

THE REAL ECONOMY

VOLUME 63



**WEARY OF
DISRUPTION AND
TRANSFORMATION,
GLOBALIZATION-LITE
HITS THE SPOT**

ESTIMATING THE PROBABILITY OF A RECESSION

CORONAVIRUS AND BOEING THREATEN
FIRST-QUARTER GROWTH

INDUSTRY SPOTLIGHT: GLOBAL INDUSTRY HAMPERED
AS CORONAVIRUS EPIDEMIC SPREADS

MIDDLE MARKET TREND WATCH: HEALTH CARE
SYSTEMS AND DIGITAL TRANSFORMATION

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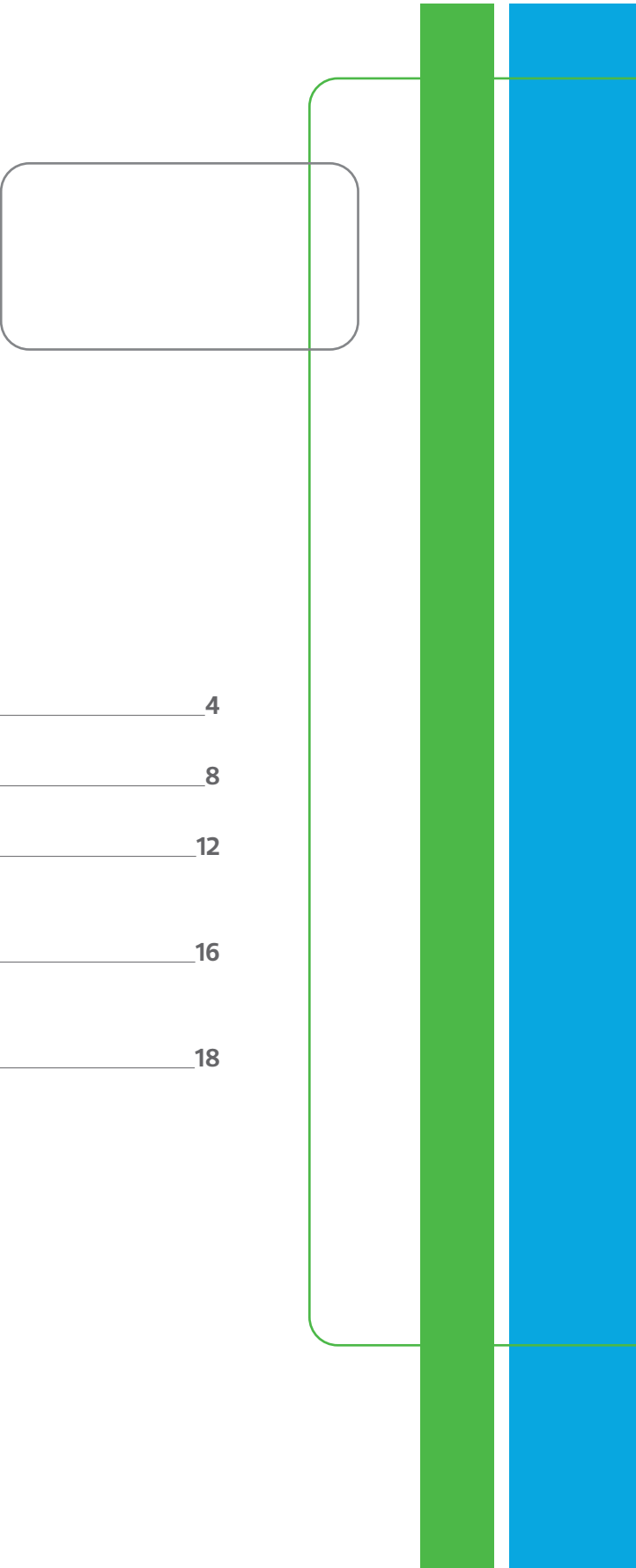


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WEARY OF DISRUPTION AND TRANSFORMATION, GLOBALIZATION-LITE HITS THE SPOT

Less-filling growth in store for global economy until appetites reawaken

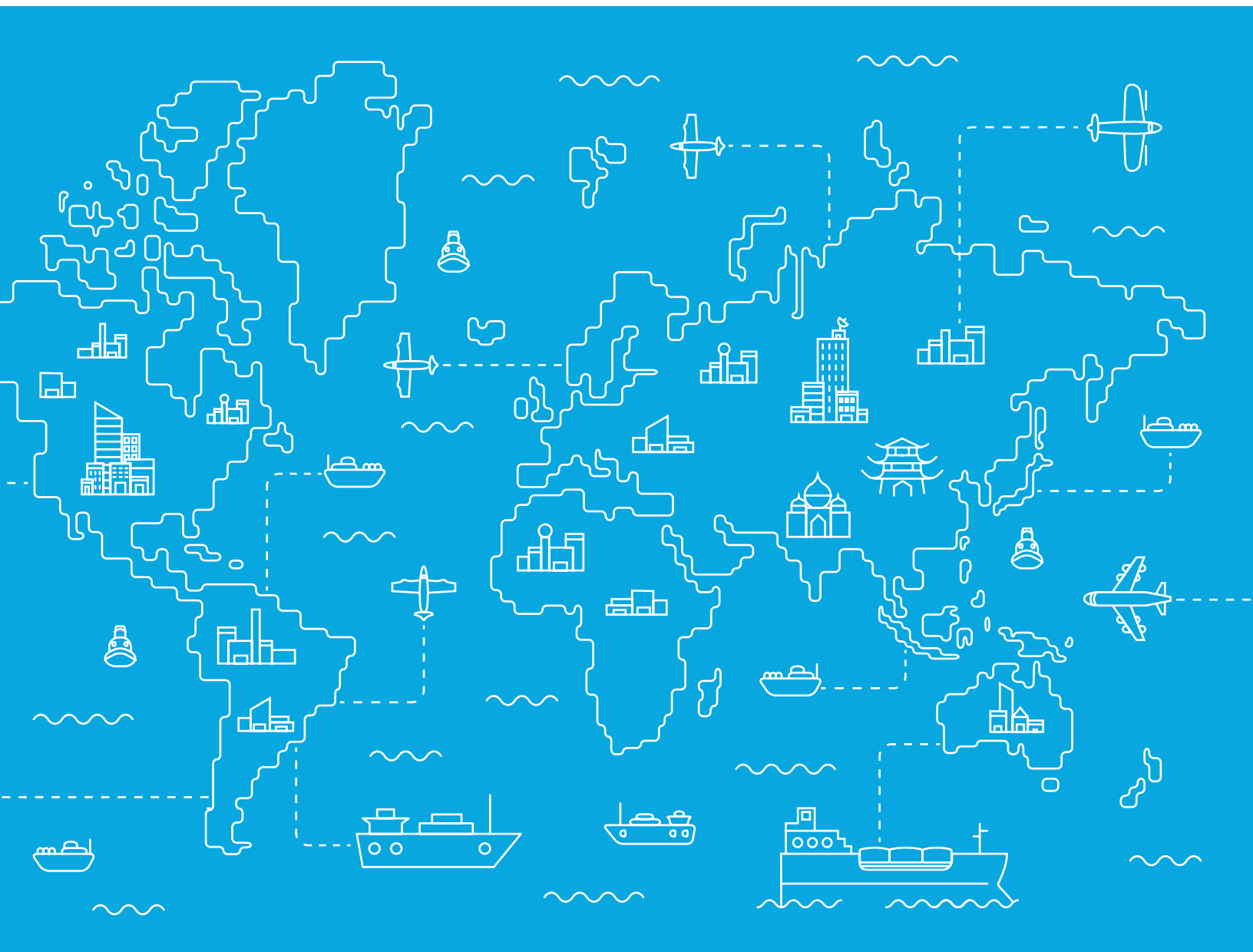
BY JOSEPH BRUSUELAS

THE RULES-BASED framework for global commerce that emerged from the ashes of World War II is evolving under the stress of technological disruption, mass migration, economic populism and rising nationalism. Globalization—the harmonization of international trade, tax and environmental rules—is clearly headed toward a temporary timeout as policymakers attempt to find novel ways to mitigate the pace and scope of economic and social change for populations that, in the wake of the Great Recession, increasingly appear unprepared for it.

While much is being said about the demise of globalization, in our estimation its death notice is premature; such thinking significantly underestimates the durability of the international institutions

constructed post-WWII and how the digital economy will effectively blunt this latest round of temporary global protectionism.

For now, we expect a temporary severing of the global economy into distinct blocs organized around regional trade arrangements and agreements—what might be referred to as globalization-lite—until new social arrangements can be made in the major economies to support the greater international integration of financial and economic life. Even so, in the long run, the pace, scope and depth of the evolution of the digital economy will operate according to its own logic, separate from that of the old traditional global economy, and ultimately, overwhelm this last gasp of old-school protectionism.

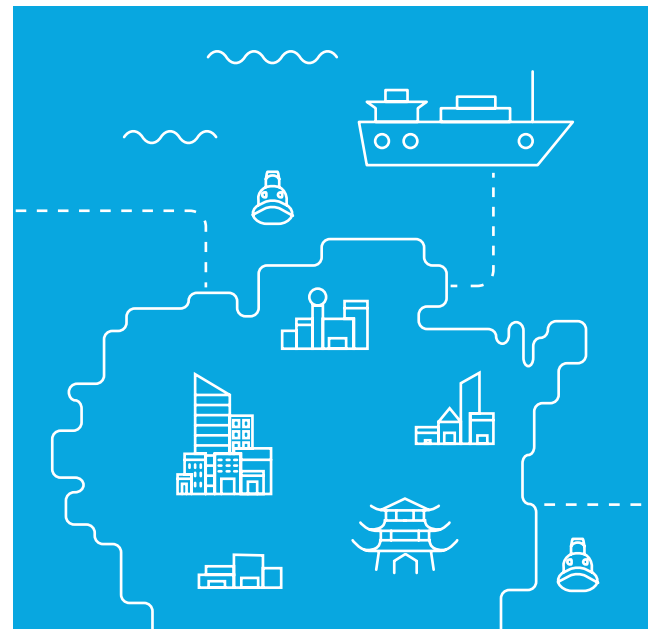
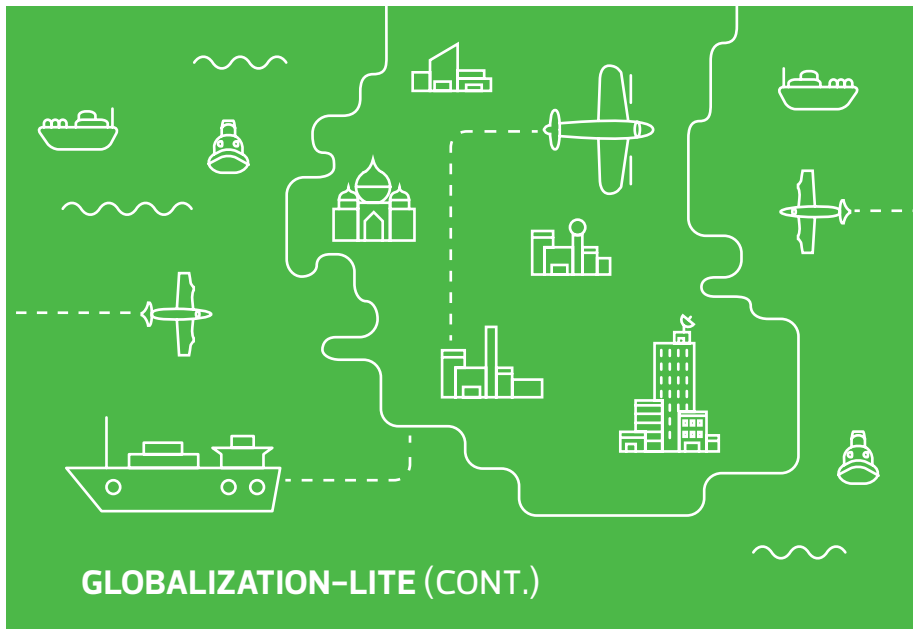


Echoes of the 1930s

After 75 years of operating within a rules-based system, the architects of the postwar order, the United States and the U.K., are ironically moving to modify that system in ways that are harming their own economies. In an eerie echo of the 1930s, masses of displaced individuals from Africa, Latin America and the Middle East have spawned rising nationalism and economic protectionism in the industrial economies, overriding the logic of trade and finance that underscore global prosperity.

In 2016 in the U.K., displaced industrial workers voted to leave the European common market, and in the United States, policy has turned to outright protectionist

measures to stem the pace of globalization. These measures have increased business uncertainty and trade and economic tensions in such a way that the protectionist policies put in place over the past few years look increasingly untenable, and will likely cause a reassessment of these developments. Tomas Philipson, economist and chairman of the Council of Economic Advisers at the White House, acknowledged the uncertainty related to trade policy in a briefing to reporters on the annual Economic Report of the President released Feb. 2. He said, "uncertainty generated by trade negotiations dampened investment." Capital expenditures have long been a soft spot in the proprietary RSM US Middle Market Business Index survey.



U.S. and U.K. trade policies adopted in the aftermath of World War II articulated the need to implement a rules-based framework for integrating the world economies and preventing another global catastrophe. First and foremost, this framework would replace conflict among nations through the promotion of international trade—better to trade goods than artillery rounds—and would facilitate economic growth among the world's economies, ushering in an era of international financing and assistance, and a rules-based framework for trade.

The attempt by economic populists to displace this framework has resulted in rising policy uncertainty and decreasing business investment, and if these policies are sustained, they will create a feedback loop that will, ironically, accelerate the loss of economic and social status of those individuals without the capacity or skill sets to compete in the new economy. The loss of investment—and in the absence of the next big thing to boost productivity—will have an enduring effect on potential growth of developed economies that follow that policy path, and again ironically, the individuals who have expressed such discontent around the most recent wave of globalization.

Regionalization for now, reglobalization later

The evidence for such an optimistic outcome can be seen in the recent United States–Mexico–Canada Agreement. About 70% of the text is taken straight from the Trans Pacific Partnership trade agreement. This is not exactly globalization in retreat. Rather, it demonstrates the institutional depth that evolved out of the Bretton–Woods Agreement of 1944, when Allied nations agreed to terms around currency exchange rates.

MIDDLE MARKET INSIGHT

Tensions and tariffs are unlikely to fade in the near-term. Longer term, the cost of doing business for firms that depend on disrupted supply chains as the global economy fragments will increase, which will stimulate a strong powerful counterreaction and subsequent move toward more efficient and lower-cost outcomes.

Yes, the United States did insert language that curbed intra-North American trade in autos and imposed a wage floor affecting 30% of auto production immediately and a target of 40% by 2023 if an auto is produced with 70% of steel and aluminum produced in North America. Yet once one examines the depth and modernization of auto production in Mexico, the rise of digital systems and ability of North American entrepreneurs to respond to other production incentives, the short-term protectionist benefits will themselves dissolve over the medium-term.

More importantly, the trade agreement was preserved and extended to previously considered novel areas of the regional economy such as digital, intellectual property, cross-border trade in services, protection of intellectual property, and reduction of the role of state-owned enterprises and provisions for small- and medium-sized enterprises to more robustly participate in trade. In our estimation, the chapters covering these substantial trade areas, taken almost verbatim from the TPP, have created a positive framework and the precedents for future modernization and subsequent trade accords.



THE EVOLUTION OF ARTIFICIAL INTELLIGENCE AND ITS IMPACT ON TRADE AND FINANCE WILL ALMOST SURELY BECOME AN IMPEDIMENT TO TRADE PROTECTIONISM.



Ironically, five years into the global populist economic experiment, the first wave of pushback is starting around the impact of such policies. The U.S.-Chinese trade conflict caused noticeable economic losses in both economies to the point where each side has, at least for now, chosen to cease deleterious tariff increases, take a step back and reduce rhetorical hostilities, and avoid what was clearly shaping up as a potential shock to both economies. This is not exactly the stuff of successful policy upon which the rollback of trade and financial agreements or the end of the World Trade Organization should be based.

Of course, the move of both the United States and U.K. to seek a free trade treaty based on the free flow of financial services and almost surely the digital integration of the two modern economies in coming months will put to the test those who wish to close off economies to trade, finance and the movement of ideas and individuals.

Digital is global

A misconception within the current wave of economic populism is that one can redirect incentives away from global economic activity. During the two-year U.S.-China trade conflict, many individual purchasers simply circumvented the trade barriers. Despite the large uncertainty tax imposed on the two economies due to the trade war, peer-to-peer and business-to-business commerce via the internet didn't suffer the damage that traditional manufacturing companies absorbed.

The ability of regulators to contain fungible technologies in the areas of electric vehicles, biotechnology and artificial intelligence has passed. These technologies are

mutable, transferable and subject to the law of digital economies. Ideas and digital innovation are not the same as technologies to produce autos. Artificial intelligence-based trade platforms such as Amazon, Alibaba, Baidu or eBay will simply outpace the capacity of regulators to keep up. Once something is digitized and its underlying information technology is available, law of pricing tends toward that which implies the cost of access, replication and distribution tends to fall toward zero.

The evolution of artificial intelligence and its impact on trade and finance will almost surely become an impediment to trade protectionism. Productivity improvements, an acceleration toward trade in services and the rapid tapping of intellectual capacity and new ideas to drive global trade and finance are sure to envelop early 20th century policy choices in the near-term.

In fact, one might make the case that the entire global movement toward trade protectionism and limiting the flow of people, ideas and capital rests on an unsteady foundation that is not prepared to face the quickly evolving logic of digital economics. The idea of a durable decoupling of the internet often causes one to think of a different time when countries created such things as a "Maginot Line." Digital Maginot Lines are not tenable and are based on an erroneous analysis of the direction of the global economy. Over time, that logic will overwhelm the recidivism around which trade protectionism is based. Beware those fighting the lost ancient wars; they will be overwhelmed by a digital logic that can foresee alternative arrangements that facilitate new avenues of growth, finance and opportunity. ■



ESTIMATING THE PROBABILITY OF A RECESSION

BY JOSEPH BRUSUELAS

CONSENSUS ESTIMATES of the probability of a U.S. recession have receded and our analysis of monthly economic data implies that risk of a recession is negligible for the time being. An alternative model run by the New York Federal Reserve suggests there is a 25.2% probability of a recession over the next 12 months; we do not get concerned until that model rises above 40%. The U.S. economy, barring an issue with liquidity, an error on the policy front or a large exogenous shock, should continue a slow and steady growth throughout the year.

The threat of an outright economic recession faded along with the rancor of the North American trade war episode and the lull in the trade disputes between the United States and China, and the United States and Europe. Domestic politics has been the most likely catalyst for China's rapprochement and for the sudden end of confrontation with the European Union.

We remain concerned about the pace of growth in the first quarter due to the shutdown of 737 Max production at Boeing and the spread of the COVID-19 virus, which will

affect supply chains across the auto, aerospace and retail industries in the period. RSM's monthly gross domestic product model implies a 1.5% pace of growth to start the year; and we expect growth in the first quarter to slow to near 1% due to the aforementioned risks.

2019 recession worries

During a six-month span beginning in the middle of 2019, it did appear as if the U.S. economy was ready to slide into recession. The manufacturing sector was already in recession; global growth was slowing and the constant threat of disruptions to the global supply chain had brought business investment to a standstill. The U.S. Treasury yield curve was inverted—a closely watched signal of the financial market's assessment of future growth and considered a necessary—but not sufficient—condition of recessions.

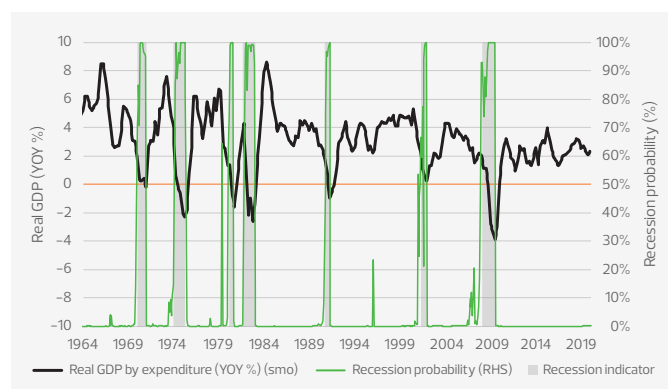
Despite the lull in policy uncertainty, by the third quarter of 2019, there was no denying that the manufacturing sector was in decline and the total real GDP growth

WE REMAIN CONCERNED ABOUT THE PACE OF GROWTH IN THE FIRST QUARTER DUE TO THE SHUTDOWN OF 737 MAX PRODUCTION AT BOEING AND THE SPREAD OF THE COVID-19 VIRUS, WHICH WILL AFFECT SUPPLY CHAINS ACROSS THE AUTO, AEROSPACE AND RETAIL INDUSTRIES IN THE PERIOD.

had begun to slip. The consumer sector was a clear holdout, having responded to a late-cycle fiscal boost in the form of tax cuts that juiced the stock market and underpinned high-income household spending.

Even so, real GDP growth remained above 2% throughout 2019. Our model suggests real GDP growth of below 2% throughout 2020 and into 2021, hampered by second-order effects from the global manufacturing slowdown and the lack of high-paying U.S. jobs. There is a low likelihood of recession, as the figure below suggests, but it comes with an asterisk: The outlook could change for the worse if the COVID-19 virus is not contained as expected; an asset-price bubble happens to burst; or U.S. trading partners in South America, Asia and Europe fall into recession. On the positive side, there is the possibility of sustained 2% growth if U.S. military spending were to suddenly increase before the election.

Monthly estimates of the probability of a U.S. recession



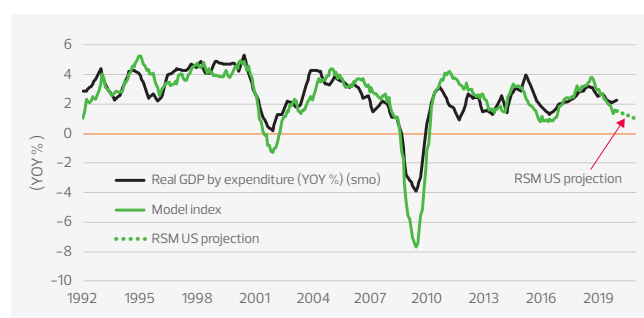
RSM Monthly Index of Economic Activity

That low level of manufacturing activity has been masked by surprisingly high consumer and government spending (and most recently by a drop in imports, which works to boost net exports). The RSM Monthly Index of Economic Activity suggests underlying monthly GDP growth of only 1.6% at the end of 2019 and continuing into 2020. (That low-growth scenario coincides with the range of consensus estimates for the first quarter, according to the Atlanta Federal Reserve.)

The estimate of underlying growth comes despite the January increase in payrolls and a similar bump up in hours worked. While the 225,000 payrolls number drew considerable attention, job increases were confined to the service sector—where wages are considerably lower than goods-producing jobs—and the long-term growth trends in both data series continue to drift lower.

These downward trends in the labor market form the basis for our forecast of eventual consumer belt-tightening, particularly for the lower-income population, whose high multiplier effect of spending tends to ripple through local economies and has ramifications for the economy as a whole.

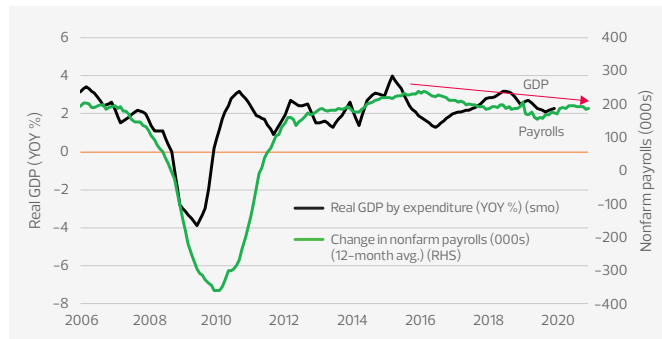
U.S. real GDP growth and RSM monthly index of economic activity



PROBABILITY (CONT.)

U.S. real GDP and changes in nonfarm payrolls

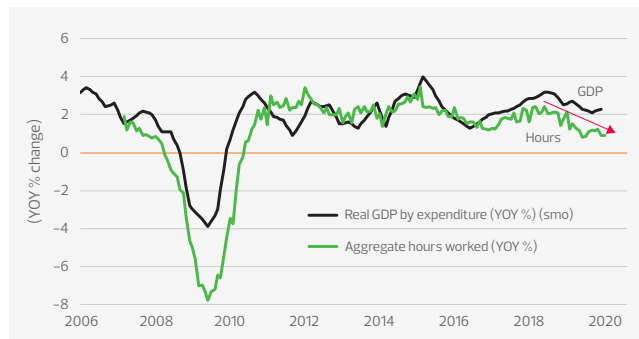
(YEARLY GROWTH RATE OF GDP AND 12-MONTH AVERAGE PAYROLL CHANGE)



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

U.S. real GDP and aggregate hours worked

(YEARLY GROWTH RATES)



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

Components of the probability model

Recessions are officially determined by the National Bureau of Economic Research, which has the formidable task of determining the month in which the economy stopped or started growing. Our recession probability analysis uses a statistical model, which uses monthly economic and financial data to forecast the probability of whether the economy is or is not in a recession—a binary condition—rather than a standard model of the level of real GDP growth.

Our so-called logit model consists of variables representing: (1) the age of the economic expansion, (2) the amount of residential investments, (3) the degree of expansion in the labor market and (4) the risk built into corporate bonds.

Age of the economic expansion—at some point, all recoveries run out of steam and become prime candidates for a major economic or financial event to send the economy into recession.

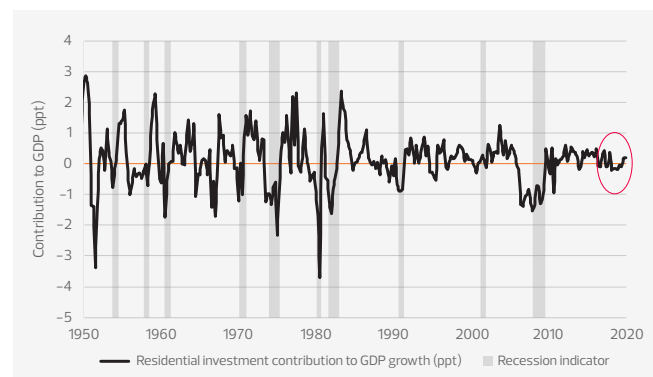
MIDDLE MARKET INSIGHT

We are currently in month 127 of the longest and perhaps most moderate of economic recoveries in the postwar era. All good things come to an end, but when will depend on how much the government decides to spend and a fiscal stimulus.

Residential investment—the U.S. economy is increasingly dependent on the consumer sector to provide demand for goods and services, with home sales forming the basis for much of that spending, while the total demand for housing (rental or purchased) adding to the price of all residential housing. As the figures below illustrate, residential investment tends to drop sharply as the risk of an economic slowdown increases, and then rises again once the economic crisis has ended and employment opportunities are restored.

Cumulative residential investment shows an even more dramatic pattern of rising throughout the expansion and then reaching a peak in the months before the next recession.

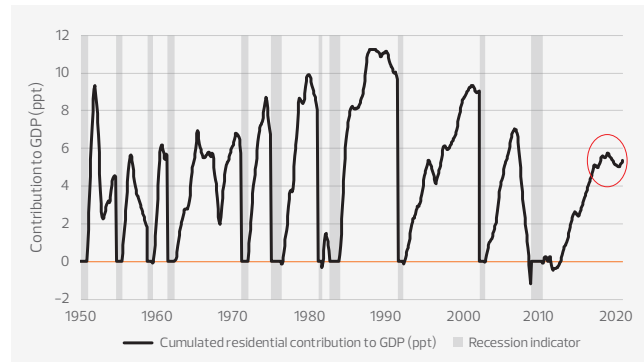
U.S. residential investment contribution to GDP growth and U.S. recessions



Source: BEA; Bloomberg; RSM US LLP

IN THE CURRENT BUSINESS CYCLE, CORPORATE BOND SPREADS BEGAN TO PUSH HIGHER AGAIN, ONCE ATTENTION TURNED TO THE ADMINISTRATION'S TRADE POLICIES.

Cumulated U.S. residential investment contribution to GDP growth and U.S. recessions

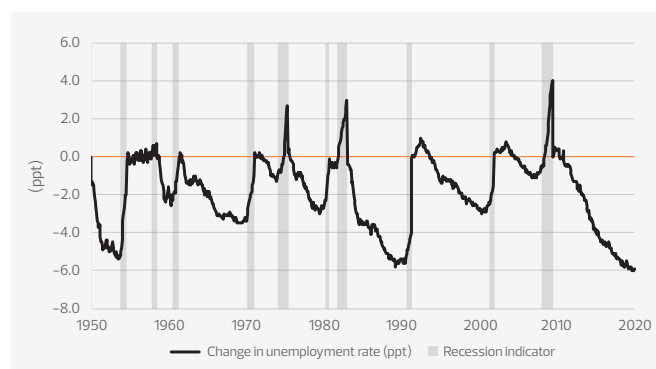


In the current cycle, residential investment recovered after the 2007–09 housing bubble, but has drifted lower since 2010, either because of buyers being priced out of the market or because of the paucity of high wage employment.

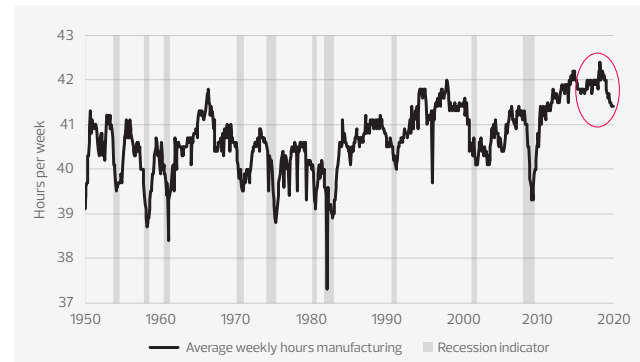
Labor market expansion—we represent the degree of expansion in the labor market by the change in the unemployment rate and the number of hours worked by manufacturing employees. Unemployment tends to fall as an economic recovery matures, and then climbs rapidly again as employers shed jobs during periods of low demand. Conversely, the number of hours increases during a recovery before plummeting during a recession.

In the current cycle, unemployment continues to fall with most job gains in the service sector. And to prove the point, manufacturing hours began to drop when

Change in U.S. unemployment rate relative to the prior U.S. recession



U.S. average weekly hours in manufacturing and U.S. recessions

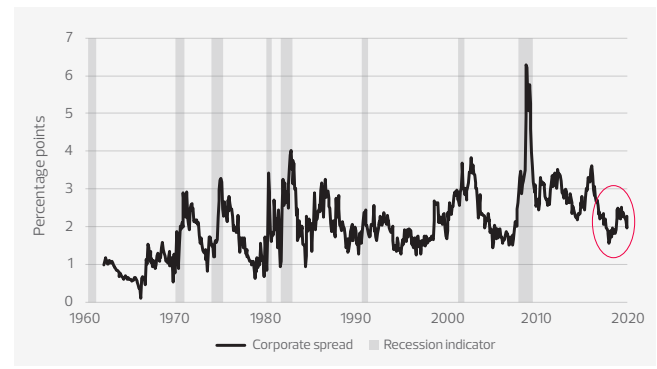


the first trade tariffs were announced in April 2018, and have continued to drop as the current manufacturing recession continues.

Corporate risk—the risk of corporate default can be measured by the difference between the yield of corporate bonds and 10-year Treasury bonds, with U.S. government debt considered to be a safe and guaranteed investment. Corporate risk is assumed to drift lower as an economic recovery takes hold, and then jumps sharply higher as corporate defaults increase during an economic downturn.

In the current business cycle, corporate bond spreads began to push higher again, once attention turned to the administration's trade policies. Spreads dropped when confidence began to rise again along with the upsurge in the stock market in 2019. ■

U.S. corporate spread and U.S. recessions (BAA LESS 10-YEAR TREASURY YIELDS)



CORONAVIRUS AND BOEING THREATEN FIRST-QUARTER GROWTH

Household consumption
expected to be strongest
segment in Q1

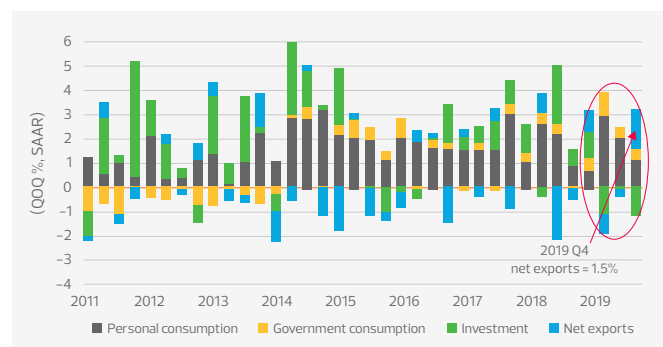
BY JOSEPH BRUSUELAS

THE UNITED STATES' gross domestic product grew an estimated 1.5% in January, according to RSM's Monthly Index of Economic Activity, following a bump up in GDP growth of 2.3% in the fourth quarter of 2019.

We are forecasting U.S. gross domestic product to grow by 1% GDP in the first quarter of 2020 with downside risk. We anticipate household consumption to be the strongest driver of that growth as ongoing production issues at Boeing and the global public health threat posed by the coronavirus disease, COVID-19, likely to cast a pall over domestic manufacturing conditions in the auto and aerospace industries.

Contributions to GDP growth by sector

GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD



Source: BEA; Bloomberg; RSM US LLP

DESPITE A MOVE ABOVE 50 IN THE JANUARY ISM MANUFACTURING SURVEY—SUGGESTING GROWTH—HARD INDUSTRIAL PRODUCTION DATA IMPLY THE CONTRACTION IN MANUFACTURING CONTINUES.

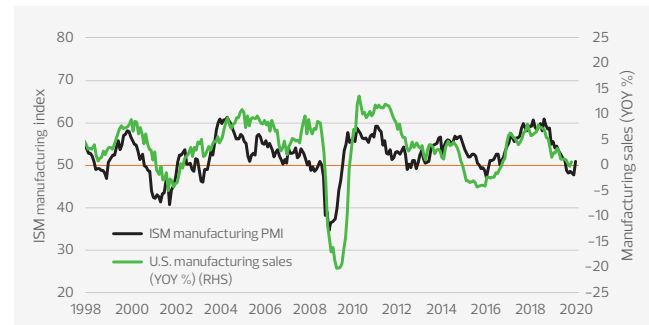
RSM's projection of 1% growth for Q1 2020 compares to more robust early forecasts of 2.6% growth from the Federal Reserve Bank of Atlanta and 2.0% growth from the Federal Reserve Bank of New York. Nevertheless, we expect a net drag of -0.2% to -0.3% on growth in the first quarter of 2020, due to likely supply chain challenges in North and Southeast Asia linked to the COVID-19 virus. And we also expect a 0.5% hit to domestic growth caused by the shutdown of 737 Max production at Boeing.

Our forecast of a low-growth scenario follows a bump up in GDP growth of 2.3% in the fourth quarter of 2019. But as the figure below shows, much of that 2.3% growth was due to an outsized 1.5% contribution from net exports resulting from a nearly 9% drop in imports. That drop in imports could be a disturbing indication of a potential drop in consumer spending and the perhaps unintended consequence of the trade war.

We remain seriously concerned about the direction of goods-producing and manufacturing hiring in the United States. Quarterly Census of Employment and Wages data shows aggregate manufacturing employment is declining, especially in the industrial states of Michigan, Pennsylvania and Wisconsin.

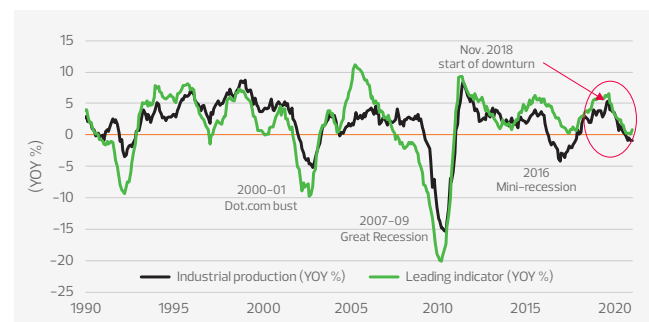
Despite a move above 50 in the January ISM Manufacturing Survey—suggesting growth—hard industrial production data imply the contraction in manufacturing continues. Industrial production declined -0.3% in January and was revised down -0.4% in December. Production of aerospace and miscellaneous production declined by -7.4% in January, almost all of which can be attributed to Boeing's halting of 737 Max production. We stand by our forecast of a net drag of -0.5% on first quarter GDP due to the ongoing issues at Boeing.

ISM manufacturing index and U.S. manufacturing sales



Source: Federal Reserve Banks; Census; Bloomberg; RSM US LLP

Industrial production and the leading economic indicator (YEAR-OVER-YEAR PERCENT CHANGES)



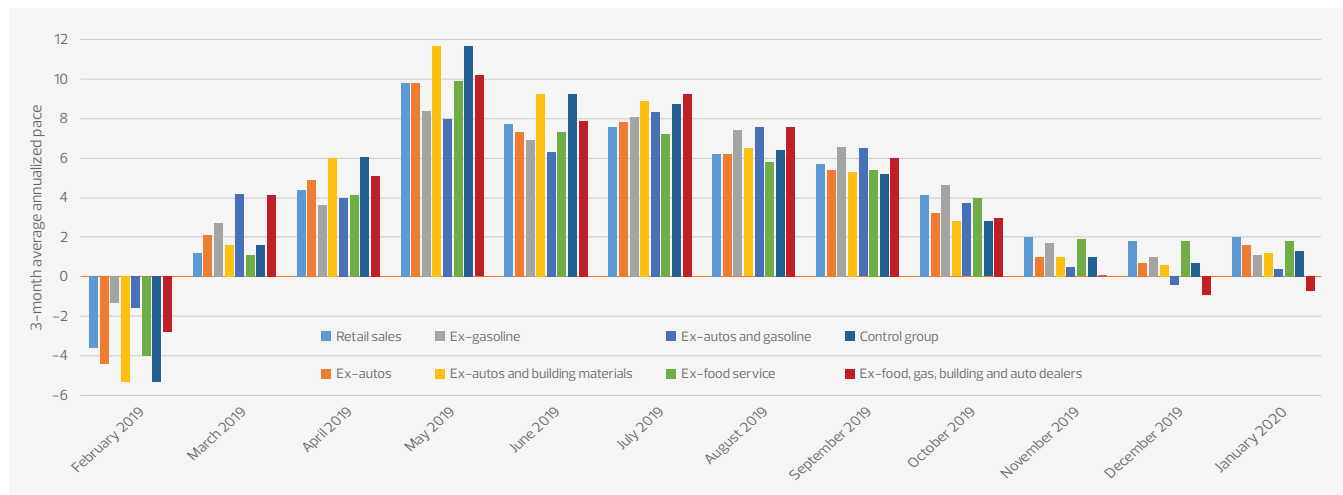
Source: BEA; Conference Board; Bloomberg; RSM US LLP

MIDDLE MARKET INSIGHT

With complete data for December now reported, our model suggests that the underlying economy grew 1.5% in the last three months of 2019. That is quite a bit lower than the 2.3% real GDP growth reported by the Bureau of Economic Analysis, which includes a significant 1.48% contribution by net exports and a half-percentage point contribution by the government sector.



Aggregate hours worked in the United States



Source: Bloomberg; RSM US LLP

Another area of concern is the quantity of aggregate hours worked by employees in the United States, which has slowed compared to the same time last year, as firms attempt to adjust to uncertainty in aggregate demand. The 13-week average initial jobless claims remained anchored around 218,000, implying firms are not moving to layoffs in response to slower demand. They are, however, reducing hours worked.

Without a doubt, the most important source of strength in the economy is the pace of household consumption. Following January retail sales data, we expect household consumption around 1.8% for the first quarter as the

traditional holiday hangover following holiday shopping outlays exerts a powerful downward pull on overall economic activity.

The control group, which the U.S. Bureau of Economic Analysis uses to estimate household consumption, was flat for the month and declined -0.7% on a three-month average annualized pace. Both of these support our forecast of a much more pronounced slowdown in overall economic activity to start 2020. ■

WATCH FOR THE Q1 2020 RSM US MIDDLE MARKET BUSINESS INDEX

The first-quarter edition of the proprietary RSM US Middle Market Business Index is due out March 19. Produced in conjunction with the U.S. Chamber of Commerce, this closely watched gauge of middle-market economic sentiment, along with commentary from RSM US Chief Economist Joe Brusuelas, provides forward-looking insights for middle market leaders.





INDUSTRY SPOTLIGHT

GLOBAL INDUSTRY HAMPERED AS CORONAVIRUS EPIDEMIC SPREADS

FEW INDUSTRIES have escaped the disruption caused by the spread of the coronavirus throughout China and beyond. From computer production slowed by factory shutdowns to the falloff in the Chinese hospitality industry as quarantines curtail travel, the impact of the epidemic has been significant, and the future damage remains uncertain. Effects have not been limited to Hubei province, where the virus began in December; for example, Chinatown restaurants in major cities throughout the United States and other western countries have suffered significant sales losses as customers shy away due to virus fears.

MIDDLE MARKET INSIGHT

As the world prepares for a potential coronavirus pandemic, middle market businesses must close attention to their vendor relationships, and ensure alternative sources of supply.

Here are some industry data points gleaned by RSM analysts.

Apparel

- 40% of U.S. apparel is sourced in China.
- The proximity of apparel-producing provinces Guangdong and Zhejiang to Hubei heightens the susceptibility of the sector to a prolonged break.
- Vietnam, Bangladesh and other predominant countries in the U.S. apparel supply chain rely on Chinese imported materials for production.
- Many apparel manufacturers in China rely on migrant workers who are hampered by travel restrictions.
- Small and midsize apparel companies lacking diversified supply chains are most at risk.

Peter Cadigan

Senior Manager, Consumer Products Senior Analyst



Hospitality

- Chinese nationals comprise the largest tourist market in the world; some 3 million visited the United States in 2018, according to the U.S. National Travel and Tourism Bureau.
- A sustained outbreak of the coronavirus poses a significant threat to this growing market, which has more than quadrupled since 2009.
- In the short-term, those hotel properties most affected by the virus outbreak are likely to be at the higher end of the market, as many Chinese travelers seek four- and five-star properties.

Laura Dietzel

Partner, Real Estate Senior Analyst

Technology

- China supplies 21% of the world's chips for PCs, servers and mobile phones.
- Nearly 17% of Apple's revenue comes from China. The company said in mid-February that second-quarter

sales were set to take a hit due to work slowdowns and temporary store closures in China, which has crimped demand; Apple is also suffering supply constraints.

- Escalating tariffs amid the U.S.-China trade war have already prompted tech companies like Samsung and Ericsson AB to shift technology to other countries in Southeast Asia.
- Spread of the coronavirus offers an additional incentive for supply chain diversification.

Victor Kao

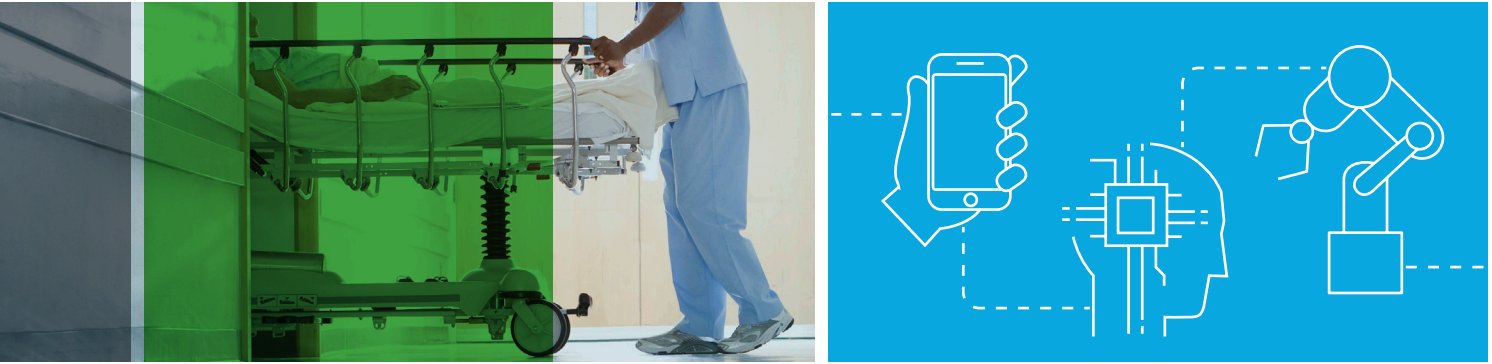
Partner, Technology Senior Analyst

Kurt Shenk

Senior Manager, Technology Senior Analyst

On the upside, technology may also provide a silver lining for those researchers fighting the illness. Adam Lohr, RSM senior analyst for life sciences, reports that advances in gene sequencing may accelerate the response to the outbreak. "Analysis technology and gene sequencing have allowed for the genome of the Wuhan virus to be sequenced less than a month after the first case was reported," he writes. ■

MIDDLE MARKET TREND WATCH



HEALTH CARE SYSTEMS AND DIGITAL TRANSFORMATION

HOW ARE NEW technologies like robotic process automation, artificial intelligence and virtual care changing the way hospital groups and other health care systems operate? What factors are middle market health care leaders weighing as this digital transformation unfolds? RSM explored these topics in a recent survey. Here's what we learned:

Digital technology enables health care systems to scale, improves process, and connects better internally and with patients. According to the survey, health care leaders indicated scalability, proficiency and transparency were the top three benefits.

Legacy systems planning, compliance and value assessment were the top three digital prioritization challenges faced by health care leaders.

Forecasting costs of various technologies, and managing learning curves and adoption are organizational challenges for health care systems.

Of those health care organizations indicating successful digital transformation implementation, half of the health care executives surveyed said having an active analytics program and team was the leading differentiating factor, followed by working with digitally savvy partners and employees.

KEY TAKEAWAY

Driving a digital strategy is complex and requires organizational change management and expertise to create a vision and process custom to the needs of the enterprise. An outside perspective may be needed to help evaluate opportunities and considerations. If your organization goes toward that route, consider engaging consultants who have deep industry experience in health care to ensure you're getting the best digital strategy guidance.

REAL BUSINESS INSIGHTS FOR MIDDLE MARKET COMPANIES

Check out *The Real Economy: Industry Outlook* and get data-driven, sector-specific insights from RSM's senior industry analysts, a select group of professionals dedicated to studying economic and industry data, market trends and the emerging issues faced by middle market businesses like yours.

Each outlook provides unique perspectives and planning opportunities affecting businesses in the following industries:

- Consumer products
- Financial services
- Health care
- Industrial products
- Life sciences
- Real estate
- Technology, media and telecom

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