The race to margin preservsation

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Rising inflation has created a uniquely challenging situation for business owners, CFOs and anyone else in charge of strategic business decisions. Not only have costs risen across the board, but inflation has also pushed up interest rates at a time when hiring and retaining talent is also difficult. This has placed significant pressure on profit margins, especially as the economic outlook becomes more uncertain and recession worries grow. As a result, there has never been a more important time to preserve margins by considering all costs to a business, evaluating financing needs and addressing labor requirements.

Perhaps the most important question for all businesses is how to weigh near-term risks with long-term opportunities. Rising costs and hiring difficulties may make navigating the next several months challenging. However, it may also be the perfect time to make strategic investments in the business — including new equipment, increased automation, expanded office space and more — to prepare for the years of growth ahead.

Costs are rising

It's helpful to recap how we arrived in this inflationary environment. Since the economic recovery began two years ago, prices have accelerated as consumer demand has grown. Global disruptions such as the war in Ukraine and international lockdowns due to the pandemic have hurt the availability of commodities and manufactured goods. Numerous government stimulus programs and emergency monetary policies have also increased liquidity in the system.

As a result, inflation has accelerated, reaching its highest level since the early 1980s. This is especially true for important consumer necessities such as food and gasoline. Additionally, higher costs for items such as fuel and raw materials have impacted essentially every business across all industries and geographies. At Bremer, we have had many conversations with business owners over the past several months around these concerns. For example, one CFO of a distribution company recently told us that steel input costs for one imported product line are increasing 68% due to the war in Ukraine. The CFO said they are passing these costs on as best they can, but it is challenging.

In response, the Federal Reserve has begun to raise interest rates at a faster pace to moderate demand and tamp down inflation. At their June meeting, the Fed announced a more aggressive policy and raised rates by 75 basis points — the largest increase in 28 years — to a target range of 1.5 to 1.75%. Forward guidance from Chair Jerome Powell and the Federal Open Markets Committee suggests that interest rate increases of 50 or 75 basis points should be expected at each of the four remaining meetings this year, reaching a level of 3.4% by the end of 2022.

It may be months before the effectiveness of these rate hikes are known. In the meantime, the Consumer Price Index has continued to accelerate at the national and regional levels. Nationally, there was a short decline in April but the May reading for consumer goods and services rebounded to a high of 8.6% on a year-over-year basis. The Midwest region has seen even greater spikes, with year-over-year inflation for all goods and services increasing 8.8% for the whole region and 8.7% for the Twin Cities metro area.

Producer prices show a similar trend. The Federal Reserve Bank of Minneapolis' Beige Book reports that "about three-quarters of manufacturers at a recent event indicated that their input prices have risen faster since the beginning of this year than last year, compared with fewer than 10% who reported that prices increased at a slower pace." As the supply of goods and services struggles to meet demand, local and national inflation measures should be watched closely.

If price pressures continue to run high and the Federal Reserve System loses control of inflation, the economic outlook could worsen. Alternatively, if oil and food prices naturally begin to decline, consumer and business spending could improve as well. This uncertainty makes it challenging to make strategic business investment decisions today.

Financing is more challenging

One of the direct effects of persistent inflation and Fed rate hikes is the increase in interest rates. This impacts Treasury securities and corporate bond yields, raising the cost of borrowing across the board. Businesses that are seeking financing to expand, engage in capital projects, build new plants and more should explore various ways of funding these projects.

Businesses must weigh the short-term volatility and expected economic conditions against long-term business goals. In the short- and medium-term, many expect interest rates to continue to increase, meaning any delay in borrowing could result in even higher costs. Therefore, it may make sense to lock in favorable rates sooner, especially if the benefits of these projects are long-term in nature.

If financial conditions continue to tighten, there is an elevated risk of an economic pullback, which could affect consumer spending and profit margins. Still, the Beige Book notes that "consumer and business contacts said it was still too early to gauge the net effects of interest rate increases on consumer spending" as other factors such as inventory shortages were having larger effects than interest rate changes. As my graduate school economics professor once taught me: "Consumer spending is the engine of the economy and consumer credit is the gas that runs the engine." Interest rate hikes make consumer credit more expensive, which could decrease demand.

However, it is important to separate short-term economic conditions that must be navigated from long-term business goals. Key capital investments should be reassessed to ensure their viability, but not delayed simply because of rising rates. As long as the returns on these projects exceed their hurdle rates, they might still make sense. Also, even with recent increases, interest rates remain at historically low levels, so promising capital investments should still be considered.

Businesses should not lose sight of long-term opportunities simply because interest rates are rising or because there is more economic uncertainty. After all, the labor market remains robust and many measures of economic growth remain healthy. Ultimately, even if contractions occur in the short-term, long-term capital investments remain an important method of growing businesses that plan to succeed and grow over decades.

Interest rates[1]

Latest data point is Jun 30, 2022

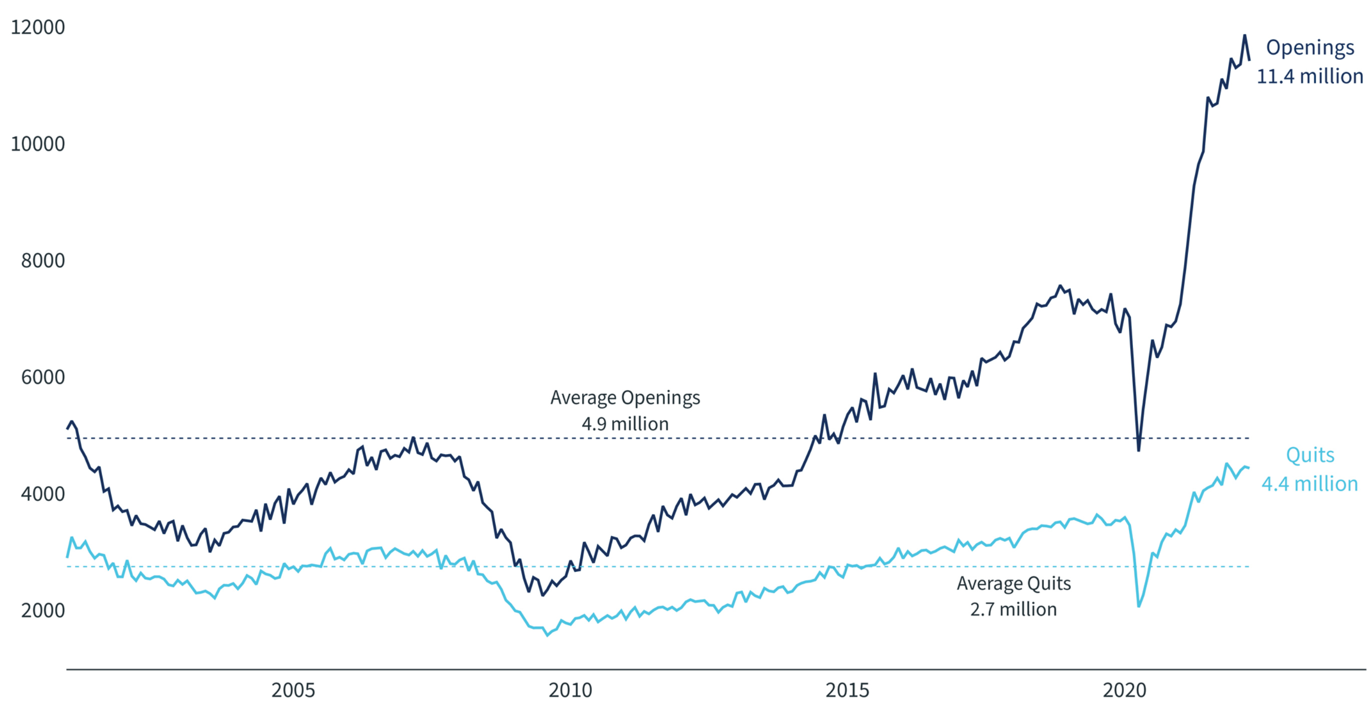
Hiring and retaining workers is more difficult

Another challenging area for business operators is the strong labor market. Despite heightened uncertainty, recent reports from the Midwestern region show that the job market remains robust. While this is a positive sign for growth in the region, it has made it difficult for many businesses to hire and retain workers. In particular, the Beige Book reports that "employee headcounts have grown more slowly than labor demand." From our conversations with businesses, this appears to be true across all types of workers, from general labor to more specialized talent. A CFO of a Bremer Bank customer recently shared that their company hired the CFO's daughter, a recent high school graduate, to do general labor such as sweep the floors and move boxes, as the company was having such a difficult time finding people to hire even for manual labor positions.

The rising mismatch between jobs and skills is apparent when examining the increase in job openings within the Midwest region. The Job Openings and Labor Turnover Survey (JOLTS) report published monthly by the Bureau of Labor Statistics highlights the job openings rate for the region. Since July 2020, the job openings rate in the Midwest has grown to 7.5%, which represents the percentage of job openings compared to the number of those who have jobs or are searching for jobs. This is well above the February 2020 level of 4.4% when the prior economic crisis began. At the same time, the hires rate has only marginally increased from pre-pandemic levels.

In the Midwest, the resignation rate has also increased significantly to 2.9% — further evidence of a "Great Resignation" as workers seek new employment and higher wages. Average hourly earnings for production and non-supervisory workers in the region increased to $27.33 in May, a 6.5% increase from a year ago. The total cost of employing an individual worker, as reported in the Employment Cost Index, has also risen 5.1% from one year ago. These are all signs that the labor market in the Midwest continues to run hot — a fact that most business operators likely know from experience.

Job openings[2]



Latest data point is Apr 2022

Even once employers can recruit more specialized workers, they face the additional challenge of retaining this talent. In such an environment, employers have no choice but to increase the productivity of their current and new hires to preserve margins.

In the short- and medium-term, productivity of employees could be increased by increasing training or providing employees with additional resources. In the long-term, businesses can invest in capital such as new equipment, more efficient processes or automation. In this environment, the tradeoff between labor force expansions and capital investments must be managed carefully, especially if costs continue to rise and the job market remains tight.

Weighing risk and reward

Although this is undoubtedly a challenging business environment, decisionmakers should continue to weigh short-term risks with long-term rewards. Maintaining discipline around financing and hiring needs is more important today than at any point since the global financial crisis, especially as costs remain high and rates rise. Businesses with long time horizons should seek opportunities to improve efficiency and productivity to maintain profit margins and position their companies for the future.

For more market insights, visit **bremer.com**.

[1] "Interest rates have jumped this year but are still near multi-decade lows." Sources: Clearnomics, Federal Reserve.

[2] "Job openings continue to be near record highs, prompting many to quit and search for better jobs and higher wages." Sources: Clearnomics, Bureau of Labor Statistics.