Assessing Inflation through a Corporate Lens

July 2022

To provide forward-looking perspective on inflation, Director of Equity Research Matt Peron and analysts from our Equity and Fixed Income Research Teams assessed comments made by listed corporations addressing the topic. They discuss how the consumer, industrials, energy and technology sectors are being impacted by rising prices and what it means for both company profitability and the health of the economy.

KEY TAKEAWAYS

- Our analysts' findings reaffirm that this spate of inflation is broad-based, emanating from both supply and demand factors.
- Many companies are facing higher labor costs as businesses compete for workers to meet surging demand.
- While companies across several sectors have thus far been able to pass along elevated input costs to customers, consumers could balk at higher prices once the savings they built up during the pandemic are depleted.

The past several months have provided a real-time case study on why central bankers and government officials obsess over price stability in the broader economy. Once the genie of accelerating inflation is out of the bottle, it can prove difficult to contain. Now that multi-decade-high inflation is here, participants across the U.S. economy can better appreciate policy makers' preoccupation with price stability and understand why it commands a central role in monetary policy.

Investors and participants in the "real economy" have both been acutely impacted by higher prices. Everyone is looking for answers and many have seemingly become experts – nearly overnight – in parsing inflation signals ranging from Treasuries' "breakevens" and consumer sentiment surveys to prices at the pump and a surge in starting wages as businesses scramble for labor. While many of these indicators provide useful insight, we believe they don't tell the full story. By their lagging nature, much inflation data is already priced into financial markets and consumers need no reminder of the pain they've been feeling for months.

To develop a stronger understanding of how the inflationary backdrop may evolve, more forward-looking signals are needed. We believe that an especially powerful tool is the public comments made by listed corporations addressing the subject. These are entities that must make investment, purchasing and pricing decisions based on their expectations of the trajectory of prices. Much depends upon their assumptions being as accurate as possible.

As fundamental investors, our Equities and Fixed Income Research Teams constantly monitor corporate statements and are in frequent contact with executives across a range of industries to discuss their views on inflation and other subjects related to the pricing environment. With an eye toward gaining a fuller understanding of how select sectors are being impacted by rising prices and what it means for both company profitability and the health of the economy, we have surveyed our analysts to distill some key takeaways that we believe add a unique perspective to the wider inflation conversation.

Supply, Demand, Or All the Above

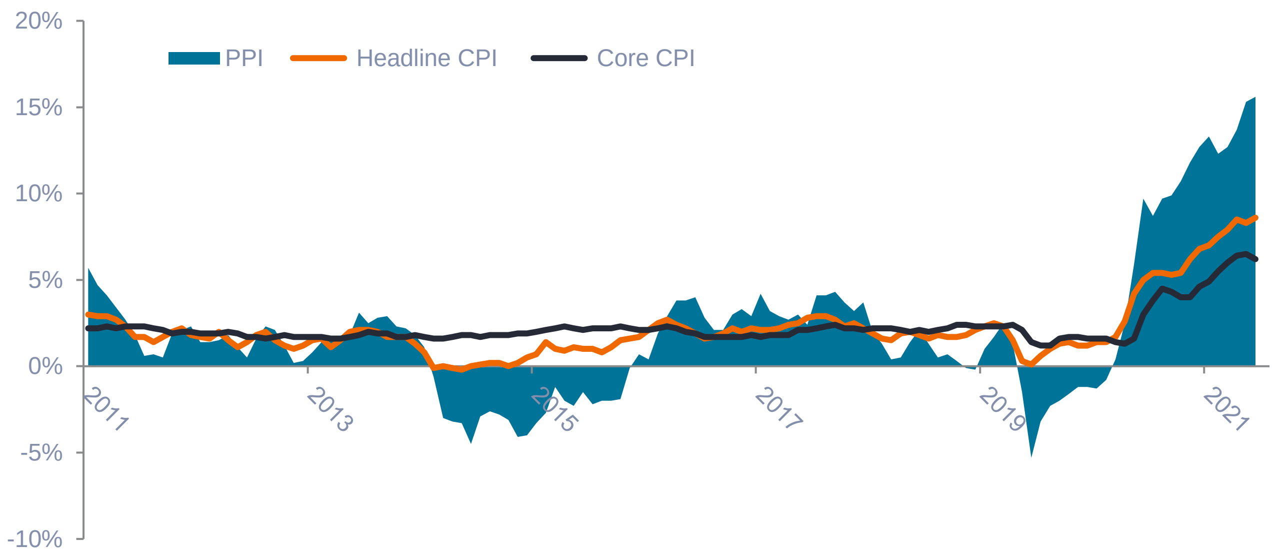
Some of our teams' findings unsurprisingly align with what is already known about this spate of inflation. Foremost, it is broad-based, emanating from both supply and demand factors. The former owes greatly to the supply dislocations that occurred during the onset of the COVID-19 pandemic and have yet to be fully resolved – think semiconductors. The war in Ukraine has added additional pressure, especially with respect to energy, certain crops and fertilizer. On the demand side, recovery – especially in the U.S. – was earlier and stronger than expected. The appetite for consumption has been further amplified by multiple waves of monetary and fiscal stimulus that left household balance sheets awash with excess savings.

Labor market tightness has increasingly become a factor as businesses compete for workers to meet surging demand. This dynamic presents the risk of igniting a wage-price spiral as companies are compelled to raise prices to account for higher labor costs. Those prices, in turn, can cause workers to demand even higher wages to absorb the rising costs of household expenditures.

Over the past two years, the U.S. economy has made up nearly all the jobs lost during the pandemic, now falling just 822,000 – or less than 1.0% – below the pre-pandemic peak. And while the unemployment rate has fallen to 3.6%, suggesting a tight labor market, hidden slack may be found in the labor force participation rate registering a suppressed 62.3% in May, 1.1 percentage points beneath its pre-pandemic level and well beneath its 20-year average of 65%. The unanswered question is whether many workers who have exited the labor force have retired early or can be lured – or compelled – to again seek employment.

U.S. Consumer and Producer Price Inflation

Companies have thus far been able to pass along higher input costs to maintain margins and consumers, for the time being, have been willing to tolerate higher food and energy prices.



Source: Bloomberg, as of 23 June 2022.

Labor plays a significant role in the trajectory of prices in service-based economies like that of the U.S. Wages comprise a considerable portion of business expenses and companies face the choice of raising prices or sacrificing margins to compensate for increased labor costs. Perhaps overlooked is that in a tight labor market, the marginal new hire is likely less productive than those with already established skills. This – in itself – is inflationary as it increases the unit labor costs of goods produced. The alternative, however, is to lack the production capacity to meet strong demand.

Thus far, companies across several sectors have had little problem passing along higher input costs to customers. This is a surprise in some respects as once inflation reaches a certain level, demand destruction could bite as customers balk at higher prices. The reasons for resilient demand likely vary across sectors, but one common thread, especially with respect to consumers, is the large amount of savings households built up during the pandemic. To be determined is how consumers react once these reserves have been spent.

The U.S. Consumer: Resilient (for Now)

Given that consumption comprises roughly 70% of the U.S. economy, insights on how consumer-focused companies are managing the inflationary environment bear special relevance. Based on industry and company data, there has thus far been no noticeable drop-off in consumer demand. That said, all the recent nominal retail sales growth has been a function of inflation whereas volumes remain flat to slightly down on a year-over-year basis.

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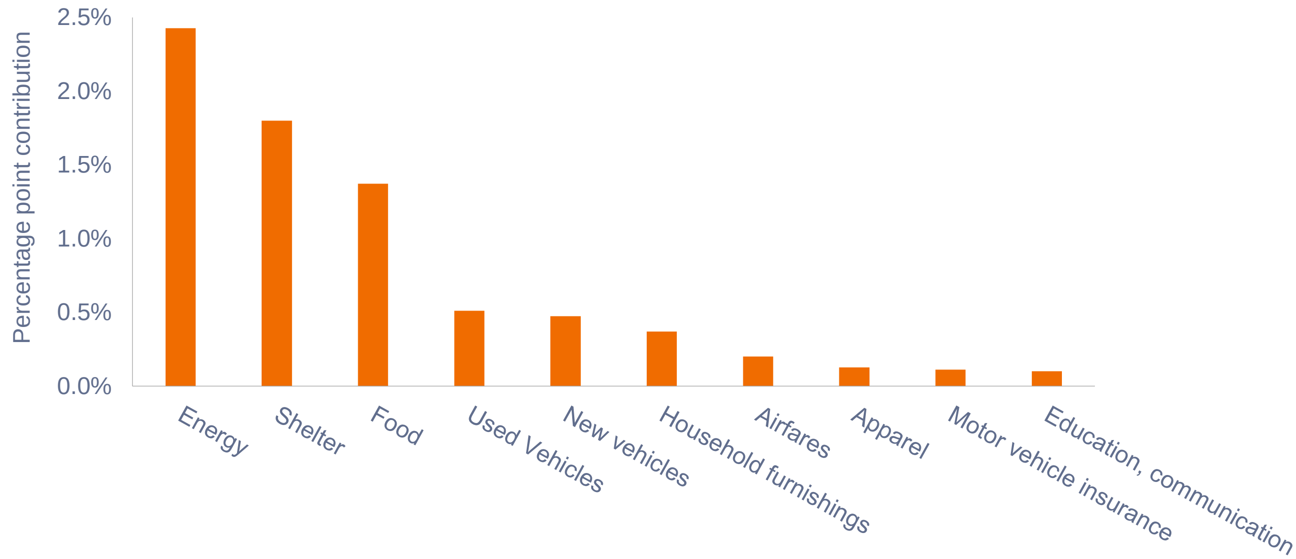
Over the past 18 months, every major category in the consumption basket has been inflationary. Yet during this period there has been a shift in which categories are contributing most to aggregate price pressure. The scramble for "stay-at-home" goods popular during lockdowns has subsided and consumers are now allocating a greater amount of their wallet toward experiences such as leisure travel and entertainment. More recently, energy costs have risen in importance, but even here consumers have perhaps surprisingly been willing to absorb $5.00 per gallon gasoline.

Contributors to U.S. Consumer Price Inflation Index, by Category

Disruptions caused by the war in Ukraine have sent commodities prices surging just as consumers began to shift their spending patterns toward experiences and away from "stay-at-home" goods.



Source: Bloomberg, as of 23 June 2022.

The transition to experiences exposes consumers to some of the categories most acutely impacted by supply constraints, namely energy and food. Wages also play a considerable role in the service-based, "experiences" economy. Both supply dislocations and wages are exerting upward pressure on consumer companies' input costs. Of the two, inflation emanating from supply-chain issues has been worse, but it is a smaller component of the total cost structure, and furthermore, there are signs of easing pressure. Wages, on the other hand, are not only an ingredient of the feared wage-price spiral, but also are proving stickier than supply factors. No company will be able to walk back recent wage increases. So even should wage acceleration subside, these expenses will likely reset at a permanently higher level.

From a profitability standpoint, we have noticed scaled and established national brands have enjoyed pricing power, and consumer behavior has proven fairly insensitive to rising prices. There are signs that this may be changing. In addition to the (expected) slowdown in "stay-at-home winner" categories, some national retailers have noted emerging signs of consumers opting for lower-priced, private-label brands, and others have commented that foot traffic has begun to slow. We expect the coming months will reveal that purchases within rate-sensitive categories – namely autos and housing – will slip given the rise in interest rates.

Looking forward, two factors are likely to have considerable influence on how much longer consumers can withstand inflationary pressure. First, real – inflation-adjusted – wages have turned negative, meaning heretofore impressive nominal wage gains are being canceled out. At some point, workers may realize they are worse off in real terms and react by cutting back on consumption. That reckoning may not have happened yet due to the second factor: flush consumer balance sheets. Since the end of 2019, U.S. household savings have risen by $3.3 trillion.[1] Those reserves have likely contributed to both buoyant consumption and inflation. As they are drawn down and the brunt of negative wages is more fully felt, consumption could cease being the marginal driver of economic growth.

[1]Source: Federal Reserve Flow of Funds Report.

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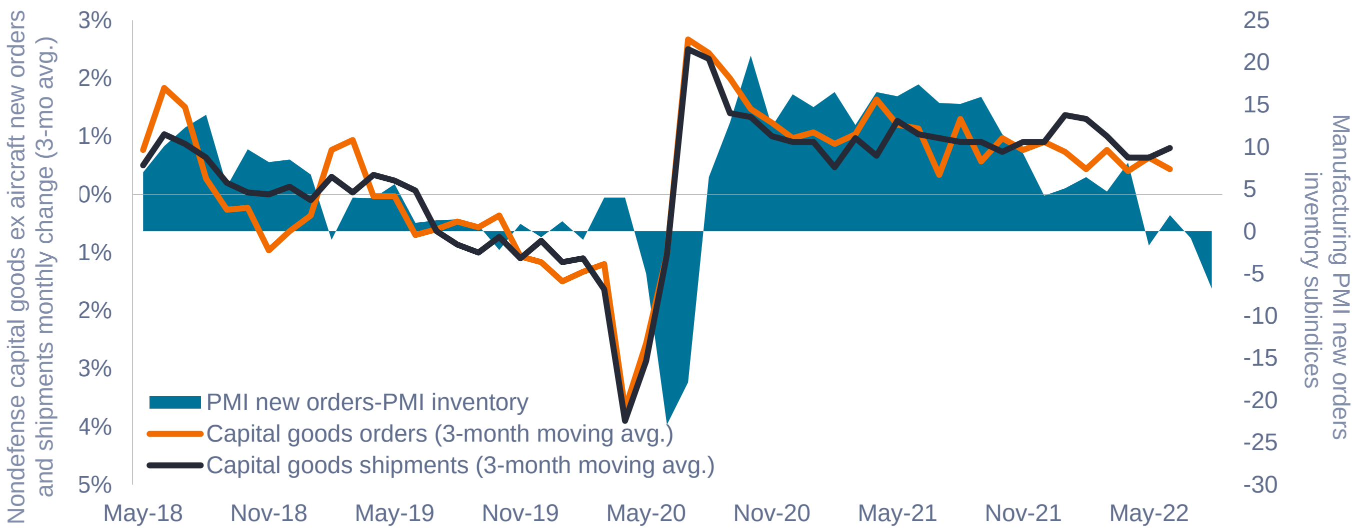
Industrials: The Crossroads of Supply Dislocations

Within the industrials space, companies have been able to successfully pass along higher input costs via price increases with very little pushback. In recent months, order books have continued to grow and backlogs are extending. These are signals one would expect to see during continued economic expansion. How they evolve merits close observation given the resetting of interest rates, which could place pressure on demand for big-ticket, capital goods. A sign of changing fortunes would likely be faltering conversions of orders to sales.

Within some businesses, there is a lag between pricing decisions and how inputs flow into the costs of goods sold. Given this mismatch, we expect to see some transitional pressure on margins, but over the longer term, margins would likely be defensible as long as demand remains robust. That is not to say there are no risks to margins. Supply dislocations across a range of industries have the potential to dampen sales. In these cases, industrial companies with considerable fixed costs could see margins pressured as those expenses are incurred regardless of units shipped.

Business New Orders, Inventory and Shipments

The leading indicator of new orders remains strong across the economy, but it bears monitoring for signs that orders are not converting to shipments or are failing to keep up with inventory levels as either would be a sign of economic softening.



Source: Bloomberg, as of 23 June 2022.

On the supply side, the industrials sector has found itself in the crosshairs of a series of challenging developments. Commodities and other inputs were already experiencing upward price pressure due to lingering pandemic-related disruptions. These have been aggravated by the war in Ukraine and the recent lockdowns in Chinese industrial centers and ports as the country continues to pursue a zero-COVID policy.

Industrial inputs responsible for inflationary pressure include iron ore, copper, fertilizer, anything related to the energy complex, freight and – as seen across the economy – labor. Although there are signs of easing on some fronts, such as shorter backlogs for container ships, those linked with the war in Ukraine may worsen as the full pain of this year's curtailed planting and production will hit markets at a later date.

From a corporate perspective, it remains to be seen whether industrial companies can retain current pricing once upward pressure on input costs eases. While such a scenario would allow for margin expansion, it's likely far down the road. Management teams with whom we've spoken believe the inflationary environment for industrial inputs will persist well into 2023. There is also the risk of an alternative scenario, which is the headwind of higher rates, when combined with supply-driven higher prices leading to demand destruction, lower revenues and shrinking margins as economic activity constricts.

Energy: A Long Time in the Making

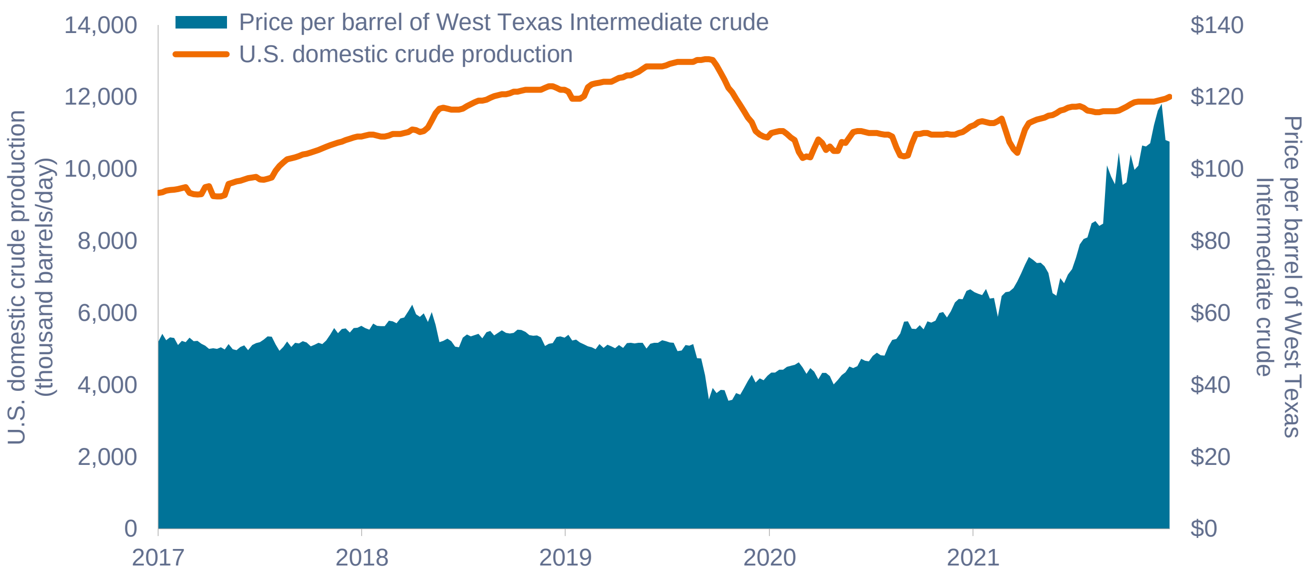
In nearly any discussion of inflation, the impact of energy typically receives top billing. That reputation is well deserved in this period as higher energy costs have permeated throughout the economy. Rising post-lockdown demand is only part of the story. The origins of the current mismatch harken back to the energy downturn of the last decade that was the result of exploration companies prioritizing growth over market balance and once again overshooting demand with excess capacity. Shareholders revolted, demanding higher returns on capital at the cost of curtailing future investment. Pandemic-related weakness only reinforced the view that capacity had overshot demand that was in secular decline as the global economy took steps to reduce its dependence on hydrocarbons.

Overlooked was that even during the depths of the pandemic, crude oil demand remained over 70 million barrels per day. Furthermore, consensus forecasts call for oil and natural gas demand to increase – not slip – in the coming decade. With the disparity between industry capacity and the post-pandemic rebound in demand already in place, crude and natural gas prices rose by more than 40% in the year *preceding* Russia's military buildup on Ukraine's border. Since then, upward price pressure has only accelerated.

Unfortunately for the rest of the economy, the lack of capacity is expected to last for the foreseeable future as there are no large-scale projects on the horizon. In looking for a lifeline, some point to Saudi Arabia possibly raising production capacity toward 12 million barrels per day. Our analysis indicates that such a level would not be sustainable. Regions outside of OPEC and the U.S. have been even more prone to underinvestment, so no help is likely to come from there. Then there are the concerted efforts to remove Russian hydrocarbons from global markets. That's proving easier said than done given the fungibility of oil in global markets and Western Europe's dependence on Russian natural gas. With it likely taking years to develop a viable alternative source for Europe's energy baseload, the region is facing a sustained period of high natural gas prices even though its rebound in demand has lagged that of the U.S.

U.S. Crude Oil Production and Price per Barrel

Rationalization of crude oil production has left the energy sector unable to meet the surprise rebound in demand for gasoline and energy product demand, a dynamic for which there is no near-term solution.



Source: Bloomberg, as of 10 June 2022.

Higher energy prices, however, have not been a windfall for the sector. Production companies are dealing with their own supply dislocations. Inputs for fracking – from sand and tubes to other metal components – have been difficult to come by and expensive when available. Multiple management teams highlighted the lack of skilled labor. Many production crews left the industry during the downturn and the pool of potential replacements command wages not aligned with their level of productivity.

Lastly, as the U.S. is in the midst of its summer driving season, one must ask how demand has been impacted by $5.00 per gallon gasoline. The answer – as of now – is not much. We attribute this to the release of demand pent up during the pandemic. Families are willing to endure high prices just to hit the road. This, however, may lead to an even fiercer pullback in consumer activity in the autumn, especially if fuel prices remain high and the cushion of excess household savings continues to dwindle.

Technology: The Pivotal Role of Semiconductors

Typically, the technology sector has been a disinflationary force for the economy as it provides the digital tools that make companies more productive and, thus, cost competitive. Yet during this cycle, tech has played a central role in perhaps the highest-profile supply-chain disruption: The semiconductor (semi) shortage. Given the ubiquity of semi chips across an ever-growing array of industrial and consumer products, a shortfall in controllers and microprocessors can shut down entire production lines, with the result being unfulfilled orders and inflated prices on the goods that ultimately reach the market. Two years after the nadir of the pandemic, used vehicles continue to be a material contributor to core inflation as new car lots remain understocked.

As with other industries, semis were caught flat-footed by the surge in demand during the pandemic – first by companies seeking to rapidly increase their digital capabilities for the *stay-at-home* economy, and then by the quick economic reopening. After reducing capacity in the wake of canceled orders, chipmakers were unable to ramp up production to meet renewed demand.

Cancellations filtered through the supply chain and these have contributed to the supply/demand imbalances that continue today. Chipmakers face higher costs from inputs such as wafers, other raw materials, freight and – like elsewhere – labor. But with end users scrambling for the chips essential to their products, semi manufacturers have had little problem passing along costs. One exception is the semi-capital equipment industry that makes the machinery to produce chips. This segment typically operates on fixed volume-price agreements governing a particular period, meaning they are unable to pass long their increasing costs to chip fabrication facilities for the duration of the contracts.

Semi companies' contribution to inflation, however, is not solely due to them passing along higher input costs. Many have capitalized on strong demand by pivoting production toward the highest-margin products. This has resulted in record profitability. Thus far, business customers including cloud, enterprise, automotive and industrial companies have absorbed higher prices as semi content comprise only a small portion of overall input costs.

Yet, knock-on effects are being felt in certain end markets. The absence of lower-margin chips means that some end users must turn to third-party markets to source essential chips, often paying up to 50 times the wholesale price. That does eat into margins. In many cases, the lack of a single type of chip can halt production on an entire product line, resulting in supply imbalances and higher prices for goods that at first glance have little connection to the chip industry. A noteworthy example is the plight of low-priced appliances. With the chips upon which they are dependent a low priority for semi makers, appliance manufacturers must curtail production. On the opposite end of the spectrum, higher costs and lower supply of inputs– including chips – are enabling automakers to capitalize on pent-up demand by prioritizing the highest-margin, highest-end vehicles. The resulting upward skew in sticker prices is a driving force behind the 17% year-over-year price for new cars in the U.S.

Looking forward, with many chips effectively sold out for the remainder of this year and little incremental supply slated to come online, we expect the inflationary environment for semis to last well into 2023. And while strong demand has meant both businesses and consumers have been willing to accept high prices for chips and chip-enabled products, a weakening economy could dampen that trend. We see the European market especially vulnerable as a weakening economy – combined with supply-driven inflation – could result softer demand for consumer products like personal computers, smartphones, tablets and TVs.

DEFINITIONS

Consumer Price Index (CPI) is an unmanaged index representing the rate of inflation of the U.S. consumer prices as determined by the U.S. Department of Labor Statistics.

Headline CPI differs from **Core CPI** in that the former includes all CPI categories whereas the latter excludes the typically more volatile food and energy categories.

Monetary Policy comprises a set of initiatives undertaken by a central bank to achieve a range of objectives within a country's or region's economy.

Nondefense Capital Goods (ex aircraft) is the category of manufactured goods aimed at increasing the productive capacity of an economy and serves as a proxy for business investment in capital.

Producer Price Index (output) is a measure of the change in the price of goods as they leave their place of production (i.e. prices received by domestic producers for their outputs either on the domestic or foreign market).

IMPORTANT INFORMATION

Energy industries can be significantly affected by fluctuations in energy prices and supply and demand of fuels, conservation, the success of exploration projects, and tax and other government regulations.

Industrial industries can be significantly affected by general economic trends, changes in consumer sentiment, commodity prices, government regulation, import controls, and worldwide competition, and can be subject to liability for environmental damage and safety.

Technology industries can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants, and general economic conditions. A concentrated investment in a single industry could be more volatile than the performance of less concentrated investments and the market as a whole.

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