Episode 8

SUPPLY PAINS - A SYMPHONY OUT OF TUNE

Tom Herrick: Welcome to the CIO Conversation Series. I'm Tom Herrick, Cary Street Partners' Chief Investment Officer. On this episode, our conversation is about all those ships that are parked off the coast of California and the consequent prices we're seeing at the store. In other words, the snarled global supply chain, and its impact on the economy. My guest today is Michael Contopoulos, Director of Fixed Income at Richard Bernstein Advisors. Mike is a Wall Street veteran of 20 plus years. He heads the research and strategy and is a senior member of RBA's Investment Committee. RBA is a New York based firm that is a trusted partner for us at Cary Street, known for its top-down macro style of investing a different perspective for most asset managers on Wall Street. We welcome Mike's insights into what looks like a historic traffic jam at our ports and container terminals, and the ripple effects that are traveling all the way to consumers and investors. Mike Contopoulos, welcome to the show.

Mike Contopoulos: Hi, great to be here, Tom. Thanks for having me.

Tom Herrick: So we're recording this during the third week of October. The news is filled with current events that have economic impact. So why don't we start with your perspective? What are the biggest headlines investors should be paying attention to right now?

Mike Contopoulos: There are a lot of big issues going on at the moment, Tom. I think first and foremost in everybody's mind, of course, is the Delta variant and what's going to happen with the health care situation in the U.S., but also throughout the globe. Clearly there are a lot of geopolitical issues going on with everything that we see in Russia and in Europe, but probably the biggest of all of them is inflation. Right? What's going on with energy prices, gas prices, consumer prices. We see inflation everywhere, it affects every aspect of the market. To us, that's one of the biggest stories out there and something that everybody should be paying attention to.

Tom Herrick: Ok, so let's expand on inflation, which I call the second scariest word, by the way. I always like to point out that if you think inflation's bad, experience deflation, which is a depression. Put it in the right context, it is an issue – but there's been bigger issues in our past. I would like to expand on that. I see something I call like this inflationary boom that's out there, not stagflation, where the economy is slowing. At the same time, we are seeing prices higher everywhere. What do you see in that regard?

Mike Contopoulos: Well, certainly prices are going up. I mean, I think they're surprising to the upside and have been surprising to the upside longer than most expect. Most economists, for sure, but the public as well. So an inflationary boom is not a bad way to put it. The real question is going to become how long does it last for, right? Is this a six-month phenomenon? Is it a 12-month phenomenon? Is it a five-year phenomenon? And of course, that's what we're all trying to do in our profession, but consumers are as well. So I see the same boom that everybody else is seeing, right? And it's affecting all aspects of the economy and all aspects of our lives as individuals.

Tom Herrick: In the press, all our audience has heard these two phrases – transitory and persistent. I mean, to the point, you know, of nauseatingly, we've heard it so many times. It seems to me that we're past a transitory phase. Where do you come down in that regard?

Mike Contopoulos: Well, I think we first have to define persistent versus transitory. It's a bit nuanced in reality. So persistent would be changes to the structural environment, changes to the structural inflationary dynamic, if you will. So there are a number of reasons why you may get structural shifts to inflation. You have globalization, right? That is a reason why you could have a structural shift to inflation, or in this particular case, perhaps deglobalization. Right? Supply side challenges have just made secular issues more pronounced, right. And so you have to decide what's permanent and what's transitory. Wage pressures, those are permanent. Right? Baby boomers are going from a generation of savers to a generation of spenders – that's permanent, that's secular. Transitory is less time-dependent and more a product of are there reasons why the transitory impulse, the inflationary impulse, might subside? And so from a Fed perspective, they say ok, listen, at some point the global economy is going to reopen. At some point, manufacturing capacity will increase. Therefore, what we're seeing is transitory. Now transitory can become permanent if it lasts long enough. And so it's a little bit of a nuanced view. Do I think the current inflation dynamic is transitory? Most likely not. I think many of those secular forces – deglobalization, right, the aging population wage pressures – those secular forces are alive, they're real and they're going to ultimately drive inflation a bit higher than expected for longer than expected.

Tom Herrick: You mentioned the Fed a minute ago, the Federal Reserve, the central bank, which has a big role here, last summer changed their policy regarding inflation. You know, for the last decade, they've had this policy of targeting 2% inflation and they kind of went early in terms of tightening money supply. A lot of times we never got to 2% inflation, not for very long. Not for anything meaningful period, anyway. And now they're targeting average inflation 2%, which de facto means they are tolerating a higher number. Does that play into your thinking as well?

Mike Contopoulos: Oh, for sure. The longer the Fed goes without tightening policy because they want to have inflation run hotter, right, the more inflation expectations are going to go up and the more persistent it's likely to become and the harder it will ultimately be for the Fed to rein in that inflation, the more aggressive they will ultimately have to be with tightening policy and raising rates. So, yeah, I think that's a big factor. One of the things that doesn't get much airtime that I think really needs to be understood are inflation expectations. It's one thing to have you know, you go to the grocery store, and you see a gallon of milk go up 10%, 5%, 15%. It's another thing for the entire public to sit there and expect persistently higher inflation. That that 5% increase on a gallon of milk is going to continue to increase 5% year over year, over year, over year. That's what inflation expectations capture. And as soon as you start believing that inflation is going to be persistent, you expect wage increases. You expect, you know, to pay more for airline tickets, more for hotels, more for consumer goods, and then it becomes self-perpetuating. So the longer the Fed continues to target average inflation and let inflation run hot, the higher inflation expectations become, the harder it will ultimately be to bring them down.

Tom Herrick: Maybe we're seeing a bit of that expectation in things like you're seeing a lot more organized labor activity. You know, I think John Deere is on strike now as a for instance, and I think there's several other companies that are a little more labor unrest that I would imagine part of that is being triggered by the inflation expectations.

Mike Contopoulos: I think that's right. I think that's right. Well, certainly because of all the supply disruptions that you mentioned in the intro, Tom. Much of the power has shifted towards the employee and away from the employer. And I think we're seeing that, right. If you want to go to a restaurant these days, sometimes hours are curtailed back. Stores aren't opening until 10, 11 o'clock in the afternoon. You know, we can't find truck drivers, you can't find people to unload container ships. And so certainly the power has shifted here to the employee. And that ultimately means that they'll be able to demand higher wages. And the question becomes at what point does the employee give and finally say, this is what we have to do to bring people back to work? So I think that's a powerful, powerful dynamic.

Tom Herrick: Ok, so that gives me a chance to pivot to a subject I want to linger on a little bit, which is the supply chain. The very visible problems – dozens of loaded ships, dozens, I mean, like tens of dozens of loaded ships anchored off the West Coast, ports overwhelmed. Not, and you alluded to this, not enough trucking capacity, not enough labor capacity. How did we get here? I mean, this is an unusual situation.

Mike Contopoulos: It is unusual, but it's pretty simple, really. I mean, this is just a continuation worsening of a problem that started, you know, pre-COVID, prior to the pandemic. If you look actually in January of 2020, December of 2019, warehouse distributions, truck drivers, there are shortages in all of it, right. There were warehouse shortages or distribution shortages, and there were truck driver shortages. It was bad. It wasn't as bad as it is today, but the makings were in place, you know, even prior to COVID. So really, what we have is a mismatch between production and demand. Right? COVID shut down manufacturing for lengthy periods of time and demand was only shut down for a fraction of that time. That mismatch there has created a situation where manufacturing just can't keep up with demand and employers can't keep up with hiring enough people to meet that demand. And, of course, mobility of labor, which is a whole new dynamic in this post-COVID world, mobility of labor has created alternatives for the workforce. And so as you have all of these playing out, you have manufacturing disruptions coupled with no disruption on the demand side and arguably in many ways because you've had a shift in the way consumers purchase goods and the goods they're purchasing, right? You have consumers that are now doing more work to their home because they're at home more. They need to do work to it more than they ever have in the past. So all of a sudden, there's a huge demand for raw materials. Right? But no one's actually going and producing those raw materials. And so you've got this constant backlog that has gotten you here that really started, like I said pre-COVID, but it's certainly been exacerbated by the pandemic.

Tom Herrick: Yeah. And you just touched on something because when we hear this phrase, supply chain issues, I mean, some of this is related to shipping and trucking and things of that nature. But there's also this element going on of shortages. You just mentioned like raw materials, energy, particularly in Europe, is really dealing with some energy issues. You know, semiconductor chips, which is playing into a variety of finished manufacturing goods. These are all at play. Is there a timeline for some of this or all of this starting to rectify itself? I mean, it seems like it's going to take a while, at the very least for the market to respond to these kinds of things.

Mike Contopoulos: Sure does. You know, you have to kind of go back in time some bit to really kind of understand what's going on in the supply chain, right? Beginning in the 1970s, companies began to outsource production, particularly of sophisticated products. And the reason why they did this was in an attempt to increase margins while keeping costs down for consumers, pretty basic economics. What that ultimately led to was a situation where in many industries 50% or more, up to 100% of a given product is produced outside of the United States. Take the Dodge RAM 1500, rolls off a U.S. auto plant. 50% of the components of that truck are made outside of the United States and Canada. That's incredible, right? That's incredible because the supply chain is no longer focused solely within the United States. And so why does that matter in the context of time horizon? It's because this is like a beautiful symphony – the global supply chain is one instruments off, and all of a sudden everything gets thrown off, and that's what the supply chain is.

Tom Herrick: That's a good analogy.

Mike Contopoulos: Yeah, and it's one it's one thing to say, ok, you know, Intel is going to build a chip plant in Arizona. First of all, that will take a couple of years. And that doesn't happen automatically, but you have to still have all of the other pieces of the symphony working and that's happening globally. And all of our recoveries are at different stages, right? China's recovery is different from Taiwan's recovery, which is different from the Philippines recovery, which is different than Mexico's recovery, which is different from the United States recovery. All these recoveries are happening at different times. It's very hard for this symphony to be in sync any time soon, in our view.

Tom Herrick: Those chips you mentioned, you know, you were referencing one truck. I read somewhere the average number of semiconductor chips in a finished vehicle is something like 1400. They're key components. They're not easily replicated elsewhere on the semiconductor chip. Then you just mentioned, yeah, you can make an announcement about building a plant, but it'll be years before that takes place as well. How does, you know, in terms of the energy and materials, how do the needs of transitioning away from carbon-based energy play into this? It sure seems like there's going to be a rush on materials here related to that and probably also infrastructure. I guess we're going to spend another trillion dollars on infrastructure or more here pretty soon in the U.S. Does that play into the dynamic as well?

Mike Contopoulos: I think it does. I think it does play into the dynamic quite a bit. Maybe even more so than infrastructure. You have some geopolitical issues going on, right? Yeah, you obviously have some key similarities to the 1970s from today with oil embargoes kind of mirroring chip shortages. But until recently, there are some key differences as well. Remember the oil embargoes of the 1970s? One of the key rationales behind that was to shift power towards petrodollars states, effectively. Right? It was a way for petrodollars states to get back to the United States and shift the balance of power to them. That was a big difference versus today's chip shortages. Today's chip shortages are more supply constraint than anything else. There's no geopolitical issues there. On the energy side, on the gas side, it's actually very similar to the 1970s. Think about what Russia is doing in limiting gas supplies and all of a sudden saying, ok, we're going to supply gas now we're going to be the savior. Right? They're basically trying to jockey for global power. And that's a very similar dynamic to what you saw in the 70s with the petrodollars states. And so there are some similarities here that are disconcerting and perhaps have longer-term implications. And then you throw on top of that, right, the consciousness around, climate change and moving away from more traditional raw materials for energy, to quote unquote clean energy. And you're going to have the potential for significant disruption, significant disruption that could cause inflationary pressure. I mean, look at OPEC. OPEC does not want to bring down prices because they want to maintain their profits.

Tom Herrick: So all these factors, you know, play into what I call a higher structural inflation dynamic. What does that look like, though? We've referenced a couple of times the 70s which have, you know, being the age I am, I have PTSD when I start thinking about the 70s and gas lines and things like that. Are we heading towards that sort of dynamic or something just higher than what we've been used to for the last, I don't know, 20 years or 30 years?

Mike Contopoulos: I think higher than what we've been used to for the last 20 or 30 years. And quite frankly, from a markets perspective, that's what matters. Are we going to be above or below expectations? Expectations right now, depending on what you're looking at, could be anywhere from, you know, two to 2.8%, depending on your time horizon. So I think higher than what we've seen within the last 20 years. There are still factors that are pushing down inflation. Let's go back to one of the first things I mentioned on this podcast, Tom. Let's talk about three key factors that drive inflation higher but can also drive inflation lower. So the first one I mentioned was globalization, and this was a reason why everybody said that you could have a disinflationary environment. You had globalization. It all comes down to the supply chain as well, right? You started to build out a global supply chain. That's globalization. Well, we probably peaked in globalization in 2008. It's a matter of fact. I think it was the New York Times today had a nice chart showing that globalization peaked about 13 years ago. Well, if globalization was helping to push down inflation and that peaked several years ago at a minimum, then shouldn't that mean that you have inflationary pressures to the upside? But I think the key here is right, if 2% is your midline, then what we're talking about are tents on either side of that midline. So maybe rather than globalization pushing you down to 1.9%, maybe coming on the other side of globalization pushes you up to 2.1 %. An aging demographic, right? You go from a generation of savers, you build a global savings glut. Maybe that pushes you from 1.9 to 1.8%. Maybe the reverse of that going from a generation of savers to a generation of spenders pushes you to 2.2. So we're talking fractions of percentage points here, where you really get the big inflationary impulse is from the cyclical forces, all the things we just spent time talking about and those will abate. They're not going to last forever. But I think inflation in a year's time is going to be 3%. In two years' time, it could continue to be around 3%. That wouldn't shock me one bit.

Tom Herrick: Yeah, so it settles in a range that's higher than expectations – not rampant, runaway. What I'm hearing from you anyway is not the numbers I experienced in my youth when it was running at 10%. Not near double digits, but rather somewhere in the single digits, maybe mid-single digits, maybe three, four anywhere in that neighborhood. Is that a fair summary?

Mike Contopoulos: I think that's right.

Tom Herrick: Ok.

Mike Contopoulos: You would have to have a Federal Reserve that really lost credibility, in my view, to get inflation to run five, six, seven, eight percent.

Tom Herrick: What about factors like, you know, again, this is seared in my memory. One of the contributors in the 70s, too, was we had price controls. We had wage and price controls under the Nixon administration and then you had oil price controls all the way up to the first week in the Reagan Administration. And, you know, anytime you control a price, it limits supplies, it feeds inflation. Does that factor in here? I'm not seeing that anywhere. You're not seeing anything of that nature, are you?

Mike Contopoulos: We're not. We're not. I'm not seeing anything like that at the moment.

Tom Herrick: Ok, that's good. We're of like mind on that. You helped us understand that you know what's going on and why. What are the market implications of this? I'm curious what your thoughts are around various asset classes and how you navigate this sort of environment on a high-level conversation?

Mike Contopoulos: Well, it's a good question. I think there are still areas of the market that will do well in an inflationary environment, and there are areas obviously in the market that will do quite poorly. So let's take equities, for example, right? You want to be long inflationary assets. What does that mean? You want to be long overweight energy, you want to be overweight materials, but you also want to be overweight sectors that will do well in a higher rate environment. You want to be overweight sectors that might do well in an environment where you have a steeper yield curve. So one area where that would be the case would be financials as an example, right? If they borrow on the front end and land in the long end, so they pick up a nice margin there. So energy, materials, financials should all benefit from higher inflation, higher rates, a steeper yield curve. But then you have the flip side of the coin, the flip side of the coin is what doesn't do well in the equity space. Well, growth doesn't do well, tech doesn't do well, right? If inflation is going up and you value a company based on future earnings and those future earnings are now worth less in today's dollars because inflation and rates are going up and the valuation of that company needs to fall. And that, by definition, is what a growth company is. And tech falls within that category of goods. It's less about broad market dynamics, and I think you're going to see some big shifts in the internals of the market as well. On the bond side clearly bonds don't do well in an inflationary environment. Depending on the underlying growth, dynamic high yield credit could do quite well because you inflate away your debt while your earnings are going up. This actually gets back to, Tom, you mentioning earlier, about stagflation. Stagflation gets thrown around so much these days, and we don't see anything that would indicate we're in a stagflation environment, right? You need to have unemployment going up. You need to have growth going down. I mean, both of those things are going the other direction.

Tom Herrick: You need to see orders falling, things like that. Go ahead.

Mike Contopoulos: Yeah, there's no basis for fearing about stagflation at the moment. And so if you assume growth is going to be ok, but inflation's going to be modestly elevated, high yield credit looks pretty good in that world. Treasuries look terrible. So again, even within fixed income, there's nuance and there's the internals of the market where you can find opportunity. Obviously, commodities, you know, I think commodities have a place to do really well here. And of course, they have over the last year. At RBA, we'll present that view to the equity side. So we'll present that view through, you know, materials and through energy primarily.

Tom Herrick: I was going to add that that there are ways to own commodities without owning the hard asset itself. You know, and in various equities sectors, you can get that exposure. What about international assets, which have been the laggards for over a decade now. They made money, don't misunderstand me audience, but we definitely have lagged U.S. assets. Does this play into that dynamic at all? Does this change that?

Mike Contopoulos: I think it does, to some degree, right? An inflationary environment, which is global, this is happening not just within the United States, but is happening outside the United States as well. Usually coincides pretty well with a strong profit cycle, right? Certainly, the early stages of an inflationary environment coincide well with early profit cycles, and I think you're starting to see that throughout the world. In China in particular, you know, emerging markets, ex China, certainly you have an inflationary dynamic that is occurring there, but many of these countries are levered to those inflationary assets. Right. They'll do well when commodity inflation is accelerating. Take LATAM as an example of that, much of the LATAM Brazil and otherwise are exposed to raw material costs and raw material costs going higher, those equity should do quite well. At the same time, you have an accelerating profit cycle in those areas. So yeah, we actually quite like non-U.S. both equity as well as credit for those reasons. Inflation should do well for many parts of the world, and many of those same parts of the world are earlier in their profit cycle.

Tom Herrick: So Mike, looking towards the future for the next five or so years – any final thoughts, advice, projections?

Mike Contopoulos: Yeah, Tom, I mean, if we're right on the inflationary environment lasting for longer than expected for higher than expected, then clearly portfolio management is going to have to change. We've all heard about the death of 60 40, and I think that's probably going to be accurate. You can't sit there and lose that 40% of your portfolio as rates go higher and the worst case scenario, of course, that rates going higher is actually the reason for lower equity prices. And so I think the way you manage a portfolio needs to be more balanced across the different risks, rather just saying I'm going to take 40% of our portfolio and put it in treasuries or investment grade assets. You need to balance out the risks and the new risk may be you need to balance out inflation risks. You need to balance out a higher rate risk. You may have to balance out a steeper curve risk. And that's a totally new dynamic I don't think any money manager has thought about for the last 20 years. So to me, that's going to be a big change in the future.

Tom Herrick: Mike, thank you for sharing your insights.

Mike Contopoulos: Thanks for having me, Tom.

Tom Herrick: That was Mike Contopoulos, Director of Fixed Income at Richard Bernstein Advisors. Thanks once more to Mike and all our friends over at RBA. And as always, thank you for listening to our conversation about inflation and the supply chain. We'll be back next month to provide insights into other important pocketbook issues as we strive to maintain Cary Street's higher standard on the airwaves. In the meantime, for more information, please visit our website at CaryStreetPartners.com. If you like the show, please share a link, subscribe to our podcast, send us your feedback. We'd like to know what you think. Thanks again for joining us. I'm Tom Herrick, talk to you next time.

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