Global CFO Survey: Concerns about consumer demand push economic optimism to 5-year low

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CONTACT: Laura Brinn (Duke)
(919) 660-2903
laura.brinn@duke.edu
or
Jill Totenberg (CFO magazine)
(212) 994-7363
jtotenberg@totenberggroup.com

GLOBAL CFO SURVEY: OPTIMISM AT FIVE-YEAR LOW AS CFOS WORRY ABOUT WEAK CONSUMER DEMAND AND WAGE INFLATION; ONE-THIRD PREDICT RECESSION

Note to editors: For additional comment, contact Duke's John Graham at (919) 660-7857 or john.graham@duke.edu or CFO magazine's Don Durfee at (212) 698-9729 or dondurfee@cfo.com. For commentary about European results, contact Janet Kersnar at +44 0 20 7576 8100 or janetkersnar@cfoeurope.com or Erasmus's Kees Koedijk at +31 10 40 82748 or ckoedijk@rsm.nl. For commentary about Asian results, contact Tom Leander at +852 2585 3262 or tomleander@economist.com.

DURHAM, N.C. –- With chief financial officers' optimism about the U.S. economy at a five-year low, many are planning for reductions in capital spending and hiring. Their sour outlook stems from concerns about consumer demand, the rising cost of labor and high fuel costs.

These are some of the conclusions of the September 2006 Duke University/CFO Magazine Business Outlook survey, which asked CFOs from a broad range of global public and private companies about their expectations for the economy. The survey concluded Sept. 10 and generated responses from 959 CFOs, including 571 from the U.S., 208 from Asia and 180 from Europe. The survey of European CFOs was conducted jointly with RSM Erasmus University in the Netherlands. Results in this release are for the U.S. firms, unless stated otherwise.

The study's main findings are:

-- The level of pessimism about the U.S. economy is the highest in more than five years(see chart at bottom of release). Nearly half of CFOs are more pessimistic about the U.S. economy, and only 19.8 percent more optimistic, than last quarter.

-- Capital spending plans have been cut, with planned increases of only 5.1 percent over the next 12 months, down from a planned increase of 7.5 percent last quarter;

-- CFOs expect earnings to increase 9.4 percent over the next 12 months, down from last quarter's 10.4 percent predicted increase;

-- Weak consumer demand, rising labor costs and high fuel costs top CFOs' lists of concerns. They say that additional capital spending and hiring cuts will follow if consumer demand weakens further.

-- CFOs' optimism about their own firms also fell, with 45.8 percent more optimistic about their company's prospects, in comparison to 49 percent last quarter.

“CFOs are feeling so negatively about the U.S. economy that one-third predict we will be in recession within one year,” said John Graham, a finance professor at Duke’s Fuqua School of Business and director of the survey.

“Pessimism is also growing about the CFOs’ own firms, though less so than about the overall economy,” Graham added. “This growing pessimism does not bode well for the economy. In fact, our analysis shows that CFO business optimism has a predictive correlation of about 70 percent with future capital spending, earnings and employment. Therefore, we expect these areas to worsen in the coming year.”

WEAK CONSUMER DEMAND TOPS CORPORATE CONCERNS

For the first time in the survey’s history, weak consumer demand ranks as the No. 1 worry facing companies.

U.S. firms are poised to respond to changes in consumer demand. Among firms that sell directly to consumers, 34 percent say they will cut back on hiring if consumer demand weakens, and 29 percent say they will cut capital spending. Another 19 percent say they will scale back their orders from other firms.

Domestic hiring is expected to rise by 0.8 percent over the next 12 months, down from expected growth of 1.3 percent last quarter. Outsourced employment is expected to increase almost 4.3 percent.

“The U.S. economy has been battered by high fuel costs and rising interest rates over the past couple years,” said Don Durfee, research editor at CFO magazine. “CFOs continue to list the direct corporate effect of high fuel costs and high interest rates among their top concerns. Now fuel costs and interest rates are reducing consumer demand, further harming the corporate sector. This negative cycle could mean cuts in corporate spending and hiring.”

LABOR COSTS AND SKILLED WORKER SHORTAGE; SKEPTICISM ABOUT FED POLICY

CFOs cite rising labor costs as their No. 2 concern. U.S. firms say they will raise wages and salaries 3.5 percent over the coming year on average, with increases greater than 4 percent in the consulting/service and high technology industries. Health care inflation will remain high, although the 7 percent expected increase continues a downward trend seen in recent quarters.

“Unit labor costs rose 1.6 percent in 2005 and CFOs see that more than doubling over the next 12 months,” said Campbell R. Harvey, founding director of the survey and a finance professor at Duke.

Another one of the CFO’s top concerns, a scarcity of skilled labor, is contributing to wage inflation. Skilled labor shortages are particularly acute in the consulting/service, high-technology and construction industries.

“To make matters worse, the CFOs fail to give the Federal Reserve a resounding vote of confidence,” Harvey said. “A surprising 45.8 percent of CFOs are skeptical that tightening will reduce the rate of inflation.”

In addition, 91.5 percent of CFOs oppose further tightening and 21 percent want the Fed to begin to reduce interest rates.

“Lack of confidence in the success of Fed policy, combined with weak consumer demand and an alarming rise in unit labor costs, accounts for the lowest CFO optimism in five years and the fact that one-third of CFOs believe that a recession is imminent,” Harvey concluded.

THE COST OF TERRORISM

Results from a special study on the cost of terrorism can be found at cfosurvey.org. Key results of that study indicate that U.S. firms now spend 2.8 percent of revenues on direct costs associated with the threat of terrorism, up from 1.7 percent of revenue prior to Sept. 11, 2001. Indirect costs of terrorism are another 1.8 percent, and include reduced employee productivity and negative shocks to consumer demand due to terror fears.

RESULTS UNIQUE TO EUROPE

European firms expect to cut their domestic workforces by 0.2 percent over the next year.

Forty-three percent of European CFOs are more optimistic about their own countries' economies relative to last quarter, and 54 percent are more optimistic about the outlook for their own firms. These numbers are up slightly from last quarter. However, this optimism is likely to fade if the U.S. enters recession: 34 percent of European CFOs say a recession in the U.S. would slightly damage the European recovery, 55 percent say it would have medium effect and 7 percent say a U.S. recession would be very damaging.

RESULTS UNIQUE TO ASIA

Forty-three percent of Asian firms expect more merger and acquisition activity in the coming year, while only 11 percent expect less.

Capital spending should jump nearly 16 percent in Asia.

Forty-five percent of Asian CFOs expect China's rate of growth to increase over the next two years, 18 percent expect it to remain steady and 37 percent predict it will gradually fall. Only one of the 208 Asian CFOs surveyed expects China's growth to decline rapidly.

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Detailed results, including tabular summaries of the numbers in this release and results from previous surveys, are available at <http://www.cfosurvey.org>.

About the survey: This is the 42nd consecutive quarter that the CFO Business Outlook survey has been conducted. Among the industries represented in the survey are retail/wholesale, mining/construction, manufacturing, transportation/energy, communications/media, technology and banking/finance/insurance. Revenue-weighted mean growth rates are provided for earnings, revenues, capital spending, technology spending and prices of products. Employee-weighted mean growth rates are used for health care costs, productivity, number of employees and outsourced employment. The earnings, dividends and cash on balance sheet weighted numbers are for public firms only. Unless explicitly noted, all other numbers are for all firms, including private.

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Optimism diffusion measures the percentage of CFOs who have increased optimism minus the percentage who have decreased optimism.