

THE REAL ECONOMY

VOLUME 60



**LOOKING TO 2020:
CONSUMER IS KING
AMID SLOWING
GROWTH**

U.S. INDUSTRIAL PRODUCTION FALLS

A SHARP 0.8% IN OCTOBER

MIDDLE MARKET TREND WATCH:

ESG: MEASURING RESPONSIBLE BUSINESS PRACTICES

INDUSTRY SPOTLIGHT:

MANUFACTURING CAUGHT IN CROSSHAIRS OF
GLOBAL TRADE TENSIONS

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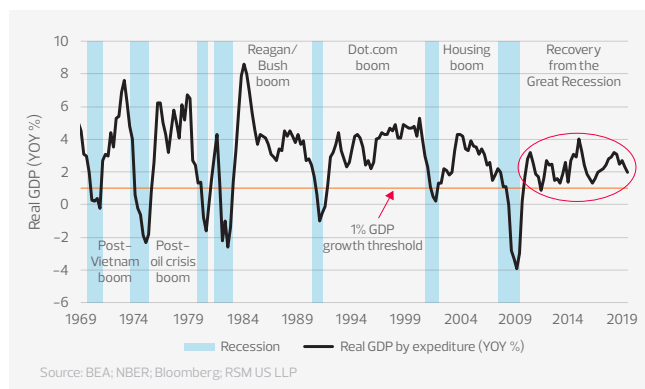
LOOKING TO 2020:

CONSUMER IS KING AMID SLOWING GROWTH

BY JOSEPH BRUSUELAS

THE AMERICAN ECONOMY will continue to slow toward a growth rate of 1.5% in 2020, below its long-term average of 1.8%, as sturdy consumer spending compensates for financial volatility and erratic trade policy. That consumption, though, increasingly depends on rising asset prices that help boost confidence, and solid job growth. As long as consumers, particularly those with higher incomes, stay confident, the domestic economy should continue to show modest, if unspectacular, growth in 2020.

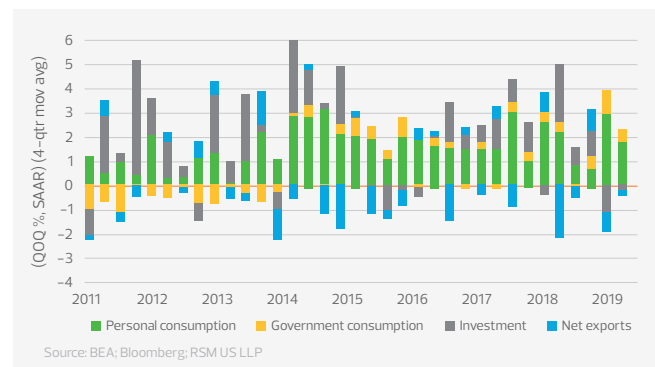
Real GDP growth at the end of economic booms/recoveries



Behind this slowing growth is a somewhat imbalanced domestic economy. The service sector is experiencing brisk growth, while manufacturing and agriculture continue to contract. So while 75% of the economy is doing just fine amid low unemployment and solid spending, one quarter is experiencing outright contraction and rising job losses. Still, overall wage growth near 3% and relatively low unemployment across the board should continue to foster enough economic activity to avoid a recession in 2020 as long as cooler heads prevail in the trade war and financial markets.

Contributions to GDP growth by sector

GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD



The primary drivers for our call for below-trend gross domestic product growth are the risks around the trade war and the uncertainty around the 2020 presidential election. We do not expect a trade deal that boosts overall economic activity. The potential use of presidential power to label European automotive imports as a domestic security risk remains the largest threat to the outlook, one that could even spell a premature end to the business cycle. While we expect no announcement on European auto tariffs in 2019, we do expect movement by spring of next year.

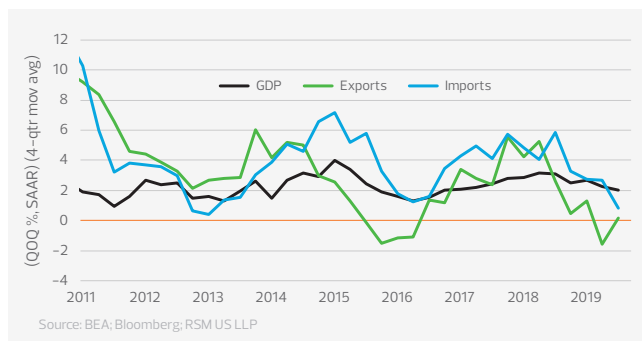
Cars, planes and elections

In addition, challenges in the domestic auto and aerospace sectors continue to damp overall manufacturing activity. In particular, once Boeing restarts production of its problematic 737 Max, some pent-up demand will provide a boost to overall business investment. But we do not anticipate an increase in production until mid-2020.

We also remain skeptical about a significant economic boost from a “phase one” trade deal with China that has been capturing headlines. Rather, we view this as reaffirmation of the status quo, which includes no new tariffs placed on Chinese imports, as Beijing promises to purchase agricultural products from the United States. To obtain a significant economic boost from a trade deal, a much more substantial agreement involving the rollback of taxes on imported goods would be required; we do not anticipate this before the election. If a substantial rollback of tariffs does occur, then we would revise our growth forecast higher.

Growth of exports and imports

GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD

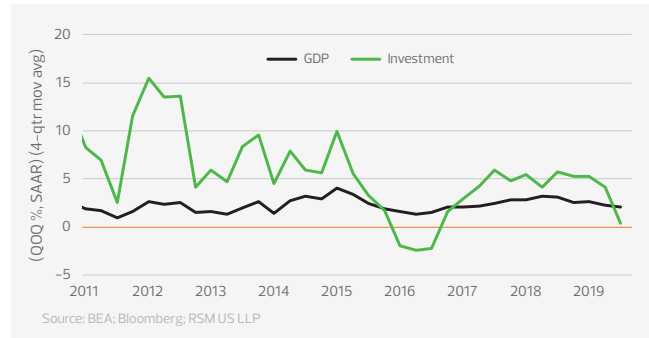


Then there is the presidential election. The two quarters leading up to the vote during the past three election cycles have seen flat capital expenditures as businesses await the election outcome. And already this year, fixed business investment has fallen by 6.3% and 1.5%, respectively, during the second and third quarters. Add to this the deep polarization around the direction of policy, and we think that overall investment will continue a downward trend during the first three quarters of 2020. This is the primary

rationale for our call of growth near 1% during the first half of the year before returning to just above trend in the second half of the year as pent-up demand for capital expenditures is released.

Growth of investment

GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD



By the second half of 2020, the lagged impact of global monetary and fiscal accommodation, as well as an improved domestic manufacturing outlook linked to strong aerospace activity in the United States, should boost overall activity slightly above the 1.8% long-term trend. A rebalancing in the composition of growth would put the economy on a much better footing, as slowing in overall hiring drops below 100,000 jobs per month, and the unemployment rate begins to rise ahead of the election.

Household consumption

Low unemployment, modest wage growth and an elevated savings rate near 8% all reinforce our confidence that the condition of the U.S. consumer will more than offset the drag from trade and investment in 2020. Annual bonus payments to workers and the move toward a minimum wage of \$15 per hour in the 20 largest metropolitan statistical areas in early 2020 will continue to place a foundation underneath the economy. But the risks to the outlook are increasingly linked to volatility in asset prices and rising economic inequality.

For some time, we have noted that the evolution of economic inequality has reframed the way in which we look at household consumption. In our estimation, 40% of households—the two upper-income quintiles—are now responsible for 60% of overall spending. For this reason, consumption will remain strong as long as a minority of upper-income households remain confident in the growth of their liquid portfolios and illiquid assets. If the equities and housing markets remain strong, overall household consumption will drive growth at or near the economy's long-term potential. But should these asset prices drop—much like the 20% drop in equity prices during the final three months of 2018 that resulted in a sharp decline in spending—then the risk of a slower pace of growth would increase.

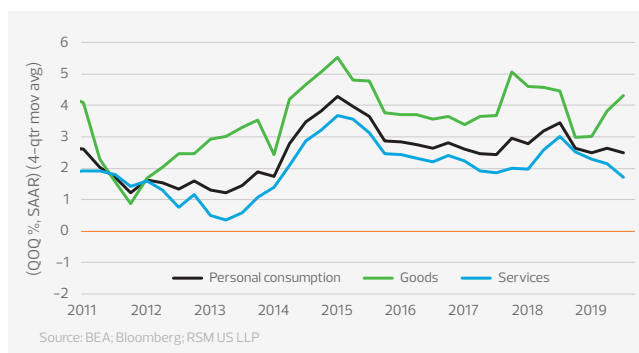


LOOKING TO 2020 (CONT.)

THE SERVICE SECTOR IS EXPERIENCING BRISK GROWTH, WHILE MANUFACTURING AND AGRICULTURE CONTINUE TO CONTRACT. SO WHILE 75% OF THE ECONOMY IS DOING JUST FINE AMID LOW UNEMPLOYMENT AND SOLID SPENDING, ONE QUARTER IS EXPERIENCING OUTRIGHT CONTRACTION AND RISING JOB LOSSES.

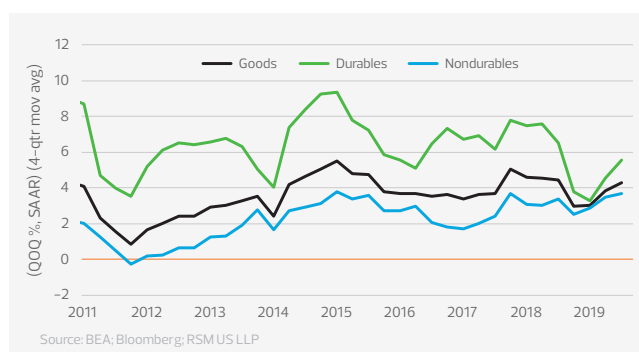
Components of growth in personal consumption: Goods and services

GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD



Components of growth in consumption of goods: Durables/nondurables

GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD



Financial conditions

Given the upcoming presidential election, we anticipate that the Federal Reserve will remain on hold for the duration of 2020. We expect the policy rate will remain in a range between 1.75% and 2%, despite a slower pace of growth in the economy. The term spectrum will be defined by a modest steepening of the fixed income curve in which the American 10-year yield tends to float between 1.75% and 2% during the year. We expect the dollar to grow modestly stronger on the back of more accommodative monetary policy from the European Central Bank, the Bank of England and the Bank of Japan.

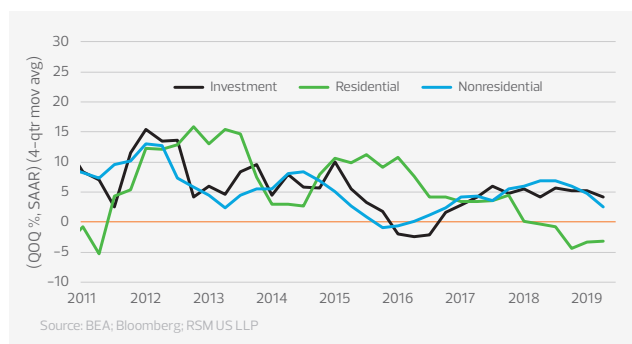


As global central banks and fiscal authorities act to offset slower global growth, we would expect that capital flows will gravitate back to dollar-denominated assets, dampening rate increases along the long end of the curve and bolstering the value of the dollar.

We also expect that the lagged impact of the Fed's easing of interest rates will bolster residential investment during the first half of 2020, which, coupled with a strong labor market and modest wage growth, should provide solid support for overall growth. It will most likely be a bright spot in an otherwise dour fixed business investment outlook. If rates follow along our path of lower rates, this should boost sales and broker commissions, which will also support overall growth.

Components of investment growth

GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD



Overall financial conditions determined by a combination of money markets (U.S. Ted spread, LIBOR/OIS spread, the commercial paper/T-bill spread), U.S. bond market (Baa/10-year Treasury spread, U.S. high-yield/10-year Treasury spread, U.S. muni/10-year Treasury spread, swaption volatility index), U.S. equity markets (S&P 500 Index, VIX Index of S&P 500 Volatility) stand at 0.40 standard deviations above neutral, which implies that conditions for modest growth remain solid. If housing and technology financial conditions are included, that improves to 1.7 standard deviations above neutral, which points to some upside risk on household consumption given the imbalance and inequality inside the economy.

Recession risks

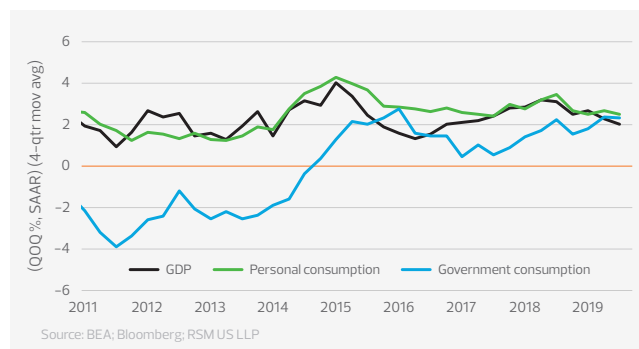
While our baseline forecast is predicated on slower overall economic activity, we do not anticipate a recession next year. Our model implies a 34% probability of a recession over the next 12 months, which is not consistent with an economic contraction in 2020. Household consumption at or near 2.5% is sufficient to compensate for the 20% to 25% of the economy—manufacturing, agriculture and transportation—that is in recession. Those sectors are simply not large enough to drag down the broader service sector, whose growth is linked to low unemployment and modest wage growth. But if the trade war intensifies, or there is a large shock to the economy over, say, energy, the risk of recession would grow.

Fiscal matters

Over the past two years, growth has been bolstered by a large increase in fiscal outlays on defense and social spending. During the first three quarters alone, government spending increased by 2.9%, 4.8% and 2%, respectively, representing an important and overlooked driver of domestic growth. But given the rising acrimony in Washington, we do not foresee another large increase in the annual operating budget for the 2020-21 fiscal year and expect a growth rate in government expenditures of closer to 1.5% next year. ■

Growth of personal and government consumption expenditure

GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD



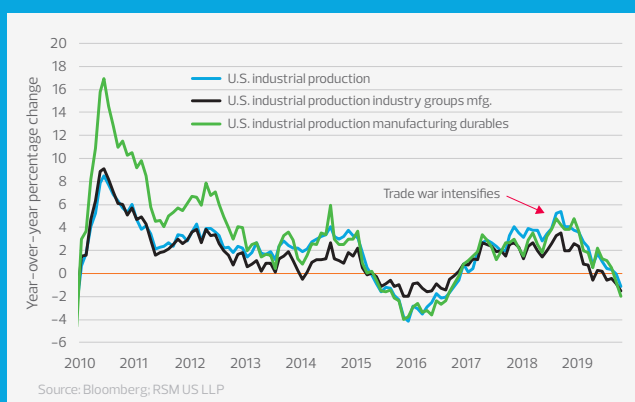


U.S. INDUSTRIAL PRODUCTION FALLS A SHARP 0.8% IN OCTOBER

BY JOSEPH BRUSUELAS

THOSE WHO ARE MAKING the case that U.S. industrial production has bottomed may want to rethink that overly optimistic statement. While auto production rebounded in November, the problems at Boeing surrounding the 737 Max and the uncertainty tax imposed on firms caused by the trade conflict with China have knocked the air out of domestic industrial production.

Trade tensions have taken a toll on industrial production



U.S. industrial production contracted by 0.8% in October—the most in 17 months, the Federal Reserve reported recently. In addition, factory output fell by 0.6% and motor vehicle assemblies collapsed by 11%, almost all of it caused by the General Motors strike, which ended last month.

The year-over-year comparisons reveal the imbalanced state of the U.S. economy. Industrial production fell 1.1%, manufacturing declined 1.5% and durables manufacturing was off 2%—all linked to the trade tensions and Boeing's struggles. At the same time, U.S. retail sales remained strong in October, increasing by a healthy 0.3%.

While demand for utilities declined 2.6% and mining output dropped 0.7%, all of this cannot be attributed to the weather, as some might be inclined to state. Rather, this has to do with the overall decline in demand driven by policy, labor strife and the self-inflicted wounds at Boeing. Our manufacturing index tends to suggest it may be some time before we can declare an all-clear on risks to the outlook linked to industrial production and manufacturing.

Moreover, we are not optimistic that there is a so called "phase one" deal that would boost the domestic manufacturing sector or lift the veil of uncertainty that has dragged down business investment in general and capital expenditures in particular. Without a general rollback in tariffs—as opposed to not imposing further tariffs—we are generally skeptical at this point on a near-term increase in overall production and manufacturing. ■

MIDDLE MARKET TREND WATCH



ESG: MEASURING RESPONSIBLE BUSINESS PRACTICES

ENVIRONMENTAL, SOCIAL AND CORPORATE governance measures demonstrate a company's commitment to ethical practices and sustainability, and the ranks of companies benchmarking with ESG is growing. Stakeholders ranging from customers to suppliers and investors use ESG criteria to help track everything from the commitment to environmental stewardship to employee, supplier and community relationships, how well the business leads and governs itself—even its market valuation. According to the Forum for Sustainable and Responsible Investment, ESG-managed investments represent \$11.6 trillion of alternative assets, or one in every \$4 invested, up 44% from \$8.1 trillion just three years ago.

Are middle market companies also leveraging ESG strategies? In RSM's fourth quarter Middle Market Business Index survey, we asked business leaders about this trend. Note the findings below. ■

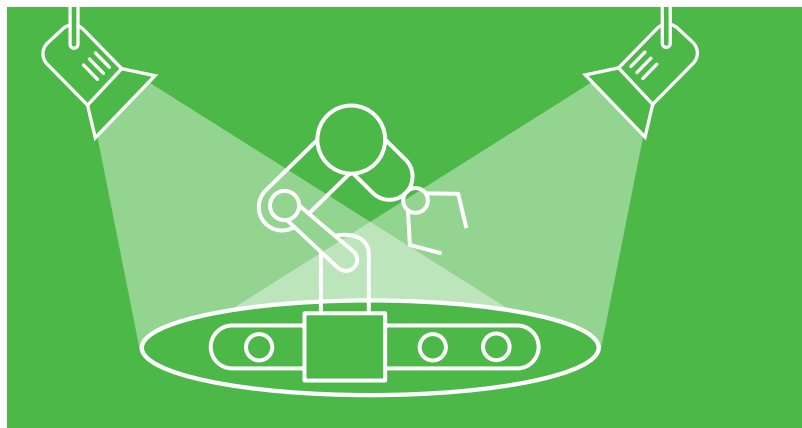
Thirty-nine percent of middle market executives say they are familiar with ESG criteria to evaluate the performance of organizations, businesses and investments.

Executives at larger organizations are more familiar with ESG than those at smaller organizations (**55% versus 27%**).

Among those familiar with ESG criteria, **79%** of middle market organizations indicated they use the ESG criteria to evaluate their own performance and **74%** use the ESG criteria to evaluate the performance of others.

Motivations identified most often for engaging in social responsibility practices are supporting the local community, reinforcing organizational values and positive impacts on the work environment.

KEY TAKEAWAY: While many middle market businesses are leveraging ESG strategies and seeing the value, more engagement is needed and companies should strive for consistent tracking efforts. To improve ESG and overall corporate social responsibility initiatives, companies should assess existing ESG and social responsibility strategies, identify new programs and charitable partners when needed, set metrics and measure, and communicate successes on a consistent basis.



MANUFACTURING

INDUSTRY SPOTLIGHT

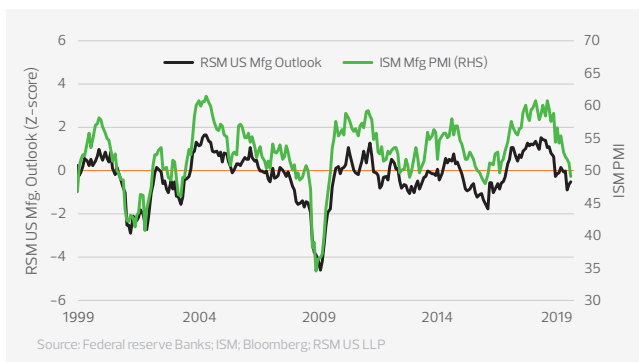
Manufacturing caught in crosshairs of global trade tensions

BY JASON ALEXANDER

AS RISKS FOR a global economic slowdown continue to rise, trade tensions, supply chain volatility, slowing job growth and a tight labor market will remain challenges for manufacturers in 2020. This will require organizations to develop innovative strategies that allow them to thrive in today's competitive landscape.

The recent trend has been clear: The U.S. manufacturing sector contracted for the third straight month in October, according to data from Institute for Supply Management, marking only a slight increase from a 10-year low registered in September 2019. This is consistent with the performance of the RSM US Manufacturing Outlook Index, which has been declining for 15 months since its peak in June 2018, and has been negative since December 2018. Performance of the index suggests the potential for a continued decline in U.S. manufacturing sales in the months ahead.

RSM US Manufacturing Outlook Index and the ISM Manufacturing Index

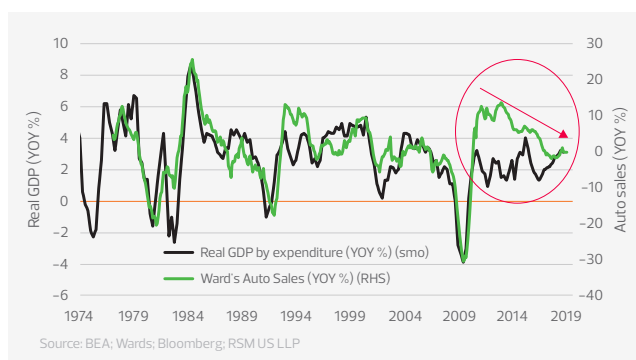


Global auto deceleration continues

Softness in the auto industry ripples across the economy more than some other sectors because of the wide array of industries involved in automakers' supply chains, such as steel and glass manufacturers.

U.S. light vehicle sales have been fairly steady over the past couple of years, but sales in the United States are expected to experience a steady decline, from 17.2 million vehicles in 2018 to 17.0 million in 2019, 16.6 million in 2020 and 16.5 million in 2021, according to the Original Equipment Suppliers Association. We expect this to soften because of increasing monthly auto loan payments, decreasing growth in incentives offered by auto dealers and manufacturers, as well as a shift toward used car purchases as a result of the growing unaffordability of new vehicles.

U.S. real GDP and Ward's Auto Sales (YEAR-OVER-YEAR PERCENT CHANGES)



The same OESA outlook noted that global sales are projected to increase by 150,000 units from 2018 to reach 94.8 million units in 2019, with North America sales decreasing around 2%, and sales in Western Europe and Asia increasing around 1%. So while it appears that growth in light vehicle sales will be constrained in the near-term, global sales are projected to reach 109.8 million units by 2026, with much of the growth coming from sales in China and India. Trade risks, though, will remain a key source of uncertainty for auto markets around the globe, especially in China.

How do middle market manufacturers thrive?

Companies that not only weather slowdowns, but also thrive, have thoughtful plans that may include a combination of the following:

- **Evaluate flexibility in staffing.** It's difficult to find skilled workers in today's environment, but manufacturers must have a plan to [address their workforce needs](#) during a slowdown.
- **Evaluate the supply chain.** Companies should consider where they source products, both domestically and internationally, to ensure that costs are appropriate and competitive or new sources can provide efficiencies and savings.

- **Evaluate and invest in new technologies.** Like other industries, manufacturing is undergoing a [digital transformation](#). Investing in technology now can help ensure that efficiency and productivity remain high and provide your organization with a competitive advantage.
- **Enhance the sales strategy.** Companies cannot rely on the same sales strategies with the same customers. The current environment creates a great opportunity to evaluate a company's sales approach, whether it is serving the changing needs of the market and its customers.

The environment in 2020 will continue to be challenging for manufacturers as they try to steer their businesses amid continued political uncertainty and volatility in costs. We expect this uncertainty to remain in the near-term. Organizations will need to increase resilience in their operations and focus on driving greater efficiencies in the core of their portfolios, from adding digital technologies to streamlining and realigning around key markets and customers. ■

THE REAL ECONOMY INDUSTRY OUTLOOK

INDUSTRY INSIGHTS FOR THE REAL ECONOMY

From emerging technologies to ongoing trade war, what are the trends affecting middle market businesses at the sector level?

The Real Economy: Industry Outlook provides a quarterly collection of industry-specific insights developed by RSM US LLP senior analysts, a select group of professionals dedicated to studying economic and industry data, market trends and the emerging issues faced by middle market businesses.

Each outlook offers a data-driven approach to industry research, examining the impact of earnings, the competitive landscape, consumer behavior, capital flows, mergers and acquisitions, supply chain, labor and more.

WATCH FOR OUR NEXT ISSUE: January 2020



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