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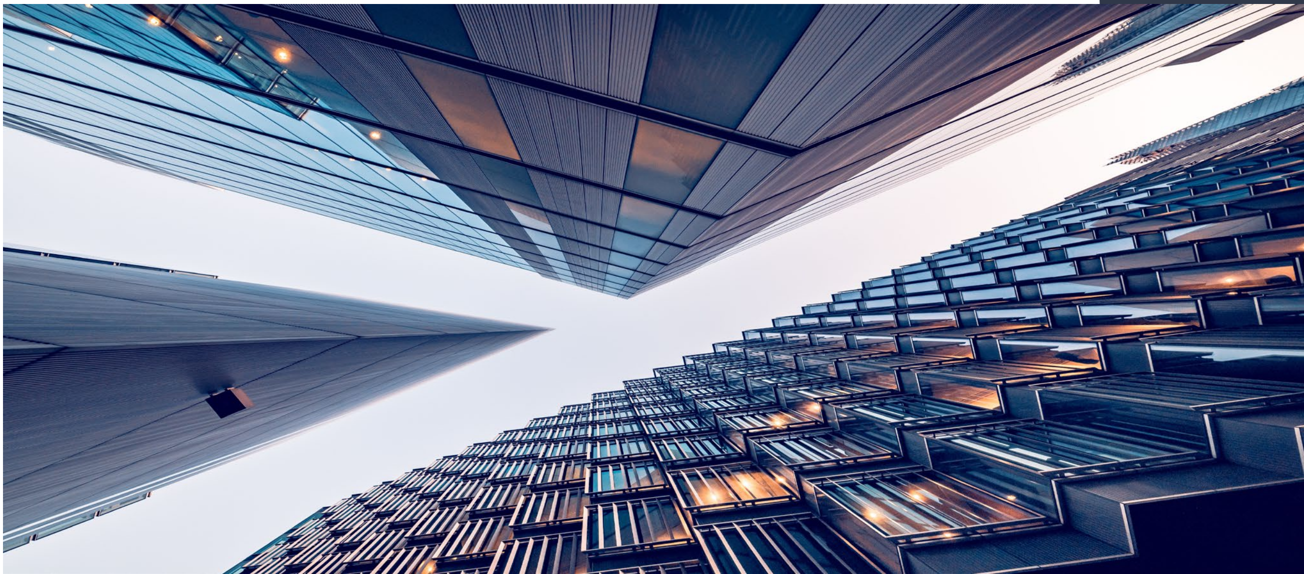
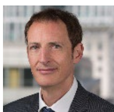
OUT OF THE ORDINARY

WEEKLY DIGEST | 14 February 2022

Margin Matters





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When the UK's Gross Domestic Product data for December was published last week, I noticed that, once again, one of the main contributors to growth was Health and Social Care, mainly thanks to a 51% increase in NHS Test & Trace activity. This would have been on account of the Omicron outbreak. And while such testing has allowed some activities to take place that might otherwise not have, I still find it hard to equate this with the sort of productive growth that would be more desirable. Gross Domestic Product is a pretty blunt measuring instrument.

Test & Trace activity will have received a further boost this morning as 73,782 people (including me) woke up to a “close contact” notification thanks to having been in attendance at Wales’s Six Nations rugby match in Cardiff on Saturday. On the basis that the latest estimate from the Office of National Statistics suggests that almost 5% of the UK’s population (just over 3.3 million) are currently infected with the virus, then I would have been more surprised not to be pinged.

But it’s testament to how far we have come in the last two years that such numbers and pings no longer have the capacity to scare us. Neither does Covid feature greatly in investors’ main list of concerns any more. The latest QuickPoll conducted by Goldman Sachs last week doesn’t even mention it. Deutsche Bank’s (DB) monthly client survey only has two mentions of Covid, in the section which asks what currently poses the biggest risk to markets. But even here the answer “New variants that bypass vaccines” has fallen from fourth to tenth in the list of concerns, with “Waning vaccine efficacy” barely registering. That is consistent with our opinion that we have been on a path towards normalisation since successful vaccine developments were announced, although bumps such as Delta and Omicron were inevitable.

And so, what are investors worried about? Three of the top four concerns on the list in DB’s survey are closely related: “An aggressive Federal Reserve tightening cycle”; “Higher than expected inflation”; and “Higher than expected bond yields”. None of this should come as a great surprise given market movements so far this year, recent central bank statements, and the latest inflation data from the United States last week, where the year-on-year gain of 7.5% in the headline Consumer Price Index (CPI) was the largest since 1982. We can expect a similar figure for the Retail Price Index in the UK on Wednesday, although the version more widely used by economists, the Core Consumer Price Index (which strips out housing-related inflation and fuel, is calculated differently and is deemed to be more representative) is forecast to be a more palatable 4.3%.

But there is no escaping the current trend of rising prices. Remember that the Bank of England now expects headline CPI to peak above 7% in April. And all this inflation raises further questions. If input costs are rising, will companies be able to pass those increases on to consumers or will margins come under greater pressure? There was a fierce debate about the sustainability of margins even before inflationary pressures started to increase. They are historically high, and many would have it that margins are mean-reverting owing to competitive factors and the cyclical rebalancing of power between capital and labour. In some cases, notably Big Tech in the US, there is the risk of margins being regulated lower. One could also cite the case for higher corporate taxes to help repair governments’ balance sheets.

Right now, though, it’s mainly about how companies deal with the rising cost of raw materials, with energy and key food ingredients to the fore, as well as many industrial commodities. The positive case for equities in the longer term is that revenues tend to grow with inflation, providing a hedge against rising prices. The flaw

with this argument in the short term is that the more successful companies are in raising prices, the greater the inflation and the greater the need for higher interest rates to curb it, which leads to downward pressure on valuations, especially for companies whose current value is driven more by expected future earnings and dividends rather than by today's.

Thankfully, raising prices is not the only way to mitigate higher input costs, and there is hope that productivity gains can take some of the strain. This might involve investing in more efficient equipment, which brings the added benefit of supporting overall growth through increased capital expenditure.

I have looked back through some of the references to margins made by companies reporting over the last few weeks, as recorded in our internal morning meeting minutes, and, so far, the overall mood is relatively relaxed, although not without some concerns. Sugar and sweetener company Tate & Lyle reported positive pricing power, with inflation-matching contract price increases for both value-added food ingredients and Sucralose. Packaging company Smurfit Kappa flagged "unprecedented cost inflation" pressure but managed to hold margins very stable by "optimising operating efficiencies and recovering cost increases through higher pricing in some categories". It seems that we can't live without cardboard boxes these days.

Somewhat disappointingly, consumer goods giant Unilever pointed towards lower margins than expected for the next couple of years, suggesting, perhaps, that not everything in the Consumer Staples sector is the safe haven that it is often assumed to be. There was a similar tone from Mondelez, where the operating margin of 15.4% was below the 16.3% consensus, reflecting broader freight and other cost pressures. It looks as though purveyors of high-end alcoholic beverages are doing OK though, with Pernod saying that pricing and savings "more than compensated" for cost inflation. Diageo recently reported a similar outlook. Maybe it's all those investment bankers celebrating large bonuses. Goldman Sachs warned of rising wages and bonus payments to hire and retain staff earlier in the reporting season. I'm not sure that this is the sort of wage growth that Joe Biden was hoping for. Credit Suisse was another bank to guide cost expectations to the top end of the range.

Here are a few more notable comments. Materials company DuPont reported margins contracting 200 basis points to 22.8% owing to raw material inflation, mainly in the Mobility & Materials segment despite increasing prices by 7% at a group level. More encouragingly, Amazon stated that supply chain headwinds and hiring costs were beginning to abate – at least in ecommerce, where Amazon operates - with sequential improvement expected as the year unfolds. Power tool maker Stanley, Black & Decker cited the headwinds of inflation, supply chains and currency, but also said that organic growth, price increases and efficiency gains are set to deliver growth despite those headwinds. And despite being in the supposedly attractive industry of making wind turbines, Vestas downgraded its margin expectations for 2021 for a third time to 3% from 4%, as cost pressures persisted. Rather worryingly for the world's green ambitions, it has raised the price of installed turbine capacity by 21% over the last year in an attempt to offset higher costs.

This is obviously a somewhat random and eclectic sample, and by no means exhaustive, but it illustrates that there is no "one size fits all" approach to margin management. That is why our analysts will continue to sift the evidence to differentiate between potential winners and losers. But margins are, I believe, going to be a hot topic through at least the next reporting season in April and May.

The more alert amongst you will still be wondering what the missing concern is from DB's top four. It's Geopolitics, in third spot. The main factor here will have been Ukraine, although it's not split out. Taiwan and Iran will also have been a bit further out on the radar. I hesitate to write anything too specific on the Ukraine situation because it might all have changed by the time you read this, and because it is a situation fraught with uncertainty. Markets hate uncertainty, which is quite different to "risk", which the market thinks it knows how to price. But all other things being equal, one would expect greater uncertainty to demand a higher risk premium and therefore somewhat lower valuations until we reach some sort of outcome.

Apart from what is available through regular media outlets, I have been lucky enough to be invited to listen to all sorts of experts in the last few weeks. These include a former US Secretary of Defense, the former Head of MI6, a former UK Ambassador to NATO and think tank members based in Washington and Moscow. They were all highly knowledgeable and well versed in their subject, although there was still a wide range of expectations. But to be honest, most of what I heard can best be described as "informed opinion". Nobody has the definitive answer here.

We entered the year with a slightly cautious view on risk assets, mainly owing to the inflation and interest rate risks. On the evidence that we have seen, we have not been inclined to take more risk off the table owing to geopolitical risk. But the drop in bond yields on Friday afternoon in the US, when it was reported that there was no agreement reached between Presidents Putin and Biden, provided a reminder of why sovereign bonds, even with their limited yields, still have some role to play in balancing the risk in portfolios.

Economic Commentary

FTSE 100 weekly winners

Company	Change
Antofagasta plc	11.4%
Informa Plc	10.4%
Whitbread PLC	9.3%
ITV PLC	8.9%
Entain PLC	8.0%
Anglo American plc	7.7%
Flutter Entertainment Plc	7.4%

FTSE 100 weekly losers

Company	Change
Evraz PLC	-8.9%
Ocado Group PLC	-8.3%
Spirax-Sarco Engineering PLC	-6.5%
Just Eat Takeaway.com N.V.	-5.8%
Croda International Plc	-5.6%
JD Sports Fashion Plc	-4.0%
Experian PLC	-3.7%

FTSE 100 index, past 12 months

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