

THE REAL ECONOMY

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U.S. HOUSING OUTLOOK

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GROWTH AHEAD, POLICY REFORM
NEEDED

ADDRESSING CYBERTHREATS:
A Q&A WITH THE U.S. CHAMBER OF
COMMERCE

MIDDLE MARKET **SUPPLY CHAIN**
WORRIES GROW AMID CHINA TRADE
TENSION



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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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U.S. HOUSING OUTLOOK: MODEST GROWTH AHEAD, POLICY REFORM NEEDED



By Joseph Brusuelas, Chief Economist, RSM US LLP

Housing demand in the United States remains brisk even as issues with supply and affordability mount, particularly in the West. We continue to forecast solid sales and consumption throughout the economy this year. We expect housing starts to be sustained near their current level of 1.25 million at an annualized pace. The late-cycle fiscal boost linked to the 2017 Tax Cuts and Jobs Act, as well as the recent budget agreement, will help to stoke aggregate demand through increased household spending and a tight labor market heading toward 3.7 percent unemployment. In short, we have a perfect recipe for strong housing demand.

It is a misnomer to label the housing outlook as “weak.” Given strong housing demand driven by a solid labor market, modest growth and demographic changes that favor risk-taking in the real estate development community, instead we see supply constraints and policy challenges preventing a breakout in housing toward the long-run equilibrium level of 1.6 million starts at an annualized pace. We are also concerned about the negative impact to new and existing home sales in large metropolitan areas along the coasts and the Upper Midwest due to the elimination of state and local tax deductions.

While the overall macroeconomic outlook remains strong, the housing market is constrained by four fundamental issues: a lack of available lots, a shortage of available workers,

high regulatory costs and federal tax law that is damping construction and sales activity in some areas of the economy.

MIDDLE MARKET INSIGHT

In our travels around the United States, a tale of lost development opportunities due to concerns about federal oversight linked to Dodd-Frank is a consistent narrative from the middle market.

Policy constraints

Two policy constraints are generating headwinds for the housing market. The first is tier one capital ratio requirements faced by banks with at least \$250 billion in assets under management. This represents a lost opportunity: These banks do not have the capabilities nor capacity to address increased regulatory oversight that accompanies funding investment opportunities that would burst through their tier one capital ratio limits. Thus, residential development in many areas where it is desperately needed simply isn't taking place.

The U.S. House of Representatives has put forward, and passed, legislation providing relief for the banking cohort with less than \$250 billion in assets under management. While leadership in both parties in the U.S. Senate has signaled it is favorably disposed toward that legislation,

it has yet to act on this specific reform so critical to the housing and residential investment outlook.

Second, soft sales in the first part of 2018 are likely linked to the 2017 Tax Cuts and Jobs Act, which significantly reduced the preference in the tax code previously conferred on home ownership. To date, both California and New York have seen slowing sales of homes primarily targeted at upper-middle-class and wealthy buyers. Given that much of the new housing stock in recent years has been built to attract that segment of the market, it is only natural that there may be a period of adjustment for homes priced at \$500,000 and above in many metropolitan and suburban areas along the coasts, as well as in and around Chicago.

While not much can be done to address these real estate development hurdles in 2018, the large states that sit in the new economy, and are linked to global trade, will likely need to address the \$10,000 deduction cap on state and local taxes tied to the new tax policy.

Residential investment

The first quarter of 2018 saw no growth in residential investment after a 12.8 percent increase during the final three months of 2017. However, that lack of growth deserves to be put in context. First, the double-digit growth late last year was primarily due to the recovery after the three large hurricanes hit the Gulf Coast region and Texas and devastating fires that impacted California. Second, speculative activity in the housing market was damped by rising interest rates and the aforementioned policy constraints.

Even so, we are forecasting a strong rebound in the current quarter, likely beginning with the May reporting data. We expect that momentum to spill over into the second half of the year. Through the end of the first quarter, the six-month average of housing starts stood at 1.287 million at an annualized pace. The forward-looking permits imply a move upward to 1.35 million starts at an annualized pace.

Meanwhile, household formation through the end of the first quarter stood at just over one million, which is well above the 900,000 average seen throughout the current business

cycle. With the employment-to-population ratio of those aged 25–54 reaching 79.2 percent—well above the cyclical low of 74.8 in 2009—there is ample room for upside in both housing starts and permits. The rising employment-to-population ratio of the median worker also supports the elevated reading of 55.5 in the National Association of Home Builders (NAHB) Remodeling Index, and 57.8 in the Future Remodeling Index.

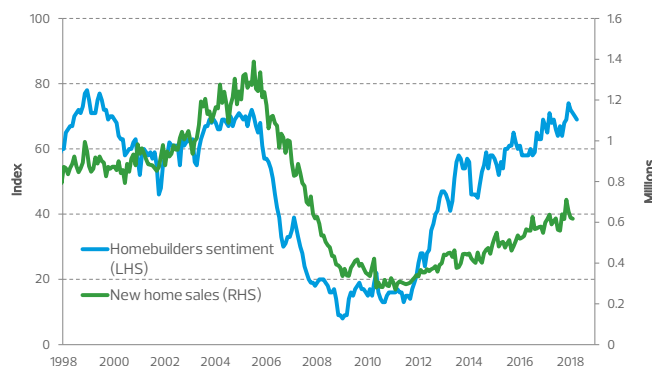
In the United States, currently 1.125 million housing units are under construction; 504,000 are in the single-family residence category, and 621,000 are in

the multifamily category. Given the decline in affordability, we expect to see a sustained increase in multifamily construction. The March data reported the completion of 1.21 million units, in line with the 1.2 million six-month average. On a regional basis, the South was responsible for 48.9 percent of all starts, the West 29.7 percent, the Midwest 12 percent and the Northeast 9.4 percent.

Homebuilder sentiment

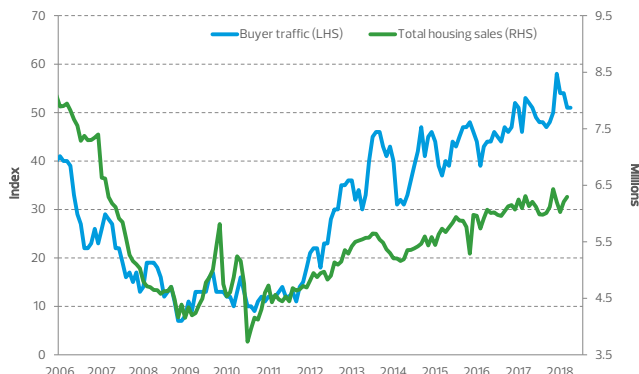
Homebuilder sentiment remains strong with the NAHB sentiment measure standing at 69, just below the cyclical high of 74 posted in December 2017. This sentiment index, which during the current cycle has a strong correlation with new housing starts, implies that the trend in residential investment is likely to remain in place. The most-recent NAHB Housing Market Index suggests that prospective buyer traffic will ease modestly, while sales should remain stout.

Supply still constrained in new homes market



Source: RSM US LLP, Bloomberg

Buyer traffic to ease modestly, though remains solid

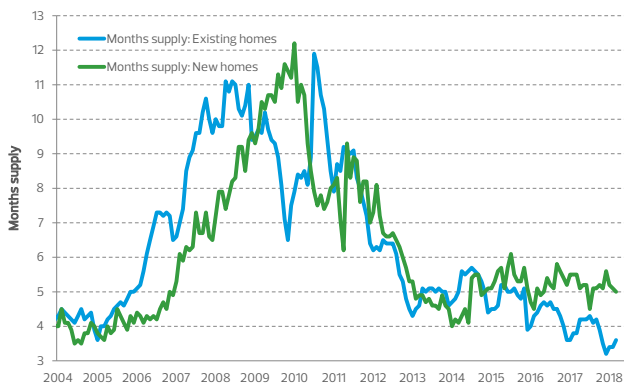


Source: RSM US LLP, US Census, NAHB

Supply

Supply constraints continue to be a major impediment to overall growth. There are roughly 3.6 months of supply in the existing home category with a 3.5-month supply in the single-family category and 3.9-month supply in the multifamily category. In the new home category, there are roughly 301,000 units available, or 5.2 months at the current sales pace.

Months supply of new and existing homes

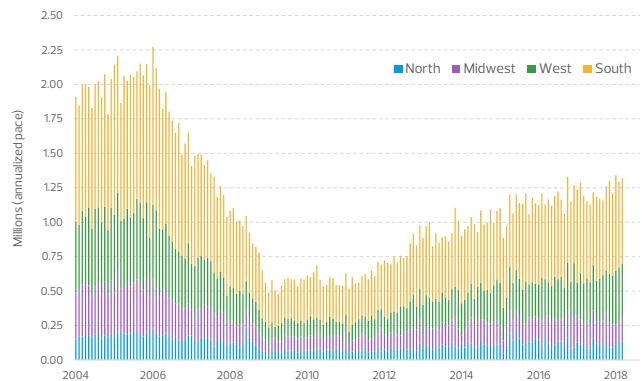


Source: RSM US LLP, Bloomberg

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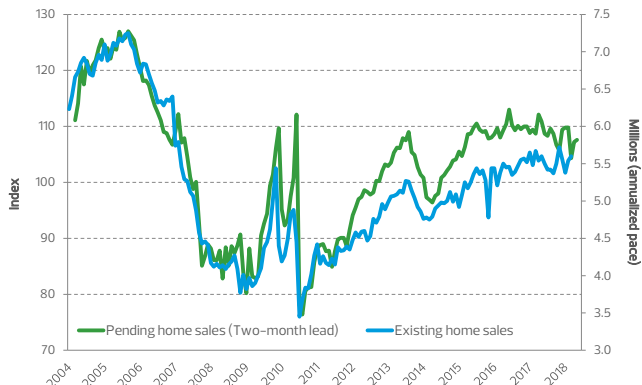
South and West lead way in regional starts



Source: National Association of Homebuilders

Homebuilders have been adding supply as fast as they can, given the previously mentioned constraints. Higher material costs, zoning requirements that have led to an environment where one out of every four dollars dedicated to each unit goes toward regulatory costs, and, most importantly, a shortage of labor to build new construction, all continue to damp overall residential investment. Thus, the inventory of existing homes on the market stands at 1.67 million, which is 7.2 percent less than it was a year ago. It is the 34th consecutive monthly decline of supply. This has caused an increase in pricing and a decline in affordability.

Pending sales imply stronger data ahead



Source: RSM US LLP, Bloomberg

Pricing

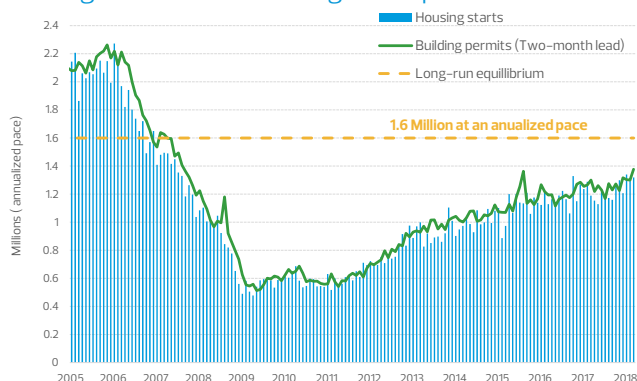
Home prices using the Case-Shiller and Federal Housing Finance Agency (FHFA) home price indexes as the primary benchmarks saw strong increases during the last reporting period in February. The FHFA saw a 0.7 percent monthly increase, 7.2 percent above year-ago levels. The 20-city Case-Shiller index increased 0.8 percent, 6.7 percent above year-ago levels. The median price of a new family home is now \$337,200 while the median price of an existing home is \$250,000.

It is clear that demand has outstripped supply as prices increase to clear the market. In our estimation, unlike the bubble that formed prior to the 2007–2009 recession, housing prices are a function of low unemployment, wage gains and an overall tightening of the supply of homes on the market.

Sales

Sales of existing homes rebounded by 1.1 percent to an annual pace of 5.6 million in March, after a weather-induced slowdown during the first two months of the year. New home sales also jumped by 4 percent to a 694,000 annualized pace. Pending home sales, which are a leading indicator (typically by two months) of overall home sales, increased 0.4 percent in March after a 2.8 percent increase in February. All of this implies a solid kickoff to the traditional buying season. Homes for sale through the end of March spent an average of 30 days on the market, compared with 34 days in March 2017, and 47 days in March 2016.

Housing starts well below long-run equilibrium level



Source: RSM US LLP, Bloomberg

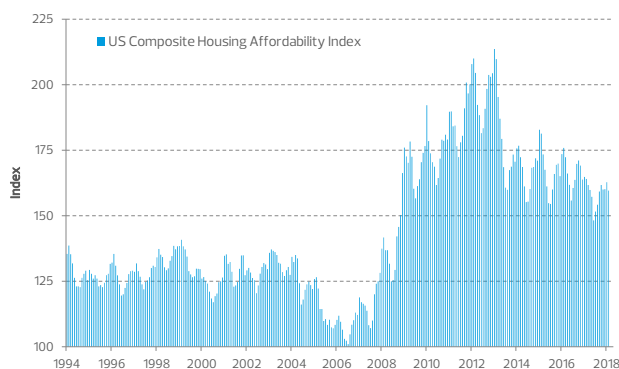
Interest rate outlook

The long-term interest rate outlook implies that potential homebuyers should anticipate higher policy and mortgage rates in the near-term. The 30-year fixed mortgage rate stands at 4.44 percent, which is 132 basis points above the yield on the 30-year U.S. Treasury bond and 149 basis points above the yield of the U.S. 10-year Treasury.

The consensus forecast is that the 10-year yield will stand at 3.1 percent at the end of 2018 and 3.47 at the end of 2019. This would imply a 30-year mortgage rate near 5 percent heading into 2020. Given the likely increase in the policy rate by the Federal Reserve to 2.5 percent in mid-2019 and 3.5 in mid-2020 from 1.5 to 1.7 percent today, either the yield curve will invert—implying a recession within 18–24

months—or fixed income investors will have to adjust their expectations on rates upward, carrying with them the risk that mortgage rates moving toward 5.5 to 6 percent by the end of 2020.

Affordability declining as interest rates increase



Source: RSM US LLP, National Association of Realtors



ADDRESSING CYBERTHREATS: A Q&A WITH THE U.S. CHAMBER OF COMMERCE

Vincent Voci offers insight and practical tips for midsize businesses

Despite a rise in cybercrime, many middle market companies may not be aware of the range of resources and regulations set up to track and respond to incidents.

RSM spoke with Vincent Voci, U.S. Chamber of Commerce senior policy manager for cyber, intelligence and security, about government assistance available at the federal and state levels.

Q: What action has the federal government taken to protect businesses from cybercrime?

Voci: The Trump administration has prioritized cybersecurity for federal networks and critical infrastructure with a May 2017 [executive order](#). The action calls for reviews of electricity disruption incident response capabilities, workforce development, market transparency and the threat of botnets, which are a series of connected devices tasked with performing a specific mission. A series of reports is expected to be signed by the president later this year.

In April, the National Institute of Standards and Technology (NIST) released an [update](#) to the *2014 Framework for Improving Critical Infrastructure Cybersecurity*. The update provides best practices for mitigating cyberthreats that midsize companies will find useful. As we [said](#), business leaders and policymakers view the framework as a pillar for managing enterprise cyberrisks and cyberthreats, including at home and increasingly abroad.

Meanwhile, the White House Council of Economic Advisors produced a [report](#) on cybercrime earlier this year. It estimates that in 2016 alone the cost of malicious cyber activity to the U.S. economy was between \$57 billion and \$109 billion. Alongside the report, the Trump administration has been active in calling out state-sponsored malicious cyber activity.

In addition, many private-sector organizations have robust reports for tracking cybercrime, including [Verizon's 2018 Data Breach Investigations Report](#) and [Symantec's Internet Security Threat Report](#), to name a few.

Q: What actors are government most closely watching?

Voci: Certainly, there's been a great deal of attention paid to malicious cyber activities stemming from Russia, including incidents related to the 2016 U.S. presidential election.

The Trump administration has also called attention to China's unauthorized intrusions into U.S. commercial computer networks and the cyber-enabled theft of intellectual property and sensitive commercial information. In addition, the U.S. government indicted Iranian individuals earlier this year for their role in a massive cybertheft campaign on behalf of the Islamic Revolutionary Guard and formally attributed a separate attack last year to a hacking group linked to North Korea.

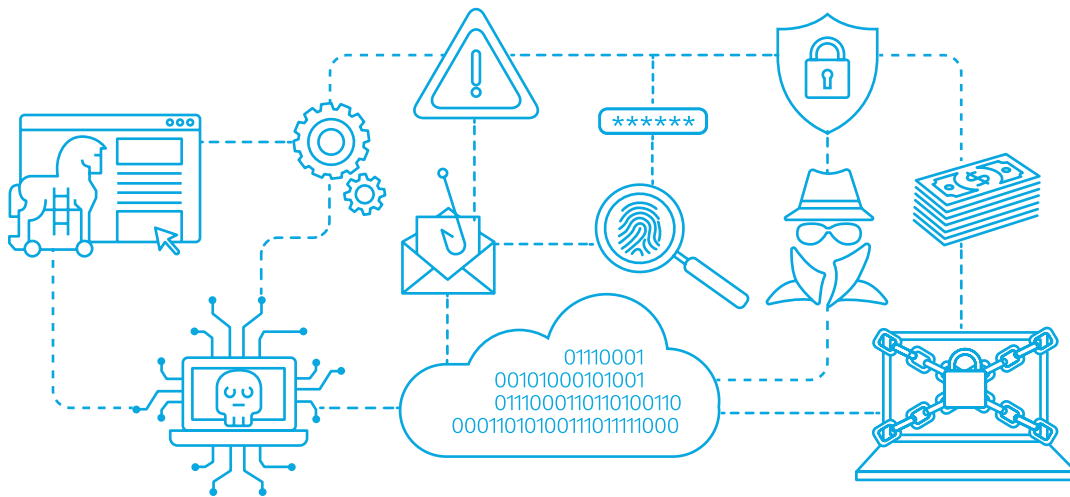
The U.S. Chamber and other organizations closely watching cybercrime are aware that the Trump administration is taking a visible and active role in calling out malicious cyber activity and imposing consequences on individuals and entities found in violation of established norms for acceptable behavior in cyberspace.

Q: How can the U.S. government keep up in such a fast-changing environment?

Voci: The road ahead for Congress is uncertain. Significant Senate attention is focused on a bill to reauthorize the Department of Homeland Security. One positive addition to the draft bill is language to reorganize the department's cyber operations into a Cyber and Infrastructure Protection Agency.

However, with recent high-profile cyber incidents, including breaches at Facebook and Uber, some cyber observers speculate the time is right for a privacy and data security bill. It's unclear if there's enough political momentum and time in the current legislative calendar for such a bill to be drafted and considered by either chamber of Congress.

Meanwhile, recent turnover at the White House's National Security Council will seemingly slow some of their initiatives.



The bottom line? Don't expect the cavalry to come from Washington to solve cybersecurity challenges for midsize businesses. Cyber continues to be a domain where public policymaking will lag behind industry advances in technology, processes, best practices and standards.

Q: What agencies or sites can provide assistance to midsize companies?

Voci: There are several options for midsize companies looking for resources or to report cyber incidents.

First, look to industry guidance. Some organizations are bound by regulatory requirements related to disclosure of incidents or data security requirements. It's a good idea for all organizations to reach out to their [sector-specific information sharing and analysis center](#). Commonly called ISACs, these groups are member-driven and provide hazard, threat and mitigation information; they typically don't include regulators, government representatives or law enforcement officials.

Depending on an organization's risk management needs and resources, engaging a law firm that specializes in cyber issues or purchasing a cyber insurance policy to help with risk management and incident response planning can be particularly beneficial.

Finally, businesses can turn to federal law enforcement. Each of the FBI's 56 [field offices](#) now includes a cyber task force. Separate [field offices](#) set up by the Secret Service include 40 electronic crimes task forces around the country. FBI resources include public-private information-sharing bodies such as [InfraGard](#), the [Domestic Security Alliance Council](#) and the [Internet Crime and Complaint Center](#) or IC3.

Q: What proactive measures should companies take?

Voci: The U.S. Chamber recommends reaching out to local federal law enforcement and building relationships prior to incidents. The Department of Justice has also been fairly active recently in training attorneys in its U.S. Attorney offices as specialists in cybercrime investigations. It also offers voluntary [cyber incident guidance](#) for organizations.

We encourage midsize businesses in states and municipalities that don't have an FBI or Secret Service field office, or an office of the U.S. Attorney, to reach out to state and local law enforcement. They should inquire about law enforcement's capabilities and expertise in cybercrime investigations. In addition, the Secret Service operates the [National Cyber Forensics Institute](#) (NCFI) in Hoover, Alabama. The Institute trains state and local law enforcement, prosecutors and judges on cybercrime. If your jurisdiction doesn't have sufficient local knowledge, ask officials to consider sending a representative to the NCFI for training.

THE BOTTOM LINE? DON'T EXPECT THE CAVALRY TO COME FROM WASHINGTON TO SOLVE CYBERSECURITY CHALLENGES FOR MIDSIZE BUSINESSES.

Vincent Voci, Senior Policy Manager,
U.S. Chamber of Commerce

Finally, the Department of Homeland Security is significantly expanding its [Cybersecurity Advisor \(CSA\) program](#) across the country. CSAs offer assistance to help prepare and protect private sector entities from cyberthreats by promoting cybersecurity preparedness, risk mitigation and incident response capabilities.

Ultimately, assistance is available for businesses of all sizes and sectors. State or local chambers of commerce resources can help organizations navigate the web of three-letter agencies to help improve risk management and incident response plans. However, at the end of the day, it's up to individuals and organizations to manage their own cyber risk.



MIDDLE MARKET SUPPLY CHAIN WORRIES GROW AMID CHINA TRADE TENSION

Although tennis Grand Slam tournaments aren't scheduled in March or April, the United States and China seemed determined to fill that void with an action-packed tariff volley—one that hasn't been particularly entertaining for business owners.

In early March, the U.S. government announced tariffs of 25 percent for foreign-made steel and 10 percent for aluminum—and then gave exemptions (at least temporarily) to nearly all countries except China. Within six weeks, more than 1,200 U.S. companies applied for waivers from the steel tariffs alone. In early April, the U.S. government also published a list that threatened China with 25 percent tariffs on a wide array of about 1,300 products, including auto parts and bakery ovens. China responded with its own extensive list of U.S. targets, including whiskey, planes, soybeans and SUVs.

As companies assess possible repercussions for their supply chains, the only thing that's certain is uncertainty. "That uncertainty causes firms to really pull back on purchases they would otherwise make until the tensions are resolved," says RSM Chief Economist Joe Brusuelas. Based on survey information he's seen, as well as anecdotal evidence and discussions with clients, he characterizes the middle market's concerns about tariffs as elevated.

"Middle market business owners deeply understand their supply chains and know where the value is extracted. Once those value chains are disrupted, it has an enormous impact on medium-sized businesses that don't have access to deep pools of capital," says Brusuelas. He also notes that cost shifts from tariffs will reach middle market firms early, considering large firms tend to immediately pass along their price increases.

"IN RESPONSE TO THE RECENT PRICE INCREASES, AND AS A HEDGE AGAINST TRADE TENSIONS' POTENTIAL EFFECTS, WE PLAN TO SHIFT ABOUT 10 PERCENT OF OUR CHINA SOURCING ELSEWHERE."

**Jeff Marshall, CFO
Trademark Global**

In April, costs for raw materials reached their highest point in seven years, based on a price index from the Institute for Supply Management. "Firms are actively looking to alternatively source materials at better pricing than what they're seeing currently," says Brusuelas.

That's the case at Trademark Global, a Lorain, Ohio-based company that sources, warehouses and ships products for big e-commerce business, including Amazon and Target. Since the fourth quarter of last year, it has seen price increases (ranging from 2 percent to 30 percent) for about 300 products from suppliers. CFO Jeff Marshall attributes

that to currency fluctuations and says the company hasn't been affected by tariffs yet. But it's closely monitoring trade tensions, considering that Trademark sources about 70 percent of products from China. "We have a high level of concern," says Marshall. "Anything



you hear about tensions or potential retribution—that always raises our eyebrows.”

In response to the recent price increases, and as a hedge against trade tensions' potential effects, Marshall says the company plans to shift about 10 percent of its China sourcing elsewhere. That diversification could include Thailand, Peru, Turkey, Malaysia, India and Pakistan.

But Trademark doesn't plan to sever ties to China any time soon. Since 2014, it's had an office in Shanghai—and this year, it plans to add two or three employees to the current staff of six. In April, the new director of global sourcing spent two weeks in China. “He didn't come back with any sort of doom and gloom [about trade tensions],” Marshall says. “Everybody's just still focused on cranking out product and making money.”

Marshall says Trademark will be able to respond to supplier cost increases with higher pricing for some of its products. But its large e-commerce customers sometimes say no to those requests. “When we're not able to pass that [price increase] on, unfortunately we have to eat that—and usually, we start looking at resourcing that product through another company,” he adds. Marshall expects Trademark will need to do that for about one-third of the products that have increased in price during the past few months.

GLE-Precision, a Michigan-based precision manufacturing company that makes specialized components for customers such as NASA and IBM, isn't directly affected by the trade tensions. None of its raw materials are sourced

outside North America, says Clint Bucholz, president of GLE. “We're also not seeing any pullbacks—about 30 percent of our products go internationally, of which maybe 20 percent is in the China market, and it's not impacted going that way,” says Bucholz.

Around 55 percent of the company's materials are carbide-based, and Bucholz has seen costs for that material increase about 8 percent since the start of the year. He attributes this to inflation pressure, considering the increase began weeks before the tariff frenzy.

But raw material costs aren't dampening business. “We are having an incredibly strong year-over-year,” he says, noting that if the company could hire enough qualified machinists to meet demand, revenue could potentially increase about 40 percent from a year ago.

“We're fairly shielded from the [tariffs on] commodities. But in six or eight months, perhaps, we'll see some of that push through to us,” Bucholz says. “Right now, it feels more just like standard inflationary push.”

Although GLE hasn't experienced tariff anxiety, the company did notice that a few customers are worrying. Bucholz says in early March, three customers called to try to assess any potential cost increases. “They'd say, ‘We've got a lot of steel in our material. What do you anticipate that it's going to go up this year?’” says Bucholz, who can only remember one other occasion when a single GLE customer tried to assess potential cost increases. “That's pretty unusual, and that was totally driven by the tariffs.”

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

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