Perspectives

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Holiday Supply Chain Woes Linger

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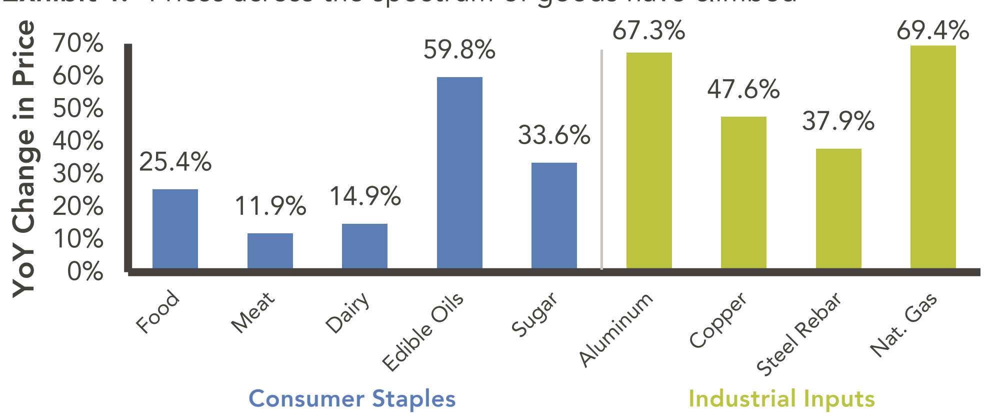
Headlines continue to buzz with worries of supply network dysfunction that seem to span every link of the chain, from truckers and shippers to commodities and semi-conductors. Clearly, the delicate balance of supply and demand is off kilter.

Supply chain disruptions began when global economies locked down amid the outbreak of COVID-19, and the problem has only been exacerbated by stop-and-start re-openings that have taken place in recent months. This newsletter seeks to understand current supply chain dynamics and what they might mean for investors and consumers alike as we move into the holiday season.

A THREE-PRONG PROBLEM: PRICES, TRANSPORT, AND LABOR

Disruptions have impacted every stage of the global supply chain, and the prices of goods markedly increased on a year-over-year basis as a result. Prices of core industrial metals including aluminum, copper, and steel rebar have notably jumped, in some cases rising more than 50–60% from last year's measures and reaching levels not seen since the Financial Crisis. As inputs for industrial production rise, so do costs paid by the consumer. While the U.S. consumer boasted a strong savings rate during the COVID-19 pandemic, individuals likely did not anticipate the global cost of food rising more than 25% in the last 12 months.

Exhibit 1: Prices across the spectrum of goods have climbed

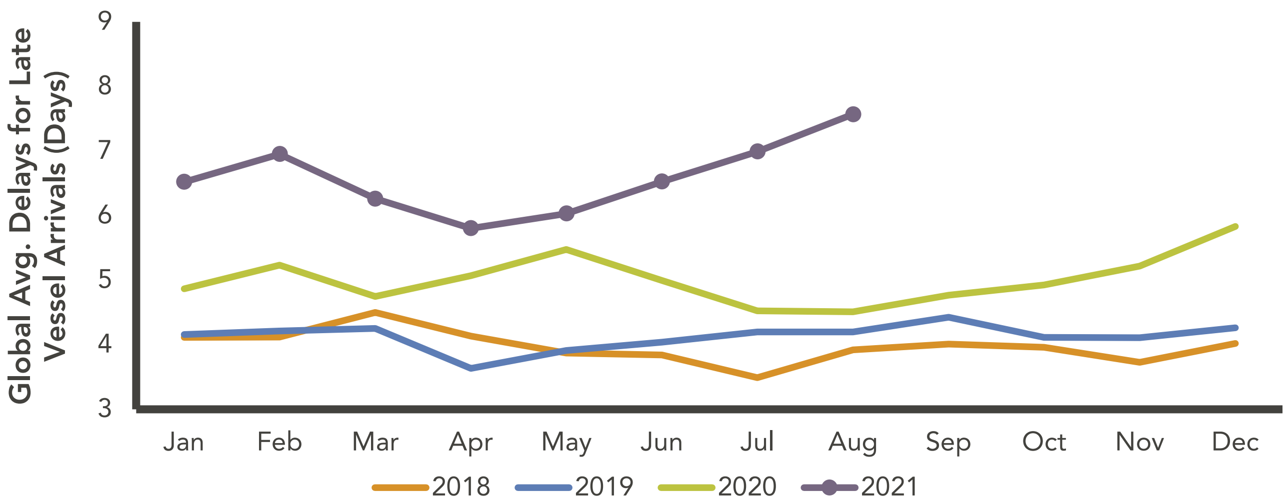


Sources: United Nation's FAO and Bloomberg as of September 30, 2021

Deloitte, a major accounting and advisory services firm, is projecting retail and e-commerce holiday sales to increase 7–9% and 11–15% on a year-over-year basis, respectively, which is likely to put pressure on an already challenged environment. While price surges tend to be temporary in isolation, the problem starts to compound and extend when other key elements of supply chain management become expensive or delayed.

Cue transportation troubles. The rate on shipping a 40-foot container from Shanghai to Los Angeles has historically cost approximately $1,500. However, shipping rates have increased sevenfold since the middle of 2020, spiking to more than $12,000 per container in September. Delays have continued to track higher as well, with no expected change as the holiday season quickly approaches. Across the globe, late shipping vessels averaged a 7.6-day delay in the month of August,[1] up from the average 4-day delay in both 2018 and 2019. Companies have been creative in working around these transportation costs and port-to-port setbacks, like negotiating 12-month contracts or reserving entire cargo ships for their products alone.

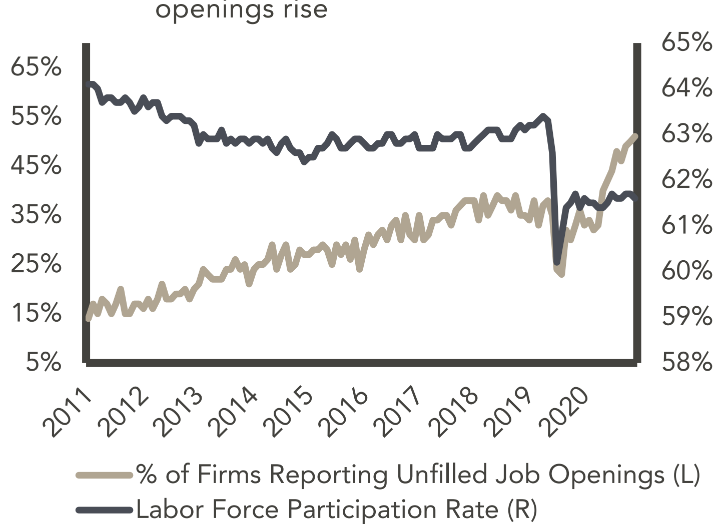
Exhibit 2: No sign of shipping time recovery, as vessels arrive more than seven days late



Source: Sea-Intelligence, Global Liner Performance (GLP) report issue 121, as of August 30, 2021

Labor market dislocations have added fuel to the fire. Since 2000, the United States labor force participation rate, a measure of the U.S. population employed or seeking employment, has gradually declined approximately 4% over the last two decades. The immediate 3% COVID-induced drop is the most significant change in the history of the metric and brings us back to a level not seen since January 1977. This has likely contributed to staggering numbers reported in a recent NFIB Small Business Jobs Survey that states that 51% of surveyed small businesses report one or more open positions yet to be filled, the highest level on record in the 35-year history of the survey.

Exhibit 3: Labor market participants drop as job openings rise

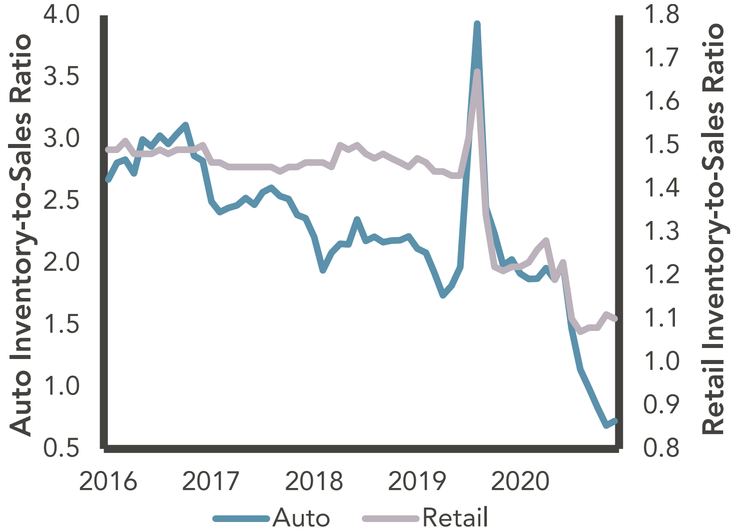


Sources: NFIB Small Business Jobs Index and U.S. Bureau of Labor Statistics as of September 30, 2021

FEELING THE SQUEEZE

With a clear break in the supply chain infrastructure, some market participants will likely feel a tighter squeeze than others. Exhibit 4 shows the inventory-to-sales ratio for domestic retailers and auto manufacturers, highlighting the dramatic decline of available goods. The August 2021 retail level of 1.1x implies that retailers have just over one month of inventory to match a month of sales, compared to the 5-year pre-pandemic average of 1.47x. This equates to approximately 11 days of inventory no longer available on shelves. While this may not seem significant, it is a challenge in a market hurtling toward efficiency. Just-in-time ("JIT") inventory management, pioneered by the auto industry, has been increasingly implemented across many goods manufacturers as a means to more efficiently allocate free cash flow. Essentially, companies only buy inputs/products for delivery "just in time" for production or to be placed on shelves. While this saves a company on costs like storage, it only takes one supplier to fail for a company's whole line of production to be impacted. This inventory shortage has had a dire effect on costs in never-before-seen ways. Since the start of the pandemic, the Manheim Used Vehicle Index has increased along with used vehicle prices, climbing 37% higher on a year-over-year basis in October. Traditionally, the auto industry experiences seasonality, with spring and fall usually denoting peak demand periods. With recent shortages of new vehicle inventory, used vehicle demand has bucked this trend in light of the changed dynamic.

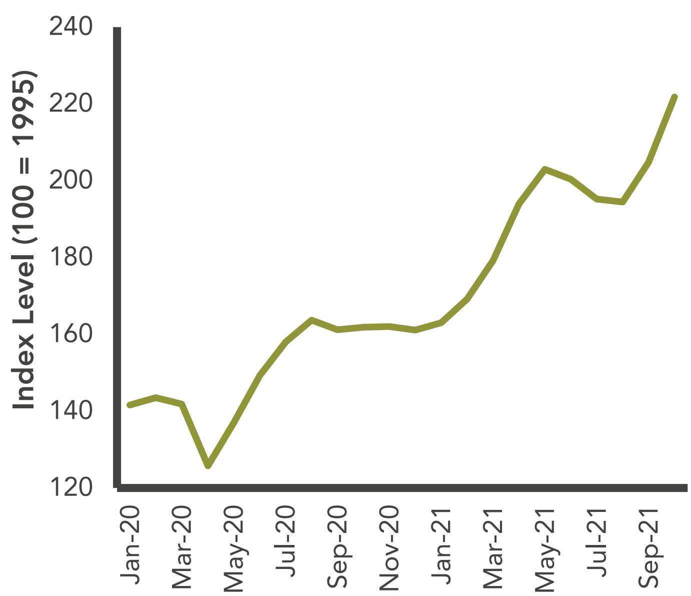
Exhibit 4: Record low inventory levels will hamper holiday shopping



Sources: U.S. Census Bureau and Bureau of Economic Analysis as of August 30, 2021

The weakness in supply chains has driven a re-evaluation of how they are managed, with China plus one — a strategy designed to diversify away from Chinese supply chain dependency — taking center stage amidst the pandemic. While supply chain diversification efforts have long been viewed as a necessary evolution for companies looking to reduce disruption risk, the impacts of the pandemic have been felt both upstream and downstream.

Exhibit 5: Manheim Used Car Index soars 37% YoY

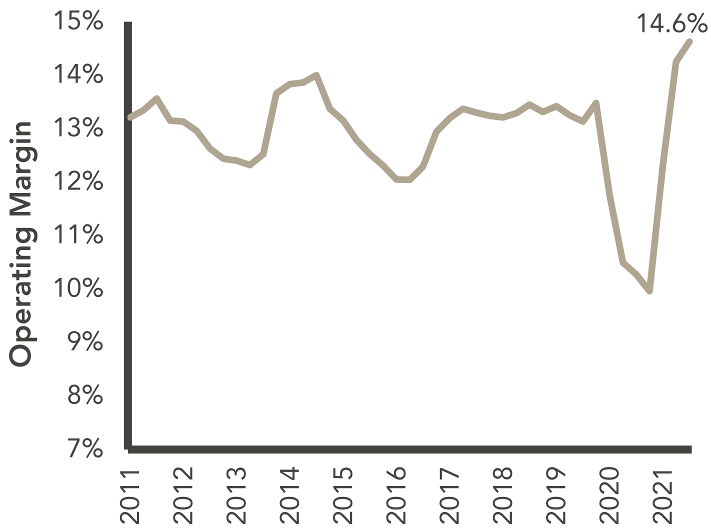


Source: Manheim Consulting as of October 15, 2021

YET COMPANY PROFITS CONTINUE

One might imagine that soaring input prices would put pressure on a company's bottom line, but that isn't what has emerged thus far in 2021. Some of the world's largest companies have continued to grow margins. In fact, the index-level operating margin on the S&P 500 expanded to 14.6% in September, exceeding the pre-Global Financial Crisis peak. Profit margins and earnings continue to rise as well, likely benefitting from lower corporate taxes implemented in recent years.

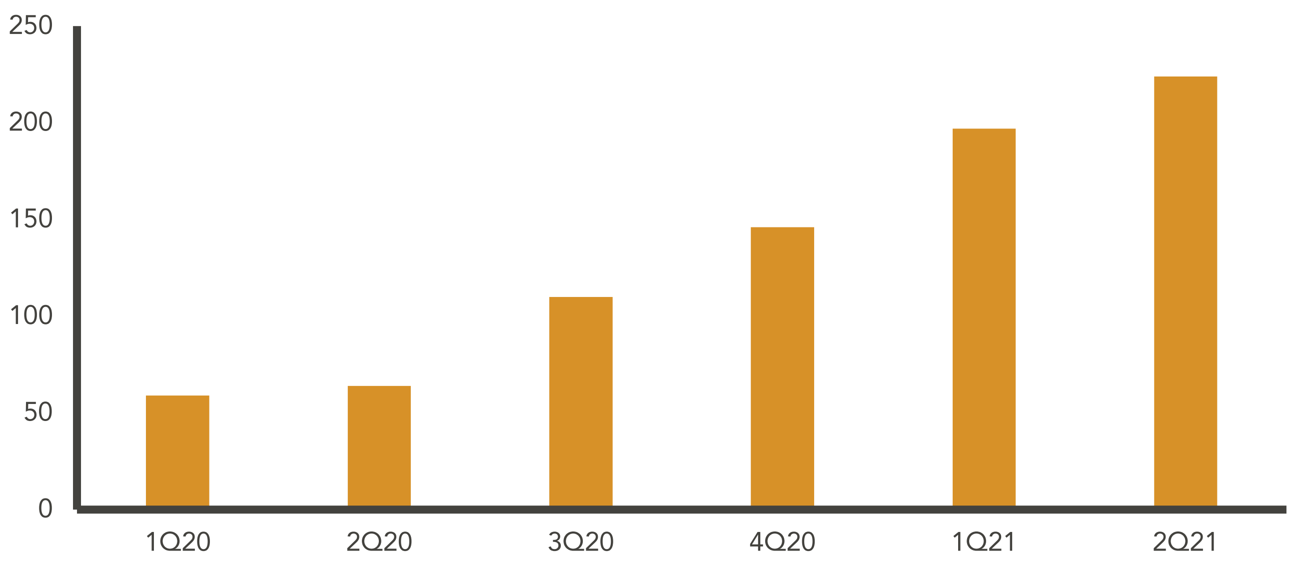
Exhibit 6: S&P 500 Operating Margins seemingly unaffected by supply chain woes



Source: Bloomberg as of September 30, 2021

Pandemic-induced lockdowns forced many companies to trim the fat. Abundant cost-cutting was implemented to maintain stability, and many of those expenses have yet to return. Digging deeper, the key contributors to this index-level profitability have been the Materials, Energy, and Industrials sectors. Notably, each of these sectors has a meaningful exposure to various commodities and the high level of margin growth implies that a significant level of pricing power exists amongst incumbents. Companies are increasingly discussing the risks of higher inflation with shareholders and as seen in Exhibit 7, the number of S&P 500 companies mentioning inflation on earnings calls has more than tripled in the span of a year. Large consumer staples companies such as Proctor & Gamble, Johnson & Johnson, Campbell's, and Kroger have increased prices to offset rising costs, and more companies will likely endeavor to do the same in order to maintain these high margins. In short, all costs eventually flow downstream.

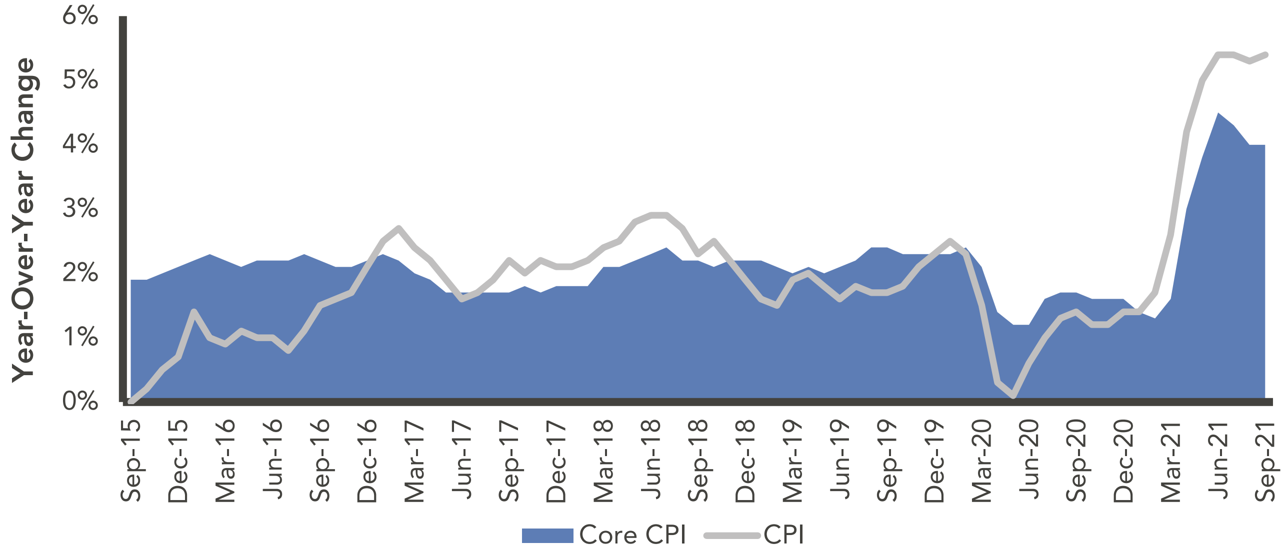
Exhibit 7: Increasing inflation fears in the C-Suite



Source: FactSet as of June 30, 2021

Exhibit 8 shows the year-over-year change in the Consumer Price Index (CPI) vs. the Core CPI, which removes Food and Energy-related costs. While many economists prefer Core CPI because it eliminates industries known for high price volatility, it can distort the overall health of the economy. Rising food and energy prices, particularly gasoline (which is up more than 40% on a year-over-year basis), are poised to significantly impact the household budgets of most consumers. With little control over the price of milk at the grocery store or a gallon of gas at the pump, consumers are likely to feel the brunt of the supply chain disruption.

Exhibit 8: Total CPI trends lower, while Core CPI remains high, impacting consumer pricing power



Source: U.S. Bureau of Labor Statistics as of September 30, 2021

WHAT'S NEXT?

The most common question asked by investors and policymakers regarding inflation has been: Are price level increases permanent or transitory? To this point, ongoing supply chain and labor market dislocations may mean higher prices for longer than expected. For the consumer, we expect challenged holiday shopping as well as a more expensive Thanksgiving dinner. Less product in stores and a healthy backlog of orders for delivery may mean a delayed gift-giving season.

As for the markets, many companies have proven their ability to navigate these influences with ease. The S&P 500 has returned more than 90% since the pandemic started, well eclipsing the initial drawdown. The longer supply chain pressures persist, the harder it will be for companies to maintain momentum and it would not come as a surprise to see the markets pause or adjust to a peak in earnings growth. Additionally, some elements of inflation, like wages, tend to lag. Non-supervisory workers have seen a commensurate rise in wages relative to the overall CPI, but salaried workers have yet to see a rebound. This may be an under-recognized risk on the horizon for U.S. equity markets as we enter the new year. The ability to absorb cost, navigate delays, and source labor will be ever more important as these pressures drag on. Thus, an allocation to actively managed investments may provide stability and potential upside in this uncertain market environment. At a minimum, investors should understand that these dynamics may portend greater volatility across markets in the coming quarters and are encouraged to remain disciplined and focused on a long-term investment horizon.

NOTE

[1] Latest available data

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