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Weighing inflationary pressures on international stocks

By: Ian Kirwan | August 17, 2021

London - There are some commanding themes running through the current earnings season that we believe will have both shorter- and longer-term implications for international equity markets.

Let's start with the bullwhip impact — or the demand distortion traveling upstream in the supply chain — that has affected many corporations as a result of the ongoing COVID-19 pandemic and the surging Delta variant. Supply chain bottlenecks, elevated freight rates and inflationary price pressures are key hurdles for many companies right now, and we're seeing margins being pinched across many sectors. Issues such as the port congestion in the U.S. have been causing headaches for several months and most companies are absorbing these additional costs in order to ensure no loss of competitiveness or sales.

Sectors face an array of challenges

Despite the acute speed and magnitude of inflationary pressures, many companies have expressed confidence that higher pricing, cost savings or other revenue-management techniques can be applied to offset them. We believe labor inflation will be important to watch over the next 12 months. Outside of badly hit service industries —such as restaurants and hotels, where there are acute labor shortages —we are not hearing about wage inflation surging. If wages do rise, the sticky nature of that trend would pose problems for central bankers and today's rock-bottom interest rates.

Semiconductors remain in short supply and prices are going up for this key commodity in today's technology-focused world. Most executives in the automotive industry are saying these delays will be felt well into 2022. For some technology companies, these shortages are allowing them to solidify their strong market positions and push through price increases. We believe that this dynamic, coupled with innovation and productivity gains, is creating sustainable medium-term advantages beyond the current market constraints.

In the consumer sectors, most companies have had to deal with high levels of inflation for at least a decade. Input cost pressure has become a predominant theme for the past few months, culminating in the current reporting season, where earnings downgrades are becoming more widespread.

One notable issue for some financial companies is that the European regulator has removed the dividend limits put in place last year. Following robust stress-test performance, European banks appear well-positioned for both enhanced dividends and improving loan growth. Banks that can fund and grow their top lines while paying a healthy dividend should outperform in the coming months. We think this is doubly true for European banks, which are currently priced at a discount to Asian and North American banks.

Companies likely to raise pricing

While there are many tools available to companies to manage costs and revenue, such as changing packaging size, we expect most firms to raise pricing. We think those companies with strong innovation pipelines or brands will be in an easier position to do this, as they may see greater consumer demand for their products.

With inventories mostly cleaned out and high demand for many products, going for price increases makes sense from a corporate perspective. We are seeing this accelerate for some sectors, such as sporting goods, as the spread of COVID has started to accelerate in Southeast Asia — further impacting the supply chain.

On the consumer side, overall, the consumer remains buoyant with significant amounts of cash at hand. In particular, we have seen U.S. consumers continue to surprise with their "spend" on luxury goods and apparel. As a result, some companies are now suggesting their margins may move ahead of previous peaks. The big question for consumer spending is what happens when the stimulus stops and people go back to work.

The strong get stronger

While creating numerous challenges, the COVID disruption has another side: Many strong companies are becoming stronger. On recent calls, a few management teams have mentioned that their market share has increased as a result of the pandemic. COVID has shown that when pushed, many companies can be agile and refocus their businesses. The use of, and increasing pivot to e-commerce and online transactions, has been a notable dividing mark for the "haves" and "have-nots."

Bottom line: Different sectors of the international equity market face an array of labor, supply chain and inflationary challenges. We believe, however, that companies with strong, sustainable business models and solid balance sheets will be better positioned to navigate shifting scenarios, while those lacking these qualities may struggle.

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Ian Kirwan
Global Equity Analyst
Eaton Vance Advisers
International Ltd.

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