

THE REAL ECONOMY

VOLUME 53



U.S. GROWTH AND THE BUSINESS CYCLE

INDUSTRY SPOTLIGHT:

GOVERNMENT OFFERS FURTHER CLARITY
IN OPPORTUNITY ZONE REGULATIONS

AS TELEMEDICINE GROWS, A 'DIGITAL FRONT
DOOR' LOWERS HEALTH CARE COSTS

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U.S. Q1 2019 GDP:
STRONG TOP-LINE 3.2 PERCENT GROWTH



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U.S. GROWTH AND THE BUSINESS CYCLE

What are the economic indicator peaks and troughs telling us?

By Joseph Brusuelas

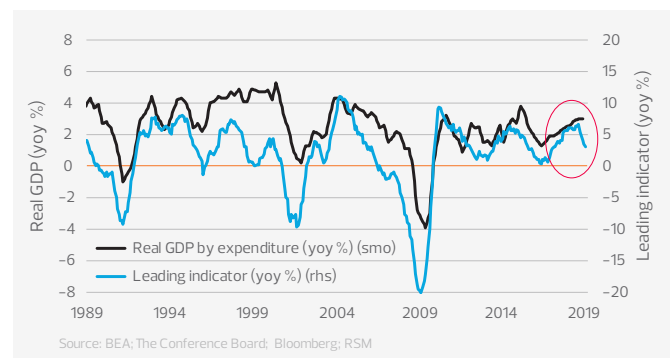
It appears likely that U.S. gross domestic product growth in the current business cycle peaked in mid-2018, bolstered by the 2017 Tax Cuts and Jobs Act and the U.S. federal budget agreement for fiscal year 2018. Following the tax reform, GDP reached 4.2 percent in June 2018 and is decelerating toward a long term trend rate of 1.8 percent.

In our estimation, the economic impact of the tax cut peaked in October 2018 and is now fading. The budget agreement is still providing net support for overall economic activity, which will be reflected in GDP in early 2019, bolstered by the public construction sector, which jumped 3.7 percent in February. However, unless a bipartisan budget agreement is reached before the end of 2019, a \$126 billion fiscal cliff awaits the U.S. economy in the 2020 fiscal year, and will begin acting as a drag on overall growth later in 2019.

A review of leading indicators of economic activity can provide forward-looking middle market company executives, investors and policymakers critical insight as the U.S. economy heads into the late innings of this current business cycle.

Foremost among these is The Conference Board's monthly Leading Economic Index®, or LEI, a composite index of 10 economic and financial metrics whose turning points have historically preceded those in the

Real GDP and leading economic indicator
YEAR-OVER-YEAR PERCENT CHANGES



U.S. economy. At present, the LEI suggests GDP growth peaked in third quarter 2018.

Recessions (and recoveries) are determined by the judgment of the National Bureau of Economic Research when business cycles peaked and troughed, rather than the convention of defining a recession as two consecutive quarters of negative growth. Nevertheless, using the performance of The Conference Board's LEI as a guide, we can see that economic recovery since the Great Recession of 2007 to 2009 is second only to the so-called dot-com business-cycle upswing of the 1990s, which ended with the 2000 recession when the bubble burst.

Deceleration Index

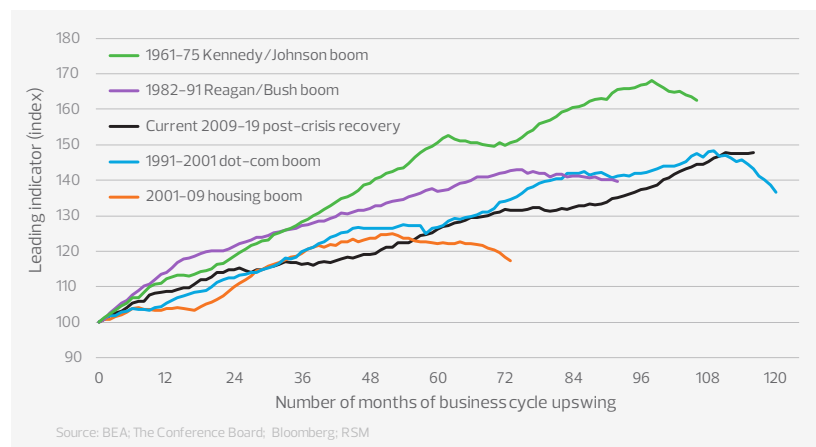
As the chart below indicates, business cycles are not necessarily smooth. Events and price shocks—such as the impact on global supply chains from the Fukushima nuclear disaster of 2011, the spillover from the 2010–12 European debt crisis or the 2015 collapse in global oil prices—can create intermediate peaks and troughs within longer-term trends in GDP growth.

To help anticipate the risk of a local peak turning into a full-fledged downturn, we've constructed a Deceleration Index based on the economic and financial components of The Conference Board's LEI. If a component has improved since the previous month, it is assigned a value of 1; if it has deteriorated, it is assigned a value of negative 1. An indicator showing no change is assigned a zero value. The index is equal to the average of the assigned component values, and reported as a percentage. Note that the low points in the Deceleration Index have anticipated intermediate business-cycle troughs.

During third quarter 2018, The Conference Board's 10 components worsened in October. From construction and manufacturing components to interest and credit expectations as well as consumer expectations, not

U.S. economic recoveries in the months after recessions

REBASED LEADING INDICATOR VALUES FROM BUSINESS CYCLE TROUGHS TO PEAKS

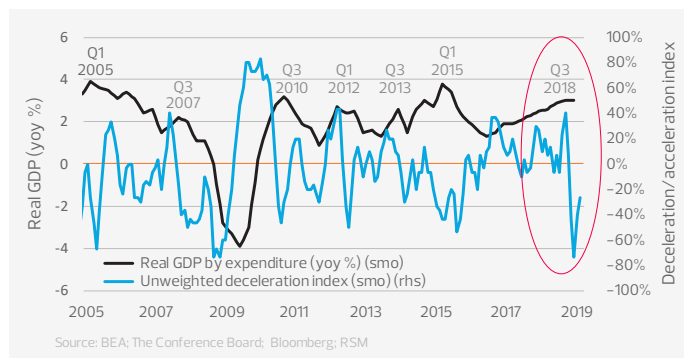


since the Great Recession were so many indicators negative at the same time.

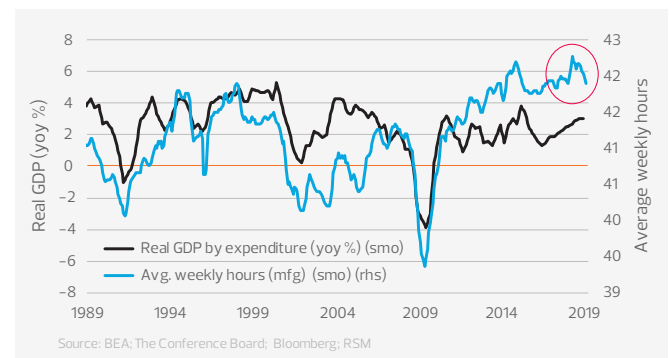
The Deceleration Index captures the sharp falloff in overall economic activity that started in third quarter 2018 and has yet to stabilize. While there are tentative signs of stabilization in soft data, such as the sentiment of purchasing managers, we have yet to observe a sustained period of stabilization in hard data. Given the negative impact on data collection due to the U.S. government shutdown from Dec. 22 to Jan. 25, we may not observe that until mid-2019. See graphs on the next page.

U.S. GROWTH AND THE BUSINESS CYCLE (CONT.)

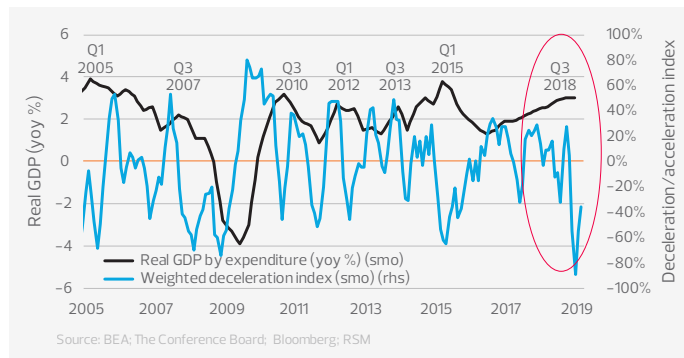
Real GDP and unweighted RSM deceleration index
WITH LOCAL PEAKS OF GDP GROWTH IN THE PRE- AND POST-CRISIS ERA



Real GDP and average weekly hours
MANUFACTURING SECTOR HOURS



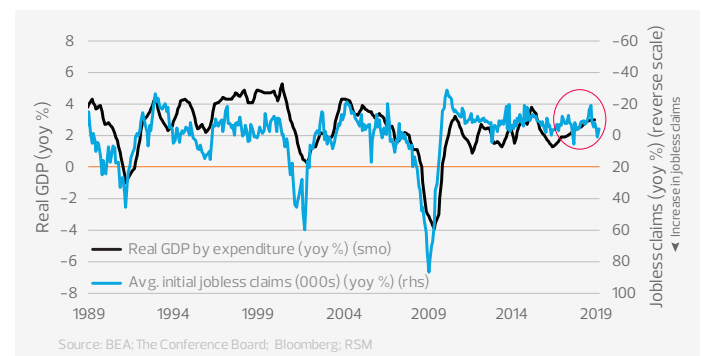
Real GDP and weighted RSM deceleration index
WITH LOCAL PEAKS OF GDP GROWTH IN THE PRE- AND POST-CRISIS ERA



Unemployment

Initial jobless claims are not decreasing as fast as earlier in the recovery. Yet, the nature of the relationship between unemployment and the business cycle suggests the need for more data to confirm the presence of a trend.

Real GDP and initial jobless claims
YEAR-OVER-YEAR PERCENT CHANGES



LEADING INDICATOR COMPONENTS

Labor market

Weekly hours

The average weekly hours worked in the manufacturing sector have been declining off and on since April 2018, suggesting either an increase in the labor pool or a slowdown and less need for overtime.

A REVIEW OF LEADING INDICATORS OF ECONOMIC ACTIVITY CAN PROVIDE FORWARD-LOOKING MIDDLE MARKET COMPANY EXECUTIVES, INVESTORS AND POLICYMAKERS CRITICAL INSIGHT AS THE U.S. ECONOMY HEADS INTO THE LATE INNINGS OF THIS CURRENT BUSINESS CYCLE.

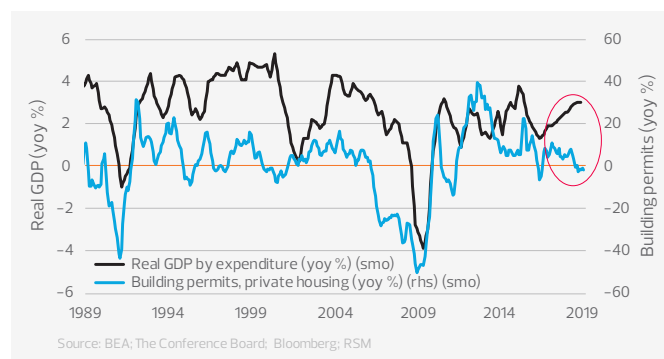
Consumer sector

Building permits

Despite the upturn in residential homebuilding since mid-2016, the growth rate of permits resumed a downward trend, reflecting household caution (see below), an aging population and a generational shift in housing tastes. In any case, the decrease is not a good sign for further economic growth.

Real GDP and residential building permits

YEAR-OVER-YEAR PERCENT CHANGES

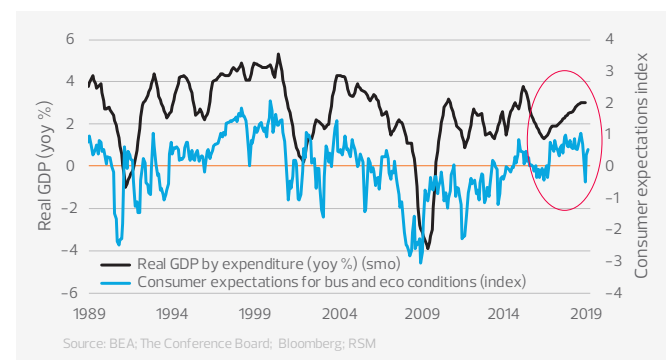


Consumer sentiment

Great gains in consumer sentiment were made during the recovery, but household expectations for business and economic conditions eventually flattened and deteriorated in the last quarter 2018.

Real GDP and consumer expectations

EXPECTATIONS FOR BUSINESS AND ECONOMIC CONDITIONS



U.S. GROWTH AND THE BUSINESS CYCLE (CONT.)

IN OUR ESTIMATION, THE ECONOMIC IMPACT OF THE TAX CUT PEAKED IN OCTOBER 2018 AND IS NOW FADING.

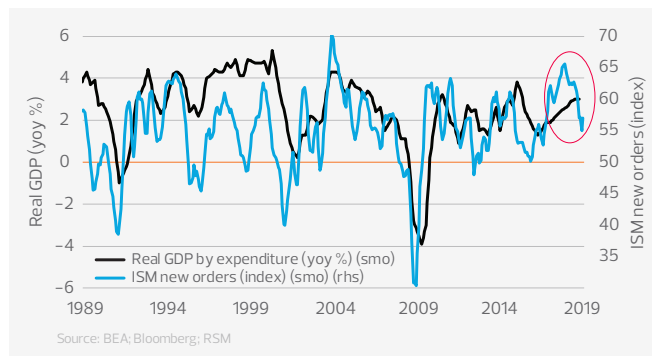
Manufacturing sector

New orders

Purchasing managers have been reporting a deterioration of new manufacturing orders since March 2018, which can unfortunately indicate a longer-term impact on economic growth.

Real GDP and the ISM new orders index

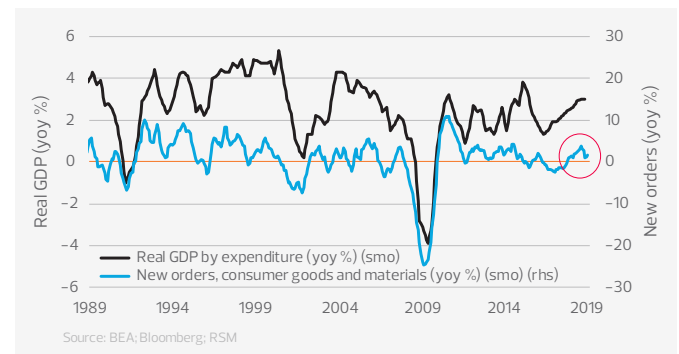
MANUFACTURING SECTOR



New orders for the manufacture of consumer goods appeared to trail off in the third quarter after a nine-month upswing. This is linked to the various trade spats in which the United States is currently engaged and the global growth slowdown that accelerated in late 2018.

Real GDP and new orders for consumer goods

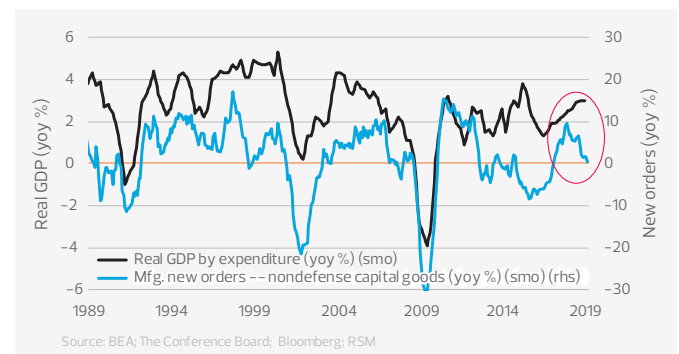
MANUFACTURING OF CONSUMER GOODS AND MATERIALS



New orders for the manufacture of capital goods (excluding aircraft) have been trending lower throughout 2018, perhaps signaling the effects of the administration's tariff policies.

Real GDP and new orders for nondefense capital goods

YEAR-OVER-YEAR PERCENT CHANGES



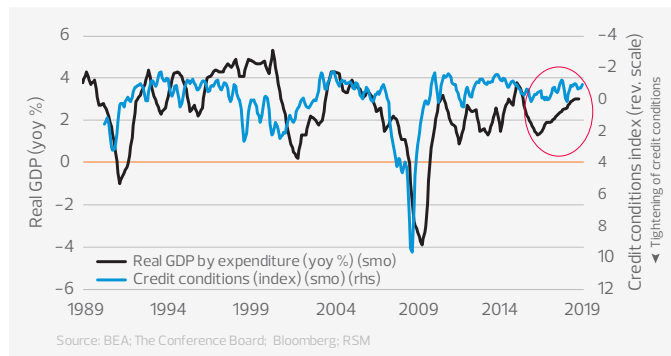
Financial sector

Credit conditions

Credit conditions remain benign as the market continues to respond to the Federal Reserve's still-accommodative policy on lending rates. Note, however, that bank senior loan officers report tightening of loan requirements for commercial and industrial loans.

Real GDP and new credit conditions

YEAR-OVER-YEAR PERCENT CHANGES

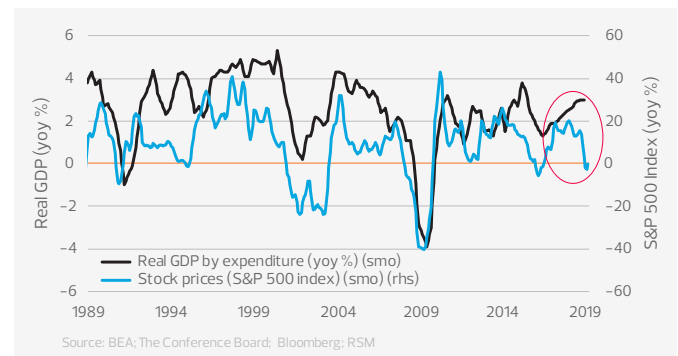


Stock market performance

The stock market is not the best predictor of overall economic growth. Although the wealth effects of this autumn's stock market crash—for the half of the population that invests in stocks—were more or less resolved by the January upswing, the hyperbolic damage to sentiment for most everyone is unlikely to be resolved anytime soon. As the crash proved, there were too many policy inconsistencies for the good times to last. And it is unlikely for the stock market to remain the only source of return for as long as it did during the era of low-for-long interest rates that characterized the decadelong economic recovery.

Real GDP and stock market returns

YEAR-OVER-YEAR PERCENT CHANGES

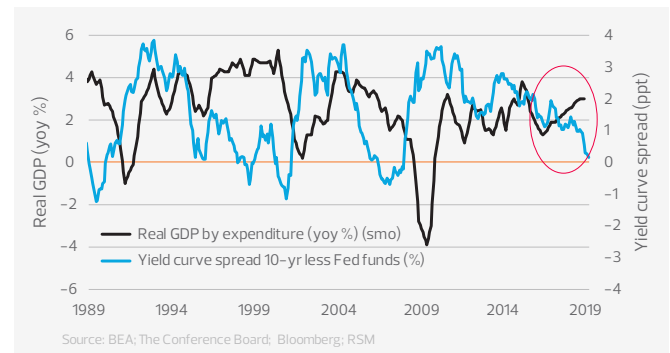


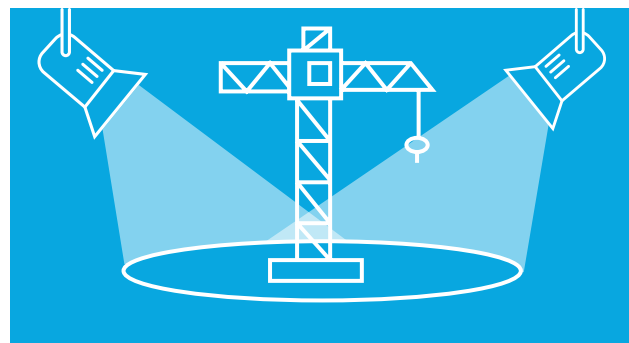
Yield curve

The Conference Board, among others, points out that an inverted yield curve has been a good indicator of an upcoming recession, with market values of long-term interest rates relative to policy-set values of short-term rates reflective of perceptions of near-term growth versus that of later periods. Given current financial conditions, we think the yield curve likely presents a head fake and that a recession is not imminent.

Real GDP and yield curve spread

10-YEAR TREASURY YIELD LESS FED FUNDS RATE





REAL ESTATE Industry SPOTLIGHT

GOVERNMENT OFFERS FURTHER CLARITY IN OPPORTUNITY ZONE REGULATIONS

By Troy Merkel

In April, the U.S. Department of the Treasury released its latest set of [regulatory guidelines](#) on opportunity zones offering significantly more clarity about the program, which provides tax incentives to developers entering geographic areas slated for improvement.

The new guidelines address a number of real estate-related concerns, such as how multiasset funds and REITs can be exited, flexibility in making investments and reinvesting within a fund, the treatment of debt-financed distributions, and the handling of both improved and unimproved land. REITs, multiasset funds and single asset investments all appear to work within the structure of the program.

Real estate investors appear to be getting everything they want from the program. As a result, we expect the already frothy real estate market to accelerate deal flow and drive investment over the next two to three years.

Operating businesses also received a significant amount of attention after being neglected in the previous guidance. The most critical clarification addressed the 50 percent revenue requirement, which will be tied to employee hours, employee salaries or, effectively, a company's headquarters location. Given the examples the IRS used for the first two measurements—a tech company and a service company—it's clear the government sees most job growth in the U.S. economy driven by these sectors.

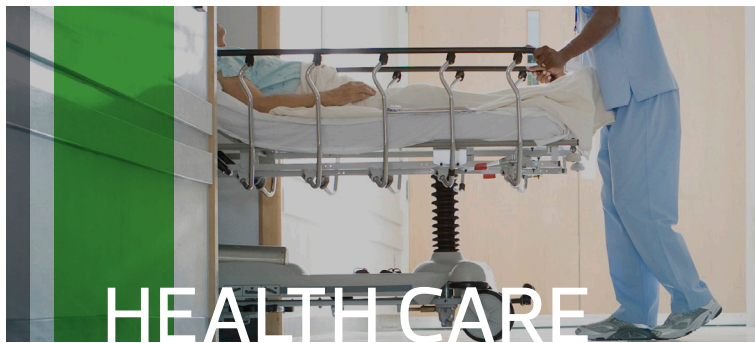
The examples helped to explain how these types of companies could leverage the program's employee requirements to drive growth in economically depressed areas. It is notable that the headquarters example was

THE BIGGEST CONCERNS HOLDING BACK THE PROGRAM NOW WILL BE ECONOMICALLY DRIVEN, AS LAND PRICES (PARTICULARLY THOSE IN OPPORTUNITY ZONES) AND THE LACK OR COST OF LABOR WILL CREATE HEADWINDS FOR THE PROGRAM AND DILUTE THE TAX BENEFITS.

of a landscaping company, a type of business not likely to be a big driver of economic growth. The headquarters rule appears to provide the most leeway for companies to meet the 50 percent revenue requirement. Given its flexibility, this provision could be open to abuse by taxpayers with investments that do not drive the level of economic growth in a census tract expected by politicians sanctioning the project.

The biggest concerns holding back the program now will be economically driven, as land prices (particularly those in opportunity zones) and the lack or cost of labor will create headwinds for the program and dilute the tax benefits. The IRS is attempting to exclude capital gains that would arise during the 10-year hold period for investments, but it is struggling to find a legal way to make this happen.

Overall, the new revenue guidance—along with comments on how leases and leased equipment will be treated by the program—has cleared the way for businesses and investors to invest in opportunity zones and drive the economic growth that regulators desire.



HEALTHCARE Industry SPOTLIGHT

AS TELEMEDICINE GROWS, A 'DIGITAL FRONT DOOR' LOWERS HEALTH CARE COSTS

By Rick Kes

Telemedicine—like other industries where digitization of service has transformed an entire ecosystem—is dramatically changing health care delivery. Many large integrated health care systems view telemedicine as an opportunity to more affordably provide primary care. The technology allows patients to be examined virtually using two-way video conferencing for a wide array of symptoms, often for very low fixed fees. Frequently, health care systems are partnering with telemedicine providers to build-out a digital front door to patient care.

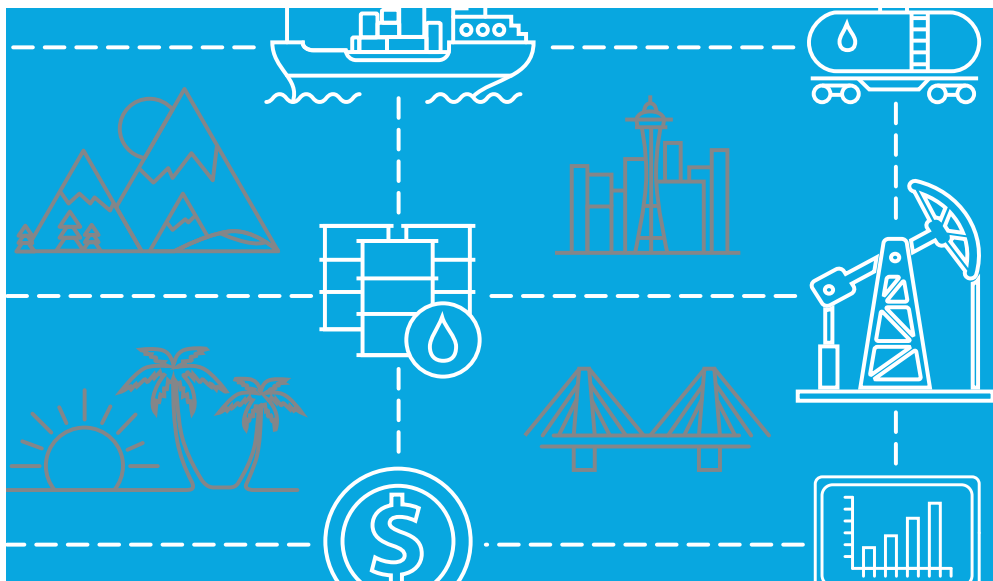
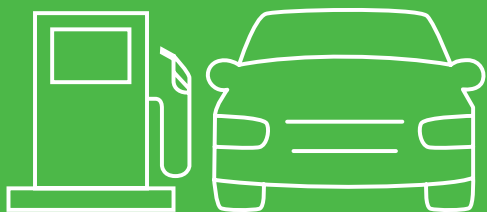
One of the most prolific businesses in the telemedicine field is Teladoc Health, Inc., a publicly traded company with a global presence. Teladoc offers two business models: direct-to-consumer and partnerships with health systems, health plans or employer groups. Teladoc and other telemedicine providers generally want to deliver enhanced access to consumers at a lower price. In a survey of 2 million of its members, Teladoc found that each member saved \$472 on average per general medical visit using the technology, the company disclosed in its 2018 annual Form 10-K filing with the Securities and Exchange Commission.

Beyond cost savings

Besides reducing the financial burden for global health care, telemedicine could also help solve the growing issue of provider burnout by leveraging technology to reduce the workload of providers offering services in physical locations. Some telemedicine providers have already expanded beyond standard care to tackle behavioral health services, providing additional value for the health care system.

ACCORDING TO GRAND VIEW RESEARCH INTELLIGENCE, THE GLOBAL TELEMEDICINE MARKET HAS THE POTENTIAL TO GROW TO \$113.1 BILLION BY 2025.

The investor community has recognized the value of players such as Teladoc. Teladoc's stock is up more than fivefold since its low of \$9.50 on March 28, 2016, to close at \$58.09 on the New York Stock Exchange recently. Investor enthusiasm is bolstered by the company's increase in annual visits, its continued expectation for growth and its expansion of Center for Medicare and Medicaid Services' virtual care programs. According to Grand View Research Intelligence, the global telemedicine market has the potential to grow to \$113.1 billion by 2025 ; however, it is now only roughly a \$1 billion market, according to Bloomberg Intelligence. There is plenty of room for providers to expand their reach in this somewhat unsaturated space.



GASOLINE PRICES POINT TO 8 PERCENT RISE IN TIME FOR SUMMER HOLIDAYS

By Joseph Brusuelas

U.S. consumers are likely to feel a modest jolt in commuting costs, as wholesale gasoline futures now point to an 8 percent rise in retail gasoline prices in coming days, with risk of a much more pronounced increase to follow.

The surge is due to nonmarket derived pricing action caused by a recent policy shift from Washington on waivers around imports of Iranian oil. The shift resulted in a decline of 700,000 to 800,000 barrels per day, which triggered a 4 percent increase in futures of Brent Crude and a 3.8 percent rise in those of West Texas Intermediate. These increases will ultimately result in a loss of personal disposable income and overall household consumption in the current quarter.

The new policy shift reinforces the sharp recovery in the price of West Texas Intermediate, which is up 41.92 percent this year and the global benchmark Brent Crude, which has risen 35.5 percent, largely due to declining global oil production.

Through the end of March, OPEC production reached a four-year low of 30.4 million barrels per day, down 280,000 daily barrels from February; 79 percent of the drop was directly attributable to the 220,000 barrel-per-day reduction by Saudi Arabia.

Due to the rapid deterioration of production in Venezuela and associated geopolitical-driven declines across the Middle East and North Africa, it is highly unlikely any

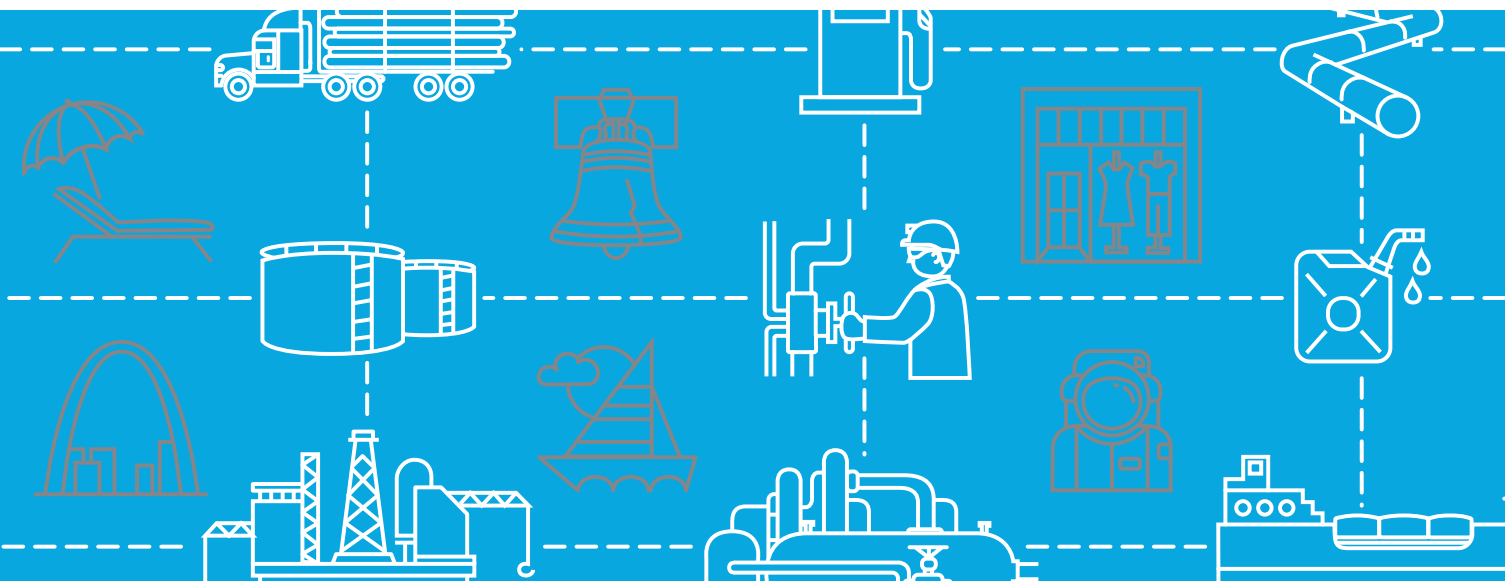
economy other than Saudi Arabia—which has a million barrels of spare capacity—can step into the market to fill the gap. At this point, there is simply no indication that Saudi Arabia, whose relationship with the United States has been fraught in recent months, intends to do that.

THE U.S. PUBLIC SHOULD PREPARE FOR HIGHER PRICES ENTERING THE SUMMER DRIVING SEASON, WHEN GASOLINE PRICES HAVE TRADITIONALLY PEAKED ON OR AROUND THE JULY 4 HOLIDAY.

Higher prices for the holidays

Thus, the U.S. public should prepare for higher prices entering the summer driving season, when gasoline prices have traditionally peaked on or around the July Fourth holiday.

Despite the decadelong increase in domestic oil production, in our estimation, the United States is not in a position to make up lost global supply; domestic infrastructure constraints will not permit the economy to export our highly desired light sweet crude to foreign buyers.

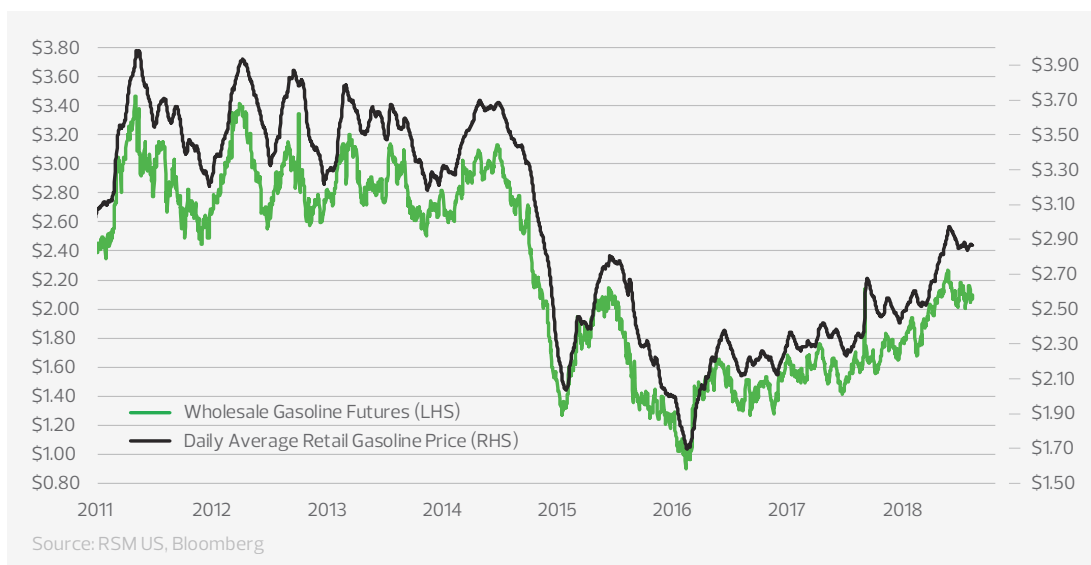


One little-understood reality about the domestic U.S. oil complex is that domestic refining capacity is aligned with refining heavy sour oils that countries such as Canada and Venezuela produce. It will be a number of years before the refinery and pipelines will be in place to permit the United States to utilize its prodigious capacity to produce significant shipments destined for export to make up for shortfalls caused by non-market action. Thus, the non-market-derived pricing actions now imply upside risk to retail gasoline prices, all of which will be absorbed by American consumers.

For most of the past 50 years, an increase in oil prices that flowed through to consumers through higher retail gasoline prices would set off alarm bells in Washington over declining

consumption and higher inflation. While the structure of the economy has changed—considering fuel efficient autos, the shift to natural gas and renewables, and offsetting increases in capital expenditures in oil and mining—the sensitivity of the policymakers has not evolved in a similar fashion. So, one should anticipate calls for use of U.S. strategic oil reserves to mitigate the shortage of global supply that will follow the actions taken by the White House recently.

At this point, a single-digit increase in gasoline prices, which will feed into headline inflation over the next few months, is likely not to move the Federal Reserve off the prudent pause it has signaled to the market. We do not expect any move from the Fed on higher lending rates until late 2020 or early 2021 at the earliest.



U.S. Q1 2019 GDP: STRONG TOP-LINE 3.2 PERCENT GROWTH, REAL PRIVATE DEMAND AT 1.3 PERCENT

By Joseph Brusuelas

U.S. economic output for the first three months of 2019 expanded at a strong 3.2 percent pace, despite a slowdown in household consumption to 1.2 percent, headwinds from the external sector, a lengthy government shutdown and a rough winter.

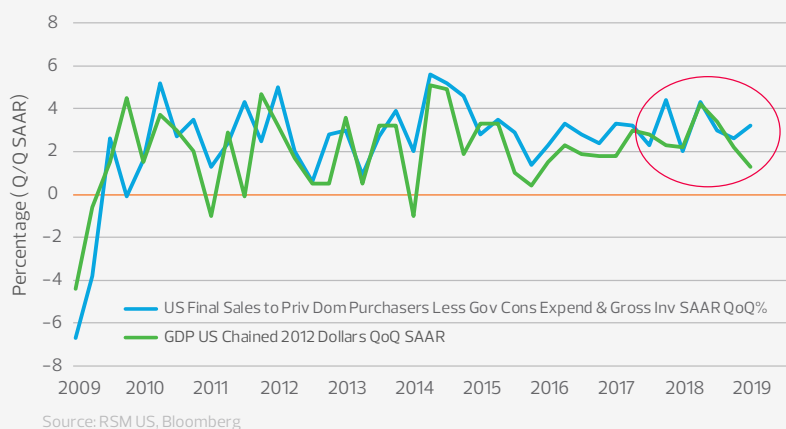
The primary growth drivers were a massive increase in inventory accumulation of \$128.4 billion and a narrowing in the trade deficit to \$899.3 billion from \$955.7 billion, both of which provided a one-time boost to growth that will not be replicated in the current quarter. Stripping that out, the growth picture is decidedly different and points to a slowing toward the long-term trend growth rate of 1.8 percent.

Final sales to domestic private domestic purchasers increased at a more modest 1.3 percent, final sales to domestic purchasers increased 1.4 percent and real final sales advanced 2.5 percent. To put this in perspective, real final sales to domestic private domestic purchasers slowed from 4.3 percent in mid-2018 to 1.3 percent just nine months later. This is not the stuff of an economy growing at or above 3 percent on a sustainable basis.

No inflationary risk seen

The economy avoided a recession on the back of the mini-financial shock in the final quarter of 2018; once one strips out volatile components, it looks to be slowing back toward the long-term trend growth rate of 1.8 percent. This data reinforces the prudent pause the Fed is engaged in, and forward-looking investors and chief financial officers should expect no rate hike or rate cut until 2021.

Inside the U.S. Commerce Department report, household consumption slowed to 1.2 percent due to a 5.3 percent decline in purchases of durable goods, a modest increase of 1.7 percent in non-durables and a 2 percent increase in services demand. One should anticipate a modest rebound



in the current quarter, driven by sustained hiring and mild wage increases.

Gross private investment increased 5.1 percent, while fixed business investment advanced at a 1.5 percent pace. This was driven by an increase in government-sponsored construction, which resulted in a 2.7 percent increase in non-residential investment. Like the trade and inventory data, this is not a sustainable increase, thus it will be partially reversed in the current quarter and act as a drag on growth.

On a more encouraging note investment in intellectual property advanced 8.6 percent, which more than overshadowed the anemic 0.2 percent increase in outlays on equipment. Residential investment overall declined by 2.8 percent.

Government spending advanced 2.4 percent as national defense spending increased 4.1 percent, state and local spending fell 3.9 percent and non-defense spending dropped 5.9 percent. Clearly this pace will not be replicated in the current quarter. Moreover, there is a \$126 billion dollar fiscal cliff awaiting the economy, should there not be a bipartisan movement toward extending temporary measures from the 2017 Tax Cuts and Jobs Act and the Fiscal Year 2018 budget.

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RESEARCH SHOWS MIDDLE MARKET CYBER RISK

Nearly 50 percent of midsize companies expect they will face unauthorized users attempting to breach their data or systems this year, according to executives RSM surveyed. Despite incidents of rising cybercrime, just half of the businesses surveyed carry cyber insurance policies to protect against internet-based risk. Our study shows that many of those policies may fall short of comprehensive coverage.

Meanwhile, the C-level executives we surveyed may be overly confident in their firms' internal abilities to thwart an attack. Some 93 percent of respondents were confident in their organizations' ability to safeguard customer data. The reality—based on actual incident reports—is proving that confidence may be misguided.

Learn more in the [full report](#).



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