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Q&A with Luke Templeman

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In our latest edition of “Q&A with”, Luke Templeman, Thematic Research Analyst, shares his view on the implications of rising wage costs, greater political instability and higher interest rates for corporates.

Q: What options do corporates have if rising wage costs become the norm?

A: Companies used to cut their labour costs by outsourcing. This is now difficult as the so-called wage arbitrage between countries, particularly between the US and China, has shrunk. Meanwhile, geopolitical and supply chain risks are tilting companies towards some form of nearshoring or localisation.

The short-term response is for firms to either absorb higher costs, pass them on, or downsize their workforce. Clearly, the former earns companies more social and political points, yet layoff announcements and labour cost pressures are starting to dominate corporate news headlines. Did the post-covid hiring spree go too far? For investors, metrics such as “revenue per employee” will become more significant. In the medium term, we might start seeing companies working to automate goods and services or at least make them less labour intensive.

Q: What does rising political instability mean for corporate profits?

A: There are two key issues here: investment policy and costs. For the former, political and geopolitical uncertainty is beginning to weigh on corporate investments as the range of outcomes of projects has broadened. Meanwhile, the increased frequency of “left tail” events means greater unpredictability and more sunk costs.

For corporates exposed to reshoring initiatives, in the semiconductors sector for example, dependence on government incentives may become a source of risk if geopolitical tensions continue to rise. That may curb the ambitions of other business plans.

Political tensions are also likely to keep commodity prices more volatile for longer and increase the risk of shortages. As a result, hedging may become more expensive. Other cost increases will come from shipping, labour and the consequences of potential expropriation. This will be especially relevant for firms with global supply chains, where local changes can ripple across global operations.



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Q: How will higher interest rates impact corporate profits beyond simply raising borrowing costs?

A: Higher rates will curtail M&A activity that has boosted profits over the last decade. In its place, managers are being forced to focus on asset turnover – that is, generating more sales from existing assets. Higher rates also increase the discount rate, which decreases the value of goodwill and other intangibles purchased during a decade of acquisitions. Any write-downs will impact profits.

Higher interest rates also change investment and financing decisions inside firms. This may result in longer-term or riskier projects being abandoned, foregoing potentially high cash inflows and other benefits.

The movement against profit-generating capex is also being highlighted by markets. Investors are pushing for shorter-term returns, preferring dividends and buybacks over long-term projects that require large investment.

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