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The Return of Pricing Power: Key Themes From the US and Europe

A survey of our US and European sector strategists signals that pricing power is coming back

Core inflation in each of the major regions over the last six months has been higher than we expected, and inflation is running at higher levels than last year in a range of economies around the world.

While some of the recent pickup in global inflation simply reflects the pass-through from higher oil and commodity prices, pricing power (or at the very least reduced pricing pressure) also appears to be returning more quickly.

Surveys of our US and European equity analysts confirm that pricing is coming back. Pricing power clearly appears to be improving in several 'intermediate' industries where demand has been strong. That finding receives support from producer price indices, which show input price pressure gradually spreading down the supply chain. Yet we also find that pricing power is still quite weak in industries where competitive pressures remain intense or excess capacity is still a big issue.

At one level, the rise in inflation is good news. Fearful of deflation, the world's central banks have essentially been trying to push inflation up from unusually low levels.

But the recent upside surprises also raise some concerns. The big risk to our own relatively benign views on inflation is that unit labour cost pressure appears more quickly, either because wage demands resume earlier than we think or productivity growth slows more (or both). After a period of strong growth and low inflation, the risk is that we are now entering a period of softer growth and rising inflation—where the trade-off for policy could be worse than in the recent past.

Not Just Commodity Prices, But Less Slack and More Pricing Power

Some of the upward pressure on inflation is clearly due to the gradual pass-through of higher oil and other commodity prices. With oil prices surging above $40/bl, compared to $30/bl at the start of this year, the oil price spike has lasted longer and had a more prolonged impact on prices than we had expected. Our latest oil forecasts suggest that there may also be less relief from that spike than initially thought, with oil now expected to trade around $35/bl, higher than we had initially pencilled in for the year.

While higher commodity prices have contributed to the recent pickup in inflation, part of the story also seems to be that strong growth is eating into excess capacity and leading to a more rapid return of pricing power than we had expected. A simple way to illustrate that much of the excess capacity that existed in the world economy last year has been used up is found in our global 'output gap' measures. These measure the slack in the G3 on a consistent basis.

The G3 output gap has narrowed from -1.4% of GDP in 2003Q2 to an estimated -0.3% in 2004Q2. Sustained above-trend growth in both the US and Japan is responsible for this; in Euroland, weak growth has left the output gap broadly steady.

Put simply, increased demand and reduced slack appear to have made companies more comfortable in raising prices—or at least in removing or reducing the discounting that prevailed when the major economies were weaker. It has also made them more comfortable passing on input cost increases than they had been.

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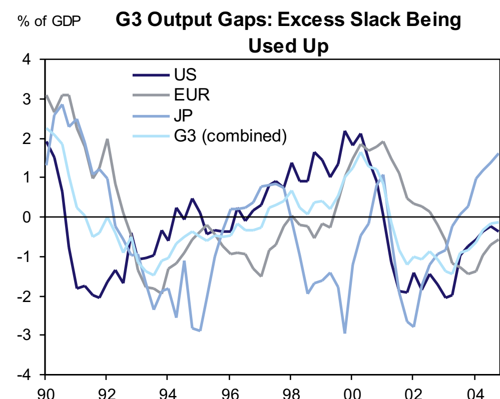

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GS Pricing Power Survey

That intuition is confirmed by a survey of our US and European analysts. We asked our sector teams whether there were signs of a) increased input price pressure and b) increasing pricing power in the sectors they cover, relative to six months ago.

The table shows the key results of the survey. In the US, we would highlight several conclusions:

- On balance, pricing power has increased (there are more sectors where pricing power is higher than lower).
- Input costs have increased – particularly reflecting commodity price increases – but the rise in input costs appears less widespread than is the increased pricing power in final markets.
- The ability to raise prices has spread beyond the pure commodities sectors (who are largely price-takers) to include machinery, electronics manufacturers, steel and semiconductors (equipment and services). Some other sectors (airlines, autos) have seen the rate of price decline ease. This suggests that the return of pricing power is moving further down the supply chain.
- In several sectors (air freight, consulting, healthcare distributors) competition remains a strong restraining factor.
- In consumer-related sectors, the outlook for pricing has generally been more mixed than for those supplying businesses. Some sectors have reported improved pricing power (retailing and department stores), while others (household and personal products) have not seen much improvement.
- Key winners in pricing are machinery, electronics manufacturers, semiconductor equipment and services, steel and tobacco. Key losers are air freight, consulting and outsourcing, and healthcare distributors.

Europe Sees A More Gradual Return To Better Pricing

Although our European survey shows some signs of returning pricing pressure, that picture is more mixed than in the US. Since Europe's recovery has been significantly weaker to date than in the US and since the euro has in general been appreciating against the dollar, this may not be surprising. Key conclusions from the European survey are:

- Rising input costs appear to be a bit more prevalent in the European corporate sector than in the US. A higher proportion of sector analysts surveyed report rising input prices in Europe than in the US.
- But while pricing power is returning in Europe, it is only happening gradually relative to the US. On balance, the majority of European sectors still report no increase in pricing leverage.

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GS Analysts Survey Confirms That Pricing Is Back

US Sectors	Increasing Pricing Power?	Increasing Input Prices?	European Sectors	Increasing Pricing Power?	Increasing Input Prices?
Airlines	No	Yes	Aerospace and Defense	No	No
Air Freight	No	Yes	Autos	No	No
Autos and Autoparts	Yes	No	Beverages	No	Yes
Consulting & Outsourcing	No	No	Business Services	Yes	No
Contract Research Organizations	Yes	No	Capital Goods	Yes	Yes
Cosmetic, household & personal	No	Yes	Chemicals	Yes	Yes
Electronic manufacturers	Yes	No	Commtech Equipment	No	No
Gold	na	Yes	Consumer Products	Yes	Yes
Healthcare Distribution	Yes	No	Games	No	Yes
Integrated Oil	na	Yes	Paper	No	No
Lodging	Yes	Yes	Lesiure	No	Yes
Machinery	Yes	No	Personal Care	No	No
Natural Gas	No	No	Internet	No	Yes
Oil Services and Equipment	Yes	Yes	IT Services	No	Yes
Paper and Forest Products	Yes	No	Luxury Goods	Yes	No
PC hardware	Yes	No	Media	No	No
Pharmacy Benefit Managers	No	No	Medical Technology	Yes	Yes
Retailing/ Department Stores	Yes	Yes	Retail	No	No
Semiconductor Equipment	Yes	No	Semiconductor	No	No
Semiconductor Services	Yes	No	Software	No	Yes
Steel	Yes	Yes	Telecom - Mobile	No	No
Storage software/hardware	Yes	No	Telecom - Incumbent	No	No
Tobacco	Yes	No	Transportation	No	Yes
Wireless telecom services	No	na	Utilities	Yes	Yes

Note: "No" refers to the same or less pricing power/input price pressure relative to 6 months ago (in the US) and relative to the market (in Europe). Na refers to sectors which are price-takers in their final markets.

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- Our European analysts may be underestimating companies' ability to pass through price rises. At the same time, it perhaps is a reflection that European firms were able to retain more of their pricing power in recent years. Due to weaker competitive pressure than in the US, European firms on average have been under less pressure to make strong productivity gains as they had the ability to boost profit margins through price increases. Another possible explanation is that the strength of the euro over the past year appears to have dampened the effect of rising input costs.

- Direct commodity users such as utilities, capital goods and chemicals generally find it easier to pass increases in input costs onto their end users. That shift is also visible in the US results. By contrast, intense competition has meant that European software and beverages are still unable to pass on any cost increases. Regulation in the telecoms sector and strong competition also makes quick price adjustment in response to cost pressures difficult.

- As in the US, the ability to pass on rising costs varies across consumer-related sectors. While the retail and personal care sectors do not report rising pricing power, consumer products and luxury goods have seen some improvement.

- Unlike the US, the European semiconductor sector and other IT related industries report no improvement in pricing power. The situation in much the same in autos, where the US has seen a return of pricing power but Europe has not.

- The luxury goods and business service sectors stand to benefit the most from a reflationary environment.

The strongest evidence of pricing power in both regions comes in sectors that have benefited from the strength of the industrial/investment recovery after a long period of intense pressure. Macro data for the US shows that capacity utilisation has increased most across industries for semiconductor equipment, computers and peripherals, machinery and steel. It is not surprising to see that these sectors have also seen pricing power improve.

Unit Labour Costs Increasingly the Key to Our Benign Inflation Story

Our core view is still that inflation will rise only gradually in most places. Although we expect US inflation to remain firmer over the next few months, our forecasts do not show it pushing quickly or far beyond 2%.

The main reason (particularly in the US) for this benign view is that we find it hard to see core inflation rising significantly while unit labour costs are falling and profit margins are at historic highs. As long as productivity growth remains relatively high and real wage growth modest, input price increases (even intermediate inputs) should not translate into significant consumer price inflation. ■

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A Change in Our US Views

We have abandoned our forecast of no Fed tightening until mid-2005 and now expect interest rates to reach 2.0% by year-end, starting with a 25bp rate hike in late June

Strong payroll gains, an uptick in core CPI, a rise in inflation expectations and a clear shift in thinking among Fed officials have made our prior forecast of no Fed tightening until mid-2005 untenable. We now are looking for 100 basis points of tightening this year in four 25 basis point increments, beginning in late June.

What Went Wrong?

Three key issues led us to change our thinking:

- The improvement in the labor market happened more forcefully and powerfully than we had expected.
- Core inflation rose, reducing the risk of deflation and causing the market to lose confidence in the Fed.
- Fed thinking changed along with this changing data. Most key Fed officials did not expect core inflation to move upward while the US economy experienced a still sizeable output gap. But while it did so, inflationary expectations were also climbing. This shifted the risk/reward calculations that dominate the policy-setting process from the risks tilted to the side of being patient to the risks tilted to at least suggesting that the tightening process get underway.

At this point, a June tightening seems very much in the cards as long as the data does not weaken considerably. Not to tighten in June would raise the risks of a further loss of market participants' confidence in the Fed.

Why 25bp rather than 50bp? We see no reason for the Fed to be aggressive with inflation this low. Moreover, 25bp is much more consistent with the 'measured' language of the last FOMC statement. But this could be affected by the data. If one imagined two horrible core CPI readings for April and May, Fed officials could conceivably be pushed into something more aggressive. In the absence of something like this, however, a 50bp move might disrupt markets or worry investors by suggesting that the Fed is afraid of being behind the curve.

Our expectation that the Fed will raise rates by 25bp four times this year, while somewhat of a guess, is based on three ideas. First, the threshold to begin tightening is a lot higher than that to continue tightening, so we should expect to see a series of moves. Second, after 100bp, some Fed officials could reasonably argue that they want to wait a while to see whether the tightening was working. It would be hard to make this argument before 100bp of tightening.

Third, we expect the tightening process to come to an end when Fed officials 'look out the window' and see that the economy has slowed, the unemployment rate has stopped falling and inflation is steady at a low level. That probably will take some time, given the momentum of the labor market. But this is what we expect because the consumer side of the growth equation is vulnerable.

This Is Not a Repeat of 1994

Our strongest view is that the 1994 template, when the Fed hiked rates by 300bp in 12 months, is the wrong one. We several key differences between now and then.

- Core inflation is currently at or a bit below the FOMC's preferred level, whereas then it was clearly above.
- Although the commodity price pass-through is more intense now, labor costs are more benign.
- The Fed has the benefit of knowing that core inflation did not kick up in 1994. With the benefit of this experience, the Fed may be less aggressive this time around, especially given the lower starting point for inflation.
- Energy prices have been rising, whereas then they were falling. Although this might seem to be a reason why the Fed would tighten more quickly, it is more likely to worry about the potential for higher energy prices to squeeze growth in real income.
- A massive tax stimulus is coming to an end. US households have benefited from two large cuts in personal income taxes that, at times, have boosted annualized growth in real disposable income by more than three percentage points. Over the next year, the restraint is likely to be on the order of a percentage point. Moreover, corporate taxes have been cut by smaller amounts, and defense spending has accelerated to its strongest growth rate in more than 20 years. The economy is more likely to slow in response to a shift in fiscal policy than was the case a decade ago.
- Low saving makes US households more vulnerable to unexpected weakness in income. Currently, personal saving is 1.9% of disposable income, and US households are outspending their income by a record 2.6% of GDP. In 1993, the saving rate was about 5%, and income exceeded spending by about 1.5% of GDP. The low level of saving points to slower growth in coming quarters as households lose the benefit of tax cuts and rely more heavily on labor income to support their spending.

Things to Watch

Five developments over the next few months will affect our views: 1) core CPI, which is important for inflation expectations and the need for the Fed to tighten to keep them in check; 2) consumption (the area of vulnerability); 3) employment, especially the unemployment rate as a measure of the slack of labor market); 4) compensation costs; and 5) productivity growth. If this were to fall sharply, unit labor costs would turn up more quickly. ■