

# 2016 ECONOMIC AND RISK OUTLOOK



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# Presenters



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# 2016 OUTLOOK



# U.S. Outlook

- **Base Case: Trend U.S. growth near 2.2 percent in 2015**
  - Deceleration in Q1 to 0.6 percent followed by Q2 rebound of 3.9%
    - Household consumption tracking at 3.6%
    - Third quarter growth likely to arrive near 1.1%
      - Slower pace of inventory building a 1.5 ppt drag on growth
      - Drag from widening trade deficit of 0.5%
      - Manufacturing sector and stronger dollar
      - Focus on real final demand which should be near 3.5%
    - Fourth quarter rebound to near 2.7%
  - **Growth Drivers**
    - Employment: gains near 2015 trend of 198,000 to continue
    - Consumer outlays: strong demand for services and autos
    - Solid residential investment
    - Financial conditions: private credit creation up 6%

# U.S. Outlook

- **Inflation and Rate Drivers**

- Inflation remains muted, below 2 percent central bank target
- Long-term rates remain in range between 2.0 and 2.25 percent
  - Rate drivers
    - Policy divergence among global central banks
    - Investor expectations in growth, inflation and employment
    - Capital flows from EU, Asia and EM space to keep rates low
    - Fed rate hike December 2015 or March 2016

# U.S. Outlook

- **Energy Costs**
  - Oil to remain near recent levels and oversupply conditions persist
  - Natural gas prices at or near historic low levels
- **Commodity Prices**
  - Weak global demand as China and emerging markets rebalance economies
  - Stronger dollar to weigh on demand for commodities
- **Residential Real Estate**
  - Housing starts moving to 1.2 million annualized pace
- **Commercial Real Estate**
  - Solid expansion with cap rates near cyclical lows

# U.S. Outlook

- **Risks to the Outlook**

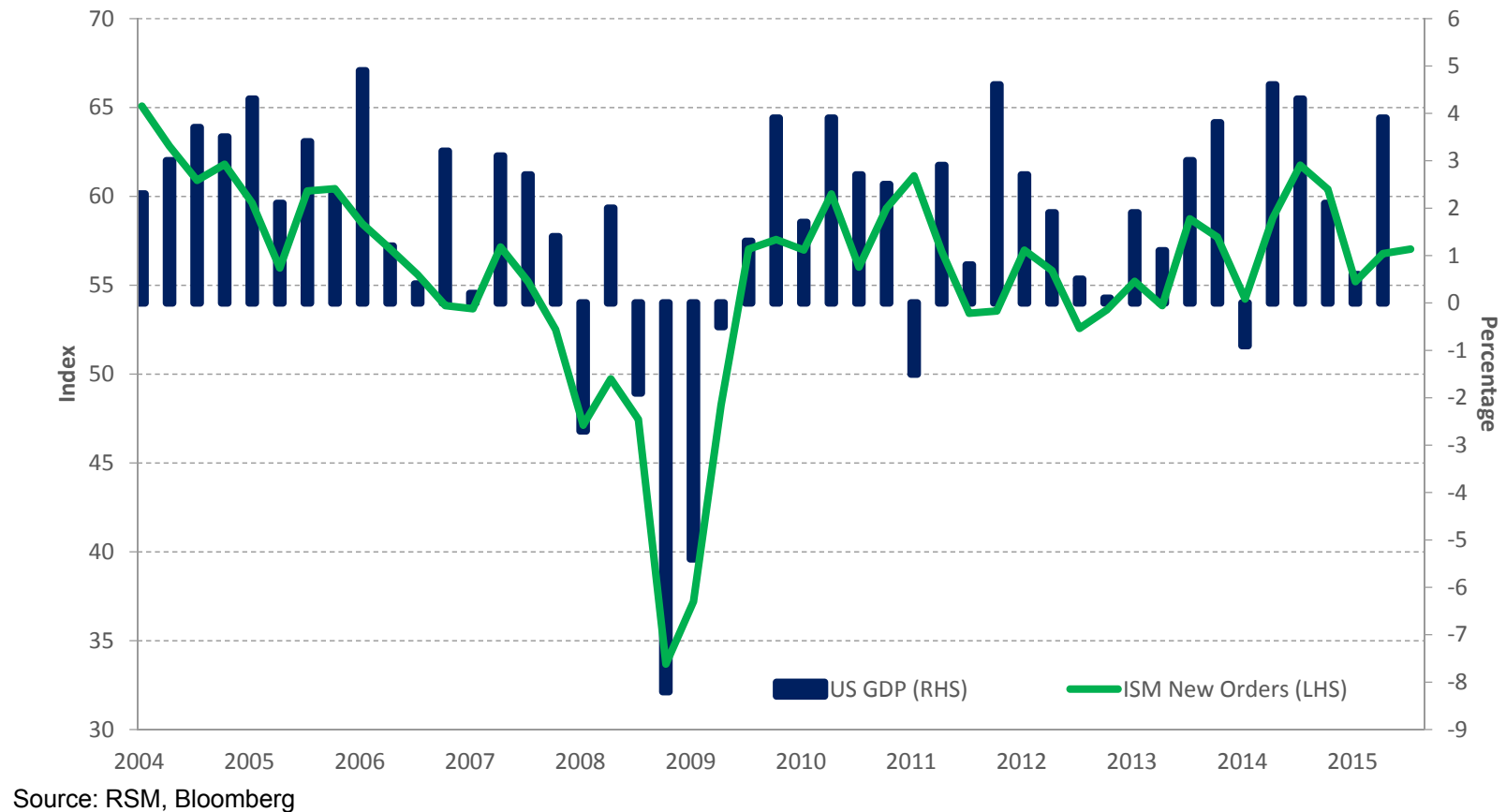
- Slowing external demand
- Chinese secular growth deceleration
- Emerging markets slowdown due to softer demand from China
- Persistent European economic weakness
- Policy errors in Washington D.C.

# U.S. Growth Forecast 2015-2017

	Q1'15	Q2'15	Q3'15	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16	2017
Real GDP	0.6	3.9	1.1	2.7	2.6	2.7	2.8	2.9	2.5
Unemployment	5.6	5.4	5.2	5	4.9	5	4.9	4.7	4.5
CPI	-0.1	0	0.2	1	1.8	1.9	2	2.1	2.3
PCE Core	1.3	1.3	1.3	1.4	1.6	1.7	1.8	1.9	2
Central Bank Rate	0.25	0.25	.25	.25	.25	.50	.50	.75	1
3-Month Rate	0.27	0.28	0.32	0.59	.84	1.11	1.36	1.4	1.6
2-Year Note	0.56	0.64	0.63	1.05	1.29	1.34	1.5	1.63	1.95
10-Year Note	1.92	2.35	2.04	2.19	2.25	2.35	2.5	2.60	3.0
EUR/USD	1.07	1.11	1.07	1.08	1.07	1.07	1.07	1.06	1



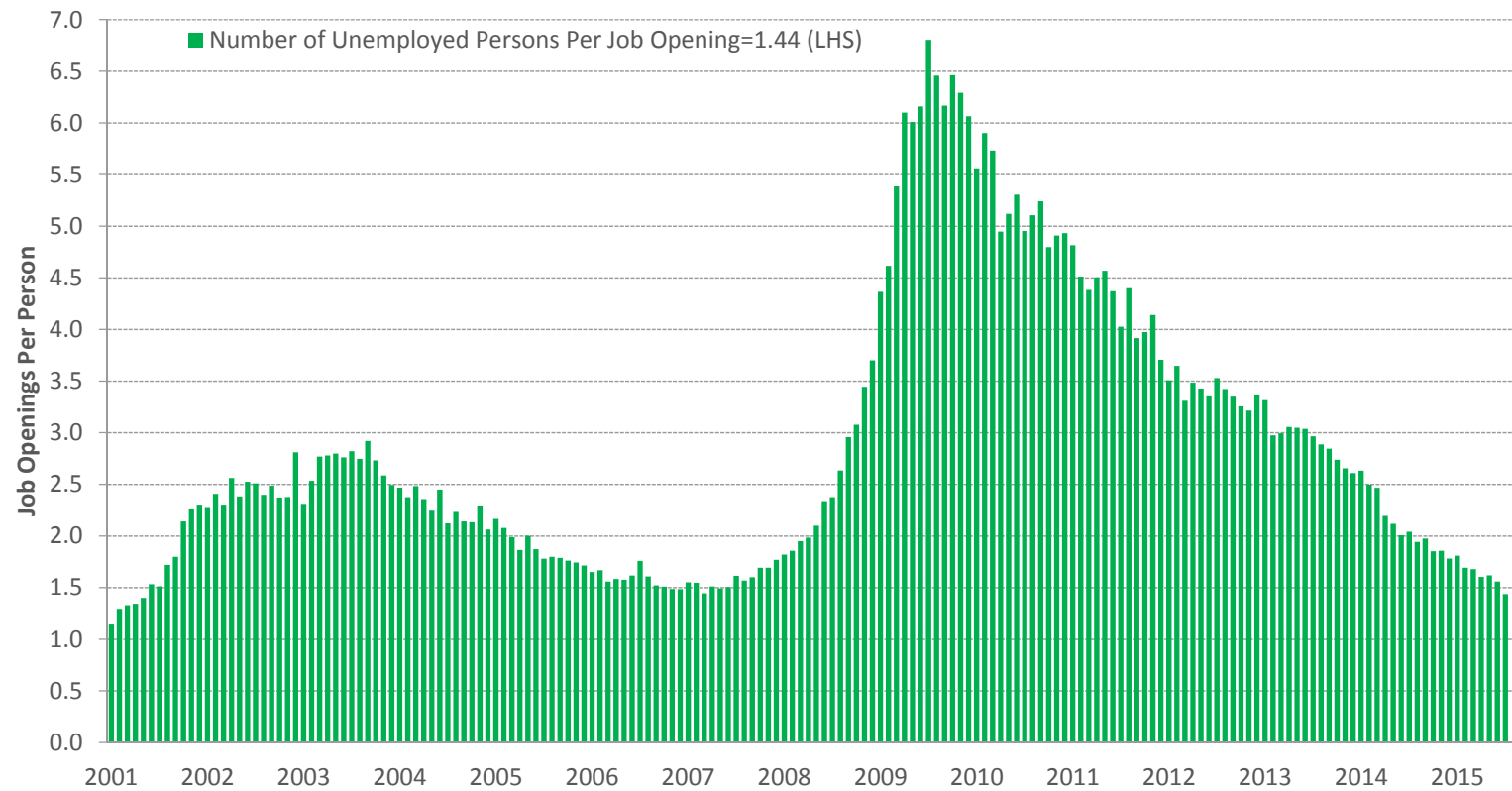
# U.S. Growth & Manufacturing



# U.S. Employment & Consumption Outlook

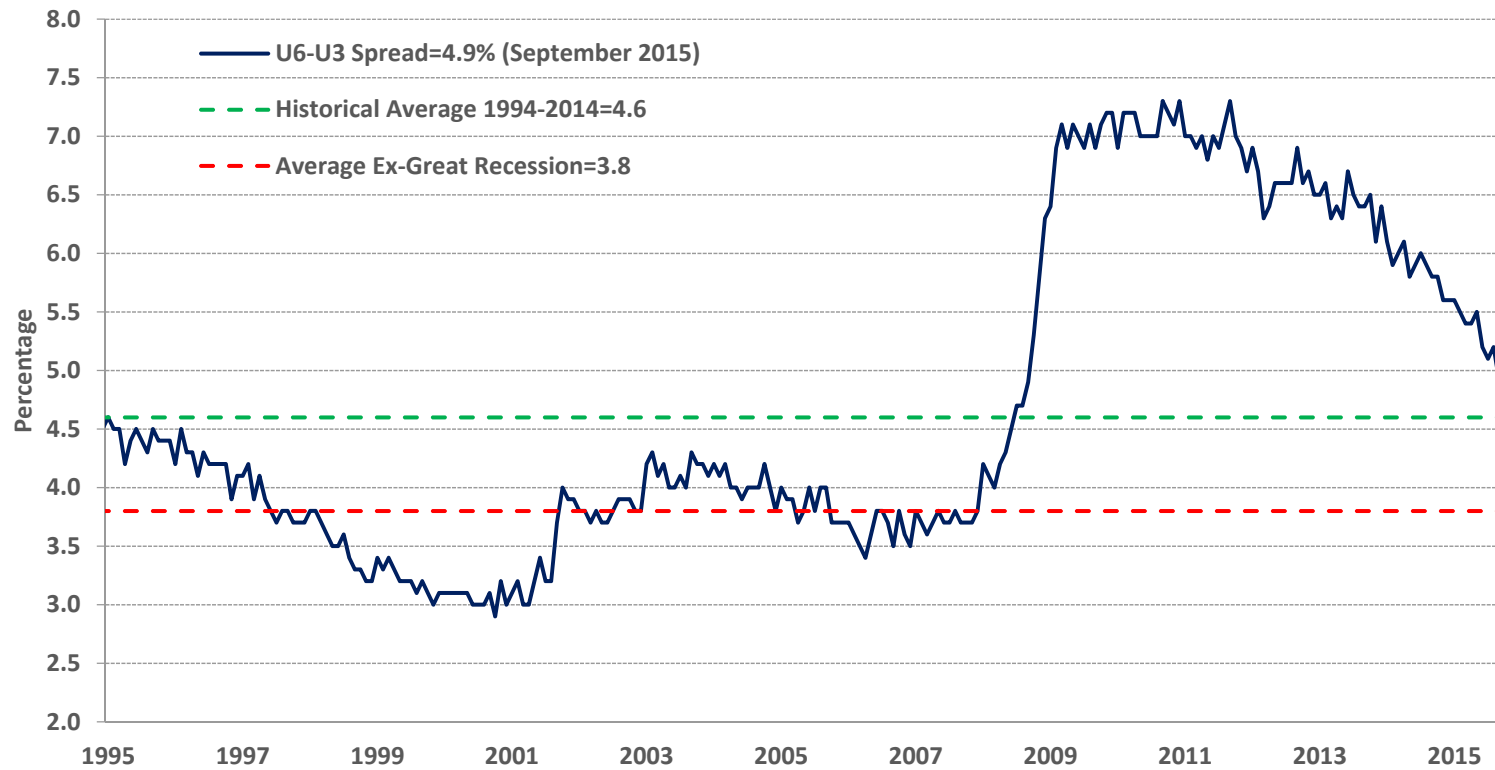
- **Hiring improves, unemployment slowly declines**
  - Individuals re-entering the labor force cause of falling unemployment rate
  - Underlying trend in job growth of 175,000 to 200,000 per month likely to continue
  - Hiring of roughly 100,000 per month sufficient to bring down unemployment rate
- **Composition of hiring improves**
  - Higher-wage jobs outpacing low-wage hiring
  - Middle market employers the main driver in hiring
  - Wage pressure building
- **Consumption**
  - Inflation adjusted spending averaged is 3.2% over past year

# Labor Market Tightening



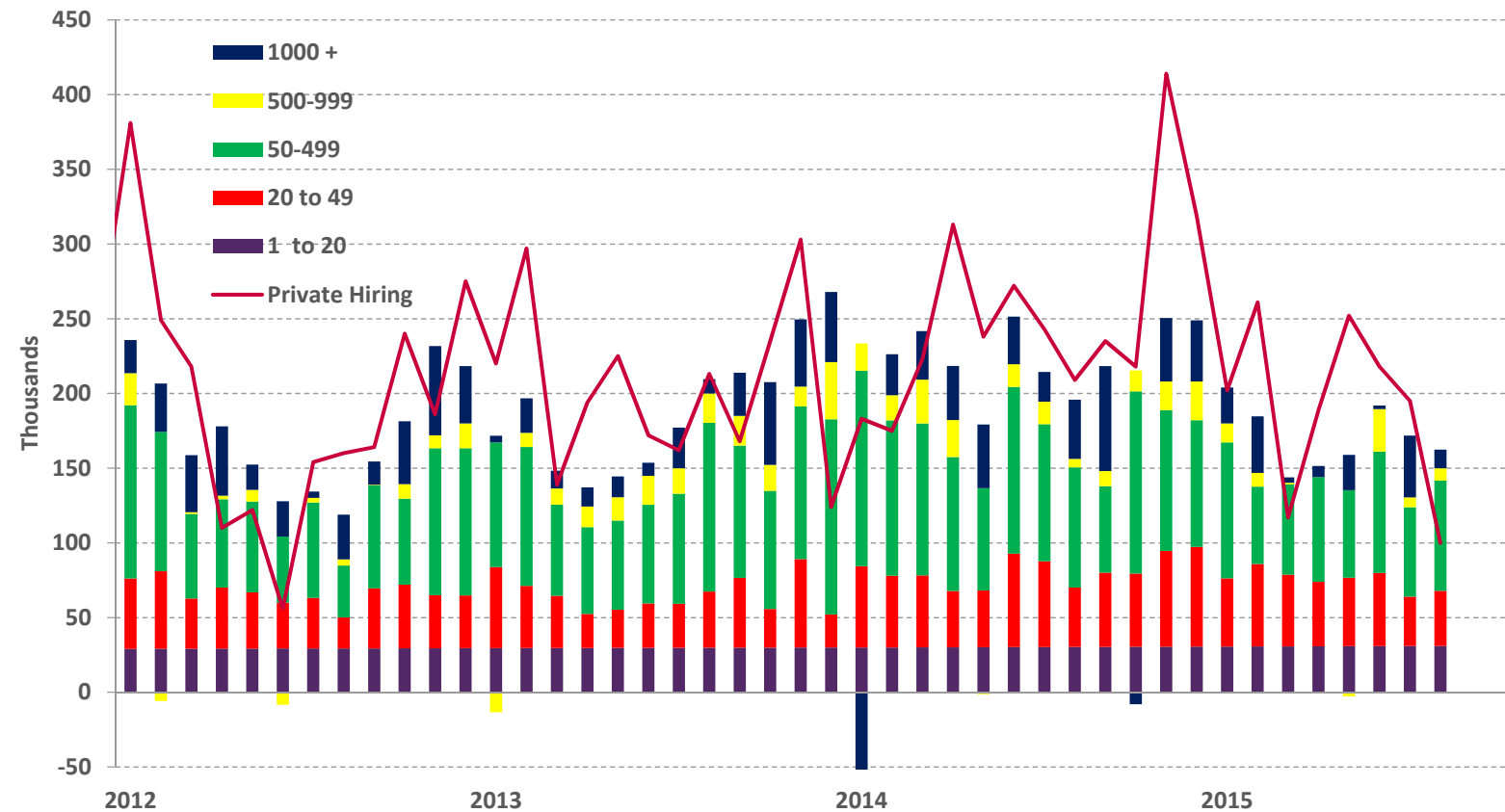
Source: RSM, BLS

# Labor Market Tightening



Source: RSM, BLS

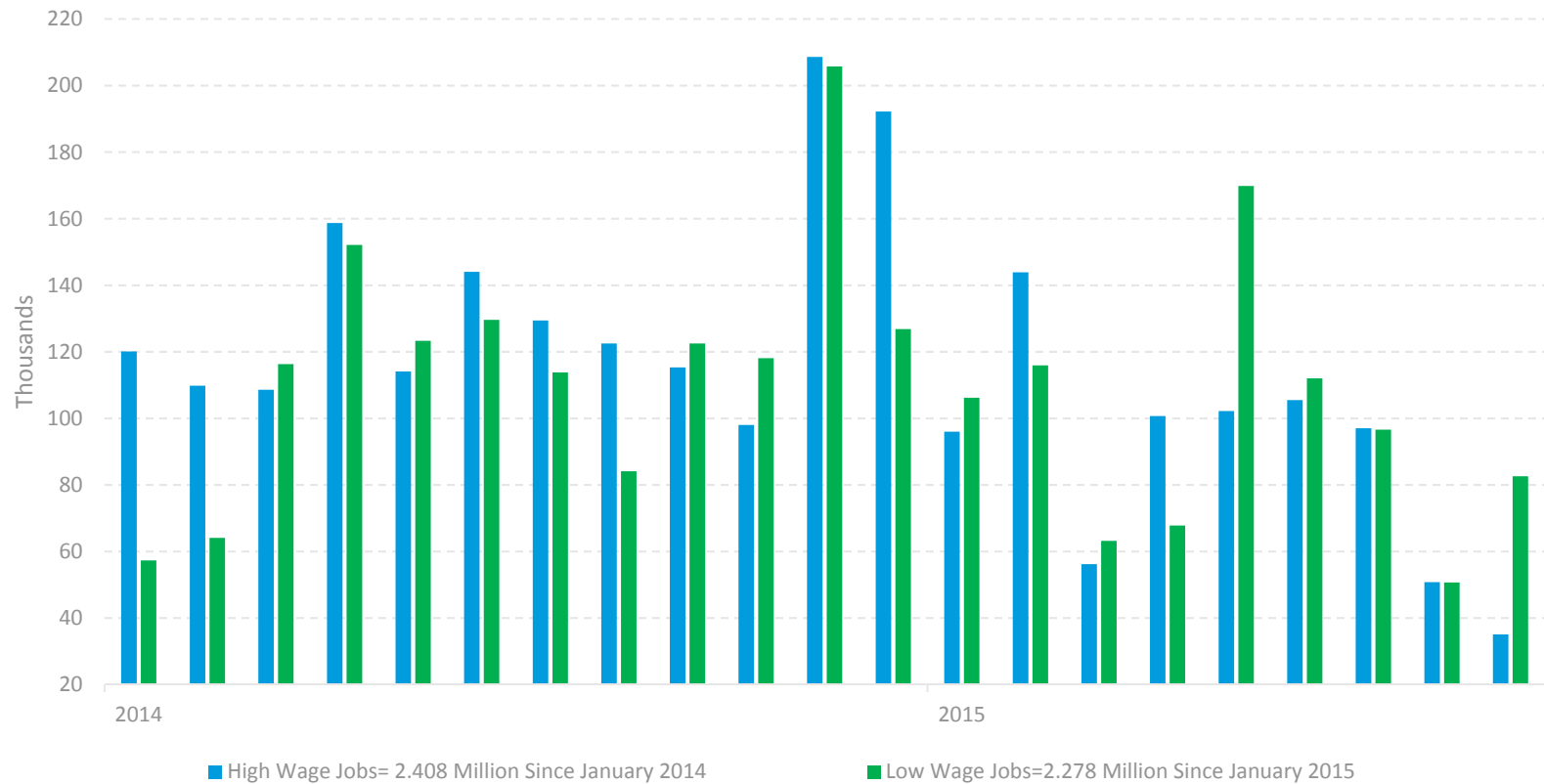
# Middle Market Firms Lead Way in Hiring



Source: RSM, ADP, BLS



# High Wage Job Creation Outpacing Low Wage

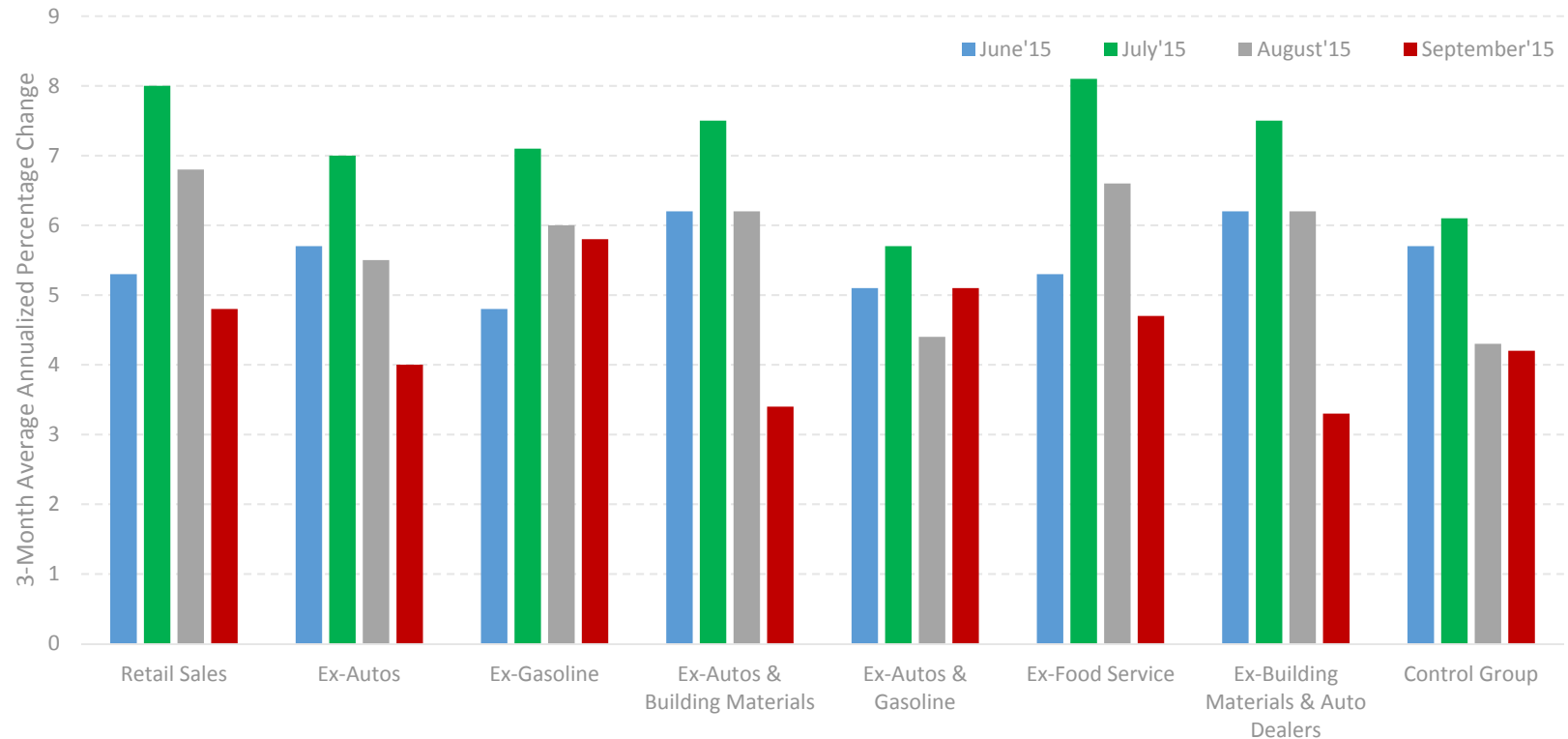


Source: RSM, BLS

# Impacts and Risks From Tighter Labor Market

- **Impacts of a tighter labor market**
  - Rising employee compensation costs
  - Increased attrition
  - Difficulties recruiting talent, competition for top employees
- **Risk offsets**
  - Increased automation strategies
  - Off-shoring, outsourcing, contractor services
  - Compensation programs to encourage retention
  - Recruitment modifications, alternative talent identification
- **Control activities**
  - Audits of vendor management program
  - Audit of Capex/construction activities
  - Audit of employee onboarding and separation activities

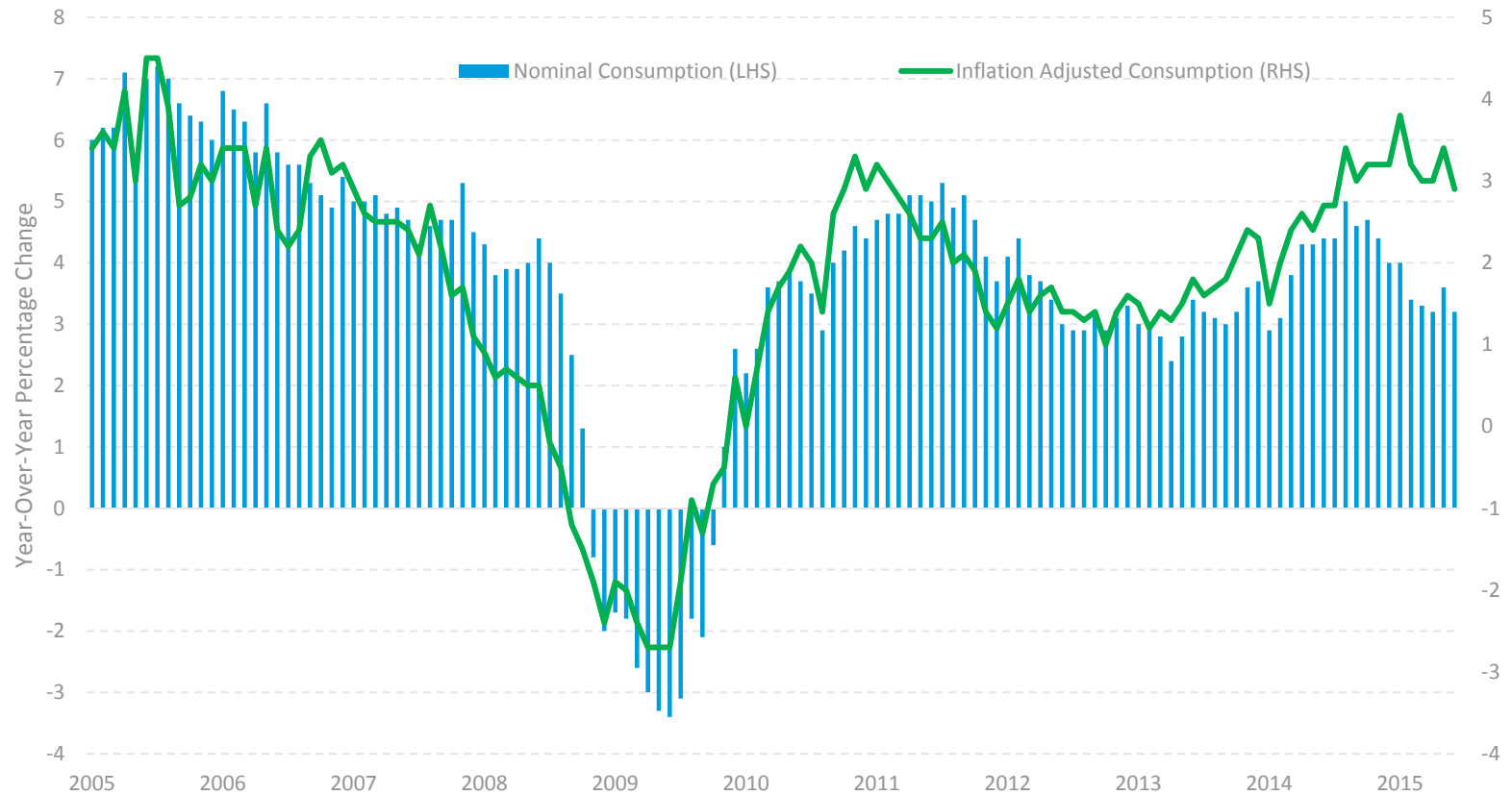
# Improving Spending Outlook



Source: RSM, Bloomberg



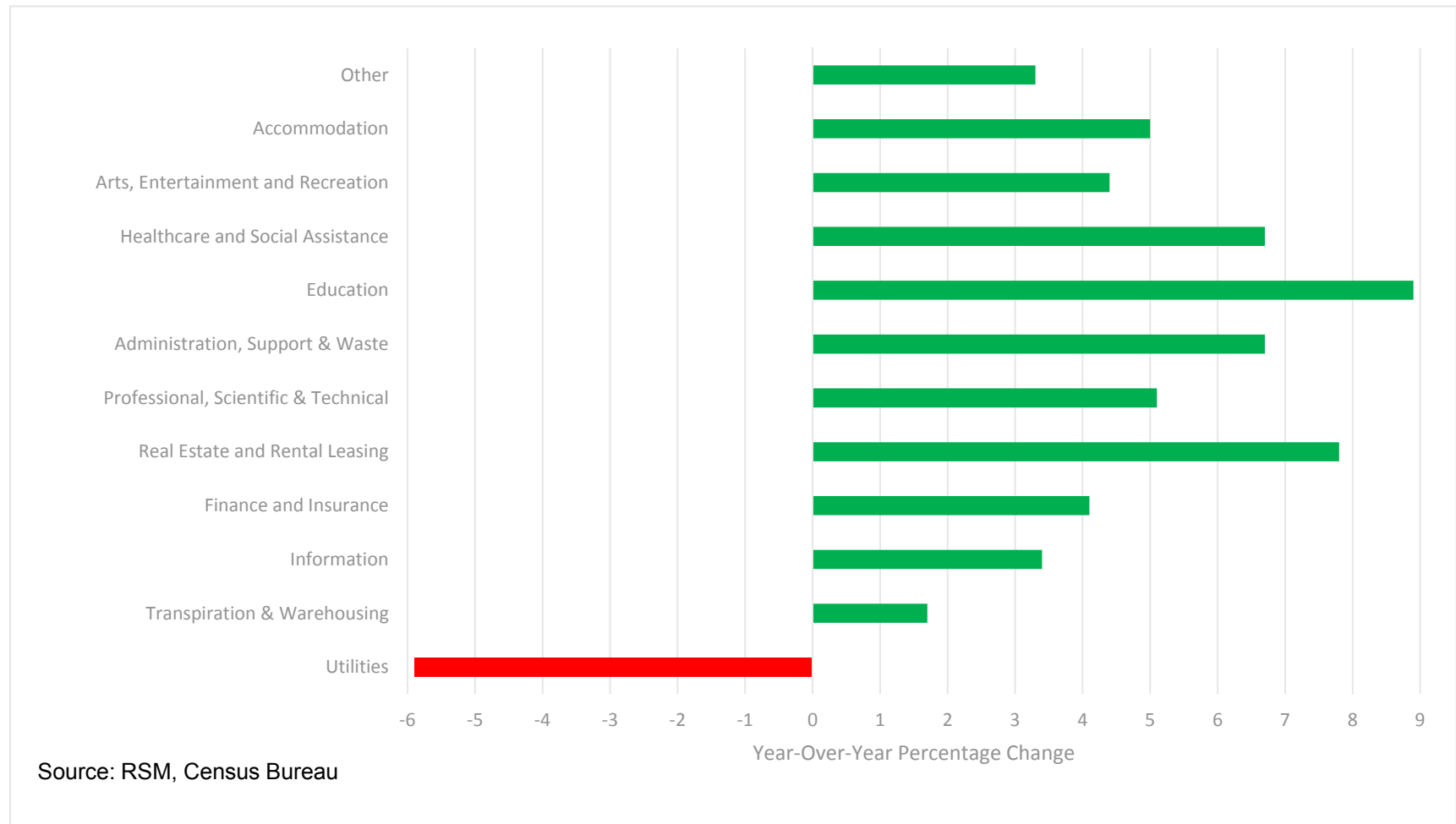
# Real Consumption Rising



Source: RSM, Bloomberg



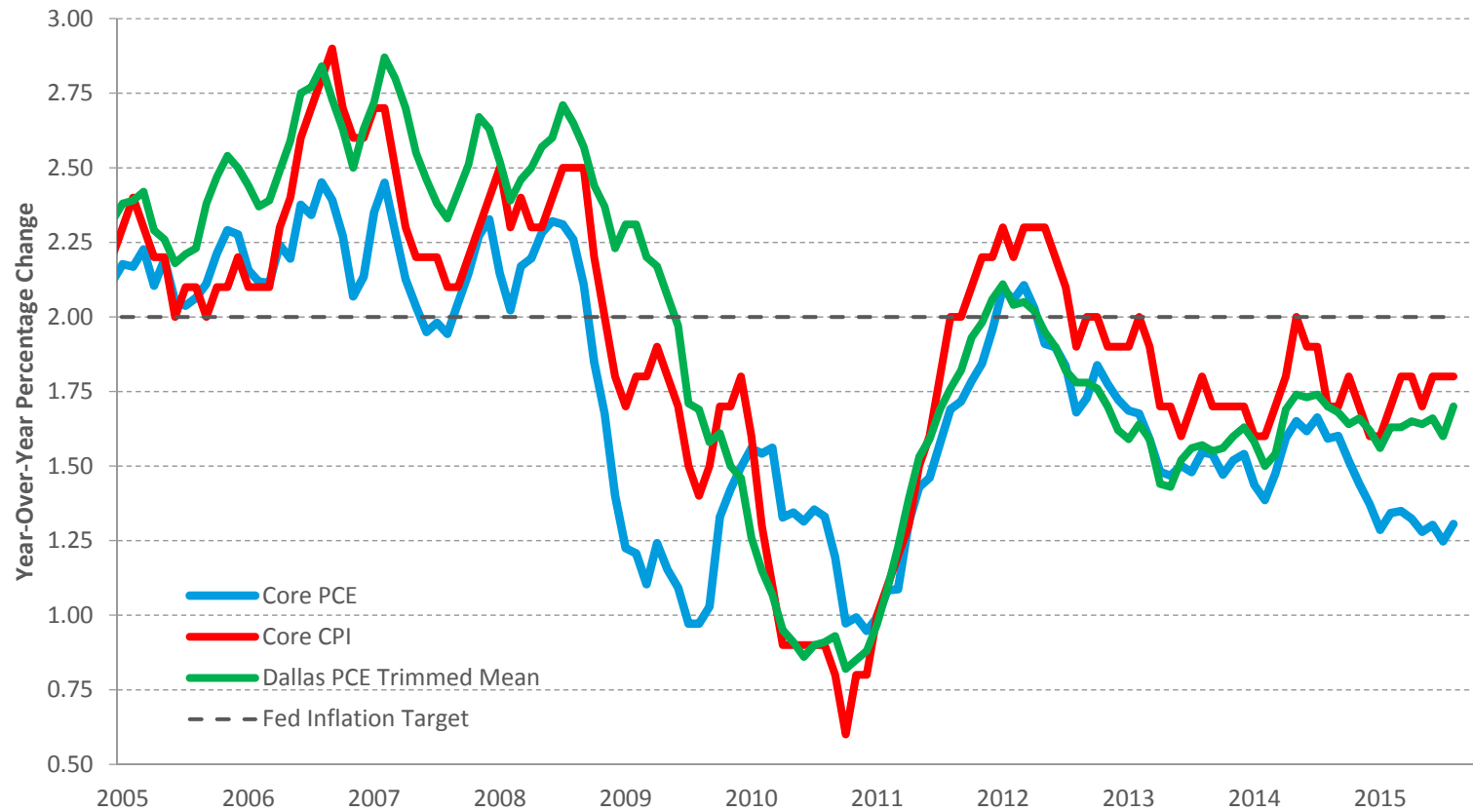
# Solid Service Sector Demand



# U.S. Inflation & Energy Outlook

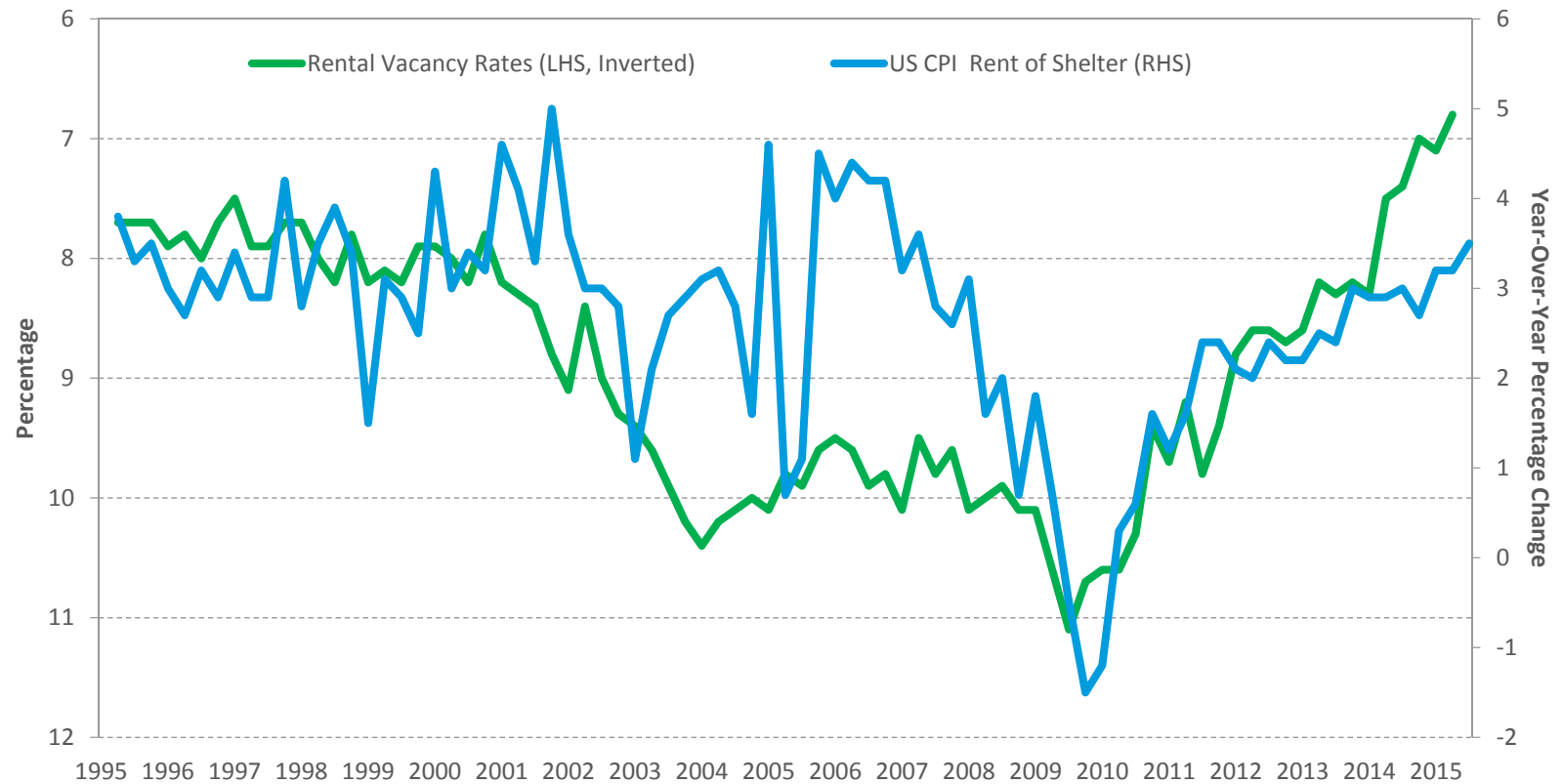
- **Inflation to remain muted**
  - Positive supply shocks in energy and technology inherently disinflationary
  - Energy shock to modestly fade in fourth quarter of 2015
  - Rents and demand for housing to provide impetus for rising inflation
  - Back toward central banks 2% percent target in 2017
- **Energy**
  - Second leg down in oil
  - Five year forward contracts: recent volatility that requires monitoring
    - West Texas Intermediate: \$60.03
    - Brent Crude: \$64.27
  - Serious oversupply problem currently: roughly 2.87million barrels per day
  - Global demand softening as external sector decelerates
  - Global demographics favor higher prices over medium term to long term

# Inflation Slowly Moving Towards Target



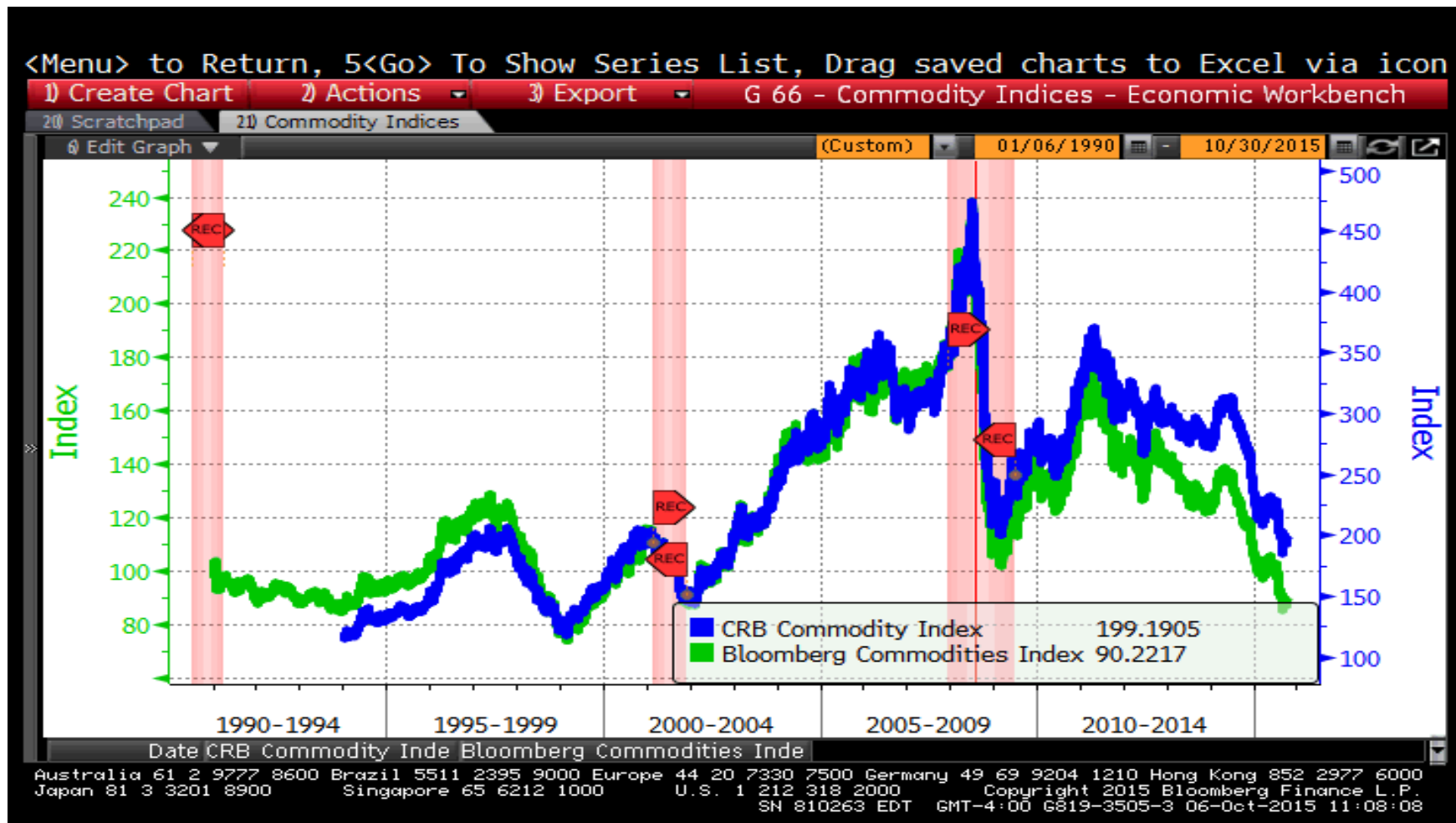
Source: RSM, Bloomberg

# Vacancy Rate Implies Rising Shelter Costs



Source: RSM, Bloomberg

# Commodities Deflation In Train



# Impacts and Risks From Inflation Challenges

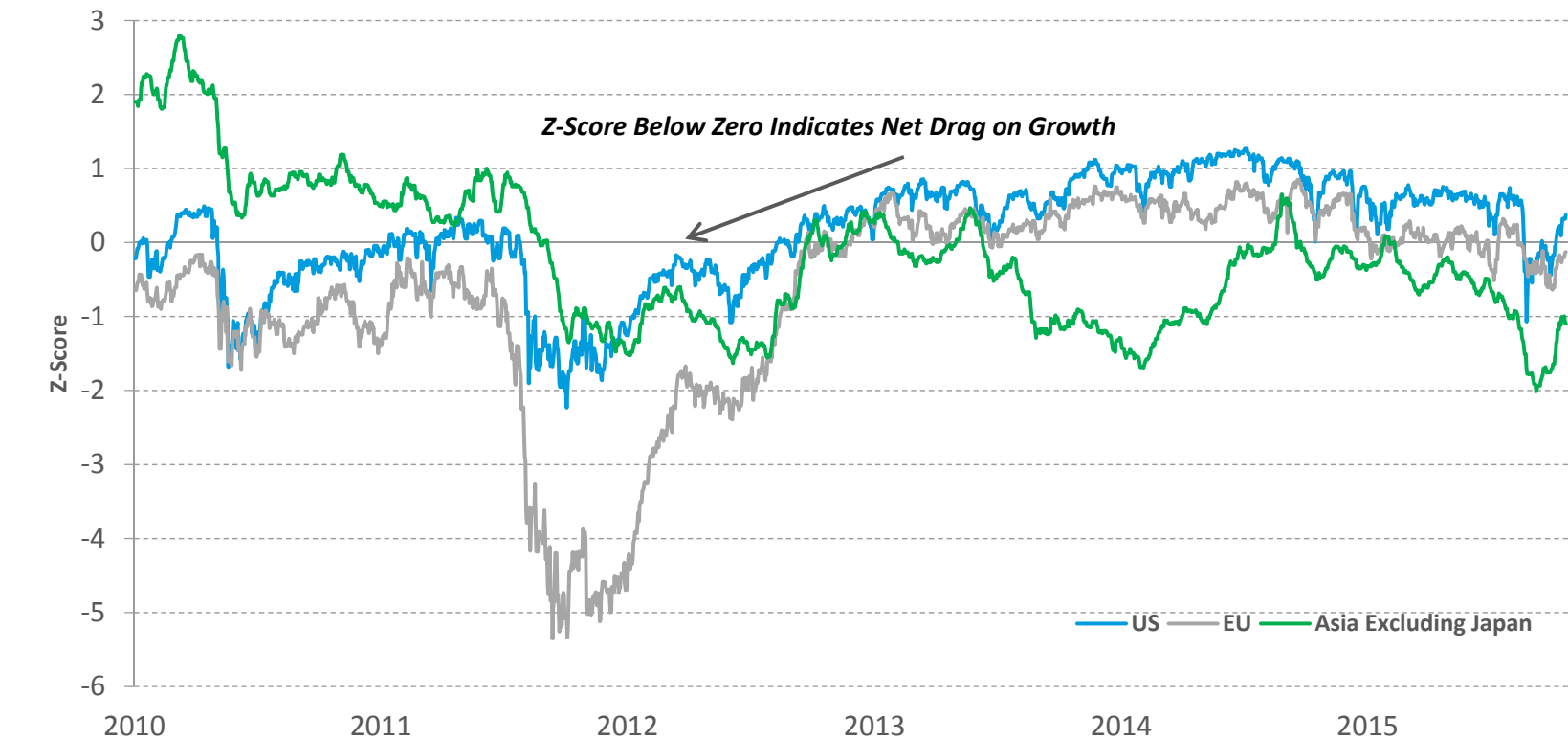
- **Impacts of accelerating inflation**
  - According to MMLC survey, 67% of executives anticipate increases in prices paid during next 6 months, up from 54% in second quarter.
  - Delays or changes to capex plans
  - Reduction in relative debt service burden for fixed cost debt
- **Risk offsets**
  - Explore efficiency, cost-cutting programs
  - Hedging strategies
  - Shift purchasing patterns
  - Implement supply chain adjustments
- **Control activities**
  - Monitor risk implications to working capital from purchasing adjustments
  - Vendor management audit
  - Monitor financial stress related to margin compression at significant customers and vendors

# U.S. Financial Conditions Outlook

- **U.S. Financial conditions remain solid**
  - European risk remains: Greek exit would roil global asset markets
  - Asian financial conditions a drag on global economic activity
  - Uncertainty over timing of first Fed rate hike an issue
- **U.S. Private credit creation on upswing**
  - Up 6.9 percent through Q1 2015
- **U.S. Equity markets appear mildly overbought**
  - S&P 500 down -3.75% 2015 due to slower global growth and softer pace of earnings
- **Stronger U.S. dollar**
  - Embarked on long-run dollar bull cycle

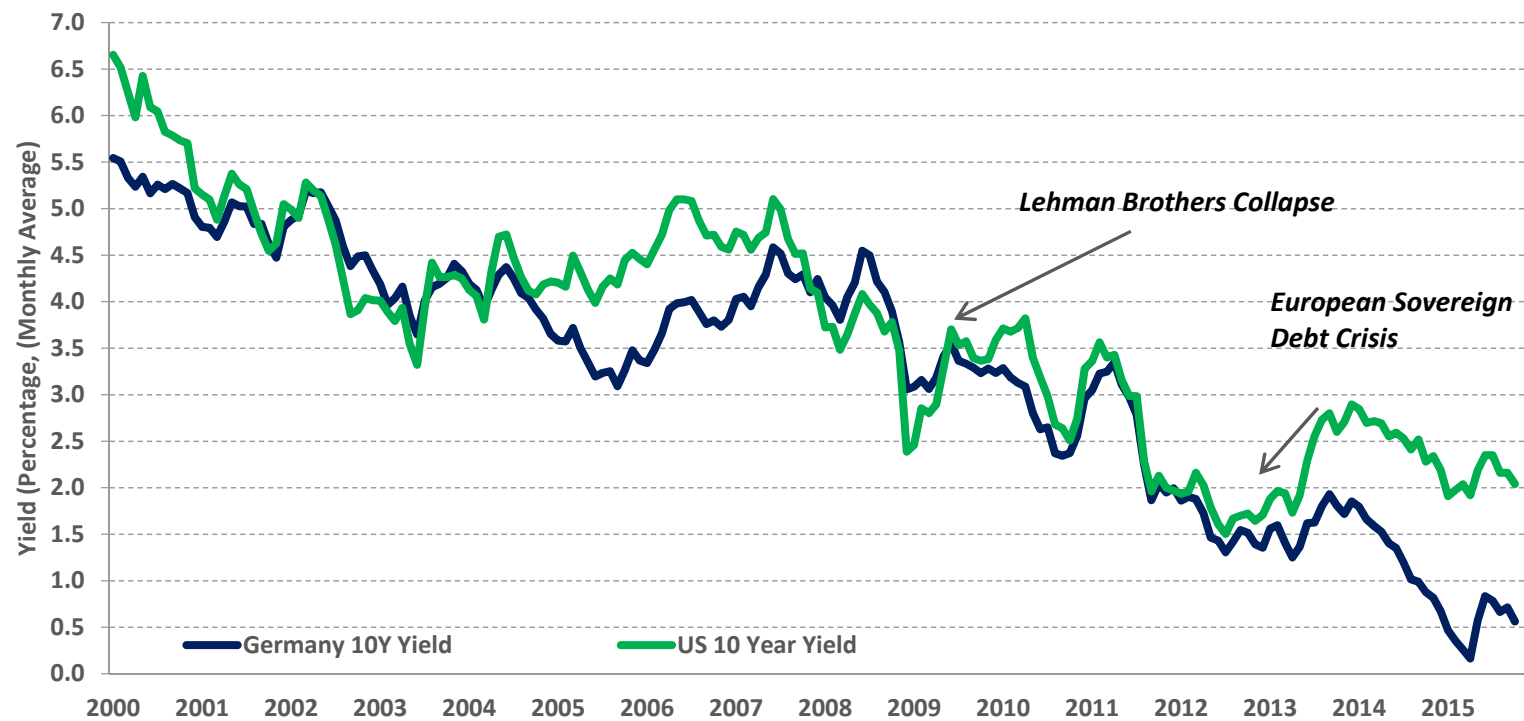


# Global Financial Conditions



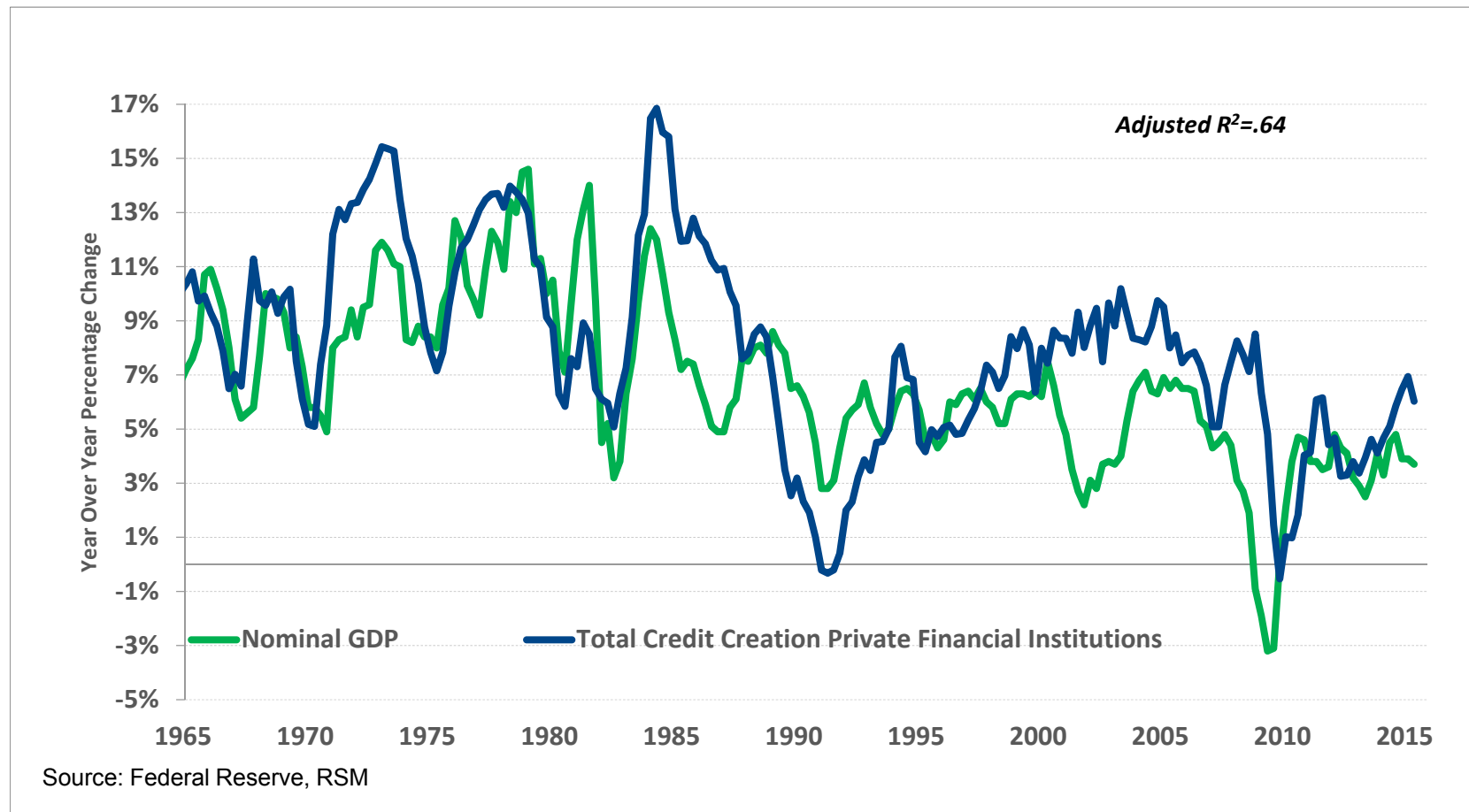
Source: RSM, Bloomberg

# Global Rate Divergence

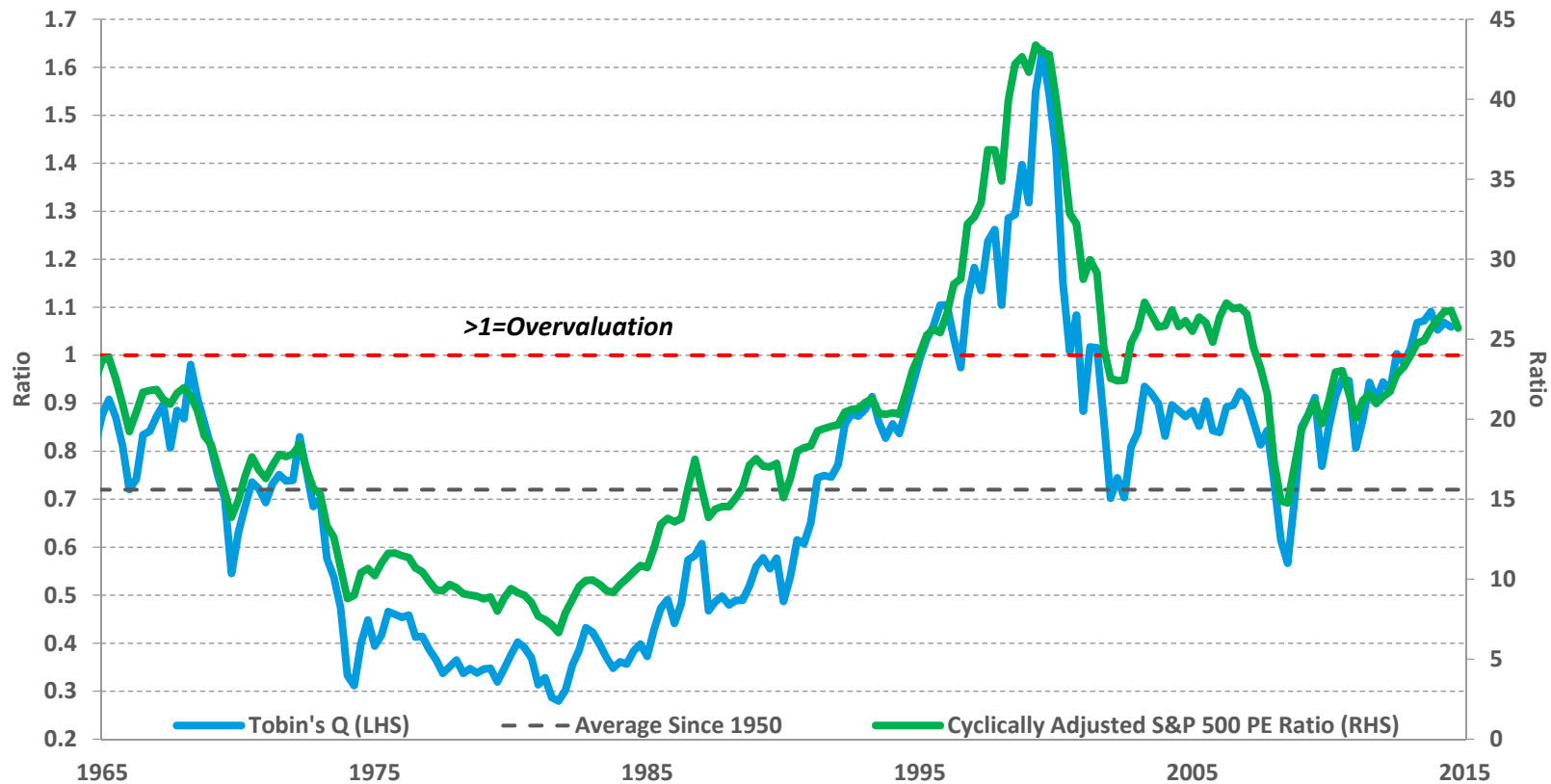


Source: RSM, Bloomberg

# U.S. Private Credit Creation



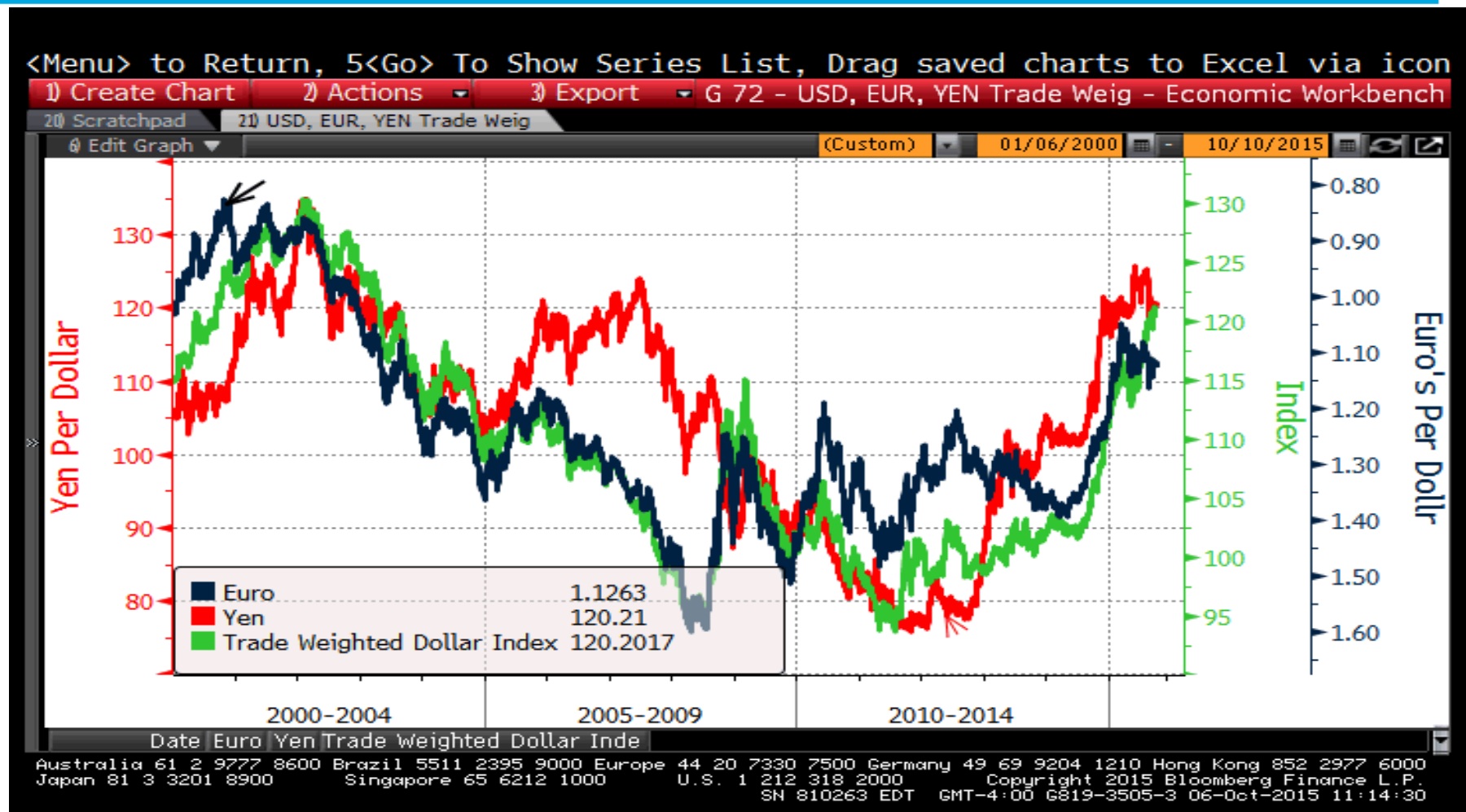
# U.S. Equity Markets Modestly Overbought



Source: RSM, Robert Shiller, Bloomberg



# Stronger Dollar In Train



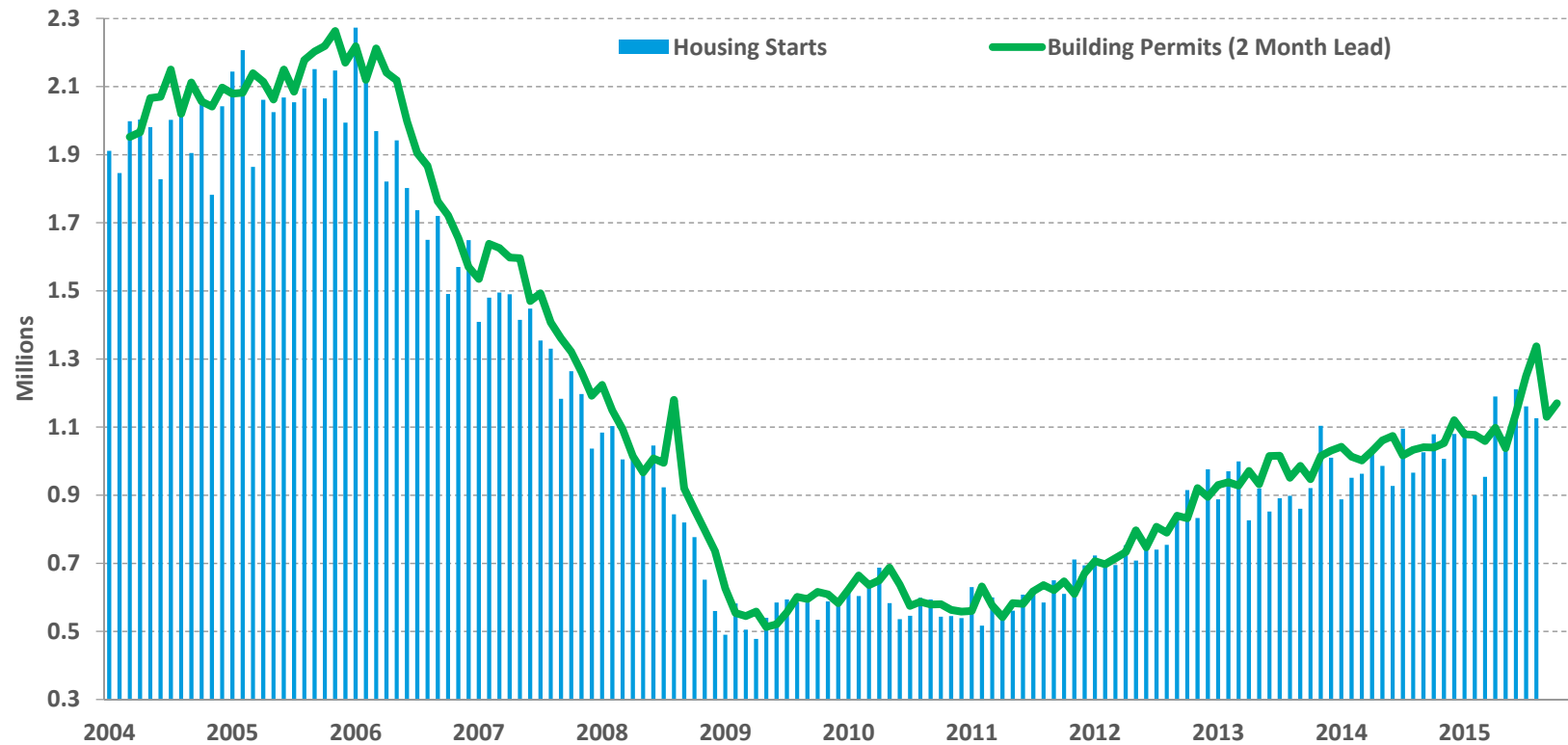
# Business Impacts, Risks From Stronger Dollar

- **Impacts of a stronger dollar**
  - Creates headwinds for U.S. exports
  - Increases U.S. purchasing power for foreign-sourced inventory
  - Diminishes value of foreign earnings reported in U.S. Dollar denominated financial statements
  - Makes global expansion through acquisition more financially attractive
- **Risk offsets**
  - Adjust supply chain to benefit from lower-priced foreign goods
  - Hedging strategies
  - More aggressive off-shore resourcing options
- **Control activities**
  - Vendor management audit
  - Monitor counterparty risk associated with hedges

# Residential Investment

- **Likely to rebound in 2015**
  - Falling unemployment
  - High-wage jobs versus low-wage jobs
- **Employment of those aged 25-34 remain key**
  - Job gains, wages and household formation
  - Behavioral shift?
- **Federal Reserve to attenuate policy to conditions in residential investment**
  - Focus on single-family residencies
  - One of the major reasons why Fed will remain accommodative for some time

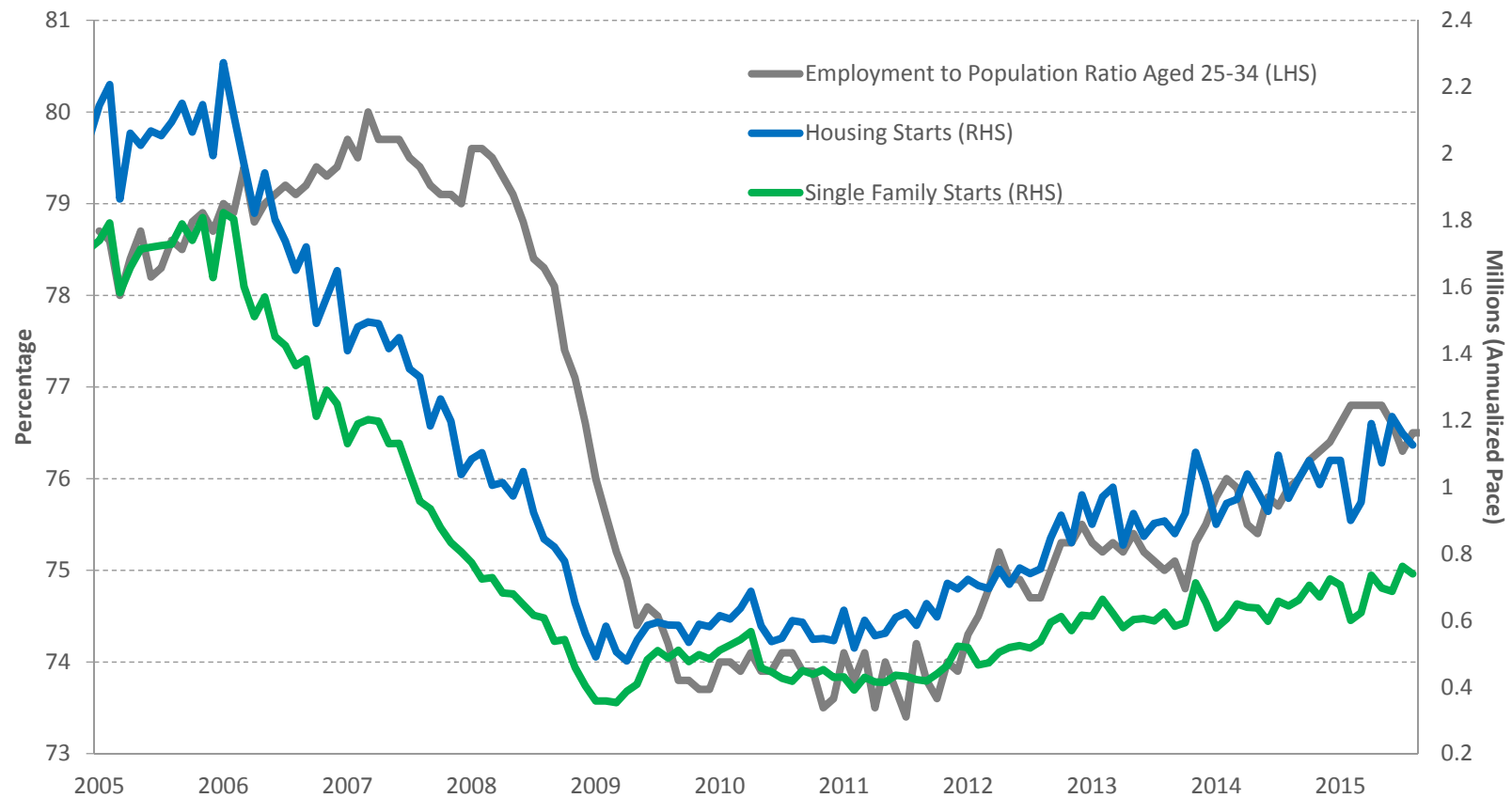
# Residential Investment



Source: RSM, US Census

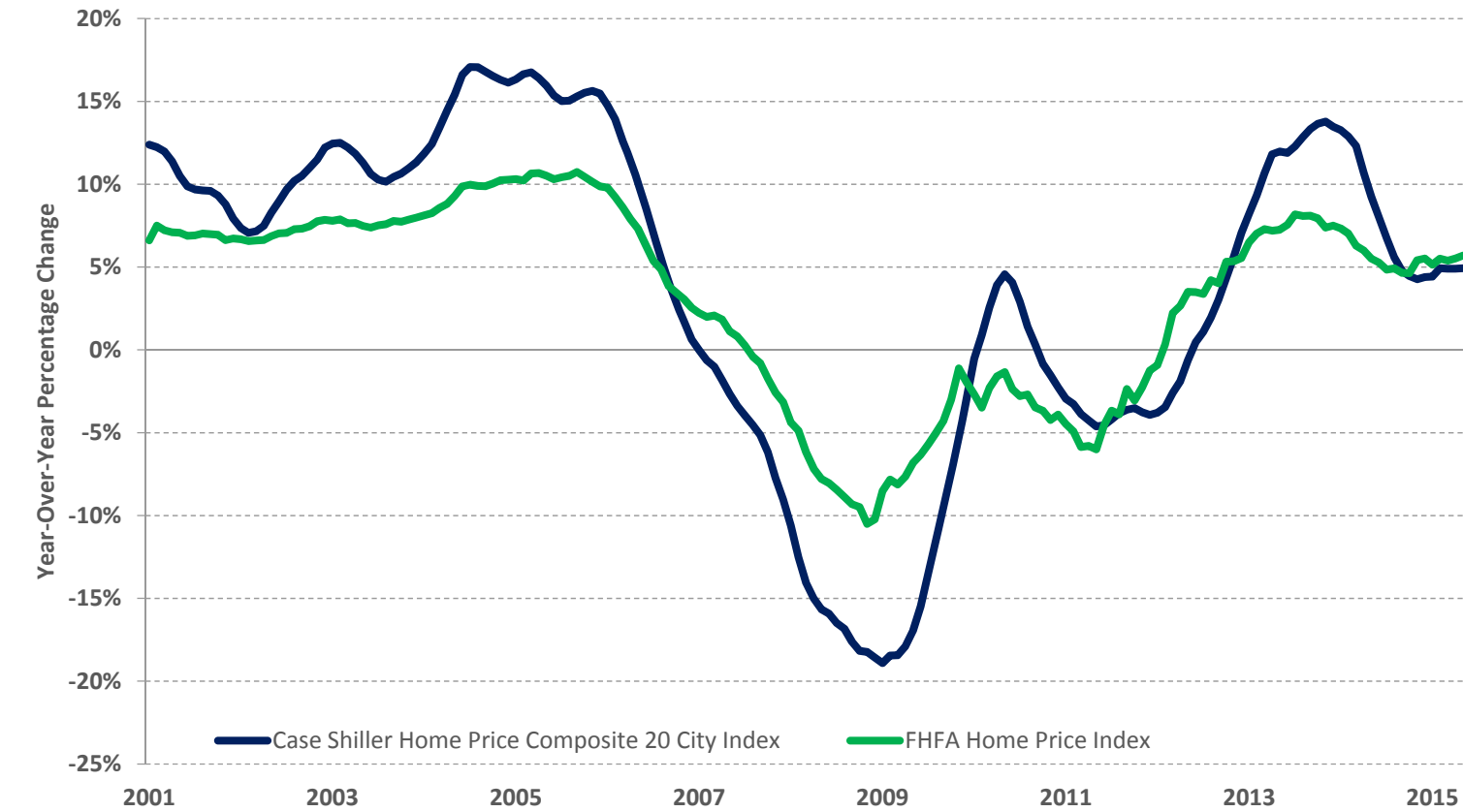


# Key Driver of Demand for Residential Starts



Source: RSM, BLS

# Residential Real Estate Pricing



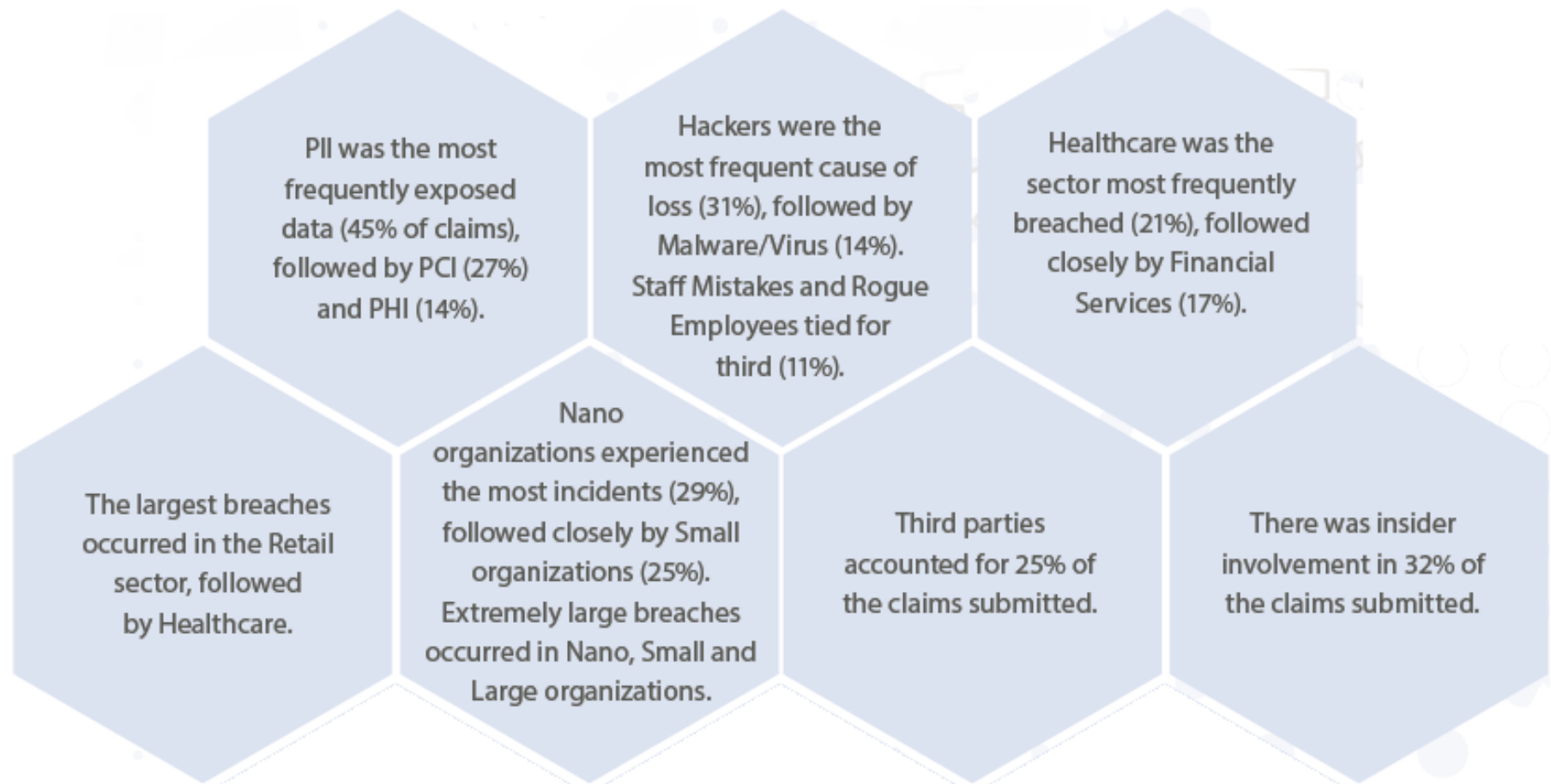
Source: RSM, Bloomberg



# ADDITIONAL RISKS

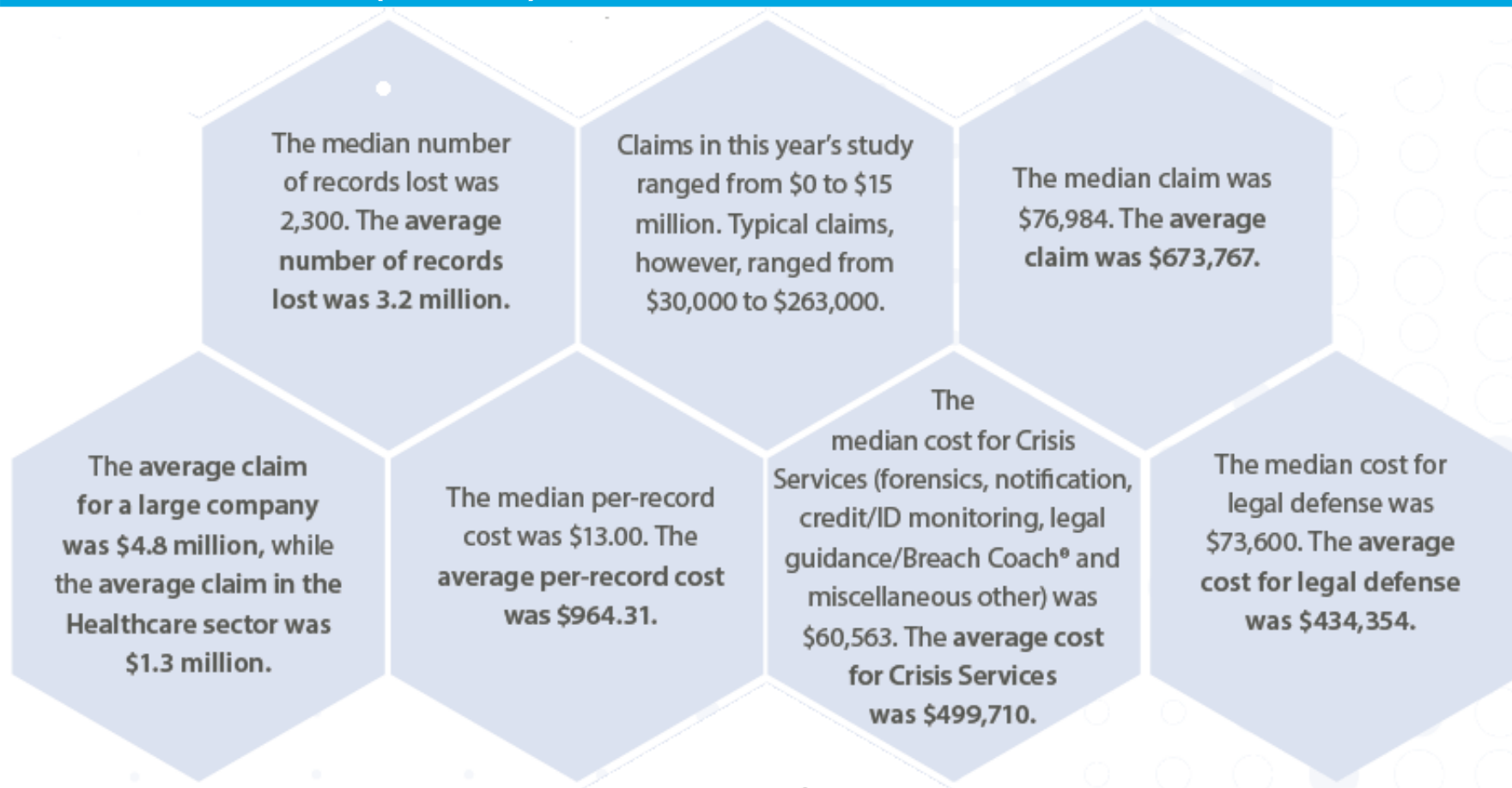
TO MONITOR/MANAGE IN 2016

# Cybersecurity – 2012 thru 2015 Data Breach Statistics



Source: NetDiligence® 2015 Cyber Claims Study

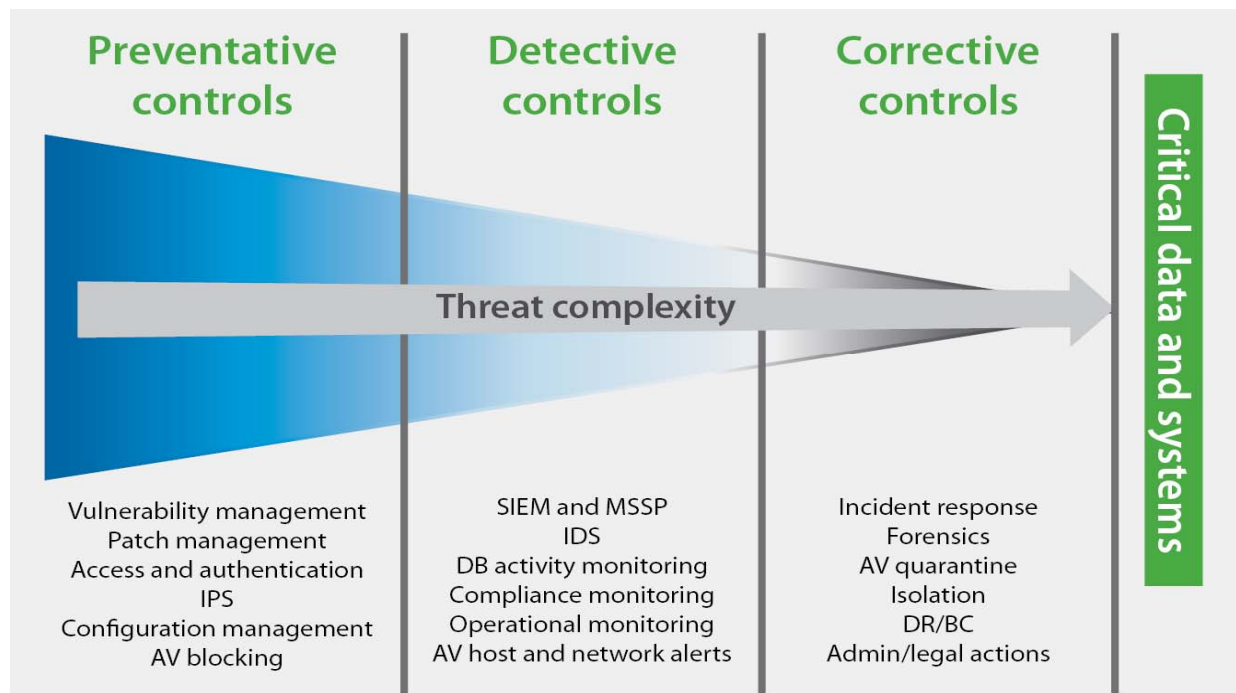
# Cybersecurity – 2012 thru 2015 Data Breach Statistics (cont.)



Source: NetDiligence® 2015 Cyber Claims Study

# Information Security Controls

- Make sure you have basic controls in three layers
  - **Prevent → Detect → Correct**
    - Have you made yourself a hard target?
    - Are you capable of knowing if you have been breached?
    - Can you respond effectively?



# Third-party Contract Governance and Management

- With the increasing reliance on third parties brought about by improvements in logistics, technology and skill specialization, businesses are faced with managing an array of increasingly significant risks, including:
  - Execution of the company's strategic plan is dependent upon the performance of others
  - Companies face uncertain liabilities associated with the performance, or non-performance, of others
  - The level of technological interconnectivity between entities is rapidly expanding, increasing the difficulty of managing cybersecurity risks
  - With a rapid changes in social media and regulatory structures, companies are increasingly assuming reputational risk resulting from the activities of others

# Third-party Contract Governance and Management

- **Risk considerations for 2016:**
  - Do you know where all your contracts are located? Stored electronically?
  - What is your organization's responsibilities under the contract? Are you fulfilling all your contractual responsibilities?
  - Have your contracts been updated to reflect new regulations for privacy and data security?
  - Are you adequately screening, and monitoring, the IT risks associated with 3<sup>rd</sup> parties with whom you electronically interact?
  - Is there adequate insurance coverage by the third-party in the event of a data breach incident?
  - Have your audits of the contract performance and the related invoices keep pace with the expectations of acceptable risk levels directed by Senior Management and the Board of Directors?



THANK YOU FOR  
YOUR TIME AND  
ATTENTION



# For more information

- **Contact us:**

- Rob Kastenschmidt - [rob.kastenschmidt@rsmus.com](mailto:rob.kastenschmidt@rsmus.com)
- Joe Brusuelas - [joe.brusuelas@rsmus.com](mailto:joe.brusuelas@rsmus.com)

- **Additional resources:**

- [Read the global edition of The Real Economy](#)
- [Subscribe to The Real Economy](#), a monthly publication highlighting economic trends impacting the middle market.
- [Subscribe to Risk Bulletin](#), a quarterly newsletter providing insights to help your organization manage evolving risks.

# Before we conclude

## How did we do?

- Please take a moment to participate in the attendee survey by following the link in the Resource List to the right of your screen

## CPE credit

- Eligible participants will receive 1.0 credit for attending today's event
- Visit the Certification panel to the right of your screen
  - Be sure to download and save your certificate to your computer before the event concludes
  - Certificates are not available for download from a smart phone. Download your certificate from any computer using the same link you are using to view the webcast
  - You must have Javascript and Cookies enabled to download the certificate
  - McGladrey employees: CPE will automatically appear on your LearningLinks transcript within 30 days (no further action is required)

## Follow-up

- We will respond to all questions following today's event
- The presentation slides and a link to the call recording will be sent to all participants within a few days





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