Contact Asset Management

INSIGHTS

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Sorry For the Delay… We are experiencing some supply chain issues!

The global stimulus packages distributed during 2020 were a lifeline for many countries, businesses and individuals. Many of these packages have continued into 2021 and are only just now rolling off. Few appreciated the impact these handouts would have. They were released at a time of panic and the size of the stimulus was unprecedented. The initial results were positive, however the secondary effects of flooding the world economy with cash have been extraordinary. Global central banks wanted inflation and inflation they got! The trouble is, we are all now paying for it through production capacity challenges, price rises and a significant wait time due to a global supply chain bursting at the seams.

It all started with low rates

The Covid-19 health crisis led to major disruptions to economic activity across the world in early 2020. Central Banks moved swiftly through implementation of wide-spread interest rate cuts. The US Federal Reserve cut rates to zero; China lowered its benchmark 1 year Prime Rate by 10 bps to 4.05%; The Bank of England announced an emergency cut in interest rates from 0.75% to 0.25%, taking borrowing costs back down to the lowest level in history; The Bank of Japan's short-term interest rate was already at -0.10%; The NZ Governor cut the official cash rate to 0.25%, an all-time low and in early March 2020, the RBA cut Australian rates to a record low 0.10%.

Financial market volatility was extremely high and equity prices experienced large declines. Government bond yields declined to historic lows and despite historically low rates funding markets were only open to the highest quality borrowers.

Support Packages

The first and most important response to the virus has been to manage the health of the population, as is appropriate. As Covid-19 reached pandemic status, we have seen multiple lockdowns and have since been watching as the vaccines were trialled and tested and are now finally being rolled out. The short-term priority for Central Banks around the world was to support jobs, incomes and businesses, so that when the virus was contained, their country would be well placed to return to growth.

Monetary policy has played a very important role in reducing the economic and financial disruption resulting from the virus. We have seen governments around the world continue to stimulate their economies, which were affected by the pandemic, shutdowns, and ongoing travel restrictions. The Australian government's stimulus spending in response to Covid-19 has been something never seen before. The combined capital injection into the Australian economy since the pandemic began is now over AU$400 billion.

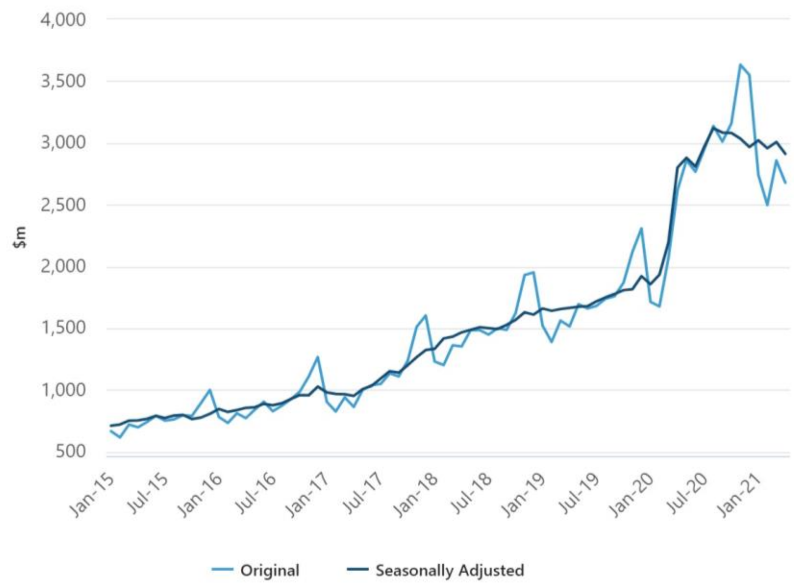
The phrase "Don't fight the Fed" was adopted early. The US Federal Reserve has seemingly pursued a "whatever it takes" policy to stem the impact of Covid-19 on the US economy. This involves maintaining near-zero interest rates for several years and significant liquidity injections through money printing. President Biden was elected on January 20, 2021 and has already introduced a US$1.9 *trillion* stimulus package. This was on top of the US$900 billion stimulus package announced last December, and there is also a proposed US$3 trillion package targeted for infrastructure and social welfare reform to come. It is estimated that various global monetary and fiscal packages now exceed US$12 trillion, and we don't believe we have seen the end of it.

With a year now passed, while the virus remains uncontained globally, the economic recovery has been immense. Most borders are still closed, international travel is basically non-existent and the percentage of people working from home is considerable. So there has only been one thing to do . . . consume.

The cash has burnt a hole in my pocket

When the pandemic hit, the world went into lockdown. We saw panic buying emerge for disposable items and we will never forget the scenes at our local supermarkets. Businesses closed, factories closed, and orders were cancelled globally. No one knew how long this was going to last, business revenues stopped, and no one wanted to be stuck with excess inventory; the supply chain stopped dead.

However, with rates cut to near zero levels and several government support packages, such as JobKeeper, JobSeeker, HomeBuilder, early superannuation access and tax concessions being handed out, it become easier than ever for people buy, invest and to borrow. We also saw during the 2020 year a significant shift in international holiday travel spending due to border closures. A typical year would see about $18 billion in spending by Australian households on international travel. According to the ABS, following the 2020 re-weight, the updated spend on international travel only represented about $0.4 billion of spending.



Source: Australian Bureau of Statistics, Online sales, April 2021 - Supplementary COVID-19 analysis 3/06/2021

As a result of multiple support packages, low rates and a shift of international travel spend, we have seen a staggering boost in demand for goods and services. With a consumer having cash burning a hole in their pocket they have literally spent as much as they can on discretionary items both in store and online. The chart on the left from the Australian Bureau of Statistics shows the significant growth of total online sales in Australia. Total online sales have averaged an annual rise of 59.4% between the 12 months of May 2020 to April 2021.

Over the last year as Covid-19 lockdown restrictions have eased and stimulus cash continued to flow into bank accounts we have seen some very strong retail sales data. We have conducted multiple store walks and have held several meetings with various retail management teams. The feedback is unanimous: trade conditions are strong, and people are keen to keep spending.

An increasing challenge of the demand surge has been the resulting pressure on the supply response. The trouble early on was that factories had to switch back on and business owners needed the confidence to begin to reorder goods. Household consumption increased 4.3% in the December 2020 quarter, following the record rise of 7.9% in the September 2020 quarter. Consumer Spending in Australia has continued into 2021 and there seems to be no end in sight. It has been this significant spend and a slow restart to production that has seen the start of the supply chain issues emerge.

The behaviour of consumers will continue to be influenced by stimulus packages and low rates, but also by the rate of the vaccination roll-out and the easing of travel restrictions. Many countries are in a good place, with a relatively fast vaccine rollout and large parts of the economy opening up. This should mean that consumers will continue to spend, and the economy will recover quickly.

Supply Chain

The increased demand on consumable goods and services driven by significant spending over the last year has placed pressure on the supply chain. We wrote about this in the Contact Quarterly Report - September 2020. *"The other issue garnering our attention is the supply chain. Our discussions across various industries increasingly point to bottlenecks in the supply chain – be it mobility of labour, access to inventory or availability of spare parts. Domestically, the lockdowns in Victoria are creating supply chain headaches for many businesses. However, this is also a global issue. We think this issue could be a potential headwind on the earnings recovery story."*

The swift change in consumer behaviour from multiple stimulus packages and availability of cash across the globe is causing some damage to economies that may outweigh the positives of inflation. There is such a significant demand for goods and services, that we are now seeing substantial shortages in supply. There are shortages in labour, there are shortages in manufacturing, in shipping and in containers. Our ports are saturated, we do not have enough dockworkers or truck drivers. The system is stretched and is approaching breaking point.

This has caused a shortage of product across most parts of the world, and we have all experienced the extensive wait times when purchasing goods. Inventory levels are so low that many stores are holding products that have already been sold. Wait times for cars, industrial machinery, farm machinery, boats, campers, bikes, building products and sporting products have ballooned.

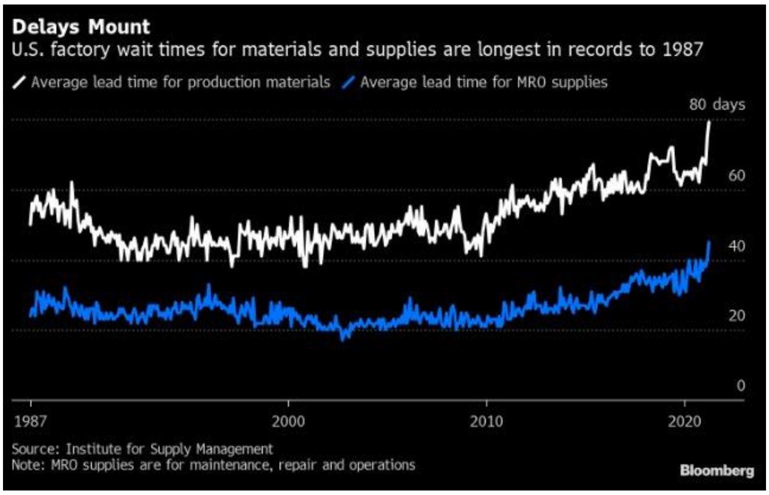
Labour shortages

We have also all found it just as hard to find appropriate levels of services with labour shortages in trades, agriculture, transport, retail, hospitality and healthcare weighing on the supply chain issue. People need to want to work. The downside of having such attractive Jobseeker and JobKeeper programs means that it has been challenging to incentivise employees to return to work. Despite this, we have begun to see lower unemployment numbers come through the system and until our borders re-open the limited supply of labour will be ongoing in Australia. A great situation to be in post a pandemic, however the labour shortage position Australia is in just throws additional fuel on the fire when it comes to supply chain issues.

Source: Bloomberg. Institute of Supply Management

Manufacturing

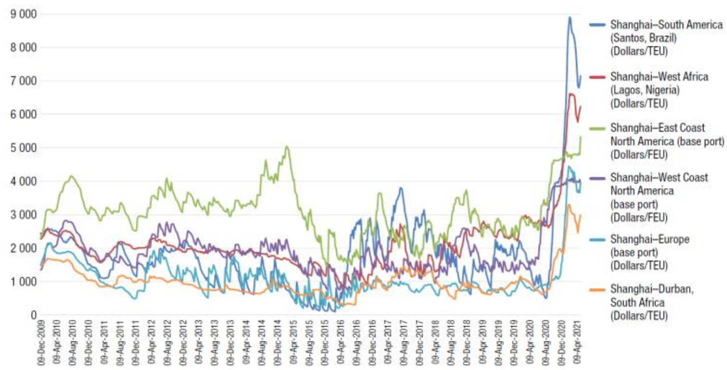
Australia's manufacturing sector has been in decline for decades. Even seven years ago Australian manufacturing costs were higher than any other of the top 25 exporters in the world, according to a report from Boston Consulting Group. Even in 2014 it was 30% more expensive to manufacture here in Australia than in the US. Asian countries like China, India and Indonesia have had even bigger cost advantages to our local manufacturing for many years now. However, during the Covid-19 pandemic our concept of local manufacturing changed. A recent Roy Morgan poll showed 52% of Australians have a higher preference for Australian-made products since the start of Covid-19. With the survey also showing 89% of us believing more products should be manufactured in Australia.



Source: Bloomberg. Institute of Supply Management

Shipping

Shipping rates are a major component of the cost of supply. It is estimated that 80% of the worlds goods are carried through the shipping network. The world relies very heavily on the shipping process and the recent stoppage of shipping flow through the Suez Canal for a week triggered a new surge in container freight rates. The stronger than expected increase in demand discussed earlier was not met by the appropriate level of supply of shipping capacity and this has seen prices skyrocket. The chart to the right shows how far prices have moved. The Shanghai containerized freight index,



weekly spot rates, between 2009 and April 2021 has increased over 400% in many cases.

Source: UNCTAD calculations, based on data from Clarksons Research, Shipping Intelligence Network Time Series.

Pricing Power will Win

It appears that the only short-term fix to relieve supply chain issues is increased prices. Not just the good itself but for each segment of the supply chain. Goods sold and services provided in Australia will continue to increase in price the longer the supply demand imbalance continues. Businesses will continue to fund higher costs for freight, materials, labour and manufacturing. It will be those businesses who have pricing power and can pass pricing on to the customer who will win.

This pricing issue has affected almost all industries. Australians are paying almost 40% more for used cars now than they were in 2019. The demand continues and the supply is very short. SUVs and Commercial Utes are almost impossible to order. House prices have grown over 2020 and two of the major Australian banks are forecasting Australia's house prices to rise another 16% -19% in the next two years in what they're calling a housing market boom. pending on household furnishings and equipment was up more than 50% during 2020. The list goes on.

We seek to invest in high quality businesses that display a competitive advantage to withstand external pressure better than peers. For many of our investments, the benefits of scale bring pricing power - e.g. Bunnings / Wesfarmers and Woolworths. For others, long-term relationship with suppliers ensures less inventory challenges - e.g. Harvey Norman. And finally, one of the best mechanisms of defence is a high-quality product where loyal customers do not want to substitute for poorer quality - e.g ARB Corporation, ResMed Inc, PWR Holdings, AV Jennings, Cedar Woods and Reece.

Yes, we concede that there may be short-term challenges in meeting demand. However, the silver lining could be that this likely extends the period of buoyant conditions. This is a better outcome than a boom / bust scenario. The quality companies will take a longer-term view.

Never Waste a Crisis

Finally, one of the other catch-cries of the past twelve months has been “Never Waste a Crisis”. As we ponder the longer term, one question we are asking ourselves - is it all about the pricing, or should stability and certainty of supply be a bigger focus point? Is this the manufacturing wake-up call Australia needed? Having more manufacturing back in Australia reduces our reliance on other countries, currencies, regulations, political uncertainty and the risk associated with international supply chains. There are many Australian companies that still manufacture here but if this were increased, we would create thousands of local jobs, thereby supporting hundreds of Australian businesses. Quality control, inventory management and our overall economy would be in a better place. Our policy makers have a wonderful opportunity to fortify the Australian economy and diversify away from a heavy reliance on iron ore and services. Continued investment into infrastructure, supply chain efficiencies and manufacturing would be a sensible approach to future proof our economy.

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