Weekly Digest

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The Bullwhip

Although we are not in the vanguard of such behavior, my wife and I are in the process of expanding and renovating our home. Having finally negotiated the trials of planning permission, which included Hackney Council being hacked and losing all of their planning data, we are now onto the fun stuff – choosing a builder. We had already heard plenty of scare stories about COVID-induced delays. For example, one neighbouring family has been in rented accommodation for a month short of two years for a job that was supposed to take twelve months… and the hoardings are still up! Our architect informed us that on one job the builders had run out of cement. Apparently there is no shortage of actual cement, but there are no bags available to transport it in! Thus we have concluded that there is little point starting our work until most of the supplies required are on hand, although I fear that this might be an unrealistic approach.

This is just one very small example of the effects of bottlenecks in global supply chains currently, a phenomenon that has the potential not only to suppress growth, but also to put upward pressure on prices as buyers compete for what's left. After all, in some cases it might well be financially expedient to pay more for a component or delivery of materials than to be subject to a delay that might incur even more costly penalties.

All of this will serve to cloud an already fuzzy outlook on the next phase of the economic recovery. As we have written about on numerous occasions recently, inflation is the topic du jour for investors. But what if central banks are thrown off course by what turns out to be no more than a fleeting problem of higher prices? Yes, they currently view the latest spike in inflation indices as "transitory", but it's also clear from breakeven inflation rates (that is what the market thinks inflation will be in the years ahead) and interest rate futures that many people believe that the spike will be more persistent – or at least they are taking out insurance against that possibility.

Investec

I listened last week to a fascinating interview with the CEO of an American company that supplies supply chain management software. He cited the long chain of bottlenecks between, say, a factory in China and a consumer in the United States. First of all there is a huge global shortage of shipping containers, around half a million in his opinion. According to what I can find (not fact-checked, admittedly) on an internet search, that is out of a total of around six million containers usually in transit at any one time, and so a not insubstantial percentage of the overall capacity. One reason for this is that there is more stuff leaving China than going back to it, and few people are willing to bear the cost of repatriating empty containers. Quite a lot of them appear to have been converted to office and retail space in East London!

And so one's first challenge is to find a container. But even if you think you have found one, you might well be bumped off. The container shipping industry has historically operated an overbooking system such as the one that prevailed in the airline industry (but which is less prevalent today owing to demand management software and dynamic pricing). Suddenly it is faced not with customers dropping out, but with excess demand. Capacity is reserved either for loyal customers (especially those who will be reliable bookers of space in the future), or for those willing to pay up for it.

Once on your ship, the container will hopefully not be delayed in the Suez Canal (which is its own special story), especially if it's on its way to the US. Once it has arrived at a US port, the next problem is an insufficient number of stevedores, either because of COVID-related illness or restrictions, or a lack of motivation to return to work while unemployment benefits remain attractive. That leads to further delays, as well as queues of ships outside the port owing to the limited number of berths.

The next problem is a shortage of truck drivers. The profession of truck driving, romanticised in any number films over the years, notably "Smokey and the Bandit" and "Convoy" (but probably not "Duel", the professional directorial debut of Steven Spielberg), is not an attractive proposition to those entering the workforce today, possibly because they fear that they will quickly become redundant once self-driving trucks take to the roads in force. But until they do, capacity will remain constrained.

Overlaying all of this is the behaviour of consumers, retailers and wholesalers, and the Bullwhip Effect of the title this week. This happens when supply and demand become desynchronised and also harder to forecast. If we look back a year, consumer demand fell off a cliff, and retailers and wholesalers shed inventory as fast as they could to shore up finances. And remember that this is exactly what investors were exhorting companies to do. Then, as the recovery progressed, we witnessed abnormally high demand for some things, such as building materials and electronic goods, leading to the first round of shortages. As shipping costs increased, many retailers and wholesalers, especially those with slim margins, were unwilling to pay the extra costs, believing (or hoping) that they would come down soon. But you can't run a business with no inventory, and so they, too, are now capitulating.

This should all sort itself out in good time, but nobody really knows how long. Just to add to the headaches, the risk of investing in increased supply chain capacity to meet today's demand is that it will come on stream just as demand peaks once the COVID spending binge on "stuff" subsides and attention turns from the purchase of goods to that of services (which will bring its own potential problems in the form of labour shortages).

As I mentioned, much of this is reflected in rising market-derived inflation expectations. But businesses are only too well aware of it. The Atlanta Fed's Business Inflation Expectations Survey is at a decade high, closing in on 3%. We are witnessing more companies citing inflation more often on results calls. Purchasing Manager surveys are full of evidence of bottlenecks. The latest batch from Europe, for example, stated that backlogs of uncompleted orders are now rising at the fastest pace since the series began in

November 2002. Consequently, that is leading to price pressures, with the PMI's prices-charged measure recording an all-time high.

Bank of America's latest Global Fund Manager survey cited "Inflation" as the highest probability tail risk to investors currently, with "Taper Tantrum" a close second. In reality, the two are joined at the hip, as rising inflation will potentially force the Federal Reserve's (and other central banks) hand when it comes to tightening policy. Deutsche Bank's latest client survey has a similar, consistent, message. The top risk for its respondents is "Higher than expected inflation/bond yields". Second on the list (with respondents having been allowed to choose three) is a vaccine-resistant COVID variant, although the score is lower than it was last month.

Third on the list is "Central Bank Policy Error", although it is not clear whether this means being too slow or too fast to tighten policy – probably too slow, given fear number one, and especially as 85% of respondents see COVID as being an inflationary force on a one-to-five year view.

And if you think all that adds up to a shoo-in case for persistently high inflation, be mindful of Wall Street veteran Bob Farrell's ninth rule (out of ten) of investing: "When all the experts and forecasts agree – something else is going to happen". Our view remains that it is not the time to "bet the farm" on inflation, but to be mindful of the risks, and to add a few suitable hedges to balanced portfolios.

Last week's Economic Highlights

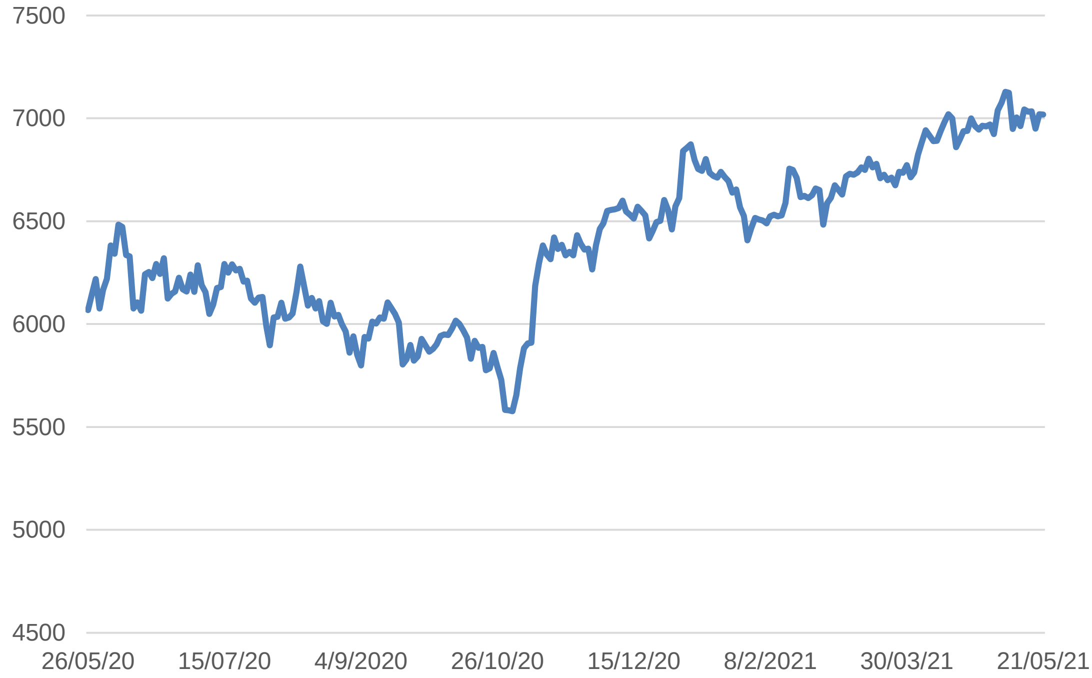
FTSE 100 Weekly Winners

BT Group plc	8.8%
Polymetal International Plc	6.6%
Ferguson Plc	4.9%
NatWest Group Plc	4.9%
Imperial Brands PLC	4.7%
London Stock Exchange Group plc	4.4%
Croda International Plc	3.9%

FTSE 100 Weekly Losers

Antofagasta plc	-13.5%
Vodafone Group Plc	-9.4%
Informa Plc	-5.6%
BHP Group Plc	-4.8%
Glencore plc	-4.4%
Taylor Wimpey plc	-3.9%
Anglo American plc	-3.8%

FTSE 100 Index, Past 12 months



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