Wednesday, January 12, 2022

Frances Donald, Global Chief Economist, and Global Head of Macroeconomic Strategy, Manulife Investment Management

Now, related, the second thing known unknown: supply chain disruptions. Who has not been impacted in their daily lives by supply chain disruptions? Everything we want. I ordered my mother-in-law's iPad, like, November first and it said it would arrive December 23rd for Christmas. And every night I went to bed, please get this iPad for my mother-in-law here in time. But we feel this in all areas. We had to get a new car, we moved to the suburbs so now we have to have two cars because we're that family. And we ordered that car in I think October, and we might get it in June. And, of course, everyone just accepts these things now, right, which is we're just acclimatized. I remember going to the restaurant before the recent lockdowns, and I really wanted fried pickles, and they said, "We don't have any. Supply chain disruptions." Which made me think, I mean, do you really or that's just a common thing that we all say now if you want to get away with it? Supply chain disruptions. So, yeah, we all know those.

In any case, supply chain disruptions have been the most problematic element of this crisis. And figuring them out, in my view, is the absolute key to determining where we come out of the crisis. But there's the challenge with that. This is how economists construct forecasts. So we basically look at a situation and we try to find a situation in the past that's most similar to it, and then we say, well, when X happened, Y occurred with this amount of probability. And that's basically what we do. It's not brilliant, so we don't actually have a crystal ball.

The extent of supply chain disruptions that we have witnessed this year are unparalleled. I have nothing close – nothing close to being able to model what this might look like. I have a 5-page chart pack on every single datapoint I could possibly find on supply chain disruptions, and I run it every single day. I have a little map on my computer that has little dots for each boat that's in the LA Ports right now. I track all of this. What it tells me is that early December was probably the worst of the supply chain disruptions, and that as we move forward, these supply chain disruptions, all of the cars, planes, automobiles, things that are stuck, will be unstuck, likely by the second half of the year.

But I don't know. I don't know and I have no way of saying with confidence that that's what will happen, especially if Omicron is resulting in large shutdowns in China. That is the biggest problem. And I'll just re-emphasize this. Whether or not Floridians care about Omicron is not as important as whether China shuts down again. That was the initial hit to the market back in March 2020, that is what we need to watch repeatedly.

And yet, in the spirit of supply chain disruptions, I will tell you that I managed one business trip last year. In between Delta and Omicron, one business trip. I went to go see a variety of clients in LA, in California, and while I was there, I begged the taxi driver to drive me to the LA Ports. Other people are, like, take me to the Hollywood side. I'm like, can we go to the ports? And it was crazy because just looking out over the ocean, they're like Lego blocks. Just like a wall of ships that were lined up. It was incredible. And we saw, you know, massive, massive backlog happening in supply, just LA and Long Beach ports, which, by the way, are responsible for about 60% of all of the port activity that happens in the US. And we saw that ports were stuck for weeks – I'm sorry, boats were tuck for weeks just trying to get a spot on the port that normally would take two days to unload a boat, and it would actually take closer to six to eight days once you even got there. This was a huge slowdown for the US and Canada economists.

And I think what's really fascinating about the LA Port problem is that it's a microcosm for what occurred to the entire supply chains globally. And I'll show you why that is. If you can understand LA Ports, you can actually understand why supply chains are such complicated things that are microcosms for everything else. The first thing that happened, is that we did see a surge in demand. However, the demand was for very specific things in this economy. We were not seeing a surge in demand for services and restaurants and these types of things, no. We saw a surge in demand for goods. Things like the web cam that I'm talking to you, or the ring light which hopefully smooths my face, or the fencing that I tried to get, or the pool that I ordered last year that maybe won't get out, I don't even know if we're going to get it this year, right. So goods, things that turn our homes into all-inclusive resorts and help us work from home in a productive fashion.

We all have here at Manulife these signs. Someone had to order all of those and probably shipped some stuff from China. So we actually saw a 17% increase in the amount of things coming into LA Ports. And yet, this is not solely a demand problem. It highlighted a variety of issues with our existing economy, one of which is that North America in particular has very inflexible supply constraints. Many of us are familiar with the concept of Just-In-Time inventories for example. But what this highlighted is just how weak the North American supply system is. For example, there are about 351 major ports in the world, and LA Ports never even – US ports never even cracked the top 50. In fact, they're usually in the bottom 25, even though they're some of the most important in the entire system.

In Asia, ports run 24/7. In North America, they run about 110 hours a week, largely because of union power. So we could see that there was inflexibility to absorb these surges in demand. And then the third issue happened. Of course, this is also a microcosm. Another supply shock:

major labour shortages. Availability of labour tanked. And this is one of the really big supply issues; people don't think about labour as a supply issue, but it absolutely is. If you don't have people to do the jobs, you can't get it done.

So the LA Ports experienced a massive shortage of dock workers, for example. They also experienced a lot of pressure from the dock worker's unions to increase their pay in this moment. Certainly, a good time to do that if that's your goal. Then we had, of course, China closing its port, gumming up the works. This is what was happening globally in every supply chain point in the world. Inflexibility, labour shortages, China shutdowns occurred just about everywhere. And yet, now we're beginning to see things are easing and the LA Ports are once again a really good microcosm for this.

First there was an administrative decree from the Biden administration, you must be open 24/7. We saw other cities jumping in to offer support. And my favourite thing, never underestimate the power of good old-fashioned capitalism. Companies like Walmart said, you know what, forget this, we're going to go from 40-foot containers to 53-foot containers. Home Depot said forget LA, we're going to go to San Diego. Now I know it sounds like I'm really tangenting. What does this matter for my portfolio? But what it tells you is that in the midst of this massive crisis that was gumming up the global economy, there was a variety of forces that came in and tried to fix the problem quickly. And we are already seeing that come-down time in the amount of time ships spend sitting in the ocean, the freight costs. These are all starting to decline.

The problem is that this has occurred in confluence with other major supply shocks, one of which is we've had wise-scale droughts in Latin America that have pushed up food prices, also a supply issue. OPEC has kept energy prices relatively restrained; also, a supply side issue. And we've had Brexit and US-China tariffs; also supply-driven areas that create disruption and raise the prices of things; also, inflationary.

So as a result, there times in the crisis – and it's a little less true now – where supply side driven issues were creating about 80% of the inflation in the system. That much. Now, it's closer to 60%. Of course, there was a demand element, but the bulk of this was coming from global supply issues. And there's two problems with this.

The first one is that it creates demand destruction. We tend to think about these supply side issues as being inflation related. And in some ways, of course, they are, but we missed the story there. What we missed is that in the meantime, while we wait for these problems to unwind, consumers are facing such exacerbated high prices, they're actually reducing their desire to purchase things: homes, cars, large appliances. Interest in purchasing these items is the lowest it has been since the 1980s and is back near recession levels. Consumers don't take this level of disruption really lightly at all.

The second problem with this – and we'll get into it in a couple more minutes – is that these issues are not solved by higher interest rates. You can hike interest rates all you want; it's not going to change COVID zero policies in China; it's not going to open ports of LA or make people move faster; it's not going to bring people back to work; it's not going to make it rain; it's not going to reverse Brexit or US-China. And that is the fundamental challenge we have here. So we have a lot of people calling for higher interest rates. In this particular environment, we will get higher interest rates, I'm pretty sure about that. Will that solve inflation? I don't think so.

Follow the Private Wealth Podcast on www.manulifeprivatewealth.com or contact us via manulifeprivatwealth@manulife.com for more information.

any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. Manulife Private Wealth does not provide legal or tax advice, and you are encouraged to consult your own lawyer, accountant, or other advisors before making any financial decision. Prospective investors should take appropriate professional advice before making any investment decisions. All opinions expressed were obtained from sources believed to be reliable and in good faith, no representation or warranty, expressed or implied, is made as to its accuracy or completeness.

The information in this recording, including statements concerning financial market trends, future events, targets, management discipline or other expectations, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. There is no assurance that such events will occur, and if they were to occur, the results may be significantly different than those shown here. This recording may contain forward-looking statements about the markets, model portfolios and expected future performance. Forward-looking statements are not guarantees of future performance. Forward-looking statements involve inherent risks and uncertainties, both about the individual portfolio components and general economic factors, so it is possible that expectations, forecasts, projections and other forward-looking statements will not be achieved. Manulife Private Wealth cautions you not to place undue reliance on these statements as a number of important factors could cause actual events or results to differ materially from those express or implied in any forward-looking statement made herein. These factors include, but are not limited to, general economic, political and market factors in Canada, the United States and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological changes, changes in laws and regulations, and catastrophic events. Before making any investment decisions, Manulife Private Wealth encourages you to consider these and other factors carefully. Should you have any questions, please contact or ask to speak to a member of Manulife Private Wealth.

Manulife Private Wealth is a division of Manulife Investment Management Limited and Manulife Investment Management Distributors Inc. Investment services are offered by Manulife Investment Management Limited and/or Manulife Investment Management Distributors Inc. Banking services and products are offered by Manulife Bank of Canada. Wealth & Estate Services are offered by The Manufacturers Life Insurance Company. Manulife, Manulife & Stylized M Design, Stylized M Design, and Manulife Private Wealth are trademarks of The Manufacturers Life Insurance Company and are used by it, and by its affiliates under license. This information does not replace or supersede KYC (know your client) suitability, needs analysis or any other regulatory requirements.