Making the Most of Reflation

A Stock-picker's Guide

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KEY POINTS

- **Inflation should be contained longer term, but is due a cyclical uptick**
- **Such a backdrop presents an abundance of opportunities for stock-pickers**
- **In-depth knowledge of inflationary influences on economies and sectors is critical to determining which companies should outperform if inflation re-emerges**

2018 opened with an inflation scare that roiled bond markets and caused equities to seesaw.

While structural factors may weigh on inflation over the long-term, and a broad-based acceleration in corporate investment should boost productivity growth, the likelihood of a cyclical uptick in prices makes it worth considering which stocks might outperform in a reflationary environment.

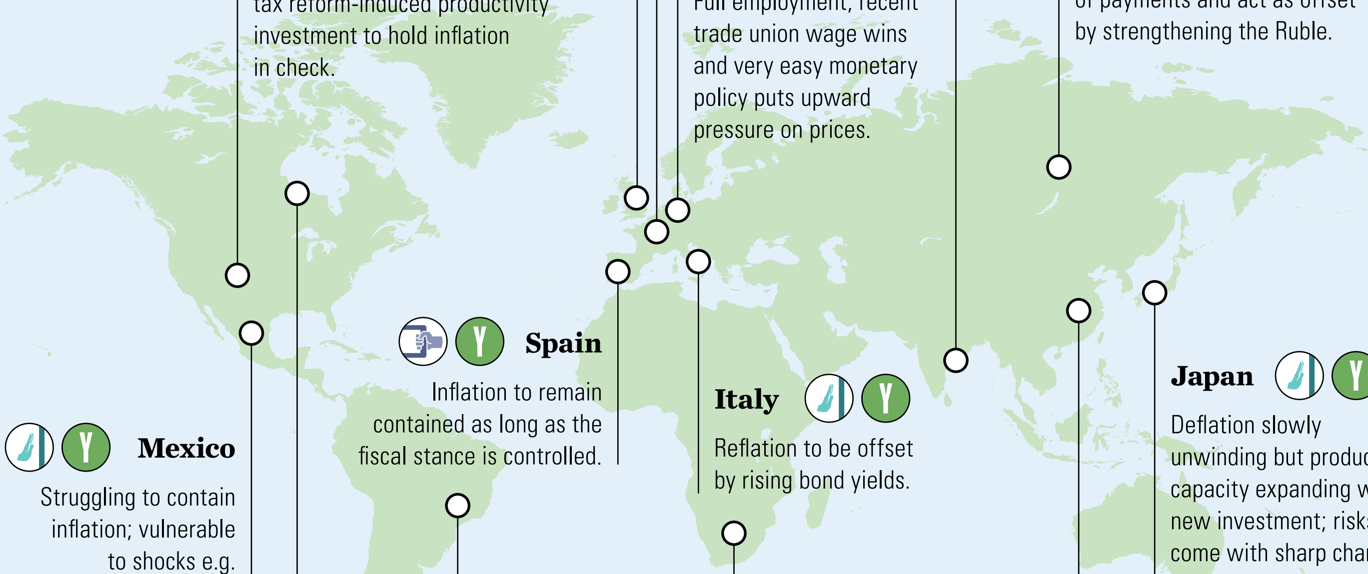
In this paper we analyse the inflationary influences across countries and sectors and examine how we as stock-pickers can best exploit these.

INFLATIONARY INFLUENCES WITHIN COUNTRIES

Economic textbooks define two types of inflation: demand-pull inflation and cost-push inflation. However, they are not mutually exclusive and the distinct causes of inflation might be difficult to distinguish in a dynamic economy. Demand-pull inflation occurs when domestic demand rises faster than the economy's productive capacity. Cost-push inflation occurs when input prices such as raw material prices rise sharply or when, in a very open economy, there is a sudden and sharp depreciation in the exchange rate, which in turn pushes up import and cost prices.

Here we outline the most likely inflationary influences on the major global economies and sectors. This helps us determine which companies might benefit more or less from a global reflationary backdrop.[1]

Cost-push Inflation
Demand-pull Inflation
Exchange-rate Sensitive — Y
Not Exchange-rate Sensitive — N



UK Y
Cost push inflation driven by weak £; migration holding wage inflation back and dampening purchasing power.

France Y
Tightening fiscal policy and underemployment to keep inflation contained.

India N
2017 monetary squeeze dampens inflation, but price levels could reflate with strong demand and expansionary fiscal stance; watch food prices.

Russia Y
Historically stubborn inflation keeps monetary policy tight; higher oil prices boost balance of payments and act as offset by strengthening the Ruble.

US N
Federal Reserve rate rises and tax reform-induced productivity investment to hold inflation in check.

Germany Y
Full employment, recent trade union wage wins and very easy monetary policy puts upward pressure on prices.

Spain Y
Inflation to remain contained as long as the fiscal stance is controlled.

Italy Y
Reflation to be offset by rising bond yields.

Japan Y
Deflation slowly unwinding but productive capacity expanding with new investment; risks come with sharp changes in the Yen's value.

Mexico Y
Struggling to contain inflation; vulnerable to shocks e.g. NAFTA dissolution.

South Africa Y
Politics curbs private investment growth and leaves the Reserve Bank with little margin for manoeuvre on rates as it fights to stabilize the exchange rate.

Canada Y
Vulnerable to an exchange rate decline, given strong domestic demand and a large current account deficit.

Brazil N
Productive capacity growth to remain stunted by high real rates and a large budget deficit; inflation trend is downward.

China Y
Ongoing demand strength and wage inflation sustain upward inflationary pressure; exchange rate targeting complicates monetary policy action.

INFLATIONARY INFLUENCES ON SECTORS

Sector	Segment	MSCI ACWI Index Weight (%)	Inflation Impact	Factors Influencing Inflation Impact
Consumer Discretionary	Autos and components	2.6	Negative	Strong competition in industry with high fixed cost base
	Consumer durables and apparel	2.0	Positive	Requires strong brands for pricing power and power over suppliers
	Consumer services	1.7	Positive	Requires strong brands for pricing power and power over suppliers
	Media	2.1	Negative	A highly competitive sector going through structural change implies hard-to-manage cost push inflation
	Retailing	3.9	Negative	Strong industry competition needs power over suppliers to avoid margin compression
Consumer Staples	Food and staples retailing	1.7	Positive	Depends on the degree of competitive rivalry
	Food, beverages and tobacco	4.8	Positive	Requires strong brands for pricing power; cost base becoming more flexible; needs power over suppliers
	Household and personal care	1.9	Positive	Requires strong brands for pricing power; cost base becoming more flexible; needs power over suppliers
Energy	—	6.5	Neutral	Unless oil prices rise, cost inflation will pressure margins
Financials	Banks	10.3	Positive	Positive until interest rates slow the economy and debt cycle begins
	Diversified financials	4.2	Neutral	Higher interest rates dampen demand while wages increase; technologically driven firms win
	Insurance	4.0	Positive	Positive for life insurance as bond yields rise; negative for property and casualty
Real Estate	—	2.9	Negative	Depends on lease duration
Healthcare	Healthcare equipment	3.7	Positive	Proprietary technologies coupled with flexible cost base are winners
	Pharmaceuticals, biotechnology	7.0	Negative	Cost increases alongside price pressure in bid to control healthcare budgets; biotech positive for successful products
Industrials	Capital goods	7.6	Neutral	Competitive segment; requires strong proprietary technologies to win
	Commercial and professional services	1.0	Negative	Wage and price-sensitive sector
	Transportation	2.2	Negative	Sensitive to higher oil prices and wage costs; requires strong demand to pass along cost increases
Information Technology	Semiconductors and semi equipment	3.3	Positive	Strong demand in a highly automated industry with operating leverage
	Software and services	10.5	Positive	Strong demand but with high wage growth
	Technology hardware and equipment	5.0	Positive	Requires strong brands for pricing power; cost base becoming more flexible; needs to overcome buyer price sensitivity
Materials	—	5.4	Positive	Requires strong proprietary technology for pricing power and to prevent switching; depends on demand/supply dynamics
Telecoms	—	2.9	Negative	Profitability and pricing constraints
Utlities	—	2.9	Negative	Profitability and pricing constraints

How Higher Inflation Might Affect Stock Returns

In a benign reflationary environment, companies with strong market positions and pricing power, coupled with a flexible cost base, can continue to grow their earnings. They can also provide an inflation hedge, making them more sought after and likely to outperform. While we believe better productivity growth is on the horizon, perhaps mitigating some of the anticipated price and wage growth and making a sustained acceleration in inflation less likely, we see longer-term trends emerging as the liquidity experiment undertaken by central banks in the wake of the financial crisis draws to a close.

In countries experiencing stronger wage pressures, companies could relocate, generating capital movement. Germany is a case in point. With tax reform in the US making the German tax system look relatively uncompetitive and labour market pressure mounting, capital flows out of Germany could accelerate. The US tax reforms and lower corporation taxes across some of the other major economics could simultaneously drive greater capital investment that in turn should boost productivity and offset higher inflation.

In those sectors where well-managed companies find themselves in intractable cost-push situations, i.e. their input costs are increasing, we expect them to invest in new technologies to increase efficiency. Companies that make productivity gains and reduce costs will ultimately be rewarded by markets. One sector we believe could do well (despite recent threats of regulatory intervention) is Information Technology, where companies tend to be highly dynamic and have healthy balance sheets and cash flows, enabling them to invest for the future. Materials and parts of the consumer and financials sectors could also benefit.

CONCLUSION

If we are correct in our thinking and productivity growth is stronger than official figures suggest, then inflation may rise above its current level but remain contained over the longer-term. Such a backdrop presents stock pickers with an abundance of opportunities.

However, an in-depth knowledge of the countries, sectors and companies in our universe, alongside systematic analysis of technologically-driven structural change, is going to be especially critical in identifying those stocks which can ride out any near-term reflation and outperform over the long-term.

Appendix

Reference Indicators (2017)

	GDP Deflator (%, est. average)	Current Account Balance (% GDP)	Fiscal Balance (% GDP)	Central Bank Official Rate (% Current)
United States	1.8	-2.4	-4.3	1.75
Canada	2.3	-3.0	-0.9	1.25
Brazil	4.4	-0.5	-7.8	6.50
Mexico	6.3	-1.6	-0.9	7.50
Japan	-0.2	4.0	-4.0	-0.10
China	4.5	1.4	-3.0	4.35
India	3.9	-2.0	-6.3	6.00
Germany	2.6	8.0	1.2	-0.40
France	0.8	-1.2	-2.8	-0.40
Italy	0.6	2.9	-1.9	-0.40
Spain	0.9	1.7	-3.1	-0.40
United Kingdom	2.0	-4.6	-2.1	0.50
Russia	6.3	2.6	-1.5	7.25
South Africa	5.8	-2.5	-4.2	6.50

Source: SSGA, Citigroup, Bloomberg Country Statistics as of 17 April 2018.

[1] We use the GDP deflator as our inflation measure, which covers price changes in personal consumption, investment, exports and government spending, rather than the less comprehensive Consumer Price Inflation. Except for Germany, all major country deflators have been showing readings that are below 2.0%, the inflation target for most central banks. We also use other reference indicators listed in Figure 1 to build a picture of inflation sensitivities for each country. See Reference Indicators chart in Appendix.

Central Bank Official Rate The rate at which a nation's central bank lends money to domestic banks.

Current Account Balance The sum of net exports, net income from abroad and net current transfers.

Fiscal Balance The difference between government revenues and government spending.

Gross Domestic Product (GDP) Deflator A measure of the price level of all domestically produced final goods and services in an economy.

Inflation The rate at which the general level of prices for goods and services is rising and, consequently, the purchasing power of currency is falling. The Consumer Price Inflation index is a basket of goods whose prices are used to measure inflation.

MSCI ACWI Index A market capitalization weighted index designed to provide a broad measure of equity market performance throughout the world. It comprises stocks from both developed and emerging markets.

NAFTA A pact negotiated by Canada, Mexico and the US that came into force in 1994.

Reflation A phase in the business cycle characterized by an increase in the money supply and a reduction in taxes with the intent of bringing the economy back up to the long-term trend.

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