THE REAL ECONOMY

VOLUME 96

THE ECONOMY AND THE MIDDLE MARKET IN 2023

- IS A RECESSION COMING? LOOK TO THE SECOND HALF OF THE YEAR.
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TREND WATCH: THE MIDDLE MARKET IS RESILIENT BUT PREPARING FOR A RECESSION

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U.S. ECONOMIC OUTLOOK: RECESSION ON THE HORIZON

BY JOSEPH BRUSUELAS

OUR BASELINE FORECAST for the American economy next year calls for a mild recession by the second half of the year as the impact of higher interest rates sets in.

For some time, our forecast has included a 65% probability of recession over the next 12 months. Next year, we expect a 0.1% decline in overall output, with the risk of a steeper contraction nearing 0.5%.

We expect the unemployment rate to reach 4.6%, which would mean the loss of more than 1 million jobs. The construction and manufacturing ecosystems, which are most sensitive to interest rate increases, are likely to bear the greatest losses, in addition to finance and technology.

We expect inflation next year to average 5%. We also anticipate the policy-sensitive core personal consumption expenditures deflator will average 3.7%, falling to slightly below 3% by the end of the year.

Probability of recession: 65%*

	2020	2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	2022	2023	2024
Real GDP (Q/Q% SAAR)	-2.8	5.9	-1.6	-0.6	2.6	1.5	0.7	-0.1	0.5
Consumer Spending	-3.0	8.3	1.3	2.0	1.4	1.2	1.7	0.2	0.5
Private Investment	-5.3	9.0	5.4	-14.1	-8.5	0.8	-2.2	-2.1	3.1
Industrial Production	-0.8	-7.3	4.9	4.6	4.4	2.0	3.6	0	2.0
Consumer Price Index (Y/Y%)	1.2	4.7	8.0	8.7	8.3	7.5	8.1	5.0	2.7
PCE Price Index (Y/Y%)	1.1	4.0	6.4	6.6	6.3	5.8	6.3	4.2	2.5
Core PCE (Y/Y%)	1.3	3.5	5.3	5.0	4.9	4.7	4.9	3.7	2.5
10-Year Yield	0.9	1.5	2.34	3.02	3.8	4.0	3.3	4.25	3.5
Policy Rate	0.25	0.25	0.50	1.75	3.25	4.25	3.9	4.4	3.6
Unemployment	8.1	5.4	3.8	3.6	3.6	3.8	3.6	4.2	4.7

Source: RSM US LLP

* Note: Forecasts are in red

The combined dynamics on growth, inflation and employment will lead the Federal Reserve to consider redefining its inflation target to 3% and to pivot its focus away from price stability and toward employment.

We do not expect rate cuts to begin until early 2024.

Our alternative to this baseline forecast is that inflation abates early next year and, combined with a strong and steady labor market, bolsters confidence in a way that narrowly avoids a recession.

That alternative hinges on the chance that the central bank keeps rates steady throughout the year as economic growth slows below 1%.

Risks to the outlook

The primary risk to the economic outlook is elevated inflation sapping household demand as incomes decline. Other risks include the rising cost of issuing public and private debt, and a potential standoff in Congress over lifting the debt ceiling.

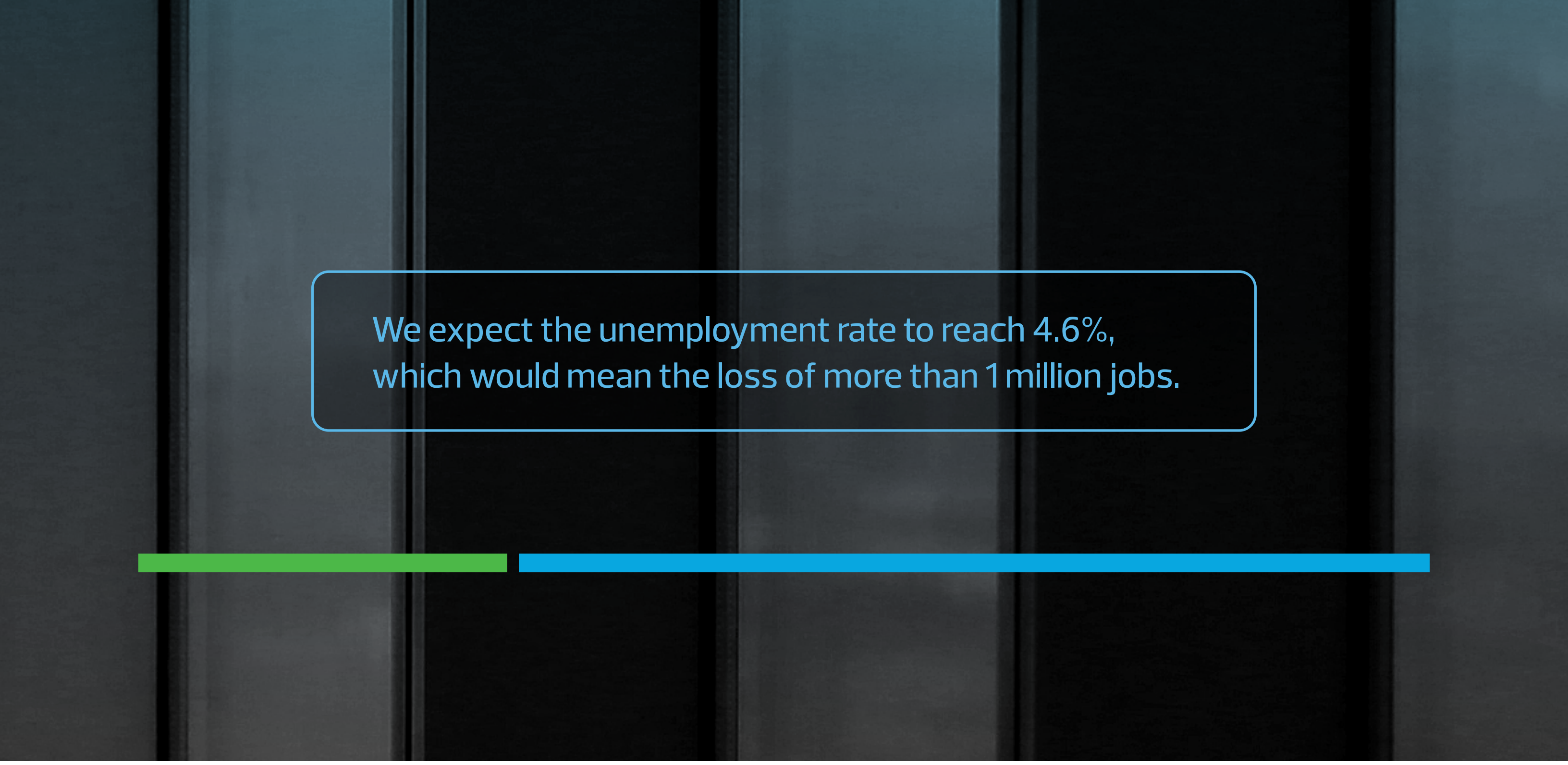
MIDDLE MARKET INSIGHT

The construction and manufacturing ecosystems, which are most sensitive to interest rate increases, are likely to bear the greatest job losses, in addition to finance and technology.

In some respects, the debt ceiling is the biggest wild card. The U.S. fixed income market remains the linchpin of the global economy. Default is not an option, and another debt ceiling debacle along the lines of the one in 2011 would damage corporate and consumer confidence.

In such a standoff, asset prices would decline and American consumers would pull back on spending, creating further downward pressure on the economy at a vulnerable time.

The second major risk to the economic outlook is tied to the Russia-Ukraine war. The United States and its allies are trying to place an effective price cap on Russian oil exports. If Russia retaliates by terminating all oil exports to the West and Japan, the inflation and policy outlooks will change rapidly and the prospect of a deeper recession will be at hand.



Policy considerations

The question, then, is what the Fed will do as a recession approaches and how Congress can bolster aggregate demand given elevated inflation and a renewed resistance to fiscal stimulus.

First, we expect the central bank to hike its policy rate by 50 basis points at its December policy meeting, then by 25 basis points at its January and March meetings. Those increases would bring the policy rate to between 5% and 5.25% by the end of the first quarter.

Then we expect the Federal Reserve to engage in a lengthy pause to ascertain the impact of its rate hikes over the previous year. Recent policy has clearly resulted in fewer housing starts and has led to price depreciation in some areas. In addition, rising interest rates will most likely further sap demand for automobiles.

Second, the policy outlook for the fiscal authority will be constrained by higher inflation and political gridlock.

Republicans, having regained control of the House of Representatives, will almost certainly call for the 2017 Tax Cuts and Jobs Act to be made permanent and push to expand the production of oil and other fossil fuels. Democrats, in control of the Senate and the White House, will have other ideas, including a renewal of the expanded child tax credit that proved popular and effective during the pandemic.

MIDDLE MARKET INSIGHT

The primary risk to the economic outlook is elevated inflation sapping household demand as incomes decline.

We think there will be some agreement around policy measures that could include:

- Extending and enhancing unemployment insurance
- Extending and enhancing food stamps and other aid to needy families
- Pulling forward supply side increases in infrastructure spending from future years and accelerating the permit process for energy projects
- Allowing full expensing of productivity-enhancing capital expenditures
- Increasing tax credits and federal spending on research and development

Finally, given the broad structural changes in the global goods market and the decoupling of the American economy from China, higher inflation and higher interest rates are likely to continue.

That implies narrower fiscal space and a possible return to fiscal austerity to bring down inflation. It also indicates the chance of a deeper recession than our forecast calls for.

Though roughly $1.9 trillion in excess savings is still in consumer pocketbooks, most of it is in the upper two income quintiles.

Inflation: Easing but still elevated

Negative base-year effects linked to higher food and fuel costs will drive down top-line inflation through the middle of next year, setting up a fierce policy debate over how long the Federal Reserve should hold its policy rate at or above 5%.

We anticipate that by the end of the year, the consumer price index will reside at or below 5% and the core personal consumption expenditures index will stand at or near 3%.

Both are well above the Fed's 2% inflation target, a figure that will require careful consideration of policymakers at both the monetary and fiscal authorities.

Our forecast anticipates further normalization of supply chains, declines in transportation costs, a peak in shelter costs and slower wage growth.

All those dynamics will contribute to a substantial easing in overall inflation next year, helped by the negative base-year effects in food and energy.

In particular, the goods constraint that hurt manufacturing and technology sales this year will be lifted as the production of microchips returns to pre-pandemic levels. This, in turn, will set the stage for what we expect to be a modest recovery in 2024.

MIDDLE MARKET INSIGHT
The policy outlook for the fiscal authority will be constrained by higher inflation and political gridlock.

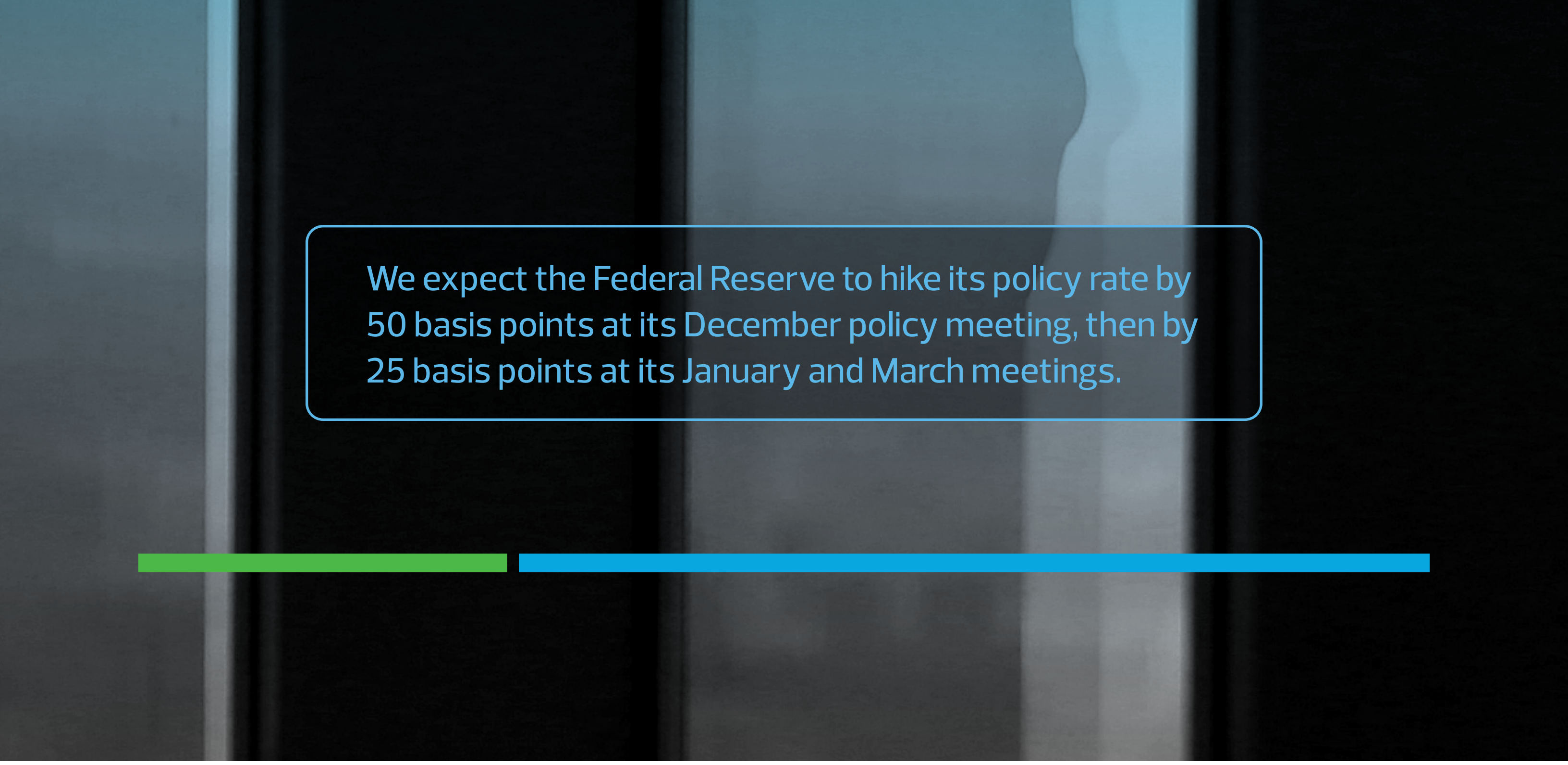
In a recent research paper, we made the case that core inflation would not substantially ease until after the cost of shelter and rents peaked, which we do not anticipate until the third quarter of next year.

From our vantage point, shelter costs need to be tamed before the easing of monetary policy can be considered.

Housing inflation remains high, approaching 9%. In our view, it is premature to end efforts to restore price stability. Any notion of a pause or pivot in that pursuit would result in a costly series of stops and starts in monetary policy that would only prolong elevated inflation.

But there is relief in sight when it comes to housing. One million apartment units are either permitted or under construction, the most in six decades. Those new units will provide relief on overall housing costs later next year and into 2024.

Because of all these factors, we do not see the Fed seriously considering rate cuts until late next year or, more likely, early 2024.



> We expect the Federal Reserve to hike its policy rate by 50 basis points at its December policy meeting, then by 25 basis points at its January and March meetings.

Financial conditions: Tightening

Current financial conditions stand between 1.5 and two standard deviations below neutral because of rising interest rates, volatility in asset prices and a 17% decline in the S&P 500 as of the end of November.

Because tighter financial conditions are one objective of the Fed's price stability campaign, we do not anticipate any sustained improvement in asset prices until the central bank signals it intends to pause rate hikes.

In addition, we will not see a real recovery in asset and housing prices until the central bank begins hinting at possible rate decreases later next year.

For now, risk appetite will remain subdued, and a mild negative wealth effect that will disproportionally hit upper-end consumers is in the cards.

The interest rate outlook remains dour. We expect the yield on the 10-year government security to finish this year at or near 4% and to average 4.25% next year.

If the policy rate sits between 5% and 5.25% for much of the year, as we expect, an inverted yield curve will likely prevail, which explains the general malaise that has crept into fixed-income markets.

Employment: Solid but slowing

Solid, albeit slowing, employment gains will most likely characterize hiring conditions during the first part of next year, followed by outright declines in the second half.

MIDDLE MARKET INSIGHT

Core inflation will not substantially ease until after the cost of shelter and rents have peaked, which we do not anticipate until the third quarter of next year.

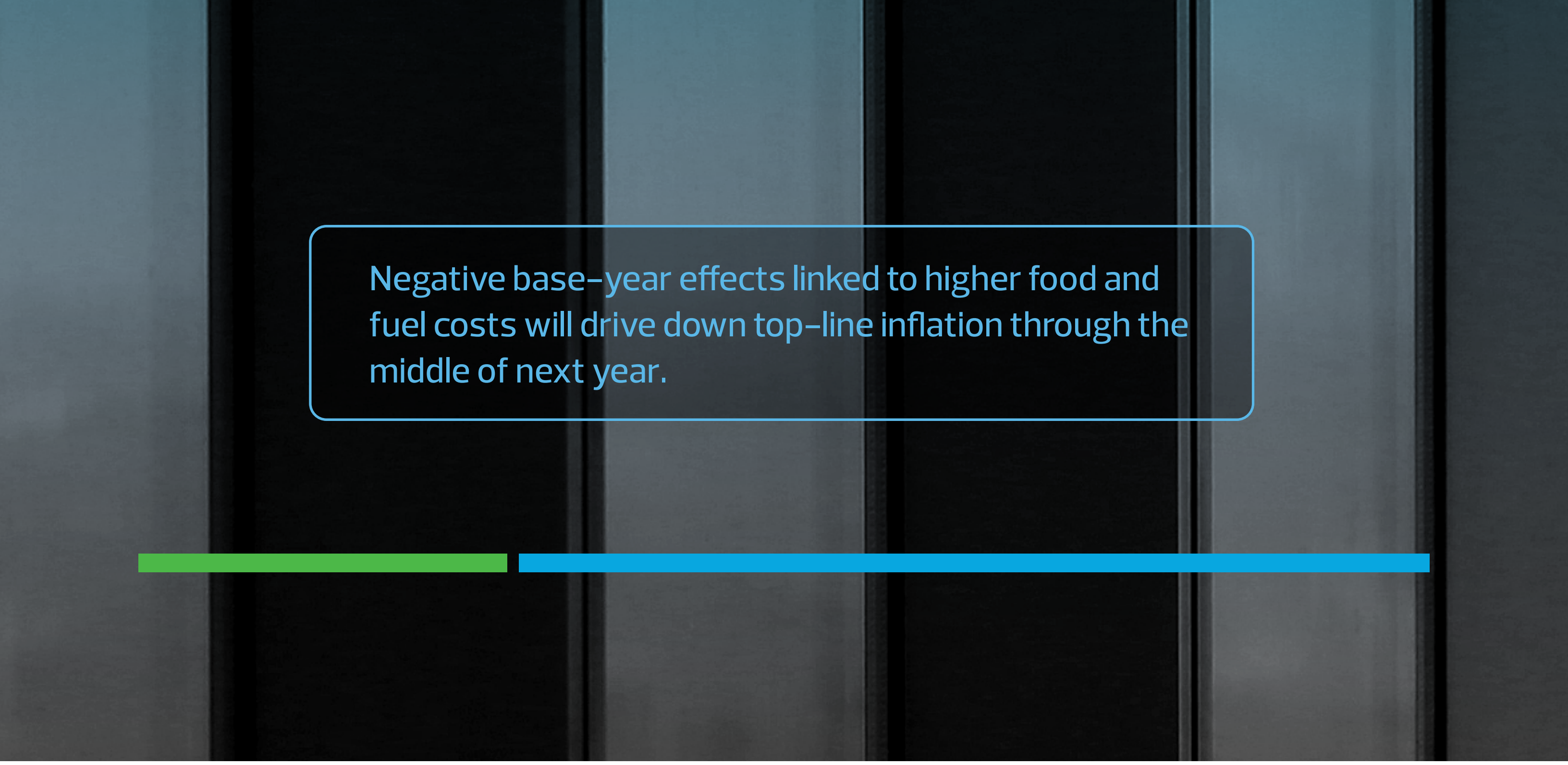
The forward-looking employment component of our RSM US Middle Market Business Index indicates that just over half of the survey's respondents expect to increase hiring over the next six months.

Given the significant demographic changes and the slowing in labor market growth to below 0.5%, the economy needs to generate only 65,000 workers per month to keep the unemployment rate stable.

This is a major reason why we do not anticipate a large increase in unemployment above the 4.4% implied by the Congressional Budget Office, though we expect the rate to hit 4.6% by the end of the year.

Household spending: Exhaustion

Normally, a year-ahead forecast would lead with household spending, which accounts for roughly 70% of gross domestic product. But as households begin to access more credit and draw down their savings, especially among lower-income households, the recent run of inflation will begin to have an impact on spending—which is why we expect a modest 0.5% increase in consumption during the year ahead.



MIDDLE MARKET INSIGHT

Negative base-year effects linked to higher food and fuel costs will drive down top-line inflation through the middle of next year.

Though roughly $1.9 trillion in excess savings is still in consumer pocketbooks, most of it is in the upper two income quintiles. For these consumers, the combined decline in housing and equity prices should have a modest negative wealth effect.

Manufacturing: Pent-up demand

Pent-up demand for autos and a likely increase in military spending will put a floor underneath the manufacturing sector. We expect a modest 1% year-over-year rise in manufacturing output next year.

While that floor will partially offset a difficult transition to a higher-cost environment, it will not completely counter the shock of higher interest rates and rollover risk with respect to debt financing.

In addition, the delayed impact of U.S. dollar appreciation will dampen exports because of higher real costs and because of the recession in the United Kingdom and European Union, and, potentially, Canada and Mexico.

In each recession during the postwar era, the manufacturing sector has used that downturn to become more efficient. We do not anticipate the coming slowdown to be any different.

A higher cost of financing will almost surely lead to consolidation in manufacturing amid a permanent rise in costs. Adding to this consolidation is the return of industrial policy in areas like semiconductor manufacturing. Expect firms with economies of scale to make their own strategic acquisitions and take advantage of this shift in economic policy.

Housing: Considerable collateral damage

Pandemic-induced distortions within the housing complex and the bleeding of inflation into the cost of shelter will be the defining narratives in the housing sector next year.

We expect just under a 10% correction in housing prices, with the risk of a large downturn in metropolitan areas that had a population influx during the pandemic. Metros like Austin-Round Rock, Texas; Boise, Idaho; and Salt Lake City-Provo, Utah, may have large downturns as rising financing costs and affordability issues drive a correction.

While that will provide some relief on longer-term supply issues, it will not prove decisive. Our own research indicates that the United States is short approximately 3.5 million housing units and needs to build around 1.7 million units a year to meet overall demand. The housing complex would do well to return to building 1.5 million units at an annualized pace by the end of the year.

THE POST-PANDEMIC ERA AND THE END OF HYPER-GLOBALIZATION

BY JOSEPH BRUSUELAS

THE AMERICAN ECONOMY is in the midst of a long-lasting structural change following the severe shocks unleashed by the pandemic.

The hyper-globalization that has dominated the global economy over the past 30 years is giving way to an era of regionalization that is radically altering the flow of trade, investment and technology.

Rapidly fading is an era defined by insufficient aggregate demand, when consumers enjoyed low-cost goods produced in low-wage regions and delivered in tight-knit supply networks. In its place will be a period defined by insufficient aggregate supply, supply shocks and persistent geopolitical tensions.

Globalization, as we have known it, is ending.

Identifying such a shift is always difficult, and it's even harder during periods of crisis and disquiet, as we are in now. But the changes taking place in geopolitical alignment, globalization, growth and liquidity are too significant to ignore.

Big-picture changes in the U.S. economy

Moving from pre-pandemic financial and real economy conditions to "what comes next"

1990–2020 Era before the pandemic and Russia-Ukraine war	Post-pandemic economy
Insufficient aggregate demand	Insufficient aggregate supply
Excess savings	Liquidity constraint
Hyper-globalization	Dichotomy of globalization Re-globalization/regionalization Industrial policy: Infrastructure build-out and energy transformation Digital globalization intensifies
Low inflation	High inflation
Low interest rates	Higher interest rates
Plentiful labor	Demographic constraints: Less labor

At the center of this transformation is the decoupling of the American, European and Japanese economies from China. This shift is altering the flow of trade and investment across the global economy.

In the early phases of this decoupling, as the global economy is in now, the redirected flow of goods will initially lead to a period of economic stagnation and diminished liquidity. Policymakers will have narrower fiscal and monetary space in which to respond to these shocks.

Whatever policies are adopted will require a bias toward price stability and higher interest rates as the economy emerges from pandemic-era disruptions.

A break from the past

Globalization, growth and liquidity to significantly change

1990–2020 Pillars of the pre-pandemic and prewar era	Catalyst for change	Emergence of new paradigms
Hyper-globalization	Supply chain shocks	Shortening of supply chains, regionalization and digital transformation
Slow growth	Demographic transition and economic populism	Recession and below long-term trend GDP growth
Ample liquidity	Scaling back of quantitative easing	Tighter monetary policy, higher unemployment and inflation target

Consumers, businesses and investors will understandably feel uncertainty. While trends like digital transformation that characterized the global economy over the past three decades will endure, many other dynamics that shape growth, like trade and investment, will be different.

The changes in those conditions will require different managerial and technological skills to navigate.

From hyper-globalization to regionalization

Adapting to the increased risk of breakdowns of supply chains for goods

1990–2020 Pillars of the pre-pandemic and prewar era	Catalyst for change	Post-2022 paradigm: Dichotomy of globalization of goods and services
Hyper-globalization	Supply chain shocks	Regionalization

Shortages and higher prices

- Inconsistent supply of consumer goods and intermediate products
- Persistence of high prices
- Regionalization of supply chains for goods
- Continued globalization of supply chains for services

How regionalization plays out

The decoupling of the American, European and Japanese economies from China is resulting in bifurcation of trade relations into two tracks: the goods economy and the services economy, with technology at the center of it all.

The goods track: On the first track—goods—trade, capital and technology flows are being heavily influenced by security concerns among G-7 nations as they embrace the return of industrial policy.

Consider the recent restrictions on transfers of technology, including sophisticated microchips, placed by the United States on China. A primary goal of these restrictions is to nurture nationally important industries and to protect a manufacturing labor base.

Some businesses will come out as winners in this new landscape. But for consumers, these policies will result in generally higher prices as firms shift from low-cost manufacturing centers in China.

This, in plain English, is what Treasury Secretary Janet Yellen means when she says American firms and their major trading partners should consider "friendshoring," or relocating production to countries that fall within the U.S. economic sphere of influence.

MIDDLE MARKET INSIGHT

The new era will most likely be defined by insufficient aggregate supply, supply shocks and persistent geopolitical tensions.

Such a shift will almost certainly result in more North American investment by foreign firms that want access to wealthy U.S. consumers. It will also result in more investment in places like India and Vietnam for American firms that want access to the dynamic Asian economic region.

Apple's recent announcement that it would begin sourcing sophisticated chips from North America is the signal that many global firms have been waiting for to begin reducing their exposure to China.

The services track: On the second track—services—policymakers are taking a different approach. For the most part, the service sector will continue with fewer trade restrictions, just as it has over the past three decades. If anything, that approach will accelerate.

Scott Lincicome at the Cato Institute finds that even as the global trade of goods peaked before the financial crisis, the digitization of services has enabled increased global trade of services.

Digital globalization offers tremendous potential for rural communities, health care, small businesses, manufacturing and especially entertainment, all of which benefit from greater access to international markets as broadband proliferates.

It is natural for economies to help push this along as they move from providing basic goods to meeting the increased demand for services that results when incomes rise and consumer choice expands.

In short, it is natural that firms and households will want to move up the value chain as the global digital transformation of commerce advances.

This trend is happening in advanced economies all over the world, wherever internet access is commonplace. Expect it to become the norm in developing economies as well. In the meantime, we are nowhere near the end of identifying all the implications of digital trade or managing its governance.

The competition for geopolitical security for the most part will not alter the digital transformation of the service sector. The ideas behind that evolution are fungible, easily transferable and not amenable to trade restrictions.

It is far easier to put constraints on the transfer of existing or older technology, as well as physical goods, than it is to stop the movement of ideas. Recall how quickly the American nuclear monopoly melted after 1945.

MIDDLE MARKET INSIGHT
Consumers, businesses and investors will understandably feel uncertainty as the global transformation takes place.

But there will be constraints outside of those economies that remain on good terms with Washington, Brussels, London and Tokyo. For this reason, the flow of capital is also going to be constrained.

Stagnating growth

When an economy experiences a series of shocks, it often ends up with less capacity to produce as firms exit existing patterns of production and investment shifts to more profitable and/or less risky areas of the economy.

The post-pandemic era will be no different, and we expect stagnant growth over the next 24 to 36 months.

Growth in the U.S. economy is a function of productivity and labor force expansion. During the past decade, annual economic growth overall was generally 2%, driven by growth of roughly 1.5% in productivity and 0.5% in the size of the labor force.

The American labor force grew by an average of 1% annually during the postwar period. That increase was as reliable as the sun rising in the morning and setting in the evening. Today that is not the case, and labor force growth has settled in below the recent 0.5% trend.

From slow growth to picking winners and losers

Adapting to the increased risk of just getting by

1990–2020 Pillars of the pre-pandemic and prewar era	Catalyst for change	Post-2022 paradigm: Recession followed by below-trend GDP growth
Slow growth	Demographic transition and economic populism	Recession

Demand for fiscal support

- Period of slower growth until inflation returns to tolerable level
- Increases in direct and indirect income support
- Government infrastructure spending and support for at-risk industries

Now, when rising costs driven by the shift of production away from China are added to this slowing productivity and labor force growth, the result will be a slower overall pace of growth.

Today, the growth of the labor supply is not sufficient to meet demand. Baby boomers are retiring, immigration has slowed and the pandemic is still taking a toll on labor force participation. For this reason, trend growth is likely to decline to between 1% and 1.5% in the near term, following what we expect to be a recession during the second half of next year.

In addition, as inflation continues to act as a dead weight on real income growth, there will be calls for government assistance during the coming economic downturn.

That is just one factor that will lead to greater competition for scarce capital, which will in turn drive interest rates higher and restrain growth.

MIDDLE MARKET INSIGHT
Some businesses will come out as winners in this new landscape. But for consumers, the changing trade landscape will result in generally higher prices.

The end of easy money

Contributing to this stagnating growth will be the end of historically low interest rates. The era of ultra-accommodative policy on the part of the major central banks, except for Japan, will result in a net reduction of liquidity within the American and global economies.

Rising policy rates and the reduced size of balance sheets will cause interest rates to rise along the longer end of the investment curve.

This will result in an increase in the cost of issuing debt for public and private actors. The cost of financing economic expansion—be it for a large, publicly held firm, for a private midsize firm or through government-issued debt—will become more expensive.

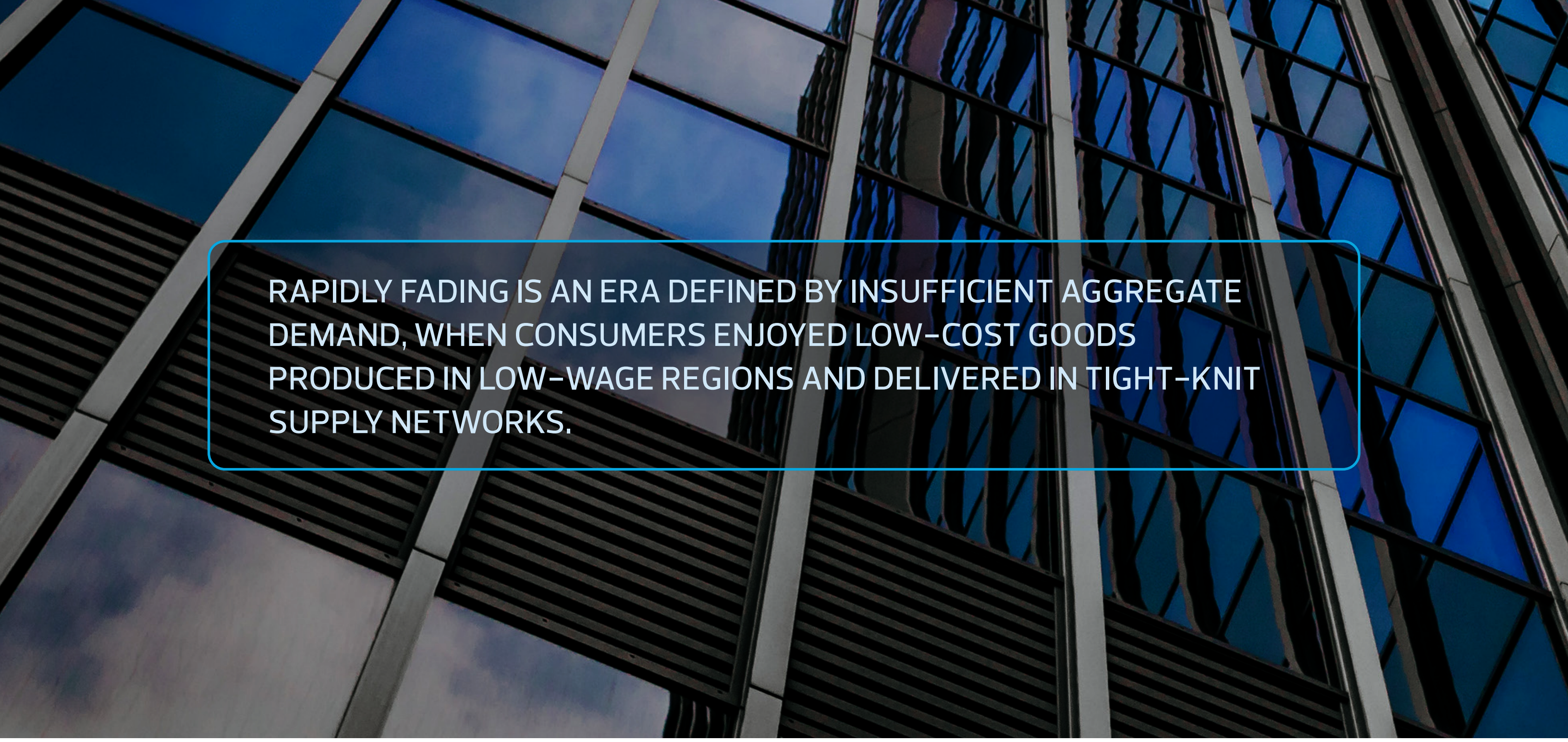
From monetary accommodation to increased financial risk

Adapting to growing unwillingness to borrow or to lend

1990–2020 Pillars of the pre-pandemic and prewar era	Catalyst for change	Post-2022 paradigm: Tighter monetary policy, higher unemployment and inflation target
Ample liquidity	Scaling back of quantitative easing	Tighter financial conditions

Increased risk

- Shift in monetary policy regime
- Tighter financial conditions and higher financing costs
- Inconsistency between monetary and fiscal policy



RAPIDLY FADING IS AN ERA DEFINED BY INSUFFICIENT AGGREGATE DEMAND, WHEN CONSUMERS ENJOYED LOW-COST GOODS PRODUCED IN LOW-WAGE REGIONS AND DELIVERED IN TIGHT-KNIT SUPPLY NETWORKS.

MIDDLE MARKET INSIGHT

As broadband proliferates, digital globalization offers tremendous potential for rural communities, health care, small businesses, manufacturing and especially entertainment.

As those interest rates rise and tighter financial conditions ensue, firms that have lived off nominal zero-interest rates and negative real rates will face substantial rollover risk.

Risks around the commercial real estate sector will grow, and firms that inhabit slower-growing portions of the economy or have exposure to higher material costs will face greater challenges over the next several years.

While that will provide opportunity for the private equity and merger-and-acquisition communities, it will nevertheless entail substantial transition costs in terms of servicing debt, loss of employment and a slower overall pace of growth.

It is useful to remember what drives rates higher over the medium term. Interest rates are determined by expectations for inflation, the response to that inflation by monetary authorities and the risk of holding a security until maturity.

Interest rates tend to move lower during periods of disinflation and higher during periods of inflation as the central bank pushes the overnight policy rate higher.

Another component, known as the term premium, includes the risk of inflation moving higher or lower than expectations. For instance, if inflation were to exceed expectations, then the Fed would be required to push short-term rates higher, causing a bond market sell-off that would reduce the value of holding that security.

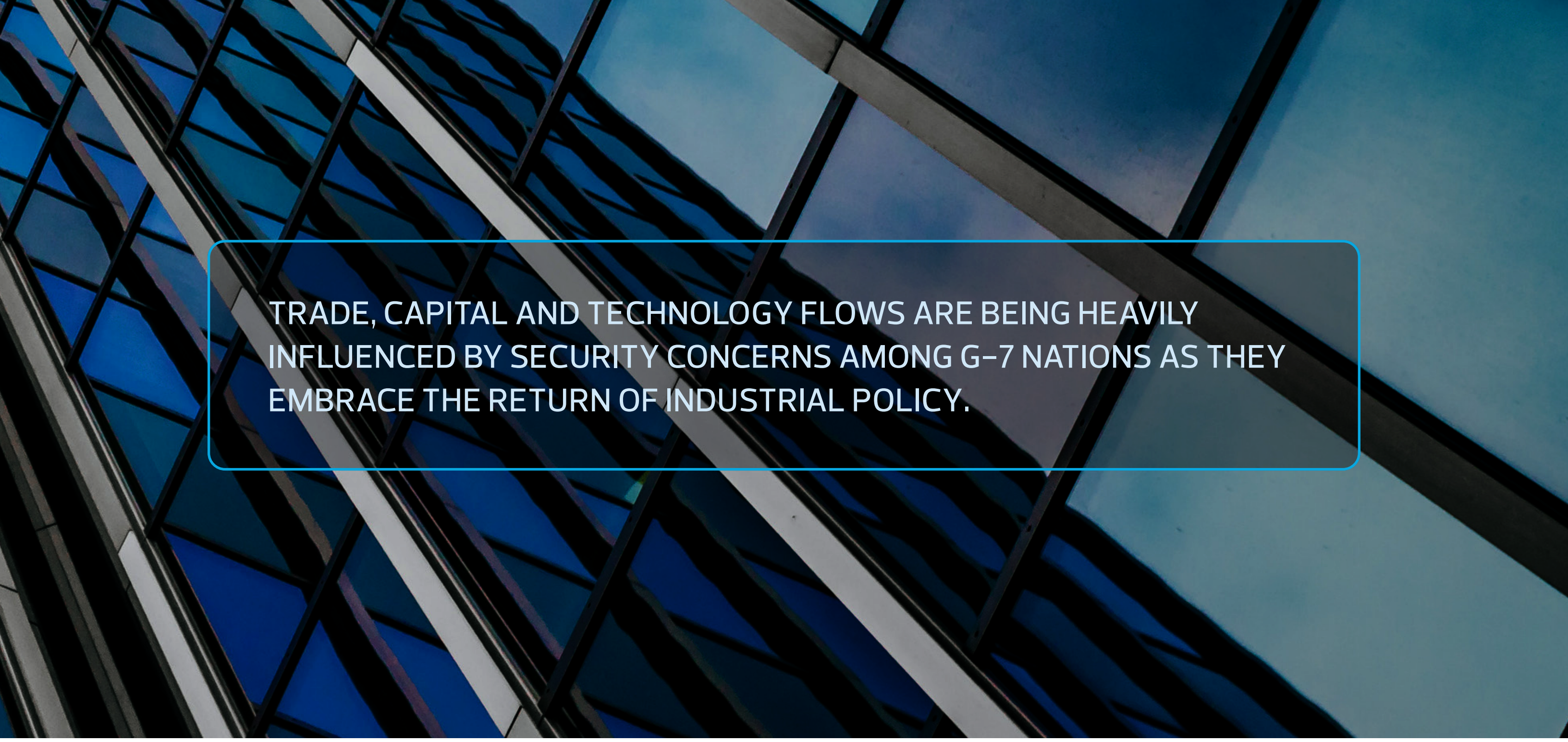
As the nature and composition of globalization change and as growth slows, a shift in structure is occurring within the real economy and the financial markets.

We anticipate that economic growth will slip into a recession next year because of the monetary tightening, ongoing geopolitical tensions in Europe and Asia, and households reducing their spending.

Once the economy emerges from recession, we expect it to be characterized by stagnation, with annual growth ranging between 1% and 1.5%, a notch below the pre-pandemic rate of 1.8%.

Why are we focused on the long-term growth trend within the context of an increasing liquidity constraint?

Recall that short-term bond yields are directly affected by monetary policy, with two-year bond yields representing the present value of expectations for short-term money market rates over the course of two years.



MIDDLE MARKET INSIGHT

Contributing to stagnating growth will be the end of historically low interest rates and the era of easy money.

But yields on long-term bonds—while still affected by changes in the policy rate, as we've seen lately—are more likely to include perceptions of economic growth and the real return on investment.

As those growth expectations reset lower, firms will be tempted to hold back on critical productivity-enhancing investments, which feeds back into the post-globalization transition and its rising cost structure.

Because of economic uncertainty, the risk premium for issuing government and corporate debt is rising. At present, lenders are requiring increased compensation from borrowers to cover the risk of recession and diminished demand, with the yield spread between investment-grade corporate debt rising above two percentage points. Riskier high-yield debt is now requiring four to five additional percentage points of compensation.

As both the American and global economies adjust to higher input costs and risk around purchasing debt as inflation remains elevated, both the policy rate set by central banks and longer-term interest rates determined by the private sector will reset higher.

In the end, the result is a higher cost of doing business for all firms.

The takeaway

Starting with the collapse of the Long-Term Capital Management hedge fund in 1998, through 9/11, the 2007—09 financial crisis, and into the pandemic, the primary policy response to those shocks has been ever-lower interest rates. At the time, that monetary policy was seen as unorthodox and sought to stimulate growth in the context of insufficient aggregate demand.

That era has likely ended. We have entered a period of insufficient aggregate supply, persistent supply shocks, higher inflation, higher interest rates and slow growth.

The onset of the pandemic and the economic forces that were unleashed have resulted in a structural shift that is transforming globalization, growth and liquidity.

That regime change in those three areas of economic and commercial life will result in a higher cost of issuing debt to finance economic expansion and meet social obligations.

Perhaps the geopolitical tensions between China and the developed economies led by the United States will abate, and the conditions that characterized the hyper-globalization of 1990 to 2020 will return.

I am not holding my breath.

UNCERTAINTY, POLICY CHOICES AND THE PROSPECTS FOR MIDDLE MARKET INVESTMENT

BY JOSEPH BRUSUELAS

STUBBORNLY HIGH INFLATION and rising interest rates are fostering uncertainty among business owners and investors, leaving policymakers with few good options.

But with the right targeted measures that encourage businesses to make productivity-enhancing investments, policymakers can help businesses position themselves for long-term success.

Today, firms are reporting lower earnings and revenues, which is leading them to dial back their fixed investments and potentially miss out on productivity gains in the future.

For the broader economy, it is all happening at an inopportune time. As confidence among businesses declines, the risk of a more severe downturn rises.

Policymakers, then, face a quandary: How can they confront declining output when the traditional methods of fiscal and monetary stimulus are not an option?

There are alternatives. One is to invest in infrastructure that boosts productivity and capacity. These investments are not inflationary, and position businesses for long-run success, especially in an economy with a chronic shortage of workers.

The second option is for policymakers to embrace the full deductibility of new business investment as well as increased support for research and development.

Both measures would boost productivity and reduce costs over the medium to long term without spurring inflation.

And the middle market is ready to make such investments.

With the right targeted measures that encourage businesses to make productivity-enhancing investments, policymakers can help businesses position themselves for long-term success.

MIDDLE MARKET INSIGHT

Firms are reporting lower earnings and revenues, which is leading them to dial back their fixed investments and potentially miss out on productivity gains in the future.

Over the past eight quarters, our RSM US Middle Market Business Index, a survey of the nation's leading middle market executives, showed that a majority of survey participants intended to boost investments to enhance productivity.

This view is notable because it comes from a cohort of the American economy that traditionally is slower to make these investments.

Any policies that dampen the risk appetite among medium-sized businesses would represent a significant setback for an important sector of the economy.

Encouraging these investments offers a number of benefits. First, it represents a middle ground that allows for higher interest rates to battle inflation and avoids fiscal and monetary stimulus that would otherwise fuel rising prices, all while still encouraging investment.

Second, our approach would avoid imposing undue hardship on the general public through higher-than-necessary rates of unemployment.

Real economy investment

A 1980 National Bureau of Economic Research paper by Ben Bernanke, who would later become Federal Reserve chairman, suggested investors will postpone a project if they think they need additional information regarding its profitability.

That information may suggest abandonment of the project, or that further delay might negatively affect profitability.

Bernanke found that because uncertainty increases the value of waiting for new information, it can impede investment.

As the U.S. economy approaches the end of the business cycle, rising uncertainty among businesses over inflation, growth and policy represents a danger to fixed business investment, productivity and, ultimately, the ability of the Fed to restore price stability.

Measuring risk

How can we measure the uncertainty factored into the decision of whether to invest? We rely on two surveys of business intentions, as well as a measure of risk priced into financial securities and a measure of policy uncertainty.

First, the RSM US Middle Market Business Index shows that after an extended period of solid revenue and profits, sentiment among executives has become aligned with the overall pessimism linked to inflation and the economy.

Even so, in the fourth-quarter MMBI survey, 38% of respondents reported increased productivity-enhancing capital expenditures during the third quarter, and 50% indicated they expected to increase those expenditures over the next six months.

Five of the regional Federal Reserve banks conduct similar surveys of manufacturing establishments regarding current activity and expectations for the next six months. While manufacturing activity has been slowing since Russia's invasion of Ukraine, firms continue to expect continued investment in productivity-enhancing equipment.

Investment normally entails financing of debt, with uncertainty regarding the state of the economy and the ability of borrowers to service that debt factored into the cost.

Any policies that dampen the risk appetite among medium-sized businesses would represent a significant setback for an important sector of the economy.

After an extended period of low risk brought about by monetary policy accommodation and extremely low interest rates, the RSM US Financial Conditions Index has now fallen to two standard deviations below normal.

RSM US Financial Conditions Index

Source: Bloomberg; RSM US LLP

*Positive values: increased level of accommodation; Negative values: increased level of risk

This decline indicates a significant degree of excess risk being priced into securities and a reduced propensity to borrow or to lend.

Because investment is required for economic growth, financial conditions dropping to such a low level are associated with recessionary periods.

Next, we see investor reaction to events and a building sense of the inevitability of an eventual economic slowdown as an explanation for the instability of investment over the business cycle.

Because monetary, fiscal and national security policies are determinants of economic activity, we can use the economic policy uncertainty indices devised by the economics professors Scott Ross Baker, Nick Bloom and Steven J. Davis to measure uncertainty surrounding public policy.

We show the index in two of its forms—the composite economic policy uncertainty index and the more volatile news-based index—both of which are normalized around a value of 100.

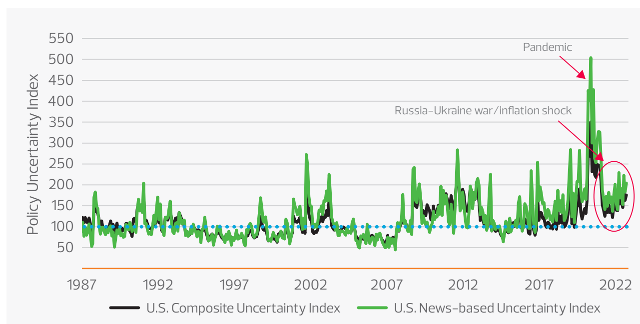
MIDDLE MARKET INSIGHT

As the end of the business cycle nears, rising uncertainty represents a danger to fixed business investment, productivity and, ultimately, the ability to restore price stability.

Two of the dramatic examples of U.S. policy uncertainty occurred in the past four years: the U.S.-China trade war and the pandemic. Those shocks are subsiding, but uncertainty is building once again.

This time, we attribute the increase to the oil and inflation shocks, the geopolitical risk introduced by Russia, and the prospect of a recession.

U.S. Economic Policy Uncertainty Index*



Source: Baker, Bloom and Davis; Bloomberg; RSM US LLP

*Baker, Bloom and Davis composite and news-based indices

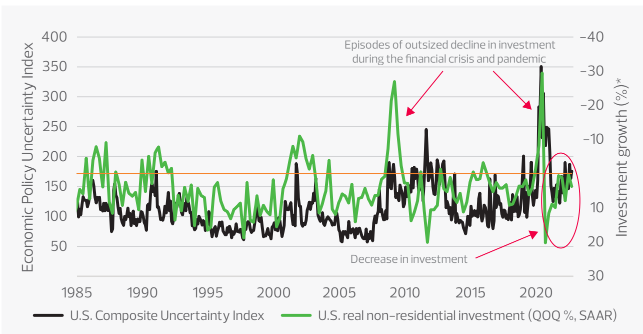
Using the uncertainty index as our benchmark, we show an imperfect but consistent relationship between uncertainty and nonresidential investment: As uncertainty increases, business investment decreases.

The imperfection is somewhat due to short-term fluctuations in perceptions of uncertainty, but more from the exaggerated quarter-to-quarter changes in investment that occur within a business cycle.

> After an extended period of extremely low interest rates, the RSM US Financial Conditions Index has now fallen to two standard deviations below normal.

And as we've seen by the response of the financial markets to the now-abandoned U.K. budget proposals by the Truss government—an effective veto by the bond market—those policy actions can have a lasting impact on investment, growth and employment.

Increased uncertainty corresponds to decreased investment



Source: Baker, Bloom and Davis; U.S. Bureau of Economic Analysis; Bloomberg; RSM US LLP

*Reverse scale

Current state of play

In terms of increased investment in equipment and intellectual property, we can attribute the willingness to invest in those areas to the need to remain competitive.

And because a business cycle is rarely a straight line from recession to recovery, we can offer some generalized remarks.

First, investment tends to increase along with growth as lagging information about the recovery becomes evident. Second, as the business cycle matures and growth decelerates, there will be disinclination to invest as confidence declines.

We can see the impact of the loss of confidence in the 2020-22 business cycle, with investment first increasing in response to the release of pent-up demand after the pandemic.

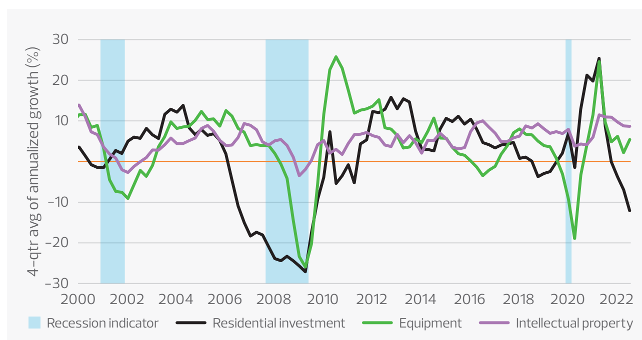
This was followed by the deceleration of overall growth and investment as the depth of the inflation and energy shocks became apparent.

Still, there are other factors to consider. For instance, we expect residential and commercial real estate prices and investment to decrease as interest rates rise. But despite a clear correction in the housing market in many areas, there still is a housing shortage, which will tend to keep residential investment, and prices, higher.

Second, risks around rolling over lower-cost debt that is coming due and the continuing interest in working from home are two major factors in declining investment in commercial real estate.

In the business sector, the increased cost of capital and the likelihood of an economic slowdown or outright recession next year suggest postponement or abandonment of investments.

Business investment in equipment and intellectual property and the 2022 decline in residential investment*



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

*Inflation-adjusted components of U.S. real GDP

The takeaway

As workers continue to be in short supply, businesses will need to continue investing in labor-enhancing equipment, intellectual property and software to meet demand.

Whatever policy prescriptions are put forward during the early phase of a recession, productivity should remain a top consideration.

Policymakers will have to tread carefully as they combat increasing uncertainty while simultaneously bolstering the economy without causing further inflation. But, as we have proposed here, there are solutions.

WHEN WILL INFLATION SLOW? PAY ATTENTION TO HOUSING.

BY JOSEPH BRUSUELAS AND TUAN NGUYEN

A CORRECTION in the housing market as mortgage rates reach 20-year highs is underway. While overall price growth has cooled, though, the housing components of the two inflation reports—the consumer price index and the personal consumption expenditures price index—have shown no signs of peaking.

We estimate an approximately 18-month lag between changes in housing prices and in the housing components of inflation. That means we do not expect housing inflation to peak until the third quarter of next year or to fall to the pre-pandemic level until late 2024.

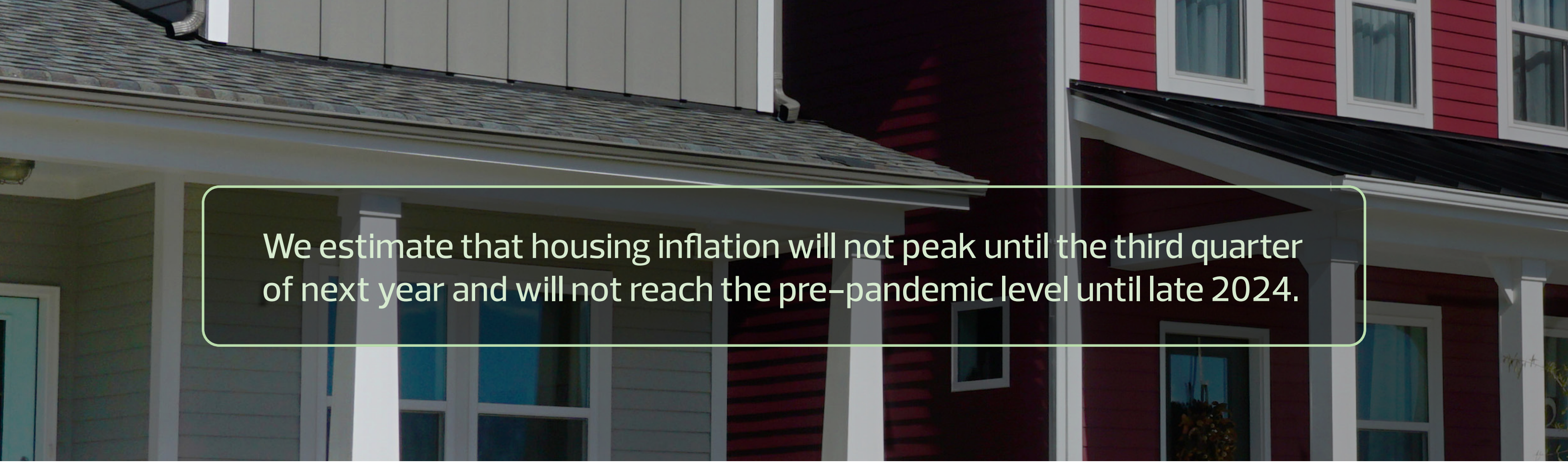
The Federal Reserve will almost certainly need to lift its policy rate above 5% and be prepared to hold it there, because inflation driven by housing tends to be persistent.

Housing inflation: Long and variable lags

We used more than 20 years of historical data to estimate the correlation between current housing inflation and past housing price growth.

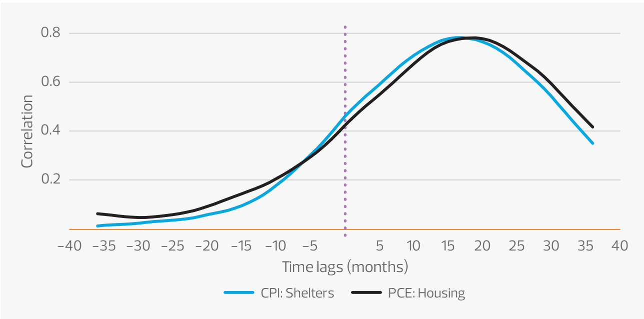
The results show that housing inflation in the consumer price index can be best predicted using data on housing price growth from 17 months prior, and in the personal consumption expenditures index from 19 months prior. There is roughly an 18-month to two-year lag before policymakers can assess the impact of changing housing prices and inflation.

The correlations are also strong between housing prices and the housing components of inflation reports, suggesting that housing price growth can be a reliable predictor for housing inflation despite the different methods used to calculate the two series.



First, we track the correlation between the two:

Correlation between housing prices and housing components of inflation reports



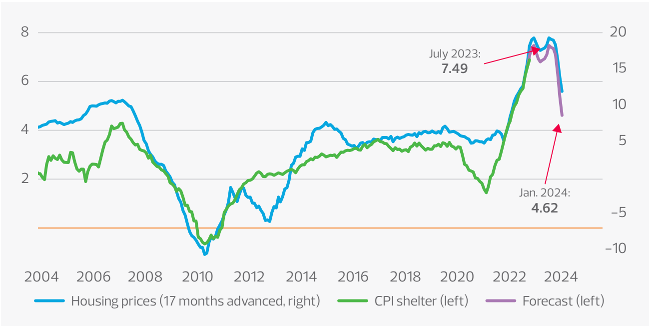
Source: U.S. Bureau of Labor Statistics; Federal Housing Finance Agency; RSM US LLP

MIDDLE MARKET INSIGHT

With housing accounting for 32% of the consumer price index, we expect inflation to stay sticky throughout next year.

Then, we can forecast the housing inflation components for both the CPI and PCE reports:

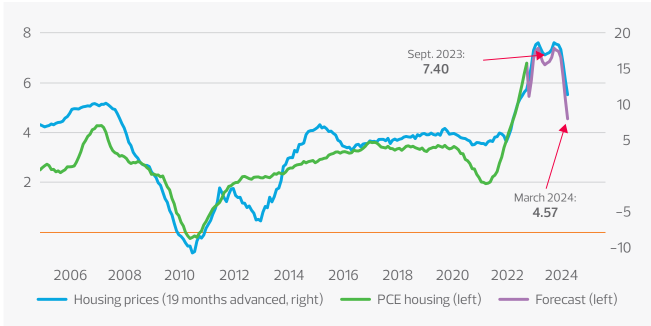
CPI shelter component and housing prices*



Source: U.S. Bureau of Labor Statistics; Federal Housing Finance Agency; RSM US LLP

*Year-over-year % change

PCE housing component and housing prices*



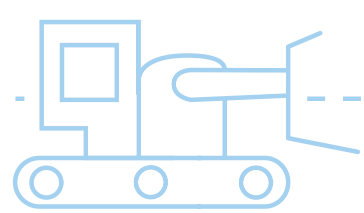
Source: U.S. Bureau of Labor Statistics; Federal Housing Finance Agency; RSM US LLP

*Year-over-year % change

At their peaks in the third quarter next year, the year-over-year housing component growth rates would be 7.49% for CPI and 7.4% for PCE.

Those would translate to 2.4 and 1.3 percentage-point contributions to overall CPI and PCE inflation, respectively.

By the first quarter of 2024, housing inflation from both reports would be 4.62% and 4.57% for CPI and PCE, respectively, remaining substantially elevated above pre-pandemic levels.



MIDDLE MARKET INSIGHT
There is an approximately 18-month lag between changes in housing prices and in the housing components of inflation.

Policy implications: Lift and hold

With housing accounting for the largest portion of total consumer spending in both inflation reports—more than 32% in CPI and 17% in PCE—we expect inflation to stay sticky throughout next year, especially core inflation, which strips out the more volatile food and energy prices and affects the central bank's policy path.

The Fed has signaled it will consider the lagging impact of monetary policy, particularly regarding the housing market, to determine the pace of its rate increases.

While we acknowledge that anecdotal evidence now shows rents possibly peaking, our interpretation of the data suggests that to pause or pivot on rate hikes would most likely result in a series of stops, starts and reversals in the policy path.

In the end, that approach would prove unproductive and put the anchoring of medium- to long-term inflation expectations at risk.

Long and variable lags associated with housing inflation should concern the Fed in two ways:

- **Transparency:** The lags add to the risk of higher and more entrenched inflation expectations that would prove difficult and costly to roll back. Given that the economy would have experienced high inflation for more than two years by the time the housing components peak later next year, such a sustained period of high inflation further erodes the already strained credibility of the central bank. We think the Fed will have to be more transparent about its policies should inflation remain elevated—which seems likely, based on our research.
- **Reaching the target:** As housing price growth remains above the pre-pandemic level, returning to the Fed's target of 2% inflation would require more work from the central bank. That means more rate hikes to come—or, as Chairman Jerome Powell said Nov. 2, "Some ways to go." And with inflation most likely remaining elevated for longer, the probability of a lift-and-hold monetary policy over the next 12 months, perhaps well above our current range of 5% to 5.2%, looks a lot higher.

The takeaway

Housing's lagging reaction to rate increases will make the Fed's job more complicated for months to come, even as housing inflation eases as anticipated.

While there are signs of inflation slowing, it will most likely not go back to the target rate anytime soon, which supports our forecast of a 3% core inflation rate by the end of next year as the economy continues to transition to a higher-priced environment.

MIDDLE MARKET **TREND WATCH**

A RESILIENT MIDDLE MARKET PREPARES FOR A RECESSION

BUSINESS CONDITIONS in the real economy deteriorated in the final quarter of the year, a proprietary survey conducted by RSM US LLP has found. The top-line RSM US Middle Market Business Index eased by 12.5 points to 124.2 from 136.7.

While that reading signals expansion and reflects the resilience of the broader economy, two years of rising prices have taken a toll on overall business conditions.

The survey was conducted Oct. 3 to Oct. 21; 408 senior executives at middle market firms participated. Among the findings:

Middle market firms continue to make critical investments.

50%

of respondents said they intended to increase capital expenditures over the next six months. That follows **8** straight quarters in which a majority said they intended to do so.

Yet more are keeping a wary eye on head count.

14%

of firms are planning to reduce head count over the next six months, the highest figure since 2020.

As higher input costs continue to be an issue ...

77%

of respondents said they paid higher prices over the past quarter, the seventh consecutive quarter above **70%**.

...the ability to pass along those higher costs is beginning to ebb.

53%

of respondents noted an increase in prices received in the fourth quarter, down from 69% in the third quarter.

Read the full report from the RSM US Middle Market Business Index.

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

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