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WELCOME TO
THE REAL ECONOMY

The U.S. middle market makes up one-third of the country’s economy and employs one-third of its workforce, yet this economic growth engine is often overlooked. The business conversation is dominated by the needs of the largest and smallest companies. As the leading provider of assurance, tax and consulting services to middle market businesses, McGladrey wants to change the conversation.

The Real Economy is a first step. This monthly publication provides economic information and insights for and about the middle market. It helps shine a light on the unique needs and opportunities of this important segment of our economy.

This first edition features McGladrey’s Chief Economist’s outlook for 2015, and it is the brightest we have seen in a while. With projected above-trend growth in the overall U.S. economy, strong employment gains, continued low interest rates and the increasing strength of the U.S. dollar, 2015 should be an outstanding year for middle market businesses to invest and grow domestically and abroad.

Yet some headwinds still exist. McGladrey’s recent tax survey showed that middle market companies were hit hard with tax increases as a result of the American Taxpayer Relief Act of 2012, and we anticipate another impact this year as companies begin to comply with the employer mandate of the Affordable Care Act. Global economic conditions also pose a potential threat as growth in Asia continues to decelerate and the eurozone remains on the brink of recession.

I hope you will enjoy this first edition of The Real Economy and that you stay tuned throughout the year to understand the changing opportunities and threats for the middle market. You can subscribe to The Real Economy and to our RSS feed of real-time breaking economic updates via our website at www.McGladrey.com.

Here’s to a prosperous 2015!

Sincerely,

Joseph M. Adams
Managing Partner and CEO, McGladrey LLP
U.S. ECONOMIC OUTLOOK: BROADENING GROWTH, PROSPERITY TO DEFINE 2015

by Joe Brusuelas Chief Economist, McGladrey LLP

Improving fundamentals should result in a broad-based increase in economic activity driven by an expansion of small and middle market firms that make up the real economy. Amid a tightening labor market, rising real wages and dividends, the U.S. economy will probably grow on average 2.7 percent this year with some possibility of a faster pace of growth above 3 percent.

Momentum generated in the final three quarters of 2014 will spill over into the early portion of 2015. Growth will likely be somewhat faster in the first half of this year, bolstered by lower gasoline prices, and then slow slightly in the second half as the lagged impact of recent U.S. dollar appreciation affects foreign demand.

Key Growth Drivers The composition of U.S. growth should improve with household sector, manufacturing and business investment boosting total economic activity. U.S. households benefiting from income growth, sharply lower gasoline prices and an improved balance sheet should lead the way.

Real consumption will probably increase near 2.7 percent, up from the cyclical average of 2.2 percent. The record increase in civilian aircraft orders and the surge in unfilled orders for motor vehicles and parts should keep U.S. assembly lines humming throughout the year as the revival of the domestic manufacturing sector continues.

The 7 percent growth trend in capital expenditures (through the end of the third quarter of last year) is helping boost fixed business investment. That growth will be broad-based with small and medium-sized enterprises finally joining the party and increasing their investments in software and equipment.

As well, growing confidence in the sustainability of aggregate demand should result in large corporations reducing stock buybacks and instead focusing on increasing dividends and capital expenditures. This shift is key to an improved employment picture, greater productivity and rising living standards. The difference between a solid 2.7 percent rate of growth and a better than 3 percent rate of expansion will be the choices made by middle market and large firms regarding capital expenditures, which carry the potential to offset the mild slowing of capital investment in the energy sector this year.

Interest Rate Outlook and the Fed The interest rate outlook will remain relatively stable even with the Federal Reserve likely raising rates in the second half of the year to better align policy with an economy that is growing above the long-term trend rate of 2.15 percent. The Fed summary of economic projections (SEP) implies that the upper end of the Federal funds target rate could reach as high as 1 percent by the end of this year, and 2.5 percent by the end of 2016. We anticipate that the central bank will remain cautious and may choose to raise rates at a pace slower than that implied by the SEP because of the sharp fall in inflation expectations, economic deceleration abroad and concerns about the condition of the U.S. housing market.

While rates at the short end of the Treasury curve will continue to rise, the long end should remain relatively unchanged and continue to move in a range between 2.2 and 2.5 percent. This will be due, in part, to external capital flows into the U.S. as investors try to profit from policy divergence among the major central banks and differentials in interest rates, growth and inflation expectations among the major world economies.

Employment The trend in employment gains should continue near the six-month average of 258,000 new jobs per month and the unemployment rate should fall to 5.2 percent by the end of the year, indicating that the economy is moving toward the Fed’s definition of full employment. In 2014, in seven of the first 11 months of the year, creation of high-wage jobs outpaced low-wage jobs. That trend should continue this year. With the unemployment rate falling, millions of people per month are now leaving their jobs for better opportunities. The labor market should therefore continue to tighten, attracting people who have been outside the labor force in the wake of the financial crisis. This should create the conditions for a rise in real wages to 2.5 to 3 percent this year.

Inflation One major economic and policy narrative this year will be the coming sharp decline in the top-line consumer price index due to falling oil and gasoline prices. Concerns about deflation, which were evident in the recent decline in the Fed’s five-year forward breakeven inflation rate to 1.9 percent, should affect the timing and pace of Fed rate increases this year.

On a year-ago basis, the CPI is up 1.4 percent. Given the 40 percent drop in oil and gasoline prices over the past six months it would not be surprising to see either a flat or negative print on inflation by mid to late 2015. Once oil and gasoline prices stabilize, the CPI will move back toward the Fed’s long-term inflation target of 2 percent in late 2016 or early 2017. Although policy makers aren’t likely to confuse a one-time adjustment to the price level with a persistent decline in the total rate of inflation, falling inflation expectations will probably lead the Fed to adopt a gradual and orderly rate hike campaign.

Government and Trade Outlays at the federal, state and local level related to higher tax revenues as a result of stronger economic growth should increase near a 1 percent rate, possibly even higher if federal defense spending grows. Meanwhile, the economic deceleration in Europe and China, along with competitiveness issues associated with a stronger U.S. dollar, should result in a net drag on U.S. economic growth of 0.5 percent this year.
GLOBAL ECONOMIC OUTLOOK: YEAR OF POLICY DIVERGENCE AHEAD

by Joe Brusuelas Chief Economist, McGladrey LLP

Policy divergence among the major central banks and growth differentials among the major trading nations will be the main economic narrative this year. The end of the U.S. Federal Reserve’s large scale asset purchases and the probability of a rate hike later this year will stand in stark contrast with the European Central Bank, the Bank of Japan and the People’s Bank of China, all of whom will probably turn to aggressive monetary stimulus to support their flagging economies. That policy divergence will shape the term spectrum of global interest rates at the long end of the curve and help drive capital flows away from Europe, China and emerging markets and toward the U.S.

The global economy has averaged 2.7 percent growth during the past five years, which is well below the 3.5 percent long run potential average. Because of stronger growth in the U.S. and reduced oil costs, the global economy should see growth near 3 percent, up from what will probably wind up being a 2.4 percent rate of output last year.

Further, an improving U.S. economy should bolster the fortunes of NAFTA trade partners, which absorb about 45 percent of all U.S. exports, as they adjust to lower oil prices. While the improvement in the U.S. growth and structural shift in oil prices may bode well for the U.S. and its NAFTA trading partners, it partially masks a very challenging global environment.

**Euro Area** The single-most important event in global financial markets this year will be the decision by the European Central Bank to inject €1 trillion into the euro-area economy through asset purchases, including government bonds. The southern tier of Europe’s economy remains mired in depression, highlighted by elevated unemployment rates and deflationary conditions. With German industrial production slowing to below 1 percent on a year-ago basis, there is a strong chance that the euro-area economy will slip into recession in the first half of the year, if it hasn’t already done so. After adding in the continuing drag from fiscal restraint and austerity programs, the prospects for deflation have increased, which has probably created a sense of urgency among European policy makers.

Investors have moved aggressively to price in this major policy change by pushing long-term yields on the benchmark German 10-year Bund to 0.6 percent, compared with the U.S. 10-year Treasury near 2.2 percent. If the German contingent blocks or reduces the size of the expected asset purchase program, it will probably roll global asset markets, including those in the U.S.

**United Kingdom** Growth in the U.K. should moderate from an impressive 3 percent in 2014 to about 2.6 percent this year. An improving employment outlook should help move back the economy toward full employment during the next 18 months, resulting in a sustained increase in real wages and growth. Given the improvement in the economic picture, the Bank of England will probably move to normalize policy in the third quarter.

The risks to this outlook revolve around the stalling of the European economy, which absorbs a majority of exports, and a slowdown in housing price appreciation in London, which plays an outsized role in the island economy. This year the political economy will also come into focus with the general election in May.

**Japan** The Japanese economy slid into its fourth recession in six years after the imposition of part one of a national consumption tax. Growth probably rebounded to near 3 percent in the final quarter of 2014 after a 6.7 percent contraction in the second quarter and a 1.9 percent decline the third.

The effect of Abenomics at this point remains uncertain as the government attempts to revive and reflate the economy. The postponement of the second round of the tax increase until April 2017 should support an improvement in consumer and business sentiment this year and be a net positive for the economy. The Bank of Japan is expected to follow through with its aggressive asset purchase program, resulting in further yen depreciation and a net improvement of the competitiveness of Japanese exports.

**China** While the Chinese economy will continue to post growth rates near 7 percent, there is a growing possibility that the pace of economic expansion will slow below that recessionary threshold. Chinese economic authorities are attempting to achieve a rebalancing of the domestic economy away from an export-oriented model toward one organized around domestic production and consumption, while simultaneously deflating a bubble in residential and commercial real estate.

China, like many emerging market countries, should benefit from reduced energy costs and export demand from the U.S. However, the challenges in the residential and commercial real estate sectors will provide a powerful downward gravitational pull. Should that continue, those with exposure to China should anticipate further monetary stimulus out of the People’s Bank of China.

**Emerging Markets** Emerging economies will probably underperform this year thanks to a decline in demand for commodities due to a stronger dollar, a slowing Chinese economy and a redirection of capital flows toward economies with higher interest rates and faster growth. Emerging-market growth will probably slow to 1.5 percent this year before resuming better growth in 2016.

The collapse of the Russian ruble may serve as a bellwether for many emerging economies, especially those that are running large current account deficits and which have large dollar-denominated debt. Countries such as Ukraine, Turkey, Indonesia, Venezuela and Brazil may see further pressure on their currencies and financial systems.

Meanwhile, countries such as India and Mexico, which have made substantial structural reforms during the past few years, should begin to reap the benefits of improving growth and debt dynamics. That will likely prove to be a 2017-2018 story as 2015-2016 will be a period of adjustment and transition.
Global Rate Divergence Changes in U.S. central bank policy and a slowing of growth in Europe have caused investors to send the two long-term global benchmark rates in different directions. With the yield on the 10-year German Bund residing at 0.673 percent, the Japanese 10-year at 0.34 percent and the U.S. 10-year at 2.1 percent, such rate differentials should serve as a magnet to attract foreign capital to the U.S.

U.S. Private Credit Creation Private credit creation increased 5.9 percent in the third quarter of 2014, up from 5.1 percent previously and the sixth straight quarterly increase. Policy makers would like to see both nominal GDP and private credit creation move at a pace above 7 percent, which would stimulate an increase in monetary velocity.

U.S. Dollar Ascendance The U.S. dollar is up 12 percent against the euro since March and has appreciated 6 percent against a trade-weighted basket of currencies since February 2014. The 12-year dollar bear cycle has ended and investors would do well to prepare for what looks to be the onset of cyclical dollar bull cycle.

The common thread that binds together middle market firms is sensitivity to movements in financial conditions and access to credit markets. This access is necessary for many middle market firms to help manage inventory needs and capital investments beyond what balance sheets can support. Financial conditions in 2015 will likely remain supportive of growth in the U.S. Historically-low interest rates, a stronger U.S. dollar and improved credit creation imply a better outlook for consumer and industrial products, financial services, residential and commercial real estate.
INDUSTRY SPOTLIGHT: POTENTIAL RETAIL DISRUPTORS
by Jeff Edelman, Director of Retail and Consumer Products Advisory Services, McGladrey LLP

It Probably Won’t Be the Economy This Time
Economic activity remains on an uptrend and, based on latest forecasts, 2015 could be one of the best years for growth in quite some time. Last year ended on a strong note, paced by record automobile sales which likely siphoned discretionary dollars from other areas. Holiday sales closely matched expectations, driven by heavy promotions that took a toll on margins, but left inventory throughout the pipeline fairly clean. The stage should be set for a more manageable business environment; however, there are a number of potential disruptors beyond management’s ability to control. This list seems to grow each year.

2015 could be one of the best years for growth in quite some time.

Declining Mall Traffic May Continue
The internet has siphoned off considerable sales from malls at an increasing rate over the past several years. Brick-and-mortar stores have been a large beneficiary of online shopping, thanks to their increased omni-channel focus. Many of those, including Macy’s and Nordstrom, have been successful in more than offsetting the loss of comparable store volume. Online sales have enabled many retailers to maintain or increase market share; the jury is still out on overall profitability, which is declining at the store level and generally lower for the online business. The more productive A and B malls (the larger volume and more successful of which account for about 25 percent of the nation’s total) have a better chance of survival because many of their tenants are destination points. It is a different story for the C and D malls, many of which will likely see the ongoing exodus of tenants such as Sears and possibly JCPenney. Many of their stores are just too large and poorly located such that these closings could represent the demise of the rest of the mall, and possible margin pressures for remaining stores.

Profitability of online volume trails that of bricks-and-mortar because of shipping costs and the extra handling involved; returns can add to the cost because of free shipping. One bright spot would be those stores with a successful online presence, which can benefit from ease of returns and the likelihood of consumers spending a greater amount through trade-up and/or impulse spending.

Demographics Could Slow Spending Growth
The aging population is impacting consumer spending patterns. (Interestingly these “mall walkers” generate mall traffic, but the stores are generally closed in the early hours.) Priorities of those consumers have changed, such as spending less on apparel and more on health care. This consumer has been increasingly value-focused.

At the other end of the spectrum, the younger generation is moving away from the “logo stores” such as Abercrombie & Fitch in favor of many of the “fast fashion” stores such as H&M, Top Shop and Zara that offer more up-to-date fashion at lower prices.

The decline in middle-income households relative to growth in the higher-income households suggests marketing programs have to be updated. This could have implications for middle market retailers such as JCPenney and Kohl’s.

More Brand Consolidation Likely
Management teams are analyzing their merchandise mix, looking to cull out the lowest performers in terms of sales and profit per square foot. In the case of Kohl’s, among others, there has been increased emphasis on national brands, reducing its selection of poorly-performing private brands it had increased only a few years earlier. Other retailers, such as Macy’s, continue to build successful private brand programs, to some degree at the expense of marginal, secondary national brands.

This should have a ripple effect through the vendor community as weaker brands’ profitability declines due to reduced volume. Of even greater consequence would be the impact on manufacturers of private brands as retailers gain scale to purchase direct more economically. We believe this will become more evident in 2015 as retailers will look more actively to offset margin pressure from declining store traffic.

It’s a never-ending cycle as consumers seemed to have gained power over the retailer, who in turn is pushing back further on the supplier.

Some Brands Sacrificing Brand Power for Short-Term Gains
At what point does increased distribution through factory outlet stores cause brand saturation? If a product looks the same, the feel might not be identical. A knit shirt after several washings is the acid test between products made for factory outlets or department and specialty stores. The consumer has voted to buy discounted brands, but there is a noticeable quality difference from the original product, and it’s probably only a question of time before that is realized. Sizing, which has always been a strong point for brands because of consistency, is also more unreliable in factory outlets and off-price stores.

Headwinds Gaining Momentum
Retailers and vendors have been struggling over the past several years but are now at a point where many should begin to feel a little wind behind their backs. However, a growing number of retailers have noted fast fashion as an increased competitive factor. It is likely that stores such as Forever 21, H&M and Zara, along with other value-focused retailers including factory outlets and off-price stores, could capture around two-thirds of expected growth of apparel and accessory sales through 2020. This will have an increasingly important impact to both the retail and vendor community.

Complacency Could Be the Biggest Unrecognized Problem
Too many retailers and brands seem to see the consumer for granted, generally the major cause behind their downfalls. They can’t continue to do the same thing they did yesterday, as someone else has probably already passed them on the competitive front.

Understanding the targeted consumer is critical for survival and profitable growth. The appropriate value proposition has to be emphasized, and that differs by product within each demographic group. The same shopper could frequent Neiman Marcus, Kohl’s, Target and Costco, raising the importance of consumer research, which could be the key differentiator this year.