Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Shrinkflation

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Economist Pippa Malmgren has been credited for coining the term "shrinkflation", meaning, in its most common usage, when a company reduces a product's size while maintaining its price. A less common usage of this term may refer to the pertinent macroeconomic situation where the economy is contracting while also experiencing a rising price level, perhaps better known as stagflation.

Against a backdrop of rising rates and inflation, markets are shrinking too, in stark contrast to the cost of living. March U.S. consumer price index data took the annual rate of inflation to 8.5%, its highest since December 1981.

Inflation so far has been driven by "stuff", as there has been a shortage of goods and commodities as economies have bounced back fast from the COVID-19 crisis, given the combination of massive government support and the vaccine miracle, in developed markets at least. This has then been aggravated by further supply shocks in food and energy, owing to the Russian invasion of Ukraine, and may be made worse still if COVID-19 shutdowns affect Chinese production.

The question from here is whether the inflation leaks from "stuff" to "staff", with rising wage settlements in a tight labour market, and jobs easy to find and hard to fill. U.S. wage growth has accelerated to 5%,[1] the highest seen so far this century, though still behind the consumer inflation

[1] Source: U.S. Bureau of Labor Statistics Employment Cost Index, March 2022

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rate, implying falling real wages. Ultimately, there is a bit of a Catch-22 for companies—either wages rise, potentially squeezing corporates' margins; or they don't, threatening real wage falls that could hurt consumption and thus corporates' top-line sales.

Shrinkflation is an increasingly common response by companies to inflation—fewer sheets per roll, fewer caplets per bottle, fewer washes per box. Brands quietly downsize their products without decreasing prices accordingly, to maintain or boost profits as they try to navigate increases in the cost of materials, labour, energy, packaging and transport, or to maintain market share in the face of stiffer competition for every dollar. The service sector is not immune, with hotel chains making guests opt in to daily room cleaning and not rushing to restore breakfast service post-pandemic. Customers are typically more sensitive to price over contents, and "improved" formulations in a rebranded or repackaged (read smaller) bag are perceived less negatively or barely noticed. However, companies need to be careful of consumer backlash and cannot afford to shrink their products repeatedly or they risk losing consumer trust. In fact, in a world of social media and an emphasis on integrity, shrinkflating companies in 2022 are more likely to need to explain their downsized offerings.

So far, company earnings forecasts are proving largely immune to these fears. MSCI World Index 12-month forward earnings estimates are up 6%[2] so far this year, as companies enjoy the inflationary impact on revenues without taking margin pain … yet. Indeed, EBIT[3] margins remain at extremely elevated levels, approaching 17% for the MSCI World Index, versus the pre-pandemic peak of 15% and the 20-year average of 13.4%.[2] These stretched margins have to be under threat, either from the inflation itself or any slowdown caused by the attempts to tackle the inflation. One key to navigating this environment as an investor is to focus on companies with robust fundamentals that enjoy pricing power—the ability to pass on input costs, be they stuff or staff—to consumers.

- Staples companies that sell essential products can even increase prices in this tough environment. For example, a multinational consumer hygiene company we hold reported that its strong portfolio of brands has allowed for "responsible price action", i.e. an increase in pricing of 5% in the first quarter across its business, while a Dutch brewing company we own managed double-digit "price mix" in the first quarter, as it passed on costs, helped by the return to bars and restaurants in Europe. This contrasts with the fortunes of general retailers (which we don't own), which have suffered the mistake of increasing their inventory of home equipment at a time when a post-pandemic consumer is shifting towards leisure and services outside the home.
- Mission-critical software-on-subscription models also enjoy fortress-like pricing power and recurring revenues, as an American technology company proved with its announced price increases for commercial products that took effect 1 March 2022. Typically, such announcements are softened with reference to innovative improvements, for example new artificial intelligence tools or enhanced security being included in the price.
- Payments companies, which take a clip of every dollar in a rising inflation environment, gaining revenue without having to increase prices, are often overlooked inflation plays—never mind that they have been able to effect increases in merchant fees.
- Within medtech and life sciences, product mix matters, and in some categories like nutrition, it is easier to effect price increases than in more commoditized areas. Medical and scientific supplies companies enjoy some protection, as hospitals and scientists will continue to prize reliability and quality, raising switching costs. This is particularly the case where the products and services provided are a small part of the customers' cost base.

We started the year very worried about both earnings and multiples. Five months of derating has eased our fears on multiples, though they are not in any way low, as they are still at the top end of their 2003-2019 range—but at least they are no longer a scary 20% above that range. By contrast, our concerns about earnings have continued to rise, along with the earnings themselves, aggravated by the growing risks to the stretched margins from either inflation or a downturn. Given the risks to earnings, it may be a particularly good time to own compounders, i.e. companies that can grow their earnings steadily across cycles because their pricing power and recurring revenue make their earnings resilient in tough times.

[2] Source: FactSet

[3] Earnings before interest and taxation

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