Key Questions

February 23, 2022

What Are Companies Saying About Inflation?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

After combing through earnings calls for the fourth quarter in 2021, we thought it would be timely to recap what we are hearing from CEOs and CFOs of publicly traded US companies.

Based on what we heard, we extracted a few key themes:

1. Labor markets are so tight that revenue models are being disrupted and wages are rapidly rising.
2. Many, but not all, companies are successfully passing through costs to customers (i.e., price increases).
3. Supply chain issues are also affecting revenue models and raising the cost of doing business known as the cost of goods sold.

War for Talent

Across industries, we heard that attracting and retaining talent is a challenge for many companies. In our view, this is tangible evidence of inflation as a strong economy with many demands is now faced with a shortage of labor supply to service this demand.

We think there are a few reasons for this labor shortage, including:

1. Early retirements as 401(k) balances have increased significantly in the last several years.
2. A re-evaluation of priorities by workers.
3. Government entitlements that have reduced labor supply.

Passing Costs to Consumers

As labor supply declines, all else equal, the cost of labor must increase, which brings us to our next theme: Many, but not all, companies are successfully passing through prices to customers.

As labor costs balloon, companies seek to pass these costs onto their customers through price increases. This dynamic has the potential of creating a wage-price spiral, though we do not think we are in this situation yet. That said, we would not be surprised to see this happen. We all have seen the headlines decrying the highest inflation in four decades. This can be traced in part to the issues in the labor market, and to a lesser extent, some of the supply chain issues that have been present for the better part of a year.

Supply Chain Disruption

This brings us to our third theme: Supply chain issues are also affecting revenue models and raising the cost of goods sold.

As some countries pursue more restrictive COVID mitigation policies relative to those that are present in much of the developed world, we would expect to see demand begin to outpace supply of many goods. For example, a company in China produces a component for a product sold in the United States. As China pursues a restrictive COVID policy, this can create production shortfalls if fewer workers are available to assemble and produce an end-product that is in high demand in the US, which is generally more open relative to other countries.

Companies tell us that when a supplier has a shortage, they place their customers' orders on allocation. This means that customers only get a portion of what they ordered. As a result, customers begin placing larger and larger orders in order to counteract the allocation policy. This exacerbates inflationary pressures and adds to additional backlogs as companies scramble for input materials.

These shortages result in fewer finished goods that can be manufactured and sold, causing a revenue disruption, and higher prices. We know from economics that if there are shortages in supply while demand remains high, the cost of goods sold rises.

Our Outlook

Many companies aggressively addressed inflation in their quarterly communications with investors and most noted that they believe cost inflation is manageable via price increases and supply chain remedies.

Still, we would warn that these solutions could create further inflation. We also think that the current dynamics will weigh on profitability as costs are rising, and revenue is negatively affected by higher prices and disruptions to product availability. Clearly, some companies will be able to weather this environment better than others.

In our view, skilled active managers should outperform, and security selection is critically important in this environment. The outlook for inflation remains highly uncertain. We encourage investors to remain disciplined and take steps to ensure their portfolios are well diversified. These steps would include a slight tilt toward high-quality cyclical/value stocks and bonds, a balanced view with respect to international markets that are currently holding up better than their US peers, and incorporating real assets and other portfolio diversifiers where appropriate.

For more information, please contact your advisor.

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