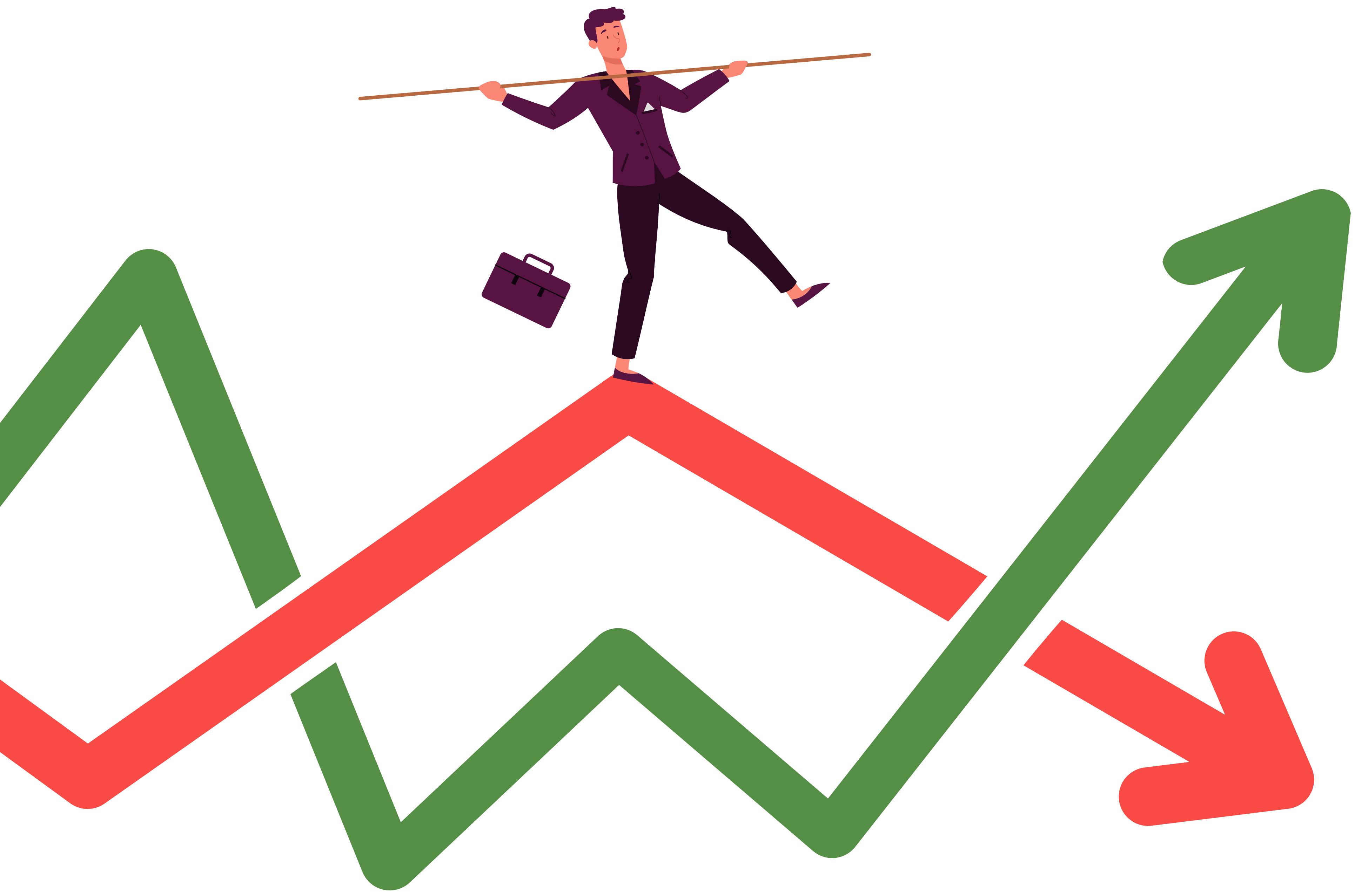
STAGFLATION?
Brace for Impact.

7 Steps to Navigating Uncharted Waters



PARTNER
ECONOMICS

Just as the turmoil caused by the pandemic began to subside, we now see it being replaced by runaway global inflation, war in Europe, rising interest rates, and a bear market.

We’re all left asking where this might end.

Partner Economics believes it’s time for Microsoft Partners to take a step back, identify and assess key potential risks, and put appropriate plans in place to ride out this “new normal”.

What are the Risks?

No one has a crystal ball and nothing about the future is ever certain, but history leaves clues in the form of leading indicators. We believe the most important now are:

1. Consumer confidence.

Spending by consumers accounts for roughly 70% of a modern economy (gross domestic product or GDP), so when the consumer loses confidence in where things are headed and curtails spending an economic slowdown is all but guaranteed. US consumer confidence is now at a level not seen since the 1980 recession1. Consumers in the European Union are somewhat more optimistic, but only slightly.

2. Real incomes.

When wages overall rise less than inflation, real purchasing power is lost. As that happens, the economy slows. Although there have been "nominal" wage gains since the beginning of the pandemic, rising inflation has actually reduced "real" incomes, particularly for those on the lower economic rungs.

3. Debt levels.

As real incomes fall, many individuals borrow to make ends meet and increase their debt levels. This can keep the economy propped up for a time, but obviously not forever. Similarly, governments cannot borrow more forever without consequences, and almost every central bank in the developed world has issued significant debt to finance pandemic relief. Both individual and government debt levels are currently very high relative to underlying economic productivity. At some point, this piper must be paid.

4. Inflation.

Inflation is essentially a tax on savings and wages – it reduces the purchasing power of both. As purchasing power declines, so does economic growth. We are currently experiencing inflation levels not seen in 4 decades, and as each day passes it becomes more apparent that this inflation is likely not "temporary". Indeed, we face the very real prospect that we have already entered a wage-price spiral in which inflation will feed on itself.

5. Interest rates.

In the modern economy, credit spends exactly the same as cash. And when interest rates are low, carrying costs on debt are also low. But as interest rates rise, credit becomes harder to get as well as more expensive to use, and economic activity slows. Central banks everywhere are now hiking rates to combat inflation.

6. Geopolitical tensions.

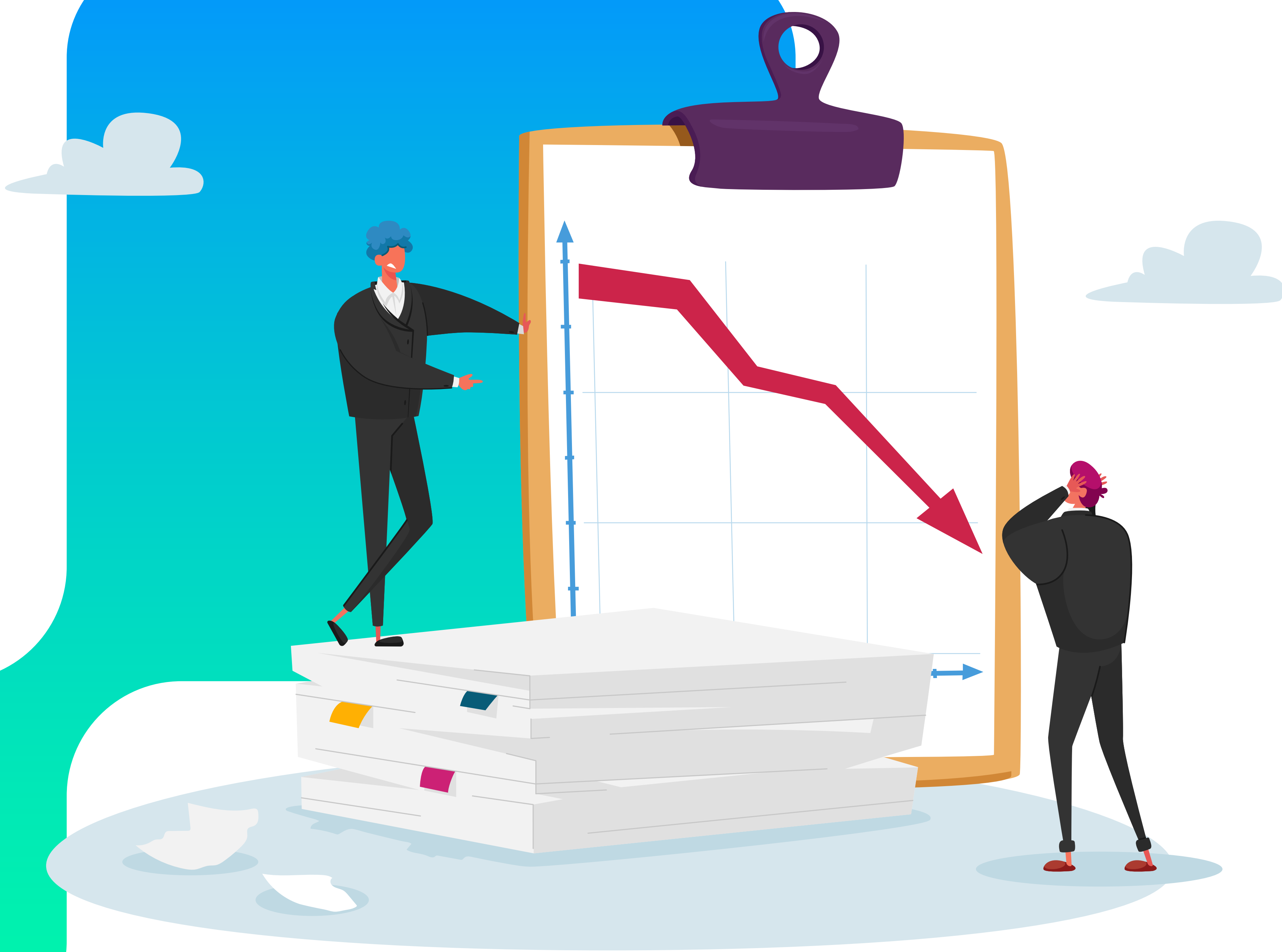
Wars introduce economic uncertainty as well as impose costs, even if you are not directly involved. Clearly, we are in that situation now.

Recession or Stagflation?

Considering all this, Partner Economics has to conclude that there is indeed a material risk of recession, stagflation, or heaven forbid, some combination of the two.

What's the difference between **recession and stagflation?**

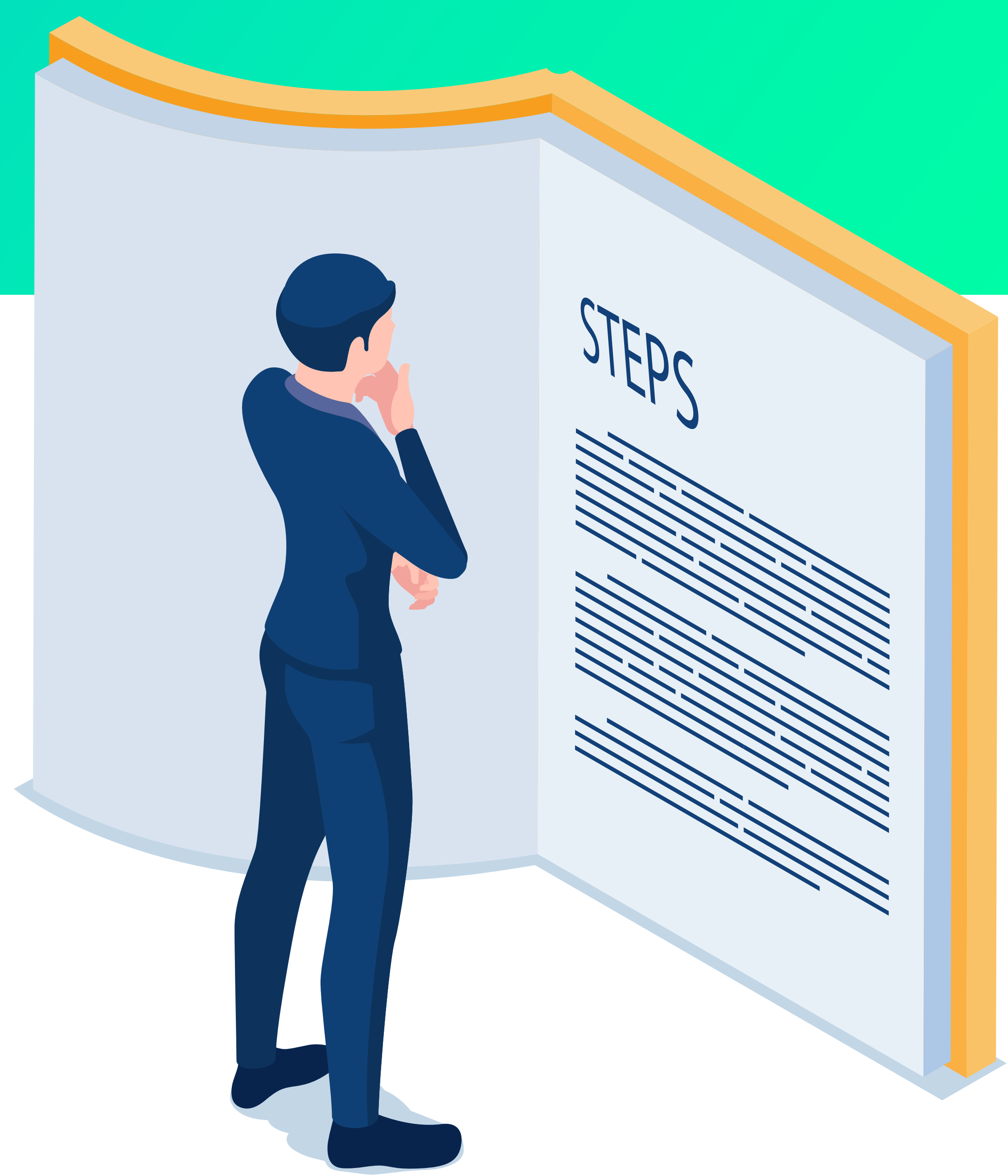
Technically, a recession is defined as 2 consecutive quarters of negative economic growth. The last global recession began in 2007 and lasted roughly 24 months. Stagflation is defined as persistent high inflation combined with high unemployment and stagnant demand. The last time we experienced that was in 1974. It lasted until 1982. At its peak in 1980, unemployment and inflation combined (the so-called "misery index") reached 20.6% in North America. Those of us who lived and worked through that period know it was no joke.



How would I deal with a recession?

Two years ago, we published “The 7 Steps to Riding out Economic Turmoil in the Microsoft Ecosystem”. It is essentially a handbook for dealing with a recession, and the 7 steps are:

1. Assess your current operational and financial readiness and performance levels.
2. Identify and mitigate any customer concentration risk.
3. Mine your existing accounts.
4. Trim the fat.
5. Keep the core team intact.
6. Don’t stop marketing.



For more detail on all these steps, you can download that document here.

How would I deal with stagflation?

Stagflation is a more complex beast to contend with, and worse usually lasts far longer than a recession. It is a marathon rather than a sprint. Since the last time we faced it was over 40 years ago, the typical business owner today has little or no first-hand experience to call on in dealing with it. Having weathered a financial crisis and a pandemic just does not provide the needed management skills. A new approach is required, that uses past techniques as well as new ones.

Partner Economics believes there are **7 critical elements** to dealing with stagflation, which are:

1

Defend margins.

It may sound like heresy, but if push comes to "stagflation-shove", margins will be more important than revenue growth. With median partner margins now hovering at 33%[2] this will be especially critical. A business owner will have to dig significantly deeper into income statement management than in the past to get this job done. Every quote or proposal will have to be rigorously costed and priced in a way that delivers adequate margins. You can not rely on historical processes to ensure this happens.

2

Defend cash flow.

To create shareholder value in a time of stagflation, a business owner must increase cash flow in real terms. This will require an especially delicate balancing act – cutting unnecessary expenses and passing on cost increases to customers without significantly impacting revenue. It's like walking, chewing gum, and juggling knives all at once.

3

Keep marketing.

Stagflation does not mean no deals are done, just fewer. You will need your share to survive. Ensuring your marketing investments are measurable, deliver the right type of leads, and can be scaled will be very important.

4

Defend charge-out rates.

One of the most significant current ecosystem pressures is rising labour costs, and these rising costs simply must be passed on to the customer in a meaningful way, or margins will shrink to unsustainable levels (and with rare exceptions, they're already close). For customers to accept higher costs, a value-based pricing approach will become mandatory. This will require another significant break from past practices. We recommend semi-annual rate adjustments during high inflation periods.

5

Streamline delivery.

This will be a key element of margin defense. It is now nearly a decade since we delivered our "Road to Repeatability" workshops, and regrettably few Partners have fully embraced the approach and techniques we recommended. This will become a pre-requisite to survival in an era of stagflation. In addition, the ecosystem will have to collectively and comprehensively address the lack of delivery capacity creation which is today gasoline being poured on the labour cost fire.

6

Examine sales productivity through a critical lens.

Lately technology demand has far outstripped supply, allowing even a poor salesperson to hide within that demand stream. Now is the time to make sure those selling are producing more than they are costing you.

7

Defend the balance sheet.

Finally, owners will have to monitor and manage working capital far more carefully than in the past. The New Commerce Experience will present special challenges here.

Conclusion

In Partner Economics' view, we are almost certainly headed for a recession as central banks must now raise interest rates to curb inflation. The hope is that modest rate hikes will do the trick and not plunge global economies into severe recession. The big risk is that inflation will not be tamed by these modest measures. If that happens, prolonged stagflation becomes much more likely.

At the very least, we believe Microsoft Partners must now take steps to protect themselves from a stagflation scenario. We strongly recommend that every owner work with their senior management team over the summer to develop concrete plans based on the 7 steps outlined, and execute those plans come the fall.

Even if we avoid stagflation, your business will be far stronger as a result. And if stagflation does become a reality, survival itself may be at stake.