Rethinking the Severity of the Shipping Crisis

Scott McIntyre, CFA
HilltopSecurities Asset Management
Senior Portfolio Manager
Managing Director
512.481.2009
scott.mcintyre@hilltopsecurities.com

Greg Warner, CTP
HilltopSecurities Asset Management
Senior Portfolio Manager
Director
512.481.2012
greg.warner@hilltopsecurities.com

It seemed pretty straight forward at first: massive demand for goods is swallowing up limited supply. This is an age old economic equation that capitalism solves by raising prices to curb demand until production can catch up . . . *Except, it doesn't work when the entire world is experiencing the same thing at the same tim*e.

The rapid advance of technology, and the ease of just-in-time inventory management has caused companies to shy away from stockpiling extra materials and parts for emergencies. *This vulnerability is now being exposed on a broad-scale*. Last spring when Covid-19 infections began to mount, factories shifted, delayed or halted production. It didn't matter too much at first, because overall demand was expected to drop during the lockdown . . . *and it did*, but it came roaring back in the summer as economies reopened and consumers began spending stimulus dollars. Before the pandemic, Americans had spent significantly more on services, but the virus brought that seven-year uptrend to an abrupt halt. With bars and restaurants, air travel, lodging, concerts and sporting events still limited or unavailable, the focus shifted hard to goods.

It quickly became apparent how much cash was rattling around, but what wasn't quite as apparent were jaw-dropping gains in housing and stocks that lifted U.S. household wealth to progressively higher highs over last five quarters. As a result, *capacity to spend* has reached an all-time high. Demand for goods is both massive and global in scale. The problem is on the supply side, which complicates both monetary and fiscal policy. Supply chains represent millions of separate agreements between individual companies acting in their own self-interest. *There is no central command.*

Supply chains represent millions of separate agreements between individual companies acting in their own self-interest. There is no central command.

The most evident and pressing shortage is in microchips, which are essential in the production of not only vehicles, but just about everything electronic, from phones, tablets and laptops, to medical devices, appliances and gaming consoles. The world's leading chip producers, including Taiwan Semiconductor Manufacturing Company(TSMC), Samsung and Intel have all announced multibillion dollar global expansion plans with an estimated $146 billion in capital expenditures this year alone, according to the *Wall Street Journal*. On the domestic front, Congress has already approved $52 billion for new microchip production facilities, but these plants are unlikely to contribute before 2023.

One of countless related issues is that the majority of new production will be directed toward "next generation" chips, which are more profitable and much more powerful. Older "legacy chips" (which the world is starving for) aren't a high priority as facilities expand and the future. This technology disconnect could be a gamechanger over time, but a crushing blow to hopes that the supply knot will untangled itself next year.

This technology disconnect could be a gamechanger over time, but a crushing blow to hopes that the supply knot will untangled itself next year.

News of vehicle shortages have given way to stories of clogged ports and literally millions of stranded shipping containers, stuffed with consumer goods and essential parts. In early October there were nearly half a million 20-foot containers on ships waiting to dock and unload, according to Southern California Marine Exchange data. Unfortunately, reaching shore is just a single step in the complex distribution channel. In September, the Los Angeles and Long Beach ports, which together receive roughly 40% of imported goods, were operating at just 60% to 70% capacity. Both ports have subsequently committed to 24/7 operations, but dock workers are in short supply, as are workers operating on more than 70,000 global merchant ships.

With the world awash in available jobs, it's likely many of these burned-out sailors will choose to remain on dry land when the opportunity presents itself.

According to a story written by Bloomberg guest columnist *Adam Minter*, many of the world's 1.9 million seafarers haven't set foot on shore for months, and in some cases over a year as global ports have prohibited sailors from leaving their ships during the pandemic. There have been reports of declining mental and physical health, depression and fatigue. With the world awash in available jobs, it's likely many of these burned-out sailors will choose to remain on dry land when the opportunity presents itself.

If, and when the containers are unloaded and sorted, the goods still need to be moved away from the port and stored. However, roughly 98% of warehouses in the Southern California Inland Empire region are now fully occupied, along with 96% of available warehouse space in the Western region according to *Yahoo News*. Once goods are stored, they ultimately have to be transported to destinations across the U.S.

The perception of well-intended, but poorly timed fiscal spending will only add to the immediate problem, while the Fed can do little but stand back and watch the situation unfold.

The trucking story is well documented. Drivers are paid by the mile, making lengthy wait times unproductive. Many older drivers have already chosen to walk away. The *American Trucking Association* recently estimated the industry is short 80,000 drivers. Making the situation worse is the fact that the industry is in dire need of new trucks …but vehicle production is hamstrung by the ongoing chip shortage.

The entire global shipping system is gummed up, and there's no immediate fix. Short of training the National Guard to unload container ships and drive goods across the country, there seems to be little the government can do …at least in the near-term to expedite the process. This suggests limited supply will constrain consumption and stunt GDP growth. It also indicates that prices will remain under pressure for months or even years. How the world ultimately deals with this crisis isn't clear, but it's likely to dramatically reshape global business and the political landscape. The perception of well-intended, but poorly timed fiscal spending will only add to the immediate problem, while the Fed can do little but stand back and watch the situation unfold.

Market Indications as of 11:10 A.M. Central Time

DOW	Up 172 to 36,094 (HIGH: 36,432)
NASDAQ	Up 132 to 15,836 (HIGH: 15,982)
S&P 500	Up 32 to 4,681 (HIGH: 4,702)
1-Yr T-bill	current yield 0.16%; opening yield 0.15%
2-Yr T-note	current yield 0.52%; opening yield 0.54%
3-Yr T-note	current yield 0.85%; opening yield 0.87%
5-Yr T-note	current yield 1.23%; opening yield 1.25%
10-Yr T-note	current yield 1.57%; opening yield 1.58%
30-Yr T-bond	current yield 1.94%; opening yield 1.90%