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5 Challenges CFOs Must Navigate to Grow Earnings Amid Economic Headwinds

The tailwinds that powered the last decade's strong corporate performance are giving way to a "deadweight" economy with tepid demand growth, stubbornly high costs and constrained access to capital. CFOs must take action against five challenges to drive profitable growth in this environment.

Overview

The growing optimism of a potential economic soft-landing after high inflation and monetary tightening in the U.S. and other advanced economies obscures an inconvenient truth. The tailwinds of strong demand growth, healthy labor market conditions and cheap debt, which powered strong corporate earnings across most of the last decade, have disappeared.

Although optimists believe the reopening of society, AI breakthroughs, and government spending will continue to buoy corporate performance, many observe durable headwinds that suggest otherwise. CFOs now contend with tepid demand growth, stubbornly higher costs and constrained access to capital, making it harder to sustain the corporate performance stakeholders have come to expect. Gartner characterizes this combination of headwinds as "the deadweight economy," and it presents a set of underappreciated challenges to managing corporate performance.

Key Findings

- The economic tailwinds that powered corporate performance in the U.S. and other advanced economies over much of the past decade have given way to a deadweight economy, characterized by tepid demand growth, stubbornly higher costs, a tight labor market, and high capital costs.
- Leaders can expect deadweight economic conditions to linger through most, if not all, of organizations' current strategic planning horizons.
- The deadweight economy gives rise to new and underappreciated competitive challenges that undermine the effectiveness of traditional approaches to revenue growth, pricing, investment funding, cost management, people management and productivity improvements.
- The deadweight economy increases the pressure to realize productivity and asset efficiency gains from enterprise digital investments over the past decade.

Recommendations

To better alleviate constraints imposed by the deadweight economy and better position their organizations for success compared to their peers, CFOs must:

- Learn the five emerging challenges created by the deadweight economy and educate their executive leadership teams and boards about them to enable a coordinated management response that delivers outperformance.
- Adopt the mindset of an activist investor to diversify funding sources and ensure capital flows to highest return uses.
- Redirect spending away from easily copied capabilities toward assets and capabilities that support the organization's points of differentiation.
- Harness the interdependencies across disparate digital initiatives and investment time horizons to create capabilities that deliver the full value from enterprise technology spending.

What Is the Deadweight Economy?

The global reopening of society and technology breakthroughs, such as generative AI, provide a welcome respite for many companies grappling with slow revenue growth, inflationary cost pressures and worker shortages. Yet, CFOs are taking no chances in protecting earnings, with 65% of companies in the S&P 1200 taking actions to reduce costs in the last 18 months, and 12% announcing significant workforce cuts. Although this may temporarily assuage investors' concerns about profitability, many CFOs are ignoring the real, arguably even more material, issue that many of the economic headwinds they now face will outlast the benefits of any temporary cost cuts.

Gartner has consolidated forecasts from a variety of official, reputable sources including the International Monetary Fund, the United Nations, the Federal Reserve, the U.S. Bureau of Labor Statistics, the European Central Bank, the Bank of England and others to identify which economic headwinds are likely to have staying power in advanced economies. Unfortunately, these forecasts suggest that organizations face a medium-term environment characterized by tepid demand growth, stubbornly high costs and constrained access to capital. Gartner calls this unique combination of economic headwinds the deadweight economy. Rather than being a tailwind that powers corporate performance, the economy is now a deadweight that organizations must carry, making it much harder to sustain the corporate performance investors and stakeholders have come to expect (see Figure 1).

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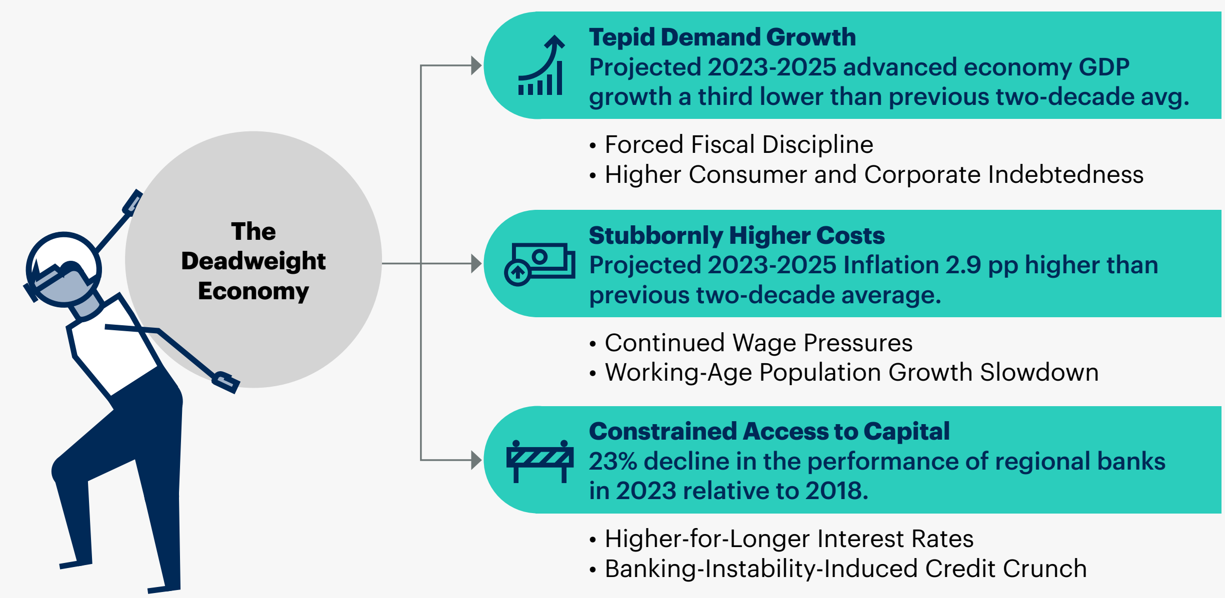
Figure 1: Weak Demand, Cost Pressures and Scarce Capital Drive the Deadweight Economy

Bulleted Economic Trends Inform the Deadweight Economy Characterization



Source: Gartner

The deadweight economy is characterized by:

- Tepid demand growth, which is an accumulation of weak real GDP growth, forced fiscal discipline, and high consumer and corporate indebtedness. The IMF forecasts advanced economy GDP growth over 2023-2026 to be one-third lower than the previous decade average.
- Stubbornly higher costs, which are a result of persistent inflation in services, continued wage pressures for critical roles and declines in the working-age population. Inflation rates are coming down in many advanced economies, but they are still positive, meaning input prices and wages continue to increase.
- Constrained access to capital is driven by higher-for-longer interest rates, the weakening of regional bank balance sheets as a result of declining commercial property values, and more restrictive bank lending across both U.S. regional banks and European banks.

Absent fortuitous events such as a surprise end to geopolitical conflict, a swift halt to inflation or the quick realization of dramatic productivity gains from AI, CFOs should expect many of the underlying economic trends contributing to the deadweight economy to persist across their strategic planning horizon. Why? As Figure 2 shows, the durability of the trends currently driving the deadweight economy require significant attention.

Figure 2: The Trends Driving the Deadweight Economy Are Durable

Multiple External Sources

	Tepid Demand Growth[1]		Stubbornly Higher Costs[2]		Constrained Access to Capital[3]	
	Growth in Government Spending	Consumer and Corporate Indebtedness	Wage Inflation (Employee Cost Index)	Working-Age Population	Federal Funds Rate	Assets and Liabilities of Commercial Banks
"Historical" Average (2010-2022):	+5.20%	+17%; +65% (2010-2019)	+2.27%	+5.0	+0.88%	+6.52%
Projection Average (2023-2025)	+2.42% ▼	+43%; +108% (1Q23)	+4.17% ▲	+1.2% ▼	+4.1% ▲	+0.76% ▼
	↓	↓	↓	↓	↓	↓
Economic Characterization	Forced Fiscal Discipline	Higher Consumer and Corporate Indebtedness	Continued Wage Pressures	Working Age Population Growth Slowdown	Higher-for-Longer Interest Rates	Bank-Instability Induced Credit Crunch

n = 31 all respondents

Q: What technology capabilities do your service providers offer in your current outsourcing arrangement?

Source: [1]Average Annual Percentage Change of Government Total Outlays [Congressional Budget Office], Percentage Increase in Proportion of Debt (or Business Debt), Nonhousing Debt (or Corporate Debt) [Federal Reserve Bank of New York, Federal Reserve System]. [2]Projected Inflation, in Percentage [OECD], Annual Percentage Change in Employee Cost Index [Bureau of Labor Statistics], # of 15 to 64 Year Olds, More Advanced Countries, by Decade [United Nations]. [3]Federal Funds Rate, United States [FRED], Projected Fed Funds Rate [Federal Reserve], Annual Percentage Change of Selected Assets and Liabilities of Commercial Banks [Board of Governors of the Federal Reserve System].

The projections for many of the macrotrends driving the deadweight economy are unfavorable over the coming three years.

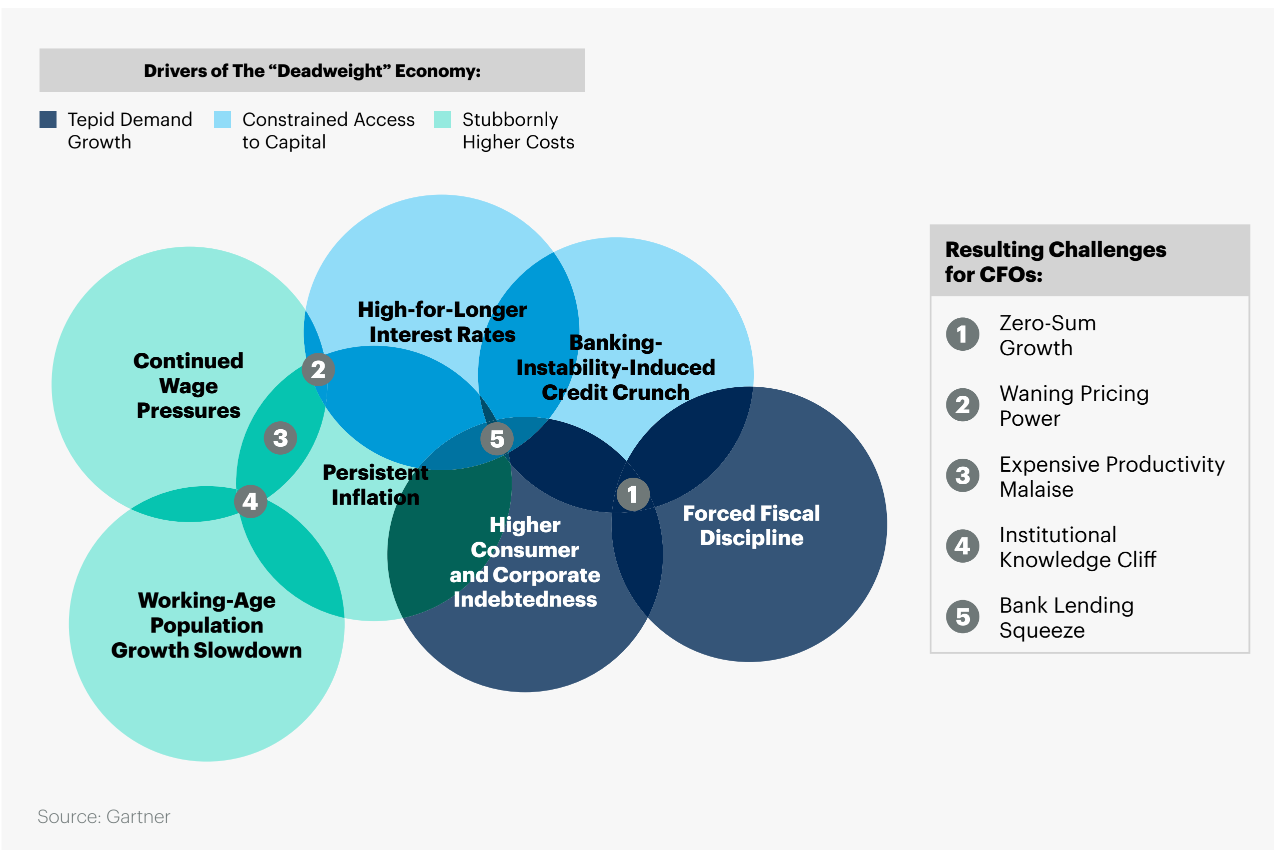
- Higher indebtedness of governments, corporations and consumers will not disappear overnight, acting as a drag on spending and reducing demand growth over the foreseeable future.
- An aging population and declining labor force participation rates in many advanced economies cannot be reversed in the next few years, which will keep wages stubbornly high in many professions and industries.
- Inability of central banks to lower interest rates as inflation persists, coupled with the secular decline in commercial property values as hybrid work becomes the norm, will constrain lending by smaller U.S. banks, far beyond constraints imposed by the 2022-2023 bank collapses.

An organizations' performance now depends on management's differentiated actions and realizing digital's promised productivity gains, rather than on economic tailwinds. Executives will have to take actions that drive outperformance rather than conducting business as usual. However, achieving outperformance is getting increasingly out of reach.

What Challenges Do the Deadweight Economy Create for CFOs?

The deadweight economy challenges an organization's ability to meet corporate performance expectations by constraining or invalidating business-as-usual approaches for growth, pricing, cost and productivity management, financing, and talent deployment. See Figure 3 for how various drivers of the deadweight economy interact to create nonobvious business management challenges.

Figure 3: Interactions Across Drivers of the "Deadweight" Economy Create Five Nonobvious Challenges for CFOs



In various interactions and combinations, the above drivers of the deadweight economy drive five nonobvious challenges for CFOs and their organizations:

1. **Zero-Sum Growth —** Given cooling demand conditions in advanced economies, robust revenue growth requires capturing market share from (often larger) competitors.
2. **Waning Pricing Power —** Greater price sensitivity from indebted consumers and B2B customers reduce the viability of pass-through pricing as a way to neutralize the impact of cost pressures.
3. **Expensive Productivity Malaise —** As the productivity stagnation continues, organizations will find it critical to drive scalable outcomes from expensive digital investments.
4. **Institutional Knowledge Cliff —** The tacit and experiential knowledge required to fully digitalize processes is quickly eroding due to the aging workforce and labor market trends.
5. **Bank Lending Squeeze —** Recent bank collapses, as well as bank balance sheet weakness from floundering commercial property mortgages, are constraining lending, while high interest rates raise the cost of borrowing.

Five Challenges Arising From the Deadweight Economy

The deadweight economy, coupled with recent social, political, and economic shifts and events, brings new and unique challenges to current CFOs. However, successfully navigating these challenges, while the average organization resorts to managing against short-term economic volatility, can dramatically improve an organization's performance trajectory and create sustained competitive advantages.

1. Zero-Sum Growth

In a low-demand growth economy with higher interest rates, organizations find it harder to grow top-line revenue organically. Industry consolidation and concentration further complicate the dynamics of revenue growth. In 2023, the five largest U.S. companies by revenue combined for at least 80% of total revenue among publicly traded industry peers in 91 of the 157 primary industries tracked by S&P Global Market Intelligence. This number is up from 71 industries in 2000.

As industry power concentrates, it becomes harder for the typical company to grow revenue without stealing market share from larger competitors in their industry. And, investors rarely accept weak economic conditions and tougher competition as excuses for mediocre growth. CFOs and their executive teams will have to deaverage their segmentation of markets, customers and value chains to identify new growth opportunities and customers that are underserved by industry titans. By taking such actions organizations during periods of economic shifts, organizations maintain growth while toppling less dynamic competitors and restacking industry rankings.

2. Waning Pricing Power

Closely related to the problem of growing market share is the issue of pricing strategy. Although pass-through pricing protected, and in many cases, enlarged corporate earnings at the onset of inflation, steep and persistent inflation has driven price sensitivity and consumers' propensity to switch products and brands to new highs. In 2023, 90% of consumers switched to an alternative brand. For consumers who noted they were affected by inflation and experienced financial hardship, a significant majority switched products. This pattern is consistent across industries (see Figure 4).

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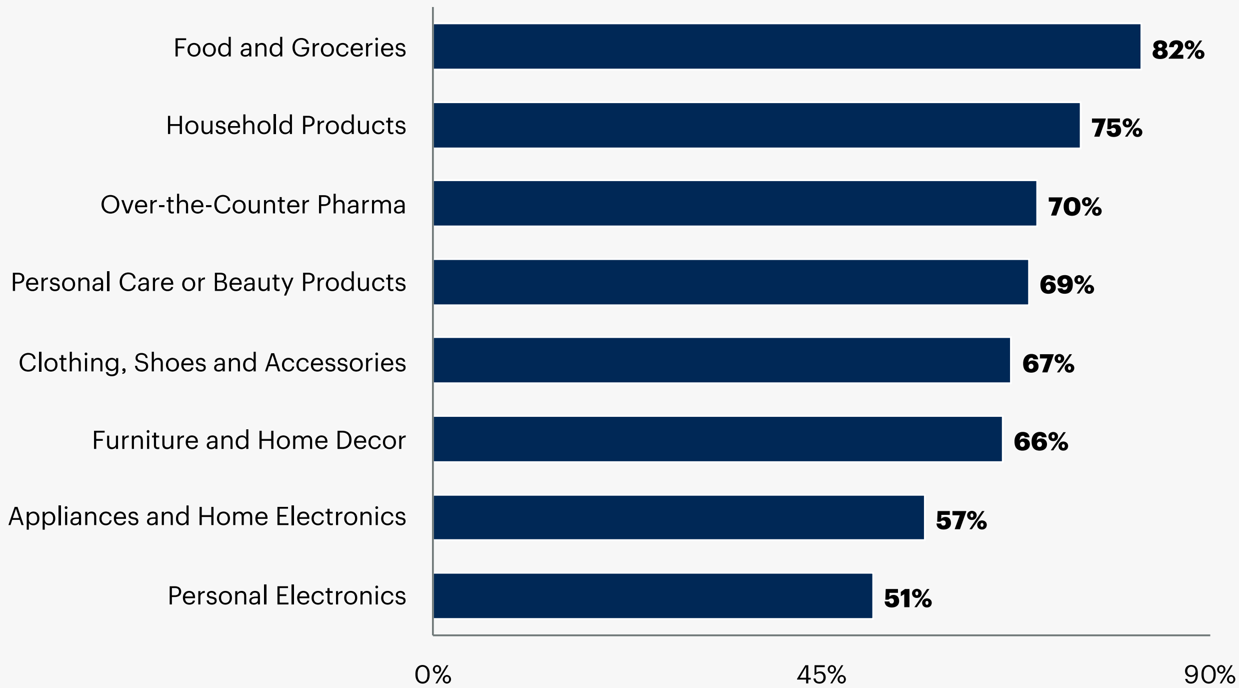
Figure 4: Across Industries, Price Sensitivity Drives Product Switching



n = 676 (n may vary). U.S. Consumers Age 18+ who shop in each product category
Q1: What has been the impact of recent price increases on you and your household, if any?
Q2: In what way, if at all, were you most likely to change which products you bought in the past year? I have switched to a less expensive brand name, a store brand, a generic brand or a simpler, less expensive product type.
Source: 2023 Gartner Consumer Cost-of-Living and Price Sentiment Survey

Gartner finds significant misalignment between consumers' and business executives' views on pricing. While most consumers express a desire for businesses to keep prices steady, this is only priority seven of nine for businesses. Given the increased propensity for price-related brand switching, and rising levels of consumer indebtedness, CFOs should reconsider their automatic pass-through pricing strategies and assess opportunities for dynamic pricing.

B2B companies are not immune either. Falling demand and cost consciousness has made several retailers and importers hold on signing new shipping contracts until spot prices come down further. Spot pricing for a 40-foot container has come down from a peak of $19,200, in September 2021, to $1,200, in February 2023, closer to long-term rates offered by carriers.

3. Expensive Productivity Malaise

Faced with margin pressure, worker shortages and turnover, many organizations have accelerated digitalization efforts to automate processes and transform business models. However, the results have been underwhelming for many organizations. More than two-thirds of CFOs believe enterprise digital spending has underdelivered against expectations for worker, asset and revenue productivity. Many digital initiatives result in tools that could automate an activity partially, but don't really yield the end-to-end productivity and time savings specified in business cases. Technology pilots are fine, but don't pay the bills.

This unrealized productivity in a deadweight economy is costly for several reasons. First, digital initiatives are inherently costly, from the spending on expensive technology to the premium skills required to implement, run and maintain the underlying systems and applications. This challenge also adversely affects job satisfaction, as low-productivity tasks cannibalize the time for creative thinking and value-added work. Further, investor expectations for productivity gains remain elevated.

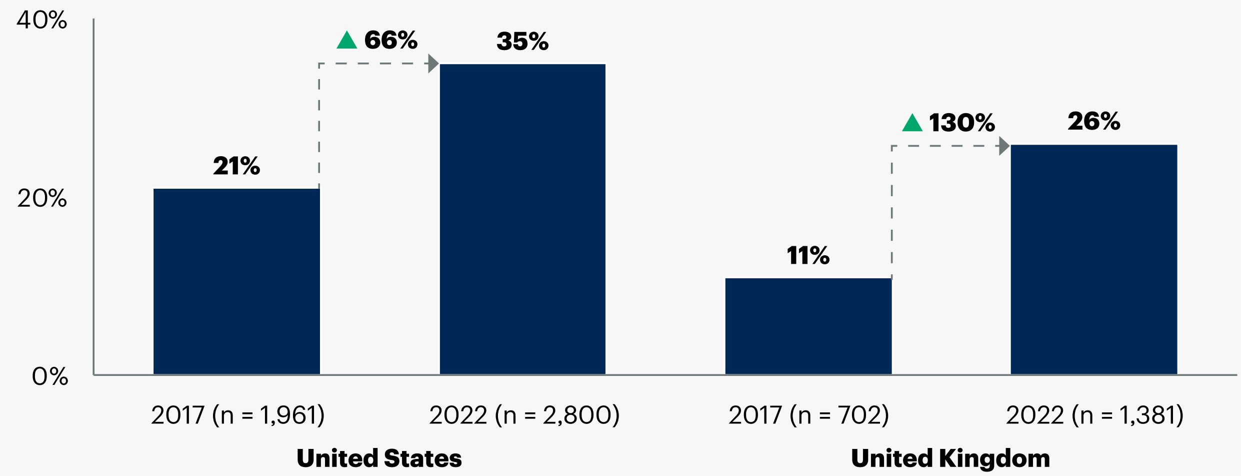
Productivity doesn't just apply to frontline workers. Knowledge workers also have significant room to improve productivity by treating technology not just as a tool, but a coequal partner that learns from humans and can complement human strengths while also compensating for its weaknesses. The impending commercialization of generative AI and the rise of machine customers makes it ever more important to strengthen the working relationship between humans and technology.

4. Institutional Knowledge Cliff

Digital acceleration has been a constant since the onset of the COVID-19 pandemic, and it is happening out of necessity due to worker shortages and the normalization of hybrid work. However, organizations seeking to accelerate digital must do so in a seller's market for technical skills, as the demand for digital talent far outstrips its supply. Expensive digital talent requires institutional knowledge to implement and run digitalized processes and analytics that deliver against lofty ROI expectations. Younger colleagues are less effective at imparting institutional knowledge to digital talent because they grew up in an era of automation without fully developing the expertise of how the underlying processes really work. Many of the employees who can impart institutional knowledge are nearing or are already above retirement age, as shown in Figure 5.

Figure 5: Significant Increase in Retirement-Age Workforce

Growing Proportion of Respondents, Aged 60+ for 2017 and 2022



n = varies

Source: 2017 Gartner Global Labor Market Survey; 2022 Gartner Global Labor Market Survey

The share of an organization's employees near or above retirement age (60 and older) has grown by 66% in the U.S. and more than doubled in the U.K. (130%). Retirement is not a new issue for companies, and older workers will not all retire at the same time. However, given today's levels of attrition, from voluntary resignations and job-hopping, the sheer size of the near-retirement worker cohort creates the real risk of a material loss of institutional knowledge.

Optimists will point out that AI-based technologies used in digitalizing business processes increasingly have built-in capabilities for advanced root causing, causal analyses and assistive recommendations to connect workers to in-depth process knowledge. However, the reality is that these tools require the large-scale digitalization of organizations' tacit knowledge. This shift might be easier to execute using global process owners in corporate functions like finance, legal and IT, but is significantly harder in manufacturing, engineering and R&D processes. Digitizing standard operating procedures manuals, research and engineering content, and other analog information stored in three-ring binders is no simple task.

Longer term, the working-age populations of many advanced economies are set to slow down over the next 10 or so years, which means the knowledge cliff challenge is here to stay and requires deliberate executive attention.

5. Bank Lending Squeeze

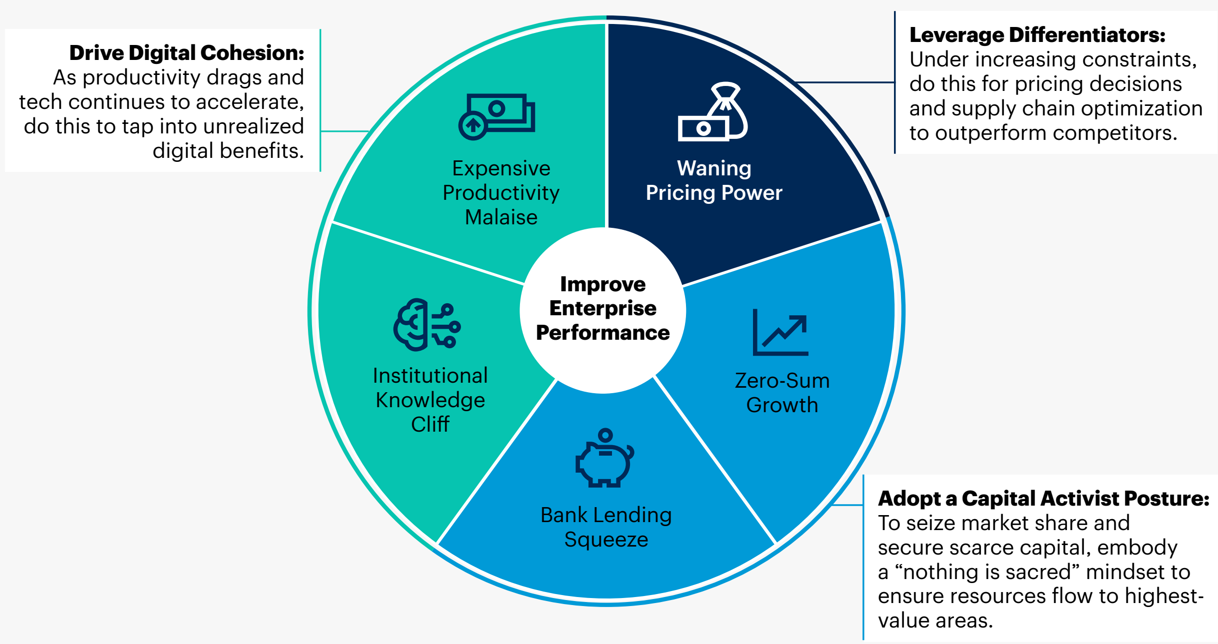
The combination of higher interest rates, quantitative tightening and hybrid work have decreased the demand and value of commercial real estate. This shift has considerably weakened the balance sheets of small, regional banks and diminished their ability to lend (i.e., regional banks are the primary owners of the commercial property mortgages and mortgage-backed securities). Compounding the problem are the higher fee structures and loss of negotiating power when dealing with large banks, which may dissuade organizations from forming new banking relationships with well-capitalized entities. A plurality of CFOs in a 2023 Gartner survey (47%) note that they would hold more excess cash in 2023 than in 2022 to increase their operational flexibility. And a majority of CFOs (55%) are less likely to take on new debt in 2023 as it continues to get more expensive.

As many organizations come up on maturity dates for debt and revolving lines of credit, and encounter higher costs when refinancing, their CFOs will now have to consider alternate sources of financing for growth and maintaining cash reserves. This means exploring nontraditional funding sources, such as secondary equity issues, public-private consortia (e.g., opportunities exist in the U.S. CHIPS and Science Act, the U.S. Inflation Reduction Act, the U.S. Infrastructure Investment and Jobs Act, etc.), private investment in public equity, venture capital, peer-to-peer lending and nondilutive financing options (e.g., the U.S. Small Business Innovation Research program, the U.S. Small business Technology Transfer program, funding from the U.S. Small Business Association, etc.).

Three Strategies for CFOs to Alleviate Deadweight Economy Constraints

Although the deadweight economy poses material performance challenges and risks to organizations, CFOs can use proven strategies to cultivate outperformance. Gartner has identified three ways in which CFOs can bring an outside-in perspective to improve the quality of budgeting and spending decisions, capital allocation and performance management of digital initiatives (see Figure 6).

Figure 6: CFOs Should Leverage Three Strategies to Minimize Economic Headwinds



Source: Gartner

CFOs can boost credibility with their executive team and board by instituting the lenses of cost differentiation, capital activism and digital cohesion as prerequisites for all decision making. These three approaches, when leveraged as concepts to guide decision making, can help CFOs target and alleviate the challenges imposed by the deadweight economy.

Focus Spending, Resources and Efforts on Points of Differentiation to Inform Pricing Decisions

The deadweight economy makes it more essential to capture market share from competitors in order to grow, meaning it is increasingly critical for organizations to differentiate their products, services, talent acquisition and retention efforts, and delivery models from those of their peers. CFOs should emphasize to their peer executives the primacy of differentiated spending and should encourage planning processes that disproportionately drive spending and resources to areas that support or create unique capabilities that differentiate the organization from its competitors. Additionally, CFOs should push to reserve most new or growing technology investments for areas that differentiate the organization from its competitors to drive outperformance. Consumers are also more likely to tolerate higher pricing if they recognize the differentiated value in the organization's offerings.

Adopt a Capital Activist Posture to Grow Market Share and Secure Funding

As capital becomes scarcer and more expensive, CFOs and executive leaders must adopt an activist investor mindset to ensure capital flows to highest return uses. Capital activists, CFOs who adopt the mindset of an activist investor when making capital allocation decisions, embody a mindset that "nothing is sacred but the strategy." This perspective helps channel funding to the shortlist of strategic priorities that are most critical while demoting or terminating initiatives that do not make the cut. Capital activist CFOs are also more opportunistic, evaluating multiple sources of funding beyond traditional avenues and diversifying funding based on market conditions and capital availability. Specifically, in this deadweight economy, employing the capital activist lens will make sure the organization is well-capitalized and ready to pursue growth.

Relentlessly Drive Digital Cohesion to Realize Productivity Gains

Most organizations only achieve digital success sporadically — most times accidentally. CFOs, especially those who own IT or work with IT leaders as peers, face an entrenched and almost debilitating time of it. A proven way to drive better productivity and business results from digital spending is to focus on digital cohesion. This strategy requires assessing the interdependencies between various digital initiatives, and across digital initiatives, existing enterprise capabilities, data and skill sets, and using that knowledge to make informed funding and project performance management decisions in service of an enterprise outcome.

Driving business outcomes in a digitally cohesive way is a team sport and it will require CFO, CIO and head of data and analytics (i.e., chief data and analytics officer [CDAO]) to work together. By using a shared vocabulary for understanding digital interdependencies (e.g., using a metrics cascade to map clusters of digital initiatives and tie them to a bigger outcome), driving stronger collaboration with the CIO, CDAO and other technology leaders, and evangelizing the importance of a human-machine learning loop, CFOs can position their organizations to realize significant productivity gains from digital.

Conclusion

Currently, CFOs face a unique confluence of economic headwinds. Unlike the period of tailwinds organizations took advantage of over the last decade, organizations must deliver corporate performance in a deadweight economy, which will likely last over most of their strategic planning horizon. CFOs will have to successfully navigate zero-sum growth, waning pricing power, an expensive productivity malaise, the institutional knowledge cliff and a bank lending squeeze in order to grow profitably. CFOs and their executive teams must adopt the lenses of cost differentiation, capital activism, and digital cohesion as prerequisites for all decision making.

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