Europe

Strategy Matters

Portfolio Strategy Research

The new order: Large shifts in pricing power

In recent months we have seen large falls in both commodity prices and inflation expectations. For listed European companies, the disinflationary pressure is even more aggressive. Weighting the components of CPI and PPI by their sector sales-weight in the market, we estimate selling prices are down 0.5% yoy. But while selling prices are under pressure input costs are falling; inflation in imported raw materials has been running at -4% to -7%. For those companies selling to the consumer, or at least with some pricing power, the relative moves in pricing should be supportive.

No more 'revenge of the old economy'

Recent moves in pricing between CPI, PPI, import inflation and commodity prices point to large shifts in relative pricing power for companies. The S&P GSCI commodity index is down 14% in euros since June, and raw material prices and PPI are running well below CPI. Unsurprisingly commodity-related sectors perform poorly as prices fall, but so do sectors further up the supply chain such as chemicals and industrials (see below).

Consumers win

Consumer sectors have gained historically. But for some, such as retail, structural changes have worked against this recently. Telecoms, media and healthcare tend to benefit as commodity and producer prices fall relative to CPI. This may seem counterintuitive as they are not known to have high commodity inputs, but they gain from not requiring higher commodity inflation to set their prices, and from the real income boost to consumers.

Although at a price

Producer sectors now offer a higher dividend yield than consumer sectors; the reverse was true in 2011 and 2012. But this shift in relative yield has merely tracked relative pricing power, and is not extreme compared to the pre-2003 period. Given recent moves in commodity prices and the further falls expected by our commodities team (in oil and copper), it is likely that downward pressure on producers' selling prices will be persistent.

Correl. since 2003 between performance and Commodity prices vs. CPI

Most & least correlated sectors with Commodity prices vs. CPI inflation			
High positive correlation	**Correl.**	**High negative correlation**	**Correl.**
Basic Resource	0.67	Retail	-0.62
Chemicals	0.36	Telecom	-0.46
Inds Gds & Svs	0.32	Health Care	-0.44
Oil & Gas	0.26	Media	-0.37

Datastream, Goldman Sachs Global Investment Research.

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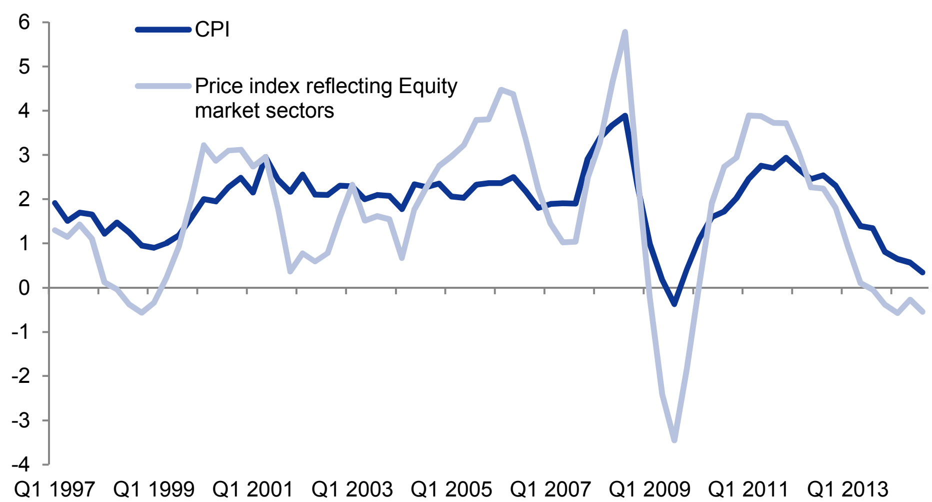
Pricing power, inflation and the impact of the new oil order

In recent months we have seen large moves in commodity prices, together with the markets' expectations for inflation. For the Euro area, medium-term inflation expectations measured by 5-year five years' forward rates have moved down, to 1.9% from 2.1% in the spring. Meanwhile, current headline inflation is not far from zero; it edged up from 0.3% in September to 0.4% in October. Our economists argue that while the likelihood of deflation in the Euro area appears low, even in the presence of a large negative output gap, inflationary pressures are likely to rise only slowly, once the recovery in demand becomes firmly established.

Listed companies suffer from price deflation

For listed companies, the disinflationary pressure is even more aggressive in our view. Weighting the various components of CPI and PPI (for example chemicals, communications, healthcare etc.) by their sector sales-weight in the European equity market **we estimate that selling prices for corporates are down 0.5% over the past year, a reflection largely of the high percentage of the equity market in commodity-facing sectors.** The only time disinflationary pressures were notably worse than today was during the financial crisis, when the contraction in aggregate demand was far greater.

Exhibit 1: Pricing for listed companies is running below that for general CPI...
(% yoy): Euro area CPI inflation, price index reflecting equity market sectors: individual industry breakdown of CPI/PPI weighted by sector sales within the European equity market

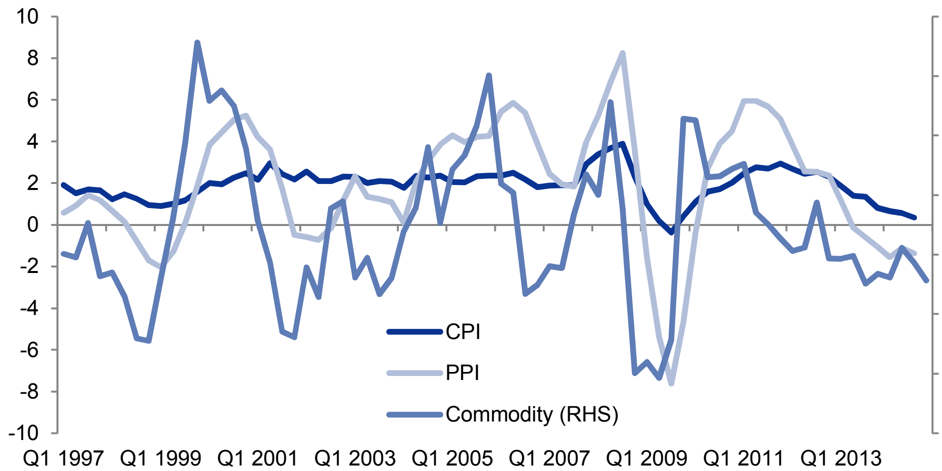


Source: Datastream, Goldman Sachs Global Investment Research.

But falling costs help some, especially in services where pricing power is greatest

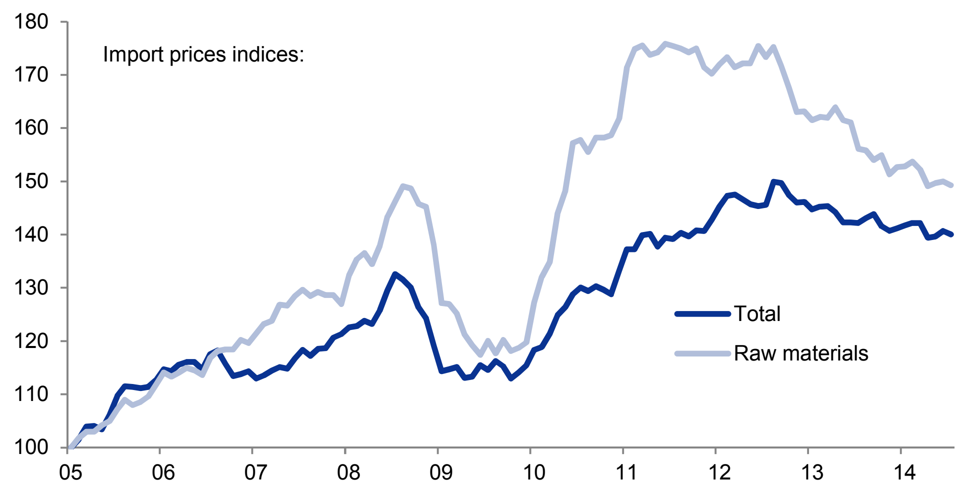
While selling prices are under pressure, many input costs are falling sharply. The fall in commodity prices is dragging down producer prices and the cost of imported goods for companies**. Inflation in imported raw materials has been running at -4% to -7% in the last few months** so for those companies selling to the consumer, or at least with some pricing power, the relative moves in pricing should be supportive (Exhibits 2 and 3).

Exhibit 2: ...although their costs are falling, both domestic...
(% yoy, in euros), S&P GSCI Commodities index spot



Source: Datastream, Goldman Sachs Global Investment Research.

Exhibit 3: ...and especially imports
Euro area import price indices (EUR)

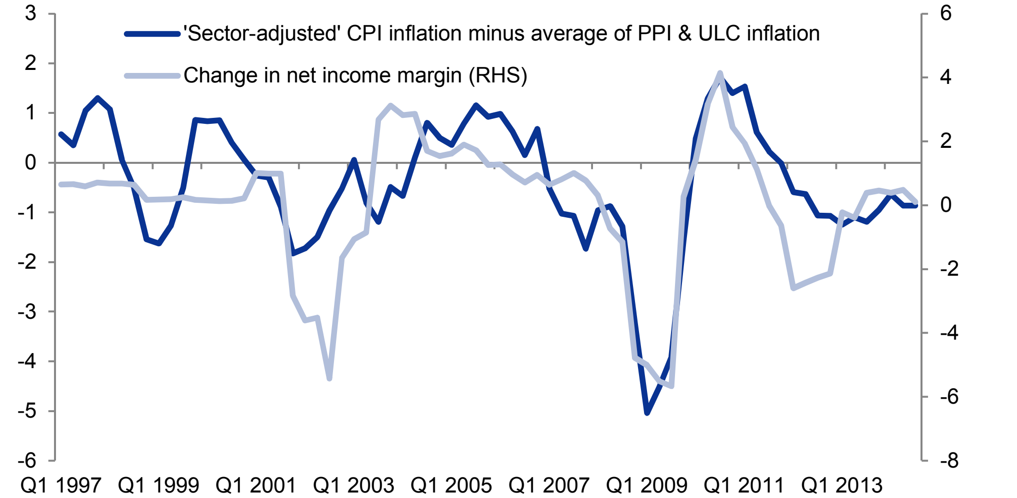


Source: Statistical Office of European Communities via Haver.

Wages, however, have proved relatively sticky, reflecting the persistent problems which Europe faces in its lack of labour market flexibility. And because growth has been so low, unit labour costs are still growing, albeit relatively slowly. If we compare our sector-weighted selling price inflation (currently at -0.5%) with a weighted-average of costs (assuming a 70% weight to unit labour cost growth and a 30% weight to producer price inflation) we find that selling prices are falling slightly faster than costs.

Company margins have done well to stablise in the last year, perhaps gaining from falls in other costs (deprecation and amortization, provisioning for the banks, interest costs given the declines in debt levels and the falls in interest rates). Exhibit 4 shows the change in margins with selling pricing minus cost inflation. We note that comparing changes in selling prices with costs is one way to look at margins and not in our view the best way. We have shown in the past that the most important dynamic for driving changes in margins is the change in GDP growth. But of course these are not entirely independent things: when GDP growth improves substantially, costs (some of which are fixed or sticky such as wages) are unlikely to grow as fast as selling prices or volumes.

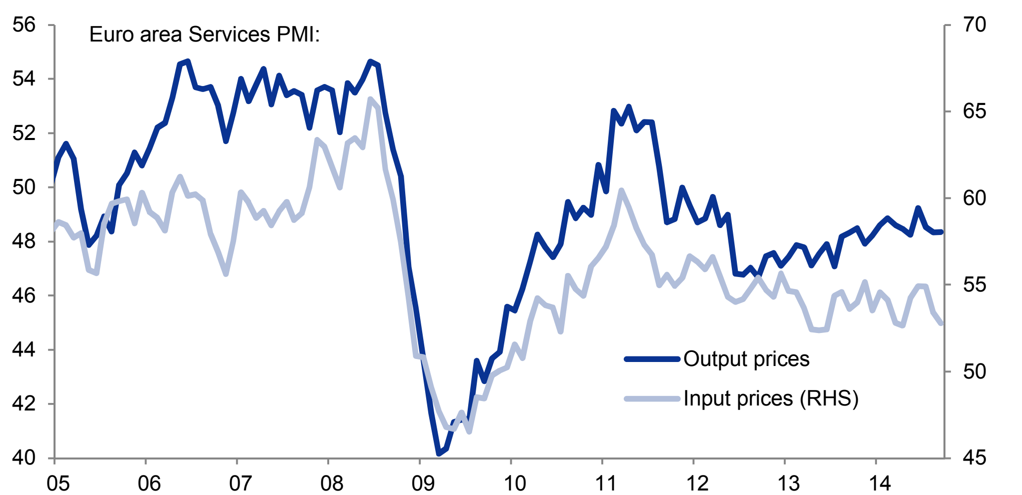
Exhibit 4: Margins have stabilised despite a quite weak mix of selling prices and costs (raw materials and labour costs)
% difference in selling prices and cost inflation with % pt change in net income margin



Source: Datastream, Goldman Sachs Global Investment Research.

While input costs are falling not everyone is gaining to the same extent. The Services PMI for the Euro area has shown gradually increasing selling prices since the end of 2012 but flat to down input prices. There is now a relatively sizeable gap in how the two have evolved, suggesting at least for services companies in Europe, that they are gaining from the lower input costs (Exhibit 5).

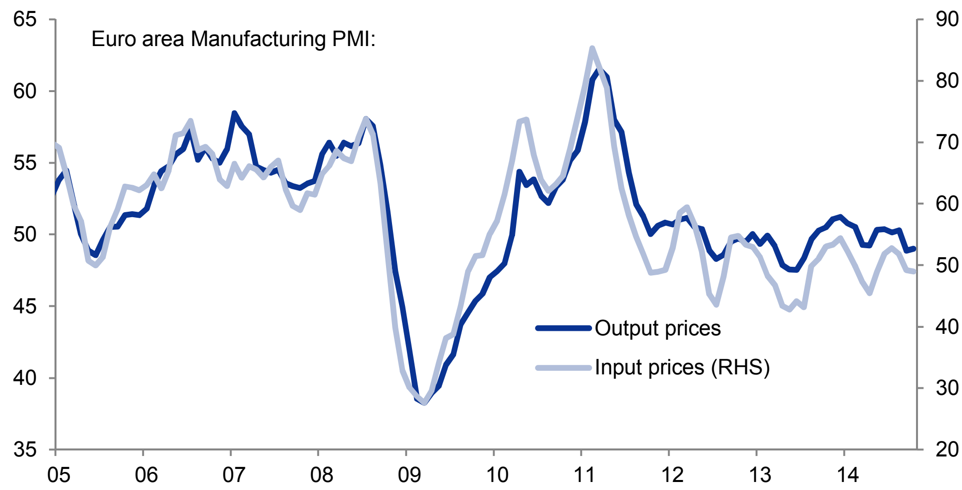
Exhibit 5: Services companies have enjoyed better pricing power as output prices improve versus input costs...



Source: Markit PMI via Haver.

Conversely, for the manufacturers pricing seems to be more closely aligned with input costs. There is no obvious disconnect in recent months with falling input costs having been met with falling selling prices (Exhibit 6).

Exhibit 6: ....whereas the manufacturers have little pricing power with output prices hugging input costs



Source: Markit PMI via Haver.

Who is most sensitive to inflation?

Exhibit 7 shows the correlation between relative sector price performance and CPI inflation over the last ten years. **The sectors most positively correlated with inflation are in commodities or manufacturing. When inflation is higher, it is often because growth is improving and commodity prices are rising and sectors in these industries are able to push up prices.** Conversely, the sectors negatively correlated with inflation (doing *relatively* well as inflation falls) are the more consumer areas or more service-orientated sectors.

Exhibit 7: Sector correlations with CPI inflation
Monthly changes in inflation compared with monthly changes in relative sector price performance

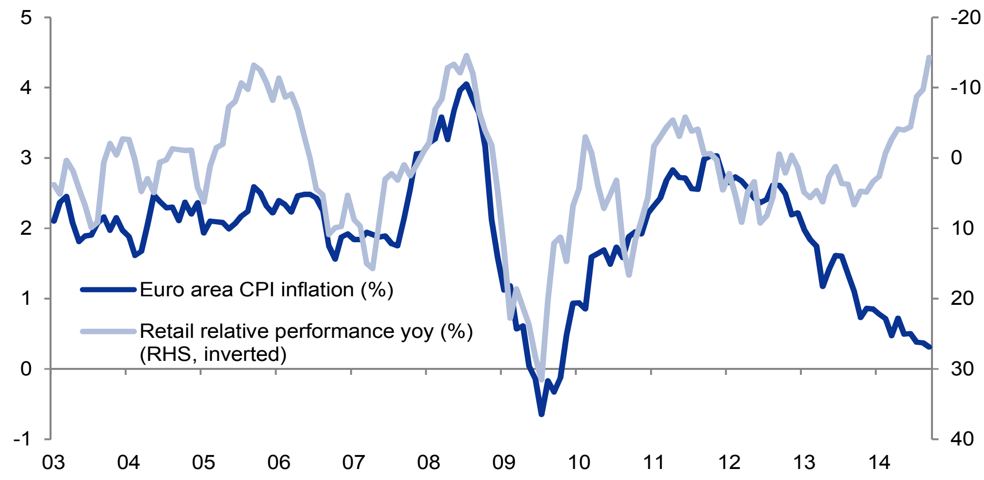
Most & least correlated sectors with CPI inflation (2003 monthly change in rel price perf.)			
High positive correlation	**Correl.**	**High negative correlation**	**Correl.**
Chemicals	0.49	Retail	-0.53
Oil & Gas	0.48	Media	-0.52
Basic Resource	0.31	Travel & Leis	-0.40
Utilities	0.27	Con & Mat	-0.36
Auto & Parts	0.19	Banks	-0.34
Food & Bev	0.11	Technology	-0.23
Pers & H/H Gds	0.06	Insurance	-0.17
Inds Gds & Svs	-0.01	Telecom	-0.13
Real Estate	-0.01	Financial Svs	-0.08
		Health Care	-0.06

Source: Datastream, Goldman Sachs Global Investment Research.

Retail has a high negative correlation; falling inflation has generally been good for the sector on a relative basis. Falling inflation often means better real income growth for consumers and retailers have more control on prices than sectors closer to the input costs.

However, this dynamic has not worked in the last two years; inflation has fallen but the retail sector has been one of the weakest performers (Exhibit 8).

Exhibit 8: Retail sector has underperformed as inflation has fallen

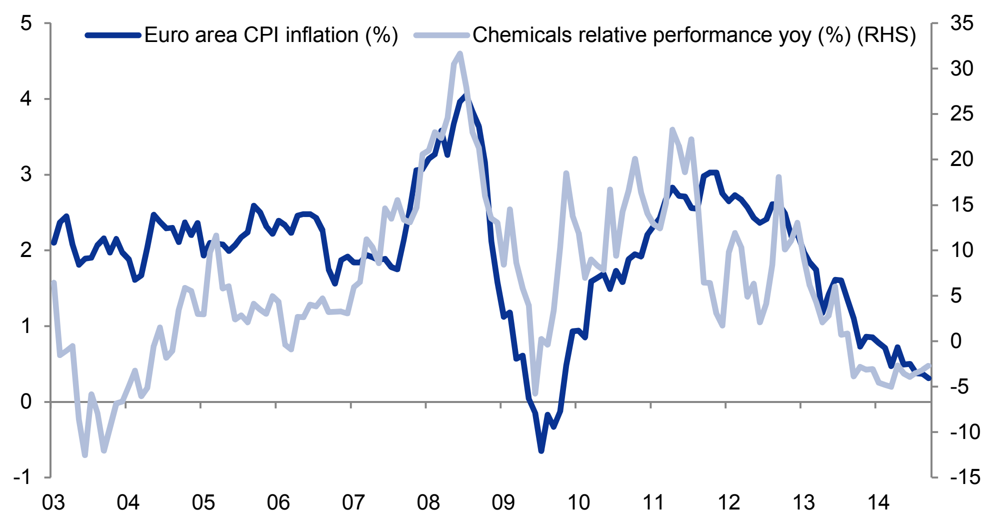


Source: Datastream, Goldman Sachs Global Investment Research.

The retail sector has had less pricing power and less control over margins than was the case historically because the industry has changed, with the disruptive influence of the hard-discounters (which are generally privately owned) and the move to on-line. Even for retailers with an established online presence, these shifts have tended to put downward pressure on margins. We remain underweight retail in our recommended sector portfolio for precisely this reason. The gap between CPI inflation trends and the sector is shown above. Whereas falling inflation was once a clear positive it has seemingly swung to being a negative. Also, the BRC index (which tracks inflation in retail prices in the UK) has already moved into deflationary territory (undershooting broader inflation), as a large part of the listed retail sector is in the UK.

For some sectors though, the relationships have held strongly. For chemicals and oil for example, which largely rely on marking-up commodity-related inputs, the performance as inflation has fallen has clearly deteriorated (Exhibit 9 shows chemicals' relative performance with CPI inflation). Reading approximately from the chart, for chemicals to outperform, inflationary levels would need to rise above 1% again, something our economists do not forecast until 3Q 2015.

Exhibit 9: Chemicals underperforms when inflation is low or falling

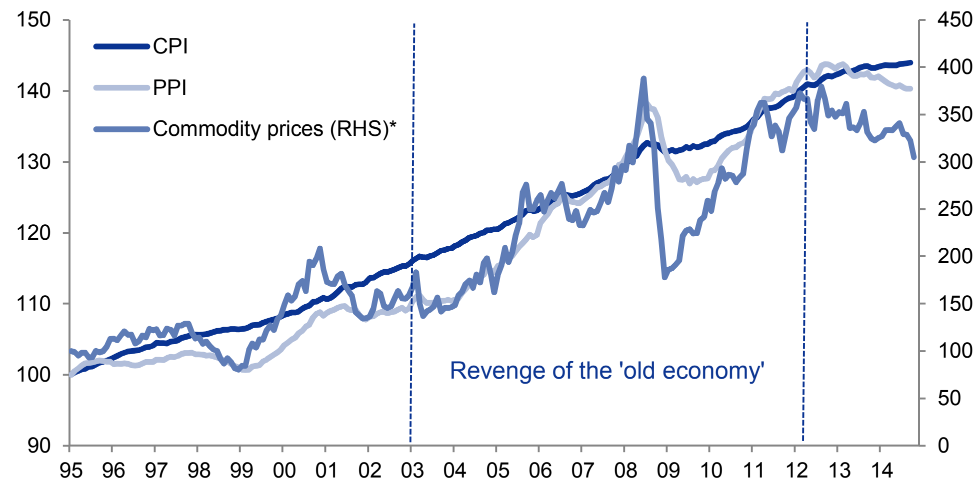


Source: Datastream, Goldman Sachs Global Investment Research.

No more 'revenge of the old economy'

The big shift in recent months has been not so much a fall in consumer price inflation (although that has certainly happened) as a large price decline in commodities – the S&P GSCI commodity index is down 14% in Euro terms since June. In the decade from 2003 to 2012 commodity price inflation was high, helping to push up prices throughout the supply chain because of the long legacy of under-investment over the previous two decades (something which our commodities team termed 'revenge of the old economy'). Exhibit 10 shows that since 2012 the opposite has been true, a function of low aggregate demand globally and over-supply in many commodities.

Exhibit 10: Commodity prices and inflation - no more 'revenge of the old economy'
*S&P GSCI commodity spot index



Source: Datastream, Goldman Sachs Global Investment Research.

Our commodities analysts have recently revised down their oil price forecasts (see, "O*il: The new oil order",* October 26, 2014) bringing forward their medium-term bearish oil outlook. They now forecast that prices will need to decline further in 2015 as: (1) accelerating non-OPEC production growth outside North America will outpace demand growth; (2) the scale and sustainability of US shale oil production is driving the global cost curve lower and sustaining cost deflation; and (3) OPEC will no longer act as the first-mover swing producer and that US shale oil output will be called upon to fill this role.

They argue oil prices will need to decline to slow US shale. **They now forecast WTI crude oil at US$75/bbl for 1Q15, falling to US$70/bbl in 2Q15 before rising modestly back to US$75/bbl in 2H15.** In 2016, they expect stabilising fundamentals with moderate cuts to OPEC production once a slowdown in US production growth is apparent. Their 2016 and long-term forecasts are now US$80/bbl WTI and US$90/bbl Brent. Uncertainty around the required price to slow US shale production growth is a key risk to their forecast.

For other commodities, it depends on specific supply-demand dynamics and their exposure to China property in particular. Chinese GDP growth is expected to slow to 7.2% in 2015 from 7.4% in 2014, with the commodity intensity of growth likely to slow given China's focus on structural reforms. In our view, copper is most exposed to these trends.

Lower energy prices, and more broadly lower commodity prices are likely to flow through to lower costs of production (via lower producer currencies or via reducing costs of fuel/explosives/tyres etc.) **and thus lower cost support for commodities in balance/surplus.**

Sector performance as commodity prices fall

Sector performance versus commodity prices (relative to CPI) is shown in Exhibit 11. **Again, commodity-related sectors perform poorly as commodity prices fall, but so too do sectors further up the supply chain such as chemicals and industrial goods & services.**

Exhibit 11: Sector correlations with commodity prices vs. CPI inflation since 2003
Monthly changes in commodity prices vs inflation compared with monthly changes in relative price performance

Most & least correlated sectors with Commodity prices vs. CPI inflation			
High positive correlation	**Correl.**	**High negative correlation**	**Correl.**
Basic Resource	0.67	Retail	-0.62
Chemicals	0.36	Telecom	-0.46
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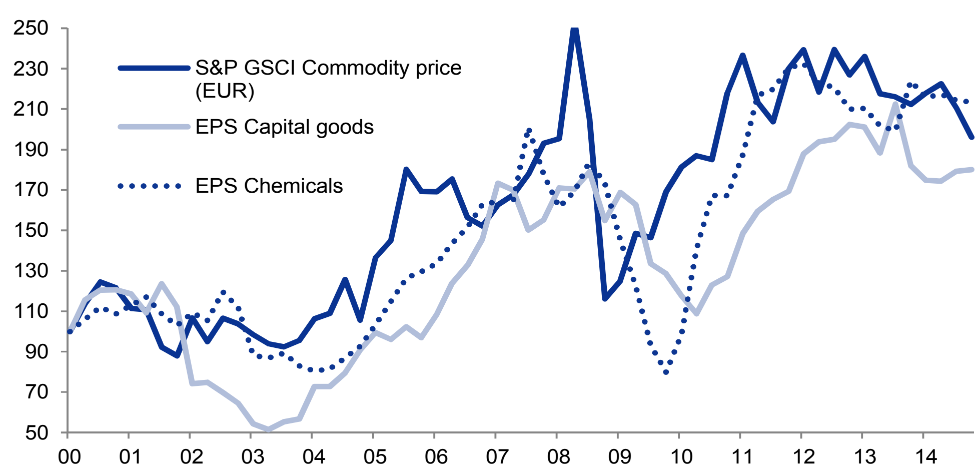
Real Estate	0.16	Technology	-0.25
Banks	0.13	Food & Bev	-0.15
Insurance	-0.01	Auto & Parts	-0.08
Utilities	-0.02	Pers & H/H Gds	-0.05
		Con & Mat	-0.03

Source: Datastream, Goldman Sachs Global Investment Research.

The correlation in performance is not all that surprising for these producer sectors given that much of their demand in recent years has been driven by the commodity super cycle and/or growth in EM infrastructure demand, both of which are now slowing. As these have slowed earnings and valuations have started to decline. Exhibit 12 shows the S&P GSCI commodities index in euro terms with EPS for capital goods and chemicals (which have moved remarkably closely over time). Some of this of course is because commodities reflect the demand cycle globally, and weak or strong global growth is also what is driving both commodity prices and the earnings for these sectors. Nonetheless, we think a substantial amount of what has driven these sectors, earnings especially since 2009, has been demand from commodity or EM-related areas, especially as the economic recoveries in Europe and the US have been relatively weak (see "*GOAL- Global Strategy Paper No. 16, Adventures in Wonderland"*, October 21, 2014).

Exhibit 12: The super cycle in commodities has boosted earnings up the value-chain
EPS for European capital goods and chemicals indexed to 100 in 2000



Source: Worldscope, Datastream, Goldman Sachs Global Investment Research.

Among sectors negatively correlated as commodity prices fall, retail again scores well. But as before we would see the advantages of falling commodity prices being outweighed by some of the structural problems in the industry.

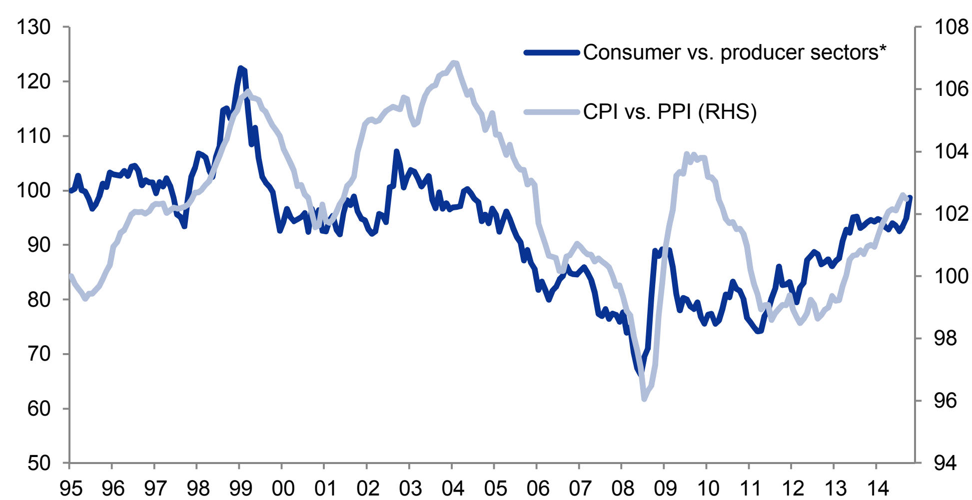
Telecoms, media and healthcare score highly here. They benefit as commodity prices fall relative to CPI, which may seem counterintuitive as they are not known to have high commodity costs. However, on a relative basis they gain from not requiring higher commodity price inflation to set their prices, and from being exposed more to services and the consumer (consumers should benefit as oil prices and others fall) rather than producer areas.

Autos' relative performance has very little correlation with commodity price moves and neither does that of construction and materials. These are consumer-focused sectors but are also very cyclical and economy-driven. As such, falling commodity prices help costs but are generally associated with poor demand, illustrating the difficulty of disentangling the two factors.

Consumer vs. producers

One way of summarising this is to look at consumer versus producer sectors. Consumer sectors tend to outperform as CPI is rising versus PPI, and this has been true for the last three years. Prior to this though, in the period from 1999 to around 2011, the producer sectors tended to perform better.

Exhibit 13: Consumer sectors have outperformed as CPI has risen faster than PPI...
*Consumer: autos, retail, travel & leisure, healthcare, media, real estate, telecoms, food & beverages, personal & household goods. Producer: oil & gas, basic resources, chemicals, industrial goods & services, construction & mats

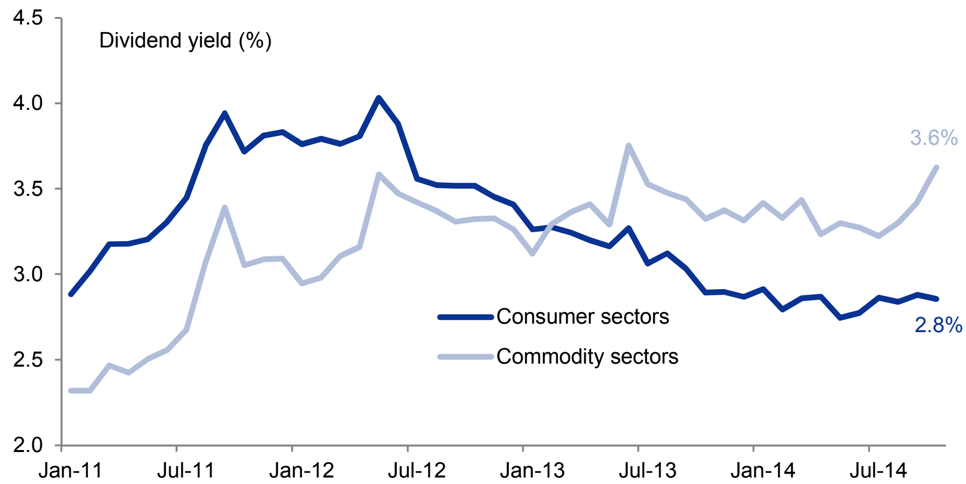


Source: Datastream, Goldman Sachs Global Investment Research.

Producer and commodity sectors in particular now offer a higher dividend yield than the consumer sectors (this was not the case in 2011 and 2012 and indeed the reverse was true). However, commodity sectors now offer a dividend yield of 3.6% versus 2.8% in the consumer areas.

Exhibit 14: ...but the yield offered by consumer sectors is now low, especially relative to commodity–related ones…

* Consumer: autos, retail, travel & leisure, healthcare, media, real estate, telecoms, food & beverages, personal & household goods. Commodity sectors: oil & gas, chemicals, basic resources

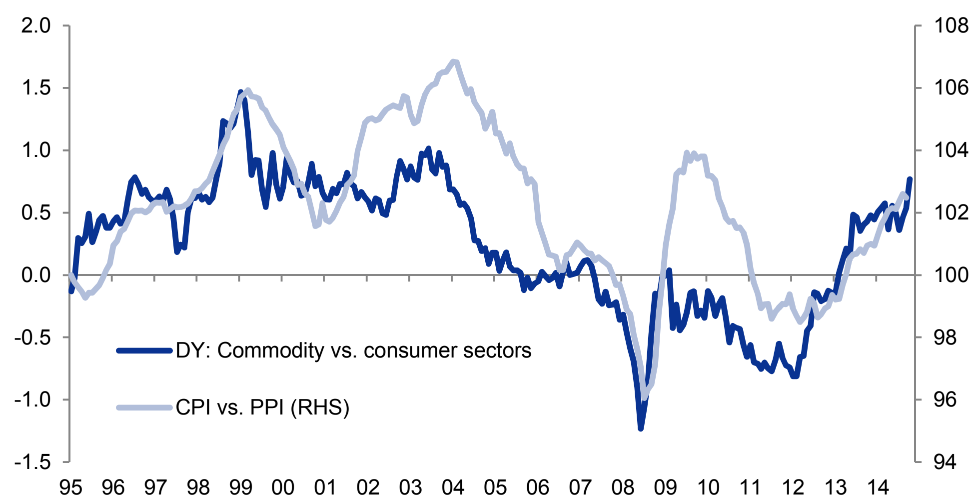


Source: Datastream, Goldman Sachs Global Investment Research.

Is this premium for consumer stocks too much? As shown in Exhibit 15, the premium is very much a function of the relative moves in pricing power. The difference in yields at the moment is not extreme compared to that prior to 2003. Given recent moves in commodity prices, and the further falls expected by our commodities team (especially in oil and copper), it is likely that downward pressure on producers selling prices will be persistent.

Exhibit 15: …because of the swing in relative pricing power – consumer pricing is stickier and consumer-related sectors should gain

* Consumer: autos, retail, travel & leisure, healthcare, media, real estate, telecoms, food & beverages, personal & household goods. Commodity sectors: oil & gas, chemicals, basic resources



Source: Datastream, Goldman Sachs Global Investment Research.

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Reg AC

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