PUBLIC SECTOR WEBCAST: 2019 ECONOMIC UPDATE

Jan. 29, 2019
Our presenters

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National State & Local Government Industry Leader

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Economics Director
ECONOMIC OUTLOOK
U.S. economic outlook

• Base case – growth 2.2 percent in 2019 with downside risk
  - Tax effect fades in 2019
    • Growth deceleration with risks around trade deficits and business investment
  - Household consumption
    • Early-year spending hangover
    • Modest household spending near 2.5 percent
  - Early year pause by Fed and then 1-2 rate hikes
    • Fed keen to avoid over-tightening of financial conditions
  - Weak business outlays on capital expenditures
  - Demand pulled forward into 2018 to avoid tariffs
    • Likely to see soft manufacturing, household spending in early 2019
U.S. economic outlook

• Medium to long term outlook
  – Long-term growth trend 1.8 percent (1945-2007 2.5 percent)
    • Economic and wage growth uneven around the country
    • Recession probability 21 percent

  – Household consumption slowing in 2019
    • Solid consumption and services demand driven by rising incomes and low unemployment rate
    • Risk aversion - wealth effect at end of business cycle:
      – Every 1 percent in wealth created translated to 3.5 percent spending in prior two business cycles
      – Now only 1 percent

  – Weak business outlays on capital expenditures
    • Middle market falling behind
    • Some investment likely not measured
Consumer confidence and consumption

UMich Consumer Confidence Index and Real Consumer Spending

Lehman Collapse / Global Financial Crisis

Source: Thomson Reuters; BEA; Bloomberg; RSM US
Consumer confidence and consumption

UMich Consumer Confidence and Retail Sales
2015-2018

Source: Thomson Reuters; BEA; Bloomberg; RSM US
Private fixed investment: Policy key to reversing slide

Source: RSM US, BEA
U.S. economic outlook: Labor market

• U.S. labor market outlook: robust
  – 2019 monthly job creation: 155K per month
    • Unemployment Rate: Heading to 3.4 percent
  – Wage growth: 3 percent
    • Trend at 3.3 percent at 3-month average annualized pace
    • We expect near 4 percent at outset of 2020
    • Real wage growth obscured by demographic trends
  – Rebound in prime aged workers
    • 82 percent of prime aged workers 25-54 at work
  – Less than one unemployed individual per job opening
  – Finding willing and available workers primary challenge
Tight labor market

Source: RSM US, BLS
Atlanta Fed wage growth tracker

Wage Growth Tracker by Job Switcher/Stayer
12-month moving average of median wage growth


Exported on: Tuesday, November 20, 2018
U.S. economic policy outlook

• Policy outlook
  – Fiscal deficits
    • Annual operating deficit of $1.3 trillion in FY 2019
    • Toward 5.5 percent of gross domestic product (GDP) in 18-24 months
  – Spending
    • Large increase in defense and social outlays
    • Infrastructure: $3 trillion needed
    • Transportation-focused
    • National energy grid, telecommunications network upgrade unlikely
  – Regulation
    • Regulatory relief for banks with under $250 billion assets (Passed into law in May 2018)
      – Significant win for the middle market
      – Has not yet produced an increase in residential investment
      – Affordability, risk aversion
Total U.S. budget deficits or surpluses, 1968 to 2018

- $1.41 trillion deficit in 2009
- $236 billion surplus in 2000
- $779 billion deficit

Source: RSM US
Total U.S. budget deficit or surplus as a percentage of GDP

50-yr. average: 2.91%

9.8% in 2009

Surplus was equal to 2.3% of GDP in 2000

Source: RSM US
U.S. economic policy outlook: Government shutdown

• Government shutdown
  – Economic impact
    • $1 billion per week
    • At least 0.1 percent per week off GDP growth

  – Just a dress rehearsal!
    • U.S. debt ceiling next: August to November

  – Supplemental Nutrition Assistance Program (SNAP)
    • First government shutdown where SNAP may not be available
    • 40 million individuals
    • 20 million households
    • 23,000 military families
Millions at risk of losing food stamp benefits due to government shutdown

- US Citizens on Food Stamps: 40 Million
- 20-Year Average: 34 Million
- Current Cyclical Expansion Average: 43 Million

Source: RMS US, USDA
Financial conditions

• Narrower margins, volatility and rising wages
  – Equity volatility a concern
    • Volatility a proxy for disrupted cash flows due to trade policy
  – Corporate profits likely peaked following tax cuts
  – How to value companies with global supply chains?

• Global financial conditions remain a net positive for growth
  – US financial conditions ~1 standard deviations above neutral
  – Financial conditions important to watch given risk linked to trade policy

• Rate drivers
  – Long-term rates range between 2.75 percent and 3 percent in 2019
  – Growth positive relative to rest of world
  – US safe haven
Global financial conditions

- Bloomberg US Financial Conditions Plus=1.048
- Bloomberg European Financial Conditions= -0.56
- Bloomberg Asia Financial Conditions Excluding Japan=-1.844

Source: RSM US, Bloomberg
Recession probability rising

U.S. recession probability: 21.35%

Source: RSM US, New York Federal Reserve
The RSM US Middle Market Business Index eased in the Q4’18
U.S.-Global economic relations: Difficult period ahead

• U.S.-global trade friction: Major 2019 policy issue
  • This is the major risk to domestic economic outlook
    • China, EU, and auto tariffs
    • Will shave 0.3-0.4 percent off growth
    • Pricing to be impacted with upside risk to inflation
      - Reduction of purchasing power, competitiveness, rising prices
  - China-U.S.
    • Cease fire till March 1
    • Possible 25 percent on additional $267 billion by mid-2019
  - NAFTA modernization
    • First trade treaty that raises trade barriers
    • Higher prices for Canadians and American consumers
    • Mexico bears burden of adjustment
State imports from China

AS A PERCENTAGE OF TOTAL DOLLAR VALUE OF ALL IMPORTS

Source: RSM US
Foreign direct investment in U.S. industries: 2017

<table>
<thead>
<tr>
<th>Industry</th>
<th>Investment (in billions)</th>
<th>Percentage change from 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>$1,607.2</td>
<td>4.2%</td>
</tr>
<tr>
<td>Chemicals</td>
<td>$702.6</td>
<td>2.2%</td>
</tr>
<tr>
<td>Other manufacturing</td>
<td>$353.8</td>
<td>5.7%</td>
</tr>
<tr>
<td>Transportation equipment</td>
<td>$149.5</td>
<td>8.8%</td>
</tr>
<tr>
<td>Machinery</td>
<td>$101.7</td>
<td>7.0%</td>
</tr>
<tr>
<td>Food</td>
<td>$101.6</td>
<td>3.8%</td>
</tr>
<tr>
<td>Computers and electronic products</td>
<td>$81.9</td>
<td>1.8%</td>
</tr>
<tr>
<td>Primary and fabricated metals</td>
<td>$66.0</td>
<td>3.1%</td>
</tr>
<tr>
<td>Electrical equipment, appliances and components</td>
<td>$49.8</td>
<td>11.2%</td>
</tr>
<tr>
<td>Other industries</td>
<td>$672.4</td>
<td>10.9%</td>
</tr>
<tr>
<td>Finance (except depository institutions) and insurance</td>
<td>$538.9</td>
<td>5.9%</td>
</tr>
<tr>
<td>Wholesale trade</td>
<td>$425.4</td>
<td>13.7%</td>
</tr>
<tr>
<td>Professional, scientific and technical services</td>
<td>$212.0</td>
<td>2.4%</td>
</tr>
<tr>
<td>Depository institutions (banking)</td>
<td>$205.6</td>
<td>4.0%</td>
</tr>
<tr>
<td>Information</td>
<td>$184.1</td>
<td>6.5%</td>
</tr>
<tr>
<td>Real estate and rental and leasing</td>
<td>$90.8</td>
<td>13.0%</td>
</tr>
<tr>
<td>Retail trade</td>
<td>$88.6</td>
<td>17.3%</td>
</tr>
<tr>
<td><strong>ALL INDUSTRIES</strong></td>
<td><strong>$4,025.4</strong></td>
<td><strong>6.9%</strong></td>
</tr>
</tbody>
</table>
World Trade Organization complaints by country

<table>
<thead>
<tr>
<th>Country that filed dispute</th>
<th>Countries that have joined dispute</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COUNTRY THAT FILED DISPUTE: DATE FILED</strong></td>
<td>Canada</td>
</tr>
<tr>
<td>1. China</td>
<td>4/5</td>
</tr>
<tr>
<td>2. India</td>
<td>5/18</td>
</tr>
<tr>
<td>3. Canada</td>
<td>6/1</td>
</tr>
<tr>
<td>4. EU</td>
<td>6/1</td>
</tr>
<tr>
<td>5. Mexico</td>
<td>6/5</td>
</tr>
<tr>
<td>6. Norway</td>
<td>6/12</td>
</tr>
<tr>
<td>7. Russia</td>
<td>6/29</td>
</tr>
<tr>
<td>8. Switzerland</td>
<td>7/9</td>
</tr>
<tr>
<td>9. Turkey</td>
<td>8/15</td>
</tr>
</tbody>
</table>

Source: RSM US
U.S. economic outlook

• Policy normalization amid low rate structure
  – Central Bank
    • Fed on pause for first six months of 2019
    • Fed forecasting 2 rate hikes in 2019
    • Balance sheet “normalization” in process
      – $50 billion in balance sheet reduction per month
  – Interest rates
    • Flat yield cure
    • 10-year to trade between 2.7 to 3 percent
  – Inflation
    • Core personal consumption expenditures (PCE) inflation at 2 percent target, consumer price index (CPI) at or above 2.25 percent
      – 1H’19: Soft inflation due to falling oil prices in late 2018
    • Tight labor market to have impact on inflation 2019-2020
    • Fiscal operations likely to push inflation and bond yields much higher over the medium to long term
Direction of Fed policy rate

Source: RSM US, Bloomberg
U.S. yield curve
U.S. inflation outlook: policy variables

Source: RSM US, Bloomberg
U.S. inflation outlook: Expectations

Inflation expectations well anchored

Source: RSM US, Bloomberg
U.S. economic outlook

• Global risks to the outlook
  – Brexit
    • March 2019: Heading towards a hard Brexit
    • Elevated risk of global financial turmoil
  – Emerging market crisis
    • Italy, Turkey, Argentina
    • China slowdown elevates emerging market risk
  – China debt dynamics
    • Longer-term risk
Brexit scenarios possible economic effects

- Brexit deal agreed for 29.03.19
- Creative Brexit
- No Deal Hard Brexit
- No Deal with change of government

<table>
<thead>
<tr>
<th>Economic Indicator</th>
<th>Current levels</th>
<th>Brexit deal agreed for 29.03.19</th>
<th>Creative Brexit</th>
<th>No Deal Hard Brexit</th>
<th>No Deal with change of government</th>
</tr>
</thead>
<tbody>
<tr>
<td>£/$ FX</td>
<td>1.3</td>
<td>1.4</td>
<td>1.7</td>
<td>1.1</td>
<td>1.0</td>
</tr>
<tr>
<td>UK interest rates (%)</td>
<td>0.8</td>
<td>0.8</td>
<td>0.5</td>
<td>0.3</td>
<td>-0.7</td>
</tr>
<tr>
<td>GDP level (£'000,000)</td>
<td>1.3</td>
<td>1.5</td>
<td>1.7</td>
<td>2.5</td>
<td>2.1</td>
</tr>
<tr>
<td>UK inflation (%)</td>
<td>2.1</td>
<td>1.5</td>
<td>2.1</td>
<td>3.0</td>
<td>3.7</td>
</tr>
<tr>
<td>Employment level (%)</td>
<td>4.1</td>
<td>4.1</td>
<td>4.4</td>
<td>4.0</td>
<td>4.9</td>
</tr>
<tr>
<td>Wage movement</td>
<td>1.6</td>
<td>1.0</td>
<td>1.6</td>
<td>1.1</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Source: RSM US
China’s debt problem

Source: RSM US, Bloomberg
Production and manufacturing

• Industrial production and manufacturing
  – Noticeable deceleration in U.S. and global manufacturing
    • Auto production, sales easing on rising rates and sagging demand
      – Tariffs a risk to the sector
      – NAFTA modernization
  
  • U.S. Institute for Supply Management (ISM) Manufacturing Index
    – Some pulling forward of activity to avoid tariffs so a risk of payback in near term

• Global demand easing
  – Collateral damage linked to U.S.-China trade spat
Auto inventories elevated

Source: RSM US, Bloomberg
Manufacturing slowing

Source: RSM US, Bloomberg
Global manufacturing: Collateral damage

Source: RSM US, Bloomberg
Housing outlook

• Housing shortage growing
  – On average about 250,000 units short of full potential
  – Carries implications for inflation

• Four problems
  – Lack of available lots
  – Affordability issues
  – Shortage of skilled workers
  – Regulatory costs

• Homeowners staying put
  – Lack of supply
  – Rising prices
Residential investment recovery

Source: RSM US, Bloomberg

1.5 million at an annualized pace
Housing affordability

Source: RSM US
Global manufacturing: Collateral damage

Source: RSM US, Bloomberg
Business considerations

**Supply chain**
- Supply chain mapping
- NAFTA/WTO tariff review
- Customs declarations infrastructure
- Inventory levels and working capital

**Licences and regulation**
- Trade marks and intellectual property
- Contract reviews/re-negotiation

**Banking**
- International debt exposure
- Cash management and FX exposure
- International accounts and lending lines

**Macro**
- Geo-political risk analysis
- Global risks exposure
- Business structure

**Productivity and efficiency**
- Automation
- Top-down review
- Diversification

**Budgetary**
- Price shocks: labor costs, supply chains
- Evaluate import/export additional cost
- Lead time delays
- Insurance adequacy

**Talent**
- Staff requirements

**Financial modelling/stress testing**

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Thank you

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Mark your calendar

RSM Annual State and Local Government Accounting Update
Tuesday, April 16
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