THE REAL ECONOMY

VOLUME 97

RISING RISK AND THE MIDDLE MARKET: HOW TO NAVIGATE A PERILOUS ECONOMY

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- HOW FISCAL SPENDING IS AFFECTING THE REAL ECONOMY
- A GUIDE TO MAKING THE RIGHT TECHNOLOGY INVESTMENTS
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TREND WATCH: WHAT DRIVES EMPLOYEE SATISFACTION?

THE POWER OF BEING UNDERSTOOD
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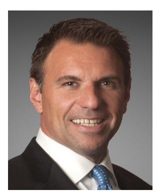

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PRIVATE INVESTMENT AND THE REINTRODUCTION OF RISK

BY JOSEPH BRUSUELAS

THE END OF HYPER-GLOBALIZATION heralds the end of an era of low inflation and low interest rates.

Regime changes in global trade, growth and liquidity, along with a significant increase in geopolitical tensions, are reintroducing political and economic risk.

To manage this risk, middle market firms will need to invest within friendlier trading blocs if they are to realize greater yields down the road.

But it won't be easy. The cost of capital is rising, and reconfiguring supply chains is difficult and time-consuming.

In the past three years alone, the pandemic, Russia's war in Ukraine, China's renewed aggression toward Taiwan and rising authoritarianism have disrupted global supply chains.

Now, global trade is increasingly divided into two blocs, one led by the United States and its trading partners and the other by China.

To manage rising global risk, middle market firms will need to invest within friendlier trading blocs if they are to realize greater yields down the road.

One bloc maintains state capitalism and industrial policy where the government picks winners. The other adheres to democracy and the rule of law, with pricing and choice determined by market forces.

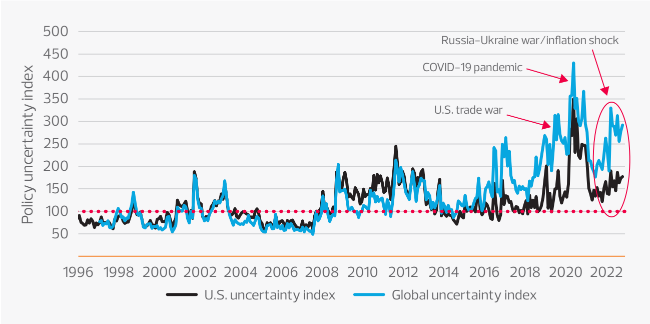
Amid these tensions, monetary policy has been shocked out of gradualism and dramatically increased the cost of capital.

Wartime shortages and misallocation of resources are threatening growth. If the past 30 years were characterized by insufficient aggregate demand and excess supply, the new era will be shaped by persistent supply shocks and geopolitical tensions.

Other, more benign factors will continue to affect firms' ability to raise capital. Examples include the impact of Brexit, the cutoff of Russian energy supplies, the fight in the United States over raising the debt ceiling, and the potential end of Japan's yield-curve control.

These factors have only added to the policy uncertainty that plagues the world markets.

U.S. and world economic policy uncertainty indexes



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

MIDDLE MARKET INSIGHT

In the past year, surveys conducted by RSM US LLP and by regional Federal Reserve banks show increased investment in productivity among U.S. corporations.

U.S. financial market risk

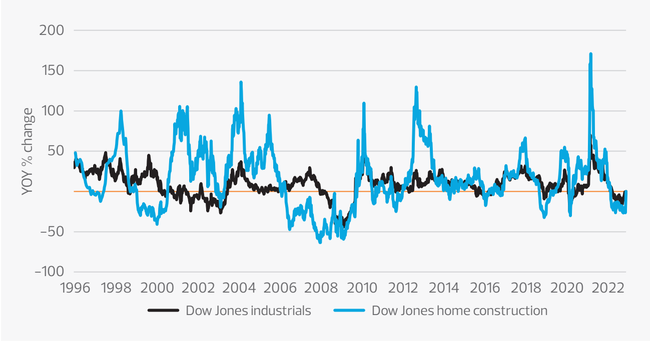
The U.S. financial markets have been left balancing high inflation with tighter monetary policy. It's a lose-lose situation that raises the cost of capital and adds to investors' perceptions of risk.

One result of this new environment has been the bursting of speculative market bubbles that flourished during the days of easy money.

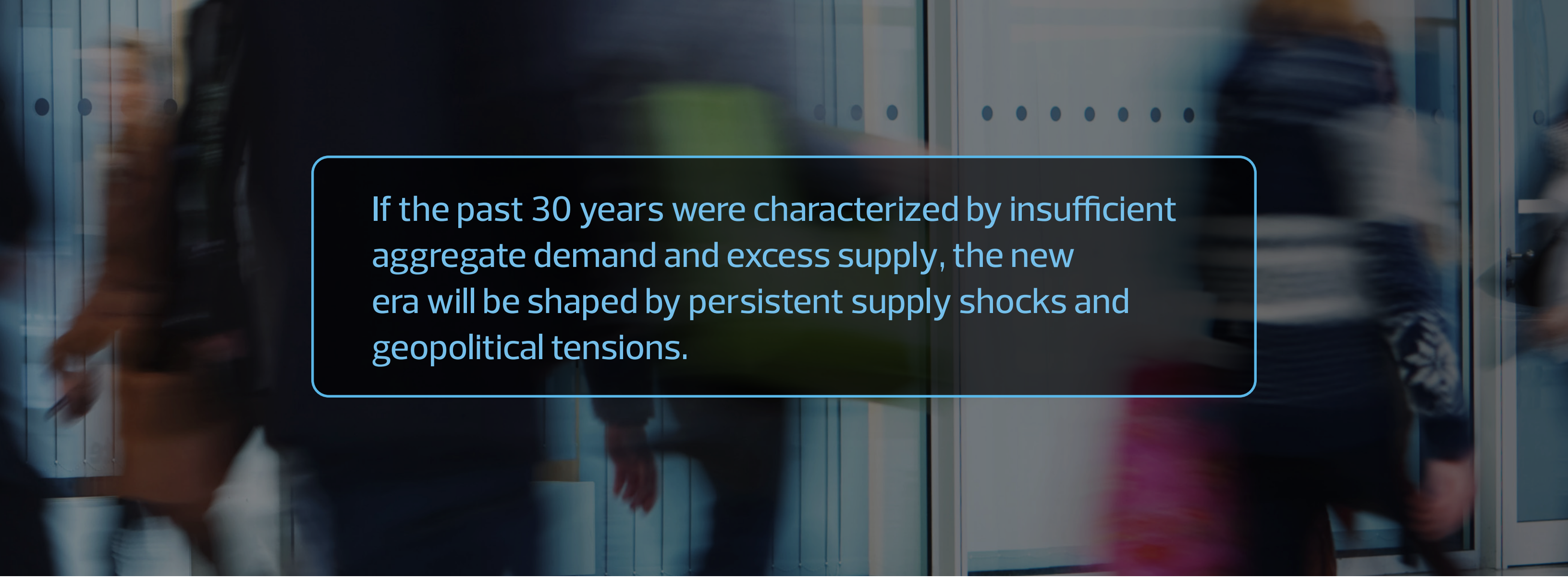
Two examples are the excessive funding of fledgling technology firms and the risky investments in the cyber-asset class. Another example is the bubble that formed in select local housing markets during the pandemic.

Plunging equity markets have followed, which are bound to affect spending by individual households and hurt overall growth and future investment.

Yearly returns of the Dow Jones Industrial Average and U.S. Home Construction Index



Source: Bloomberg; RSM US LLP calculations



If the past 30 years were characterized by insufficient aggregate demand and excess supply, the new era will be shaped by persistent supply shocks and geopolitical tensions.

A reassessment of corporate debt

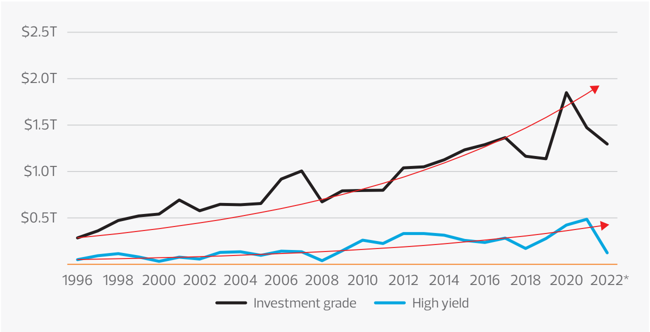
The increase in risk has prompted a reassessment of corporate debt. According to [a 2019 study](#) by the International Monetary Fund, the low interest rates in the U.K., the United States, Germany and Japan encouraged businesses to increase their borrowing, often to finance payouts to shareholders rather than investment.

They point out that 40% of that corporate debt—some 15 trillion pounds—would be impossible to service if there were a downturn half as serious as that of a decade ago.

A pandemic later, the rising cost of capital and the risk of a slowdown appear to have taken a toll on the willingness or the ability of corporations to take on additional debt.

The 20% drop in investment-grade (Baa) debt issuance in 2021 was followed by a 12% drop in 2022. After riskier high-yield issuance increased in 2021, it dropped 74% in 2022. Both sectors have fallen below average annual increases experienced from 1996 to 2017, before the trade war and pandemic.

Issuance of corporate debt



Source: SIFMA; RSM US LLP *2022 = 12 months ending November 2022

MIDDLE MARKET INSIGHT

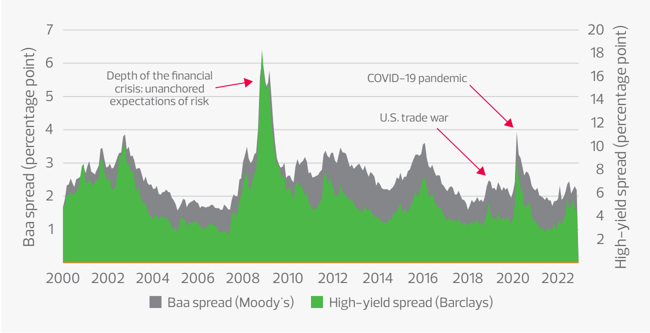
Global trade is increasingly divided into two blocs, one led by the United States and its trading partners and the other by China.

In the past year, however, surveys conducted by RSM US LLP and by regional Federal Reserve banks show increased investment in productivity among U.S. corporations.

These investments were ostensibly prompted by the pandemic, most likely in response to the shortage of labor, rising labor costs and supply chain problems.

Regardless of the intentions, the corporate bond market is pricing in an increased risk of an economic slowdown. The interest rate spreads between U.S. corporate debt and risk-free 10-year Treasury bonds in 2022 have risen to levels consistent with the economic stress of the trade-war era.

Risk premium of investment-grade and high-yield U.S. corporate debt*



Source: Bloomberg; RSM US LLP *Yield spreads between corporate debt and 10-year Treasury bonds

> The rising cost of capital and the risk of a slowdown appear to have taken a toll on the willingness or the ability of corporations to take on additional debt.

Foreign investment risks

Before 2022, we had come to take China's role as a supplier of goods and its expanding influence around the world as a given. But because of its disastrous COVID-19 policies and a long-simmering financial and housing crisis, a Chinese recession or debt crisis has become increasingly likely.

With China's restrictive policies in Hong Kong, its renewed belligerence toward Taiwan and its reneging on trade agreements, the schism between Beijing and Washington has only widened.

For example, the Biden administration has shown little appetite for granting China access to U.S. technology or for repealing Trump-era tariffs.

Businesses and investors are looking to shift production to other low-wage centers. Two are Latin America, which offers proximity, and India, whose educated, young, English-speaking labor force is a plus.

If only it were that simple. While India, for example, has a long history as a democracy with a long legal tradition, attracting investment is another matter, Arvind Subramanian and Josh Felman wrote recently in *Foreign Affairs*.

MIDDLE MARKET INSIGHT

One result of rising risk has been the bursting of speculative market bubbles that flourished during the days of easy money.

Investment risks in India remain too high, policy inwardness is too strong and macroeconomic imbalances are too large, the authors wrote.

In addition, firms lack the confidence that authorities will apply the law evenly after an investment is made. By attaching high tariffs to imported parts, New Delhi has provided a powerful disincentive for firms contemplating production facilities in the country.

But Apple's recent decision to reduce its risk exposure to China may prompt other companies to seek greater investment in places like India, Vietnam and back in the Western Hemisphere.

The takeaway

The reintroduction of greater political and economic risks is going to reallocate investment back inside competing trade blocs. Longer-term returns on investment will require higher short-term costs. That scenario, in turn, will require a different outlook and varied management skills. ■

DID FISCAL SPENDING GO TOO FAR?

BY JOSEPH BRUSUELAS

FISCAL RESPONSES by governments around the world during the pandemic were unprecedented. Many governments spent 20% to 30% of gross domestic product to mitigate the impact of economic shutdowns.

Now, after months of elevated inflation and surging interest rates, a different price and rate environment is emerging.

Policymakers, firm managers and investors should anticipate a significant fiscal narrowing for both public and private actors in the post-pandemic period.

An International Monetary Fund analysis in March of government spending during the health crisis found that "the power and agility of fiscal policy were far beyond what was previously thought possible. Governments channeled cash directly to households and businesses to save jobs and livelihoods."

These actions demonstrated governments' special role when things go bad, analyst Gita Bhatt wrote.

"But now, the bill is coming due," she added. "Governments face the tricky task of reducing unprecedented debt to more sustainable levels while ensuring continued support for health systems and the most vulnerable."

In some respects, central banks' efforts to restore price stability will not only result in fiscal narrowing, but also constrain the ability of governments to use inflation to offset the impact of large fiscal imbalances.

There is little argument that government spending on vaccines and maintaining income streams during the pandemic saved the global economy from collapse.

MIDDLE MARKET INSIGHT
The U.S. bond market is the dominant force in world finances, and likely to remain that way for the foreseeable future.

Data from the IMF shows the jump in emergency government spending in 2020 being financed by debt. This came as revenue plunged during the economic shutdown.

Though the debt relative to GDP in most countries is expected to moderate over the next five years, debt in the United States is expected to increase because of slowing economic activity. And China's debt accumulation is expected to accelerate, reaching 100% of GDP by 2027.

So has spending gone too far? Are we now paying for it with rising inflation and interest rates that will crimp consumer spending and push the global economy into recession? Has public debt risen to heights that will crowd out private investment and limit growth?

In an IMF discussion on public debt, economist Olivier Blanchard rejected simple fiscal rules and said policymakers must consider the interplay of projected interest rates, economic growth and political stability.

He noted the complications that arise when debt in emerging markets is denominated in foreign currencies, as seen in previous financial crises.

Ricardo Reis, an economics professor at the London School of Economics, warned in an IMF article that price stability matters more than ever if debts are to stay sustainable.

The expansion of public debt over the past 20 years was made possible by the decline in inflation and interest rates, he wrote, adding that debt will be sustainable as long as it continues to attract investors.

But as prices accelerate around the world, will we see a run of sovereign debt crises?

In another IMF piece, Emmanuel Saez, an economics professor at the University of California, Berkeley, pointed out that government spending among advanced economies has pivoted from national security basics to providing a social safety net, with public education deemed necessary for economic advancement.

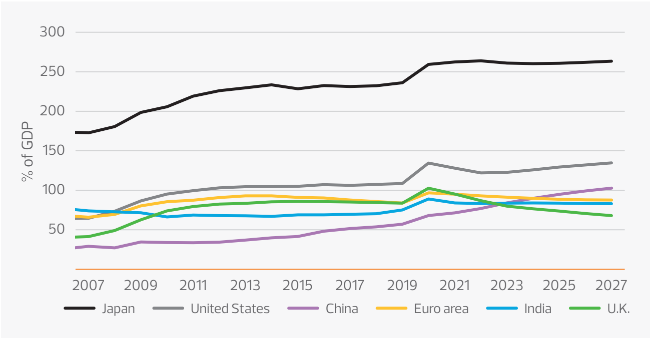
Although spending among emerging economies is increasing, he said it has been insufficient, as evident in the wide disparity of gross income per capita.

We would add to the discussion that the ability to issue debt is an important indicator of the health of the economy.

Japan's debt has exceeded 100% of its GDP for decades, so there must be a willing audience for that debt. Foreign purchases of U.S. debt subsided during the pandemic as investors sought the safety of cash.

Within those purchases is the implicit guarantee of repayment now threatened by the debate over lifting the U.S. debt ceiling. Forfeiture would worsen the rise in interest rates and deter private investment, hurting growth.

IMF projections of gross debt as a percentage of GDP



Source: International Monetary Fund; Bloomberg; RSM US LLP

THOUGH THE DEBT RELATIVE TO GDP IN MOST COUNTRIES IS EXPECTED TO MODERATE OVER THE NEXT FIVE YEARS, DEBT IN THE UNITED STATES IS EXPECTED TO INCREASE BECAUSE OF A SLOWING ECONOMY.

How much public debt is too much?

The rule of thumb was that countries with debt-to-GDP ratios of 100% or more were in danger of default—a convenient milestone.

The United States reached 100% in 2012, and Japan long before that, but neither is at the breaking point. So there must be something else that determines when a country has become so profligate that investors lose confidence.

We attribute Japan's ability to increase debt to its population of savers encouraged by culture and demographics. At worst, the public was willing to finance bridges to nowhere. At best, it accepted a progressive tax policy to finance that debt.

As for the United States, whose taxes have arguably become more regressive with each tax cut, the dominance of the dollar benefits all taxpayers.

In recent decades, the safety of that debt has attracted so-called hot money due to the relatively higher rates of return on dollar-based assets in a world of extremely low interest rates.

Among the economies with debt-to-GDP ratios of less than 100%, the bond market serves as the hall monitor for unfunded, ideologically driven spending, with the United Kingdom and its aborted tax cuts being the most recent example.

Previous debt crises have occurred in Mexico, Latin America and Asia, all inflicting various degrees of damage to financing in the global economy.

MIDDLE MARKET INSIGHT

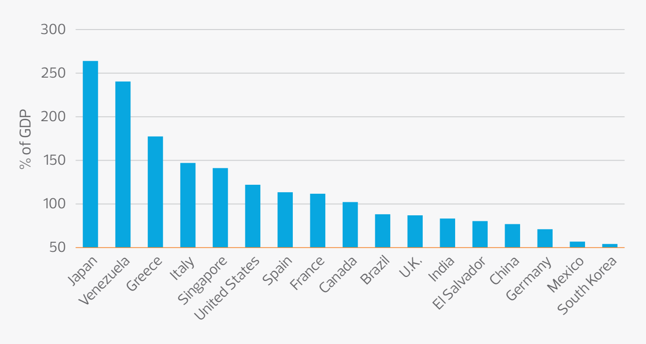
Central banks' efforts to restore price stability will not only result in fiscal narrowing, but also constrain the ability of governments to use inflation to offset fiscal imbalances.

Should El Salvador's experiment with cryptocurrencies backfire, it would be hard to envision the damage spreading beyond its immediate investment and trading partners.

But if confidence in Greece's ability to repay its loans were to collapse, common sense would suggest a solution exists within the whole of the European community, no matter the eventual cost.

Recent analysis by the IMF found that managing the high debt levels in some countries would become "increasingly difficult if the economic outlook continues to deteriorate and borrowings costs rise further." The analysis added that if high inflation were to persist, investors would demand a higher inflation premium when lending to governments and the private sector.

Debt-to-GDP ratios of selected economies*



Source: International Monetary Fund; Bloomberg; RSM US LLP *International Monetary Fund 2022 estimates

MIDDLE MARKET INSIGHT

The U.S. debt has reached what was once an unthinkable height reserved for Japan and less prosperous economies.

Assessing the status of U.S. debt

So with its debt-to-GDP ratio of 122%, where does that leave the United States' ability to fund that debt and sustain the viability of its financial markets? Consider these factors:

Confidence in the dollar

The dollar is *the* vehicle of global trade, with exporters parking the proceeds from sales into U.S. money market securities.

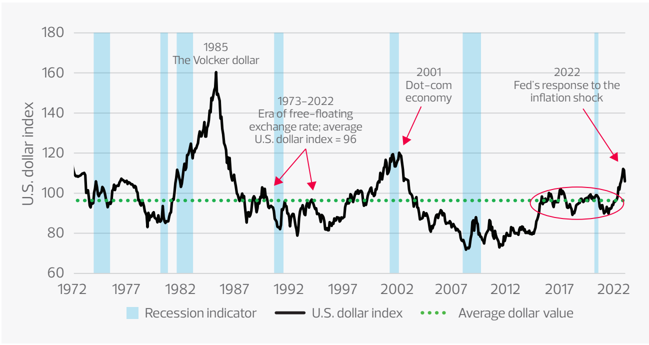
The dollar became the store of value among the world's currencies in the realignment of global finances at the end of World War II, officially taking over the role held by the British pound.

More than 60% of foreign exchange reserve holdings are in dollars. Euro holdings are now at 20% and have gained traction since the euro's creation in 1999, particularly because of increased trade with emerging markets in eastern Europe and Africa.

And with most commodities priced in dollars, the transaction demand for dollars remains a dominant force in determining its value.

In fact, the demand for the dollar is at its strongest point of the past two decades, rivaling the 1995–2001 surge of demand for dollar-based tech investments. While recent dollar strength is due to investors surging into the higher returns of dollar-based assets, the fundamental strength of the U.S. economy and the safety provided by its securities show no sign of reversing.

Assessing the dollar's value*



Source: Bloomberg; RSM US LLP

*U.S. trade-weighted dollar

Confidence in the Treasury market

The U.S. bond market is *the* dominant force in world finances.

And because of the U.S. commitment to its framework of laws, regulation of its financial system, and the depth and breadth of its securities, the U.S. bond market is unlikely to lose that status anytime soon.

U.S. federal debt doubled from 40% of GDP in 2006 going into the Great Recession to 80% of GDP before the pandemic. Add another 40% onto that during the health crisis and the U.S. debt has reached what was once an unthinkable height reserved for Japan and less prosperous economies.

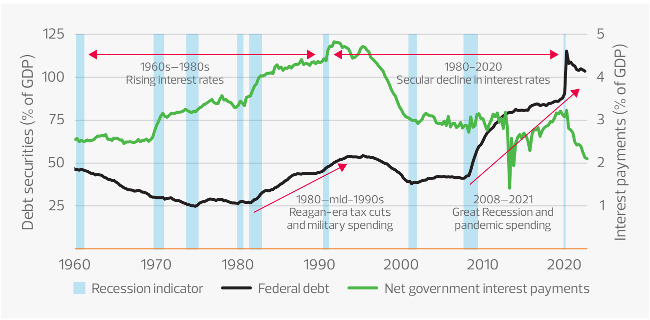
But interest rates were in decline due to a number of factors—including not only the squashing of inflation by central bankers, but also, more significantly, the decline in energy prices. That led to a decline in net interest payments on government debt.

THE DEMAND FOR THE DOLLAR IS AT ITS STRONGEST POINT OF THE PAST TWO DECADES, RIVALING THE 1995–2001 SURGE OF DEMAND FOR DOLLAR-BASED TECH INVESTMENTS.

By the beginning of December 2022, U.S. long-term interest rates had reached 4%, with expectations that inflation would remain higher than the Fed's 2% target and that interest rates would normalize in the range of 4% to 5%.

In our view, the normalization of U.S. interest rates will not detract from the attractiveness of holding dollar-denominated securities. Rather, because of the increase in global risk, we expect the healthy demand for dollar-based securities to continue.

Federal debt and net interest payments as a percentage of GDP



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

The U.S. budget

The last time the United States ran a budget surplus was in 2001. Expenditures overwhelmed revenue during the recovery from the Great Recession and then again from 2017 to 2020, that most recent episode being the result of unfunded tax cuts and the drop in revenue because of the U.S.-China trade war.

During the pandemic, expenditures rocketed as government programs subsidized income. Those expenditures have since retreated as those subsidy programs ended.

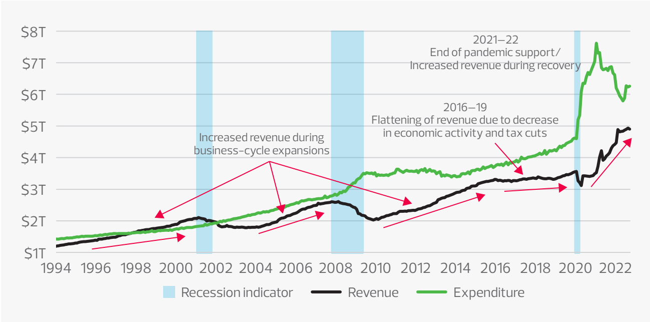
Fully funded infrastructure spending is scheduled to begin in earnest now that the midterm elections are over, bringing with it expectations of expanded economic activity.

There is little concern that the U.S. economy will falter to the extent that net tax revenue would be insufficient to cover its debt payments. But there are threats from those in Congress who would run the risk of default as a method of shrinking the federal government.

We think that approach is a nonstarter with respect to putting the federal deficit on a path toward sustainability. Given that there is no sizable constituency in Washington or in financial capitals around the world willing to run that risk means we are lapsing back into the status quo that uses the global fixed income market to impose discipline on government spending.

That returns us to the concept of government spending paving the way for economic progress and prosperity, with the bond markets providing the guardrails to ensure sane practices. ■

Federal revenue and expenditure*



Source: Federal Reserve; U.S. Bureau of Economic Analysis; Bloomberg; RSM US LLP *12-month moving sums

MIDDLE MARKET TECH INVESTMENTS INCREASE, BUT WHAT SHOULD THEY TARGET?

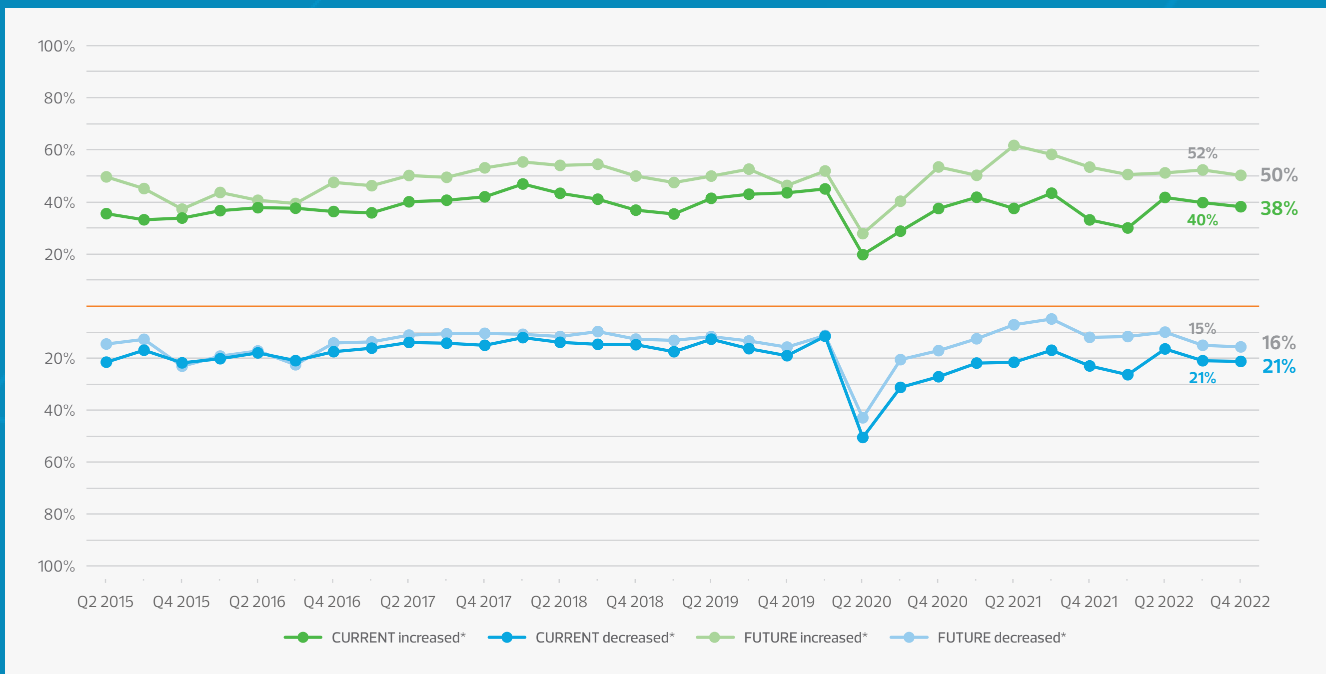
BY JOSEPH BRUSUELAS, NATE FARSHCHI, BILL KRACUNAS AND ERNEST J. NEDDER

DIGITAL TRANSFORMATION is not a new concept, but the middle market's approach to it has shifted. One of the remarkable changes since the beginning of the COVID-19 pandemic has been a reorientation to, and renewed investment in, productivity-enhancing software, equipment and intellectual property.

Data shows a real, and what looks to be a permanent, trend of the middle market taking a more proactive approach to digital transformation—and companies that don't keep up are at risk of losing productivity and revenue.

For the last nine quarters, at least half of the respondents in the RSM US Middle Market Business Index survey have indicated they plan to increase productivity-enhancing capital investments in the next six months—50% of respondents identified such plans in the most recent survey, conducted for the fourth quarter of 2022.

AGGREGATE CAPITAL EXPENDITURES/INVESTMENTS PERFORMANCE



Thinking about your organization's aggregate capital expenditures or investments this quarter versus last quarter, how would you describe your organization's current capital expenditures/investments? Would you say capital expenditures/investments have…?

*Seasonally adjusted

What are your expectations regarding your organization's aggregate capital expenditures or investments over the next six months? Would you say capital expenditures/investments will…?

Source: RSM US Middle Market Business Index, Q4 2022

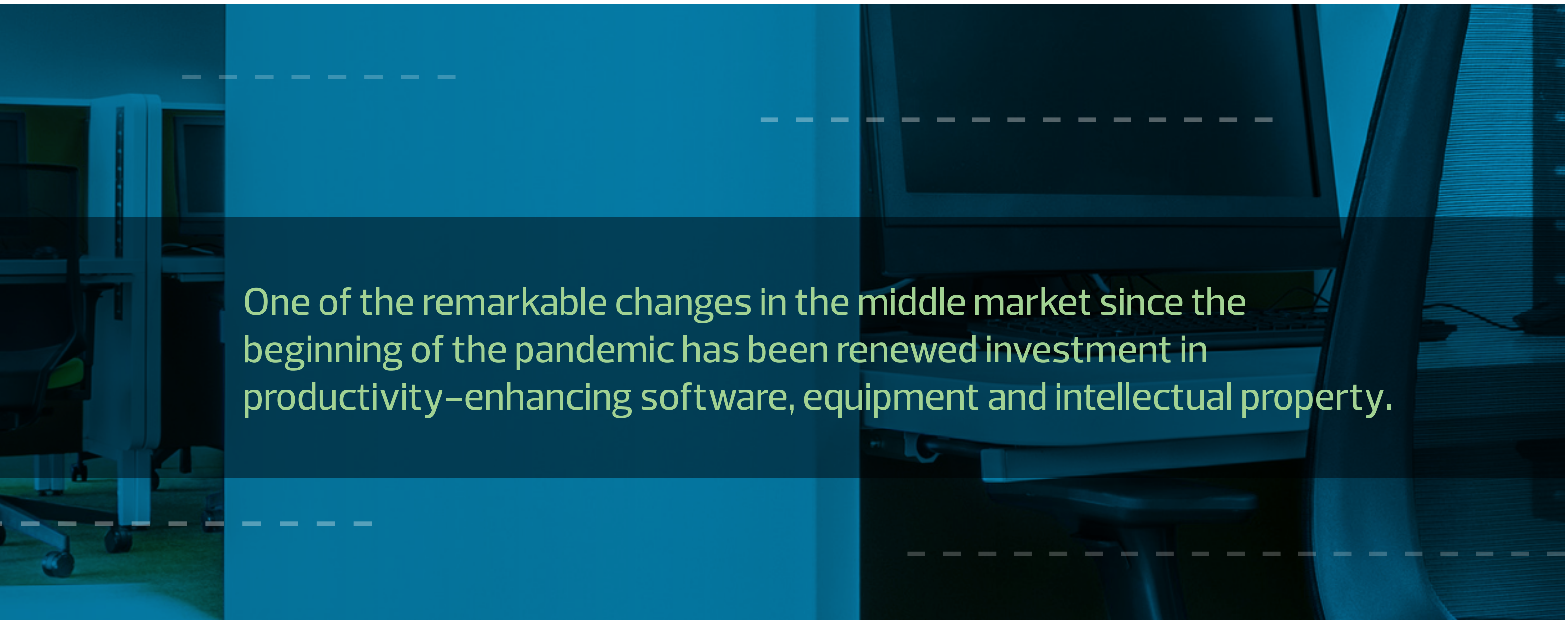
"This is particularly notable because for decades, middle market companies have notoriously been well behind the curve when it comes to technology investments, waiting to identify best practices," says Joe Brusuelas, chief economist at RSM US LLP. "But the changes unleashed by the overall structural shock of the pandemic have resulted in a rare restructuring of actual behavior."

In addition to its role in enabling businesses to implement changes dictated by the pandemic, technology's ability to help companies address ongoing labor challenges illustrates that this change in investment is not a short-term fad. "The commitment to reallocate investment on a permanent basis—to increase efficiency and productivity to plug the gap where labor is not available in order to meet demand—is now essential to how the middle market operates," says Brusuelas.

Pressure from the market

Many organizations are investing a lot of money in technology right now, because companies can see better ways to accomplish many tasks. An unspoken understanding within industries is that if someone is thinking about leveraging a potential innovation, competitors are likely thinking about it too—and somebody is going to do it.

"Companies have to be careful because they can quickly get outmoded in today's world if they do not keep innovating," says Bill Kracunas, RSM principal and management consulting leader. "If they do not continue to spend and find themselves playing catch-up, it could end up costing twice as much or more to get back in alignment."



One of the remarkable changes in the middle market since the beginning of the pandemic has been renewed investment in productivity-enhancing software, equipment and intellectual property.

MIDDLE MARKET INSIGHT

To remain competitive, company management needs to evaluate and institute more forward-looking digital transformation strategies.

But with this level of investment, accountability is key. Companies put systems and initiatives in place, but how do they know their efforts are successful?

"There is a measurement aspect to change, and organizations need to understand the focus of innovation projects, how they are influencing customer and employee sentiment and behavior, and the short- and long-term benefits of projects as they move forward," says Kracunas. "The increased spending is ultimately designed to make money, and establishing appropriate levels of accountability will help achieve that goal."

Where to focus energy?

In the past, digital transformation may have meant implementing a new enterprise resource planning or customer relationship management system. But while these tools are extremely important, they have become more of a requirement than a transformational technology. Upgrading an ERP system will likely make a company more efficient, but won't necessarily differentiate its products or services.

Technology is constantly evolving and new, and improved, solutions are steadily becoming available. Making the right innovation choices can yield more useful data to strengthen business operations, increase efficiency and boost productivity.

"More and more, we see that the client experience is being transformed by technology and the digital world," says Ernest J. Nedder, RSM chief strategy officer. "The power of data, artificial intelligence, automation and user experience is transforming how clients connect with—and deepen relationships with—their key service providers."

While effective digital transformation requires a nuanced approach, and success can mean different things for different companies and industries, organizations should consider the following strategies to strengthen key processes:

- **Get the most out of the cloud:** At this point, almost every company uses the cloud to some extent, but the solution continues to evolve to provide greater storage capabilities and accessibility and better security for files and applications than on-premise storage due to economies of scale.
- **Enhance the customer and employee experience:** As the pandemic unfolded, customer and employee expectations began to change. Flexibility became more important for both groups, and companies have come to understand that a human-centered approach that creates more experience-driven processes can pay big dividends, helping them maintain and build market share and retain and attract employees in a tight labor market.

MIDDLE MARKET INSIGHT

At least half of the respondents in the RSM US Middle Market Business Index survey have recently indicated they plan to increase productivity-enhancing investments.

- **Take advantage of managed services:** Managed services strategies are a significant untapped resource for many middle market companies, especially given the labor challenges expected to continue in the near term. These approaches are inherently flexible, and can range from fully managed programs to co-sourcing strategies that supplement existing company resources while supporting a host of critical functions, including IT. Companies can access advanced tools and resources previously out of reach while benefiting from a predictable monthly expense, as well as scalability and stability as the business changes.
- **Embrace data analytics:** All companies have vast amounts of data that can help them set more effective goals and guide organizational decision-making. For example, data analytics solutions can help stakeholders gain a deeper understanding of customer patterns that drive sales and can help identify patterns in your business to strengthen operations. In addition, enhanced analytics can enable more in-depth analysis of tax compliance data to aid decision-making and can increase audit capabilities to develop helpful insights for the board and C-suite.
- **Adopt and integrate automation:** AI and ML, which are the foundation of automation, are still commonly seen as technologies of tomorrow, but they are providing significant benefits in many applications today. For example, AI and ML can be used for everything from predicting specific outcomes or recommending products to customers to automating compliance with regulatory requirements. "For middle market companies, the decision isn't so much whether automation should be ultimately adopted, it's a question of when," says Nate Farshchi, RSM technology senior industry analyst.

The takeaway

"With digital transformation, companies not only have to talk the talk, they have to walk the walk," Brusuelas says. "What we see is that our clients are now beginning to realize they have to walk the walk. Therefore, even as we come out of a very difficult three-year pandemic period, and even during the challenges from the inflation shock and the rate shock we are all experiencing, one is still bullish looking forward at the capacity and the ability of the middle market to advance digital transformation initiatives."

The structural adjustments that companies are going through due to a variety of external forces have prompted a different approach to productivity and profitability. To remain competitive, company management needs to evaluate and institute more forward-looking digital transformation strategies and must be willing to commit to a new cost structure appropriate for a hypercompetitive American real economy.

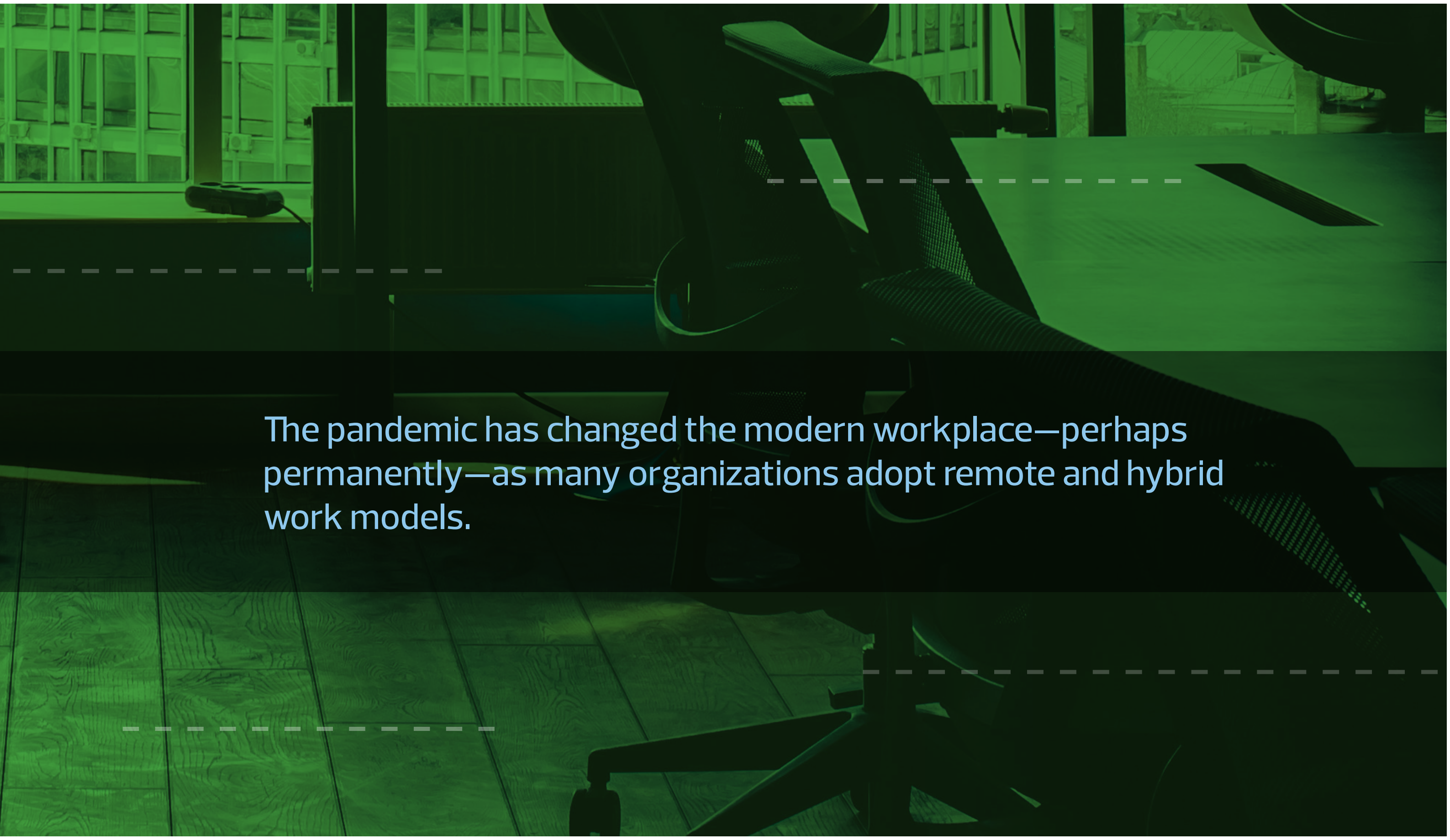
THE BATTLE FOR RETENTION: WHAT DO WORKERS WANT?

FACING RECORD-LOW UNEMPLOYMENT, middle market companies have placed even greater emphasis on retaining employees and establishing continuity in a time of frequent change. The pandemic has changed the modern workplace—perhaps permanently—as many organizations adopt remote and hybrid work models. And with trends like quiet quitting and the "great resignation" creating upheaval and stress in personnel departments across North America, keeping existing employees on the rolls has never been more important.

Earlier this year, an RSM Middle Market Business Index special report looked at how the pandemic changed the middle market workplace and how employers restructured operations in response. However, with the balance of power shifting from employer to employee, more perspective was needed from employees. In response, RSM conducted an online survey in the fall of 2022 of over 4,000 workers in both the United States and Canada, split between middle market and large organizations. The resulting data provides a deeper understanding of how employees feel about their current employer, their role in the workplace and what factors could build greater satisfaction moving forward.

Many proud employees, but several looking elsewhere

The survey shows that more United States middle market employees are proud of where they work (83%) compared to those at larger organizations (78%), while about three-quarters of employees at Canadian middle market and large organizations are proud of their workplace (77% and 75%, respectively). However, despite the level of pride in their organizations, middle market employees have greater retention risks.



MIDDLE MARKET INSIGHT

The RSM survey shows that more United States middle market employees are proud of where they work (83%) compared to those at larger organizations (78%).

The pandemic environment forced many companies to adopt a more flexible work environment and the data shows that many employees want that flexibility to continue. In fact, U.S. middle market employees are significantly more likely than those working at larger organizations to wish they had more flexibility to set their own hours and schedule (62% vs. 56%). The trend is similar in Canada, with 64% of middle market employees seeking more flexibility compared to 57% of workers at larger companies.

In addition, U.S. middle market employees are significantly more likely than those at larger organizations to report they are actively applying for a new role outside their organization (26% vs. 14%). A fairly consistent number of Canadian employees at middle market and larger organizations report actively applying for jobs outside their current company (15% vs. 13%).

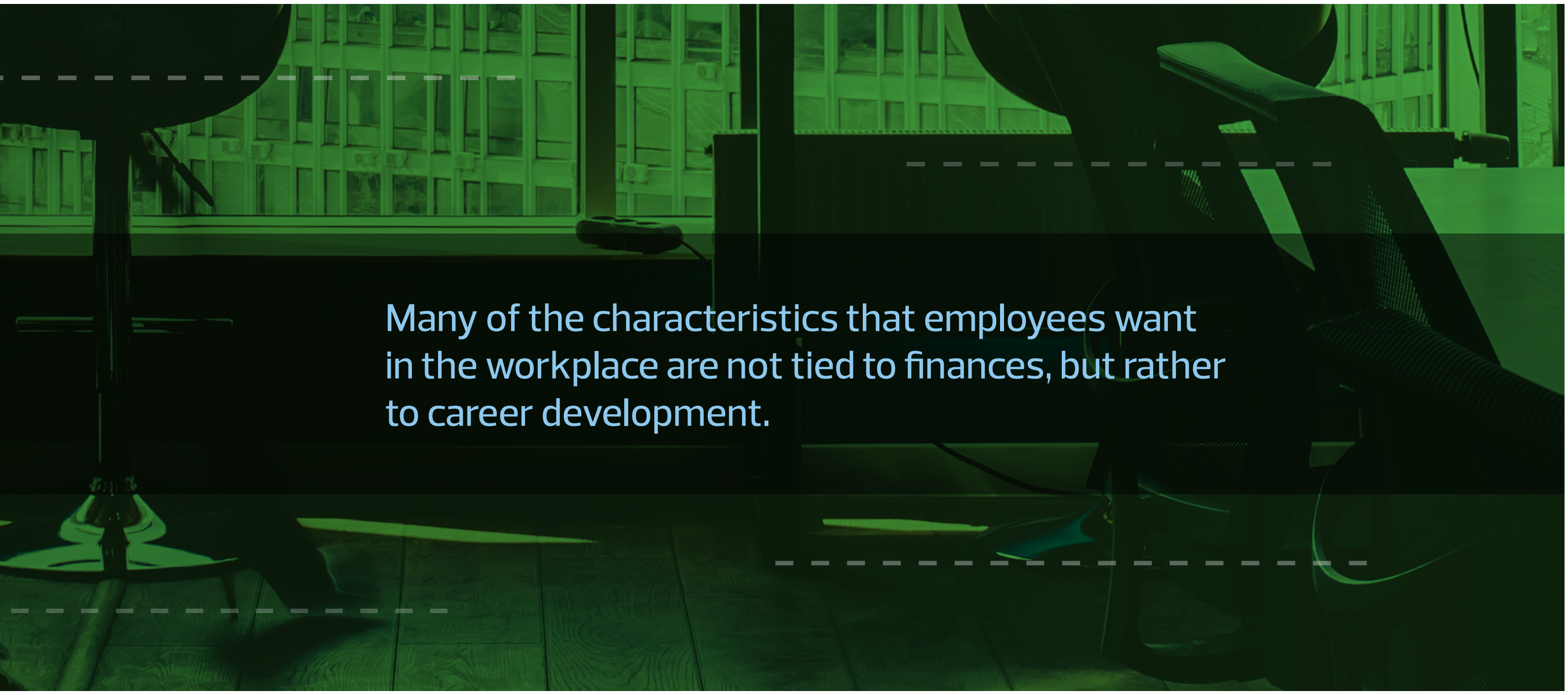
Compared to counterparts at larger companies, U.S. middle market employees also report that it would be easier to get a new job than to ask for a raise (54% vs. 47%).

"Instead of waiting for your employees to ask you for a raise or a promotion, you can ask them what they need to stay at your company and grow," commented Marni Rozen, RSM's human capital consulting leader. "People will generally tell you what they're looking for, and even opening up that dialogue and letting people know what opportunities are available is a positive step forward."

The (mostly) good news

While the current environment for talent retention can seem daunting, middle market companies can make the adjustments necessary to address many of the features employees are looking for in the workplace.

Not surprisingly, among those who are actively looking for a new position, salary and benefits are a top theme, according to qualitative data. And while many companies initially responded to staffing shortages by increasing compensation, that may not always be the best response.



Many of the characteristics that employees want in the workplace are not tied to finances, but rather to career development.

MIDDLE MARKET INSIGHT

U.S. middle market employees are significantly more likely than those at larger organizations to report they are actively applying for a new role outside their organization.

"While compensation is obviously important, it is often not the most critical thing," said Rozen. "It doesn't necessarily solve the other issues that we're seeing that employees may find more important, such as flexibility and more autonomy over their schedules."

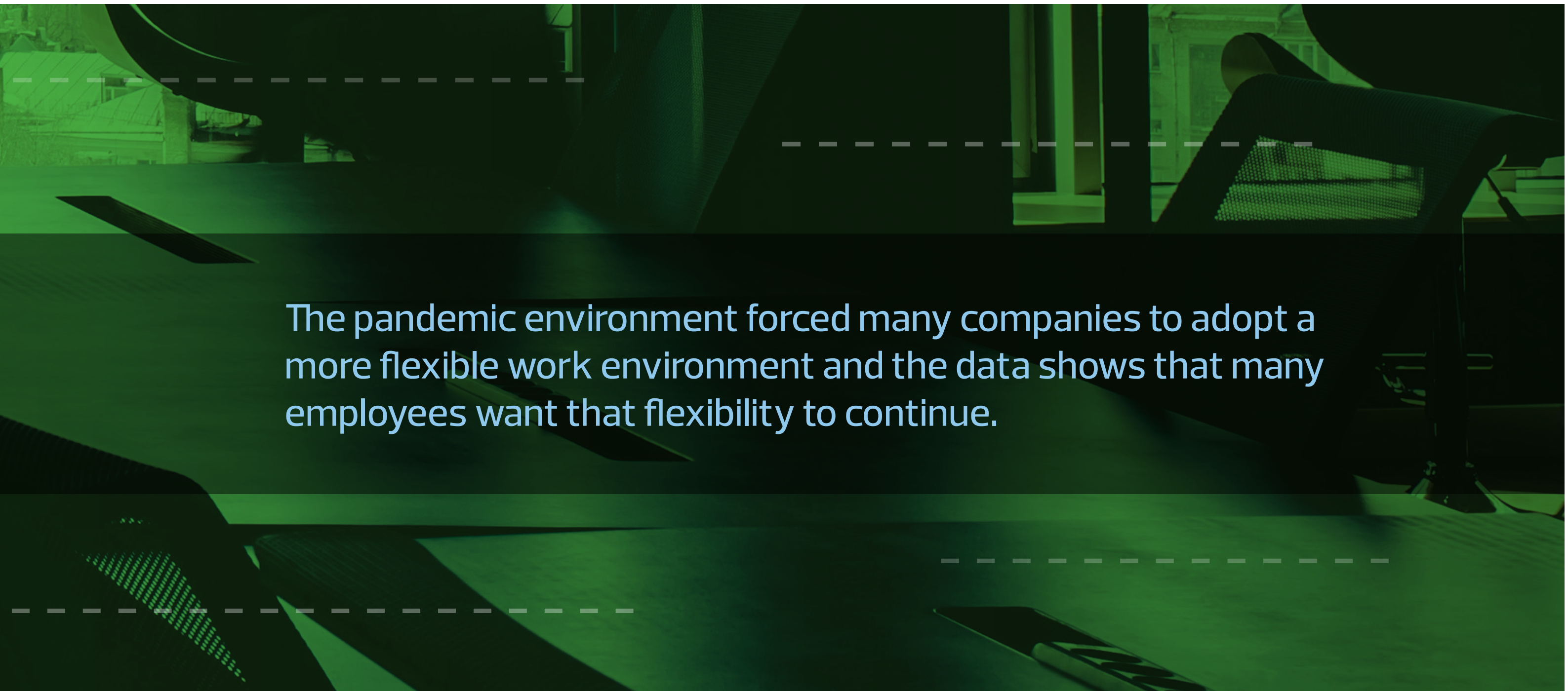
In addition, increasing compensation is not always possible. But luckily, many of the additional characteristics employees want in the workplace are not tied to finances, but rather to career development. For example, according to qualitative data, knowledge/skills/opportunity is also a leading theme for U.S. and Canadian middle market employees who are actively evaluating new opportunities.

"From a tactical and people perspective, focusing on career development is a win-win," said Rozen. "Closing any potential skill gaps is important from a business perspective, but overall development is also what people are seeking. I think people would stay at an organization when they see opportunity ahead of them, they feel like they're working for something and they see a middle market company investing in them."

Further, middle market employees were asked about what they have versus what they want at their current job. In both the United States and Canada, the most considerable gaps were with above-market compensation and incentive compensation arrangements. However, just below these gaps for U.S. middle market workers were defined career paths and equity/share ownership.

When asked about the elements of an ideal job, middle market workers in the United States and Canada were once again generally in agreement about what is most important. Employees in both countries believe that work-life balance, support from a supervisor/boss, fulfilling work and the potential for advancement/promotion are the most critical elements of the ideal position. Focusing on or expanding upon any or all of these characteristics presents a key opportunity for middle market organizations to stand out to employees and increase satisfaction.

"These opportunities don't have to be things that have a large dollar cost," said Anne Bushman, leader of compensation and benefits in RSM's Washington National Tax practice. "The survey shows there are many things your employees are likely looking for that are not purely financial. There's a way to build loyalty through items that are not necessarily all that expensive."



The pandemic environment forced many companies to adopt a more flexible work environment and the data shows that many employees want that flexibility to continue.

MIDDLE MARKET INSIGHT

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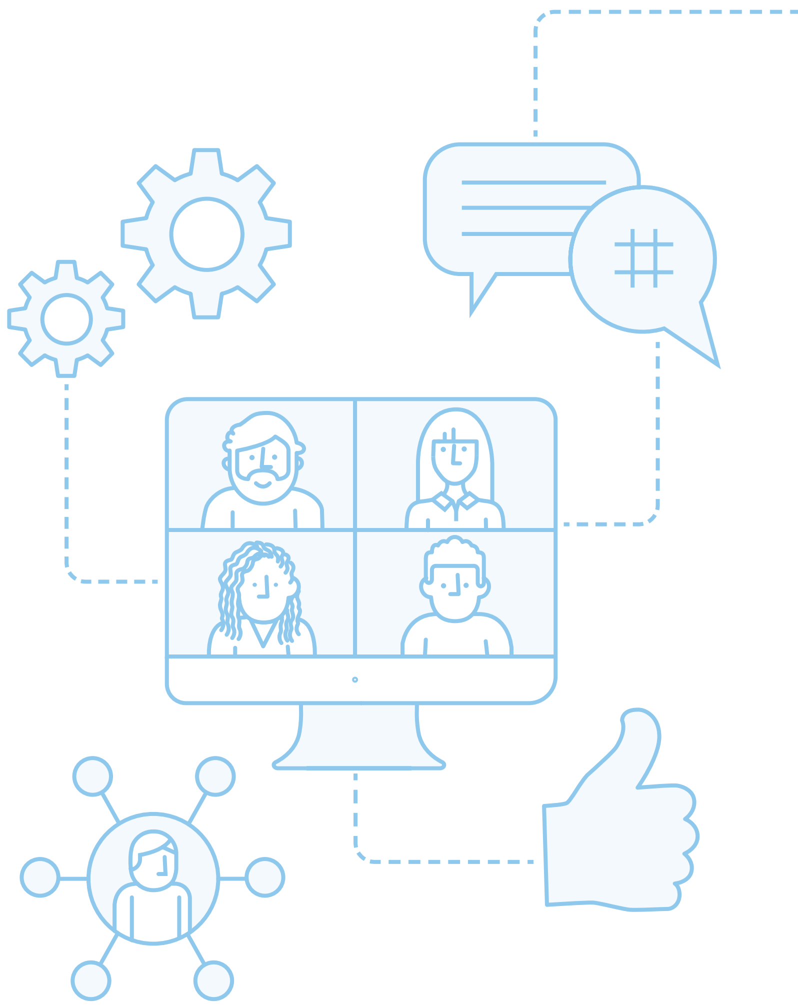
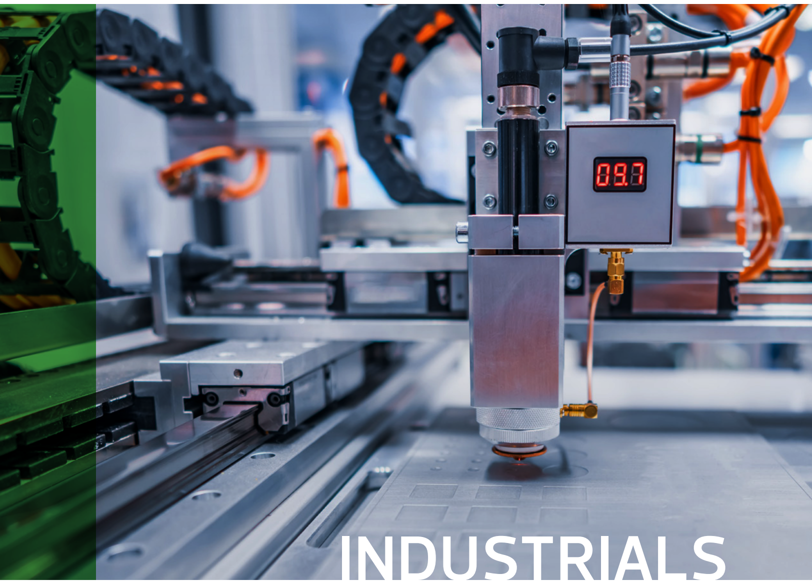


Considerations for change

Changes to operations will likely be necessary on an ongoing basis to keep middle market employees engaged and satisfied, and therefore encourage more of them to stay with their current company. But in many cases, careful planning is necessary to ensure new processes and strategies align with overall business goals and any potential compliance requirements.

For example, Bushman detailed how taxes could be a compliance concern for any new employee retention strategies. "You need to make sure that you're not unintentionally increasing a tax cost that you didn't know was there," she said. "When you do something completely different—especially when it involves compensation or benefits—you want to go in with eyes wide open about potential costs and tax requirements. It may or may not affect your decision, but it's just another thing that you must consider up front." ■



GLOBALIZED MANUFACTURING ENTERS A NEW ERA

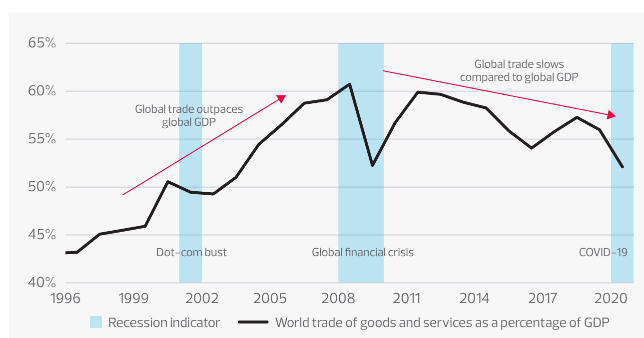
BY MATT DOLLARD

THE ERA OF GLOBALIZATION, which brought cheap goods, low inflation, rapid growth and inexpensive capital, is transitioning to a new state. Globalization is not dead, but the makeup of its participants has shifted, and global trade rules continue to be rewritten as businesses diversify where they source and make their goods. The impact of these structural changes is profound.

This isn't a new narrative; world trade as a percentage of world gross domestic product has been on a downward slope since the global financial crisis. But strained government relations and new policies have pushed manufacturing further into this new era. As a result, industrial companies will need to assess alternative strategies and operational locations.

Trading with unfriendly nations like Russia is taboo. Trade with China in certain technologies related to telecom, computer chips and surveillance is verboten. The number of businesses and people on the U.S. Commerce Department's restricted entity list doubled to nearly

World trade of goods and services as a percentage of GDP



Source: Bloomberg; World Bank; RSM US LLP

1,200 between 1997 and 2000, and the world put 9,098 new sanctions on Russia since the start of the invasion of Ukraine. The saber rattling with China, plus another term with the current Chinese leadership, is leaving businesses wary of further investment in the country.

Globalization is not dead, but the makeup of its participants has shifted and the rules of global trade continue to be rewritten.

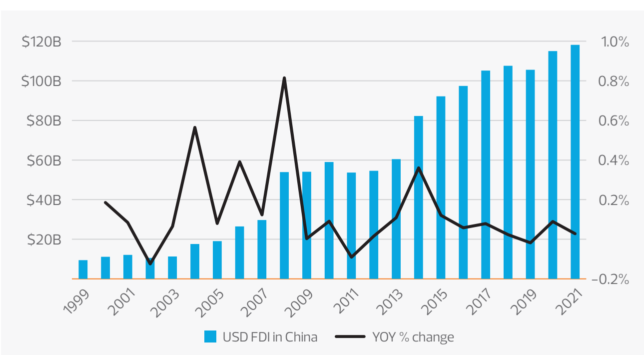
MIDDLE MARKET INSIGHT

Businesses that diversify their manufacturing footprint should use the opportunity to ask themselves what they can do better.

Of course, global trade wasn't always this way. The world embraced its last surge in global trade when the Berlin Wall fell in 1989. Global trade became policy. In 1995, the World Trade Organization was founded to reduce tariffs and make trade smooth, predictable and free. Then China joined the WTO in 2001, codifying its shift as the factory of the world, and the United States led support for that shift by investing over $118 billion in China by 2021. U.S. living standards rose, as did a global middle class through access to lower-priced, easy-flowing goods and job creation. Growth was high, and inflation stayed low.

But all of this has changed. Since 2016, the year-over-year percentage change of new U.S. foreign direct investment in China has consistently slowed to single digits—signaling a more tepid investment appetite.

U.S. foreign direct investment in China*



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

*Historical-cost basis and YOY % change for all industries

Starting in 2018, the United States slapped tariffs on Chinese goods, and a trade war began. Then in early 2020, the pandemic sent shock waves through global supply and demand. Two years later, war broke out in Europe and exacerbated inflation through the energy and commodity channels. Geopolitical tensions reset to Cold War levels.

Individually, these events weren't tipping points, but their cumulative shocks echoed throughout policymaking bodies and boardrooms worldwide, leaving an indelible mark on the global economy.

New math, new incentives, different options

The total historical cost of U.S. foreign direct investment in China of $118 billion is slanted heavily to the manufacturing sector, with 48.2% (or $56 billion) going to food, chemicals, metals, machinery, computers, electrical equipment, transportation and other sectors. After that, wholesale trade is the largest nonmanufacturing sector and represents 15.5% or $18.3 billion of U.S. investment. These sectors represent the core investments in China that make and move goods, and rapid change in these areas is difficult.

Now calculations made 15 to 25 years ago about where to source and manufacture goods are outweighed by security interests, increased risk, productivity losses, higher costs and uncertainty.

A recent mix of legislative incentives and deterrents is creating an about-face and helping create a U.S. renaissance in manufacturing for semiconductors, telecom materials and 5G infrastructure. Other incentivized U.S. investment priority areas include green energy equipment, active pharmaceutical ingredients, and strategic and critical minerals.

In August 2022, legislators signed the CHIPS and Science Act into law, directing $200 billion in spending on research and development and over $52 billion on semiconductor manufacturing over the next 10 years.

That same month, the Inflation Reduction Act was codified into law and will invest $369 billion in energy security and climate change programs over 10 years.

This leaves a multitude of other consumer goods and industrial manufacturers that invested in China assessing alternative strategies. It is unrealistic to believe many of these businesses will return to the United States.

Barring immediate strategic needs or government incentives, locations for such operations will continue to depend on labor, access to materials, transport costs, proximity to end customers, and risk profile.

Manufacturers need to consider a host of internal and external factors when deciding whether to explore alternative locations.

MIDDLE MARKET INSIGHT

Since 2016, the year-over-year percentage change of new U.S. foreign direct investment in China has consistently slowed to single digits—signaling a more tepid investment appetite.

For businesses that explore alternatives, the key options are to continue to invest in China and do business as usual, curtail new investments in China but maintain operations there, or close operations there and relocate within the Asia-Pacific region or near-shore to a country like Mexico.

Whatever route companies take, they won't be able to ignore China's market. It is the United States' largest goods and services trading partner, and future market access is important. Additional U.S. investment in China is likely to continue its taper compared to prior periods in favor of other markets like India or Mexico. Still, the extent of that slowing investment remains to be seen.

How should businesses adapt?

Manufacturers need to consider a host of internal and external factors when deciding whether to explore alternative locations. The weight of each factor will vary by business.

Internal factors include whether the organization has the management capacity and experience to develop a new manufacturing strategy. This effort requires taking the time to research options, as well as seeking input from team members and stakeholders, calculating the financial and nonfinancial impacts, evaluating risk, and creating an investment schedule and road map for decision-makers.

External factors include transportation and logistics costs and options, labor, material sourcing, customer proximity, ease of operating, technological requirements, cost of capital, tariffs, taxes, regulatory requirements and, of course, geopolitical risk.

Projects like these are disruptive for many of today's lean management teams. The substantial level of effort and potential capital investment involved will deter some businesses from changing where they operate. But given the shifts in globalization, businesses need to thoroughly examine whether diversifying their locations will maximize their long-run prospects.

Change equals opportunity

Businesses that diversify their manufacturing footprint should use the opportunity to ask themselves what they can do better. Answering this question can unlock unexpected enterprise value.

Adopting new productivity-enhancing equipment and state-of-the-art technology, for instance, can reduce reliance on labor, lower variable costs and maximize long-term capital investments.

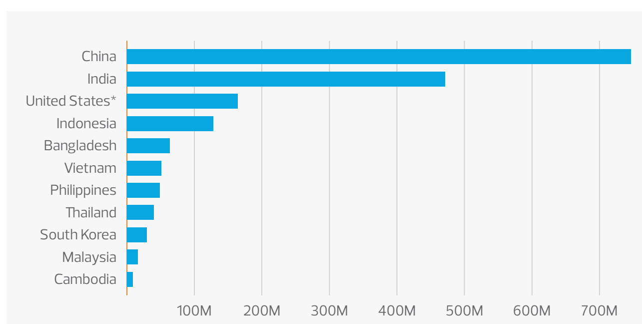
A way to explore these options before making costly decisions is by using digital twin technology to create 3D models of shop floors, equipment layouts, and employee productivity and run myriad scenarios to identify the most efficient use cases.

Solving for access to talent and labor, no matter the country, will present challenges compared to China; no country except India will match the size of its workforce. Augmenting labor and automating tasks will be necessary for scenarios where labor costs are higher and access to workers more limited.

The takeaway

Whatever the mix of key driving factors for each business, manufacturers that reassess what this new global picture means for their operations can likely find efficiencies in terms of transportation costs, energy or raw materials. Operating in new locations can create different tariff opportunities, transportation savings and landed cost savings. ■

Labor force totals by country—Asia-Pacific region 2022



Source: Bloomberg; International Monetary Fund; World Bank; RSM US LLP

*United States included for perspective

WHAT DRIVES EMPLOYEE SATISFACTION AND RETENTION?

IT CONTINUES to be a difficult labor environment, but employees of middle market companies generally have a positive attitude and outlook about where they work.

However, significant retention risks persist. A new RSM survey details the impressions American workers have of their current employers and the strategies that can attract or retain them moving forward.

More middle market employees are proud of where they work.

83% are proud to work for a middle market organization.

78% are proud to work for larger companies.

However, more middle market workers are applying elsewhere.

Middle market employees are significantly more likely than those at larger organizations to actively apply for new roles outside the company.

26% Middle market workers

14% Workers at larger organizations

Why are middle market employees looking for new jobs?

31% Salary/benefits

12% Knowledge/skills/opportunity

Flexibility has become critical.

Middle market employees are significantly more likely than those at larger organizations to wish they had more flexibility with their hours and schedules.

62% Middle market companies

56% Larger organizations

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

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