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UNIT TRUST CORPORATION
ADVISORY SERVICES DEPARTMENT

Newsletter

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GLOBAL SUPPLY CHAIN DISRUPTIONS

The COVID-19 pandemic has impacted many aspects of business, including the disruption of global supply chains resulting in shortages and delays in everything from semiconductors and cars to sneakers and exercise equipment.

The global supply chain can be considered a complex, sophisticated network that spans multiple continents and countries and connects the supply with the demand for goods and services. It includes the product manufacturers, the companies that supply materials to create them, the cargo ships, trains and trucks that deliver them, and the stores selling them. This system has allowed manufacturers and industries to be more efficient as previously they were forced to rely on self-sufficient factories.

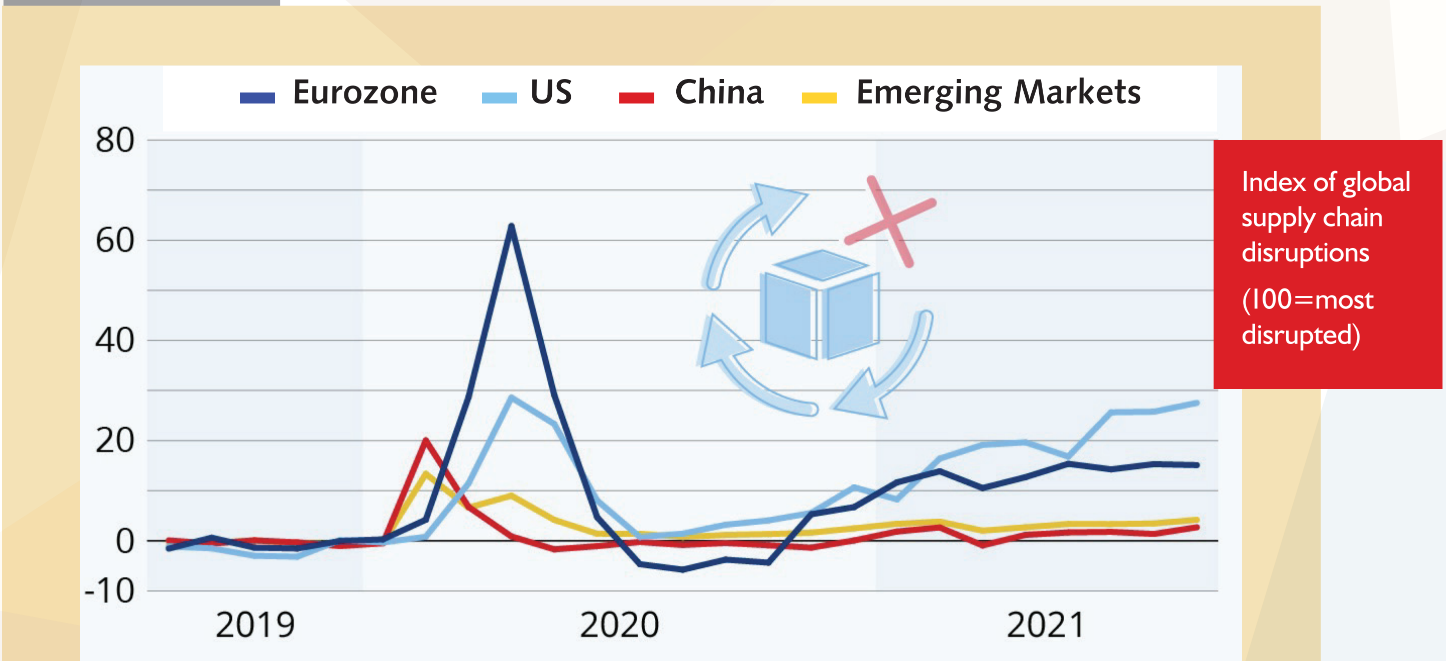
However, the COVID-19 pandemic exposed the vulnerabilities in the system. Initially, the rapid spread of the virus in 2020 prompted worldwide shutdowns of industries. China is considered a dominant force as the "world's factory". As such, any major disruption there leaves global supply chains at risk. This was made clear as more than 200 of the Fortune Global 500 firms have a presence in the highly industrialized province of Wuhan, where the COVID-19 outbreak originated.

The COVID-19 pandemic was somewhat unique as it affected both ends of the supply chain. As governments imposed lockdowns and companies grappled with the loss of manpower due to illness or travel restrictions, there was reduced industrial activity which, in turn, diminished supply. At the same time, after the initial lull in purchasing, demand skyrocketed from employees working from home and recipients of government COVID-19 stimulus packages.

The International Monetary Fund (IMF) computes an index of global supply chain disruptions by using the difference between the delivery time and production indices, components in its Purchasing Managers' Index (PMI). The higher the value, the more disturbances occur in global supply chains. Figure 1 shows how supply chain disruptions have evolved throughout the pandemic. It can be seen that there was a spike in early 2020 and as people settled into the new normal in 2021, the disruptions started increasing in the US and Eurozone. However, supply chains in China and the Emerging Markets were less affected.

FIGURE 1: **SUPPLY CHAIN DISRUPTION INDEX**

SOURCE: IMF, CHART: STATISTA



The COVID-19 pandemic exacerbated pre-existing issues in the global supply chain and exposed the model's weakness. Pre-pandemic, many companies' supply chains were focused on "just-in-time" inventory levels which involve only ordering and receiving inventory for production and customer sales, as needed to produce goods. Nothing is stockpiled as carrying too much stock is a drain on working capital, tying up cash that could be used elsewhere in the business.

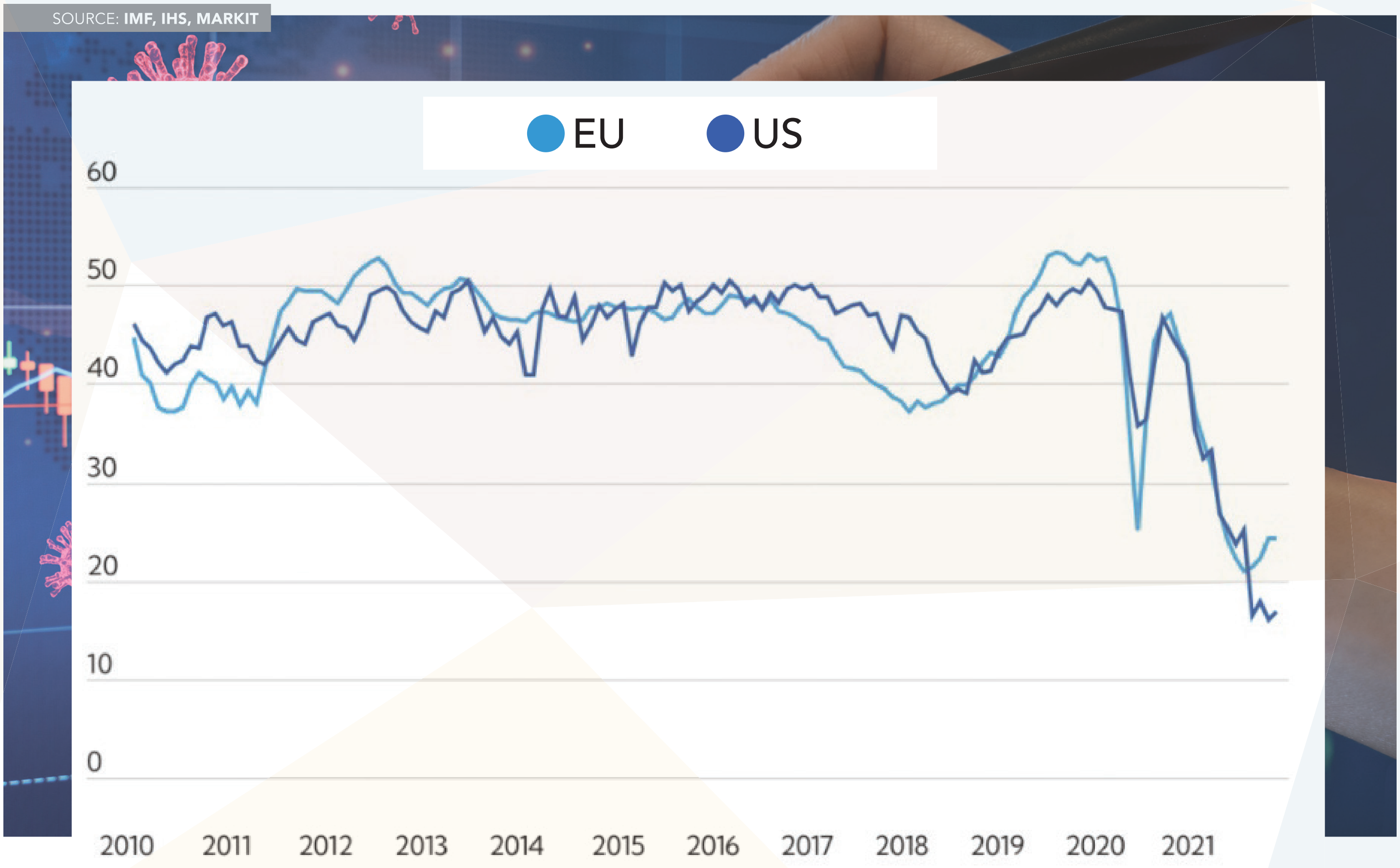
These disruptions have resulted in big increases in freight costs and delivery times. 90% of the world's global trade is shipped by sea, with 70% in containers, and it is estimated that there are more than 170 million shipping containers across the globe. Notwithstanding, in August 2021, according to Bloomberg, 77% of the world's ports were experiencing abnormally long turnaround times.

IHS Markit's suppliers' delivery times index is constructed from Purchasing Managers Index business surveys and reflects the extent of supply chain delays. To compute it, purchasing managers indicate whether their suppliers' delivery times are on average, slower, faster, or unchanged compared to the previous month. Readings at 50 signal no change whereas those above 50 indicate faster delivery times and those below 50 indicate slower delivery times compared with the prior month.

Figure 2 shows a sharp drop in late 2020 as suppliers' delivery times in the US and the European Union (EU) hit record highs, an indication of either surging demand, widespread supply constraints, or a combination of both.

FIGURE 2: **IHS MARKIT'S SUPPLIERS' DELIVERY TIMES INDEX**

SOURCE: **IMF, IHS, MARKIT**



Another major clog in the supply chain is cross-border land transportation. According to the Business Continuity Institute, Supply Chain Resilience Report 2021, it was the most reported logistics issue for the companies surveyed. Figure 3 shows the percentage of organizations reporting logistics issues by transportation type. Organizations noted a significant increase in the number of supply chain disruptions encountered in 2020 compared with the previous year.

FIGURE 3: **PERCENTAGE OF ORGANIZATIONS REPORTING LOGISTICS ISSUES BY TRANSPORTATION TYPE**

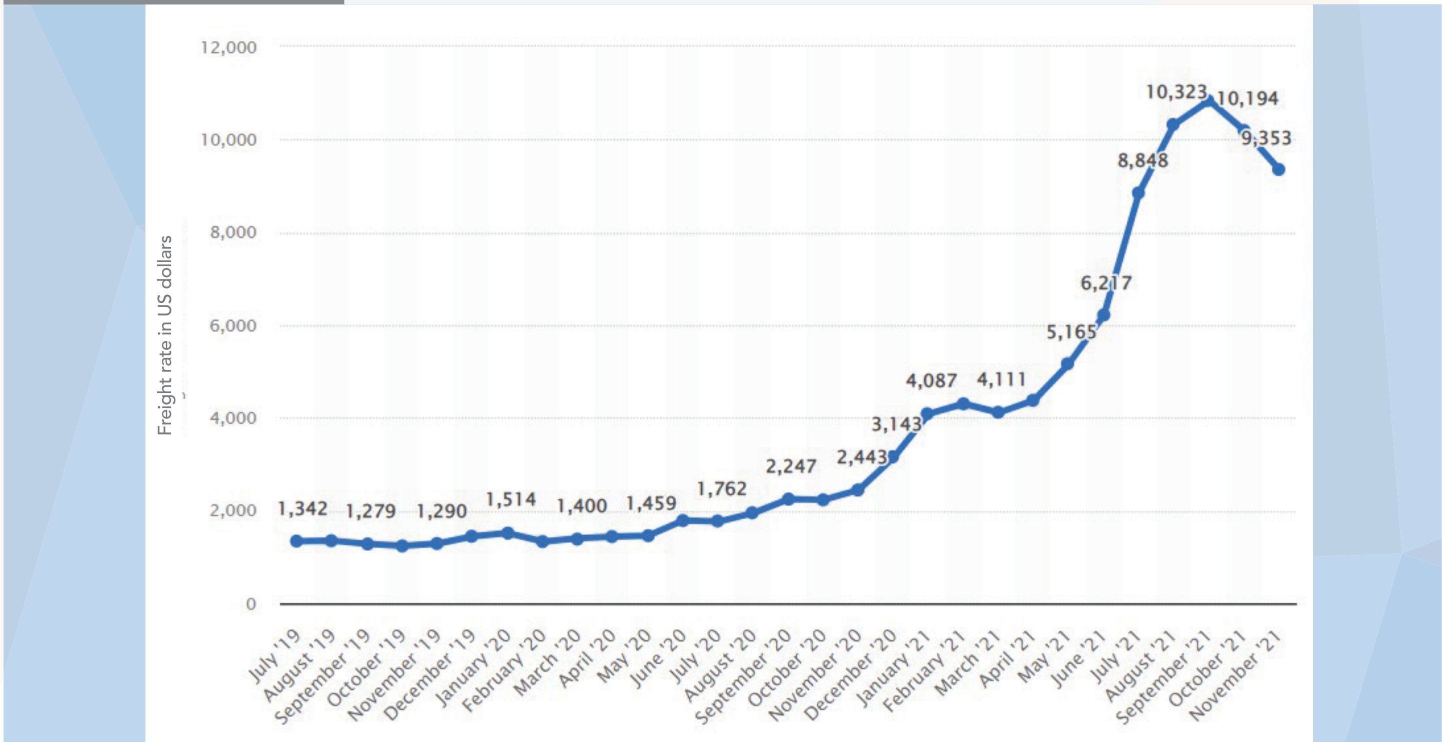
SOURCE: **THE BUSINESS CONTINUITY INSTITUTE, SUPPLY CHAIN RESILIENCE REPORT 2021**

Ports have also experienced high levels of congestion. COVID-19 lockdowns and outbreaks temporarily closed and reduced capacity at ports around the world. Currently, there are hundreds of container ships stuck at sea, waiting for prolonged periods, days, and sometimes even weeks, for dock space to unload. Additionally, in some countries, there is a worker shortage of truck drivers to remove containers from the ports. These disruptions have led to empty containers stacked up at some ports and a container shortage at other ports, thereby causing empty ships to ply the seas to pick up empty containers.

This has resulted in a sharp increase in the freight rate for containers in 2021 (Figure 4). The global container freight rate index reached a record price of over US$10,000 in September 2021 and declined to approximately US$9,400 for November, which is still much higher than pre-pandemic prices.

FIGURE 4: **GLOBAL CONTAINER FREIGHT RATE INDEX**

SOURCE: **STATISTA**

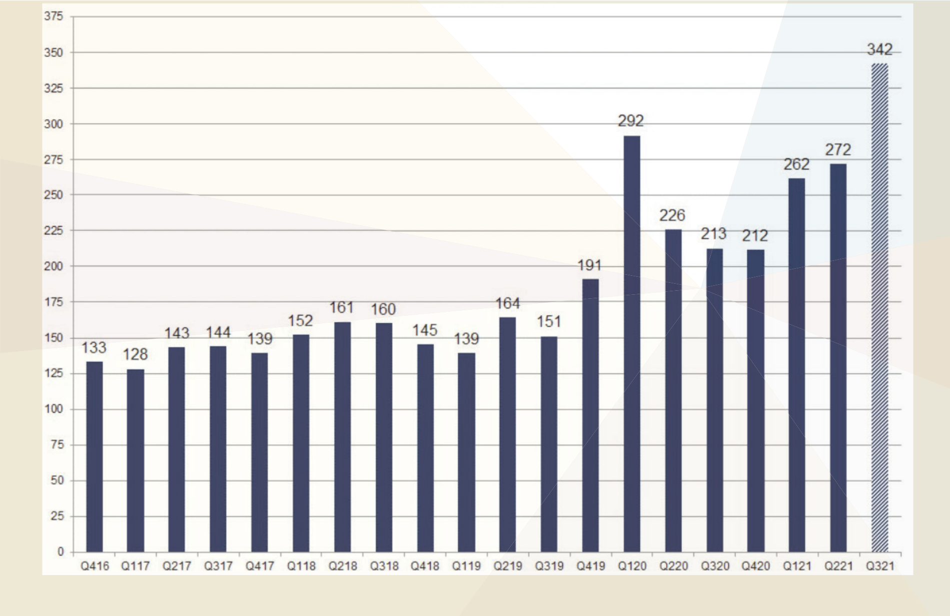


Businesses are also feeling the effects of the disruptions. FactSet conducted a review of the transcripts of conference calls between S&P 500 companies with analysts to discuss Q3 earnings results during the period September 15 and November 19, 2021.

Of the 475 companies that reported Q3 results, 342, or 72%, mentioned supply chain. This is well above the five-year average of 178 and surpassed the previous record for the most frequent mentions set in Q1 2020 when 292 companies mentioned supply chain. Figure 5 shows the number of companies that mentioned supply chain over the last five years.

FIGURE 5: **NUMBER OF S&P 500 COMPANIES CITING SUPPLY CHAIN ON EARNINGS CALLS**

SOURCE: **FACTSET**

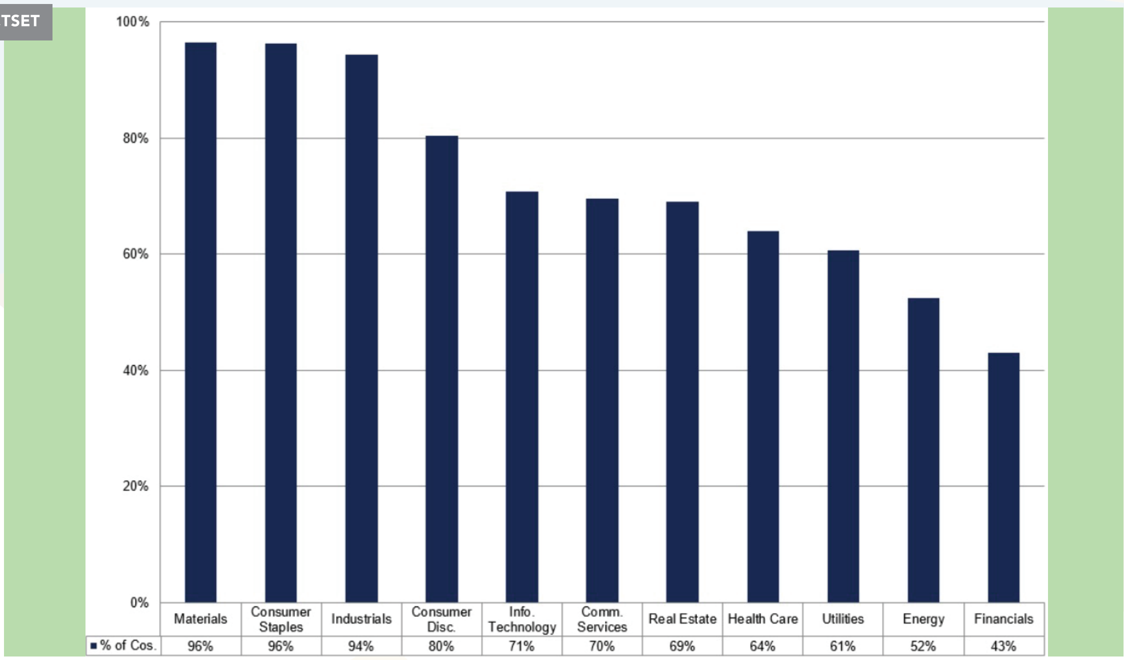


The data can be further broken down into sectors. Figure 6 shows the percentage of companies in each sector that mentioned supply chain in their Q3 earnings calls.

The top three sectors with the highest percentage of companies, all over 90%, are the Materials (96%), Consumer Staples (96%), and Industrials (94%) sectors.

FIGURE 6: **PERCENTAGE OF S&P 500 COMPANIES CITING SUPPLY CHAIN ON EARNINGS CALLS**

SOURCE: **FACTSET**



Several things are sure about a crisis, there is always some level of uncertainty about what will happen next, how (or when) it will end or, what its lasting impact will be.

Experts estimate that it will be at least a year until shipping returns to normal as shipping and manufacturers need time to clear the backlog. This can lead to lasting effects for consumers. According to the IMF, supply chain disruptions along with increasing raw material prices play a major role in the rise of consumer prices. The IMF is predicting that this global inflation will reach its peak at the end of 2021 and return to pre-crisis levels in many countries by the middle of 2022.

Investment Checklist

The current supply chain disruptions have shown the importance of investing in companies that are not just able to survive, but that are able to adapt and emerge stronger. Whether you are re-evaluating your current investment portfolio or looking to increase it, ensure that the business you are investing in has implemented the following steps to address the impact of the supply chain disruptions:

1. Recalibrated its supply chain strategies to increase focus on stability instead of primarily on efficiency and profitability with integrated demand and supply planning to optimize their operations based on expected customer needs.
2. Deployed strict category management for monitoring and processing all orders for the necessary inputs to the process.
3. Strengthened their Supply Chain Risk Management framework to monitor, evaluate and be able to eliminate any high priority gaps in their operation.
4. Developed a business continuity planning framework to ensure that there are plans in place for operations to continue no matter the disruption e.g. natural disasters or labour constraints.
5. Focused on improving their digital capabilities and automation to optimize their operations.
6. Increased their use of technology for supply chain mapping.

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