The Ultimate Guide to Inflation

and how to protect your business

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FINANCIAL SERVICES

What is inflation?

The technical definition of inflation is the rate at which the value of a currency is falling and, consequently, the prices for goods and services are rising. While we can't see the value of our currency falling, what we can see - and definitely feel - are price increases. The most notable inflation pressure can be seen in energy and food. The costs to heat or cool our homes, fill up our vehicles, and feed our families.

Our needs as humans are not limited to just energy and food, we rely on healthcare, entertainment, transportation, and more for a comfortable life. Therefore, **"inflation aims to measure the overall impact of price changes for a diversified set of products and services, and allows for a single value representation of the increase in the price level of goods and services in an economy over a period of time,"** according to Investopedia.

Currently that single value rate of inflation is surpassing most economists' predictions. Also surpassing their predictions is the length of time we will experience inflation. What was once thought to only last thru 2021 is now predicted to last far longer. According to The Associated Press, **"Higher prices will likely last well into next year, if not beyond."**

Understanding Consumer Price Index

> On November 10, 2021, the government reported a 6.2% increase in the consumer price index from a year ago. This increase is the biggest 12-month jump since 1990.

The U.S. Bureau of Labor Statistics (BLS), along other government statistical agencies, measure inflation by calculating how the prices of items that are included in a reference basket change from one period to the next. There are over 200 categories of goods and services in the reference basket which are divided into eight major categories.

Consumer Price Index Eight Major Groups

- Food and Beverages
- Housing
- Apparel
- Transportation
- Medical Care
- Recreation
- Education & Communication
- Other Goods and Services

How does recession differ from inflation?

Which is worse?

Just like inflation, recession is a macroeconomic term. Unlike inflation, recession is a decline in economic activity that is characterized by decreasing production and elevated unemployment. Businesses must strategize for both recessionary and inflationary periods, however many economists argue that the effects of inflation can be worse than recession. **“Everything costs more every year, so if you’re on a fixed income, you have less and less buying power. And inflation is terrible for savings and investments: If you have $1,000 in the bank today, it buys less tomorrow and even less next month,”** explains NBC News.

Most would say that recessions can correct themselves; when people spend less, there is less demand for borrowing, and lenders naturally lower their rates to attract any loan activity they can find. Eventually consumers, and businesses, begin to borrow again at those low rates and the economy begins to fix itself. Inflation, on the other hand, is harder to correct, most would argue.

With inflation, rates need to increase so that consumers and businesses borrow less money. But how high do they need to increase and what are the consequences of a higher rate? The U.S. experienced similar inflation in the 1970’s and it wasn’t until the Fed increased rates by 20 percent that the inflation finally slowed down. However, in doing so the financial markets took a hard hit and people on fixed incomes felt the pressure. Does anyone remember the days when mortgage rates were 19%?

So, should we expect interest rates to increase?

Yes, in order to control the overwhelming increase in prices the Fed will need to raise the fed funds rate. As defined by The Balance, “The fed funds rate is the interest rate banks charge each other to lend Federal Reserve funds overnight. The nation's central bank uses it in addition to other tools to promote economic stability by raising or lowering the cost of borrowing.” Since late 2019, this rate has been on a decline. On March 15, 2020, the Fed lowered the rate to almost 0% on March 15, 2020 in an effort to boost the economy amidst the impending threat of the coronavirus pandemic. **Today, the rate remains close to 0%.**

In September, **the Fed announced that America should expect at least two Fed rate hikes in 2022.** Economists predict these increases will be sooner than anticipated as the consumer price inflation continues to skyrocket.

But how will businesses handle the increased interest rate, in addition to the increased cost of their raw materials and the demand for higher pay from employees (to compensate for inflation?) The need for a financial strategist has never been more evident.

Coveted's 3 Step Approach to Manage Inflation

1 Manage Interest Rate **Costs**

2 Manage Gross Margin **Real Time**

3 **Outsource** labor costs

What you can do

Manage Interest Rate **Costs**

How much does it cost for your business to carry debt?

As mentioned earlier, rates have been extremely low since late 2019. In response, most businesses moved their lines of credit to a floating rate to take advantage of the lower carrying costs. However, the anticipated rate increases will dramatically increase carrying costs.

For example, $1 million line of credit at 5.5% will cost

$25,000

per year.

With at least two rate hikes in the foreseeable future, Coveted Financial suggests moving a portion of your evergreen loan to a fixed rate loan to mitigate rate risk. **An evergreen loan does not require the repayment of principal during the life of the loan, or during a specified period of time.*

Our team will work with your business to determine how much debt you should move to a fixed rate and what monthly payment amount your business can best afford. Additionally, we'll help you negotiate the best rate, determine how long the loan should be, and provide a cash flow analysis to see the effect of the new loan.

What you can do

Manage Gross Margin **Real Time**

What is your true cost of goods sold?

Most businesses are experiencing increased costs for raw materials. Additionally, to compensate for inflation, wages are increasing. Both of these should be factored into the Cost of Goods Sold. While those may seem straightforward, accounting for holding costs and work in progress can be a bit more difficult. Companies are experiencing bottlenecks in their production as they wait for specific parts or raw materials. Meanwhile their inventory stands idle, waiting to be completed and sold.

All of these variables can make it increasingly difficult to not only manage gross margin, but to accurately compute it!

Coveted Financial works with businesses to produce accurate financial reports real time so that the correct gross margin can be calculated and adjustments can be made. Even the smallest increases in margin can determine the profitability, or even break even point, of a business. If a business isn't monitoring their gross margin frequently enough, they don't have time to make the necessary adjustments.

What you can do

Outsource Labor Costs

How much more are you paying for labor?

With such a shortage in the labor market, employees are able to demand higher wages. Even the slightest increase in wages can make a huge difference.

For example, a laborer requests an increase of $2.00 on their $14.00/hour wage. This represents a 14.2% increase.

A 14.2% increase on a $100,000 monthly payroll is

$170,400

per year.

Coveted Financial suggests outsourcing labor to better control labor costs. While a specialist in their field may cost more per hour, it is likely they are extremely efficient in their role. Additionally, outsourced labor does not come with the added costs of benefits like insurance and 401k.

Additionally, many companies will realize increased efficiencies with outsourced labor, as internal employees are able to focus on their responsibilities and new processes are utilized.

BONUS TIP:
AUTOMATE TO INCREASE PRODUCTIVITY

There has never been a better time to utilize automations in business. From new softwares to equipment, the increased production will quickly outweigh the upfront cost.

Coveted Financial works with businesses to produce accurate ROI reports for automation initiatives; working the purchase and implementation costs into a detailed cash flow analysis.

According to the Washington Post, not only do people not want to return to work, those who have returned are voluntarily quitting. **"Some 4.3 million people quit jobs in August — about 2.9 percent of the workforce,"** quotes the Post. The change in worker's minds means it is time to think about how to continue without them.

In conclusion

- The Consumer Price Index continues to rise.
- To control inflation, the Fed is proposing at least two rate increases in 2022.
- Move a portion of debt into a fixed term loan to avoid increased carrying costs of debt tied to variable rates.
- Understand gross margin in real time so that adjustments can quickly be made to sales prices.
- Consider outsourcing labor to increase efficiencies and better control wage costs.

Now is the time to combat inflation and prep for increased interest rates. We can help.

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