

THIN-MARGIN COMPANIES WILL FEEL INFLATION'S PINCH

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Whether it's from house hunting, a rent raise or a visit to a car lot, everyone has a 2021 [inflation](#) story.

But until now, Corporate America has been able to march along to record profits as the world recovers from the COVID-19-inspired depression. The Street consensus [S&P 500](#) operating earnings estimate for 2021 is \$211, with a further rise to \$223 being penciled in for next year. That puts the S&P's earnings multiples at 20.6x and 19.5x, respectively, based on its recent trading level of 4,345.

That's not too lofty if you consider another route: 0% [interest](#) on a savings account.

But what happens if earnings disappoint? I think the driver would be margin pressure from both wage and input cost inflation.

Should that scenario come to pass, stocks that rank low in screens for the [quality factor](#) are the trouble spot.

When average weekly household earnings witnessed a sudden spike above \$1,000 in 2020, many among us pointed out the anomalous nature of the move. It happened, we stated, because high-paid laptop workers kept their jobs while baristas were tossed out en masse. The arithmetic sent the average northward.

Now that low-wage workers are coming back, the average should have retraced. But it has not. For many companies, paying the rank and file \$980 per week could have been low enough threshold to turn a profit. At \$1,066 per week, it may be a different story (figure 1).

Figure 1: U.S. Average Weekly Earnings of All Employees, Total Private (\$)



Source: Bureau of Labor Statistics, as of August 2021.

I am not sure what would take the pressure off wages now that my eyes are set on a sub-5% unemployment rate any month now.

Employees are going to ask for raises.

If you have been to an auto dealership in recent months, you know that you will pay through the nose for both new and used vehicles.

In August, the average new vehicle in the U.S. sold for \$43,355, according to Kelley Blue Book. But because so many

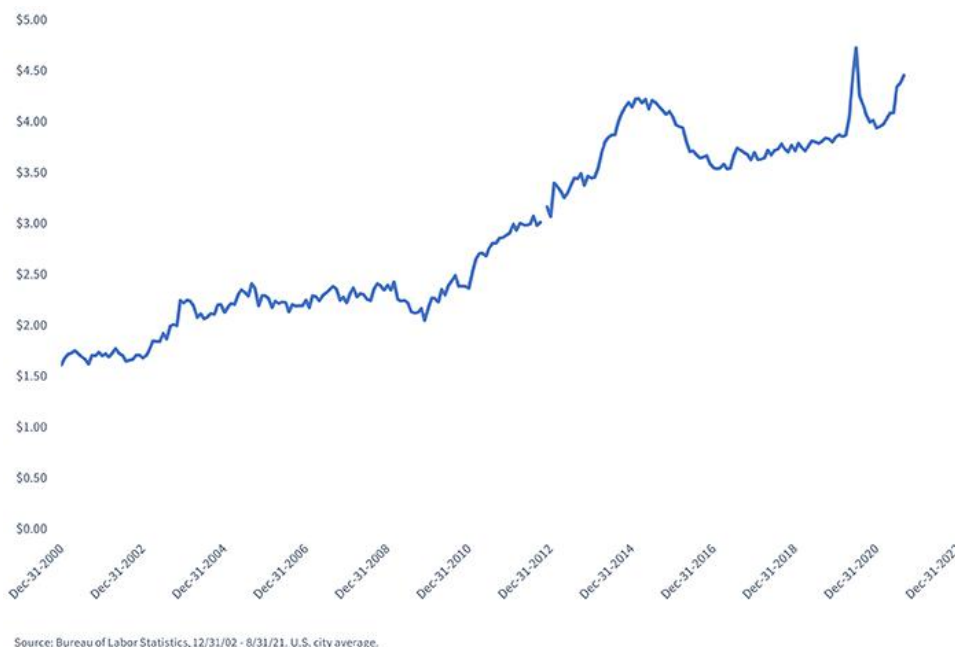
parts are on back order, customers who need to purchase a car or truck right now are often paying more for 2018 and 2019 models than the original sticker price.

That is the type of expenditure that sends employees into the boss's office to have THE conversation.

Home prices are also moon shooting. The 3.0% national average conforming mortgage rate has conspired with stimulus money to send the [S&P CoreLogic Case-Shiller 20-City Composite Home Price Index](#) up 19% in the year to August.

Sure, stimulus money sent car and house prices sky-high. But what is the excuse for the jump in the price of ground beef, which is about \$4.50 per pound, up from about \$3.50 in recent memory (figure 2)?

Figure 2: U.S. Average Price: Ground Beef, Per Lb.



It's not like we are collectively eating much more or less of it. It's because of all the new money sloshing around, created by the [Federal Reserve \(Fed\)](#).

Beef is not the only food whose price has gotten dear. Using NielsenIQ data, NBC News tracks it and five other common supermarket items. From October 3, 2020, to August 28, 2021, orange juice, chicken, bread, eggs and bacon each saw prices rise 4%–16%.

There is respite.

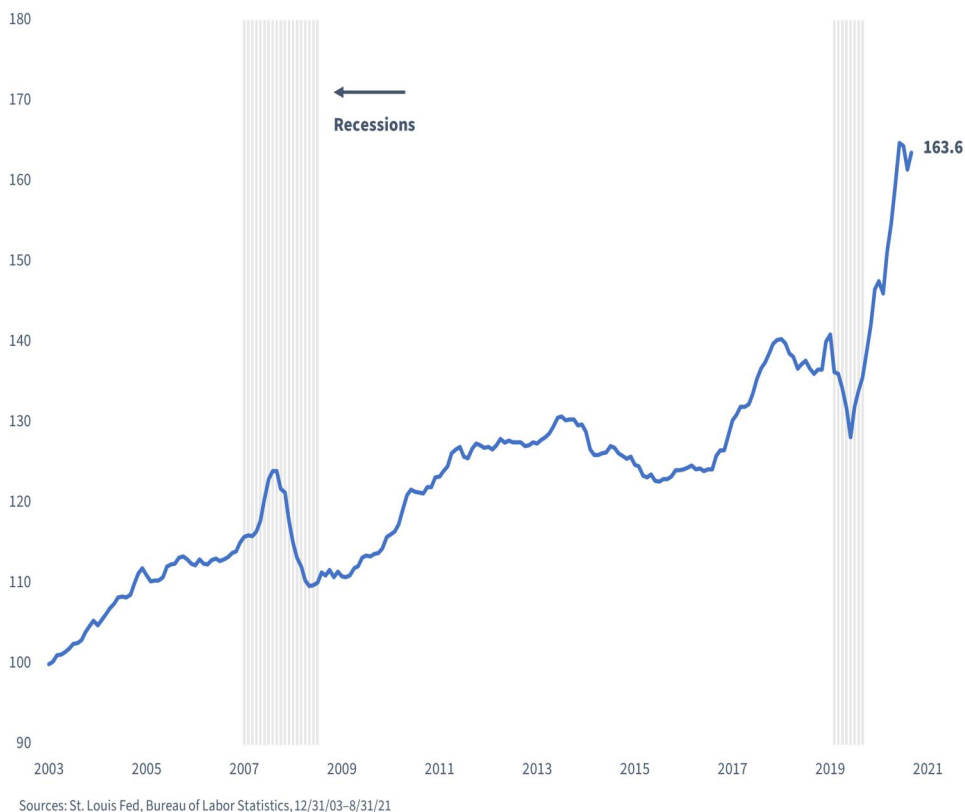
The national average gasoline price has popped, but at \$3.17, it is still well below the \$4 peak from the commodity supercycle years (figure 3). Additionally, late-model cars are much more fuel efficient than the ones we owned a generation ago, so it may take a number well north of \$4 to really hit consumers' wallets. Nevertheless, with oil prices in the ascendant, the gasoline price may continue to be pushed higher.

Figure 3: U.S. Regular All Formulations Gas Price



Also, paying more to fill up an 18-wheeler that is bound for the other side of the country hurts acutely when you are paying the truck driver \$87,000 per year. That is the number Walmart is laying on the table—plus a signing bonus—in its current postings. Just look at figure 4.

Figure 4: U.S. Producer Price Index: General Freight Trucking, Long-Distance Truckload



The combination of rising energy, transportation and labor costs—not to mention supply chain frustrations—poses an obstacle to firms that have questionable profitability.

Levering up thin [profit margins](#) to present a robust [return on equity \(ROE\)](#) can work just fine when operating costs are kept at bay. The problem is what happens when that scenario changes, when leverage works the other way in red ink situations.

Here is a small sample of WisdomTree products that rank high on ROE and [ROA \(return on assets\)](#), with the interaction of the two giving you an idea of business risk in the form of leverage (figure 5). If profit margins take a hit in the coming quarters, these high ROA and high ROE ideas may save face.

Figure 5: Quality Metrics by Asset Class

Metric	U.S. Large Cap		U.S. Small Cap	
	DGRW	S&P 500	DGRS	Russell 2000
Return on Assets (ROA)	8.1%	3.6%	3.2%	1.4%
Return on Equity (ROE)	28.2%	16.9%	15.6%	6.6%
Leverage	3.5	4.7	4.8	4.8
Price/Earnings Ratio (fwd.)	17.4	21.5	13.5	16.2
Metric	International Developed		Emerging Markets	
	IHDG	MSCI EAFE	DGRE	MSCI Emerging Markets
Return on Assets (ROA)	9.9%	1.5%	2.5%	1.9%
Return on Equity (ROE)	26.0%	10.8%	14.8%	12.3%
Leverage	2.6	7.3	5.8	6.3
Price/Earnings Ratio (fwd.)	14.8	15.6	12.0	12.6

Source: Source: WisdomTree Digital Portfolio Developer, as of 8/31/21. You cannot invest directly in an index. Unless otherwise stated, all data from Thomson Reuters Refinitiv, as of 9/20/21

For definitions of terms in the chart, please visit the [glossary](#).

Funds Referenced in figure 5:

DGRW: [WisdomTree U.S. Quality Dividend Growth Fund](#)

DGRS: [WisdomTree U.S. SmallCap Quality Dividend Growth Fund](#)

IHDG: [WisdomTree International Hedged Quality Dividend Growth Fund](#)

DGRE: [WisdomTree Emerging Markets Quality Dividend Growth Fund](#)

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DEFINITIONS

Inflation : Characterized by rising price levels.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Quality Factor : Excess returns achieved by companies exhibiting higher quality or profitability vs the market. Typically measured using operating profitability, return on equity and/or return on assets.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Profit margins : Net income divided by total sales. Higher values indicate a greater fraction of each dollar of sales being left to the firm and its owners after expenses are accounted for.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.