INVESTMENT STRATEGY INSIGHTS

Inflation Permeation

April 25th, 2022

Is Inflation Sandbagging Earnings?

- Earnings growth, while weakening on the margin on a real basis, so far remains relatively resilient amid high inflation

Inflated Home Prices

- Home price gains should moderate, but economically-damaging home price declines appear less likely

Real Yields Turn Positive

- As interest rates continue to tick higher, shorter-duration fixed income may begin to look attractive

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- **Parsing Q1 Earnings Results.** Another earnings season is underway, providing some of the first glimpses at profit trends for 2022. With ~20% of companies reporting so far, the blended year-over-year earnings growth estimate for the S&P 500, which combines actual results with consensus estimates for firms that have yet to report, currently sits at 6.5%. Given the inflationary backdrop and expectations for an aggressive Fed tightening cycle, forward guidance will be an important factor to observe through the season.
- **Costs Higher but Margins Resilient.** Inflationary pressures appear to be having an impact beneath the surface of earnings reports so far. For example, the year-over-year growth in cost of goods sold for the S&P 500 now sits at 16%, which is a new multi-decade high. Interestingly, profit margins have so far withstood these rising costs, as it seems U.S. firms in aggregate have been able to successfully pass through higher costs via higher prices of end goods. However, it's possible that companies may eventually run into limitations on their pricing power if inflation continues to persist.
- **Nominal vs. Real Earnings Growth.** Remarkably, amid recessionary fears, heightened geopolitical tensions and elevated market volatility, earnings expectations have remained relatively resilient. Consensus earnings growth for 2022 for the S&P 500 has jumped to 10.2%, higher than its 9.0% estimate as of the end of last year. However, controlling for rising inflation expectations reveals a different picture. Real earnings growth expectations for this year sit at 3.7%, which has dropped from 5.0% to start the year.

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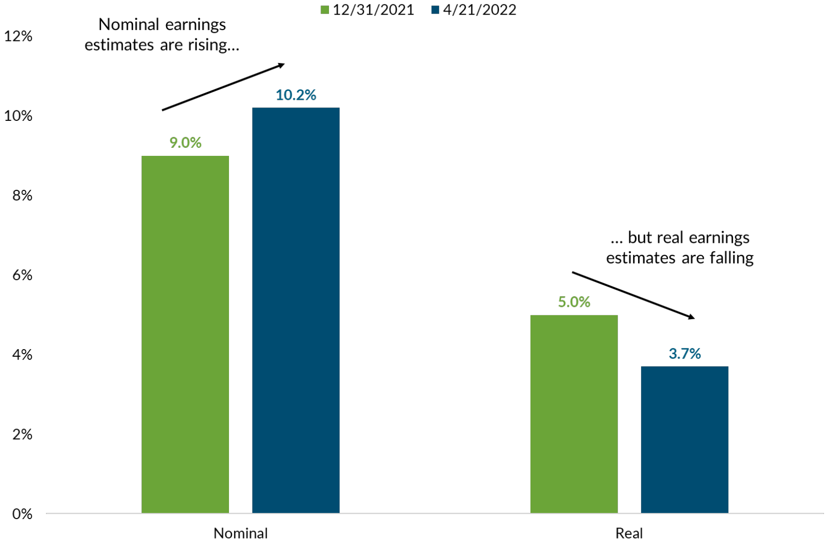
Chart of the Week:

Earnings expectations have risen, but are softer after inflation adjustments

S&P 500: 2022 Earnings Growth Expectations



Source: Glenmede, FactSet Data through 4/21/2022

Data shown are 2022 earnings growth expectations for the S&P 500 on both a nominal and real (adjusted for inflation expectations) basis, as of the end of 2021 and latest estimates. Past performance may not be indicative of future results. Actual results may differ materially from projections. One cannot invest directly in an index.

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Inflated Home Prices

- **An Imbalance in Housing.** A supply/demand mismatch is a leading contributor to strong U.S. house price appreciation, which is partly a product of the recent decade of underinvestment. From the late 1950s through the '08/'09 financial crisis, fixed investment in single family structures as a percent of GDP averaged 2.3%. Since then, it's averaged about half that pace. As a result, the supply of housing in the U.S., controlled for the number of households seeking that shelter, has steadily fallen.
- **Housing Demand Slips.** Despite 30-year fixed mortgage rates rising above 5% (its highest level since 2011), the U.S. median home sale price was up 17% year-over-year as of mid-April. However, the sales volume appears to be taking a hit, with existing home sales dropping 2.7% to a seasonally adjusted annualized rate of 5.8 million units as of March. Though the recent sales decline reflects undersupply and hesitation to higher home prices, the housing market is also sensitive to interest rates. As the Fed looks to slow inflation, higher borrowing costs may cool housing demand on the margin.
- **Trying to Keep Up with Demand.** As builders seek to restore housing inventory, new U.S. construction rose unexpectedly in March to the highest level since 2006. Housing starts climbed 0.3% last month to a 1.8 million annualized rate, reflecting the strongest pace of multi-family home construction since January 2020. Though the pace of housing starts remains elevated and above pre-pandemic levels, builders are still facing shortages, in both labor and materials due to supply chain bottlenecks, which may be holding back potential activity.

Home price gains should moderate, but economically-damaging home price declines appear less likely

Real Yields Turn Positive

- **Real Returns in Treasuries.** After beginning the year yielding 1.6%, rates on 10yr U.S. Treasury Bonds finished last week at 2.9%, a dramatic rise by historical standards. The main catalyst has been ever increasing expectations for tightening from the Federal Reserve, as it seeks to rein inflation under control. Interest rates have moved so dramatically, that 10yr Treasuries now offer positive real (inflation-adjusted) yields for the first time in two years.
- **Eying Up Bonds.** After two years of paltry yields in fixed income, the rise in interest rates, all else equal, should begin to make bonds look more attractive to investors. In recent years, negative real yields encouraged investors to tilt their portfolios toward riskier assets such as equities and non-investment grade credit. With the U.S. economy beginning to show signs of typical late cycle activity, this is historically an environment where expected returns for risk assets tend to soften. In reaction, investors should still maintain an underweight to core fixed income given the risks of further rising yields, but should, at the margin, begin to get incrementally more constructive on the asset class.
- **Selectivity in Fixed Income.** Investors seeking to take advantage of higher interest rates by deploying their incremental dollars into fixed income should prefer to do so on the shorter-end of the yield curve. The 2yr – 3yr portion of the curve is the duration with the largest marginal pickup in yield due to the magnitude of Fed tightening expectations over that timeframe. In addition, bonds with shorter terms to maturity are typically less sensitive to changes in interest rates, which may be key given the ongoing momentum higher in rates.

As interest rates continue to tick higher, shorter-duration fixed income may begin to look attractive

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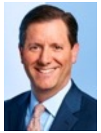

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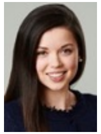

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