

# UPSIDE ECONOMY 2014 ON STAGE

By Ramona Dzinkowski

While CFOs are generally bullish on their prospects for 2014, they are concerned about currency volatility, uncertainty around interest rates, the potential for rising healthcare costs, and flat or falling commodity prices.

Given the number of global economic forecasts for 2014, it isn't always easy to uncover the main plotline for the year to come. It may be even more difficult to figure out how and how much these predictions will affect management accountants and other financial professionals in companies across America. On one hand, companies are optimistic about revenue and sales growth, yet they're concerned about rising healthcare costs and weak consumer demand, particularly with the slowdown in growth in emerging markets and continued economic weakness in Europe. On the other hand, currency volatility in emerging markets, the increasing strength of the U.S. dollar, the expectation of flat and falling commodity prices, and uncertainty around the timing of a rise in U.S. interest rates have finance managers scratching their heads.

What does all this mean to corporate managers in America and, ultimately, the bottom line?

To untangle the general plot for 2014 and to synthesize what the economic outlook holds for senior finance executives in the months ahead, let's take a look at insights from some of the world's leading think tanks, the results of surveys of hundreds of CFOs across America, and an exclusive interview with renowned forecaster Dr. Nari-man Behraves, chief economist at IHS (formerly Global Insight).

## A Pretty Good Year So Far

Generally speaking, aside from the bumpy start for global equity markets early in the first quarter, the outlook for the remainder of 2014 is favorable, with predictions for global growth ranging from 3.0% to 3.5%. (The International Monetary Fund (IMF) is slightly more optimistic than most, forecasting a 3.7% rise.) While growth in emerging markets is anticipated to be slower than the boom of previous years, companies targeting sales in the region can still expect favorable conditions with predicted growth of 5.1%. Emerging Asian markets (China, India, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam) continue to hold opportunities for U.S. companies, with growth in China—although slowing from past trends—leading the region once again, at 7.5% year over year. The longer-term trend for emerging Asia is also positive, according to an Organisation for Economic Co-operation and Development (OECD) outlook, with expectations for growth of 6.9% annually between 2014 and 2018.

For companies with significant exposure to European markets (approximately 17% of U.S. exports are destined for the European Union (EU) countries, and total U.S.

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investment in the EU is reported to be three times higher than in all of Asia), the story is less bright for 2014, the IMF reports. Although policy actions have reduced major risks and stabilized financial conditions, gradually pulling the euro region out of recession, growth in economic activity is expected to limp along at 1%—though that represents an improvement after two years of negative growth. (For more information about the IMF *World Economic Outlook* of January 2014 and April 2014, visit [www.imf.org](http://www.imf.org).)

According to the latest European Commission statistics, growth in 2014 will be strongest in Latvia (4.1%), whose biggest export is refined petroleum. The Baltic States generally will outperform the region as a whole, but much of the recovery can be explained by Germany, as it plugs away at an anticipated 1.7% (which is a touch more optimistic than IMF forecasts).

Companies relying on consumer demand will continue to feel the pain of high unemployment in the region. The Commission predicts that employment in the Eurozone will remain flat for the coming year at a disappointing 12.2%. This compares with the marginal improvements expected for the U.S. and the U.K., with unemployment rates decreasing to 6.9% and 7.5%, respectively, in 2014.

## The EU and America: FAST FACTS

- ◆ Total U.S. investment in the EU is three times higher than that in all of Asia.
- ◆ EU investment in the United States is approximately eight times the amount of EU investment in India and China combined.
- ◆ It's estimated that a third of the trade across the Atlantic consists of intracompany transfers, such as vertically integrated companies that sell inputs to divisions across the enterprise.
- ◆ Either the EU or the U.S. is the largest trade and investment partner for almost all other countries in the global economy.
- ◆ The EU and U.S. economies together account for about half of global gross domestic product (GDP) and nearly a third of world trade flows.

Source: European Commission



**Table 1: Top Concerns for U.S. CFOs in 2014**

RANK	EXTERNAL ISSUES	INTERNAL ISSUES
1	Consumer demand	Ability to maintain margins
2	Federal government policy	Cost of healthcare
3	Price pressure from competitors	Attracting/retaining qualified employees
4	National employment outlook	Ability to forecast results
5	Federal budget deficit	Maintain morale/productivity
6	Financial regulation	Working capital management
7	Credit market/interest rates	Managing IT systems
8	Global financial stability	Balance sheet weakness
9	State or local government budget deficits	Cost of nonfuel commodities
10	Cost of nonfuel commodities	Data security
11	Corporate tax rates	Protection of intellectual property
12	Potential for stock market correction	Pension obligations
13	Foreign competition	Counterparty risk
14	Environmental regulation	
15	Cost of fuel	
16	Global political instability	
17	Inflation	
18	Currency risk	

Source: Duke University/CFO Magazine Global Business Outlook Survey, December 2013.

## U.S. CFOs Are Fairly Bullish . . .

Against this backdrop, the U.S. economy continues in recovery mode, with companies reaping the benefits in the form of increased revenues and more favorable cash flows while taking the opportunity to make capital investments in research and development (R&D) and productivity-improving technologies. CFOs are generally bullish about their prospects for 2014, according to the latest Ernst & Young CFO Capital Confidence Barometer, with 60% of senior finance chiefs believing that the global economy is improving.

In its 2014 CFO Outlook of mid-market companies, Bank of America Merrill Lynch reports that more than half of all companies it surveyed predicted higher sales in 2014 than in the previous year and that almost all com-

panies would be implementing some form of growth strategy to capitalize on improving economic conditions. The vast majority of CFOs (82%) said that their companies were planning to increase market share by selling more products and services to existing customers, followed by 77% who indicated they would be targeting new customers or markets.

Similarly, according to the latest Duke University/CFO Magazine Global Business Outlook survey released in December, all U.S. finance chiefs' expectations for earnings growth, spending, and cash on the balance sheet were higher for 2014 than in 2013 (see Table 1). The biggest uptick in growth is expected for cash on the balance sheet, with an average increase of 7.4% in 2014 compared to a mere 0.6% in 2013. Capital investment is

## Interview with Nariman Behraves, Ph.D.

**Nariman Behraves** is chief economist of IHS (formerly Global Insight). He's responsible for developing the firm's economic outlook and risk analysis for the U.S., Europe, Japan, China, and other emerging markets. In addition, he oversees the work of more than 400 professionals located around the globe, who cover economic, financial, and political developments in more than 200 countries. Dr. Behraves was ranked as one of Bloomberg's Top 10 economists for 2009 and 2010.



**IMA:** In terms of specific industries, where do you see the good news and bad news residing for the next year?

**Behraves:** In the case of North America, energy is huge...expect a huge boost to growth for that sector and companies that serve it downstream, in places like chemicals and, more generally, manufacturing. Clearly, this is reflected in the investment and jobs growth that we're seeing in the U.S. natural gas sector and in oil in Canada,

specifically in the Tar Sands in Alberta. If you put both these direct and indirect effects together over the last five years, for example, the unconventional oil-and-gas sector alone has generated somewhere in the order of 1.5 million new jobs, and we expect another 1.5 million in the coming five years. Commodities, however, aren't going to be the darlings that they have been for a while, as growth, particularly in places like China, slows a bit. Any gradual strengthening in demand in the coming year will be balanced out by either higher production or the drawing down of ample inventories.

**IMA:** What will be some of the drags on the U.S. economy in 2014?

**Behraves:** Companies have a lot of cash, but they're being very careful how they spend it, and they're hiring very gradually. The fact that there has been a lot of policy uncertainty in the U.S. and Europe has made them very risk averse, increasing their desire to hold cash as a cushion. Consequently, slow jobs growth will probably persist to the end of this year. There's also the increase in part-time workers, rather than having full-time workers, because of the cost of the new U.S. healthcare law. Furthermore, companies will remain kind of skittish in 2014. They're worried about policy uncertainty with respect to quantitative easing. It's not so much that this is going to kill the economy—it's just going to be one more thing that prevents the recovery from gaining a lot more momentum.

**IMA:** What are some of the downside risks in 2014?

**Behraves:** The oil price story is the obvious wild card. I think probably the biggest worry is about some geopolitical shock that would affect oil prices. For example, if some event were to happen in the Middle East—let's say Iran closes off the flow of oil—then you're looking at \$200 or \$250 a barrel. That would kill the recovery in the U.S. and the global economy. What's the probability of that? I'd say certainly no more than 20% to 25%, but it's the one thing that could push us back into recession.

**IMA:** Taking a more global view for a moment, what are the biggest growth drivers?

**Behraves:** Clearly those countries that have had big housing busts are now seeing recovery in the construction industry. In Brazil, for example, there's a construction boom. Infrastructure is another one where obviously a lot is going on already, and there's more to come. In other industries, in terms of the developed world, healthcare is big, despite the rising costs. Again, aging populations are creating a growth industry. And then there's always the high-tech sector...very dynamic, huge growth there, and it's changing rapidly in ways that some of us wouldn't have foreseen even a couple of years ago. For example, PC use is falling, and tablets and smartphones are on the rise. In the developing world, in places like China and India, the automotive sector is going to be very strong because there's simply a lot more people who will be able to afford to buy cars.

expected to grow by 7.3% compared to 2.5% in 2013, with spending on technology and R&D growing by 5.6% and 2.3%, respectively. Meanwhile, there's potential for cost savings in general as companies increasingly use temporary and outsourced employment to facilitate revenue growth.

### **. . . But Not All of the News Is Rosy**

For those trying to steer their companies through the twists and turns of the global economy in 2014, the plot thickens. The main protagonists attempting to sour the happy ending for many companies are currency volatility and its partners: uncertainty around interest rates, the potential for rising healthcare costs, and, for some firms, flat or falling commodity prices. Currency volatility—particularly for those companies with large exposure to emerging markets—can cause havoc to cash flows and, by extension, operating profit. Companies are reducing their foreign exchange exposure in a variety of ways, including

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hedging cash flows just long enough to pass through product prices in local currencies. At the same time, companies have responded to uncertainty around rising interest rates by locking in existing rates. According to a December 2013 survey of senior finance executives by the Association for Financial Professionals (AFP), 55% of companies took action in 2013 to hedge against rising rates. Of those, more than half refinanced long-term debt, and 28% locked in rates with swaps or options.

For U.S. CFOs specifically, according to the Duke University survey, things that may keep them up at night throughout 2014 include the strength of consumer demand, federal government policies around quantitative easing, increasing price pressures from competitors, and the domestic outlook for employment. Of least concern to U.S. finance chiefs are changes to environmental regulations that would impact their business, the cost of fuel, global political instability, and inflation.

When CFOs were asked what concerns them most about managing their companies effectively, the same study

found three common threads in every region of the world: the challenge of maintaining profit margins, the difficulty of hiring and retaining qualified employees, and worries about employee morale and productivity. Not surprisingly, internal management challenges varied according to where you sit. European companies, for instance, were worried mainly about balance sheet and liquidity weakness. Brazilian CFOs were concerned about inflation, U.S. companies indicated rising healthcare costs as a major issue, and Japanese CFOs were challenged with the uncertainty around forecasting corporate performance in 2014.

### **Healthcare Costs Remain a Concern**

In 2014, healthcare costs will continue to be a ball and chain on profitability in the U.S., with expected increases of 10.2% over the previous year. In fact, anticipated cost increases because of the Affordable Care Act (ACA) are causing companies to rethink their employment strategies. As the Duke University/*CFO Magazine* survey shows, nearly half of U.S. companies were reluctant to hire full-time employees, roughly 40% of CFOs said their companies may switch some jobs to less than 30 hours per week, and 44% of companies are considering reducing health benefits to current employees.

According to Alex Davern, CFO of National Instruments, the ACA has increased the company's healthcare costs by an estimated 15% per active employee and more generally is putting pressure on employers to reduce existing benefits and has created an environment of "adverse selection." As he explains, "We now have to cover our employees' adult children under the age of 26. So the challenge that this creates for a company like National Instruments, which has a history of providing very good benefits, is that even though these adult children may be working somewhere else that provides poor health coverage or none, they'll choose to be on our healthcare plan. That means that we as a company, if we choose to provide very good healthcare benefits, have to take on the healthcare burden of other employers. As more and more employers exit employer-based healthcare, this adverse selection problem becomes a bigger and bigger challenge."

As you can see, when the curtain closes on 2014, risk management will be the star of the show...once again. **SF**

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