READY THE BULLPEN: BUSINESS CYCLE ENTERS LATE STAGES

ONE STEP CLOSER TO GLOBAL TRADE WAR

ANALYZING THE DEPTH OF CYBERTHREATS FOR MIDDLE MARKET COMPANIES
ABOUT THE AUTHORS

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:

Joe Brusuelas, Chief Economist, RSM US LLP

Kevin Depew, Deputy Chief Economist and Industry Eminence Leader, RSM US LLP

Daimon Geopfert, Principal, National Leader, Security and Privacy Consulting, RSM US LLP
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READY THE BULLPEN: BUSINESS CYCLE ENTERS LATE STAGES
FED WEIGHS POLICY OPTIONS AHEAD OF NEXT DOWNTURN

By Joseph Brusuelas
Chief Economist, RSM US LLP
The business cycle is clearly closer to its end than beginning. To use a baseball analogy, the starting pitcher is about to leave the mound and it’s time to get the bullpen warmed up. In other words, the middle market should begin to consider what the end of the business cycle will look like and what that means for future growth. The post–economic expansion phase of the current cycle is clearly on the minds of policymakers and has been a topic of conversation in several of the most recent Federal Reserve meetings.

Since 1945, the Fed has relied on about 400 basis points of firepower accompanied by a significant boost from fiscal policymakers to stimulate the economy. However, the current economic expansion has been like no other. With the Fed’s benchmark policy rate floating between 1.5 and 1.75 percent, and a late-cycle fiscal boost of $1.5 trillion following passage of the 2018 $1.3 trillion budget, policymakers’ capacity to act forcefully in the face of a recession is far more constrained than usual.

When the business cycle does end, the onus on fighting the recession will fall squarely on the shoulders of the central bank. With the policy rate well below what has been considered normal at this point of the business cycle, the Fed will likely be forced to resort to another series of unorthodox policies to help the economy recover, especially if the downturn is deeper or runs longer than expected.

Term premium expected 10–year fitted yield

The U.S. budget deficit as a percentage of nominal gross domestic product (GDP) at the onset of the past six recessions (1973–2001) has averaged 1.8 percent. Based on RSM projections, if the United States were to hypothetically enter a recession sometime around 2020–2021, the budget deficit–to–GDP ratio would stand at a minimum of 5.1 percent, with considerable risk of a much deeper deficit. This will leave fiscal policymakers a very narrow margin to plug the hole in private sector activity without putting severe upward pressure on interest rates.

Given the trajectory of the U.S. fiscal imbalance due to a combination of sluggish growth and increasing fiscal and trade deficits, it is difficult to conceive of a situation where an attempt by the U.S. Treasury to mitigate an economic downturn through fiscal policy wouldn’t trigger an increase in the risk premium (i.e., higher interest rates) demanded by domestic and foreign purchasers of Treasury notes along the entire maturity spectrum. Although we do believe the fiscal authority will act, it is highly doubtful (given the late–cycle fiscal boost put in place over the past year) that it will be anything other than a modest complement to the steps the Federal Reserve will be forced to take, especially if the downturn is more than the garden–variety average nine–month recession. The 2007–2009 Great Recession, the worst economic crisis since the Great Depression, was the exception rather than the rule among postwar economic downturns.

U.S. Treasury federal budget deficit or surplus as a percentage of nominal GDP

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Given the trajectory of the U.S. fiscal imbalance due to a combination of sluggish growth and increasing fiscal and trade deficits, it is difficult to conceive of a situation where an attempt by the U.S. Treasury to mitigate an economic downturn through fiscal policy wouldn’t trigger an increase in the risk premium (i.e., higher interest rates) demanded by domestic and foreign purchasers of Treasury notes along the entire maturity spectrum. Although we do believe the fiscal authority will act, it is highly doubtful (given the late–cycle fiscal boost put in place over the past year) that it will be anything other than a modest complement to the steps the Federal Reserve will be forced to take, especially if the downturn is more than the garden–variety average nine–month recession. The 2007–2009 Great Recession, the worst economic crisis since the Great Depression, was the exception rather than the rule among postwar economic downturns.
Consequently, the Fed will be left with the job of mitigating a downturn through a combination of lower real rates, which will likely again veer into deep negative terrain, and a series of unorthodox monetary policy steps that will again attempt to suppress long-term interest rates to increase accommodations, as the central bank implements policy along the nominal zero boundary of interest rates.

In the 12 recessions since 1945, the Fed has cut interest rates by an average of 400 basis points. However, in the most recent six recessions since 1973, those cuts have increased to an average of about 527 basis points. This suggests that even if the Fed hits its target by the middle of 2020 (based on the current summary of economic projections of 325 to 350 basis points in policy maneuverability), it will have firepower well below what it has had access to during the past six recessions.

This means that in the next recession the Fed will likely do two things: First, it will aggressively cut the nominal rate and reach the zero boundary of interest rates quite quickly, likely within one year of the start of its accommodation campaign.

Second, given the experience of forward guidance, the phrase describing explicit qualitative communication strategy the Fed used during the Great Recession to explain the expected future path of its main policy rate, the central bank would likely utilize both the “dot plots” inside the quarterly summary of economic projections and the monthly policy communiqué to signal the commitment that rates will remain lower for longer than implied by estimates of the central bank’s reaction function. This would have the effect of compelling market participants to bid down long-term yields. That, in turn, would provide increased accommodations, even as the policy rate bumps against the zero boundary. In our estimation, the greater the time-dependent forward-looking guidance the policy communication is (for example, lower rates for one or two years), the greater the probability that policymakers will likely push rates lower, creating conditions for the resumption of economic growth.

‘Quantitative easing’ unlikely to be a Fed tactic

Unlike during the Great Recession, the Fed will probably refrain from large-scale asset purchases, or what is referred to as quantitative easing. Only if the economy were to suffer a severe shock would the central bank resort to this policy tool to lower interest rates and increase the money supply.

While we can make a strong case that central bank purchases of open market securities financed by the creation of bank reserves held at the central bank were decisive in putting a floor under the Great Recession (and resulted in a relatively stronger recovery than would otherwise have been the case), quantitative easing is a policy tool unlikely to be used outside of an unforeseen economic shock. And even then, such a tactic would face significant opposition in Washington D.C., which remains deeply divided on party lines.
So this raises a question: If the next downturn proves more difficult than expected, what alternatives could the central bank turn to? Some suggest the United States could lift the inflation target (2 percent), turn to negative interest rates as the European Central Bank and the Bank of Japan (BOJ) have done, or target the yield curve as the BOJ has done. In our estimation, lifting the inflation target would place transition costs on the public in a way that would likely reduce the Fed’s hard-earned credibility, prove confusing to the public and investors alike, and be very difficult to manage if inflation expectations become unanchored.

Turning to negative interest rate policy would likely yield a major backlash from Washington D.C. policymakers and currently has little support inside the Fed. While targeting of the yield curve is a popular academic discussion, there is significant doubt about its practical implementation in the United States.

Recently, former Federal Reserve President Ben Bernanke recommended that the central bank consider yet another alternative, a temporary price level target analogous to what the Fed, in recent statements, refers to as its “symmetrical inflation policy objective.” What this means is that, as the central bank attempts to keep the long-run average of 2 percent near its inflation target, it will accept a temporary deviation from that target during economic downturns and recoveries. But this could result in long-term inflation expectations becoming unanchored. Or, to paraphrase Bernanke, a price level targeting regime would commit to reversing temporary deviations of inflation from the target by following a temporary surge in inflation with a period of inflation below target, then following an episode of lower inflation with a period of inflation above target.

In our estimation, the Fed’s recent use of the phrases of “symmetric 2 percent objective over the medium term” and “the committee will carefully monitor actual and expected inflation developments relative to its symmetric inflation goal” in its May policy statement means the Federal Open Market Committee is clearly signaling to market participants that it intends to tolerate temporary deviation away from its inflation target in the near–term. More importantly, the Fed is providing a road map for those who are serious about monetary policy and the probable policy options ahead of the next recession.

While it is understandable that many middle market businesses may, at first glance, read this as a significant deviation away from the type of monetary policy that characterized the period of 1985–2005, it’s critical that forward–looking businesses consider the impact of possible policy options that both the fiscal and monetary authorities will consider well ahead of any downturn.
What a difference a month makes! Effective June 1, four weeks after declaring trade spats on hold, the Trump administration slapped tariffs of 25 percent on steel and 15 percent on aluminum for Canada, France, Germany, Italy, Japan and the United Kingdom—key U.S. trading partners—and promised to slap an additional $50 billion worth of tariffs on China beginning June 15. In our estimation, if fully implemented, these tariffs, in aggregate, will shave 0.2 percent from potential growth and put more than 2 million jobs at risk. This estimate may actually understate the true nature of the tariff impact due to uncertainty around likely retaliation by China, Canada and other G-7 trading partners.

The steel and aluminum industries support some 10,000 U.S. jobs. RSM estimates that the U.S. tariff structure amounts to a cost of approximately $915,000 per job to protect those industries. Similar to attempts by the Bush and Obama administrations to engage in protective trade activity, the current plan will also likely prove untenable and cause adverse outcomes for auto and aerospace businesses, as well as introduce higher costs for American consumers. In fact, near-term substitution effects by downstream producers are already causing demand for domestically produced steel to decline, the very opposite of the outcome that the policy shift sought.

The U.S. imports $2.4 trillion of goods and services each year that it otherwise does not produce in sufficient quantity or quality to meet the preferences of domestic consumers. Potential import targets based on the administration’s threats include autos (equal to about $176 billion, or 8 percent of total trade), aluminum (around $13 billion) and steel (roughly $30 billion). Together these industries account for slightly less than 2 percent of trade, and just 0.21 percent of total gross domestic product (GDP).

The administration has also threatened to place tariffs on China of about $50 billion in the near-term, and a total of $150 billion overall. (The U.S. imports about $136 billion in goods from the targeted China industries, which include the transportation, agricultural and chemicals industries, among others.) The latest moves imply that an intensified trade spat could easily turn into a tit-for-tat retaliatory trade war. That would almost certainly spill over into broader consumer imports and translate into higher consumer prices in the near-term, with the largest impact on the two lowest quintiles of income earners.

At this time, widespread reports of non-tariff barriers being imposed by China on U.S. agricultural and auto products are wreaking havoc among businesses attempting to estimate demand and production schedules for the second half of 2018.

Risks

There are two broader risks associated with the intensification of the trade spat. The first is linked to the disruption of the North American supply and value chains that have been constructed over the past quarter century.
Based on recent visits with our Canadian and Mexican trade partners who have taken the risk of a breakdown in NAFTA much more seriously than their American counterparts, middle market businesses based in those economies are already well along the way toward identifying and arranging for alternative sources of inputs in earlier stages of production and intermediate goods necessary to meet demand.

The second risk is the “uncertainty tax” linked to a general disruption of the global rules-based trading system for middle market businesses with exposure to the global economy. In our estimation, any disruption associated with the imposition of tariffs, quotas and an array of non-tariff barriers will distort patterns of gross private investment in general, and capital expenditures in particular.

THE LATEST MOVES IMPLY THAT AN INTENSIFIED TRADE SPAT COULD EASILY TURN INTO A TIT-FOR-TAT RETALIATORY TRADE WAR.

While the respective trade spats are still in early stages, investors have already moved to drive prices higher. One needs to look at the price of Canadian soft lumber (one of every three pieces of wood used to construct U.S. homes is imported from Canada), which have faced a tariff since early 2017, and have increased 20 percent this year. In the United States, this has caused the price of homes to appreciate by more than 1 percent, an increase directly linked to the tariff. Similarly, aluminum prices are up more than 25 percent this year, and steel prices are up nearly 30 percent.

These tariffs may support some steel producers, but come at the cost of harming all downstream businesses that use steel and, of course, consumers who are in the process of absorbing the pass-through costs of rising prices caused by the policy.

MIDDLE MARKET INSIGHT

The most exposed middle market businesses are those downstream in the manufacturing, agricultural, construction and industrial products ecosystems. If the trade spat intensifies and begins to include consumer products, the broader retail, footwear and apparel industrial ecosystems will be hardest hit in the near- to medium term.

In our proprietary fourth quarter 2017 RSM US Middle Market Business Index survey set of special questions on capital expenditures, a plurality of firms said they intended to increase outlays on software, equipment and intellectual capital, even amid mounting technological disruption across industrial ecosystems. We believe an erosion of the rules-based global trading regime, due to this uncertainty tax, will cause businesses of all sizes to pull back on critical capital expenditures, having direct implications for middle market growth.
While cybersecurity breaches at large corporations and government entities tend to grab headlines, the middle market has become the prime target for hackers and cybercriminals. Unfortunately, many companies often exhibit a false sense of security and overestimate their internal controls, creating vulnerabilities at a time when threats from external and internal parties are evolving and increasing.

The recent RSM U.S. Middle Market Business Index: Cybersecurity Special Report outlines the severity of threats to middle market businesses, what sectors are most susceptible and how to respond to emerging risks. While the study finds that companies are fundamentally confident in the effectiveness of internal security measures, 13 percent of respondents claim to have suffered a data breach in the last year—up from just 5 percent three years ago.

There is no denying that the middle market is a focus for cybercrimes, but larger midmarket companies are specifically in the crosshairs of hackers. The survey finds that 19 percent of larger middle market organizations ($50 million–$1 billion in revenue) suffered more than double the number of breaches than smaller ($10 million–$50 million) counterparts. The upper middle market represents

Visit https://rsm.us/2IlS0Eo to download the RSM US Middle Market Business Index: Cybersecurity Special Report.
the intersection of opportunity and vulnerability, as hackers generally believe that information at smaller organizations may not hold significant value, and larger companies have likely heavily invested in security.

In addition to the shift in targets, cybercrime tactics have also evolved, with hackers realizing that stealing data is not the most efficient strategy. Data theft certainly still occurs, but hackers now see more direct gain from ransomware attacks that hold key systems hostage and demand large sums to unlock them. Forty-one percent of middle market executives consider themselves likely targets for a ransomware attack, with larger middle market companies (15 percent) viewing the threat as very likely more than twice as much as smaller companies (7 percent).

Cyber liability insurance policies are a key, although potentially underutilized, strategy to lessen the blow of a potential cybersecurity incident. When coupled with a comprehensive security program, cyber insurance can be very effective, protecting servers and technology systems, and offsetting the financial, operational and reputational implications of an incident.

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For many middle market companies, cyber insurance is the main reason they were able to stay in business following an incident. Unfortunately, only 52 percent of the respondents in our survey carry a cyber insurance policy, and only 53 percent of those companies understand their level of coverage.

Companies are generally confident that a breach won’t happen to them, either because they think they are too small, or that their data and operations are secure. But in many cases, it’s not a matter of if a breach occurs, but when. Organizations must realistically evaluate their security posture and implement protective measures, because breach response costs can be excessive and damaging for unprepared organizations.