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How CFOs can rise to meet the challenge of soaring inflation

The last time many sitting CFOs faced a soaring inflation rate similar to today's would have been approximately, well, never.

In the late 1970s, a long-simmering brew of issues, including heavy federal spending and global oil price shocks, ultimately pushed the inflation rate into the double digits. But many future CFOs likely avoided the problem by staying in preschool—and some were probably still working their way toward the top finance job when the Great Recession began in 2007.

But now CFOs are getting schooled in both inflation and recession. Inflation was 9.1% in June, reaching its highest rate since 1981, before easing slightly to 8.5% in July.[1] In July, the Fed raised its benchmark interest rate by three-quarters of a point, its fourth hike this year.[2] Furthermore, Gross Domestic Product (GDP) just recorded its second consecutive quarterly drop, commonly viewed as a recession signal.[3]

Many CFOs have seen the economy losing steam, but perhaps not to this degree or at this speed. In Deloitte's North American *CFO Signals*™ survey for the second quarter of 2022, respondents cited inflation as one of their most worrisome external risks. They also adjusted downward their year-over-year growth expectations for revenue, earnings, and capital spending.[4]

Earlier, CFOs who responded to Deloitte's *CFO Signals* survey for the fourth quarter of 2021 even predicted the timing of the Fed's anticipated interest-rate increase. More than two-thirds (69%) saw it coming in this year's first or second quarters.

As it turned out, both predictions were right. All indications are that the 23% who foresaw an interest-rate increase coming in this year's third quarter will also see their expectations met.[5] But sensing what's coming—an advantage that few, if any, CFOs had when the COVID-19 pandemic descended— isn't the same as knowing what to do about it.

In this edition of *CFO Insights*, we'll explore the options for countering the margin-shrinking impact of an inflationary operating environment, whether through such means as selectively increasing prices, resetting capital spending plans, or modifying hedging strategies. As borrowing costs rise, CFOs will likely question what levers they can use most effectively—especially given how few CFOs have worked in such an inflationary environment.

Inflation on the rise

Almost as worrisome as the actual rate of inflation is its pervasiveness throughout the economy. No longer are price increases concentrated in a few consumer goods, such as food and energy. The cost of new trucks rose 0.7% between May and June, the price of health insurance rose 2.1%, and the cost of computer software rose 2.3%.[6] Annualized equivalents of those price increases are 8.7%, 28.3%, and 31.4%, respectively.

Skyrocketing inflation was a dizzying turnabout, given that 2021 was a year of economic recovery as lockdowns ended, vaccines were distributed, and business spending surged.

In the United States and elsewhere, the increased spending was disproportionately directed toward goods, not services. Inflation-adjusted spending on goods alone soared 16.2% from February 2020 to November 2021,[7] whereas overall US consumer spending, including services, increased a more modest 4.4%.[8]

Supply chains couldn't keep up with mushrooming demand, creating shortages. Those shortages grew more severe as companies paid a premium to load up on extra inventory of, say, semiconductors. The kinks in the supply chain might have worked themselves out by now—were it not for the Russia-Ukraine war, which has led to energy shortages and a spike in oil prices (see "Why the Russia-Ukraine war may drive CFOs to reconfigure battered supply chains," *CFO Insights*, July 14, 2022).

Another factor: China's continued zero-tolerance policy toward COVID-19 led to lockdowns in key manufacturing hubs, such as Shanghai, further straining supply chains. As a result, inflation kept inflating.

Strong medicine

As disruptive as inflation may be now, the risk is that it will become embedded in the economy, generating expectations that make it difficult for companies to stabilize wages. In the 1980s, Fed Chairman Paul Volcker had to raise the Fed Funds Rate as high as 20% to wring inflation out of the economy. The result: back-to-back recessions, and a double-digit unemployment rate.[9]

Unlike then, however, the Fed is now expected to respond—quickly and aggressively—to inflation, meaning inflationary expectations are less likely to get out of hand in the event of sudden price shocks. There's no guarantee, of course, which raises questions about the economy's overall condition. CFOs who prioritize fighting inflation may want clarity on the following four questions:

1. **Does the Fed have the tools to get inflation under control?** The short answer is yes. By raising interest rates and making borrowing more expensive, the Fed is discouraging businesses (and consumers) from making big investments and purchases. This should cool demand and bring down prices. But at what cost? The Fed's cure should be applied carefully and diligently, to avoid making the patient sicker.
2. **Has inflation peaked?** Signals are mixed. Consumer prices, as measured by the Consumer Price Index (CPI), rose year over year at the fastest pace since November 1981.[10] On the other hand, core inflation—which excludes food and energy prices—peaked in March.[11] Another sign inflation may be easing: The dollar has been rallying in currency markets, posting solid gains against the euro and the Chinese yuan.[12] A strong dollar is inherently deflationary, as it brings down the cost of imported goods and commodities, including oil.[13]
3. **Are wages out of control?** While the data show significant increases in average hourly earnings—up 5.1% year over year in June—wage growth has not kept pace with inflation.[14] As a result, buying power among workers continues to fall.
4. **Is the US economy in a recession?** The answer is probably no, since too many indicators (like employment) are positive and inconsistent with the idea that economic activity is broadly contracting. However, the risk that the economy could reach a business cycle peak, and begin contracting this summer or fall, is unusually high. CFOs seem to be battening down the hatches. In the *CFO Signals* survey for the second quarter of 2022, only 32% of CFOs said this was a good time to take on more debt, with only 35% saying it was a good time to take greater risks—down from 85% and 47%, respectively, in the preceding quarter. The Q2 2022 survey results also hint that recession could overtake inflation as CFOs' top concern. While inflation was the most-cited external concern, the percentage of CFOs mentioning inflation as an external threat actually declined between the first and second quarters of 2022, dropping from 57% to 48%.[15]

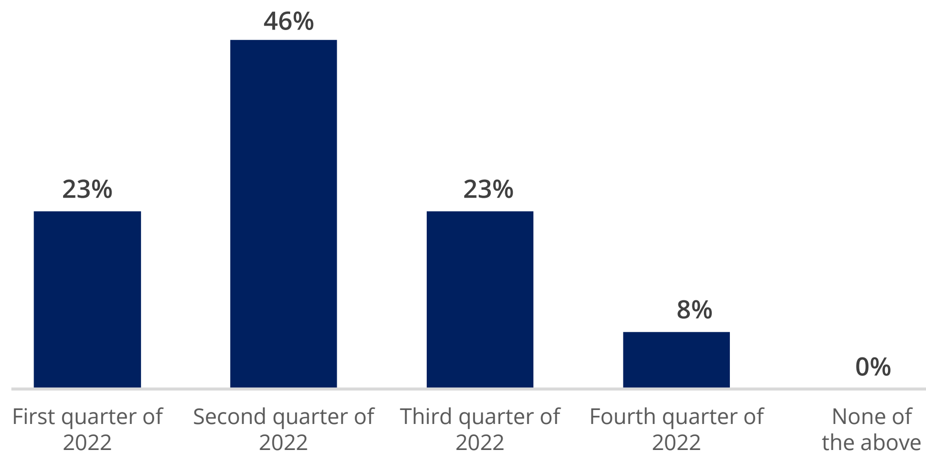
Evaluating the possibility of a recession is crucial for CFOs in deciding how to respond to inflation. That's because a CFO's response to the declining demand associated with a recession will likely be quite different from a CFO's response to the overheated demand associated with high inflation.

What's happening

With the economy at least inching toward a recession, CFOs may justifiably be uncertain as to what actions would be most effective. But, among those who responded to the *CFO Signals* survey for the fourth quarter of 2021, many anticipated the Fed's direction. Almost one-half (46%) imagined the central bank raising interest rates in the second quarter of this year, while another 46% were evenly split between the first and third quarters (see Figure 1).[16]

Figure 1. Timing is everything

I expect the target interest rate for US federal funds to be increased in: (N=120)*



Source: *CFO Signals* Q4 2021, US CFO Program, Deloitte LLP.

Those CFOs who expected a weak Fed response to inflation—one that prioritizes low unemployment over low inflation—would probably have been more likely to invest in automation, employee retention, or vertical integration (i.e., acquiring suppliers) to blunt the impact of rising costs and wages. But given the Fed's muscular response so far, the rationale for making such investments may have become moot. With that in mind, below are some levers CFOs should consider to safeguard their enterprises from the effects of high inflation.

- **Reduce accounts receivable and increase accounts payable.** Delaying when you pay suppliers makes sense when a dollar is worth less tomorrow than today. It also makes sense to insist customers pay you as quickly as possible. By reducing accounts receivable and increasing accounts payable, CFOs can minimize revenues lost to inflation and expenses paid to suppliers and contractors.[17] **Potential downside:** CFOs risk alienating dependable suppliers at a time when supply chains are weak.
- **Re-think inventory management.** In a high-inflation environment, producers of appreciating, nonperishable goods may want to hold onto more inventory, knowing that prices will likely rise down the road. **Potential downside:** If a recession hits and demand weakens, companies might get stuck with unsold inventory.
- **Shift borrowing to shorter maturities.** Since last summer, the 10-Year High Quality Market (HQM) Corporate Bond Spot Rate has more than doubled, from 2.01% in August 2021 to 4.78% in June 2022.[18] For CFOs looking to roll over loans or bonds now coming due, it's tempting to go short while waiting out the Fed's tightening cycle and waiting for long-term rates to come down. **Potential downside:** Any decision on whether to borrow short or long term should probably start with evaluating the equilibrium point for interest rates. Historically speaking, 2% or so yields on 10-year, high-quality corporate bonds have been rare; since 1985, yields on high-quality corporates have averaged 6.4% and have only been below 2.5% for a total of 12 months—all occurring between July 2020 and September 2021.[19] In a few years, it may turn out that June's 10-year HQM Corporate Bond Spot Rate of 4.78% was reasonable.
- **Prepare for possible capital losses linked to rising interest rates.** Say you're the CFO of a lender or insurer whose ability to write new loans or policies hinges on meeting certain capital requirements. And say you have a portfolio of 3% mortgages on your books at a time when the prevailing rate for new home loans is 6%. Even if home values remain high and those 3% mortgages are well-collateralized, your portfolio will still incur capital losses from the interest-rate spike. The potential for such losses means some companies may postpone major investments or acquisitions until they have a better handle on their capital situation. **Potential downside:** There could be missed opportunities in M&A, especially with equity valuations still down substantially from January.
- **Invest in safeguards against labor turnover.** High labor turnover is often associated with high inflation, and keeping top talent was hard even before inflation hit 9%. As workers seek wages that keep pace with inflation, talent-retention efforts become even more crucial. Investing in systems such as training capabilities, talent pipelines, and labor-saving automation can also smooth operations. **Potential downside:** If a recession hits and sales decline, investments in automation or better pay and benefits could make it harder for companies to align costs with revenues.

Pricing points for CFOs

Even the most obvious strategy requires taking a risk: Pass along higher costs to customers, and they may just pass up doing business with your company (see sidebar, "Increasing prices without shaking trust"). In the *CFO Signals* survey for the fourth quarter of 2021, more than three-fourths (76%) of CFOs indicated their organizations would raise prices for a substantial portion of their products or services to offset inflation.[20]

According to one Deloitte analysis, the rewards of price increases often outweigh the risks. The analysis found that if a company with 35% gross margins raises prices by 5%, the company's sales volume would need to fall by more than 12.5% for the price hike to impact contribution margin negatively.[21] Of course, some competitors will likely hold the line on price increases to gain market share.

For CFOs who already have to set (and reset) a strategic path through so much unfamiliar terrain, questions abound. Will the Fed keep raising rates until inflation is in check, given the election-year pressure? Is monetary policy even capable of fully blunting the inflationary impact of energy shocks and supply-chain tangles? Will spending continue to outpace inflation? Maybe the Fed's rate hikes will be enough to cool inflation. Then CFOs can focus on worrying about another potential management challenge: recession.

Increasing prices without shaking trust

Last year, consumers in the United States and other higher-inflation countries accepted price hikes that seemed tied to the pandemic or war. But patience may be running thin. In the United States, 60% of consumers now believe companies are using inflation as an excuse to boost profits—and not as a valid reason to offset higher costs.[22]

The challenge for CFOs: How do you raise prices without leaving customers feeling like it's nothing more than a money grab? Consider:

- In addition to any price increase, companies should communicate to customers everything they've done until now to avoid raising prices. If your company has taken steps to mitigate price increases—cutting back on packaging or sourcing cheaper raw materials, perhaps—make sure customers know this.
- Remember that sustainable products can command higher prices. With consumers willing to pay premium prices for goods and brands deemed sustainable, it may be easier to pass along price increases for such products. Globally, roughly one-half (52%) of consumers purchase at least one sustainable good or service every month. And one-third cite paying significantly more for such products and services compared to nonsustainable alternatives.[23]
- Expand customers' options. Companies that give customers more options to trade down price-wise—while remaining within their brand—will likely have a competitive advantage.

Nobody likes paying higher prices or paying the same prices for a reduced amount of product ("shrinkflation"). The key for CFOs is identifying the products and customers for whom increased prices do not mean diminished trust.

End notes

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