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Profitability and productivity

Market Comment, August 2021

An important question for equity markets right now is how corporate profit margins will develop going forward. There is a fair amount of uncertainty surrounding this issue, particularly given a backdrop of rising inflation. Below we show that while the relationship between profitability and inflation may be complex, there are a number of factors that provide ground for optimism as far as the near future is concerned. With financing costs still low and productivity increasing to surprising levels, it is likely that profit margins will be healthy in most cases, particularly at high-quality companies with price-setting power.

In phases of sharply rising inflation, many investors wonder whether this benefits or hampers earnings growth, i.e. corporate profitability. The short answer is – it depends. The relationship between inflation and earnings growth is extremely complex, involving a number of factors that for most of them change simultaneously – in other words, it is similar to an equation with many variables that typically influence each other. Historically, a general rise in prices (inflation) has typically gone hand in hand with higher growth in corporate revenues, as revenues are a nominal real – i.e. non-inflation-adjusted – variable. Many equity indices having commodity companies as constituents are benefiting from the rise in commodity prices in 2021 compared to 2020, even if the magnitude of this rise could somewhat lose its momentum as the year goes by.

For companies outside of the commodity sector, the question is whether the rise in the prices of raw materials and other key components that have become more expensive due to supply bottlenecks (e.g. semiconductors) will have a negative impact on profitability. This in turn will primarily depend on whether the increase in these so-called "input costs" can be compensated by companies through increases in the prices charged to customers. Based on the information provided by many global companies, it appears to be the case this year – in contrast to previous years – that companies are charging their customers higher prices. This is plausible for two reasons. On the one hand, more widespread financial assistance provided by both central banks and governments is supporting general demand for goods and services more than in previous years. On the other, coronavirus restrictions have led to the build-up of a substantial amount of pent-up demand, particularly in Western countries. In the US, for example, these additional savings are estimated to have reached around USD 2 trillion, with many consumers looking to spend a significant proportion of this amount in the coming months. In Europe too, there is evidence of substantial "catch-up demand" – and not just for holidays or trips to restaurants.

> "A number of factors are pointing to healthy profitability at many companies."
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> Gérard Piasko, Chief Investment Officer

Of course, the development of wages on the cost side needs to be added to the equation. In Europe there is virtually no evidence of upward pressure on wages. This can be the result of declining in organised labour (i.e. low membership rates for trade unions and employee associations) compared with earlier decades. In the US, while there is evidence of a temporary labour shortage for certain jobs, this scarcity might very well disappear after the expiry of government assistance for the unemployed in the autumn.

Two other factors are currently having a positive effect on the profitability of global companies, particularly those in the Western world. The first of these is the strong global economic recovery. Historically, business margins often improve against a backdrop of healthy economic growth. Indeed, even if growth rates lose some of their steam but are still respectable, the profit

margins of companies are likely to exhibit above-average development. Last but not least, though the financial media generally – as well as many analysts – have yet to acknowledge this development, there is evidence of a sharp improvement in productivity. It is difficult to say with certainty whether this relates to quantum leaps in the area of digitisation, closer regional cooperation on the production side, better internet infrastructure, or other factors. Yet it is a fact that productivity is on the rise. Both in Europe and in the US, it has passed almost unnoticed that productivity has grown at a double-digit percentage rate compared to its long-term average for a number of months now, a development hardly expected by anyone. This is important, as increasing productivity has historically tended to boost corporate profitability. It should also be noted that fluctuations in these two factors are having an effect not just on equity volatility, but also on the volatility of all other asset classes.

Gérard Piasko

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