THE REAL ECONOMY

VOLUME 86

THE FEDERAL RESERVE'S DILEMMA: TAMING INFLATION WHILE ACHIEVING FULL EMPLOYMENT

AMERICANS EARN MORE THAN BEFORE THE PANDEMIC, EVEN AFTER INFLATION

THE ALTERNATIVE: THE RISE OF ESG HAS GROWING IMPLICATIONS FOR THE TECH INDUSTRY

INDUSTRY SPOTLIGHT: HOW PROCESS INTELLIGENCE CAN MAKE INSURERS MORE EFFICIENT

MIDDLE MARKET TREND WATCH: A TIGHT LABOR MARKET CHALLENGES THE MIDDLE MARKET

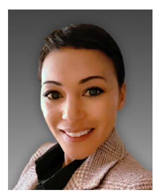
THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

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



MARLENE DAILEY
DIRECTOR
FINANCIAL SERVICES SENIOR ANALYST

TUAN NGUYEN
U.S. ECONOMIST, RSM US LLP

DAVIS NORDELL
SENIOR MANAGER
TECHNOLOGY SENIOR ANALYST

THE FED'S MANDATE | PRICE STABILITY

MONETARY AND FISCAL POLICY IN A CHANGING ECONOMY: THE FED'S MANDATE FOR PRICE STABILITY

BY JOSEPH BRUSUELAS

The first two articles in this issue of The Real Economy explore the Federal Reserve's dilemma of taming inflation while maintaining full employment. They are from a series examining the overriding monetary and fiscal policy challenges in today's economy.

IN THE YEAR AHEAD, the economy and financial markets will be influenced by how the Federal Reserve strikes a balance between its dual mandates of full employment and price stability.

With inflation at its highest point in decades, we think the central bank will move to normalize its monetary policy by first winding down its asset purchases and then raising interest rates—all without undermining the recovery.

The extent to which the Fed manages to bring down inflation and strike that balance will largely determine the lifespan of its flexible average inflation targeting policy or set the stage for an opportunistic increase in the 2% target to 3% in the coming years.

As the normalization in rates takes place this year, we do not expect steep increases like those that took place under Paul Volcker, even if inflation proves stubborn this year and next.

This is why the market has priced in three rate hikes this year, with a 90% possibility of a fourth. But even that may end up fewer given the likely appointment of three Fed members who are almost certain to lean toward the full employment side of the Fed's dual mandate.

Traditionally, fiscal and monetary authorities have moved to counter inflationary pressures through aggressive tax, monetary and regulatory policies. That means tax and interest rate increases, as well as policies that result in a better allocation of capital that discourages bubbles, whether they are in housing or financial markets.

MIDDLE MARKET INSIGHT

The imposition of price controls under current conditions would be a grave error that would only provide an illusion of short-term stabilization.

Given the use of the Fed's balance sheet as a policy tool over the past two decades, it is likely that the central bank will choose to permit a runoff of its balance sheet this year.

Between 2017 and 2019, the Fed let its balance sheet fall by roughly $50 billion per month. In our estimation, Fed officials will most likely allow that to reach $100 billion once it begins, which will probably happen after the Federal Open Market Committee policy decision in September.

Tax hikes, though, seem unlikely for now, and changing incentives around housing and financial investment will take time to work.

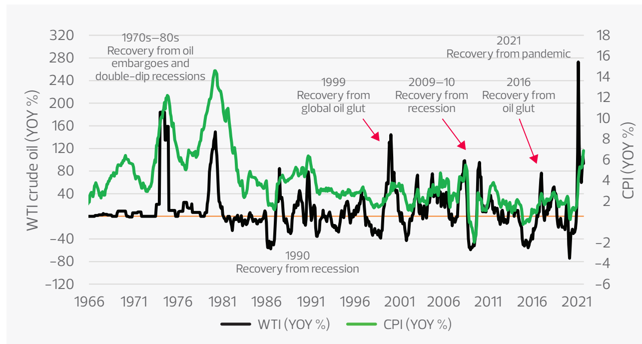
It all puts more pressure on the Fed to counter inflation by raising interest rates and by reining in speculative investment through public persuasion, known as open-mouth operations.

With inflation surging, there have already been calls for emergency price controls used to combat shortages during World War II and then again, in response to the OPEC oil embargoes in the 1970s.

While for some, selective price controls would be preferable to Fed rate hikes that have the potential of derailing the recovery, we would disagree.

The imposition of price controls under current conditions would be a grave error that would only provide an illusion of short-term stabilization. The more likely outcome of price controls would be medium-term distortions and longer-term dislocation across the economy.

The impact of price increases of U.S. crude oil on consumer prices



Source: FRED; RSM US LLP

Inflation's return

Inflation last year was a result of a series of policy-induced shocks that followed the pandemic:

- **The initial supply shock** in 2020 caused by the unprecedented pullback in economic activity and shutdown of the global economy
- **The demand shock** caused by the reopening of the economy last year
- **The second supply shock** caused by bottlenecks in the supply chain and the renewed spread of the virus among trading partners

Energy price increases accounted for more than 36% of the 6.9% total yearly increase in consumer prices last year through November, with food prices taking a 12% share.

Increases in the price of all other goods accounted for 57% of total inflation, with the limited supply of new and used cars responsible for about 22% of total inflation. Rent of shelter accounted for 18% of the total increase in inflation, with the imputed owners' equivalent rent increasing by 12%.

The increase in the cost of shelter is the one sector directly attributable to the health crisis and Fed policy. Because of the pandemic, there was an extraordinary increase in the demand for more living space, particularly for families with children fleeing cities for the suburbs.

Because of Fed policies—a zero nominal interest rate and purchases of mortgage-backed securities—mortgage rates that were already low fell even further. That decline allowed for the housing stock, which had been in short supply since the financial crisis, to be bid up.

This presents a dilemma for the Fed. What is the trade-off between the need for new housing and the need to raise interest rates from close to zero?

The largest increases in inflation have occurred during periods of sharp rises in the price of oil. (These spikes coincided with rising demand after economic slowdowns while some were the result of exogenous forces.)

It follows that in an economy that has relied on fossil fuels, an increase in the price of crude would show up in the prices of most other goods and services.

But the relationship between oil and inflation has changed. It was far stronger before 2000 than over the past 20 years. As the economy diversifies away from an overreliance on fossil fuels, that relationship should continue to fade and inflationary pressures ebb over the medium to long term.

That being said, the Fed cannot be expected to solve a public health crisis or to influence the response of OPEC to an oil shortage.

But the Fed can facilitate investment through interest rate policies to mitigate those problems. That is why even as the nominal policy rate rises, real interest rates will remain negative in the near term and are what can be called accommodative even as the economy cools this year.

MIDDLE MARKET INSIGHT

Tax hikes seem unlikely for now, and changing incentives around housing and financial investment will take time to work.

For those reasons, we anticipate an acknowledgment of the problems caused by inflation and a measured response by the Fed that will not tip the economy into recession.

Expectations for the economy

Despite increases in the cost of housing, food and energy, we doubt that the Fed intends to suddenly change course and embark on an inflation-squashing program of steep interest rate increases. Instead, there are many reasons to expect the members of the Federal Open Market Committee to talk like hawks and walk like doves, at least for the time being. Why will that condition likely prevail?

Long-term growth

First is the decline in long-term growth. It's debatable if in the medium term the underlying economy could support normal rates of inflation and interest rates once the pandemic shortages are sorted out.

Recall that real gross domestic product growth has been in decline for decades, slipping from a five-year average rate of 4% per year in the 1970s to less than 2% by late 2019, just before the pandemic. During this deceleration, the economy flirted with deflation and substandard inflation rates of less than 1.5% per year.

MIDDLE MARKET INSIGHT

The relationship between oil and inflation has changed. It was far stronger before 2000 than over the past 20 years.

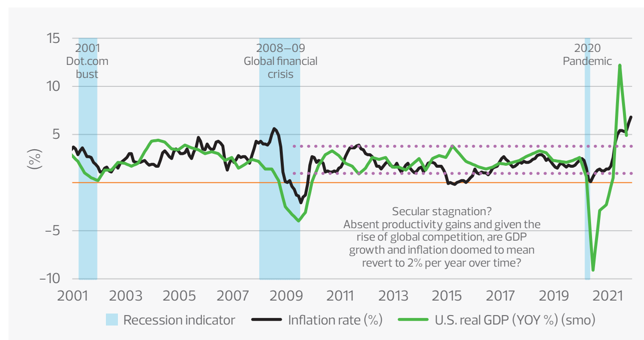
The paucity of growth removes the likelihood of long-term inflation pressures from unconstrained demand or rising wages. Inflation last year can be traced to production shortages and logistic shortfalls that will eventually be rectified. And there is little likelihood of wage increases for low-wage employees continuing for a long time.

The Fed projects that real GDP growth will recede to 4% this year and then to 2.2% next year before easing to 1.8% in the longer run. The Fed's projection for the personal consumption expenditures index—its closely watched inflation variable—has price increases receding to 2.6% this year, and then to 2.0% in the longer run. That is hardly the stuff of 1970s inflation.

These low estimates for growth most likely stem from uncertainty. In the short term, there is no clear answer regarding damages to the labor force, the long-term health consequences of COVID-19 or the ability to bridge the ideological resistance to vaccinations.

In the long term, the economy will not necessarily remain competitive without public investment. We would attribute the low expectations for inflation to diminished demand and confidence in the Fed's ability to squash inflation if needed.

Secular stagnation: Moderate growth and disinflation after the financial crisis



Source: BLS; Bloomberg; RSM US LLP

The real long-term neutral rate of interest

Second, the real long-term neutral rate of interest, or R*—which is the interest rate that supports the economy at maximum output while keeping inflation constant—is approximately 0.5% in our estimation. That low level is a result of a reduced risk appetite, demographic changes and lack of attractive investments, all of which lead to lower real returns.

The Fed cannot increase the nominal policy rate too much above 2.5% without creating conditions for a recession. To do otherwise would create longer recessions and slower recoveries.

Productivity

Third is the expectation of an increase in productivity. Because of the onset of the work-at-home economy and a strong increase in capital expenditures, we expect that productivity per hour will improve noticeably during this business cycle. In addition, the infrastructure legislation over the medium term will lift productivity and dampen inflationary pressures.

Still, it will take some time for the infrastructure boost to become a factor, and although corporations are planning capital investments—most likely because of the difficulty in staffing—the economy is relying on a labor force that is eager to move on to other endeavors, is unqualified for the requirements of advanced manufacturing or is hampered by family requirements.

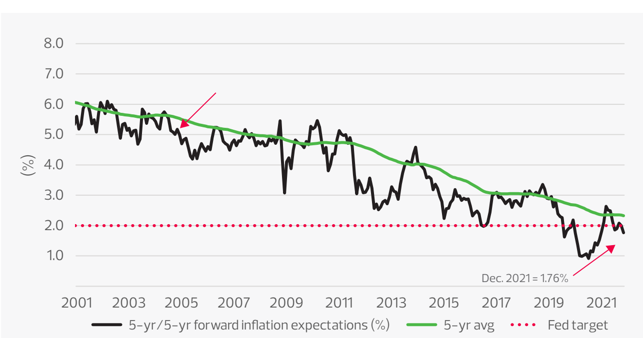
Managing expectations

Fourth are subdued expectations of inflation. To the extent that inflation is a self-fulfilling prophecy, we doubt that consumers would suddenly change their spending behavior to cause an extended and sustained increase in the demand for products.

Given that the fiscal boost is fading, the holiday crush of shopping is now over, and with infections surging again, it's more likely that consumers will remain close to home over the winter.

The Philadelphia Fed's ATSIX model of inflation expectations anticipates an inflation rate of 2.5% next year, and that will drift lower to 2.1% in 10 years. This coincides with the market expectations of 1.8% inflation in 10 years based on forward rates of five-year Treasury yields five years from now.

Inflation expectations imply price stability*



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

*U.S. Treasurys 5-year, 5-year forward rate

Price stability

Fifth, price stability does not mean zero inflation, despite assertions otherwise. Monetary authorities in developed economies, including the Fed, began targeting a 2% inflation rate in recent decades. But like the assumed Fed target of a 5% unemployment rate, the 2% target for inflation might be out of date as well.

In fact, the Fed has been explicitly looking for inflation to be higher than 2% in the short term to balance out the long period of disinflation and to move beyond the several dangerous bouts of deflation during the past decade. This is one part of the Fed's flexible inflation targeting policy.

And though the Fed's projection for the core personal consumption expenditures index remains 2.0% over the long term, a recent paper by a former Fed research director finds that raising the target rate to 3% would be in the best interest of job creation and equality of opportunity, and would also allow the Fed more room to fight recessions.

The authors cite criticism of raising the proposed inflation target, including unanchored inflation expectations. Still, there are examples that this could be achieved through explicit guidance. Examples are the Bank of Canada's 1% to 3% range around its target of 2%, which allows for more policy leeway, and the recent Fed guidance that it would accept higher temporary inflation rates.

The takeaway

Should inflation remain stubborn and not return to the 2% target in the near term, then an opportunistic resetting of the inflation target to 3% may be in the cards.

MONETARY AND FISCAL POLICY IN A CHANGING ECONOMY: MEETING THE FED'S FULL EMPLOYMENT MANDATE

BY JOSEPH BRUSUELAS

DESPITE RECENT GAINS in the labor market and rising inflation, we think the Federal Reserve will act in measured steps as it removes its financial accommodation. Monetary policy will continue to adapt to a new set of circumstances within the labor market and regarding to the potential growth of the economy.

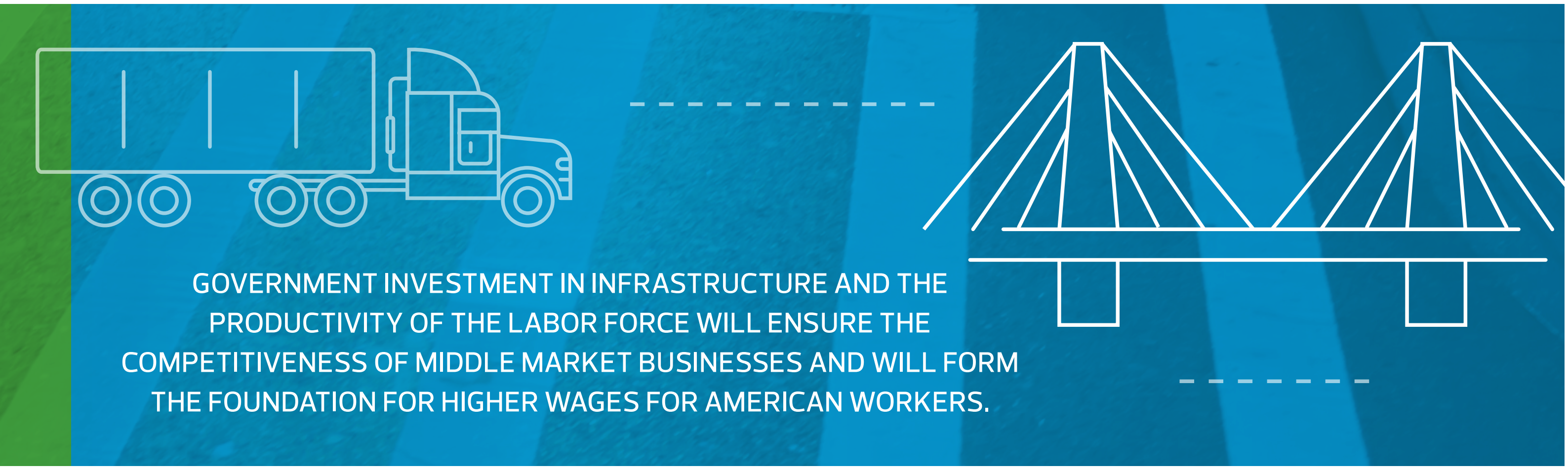
As we look ahead to the eventual transition of the pandemic into a more manageable endemic—once the omicron variant eases—we are looking for a gradual acceleration of the Fed's policy normalization beginning no later than the second quarter. There is the caveat of delayed action should new outbreaks emerge.

As for fiscal policy, Congress seems unlikely to pass the second half of the Biden administration's infrastructure revitalization program. After allocating money for rebuilding the nation's failing transportation and energy systems, this half of the administration's program was focused on boosting the productivity of the labor force and the transition to an economy centered on innovation.

These decisions, by the Fed and Congress, will affect the climate for investment. Low interest rates will continue to add to the profitability of private capital investment with debt paid off in deflated dollars.

And government investment in infrastructure and the productivity of the labor force would facilitate the global competitiveness of those businesses and will form the foundation for higher wages and wealth accumulation of the U.S. labor force.

With fiscal investment either already allocated or at the mercy of political pressures, our discussion that follows centers on monetary policy and the Fed's dual mandate for full employment and price stability.



GOVERNMENT INVESTMENT IN INFRASTRUCTURE AND THE PRODUCTIVITY OF THE LABOR FORCE WILL ENSURE THE COMPETITIVENESS OF MIDDLE MARKET BUSINESSES AND WILL FORM THE FOUNDATION FOR HIGHER WAGES FOR AMERICAN WORKERS.

This is of increasing importance as the pandemic continues to have a profound impact on the labor market, global supply chains and inflation.

What constitutes full employment?

As workers have returned to the labor force, incomes have risen and the unemployment rate has dropped to 3.9%, a robust discussion has followed over what constitutes full employment in the American economy.

For the Fed, it's more than an academic debate. Congress, after all, has given the Fed a dual mandate of maintaining price stability and achieving full employment.

The Fed defines full employment as having a 4% unemployment rate. That's down from the 5% of previous decades and reflects a shifting economic landscape. Broad demographic changes, a quicker pace of innovation and restrictions on immigration have all expanded what constitutes full employment. In our estimation, the definition of full employment is closer to a 3.5% unemployment rate or lower.

But at the same time, achieving this mandate can lead to pressures from the other half of the mandate.

Now with inflation having accelerated to the highest level in decades, policymakers face a dilemma: The Fed must achieve full employment while taming price increases. That means moving its policy variable on inflation—the core personal consumption expenditures index—back to 2% from the current 4.7%.

Indeed, that process is about to begin. We are looking for a gradual acceleration of the Fed's policy normalization beginning no later than the second quarter with the market anticipating three to four hikes in the federal funds rate this year, all of which could change if the omicron variant inflicts more damage to the economy.

MIDDLE MARKET INSIGHT

In recent decades, the rewards of working have stagnated to the point that wage growth has barely kept up with price increases.

In the end, the American workforce was dealt a significant setback during the pandemic and has yet to fully recover. Even as the unemployment rate nears what the Fed considers full employment—we see it ending the year closer to 3.5%—that goal has yet to be achieved and will require a careful balancing act by central bankers.

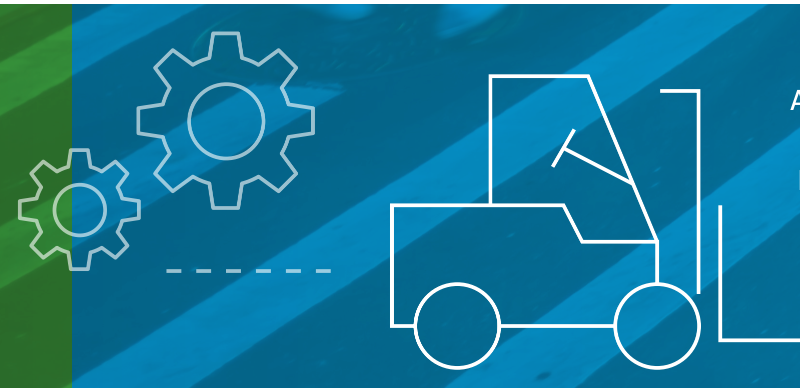
Redefining the dual mandate

In a standard Taylor Rule model of central bank behavior, the Fed responds to an overheating economy by increasing interest rates to counter a tightening labor market in which wage pressures further add to rising prices.

Current estimates of the equilibrium conditions in the labor market now center on an unemployment rate of 4%. That is, at any one time, 4% of the labor force participants are expected to move from one position to another within a growing economy capable of offering employment choices for workers.

Stability of prices is defined as long-term average price increases of 2% per year, with the 2% inflation target thought to be consistent with sustainable economic growth and sufficient consumer demand to bid up prices.

When inflation is averaging lower than 2%, that is a sign of insufficient demand and economic stagnation, as was most recently the case during the decadelong recovery from the Great Recession.



AS WORKERS HAVE RETURNED TO THE LABOR FORCE, INCOMES HAVE RISEN AND THE UNEMPLOYMENT RATE HAS DROPPED TO 3.9%, A ROBUST DISCUSSION HAS FOLLOWED OVER WHAT CONSTITUTES FULL EMPLOYMENT IN THE AMERICAN ECONOMY.

MIDDLE MARKET INSIGHT
Over the past 20 years, the equilibrium employment rate had been assumed to be about 5%. But that number has declined as the economy has changed.

All of this must be balanced with the demographic and societal changes that seemingly exploded across the economy during the two years of the pandemic. The Fed was not caught unaware and had already adopted policies to address these overriding issues.

The mandate for full employment

The tightness of the labor market is measured by the gap between the current rate of unemployment relative to its equilibrium level. If the unemployment rate is consistently lower than the equilibrium rate, that indicates the potential for rising wages as employers compete for a smaller pool of labor and an overheating economy. Under those conditions, the Fed usually raises interest rates.

But if the unemployment rate is consistently higher than its equilibrium rate, that indicates an underperforming economy, and the Fed seeks to facilitate investment and spending by pressuring interest rates lower.

Over the past 20 years, the equilibrium unemployment rate had been assumed to be about 5% in general terms. That is, in normal times, about 5% of the labor market is transitioning from one job to another as businesses close or as employees exercise their choice in employment.

Recall that labor market churn is a sign that employees are able and willing to advance themselves, growing the economy. The last time the unemployment rate dipped below 4%, during the economic boom of the dot.com years and then again in 2019, the consensus was that the equilibrium rate had briefly dipped to 4.5% in the late 1990s and 4% before the pandemic.

Formal estimates by the Congressional Budget Office of the noncyclical rate of unemployment—the rate of unemployment caused by all factors other than the business cycle—peaked at 6% in 1979, dropping to 4.5% in the third quarter of last year. Expectations are for that slow decline to continue over the next decade.

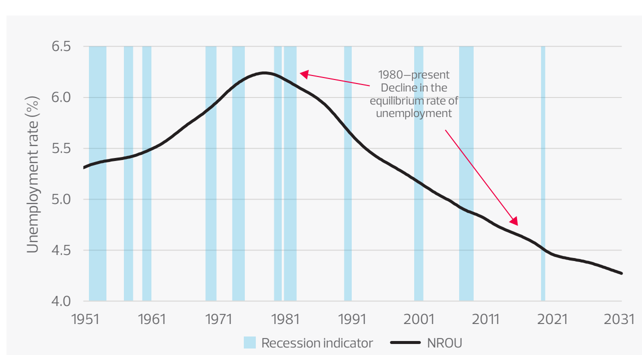
So if the unemployment rate has broached its equilibrium level—and prices are rising—why have the central banks in the United States, Canada and the U.K. balked at raising their policy rates off the zero bound?

Given the changing demographics of the labor force and the diminished reward for working in traditional occupations, we have reason to think the Federal Reserve is looking past the traditional U3 rate of unemployment, which as we'll show applies only to a segment of the population.

Given the significant changes in an evolving labor market, we'd argue that the target for the equilibrium level of unemployment should be 3.5% or lower.

Here are some factors that suggest that an accommodative monetary policy stance—coupled with investment by the fiscal authorities in the labor force—is required until the supply of labor is replenished and until all segments of society are rewarded for their labor.

CBO estimates of the noncyclical rate of unemployment*



Source: CBO; FRED; RSM US LLP

*Evolution of NROU in the modern U.S. economy

GIVEN THE SIGNIFICANT CHANGES IN AN EVOLVING LABOR MARKET, WE'D ARGUE THAT THE TARGET FOR THE EQUILIBRIUM LEVEL OF UNEMPLOYMENT SHOULD BE 3.5% OR LOWER.

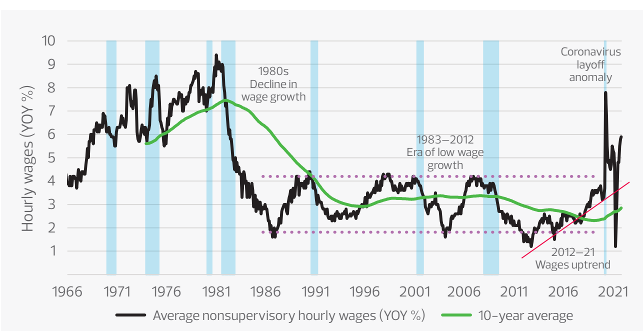
The decline in the attractiveness of employment

People don't necessarily work because they want to. The fact that they work and buy lottery tickets speaks volumes about their motivations.

In recent decades, the rewards of working have stagnated to the point that wage growth has barely kept up with price increases.

During the month before the pandemic, hourly wages adjusted for inflation were growing at 0.5% per year. Factor in added costs like child or family care, or health care, and the rational path of behavior for some in the labor force to keep working may not hold true anymore.

Monthly U.S. nonsupervisory hourly wage growth*



Source: BLS; Bloomberg; RSM US LLP

*Before and after recessions

If one argues that the wage growth before the 1980s was an unsustainable overreach of union power, then the decline in wages since those days, and before the pandemic, must be attributed to the decline of workers' bargaining power brought about by the availability of cheap labor in the South and then offshore.

What's more, advances in technology and automation have further narrowed the demand for labor, with automation reducing the need for unskilled labor.

MIDDLE MARKET INSIGHT

Advances in technology and automation have further narrowed the demand for labor, with automation reducing the need for unskilled labor.

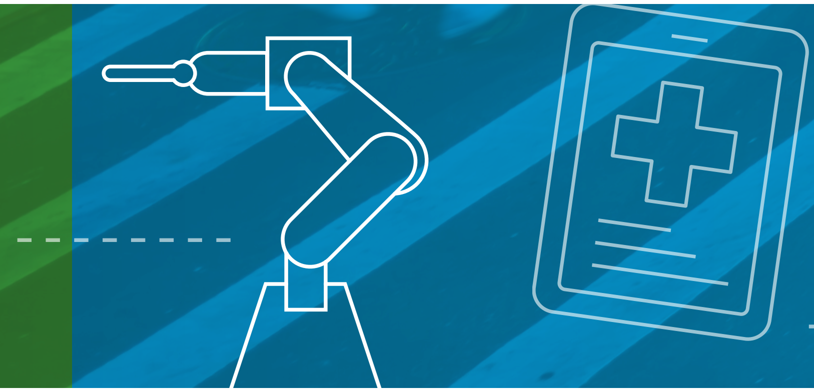
The era of low wages, automation and declining opportunities for those left behind by these changes—often in traditional manufacturing roles—has resulted in social dislocation and disengagement that affect a substantial segment of the nation's workforce.

Away from those permanent losses of manufacturing jobs, the rational behavior of underpaid employees has been to forego the diminished return on selling your labor in the service sector. We see this in the 20-year decline of employment among 25- to 54-year-olds, whom we characterize as prime-age workers.

The percentage of prime-age workers relative to their population typically plunges during recessions before increasing again during recovery. That pattern coincides with the cyclical demand for workers and their bargaining power for higher wages.

During the era of women joining the workforce from 1960 to 2000, the prime-age employment ratio increased to successively higher rates after each recession. That trend seemingly ended with the 2001 recession. Since then, both men's and women's labor force participation has been in decline as automation and offshoring have eroded employment choices and rewards.

As businesses shed jobs in favor of capital investment during the economic shakeout, we can expect further declines in the demand for less-skilled labor, resulting in stagnation of average wages, despite the recent uptick in wages at the lower end of the income spectrum.



IS THE SHRINKING WORKFORCE THE FAULT OF THE SOCIAL SAFETY NET? WE WOULD ARGUE THAT THE PANDEMIC AND THE LOSS OF OPPORTUNITIES HAVE MORE TO DO WITH PEOPLE LEAVING THE WORKFORCE.

MIDDLE MARKET INSIGHT
We expect that the labor force participation rate of prime-age workers will remain historically weak.

We expect that the labor force participation rate of prime-age workers will remain historically weak, as younger people delay their entry into the labor force, jobs in the digital economy require more skills, and older workers choose to retire or become self-employed.

Within this shrinking pool of qualified labor—and with fewer immigrants to replace missing workers or the increasing number of retirees—that implies that all available hands will be required to perform the work of increasingly technical tasks.

But that implies higher wages for only a limited subset of the labor force and a lower equilibrium level of unemployment.

The pandemic's toll

Economic growth is sustained by investment in capital and the growth of the labor force. Both have been in decline in the United States since the 1980s. Nonresidential fixed investment has been in general decline since the dot.com era, as has the labor force participation of both men and women in their prime working age.

Our analysis shows a 65-year decline in the labor force participation rate of prime working-age men from the early 1950s through about 2015. An upswing took place after the 2015 mini-recession, but then those gains stalled when the 2018 trade war developed into a late-cycle slowdown. For women, a similar declining trend developed after their participation peaked in 2000.

The labor force has yet to fully recover from its collapse during the pandemic. The number of prime working-age men in the labor force was reduced by 4.25% at the depths of the economic shutdown, with a deficit of 1.3% remaining. The number of prime working-age women in the labor force was reduced by 5% during the pandemic, with a 2.1% deficit still to be recovered.

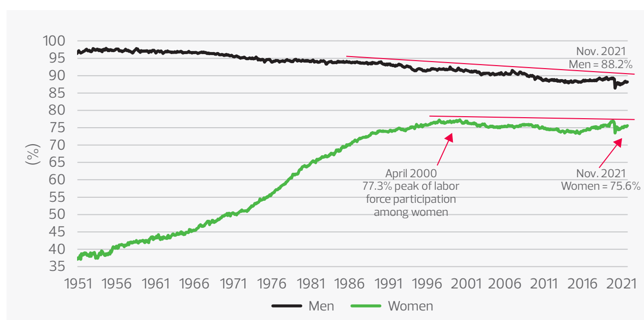
In past recoveries, though, the labor force has rebounded more fully. What's different this time?

There have been more than 70 million COVID-19 infections in the United States and more than 900,000 deaths. Furthermore, studies reported by UC Davis Health suggest that 25% to 33% of infections, no matter how severe, can lead to long-term debilitating consequences.

All of this affects the labor force as people opt out of traditional jobs or have been forced out after being infected or having their businesses close.

In one sense, these decisions are entirely rational: Older people are retiring, younger people are starting their own businesses or seeking nontraditional work options, and mothers who are priced out of day care options are staying home with their children.

Long-term trends in labor force participation of prime-age workers*



Source: BLS; Bloomberg; RSM US LLP

*25- to 54-year-old population

The ethnicity of unemployment

As the Fed has sought to stabilize the economy with aggressive monetary policies, it has spoken openly of the need to expand employment opportunities to a broader population.

ECONOMIC GROWTH IS SUSTAINED BY INVESTMENT IN CAPITAL AND THE GROWTH OF THE LABOR FORCE. BOTH HAVE BEEN IN DECLINE IN THE UNITED STATES SINCE THE 1980S.

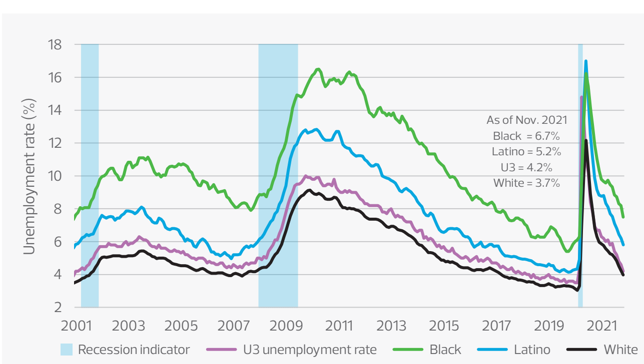
Until recently, the main focus for unemployment was on the U3 rate, which reflected job classifications mostly occupied by white workers. But white workers are less likely to be unemployed than Black or Hispanic members of the labor force. This disparity grows more pronounced during economic downturns.

Consider the different unemployment rates in November 2020: For white workers, the unemployment rate was 3.7% but was 6.7% for Black workers and 5.2% for Hispanics. That gap has persisted over the modern industrial era, with the unemployment rate averaging 5.5% among white workers, 11.8% for Blacks and 8.7% among Hispanics. (The average Asian unemployment rate is available only since 2003 and is averaging 4.9%.)

This gap is what the Fed refers to when it speaks of the need to address the persistent inequality of opportunity, and the need for its policy stance to remain accommodative until all members of society are able to take a full role in the economy.

This will be one of the more contentious issues as policymakers attempt to find the balance between price stability and a broader definition of full employment that is inclusive of all ethnicities.

U.S. unemployment by ethnicity*



Source: BLS; Bloomberg; RSM US LLP

*Latest and three-month moving averages

MIDDLE MARKET INSIGHT

As businesses shed jobs in favor of capital investment during the economic shakeout, we can expect further declines in the demand for less-skilled labor.

The opportunity for a midcourse correction

It now takes fewer workers to produce goods, and despite the growing inequalities, there is a surplus of cash in the form of household savings to allow a segment of the population to pursue other endeavors.

The result is a shrinking workforce. Only 81% of the prime working-age population is now participating in the labor force, down from the 92% rate of 20 years ago. Although we expect that ratio to increase as the recovery develops, the pattern over the past two decades is for the noncyclical rate of unemployment to continue to decline.

Is the shrinking workforce the fault of the social safety net? We would argue that the pandemic and the loss of opportunities have more to do with people leaving the workforce than with transfer payments from the government like unemployment benefits or social security payments.

The takeaway

The upshot is that if less labor is needed and if fewer workers are willing to take traditional jobs, then perhaps we should expect the Fed to consider that the current 3.9% unemployment rate is not a sign of an overheating economy.

Rather, we would hope the monetary authorities continue to see the need to ensure a widespread recovery of employment among all classes of workers.

AMERICANS EARN MORE THAN BEFORE THE PANDEMIC, EVEN AFTER INFLATION

BY TUAN NGUYEN

EVEN AS PRICES have soared in recent months, American workers are earning more than they did before the pandemic as the overall gains in their wages have outpaced inflation over the past two years.

The real average hourly wage rate in December—which is adjusted for inflation and is an indicator for purchasing power—was 2% above the pre-pandemic level, according to the most recent data from the Bureau of Labor Statistics.

As the economy rebounds from a once-in-a-lifetime crisis, robust demand—induced by aggressive fiscal and monetary policies—has driven the rapid recovery of the labor market, which recorded the strongest year of job creation on record in 2021.

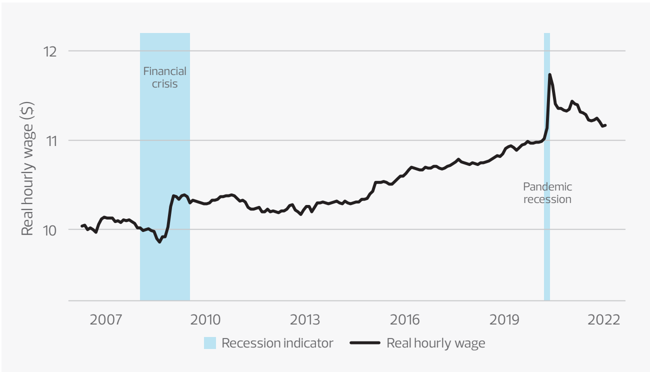
To put the recovery of the labor market in perspective, consider it took about eight and a half years following the financial crisis for the unemployment rate to decline to 3.9%, while it took less than two years following the shock of the pandemic.

And there are signs that workers will continue to benefit from the growing economy. The labor market is near full employment and the quit rate is at a record high—the perfect recipe for wage gains to remain strong.

To be sure, the impact of the omicron variant remains an open question, and it is only beginning to show up in the labor market. But if anything, its spread is likely to reinforce trends that are already in place.

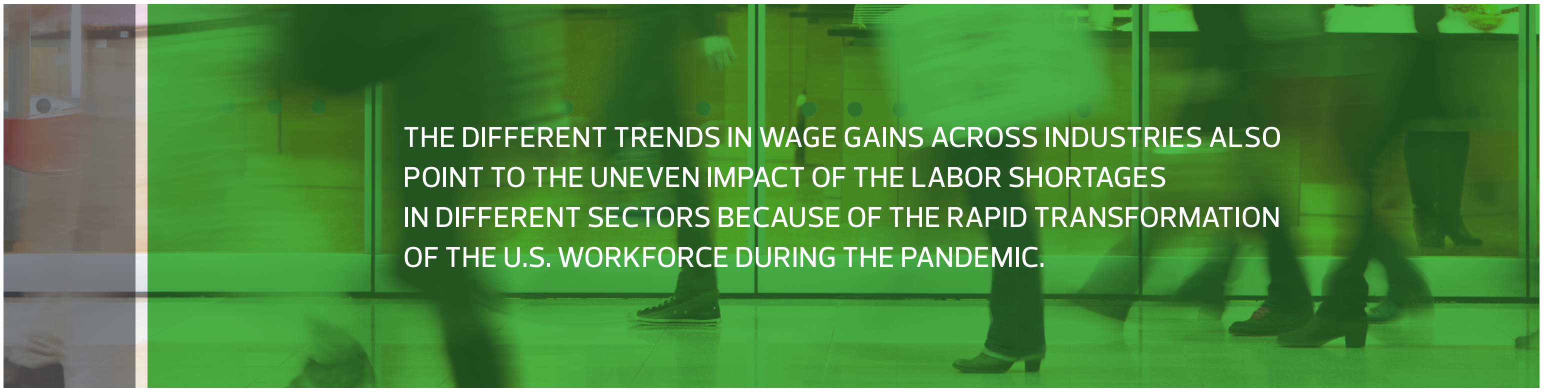
We expect real wages to rise even higher this year as inflation will most likely ease in the second half of the year and companies plan for the biggest pay jump in a decade, according to The Conference Board. At the same time, workers in 21 states will have a raise in their minimum wage.

Real hourly wage rate, private nonfarm employees*



Source: BLS; RSM US LLP

*Adjusted for inflation and seasonal effect



MIDDLE MARKET INSIGHT

It took about eight and a half years following the financial crisis for the unemployment rate to decline to 3.9%, while it took less than two years following the shock of the pandemic.

During a normal recession, when overall demand plummets, the inflation rate also declines sharply. As inflation reaches negative territory at a rapid pace—which happened during both the steep yet short-lived pandemic recession in 2020 and the financial crisis of 2008 and 2009—the real average hourly wage rate quickly peaks because wages do not decline at the same pace.

Once the recession is over, inflation starts to pick up as demand recovers, pushing the real wage rate down, which is what happened in the last two business cycles.

The difference between the two periods, however, is that the dip in the real wage rate following the financial crisis was smaller than what it was after the pandemic recession. It is the same reason why it took less time for the unemployment rate to recover after the financial crisis: a slower demand recovery rate.

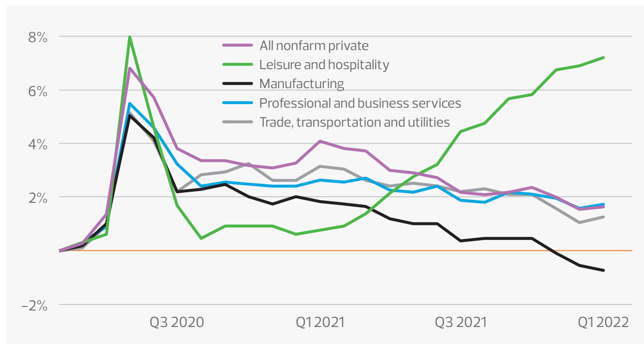
So even though hourly earnings fell at an annual rate of 2.4% in December, that comparison is misleading because it is being compared to December 2020, when economic restrictions were still in place. A better comparison for wage gains should be between the current wage rate and pre-pandemic wage rate, especially when the labor market conditions were more similar.

Real wage gains by sector

Not all industries have experienced the same level of wage growth. Most private service industries continued to have increasing real wage gains compared to the pre-pandemic level in January 2020.

The largest pay jump after adjusting for inflation comes from the leisure and hospitality sector, which has the lowest real average hourly wage rate at $6.98. It is not a coincidence: This sector has been the hardest hit by COVID-19, causing businesses to raise wages to attract workers.

Real hourly wage by industry: Percentage change since January 2020*



Source: BLS; RSM US LLP *Adjusted for inflation and seasonal effect

Higher-paid industries such as professional and business services, and financial services—which pay more than $13 an hour on an inflation-adjusted rate—also recorded strong wage gains in the past two years.

Goods-producing industries, on the other hand, have been under more pressure from inflation. The real hourly wage rate for manufacturing was down 1% in December compared to the pre-pandemic level. One reason might be that some businesses have turned to automation amid persistent labor shortages.

The different trends in wage gains across industries also point to the uneven impact of the labor shortages in different sectors because of the rapid transformation of the U.S. workforce during the pandemic.

The takeaway

With inflation expected to decline this year, the pressure on the average American's earnings from high prices will ease. That will continue to put workers in a much better position in a post-pandemic world as the likelihood of COVID-19 becoming endemic grows.

THE RISE OF ESG HAS GROWING IMPLICATIONS FOR THE TECH INDUSTRY

BY DAVIS NORDELL

THE IMPORTANCE of environmental, social and governance issues is growing across the economy, and a confluence of factors is driving the importance of ESG in the technology sector in particular. Regulators are calling for companies to put more metrics around their ESG goals, and more customers and employees are demanding businesses take a stand on these issues.

Technology companies have found themselves in the spotlight given their dominance in the market, sizable valuations and ever-growing reach into people's lives. Big technology companies have led the way in recent years on ESG issues such as climate commitments, diversity and inclusion efforts, and global governance initiatives, paving the way for the rest of the tech sector to follow along.

Investment capital earmarked for ESG assets, calls for workplace equality and equity, and a level global playing field are driving tech leaders and entrepreneurs alike to examine ways to bring ESG into the core of the enterprises they run. In a historically white- and male-dominated field, the employee base is now more diverse, necessitating more intentional inclusion efforts and highlighting the sector's reliance on H-1B visas, which draw foreign workers. As ESG issues have come to the fore, tech companies that may have been lagging on the human capital side have been forced to adapt.

MIDDLE MARKET INSIGHT

Technology companies have a significant opportunity to differentiate themselves from their peers and align with customer preferences.

Technology companies have a significant opportunity to differentiate themselves from their peers and align with customer preferences. Adopting a strong ESG strategy now will also put firms in a better position to navigate regulatory and policy responses from governments across the globe in the future.

Actions taken

Many events of 2020 provided the technology community with the opportunity to showcase their commitment to core components of ESG; the climate crisis was a key issue during the presidential election and the pandemic highlighted a range of social issues.

Many companies took a stand and implemented initiatives and changes to their core businesses to address ESG issues. According to an October 2020 study from the Task Force on Climate-related Financial Disclosures (TCFD), 60% of the world's 100 largest public companies support increased disclosures and 42% of companies with a market cap over $10 billion disclosed at least some information in line with the TCFD framework.

MIDDLE MARKET INSIGHT

A younger demographic of investors is also coming to the table, with greater ESG awareness and desire to "do well while doing good."

U.S. tech giants have all made net-zero or carbon neutral pledges to eliminate their carbon emissions by as early as 2030 in some cases and 2050 in others. Commitments like these will require vendors, suppliers and key partners to also dramatically decrease carbon emissions.

And finally, ESG capital allocations have swelled to record levels, now making up $17.1 trillion of $51.4 trillion in total U.S. assets under management, according to Bloomberg LP. Access to the capital markets will be essential as businesses grow and scale.

New regulations

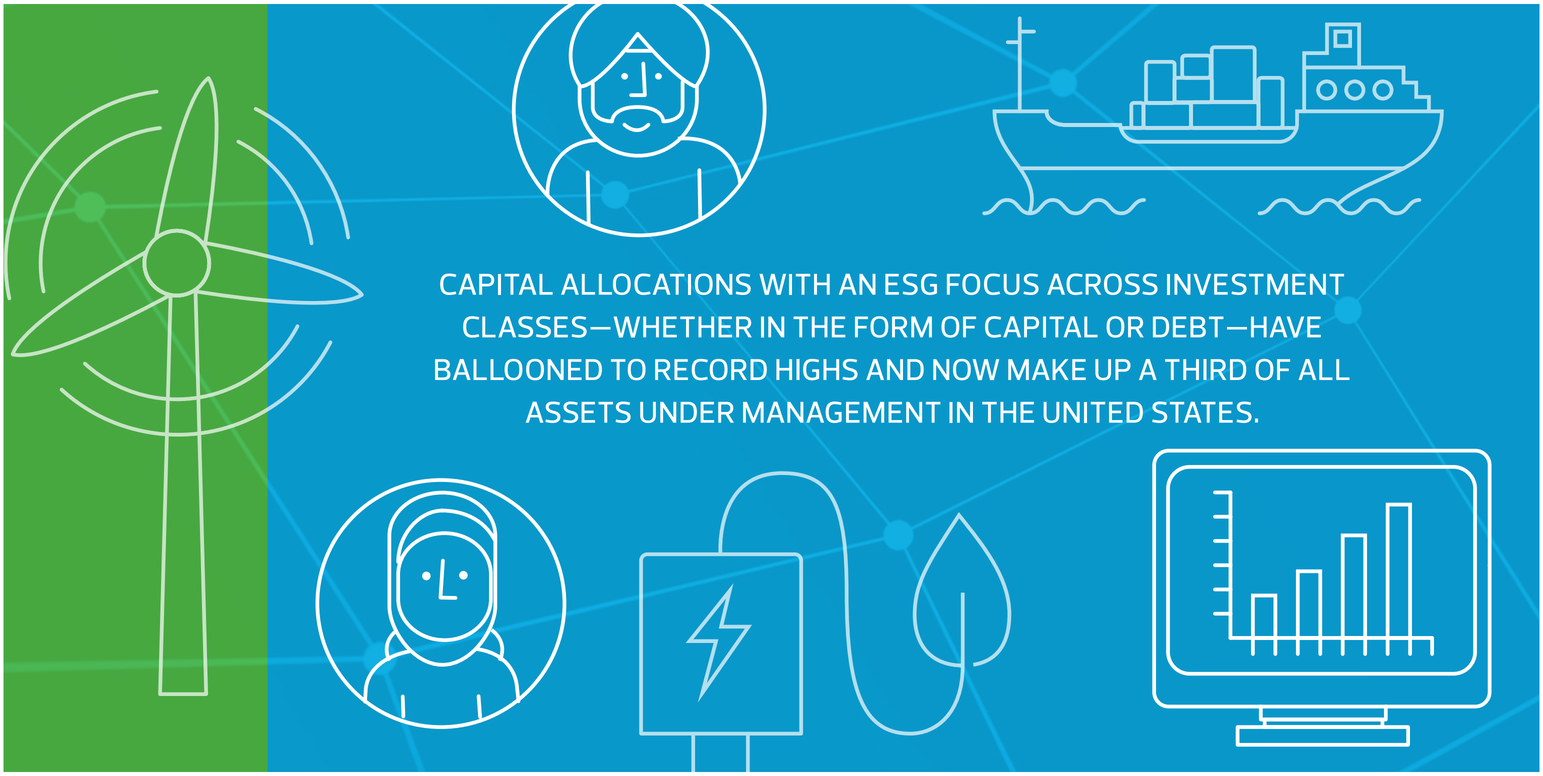
Global regulators and equity exchanges are also honing their focus on ESG, establishing standards focused on such issues. Tech companies will need to identify the data required to report on the progress of ESG initiatives if they want to meet the parameters set in these initial standards.

Especially notable on the regulation front is California's Assembly Bill 979, which went into effect in 2020 and requires publicly held technology companies headquartered in the state to have a certain number of board members from underrepresented communities, based on the overall size of the board.

Beyond individual states, the technology-heavy Nasdaq exchange earlier this year won approval to require companies that trade on its platform to appoint two diverse directors to their boards, one of whom must identify as female and another who identifies as a racial or ethnic minority or as LGBTQ+. Companies that do not meet this benchmark will be required to publicly disclose their inability to appoint diverse directors.

This new requirement is significant considering that more than a third of the companies trading on Nasdaq lack a racially diverse director, according to a study conducted by ISS Corporate Solutions and reported by Bloomberg.

Finally, Securities and Exchange Commission Chairman Gary Gensler commented that ESG reporting is also of interest to the agency, saying, "the SEC hopes to bring some consistency and comparability" to what companies report.



MIDDLE MARKET INSIGHT

ESG capital allocations have swelled to record levels, now making up $17.1 trillion of $51.4 trillion in total U.S. assets under management, according to Bloomberg LP.

Stakeholder demands

Capital allocations with an ESG focus across investment classes—whether in the form of capital or debt—have ballooned to record highs and now make up a third of all assets under management in the United States. This trend remains true for private companies with an attractive ESG positioning as private equity and venture capital investors continue to close a growing number of funds deemed "impact funds."

A younger demographic of investors is also coming to the table, with greater ESG awareness and desire to "do well while doing good." In a 2019 survey completed by Morgan Stanley, 85% of individual investors said they were interested in sustainable investing and 95% of millennials said they were interested in sustainable investing, up 10 and 9 percentage points respectively compared to a similar survey from 2017.

There are plenty of opportunities for firms that adapt to these shifting priorities, a recent RSM US report on ESG shows, and ESG awareness is growing: "Familiarity among middle market executives with the use of ESG criteria to evaluate the performance of businesses, organizations and/or investments rose significantly during the third quarter of 2021 compared to the fourth quarter in 2019," according to the third-quarter RSM US Middle Market Business Index survey.

Tech companies need to consider their priorities and focus areas for their ESG strategy and assess what data they need to capture and report to ensure that strategy is effective. As consumers and investors continue to prioritize ESG issues and as more standards are put in place, tech companies will find an ESG strategy quickly evolving from a nice to have to a must-have.

HOW PROCESS INTELLIGENCE CAN MAKE INSURERS MORE EFFICIENT

BY MARLENE DAILEY

INSURANCE COMPANIES have seen the shift to online self-service go mainstream over the last year and a half, and are now at a point where they must pivot if they want to meet the evolving demands of today's customers.

To do so, it is paramount that insurers harness technologies that will enable them to make data-driven decisions central to their operations. This will be key in avoiding investment missteps and failures.

Process intelligence uses an organization's own data from both digital and physical sources to discover patterns and insights that provide full transparency into the steps involved in a given process. Then, the organization can use that information to identify duplications, waste, bottlenecks and performance gaps to manage business process executions more efficiently.

With evolving customer behaviors, new competitors within and outside the industry, changing demographics, shifting compliance standards and the continuing pandemic, it is mission-critical for companies to have end-to-end process transparency to understand what, how, who, when and why they are conducting these process steps (such as payment processing, order to cash and escalations) to operate more effectively.

Insurers need a strategy based on data-driven, actionable insights to optimize their processes, help improve collaboration across their organizations and demonstrate regulatory compliance. All too often, companies make investments in modern, digital technologies without fully understanding how to use those technologies to their full potential. Simply investing in technology will not get the return on investment a company seeks; rather, the business needs to use that technology to assess and—as needed—transform its processes.

Finding untapped value

As insurers seek to improve the customer experience, reduce operating expenses and increase value, examining transactional data to understand what people, machines and organizations are actually doing (or not doing) can help tell the real story.

MIDDLE MARKET INSIGHT
Companies must have end-to-end process transparency to understand the what, how, who, when and why they are conducting these process steps.

Those who monetize operational data will find themselves understanding their opportunities, making better decisions, reducing their costs and serving their clients in a quicker and more meaningful way. With extra insight into their organization, insurance companies can model specific decisions more accurately before taking them across the enterprise.

Let's look at the initial step in a standard claim process—the first notice of loss—as an example. Generally, this process involves confirming the customer's identity, locating the policy number, updating contact information, updating the loss description, taking a statement, verifying damages and triaging the claim—and that's not even an exhaustive list. In this case, process mining can help create a detailed understanding of every step the customer representative makes to intake the claim.

Implementing process intelligence can allow companies to put together this detailed understanding in hours or days, rather than weeks or months like a more traditional analysis would require. This can give insurance companies a strategic advantage and improve customer satisfaction, quality and performance. To increase returns on investment, insurers can use advanced analytics to identify process steps that the organization didn't know were occurring such as late or multiple escalations, missing information, handoffs, the number of touch points with the customer and manual workarounds.

Typically, what we have found is that organizations can improve the customer experience by providing first-call solutions, which decrease the number of touch points, handoffs and escalations needed. This can also save time and money for the organization.

Best practices and benchmarks

The granularity and breadth of data derived from process mining allow insurers to identify best practices and benchmarks for processes across different lines of business as well as compare one office to another, one person to another or one unit to another.

This sheds more light on best practices, where they are being followed, where processes are breaking down and where performance improvements need to be made, but they aren't always visible to managers. The specificity of this data also means companies can access a wealth of information that goes well beyond the anecdotal.

Once organizations understand process patterns, they can identify hidden opportunities to reduce costs and improve quality and performance.

The takeaway

Integrating process intelligence for the strategic and operational management of the insurance business, overcoming divisional silo structures and barriers can set a company apart from its competition.

A TIGHT LABOR MARKET CHALLENGES THE MIDDLE MARKET

A PERMANENT WORKFORCE transformation is well underway in the middle market, according to the RSM US Middle Market Business Index (MMBI) back to work special report, presented by RSM US LLP (RSM) in partnership with the U.S. Chamber of Commerce. The report reveals that the structural shift to remote and hybrid work models is here to stay, and the data confirms that executives expect a tight labor market will continue to be a significant challenge over the next year.

The survey was conducted by the Harris Poll for RSM US between Oct. 4 and Oct. 21 before the surge of the omicron variant of the coronavirus and since the rise of the delta variant. Among the survey's findings on the tight labor market, we found the following:

56%

of surveyed companies plan to ramp up hiring over the next year.

90%

of those planning to ramp up hiring admit that it will be at least somewhat challenging to staff their open positions.

85%

of those executives planning to ramp up hiring said that staff turnover will be a challenge.

96%

of companies cited a lack of available qualified workers as a reason to anticipate staffing issues.

43%

of those companies citing a lack of available talent declared it to be a major issue.

Look for the complete findings in the RSM US Middle Market Business Index (MMBI) back to work special report.

REAL BUSINESS INSIGHTS FOR MIDDLE MARKET COMPANIES

Check out *The Real Economy: Industry Outlook* and get data-driven, sector-specific insights from RSM's senior industry analysts, a select group of professionals dedicated to studying economic and industry data, market trends and the emerging issues faced by middle market businesses like yours.

Each outlook provides unique perspectives and planning opportunities affecting businesses in the following industries:

- Business and professional services
- Consumer products
- Financial services
- Health care
- Life sciences
- Manufacturing and energy
- Real estate and construction
- Technology, media and telecom

Get the Winter 2022 issue now.

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-222