

THE REAL ECONOMY

VOLUME 70



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IN THE LONG RUN, U.S. NEEDS A PRODUCTIVITY MIRACLE

BY JOSEPH BRUSUELAS

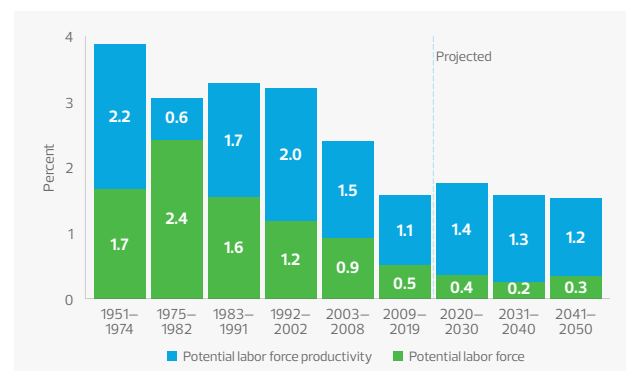
THE CONGRESSIONAL BUDGET OFFICE recently published its [long-term budget outlook](#) for 2020. Not surprisingly, its forecast of a 107% debt-to-GDP ratio in 2023, rising to 195% in 2050, garnered all of the attention. But beneath that headline are significant policy challenges facing the U.S. economy.

Because of demographic and structural changes to the economy, long-term growth has slowed noticeably. Once one looks at the baseline assumptions, it's clear that absent significant changes to immigration policy, the United States is going to need a productivity miracle.

First, let's look at the projected long-term growth rate. Because of a confluence of demographic and structural changes to the economy, long-term growth has slowed noticeably and is expected to be roughly 1.5% over the next 30 years. Most important, the slowdown in the

growth of the labor force, which economists have been shouting about for some time, is not well-aligned with current immigration policies.

Average annual growth of real potential GDP



Source: Congressional Budget Office

ONE WAY TO INCREASE PRODUCTIVITY AND GROWTH WOULD BE TO PERMIT BUSINESSES TO EXPENSE ALL OF THEIR OUTLAYS ON EQUIPMENT, STRUCTURES, SOFTWARE, AND INTELLECTUAL PROPERTY AND OTHER INTANGIBLES.

Assuming there will not be significant growth in the labor force anytime soon, the United States needs a much faster pace of growth to mitigate the permanent damage to the economy wrought by the pandemic. That can be generated only with a significant improvement in productivity. The CBO projects a long-run growth trend of only 1.8% over the next decade, and slowing to the 1.5% rate over the next 30 years. Clearly, this is not going to be sufficient to address the damage to the economy and produce fast enough growth to offset those growing deficits.

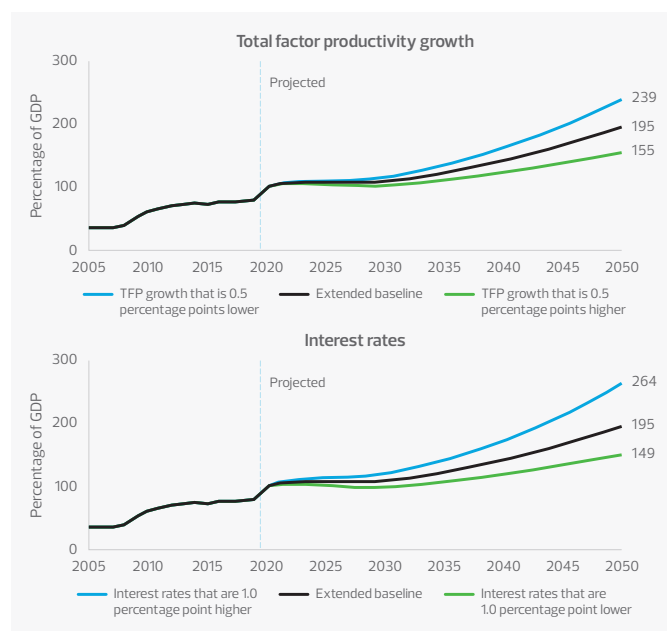
Second, take a look at the differentials in the trajectory of federal debt as a percentage of GDP based on just a 0.5% change in total factor productivity compared to the baseline projection. If total factor productivity is just 0.5 percentage points faster, that 2050 projection of 195% of GDP turns into a much more manageable 155% of GDP. Economists often state that in the short run, productivity means little, but in the long run it is everything. This data illustrates that undeniable truth.

Third, the Federal Reserve's recent Summary of Economic Projections implied that the policy rate, or the federal funds rate, will remain at zero through 2023, the endpoint of its forecast. The move to the zero-interest-rate policy early in the pandemic caused a general shift down in the U.S. Treasury curve to the point where on most days, once one adjusts for inflation, the curve is negative out to the 30-year maturity spectrum.

The market has priced in no change in the policy rate until the end of 2025. To put this in context, the CBO projects that if interest rates are just 1% higher, the debt-to-GDP ratio would explode to 264% compared to the 195% baseline projection in 2050. If interest rates are one percentage point lower—yes, that means negative nominal interest rate policy—the baseline projection falls to 148% of GDP in 2050.

For this reason, the deficit and debt dynamics of the United States almost require the Fed to maintain its zero-interest-rate policy for the near future; this is part of the reason why the central bank recently chose to change its policy regime to a flexible average inflation-targeting one.

Federal debt if total factor productivity growth or interest rates differed from the values underlying CBO's projections



We are not arguing here that the United States does not have fiscal space to address the long-term damage linked to the pandemic or its pressing social and economic needs; it clearly does. But there will need to be significant policy changes to support faster productivity and growth. One way to increase productivity and growth would be to permit businesses to expense all of their outlays on equipment, structures, software, and intellectual property and other intangibles.

Based on the data presentation by the CBO, the status quo is clearly not sustainable. ■

MIDDLE MARKET INSIGHT

Assuming there will not be significant growth in the labor force anytime soon, the United States needs a much faster pace of growth to mitigate the permanent damage to the economy wrought by the pandemic. That can be generated only with a significant improvement in productivity.

MONETARY POLICY AND INFLATION IN THE MODERN ERA

BY JOSEPH BRUSUELAS



THE FEDERAL RESERVE is embarking on a new era in monetary policy, switching from its point target of 2% inflation to a target range of 1% to 3%. This change is predicated on longer-run structural changes in the economy that are inherently disinflationary, a real neutral interest rate near zero and much slower growth in the economy, all of which have reduced the trade-off between inflation and unemployment.

By adopting a flexible average inflation target, the Fed is using its most important tool—forward guidance—to infuse confidence in investors and the general public that it will do all it can to sustain the economic recovery needed in the wake of the coronavirus pandemic.

The jettisoning of a Phillips curve framework then gives the central bank several degrees more freedom to permit the economy to run hot after periods of below-potential production and consumption without the risk to the outlook from higher inflation. The crux of the shift in policy is that the Fed will allow periods of higher

inflation to balance out periods of lower inflation, telling the markets and investors that it will provide additional stimulus whenever necessary to maintain self-sustaining growth.

Most important, the central bank will now err on the side of maximum sustainable employment. And when the unemployment rate approaches 4%, which we think approximates full employment, good things happen in the economy.

There will be critics on both sides of this new policy. One side will include the “inflationistas,” who are wary of runaway inflation and critical if the Fed allows prices to increase anywhere above their already-low levels (or if Congress allows any stimulus policy other than a tax break). The doubters on the other side will see the Fed pushing on a string should its more accommodative monetary stance not be applied in tandem with an even more accommodative fiscal stance that targets infrastructure spending and the social safety net.

MIDDLE MARKET INSIGHT

Now, because of the severe shock to the economy due to the pandemic and with inflation and interest rates so low, the economy appears more likely to fall into a deflationary spiral than to produce runaway inflation. Indeed, inflation has ranged between 0.1% and 1.6% in the past six months.

First, some basics. Keep in mind three possible sources of inflation:

- Shortages of goods that drive up prices.
- Excess income forming a bubble in the demand for assets and goods.
- Expectations of inflation that accelerate current spending.

Also keep in mind the difference between disinflation and deflation. Disinflation is the deceleration of price increases that can be the result of changes in taste or improvements in technology that reduce production costs as firms compete for market share. Deflation is the negative growth rate of prices when demand drops to levels that can no longer support a market for goods.

The drop in demand is usually the result of a shock to the economy like the loss of employment because of an economic slowdown, with the pandemic being the most recent example.

Is inflation a worry?

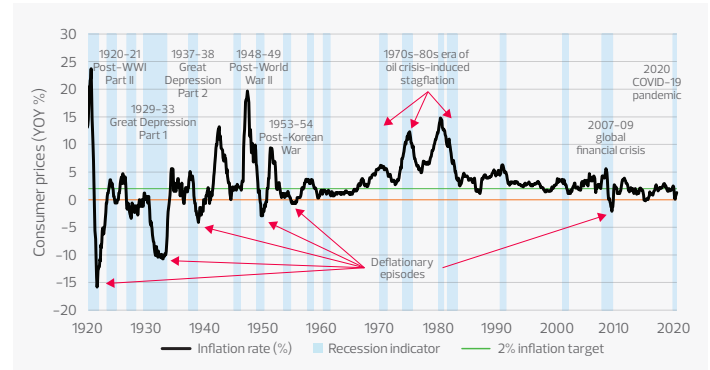
Let's begin with the inflation-worriers, who can point to inflationary periods after World War I and II, the Korean War and OPEC's oil embargoes as cause for concern. Inflation in those postwar episodes resulted from the relaxation of price controls and pent-up demand for consumer goods after years of austerity during wartime economies.

The more recent bouts of inflation during the 1970s and 1980s were the result of supply shocks when OPEC went to economic war with its client countries, pushing up the price of a good that could not be substituted at the time—fossil fuel—during the oil embargoes. What the inflationistas seem to overlook is that since the oil embargoes, inflation has been trending downward. During the 25 years from 1960 to 1984, the inflation rate during nonrecessionary months averaged 3.2%. In the 35 years since 1985, the nonrecessionary inflation rate has averaged 2.6%.

Not only did Paul Volcker's Federal Reserve figure out how to squash runaway inflation in 1985, but the world's

central banks began to target inflation instead of the money supply, sensing a shift in economic structure that would result in a secular decline in both global inflation and in long-term interest rates.

U.S. inflation rate in post-recession periods and episodes of deflation



Source: BLS; NBER; RSM US LLP

What about deflation?

There is one more trend to consider in the wake of the pandemic. The pre-1970 recessions included periods of deflation, with the drastic drop in economic activity and employment opportunities causing consumers to both limit purchases to essentials and to postpone purchases on expectations that prices would continue to fall—resulting in a “deflationary spiral” in which prices indeed continue to fall and the economy spirals downward.

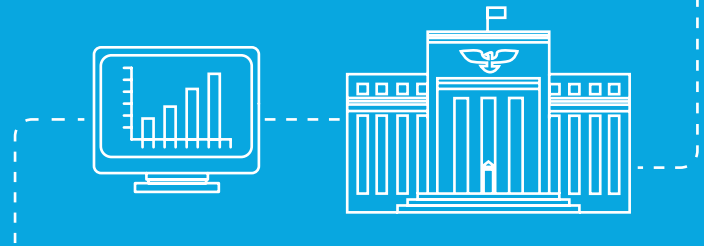
The Great Financial Crisis, or Great Recession, of this century produced 11 months of negative or abnormally low or negative inflation rates during 2009, which attested to the need for the bailout of the automobile industry and the funding of infrastructure projects to jumpstart a moribund economy. Now, because of the severe shock to the economy due to the pandemic and with inflation and interest rates so low, the economy appears more likely to fall into a deflationary spiral than to produce runaway inflation. Indeed, inflation has ranged between 0.1% and 1.6% in the past six months.

Can the Fed by itself pull the economy out of recession?

Because of the secular decline in inflation and the worldwide compression of interest rates since the 1980s, there has already been a shift in the focus of monetary policy. With inflation out of the picture, the Federal Reserve was given the leeway to be geared more toward the growth aspect of its dual mandate.

MIDDLE MARKET INSIGHT

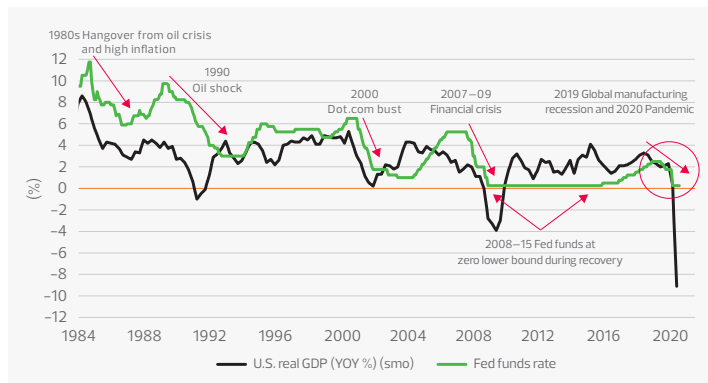
It is doubtful that the transition to a new economic structure will be possible without the Fed facilitating the necessary financing. But it is also doubtful that an accommodative monetary policy stance alone will be sufficient.



Since the mid-1990s the Fed has responded to slowing growth with cuts in the federal funds rate to maintain the ability of commerce to function. (The federal funds rate anchors the yield curve, while facilitating commercial borrowing and lending in the money market.)

Federal Reserve response to economic downturns

REAL GDP GROWTH AND FED FUNDS RATE SINCE 1984



Source: BEA; Federal Reserve; Bloomberg; RSM US LLP

Of note, the federal funds rate was raised during the 1990s, when the dot-com era spawned malinvestment, and then again during the 2000s, when mafeasance in the mortgage sector produced an asset bubble, worthless debt and a global freeze in the financial markets.

The Fed responded by holding short-term interest rates at the zero bound during much of the decade-long recovery from the financial crisis and Great Recession, allowing for the stability and the confidence in policy needed for sustainable economic growth.

Once sustainability was reached, the Fed began normalizing interest rates by slowly raising money market rates in 2015. The economy continued to grow until U.S. trade policy was turned on its head in 2018, setting off a global manufacturing recession and the need for the Fed to revert to cuts in the federal funds rate.

And now, the pandemic has the potential to exact long-term damage to the labor force and to the economy's potential growth. That leads us back into the other side of the argument; the doubt that monetary policy will be enough to stimulate an economy that has been damaged beyond quick repair and is in the process of being reimagined without much of the existing labor force and without existing centers of normal labor interaction.

It is doubtful that the transition to a new economic structure will be possible without the Fed facilitating the necessary financing. But it is also doubtful that an accommodative monetary policy stance alone will be sufficient. ■

THE TAKEAWAY

The lesson of the recovery from the Great Recession was that a fiscal stimulus must be applied quickly and be large enough and bold enough to produce the means for transforming the economy. The de facto integration of fiscal and monetary policy is going to be necessary to address the long-term economic damage wrought by the pandemic.

While the auto industry was kept afloat after the Great Recession, the terms should have required adaptation of new technologies to prevent global climate change. (Incidentally, this transformation is under way two decades later at Tesla, General Motors and our foreign competitors).

While rebuilding roads and bridges was necessary to keep the construction industry solvent, projects to build schools, hospitals and the electric grid, and to expand broadband to every community, should have been required in order to expand the capabilities of the economy.

THE ALTERNATIVE

ALTERNATIVE ANALYSIS FOR INFORMED MIDDLE MARKET DECISION-MAKING

THE VELOCITY OF MONEY AND RECESSION

BY JOSEPH BRUSUELAS

ONE LONG-HELD NOSTRUM in economics is that inflation is always and everywhere a monetary phenomenon. For years, some economists focused on growth in the money supply and the velocity of money, which is traditionally defined as the ratio at which money changes hands, to ascertain the direction of growth and risks to the outlook from inflation.

However, over the past three decades, the velocity of money has generally declined as the Federal Reserve has imposed disinflationary policies, so the measure has fallen out of favor as a useful way to predict the direction of the economy.

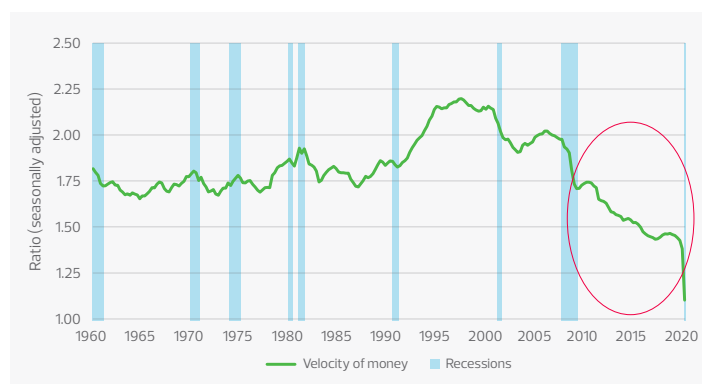
Today, the broad and deep shock unleashed by the pandemic has caused the velocity of money, which I define as the price level times the number of transactions divided by the money stock, to decline to a modern low of 1.1.

MIDDLE MARKET INSIGHT

Despite the robust increase in fiscal and monetary policy to prevent a greater economic catastrophe, that risk to the outlook remains skewed toward disinflation or outright deflation in the near to medium term.

The change in the velocity of money is generally a function of two things: the pace of growth in the economy and growth in the money supply. Despite strong growth in M2, a measure of U.S. money supply known as a money aggregate, the velocity of money has declined sharply.

Velocity of money



Source: Bloomberg; RSM US LLP

This would tend to suggest that growth will remain quite slow once the initial rebound since the reopening of the economy passes. Moreover, despite the robust increase in fiscal and monetary policy to prevent a greater economic catastrophe, that risk to the outlook remains skewed toward disinflation or outright deflation in the near to medium term.

Readings of velocity at these levels also imply generous fiscal space and room for further unorthodox monetary policy by the Fed to address the current shock and in the post-pandemic economy. Time passes; things change. ■



2020 ELECTION RESOURCE CENTER

Insights for the middle market

The November 2020 U.S. election could lead to significant policy shifts across the legislative and regulatory landscape. RSM leaders are on the front lines, working across industries and engaging with policymakers to help navigate through the policy uncertainty.

Visit our resource center and read, listen to and view our latest election-related insights, and most importantly, learn about the potential impacts the outcome of the elections will have on middle market organizations.

Check out our [resource center](#) today.

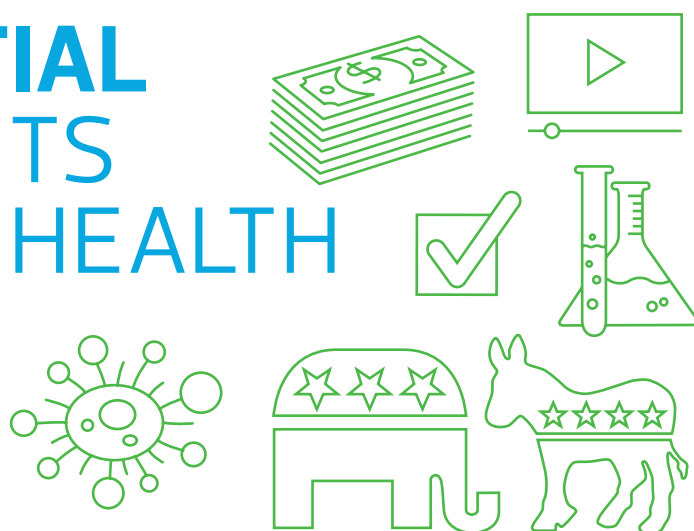
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THE PRESIDENTIAL ELECTION AND ITS IMPACT ON THE HEALTH CARE SECTOR

BY RICK KES AND MATT WOLF



AS THE NOVEMBER ELECTION approaches, discussions about the health care ecosystem have taken on greater urgency in virtual boardrooms in Washington and around the nation. What happens if Joe Biden, the Democratic nominee, wins the White House and Republicans lose control of the Senate? Or if the Democrats lose ground in the House, and President Donald Trump is reelected?

With the future of health care in the balance, it's important to consider recent federal actions and the impact that the elections will have, whatever the outcome.

Trump's health care priorities

In 2016 and early in his term, Trump campaigned on a promise to repeal and replace the Patient Protection and Affordable Care Act, better known as "Obamacare." This effort was largely unsuccessful in Congress, and continues to face challenges in court. That theme is now largely missing from the president's campaign, suggesting that the broad framework of the Affordable Care Act may remain intact regardless of how the election plays out. After all, the president's agenda, regardless if it is Trump's or Biden's, is only part of the equation, because court decisions could have a significant impact on Obamacare. And given the current push to quickly nominate a new supreme court justice, there is certainly much in play.

THE HEALTH CARE SYSTEM DOESN'T HAVE A CLEAR WINNER IN THE RACE. STATED AND INFERRED PLANS FROM EACH CANDIDATE INCLUDE MEASURES THAT WILL BE POTENTIALLY HELPFUL AND HARMFUL TO THE HEALTH CARE SYSTEM.

This has not stopped the Trump administration from championing several issues and signing executive orders affecting key elements of the Affordable Care Act. These have included:

- Price and quality transparency: The Trump administration continues to argue that providers must make patients' out-of-pocket costs available for certain shoppable procedures, among other measures aimed at allowing patients to make more informed decisions about how and where to spend health care dollars.
- Telehealth services: The administration has focused on expanding access to health care for rural and Medicare populations, and improving reimbursement by extending—beyond the current public health emergency due to the pandemic—the additional telehealth services offered to Medicare beneficiaries. This includes implementing new payment models to encourage high-quality, value-based care regardless of where it is delivered.
- Medicare Advantage: An executive order ensured greater choices and flexibility for Medicare Advantage plans.

- Short-term health insurance: The administration sought to allow certain individuals and employers to sign up for or create plans that can last as long as three years and are otherwise not compliant with the ACA.
- Reference drug pricing: The administration is trying to lower prescription drug pricing by using prices paid by other countries as the price that Medicare would be willing to pay for the same drug.

If Trump is successful in his bid for a second term, he will most likely continue to champion these issues.

Biden's statements on health care

A recent Biden campaign ad signaled his ongoing alignment with President Obama and the Affordable Care Act. His campaign continues to suggest that his administration would look to build on the work done during the Obama years.

Biden has indicated that he is campaigning on offering a public option, increasing the cost-sharing reductions provided to middle-class Americans and expanding Medicaid, including further subsidies for lower-income individuals and families.

Health care consolidation and the role of private equity

During the Trump presidency, we have seen several consolidations within the health care ecosystem, and we do not expect that to change if he were to win a second term. A Biden presidency might have a more lasting impact on the deal environment over the medium and perhaps long term, particularly given the record of Biden's running mate, Senator Kamala Harris, a former attorney general of California, who has a "[history of health care merger crackdowns](#)" according to [Modern Healthcare](#).

While vice presidents do not directly influence federal antitrust proceedings, Joel Goldstein, a professor at Saint Louis University School of Law, noted in a recent [Modern Healthcare](#) article that Biden was given influence over Obama's pick for attorney general. While Biden's vision statements in early September made no mention of health care mergers or consolidations, a task force of Biden and his former rival for the Democratic nomination, Senator Bernie Sanders of Vermont, called attention to what it called the "[concerning] increase in megamergers and corporate concentrations across a wide range of industries, from hospitals and pharmaceutical companies to agribusiness and retail chains."

Trump's health care agenda

Area of focus	Impact on providers	Impact on commercial and government payers	Impact on patients
Price and quality transparency	Unknown in the long term, but the administrative burden on health care providers presents a challenge.	Some commercial payers have embraced price transparency and already provide it to their members. Additionally, payers could use the information posted on a provider's website for their benefit when entering into contracting negotiations with health systems as well as describing their value to employer groups.	To the extent that this allows patients to make meaningful choices about how to spend their health care dollars, this will benefit them.
Rural health and telehealth	Likely helpful for providers that have focused on telehealth growth. This could also change the efforts and methods used for provider recruitment; for instance, a health care provider in a rural area may have better luck recruiting a specialist provider if the provider is not required to live in a rural area.	More preventative care in a lower-cost site of service will likely reduce overall expenditure.	Increased access to quality care in a low-cost and convenient way will likely be a net benefit.
Medicare Advantage	Varying depending on contracted rates with Medicare Advantage. Additionally, Medicare Advantage plans have sometimes been more willing to enter into value-based care arrangements, so providers with competencies in that area could benefit from this as well.	Expanded Medicare Advantage is generally viewed as a valuable business for commercial insurers.	Many patients enjoy the flexibility and additional benefits provided by Medicare Advantage plans. But members of Medicare Advantage plans often have fewer provider choices and sometimes a narrower network than enrollees with traditional Medicare.
Short-term health insurance	Only about 3 million consumers (less than 1% of the U.S. population) are enrolled in short-term health insurance plans, so on the whole the health care system is somewhat unaffected by these plans. But this could help address concerns associated with these plans.	Several commercial payers provide short-term insurance so it's likely that many of those organizations would be at a minimum indifferent toward this.	Patients may save money over the life of the plan, particularly healthy patients. But patients may face surprisingly large bills if they end up needing a procedure that isn't covered, which would leave them on the hook for large out-of-pocket expenses.

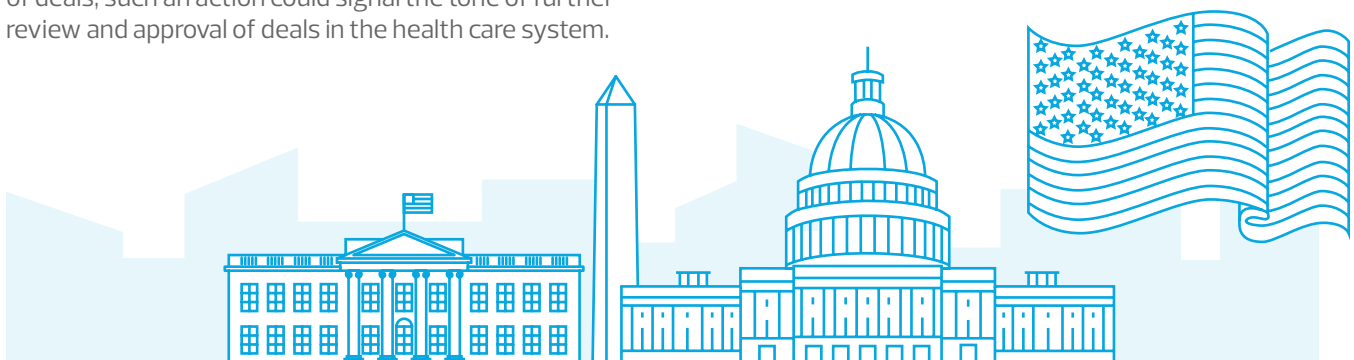
Biden's health care agenda

Area of focus	Impact on providers	Impact on commercial and government payers	Impact on patients
Public option	The devil is in the details, particularly the reimbursement rates to providers. If they are more consistent with Medicare, this is generally not helpful for providers. By some estimates, as many as 24 million Americans, many currently commercially insured, could be eligible for the expanded Medicare plan.	Again, details matter but payers may consider further expansion of Medicare Advantage plans.	This may prove a valuable option for many patients and could perhaps meaningfully reduce the out-of-pocket expenses for some beneficiaries. Intuitively providing more access to health insurance will cost the U.S., according to an article in Becker's Hospital Review. Federal government spending would increase by \$122 billion in 2020, with a decrease in national health spending (incorporating government, employer and household spending) of only \$23 billion.
Cost-sharing reductions	If more people qualified for cost-sharing reductions, that would most likely be positive for providers because their consumers would have more disposable income for their patient responsibility (deductibles and co-insurance) for services performed.	Payers for the most part are indifferent toward this issue. But, as evidenced by recent court activity, the issue of cost-sharing reductions has political ramifications. In 2017, the Trump administration announced it would stop paying cost-sharing reductions to insurers.	Appears to be intended to benefit patients by reducing their out-of-pocket costs.
Medicaid expansion	Generally, expansion is helpful for providers and payers alike. Many of the patients who are covered by Medicaid would have otherwise been uninsured.	Payers who offer managed Medicaid have more enrollees, which can help expand or diversify risk pools.	Likely provides better access to care for uninsured or underinsured patients.

The task force went on to commit to directing "federal regulators to review a subset of the mergers and acquisitions that have taken place since President Trump took office, prioritizing pharmaceutical, health care" businesses to assess issues such as market concentration, price increases and the disproportionate impact on marginalized communities. While it is likely that such a review would cover a relatively small number of deals, such an action could signal the tone of further review and approval of deals in the health care system.

Based on all this, the health care system doesn't have a clear winner in the race. Stated and inferred plans from each candidate include measures that will be potentially helpful and harmful to the health care system.

Please follow [RSM election coverage](#) for issues affecting the middle market. ■



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
- Industrials
- Life sciences
- Real estate
- Technology, media and telecom

Watch for our next issue: October 2020.





CAUTIOUS CAPEX VIEWS ARE RED FLAG

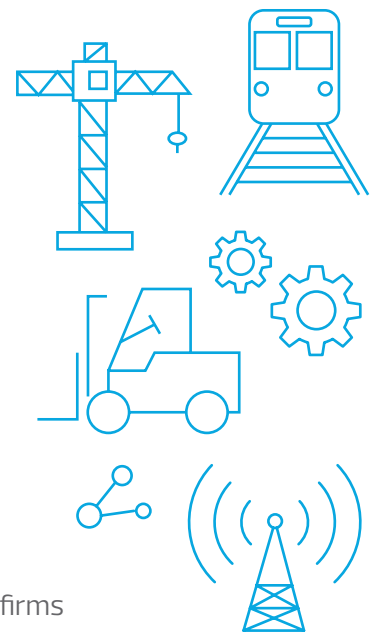
BUSINESS REOPENINGS and a period of a slightly more stable economy may be the catalyst for a hopeful sentiment among middle market executives recently. According to the [RSM US Middle Market Business Index](#) report:

47% of respondents noted that the economy improved in August and **66%** expected that to be the case six months from now.

However, the one area of the survey that denoted risks for small and midsize firms over the medium term is their caution on capital expenditures.

Only **38%** of middle market executives noted an increase in capital expenditures in their businesses.

47% stated an expectation to increase capital expenditures over the next 180 days.



THE TAKEAWAY

As middle market businesses determine growth investments and strategies during this time of economic fluctuation and uncertainty it's important to weigh a variety of areas, including incentives and key tax considerations, future business innovation needs, restructuring or acquisition opportunities, and digital transformation necessities, to name a few. Optimize capital expenditure decisions by assessing business goals and evaluating risks like revenue fluctuations, supply chain disruptions, cybersecurity issues, cash flow, marketplace shifts and more.

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