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Future scenarios: Are CFOs too worried about inflation—or not worried enough?

As CFOs watch inflation numbers rise month after month, so may the intensity of their concerns. Now that it has climbed to an altitude unseen for 40 years, they may be tempted to assume that it is bound to go even higher.

But what if the picture we have today isn't a reliable guide to what's ahead? What if by next year inflation is trending down? Or maybe even has dropped into *disinflation*, with the Consumer Price Index hovering between 0% and 1% as a result of a faster-than-expected resolution of supply chain disruptions combined with diminished consumer demand.

As far afield as that may sound, such a situation is among the four scenarios that Deloitte economists have drawn up to help CFOs prepare for the future.

While the disinflation scenario may be the most surprising of the bunch, none of the four are regarded as extreme or on the margin—as would be the case if, for example, predictions included references to deflation (CPI below 0%) or wage and price controls.

Of course, that leaves plenty of room for uncertainty about what's ahead in an economy where the inflation rate has risen to 7% (the highest 12-month rate since 1982),[1] unemployment has dipped to 3.9%,[2] and the Great Reshuffling rages.[3]

Not surprisingly, CFOs are taking a watch-and-worry approach. In Deloitte's fourth-quarter 2021 *CFO Signals*™ survey, three-quarters of the 130 respondents cited inflation as a top concern. A slightly larger proportion, 76%, of surveyed CFOs indicated that their organizations would offset increases in input costs by raising some prices (see sidebar, "Navigating inflation with pricing actions").[4]

While that may help restore profit margins, it won't tame inflation. The knotted-up supply chain, still suffering the effects of COVID-19-related port shutdowns and factory issues, has reduced the volume of goods if not, until recently, dented demand for those goods. If supply chain issues resolve themselves, what happens then? Do we return to "normal"—meaning unfettered globalization? If inflation keeps rising, which entity takes the lead in controlling it: the Federal Reserve (monetary policy), the government (fiscal policy), or corporations?

Most of today's CFOs have only worked in an environment where ultra-low interest rates have encouraged business investments. But a new setting may require CFOs to change their thinking. In this edition of *CFO Insights*, we'll present the potential scenarios of how inflation might unfold over the next three years. And we will ask what finance leaders can do to prepare their organizations to be resilient in areas including human capital, pricing, and real estate.

Vested interest

By most measures, the US economy appears to be robust. GDP rose at an annualized rate of 6.9% in the fourth quarter of 2021.[5] Unemployment is at its lowest since the pre-pandemic days of February 2020. But CFOs have watched as inflation has spread across a broad range of inputs (see Figure 1). Throughout 2021, economists debated whether it was a temporary phenomenon. US Federal Reserve Chairman Jerome Powell ceased using the word "transitory" to describe inflation only at the end of the year, when the Fed vowed to deploy its "full range of tools" to hold inflation "at the rate of 2% over the longer run."[6]

In the fourth-quarter 2021 *CFO Signals* survey, three-quarters of CFOs said they expected the Federal Reserve to raise the target interest rate for US federal funds to range between 0.26% and 1.0%. As far as the timing of the first rate increase, 46% of CFOs expected it to occur in the second quarter of 2022.

Responses to that survey were collected in November 2021. Since then, the conventional wisdom—reading the Fed's signals—has shifted, with expectations that the central bank will raise interest rates three times this year, perhaps starting in March. But no one can know for sure.

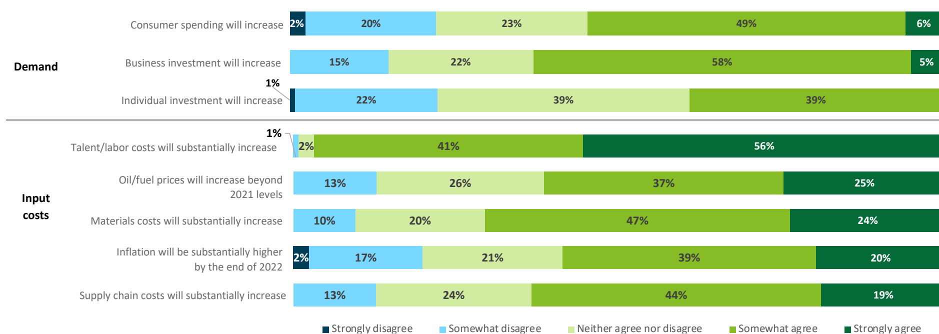
In order to help CFOs prepare for a future that no one can accurately predict, we've developed a set of scenarios to explore the question: How might inflation evolve in the United States over the next three years, and what could be the impacts on large organizations?

Four scenarios based on current trends and uncertainties

The following four scenarios explore different ways inflation might play out based on evidence and indicators in the US economy today. It is important to note that these scenarios are not forecasts or predictions: they were created to test assumptions, explore possibilities, and clarify what executives may want to prepare for or monitor. They are not exhaustive of every possibility, but they cover much of what economists and policymakers are discussing and executives may need to confront. Finally, while these scenarios focus on the US, they are designed to be broadly applicable to most other global markets (other than those currently facing a different inflation dynamic, e.g., Turkey).

Figure 1. Inflation's rising costs

In the Q4 2021 CFO Signals *survey, respondents were asked to share their expectations for the North American macroeconomic environment in 2022. With respect to inflation, 59% of CFOs believe it will be substantially higher by the end of the year.**



* 126 (97%) of respondents answered.

Source: *CFO Signals*, Q4 2022, CFO Program, Deloitte LLP

Many of today's CFOs have only worked in an environment where ultra-low interest rates have encouraged business investments. That may soon change.

1. **Blue Skies:** Current inflation is temporary and reverts to recent historical norms (about 2%) as supply chain disruptions settle during 2022 and consumer demand rebalances between services and goods. With the pandemic ebbing, individuals re-enter the workforce, stabilizing the labor supply. The Fed's response: limited and gradual interest rate increases.
2. **Sun Showers:** Inflation settles between 3% and 4% through 2024 as supply chain disruptions persist and the labor supply remains somewhat constrained. Firms and consumers adjust and growth continues, albeit unevenly across industries and players. Consumer spending and economic activity remain stable, but also stay skewed toward goods versus services. The Fed's response: moderate due to weakness in the labor market.
3. **Stormy Weather:** Inflation rises to between 8% and 9% as it becomes embedded in worker expectations and a wage/price spiral takes off. A sluggish economy dampens both consumer and business spending. Existing supply chain issues deepen, exacerbated by new COVID-19 strains. The Fed's response: sharply raises interest rates to put the brakes on inflation—which triggers a recession in 2023.
4. **Downdraft:** The US economy experiences disinflation (with inflation levels between 0% and 1%) fueled by a faster-than-expected resolution of supply chain disruptions coupled with diminished consumer demand as pandemic savings are spent down. Low growth not only dampens corporate profits, but also raises unemployment. The Fed's response: keeps interest rates at historic lows, while exploring increased bond-buying activities.

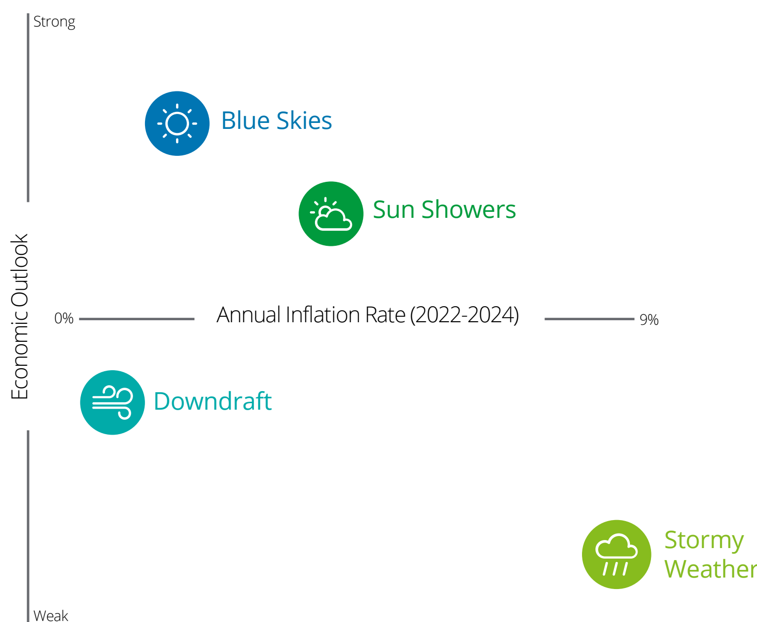
Each scenario creates opportunities and challenges

CFOs can help prepare their organizations to thrive under each scenario by considering the following:

Blue Skies
Prepare for post-pandemic growth opportunities by going long on debt to invest in foundational capabilities and growth-oriented M&A. Increase enterprise resiliency by diversifying supply chains. Optimize for growth and market share. *In this scenario, consider these options:*

- **Enterprise strategy**: Implement business KPIs to measure the organization's ability to profitably meet/exceed market growth rates and to measure organizational resilience to weather future system shocks; Invest in foundational capabilities (e.g., analytics, digital) to drive growth.
- **Human capital**: Attract and retain talent through differentiated employee experiences.
- **Supply chain**: Apply supply chain strategies to build resilience and address shifting consumer habits (e.g., diversification, near-shoring, sustainable sourcing, in-city distribution, production, localized supply base).
- **Pricing**: Address any near-term cost increases with temporary surcharges that can be later removed.
- **Capital structures**: Extend debt timelines and use debt financing to take advantage of low interest rates.
- **M&A/restructuring**: Accelerate M&A to transform business models and prioritize investments in areas with the greatest growth prospects.
- **Real estate**: Explore commercial short-term leases to increase flexibility for real estate footprint adjustments as uses and location of office space quickly evolve.
- **Tax**: Invest in and improve tax compliance functions (e.g., data, process, technology).

Figure 2. Inflation rate vs. economic outlook



Additional theoretically possible scenarios include hyperinflation (>50% monthly rise) and deflation (inflation rate <0). These possibilities were considered but ultimately discarded as inconsistent with the available data and the three-year timeframe.

Source: "The inflation outlook: Four futures for inflation," Deloitte Consulting LLP, December 2021

Sun Showers
Mitigate rising input costs and use performance improvement to invest in growth in an uneven business environment. Take advantage of inexpensive debt early on to disrupt weaker competitors or address current weaknesses to avoid disruption. Optimize for growth and consolidation. *In this scenario, consider these options:*

- **Enterprise strategy**: Implement business KPIs around competitive benchmarks (e.g., operational efficiency, supply chain resilience) to understand performance advantages and/or close the gap with competitors; focus on core competencies and address weaknesses quickly.
- **Human capital**: Invest in automation to augment existing workforce; favor direct cash compensation through wage increases (e.g., permanent, variable) to attract talent.
- **Supply chain**: Drive strategic contracting based on inflation trends to ensure steady stream of materials and secure prices; invest in supply chain automation to drive efficiencies.
- **Pricing**: Increase prices in accordance with inflation; shape market expectations with a public dialogue on cost trends.
- **Capital structures**: Pursue debt financing and lock in low rates now (e.g., revolver credit lines) and borrow responsibly for asset purchases.
- **M&A/restructuring**: Pursue a balanced investment approach across both growth and risk/resilience opportunities; take advantage of divestitures to raise capital.
- **Real estate**: Increase preference for locking in longer-term contracts before rental prices rise (e.g., shift to five-year initial period from three-years).
- **Tax**: Consider tax impacts of cost-saving strategies (e.g., pre-buying raw materials, forward contracts).

Stormy Weather

Focus on increasing efficiency and lowering risk through economies of scale and cost-saving strategies (e.g., automation). Diversify business models and use financial hedges to mitigate the risk of rising inflation. Optimize for cash turnover efficiency. *In this scenario, consider these options:*

- **Enterprise strategy**: Prepare executive team to manage in high-inflation environments and institute new KPIs for the business (e.g., cash turnover, pricing elasticity); reduce accounts receivable, increase inventory turnover, and increase accounts payable.
- **Human capital**: Use flexible, cost-saving labor models (e.g., labor-as-a-service, offshored labor, automation for substitution).
- **Supply chain**: Lock in supplier prices in anticipation of inflation and/or consider vertical integration.
- **Pricing**: Increase prices along with inflation rates; build price inflators into long-term contracts.
- **Capital structures**: Diversify portfolios to mitigate risk and invest in traditionally safe havens (e.g., gold, real estate); Avoid locking into long-term debt obligations.
- **M&A/restructuring**: Companies with competitive advantages should aggressively pursue proactive acquisitions; those with less advantage should seek to improve cost structure; explore alternative deal structures to access capabilities and position for longer-term buy option.
- **Real estate**: Look to real estate investments as a stable asset class.
- **Tax**: Consider sourcing of imports and associated customs/global trade taxes as a potential for cost reduction.

Downdraft

Drive demand and emphasize value through new experiences and differentiated offerings. Rationalize suppliers and partnerships and consider restructuring to increase efficiency and savings. Optimize for efficiency and demand generation. *In this scenario, consider these options:*

- **Enterprise strategy**: Implement business KPIs focused on customer acquisition and retention (e.g., share of wallet, cost of customer acquisition, lifetime value of customer) and operational efficiency; stimulate customer demand as customers are only buying on an as-needed basis.
- **Human capital**: Use partnerships to buy/share capabilities across an ecosystem to drive efficiencies, such as strategic outsourcing.
- **Supply chain**: Manage production to avoid oversupply; consider supply rationalization (e.g., shutting plants, managing capacity, shrinking distribution).
- **Pricing**: Strategically cut prices to attract consumers and protect share; be wary of price wars and ensure price cuts can be justified.
- **Capital structures**: Invest in low-risk assets, prioritize opportunistic investing; exploit stock valuation arbitrage.
- **M&A/restructuring**: Divest of assets/businesses that are noncore to restructure the core and raise cash.
- **Real estate**: Skew more toward short-term lease periods to increase flexibility.
- **Tax**: Make investments in transformation that can be passed through as tax reduction.

The road ahead

There are also actions CFOs may want to consider that can be beneficial no matter the future direction of inflation. These include:

- *Shoring up capital structure.* Rebalance portfolios and lock in today's cost of capital in anticipation of interest rate variability.
- *Addressing supply chain disruption proactively.* Focus on building a well-diversified supply chain with enough slack to weather uncertainty.
- *Building for continuity.* Invest in systems that enable smooth operations in periods of high labor turnover (e.g., training capabilities, automation).
- *Considering smart hedges.* Make strategic decisions about where to hedge (e.g., prebuying raw materials) considering areas most susceptible to destabilization.
- *Developing a strategic market-sensing function.* Build internal capability to monitor how the future is evolving to trigger deployment of contingent strategies and hedges.

In addition, finance executives seeking to build resilience across these (or other) scenarios might consider various ways to identify specific options and risks for their business or industry. These actions can include convening cross-functional executives to examine the implications of the scenarios for the business and determine potential strategies and hedges across scenarios; delving into inflation implications for a key functional area for the business (e.g., supply chain, M&A) to identify specific opportunities and risks; and conducting market sensing to identify key signposts/indicators to proactively monitor which scenario may be coming to pass and adjusting plans accordingly.

Navigating inflation with pricing actions

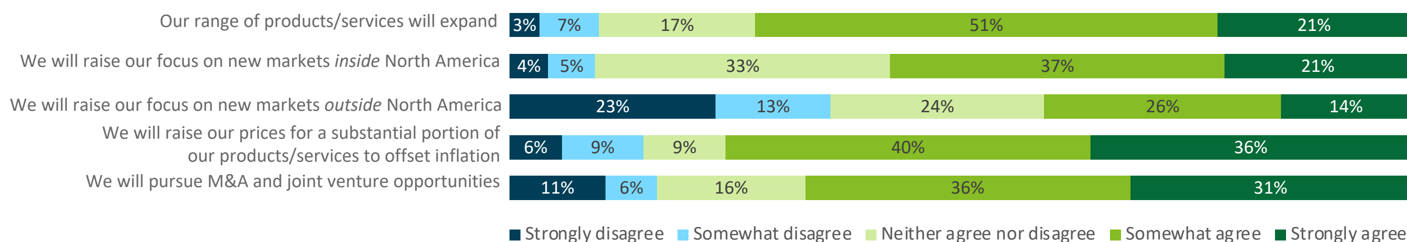
The economic recovery and recent inflation in costs has caught many companies off-guard and exposed weak, or worse, missing pricing strategies. The result has been a scramble to action, hastily planned pricing moves, and in the worst cases, outbreaks of ineffective pricing. In “Making hay with inflation,” however, Deloitte pricing specialists* argue that there is a structured way to manage input cost inflation through price increases and outline four steps companies can take to help achieve positive results:

1. **Correct the “less-than-optimal” commercial decisions made in the past.** For years, it has been a buyers’ market, with sales teams often trading profitability to meet sales goals. The present-day situation calls for taking a step back and re-evaluating this trade-off. Take this as an opportunity to clean-up your transactions including: low profitability transactions; unwarranted volume discounts; frequent small orders; unearned volume discounts; unproductive rebates; free packaging; expedited shipping; and unfavorable index pricing.
2. **Be structured and targeted in your price increases.** Anchoring on cost inflation of largest raw materials to pass broad-brush price increases is usually the norm. Typically, however, we see companies only realizing ~40%—60% of their intended price increases in the first year due to this approach. Instead, an effective strategy leverages the differences in product, channel, and customers to drive targeted price increases. Such a strategy is anchored in value, price sensitivity and costs-to-serve (in addition to raw material cost inflation). Moreover, price increase strategies that are built on a granular and well-segmented understanding of products and customers result in higher actual price realization and customer retention along with even supporting a targeted volume growth.
3. **Communicate effectively, both internally and externally.** Customers may not want price increases, but in the current environment, they expect them. Still, price increases are only effective when executed by a sales team that understands, accepts the reason, internalizes the change, and is equipped with the right information. Here are a few things to keep in mind: 1) Lead the change with effective communication: Ensure that you anchor the conversation in the value that you provide to the customer and complement communication around the price increase with the right macro-economic and industry specific inflationary insights; 2) Arm your sales teams with the right data and analytics (customers’ profitability, cost inflation, price benchmarks) to drive data-backed decisioning; 3) Drive sales teams’ behavior change through social proofing (i.e., share what other similar customers in same/similar region are paying for similar products); 4) Customize communication based on behavioral insights of different customer segments, gathered from available data and inputs from existing sales relationship.
4. **Rethink your commercial positioning.** This is the time to not just think about pricing, but to use this as an opportunity to re-think your brand, positioning, and packaging strategy. Also, consider whether cost increases can be passed through using non-price mechanisms. For example, incentivizing low-cost behaviors (such as online ordering) can make customers perceive savings. Finally, remember that it’s easy to leak away price/profitability through discounts, promotions, and other non-price actions over time. Invest in the right tools, analyses, and processes to prevent leakage by setting and maintaining target prices; assessing whether you are hitting price goals at least once a quarter; and evaluating your price structure every three to four years, or as market conditions change.

* For more information, see “Making hay with inflation,” by Georg Müller, managing director; Richard Hayes, principal; Ranjit (Jit) Singh, principal; and Ed Johnson, principal; all of Deloitte Consulting LLP.

Figure 3. Increased pricing is on the table*

To achieve growth, more than three-quarters of CFOs (76%) are eyeing price increases to combat inflation



Percent of CFOs selecting each level of agreement for each statement (N=126)

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

End notes

1 "U.S. Inflation Hit 7% in December, Fastest Pace Since 1982," The Wall Street Journal, January 12, 2022.

2 The Employment Situation—December 2021, Bureau of Labor Statistics, US Department of Labor, January 7, 2022.

3 "A record 4.5 million Americans quit their jobs in November," CNN.com, January 4, 2022.

4 *CFO Signals*: 4Q 2021, CFO Program, Deloitte LLP.

5 Gross Domestic Product, Fourth Quarter and Year 2021 (Advance Estimate), Bureau of Economic Analysis, US Department of Commerce, January 27, 2022.

6 Federal Reserve issues FOMC statement, Press Release, December 15, 2021.

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