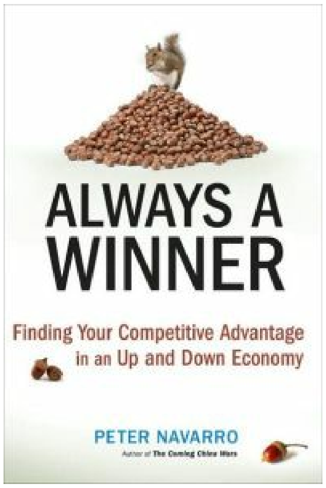

Book Always a Winner

Finding Your Competitive Advantage in an Up and Down Economy

Peter Navarro
Wiley, 2009
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Recommendation

Companies that carefully monitor the economy can prosper in all phases of the business cycle, a relentless alternation of economic expansions and recessions. Best-selling author and scholar Peter Navarro champions a do-it-yourself approach to forecasting. He says that instead of relying on outside experts, firms should produce their own economic forecasts to ensure optimal decision making in both the upturns and downturns of the business cycle. Navarro provides multiple examples of economic indicators that require no formal education in economics to understand. His book also includes case studies of companies that embraced macroeconomic analysis and of others that ignored the potential of tracking the broad economy. *BooksInShort* recommends this book to any manager who wants to use economic forecasts to make better business decisions.

Take-Aways

- Companies should do their own economic forecasting and not rely only on outside experts.
- Firms that plan for shifts in the business cycle can produce consistent profitability.
- Farsighted companies avoid both excessive spending during economic expansions and dramatic spending cuts during recessions.
- Gross domestic product (GDP) is a widely followed metric of total economic output.
- The four components of GDP are: consumption, investment, government spending and exports minus imports.
- Recessions usually develop due to a decline in one of the four components of GDP.
- Central banks raise interest rates to restrain inflation resulting from excessive consumer demand.
- When short-term interest rates exceed long-term rates, a recession may be looming.
- Companies need organizational competence and financially literate managers to make the most of their economic forecasts.
- The most important corporate strategies address the business cycle.

Summary

Bracing for the Business Cycle

Ups and downs in the economy are inevitable, so companies that prepare only for opportunity may succumb to adversity. Neither the high points nor the low points of the business cycle are permanent. Expect an endless series of economic growth spurts, slowdowns and recoveries. Knowing how to manage your business in all types of economic conditions is vital for long-term profitability.

"Every business executive must learn to become an astute business cycle forecaster."

Companies tend to respond to economic conditions either proactively or reactively. Proactive firms prioritize economic forecasting, prepare for profound changes in business conditions and, thus, perform well in any type of economy. Reactionary companies pay little heed to economic forecasts, focus almost exclusively on their customers and competitors, and operate mainly in response to current business situations. They do not perform consistently.

"Truly effective strategic business cycle management is ultimately a learning process based on an organization's cumulative experience in dealing with past adversity."

Learning to manage the impact of the business cycle strategically yields both defensive and offensive rewards. Companies that respond to broad economic trends in a timely fashion not only brace themselves for business slumps, they also position themselves to acquire assets inexpensively, recruit displaced talent and increase their market share.

A Proactive Approach to the Business Cycle

To prepare proactively for turns in the business cycle, corporate leaders must take three steps:

1. Establish an economic forecasting routine.
2. Apply forecasts to strategic and tactical business decisions.
3. Develop the economic literacy of managers and other employees.

"Both your forecasting and strategy-setting capabilities must be integrated across the firm and not segregated in different shops far from the centers of power and command."

The first step, creating a forecasting process, requires selecting a useful set of economic indicators to watch. Tracking a large number of indicators is unnecessary. The best approach for most companies is monitoring a few select signs of economic momentum. These include, for example, quarterly estimates of gross domestic product (GDP), the total output of the economy.

"Compile your own list of bellwether companies to follow during the earnings season."

The second step, using forecasts in decision making, involves strategically managing turns in the business cycle. Forward-looking strategies often produce countercyclical patterns of spending and investment. In a recession, for example, "Master Cyclist" companies spend more on advertising than "Reactive Cyclist" firms. Spending more on ads in a recession is a smart strategy because it helps businesses increase their market share ahead of an economic recovery. Personal-computer maker Dell grabbed a bigger share of the PC market by raising its ad spending during the 1990-1991 U.S. recession. Similarly, manufacturer Hyundai enlarged its share of the automobile market by increasing its advertising in 2008 after the U.S. economy had gone into recession in 2007.

"Some recessions are consumer-led while others are investment-led."

The third step, building your management team's economic knowledge, calls for creating and sustaining organizational competency with respect to the business cycle. Ensure that your company's executives fully understand basic economic and financial concepts, such as the link between inflation and interest rates, and the inverse relationship between bond prices and bond yields.

"Anytime your company engages in mass layoffs in a recession, you have done something horribly wrong in terms of managing the business cycle."

Even a management team that is wholly cognizant of the business cycle still needs rich forecast data and an optimal organizational structure. Poor data distribution hinders timely decision making. This risk is prevalent in hierarchical firms with internal information flows that tend to be vertical, not lateral. Economic forecasts do the most good when shared interdepartmentally across all your company's operations. Managers who oversee everything from inventory, payroll and marketing to finance, capital spending, acquisitions and divestitures must have a common vision of the future.

Doing Your Own Forecasting

Economic forecasting is as difficult as you make it. Forecasting can be a complex academic exercise involving countless computer calculations, but for many business managers, a simpler routine will suffice. Managers who master the business cycle draw upon four types of evidence to produce their own economic forecasts: 1) GDP estimates, 2) stock market values, 3) company forecasts of revenue and profit, and 4) the so-called yield curve.

"While stock and bond returns largely move together over the business cycle, the relative costs of equity and debt significantly differ over the cycle."

The most important economic indicator is GDP, total economic output. Watching surveys of consumer confidence can help you forecast future GDP changes. The University of Michigan, for example, calculates a monthly index of consumers' mood and their inclination to spend. Consumer spending is a telling metric because it represents the bulk of economic activity.

"Over time, chronic budget deficits are likely increasingly to threaten your organization's ability to borrow capital at reasonable rates."

Heeding the stock market pays dividends. Although gyrating stock prices may appear random and irrelevant to your firm, the stock market remains a valuable forecasting tool. Investors tend to buy or sell stocks based on their expectations of companies' future financial performance, so changes in stock prices often herald future shifts in the economy. Following a popular stock index, for example, the Standard & Poor's 500, is an easy, effective way to monitor trends in the market. Publicly held companies also publish forecasts of their financial performance. These reports are helpful for predicting future business conditions. Public companies provide quarterly guidance to investment professionals who try to forecast their sales and profits. Business managers can benefit from such guidance, too.

> “One of the most obvious symptoms of a failure to strategically manage the business cycle is the buildup of large inventories.”

The yield curve compares the yields on interest-bearing U.S. Treasury securities against their terms to maturity. The curve gradually rises when short-term interest rates fall below long-term interest rates, signaling economic expansion. When short-term rates exceed long-term rates, the curve is inverted, indicating that recession is coming.

Calculating the Components of GDP

Major developments external to the economy, for example, an oil shortage or a natural disaster, can affect all four components of the GDP: consumption, investment, government spending and exports minus imports. And usually it is one of these four components that triggers a recession. In fact, that is how the century’s first two U.S. recessions started. Slack business investment pushed the economy into recession in early 2001, and a collapse in consumption stemming from distress in the housing market did the same in late 2007.

> “Did your organization’s finance team take advantage of historically low short-term interest rates during the last two recessions to refinance long-term debt?”

For many companies, the individual parts of GDP are more important than their sum. Business sensitivities to changes in consumption, investment, government spending and the balance of trade vary by industry. For example, even if increased business investment were to reverse a decline in GDP, retailers who depend on consumption might feel only a negligible benefit.

Information for Forecasting

The data that do-it-yourself forecasters need to estimate future changes in economic activity is readily available. The best leading indicator of U.S. business investment is a monthly index published by the Institute for Supply Management. The U.S. Treasury Department issues a monthly report that business managers can use to identify trends in government spending. And, the U.S. Department of Commerce releases monthly estimates of exports, imports and the balance of trade.

> “A recession can do far more damage to your organization than any 10 competitors.”

Handle these reports with care. Trade data can mislead users who fail to analyze the numbers in a broad economic context. Many factors can account for changes in the volume of imports and exports and their impact on GDP. For instance, when exports exceed imports, trade contributes to GDP growth. But strong export growth also may reflect that the U.S. dollar is devalued relative to foreign currencies, which could have negative consequences for other components of GDP.

Inflation and Interest Rates

Inflation increases the price of everyday goods and services, but it also prompts central banks to raise the price of money. So when the U.S. government releases its monthly Consumer Price Index, no one follows it more closely than the board of governors of the Federal Reserve. In pursuing its mission to maintain price stability, the U.S. central bank often raises short-term interest rates to restrain economic activity and relieve upward pressure on prices.

> “An accurate forecast is only as good as the managers that it reaches.”

However, not every type of inflation causes the Fed to tighten monetary policy. Economists put inflation in two classes, “cost-push” and “demand-pull.” The Federal Reserve will increase interest rates to tame demand-pull inflation, which occurs when public demand for goods and services exceeds the supply. By contrast, cost-push inflation results from a sudden surge in the cost of commodities like energy or food, which may lead the Fed to lower rates.

> “I have never failed to be astonished by the widespread lack of economic and financial market literacy among a significant fraction of America’s executive corps.”

You can distinguish the demand-pull component of inflation from the cost-push component by studying the federal Consumer Price Index. In its monthly CPI estimates, the U.S. Bureau of Labor Statistics provides separate calculations for core elements of inflation and for noncore elements, like food and energy prices. In general, the core elements represent demand-pull inflation, and the noncore elements represent cost-push inflation.

Proactive companies take advantage of changes in interest rates over the entire business cycle. For example, when short-term interest rates exceed long-term rates and the yield curve becomes inverted, a recession may loom on the horizon. But rather than just reduce debt to brace for hard times, savvy firms refinance a portion of their long-term debt with cheaper short-term borrowings.

Turning Forecasts into Fortunes

Cosmetics retailer Avon provides a case study in how countercyclical action can help a company make progress in any economic climate. When the U.S. economy entered a recession in early 2001, Avon foresaw additional recruiting opportunities. It capitalized on increased unemployment by expanding its home-based workforce and enlarging its share of the retail cosmetics market. Avon’s well-timed action boosted its revenues and rewarded its shareholders with double-digit percentage increases in the stock price in both 2002 and 2003.

Apple Computer also has a proactive approach to the business cycle and has demonstrated pricing prowess based on changes in the cycle. The company introduced its iPhone mobile handset for $599 in January 2007. Then, as consumer spending began to wane and U.S. economic growth slowed, Apple lowered the price, first to $399 and then to $199, to maximize the amount of revenue the product generated.

Computer-chip maker Advanced Micro Devices (AMD), on the other hand, paid a price for ignoring the business cycle. Late in 2007, just before the U.S. economy entered recession, AMD embarked on a plan to increase its 2008 production by boosting its output of a new line of microprocessors. Within a year, economic conditions forced it to write down the book value of unsold inventory by more than $200 million.

Large write-offs and layoffs betray a lack of proactive management. Companies that operate as though economic expansion is endless often have far too many employees and unsold products when a recession takes hold. Firms with farsighted, proactive managers are less surprised when new economic trends develop.

If economic forecasting seems too arcane for your company, consider the relative importance of being able to guess what your competitors will do next. No amount of competitive damage compares with the negative consequences of failing to prepare for a major upturn or downturn in the business cycle. Indeed, most business managers would do well to worry less about their rivals and more about the macroeconomic future.

About the Author

Peter Navarro is a professor at the Merage School of Business, University of California-Irvine, and the author of several books, including *The Well-Timed Strategy* and two bestsellers, *The Coming China Wars* and *If It's Raining in Brazil, Buy Starbucks*.