

Wentz Weekly

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Will Higher Input Costs Squeeze Company Profits?



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Last week's data on inflation calms investors' concerns who believe inflation is on an uncontrollable trend upward, but also did not improve the transitory argument for those who believe inflation will be temporary. The inflation report was still much higher than trend, with the consumer price index showing a 0.3% increase in August and 5.3% higher than a year ago, following a 5.4% year-over-year increase in June and July. Those items that are considered transitory, like used car prices, did cool down in August, declining 1.5% in the month, while some stickier categories like shelter continue to increase, rising 0.2% in the month and 2.8% from a year ago. Then there are wages. Due to the lack of workers, businesses are being forced to offer higher wages to attract more workers. To avoid cutting into profits, businesses could raise prices to make up for these higher wages, another factor that could lead to inflation. Wages and salaries are up 10.1% from a year ago and 5.3% compared to February 2020, right before the pandemic hit, and are expected to continue to climb as the labor market continues to face shortages.

The increase in prices has led some companies to update their guidance or remove guidance all together due to uncertainty in being able to forecast how much these higher prices will impact profits. Take 3M for example – last week the CFO said at a conference the company is experiencing input costs for certain items outpacing its ability to raise prices during the quarter and will impact the company's profits by nearly one dollar per share. Timken said it was pulling its forecast, saying underlying demand remains strong but inflationary pressures and supply chain disruptions give it too much unpredictability. In addition, during second quarter earnings season the number of time phrases relating to higher costs was used was the highest in over a decade, according to JPMorgan. However, as Barron's notes, "higher input costs for producers of goods will eventually filter their way through to the prices that consumers are paying, the arguments goes." While the worry on prices increases is legitimate and one we continue to follow closely, we do not believe it will disrupt the bull market we are currently in – pullbacks and corrections are normal and healthy in a bull market – and we remain overweight equities and continue to favor value and cyclicals

New details on House Democrats tax plan were released last week, as part of the White House's economic agenda and 'human infrastructure' plan. To help pay for the proposed \$3.5 trillion in additional spending under the plan, the White House's plan was to raise the corporate tax rate along with a series of tax increases on individuals, mainly the higher earners. The Democrats need all 50 of its Senators to approve the bill to be passed under reconciliation rules. In attempt to gain support, the House proposed a corporate tax rate of 26.5%, above the current 21%, but below Biden's proposed 28%. On the individual side, the top individual tax rate would be increased to 39.6% from 37%, the top capital gains tax rate would be increased to 25% from 20%, and a new surtax of 3% on income above \$5 million would be created. On the retirement plan space, the proposal calls for the elimination of Roth conversions and contributions for certain people, restricting pre-tax contributions for high earners, and changing required minimum distribution rules for those with high balances. This is not the final proposal and multiple series of negotiations will happen before the final bill materializes. A key vote comes from the Senator of West Virginia, Joe Manchin. He previously wrote an op-ed in the WSJ criticizing the costs of the \$3.5 trillion spending plan at a time when debt is surging and the economic growth is thriving. His most recent comments suggest he will not accept a spending plan of this amount and increasing a corporate tax rate over 25% and has been discussing a bill closer to the \$1-\$1.5 trillion range. At the end of the day the current proposal will not pass as is and we believe will need to be closer to the \$2 trillion range to gather enough support.

During the pandemic, spending on goods surged while spending on services fell substantially. As we have progressed through the recovery, spending on goods has slowly decelerated while spending on services has accelerated as people get more comfortable going out to restaurants and events as restrictions are lifted. That observation is supported by data in recent monthly retail sales report. In the August report, total retail sales increased 0.7%, according to the U.S. Census Bureau, versus a 0.7% monthly decline that was expected. Over the last four months retail sales are down 1.6%, which largely reflects the drop in vehicle sales due to the semiconductor shortage. Despite this slowdown, retail sales are still 12% above pre-pandemic levels. Spending on electronics and sporting goods/hobbies both saw large gains during the worst of the pandemic months but have declined in recent months, falling 3.1% and 2.7% respectively in August. On the other hand, sales of apparel, personal care items, and eating out has accelerated in recent months as people head out more often. We believe this is a trend that should continue which is another reason to like value stocks going forward.

Company News

- Intuit, best known for TurboTax, announced it will acquire Mailchimp, an email marketing platform, for approximately \$12 billion in a cash and stock deal. Mailchimp currently has 13 million users globally with 800k paid subscribers.
- 3M said input costs for resin, polypropylene, wood pulp, as well as labor costs have been outpacing its own ability to raise prices. Management said the higher costs will impact EPS by approximately \$.80/share, raised from \$0.40/share from July.
- Microsoft announced last week it is increasing its dividend 11% to \$0.62/quarter. It also said it has approved a new share repurchase program authorizing up to \$60 billion in share repurchases, or approximately 2.4% of its market cap as of the day it made the announcement.

The Week Ahead

The main event on the calendar this week is the Federal Reserve's FOMC meeting, policy announcement, and Chairman Powell's press conference immediately after on Wednesday afternoon. The Fed's updated projections on growth, inflation, and rates will be released in conjunction with the policy decision. The most likely outcome is no change in policy, but more details on the timing of tapering its asset purchase program and an official announcement at its November meeting. On the economic calendar housing starts and permits are released Tuesday followed by the NAR's August existing home sales report on Wednesday. The weekly jobless claims report will come out Thursday morning where expectations are for a number closer to 300k, a post-recession low, and another large drop in those continuing claims. On Friday the Census Bureau will report on August new home sales. The earnings calendar remains light but will have several notable reports including Lennar on Monday, AutoZone, FedEx, and Adobe on Tuesday, General Mills and KB Homes on Wednesday, and Carnival, Darden Restaurants, Rite Aid, Costco, and Nike on Thursday. Elsewhere on the corporate calendar, there will be several key conferences.

The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. The Dow Jones Industrial Average (DJIA), commonly known as "The Dow" is an index representing 30 stock of companies maintained and reviewed by the editors of the Wall Street Journal. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index. The NASDAQ composite is an unmanaged index of securities traded on the NASDAQ system. Every investor's situation is unique and you should consider your investment goals, risk tolerance and time horizon before making any investment. Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification. Information contained herein was received from sources believed to be reliable, but accuracy is not guaranteed. Information provided is general in nature and is not a complete statement of all information necessary for making an investment decision and is not a recommendation or a solicitation to buy or sell any security. Investing always involves risk and you may incur a profit or loss. Keep in mind that individuals cannot invest directly in any index. Past performance does not guarantee future results. There is no assurance these trends will continue, or forecasts will occur.