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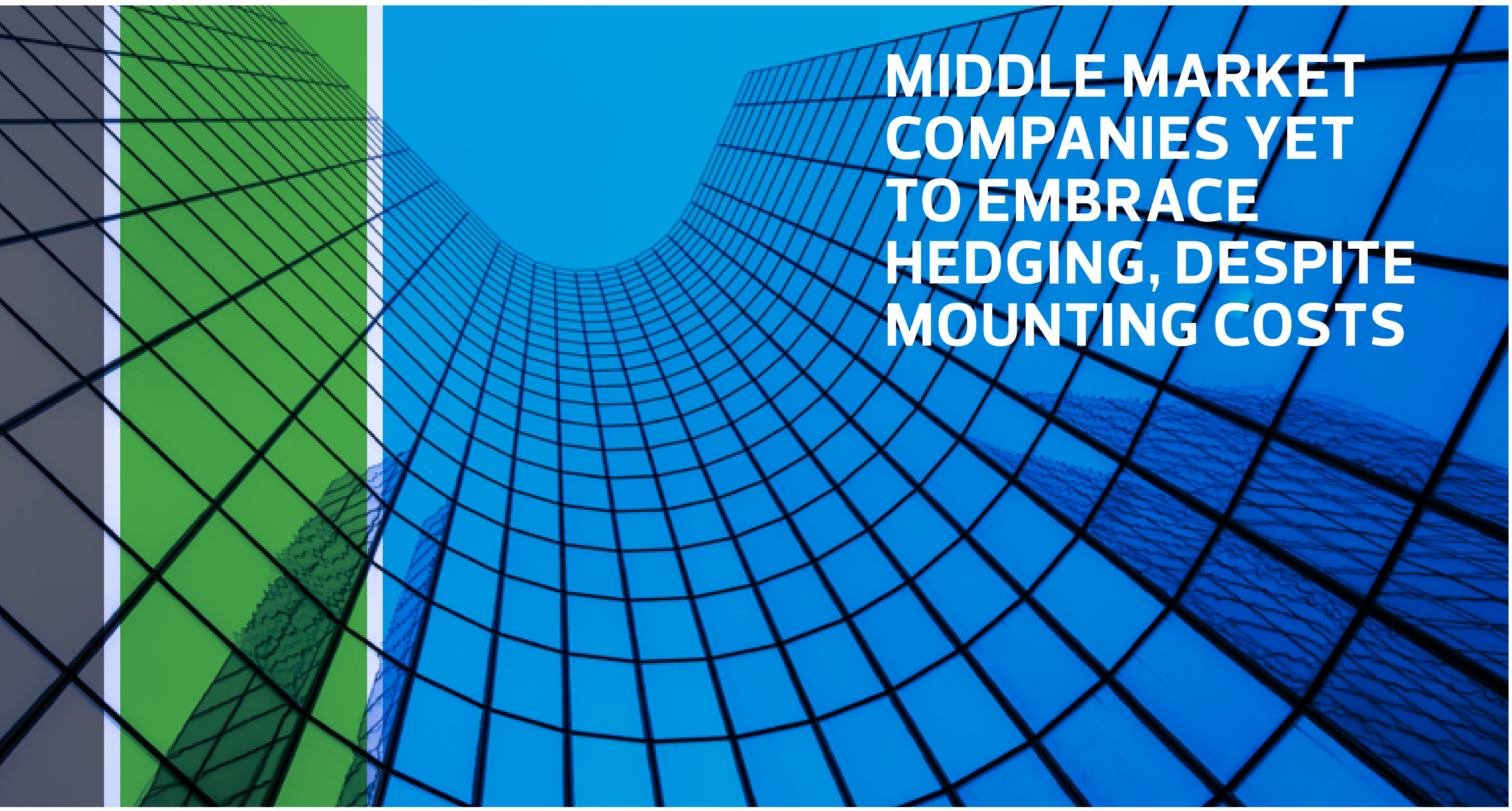

MIDDLE MARKET COMPANIES YET TO EMBRACE HEDGING, DESPITE MOUNTING COSTS

ALSO IN THIS ISSUE:

OH, SNAP! THE ECONOMIC AND POLITICAL **COSTS OF NOT PAYING FOOD STAMP BENEFITS** DURING THE GOVERNMENT SHUTDOWN

REAL GDP GROWTH POINTS TO SUB-2 PERCENT

ESG INVESTMENT RISES, BUT TRACKING METHODS FALL SHORT

THE POWER OF BEING UNDERSTOOD
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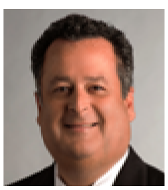
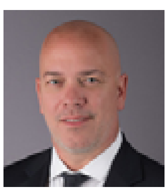
ABOUT THE **AUTHORS**

Our thought leaders are professionals with years of experience in their fields who strive to help you and your business succeed. Contributors to this issue include:



Joseph Brusuelas
Chief Economist
RSM US LLP



Kevin Depew
Deputy Chief Economist
RSM US LLP

Anthony DeCandido
Financial Services Senior Analyst
RSM US LLP

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MIDDLE MARKET COMPANIES YET TO EMBRACE HEDGING, DESPITE MOUNTING COSTS

By Kevin Depew

Despite mounting cost pressures on their supply chains, just a fraction of middle market companies appear to be hedging commodity prices for the longer term, recent RSM research shows.

Nearly 70 percent of executives surveyed in the proprietary RSM US Middle Market Business Index survey said they paid more for goods and services in the fourth quarter, up from 59 percent in the most-recent period. Yet only 14 percent of that cohort said they are instituting hedging strategies for steel, aluminum, lumber and other essential inputs in their supply chains.

"This is a worrisome indicator that the middle market may not yet be accepting the likelihood inflationary pressure will continue to build in 2019," says RSM US LLP Chief Economist Joseph Brusuelas. "We fully expect the Federal Reserve to continue additional rate hikes in 2019 that will likely lead to steeper pricing for commodities and tighter margins for medium-sized businesses, and signal a move into restrictive monetary policy."

Adding to the pressure on inputs, Brusuelas says, have been moves by the current administration to institute tariffs on a range of imported goods, primarily from China, the United States' largest trading partner.

In June, the administration instituted its first round of steep tariffs on imported steel and aluminum, marking the opening salvo in an ongoing trade dispute that has led to subsequent duties on a long list of imported goods. In early December, the administration agreed not to impose additional increases on existing tariffs scheduled for Jan. 1, 2019, pending further negotiation.

The cost of benchmark hot-rolled steel is up 9 percent year-over-year as of Jan. 10 to $726 per ton. Aluminum is down 17.57 percent to $1,831. 25 per metric ton during the same period.

EXECUTIVES OF MIDDLE MARKET COMPANIES SAID THEY ARE DEPLOYING A HOST OF STRATEGIES TO COPE WITH THEIR RISING COSTS

Coping strategies for middle market businesses

Executives of middle market companies said they are deploying a host of strategies to cope with their rising costs: top among them was increasing their companies' focus on maintaining profit margins (62 percent); and investing to increase efficiencies and productivity (59 percent).

Industries ranging from automakers to housing have registered the effects of higher input costs. General Motors said in November it planned to shutter five plants in the United States and Canada and lay off 14,000 workers, beginning in June 2019.

MIDDLE MARKET INSIGHT
Middle market companies dependent on commodity inputs with exposure to tariffs should implement a long-term hedging strategy to lock in stable pricing.

Meanwhile, labor costs are also pressuring the bottom line. As unemployment continues to track at record lows below 4 percent, midsize companies struggle to find qualified workers and have been forced to boost wages. Nearly 60 percent of executives polled in the MMBI survey said they expect to pay higher labor costs over the next six months.

These rising cost pressures add up to uncertainty heading into 2019, with only slightly more than half of executives polled by RSM expecting the economy to improve over the next six months; that's down sharply from 73 percent who registered optimism in the first quarter of 2018.

Says one survey respondent of rising costs: "This has been one of our biggest areas of concern. Raw material goods such as lumber, steel and other (items) have risen dramatically, and access to certain products is more limited."

Oh, SNAP!

THE ECONOMIC AND POLITICAL COSTS OF NOT PAYING FOOD STAMP BENEFITS DURING THE GOVERNMENT SHUTDOWN

By Joseph Brusuelas

As the U.S. government shutdown moves through its fourth week, it is becoming increasingly likely that outlays to sufficiently fund food stamps, better known as the Supplemental Nutrition Assistance Program, will run out this month. Some 40 million individuals in 20 million low-income households will be cut off from support. The SNAP program serves all 50 states and the military. Currently, 23,000 military households receive SNAP assistance.

The impact on the broader economy would be profound, and the middle market will not be immune from the disruption. Should the shutdown extend to one year, our economic analysis of SNAP cessation suggests a direct loss of $60.6 billion and an indirect loss of $48.5 billion. Depending on one's estimate of the multiplier, losses to GDP will vary from .53 percent (1.8 multiplier) to 1.03 percent (3.5 multiplier).

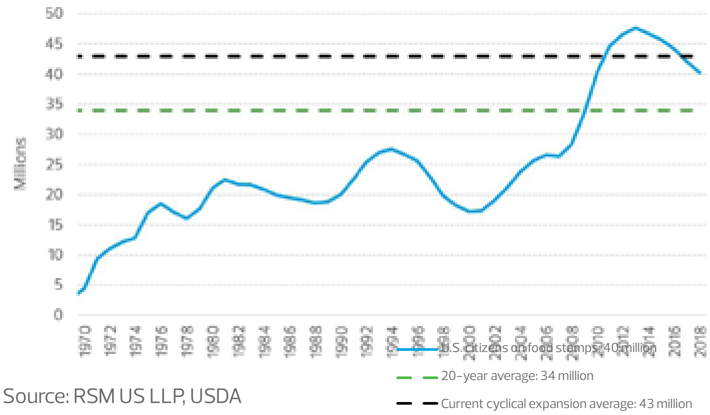
> SHOULD A SHUTDOWN EXTEND TO ONE YEAR, OUR ECONOMIC ANALYSIS OF SNAP CESSATION SUGGESTS A DIRECT LOSS OF $60.6 BILLION AND AN INDIRECT LOSS OF $48.5 BILLION.

Participation in SNAP has been declining since the depths of the Great Recession as the economic recovery has taken hold (see Figure 1), and as more households have been able to rejoin the labor force. However, a look at the data demonstrates that even amid a near decade-long economic expansion, the number of individuals on SNAP assistance has not declined to pre-recession levels. While there are roughly 40 million individuals on assistance, that number stands well above the 20-year average of 34 million, and just below the cyclical average of 43 million. The potential impact on roughly 14 percent of the U.S. population should make shutting down the government untenable.

OH, SNAP! continued.

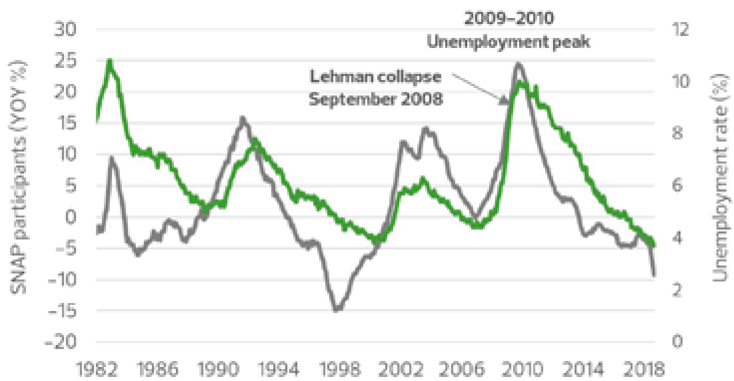
As you would expect, with less than 4 percent of the labor force currently unemployed—which is well below the 4.6 percent level that we consider to be the natural level of unemployment—participation in the SNAP program is falling at a yearly pace of 9 percent, according to the latest month's data from the U.S. Department of Agriculture (see Figure 2).

Figure 1 – The level of participation in SNAP has been declining during the recovery from the Great Recession



Source: RSM US LLP, USDA

Figure 2 – The rate of growth of SNAP participation coincides with trends in the unemployment rate

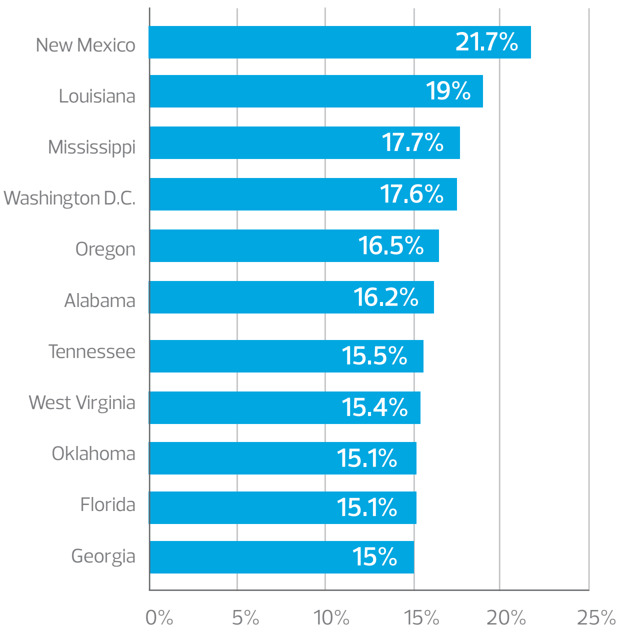


Source: RSM US LLP, USDA

While the states with the highest proportion of the population dependent on food stamps (15 percent or more) are predominantly in the South (see Figure 3), according to analysis by the Center on Budget and Policy Priorities (CBPP), the states with the most participants are those with large populations (see Figure 4). This essentially points to serious economic pain across the GOP electoral heartland should an agreement to reopen the government not be reached soon.

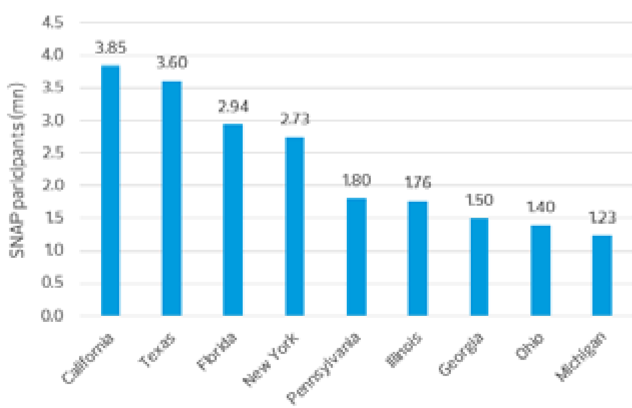
MIDDLE MARKET INSIGHT
Retailers and other businesses employing workers utilizing the SNAP program should be aware of potential labor disruptions resulting from instability caused by the program's cessation.

Figure 3 – States with at least 15 percent of the population participating in SNAP



Source: RSM US LLP, USDA

Figure 4 – States with 1 million or more SNAP participants as of September 2018



Source: RSM US LLP, USDA

Economic cost of not funding SNAP

The economic cost of not funding SNAP can be divided into direct and indirect losses. Assuming that households spend all of their SNAP benefits available to them, and that they will be unable to find additional funds to pay for those food expenses, the loss of SNAP spending by households implies a direct yearly loss to GDP of $60.6 billion. For example, if one estimates that every dollar of SNAP spending generates $1.80 of further spending by the rest of the economy (according to estimates by the CBPP), there will be knock-on losses of an additional $42.4 billion for a total loss of about $103 billion, or 0.53 percent of GDP, over one year. Because the political authority is talking about the shutdown lasting months or even years, we think that this baseline estimate should begin to incorporate that into official growth and employment estimates going forward.

Figure 5 – Estimates of direct and indirect loss of SNAP spending

	Multiplier	Yearly values	
Direct loss		60,609	US$ million
Indirect loss	1.8	42,427	US$ million
Total loss		103,036	US$ million
Nominal GDP (Q3 2018) (seasonally adjusted annual rate)		20,658	US$ billion
Loss in nominal GDP		0.53%	

Source: RSM US LLP

Furthermore, the loss of SNAP benefits is not likely to have a one-off impact on GDP growth. Like the effects of a lost day of work, a lost meal can never be recovered or made up for by two meals next month when benefits resume. And, like long-term unemployment, the indirect effects of hunger have far-reaching consequences that will lead to generational diminishment of the quality of the labor force.

REAL GDP GROWTH POINTS TO **SUB-2 PERCENT: NEW RSM INDEX**

By Joseph Brusuelas and Kevin Depew

Our new RSM monthly index of real GDP growth in the U.S. economy points to a return to below 2 percent growth in the near-term. The results, in line with our current baseline expectation for 2019 and 2020, were derived after applying forecasts of key economic indicators to determine baseline projections for U.S. real GDP growth for the coming two years.

The new index is based on a subset of monthly economic indicators used by the National Bureau of Economic Research (NBER) to determine the beginning and end of U.S. business cycles. The advantage of using this data over the quarterly national accounts values of real GDP growth is the timeliness of monthly indicators that are, for the most part, accessible and understandable to all market and industry participants.

We will now include this timely monthly index of real GDP growth in each monthly issue of *The Real Economy* (click here to subscribe).

The six indicators (and their sources) used in the model are:

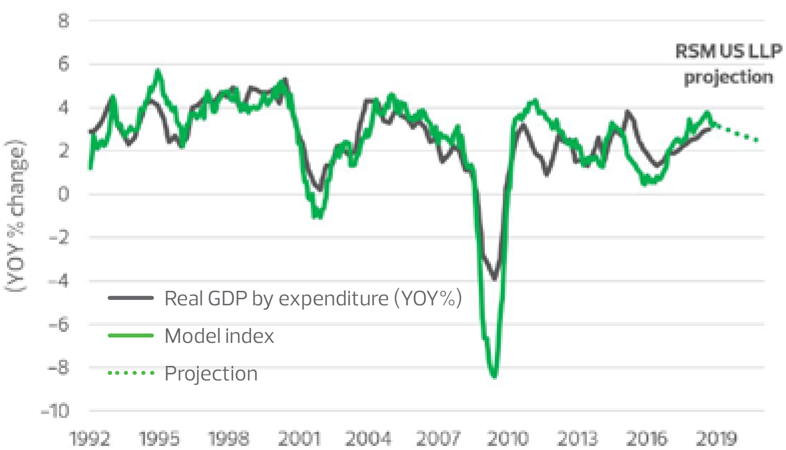
1. Industrial production (Federal Reserve)
2. Manufacturing and trade sales (Census)
3. Real consumer spending (Bureau of Economic Analysis)
4. Real disposable personal income (Bureau of Economic Analysis)
5. Aggregate hours worked (Bureau of Labor Statistics)
6. Number of payroll employees (Bureau of Labor Statistics)

As NBER's choice of these indicators changes over time, we anticipate modifying our index accordingly.

The variables in the model are represented in year-over-year percent change terms, with smoothing applied to the consumer spending and disposable personal income indicators. Note that the model has over predicted the rate of growth of real GDP by only 0.2 percentage points on average in the post-crisis era (2010-2018), but over predicted the 3.0 percent third-quarter 2018 growth rate by 0.6 percentage points (We expect that difference to diminish as the smoothing works its way through the consumer sector).

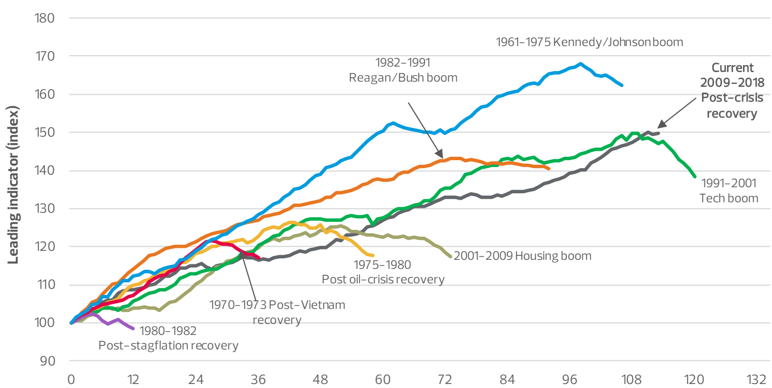
After a year of above-average growth, our projections assume that growth rates of the indicators included in our model will mean revert over the course of 2019 and real GDP growth will move toward a 1.8 percent to 2.0 percent yearly pace. We expect the historically long expansion to begin to unwind in the face of the following: threats of disruptions to the global supply chain; investment uncertainty due to rising interest rates (both at the front-end of the yield curve as the Federal Reserve continues its program of normalizing interest rates, and at the long end of the yield curve as the market begins pricing in the impact of servicing an outsized budget deficit); and as the unwinding of this year's fiscal stimulus becomes a drag on growth.

U.S. real GDP growth and RSM monthly index of economic activity



Source: BEA; BLS; Census; Bloomberg; RSM US LLP

U.S. economic recoveries in the months after recessions
(Rebased leading indicator values from business cycle troughs to peaks)



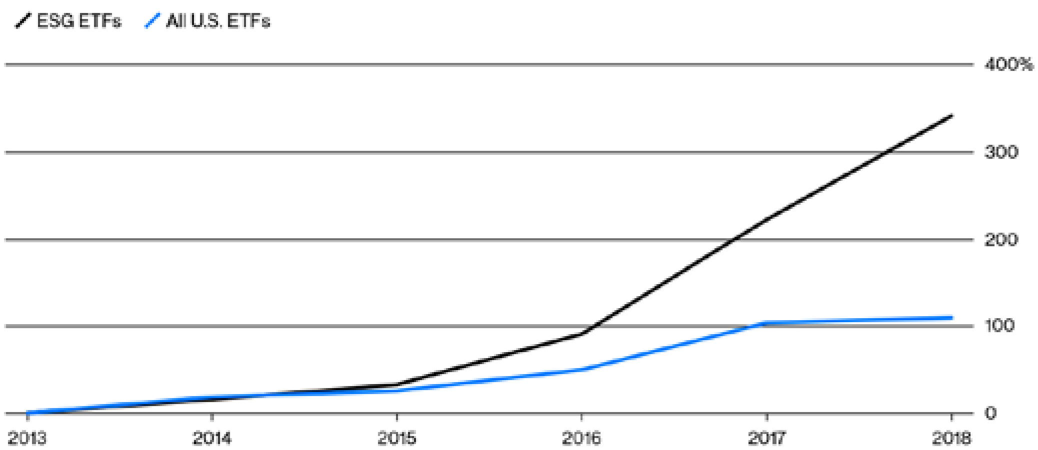
Source: NBER; Conference Board; Bloomberg; RSM US LLP

ESG INVESTMENT RISES, BUT TRACKING METHODS FALL SHORT

By Anthony DeCandido

Investing in companies whose mission includes environmental, social and corporate governance (ESG) is growing in popularity but there is still no consensus among asset managers and investors on how best to report ESG performance. According to the Forum for Sustainable and Responsible Investment, ESG-managed investments represent $11.6 trillion of alternative assets, or one in every four dollars invested, up 44 percent from $8.1 trillion in 2016. ESG reporting—which tracks everything from a business's impact on local community to its use of green energy—has been added to most due diligence questionnaires and the number of allocators requiring ESG has grown. An RSM US LLP report on corporate social responsibility found that 39 percent of middle market executives are familiar with ESG criteria to evaluate their own organizations. Yet uniform reporting requirements do not exist.

Assets in ESG funds have surged since 2015



Source: Bloomberg

Companies that implement ESG practices are perceived to achieve better business results; investment managers have jumped on this trend and implemented ESG investment strategies at a growing rate. Approximately one-third of asset managers have at least one person dedicated to ESG investing, according to surveys conducted by Bloomberg. And investment performance isn't the only motivator. Investment advisors pushing ESG are compensated with higher fees when they manage more capital; meanwhile, large endowments, pension plans and insurance carriers increasingly have ESG capital allocation targets as public demand for corporate transparency increases.

THE EMERGENCE OF MILLENNIALS AS THE MAJORITY AGE GROUP IN THE GLOBAL POPULATION HAS PUSHED INVESTING PREFERENCES TOWARD COMPANIES WITH ESG INITIATIVES.

The emergence of millennials as the majority age group in the global population has pushed investing preferences toward companies with ESG initiatives. Millennials increasingly stress social impact alongside fiscal performance, so asset managers must pursue deals that are both financially attractive and simultaneously drive social change. According to Bloomberg, millennials are set to inherit some $30 trillion in the coming decades, indicating that this new investment preference is unlikely to change and that there is a clear business case for improved ESG reporting.

Reporting challenges

The 2017 CFA Institute's ESG Survey found that 67 percent of analysts want ESG data to be verified by third parties, but only a few providers actually take this step. There are several additional challenges, however, that need to be addressed before the widespread application of ESG data within asset management.

First, most managers self-report, which creates implicit biases for the type of information they are likely to share with investors. Because nearly all affect measurements fall outside of U.S. reporting standards, questions arise about the quality of the data being sourced. Without a standard framework, ESG measurement may be interpreted very differently from one business to another. Meanwhile, managers are incentivized to promote ESG practices as a marketing tactic rather than a measure of true social impact. Worse yet, it's questionable whether investor due diligence is strong enough to unearth poor ESG behaviors.

How to report ESG impact

The lack of authoritative guidance on which measurements or disclosures should be presented to investors makes it unclear how to best report impact. There is a stark difference between process-oriented reporting such as occupational safety and health practices versus quantitative reporting such as board diversity. Also, there are far too many ESG focus areas for one, or even a few, measurements to comprehensively apply. Topics such as safety, infrastructure, clean water, tobacco, climate change and gender diversity each warrant their own customized reporting and disclosure. Consider the annual report for a public company: it calls for certain standard financial reporting plus management discussion and analysis. One can argue that ESG reporting should be no different than public company reporting.

To be sure, the Sustainability Accounting Standards Board (SASB) was developed to identify, manage and report on financially material global sustainability topics, but widespread adoption by asset managers has not occurred. SASB standards were developed using extensive feedback from companies, investors and other market participants as part of a transparent, public-documented process. They have gained traction, with public figures like Michael Bloomberg advocating for them.

Notably, asset managers currently disclose internal rates of return and other expense ratios—financial highlights to help investors make business decisions. These financial statements do not include other important, nonfinancial information such as the mission, purpose or strategy of ESG practices, nor do they include measurements of environmental or social impact. Yet including such information would enable stakeholders to gauge performance based on a company's ESG strategy and not merely on financial analysis alone.

Managers and investors stand to benefit from increased transparency regarding the impact of ESG investing and the social, environmental, and economic consequences of its strategies. Sharing this information helps managers and investors build trust in the marketplace, monitor and mitigate risk, and find other, more innovative ways to drive efficiency. This, in turn, drives a positive impact on financial results, the enduring purpose of all asset managers.

For more information on RSM, please visit **www.rsmus.com**.

For media inquiries, please contact Terri Andrews, National Public Relations Director, +1 980 233 4710 or terri.andrews@rsmus.com.

For more information on RSM thought leadership, please contact Deborah Cohen, Thought Leadership Director, +1 312 634 3975, deborah.cohen@rsmus.com.

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