LOGIC INSIGHTS

Are We Heading For a New Era of «Stagflation»?

Due to unprecedented economic shock of Covid-19, there is now a prevailing concern across all countries about the threat of stagflation. According to Bloomberg, the number of news articles mentioning stagflation has soared, currently up more than 300% since 2019. Stagflation refers to a situation first identified in the 1970s where inflation is high, economic growth is stagnant and unemployment remains consistently high. It causes real incomes to stagnate or decline while destroying purchasing power.

Our near-term macro scenario remains positive; while inflation has risen as economies have reopened, so has growth, and supply and demand will ultimately rebalance. Recent inflation is transitory, and will pass once post-pandemic supply chain pressures and labor market disruptions ease. Nevertheless the combination of supply chain disruption, high oil prices and labor shortages means the risks are worth taking seriously.

Why is it Happening ?

- Pandemic unemployment assistance and stimulus packages in the US and Europe in lockdowns meant more money in the system, combined with people ordering more goods instead of services like travel and others.
- The developed world is opening up again nowadays after 1.5 years of lockdowns which is causing bottlenecks on the supply side;
  - **On the production front:** Power cuts have closed numerous factories across China due to lack of investment in coal, which runs a big portion of electricity plants in China, in addition to the shortage of investment in renewables.
  - **On the logistics front:** shipping costs rose from $2k/container up to $15-20k due to ports not functioning at full capacity, which caused ships utilization to go down from 90% to ~45%).
- The price spike in oil, natural gas, and coal by almost 95% since last May and it is expected to further increase where some speculate that crude oil prices will go up to 200$ per barrel.
- Potential rise in fed interest rates on global borrowing rates especially for countries with low credit rating.

Khaled Akl, CEO at Halwani Brothers Egypt, recently spoke with **LOGIC's Ahmed Moharram** and shared his views on how companies should navigate the upcoming stagflationary winds and the subsequent inflationary waves. Edited excerpts of their conversation follow;

Ahmed Moharram: Khaled, what changes do you foresee in consumer behavior amid the current inflationary waves?

Khaled Akl: Overall I believe we will see the total market size shrinking in volume between 5-10% depending on the sector. Up till this point, PMI (Purchasing Managers Index) has been going down for 11 readings in a row Regarding consumers, I would say it's expected that we will see similar behaviors to what we've seen at the onset of COVID; consumers usually opt for;

- Rationalizing their consumption in consumer essentials and commodities, especially where we expect prices to increase such as wheat and oil derivatives. This would essentially mean that consumers will go for smaller SKU's.
- Becoming promo-hunters especially in sectors where branding doesn't play a major role in purchasing decision. We'll see local brands thriving again – if they managed to overcome the supply chain challenges – similar to what happened in Q2 in the previous year.
- Cutting spending on discretionary products such as chocolates and other confectionery types, ketchup, etc.

"I also believe that in Egypt, with the imminent shrinking of the middle class, we're seeing what I refer to as a "Tale of Two Cities"; one with consumers in upper socio-economic classes who are constantly looking for value, and on the other hand we find consumers in lower socio-economic classes who are switching brands, going to substitute products, rationalizing consumption, and cutting spending in the new normal."

Ahmed Moharram: And how would you say FMCG industry will change given the inflationary waves and supply shortages?

Khaled Akl: Now here is where the main problem lies; I think a lot of the medium and small sized pockets will face major issues in overcoming this wave specifically due to their expected inability to secure their supply chain requirements before inflation kicks in. Stocking up warehouses requires them to secure financing for their working capital, which will pose a threat if they opt to do it through loans especially if interest rates rise.
Firms will be faced by multi-faceted challenges and multiple hits from all sides as follows;

- Delays in shipping of raw materials which will cause overruns in production schedules
- Increasing shipping costs
- Potential increase in borrowing rates, especially if a certain company used debt to overcome impact from COVID

- Increases in minimum wage
- Increase in costs
- Inability to pass all the price increase to customers because this will cause customers to switch to other brands or worse to substitutes.

Ahmed Moharram: How do you think firms should prepare?

Khaled Akl: In response to the upcoming inflation and volatility in the markets, I think CEOs/COOs/CFOs should fight on five different fronts;

- **First Front – Avoiding Business Interruption:** companies should opt for immediate forward buying deals and increase their days inventory outstanding from 3 months to 6 months. The gains from doing so, in almost all cases, will trump the cost of working capital financing and warehousing.
- **Second Front – Being Selective:** companies should divide the implication of consumer price increases on a) reduction of discounts and promos, and b) gradual price increases. Marketing officers should not only keep an eye on their prices vs. competitors, but also on substitute products. For instance, macaroni manufacturers should keep an eye on their prices relative to rice, and dairy producers should monitor the prices of fresh milk.
- **Third Front – Cost Optimization:** CEOs should create temporary teams for every cost line to unfold cost reduction potential across all functions, and as much as possible without hurting the company's main value proposition.
- **Fourth Front – Value Engineering:** Procurement officers should focus on how to deliver same value to customers at lower costs. This essentially targets cost reduction opportunities in secondary and primary packaging and logistics. For instance, any slight change in thickness of secondary packaging or any reduction in primary pack sizes or its design can unfold great savings without hurting the value given to consumers.
- **Fifth Front – Net Revenue Management:** Commercial officers should partner with finance officers in finding opportunities to reduce their sales & marketing expenditures. Solutions can range from focusing on profitable distribution channels or certain SKUs to eliminating slow moving products/flavors in their categories, etc.

The tides will be rough and companies will either Sink, Float or Swim which in real terms means that smaller players might totally exit the market, few others will survive , but only the very resilient ones will thrive. It is expected that the situation would ease up by Q4 2022 or Q1 2023 and until then CEOs should make their primary objective to safeguard their Gross Margins.