

THE REAL ECONOMY

VOLUME 45



GLOBAL ECONOMIC
RISKS TO THE
MIDDLE MARKET

**AUTOMAKERS RESPOND TO TARIFF
UNCERTAINTIES** WITH HIGHER PRICES

PHARMACEUTICALS, **PRICING PRESSURE
AND PROFITABILITY**

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Our thought leaders are professionals with years of experience in their fields who strive to help you and your business succeed. Thought leaders who have contributed content to this issue include:



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GLOBAL ECONOMIC RISKS TO THE MIDDLE MARKET

By Joseph Brusuelas
Chief Economist, RSM US LLP



Developing markets face growing risks that present a clear and present danger to middle market firms embedded in those economies. Differentials in rate policy between the U.S. central bank and its foreign counterparts, an appreciating greenback, along with an atypical late business cycle fiscal boost, present the major driving forces in interest rate divergence between the United States and emerging economies.

At the very least, the procyclical policies pursued by the United States are going to force emerging market countries to undergo a self-induced bout of fiscal austerity or suffer through what is looking more like a classic emerging market financial and banking crisis. Those changes, along with unique political and policy dynamics, have created the conditions for a slowing global economy with risk of wider contagion, should problems in a select number of economies intensify. While the major risk to the global economic outlook continues to be a [global trade spat](#) linked to trade policy in the United States, developments in emerging markets over the past several weeks have reached the point where risks to the global and U.S. economic outlook demand consideration.

In our estimation, the developing economies most at risk include Indonesia, India, Iran, South Africa, Russia, Mexico, Argentina, Brazil, Turkey and Venezuela. Policy and political turmoil in the United Kingdom (U.K.) and Italy represents the most significant risk to the global economy among the developed economies over the next 12 months.

The most significant risks to the global economy over the next year, outside the ongoing global trade spat,

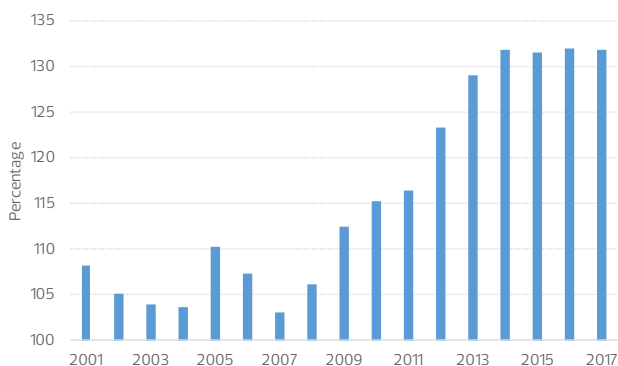


reside in Italy, the United Kingdom, Turkey and Venezuela. The potential contagion from rising debt, volatile policy and political dynamics in those economies, if it spreads, will work primarily through financial and trade channels.

Italy's growing tail risk

Growing debt and unstable political dynamics inside the world's third-largest bond market represent the largest risks to the global economic outlook over the next 12 to 18 months. Italy characterizes what financial experts refer to as "tail risk," or a risk greater than three standard deviations, associated with the right side of a probability distribution. The fatter the tail, the greater the risk. Concern is growing that the coalition government will leverage the country's economic woes to break out of what it considers the European Union (EU) fiscal straightjacket—EU member states cannot run a deficit greater than 3 percent of gross domestic product (GDP)—and potentially exit the monetary bloc, drop the euro and re-impose the Italian lira. Debt dynamics inside Italy imply elevated risk to global financial markets.

Italian debt-to-GDP ratio

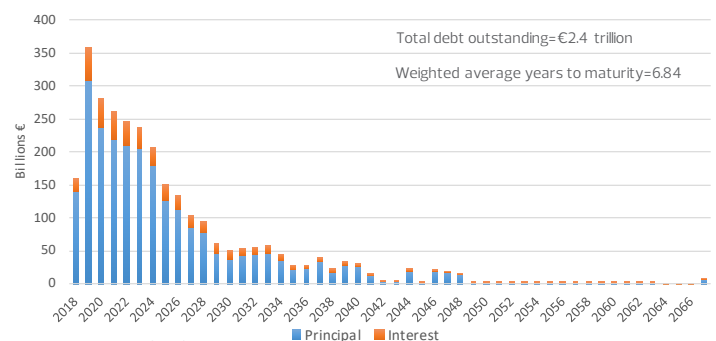


Source: RSM US LLP, Bloomberg

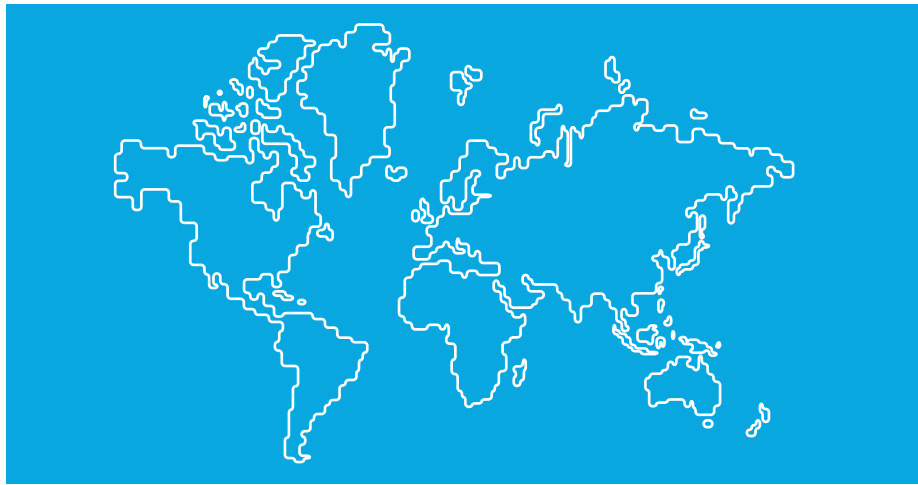
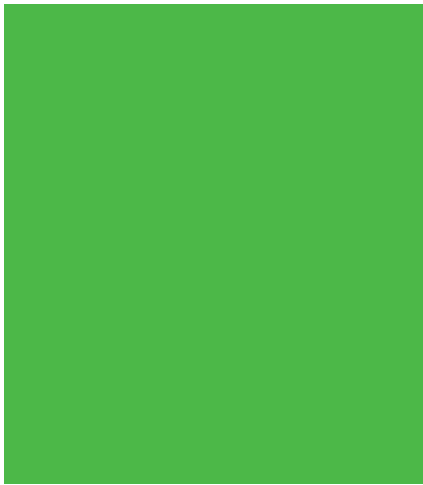
At best, any attempt by the government to hit the fiscal accelerator would suggest the global economy might revisit the 2009–2012 European Sovereign Debt Crisis. Italy has a total debt market of €2.4 trillion (\$2.7 trillion US), an average weighted years to maturity of 6.84 years, and it needs to roll over €308 billion in debt in 2019. At worst, the exit by Italy from the Euro bloc would create significant systemic risk similar to the collapse of the U.S. housing and financial markets from 2005 to 2010.

The rise of the populist governing coalition, which intends to break out of EU fiscal constraints, will, in early September, likely put Italy's economy on track toward unsustainable levels of debt the country will find difficult to finance. With a current debt-to-GDP ratio of 131.81 percent, should the ruling coalition follow through on plans to boost fiscal spending, that ratio would rise above 180 percent of GDP over the next decade. While Italy's fiscal issues are long-term in nature, dating back many decades, it would not take much to tip the economy into crisis.

Italian debt distribution



Source: RSM US LLP, Bloomberg



Bloomberg Chief European Economist David Powell has conducted research that indicates the average cost of debt is roughly 3.1 percent. Using the yield on the Italian seven-year bond as a proxy for the cost of debt, that instrument is currently yielding 2.763 percent, up 145 basis points from the beginning of 2018. Thus, the economy is only 40 basis points from creating conditions whereby global investors would begin demanding greater risk premia on Italian debt. As Powell noted, if the debt trajectory were to move beyond 3.1 percent, it would hit terrain considered unsustainable by the EU and the International Monetary Fund. Moreover, in 2019, Italy will have

Italian 7-year yield



Source: RSM US LLP, Bloomberg

to rollover €308 billion in debt. Given the emerging fiscal and debt dynamics, the policy plans put forward by the governing coalition carry implications for global financial markets starting in September 2018 and throughout 2019.

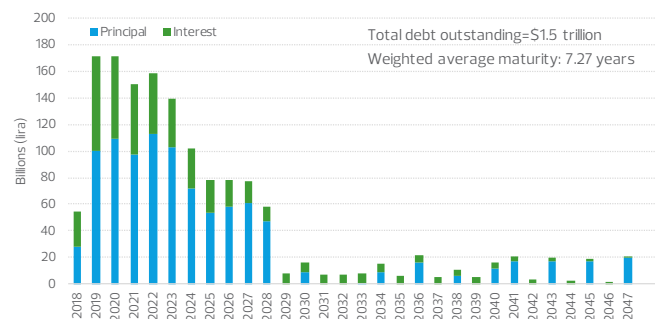
MIDDLE MARKET INSIGHT:

Developing markets face growing risks that present a clear and present danger to middle market firms embedded in those economies. Differentials in rate policy between the U.S. central bank and its foreign counterparts, an appreciating greenback, along with an atypical late business cycle fiscal boost, present the major driving forces in interest rate divergence between the United States and emerging economies.

Turmoil in Turkey

In many ways, Turkey serves as a bellwether for other emerging market economies that benefited from the zero interest-rate policy of the past decade in the United States, EU and Japan. Over that period, emerging market foreign denominated debt soared to over \$11 trillion today from roughly \$3 trillion in 2009. As policy and interest rates increase in the developed economies, financial, banking and currency crises will unfold in select developing economies. The most obvious of those is in Turkey.

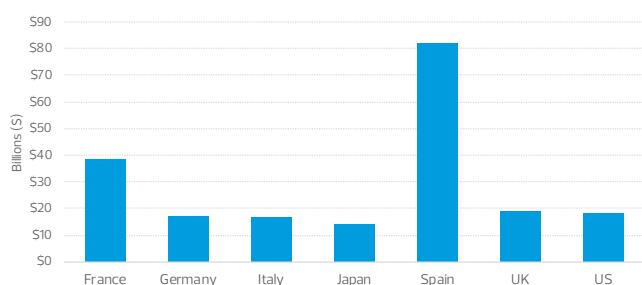
Turkish debt distribution



Source: RSM US LLP, Bloomberg

With policy normalization moving quite briskly in the United States and the EU signaling it will likely begin to lift interest rates in 2019, many emerging markets are coming under pressure as investors begin to move back into their preferred habitat of risk-free government securities in developed economies. We expect the Federal Reserve to hike its overnight lending rate in September and December by 25 basis points at each meeting, putting the Turkish lira under further pressure. That will result in a deterioration of the government's ability to meet basic social needs and roll over a prodigious quantity of debt in the pipeline over the next few years. The risk of capital flight is elevated and we would not be surprised if the Turkish government imposes capital controls and further limits on banking activity. On a year-ago basis through August, nonresident ownership of Turkish assets has declined by \$41 billion to \$51 billion from \$92

Exposure to Turkish debt via financial sector



Source: RSM US LLP, Bank of International Settlements

billion, a sign that global investors are growing quite skittish over the lack of macroeconomic discipline and populist economic policies pursued by the government of Turkish President Tayyip Erdogan.

The most recent bout of financial turbulence is linked to a dispute between Ankara and Washington, D.C., over the status of a U.S. citizen held in Turkey, resulting in the imposition of tariffs by the United States. But Turkey's economic pressures predate its current trade spat with the United States. Long-term populist economic policies implemented by the Erdogan government have resulted in an inflation rate of 15 percent, which this year triggered a 59 percent devaluation of the Turkish lira and increased investors' concerns about the level of foreign-denominated debt. Turkey runs a current account deficit equal to 6.27 percent of GDP and has net foreign liabilities equal to 53.4 percent of GDP without adequate currency reserves to cover import needs should there be another run on the Turkish lira.

Investors are beginning to price in such action and perhaps a potential default on international debentures by the government. Global nonfinancial corporations own \$330 billion in Turkish debt, the major source of capital flight as private actors look to de-risk their portfolios amid a classic emerging market crisis. Five-year credit default swaps—which provide a useful indication of what it costs to insure against default—have soared to new highs typically only experienced by serial defaulters such as Greece or Argentina. Five-year

credit default swaps have increased by 325 basis points, and are up 210 percent since the outset of 2018. With respect to Turkish debt, Spain is holding \$82.3 billion, France \$38.4 billion, Germany \$17.1 billion, Italy \$16.9 billion, the U.K. \$19.2 billion and the United States \$18 billion.

A look at the debt distribution of Turkey indicates significant rollover risk over the next five years. Ankara holds a debt portfolio of 1.5 trillion lira, with a weighted average maturity of 7.27 years. Given the precarious macroeconomic condition of the economy and depreciating currency, the government will likely face a difficult time rolling over roughly 800 billion lira in debt over the next five years, which is why investors are turning to credit default swaps to hedge against any potential default by the country.

Since Turkey is an emerging market bellwether, there is elevated concern about global contagion risk, should investors begin to pull capital from developing markets. While that risk appears manageable for now, should the Fed continue on its rate hike campaign well into 2019 or the global trade spat intensify further in the near-term, capital will flow from emerging markets to developed economies. Economies such as Argentina, Brazil, India, Mexico and South Africa are those at risk should the contagion spread beyond Turkey.

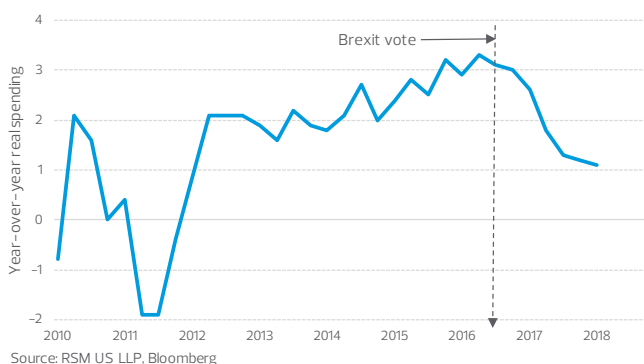
The major economies with exposure to any potential contagion via the trade and financial channels reside in the EU. Exposure in the euro area is approximately 9.1 percent of GDP via the trade channel. Australia trails at 8.9 percent with the U.K. at 3.9 percent and the United States at 3.6 percent. All of those economies have middle market firms with exposure to the aforementioned markets.

Should there be a broader global contagion spreading from Turkey, the most difficult challenge will be containing it via the financial channel. Economies with outsized total claims to emerging markets as a percentage of bank assets are primarily the U.K., EU and the United States. The U.K. has 10.3 percent of its total bank assets linked to emerging markets, the EU 6.9 percent and the United States 5.3 percent.

A hard Brexit?

In many respects the risks to the global outlook linked to Brexit have been somewhat masked by the global trade spat and potential emerging market crisis currently brewing. The U.K.'s exit from the EU is a slow motion train wreck destined to crash this fall ahead of a drop-dead deadline of March 29, 2019, at 11 p.m. GMT. To be clear, this is a purely domestically driven policy choice. The British government still has within its power the ability to reach a reasonable compromise with the EU and avoid a hard landing. However, time is running out.

UK inflation adjusted household consumption



In our estimation, as the timeline shortens, global financial markets will begin to draw their own conclusions on the probability of a "hard Brexit" despite the protestations from Theresa May's Conservative Party government. Forward-looking investors or firms with exposure to the British market should anticipate a bout of market turbulence involving currency volatility and an inability to get critical goods used at earlier stages of production and intermediate goods beginning in the final three months of this year and into early 2019. Some 10.3 percent of British banks have assets linked to total claims on emerging markets; that, along with the growing probability of a hard landing, may

cause investors to act sooner rather than later, forcing the hand of the May government.

It is becoming increasingly clear that the U.K. may just put up border restrictions around the entry points to the economy and abrogate its responsibilities under its five-decade membership in the EU. Recent announcements that the government and key private sector actors are stockpiling vital medical and food supplies in the case of a hard Brexit has not bolstered confidence among global investors. They have observed a 13.65 percent depreciation in the British pound since June 2016. Despite signals from the Bank of England that it will consider pushing up its policy rate (a genuine policy error in our estimation given a sluggish British economy), it is almost inconceivable that there will not be further depreciation of the pound and modest inflation shock to the economy in the case of a hard Brexit.

Venezuelan exodus

The long-simmering economic disaster wrought by the populist policies of Venezuelan President Hugo Chavez and his successor Nicolas Maduro have boiled over during the past year, causing the economy to collapse. Hyperinflation of 83,000 percent, the crash of the Venezuelan bolivar, and the exodus of roughly 2.3 million people, or some 7 percent of the population, provide the context for significant human tragedy unfolding in real time across the cone of South America. Venezuela has seen its economy contract by 50 percent over the past five years and has defaulted on \$4 billion of global debentures.

During the past 30 days, the Maduro regime has imposed a 3,000 percent increase in the minimum wage, engineered a redenomination of the currency that lopped off five zeros, bringing it in line with black market values. Venezuela will soon face the reality of having to "dollarize" the economy, imposing the U.S. dollar as the primary means of exchange to stave off collapse. The current currency regime is based on a new cryptocurrency tied to oil revenues, which are collapsing.

To put the failure of stabilization policies in perspective, a single packet of rice now costs 2.5 million bolivars (the old currency unit), beyond the reach for most Venezuelans. The lack of available food has caused the average Venezuelan citizen to shed 24 pounds on average in 2017.

Despite sitting on the largest accessible deposits of oil in the global economy, Venezuela's economy remains fragile. The government's economic actions over the past month are tantamount to rearranging deck chairs on a sinking Titanic. It is only a matter of if, rather than when, the economy stops functioning and descends into chaos. In the near-term, the International Monetary Fund has estimated that inflation will likely surge to 1 million percent by the end of 2018. It is just a matter of time before imports collapse and the government defaults on the remainder of its global debenture obligations.

Under normal conditions, Venezuela would be able to trade oil for aid or put up its resource-rich oil fields as collateral for a sponsored bailout from the International Monetary Fund or the United States. Given both the new currency regime and the lack of investment in vital infrastructure, that is unlikely. Moreover, during the past month, a U.S. judge gave a Canadian mining company permission to seize the assets of Citgo Petroleum's parent firm, the Venezuelan state owned oil company that provides the majority of government revenues, making any financial rescue nearly impossible.

The impact of Venezuela's economic collapse on South America is best illustrated by its massive refugee crisis. The nation of Colombia, situated on Venezuela's southwest border, has absorbed roughly 22 percent, or 500,000, of the 2.3 million individuals that have left the country in search of economic stability. It is most at risk economically due to the massive southern migration.

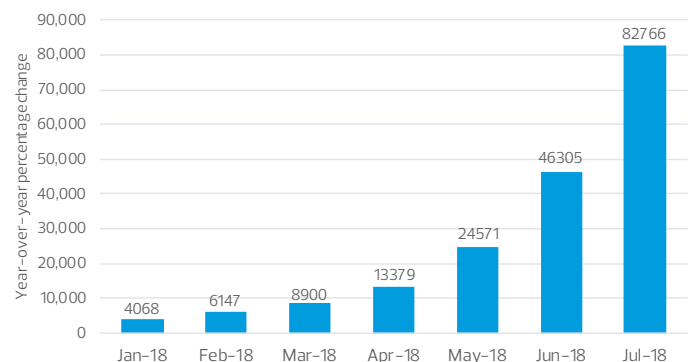
While Colombia's economy grew at an impressive 2.5 percent in the first half of 2018, it is just beginning to recover from a sluggish growth rate in 2017 of 1.7 percent that capped four years of subpar growth.

Colombia suffered significantly from the global crash in commodity prices between 2014–2016. The end of Venezuela's Maduro regime, whenever that is, will result in significant economic collateral damage, much of which will fall on the not-so-sturdy shoulders of the Colombian economy. China is the largest holder of Venezuelan debt, with an outstanding portfolio of \$23 billion.

Ecuador, Peru, Bolivia, Chile, Argentina, Uruguay and Brazil are also absorbing high volumes of Venezuelan immigrants in search of food, medicine and shelter. Venezuelan citizens are currently the largest number of asylum seekers in the United States.

VENEZUELA HAS SEEN ITS ECONOMY CONTRACT BY 50 PERCENT OVER THE PAST FIVE YEARS AND HAS DEFAULTED ON \$4 BILLION OF GLOBAL DEBENTURES.

Venezuelan inflation



Source: El Banco Central de Venezuela Venezuela

AUTOMAKERS RESPOND TO TARIFF UNCERTAINTIES WITH HIGHER PRICES

By Rick Lich, Senior Manager, RSM US LLP



There has been a great deal of disagreement in the news lately regarding the imposition of [tariffs](#).

As of March 2018, the United States began collecting tariffs on 25 percent of the steel and 10 percent of the aluminum imported into the country. The administration believes these tariffs do not add significantly to the price of a vehicle manufactured and sold in the United States.

Toyota North America, however, is one automaker that begs to differ. Toyota stated that nearly all of its vehicles are sourced with some imported parts.¹ The automaker's popular Camry model, it points out, is assembled in Kentucky

but contains approximately 30 percent non-U.S.-made parts. Toyota believes the Camry would incur a cost increase of about \$1,800 due to the tariffs, which they would pass on to customers. On the flipside, retaliatory tariffs on U.S.-exported goods may have a significant impact on the exporting strategies of U.S. automakers.

TOYOTA BELIEVES THE CAMRY WOULD INCUR A COST INCREASE OF ABOUT \$1,800 DUE TO THE TARIFFS, WHICH THEY WOULD PASS ON TO CUSTOMERS.

Consequences of trade disputes

The tariff rhetoric has been escalating for months, with the most volatile reactions between the United States and China. President Trump and others believe China has been

manipulating global markets through unfair trade practices for some time. The impact of the administration's steel and aluminum tariffs on China will remain low, however, since only 1.5 percent of all steel exports and 15.5 percent of all aluminum exports from China were bound for the United States in 2017.² However, China does represent the largest automotive market in the world,³ and a retaliatory tariff on U.S. auto exports into China will certainly be felt by U.S. automakers. Whatever tax benefits gained by automakers under the 2017 Tax Cuts and Jobs Act could be eliminated by the tariffs.

The tariff tension between the United States and Europe has eased after the July 25 meeting between President Trump and Jean-Claude Juncker, the president of the European Commission, where they agreed to hold off on further tariffs while they talk through their differences. If imposed, a tariff increase of up to 25 percent (up from 2.5 percent), as threatened by Trump, would hit Volkswagen's premium brands Audi and Porsche, as well as the BMW, Mercedes and Mini brands, which together accounted for 1.3 million vehicles sold in the United States in 2017, of which 49 percent were imported from the European Union. A tariff hike would likely wipe out their U.S. profits.⁴

Tariff tit-for-tat between countries adds a layer of complexity to supply chain planning and cost management. Automakers will need to negotiate pricing with suppliers

and rethink where a vehicle is manufactured to contain those costs, if those conversations are not happening already. Consider German automakers, such as BMW and Volkswagen, who manufacture in the United States but export over 50 percent of those vehicles.⁵ Those vehicles could be manufactured elsewhere, but at the cost of U.S. jobs.

However, it could take years to shift production out of the United States. As a result of the uncertainties surrounding tariffs, some automakers have announced price increases. This is just one of the many strategies automakers will deploy to keep the potential impact of tariffs at bay.

TARIFF TIT-FOR-TAT BETWEEN COUNTRIES ADDS A LAYER OF COMPLEXITY TO SUPPLY CHAIN PLANNING AND COST MANAGEMENT.

SOURCES

¹A. Athanasiou, "Automakers, Canada Strike Back at Trump's Tariffs" (July 9, 2018) Tax Notes International.

²"US Tariffs On Steel And Aluminium: Winners And Losers So Far" (July 31, 2018) Fitch Solutions.

³"Largest automobile markets worldwide between January and December 2017, based on new car registrations (in 1,000s)" Statista.

⁴M. Dean, G. Davis, "Global Tariffs, Forex Exposure" (July 25, 2018) Bloomberg Intelligence.

⁵Ibid.



PHARMACEUTICALS, PRICING PRESSURE AND PROFITABILITY

A Q&A with John Lanza, RSM life sciences industry practice leader

In response to rising costs and reform demands, federal and state legislatures are requiring pharmaceutical (pharma) businesses to provide more cost transparency related to their products through new regulatory compliance demands. The Trump administration, along with several states, including Oregon, California, Nevada, Maryland, New York, Massachusetts and Vermont, have introduced legislation controlling a variety of cost areas, from limits on price increases and restrictions on Medicaid drug spending to requirements on the disclosure of company metrics and expenses. Pharmaceutical companies, including those in the middle market, are challenged with meeting these new compliance demands while focusing on research and development, patient needs and ultimately, the bottom line. Many businesses understand the need for a rigorous pricing oversight; however, increased scrutiny and regulations will make meeting revenue goals more difficult.

Fifteen drug companies have reduced list prices, rolled back planned price increases or committed to price freezes. Likewise, big companies like Pfizer Inc. and Merck & Co., have already pledged to roll back prices on some drugs, although speculation abounds over the companies' commitment to these actions. Nevertheless, change is quickly happening.

How can middle market pharma businesses meet these growing demands for pricing reform while remaining competitive in the marketplace? John Lanza, life sciences industry practice leader at RSM US LLP, offers some further insights into this topic.

Q: How did we get here?

Lanza: It is the era of consumerism in practically every corner of our economy. Consumers expect accessibility, quality, affordability and convenience on their purchased goods and services, from clothes to car repair. And, in health care, they have the same expectation. Consumers require quality and transparent services at cost-competitive prices. This buying preference trend is now aligning with the prescription drug industry. Legislators are hearing the demands of their constituents and want changes on their behalf.

The pharma industry is changing, too. Hearing the needs of their consumers, some pharma businesses have subscribed to more of a value-based pricing strategy—pricing drugs on the perceived value to the consumer as opposed to historical pricing. There is still much to do around this for pharma companies; however, with a variety of areas to weigh, including assessing reimbursements, contracts, raw materials, marketplace analysis, margins and growth goals, just to name a few.

Q: What can middle market pharma businesses do to address pricing reform demands?

Lanza: Pricing reform is a reality and middle market businesses should anticipate the impact on their overall operations. This includes assessing current production efforts and gaining efficiencies where gaps are identified, analyzing reimbursement structures with federal and state governments and insurance companies, reviewing raw materials and production contracts, shoring up supply chains and evaluating margins. Finding improvements and efficiencies save costs, which can translate to more competitively priced pharma products. Middle market pharma companies must be even more diligent around cost savings and regulatory compliance, often more so than their larger competitors, due to their frequently strapped resources and tighter margins.



Q: How can technology solutions help pharma businesses manage pricing efforts?

Lanza: Technology can be a big game changer for middle market pharma companies in terms of addressing pricing challenges. For instance, some companies are deploying nanotechnology to shrink drug dosages and increase potency duration. The technology involves identifying and controlling individual molecules and atoms to enhance their properties for a variety of advantages, such as higher strength, lighter weight, greater chemical reactivity and more. So rather than recommending the consumer take two pills every four hours, nanotechnology reduces the dosage to one small pill to be taken every eight hours. This can eventually save on material costs, production and packaging, which translates to reduced pricing, as well as heightened convenience for the consumer.

Another developing technology strategy for pharma companies involves marrying a business' enterprise resource planning (ERP) system with a third-party revenue forecasting solution. Specifically, this strategy looks at a pharma's gross-to-net data collected via ERP. Revenue analysis is completed by the third party by evaluating returns and allowances, discounts, fees, chargebacks and distributor costs. Anomalies are flagged, and this intelligence helps the company make better decisions around contracts, cash flow and supply timing. This effort can mean reducing a 5 percent gross-to-net ratio to 2 percent, which means improved margins and cost savings, allowing competitive pricing adjustments on products.



Q: What's ahead in 2019?

Lanza: Consumerism will continue. Those pharma companies committed to understanding the needs of the marketplace, and being innovative with their products, will excel. Consider the huge effort in health care around wearable technology. As an example, in the treatment of diabetes, wrist monitors and patches can evaluate glucose levels throughout the day, triggering the patient when insulin is needed. This gives consumers the ease and discreteness of monitoring their health, and automates their medication at the precise time it is needed. Middle market pharma companies working in tandem with these advances will optimally serve their consumers and realize business gains as well.

Meanwhile, drug-pricing pressures will continue and regulatory changes will persist as well. For example, regulations were recently repealed so that now Medicare Advantage plans can require patients, in some instances, to try certain cheaper drugs. If the less expensive drug doesn't work, then, and only then, will the plan reimburse patients for the more expensive option. This change could mean certain pharma companies that produce the less expensive drugs, some being middle market companies, could be providing the new "first round" medicine for patients. This could affect production demands, supply chains and more.

For more pharmaceutical and life sciences business insights, [subscribe to our monthly newsletter](#).

**CONSUMERISM WILL
CONTINUE. THOSE PHARMA
COMPANIES COMMITTED
TO UNDERSTANDING
THE NEEDS OF THE
MARKETPLACE AND BEING
INNOVATIVE WITH THEIR
PRODUCTS, WILL EXCEL.**

TUNE IN TO "THE MIDDLE MARKET TRANSFORMATIVE CEO" WITH JOE BRUSUELAS



RSM US Chief Economist Joe Brusuelas teams up with business author and co-host, Robert Reiss, for a series of provocative discussions with middle market CEOs. Get the details on game-changing strategies in industries ranging from restaurants to retail and manufacturing.

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