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GET READY FOR MARGIN COMPRESSION

As a Deflation Cycle Begins

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From 2020 to 2022, we experienced unprecedented macroeconomic conditions: low interest rates, cheap capital, and a work from home consumer base that drove up demand. Supply chain managers also bulked up inventories over this period, as unexpected supply chain failures would cause unpredictable shortages.

In 2023, we now find ourselves within a drastically different dynamic: rapid interest rate tightening, normalized freight costs, and deflationary pressure in China.

Considering these changes, businesses must be aware of three critical factors that may result in compressed margins. Firstly, the rising interest rates will likely curb consumer spending. Secondly, input costs could remain elevated even as demand slows down. Lastly, the high inventory levels that were a buffer in a high demand/highly uncertain world will turn into a liability as consumer spending shrinks.

To navigate this shifting landscape, businesses must invest in multi-scenario planning, not just as a reactive measure but also as a proactive strategy, so as to rethink their overall organizational performance. At the same time, developing a dynamic supply chain cost optimization program will be key to staying ahead. Time is of the essence; those who act quickly and decisively are more likely to maintain healthier margins compared to competitors that are slower to respond.

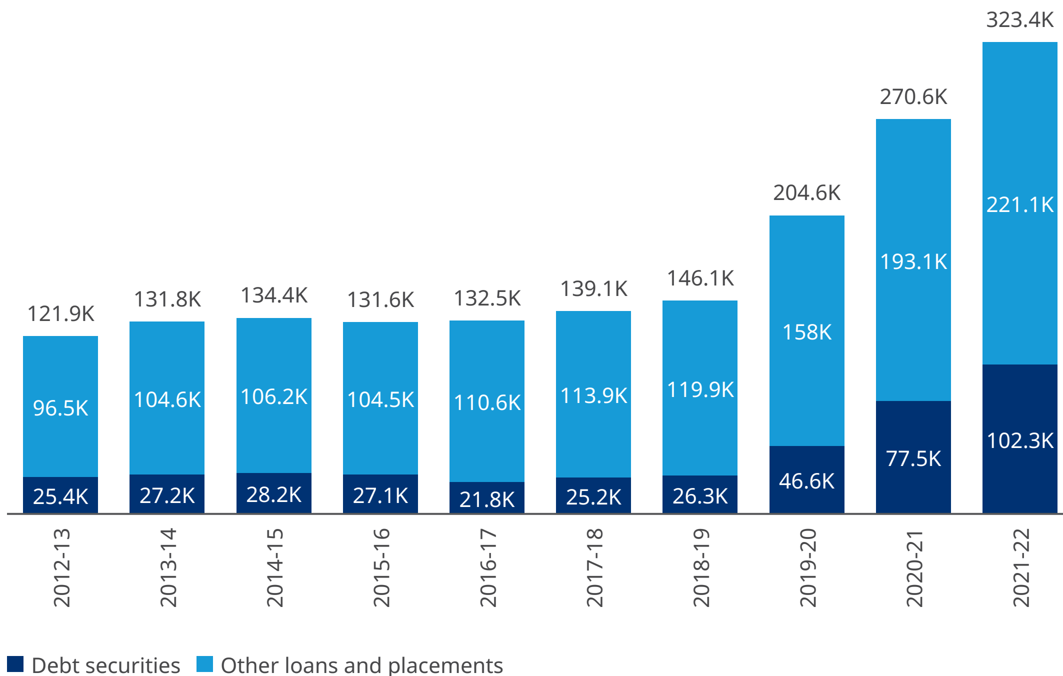
UNCERTAINTY AND EXCESSIVE SPENDING DEFINED THE COVID-19 ECONOMY

The COVID-19 pandemic triggered a coordinated fiscal and monetary response by all governments to prevent a lockdown-driven economic collapse. Government expenditure reached levels not seen since the Second World War. Many of the Group of Seven countries saw an increase in their net debt-to-GDP ratio. Japan's increased from 151% to 161%, while this ratio for the US and the UK rose from 83% to 96% and 74% to 95%, respectively, according to Statista. Meanwhile, in Australia, state government debt issuance increased more than two times from the average levels before COVID-19 to 2023, according to the Australian Bureau of Statistics. Equally supportive monetary policy enabled this spending, with interest rates dropping to 0% and many central banks committing to depressed rates for an extended period.

Stimulus checks, debt relief, and free money inevitably drove perverse incentives for many operators. Supply chain managers, for example, received a blank check to stockpile inventories to avoid stockouts at almost any cost. In retrospect, the catalysts for a gilded approach to working capital management were clear: capital was cheap, the expenditure on goods was growing rapidly with consumers stuck at home, and previously unimaginable supply chain failures were driving unpredictable shortages with spiraling prices. All of a sudden, paying global freight rates seven times higher than the norm of the previous 18 months seemed uncomfortable but acceptable, according to our analysis of the Freightos global container price index.

The war between Russia and Ukraine further exacerbated conditions. Greater supply chain disruptions happened, notably in commodities, such as wheat and fertilizer, where, according to the Organisation for Economic Co-operation and Development, the two countries are the world's leading exporters. Other countries curtailing exports to secure local supply also compounded the war and sanction-induced shortages. The situation caused wheat and fertilizer prices to skyrocket by 65% and 165%, respectively, from April 2021 to April 2022. To succeed in this environment, it was essential to maintain maximum capacity and ensure supply chain redundancy.

Exhibit 1: State government gross debt ($M)

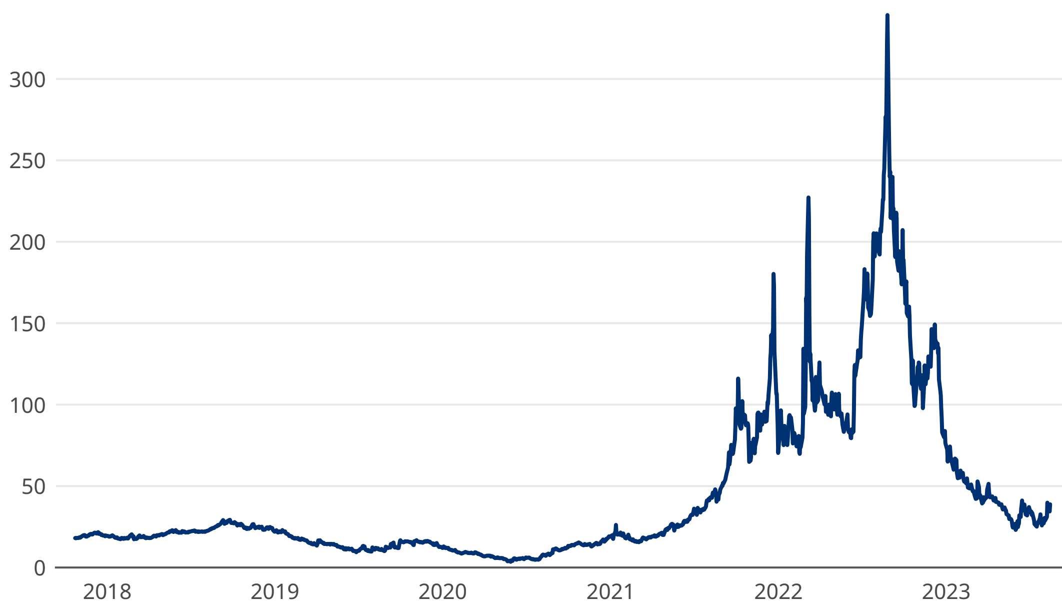


Source: Australian Bureau of Statistics, Government Finance Statistics, Annual 2021-22 financial year

Exhibit 2: Global Container Freight Index, USD, August 2020 — August 2023

Source: Freightos Global container freight index

Exhibit 3: Dutch TTF Natural Gas (Euro/MWh), daily data 23/10/2017 to 15/08/2023



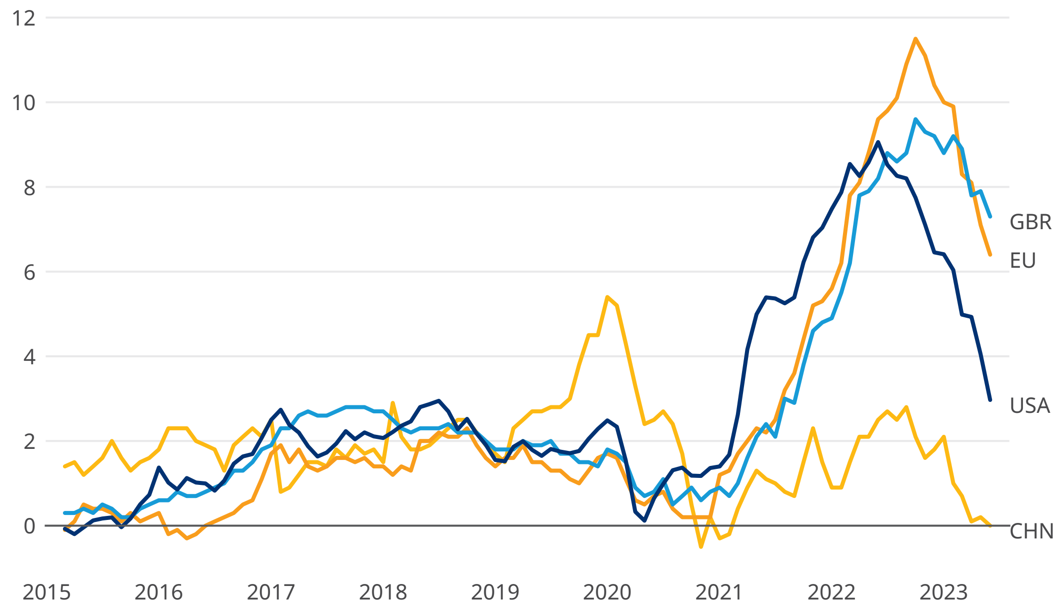
Source: Yahoo Finance

2023 SAW A COMPLETE PARADIGM SHIFT

For many of the world's leading economies, there was a sharp U-turn in 2023. Most central banks started a historically fast interest rate tightening cycle from mid-2022, with the hope of bringing inflation rates down to the 2% to 3% target range. With inflation still sitting above these target levels in the US, the UK, and the EU, the world's major central banks have signaled more rate rises are coming.

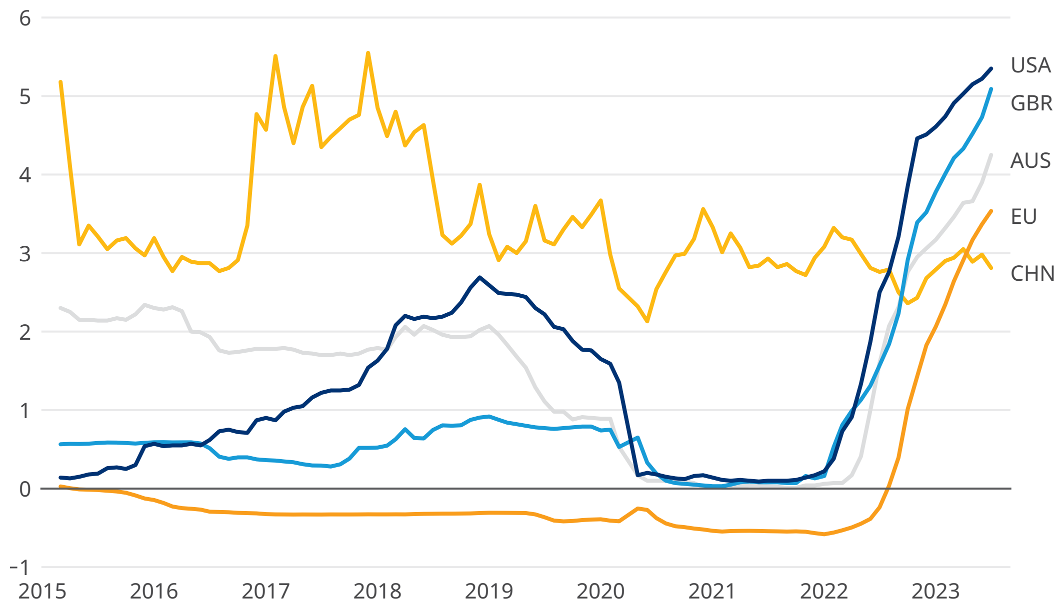
This policy shift has challenged and contracted consumer and business demand in much of the OECD. Freight and shipping costs have already returned to pre-pandemic levels. Notably, according to Freightos, since April 2022, there has been an 80% reduction in shipping rates between Asia and the west coast of the US. The challenges in China are even more dire and perhaps provide a glimpse of what is to come. The world's second largest economy is already exporting deflation; according to the OECD, in July 2023, China's Consumer Price Index fell to -0.3% year-on-year, while the value of its exports decreased by 14.5% despite a minimal change in export volume, according to CNN.

Exhibit 4: Inflation CPI (Total Annual Growth Rate (%) in the world's leading economies, March 2015 — June 2023



Source: OECD

Exhibit 5: Short-term interest rates (%) in leading economies, March 2015 — July 2023



Source: OECD

THREE UNAVOIDABLE PRESSURES POINT TO SEVERE MARGIN COMPRESSION AHEAD

1. HIGHER INTEREST RATES ARE DRAINING CONSUMER SPENDING CAPACITY

Higher interest rates are placing pressure on anyone who pays rent, or has a mortgage, credit card debt, or personal loan. From 2023 to 2024, about 1.3 million Australian households will move from fixed rate mortgages to variable ones. These changes have also impacted the rental market, with rental rates up 27.6% in the first half of 2023, according to the Sydney Morning Herald. Households have withstood cost of living pressures so far, thanks to record household savings during COVID-19. However, this buffer has been eroded with the rate of savings per household at a 15-year low of 3.7%, down from just under 20% in 2021, according to the Australian Bureau of Statistics.

This decline is also impacting consumer spending; National Australia Bank noted a 6% year-over-year decrease in retail spending from 2022 to 2023, while the Australia and New Zealand Banking Group Limited reported a drop of 10% to 20% in shopping, dining, and travel for the same period, according to the Australian Financial Review (AFR).

According to the AFR, business earnings have also been hit, with small-to-medium business insolvencies at an eight-year high, and Australian Securities Exchange-listed retailers including Harvey Norman, Baby Bunting, and Best & Less downgrading earnings expectations prior to reporting for fiscal year 2023.

2. COSTS REMAIN STICKY AND WAGES ARE RISING

Input costs in the real economy remain sticky and may not come down to match the lowering demand. The most pernicious of these costs are wages. According to the AFR, currently in Australia, real and award wages are rising faster than inflation. Also according to the AFR, this is happening with a backdrop of declining productivity, presenting a critical challenge for businesses striving to maintain financial viability. While some countries, such as the US, experienced real wage decline in 2022, nominal wages have been increasing at about 5% per year since 2021, much higher than the 10-year average of about 2%, according to the Economic Policy Institute. Wages are notoriously sticky, so these increases will become painful if inflation continues its descent towards deflation.

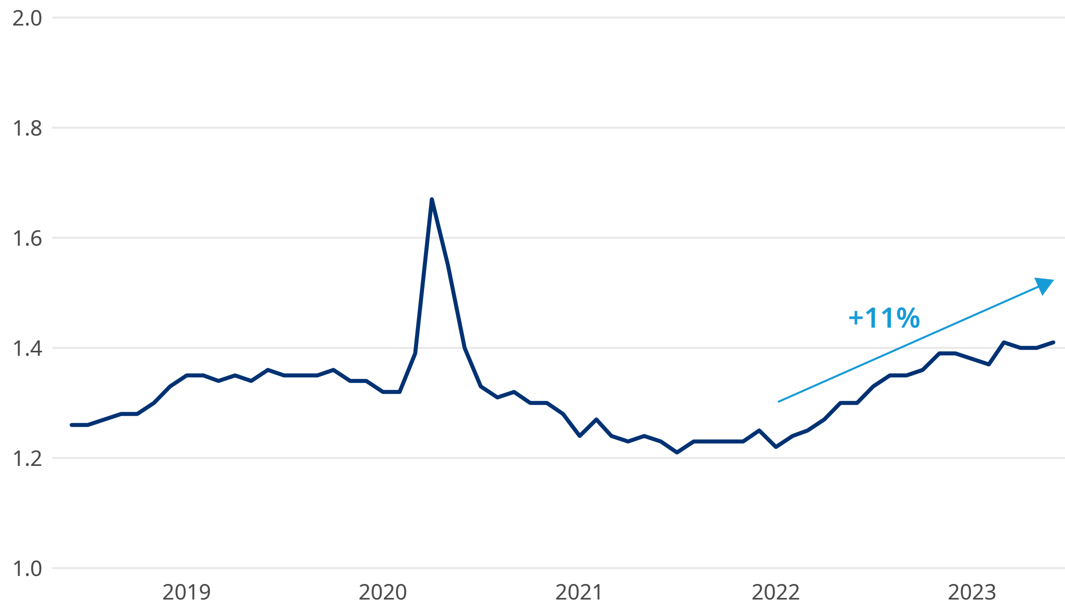
The difficulty in effective cost management was evident during the latest Australian earnings report season, with profit forecasts for fiscal year 2024 lowered by 5.7% on average and downgrades to guidance outnumbering upgrades by a ratio of three to two, according to the AFR. This problem is exacerbated in commodity-focused businesses, given the volatility in raw material prices and the downside risk of recession. Iron ore miners, for example, are starting to face margin pressure from downward trending commodity prices, due to reduced construction activity in China, combined with higher energy prices and real wages.

3. INVENTORY WRITE-DOWNS AND DEFLATIONARY PRESSURES ARE LIKELY WITH REDUCED CONSUMER DEMAND AND EXCESS STOCK

The sudden contraction in demand has caught many leaders flatfooted as seen by the build up in inventory levels, especially in the context of the significantly higher cost of capital. While we agree it is important to plan for global uncertainty, we should not ignore cost efficiency. Businesses have become accustomed to overstocking inventory to derisk supply chain uncertainty. If consumer demand continues to decline, the supply gluts within the economy will become more apparent.

Leading indicators such as manufacturing Purchasing Managers' Indices indicate contraction will persist. This dynamic is underappreciated by pundits, as the mix of plummeting demand and excess inventories means inventory write downs are a likelihood for many businesses, which will further exacerbate margins and by extension deflationary pressures.

Exhibit 6: Merchant Wholesalers Inventories to Sales Ratio, Seasonally Adjusted, June 2018 — June 2023



Source: FRED

HOW TO TACKLE THE RISK OF MARGIN COMPRESSION PROACTIVELY

Invest now in a robust multi-scenario plan that rethinks organizational performance more broadly

Sticky operational costs in a deflationary environment are not just a margin compression challenge, they present an opportunity to reassess and optimize organizational performance to create a competitive advantage. A comprehensive strategy that anticipates and effectively mitigates margin compression risk is critical. Investing now in a robust multi-scenario plan to future proof businesses only creates upside and will position organizations to be more resilient and better prepared for the challenges that lie ahead.

Develop a dynamic supply chain cost optimization program

Developing a dynamic supply chain cost optimization program is crucial for mitigating the risk of margin compression. By continually analyzing and adjusting supply chain expenses, businesses can respond to market fluctuations with agility. This allows for the better management of input costs and inventory levels, safeguarding profit margins in volatile economic conditions.

Be quick to act as early responders will fare better than their peers

Businesses face a perfect storm of declining demand, cost base pressures, and excess inventories. Successful leaders will take a proactive approach to weather challenging conditions and seize opportunities ahead of their peers. Speed of execution is of the utmost importance. When navigating disruptions, organizations must plan proactively so that they can manage uncertainty. The business benefits of pace are clear. In our experience, proactive leaders are much more likely to exceed financial targets and strategic objectives, and almost twice as effective in delivering more innovative products and services compared to their peers.

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