TD Greystone Asset Management

"Pass it on": Inflation and the Impact on Public Equities

Macro to Micro

Globally, wage inflation is slowly rising due to tight labour market conditions and this may dampen the growth outlook for some companies. We highlight how our three-step investment process focuses attention on companies with sustainable and diverse business momentum drivers, regardless of what point in the cycle we are in. Through this approach, we provide examples of companies we invest in that are less impacted by what could be sustained wage growth inflation.

Question: Where is wage inflation heading in the next few quarters or years?

Answer: We don't know for sure, but that's okay from an equity investment perspective.

There are indicators today suggesting wage inflation is on the rise: We say indicators as it is not convincingly clear whether or not wages, or inflation in general, are moving higher at all. Some observers argue that wages have been and will be structurally stagnant for years to come as higher income baby boomers retire and are replaced by a less experienced workforce. In fact, more recently some U.S. companies have mentioned that although the labour market is tight and finding workers in some industries is challenging, wage growth has not been an issue thus far. Some companies are able to pass on higher wage costs to their customers with higher prices, or through efficiency improvements. But will all companies be able to do so? In this paper, we focus on wage inflation as a potential threat to company margins.

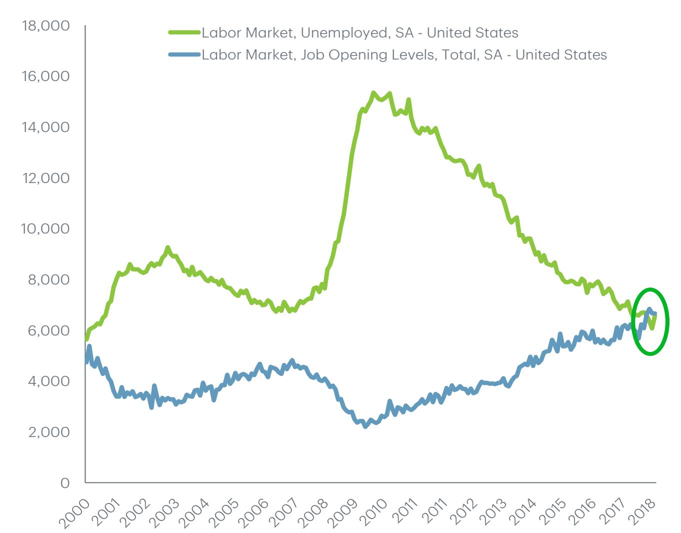
Be on the lookout for macro-events but more focused on the micro: We diligently monitor the external environment for threats to the growth outlook, such as wage inflation. However, our equity investment process focuses more on understanding the business momentum on a microeconomic level and less on the top-down macroeconomic view, which is the domain of our fixed income and asset strategy teams. Rather than focusing on "the market" we focus on "the business" in our equity process. Charlie Munger, famous investor and Vice-Chairman of Berkshire Hathaway, once said, "Micro is what we do and macro is what we put up with." Well said, Charlie.

Dedicated sector specialists provide deep insights: Our dedicated global sector analysts have a thorough knowledge of the industry in which a company operates, and they analyze how management teams make decisions in different operating and economic environments. We believe that our fundamental team's ability to concentrate on a particular sector drives efficiency, deeper insight and allows us to make high conviction investments in high-quality companies. As part of our three-stage investment process, our risk management pillar ensures that equity portfolios are guided away from overt risk concentration to macro factors and instead focus on stock-specific risk.

What indications of wage inflation are there today?

We do not tilt our equity risk based on a view of potential wage inflation or the timing of it becoming an issue. However, we are monitoring indicators of wage inflation today:

Figure 1: U.S. Job Openings vs U.S. Unemployment

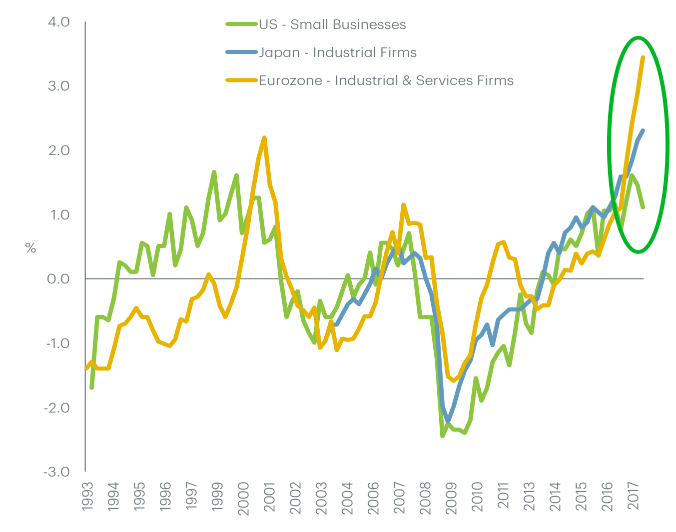


Source: Evercore ISI. Bloomberg Finance L.P.

1. **There is a general shortage of qualified labour in developed markets:** There has been an increase in labour shortages in the U.S. as shown in Figure 1. While wage growth has not yet been inflationary, it certainly has tracked labour shortages in the past and may suggest wage inflation pressures are not far away. Workforce turnover has been on the rise and the number of people voluntarily leaving their jobs in the U.S. reached an almost 20-year high last quarter. This may be a leading indicator for future wage growth and is something that we are monitoring.

Labour-based surveys in the U.S., Europe and Japan have shown that small businesses are growing increasingly concerned about labour shortages. This may imply higher wages to come as companies attempt to attract qualified workers.

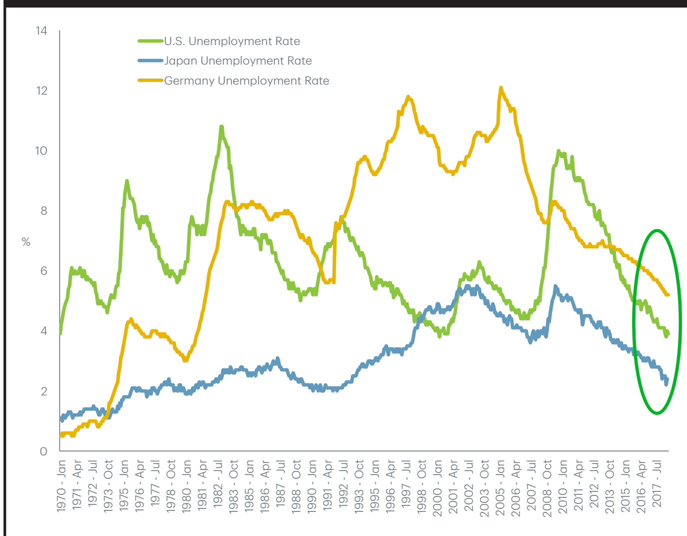
Figure 2: Selected Economies - Survey-based Labor Shortages (1993-2017) std dev



Source: NFIB. BoJ. EC. Citi Research.

2. **Unemployment trends are also reaching decade lows** across major developed markets, which may suggest wage inflation pressure moving forward.

Figure 3:
Unemployment Rate (%) U.S., Japan, Germany



Source: Evercore. ISI. Bloomberg Finance L.P.

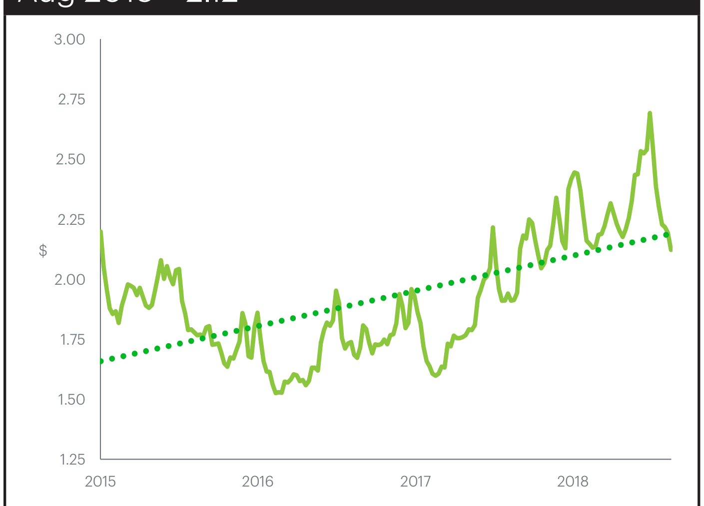
Companies are talking more about higher labour costs today: The majority of mentions of higher labour costs are still within Consumer Discretionary sectors, though mentions have also ticked up in areas such as Staples, Energy and Financials. According to a report from Bank of America Merrill Lynch Global Research, 10% of companies in the S&P 500 mentioned higher labour costs as a factor that weighed on their first-quarter results, which is up from 8% in the fourth quarter and is the highest level since they began tracking the data in 2015.

Figure 4: 10% of Companies Mentioned Higher Labour Costs in Q1-18, the Highest Since 2015

Source: Bank of America Merrill Lynch.

3. **There are other indirect signs worth paying attention to:** We realize that not all wage inflation pressures will be measured directly. Indirect, or second-order wage inflation, has been showing up through higher freight costs. The cost per trucking mile has been steadily increasing for the last few years as a result of a shortage of truck drivers relative to the high levels of demand from a robust U.S. economy. This is just one example of another indicator we are monitoring as we have heard from many companies that transportation costs and freight costs have been growing and potentially impacting their profit margins. It's unclear today if trucking capacity will be able to keep up with demand from the U.S. economy, and we would expect some of this cost pressure to be passed along through the broader economy.

Figure 5: Trucking Spot Rate (Dry Van) Aug 2018 = 2.12



Source: Truckstop.com.

The minutes of the Federal Open Market Committee (the "FOMC"), June 12-13, 2018: The FOMC noted a potential for wage inflation to pick up from here. "*.... On balance, for the economy overall, recent data on average hourly earnings indicated that wage increases remained moderate. A number of participants noted that, with the unemployment rate expected to remain below estimates of its longer-run normal rate, they anticipated wage inflation to pick up further.*"

Also, the July 2018 Federal Reserve Beige Book report provided additional confirmation of tight labour markets: All Districts reported that labour markets were tight and many noted that the inability to find workers constrained growth. Shortages were cited across a wide range of occupations, including highly skilled engineers, specialized construction and manufacturing workers, IT professionals, and truck drivers. Although wage growth isn't accelerating, the Federal Reserve indicated there were differences across sectors and a couple of Districts cited a pickup in the pace of wage growth.

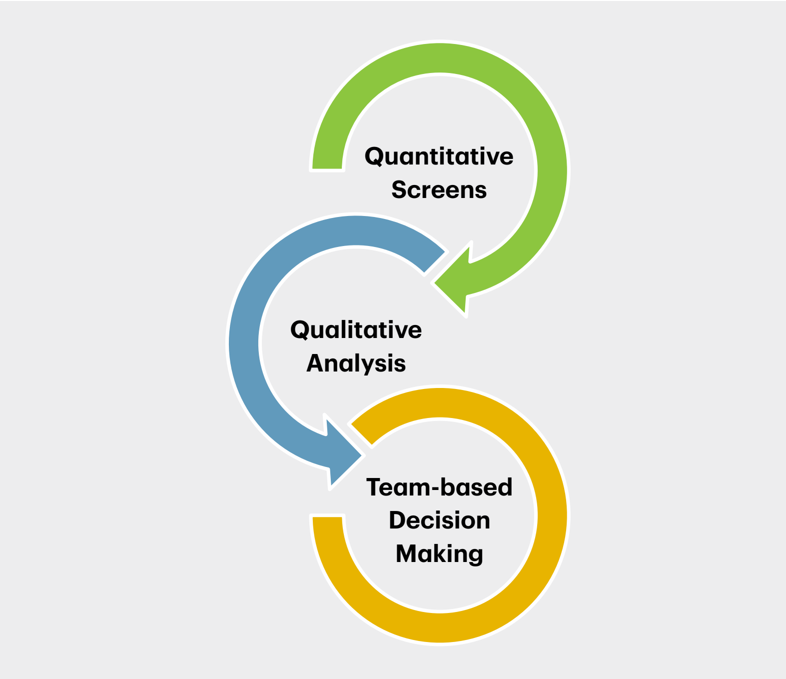
Rising wage inflation and the impact on equities:

Why should equity investors be concerned about rising wage inflation? Rising wage inflation poses a risk to a company's margins and ultimately shareholder returns. If a company cannot offset higher wages, all else being equal, with higher revenue (i.e. through price x volume, or some combination of the two), margins will decline. In the short term, lower margins could mean lower growth expectations and this may negatively impact a company's share price. Of course in the long run, successful companies adapt to rising wage and other cost pressures with a number of strategies to maintain profit margins. Raising prices, leaning out the cost structure through automation, lowering experience and skill levels for new hires, and offering other non-monetary benefits (i.e. "perks") to retain and attract employees are viable strategies companies could employ.

"Pass it on" – investing in companies with positive business momentum:

TD Greystone Asset Management's Three-step Global Equity Investment Process

At TD Greystone Asset Management, our investment process is growth-oriented, believing a company's stock reacts positively to growth in earnings and cash flow. We also believe that indicators of sustainable earnings growth appear at the company level before they are recognized in the company's stock price. As a result, we seek out companies that have demonstrated superior earnings growth, positive business momentum, and sustainable profitability while ensuring we do not overpay for these growth characteristics. Our investment process is focused on finding companies to invest in with sustainable business momentum, regardless of what point in the growth cycle we are in. Inflation (low/high/flat) should not impact the companies we invest in, nor the portfolios that we construct for our clients.

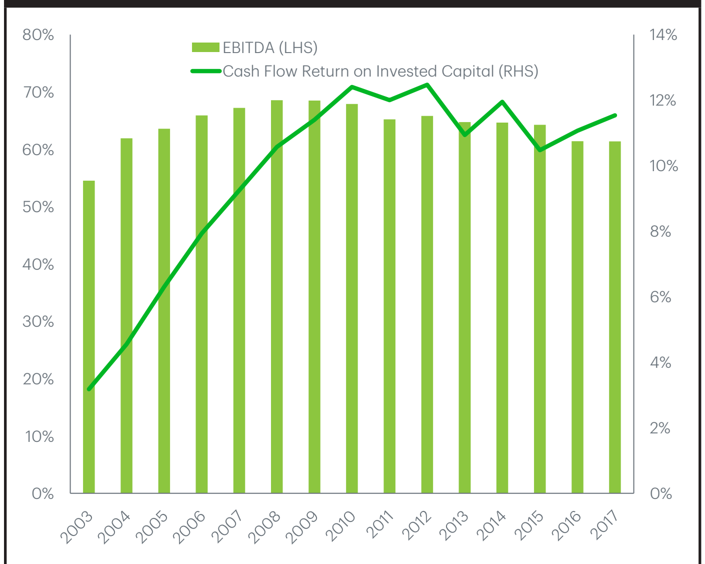


1. **Quantitative Screening - Selection pool construction:** This first step in the process narrows the investment universe to a smaller list of companies that meet carefully defined selection criteria. We screen for companies with a consistent history of sales/operating margin expansion, and growing profitability who are also trading at reasonable valuations to their growth prospects.
    - Looking for companies with pricing power: Pricing power is typically defined as the ability to raise prices in excess of inflation without either losing customers or invoking a competitive response from rivals. We look to invest in companies with pricing power relative to their competitors, regardless of the inflation environment. Stability of gross and operating profit margins are some of the ways that we screen for companies with pricing power.
2. **Qualitative Analysis:** After screening identifies a stock of interest, Our Fundamental Research team member with the applicable sector coverage undertakes an in-depth qualitative analysis to validate the future growth prospects of the company. This includes using a Porter five force analysis to better understand the company and industry drivers of business momentum and pricing power. We believe that identifying and understanding the sustainability of these growth drivers is the key to alpha generation for our clients regardless of the stage of the business cycle we are in.
3. **Team-based Decision Making:** Our Portfolio Management team must agree on all buy and sell decisions. Portfolio weights are evaluated and discussed based on the strength of the investment thesis and in collaboration with the risk management team who helps to interpret values based on market conditions and ensure all risk taken is commensurate with the Portfolio Management team's conviction level in the outcome.

Greystone Equities Portfolio Holdings – a few examples of companies that are able to "Pass it on":

American Tower Corporation ("American Tower"): One of the largest global providers of communication tower space benefits from increasing consistent demand for faster and greater mobile bandwidth, high lease renewal rates and low maintenance capital expenditures. The growth in International markets, limited competition due to high barriers to entry, and economies of scale ensure relative pricing power for American Tower. In addition to a favorable competitive environment, there are embedded lease escalators, which are typically tied to fixed percentages or a variable percentage based on a consumer price index. We would expect the company to be able to pass on rising operating costs to maintain and grow profit margins.

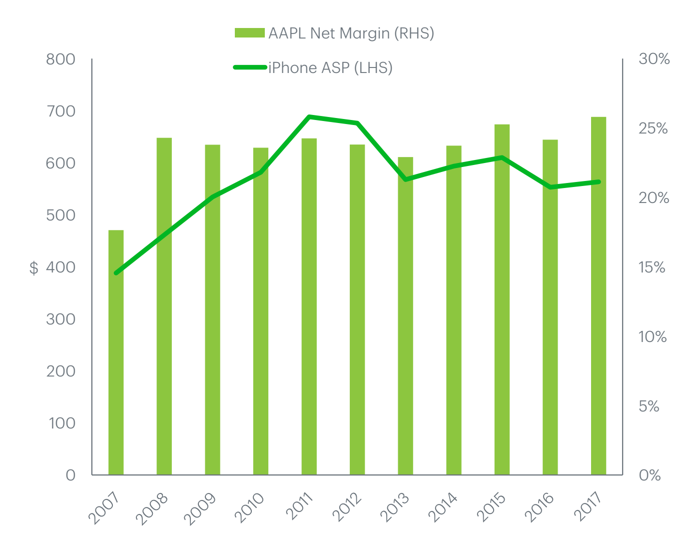
Figure 6: American Tower Corp. EBITDA %, CFROIC %



Source: FactSet, Company Reports.

Apple: Apple products are regarded as high quality and, in general, command higher price points relative to its competitors. Apple has been able to maintain industry leading gross margins given its ability to raise prices on new products, limited substitute products and high barriers to entry. While there will be a natural price ceiling for smartphones, we expect Apple's profit margins to expand over time as higher margin service-based revenue grows as a contributor to overall results.

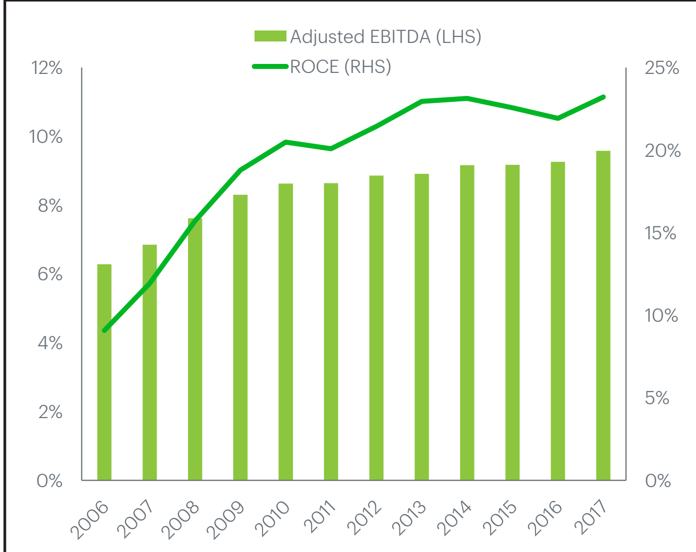
Figure 7: Apple Inc. iPhone Average Selling Price (ASP), Apple Inc. Net Profit Margin (%)



Source: FactSet, Company Reports.

Compass Group PLC ("Compass"): Compass is a high-quality, recession resilient foodservice provider to business and industry, healthcare and seniors, education, defense, sports and leisure sectors. The key to the relative stability of the margin performance of Compass comes from its operating model, where the fixed costs are mostly borne by the customer. It is Compass's greater leverage in purchasing scale economies, coupled with the more effective harnessing of the intellectual property of labour, that gives contract caterers their profit opportunity. Their business model is also structured so that they are not reliant on one particular sector, geography or group of clients.

Figure 8: Compass Group PLC Adjusted EBITDA %, ROCE



Source: FactSet, Company Reports.

Conclusion

At TD Greystone Asset Management, we primarily focus on company and industry fundamentals, which we believe add the most value. While there is no tried and true method for predicting where inflation will move in the future, we continue to vigilantly monitor the indicators of wage inflation today. When applying our three-step investment process that focuses on companies with diverse and sustainable business momentum drivers, our view is that wage inflation should not materially impact the companies we invest in or the portfolios that we construct for our clients.

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