Cost inflation hitting balance sheets

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Cost inflation was a hallmark of the most recent local earnings season as higher labour, rent, energy and transport costs become increasingly baked into corporate earnings, all but ensuring margin compression over the next 12 months. WAM Leaders (ASX: WLE) has formed core positions in defensive, market leading companies that we believe have the ability to absorb these shocks.

Wage inflation sticks

Our investment process involves positioning the portfolio ahead of inflection points. In this environment, we're particularly cautious about companies that have high labour expenses as a proportion of their total cost base. Unless those firms can dramatically reduce head count, the soaring cost of labour is an impost they will be unable to offset. This impacts the likes of the big four banks more than the materials sector for example, given their relative levels of fixed labour costs.

We are yet to see the full impacts of wage inflation hit company earnings. Wesfarmers (ASX: WES), Woolworths (ASX: WOW) and Coles (ASX: COL) are all facing significant wage inflation on labour-heavy cost bases. In a slowing revenue environment, it becomes particularly challenging to maintain profit margins. We are focused on companies with the ability to manage their cost bases through the cycle.

Interest costs surge

One item overlooked in calculations of corporate costs during earnings season was the rising cost of debt. While carrying high levels of cash or low debt might have previously been considered inefficient, it's now being rewarded. The rapid reversal of almost a decade of low interest rates by global central banks has significant implications for companies with substantial debt balances and leases.

Traditionally, Australian firms have lagged their American counterparts in hedging their balance sheets against higher rates. Notable exceptions include Westfield owner Scentre Group (ASX: SCG), which used market volatility to increase its interest rate hedging. This strategic move resulted in a standout earnings result within a challenging sector.

Australian insurance companies also saw substantial profit increases thanks to higher insurance premiums coupled with investment income rebounding. We remain positive on insurance companies such as QBE Insurance (ASX: QBE) which have the continued ability to pass on inflation to their end customers. Going forward, there will be greater scrutiny of the cost and duration of debt structures and cash flow generation.

The two tales of health and consumers

Ramsay Health Care (ASX: RHC) was a test subject for higher interest and labour costs, which required the company pay a lower than expected dividend to improve its balance sheet. The private hospital operator's results were also impacted by a slower than expected bounce back in elective surgeries.

By contrast, private health insurers such as Medibank (ASX: MPL) and NIB (ASX: NHF) reported strong results underpinned by policyholder growth and solid net investment income. The opening of international borders further boosted their travel insurance and international worker and student health insurance earnings.

We remain underweight the consumer discretionary sector as the surprising resilience of the Australian consumer is now finally buckling under the weight of higher interest rates and inflation. While valuations are steeper, we prefer consumer staples such as Woolworths and Treasury Wines (ASX: TWE).

Looking ahead, we expect economic conditions will be more volatile and central banks' rate decisions will be more variable in response. The decades of low rates that rewarded long-dated opportunities and risk taking are unlikely to repeat. Careful portfolio construction is required, and our tactical, macro-driven approach keeps us invested in companies with multiple levers to navigate volatility ahead.