

THE REAL ECONOMY

VOLUME 59



UNCERTAINTY
IS BECOMING
A DRAG ON THE
U.S. ECONOMY

CANADA ELECTION RESULTS WILL TEST
COUNTRY'S GOVERNMENT SPENDING

INDUSTRY SPOTLIGHT: SURVIVING THE UPS
AND DOWNS OF CONSUMER SENTIMENT

MIDDLE MARKET TREND WATCH:
TRACKING CONSUMER CONFIDENCE

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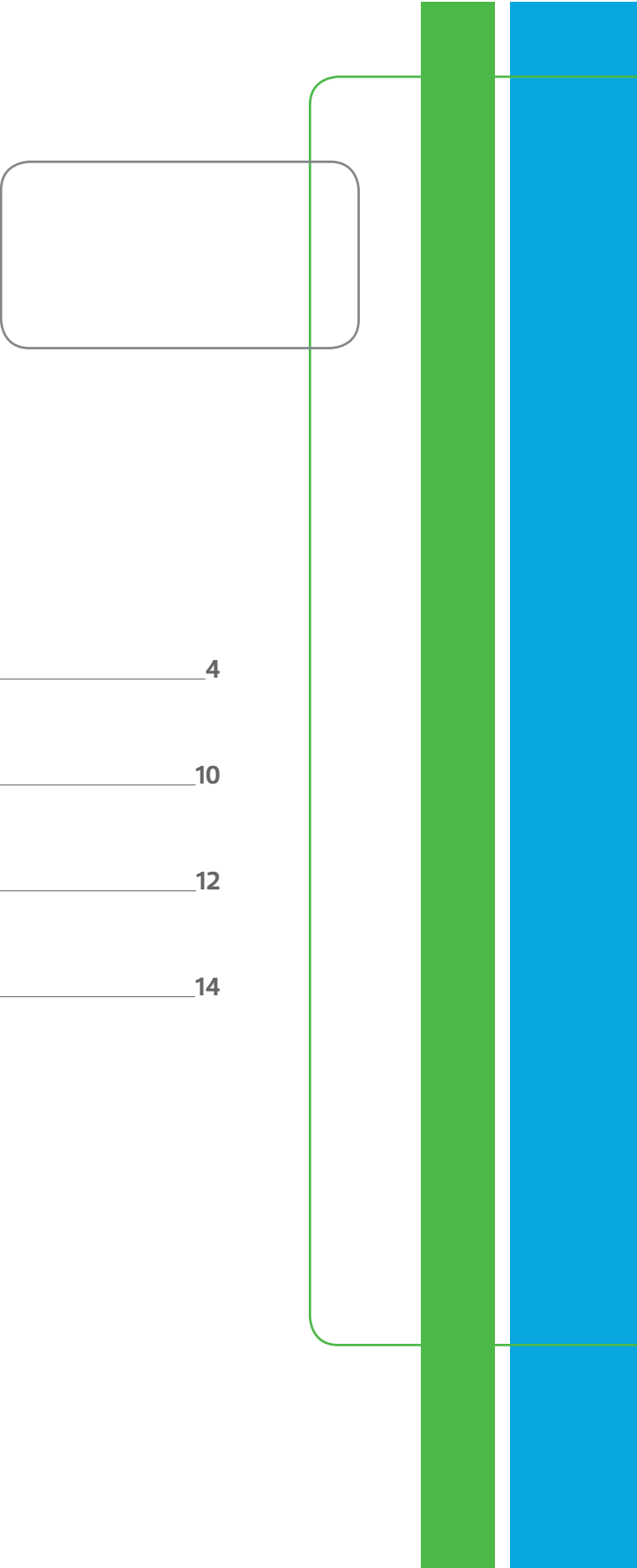


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UNCERTAINTY IS BECOMING A DRAG ON THE U.S. ECONOMY

The 'uncertainty tax' takes its toll

BY JOSEPH BRUSUELAS

AFTER A DECADE of the longest expansion in American history, the economy is entering a fraught new phase, one characterized by whipsaw changes in trade policy and a highly volatile geopolitical environment. The result is a chill on both capital investment and household spending as businesses and consumers search for stability. Call it the "Age of Anxiety."

The shift is being driven by what we call the uncertainty tax: When businesses are confronted with continuing radical shifts in trade policy, they become reluctant to invest in equipment, software and intellectual property—the kind of spending that will enhance productivity in the long term. That drop-off inevitably leads to greater volatility in asset prices, along with declines in consumption, and ultimately, employment.

The result is the U.S. economy is caught in a trap—one entirely of its own making. The conundrum is occurring just as the positive effects of the tax cuts of 2017 and higher government spending begin to wear off.

THE ECONOMIC DATA TELLS THE STORY: GROWTH IS SLOWING, INVESTMENT IS DECLINING AND EXPORT MARKETS ARE SHRINKING.

The economic data tells the story: Growth is slowing, investment is declining and export markets are shrinking. The climate could get worse, given the instability in domestic political environment and the upcoming presidential election. There is a risk that this uncertainty will increase into the first half of 2020.

This does not mean that a recession is on the horizon—it would take an intensification of the trade war or a large exogenous shock to cause a recession. But we do expect growth in the first half of 2020 to arrive around a soft 1%, a notable deceleration from the 3% rate of 2018.

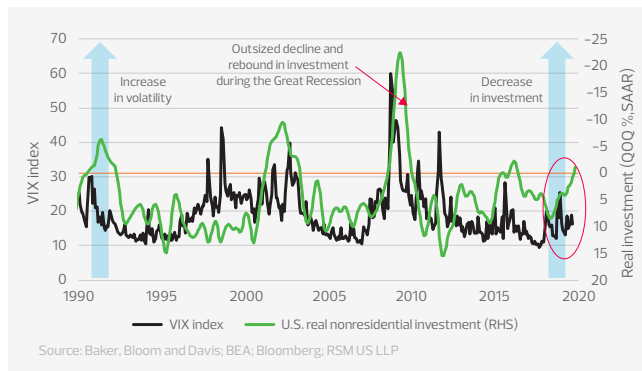
Measuring uncertainty

It's hard to escape the anxiety that looms over the economy—stories of political turmoil and shifting stances on trade dominate the news cycle. Uncertainty is reflected in the drop in exports and corporate capital expenditures, but there are other measures as well.

One example is the CBOE Volatility Index, or VIX, which measures equity-market volatility and is more commonly known as the “fear index.” Under this measure, low volatility suggests a stable environment for investment and consumption and high volatility indicates greater risk for spending outcomes.

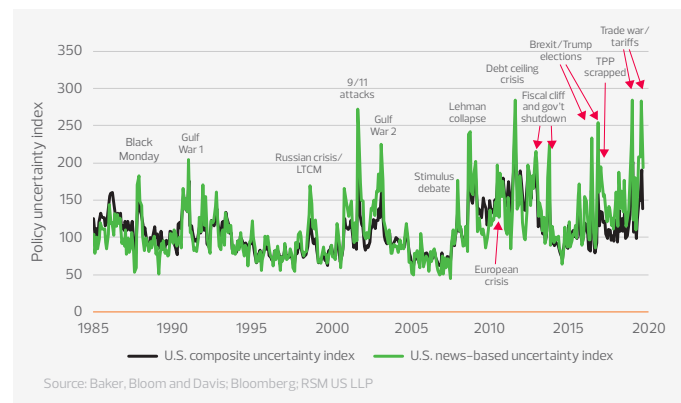
The perceived risk in the equity market has at times been a leading indicator of the rate of growth in investments.

U.S. equity-market volatility and U.S. investment growth (VIX INDEX OF IMPLIED S&P 500 VOLATILITY)



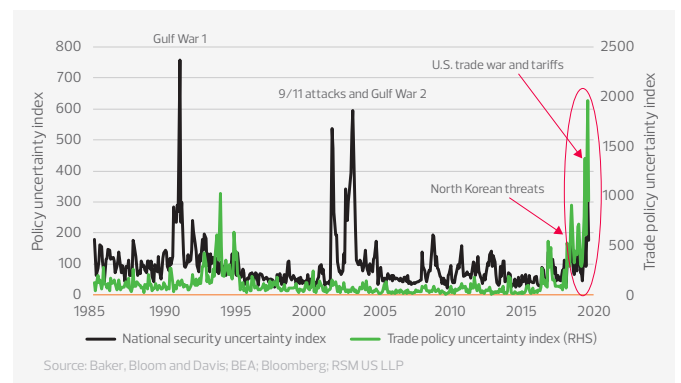
Another measure of uncertainty was introduced in [a widely circulated paper](#) at the National Bureau of Economic Research, written by the economists Scott R. Baker, Nicholas Bloom and Steven J. Davis. It traces the effect of conflicts and major events of the past 35 years.

U.S. economic policy uncertainty index (BAKER, BLOOM AND DAVIS NEWS-BASED AND COMPOSITE INDEX)



Baker, Bloom and Davis don't limit their measure of uncertainty to the broader economy; they also identify its specific causes, from the recent American saber-rattling with North Korea to the United States bailing out of the Trans-Pacific Partnership to the beginning of global trade tensions. To be sure, there have been moments of uncertainty throughout the years, but we should be aware of periods where extraordinary events have led to elevated levels of stress.

U.S. uncertainty due to national security and trade (BAKER, BLOOM AND DAVIS CATEGORICAL EPU INDICES)



UNCERTAINTY (CONT.)

Uncertainty and business investment

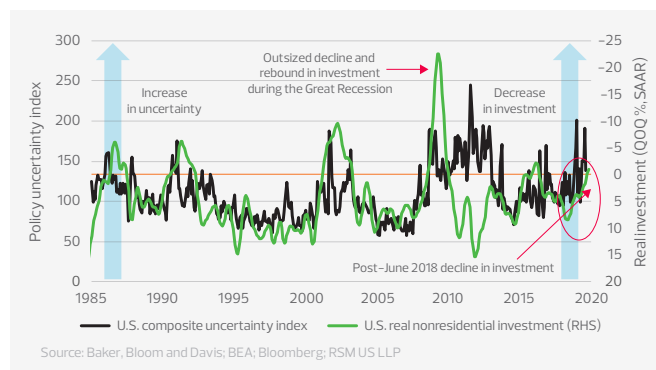
The result of these shocks ultimately affects economic decisions. That's because businesses need some sense of stability in economic and trade policy if they are to make significant long-term investments.

As Baker, Bloom and Davis wrote:

"Evidence that policy uncertainty raises stock price volatility and lowers investment rates and employment growth rates for firms in government-exposed sectors like defense, healthcare and construction, and that these effects are large enough to matter for aggregate investment, employment and output."

U.S. economic policy uncertainty and U.S. investment growth

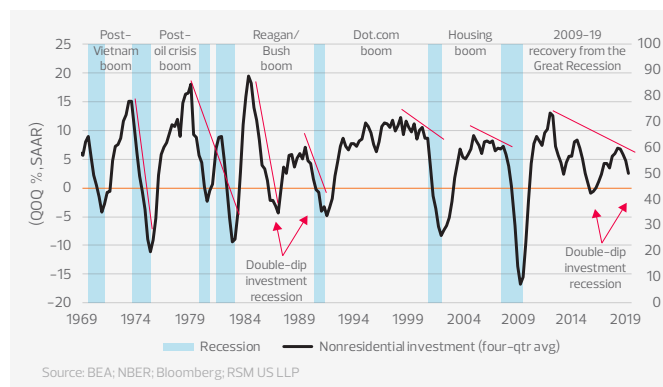
(BAKER, BLOOM AND DAVIS COMPOSITE EPU INDEX)



Each of the modern-era recessions has been accompanied by a sharp decline in investment spending. In the period immediately after a recession—and depending on the depth and duration of the downturn—investment spikes up relative to the recession level before moderating back to normal rates of increase.

The current economic recovery is noteworthy in that investment growth took longer to recuperate after the 2007–09 Great Recession, as would be expected after a financial shock, but seems to be more symptomatic of the offshoring of manufacturing that accelerated in 2009 in the depths of the crisis.

Growth of nonresidential investment at the end of economic booms/recoveries



Investment growth turned negative during the mini-recession of 2015–16 that was induced by the collapse in commodity prices. Despite the corporate tax cut in December 2017, nonresidential investment growth was negative again in the second quarter of 2019 (relative to the first quarter) and could very well become a drag on total gross domestic product growth.

Investment is dependent on perceptions of uncertainty and risk. The decline in domestic capital expenditures by business in the current economic cycle clearly reflects the mitigation of risk and can be observed in the transfer of production to low-cost centers outside of the United States. Consumers, however, cannot offshore their expenses.

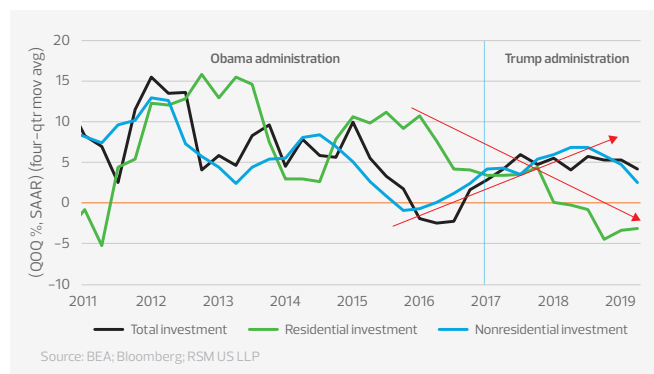
Uncertainty and household investment and spending

While business investment accelerated from early 2016 through the second quarter of 2018, residential investment has been decelerating since 2013. There could be factors other than uncertainty causing the latest decline in residential investment. For one, we are seeing major demographic shifts in housing preferences as millennials and aging baby boomers increasingly live in cities. In addition, overheated markets in some areas of the country have pushed home purchases beyond the reach of many consumers.

DESPITE THE CORPORATE TAX CUT IN DECEMBER 2017, NONRESIDENTIAL INVESTMENT GROWTH WAS NEGATIVE AGAIN IN THE SECOND QUARTER OF 2019 (RELATIVE TO THE FIRST QUARTER) AND COULD VERY WELL BECOME A DRAG ON TOTAL GROSS DOMESTIC PRODUCT GROWTH.

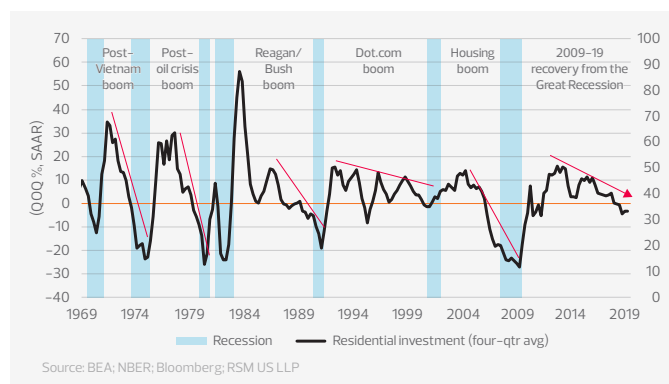
Components of investment growth

(GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD)



Nevertheless, the current economic recovery is noteworthy in that residential investment growth took longer to recuperate after the 2007-09 Great Recession—as would be expected after a housing-induced financial shock—and there were apparently no trickle-down effects from the 2017 tax cuts. Residential investment has been negative throughout 2018-19 on a quarterly basis.

Growth of residential investment at the end of economic booms/recoveries

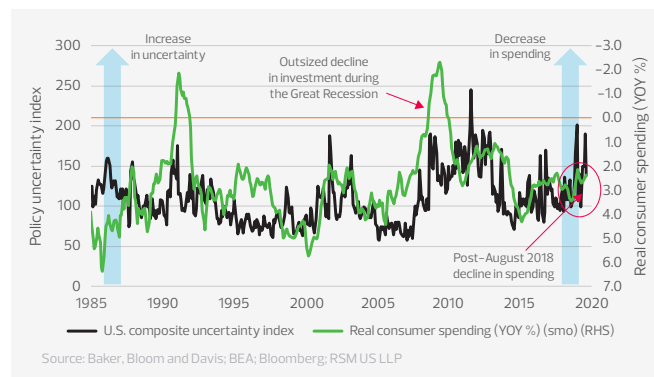


Still, there is no getting around the elephant in the room—the increasing anxiety that consumers are feeling. The Baker, Bloom and Davis data show an across-the-board increase in policy uncertainty in 2019, and it is unlikely that households would be unaware of its existence if only at the most basic of levels—like the rising cost of household products. And while there are baseline amounts of household consumption—rent, food, utilities and clothing—spending becomes more discretionary during periods of stress. Clearly, the two most recent

downward spikes in consumer spending occurred during bouts over trade between the United States and China.

U.S. economic policy uncertainty and consumer spending

(BAKER, BLOOM AND DAVIS COMPOSITE EPU INDEX)



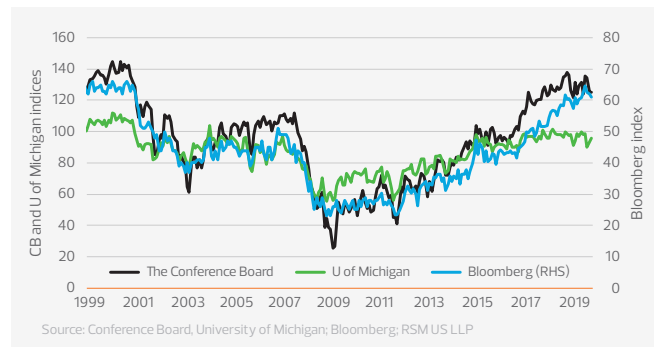
Surveying the surveys

How can we measure consumer anxiety? There are three major surveys of consumer sentiment: The Conference Board, the University of Michigan Consumer Surveys and Bloomberg. The survey results are reported as diffusion indices with the percentage of negative responses subtracted from the percentage of positive responses. And while the overall trends have been consistent among the surveys, the figure below indicates that the Michigan survey has diverged from the trend prior to 2001 and now since mid-2017.

These are surveys with different questions, different sample sizes and different scheduling, so it is logical for there to be variations from time to time. To capture all the information, we have constructed a composite, poll-of-polls index that we will use in the discussion that follows.

U.S. consumer sentiment indices

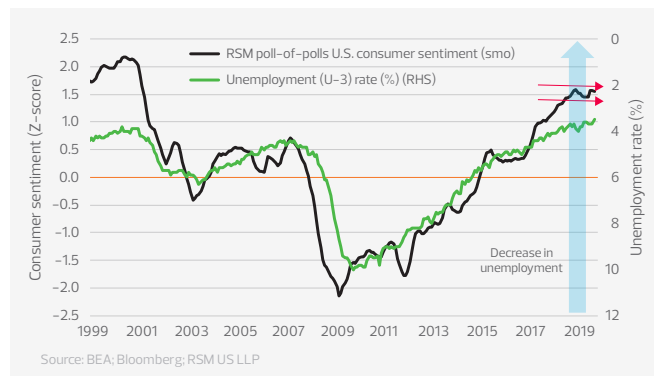
(CONFERENCE BOARD, UNIVERSITY OF MICHIGAN AND BLOOMBERG)



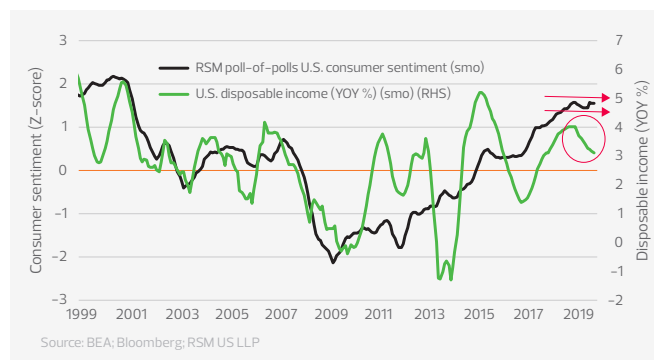
UNCERTAINTY (CONT.)

Our poll-of-polls consumer confidence index indicates that consumer sentiment might have topped out in early 2018 at 1.5 standard deviations above normal levels of sentiment, which coincides with the realization that the threats to trade were becoming policy. And as the figures below suggest, the topping out of consumer sentiment might have something to do with the maturation of the labor market and the unemployment rate reaching its peacetime limit, all within the backdrop of real disposable income trending downward since the second quarter of 2018.

U.S. consumer sentiment and unemployment rate (RSM POLL-OF-POLLS CONSUMER SENTIMENT INDEX)



U.S. consumer sentiment and disposable income (RSM POLL-OF-POLLS CONSUMER SENTIMENT INDEX)

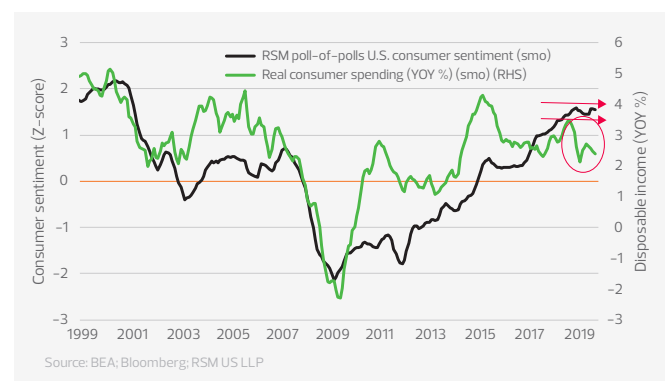


The downturn may not be confined to manufacturing

We are already in a global manufacturing recession, with U.S. trade policy affecting Chinese purchases of German machinery. But the ripple effects did not end

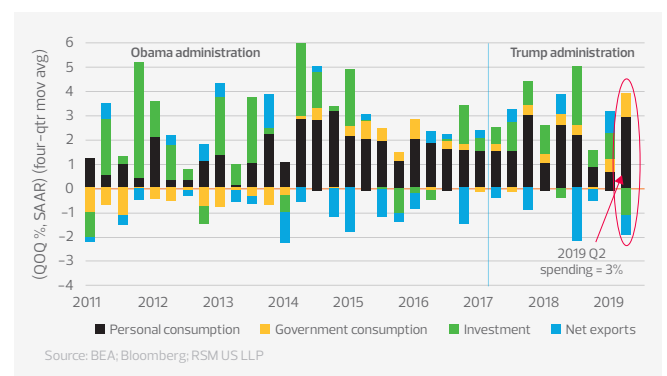
there. Diminished U.S. business investment, limited employment opportunities and a recently more-cautious consumer have led to a declining trend in disposable income. Is it any wonder that U.S. consumer sentiment has stalled and households have begun to pull back on spending?

U.S. consumer sentiment and real consumer spending (RSM POLL-OF-POLLS CONSUMER SENTIMENT INDEX)



Optimists might point to the robust 3% year-over-year growth of household spending in the second quarter of 2019 as a barometer of household resilience. But the damage to investment processes brought about by the upsurge in uncertainty has the potential for medium- and long-term effects on economic growth, wages and consumption decisions. ■

Contributions to GDP growth by sector GDP NATIONAL ACCOUNTS DURING THE 2011-19 RECOVERY PERIOD



Note: All national accounts data is through June 2019.

DIMINISHED U.S. BUSINESS INVESTMENT, LIMITED EMPLOYMENT OPPORTUNITIES AND A RECENTLY MORE-CAUTIOUS CONSUMER HAVE LED TO A DECLINING TREND IN DISPOSABLE INCOME. IS IT ANY WONDER THAT U.S. CONSUMER SENTIMENT HAS STALLED AND HOUSEHOLDS HAVE BEGUN TO PULL BACK ON SPENDING?

UNCERTAINTY'S ECONOMIC TOLL THROUGH THE DECADES

There were huge spikes in uncertainty in the first and last years of George W. Bush's presidency because of the Sept. 11 attacks in 2001, and then the Wall Street meltdown in 2008.

Policy uncertainty moderated during Barack Obama's first year in office, but by 2010, there were outsized trade concerns in the immediate post-crisis period. In the last year of Obama's second term, global trade was again a concern as an oil glut and commodity-price decline undermined the value of global trade and its effect on global growth. National security also became a concern in 2014–16, as ISIS in Iraq and civil war in Syria threatened the Middle East status quo.

By late 2016, North Korea's missile testing intensified and became the first existential threat to the United States since the 9/11 attacks. And by the start of the Trump administration in 2017, trade concerns became dominant as the administration bailed out of the Trans-Pacific Partnership, followed by U.S. tariff threats, the U.K. drawing closer to leaving the European Common Market, and Germany starting its economic decline. As of September 2019, all categories identified by Baker, Bloom and Davis were indicating more uncertainty than in 2018.

PERCENTAGE CHANGE IN YEARLY AVERAGE POLICY UNCERTAINTY BY CATEGORY

President	Senate control	House control	Year	Total	Monetary policy	Fiscal policy	Health care	National security	Entitlement programs	Regulation	Financial regulation	Trade policy
Bush	Democrat	Republican	2001	80%	82%	141%	63%	197%	93%	27%	158%	-14%
			2002	-14%	-29%	-23%	-4%	11%	-8%	1%	71%	-22%
	Republican	Republican	2003	2%	-2%	35%	13%	33%	-16%	-8%	-34%	-2%
			2004	-38%	-36%	-46%	-14%	-55%	-33%	-33%	-61%	-8%
Bush	Republican	Republican	2005	-16%	-16%	-34%	-46%	-44%	-13%	-24%	-6%	-20%
			2006	-6%	6%	-18%	-2%	-10%	-39%	10%	-12%	-30%
	Republican	Democrat	2007	4%	13%	5%	-7%	-17%	-10%	5%	78%	4%
			2008	112%	64%	182%	147%	149%	159%	169%	343%	89%
Obama	Democrat	Democrat	2009	-5%	-40%	7%	41%	-41%	30%	-6%	-19%	-51%
			2010	13%	28%	37%	47%	31%	49%	40%	15%	115%
	Democrat	Republican	2011	-1%	-1%	0%	-15%	-3%	8%	-13%	-26%	20%
			2012	1%	0%	12%	15%	3%	9%	-14%	-4%	-39%
Obama	Democrat	Republican	2013	-19%	-18%	-31%	-21%	-11%	-19%	-27%	-44%	-20%
			2014	-40%	-48%	-52%	-46%	-40%	-52%	-9%	-29%	36%
	Republican	Republican	2015	0%	29%	-15%	-37%	8%	-32%	-13%	-9%	-12%
			2016	20%	45%	34%	45%	36%	-2%	18%	32%	248%
Trump	Republican	Republican	2017	19%	-38%	46%	74%	15%	95%	9%	-11%	1%
			2018	-6%	-2%	-12%	-39%	44%	-24%	-10%	-34%	207%
	Republican	Democrat	2019	23%	147%	9%	24%	36%	8%	9%	34%	77%
			2020									
2014-19 % change				65%	185%	61%	21%	229%	7%	10%	-5%	1581%

Key: Positive values = increase in uncertainty



CANADA ELECTION RESULTS WILL TEST COUNTRY'S GOVERNMENT SPENDING

BY ALEX KOTSOPOULOS

CANADIANS RETURNED Justin Trudeau's Liberals to power in last month's election, but the Liberals fell short of securing a majority in what some commentators are regarding as a "strong minority government." The Liberals garnered enough support to win Atlantic Canada, Quebec and Ontario with 157 seats (170 is required for a majority). The Conservatives locked in 121 seats, winning 71 of 107 in Western Canada (British Columbia, Alberta, Saskatchewan and Manitoba).

The coming days will determine the direction of the new minority government: Will the Liberals form a coalition with the New Democratic Party and possibly the Green Party, or will they maintain confidence around individual issues on an ad hoc basis? History suggests that Canada's minority governments do not last long—on average about two years or less. So Canadians may be back at the polls in the not too distant future. Fiscal policy will become increasingly important in the short-term.

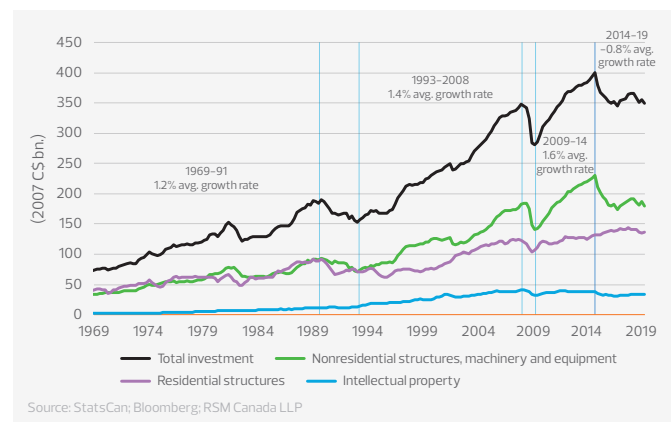
Slowing growth and fiscal policy

Canada's economy is slowing and financial conditions are tightening as the RSM Canada Financial Conditions Index shows. The global economy and Canada face considerable challenges: the U.S.-China trade war, conflicts in the Middle East and Brexit, to name a few.

The Liberals appear to favor infrastructure funding relative to other forms of fiscal stimulus (e.g., C\$3 billion per year in funding for public transit). Infrastructure funding has the potential to boost productivity over time, but may not be the best way to stimulate an economy in the short-run. Other measures, including individual and business tax relief, might be more effective at increasing consumer spending and investment in the near-term.

The Liberals announced C\$9.3 billion in new spending for 2020–21, which will increase the deficit to C\$27.4 billion in the same year. This figure could increase if the Liberals commit to a universal pharmacare plan as put forward by the NDP.

Canada investment in 2007 constant Canadian dollars





East-west divide

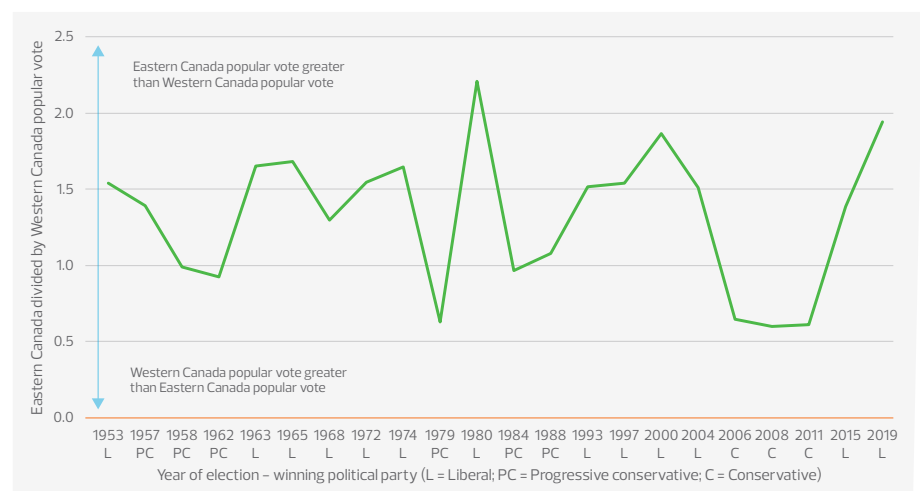
The new government will have to contend with a regionally divided country. Indeed, this is the second most divided federal election since 1980 when Trudeau's father, Pierre Trudeau, won a majority as measured by the relative popular vote in Eastern Canada versus Western Canada. Is history repeating itself? The Liberals had a popular vote that was nearly two times larger in Eastern Canada than in Western Canada.

Conservatives won nearly 70% of electoral districts, or ridings, in Western Canada. In Alberta and Saskatchewan, the Conservatives won every riding except for one. In Eastern Canada, the Liberals took 140 of their 157 seats and about 60% of all seats—excluding Quebec, they had nearly 70% of all seats. Canada has not been this regionally divided since 1980. Managing this stark regional divide will be challenging. How will the Liberals ensure representation from Alberta and Saskatchewan in the Cabinet?

Trans Mountain Expansion Project

The previous Liberal government took the extraordinary step of buying the Trans Mountain Expansion Project, which has the opportunity to generate a significant economic boost by tripling crude oil capacity in Western Canada in the face of a slowing global economy. However, the NDP and Green Party are opposed to TMX as is the Bloc Quebecois, which controls 32 seats. Navigating TMX through a minority government will not be easy. ■

Eastern Canada relative to Western Canada popular vote by election year and winning party





INDUSTRY SPOTLIGHT

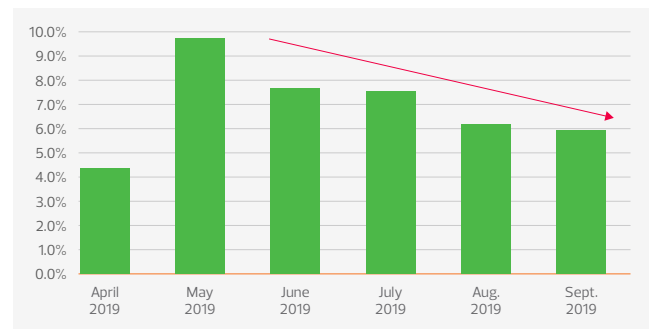
SURVIVING THE UPS AND DOWNS OF CONSUMER SENTIMENT

BY CHRIS SHAKER

EVEN AS THE U.S. economy has flashed warning signs of a looming slowdown, the consumer has been a pillar of strength by comparison, helping to extend the longest economic expansion in American history. Consumer confidence has been strong by historical standards, and consumer spending—which makes up about two-thirds of economic activity—has kept the economy growing at a pace that still exceeds the long-term average of 1.8%.

It may not last, though. Consumer confidence has shown signs of volatility this year as the global trade war and geopolitical headwinds have begun to trickle down to spending decisions. "There are significant global and domestic uncertainties that will keep consumers cautious spenders," even as rising incomes buoy their bank accounts, Richard Curtin of the University of Michigan wrote [in releasing preliminary results](#) from its October surveys of consumer sentiment. Indeed, a closer look at the trend in retail sales indicates that sales growth may have peaked in the middle part of the year.

Retail and food service three-month average annualized growth



What's a middle market retailer to do? Sharpen your strategy for discounts and promotions

Today's consumer has shown a penchant for looking for discounts. According to the National Retail Federation, the majority of shoppers were looking for discounts and sales before they made purchases during the back-to-school season.



The majority of back-to-class shoppers are planning their shopping around sale events. And this Prime Day, consumers will be looking across retailers for deals:



Source: 2019 NRF Back-to-School/College Spending Survey conducted by Prosper Insights & Analytics



But this mentality is not isolated to the back-to-school season, and it's putting a squeeze on middle market retailers who don't adapt.

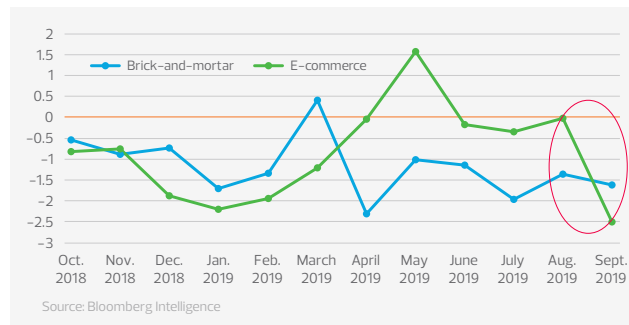
Consider the holiday shopping season, when big-box retailers have a decided advantage. As online sales continue to grow, they simply have a greater ability to scale and offer more product diversity and meet the demand for immediate and free shipping.

That means that middle market retailers need to find ways to be creative to compete. One Accenture survey found that 82% of shoppers said the top factor that determines whether or not they will travel to a brick-and-mortar location is price. For smaller retailers that don't have the size and scale of big-box competitors, they should consider capitalizing on smart promotional and discount strategies as one method to attract more customers away from big-box competitors.

Two ideas to consider:

Start early. Retailers may be able to discount early this holiday season to capture sales, especially if consumers plan to accelerate purchases to beat perceived price increases resulting from tariffs. To be sure, this discounting strategy, while it may boost sales, also has risks—namely, the pressure it puts on margins. Bloomberg Intelligence reported that the average ticket prices dropped sharply in September, both in brick-and-mortar locations as well as online.

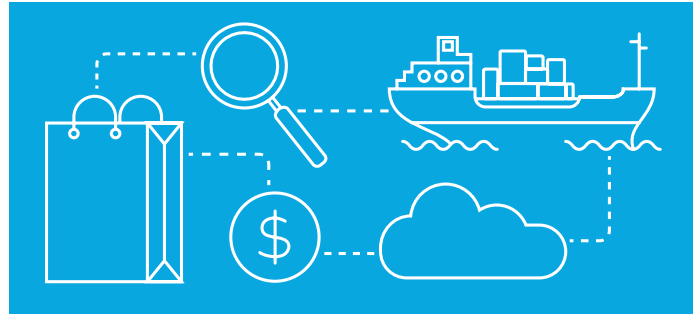
Change in ticket by channel (%)



Source: Bloomberg Intelligence

Plan carefully. Then execute. The timing and extent of discounts and promotions are often decisions made on short notice, which can lead to a poorly executed strategy. But with proper planning and execution, a successful discount strategy can help middle market retailers compete against the bigger competition—and weather the ups and downs of shifting consumer sentiment. ■

MIDDLE MARKET TREND WATCH



TRACKING CONSUMER CONFIDENCE

HOW ARE CONSUMERS viewing current economic conditions and how are buying habits and preferences affected? According to the September 2019 report from the University of Michigan Surveys of Consumers, confidence trends remain favorable; however, the outlook also points to a slow erosion of consumer sentiment. Note the findings below. ■

Consumer sentiment rose to **93.2**, up from **89.8** in August, but remaining well below last September's **100.1**.

A near-record one-third of all consumers negatively mentioned trade policies when asked to explain the factors underlying their economic expectations.

The index was only slightly below the average for the first half of 2019 (**96.5**) as well as for the average for 2017 and 2018 (**97.6**).

More consumers reported unfavorable news about the economy in September than in eight years since September 2011.

Source: [University of Michigan Surveys of Consumers](#)

KEY TAKEAWAY

Consumers are expressing rising levels of uncertainty which could signal an overall economic slowdown, or at the very least, indicate a slight shift in positive economic outlook. Middle market businesses should be proactive in their planning. Consider now what measures should be addressed to optimize supply chain, inventory management, consumer engagement, processes, systems and more. Also, weigh how the business is leveraging new technologies to address business issues and ongoing operational challenges.



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