

THE REAL ECONOMY

VOLUME 92

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THE RETURN OF KING DOLLAR: THE GREENBACK IN AN ERA OF INFLATION

BY JOSEPH BRUSUELAS



THE RETURN OF INFLATION, interest rate differentials and a quickly changing geopolitical landscape are the primary catalysts behind the recent surge in the value of the American dollar.

With the Federal Reserve continuing its campaign to boost the policy rate, we think conditions are ripe for the return of a strong dollar policy and sustained movement into dollar-denominated financial assets.

In the current phase of the pandemic, the United States is the cleanest shirt in very dirty global laundry. Whatever the reasons behind the flow of funds into dollar-denominated assets, the dollar's appreciation will dampen

overall inflation through the trade channel and most likely be the de facto policy of the U.S. Treasury until price stability is restored.

The dollar is undergoing a renaissance, growing at an average rate of 3% per year since the Great Recession. That rise was capped off with a phenomenal 20% increase in value during the ongoing recovery from the pandemic.

That increase in value, though hardly a straight line, reflects the American economy's dynamism and its ability to recover from shocks that are occurring with some regularity. We expect these trends to continue.

Like all assets and commodities traded in an open market, the value of the dollar is determined by its supply and demand. If investors were to buy more dollar-denominated assets or if businesses were to engage in more dollar-based transactions, then the dollar's value would appreciate as local currencies are sold to buy dollars.

That same argument applies to the other free-floating currencies that are supported by market-based economies operating within liberal-democratic societies. These include the euro and British pound, the dollar-bloc currencies, and a smattering of currencies in smaller independent nations. Foreign businesses and investors are buying the stability offered by advanced-economy norms.

The resource-rich economies of the dollar bloc (Australia, New Zealand and Canada) offer examples of demand-based valuations, with the shale revolution acting as the catalyst for Canadian dollar strength in recent years.

For the pound, its strength has been the attractiveness and vibrancy of British culture, in addition to the country's real estate, manufacturing, and intellectual capital and its role as a financial center.

For the dollar and the euro, the impetus has been the diversity of their large economies, the depth of their financial markets and a history of benchmark pricing of oil. With the history of their institutions, it is of little wonder that the euro-dollar exchange rate has been range-bound for so long.

A counterpoint to the stability of the developed-economy currencies is the potential for volatility in the emerging-market currencies. Like investments in junk bonds in past decades or the attractiveness of cryptocurrency speculation in recent times, emerging-market currencies entail both great risk and reward.

That takes us to the discussion of currency valuation and exchange rate exposure. Every exchange rate is two-sided and will move according to changes in the valuation of either the numerator or the denominator. A political, social or financial problem in either of the economies involved in a trade will affect the exchange rate.

And because nearly all business transactions in the modern economic system include some degree of currency risk, investors need to recognize those risks and take steps to insure against exchange rate losses.

Dollar strengths and long-term macro fault lines

Investment demand for the dollar

- Returns on financial investments guaranteed by laws and regulations
- Investment in residential and commercial enterprises protected by U.S. laws and regulations
- History of U.S. intellectual capital and innovation
- Higher returns on dollar-denominated assets

Fault lines

Dependence on imports of:

- Cheaply produced retail goods
- Low-tech intermediate products
- Rare-earth commodities
- Microchips

Low growth—Questionable ability to grow beyond pre-pandemic average of 1.8% per year

Transaction demand for the dollar

- Oil priced in dollars
- Secondary demand for US\$ securities from proceeds from Asian import sales
- Banking (SWIFT) transactions in dollars or euros

MIDDLE MARKET INSIGHT

The dollar's appreciation will dampen overall inflation through the trade channel and most likely be the de facto policy of the U.S. Treasury until price stability is restored.

So why mess with success?

There have always been complaints about the value of the dollar, as if it were the government's job to protect every industry from foreign competition or to rail against the supposed impact of another government's program.

Western economies have thrived within this market-based exchange-rate system. It fully emerged with the free-floating of the dollar by the Nixon administration in 1973 and the maturation of monetary policy by the world's central banks in the decades that followed.

With the potential exception of Switzerland and Japan, developed nations no longer use exchange rates to achieve economic policy goals. Despite the occasional calls for a weaker or stronger dollar by special-interest groups, currency valuations are left to competition among nations.

If South Korea makes the most popular phones, Britain the best murder mysteries, Italy the sexiest cars and New Zealand the best refrigerators, so be it. Let the free flow of goods and ideas be the determining factor.

Attempting to manipulate a currency's value is most likely a fruitless enterprise. In addition, as shown during the recent trade war—in which tariffs replaced currency manipulation—producers, wholesalers, retailers and consumers will quickly adapt purchasing behavior to whatever works best, thwarting the intentions of interventionist policy.

What determines the value of the dollar?

Transaction demand for dollar-denominated goods and services



Transaction demand for dollar-denominated financial assets



Direct demand for dollar-denominated assets



Store of wealth



With the Federal Reserve continuing to boost the policy rate, we think conditions are ripe for the return of a strong dollar policy and sustained movement into dollar-denominated financial assets.

Forecasts for the dollar

The consensus among forecasters is that the dollar will maintain its elevated value in the third quarter and then gradually fall back next year as tighter Federal Reserve policies cool an overheating economy.

Dollar strength in the near term seems particularly likely, given substantial Fed rate hikes at a time when policy rates in the euro area and Japan remain close to zero. That should increase the return and demand for higher-yielding, dollar-denominated securities.

Next year, Europe might be dealing with an energy crisis if Russia cuts off natural gas supplies. At the same time, politics will most likely play a part in maintaining Japan's extraordinarily accommodative monetary policy, pressuring the yen lower just as the Fed maintains upward pressure on interest rates and the dollar.

In a longer-term view, there's no reason to doubt that the secular convergence among the developed economies in terms of interest rates and economic growth will continue, particularly given the recent political changes and the reemergence of common causes.

But that's not to say there won't be episodes where a shock is felt by one economy more than another. The world goes from one crisis to another, a situation unlikely to change, and we should expect exchange rates to reflect the ability of each region to absorb those shocks.

This current episode of dollar strength began in May 2021, as it became clear that the vaccination program would succeed and the U.S. economy would most likely lead the rest of the world out of the health crisis.

The dollar's value was supported in anticipation of higher U.S. interest rates and the self-fulfilling higher returns on investment in dollar-denominated financial assets.

MIDDLE MARKET INSIGHT

Recently, nearly 80% of the transactions were dollar- or euro-based, which might help explain the narrow range of trading between the dollar and the euro.

That is, the higher yield of U.S. short-term securities—relative to the still-negative rates of euro- and yen-denominated securities—generated increased demand for those dollar-denominated securities. That pressured the dollar higher and increased the total return on foreign purchases of those same securities.

And with domestic demand growing in recent months, imports have far outstripped exports. Proceeds from increased sales of imported goods were, as usual, being parked in the convenience of short-term, dollar-based securities, all of which added to dollar strength.

The dollar declined from \$1.22 versus the euro in May 2021 to \$1.01 in the first weeks of July—appreciation of roughly 17%, and a significant move toward parity with the euro—while gaining 26% on the Japanese yen.

U.S. dollar/euro exchange rate



Source: Bloomberg; RSM US LLP

The increase in the dollar's value reflects the American economy's dynamism and its ability to recover from shocks that are occurring with some regularity.

MIDDLE MARKET INSIGHT

At the end of global economic downturns, U.S. spending has helped kick-start global recoveries, with U.S. purchases helping spur foreign growth.

International trade and the dollar

What can we say about the current demand for the dollar, and what will determine the extent of that demand over the coming quarters? Let's begin with the inconsistent impact of foreign demand for U.S. goods and services on the dollar.

Protectionist practices such as manipulating currency values were long ago thought to maximize output and profit. But the relationship between currency value and external balance is far more nuanced, as the 2018–19 trade war and the manufacturing recession it kicked off should remind us.

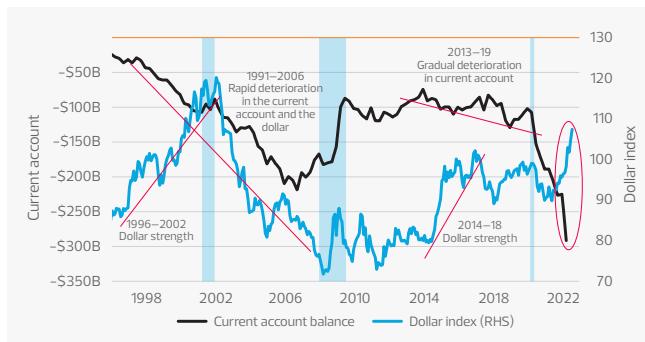
Consider the history of foreign demand for U.S. goods and services and its effect on the current account balance. During the 1995–2001 technology boom, the United States was thought to be at the vanguard of a brave new world, and the value of the dollar shot up.

But at the same time, actual production was being sent offshore. The United States was no longer the factory floor for the world, and the current account continued to worsen. After the technology stock bubble burst in 2001, the dollar weakened in lockstep.

During portions of the decade-long recovery from the 2008–09 Great Recession and into the pandemic, there were episodes when you could argue that the current account and the dollar index were moving together. But there were also periods of the dollar strengthening during a deterioration trend in the current account. And now in the late-pandemic period, there is renewed dollar strength even as the current account balance is falling off the table.

That points to the dominance of the financial sector in determining the dollar's value relative to the value of trading-partner currencies. International trade and global and local economic activity function only if the financial sector agrees to support it. The financial sector determines the cost of undertaking that activity.

U.S. current account balance and the dollar index



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

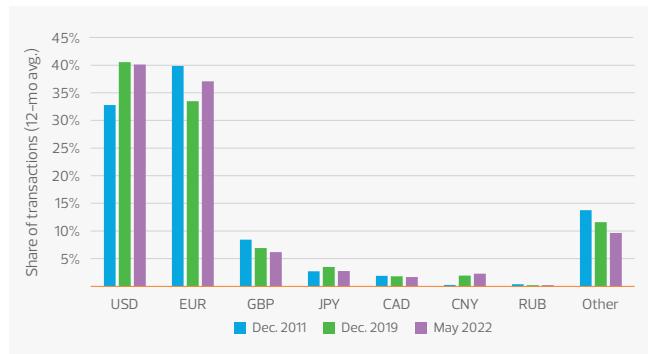
In the late-pandemic period, there is renewed dollar strength even as the current account balance is falling. That points to the dominance of the financial sector in determining the dollar's value.

Financial transactions and the demand for dollars

Banking transactions since 1973 have been executed through SWIFT—the Society for Worldwide Interbank Financial Telecommunications system based in Belgium with data centers in the United States, the Netherlands, and Switzerland, and a command center in Hong Kong.

Recently, nearly 80% of the transactions were dollar- or euro-based, which might help explain the narrow range of trading between the dollar and the euro. The British pound was used in 8% of SWIFT transactions in 2011, with the recent drop to 6% perhaps an unintended consequence of Britain closing itself off from Europe.

Share of SWIFT financial transactions by currency*



Source: SWIFT; Bloomberg; RSM US LLP

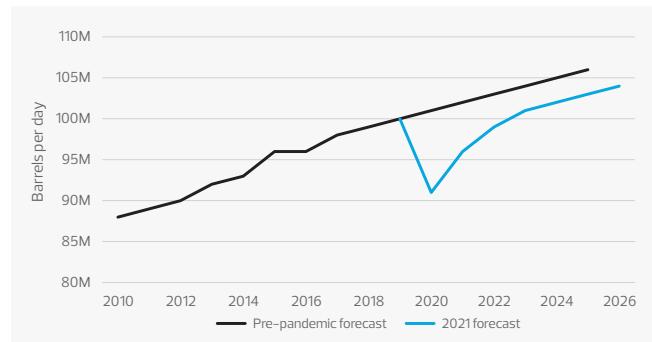
*Transactions in local currencies via SWIFT system as of 2011, 2019 and 2022

Oil transactions and the demand for dollars

Last year, we estimate, roughly \$6.5 billion changed hands each day in the buying and selling of crude oil. In the first half of this year, that jumped to approximately \$10 billion as the price of oil topped \$100 per barrel.

Regardless of the price, there will be a consistent global demand for oil in the coming years, with China the largest importer. That implies a consistent selling of renminbi to buy dollar-denominated barrels of oil, with implied support for the dollar's value whether or not the plan to cap the price of Russian supplies is successful.

Oil demand forecasts



Source: International Energy Agency; RSM US LLP

Interest rate differentials

Interest rates in each country are determined by monetary-policy settings for short-term securities, with longer-term bond yields including the risk of holding those securities over the course of years. Implicit in those settings is the ability of each economy to support growth and the return on investment.

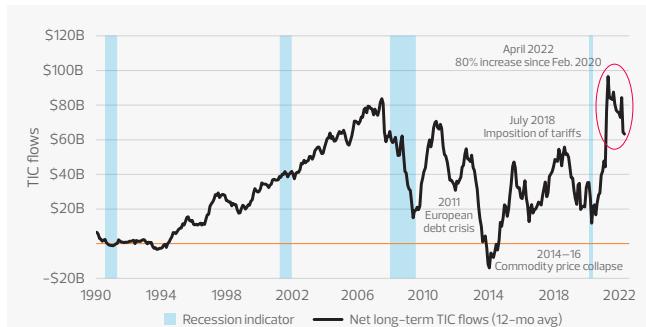
Because of the depth of the bond markets, you would expect an efficient setting of interest rates. As such, 10-year interest rates in the developed economies declined until 2012 in response to the universal elimination of the risk of inflation and the concurrent moderation of growth.

As the recovery from the global financial crisis took hold, 10-year interest rates remained higher in the United States than in Europe and Japan, which corresponded with the increase in net portfolio investment by foreigners in U.S. long-term securities. Those portfolio flows implied confidence in U.S. institutions and the nation's economy, with higher nominal and real (inflation-adjusted) returns on U.S. investment resulting on balance in a stronger dollar.

Net foreign portfolio investment in U.S. long-term securities increased again after 2020, and the dollar responded likewise.

In terms of inflation, a stronger dollar makes final and intermediate foreign products more affordable, which should apply downward pressure on the inflation rate.

Net foreign portfolio investment in U.S. long-term securities



Source: U.S. Department of the Treasury; National Bureau of Economic Research; Bloomberg; RSM US LLP

Nominal U.S. and German 10-year bond yields



Source: Bloomberg; RSM US LLP

The effect of a stronger dollar

In terms of inflation, a stronger dollar makes final and intermediate foreign products more affordable, which should apply downward pressure on the inflation rate.

In contrast, a weaker dollar makes foreign products less affordable and gives domestic producers the leeway to raise their prices as well, pressuring inflation higher.

MIDDLE MARKET INSIGHT

The dollar will maintain its elevated value in the third quarter and then gradually fall back next year as tighter Federal Reserve policies cool an overheating economy.

A weaker dollar should help exporters retain their global market share. But that assumes that price is the only criteria for foreign consumers and producers, who might instead base their preferences on the reliability and quality of other suppliers.

There has traditionally been a time and place for a strong dollar. At the end of global economic downturns, U.S. spending has helped kick-start global recoveries, with U.S. purchases of cars and American occupancy of hotel rooms and restaurants helping spur foreign growth.

The takeaway

In the current recovery, taking place amid geopolitical tensions and disrupted markets, we would bet on the relative energy independence of the United States and the resilience of the U.S. economy.

As we saw during the global financial crisis, the consequences of the war and energy shortages in Europe will undoubtedly spill over into the North American financial markets and the economy. This should be a reminder for policymakers to address short-term needs within the framework of longer-term investment in that resilience. ■



THE AMERICAN HOUSING DEFICIT AND WHAT IT TAKES TO CLOSE IT

BY JOSEPH BRUSUELAS, NICK GRANDY, TUAN NGUYEN
AND CRYSTAL SUNBURY

OVER THE PAST 15 YEARS, the United States has not built enough homes to keep up with growing demand. The problem has intensified during the pandemic, with demand skyrocketing because of the shift to working from home and the availability of historically low mortgage rates.

We estimate that at the end of 2021, the United States was about 3.5 million homes short of the number required to maintain a stable market.

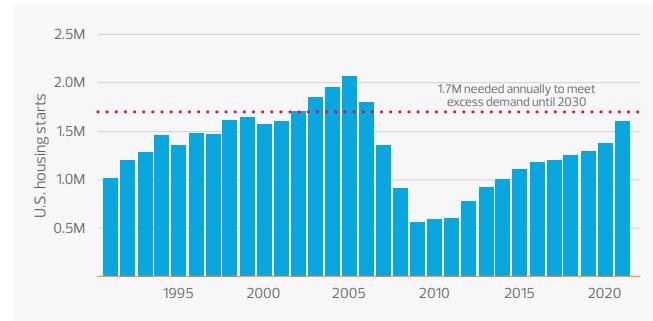
Together with the rising cost of building materials, the depleted supply of new homes has pushed housing prices to record highs, contributing to a rate of inflation not seen in more than 40 years.

To close the gap, the U.S. housing market will need 1.7 million new homes on average each year until 2030, according to our estimates. This figure is calculated based on current economic conditions, cost of living and a long-term growth forecast of 1.8% annually.

Given that there were only 1.6 million new housing starts last year, when the market was booming, it would be impossible to rely on the private sector to deliver such a high level of new homes each year, especially as the market for housing has cooled sharply.

We believe government agencies at the national and local levels need to take a more active role to overcome the current housing deficit, by adopting policies that include more flexible zoning restrictions, expanded housing tax credits, and provisions that broaden affordability.

U.S. housing starts—annually



Source: U.S. Census Bureau; RSM US LLP

THE HOUSING BOOM DURING THE PANDEMIC YEARS, DRIVEN BY STEEP RISES IN DEMAND AND PRICES, HAS HELPED INCENTIVIZE BUILDERS TO PROVIDE MORE NEW HOMES.

Forecasting housing demand

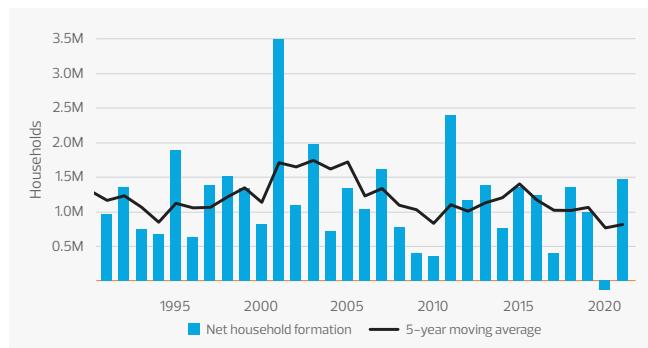
The collapse of the housing market during the 2008–09 financial crisis not only slowed demand for new homes, but also made builders wary about being too aggressive. Sentiment among builders plunged so low that it did not recover until 2017.

From 2007 to 2020, new housing starts—a proxy for new housing supply—never crossed the 1.5 million mark, which was widely estimated to be the average annual supply needed to meet target household demand in the 2010s.

This resulted in a growing housing deficit that reached 3.8 million units by the end of 2020, according to [a recent report from Freddie Mac](#), a figure we used as a benchmark to then calculate the 2021 deficit.

The long-term supply to meet household demand through 2030 in our base case is 1.3 million units each year. This figure includes 900,000 units for newly formed households annually, and is consistent with the five-year average of net household formations from 2016 to 2021, according to data from the Current Population Survey of the U.S. Census Bureau.

U.S. net household formation



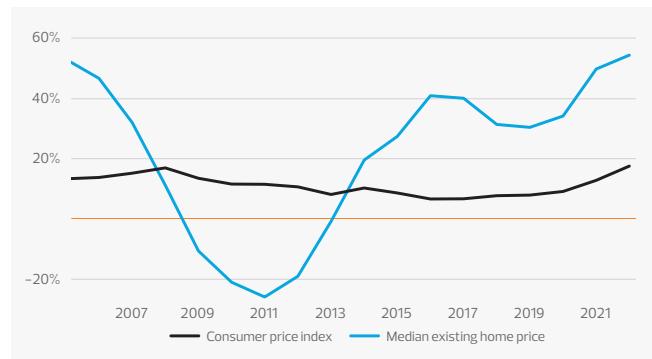
Source: Current Population Survey; RSM US LLP

The estimate for new household formations is also in line with Freddie Mac's lower bound forecast for housing demand in the 2016–2025 period. The lower bound was based on the assumption that the cost of living for households in 2025 would be 20% higher than before 2016, and that higher living costs have been found to discourage household formations.

The assumption is not far off, as the five-year change in the consumer price index reached 13% in 2021 and 17% in the first half of 2022. We expect inflation to persist in the second half of this year, especially regarding housing costs, which also hamper the formation of new households.

The other 400,000 units account for second-home demand, existing-home replacements and a healthy stock of vacant units, required to stabilize the market.

Change in cost of living from five years ago



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

MIDDLE MARKET INSIGHT

Regulatory barriers around local and state economies will need to be reduced, and the affordability crisis faced by Gen Z and millennial cohorts needs to be immediately addressed.



WE BELIEVE GOVERNMENT AGENCIES AT THE NATIONAL AND LOCAL LEVELS NEED TO TAKE A MORE ACTIVE ROLE TO OVERCOME THE CURRENT HOUSING DEFICIT.

The housing boom during the pandemic years, driven by steep rises in demand and prices, has helped incentivize builders to provide more new homes. The Census Bureau recorded 1.6 million new housing starts in 2021. That total included an extra 300,000 new housing units beyond the 1.3 million needed annually, pushing the total deficit from 3.8 million in 2020 down to 3.5 million units last year.

To completely close such a deficit and at the same time meet the new annual demand of 1.3 million new homes, the United States will need about 1.7 million units each year until 2030.

That said, our estimate would be subject to downside risks from rising inflation, which reduces Americans' desire to form new households. There is also the risk of an economic slowdown or even an outright recession as the Federal Reserve aggressively raises interest rates to tame inflation.

In the past two business cycles, net household formations dropped significantly during the recession years, falling to fewer than 1 million from 2007 to 2010, and even dropping to negative territory in 2020. The demand for new homes and the creation of new households often decline during recessions as personal incomes drop and spending falls substantially.

But even with an economic slowdown or potential recession in the coming months, construction of new homes will need to increase to close the existing gap. Deteriorating builder sentiment due to rapidly rising mortgage rates, which hit 5.65% as of June 17, and continued headwinds from labor and supply chain challenges are poised to limit new construction, exacerbating the housing shortage.

MIDDLE MARKET INSIGHT

To close the gap, the U.S. housing market will need 1.7 million new homes on average each year until 2030, according to our estimates.

Closing the housing gap

The shortfall is in many respects an outgrowth of the financial crisis over a decade ago. The long-lasting impact of that crisis will not be fixed overnight and will require a sustained and balanced approach to increasing the housing supply. Two measures can help address the shortfall:

- **Fix the zoning rules:** First and foremost, zoning that limits construction needs to be relaxed and redesigned to reflect the changing demographics of those in need of housing.
- **Expand affordability:** Low-income housing tax credits and tax credits that support construction and redevelopment of homes under the Neighborhood Homes Investment Act need to be put in place through federal and state financing to address the affordability crisis.

Regulatory barriers around local and state economies will need to be reduced, and the affordability crisis faced by Gen Z and millennial cohorts needs to be immediately addressed. Both are necessary to promote generational economic equity and to relieve a housing shortage that is now contributing to overall inflation.

The takeaway

Providing enough affordable housing for all Americans would have a significant impact on the economy. Such an achievement would not only address rising housing costs, but also increase the availability of decent shelter, a goal currently unattainable for many Americans.

But the private market can't do it alone—local and federal governments must redesign policies that incentivize more supply while keeping prices down. Only then will the market provide the 1.7 million homes a year needed to meet the growing demand of a rising generation. ■

CAN A PRICE CAP ON RUSSIAN OIL WORK?

BY JOSEPH BRUSUELAS



THE UNITED STATES is urging its trade partners to adopt a novel proposal that would put a cap on the price of Russian oil during a time of shortages in global production.

Treasury Secretary Janet Yellen's proposal is a creative idea, but it carries risks and could result in another surge in oil prices. Middle market firms need to understand these risks as they plan for the second half of the year.

The proposal has three objectives:

- **Constrain** Russia's ability to finance its war in Ukraine
- **Prevent** a further energy catastrophe in the European Union and the United Kingdom
- **Put downward pressure** on global oil markets to help tame surging inflation

To achieve the objectives, the policy would create a purchasing cartel that would limit the price of Russian oil to, say, around \$40 per barrel, while not completely cutting off the flow of oil out of Russia.

But that still leaves the question of enforcement—or how to prevent Russia and other nations from getting around the cap.

The answer lies in insurance. The United Kingdom and the European Union insure somewhere between 85% and 90% of Russian oil exports. Together with the United States, they would refuse to permit the insurance of any ship that transports Russian oil priced above the cap.

The U.S. government estimates that oceangoing transport ships move roughly 70% of Russia's 5.6 million barrels a day of crude exports, with the rest sent through pipelines to Europe and China.

The proposed cap on the price of Russian oil has three objectives: Constrain Russia's ability to finance its war, prevent a further energy catastrophe and reduce inflation.

MIDDLE MARKET INSIGHT

As with any market interference, a cap on the price of Russian oil would carry unintended consequences.

One approach to limiting Russian oil revenues would be to apply significant tariffs. But India or China would resist such tariffs because of the economic damage they would cause. That leaves the price cap, along with the insurance limitation, as the most viable way to limit Russian oil revenues.

Without insurance, it would become almost impossible for Russian oil to be transported. But the approach carries risks:

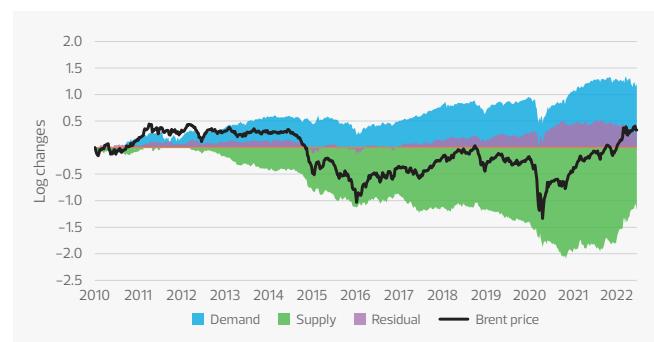
- **The likelihood of cheating.** As with all sanctions—and this proposal is essentially a sanction, albeit a creative one—there will be loopholes and cheating, especially given Russia's sizable share of oil exports. The price difference between our hypothetical \$40 cap and the current market price of around \$95 per barrel is simply too great.
- **The possibility that Russia acts first.** Russia may choose to cut off any further oil exports to the world, which would surely send oil surging back toward recent highs near \$130 per barrel.
- **Distortions to the market.** The policy would create further distortions in the global oil market by making it nearly impossible for commercial enterprises to hedge volatility in the market.
- **The wild card of China and India.** Russia and its largest current consumers—China and India—could simply choose to create an insurance market to cover the risk of transport of Russian oil. At this time, none of those countries appear to have the resources or global trust to create and sustain such a market, but it cannot be discounted.

Supply constraints

Analysis by the Federal Reserve Bank of New York found that increases in oil prices are currently more a function of anticipation of limited supplies than overwhelming demand. [The analysis](#) found that excess supply became a significant driver of oil prices in 2012 and generally dominated price dynamics after 2014.

In the latest period, the analysis found that anticipation of decreased demand in the second quarter of 2022 was offset by expectations of a greater decrease in the supply of oil. By our calculations, that resulted in the futures price of Brent crude oil increasing by 9.5% from March 31 to June 28.

Supply, demand and price of crude oil*



Source: Federal Reserve Bank of New York; RSM US LLP *Cumulative weekly decomposition, 2010–present

Given the response of the West to the invasion of Ukraine and Russia's threats to cut off energy supplies to Europe, the relative importance of limited supplies of oil should come as little surprise. But in terms of policy debate, the root cause of high oil prices and their effect on the inflation rate need to be accurately portrayed.

For example, recent news reports suggest that OPEC can simply turn on its pumps to counter the withdrawal of Russian supplies. Even if geopolitics were to allow production to increase, [Reuters now reports](#) it might be wishful thinking.

Before the shale revolution, the debate in the early 2000s centered on "peak oil," a theory that the world was fast running out of a finite resource.

Saudi Arabia and the United Arab Emirates were recently considered to have excess capacity. But the UAE's leader, in recent statements he later discounted, said not only that the Saudis are approaching their production limits, but also that UAE production is maxed out. Libya says [it might suspend exports](#) because of its political crisis, and Ecuador's labor strife threatens to shut down that country's production.

This would not be the first time oil abundance has been a trending topic. Before the shale revolution, the debate in the early 2000s centered on "peak oil," a theory that the world [was fast running out](#) of a finite resource.

More to the point, the concern was that peak oil supplies marked the end of cheap oil. As noted in 2014, oil is a most efficient source of energy, with a liter of diesel capable of moving tons of matter great distances at a cost of less than a cup of coffee.

Policy alternatives

This brings us to policy alternatives and choices, whether or not the global producers have reached a peak. The current oil crisis is only the latest brought on by a shortage of supply.

The need for fossil fuels will be around for some time. It's hopeless to think that the West could transition to alternate sources of energy overnight without some cost to the economy or the population. Neither could it sufficiently mitigate the demand for liquid fuels to bring down the price of energy.

MIDDLE MARKET INSIGHT

The proposed cap on the price of Russian oil is a creative idea, but it carries risks and could result in another surge in oil prices.

Is there a policy that allows for market-based pricing of energy, with multiple sources of energy competing for market share?

As the market is set up now, oil can be extracted from a limited number of fields, with Russia one of the dominant producers. While the West hoped that Russia would join the Western alliance of market-driven economies, that's no longer realistic.

OPEC is now OPEC Plus, which includes Russia. With the supply of oil regulated by fiat or by physical restraint, price signals remain constrained.

The proposal to place a cap on the price of Russian oil would have a direct positive effect on large Russian clients like India and China while reducing Russia's receipts.

In effect, that would set up a two-tiered market, with prices in Asia determined by the alliance of developed economies, and prices in the West determined by the interaction among private suppliers and consumers. But as with any market interference, there are bound to be unintended consequences. ■



CONSTRUCTION



HOW LUMBER TELLS THE STORY OF HOMEBUILDING DURING THE PANDEMIC

BY NICK GRANDY

LUMBER PRICES have had a tumultuous two years. Since March 2020, lumber futures have risen 359%, declined 68%, risen again 159% and declined 55%. Despite the roller-coaster ride, lumber prices are still significantly higher than they were before the pandemic, with futures in May nearly double what they were before the pandemic.

The increase has been blamed for the rising price of new homes, with the National Association of Home Builders noting in April 2021 that the increase in lumber prices alone was responsible for adding as much as \$36,000 to the average price of a new home.

But that prompts a question: With lumber prices declining, why hasn't the cost of a newly built home declined as well? Part of the answer lies in the economies of scale at which large developers operate, helping them endure the ebbs and flows of the market. It's a different story for smaller builders, though, which have been more vulnerable to the swings in input costs like lumber.

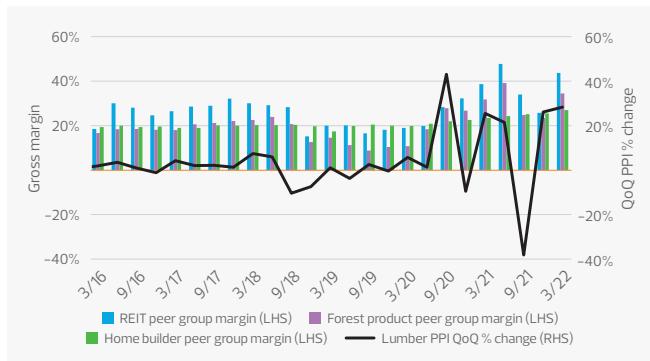
To understand this dynamic, consider what happens with a piece of lumber as it goes from the forest to a construction site, and how the biggest builders reap the biggest rewards.

The timber companies

The journey for lumber begins anytime from 25 to 50 years before the tree is harvested. A tree is planted in one of the approximately 200 million acres (about the area of Texas) of commercial forested timberlands in the United States. Most of this land is owned by private individuals or corporations, but three primary, publicly traded real estate investment trusts control 10% of the timberland.

As lumber prices rose throughout the pandemic, margin prices among the investment trusts soared, with average gross margins hitting close to 48% in June 2021, double the pre-pandemic three-year average of 24%.

Peer group gross margin and PPI changes



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

AS LUMBER PRICES ROSE THROUGHOUT THE PANDEMIC, MARGIN PRICES AMONG INVESTMENT TRUSTS SOARED TO DOUBLE THEIR PRE-PANDEMIC THREE-YEAR AVERAGE.

MIDDLE MARKET INSIGHT

Large developers operate with economies of scale that help them endure the ebbs and flows of the market. It's a different story for smaller builders.

The increase in margin reflects the industry's supply challenges. Aside from the United States, a major source of timber is British Columbia. In the early 2000s, British Columbia was devastated by a pine beetle infestation. The response was to salvage as much lumber as possible. This drove up supply right before the financial crisis. The combination of muted demand and high supply forced many Canadian loggers out of business, reducing competition.

Now, with demand for lumber soaring, the United States doesn't have much excess timber capacity, allowing these large REITs to effectively raise prices unencumbered.

Smaller and midsize timber companies, by contrast, have struggled. Loggers do not have a large marketplace in which to sell their lumber to different sawmills or timber buyers. Instead, loggers harvest lumber for a specific mill or timber buyer on a contract basis.

Sometimes these buyers will place quotas on the loggers, limiting them to bringing a certain tonnage of lumber to sell at the mill for a designated period. These quota systems serve as a means of limiting excess harvesting and guarantee prices to these sellers.

But the quotas are often not set in stone, changing on a weekly or even daily basis. With the shortage of truck drivers, these loggers are feeling a pinch because they are limited in what they can sell to each sawmill and there are not enough drivers to deliver their logs to sawmills outside of the local areas, which is limiting production.

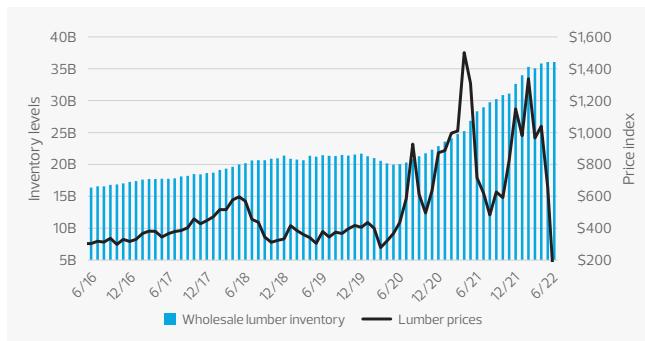
The producers

Once the timber is harvested, it is sent to the sawmill, where the lumber is cut. Early in the pandemic, sawmills cut back on production because of the health crisis

itself and also because producers thought that demand for lumber would plunge, as it did during the financial crisis in 2008.

This prediction proved to be inaccurate, though, as demand surged. At the pandemic onset, this left many sawmills underproducing usable lumber. However, by the fall of 2020, many of the publicly traded forest companies were back up and running, humming with orders, which helped enable them to expand their margins from a pre-pandemic five-year average of 17% up to 48% by the second quarter of 2021 (based on a select peer group of American and Canadian forest product companies).

Inventory levels and lumber prices



Source: U.S. Census Bureau; Chicago Mercantile Exchange

By the summer of 2021, inventory levels began to improve across the resellers, driving down lumber pricing and margins for forest product companies, with gross margins of the average peer group dropping to 26%. The declines were short-lived, though, as speculation began to enter the market, because of the large focus placed on homebuilding throughout the pandemic. Now, we are again seeing a drop-off in lumber prices. With the Federal Reserve raising interest rates to tame inflation, demand for building products will continue to ease to more normalized levels.

These factors should bring lumber prices back in line with long-term price trajectories set before the pandemic and serve to tighten up margins back to pre-pandemic levels.

ON TOP OF DECLINING DEMAND, SUPPLY CHALLENGES FROM THE RISING COST OF MATERIALS AND LABOR WILL MOST LIKELY SQUEEZE PROFIT MARGINS FOR HOMEBUILDERS AND PUSH MARGINS BACK TO PRE-PANDEMIC LEVELS.

The builders

Housing has been one of the largest of the inflationary pressures in the economy, rising by 21.2% year over year as of April, according to the S&P CoreLogic Case-Shiller National Price Index.

Builders have benefited on both the supply and demand fronts. On a supply front, the United States has underbuilt homes since 2007, because many builders did not want to get caught with excess inventory the way they did after the Great Recession. This underbuilding—the nation is about 5 million homes short of what it needs—coupled with the emergence of millennials as a buying force, has led to a steep decline in inventory levels.

This shortage was further worsened by significant growth in demand, pushed by the Fed's lowering of interest rates in 2020 to combat the pandemic and by the widespread desire for more home space to live and work.

Housing starts/permits and existing housing market supply



Source: U.S. Census Bureau; National Association of Realtors; RSM US LLP

Now, with the Federal Reserve raising interest rates, builders will need to approach the next year with caution. The existing-homes market, which is about 10 times larger than the market for new homes, is heavily undersupplied, with inventory levels, measured by months of supply, at 2.6 months as of May. The new-home market, however, is at 7.7 months. Equilibrium for these markets is typically between four and six months.

MIDDLE MARKET INSIGHT

With the Federal Reserve raising interest rates, demand for building products will continue to ease to more normalized levels.

Large, publicly traded homebuilders have been trying to pace production to limit exposure to oversaturation. But with rising interest rates, homeowners are facing decreased affordability. This will slow demand for housing to more normal levels.

On top of declining demand, supply challenges from the rising cost of materials and labor will most likely squeeze profit margins for homebuilders and push margins back to pre-pandemic levels. But that has yet to happen.

Based on a peer group analysis of publicly traded homebuilder margins, gross margins in the first quarter grew to 27%, up from pre-pandemic levels of 20%. While we do not expect a recurrence of 2007—a crash in the housing market—there are certainly headwinds that homebuilders need to continually watch to ensure they protect their margins and remain profitable.

The takeaway

As rising interest rates increase the cost of owning a home, it appears that we have reached peak market demand and that prices will soon begin to ebb.

The slowing of demand should give builders a chance to deal with some of the supply chain and labor issues they have faced. A slowing of construction will, in turn, result in a decline in lumber prices, bringing them back in line with long-term averages.

While the shifting tides will lead to lower margins throughout the supply chain, opportunities are still plentiful. Builders may just have to work a little harder to find them. ■

AMID SUPPLY DISRUPTIONS, ORGANIZATIONS HAVE ADAPTED, RSM SURVEY FINDS

MORE THAN TWO YEARS into the pandemic, supply chain snarls persist for middle market American businesses, forcing many to adapt by finding other sources for their supplies or dropping product lines, according to proprietary Middle Market Business Index data from RSM US LLP.

Of companies hurt by upstream supply disruptions, the majority, or 70%, said they had found other sources of supply in the United States during the previous 12 months. This was especially true for businesses at the smaller end of the middle market, or those with \$10 million to \$50 million in annual revenue, than for larger middle market businesses with \$50 million to \$1 billion in revenue.

The survey polled middle market executives from April 4 to April 25 on issues specific to supply chains, as well as on costs and inflation.

Among the survey's findings:

When supply chain disruptions have hit, businesses have adapted.

70%

have found other sources of supply in the United States.

51%

have purchased some supplies from competitors at a premium.

36%

have found other sources of supply outside the United States.

Finding other sources inside the United States was especially true at the smaller end of the middle market.

80%

of businesses with \$10 million to \$50 million in annual revenue reported finding other sources of supply inside the United States.

55%

of larger middle market businesses, or those with \$50 million to \$1 billion in annual revenue, reported doing so.

In some cases, the disruptions have led businesses to drop a product line altogether ...

32%

of businesses affected by the disruptions have exited one or more product lines.

... and that was more the case at the larger end of the middle market:

42%

of the larger middle market businesses exited a product line.

25%

of smaller middle market businesses reported doing so.



Download the [special report](#).

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