ADVISOR PERSPECTIVES

Inflation Angst Is About to Rewrite the Stock Market Playbook

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by Lu Wang

For bond investors, inflation is pretty much all bad news, eating into the value of future returns. For equity traders, the tidings can be less categorically awful, given the ability of certain companies to wring profits from higher prices.

While there will be plenty of stock-market casualties should price pressures perk up, history suggests the landscape isn't devoid of opportunity. Energy shares have been persistent winners during times of high inflation over the past five decades, a study from Ned Davis Research shows.

Goldman Sachs Group Inc. recommends companies better equipped to derive earnings from sales, such as automaker Ford Motor Co. and media firm Discovery Inc. To Societe Generale SA, supply and demand imbalances suggest mining shares and fertilizer producers offer better hedges should pressures build.

No matter how sanguine Federal Reserve Chair Jerome Powell is about the topic right now, inflation will one day matter again for stocks. Just in the last few weeks, hawks have observed worrying signs in everything from a global shortage of computer chips to the biggest jump in U.S. producer prices on record.

With the economic outlook brightening, Covid-19 cases falling and more fiscal stimulus on the horizon, nervousness about inflation is percolating. That means pricing power is set to become "an intriguing alpha generator" due to the wide variance in how companies cope with it, according to Tobias Levkovich, Citigroup Inc.'s chief U.S. equity strategist.

"Lead indicators suggest that an inflation scare may be in the making," Levkovich wrote. "Companies with price flexibility should come out as winners."

Energy stocks have the best track-record during periods of rising consumer prices, according to Ned Davis. In seven out of nine cases of high inflation since 1972, the industry outperformed the S&P 500 by a median of 14 percentage points, the study showed.

When ranked by investment style, cyclical value stocks -- companies whose sales are more sensitive to economic swings and usually trade at relatively cheap valuations -- tend to do better when inflation runs high, Ned Davis noted.

Crude oil has surged this year, bolstered by confidence in a global economic recovery. Those bets have been reflected in the stock market, with energy producers including Exxon Mobil Corp. and Marathon Oil Corp. soaring. The industry has led gains in the S&P 500 in 2021, climbing five times more than the equity benchmark.

While inflation's ramifications for the broader market are not straightforward, a look under the surface shows investors are preparing for the outcome by favoring companies with high operating leverage, or the ability to extract profits from revenue.

While both sales and input costs tend to increase when inflation rises, companies with strong leverage potentially offer a safer trade. The reason is: the effect of growing revenue would outweigh the production costs.

Since the start of February, a basket of stocks with the highest operating leverage that strips out industry bias has beaten the cohort of weakest ones by 1.7 percentage points, data compiled by Goldman Sachs and Bloomberg show. The gauge is poised for a fourth straight month of outperformance, the longest streak since the taper tantrum year of 2013.

Higher input costs such as commodities pose little threat to overall earnings for S&P 500 companies partly because some industries gain as material prices climb and others hedge exposure, according to Goldman Sachs strategists including David Kostin.

Labor costs, on the other hand, are a bigger headwind, with an increase of 100 basis points in wage growth likely amounting to a 1% reduction in company profits, their estimates show. Accordingly, they advise investors to favor firms whose labor costs make up a smaller share of revenue, such as Under Armour Inc. and Biogen Inc.

“Many investors believe the spending boost will lead to higher inflation and interest rates, which would reduce the value of equity duration and increase the importance of near-term growth,” Kostin wrote in a note earlier this month. “Historically, inflation has boosted nominal S&P 500 revenues, but weighed on profit margins as companies struggled to lift prices at the same pace as rising input costs.”

Societe Generale’s strategists led by Andrew Lapthorne have built a basket of stocks based on their sensitivity to metrics like fluctuations in copper and food prices. Basic materials, technology and energy shares currently make up two thirds of the portfolio.

While the group has proved its worth by rising with inflation expectations in recent months, one drawback is its poor performance during times of disinflation -- something that has gripped the market for much of the past decade, they noted. To offset that deficiency, the Societe Generale strategists designed a trade dubbed “call replication” that limits the downside risk while maximizing the upside.

“When we speak to investors, they want the upside from value rallies and would like to hedge inflation risk, but most find the volatility incompatible with their risk tolerance,” Lapthorne wrote in a note Thursday. “Call replication strikes the right balance.”