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WHO'S AFRAID OF INFLATION? A CORPORATE VIEW

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Executive Summary

- *Strong cash balances (EUR690bn above pre-crisis levels in the Eurozone and more than USD765bn in the US), as well as rising profitability and capex, are cushioning most US and Eurozone companies from high input prices – for now. But as the earnings season unfolds, the most pressing question is which firms will be able to offset higher wage bills with productivity enhancement, and bear increasing borrowing costs.*
- *With inflation set to remain above 2% until late 2023, corporates have the leeway to withstand a moderate monetary policy tightening cycle (around +100bp). However, should commodity prices, wages or interest rates rise more than expected, we find that the construction, power, metals and the US transport sectors are most at risk of a liquidity and profitability squeeze.*

Strong cash balances, as well as rising profitability and capex, are cushioning most US and Eurozone companies from high input prices – for now. In 2021, input prices outpaced retail prices in most sectors, the result of supply-chain disruptions, the strong rebound in demand, constraints on the commodity supply and the rise of safety restocking. However, only about 40% of sectors on both sides of the Atlantic had retail prices rising faster than wholesale prices (see Figure 1). Over the long-term, 53% of Eurozone sectors (including automotive, sporting goods, pharmaceuticals) have seen retail prices grow faster than their wholesale prices against 25% for the US. And while a year-end survey showed that a majority of firms are planning to raise prices, we find that only a handful really have the ability to pass on higher input prices (see Table 1) – notably oil, air transport and textiles, as well as some sub-sectors of food manufacturing. In addition, some industries could face the prospect of risking increasing prices even as demand is waning.

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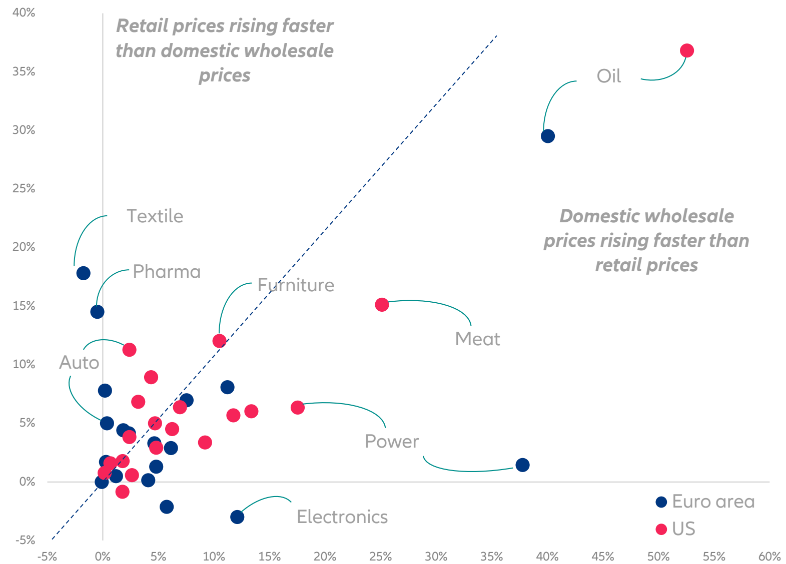
Figure 1 – CPI vs PPI in 2021, US vs Eurozone



Sources: Euler Hermes, Allianz Research, BLS, Eurostat

Table 1 – Short-term pricing power by sector

	US	Eurozone
Electricity	✗	✗
Food	✓ Dairy, beverages & meats (1-2 months lag)	✓ Most products (1-2 months lag)
Textile	✓ Apparel (1 month lag)	✓ (1 month lag)
Gasoline	✓ (2 months lag)	✓ (1 month lag)
Pharmaceuticals	✗	✗
Computers	✓ (1 month lag)	✓ (2 months lag)
Consumer electronics	✗	✓ (2 months lag)
Automobile	✗	✗
Air transport	✓ (2 months lag)	✓ (1 month lag)

Sources: Euler Hermes, Allianz Research

With high input prices expected to persist until H2 2022, companies' cash balances are key to cushioning the blow. Fortunately, these stand more than EUR690bn above pre-crisis levels in the Eurozone and more than USD765bn in the US (Table 2). In addition, since 2021, firms have also been increasing capex, mostly in reaction to supply-chain disruptions to avoid missed sales opportunities. This is echoed in the broad increase in inventories. Furthermore, pent-up demand in 2021 helped most firms preserve or even increase their margins. Overall, in our baseline scenario, we expect most sectors in both the US and the Eurozone to gain profitability in 2022 compared to 2021 (see Figure 2).

The increase in sales as estimated by sell-side analysts should allow firms to offset higher wages (+4.7% in the US and +2.5% in the Eurozone), higher interest rates (+75bps in the US and +25bps in the Eurozone) and higher oil prices – we expect an average Brent price of USD81 in 2022. In

particular, we see strong profitability gains for the US construction and machinery & equipment sectors, and for the Eurozone household equipment industry. The Eurozone metals sectors, which performed very strongly in 2021, is expected to lose some profitability in 2022, mostly because of its higher energy bill.

Table 2 – Cash holdings of non-financial corporates (NFCs)

	France		Italy		Belgium		Germany		Netherlands		Spain		UK		US	
	21/20	21/19	21/20	21/19	21/20	21/19	21/20	21/19	21/20	21/19	21/20	21/19	21/20	21/19	21/20	21/19
Financials	6%	39%	17%	78%	26%	73%	0%	17%	-3%	41%	19%	56%	34%	46%	17%	56%
Utilities	-3%	3%	-10%	-7%	138%	71%	16%	33%			9%	42%	58%	-32%	21%	60%
Energy	-13%	-3%	10%	23%	128%	18%	-23%	13%	7%	83%	6%	5%	40%	27%	45%	51%
Consumer Staples	-18%	-20%	26%	32%	-53%	0%	-10%	13%	-32%	1%	6%	30%	33%	29%	2%	44%
Industrials	-8%	1%	-7%	27%	-19%	13%	2%	31%	-19%	36%	-4%	15%	26%	35%	3%	39%
Communications	-2%	-8%	9%	61%	-20%	-21%	-33%	42%	30%	20%	125%	102%	45%	40%	4%	25%
Consumer Discretionary	-29%	33%	-20%	3%	15%	15%	-1%	13%	69%	158%	-20%	6%	82%	106%	11%	71%
Materials	-8%	33%	-24%	-5%	14%	73%	-17%	51%	26%	26%	1%	29%	38%	63%	9%	69%
Health Care	-13%	33%	41%	160%	-15%	-21%	-36%	30%	-27%	30%	-3%	9%	72%	52%	18%	19%
Real Estate	-18%	10%	-42%	-43%	15%	56%	-16%	-11%	-50%	-22%	59%	81%	88%	121%	11%	49%
Technology	38%	89%	-7%	25%	15%	-2%	20%	29%	-10%	26%	-8%	122%	31%	39%	1%	7%
TOTAL (NFC)	**-12%**	**9%**	**-4%**	**21%**	**-23%**	**8%**	**-8%**	**28%**	**14%**	**68%**	**9%**	**30%**	**46%**	**42%**	**9%**	**28%**

(*) 2021: H1 data for European sectors, Q3 for the US.

Sources: Bloomberg, Euler Hermes, Allianz Research

Figure 2 – Change in corporate profit margins in 2022 in the US and Eurozone in our baseline scenario

Sources: Euler Hermes, Allianz Research, Refinitiv (analyst estimations as of mid-January 2022)

Nevertheless, three scenarios could threaten corporate resilience: 1) A surge in oil and gas prices as a consequence of rising geopolitical tensions between Russia, Ukraine and NATO; 2) cumulative one-year wage growth reaching +10% and 3) interest rates increasing by +200bp.

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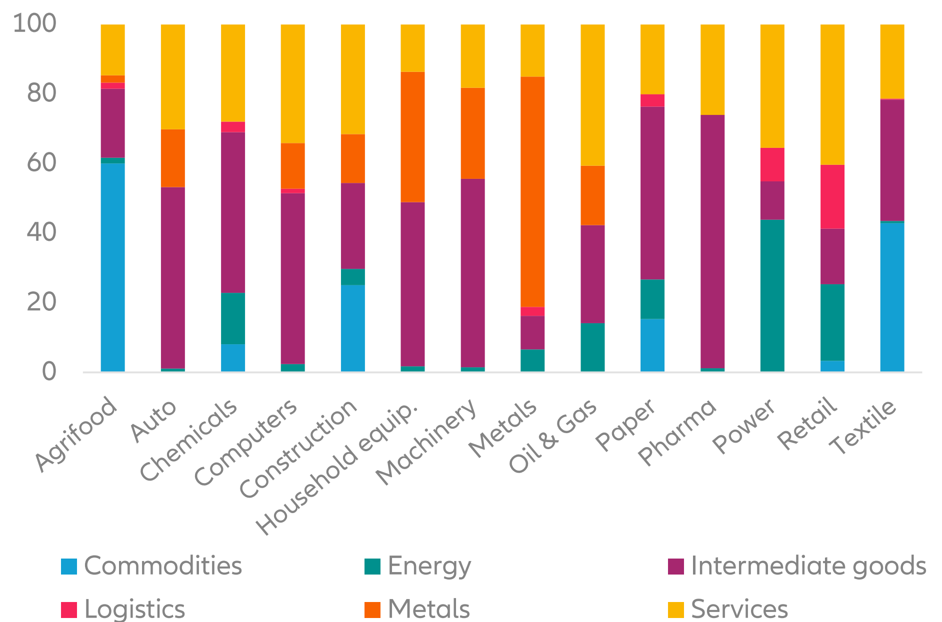
A commodity price shock would put the power and metals sectors most at risk: We estimate that oil prices rising to USD100/bbl would cut margins by more than -2pp for the power sector. Looking at the breakdown of costs for selected industries, we observe that the energy bill is mostly an issue for the power sector (see Figure 3). In addition, food manufacturing, metals and automotive have a heavy commodity bill through their demand for metal products/commodities. Interestingly, the retail sector is the most reliant on logistics costs, while the oil & gas sector is spending a sizeable amount on services (i.e. support to operations, exploration etc.). When simulating a shock on commodity prices on the balance sheets of over 1600 firms based in the Eurozone and in the US, we find that the power and metals sectors in both regions are most at risk of a drop in profitability (see Table 3).

Figure 3 – Inputs breakdown in industry costs*



*Based on US data, for input less labor & capex
Sources: Euler Hermes, Allianz Research, BLS

Table 3 – Sectors most impacted by higher commodity prices

	Sector	Country	Impact on EBITDA Margin
Energy price surge (Brent at USD100, +10% on gas)	Power	US	- 2.5 pp
	Power	Eurozone	- 2.4 pp
	Retail	US	- 1.8 pp
+10% rise in non-energy commodities	Metals	Eurozone	- 6.1 pp
	Metals	US	- 5.2 pp
	Agrifood	US	- 4.8 pp

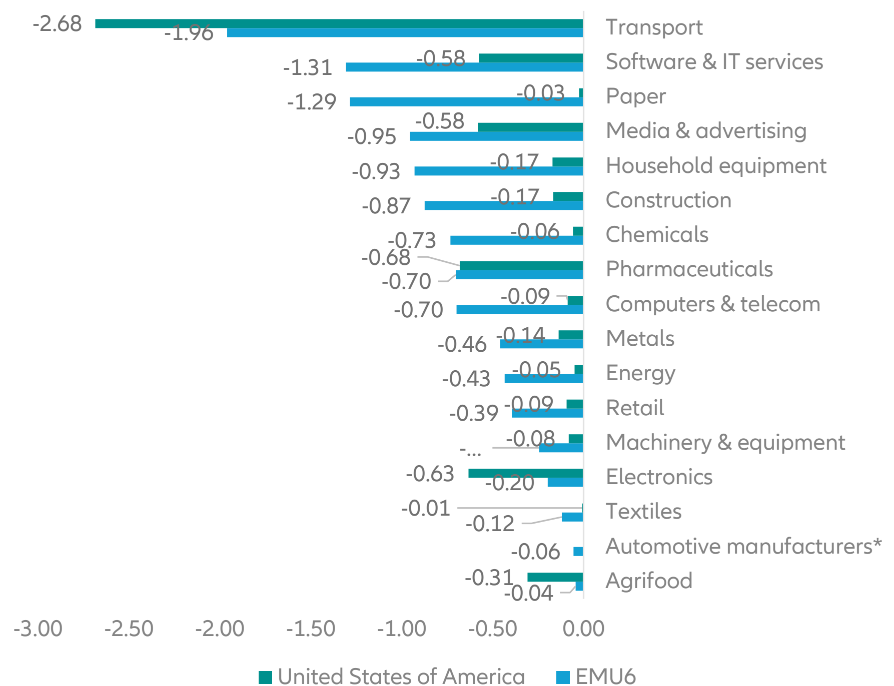
Sources: Euler Hermes, Allianz Research

What if inflationary pressures lead to higher wages? The transport sector in the Eurozone and the US, software & IT in the Eurozone and electronics

in the US are on the front line in case of a wage shock. Accelerating wage growth is likely to push up corporate cost bases in 2022: We expect strong wage growth of +4.7% in the US, +2.5% in France and +2.6% in Germany, though we see limited further upside pressures going forward as price acceleration will slow down in H2 2022 and productivity gains have remained contained, mainly in the Eurozone.

While we do expect inflation to recede by 2022 as pandemic-related disruptions ease, sustained rising prices could put the UK and France most at risk of a wage-price loop materializing in end 2022 and 2023[1]. Firms' wage bills are slightly higher in the Eurozone's industrial sectors than in the US, with the sectors spending most on personnel being pharmaceuticals, computers, textiles and electrical equipment. In case of a 10% wage increase, the transport sector, both in the US and the Eurozone, would take a severe profitability hit (see Figure 4). Software & IT services in the Eurozone is also vulnerable. In the US, the second most vulnerable sector is electronics. Note, however, that our simulations are limited in scope as we only cover listed firms reporting their wage bills. For instance, we do not have a large enough sample to closely look at companies in the labor-intensive food and accommodation sector (6% of total employment in the Eurozone in 2019), mostly composed of SMEs (over 2mn legal entities).

Figure 4 – Impact on profitability of +10% increase in wages*



* Profit excluding depreciation & amortizations based on a sample of more than 1700 listed firms on 2021 financials (up to Q3)
Sources: Euler Hermes, Allianz Research, Refinitiv

Which sectors are at risk of rising interest rates? In the US, the energy and transport sectors would be hit the hardest. With inflation set to remain above 2% until 2023, we expect central banks to gradually raise interest rates[2], which will increase financing costs for corporates. They do have the

[1] See our report *Frying pan to fire: Will inflation spark a wage-price spiral in 2022?*
[2] *See our macroeconomic scenario Economic outlook: Don't look up!*

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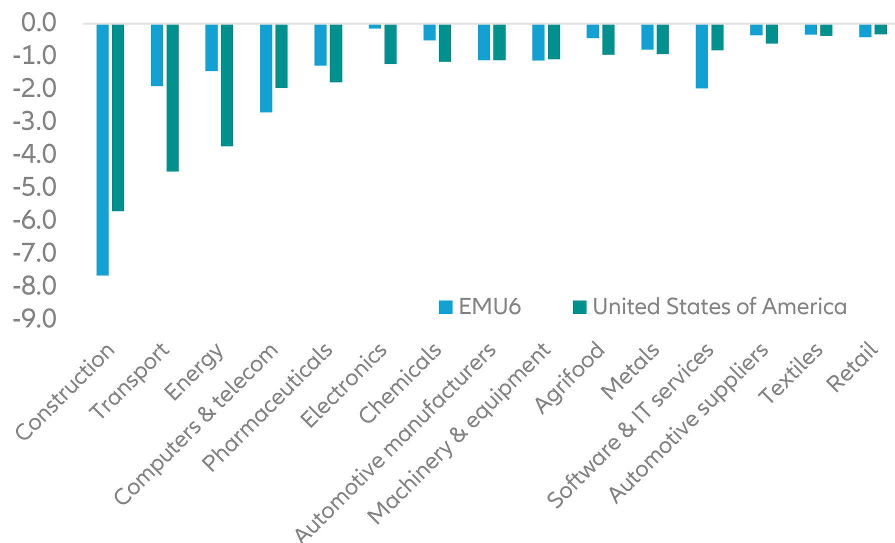
leeway to withstand a moderate monetary policy tightening cycle, though: Previous cycles have shown that the sensitivity of +100bp increase in key interest rates is highest in the US, the UK and Italy, and 90% of the pass-through materializes after four months, with the full pass-through achieved after seven months. However, the transmission from higher interest rates to the real economy can be slower this time, thanks to corporates' high cash positions (+27% compared to 2019). As a result, we estimate that an increase of +100bp in key interest rates would translate into a fall in non-financial corporates' margins of -1pp in Germany, -2.3pp in France, -1.5pp in the UK and -1.4pp in the US.

However, if interest rates rise faster than expected, highly leveraged and risky sectors would likely be hurt. Our simulations on a sample of over 1600 listed firms' debt structure and interest expenses indicate that the construction sector in both regions, and the US energy and transport sectors, are most at risk in the event of a sharp interest rate shock, i.e. +200bp (see Figure 5).

Figure 5 – Impact on pre-tax profit margin of +200bp increase in interest rates*



* based on a sample of more than 1600 listed firms on 2021 financials (up to Q3)
Sources: Euler Hermes, Allianz Research, Refinitiv

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