Festive season puts spotlight on supply chain inflation

By Anthony Aboud
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With the inflation debate well and truly established as an investment theme, we spoke to Australian supply chain insiders to get a snapshot of exactly what is going on in their

businesses. Perpetual SHARE-PLUS Long-Short Fund Portfolio Manager Anthony Aboud takes us through the findings.

Fund manager quarterlies and stock broking strategy pieces are coming in thick and fast, all offering opinions about inflation. Everyone has a well-articulated argument as to why inflation is going to be sustained or transitory. Rather than focus on the top-down perspective, we thought it would be more useful going to the coal face and leveraging our large investment team at Perpetual – who speak with hundreds of companies a year – to try and get a feel of what is going on at our investee companies. In October, we did one better and spoke to two dozen supply chain insiders from both unlisted and listed companies in our investment universe. Our goal was to get a snapshot of the current and emerging trends in the supply chain and then use our judgement to work out how this may play out over the medium term.

As a result, we believe we are currently seeing a perfect storm of inflationary pressures. Whereas in February this year, when much of Australia came out of lockdown, we saw pockets of inflation (e.g. WA Labour, used cars, timber) called out by the companies we interviewed, it now seems to be much more widespread as we approach calendar year end. Our key findings were:

Cost Inflation is rampant

This was consistent feedback and we believe that both retailers and manufacturers are seeing cost push inflation – inflation caused by an increase in prices of inputs like labour and raw materials – from the following sources.

- Freight (2 - 5 times typical container shipping costs),
- Extra warehousing/distribution costs due to labour issues/required inventory build,
- Anything with an oil base – plastic, resin, diesel,
- Commodities – copper, meat, coffee, sugar, wheat, cotton, steel, timber, energy costs, petrol/diesel,
- Labour – availability and productivity of labour is extremely tight. While there has yet to be an impact on unit cost of labour, the reduction in productivity is inflationary as it costs more to produce the same one unit of a good,
- Manufacturing costs in China – whether it be due to energy costs or higher labour costs, China is starting to pass those costs through to exported goods.

Imports/Exports face major disruption

Even now, we are seeing increased delays getting things into Australia from key supply regions like Vietnam or China. The issue in China was originally COVID shutdowns but now we believe it is being impacted more so by the cost and rationing of power in the certain provinces. Other issues for imports/exports that we see as causing major disruptions:

- Availability of containers at major ports,
- Cost and availability of freight is significantly higher compared to past years,
- Australian ports are already backed up, but we believe this is about to get worse with threats of stevedore strike action, which could be up to a month long if similar to previous strikes,
- Scarcity of truck drivers is elongating delivery times and costs as well as there are now few drivers due to labour shortage.

Ongoing labour issues

One retailer we spoke with has job ads out there for up to 1000 jobs which they are struggling to fill. One food manufacturer has 500 unfilled job ads. This has been driven by a variety of factors, we believe the most important of these to be:

- COVID Rules – even if a worker has been double vaccinated and has a negative test, they may be required to isolate for a fortnight if they are a close contact. This has resulted in distribution centres and warehouses operating at materially below capacity.
- Seasonal Labour Shortages – whether it be fruit pickers, hospitality workers or truck drivers, the lack of inbound foreign workers with temporary working visas coming to Australia has stopped. This has created labour shortages in some crucial sectors.
- Refusal to get vaccination also restricts the unvaccinated subset of the labour force from taking jobs which require vaccination as a condition of employment.

While we're not seeing an obvious widespread wage inflation as yet, the lead indicators of strong demand for labour combined with shortages in the labour supply are likely to feed into wage inflation in the future.

What does this mean?

Over the last fortnight, we have also spent a lot of time listening to management commentary from overseas companies on their quarterly earnings. What is interesting to us is these supply chain issues appear to be a world-wide phenomenon. This is unfortunate for Australia as there is unable to be slack provided from other parts of the world. The 2021 September quarter Consumer Price Index (CPI) in Australia rose 3% over the twelve months from the corresponding quarter in 2020. The CPI is a weighted average of the price for a basket of consumer goods services, which acts as a key inflationary indicator. While high, most market commentators explained it away as being impacted by base effect (i.e. last year was so low) and transitory rather than long-lasting price increases.

If we look at what makes up CPI, it is important to note that food is a very large component at roughly 17% of the CPI basket. Food inflation was relatively subdued at 1.3% YOY in the September quarter. Our concern is that we believe we are seeing all the early signs for inflation in goods and services for consumers to be widespread. We believe that all of the cost

pressures through the supply chain will end up being passed on from retailers and service providers to the end customer in the form of price increases. For example, retail analysts are noting that the major supermarkets have started to reduce the number and size of promotions. We think that, based on what we have heard from our calls, material price increases will likely come over Christmas and into the new year.

For more on two x-factors that could impact inflation and inflation expectations, click here.

Find out more about Perpetual's SHARE-PLUS Long - Short Fund.

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