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Transportation Costs Put the Pedal to the Metal

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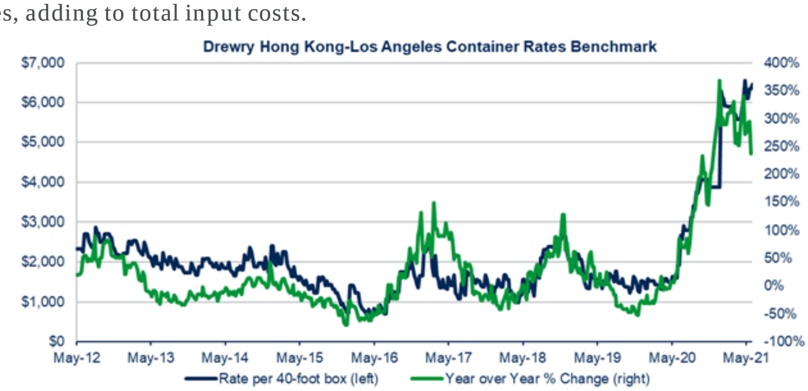
Rising demand for goods, combined with supply chain disruptions, is causing delivery times to soar as transport costs rise. Prices in several areas of the economy are rising, which we view as largely temporary. However, in some areas, such as transportation, "temporary" may last well into 2022. When the crisis hit, the world shut down and companies, many of which faced huge uncertainty about future demand for their products, reacted by cutting production and drawing down inventories. However, following unprecedented levels of government support, it became apparent that fiscal and monetary policies were supporting demand. This resulted in a surge in consumer demand for goods, efforts to rebuild inventories, and a strong rebound in single-family construction, all of which boosted demand for transporting goods.

Source: Bloomberg, as of June 3, 2021.

Bottlenecks are resulting from a number of factors: extreme port congestion, inefficient use of containers given logistical challenges, and a shortage of drivers that began prior to COVID and has only worsened. A lack of availability of containers has quadrupled their price, with a 40-foot box jumping from about $1,500 prior to the crisis to over $6,000 in May 2021. Labor shortages, due to COVID and tighter government regulation capping working hours for those at work, is leading to higher wages, adding to total input costs.



Source: Bloomberg, as of June 3, 2021.

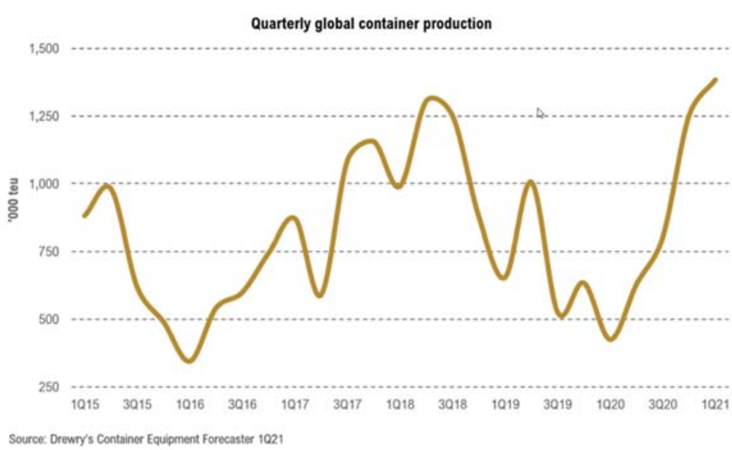
Many economists—and the Federal Reserve—argue that price pressure from these supply chain imbalances and the reopening boom is temporary; the question, however, becomes "how long is 'temporary'?" Barings' investment teams see prices associated with the transport of goods remaining at elevated levels over the next 18 months for a number of reasons:

- While we are currently at what is normally low-season for domestic shipping, the already near-record demand will only rise during the August-December holiday season;
- Strength of the single-family construction market, and the likely passage of an infrastructure bill in the U.S., should further boost demand for materials and transport;
- We have become accustomed to ordering goods with the click of a button, but shipping that order across the country or ocean doesn't happen as fast, and neither does the rebalancing of the transportation system. For instance, the major hurricanes in 2017—which caused a much less severe shock than the COVID disruption—required nearly a year for domestic shipping to normalize again, so expect it to take longer this time.

In the U.S., the average share of transport costs in the final retail price of produce before the pandemic was about 25%; now it could be close to 40%, due to higher transport and fuel prices. This helps explain a portion of the recent jump in U.S. producer prices, though costs have increased on other global routes involving Asia and Europe, so the price impact will likely be felt there as well. The extent to which companies are willing and able to pass these higher costs on to consumers will impact the magnitude of the near-term rise in consumer price pressures.

Companies have responded to increased shipping demands by investing in container boxes. While this may initially raise concerns for the outlook once demand normalizes, our investment teams note the increase in production is not excessive, believing both lessors and companies are in good shape due to:

- About half of production increases are due to replacement from a slow-down prior to COVID;
- Demand for containers is strong;
- There is a long-term positive trend towards e-commerce, which should support the sector;
- Lessors are taking advantage of longer lease terms.



Source: Drewry's Container Equipment Forecaster, as of 1Q2021.

Overall, extreme supply and demand imbalances have caused severe disruptions throughout the sensitive transportation system. While this increases input costs for companies, some of which may pass a portion on to consumers in the near-term, prices are expected to normalize following the 2022 peak season as the transportation system rebalances.

Special thanks to members of Barings Transportation Committee including: Julie Niedzwiecki, George Stone, Jordan Alexander, and Austin Tucker.

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