymakers at the central bank as they look to achieve a soft landing for the U.S. economy as the current business cycle concludes. General Motors said in November it plans to cut five plants and eliminate 14,000 jobs in the United States and Canada, the result of its move to eliminate slow-selling sedans from its product line.

The U.S. auto sector, despite integrating advanced technology into the fleet, has reached its mature phase. Behavioral changes among the emerging demographic majority and the urbanization of the population are likely to alter the scale and scope of domestic auto production. The updated NAFTA treaty, now known as USMCA, creates

2019 ECONOMIC GROWTH continued.

Tracking U.S. GDP



Source: RSM US LLP, Bloomberg

incentives for the large automakers to shift new supply chain investment toward the large growth markets in China and India.

The new rules of origin requirements in USMCA, if approved, along with the evolving wage floor, will result in a bit of sticker shock to domestic auto buyers during the next 12 to 24 months, all of which point toward a much slower pace of auto production in 2019 and 2020. We expect sales to fall back to a pace of 16.5 million annually with risk of a much slower production and sales, especially in the second half of next year.

Meanwhile, new housing investment has remained at 1.25 million annualized units, well below the long-run equilibrium of 1.5 million units. With clear affordability issues mounting due to a lack of inventory, we expect to see one of the softer years in the property market during the current economic expansion. Our interest rate forecast implies a near-term move above 5 percent in the 30-year mortgage rate, which will only exacerbate stresses in the market.

A lack of available units, shortage of available workers with construction skills and an onerous zoning and ordinance framework that adds to building costs will continue to characterize a disappointing residential investment market. We expect residential investment to slow to 1.17 million units in 2019.

Risks to outlook: Domestic and external

The major risks around our economic outlook are linked to trade tensions, a slowing global growth picture, emerging markets, Brexit and the Italian fiscal challenge.

These would negatively affect pricing for middle market businesses across all ecosystems. So far, the Chinese have permitted their currency to depreciate by about 11 percent, thus offsetting the 10 percent U.S. surcharge on exports to the United States. If the United States increases tariffs to 25 percent, there is a risk that the trade spat will turn into a full-blown trade war that would include the use of financial weapons. If that happens, pronounced threats to our growth, employment and inflation forecasts would result.

MIDDLE MARKET INSIGHT

A small hint of a silver lining in the ongoing trade dispute: some middle market businesses are now reporting success in gaining exemptions from the U.S. Trade Representative's office. (See article: Tariff exemptions for middle market slowly increasing)

Global economic growth should slow to 3.3 percent this year amid a growing series of risks. The level of dollar-denominated debt has increased to \$11 trillion from \$3

Key economic indicators

Recession probability 15%									
	Q1'18	Q2'18	Q3'18	Q4'18	Q1'19	Q2'19	Q3'19	Q4'19	Q1'20
Real GDP	2.6	2.9	3	3.1	2	2.5	2.8	2.3	1.9
Unemployment	4.1	3.9	3.8	3.7	3.6	3.5	3.3	3.2	3.2
CPI	2.2	2.7	2.6	2.4	2.2	2.3	2.4	2.4	2.5
PCE core	1.8	1.9	2	2	2	2.1	2.2	2.2	2.3
Central bank rate	1.75	2	2.25	2.45	2.7	2.75	3	3.1	3.1
Three-month rate	2.31	2.34	2.4	2.68	2.85	3.05	3.2	3.27	3.3
Two-year rate	2.27	2.53	2.82	2.95	3.05	3.16	3.24	3.28	3.32
10-year note	2.74	2.86	3.06	3.2	3.3	3.36	3.41	3.44	3.53
EUR/USD	1.23	1.17	1.16	1.15	1.16	1.18	1.2	1.2	1.2

Source: RSM US LLP

trillion over the past decade. As U.S. interest rates rise, economies with large portfolios of dollar-denominated debt will find it quite difficult to service it. Those economies holding large portfolios of dollar-denominated debt relative to GDP—Turkey, Mexico and South Africa—are the bellwethers for risk around emerging markets.

There are two transmission channels for emerging markets' economic problems: trade and financial. For example, if there is a move by Turkey to renegotiate its debt or possibly even default, the contagion will spread into the European Union quite quickly via trade, and into financial markets in Spain, Germany, France, Italy and the U.K.

Fiscal policy

In the 2018–2019 fiscal year, which runs from Oct. 1, 2018 to Sep. 30, 2019, the U.S. government is likely to embark on a multiyear period of trillion-dollar annual operating deficits. This fiscal year the deficit is on target to hit \$1.3 trillion, at a minimum.

Unfortunately, there is no constituency on either side of the aisle in Washington, D.C. for fiscal probity. As long as global economic risks proliferate, there will be a safe haven move into dollar-denominated assets, which permits the United States to have its cake and eat it too ... for at least a while longer. Call it America's Marie Antoinette moment.

However, moments come and go, and at one point, there will be a positive risk premium placed on the neutral interest rate, which will lead to a much more expensive cost of running large government deficits.

MIDDLE MARKET INSIGHT

Deficits that crowd out investment and cause interest rates to increase are a risk to the vitality of middle market businesses due to their financing and investment needs.

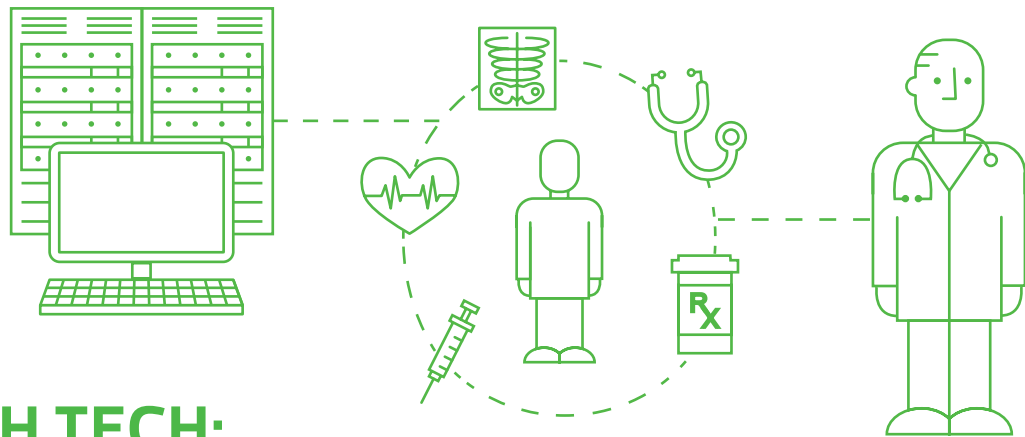
We would recommend putting the fiscal path on a more sustainable pace by attempting to balance the primary U.S. budget (budget excluding interest owed on past debt) during a period of above long-term trend growth. However, with the United States running the most pro-cyclical fiscal policy in recent memory, rather than a narrowing deficit, which would traditionally be seen late in the business cycle, the economy is about to enter a period of multiyear trillion-dollar deficits



UPDATES BY INDUSTRY

Next year promises to bring important technology improvements to a range of industry sectors. Artificial intelligence and machine learning are becoming important themes against the backdrop of record low unemployment, rising wages and challenges finding qualified workers. Meanwhile, rising prices on commodities such as steel and timber are forcing middle market companies to explore myriad ways to keep their costs in line as margin pressures increase.

From the use of blockchain to bring transparency to the consumer products supply chain to experiments with wearable technology that measures heart rate and other key vitals for health care providers, our industry analysts give you a preview of important industry trends worth watching.



HEALTH TECH: WILL YOUR DOCTOR BE IBM'S WATSON OR A WARM-BLOODED HUMAN?

By Kurt Shenk

Unemployment remains at historic lows and the cost of labor is rising. Health care costs approximate 20 percent of the GDP and double that of three decades ago. Some of the increase relates to baby boomers retiring and needing more care, but some is due to market inefficiencies. Great opportunities to leverage technology through artificial intelligence (AI) and machine learning (ML) exist within the industry. Given these shifts and advances, in the not-too-distant future of health care checkups, an IBM Watson-style virtual attendant, in addition to a real person, will likely greet you.

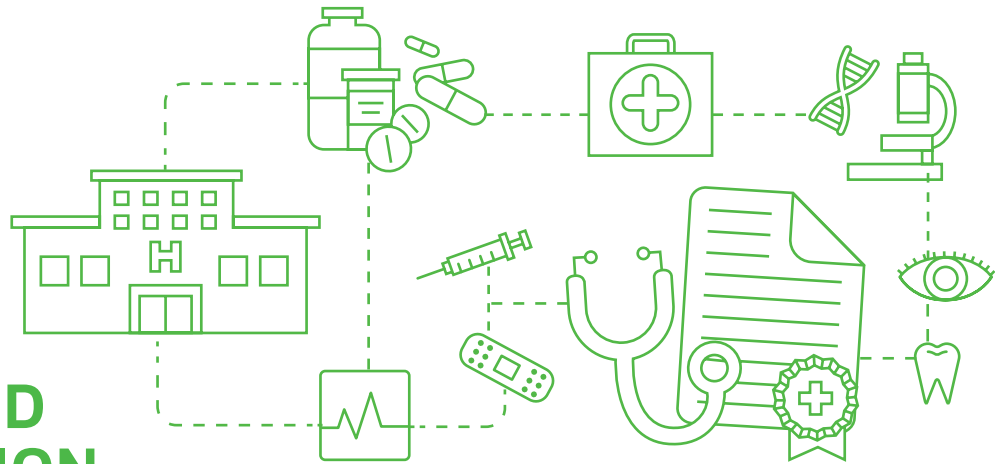
AI and ML thrive on large amounts of data, and there is no shortage of data in health care. At this point, much of that information is unstructured and fragmented across service providers, leaving the industry ripe for disruption. However, patient privacy and regulatory concerns also factor in.

Despite regulatory barriers, health care professionals can leverage AI and ML through virtual personal assistants, relying on them to help recall medical research, gather patient data and provide diagnostic recommendations. Studies have shown that AI and ML can be used to diagnose medical conditions such as tuberculosis and pneumonia with greater accuracy than a panel

of specialists. IBM's Watson Health, already used in a handful of hospitals, can identify 13 different types of cancers, a number that is increasing. Chat bots—the computer programs that simulate auditory or textual conversations—can be leveraged for initial patient screening that limits wasted visits to physicians. And, with the use of wearable technology that relies on AI, doctors can monitor vitals and deliver personalized health care. AI can also be deployed outside of the doctor's office to diagnose conditions like skin cancer with great accuracy.

Significant opportunities exist to use deep learning—a machine learning method that relies on interpreting data representations—for the development of new drugs. With AI and ML, drug development will speed up, become less costly due to lower failure rates and be brought to market more seamlessly than before. Additionally, as the health care industry leverages industry data in additional ways, personalized health care solutions of the future are expected to greatly aid doctors as they diagnose and treat their patients.

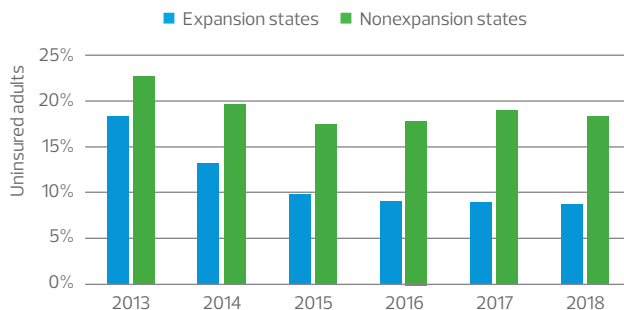
MEDICAID EXPANSION TO LIFT HEALTH CARE IN 2019



By Matt Wolf and Rick Kes

Four states—Idaho, Nebraska, Utah and Montana—included Medicaid expansion on their ballots in 2018's midterm elections. Montana's ballot item was a renewal of expansion, which failed; the three other states saw Medicaid expansion initiatives pass, and we expect health care providers in those states to benefit in 2019.

Impact of Medicaid expansion



Source: U.S. Dept. of Health and Human Services

In addition, a few states saw party changes in their gubernatorial elections. In Kansas and Wisconsin, for instance, newly elected Democratic governors now make expansion possible.

Data from the Centers for Disease Control and Prevention show that states with Medicaid expansion have about half the uninsured adults of states without it, a trend that positively affects health care providers in states with the expanded government benefit. In addition to a favorable impact on organizations such as hospitals and physicians' practices, we would also expect to see an increase in private equity investments related to behavioral health companies such as those that address substance abuse for Medicaid enrollees.

BETTER DATA USE HAS PROS AND CONS FOR LIFE SCIENCES IN 2019

By Matt Wolf

The volume and variety of health care data should expand significantly in 2019. Specifically, we will be monitoring growth in data sources outside those collected from traditional electronic health records, including information gleaned from wearable technology and direct-to-consumer genetic testing.

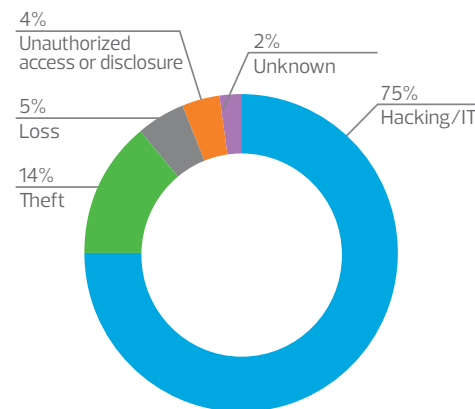
Life science companies should consider how best to leverage this growing trove of information as they seek to more quickly bring effective and personalized therapies, drugs and devices to market, while simultaneously managing inherent cybersecurity risks. The global personalized medicine market is expected to reach \$194.4 billion by 2024 from an estimated \$92.4 billion in 2017, according to research from ResearchandMarkets.com.

Data is the fuel that powers artificial intelligence and machine learning, which both represent significant opportunities for life science. A recent [study from Carnegie Mellon](#) suggests that AI could reduce the cost of drug development by 70 percent. The technology is already capable of shortening the lead-time required to source candidates for cancer treatment clinical trials to mere weeks from years.

Data, however, also represents a liability. Not only is medical information highly regulated by HIPAA, HITECH, GDPR and other laws, it is also extremely valuable. A 2013 report issued by the FBI estimates that medical data is 50 times more valuable than social security numbers to bad actors on the black markets of the internet. The Department of Health and Human Services estimates that hackers—not theft or careless employees—are responsible for 75 percent of health care data breaches involving 500 or more individuals.

We expect middle market companies to leverage this opportunity through strategic alliances with contract research organizations or other partners. In fact, based on a recent survey we jointly conducted with the Center for Business Intelligence, nearly 80 percent of development companies employ these relationships. Unfortunately, these arrangements do not necessarily limit the liability related to a data breach or cyberattack. The regulatory environment generally implicates partners and business associates in such incidents. We will continue to monitor the relationship between the risks and opportunities big data presents to the middle market life sciences sector in 2019 and beyond.

Health care breaches reported to HHS involving 500 or more individuals



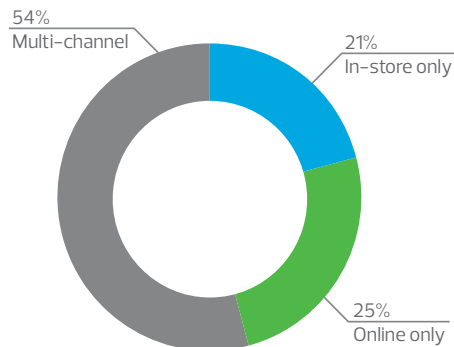
Source: U.S. Dept. of Health and Human Services

HEALTHY 2019 RETAIL SPENDING LIKELY TO BE OFFSET BY TARIFFS, LABOR COSTS

By Chris Shaker

As economic momentum carries over into next year, the driving forces in the retail sector include consumer spending, tariffs and labor. Spending should remain strong well into 2019, allowing for healthy top-line performance for most retailers. However, managing margin and costs will become a strategic focus for middle market retail companies as they face higher costs.

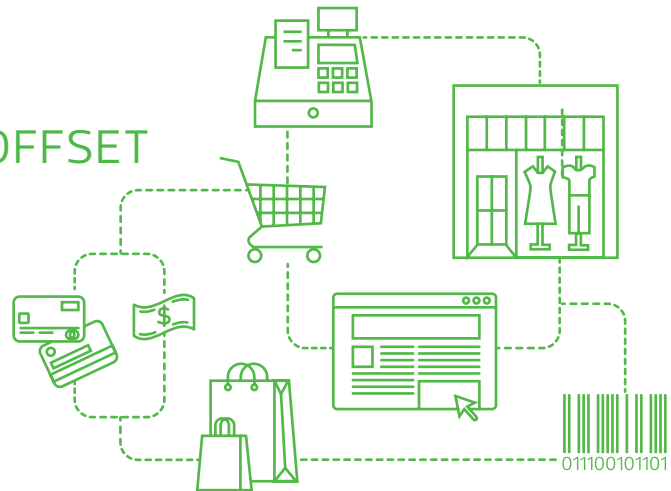
Thanksgiving weekend shopping by channel



Source: National Retail Federation

All signs point to unemployment remaining at historic lows and wages continuing to rise, creating challenges for retailers trying to closely manage costs against the backdrop of uncertainty with respect to tariff rates in 2019. There is no guarantee that tariffs will not still increase in 2019 if a compromise is not met within the 90-day window set by the administration. If tariffs do increase, retailers will pass some of the additional expense through to customers in the form of price increases; however, a portion of the additional costs will inevitably be absorbed throughout their supply chains.

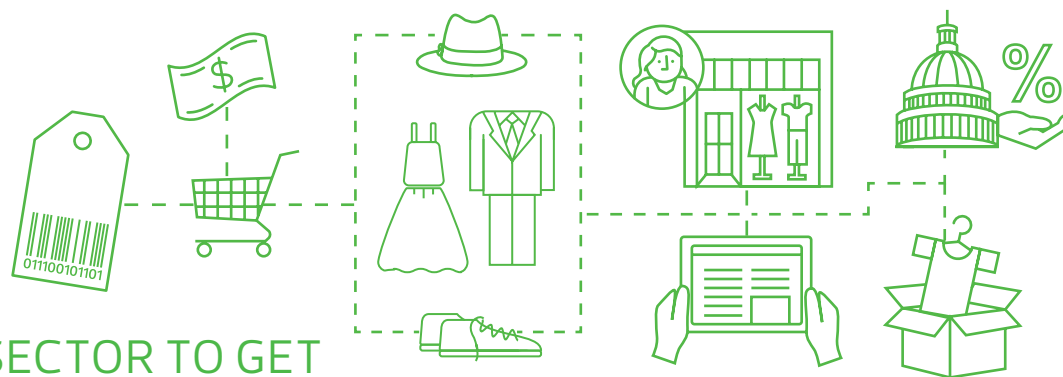
Labor costs have traditionally been one area to scrutinize when managing the bottom line amid tightening margins. During 2018, many middle market retailers kept their staffing levels consistent throughout the year, rather than slimming down in slower periods, fearing they wouldn't be able to staff up fully in time for the holiday season. Even so, many retailers—as well as fulfillment



centers and delivery companies—entered the season understaffed. The shortage of workers throughout the supply chain, in many cases, had a negative impact on the overall customer experience, and likely resulted in lost sales, or even worse, lost customers. With the continued shortage of qualified workers, we expect a similar approach to staffing by retailers in 2019; as a result, managing labor costs is one lever that will be very difficult to pull.

In 2018, research from the RSM US Middle Market Business Index indicated that middle market companies were slow to make capital expenditures. Their inability to squeeze savings out of labor costs, coupled with economic uncertainty stemming from the ongoing trade spat with China and other external factors, likely means they will remain hesitant to invest in 2019. However, finding a balance between managing costs and investing in a digital strategy that will satisfy tech-savvy consumers will be critical for middle market retailers in the coming year.

In the middle market, many retailers have been investing in omnichannel strategies to try to keep up with big-box competitors for some time. The most successful companies have realized that upgrading technology is a continuous process, not a one-time investment. Having a sophisticated website with real-time inventory and a loyalty program that tracks customers throughout their digital shopping experience was considered fairly advanced not too long ago. However, during the 2018 holiday shopping season, consumers showed a preference for purchases made on mobile devices versus desktop computers. A mobile friendly customer experience requires different technology. Middle market retailers that commit to a long-term strategy of investment in their digital experience throughout the supply chain will be the ones destined to succeed.



FASHION SECTOR TO GET LIFT FROM SPENDING AMID TRADE AND LABOR CHALLENGES

By Chris Shaker

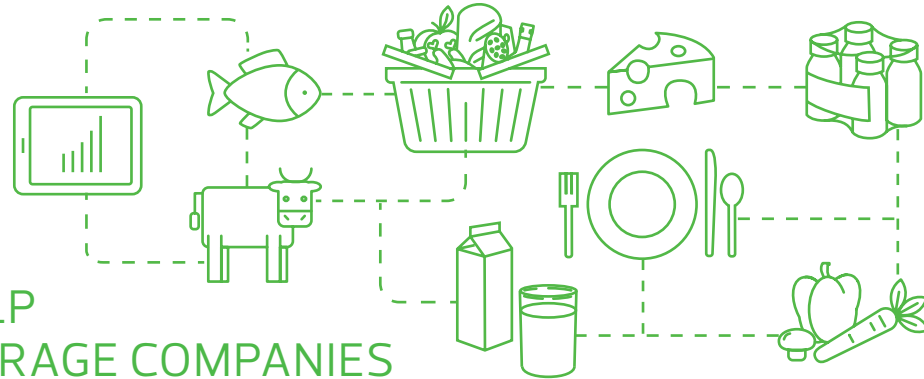
Consumer confidence and spending created some momentum for the fashion sector in 2018. Continued strong consumer confidence, along with the threat of trade regulations and a tight labor market, will be dominant themes for the sector—and the broader retail space—heading into 2019.

In 2018, apparel retailers saw sales rise 7.5 percent for the week of Black Friday ended Nov. 24, compared to a year earlier. The overall increase in retail sales during the same period was just .5 percent, indicating that despite ongoing migration to online transactions, brick-and-mortar stores are still very relevant in the fashion industry.

Amazon remains a threat, as it continues its push into fashion. Amazon's infrastructure provides distinct advantages over middle market competitors. Its ability to collect and analyze data to meet the ever-changing preferences of today's consumer is a significant asset that helps it capture even more market share. Amazon has also perfected speed through its supply chain, which has also been a focus for many of the big names in fashion, including Macy's and Kohl's. Middle market fashion brands and retailers that offered a compelling shopping experience using features such as augmented reality were able to maintain market share and protect their brands in 2018. They must continue to present strong digital strategies to remain competitive next year.

The fashion sector will also need to heighten its focus on managing costs. The future of tariffs and the ongoing trade dispute with China will play a significant role in whether fashion companies importing from China can survive. Some expect they will be able to absorb an additional 10 percent cost increase resulting from the trade spat, especially if the cost can be shared with Chinese suppliers. However, an increase in tariffs to 25 percent may be too much for some fashion companies to shoulder, and could further strengthen disruptors such as Amazon as they continue to use artificial intelligence and data to help drive sales and reduce cost.

Creating an engaging consumer experience that showcases the brand becomes increasingly important—and more challenging in a tight labor market. With unemployment at record lows below 4 percent, labor remains tight in 2019, and wages will continue to rise. The labor shortage will challenge the entire supply chain, from manufacturers to distributors and retailers. It will be a challenge to find good help in stores, online, in the distribution center, on the design team and in the sample room. Many middle market fashion companies feeling the labor crunch have begun hiring longer-term and planning to keep more help on staff through the slower seasons to avoid difficulty finding qualified workers in 2019.



DATA TO HELP FOOD-BEVERAGE COMPANIES MANAGE CONSUMER TRENDS, BOOST TRANSPARENCY

By Victor Kao

The 2019 outlook for the food and beverage sector remains cautiously optimistic; however, macroeconomic trends and public policy headwinds make it increasingly important for middle market companies to pay close attention to consumer preferences, while leveraging technology to drive process improvements and optimization.

Margin pressures remain front and center due to increases in transportation expenses, wages and tariffs. Vendors absorbed unanticipated costs in 2018, but we expect costs next year to transfer further down the supply chain. With unemployment hovering at record lows, tightening labor markets have reduced the supply of available truck drivers, increasing transportation costs and adding to distribution challenges such as on-time deliveries. The recent decline in oil prices and futures should provide some margin relief.

Consumer tastes remain a moving target. But big data, analytics and artificial intelligence offer more transparency for companies to target consumers in 2019. We expect to see continued growth in healthy foods and organics; at the same time, however, on-the-go offerings remain popular amid demand for products that reduce meal preparation time such as packaged foods. Consumers are more conscious of lowering their intakes of sugar rather than sodium, with demand for salty snacks increasing as high-sugar products such as confectioneries and soda, declining. For the first

time, sales of bottled water surpassed soda due to the unexpected popularity of sparkling water. We expect to see more momentum and product diversification in 2019. The beer industry, for example, is developing alcoholic sparkling water and seeing an uptick in hard cider sales as an alternative to high-carb beer.

Technology played a large role in 2018, and will have an even greater impact in 2019. Although rising interest rates may slow down capital expenditures, it will be increasingly important for companies to strategize and prioritize technological investments to enhance and optimize cost efficiencies. Given the tight labor market and rising wages, we've seen more investment in robotics, process automation and enterprise resource planning.

Meanwhile, food safety will become increasingly important next year, as blockchain technology is deployed to improve traceability and transparency of an end-to-end supply chain. Tracing the origin of a product used to take weeks; now it takes a matter of seconds. Given the recent E coli outbreak in romaine lettuce, the FDA is set to place more emphasis on traceability of products to prevent further recalls.

Technology continues to be a differentiator. Businesses that understand their consumers, spend wisely and manage expenses will be well-positioned in 2019.



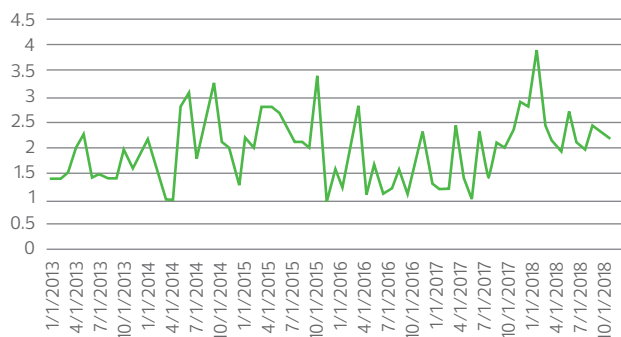
RESTAURANTS COULD CONTINUE MODERATE GROWTH IN 2019

By Alex Monahan

Restaurant performance in 2018 was characterized by moderate growth from increased ticket sales offset by slowing same-store traffic. We expect more of the same next year as consumers continue to demand convenience and value. Competition is growing from C-stores and grocery, which have been increasing their focus on prepared meals; and from Amazon, which is adding more cashier-less AmazonGo stores. Next year, we expect additional moderate growth fueled by strong consumer spending. Restaurants will also pay more for workers, with wage growth expected to reach 4 percent by the end of 2019.

While wage growth is promising, the consumer emphasis on value provides quick-service restaurants (QSR) and some casual-dining chains the opportunity to boost same-store sales by expanding their discount menus and adapting to third-party delivery options to help drive traffic. According to the National Restaurant Association, 41 percent of operators expect to see an increase in same-store sales in the beginning of 2019. The increase in the spread of optimism for customer traffic compared to increased sales signals that operators expect higher same-store sales from increased ticket levels.

Same store sales vs. customer traffic spread



Source: National Restaurant Association

With some operators already hanging on by a thread amid an oversupply of restaurants in the market, these challenges, led by the tight labor market and reduced margins, will likely lead to some closures. The restaurant concepts that rise to the top will likely have adapted to smaller footprints and technology innovations to accommodate tighter margins; they will capture new customers as the field of competition narrows.



FINANCIAL SERVICES: RISING INTEREST RATES WILL CAUSE ASSET MANAGERS TO RECALIBRATE

By Anthony DeCandido and Jason Kuruvilla

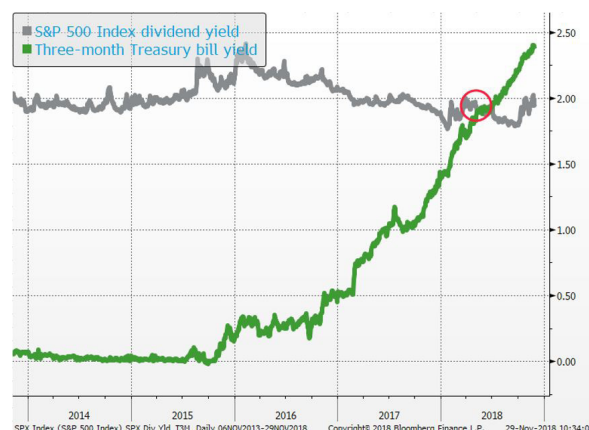
Policymakers believe the economy is on a strong footing, but the pace of rate increases going forward remains uncertain, and the effects on asset management could be significant. The Federal Open Market Committee is set to meet on Dec. 19, and an interest rate increase of 25-basis-points appears to be 75 percent likely, according to Bloomberg analysts. Meanwhile, there is just a 3 percent chance of another increase during the Jan. 31 meeting.

Federal Reserve Chairman Jerome Powell cited slowing demand abroad, fading fiscal stimulus and the lagging effect of the Federal Reserve's several rate increases on the economy since 2015 as possible headwinds. Trade tariffs bring substantial uncertainty to the markets as well, as companies reinvent their supply chains to preserve profit margins.

Rising interest rates call into question how investors will deploy capital and could create a sell-off for asset managers who prefer safer assets. Fixed income and credit products are likely to grow in popularity; the three-month Treasury yield has outperformed the S&P 500 dividend yield since the second quarter of this year.

In the first nine months of 2018, real assets, real estate and debt are additional asset categories that have attracted more capital from investors than they did during the same period in 2017.

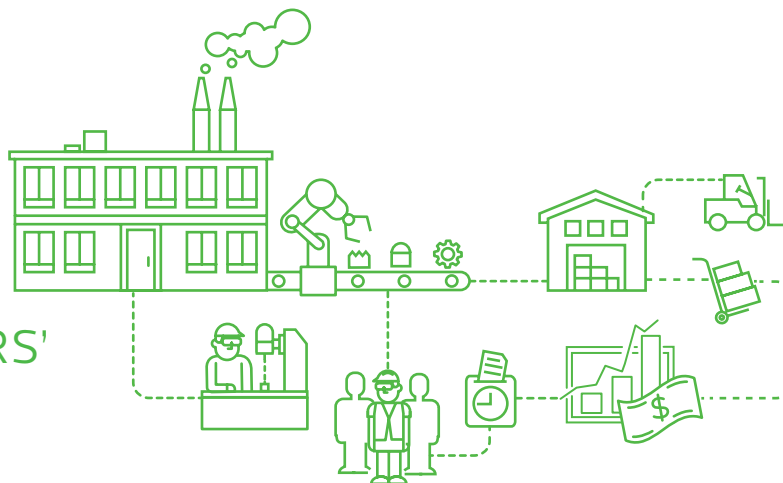
Higher interest rates will pinch private equity returns, but a significant de-escalation in mergers



and acquisitions (M&A) activity is not imminent. Private equity (PE) firms often fund the takeover of companies using debt. Over the last several years, these firms have benefited from historically low interest rates and have generated high returns, beating the S&P 500 Index by a compound annual rate of return of 5 percent. Returns are likely to decline and PE-owned companies will focus instead on maintaining steady cash flow to service their increased borrowing costs.

Firms looking for acquisitions will benefit from declines in pricing, while the opposite will be true for sellers. Approximately \$1.1 trillion of commitments remain available for deployment, and a 25 basis point or greater increase in rates is unlikely to decelerate M&A volume.

TIGHT LABOR MARKET, RISING WAGES TOP MANUFACTURERS' ISSUES IN 2019



By Jason Alexander

Forecasts call for manufacturing growth to increase faster than the general economy in coming years, with production estimated to rise 2.8 percent from 2018 to 2021, according to the Manufacturers Alliance for Productivity and Innovation Foundation (MAPI). This sustained growth will continue to put strains on manufacturers as they compete for an ever-shrinking pool of talent.

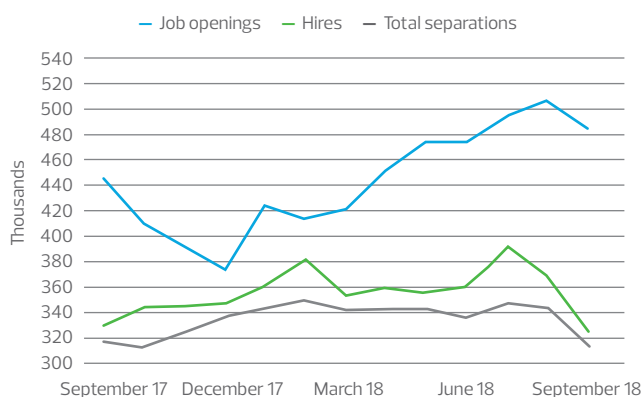
According to the Bureau of Labor Statistics, the United States has approximately 12.75 million manufacturing jobs and employs around 8.5 percent of the U.S. workforce. As of November, there were about 500,000 open U.S. manufacturing jobs, compared to roughly 465,000 unemployed persons, exemplifying an ongoing trend of more available jobs than people to fill them. We continue to see a divergence in the unemployment rate of manufacturers in durable goods (2.5 percent) versus nondurable goods (4.3 percent). Durable goods accounts for more than 80 percent of the 296,000 jobs added in manufacturing year-to-date. Historically, this has been an indicator of more job availability in the future.

Continued tightness in the labor market, due in large part to a significant shortage in skilled labor, has also led to increases in wage growth, with U.S. average hourly earnings reaching \$27 in October. Production and nonsupervisory workers earned \$21.68 an hour on average, at or near an all-time high.

We expect both the tight labor pool and rising wages to continue in 2019, boosting manufacturing

overhead expense and squeezing profit margins. Every incremental cost increase can have a material impact on a manufacturer's profitability, so we expect manufacturers to continue to evaluate the value of labor and to reposition their focus on creating the most positive output for each dollar spent. By deploying more robotic process automation, for instance, manufacturers can enhance processes to not only be more efficient, but to also to produce lower cost profiles and limit impacts of wage increases going forward.

Manufacturing job openings, hires and separations
(September 2017–September 2018, in thousands of workers)



Source: BLS, RSM US LLP



DEMOGRAPHICS AND POLICY TO DRIVE REAL ESTATE INVESTMENT IN 2019

By Troy Merkel and Laura Dietzel

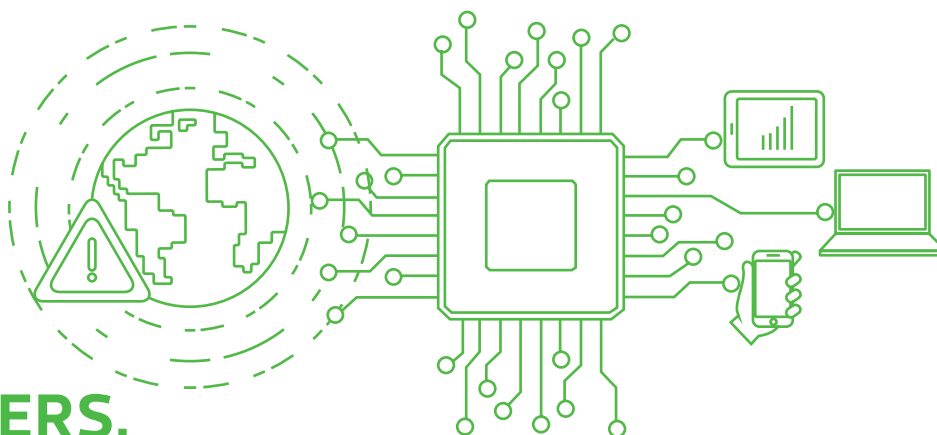
Fundamentals in the real estate market continue to be strong; however, at this late stage in the business cycle, investors need to be cautious as they venture into the development of more third-tier markets. Changes in demographics will also influence real estate as more people opt to rent, e-commerce grows and the density of offices' increases amid an increasingly mobile workforce.

In housing, homebuilders' profits are being squeezed, due to tariffs, lack of land and most significantly, a shortage of labor. Concurrently, any additional purchasing power for buyers driven by wage growth is being offset by interest rate hikes and the new state and local tax laws. Interest rate hikes are having a two-fold effect: Existing homeowners are reluctant to move and take on a higher interest rate, and would-be homebuyers are priced out of the market. Multifamily dwellings will continue to be top performers, with the exception of senior living, which continues to outpace current demand. Long term, this will stabilize as the baby boomers continue to age.

Steady growth in e-commerce and the resulting closures of big-box stores raise the question of whether brick-

and-mortar is dead. The answer is no, but it is evolving. Retail real estate investors will continue to diversify into experiential and omnichannel concepts with smaller footprints. In addition, mixed-use projects that reduce concentration risk, and cater to the desire to live, work and play in one location will dominate investments in this area. Also, the quest for the last mile will continue to drive valuations in industrial assets.

The office market has reached a point of oversupply in many regions, with the exception of those driven by the technology, life sciences and media sectors. The market is near full employment, and the last millennials are entering the workforce. This will lead to a plateau in employment, as there will not be enough new workforce entrants to offset the retiring baby boomers. In addition, employers continue to make offices denser with more employees as they promote workforce mobility. These factors will continue to drive office vacancies in many markets, which have already seen a significant amount of supply come online in the past few years.



CHIPMAKERS, OTHER TECH PRESSURED BY GLOBAL ISSUES IN NEAR-TERM

By Kurt Shenk

Macroeconomic indicators signal slowing growth in 2019, and the tech industry is likely to follow suit. Adding to concerns is the future of the trade spat between China and the United States, which remains unclear. As a result, some U.S. technology verticals, such as semiconductors, will be forced to absorb margin pressure by adjusting their pricing structure or shifting their supply chains out of China.

Record low unemployment, which has remained below 4 percent, may leave some technology verticals that provide platforms characterized by implementation or ongoing service finding the service side of their business struggling to keep up with orders. To mitigate this trend, middle market tech companies will continue to expand into newer technology urban hubs cropping up across the United States where labor shortages are less acute.

Despite volatility in the NASDAQ during the fourth quarter of 2018 characterized by steep share declines in tech giants such as Apple, we still find ourselves in the midst of an era of digital transformation. This industrywide trend is requiring companies to think innovatively about how to leverage technology in

new ways. Many companies are willing to invest in technology and pay high M&A premiums for technology companies in order to absorb technologies that allow them to remain competitive.

Many technology unicorns have been born from the digital age, and we expect high valuations for tech companies in 2019, especially those focused on cloud, security and data analytics. The equity markets eagerly anticipate the public offerings of companies, including Uber, Lyft and Airbnb, in what could be a record-breaking year for IPOs, with valuations in excess of \$100 billion.

Valuations of popular tech companies

Company	Latest valuation	Total equity funding	Last valuation
Uber	\$72 B	\$19.9 B	Oct. 2018
Airbnb	\$31B	\$4.4 B	Sept. 2017
WeWork	\$21B	\$4.8 B	Nov. 2018
Lyft	\$15 B	\$4.9 B	Oct. 2018
Pinterest	\$12 B	\$1.5 B	June 2018
Instacart	\$8 B	\$2.0 B	Nov. 2018

Source: Bloomberg



HOW THE TARIFF EXEMPTION PROCESS WORKS

By Chris Shaker

In the [October issue of The Real Economy](#), we discussed how trade tensions between the United States and China continue to be a concern for middle market companies. In that issue, we answered some common questions about the possibility of exemptions and the difficulty and low success rate of the process to date. Since then, we have seen some success with the process.

In order to gain a better understanding of the process, RSM spoke with one manufacturing client about their experience. They were pleasantly surprised with the ease of the application process. In fact, they described the instructions at the [government website](#) as “outstanding.” Below are some key takeaways, based on our exchange with that client.



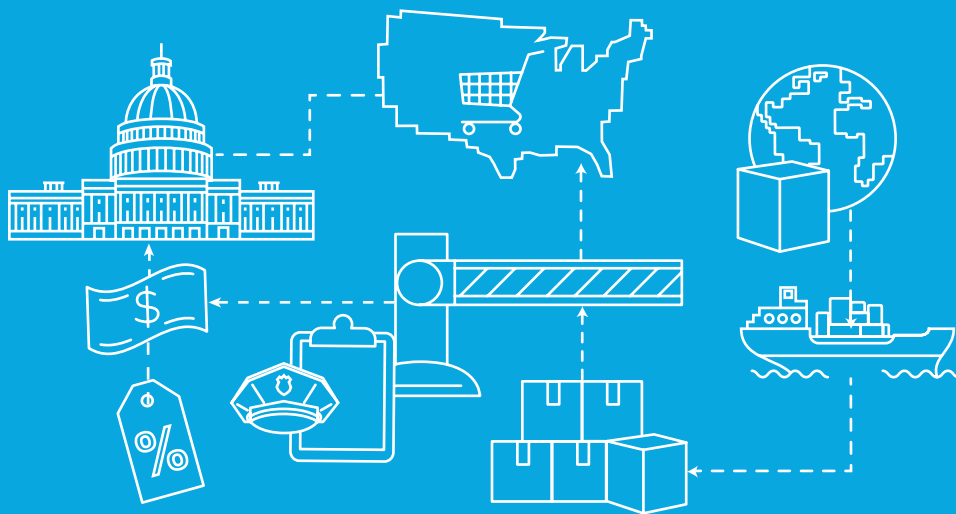
Is there a lot of paperwork?

The entire process is electronic and any additional information required by the application can be attached electronically.



What information is needed?

Some detailed information is required. For instance, in this particular case, the company was required to attach a document that described the chemical composition of the specific steel for which they were seeking an exemption. However, it was information they already had, and they felt that all of the information required was readily available. The application itself did not take them a significant amount of time.



Are the applications public or private?

The applications are public and anyone is able to comment on the application during the comment period.



What happens after the application is submitted?

It took approximately 30 days for the application to show up on the government website for comment.



How long was the comment period and what happens if someone comments on the application?

The comment period was open for about 60 days. This company did receive one objection from a U.S. supplier claiming to be able to supply the product that the company was requesting an exemption for. The company was able to submit a rebuttal to the objection to explain why they didn't believe that the supplier could provide the exact product in question.



What happens after the comment period closes?

The company did not hear anything for approximately 30 days after the application was removed from the website. They then received a decision memo granting them their exemption for the product. The decision memo included an exemption number that can be provided to the import broker in order to avoid paying the tariffs when the product hits the U.S. border.



How long does the exemption last?

The exemption is good for one year from the date that the application was filed. So the company is currently in the process of applying for a refund for the tariffs paid from the date they submitted the application to the date the decision memo was received.



So what happens when the one-year exemption expires?

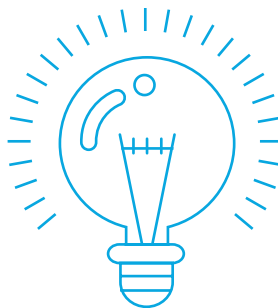
A new application must be filed every year. Because the entire process took approximately 90 days in total, the company is already considering applying for the next year. However, they believe they'll be able to leverage most of the information gathered from the initial application and they do not believe the process will be a burden.



So should everyone apply for an exemption?

This is only one example; however, based upon the experience of this middle market manufacturer, if you believe your product is not available in the United States, it may be worth submitting an application for exemption.

OTHER VALUABLE RESOURCES



CAPEX AND THE MIDDLE MARKET: A MISSED OPPORTUNITY?



The proprietary RSM US Middle Market Business Index has shown that middle market leaders have been slow to increase capital expenditures throughout this business cycle. Find out what's behind this trend—and where surplus dollars should be deployed—in our latest special report.

Download a copy of the [report](#).

CORPORATE SOCIAL RESPONSIBILITY, DIVERSITY AND INCLUSION



A BUSINESS IMPERATIVE TO WALK THE TALK

A new RSM US MMBI report examines the value of CSR to middle market businesses and the communities and stakeholders they serve.

Download the full report [here](#).

TUNE IN TO "THE MIDDLE MARKET TRANSFORMATIVE CEO"



RSM US Chief Economist Joe Brusuelas teams up with business author and co-host, Robert Reiss, for a series of provocative discussions with middle market CEOs. Get the details on game-changing strategies in industries ranging from restaurants to retail and manufacturing.

To listen, visit rsmus.com/CEOradio

RESEARCH SHOWS MIDDLE MARKET CYBERRISK

Nearly 50 percent 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 percent 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.

Download the full report [here](#).



For more information on RSM, please visit www.rsmus.com.

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