by DOUG SANDLER, CFA

THE RIVERFRONT WRITING TEAM

REBECCA FELTON
Senior Market Strategist

CHRIS KONSTANTINOS, CFA
Director of Investments |
Chief Investment Strategist

KEVIN NICHOLSON, CFA
Global Fixed Income Co-CIO |
Co-Head of Investment Committee

DOUG SANDLER, CFA
Head of Global Strategy

ROD SMYTH
Chairman of the Board

SUMMARY

- The economic re-opening has led to supply constraints which threaten growth.
- Historically, a combination of technological gains, human ingenuity, and labor and mix shifts have alleviated supply constraints.
- We view supply constraints as more of a speedbump and less of a roadblock.

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Supply Chain Shortages Present Challenges for Companies (Part 2)

Supply constraints more likely a speedbump than a roadblock

Undoubtedly, we believe better economic times are coming as a result of pent-up demand and high consumer savings rates. However, for the first time in a while, our view is that the biggest threat to future growth may not be a lack of demand but rather constraints on supply.

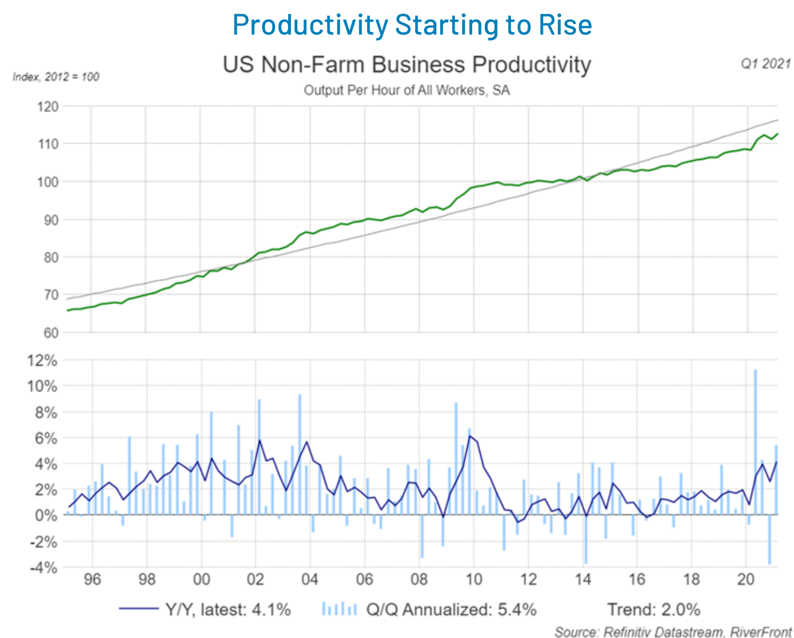
Last week, we highlighted some of these supply-related challenges facing the economy including labor supply and manufacturing and services capacity. This week our focus is on the potential fixes to these supply shortages and challenges to our thesis.

Potential Fixes:

- **Technology:** From the steam-engine to artificial intelligence, technology has always played a pivotal role in narrowing the divide between demand and supply. In our view, the rapid adoption of technology by many companies to operate effectively during the COVID-19 pandemic, will turbo-charge productivity gains in coming years. As can be seen in the chart below, productivity growth has picked up since COVID-19 registering 4.1% year-over-year and 5.4% quarter-over-quarter increases. This rate of growth is significantly higher than the 2% growth trend that has existed since the mid-1990s.

  In effect, we believe almost all companies are tech companies whether they supply it or use it. Technology will continue to transform companies' ability to tackle change.

Productivity Starting to Rise



Past performance is no guarantee of future results. Shown for illustrative purposes. Not indicative of RiverFront portfolio performance.

- **Human ingenuity:** Using history as a guide, supply shortages typically get rectified. Higher prices bring more competitors, workers, and capacity to an industry. Eventually, we believe this will get figured out. After all, we developed a vaccine for COVID-19, a never-before-seen disease, in less than one year.... building a new sawmill or auto plant should be child's play in comparison.

- **Onshoring:** 'Onshoring' occurs when a job that was 'offshored' to a lower wage country comes back to the US. This trend toward onshoring started as the cost/productivity advantages of offshoring started to decline. President Donald Trump's trade war and more vehement public opposition to outsourcing accelerated the trend. Today, any additional disruptions to the global supply chain, like COVID-19 or shipping challenges, will only accelerate the trend further, in our view.

- **Mix Shifts:** The pandemic was all about goods as the service part of the economy was shut down. However, reopening could reduce demand for goods, as consumers reallocate spending more towards services underutilized during the pandemic, such as entertainment and travel. We believe this could also potentially alleviate some of the inflation pressures that have arisen as a result of constraints on supply. Recently the prices of a number of commodities (lumber, copper, agricultural products, etc.) appear to have started to cool off slightly, as an example.

- **Service fees:** Service wages need to increase, in our view. The government's enhanced unemployment benefits are partly to blame but other factors also contribute. For many service workers that depend on tips, the economics of working at a restaurant or hair salon running at half capacity with limited hours is not tenable. Long-term factors like a lack of benefits and disruptions to public transportation may also be contributing factors. One solution would be to raise service worker wages and benefits funded through a mandatory service charge in lieu of tips. Such models are commonplace throughout Europe and may be ready for prime time in the US, especially as COVID-19 has highlighted the value of these professions.

Challenges to our thesis:

- **Significantly higher rates and/or significantly lower US dollar:** As the public worries about higher prices and inflation, the bond and currency markets have been signaling that long-term inflation is not yet a concern. A spike in long-term interest rates, currently below 3%, would be cause for concern, as would a significant and sustained drop in the value of the US dollar.

- **Absence of productivity gains:** The best antidote to supply-side inflation is productivity gains. Productivity gains represent the economy's ability to produce more for the same cost. If productivity gains begin to subside, some of the 'transitory inflation' now being experienced may prove to be 'structural' and cause for additional concern.

- **Poor management decision making:** 'Transitory or structural' is the question many business executives are grappling with. If the supply shortage is viewed as transitory, brought on by pent-up demand and stimulus, then massive changes to supply chains are unnecessary. However, if the shortages are viewed as structural, i.e., a function of de-globalization and the millennials reaching their 'prime spending' years, then further action is required. The consequences to answering this question incorrectly could be significant. The boom-and-bust cycles of the 50s, 60s, 70s, and 80s were brought on by business leaders misinterpreting demand surges. Back then it was common for businesses to produce extra inventory, aggressively hire workers and expand their manufacturing capacity; often financed through massive amounts of debt. Inevitably, the economy would hit an obstacle deeming their demand forecasts too rosy and much of their efforts would have to be reversed: fire-selling inventory, laying off workers, and closing factories. Since much of the expansion was funded with debt, the economic consequences of misjudging demand were often total (bankruptcy). If companies were raising the risk profiles of their businesses by overspending, we believe it would be first reflected in their credit ratings. A material decline in overall credit ratings would be something that would worry us.

Conclusion:

We believe that a combination of American ingenuity and a lowering of investor expectations will prevail, and the bull market will remain intact. To get there it may take a quarter or two of lower-than-average equity returns. Our portfolios remain slightly overweight stocks relative to bonds, consistent with our positive long-term outlook.

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