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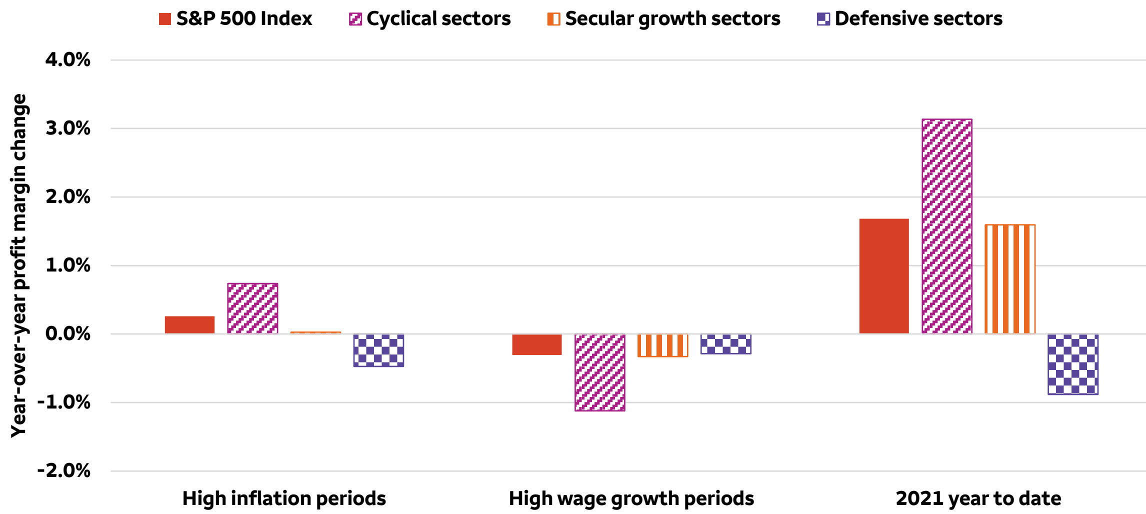
Investment Institute

Chart of the Week

Weekly market analysis on key market indexes — December 14, 2021

Inflation — How cyclicals have risen to the occasion



Sources: Bloomberg and Wells Fargo Investment Institute. Data as of October 29, 2021. Cyclical sectors include Industrials, Financials, Energy, and Materials. Secular growth sectors include IT and Consumer Discretionary. Defensive sectors include Health Care, Consumer Staples, and Utilities. Real Estate and Communication Services were not included due to short history or material membership change in recent years. High inflation periods are months: (1) between 1990 and 2020 (2) when year-over-year consumer price index change was above 3.5% (3) that did not overlap with recessions. High wage growth periods are months (1) between 1990 and 2020 (2) when the year-over-year wage increase was above 4% (3) that did not overlap with recessions. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Average profit margin change during periods between 1990 and 2020, and in 2021

High-inflation periods have been infrequent in recent decades but have generally occurred when manufacturers found it difficult to keep up with surging consumer demand. The chart shows that in high-inflation periods, the headwinds from higher input prices typically didn't negate the tailwinds from economic growth as companies have been able to pass the higher cost to consumers.

Cyclical sectors (purple bar, diagonal lines) historically have posted strong profit margin growth (relative to the S&P 500 Index) in inflationary periods because they have generally felt less impact from rising input costs. This has been the case in 2021 as well.

What it may mean for investors

We expect operating margins to remain elevated in 2022, despite potential above-average inflation and wage growth. Ultimately, a key support of high profit margins is the soothing of imbalances in the global supply chain, retail market, and workforce. We expect these factors to improve in 2022, supporting margins at record levels and maintaining healthy fundamentals for the S&P 500 Index.

Chao Ma, CFA, PhD, FRM, *Global Portfolio and Investment Strategist*
Excerpted from the Investment Strategy report dated December 6, 2021.

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors.

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