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Dear Client:

Another strong earnings season is cheering investors and pushing stocks to record highs. But dig a bit deeper into the results and a more complicated story emerges, exacerbating a performance gap that gathere4d steam during the pandemic between digital businesses and everything else. While we think internally about this divergence in somewhat esoteric research-speak (intangible versus tangible businesses), it is at its roots, a story of the haves and have-nots.

The haves are companies that are successfully growing their bottom lines despite rising wages, escalating inflation, and disrupted supply chains pushing input costs higher. They enjoy the tailwinds of secular demand and a growing market for their products. The haves also tend to be businesses that invest in technologies that manage costs and improve productivity. For example, LCES portfolio company (Microsoft) continues to grow at a phenomenal rate for such a large company, riding high on the strength of its cloud business and demand for workplace collaboration software. They generated +48% in revenue growth this quarter. The have-nots are not as fortunate. These companies are typically what we think of as “utilities”: necessities to be sure, but lacking price elasticity. And quarterly earnings confirm this, with continued malaise from the physical side of the economy, as exemplified by old-line, non-portfolio company (General Motors), who reported a plunge (***minus*** 25%) in revenue, as shortages of computer chips hit production as consumers pull back from the larger, durable outlays.

At the sector level, financial and technology companies are mostly unfazed by snarled supply chains and worker shortfalls and are “blowing earnings away”, while manufacturers, retailers and restaurants are missing estimates and guiding their outlooks lower. So called “pricing power” -- the ability to pass costs to customers without harming sales -- has long been prized by investors, with Warren Buffett describing it as “the single most important decision in evaluating a business”. This is because when businesses are hit with unexpected expenses and lack the ability to pass it on, they are forced to either cut other expenses or absorb the costs and consequent lower profit margins. If costs continue to spiral, the power to raise prices will become even more important, and persistent gaps between input and output prices will likely be scrutinized with caution.

Unsurprisingly, size is a factor and companies with greater market share have more pricing power than smaller ones. This is confirmed by a recent Federal Reserve survey which found that 85% of large firms reported passing on cost increases to customers, compared to less than 60% of small firms. In a separate report, JP Morgan found that firms providing consumer staples, communication services, and technology have the most pricing power, while energy and materials companies have the least.

For now, demand is robust, and consumers seem relatively insensitive to price changes, but that won’t likely persist. The big issue is whether an economy with shortages that is running hot ultimately forces an end to the managerial consensus of the past decade, which has favored keeping margins high and being stingy with investment in order to maximize cashflow. Rising investment is exactly what economists want because it increases capacity today and boosts the economy’s potential. Yet whether investors are prepared to accept higher capital expenditures at the expense of cashflow distributed to shareholders remains to be seen.

Regards,

Adam S. Abelson
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U.S. Large Cap Equity Strategy

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