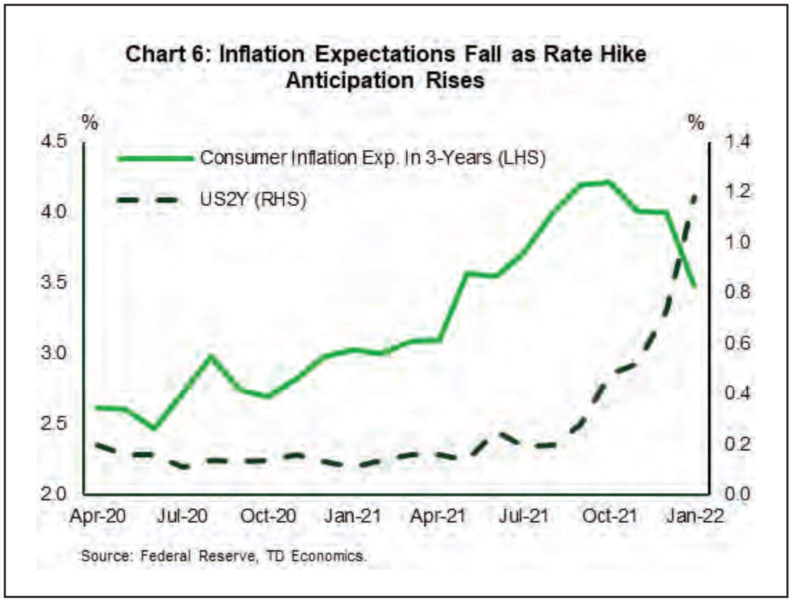
TD BANK | BY BILL FINK AND PHILIP DERASMO

MANAGING INFLATION AND INTEREST RATE HIKES:

Strategies for Manufacturers to Navigate the Current Economy

Computer chips, chicken and chlorine are not products typically grouped together except that they fit into the category of goods that have been affected by COVID-19 supply chain woes during the last 12 months. There is some hope that supply side challenges will continue to ease as the Institute for Supply Management's Manufacturing Index has been expanding for more than 20 months. Supply delivery times are still high, however, with continued worldwide shipping and trucking delays.

Reflecting on the classic Laws of Supply and Demand, it is no surprise that outsized demand of available goods in the face of a reduced supply has driven up prices. This, coupled with slow wage growth until recent months and the loss of 3 million to 4 million Americans in the workforce, has pushed inflation to levels not seen in decades. In fact, inflation hit a 40-year high in December 2021 that was then surpassed again in January 2022. Energy and fuel costs led the way in inflation, with prices climbing 50% in 2021.



Further complicating the U.S. economic picture are current geopolitical tensions such as the Ukraine conflict. Fuel prices climbed even higher in late February and world markets dropped significantly. The spike in fuel prices resulting from European conflict could be temporary or could have a real gross domestic product (GDP) effect both in Europe and in the U.S.

A significant, sustained rise in oil and natural gas prices could stall economic recovery in the first half of the year by further eroding consumer spending power, according to TD Economics, the research arm of TD Bank.

To restore some balance in the economy, the Federal Reserve will implement interest rate hikes throughout 2022 and attempt to bring inflation back from its 7.5% peak to a range of 3.0–3.5% by year's end. Rate increases will likely begin with a 50-basis-point increase in March. Analysts at TD Bank then expect to see further rate hikes even higher than what has been publicly indicated by the Fed, expanding to a possible 75-to-100 basis point increase over the next few quarters in addition to the initial increase.

This is largely an educated guessing game by policymakers, however.

"Nearly every recession in modern history has been preceded by a peak in the Federal Reserve's policy rate. In an ideal world, the Fed's rate increases will bring demand into balance with its underlying potential supply, allowing for both stable economic and price growth," wrote TD Economics in a recent report. "This is a tall order. One reason is that the Fed doesn't know in real time the appropriate level for interest rates that will perfectly balance the economy. This is only truly known in hindsight."

In other words, it is a delicate balance between raising interest rates too high and curbing economic growth and bringing inflation down to a more manageable level.

Investments in capital equipment, whether it be through outright purchasing or leasing, are especially important to do before rates climb.

What does this mean for manufacturers? Below are strategies companies should consider as they prepare for rising interest rates:

1 REFINANCE

Companies with fixed-rate debt should have refinanced already to take advantage of historically low rates, but without a strong sense of urgency that rates could change, many businesses who are eligible to refinance failed to do so. The potential for multiple rate hikes during 2022 will help spur motivation for more businesses to refinance or to move into a long-term, fixed-rate product. Manufacturing companies may also consider an interest rate swap on an existing credit line or loan to help offset increasing costs.

2 INVEST IN CAPITAL EQUIPMENT

While some manufacturers may have made investments in new technology or equipment to combat labor shortages or create production efficiencies, many still plan on capital expenditures in the near-term, with investments in technology, facilities, and data security topping the priorities list. Investments in capital equipment, whether it be through outright purchasing or leasing, are especially important to do before rates climb. Companies that have put larger purchases on hold for several years now see a need to reinvest to increase operational efficiencies through new technologies or automated processes to relieve supply chain bottlenecks or enhance protections in cybersecurity to avoid being the next headline. Manufacturers that are planning expenditures may also want to consult with their CFO or accountant to consider the impact of asset depreciation that comes with investing in new equipment.

3 DETERMINE WHAT'S IMPACTFUL

Before reacting to the Fed's interest rate increases, executives need to determine what's more impactful to their business – interest rate or dollar exchange – and how that influences operations. Domestic-oriented manufacturers with domestic customers will be most affected by a rate hike. Conversely, continued strength of the dollar is more worrisome for manufacturers that work internationally and companies exporting to Asia and Europe are most notably impacted by the strong dollar. The strength of the U.S. dollar compared with other currencies has been meaningful, and many companies haven't been able to adjust their business operations and inventories yet to account for it. Geopolitical tensions could cause further fluctuations in foreign currencies, so those manufacturers with a strong export business may want to consider using an interest rate hedging product through a bank's foreign exchange group to potentially lessen these financial impacts. A company that maintains modest debt and adequate cash reserves will better enable it to weather the downturn in export markets.

4 USE CREDIT

From a financing perspective, inflation and increased real inventory is raising working capital requirements. As such, financing requests have spiked as many companies look for new credit facilities or an increase to their existing lines of credit. Some industries are considering alternative structures such as an asset-based line of credit to increase availability by tying their level of working capital, both accounts receivable and inventory, or equipment assets directly to the amount they can borrow. This can be a helpful strategy to cover short-term cost increases such as wages while business productivity returns.

Financial institutions like TD Bank currently have strong balance sheets as they released reserves, a primary contributor to the industry's strong earnings in 2021, and accumulated deposits in 2020 and 2021 while businesses and consumers saved for the unknown and cut spending. Banks have ample liquidity and capital and are seeking to put it back to work, creating a favorable market for companies looking to finance new projects, mergers and acquisitions, and organic growth in 2022. The continued access to capital combined with a strong financial partner will provide plenty of options for manufacturers looking to survive and thrive in this period of uncertainty and increased volatility.

Manufacturing executives should examine how the initial interest rate increase – and additional hikes in the coming quarters – fits into their businesses' strategic plans. Ultimately, the Fed's decision to raise interest rates reflects economic growth and should help to stabilize inflation by the end of 2022.

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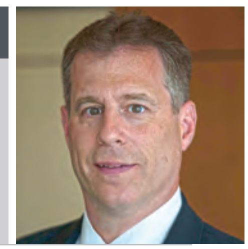


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