Covid, Supply Chain, Inflation, Oh My!

Causeway Fundamental Portfolio Managers Discuss Supply Chain Disruptions

About 25 miles southeast of Causeway's Los Angeles headquarters lies the nation's busiest container hub, the Port of Los Angeles. With its neighbor, the Port of Long Beach, it forms a complex that processes roughly 40% of incoming sea freight to the United States. Currently congested with record numbers of idling container ships, the port has become emblematic of the supply chain strains plaguing global trade. Yet it is not proximity to the port, but Causeway's direct access to company managements operating in supply-chain disrupted sectors that helps us develop a nuanced understanding of these headline issues.

From the benefits of scale to the limits of pricing power, Causeway fundamental portfolio managers share how they have been seeking over the last few months to position portfolios to protect against, and in some cases benefit from, supply chain disruptions.

Jonathan Eng on Industrials, Consumer Discretionary, and Energy

"The inflation genie is out of the bottle."

The lumber shortage this past spring was the canary in the coal mine for disruptions in the industries I cover, including autos. Covid-related supply decreases, from labor shortages to reduced transport capacity, were compounded by rising demand as consumer spending shifted from travel and entertainment to home improvement and autos. Prices responded rapidly, moving sharply upward. Once labor returned to the lumber market, supply rose quickly to meet demand. It may take longer to add sufficient capacity for the semiconductors used in autos. But I believe the supply response is underway: chip manufacturers are adding capacity. Some may add too much, but markets should sniff out overcapacity down the road.

Lumber taught us that supply chain issues can be temporary. I think demand generally will remain strong, so for client portfolios we have been buying select stocks on supply chain weakness. We added shares of a vehicle parts supplier, a carmaker, and an industrial automation manufacturer. We want to be exposed to companies with pricing power, often found in consolidated markets, because their valuation multiples tend to be resilient. We are wary of capital goods companies that use large quantities of raw materials or are particularly sensitive to rising energy costs. There are limits to pricing power: we want to avoid companies whose cost increases will materially outpace their ability to increase prices. The oil and gas energy sector tends to benefit from tightening supply/demand balances, typically resulting in spiking spot prices for oil and gas as well as a gradual shift up in forward curves. We have been adding energy exposure via integrated oil companies to client portfolios.

From truck drivers to factory and restaurant workers, labor availability has been a serious constraint. Workers have more bargaining power in a tight labor market, particularly as Covid continues to disrupt supply chains. As word of wage gains spreads, more employees may seek to negotiate higher pay. Those pay increases are sticky, so we are scrutinizing companies' abilities to manage higher unit labor costs. I think scale helps a lot. Large companies can potentially move labor to different sites based on density and need. They may negotiate more attractive terms with their customers. Our clients own shares of a food services provider that converted a substantial number of its customer contracts to cost-plus during the pandemic. I think inflation is going to pick up over the next twelve months in many categories: energy, food, rent, labor. The inflation genie is out of the bottle.

Ellen Lee on Consumer Staples

"I am focused on market share wins."

Some of the supply chain disruption to the consumer sector stems from port closures in China, the origin of ships that carry consumer goods from Europe to their end-destinations. "Just-in-time" vessel rotation breaks down when a Covid outbreak shutters a Chinese port for ten days. Transport materials shortages also have delayed goods distribution. Management of a company that sells bottled water told us it has not been able to ship its product because it cannot procure the paper-thin material that separates layers of bottles on the shipping pallets. But because food and beverage companies tend to make their products near their consumption markets, they generally can access the raw materials they need. The simple, regional nature of fast-moving goods supply chains has generally insulated consumer staples firms from greater disruptions.

Labor is scarce, though. An operator of food kiosks in airports and train stations told us it could open 20 to 30 more stores if it only had more labor availability. Labor shortages are acute in the United States and United Kingdom. In the United States, e-commerce—Amazon warehouses, for example—has drawn workers from traditional factory and agricultural jobs. Over the past four years the United Kingdom has lost over 56,000 lorry (truck) drivers to retirement and pandemic reasons, according to the UK's Office for National Statistics, and Brexit restrictions are preventing foreign drivers from replenishing the workforce.

I am focused on market share wins. Like Jonathan, I recognize the competitive advantages of scale players. Amid these shortages, the largest consumer companies are generally negotiating front-of-the-line passes with suppliers. They are typically the preferred customers of overstretched trucking companies, who can fill up product at a scale player's single destination rather than make multiple stops for smaller companies. And firms with dominant brands are growing volumes of goods sold. You might think private label goods would pose substitution threats to branded goods as prices rise. But, based on my observations, in this environment, private label competitors often cannot get their products to market. Large companies have gobbled up the materials and transport capacity. Large companies also generally benefit from greater financial flexibility. They can more easily reduce advertising and other discretionary expenses. Private label firms operating on razor thin margins have little to cut.

Input costs have risen across the board for raw agricultural materials, energy, and transport. Consumer staples companies tend to use hedge contracts, so those cost increases have not yet hit margins. Hedge contracts will typically renew next year, and the market appears concerned there will be negative revisions to 2022 earnings. That is why I am asking consumer companies a lot of pricing questions, to assess what cost increases they can push through this year and next. I am watching their price increases like a hawk. Longer term, I will be monitoring the second leg of the supply chain—how the destocking cycle plays out. I expect some lasting changes to company operations: more automation, higher levels of inventory-on-hand, and sourcing from multiple vendors.

Covid disruptions, cost inflation, and supply chain volatility are presenting investment opportunities. We believe in the reopening trade, which is on a lagged recovery cycle in many emerging markets. We hold consumer sector stocks with exposure to Southeast Asia, where we currently expect a rebound in volume consumption next year. Causeway international value portfolios hold shares of a company that sells food for out-of-home consumption, such as ice cream for Eiffel Tower tourists. I believe those sales should recover. In the meantime, the company is cutting costs. For global value portfolios, we rebought shares of a snack producer that were weak on supply chain volatility. I believe their product portfolio is a good mix of global and local brands and they are taking market share for 80% of their products. Other products may be intrinsically better positioned for supply chain delays. Causeway international value clients currently own shares of a spirits producer. The market has rewarded its flexibility, recognizing cognac can barrel-age until supply chain conditions improve.

Brian Cho on Information Technology

"Demand for memory is not going away, it is just deferred."

Heading into this year, many technology firms expected supply chain constraints to ease as early as the second half of 2021, with product demand remaining robust. So, many manufacturers of electronics—PCs, smartphones, televisions—aggressively procured components. Instead, supply chain disruptions persisted. Companies still are waiting on one or two small components to finish their goods. Even Apple, the top-priority customer for many suppliers, is complaining about supply constraints. With large customers like Apple taking priority, smaller vendors often cannot obtain parts, even if they pay a premium. PC backlog waits have reached twelve weeks, a record three times the long-term average. One US chipmaker we hold in global value portfolios recognized that many of its customers were double or even triple ordering. It established a bidding system for high demand parts to minimize global ordering and ship consistent with end demand. Many companies are still bidding for expedited shipping, paying 150-200% of chip value, although I believe those premiums are likely peaking.

Several factors created these shortages. Political tensions between the United States and China led the United States to restrict Chinese purchases of US chip technology. Chinese companies began stockpiling chips during the Trump administration in anticipation of additional restrictions. The pandemic dealt additional blows. Lockdowns in Vietnam and Malaysia closed key technology component manufacturing and assembly factories. And shipping bottlenecks exacerbated delays.

As work-in-progress (unfinished) inventory accumulated, manufacturers of certain end products, such as PCs, stopped buying readily available components including memory chips. In my view, demand for memory is not going away, it is just deferred. In other end markets such as data centers, we expect robust growth next year.

Supply chain constraints are slowly beginning to ease. In Southeast Asia, many companies are paying out of pocket to vaccinate their employees. They have added enough staff to run multiple shifts and have contingency plans in place. There could be setbacks if another Covid variant emerges. But, for now, many of these companies have an operational playbook for Covid disruptions. I think they can respond quickly. Even if supply growth picks up, in my view, it will take time for the industry to build adequate levels of product inventory.

For our information technology cluster and the overall technology ecosystem, these disruptions mean earnings upside may be limited in the near term. Many companies are missing their revenue targets because they cannot ship their products. We could see a seasonally stronger first half 2022 as supply chains improve and production catches up to end demand. Beyond that, demand forecasting becomes more uncertain: we do not yet know what reopening means for PC, smartphone, or TV demand. Supply chain disruptions can serve as convenient company excuses, disguising end-demand weakness. We will be closely monitoring demand in the months ahead.

Conor Muldoon on Materials

"Investment can resolve commodity shortages, but bottlenecks may linger."

China's energy shortages are reducing supply across the commodity complex. China's National Bureau of Statistics estimates more than half of China's power comes from coal. Beijing-mandated carbon emission reductions and flooding in coal-producing provinces reduced coal supply as reopening-led demand for power surged. As the cost of coal soared, electricity price caps remained in place. Facing substantial margin erosion or operating losses, Chinese power generators began limiting customers' consumption, including restricting usage for heavy industrial users. Currently, over half of China's provinces are rationing power. These shortages have led to a fall-off in exports of certain commodities. For example, one of the biggest industrial users of power in China is the aluminum industry, which supplies the rest of the world. Chinese magnesium also is in short supply, creating tight markets for steel and other alloys. China's strict Covid protocols, including factory closures, exacerbate these shortages.

Investment to add capacity can resolve commodity shortages, but bottlenecks may linger. It takes time to open new mines.

Where we believe valuations and fundamentals are supportive, we have invested in companies in the materials sector. We initiated a position in a European steel manufacturer for international value portfolios in 2020, when the market was pricing in permanent demand destruction. As Europe decarbonizes, we expect protections for European domestic steel. We believe the company also should benefit from a recent easing of steel tariffs between Europe and the United States. This year, we bought shares of two US-based packaging companies for Causeway global value portfolios. One makes cardboard and paper products for industrial businesses. Containerboard pricing is benefiting from Covid-driven growth in e-commerce. The other makes plastic consumer goods packaging including toothpaste tubes, shampoo bottles, and woven plastic wipes—it manufactures thousands of stock-keeping units. Plastic packaging producers generally use contracts that pass through the costs of resin and other input materials to their customers, often on a lag of up to a year. But management of this packaging company told us it is negotiating more rapid price "pass-throughs." Demand for its products is strong and, because nearly every packager is vulnerable to these cost increases, competitors are not undercutting one another. We believe the benefits of scale are relevant here, too. The plastic packager we hold in client portfolios is one of the largest in the industry, buying about seven billion tons of resin annually. A buyer of that size generally takes priority over smaller customers, so shortages are less of an issue for it. By maintaining long-term company relationships in the economically defensive consumer staples sector, the company typically generates stable cash flow. That cash flow compounds; in our view, investors need that in a low interest rate world.

Goods orders have risen in the lead-up to the 2021 year-end holidays. With that seasonal surge in demand, we do not expect much relief in supply chain constraints in 2021. But, in 2022, we believe manufacturers and their suppliers may reach a better understanding of demand and inventory constraints. Suppliers may also have time to invest in expanded capacity in those segments where they expect demand to stay high. In our view, in the next six months, the uptake in vaccinations and new treatments for Covid-19 should pave the way for normalization of production and distribution.

Risks to normalization include a fiscal spending binge that stokes demand and worsens shortages in 2022-2023, or a new coronavirus variant that leads to plant closures and transportation restrictions. The longer these disruptions persist, the greater the likelihood of cost pressures pushing up prices and wages. Conversely, demand could sag. Supply bottlenecks might be masking demand weakness, especially against the backdrop of slowing Chinese growth, while rising energy prices are set to squeeze consumers' purchasing power and corporate profit margins. Adding to economic sobriety, many central banks are considering tapering their quantitative easing programs in 2022.

We are monitoring ocean freight rates, vendor delivery times and prices, retail inventory levels and a host of other data. We continue to discuss salient supply chain issues with company managements. We currently see evidence globally of corporate spending on logistics technologies and automation. We believe these investments should translate into more capacity and higher productivity, and better prepare those companies for the next supply chain disruption.