

THE REAL ECONOMY

VOLUME 78

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FORECASTING THE DOLLAR IN A POST-PANDEMIC WORLD

BY JOSEPH BRUSUELAS

THE PROBABILITY of the economy and financial markets returning to their pre-pandemic state is quite low. Nowhere is this more evident than in trying to estimate valuations of the U.S. dollar. Despite the robust rebound in consumer demand, a sluggish external sector and pandemic-induced economic distortions add a worrisome element to the breadth of the recovery and to the value of the dollar.

There is good reason to think that the United States will be the first of the developed economies to close its output gap, with increased demand in coming months that will turn recovery into economic expansion.

We are anticipating the highest rates of growth in gross domestic product since the 1980s, supporting 10-year interest rates reaching upward to 1.9% over the course of the year. And one must note that those high nominal interest rates must be coupled with real interest rates that are negative in the United States and likely to grow more so in the coming months.

For this reason, we expect that the value of the greenback will experience notable volatility with modest downward pressure, causing the dollar to decline in value against major trading currencies.

For middle market firms with significant exposure to the Canadian dollar and Mexican peso, this implies modestly higher prices on the margin.

Yet there is a lot of ground to cover before we can declare global victory over the pandemic. There is still too much uncertainty regarding the rapid spread of the virus and its variants in India, South Africa and Brazil, and the risk of spread to the unvaccinated American public.

In addition, long-term scarring to the U.S. labor force; the lack of immigration and a low birthrate; and [the loss of U.S. market share during the trade war](#) might prove to be unrecoverable in the short term, and difficult to mend over the long haul.

In the next sections, we'll outline the difficulty in forecasting the dollar in an environment in which the efficiency of the global supply chain has undeniably become part of commercial life and the United States is no longer the only major exporter to the world. And we'll discuss the efficacy of the debate over dollar strength and the economy, branding that discussion more as a holdover from an earlier time.

Relative growth and the dollar

Given expectations by international economics officials that the U.S. economy will be the first among developed economies to expand, doesn't that imply that the dollar will be stronger?

That assumption is not necessarily true. The value of the dollar, like any other commodity, depends on the demand for dollar-based assets—both financial and physical—and the transactional use of the dollar in commercial activity. The demand for dollars depends on a host of factors, both domestic and foreign. There have been several recent examples where the relationship between domestic growth and the value of the dollar has been inconsistent.

For instance, the U.S. economy took off during the mid-1990s as the digital age began. Investment was pouring into the technology sector, and the dollar appreciated versus the deutschmark, which was the European benchmark at the time. That era of dollar strength ended with the thud of the 2001 dot.com bust.

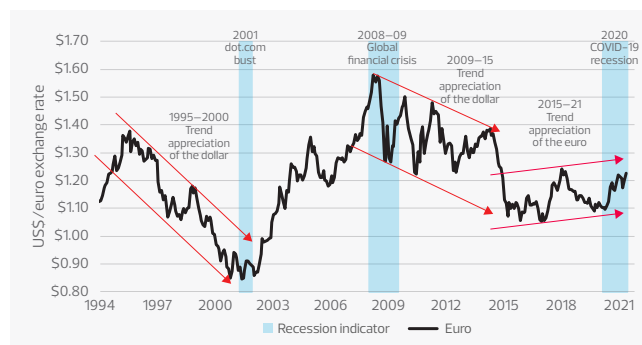
The dot.com bust happened at the same time as anxiety over European unification and its single currency were overcome, followed shortly by the attacks on the United States and the onset of wars in Iraq and Afghanistan. The dollar weakened versus the euro until the 2008–09 financial crisis.

With the Federal Reserve cementing its role as lender of last resort to the world during the financial crisis, the dollar started a period of appreciation versus the euro despite the reluctance of American fiscal authorities to juice the tepid economic recovery from the Great Recession. To be fair, some of the dollar's early strength was because of the ongoing saga of the European debt crisis, which was more than enough to scare off investors.

In the second half of the latest decade, Germany's economy was growing at a five-year average rate of only 1.6%, having been dragged into the U.S. trade war and the global manufacturing recession. From 2015, the U.S. economy grew at an average rate of 2.5% before slipping a bit in the last quarter of 2019.

Yet despite the attractiveness of U.S. equity returns, the euro range-traded during 2015–16 before entering a jagged uptrend versus the dollar. The euro has appreciated by 18% since January 2017 and then in the latest episode by 14% since the pandemic shutdown and equity market collapse of March 2020.

U.S. dollar/euro exchange rate



Source: OECD forecasts; Bloomberg; RSM US LLP

Given the randomness of event risk, can we say anything about the relative growth of the U.S. and German economies and the direction of the dollar from here?

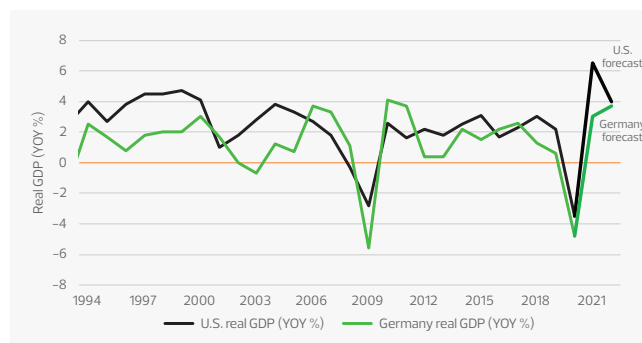
We show the growing interconnectedness of the German and U.S. economies and the casual-at-best relationship between Germany–U.S. growth differentials and the euro exchange rate in recent years.

What these figures suggest is that as the developed economies become more in sync in terms of monetary policy and as cross-border commerce grows, the exchange rate is more likely to mean-revert within a narrowing range. It will operate more as an agent of exchange and less as a component return on investment.

The euro's center of gravity has been \$1.20 for decades, and as political and economic alliances are rebuilt, mean-reverting seems to be the opening bid on the exchange rate's direction.

U.S. and Germany real GDP growth

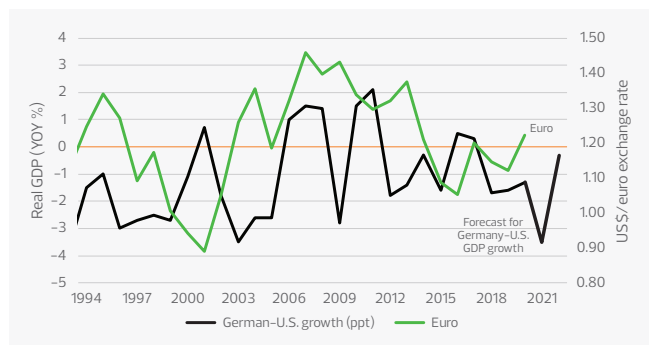
AND OECD FORECASTS OF 2021–22 GROWTH



Source: OECD forecasts; Bloomberg; RSM US LLP

Germany–U.S. real GDP growth differential and the euro

OECD FORECASTS OF 2021–22 GROWTH



Source: OECD forecasts; Bloomberg; RSM US LLP

Real and nominal interest rates and the dollar

Given the expectations that the U.S. economy will support higher interest rates—and given that nominal German interest rates are negative—doesn't that imply that the dollar will be stronger?

It's not that simple anymore. First, a little history on how we got here.

During the first decades of free-floating exchange rates—starting in 1973 when President Richard Nixon ended the dollar's convertibility to gold—the direction of the dollar could be determined by the real (inflation-adjusted) interest-rate differential between trading partners.

The currencies of nations that could support higher real interest rates relative to their trading partners would appreciate on trend. The idea was that the nations with the highest available inflation-adjusted return on investment would attract the highest demand for their assets.

That relationship became less reliable in the 1990s as the United States lost its dominance in international trade as Asian economies produced consumer goods and then intermediate goods along a growing global supply chain.

But the most important factor in the demise of the relationship was the adoption of inflation targeting among the world's central banks. This policy damped inflation as interest rates among the developed economies converged at extremely low levels. There was no longer enough space between foreign and domestic interest rates to make a difference where you put your money.

The result was an increase in savings, a flood of cash sloshing around the globe, the decline of U.S. investment, and U.S. relinquishment of industrial dominance. Starting in 2006, the trends in German–U.S. real interest rate differentials and the euro were at times moving in opposite directions, or, at best, moving together.

MIDDLE MARKET INSIGHT

Though U.S. imports appear to be making up for the dearth of consumer spending during the pandemic shutdown, exports of goods remain underwater.

In some respects, the global savings glut remains the biggest force influencing financial markets including the valuation of the dollar and other major trading currencies.

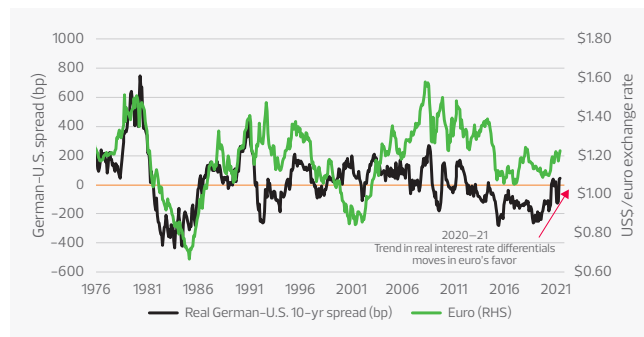
It's hard to argue that German fixed-income assets will draw much attention from foreign investors. The yield on 10-year government bonds approached zero by 2015, and then turned negative and stayed there. U.S. bond yields are low, but positive, and are being pushed by expectations for increased growth and normal levels of inflation.

In a vacuum, it would be difficult to argue that global investors would choose a negative return over the positive return of a guaranteed U.S. security.

So based on nominal yields, we could mark this on the plus side for the dollar. But with U.S. real interest rates becoming more negative because of the jump in inflation and with nominal U.S. yields suppressed by monetary policy, it's a risky call.

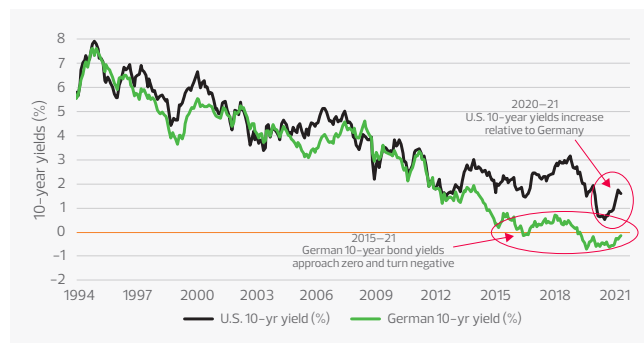
Real 10-year interest-rate spreads and the dollar

U.S. LESS GERMAN INFLATION-ADJUSTED 10-YEAR YIELD DIFFERENTIALS



Source: Bloomberg; RSM US LLP

Nominal U.S. and German 10-year bond yields



Source: Bloomberg; RSM US LLP

The external sector and the dollar

There are several sources of demand for dollar-denominated assets. The first is the demand for U.S. goods and services, which includes everything from exports of soybeans to foreign demand for U.S. movies. Second is the demand for dollar-based financial assets, which includes everything from technology ETFs to Treasury bonds. Third would be demand for foreign direct investments in U.S. shopping malls and businesses.

Foreign trade

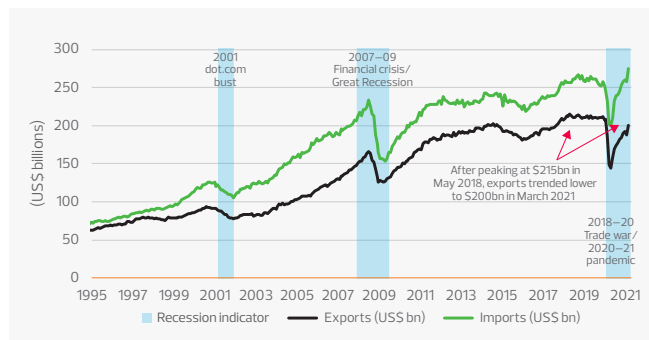
After peaking in May 2018, U.S. exports have been in decline and have yet to recover their lost ground. Though U.S. imports appear to be making up for the dearth of consumer spending during the pandemic shutdown, exports of goods remain underwater. The decrease in U.S. exports coincides with the onset of the U.S. trade war, but the United States is not the only nation affected, and the loss of market share began 20 years ago.

According to International Monetary Fund data, the U.S. share of global exports has been dropping on trend for two decades, from a 19% share in 2000 to a 13% share in 2021. Euro-area exports have also fallen, from a 29% share in 2000 to 23% in 2021. Where have all the exports gone?

The dot.com era in the mid to late-1990s led to the development of advanced logistics and to a positive shock for the low-labor-cost centers of production in the emerging markets. The share of global exports produced in the advanced economies began to shrink from 78% in 2000 to 61% in 2021. The share of exports produced in the emerging economies increased from 23% to 39%.

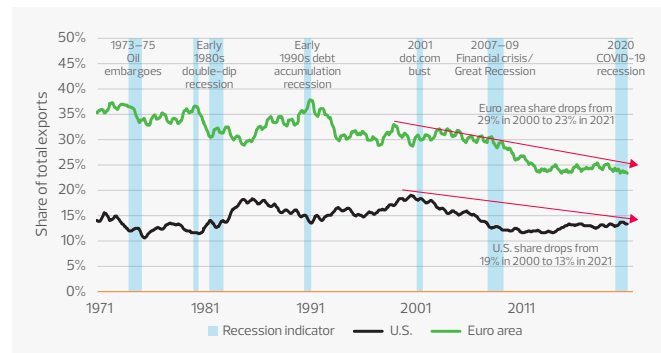
U.S. exports and imports during recessions

IN BILLIONS OF U.S. DOLLARS



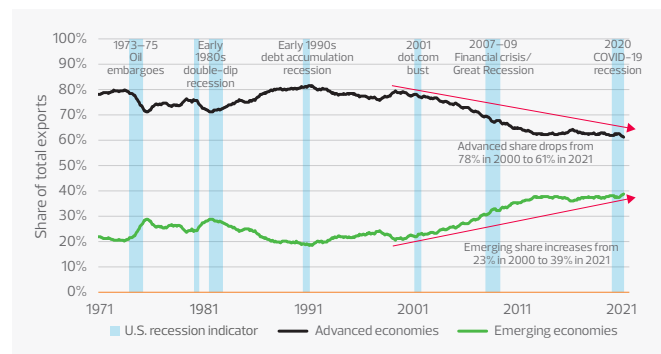
Source: US Census; NBER; Bloomberg; RSM US LLP

U.S. and euro area share of global exports



Source: IMF; Bloomberg; RSM US LLP

Advanced and emerging economy share of global exports



Source: IMF; Bloomberg; RSM US LLP

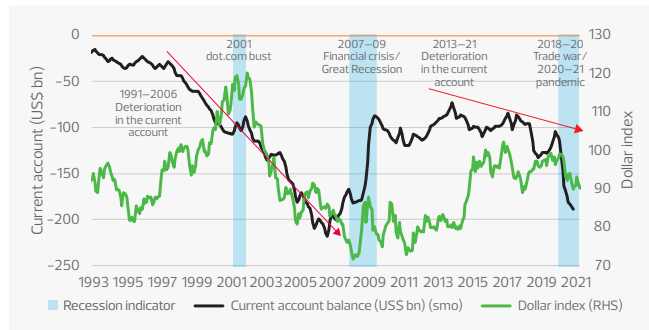
Nevertheless, the decrease of U.S. exports since 2018 is disconcerting as is the 2013-21 deterioration of the U.S. current account balance, which is dominated by the trade of goods but includes services, which are vital for an economy now dependent on thought.

Again, there was a striking relationship between the current account and the direction of the dollar from 2000 to 2006. But that ended with the sketchy investments during the housing boom, and continued to lose some of its luster after the financial crisis.

Both the current account and the dollar deteriorated during the pandemic, and the loss of U.S. market share is likely to continue without the United States' willingness to undertake significant investments in the intellectual and physical infrastructure necessary to sustain a modern economy based on information and digital technologies.

U.S. current account balance and the dollar index

IN BILLIONS OF U.S. DOLLARS



Source: BEA; NBER; Bloomberg; RSM US LLP

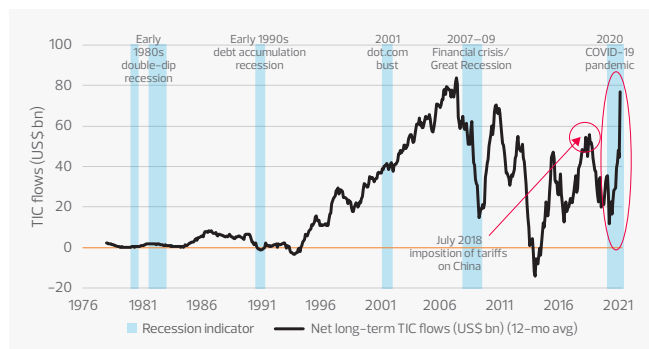
Foreign portfolio investment

The Treasury tracks purchases of net foreign portfolio investment; that is purchases less sales of U.S. long-term financial assets by foreigners. From the 1990s to the end of the housing boom in 2007, net purchases increased along with the dollar, with foreign investors earning the guaranteed rate of return of U.S. Treasury notes and bonds augmented by a positive currency return component on their investment.

The financial crisis brought that era to an end. The sluggish economic recovery after the Great Recession required an accommodative monetary-policy response, and the extremely low interest rates and sluggish recovery of the dollar were no longer an attractive investment for foreign investors.

Recent months have been the most encouraging since the dry spell that began with the self-exile of the U.S. from international relations and trade and the subsequent monetary response from the Fed and then the pandemic. Long-term U.S. interest rates are increasing again along with employment and growth, and net long-term portfolio purchases by foreign investors are moving higher. That should support the dollar.

Net foreign long-term portfolio investment in the U.S. before and after recessions



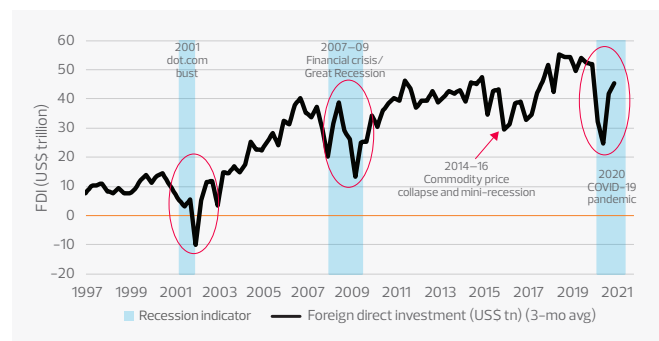
Source: U.S. Treasury; NBER; RSM US LLP

Foreign direct investment

Foreign direct investment has dropped in each of the past three recessions (and the unofficial 2014-15 mini-recession brought on by the collapse of commodity prices). Foreign direct investment has grown in recent quarters, but remains roughly 13% lower than year-end 2019 and 18% below mid-2018 levels when the tariffs took hold.

History suggests that there is a lag before the direct investment gap is closed after a recession, with foreign investors taking a pause while evidence of a sustained recovery materializes. That would suggest a delayed response by the dollar as well.

Foreign direct investment in the U.S. before and after recessions

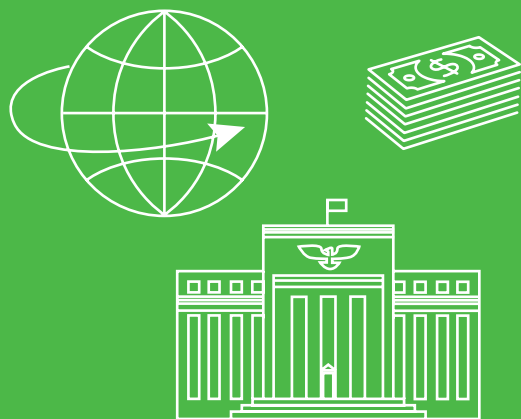


Source: BEA; BLS; NBER; RSM US LLP

The strength of the argument over the strength of the dollar

The recent recession and recovery have been unusual, and the ensuing expansion will depend on the ability to vaccinate the U.S. public as well as the global population. There are no guarantees. But we do think the United States (and the U.K.) will be vaccinated earlier than other major economies and that U.S. monetary policy will be prudently allowed to adjust when circumstances allow.

With that in mind, and with the difficulty of predicting the dollar, we might nevertheless expect the dollar to appreciate as soon as 10-year bond yields are no longer tethered by Federal Reserve purchases of long-term assets and until the Fed begins to move its policy rate off the zero lower bound. Raising the federal funds rate will at some point cause investors to expect slower growth, prompting an opposite and transitory bond market reaction.



THE VALUE OF THE DOLLAR WILL BE DETERMINED BY ITS USE AS A VEHICLE OF COMMERCIAL EXCHANGE AND BY THE DEMAND FOR U.S. GOODS AND IDEAS. THE FOUNDATION OF THAT DEMAND WILL BE DETERMINED BY THE STABILITY OF THE ECONOMY AND SOCIETY, AND THE LAWS AND INSTITUTIONS THAT GUARANTEE THAT STABILITY.

We do not expect the Fed to start discussing the tapering of its \$120 billion in monthly asset purchases until later this year, nor do we expect it will start the actual reduction until 2022 and increase its policy rate until early 2023. For this reason, the next year will most likely be defined by volatility and downward pressure on the greenback against the major trading currencies.

The lack of exports is unlikely to be resolved overnight, however, and that would temper any dollar gains. Our trading partners will find that the time and cost of realigning their supply chain back to U.S. suppliers may not be worth the effort, and at some point, U.S. exporters will be forced to turn their energy to other endeavors. That is the cost of poorly conceived policy, and every effort should be made (or has been made) to reverse those decisions.

These are short-term issues for the dollar. If one believes in the efficiency of the market, and if international cooperation and development are allowed to produce the best outcomes, then movements of the dollar become part of business. There are hedging techniques that can mollify the risk of currency exposure, and any entity that operates within the global supply chain—and we all do—should weigh the cost of hedging versus the risk of currency losses.

Overall, arguments over the strength of the dollar belong to another era. We no longer operate under a self-defeating mercantilist system or use currency manipulation to make our products more attractive than our trading rivals.

Rather, as economies become integrated, currencies act as a medium of exchange and neither a store of value nor a measure of the economy's direction.

The value of the dollar will be determined by its use as a vehicle of commercial exchange and by the demand for U.S. goods and ideas. The foundation of that demand will be determined by the stability of the economy and society, and the laws and institutions that guarantee that stability.

So it might be a waste of time to argue that some industries need the protection of a weak dollar, or that a certain policy will result in a weak or strong dollar. In a free market, the value of a free-floating exchange rate is out of our hands.

If an industry is deemed to be essential but some other country holds a competitive advantage (for instance, producing protective wear during a pandemic), then it makes sense that the government stockpile those goods (as was the case for Finland before the pandemic) or to operate those industries as public utilities to ensure sufficient domestic production.

The takeaway

The foolishness of thinking that we live in a zero-sum world of competing economies is in full display. Protectionist tactics brought the global manufacturing sector to its knees and to no one's benefit before the pandemic. And as a result of those tactics, some sectors of the U.S. economy have quite possibly lost market share.

It bears repeating: The dollar's value will be determined by the strength of our ideas not by zero-sum protectionist policies that are inward-looking and insular. ■



THE DIFFERENCE BETWEEN NOISE AND SIGNAL IN U.S. WAGE GROWTH

BY JOSEPH BRUSUELAS

THE PANDEMIC and the economic shutdown it prompted have injected an inordinate amount of noise into the economic data, making policy judgments, which are always difficult, far more challenging.

With those challenges, the risk of large errors that carry significant ramifications for the economy is embedded into the discussion around the risks linked to inflation.

So what are those risks? If policymakers exit too early from accommodative positions, they would almost certainly face another decade of disappointing economic and wage growth. But if they overplay their hands and continue the accommodative policies for too long, they risk overstimulating the economy and spurring unwanted inflation.

At the center of this discussion is wage growth. While we are observing some indicators that imply modest wage growth, at this point, it is more noise than signal and does not imply an imminent breakout in wage push inflation that would end the three-decade period of quiescence in pricing.

Cause for concern?

Government support for employers and direct subsidies through unemployment insurance have managed to maintain an income stream for low-wage workers. Spending among low-income households is up 22.6% compared to January 2020 largely because of those direct transfer programs, and it has put a floor under the economy during the pandemic. Furthermore, direct payments for child support beginning in July will help more parents afford child care and allow them to return to work.

These payments, along with accommodative monetary policies, have stimulated a discussion around whether too much money is flowing into the economy and if that poses a risk of inflation.

Given the increase in the M2 money supply from \$15.4 trillion to \$19.8 trillion during the pandemic, in addition to the \$5.7 trillion in fiscal aid over the past year, this concern is understandable.

WHILE WE ARE OBSERVING SOME INDICATORS THAT IMPLY MODEST WAGE GROWTH, AT THIS POINT, IT IS MORE NOISE THAN SIGNAL AND DOES NOT IMPLY AN IMMINENT BREAKOUT IN WAGE PUSH INFLATION THAT WOULD END THE THREE-DECADE PERIOD OF QUIESCENCE IN PRICING.

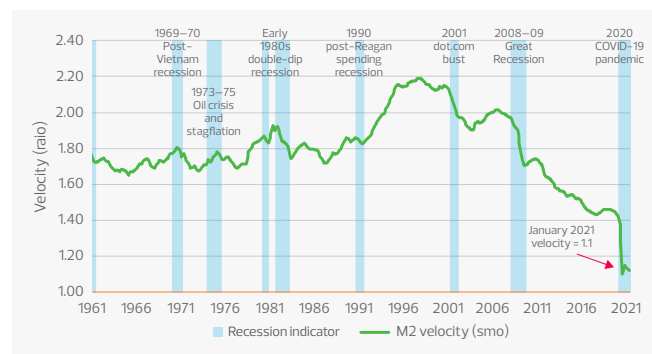
Transmission mechanism and expectations

But there needs to be a transmission mechanism to cause that inflation. If one expects an increase in inflation, then one should expect an increase in the velocity of money—or the rate at which money changes hands—and a change in inflation expectations. A look at that is quite illuminating.

The velocity of money has barely budged. After a modest increase in early 2020, it then moved down to close the year. Put simply, there has not been a statistically significant relationship between economic growth and the supply of money for decades.

Growth in the M2 money supply increased from \$3.7 trillion in 1996 to \$15.4 trillion in January 2020, a period when broad disinflation characterized the U.S. economy. During the past decade, when inflation averaged 1.5%, the growth in the M2 money supply increased from \$8.4 trillion to \$15.3 trillion.

Velocity of money before and after recessions

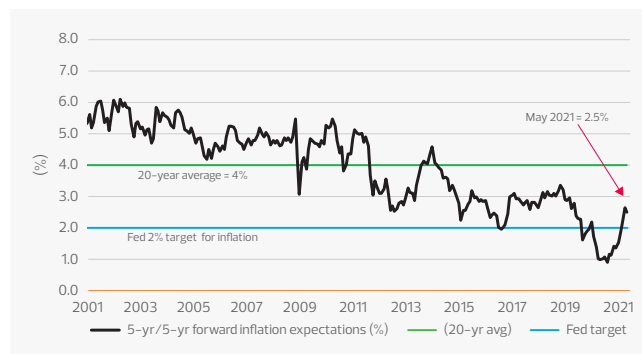


Source: Federal Reserve of St. Louis; BLS; NBER; RSM US LLP

In addition, a look at inflation expectations—our preferred metric, the Federal Reserve's five-year, five-year forward inflation expectation rate, stands at 2.5%—shows that they remain well anchored and imply price stability, not inflation, hyperinflation or dollar debasement.

Inflation expectations imply price stability

FEDERAL RESERVE 5-YEAR, 5-YEAR FORWARD RATE



Source: Federal Reserve Bloomberg; RSM US LLP

Noise and signal

Given the broad and deep disruption to the economy during the pandemic, it can be difficult to discern noise from signal in the data.

For example, going into the pandemic, the 10-year average of hourly wage growth for nonsupervisory employees was less than 2.4% per year, not much considering that ordinary levels of inflation would negate most of those gains. That is a pure signal.

But after wages rose at an abnormally high rate during the pandemic—mainly because higher-paid workers were retained and lower-paid workers were let go—hourly wages in March grew by 4.2% on a year-ago basis.

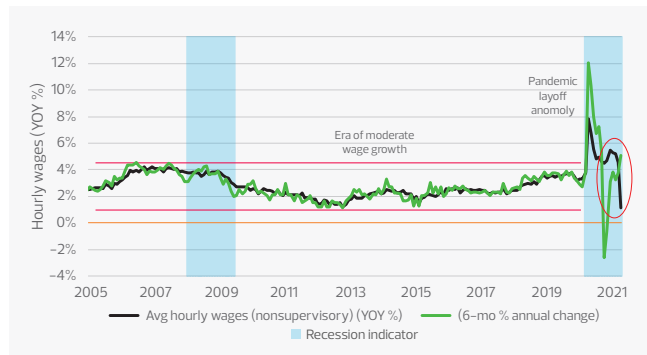
Then as 311,000 low-paid workers in leisure and hospitality returned to the labor force, that year-ago metric slowed to 0.3%. We would categorize this as noise.

That being said, wage growth for nonsupervisory employees advanced 5.1% on a six-month average annualized pace inside the April jobs report. This captures the early portion of the recovery and the competition for workers returning to the labor force as the recovery accelerates.

WITH A HEADLINE UNEMPLOYMENT RATE OF 6.1% AND A 10.4% UNDEREMPLOYMENT RATE, THE 8.2 MILLION PEOPLE STILL OUT OF WORK ARE UNLIKELY TO FORM THE IMPETUS FOR WHAT WAS ONCE REFERRED TO AS WAGE-PUSH INFLATION.

U.S. nonsupervisory hourly wage growth

YEAR-OVER-YEAR % CHANGE AND 6-MONTH ANNUALIZED % CHANGE



Source: BLS; Bloomberg; RSM US LLP

That dynamic, along with the increase in economic activity, has raised concerns of an overheating economy and price increases because of labor market tightness and wage pressure.

But with a headline unemployment rate of 6.1% and a 10.4% underemployment rate, the 8.2 million people still out of work are unlikely to form the impetus for what was once referred to as wage-push inflation.

This is more likely to reflect temporary and transitory noise for what will be a unique recovery and expansion following the exigent circumstances of the pandemic.

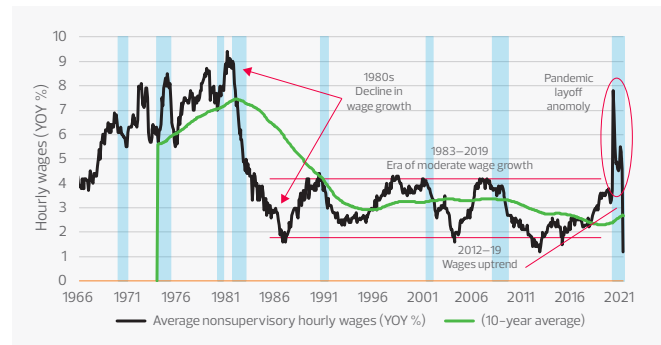
In addition, we would urge caution in drawing conclusions on past recoveries and expansions compared to the unique context of the post-pandemic economy. Focusing too much on what we think constitutes noise will lead to a premature curtailment of the current recovery that would dampen growth and employment conditions.

MIDDLE MARKET INSIGHT

Direct payments for child support beginning in July will help more parents afford child care and allow them to return to work.

Monthly U.S. nonsupervisory hourly wage growth

BEFORE AND AFTER RECESSIONS



Source: BLS; Bloomberg; RSM US LLP

Nevertheless, policymakers are bound to point toward wage growth in the first quarter of the year, which remained at 5%, well above its trend during the 2010-19 recovery from the Great Recession.

Though the employment cost index (salaries plus benefits) leveled off at 3% per year in 2018-19 before dropping off during the pandemic, the upward trend in the marginal cost of labor will likewise draw attention, spurring calls for the central bank and the fiscal authority to pull back on their accommodative policies. ■

Wage and benefit components of the U.S. Employment Cost Index for all civilian workers since 2010

YEAR-OVER-YEAR % CHANGES IN SEASONALLY ADJUSTED ECI INDICES



Source: BLS; Bloomberg; RSM US LLP

HOW TO STOP WORRYING ABOUT RISING TREASURY YIELDS AND LOVE THE RECOVERY

BY JOSEPH BRUSUELAS

THE YIELD on 10-year Treasury bonds approached 1.7% in May, within 20 basis points of already low pre-pandemic rates. Though that move higher has since moderated, it was in response to signs of an economic recovery and perceived risks around higher inflation.

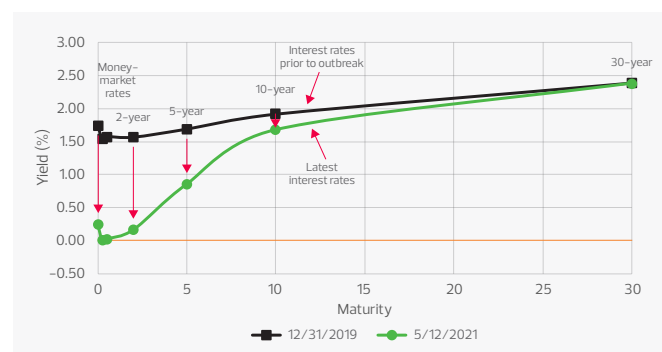
But sub-2% 10-year interest rates are far from what a healthy economy would support and suggests the need for additional government response in the form of fiscal stimulus and widespread development of intellectual capital despite those perceived risks.

MIDDLE MARKET INSIGHT

During the decade-long recovery from the Great Recession, U.S. real short-term interest rates have been negative and below the natural rate estimates for all but a few occasions.

Change in the U.S. Treasury yield curve since before the coronavirus outbreak

YIELDS AS OF DEC. 31, 2019, AND MAY 12, 2021



Source: Bloomberg; RSM US LLP

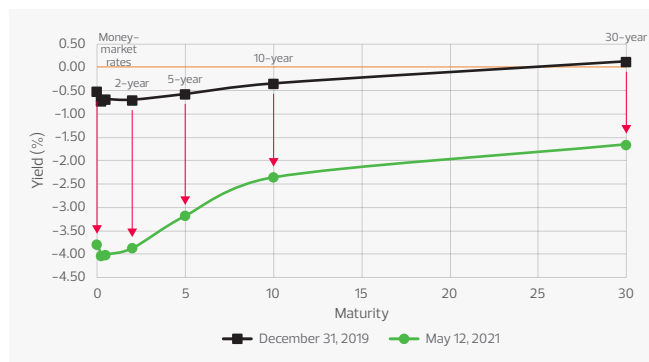
THE FED HAS SAID THAT BECAUSE INFLATION AND DEMAND HAVE BEEN ABNORMALLY LOW FOR SO LONG, IT WILL TOLERATE INFLATION RATES GREATER THAN ITS 2% TARGET BEFORE IT UNDERTAKES RATE HIKES.

Changes in real yields

The increase in inflation to 4.2% in April from 2.6% in March has pushed the real (inflation-adjusted) yield on 10-year Treasury bonds even lower, to negative 2.4%. The goal of the monetary policy is to facilitate investments by pressuring interest rates lower. A negative yield curve and expectations for a growing economy and sustained normal levels of inflation will allow those investments to be paid back in inflation-depreciated dollars.

Changes in the real (inflation-adjusted) U.S. Treasury yield curve since before the coronavirus outbreak

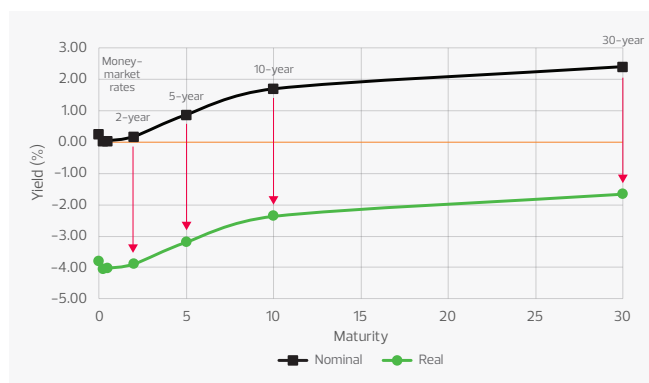
TREASURY YIELDS LESS INFLATION AS OF DEC. 31, 2019, AND MAY 12, 2021



Source: Bloomberg; RSM US LLP

Nominal and real U.S. Treasury yield curves

NOMINAL TREASURY YIELDS AND INFLATION-ADJUSTED YIELDS AS OF MAY 12, 2021



Source: Bloomberg; RSM US LLP calculations

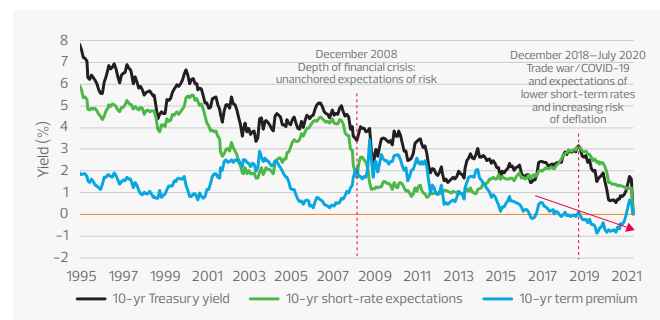
Why rising 10-year yields are a good thing

Confidence in the recovery has nearly eliminated the perceived risk of economic collapse and deflation. At the same time, guidance from the Federal Reserve consistently suggests that money market rates will be low for a long time. The result is an economy that can support higher long-term interest rates, while monetary policy pressures short-term bond yields lower—that is, a steep yield curve out to 10 years that is conducive for bond trading.

But there are never straight lines in asset pricing, with recent adjustments in the term premium priced into 10-year Treasury yields, and expectations for short-term rates over the next 10 years.

Expectations and risk components of 10-year yields

EXPECTATIONS OF SHORT-TERM RATES AND THE TERM PREMIUM BUILT INTO 10-YEAR TREASURY YIELDS

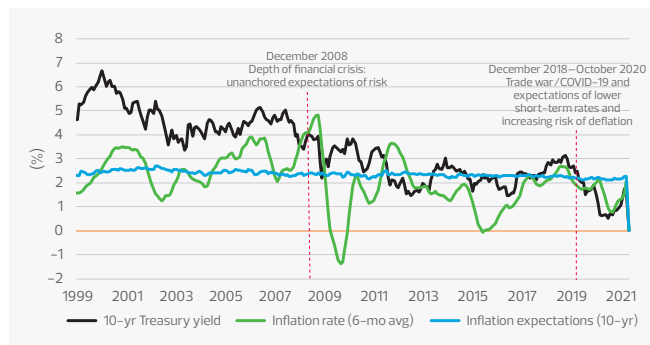


Source: FRBNY; Adrian Crump & Moench; Bloomberg; RSM US LLP

The inflation rate is moving higher, a welcome sign of increased demand and economic activity. Yet inflation expectations have been stable both during the pandemic and as the recovery took shape this year, increasing only slightly to 2.25% in May from 2.10% last August. That is broadly in line with price stability.

The Fed has said that because inflation and demand have been abnormally low for so long, [it will tolerate inflation rates greater than its 2% target](#) before it undertakes rate hikes.

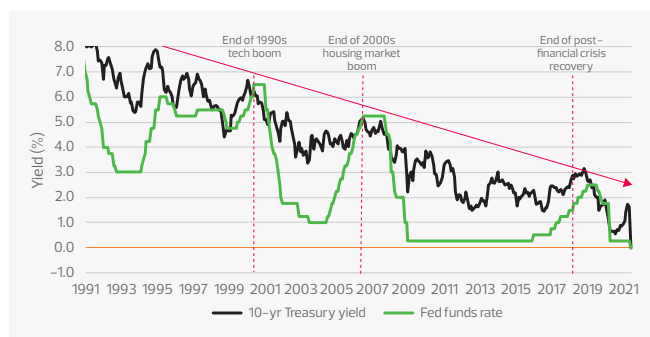
10-year yields, the CPI and inflation expectations



Source: Philly Fed; Bloomberg; RSM US LLP

Fed funds rate and 10-year yields

10-YEAR YIELDS AT THE END OF FED RATE-HIKE EPISODES



Source: Bloomberg; RSM US LLP

Even if 10-year yields were to reach 2.0% in the months ahead, interest rates would still be below the trend decline in interest rates shown in the analysis below. A break above 2.0% would be a sign of a healthy and competitive economy, and would go a long way to thwarting the development of bubbles in other asset classes.

When will the economy support higher rates?

Because of the structural shifts in the global economy—automation, the advent of the global supply chain and the adaptation of inflation-targeting by central banks—the expected return on investment has trended lower. This is particularly the case in the aftermath of the global financial crisis and the Great Recession. The world's developed economies arguably could no longer support the high real (inflation-adjusted) rates of return in earlier decades.

According to [an analysis](#) by Kathryn Holston, Thomas Laubach and John C. Williams at the Federal Reserve Bank of San Francisco, the natural rate of interest is defined as “the real short-term interest rate that would prevail absent transitory disturbances.”

[Another analysis](#), by Thomas A. Lubik and Christian Matthes at the Richmond Fed, holds that the natural rate of interest is a hypothetical rate that is “consistent with economic and price stability.”

According to Holston, Laubach and Williams, the natural rate provides a benchmark for monetary policy. Real short-term rates below the natural rate indicate an expansionary policy, while real short-term rates above the natural rate indicate a contractionary policy. According to Lubik and Matthes, “it is not the level of the natural rate that matters, but its value relative to other interest rates.”

During the decade-long recovery from the Great Recession, U.S. real short-term interest rates have been negative and below the natural rate estimates for all but a few occasions.

That indicates an accommodative monetary policy, even during the period of interest-rate normalization near the end of the recent business cycle that drew so much criticism.

In our opinion, the decline in the natural rate from the Great Recession to the present and the concurrent secular decline in 10-year yields and GDP growth—which we show in the figures below—suggest structural issues in the economy that we have yet to overcome. Despite the best efforts of the monetary authorities, we need to do more to avoid becoming the Japan of this century.

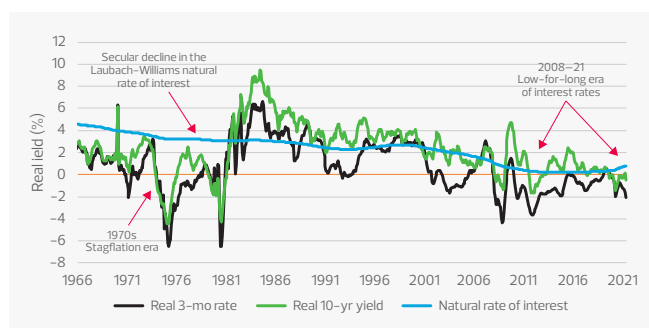
We need to create the foundation for the next economy, both in physical terms—through traditional structural improvements such as rethinking the energy and broadband grids—and in intellectual terms, by addressing the deficiencies in education and health of the labor force.

The United States is no longer the leading exporter of the world. Simply rebuilding the old economy is shortsighted and a waste of resources.

In our estimation, an increase in the natural rate during the first quarter is a positive first step toward the normalization of interest rates, the potential for a sufficient return on investment and the reimagining of the U.S. economy.

Real interest rates and the natural rate of interest

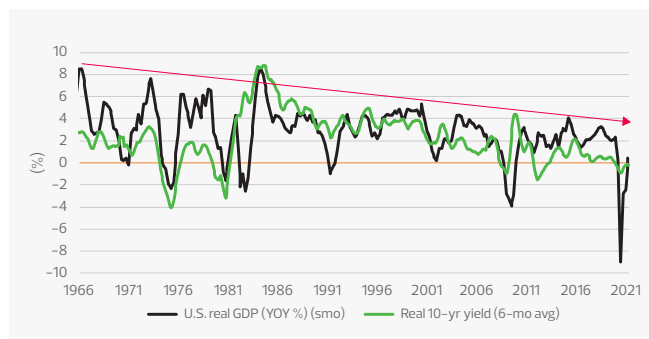
3-MONTH T-BILL RATE AND 10-YEAR TREASURY YIELDS LESS INFLATION



Source: Laubach-Williams; Bloomberg; RSM US LLP

Long-term trends in real GDP growth and real 10-year interest rate

10-YEAR TREASURY YIELDS LESS INFLATION



Source: BEA; BLS; Bloomberg; RSM US LLP

Treasury bonds are back in fashion with foreign investors

The recovery—or, more to the point, the confidence in the vaccination program and the growth it has helped spur—is best seen in the spread between high-yield corporate bonds and Treasury bonds. A growing economy indicates diminished risk of corporate default, and a reduced premium required to hold those bonds.

The bid-to-cover ratio has remained comfortably above 2, an indication of the demand for Treasury securities despite their lack of return relative to other, more risky assets.

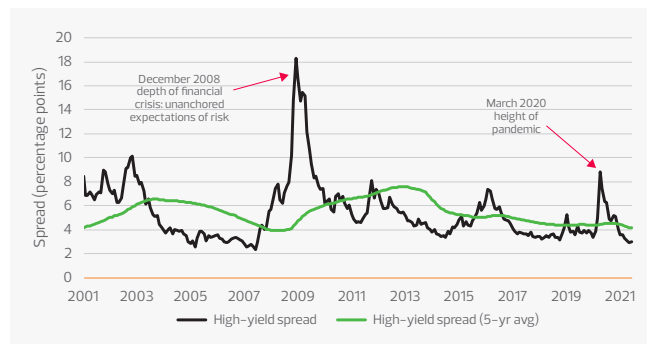
MIDDLE MARKET INSIGHT

A growing economy indicates diminished risk of corporate default, and a reduced premium required to hold corporate and Treasury bonds.

Purchases of Treasury bonds by foreign investors are increasing once again, indicating commercial demand and for parking profits from trading with U.S. importers. That suggests that increased consumer demand will augment growth in the manufacturing sector to form the basis for a sustained recovery. ■

U.S. high-yield bond spread

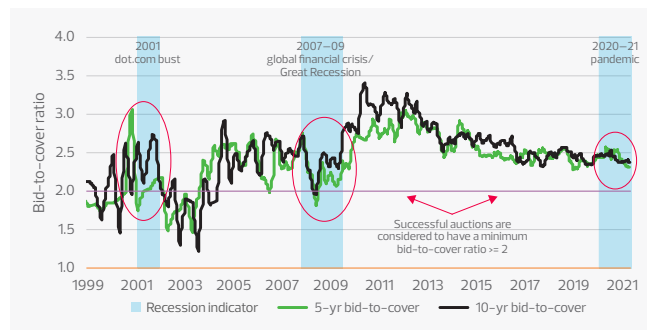
BLOOMBERG BARCLAYS U.S. CORPORATE HIGH-YIELD SPREAD OVER TREASURYS



Source: Bloomberg Barclays Indices; RSM US LLP

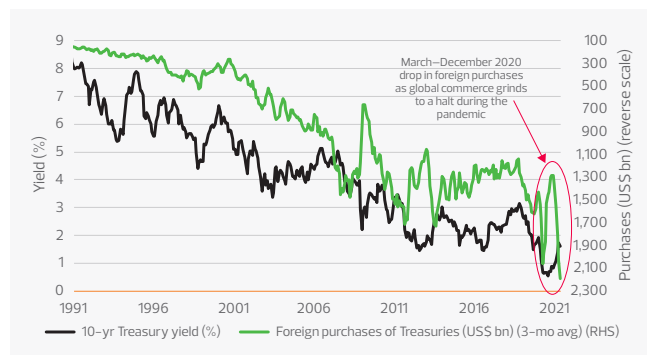
Bid-to-cover ratio of 5- and 10-year Treasury bonds

13-WEEK AVERAGE (AND LATEST) RATIO OF AMOUNT OF BIDS RECEIVED TO BONDS SOLD AT AUCTION



Source: BEA; Bloomberg; RSM US LLP

10-year yields and foreign purchases of Treasury bonds



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



THE ALTERNATIVE

ALTERNATIVE ANALYSIS FOR INFORMED MIDDLE MARKET DECISION-MAKING

SEC PRIORITIES UNDER GARY GENSLER

BY BRANDON KOESER

IN APRIL, the former investment banker and former government official Gary Gensler was sworn in as the head of the Securities and Exchange Commission, and the direction of the agency under his leadership is beginning to take shape. This was especially clear in his testimony at a hearing before the House Financial Services Committee to discuss the surge in meme stock trading fueled by social media.

While Gensler's tenure as chair of the SEC is in its early stages, here is what we see as focus areas for the agency based on what he told lawmakers:

Environmental, social and governance

The surge in popularity of ESG issues has prompted increased scrutiny from the SEC in two regards:

- **Investment funds**—in April, the SEC's examination unit indicated that some money managers are promoting their funds as sustainable or socially conscious, when the reality is quite different. With the demand for ESG-focused investment funds expected to grow rapidly, the SEC will continue to focus more resources on examining such investments to ensure they are accurately representing the funds' strategy to investors. If failures continue to be identified by the agency, one can anticipate the SEC will be left with no choice but to start sanctioning funds found in violation.

- **Public company reporting**—increasing demand by investors for climate change disclosures in public company reporting is leading more organizations to add these disclosures to their SEC filings. Yet there is no uniform requirement mandating such disclosures or even consistency among disclosures. Upon the close of the comment period on the matter in June, the SEC will likely develop a requirement and a framework for such disclosures to provide investors with consistency and comparability to what is being reported.

Rise of the retail trader

While retail trading is not new, the increase in trading options for retail investors—coupled with the power of social media—led to an explosion of retail trading activity in January focused on widely popularized meme stocks such as GameStop. This unprecedented retail activity has led the SEC to review what transpired.

The focus of the review, which Gensler is pushing to publish by summer, will likely touch on the rise of retail trading platforms, including the gamification of trading on select platforms and the use of social media platforms in trading. While awaiting the results of the review, it is too early to speculate on what, if any, regulatory changes will come.

GENSLER INDICATED THAT THE SEC WILL PURSUE ENFORCEMENT ACTIONS ON THOSE DETERMINED TO BE MANIPULATING THE MARKET THROUGH USE OF SOCIAL MEDIA PLATFORMS.

That leaves one to focus then on Gensler's testimony on Capitol Hill, where he indicated that the SEC will pursue enforcement actions on those determined to be manipulating the market through the use of social media platforms, and that fresh rules may be needed to protect investors who may be prompted to make unnecessary trades due to the gamification used by select retail trading platforms.

Pay for order flow

Given Gensler's comments that a limited number of market makers dominate the trade execution landscape, which in turn can lead to negative outcomes for traders, the practice of payment for order flow will become a significant area of focus. Gensler has indicated that while this practice has led to the advent of commission-free trading, certain inherent conflicts of interest for the market maker may require a review of existing regulation with changes that may be warranted to protect investors.

Cryptocurrencies

The explosion in popularity of cryptocurrencies has not gone unnoticed by the SEC. Gensler, a professor at the MIT Sloan School of Management who has taught classes on digital assets, has long been speculated to lead the charge at the SEC on increasing cryptocurrency acceptance. Many expect regulation to be a key factor in that effort.

While more had hoped for stronger commentary from Gensler related to the SEC's plans regarding cryptocurrencies and related exchanges, his acknowledgment before Congress that cryptocurrencies such as Bitcoin leave U.S. investors exposed or unprotected gave cryptocurrency enthusiasts some indication of what may come.

If the SEC is granted authority to move forward with regulation surrounding the crypto space, many will applaud the move; such regulations would likely lead to

broader acceptance of cryptocurrencies by institutions and retail investors alike. Still we also anticipate there would be some criticism.

Market plumbing

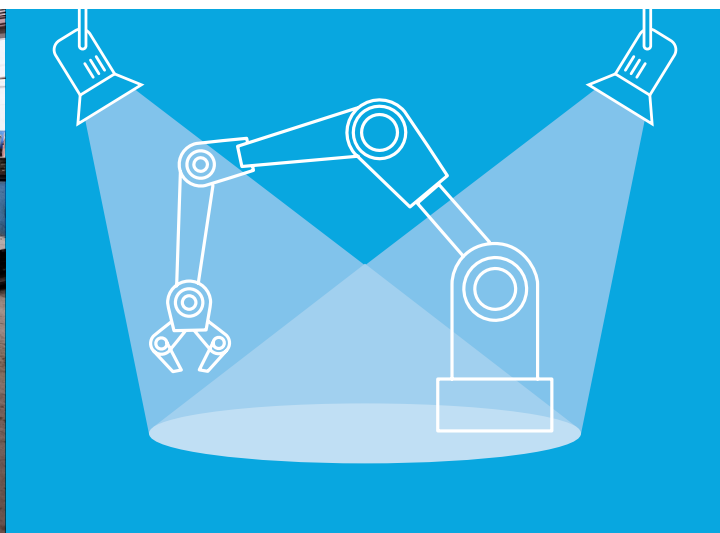
The trading surge in January led to rapidly changing prices, swings in volatility and trading volumes that created problems for some broker-dealers as they worked to manage liquidity and overall risk when clearing these trades. These problems then resulted in some broker-dealers restricting trading of certain stocks, which then hurt many retail traders.

While Gensler has indicated that there may not be sufficient disclosures for such items as margin requirements and trading restrictions for retail investors, his consideration of the overall timing it takes a trade to settle is drawing more attention. The SEC is reviewing the customary T+2 (trade day plus two days) settlement cycle to determine the feasibility of moving to T-0 or T-evening (same-day settlement). Given advances in technology, such a settlement cycle isn't impossible to envision. Yet the effort by capital markets firms to make such a move is likely to be a very burdensome undertaking.

The takeaway

The common thread among these five areas is that market participants are being put on notice by the SEC as the agency moves to modernize.

For participants, it will be critical to monitor the latest developments from the SEC for any rule changes, disclosure requirements or other agency commentaries that may require action. When the SEC is involved, simply doing nothing is an unacceptable answer. ■



INDUSTRIAL COMPANIES ARE AT HIGH RISK OF A CYBERATTACK

BY TAUSEEF GHAZI, MARTIN RUBIO, DAVID CARTER AND WES LADD

CYBERSECURITY in industrial environments has always been a concern, but the current cyberthreat landscape is making it a priority. On May 7, Colonial Pipeline, the operator of the largest fuel pipeline supplying the eastern United States, fell victim to a ransomware attack. The attack led the company to freeze its information technology systems and shut down all pipeline operations for several days as a protective measure, which has led to major shortages of gas, diesel and jet fuel throughout the eastern United States. The Colonial Pipeline ransomware attack has exposed how the industrial sector is at high risk for devastating cyberattacks.

Why is the industrial sector at such high risk?

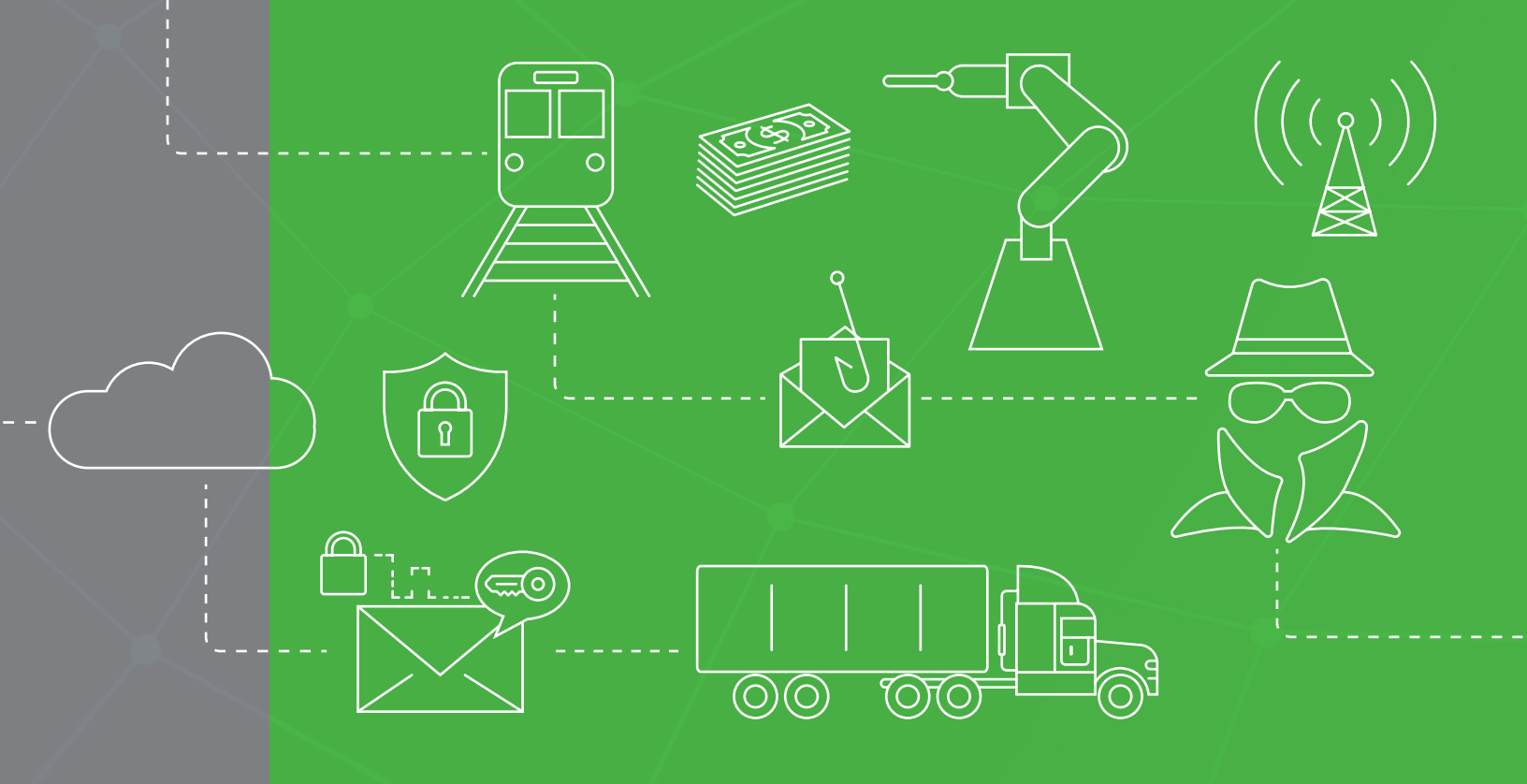
For decades, our economies and daily lives have depended on operational technology (OT), such as industrial control systems (ICS) or supervisory control and data acquisition systems (SCADA), for basic necessities like bringing water, power and gas into our homes; transporting gasoline needed for vehicles; running public transit; and manufacturing consumer products like food, medicine and beverages.

OT was not designed for our digital world, and therefore, much of our critical infrastructure runs on legacy systems that are more susceptible to cyberattacks. Many of these systems don't have the protective features and capabilities that we've come to expect from modern systems (e.g., antivirus, security patches, passwords, etc.). Operational limitations historically kept such protections from being used. However, the need for real-time information when making business decisions and optimizing performance has required these systems to be connected to our business networks and the internet.

Cyberattacks on these systems now have the ability to affect the safety of workers and the public. As a result, our critical infrastructure must not only secure these systems against attacks, but also design operational resilience for continued operations in the event of a successful cyberattack.

MIDDLE MARKET INSIGHT

Operational technology was not designed for our digital world, and therefore, much of our critical infrastructure runs on legacy systems that are more susceptible to cyberattacks.



What is the potential fallout of a cyberattack affecting OT?

Considering the impact these OT/ICS/SCADA systems have on our daily lives, including many critical infrastructure processes, the availability of these systems, and any other applications they rely on, is critical. As with the Colonial Pipeline ransomware attack, security breaches in the IT environment can create a chain reaction that is harmful to our economy, infrastructure and daily lives.

Here are some possible consequences when OT/ICS/SCADA systems are affected by a cyberattack:

- **Loss of utilities**—no water, energy or gas for homes, hospitals and military bases
- **Loss of communications**—no cellphones or landlines, no first-responder communications
- **Transportation disruptions**—insufficient fuel to supply cars, buses and planes; delays or loss of automation-dependent public transit (e.g., subway, light rail)
- **Public safety concerns**—explosions, contamination of air and water, civil unrest resulting from prolonged loss of utilities
- **Scarcity of consumer products**—cleaning supplies, food, medicines, beverages, etc.

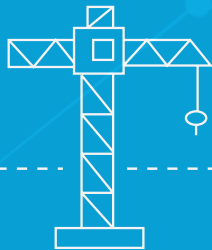
MIDDLE MARKET INSIGHT

Our critical infrastructure must not only secure OT systems against attacks, but also design operational resilience for continued operations in the event of a successful cyberattack.

Has the industrial sector ever experienced an attack like this before?

Many times. In fact, the online database RISI, which tracked security incidents affecting OT/ICS/SCADA systems, identified more than 150 such events by January 2015. Some notable recent attacks include the following:

- **In March 2021**, Molson Coors suffered a ransomware attack that affected its business and brewery operations, leading to supply chain disruptions and shortages of its products on some store shelves.
- **In June 2020**, Honda suffered a ransomware attack that led it to shut down factories in Japan, Europe and the United States and disrupted customer service and financial services.
- **In February 2020**, an energy company shut down a portion of its pipeline for two days after ransomware hit a natural gas compression facility.



NOT ALL COMPANIES NEED HIGHLY COMPLEX SECURITY PROGRAMS, BUT ANY INDUSTRIAL ENVIRONMENT SHOULD HAVE AN INDUSTRIAL CONTROL SECURITY PROGRAM IN PLACE.



So while details of the Colonial Pipeline attack are still emerging, this is not the first time that a cyberattack has disrupted operations. It's just the most recently publicized and impactful one to affect the United States.

Safeguarding against cybersecurity incidents affecting operations

Although it's too early to tell how the Colonial Pipeline event could have been prevented, many of the existing recommendations for the security of OT/ICS/SCADA environments and protections against ransomware continue to ring true. The joint guidance released by the Cybersecurity and Infrastructure Security Agency (CISA) and FBI following this incident reaffirm such recommendations.

Not all companies need highly complex security programs, but any industrial environment should have an industrial control security program in place. When developing these programs, companies should consider basic elements to protect their systems, detect possible attacks, and respond and recover from an incident. Examples of basic cyber hygiene that CISA has recommended as countermeasures include the following:

Reduce the risk of compromise by using or implementing strong security measures like:

- **Multifactor authentication** (e.g., one-time PIN, hardware token) for remote access to IT and OT networks

- **Asset mapping** to identify critical systems for operational processes to ensure those systems are properly secured
- **Continuous security assessments** to evaluate the access and impact of an attacker on the network
- **Spam filtering** to prevent phishing emails with malicious files and links from getting to users
- **Security training and phishing testing** to support user awareness
- **System security updates** to avoid compromises with known vulnerabilities
- **System hardening** to disable unnecessary applications and services that attackers commonly use

Reduce the impact of an attack by:

- **Implementing network segmentation** between IT and OT environments to prevent attacker access to OT systems, and to allow continued OT operations in case of IT environment compromise
- **Identifying system dependencies** and testing manual workarounds to build resilience against technology-induced outages
- **Implementing monitoring and detection mechanisms** to be alerted of malicious activity instantly
- **Backing up critical systems and data regularly**, testing the backups, and keeping offline and offsite copies ■

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
- Manufacturing and energy
- Life sciences
- Real estate and construction
- Technology, media and telecom

Check out [the Spring 2021 issue](#) now!





AN IMPROVED OUTLOOK WILL SPUR MORE INVESTMENT, MMBI SURVEY FINDS

After a year of whipsaw change in the American economy, senior executives at the nation's middle market businesses see economic conditions turning the corner over the next six months, according to the May proprietary RSM US Middle Market Business Index survey. And they are planning to make productivity-enhancing investments that will help their companies compete in the hypercompetitive post-pandemic economy.

The survey of 404 senior executives, conducted from April 7 to April 28, reflected an optimistic outlook for the economy, one that is on the cusp of the most robust expansion in decades.

Among the findings:

74% of respondents expect an improved economy over the next six months.

72% anticipate better revenues as well.

71% expect rising net earnings over that time period.

62% said they intended to engage in productivity-enhancing capital expenditures over the next six months, a strong increase over the 35% who said they had done so over the recent quarter.

THE TAKEAWAY

We anticipate a new wave of competition once the economy fully emerges from its pandemic-induced slumber that will feature the pulling forward of a decade's worth of technology into the next few years. This is a positive development in both the long run and in the near term.

A VOICE FOR THE MIDDLE MARKET CELEBRATING FIVE YEARS OF THE RSM US MIDDLE MARKET BUSINESS INDEX

Five years ago we saw an opportunity to bring deeper insight and knowledge to our clients, policymakers, media and others about the broader middle market economy. The question we wanted to answer: How could we give a much-needed voice to this important segment, which accounts for more than a third of U.S. employment and 40% of our gross domestic product? Enter the RSM US Middle Market Business Index.

[Learn more](#) about the MMBI's origin, the evolution and the direction it's heading in this video and article.



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

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