Mastering compound volatility

Strategies for business leaders to get through the next quarter—and the next five years

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Introduction

After decades of favorable and predictable business conditions, the U.S. economy has entered the age of "compound volatility." By this, we mean the combination of near-term volatility caused by disruptive events—the pandemic, inflation, war, natural disasters—and a series of powerful structural changes. Decades of easy money, plentiful labor, nearly friction-free global trade, and low inflation have ended. The coming years are shaping up to be a time of scarcity and high input costs, and according to economists, lower potential growth.

These structural changes raise the cost of doing business, limit degrees of freedom for strategic action, and reduce the margin for execution error. Layer on the likelihood of continuing disruptions—geopolitical clashes, another deadly virus, severe weather events—and you have compound volatility.

The short-term disruptions and long-term trends reinforce each other in unwelcome ways: when a disruptive event hits a slow-growth economy, the impact will be magnified—there is less cushion.[1] Supply-chain glitches in a time of weak demand will be more painful.

To prosper in the age of compound volatility, companies will need new approaches to strategy, planning, investing, culture and talent. Executives will need to operate simultaneously on multiple time horizons—to plan for and invest confidently in long-term strategies, remain flexible and agile enough to respond to surprises, and be prepared to take advantage of unforeseen opportunities.

As they adopt more agile approaches to strategy, leaders will want to make sure that they have also built resilience in supply chains, capital structures, critical processes, and their entire organizations. To win in this environment, risk management should become part of every decision, not just a checkbox or an organizational silo. Enterprise risk management (ERM) not only helps manage risks but identify viable new opportunities. Applying new technological tools like generative AI will help companies pick up early on signals of change, including growth opportunities, and enable new ways of working.

This paper explains the underlying forces behind compound volatility and how they shape the business environment. We lay out the implications for business leaders and offer some insights into how companies can maximize opportunities, manage risk, and deliver value amid unprecedented volatility.

[1] "World Economic Outlook," International Monetary Fund, April 2023

The rise of compound volatility

There is no reason to expect event-driven volatility to go away. We can't say what the next "black swan" event will be, but we should assume that a health emergency, weather disaster, bank failure, or armed conflict is a possibility. The top portion of the infographic on the next page shows the major disruptions of the past few years and how they have increased volatility on a range of metrics.

The GDP chart, for example, shows two decades of moderate, steady growth, interrupted by the financial crisis that brought on the so-called great recession. The recession was severe, but led to the longest recovery in U.S. history. The recovery ended dramatically with the deepest and fastest plunge in GDP since the Great Depression, as the global economy shut down in an attempt to contain the COVID-19 epidemic. Since then, GDP growth has careened dramatically, recovering rapidly after pandemic relief money hit the economy and restrictions were lifted—only to be hit again by the Russia-Ukraine war and the impact of surging inflation, which started with the supply-chain shocks of the pandemic.

Stock market volatility tells an even more dramatic story. Markets react not only to actual developments in the economy, they also react (negatively) to uncertainty about the direction of the economy. The chart of the VIX, an index that tracks S&P 500 options contracts, has been highly volatile since the pandemic, as uncertainty over the direction of the economy has grown. In 2020, the VIX broke 30 (considered a threshold for extreme uncertainty) for the first time since 2011. While economists debate the connection between the stock market and the real economy, researchers have shown a correlation between stock-market volatility and spending on business investment and consumption of durable goods.[2]

The producer and consumer price indices show how pandemic-induced shortages and surging demand after the 2020 lockdown set off inflation.[3] Since the mid-1980s, when the Federal Reserve finally brought inflation under control with draconian interest-rate hikes, inflation had remained tame in the U.S., thanks to many factors, including globalization.

The chart on global trade shows the impact of the pandemic—the biggest drop in world trade volumes since the Global Financial Crisis. It also shows the impact of the Russia-Ukraine war and continuing weakness. After decades of increasing international cooperation and expansion of free trade, the U.S. and other nations began adopting more protectionist policies, including punitive tariffs and retreat from multi-lateral trade agreements.

In the bottom half of the infographic, we lay out the important structural changes that, along with periodic disruptive events, define compound volatility. These structural changes—in the cost of capital, in global trade, in demographics, etc.—add up to a far more challenging business environment than business leaders faced before the volatility of the past few years. If there is a "new normal" emerging, it is very unlike what was accepted as normal for the past two decades.

[2] Burkhard Raunig, Jonathan Scharler, "Stock Market Volatility and the Business Cycle," Monetary Policy & the Economy, Q2/10

[3] The PPI, which measures input inflation for producers, is a leading indicator of the CPI as increases in production costs are often passed on to consumers.

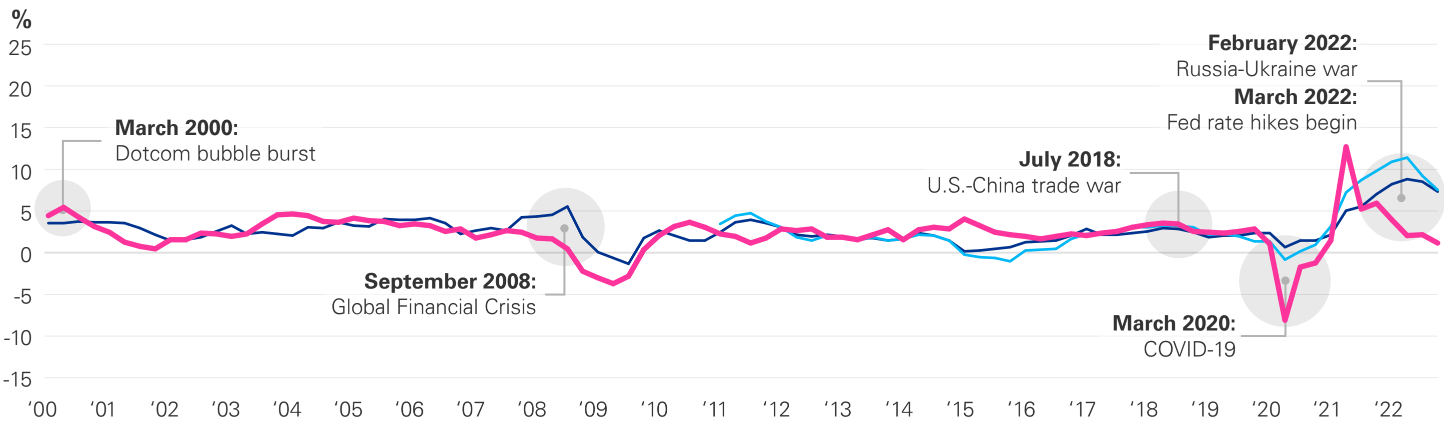
Disruption + structural change = Compound volatility

Disruptive events

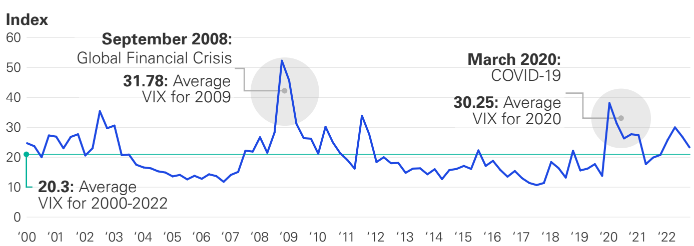
Real GDP Post-pandemic GDP growth has been even more volatile than in the periods after the Global Financial Crisis and dotcom bubble.

Consumer price index (CPI) Post-pandemic inflation was driven by spiking energy and food prices and the cost of many goods; the average price of new cars rose by 25 percent from 2019 to 2022.

Producer price index (PPI)* The PPI was stable for years before COVID-19; major supply-chain disruptions triggered a sharp increase.



Stock market volatility (VIX) The spike in volatility amid the multiple disruptions from the outbreak of COVID-19, U.S.-China trade tensions, and the Russia-Ukraine war almost matched that of the Global Financial Crisis.



Global trade Global trade began stalling with tough U.S. rhetoric on China and became more volatile post-COVID amid supply-chain disruptions.

Source: EIU, U.S. Bureau of Labor Statistics, S&P Capital IQ, CPB World Trade Monitor
*PPI data from the BLS prior to 2011 uses a different measurement model and was excluded.

Structural shifts

01 Sticky inflation.

Decades of tame inflation in the U.S. ended with the price spiral that began in the wake of the pandemic. The pace of inflation has slowed, but price pressures on labor and commodities remain.

02 High cost of capital.

The era of cheap capital has ended. Even if the Federal Reserve rate hikes end in 2023, interest rates are not likely to fall quickly, barring a massive recession.

03 Retreat from globalization.

Geopolitical and trade tensions are reversing decades of globalization, limiting market access, raising cost of inputs, and triggering onshoring and near-shoring of supply chains.

04 Slower secular growth.

The consensus for potential GDP growth in the U.S. has fallen to less than 2 percent, down sharply from the 3-percent-plus average in the 1980s and 1990s.[4]

05 Demographic shifts.

Aging, falling labor participation rates, and limits on immigration will continue to curb labor-market growth. Talent shortages will likely persist.

06 Natural disasters.

Severe storms, flooding, drought, and other effects of climate change are devastating communities and exacting a huge economic toll.

07 Energy transition.

Hundreds of billions is being invested to electrify transportation. To meet investor demands, companies are rethinking and adapting operating models.[5]

[4] Kevin Dubina, "Projections of the U.S. economy, 2021–31," U.S. Bureau of Labor Statistics, September 2022

[5] "Place your billion-dollar bets wisely: Powertrain strategies for the post-ICE automotive industry" KPMG LLP, 2021

What it means: more risk across the business

Compound volatility means new and compounding risks, which will need to be accounted for in strategy, planning, and investment. Higher cost of capital, for example, raises the risks for any investment. Internal hurdle rates will be higher, so projects will need to be more ambitious. Finding investments that pay will become harder.

Slower GDP growth means that organic growth in many industries will also slow. To achieve differentiated performance, companies may need to think about new growth strategies or move into faster growing businesses, both of which will increase risk. For example, complex cross-industry deals (e.g., an industrial company purchasing a tech company to acquire digital products and services) can be far riskier than traditional scale deals.[6]

Geopolitical risks are vastly greater than they were pre-pandemic. A ground war rages in Europe, U.S.-China relations are at their lowest point in decades, and there are increasing trade tensions between the U.S. and the EU.[7] This has huge implications for deciding where to play and how to play in global markets, and is forcing companies to rethink sourcing strategies to reduce risk and build resilience—but at a cost.

> The challenges of the new compound volatility environment also mean that there are greater execution risks.

Climate change is becoming a tangible business risk. Companies of all kinds need to become resilient to climate-change-related weather events and changes in the environment, such as rising sea levels and more frequent and destructive storms. To meet investor demands and, soon, U.S. Securities and Exchange Commission requirements, publicly traded companies will have to report on their carbon-reduction efforts.

Digital transformation is no longer an option. Advances in technology will continue to enable new business models, redefine jobs, and streamline business processes. Our clients now believe that successfully deploying generative AI could quickly become a critical competitive advantage.[8]

[6] "Navigating complex M&A," KPMG LLP, June 2022

[7] "Europe can't decide how to unplug from China," The Economist, May 15, 2023

[8] "KPMG U.S. survey: Executives expect generative AI to have enormous impact on business, but unprepared for immediate adoption," KPMG LLP, April 24, 2023

New approaches to business strategy and planning

To manage through compound volatility, a useful first step is to get over the idea of a "new normal" steady state on which to build long-term strategy. Yes, organizations need long-term plans and goals. They need to be able to make big bets and invest in the future. But strategy may need to be more fluid and continuous, too. Leaders may need to be open to new ways of tackling problems.

Standard approaches to managing costs, for example, may not suffice when offshoring and outsourcing are less attractive options and when employers must consider the talent shortage when contemplating layoffs. When financing is expensive and hurdle rates are high, standard portfolio moves—bolt-ons to add scale—may be less effective than "transformational" deals that help companies digitize their businesses or move into faster-growing markets.[9]

Amid compound volatility, companies may need to hedge long-term bets with smart and timely tactical moves to power through disruption or seize sudden opportunities. These include game changers like generative AI or discrete projects to make a particular process run better.

In the following pages we look at some of the adaptations we believe that business leaders will need to make to thrive in the face of compound volatility. These changes begin with strategy and planning and include enterprise risk management (more important than ever), new thinking about investments, an acknowledgment that transformation will be a continuous activity, and ways to manage culture and talent that fit the times.

[9] "Navigating complex M&A"

Flexible strategy and planning processes to generate momentum

The typical "five-year strategic plan + three-year refresh + annual review" approach will no longer be adequate. Leaders will still need to craft long-term strategies and commit significant investment and resources to see them through. To remain competitive, companies will need to transform operating and business models acquisitions, divestitures, automation, cost, and business transformation.

However, strategists will have to simultaneously operate on a shorter time horizon, too. In this environment, small and quick bets—"micro-commitments"—make more sense. Speed is essential: small deals, minority investments, and partnerships can help companies address specific challenges and priorities quickly.

Make risk management a reflex and institutionalize risk response

As noted, the era of compound volatility is inherently riskier. By embedding ERM across the organization—rather than using ERM as a stand-alone function—companies can build risk assessment and mitigation into strategy and operations. Use ERM to understand the costs and trade-offs of building greater resilience—to calculate the costs and benefits of investing in redundancy or "reshoring" to bolster supply-chain resilience.

To anticipate and respond to sudden changes—another disruption—build early-warning systems that can separate the signals of change from the noise of daily operations. In response to the pandemic and the Russia-Ukraine war, many companies built formal systems and rigorous plans for rapid response to disruptive events. Some created committees and SWAT teams to guide emergency responses.[10] It will pay to keep these capabilities in place.

Recalibrate investment strategies for a time of tighter money

Higher cost of capital may persist for years. This will not only require more careful capital management at all times but also adjustments to investment strategies. Higher borrowing costs mean higher hurdle rates, higher internal rates of return, and greater risk. When money was cheap, companies could entertain internal projects or deals that had a modest return. Now, only projects that can beat today's higher capital costs can be justified. It also means revisiting projects in the pipeline, including technology investments, to make sure they are still accretive. Viewing investments through the lens of ERM will allow you to invest with confidence.

In this environment, the markets will be looking at how companies are shaping their portfolios of businesses to maximize value. Business leaders should ask the hard questions: "Are we still the best owners of this business?" "Can we reshape our portfolio by divesting this business and adding others more aligned with our unique ability to create value?" Acquisitions may also be more challenging, both because of higher cost of capital and because of greater complexity. To pay off, deals will likely require both significant revenue and cost synergies.

[10] "Russia-Ukraine war: Building resilience amid radical uncertainty," KPMG LLP, 2022

Learn to manage continuous transformation

The pace of change in business forces companies to invest in transformation programs that help them streamline business processes, develop better ways to connect with customers, and drive growth. Compound volatility will likely require even more adaptations. In a recent KPMG study, 60 percent of business leaders who are involved in leading transformations said that in their organizations transformation has become continuous. On average, they are running three transformation projects simultaneously and projects are becoming more complex.

This means that transformations may need to be more agile—testing and failing and redesigning in flight. And they need to be properly managed and orchestrated so that one project does not interfere with another and all projects get adequate resources and oversight. Successful transformations also need to be driven by a clear strategic vision and consistent and visible leadership from the top. In our survey, respondents agreed that the No.1 reason that transformations come up short is "lack of alignment with other transformations and strategic initiatives."

The importance of good governance

An industrial manufacturer with an ambitious set of transformation initiatives across its manufacturing, supply chain, finance, procurement, and aftermarket functions needed a common way to govern the resulting changes. Each initiative had a potential impact on one or more existing processes, and there was an inherent risk of overlap or conflict.

We helped the client to establish an enterprise-wide taxonomy and operating model framework that provided the structure to assess the impact of each change in the context of all initiatives rather than in isolation. This in turn provided the foundation for effective governance while allowing autonomy within each program.

People and culture issues are more important than ever

The changed business environment resulting from compound volatility places fresh demands on organizations. Companies need to foster a culture that embraces change and encourages people to pursue innovative thinking and take risks. Experts are predicting that the adoption of generative AI will have widespread impact on organizations—even if the technology is used to augment rather than replace talent, many jobs will likely be redesigned.[11] Companies will have multiple transformations. Leaders will need to help their people embrace change—and protect them from change fatigue and burnout.

These organizational challenges will play out in an environment of talent shortages. Labor markets are tight and the supply of new workers is not keeping up with retirements and labor-market exits. And post-pandemic, employees have different expectations about flexibility and finding value and meaning in their work. All this suggests that companies still need to refine how they hire, retain, and deploy talent to create an enduring culture of excellence.

Organizations can also become more "connected" and responsive—using technology and data to connect people within the organization, work more efficiently with partners, and create better user experiences for customers. In a connected organization, front, back, and middle office functions are connected and data silos are eliminated. Organizations have been delayered and decentralized. Now they need to be connected.

Even if a recession occurs in the near term, the long-range outlook is for continuing competition for scarce talent and capabilities.[12] To attract and retain talent, companies may need to look at how roles are designed and work is assigned. Employees want more flexibility, opportunity, and meaning in their jobs.

An engaged, empowered, committed workforce will be more productive and capable of the creative problem solving that a volatile environment requires. More work may be done in agile teams, rather than in fixed departmental roles. Companies may need to invest more in training and building career paths.[13] For example, train everyone to be more technology-savvy to ensure that the speed from idea to execution is best in class.

Pay particular attention to supply-chain issues

Companies have worked through the severe supply-chain problems caused by the pandemic and the Russia-Ukraine war. But building long-term supply-chain resilience is still a priority. Geopolitical tensions, particularly between the U.S. and China, remain high and companies still need to consider how to adapt to a world with more obstacles to global sourcing and trade.

For three years, leaders have focused on supply-chain triage—solving for the problems caused by disruptive events. That has diverted attention from the day-to-day work of improving supply-chain efficiency and not allowed leaders to focus fully on the long-term work of rearranging supply chains for the new business environment.

Disruptions of the last few years to supply chains have started to settle down but are far from over, requiring companies to continue building much greater resiliency. Near-shoring, reshoring, right shoring—whatever you're calling it, you're still trying to figure out the best option to build the right flexibility and redundancy into your supply chains. You need to have more visibility despite the potential cost. In a world where competitors set the bar for the right product or service right now, those who delay delivery or make that customer journey unpleasant will lose market share to those that have built more robust supply chains.

[11] "Generative AI: From buzz to business value," KPMG LLP, 2023

[12] "A recession won't close the talent gap," KPMG LLP, February 2023

[13] "Clearing the career path: How employers can fill their talent pipeline from within," KPMG LLP, 2023

Getting started

There are several things companies can do now to lay the groundwork for the changes they may need in strategy, planning, and operations. Here are some possible no-regrets moves to consider:

1. **Strategy review**. Review strategic plan in the context of compound volatility. What are the most likely future disruptions to plan for? What are the risks that were not accounted for in the original plan? How resilient is the strategy in the face of disruptions? How do your current investments stack up against your current hurdle rate? Should some projects be stalled, or should they move forward?

2. **Update ERM**. Revisit risk assessments and apply ERM more broadly. Build mechanisms for handling disruptions.

   - **Build an early warning system**. Look for ways to use data analytics and artificial intelligence to improve the organization's early warning system. Can you use historical data to help predict and detect disturbances in your markets?

   - **Make resilience a function**. In these times, companies must thoughtfully determine where to invest in resilience, not just optimize cost. To prepare for disruption, companies can also create SWAT teams that are staffed, trained, and equipped with playbooks to respond to disruptive events.

3. **Accelerate key transformation efforts**. Organizations typically have multiple transformation projects under way. Make sure to prioritize the ones with the greatest potential impact and give them the attention and resources needed to be completed successfully and start delivering value.

How KPMG can help

We work closely with clients across every step of the transformation journey. With deep industry knowledge and experience, we deploy an integrated, cross-functional business transformation approach designed to optimize performance, digitize processes, and seek growth while navigating economic volatility and rapid market shifts. Whether it's working with the latest technology, integrating an acquisition, or adapting the business model to new challenges, we thoughtfully address our clients' concerns about transformation to avoid common pitfalls and ensure success.

In our experience, successful transformations have four elements in common:

Focus on value. We know that companies focus more than ever on value when undertaking transformations. We put value at the center of everything we do, always balancing risk and reward. We carefully monitor and orchestrate multiple transformation projects to ensure successful execution and value capture.

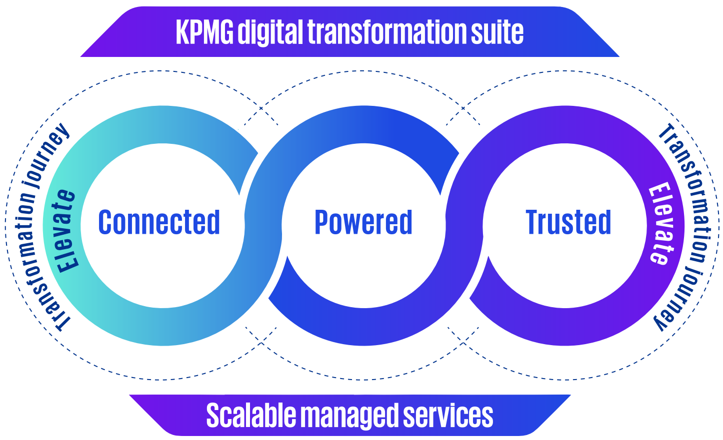
Close attention to culture. We also know the critical role people and culture play in making change stick. We emphasize ongoing leadership commitment and help generate employee engagement to create a culture that embraces continuous improvement and innovative thinking.

Smart application of technology. Technology and data are the engines that drive transformation. Data-led insights enable our ability to increase financial value by uncovering new opportunities for clients to perform better, profit more, explore new potential, and save costs.

Reimagining experiences. By examining, exploring, and reframing what's possible, we help clients develop processes and ways of working that create better experiences for all stakeholders—employees, customers, partners, and clients.

The KPMG approach

From strategy through execution and beyond, we help clients integrate multiple transformation initiatives. These are our collection of transformation solutions:



Elevate
Quantifies value-creation opportunities using a data-driven approach—helping to achieve measurable improvements to revenue, margin expansion, cost management, and capital structures.

Connected
Aligns your business around your customers to create a seamless, agile, digitally enabled organization that delivers better experiences and new levels of performance and value.

Powered
Transforms functions with target operating models that are designed with the future in mind for optimized processes, governance, KPIs, people skills, and data.

Trusted
Brings together risk and regulatory services to foster the confidence of your business and your stakeholders for continued organizational resilience.

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Todd is a principal in the KPMG Strategy practice. He has more than 25 years of experience in strategy and corporate advisory. He currently serves primarily the automotive industry, providing consultation services to passenger and commercial vehicle original equipment manufacturers, Tier 1 suppliers, and emerging players.

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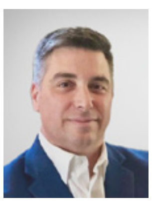

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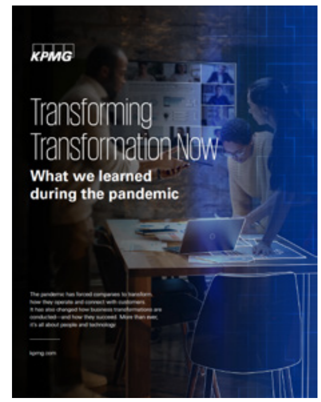

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