

THE REAL ECONOMY

VOLUME 75



GOVERNMENT TRANSFERS FUEL ROBUST INCOME AND SPENDING

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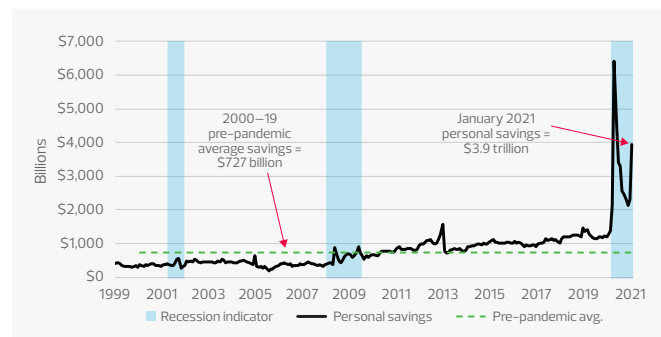
GOVERNMENT TRANSFERS FUEL ROBUST INCOME AND SPENDING

INCOMES EX-TRANSFERS ILLUSTRATE NEED FOR ADDITIONAL STIMULUS

BY JOSEPH BRUSUELAS

GOVERNMENT TRANSFERS from the end-of-year \$908 billion fiscal aid package were the primary catalyst for the 10% increase in income and the 2.4% jump in spending, a robust kickoff to what is going to be one of the more memorable years in economic activity in decades. The personal savings rate increased to 20% in January from 13.7% in December. The amount of national savings now stands at \$3.93 trillion, \$3.2 trillion above the pre-pandemic average. This combination of excess savings built up over the past year as a result of business curtailment and fiscal aid/stimulus that is in the legislative pipeline is the kindling for what will likely be an economic boom later this year.

U.S. savings: \$3.2 trillion above pre-pandemic levels

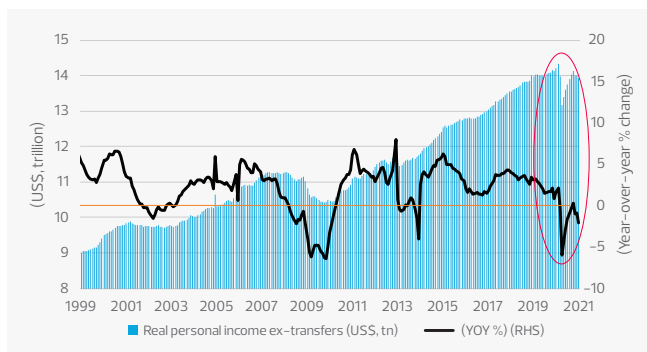


Source: BEA; Bloomberg; RSM US LLP

WHILE FINANCIAL MARKETS ARE MOVING SWIFTLY TO PRICE IN BETTER GROWTH AND PUSHING INTEREST RATES HIGHER AT THE LONG END OF THE TREASURY CURVE, RECENT DATA WON'T CAUSE THE FED TO ALTER ITS ZERO INTEREST RATE POLICY OR THE PATH OF ITS \$120 BILLION DOLLAR MONTHLY ASSET PURCHASE PROGRAM.

For those questioning the need for fiscal aid, here's the rub: after excluding government transfers, income actually showed a third straight monthly decline. January personal income ex-transfers declined by -0.5% even after an 11% increase in disposable income. This reaffirms our view that another round of aid is in order even after the boom-like January retail sales, spending and income data. The decline in personal income ex-transfers will reaffirm the Federal Reserve's policy path and its forecast of a modest transitory bump in inflation midyear that will then fall back toward its 2% target later this year and into 2022.

U.S. real personal income excluding government transfers IN 2012 DOLLARS AND YEAR-OVER-YEAR % CHANGE



Source: BEA; Bloomberg; RSM US LLP

While financial markets are moving swiftly to price in better growth and pushing interest rates higher at the long end of the treasury curve, recent data won't cause the Fed to alter its zero interest rate policy or the path of its \$120 billion monthly asset purchase program.

The central bank wants to see the reflation of the economy, higher inflation (at least in the short term) and an eventual move back to full employment, which we define as an unemployment rate at or below 3.5%. In our estimation, they will achieve the former later this year, while full employment still remains a number of years away.

The response in fixed income market to this data is notable. Just prior to the data release the U.S 10-year Treasury was trading near 1.47%, well above the 0.91% level at which it started the year. In our view, this is a positive development, reflecting the reflation of the economy and not indicative of risks linked to inflation. In the immediate aftermath of this recent data, the 10-year eased to 1.45%, perhaps indicating a modest break in the recent bond selloff after several volatile days of trading, and certainly related to the third straight decline in personal income ex-government transfer noted.

Inside the details of the report, the policy-sensitive core personal consumption expenditure index (policy-sensitive because the Fed uses this metric to formulate monetary policy) advanced 0.3% on the month and 1.5% on the year. This is in line with our preferred forward-looking inflation metric, the Fed five-year and five-year forward, which points to a 2.2% rate of inflation over the next 10 years. This does not scream inflation, hyperinflation or dollar debasement. Rather, it implies long-term price stability. ■

CHECK OUT THE Q1 2021 RSM US MIDDLE MARKET BUSINESS INDEX

The first-quarter edition of the proprietary RSM US Middle Market Business Index is out now! Produced in conjunction with the U.S. Chamber of Commerce, this closely watched gauge of middle market economic sentiment, along with commentary from RSM US Chief Economist Joseph Brusuelas, provides forward-looking insights for middle market leaders. Download [the full report](#).





HOW TO BRIDGE THE OUTPUT GAP AND RETURN THE ECONOMY TO FULL EMPLOYMENT

BY JOSEPH BRUSUELAS

NEGOTIATIONS BETWEEN the Biden administration and the GOP minority in the Senate reveal strengths and shortcomings in their policy preferences and objectives about how to promote an economic recovery.

Through it all, estimates of the domestic output gap—the difference between actual and potential gross domestic product—and what it will take to achieve full employment strongly suggest the need to go big on fiscal aid and stimulus programs.

While it is encouraging that both the GOP and Biden administration are targeting fiscal relief in excess of the nominal output gap, the administration clearly intends to err on the side of a return to full employment as soon as possible. Our estimate of what that will take, within the context of the pandemic-induced shock, strongly implies the need for roughly \$2 trillion in fiscal aid.

The risk to the economic outlook, after all, is not in doing too much—resulting in large and sustained fiscal activity—but rather in fiscal fatigue and the inclination to wait and hope for the best, as some would prefer.

The output gap and full employment

Recent estimates by the Congressional Budget Office imply that real potential U.S. growth has been below 2% since 2007 and will average 1.8% over the next decade before falling to 1.7% in 2031.

Given the lingering economic damage caused by Trump-era policies and the economic scarring caused by the pandemic, a vigorous economic response is needed. The objectives are to bolster near-term growth, to ensure that the U.S. economy avoids the sub-2% growth rate of the 2010–2020 period and to bring the economy back to full employment, which we define as a 3.5% unemployment rate.

To do that, one must accurately estimate the size of the output gap and then adjust that gap for the long-term effects of the pandemic. This will allow us to identify the minimum fiscal boost necessary to return to full employment.

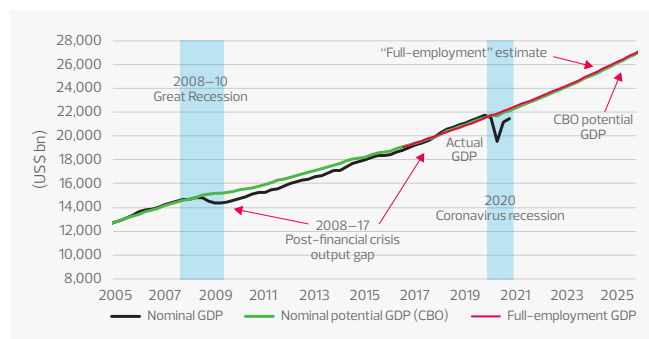
THE GREATEST ENEMY OF A RETURN TO FULL CAPACITY TO PRODUCE AND FULL EMPLOYMENT WITHIN THE U.S. ECONOMY IS FISCAL FATIGUE, NOT OVERSPENDING.

We start with an initial \$666 billion output gap, which compares the existing economy to what the CBO model considers to be attainable. But once we adjust potential GDP for the damage to economy caused by the pre-pandemic manufacturing recession and the pandemic itself, that output gap climbs to \$816 billion.

All of this suggests that a significantly longer timeframe and much more substantial fiscal boost will be needed to get back to full employment. The CBO estimate informs the current policy debate in Washington over next steps on fiscal aid. In fact, the GOP proposal of an additional \$619 billion hews closely to plugging the output gap that existed at the end of last year.

The Biden administration—likely due to lessons learned during the Obama years—has put forward a \$1.9 trillion proposal that looks to provide immediate relief as well as put the economy back on track toward closing the employment gap.

U.S. actual and potential nominal GDP IN CURRENT DOLLARS



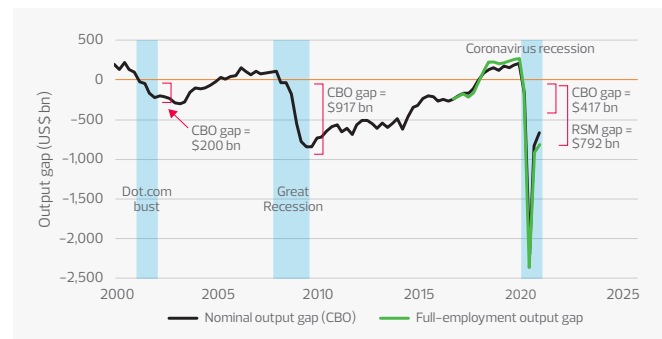
Indeed, our conservative estimate of the fiscal multiplier of 0.3 yields an implied aid/stimulus of \$1.65 trillion to return to the full capacity of the economy to produce and \$2 trillion to return to full employment.

This estimate indicates that the GOP proposal will most likely fall short on both goals while producing a suboptimal recovery and expansion. Given that in the aftermath of the Great Recession it took several years to return to the maximum sustainable level of GDP and more than a decade to return to full employment, this is the major policy discussion of the moment outside efforts to speed up vaccine distribution.

While economic activity is recovering and the output gap will narrow by the end of the year—this is different from maximum sustainable output—we anticipate severe dislocations in the labor market and commerce that are bound to outlast the pandemic. As such, we are at least three years from returning to anything resembling full employment. In our estimation, the CBO data on its surface tends to understate the size and duration of fiscal aid and stimulus needed to close the output gap and return to full employment.

U.S. nominal GDP output gap

CBO ESTIMATES AND RSM US "FULL-EMPLOYMENT" ESTIMATES IN US\$ BILLIONS



When one faces such a shock, that policy path requires the effective combination of fiscal and monetary policy—i.e., large spending programs and zero interest rates—and policymakers who are willing to overwhelm the problem and then stick with it. The greatest enemy of a return to the full capacity to produce and full employment is fiscal fatigue, not overspending.

What is the cost of returning to pre-pandemic levels?

Can we estimate the cost of programs necessary to kick-start the economy in 2021 and get it back to its potential? The nonpartisan Bureau of Economic Analysis calculates the value of actual economic activity, and the nonpartisan CBO offers estimates of the economy's potential output, with the difference referred to as the output gap.

The framework for the CBO's estimate of potential GDP focuses on two factors: labor input, or hours worked, and additions to the nation's stock of plants and equipment.

IN RETROSPECT, THE \$787 BILLION OF AID UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT WAS INSUFFICIENT AND NEEDED TO BE MUCH LARGER.

MIDDLE MARKET INSIGHT

While economic activity is recovering and the output gap will narrow by the end of the year—this is different from maximum sustainable output—we anticipate severe dislocations in the labor market and commerce that are bound to outlast the pandemic. As such, we are at least three years from returning to anything resembling full employment.

If the number of hours worked is reduced—because of a health crisis, for example—the potential output of the economy will be reduced. If the productivity of the labor market undergoes changes because of technological advances, the potential output of the economy will increase alongside those advances. (The [CBO's model](#) of potential GDP is more sophisticated and includes input from other sectors of the economy and other factors such as the effects of taxes and inflation.)

So a starting place for determining the amount of fiscal stimulus is the CBO's estimate of the output gap. In fact, during the depths of the 2008–09 financial crisis—and while the Federal Reserve became the lender of last resort for the world—the Treasury Department and Congress worked in concert to fill an output gap that reached \$917 billion. Their efforts saved the U.S. economy from falling into an outright depression.

Congress passed the \$787 billion [American Recovery and Reinvestment Act](#), which roughly matched the CBO's \$870 billion average estimate of the output gap in 2009.

Though the ARRA was long on tax relief, the tax benefits were distributed among households with the intent of propping up take-home pay and enabling consumer spending.

Also notable were grants to state and local governments, with a particular focus on education and extensions for state-run and financed unemployment benefits.

In retrospect, though, that aid and stimulus program were insufficient and needed to be much larger. In our estimation, this is one of the primary reasons—structural and demographic changes play a role here, too—why the pace of growth and real potential growth in the years following the Great Recession fell below 2%.

As we showed in the previous figure, the CBO lowered its estimates of U.S. potential GDP during each of the past three recessions. This is in line with the estimation framework discussed earlier.

The CBO's estimate of potential GDP tells us what is attainable, given the economy's capabilities in each particular circumstance. As such, the CBO is anticipating the economy to return to its pre-pandemic rate of growth only by late 2022. That seems to be a reasonable estimate were it not for the nearly 10 years that it took to close the gap after the financial crisis.

So should the targets for fiscal policy be only what is attainable? Or should the target for policymakers include what should have been, had there not been a policy mistake or an event that was out of anyone's control—and what could be if innovation is fostered in the public sphere? We'll call that the "full employment" target.

In that spirit, we estimated potential GDP before the 2018–2020 manufacturing recession and the 2020–2021 pandemic. It's a simple extrapolation of the growth trends that were in place before 2018, which are then spliced into the CBO's estimated growth trends in later years.

Estimates of the nominal GDP output gap and the stimulus necessary to return to "full employment" growth

	Nominal GDP* (1)	Potential GDP* (2)	Output gap* (4) = (2)–(1)	Multiplier (3)	Minimum aid/stimulus* (5) = (4)/(3)
CBO	\$21,480	\$22,146	\$6,660	0.4	\$1,665
RSM US	\$21,480	\$22,296	\$8,160	0.4	\$2,040

Source: CBO; Bloomberg; RSM US LLP

* US\$ bn

Using those estimates, the current output gap widens from \$666 billion to \$816 billion. Assuming a generous multiplier of 0.4, this implies a minimum fiscal stimulus of \$1.66 trillion to return to maximum sustainable activity and \$2 trillion to achieve maximum sustainable employment.

Still, those figures are bare minimums for getting the economy back to potential and to fund "back pay" for those who had to accept lesser salaries at substitute jobs, and those who experienced a permanent loss in living standards. This also does not include any efforts to modernize the economy's crumbling infrastructure. ■

THE ALTERNATIVE

ALTERNATIVE ANALYSIS FOR INFORMED MIDDLE MARKET DECISION-MAKING

THE GENDER PARITY AND WEALTH GAP

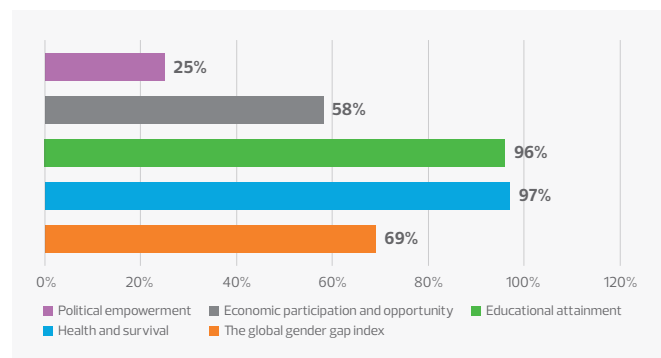
PANDEMIC COMPOUNDS THE INCOME AND WEALTH STRUGGLES FOR WOMEN

BY KAREN GALIVAN

GENDER PARITY will not be attained for another century. That forecast was posited by the World Economic Forum in its Global Gender Gap Report 2020. With March marking both Women's History Month in the United States and International Women's Day on the 8th, there is no better time to pull back the curtain on this sobering statistic.

The World Economic Forum study released in December 2019 found that economic participation and opportunity has only closed the gap by 57.8%, second only to political empowerment. Even more discouraging, less than half of all women globally or 47.1 as a percentage participated in the labor force, down from 51% in 1990 according to the International Labour Organization database as of the end of 2019. According to the U.S. Census Bureau's data on 2019 median earnings—the most recent U.S. figures available—women earned 82 cents for every dollar men earned. And, this was all before the pandemic.

State of global gender gaps



Source: World Economic Forum, Global Gender Gap Index 2020

MIDDLE MARKET INSIGHT

Middle market businesses must pay closer attention to the wage gap between men and women in order to attract and retain the best talent and foster a more diverse workforce in the competitive pandemic environment and beyond.

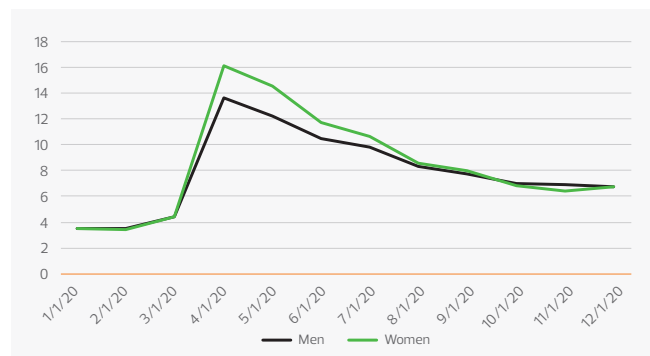
THE EFFECTS OF THE GLOBAL PANDEMIC ON WOMEN IN THE WORKPLACE HAVE BEEN STAGGERING, IN PART DUE TO DISPROPORTIONATE NUMBERS OF FEMALE WORKERS IN THE HARD-HIT SERVICE INDUSTRY.

The pandemic's damaging impact

The effects of the global pandemic on women in the workplace have been staggering. According to the U.S. Bureau of Labor Statistics, there were nearly 2.2 million fewer women in the labor force in October of 2020 than in February 2020, when the outbreak began. Women were hit hard for several reasons. First, they are more likely than men to work in a service occupation such as retail, tourism and hospitality, or restaurants, all among those industries suffering from government stay-at-home orders. Second, many in-person occupations deemed essential, such as health care and social work, are predominantly held by women, often with no telecommuting options available. These are also fields that frequently put workers' health and safety at risk.

Some women have made the decision to leave their positions for fear of exposure and complications to their own preexisting health conditions. Finally, women with children bore the brunt of childcare and homeschooling, according to a July 2020 study by Caitlyn Collins, assistant professor of sociology at Washington University. The reduction of women's work hours during the pandemic, due to childcare and other concerns, will likely intensify existing gender challenges in the future, including professional opportunities, networking, promotions and raises. Simply put, women on average are already making less than their full-time equivalent male coworkers and are now earning even less through reduced work hours and leaving the workforce either by choice or layoff.

U.S. unemployment rate by gender



Source: Bureau of Labor Statistics

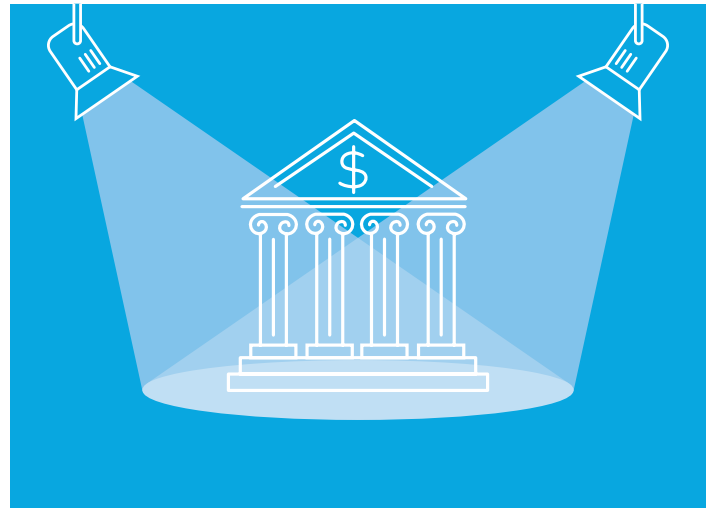
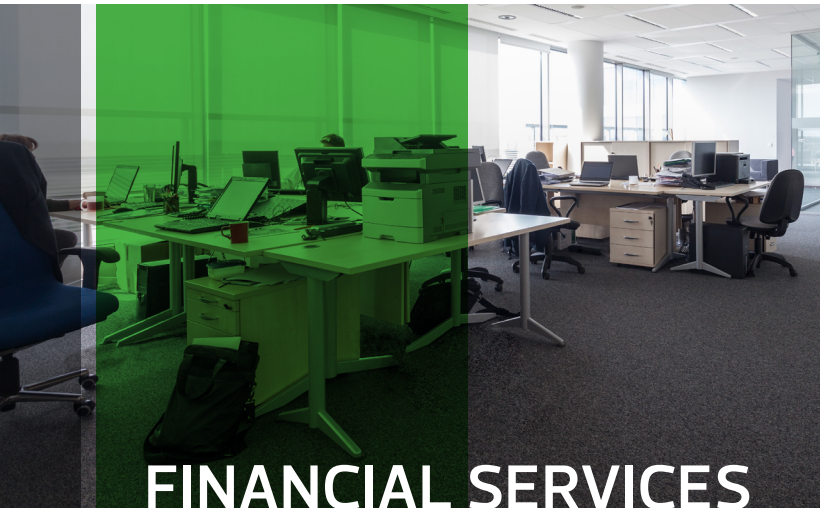
Women and wealth

Surprisingly, when childcare responsibilities are factored out of the equation, the wealth gap between women and men remains staggering. The largest gap, in fact, is between women who never married and men who never married, according to a research study from the Federal Reserve Bank of St. Louis. The data from the bank's triennial consumer study, analyzed by economists Ana Hernandez Kent and Lowell R. Ricketts, found that women who never married obtained 34 cents of wealth for every dollar held by men. After weighing various control factors such as age, education, home ownership and employment, the gap decreased; however, women still only had 71 cents of wealth for every dollar held by men. The income gap is often explored, but the wealth gap may take even longer to close. Having a large part of an economy not able to participate in that economy from lack of wealth creates a burden for all.

The takeaway

In order for the economy—and society as a whole—to thrive, we need diversity in talent and representation in order to create an environment where both men and women can succeed. We must also equip the younger generation with the skills necessary for the job market of the future. These skills lead to opportunities, leadership and an eventual closing of the gender parity gap, making way for wealth equity as well. Though these goals will take time, business leaders have the opportunity now to make progress, accelerate opportunities and provide a more equitable working environment:

- Consider offering a pandemic leave of absence or flexible work option to retain talented female employees
- Consider offering wellness programs that include mental health resources and coaching
- Improve hiring practices by including a diverse pool of candidates
- Continually encourage participation in health and welfare benefits and offer retirement plans for both full-time and part-time employees
- Continually provide education regarding saving and investing that meets employees' needs, not just when they are first hired
- Raise awareness with government officials on the need for policy that accelerates gender parity and closes the pay gap ■



SPACS AND DIRECT LISTINGS ARE RESHAPING THE CAPITAL MARKETS

BY KENNEDY CHINYAMUTANGIRA AND NELLY MONTOYA

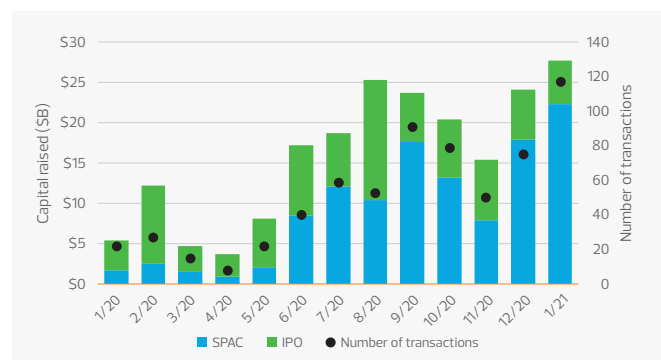
THE VOLUME AND DOLLAR value of public listings went on a tear last year as private companies took advantage of a bullish stock market to raise cash at attractive valuations.

Activity in January indicates that this momentum has carried over into the new year with three methods of going public — special purpose acquisition companies, direct listings and traditional initial public offerings — showing signs of a strong opening quarter and the potential for another stellar year.

Special purpose acquisition companies

SPACs were the buzz of 2020, a record-breaking year, and are off to a quick start this year with January being the best-ever month for new SPAC listings. The continuing interest in SPACs has been supported by a rising stock market, which has delivered spectacular gains for early investors in new SPAC offerings.

IPO and SPAC activity since January 2020

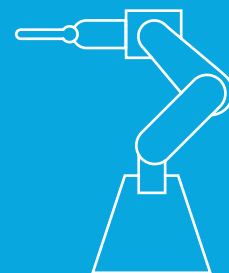


Source: Bloomberg; RSM US LLP

A SPAC essentially flips the traditional IPO process on its ear, by first creating the shell company, then going out and finding acquisitions to fill out its portfolio. SPAC investors bet on the skill and talent of the SPAC management team and the likelihood that the managers will identify a suitable target company within a two-year time frame. SPACs are likely to continue to generate interest for as long as the market performs well.



WITH COMPETITION TO SECURE SUITABLE TARGETS INTENSIFYING, SPACS HAVE BEEN MOVING DOWN THE MATURITY LADDER IN SEARCH OF COMPANIES TO ACQUIRE.



All of these bets have the ability to do well both in a rising stock market and when market expectations for the post-merger success of the target companies are elevated. Consider the electric vehicle industry. The stock market performance of electric vehicle manufacturers, or their suppliers, has spurred investors to search for the next startup to deliver the outsized returns that Tesla delivered in 2020. Moreover, this industry has a favorable long-term outlook as a more environmentally friendly administration transitions into government and the focus on renewable energy grows.

SPACs are likely to continue to generate interest for as long as the market performs well and the appetite for the next big thing detracts investors' attention from some of the rising risks of each additional dollar of SPAC dry powder accumulated.

As more SPACs are launched, competition to find targets is heating up, raising the possibility of SPACs overstretching to secure targets or, in some cases, failing to complete the merger within the prescribed time frame.

With competition to secure suitable targets intensifying, SPACs have been moving down the maturity ladder in search of companies to acquire. The expectation for the market to continue to be receptive to SPACs taking early-stage companies public remains to be tested. Public equity markets can be shortsighted when it comes to evaluating performance from one quarter to another.

As an increasing number of less-mature companies are brought to the public markets through a merger with SPACs, it remains to be seen how patient investors will be in allowing these early-stage companies to develop their products, grow their revenues and achieve profitability. A bout of stock market panic and volatility could put this to the test, and it may not be long in coming, with some pockets of the stock market starting to exhibit signs of froth.

Direct listings

Direct listings have been little used as an avenue for going public. Before 2020, the only notable companies that took this route were Spotify and Slack. Interest in this option increased in late 2019 following soured investor sentiment due to poor performance of a number of mega-IPO deals. Investors and venture capital-backed companies began to seriously deliberate the possibility of using direct listings as an exit route, but the mechanics of this alternative rendered it an avenue only open to a limited few.

Under a new rule, a company in a direct listing will be able to issue new shares on the first day of trading.

In its current form, a direct listing results in existing shares being listed on the public markets with no additional capital raised. Mature private companies with ample capital or with steady cash flows and no immediate need to raise cash may find this route preferable as a means to offer investors liquidity. The majority of venture capital-backed companies do, in fact, need the cash and go public in order to tap the public markets for additional capital.

A direct listing also has less involvement by investment banks and does not have similar restriction periods for the trading of shares by existing stockholders in the immediate aftermath of the public listing. For lesser-known companies, this lack of support by an underwriter and lack of trading restrictions can make for volatile share price performance.

Direct listings attracted greater attention in 2020 following the high-profile direct listings of Palantir and Asana at the end of the third quarter. But what will make them more compelling in the future are new rules proposed by the New York Stock Exchange that will change the direct listing from being not only a liquidity event for existing shareholders, but also a way to raise capital.



In December, the Securities and Exchange Commission approved the NYSE's proposal for a new direct listing process in which a company will be able to issue new shares in the opening auction on the first day of trading and sell directly to the public.

This change, which lifts the previous impediment of not being able to raise new capital upon listing, should raise the popularity of this route as a viable option for more companies looking to go public.

News of Roblox and the cryptocurrency trading platform Coinbase planning to go public via direct listing has already brought forward two high-profile candidates that are pursuing this option to add to the slowly growing list of mature companies opting for this route. This will most likely not be the last to be announced this year. We expect more to come.

Traditional initial public offerings

The traditional IPO will remain an important way for companies to raise capital, even as the proponents of SPACs and direct listings assail the traditional process. The IPO remains an avenue accessible to all companies looking to go public and has endured through changing market cycles.

Similar to SPACs, the strong end to 2020 seems to have rolled into this year with an impressive lineup of companies expected to drop in 2021. Last year ended with Airbnb and DoorDash arriving to the public markets through the traditional IPO and seeing substantial pops during their first days of trading. While these IPO pops may stir companies to consider the alternative options for listing in fear of leaving a lot of money on the table, we expect a good number of the highly anticipated IPOs for 2021 will still pursue the traditional IPO route.

This year has already seen the arrival of Affirm (AFRM), Petco (WOOF), Poshmark (POSH) and Ortho Clinical Diagnostics (OCDX). Large names in the IPO registration pipeline include the social media platform Bumble, the webinar and virtual event platform ON24 and the robotic process automation company UiPath.

A number of life sciences companies have also filed for IPOs in January. Beyond this, other household names, including Robinhood and Instacart, are said to be preparing to file for an IPO this year.

The takeaway

The landscape in public markets is continually changing. Here is what to expect for the three methods of raising capital:

- SPACs are on pace for a record quarter, but some risks are emerging as competition for targets rises and SPACs wade into less-mature targets that may not fare well should markets turn bearish.
- Direct listings are set to gain in favor following the SEC approval of new rules proposed by the NYSE. Even as more direct listings are expected, this option should continue to be more viable for mature, established companies.
- Traditional IPOs remain the tested approach that is available to most companies and will continue to see a fair share of transactions despite the rise in other methods of going public. ■



CYBERATTACKS ON THE RISE

MIDDLE MARKET COMPANIES saw a sharp uptick in cyberattacks in the past year, according to an RSM US Middle Market Business Index survey. Many middle market executives indicated that they faced new IT safety challenges amid the pandemic-induced shift to remote work.

28% of respondents said they experienced a data breach, up from **18%** a year earlier—the highest level since the first quarter of 2015, when RSM began surveys on cybersecurity.

64% said they expected unauthorized users to attempt to breach their systems this year, up from **55%** a year ago.

33% said their companies experienced a ransomware attack in the past year.

Slightly more than half said their organizations had been the target of a business takeover attempt.

THE TAKEAWAY

To strengthen cybersecurity efforts, businesses must assess physical, virtual and personnel vulnerabilities from various attack scenarios, including remote work processes and practices. Additionally, businesses should develop an enterprise security program that complies with evolving data privacy regulations as well as establish an agile governance structure—across all facets of security—that aligns with their business strategy. Finally, businesses should encourage a culture of cybersecurity awareness. For more on this topic, look for our full MMBI special report on cybersecurity issues, due in April.

Congratulations, Joe!

The Alliance of Merger & Acquisition Advisors has named RSM Chief Economist Joe Brusuelas the 2020 Middle Market Thought Leader of the Year.



[Watch this video](#), featuring Joe's RSM colleagues, to learn more about his recognition and this award.

This honor recognizes members of the private middle market financial community who generate new ideas that add value to the marketplace. These contributions augment the body of knowledge that serves as a solid foundation for AM&AA's education and credentialing programs.

Through his role at RSM, Joe has created numerous programs and initiatives, including The Real Economy publication, to support the middle market, advance the next generation of business leaders, disseminate information relevant to executives and advocate for the middle market among elected officials.



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

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