THE REAL ECONOMY

Housing Outlook Remains Fundamentally Strong

Auto Outlook: Driving Toward a Perfect Storm

Trump Administration Releases Tax Reform Proposal

Consumer Prices: Down the Slippery Slope
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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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The fundamental outlook for the housing sector remains strong even as gathering policy and cost headwinds imply rising risk as the residential investment recovery enters its eighth year. Even so, strong job gains, rising wages, demographics and historically low interest rates are supportive of sustained, if modest, improvement in the industry and are poised to offset current inflationary, financial and policy headwinds.

The major challenge for housing is on the supply side due to regulatory costs, which absorb one out of every four dollars invested in new startups. Meanwhile, a lack of useable lots across the economy, a lack of skilled labor to build new homes and the recent tariff imposed by the Trump administration on soft Canadian lumber are also risks to the outlook.

That said, based on the first three months of data in 2017, we maintain our forecast of housing starts to reach 1.3 million on average this year and for sales of new homes to increase 8.5 percent to about 600,000 at an annualized pace. That would still leave the housing market about 350,000 units below the long-term equilibrium of 1.6 million starts at an annualized pace, which means there is room for growth in coming years as long as policy is aligned with greater residential investment.

Policy risk and cost structure

The recently announced 20 percent tariff on soft Canadian lumber will directly alter the cost structure of residential investment. Imported lumber from Canada accounts for 31 percent of all wood used in residential structures. We estimate that the tariff will add, at a minimum, 1.1 percent or about $3,600 to the median price of a new home ($315,100 as of March).

Equally damaging has been the 9.4 percent increase in the price of soft lumber since the election. The Random Lengths Composite Index for lumber, closely in the industry, is up 22 percent since the beginning of the year on expectations of a White House policy shift on trade. On a year-ago basis, the price for soft lumber is up 12.9 percent.

The rising cost structure due to this change in policy will generate headwinds for homebuilders that may require price increases of near 2 percent, with most of that cost passed through to consumers, to keep gross margins flat across the industry (framing lumber accounts for about 18 percent of the cost of a single–family unit so the increase in prices will impact overall activity and cause further problems with affordability at a time of rising rates).

Residential investment

Single–family starts averaged 832,000 per month in the first quarter, the strongest start since 2007. Through the end of the first quarter, starts of single–family residences (SFRs) are up 9.3 percent on a year–ago basis and multifamily dwellings (MFDs) are up 8.8 percent during the same period. Currently, there are 1.085 million units under construction, slightly above the 1.068 million six-month average, with 454,000 SFRs and 631 MFDs under construction. Completions during the first quarter averaged 1.151 million, slightly above the six–month average of 1.38 million at an annualized pace. Just as encouraging is the fact that household formation appears to be growing again at just above a 1.2 million pace through the first quarter.

Given that the major impetus for growth during the housing recovery has been multifamily starts the
improvement in SFR starts is particularly encouraging as it reflects a normalization of the national housing stock. The forward-looking permits data points toward a move in the near-term toward 1.26 million at an annualized pace, and we continue to anticipate growing demand linked to solid economic fundamentals which will support a move toward a peak of 1.3 million this year. With vacancy rates in housing increasing to 7 percent, we don’t expect a sustained move in overall investment conditions much above our forecast.

Sales

Housing sales, while showing modest gains, are facing constraints that are mainly due to a lack of supply. This has caused an increase in pricing and intensified affordability issues across the economy. In particular, local ordinances have created a regulatory headwind that will be difficult to unwind given the political polarization across much of the nation. The median price of a used home is $278,500 and is up 5.3 percent from a year ago, while the median price of a new home is $315,100, up 1.2 percent. Meanwhile, the most-recent Federal Reserve’s senior loan officer survey indicated a net tightening of lending conditions across the economy, while the rate on a conventional mortgage rate stands at 4.31 percent.

Despite those headwinds, existing home sales posted a cycle peak of 5.71 million and were up 5.6 percent through the end of the first quarter. Real residential investment, including brokers’ commissions, was up 13.7 percent in the first quarter and was one of the few bright spots in the growth picture to kick off 2017.
The U.S. auto industry is facing a classic inventory overhang that is putting at risk the nascent recovery in overall manufacturing and production. The Detroit Three manufacturers have an inventory level of 87 days while total vehicle sales stand at 73 days. The rise in inventories reflects a switch in underlying demand, toward sales of coupes and sedans from larger trucks and SUVs, that may have caught the industry off guard; 64 percent of profits and revenues are driven by truck and SUV sales.

Meanwhile, rising interest rates and profit narrowing discount pricing are creating additional pressures on the industry. If not reversed quickly, this may lead to declining auto manufacturing and overall industrial production, thus placing overall downward pressure on U.S. gross domestic product (GDP).

North American production

Mexican auto production increased 36 percent on a year-ago basis, posting a record 363,687 units in March, while first quarter output jumped 17 percent on a year-ago basis. Mexican auto exports increased 33 percent by 297,571 and are up 14 percent to 750,162 units in the first three months of the year. About 76 percent of that production is sent to U.S. consumers. During the month of March, U.S. industrial production of motor vehicles and parts declined 3 percent. U.S. domestic auto production was down 15.4 percent from a year ago and stood at 553,900 units produced so far this year. Overall, U.S. auto production accounts for just under 3 percent of GDP. Canadian auto production slowed to a little over 8 million at an annualized pace.

US sales

Overall, U.S. auto sales have slowed to 16.81 million at an annualized pace, below what we expect to be the full-year trend line of 17 million. U.S. domestic sales have also slowed, to 13.12 million at an annualized pace, well below the peak of 14.25 million at an annualized pace posted in September 2015. Retail sales are down 3.7 percent on a year-ago basis with Ford retail falling 7.1 percent, Chrysler Fiat down 7 percent and GM declining 5.8 percent. Truck sales, the primary profit driver, were down 8.2 percent on a year-ago basis, while sales of cars dropped 8.8 percent. Weak topline sales along with tightening credit conditions imply growing signs of stress and narrowing profit margins ahead despite discounts of nearly $4,000 per vehicle. Sustaining a pace of sales north of 17.5 million to help clear the market would require a stronger economic rate of growth than our baseline forecast of 1.9 percent this year.

Financial conditions

We have made the case for some time that the key risk to the auto sector was an overreliance on the use of subprime loans to finance sales as the average maturity of new auto loans has climbed to six years. During the current business cycle, subprime loans have averaged 22 percent of all sales per quarter, and in the final three months of 2016, they averaged 19 percent and accounted for about $300 billion in outstanding loans. There are currently $27.2 billion in loans outstanding to those with a credit score below 620 and another $17.8 billion with scores below 659. Two-point-three percent of all auto loans are more than 90 days delinquent in their payments, which equates to about $14.52 billion in outstanding loans. Total auto debt through the end of the fourth quarter of 2016 stood at $863 billion dollars, down from $955 billion one year ago. With lending officers indicating a tightening of credit, and the Federal Reserve likely to hike the policy rates twice more this year, this may put additional downward pressure on overall sales.

Auto equity value and inflation

Rising negative equity of vehicles (number of used cars coming to market) is another source of intraindustry stress. Manheim, which specializes in auction services for registered auto dealers, reports that 3.6 million used vehicles should roll off the market in 2017, followed by
4.1 million next year. On a historical basis, around 4.3 million should roll off leases in 2019. This will put marginal downward pressure on the price of used vehicles, posing a risk to the pace of total vehicle sales, the production of new vehicles and overall industrial production. At this point, about 32 percent of trade-ins are underwater with an average negative equity value of $4,382 per vehicle.

Used vehicle price deflation has been an issue in the industry for the past year. In the U.S. Consumer Price Index, used car prices have fallen 4.7 percent on a year-ago basis, while the Manheim U.S. Used Car Index has been negative during three of the past five months and up just 1.4 percent on a year-ago basis. Falling vehicle prices negatively impact trade-in cycles and cause lenders to tighten credit further as lenders become more risk averse due to collateral risk.

**Global picture**

Global sales have likely reached a post-financial crisis cyclical expansion peak. Middle market manufacturing firms with direct exposure to the global sector should prepare for a plateau later this year and decline in subsequent years, despite an improving international outlook. The key is a deceleration in Chinese automotive demand and the withdrawal of Ford and GM from Europe and Russia as outlets for late-cycle expansion. Firms with exposure to the GM, Toyota and Volkswagen ecosystems should actively prepare for a slowdown in 2018-19. If the United States adopts a border adjustment tax, the German, Japanese and Korean automotive ecosystems, in particular, would all face an adverse shift in pricing models for exports into the U.S. domestic market and lose shares to the Detroit Three.

**Days supply implies inventory imbalance in auto production**

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Source: RSM US, Bloomberg
On April 26, 2017, top representatives from the Trump administration announced their long-awaited proposal for tax reform. National Economic Council Director Gary Cohn and Treasury Secretary Steven Mnuchin presented the administration’s broad objectives, laying out target tax rates and a few proposals affecting the tax base, while leaving many details to be worked out in the coming months.

To some observers, the announcement was more important for what it did not say: The administration’s proposal neither endorsed nor completely rejected the House Republican plan for a border adjustment tax to address the nation’s trade imbalance, and did not address or criticize the House Republican plan to allow immediate expensing of depreciable assets to stimulate economic growth. Since the House is expected to act first on any tax measure, and since the House Republicans are still embracing their tax reform ‘blueprint,’ some may view this administration announcement as simply putting the ball back in play, but in the hands of the House.

The details of the proposal are similar to President Trump’s campaign proposals.

On the business side, the administration proposed a 15 percent tax rate on all business income, including income taxable to individuals through pass-through entities. While the House GOP blueprint, which provided a similar special rate for business income taxable to individuals, proposed extending their special rate to sole proprietorships as well as partnerships and S corporations (the entities traditionally described as pass-through entities), the administration’s proposal did not discuss whether this rate would apply to businesses taxed as sole proprietorships.

Also proposed was a move to a territorial system for international taxation, where income earned by U.S. companies outside of the United States would not be subject to U.S. tax. Currently, U.S. companies are taxed on their worldwide income, with opportunities for deferral of certain income earned overseas until repatriated. As indicated previously, the border adjustment tax proposal, found in Speaker Paul Ryan’s House GOP blueprint, was not included in the administration’s proposal, and the presenters indicated their belief that it was ‘unworkable’ in its current form.

Interestingly, with what appears to be a 20 percent tax rate on individual capital gains, but a 15 percent tax rate on the ongoing earnings of corporations or owners of pass-through businesses, the incentive to dispose of a successful business in order to realize tax-favored capital gains may be diminished or eliminated.

On the subject of deferrals and repatriations, the proposal included a one-time deemed repatriation of all deferred earnings held in overseas subsidiaries, at an unspecified tax rate.

Base-broadening through the elimination of unspecified tax breaks for businesses was stated as an objective, but no specifics were discussed during the presentation or contained in the succinct written summary.

On the individual side, the administration proposed a move from the current seven tax brackets to three: 10 percent, 25 percent and 35 percent. The thresholds at which these rates would take effect were not discussed in the announcement.
Other proposed changes to the individual tax system include:

- Doubling the standard deduction for all taxpayers
- Repealing the alternative minimum tax
- Repealing the 3.8 percent net investment income tax (sometimes known as the Obamacare tax)
- Expanding (in an unspecified way) tax benefits for child and dependent care
- Keeping current tax benefits for home mortgage interest, charitable contributions and retirement savings, while eliminating most other itemized deductions, including the deduction for state and local income taxes

The administration also indicated their intent to repeal the estate tax, possibly without any phase-out period as occurred under the Bush-era estate tax repeal (a repeal that was in full effect for only a year). Other aspects of the federal transfer tax system—the gift tax and generation-skipping transfer tax—were not addressed.

The well-worn cliché that the ‘devil is in the details’ certainly applies to tax reform, and most of the details of this proposal are yet to be worked out. RSM will continue to monitor developments in the tax reform arena as they occur. For additional information, visit our tax reform resource center.
CONSUMER PRICES: DOWN THE SLIPPERY SLOPE

By Jeffrey Edelman, Director, Retail and Consumer Products

What’s on the horizon for consumer products pricing in a rigorously cost-conscious marketplace? Jeffrey Edelman, director in RSM’s retail and consumer products industry practice, provides his observations and insights.

The race to the bottom

While most consumer products companies are focused on improving profitability this year, there is increased risk for many in this cost-competitive environment. Last year’s winners were largely within the value sector, particularly off-price retailers. This year will likely reflect a narrowing of the pricing gap with traditional retailers. We noted in our March commentary, Kohl’s and Macy’s both announced strategies of sharper pricing; since then, there have been more companies singing a similar tune. Many are using Walmart and Amazon as benchmarks and will be more closely attuned to online price comparison. The ability to keep up with frequent price changes is difficult. Consumers can search and buy faster than other sellers can match. Target, keen to stay relevant in the fray, said it would sacrifice full-year margins to keep its prices competitive. We could be looking at a deep black hole in terms of price reductions as retailers race to address a demanding marketplace.

Price reductions spread

Supermarket operator Kroger reported a surprise decline in holiday-quarter same-store sales as competition in the grocery industry intensified amid falling food prices and anticipation of increased pressure from German discount grocery chain, Aldi. Walmart, not to be outdone, indicated it is running a price-comparison test in approximately 1,200 U.S. stores as it looks to close its pricing gap with such rivals as Aldi and Kroger.

In related news, Costco recently announced its intention to raise its membership fees around midyear. This will be phased in over the next year or so. Of note, Costco has typically raised its membership fees every five to six years as an offset to its competitive pricing. Its management recently indicated it believed it was facing stiffer competition in the pricing of a number of visible products and categories, implying this move could have more significance than in the past. Additionally, Costco’s promotional program will be tweaked to emphasize sharper pricing on fewer items. The retailer’s membership fees approximated 72 percent of its operating income last year, its operating margin was around 3 percent and gross margin was 11 percent. This successful formula has maintained steady increases in membership and renewal rates.
Consumers continue to focus more on price than fashion

Value-conscious consumers are placing different emphasis on fashion, quality and price today than in previous years; a trend apparently poised to continue. There are different considerations that are determining where to make purchases. Omnichannel is only part of the answer, although it does exert downward pressure on prices. The value proposition was enhanced by the consumers’ willingness to frequent discount channels more often; that is, remaining focused on the brand but at a lower price. Many brands have introduced a lower price point in some categories to attract that value customer.

Off-price retail has become even more relevant

TJX continues to raise the bar for the industry. We estimate factory outlets and off-price retailers combined sales approached $70 billion last year, nearly approximating that of the six largest department store companies, in part due to the latter’s store closing programs. Additionally, TJX will be expanding further into home-related categories as well as international markets.

One has always questioned the availability of fashion-right merchandise in off-price stores; however, given industry consolidation and increased buying clout, these strong retailers continue to gain market share. Their sales increased roughly 40 percent between 2011 and 2016. Many brands create specific merchandise for these outlets that are not necessarily identical to the products sold through department stores. Additionally, other brands have been resurrected and sold exclusively through these outlets, offering more of a perceived value. This segment has become even more saturated given growth by department stores such as Saks, Nordstrom, Neiman Marcus and Bloomingdales.

Unknown variable

The major variable, and likely unknown for months, will be the impact of import taxes as reform policies like the proposed border adjustment tax have yet to be realized. History suggests these and other costs will not likely be passed through to consumers immediately, but rather a phase-in that could ultimately impact profitability through the supply chain.