THE REAL ECONOMY

VOLUME 101

ECONOMIC HEADWINDS AND THE MIDDLE MARKET

- IS THE GLOBAL ECONOMY DE-DOLLARIZING? NOT ANYTIME SOON.
- HOUSEHOLDS REMAIN FLUSH, BUT SOME ARE FEELING SQUEEZED
- HOW LONG WILL CONSUMERS CONTINUE TO SPEND?
- SIGNS ARE POINTING TO AN END OF THE CURRENT BUSINESS CYCLE

MIDDLE MARKET TREND WATCH: CYBER RISKS REMAIN A CONCERN

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

RSM

ABOUT THE **AUTHORS**

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

JOSEPH BRUSUELAS
CHIEF ECONOMIST, RSM US LLP

MIKE GRAZIANO
DIRECTOR
CONSUMER PRODUCTS SENIOR ANALYST

PETER CADIGAN
PARTNER
CONSUMER PRODUCTS SENIOR ANALYST

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

ECONOMIC HEADWINDS AND THE MIDDLE MARKET

WHY THE DOLLAR REMAINS THE WORLD'S RESERVE CURRENCY

BY JOSEPH BRUSUELAS

RECENT TALK that China, India and Russia are settling purchases of oil in nondollar denominations has generated speculation that the dollar's days as the world's reserve currency are ending.

This is nothing new. There were similar discussions during the financial crisis 15 years ago and, more recently, during the cryptocurrency bubble.

Now, most measures of dollar valuation suggest continued dollar strength.

Citi U.S. dollar real effective exchange rate index

Source: Citi; Bloomberg; RSM US LLP

The rule of law, foreign direct investment and the dollar's support of the global economy's rules-based order all reinforce U.S. economic and financial power.

Using Citi's real effective exchange rate index, the American dollar stands at 103.81, below its recent peak of 111.90 in October. Yet 103.81 is well above where it has been for most of the past 20 years. The index measures the value of the dollar, where 100 is neutral.

The dollar accounted for roughly 60% of global currency reserves at the end of last year, down from its recent peak of just above 70% in the first part of this century but well above the 50% of 30 years ago.

We find the recent discussion around the end of the dollar dominance bereft of any linkage to the reality of international finance and understanding of the dollar's role as the anchor of the rules-based order that governs global economics.

Rather, the recent conversation is stoked by global grievances about the relative disparity of economic power and the dead end that some economies find themselves in.

While these economies may desire an end to dollar dominance, they are experiencing major challenges on their own. Calling for an end to dollar preeminence is premature at best.

The global financial system rests upon the stability of the dollar and the large trade deficit of the United States.

In essence, the United States exports dollar stability to obtain goods and services at a cheaper price, and in doing so enhances the welfare of its citizens.

In return, the major trading economies get to hold a currency that is sounder than their own—think of the Chinese yuan, which relies upon the depth of global liquidity markets based on the dollar to maintain that country's currency regime. That reliance, in turn, reinforces the dollar's hegemony.

In short, the economies that run surpluses need that dollar-based demand from the United States to make up for their own weak consumption and high savings rates.

MIDDLE MARKET INSIGHT

A reserve currency needs to be stable and safe, a store of value and a medium of exchange, and widely accepted and trusted.

China, which accounts for 2.7% of global reserves, is a case in point. For the yuan to become a true reserve currency, China would have to liberalize it.

Such a loosening would result in a decline in the ability of the regulatory authority to control credit, and in relinquishment of control of its capital account and current account.

China would have to be willing to alter its economic framework so that its economy plays the same role as that of the United States. Given China's current political arrangements, that will not happen. And the dollar will remain dominant.

Moreover, the soft power of the United States is too often discounted. The rule of law, foreign direct investment—with the notable exception of China and Russia—and the dollar's support of the rules-based order all reinforce U.S. economic and financial power.

Global foreign exchange data

The vast majority of international trades, almost 90%, is invoiced in U.S. dollars or euros, according to a recent analysis by the Federal Reserve Bank of New York.

That corresponds to the 80% of total foreign exchange reserves allocated to the dollar and euro held by central banks at the end of last year. The dollar accounted for 60% and the euro 20%.

China, Russia, India and Saudi Arabia are not in any economic shape to support such a change in the rules-based order.

We find the discussion around the end of the dollar dominance bereft of any linkage to the reality of international finance and understanding of the dollar's role in global economics.

MIDDLE MARKET INSIGHT

Economies that run surpluses need dollar-based demand from the United States to make up for their own weak consumption and high savings rates.

Despite the global economic growth over the past three decades, the current order is simply not going to change at the scale necessary to supplant the American dollar and the global order it supports.

Only three other economies have some of the qualities needed to support a reserve currency: the eurozone, Japan and the United Kingdom.

But none of those have financial markets with the depth and liquidity to form the backbone of international finance and trade.

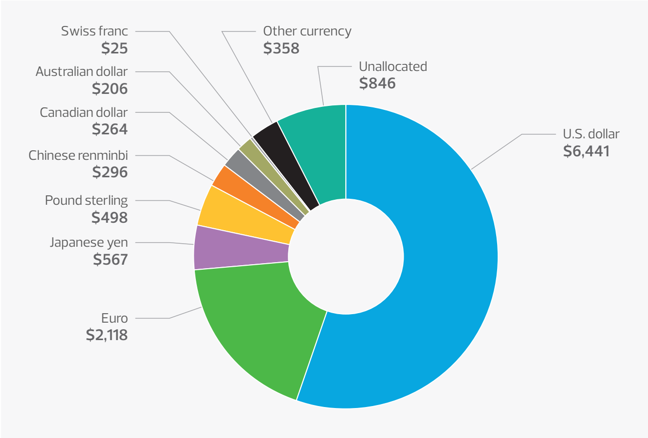
In the early 2000s, the percentage of dollar and euro reserves was as high as 90%, with the gradual decline since then most likely occurring because of increased trade among smaller economies and, more important, their reduced reliance on the foreign issuance of debt.

The International Monetary Fund also notes that as stockpiles of foreign currency reserves grow, so does the case for portfolio diversification.

Currencies of smaller economies that have not traditionally figured prominently in reserve portfolios but offer high returns and stability— like the Australian and Canadian dollars, Swedish krona, and South Korean won— account for three-quarters of the shift from dollars.

Other IMF analysis notes that the dollar is the dominant reserve currency by default. The absence of an alternative to the safety of dollar-trade invoicing, international funding markets, and the large supply of guaranteed Treasury bonds suggest that the dollar's role in the global economy is secure.

Currency composition of foreign exchange reserves as of December 2022*



Source: International Monetary Fund; Bloomberg; RSM US LLP *USD billions

What determines a reserve currency

A reserve currency needs to be stable and safe, a store of value and a medium of exchange, and widely accepted and trusted.

This is according to an analysis by Vivek Joshi in India's *Sunday Guardian*, which notes additional societal and economic criteria for a global reserve currency, including:

- The stability of the political system of the issuing country
- The size and prospects of the economy
- Global integration of its markets and economy
- A transparent and open economic system
- A credible legal system
- The quality of its sovereign debt
- The ability to bear costs associated with a reserve currency
- The size, depth and liquidity of financial markets

The most important factor in exchange rate stability has been the synchronization of economic growth and the coordination of monetary policy among developed nations.

There is good reason for the shared dominance of the dollar and the euro, and, to a lesser extent, the Japanese yen and the British pound.

They represent the major economic centers of the world and operate within the rule of law.

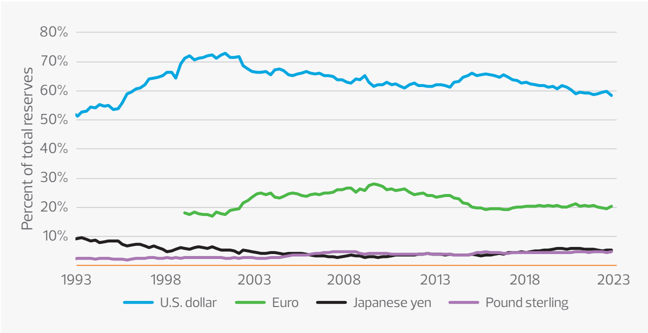
There is good reason that other currencies do not yet qualify. They are either too small (Switzerland), operate under totalitarian regimes (Russia and China), or allow for protectionism (India).

Finally, a reserve currency needs to be market-based, free-floating and, most important, stable. That rules out cryptocurrencies, which are prone to wild swings and live outside the regulatory system.

There have been two major reserve currencies in modern times: the British pound until World War II, and the American dollar for the past 75 years.

The euro has gained status since its inception as a single currency in 1999, now bolstered by the increase in transaction demand for it by developing economies in Eastern Europe and Africa.

Foreign exchange reserves by currency as a percentage of total allocated reserves



Source: International Monetary Fund; Bloomberg; RSM US LLP

MIDDLE MARKET INSIGHT

Rising interest rates in the United States, and near-zero rates elsewhere, made the dollar and dollar-denominated assets that much more attractive.

Stability of the dollar

The traditional U.S. dollar index is the weighted average of the exchange rates of six developed economies: the eurozone, Japan, the United Kingdom, Canada, Sweden and Switzerland.

The euro has a weight of 58% in the dollar index and a correlation coefficient of 0.98 based on monthly values of the dollar index and the euro since 1980.

Since 1990, the dollar index (and the euro) has experienced three periods of trading within narrow ranges, interrupted by consequential events that have altered either the demand for U.S. assets or the mix of monetary and fiscal policies.

As we show below, the pattern of range-trading followed by a breakout of the exchange rates became apparent when advances in desktop computing created the technology boom in the 1990s.

A bust followed, along with a period of the dollar range trading at a lower level from 2005 to 2015 as the sluggish U.S. economic recovery trudged along.

Late 2015 was the next turning point, when the Federal Reserve began to normalize interest rates while the monetary authorities in Europe and Japan kept rates at or below zero.

That shift in monetary policy provided a dramatic boost to the dollar as it quickly moved to a higher trading range that lasted until March 2022.

Despite the global economic growth over the past three decades, the world's current economic order is simply not going to change at the scale necessary to supplant the dollar.

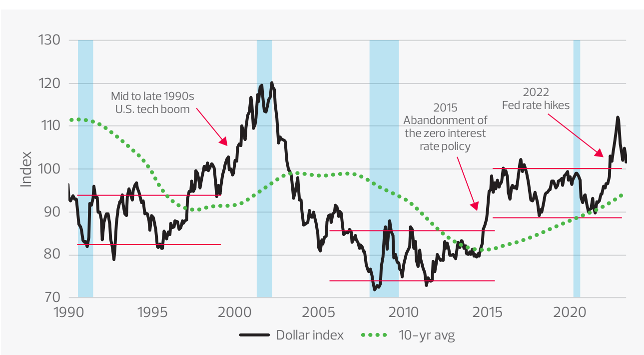
This most recent breakout was the result of the dramatic introduction of a dollar-friendly policy mix last year.

The American government was in the midst of the greatest fiscal response to an economic crisis since the Great Depression, when the Federal Reserve rapidly hiked its policy rate. The dollar soared while the European Central Bank had a lagged response to inflation and the Bank of Japan maintained its yield-curve control.

The mix of tightening monetary policy and expansive fiscal spending pushed U.S. interest rates higher. With interest rates still near zero in Japan and Europe, the dollar and dollar-denominated assets became that much more attractive.

Global investors looking for higher returns on investments in U.S. securities and business opportunities, augmented by the self-fulfilling higher currency return, flocked into dollar-denominated assets.

Breakouts from range-trading periods in the U.S. dollar index



Source: Bloomberg; RSM US LLP

Where do we go from here?

The differences in monetary policy between the United States and Europe were unlikely to last forever, as evidenced by the dollar's peak most likely occurring last September and the euro now trading back within its 2015—22 range.

We can attribute the strengthening of the euro over the past seven months to the shrinking spread between the Fed's and European Central Bank's policy rates as the ECB continues to respond to its 10% inflation rate.

There is also the newfound ability of Europe to survive the winter with diminished supplies of energy and its efforts to expand NATO. All of this is buffeted by the uncertainty surrounding the war in Ukraine.

We do not expect that an economic slowdown will drastically affect the relative policy mixes of the United States and its trading partners.

Instead, the most important factor in exchange rate stability has been the synchronization of economic growth and the coordination of monetary policy among developed nations. This is unlikely to change.

There are bound to be deviations in policy (e.g., Japan's likely end to yield-curve control) that will continue to affect individual currencies.

And there will be differences in the transaction demand for currencies, with the currencies of economies dependent on resource extraction (see Canada and Australia) more affected by trends in economic growth and in particular by the price of energy (see Japan again).

Still, we need to recognize that previous large shifts in the dollar's value were attributable to innovation breakthroughs, financial busts, or consequential changes that have affected the demand for U.S. assets.

Since 2015, the range of dollar trading has been between $1.05 and $1.20 against the euro, with a $1.12 center of gravity.

By any measure, the dollar at $1.10 is within range of its longer-term average value. Its movements beyond that range will depend on inflation, economic growth and monetary policy, all relative to what happens in the rest of the world.

There are no viable or readily available alternatives to the U.S. dollar being the reserve currency.

Whether it breaks out below or above its recent range will depend on the next round of innovation or the next crisis.

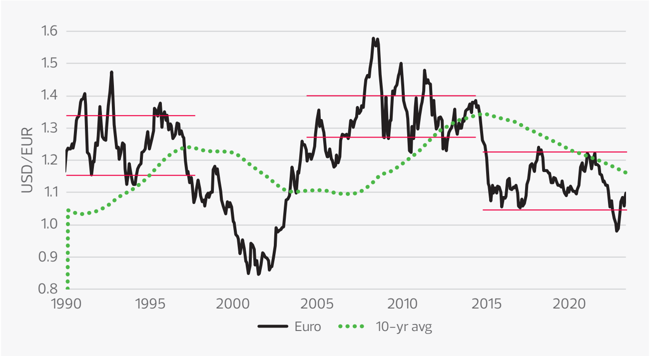
The next crisis could occur as early as June. The debt ceiling debate will devolve into an existential crisis only if Congress allows the United States to default on its debts this summer or if it accepts a thousand cuts to the dollar if this stumbling block is allowed to exist in perpetuity.

There are no viable or readily available alternatives to the U.S. dollar being the reserve currency. The result would be chaos in international trade and finance, with the cost borne by American businesses and consumers.

We also expect to hear calls for the abandonment of the regulation provided by central banks and the abandonment of traditional currencies in favor of cryptocurrencies.

Crypto advocates attribute crypto instability to growing pains and argue that, like traditional currencies, crypto fluctuates according to demand. But the demand for any currency is based on economic and societal factors underlying the currency and not purely on speculative behavior.

Range-trading periods in the U.S. dollar/euro exchange rate



Source: Bloomberg; RSM US LLP

Previous attempts to de-dollarize

The efforts of the United States, the European Union and Japan to use their prodigious financial and economic power to address the Russian invasion of Ukraine have rekindled the ideal of de-dollarization.

This is not exactly a new phenomenon. Latin American and Middle Eastern economies have attempted to exit the dollar-based system.

Since the 1970s, Latin American nations like Chile and Venezuela have tried to exit the dollar-based global financial order. Venezuela has for some time attempted to purchase oil in Chinese yuan.

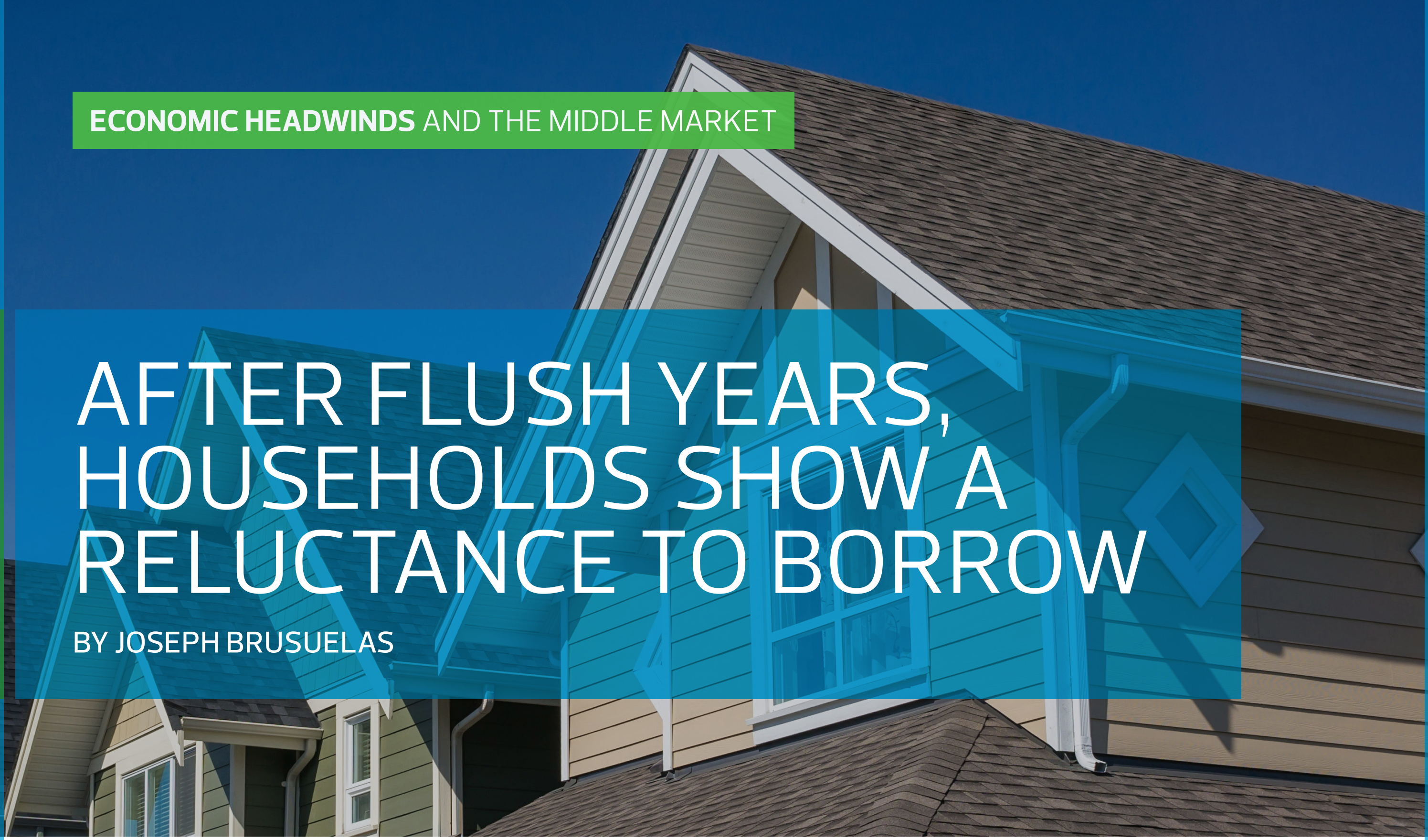
During the past half-century, Iraq and Libya attempted to move away from the dollar through the euro and a pan-African solution.

And we should all remember the entreaties by Japan in the late 1980s for the United States to consider a broader role for the yen before the bursting of the Japanese financial bubble.

That request was politely rebuffed by the Reagan administration. And one should expect no different from the current and subsequent American governments.

While we recognize that the international economy has been altered by geopolitical tensions, shifting supply chains and the return of industrial policy, we just do not see a major alternative to the rules-based system supported by the American dollar.

In fact, the only thing that would really alter the current international status quo would be for the United States to default on its debt. But that is another story for another day.



ECONOMIC HEADWINDS AND THE MIDDLE MARKET

AFTER FLUSH YEARS, HOUSEHOLDS SHOW A RELUCTANCE TO BORROW

BY JOSEPH BRUSUELAS

A PILLAR of the American economy in the recovery from the pandemic has been household balance sheets, which have been bolstered by a robust labor market and nominal income growth.

But now, with the prospect of tighter lending standards and reduced spending caused by the recent banking turmoil, it is time to take a closer look at household finances.

The data suggests that household balance sheets, along with corporate capital expenditures, have contributed to the resilience of the domestic economy and have spurred its modest growth, so far keeping a mild recession at bay.

Households have held on to approximately $4 trillion in liquid financial assets over the course of the pandemic assistance programs. Because households waited for the all-clear signal at the end of 2021 before spending again, their balance sheets are arguably in better shape than at any time since the early 1990s.

At the end of last year, households were sitting on roughly $1 trillion in excess savings alone, by our estimation.

But as these flush households face the potential of an economic slowdown, they are reluctant to take on debt. Instead, households appear to prefer precautionary saving in contrast with overconsumption.

The upper two quintiles of households, which account for roughly 60% of overall spending, are most likely sitting on more than half a trillion dollars in excess savings alone.

While most households benefited from the pandemic assistance programs either directly or indirectly, not all income groups are expected to fare as well once those programs end.

Specifically, inflation has taken a far greater toll on low-income households as they face higher food and energy costs.

Below, we look at households and their propensity to take on debt, concluding that households entered this year with a solid financial foundation and now want to maintain that status by avoiding additional debt.

Household liquidity

On a broad basis, household holdings of easily accessible funds—bank deposits and money market funds—surged during the pandemic before declining slightly in the second half of last year.

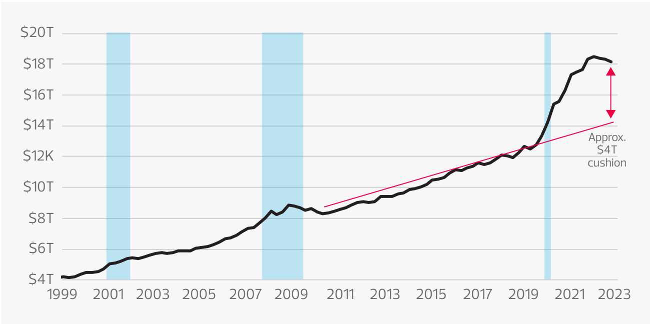
Assuming that the pre-pandemic growth in bank deposits and money market funds has continued, we think that available funds currently total $4 trillion more than would have been expected before the pandemic.

If, as we anticipate, an economic slowdown occurs in the second half of this year, those liquid funds should act as a cushion for at least a segment of the population.

And because household spending is the major component of economic activity, we can expect a relatively shallow recession or even just an economic slowdown should inflation stay elevated.

THE MOST RECENT SENIOR LOAN OFFICER OPINION SURVEYS FROM THE FED, IN OCTOBER AND JANUARY, CORRESPOND TO BOTH THE LOWER SUPPLY OF AND LOWER DEMAND FOR BANK LENDING TO HOUSEHOLDS.

Consumer liquidity*



Source: U.S. Federal Reserve; Bloomberg; RSM US LLP

*Household holdings of checkable deposits, time and savings deposits, and money market funds

Our baseline forecast for this year included a 65% probability of a recession induced by the Federal Reserve's campaign to raise interest rates and tame inflation. That rate hike campaign is partly responsible for the recent banking turmoil and the probability of reduced lending.

Consider commercial bank lending. Those loans declined by roughly $105 billion during the final two weeks of March, the sharpest decline on record dating to 1973, when that data started being collected.

Almost all of that decline was driven by small banks.

The Dallas Federal Reserve found in its recent regional economic survey that lending standards have tightened overall. It is highly likely we will see other soft survey evidence in the near term before we see it transformed into slower economic activity or an outright contraction.

The source of household liabilities

The growth of total household liabilities tends to follow mortgage expenses. Mortgages have constituted 60% to 70% of total liabilities over the decades and now account for roughly two-thirds of all liabilities.

When interest rates were sent to near zero after the financial crisis, the yearly growth rate of mortgage expenses and total credit expenses decelerated rapidly.

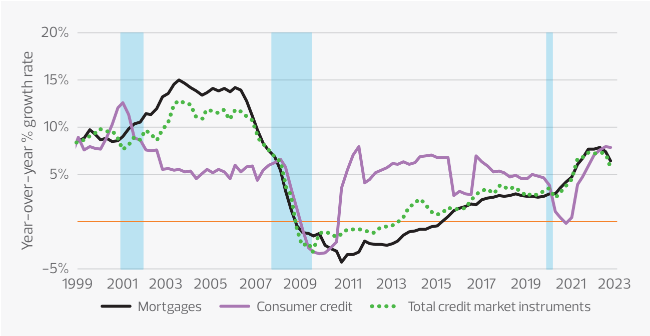
MIDDLE MARKET INSIGHT

We think that available funds currently total $4 trillion more than would have been expected before the pandemic.

During the recovery from 2011 to 2019, mortgage expenses increased along with house prices. When the demand for living space increased during the pandemic, mortgage liabilities accelerated before peaking last year.

In total, consumer credit has grown about 5% a year for most of the past two decades, except during and immediately after recessions. So the 7% growth of consumer credit last year is not all that high, coming off the low demand for credit in 2021 and reflecting a cautious outlook by households.

Growth rates of mortgage and consumer credit liabilities and total household credit market instruments



Source: U.S. Federal Reserve; Bloomberg; RSM US LLP

Balancing liabilities with liquid assets

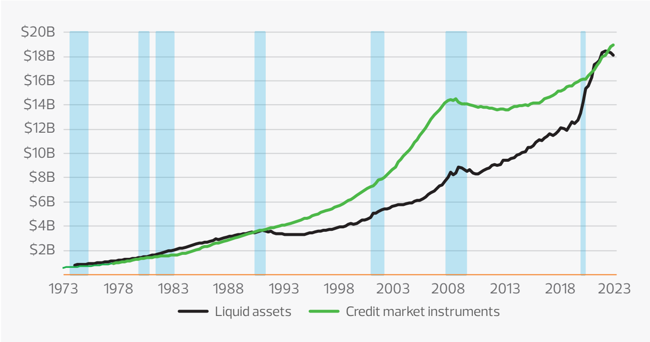
Liquid assets available to households did not keep up with household liabilities from 1991 to 2019. But that all changed in 2020 and 2021, when Congress, in concert with the Trump and Biden administrations, kept businesses afloat, kept workers employed and pumped money into family balance sheets.

CONSUMER CREDIT HAS GROWN ABOUT 5% A YEAR FOR MOST OF THE PAST TWO DECADES. SO THE 7% GROWTH LAST YEAR IS NOT ALL THAT HIGH, COMING OFF THE LOW DEMAND FOR CREDIT IN 2021.

In addition, Russia's invasion of Ukraine wreaked havoc with food and energy prices, while the pandemic altered the supply chain, the labor market and living choices. The result was a higher cost of goods and services.

That was closely followed by the bursting of the technology and crypto bubbles and the turmoil in the banking sector, all of which threatened the financial sector. Those events, combined with the Fed's response to inflation, are likely to increase caution among households and precipitate an economic slowdown or a recession.

Household holdings of liquid assets and liabilities



Source: U.S. Federal Reserve; Bloomberg; RSM US LLP

Reduced willingness to lend

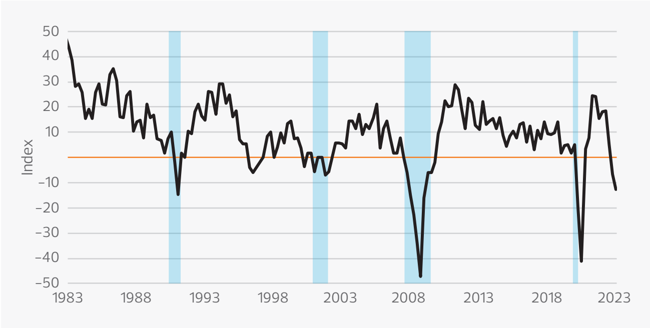
The Fed's survey of bank lending and lending standards confirms the increase in caution by both banks and lenders.

It makes sense that banks would indicate a greater willingness to make consumer loans during economic recoveries than they would during an economic downturn.

The most recent releases of the Federal Reserve's Senior Loan Officer Opinion Survey, in October and January, correspond to both the lower supply of and lower demand for bank lending to households in the third and fourth quarters of last year.

As we show, the second half of last year would be the first time that banks indicated a decreased willingness to lend outside of a recession since the first loan officer survey in the early 1980s.

Supply of consumer loans*



Source: Federal Reserve Senior Loan Officer Opinion Survey; Bloomberg; RSM US LLP

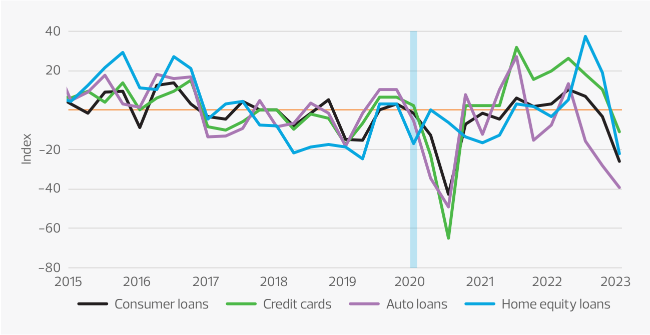
*Increased willingness of banks to make a consumer loan

Consumer demand for loans falls

As it turns out, the unprecedented drop in the willingness to lend was matched by a drop in consumer demand for loans during the fourth quarter.

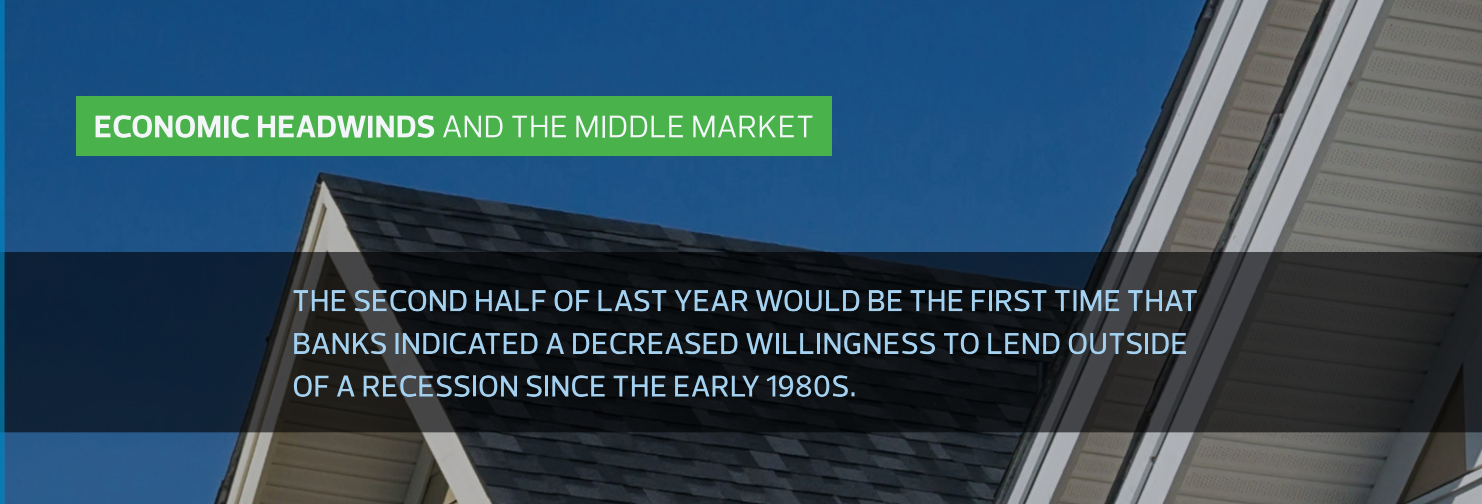
In fact, this is the first time since the depths of the pandemic that the loan officer survey was negative regarding consumer loans, credit cards, auto loans and home equity loans.

Demand for consumer loans*



Source: Federal Reserve Senior Loan Officer Opinion Survey; Bloomberg; RSM US LLP

*Banks reporting increased demand for consumer loans



THE SECOND HALF OF LAST YEAR WOULD BE THE FIRST TIME THAT BANKS INDICATED A DECREASED WILLINGNESS TO LEND OUTSIDE OF A RECESSION SINCE THE EARLY 1980S.

MIDDLE MARKET INSIGHT

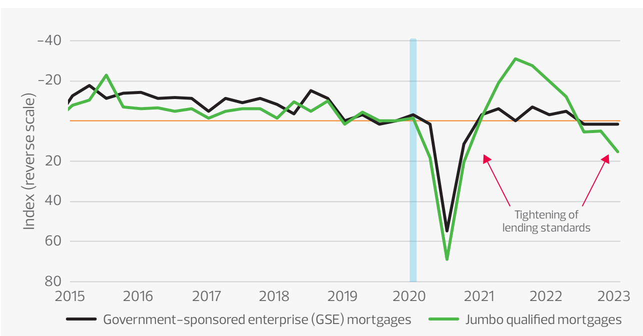
Commercial banking loans declined by roughly $105 billion during the final two weeks of March, the most on record. Almost all of that decline was driven by small banks.

Tightening mortgage standards

Surveys of lending standards and demand for mortgages are available only since 2015. As one would assume, banks have developed more stringent criteria for mortgage lending, particularly since the bursting of the housing bubble was the catalyst for more than 500 bank failures between 2008 and 2014.

The increase in banks reporting tightened lending standards for residential mortgages in the last three quarters of last year suggests rising caution by lenders and a drop in funds available for homebuyers.

Implied supply of residential mortgages*



Source: Federal Reserve Senior Loan Officer Opinion Survey; Bloomberg; RSM US LLP

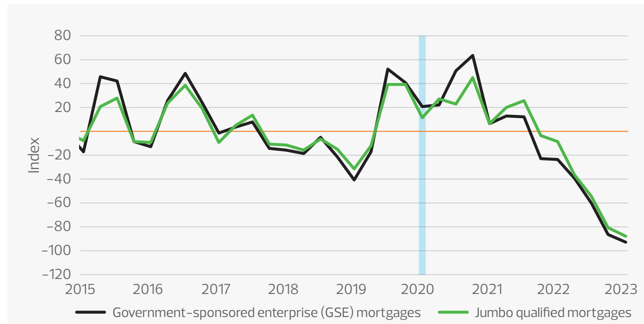
*Banks reporting tightening of lending standards for mortgages

Decreased mortgage demand

The tightening of lending standards also implies an increase in the cost of borrowing and an expectation for a decrease in the demand for mortgages.

Interest rates for 30-year fixed-rate mortgages more than doubled, from less than 3% in 2021 to more than 7% last year. Banks subsequently reported a steady decrease in the demand for mortgages.

Demand for residential mortgages*



Source: Federal Reserve Senior Loan Officer Opinion Survey; Bloomberg; RSM US LLP

*Banks reporting increased demand for mortgages

Looking ahead

We expect the next loan officer survey, in May, to show mortgage rates drifting lower and a further moderation in demand for mortgages as households reach their limit on debt.

Given the recent financial instability and the increase in inflation, the maintenance of the 2020–21 accrual of liquid assets by households suggests a lower propensity to spend and a preference for precautionary savings.

Consumers have many reasons to remain cautious. We are far from the Federal Reserve's 2% inflation target or the resolution of the war in Ukraine. We are also still affected by OPEC's influence on oil supplies.

All those factors suggest that inflation will remain high and that the Fed will need to continue to keep interest rates elevated.

We can expect households to reduce spending as they factor in slower growth. All in all, a consumer pullback would curtail employment and further slow economic growth.

ARE THE GOOD TIMES IN CONSUMER SPENDING COMING TO AN END?

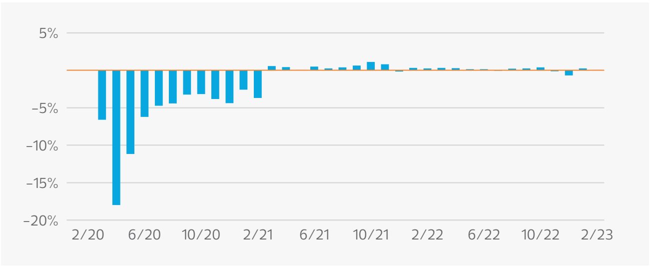
BY MIKE GRAZIANO, PETER CADIGAN AND TUAN NGUYEN

AMERICAN CONSUMERS have shown remarkable resilience as the economy has rebounded from the depths of the pandemic. Overall spending has remained robust, despite elevated inflation and rising interest rates.

But that could be changing. Lower-income consumers have started to show cracks in demand, and that could spread as the Federal Reserve's rate hikes and recent banking instability take their toll.

The following analysis looks at where consumer spending has been concentrated over the last three years, the difference in buying power across income quartiles and other macroeconomic factors that will affect spending moving forward.

Spread between real consumption and pre-COVID-19 estimates*



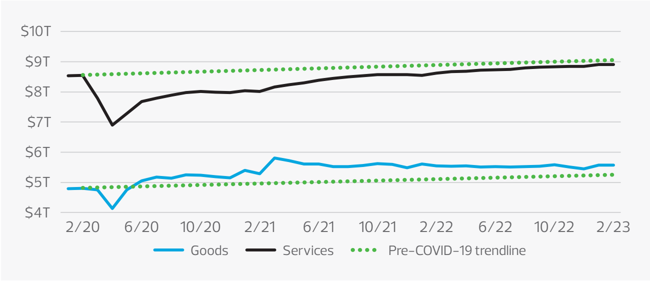
Source: U.S. Bureau of Economic Analysis; RSM US LLP

*Pre-COVID-19 estimates are based on the average monthly growth rate over the Five years preceding the pandemic (0.2%) applied to the base period February 2020.

Consumption overview and outlook

After the initial shock of the pandemic in March and April 2020, the spread between cumulative real consumption (adjusted for inflation) and pre-COVID-19 estimates reached a trough of 18.0%, as the unemployment rate reached an all-time high, 14.7%, in April 2020. Aided by economic stimulus payments, real spending exceeded pre-COVID-19 estimates in March 2021 and continued through that December, when a resurgence of the coronavirus cut into spending. But even with that pullback, real spending increased 8.3% in 2021, after a 3.0% decline in 2020. Last year, overall consumption continued to grow, increasing 2.8%.

Goods vs. services consumption

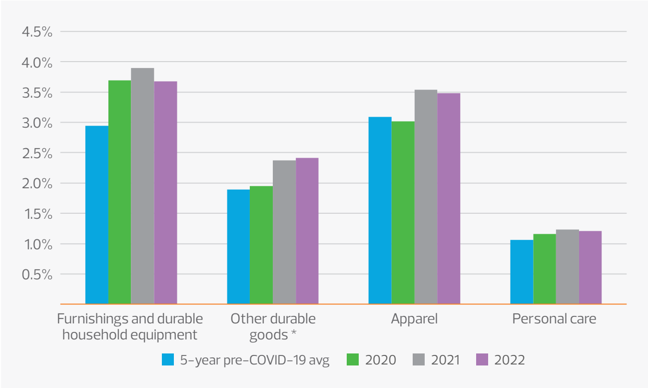


Source: U.S. Bureau of Economic Analysis; RSM US LLP

REAL CONSUMER SPENDING HAS BEEN ROBUST, RISING BY 8.3% IN 2021 AFTER A 3.0% DECLINE IN 2020. LAST YEAR, OVERALL CONSUMPTION CONTINUED TO GROW, INCREASING 2.8%.

The largest beneficiary of spending over the past three years has been consumer products companies. In the five years before the pandemic, monthly spending on services like dining out, travel and home repairs averaged 65% of total monthly consumption. But since March 2020, this percentage has declined to 61%, with the balance shifting to goods.

Percentage of monthly consumption for discretionary consumer goods—in real dollars



Source: U.S. Bureau of Economic Analysis; RSM US LLP
*Other durable goods includes: Jewelry and watches, therapeutic appliances, educational books, luggage and similar personal items, and telephone and facsimile equipment

Discretionary consumer categories have benefited from this shift as monthly wallet share percentages continue to exceed the five-year pre-COVID-19 average. For example, furniture and home furnishings accounted for 2.9% and apparel 3.1% of monthly consumption on average in the five years before the pandemic. In 2021, these percentages increased to 3.9% and 3.5%, an increase of 34.5% and 12.9%, respectively. Much of the demand for these goods was driven by the refinance and renovation boom in 2021 spurred by historically low mortgage rates, as well as the shift to hybrid work and repurposing of wardrobes toward athleisure and luxury goods.

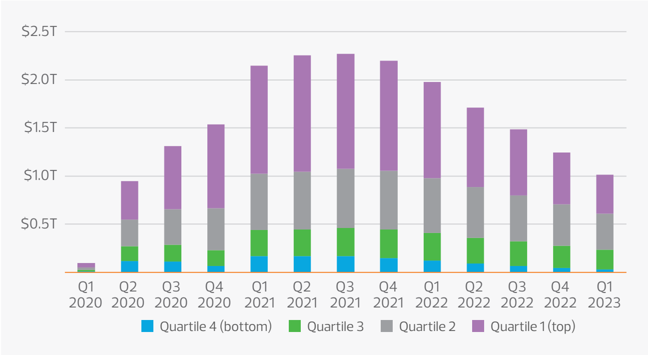
With the second quarter underway, however, there is evidence that some of the spending on discretionary goods has begun to recede. Over the past 12 months, monthly wallet share for home furnishings and apparel has fallen from the peak in 2021, and many public statements from consumer products companies have pointed to softness in demand.

Excess savings impact

Excess savings have been a significant tailwind for consumers since early in the pandemic. Even with an estimated $1 trillion of excess savings remaining, though, this is not expected to have the same impact on consumption as it did in 2021, because nearly 75% of excess savings is concentrated among the top two quartiles of income earners.

Since this cohort accounts for approximately 60% of consumption, many consumer products companies are leaning into the "premiumization" of everyday products, in an effort to capture discretionary dollars from those willing and able to spend. However, as more everyday products target top income earners, this will put further pressure on lower-quartile earners, who have eaten into nearly all their excess savings, based on our estimates.

Cumulative excess savings by income level since 2020



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

Debt levels by quartile

Consumers are known to stop spending not when they should, but rather when they have to. For some income levels, the point at which they should have curtailed spending has most likely already passed. Consumer debt levels showed year-over-year increases for all income quartiles in December 2022, with the exception of the top quartile, according to the Federal Reserve.

ECONOMIC HEADWINDS AND THE MIDDLE MARKET

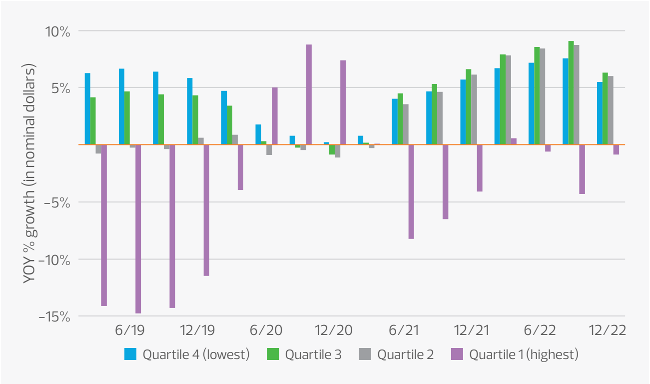
THE TOTAL CONSUMER DEBT ATTRIBUTED TO THE LOWER TWO QUARTILES REACHED NEARLY 92% IN DECEMBER, THE HIGHEST LEVEL FOR THIS COHORT IN 10 YEARS.

MIDDLE MARKET INSIGHT

As the second quarter approaches, there is evidence that some of the spending on discretionary goods has begun to recede.

In addition, the total consumer debt attributed to the lower two quartiles reached nearly 92%, the highest concentration of consumer debt in this cohort in 10 years, with a large portion attributed to student loans. But it excludes the impact of buy now, pay later, which has grown to include everyday products, suggesting the debt burden for the lower-income quartiles is greater than it appears.

Consumer debt by income level*



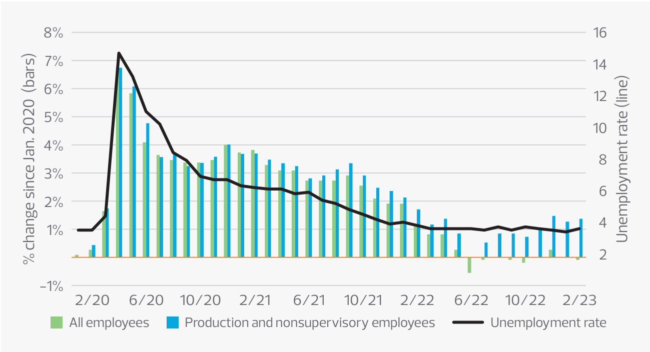
Source: U.S. Federal Reserve; RSM US LLP

*Consumer debt includes revolving and nonrevolving consumer credit

While the most recent consumer price index experienced a top-line decline to 5.0% in March, inflationary pressures for fixed monthly categories remain elevated and continue to disproportionally affect lower-quartile earners' ability to spend, forcing those consumers to dip into savings or rely on debt to purchase everyday goods. In addition, these consumers typically do not have the benefit of a hybrid workplace and will be hurt by higher gas prices, similar to last summer.

Amid sustained inflationary pressures, consumer shopping patterns appear to have shifted toward discount and club stores and products, shelf-stable food, and private label goods, which indicates upper-level consumers are trading down and looking for value.

Unemployment and real wages



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

Finally, labor continues to be a bright spot for consumers. With the unemployment rate at 3.5% for March, there is no shortage of open jobs. As long as consumers have a consistent paycheck, some discretionary spending will most likely continue. Further, while excess savings levels have fallen for lower-income earners, real wages for production and nonsupervisory employees increased by 1.4% in February, providing critical financial support.

The takeaway

While consumer spending has returned to pre-COVID-19 expected levels and some tailwinds remain, particularly for upper-income employees, a consumer pullback is likely a matter of when, not if, consumers pull back. Understanding the pressures across income quartiles will be critical in future periods for consumer products companies.

While upper-income earners continue to maintain ample savings to spend at will, and since this cohort accounts for the majority of consumer spending, overall retail sales or consumer spending growth could mask the pressures felt by other consumers. As long as inflation—especially on food, gasoline and shelter—remains elevated, lower-quartile earners will continue to face sustained financial pressure and will have to start pulling back on their spending habits, if they have not already done so.

GROWTH, EMPLOYMENT AND IDENTIFYING THE END OF A BUSINESS CYCLE

BY JOSEPH BRUSUELAS

U.S. ECONOMIC GROWTH during the first quarter most likely reached 2.35% based on our RSM forecast, in contrast with the 2% estimated by other sources.

This growth, though, is not likely to last. Given the emerging consensus among other economists that the economy will fall into a recession this year, a discussion around identifying the end of the business cycle is in order.

RSM now forecasts a 75% chance of a recession over the next 12 months, an increase over our previous estimate of a 65% probability in the second half of the year. This change has been driven by the likelihood of tighter lending standards following the recent turmoil in the banking sector.

This higher probability of a recession follows a period of strength in the economy. If anything, the R word that should be used in connection with the American economy should be resilient, not recession. That nearly two years of elevated inflation and interest rate increases have not resulted in a recession by now is something to be analyzed and understood.

Yet that resilience appears to be giving way. The Federal Reserve's rate hikes are starting to pull down growth just as tighter lending will probably cool the economy further over the next few months. The risks of a recession despite that resilience cannot be discounted.

The business cycle

The current business cycle will most likely go down as one of the shortest in American history.

In three years, the economy has gone from a health-crisis shutdown to a rapid recovery to a monetary policy-induced slowdown.

While it's up to the National Bureau of Economic Research to identify the peak and trough of each business cycle after the fact, it's equally important for businesses and households to analyze economic crosscurrents so they can plan for what's ahead.

Let's start with the NBER's definition of a recession, which involves a significant decline in economic activity that is spread across the economy and lasts more than a few months. It treats three criteria—depth, diffusion and duration—as somewhat interchangeable in its analysis.

RSM NOW FORECASTS A 75% CHANCE OF A RECESSION OVER THE NEXT 12 MONTHS, AN INCREASE OVER OUR PREVIOUS ESTIMATE OF A 65% PROBABILITY IN THE SECOND HALF OF THE YEAR.

MIDDLE MARKET INSIGHT

It is quite clear that the real estate sector—another area of the economy sensitive to interest rates—has been in recession for some time.

The most recent example is the plunge in economic activity during the pandemic, which lasted for two months and overwhelmed the NBER's traditional criteria of a recession.

In contrast, the negative growth in two consecutive quarters at the start of 2022 was not identified by NBER as a recession, primarily because it did not occur contemporaneously with a broad-based decline in employment and real final sales.

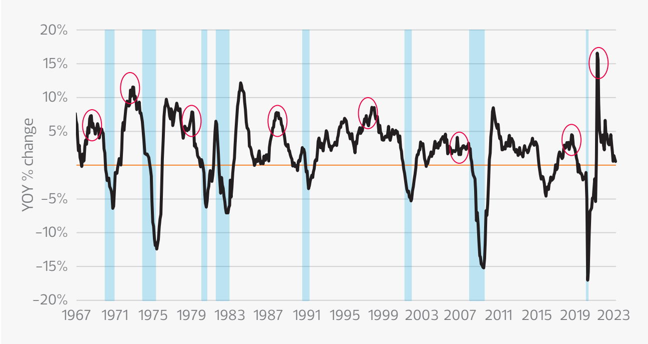
The NBER looks at several indicators to identify the chronology of a business cycle, including:

- Real personal income less transfers
- Nonfarm payroll employment
- Employment as measured by the household survey
- Real personal consumption expenditures
- Wholesale and retail sales adjusted for price changes
- Industrial production

It's important to note the NBER's finding that the economy is usually expanding. Recessions occur, but they are usually short-lived.

Consider industrial production, an area of the economy that is sensitive to interest rates and grows along with the expansion of the business cycle, but often peaks long before the end of each cycle. At the end of some cycles, industrial production has dropped quickly, but only after the economy has slipped into a recession. Most recently, industrial production had already become contractionary in 2019 before the economy suffered from the 2020 health crisis.

U.S. industrial production at the end of business cycles



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

While industrial production is still growing, manufacturing sentiment has resided in terrain consistent with a recession for the past four months.

And it is quite clear that the real estate sector—another area of the economy sensitive to interest rates—has been in recession for some time.

So what can we say about the likelihood of this business cycle lasting only a few more months?

To begin with, the Federal Reserve has determined that restoring price stability is in the long-term best interest of the economy. Price stability is a precondition of maximum sustainable employment, and inflation must be reduced to tolerable levels to cool an overheated economy.

The effect of increasing rates by 475 basis points over the past 12 months is finally having an effect on inflation, investment decisions and, increasingly, the labor market. Upcoming economic data on gross domestic product and the personal consumption expenditures index should demonstrate further signs of cooling in the economy.

But with underlying inflation still running somewhere between 4% and 5%, it will be some time before the all-clear signal can be declared on inflation and the policy rate can be cut.

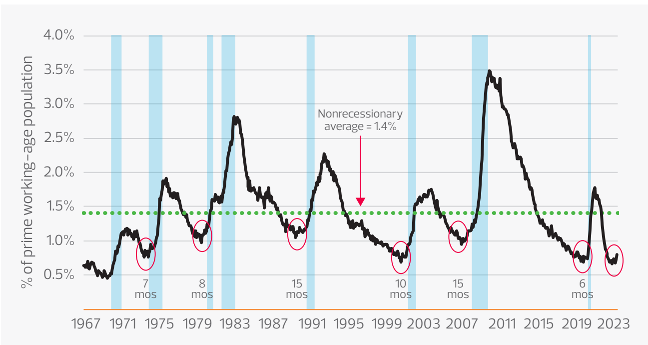
WHILE INDUSTRIAL PRODUCTION IS STILL GROWING, MANUFACTURING SENTIMENT HAS RESIDED IN TERRAIN CONSISTENT WITH A RECESSION FOR THE PAST FOUR MONTHS.

We expect the Federal Reserve to increase its policy rate by 25 basis points at its next meeting on May 3, and do not expect any rate cuts this year.

In terms of a possible wage-price spiral, wages for higher-paying manufacturing jobs have dipped to less than a 5% yearly growth rate in the past two months.

Average hourly earnings that were growing by 7% in March 2022, before the Fed began its rate hikes, have slowed to a 5.1% yearly growth rate, with most of those gains occurring among lower-wage jobs.

U.S. permanent job losses at the end of business cycles*



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

*And number of months between trough in losses and the following recession

In terms of employment opportunities, which indicate the demand for labor and, ultimately, the cost of labor, there are now signs of maturation in the labor market similar to what occurred at the end of each of the business cycles since the 1970s.

As one would expect, the demand for labor increases along with the progression of the business cycle. Increased economic activity results in higher demand for labor and fewer job losses.

But as the business cycle wanes, the demand for labor wanes, and job losses increase. We see this in the months before a recession officially begins.

For instance, in September 2022, the U.S. Bureau of Labor Statistics reported 1.76 million permanent job losses. Six months later, there were nearly 2.12 million permanent job losses.

MIDDLE MARKET INSIGHT

If anything, the R word that should be used in connection with the American economy should be resilient, not recession.

If this increase in job losses were to persist, that would suggest an increase in the supply of available labor and a reduced need to offer higher wages.

The loss of jobs and the reduction in income imply a growing reluctance to spend on the part of households and businesses and a slowdown in overall economic activity.

We don't expect this to happen overnight. Businesses will be reluctant to shed workers who were so hard to attract after the pandemic.

There will be sustained demand for labor for the infrastructure programs enacted in 2021—22. And there will be continued government spending on defense outlays and likely additional special supplemental spending bills to support efforts in Ukraine. All these dynamics will stoke industrial production and moderate job losses.

Still, recessions are typically the result of a financial or economic shock that pushes a mature business cycle into recession.

The recent turmoil among small and regional banks will almost certainly result in tighter lending. Small firms obtain roughly 70% of their commercial and industrial loans from these institutions.

This tighter lending, in turn, will place an additional constraint on growth in the real economy in the middle of the year. That also happens to be when the next potential shock—the standoff over raising the nation's debt ceiling—will most likely take place.

Tighter lending and a bout of financial turmoil caused by the political sector are possible tipping points that could turn a Fed-induced slowdown into a recession.

CYBER RISKS REMAIN A CONCERN

THE MIDDLE MARKET is bolstering its cybersecurity as threats to proprietary information persist, according to data in the recent RSM US Middle Market Business Index survey.

The number of organizations with a dedicated function for data security and privacy jumped by 17 points to 77% from a year earlier, with the highest level of commitment (91%) at larger middle market organizations, according to MMBI data for the first quarter.

The survey was conducted from Jan. 9 to Jan. 30 and reflects the views of 406 senior executives at middle market firms across industries.

Among the findings of the survey:

Cybersecurity concerns increasingly go straight to the top ...

40%

of firms with a cybersecurity officer said that person reports directly to the chief executive officer.

25%

responded similarly a year earlier.

... as cyberattacks continue, though they are abating.

20%

of firms reported a data breach in the past year. That's down only slightly from a year earlier, but well below the **28%** in 2021.

Larger middle market firms remain vulnerable, though ...

28%

of larger midsize firms, or those with $50 million to $1 billion in annual revenues, experienced a breach last year.

For the full details on the MMBI cybersecurity findings, be on the lookout for our special report, coming soon.

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

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

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

TRE-NT-ALL-ALL-523

RSM