

THE REAL ECONOMY

VOLUME 43



THE CASE FOR
A US-UK
FREE TRADE
AGREEMENT

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AGREEMENT**

THE TIME IS RIPE FOR **TECHNOLOGY
INVESTMENT**

TIMBER! **RIISING CANADIAN LUMBER PRICES**
FELL BUILDER CONFIDENCE



ABOUT THE **CONTRIBUTORS**

Our thought leaders are professionals with years of experience in their fields who strive to help you and your business succeed. Thought leaders who have contributed content to this issue include:



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THE CASE FOR A **US-UK** **FREE TRADE** **AGREEMENT**

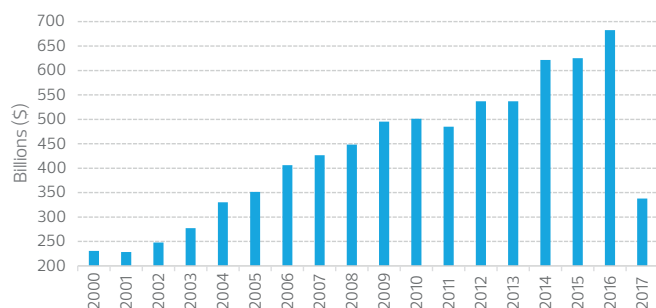
By Joseph Brusuelas
Chief Economist, RSM US LLP

The business cycle is clearly closer to its end than its beginning. Increasing uncertainty about the policy direction of the United Kingdom (U.K.) as it approaches a March 29, 2019, deadline to negotiate an exit from the European Union (EU) hangs heavy over the British economy. Unresolved questions over whether the U.K. will remain within the EU orbit or operate outside as "Global Britain" contribute to a weak environment for business investment and consumption. While moves toward a U.S.–U.K. free trade agreement (FTA) may seem counterintuitive, given the lack of answers to those questions and rising protectionism from the Trump administration, now is the time to begin laying the groundwork for such a partnership.

Since the Brexit referendum, active trade associations inside Washington, D.C., have quietly been preparing for the day when the U.K. and EU resolve the treatment of third parties. Inside the U.S. political authority, the construction of a U.S.–U.K. free trade caucus has already been formed and the Trump administration has clearly signaled enthusiasm to negotiate a bilateral FTA.

The relationship between the two economies and their complementary political and legal institutions make this a natural move. U.S. foreign direct investment in Great Britain until 2017 steadily improved, cresting at \$682 billion in 2016 before falling to \$337.9 billion in 2017, mostly due to uncertainty over the U.K.'s economic direction following the 2016 Brexit referendum.

U.S. foreign direct investment in the U.K.



Source: RSM US LLP, Bloomberg

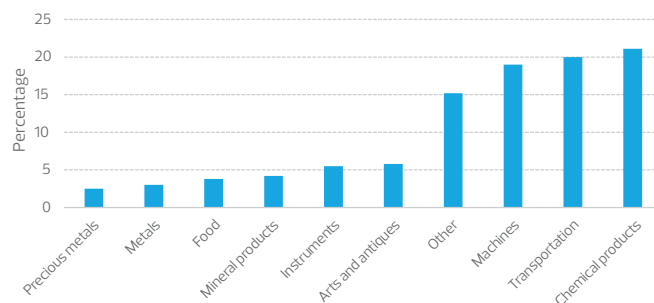
MIDDLE MARKET INSIGHT

In a time of transition for the global economy it would make sense for the US and the UK to engage in a free trade agreement that places the middle market at the center of that treaty.

Despite the decline in U.S. direct investment, the trade relationship between the two economies remains robust. U.S.–U.K. trade in goods totaled \$119.9 billion in 2017, while services reached \$71.2 billion. Moreover, dense links between the financial sectors of the two economies, as well as strong relationships between cities such as Chicago and Birmingham, England, have fostered deep and enduring trade alliances in heavy manufacturing tied to the defense industrial base in both countries; those alliances illustrate that the countries are more than just allies in commerce.

To be sure, the negotiation of a U.S.–U.K. trade agreement will not happen overnight. Public discussion that an FTA could be agreed upon in a matter of hours or weeks is counterproductive and not tethered to any economic, financial or political reality. A reality check on timing is important.

U.S. exports to the U.K.



Source: RSM US LLP, Bloomberg



The better parallel would likely be the U.S.–Australian FTA, which took 14 months from start of negotiations to agreement and 22 months from origination of talks to implementation. With respect to all bilateral trade agreements that the United States has negotiated, the average duration from start to agreement is 18 months and start to implementation is 45 months. Thus, policymakers on both sides of the Atlantic should begin to put in place appropriate personnel and budgets for a period of negotiations that will at least stretch over a two-year period, with additional time included to account for the gap between the end of negotiations and implementation.

U.K.'s negotiating difficulties are an open secret

It's an open secret on both sides of the Atlantic that the U.K. finds itself in a very difficult negotiating position. Should Britain exit the European Economic Community, it will need to strike a

deal quicker than it otherwise would have to support economic activity. So how can a mutually beneficial deal be reached?

INSIDE THE U.S. POLITICAL AUTHORITY, THE CONSTRUCTION OF A U.S.–U.K. FREE TRADE CAUCUS HAS ALREADY BEEN FORMED AND THE TRUMP ADMINISTRATION HAS CLEARLY SIGNALLED ENTHUSIASM TO NEGOTIATE A BILATERAL FTA.

First, both London and Washington, D.C., need to accelerate cooperation between the U.S.–U.K. Regulatory Working Group ahead of any final status agreement with the EU. Discussions on harmonization of financial services regulation should be given priority and moved forward over the next several months on the assumption that the U.K. will be exiting the European economic orbit. Given that financial services account for roughly 17 percent of U.K. exports to the United States and conversely 21 percent of U.S. exports to the U.K., the natural industrial ecosystem requires the start of negotiations.

Second, it's critical that industry trade associations on both sides of the Atlantic get to work on expressing preferences on potential trade alignment in sectors, including agriculture, pharmaceuticals, technology and telecommunications.

Third, while these negotiations will be tough and at times contentious, the two sides must keep in mind that the benefits of a bilateral FTA will be tremendous. Not unlike the U.S.–Australian FTA, impending talks will test a longstanding special relationship and both parties will likely exit bruised. Indeed, there is a strong probability that negotiations could get bogged down around nontariff and regulatory concerns surrounding the issues of cybersecurity, food safety, genetically modified

MIDDLE MARKET INSIGHT:

One of the innovations in trade that wasn't around during the time of NAFTA or the World Trade Organization is the fact that US bilateral trade treaties carved out special exemptions for middle-market firms.

organisms, information access by U.S. health care firms and privacy protection.

Once an FTA is agreed upon, there will be more agriculture coming from the United States than there are stars in the sky. Food prices will fall significantly inside the U.K., and Scotland will find a deep and wealthy export market for its whiskey and Angus beef. The logical integration of the Anglo-American financial services and defense sectors can proceed. And what of chlorine-washed chicken? It's been banned since 1997 in the EU but is now receiving outsized attention in Britain as the U.K. considers its post-Brexit import options from the United States. Contrary to popular opinion across the pond, the United States has a healthy supply of free-range and organic poultry that can clearly meet U.K. standards.

MIDDLE MARKET INSIGHT:

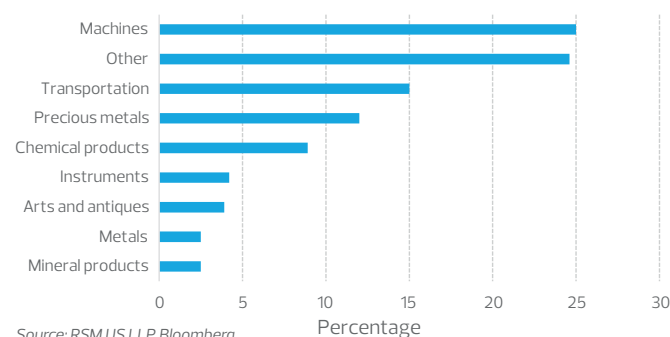
A risk for middle market would be a slowdown in consumption over the next few months due to rising import prices on both sides of the Atlantic.

THE BENEFITS OF A U.S.-U.K. AGREEMENT OVER FREE TRADE ARE QUITE CLEAR.

The benefits of a U.S.-U.K. free trade agreement are quite clear. Currently, the trade-weighted tariff for all goods is 2.7 percent in the U.K. and 2.2 percent in the United States. In agriculture, these tariffs are 8.5 percent and 3.8 percent, respectively. Bringing these tariffs to zero would boost economic activity and improve the living standards in both economies. Free trade is the solution and not the problem—something both sides of the

Atlantic would do well to remember so as to not miss a major economic opportunity that lies just over the horizon.

U.K. exports to the United States



THE TIME IS RIPE FOR TECHNOLOGY INVESTMENT



By Joseph Brusuelas, Chief Economist, RSM US LLP

Fostering investment by businesses in productivity-enhancing areas such as software, computers, machinery and intellectual property was a primary consideration behind Congress' 2017 tax overhaul, but RSM's proprietary research shows that many middle market companies have yet to take the bait.

Data from the 2018 second-quarter RSM US Middle Market Business Index survey (see results on following page) finds that while a plurality of midsize businesses are willing to increase their overall pace of investment in capital expenditures, the majority are not currently planning to increase the amount of their outlays over the next three years, despite the sharply lower 21 percent statutory corporate tax rate (down from a prior 35 percent) stipulated under the 2017 Tax Cuts and Jobs Act (TCJA).

Of middle market leaders expecting changes in tax law to improve their after-tax cash flows, 71 percent reported that increasing capital expenditures was a priority. Yet when all survey participants were asked about the TCJA's impact on their capex plans over a three-year period, only 38 percent said they would boost outlays. This tracks closely with actual

capital expenditure increases reported by middle market leaders in our top line index during the last 12 months, which have hovered between 40 to 45 percent.

What is going on with the other 62 percent of middle market companies polled in the second quarter? Their reluctance to commit to capex outlays could be due, in part, to a lack of awareness on how certain provisions of the TCJA could benefit them through opportunities to get ahead in important areas such as investing in technology.

Embracing disruption

Technology investments may be beyond the reach of some businesses, either because they are too expensive, too unknown or too irrelevant. But tech investment is particularly important now as the country rides the tail end of an economic cycle marked by record unemployment; the U.S. unemployment rate, which in April dropped below 4

percent for the first time since 2000, is now 3.8 percent, and shows little sign of abating. In an environment where qualified labor is becoming scarcer and more expensive, now appears to be an ideal time to make technology investments.

Tech spending—on everything from cloud computing to improved automation and artificial intelligence—is particularly important now, as the economy moves through a period of profound disruption and disruptors (think gig economy players such as Uber and WeWork) have the ability to upend established markets.

TECH SPENDING—ON EVERYTHING FROM CLOUD COMPUTING TO IMPROVED AUTOMATION AND ARTIFICIAL INTELLIGENCE—IS PARTICULARLY IMPORTANT NOW, AS THE ECONOMY MOVES THROUGH A PERIOD OF PROFOUND DISRUPTION.

MIDDLE MARKET INSIGHT:

As challenging as it may be during a time of economic uncertainty, middle market businesses must find a way to allocate investment capital to keep pace with technological changes.

The reticence over capital expenditures is not altogether surprising, however, considering that only 58 percent of executives polled in the second quarter said the new tax legislation will have a moderate or strong impact on their overall growth conditions, while slightly less (52 percent)

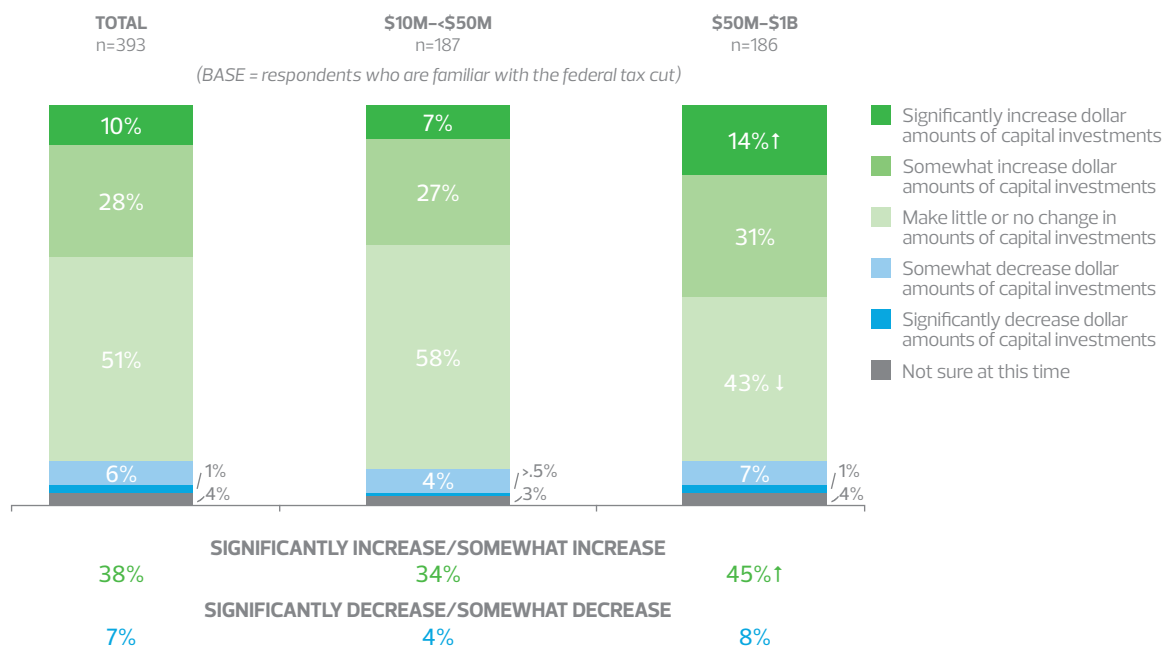
expect the change to improve their after-tax cash flows.

To be sure, this reluctance to boost capex investment, in light of other macroeconomic forces at play, is one issue RSM will be watching closely.

RSM Middle Market Business Index Survey, 2018 Q2

IMPACT OF PROVISION ALLOWING FOR ACCELERATED EXPENSING/DEPRECIATION ON PLANNED DOLLAR VOLUME OF CAPITAL INVESTMENTS OVER NEXT THREE YEARS

Among those familiar with the TCJA, 38 percent indicated they will increase capital investments over the next three years. Executives at larger organizations are more likely to do so (45 percent versus 34 percent) than smaller organizations.



- Overall, how would you rate your level of familiarity with the recent federal tax cut also known as the Tax Cuts and Jobs Act of 2017 (TCJA)?
- The TCJA permits the immediate expensing of many capital investments. What impact, if any, will the provision allowing for accelerated expensing or depreciation have on the planned dollar volume of your organization's capital investments over the next three years?



TIMBER! RISING CANADIAN LUMBER PRICES FELL BUILDER CONFIDENCE

A Q&A with Brandon Maves, RSM partner and national construction sector leader

The cost of Canadian lumber, a major source of wood for U.S. homes, has risen sharply this year, due in part to tariffs of about 20 percent put in place in 2017, when the U.S. Commerce Department determined that Canadian companies were selling lumber in the United States at unfair prices.

The higher prices, which come amid additional U.S. tariffs on Canadian goods, have served as a wake-up call for U.S. homebuilders, driving up home prices and creating concern about the future of the supply chain. RSM's national construction industry leader, Brandon Maves, discusses how builders have adapted—and how they can plan for the months ahead.

Q: It looks like a good time to be a lumber producer and a challenging time to be a homebuilder. What cost increases are builders seeing?

Maves: That's a very good way to put it. While clients aren't talking about lumber prices specifically, they're concerned because it's part of the broader construction cost increase. Costs overall have gone up 10 percent to 20 percent during the past two years. That includes increases in labor costs and the price of nails due to steel tariffs.

Q: How are builders responding to the rise in construction costs?

Maves: They're passing all of it on to the buyer. The question is, how long can you do that? Because you've also got rising interest rates, so the cost to finance a house is also going up. That doesn't matter as much for higher-end buyers who can handle the difference between a \$1 million and \$1.1 million home. But the lower-end builders—including some townhouse builders—are much more sensitive to price changes for lumber and other materials, because their buyers are more sensitive to those changes.

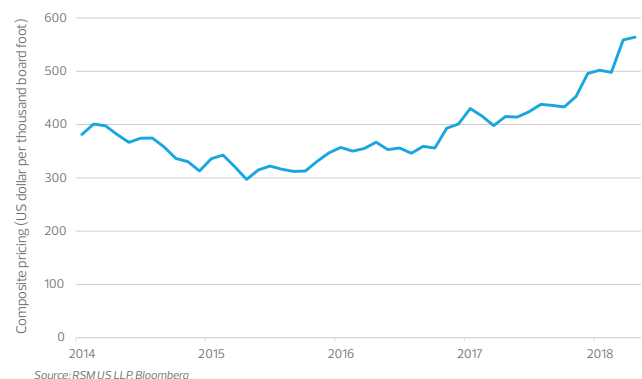
Q: Are builders using different materials to avoid high costs? Is anyone saying, "We're getting more in love with brick?"

Maves: No, no brick love yet. I haven't heard a word about alternative building materials. That would be a major departure—they've been building houses with soft lumber for centuries.

Q: Have rising costs prompted other changes in doing business?

Maves: Builders are unwilling to take bigger risks. A developer client of mine said that around 2005, he was getting as much land as possible. He couldn't spend money fast enough. Now, his buying process is much more reserved. That's true for other builders. Whether it's land or lumber or any other materials, they're much more diligent and taking a just-in-time approach, so they don't get overextended.

Framing lumber composite





Q: What advice do you have for homebuilders in this economic landscape?

Maves: We're encouraging our clients to make sure they've got good access to capital via lines of credit and other debt instruments. And we tell them to be mindful of how far ahead they get. Don't make any purchase commitments that they don't feel they can turn quickly.

Q: As you keep an eye on the economic shifts that concern homebuilders, what numbers have caught your attention?

Maves: The 10-year Treasury note tends to be the trend line that the 30-year mortgage follows. As that rises, it usually portends a rise in mortgage rates. I also pay attention to the rising cost of building materials, as we've talked about. One thing I watch is the Bureau of Labor Statistics Producer Price Index. It doesn't point to the future, but shows monthly price changes for key building components, such as steel, lumber and cement.

I also listen to the overall chatter from the Federal Reserve. It gets a lot of data, and as the short-term rate increases come through, that affects contractors' ability to obtain working capital.

Q: Tariffs play a role in the price increases, but aren't there other causes—like growing demand accompanied by supply shortages (due to severe Canadian wildfires last year and also a pine beetle infestation in British Columbia)?

Maves: I view that as kind of the normal part of the course of business. The flow of construction materials goes up and down, and overall demand moves in the market. Some of that is what I would call just normal things that do happen. They're not great, whereas the tariffs are something we've kind of thrown on top of it.

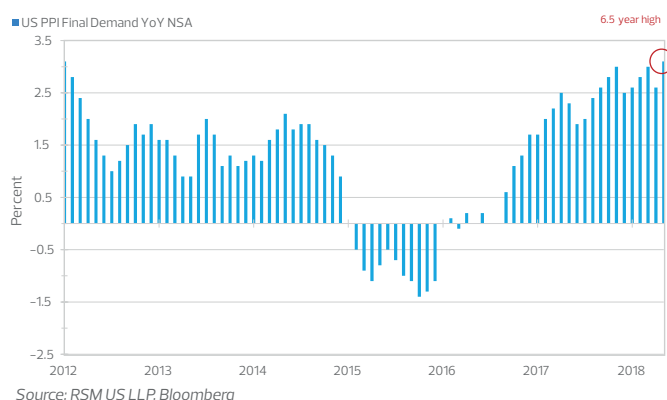
Q: With the ongoing cost challenges, how would you describe builders' mood about the economy overall?

Maves: They are cautiously optimistic about the next 18 months. After that window, they get pretty nervous. The economy is growing at a good clip, and for the next 18 months, they can see where the revenue is coming from. Their concern is what happens after that.

As costs keep rising, you can only go so far with passing it on to consumers. The last time homebuilders consistently raised prices like this was the last real estate boom around 2006. As a result of the bust, lots of middle market homebuilders were largely wiped out.

Homebuilders don't want to repeat that. When the market slows down, they don't want to get caught on the wrong end of it.

U.S. production costs



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