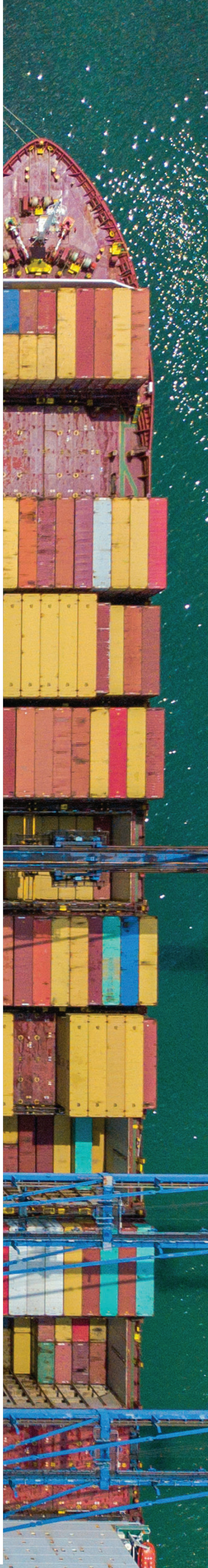

Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Supply Chain Squeeze

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It's not demand, it's supply: Eighteen months ago, demand for goods and services collapsed as the COVID-19 pandemic swept over the globe. Many countries suffered their largest gross domestic product contractions ever recorded.

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Today, with some exceptions (e.g., the travel industry), demand for goods and services in the corporate world is stronger than ever. But companies are facing more operational challenges due to a squeeze in supply chains resulting from shortages in labour, raw materials and components, as well as tight logistics capacity, all putting upward pressure on costs and restricting product availability.

We are now observing something unusual: profit warnings due to a lack of supply, rather than an unexpected drop in demand.

How did we get here? Put simply, COVID-19 has led to a dramatic shift in the types of goods and services people want over a relatively short space of time. This isn't a huge surprise because the way we live and operate, for the broad population, has changed dramatically. Such rapid shifts in demand are not easily matched by supply chains, which take longer to build up.

"COVID-19 has led to a dramatic shift in the types of goods and services people want"

If we take a specific example, demand for sporting goods has surged. Over the past 18 months, we have seen an acceleration of a fairly established trend as people have looked to stay fit and healthy in new ways due to the pandemic. The importance of being fit and healthy has been brought to the front of mind for many people.

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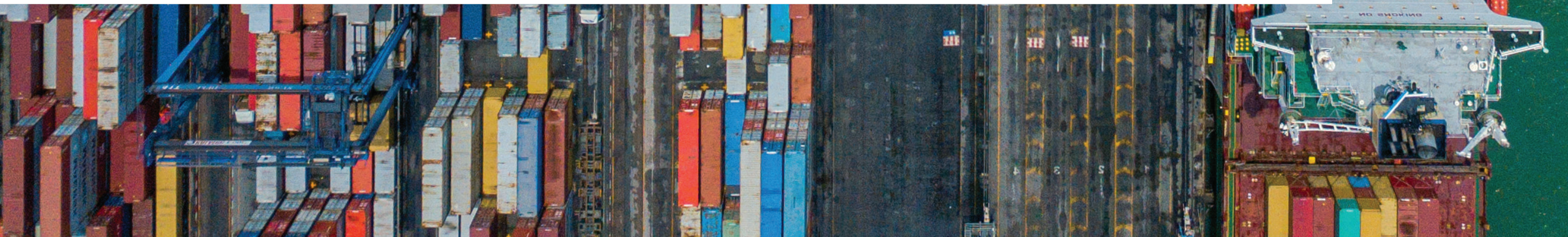

"A lack of shipping containers and port capacity is resulting in goods taking twice as long to reach their destination"

Sporting goods manufacturers are largely based in Southeast Asia, specifically Vietnam, Cambodia and China. Vietnam is a clear reminder that the pandemic remains with us, almost two years after it began. A government-ordered lockdown in Vietnam has resulted in factory closures, causing many weeks of lost production, and many weeks to ramp back up. Footwear and apparel, which need to travel across the globe to reach consumers, have been delayed due to a lack of shipping containers and port capacity, resulting in goods taking twice as long to reach their destination. This is a knock-on effect from the collapse in air travel, which has eliminated a significant proportion of air freight capacity, pushing up costs and encouraging businesses to switch to ocean freight. The result? Lost sales as fewer shoes and clothes make it to shelves.

How big a problem is this? As the entire industry uses outsourced production, largely from the same suppliers, it is an industry-wide problem, not a company-specific one. On balance, they all lose out. Profits will take a hit, ironically because fewer goods will ultimately be sold. There may be some partial compensation from net pricing because there will be limited unsold inventory to discount. This is something the industry is striving for to improve gross margins and return on capital. So, one silver lining is that this could be another step forward in conditioning consumers to not wait for discounts. The risk? People spend their money on something else, i.e., consumption shifts elsewhere and it does not all come back when supply resumes.

The larger companies, which our global portfolios tend to own, have the scale to weather the storm and to continue investing in their digital platforms; however, smaller companies, which were already playing catch up, may find themselves further behind in the digital race.

The rush to "not miss out" on demand creates environmental, social and governance risks, as well. There are well-documented supply chain controversies for the sporting goods industry; its constituents need to be careful not to add to the list with the pressure to ramp up production quickly while balancing labour welfare. This could be a good test of how much progress a company has made in making people a priority in their way of doing business.

"There is no easy fix to the semiconductor shortage—it can only be addressed by new manufacturing capacity"

Of course, while sporting goods are a recent victim, semiconductors were perhaps the earliest category where there was a clear mismatch in supply and demand. Here, increased demand as a result of COVID-19 (working from home, home schooling, etc.) hit up against relatively fixed near-term supply. This has had a knock-on effect in many parts of the economy, most notably stalling the automotive sector, which goes to show just how pervasive technology is becoming within the global economy. There is no easy fix to the semiconductor shortage—it can only be addressed by new manufacturing capacity. Here the leading Taiwanese foundry has indicated it will invest $100 billion over the next three years. The shortage has also shone a light on just how narrow and globalised the semiconductor supply chain has become, with capacity provided by only a handful of major chipmakers and equipment manufacturers.

"Pricing power is vital"

For companies with pricing power, cost inflation can be passed on to the end customer. The strong demand environment today means many companies, even those with historically weak pricing power, are confident they can pass on cost increases, minimising the impact on profits. The difference is, for those with weak pricing power, pricing may not stick once this period of supply squeeze abates.

Pricing power is a vital attribute we seek in the companies we own in our global portfolios. So, while there may be some short-term volatility for their earnings and returns, we think the earnings potential of these higher quality companies should be rebased higher once this episode is complete, and the gap between the high quality and low quality companies widened.

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Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required.

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