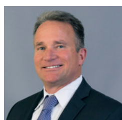
Passing the Buck

If inflation pressures persist, profitability may come under pressure for some businesses



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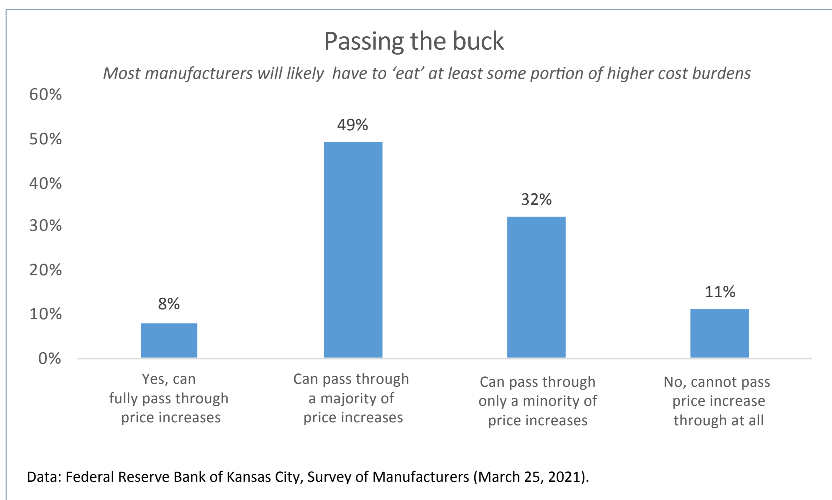
- The prevailing view is that the recent spike in inflation is temporary.
- But businesses are undoubtedly feeling pressure and typically can't (or don't) pass higher costs on to customers on a one-for-one basis.
- That could put profitability at risk if inflationary pressures persist.
- The resulting margin pressure would be ill timed given that equity valuations remain stretched.
- We believe this is may represent an underappreciated risk that investors should be aware of.

It's a tough time to run a business. The COVID-19 pandemic has created all kinds of challenges, from an uncertain and highly volatile demand environment to supply bottlenecks and a surprisingly tight market for labor. Now, business leaders may have another COVID-related challenge on their hands: inflation.

In April, two broad measures of inflation, consumer and producer price indexes (CPI and PPI, respectively) surprised economists by rising sharply — a trend that continued when May's results were reported as well. The prevailing view is that these and other recent jumps in broad inflation are both explainable and transitory: After all, it's hardly surprising to see a statistical surge in prices when you're trying to compare this year's relatively normal pricing environment to last year's pandemic-depressed values (these are the so-called "base effects" that have gained so much attention in the financial press in recent months). Moreover, with supply chains still suffering post-COVID hangovers of their own, it's only natural to see costs jump temporarily while things like staggered plant reopenings and tangled logistics networks sort themselves out. Besides, even if there is some real inflationary fire behind all that smoke, the Federal Reserve has all this well in hand.

Right?

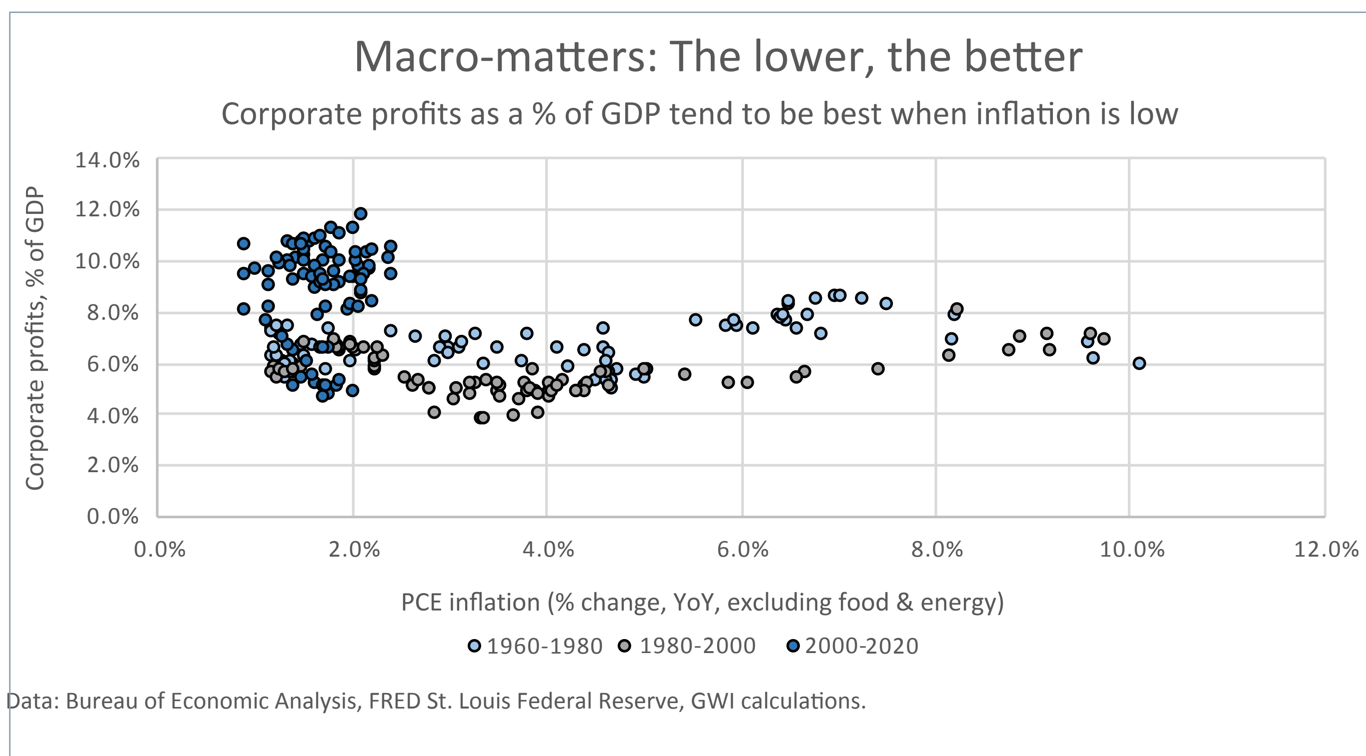
That's the theory, anyway and, so far, markets seem to have internalized that confidence by taking all this inflation news more or less in stride. But hidden behind all that macro-talk, there's a microeconomic quirk to consider as well: Any time the costs of doing business rise, whether because of higher materials prices, rising labor costs or whatever, the ability of businesses to pass those higher costs on to consumers is rarely one-for-one. For example, in March, the Federal Reserve Bank of Kansas City asked manufacturers in its region — which covers a significant swath of geography in the middle of the United States — whether they could fully pass through the substantial price increases they're seeing on to their customers. Fewer than one in 10 said they could. Nearly a third (32%) said they would be able to pass through only a minority of those higher costs, while 11% said they weren't confident in their ability to pass through any increases at all.[1]



Data: Federal Reserve Bank of Kansas City, Survey of Manufacturers (March 25, 2021).

You might be tempted to dismiss this result as a one-off given the relatively narrow scope of the survey, but these surveys have shown a consistent gap between the number of firms facing higher prices themselves (sometimes shortened to "prices paid") and those able to charge higher prices to their own customers ("prices received"). Significantly, that gap has widened noticeably as the post-COVID reopening has progressed. This apparent inability to recoup all, or in some cases even a substantial majority of rising costs, could matter — both to firms themselves and to the market at large.

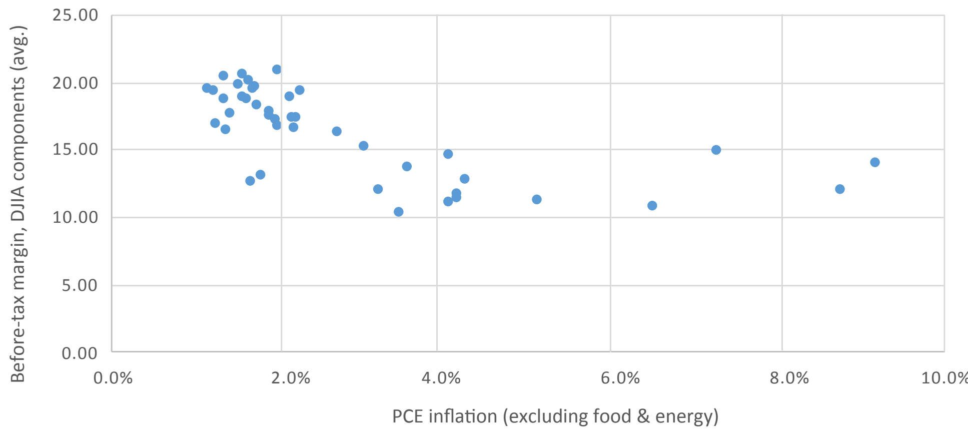
Here's why. In the simplest possible terms, the difference between what a firm pays to produce the goods it sells and the prices it ultimately charges its own customers is expressed as its profit margin. If the gap between those two measures is widening, then firms could see their profit margins erode as inflation picks up and becomes self-sustaining. And empirically there's reason to believe that at least some relationship between profits and inflation exists at the macro level: Corporate profits as a percent of GDP have tended to be higher when inflation is lower, especially in more recent periods. Indeed, the best years for corporate profits, by far, have been during the last two decades, when inflation has consistently hovered around 2%.



Data: Bureau of Economic Analysis, FRED St. Louis Federal Reserve, GWI calculations.

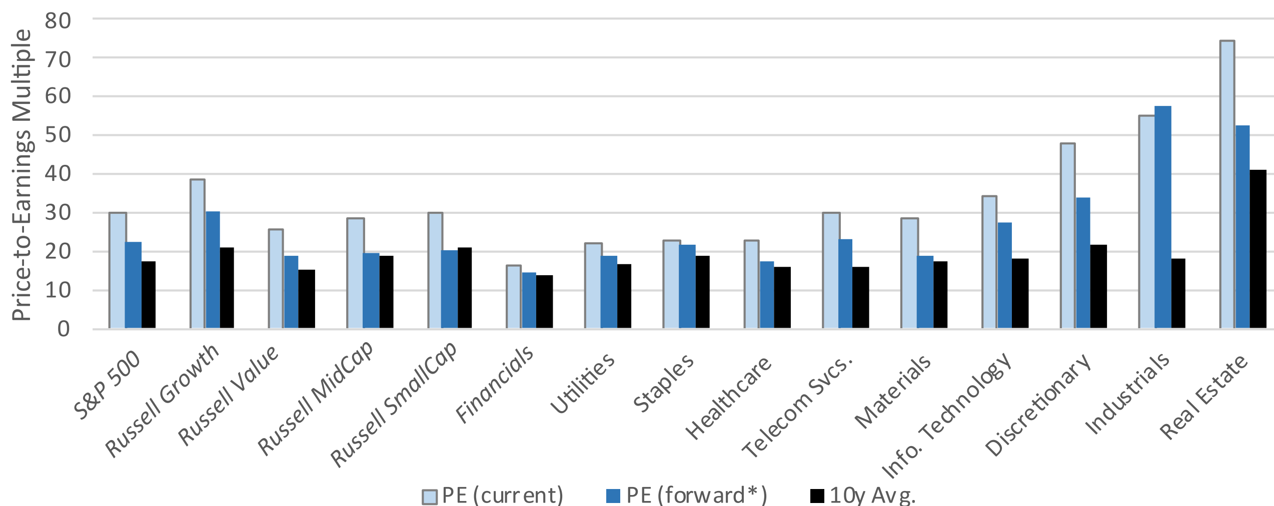
This analysis is admittedly fairly crude. After all, tons of things factor into profitability that GDP and national accounting figures aren't very good at capturing — like taxes, labor productivity, management practices, innovation and countless others that hold at least as much sway over margins as do the level and direction of prices across the economy. But if we switch our lens from the macro to the micro, the pattern repeats: the higher inflation runs, the less profitable companies themselves have tended to be. Below, we plot the average before-tax profit margin for all 40 stocks that currently compose the Dow Jones Industrial Average versus inflation over the last four decades.[2] Interestingly, the conclusion remains generally the same: as inflation rises, profitability tends to decline.

Under normal circumstances, this may not be much to worry about. In fact, one way to view this apparent trade-off between inflation and profitability — insofar as it actually exists — is that it represents a normal adjustment mechanism inherent in modern capitalist society: As profitability declines, businesses are compelled to adjust accordingly, making



tweaks to their operations, staffing and other strategic plans until equilibrium is restored (and those that can't evolve simply cease to exist by way of "creative destruction" — that brutal-but-elegant Darwinian dance of modern macroeconomics). And that's probably healthy in the long run.

But these are far from normal times. While opinions vary, most market watchers would likely agree that current market valuations are at least somewhat stretched. By some measures, valuations are reaching unusual extremes, placing a great deal of pressure on earnings to "fill the gap" by delivering earnings growth that justifies currently elevated valuations. Insofar as margins and profitability are key to producing that growth, the imperfect pass-through of rising costs — as well as the apparent relationship between margins and inflation it implies — could represent another headwind that post-COVID markets may have to deal with.



1 Federal Reserve Bank of Kansas City, Manufacturing Survey, March 25, 2021.

2 Data: Bureau of Economic Analysis, Morningstar (5/21), company reports and GWI calculations. Firms included in the margin calculation from the date of first availability of annual financial reports via Morningstar Direct.

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