PACIFIC FUNDS insights

JULY 2021

IN SHORT SUPPLY

Temporary supply-chain bottlenecks and labor storages may fuel transitory inflation, but what's beyond that?

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Market Review

Market style factors reversed course over the second quarter, as small-cap value stocks fell behind their large-cap growth counterparts. Falling discount rates and concerns about the Federal Reserve (Fed) prematurely slowing down the economy due to inflationary concerns may have contributed to this shift toward defensive growth and away from cyclical value stocks over the second quarter. Fears of runaway inflation also helped real estate investment trusts (REITs). Moreover, malls and shopping centers have avoided mass defaults because banks have been willing to rework loans.

Within fixed income, higher inflation expectations amid still-ample monetary support spurred TIPS and high yield, respectively, to outperform the broader Bloomberg Barclays US Aggregate Bond Index. On the other hand, with the Fed keeping the Fed funds rate anchored, short-term bonds lagged the broader fixed income market.

Outlook

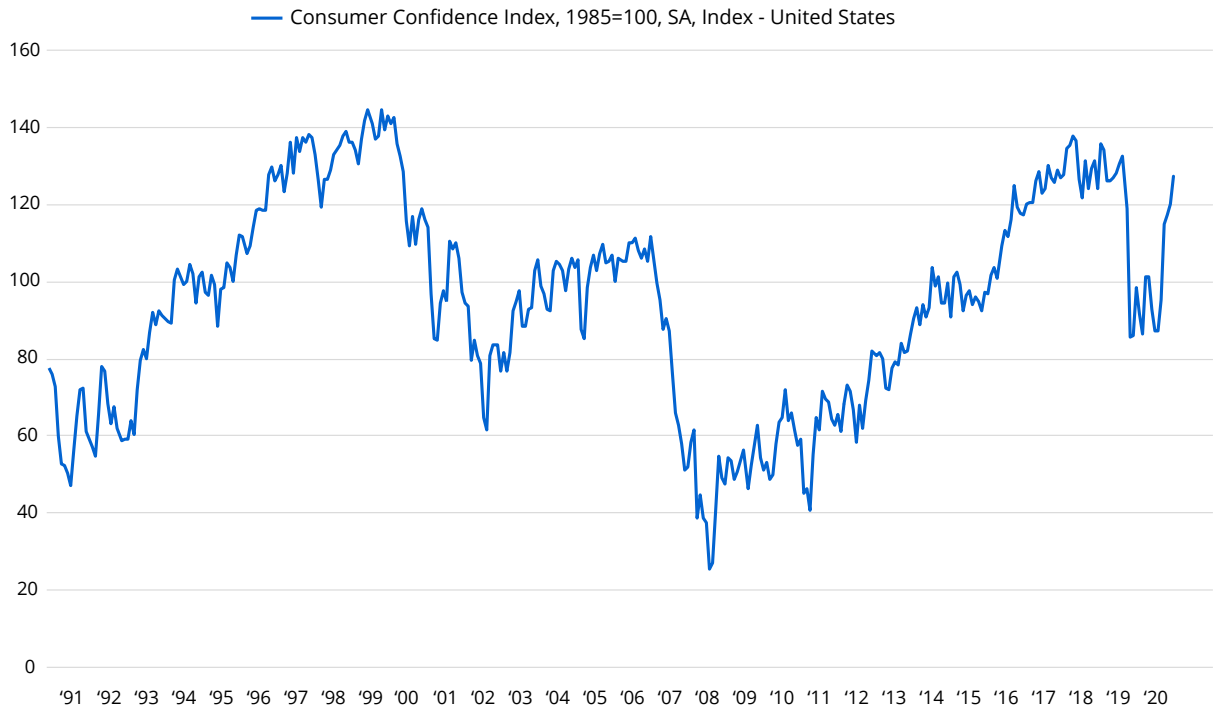
When it comes to inflation, we currently face short-term and long-term effects. Here we discuss some of those transitory effects as well as some that could be more lasting.

Short-term Inflation Impacts

Some of the recent run-up in inflation was driven by demand dynamics that may have been transitory. The stay-at-home conditions induced by the pandemic shifted consumers' consumption to products and electronic gadgets and away from entertainment and travel. This unexpected surge in demand for physical goods over services along with incidents such as the Suez Canal blockage has contributed to the rising inflation. While some may be transitory, others will have more lasting effects on inflation.

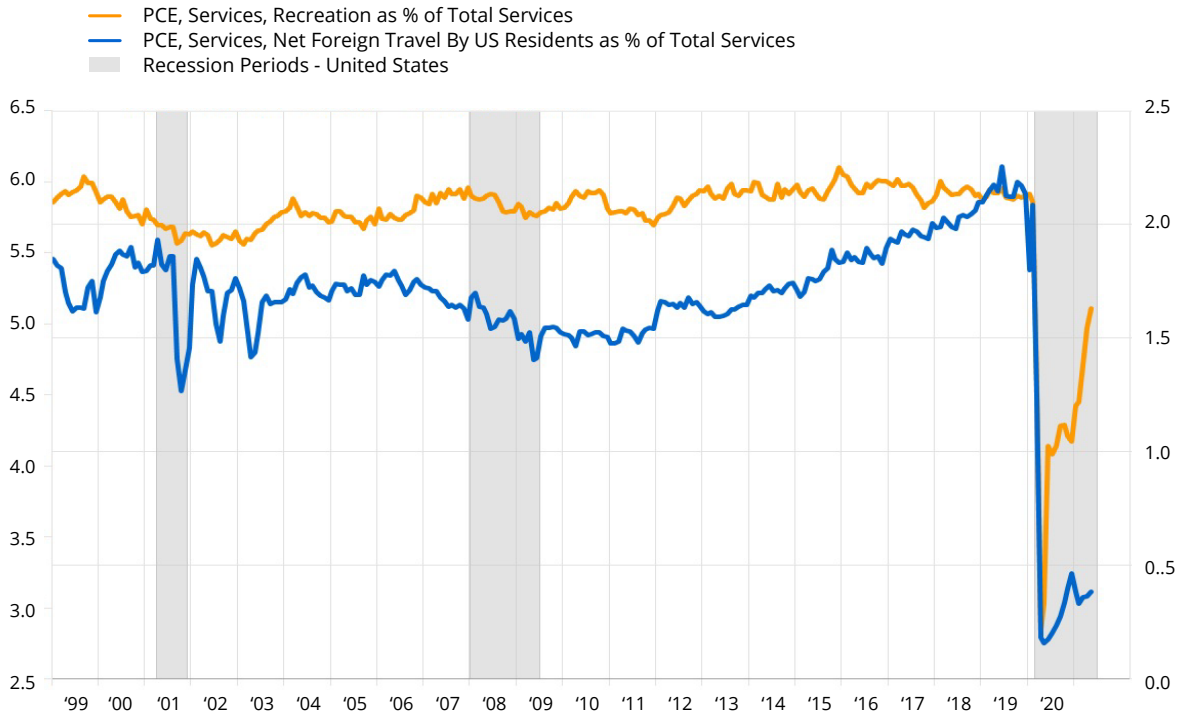
Demand

Extraordinary assistance from the federal government boosted consumer confidence.



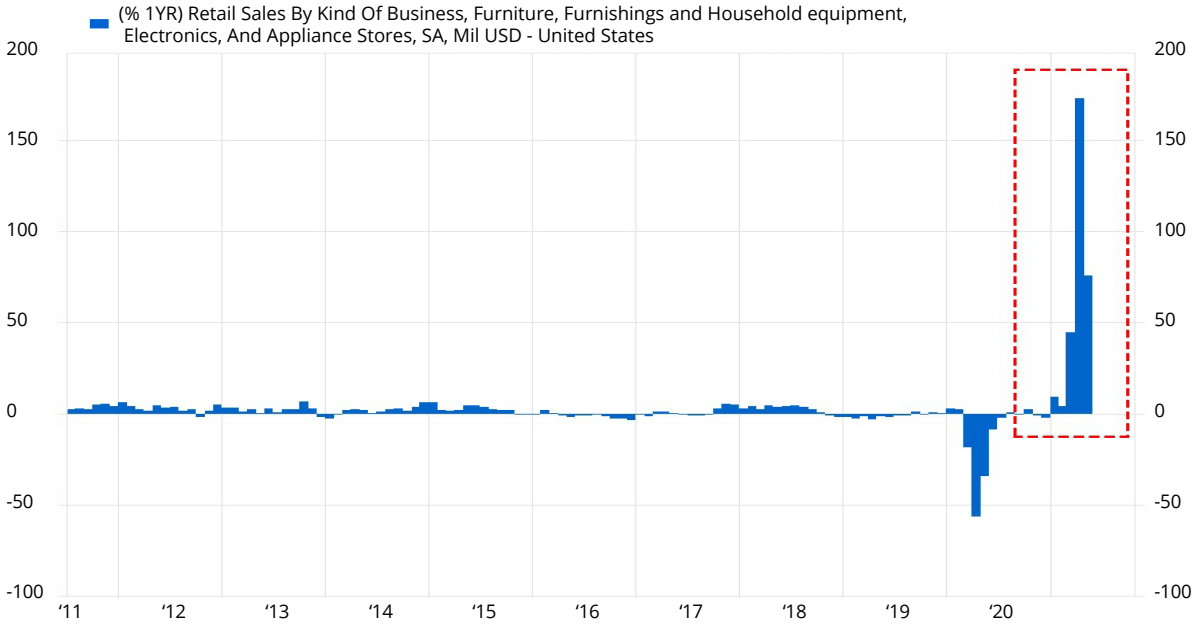
Source: FactSet as of 6/30/21

During 2020's statewide lockdowns, consumers could no longer spend on services like entertainment and international travel.



Source: FactSet as of 6/30/21

As they acclimated to the work-from-home lifestyle, consumers rushed to buy furnishings and electronics to improve the quality of the time spent at their residences.



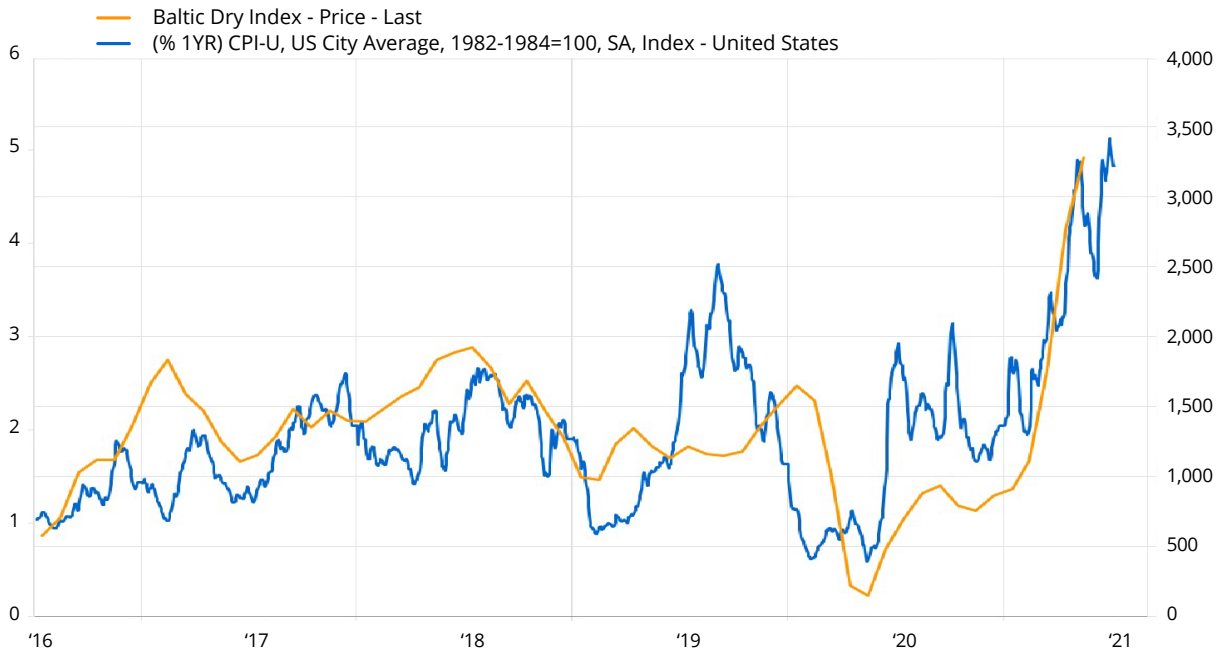
Source: FactSet as of 6/30/21

Shipping

The surge in demand is made evident by the rise in shipment activity. For instance, the Port of Los Angeles processed over one million container units in May, setting a record for and marking the 10th consecutive month of year-over-year increases.

The congestion is more jammed than Los Angeles freeways during rush hour, as some vessels have been forced to wait up to five days just to dock. It has been reported that it could take additional 10 days or more to unload shipments from ships to trains for their final destination.

Shipping costs (as measured by the Baltic Dry Index) have also climbed higher in recent periods. For example, the Drewry World Container Index showed shipping costs to the U.S. from China have surged 229% in a year to roughly $10,000. In comparison, the average cost from Shanghai to Los Angeles was less than $1,800 per container from 2011 to March 2020. As is often the case, businesses passed these higher costs to customers, causing goods prices, and thus inflation, to jump higher.

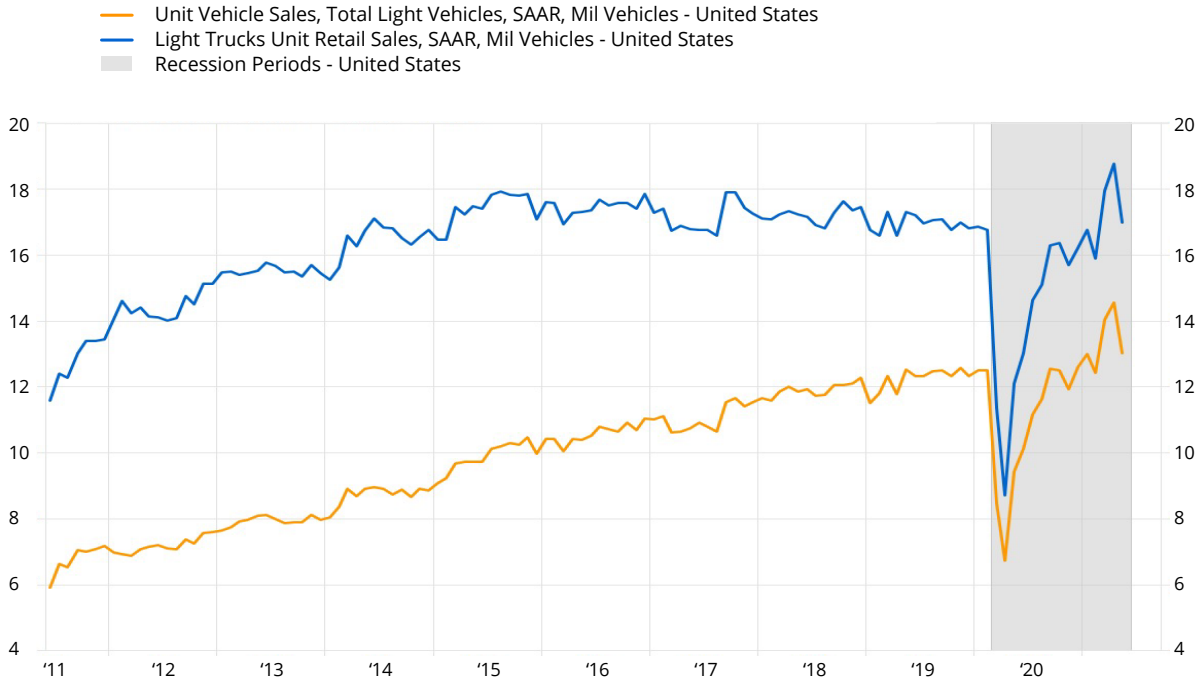


Source: FactSet as of 6/30/21

As logistics clear up, shipping costs will likely normalize, meaning that this inflationary pressure should be temporary.

Supply-Chain Bottlenecks

Despite a strong recovery in auto demand (particularly for trucks, SUVs and vans), car production has plunged due to a shortage of semiconductor chips.



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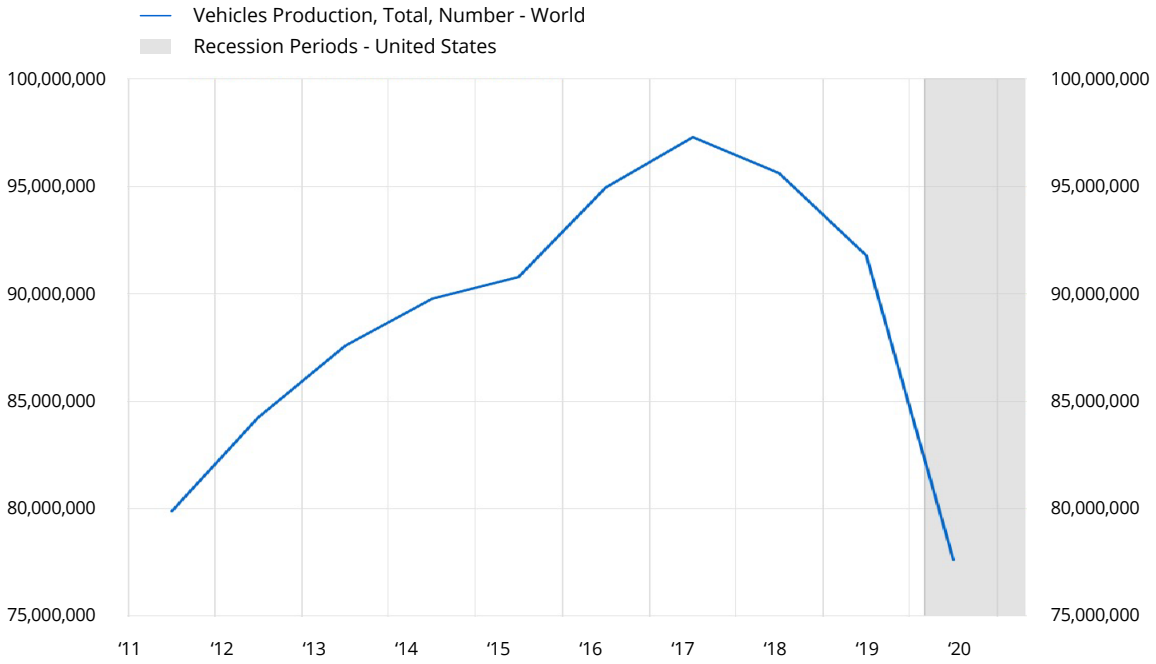
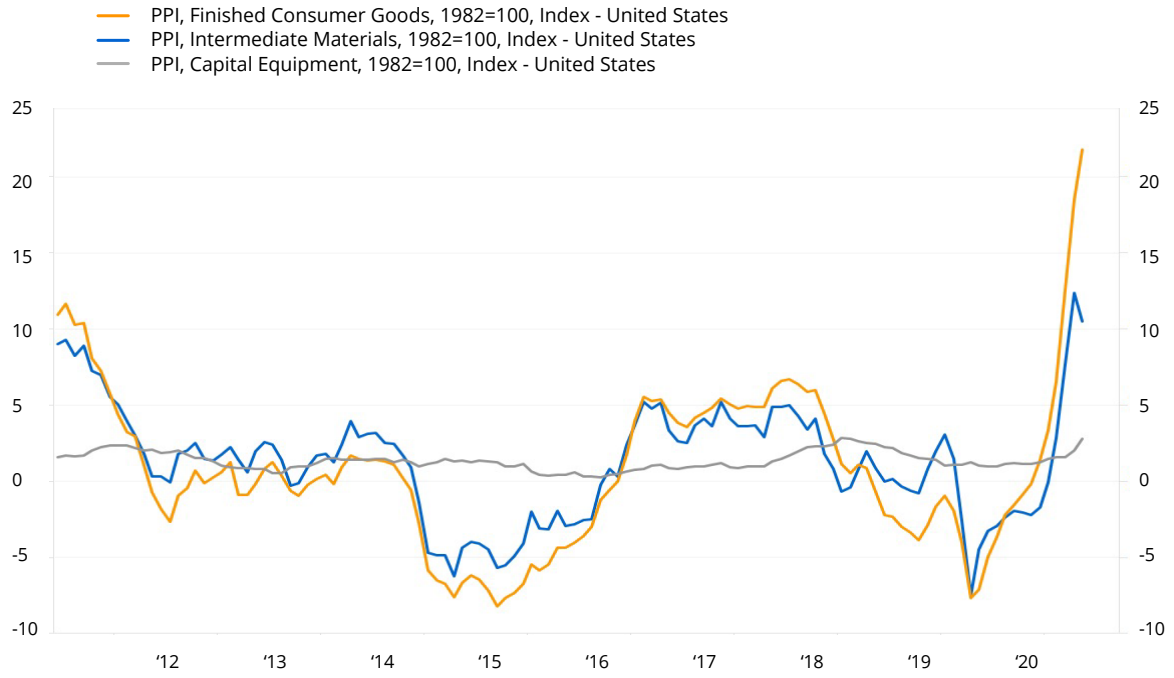


Source: FactSet as of 12/31/20

As indicated earlier, the semiconductor chip shortage stemmed from the surge in purchases of electronics and home appliances. We discuss these chip shortages in detail in our recent semiconductor Insights piece. This is an example of how one industry can disrupt multiple sectors of the economy.

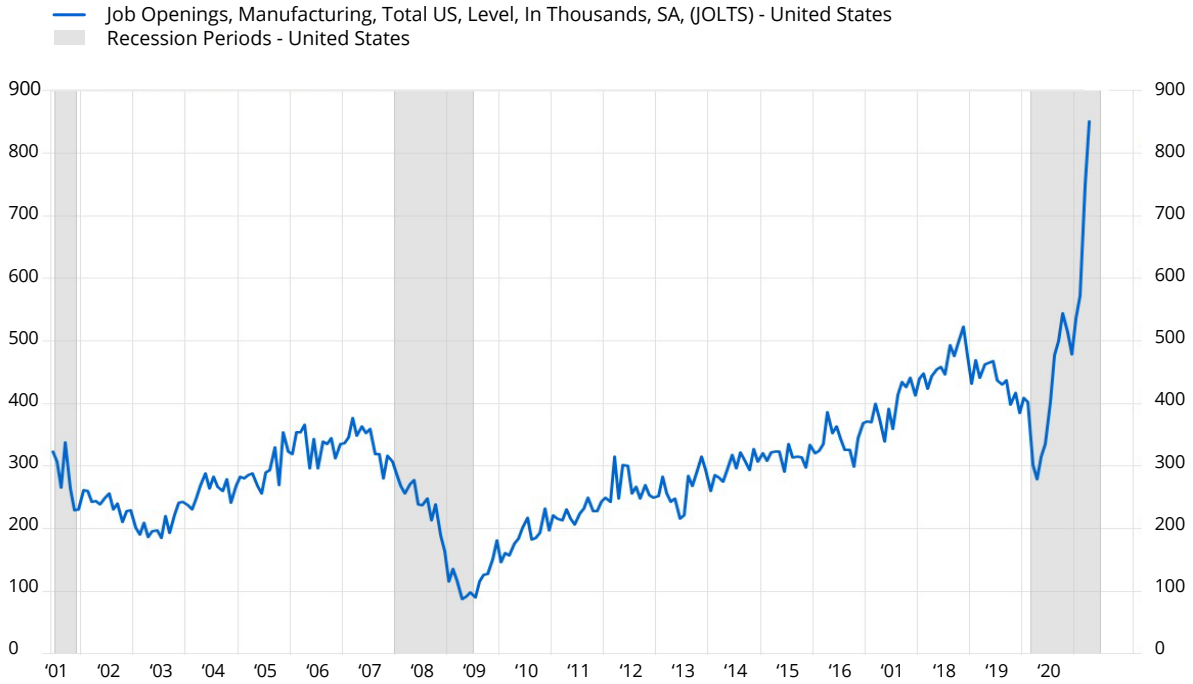
Supply-chain bottlenecks that disrupt supply can keep inflation heading higher, as producers are seeing their input costs rise.



Source: FactSet as of 6/30/21

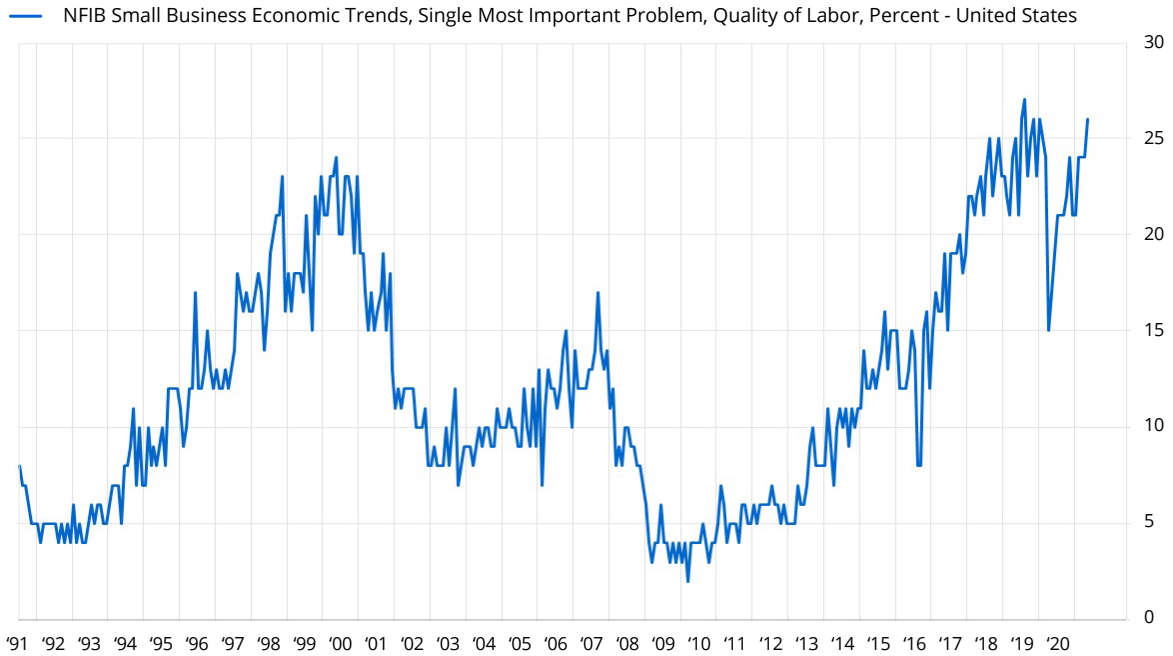
Although the Fed generally believes that these inflationary pressures remain transitory, supply-chain disruptions continues to keep prices inflated. Demand outstripping supply and labor shortages are contributing to rising cost pressures.

While the manufacturing industry recovered many of the lost jobs from the pandemic, a surge in manufacturing job openings illustrate the difficulty filling those spots.



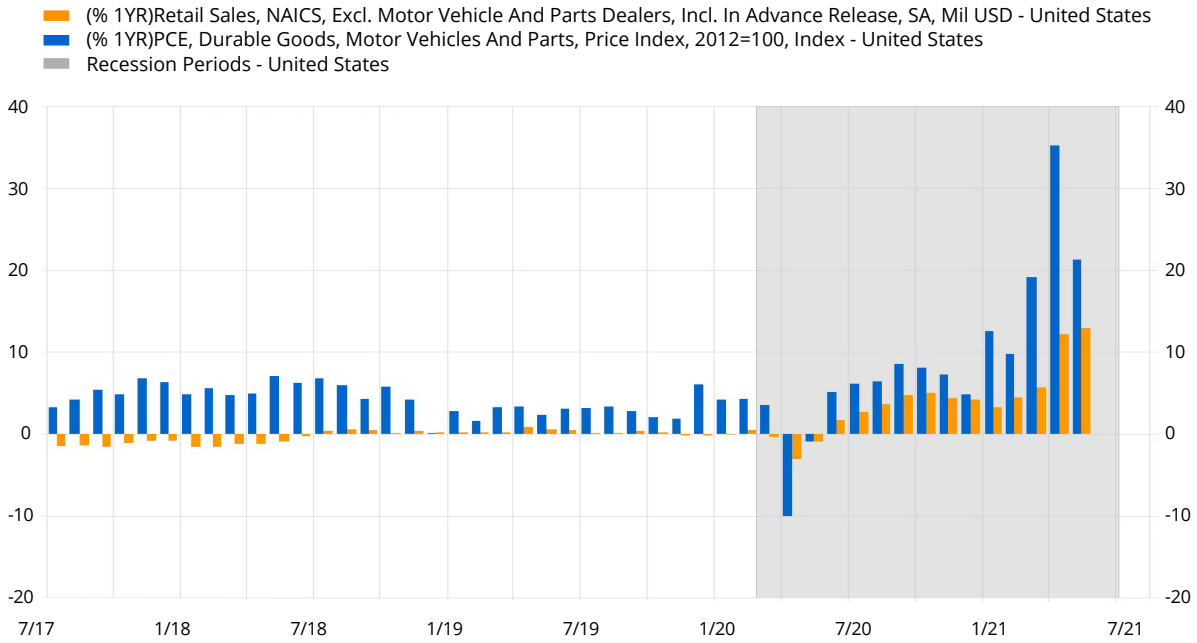
Source: FactSet as of 6/30/21

A skills gap may keep this mismatch lasting for a few years as manufacturers have found filling these positions difficult. As was the case prior to the pandemic, more than a quarter of small businesses surveyed by the NFIB have identified "Quality of Labor" as the single most important problem.



Source: FactSet as of 6/30/21

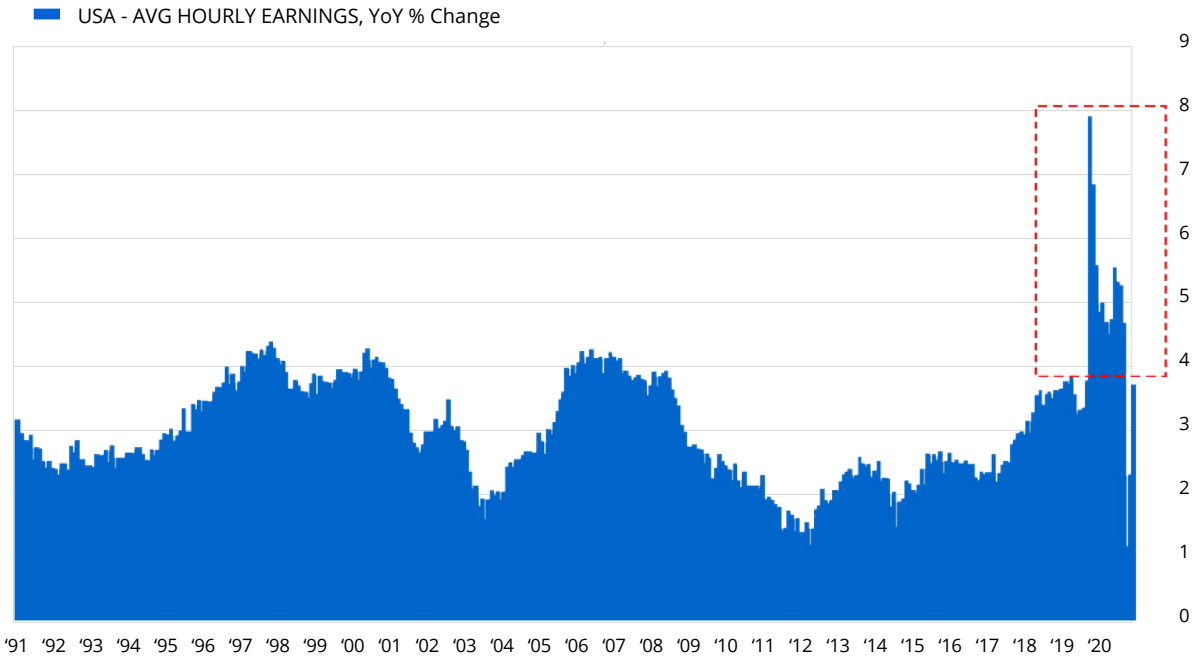
This means employers will likely need to increase compensation to attract potential hires. In general, wage inflation must occur in order to attract enough workers to allow production to run at optimal capacity. Otherwise, the labor shortage will remain a challenge for businesses that would otherwise be losing out on potential revenue. In other words, as long as demand outstrips available goods, inflation will continue creeping higher. This is particularly true for auto prices as the economy continues to reopen and individuals resume their normal driving patterns.



Source: FactSet as of 6/30/21

Labor

Businesses are beginning to raise income and compensation to attract workers. Whether this trend will continue as expanded unemployment benefits expire by September remains to be seen.



Source: FactSet as of 6/30/21

While some supply-chain bottlenecks may be transitory, persistent factors like rising wage inflation and demand exceeding supply could lead to higher overall inflation. This is especially true if businesses anticipate that consumers, whose savings swelled during the pandemic, have the ability to absorb higher prices. With higher earnings expectations leaving little room for margin compression, raising prices is the rational alternative for many manufacturers.

Conclusion

Evidence shows that companies face margin pressures from multiple sources. Rising CPI also indicates that producers have been passing along some of the costs to consumers. The question is how much more costs can companies absorb and will shipping costs determine how much inflation is passed onto consumers?

During the pandemic, American consumers bought electronics such as smartphones and laptops as well as other home products, which all contributed to the congestion in the global supply chain. The lockdowns spiked demand while simultaneously slowing production. The log jam in supply chains could improve when people begin to once again shift their disposable income spending to services such as travel and entertainment. Some of these trends are just now beginning to emerge.

Still, back-to-school and holiday shopping seasons will likely keep the ports busy, as cargo traffic volume is unlikely to ease until sometime next year. Until supply chains return to normal, shipping costs may stay elevated and keep inflation above-trend over the next few quarters. If the Fed shifts its current outlook and deems inflation concerning and persistent rather than transitory, then it would likely lead to correction across riskier assets, especially cyclical stocks and credit. Conversely, if inflation abates, these same assets could resume their rally.

Definitions

The **Bloomberg Barclays U.S. Aggregate Bond Index** is composed of investment-grade U.S. government and corporate bonds, mortgage pass-through securities, and asset-backed securities and is commonly used to track the performance of U.S. investment-grade bonds.

The **Baltic Dry Index (BDI)** is a shipping and trade index created by the London-based Baltic Exchange. It measures changes in the cost of transporting various raw materials, such as coal and steel.

The **Consumer Confidence Index (CCI)** is a survey, administered by The Conference Board, that measures how optimistic or pessimistic consumers are regarding their expected financial situation. The CCI is based on the premise that if consumers are optimistic, they will spend more and stimulate the economy but if they are pessimistic then their spending patterns could lead to a recession.

The **Consumer Price Index (CPI)** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living

The **Drewry World Container Index (WCI)** measures the bi-weekly ocean freight rate movements of 40-foot containers in seven major maritime lanes. It is expressed as an average price per 40-foot container (in US$).

The **MSCI EAFE Index** is designed to measure the equity-market performance of developed markets in Europe, Australasia, and the Far East.

Personal Consumption Expenditures (PCEs) refers to a measure of imputed household expenditures defined for a period of time. Personal income, PCEs, and the PCE Price Index reading are released monthly in the Bureau of Economic Analysis (BEA) Personal Income and Outlays report.

The **Producer Price Index (PPI)** published by the Bureau of Labor Statistics (BLS), is a group of indexes that calculates and represents the average movement in selling prices from domestic production over time.

The **S&P 500 index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market.

Treasury Inflation-Protected Securities (TIPS) are a type of Treasury security issued by the U.S. government. TIPS are indexed to inflation in order to protect investors from a decline in the purchasing power of their money.

It is not possible to invest in an index

About Principal Risks: There is no guarantee the Fund will achieve its investment goal. Asset allocation and diversification do not guarantee future results, ensure a profit or protect against loss. Although diversification among asset classes can help reduce volatility over the long term, this assumes that asset classes do not move in tandem and that positive returns in one or more asset classes will help offset negative returns in other asset classes. There is a risk that you could achieve better returns by investing in an individual fund or multiple funds representing a single asset class rather than using asset allocation. A fund-of-funds does not guarantee gains, may incur losses and/or experience volatility, particularly during periods of broad market declines, and is subject to its own expenses along with the expenses of the underlying funds. It is typically exposed to the same risks as the underlying funds in which it invests in proportion to their allocations.

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