Managing the trilemmas: responding to inflation

July 2022

EY Parthenon

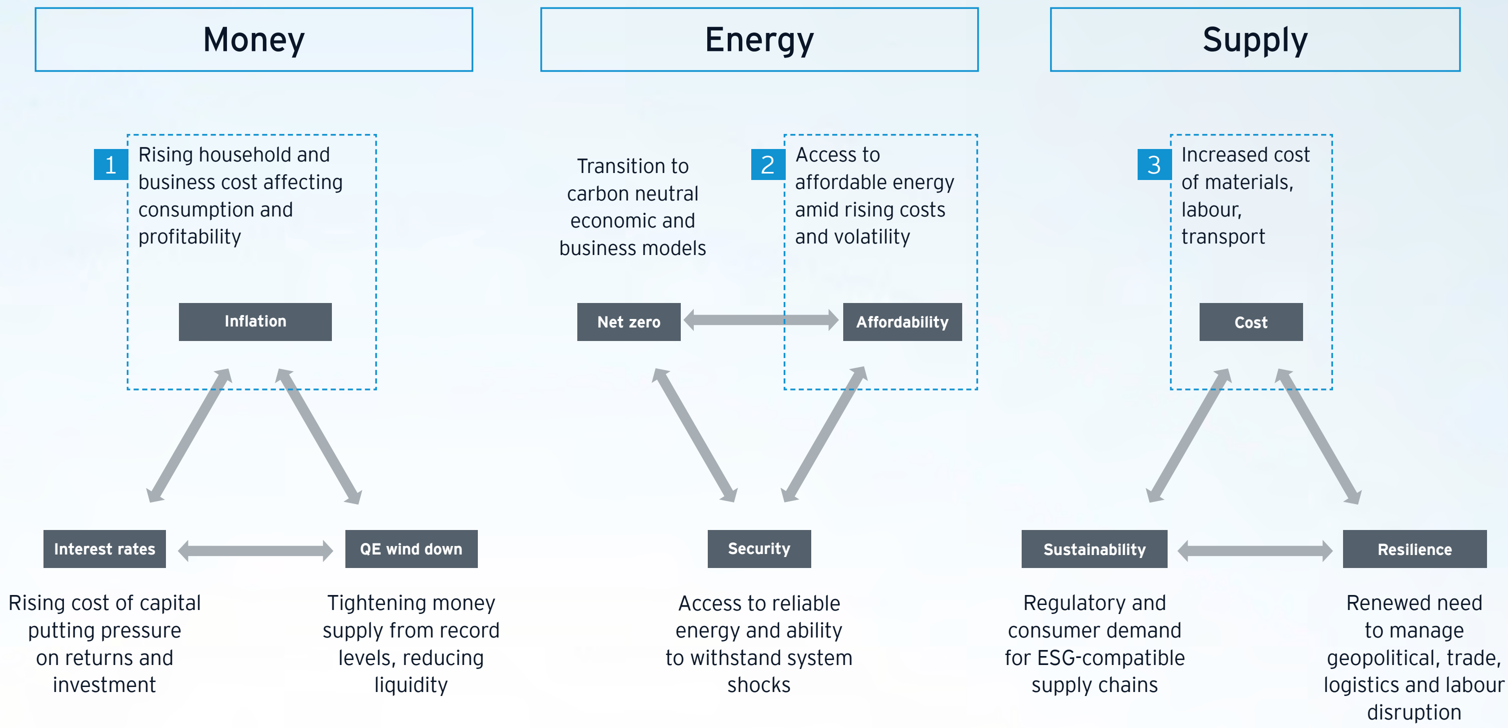
Building a better working world

Trilemmas series

This is the first in a series of publications in EY-Partnenon's 'Trilemmas' series. How businesses manage the below three uniquely interacting 'trilemmas' will largely determine their success. These trilemmas summarise the vast majority of external pressures facing companies across sectors at the moment, and are a useful starting point for firms wanting to identify pressure points, manage downside risk and seize opportunities.

How businesses manage three uniquely interacting trilemmas will in large parts determine their success – these mutually reinforcing drivers increase inflation.

Inflation, overwhelmingly driven by supply side costs, will materially affect businesses now and in the coming years.



Contents

Key points

- Inflation is becoming an acute challenge for business, with many facing 20%+ inflation when considering exposure to input prices.[1]
- The era of cheap money is over. A whole generation of business leaders have never faced cost inflation pressures of this magnitude before, and are now struggling with where to start.
- The future for energy and food costs, supply constraints, consumer and company expectations and wage setting – and interaction with recessionary pressures – naturally mean CPI inflation could both drop lower and rise significantly higher than central forecasts.
- In the past year, it has taken three months for peak inflation in the 95th forecast percentile to become reality – so low probability scenarios can happen.
- EY Parthenon's worst case scenario has CPI inflation peaking at 15.4% over the winter, which could happen if Russia turns off the taps and food inflation goes higher than expected.
- Business leaders need to scenario plan around inflation and urgently consider levers to prepare for, and address, continued elevated inflation levels to enhance revenue, reduce cost and create value.

1. Producer price inflation, UK – Office for National Statistics (ons.gov.uk)

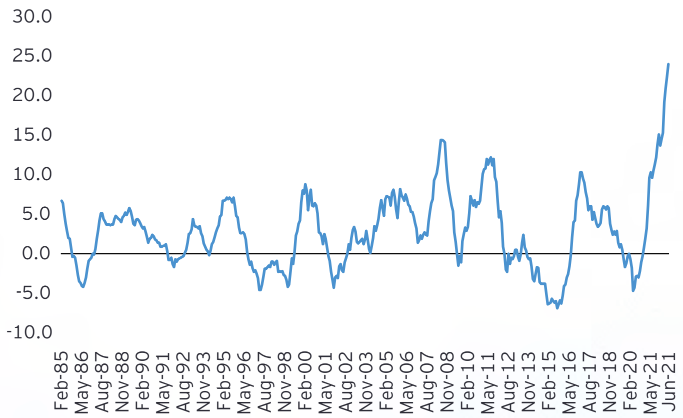
Trilemmas

1. Inflation is becoming an acute challenge for many businesses

CPI inflation is a macro-economic indicator which captures a 'basket' of c.700 consumer goods, many of which companies will not be exposed to. So for a business to understand its true exposure to inflation it needs to look at inputs instead.

Input cost inflation for UK manufacturers has risen 24% YoY — the highest rate on record. Energy prices and metal and non-metallic minerals in particular are driving these increases. So for many companies, inflation has in reality already hit 20% and higher, depending on exposure to supply cost increases.[2]

UK manufacturing input PPI inflation



A global consumer product business we recently worked for has seen their cost base increase by over 30% in 24 months. A manufacturing business, for whom energy accounts for 32% of total cost, has seen its margin erode. They're not alone.

There are also firms that are far less exposed, particularly in the service sector. But the picture is clear.

[2] Producer price inflation, UK - Office for National Statistics (ons.gov.uk)

2. Businesses need to plan for scenarios where inflation continues to beat expectations

In February 2022, the Bank of England gave only a 5% probability of inflation peaking at 9% in the UK in 2022 (95th percentile). Only three months later, in May, inflation hit 9.1%.

This illustrates how difficult it has been to forecast the interaction between prices, labour market (including wages) and expectations that drive inflation, amid a range of disruptions, from geopolitics to the pandemic, to extraordinary policy responses.

It also shows, however, how inflation has all the potential to continue to surprise companies and policymakers alike, and be a significantly larger driver of business performance than currently assumed.

Thinking about the world more along the three trilemmas framework also shows that inflation is more structural than transitory, and intertwined.

3. What could drive inflation higher than current forecasts?

There are some positive signs around inflation easing. In the UK, the latest CPI data shows that core inflation, stripping out food and energy, was down on previous month. In the US, inflation expectations and in the UK PMIs seem to be easing.

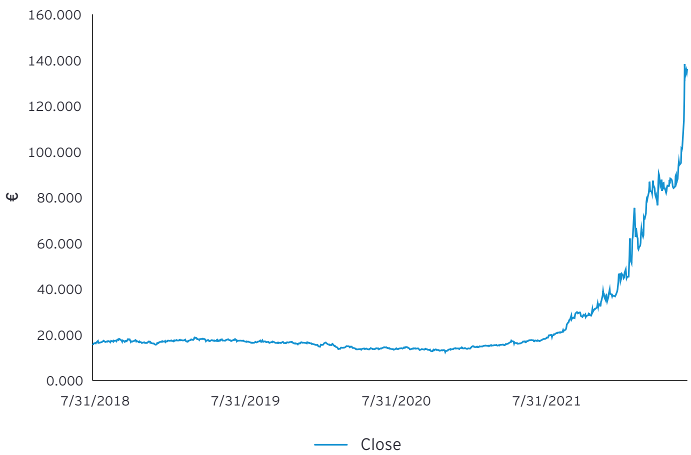
But for businesses looking to scenario plan, there are four key drivers that now risk driving inflation higher than current forecasts:

3.1 Energy trilemma: Elevated energy costs are causing significant immediate and lasting pressure

We expect energy prices to remain elevated and volatile for the foreseeable future – at least until the war in Ukraine cools, or Europe diversifies away from current dependence on Russia (41% of European Gas is imported from Russia), which could take until 2024.

German future natural gas prices have increased by 274% since the start of 2022 (see graph). German power peak July 2023 futures have risen by 78% in the last month alone, to record highs.

German The Natural Gas Futures, July 2023



Clearly, inflation will be fuelled further if Russia fully cuts off gas supply to Europe, which the European Commission is repeatedly warning about. This could include Russia closing the Nordstream 1 pipeline.

In the UK, the soon-to be announced autumn energy price cap is already expected go higher than the previous forecast of £2,800, with Cornwall Insight estimating it to climb to £3,244 or 64.5%[3]. It would likley come under further pressure for its April 2023 revision, with a further signficant increase possible if Russia stops gas supplies to Europe. All else equal, according to EY Item Club, every 10% rise in the cap from the current level would raise inflation by around 0.4ppts.

[3] Dr Craig Lowrey, 'Default Tariff Cap forecast climbs further as Ofgem announcement looms', Cornwall Insight, 8 July 2022. https://www.cornwall-insight.com/default-tariff-cap-forecast-climbs-further-as-ofgem-announcement-looms/

This means that BoE's 16th June forecast of CPI inflation peaking at of 11% in October looks optimistic, as it is based on a price cap increase of 42%.

More medium-term, the need to manage the full energy trilemma, including the structural change from fossil fuels to clean energy will add further pressure to prices during this decade. Carbon prices have been increasing steadily, with future prices showing continued elevation.

Carbon futures (Dec 22)

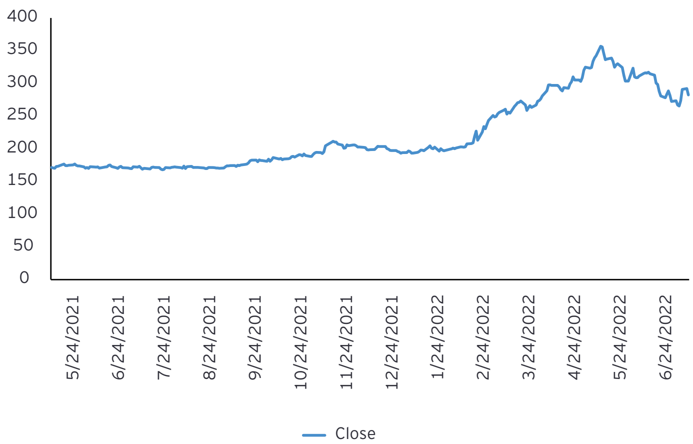
3.2 Supply trilemma: structural supply constraints risk lengthening cost pressures from supply chains

Elevated energy costs add to a series of supply chain disruptions over the next 12 to 18 months. There are welcome signs that some supply chain pressures are starting to ease, with shipping costs falling as an example.

But other supply chains may have the worst yet to come, driven by the war in Ukraine, challenging weather conditions including heatwaves and China's zero COVID-19 policy.

Food is most critical. The European Commission's latest short-term agricultural outlook on crop now forecast 286.4 million tonnes versus 293.3 million tonnes in the Spring, due to intense drought. EU cereals exports have been revised down by 30% to 41.4 million tonnes, not enough to offset the drop in global cereal availability due to the blockage of the Ukrainian sea ports.

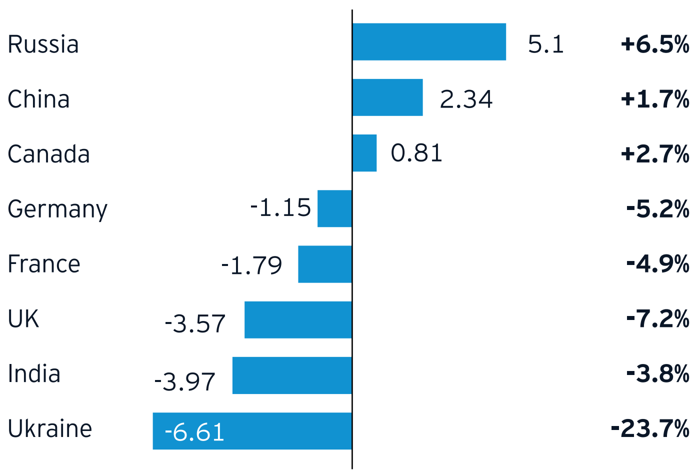
Feed Wheat May 2023, £



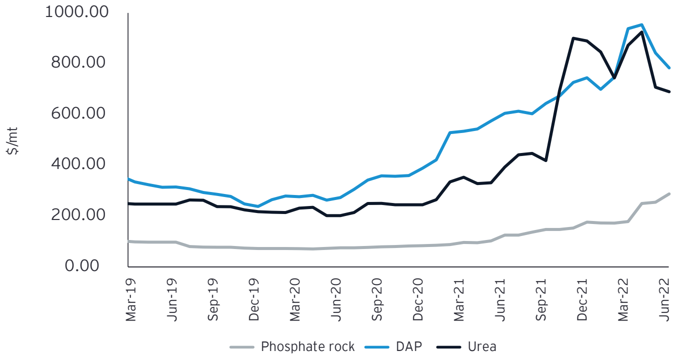
A lasting agreement for Russia to unblock Ukraine's Black Sea ports could help to ease these pressures significantly, but its stability remains uncertain.

Reductions in fertiliser prices from April 2022 have come too late for use for the Summer 2022 harvest and will threaten crops due to be planted in autumn for collection in 2023.

Forecast for 2022 wheat harvest compared to 5 year average (million tonnes) **% Change**

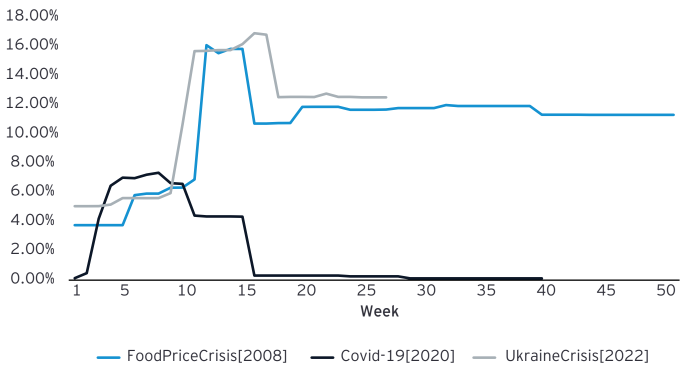


Key fertilizer price trend



Meanwhile, export controls continue to disrupt functioning food supply chains. 12.5% of global traded calories are subject to export controls from a peak of close to 17% – more than during the 2008 food crisis and COVID-19. The majority are planned to continue to last at least to the end of 2022.

Percentage of traded calories subject to export controls

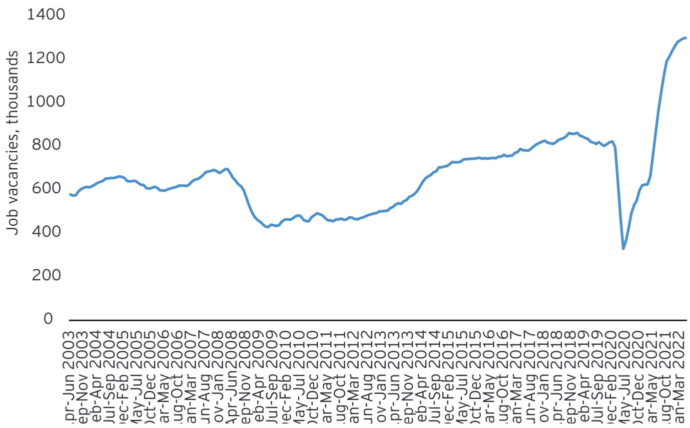


In combination, food inflation could be greater than the BoE and others expect as a baseline scenario. The Institute of Grocery Distribution (IGD), for example, expects food inflation to peak at above 14.5% between July and October 2022, a rate higher than the contribution of food forecasted by the BoE for its baseline that CPI inflation will peak at 11%, although it notes risks to the upside.

More medium-term, there are other supply chains where disruption is stickier than often assumed. According to forthcoming EY-Parthenon analysis, semiconductors and microchips, while constraints have eased due to drop in demand, could be subject to supply constraints for significant stretches of the 2020s due to constraints relating to physical inputs and geopolitics.

In the UK, medium-term, it's also important to look at the labour market which will continue to see constraints to labour supply. UK job vacancies are the highest on record at 1.3m (see graph); as well as shelter factors (housing, rent) that are stickier and less volatile.

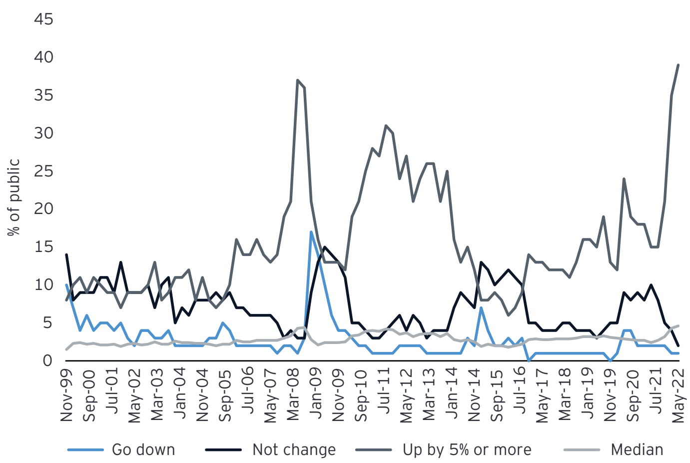
UK job vacancies



3.3 Businesses and consumers expect inflation to continue rising, indicating the risk of entrenched inflation psychology

UK consumers now expect inflation to be above 5% – at the highest level recorded.[4]

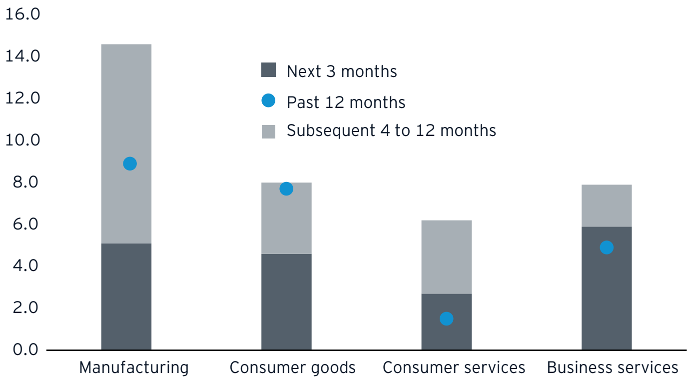
UK public expectation of inflation over next 12 months



[4] Bank of England (2022)

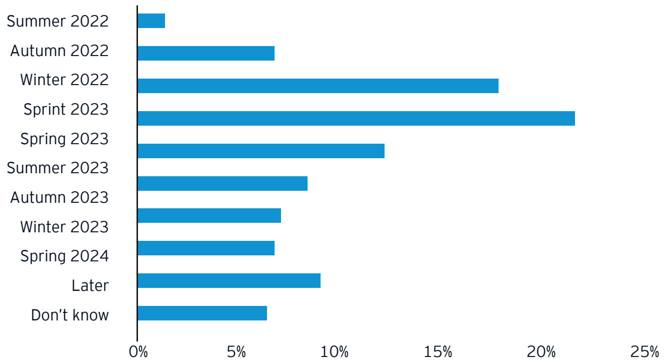
Seventy-eight per cent of of non-labour costs are currently being passed on to customers by UK firms.[5] However, UK businesses are expecting to pass on even more costs on to customers in the coming year than they have done over the course of the last year.[6]

Average reported and expected price change, %



In a June survey carried out by the Institute of Directors' (IoD), 21% of IoD members thought inflation would peak next spring and a further 45% thought the peak would come even later.

Two thirds of business leaders expect inflation to peak in Spring 2023 or later (IoD)



Expectations from business leaders and consumers that inflation will be more persistent will lead them to adjust their behaviours accordingly, leading to a potential for the expectation of price rises to become self-fulfilling.

These trends interact with a drop in consumer spend and confidence which of course can serve to counteract inflation, but with the economy at capacity and inflation being heavily supply-driven, even drop in demand may not bring down inflation quickly (see below). This is particularly true as according to EY ITEM Club's latest forecast, pandemic savings among UK consumers remain largely untouched.[7]

3.4 Wage increases risk creating an inflationary spiral – adding to current pressures

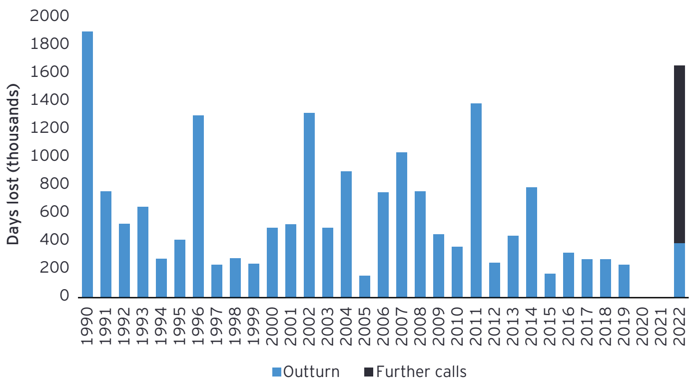
Inflation pressures and inflation psychology are starting to seriously interact with wage setting, fuelled by historically very hot labour markets in the US, UK and elsewhere. USA wage inflation is over 9%.

Private sector wage growth in the UK was 7.2% in March to May, and for the public sector 1.5%. In total, however, pay fell in real terms. This is causing pressure for further pay growth in a tight labour market. Public sector pay has been mooted at 5%, but this is still not enough for many unions, which are calling for pay increases as high as 30% to avoid industrial action.

According to our analysis, as a proxy for inflation pressures, the UK could be on course for the most days lost to strikes since 1990 as pressure for more wage increases grow.

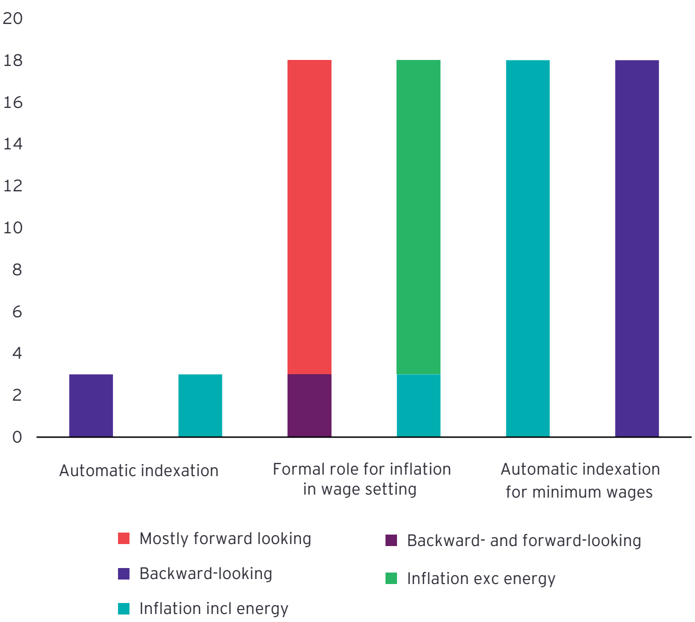
5. Bank of England (2022)
6. Bank of England (2022)
7. EY ITEM Club (2022)

Working days lost to strikes



The eurozone has seen more limited impact with 2.7% wage growth in Q1 2022. However, 60% of EU workers – almost 120 million – have collective bargaining in place for contractual negotiation. Around 27m private sector workers have wages based on inflation. When inflation expectation hit the massive European collective bargaining cycle, we may see a significant inflation ratchet in wage setting – leading to entrenched inflation expectations and the dreaded wage-price spiral.

Private sector employees in the euro area with inflation linked wages, % (2021)



4. Scenario planning: how high can inflation go and how long will it last?

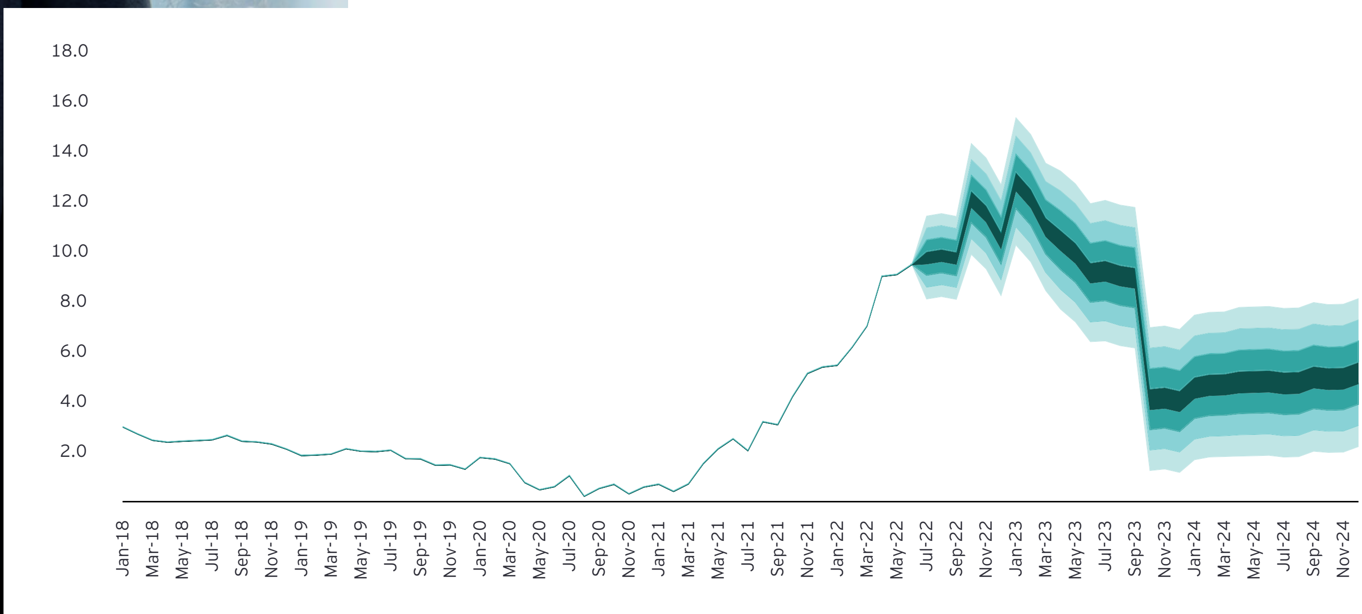
The above dynamics show that there are a range of inflation outcomes in play and the basket of indicators remain exceptionally volatile.

EY-Parthenon have developed a stress-testing inflation model by including assumptions of higher energy and food price inflation to a baseline forecast based on the BoE and EY ITEM Club central inflation forecasts. The assumptions based on heightened supply side restraints we include within our model are the UK energy price cap increasing to £3,244 in October, a sustained increase in the price of gas from January 2023 from Russia completely stopping gas supplies to Europe, and higher forecasted food price inflation due to the impact of high energy prices, the war in Ukraine and climate damage in Europe this Summer.

Our result is a normally distributed inflation model that allows us to extract three scenarios to account for the current sensitivity of market prices. We have taken the mean results of the model as our central scenario (50% confidence level), while the other two scenarios include variation of plus or minus two standard deviations from the mean to arrive at the best-case scenario (5% confidence level) and the worse-case scenario (95% confidence level). This is similar to the Bank of England's approach to deviation from the mean where they follow a normal distribution in the short run and a positively skewed distribution in the medium run. It allows for scenario planning based on our central assumptions where the best and worse-case scenarios are outliers but plausible. In the past year, it has taken three months for peak inflation in the 95th forecast percentile to become reality — so low probability scenarios can happen, and firms need to scenario plan.

As shown in the fan chart below, in the central scenario EY Parthenon's higher mid-range inflation forecast is 12.1% in October 2022 and peaks in January 2023 at 12.8%. Our worse-case scenario, CPI inflation is 14.3% in October 2022 and peaks at 15.35%. These results point to supply side dynamics creating a higher and more sustained inflationary environment than the 11% peak in October 2022 predicted by the BoE in June 2022.

EY-Parthenon's inflation scenarios



5. The levers companies urgently need to consider to manage inflation

Policymakers will come under huge pressure to respond, but it's notoriously difficult to get inflation under control quickly. Central banks will clearly need to continue increase interest rates – which also then could go higher than expected.

However, this may not have a sufficiently deflationary impact. Inflation in the UK is unusually supply driven, and the UK has a strong labour market, supported by consumer spending headroom. What's more, the UK's slowing GDP growth, labour shortages and falling real incomes could result in this causing a period of prolonged weaker growth and sustained inflation going forward. Equally, therefore, reduction in demand may not mean that inflation comes down quickly.

All of this points to a difficult conclusion for businesses: whether high inflation leads to runaway input costs or lower demand – or more likely both – they will have to take actions to deal with exceptional pressures on margins.

The good news there are a series of levers they can pull. But any effective inflation management program will likely have to be conducted end-to-end; not single part of a business can solve it.

Diagnose

Stress test your current exposure to inflation based on input pricing, since headline rates will obscure your real cost pressures. Isolate the precise cost pressures to determine mitigation strategies. These are likely to be based on the four drivers we have set out, but may vary depending on your exposure. Understanding second order effects, such as on wages will be critical to identify how pressures interact; as well as your exposure further down the supply chain and in different locations.

Scenario plan

Model outlier scenarios to understand exposure. Modelling forward looks should factor in significant downside scenarios, such as gas reduction or stoppage from Russia or continued food shortages, to support scenario planning.

Identify the levers

These can include:

- **Enhance revenue using pricing strategies**, including understanding where costs can be passed on.
- **Improve margins using portfolio review and rationalisation**, to identify and remove loss making products and services.
- **Improve margins using value engineering**, to create value and focus on total cost to serve. This includes establishing time horizons for improving margins, including via a triangle of procurement, commercial and R&D.
- **Reduce cost via productivity and efficiency improvements**. This includes benchmarking, re-evaluating operating expenses, IT cost structure, logistics, G&A and infrastructure costs. Aim to apply 'first principles' for increased savings, and reduce costs while safeguarding future growth potential.
- **Recalibrate your Employer Value Proposition**, to manage total labour cost escalation and better leverage your talent. This includes profit sharing and focusing on a positive employer brand, aiming to keep hold of talent to support future growth.
- **Optimise policy to reduce cost base through regulatory and government support.** This includes tax incentives, cap-ex and op-ex support and regulatory support to reduce energy costs.
- **Optimise your footprint** through more vertical integration, local production or bringing more processes in-house to insulate against fluctuating global prices.

EY has successfully executed these levers across portfolios and businesses in every sector. Get in touch for more detail on how we support companies with these seven levers.

Authors

Mats Persson
EY-Parthenon Partner,
Strategy and Transactions
mpersson@parthenon.ey.com

Himanshu Vora
EY-Parthenon Manager,
Strategy and Transactions
himanshu.vora@gds.ey.com

Alex Hitchcock
EY-Parthenon Assistant Director,
Transaction Strategy and Execution
alex.hitchcock@parthenon.ey.com

Contacts

Our team has experience across sectors and functions

Economics

Peter Arnold
UK Chief Economist
parnold@uk.ey.com

Financial

Meg Wilson
EY-Parthenon Partner,
Strategy & Transactions
meg.wilson@parthenon.ey.com

Demand strategy

Laura Higgins
EY-Parthenon Partner,
Strategy
laura.higgins@parthenon.ey.com

Reshaping results

Mike Parr
EY-Parthenon Partner,
Transaction Strategy & Execution
mparr@parthenon.ey.com

Jon Morris
EY-Parthenon Partner,
Strategy & Transactions
jmorris10@parthenon.ey.com

Operations

John Cooper
EY-Parthenon Partner,
Transaction Strategy & Execution
john.cooper1@parthenon.ey.com

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