

# THE REAL ECONOMY

VOLUME 58



**COMPLETING  
THE RENOVATION  
OF DETROIT:  
TRANSFORMING THE  
AUTO INDUSTRY**

**MIDDLE MARKET BUSINESS SENTIMENT DECLINES**  
AMID SLOWING GLOBAL GROWTH

**INDUSTRY SPOTLIGHT:**  
RETRANSMISSION FEES GIVE LIFT TO TV BROADCAST  
REVENUE AS ADVERTISING DECLINES

**MIDDLE MARKET TREND WATCH:**  
THE IMPACT OF TARIFFS

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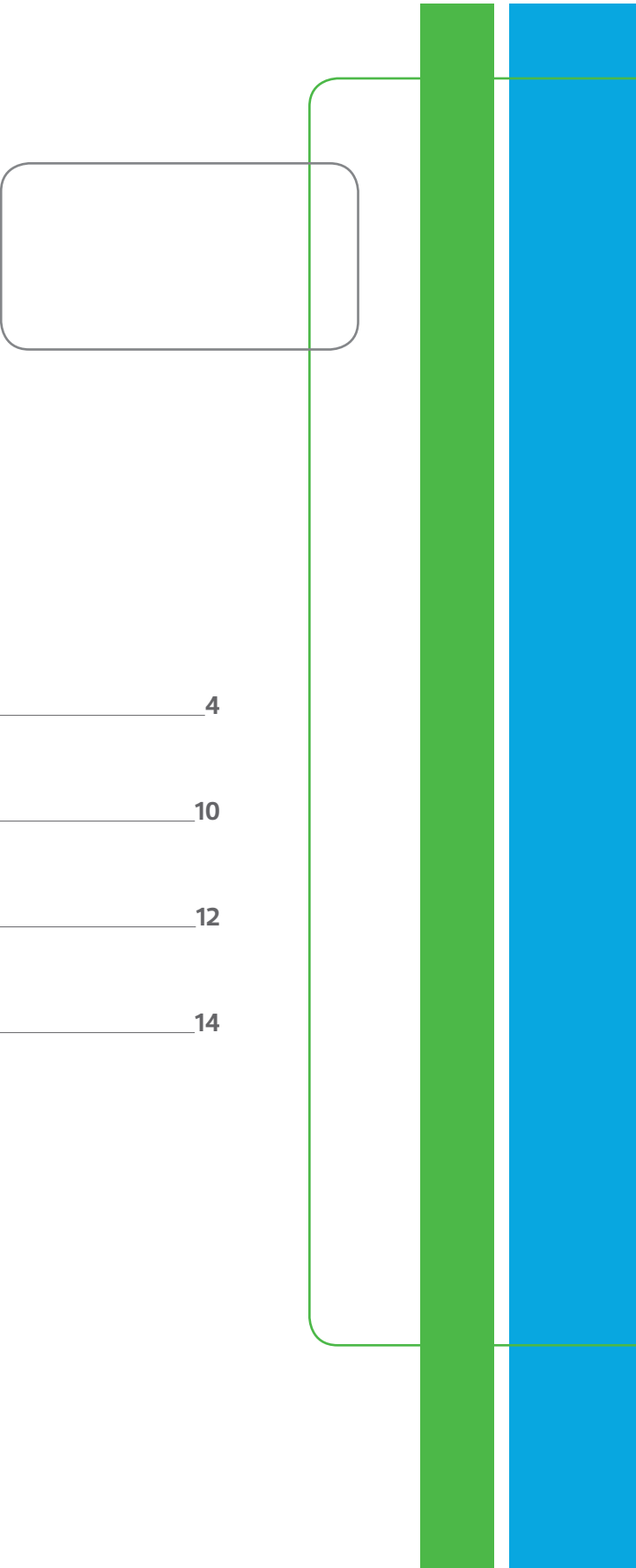
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A photograph of the Detroit skyline at night, with several skyscrapers illuminated against a dark blue sky. The city lights reflect on the water in the foreground. The image is used as a background for the top half of the page.

# COMPLETING THE RENOVATION OF DETROIT: TRANSFORMING THE AUTO INDUSTRY

JOSEPH BRUSUELAS

**TEN YEARS AGO**, the U.S. government sponsored an orderly bankruptcy of General Motors and Chrysler, and their lending arms during the most intense phase of global financial crisis. That bailout—fueled with roughly \$80 billion in taxpayer money—forced a sweeping restructuring of the domestic auto industry and set the automakers on a path to profitability that came more quickly than even the most ardent skeptics imagined.

But few could have predicted the challenges that the auto industry faces today. From electrification to autonomous driving and changing consumer tastes, the big three U.S. automakers are grappling with profound change.

It is clearly time that they move toward consolidation and reshape the industry. But that restructuring will, in turn, hit workers as their share of production declines. Worker dislocation will require a set of policies to cushion the effects of a transformation that will only intensify following the end of the current business cycle.

Most important, the North American and global supply chains built over the past quarter of a century are not likely to be abandoned, and will become even more global, despite the radical shift in U.S. trade policy over the past 18 months. Look no further than China, which has become the biggest producer and consumer of automobiles in the world; the United

States is now second. The composition of production will most likely continue to move toward a broader and deeper form of globalization.

That globalization will sometimes favor North American supply chains. Even as General Motors announced that it would close four plants in the United States and one in Canada in 2019, Volkswagen is investing \$800 million to make electric vehicles at its plant in Chattanooga, Tennessee. A joint venture between Toyota and Mazda will invest in an assembly plant in Huntsville, Alabama, according to a report from the Wharton School. Ford and VW are about to start a joint venture in producing self-driving autonomous vehicles for global production.

## MIDDLE MARKET INSIGHT

U.S. and global middle market firms with exposure to North American and global supply chains should begin preparing for a period of consolidation and dynamic change. The large international auto producers will begin to integrate sophisticated technology into autos amid reduced sales in the wealthy advanced economies.

## IN THE END, THE CHALLENGES OF A CHANGING INDUSTRY LEAVE AUTOMAKERS AND THEIR VAST NETWORK OF SUPPLIERS SCRAMBLING TO ADAPT IN A WAY FEW COULD HAVE IMAGINED EVEN A DECADE AGO.

All of this change is coming as automakers grapple with profound shifts in consumer taste, from the type of car to purchase to whether to opt for alternative forms of transportation. Take affordability. As new cars become ever more expensive, many consumers are opting to buy a used vehicle coming off a lease. Edmunds, the auto research firm, [reported](#) that the price gap between new and three-year-old used vehicles grew to 62%, or \$14,000, in 2018, up from 56% and \$11,000 in 2013. And when consumers do buy a new vehicle, they are increasingly favoring light trucks over traditional sedans (see chart), a trend that was pushed along by the 2015 oil price shock. Then there is the question, particularly among millennials and other younger buyers, of whether to own a car at all. For many in this generation who live in cities, it's cheaper and more convenient to ride-share or opt for public transportation. This trend will continue to reshape the parameters of ownership, consumption and auto production.

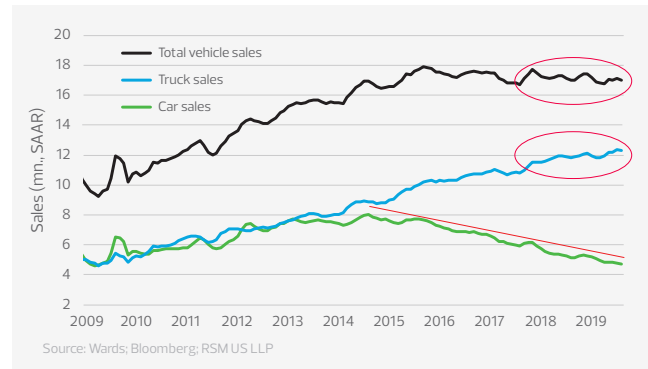
Another factor influencing individual car ownership is growing awareness of the social costs of individual, gas-powered transportation. Autos, after all, are a leading cause of polluted air in cities, worldwide climate change and the accompanying health issues.

Automakers are keenly aware of these changing tastes. "We believe the future is electric, and we also believe it is autonomous, connected and shared," said GM in its sustainability report in 2018. The company's stated vision calls for zero emissions and it has restructured around this goal.

Ford, meanwhile, announced the electrification of its most popular U.S. product, its 20 mpg F-150 pickup truck. The move seems to sum up the state of the industry—holding onto existing customers and trends, while trying to move forward. It's easy to be critical of the remaining automobile corporations as being too big to be innovative and too big to fail. But imagine trying to retool the Titanic in the middle of the North Atlantic.

In the end, the challenges of a changing industry leave automakers and their vast network of suppliers scrambling to adapt in a way few could have imagined even a decade ago.

**Trends in U.S. cars and truck sales in the postcrisis era**  
(ANNUALIZED CAR AND TRUCK SALES)

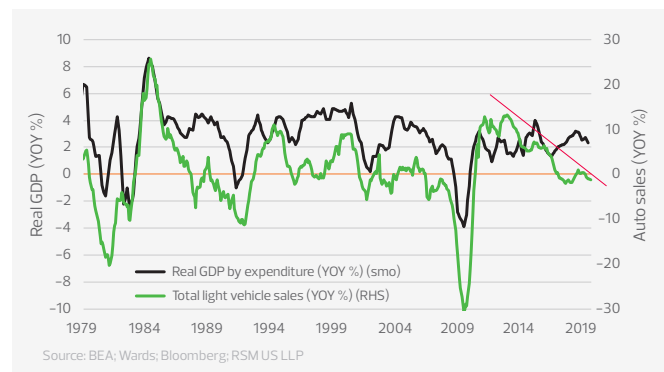


### Changes in automobile demand

Despite population growth, there has been a million-unit drop in U.S. light motor vehicle sales (cars and light trucks) from a rate that hit nearly 18 million per year in 2015 to 17 million in 2019. Given the prominence of autos in U.S. personal transportation, the growth of auto sales could be expected to move in sync with real gross domestic product growth. That seemed to be the case from 1979 to 2013 (see chart).

Since 2013, however, auto sales have decelerated from a 10% per year growth rate to negative growth, while GDP has been centered on a 2.3% rate of growth. There are undoubtedly multiple reasons for the decline in demand for motor vehicles, ranging from affordability—incomes have not kept up with price increases—to the higher-quality/longer-life of cars that no longer require frequent replacement.

**U.S. real GDP and total light vehicle sales growth**  
(YEAR-OVER-YEAR % CHANGES)



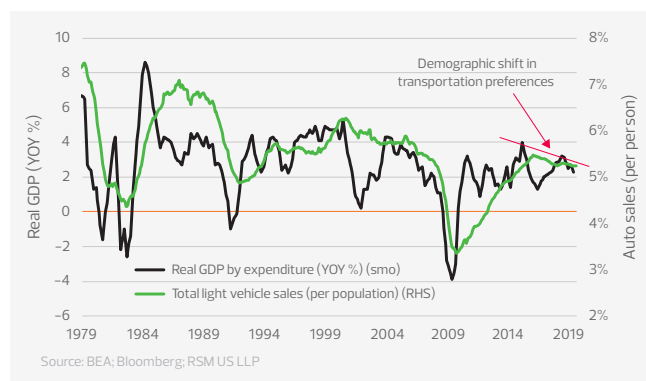
## COMPLETING THE RENOVATION OF DETROIT (CONT.)

While the current gap between GDP growth and automotive sales can be attributed, in part, to the Trump administration's late-cycle fiscal stimulus that pushed 2017–18 GDP growth higher, there were also unanticipated changes on the demand side. As the following chart shows, the ratio of auto sales to the population has declined steadily since 2013, which suggests the impact of longer-term demographic changes, and shifts in lifestyle preferences.

As the population ages and as baby boomers retire, there is less need for two-car families. The increase in retirees (and the decrease in interest income because of extremely low interest rates) suggests a decline in disposable income and the propensity to spend. Maybe one car per household is sufficient for the older set.

As to lifestyle preferences—and at the opposite end of the age spectrum—younger cohorts are moving to cities where cars are an expensive nuisance rather than a necessity. For these consumers, owning a car has quickly been replaced by ride-sharing, bicycling to work, and light rail or bus options. (Analysts also point to a 2017–18 resurgence in auto purchases by millennials, who found themselves having babies and moving to the suburbs.)

### U.S. real GDP growth and light vehicle sales per person



### Changes in automobile supply

The supply of motor vehicles at any one time is a function of past decisions by producers, and current decisions by consumers. The gap between supply and demand becomes overhanging inventory that drives down prices and profits. As the next chart suggests, when economic

growth decelerates and disposable income decreases, the inventory to sales ratio of automotive wholesale dealers increases.

The recent sharp increase in the wholesale inventory of vehicles relative to sales appears to both confirm the lack of demand because of the global economic slowdown, and speak to the difficulty of correctly anticipating changes in consumer buying patterns and taste.

Domestic automakers have moved out of the sedan business in response to the public's desire for sport utility vehicles and trucks. Sedans that remain in product lines are manufactured by foreign affiliates.

"Automakers' response to consumer preference has been to shift production away from industry-relevant vehicles," IBISWorld, a market research firm, reported in July. "In 2017, Fiat Chrysler Automobiles N.V. halted production of cars and sedans in the United States. In 2018, General Motors and Ford Motor Company both announced plans to further restructure operations."

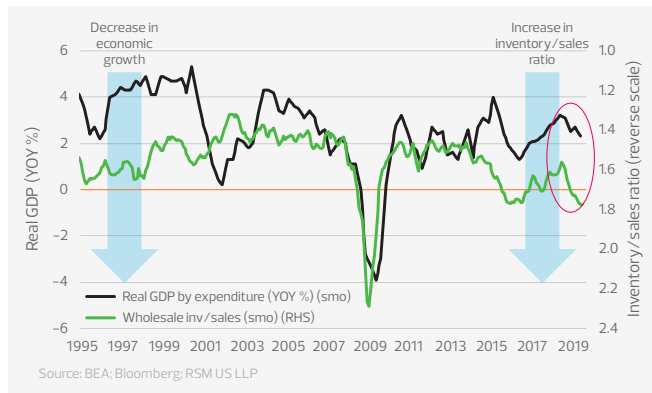
But retooling to accommodate current demand for light trucks might turn out to be late in the game. After all, the resurgence in demand for gas-guzzling trucks (what followed demand for muscle cars such as Dodge Chargers and Chevy Camaros) is due, in part, to the 2014–15 collapse of oil prices seen in the following chart. It wasn't that long ago that gas shortages upended consumer preferences. In the 1970s, demand for fuel-efficient cars led to the creation of domestic models like the Ford Pinto and Chevy Vega, and the eventual takeover of that segment of the industry by Japanese imports of Toyota and Datsun, now Nissan. Ultimately, voluntary import quotas led to the growth of domestic manufacturing by foreign-owned corporations.

Although the fossil-fuel industry now operates within a global market, and although the United States now produces more crude oil than the Saudis or the Russians, further attacks on Saudi Arabia's Aramco production facilities, the crippling of Venezuelan trade or further sanctions on Russia would, nevertheless, act to drive gasoline prices higher, with a deleterious effect on U.S. personal spending and rapid changes in transportation preferences.



## U.S. real GDP and wholesale automotive inventory/sales ratio

(INVENTORY / SALES RATIO OF MOTOR VEHICLE AND PARTS WHOLESALERS)

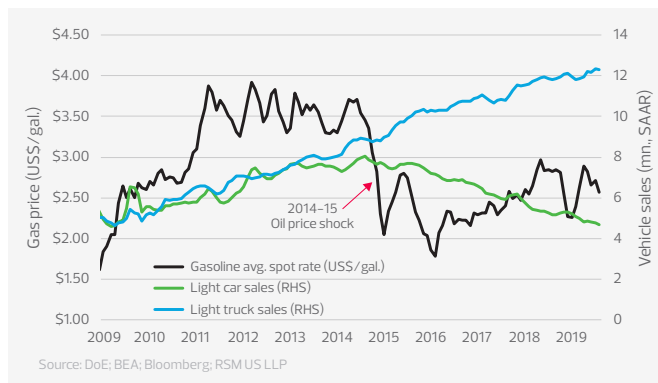


As illustrated in the next chart, automation took off in the late-1990s before peaking in 2016. Note that while there has been a decrease in robotic installations in motor-vehicle manufacturing since 2016, installations continue to grow in automotive parts manufacturing.

The 2018 increase in the number of automotive assembly employees suggests an industry that was preparing for restructuring. Rather than spending capital on the manufacture of end-of-cycle models, it might have been cheaper to throw expendable labor at meeting increased demand for current models (i.e., light trucks powered by fossil fuel).

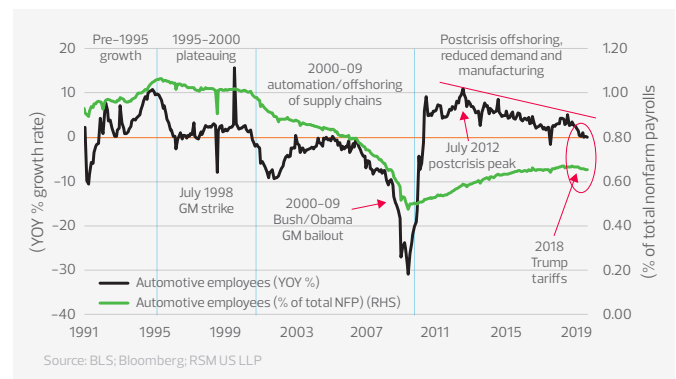
And if wages are determined by productivity of labor, and because robotic installation was greater in the parts sector than in motor vehicle production, one would expect greater wage gains in parts manufacturing than in vehicle assembly as seen in the next chart.

## Gasoline prices and light vehicle car and truck sales



## Automotive production employees

(YOY % RATE OF GROWTH AND AS A % OF TOTAL NONFARM PAYROLLS)



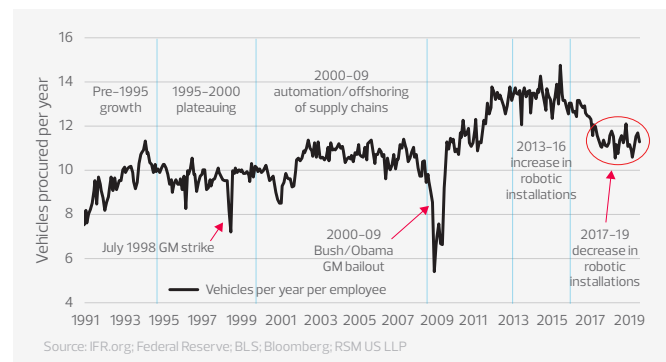
## Automation and labor substitution

Employment in the automotive sector has been declining with a few exceptions in the 2011-19 post-financial crisis era, falling from a 10% per year rate of growth in the number of 2012 employees to zero growth in 2019 (see next chart). As soon as the 2018 tariffs were announced, the number of automotive workers as a percent of total nonfarm payrolls began to decline, a further blow to labor in the U.S. manufacturing sector.

The International Federation of Robotics lists the automotive industry as the main customer of robotics, as the transition to electric vehicles spurs further automation. Automation would imply a reduction in the demand for labor and changes in required skills.

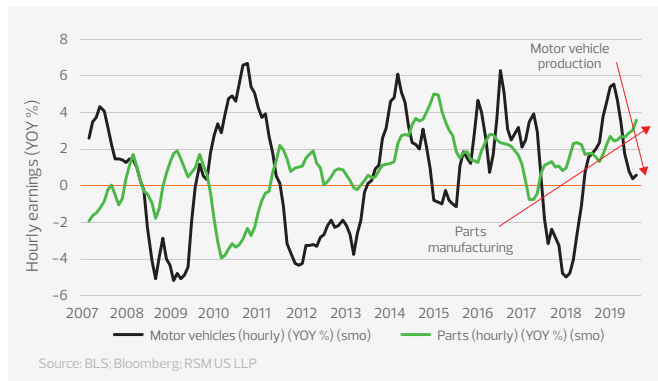
## Productivity of automotive employees

(NUMBER OF VEHICLES PRODUCED IN A YEAR PER EMPLOYEE)



## COMPLETING THE RENOVATION OF DETROIT (CONT.)

### Growth of automotive production hourly earnings (YOY % CHANGES IN MOTOR VEHICLE AND PARTS MANUFACTURING)



### How bad is it for the automotive sector?

The global manufacturing slowdown took hold in the United States in the third quarter of 2018. The auto industry has not been immune.

- GM's second-quarter revenue rebounded after a 9.2% drop in the first quarter. According to GM's [press release](#): "U.S. retail market share is estimated to be flat compared to a year ago, with trucks and crossovers offsetting lower passenger car sales." GM also said its China divisions sold 754,000 vehicles in the second quarter, about 100,000 fewer than the previous year's quarter.
- Ford [announced](#) a 22% decline in car sales, an 8.6% decline in SUV sales and a 7.5% increase in truck sales relative to the second quarter of 2018. Over the last two quarters, its total revenue dropped 7%, North American revenue fell 7.4% and Asia-Pacific revenue was down 50%.
- Nissan's revenue fell 23.9% in North America and 13.1% in Asia over the last two quarters. Nissan also said it would cut 12,500 jobs.
- Honda's total revenue increased in the last two quarters by 6.7%; however, revenue in Asia dropped 6.8% over the same period.
- Daimler AG's revenue has fallen 9.9% since the start of 2018.

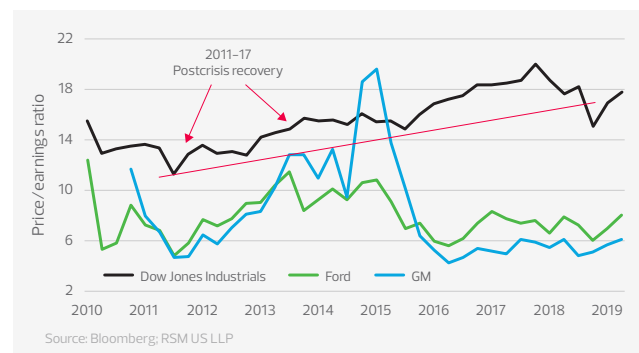
These results show that the U.S. automotive sector has undergone a slowdown in demand, with real economy indicators showing an overhang of inventory and diminished employment opportunities. This slowdown has forced automakers to make difficult decisions to restructure and retool motor vehicle production.

While signals in the real economy are mostly coincident with the business cycle, financial markets have the advantage of being forward-looking. The equity market's price-to-earnings ratio is considered a leading indicator of future growth, with the market pushing up the price of a stock relative to current earnings if investors anticipate higher future earnings.

As the next chart identifies, the price-to-earnings ratio of the Dow Jones Industrial Average rose steadily throughout the decadelong recovery from the financial crisis before peaking at the end of 2017. In contrast, the private equity ratios for Ford and GM began declining in 2014–15, with the market perhaps at best anticipating diminished demand at the end of the business cycle and the unrealistic goal of auto giants acting like startups.

Today, the price-to-earnings ratios of Ford and GM are barely half the Dow Jones average or the likes of Apple, which is a unique combination of manufacturer and software developer. Does the decline in the automotive sector's PE ratios suggest a lack of confidence in the profitability of traditional automotive production? And would a more nimble Ford and GM have been able to better compete within a world market and have prevented the decline of U.S. production to less than half of total U.S. automotive sales?

### Price/earnings ratio of U.S. automotive corporations and the Dow Jones Industrials





## Industrial policy

The United States does not have an industrial policy, but it does have the means to promote industrial activity. The federal government can create and enforce product standardization, protect the returns on intellectual capital, and promote safe production and safe consumption, all of which allow the market to decide what gets produced within a rational framework. Furthermore, the market allows for efficiencies in consumer choice based on rational expectations of product capabilities.

The U.S. judicial system has the mandate (if the government decides) to prevent monopolistic behavior, which otherwise creates an environment with reduced innovation and crimped consumer choice, and has also allowed foreign competitors to overwhelm the U.S. auto sector.

In the meantime, China's government is actively promoting the development and sale of electric vehicles. Is there some action the United States can take while staying within the bounds of capitalism, free enterprise and market-driven choice?

The government could pursue policies that:

1. Employ displaced automotive workers in infrastructure projects to repair roads and bridges, creating a safer environment for drivers.
2. Employ displaced automotive workers in infrastructure projects that offer alternate methods of transportation. Such a policy would reduce:
  - Traffic congestion
  - Wasted energy and dependence on fossil fuels
  - Pollution, while improving public health
  - Wasted time that could otherwise be used for personal activity or other productive endeavors
3. Provide educational opportunities for displaced automotive workers (and all other potential members of the labor force) needed for high-end manufacturing. Projects such as promoting private high-speed trains and electric charging stations come to mind. ■

## POTENTIAL EFFECTS IF TRUMP ADMINISTRATION TAXES EUROPEAN CARS

If the Trump administration were to slap a tariff on European cars, the impact on the world economy could be profound. Germany is already in a manufacturing recession, and further damage to the German auto sector could magnify the consequences of already slowing demand from China and the rest of the world. Such a tariff could mark the tipping point in the difference between slow growth and recession.

BMW, Mercedes and Volkswagen all have significant operating revenue coming from the United States:

- BMW receives roughly 17% of its revenue (\$19 billion) in the United States.
- Daimler AG gets roughly 25% of its revenue (\$48.6 billion) in the United States.
- Volkswagen receives 16.1% of its revenue (\$44.5 billion) in North America.

# MIDDLE MARKET BUSINESS SENTIMENT DECLINES AMID SLOWING GLOBAL GROWTH

Revenue and profits strong, despite underlying risks

BY JOSEPH BRUSUELAS

**MIDDLE MARKET BUSINESS** sentiment declined in the third quarter of 2019 to 129.4 from 132.3 in the prior period, according to the [RSM US Middle Market Business Index](#), as overall global economic growth slowed, the manufacturing sector continued to contract and tariffs began to affect business results. While current-quarter sentiment remains solid, forward-looking indicators in the survey's subindices denote some risk for middle market businesses in the months ahead.

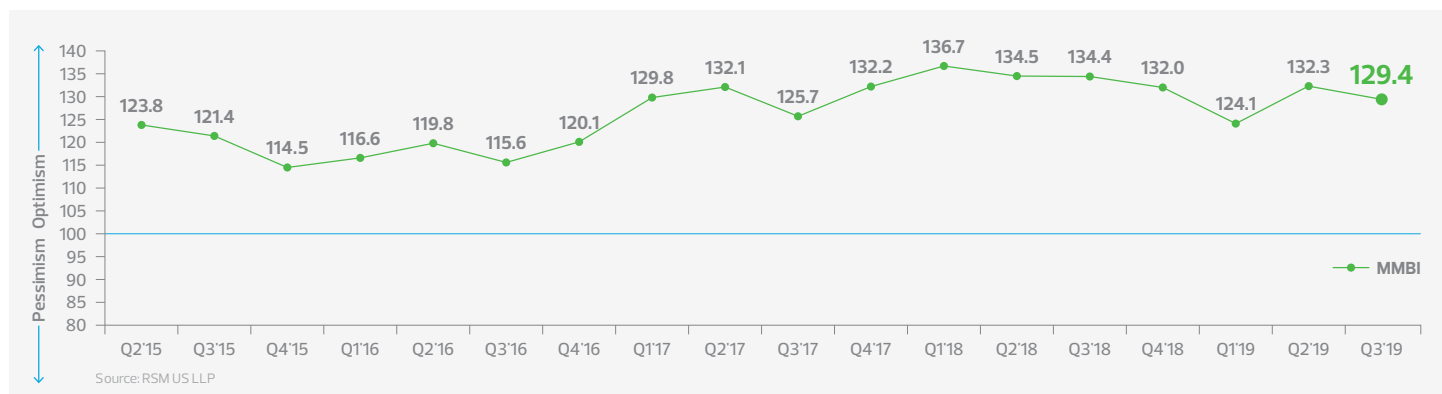
It is important to note that the third-quarter MMBI survey was conducted prior to the most-recent escalation of the trade war between the United States and China, the resulting impact on the global supply chain and the ensuing tightening of financial conditions reflected in declining stock prices, an inversion of the yield curve and

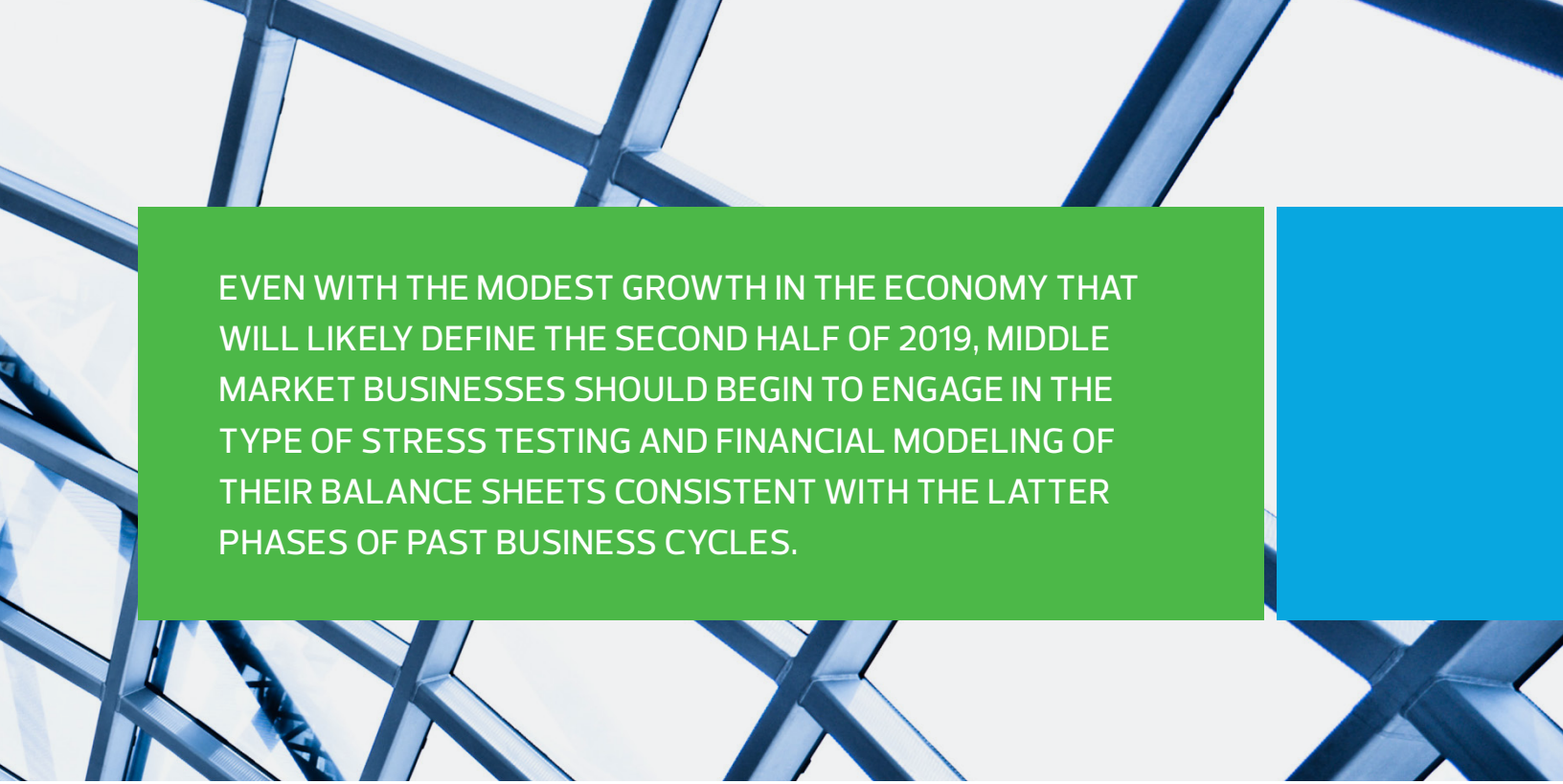
a widening of credit spreads in the bond market. These developments may cause further deterioration of middle market business sentiment in coming quarters.

The heightened level of concern around the economy's direction is most noticeable in the relatively low number of middle market executives who indicated they expect to boost capital outlays on fixed business investment—a telltale sign of the heightened “uncertainty tax” resulting from instability in the macroeconomic environment.

In the current quarter, 49% of executives polled say they expect to increase capital spending during the next six months, down from 51% a year ago. Meanwhile, 44% increased capital expenditures in the current quarter, edging up slightly from 41% a year ago and 39% in the most-recent period. Combined with the 42% of

**RSM US Middle Market Business Index (MMBI)**





EVEN WITH THE MODEST GROWTH IN THE ECONOMY THAT WILL LIKELY DEFINE THE SECOND HALF OF 2019, MIDDLE MARKET BUSINESSES SHOULD BEGIN TO ENGAGE IN THE TYPE OF STRESS TESTING AND FINANCIAL MODELING OF THEIR BALANCE SHEETS CONSISTENT WITH THE LATTER PHASES OF PAST BUSINESS CYCLES.

executives who noted an improvement in the economy in the current quarter and the 46% who expect continued improvement over the next six months, it is clear that the risk of deterioration in middle market business sentiment is elevated for the near-term.

Even with the modest growth in the economy that will likely define the second half of 2019, middle market businesses should begin to engage in the type of stress testing and financial modeling of their balance sheets consistent with the latter phases of past business cycles. Given the elevated risks in the global economy, which have spread to U.S. manufacturing and may shortly spill over into the U.S. services sector, the prudent path ahead involves planning for a premature end to the current business cycle.

### **A focus on business sentiment**

A decelerating economy and increasing trade tensions underscore the importance of monitoring business and consumer sentiment. The question remains whether recent events will lead to even further deterioration in sentiment, which in turn will damp overall economic activity. During potential economic inflection points, business sentiment takes on increased importance and can provide an early warning sign of greater slowdowns in capital expenditures, hiring and compensation.

While middle market business sentiment tracked in the MMBI does not imply near-term risk of a greater slowdown—remaining well above levels consistent with an economic downturn—the easing in MMBI subindices relative to the top line does denote some impending risk.

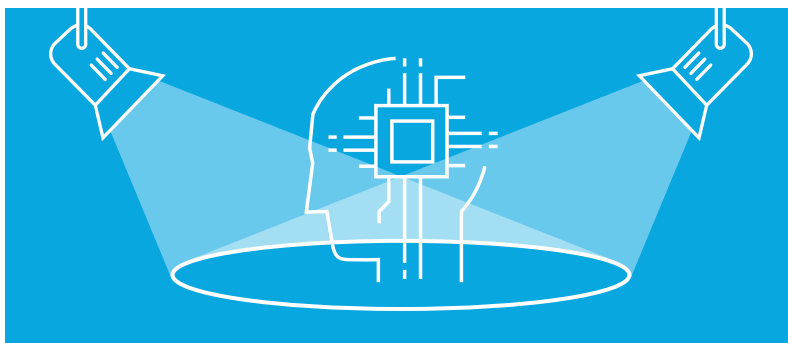
These forward-looking economic indicators reflect the broader slowdown in growth: Revenues, net earnings, hiring and planned capital outlays all weakened in the third quarter compared to a year ago; inventories, compensation and borrowing were stagnant.

### **Policy implications**

The MMBI third-quarter survey results are consistent with other business sentiment and CEO surveys, as well as our own RSM US Manufacturing Outlook Index, which reflects an ongoing downturn in the automotive and aerospace sectors. The manufacturing sector represents that part of the economy with the widest exposure to global disruptions caused by the trade war and volatility in the currency markets.

The global economy is slowing at a much faster pace than the U.S. economy, and it is now clear that worldwide manufacturing—which is interwoven with far-reaching supply chains—is in recession. Exposure to this sector will likely lead to a slower pace of growth in coming quarters, as well as a potential spread to the services sector, unless there is a significant change in trade policy. A key indicator of services sector performance, the ISM Nonmanufacturing Index, shows that services are now growing at their slowest pace in a decade.

Absent a larger policy error on trade, significant changes to interest rates or an exogenous shock to energy markets, our forecast stands that there will be no recession in 2019; however, we stress that the risks of an economic downturn over the next 12 months are now elevated. ■



## INDUSTRY SPOTLIGHT

# RETRANSMISSION FEES GIVE LIFT TO TV BROADCAST REVENUE AS ADVERTISING DECLINES

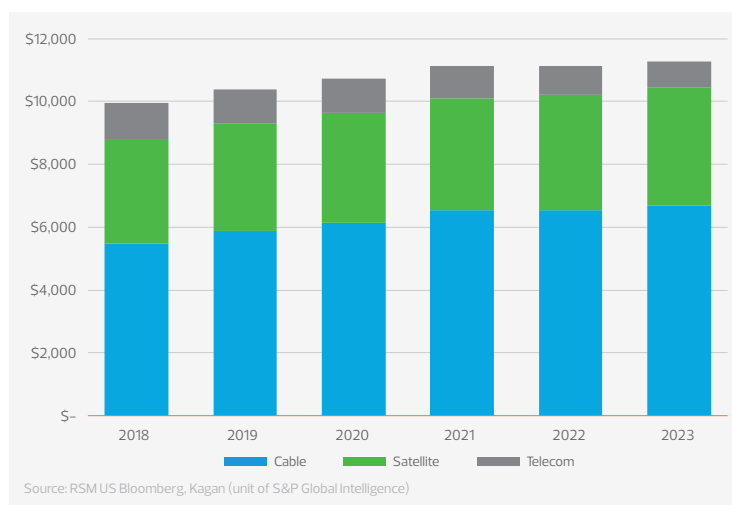
BY VICTOR KAO

**IT MAY COME AS** no surprise that advertising revenue for broadcast television has been declining for the past decade as on-demand streaming options such as Netflix and Amazon Prime have proliferated. According to second-quarter 2019 Nielsen data, traditional television viewing among 18- to 24-year-olds fell more than 50% from five years ago to a weekly average of 12 hours. Naturally, ad agencies have caught on to viewer trends and shifted their clients' dollars away from cable and broadcast TV to the internet, creating significant headwinds for broadcasters reliant on ad revenues.

With a very crowded presidential race, broadcast networks can expect a decent spike in campaign advertising dollars, as more viewers tune in to watch real-time debates, town hall events and the like. On-air campaign-related advertising is projected to top \$3 billion, according to Bloomberg, compared to \$2.6 billion during the 2016 presidential election. While a \$400 million increase may not seem significant, one might have expected a decline, given the fierce advertising competition from social media platforms, including Twitter and Facebook, which have been expanding their reach.

Although cyclical advertising revenue tied to the presidential race and major sporting events provides some lift for TV broadcasters, there is still a significant gap to make up for the decline in core advertising. Even amid their waning advertising revenue, TV broadcasters have outperformed the S&P 500 Index since the beginning of 2019 (see chart below). How is this possible?

Projected retransmission fees (in millions)

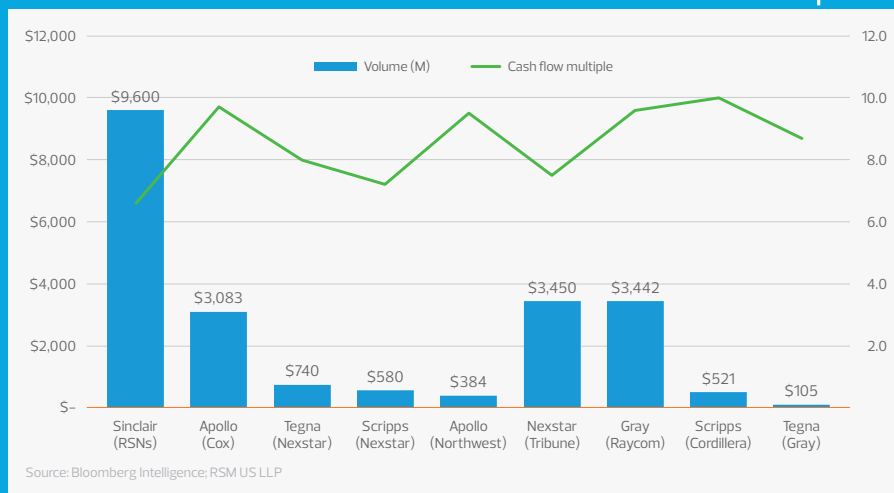


## Retransmission revenues: From zero to hero

The answer lies in so-called retransmission fees. Broadcasters are making up for their ad revenue shortfalls, in part, by placing more emphasis on the fees paid by cable, satellite and streaming platforms to retransmit local TV broadcast signals to their platforms. These fees, which are calculated based on viewership, have overtaken traditional TV advertising as a broadcast revenue source. In fact, just 10 years ago this revenue was virtually nil for most broadcasting companies. Today, retransmission fees are expected to top \$10 billion annually in the United States and to grow at a compounded rate of 15% each year (see chart below).

The popularity and acceptance of retransmission fees have sparked a slew of merger and acquisition activities in a race to become the most dominant player in the "retrans" market. Sinclair Broadcast Group's recent acquisition of Fox Regional Sports Networks for \$10.6 billion positions Sinclair as one of the largest local TV broadcasters by revenue. As other notable acquisitions (see chart below) consolidate the industry, it is likely the federal government will keep a closer eye on competition as monopolies or oligopolies start to form.

### Notable TV broadcast acquisitions in 2018 and 2019



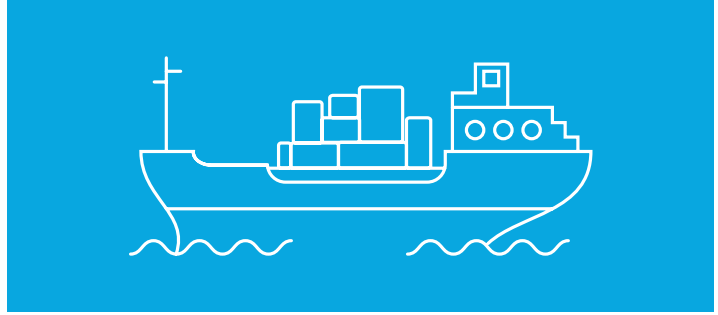
## Everyone wants a cut

However, while retrans revenue is steadily increasing, major networks such as NBC, ABC and CBS now want a cut, and are charging broadcast TV reverse retrans fees to stay within their networks. What was once a close relationship between broadcasters and the major networks has become more strained as networks are increasing their fees, cutting into broadcasters' newfound source of revenues. Networks have justified the fees to continue supplying prime-time content and amid large licensing fees paid to professional sport affiliations like the NFL. According to Bloomberg, reverse retrans fees are projected to rise 4% to \$3.3 billion in 2019.

Despite the revenue sharing, retrans fees will continue to give television broadcasters a much-needed lift to their revenues and share prices, at least in the immediate future. ■



# MIDDLE MARKET TREND WATCH



## THE IMPACT OF TARIFFS

**MANY MIDDLE MARKET** businesses are feeling the pinch of ongoing U.S. trade disputes. In this month's *The Real Economy*, we examine business sentiment data from our third-quarter [RSM US Middle Market Business Index](#) to understand what's on the minds of executives across industries related to ongoing trade tensions. Note the findings below.

**40%** of middle market executives said the imposition of tariffs on imported goods had a negative impact on their business.

**26%** of midsize companies said retaliatory tariffs placed on exports were damaging.

**44%** of executives polled said new tariffs posed one of the biggest risks to their business.

Tariffs and the lack of skilled labor were the top policy issues negatively affecting the middle market, with the majority of executives expecting them to remain critical concerns over the next **12** months.

### KEY TAKEAWAY

With increased risk due to the trade war, global economic slowdown and volatility in financial markets, middle market leaders should begin assessing their business processes, operations, systems and more. Look especially to stress test the following areas:

- Licenses and regulations
- Supply chain
- Banking and cash management
- Budgetary and costs
- Productivity and efficiency
- Macro risks
- Talent needs



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