THE REAL ECONOMY

VOLUME 93

THE MIDDLE MARKET BRACES FOR ECONOMIC HEADWINDS

THE ECONOMY IS NOT IN RECESSION. HERE'S WHY, AND HOW TO TELL WHEN IT IS.

WHAT TO EXPECT AT THE END OF THE BUSINESS CYCLE

A SECTOR-BY-SECTOR LOOK AT HOW THE MIDDLE MARKET IS PREPARING FOR A CHANGING ECONOMY:

- HOSPITALITY
- PRIVATE EQUITY
- NONPROFITS
- HOUSING

TREND WATCH: SMALLER BUSINESSES TAKE THE BRUNT OF SUPPLY CHAIN BOTTLENECKS

THE POWER OF BEING UNDERSTOOD
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ECONOMIC HEADWINDS

WHY THE U.S. ECONOMY IS NOT IN A RECESSION, AND HOW TO KNOW WHEN IT IS

BY JOSEPH BRUSUELAS

THE U.S. ECONOMY has yet to slip into a recession despite two consecutive negative quarters of growth. There is a difference, after all, between the conventional definition of a recession and the formal definition of one. Put simply, recession requires more than just two quarters of contraction.

In addition, our proprietary RSM US Middle Market Business Index improved to 138.5 in the third quarter, a 7.3-point increase from the second quarter. That strongly implies a real economy that continues to expand even in the midst of inflation, interest rate increases and the lingering impact of the pandemic.

RSM US Middle Market Business Index

Source: RSM US LLP

*Seasonally adjusted

That improvement came about because businesses have been able to pass along price increases to customers—71% of executives in the MMBI survey reported doing so—while revenues and net earnings remained stout.

This is not to say that firms will be able to do that indefinitely. They will not. Yet for now, businesses have been able to absorb the shocks without a significant downturn in hiring, income, industrial production or sales.

A clear majority of executives in our survey said they intended to hire more workers, pay them more and invest in improved productivity, all while expecting revenues and net earnings to increase.

For this reason, we do not expect a recession for the remainder of 2022 despite a 45% probability of one hitting the domestic economy over the next 12 months.

But many executives remain concerned about the prospect of a recession, so in this month's issue of *The Real Economy*, we spell out what a recession will look like and what to look for.

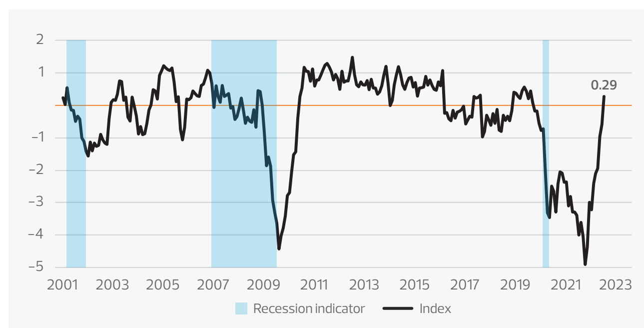
We present useful metrics to identify whether a recession has started and analyze critical industrial ecosystems to illustrate the variation in growth, employment and inflation across the underlying economy.

Why is the economy not in a recession?

From our vantage point, the economy has not slipped into recession. During the first seven months of the year, 3.4 million jobs were created and the unemployment rate—taken out to three decimals—fell to 3.458%, a 50-year low. More individuals are working now than before the pandemic, with real wages up 0.5% despite an 8.5% inflation rate.

In addition, our own RSM US Supply Chain Index indicates that the snarled domestic chains are normalizing. In July, the index was above neutral for the first time in nearly three years on the back of the strong rebound in inventories and capacity utilization. This unsnarling of supply chains should on the margin dampen inflation and bolster output in the second half of the year, when we expect growth to advance by 1.5%.

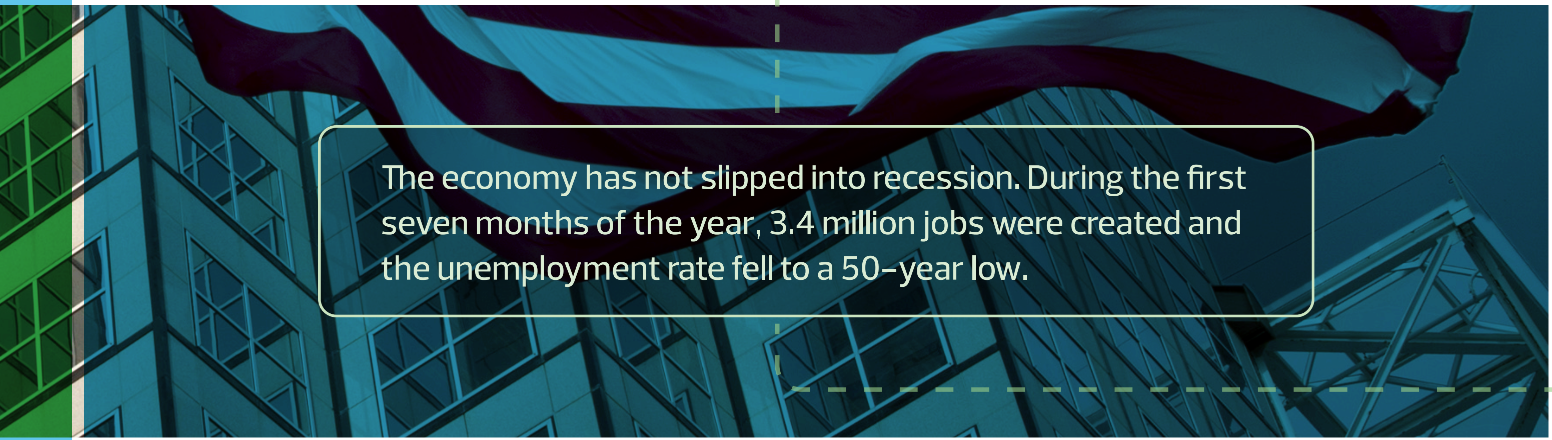
RSM US Supply Chain Index*



Source: Various government and private organizations; Bloomberg; RSM US LLP
Note: An index value of zero is defined as a normal level of supply chain efficiency. Positive index values suggest adequate levels; negative levels suggest deficiencies.
*Z-score based on mean and standard deviation from 2001 to 2019

With COVID-19 mostly in retreat and supply chain bottlenecks easing, we should expect substantial relief coming from the supply-induced components of inflation, which account for about 35% of year-over-year inflation, according to our estimate.

Our index, however, does not capture the issues surrounding the housing deficit, a sticky component of inflation. On top of the housing shortage, the labor market remains tight as the labor supply is slow to come back to its pre-pandemic level, reflected in the stagnant labor force participation rate in recent months.



The economy has not slipped into recession. During the first seven months of the year, 3.4 million jobs were created and the unemployment rate fell to a 50-year low.

MIDDLE MARKET INSIGHT
With COVID-19 mostly in retreat and supply chain bottlenecks easing, we should expect substantial relief coming from the supply-induced components of inflation.

That should keep the Federal Reserve on its course to raising rates this year—we think the federal funds policy rate will be lifted to 4% before the end of 2022—to combat elevated inflation, which is still far from the long-term target of 2%.

While our base case shows inflation will continue to retreat, we expect the annual inflation rate will most likely fall to around 3% by the end of next year and remain above the 2% target rate for a while.

What we can expect if the economy slips into recession

A recession brings about labor market slack, diminished production and subsequent losses of income and sales.

Note that a recession entails an extended period of decline in economic activity. That's not to be confused with deceleration of growth that typically occurs amid the ebb and flow of a business cycle.

The final descent of a business cycle into recession is usually brought on by an event like an energy-supply shock or a financial crisis that affects the broader economy.

Absent such a shock, our forecasting model estimates a 1.7% probability of a U.S. recession as of June 2022, which is different from our probability estimate of 45% over the next 12 months.

Given long and variable lags in the data and the unique impact of the energy shocks and geopolitical tensions still coursing through the economy, it will be a while before a recession hits.

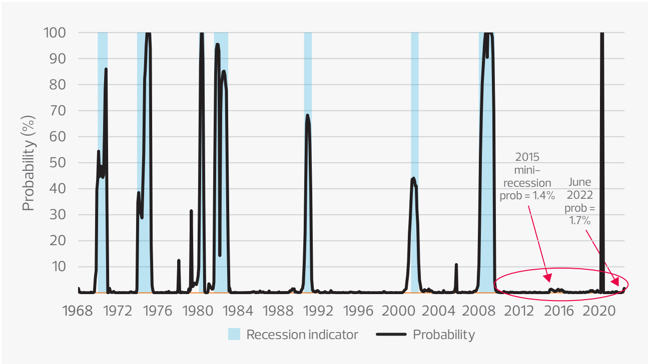
The current estimate of 1.7% is based on an econometric model developed after the early-1990s recession that continues to predict turning points in the economy and the ongoing status of the business cycle.

The authors, Marcelle Chauvet and Jeremy Max Piger, applied their model to four monthly coincident variables that correspond to the health of the economy. These indicators can be followed in the mainstream press and in our articles, and they offer insight into the depth and duration of the recession:

- Nonfarm payrolls
- Industrial production
- Real personal income, excluding transfer payments
- Real manufacturing and trade sales

We can use their work identifying the turning point in a business cycle to understand what to expect during periods of recession.

U.S. recession probabilities*



Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis; RSM US LLP

*Estimates by Marcelle Chauvet and Jeremy Max Piger

Nonfarm payrolls

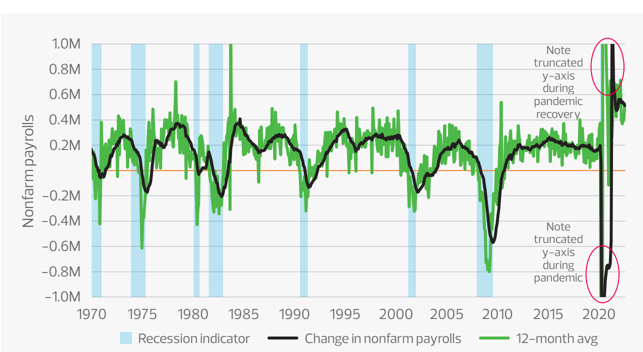
If a recession is the absence of growth or an outright decline, then a consistent drop in job creation below normal levels would signal a recession.

A rule of thumb in normal times—borrowing from the Sahm Rule for unemployment—is that a consistent drop in the monthly change in payroll employees below the 12-month average signals a descent into recession, while negative values of job creation characterize an economy in recession.

Over the past decade, job creation mean-reverted to around 200,000 new jobs per month. In the past 12 months, the monthly increase in nonfarm payrolls has averaged 512,000. So, job creation remains in the post-pandemic stratosphere, which is a good sign but makes comparisons to other business cycles difficult.

Nonetheless, the lack of job creation would normally indicate slack in the labor market, resulting in moderated pressure on wage growth. But in an environment distorted by a limited supply of labor, wages would be expected to remain somewhat sticky, with investments in automation pointing to higher wages for a smaller and more-qualified labor force and the lack of immigration pointing to upward pressure on wages in low-income occupations.

Job creation during recessions



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

MIDDLE MARKET INSIGHT

Real income growth has decelerated to less than 1% relative to June 2021 as inflation has accelerated to an 8.5% yearly rate.

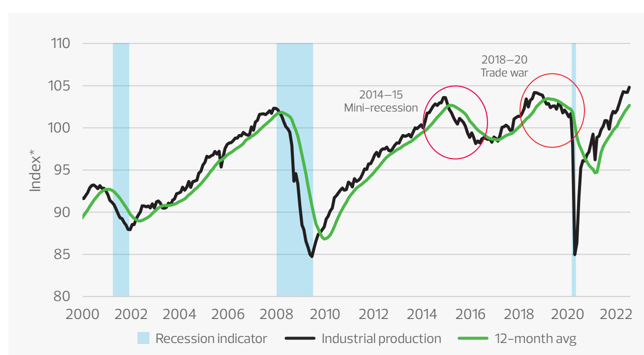
Industrial production

The Chauvet-Piger model looks at the index of industrial production. In the decade-long business cycle after the Great Recession, two downturns in the industrial production index signaled distress.

The first coincided with the commodity-price collapse of 2014, which led into the so-called 2014-15 mini-recession. The second coincided with the 2018 onset of the trade war that led into the 2019-20 global manufacturing recession.

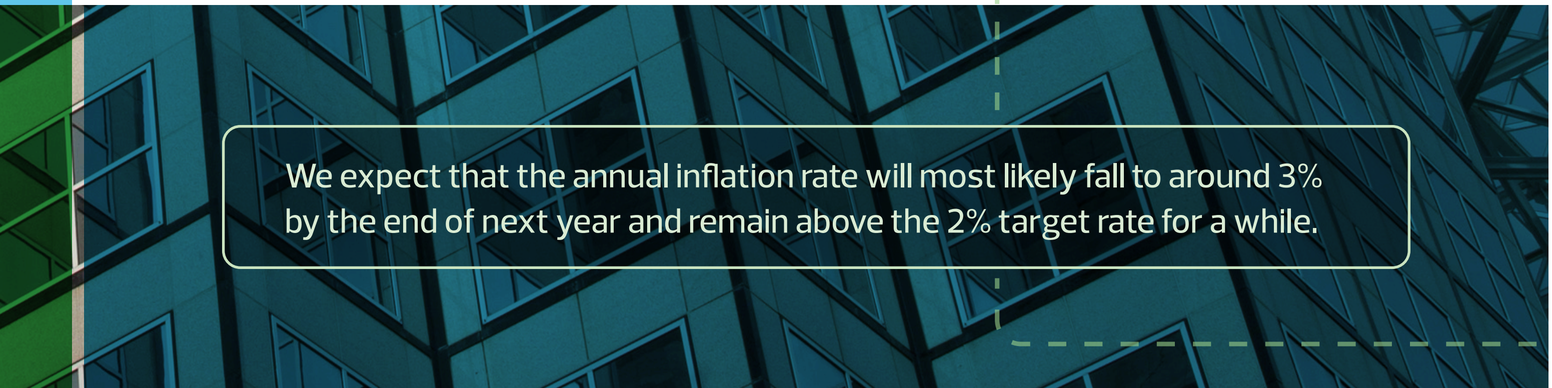
In the first instance, the price of energy plummeted, allowing consumer spending to continue. In the second instance, the pandemic pushed the economy into a sharp recession.

Industrial production index and the business cycle



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

*2017 = 100

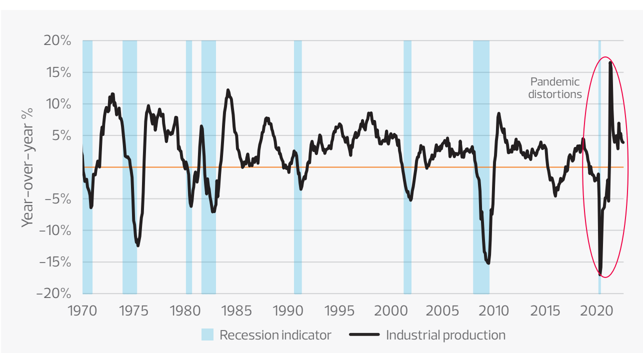


We expect that the annual inflation rate will most likely fall to around 3% by the end of next year and remain above the 2% target rate for a while.

The trends in the growth rate of industrial production coincide with the direction of the overall economy, with the presence of negative growth of industrial production signaling the sudden start of a recession. The reemergence of growth of industrial production (relative to months of the previous year) coincides with the end of the recession.

A rule of thumb is that drops in industrial production of more than 5% signal a more severe and longer recession than, for instance, the shallow recession of the early 1990s.

Industrial production growth during recessions



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

Real personal income

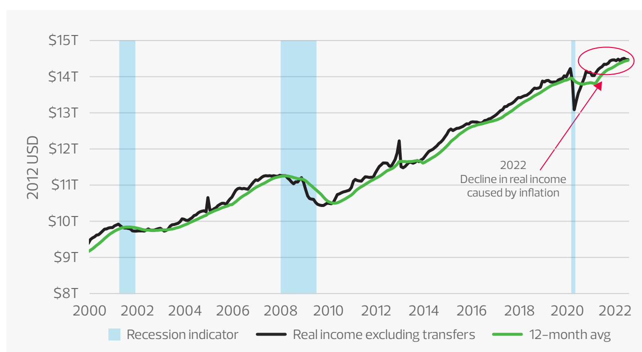
Real personal income is a measure of both the availability of employment and the ability to consume goods and services, given the effect of inflation on household balance sheets. As would be expected, the drop in the monthly measure of real income below its 12-month moving average occurs at the outset of a recession as employment opportunities decrease, and then continues over the duration of the recession.

MIDDLE MARKET INSIGHT

Job creation remains in the post-pandemic stratosphere, which is a good sign but makes comparisons to other business cycles difficult.

In the current period, real income growth has decelerated to less than 1% relative to June 2021 as inflation has accelerated to an 8.5% yearly rate. That explains the Fed's focus on preventing further deterioration in the purchasing power of wages.

Real income excluding government transfers during recessions



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

Real manufacturing and trade sales

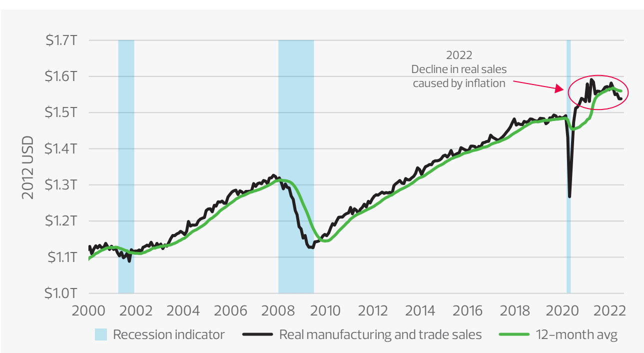
Just as inflation is limiting consumer buying power, it is also eating into sales and revenues, threatening the recovery in the business sector. While nominal manufacturing and trade sales have been growing at a 15% yearly rate over the past six months, sales growth in inflation-adjusted terms has been negative over the past four months.

MIDDLE MARKET INSIGHT

Recessions carry with them long-term direct and indirect costs to the labor force and to the potential growth of the economy.

As would be expected, manufacturing and trade sales in real terms drop during recessions, with sales growth hitting bottom near the end of the recession. This goes along with losses of employment and the ripple effects of increased uncertainty as households refrain from spending and businesses pare back.

Real manufacturing and trade sales during recessions

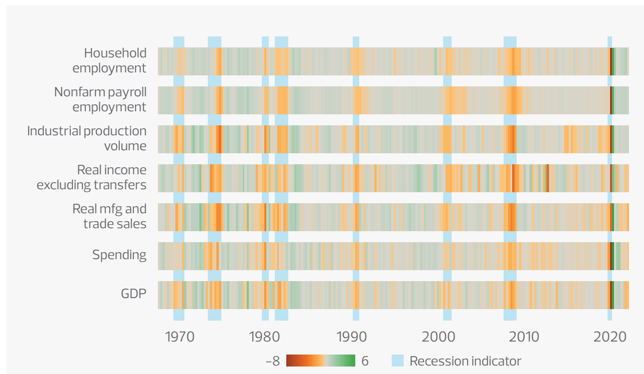


Source: U.S. Census; Bloomberg; RSM US LLP

Calling a recession

The Chauvet-Piger model, however, uses only four out of six variables spelled out by the [Business Cycle Dating Committee]() of the National Bureau of Economic Research to identify official recession dates. The two other variables are the employment level, as determined from a household survey, and real personal spending.

U.S. recession tracker: Jobs and industrial production temper recession fear*



Source: Bureau of Economic Analysis; National Bureau of Economic Research; RSM US LLP

*Quarterly growth rates normalized using z-score; red indicates contraction and green indicates expansion

Together with gross domestic product data, we can develop a tracker for the growth rates of all six variables in a heat map. All variables are normalized using z-scores, with scores under zero indicating activities lower than the long-term normal level while scores above zero indicate activities stronger than the long-term normal level.

Benchmarking against official recession dates in the past, the heat map shows just how consistent the NBER has been in calling a recession, which it defines as "a significant decline in economic activity that is spread across the economy and that lasts more than a few months." In each of the past eight recessions, the downturns were officially dated only when all variables showed significant declines.

During the first six months of this year, three out of the six variables—job gains from the household survey and payroll report, and industrial production volume—continued to expand, countering any notion that the U.S. economy was in a recession.

MIDDLE MARKET INSIGHT

After the shallow recession in the early 1990s, it took 8.2 years for the labor force to return to its pre-recession unemployment rate of 5%.

The takeaway

Recessions carry with them long-term direct and indirect costs to the labor force and to the potential growth of the economy.

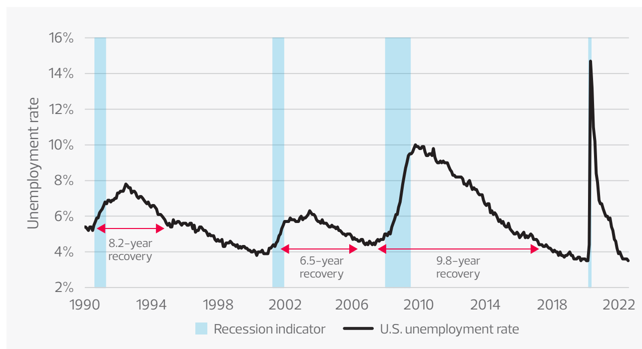
After the shallow recession in the early 1990s, it took 8.2 years for the labor force to return to its pre-recession unemployment rate of 5%, which incidentally corresponded to rule of thumb estimates of the equilibrium rate of unemployment at the time.

After the shallow recession in the early 2000s, it took 6.5 years to reach the pre-recession unemployment rate, which in that case was 4.4%. And then after the Great Recession, it took 9.8 years for unemployment to drop back to the 4.4% rate, which matches the latest estimates of the equilibrium rate.

During those years, the unemployed population fell behind in terms of skills, with the labor force suffering unrecoverable losses in income, while businesses suffered losses in productivity, competitiveness and revenue.

The upshot is to expect a years-long recovery period if the economy sinks into recession while policymakers and businesses rethink ways to maintain output and future growth. ■

U.S. unemployment rate during recessions and number of months to return to pre-recession rate



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

ECONOMIC HEADWINDS

WHAT TO EXPECT AT THE END OF BUSINESS CYCLES

BY JOSEPH BRUSUELAS

THE FEDERAL RESERVE has a blunt yet effective instrument to fight inflation: raising the federal funds rate. But using it requires a delicate balancing act.

In the best-case scenario, the Fed, by raising rates, reduces discretionary spending enough to stabilize prices, and the economy continues to grow. But in the worst-case scenario, economic growth comes to a screeching halt as spooked consumers rein in spending, and the economy tumbles into recession.

We expect the current pattern of the gradual deceleration of economic growth to continue into the next year and for the Fed to operate largely on its own, without the benefit of any fiscal measures from Congress.

To be clear, the economy is not in recession. Real growth in gross domestic product over the past four quarters has been higher than in the preceding quarters.

These days, we have an economy buoyed by roughly $2.2 trillion in excess savings accumulated during the pandemic, a robust labor market, and strong, fixed business investment that continues to bolster a growing economy. But we cannot ignore rising retail and wholesale inventories and the soaring costs that are impeding the ability of firms and households to sustain that growth.

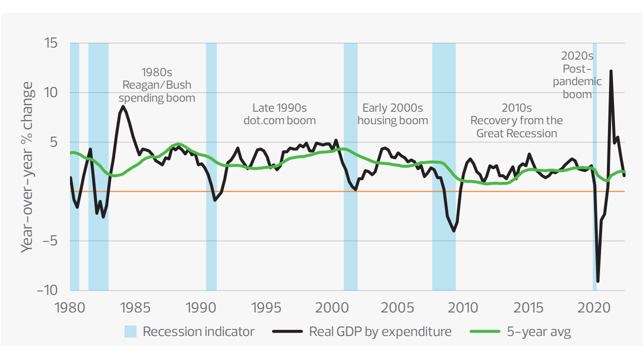
For this reason, we have revised our forecast for growth this year down to 1.5%, with the risk of a slower pace.

MIDDLE MARKET INSIGHT

Beginning in the third quarter of 2020, there have been eight consecutive quarters of positive growth in investment in intellectual property.

The figures that follow should help explain our viewpoint: Even as the economy stays out of recession, it is operating on a knife's edge and is vulnerable if conditions deteriorate.

Real GDP growth at the end of economic booms/recoveries

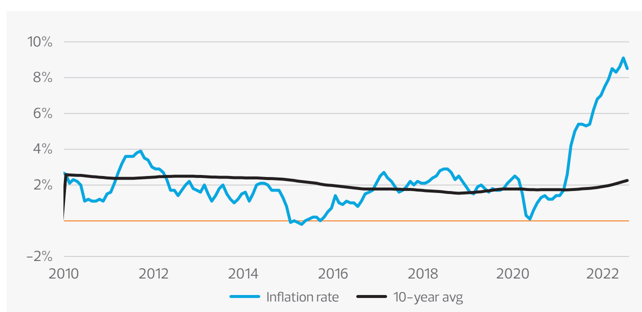


Source: Bureau of Economic Analysis; Bloomberg; National Bureau of Economic Research; RSM US LLP

Inflation

The Fed has a dual mandate: to promote full employment and price stability. Now, the multiple shocks of the health crisis, supply chain issues and geopolitical strife have created the conditions for persistent inflation, which the Fed is addressing by raising interest rates and reducing its balance sheet.

Americans expect an abundance of cheap goods and low rates of inflation*



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

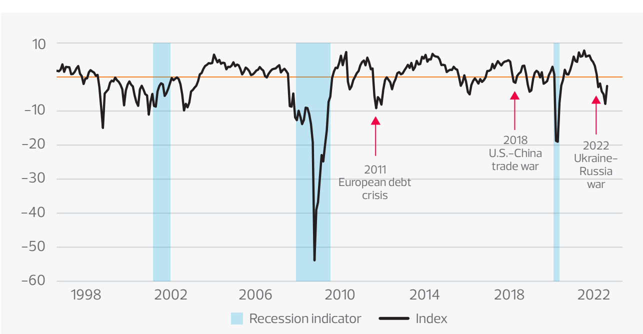
*Consumer price inflation rate and 10-year average

MIDDLE MARKET INSIGHT
We have revised our forecast for growth this year down to 1.5%, with the risk of a slower pace.

Financial conditions

U.S. financial conditions have been tightening since it became clear that the Fed would begin hiking interest rates. In recent trading, financial conditions improved along with the equity markets but continue to imply an increased level of risk. That increased risk results in a higher cost of investment and a lower propensity to borrow or to lend.

RSM US Financial Conditions Index*



Source: National Bureau of Economic Research; Bloomberg; RSM US LLP

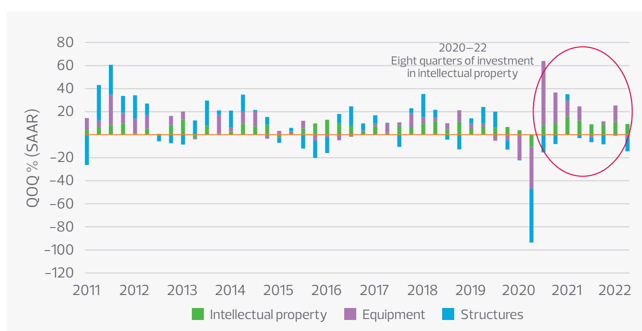
*Z-score with positive values values indicate accommodating conditions and negative values indicate risk levels.

Investments in competitiveness

Beginning in the third quarter of 2020, there have been eight consecutive quarters of positive growth in investment in intellectual property.

While you would expect business investments to decelerate as the business cycle winds down, the peculiar circumstances of the post-pandemic labor market—along with the availability of near-zero interest rates—has spurred ongoing investments in productivity, suggesting the potential for the production sector to maintain increased output.

Business investment in IP, equipment and structures*

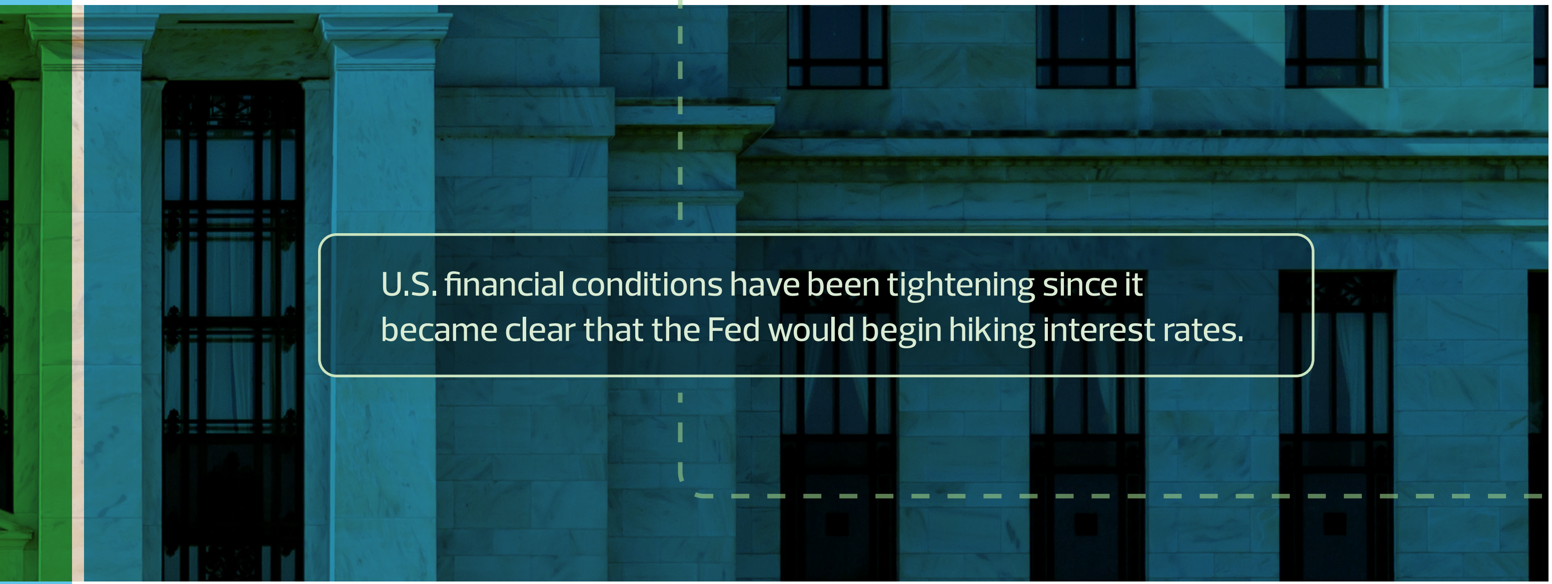


Source: Bureau of Economic Analysis; Bloomberg; RSM US LLP

*GDP national accounts of nonresidential investment

Inventories

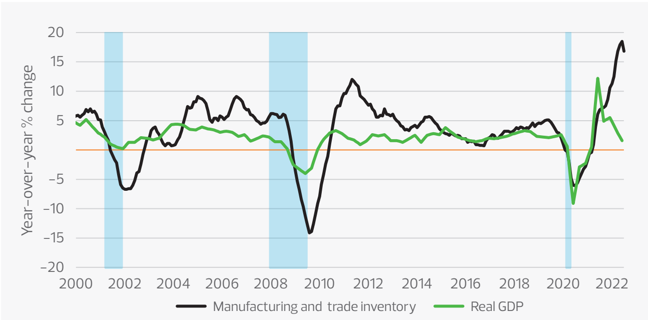
The supply chain has been making progress over the past nine months after bottoming out last October, according to the RSM US Supply Chain Index. Along with the impact of recent tightening in monetary policy, improvements in the supply chain have created the conditions for increased inventories.



Manufacturing and trade inventories in nominal dollar terms grew at a 16% yearly rate in the first six months of the year, compared to a 3.6% nonrecessionary average from 1992 to 2019.

In real (inflation-adjusted) terms, inventories are growing at a nearly 5% yearly rate after declining throughout the two-year period of supply chain issues.

Real inventories and real GDP*



Source: U.S. Census; Bureau of Economic Analysis; Bloomberg; RSM US LLP *Yearly growth rates

What could derail the economic recovery?

Typically, economic growth begins to wane as the business cycle matures. But it usually takes an event to push it over the edge into recession.

What are the tripwires for the next recession? The most obvious candidate is the collapse of cryptocurrencies if it reduces confidence in the stability of the financial markets or causes a fire sale of other assets. But the more likely catalysts for a recession are the continuance of Russia's war on Ukraine and a debt crisis or health crisis in China.

MIDDLE MARKET INSIGHT

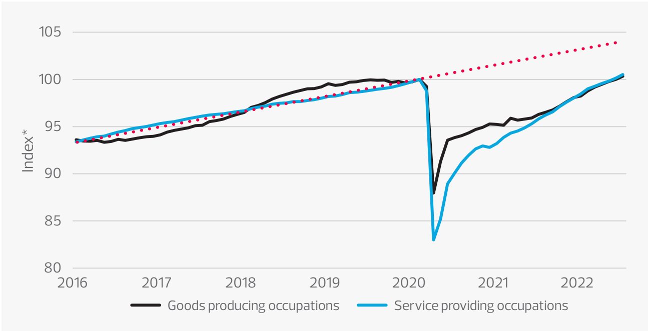
Typically, economic growth begins to wane as the business cycle matures. But it usually takes an event to push it over the edge into recession.

Even without a crisis, a slowing economy has the potential to cause further distortions and long-term damage.

For instance, much has been made of the labor market reaching a milestone—a general return to pre-pandemic levels of employment.

Reaching that milestone is encouraging, but only puts us back to square one. There is still work to be done to recover the lost output over the past two and a half years, and for the labor market to accommodate population growth. ■

Number of employees on nonfarm payrolls returns to pre-pandemic levels



Source: U.S. Bureau of Labor Statistics; Bloomberg; RSM US LLP *February 2020 = 100

ECONOMIC HEADWINDS AND HOSPITALITY

BY RYAN MCANDREW

KEY TAKEAWAYS

- Supply chain constraints are hampering hotel operations.
- Hospitality's labor challenges call for new ways to attract and retain employees.
- Inflation and rising interest rates are limiting returns on hotel transactions.

THE HOSPITALITY INDUSTRY has arguably experienced the worst recovery of any sector of the U.S. economy. Supply chain and labor constraints have hurt hotel operations, and rising interest rates have stymied capital investment and acquisitions of hotel properties. The unemployment rate for hospitality is elevated, reaching 5.1% in May, compared to the broader economy's rate of 3.6%.

The industry now struggles with the availability of necessary supplies required to support guest services. Demand recovery continues to provide green shoots for investors and operators, but the hotel business model will need to change rapidly to address shortages in goods and talent.

> Wage growth within hospitality has been the most significant of any sector of the economy, up about 15% since March 2020 compared with roughly 9% in the broader economy.

MIDDLE MARKET INSIGHT
The hospitality industry now struggles with the availability of necessary supplies required to support guest services.

By the numbers

The average daily room rate of $155 for the week ending June 11 is the second-highest on record since hospitality analytics firms started tracking rates in 2000. Travelers have been mainly undeterred by the inflationary costs of travel, but the onset of a recession may rapidly reverse this trend.

The top challenge for the hospitality in a slowing economy is labor.

The U.S. economy added 390,000 jobs in May, with hospitality contributing about 84,000. In the bigger picture, however, hospitality has lost over 7.5 million jobs since March 2020, the start of the pandemic. Even with 6.9 million jobs added back in that time period, the sector shows a net loss of 600,000 jobs. By comparison, all other major sectors have experienced net job additions. Hospitality jobs will likely not return, as the favorable labor market lures workers to other sectors with competitive perks. If the unemployment rate ticks up due to recessionary pressures, the hospitality industry is likely to suffer greatly.

Cap rates present another challenge to the sector.

Cap rates, or the rate of return from investment after fees and leveraging costs, were nominal in the real estate industry before the pandemic. The resulting increases in interest rates are further squeezing the profitability of hotel transactions, which slows investment in the hotel sector. There is potential for deployment of dry powder from acquisition funds to acquire hotel properties with less leverage, but other areas of real estate may appear safer to private equity funds.

Hospitality is focusing on an improved work experience to mitigate labor challenges.

Hotel owners and operators are looking for opportunities to attract new talent and maximize existing staff within their organizations. Wage growth within hospitality has been the most significant of any sector of the economy, up about 15% since March 2020 compared with roughly 9% in the broader economy, data from the U.S. Bureau of Labor Statistics shows. But increased wages alone are not sending qualified workers back to hospitality. Flexibility, culture, upward mobility and ancillary benefits such as education stipends and paid health care premiums are emerging as key drivers to attract and retain talent to hotel properties.

Other top considerations to offset the impact of the slowdown on hospitality:

- **Investment in customer-facing technology** supports customer needs amid reduced staffing, while providing alternative methods for customer check-in and service requests, as well as positive experiences for younger, tech-savvy travelers.
- **Investment in back-of-the-house technology** can improve data aggregation and management functions within hospitality organizations, supporting identification of high-margin customers and creation of customer profiles that can be used for targeted marketing and revenue management.
- **Finding alternative uses for existing space,** such as remote workspace in excess hotel rooms and wellness or unique dining experiences in other unused areas, can provide new opportunities for revenue.

ECONOMIC HEADWINDS AND PRIVATE EQUITY

BY KENNEDY CHINYAMUTANGIRA

KEY TAKEAWAYS

- Fund performance will drop as portfolio company valuations experience markdowns.
- Value creation and exit strategies will become increasingly challenging to execute.
- Stall tactics are helping fund managers avoid having to sell in the current environment.

PRIVATE EQUITY fund performance is set to drop as portfolio company valuations experience markdowns amid a rapidly changing economic landscape. Contributing factors include the fall in public market comparable companies, the rising discount rates in response to the Federal Reserve interest rate hikes and—as the market recalibrates portfolio company growth rates amid recession fears—supply chain constraints, inflationary pressures and labor shortages.

As the economy slows, fund performance will also suffer from extended holding periods, with managers expected to delay exits in hopes that bids on their portfolio companies will return to levels closer to what the private markets became accustomed to in 2021.

By the numbers

PitchBook data shows that $529.2 billion worth of private equity deals were completed in the first half of 2022, representing a drop of 28% compared to the $735.5 billion in the second half of last year. Deal count dropped by 17%, closing at 4,337 versus 5,255 in the second half of 2021. We expect the second half of this year to return even lower numbers.

MIDDLE MARKET INSIGHT
Beyond having to preserve or grow earnings amid rising prices, managers must contend with a competitive labor market and supply chain disruptions.

The top challenge for private equity sponsors in a slowing economy is the drying up of exit options.

With volatility in the public markets at elevated levels and the stock market experiencing its worst first half since 1970, the ability to exit via the initial public offering route is all but frozen. This position leaves the sale to other private equity sponsors or corporate strategic buyers as the available exit routes. Given the negative sentiment and the prevailing cautious mood, these participants are also not eager buyers. For private equity funds at or nearing the end of their term that must sell in this market, giving back some of the unrealized gains built up over the past couple of years will be a tough pill to swallow.

Value creation presents another challenge for private equity managers.

Private equity managers create or unlock value from portfolio companies through the expansion of multiples; growth of earnings before interest, taxes, depreciation and amortization; or deleveraging. All three will be under pressure in the current environment. Multiples will be restricted by dropping valuations, as outlined above. Deleveraging will be challenging because the rise in interest rates will make it difficult for portfolio companies to service or refinance debt. EBITDA growth is the one lever that private equity sponsors will have more room to maneuver. Beyond having to preserve or grow earnings amid rising prices, managers must contend with a competitive labor market and supply chain disruptions—all of which will put their skills and acumen to the ultimate test in turning around or advancing their businesses.

Private equity sponsors are using stall tactics to help mitigate these challenges.

Private equity sponsors are biding their time and putting off exit plans when possible. Some that have to exit are exploring general-partner-led secondary transactions in the form of continuation funds in order to extend their holding period in anticipation of a more receptive selling market in the future. Where fund documents give leeway to extend the fund's life, private equity managers will likely take advantage of such provisions to allow them enough time to secure a more orderly liquidation of the remaining portfolio holdings. Should there be a need to continue financing these portfolio companies, some private equity managers will look to private credit funds and net asset value, or NAV, loans to bridge the gap.

Other top considerations to offset the slowdown's impact on private equity:

- **Buying opportunities:** For funds that are still actively deploying capital, the current environment may present a golden buying opportunity at more compelling prices and more favorable terms.
- **Fundraising:** For top-tier managers with stellar track records, fundraising in the current environment is still possible, albeit very competitive, with several managers in the market looking to replenish their war chests after expending dry powder in a year of quick deployments in 2021.
- **Prioritization:** Though private equity managers are not quite in the triage or crisis mode they experienced during the height of the COVID-19 pandemic in the late first quarter and second quarter of 2020, it is clear that managers will have to be more attentive and work closely with portfolio companies to help them navigate the current headwinds. Assessing how each is uniquely affected will be crucial to prioritizing and strategizing accordingly.

ECONOMIC HEADWINDS

FOR NONPROFITS, RECESSIONS PACK A DOUBLE PUNCH

BY MATT HAGGERTY

KEY TAKEAWAYS

- Inflation has devastated the budgets of nonprofit organizations.
- Nonprofits may have to dip into their endowments or reserves, but this comes at a cost.
- Donors are feeling the pain as well, and contributions may decline.

FOR NONPROFIT ORGANIZATIONS, inflation hits doubly hard, with demand for services rising along with the costs of providing those services. In addition, nonprofits often see donor pools dry up as the economy worsens over time. Nonprofits grapple with these challenges along three lines: budgets, reserves and contributions.

By the numbers

Most nonprofits budget on annual cycles; depending on the start of their fiscal years, organizational budgets may have been constructed up to 12 months ago in a very different economic context. When these budgets were approved, it is highly unlikely that current levels of inflation were taken into account.

MIDDLE MARKET INSIGHT
Data shows that contributions to nonprofits, on average, decrease 0.5% in down economic years, while they increase 4.7% in up years.

This means most organizations will face higher-than-planned expenses unless they make significant operational changes, which is often difficult in the middle of a fiscal year. Organizations that rely heavily on travel—such as those that present conferences or distribute food—are paying over a third more for flights and over 40% more for gas. Offsetting these price increases requires some combination of additional revenue, reserve spending or a change in operations to reduce services.

Catch-22 for endowments and reserves

An organization with a healthy endowment or operating reserve might typically cover short-term price increases by drawing from those resources to maintain service levels without sacrificing future operations. However, with both stock and bond markets significantly down year to date, additional draws only hinder the long-term success of those investments by locking in the losses of the past year. Therefore, pulling funds out of the market may be an especially difficult pill for nonprofits to swallow.

Contribution instability

Donors, grantors and association members are the lifeblood of nonprofits of all types, so it is important to consider economic impacts on them and the subsequent impact on their philanthropy. Data shows that contributions to nonprofits, on average, decrease 0.5% in down economic years, while they increase 4.7% in up years. Foundations are squeezed to the same degree as nonprofit endowments, but are required to distribute 5% of their net assets annually. Smaller asset portfolios mean that foundations have less to give. Similarly, associations that have members with squeezed budgets may find that their value propositions are less effective in enticing dues renewals and new members.

There is no doubt that current economic struggles are hitting the nonprofit industry hard. Demand for services is high, while revenue is strained, and expenses have risen faster than planned. During recent good years, many nonprofits built rainy-day funds and created operating reserve policies. It may be time to tap those funds or utilize those policies while waiting for the sunshine to reappear.

Other top considerations to offset the impact of the slowdown on nonprofits:

- **Invest in budget and planning tools:** These can enhance the nimbleness and frequency of projections.
- **Be transparent with donors and grantors:** Show how rising costs made your programs more expensive than planned and how you have adjusted your budget, and see if there is an opportunity to raise additional funds.
- **Consider ways to cut long-term costs:** Look especially in the back office, and focus on technology upgrades, outsourced services and operational planning.
- **Focus on the value of communications:** Connect with your members and donors throughout the year, not just at renewal times.

ECONOMIC HEADWINDS

SUPPLY AND AFFORDABILITY PRESENT CHALLENGES FOR THE HOUSING SECTOR

BY CRYSTAL SUNBURY

KEY TAKEAWAYS

- While America still needs more houses, cooling demand has caused builders to slow construction.
- The pandemic exacerbated the tight labor market and brought other challenges to builders, including material shortages and shipping delays.
- Builders are adapting to market conditions by adjusting pricing and incentives to continue selling their inventory.

THE ECONOMIC DOWNTURN caused by the pandemic created widely differing experiences across sectors, with housing emerging as a bright spot in the economy. After temporarily plummeting in 2020, demand for housing rebounded stronger than ever as a result of changing consumer preferences and historically low mortgage rates. Limited resale inventory pushed many buyers to the market for new homes; however, lack of skilled labor and supply chain constraints restricted the ability of builders to meet surging demand.

Just as supply chains are beginning to ease, builders are now facing a considerable slowdown in demand. The rapid appreciation of homes over the last two years, and an even more rapid rise in mortgage rates resulting from the Federal Reserve's efforts to control inflation through aggressive policy rate hikes, have crushed affordability for aspiring homebuyers, causing many to pull back.

By the numbers

Housing sentiment has fallen sharply over the last few months, a direct result of prices becoming unaffordable for many. The Home Builders Market Index, as measured by the National Association of Home Builders, fell to 55 in June from 83 in January. Weaker sentiment is a direct result of declining demand caused by affordability constraints for buyers. It has caused a pullback in new home construction, particularly affecting the single-family market.

Annualized single-family permits and starts declined to 970,000 and 982,000, respectively, in June, from 1.051 million and 1.068 million in May, according to the U.S. Census Bureau—each falling below 1 million for the first time in two years. While builders are still working through backlogs, new permits and starts are likely to continue falling as builders work to complete homes already under construction and push completed homes and homes nearing completion in an environment of softer demand.

The top challenge for the homebuilding industry in a slowing economy is affordability.

The cooling in demand does not mean that Americans no longer need homes; in fact, it's quite the contrary. We estimate that the United States was short approximately 3.5 million homes at the end of last year. Meanwhile, household formations continue to grow. Rapid appreciation of home prices and even more rapidly rising mortgage rates due to the Fed's rate hikes have pushed would-be buyers to the sidelines. The Housing Affordability Index, as measured by the National Association of Realtors, fell to 102.8 in the second quarter, from 147.7 in the same period last year, while the New Buyer Affordability Index dropped to 68, compared to 97.3. Both were record lows. A value of 100 means that a family with the median U.S. income is earning exactly enough to qualify for a mortgage on a median-priced home, assuming a 20% down payment.

MIDDLE MARKET INSIGHT

As demand softens, builders are adjusting pricing and incentives to continue selling their inventory and help offset affordability constraints for buyers.

While America still needs houses, builders have slowed construction as they work to manage inventory levels in a softer demand environment.

Labor and supply chain constraints present additional challenges to the sector.

Builders have struggled with a shortage of skilled labor for years, as much of the workforce upskilled or reskilled following the layoffs from the Great Recession. The pandemic exacerbated the tight labor market and brought other challenges, including material shortages and shipping delays.

Construction activity has slowed, with permits and starts at annualized rates of 1.67 million and 1.45 million, respectively, in July, compared to 1.84 million and 1.67 million at the beginning of this year.

Construction activity has slowed, with permits and starts at annualized rates of 1.67 million and 1.45 million, respectively, in July, compared to 1.84 million and 1.67 million at the beginning of this year, according to the U.S. Census Bureau. Builders continue to deal with labor and supply challenges, which prevent them from returning to historical build times. On the plus side, supply chain constraints appear to be easing.

Further pullback in construction may create a more balanced labor market for builders; however, builders must be cautious by evaluating long-term conditions and continuing to recruit.

The sector is mitigating these challenges in various ways.

As demand softens, builders are adapting to market conditions. They are adjusting pricing and incentives, such as rate buy downs, to continue selling their inventory and help offset affordability constraints for buyers. This should not present a problem for builders, as they have benefited from record margins over the last couple of years.

Builders have also had to increase compensation and benefits to attract labor. And they are adding suppliers and providing lead time to their suppliers on future needs, to help mitigate some of the supply chain challenges and stabilize build times.

MIDDLE MARKET INSIGHT

Many builders have also entered into or expanded their build-to-rent operations, which offer options for those not ready to buy.

Many builders have also entered into or expanded their build-to-rent operations. Single-family build-to-rent communities provide housing options for those not ready to buy or still saving for a down payment, while helping builders diversify income streams.

Other top considerations to offset the impact of headwinds facing housing:

- **Monitoring conditions** in each market where builders operate and rebalance pricing and incentives as needed
- **Diversifying operations** to provide more affordable housing options for Americans, including rentals and modular homes
- **Investing in technology** to modernize operations and produce homes more efficiently and at lower costs
- **Valuing partnerships** with trade high schools and technical colleges to recruit early, communicating the value proposition to attract future employees

SMALLER BUSINESSES TAKE THE BRUNT OF SUPPLY CHAIN BOTTLENECKS

IT'S NO SECRET that businesses of all sizes have had to contend with supply chain bottlenecks as the economy has emerged from the shock of the pandemic. But smaller businesses are being hit the hardest, a recent survey for the RSM US Middle Market Business Index found.

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

Overall, nearly half of respondents to the survey—48%—said their organizations had experienced significant negative effects because of unexpected changes or disruptions in supply from an upstream supplier during the previous 12 months. These issues were particularly acute for the smaller end of the middle market. Among the survey's results:

Delays in order fulfillment or receipt were an issue for the middle market overall.

76%

of respondents for larger and smaller businesses combined faced delays in order fulfillment or receipt.

But there was a divide between larger and smaller businesses ...

91%

of respondents from smaller companies, or those with annual revenues of $10 million to $50 million, reported such delays.

56%

of those from larger companies, or those with annual revenues of $50 million to $1 billion, reported delays.

... and many companies reported unreliable or inconsistent times for order fulfillment.

74%

of executives overall reported these kinds of delays.

88%

of smaller businesses said this unreliability was an issue.

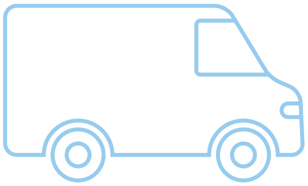
55%

of larger businesses said they had experienced such unreliability.

But there is good news. Since the survey was taken, supply chain bottlenecks have started to ease.

0.29

The RSM US Supply Chain Index in July was above neutral for the first time in nearly three years on the back of the continuing strong rebounds in inventories and capacity utilization.



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