Vasquez & Company LLP
Certified Public Accountants and Business Consultants

Insights for Smarter Decisions

As a member of the RSM US Alliance, we would like to share the following with you.

The Real Economy: Volume 76

LOCALLY OWNED. NATIONALLY AFFILIATED. GLOBALLY CONNECTED.

An independently owned member
RSM US Alliance
RSM

Vasquez & Company is a proud member of the RSM US Alliance, a premier affiliation of independent accounting and consulting firms in the United States. RSM US Alliance provides our firm with access to resources of RSM US LLP, the leading provider of audit, tax and consulting services focused on the middle market. RSM US LLP is a licensed CPA firm and the U.S. member of RSM International, a global network of independent audit, tax and consulting firms with more than 43,000 people in over 120 countries.

Our membership in RSM US Alliance has elevated our capabilities in the marketplace, helping to differentiate our firm from the competition while allowing us to maintain our independence and entrepreneurial culture. We have access to a valuable peer network of like-sized firms as well as a broad range of tools, expertise and technical resources.

Los Angeles +1 213.873.1700 | Sacramento +1 916.503.3269 | San Diego +1 619-254-6605 | Manila +1 213.873.1720

For more information:
solutions@vasquezcpa.com

THE REAL ECONOMY

VOLUME 76

U.S. INFLATION OUTLOOK: DON'T BELIEVE THE HYPE

MAKING SENSE OF INFLATION: WHAT WE CAN LEARN FROM POST-RECESSION RECOVERIES

ECONOMICS OF THE $1.9 TRILLION AMERICAN RESCUE PLAN

THE ALTERNATIVE: LIVING AND ADAPTING WITH COVID-19

INDUSTRY SPOTLIGHT: WITH EMBEDDED FINANCE, WALMART TAKES AIM AT CONSUMER FINANCIAL SERVICES

MIDDLE MARKET TREND WATCH: PRICING CONCERNS SURFACE, MMBI DATA SHOW

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

RSM

ABOUT THE **AUTHORS**

Our thought leaders are professionals who strive to help you and your business succeed. Contributors to this issue include:

JOSEPH BRUSUELAS
CHIEF ECONOMIST

STEVE KEMLER
DIRECTOR
LIFE SCIENCES SENIOR ANALYST

ADAM LOHR
PARTNER
LIFE SCIENCES SENIOR ANALYST

NELLY MONTOYA
SENIOR MANAGER
FINANCIAL SERVICES SENIOR ANALYST

U.S. INFLATION OUTLOOK: DON'T BELIEVE THE HYPE

BY JOSEPH BRUSUELAS

THE REFLATION of the American economy following the debilitating effects of the pandemic has begun. Recent increases in growth forecasts, trillions of dollars in fiscal aid and stimulus, and the prospect of a household-led boom over the next two years have spurred a debate around the prospects for inflation and rising interest rates. Modest increases in inflation, coupled with rising expectations, have fueled an active discussion around fiscal and monetary policy and the risks of pricing to the economic outlook.

In our view, concerns about inflation risk are premature and overblown. Current monetary policy is well-positioned to support the reflation of the domestic economy, a return to full economic potential later this year and full employment over the next three years.

This view is consistent with the Federal Reserve's longer-run objectives and will not stoke higher inflation on a sustainable basis. Nor will it engender a return to 1970s-style inflation. In fact, if one looks at core metrics of inflation expectations, one will not find indications of hyperinflation, inflation, stagflation or dollar debasement. Instead, one finds indications of long-term price stability.

We expect a transitory midyear bump in top-line inflation because of year-ago base effects from last March and April, when the pandemic set in and caused a plunge in the price of oil, commodities, rents in major urban centers and many services.

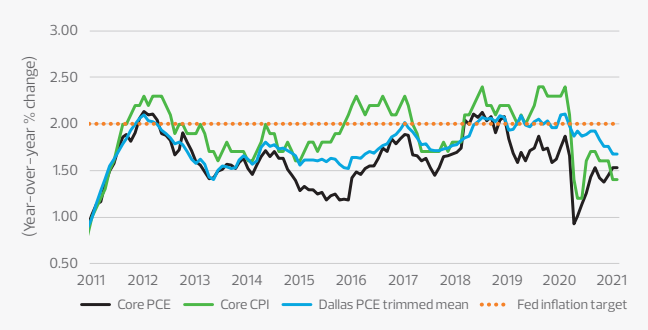
The policy error here, in our view, would be to reverse course in response to what is going to be a temporary deviation from the current and long-term trend in prices. Policymakers at the central bank will look right through this development and continue to focus on what will most likely be a multiyear journey back to full employment rather than preemptively truncate a nascent economic recovery.

OUR FORECAST FOR THIS YEAR IMPLIES THAT THE TOP-LINE CONSUMER PRICE INDEX WILL REACH 3% IN JUNE AND FALL BACK TO 2.3% BY THE END OF THE YEAR.

U.S. inflation

Our forecast for this year implies that the top-line consumer price index will reach 3% in June and fall back to 2.3% by the end of the year. Similarly, we forecast that the Fed's preferred measure of inflation, the core personal consumption expenditure index, will peak at 2% midyear and fall back to 1.7% by the end of the year. This is consistent with forward-looking metrics of inflation compensation and inflation expectations that are priced into financial securities, all of which imply price stability at or near a 2% inflation rate.

Core inflation metrics remain muted



Source: BLS; Dallas Fed; Bloomberg; RSM US LLP

Concerns around rising prices are directly linked to the fiscal spending in 2020 that was equal to approximately 20% of gross domestic product and put in place to offset the loss of income during the pandemic. The prospect of another $2 trillion this year and roughly $1.65 trillion in excess household savings has only fueled concerns over the pent-up demand and over-the-top spending by consumers once the pandemic has been contained.

Given that more than 75% of the new relief package is one-time disaster aid and is not a permanent increase in spending, the talk of runaway inflation is not only erroneous, but it also ignores the dynamic structural changes in the economy over the past two decades.

The major difference in distinguishing between transitory and permanent price increases is growth in wage income. Although the employment cost index is showing a solid 2.5% increase year over year, this recovery is K-shaped, meaning that wage gains among higher-income earners are outstripping lower-income workers. This distorts the true underlying downward pressure on wages. For inflation, it means that a persistent and permanent increase through the wage channel is a non-starter, and that inflation is most likely years away.

Policymakers and the public should not anticipate sustained upward pressure on the economy while the labor market remains 10 million jobs short of its pre-pandemic levels, real unemployment hovers near 10% and several million people have taken a pay cut to remain on the job.

Current conditions indicate that tepid wage growth and plentiful slack in the labor market are simply not conducive to a persistent increase in inflation. This is why the Federal Reserve has made abundantly clear that it is not interested in raising interest rates until labor conditions return to pre-pandemic levels or what we interpret to be full employment at or below a 3.5% unemployment rate.

Policy implications

The market has priced in a rate hike in the first quarter of 2023, which we think is out of line with the fundamentals. Nevertheless, the backup in interest rates in general and the increase in the five- and 10-year Treasury yields will have gained the Fed's attention. At this point, the Fed will most likely look to make subtle policy changes that do not alter the size of its balance sheet but extend the duration of its portfolio.

At the front end of the yield curve, we expect that the Fed would, if need be, lift interest rates paid on excess reserves (currently 10 basis points) and overnight repo rates (currently zero) by 5 basis points each.

As to longer maturities, it would not be surprising if central banks began hinting at a possible Operation Twist III—or the simultaneous buying of long-term bonds and selling of short-term bonds. The intent would be to dampen rates at the long end of the yield curve, while extending the duration of its portfolio without increasing the size of the Fed's balance sheet. The Fed has used this approach twice before—in February 1961 and in September 2011.

This would signal to other policymakers, market players and investors that the central bank intends to achieve its policy goals and is willing to inflict losses on those who challenge its credibility.

THE ECONOMIC DATA DOES NOT SCREAM INFLATION, STAGFLATION OR DOLLAR DEBASEMENT. RATHER, IT IMPLIES LONG-RUN PRICE STABILITY.

Quality improvement and the digital economy: Bring the noise

Within the community of policymakers and economists, it is generally understood that technological innovations, productivity gains and the rise of the digital economy have mitigated increases in inflation. But many in the financial sector are operating on old heuristics, or rules of thumb, that are no longer adequate to ascertain risks around pricing and the direction of inflation.

For example, quality adjustments over the past decade have resulted in a noticeable impact on the cost of durable goods inside the PCE index. Over the past 25 years, the cost of durables has fallen by 38%. If one includes quality improvement in the auto goods and parts sector, prices have increased by only 9% since 1995.

While those improvements in quality are widely accepted as a tempering factor on inflation, the rise of the digital economy and its impact on the cost of services are not. In fact, we would make the case that the digitization of the service sector is profoundly disinflationary. As Erik Brynjolfsson writes in his book, *Machine, Platform, Crowd*, once something is digitized, the cost of reproduction, distribution and access tends to fall toward zero. This is not your father's or grandfather's economy.

With the rise of zero-pricing business models in everything from entertainment, banking and financial trading, this shift is one of the structural changes not included in many of the arguments and explanations on why inflation might be a rising risk.

From our vantage point, those making the case about the return of 1970s-style inflation are prisoners of the past and fighting the wars of the 1960s and 1970s. They are missing the broad structural changes reshaping the economy.

MIDDLE MARKET INSIGHT

Policymakers and the public should not anticipate sustained upward pressure on the economy while the labor market remains 10 million jobs short of its pre-pandemic levels, real unemployment hovers near 10% and several million people have taken a pay cut to remain on the job.

Pricing expectations and the real economy

The recovery of oil, energy and commodity prices has facilitated an increase the cost of goods used at earlier stages of production and some intermediate goods. Given historical declines in economic activity during the first half of 2020 and those prices—the cost of West Texas Intermediate closed at negative $-37.63 a barrel on April 20, 2020—a reflation in prices and expectations around inflation was always going to be part of the narrative once economic reflation began.

Market-based inflation expectations and Fed inflation target

FIVE-YEAR/FIVE-YEAR FORWARD RATE

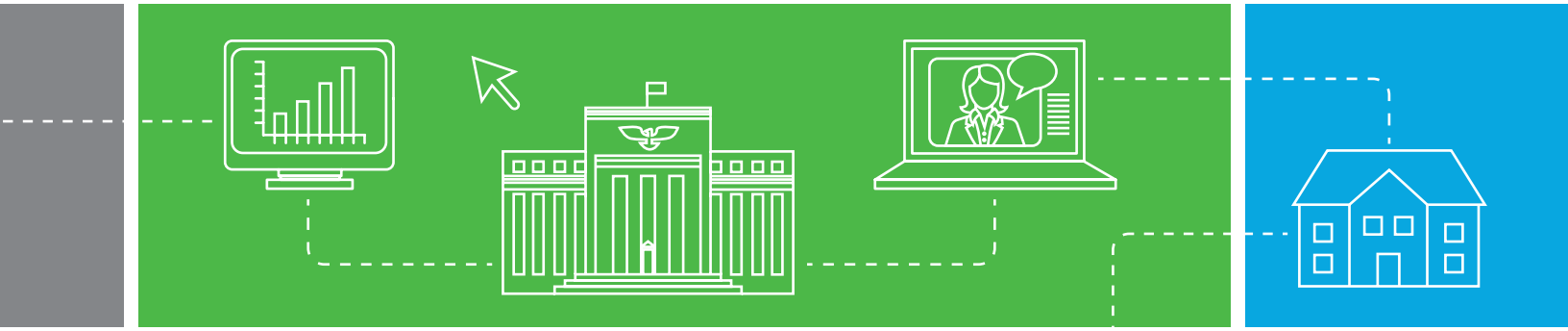
Source: Federal Reserve Bloomberg; RSM US LLP

So where are we in the real economy with respect to pricing and pricing expectations?

In the February RSM US Middle Market Business Index, 58% of executives surveyed noted an increase in prices paid. But only 38% reported passing along those price increases to clients.

This six-month average of prices paid stands at 60% and that same metric for prices received rests at 42%, both near current levels. Looking forward, 69% expect prices paid to rise and 59% state that they intend to pass along those price increases to customers, both above their respective averages of 64% and 53% over the previous six months.

This implies that current concerns about an immediate and permanent increase in the price level—that is the definition of inflation—are overblown. But it will be interesting if firms that for years have not had pricing power suddenly find that they have that power and that clients are willing to accept higher costs.



Given the modest backup in interest rates and inflation expectations—both remain near 2%—this will be one of the more interesting economic narratives this year and next. Right now, firms that constitute the beating heart and soul of the real economy are not pointing to a near-term risk in pricing to the economic outlook.

Moreover, once one examines core forward inflation expectations, it is difficult to make the case that there is near-term inflation risk. For example, the Fed's preferred forward-looking inflation metric, called the five-year, five-year forward inflation expectation rate, hovered around 2.1% in March. That is up from a pandemic low of 0.86% posted on March 19 last year. And looking at a longer-term view, the current level is well below the 20-year average of 4% and stands at or near the Fed's long-run 2% target.

Neither inflation expectations in the real economy nor pricing metrics over the next decade imply a significant risk of the return of debilitating price increases in the near term or 1970s-style inflation over the long run. This data does not scream inflation, stagflation or dollar debasement. Rather, it implies long-run price stability.

1970s-style inflation

Aggressive fiscal and monetary policies put in place to offset the economic impact of the pandemic have stoked a discussion around the return of 1970s-style inflation. What that means is the type of inflation observed in the United States between 1965 and 1985, when the CPI averaged 6.1% with a year-over-year high of 14.8% posted in March 1980.

So what caused that?

The popular explanation is that it was social spending on the Great Society. In reality, it was other factors as well: spending on the Vietnam War, domestic social spending, the arrival of the baby boomers into the labor market and the twin oil shocks of 1973 and 1979. The result was a two-decade effort to tame inflation.

But the ensuing oil glut and global central banks' overriding commitment to price stability set the stage for the next three decades of disinflation and then sustained low inflation.

When one looks at the current economic conditions—tepid wages, slack in the labor market, tempered oil and commodity prices, and accommodative monetary and fiscal policies—it is difficult to accept arguments that the return of 1970s-style inflation is imminent.

It is important to note that the U.S. economy during that era was one predicated on manufacturing. That was well before the rise of services, information and the new digital economy that defines the current era. Making policy decisions around conditions that were last seen several economies ago is the working definition of fighting the last war.

Phillips curve flattened

Last year, the Federal Reserve changed its policy regime to reflect the broader structural changes that have occurred over the past two decades. The new flexible average inflation targeting regime is organized around achieving an average 2% target over a period of time.

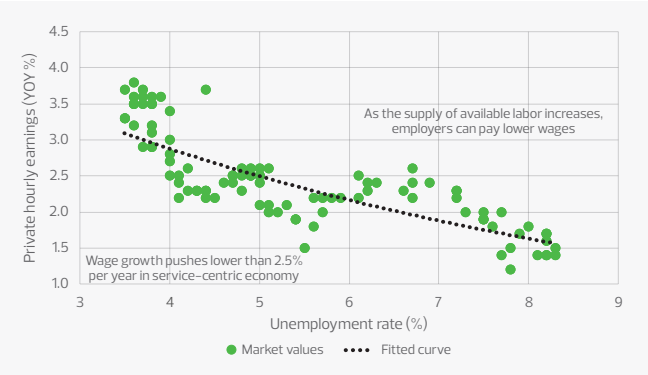
Given that core PCE inflation—the Fed's choice for its 2% inflation policy target—has averaged 1.6% since the last economic expansion, the Fed is positioned to let inflation run above target for a period of time.

In fact, Federal Reserve Chairman Jerome Powell, in his recent semiannual testimony on monetary policy, indicated that the central bank is prepared to let inflation run above target for three years before it may choose to change the path of monetary policy. To that point, policy decisions (rate hikes, asset purchases and forward guidance) will be based on shortfalls of employment from its maximum levels and not deviations. Given that we expect core inflation to reach 2% this year, we do not anticipate any rate hikes until late 2023 or early 2024.

IN OUR VIEW, CONCERNS ABOUT INFLATION RISK ARE PREMATURE AND OVERBLOWN. CURRENT MONETARY POLICY IS WELL-POSITIONED TO SUPPORT THE REFLATION OF THE DOMESTIC ECONOMY, A RETURN TO FULL ECONOMIC POTENTIAL LATER THIS YEAR AND FULL EMPLOYMENT OVER THE NEXT THREE YEARS.

The Phillips curve in a service-sector economy

THE RELATIONSHIP OF UNEMPLOYMENT AND WAGE GROWTH (2012–20)



Source: BLS; Bloomberg; RSM US LLP calculations

A decline in the unemployment rate by itself will not be sufficient to trigger an increase in rates or other forms of tighter monetary policy without other evidence that inflation is at risk of moving above mandated levels consistent with price stability.

In short, the long-term decisions around monetary policy, standard Phillips curve models or the trade-off between inflation and unemployment have been de-emphasized as the Fed formulates its policies.

Why is that?

Over the past economic cycle, the relationship between inflation and unemployment has flattened out. While measures of labor market tightness or slack can be somewhat helpful in forecasting inflation, estimating the direction of prices remains difficult and subject to random noise and events.

Our research suggests that the Phillips curve flattened out notably over the past few decades as the economy transitioned from one based on manufacturing to one based on services, information and digital technology.

Based on what is referred to in policymaking circles as a lagged accelerationist Phillips curve model—which uses actual lagged inflation as a proxy for inflation expectations—that implies that a half percent reduction in the unemployment rate would result in a 0.1 percentage point increase in inflation. Under current circumstances, one might expect a modest 0.2 to 0.3 percentage-point increase in inflation based on our year-end 4.7% unemployment rate target.

But the best research around this quantitative approach implies that inflation expectations tend to negate or offset accelerationist models, so there is likely downside risk to our midyear forecast of 3% in the CPI and 2% in the policy-sensitive core PCE index.

Bond yields

The yield on the 10-year government security increased more than 75 basis points since the start of the year through March 23. The yield curve—or the difference between yields on the 10-year versus the two-year Treasury—increased from 80 basis points on Jan. 1 to exceeding 155 on March 23.

While we expect the Fed to keep its policy rate at zero, anchoring the front end of the curve, we expect the 10-year to end the year approaching 2%, up from our year-ahead forecast for 2021 of 1.3%. This just about perfectly captures the building optimism on economic reflation and improved lending conditions that often follow the steepening of the U.S. yield curve.

The brightening outlook is a positive development that reflects the move of the economy back toward the use of its full capacity to produce goods and services and is not signaling a significant increase in inflation because of a likely rise in wages, employment and pricing. ■

MAKING SENSE OF INFLATION: WHAT WE CAN LEARN FROM POST-RECESSION RECOVERIES

BY JOSEPH BRUSUELAS

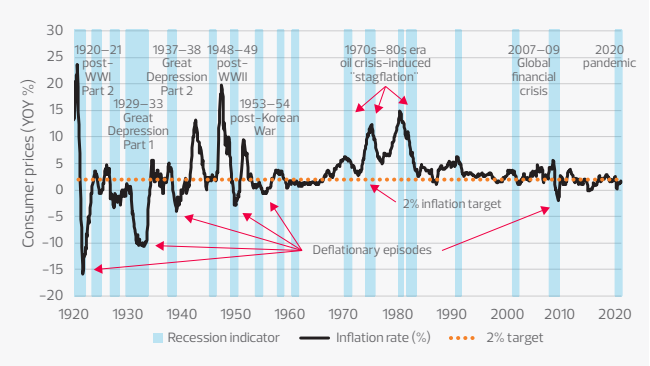
IT'S A CENTRAL TENET of economics: We should expect prices to rise when the demand for goods and services increases, and to decline when demand diminishes. Price rigidity and the presence of product choices will dictate the speed at which price changes occur.

This has held up in our analysis of the postwar business cycles, which shows that inflation does indeed drop when demand falls during an economic downturn. The lowest rate during the cycle normally occurs 22 months after the start of the recession.

It can then take an average of 27 months for inflation to return to normal as sustained economic growth is attained and inflation reaches its assumed 2% target. This implies that some of the recent concerns around inflation are premature and that risks around the outlook linked to higher pricing are overblown.

We are now more than 12 months into a unique pandemic-induced recession. Because of the demand shock caused by the pullback of households and government-mandated economic shutdowns, it took only three months to reach the low point in inflation for this cycle.

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



Source: BLS; NBER; RSM US LLP

Does that mean that, because of the large amount of fiscal aid already applied and the accompanying debt, inflation will skyrocket?

We contend that the underlying forces of the economy are unlikely to generate anything like the hyperinflation that plagued Germany after the First World War, or the product shortages that plague the broken-down economy in Venezuela today.

Length of time for inflation to reach 2% target after recessions

	Inflation at the outset of the recession		Highest inflation rate after the recession			Getting back to normal	
	Date of start of recession	Inflation rate in month before recession	Date of lowest inflation rate in cycle	Lowest inflation rate in cycle	Number of months after start of recession	Date of reaching inflation target	Number of months to reach target
Postwar recessions	Jan. 1945	2.30	Feb. 1946	1.70	13	na	na*
	Nov. 1948	4.80	July 1949	–2.90	8	Aug. 1950	13
1950s monetary tightening	July 1953	0.40	Oct. 1954	–0.70	15	July 1956	21
	Aug. 1957	3.70	March 1959	0.30	19	Feb. 1960	na**
1960s monetary and fiscal tightening	April 1960	1.70	June 1961	0.70	14	Feb. 1966	56
	Dec. 1969	6.20	June 1972	2.70	30	June 1972	na**
Oil crisis–induced recessions	Nov. 1973	8.30	Nov. 1976	4.90	36	Dec. 1976	na**
	Jan. 1980	13.90	June 1981	9.60	17	June 1981	na**
	July 1981	10.80	Dec. 1986	1.10	65	Feb. 1987	2
Austerity and energy crises	July 1990	4.80	Jan. 1992	2.60	18	Nov. 1997	70
	March 2001	2.90	Jan. 2020	1.10	10	Oct. 2002	9
Financial and health crises	Dec. 2007	4.10	July 2009	–2.10	19	Feb. 2011	19***
	Feb. 2020	2.30	May 2020	0.10	3	na	na****
Average number of months					**22**		**27**

Source: NBER; BLS; Bloomberg; RSM US LLP
* Inconsistent data due to lifting of price controls ** Inflation did not reach target before next recession *** Includes shock from 2011 European debt crisis **** Assumes recession starts in March 2020

Rather, we anticipate the relative stability and moderate growth that characterized the decadelong recovery from the Great Recession as the economy continues its transition from one based on manufacturing to one based on information and digital technologies.

Most important, inside the digital transformation of the U.S. economy lies a powerful downward pull on pricing as quality improvements and the decline in prices toward zero for all things digitized affect overall inflation.

Wage pressure

During previous business cycles, consumer price inflation was considered a byproduct of wage inflation. If wages were increased, then the demand for scarce goods would pressure the price of those goods higher in a closed economy.

While this could seem reasonable, there were other factors at play, including the supply and cost of energy—think of the twin oil shocks of the 1970s or the natural gas revolution of the past two decades—that affected the entire economy and were important determinants of inflation.

U.S. manufacturing wages during and after recessions

Source: FRED; NBER; RSM US LLP

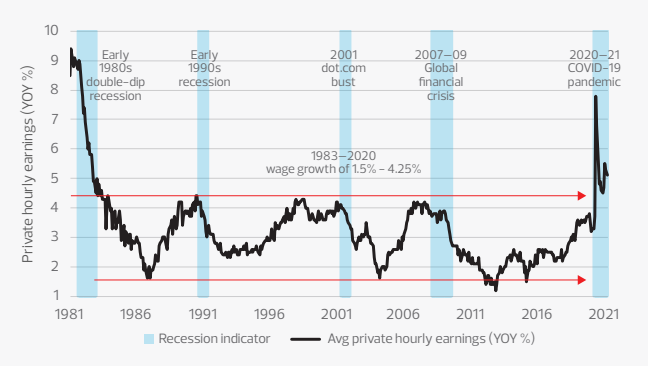
If there was a break in the impact of wages on consumer prices, it occurred during the double-dip recession of the early 1980s. That period marked a confluence of factors, including the sharp reduction of labor union representation, the development of the global supply chain, automation and, in the ensuing decades, the development of the digital economy.

By 1983, following two short and painful recessions, the rate of change in manufacturing wages dropped sharply and never recovered.

Average hourly earnings, which includes white- and blue-collar employment, have grown within a 1.5% to 4.25% range, dropping during recessions and then increasing during the following recovery as employers compete for a limited supply of labor.

The current labor market has had a unique impact on average earnings. The economic shutdown resulted in instant furloughs of staff, leaving only the highly paid and most capable workers left to operate the business. That has distorted top-line figures of wage gains, making them look much stronger than they actually are and underscoring our view of a K-shaped economic and wage recovery. We anticipate that dynamic to lessen when the economy finally reopens.

U.S. average private hourly earnings during and after recessions



Source: NBER; BLS; Bloomberg; RSM US LLP

Moderation of economic growth and inflation

Inflation can arise from a supply shock (for example, the oil embargoes of the 1970s), or, conversely, a lack of inflation can exist because of weakness of demand. The U.S. economy has undergone two shocks in the past 14 years (the 2008-09 financial crisis and the 2018-21 trade war and pandemic), both of which caused sharp reductions in demand and disinflation that threatened to devolve into deflation.

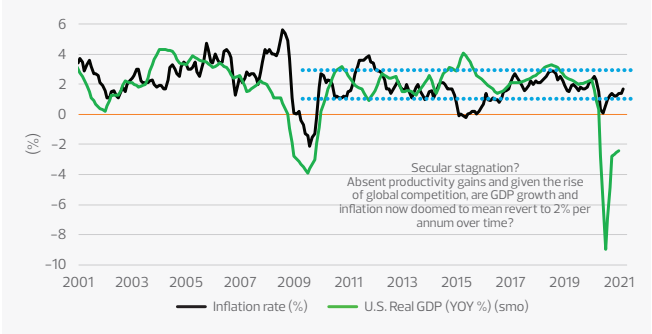
Outside of the shocks, both the economy and prices settled into a narrow range of moderate growth and moderate inflation from 2010 to 2020. While stability is a good thing, economic growth that cannot get above 2% doesn't leave much room for policy error. The proof of that hypothesis is the reaction of the global economy to the trade war, which pushed the U.S. economy perilously close to recession in the years before the pandemic.

Let's not forget that the moderation of inflation in this latest period is also because of decreases in production costs (through automation) and the availability of alternative sources of supply along a now-global supply chain.

Economic analysis now recognizes the interconnectedness of all of these factors, rather than simply accepting the adage that inflation is determined by the supply of money or the amount of debt.

That is why the idea that inflation is always a monetary phenomenon does not resonate in this economy the way it did in previous eras. There have been enough examples to put those notions to rest.

Secular stagnation/moderation in growth and inflation



Source: BLS; Bloomberg; RSM US LLP

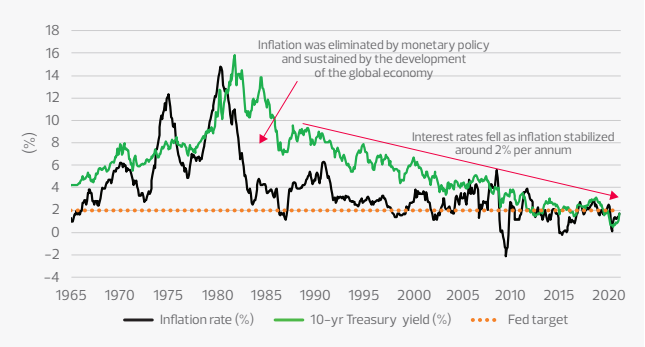
The impact of inflation on interest rates

Long-term interest rates in the United States are comprised of two components: expectations for short-term money-market rates anchored by the monetary authorities at the Federal Reserve, and a risk premium for holding the long-term security over the life of the bond. That risk premium includes expectations for episodes of inflation (or deflation) occurring during the investment period.

As we show in the following figure, the risk of inflationary periods was gradually squeezed out of that calculation by the maturation of monetary policy during the 1970s. Inflation rates and Treasury yields that were 14% to 16% in 1981 are now 1% 40 years later.

Until January, the bond market was still pricing in the risk of policy errors and the risk of deflation into the yield of 10-year Treasury bonds. Recent moves in the 10-year yield to above 1.5% can be construed as a vote of confidence in the monetary and fiscal authorities' ability to contain the pandemic and to increase economic demand such that inflation reaches the Federal Reserve's 2% target.

Secular declines in inflation and long-term interest rates



Source: BLS; Bloomberg; RSM US LLP

Inflation expectations

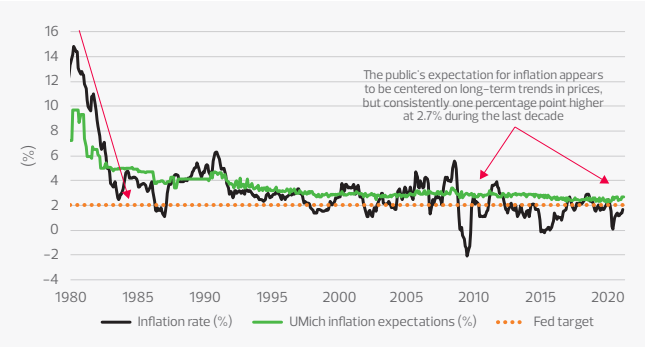
If short-term rates—which are determined by the monetary authorities—are a component of interest rates, is measuring inflation expectations a valid exercise?

There are two methods of determining inflation expectations: surveys of public sentiment, and market-based indicators. Both methodologies are crowd-sourced and arguably based more on the current level of inflation than on clairvoyance.

The University of Michigan's survey of the public's five-year inflation expectations has followed the secular decline in inflation. Over the past decade, the survey results have reported forecasts that were consistently a full percentage point over actual inflation.

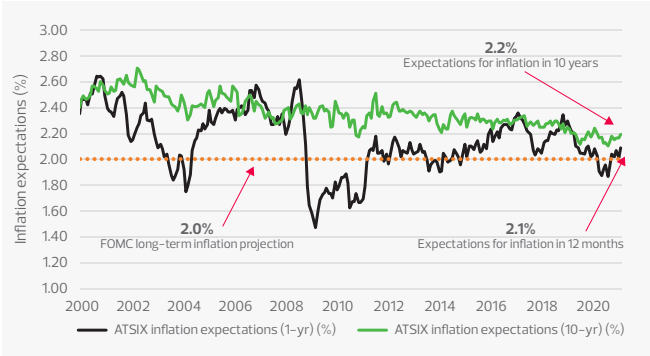
The ATSIX (Federal Reserve Bank of Philadelphia) compilation of surveys has inflation rising to 2.1% over the next 12 months and to 2.2% over the next 10 years, both of which are close to the forward guidance from the Federal Open Market Committee.

Secular decline in inflation and UMich inflation expectations



Source: BLS; Bloomberg; RSM US LLP

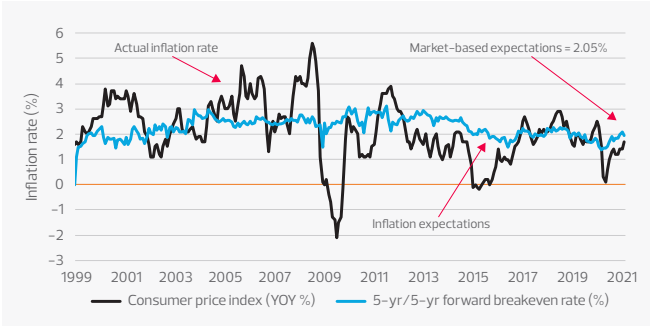
ATSIX survey-based short- and long-term inflation expectations



Source: Philadelphia Fed; Bloomberg; RSM US LLP

Analysis of the price of financial assets can be used to derive the rates of inflation expectations built into those prices. Again, the information built into those assets is arguably contained in the forward guidance of the monetary authorities who are responsible for the direction of inflation, economic growth and short-term money market rates. ■

Inflation rate and market-based estimates of 10-year inflation expectations



Source: BLS; Bloomberg; RSM US LLP

ECONOMICS OF THE $1.9 TRILLION **AMERICAN RESCUE PLAN**

BY JOSEPH BRUSUELAS

PRESIDENT BIDEN signed a $1.9 trillion fiscal aid and stimulus package into law on March 11. The American Rescue Plan Act of 2021 will provide a robust tail wind to the domestic economy as it recovers from the pandemic and will most likely boost gross domestic product by an additional three percentage points.

Based on this latest stimulus package, we have upgraded our growth forecast for the year to 7.2% (previously 6.1%) and our 2022 growth estimate to 4.8% (up from 3.2%). For 2023, we now expect a 2.9% pace of growth. These estimates are well above the long-term growth rate in the United States of 1.8%.

It is critical to point out that we think there is notable risk of much faster growth over the 2021-23 period because of this legislation and the $1 trillion or so of spending still in the pipeline from December's relief package.

Roughly 85% of the $1.9 trillion is dedicated to addressing the pandemic, 75% or so is one-time spending and nearly $1.16 trillion of it is designed to be spent this year. Inside that, roughly half of the $680 billion in income transfers this year will be in the form of stimulus checks.

We expect those checks will boost net household savings, which through the end of January totaled $3.97 trillion, creating the conditions for a household-led economic boom that will almost certainly be the largest in anyone's lifetime. Policymakers, investors and firm managers should anticipate the best growth in the American economy since the mid-80s and quite possibly since the World War II era.

Perhaps the most ambitious portion of the plan is the major expansion of the existing child tax credit, which provides $2,000 per year for children from birth through the age of 16. Under the new Biden plan, most families will receive $3,600 for each child under the age of 6 and $3,000 per year for each child ages 6 to 17. In our estimation, this represents the most significant expansion of the social safety net in the United States in more than 50 years.

Based on the latest Congressional Budget Office estimate, this will result in a cumulative increase of $1.85 trillion in the federal debt over 10 years. These eye-popping growth estimates are what has been behind the recent move upward in the yield of the 10-year Treasury, which pushed past 1.6% in March, up from 0.91% to start the year. They have stimulated the debate across financial markets and in policy circles on the risks of an overheating economy and inflation.

While we expect inflation to increase toward 3% in the top-line consumer price index in mid-2021, mostly because of year-ago base effects linked to the recovery in oil and energy prices, that increase will likely be transitory. In our view, the top-line inflation number will ease back toward 2% over the next 12 to 24 months. We do not anticipate a permanent increase in the price level nor a change in inflation expectations that results in higher inflation or any significant risk to the economic outlook linked to pricing.

Check out RSM's take on tax implications of the American Rescue Plan Act of 2021.

LIVING AND ADAPTING WITH COVID-19

BY ADAM LOHR, STEVE KEMLER AND JOSEPH BRUSUELAS

OVER THE PAST YEAR, leaders around the globe have held their breath as the pandemic unfolded and drastic measures were tested, from safety mitigation and scientific developments to unprecedented fiscal stimulus. And now, as we emerge from the cloud of 2020, it is likely the current pandemic will soon pass to become an endemic. Even with this transition, the fight is not over. Governments and businesses—including the middle market firms that constitute the real economy—will face a host of new challenges as the economy comes back online.

Whether it's decisions about vaccine requirements, including the role of the workplace for annual jabs; accelerating a decade's worth of lagging productivity-enhancing capital expenditures into the next 24 months; or navigating the major shift toward remote work, the near-term will be one of resilience and reinvention. With roughly $90 trillion of global gross domestic product on the line, we are past the point of wait and see; it is time that governments and businesses alike start to evolve as quickly as the virus.

The luxury of a contentious decision

Vaccines continue to be administered globally, new vaccines and therapeutics are being approved, and in the United States, cases have fallen to their lowest level since October.

At the same time, global cases have been rising again, according to officials from the World Health Organization, driven by the Americas (excluding the United States), Europe and Southeast Asia. That increase is also due in part to "relaxing of public health measures, continued circulation of variants and people letting down their guard," according to the WHO.

Domestically, with the approval of Johnson & Johnson's vaccine alongside those of Moderna and Pfizer/BioNTech, the United States is expected to have sufficient doses by the end of May to vaccinate all eligible adults, and will likely be able to vaccinate everyone who wants a jab before then. Given that herd immunity in the United States could be achieved in less than 12 weeks, many leaders in government, scientific and labor groups are questioning some states' decisions to ease restrictions and allow full capacity at businesses.

As the second most populous state in the nation, Texas has been front and center in the reopening discussion, and will likely prove to be a microcosm of the decisions and impacts that will play out across the country and globe as economies struggle with how best to reopen. Experience from the second and third waves indicates that the previous reopenings were followed by sharp increases in cases. Given the unknown protection provided by vaccinations and previous exposure, health officials warn that lifting mask mandates and capacity restrictions will lead to a fourth wave of infections and deaths, dragging out the pandemic even longer.

And while the future is unclear, it's important to keep in mind how fortunate we are to even be able to deliberate the merits of reopening economies. In less than a year, the world has gone from global lockdown because of a deadly new virus, to making intentional decisions to reopen because of controlled cases and growing immunity due to novel vaccines.

The toll on lives and economies cannot be understated; however, it seems this pandemic could have been significantly worse. The question now: How can we continue to move fast on vaccines and therapies, without rushing to reopen, while also bravely facing a new normal where COVID-19 is controlled as a manageable endemic?

Frustrating resilience of disease

"SARS-CoV-2 is not going away. We are going to live with this virus, we think, forever," was the chillingly honest commentary from Moderna's chief executive, Stephane Bancel, at the J.P. Morgan Health Care Conference in January. While the virus is likely here to stay, we should not mistake the inability to eradicate COVID-19 as a failure, or expect that deaths, economic lockdowns and perpetual masking will be the norm.

For better or worse, endemic diseases are woven into the fabric of our lives. We live with them and adapt behaviors, policies and expectations surrounding them. Hepatitis, malaria, HIV and the flu are a few of the most common diseases around the globe, and despite the best efforts of health and scientific communities, they are all frustratingly endemic.

Smallpox, which resulted in an estimated 300 million to 500 million deaths, is the only disease affecting humans that has been successfully eradicated. That lone achievement is due in part to the nature of the virus, not just the existence of vaccinations. According to the American Society for Microbiology, eradication of a disease is facilitated by four criteria which COVID-19 does not follow.

In a recent blog post, we discussed the emergence of COVID-19 variants and the challenges that they present combating the pandemic from a vaccination and herd immunity perspective. It is our opinion, and that of many in the scientific community, that the transmission and natural mutation of the virus across hundreds of millions of hosts across the globe are why COVID-19 is destined to become endemic.

On March 8, the journal *Nature* released a study of the effectiveness of the Pfizer and Moderna vaccines against the U.K. and South Africa variants. According to the authors, "Mutationally, this virus is traveling in a direction that could ultimately lead to escape from our current therapeutic and prophylactic interventions directed to the viral spike. If the rampant spread of the virus continues and more critical mutations accumulate, then we may be condemned to chase after the evolving SARS-CoV-2 continually, as we have long done for influenza virus. Such considerations require that we stop virus transmission as quickly as is feasible, by redoubling our mitigation measures and by expediting vaccine rollout." We refer to this not as a lesson in disease transmission and eradication, but as a reminder that the same challenges of controlling a disease on a global level are also present in our local communities.

Now is the time to double down on efforts to prevent and contain the virus so that so much hard-fought ground is not lost. And this is not just a matter of action for states and counties in the United States, but for all nations as we collectively fight the pandemic. This is a large reason why the efficient and equitable distribution of vaccines across

Eradication criteria	SARS-CoV-2 / COVID-19 considerations
Disease is easily diagnosable and recognizable	Asymptomatic cases of COVID-19 are common and without proper testing may go undiagnosed or be classified as another disease, including other coronavirus's that are globally endemic (e.g., the flu).
No non-human reservoir or vector to support the spread	SARS-CoV-2 is able to cross phylogenic boundaries between species (e.g., known cases in pets and zoo animals), and the virus most likely originated from bats and was spread in a live animal market. Smallpox in comparison was only transmittable between humans.
Disease is easily diagnosable and recognizable	The global economy makes geographic restriction practically impossible, especially given asymptomatic infections, reinfections by different variants (Brazil's variant warning to the world), and current vaccines that do not provide full immunity against the disease or its variants. Note: *Smallpox was globally distributed, but the cost and time of cross border travel hindered major population movement.*
Vaccine or other transmission-disrupting alternatives exist	The goal of vaccines and disruption measures are to generate herd immunity or reduce transmission until the virus peters out in an affected population. With COVID-19, vaccines have been developed at a record pace, and simple actions such as social distancing, masking and use of sanitizers have proven to significantly limit transmission of the disease. Going forward the primary issue will be rapid vaccine distribution and high levels of adoption across the globe, as well as the continued use of mitigating measures until sufficient herd immunity is achieved.

Source: RSM US LLP

rich and poor nations is critical, and why every effort should be taken to support vaccination roll outs and the further development of vaccines, boosters and therapies.

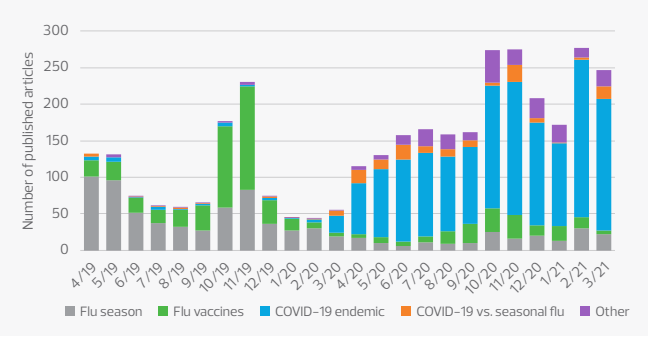
As long as there are reservoirs of the virus around the globe, there will be outbreaks of COVID-19, and the specter of 2020 will dampen the global economic recovery and the return to our evolved vision of normal. This is not intended to be disheartening, but it is the reality that legislators, business owners and our communities need to come to grips with as the economy pushes forward with reopening.

An endemic new normal

What will life, ecosystems and the marketplace look like in an endemic new normal? Some governments and businesses have already begun thinking in terms of an endemic future, even if doing so unintentionally. Evaluating existing business models, updating policies and making investments in technology and digital infrastructure are just a few components of this new normal.

The charts below visualize the volume and velocity of published articles referencing an endemic or epidemic, inclusive of references to COVID-19, and seasonal flu; and serve to illustrate the increased prevalence of the endemic conversation taking place in the community, even with the distribution of vaccines in the new year.

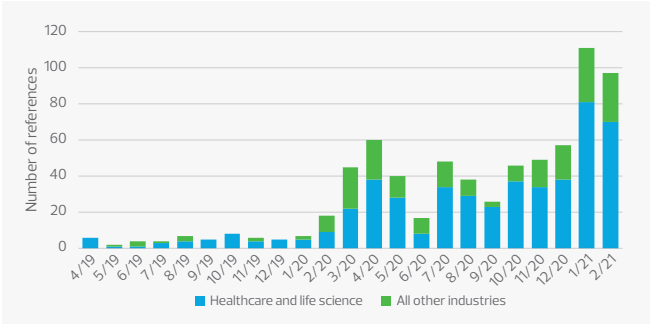
Published articles reflecting endemic, epidemic, COVID-19 and flu-related terms



Source: RSM US LLP

And note, it's not just health care and life sciences businesses thinking about life with COVID-19. Other industries have continued to ruminate about an endemic future.

Prevalence of endemic conversation by businesses



Source: RSM US LLP

And businesses have much to ponder. While there are pandemic-driven headwinds to address amid the full recovery of the economy, there is overwhelming momentum from a demand, fiscal stimulus and monetary policy perspective. Recovery will look different for each business, but there are some basic factors that should be considered.

Business model evolution

Professional services firms have been serving clients remotely for a year, doctors and patients are embracing telehealth, and e-commerce grew by more than 33% in 2020 according to the research firm eMarketer. As reported by Bloomberg, "10 large retailers accounted for 68% of all U.S. e-commerce sales last year," with Amazon representing more than half of all online sales.

Business owners will need to evaluate new consumer preferences, who their customers were before and during the pandemic, and how those interactions have changed. As the economy reopens and a flood of pent-up consumer demand is released, the new challenge for middle market businesses is likely to focus around how they remain relevant and competitive in an increasingly consolidated and technologically advanced economy.

MIDDLE MARKET INSIGHT

Business owners will need to evaluate new consumer preferences, who their customers were before and during the pandemic, and how those interactions have changed.

AS PANDEMIC SAFETY MEASURES ARE LIFTED, AND ECONOMIES PUSH TO REOPEN, IT WILL BE THE RESPONSIBILITY OF FIRMS TO DECIDE HOW TO MOVE FORWARD IN THE BEST INTEREST OF THEIR CUSTOMERS.

Weighing local rules, federal recommendations and community attitudes

As pandemic-driven safety measures are lifted, and economies push to reopen, it will be the responsibility of firms to decide how to move forward in the best interest of their customers, employees and bottom line. In response to the easing of mask mandates and occupancy limits by some state and local governments, many large retailers (including Starbucks, Target, Macy's and Kroger) have decided to maintain their requirements for face coverings and have stated they will continue to follow federal guidelines on social distancing. Unions and employee associations are also likely to push for continued safety measures to keep their members healthy.

Just as the implementation of COVID-19 measures generated disagreement, so too will the lifting of such measures. And it looks increasingly likely that business leaders will be tasked with navigating this uncharted territory, as well as enforcement of their own internal and customer-facing policies. As reported by Bloomberg, there has been a hiring spree for security guards, but many have also faced violent confrontations regarding masks and social distancing.

MIDDLE MARKET INSIGHT

In the pandemic environment, organizations will need to create new roles or expand existing ones to communicate and enforce company policy around COVID-19 safety measures such as office protocol and travel, and to monitor local and federation regulations.

Vaccination passports and health screening

Many governments, including the United States, U.K. and the European Union are contemplating easing travel restrictions, as well as the adoption of vaccine passports or health certificates. Conceptually, such passes would show vaccination, previous infection or a recent negative test. But this is far from perfect science given vaccines and natural antibodies have had varying degrees of effectiveness, and there is limited research about disease transmission from a vaccinated person to an unprotected party.

Some health officials and civil liberty groups have also warned of inherent (while often unintentional) inequality to the process given that most countries do not have sufficient access to vaccines. When we think about the domestic and international K-shaped recovery, the introduction of health passports would likely enhance that disparity. Actual or implied inequality would span political, cultural and religious lines. That, in our estimation, would lead to fewer open markets, nationalization of supply chains and a weaker economic recovery.

For business owners, the adoption of vaccination certificates or health screening measures can create headaches beyond a human resource and privacy perspective. They could also have a chilling effect upon the culture of an organization. Whether for health, religious or personal reasons, it is easy to see the downside risk of lines being drawn between the vaccinated haves and have-nots.

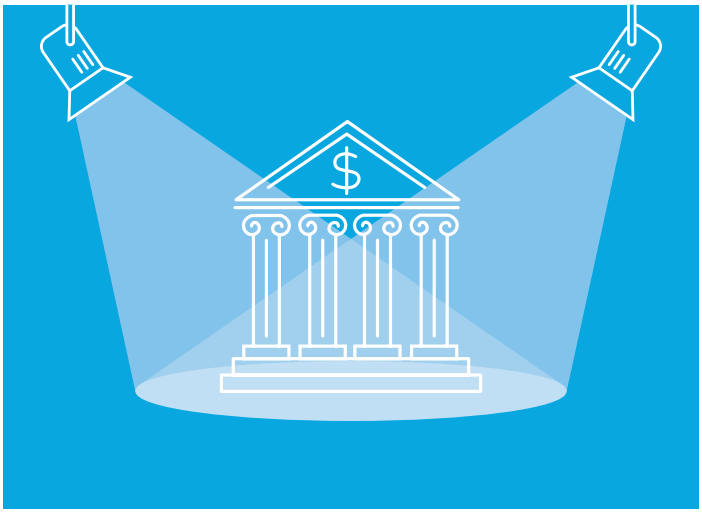
Work from home becomes work from anywhere

Of all the pandemic changes, the shift from the office, to home, to anywhere will prove to be one of the most dramatic and challenging.

For many industries, the talent pool has increased exponentially overnight, and employees finally received the flexibility they have been craving. This will theoretically allow firms to more easily recruit the right talent for the job, and moderate labor costs away from traditional high talent and high-cost labor hubs. There is also the added risk of employee burnout and a lack of connectivity to the company or peers, which can negatively affect morale, collaboration and innovation.

As a result, business leaders will need to consider how a post-pandemic workforce will interact with each other and a community that is now structurally different and increasingly digital. Communication, collaboration, training and evaluation will all look different going forward, and the need to embrace technology solutions is higher than ever.

There is much to do and to anticipate, but we've come so far from a year of despair and uncertainty. Businesses and communities have learned and adapted. It will take that reserve and know how to tackle the next leg of our COVID-19 journey—living and growing despite its endemic challenges. ■



WITH EMBEDDED FINANCE, **WALMART TAKES AIM AT CONSUMER FINANCIAL SERVICES**

BY NELLY MONTOYA

THE NEWS IN EARLY MARCH that Walmart hired away two executives from Goldman Sachs to run its nascent fintech division was the clearest sign yet that the retailing giant intends to compete in the consumer financial sector, especially in the middle market.

David Stark and Omer Ismail, both former Goldman Sachs partners, will build what is expected to be a major presence in consumer banking for Walmart. They are credited for being instrumental in Goldman's push toward the middle market through its digital bank, Marcus.

It's not the first time that Walmart has made a foray into consumer banking. In 2006, Walmart applied for a bank license using the industrial loan company (ILC) route. Back then, Walmart faced stiff opposition from bankers, lawmakers and industry watchdog groups. The Federal Deposit Insurance Corporation even instituted a moratorium on ICL charters, and eventually Walmart abandoned its modest plans of reducing its back-office payment handling costs.

But for Walmart, it's not about winning a battle; it's about winning the war. And in 2021, it is about winning the digital war with the help of embedded finance.

In January, Walmart announced its fintech startup with Ribbit Capital, a fintech-focused venture capital firm. Through this partnership, Walmart plans to build affordable digital financial products for its more than 230 million customers who visit its 10,800 locations. At the time of the announcement, not many details were provided beyond saying that they were building a management team with experienced fintech leaders.

A brief history of Marcus

That's where Stark and Ismail come in. Goldman has been slowly moving into consumer finance and launched its Marcus by Goldman platform in 2016. Initially, the platform provided personal loans and savings accounts. It recently began offering investment capabilities, and it plans to eventually launch a checking account to be a one-stop shop for banking.

Marcus has also expanded to the U.K., highlighting Goldman's continued interest in serving Main Street customers. Both Stark and Ismail were central to building the partnerships, like the one with Apple and its credit card, behind the growth of Marcus.

Now that Stark and Ismail will be at the helm of Walmart's fintech venture, and with Ribbit Capital's expertise honed from backing fintechs, such as Credit Karma, Coinbase, Robinhood and Affirm, we expect a significant impact on Walmart's customers and broader implications as traditional companies continue to partner with fintechs.

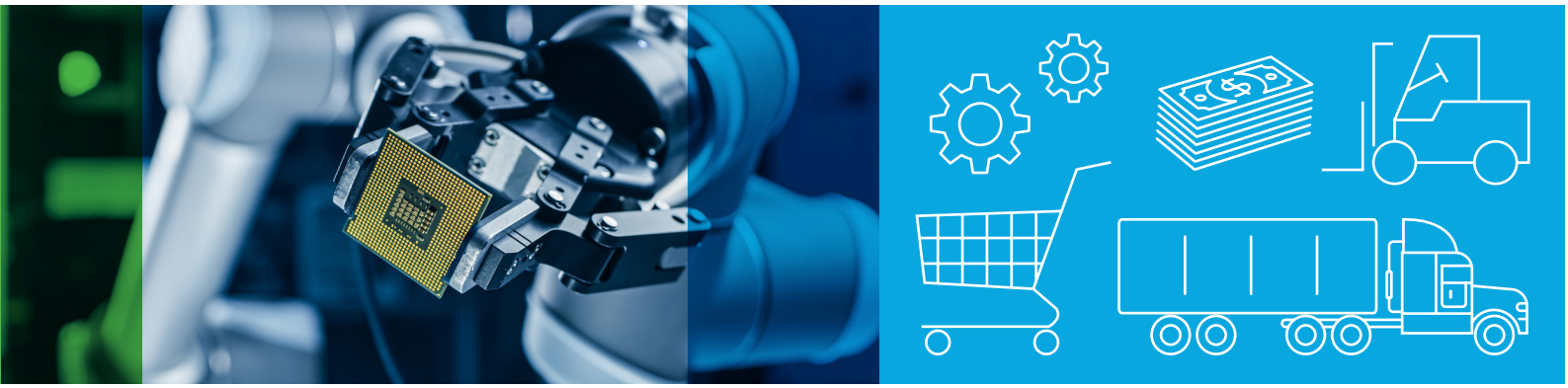
Leveraging Stark's and Ismail's expertise along with Ribbit's institutional knowledge could be the start of a super app that handles all of Walmart's consumer finance needs. For example, access to Walmart's customer data can provide insights to offer financial literacy tools, credit score management and installment payment options (buy now, pay later). Next, we could see savings, investments or, perhaps, eventually a pivot into cryptocurrency.

As a trusted brand to millions of customers, Walmart provides financial products like digital payment options (Walmart Pay) and even marketplace lending through a previous partnership with Goldman. If a Walmart app comes along that integrates other capabilities via application programing interfaces, and if those capabilities show up at the time of need, why would anyone choose to bank elsewhere?

Broader implications

Embedded finance has paved the way for many companies to add financial service products (e.g., loans, insurance and savings) to their service offerings. These products are added through APIs and allow the companies to manage the relationship with the customer and offer products at the time of need in a seamless process.

Moreover, embedded finance allows companies to curate the customer journey by mixing and matching different financial service offerings to provide tailored experiences. Now, Walmart, with its pricing power and consumer reach, is poised to become a major force in this still-evolving industry. Walmart was not allowed to proceed with its banking charter back in 2006, and now it certainly doesn't need it to become a finance super app.



PRICING CONCERNS SURFACE, MMBI DATA SHOW

BY JOSEPH BRUSUELAS

With the economy poised to embark on a period of robust growth, middle market businesses have been wrestling with questions over pricing amid still-constrained supply chains.

A subindex of February's RSM US Middle Market Business Index survey offers some answers.

58% of executives surveyed note that they paid higher prices paid for goods, down from **66%** in January.

69% said they expect to pay higher prices over the next six months.

38% of respondents said that they received higher prices for goods or services.

59% indicated that they intend to try to pass along price increases to their customers over the next six months.

THE TAKEAWAY

First, firms that have not been able to pass along price increases are somewhat skeptical about being able to do so. While a majority intends to try, this may prove difficult because of wage pressures in a global economy, among other factors.

Second, middle market firms will need to focus immediately on increasing efficiencies and engage in productivity-enhancing investment to address rising input prices.

Third, this data does not point to an immediate and permanent increase in the price level across the economy. Rather, it shows a transitory increase in inflation caused by year-ago base effects.

Fourth, the recent backup of Treasury yields along the long end of the maturity spectrum looks to be overdone. We would not be surprised if Federal Reserve begins to use its potent policy toolbox to begin dampening rates along the long end of the curve.

Finally, wage pressures, a key component of rising inflation, have not shown up in the economy, and this was confirmed in the RSM survey. Only 32% of firms reported an increase in compensation, 21% noted a cut and 45% stated that wages and salaries remained unchanged.

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

For media inquiries, please contact Terri Andrews, national public relations director, +1 980 233 4710 or terri.andrews@rsmus.com.

For more information on RSM thought leadership, please contact Deborah Cohen, thought leadership director, +1 312 634 3975 or deborah.cohen@rsmus.com.

TRE-NT-ALL-ALL-0421

RSM