THE REAL ECONOMY

VOLUME 51

THE RSM BREXIT STRESS INDEX:

BREXIT'S IMPACT ON TRADE, WEALTH, BUSINESS CYCLE AND CORPORATE PROFIT

ALSO IN THIS ISSUE:

RSM REAL GDP TRACKER INDEX **FORECASTS SUB–2 PERCENT GROWTH**

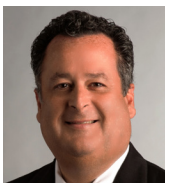
CYBERTHREATS FOR MIDDLE MARKET COMPANIES RISE BUT CONFIDENCE LEVEL INCREASES

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

RSM

ABOUT THE **AUTHORS**

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



Joseph Brusuelas
Chief Economist
RSM US LLP

Kevin Depew
Deputy Chief Economist
RSM US LLP

TABLE OF **CONTENTS**

The RSM Brexit Stress Index:
Brexit's impact on trade, wealth, business cycle and corporate profit **4**

RSM Real GDP Tracker Index **forecasts sub–2 percent growth** **8**

Cyberthreats for middle market companies rise
but confidence level increases **10**

This publication represents the views of the author(s), and does not necessarily represent the views of RSM.
This publication does not constitute professional advice.

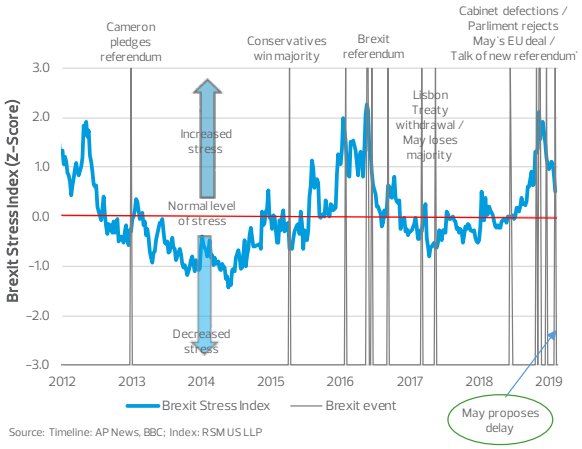
THE RSM BREXIT STRESS INDEX: BREXIT'S IMPACT ON TRADE, WEALTH, BUSINESS CYCLE AND CORPORATE PROFIT

By Joseph Brusuelas

The prospect of Britain's departure from the European Union has created uncertainty in the economy and volatility in financial markets. Disruptions to the UK supply chain—a system built over decades within a European common market—will ultimately create losses for consumers through higher prices and diminished consumption choices.

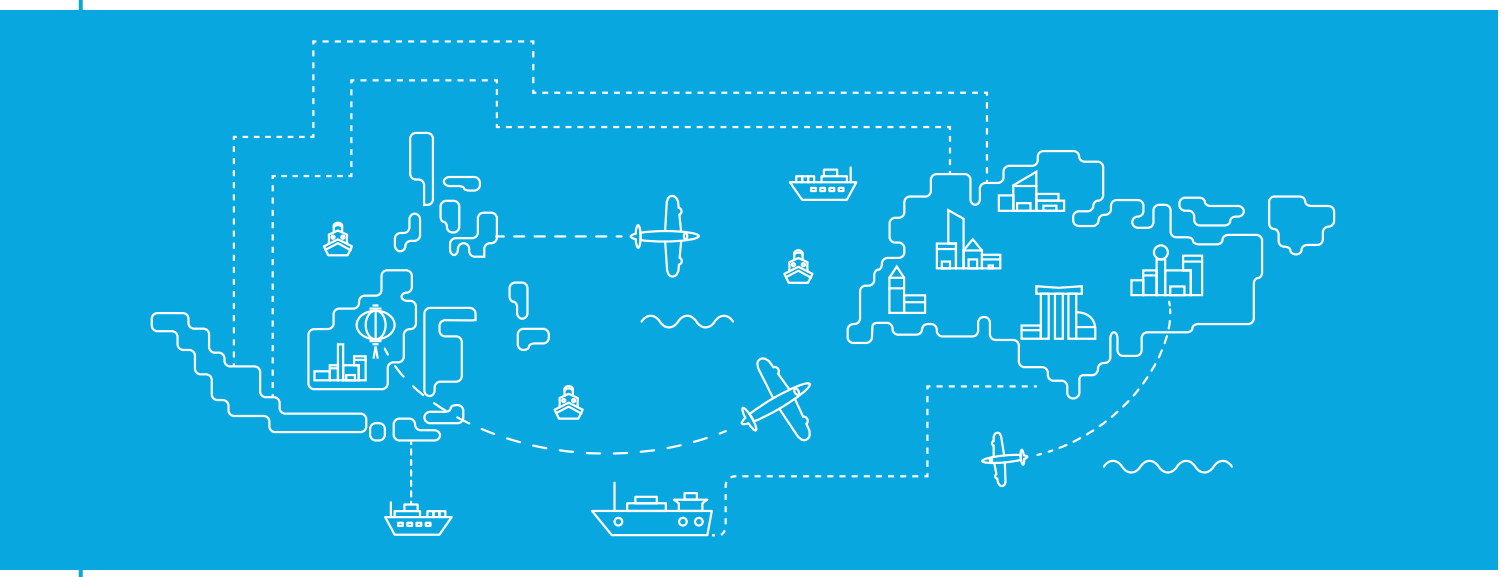
RSM has developed the RSM Brexit Stress Index to measure Brexit's impact on UK economy. The index is composed of six financial variables whose weekly performance indicates the market's assessment of Brexit on trade, wealth, the business cycle and corporate profits. The RSM Brexit Stress Index tightened for the week ended March 8 to 0.7 standard deviations above neutral from 0.5 above neutral the week prior; however, it is important to note that the index has declined from over 2 standard deviations above neutral in December, mostly due to financial markets pricing in a reduced probability of a hard exit from the European Union. This implies that economic and financial risks around the policy choices to be made over the next few weeks have eased.

Brexit Stress Index and Brexit vote timeline



Source: Timeline: AP News, BBC; Index: RSM US LLP

A brief history shows the index moved higher in the run-up to the 2016 Brexit referendum, moved lower in the long period of negotiations and preparations thereafter, and then spiked higher as consequences of an exit from the common market became real.



INDEX VARIABLES

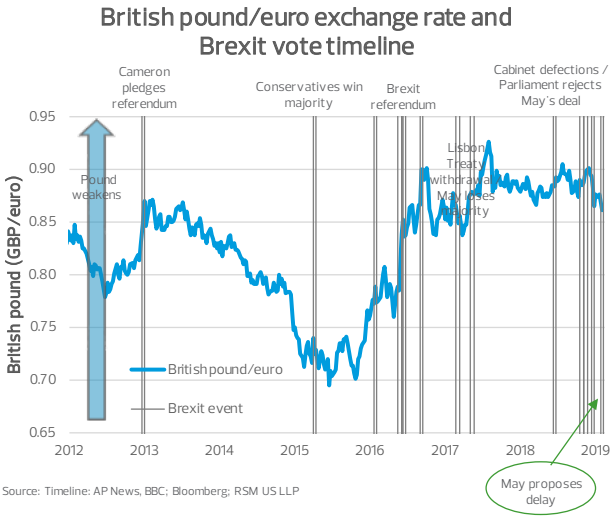
Expectations for foreign trade (via the currency market)

1. British pound/euro exchange rate

RSM uses the British pound/euro exchange rate relative to its pre-Brexit level to measure the degree of stress in the foreign exchange market. An exchange rate is a two-sided variable that measures expectations of relative interest rates (and the return on investment in one country relative to another) and the demand for one currency relative to another due to trade and current account flows.

Note that the pound appreciated against the euro in the run-up to the UK's Conservative Party majority win in 2015, but then lost value once the prospect of a referendum became certain and as steps to leave the common market and disruptions of trade became reality.

In the current environment, rejection of Prime Minister Theresa May's deals with the EU and talk of delay, or rethinking that another referendum might be the preferred option, the pound has been range-trading or perhaps leaning toward strengthening again.

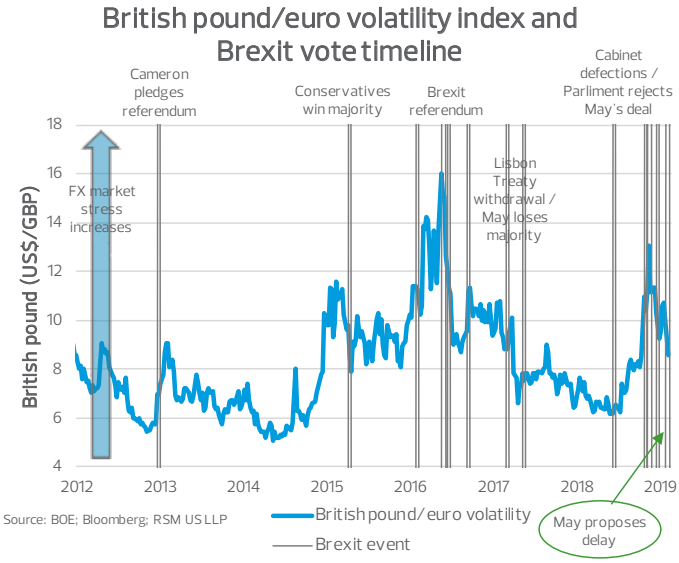


Source: Timeline: AP News, BBC; Bloomberg; RSM US LLP

2. Volatility of the British pound/euro exchange rate

Exchange rate volatility measures the standard deviation of exchange rate at any given time within the previous 90-day period. Low volatility suggests a stable environment in which to make investment or trade decisions. A spike to high volatility indicates uncertainty in the market.

In the case of the British pound/euro exchange rate, volatility spiked up both in the run-up to the Brexit vote and as Brexit negotiations became reality and political ramifications took hold. Recently the level of volatility has retreated but remains higher than normal.



Source: BOE; Bloomberg; RSM US LLP

Expectations of wealth

3. Equity market performance

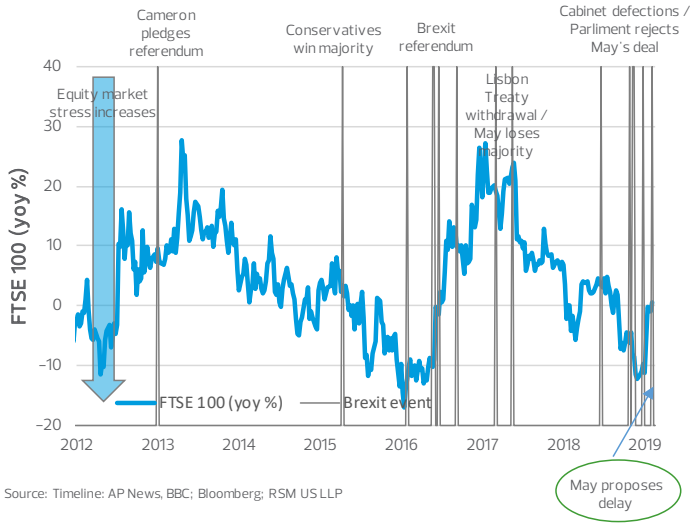
Because stock indices have shown a tendency to grow over the years (in the absence of shocks), we look at the weekly level of the Financial Times Stock Exchange (FTSE) 100 Index relative to the same week of the previous year. The measure of performance of the FTSE 100 stock index is not only the factual return on an investment in the business sector, but also an indication of expectations for the direction of and acquisition of household wealth.

The diminished yearly rate of return of the FTSE 100 in the run-up to the election of the Conservative government in 2015 and the subsequent improvement in the run-up to the Brexit vote might be due to dissatisfaction with the labor government in the first instance, and expectations of Conservative activism in the second.

THE EQUITY MARKET LOSSES AFTER THE BREXIT VOTE COULD BE CONSTRUED AS A REALITY CHECK THAT THERE ARE INDEED COSTS TO BREXIT.

In the latest period, the rate of return in the equity market is once more approaching positive levels, perhaps due to anticipation of a delay or reversal of Brexit.

Growth of the FTSE 100 Index and the Brexit vote timeline

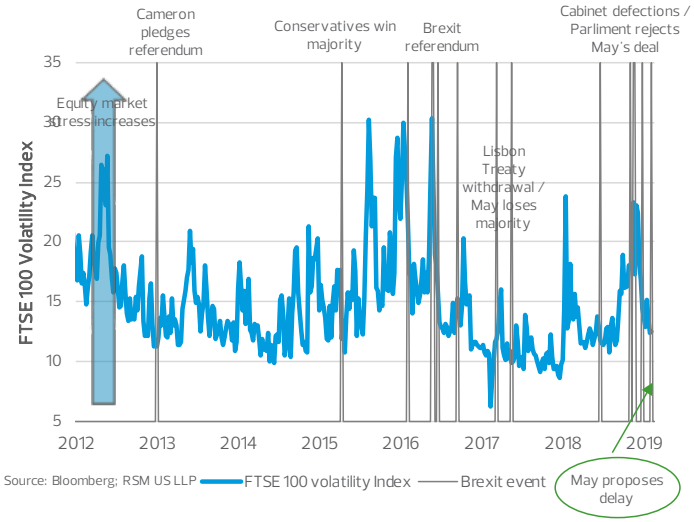


Source: Timeline: AP News, BBC; Bloomberg; RSM US LLP

4. Equity market volatility

As in the foreign exchange market, spikes in the volatility of the FTSE 100 suggest the potential of a shock and an environment of uncertainty. Volatility trended higher in the run-up to the Brexit referendum, and then retreated to normal levels in 2017 and 2018 before spiking upward as the Brexit negotiations came to the front. In recent weeks, volatility has retreated again, perhaps in response to the increasing prospect of delay and reversal took hold.

FTSE 100 volatility and Brexit vote timeline



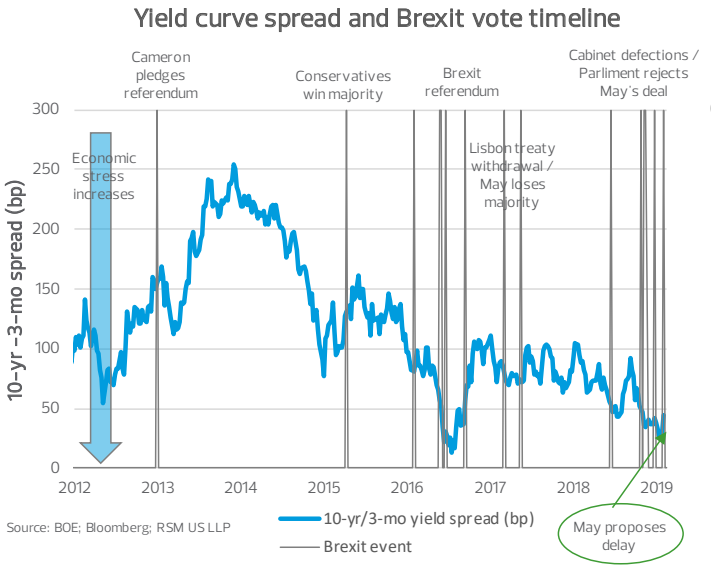
Source: Bloomberg; RSM US LLP

Expectations for the business cycle

5. Yield curve spread

The shape of the yield curve—as measured by the spread between the yield on 10-year gilts and three-month interest rates—is an indication of the market assessment of the direction of the business cycle. When long-term yields are substantially higher than short-term rates (referred to as a steep yield curve), the market is holding expectations of sustained, long-term growth. When long-term yields are somewhat equal to short-term rates (referred to as a flat yield curve), the market is expecting low levels of growth.

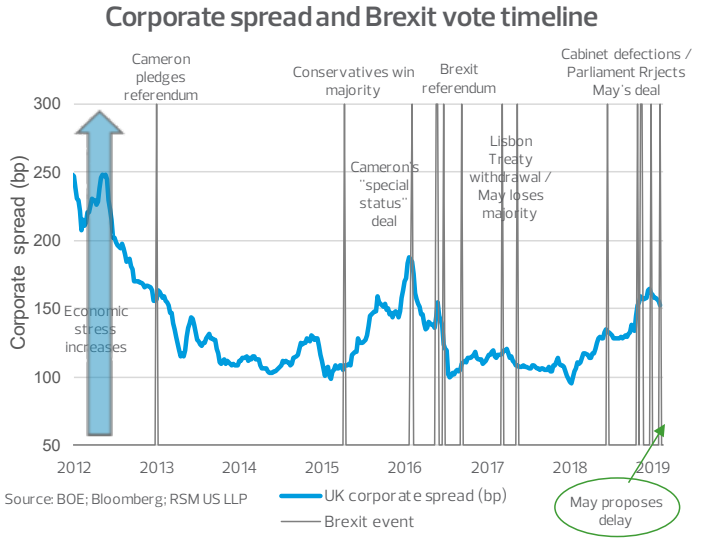
While the flattening of the yield curve in 2014 and 2015 was a reflection of expectations of low growth that probably helped the Conservatives win the majority in 2015, the continued flattening through the Brexit vote and stabilization thereafter most likely reflects the prospect of secular stagnation due to Brexit's disruption of the supply chain.



Expectations of corporate profitability

6. Corporate yield spread

The corporate yield spread measures the risk of holding a corporate security versus the safety of a risk-free government security. Corporate bond yields include a premium to cover the risk of holding a security that has the potential of default. In the Brexit Stress Index, we utilize the JP Morgan Eurosterling Corporate seven- to 10-year government bond spread. As the business cycle evolves and shifts, the spread between corporate bond yields and gilts indicates expectations of corporate profitability in coming years. The higher the spread is, the more the perceived risk of economic distress and the prospect of corporate defaults.



Brexit adds another dimension to the life span of a corporate entity. After decades of doing business within a common market and within an open labor market, there are likely to be corporate winners and losers. Interestingly, corporate spreads narrowed in the run-up to the Conservative's election victory in 2015, and then spiked higher in early 2016 on former Prime Minister David Cameron's seeking a "special status" for the UK within the common market.

Corporate spreads moved lower and stabilized after the referendum and then widened again as Brexit negotiations with the EU took shape. In recent weeks, the corporate spread has narrowed somewhat as Prime Minister May's deal with the EU fell apart in Parliament and as talk began of a Brexit delay or reversal took center stage.

RSM REAL GDP TRACKER INDEX **FORECASTS SUB-2 PERCENT GROWTH**

By Kevin Depew

RSM's forecast model for real gross domestic product growth in the U.S. economy over the next 12 months continues to point to a return to below 2 percent 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 percent.

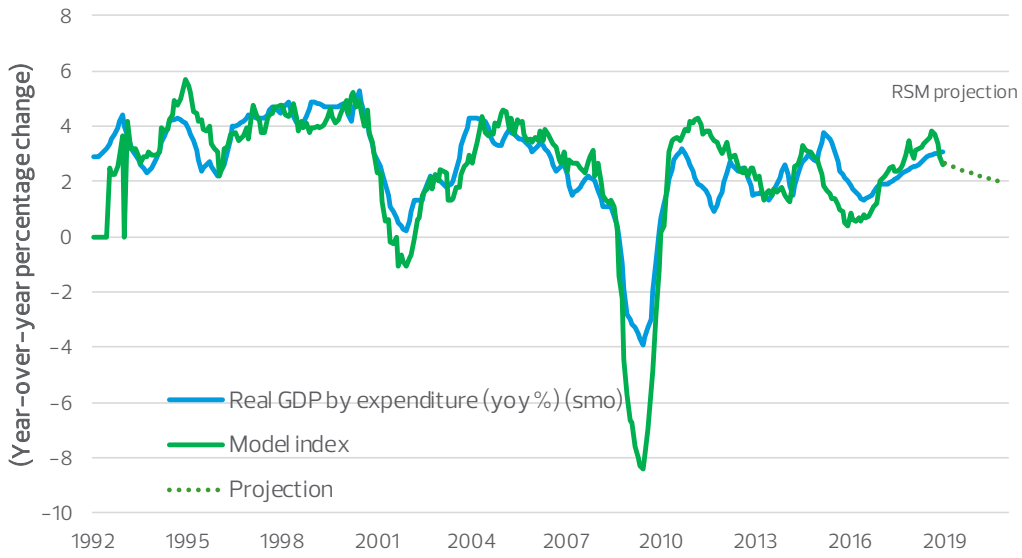
The historically long expansion is being weighed on by several factors: threats of global supply chain disruptions; investment uncertainty due to rising interest rates (both at the front-end of the yield curve as the Federal Reserve continues its program of normalizing interest rates, and at the long 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 from the tax cuts recedes.

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: Updated January manufacturing and January trade sales data are delayed until May due to the government shutdown.

The index is based on a subset of monthly economic indicators used by the National Bureau of Economic Research 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 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

TUNE IN TO "THE MIDDLE MARKET TRANSFORMATIVE CEO" WITH JOE BRUSUELAS

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**

CYBERTHREATS FOR MIDDLE MARKET COMPANIES RISE BUT CONFIDENCE LEVEL INCREASES

Unauthorized users will attempt to access proprietary data at more than half of the middle market businesses polled by the proprietary RSM US Middle Market Business Index survey in the first quarter—up significantly from 47 percent in 2018—illustrating that companies continue to battle the moving target of cyberthreats afflicting organizations of all sizes.

At the same time, some 93 percent of executives polled in the survey said they are confident in their organization's current measures to thwart attacks on critical information at their businesses.

Daimon Geopfert, national leader, security and privacy consulting at RSM, said this confidence speaks to a growing information gap between C-suite executives and their information technology teams that deal with day-to-day incidents on the ground.

Meanwhile, actual data breaches at middle market companies are creeping up as well; 15 percent of companies polled for the MMBI said they experienced a breach in 2018, compared with 13 percent a year earlier.

The issue of data privacy is heating up in the United States following the advent of Europe's General Data Protection Regulation (GDPR) standard in May 2018. California has taken the lead on implementing legislation to protect the privacy of consumers in that state with a law that takes effect in 2020. Meanwhile, Congress has held recent hearings on the pros and cons of related legislation at the federal level.

"THE NUMBERS KEEP GETTING WORSE, BUT THE GROUP IN THEIR FOCUS KEEPS GETTING MORE CONFIDENT," SAYS GEOPFERT, ADDING THAT HE SEES EXAMPLES OF THIS DISCONNECT FIRST-HAND IN HIS CONSULTING PRACTICE.

MMBI survey respondents said moves to protect their companies' data security flanks included updating security protocols (73 percent), purchasing new software or updating existing systems (61 percent) and revamping privacy policies (55 percent). Sixty-eight percent of executives indicated their organization has a dedicated function for data security and privacy.

RSM and the U.S. Chamber of Commerce are following the issue of data security closely. A special report based on the cybersecurity findings from the first quarter MMBI survey will be released in April.

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

For media inquiries, please contact Terri Andrews, National Public Relations Director, +1 980 233 4710 or terri.andrews@rsmus.com.

For more information on RSM thought leadership, please contact Deborah Cohen, Thought Leadership Director, +1 312 634 3975, deborah.cohen@rsmus.com.

This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute audit, tax, consulting, business, financial, investment, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. RSM US LLP, its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person. Internal Revenue Service rules require us to inform you that this communication may be deemed a solicitation to provide tax services. This communication is being sent to individuals who have subscribed to receive it or who we believe would have an interest in the topics discussed.

RSM US LLP is a limited liability partnership and the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. The member firms of RSM International collaborate to provide services to global clients, but are separate and distinct legal entities that cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party. Visit rsmus.com/aboutus for more information regarding RSM US LLP and RSM International.

RSM, the RSM logo and *the power of being understood* are registered trademarks of RSM International Association.

© 2019 RSM US LLP. All Rights Reserved.

TRE-NT-ALL-ALL-0319

RSM