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The KG Index

Q4 2018

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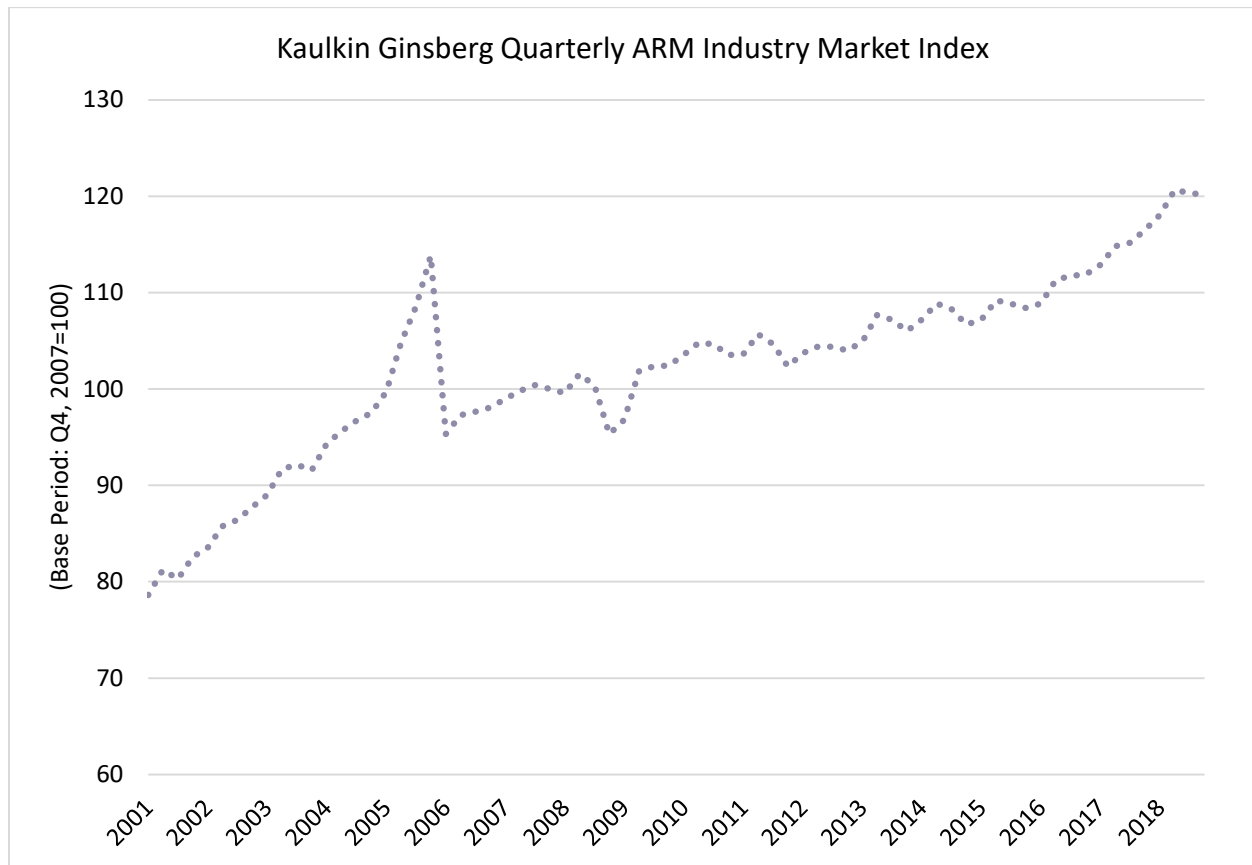
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The Economy's Effect on the ARM Industry: The KG Index



Q4 2018 data releases are complete, and that means it's now time to review fourth quarter market conditions for the U.S. accounts receivable management (ARM) industry and discuss what you should look for in the first few months of 2019. Following a few historical revisions to prior quarters' data points, we saw a net decline in the quarterly index for two straight quarters. While the ARM Index finished 2018 higher than it started the year, market conditions did deteriorate and could be an indication of things to come in 2019.

More importantly, Q4 2018 came in at an index value of 120.15. This indicates that the ARM index showed negative growth in the amount of (0.1%) on a quarter-over-quarter basis with a negative annualized growth rate of (0.6%), which is down from the Q4 2017 annualized growth rate of 4.7%. While this may sound really bad, it's important to keep in mind that the second half of the year aren't strong periods, and 2017 overachieved relative to historical precedent, which gives us several things to consider.

If the ARM industry's market conditions were nothing short of ideal from 2016 through the first half of 2018, then the market may be stabilizing and returning to more normalized operating conditions. This isn't a bad thing so long as the market, on average, continues to grow. Taking this view a step further, a market that is growing under more predictable conditions better supports investment decisions into a business since rapidly growing market conditions have a habit of encouraging more significant investments in growth than should normally occur that even hurt long-term growth.

Alternatively, it's not clear if the shift is more a result of the normalizing market conditions or a byproduct of fiscal and monetary policy. Economic growth for the U.S. slowed considerably during the second half of 2018, trade imbalances worsened, and rates increased all while the global economy slowed and growth estimates for the major developed economies were lowered by international organizations like the World Bank and International Monetary Fund.

Overall, the four key indicators contributing to our index – consumer bankruptcy filings, retail sales, official civilian unemployment rate (U3), and home price index – all diverged from their respective trends over the last few years. Here are a few of our notes on the current trends within each variable:

Consumer Bankruptcy Filings

In any given year, the first and second quarters tend to be the highest points, while the third and fourth quarters trend downward through the remainder of the year. This trend changed for the first time in a while, with Q3 2018 being greater than Q1 2018, and the quarterly values for Q3 and Q4 2018 increasing relative to the same quarters in 2017. Additionally, the total number of consumer bankruptcy filings increased for the first time since 2010. Generally speaking, some volatility and growth in bankruptcy filings is considered good for the ARM industry. However, systemic increases are an indication of an overheated consumer credit market that is trending towards a recession. Monitoring this trend could be very telling since most economists believe that the U.S. is headed toward a recession between 2020 and 2021, but could get there sooner if fiscal and monetary policy doesn't achieve its growth objectives.

Retail Sales

While retail sales tend to maintain a long-term steady growth rate, the greatest period of growth is, unsurprisingly, concentrated in the third and fourth quarters of the year, while the first and second quarters are more flat. However, retail sales were down marginally (essentially flat) in Q4 2018, relative to Q3 2018. On the surface, this slight deviation from historical trends may not imply much since total retail sales for the year increased by nearly 4.2% relative to 2017 which is a strong growth rate. Below the surface, KGC identified only three instances over the last 20 years where retail sales for Q4 came in lower than Q3; 1) 2000 following the Dot Com Bubble, 2) 2008 following the Great Recession, 3) 2014 when the [global economy nearly fell into recession](#). It may be too early to write-off Q4 2018 as an indication of a pending recession since multiple revisions will occur over the next few quarters, but the data still indicates a comparably weak quarter for retail sales.

Official Unemployment Rate (U3)

The unemployment rate came in at 3.9% for Q4 2018. While the quarter-over-quarter unemployment rate increased 0.2 percentage points, it's still exceptionally low relative to the last 20 years. As always, the quality of employment and corresponding labor force participation rate should be examined since they call into question the value of the current unemployment rate. With the labor force participation rate perennially stuck at roughly 63% and real median weekly earnings for 2018 increasing only marginally over 2017, the state of the U.S. labor force could be better (or worse) depending on the analyst. However, one thing is clear. The Tax Cuts & Jobs Act (TCJA) hasn't been the boom to economic growth the Trump administration claimed it would be at the end of 2017, and anyone believing that it would lead to significant increases in hiring and wages will be rather disappointed with these results. As for the ARM industry, fluctuations in employment activity tend to be ideal since it allows for cyclical delinquencies as well as increases in credit utilization. The last few years haven't shown much volatility,

so a significant recession could lead to a high degree of uncollectible debt if the credit market is overheated.

Home Price Index

The home price index is positively correlated with the ARM industry and facilitates consumer confidence – especially in their ability to leverage debt – since homes account for the majority of most individual's wealth. In Q4 2018, the index declined from 205.72 in Q3 2018 to 205.35. Typically, a drop of just 37 basis points isn't all that newsworthy, but this marks the first time the index decreased in value since Q4 2014 (a recent global slowdown as noted above) and aligns with other indicators of a pending recession. Given current housing trends, monetary policy, and other economic indicators, it appears that the housing market will level off in 2019 and will likely decline further in 2020. The element that isn't clear is how long the period of decline will last or the degree to which this will impact the consumer credit market since it pulls a safety net away from most consumers. The response from builders over the coming months will be very telling for the 2019 and 2020 housing market. If builders keep inventory low in 2019, then they believe a recession is coming and the shortfall in housing will push the index higher during the summer months before it's pulled down by the tightening credit market. However, if the builders keep inventory high, then they likely see the market staying strong for at least one more year and a recession not taking route until late 2020 or early 2021.

What to Look for Throughout 2019

While 2018 was a strong year for the ARM industry with many of the key economic variables facilitating significant growth for collection agencies, 2019 looks to be more of a return to normalized operating conditions. The data in Q4 2018 indicated that the U.S. economy is moving closer to the recession that many believe is long overdue, so the first two quarters of 2019 might provide an indication of the timing of this recession. From a strategic planning perspective, owners and operators will want to carefully assess how much of an investment they are willing to make into technology upgrades and facilities in the name of growth.

Contact us at hq@kaulkin.com if you have any questions.