THE **REAL** ECONOMY

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INFLATION, GLOBAL RISK AND THE MIDDLE MARKET: HOW BUSINESSES CAN MANAGE TURBULENT TIMES

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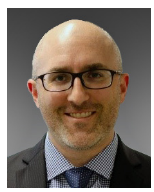

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THE ILLUSION OF INVENTORY AND PRICE CONTROLS IN THE CURRENT ECONOMY

BY JOSEPH BRUSUELAS

SYSTEMIC DISRUPTIONS of supply chains over the past two years because of the pandemic and, more recently, the Russian invasion of Ukraine have renewed calls for political authorities to do something about soaring prices.

With inflation hitting 8.5% in March and risks of another oil and energy price shock should the war deteriorate, the impulse of policymakers to take more action is rising. As one might expect, this has resulted in talk around price controls should conditions in commodity and energy markets deteriorate further.

The exigent circumstances under which the federal government needs to step in and put on what might be termed as "hard price controls"—as opposed to "soft price controls" of the type that are regular features of the American political economy—are simply not present despite the war in Ukraine.

The immediate instinct to do something to provide relief to households under duress because of rising inflation and the jump in gasoline prices is indeed understandable.

After all, fuel oil prices accounted for about a quarter of the 6.8% inflation rate encountered by consumers last year, and now, most recently, more than half the 1.2% monthly increase in the consumer price index in March.

But the imposition of price controls, in our estimation, would be a significant policy mistake under current economic conditions.

THE CIRCUMSTANCES UNDER WHICH THE FEDERAL GOVERNMENT NEEDS TO PUT ON WHAT MIGHT BE TERMED AS "HARD PRICE CONTROLS" ARE SIMPLY NOT PRESENT DESPITE THE RUSSIA-UKRAINE WAR

What are price controls?

Price controls are easy to talk about but are far more difficult to understand, given the government's participation in setting basic prices like interest rates and in health care across the American economy.

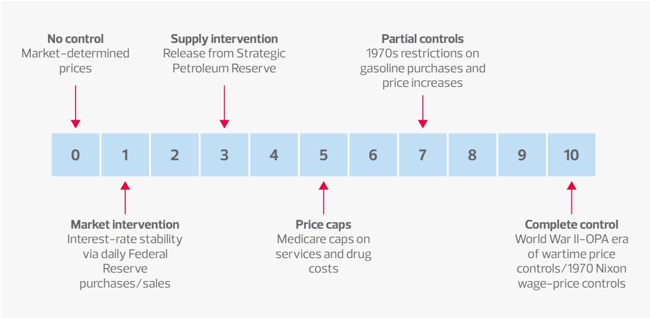
First and foremost, let us dispense with the gentle fiction that we Americans like to tell ourselves. There is no such thing as a perfect market, and in many of our most important markets, price is not purely a function of free exchange.

Rather, prices are the result of a complex and deep set of interactions that involve regulatory activity and direct government intervention.

That being said, many forms of price controls—such as rent controls—are generally and widely recognized as mid-20th century failures that distorted market functions, resulting in pervasive shortages and increased costs. That should not be replicated anytime soon.

The ideas of price controls need to be defined first before moving on to a general evaluation of them under current conditions.

Sliding scale of U.S. price controls



Source: RSM US LLP

Price controls should be best understood as the range of costs influenced by various degrees of government intervention into markets.

They can be viewed as existing on a spectrum that moves from left to right, with those on the far left-hand side reflecting little to no government influence on prices and those on the far right-hand side reflecting a hard cap on the maximum that can be charged for a good or service.

So what does that look like? The minimum area of price control, and the most subtle, is the permanent intervention by the Federal Reserve into financial markets through its daily open-market operations. The operations desk at the Federal Reserve Bank of New York controls moves in the federal funds rate. It remains the primary policy tool of the Federal Reserve in determining the price of money for fixed-income securities from overnight rates out to 30 years' maturity.

So the common assumption that the price of money along the maturity spectrum is set by the private sector is a gentle untruth. Interest rates are significantly influenced by the policy preferences of the central bank. We would assign a score of 1 to this subtle form of price control on our sliding scale, putting it at the far left of the price control spectrum.

In the middle of a spectrum, one might think about the cost of medical care. Health care, in general, accounts for roughly 18% of the American economy. For roughly the past century, the federal government has participated in managed care and, in some cases, set the price of medical care and drugs.

The current policy debate around setting a cap on the cost of insulin is a prime example of the long-term capping of prices on medical care. In our estimation, this would be assigned a score of 5, sitting midway between no control and total government control.

On the far right of the spectrum would probably be what most people would define as price controls when the government directly sets the cost of a good or service with little or no market participation in the setting of such costs.

MIDDLE MARKET INSIGHT
What's an example of a soft price control? The desk at the Federal Reserve Bank of New York controls moves in the federal funds rate.

The best example of this would be what the United States did during World War II through the Roosevelt-era Office of Price Administration. The OPA set prices in just about every market imaginable to support wartime efforts to run the economy at maximum output and to support wartime production under conditions of general resource constraints. If one wanted to purchase gasoline, rubber, sugar or coffee during the war, one had to do so under conditions of general rationing.

The only period of the modern era that resembled this was during the Great Inflation era of 1965 to 1985, when people in some states could purchase gasoline only on days that matched the last number of their license plates.

Short-run disruptions to the global oil and gasoline markets resulted in states like California, New Jersey, New York, Pennsylvania and Texas all rationing gasoline. In California in 1979, residents with license plates that ended in odd numbers could obtain gasoline on certain days and those with even numbers on others.

If hard price controls like those imposed during the war earned a 10 on our spectrum, the gasoline rationing imposed during 1979 would garner a 7. The Nixon-era wage and price controls would be a 10, right up there with Roosevelt's OPA era.

1979 redux?

Rising energy prices are stimulating calls for the U.S. government to do something in response to the Putin price shock that caused the cost of gasoline in the March CPI to increase by 18.3%. Tapping the strategic petroleum reserves, selling more leases to drill on public land or in the ocean, and imposing price controls have all become part of that discussion.

After the failure of ill-conceived price controls in the 1970s, the standard reaction to price spikes has been to demand intervention in the supply of petroleum products. The thinking is that any steps toward increasing supply would be met by increased production by foreign (and now domestic) producers that are more concerned with maintaining market share than profit.

In order to proceed in this conversation, it is important to note the current conditions within such policy decisions need to be made:

- **North America is energy-independent** for all practical purposes.
- **Inflation and, in particular, energy-price inflation have reached 1974 and 1980 levels.**
- **The war in Ukraine will inevitably lead to lower fossil fuel supplies.** Russia is second only to Saudi Arabia in production. The war seems likely to lead to higher petroleum prices, disruptions to the global supply chain and an economic slowdown spilling over into most if not all economies.
- **Private financing has become more difficult for the fossil fuel industry.** Lenders are unwilling to risk volatile pricing in a resource extraction business with a shrinking investment horizon and whose significant competitors are state-run enterprises that have shown their willingness to exert their dominant position.
- **The developed economies are quickly turning to renewable energy.** At some point, that will severely crimp the demand for fossil fuels.
- **The price of petroleum is determined within a global marketplace that consists of producers, consumers and speculators.** Each of these is concerned primarily with its own self-interest.

State actors are becoming involved. Lithuania has ceased all purchases of Russian energy, even though it is the cheapest source available. Germany is reluctant to endure the economic damages if it were to cut off Russia's supply of natural gas and coal. Yet given the war's direction in Eastern Europe, that may become a short-term reality.

And the European Commission is now requiring EU countries to fill their natural gas storage to at least 90% of capacity ahead of winter. The Biden administration has coordinated the release of oil reserves among allied countries.

Lost economic output from the two oil shocks in the 1970s was estimated at $1.2 trillion in 1997–98 dollars by the U.S. Department of Energy. There will undoubtedly be economic losses in this current episode, but will these well-intentioned steps mitigate those costs? Let's look at the track record of market interference.

Past instances of price controls

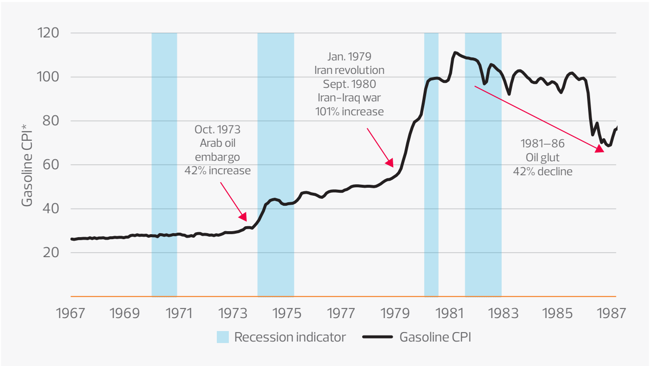
Market intervention in the U.S. economy would not be new. As we mentioned, wartime wage and price controls remained in place between 1942 and 1946.

Following the lifting of wartime price controls, inflation moved sharply higher through the end of 1948 and then eased. Nevertheless, it took the rest of the decade and beyond to retool for a peacetime economy and resolve supply and demand imbalances. (This will likely be the experience for Europe as it makes the transition away from Russian energy supplies and fossil fuels in general.)

In 1970, the Nixon administration implemented wage controls in an attempt to control inflation. Between 1974 and 1977, the Federal Energy Administration implemented oil allocation and pricing regulations in response to the first Arab oil embargo.

But those price controls didn't work—the price of gasoline continued to rise, and price controls and stringent rules for purchases resulted in inefficiencies. In short, the Nixon-era price controls spectacularly failed.

Gasoline price index during the 1970s–80s oil embargoes



Source: Federal Reserve Economic Data; RSM US LLP

*1982–84 = 100

MIDDLE MARKET INSIGHT

The jury is still out if the recent drawdown of the Strategic Petroleum Reserve will help at the margins or will be countered by OPEC policy and expectations of further conflict.

Instead of mandating a single price level, prices were allowed to increase in increments based on the previous day's price. So, of course, rational providers held back supplies until the following day when prices were higher. And consumers took to driving miles to find gasoline when their local gas station ran out or using two sets of license plates to avoid every-other-day restrictions.

In our estimation, the oil shock of the 1970s created the conditions for the worst of the Great Inflation era that did not ease materially until reaching nearly 15% in 1980. It took the monetary-policy shock of Paul Volcker, the Fed chairperson at the time, and the severity of double-dip recessions that followed to end inflation's grip on the economy.

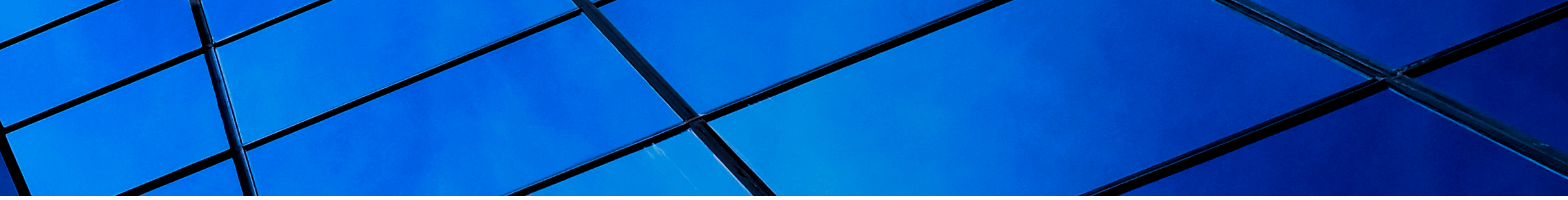
The benefit of the 1970s price shocks was a change in consumer taste that tempered the wasteful use of fossil fuels. We do not think that is what it will take to address the current policy challenge around inflation.

In the decades after the 1980s and until the pandemic, several factors expunged excessive inflation from the economy. These included the demise of union power, the shift of the production floor to low-wage production centers, and the ability of the global supply chain to deliver cheaply made goods to consumers and manufacturers.

More recently, technological advances have allowed for profitable extraction of North American crude oil, which has allowed for the supply side of energy independence.

But crude oil is a fungible commodity, the price of which remains arbitraged within a global marketplace, with the majority of supply determined by state actors not aligned with Western ideals.

Short of further devolution of this crisis, we do not see any material changes that would require the implementation of price controls. The Fed has the tools to deal with inflation, and with the exception of exigent circumstances, it's best to have consumers determine how much petroleum they need to consume.



Inventory control

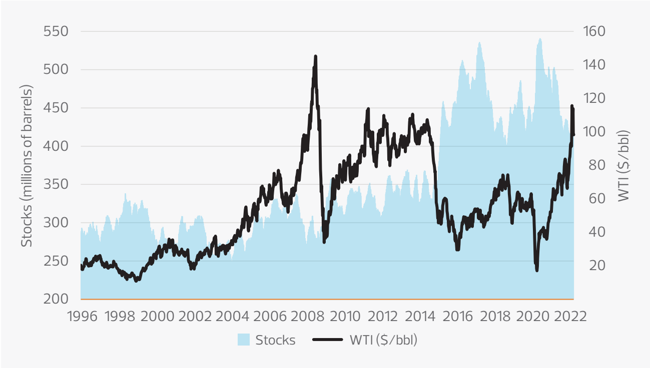
In a 2001 paper, "The role of inventories in oil market stability," the economists Amy Myers Jaffe and Ronald Soligo argue that in the case of energy commodities, "it is reasonable to ask whether the management of inventories can be left to market forces. After all, petroleum products are a vital input to the economy and national security purposes."

During the time of the paper's release, substitutes for fossil fuels were not easily available for private transportation, while switching among home heating alternatives remains costly for most households to this day.

As the authors put it, the issue is whether private agents will hold the socially optimal level of inventories to meet the "once-in-a-decade" supply shocks that characterized the 1970 Arab oil embargoes. We now need to add the shocks of the supply-demand imbalances of the pandemic era and the removal of Russia's supplies from the world market.

Maintaining large inventories can be costly, and we cannot expect private agents to do so profitably. Should the government have a role in stabilizing the availability of essential goods such as energy or food?

U.S. weekly stocks and price of crude oil*



Source: U.S. Energy Information Administration; RSM US LLP

*Excluding Strategic Petroleum Reserve

The authors found that commodity markets are unlikely to provide socially optimal inventories if left to their own devices. And though buffer stock programs became fashionable in the 1960s and 1970s and were initiated in sugar, tin, cocoa and natural rubber markets, the authors point to the consensus that the programs were not working and that serious consideration of such programs has ceased.

MIDDLE MARKET INSIGHT

The attempt to control the price of gas in the 1970s didn't work—the price continued to rise, and price controls and stringent rules for purchases resulted in inefficiencies.

We find that the inverse relationship between private inventories of crude oil and its price has grown stronger, with a correlation of negative 0.85 over the past 10 years. This implies that as the benchmark price of the West Texas Intermediate crude oil declines, the amount of oil in storage tends to increase. Conversely, as the price of WTI rises, the amount of storage drops.

Correlation does not imply causality, however, but rather co-movement. As such, our analysis suggests that when prices move higher, inventories are drawn down, perhaps because production does not or cannot keep up with demand.

In this latest period, there is a reluctance to finance additional oil production for concern over price volatility and loss of previous episodes and because of the limitations of the investment horizon as Western nations move away from fossil fuels.

Finally, the jury is still out on whether the recent drawdown of the Strategic Petroleum Reserve will help at the margins or will be countered by OPEC policy and expectations of further conflict.

Patience

The experience of the dramatic drop in demand for oil during the pandemic—which was quickly followed by an inadequate production response to the post-pandemic surge in demand—should put to rest the idea that price signals alone are infallible.

Meeting an upsurge in demand or countering the loss of Russian supplies is not just a matter of flipping a switch in the Permian Basin.

Nevertheless, there are costs of ignoring price shocks in essential commodities. If this latest episode of higher prices continued, there would certainly be a misallocation of resources and economic losses. However, those losses would not be equally distributed among households or businesses.

AFTER THE FAILURE OF ILL-CONCEIVED PRICE CONTROLS IN THE 1970S, THE STANDARD REACTION TO PRICE SPIKES HAS BEEN TO DEMAND INTERVENTION IN THE SUPPLY OF PETROLEUM PRODUCTS.

Academic work appears to be somewhat inconclusive regarding an asymmetric relationship between energy prices and output. While higher energy prices can result in lower gross domestic product, lower prices are not necessarily a cause for higher levels of GDP. But that might depend more on the time frame and technological changes.

Should the government intervene in every instance of market failure? Was the government obligated to step in on behalf of oil producers when the market plunged during the pandemic?

The current market is unlike any previous episode of volatile petroleum pricing. Instead of dealing merely with OPEC, Europe is dealing with an expanded OPEC+ that includes a nation armed with nuclear warheads.

This current pricing episode started with the price of West Texas Intermediate crude oil peaking along with the economic recovery in June 2018 at $74 per barrel. Price then began dropping as the U.S. trade war became the 2018-20 global manufacturing recession.

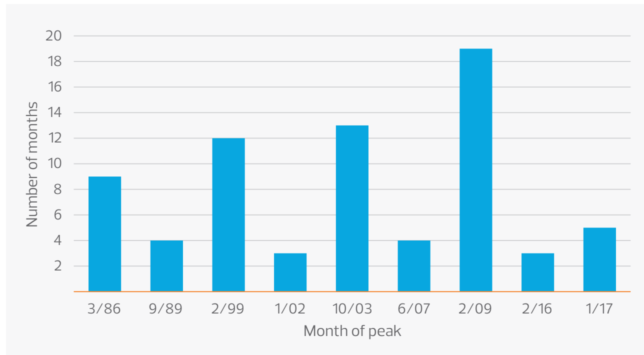
WTI futures prices had already dropped to $45 per barrel by February 2020 before plummeting to below $20 by April as the pandemic shut down the economy. Inventories became so bloated that the futures price became negative, with nowhere to store the excess oil.

Twelve months later, the price increased by a record 237% to more than $63 per barrel from a low starting point of $18.84 as the economy reopened and demand surged.

Then in early March, Russia's invasion of Ukraine pushed WTI prices as high as $123 per barrel. Prices fell to $94.29 by the second week of April, essentially an increase of 62% from last April, with the markets unsettled as they wait for the next shoe to drop.

Price increases do not last forever. Our analysis shows that since 1986, in five of the nine episodes when the WTI price increased by 50% or more relative to the previous year, prices troughed three to five months after the peak month. In the remaining four episodes, it took from nine to 19 months for prices to subside to levels before the spike.

Number of months between spike in peak crude oil price and following trough*



Source: Bloomberg; RSM US LLP

*1986–2017

So if it weren't for the events in Ukraine, there would be a case for patience. Last year, the spike in oil appeared to be resolvable 12 months after its beginning. But a second spike occurred because of the increased risk of the war spreading beyond Ukraine.

Consumers have shown the ability to adjust spending habits and lifestyles to the new level of prices at the pump. Because of the war, they now have to alter their expectations of maintaining whatever lifestyle they might have already adopted.

The takeaway

There are two lessons from the 1940s and 1970s. First, while there is a rationale for price controls during wartime—when the entire country is enlisted in self-preservation—the 1970s episode was not an example of that. The embargo didn't last forever, and we all got through it, albeit in compact cars. Second, prices in an open economy are the most efficient mechanism for determining consumer choice.

The current episode of extremely high oil prices cannot necessarily be categorized as a market failure. Instead, prices are high because of geopolitical uncertainty and the failure to move quickly beyond a single energy source.

Rather than manipulating the supply or demand for oil, governments might find it more efficient to advance the transition from fossil fuels and subsidize those who cannot afford to make that transition quickly.

CONFIDENCE IN THE FED, BUT UNCERTAINTY OVER LONG-TERM GROWTH

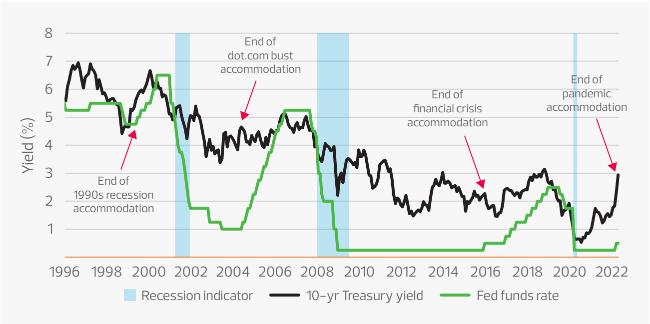
BY JOSEPH BRUSUELAS

THE FEDERAL RESERVE has started normalizing interest rates, lifting the short-term transaction cost off the zero bound following two years of crisis policy.

The result has been a 100-basis point increase in the yield on 10-year Treasury bonds, which have increased from just under 2% to nearly 3% in a little more than 60 days. If rates do not stabilize in the near term, we will have to lift our provisional forecast for the 10-year Treasury to end this year at 2.95%.

The initial impetus for the policy shift was the growing strength in an economy now able to support higher interest rates and the gradual deflation of asset bubbles that formed during the low-for-long interest rate policy during the trade war and the pandemic.

Monetary policy normalization and 10-year yields*



Source: Bloomberg; RSM US LLP

*10-year Treasury yields during Fed rate-hike episodes

THE INITIAL IMPETUS FOR THE FEDERAL RESERVE'S POLICY SHIFT WAS THE GROWING STRENGTH IN AN ECONOMY NOW ABLE TO SUPPORT HIGHER INTEREST RATES AND THE GRADUAL DEFLATION OF ASSET BUBBLES.

MIDDLE MARKET INSIGHT

The bond market anticipates an acceleration of Fed rate increases and a drawdown of the Fed's accumulation of long-term Treasury bond purchases.

Because of the persistence of inflation, the bond market now anticipates an acceleration of Fed rate increases and a drawdown of the Fed's accumulation of long-term Treasury bond purchases.

We anticipate 50 basis-point increases in the policy rate at both the May and June meetings and the central bank to draw down its balance sheet by roughly $3 trillion over the next three years.

In our estimation, the expectations of rate hikes and the Fed's emerging balance sheet strategy have resulted in the shape of the 2-10 yield curve, which now has a positive upward slope after inverting in early to mid-March.

For the time being, the increase in the bond yields along the curve is attributed to expectations of increases in the path of short-term interest rates as the Fed normalizes rates.

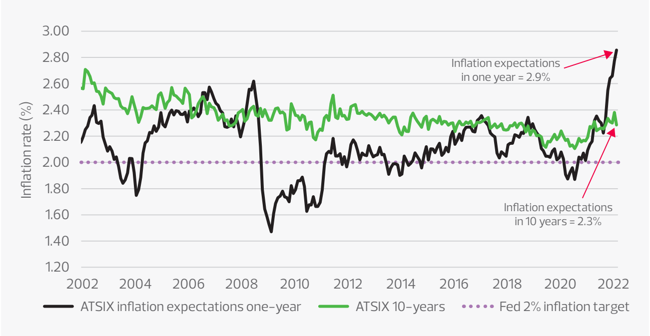
But the decrease in the term premium—the compensation for the risk of holding a bond over its maturity—signals concern for long-term growth. This concern is most likely because of the Fed action to slow the economy to constrain inflation and the risks presented to the global economy by Russia's invasion of Ukraine.

Inflation expectations remain subdued

Model-based estimates of inflation expectations point to inflation rates less than 3% in 12 months and 2.3% in 10 years, which roughly conforms to consumer expectations of 3% inflation over the next five to 10 years and expectations derived from the forward markets.

This speaks to the confidence of the public and the markets in the Fed's ability to control inflation.

Expectations of inflation in one year and 10 years



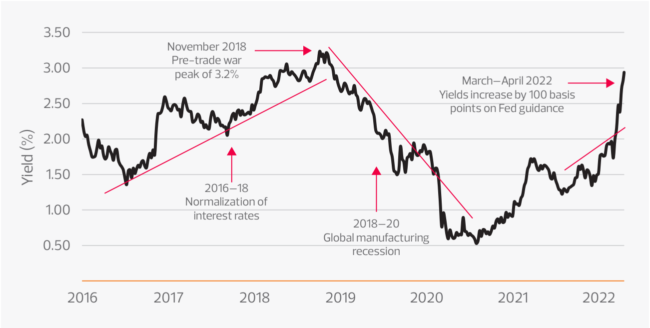
Source: Federal Reserve Bank of Philadelphia; RSM US LLP

*Aruoba Term Structure of Inflation Expectations (ATSIX)

Interest-rate normalization program

It is important for the Fed to restore normal levels of interest rates to extend the range of future policy options and to restore balance among the returns in the financial markets. But the sharp increase in 10-year Treasury yields from 2% to 3% might better have occurred more gradually and under less stressful circumstances.

10-year interest rates since 2016*



Source: Bloomberg; RSM US LLP

*Weekly yield of 10-year Treasury bonds

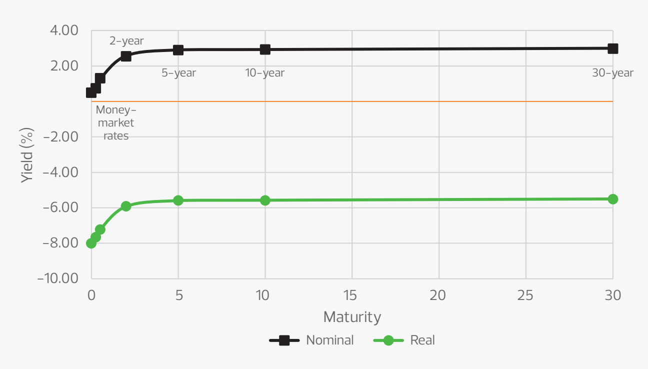
The persistence of inflation because of past policy, continued shortages of energy and housing, and the war in Ukraine required a swift response from the world's central banks.

IT IS IMPORTANT FOR THE FED TO RESTORE NORMAL LEVELS OF INTEREST RATES TO EXTEND THE RANGE OF FUTURE POLICY OPTIONS AND TO RESTORE BALANCE AMONG THE RETURNS IN THE FINANCIAL MARKETS.

Real yields remain negative

Because of the sharp increase in inflation, real yields remain negative across all maturities despite the increase in nominal yields. This implies a level of accommodation for long-term investors who will pay back the loans in deflated dollars.

Nominal and real U.S. Treasury yield curves*



Source: Bloomberg; RSM US LLP calculations

*Nominal Treasury yields and inflation-adjusted yields as of April 4, 2022

While the yield curve is no longer inverted, it remains too flat in our estimation, signaling uncertainty about the ability of the economy to support higher rates of return and to continue growing.

We expect growth to arrive at or below 1% in the first quarter, rebound strongly in the second and third quarters, and then be subdued as higher rates of interest and inflation affect the consumer sector's propensity to spend.

Thirty-year and five-year Treasury yields

You would expect 30-year bond yields to reflect the greater risk of holding a security over that length of time, with the prospect of event risk disrupting economic growth at some point. Instead, we find five-year Treasury yields rising above 30-year yields, and the yield spread becoming negative.

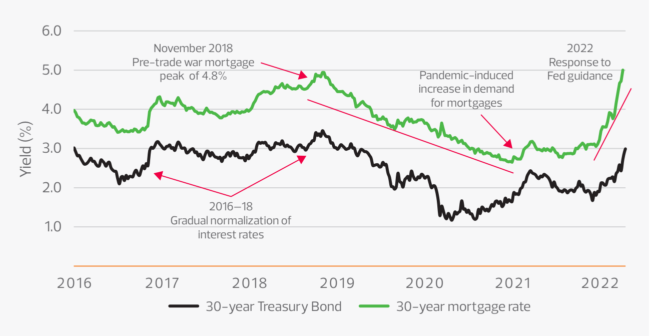
We attribute the increase in the five-year yield to the larger impact of monetary policy on short-term securities. And while we expect a more subdued impact of monetary policy on bonds 30 years out, there is also concern that the economy has yet to make significant improvements in its potential growth.

We attribute that to the absence of infrastructure spending, which was delayed until after the midterm election to get bipartisan support. As such, it may take at least another year for the bond market to assess the prospect of an economy more advanced than the stagnant, low-growth economy of the years before the pandemic.

Mortgage rates have responded

The average mortgage rate calculated by Freddie Mac shows that new homeowners are facing a 5% cost of carry, substantially higher than the less-than 3% rates of the pre-pandemic era. We expect those rates to put a crimp in the demand for housing, which, because of its weight in determining the consumer price index, will have a large impact on the inflation rate.

30-year Treasury yield and average mortgage rate since 2016



Source: Bloomberg; RSM US LLP

In addition, the 30-year fixed mortgage rate of around 5.5%, resting above the 30-year jumbo rate of 4.4%, will almost certainly cool demand for housing for anyone who cannot or is not willing to put down more than 20% to purchase a home.

3 THINGS TO KNOW BEFORE RAISING YOUR PRICES

BY TUAN NGUYEN

IT HAS BEEN a year since inflation in the United States started to become a dominant economic issue. Now, with rising prices proving to be stickier than expected, business leaders have been facing a challenge: how to set prices in a highly inflationary environment.

In many industries that are heavily dependent on commodity prices, like food suppliers and energy producers, there is little choice but to peg prices to the overall market. The costs of making their products are tied too tightly to commodity prices.

But in other industries, the answer is not so straightforward, and those businesses have been grappling with a classic economic trade-off: higher prices mean lower sales.

That's because lower sales often lead to less market share, which erodes market power and profit margins in the long run. In addition, profit is not always the primary business objective, especially for businesses that prioritize growth or long-run sustainability.

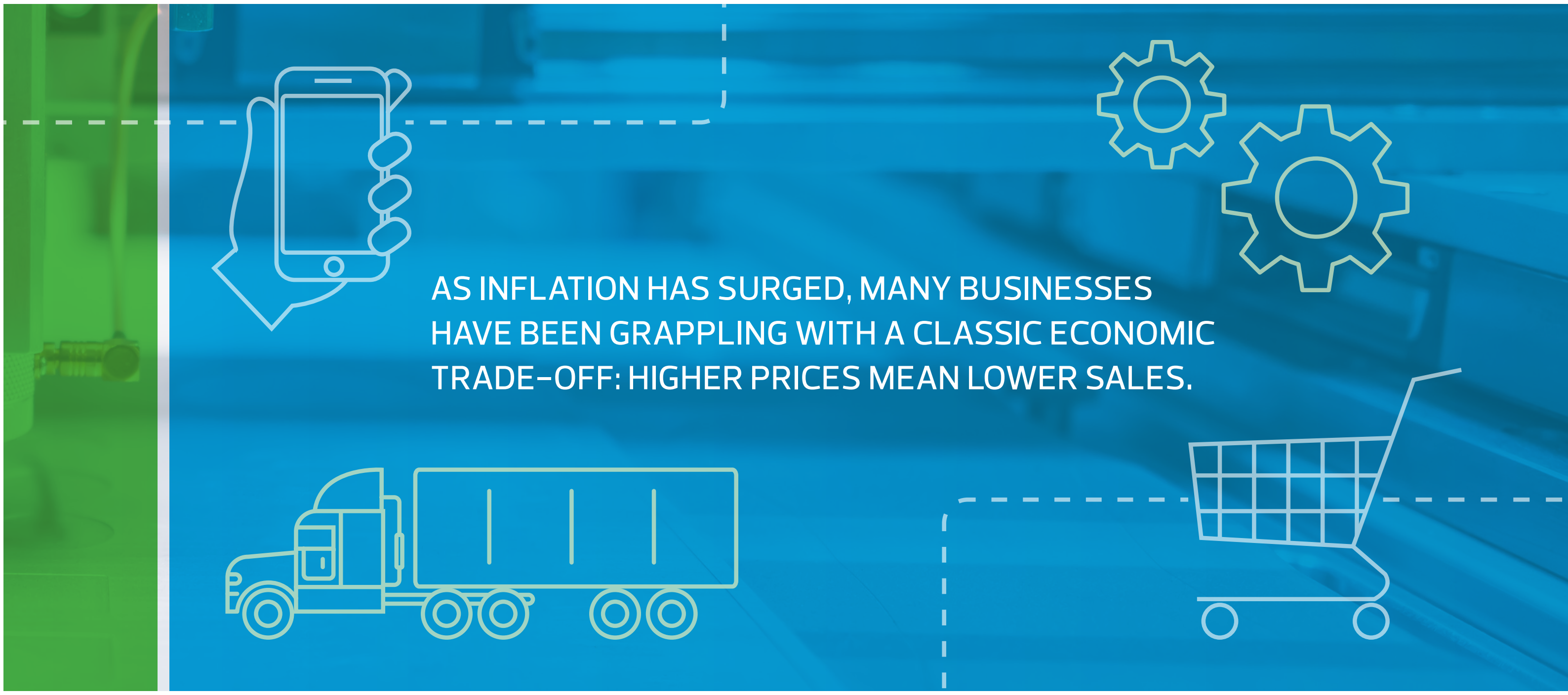
What, then, is a business to do? We examine three important factors that could help business leaders make better pricing decisions: demand forecast, market competition and business objectives.

Building demand forecast methods

To protect total profits, businesses should prioritize developing data-driven demand forecast methods that can help to quantify the trade-off between prices and sales.

It's not an easy task, but those methods do not have to be as sophisticated as the approach at Amazon, with its hundreds of economists dedicated to designing pricing and demand algorithms.

Smaller firms can look to high-level macroeconomic data as the foundation to forecast underlying economic trends. The Federal Reserve's plan to raise interest rates to tame inflation is one example of what can affect overall market demand, as higher interest rates would drive demand to moderate.



Data on consumer income, spending and retail sales—which are released every month and are available at the industry level—is also essential to help predict demand trends.

For example, producers of durable goods are seeing their demand dwindling quite rapidly because consumers are moving away from spending on durable items to services as the impact of the pandemic retreats. The risks of losing demand while raising prices will undoubtedly be much higher for goods producers than service providers.

Studying microdata on past and current customer behaviors is the next step to improving a business' demand forecast. For industries where demand often fluctuates because of seasonal factors, capacity constraints or product cycles, dynamic pricing models that incorporate data on demand volatility and consumer sensitivity to price changes can help businesses more nimbly adjust their prices.

For industries where price changes are less frequent, like manufacturing or wholesale, the decision to raise prices should include both short-term and long-term impacts on demand. It is often much more sensitive to prices—the reason why changes in prices are less frequent in the first place.

Lower price variability also means fewer data points to predict demand. Market testing and implementing "what-if" scenarios can provide data-driven and informed solutions to pricing decisions that are less biased than the traditional rule-of-thumb or experience-based pricing methods.

MIDDLE MARKET INSIGHT

To protect total profits, businesses should prioritize developing data-driven demand forecast methods that can help to quantify the trade-off between prices and sales.

Building a data-driven model to forecast demand can improve upon itself when more data is collected. And that is the reason why companies should start investing their resources early, no matter how limited those resources might be.

Understand your competition

The second factor that forces businesses to think twice about raising prices is market competition. The risk from higher prices is not only lower sales but also reduced market share, especially when competitors do not raise their prices. This often happens in markets where products are less differentiated, and profit margins are large enough to compensate for higher input costs without raising prices.

Moving first to raise prices in these markets would be a disadvantage unless the company is a dominant player with a high enough market share. Companies that do not have that luxury will have to base their pricing strategies on their competitors' pricing responses.

That requires a certain amount of data on competitors' prices, market share and products to monitor those responses and act quickly. Leveraging publicly available data on competition is a must before making any pricing decisions.

MIDDLE MARKET INSIGHT

The risks of losing demand while raising prices will undoubtedly be much higher for goods producers than service providers.

Equally important is identifying the company's specific comparative advantages and the market's barrier to entry. For example, raising prices to protect profit margins would invite innovations and entries from competitors that could chip away market share. Those risks can sometimes be hard to envision yet can seriously affect a company's survival in the long run.

Market competition can also happen at the supplier level. If there is a dominant firm that supplies input materials for the entire market, chances are your competitors are facing the same problem. Your pricing decisions again should follow your competitors' reactions closely.

But upstream competition can open the door for new opportunities like strategic partnerships, vertical mergers or acquisitions. Instead of fighting higher input costs, companies can take matters into their own hands by having more control over their suppliers. That control can be further expanded into downstream market power by eliminating double marginalization and becoming more efficient.

Align pricing decisions with strategic goals

There is no one-size-fits-all solution to pricing decisions in a highly inflationary environment. The risks that come with higher prices can affect various parts of the business that might not always support the company's strategic goals.

Protecting profit margins may be less pressing for companies that prioritize growth than protecting market share and locking up more customers. Omnichannel companies that focus on customer experience and direct sales may also need to be more careful when raising prices because of potential customer adverse reactions to higher prices.

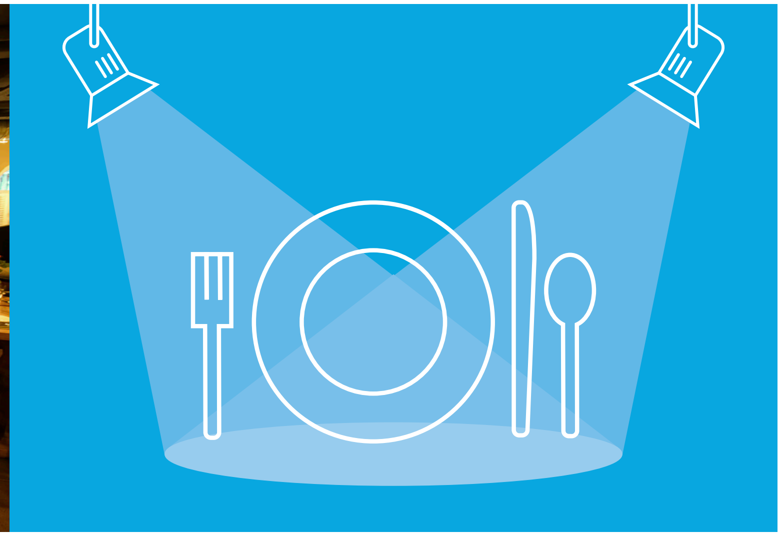
But for companies that prioritize recouping profit quickly for new products or face capacity constraints, raising prices should be an easy decision.

Most companies do not rely on a single strategic goal but rather a combination of priorities and business plans. Pricing decisions then become more complex than a simple yes or no question; those decisions also include questions like by how much and for how long.

The takeaway

While these three factors are important to consider in an inflationary environment, they can also work well even when inflation is not a problem because they lay out the principles behind every pricing strategy.

By building a strong foundation with the help of data-driven studies to understand the risks, benefits and opportunities around pricing strategy, businesses will be better prepared to make sound decisions. That includes the uncertainties around inflation that might take months or even years to subside.



TIGHTER BUDGETS AND A SHIFT TO SERVICES

BY MIKE GRAZIANO

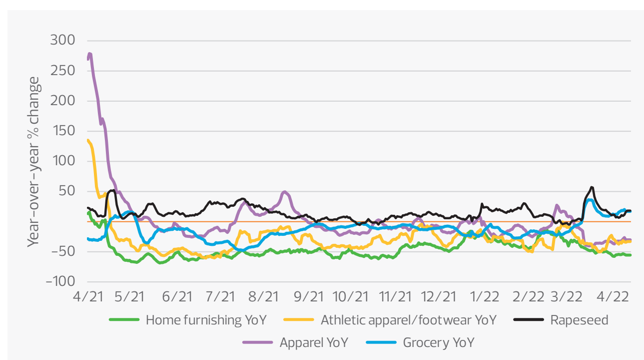
AS THE ECONOMY reopened following the shock of the pandemic, the ensuing recovery has unleashed a surge in consumer buying power as wages have increased, government aid has landed in checking accounts and household savings have soared.

But as inflation continues to rise, reaching 8.5% in March, consumers are feeling a squeeze as they devote a larger percentage of their monthly budgets to meeting fixed costs like groceries, rent and energy.

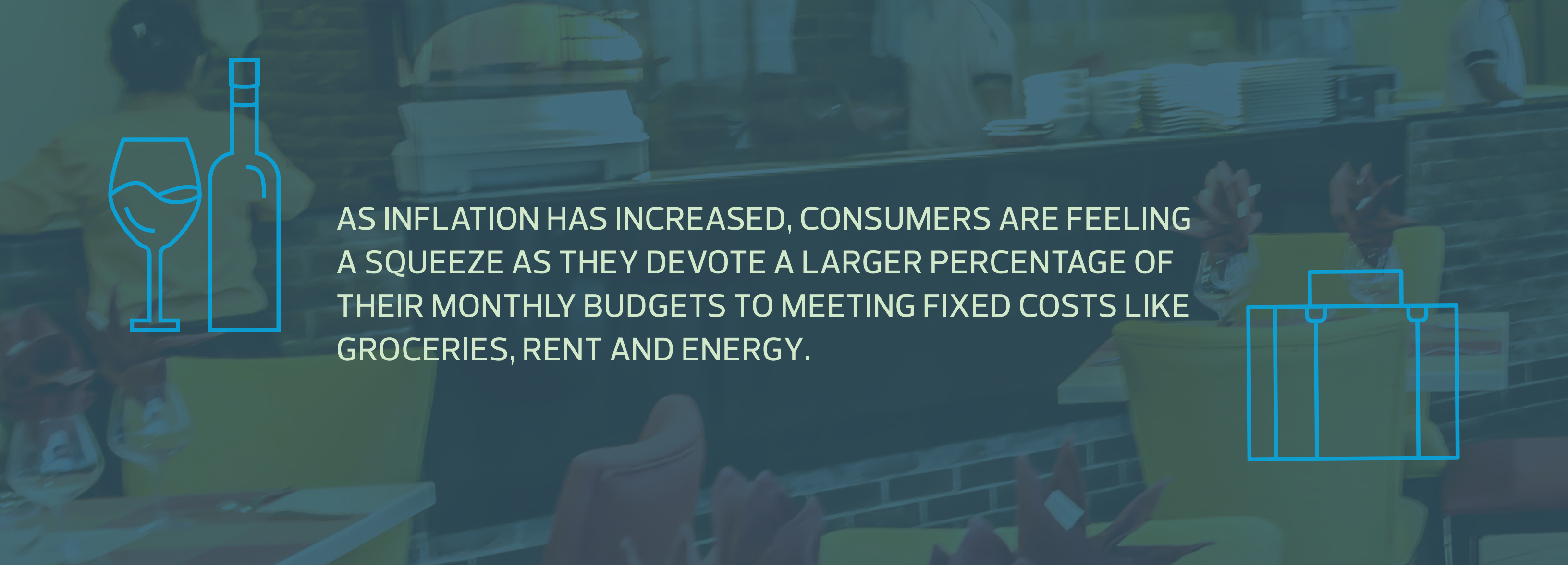
Now, as the Federal Reserve raises interest rates and Congress reins in spending, middle market businesses are dealing with a new question: Are consumers still wielding that strong buying power to purchase goods, or has sentiment shifted?

What's clear is that consumer goods companies need to adjust to a rapidly changing landscape where household budgets are tighter and consumers spend on services as the economy continues to reopen.

Low and middle income spending



Source: Facteus; Bloomberg; RSM US LLP



AS INFLATION HAS INCREASED, CONSUMERS ARE FEELING A SQUEEZE AS THEY DEVOTE A LARGER PERCENTAGE OF THEIR MONTHLY BUDGETS TO MEETING FIXED COSTS LIKE GROCERIES, RENT AND ENERGY.

MIDDLE MARKET INSIGHT

Even with disposable income dollars above pre-pandemic levels, real disposable income has declined as inflation has eaten into discretionary dollars.

The impact of price increases

While consumers had largely overlooked price increases throughout the recovery, that has changed in recent months, particularly among lower-tiered earners.

Since March, low- and middle-income wage earners increased their spending on essential items like groceries and gas by an average of 12% and 17%, respectively, on a year-over-year basis, according to Facteus, an alternative data research company. Over the same period, purchases of less essential items like apparel and home furnishings declined by more than 25% each. While a portion of this decline is attributed to government stimulus, the increase in grocery and gas is notable.

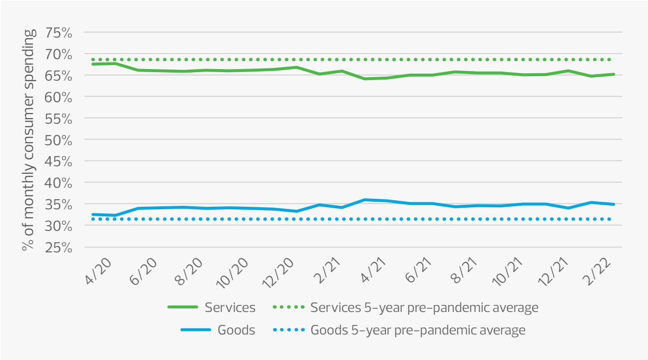
In April, consumers continued to pull back on many nonessential purchases, including the decline in demand for nearly all nonedible categories, according to recent spending data provided through the IRI CPG Demand Index. In the most recent University of Michigan consumer sentiment readings, consumers indicated that they are less confident in their ability to absorb additional price increases; 40% view this as a bad time to make large household durable purchases.

Even with disposable income dollars above pre-pandemic levels, real disposable income has declined as inflation has eaten into discretionary dollars. Retail sales excluding food service, gas, building materials and motor vehicles declined each of the last two months, the first time this occurred since April and May 2021, according to U. S. Census Bureau data.

As these pricing pressures continue, consumers will most likely shift some buying preferences to more necessary and shelf-stable items, like frozen foods, pasta and private-label goods, to operate within established home budgets rather than spending on desirable goods.

As a result, consumer goods companies will need to rethink sales strategies to ensure they are providing value consumers are willing to spend on as a decline in sales volumes pressures companies to protect margins.

Goods vs. services split



Source: U.S. Bureau of Economic Analysis; Bloomberg; RSM US LLP

The shift to services

Another factor expected to affect consumers' spending is the anticipated transition of spending on services like travel, dining out and events.

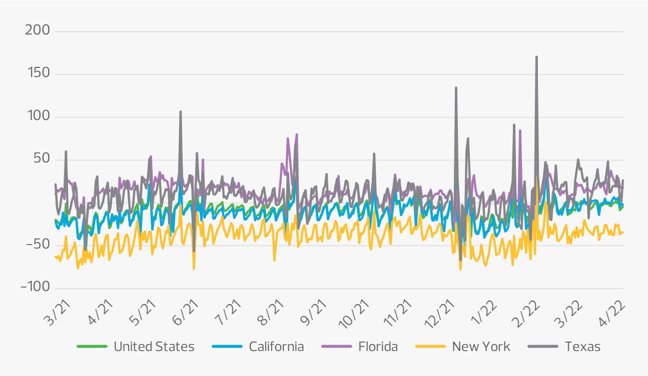
Since the start of the pandemic, goods purchases have accounted for on average 34% of wallet share, compared with the five-year pre-pandemic average of 31%. Similarly, spending on services has accounted for on average 66% of consumer wallet share, down from the 69% five-year pre-pandemic average.

CONSUMERS CONTINUED TO PULL BACK ON MANY NONESSENTIAL PURCHASES IN APRIL, SUPPORTED BY THE DECLINE IN DEMAND IN NEARLY ALL NONEDIBLE CATEGORIES.

As states relax COVID-19 restrictions and the summer approaches, we expect to see consumer dollars shift from goods to services. In the latest consumer spending data available, service volumes had returned to pre-pandemic levels; however, goods purchases were still elevated from historical norms.

Service spending will vary by region, as evidenced by mobility data provided by Open Table. In March, the average number of seated diners across the United States was approximately 95% of 2019 levels. When this data is viewed at a state level, though, the averages vary. For instance, in Florida, seated diners averaged 115% of 2019 levels, while in New York, the average was 65% of 2019.

Seated diners against FY 2019 baseline



Source: Open Table; Bloomberg; RSM US LLP

MIDDLE MARKET INSIGHT

Consumer goods companies need to adjust to a rapidly changing landscape where household budgets are tighter and consumers spend on services as the economy continues to reopen.

The takeaway

In the coming months, consumer goods companies will need to continue to evaluate what consumers are willing to spend on as budgets tighten in today's inflationary environment.

Companies cannot operate as if last year represented a return to normal. We expect much of the spending that drove the strong financial performance of consumer goods companies to shift toward other areas like services this year and beyond.

As a result, consumer goods companies should ensure they are strategically positioned to take advantage of consumer spending habits and be nimble to protect margins.

HOW ENGINEERS CAN BRING INNOVATION TO A COMPANY'S ESG STRATEGY

BY JAKE SALPETER

OVER THE PAST FIVE YEARS, environmental, social and governance practices have grown exponentially across industries as stakeholders have demanded that companies take action.

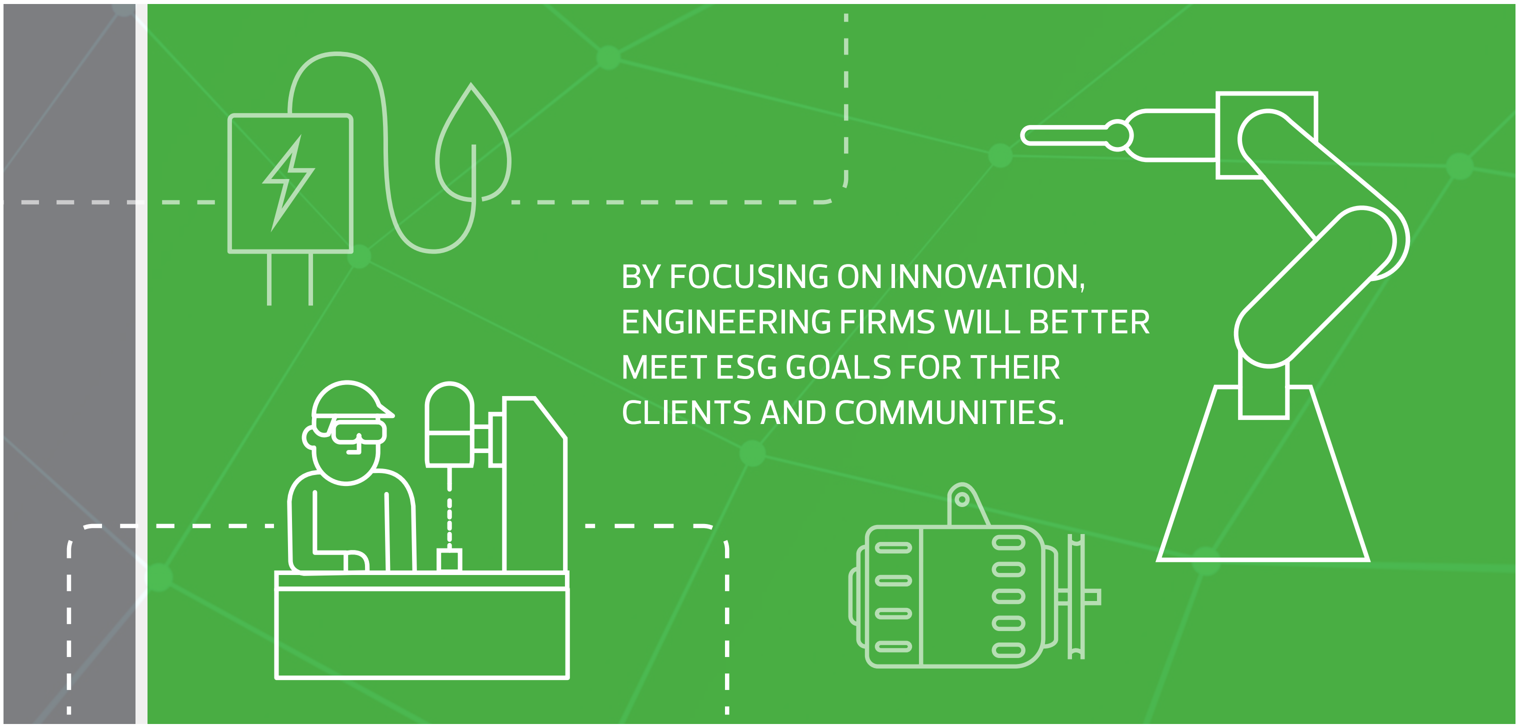
A special report on ESG from RSM last year showed a dramatic rise in middle market business executives who said they were familiar with the subject, increasing from 39% in the fourth quarter of 2019 to 69% in the third quarter of 2021.

ESG has now become an expectation among middle market firms, leading to the question, "How can companies and organizations differentiate themselves further through ESG?" The answer to this lies in an additional letter—I, representing innovation.

MIDDLE MARKET INSIGHT
Innovation drives ESG progress and enables organizations to achieve their ESG goals.

Innovation drives ESG progress and enables organizations to achieve their ESG goals. Without innovation, ESG would not have reached its current level of prominence within both public and private domains.

Engineers are uniquely positioned to drive this innovation and help their companies, clients and communities make significant strides in adopting ESG practices from a technical, operational and executive perspective.



The benefits of ESG

Aligning social and environmental goals and improving financial performance can be achieved only through the meaningful and intentional integration of ESG into the company's operations.

Through innovation, consulting engineers can promote this integration in several ways:

1. **Sustainable design:** Many innovative ESG concepts—including societal and environmental impact studies, circular economy models and product differentiation—can be leveraged as part of the integrated design process for engineering projects. Asking the right questions at the outset of a project allows engineers to make innovative and well-informed decisions that will affect the outcome of a project.

2. **Emerging technology:** Innovative and emerging technology is critical to incorporating ESG into the design, implementation and management of projects. Much like building information, modeling changed the landscape for how infrastructure projects are managed. New and emerging technologies like environmental management systems, void analysis tools and impact reporting software are used by engineering firms to incorporate and communicate the value of sustainability innovation in their projects.

MIDDLE MARKET INSIGHT

By adding another letter—I, for innovation—companies and organizations can differentiate themselves further through ESG.

3. **Fostering next-generation leaders:** Innovation and ESG can successfully address global environmental and social issues only if it is sustainable across multiple generations of professionals. Fostering a culture of innovation and creativity within a consulting engineering firm is just as important to the long-term success of the engineering industry as providing innovative solutions. The next generation of innovative engineers will require a canvas to learn, grow and explore. Engineers in training can flourish in an environment that encourages innovative solutions and creative thinking.

The takeaway

By focusing on innovation, engineering firms will better meet ESG goals for their clients and communities.

ESG INSIGHTS

Q&A: IMPROVING ESG REPORTING STANDARDS

ALEX KOTSOPOULOS, a partner in RSM Canada's environmental, social and governance advisory practice, discussed the importance of taking a structured approach to ESG reporting and integration. What follows is a conversation that has been edited for brevity and clarity.

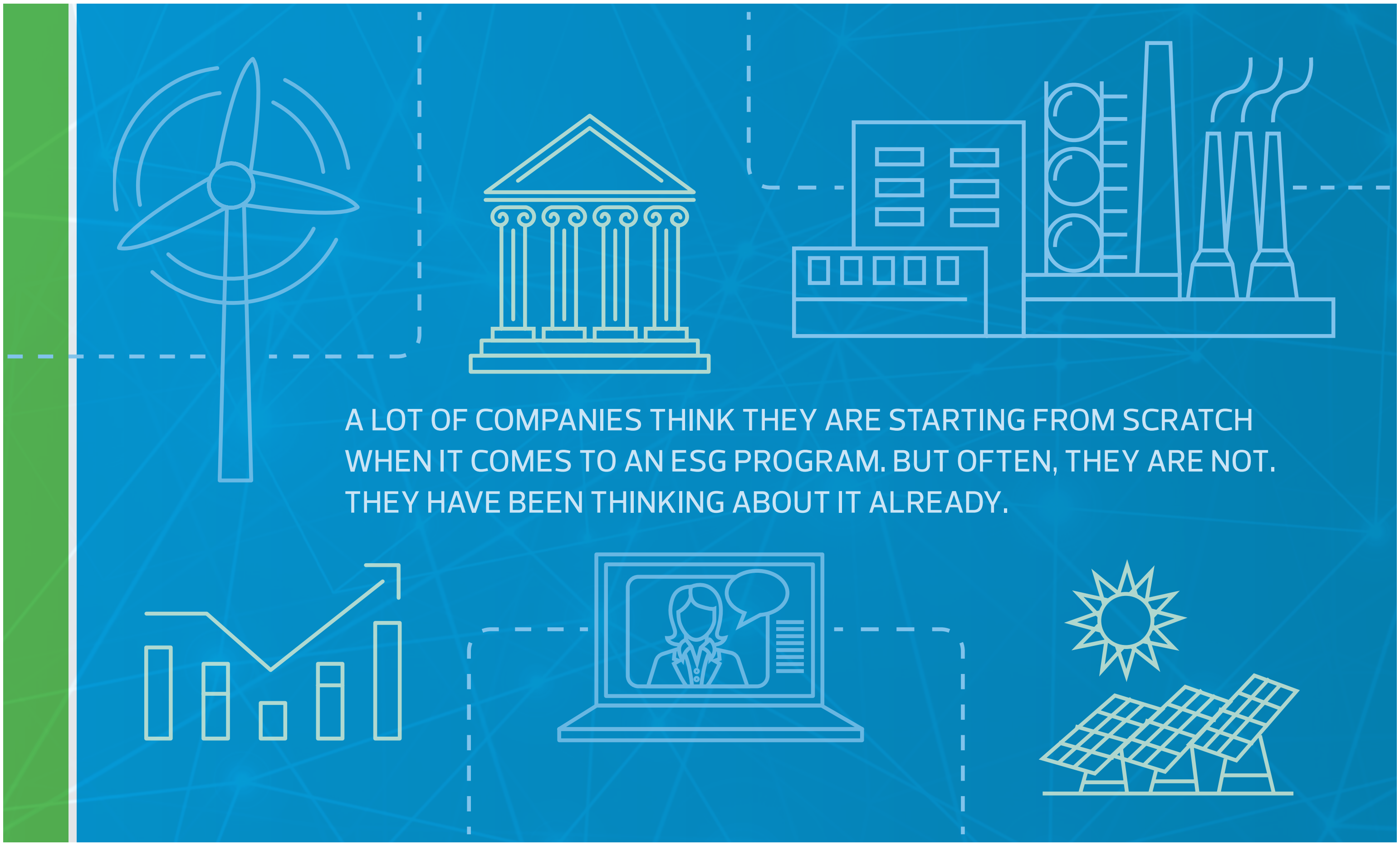
Q: How has the conversation surrounding ESG changed recently?

A: Companies of all shapes and sizes have been thinking about sustainability for a long time now. It is not a new topic. Companies fundamentally understand that they need to think about their stakeholders and the communities where they operate. What's changed are the expectations of these companies and that they are being held accountable. That's where rigorous ESG reporting comes in. Stakeholders are demanding that companies report on these factors in a much more structured way and think about ESG at an operational level across the organization.

> **MIDDLE MARKET INSIGHT**
> What's changed are the expectations of these companies and that they are being held accountable.

Q: How can a company improve its ESG reporting?

A: It's important to take a structured approach. To begin with, companies have to be thoughtful about materiality, which is another way of saying how a company's operations are affecting their community in a material way. It can vary widely from company to company and industry to industry. So figuring out what is material to a specific company and what comprises a risk is a substantial hurdle to clear. The good news is that organizations like the Sustainable Accounting Standards Board provide some guidance on what is relevant to companies within specific industries.



Q: So that's a start. Where do companies go from there?

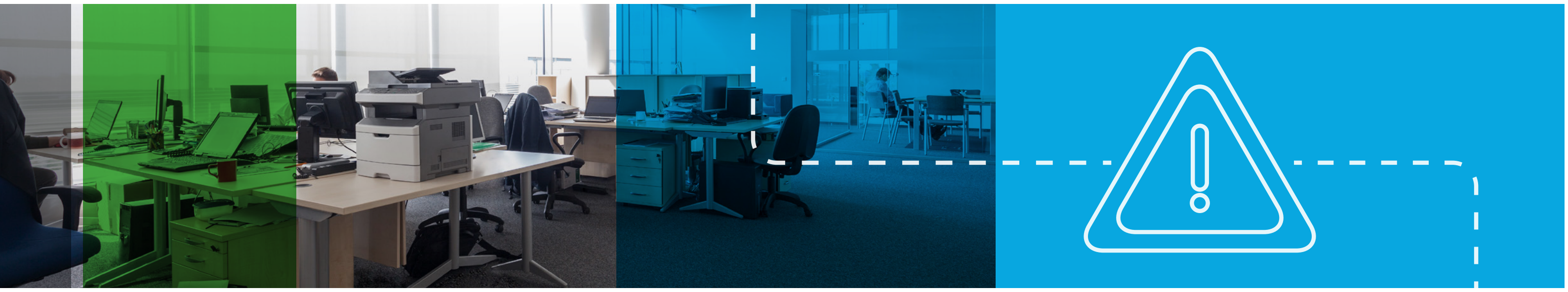
A: First, companies need to build on top of what they are already doing. A lot of companies think they are starting from scratch when it comes to an ESG program. But often, they are not. They have been thinking about it already. A mining company, for example, already tracks the health and safety of its workers. So they can build on that and expand the scope of how they are reporting on other ways they are having an impact on their workers and communities.

The second piece lies in technology. Companies need to start thinking about this early in the process. Capturing ESG data doesn't have to be a significant burden—if the right technology is in place. The right systems can collect lots of data from various sources, all of which can be automated. While putting these systems in place takes resources and effort, it's important not to lose sight of the goal: to collect data that helps a company make better decisions.

MIDDLE MARKET INSIGHT
Stakeholders are demanding that companies report on these factors in a much more structured way.

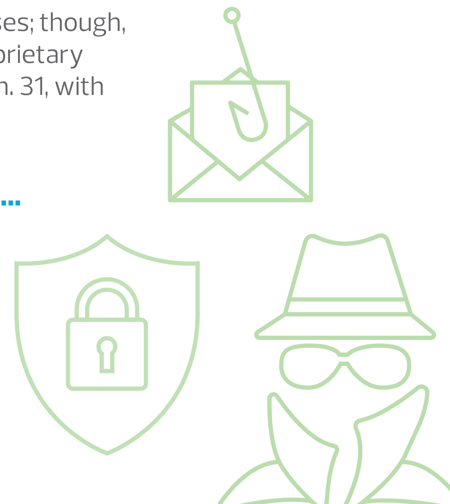
Q: What do you say to a smaller firm that says it will cost too much?

A: ESG is a marathon, not a sprint. People realize this will take time. The expectations of smaller companies in terms of disclosure are a lot lower than they would be for a larger company. But it's important to start somewhere. There are ways to design a program that fits the goals of companies of any size. It is all very possible. ■



REPORTED DATA BREACHES DROP, BUT SIGNIFICANT CONCERNS PERSIST

THE THREAT of data breaches remains a big concern among middle market businesses; though, those concerns have eased somewhat over the past year, a recent survey for the proprietary RSM US Middle Market Business Index shows. The survey was taken from Jan. 10 to Jan. 31, with 402 senior executives at middle market businesses responding.



Overall, the number of executives reporting data breaches has eased ...

22%

said their organization had experienced a data breach in the past year, down from 28% the year before.

... but the threat remains real ...

72%

said it was very or somewhat likely that unauthorized users would deliberately and illegally attempt to access their organization's data or systems this year. A year ago, that figure was 63%.

28%

said it was very or somewhat unlikely, down from 37% a year ago.

... even as they have confidence in their safeguards.

96%

were very or somewhat confident in their organization's current measures to safeguard sensitive customer data. A year ago, it was 93%.

4%

were very or somewhat unconfident in their ability to protect data.

Download the full report.

WEBCAST
THE **REAL ECONOMY**

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INFLATION, SUPPLY SHORTAGES AND THE MIDDLE MARKET

A conversation on challenges in the economy

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CHIEF ECONOMIST, RSM US LLP

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