

TRENDMACRO LIVE!

## On Wal-Mart's Deflation Call

Thursday, November 16, 2023

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Deflation is coming. The consensus thinks that's bad. Walmart is telling you it's good.

We've been saying all year that the big surprise of 2023 would be the transition from inflation to deflation (see, among many, ["Surprises of 2023 Volume 1: From Inflation to Deflation"](#) January 3, 2023). It's been hard enough to get the consensus to come around to our view that inflation has been conquered – and now it seems Tuesday's CPI report has done it (see ["Celebrate Victory Over Inflation, Even if the Fed Doesn't"](#) November 14, 2023, and ["Data Insights: CPI/PPI"](#) November 14, 2023). And maybe this morning's earnings report from Walmart will start moving the consensus toward our view on the coming deflation.

- That would mean, first, that deflation is coming (which almost no one believes).
- But it would also mean, second, that deflation is good (which no one believes).

CEO Doug McMillon kicked off the conference call by saying,

*"In the US, we may be managing through a period of deflation in the months to come."*

As of this writing the market isn't pleased, with Walmart's stock down more than 7%. This may reflect concerns that we hear every day from clients when we talk about the coming deflation: that it will necessarily crush corporate margins. We must admit there will be losers from the deflation, but there will more winners. McMillon said as much:

*"... we welcome it because it's better for our customers..."*

*"... if the food prices come down [in] dry grocery and consumables. And [if] we started seeing deflation, those categories, that will free-up dollars to be spent in general merchandise. And with the rollback positioning and some of the prices we're hitting it makes sense that people would be able to shift back to GM as they shop the box to the app. The great thing about our position is we don't really care, like they can buy whatever they want to buy..."*

### Update to strategic view

#### US MACRO, US EQUITIES, FEDERAL RESERVE:

In this morning's earnings call, Walmart CEO McMillon called for "a period of deflation in the months to come," and the stock is down sharply. But he went on to say that it is "better for our customers" and will lead to "growth in units." Corporate profitability comes not just from top-line pricing power, but from unit sales. And margins are also driven by cost of goods sold, which falls in a deflation. Walmart is telling our deflation story: after three years of an inflation shock, a little deflation will be relief for consumers and will stimulate a wave of deferred consumption. The consensus is finally conceding that inflation has been conquered. Now it will have to begin to accept the inevitability of deflation. Ultimately, it will have to learn that this deflation will be good. In the meantime, a bonus: deflation fears will bring forward in time the first Fed rate cut, and accelerate the coming easing cycle.

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*“One of the things that we're looking at closely in our business is units. And we've seen good growth in units. So this has not been entirely driven by just higher prices. We think we're positioned well.”*

This is exactly what we've been telling clients. Margins come not just from top-line prices, but from the number of units sold (because the marginal unit is the most profitable unit). Following the catastrophic inflation of the last three years, a little deflation will effectively put America on sale for consumers, offering them relief from three years of diminished purchasing power, and we think stimulating a wave of deferred consumption. The deflation will be a form of what a modern politician would call [“reparations,”](#) or what a modern engineer would call [“optimal control”](#) (see [“Video: What you're not hearing about the coming deflation”](#) June 23, 2023).

And, of course, bottom-line profits come not just from top-line pricing power anyway, but from the difference between selling price and cost of goods sold. In a general deflation, that difference may well end up changing not at all across corporate America overall.

But most market participants think “deflation” is a synonym for “recession.” They are not the same thing. Deflation is simply a decline in the overall price level of goods and services. Recession is a contraction in economic activity.

To be sure, deflation has been associated with recessions over history. But it hasn't caused them. And in this case, after an inflation shock that followed four complacent decades of price stability, deflation will prolong and accelerate what is already a booming post-pandemic business cycle. In the meantime, deflation fears, however ultimately misplaced, will have the happy effect of bringing forward in time the first Fed rate cut and accelerating the coming easing cycle.

The price action in Walmart stock this morning shows that the consensus isn't seeing it our way at the moment. Deflation bad. But actually, deflation good.

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## Bottom line

In this morning's earnings call, Walmart CEO McMillon called for “a period of deflation in the months to come,” and the stock is down sharply. But he went on to say that it is “better for our customers” and will lead to “growth in units.” Corporate profitability comes not just from top-line pricing power, but from unit sales. And margins are also driven by cost of goods sold, which falls in a deflation. Walmart is telling our deflation story: after three years of an inflation shock, a little deflation will be relief for consumers and will stimulate a wave of deferred consumption. The consensus is finally conceding that inflation has been conquered. Now it will have to begin to accept the inevitability of deflation. Ultimately, it will have to learn that this deflation will be good. In the meantime, a bonus: deflation fears will bring forward in time the first Fed rate cut and accelerate the coming easing cycle. ▶