12 DAYS IN SEPTEMBER: CONGRESS RETURNS TO WORK

TIGHT LABOR MARKET CREATING CHALLENGES FOR MIDDLE MARKET

OUTSOURCING: A COMMON SOLUTION TO SKILLED LABOR SHORTAGES

DATA SHOW MULTIFAMILY HOUSING COOLING
ABOUT THE AUTHORS

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

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Congress returned from summer recess on Sept. 5 to find a restive public and a significant regional crisis along the Gulf Coast caused by a landmark natural disaster in Hurricane Harvey and the ensuing flooding. Unfortunately, Congress has only 12 legislative days scheduled on the calendar to get its house in order and begin debate on the long-anticipated plan to engage in tax reform and cuts this year.

Keep in mind, for Congress to even begin to move on tax reform and tax cuts, it needs to lift the debt ceiling and arrive at a fiscal year 2018 budget that will create the conditions to use reconciliation to pass tax legislation with a simple 50-plus-one-vote majority. While the deal cut by the Trump administration with Democrats to temporarily lift the debt ceiling until Dec. 15 and provide the first tranche of funding for relief on the Gulf Coast will help on the margin, it won’t be sufficient to create the conditions for a quick turn to tax reform. As a result, there will be a stark divergence between the demands of Wall Street (lifting the debt ceiling limit) and the needs of Main Street (flood insurance and Children’s Health Insurance Program (CHIP)), which will likely intensify divisions between the two parties.

Below are the areas we’re watching for the middle market:

**Debt ceiling**

This issue carries with it the greatest risk of upsetting domestic and global financial markets. Given the acrimony between the two parties, which during the last debt ceiling debate included a lengthy government shutdown and a downgrade of the U.S. credit rating, financial market participants are highly attuned to the risks associated with the issue and financial markets would likely decline if an agreement isn’t reached.

In order to lift the debt ceiling, the GOP will need the votes of at least eight Democrats in the U.S. Senate, which will likely create the conditions for a confrontation over President Trump’s demand that money in the fiscal year 2018 budget be allocated to the construction of a wall on the southern border. Equally risky is if the administration decides to move toward a clean debt ceiling bill. The roughly 40 members in Congress that make up the “Freedom Caucus” would reject this and likely try to force budget cuts to offset a lifting of the $19.1 trillion statutory limit. This could set the foundation for a significant fiscal clash between the three factions of the GOP and the Democrats whom the Republicans will depend upon to pass any bill.

While a near-term shutdown of the government is no longer a risk, one cannot discount the risk of another government shutdown at the end of 2017 that extends into the new year. In addition, the more pressing problems along the Gulf Coast, and the difficulties associated with reauthorizing the National Flood Insurance Program will be significant problems. We are not yet convinced that the Trump administration recognizes that its presidency is now going to be organized around rebuilding America’s fourth largest city. Houston has a GDP that is larger than that of Sweden ($530 billion). If a government shutdown materializes late this year, expect about 0.1 percent per week to be shaved from fourth quarter GDP, depending on the duration of the shutdown, with payback occurring in the following quarter as work hours normalize.
Federal flood insurance program

The National Flood Insurance Program (NFIP) is $24 billion in debt. Recent data imply that there is only $5.3 billion ($1.6 billion already dedicated to other needs) on hand to respond to flooding from Hurricane Harvey. The NFIP paid out $16.3 billion following Hurricane Katrina in 2005 and $8.4 billion in the aftermath of super storm Sandy in 2012. According to Bloomberg data, NFIP coverage in Texas stands at $161 billion with the areas of the state impacted by the storm possessing greater than $105 billion.

This will be among many uncomfortable conversations that the federal government will have with the American public this month. Given the increasing number of natural disasters that appear to be building around coastal areas in the United States, it is likely that some in Congress and the administration will demand reforms to the program that could involve higher premiums, shifting costs to states and cities and incentives that discourage rebuilding in higher-risk areas to mitigate the costs of reconstruction going forward. If Congress doesn’t find an equitable compromise this year, current flood insurance policies will remain in effect and no new policies will be written, which would impair the sale of homes with federal-backed mortgages, which must include flood insurance.

CHIP reauthorization

CHIP provides low cost health coverage to children in families that often earn too much money to qualify for Medicaid. Coverage varies by state. CHIP was last authorized as part of the Affordable Care Act (ACA), thus debate around it may turn into something of a continuation of the politically sensitive collapse of GOP efforts to reform the ACA. Given that tax writers in Congress are on record not wanting tax reform or cuts to have anything to do with health care, this could be an issue that complicates the ability of Congress and the administration to get anything other than budget and debt ceiling issues done this year.

Tax reform

We put this last in the sequence of things that are likely to get done this year on purpose. At this point, given the unexpected natural disaster on the Gulf Coast and the increasing partisanship in Washington D.C., we don’t anticipate that anything on taxes will get done until next year. The aforementioned policy sequencing is necessary for the GOP-held Congress to use the reconciliation process to push through either tax reform or a tax cut on a simple majority vote. The administration recently noted that they would not put forward a plan outside of the framework proposed by the “Big Six” consisting of Paul Ryan, Kevin Brady, Mitch McConnell, Orrin Hatch, Gary Cohn and Steve Mnuchin. We expect some sort of framework to be delivered in October or November outlining Plan B in the wake of the death of the border adjustment tax as a plausible mechanism to pay for some portion of the reductions in the corporate income tax and the collapse of the current seven individual income brackets into three. Despite the recent attempts of the administration to highlight its support for tax reform, it will be more noise than a signal as it takes a backseat to the more pressing concerns accumulating on Main Street rather than those favored by Wall Street.

Special supplemental for Hurricane Harvey relief

As of Aug. 24, the federal government has $50.6 billion of cash on hand. The Department of Homeland Security has only $3.8 billion on hand. It is almost certain that a special supplemental will need to be passed to address the crisis in Texas and Louisiana. While the Senate has authorized $15 billion in aid, it is unlikely to be enough. Following Hurricane Sandy in the Northeast, Congress appropriated about $60 billion in federal aid, which took close to three months in late 2012 and engendered significant partisan opposition on the part of the GOP who insisted on some offsets in the budget to pay for the appropriations.
The U.S. labor market has tightened considerably during the past few months, creating a broader challenge for middle market businesses in filling skilled and unskilled labor positions. This is likely going to be a major problem throughout the remainder of the current business cycle and well into the next.

Chief drivers of the tight labor market are rapidly changing demographics in the United States, the large number of men aged 25 to 54 years old that are on permanent disability and changing preferences among millennials related to work-life balance. Other contributing factors include drug test failures due to the opioid crisis and a sizable but unknown number of individuals who have served time in prison and are not able to participate in the civilian workforce.

RSM’s labor dashboard shows that there are currently only 1.13 individuals per job opening in the economy, a symptom of the growing labor shortage that is already negatively impacting residential real estate construction, manufacturing and agriculture. Meanwhile, the 12-month moving average of job gains is 180,000 per month, more than double the size necessary to meet the demands of new entrants into the labor market, and the primary reason why the unemployment rate has dropped to 4.3 percent. Our forecast for the end of the first quarter of 2018 is for the unemployment rate to drop below 4 percent, which has the potential to cause wages to rise and pressure profit margins.

**TIGHT LABOR MARKET CREATING CHALLENGES FOR MIDDLE MARKET**

Some businesses face production bottlenecks

Joseph Brusuelas, Chief Economist, RSM US LLP
Businesses are now being forced to manage their labor force carefully to meet demand and ensure productivity. Thus, the pace of firings in the economy has dropped to multidecade lows. Our preferred metric to track this—the 13-week moving average of first-time jobless claims—has fallen to a cyclical low of 242,000, which supports our outlook that middle market businesses will continue to find it difficult to recruit and retain both skilled and unskilled workers.

How are middle market businesses, specifically, responding to an increasingly tight labor market? Based on our third quarter proprietary RSM US Middle Market Business Index survey, which will be published on Sept. 19, 64 percent of middle market executives say they are increasing compensation levels. Of those, another 28 percent are increasing overtime levels to help recruit and retain skilled labor. With respect to unskilled labor, 52 percent of middle market executives are increasing compensation levels, and 32 percent are increasing overtime. Meanwhile, 72 percent said they are having trouble finding skilled labor either “to some extent,” or “to a great extent,” while 42 percent said the same about unskilled labor.

As a result of the labor shortage, 19 percent of respondents with respect to skilled positions, and 17 percent of respondents with respect to unskilled positions, have turned to eliminating some functions completely, which is likely due to rising wage pressures and policy changes associated with the $15 per hour minimum wage movement. In our estimation, this has led many middle market businesses in food and beverage, retail, leisure and hospitality to substitute technology for labor.

Perhaps more problematic, the survey noted that 17 percent have delayed expansion plans due to problems acquiring skilled labor and 13 percent indicated the same due to a lack of unskilled labor. Another 8 percent are scaling back on production levels or targets due to an inability to obtain skilled or unskilled labor.

For the past several months, we warned that bottlenecks in production would likely develop as a result of the lack of supply in the labor market. Our view is this would intensify due to a misalignment of federal immigration policy with the shrinking number of workers who are able and willing to fill entry-level positions, manual labor and agricultural sector jobs. We are rapidly approaching the point where middle market businesses are going to be in the unenviable position of turning down work and growth opportunities. We have seen similar behavior among small banks (those with less than $250 billion in assets under management) due to regulatory oversight linked to Dodd-Frank, and, unfortunately, we anticipate we will soon begin to get similar anecdotal evidence from the broader real economy.

### Actions taken to combat the challenge of attracting skilled labor

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<thead>
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Outsourcing: A Common Solution to Skilled Labor Shortages

But do providers align with evolving needs?

By Rob Wagner, Partner, RSM US LLP

Nearly all organizations utilize third parties for a variety of processes, from tax compliance to technology staffing and back-office finance and accounting processes. It is important for businesses to consider how their providers are preparing for and addressing the same economic and industry challenges the company itself may be facing. Outsourcing is a key strategy for overcoming the skilled labor challenges within many key business functions. Unfortunately, that trend also extends to many third-party providers, especially with the increasing demand for their services.

Third-party providers may continue to be sufficient from a compliance and regulatory perspective, but they may not have the capacity to deliver the necessary productivity and efficiency to meet a company’s growth goals. In addition, the complexity of the business may have increased to require specialized knowledge or experience that the current provider doesn’t support.

When evaluating the health and ongoing fit of outsourced service providers, companies should consider:
• **Planning for the future:** Many companies have worked with their provider for a long time, and are understandably loyal. However, if it is a small organization, an individual approaching retirement or leaving the organization can have a major effect on service. Who is next in line? Will the business be as comfortable with that next person?

• **Increasing complexity during growth:** Triggers within normal operations can lead to the need for more resources, and potentially, a new outsourcing provider. For example, as a business expands and loan amounts grow, the bank may suggest working with a firm with more expansive capabilities. In addition, many firms do not provide auditing and review services, and continued growth may require an audit.

• **Emerging challenges with global expansion:** With greater connectivity, the world is shrinking and making it easier to conduct business overseas. Unfortunately, many outsourcing providers do not have the experience or knowledge to manage a company’s international business and compliance needs.

• **Operating across state lines:** For many years, small and midsized companies have conducted business in multiple states, but those operations are becoming more complicated. For example, many states are now issuing more inquiries as they become more aggressive in capturing potential revenue and ensuring the business pays where it plays. These sales can trigger a sales and income tax nexus, and many companies may not have dedicated resources that can reduce exposure to individual state and IRS inquiries or audits. Experienced outsourcing providers can automate sales tax requirements, as each state’s laws are different and often create significant challenges.

• **Realizing the company’s own capabilities are not sufficient:** Are other vendors expressing concerns about a company’s outsourced processes? A business is dependent on many functions working together, and if their outsourcing partners do not provide the right information, other related operations can suffer. For example, how finance and accounting data is compiled and shared can affect tax compliance and business projections. Does the business know where their data is coming from, and is their finance and accounting outsourcing provider sophisticated enough to meet their needs?

Whether using outsourcing to create operational efficiencies or to focus internal recruiting efforts on labor shortages in critical business areas, it is important to understand how a shrinking skilled labor pool can also disrupt third-party relationships.
Multifamily housing finance has had a robust start this year and, by some industry estimates, it may match or surpass 2016 business volumes. However, some U.S. government data may offer early hints that activity in this segment of housing—as measured by multifamily starts and permits—is cooling off from 2016 levels.

Demand for multifamily housing, construction activity in this segment of commercial real estate and the finance of these properties have been robust in the wake of the credit and housing crisis. New construction and financing activity related to this property type has trended higher amid a decline in the U.S. homeownership rate to 63.7 percent, as of the second quarter of 2017, from 69 percent in 2004. The homeownership rate was as low as 62.9 percent in the second quarter of 2016, according to the U.S. Census Department.

That shift in housing has been reflected in multifamily prices. Apartment property prices are up about 54 percent above their pre-crisis peak level, according to a report published by Moody’s earlier this year.

A large portion of the multifamily finance universe has been driven by U.S. housing agencies where, for one agency, funding activity was up during the first half of the year from the same period in 2016. Agency collateral continued to account for a bulk of the debt resold into commercial mortgage-backed securities (CMBS) and yield premiums for these securities were narrower at midyear from year-ago levels.

When it comes to building activity, U.S. government data show that starts and permit activity are down from year-ago levels. Permits for properties with five units or more showed a 14.6 percent month-over-month seasonally adjusted increase in June from May, but they are off 2.4 percent from year-ago levels, according to the U.S. Census Department. Starts for properties with five units or more showed a similar pattern. Housing starts for this segment of the housing market showed a 15 percent seasonally adjusted gain in June from May but starts for properties with five or more units were down 10.7 percent from a year ago.

When it comes to multifamily finance, the U.S. housing agencies have been active in 2017, following a robust 2016, and finance of multifamily properties could equal last year’s levels if not exceed them, some observers say.

Lending for multifamily properties tied to Fannie Mae programs was at $29.7 billion as of June, up from the same period a year ago when it totaled $22.8 billion. In 2016, Fannie Mae–related multifamily financing for the full year totaled $55.3 billion, up from $42.3 billion in 2015.

The increase in multifamily lending, and general activity in this segment of commercial real estate, is tied to a strong U.S. economy—specifically a strong jobs market that has fueled demand for multifamily housing—and demographics, according to market observers. These industry observers warned, though, that an influx of new supply could pressure rents and send vacancy rates slightly higher.

When it comes to the resale of commercial property debt into securities, issuance of U.S. CMBS totaled just over $57 billion as of June. Much of the issuance was driven by collateral from housing agencies Fannie Mae and Freddie Mac. In the first two quarters of 2017, 60 percent of all commercial property debt resold into CMBS, or $34.4 billion, was agency collateral. Agency debt accounted for $82.67 billion, or 52 percent, of all collateral resold into CMBS in 2016.

Securities backed by pools of commercial properties, including multifamily, saw demand from investors in search of extra yield. Yield premiums of 5–year (CMBS 2.0, CMBS 3.0) AAA–rated bonds pooling commercial mortgage debt were at 50 basis points in June, down from 79 to 80 basis points at the same time a year ago.
AAA 5-year CMBS spreads tighter from year-ago levels

Lower rated classes of CMBS also declined year over year. In June, BBB–CMBS was at about 470 basis points over swaps, in from 615 basis points in June 2016. They were as wide as 542 basis points in January 2017.

BBB–CMBS yield premiums narrower from year-ago levels

Meanwhile, multifamily delinquencies were at 0.24 percent in June, up slightly from May’s 0.22 percent. They are down from July 2016 when they were at 0.31 percent, and they started the year off at 0.27 percent.

When it comes to who holds much of the multifamily debt, data from the Mortgage Bankers Association (MBA) may offer a clue. According to the industry group, the largest holders of multifamily mortgages are commercial banks. Government–sponsored enterprise (GSE) portfolios and the MBS follow as the second largest holders of multifamily mortgages. The industry group said in a report published earlier this year that multifamily mortgage debt outstanding rose to $1.17 trillion at the end of the first quarter of 2017, up $23.4 billion or 2 percent from the fourth quarter of 2016. Much of that gain was tied to increases in multifamily mortgage debt outstanding, and 80 percent of that came from portfolios and MBS–held or guaranteed by federal government agencies and the housing agencies.

While lending activity has been robust, there may be some indicators that suggest a slowing in the broader commercial real estate markets.

For example, the Green Street Commercial Property Price Index—a measure of unleveraged U.S. commercial property values that captures the prices at which commercial real estate transactions are currently being negotiated and contracted—was slightly lower from a year ago.

In June 2017, that index recorded a reading of 125.5, down from 125.8 in the same month a year ago. The index has flattened out as higher cap rates have offset growing rental income. “Cap rates for most types of property have been moving up, which is acting as a headwind for values. Price declines have been largest in the retail space, while industrial, medical–office and life–science properties continue to hit new highs,” according to a Green Street report published in July.

While there may be signs that some corners of commercial real estate may see declines in prices, multifamily likely will benefit over the long term from demographics.

According to a report published earlier this year by Harvard’s Joint Center for Housing, projected household growth will add 8.9 million homeowner households and 4.7 million renter households by 2025. By 2035, projected household growth will add 15.7 million homeowner households and 9.4 million renter households.

Links for reference:

Joint Center for Housing:

Moody’s:
https://www.moodys.com/research/MoodysRCA-CPPI-up-slightly-in-February-retail-property-prices-decline--PR_364835

Census (homeownership rate):
https://www.census.gov/housing/hvs/files/currenthvspress.pdf

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https://www.census.gov/construction/nrc/pdf/newresconst.pdf

Commercial property price index (Green Street):
https://www.greenstreetadvisors.com/insights/CPPI
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