FISCHER STRALEM

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Dear Client:

In our current quarterly letter, we allude to the pandemic-driven disarray in the ocean-going supply chain and note the impact on businesses to meet a growing surge in demand. It is appropriate then, that the lasting memory in March was a photograph -- a container ship roughly a quarter of a mile long blocking the Suez Canal -- and a symbol of the past year's preponderance with the structure and fragility of global supply chains. The grounded ship was the latest hitch to entangle global trade this past year so that, what began as a shortage of toilet paper, cleaning supplies, and masks, has metastasized into a scarcity of semiconductors (forcing auto plants to shut production), supplies of crude oil and its derivatives (plastic), and the shipping containers themselves. As we have mentioned in prior communiqués, supply chains were bred to maximize efficiency as business sought to specialize and concentrate specific tasks in places that offered economies of scale and lowest pricing. Today however, like a ship which is too big to steer, supply chains are now a perceived source of vulnerability.

The blocking of one of the world's most vital transit hubs accentuates how several forces have come together to squeeze the world's supply chains, from the pandemic-driven rise in consumer demand for tech goods, to U.S. factory outages caused by extreme weather events. Today, the pursuit of optimal efficiency continues to come at a cost, creating more chokepoints for fewer inventories. It was only one year ago that we were horrified by the scramble for imported PPE and testing-kits, but it is far more significant that half of advanced semiconductors are made only in Taiwan and South Korea, and that China processes three quarters of the world's cobalt used in electric-car batteries (the same McKinsey analysis estimates China has monopolized the export of ~180 other products).

Global supply chains also rely on inter-governmental cooperation and détente, but as geopolitics have become more confrontational, and the decay of trading agreements makes countries wary of relying on each other. As governments battle the pandemic and manage rising social tensions many, including the U.S., are threatening to turn from the pursuit of efficiency towards resilience and self-reliance. It makes sense for supply chains to be more diverse and resilient -- when national security is at stake, governments have a role in making supplies more secure. But ideally, subsidies in pursuit of "domestic preferences" are justified only when a vital input relies on a monopoly supplier and is subject to potential interference. Some rare earth minerals fall into this category, hand-sanitizer does not.

U.S. firms reportedly have ~$36 trillion invested around the world, so the potential erosion of efficiencies, and expense of duplicating production chains would come at a steep cost. And we might expect many companies will look at increasing inventories to deal with future shocks, implementing a "just in case" strategy that provides a cushion in the event of trade frictions or global crises, which would supplement the current "just-in-time" inventory practice. This isn't a short-term risk -- supply chains are sticky and take time to adjust to new policies or changes in global trends. Companies have sunk costs into infrastructure and even with changes in legislation and trade wars, moving these facilities and re-routing supply chains is often prohibitively expensive. Globalization is the work of decades and, hopefully, we do not let it run aground.

Regards,

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