SUMMIT
ASSET MANAGEMENT

**“It takes 30,000 parts to build a car and only one not to.”**

-Toyota Motor Company

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Dear Clients and Friends: October 20, 2021

The third quarter of 2021 began with optimism. We were seeing strong corporate earnings, positive economic momentum, and consumers with cash to spend and places to go! Negative news was just ignored. “Value” stocks, viewed as more tied to a broadly expanding economy, were finally outperforming their “growth” counterparts as confidence increased that COVID had loosened its grip on our daily lives. However, by mid-August, things started to change. The Delta variant crashed the recovery party, bringing anxiety back to both the stock market and the glimpse of normalcy that had started to emerge.

For stocks, it was mostly a flat to down quarter. Major indices, both in the U.S. and abroad, were little changed, holding steady with year-to-date gains of 15% and 8% respectively. Smaller company stocks seemed most vulnerable to the new anxiety of potentially slowing growth as supply chain disruptions and labor shortages began to dominate the headlines. They closed down more than -4% for the quarter but remain up 12% on the year. Individual sector returns also zigzagged from week to week as the news flowed. Meanwhile, emerging markets continued to suffer under the Chinese government’s regulatory crackdown, declining almost -9% for the quarter and falling -2.5% for the year.

Bonds were also mostly flat. Yields fell initially, then rallied back in September. While they ended the quarter about where they started, the upward momentum was attributed to inflation becoming more prominent and the Fed’s maneuvering to combat it. Year-to-date returns for the broad bond market are down about -2%.

**Supply Chain Issues**

For most of us, the return to normalcy involves buying things and going places. We do not usually think about the complex choreography that makes modern shopping possible. We just click and wait. Increasingly, we are running into bottlenecks blamed on “supply chain issues”. The world’s supply chains have elbowed their way into the foreground. What’s going on?

The causes for the shortages since the start of the pandemic have been many and varied. Some have been true “one-offs” while others are the results of modern corporate management and the 30-year evolution of “just-in-time” inventories. The troubles began in late 2019. Many economists had been forecasting a slowdown in 2020. Companies had begun to prepare. Then COVID hit. Most firms continued to throttle back and ultimately idled production amid the lockdowns. Logically, most expected a demand slump but were instead met with a surge. Consumer behavior took an unexpected turn, and manufacturers were not prepared. Their factories were closed and their workforces were at home.

Bolstered with stimulus checks, especially in America, consumers skewed spending toward goods rather than services. That missed trip to Disney World suddenly became a new big screen TV or a laptop or home exercise equipment. This shift in demand led to runs on key components, like computer chips for appliances and cars.

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Sales of consumer goods, especially those exported from Asia, jumped 20%. That compares with just a 1.5% increase the previous five years. The vaccine was supposed to reverse that trend. However, uptake has been slow in some places, and the Delta variant has raged in others. As a result, goods spending has remained elevated and well above pre-pandemic levels.

Unexpected demand was only half the problem. The shipping industry had no real spare capacity entering the pandemic. The industry compares the situation to fans leaving a sold-out football game. The usually sufficient thoroughfares suddenly seem woefully inadequate. With Trans-Pacific shipments up some 30% this year, a shortage in 40-foot shipping containers emerged leading to shipping costs soaring and long delays. The once $2,000 trip can now cost $20,000. Additionally, transportation companies and ports have had to deal with the same COVID issues as everyone else: lockdowns and labor shortages.

The rise in shipping costs has also influenced what's making it into port. Smaller, high value, higher margin products are finding their way because the shipping costs can be better absorbed. However, larger, bulkier items with lower margins are being sidelined.

Under normal circumstances, the number of ships anchored outside California's San Pedro Bay Ports Complex (housing the entrances for ports in both Los Angeles and Long Beach), is zero. In June there were six, down from an earlier pandemic high of 40. Currently, 88 vessels are waiting to dock. Shippers have been adding capacity to deal with the new demand; unfortunately, truckers and warehouses have struggled to keep up. Labor shortages continue to be the biggest problem. Unloaded containers are sitting at ports for six days rather than two and at warehouses for eight days instead of the usual three.

It's not all COVID's fault. Many unique events have added to the global supply chain headache. Back in March, the *Ever Given*, one of the world's largest container ships, was stuck in the Suez Canal for over a week, delaying global deliveries for even longer. An unusual number of factory fires in the U.S. have disrupted production of vital chemicals used in manufacturing. Even Mother Nature has been involved. The California wildfires have interfered with transportation routes from West Coast ports. In the aftermath of the Texas Freeze, plumbing and hardware supplies were "drained" throughout the Southwest for months. More recently, Hurricane Ida shut down crude oil production and refining activity across the Gulf Coast. Over in Europe, Brexit, a supply chain headache to begin with, has only compounded issues.

All these delays affect both the production and delivery of final goods. The logistics industry refers to this as "The Bull-Whip Effect" where even small fluctuations in supply and demand reverberate through the entire system. With the system stretched thin, a mishap anywhere affects the movement of goods everywhere. We've spent decades optimizing supply chains to carry a very specific amount of cargo during very specific times of the year across very specific modes of transportation. As soon as we exceeded the design capacity of those systems, they broke.

Shortages of components and raw materials are squeezing manufacturers around the world. Part of the problem is that the global economy is out of sync because of the pandemic, restrictions, and recovery. Factories and retailers in Western economies, which have largely emerged from lockdowns, are eager for finished products, raw materials and components from long time suppliers in Asia and elsewhere. However, many countries in

Asia are still in the throes of COVID surges and unable to meet demand. In more recent developments, energy shortages in Asia are causing electricity rationing and furthering factory slowdowns.

In the meantime, firms are not abandoning global supply chains; they are improvising. Large retailers, like Walmart, Target and Home Depot, have taken to chartering entire ships exclusively for their own cargo. With the delay in the return of international passenger flights, airplanes are being refitted for freight. In the U.S. and Japan, government policies are incentivizing the "reshoring" of production. Several carmakers are bringing parts of their supply chains in-house or at least closer to home, especially for computer chips.

Global supply chains will survive this trial. Eventually, supply and demand will equalize. We are similarly learning that global logistics are incredibly complex but also very informal. Adjustments and investments are being made in response to recent woes that will make them more resilient, trustworthy, and better able to cope with future disruptions. Innovation is spreading rapidly. The Biden administration is also in talks with logistics companies, port officials, and transportation unions on how the federal government can help alleviate bottlenecks. With time, these supply chains can fade back out of sight and out of mind.

**Economic Growth and COVID**

Global economic growth is slowing, but from a very high rate to a less high rate. The U.S. is receding from first quarter growth of 6.3% to about 5% in the back half of 2021 and is expected to average about 4% next year. This is well above the historical growth rate of 2%. Growth estimates for most of the rest of the world will remain well above trend this year and next as well. Slowing growth does not portend a recession.

COVID data is also improving. Almost half the world's population has been vaccinated and rates continue to rise, especially outside of the U.S. Herd immunity seems ever closer when you include those having been infected. The Delta variant, while still causing issues globally, appears to be diminishing. COVID will likely never go away, but we will learn to manage and live with it.

**Inflation**

We believe the current spike in inflation is being caused primarily by temporary supply chain issues and will moderate. However, higher labor costs may be here to stay. Supply chain pressures will ease as inventories are replenished, demand is satisfied, and logistical kinks are worked out of the system.

Higher labor costs are more persistent. Demand for workers, in just about every field, is through the roof. Employers are being forced to increase wages. Currently, the U.S. has a record 10.9 million job openings, 3 million more than before COVID. Unlike semiconductors and automotive parts, the supply of labor is dependent on population growth and immigration, both of which are barely growing. Technological innovation will move forward in filling the gaps from labor shortages. Nevertheless, until robots take over and make us all obsolete, higher wages are likely here to stay.

We had become accustomed to inflation rates of under 2% in the pre-COVID world. Going forward, expectations for longer-term inflation will likely reach the 2% to 3% range. In

the short run, risks to the upside are possible; however, we believe that many of the forces that have kept inflation in check for the last 30 years remain.

**The Fed, Stimulus, and Taxes**

There is a lot of talking going on in various departments of government, but not a lot of action. The Fed has been telegraphing reducing or "tapering" its emergency era bond purchases for quite some time. They want to avoid surprising the market in any way. However, each economic release seems to house enough information for them to delay starting. Our expectations are that the inflation numbers will force their hand later this year, at least with the tapering. Raising interest rates will likely happen next summer.

The White House and Democrats in Congress have proposed several large spending packages. They are aimed at both the country's physical infrastructure and human infrastructure. These packages are trillions of dollars in scope with the spending being offset with rollbacks of certain Trump tax cuts and introductions of new taxes on the wealthy. However, with such a small majority in Congress, progress on passage is hitting resistance at every turn. Whatever ultimately gets passed will likely be much smaller in nature than the original plans.

**Outlook**

As always, we emphasize a long-term perspective and being cautious of increased volatility. The fluctuations in late September marked the first 5% pullback in almost a year. This was the 7th longest time on record. Greater volatility under the surface has also been masked by the stability of the major indices. The average stock in the S&P 500 and Russell 2000 has had its price correct -21% and -44% respectively. This has relieved some of the sentiment and valuation issues present earlier in the year.

The supply chain disruptions create an outlook of reduced, but still robust economic growth. Jobs are plenty and wages are getting a needed boost. JP Morgan estimates that savings, stock prices, and home equity have generated almost $25 trillion in new wealth since the beginning of COVID. This is a 20% increase since 2019 and should act as a tailwind for consumer spending. The Fed, while transitioning to tighter monetary policy, remains extremely accommodative. Overall interest rates remain at generational lows. There also remains the prospects of additional fiscal spending from the two infrastructure bills making their way through Congress. These conditions should all promote economic growth at least through the end of next year with inflation pressures moderating but persisting.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us, and stay safe and well.

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