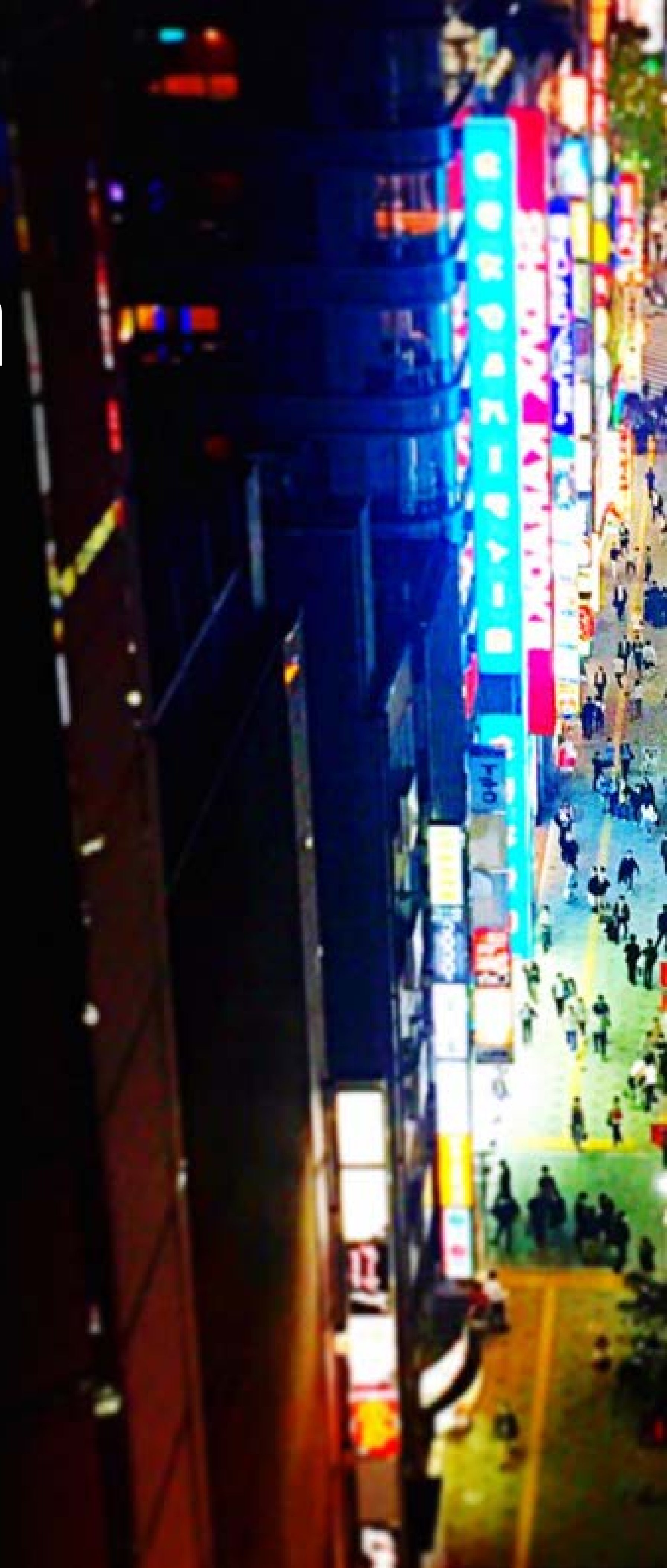
Inflation within Consumer & Retail: Transitory or Sustained?

Consumer & Retail



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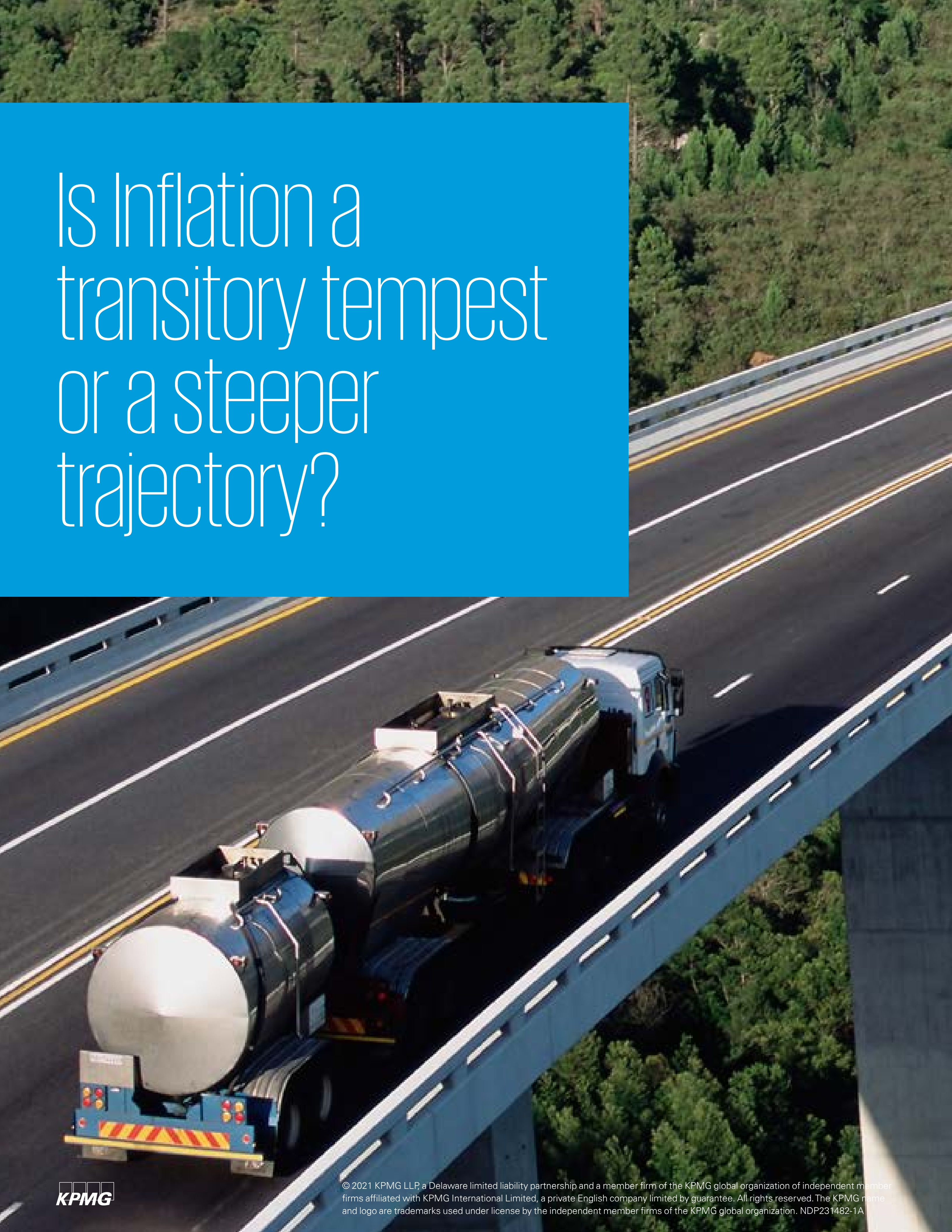
Is Inflation a transitory tempest or a steeper trajectory?



KPMG

Consumers and businesses alike are finding that prices of goods and services are rising as we emerge from the pandemic. In fact, prices are increasing at their fastest pace since the 2008-2009 Global Financial Crisis (GFC). Recessions, such as the GFC and the pandemic, decrease demand, which in turn, depresses prices. However, as the economy recovers, base effects from the previous year can cause year-over-year price data to be elevated shortly after a recession in the early recovery phase of the business cycle. The current increase in prices is due to a combination of base effects, a surge in demand, and supply constraints.

As the global economy reboots itself from pandemic-related shutdowns, it has an additional component to contend with—considerable shortages of goods and materials ranging from apparel to chemical products to semiconductors due to Covid-19 related restrictions and closures. These shortages are further compounded by labor frictions. It turns out that getting millions of people back to work has been more challenging than initially laying them off when the pandemic was at its most severe. While this is a challenge being felt globally, it is especially true in the food, beverage, consumer goods, retail and restaurant sectors where so many employees need to work in-person.

As consumer and retail companies consider the tradeoffs between retaining customers by holding prices steady or preserving margins, they must consider the nature of price increases for all of their cost of goods sold. Some inputs from cost of goods sold, such as distribution and transportation for retailers, are experiencing extremely large price increases that although severe may not last beyond the next several quarters, while other inputs have structural components that are more durable. Food and beverage retailers have also experienced a surge in demand for their products, further intensifying the inflationary forces they face. Investing in low cost operating models, deciding how to attract workers, and how to manage the increase in the cost of input goods are all critical to not just survive, but thrive, through a transitory inflation tempest.

For example, many retailers face inflexible pricing and promotion review processes and are unable to adequately respond to rapidly rising input costs and shrinking inventory in high demand categories. In such a dynamic environment coupled with a rapidly growing digital commerce channel, retailers must find the best way to redesign their pricing and promotion processes to meet customer demand and address rising input costs. More frequent reviews underpinned by analytics and artificial intelligence as well as trends analysis of external data signals are needed to determine the best decisions for both pricing and promotion. Such adjustments will enhance margins and reduce margin leakage during an inflationary period.

Examining the history of pandemics, an observation can be made that prices for goods and labor normally rise, sometimes quite steeply as the pandemic and its aftershocks impact preferences, labor availability, and large shifts in demand that the economy must digest. As the world grapples with the various strains of COVID-19 and vastly different vaccination rates, the pace of economic growth and the duration of pandemic-related supply shortages around the world depends on the trajectory of the virus and the efficacy of the global policy response.

Supply chain disruptions aren't permanent, but may not dissipate as quickly as hoped

Supply chain interconnectedness and the prevalence of just-in-time manufacturing have compounded the disruptions to global supply networks. In normal times, elevated prices would induce businesses to build additional capacity and find new and more efficient ways to bring their products to market. Given the pandemic, much of the global supply needs to be brought back online rather than created from scratch. Capacity utilization is running at just above 75%, well below recent peaks of just over 80% seen in recent expansionary periods . In addition to reduced capacity utilization, there was also a surge in demand for goods, so much so that the incremental change in goods consumption in the first half of 2021 exceeded all of the incremental change in 2019. This type of demand surge coupled with reduced capacity utilization has created a double whammy for prices that will begin to abate once the traffic jam in distribution channels can be cleared.

However, since the pandemic itself is proving difficult to control, the period of transitory disruption in terms of supply and labor shocks is elongated. While we anticipate that the supply shock will abate in 2022, frictions in the labor market may take longer to clear. Furthermore, some of the labor market shortages have structural elements that are likely to keep the price of in-person labor elevated for some time.

For example, trucking, a key input to food, beverage, consumer and retail industries, faced labor shortages due to an aging workforce and changing preferences among younger workers prior to COVID-19. The pandemic prompted early retirement for many, exacerbating the pre-existing shortage of truckers. Therefore, ground transportation labor shortages, and their corresponding elevated prices, are likely to continue beyond 2022.

In addition to having difficulty keeping existing drivers on the payroll due to an aging workforce and a high number of retirements during COVID-19, training new drivers can take six or seven months. New workers are also demanding higher pay.[3] Wages for the truck transportation industry were rising 4.5% prior to the pandemic, compared to a 3.0% for overall wages. While the worker shortage may seem more acute in the face of elevated demand, wages remain up 4.5% compared to 4.6%[4] for the overall average.

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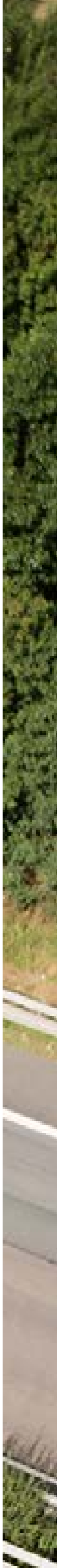
[1] KPMG Economics, The Federal Reserve Board, Haver Analytics, September 2021

[2] KPMG Economics, U.S. Bureau of Economic Analysis

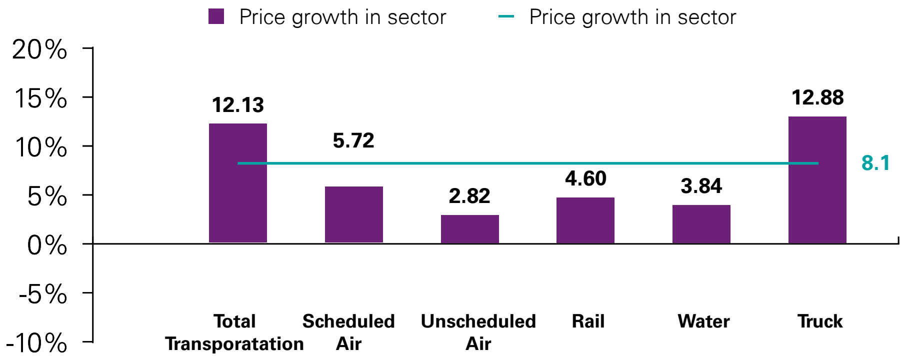
[3] Center for Employment Training website. https://cetweb.edu/program/truck-driver/

[4] Wage data is February 2020/February 2019 for the pre-pandemic data: for present period, August 2020/August 2021 for truck transportation, September 2020/September 2021 for overall.



Price Growth in Transportation Sector since February 2020

PPI Index, Percentage Change



Source: Bureau of Labor Statistics (August 2021)

Note: Freight transportation accounts for roughly 3.1% of the PPI index in 2021

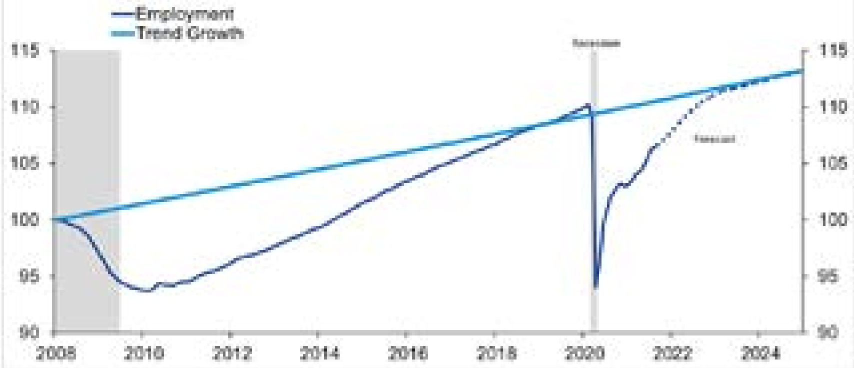
The transportation industry is also impacted by the cost of raw materials, especially the cost of fuel. Here pandemic impacts are intersecting with geopolitics and switching fuel preferences. Increased fuel costs put additional pressure on the transportation sector. While some of these pressures are likely to ease over time, much is dependent on factors such as the severity of winter heating needs, the amount of supply and investment in fossil fuel extraction. The transportation industry could well face a challenging fuel environment into 2022.

Such challenges are intensified by the continued acceleration of online, direct-to-consumer sales in consumer and retail sectors. This higher channel growth puts significant pressure on transportation costs and complexity, especially when it comes to last mile fulfillment. The increases in digital channel sales elevate such challenges at a higher rate than the industry has historically had to manage through. For example, many specialty retailers are forecasting digital demand at or above 50 percent of total sales, in contrast to 20 to 25 percent pre-pandemic. For consumer goods companies, the successful growth (representing, in some cases, triple digit percent increases) and increasing emphasis on direct-to-consumer services further compounds the mounting pressure put on transportation costs and existing capacity constraints.

Labor market frictions arise from disequilibrium

Total Employment vs. Trend

Indexed to January 2008



If they were only grappling with a shortage of goods, many consumer and retail companies may be less worried about future prices. Goods consumption increased dramatically in the first half of 2021 and this pace of increase, and the corresponding price pressure is unlikely to last. However, the current labor market frictions are proving an incremental source of concern for business leaders. Organizations are experiencing elevated turnover–not just in store labor, but for corporate jobs as well. Workers are emerging from the pandemic wanting to maintain greater work-life balance. Many skilled workers are switching jobs and capitalizing on the war for talent by seeking higher paying opportunities, putting additional pressure on companies to raise wages in order to retain existing workers.

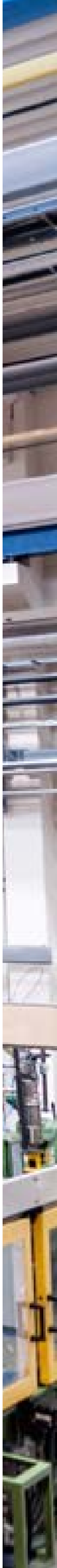
While there is still what economists deem an "unemployment gap" (i.e. the gap between the current number of people employed and the trend trajectory), wages are rising faster than inflation for many businesses. In prior recoveries, so long as the output gap remained, wage pressures were low.

Most recently in the post-Global Financial Crisis expansion, even after the unemployment gap was closed, wages were slow to rise. This is because the long expansion caused more people to enter the labor market, which is one of the factors that helped keep wage pressures subdued. Economists expect that at least 50% of the record number of people who retired and left the labor force during the pandemic will return to work.

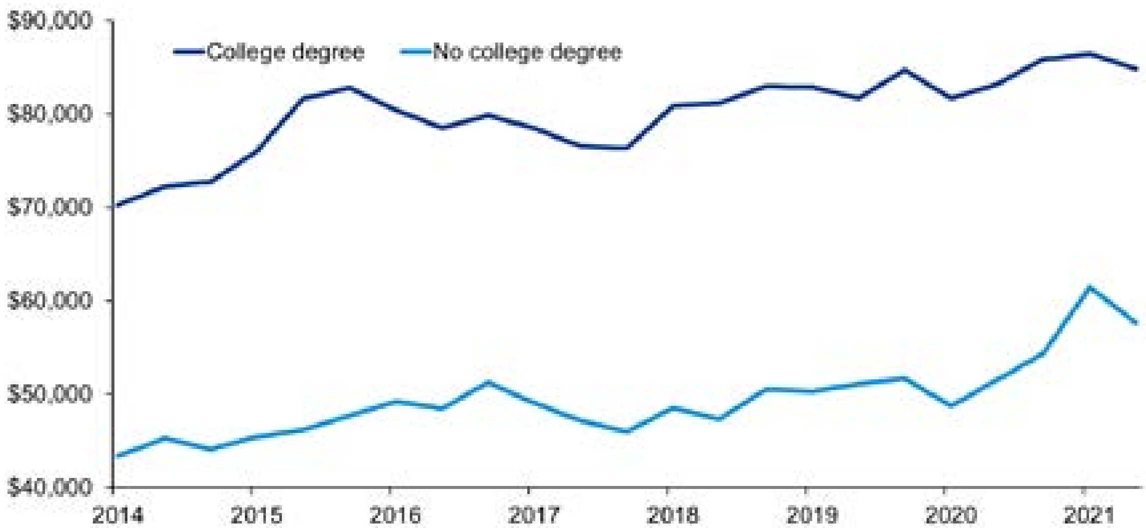
One key factor holding back labor force participation is the availability of childcare. A variety of factors including the inability to vaccinate children under the age of 12, workers changing professions, wage rate and stressful pandemic working conditions are all contributing to the shortage of childcare workers. While economists do expect things to return to normal eventually, it could take over a year for these vital services to return to normal. Lack of childcare and continued health and safety concerns holds back labor force participation.

When looking at data from past pandemics one key feature of the post-pandemic economic landscape included rising real wages due to the labor shortages (via death or people moving/changing jobs or leaving the labor force).[5]

[5] Longer-Run Economic Consequences of Pandemics, April 2020, NBER, Jorda, Singh, and Taylor.



Reservation Wage: Average lowest wage respondent willing to accept for new job



The rise in wages occurred during pandemics but not after wars, which often saw similar or greater loss of life. What explains this difference? In addition to a smaller pool of labor due to loss of life, workers' reservation wage, which is the lowest wage at which they are willing to work, may have changed after pandemics.

In the aftermath of the current pandemic, examining data from the New York Federal Reserve on the wages that workers are willing to accept helps explain this. For example, it is puzzling that wage pressure is coming mostly from the portion of the labor market that has the most elevated slack—i.e., workers who must work from their job site and where the unemployment rate is 4.5 percent.6

The seemingly low unemployment rate which would normally be a good sign can be attributed to a decline in labor force participation in September. For those without bachelor's degrees the labor force participation rate fell by 0.6 percent, due largely to the Delta variant of the virus.

According to the latest New York Fed survey released in early September, these workers, who tend to be those without bachelor's degrees, are demanding, on average, a 16.5 percent increase from pre- pandemic wage levels. Meanwhile, the approximate 32 percent of U.S. workers who can work from home and who tend to have bachelor's degrees, are demanding a more modest 2.9 percent increase despite having an unemployment rate of 2.5 percent, which suggests very little slack.

This data goes against the findings from the so-called Philips Curve, which suggests there is less wage pressure when there is greater unemployment.8 This deviation from what one would expect, even with a weak Philips Curve relationship, is likely explained by the risks and difficulties brought on by the pandemic for workers engaging in in-person work. This pattern of the data since the onset of the pandemic confirm that the frictions are largely pandemic related.

Currently, 75% of the working age population is vaccinated.9 The higher percentage is certainly welcome news although the pace of new vaccinations is slower than when vaccines were first rolled out. In recent months, the rate of increase has slowed, and this pattern appears to be sustained despite the rollout of vaccine mandates. At this juncture, some companies are considering offering a carrot, in addition to a stick when it comes to vaccinations. For organizations where a number of workers remain unvaccinated payments for those who are already vaccinated and those who get vaccinated may be enough to entice more people to get vaccinated.

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[6] KPMG Economics Calculations, Bureau of Labor Statistics September 2021 Nonfarm Payroll Report

[7] K-12 School Reopening Trends week reports (mid-May through mid-June). burbio.

[8] From the work of A. W. H. Phillips's study of wage inflation and unemployment in the United Kingdom from 1861 to 1957

[9] CDC, October 19, 2021

The pandemic has created increased responsibilities related to health and safety of workers in plant locations, stores, and restaurants, including the challenge of effective social distancing. Furthermore, the expansion of customer channels, including buy online pickup in store (BOPIS), ship from store, curbside pickup or carryout have increased store and restaurant employee responsibilities, further adding to employer and employee challenges.

All these industry sector dynamics contribute to the task of finding labor and managing through the wage rate inflation. While we view many of the wage increases as a step-change in the wage level demanded, certain sectors such as trucking suffer from longer-term structural factors that will likely put upward pressure on wages for the next several years. Post-pandemic, we expect that workers with less than a bachelor's degree, most of whom must work at their job site, will be expecting wage increases more in line with inflation. Additionally, as the expansion continues companies should anticipate the possibility that a tight labor market for those with bachelor's degrees could lead to greater wage pressure among certain highly sought-after skill mixes.

Consumer inflation expectations signal willingness to accept higher prices

Commodity prices and U.S. inflation expectations

Recent intensifying of cost-push inflationary pressures for retailers does not necessarily mean tighter margins. A rebounding economy and three historic rounds of fiscal stimulus have left household balance sheets in a strong position, and demand for food, beverage, and retail goods should remain firm even if consumers shift more spending towards services. Additionally, consumers' expectations of inflation over the next year have been rising steadily indicating a willingness to accept higher prices at the register, which should be welcomed news for retailers.

Consumers are definitely demonstrating a willingness to accept price increases over the last several months. This was evident from the results of a recent KPMG survey of consumers. In Fresh Start: Consumer Pulse Survey Back to School 2021, consumer respondents said they expected to spend 9 percent more on their back-to-school purchases. Approximately 39 percent of respondents prepared to do so believed items will be more expensive, followed by 29 percent that cited a need to replace more items.

Consumer willingness to accept price increases has been welcome news for consumer and retail businesses. Consumer goods companies and retailers are much less likely to discount versus historical periods as they are concerned about tight inventories and lack of ability to restock due to how the pandemic is impacting supply chains.

Many realize that certain footwear and apparel-producing countries (i.e., Vietnam), where production demand has increased in recent years, have been hit hard by the Delta variant and forced to shut down production for extended time periods. This dramatically increases the risk of inventory shortages over the next six months. If this is the case, they could miss an entire season of products produced in certain high-risk countries. As a result of the inventory shortages and increasing customer demand, there is likely going to be much less promotional activity, which also preserves margins to cover higher input costs.

Conclusion

Industry professionals largely view the recent rapid pace of price growth as transitory, meaning that the rise in price is state-dependent and not dependent on structural shifts in the economy such as demographics or the advancement of technology. The state that is most influencing prices is the pandemic and its aftershocks, demand surges and supply constraints.

Still, much is uncertain; shortages of labor and equipment in the transportation sector, and continued virus outbreaks have the potential to elongate the time period that the pandemic impacts the economy. Additionally, some longer-term price pressures are also present in the labor market as it will take time for those who left the labor force to return.

That said, economic slack persists in the global economy and, at some point, new production lines and innovation will limit cost growth. In the meantime, households are in relatively good financial health and consumers expect prices to go up in the near-term, signaling a willingness to accept higher pass-through pricing, which should help margin pressure.

What does this mean for businesses in the consumer and retail sector?

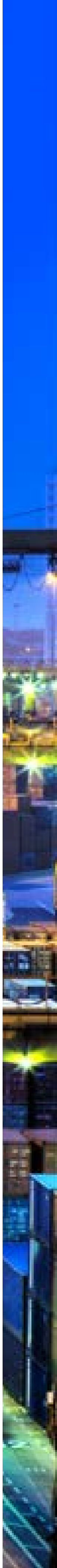
Given the uncertainty surrounding the labor market, supply chains, and pricing, consumer and retail companies should be thinking about how to manage the impacts on their businesses' bottom lines. The pandemic resulted in a number of common performance improvement triggers being activated, and a number of levers that can be pulled to counteract negative financial performance.

Longer-than-expected labor shortages and wage increases, constraints on supply chains, and price inflation should not necessarily lead to demise for businesses that proactively manage their cost and revenue structures to protect margins.

How KPMG can help

KPMG Elevate helps consumer and retail businesses quantify the financial impact of these dynamic factors and use this data to develop a precise plan for rapid performance improvement. Through a proprietary set of analytical tools, we identify and prioritize our clients' most valuable opportunities, and establish a roadmap to expand profits.

Elevate focuses on both commercial opportunity and cost effectiveness. Commercial opportunity, or growth-oriented initiatives, focus on accelerating profitable growth through geographic, customer, channel, or product expansion. Cost effectiveness targets inefficiencies in the P&L to drive greater scale and expand margin rates. We work side-by-side with clients to define, develop and accelerate value creation across both commercial opportunities and cost effectiveness. Given the external pressures from the imbalanced labor market, supply chain constraints, and increasing prices now is the time to take a fresh perspective to optimize performance in this transitory period.



Client Story

Our client, a global manufacturer and retailer, challenged us to help improve their EBITDA by quantifying profitability across 40+ countries, a portfolio of 15+ brands, and 10 product categories with numerous channels and customer profiles.

The issue of disparate reporting systems prevented clear line-of-sight into profitability drivers and increasing costs. Additionally, COVID-19 had significantly impacted client's sales; near-term sales forecasts were expected to be 40% lower than pre-COVID levels.

KPMG took on the challenge, analyzing 5 years of global point-of-sale, ecommerce, and wholesale transactions; partnering with HR, Data & Analytics departments, and working with more than 50 executives from around the globe to conduct over 50 workshops.

The analysis was built from the bottoms-up, combining transaction level detail with trial balance, employee census and indirect spend data to construct a fully allocated global financial model. The client used these insights to develop and implement a range of EBITDA improvement opportunities, including growth strategies, margin improvement initiatives and cost reduction activities. The company dramatically improved profitability and continues to accelerate performance with a refocused business and operating model.

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