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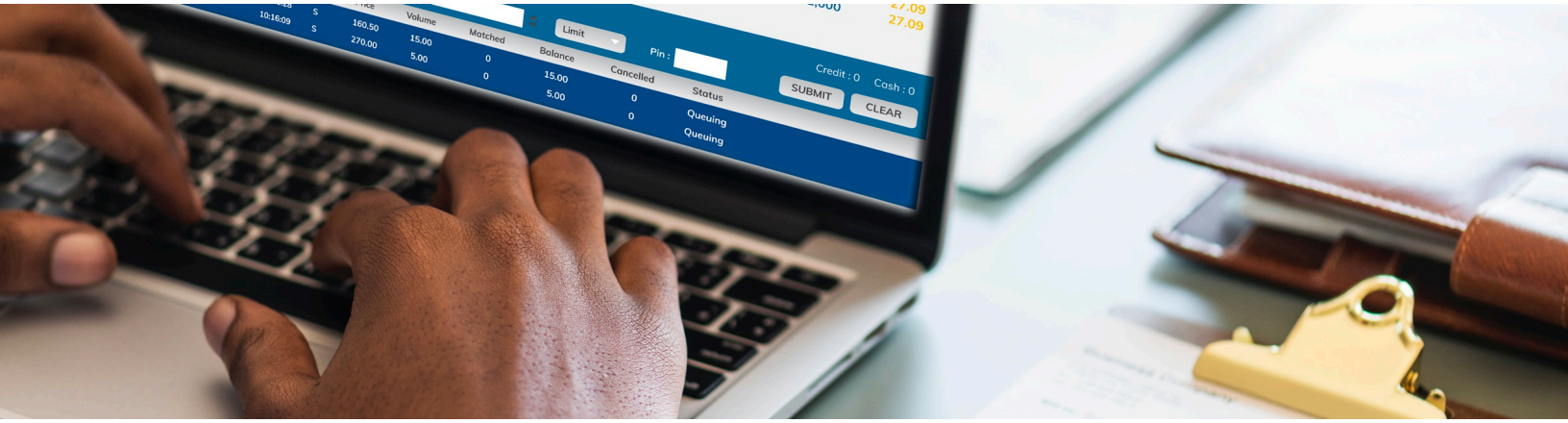

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The Real Economy 82

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THE REAL ECONOMY

VOLUME 82

GLOBAL SUPPLY CHAIN DISRUPTIONS ACCELERATE, PRESENTING A CHALLENGE TO THE MIDDLE MARKET

INDUSTRY SPOTLIGHT: HOMEBUILDERS, FACING SHORTAGE OF MATERIALS, CAN'T MEET SOARING DEMAND

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CHILD TAX CREDIT: POTENTIAL GAME CHANGER FOR AMERICAN FAMILIES

THE HIGH COST OF BRINKMANSHIP OVER RAISING THE NATION'S DEBT CEILING

THE ALTERNATIVE: ALREADY HOT 'BUY NOW, PAY LATER' SPACE GETS A BIG BOOST FROM AMAZON

MIDDLE MARKET TREND WATCH: ESG GAINS PROMINENCE IN THE MIDDLE MARKET

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

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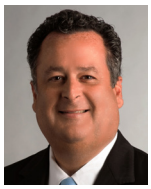

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SUPPLY CHAIN SPECIAL FEATURE

GLOBAL SUPPLY CHAIN DISRUPTIONS ACCELERATE, PRESENTING A CHALLENGE TO THE MIDDLE MARKET

BY TUAN NGUYEN AND JOSEPH BRUSUELAS

FRAGILE GLOBAL SUPPLY CHAINS are facing another round of port closures, factory shutdowns, production halts and labor shortages as the delta variant spreads.

These disruptions will almost certainly delay the return of full production in the global economy until the middle of next year and create the conditions for further price volatility until the temporary roadblock that is the delta variant eases.

Middle market firms should prepare for disruptions as they build inventories ahead of the critical holiday season. Finding alternative domestic suppliers and adopting dynamic pricing strategies probably present firms embedded in the American real economy with the best approaches to contend with rising prices and the shifting composition of supply and demand.

All of these challenges come on top of the need to invest in productivity-enhancing software, equipment and intellectual property that can help firms manage those higher prices and the surging demand. There is no other credible alternative for middle market firms.

A short-term challenge

But middle market firms should know that this mismatch of supply and demand is not a permanent condition. It is likely to be more similar to the experience of last year, early in the pandemic, when businesses and consumers contended with shortages of everything from masks to toilet paper, and dealt with volatility in food prices.

Those shortages were quickly relieved by the supply responses from Asia, the world's biggest factory floor, and the North American supply chain. While it will be some time before the current disruptions ease, this too shall pass.

In the near term, though, there is no getting around the constraints in the supply chain. Middle market companies that rely on imports must prepare for two major issues that will last well into the first half of next year until Asian supply chains get back to full production: rising international transportation costs and depleted inventories.

MIDDLE MARKET INSIGHT
Middle market companies that rely on imports must prepare for rising international transportation costs and depleted inventories until Asian supply chains get back to full production.

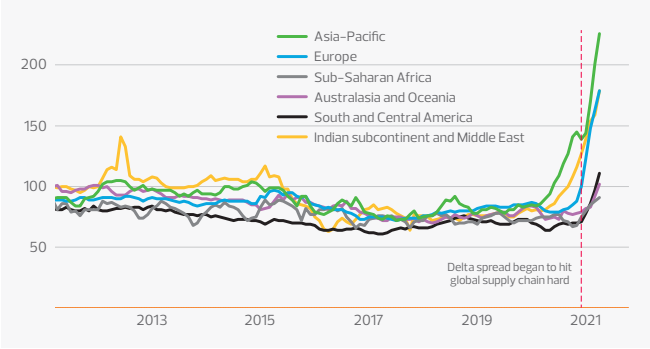
All roads lead to America, but at a higher cost

From every part of the world, container shipping costs to North America have skyrocketed, according to the price index data from Container Trades Statistics.

Most notably, the average cost to ship a container from Asia-Pacific—which accounts for about 68% of all monthly shipping volume to North America—increased by 63% in the March-to-July period, while the same cost from Europe increased by 79%.

Port congestion around the world, from the Ningbo port south of Shanghai to the Los Angeles/Long Beach ports, points to rising costs and further delays as the global supply chains struggle to keep up with strong American demand.

Global container price indexes to North America



Source: Bloomberg; Container Trades Statistics; RSM US LLP

India, one of the countries hit hardest by the delta variant, also contributed to a 41% increase in container shipping prices from the Indian subcontinent and the Middle East in the same period.

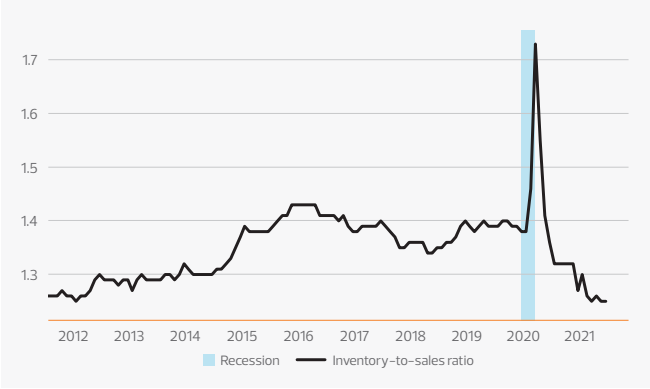
Regions that share smaller container volumes headed for North America, like Australasia and Oceania, Latin America, and sub-Saharan Africa, have also experienced significant upticks in price levels, rising by 29%, 56% and 21%, respectively.

Backlog of orders piles up

Because companies often stock enough goods for at least one season ahead of time, the impact from the lack of inventories will be less severe on sales for the upcoming holiday season, but it will soon become a headache, as inventory restocking is not increasing quickly enough to keep up with overwhelming consumption demand.

According to the U.S. Census Bureau, the monthly manufacturing and trade inventory-to-sales ratio dropped to 1.25 in June, or 12.8% below last year's June level, and about 11% below the pre-pandemic average.

Monthly manufacturing and trade inventory-to-sales ratio*



Source: U.S. Census Bureau; RSM US LLP

*seasonally adjusted

MIDDLE MARKET INSIGHT
With international shipping costs so high, one natural solution is to look for alternative domestic suppliers that are now more in a position to compete in terms of pricing.

The Institute for Supply Management's manufacturing survey in July and August echoed the problem, stating, "All segments of the manufacturing economy are impacted by record-long raw-materials lead times, continued shortages of critical basic materials, rising commodities prices and difficulties in transporting products."

In particular, the backlog of orders index climbed to 68.2 in August, 3.2% higher than the prior month, and was on a growth trend over 14 straight months.

So, what about now?

Business optimism remains robust amid strong domestic demand. But spending slowed in August and will likely continue to decelerate in the upcoming months, putting downside risks on sales revenues.

With the global supply chain not expected to return to normal until the middle of next year, middle market companies should look for alternative solutions so they will not miss out on the opportunity to benefit from such strong consumption demand.

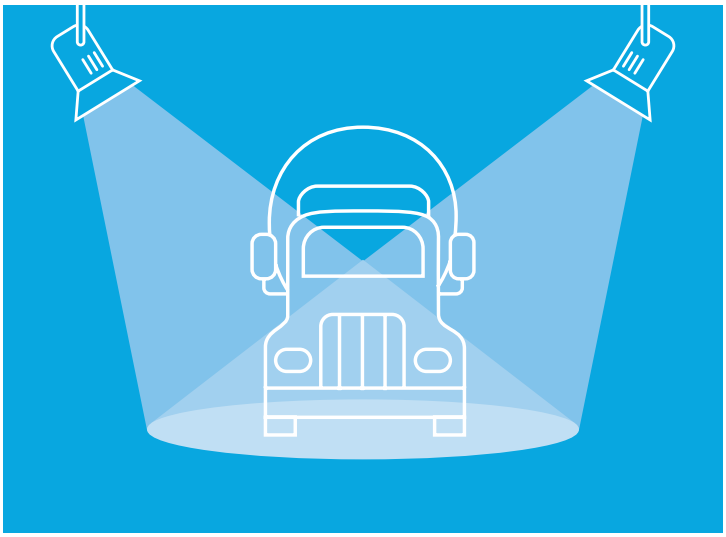
With international shipping costs so high, one natural solution is to look for alternative domestic suppliers that are now more in a position to compete in terms of pricing.

The other solution is to adopt dynamic pricing strategies that give companies the best tools to change prices quickly given the changing supply and demand in the market. To do this, investing in relevant technologies and human capital to optimize automation and data analytics is critical.

Prices are usually sticky, and there are often reasons for that. But big tech companies like Amazon, Airbnb and Uber have proven that flexible prices might be much more profitable if used properly.

The takeaway

There is little mystery to what is behind the disruption to the global supply chain. The rise of the delta variant, and the lag in vaccinating enough of the global population to reduce its impact, are combining to present a challenge to middle market businesses that many had hoped would be fading by now. Those firms that remain nimble, and make smart investments to improve their productivity, will emerge from the current challenges in a stronger position. ■



SUPPLY CHAIN SPECIAL FEATURE

HOMEBUILDERS, FACING SHORTAGE OF MATERIALS, CAN'T MEET SOARING DEMAND

BY CRYSTAL SUNBURY

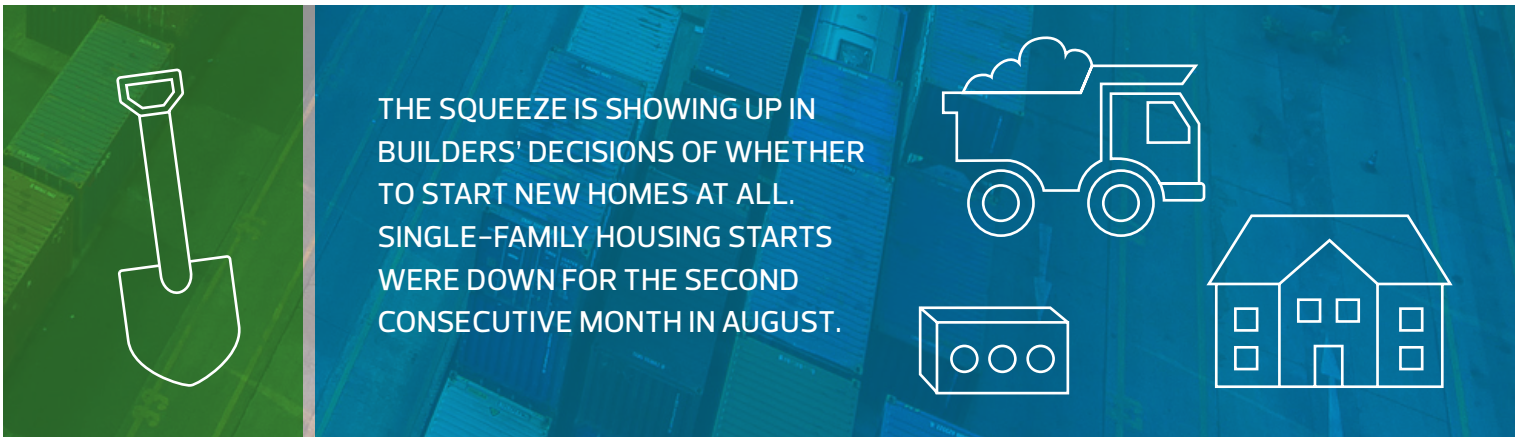
EVEN AS the housing market continues to lead the U.S. economic recovery, homebuilders, whipsawed by more than a year of dramatic changes fueled by the pandemic, are facing new pressures as they try to meet surging demand.

Already, builders have been scrambling to find enough workers to put up homes. But now, builders face an acute shortage of raw materials, putting the industry under additional pressure just to keep up with buyers' voracious demand.

The squeeze is showing up in builders' decisions of whether to start new homes at all. In August, housing starts and permits recovered slightly from dips in previous months, with total starts reaching 1.62 million annualized and total permits 1.73 million, up from 1.55 million and 1.63 million in July. But single-family starts were down for a second consecutive month, with 1.08 million, compared to 1.11 million in July, while permits remained unchanged at 1.05 million, according to data from the Commerce Department.

Much of this recent squeeze can be traced to the shortage of raw materials. Everything from steel to piping to gypsum to tiles is in short supply as builders scramble to secure limited supplies and, when they do, pay sharply higher shipping costs. Even lumber, despite its recent decline from its pandemic high, remains volatile and has increased to more than one and a half times what it cost before the pandemic.

And there are signs that these shortages will last longer than many believed even a few months ago.



MIDDLE MARKET INSIGHT
Even as the easing of lumber prices has created opportunities for homebuilders, shortages and delays of other supplies and materials remain.

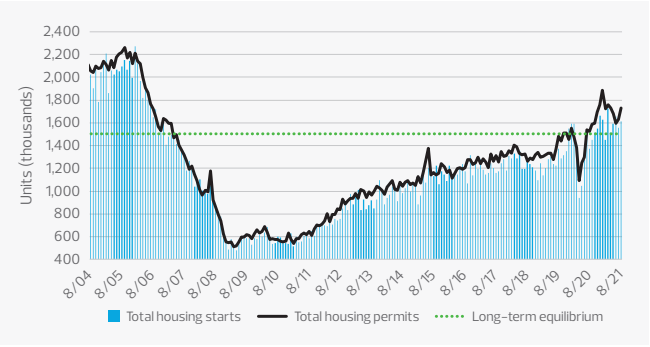
The homebuilder Lennar, for example, told investors in its fiscal third quarter earnings call on Sept. 20 that supply shortages were forcing it to build fewer homes and that its earnings would be affected.

"During the third quarter, our company and the homebuilding industry as a whole continued to experience unprecedented supply chain challenges which we believe will continue into the foreseeable future," the company's executive chairman, Stuart Miller, said.

Lennar is not alone. Pulte, Toll Brothers and D.R. Horton have issued similar warnings, saying that building product shortages are affecting their ability to complete homes, resulting in significant backlogs and extended cycle times across the industry.

In the end, the shortage is forcing builders to adapt in ways that were hard to imagine before the pandemic.

The underbuilding gap



Source: U.S. Census Bureau

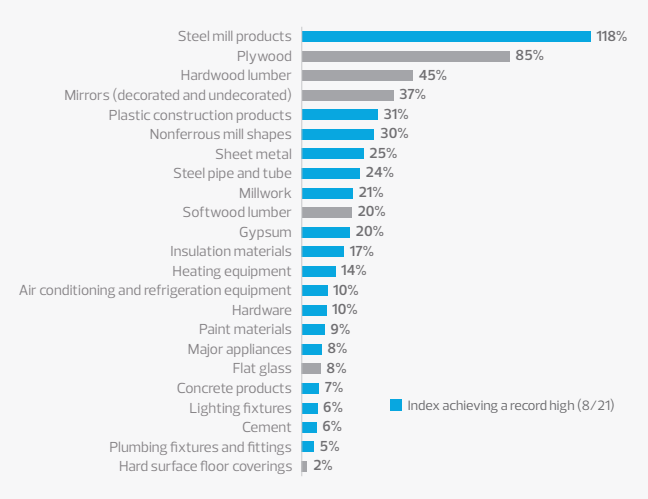
An industry playing catch-up

The gap in inventories has been building for some time. For more than a decade following the Great Recession, new housing starts and permits consistently fell significantly below 1.5 million annualized units, the amount considered necessary to sustain market equilibrium.

It all leaves the industry trying to play catch-up. A recent study by realtor.com estimated that the United States was short 5.24 million homes as of June. Despite the shortage of homes, housing starts and permits have not increased at the levels needed to begin to close the housing shortage gap.

Rising costs of materials

PERCENTAGE CHANGE BETWEEN JANUARY 2020 AND AUGUST 2021



Source: U.S. Bureau of Labor Statistics

SUPPLY CHAIN DISRUPTIONS ARE EXPECTED TO PERSIST, AS EXPORTERS CONTINUE TO FACE HALTS DUE TO THE SPREAD OF THE DELTA VARIANT AND PRESSURES FROM INCREASED DEMAND AS THE HOLIDAY SEASON APPROACHES. THESE LOGJAMS ARE EXPECTED TO CONTINUE TO PRESSURE PRICES HIGHER.

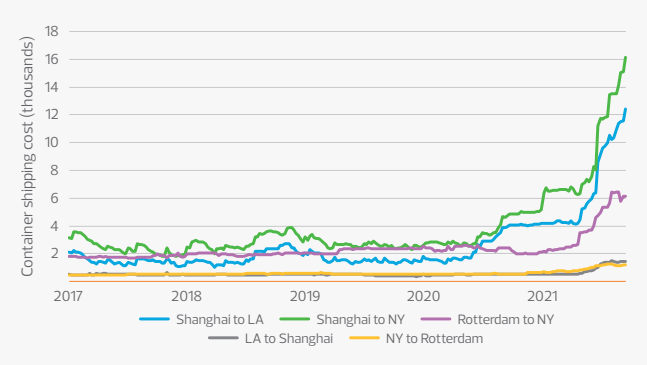
Surging shipping costs

Adding to the pressure on builders is the difficulty of obtaining imported goods. Demand remains elevated across industries, helping to push shipping costs higher. The ports of Los Angeles and Long Beach had an average of about 860,000 inbound containers each month this year, 24% more than the typical monthly volume in the five years before the pandemic.

Some of the elevated demand can be traced to panic orders from companies nervous about running out of products; however, acceleration of online shopping has also had an impact.

The high demand for imported goods has caused significant delays in shipping, as logistics companies struggle to keep up with demand. As a result, shipping costs to the U.S. have skyrocketed, with costs from Shanghai reaching eight times their pre-pandemic levels.

Shipping costs soar



Source: Drewry World Container Index

Supply chain disruptions are expected to persist, as exporters continue to face halts due to the spread of the delta variant and pressures from increased demand as the holiday season approaches. These logjams are expected to continue to pressure prices higher.

MIDDLE MARKET INSIGHT
As builders look to increase production of homes, they must manage customer expectations for delivery timelines and new home orders.

What is a builder to do?

Even as the easing of lumber prices has created opportunities for homebuilders, shortages and delays of other supplies and materials remain. Strategies that builders can pursue to weather this period include:

- **Manage customer expectations:** As a result of the labor and building product constraints, many builders have strategically slowed their home sales pace to more closely align with their current production levels.
- **Consider other supply sources:** When materials come from foreign sources, builders can be subject to economic shutdowns in other countries and to the higher shipping costs that are resulting from surging consumer demand in the United States. Sourcing goods domestically can offer some relief, even if limited, from these pressures.

Middle market takeaway

Supply chains remain fragile, and uncertainties will remain for the foreseeable future, as the world continues to be affected by the spread of the delta variant. As builders look to increase production of homes, they must manage customer expectations for delivery timelines and new home orders. These shortages will ultimately ease, but until then, a logical first step is to more closely align production goals with the ability to produce. ■

SUPPLY CHAIN SPECIAL FEATURE

APPAREL FIRMS SHOULD PLAN FOR A LONG WINTER AS THE IMPACT OF VIETNAM'S FACTORY SHUTDOWNS SETS IN

BY TUAN NGUYEN

THE DISRUPTION of global supply chains will take years to work through and, in the near term, will almost certainly affect the critical holiday shopping season across the international economy.

Middle market firms in general and those with broad and deep exposure to apparel supply chains in the Far East more specifically should anticipate shortages of finished goods this year as economic shutdowns prompted by the spread of the delta variant interrupt the normal flow of goods.

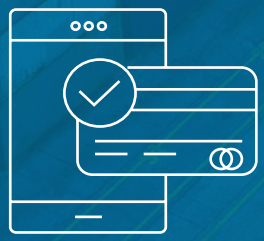
Nowhere is this interruption more evident than in Vietnam, a leader in apparel and footwear manufacturing that has suffered an escalating series of economic lockdowns since July as the delta variant has spread.

Nike, for example, was downgraded recently by the Wall Street research firm BitGreen, which cited significant supply disruption in Vietnam. Nike relies on Vietnam for more than 50% of its footwear production and 30% of its apparel units, BITG said.

But the issue has gone well beyond Nike. Adidas, Lululemon, Columbia Sportswear, Under Armour, Capri Holdings—the parent company of Michael Kors and Versace—and VF Corp, which owns Vans and the North Face, all have major production bases in Vietnam.

The issue has become all the more acute because many companies shifted production to Vietnam as trade tensions between the United States and China escalated starting in 2018, and also because Vietnam was able to keep its economy mostly open during the initial waves of COVID-19 last year.

Now, even though Vietnam has started to relax some of its travel and work restrictions, its government has said that its economy will not be fully open until at least January. So at best, Vietnam will be limited to 50% to 70% of production capacity until the end of this year, on top of the full shutdown of production from July to September. And that scenario depends on the spread of COVID not worsening in Vietnam.



VIETNAM HAS SUFFERED AN ESCALATING SERIES OF ECONOMIC LOCKDOWNS SINCE JULY AS THE DELTA VARIANT HAS SPREAD, HAVING A RIPPLE EFFECT ON THE APPAREL AND FOOTWEAR INDUSTRIES.

MIDDLE MARKET INSIGHT

Middle market firms in general and those with broad and deep exposure to apparel supply chains in the Far East more specifically should anticipate shortages of finished goods.

For apparel and footwear companies, it could make for a difficult holiday shopping season, although just how difficult will be hard to measure. Companies often stock up goods ahead of time and their performance can be assessed only after data becomes available in their next public filings months from now.

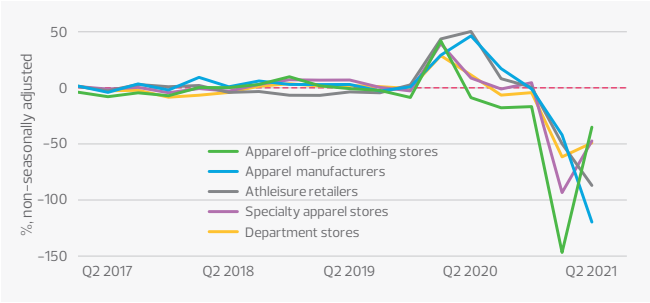
But we expect that maintaining inventories, a challenge since early this year, will become more of a problem in the first half of next year.

The challenge is already showing up in the data. The inventory-to-sales spread, which calculates the difference in growth rates between inventories and sales, plunged for all major retail groups in the first two quarters of this year, from close to zero to less than negative 35% amid significant spikes in consumer demand.

The athleisure group, which includes Nike and Adidas, was heavily affected by Vietnam's supply disruption, posting a spread of negative 87% in the second quarter, while the apparel manufacturer group, which includes Capri Holdings, Columbia Sportswear and Under Armour, recorded the lowest spread in the same quarter at negative 119.7%.

Major department stores and off-price retailers, despite their more diverse sourcing portfolios, have also been affected by the supply chain disruption, dipping to negative 49.1% and negative 35.1% in second-quarter inventory-to-sales spreads, respectively. These include Kohl's, Macy's and Nordstrom.

North America inventory-to-sales spread by group



Source: Bloomberg; RSM US LLP

What's ahead?

Even with these constraints, consumption is expected to increase well into next year as the spread of the delta variant eases, child tax credit payments continue and households use their high level of savings.

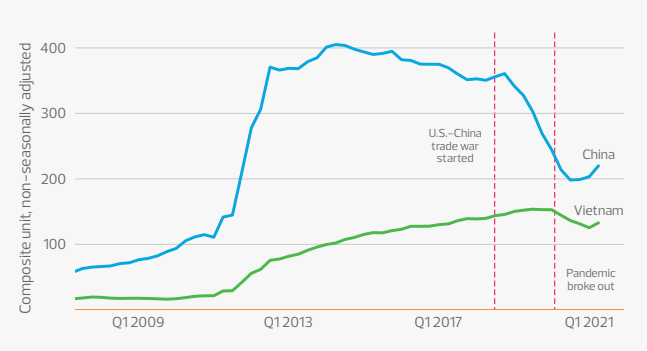
That elevated demand poses a challenge to hardest-hit companies like Nike and Under Armour, which will most likely face risks maintaining their inventories because of supply constraints from Vietnam as early as this holiday season. Should those supply challenges materialize, then consumers will almost certainly shift their spending from goods to experiences and travel.

While many apparel and footwear companies have used inventory shortages as a profitable business and marketing strategy—think of Nike and some of its hard-to-find sneakers—for most competitive markets, not having goods in stock often raises the risk of turning consumers away.

As a result, analysts have been talking about a shopping season with fewer discounts as companies raise prices—equivalent to smaller or no holiday markdowns—to lessen the impact from inventory shortages.

THE SHIFT IN SOURCING STRATEGY SHOWS A TEMPORARY REVERSAL OF A TREND THAT PREDATES THE PANDEMIC: COMPANIES MOVING THEIR PRODUCTION FROM CHINA TO VIETNAM, WHICH WAS ACCELERATED BY THE U.S.-CHINA TRADE WAR IN 2018 AND 2019.

U.S. apparel imports
12-MONTH MOVING AVERAGE



Source: Bloomberg; RSM US LLP

The other solution, implemented by several companies like Designer Brands, which owns DSW, and Lakeland Industries, which sells protective clothing, is to quickly move back to China from Vietnam. Companies are doing this despite the potential significant extra costs of relocation, and the higher wages and tariffs compared to Vietnam.

This suggests that companies are willing to sacrifice short-term profits to avoid inventory shortages, which can be even more costly.

The shift in sourcing strategy shows a temporary reversal of a trend that predates the pandemic: companies moving their production from China to Vietnam, which was accelerated by the U.S.-China trade war in 2018 and 2019.

On a 12-month moving average, U.S. apparel imports from Vietnam climbed steadily from 2011 to 2019, while imports from China stagnated from 2012 to 2018, before declining sharply during the trade war.

MIDDLE MARKET INSIGHT
Many companies shifted production to Vietnam as trade tensions between the United States and China escalated starting in 2018.

One bright spot comes from the recent change in the Vietnamese government's approach to combating COVID-19, switching from extreme restrictions to partial opening while pushing for faster vaccination rates by using not only Pfizer, Moderna and AstraZeneca vaccines, but also Sinopharm from China and Abdala from Cuba.

The change in approach comes in the wake of a recent letter to the prime minister from major international commerce associations representing foreign companies in Vietnam, asking for a more flexible opening plan. Companies that planned to move to Vietnam are reported to have been reconsidering, at least for now.

Earlier, a trade group representing Adidas, Gap and other major fashion brands lobbied in July for more vaccines for Vietnam, while at the same time, the American Apparel & Footwear Association also asked President Biden to ship more vaccines to Vietnam.

The takeaway

The prolonged and significant disruption to the U.S. apparel and footwear retail ecosystem is expected to last until at least next summer. But recovery will depend on vaccination progress in Vietnam, where only 6.9% of the population has been fully vaccinated, according to data from VnExpress.

Without the vaccine, Vietnam's economic recovery will continue in fits and starts, and the global economy will feel the effects. ■

CHILD TAX CREDIT: POTENTIAL GAME CHANGER FOR AMERICAN FAMILIES

BY JOSEPH BRUSUELAS

ONE ASPECT of the American Rescue Plan signed into law in March included an extension of the child tax credit, first enacted in 1997, to send direct aid to families.

Those aid checks, for families with children making up to $150,000 for a couple or $112,500 for a single parent who is head of household, began arriving in American family pocketbooks during the week of July 15. They will provide an additional boost to overall spending at a time of rising risks to the spending outlook linked to the spread of the delta variant.

Now that child tax credit could be made permanent if the House and Senate pass the measure.

We estimate that the expanded child tax credit already approved will result in a roughly $35 billion increase in consumer spending over the next year, bolstering both employment and business growth.

This is based on estimates by the congressional Joint Committee on Taxation and an assumption of a fiscal 1.4 multiplier, which is consistent with the 1.22 fiscal multiplier for lump-sum payments during the Great Recession.

MIDDLE MARKET INSIGHT

The expanded child tax credit provides aid for the most part to the three lowest quintiles of income earners—or those who tend to spend any additional income that comes their way.

We think that the economic shock and the follow-on policy support by both the fiscal and monetary authorities create the conditions for a modestly higher fiscal multiplier given the already elevated level of savings. Conditions are ripe for the more modest increase in spending implied by our estimate.

The extension of the tax credit increases payments from $2,000 to $3,000 per child for children over the age of 6 and from $2,000 to $3,600 for children under the age of 6, and raises the age limit from 16 to 17.

Since the legislation increases payment amounts, expands eligibility and makes the credit fully refundable — previously it was only partially refundable—it will increase aid to families and boost overall economic activity.

RESEARCH ESTIMATES THAT THE FEDERAL GOVERNMENT WILL RECAPTURE MOST OF THE COSTS OF THE TAX CREDIT THROUGH LOWER OUTLAYS ON HEALTH CARE AND CRIME PREVENTION, AND THROUGH INCREASED FUTURE TAX REVENUES.

MIDDLE MARKET INSIGHT

The direct objective of the expanded child tax credit is to reduce poverty and secure a direct flow of aid to families to meet daily costs.

Perhaps more important, half of the credit is being directly disbursed to families in the current calendar year. This program provides aid for the most part to the three lowest quintiles of income earners, including the beleaguered American middle class.

The direct objective is to reduce poverty and secure a direct flow of aid to families to meet daily costs. According to the Congressional Research Service, the expansion of the child tax credit will reduce the child poverty rate from 13% to 7%. Based on that group's scholarship, 96% of families with children will benefit from the expanded credit, up from 84% previously.

Because almost all of the direct cash payments are going to low- and middle-income households, recipients will have a higher marginal propensity to consume all the additional income and save little of it. Most of the cash payments will be spent bolstering growth in the national and local economies.

The credit then declines with families above the income limits. It is phased out for couples with two children earning $480,000 and for single-parent households above $280,000, with some variation around top income levels depending on the number of children in the household.

Costs and benefits

The Congressional Budget Office estimates that it will cost the federal government more than $100 billion once lost revenue and increased outlays are accounted for.

But research conducted by the Center on Poverty and Social Policy at Columbia University estimates that the federal government will recapture most of those costs through lower outlays on health care and crime prevention, and through increased future tax revenues linked to the child tax credit.

Why is that? Because the research shows that the long-term benefits of the child tax credit include higher future lifetime earnings and improved health-related outcomes that are roughly eight times larger than the costs of the program.

Here is how it works: A hypothetical family with $100,000 in annual income with two children under six now receives a child tax credit of $7,200. That is an increase from $4,000 previously. But unlike the previous lump-sum benefit that was taken when filing taxes, the household now receives half ($3,600) of the total benefit in six monthly installments of $600 between July 2021 and December 2021. They then receive the balance ($3,600) of the tax credit when filing their 2021 tax return in 2022.

This program is authorized only through December, with the remaining balance of the credit to be disbursed by the spring of next year. So extending the tax credit will be part of the policy narrative and budgetary debate heading into the midterm elections next year.

The cost of making the extension of the tax credit permanent will be large. Congress and the administration should consider tax and spending measures to support it if lawmakers decide to reauthorize the program. But the long-term benefits of investment in such social infrastructure should be integrated into any cost-benefit analysis. In our estimation, the fiscal authority should strongly consider making this program permanent. ■

THE HIGH COST OF BRINKMANSHIP OVER RAISING THE NATION'S DEBT CEILING

BY JOSEPH BRUSUELAS

AFTER CONGRESS returned from its summer recess in September, it took little time for the debate over raising the nation's debt ceiling to escalate.

With the fiscal year ending at the end of September, it soon became clear that the government was heading for another debt ceiling crisis like those in 2011 and 2018.

While the causes of those crises differed, the prolonged shutdowns exacted an economic price on the public. A measure to fund the government through Dec. 3 was approved on Sept. 30, but the standoff over raising the debt ceiling remained unresolved. Another politically induced artificial crisis is not in the interest of the economy as it faces uncertainty around the spread of the delta variant.

The debt ceiling is a political artifact that needs to be put to rest. Opportunity will always exist for political actors to create an artificial crisis where there is none. In the past, debt ceiling showdowns have disrupted financial markets, and when the government shuts down, overall growth takes a hit.

MIDDLE MARKET INSIGHT

The most recent shutdown, in 2018, lasted five weeks and shaved 0.1% of gross domestic product from fourth-quarter growth.

So here we are with another artificial crisis unfolding. Where do we stand?

Don't push it too far

The U.S. Treasury is taking what it has referred to as "extraordinary measures" to keep the government functioning. The real drop-dead date on a potential default is around Nov. 2. If federal government spending increases because of the pandemic or in the wake of an environmental disaster, that drop-dead date could arrive sooner.

There is always time for both parties in Congress to agree on a continuing resolution, and ample room for compromise like the one that led to the Senate's recent approval of a national infrastructure package.

WHILE THE CAUSES OF PREVIOUS CRISES OVER THE DEBT CEILING DIFFERED, THE PROLONGED SHUTDOWNS EXACTED AN ECONOMIC PRICE ON THE PUBLIC.

But the Democrats do not want to attach a continuing resolution for an increase in the debt ceiling because it would take 60 votes in the Senate to pass and Republicans are on record as being unwilling to cooperate. The risk of a government shutdown on Oct. 1 is rising.

Default is not an option

Put simply, default on U.S. debt is not a reality-based policy option and is a nonstarter. Default is a recipe for chaos across global financial markets and would take the economy back to the depths of the financial crisis in 2008. Individual policy actors who speak of default as an option should not be taken seriously.

Learn from the past

The lessons of past debt ceiling crises and government shutdowns should be heeded.

The 2011 debt ceiling crisis caused a decline in the S&P 500 of roughly 17% between July 22 and Aug. 8 that year, along with a spike at the front end of the curve for Treasury bills as investors sought the safe haven of short-term debt even at the risk of taking losses on their principal.

Short-term U.S. debt with coupon payments around the possible October to November deadlines is currently trading modestly cheaper than other notes. This discount implies that the investment community is beginning to price in a possible debt ceiling crisis at a minimum. Should the specter of a default loom large, as it did back in 2011, short-term debt will be trading far cheaper compared to other notes around the potential Nov. 2 drop-dead date.

MIDDLE MARKET INSIGHT

Given the risks to the economic outlook linked to the delta variant, this is no time for a politically induced economic event.

In the wake of the 2011 crisis, the Conference Board's Consumer Confidence Index declined by 31% between July and October of that year, while S&P downgraded the credit rating for the first time in the nation's history.

The most recent shutdown, in 2018, was because of a budget standoff over funding of a proposed border wall. It lasted five weeks and shaved 0.1% of gross domestic product from fourth-quarter growth that year and 0.3% from first-quarter growth in 2019, or about $7 billion per week from the economy.

Now is not the time

Given the risks to the economic outlook linked to the delta variant, this is no time for a politically induced economic event.

What's more, with the Federal Reserve signaling it intends to begin paring back its $120 billion per month in asset purchases, a fall debt ceiling crisis would almost certainly result in the pushing of paring operations into next year. ■

Government shutdowns/debt ceiling crisis

Date	Duration	Cost	Cause
1990: Oct. 5–9	4 days	Minimal	Budget resolution/deficit reduction package
1995: Nov. 13–19	6 days	Minimal	Budget resolution/balanced budget
1995–96: Dec. 5–Jan. 6	1 month	$1.4 billion	Budget resolution
2011: July–August	1 month	$18.9 billion	Debt ceiling
2013: Oct. 1–17	16 days	$24 billion	Budget resolution/Obamacare funding
2018: Jan. 19–22	4 days	Minimal	Budget resolution/immigration reform
2018–19: Dec. 22–Jan. 25	5 weeks	$35 billion	Budget resolution/border wall funding

Source: Congressional Budget Office; Bipartisan Policy Center; RSM US LLP

ALREADY HOT 'BUY NOW, PAY LATER' SPACE GETS A BIG BOOST FROM AMAZON

BY NELLY MONTOYA AND MIKE GRAZIANO

AMAZON, which has been slowly adding financial services products to its portfolio, has entered the hot "buy now, pay later" space. The e-commerce giant recently announced its partnership with Affirm, a buy-now-pay-later platform that allows customers to pay for purchases in installments. This partnership means customers shopping on Amazon will be able to use Affirm when they check out, for purchases over $50.

Amazon's partnering with Affirm is—along with Square's early August announcement of a $29 billion acquisition of Afterpay—one of the latest signals that BNPL offerings are here to stay, on the heels of strong performance in this space last year.

It also signals that online and brick-and-mortar retailers that don't have BNPL options should assess what that means for their competitiveness. The use of BNPL resulted in $1.1 trillion in U.S. e-commerce sales in 2020, according to FIS's 2021 Global Payments Report, and that figure is expected to grow to $1.78 trillion by 2024.

Amazon's customers that use Affirm will not be charged interest or late fees and will know the total cost of their purchases upfront, typical terms BNPL providers offer. The option to use Affirm for Amazon purchases is initially launching for select customers before rolling out more broadly.

The news comes at a good time for Affirm, which suffered a dip in its share price when Peloton announced it would decrease the price of its bikes during its fourth-quarter fiscal year 2021 call.

As Peloton purchases currently make up about 20% of Affirm's revenue, investors didn't relish the potential negative implications. As such, it is no surprise that Affirm's shares soared in the immediate aftermath of the Amazon announcement as investors absorbed the potential implication of the partnership. If Affirm captures even 1% of Amazon's North America sales, it could add $900 million to its revenue, according to Bloomberg.

Amazon's interest in offering BNPL through Affirm also makes sense, as its mission is to offer low prices, a vast selection of goods and utmost convenience to customers. Splitting up a purchase into more manageable installments at the click of a button is the latest way Amazon is providing a frictionless experience for customers.

SPLITTING UP A PURCHASE INTO MORE MANAGEABLE INSTALLMENTS AT THE CLICK OF A BUTTON IS THE LATEST WAY AMAZON IS PROVIDING A FRICTIONLESS EXPERIENCE FOR CUSTOMERS.

MIDDLE MARKET INSIGHT

Amazon's entry into the buy now, pay later market signals that online and brick-and-mortar retailers that don't have BNPL options should assess what that means for their competitiveness.

Additionally, the ability to split purchases into monthly installments could further extend Amazon's reach into larger consumer purchases such as appliances or furniture. This could give Amazon an advantage over traditional brick-and-mortar retailers that use promotional product discounts or interest-free financing on branded credit cards to help increase in-store foot traffic.

A more seamless buying option

Providing customers a more seamless buying option could help drive online sales for customers still hesitant about in-person shopping.

But the importance of the partnership goes beyond the implications it could have for Affirm—this partnership solidifies buy now, pay later as a ubiquitous business model. After all, a partnership with the top e-commerce retailer in the United States—especially when North America's aggregate e-commerce volume is expected to grow at an 11% compound annual rate through 2024, according to FIS's Global Payments Report—is no small feat.

Given the number of monthly active users among the top five BNPL providers—Klarna, Afterpay, Affirm, QuadPay and Sezzle—it is evident consumers are drawn to this option. When comparing the monthly active users of the top five BNPL providers from the second quarter in 2020 to the second quarter in 2021, the growth is staggering—on the low end, Klarna grew 68%, but Sezzle grew 292%, according to Bloomberg.

The potential of BNPL

The potential reach of BNPL is huge, especially now that Amazon offers it as an option. Fundamentally, BNPL could be used for any purchase, whether predictable—such as rent and utilities—or not, like an unexpected health care expense.

Flex, for example, is a BNPL provider that allows you to split up rent into smaller payments and pay your bills based on when it's most convenient for you, not on your utility provider's schedule.

Another company, Walnut, allows you to pay for health care expenses in installments. Sunbit works with merchants in retail, automotive parts and service, dental, and eyewear, and offers consumers the option to buy anything from those segments and pay over a three-to-24-month term based on the type of expense. This is all in addition to consumers already using BNPL to pay for travel, flights, and even brick-and-mortar store purchases.

The takeaway

Given the significant activity in the BNPL space over the last month, merchants of all sorts should examine whether BNPL could help them deliver a better customer experience. ■

ESG GAINS PROMINENCE IN THE MIDDLE MARKET

As gender equity, climate, racial equality, income disparity and other social issues gain national prominence, the role of corporations around social imperatives has come to the fore. It's not surprising that middle market businesses have now elevated environment, social and governance (ESG) measures as a business priority.

RSM US LLP asked senior executives at middle market businesses about their views of ESG in the third-quarter RSM US Middle Market Business Index survey. The survey was conducted from July 8 to July 26, and 413 executives participated. What follows are some of the answers they provided.

41% of the executives indicated their organization had devised a formal plan around ESG issues, led by larger middle market businesses, or those with annual revenue of $50 million to $1 billion.

Nearly all of the midsize companies with a formal ESG plan indicated they had committed to a corporate structure and reporting standards that incorporate social responsibility or environmental initiatives.

66% have a senior executive primarily focused on ESG issues.

Environmental issues, fair trade, community health and wellness, support for underrepresented businesses and support for minority-led startups were among the top issues that middle market executives cited in their company's ESG plan.

84% of respondents among these companies said ESG measures would be used to evaluate their company's performance. Executives cited a range of reporting standards, including sustainable development goals and global reporting initiative standards.

Watch for the full report, coming soon from RSM US, containing the full findings from the special questions on ESG and climate issues.

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

Look for the Fall 2021 issue coming soon!

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

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