INSIDE SUPPLY MANAGEMENT® $15.00
VOL.28 NO.1 | JANUARY/FEBRUARY 2017

Cover story

The Big Unknown

By Sue Doerfler

In the year to come, supply management professionals will face uncertainties that range from changing economic arenas to geopolitical threats.

The U.S. presidential election may be over, but there is lingering apprehension about the new administration's policies, as well as the possibility of slowing economic growth and a recession. Labor woes continue as baby boomers retire, leaving other workers struggling to gain needed skills. Interest rates have gone up slightly, fueling investment and expansion concerns. Brexit passed but has yet to be implemented. China is transitioning from a manufacturing-based to a consumption based economy. And numerous geopolitical threats loom.

This year, more so than in the last few years, brings uncertainty and a host of challenges for supply management practitioners as they strive to handle changing economic, political and global issues.

US ECONOMIC OUTLOOK

Prior to the presidential election, the U.S. economy had been strengthening: Consumer spending was up, wages were rising faster than inflation, unemployment was around 5 percent, and GDP was growing, albeit at a slower pace than the 2.6 percent recorded in 2015.

The election of Donald Trump likely will change that growth trend, says **Bernard Baumohl,** chief global economist at The Economic Outlook Group, LLC in Princeton, New Jersey. He forecasts 2017 U.S. GDP growth to be 2 percent, lower than the 2.7 percent he had predicted under a Hillary Clinton presidency.

The reason? Trump believes he can handle the U.S. economy the way he runs his businesses, **Baumohl** says. "That would be a grave mistake," he says. "His proposals to slash personal and corporate taxes while boosting federal spending on infrastructure and defense do not sit well with many conservative Republicans because they will explode the budget deficit. So I expect Congress will push back and dilute his stimulus program. That means consumers and businesses will also pull back on spending," he says.

"Another major concern is that Trump has threatened to impose substantial tariffs against Mexico and China. If he goes through with it, we must then anticipate they will retaliate against the U.S.," says **Baumohl**. "That would trigger a trade war at a time when the U.S. economy is growing at barely 2 percent. That's not much of a buffer to protect the economy from slipping into a recession." **Baumohl**, however, says that if there is a recession, he would expect it to be mild, lasting about two quarters.

Economist Chris Christopher of IHS Markit in Lexington, Massachusetts, has an alternate take. While he agrees that trade growth will be impacted, he says that the strong economic momentum leading into this year will have a positive effect. "At the moment, GDP numbers seem strong, employment numbers are chugging along and the financial markets are doing well," he says. "There's no reason to believe that there's a heightened sense of a recession anytime soon. It's a possibility — we think about 20 percent. If it were to happen, it would be at the end of the year." Other factors point to a good growth outlook, Christopher says, one being the Republican-controlled House of Representatives and Senate. "There will be some issues, but the new administration will try to promote job growth, tax cuts and infrastructure spending, and will try to modify Obamacare," he says. "All of these are positive." Two other considerations affect the outlook:

Unemployment. Although unemployment has been relatively low, talent shortage has been an issue — and it's been an impetus for rising wages. "There are more than 5 million job openings right now, and companies are struggling to fill many of them because people don't have the skills for these jobs," **Baumohl** says. "I expect salaries to go up as companies try to attract the best workers or find other workers and retrain them."

Interest rates. The strengthening U.S. economy was a factor in the Federal Reserve Board raising its benchmark interest rate a quarter percentage point in December, according to Christopher. But there could be another underlying reason for raising rates, **Baumohl** says. "Should the economy stumble under a Trump administration, the Fed wants to have an opportunity to then lower rates," rather than entertain a negative-interest rate strategy that may not result in economic stimulation, he says.

EFFECTS ON SMALL AND MIDSIZE BUSINESSES

Prior to the election, the Fed had projected to raise rates to about 2 percent by 2018. If the economy were to continue to grow, Christopher expects the Fed to follow suit by raising rates a bit more.

Such a move could affect small to midsize businesses that are looking to borrow money. “Small and midsize companies are critical when it comes to generating jobs and capital investment spending, more so than large multinational companies,” says **Baumohl**. “Small and midsize companies hire three out of every four workers in the country.” Easing governmental regulations affecting these businesses should be among the top concerns of a new administration, he says.

Many of those regulations were developed in response to the 2008 financial crisis, to prevent such a situation from happening again, says Dru Shiner, chief sales officer at C2FO in Fairway, Kansas. Some regulations, such as Basel III, which addresses banking risk, have adversely affected how small and midsize companies raise capital, he says: “Thus, what’s happened is that a small- or medium-sized company’s access to liquidity and funding at rates commensurate with 2008 levels has contracted significantly.”

According to C2FO’s *2016 Working Capital Outlook Survey*, more than 40 percent of the 1,800 small to midsize businesses surveyed in the U.S., United Kingdom, Italy, Germany and France indicated their working capital needs have increased since 2015. The figure was 47 percent among U.S. companies. The survey also found that borrowing is most expensive in the U.K. and U.S., and U.S. respondents said that high interest rates were their biggest challenge in securing financing.

“The good news is that 61 percent of those surveyed are focused on future long-term growth, and more global corporations are partnering with their suppliers to offer innovative working capital solutions that encourage mutual success,” Shiner says.

GLOBAL ECONOMIC LANDSCAPE

Despite working capital needs among businesses, the global economy is expected to grow in 2017. **Baumohl** predicts 2017 global GDP growth to be 2.9 percent, up from the 2.4 percent forecast for 2016. The International Monetary Fund forecasts global GDP somewhat higher at 3.4 percent for 2017, saying, however, that “prospects differ sharply across countries and regions,” according to its October 2016 World Economic Outlook.

Indeed, economic conditions differ around the world. About 25 percent of global GDP is produced in countries with a negative interest rate regime, Christopher says. Central banks in the Eurozone, Japan, Denmark, Sweden and Switzerland have put their interest rates into negative rate territory to spur lending and increase spending in an attempt to help their economies, he says.

Baumohl says that this negative-rate strategy "isn't working as well or as quickly as policymakers there had hoped."

Other global economic considerations, Christopher says, include:

• Brazil and Russia are inching out of their recessions.

• China, once a key factor in the increase in overall global trade, is transitioning from an economy focused on construction and heavy manufacturing to a services economy.

• Vietnam is developing into a manufacturing destination.

• Oil prices will likely gradually increase, potentially spurring growth in energy-related fields.

• A stronger dollar points to more global exports to the U.S. (and fewer U.S. exports).

• A rising wave of protectionism/isolationism — the kind that inspired the Brexit vote — is also affecting global trade. **Baumohl** considers Brexit to be more of a political crisis for Europe than a global economic concern. However, the vote has led to economic issues in the U.K., where the pound dropped in value following the vote. "Financial markets were crushed repeatedly after the vote," **Baumohl** says, "but the shock has now subsided. The markets bounced back. The economic news coming out of the U.K., for example, is looking better than it did before."

The U.K. High Court ruled in November that Parliament must approve before the process to leave the European Union can be initiated, causing the pound's value to increase. And there is still nervousness and anxiety about potential long-term implications of Brexit, **Baumohl** says. But he expects the regions most affected will be the U.K. and Europe, saying they will likely experience slower growth than they would have otherwise.

OTHER GLOBAL CONCERNS

In addition to economic factors, looming geopolitical threats have the potential to impact the global marketplace. "These threats could lead to serious disruptions that could affect the whole supply chain network over the next two years," **Baumohl** says.

They include:

Potential volatility of Saudi Arabia. Various forces "are focusing on destabilizing that country, undoing the monarchy," **Baumohl** says. "If that succeeds, we could see oil, for the first time in a while, shoot up to triple digits. That certainly could affect the cost of production around the world and can obviously affect supply management as well."

North Korea's potential nuclear threat. According to reports, North Korea in 2016 launched more than 20 missiles, some of which reached as close as 200 miles from Japan's coast. "Japan is now faced with the possibility of having to raise taxes to fund a military program, maybe to become, for the first time, a nuclear military power," **Baumohl** says.

China's determination to have sovereign control over the South China Sea. A July ruling by the Permanent Court of Arbitration at The Hague determined that China had no legal basis to claim sovereignty over the South China Sea. China has said it will not abide by the ruling. "If they don't abide by it, countries like Indonesia, the Philippines, Vietnam and Japan will look to the U.S. to take a stand against China," **Baumohl** says. But would there be such a stand? "We don't know how Trump is going to react," says **Baumohl**. "Will he be aggressive and put a greater naval presence in the area to show that the U.S. won't allow China to gain sovereign control over that region? Or will he be more passive?"

Baumohl, who calls this situation "the biggest threat to the freedom of the seas since World War II," adds that it is particularly significant to supply management professionals. "What troubles me most is this area is a very critical maritime route for not just Asian countries but also U.S. firms that deal with goods coming out of China, Vietnam and Malaysia," he says. "Fifty-five percent of the world's entire merchant fleet tonnage and 65 percent of all natural gas shipments in the world pass through this area. So many countries in that area depend on those routes that China now claims it is sovereign over."

PLANNING FOR DISRUPTIONS

Volatile global economic and geopolitical situations can affect organizations in different ways. Thus, **Baumohl** suggests supply management professionals look at where their assets are located, then determine the probability of disruption and where risk is likely to be greatest. Having specialized teams dedicated to handling those risks and who understand the political and economic dynamics at play can help to properly assess situations.

Baumohl also recommends that organizations conduct stress tests. "Introduce what-if scenarios — adverse hypothetical scenarios that could disrupt the supply chain network of your industry," he says. "Ask yourself what the most vulnerable points in the chain are and what you can do to protect yourself in those kinds of scenarios. You must anticipate.

These rigorous stress tests are going to become increasingly crucial as companies prepare for what's going to be a very unstable geopolitical environment."

To mitigate risk, organizations should develop contingency or governance plans that can be implemented quickly, **Baumohl** says. "If you don't have them, you could suffer reputational risk. Your clients could abandon you," he says. "You need to show your customers that you've taken precautions and that they can depend on you."

A contingency plan could include shifting production to unaffected locations, expanding into new territories and enlarging the supplier base, Christopher says. For example, if an organization has locations in Vietnam and China, and an issue arises in China, operations could feasibly be switched to the Vietnamese site, he says.

THINKING AHEAD

Unlike in past years, there are no clear emerging markets, Christopher says. "Supply management professionals are going to have to search for the opportunities. The days of hyper-globalization are over," he says. "Going back 15 years, it was easy to know what to do. You knew you had to be in China. Right now, you're not sure where to be."

That underscores the theme of uncertainty characterizing 2017. The new U.S. presidential administration with its yet to-be-determined policies, increasing capital needs among small and midsize businesses, the talent shortage, and volatile economic and geopolitical concerns make it difficult to predict exactly how the year will play out.

Baumohl says that supply management professionals need to be prepared for disruptions to the supply chain. "This year poses a serious problem for anyone who orchestrates or monitors the distribution network of their goods traveling around the world," he says. He suggests approaching the year with caution and contingency plans. ISM

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