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U.S. TRADE POLICY: RISING RISKS, DELAYED TIMETABLES

By Joseph Brusuelas

In our 2019 economic forecast, we made the case that trade policy was the greatest risk to the global and domestic economic outlook. At the time, we expected passage of the North American Free Trade Agreement modernization pact by Congress early in the year and a possible roll back of the trade spat with China. That optimistic forecast has been diminished by a lack of action on the ground and a rapid deceleration of both U.S. and global growth prospects.

During recent days, voices from the U.S. administration have damped expectations of a near-term resolution to the multifront series of trade conflicts the country is engaged in. Meanwhile, it’s possible the White House may choose to open a new front around auto imports from the UK, Europe and Asia. These factors make it likely U.S. growth in the first half of the year will track below the long-term trend of 1.8 percent. It is critical that middle market businesses, especially those with exposure to auto manufacturing, take steps to stress test their balance sheets and protect against further disruptions to regional and global supply chains. Learn more.

NAFTA modernization: Delayed legislation, risk to passage of agreement

Last November, the United States, Canada and Mexico agreed to modernize the 1994 NAFTA deal under the United States–Mexico–Canada Agreement, or USMCA. The new pact included many of the terms of the now-abrogated Trans Pacific Partnership, including section 24, which addressed key opportunities and concerns for small and middle market companies. In our estimation, this inclusion created an avenue of global growth for U.S. small and medium-sized enterprises. However, early-year hopes for approval have been dashed; Congress is still awaiting a report by the International Trade Commission on the agreement before it can submit USMCA for legislative review and passage.

The new NAFTA agreement also faces bipartisan opposition on several key points. First, Republican Party senators, including Finance Committee Chairman Charles Grassley, are demanding the removal of steel and aluminum tariffs on Canada and Mexico before any agreement can be considered. They have a good point. According to our colleagues at the Peterson Institute for International Economics, steel tariffs imposed a cost of $5.6 billion on U.S. steel users, while domestic steel producers’ pretax earnings increased by $2.4 billion on higher steel prices. Aluminum tariffs added a burn of about $1.7 billion to domestic consumers. Most importantly, both direct and indirect costs linked to tariffs were passed downstream to producers in those ecosystems and more broadly, to...
U.S. consumers, reducing overall economic activity. The exemptions on steel tariffs for Canada and Mexico expire June 1, putting additional economic risk on the table for the second half of the year.

Democrats, the new majority in the House of Representatives, are demanding changes to the new NAFTA agreement around labor, including limits on outsourcing and environmental standards in the biologics section.

It is clear each side of the aisle in both chambers of Congress will add amendments to the agreement. And, in the past year, the administration has threatened to abrogate NAFTA altogether if Congress were to make such changes, and it has until June 30 to notify Congress of its intent to withdraw from NAFTA. Given such hurdles, congressional approval in 2019 now looks unlikely.

Finally, the administration’s threat to close the U.S.-Mexican border amid debate over immigration policy cannot be separated from the risk around economic outlook. The United States conducts $1 million of trade each minute with its southern neighbor. The spillover of economic risk, due to administration immigration policy, appears to be growing, adding further doubt the USMCA will be made law.

**China: Waiting on resolution and rollback**

Meanwhile, ongoing negotiations between the United States and China appear to be deadlocked. In late March, Larry Kudlow, director of the U.S. National Economic Council, indicated that talks could extend for months, damping hopes for an early-year resolution to the Sino-American trade spat. The United States has placed a 10 percent tariff on $200 billion of imported Chinese goods and Beijing has retaliated in kind. While the parties reached a cease-fire Dec. 1 to prevent boosting the tariff to 25 percent on all $635 billion of Chinese goods, it looks increasingly likely that the tariffs will remain on the books indefinitely.

Both sides have engaged in significant tariff mitigation for producers harmed by the trade spat; China has permitted its currency to depreciate to fully offset the price of tariffs, indicating its commitment to contend with tariffs for the longer term.

**SHOULD NEGOTIATIONS ROLL ON FOR MONTHS OR FAIL, RESULTING IN HIGHER TARIFFS, THERE IS RISK OF DECLINING EQUITY PRICES AND DETERIORATING FINANCIAL CONDITIONS.**
Our concern is twofold. First, the institutionalization of tariffs and their potential use as political cudgels will create a permanent drag on overall economic activity within the agricultural and retail sectors, which are particularly vulnerable to nonmarket actions on a continuous basis. Second, the pricing in of the potential rollback was a critical catalyst in the 21.5 percent increase in value of domestic U.S. equity prices since December. Should negotiations roll on for months or fail, resulting in higher tariffs, there is risk of transmission to the real economy in the form of declining equity prices and deteriorating financial conditions.

At this point, a grand bargain between the two parties looks like it will be difficult to be reached. China clearly is not going to budge on its government-directed business model, and U.S. enforcement around intellectual property theft will be difficult at best. If there is an agreement, it will revolve around increased purchases of U.S. agricultural products and liquefied natural gas going forward and a narrowing of the bilateral U.S.—Chinese trade deficit. We would urge our clients to note that this will likely result in the Chinese shifting final assembly of goods to offshore suppliers throughout Southeast Asia, resulting in no net change to the U.S. trade deficit.

**Auto tariffs: Heightened future risk**

On Feb. 17, the U.S. Commerce Department began an investigation under section 232 of the Trade Expansion Act of 1962 into whether there are national security implications tied to $360 billion in auto imports, including vehicles and parts. The administration has until late May or early June to decide whether to impose a proposed 25 percent tariff on these products. Based on our contacts in each party across Congress and the agencies in Washington D.C., we believe that the president will act to impose tariffs.

This 25 percent tariff would be equivalent to a $90 billion tax on U.S. producers and consumers. Our colleagues at London-based IHS Markit have estimated that the imposition of this tax would result in a $290 billion drag on GDP over the next decade, with deadweight losses of $22 billion in 2019 and $31 billion in 2020 to overall economic activity.

As such, there is widespread bipartisan opposition to auto tariffs. If the administration were to pursue such a policy, it would need to create exemptions for South Korea, Mexico and Canada, without creating significant disruptions to other important trading partners. Ongoing talks with Japan and a lack of engagement with Germany also represent significant risks around domestic and global economic outlooks.

**Global headwinds: Brexit, Europe and Asia**

The aforementioned risks cannot be separated from a broader global economic context. The global economy is likely to slow to near 3 percent in 2019. Anything below that level is typically associated with a global recession. With the EU and its most important economy, Germany already teetering on the edge of recession, and given political dysfunction in the U.K. linked to Brexit, the risk of a recession throughout Europe is elevated. The slowdown in Asia linked to a reduced pace of growth in China caused by the lagged impact of that country’s debt and deleveraging policies, not to mention the trade spat with the United States, are issues that are not going to go away soon.

Despite a generous fiscal stimulus recently imposed by China to support growth, there is no conclusive global data indicating global stabilization has been obtained. While global trade appears to have increased by 2.3 percent in January, it remains flat on a year-ago basis. Meanwhile, rising protectionist sentiment in the United States, Germany and China poses a risk to the economic outlook in 2019 and 2020.
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RESEARCH SHOWS MIDDLE MARKET CYBER RISK

Nearly 50 percent of midsize companies expect they will face unauthorized users attempting to breach their data or systems this year, according to executives RSM surveyed. Despite incidents of rising cybercrime, just half of the businesses surveyed carry cyber insurance policies to protect against internet-based risk. Our study shows that many of those policies may fall short of comprehensive coverage.

Meanwhile, the C-level executives we surveyed may be overly confident in their firms’ internal abilities to thwart an attack. Some 93 percent of respondents were confident in their organizations’ ability to safeguard customer data. The reality—based on actual incident reports—is proving that confidence may be misguided.

Learn more in the full report, coming soon.
While tariffs have not affected most U.S. imports, the actions taken by the administration have strained not just specific industries, but also the relationships the United States has with affected countries. The steel and aluminum tariffs have hit trade partners, including Canada and Mexico. Both countries have said they will refuse to sign the USMCA until the United States lifts these tariffs. After the steel and aluminum tariffs, the EU, Turkey and Russia have set retaliatory tariffs on U.S. goods, India has threatened tariffs and nine countries have filed suit against the United States at the World Trade Organization. The EU has said it would lift its tariffs if the United States also removes the steel and aluminum tariffs.

“*The data provided by the Census Bureau and BEA do not include specific data for Australia and Argentina, which are included in “All other countries.”*
BIOTECH NEEDS CASH IN HESITANT MARKET

By Matt Wolf

Life sciences companies require a cash infusion at least twice as big as that of 2018 to fund research and development at a time when investors remain skittish, according to a Bloomberg analysis.

The analysis suggests that over 100 biotech companies, including makers of oncology therapies and treatments for other life-threatening conditions, need to raise $7 billion to $8 billion this year, if not significantly more, to sustain research and other operations. That’s up sharply from 2018, when 102 companies raised about $3.6 billion.

Despite a healthy supply of capital, however, investors’ attitudes toward biotech appear to be hesitant, scared off in part by a surge in volatility in the public markets in the fourth quarter amid global economic concerns. The CBOE Volatility Index, which measures instability in the stock market, peaked on Christmas Eve, and was up again in February and late March.

Even so, the balance of global biotech and pharmaceutical venture capital dry powder is approximately $10 billion in closed funds dedicated to biotech, with another $8.4 billion raised. Bloomberg data shows. The balance of global dry powder sitting in buyout funds stands at approximately $55 billion, with $3.3 billion raised.

Compared to the broad equity market and the pharmaceutical sector, biotech investment activity is particularly sensitive to volatility shocks like the one U.S. markets experienced in the fourth quarter. The Nasdaq Biotechnology Index fell more than 20 percent in that period.

If recent volatility shocks are any indication, we will not see broad biotech stock performance—considered a proxy of investor interest—recover until late spring or summer. With many investors on the sidelines, biotech startups will need to closely monitor their cash and clearly communicate their value proposition to attract capital.
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From tariffs and trade policy to interest rate hikes, real GDP, employment, retail sales, and more, The Real Economy Blog offers daily reaction to economic news that can impact your company and help you plan for the unexpected.

Recent posts explore topics ranging from Brexit’s impact on the British economy to fallout of a potential U.S. border closure, FOMC rate policy and the impact of Apple’s recent “heart study” on the wearable technology market.

The Real Economy Blog is offered as a complement to RSM’s macroeconomic thought leadership reports, including the proprietary RSM Middle Market Business Index, published quarterly, and The Real Economy, delivered monthly. Subscribe at realeconomy.rsmus.com.