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# Adapting to inflation: a bottom-up view



**Rynhardt Roodt**  
Co-head of 4Factor



**Christine Baalham**  
Portfolio Manager



**Jonathan Parker**  
Portfolio Manager

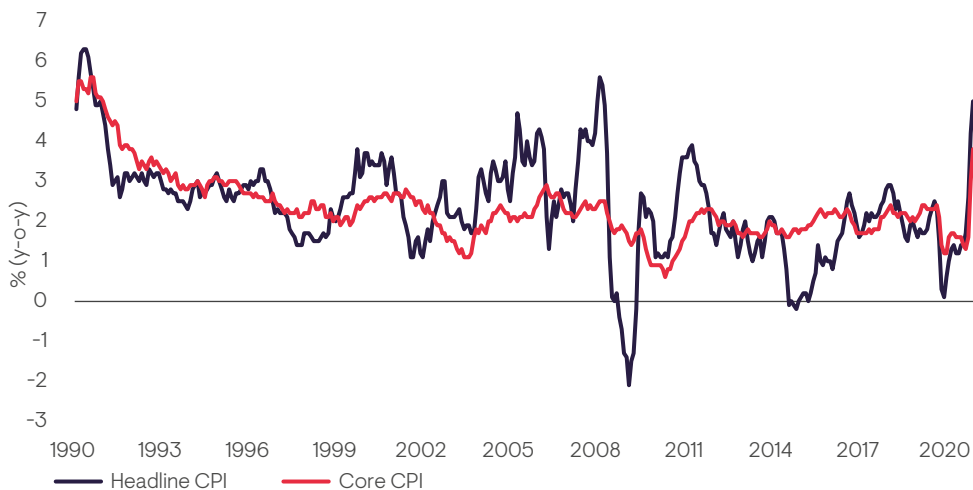
## The fast view

- The post-pandemic economic recovery is unusual in its combination of a sharp rebound in activity, unprecedented stimulus and supply-chain shortages – leading to the longest delivery times in the US in almost 50 years. These recovery dynamics are creating uneven inflationary pressures globally.
- Whether or not inflation proves transitory, investors still need to be mindful of how companies are likely to be impacted as pressures emerge.
- Many businesses have benefitted from the recovery and margins in some places are at record highs. However, market sentiment has become more muted with some investors sceptical about how sustainable margins are, given rising costs.
- As these price increases filter through supply chains, we believe that company second-quarter earnings are likely to diverge as sectors face different inflation challenges.
- We analyse how companies are responding and how they are likely to fare if inflationary pressures persist.

# An unequal inflation backdrop

As economies rebound, the substantial policy stimulus, resurgent demand and supply-chain disruption are adding new twists to global inflation dynamics. US consumer-price data is at multi-decade highs (albeit this needs to be considered in the context of low base effects, with prices compared to pandemic-depressed readings).

**Figure 1: US CPI has reached multi-decade highs**



Source: Bloomberg, 31 May 2021.

This combination of supply and demand factors is key to assessing differing inflation dynamics. In the near term, both factors are likely to lead to a general but uneven effect, with pricing pressures concentrated in specific sectors where growing demand outpaces supply. This is reflected in the sharpest price gains emerging in certain categories, such as used vehicles, energy and transportation services (Figure 2). What is notable is that all these categories are not only beneficiaries of re-opening demand, but also have faced supply chain disruptions. For example, used car prices are benefitting from both increased demand as people return to a more mobile lifestyle and disruption to new car sales from temporary COVID-related manufacturing shutdowns last year and current disruption in the automotive semiconductor supply chain. The pandemic-related disruption to supply chains has seen the US reporting the longest delivery times in almost 50 years.

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**Figure 2: Uneven inflation driven by supply-demand dynamics**

Annualised inflation rate across all components of the US consumer price index

Component (% y-o-y)	May-21	Apr-21	Mar-21	Feb-21	Jan-21	Dec-20	Nov-20	Oct-20	Sep-20	Aug-20	Jul-20	Jun-20
Headline CPI	4.99%	4.16%	2.62%	1.68%	1.40%	1.36%	1.17%	1.18%	1.37%	1.31%	0.99%	0.65%
Food	2.15%	2.37%	3.47%	3.62%	3.78%	3.93%	3.70%	3.93%	3.95%	4.13%	4.10%	4.54%
Energy	28.55%	25.14%	13.17%	2.36%	-3.65%	-6.96%	-9.43%	-9.19%	-7.69%	-9.04%	-11.16%	-12.65%
Core CPI	3.80%	2.96%	1.65%	1.28%	1.41%	1.62%	1.65%	1.61%	1.71%	1.74%	1.57%	1.19%
Household furnishings and supplies	3.69%	3.15%	2.83%	2.26%	2.44%	2.94%	2.87%	1.88%	2.09%	2.63%	1.50%	1.28%
Apparel	5.56%	1.91%	-2.48%	-3.57%	-2.54%	-3.93%	-5.19%	-5.53%	-6.03%	-5.94%	-6.46%	-7.28%
Motor vehicles and parts	13.32%	9.24%	4.46%	4.18%	4.60%	4.95%	5.05%	5.32%	4.55%	2.04%	0.08%	-1.12%
New vehicles	3.34%	1.96%	1.49%	1.16%	1.44%	1.96%	1.60%	1.53%	1.03%	0.65%	0.52%	-0.21%
Used cars and trucks	29.74%	20.97%	9.37%	9.29%	9.99%	10.04%	10.86%	11.54%	10.27%	3.98%	-0.88%	-2.78%
Medical care commodities	-1.85%	-1.73%	-2.44%	-2.55%	-2.27%	-2.48%	-1.10%	-0.82%	0.92%	0.76%	1.08%	1.26%
Recreation commodities	3.54%	2.86%	0.76%	0.26%	-0.20%	-0.24%	-1.00%	-1.25%	-0.81%	-0.37%	-1.28%	-2.13%
Education and communication commodities	-1.43%	-2.21%	-4.93%	-2.74%	-1.90%	-2.49%	-4.31%	-4.99%	-6.01%	-4.76%	-4.29%	-2.96%
Alcoholic beverages	1.55%	1.89%	1.95%	2.03%	2.43%	2.79%	2.98%	2.26%	1.76%	1.72%	1.51%	2.18%
Other goods	2.53%	2.32%	1.89%	2.05%	2.24%	1.84%	1.09%	0.92%	1.48%	1.32%	2.13%	2.68%
Shelter	2.21%	2.11%	1.70%	1.47%	1.62%	1.84%	1.92%	2.03%	2.04%	2.29%	2.33%	2.36%
Owners' equivalent rent of residences	2.11%	2.04%	2.01%	2.03%	2.01%	2.17%	2.28%	2.50%	2.49%	2.69%	2.80%	2.84%
Rent of primary residence	1.82%	1.80%	1.83%	1.96%	2.05%	2.28%	2.45%	2.67%	2.72%	2.95%	3.12%	3.22%
Lodging away from home	9.00%	7.37%	-6.41%	-14.94%	-11.40%	-9.52%	-10.79%	-13.75%	-13.00%	-11.41%	-13.36%	-14.03%
Water and sewer and trash collection services	3.44%	3.55%	3.53%	3.61%	3.57%	3.59%	3.35%	3.26%	3.40%	3.43%	3.04%	2.91%
Household operations	8.26%	4.92%	4.34%	4.32%	4.73%	4.12%	2.19%	2.73%	2.71%	2.09%	1.52%	1.78%
Medical care services	1.52%	2.16%	2.71%	3.02%	2.91%	2.75%	3.22%	3.73%	4.94%	5.32%	5.94%	5.97%
Transportation services	11.18%	5.62%	-1.64%	-4.37%	-4.06%	-3.47%	-3.41%	-5.09%	-5.10%	-4.00%	-3.74%	-6.96%
Airline fares	24.08%	9.64%	-15.07%	-25.62%	-21.31%	-18.26%	-16.98%	-20.40%	-24.98%	-23.51%	-23.66%	-26.99%
Recreation services	0.62%	1.76%	1.23%	1.06%	0.30%	1.58%	2.56%	2.62%	2.67%	2.17%	2.08%	3.43%
Education and communication services	2.19%	2.02%	2.04%	2.11%	2.04%	2.32%	2.40%	2.73%	2.84%	2.90%	2.90%	1.76%
Other personal services	2.78%	3.01%	2.87%	2.18%	1.99%	2.90%	2.36%	2.83%	3.07%	2.92%	3.14%	3.01%

Source: Bank of America, May 2021.

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As vaccination rates improve and supply chains and demand normalises, it is likely that many of these sharp price rises will start to slacken. What is harder to judge is whether their second order effects will ripple wider and remain with the economy for longer. Looking at the labour market, for example, it shows restrictions on migration and temporary unemployment subsidies – which may be discouraging a return to work – are resulting in localised labour shortages, leading to pockets of wage inflation as employers compete for workers. In turn, to compensate for these higher wages and other input costs, businesses are trying to push price increases onto customers.

While many companies reporting in the first quarter signalled additional price increases to account for the rise in input costs, in many cases a lag in implementation is expected, creating risks to margins in the short term. In a number of instances, the market response to good corporate results and margin growth has been muted as some investors have become sceptical that current high margins are sustainable in the teeth of rising cost pressures. Second-quarter earnings are likely to increasingly diverge as price increases filter through supply chains.

Since inflation effects are uneven it follows that rising price pressures will have different impacts at the sector and the company level – depending, for example, on a company's position within a supply chain. Broadly, inflation is seen as particularly positive for the cyclical sectors which are supplying primary inputs, such as **resources, financials** and **industrials**, and more negative for those exposed to input costs such as **consumer staples**. For a deeper explanation on the many nuances that influence the ability to pass on price increases, we now turn to how inflation impacts particular sectors.

# Cyclical beneficiaries of higher inflation

Energy and materials: higher risks of a commodity super cycle?

Figure 3: Oil prices are a key driver of inflation expectations



Source: Bloomberg, 28 June 2021.

Although **energy** and **mining** companies are experiencing some pressure from higher raw material and energy costs, this is being offset by the substantial revenue benefit from rising output prices. For **chemical** companies, if end-customers are seeing strong demand – for example in autos – it is easier to secure compensating price increases. Oil price expectations are a significant driver of inflationary pressures and are likely to remain so in the short term (Figure 3). The 90% increase in the oil price over the last 12 months is feeding into higher costs for chemical companies, but they have broadly been able to maintain margins by raising end-product prices. One example is Eastman Chemicals\*, where a premium for its more speciality products has contributed to rising earnings revisions. Companies like LyondellBasell\* are benefitting from higher producer prices aligned with the subdued pricing of US natural gas, which is its main raw material.

\* These stocks are held in 4Factor portfolios.

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Commodities have historically provided inflationary protection during periods of significant inflationary drawdown. In particular, investment returns in oil and copper have been strong at times of rising interest rates.

**Copper producers** seem well placed to thrive given limited new supply on the horizon — partly due to resource nationalism in Latin America — alongside a structural demand tailwind from increased investment in electric vehicles and renewable energy. The energy transition will limit demand for oil, reducing inflationary pressures, although it will increase demand for other materials, such as copper.

As for the possibility that pricing pressures reflect a new commodity super cycle, the risks have increased. However, a range of factors — including China's moves to control commodity pricing, the restocking nature of much short-term demand and the energy transition limiting oil demand — may contribute to less extreme commodity price behaviour than seen during previous super cycles.

## Industrials: pricing power is key

Similarly, as beneficiaries of rising inflation, most of the larger names in the industrial sector have a degree of pricing power and have shown the ability to expand margins in low-volume growth environments, using market positions to pass on input cost increases to customers. Many companies in the sector will also directly benefit from underlying drivers of inflation, namely rising commodity prices (mining & agricultural equipment manufacturers); freight costs (transportation providers) and labour shortages (factory automation).

Businesses with longer lead times and therefore more exposure to input cost inflation will have more issues — for example in the construction industry. That said, there does tend to be more flexibility in current contracts for these companies to account for raw material inflation. In addition, supply is so tight that companies will accept a price hike mid-project to ensure availability. As price increases feed through, we anticipate greater divergence in operating performance than in the most recent quarter and so companies with a high degree of pricing power are more likely to be resilient.

## Financials: banks are potential beneficiaries

Traditionally, financials have proved to be among the best hedges against inflation, as rising prices pave the way for interest rate hikes which is generally positive for the profitability of financials' balance sheets. **Banks** look particularly well placed given the economy is growing, trading income is elevated, loan losses are well provisioned for and yield curves are steepening. However, it is rising short-term rates that are pivotal for bank profitability<sup>1</sup>, which together with recovering loan growth, we believe will be required to drive a longer-term re-rating of share prices. Banks like Austria's Erste Bank Group or Finland's Nordea\*, in our view, should benefit from a more imminent rise in short term rates, which alongside a more diversified revenue mix, should generate greater operational leverage and drive earnings upgrades. Conversely, **property & casualty (P&C) insurance** companies are geared to shorter-duration assets to match their liabilities, where asset returns vary directly with inflation. These companies also have exposure to the replacement costs of goods, which increases claim costs and could pressurise reserves.

We believe rising short-term rates and recovering loan growth will be required to drive a longer-term re-rating of bank share prices.

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1. Source: Ninety One, 'What the rise in inflation means for banks', 14 May 2021.

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# Inflation effects differ for defensive sectors

## Telecommunication services, utilities and real estate: inflation is more key for utilities

Inflationary pressures are not significant in these sectors. The telecommunications environment remains deflationary, and lower pricing for services shows few signs of abating. Growth for **internet services** in particular may ease as the demand impetus stimulated by COVID-related lockdowns and working from home fades. In **real estate**, inflation is of little concern as market supply and demand characteristics alongside interest-rate changes are the main drivers of value.

Within **utilities**, inflation has historically been viewed as a negative for the regulated sector, especially where there is a delay between rising expenses and potentially contentious rate increases for customers. However, Iberdrola\*, has a business mix geared towards renewables, offering some resilience in the face of rising inflationary pressures. Key input costs for operational energy assets are negligible (dependent on atmospheric conditions), while much of the expected productive capacity is tied into long-term power purchase agreements (PPAs). In contrast, the unregulated sector is generally poor quality from an investment perspective.

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## Health care: some areas have better pricing power

Health care tends to lag with other defensives when breakeven inflation — a measure of expected inflation — rises. While input cost inflation is manageable as this is a relatively labour-light sector, pricing power is also limited given regulatory scrutiny on costs faced by the consumer.

Affected by rising input prices, **MedTech** in particular may struggle to raise prices given already high hospital bills. However, there are huge waiting lists for procedures which is supporting demand for products. Rising input costs affect the **pharmaceutical** sector to a lesser degree, but it is worth noting that companies are under pressure not to raise drug prices. Historically they were able to increase prices on certain drugs, but this will be very difficult now given looming worries around drug pricing reform from the Biden administration.

There are subsectors, such as tools, parts of animal health and dental, which have pricing power in inflationary environment. This is because these are not as tightly regulated and are generally perceived as more insulated from such cost pressures, as higher costs have historically been passed on.

## Consumer staples: a premium green opportunity?

In staples like **food and personal-care** products, gross margin pressure has stepped up a gear. Even the world's second-largest staples company P&G — which is better placed to absorb cost headwinds than smaller firms given its greater balance sheet flexibility and negotiating power — have acknowledged that its shorter-term profits may be affected.

“We will offset a portion of this impact with price increases... The exact timing and amount vary by brand and sub-brand in the range of mid-to-high single digits... We are analysing raw material and FX impacts on other categories and markets, and we are assessing the need for additional pricing moves”.

P&G CFO on increased packaging and transport costs at its quarterly results in April.

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Nevertheless, because of brand power, as referenced by P&G, the sector has shown itself to be adept at recovering such inflation over the longer term.

“We feel confident that we can price away inflation ... but it is a gradual implementation of pricing over time”.

CFO of Mondelez\*

We believe the greatest effect will be felt at the more commoditised end of the market where gross margins are lower. **Food processors**, for example, with higher input costs, will find it more difficult to protect margins. Premium products in the **spirits** or **cosmetics** markets will be less affected because of their high gross margins and greater pricing power. Increasing pressure to invest in making products and production processes more sustainable will also create margin pressure, given high upfront costs. However, actions to reduce packaging costs and shorten supply chains, such as through ‘near-shoring’, may ultimately serve to reduce both costs and carbon footprints. Consumers may also be happier to pay higher prices for ‘greener’ products, though the net effect is unlikely to be positive for margins in the short term at least.

Deal integration may also provide a buffer for some companies, with mergers and acquisitions providing cost-cutting and product-streamlining opportunities. Recent deals in the **drinks** industry – whether that be Coca Cola Europacific Partners or Asahi Group\* – give companies the potential to protect or improve margins even as external cost pressures grow. Similarly, substantial stock-keeping unit<sup>7</sup> (SKU) cuts benefit operations as they become simpler, making companies more efficient and flexible, potentially lifting margins. It also benefits working capital as fewer inventories are held.

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# Adapting to a more inflationary backdrop

The effects of the pandemic continue to disrupt supply chains, labour availability and transport, compounding cyclical pressures in the uneven economic rebound. Whether or not inflation is transitory, we expect the impact of such pressures to become more widely felt by companies during the second half of this year.

Sectors that traditionally perform best during inflationary periods — such as **materials, energy, industrials** and **financials** — seem set to benefit, but they may not be the only ones to prosper. The 4Factor Global Core Equity Strategy is overweight those sectors that are perceived as inflationary beneficiaries and underweight those where inflationary pressures might prove to be a headwind. We therefore believe that the portfolio is well positioned to thrive if inflationary pressures last for longer than expected. More agile business models could be less exposed to rising input costs, such as those in the digital economy, which is able to side-step most of the current cost pressures. A company's position in the supply chain, and whether its offering is at the commoditised end of the market, are also key.

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The ability to pass cost inflation onto customers will be defined by a number of factors. Strong end-market demand is one, where structural trends, such as the rise of electric vehicles, are key to sustaining this. Companies with dominant market positions or premium products will have stronger pricing power and making greener premium products could facilitate a long-term margin benefit.

Our research suggests that inventory efficiency, a superior brand/product set and high gross margins seem to provide the best protection against inflation. While we can look at inflation on a sector view, it will be the strength of individual companies that define success in this difficult operating environment. This is why in-depth fundamental research is key to assessing how companies are responding to price pressures. Coupled with the 4Factor screen which helps capture the nuances of stocks' operating momentum, this helps us build resilient portfolios for our clients.

**General risks.** The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made.

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**Australia**

Level 28 Suite 3, Chifley Tower  
2 Chifley Square  
Sydney, NSW 2000  
Telephone: +61 2 9160 8400  
australia@ninetyone.com

**Botswana**

Plot 64511, Unit 5  
Fairgrounds, Gaborone  
Telephone: +267 318 0112  
botswanaclientservice@ninetyone.com

**Channel Islands**

PO Box 250, St Peter Port  
Guernsey, GY1 3QH  
Telephone: +44 (0)1481 710 404  
enquiries@ninetyone.com

**Germany**

Bockenheimer Landstraße 23  
60325 Frankfurt am Main  
Telephone: +49 (0)69 7158 5900  
deutschland@ninetyone.com

**Hong Kong**

Suites 1201-1206, 12/F  
One Pacific Place  
88 Queensway, Admiralty  
Telephone: +852 2861 6888  
hongkong@ninetyone.com

**Italy**

Palazzo Toschi Cornelianani  
Corso Venezia 44  
20121, Milan  
Telephone: +39 02 3658 1590  
enquiries@ninetyone.com

**Luxembourg**

2-4, Avenue Marie-Thérèse  
L-2132 Luxembourg  
Telephone: +352 28 12 77 20  
enquiries@ninetyone.com

**Namibia**

First Floor, 6 Thorer Street  
Windhoek  
Telephone: +264 (61) 389 500  
namibia@ninetyone.com

**Singapore**

25 Duxton Hill #03-01  
Singapore 089608  
Telephone: +65 6653 5550  
singapore@ninetyone.com

**South Africa**

36 Hans Strijdom Avenue  
Foreshore, Cape Town 8001  
Telephone: +27 (0)21 901 1000  
enquiries@ninetyone.com

**Sweden**

Grev Turegatan 3  
114 46, Stockholm  
Telephone: +46 8 502 438 20  
enquiries@ninetyone.com

**Switzerland**

Seefeldstrasse 69  
8008 Zurich  
Telephone: +41 44 262 00 44  
enquiries@ninetyone.com

**United Kingdom**

55 Gresham Street  
London, EC2V 7EL  
Telephone: +44 (0)20 3938 1900  
enquiries@ninetyone.com

**United States**

Park Avenue Tower, 65 East 55th Street  
New York, 10022  
US Toll Free: +1 800 434 5623  
usa@ninetyone.com

**www.ninetyone.com**

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