CRITICALEYE
The peer to peer Board Community

GLOBAL ECONOMIC OUTLOOK: A ROCKY RIDE

Members of Criticaleye's global Community assess what lies ahead for companies and consumers after a rocky ride in the first six months of 2023, which was marked by central banks continuing to raise interest rates to quell inflation. Other macro challenges range from geopolitical tensions to climate change and AI

As broadly expected, the first half of 2023 was a rocky ride. A fundamental shift in the economic landscape, not least the end of low interest rates, is causing some major headaches for governments, Boards and consumers.

The War in Ukraine, tensions between China and the US and ongoing faults in the global supply chain continue to create pressures that effect decisions made in the Boardroom. Here, a range of business leaders share their thoughts on inflation, climate change, military conflict, access to finance, artificial intelligence (AI) and why we might need to strap ourselves in for the remainder of 2023 and beyond:

Peter Arnold
Partner,
UK Chief Economist
EY

EY's Item Club predicts further interest rate increases and muted growth in the UK.

In the US, inflation was largely driven by a post-Covid rebound and fiscal stimulus meeting supply side constraints, whereas Europe was more exposed to the increase in energy prices following the War in Ukraine. The UK faced the worst of both worlds, plus it's feeling the effects of underlying structural issues in the labour market, making inflation stickier than in other global economies. Moreover, resilient consumer spending and business activity, which have prevented a recession in the UK so far, have also likely kept inflation higher than expected.

> *"[Interest] rates will stabilise at around four to five percent rather than falling back to close to zero – we'll have to get used to these historically normal interest rates again"*
>
> Peter Arnold

The EY Item Club is predicting further interest rate rises this year, although by mid-2024 we may see rates coming down. However, rates will stabilise at around four to five percent rather than falling back close to zero – we'll have to get used to these historically normal interest rates again. Inevitably, this will affect the corporate landscape. For companies that have borrowed on a fixed rate, particularly to finance deals, there will be a period of painful refinancing as the new debt becomes unaffordable; assets valued in a low interest rate world will need revaluation and the private equity model itself – that has benefitted from relatively cheap debt – will need to be re-assessed.

The EY Item Club forecast for UK GDP for the remainder of 2023 and into 2024 is downbeat, with continued slow growth. Economic headwinds will move away from cost and margin pressures and will instead come from the dual impact interest rates will have on the consumer and corporate sides. Around two million households will refinance over the next 12 months, which means consumer discretionary spending power will be significantly reduced. On the corporate side, executives will be thinking more about managing their financial position and liquidity in the face of higher interest rates.

Steven Cooper
CEO
Aldermore Group

The UK is facing a prolonged period of low growth. Boards must prioritise the bottom line while supporting staff and customers.

In the UK, a recession is looking increasingly unavoidable. Even if a recession is avoided, we are in for a prolonged period of low growth. This is combined with continued inflation, which brings the prospect of increasing costs and difficulties in generating revenue. The blend of a tight labour market and post-Brexit disruption means inflation is hitting harder in the UK than elsewhere.

Interest rates are having a significant impact for some. We are seeing fewer businesses investing as debt becomes more expensive. Households have been struggling with a greatly reduced disposable income. While this hasn't >

fully come through the economy yet, it will do within the next 12 months. Conversely, individuals and organisations with lower levels of borrowing have been less impacted by interest rates. When interest rates do eventually peak, they won't come down anywhere near as low as they have been. The 'benign' environment of very low interest rates is long gone and is unlikely to return within our lifetime.

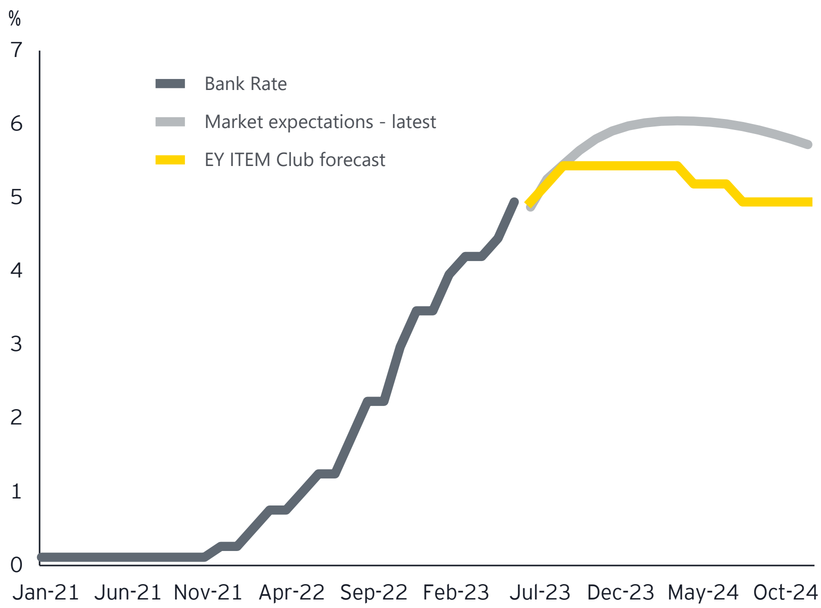
The current macroeconomic situation and rapidly evolving technology is creating a very different environment for Boards. Reaching out to people who have experienced high inflation environments to gain perspective is really important. Boards should prioritise three things: where they can get revenue growth; how they can transform their cost base; and how to look after their colleagues and customers. While this is arguably little different to what CEOs and Boards have always thought about, these decisions are becoming increasingly challenging.

Venkataramanan Anantharaman
Non-executive Chair
Ecom Expres

Interest rates in Asia have flatlined, but climate events and geopolitics will continue to impact global inflation.

Inflation across the globe is stubborn. Extreme climate events and geopolitics will both impact inflation rates. Central banks have increased interest rates, with further increases in the US and UK not being ruled out. In contrast, interest rates in Asia have paused. Growth in India and China is the result of government investment in infrastructure and allied areas, rather than consumption.

UK: Forecasts for Bank Rate



Source: EY ITEM Club Summer Forecast, July 2023

In this environment, consumer discretionary spending has gone down. Fortunately, in the previous low interest rate environment, most companies raised equity so the stress to corporate balance sheets is minimal.

Concurrently, I think the private sector is approaching new capital expenditure with caution. One thing to consider is that the impact of higher rates has not filtered through in areas such as mortgages; when mortgage rates get reset, financial stress on consumers is expected to increase.

Geopolitics is changing and new alliances are being made. Nothing is fixed, everything is transient. There is a lot of talk in the West – and even in India – about trying to be self-sufficient and to decouple from China. However, the reality is that China has created such large capacities and economies of scale that the world will continue to depend on China for manufactured products and intermediates. So, for the most part, I don't see change on the horizon.

IT services and business process outsourcing are two sectors AI will impact sooner than others, as much of the work can be done by AI generated systems. In other sectors, AI will be largely used to support people. However, AI will give rise to a slower rate of employment growth in [some] sectors.

For the rest of the year, I think the situation will be cautious with continued weak consumer sentiment and conservative private sector investment. Geopolitics and climate change will have an impact and economies will rely on government spending for growth. >

Mary Jo Jacobi
NED
Savannah Resources

North America's economy is in a strong position comparative to other regions. Geopolitics and the rise of AI will continue to dominate the macro.

I had predicted that a recession was likely in North America in the first half of 2023. While I'm relieved to say I was wrong, it feels like the inevitable has been delayed, with many forecasting a recession in the next 12 months. US consumers remain active, supply chain pressures have stabilised and inflation is declining, so North America looks strong relative to the rest of the world.

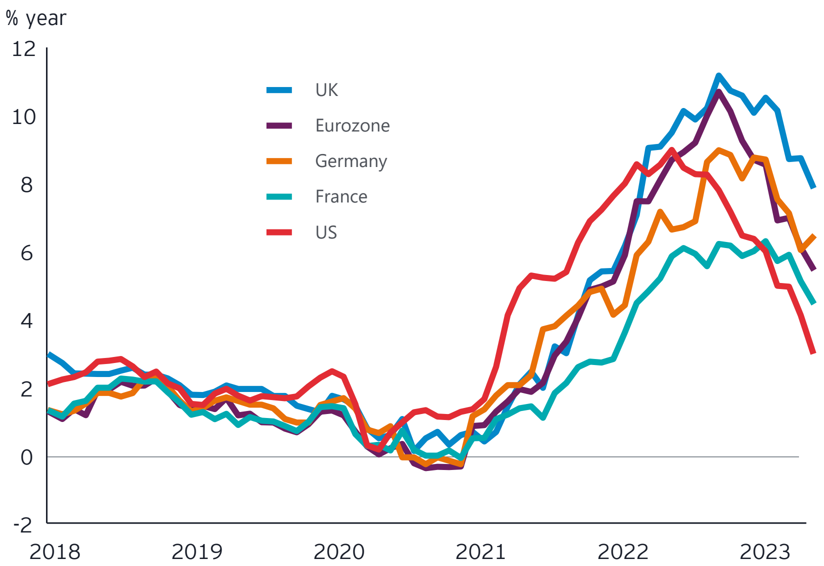
However, as the US moves towards the 2024 Presidential election, I expect unease and nervousness to dampen economic activity.

The rapid shift from the Covid economy to the wartime economy has tested the resolve in Boardrooms across the world. Indeed, the ongoing War in Ukraine has been a shock to the economic system, slowing growth last year to just over three percent. The longer the war drags on – with its huge, unbudgeted expenditures – the greater the likelihood of taxpayers growing weary in the context of the cost-of-living crisis.

Beyond the war, China remains a concern as it expands its sphere of influence in the Global South in response to its domestic economic weakness. The two-theatre threat of Russia and China could challenge large corporations to reign in their globalist tendencies in the coming months.

Additionally, we need to think expansively about how AI can help our businesses, but also be realistic about the threats it poses – particularly if competitors adopt technologies faster and more effectively. In the next half of 2023 and beyond, I expect geopolitics to be the number one macro topic, followed by the challenges of managing sustainability and finally technology and the rise of AI. One must challenge whether the Board has the right skill set to deal with these rapidly evolving issues.

CPI Inflation



Source: EY ITEM Club Summer Forecast, July 2023

Matthew Blagg
CEO
Criticaleye

Interest rate rises will start to have implications for consumers and businesses, but growth opportunities remain. The US will act as a bellwether for the global economy.

There's definitely been a tightening economically, but I think businesses have traded fairly well in the year so far. There's been cost inflation coming through, but they've generally been able to push it on to the customer. Headcount numbers have generally been flat, but the question is what comes next? The implications of interest rate increases are slower to come through than most people think. You've also got inflation in certain markets remaining high. You are seeing it come down now, which is positive.

There is still lots of capital around and that means there will be opportunities for sustainable growth, although there is a danger that the heightened risk environment makes businesses overly cautious. To take advantage, you must have a tight understanding of your environment and be quick to react. There are obviously net gains; >

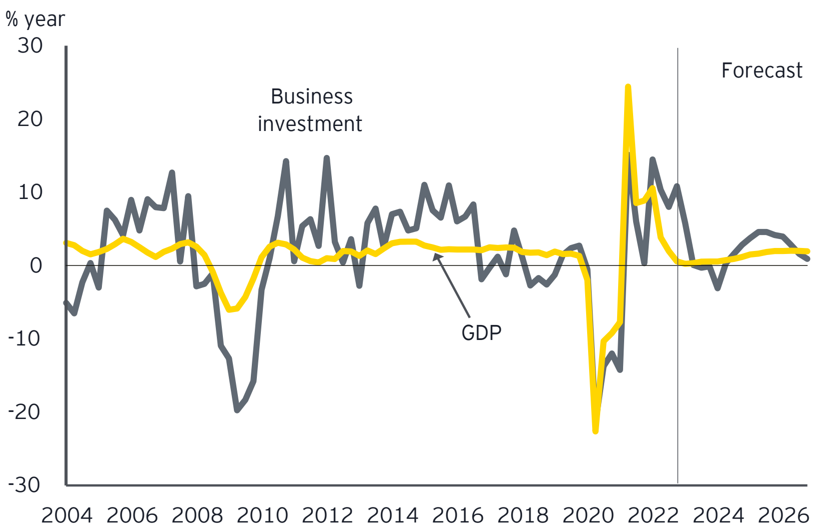
the drive towards AI is significant and the reality of that is it's linked to cost reduction and efficiency.

Countries and companies are facing the same challenge in terms of managing the drive towards addressing climate change, but with a greater understanding that there is a balancing act to maintain. It's partly reflected in the UK's recent decision to issue more oil licences. Boards are more cognisant of this kind of complexity and how they probably need to compromise more than they might like.

The big thing to watch for is the US market. If the US market powers through, this won't be as significant a downturn as previously thought. If the US deteriorates, then I think there's a bigger implication. That's the big question mark as we go into the autumn when a significant amount of debt is due for refinancing. I think that's a key indicator for anyone looking at their own business.

> *"The big thing to watch for is the US market. If the US market powers through, this won't be as significant a downturn as previously thought"*
>
> **Matthew Blagg**

UK: Business Investment and GDP



Source: EY ITEM Club Summer Forecast, July 2023

Sally Bridgeland
Chair
Impax Asset Management

Inexperienced executives need to lean into their Boards for guidance through the challenging external environment.

For those companies where I'm on the Board, it [the challenging macro environment] seems to have heightened the focus on using resources and adopting business strategies which are sustainable in all senses of the word. The risks to finances and reputation of ignoring the necessary transition are increasingly understood and used to challenge business plans and objectives.

It's always important for Boards to make sure that they have the right talent at the top of an organisation. But in a more benign environment, they can be more relaxed, set objectives carefully and keep an eye on progress. Right now, inexperienced or inflexible C-suite members may lack the confidence to be decisive and need more coaching or support. The most difficult decision, of course, is changing the Chief Executive and that's firmly in the remit of the Chair.

As an actuary you'd expect me to think about risks as much as opportunities, and the longer-term perspective. I'd encourage Boards to think about what they might see as low probability but high impact undesirable scenarios for their businesses and check that they have the contingency plans and resilience to survive. [Consider areas like] whether or not to do more business in or with China, how to invest in AI and how to make the most of space ... the final frontier. >

Alastair Mills
Managing Director &
Head of European Business
Services, H.I.G. Capital

Interest rate hikes have dampened dealmaking and will continue to put pressure on private equity-backed businesses.

Deal volumes are currently materially down as there are fewer opportunities being brought to the market. As it stands, there's an insufficient meeting of minds between buyers – apart from the very high-quality assets, where valuations have largely held up – and sellers who still probably hope they can get yesterday's valuation, or close to it.

Consecutive interest rate rises have put pressure on businesses, particularly private equity-backed companies that typically have more leverage in their structures. The latest view is that the UK is 25-50 basis points off peak. That rate is not expected to come down quickly and we might be at, or close to, this peak until the back end of next year. More importantly, because the rises have been so consistent over a short period of time, we haven't yet seen the full-year effect, whether it's a business that was hedged for a short period, or a house owner having to remortgage. We're starting to see the full impact coming through and that ultimately puts pressure on a wide array of businesses and consumers alike.

> *“I'd encourage Boards to think about what they might see as low probability but high impact undesirable scenarios ... and check that they have contingency plans and resilience to survive”*
>
> Sally Bridgeland

Economists are indicating we will enter some sort of recession in the next couple of quarters as the full impact of interest rate increases start to really bite. Inflation hasn't disappeared – particularly in the wages and services categories – even if the broader inflation measure has reduced in the last few months. That said, PE houses have significant capital to spend and they haven't been deploying at historic levels over the last 12 months. What we saw after Covid was that weight of money caused investors to become a little less selective about what they target. That built momentum and transaction volumes increased as a result. So, I think unless there's a big deterioration in the economic situation, we'll see volumes increase in 2024 – even if the economic backdrop is not that favourable. ■

GROWTH COMPANY FORUM 2023

Criticaleye is hosting its annual Growth Company Forum on 28 September. Please click here for more information or to register to attend this virtual event.

Featuring commentary from:

Peter Arnold
Partner, UK Chief Economist
EY

Steven Cooper
CEO
Aldermore Group

Venkataramanan Anantharaman
Non-executive Chair
Ecom Express
& Board Mentor, Criticaleye

Mary Jo Jacobi
NED
Savannah Resources
& Board Mentor, Criticaleye

Matthew Blagg
CEO
Criticaleye

Sally Bridgeland
Chair
Impax Asset Management
& Board Mentor, Criticaleye

Alastair Mills
Managing Director &
Head of European Business Services
H.I.G. Capital

Contact the contributors through:
www.criticaleye.com