Inflation Shocks and Firm-level Resilience: The Role of Pricing Power

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We ask: How is equity value affected by a firm's pricing power (PP) in inflationary periods, theoretically and empirically?

Cost-shock inflation (1 + π)

Heterogeneous pass-through of π to FCF components

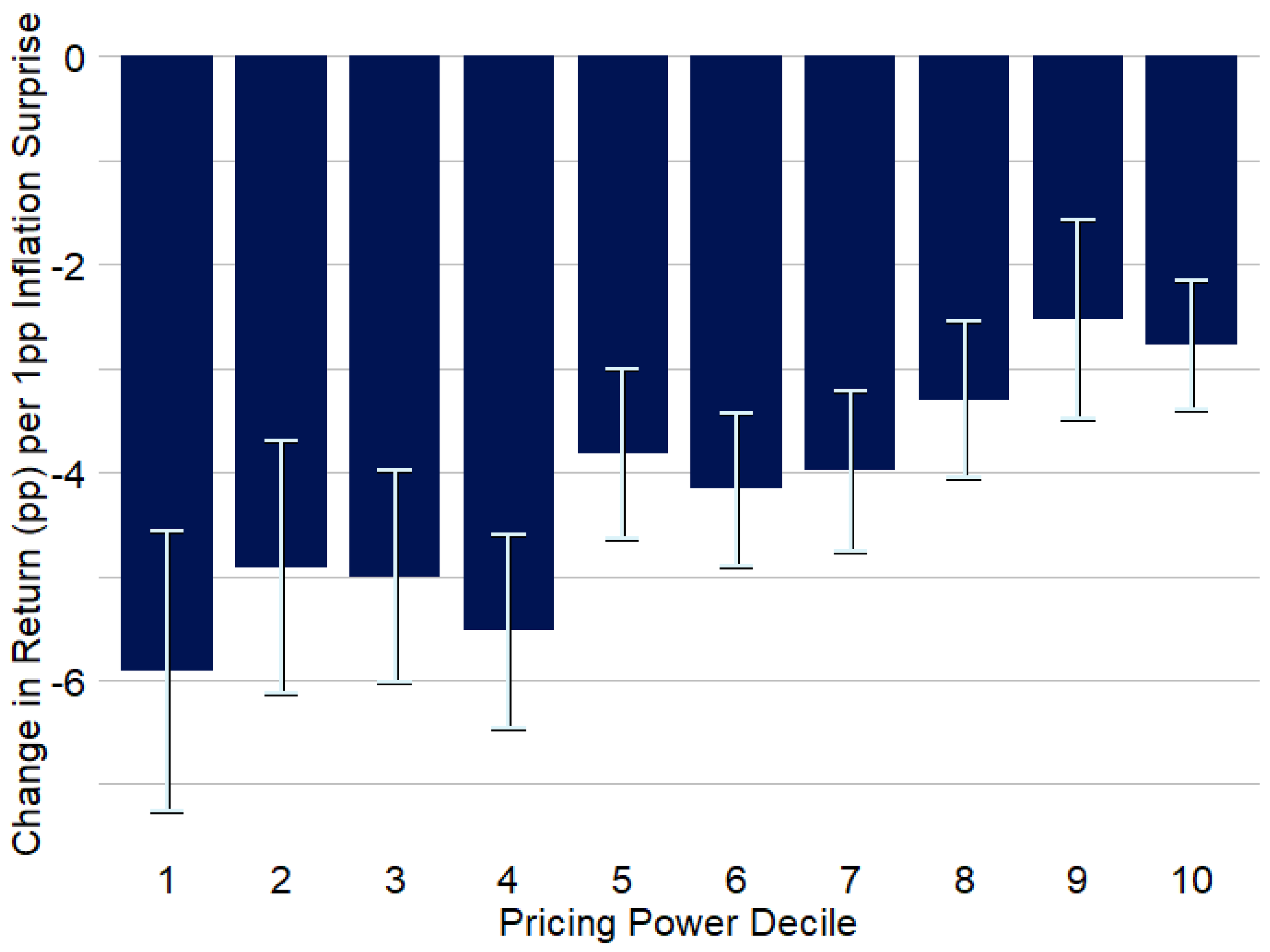
FCF (1+$\lambda_i\pi$)

Overall pass-through λ_i varies by firm!

Theoretically, we find

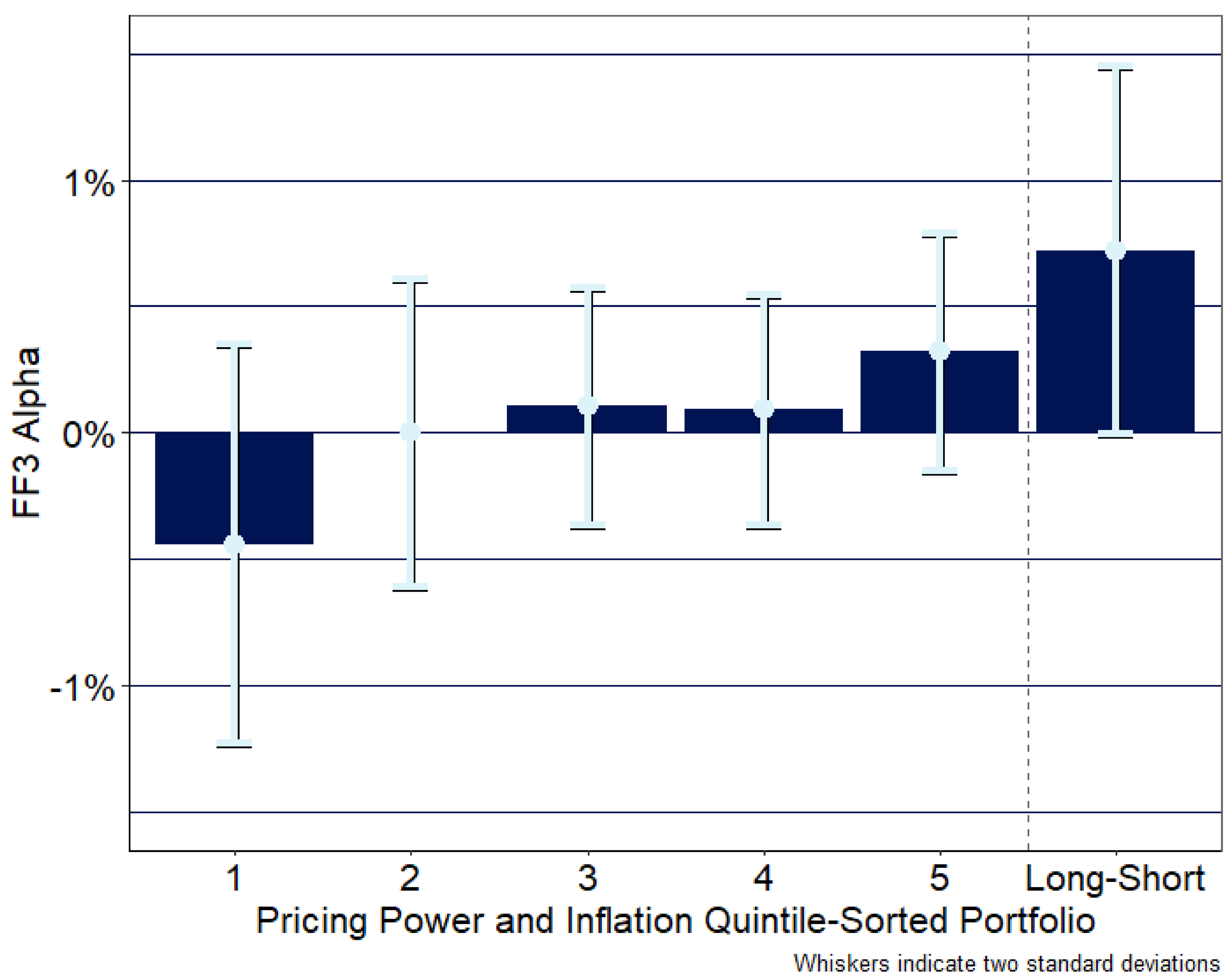
– Firms with high PP have more **resilient free cash flows and lower cost of capital** post inflation.
– Fisher Equation needs to be adjusted and applied to the **individual firm**.
→ Firm value of higher PP firms is less negatively, or even **positively influenced** by inflation.

Empirically, high pricing power firms experience lower costs of capital and more resilient stock returns and free cash flows during inflation, on average.



- The negative stock price reaction in the month following unexpected inflation is mitigated linearly in PP.
- A one-standard-deviation increase in PP hedges 15% of the negative stock price reaction.
- FCFs are more resilient for high PP firms post unexpected inflation.
- Implied costs of capital of high PP firms decrease post unexpected inflation.

A trading strategy on inflation and pricing power generates a significant 1.2% monthly FF3-alpha.



- Trading period: 2009:01 - 2023:02.
- Long-Short portfolio buys (shorts) stocks in the highest (lowest) PP quintile if inflation (yoy) is positive. If deflation is present, the signals are reversed.
- The FF3-adjusted monthly alpha is 1.2% (p-value = 0.04).
- Trading on PP only (without inflation) yields no significant alpha.

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