Inflation and Rate Changes in 2022

Implications and responses for corporate treasurers

Inflation continues to rise at record rates, with a painful spike in consumer prices not seen in forty years. Consumers, governments, corporations and investors have all been adjusting to new considerations: forecasts of global liquidity, higher rates of inflation and labor market data. Nonetheless, the essentials of inflation don't falter; as always, it hinges on supply and demand.

Let's take a closer look at the levers that can be adjusted in response to current conditions — as well as what to expect.

Components of today's inflation rate

Supply has been severely disrupted as a result of COVID-19, and now made more complicated by geopolitical conflict. Supply chains are going to take time to recover to where they were pre-COVID-19, and it's possible that some of these disruptions will be permanent and will need to be rebuilt or resourced. Consumers and businesses may need to consider sourcing alternative products to avoid delays and higher prices.

Demand increased significantly due to COVID-19 and supply chain issues. This led to a significant fiscal policy response, especially in the U.S. That was supplemented with a forceful monetary policy response, including direct checks to individuals and support for businesses. These delivered a strong economy that is currently operating above trend and is expected to continue for some time, certainly for the remainder of this year and well into the early parts of next year.

The Fed's response

It is challenging for central bank policy to directly affect the supply side of the economy, but it can help cool demand. Tightening financial conditions helps to bring supply-demand equilibrium back into better balance. It has two tools at its disposal to achieve this:

1. Increasing the level of overnight interest rates, thereby increasing interest rates broadly. The Fed will adjust the amount and timing of its rate increases based upon responding economic conditions and inflation. As expected, the Fed started raising interest rates the week of March 16, 2022, and will continue to do so depending on how the economy responds.

2. Reducing the size of its balance sheet — *quantitative tightening* (QT). Running down the size of its balance sheet means that the Fed is going to be tightening. This will be done slowly and methodically.

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Corporate treasurers should consider:

For companies with significant debt, **financing costs will increase**. But for companies carrying record levels of cash on their balance sheet (thanks to government stimulus and monetary policy in the last two years), increased global interest rates **could mean an investment opportunity**. This is an option for the cash hoarders that haven't seen much return or yields on those balances in the last two years.

These conditions are not an isolated event to a particular country. For multinationals often dealing with as many as 30 different currencies, it can be challenging to keep up.

Our recommendations:

1. Stay close and connected to your banking partner. It's our business to monitor markets and stay on top of what's going on.
2. Be prepared for all sorts of different inflationary and market scenarios, and be ready to revise forecasts. A forecast done in December probably is already outdated, given all the shifts in the various yield curves and central bank expectations.
3. Leverage technology to your advantage. The more accurate cash flow forecasting is, the more prepared you're going to be for your liquidity needs and your ability to react to central bank moves.

Segmentation and liquidity

Inflation brings risks and opportunities for many companies. Much depends on the specific situation, but good, prudent treasury management is the best strategy to mitigate the impact of inflation. Most depends on how the balance sheet is constructed and what its composition is.

Consider these options:

- **Segment your cash portfolio** and find the right option for each segment or each bucket: day-to-day operations, medium-term needs and longer-term strategic requirements.
- **Maintain liquidity**. Anticipated rising rates, geopolitical concerns and broader market volatility are making clients cautious.
- **Extract the most value of cash** by using solutions like the earnings credit rate product in the U.S., which allows a fully automated way of offsetting bank and treasury fees.

Contact your Bank of America Liquidity professional to discuss these topics and more.

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