A CLASSIC HEAD FAKE? WHY MARKET VOLATILITY DOESN’T PORTEND A DOWNTURN

CHINA TRADE WAR:
WHAT’S THE IMPACT FOR CONSUMER PRODUCTS?

BEYOND BITCOIN: PREPARING FOR BLOCKCHAIN BUSINESS
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A CLASSIC HEAD FAKE?
WHY MARKET VOLATILITY DOESN’T PORTEND A DOWNTURN

By Joseph Brusuelas, Chief Economist, RSM US LLP

Over the past year, the improved picture for the financial services community has been predicated on rising interest rates, strong financial conditions, modest inflation and an overall improving economy. Recently, however, a flattening yield curve has fostered concern about a premature end to this positive business cycle. Our view, however, is things may not be quite what they seem.

In our estimation, these worries represent a classic financial sector head fake related to residual seasonality in growth that often impacts the first quarter and a term premium that has recently turned negative, suppressing the long end of the curve. Moreover, the Federal Reserve’s ongoing policy normalization features both increases in the policy rate and the paring down of the central bank’s prodigious $4 trillion-dollar balance sheet. Rather than facing stark harbingers of recession, we believe middle market business managers will likely see a series of positive economic events that will trigger an increase in fixed income yields and a decline in bond prices. Indeed, it would not be surprising to see a reversal in the term premium, placing upward pressure on U.S. fixed income yields partially triggered by the expected increase in short-term interest rates.

If one examines current and forward-looking estimates of term premiums along the maturity spectrum, they remain historically low. Absent a major systemic event, the probability of an increase in the term premium will move higher from current levels. The risk of rising bond yields is clearly to the upside, underscored by equity markets and the Chicago Board Options Exchange’s Volatility Index, or VIX, now emerging from a long period of low volatility, coupled with uncertainty linked to rising protectionist policies stemming from the Trump administration.

**Stocks and the US term premium**

**US bonds and the term premium**

Source: RSM US LLP, New York Federal Reserve
Four primary components underscore Fisher’s long-term interest rate model: the expected real rate of interest, forward-looking inflation expectations, the real risk premium and the inflation risk premium. A combination of long-term trends in declining yields and inflation, in addition to the decade-long shift in monetary policy by the Federal Reserve (which included the purchase of assets across the maturity spectrum), caused both nominal and real yields to decline. Over the past several years, the risk premium built into U.S. Treasuries, which has been declining, was a primary cause of low yields in addition to aforementioned reasons. Between July 2016 and December 2016, the term premium trended higher, temporarily moving into positive territory. However, since January 2017, the term premium has resumed its decline and bottomed out on Dec. 15, 2017. During that time, the yield on the 10-year bond has increased to a high of 2.95 from 1.35 before retreating recently to near 2.75 percent.

**Fed’s five-year forward breakeven inflation rate**

![Chart showing Fed’s five-year forward breakeven inflation rate and Fed’s inflation target over the years from 2000 to 2018. The chart illustrates the percentage changes in both values.](source: RSM US LLP, Bloomberg)

**Real interest rate remains historically low**

![Chart showing U.S. real interest rate and Fed’s inflation target over the years from 1998 to 2018. The chart illustrates the percentage changes in both values.](source: RSM US LLP, Bloomberg)
Another three expected rate hikes from the Fed in 2018 and three more in 2019 (the Fed’s most-recent summary of economic projections implies a policy rate of 3 percent to 3.5 percent by mid-2020) will almost certainly trigger an increase in the term premium. This environment should boost merger and acquisition activity and net interest margin for credit unions and banks, as well as improve business conditions for insurance firms, consumer financial companies and private equity funds.

In past economic cycles, the term premium often acted as a neutralizing factor as long-term rates increased. Given the very unusual set of conditions outlined above, the term premium could, in the near term, act to push rates higher as the Fed takes the next step in normalizing monetary policy. When will this occur? Timing is always difficult to identify. Given that there is a strong fiscal boost linked to the Tax Cuts and Jobs Act passed in late 2017 and the recent two-year budget agreements (which should throw another $320 billion in accelerant to the fiscal fire), it will likely occur in the second half of 2018.

Regardless, with the Fed implying a much higher policy rate on the way, and the consensus pointing to a 3.67 percent median forecast on the 10-year Treasury yield by mid-2020, something must give. Either the Fed must slow or end its normalization process, the term premium must increase, or the economy is going to fall into recession in the near term. That said, we continue to anticipate a significant increase in the term premium later this year, which should spill over into 2019 and trigger a much steeper yield curve, thus alleviating conditions the market is, for now at least, identifying as a potential harbinger of recession.
FORWARD RATES

Forward rates are often useful indicators of where market participants expect yields to move along the maturity spectrum. Yields along the spectrum can be decomposed into a series of short-, intermediate- and long-term dated securities. This permits an analyst to estimate if long-term yields are shifting due to changes in short- or long-dated market expectations.

This model, put forward by economists Gurkaynak, Sack and Wright at the New York Federal Reserve Board, implies that long-dated forward rates have increased modestly, with a much sharper increase in short-dated forward rates, most certainly due to Fed rate hikes and considerations of market participants about changing growth and inflation considerations.

**US one-year yield**

![Graph showing US one-year yield from 2010 to 2018](Source: RSM US LLP, Bloomberg)

**MIDDLE MARKET INSIGHT**
Forward rates are often useful indicators of where market participants expects yield to move along the security spectrum.

**Forward rates and term structure of interest rates**

Decomposition of long-term interest rates into a series of one-year forward rates

![Diagram showing decomposition of interest rates](Source: Gurkaynak, Sack and Wright)

**US one-year, nine years forward rate**

![Graph showing US one-year, nine years forward rate from 2010 to 2018](Source: RSM US LLP, Bloomberg)
CHINA TRADE WAR:
WHAT’S THE IMPACT FOR CONSUMER PRODUCTS?

How are U.S. and China trade frictions affecting consumer products companies?

Joe Brusuelas, RSM Chief Economist, shares his insights.
**Q:** The U.S. tariff list was just published. It does not contain specific consumer products, but rather machinery and equipment used to manufacture these products. What effect do you think these tariffs will have on U.S. consumer products companies?

**A:** I expect a series of mostly indirect effects on the U.S. consumer product space. The indirect impact will be felt on brick and mortar retailers in the form of higher costs for product display, shelving and storage due to higher costs of basic metals and industrial products. These higher costs could lead to retailers seeking cuts in other areas, including lower prices paid for products they sell to customers. The first round of the tit-for-tat tariff retaliation largely spared the U.S. consumer products industry.

**Q:** China retaliated by sending out its own tariff list. How might China’s tariffs impact RSM consumer products clients?

**A:** At this time, it appears the impact of China’s retaliation will not materially impact RSM’s consumer products clients. But there is risk this intensifying trade spat has the possibility of turning into a trade war. Once tariff engagements begin, they are difficult to stop and they tend to spread to other areas of the economy, as successive rounds of tit-for-tat tariff retaliation. The Chinese are well aware of the vulnerability of the U.S. consumer space in general, and retail, in particular. Should things begin to spin out of control, consumer products could be the target in successive rounds.

**Q:** How do you think this environment will impact U.S. companies looking to grow their global revenue by selling to the increasing number of middle class Chinese consumers?

**A:** Trade spats and trade wars are the ultimate conflicts of choice. They are easy to start, difficult to end and tend to produce no winners. The trade friction that is rapidly moving toward a trade war will make it much more difficult for U.S. companies to engage in growth strategies using China’s export market. Typically, once economies begin to engage in trading tariffs, nontariff barriers tend to spring up and classical protectionist measures such as increasing paperwork, idiosyncratic rules governing entry of goods into markets and outright graft almost always follow in such a way that they disrupt economic relationships.

**Q:** What are your thoughts on potential changes to the North American Free Trade Agreement (NAFTA)?

**A:** The NAFTA modernization talks appear to be moving toward a successful conclusion. The three economies involved in the first seven rounds of talks essentially leveraged the modernization framework embedded in the Trans Pacific Partnership. They used it to cover both manufacturing and services, including technology and life sciences areas of commerce that did not exist when the agreement went into force in 1995. The two outstanding areas of concern are dispute settlement and quantitative requirements on auto contents. On qualitative requirements, the Trump administration has given way in recent days clearing the way for a compromise. And at this point, the Canadians and the Mexicans are ready to accept a U.S. exit from the dispute settlement in the framework, which will leave U.S.-based firms without recourse. My sense is that the administration will retreat on this issue during the upcoming eighth round of talks and conditions will be created to converge on an agreement over the next four to six weeks. It is critical that an agreement is in place before the Mexican election in July and is ready for ratification in the Mexican Senate prior to the new Mexican president taking office in early December. This should be a relief for U.S. consumer products companies buying and selling their products cross border to Canada and Mexico.
Blockchain is best known as the platform supporting the cryptocurrency bitcoin, but the technology’s most far-reaching impact is developing quietly behind the scenes.

Blockchain technology allows for the recording, execution and auditing of contracts in real time on distributed ledgers. It can be adopted to asset sales, payments, loans and contracts of all types.

Bitcoin’s value could fall to zero and blockchain would still disrupt industry transactions.

Bitcoin’s value could fall to zero and blockchain would still disrupt industry transactions.

By Jay Schulman, Principal, RSM US LLP

Here’s how: by eliminating the need for trusted third parties, blockchain continues the internet’s elimination of middlemen.

Bitcoin might have been created in a libertarian mindset, but corporate America has moved in. Microsoft allows you to run a blockchain on its cloud platform. IBM is positioning itself in big blockchain applications. Walmart is using blockchain to speed up the food recall process. Former Wall Street executives are using blockchain to redesign stock exchanges.

Ultimately, disruption will come to arbitragers of all stripes.

Industries on the brink

While blockchain’s full impact may still be three to five years away, companies in four industries will soon find themselves on the bleeding edge:

1. Supply chain. Business will change as blockchain increases efficiency and reduces the need for some third-party intermediaries.
2. Financial services. International wire transfer services, as an example, may decrease in favor of cryptocurrencies.
3. Nonprofit. Nonprofits may seek to make delivering aid more effective.
4. Health care. Many startups are looking to disrupt the industry.

Consider what happened with the advent of the internet. Companies with profitable businesses that relied on paper, faxes and traditional mail suddenly found that they weren’t in profitable businesses any more.

To be sure, it’s important to remember that blockchain is in its infancy. It’s like basic text-based email. Creating human-friendly blockchain applications will take time.
New types of contracts

Viewing a blockchain simply as a technology or database overlooks its true disruptive impact—its ability to reengineer processes.

In the future blockchain will create a new way to deliver contracts and transactions between parties.

These new contracts will need to address the risk of error. In the past, a phone call to a bank officer could stop a wire transaction. Blockchain’s automatic execution is merciless to fat fingers.

Transactions will need to be redesigned to specify exactly when payment–triggering events occur, and a neutral oracle will be required to help resolve smart contracts.

Planning for disruption

Right now, companies should be analyzing how blockchain and cryptocurrencies could disrupt their businesses, planning counterstrategies, and perhaps exploring new opportunities.

Banks with wire transfer businesses should take steps to compensate for the loss of those future profits.

Suppliers should consider the profit that could be lost if processes are reengineered.

MANY BUSINESS IDEAS PREDICATED ON BLOCKCHAIN WILL GO BUST AS UNDERSTANDING REPLACES ENTHUSIASM.

Controlled enthusiasm

Not every business process will benefit from blockchain. With so much hype around blockchain, everyone is trying to incorporate the technology into their new idea.

Many business ideas predicated on blockchain will go bust as understanding replaces enthusiasm. That doesn’t mean disruption won’t occur—and even if it doesn’t happen all at once, businesses cannot sit back and wait.

As with the internet and social media, this new technology will eventually become ubiquitous.

With special thanks to Omid Malekan, author of “The Story of Blockchain: A Beginner’s Guide to the Technology That Nobody Understands.”