

THE REAL ECONOMY

VOLUME 46



**HOLIDAY SPENDING
SHOULD BE ROBUST
(WITH AN ASTERISK)**

FOMC COMMENT:
SHAPING MARKET EXPECTATIONS
FOR A **DECEMBER RATE HIKE**

NAFTA MODERNIZATION: A MIXED
BAG FOR THE MIDDLE MARKET

TARIFFS BY THE NUMBERS

HOW TARIFFS ARE AFFECTING CONSUMER
AND INDUSTRIAL PRODUCTS COMPANIES

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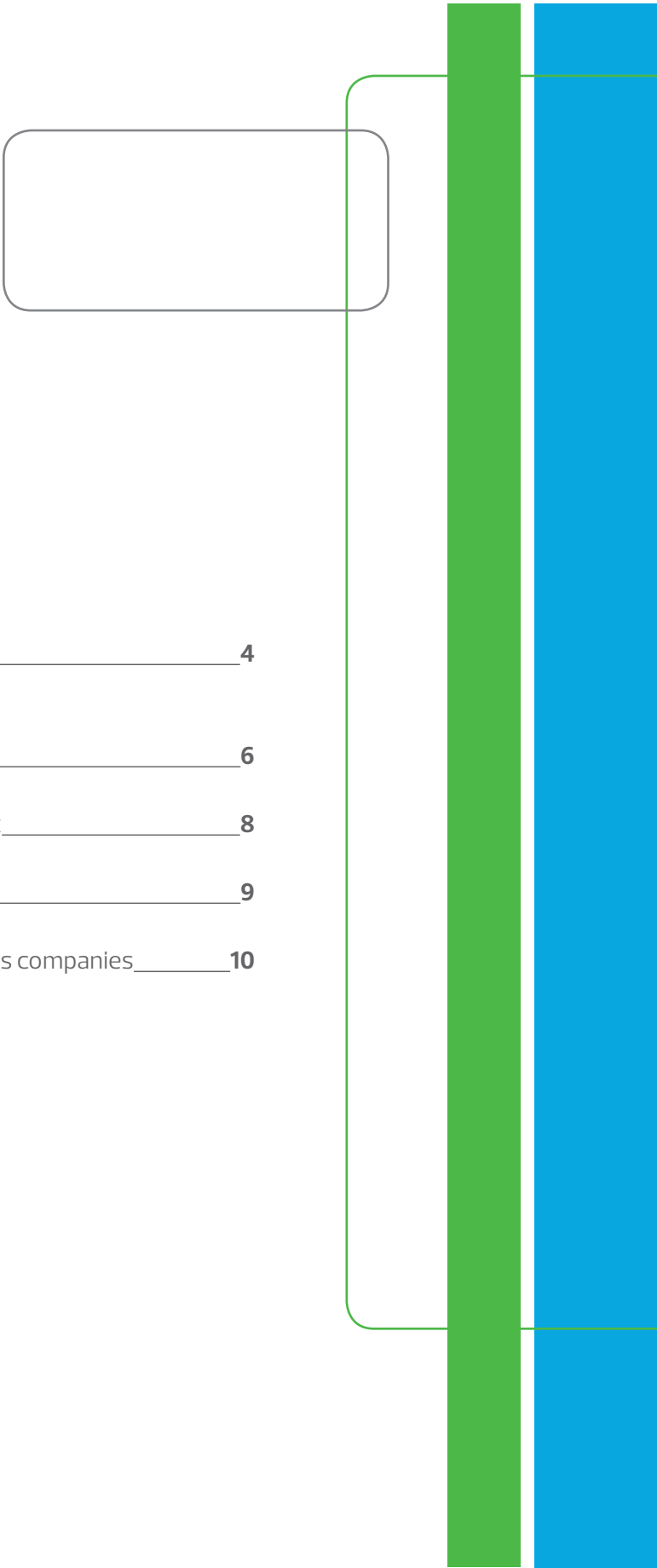


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HOLIDAY SPENDING SHOULD BE ROBUST (WITH AN ASTERISK)

By Joseph Brusuelas, Chief Economist, RSM US LLP

Favorable employment and income dynamics in the U.S. economy should result in a robust period of holiday spending this year that translates to a near 6.3 percent increase in sales, well above the 5.5 percent rise posted in 2017. We expect an increase to \$735.5 billion from the \$691.9 billion mark a year ago, a figure that does not include spending on restaurants, vacations and other leisure, automobile dealers or gasoline stations—all of which additionally imply a much stronger period ahead for the upcoming holiday season.

Moreover, we expect online sales to advance at a 15.4 percent pace to \$159.71 billion, up from \$138.4 billion in 2017. In our estimation, the combination of internet sales, a wealth effect garnered by rising stock prices, and the pulling forward of spending due to anticipated tariffs and higher retail prices on a wide array of consumer goods portends stronger sales during the critical holiday season—strength that may be offset, however, by a slowdown next year after expected tariffs kick in.

The probability of increased spending to avoid higher tariff-driven prices could result in an additional one-half of 1 percent on holiday outlays: it is the primary catalyst for our optimistic forecast. Such a trend deserves a giant

asterisk attached to it in the annals of holiday spending. In fact, there is some evidence that accelerated spending is already in train within the automotive industry and other manufacturers dependent on imported steel and aluminum—both early targets of increased duties—as consumers stock up on new cars, washers and other big-ticket items ahead of expected price boosts.

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So why are we adding one-half of 1 percent to what would otherwise be a respectable 5.7 percent year-over-year gain? We expect the U.S. consumer to behave in an eminently rational manner in the face of the recent imposition of a 10 percent tax on 5,745 individual goods imported from China valued at \$200 billion. Moreover, given a push by the current administration to boost that tax to 25 percent in January, as well as potentially impose an additional 25 percent tax on an unnamed number of goods valued at \$267 billion, it is likely American consumers will pull a

good bit of consumption and economic activity forward into the final quarter of 2018. When demand pulls forward, it usually results in a noticeable decline in overall consumption in the periods that follow and begs asking the question: Are we understating the likely behavior by U.S. consumers conditioned to falling prices over the past three decades to a sudden price shock on core consumer goods?

The Brexit behavior precedent

In many respects, this pull-forward effect will roughly parallel behavior in the United Kingdom following the price shock that followed the June 2016 Brexit vote. As it became clear that a 19 percent devaluation in British sterling would result in a near-term increase in inflation (which jumped from 0.5 percent on a year-before basis to 3 percent over following 18 months), rational behavior supported an increase in consumption before the price shock arrived. In many respects, the U.K. consumer experience following the Brexit vote provided a natural experiment on how an advanced wealthy consumer base responds to self-induced price shock. It is a solid benchmark to estimate U.S. spending, both in the third quarter of 2018 and in the holiday season, that drives spending over the final three months of the year.

So how did British consumers behave? They sustained an inflation-adjusted pace of spending at 3.1 percent in the two quarters following the policy shock, and then subsequently, began to pull back on consumption to a nadir near 1.1 percent, where it currently stands. While we do not anticipate a similar severe decline in U.S. consumption following the year-end holidays, disruptions to supply chains across both manufacturing and service sectors and the risk of further increases in import taxes all point to a noticeable slowdown in the pace of consumption after an anticipated one to two quarters or more of robust outlays on goods identified as taxable imports.

The tailwinds behind the consumer sector are simply the best that they have been during the current business cycle. Job gains over the past six months have averaged 192,000 per month, and the overall labor supply has increased just under 0.8 percent, well above the long-term trend of 0.5 percent, with average hourly earnings on a year-ago basis at a cyclical high of 2.9 percent. Consumer confidence stands at 138.4, another cyclical high, and the savings rate stands at 6.7 percent of personal income; meanwhile, personal income growth is up 4.7 percent on a year-ago basis. Spending dynamics in the retail sector, on a

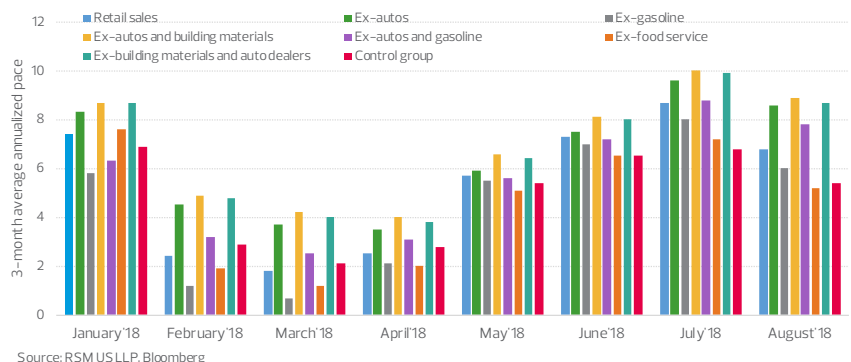
IN MANY RESPECTS, THIS PULL-FORWARD EFFECT WILL ROUGHLY PARALLEL BEHAVIOR IN THE UNITED KINGDOM FOLLOWING THE PRICE SHOCK THAT FOLLOWED THE JUNE 2016 BREXIT VOTE.

three-month average annualized basis through August 2018, are up 6.8 percent, excluding autos (8.6 percent), outlays on gasoline (6 percent), building materials (8.9 percent), food service (5.2 percent), and auto dealers (8.7 percent); excluding food, gasoline, building materials and auto dealers, retail sales are up 5.4 percent using that metric. (This particular metric is used by the Bureau of Economic Analysis to estimate quarterly consumption.) So any way one slices it, spending in the household sector is on fire following an overall increase of 4 percent in the second quarter of this year.

As always, the composition of goods and services purchased during the holiday period is critical. A significant spending boost due to record equity prices will support an aggressive increase in purchases by the upper two quintiles of income earners via the wealth effect. At the current time, each 1 percent increase in wealth should likely result in an additional 1 percent increase in spending, and will be the primary driver of the holiday spending boost.

While the aforementioned tailwinds will support an improved spending picture among the middle strata and the lower two-income quintiles heading into the final months of 2018, given the relative demand elasticities in the face of rising prices, we anticipate that most consumers in those three quintiles will choose to make purchases around the holidays. By doing so, they will avoid the coming increase in prices associated with the most-recent tariffs imposed and those that will likely be put upon consumers in early 2019.

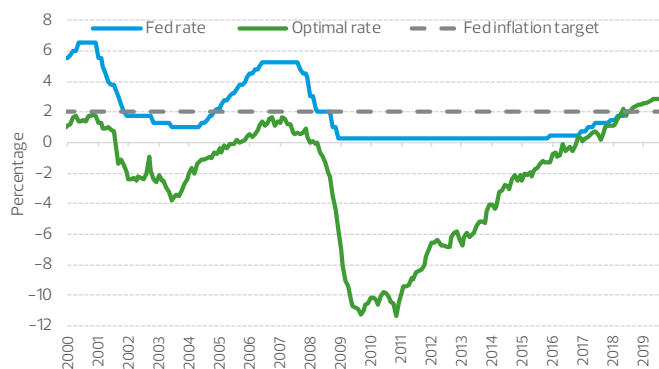
Retail sales to stage rebound



FOMC COMMENT: SHAPING MARKET EXPECTATIONS FOR A DECEMBER RATE HIKE

By Joseph Brusuelas, Chief Economist, RSM US LLP

The Federal Open Market Committee (FOMC) increased the target range for the federal funds rate by 25 basis points to 2–2.25 percent on Sept. 26 and took the next step in preparing the market for a December rate hike. This is in line with Fed rhetoric and the implied path of monetary policy embedded in the dot plots and the summary of economic projections. The dot plot indicated that 12 of 16 participants are forecasting a fourth rate hike in 2018 and 11 of 16 expect three rate hikes in 2019, which would lift the range on the federal funds rate to between 2.75 to 3 percent roughly one year from now. The committee expects the median federal funds rate of 3.4 percent in 2021.



Source: RSM US LLP, Bloomberg

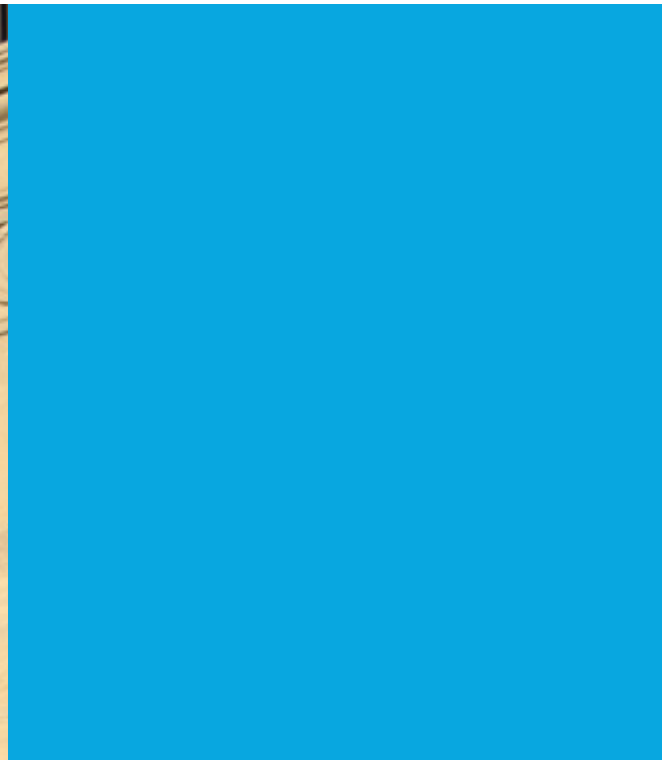
The major takeaway from the statement was the surprise removal of the word “accommodative” from the statement, and is a major step forward by the central bank to prepare market participants and the public for the day when policy becomes restrictive. However,

the combination of the statement and the summary of economic projections does create a bit of uncertainty over where the real neutral rate actually is. We are not in agreement with the Fed's assessment that the policy rate will remain at neutral over the next two years. Our model of the Fed reaction function implies that 2.86 percent represents the upper boundary with any policy rate above 3 percent restrictive. We expect a major effort by the Fed over the next three months to explain the estimation of when rates become restrictive, even if Chairman Jerome Powell is uncomfortable with that monetary policy discussion.

The Fed, as expected, lifted its forecast of 2018 growth to 3.1 from 2.8 percent and lifted the growth rate forecast in 2019

to 2.5 percent. The central bank also lowered its unemployment rate forecast to 3.5 percent in 2019 and it anticipates that will hold through 2020 and then increase to 3.7 percent in 2021.

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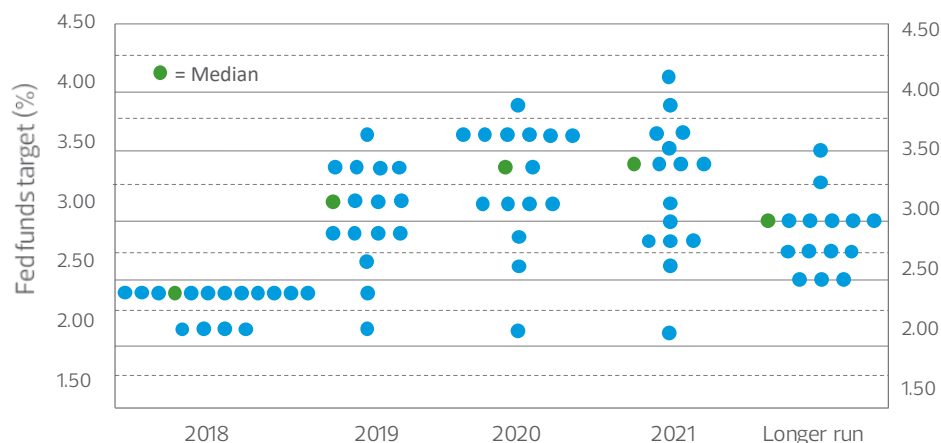


While the year ahead in the policy landscape faced by the FOMC should be rather quiet, excluding the risks associated with an intensifying trade spat and the external sector, the challenge that lies ahead is shaping market expectations for a turn to restrictive policy in the second half of 2019. The Fed expects inflation to hold between 2 and 2.1 percent over the next three years.

Our estimate of the Fed's reaction function implies that the central bank will lift the federal funds rate from its current range of 2 to 2.5 percent to 2.75 to 3 percent one year from now. Based on our estimate of r^* (.86) and NAIRU (3.5 percent), a setting of the policy rate above 2.86 percent represents the upper boundary of what

should be considered neutral. Both policymakers and investors should note that small and medium enterprises, which have been the primary drivers of growth and hiring during the cyclical expansion, do not generally have access to the deep and broad capital markets that large firms regularly tap. These smaller firms are heavily reliant on marginal or nonbanking lenders, thus an inversion of the yield curve accompanied by a move in the federal funds rate above 3 percent in 2019 will result in restrictive policy and financial conditions for small and medium enterprises. From our vantage point, the Fed should proceed with caution as it lays the predicate for a shift in its language and forward guidance.

FOMC's assessment of the appropriate federal funds rate
at the end of 2018, 2019, 2020, 2021 and in the longer run



Source: Federal Reserve, *Summary of Economic Projections (SEP)*, Sept. 26, 2018



NAFTA MODERNIZATION: A MIXED BAG FOR THE MIDDLE MARKET

By Joseph Brusuelas, Chief Economist, RSM US LLP

NAFTA modernization represents something of a mixed bag for middle market businesses. The new treaty, dubbed the United States–Mexico–Canada Trade Agreement (USMCA), includes an important chapter dedicated to small and medium–size enterprises and a wide array of provisions from the abrogated Trans–Pacific Partnership (TPP) trade treaty, which represent major wins for the middle market.

It also includes requirements for improved labor practices, environmental policies, facilitation of digital trade, cross–border trade in services, protection of intellectual property and a reduced role of state–owned enterprises. In our estimation, the chapters covering these substantial trade areas have created a positive framework for future modernization and a precedent for subsequent trade accords.

But these gains are countered by other stipulations that may directly affect middle market businesses: they include renegotiation of so–called auto rules of origin up to 75 percent from 62.5 percent, and the imposition of a wage floor of \$16 per hour on 30 percent of autos produced. The production amount rises to 40 percent of vehicles by 2023 if an auto is manufactured with 70 percent steel and aluminum produced in North America. Those wage production thresholds will result in higher vehicle and parts pricing as well as a subsequent erosion of the existing discount of roughly \$5,000 per vehicle for all autos produced and purchased within the North American supply chain. In addition, we will see a modest rollback of the deep economic integration of the three economies—the United States, Canada and Mexico—organized around auto production.

Read an extensive analysis of the [USMCA agreement here](#), and watch for RSM's upcoming white paper.

**ADDITIONAL LAYERS OF
COSTLY REGULATIONS
AND A MOVE TOWARD
MANAGED TRADE FROM
FREE TRADE INSIDE THE
NORTH AMERICAN AUTO
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IN A LESS EFFICIENT
ALLOCATION OF SCARCE
RESOURCES AND HIGHER
PRICES FOR ALL FIRMS
THAT PARTICIPATE.**



TARIFFS BY THE NUMBERS

IMPACT WILL VARY SIGNIFICANTLY, STATE BY STATE

By Kevin Depew, Deputy Chief Economist, RSM US LLP

On Sept. 24, the United States imposed a 10 percent tariff on \$200 billion worth of Chinese goods. Barring a resolution with China, the tariffs on these products will increase to 25 percent in 2019. If tariffs are fully implemented, RSM estimates they will shave 0.3 to 0.4 percent off growth.

About half of the \$505 billion in goods that come to the United States from China—some 22 percent of total imports—are now impacted by the tariffs, which cover more than 5,000 product codes ranging from agriculture and electronics to apparel and furniture. In turn, China is now collecting between 5 and 10 percent taxes on 5,207 items exported by the United States to China that are worth about \$60 billion.

While the initial round of China's tariffs targeted nonconsumer goods, the wide-ranging scope of this most-recent round means consumers may soon begin to feel the effect of these tariffs, with the agriculture, consumer products and manufacturing industries most at risk.

MIDDLE MARKET INSIGHT

Middle market businesses will likely bear the brunt of tariffs due to their limited ability to either win exclusions or repatriate supply chains.

The maps, a rough approximation of the tariffs, show estimates of the percent of net exports and dollar values affected on a state-by-state basis.





HOW TARIFFS ARE AFFECTING CONSUMER AND INDUSTRIAL PRODUCTS COMPANIES

Breaking down what tariffs really mean for the middle market

By Steve Menaker and Carol Lapidus

In September 2018, the federal government announced the third tranche of tariffs imposed on Chinese imports. This latest list includes over \$200 billion of tariffs on everything from building materials to food to textiles. For leaders of middle market businesses that import raw materials and finished goods from China, tariffs are clearly top of mind. The uncertainty regarding these and potential future tariffs—combined with their significant impact on operations, supply chains and profit margins—has sharpened the focus on this issue for middle market executives.

A choice of approaches

It's clear there is not a one-size-fits-all approach for middle market companies importing from China. Some of the options range from increasing prices charged to customers to absorbing the higher costs to negotiating cost reductions with suppliers.

Following are strategies some manufacturers and importers are using to address their tariff challenges.

Price increases

A global manufacturer of consumer products for the construction and renovation industry that we work with implemented price increases when tariffs were first announced. Its agreements with customers specified pricing based on delivery dates; therefore, some sales price

increases were delayed. However, the approach enabled the company to get ahead of future cost increases.

However, not all middle market companies will be able to react as easily. Some are implementing quick price increases, while others are taking a more restrained approach. There is a concern that higher sales prices could ultimately lead to a loss of business.

Passing along price increases may be especially challenging for companies that sell products to department stores and other big-box retailers. Retailers have stated they will not entertain price increases on products for which they already have confirmed purchase orders. Their strategy is to put off the inevitable as long as possible. As many suppliers have already received approved purchase orders for 2019 deliveries, they will need to shoulder the cost of the tariffs until mid-2019. This could severely affect their financial position. Each company must evaluate its customer base before increasing prices and consider alternative sources of products, as well as other strategies to mitigate the impact.

Split the difference

Several retailers have agreed to a shared-loss approach in which they absorb a share of the increased costs due to the tariffs, with their suppliers and customers also bearing a portion. Many importers are also asking their factories in China to share the increase, taking advantage of the need for these factories to keep manufacturing, rather than risk a shift to other countries. This approach may be equitable to all, but the challenge is in the implementation, and whether the consumer is willing to pay a higher price.

Move the supply chain

Some large manufacturers report that tariffs present a significant challenge to global sourcing. Many companies, including those in the automotive industry, have

established their global supply chains over the course of many years. Establishing new supply chains that are not affected by the tariffs may be laborious, depending on the types and pricing of their components. Several manufacturers are considering moving goods from China through Europe, Canada and other locations where logistics might be more difficult, but tariffs are lower.

On the other hand, not all companies are losers in this scenario: Several have been shifting production back to the United States over the past 10 years, and are well-positioned to respond to the tariff uncertainty. As consumers focus on value in addition to quality, the ability to compete on price with "Made in USA" products is attracting new customers.

Feel the squeeze

One chemical manufacturer is reliant on importing products from China where its supplier has control over certain materials. The company is left with no choice but to bear the brunt of the increased costs resulting from the tariffs. This manufacturer is not alone. Some companies can only source finished products, raw materials or components from China, in part because the production quality in other countries is not as high. As a result, some U.S. companies are experiencing rising costs from their global suppliers, and managing these changes is a top priority. The best approach is to focus on further reducing costs in the manufacturing and sourcing process.

Wait and see

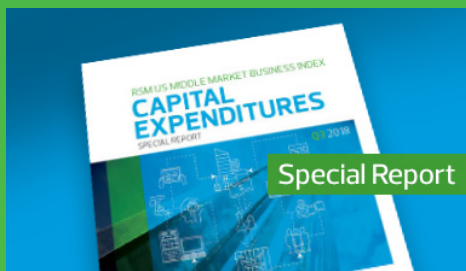
One middle market manufacturer decided to absorb the costs for now and may reassess this approach if there are no changes to the tariffs in the coming months. This approach is easy, but has the highest risk of negative financial impact. With no path toward resolution currently in sight, the China tariffs will likely impact middle market businesses for the foreseeable future.

Developing a strategy

In light of the recent tariffs and uncertainty of U.S. trade policy, companies must be proactive in managing their businesses. Determining how to address the challenges posed by the tariffs will depend on the unique set of circumstances surrounding each company's supply chain. A holistic approach to dealing with the current situation is needed—one that balances price, quality and the financial success of their business. Such a comprehensive strategy requires a systematic approach to help companies minimize the impact of tariffs, including:

- Determine which products or components are affected by the tariffs and what the financial impact will be
- Determine if products/components could be modified so they don't fall on the tariffs list
- Review the company's operations to reduce costs in the entire supply chain
- Review customer agreements for contractual dates, and terms for price increases related to tariffs
- Negotiate pricing, possibly in phases, for price increases
- Evaluate alternative sourcing options to reduce the cost of goods purchased
- Determine if the company could claim an exclusion or exemption from the tariffs
- Consider increasing sales prices based on market acceptability
- Evaluate transfer pricing studies to determine how they are affected by the tariffs
- Re-evaluate international corporate structure to ensure supply chain changes are as tax efficient as possible
- Consult with customs/duty experts to review product classifications and understand best practices

CAPEX AND THE MIDDLE MARKET: A MISSED OPPORTUNITY?



The proprietary RSM US Middle Market Business Index has shown that middle market leaders have been slow to increase capital expenditures throughout this business cycle. Find out what's behind this trend—and where surplus dollars should be deployed—in our latest special report.

Download a copy of the [report](#).

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

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