

Wentz Weekly

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Supply Chain Issues, Bottlenecks, and Inflation. What it Means for Fed Policy



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The past year is turning out to be one of the strongest years for earnings growth in recent memory. Companies have grown earnings at least 20% for three consecutive quarters and are expected to do so again in the fourth quarter, according to FactSet. With earnings season for the third quarter coming to an end, the growth rate currently stands at 39.8%, up from the projections of 27.3% when the quarter began reflecting the stronger conditions than what analysts expected. As we expected, supply chain issues, bottlenecks, and labor shortages have caused a sharp rise in inflationary pressures and more companies have commented on this during earnings calls than any other time since data began in 2010. Of the S&P 500 companies, about 300 of them cited inflation in their earnings calls, above the five-year average of 137 and we expect the same for the upcoming fourth quarter earnings season that begins next month.

These issues – all caused by very strong demand fueled by a very accommodative monetary and fiscal policy – were key topics from the third quarter earnings season, which saw mixed comments with some companies seeing a slight improvement but most expecting the issues to continue. The backlogs at ports has gotten no better despite headlines that suggest the line of containership waiting to dock was cut in half recently after reaching over 80 not too long ago (and up from 37 from our August newsletter). Bloomberg reported these ships were hiding from the official count by moving further in the Pacific, leaving the actual bottleneck of ships at 96, now the highest we have ever seen. We expect this to continue well into 2022, leading to more persistent inflation and resulting in a tighter monetary policy. We expect to see the first indication of this at the Fed's December meeting Tuesday and Wednesday with an announcement to accelerate its tapering of quantitative easing at the conclusion. We also believe we will see an update on the "dot plot" where Fed members will pull forward expectations of interest rates over the short- and medium-term. Tightening policy will not fix the supply chain issues, but it does risk slowing demand too much and causing a bigger contraction (and leaving businesses with too much inventory). What this means for us is an increase in volatility as we close out the year.

The most common measure of inflation, the consumer price index (CPI) released by the Bureau of Labor Statistics, released Friday showed a 0.8% increase in consumer prices in November, above expectations after a 0.9% increase in October. Prices compared to a year ago are 6.8% higher, the highest since 1982, while the index for core prices (excludes the volatile food and energy categories) rose 4.9% from a year ago, the highest since 2008. While us as consumers may notice inflation the most at gas pumps, inflation pressures are becoming more broad. New and used cars continue to experience the largest increases with used car prices up 31.4% from a year earlier and new car prices up 11.1%. Shelter costs (rents and rent equivalents), the largest component of the index and tends to be stickier and longer lasting, rose 0.5% in the month and is now up 3.8% from a year ago. Despite the higher inflation, market's reaction was muted. News is already priced in, but Treasury inflation-protected securities (TIPS) are saying a different story, with yields suggesting price pressures will be improving instead of getting worse. We can find that by looking at the breakeven spread between nominal Treasury yields and real yields on TIPS which is the market's longer-term inflation expectation, according to Barron's. That 10-year breakeven rate fell to 2.46% from 2.51% right before the CPI report was released. This has continued a trend over the last several weeks from when expectations reached a peak of 2.76% in mid-November.

The ports of Los Angeles and Long Beach have seen a surge in containerships waiting to unload. The backlogs have gotten no better despite headlines that suggest the line of containership waiting to dock at ports was cut in half recently after reaching over 80 not too long ago (and up from 37 from our [August newsletter](#)). But those ships moved further out into sea, removing them from the official count. Including these ships brings the total bottleneck of ships at 96, the highest number ever and keeping shipping rates at high levels. The price to ship a container from China to the West Coast is creeping back up after falling 28% from a record high in September, but still over ten times more than prices from the same period in 2019. In some instances, the cost to transport goods via ships has exceeded the cost to transport on airplanes which is expected to keep air freight costs at high levels as well. A partial solution could be fixing the trucker and warehouse worker shortages. Many of these goods at ports are being left there waiting on a trucker to ship it to the warehouse. While headlines might suggest improvements, bottlenecks still exist and we still see it as months before the problem abates, leading to longer lasting inflation.

A potential catalyst for further volatility is China's troubling property sector. Credit rating agency Fitch Ratings said China's largest property developer Evergrande has defaulted after failing to make two more coupon payments by the end of its grace period and has downgraded the company's debt rating to "restricted default." The property sector has been in a decline under falling home prices, governments tightening rules on borrowing, and a bond market selloff making additional deals difficult. Another one of China's largest offshore borrowers, Kaisa, was downgraded to the same rating, following several other smaller companies in default. While this is happening, China's central bank officials are insisting this will not cause more problems or longer-term damage to the markets. It was just Monday that the central bank announced a cut to its reserve ratio, the amount banks are required to hold in reserves, which was meant to free up more liquidity and could signal the start of an easing cycle in attempt to prevent further damage in the already struggling real-estate sector.

Company News

- Intel said it is planning to publicly list shares of its Mobileye unit, its autonomous car business, sometime in mid-2022. The move could value Mobileye near \$50 billion, according to the WSJ. Intel acquired Mobileye in 2017 for \$15 billion.
- In its investor day meeting, CVS raised its 2021 financial guidance with revenues above analysts consensus expectations and provided 2022 projections that were also above estimates. In addition, it announced a new \$10 billion share repurchase program and raised its dividend 10%.
- American Airlines said it will reduce international flights next summer due to it receiving fewer of the new 787 Dreamliners from Boeing than it originally expected. The company so far has received one versus the 14 it had expected to receive by now.

The Week Ahead

The calendar is busy with economic data reports but light with corporate and earning reports. The week begins with a quiet Monday then the producer price index report on Tuesday where economists expect producer's price to accelerate to a 9.2% y/y increase, a rate almost 3% higher than consumer prices. A wave of reports come out Wednesday and Thursday with retail sales, import and export prices, business inventories on Wednesday and housing starts, weekly jobless claims, industrial production and several manufacturing survey indexes including ones from the Empire State report, the Philly Fed, and the PMI. For retail sales, the consensus sees another strong increase in November with a 0.8% jump. The earnings calendar will be very light with the only notable reports from Adobe, Carnival, and FedEx on Thursday and Darden Restaurants on Friday. But the highlight of the week will be the Federal Open Market Committee's two day meeting on Tuesday and Wednesday with its latest policy announcement along with its updated "dot plots" and economic projections at the conclusion on Wednesday at 2:00. It is expected, after Powell's comments from his testimony to Congress, that the Fed will announce an accelerated timeline for tapering its asset purchases.

The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. The Dow Jones Industrial Average (DJIA), commonly known as "The Dow" is an index representing 30 stock of companies maintained and reviewed by the editors of the Wall Street Journal. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index. The NASDAQ composite is an unmanaged index of securities traded on the NASDAQ system. Every investor's situation is unique and you should consider your investment goals, risk tolerance and time horizon before making any investment. Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification. Information contained herein was received from sources believed to be reliable, but accuracy is not guaranteed. Information provided is general in nature and is not a complete statement of all information necessary for making an investment decision and is not a recommendation or a solicitation to buy or sell any security. Investing always involves risk and you may incur a profit or loss. Keep in mind that individuals cannot invest directly in any index. Past performance does not guarantee future results. There is no assurance these trends will continue, or forecasts will occur.