The high inflation impact:

Higher prices… yet lower equity values

To understand inflation and its impact on valuations of businesses and investments, one must understand its two forms: the demand side and the supply side

Inflation has recently hit new highs across the globe; for most European and American countries, prices are rising faster than they have in the past 40 years. The Dean of Valuations at New York University, Professor Damodaran, recently commented: "The good news is that the culprit behind the volatility in current markets is easy to identify, and it is inflation, but the bad news is that inflation remains the most unpredictable of all macroeconomic indicators to factor into stock prices and value."[1] But why is that so?

To understand inflation and its impact on valuations of businesses and investments, one must understand its two forms: the demand side and the supply side.

Inflation on the demand side occurs when the demand for goods and services outpaces the available supply. On the other hand, supply side inflation is caused by a shortage of input goods and services as a result of diminished supply.

COVID-19 affected both the demand and supply of goods and services in recent times. The demand side was affected by government stimulus packages announced globally to support those affected by lockdowns, resulting in increased spending power, although temporary, and therefore driving demand. On the supply side, there were a number of disruptions, including manufacturing disruptions, lockdowns to contain COVID-19, as well as logistics and supply chain issues.

Central banks are mandated to keep inflation under control by exercising the available monetary tools, the primary one being to set benchmark interest rates. By controlling interest rates, central banks can influence spending, borrowing, and saving patterns. They can lower the demand for goods and services today by encouraging saving and reducing borrowing through increasing interest rates. However, the control of central banks is limited to demand side factors as they are unable to affect global supply related issues noted above. Therefore, the ability of central banks to actively control inflation is limited. Nonetheless, among the available tools, interest rates typically rank at the top when attempting to fight inflation. Between January and July 2022, the US Federal Reserve raised interest rates four times from near zero to a level between 2.25% to 2.5%.[2] These hikes have led central banks in the GCC to follow in order to maintain their currency's peg to the US dollar.

In any intrinsic valuation exercise, there are two key inputs: the forecast cashflows and the discount rate used to calculate the present value of these forecast cashflows. Inflation directly impacts forecast cashflows and underlying growth rates as prices of goods and services rise. In the discount rate, there are three components which tend to increase with rising inflation:

a) Risk free rates which are driven by benchmark interest rates set by central banks. These are also often considered as a proxy for long-term steady state growth rate at any point in time;
b) Equity risk premium which tends to go up during periods of high volatility and high inflation; and
c) Cost of debt or simply the borrowing rate which rises with increasing benchmark interest rates.[3]

Any increase in discount rate lowers the present value of future cash flows, thus lowering equity value.

The demand and supply side forces, and the response by central banks, all play an important role in setting valuation expectations. An induced slowdown of the economy by raising interest rates can reduce demand side inflation factors; but it also suppresses valuations in the short term. If supply side inflation persists, the market volatility will continue, causing an increase in return required by equity holders because of the higher equity risk premium, which will also suppress valuations. Therefore, in general, high inflation is detrimental to value.

However, these demand and supply inflation forces do not affect all industries equally. As per research undertaken by Schroders, energy, oil, and gas companies typically tend to outperform during high inflation periods as their revenue is naturally tied to energy prices, a key component of inflation indices.[4] Similarly, Equity Real Estate Investment Trusts (REITs) perform better than broader markets as they provide a partial inflation hedge via the pass-through of price increases in rent. In contrast, mortgage REITs generally underperform as a sector as their future payments become less valuable due to inflation. In the same way, consumer staples perform better than consumer discretionary sector. Early-stage technology companies are also harmed by inflation as the bulk of their cash flows are expected to come in a distant future, which will be worth less in today's present value terms.

According to Bloomberg, the oil rich GCC countries have fared better in terms of inflation due to caps on domestic fuel costs in some countries and price controls/ subsidies on food items.[5] As a result, inflation is expected to remain lower in the GCC than in the US, at least in the short term. Most countries in the region are beneficiaries of high oil prices and are expected to run large budget surpluses in 2022, according to the International Monetary Fund (IMF). This provides some flexibility to have a mix of fiscal and monetary policy to control inflation and its effect on citizens.

In summary, it is important to note that the impact of inflation on investment valuations will vary across businesses, industries, and geographies. For the valuation of individual businesses, the operational and financial leverage will play a key role with higher leverage resulting in greater adverse exposure. Some sectors tend to outperform others depending on their ability to pass on price increases to their customers, long-term debt levels, and the timing of expected future cash flows. Lastly, not all countries are experiencing the same level of inflation, resulting in a variety of monetary policy responses by central banks in the form of higher interest rates and, thus, a varying level of adjustment is seen to the 'price of risk' as measured by the discount rate. For these reasons, the specifics of each valuation must be carefully considered in order to appropriately account for inflation.

By **Muhammad Faiq Khalid**, Director, Valuations & Modeling, Financial Advisory, Deloitte Middle East

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Endnotes

1. "In Search of a Steady State: Inflation, Interest Rates and Value" by Prof. Damodaran dated 6 May 2022 (https://aswathdamodaran.blogspot.com/2022/05/in-search-of-steady-state-inflation.html)
2. "Fed Hike Leads Gulf to Follow, But Rate Paths Diverge Again" by Bloomberg, published on 27 July 2022. (https://www.bloomberg.com/news/articles/2022-07-27/fed-s-hike-prompts-gulf-to-follow-but-rate-paths-diverge-again)
3. "In Search of a Steady State: Inflation, Interest Rates and Value" by Prof. Damodaran dated 6 May 2022 (https://aswathdamodaran.blogspot.com/2022/05/in-search-of-steady-state-inflation.html)
4. "Which equity sectors can combat higher inflation?" by Schroders, published on 24 March 2021. (https://www.schroders.com/es/media-relations/newsroom/insights/which-equity-sectors-can-combat-higher-inflation/)
5. "Fed Hike Leads Gulf to Follow, But Rate Paths Diverge Again" by Bloomberg, published on 27 July 2022. (https://www.bloomberg.com/news/articles/2022-07-27/fed-s-hike-prompts-gulf-to-follow-but-rate-paths-diverge-again