

THE REAL ECONOMY

VOLUME 50



IS THE ECONOMY
HEADED FOR
RECESSION?

GDPR AND BEYOND: EUROPE'S TAKE
ON DATA PRIVACY IS SPILLING INTO
THE UNITED STATES

RSM REAL GDP INDEX POINTS TO
SUB-2 PERCENT GROWTH

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IS THE ECONOMY HEADED FOR RECESSION?

Trade policy, interest rates,
corporate debt, slowing
global growth ... economic
headwinds are growing

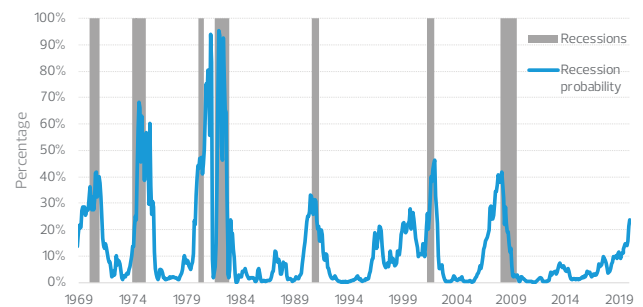
By Joseph Brusuelas



A confluence of factors is conspiring to lay the groundwork for conditions increasingly threatening an end to the current business cycle. In this issue of *The Real Economy*, we present a number of easy-to-use metrics and data visualizations for middle market businesses to formulate judgments around risks to the economic outlook. These include an array of financial, consumer and labor market indicators that, in some cases, can warn of a possible economic downturn.

Our preferred recession probability model, the New York Federal Reserve's Markov switching model, is currently forecasting a 23.62 percent chance of a recession occurring during the next 12 months.

U.S. recession probability: 23.62%



Source: RSM US LLP, New York Federal Reserve



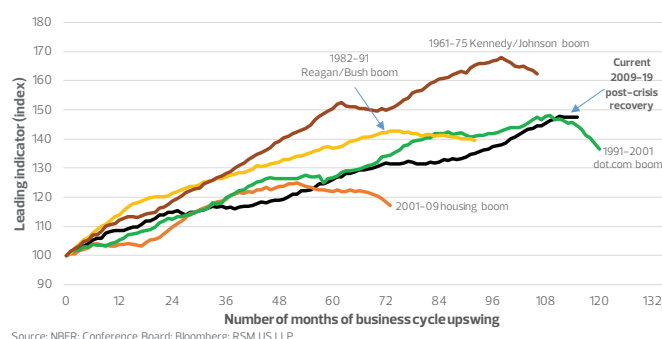
Since 1960, once the Markov model breached 30 percent, a U.S. recession has always followed. What we present here is intended to facilitate a discussion by middle market businesses on preparing for the end of the business cycle through balance sheet considerations organized around budgetary, supply chain, banking, talent, productivity and efficiency needs inside their businesses.

The end of U.S. business cycles are never slow, but easily observable events. When the U.S. economy falls into a recession, it tends to fall off a cliff driven by a combination of endogenous and exogenous shocks or policy mistakes. Thus, a notable decline in fixed business investment, a drop in inflation-adjusted spending, a deterioration in business sentiment and key credit and corporate spreads—all of which are incorporated into our preferred recession model—can, on the margin, be decisive factors in creating the conditions for a recession.

Many old rules of thumb that worked before the fracture of the domestic economy a decade ago during the Great Recession are no longer useful in identifying the end of the modern business cycle. For example, the old saw “a recession is comprised of at least two consecutive quarters of negative growth” does not necessarily accurately identify that the economy has fallen into recession.

Instead, we prefer the National Bureau of Economic Research's (NBER) definition of a recession—a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real gross domestic product (GDP), real income, employment, industrial production and wholesale–retail sales

U.S. economic recoveries in the months after recessions (Rebased leading indicator values from business cycle troughs to peaks)



When assessing the transmission mechanism between the aforementioned risks to the economic outlook, one should focus on real income, employment and real GDP, in addition to a number of other factors. Those include defaults on home and auto loans, rising credit card debt and declines in consumer and business confidence. What follows are some useful metrics for middle market businesses to track and gauge recession risk.

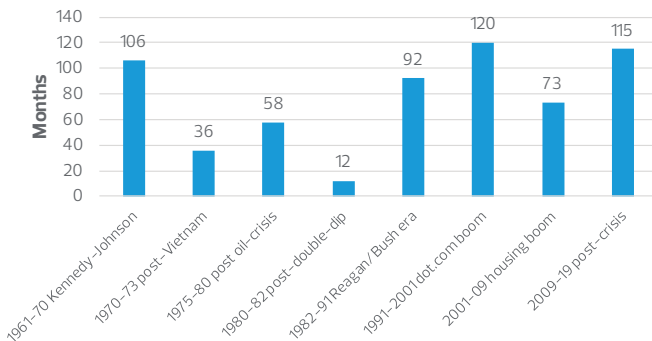


IS THE ECONOMY HEADED FOR RECESSION?

THE YIELD CURVE AS A RECESSION INDICATOR

The U.S. economy has been growing for the past nine years, making this current recovery just months short of becoming the longest expansion in modern history. The knee-jerk reaction may be to assume the economy is ripe for a setback.

Duration of business cycle upswings

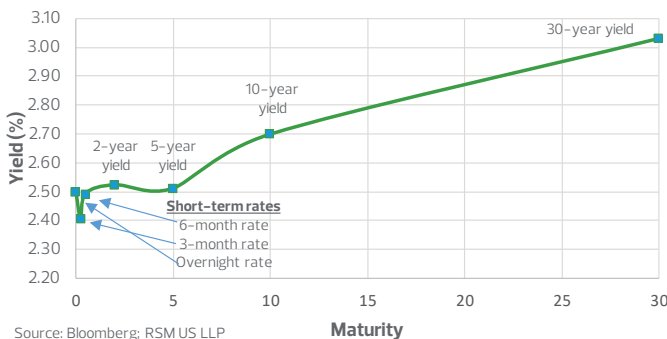


Source: NBER; RSM US LLP

Meanwhile, analysts have increasingly pointed to the flattening yield curve, which has flirted with inversion at points along the curve as a harbinger of recession. The 2.75 percent yield on the 10-year Treasury is only 25 basis points higher than money market rates. Does this mean that U.S. economic growth is stalling and that a recession is inevitable?

U.S. Treasury yield curve 10 years after the crash

as of Feb. 5, 2019



Source: Bloomberg; RSM US LLP

Follow the yield curve

David Andolfatto and Andrew Spewak of the Federal Reserve Bank of St. Louis indicated in a recent analysis that the yield curve has flattened and inverted before each of the past three recessions. They also noted the following:

- Curve inversions were a poor predictor of the timing of the recession.
- Most recessions were triggered by events, ranging from oil crises and war to the bursting of an asset-price bubble like the dot-com bubble before the 2000 recession or the housing-market bubble that led to the Great Recession.
- Slow-growing economies are more likely to be sent into a recession in reaction to a shock than a healthy, fast-growing, high-interest-rate economy. "In this way, an inverted yield curve does not forecast recession; instead, it forecasts the economic conditions that make recession more likely."

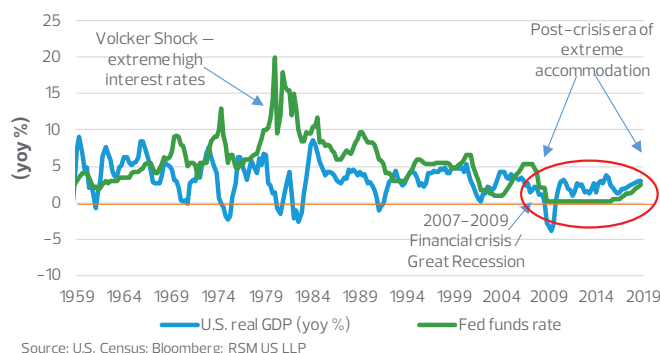
It's fair to think that the current recovery could follow suit. After all, there has already been a shock in the financial sector: The stock market correction of late 2018 wiped out a year's gains as decreased earnings expectations grew out of investor concern that the Federal Reserve's monetary policy tightening regime was too severe and too soon, considering the constant threats to international trade and the moderation of global growth.

No business cycle is the same

Even so, not all business cycles are the same, and the current expansion is anything but cookie-cutter for the following reasons:

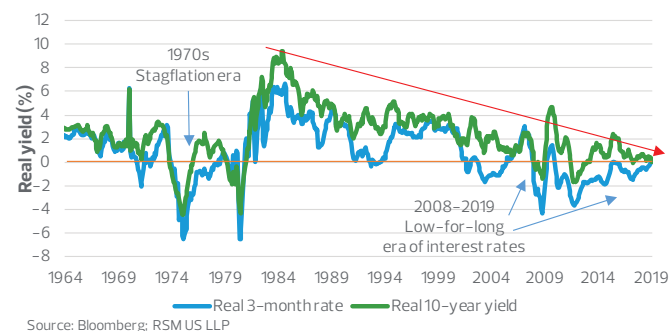
- Monetary policy has never been so aggressively accommodative for so long in the modern era.
- The recovery after the Great Recession, though long-lived, has grown at a moderate pace and more in line with what appears to be a secular decline in U.S. economic activity than what we might normally expect after a downturn.
- Real interest rates have never been so low for so long, reflecting perhaps a new slow-growth paradigm.
- The manufacturing sector has undergone a shift in structure that was accelerated by the recent financial crisis and Great Recession, with traditional domestic production replaced by a global supply chain.
- Global interest-rate compression (resulting from a secular decline in global inflation) and the safe-haven demand for Treasuries by foreign investors have played a role in pressuring long-term interest rates lower.

U.S. real GDP growth and Fed policy



Real interest rates

3-month T-bill rate and 10-year Treasury yields less inflation



10-year yields and foreign purchases of U.S. Treasuries



The repercussions of the Great Recession have been undeniably severe, widespread and long-lasting. Not only was there a huge loss of income, but the years of lost employment and lost output are unlikely to be recovered anytime soon, if at all. The immediate loss was compounded by a reduction of output due to the retirement of the baby-boomer generation and an aging global demographic. We have been calling for U.S. growth of less than 2 percent in 2019, with even that growth rate at risk given the government shutdown(s) and the administration's attempts to unwind the global supply chain. Therefore, it could be argued that the stage has already been set for a slow-growing economy to be pushed into recession by a crisis or event as outlined earlier.



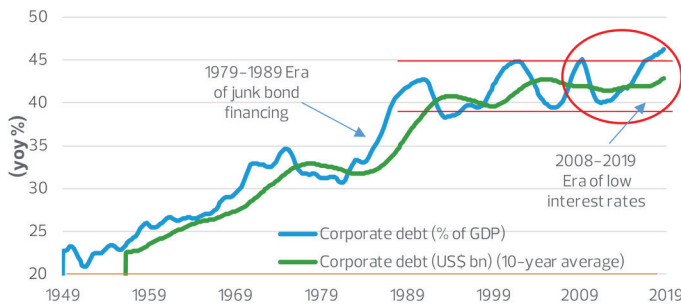
IS THE ECONOMY HEADED FOR RECESSION?

CORPORATE DEBT AND YIELD SPREADS

Issuance of corporate debt underwent a shift of structure from 1979 to 1989 as junk bonds emerged as an alternative to equity financing of takeover and merger and acquisition activity. Since the 1990s and until recently, issuance remained in the range of 40 to 45 percent of nominal GDP.

Corporate debt as a % of GDP

and a 10-year moving average

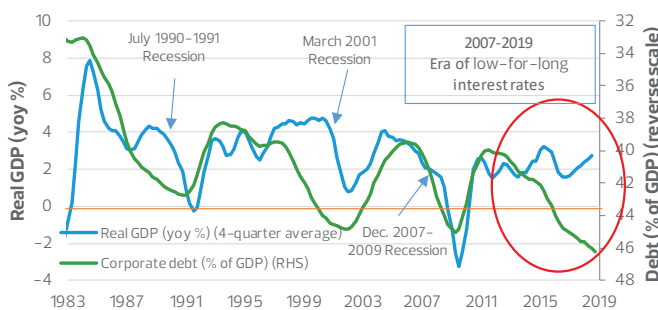


Source: Federal Reserve; BEA; Bloomberg; RSM US LLP

Before the recent financial crisis, issuance appeared to follow the business cycle, increasing relative to diminished output and as interest rates were lowered in response. Interest rates have been abnormally low for the decade following the crash, and corporate debt is now at 46 percent of nominal GDP.

Real GDP growth and corporate debt

Corporate debt as a % of nominal GDP

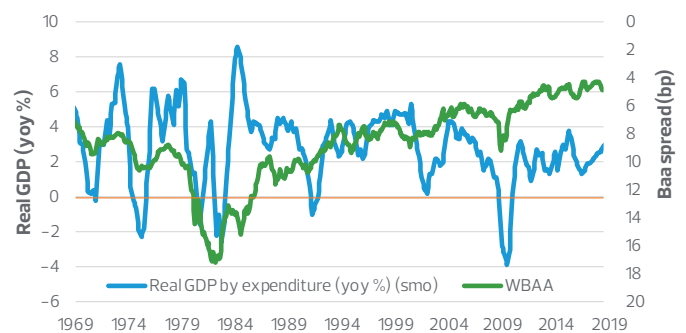


Source: Federal Reserve; BEA; NBER; Bloomberg; RSM US LLP

The spread between investment-grade corporate bonds (with Baa ratings) and 10-year Treasury bonds has typically decreased as economic activity picks up and perceptions of risk move lower. The recent increase in the Baa spread is therefore, a potential signal of a slowdown in activity.

Real GDP and Baa corporate yield spread

Investment grade less 10-year Treasury yield

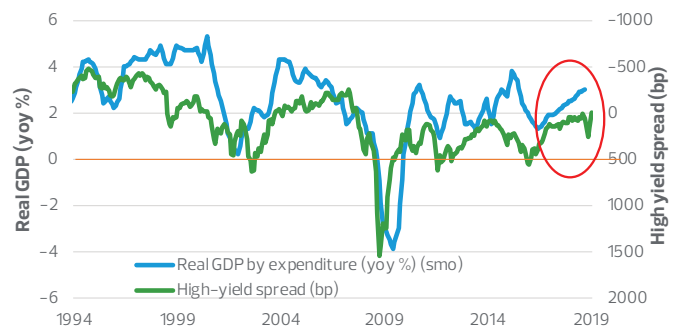


Source: BEA; Bloomberg; RSM US LLP

One might expect that high-yield bonds (the securities formerly known as junk) would be more attuned to perceptions of risk. While Q3 2018 economic growth hit 3 percent, spread between high-yield bonds and 10-year Treasuries immediately began moving higher, perhaps suggesting more risk to forecasts of growth in coming quarters.

Real GDP and high-yield spread

Junk bond less 10-year Treasury yield

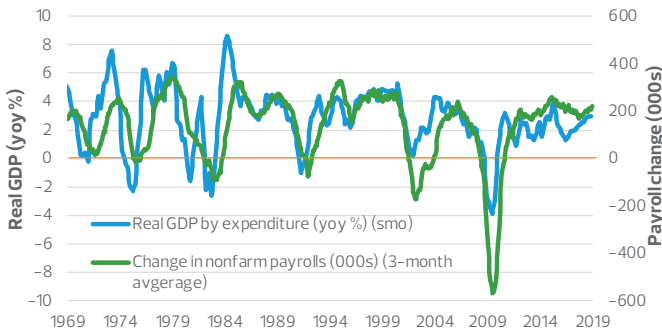


Source: BEA; Bloomberg; RSM US LLP

LABOR SECTOR

The labor market will often lag in the business cycle, often due to contractual issues or production timing. After decelerating since 2015, nonfarm payrolls re-established its upswing in 2018 in line with the acceleration of output growth.

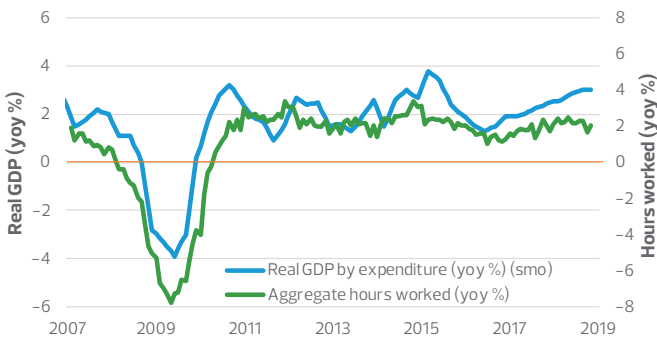
Real GDP and changes in nonfarm payrolls



Source: BEA; BLS; Bloomberg; RSM US LLP

The growth rate in hours worked accelerated in 2016. With the potential of an increased labor demand, wages would push higher, increasing disposable income and spending, and attracting more of the population back into the labor force, increasing potential output.

Real GDP and aggregate hours worked

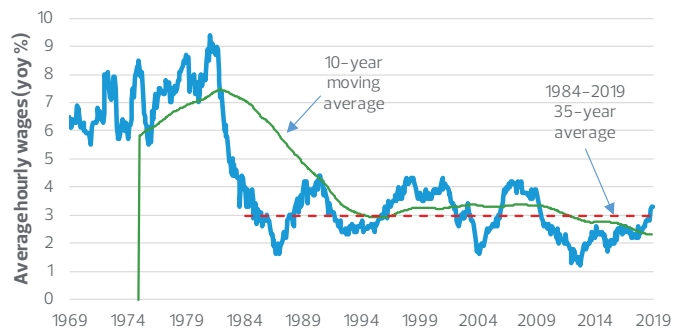


Source: BEA; BLS; Bloomberg; RSM US LLP

Hourly earnings peaked in 1981 and then dropped precipitously as the political support for collective bargaining evaporated and as manufacturing was off-shored to cheaper labor locations. Hourly earnings have been recovering along with the economy, with the growth rate moving above post-1984 long-term averages.

Long-term trend in hourly earnings

10-year moving average of your % change

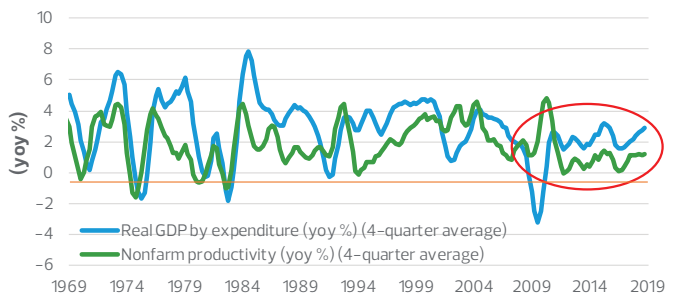


Source: BLS; Bloomberg; RSM US LLP

Productivity growth, thought to be an essential factor for increased and sustained levels of output growth, remains low, setting the stage for a low-growth regime and the greater likelihood for a recession.

Real GDP and productivity

4-quarter moving averages



Source: BEA; BLS; Bloomberg; RSM US LLP

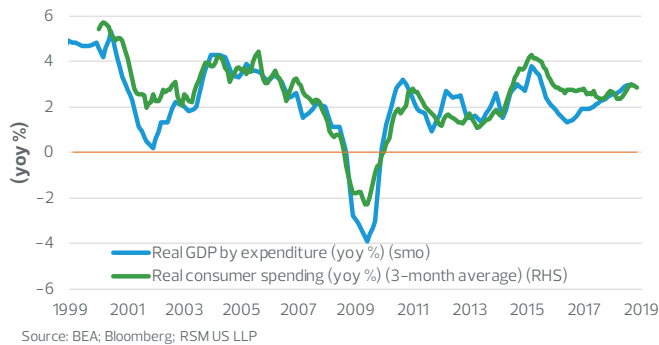


IS THE ECONOMY HEADED FOR RECESSION?

CONSUMER SECTOR

The consumer sector approximately comprises two-thirds of the U.S. economy, with spending slowing to about 2.8 percent in Q4, while Q3 real GDP grew at a 3 percent rate.

Real GDP and real consumer spending



Economic theory suggests that household consumption can be more dependent on perceptions of future rather than current income growth. The latest available retail data suggested the possibility of a slight slowdown in household spending.

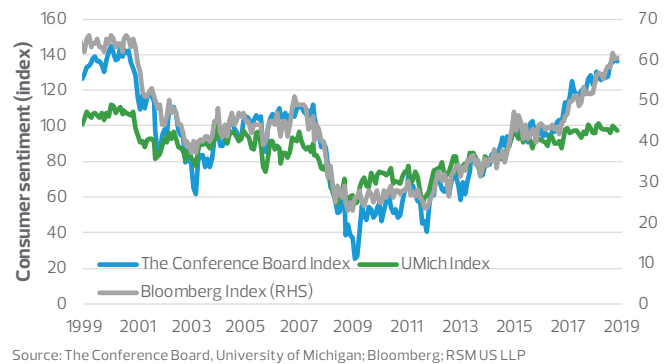
Real GDP and retail sales



The role of consumer confidence in household spending

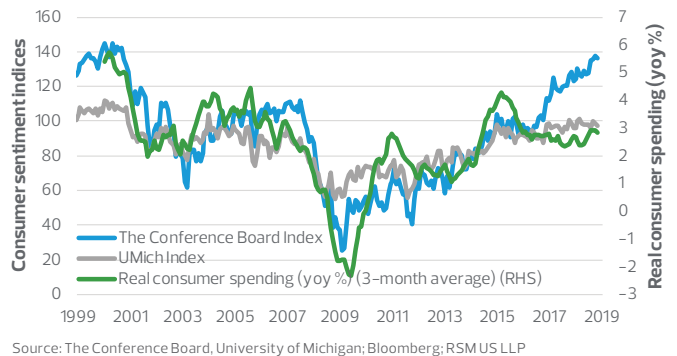
There are three major consumer sentiment surveys, with The Conference Board and Bloomberg indices reporting increasing confidence since 2017, while the University of Michigan (UMich) survey reports a flattening of confidence since the end of 2016.

Consumer confidence indices



The UMich survey confirms what looks to be a late-in-the-business cycle stabilization of consumer spending. The Conference Board survey suggests a more optimistic outlook for the consumer sector.

Consumer confidence and real consumer spending



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GDPR AND BEYOND: EUROPE'S TAKE ON DATA PRIVACY IS SPILLING INTO THE UNITED STATES

By Alain Marcuse

The European Union's General Data Protection Regulation, better known as GDPR, stipulates tight controls for companies that handle EU residents' consumer data.

Those rules are presenting challenges for U.S. firms doing business abroad, and now efforts to adopt similar controls in the United States are starting to surface.

A \$57 million fine imposed by French regulators on Google in January 2019, among other recent GDPR sanctions, confirms the urgency of compliance. GDPR changes data privacy rules for all companies that transmit, process or hold data pertaining to EU residents, regardless of whether those companies have physical operations in the EU. U.S. businesses must navigate the regulation's complexity—while also keeping an eye on emerging U.S. and global data privacy regulations.

**IT IS IMPORTANT
TO NOTE THAT THE
FINE ON GOOGLE
WAS IMPOSED EVEN
THOUGH NO DATA
BREACH HAD TAKEN
PLACE TO EXPOSE
PERSONAL DATA.**

These fines have a commercial domino effect that should not be underestimated. U.S. companies are starting to find that the European businesses they

partner with are increasingly demanding GDPR compliance, lest they themselves be subject to these fines—and are taking their business elsewhere if such compliance is not forthcoming.

GDPR enforcement begins

GDPR enforcement began May 25, 2018, with the first complaints filed on the day the law took effect. In the intervening months, the first wave of enforcement actions covered a wide range of violations. The Google penalty imposed by CNIL, the French data protection

authority, is the most significant sanction to date, sending a clear signal that EU regulators are taking enforcement seriously.



It is important to note that the fine on Google was imposed even though no data breach had taken place to expose personal data. The CNIL fined the tech giant for its lack of transparency in data collection and processing, and for not properly obtaining consent for ad personalization.

While the Google example illustrates how heavy fines can be triggered by noncompliance with the GDPR, smaller fines illustrate the full breadth of the law's application. For example:

- Austria's data protection authority fined a retail establishment 4,800 euros because its surveillance camera captured too much of a sidewalk.
- A hospital in Portugal was fined 400,000 euros for handling patient information inappropriately.
- A German chat platform was fined 20,000 euros for a breach of user passwords.

While these violations and fines vary, they contain clues about future enforcement actions. For example, each country's supervisory authority has significant latitude in how strictly the law is interpreted and what the penalties for noncompliance should be.

Perhaps most importantly, these fines demonstrate that companies that cooperated with regulators and showed progress toward compliance were shown leniency. GDPR is an expansive law and, at least at this early stage of implementation and enforcement, some regulators appear to be looking favorably on companies that demonstrate a serious GDPR compliance effort, as the German example shows.

A focus on residents, not operations

If your company has European operations, these fines are a reminder of the direct impact the GDPR can have on your

organization. However, even if you don't have a European presence, data privacy has become a global issue affecting all companies, requiring a closer look at how personal data are collected and managed.

GDPR rules also apply to U.S.-based companies with European customers, since the law's focus targets the individual's location, not that of the company. Therefore, additional safeguards and controls are likely necessary to adequately protect EU-resident data and to adhere to GDPR standards.

Emerging U.S. data privacy legislation

Data privacy law has moved beyond Europe, and is squarely in the sights of some state regulators, with potential federal laws on the horizon. The California Consumer Privacy Act was signed into law in June 2018,

creating new requirements for the protection of personal information of California residents. While the law is not slated to become effective until the beginning of 2020, some other states, including Massachusetts and Texas, already have some level of data privacy protections in place.

With public pressure increasing on how companies collect and manage data, discussions have begun about expanded federal privacy regulations. It is only a matter of time before more extensive U.S. data privacy laws are

developed at both the state and federal levels, and effective preparation is key to protecting customer data and avoiding potential sanctions.

(Please visit [GDPR and beyond: The impact of initial sanctions and new regulations](#) to see an expanded version of this article, and more details on how you can prepare your company for GDPR compliance.)

**WITH PUBLIC PRESSURE
INCREASING ON HOW
COMPANIES COLLECT
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DISCUSSIONS HAVE
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RSM REAL GDP INDEX POINTS TO SUB-2 PERCENT GROWTH

By Joe Brusuelas and Kevin Depew

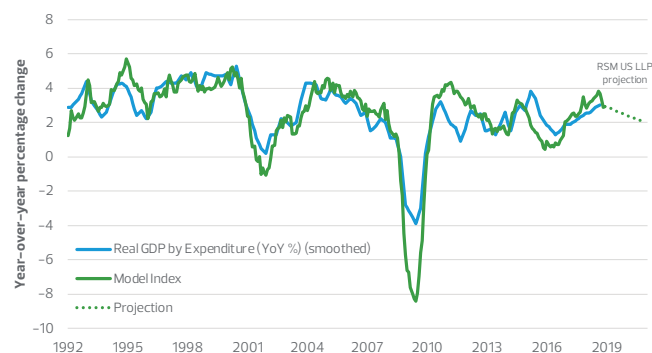
RSM's monthly forecast model for real GDP growth in the U.S. economy continues to point to a return to below-2 percent growth during the next two years. After a year of above-average growth, our projections assume that growth rates of the economic indicators included in our model will revert over the course of 2019. As a result, real GDP growth will ultimately move toward a yearly pace of 1.8 to 2 percent.

The historically long expansion will continue to slow, hampered by several factors: continued threats of global supply chain disruptions; investment uncertainty due to rising interest rates (both at the front-end of the yield curve as the Federal Reserve continues its program of normalizing interest rates, and at the long-end as the market begins pricing in the impact of servicing an outsized budget deficit); and as the unwinding of this year's fiscal stimulus becomes a drag on growth.

The model forecast, in line with our current base case estimate for 2019 and 2020 growth, was derived after applying forecasts of key economic indicators to determine baseline projections for U.S. real GDP growth for the coming two years.

Editor's note: The new index is based on a subset of monthly economic indicators used to determine the beginning and end of U.S. business cycles. The advantage of using this data over the quarterly national accounts values of real GDP growth is the timeliness of monthly indicators that are, for the most part, accessible and understandable to all market and industry participants.

U.S. real GDP growth and RSM monthly index of economic activity



Source: BEA; BLS; Census; Bloomberg; RSM US LLP

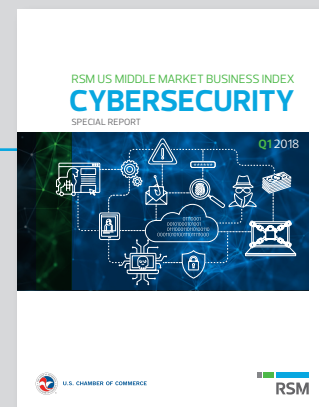


RESEARCH SHOWS **MIDDLE MARKET CYBERRISK**

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](#).



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