FLASH REPORT

Downside Risks: What Can Go Wrong—Assessing Macroeconomic and Print Market Threats

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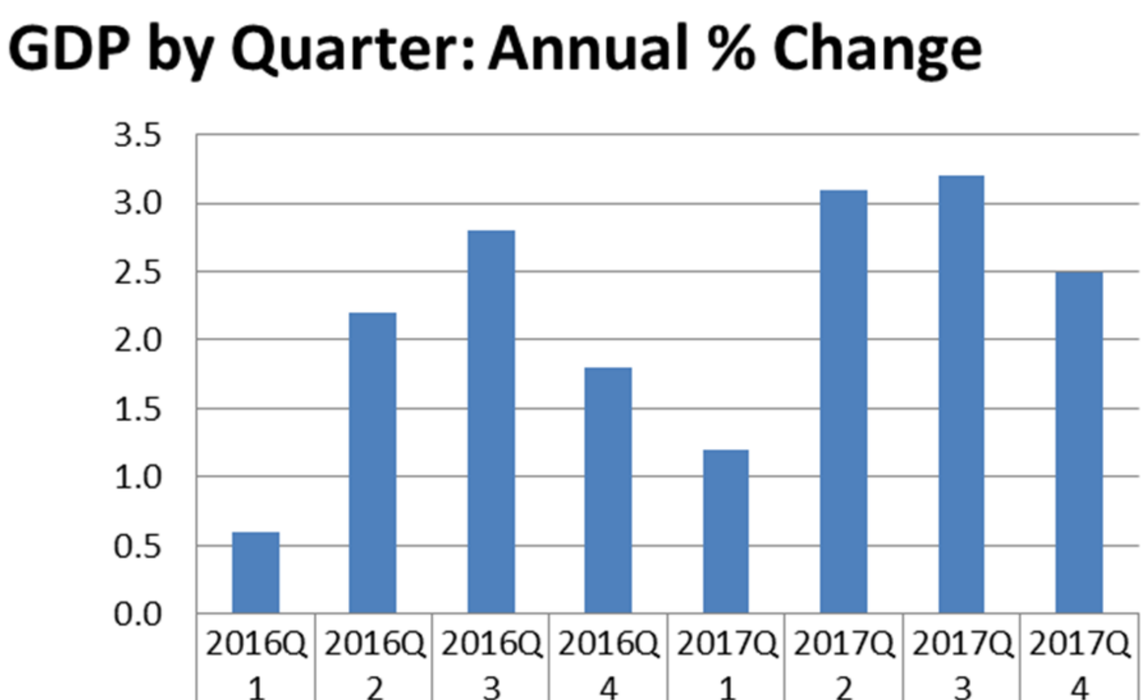
For the most part, the news on the "real" economy is good—inflation-adjusted GDP is growing at a healthy pace accelerated by deregulation and the cut in corporate and individual tax rates. Labor force participation rates, hiring, and employment are up. In general, optimism abounds. So what can go wrong?

In this *Flash* we answer this question by taking a contrarian view and a look at the "dark side" of the macroeconomy and print markets—what can go wrong? We aren't saying all will go wrong but printers and suppliers must always be prepared for the worst even in the best of times.

Before turning to the dark side let's admit that right now the economy and print markets still look good. Fourth quarter 2017 GDP grew at an annual rate of 2.5 percent, making it three quarters of growth above 2 percent. Wages are increasing and business investment has improved. So, the outlook is for continued strong economic growth.



	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Annual % Change	0.6	2.2	2.8	1.8	1.2	3.1	3.2	2.5

Print markets also continue to show strength. Printing and related support activities soared in February according to the latest ISM (Institute for Supply Management) survey of manufacturing covering 18 U.S. manufacturing sectors:

- Print was number one out of 15 industries with growing sales.
- Print was number three out of 15 sectors with growth in new order.
- Print was number one out of 14 sectors in growth of production activity.
- Print scored number one out of 11 sectors with growing employment.

But, at some point the good times will end. As the current recovery closes in on its ninth anniversary let's look at what can go wrong.

So What Can Go Wrong?

Even with all the good news there is still a witches brew of potential severe scenarios that could let the steam out of the recovery. On the macroeconomic side these include:

1. Trade restrictions/barriers slow down the U.S. global economy.
2. Labor shortages restrict growth coupled with immigration restrictions (total number, quantity and quality, age). Immigrants—substitute or complement to U.S. labor supply?
3. Bottlenecks—particularly transportation
4. Costs and price pressures—Both are inherent in the growing economy and as a result of possible missteps by the Federal Reserve as it unwinds the bond-buying push of the last few years.
5. Interest rates up from inflation and increases in deficit crowd out private investment
6. Wild card issues

Some of these scenarios overlap in the sense that they are both causes and possible effects of others. Any of the above scenarios will, of course, disrupt print markets since print moves consistently with the macroeconomy. On a microeconomic or print-specific level, risks include:

1. Labor issues specific to print
2. Postal issues
3. Paper prices and supply issues including possible trade restrictions

We discuss each threat in terms of both the likelihood of occurring and the potential significance of its impact on the macroeconomy and print.

Macroeconomic Threats

1. Trade Wars—Least Likely but Largest Potential Negative Impact—We start with the scenario that we believe has the potential for the largest negative disruption—trade restrictions turning into wide-scale trade wars**.** While not likely to happen, this is a real threat. As has been reported concerning the steel import restrictions, the numbers of workers in domestic industries that purchase steel far outnumber those in the steel industry—by a multiple of around 20 to 1. At the extreme this scenario could stop recovery in its tracks and has the potential to cancel much of the significant gains from deregulation and corporate tax cuts. As we previously indicated in an earlier *Flash*, these two initiatives have resulted in a surge in GDP growth from 2 to 3 percentage points per year, or a 50-percent rise.

2. Labor Shortages Restrict Growth—The recent acceleration of economic growth from around two percent to three percent has already pushed up the demand for more labor and increased wages. With the economy currently at full employment, we needed an increase in the labor-force-participation rate to pull workers off the sidelines. So far, it appears that this is happening, and we might still have a way to go before economy-wide shortages stifle growth. At this time, PIA believes we can sustain a growth rate of three percent. A side issue is the political hot potato of immigration. From an economic growth perspective, more immigration, particularly of younger immigrants, is a plus. Further, side issues include the skill set of the immigrants and whether immigrants are substitutes for domestic labor or complements.

3. Bottlenecks Constrain Growth—Beyond labor constraints there are additional bottlenecks in specific sectors that may limit growth. Transportation is a particular choke point with reports of large trucks already common. These restraints would not be economy wide but more targeted to specific sectors. Still, the impacts could reduce overall economic growth by a noteworthy amount.

4. Inflationary Pressures Cramp Economy—Inflation has been held in check over the course of the economic recovery (since 2009) as supply has grown in response to increasing demand. Can this continue? There are increasing signs of inflation as wages escalate. If inflation inches up just slightly, there should be no major disruptions. However, if inflation escalates much beyond the two-percent range seen by the Federal Reserve as acceptable, we could see more interest rate increases from the Fed and other issues arise that could put a lid on growth. We are not there yet, but this is an issue to watch.

5. Rising Interest Rates Crowd Out Private Investment and Constrict Economy—As specified in the discussion on inflation above, there is a danger that the Federal Reserve will raise interest rates beyond current expectations. If so, this will dampen investment even as deregulation and lower taxes are pushing it up. Again, this is not a threat right now but is an issue on the watch list.

6. Other "Wild Cards"—It is impossible to list all potential scenarios that could disrupt the U.S. economy or the global economy. While the five threats listed above are, at this time, the most likely candidates for disruptions, there are many others including global geopolitical events as well as domestic disturbances. While not a short-run threat, the rising federal budget deficits and long-term viability of Social Security, Medicare, and Medicaid programs pose serious risks to the long-term health of the economy.

Print Market Threats

As stated earlier any scenario constraining growth or forcing declines in the economy will work its way down to print and printers. Most likely, the relative impacts on print will be worse than the relative impacts on the economy since, as we have often observed, print typically turns down sooner and harder than the overall economy in recessions. But print also has its own specific issues.

1. Print Labor Shortages and Compensation Increases—Commercial printing and print-based publishing still employed over 1.1 million people last year. Even though the total is trending downward, this is still a large base that creates demand for new hires as old workers retire, leave for new jobs, and other reasons. For 2017, we estimate the combined printing and print-based publishing industries hired approximately 45,850 employees—a noteworthy sum for sectors that trended down in total employment. Of course, these replacement employees likely have different skill sets as print moves from conventional print processes to digital processes and more service-based business models.

2. Rising Postal Rates Crimp Direct Marketing—There is a very serious threat to direct marketing, print, and other print that enters the mail stream from issues related to the United States Postal Service. The Postal Regulatory Commission (PRC), the independent regulatory agency tasked with USPS postage rate oversight, has proposed radical postage rate increases. Based on research we performed a few years ago, the estimated cross elasticity of demand for print from a postal rate increase was -0.4 percent. In other words, a one-percent increase in postage resulted in around a 0.4-percent decline in print volume for print that went into the mail stream. It is PIA's belief that a proposed rate increase will do lasting harm to USPS and risks putting many mail and supply chain stakeholders out of business, forcing them to find alternative, cheaper, and more stable distribution methods.

3. Paper Price Inflation and Trade Restrictions—Printers typically devote around 20 percent of their total revenues to paper. While some printers spend less, others spend much more. The other large cost is labor (around 40 percent of sales), while paper is the most significant outside purchase. Although the U.S. has a robust domestic paper industry, much of the paper printers buy is imported. Recent initiatives to restrict imported paper are a significant threat to printers' sales and profitability. Printers typically earn only around three percent in before-tax profit as a percent of sales. Even a small percentage boost in the price of paper can significantly reduce printer profits and also reduce sales as customers may move to other forms of communication when faced with a price increase.

Anything You Can Do?

The short answer is that individual printers cannot do anything themselves to stop or change the above scenarios from taking place. It is true that through collective action from Printing Industries of America printers can address the international trade and postal rate issues and our Government Affairs Department is working on these issues.

However, printers can take individual actions to prepare for and address the above threats if indeed they materialize. These include:

- Support PIA's Government Affairs Department in their efforts to work on the issues of postal pricing and reform and international trade restrictions
- Prepare to play defense if these scenarios do materialize. While you have to keep your day-to-day managerial oversight, you should assess the degree to which your business is at risk from any of the above threats. This would involve a focused marketing and risk assessment to quantify how these threats might impact on your customers, your specific print products and services, and other factors.
- Focus on your own operations. There are key business practices that work in good times and bad. These include benchmarking; cost controls; waste and spoilage minimization; and retaining, recruiting, and rewarding your employees.
- Play offense. In this case you not only play defense but also think about how some of these threats may actually create opportunities for your firm.

Note on PIA's Center for Print Economics and Management publications: As you may be aware, we recently added another on-going publication to our portfolio—The *Management Alert*. What is the difference between the *Flash Report* and the *Management Alert*? The *Flash Report* is focused on macro trends and developments ***outside the printing plant***—the overall economy and the printing industry including analysis of past trends and forecast of coming trends. The *Management Alert* is focused on developments ***inside the printing plant***—key performance metrics and business strategies and operations to improve performance.