THE REAL ECONOMY

VOLUME 90

GLOBAL TURMOIL HITS HOME FOR THE MIDDLE MARKET

THE APPETITE FOR RISK DECLINES

THE NOT-SO-ENCOURAGING OUTLOOK FOR INFLATION

WHY AN EXCESS DEMAND FOR LABOR IS UNHEALTHY

A NEW ROUND OF SUPPLY CHAIN BOTTLENECKS? GET READY.

ABOUT THE **AUTHORS**

Our thought leaders are professionals who strive to help you and your business succeed. Contributors to this issue include:

JOSEPH BRUSUELAS
CHIEF ECONOMIST, RSM US LLP

MATT DOLLARD
DIRECTOR
INDUSTRIALS SENIOR ANALYST

TUAN NGUYEN, PH.D.
U.S. ECONOMIST, RSM US LLP

RISK AVERSION RETURNS AS FINANCIAL CONDITIONS TIGHTEN

BY JOSEPH BRUSUELAS

FINANCIAL CONDITIONS in the United States deteriorated again in May after a pause in late April. The recent selloff across equity markets is indicative of the policy shift at the Federal Reserve, which intends to tighten financial conditions to achieve price stability.

While we continue to make the case that a recession is not imminent—it is more likely a 2023 narrative—falling equity prices in the near term will dampen consumption among higher-income consumers. These consumers are the 40% of households that account for more than 60% of overall spending, which is critical to the sustainability of the current economic expansion.

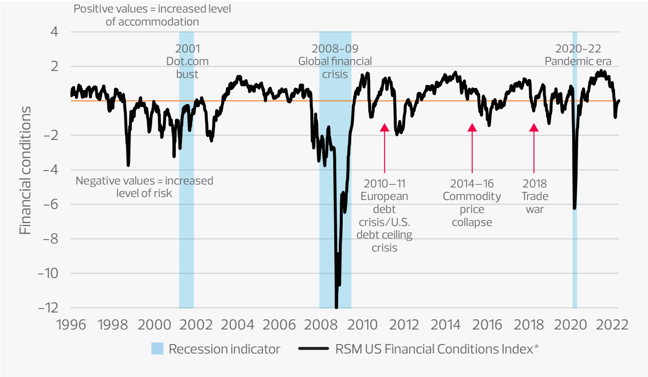
And that spending is at the core of rising concerns about the durability of the expansion as the Fed hikes its policy rate and draws down its balance sheet while the American public contends with higher inflation.

The RSM US Financial Conditions Index is now more than 1.20 standard deviations below normal as losses in the equity markets pile up, volatility increases and credit spreads widen in the bond market.

All this signals a tightening of financial conditions and the slowing of the propensity to borrow and lend resulting in a drag on economic growth.

SPENDING BY CONSUMERS IN THE TOP 40% OF INCOME EARNERS IS AT THE CORE OF RISING CONCERNS ABOUT THE DURABILITY OF THE EXPANSION AS THE FED TIGHTENS MONETARY POLICY.

RSM US Financial Conditions Index



Source: Bloomberg; RSM US LLP *Z-score

Central bankers now accept that monetary policy is transmitted to the economy through the financial markets. To reduce inflation, the Fed pressures interest rates higher, which dampens demand and increases the cost of investment.

Over the past two years, the level of financial accommodation has reached as low as six standard deviations below normal at the depth of the pandemic. It then rebounded to 1.7 standard deviations above normal as money was pumped into the economy, and vaccinations allowed for normal economic interaction.

Since the end of last year, however, the withdrawal of income support by the government and new waves of coronavirus cases have reduced that perceived normalcy, as has Russia's invasion of Ukraine.

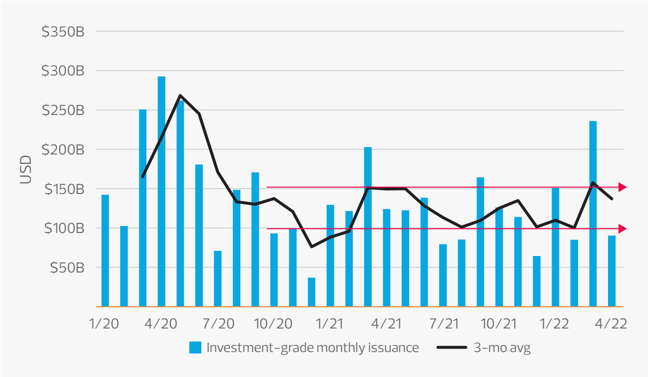
These events—and the acceptance of the eventual slowing of economic activity—are leading to renewed risk aversion among originators of debt and retail investors.

Risk aversion returns

Corporate issuance of investment-grade debt took a hit during the trade war and the global manufacturing recession that preceded the pandemic. Remarkably, issuance bounced back in 2020 as companies took advantage of near-zero interest rates.

Investment-grade issuance has been within $100 billion to $150 billion per month starting last year.

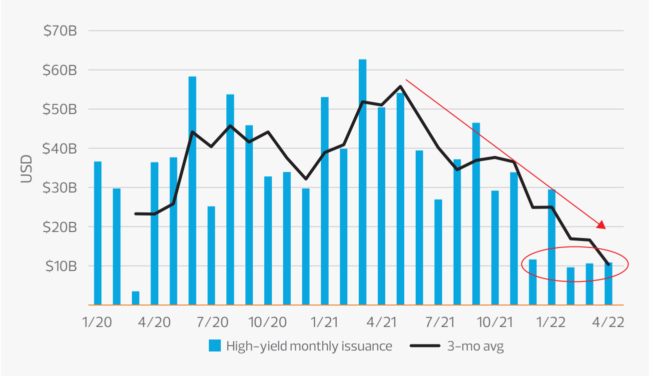
Issuance of investment-grade corporate bonds*



Source: SIFMA; RSM US LLP *2020–22

Issuance of riskier high-yield debt, or junk bonds, has been falling since last year. That is perhaps a sign that investors are unwilling to take on risk at a time when returns on more reliable assets were sure to be higher.

Issuance of high-yield corporate bonds*



Source: SIFMA; RSM US LLP *2020–22

It's a different story for retail investors. The recent plunge in equity markets and nontraditional investments should be a reminder that all investing involves risk and that it was necessary for the Fed to normalize interest rates.

THE SELLOFF IN THE BOND MARKET HAS RESULTED IN HIGHER VOLATILITY IN THE TREASURY MARKET AND AN INCREASE IN THE COST OF FUNDING PRIVATE DEBT.

MIDDLE MARKET INSIGHT
Issuance of riskier high-yield debt, or junk bonds, has been falling since last year—a sign of increasing reluctance to take risk.

With fixed-income returns so low for such a long time, it was inevitable that asset bubbles would form as investors searched for higher returns. Investors became inured to the potential loss, whether in GameStop, crypto or index funds.

Bitcoin—which has twice lost more than 50% of its value in the past 12 months—was purported to be a hedge against inflation and a store of value. It has turned out to be neither.

Dealing with uncertainty

There are nascent signs that China, after recent economic shutdowns because of the pandemic, is getting back to normal production levels. But the impact on global supply chains will endure long after the reopening as ports deal with a surge in activity. It is almost certain that the logjams of last summer will return as epic congestion in the South China Sea is cleared, and those ships head toward the United States.

When those supply chain bottlenecks are added to rising inflation and the war in Ukraine, uncertainty permeates global financial markets, affecting their pricing and stability.

Equity markets

The S&P 500 index lost roughly 18% of its value between the end of last year and May 19, with technology stocks leading the way.

Volatility has increased above its long-run average, implying reluctance among increasingly risk-averse investors.

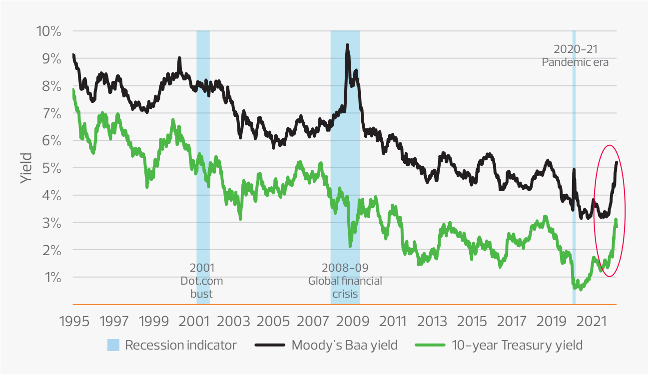
Our composite indicator of equity-market performance is now more than two standard deviations below normal, a level reached only during economic or financial crises.

Bond markets

The bond market's selloff has 10-year Treasury yields now flirting with 3%. Analysis by the Fed suggests that expectations of higher short-term rates have been the predominant factor in the selloff, which seems a logical response to the Fed's intentions to crush inflation.

The selloff has resulted in higher volatility in the Treasury market and an increase in the cost of funding private debt in absolute terms and relative to risk-free Treasury bonds.

U.S. Baa corporate bond and 10-year Treasury yields



Source: Bloomberg; RSM US LLP

*Moody's average Baa investment-grade corporate bond yield

Money markets

The money markets appear to be reacting to changes in monetary policy, with Libor and the floating rate agreements anticipating additional Fed rate hikes. At the same time, an insufficient supply has moderated Treasury bill rates, sending the commercial paper and the TED spread higher.

The result is that risk in money markets is at normal levels while we wait out the disruptions to the supply and demand for short-term financing.

THE PRICE OF WAR: RISKS AROUND THE INFLATION OUTLOOK

BY JOSEPH BRUSUELAS

WHILE WE EXPECT the annual inflation rate to peak this quarter as the comparisons to the lower levels of a year ago wear off, the risk of rising prices will remain as the twin shocks of the Russia-Ukraine war and China's coronavirus shutdowns endure.

These price shocks will have the biggest effect on lower-income households, reducing their ability to pay for the living essentials, whether it's driving to work, heating and cooling a home, or putting food on the table.

But the price shocks will also lead to reduced discretionary spending, which will, in turn, cause a slowdown in economic growth that will affect all income classes and businesses.

Already, the impact has been significant. In March, food prices increased by 1% over February, and energy prices increased by 11%. The so-called core inflation rate, the items excluding food and energy, increased by 0.3% as rents increased by 0.5%.

The overall consumer price index increased by 1.24% for the month, which over 12 months would amount to an inflation rate of around 15%.

Although we do not anticipate that pace will continue, one has to note the risks around the outlook linked to idiosyncratic factors beyond the control of policymakers and not linked to domestic economic fundamentals.

With the European Union's partial ban on Russian oil, we could very well see another test of highs in oil, gasoline and energy prices.

Such price increases would upset the evolving consensus that inflation has peaked and could set the stage for a premature end of the business cycle.

The Federal Reserve can do little about the war or the pandemic in China. So its task is to tamp down embedded inflation expectations, which, if they increase, would most likely lead to hoarding—as we saw in the early months of the pandemic—and a dramatic tightening of monetary and financial conditions.

WITH THE EUROPEAN UNION'S PARTIAL BAN ON RUSSIAN OIL, WE COULD VERY WELL SEE ANOTHER TEST OF HIGHS IN OIL, GASOLINE AND ENERGY PRICES.

As in the 1980s, an increase in interest rates to levels needed to end 15% inflation would cause a severe drop in demand and a deep recession, sending millions out of work and defeating the Fed's mandate for full and equitable employment.

Is a recession inevitable? Can the Fed engineer a soft landing for the economy and bring about price stability?

We think the underlying economy is strong, with businesses taking steps to navigate around supply chain roadblocks and improve productivity. In addition, we expect infrastructure spending to kick in at the end of the year despite further political roadblocks.

Finally, we think that the monetary authorities have the flexibility to adapt to rapidly changing conditions, whether in the rate of economic growth or the rate of inflation. There have certainly been enough disturbances and shocks over the past five years to believe that.

So we remain optimistic, but with our eyes wide-open to the risks.

How did inflation surge so quickly?

Before the war in Ukraine, the focus regarding inflation had been on select items in short supply—as a result of supply chain issues—and the increase in housing costs that account for nearly a third of the overall cost of living.

Many of the increases in product costs were expected to be transitory—as, for example, the skyrocketing cost of used cars that is now decelerating. And with the recovery taking shape, expectations were for the Fed to gradually raise interest rates, which would cool an overheating housing market. At the same time, the end of pandemic income assistance programs and the reduction in savings would moderate consumer demand.

MIDDLE MARKET INSIGHT

The Federal Reserve can do little about the war or the pandemic in China. So its task is to tamp down embedded inflation expectations.

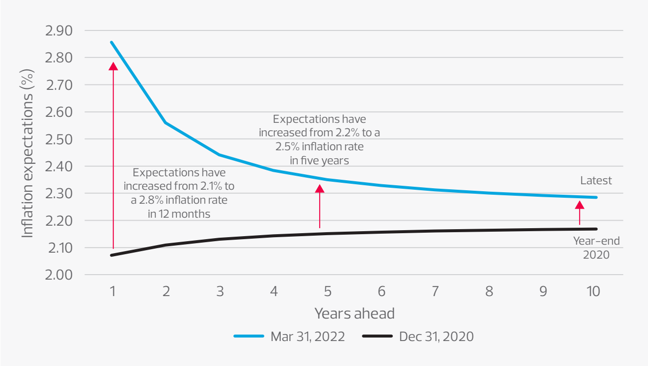
Given the extraordinary circumstances of the pandemic and the confidence that the monetary authorities among the developed economies would take reasonable action to constrain inflation, expectations for inflation remained low.

At the end of 2020, which marked the rollout of the vaccines and the acceleration of the recovery, the inflation rate was expected to remain close to the Fed's 2% target.

That was after years of disinflation and a consumer sector accustomed to the availability of cheap goods and gasoline.

Even after the wartime oil price shocks sent the inflation rate above 7%, expectations remain subdued. As of April, inflation is expected to remain less than 3% over the next 12 months, reaching only 2.3% in 10 years. None of that is earth-shaking.

Inflation expectations during the recovery from the pandemic



Source: Federal Reserve Bank of Philadelphia; RSM US LLP

*Aruoba term structure of inflation expectations for 1-10 years

MIDDLE MARKET INSIGHT
There is little reason to believe that energy prices will moderate any time soon.

And because of those low levels of inflation expectations, it seems unlikely that consumers would rush out to buy more goods for fear of rising prices. For one, those goods might not be readily available if China remains on coronavirus lockdown. Furthermore, April sentiment surveys suggest that consumer expectations have yet to absorb the full impact of prices rising at an 8.5% pace.

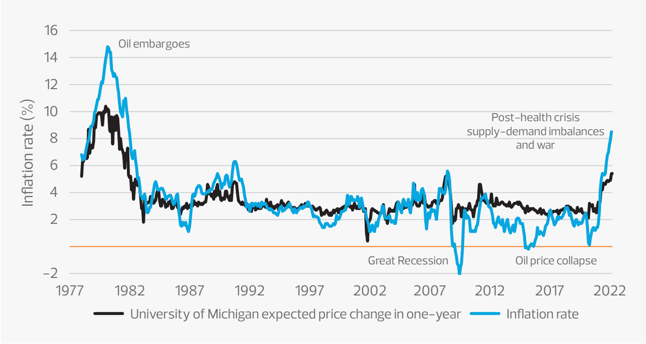
After all, consumer expectations are roughly based on prices at the pump and experience. That tends to lend itself to underestimating the full impact of price shocks, from oil shortages (the 1970s), severe economic downturns (2008–09), oil price collapses (2014–15), and, most recently, to the fuel and product shortages of the post-pandemic era.

Additional product shortages seem particularly acute if China's vaccines remain ineffective. That would imply the potential for more coronavirus variants, more infections and more shutdowns in the months, if not the years, to come.

With the exception of housing, consumers have the flexibility to choose among products or to delay purchases. Consumers do not have a choice when it comes to food or energy.

Now consumers will have to factor in the war and any additional geopolitical shocks. That will involve accounting for disruptions in the supply of petroleum products that affect a host of products, ranging from cheaply made goods shipped to North America to the fertilizers and diesel used in a global agricultural sector.

Consumer expectations of inflation in one-year and actual inflation*



Source: Federal Reserve Bank of Philadelphia; RSM US LLP

*University of Michigan monthly survey of inflation expectations

The impact on energy and food

The Fed has the difficult task of adapting to fast-moving circumstances after a period of worrying about deflation, insufficient investment in domestic productivity and the inefficient distribution of wealth.

Costs for all items, excluding food and energy, were rising by only 1.9% per year from 2014 through the early months of the pandemic, a sign of a stagnant economy.

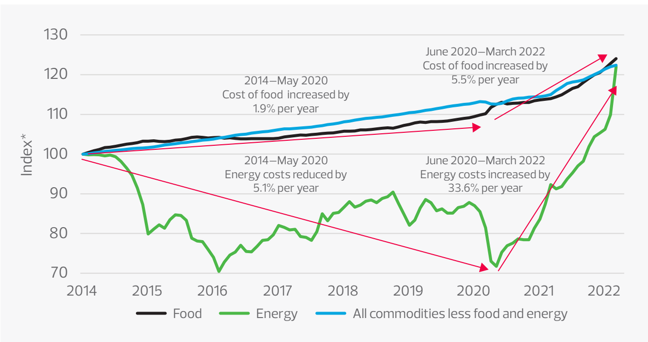
But since June 2020, those nonfood and nonenergy goods and services have been increasing at a 4.7% average annual pace, with much of that acceleration coming after the introduction of the vaccines and because of the rising costs of a housing shortage.

Consumers have little consequence that energy costs dropped by 5.1% per year from 2014 to May 2020. Since then, energy price increases have become a fixture, rising at an average rate of 33.6% per year. To make things worse, energy prices increased by nearly 16% in the first few months of the year, with crude oil prices increasing by nearly 40%.

MONETARY AUTHORITIES HAVE THE FLEXIBILITY TO ADAPT TO RAPIDLY CHANGING CONDITIONS, WHETHER IN THE RATE OF ECONOMIC GROWTH OR THE RATE OF INFLATION.

Food price increases from 2014 to 2020 were subdued, growing at a 1.9% annual pace, which was roughly in line with the general trend with core CPI, which excludes food and energy. Since June 2020, the food prices have increased at a 5.5% annual pace, with the breadbaskets of Europe under siege in Ukraine or cut off from markets in the West by sanctions.

Price indices for food, energy and all other items



Source: U.S. Bureau of Labor Statistics; Bloomberg; RSM US LLP *Jan. 2014 = 100

Energy shortages and higher prices

There is little reason to believe that energy prices will moderate any time soon.

Russian oil supplies are coming off the market in Europe. Although the demand for natural gas will diminish over the summer, it will most likely take more than the summer for Europe to complete its crash course in ending its dependence on Russian petroleum products.

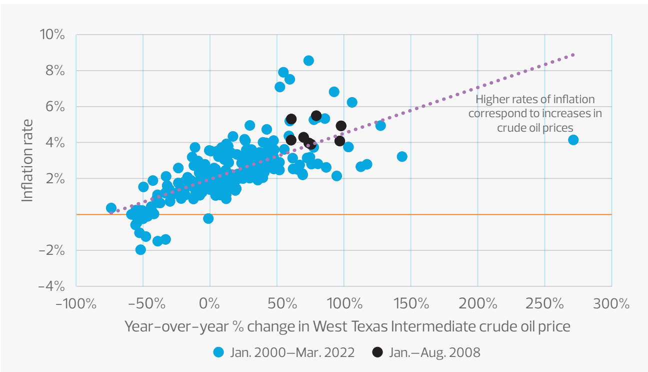
And Russian oil companies have been required to increase their percentage of domestic gasoline and diesel product sales. At the margin, at least, this implies further disruptions to the global energy market and continued high prices.

As we have noted, higher inflation rates accompanied rising energy prices from 2000 through March 2022. Extraordinary inflation rates occurred because of base-period effects relative to the sharp drop in demand during the pandemic and in the first months of 2008 when oil prices spiked higher.

MIDDLE MARKET INSIGHT

Additional product shortages seem particularly acute if China's vaccines remain ineffective.

The relationship between crude oil price changes and inflation



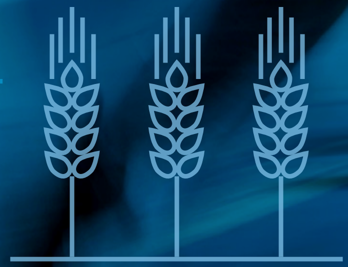
Source: Federal Reserve Economic Data; RSM US LLP

Interestingly, the current period seems most similar to 2008, when production issues and turmoil in the Middle East led to shortages and oil prices exceeded $130 per barrel.

Unless there is a diplomatic breakthrough, the war in Ukraine is likely to grind into a stalemate, with the West no longer willing to fund Russia's military spending through energy purchases.

Crude oil at $108 a barrel is about 20% below the 2008 peak of the West Texas Intermediate benchmark. But a direct comparison and forecast of where all this will end are difficult to make.

The shale revolution in North America has increased supply over the past decade. And the move toward nonfossil fuel generation and the greater efficiency of vehicles all need to be considered.



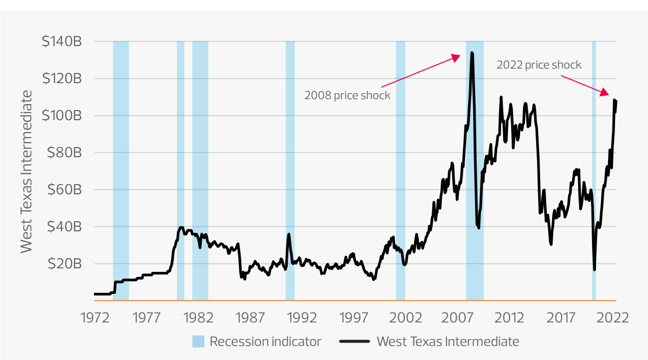
RUSSIA AND UKRAINE ACCOUNT FOR 30% OF WHEAT EXPORTS, WHICH WILL NOT BE EASILY REPLACED.

MIDDLE MARKET INSIGHT
While Russia's agricultural sector will most likely suffer from trade restrictions with the West, Ukraine's infrastructure is being destroyed.

In addition, a quarter of the World Trade Organization, including India and China, has not signed on to the boycott of Russian trade.

It seems unlikely for OPEC to significantly increase its production if the major players value the efficacy of OPEC+ and with production among the lesser players approaching limits. The likelihood of a price crash or correction seems less likely in the near term.

Crude oil prices since 1972



Source: Federal Reserve Economic Data; RSM US LLP

Food shortages and higher prices

The World Trade Organization finds that "the most immediate economic impact of the crisis has been a sharp rise in commodity prices. Despite their small shares in world trade and output, Russia and Ukraine are key suppliers of essential goods, including food, energy and fertilizers, supplies of which are now threatened by the war. Grain shipments through Black Sea ports have already been halted, with potentially dire consequences for food security in poor countries."

This distressing assessment comes on the heels of what looked to be a cooling of foodstuff costs at the end of last year. Because of Russia's invasion, the price of foodstuffs resumed its 43% average annual growth rate that began during the economic shutdown in early 2020.

While Russia's agricultural sector will most likely suffer from trade restrictions with the West, Ukraine's infrastructure is being destroyed, eliminating Russia's competition in Eastern Europe.

Foodstuff commodity prices

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

*1967 = 100

According to *The New York Times*, Russia is the largest exporter of fertilizer, with producers in South America scrambling for alternative suppliers.

And Russia and Ukraine account for 30% of wheat exports, which will not be easily replaced. According to the United Nations, inventories are already tight in the United States and Canada, Argentina is limiting exports, and Australia is already at full shipping capacity.

Finally, in addition to the burden on households dealing with rising prices, food shortages become a national security problem for everyone. As the World Trade Organization highlighted, should disruptions in the supply chain for commodities continue, history has shown that we can expect social unrest in countries that rely solely on food imports.

WHY EXCESS LABOR DEMAND IS UNHEALTHY

BY TUAN NGUYEN

THE LABOR MARKET'S RECOVERY from the pandemic has been nothing short of remarkable. Most of the staggering number of job losses have been recovered, and the unemployment rate is near its pre-pandemic low.

But sometimes, in economics, there can be too much of a good thing. In this case, it's the demand for workers, or, to put it more accurately, an excess demand for workers.

The economy is fewer than 1 million jobs from reaching its pre-pandemic level. Yet there were a record 11.55 million job vacancies—a proxy for labor demand—reported in March, according to government data.

That's because as strong as the economy has been, companies today are facing a harsh reality: The rapid growth of the past year won't come back anytime soon. Yet many companies are planning to hire workers as if such growth is sustainable.

Although there are signs that companies are adjusting, especially as equity markets retreat, many companies have yet to get the message. And the scramble by companies to find workers—or simply to keep the ones they have—leads to higher wages, which in turn, leads to higher inflation.

The result is the stunning number of job vacancies as workers continue to quit their jobs at historically high rates.

The squeeze is made worse as workers who have been on the sideline since the start of the pandemic have been slow to come back to the labor force.

SOMETIMES, IN ECONOMICS, THERE CAN BE TOO MUCH OF A GOOD THING. IN THIS CASE, IT'S THE DEMAND FOR WORKERS.

MIDDLE MARKET INSIGHT

The scramble by companies to find workers—or simply to keep the ones they have—leads to higher wages, which in turn, leads to higher inflation.

In a sense, it's a virtuous circle gone wrong as labor demand spirals out of control. Then, it is no surprise that Federal Reserve Chairman Jerome Powell said that the labor market is at a "tight to an unhealthy level"—hardly the characterization a Fed chairman usually utters in a strong economy. It is clear forward guidance for the market to start reacting as the Fed moves to put an end to an era of near-zero interest rates.

We believe this imbalance should prompt companies to reassess their growth potential, and as a result, their demand for labor.

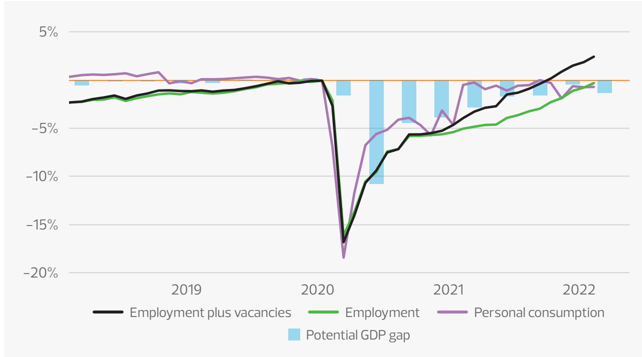
Such a reassessment, in fact, might work in the Fed's favor as a major decline in labor demand might take place before interest rates are brought back to neutral, potentially in the second half of the year or early next year. The decline will most likely be a sharp one, but it is inevitable and necessary.

An unrealistic level of labor demand

Behind the surging labor market is an overheating economy. Last year, elevated spending and economic growth rates contributed to a significant increase in corporate profits, rising by 20.97% in the fourth quarter on an annualized basis. That bullish sentiment spilled over to outsized gains in the equity markets.

So, companies reason, why not keep a good thing going? The expectation for further growth, especially when order backlogs remained historically high because of global supply chain issues, pushed labor demand to outpace personal spending and even overall gross domestic product last year and continued in the first quarter.

Labor demand outpaces spending*



Source: U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics; U.S. Congressional Budget Office; RSM US LLP
Note: Data is normalized to use February 2020 as the benchmark.
*Percentage gap vs. February 2020

We normalize the levels of employment and employment plus vacancies by using the pre-pandemic level in February 2020 as a benchmark. For GDP and personal spending, while using the same benchmark, we further normalize the two series such that the pre-pandemic upward trend for personal spending and potential GDP, calculated by the Congressional Budget Office, are also controlled.

What has become clear is that even as the level of employment has nearly reached what many consider full employment, with the unemployment rate at 3.5%, total labor demand—employment plus vacancies—continues to surge. In March, it was 2% higher than in February 2020, or 4.1 million in extra demand.

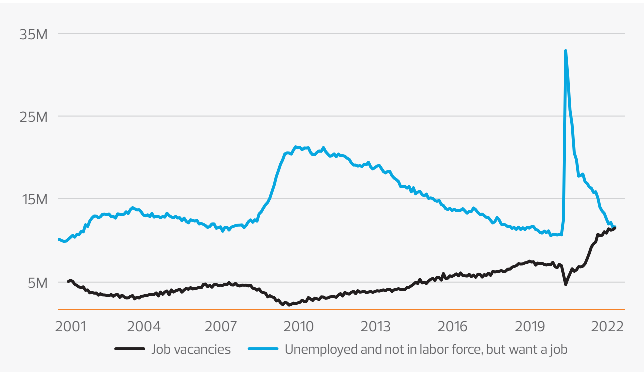
Yet the underlying economic foundation—shown by the level of personal consumption and GDP, which are both near the pre-pandemic trend—shows no support for such a high level of labor demand.

As spending approaches its potential level at full employment, growth is expected to slow down to the long-term rate of 1.8%.

NEVER BEFORE HAVE WE SEEN SUCH A SMALL GAP BETWEEN JOB VACANCIES AND POTENTIAL LABOR SUPPLY.

But because companies misjudge growth potential, they continue to make more hiring plans to meet what they see as a much larger demand down the road than it turns out to be.

Enough jobs for everyone



Source: U.S. Bureau of Labor Statistics; RSM US LLP

Never before have we seen such a small gap between job vacancies and potential labor supply, which includes unemployed workers in the labor force and includes workers not in the labor force but who still want a job.

There were 11.55 million job vacancies in March, while the number of unemployed workers was 5.95 million. The number of not-in-the-labor-force workers who want a job was 5.7 million. The combined number for labor supply was 11.65 million.

That means theoretically, even if everyone who left the labor force because of COVID-19 came back, there would still be enough jobs for everyone but only 100,000 of the total number of workers who want a job.

That scenario would never happen; not all vacancies can be filled with unemployed workers because of mismatches in skills or preferences. But it still shows just how improbable labor demand has been because there are simply not enough workers.

MIDDLE MARKET INSIGHT
Even as the level of employment has nearly reached what many consider full employment, with the unemployment rate at 3.5%, total labor demand—employment plus vacancies—continues to surge.

Early evidence from companies like Amazon, Netflix, Meta (previously known as Facebook), Peloton and Snapchat—which have seen their stock prices drop because of significant declines in demand—points to the disconnect between where the economy is heading and what businesses had expected. Meta, for example, recently announced it would curtail hiring because of stagnant growth. Uber also said it would reduce hiring because of what it called a "seismic shift" in market conditions.

That said, the flaws in growth expectations are quite difficult to avoid during the current volatile and uncertain period that even the Federal Reserve has been struggling to deal with. Moreover, unforeseen economic shocks like the recent COVID-19 wave and the Russia-Ukraine war also contribute to the complexity of predicting demand and growth.

The takeaway

Most labor shortage issues can be traced to workers who left the labor force because of the pandemic and were slow to return. But with employment getting closer to the pre-pandemic level, outsized labor demand is becoming the main cause of labor shortages.

The Fed's move to increase its policy rate by 50 basis points in May, the largest one-time increase since 2000, will certainly help drive down growth expectations and dampen labor demand.

We believe it is now crucial to turn the focus toward private companies' shift in labor demand to better assess how the tight labor market will unwind.

GET READY FOR ANOTHER ROUND OF SUPPLY CHAIN BOTTLENECKS

BY MATT DOLLARD

THE MONTHSLONG lockdown in Shanghai, China's most populous city and home to the world's largest container port, was only recently lifted but still caused a pileup of ships that anchor off the Chinese coast. Factory shutdowns and the reduced flow of goods from the city's port will cause another jolt to U.S. supply chains in the weeks and months to come.

The predictable knock-on effects of the Shanghai lockdown—while far from a total supply disruption akin to that of the early days of the pandemic—will certainly sustain or worsen supply shortages and sustain worldwide inflation.

What's happening now?

On March 28, the Chinese government began locking down the port and the city of Shanghai to stem the spread of COVID-19. The port and, subsequently, several factories were placed in a "closed-loop" system that requires workers to sleep at their place of work or bus to and from hard-to-find hotels already booked by out-of-town health care workers.

Some factories received approval to reopen, but they and the port were not functioning at full capacity because of the logistical hurdles of sheltering, transporting and feeding workers as COVID-19 prevention measures remain in place.

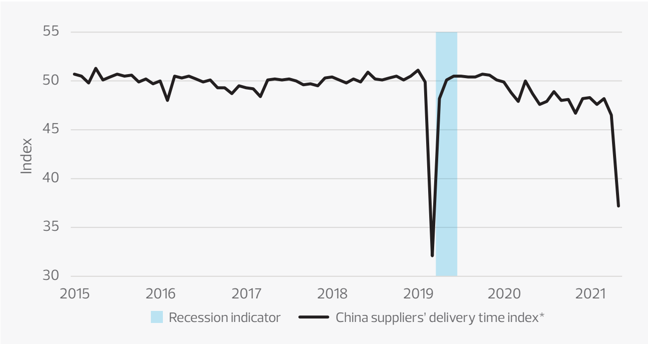
In addition to ships piling up near the port, inventory overload is becoming an issue. According to the National Bureau of Statistics of China, the April 30 logistic logjams sent stockpiles of finished goods in China to a high not seen since summer 2012. Also, in April, the Port of Shanghai ran out of space for refrigerated containers, which forced shippers to store them off-site, creating additional delays.

April's container throughput in Shanghai dropped 24% month over month to 308,500 units—a low beaten only in February 2020, when the port usually experiences its seasonal low. Some shipments leaving Shanghai were diverted to the smaller Port of Ningbo-Zhoushan, which can't handle Shanghai's volume and acts only as a stopgap.

IN EARLY APRIL, THE TIME A SHIPPING CONTAINER SPENT AT THE PORT OF SHANGHAI WAS OVER 10 DAYS, UP FROM THE TYPICAL ONE OR TWO, ACCORDING TO THE LOGISTICS DATA TRACKER FREIGHTWAVES.

In early April, the time a shipping container spent at the Port of Shanghai was over 10 days, up from the typical one or two, according to the logistics data tracker FreightWaves. In addition, the China Purchasing Managers Index, a measure of suppliers' delivery time, was tracking to lows not seen since the early stage of the pandemic, characterized by toilet paper shortages and other supply crunches. These trends signal a dearth of stock in the United States later this year.

China suppliers' delivery time index*



Source: Bloomberg; China Federation of Logistics and Purchasing; RSM US LLP

*Purchasing managers index seasonally adjusted

What happens next?

When Chinese lockdowns lift, manufacturers and shipping companies will compensate for disruptions and strive for peak output, resulting in a whipsaw of production and shipping. That will hold for the current situation. Another wave of container ships will sail across the Pacific to meet those currently loitering just over the horizon of the U.S. West Coast, awaiting their opportunity to anchor in San Pedro Bay or occupy a berth. The expected dip in output from the lockdown of China's port cities will be followed by another spike in already-elevated U.S. container traffic.

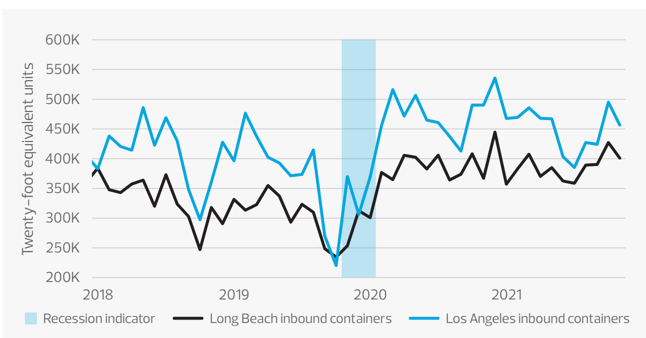
Beyond the West Coast ports, the United States as a whole continues to see higher-than-normal container volumes. Elevated container volumes worldwide have led to the highest container shipping prices in history. Even as spot rates in Asia have eased from highs late last year, they remain five times above pre-COVID-19 levels. Sending a 40-foot container from Shanghai to Los Angeles was listed at $8,587 at the end of April versus $1,654 at the start of 2020, according to the Drewry World Container Index.

FACTORY SHUTDOWNS AND THE REDUCED FLOW OF GOODS FROM THE CITY'S PORT WILL CAUSE ANOTHER JOLT TO U.S. SUPPLY CHAINS IN THE WEEKS AND MONTHS TO COME.

MIDDLE MARKET INSIGHT

The effects of the Shanghai lockdowns in China will worsen supply shortages and sustain worldwide inflation.

Los Angeles and Long Beach inbound containers through April 2022

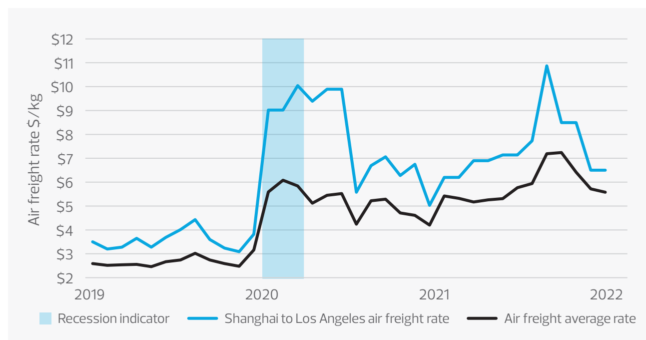


Source: Bloomberg; Port of Los Angeles and Long Beach; RSM US LLP

In early November 2021, the Pacific Maritime Association instituted a new system requiring ships heading toward Los Angeles and Long Beach ports to call ahead of their approach. The result is fewer ships loitering at anchor within sight of shore and significant numbers motoring just over the horizon awaiting their turn. While reducing congestion and pollution nearer to shore, the new rule has done little to reduce the overall logjam.

In March, the Long Beach and Los Angeles ports were again approaching their highest peaks of inbound containers since before the pandemic at 922,476, compared to 544,226 in March 2019, according to data published by each port and distributed by Bloomberg.

Air freight rate $/kg average vs. Shanghai to Los Angeles

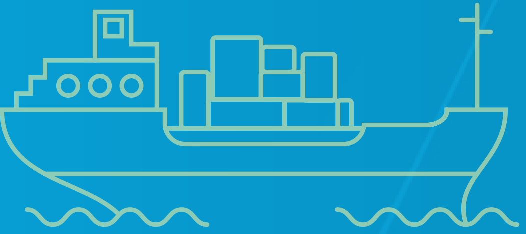


Source: Bloomberg; RSM US LLP

Alternate transportation methods

Several Asian ports are bigger, newer and more efficient than their U.S. counterparts, and it will take time for the United States to catch up. A 2020 Container Port Performance Index prepared by the World Bank and IHS Markit ranked Long Beach No. 333 and Los Angeles No. 337 in overall worldwide performance. By comparison, Shanghai ranked No. 47, while ports in China's Pearl River Delta collectively ranked No. 29. This U.S.–China disparity creates a capacity mismatch. Meanwhile, efficiency at U.S. ports also hinges on successful contract negotiations for 22,000 West Coast dockworkers, which need to be settled before July 1. Smooth talks with the International Longshore and Warehouse Union could help prevent port backlogs from worsening.

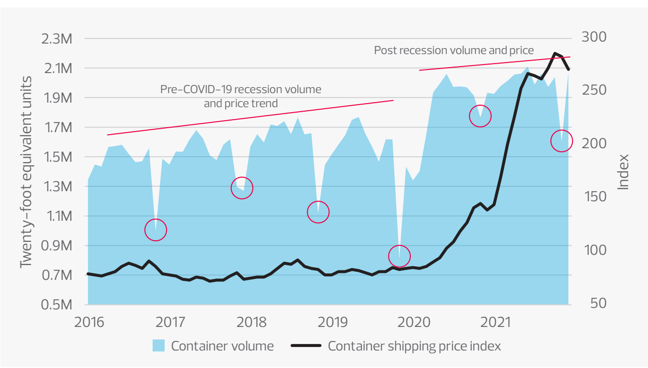
Meanwhile, U.S. businesses across all sectors are exploring alternative means of transport. Price indices for one option, air freight, were trending downward in February but held firm in March. April may see price increases due to higher costs for jet fuel, which reached $4.22 per gallon at the end of March, up from $2.76 the prior month.



ELEVATED CONTAINER VOLUMES WORLDWIDE HAVE LED TO THE HIGHEST CONTAINER SHIPPING PRICES IN HISTORY.

In short, pricing for air freight is expected to remain above pre-pandemic levels; carriers don't eat the added costs and easily pass them through to customers due to well-established and frequently updated fuel surcharges.

Asia to North America shipping container volume and price index remain elevated through March 2022



Source: Bloomberg; RSM US LLP

While trucking is no substitute for direct maritime routes, businesses are now leaning more heavily on this mode of transport, boosting demand and throwing another wrench into logistical logjams. According to FTR, a transportation intelligence firm, truck utilization rates show a shortage since October 2020. The pending wave of incoming containers at the ports will result in additional shortages, either sustaining rates or pushing them higher.

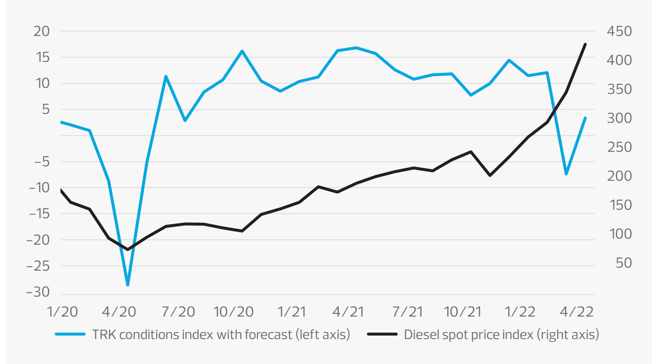
Adding to upward pricing pressure is the high cost of diesel fuel and the ongoing shortage of qualified drivers. Diesel costs hit $4.27 per gallon at the end of April, up from $1.42 in February 2020, before the pandemic.

MIDDLE MARKET INSIGHT

In addition to ships piling up near the port, inventory overload is becoming an issue.

The trucking labor erosion adds to the industry's challenges. Pandemic restrictions led to the exit of some nondomestic drivers and slowed the testing of new ones, according to a recent report from Gartner. At the same time, the pool of younger applicants is waning amid poor working conditions and a lack of work flexibility. Roughly two decades ago, the drivers' age was evenly split above and below 45. In 2021, the mix had skewed significantly older, with 65% over 45.

Truck conditions index sinking due to high cost of diesel



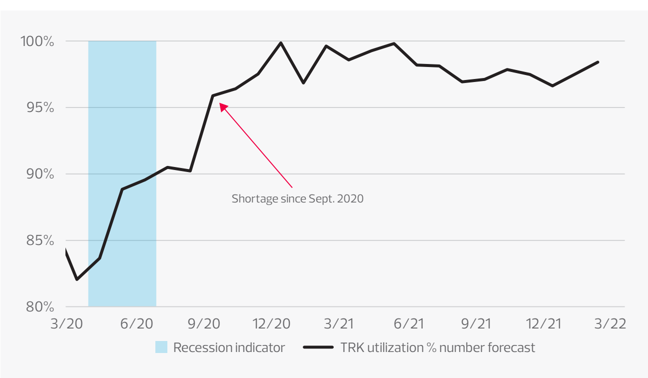
Source: Bloomberg; FTR Transportation Intelligence; RSM US LLP

CONTINUED PRICING PRESSURE ON THE TRANSPORTATION SECTOR WILL REMAIN ONE OF THE KEY DRIVERS OF INFLATION.

MIDDLE MARKET INSIGHT
U.S. businesses across all sectors are exploring alternative means of transport, including air freight.

Some 1.89 million trucking companies operate in the United States, and more than 91% have six or fewer trucks, according to the U.S. Department of Transportation. Margin pressure on these smaller companies is particularly acute because they can't pass on higher fuel costs to customers and buy diesel at the pump. Unlike their larger counterparts, they are unable to buy diesel wholesale and bill fuel surcharges to customers. These smaller operators may be forced off the road at a time when demand is still near its peak.

Truck utilization %—trucks needed vs. active trucks*



Source: Bloomberg; FTR Transportation Intelligence; RSM US LLP *95% or above indicates a capacity shortage

Economic knock-on effects

Continued pricing pressure on the transportation sector will remain one of the key drivers of inflation. Unless the United States experiences a significant slowdown in economic activity going into the second half of the year, continued upward inflationary pressure from the sector is expected.

The takeaway

- A significant backlog in maritime shipping containers has yet to clear the supply chain.
- Businesses need to carefully estimate transport times and build additional slack into their forecasts in the coming months.
- Purchasing managers will need to plan purchases sooner in the year and account for increased transport costs in their models.
- Smaller trucking companies not using fuel surcharges will need to find a way to include them in future contracts to defray the increased fuel costs.

CYBERATTACKS REMAIN A CONCERN THOUGH SOME BUSINESSES REPORT A DECLINE

CONCERN ABOUT cyberattacks on middle market businesses remains front and center for senior executives, a recent survey for the proprietary RSM US Middle Market Business Index found. However, there were signs of improvement, especially among larger middle market businesses.

The survey was taken from Jan. 10 to Jan. 31, with 402 senior executives in middle market businesses responding. The results of the survey's special questions are part of a special report from RSM US LLP.

Among the findings:

Cyberattacks remain a real threat ...

45%

of executives said that their business had been the target of a takeover attempt in the past year. That is statistically comparable to a year before.

27%

of executives said attempts to manipulate employees were successful, down from 45% a year before.

... and smaller businesses reported being more of a target.

51%

of executives with businesses that have revenue from $10 million to $50 million reported such an attempt, up from 44% a year earlier.

40%

of businesses with revenue from $50 million to $1 billion reported such an attempt, a significant drop from the 57% a year earlier.

Of those attempts, about a quarter were successful.

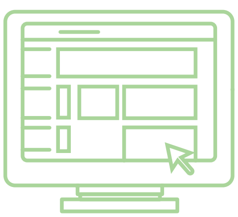
27%

of executives said that such attempts to manipulate employees were successful, a drop from 45% a year earlier.

Finally, third-party attempts to manipulate employees reached a new high.

73%

of respondents said their organizations were at risk from third-party attempts to manipulate employees over the next 12 months—a new high.



Download the full report.

For more information on RSM, please visit **rsmus.com**.

For media inquiries, please contact Kim Bartok, national public relations director, +1 212 372 1239 or kim.bartok@rsmus.com.

For more information on RSM thought leadership, please contact Deborah Cohen, thought leadership director, +1 312 634 3975 or deborah.cohen@rsmus.com.

TRE-NT-ALL-ALL-622

RSM