



## Inflationary Pressures & Potential Opportunities

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**M3 Advisory Partners, LP**

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# Introduction

## ■ Inflation has become a hot topic

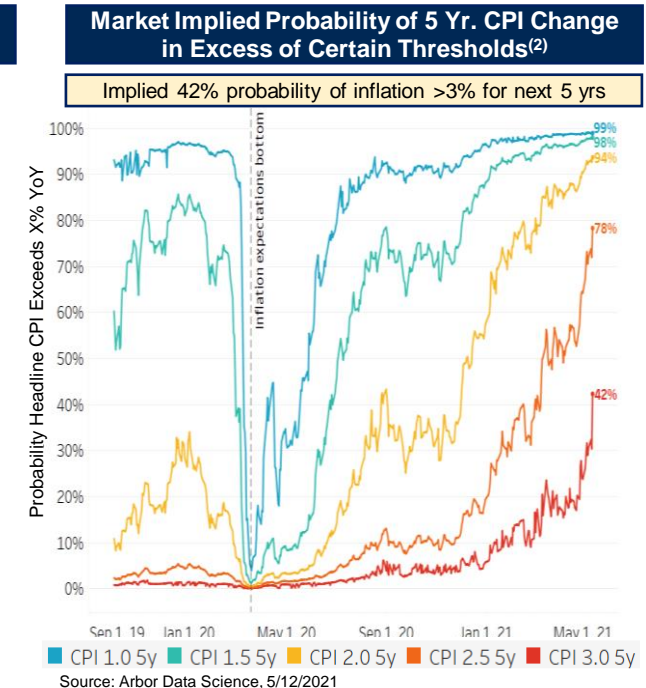
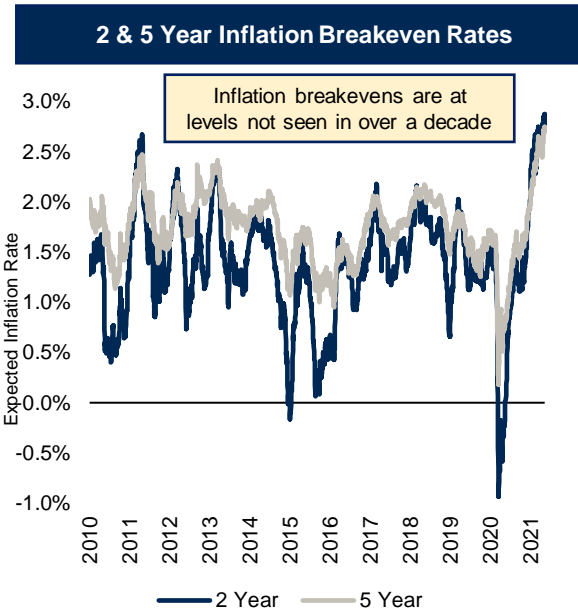
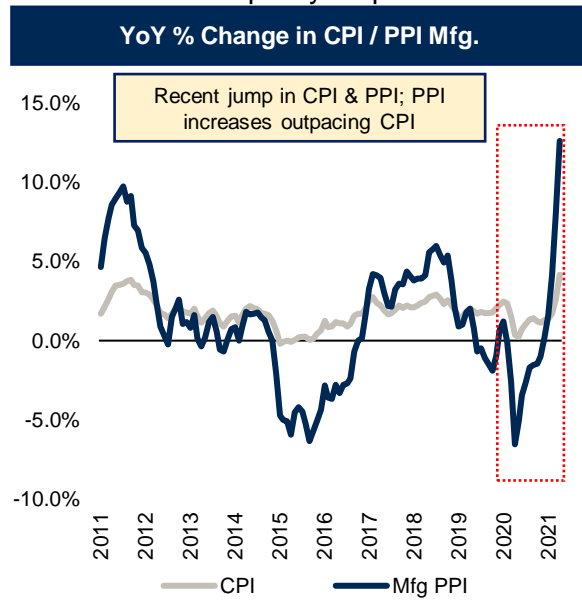
- Inflation represents a rate of change in the prices of goods and services in the economy. It is often measured via indicators including:
  - Consumer Price Index (“CPI”): measure of the average change in prices of a basket of consumer goods and services<sup>(1)</sup>
  - Personal Consumption Expenditures Index (“PCE”): similar to the CPI, measures changes in consumer prices. However, it entails a different methodology. The Federal Reserve (“FED”) focuses on PCE (with certain adjustments) in setting monetary policy
  - Producer Price Index (“PPI”): average change in prices received by producers for their output

## ■ Over the last decade, the U.S. has experienced a period of low and stable inflation, benefitting from disinflationary forces, including:

- Demographics, technological adoption, globalization, etc.

## ■ Recently, evidence of inflationary pressure has been growing in published indicators of both realized and prospective inflation

- Inflation uncertainty has increased, despite the FEDs reiteration that inflation is likely to be “transitory” and does not require an immediate policy response



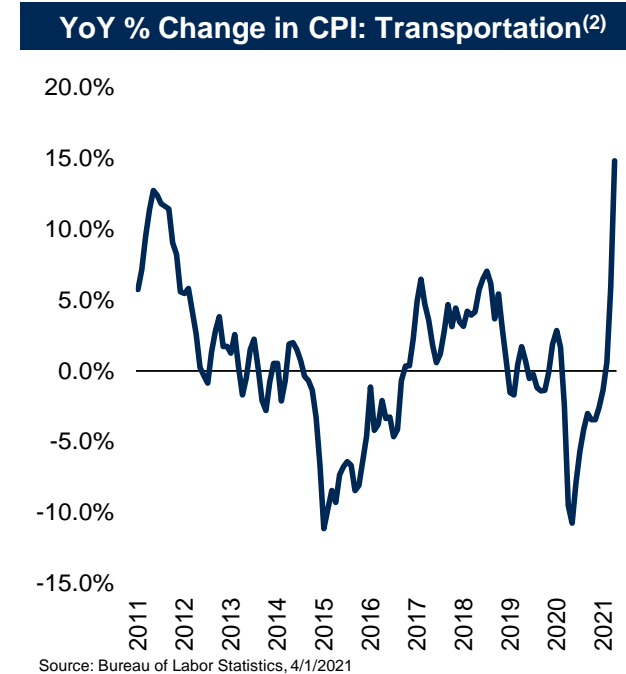
(1) Basket of goods include: food at home and away from home; fuels & utilities; household furnishings; apparel; transportation; medical care; education; and recreation and other services

(2) Implied probabilities using 5-year inflation swap caps and floors with strikes from 1.0% to 3.0%

Other indicators suggest buildup of inflationary forces

- Survey results consistent with inflationary momentum
- Increases in transport costs and supply chain issues
- Significant increases in commodity prices
- Evidence of growing wage pressures

## Introduction (Cont'd)



Selected Commodity Prices					
	Price	5/12	YTD Gain	YoY Gain	20 Yr High 20 Yr Low
BB Commodity Index	\$	93.9	20%	53%	\$ 238.0 \$ 59.5
Lumber		1,610.0	84%	372%	1,686.0 138.1
Lean Hogs		111.8	59%	64%	133.9 30.1
Soybean Oil		68.7	58%	164%	70.4 14.5
Corn		757.5	57%	134%	831.3 184.5
Steel		1,510.0	50%	220%	1,519.0 364.0
Crude WTI		66.1	36%	156%	145.3 (37.6)
Copper		475.3	35%	101%	477.9 60.6
Aluminum		19,930.0	27%	53%	23,730.0 9,825.0
Soybean		1,660.5	26%	96%	1,771.0 418.0
Wheat		754.8	18%	45%	1,280.0 242.8
Natural Gas		3.0	17%	73%	15.4 1.5
Sugar		17.8	15%	74%	35.3 5.0
Lead		2,167.8	9%	34%	3,979.0 406.0
Zinc		2,951.0	8%	47%	4,594.0 721.0
Nickel		17,765.3	7%	45%	53,750.0 4,350.0

Source: Pricing from Bloomberg as of 5/12/2021

(1) PMI is an economic indicator derived from monthly surveys of private sector companies; a result greater than 50 indicates an expansion versus prior month

(2) CPI Transportation: components of consumer price basket related to transport

# Selected Q1 Earnings Commentary from US Corporates

## ■ Recent earnings commentary provides additional anecdotal support for inflation concerns

"We are all watching very carefully comments from central banks around the world as we look forward. I think in my opinion, there's no question that we will see an increase in inflation. The question is how much, how quickly, and how we respond to that"

**- David Solomon, CEO Goldman Sachs, April 2021**

We are seeing very substantial inflation. It's very interesting. We are raising prices. People are raising prices to us and its being accepted... We've got nine homebuilders in addition to our manufacture housing and operation... The costs are just up, up, up...

**- Warren Buffet, CEO Berkshire Hathaway, April 2021**

We continue to maintain a disciplined pricing strategy. We are targeting inflation or better price increases. Right now the macro pricing environment appears to be very healthy

**- Mike Naatz, CMO Kansas City Southern, April 2021**

...Inflationary pressures – particularly surrounding some of our key commodities- it looks like it is going to be more of a headwind in [2021 and 2022]... I think it is important to highlight that, as an overarching principle around the world, we typically look to take pricing in line with inflation. And I would expect that principle will continue to be adhered to as we move into the back half of 2021 and even into 2022.

**- John Murphy, CFO Coca-Cola, April 2021**

The global material cost inflation, in particular steel and resins, will negatively impact our business by about \$1 billion. We expect cost increases to peak in the third quarter.

**- Jim Peters, CFO Whirlpool, April 2021**

Certainly, where we're feeling the biggest inflation right now is on the freight side... We are seeing a little bit of higher input costs, particularly with resins, and some of that's pretty directly attributable to the weather issues that were in Texas earlier this past quarter. And then copper prices, we've seen those creep up

**- Heath Mitts, CFO TE Connectivity, April 2021**

We're watching and seeing [cost] inflation in different parts of the world and in different parts of the business, ranging from wage inflation to help mitigate inflation in the second half of the year.

**William Stengel, President Genuine Parts Co., April 2021**

# Sectors Potentially Impacted by Rising Prices

<u>Illustrative Inflationary Exposure</u>	<u>Potentially Impacted Sectors</u>	<u>Notes</u>
<b>Industrial Commodities</b> (e.g. Steel)	Automotive OEMs	>35% of automobile raw material inputs is steel
	Non-Residential Construction	Non-residential real estate markets face headwinds; Steel is a significant input cost
	Engineering & Construction	Exposure to fixed rate contracts may not cover material increases to input costs
	Machining (e.g. certain Capital Goods and Consumer Durables)	16% of global steel end usage
<b>Lumber</b> (e.g. Hardwood & Soft Wood)	Residential Construction	As of May 2021, rising [hard wood] costs have translated to \$36K increase in price of new homes in last 12 months
	Packaging & Paper Products	Certain segments have low margins and input costs and key input costs are rising
<b>Transportation</b>	Base & Specialty Chemicals	Transportation costs for upstream companies represent 4% - 5% of sales
	Select Automotive Suppliers	Lean supply chain shift has made suppliers more dependent on logistics and premium freight
	Agriculture	Low value product with shipping requirements
	Mining (e.g. Coal)	Low tonnage value with exposure to rail cost
<b>Agricultural Commodities</b> (e.g. Corn & Soybeans)	Packaged Foods & Meats	Raw materials largest variable cost in manufacturing goods for General Mills
	Livestock Farming	Feed represents ~15% of expenditures
	Refiners	U.S. Gasoline is comprised of 10% ethanol
<b>Wages</b>	Restaurants	Labor is typically 20-30% of sales
	Retail	Retail labor typically 20-35% of sales
	Grocers	Labor averaged 15% of sales for 10 largest grocers; thin margins
	Multi Level Marketers	Labor competition for representatives

# M3 Partners Team

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## Appendix: Additional Information



# Economic Conditions Are Improving Rapidly

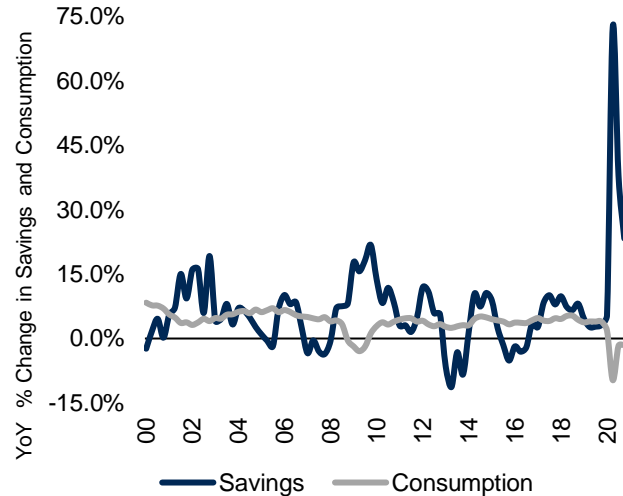
Rapid rebound in the economy, excess savings, and supportive monetary and fiscal policy, supports inflationary impulse

Estimates suggest U.S. households have saved an extra \$2tn during the pandemic<sup>(1)</sup>

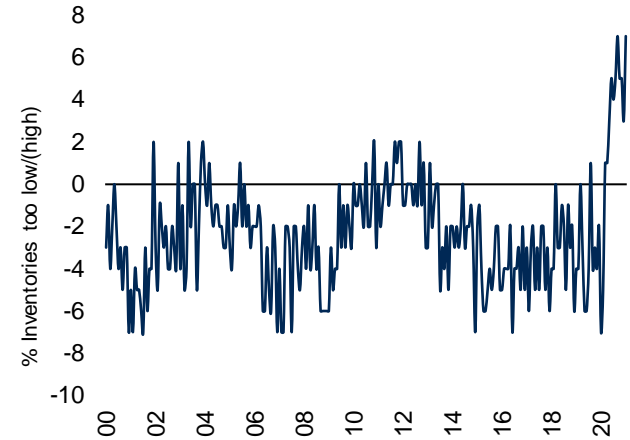
Multiple coincident and leading indicators are at/near peaks

Manufacturing and services surveys indicate strong expansion, inventories are low, and transport costs have jumped

## Excess Spending Potential



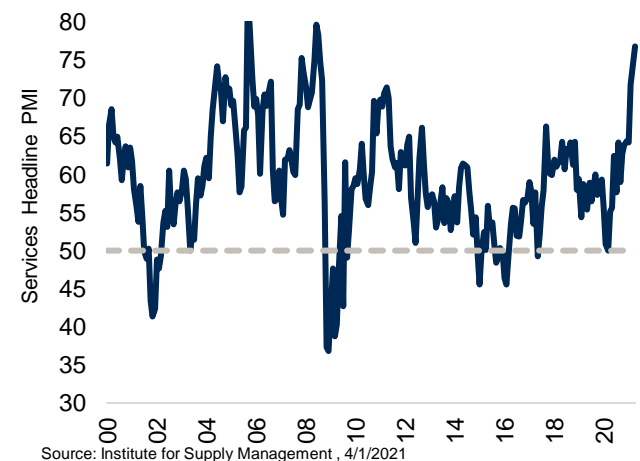
## Business Inventories<sup>(2)</sup>



## Manufacturing PMI Index<sup>(3)</sup>



## Services PMI Index<sup>(3)</sup>



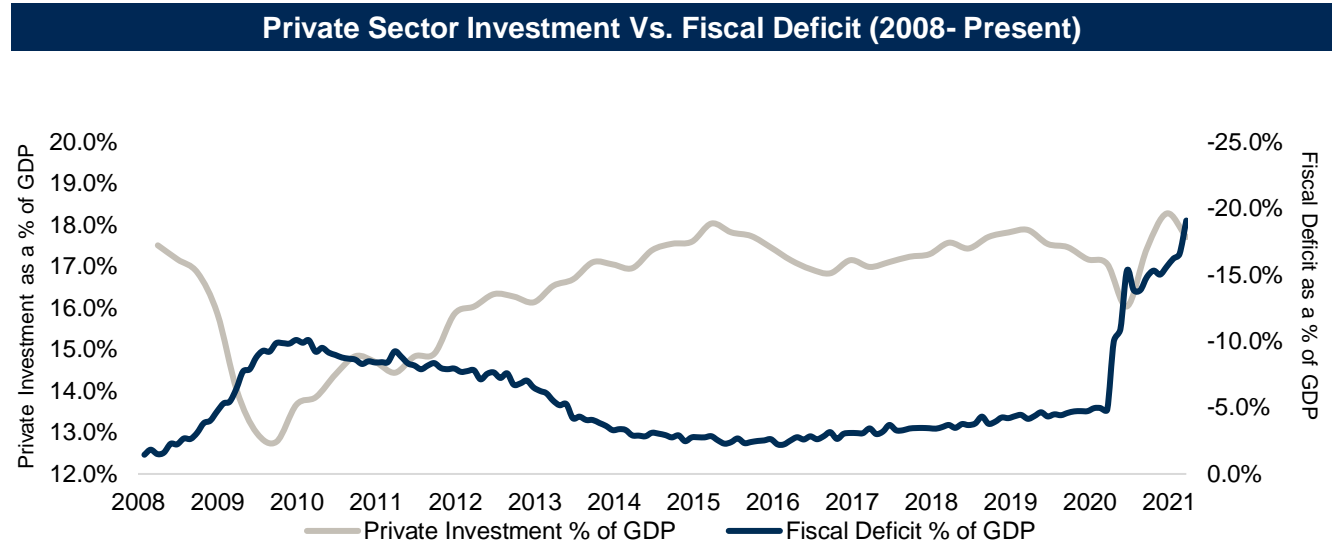
- (1) Financial Times: Global savers' \$5.4tn stockpile offers hope for post-Covid spending, 4/18/2021
- (2) Results from the Business Economic Survey conducted by the NFIB Research Center
- (3) A result greater than 50 indicates an expansion versus prior month

Large fiscal stimulus together with increasing private sector demand

Pro-cyclical fiscal policy is unusual historically

If the Biden administration's \$2.3tn infrastructure plan and \$1.8tn social equity programs pass, demand would likely increase further

## Strong Fiscal Impulse



Dramatic growth in the money supply dwarfs prior monetary episodes

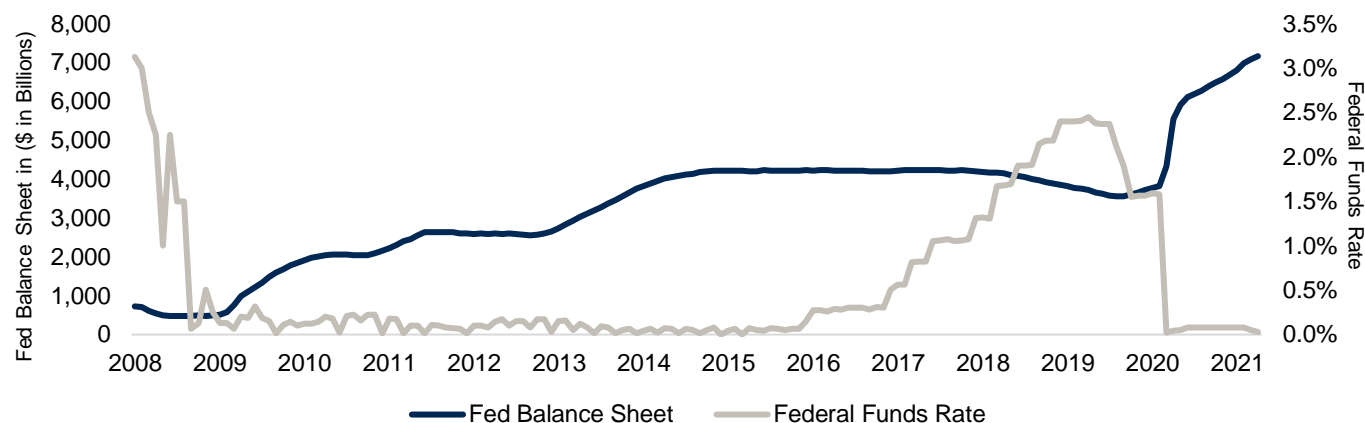
Continuing low policy rates and FED bond purchases

FED still expects transitory inflation, consistent with its “symmetric” inflation targeting strategy... but it risks tightening too late

FED forecasts have been notoriously inaccurate

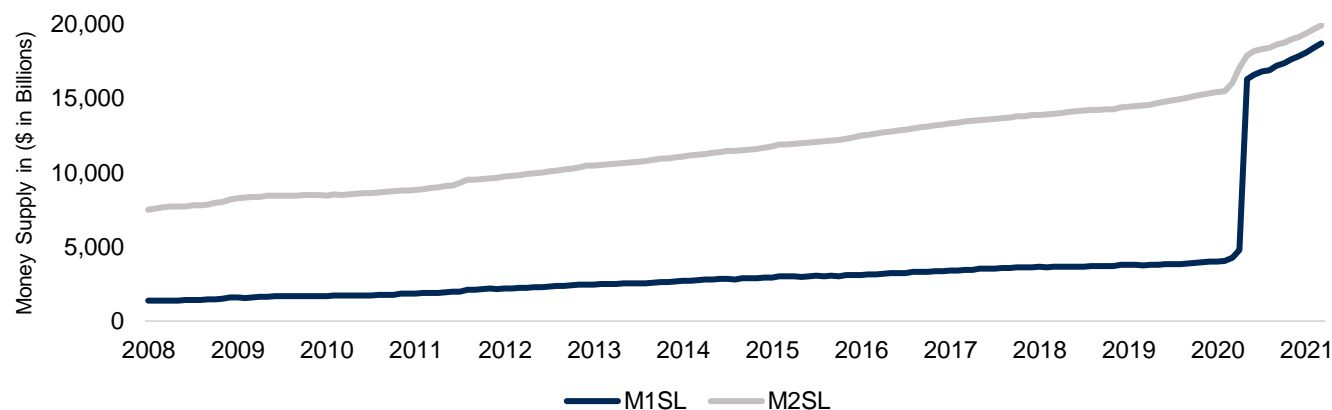
## Accommodative Monetary Policy

FED Balance Sheet / FED Funds Rate (2008 – Present)



Source: Bloomberg, 4/30/2021

M1 Money Supply<sup>(1)</sup> / M2 Money Supply<sup>(2)</sup> (2008 – Present)



Source: Federal Reserve Bank of St. Louis, 3/31/2021

- (1) Includes: (1) currency outside U.S. Treasury, Federal Reserve, and vaults of depository institutions; (2) deposits at commercial banks (excluding amounts held by depository institutions, the U.S. government, and foreign banks and institutions) less cash items in the process of collection and Federal Reserve float; and (3) other liquid deposits, consisting of OCDs and savings deposits (including money market deposit accounts).
- (2) Incorporates M1SL components in addition to: (1) small-denomination time deposits (less than \$100,000) less IRA and Keogh balances at depository institutions; and (2) balances in retail MMFs less IRA and Keogh balances at MMFs

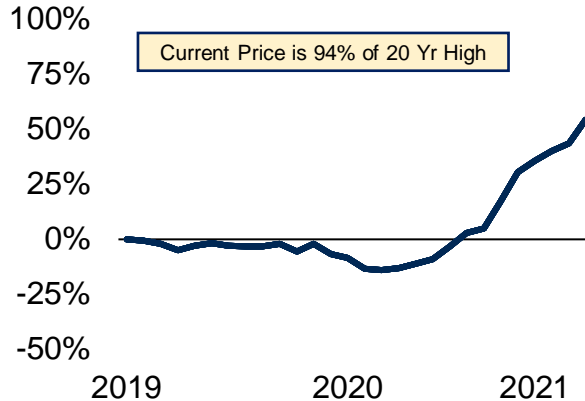
Significant increase in agricultural commodities prices YTD

Key agricultural commodity prices are trending towards 20 year highs

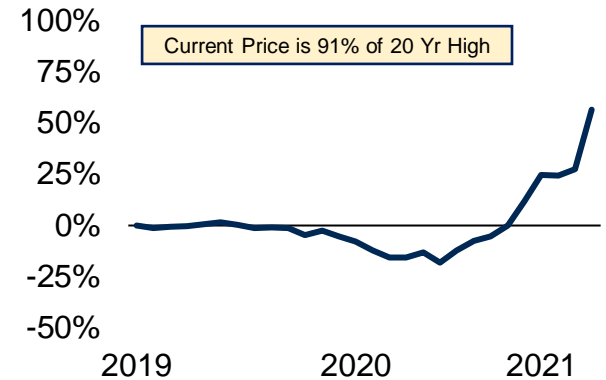
Agricultural commodity price increases imply higher input costs for food producers, livestock and poultry farmers, and other intermediate and ultimate purchasers

## Agricultural Commodities Price Increases<sup>(1)</sup>

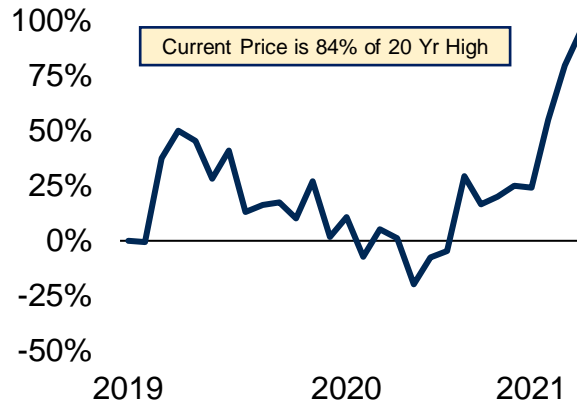
Generic 1<sup>st</sup> Soybean Price



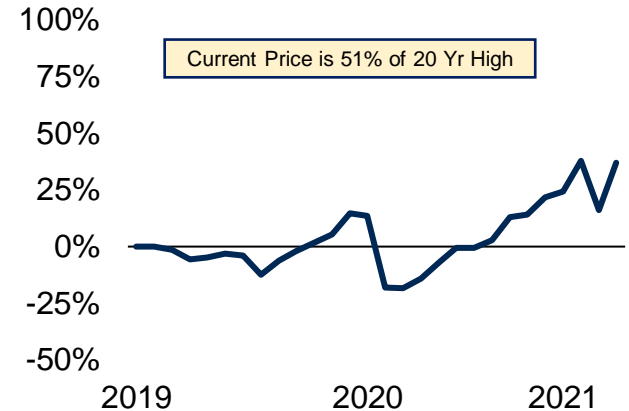
Generic 1<sup>st</sup> Corn Price



Generic 1<sup>st</sup> Lean Hog Price



Generic 1<sup>st</sup> Sugar Price



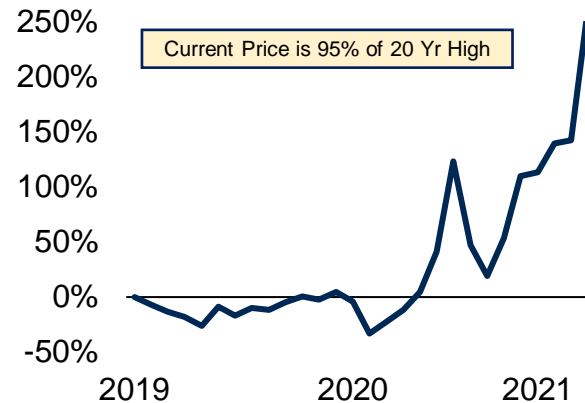
Industrial commodities prices are at or near record highs

Pricing reflects near term supply constraints and robust demand trends

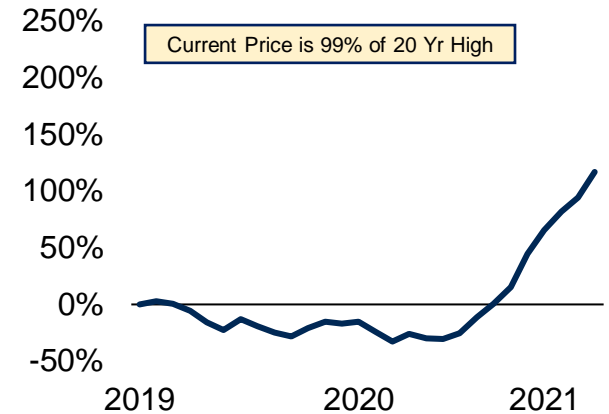
Steel has increased ~50% year to date, its highest levels in 20 years

## Industrial Commodities Price Increases<sup>(1)</sup>

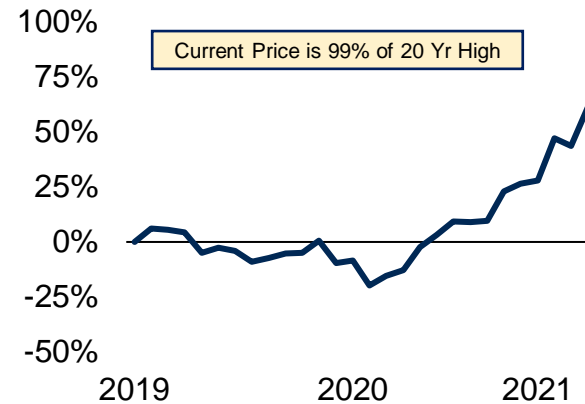
Generic 1<sup>st</sup> Lumber Price



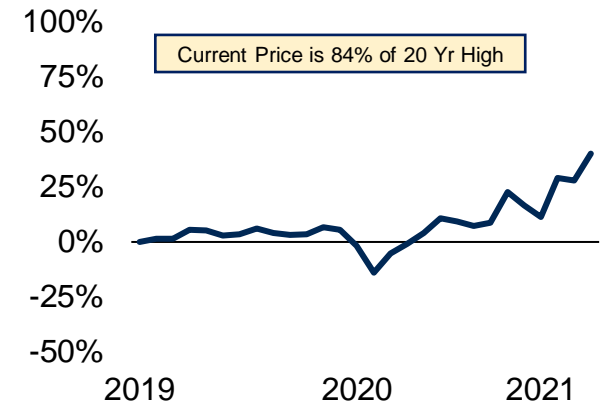
Generic 1<sup>st</sup> Steel Rolled Coil Price



Generic 1<sup>st</sup> Copper Price



Generic 1<sup>st</sup> Aluminum Price

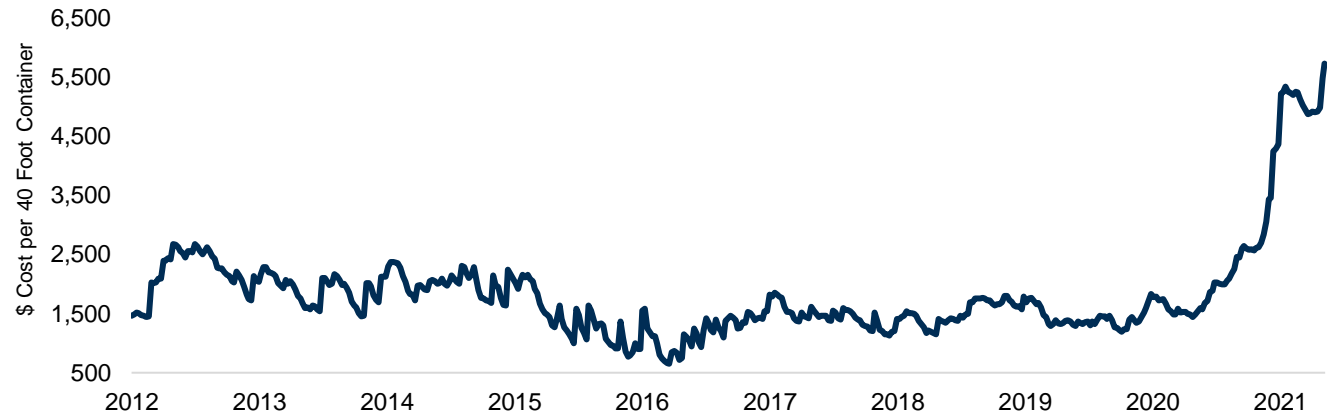


As demand for freight surges, costs of shipping containers reaches new heights

Freight demand and shipping bottlenecks have contributed to recent transportation cost increases

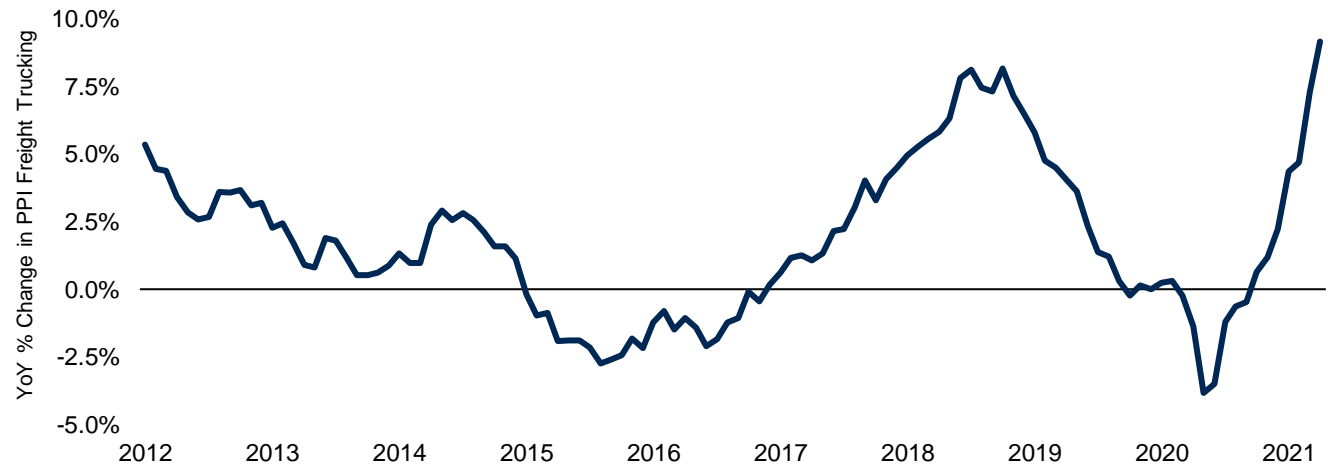
## Transportation Cost Increases

World Container Index: \$ per Container<sup>(1)</sup>



Source: Drewry Shipping Consultants Limited, 5/13/2021

YoY Change in Producer Price Index: Freight Trucking



Source: Bureau of Labor Statistics, 3/31/2021

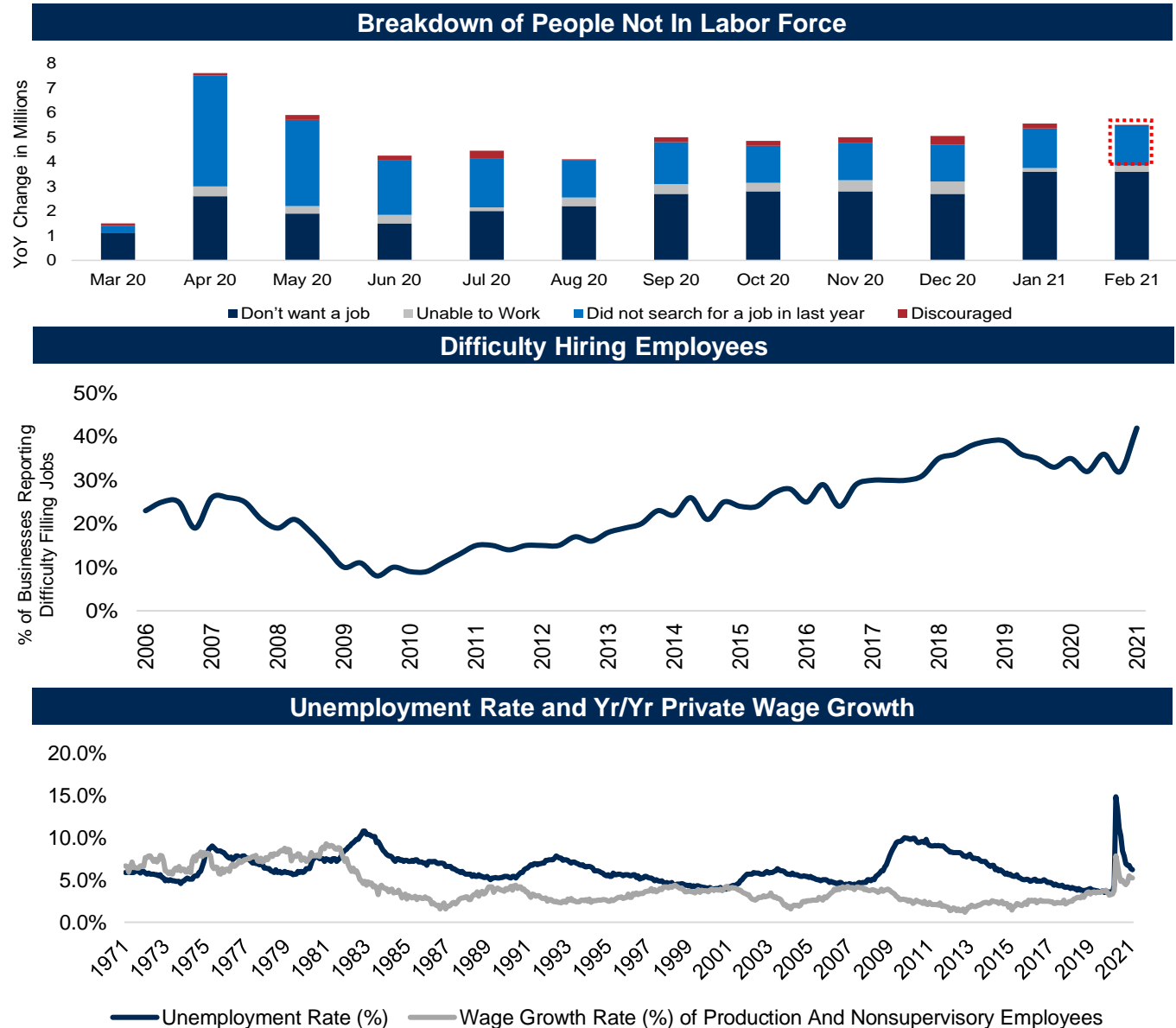
(1) Actual spot container freight rates for major East-West trade routes. Reported in USD per Forty Foot Container. The composite represents a weighted average of the eight shipping routes by volume.

Labor force participation rates increasingly reflect non-economic factors vs. economic ones

Businesses reporting difficulty in filling jobs have increased

Evidence of accelerating wage pressures

# Upward Wage Pressure





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