Marble Harbor Investment Counsel, LLC
Third Quarter, 2021 Letter

We are pleased to send an excerpt from our third quarter client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb, Daniel Rosenblatt and Howie Cowan

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For a long time, inflation was nary a whisper. Today you can hear it loud and clear. It bellows when you go to the grocery store, when you fill your car up with gas, or if you try to buy a new car. Supply chain issues, shortages and unusual demand patterns are creating a daily rumble of inflation the likes of which we haven't heard for years.

In March of 2020, amidst the upheaval of the pandemic, car manufacturers forecast plummeting demand for automobiles and cancelled their orders for semiconductors. This turned out to be a grave error. They hadn't predicted that, out of health concerns, people would stop taking public transportation and start driving more. As people sought to get back to work and their lives, demand for vehicles rose rapidly, quickly clearing out new and used car lots. Vehicles couldn't be manufactured without semiconductor chips, and so as inventories plummeted, the prices of both new and used cars increased dramatically. For example, used car prices are up an unheard of 40% over last year. The shortage is so acute that some of our colleagues have been approached by car dealers with offers to buy back their used cars. Perhaps this has happened to you too. The semiconductor shortage is driving up prices in numerous other products as well.

In a normal recession, consumer spending falls as people lose their jobs and those who remain employed cut back. The pandemic was unique. With massive direct stimulus both here and in other countries, after pausing briefly, consumers kept spending. Without the options of eating out or travel, they spent on durable goods, and demand for stuff remains strong. By now it's commonplace to hear of furniture and appliance deliveries being delayed for 6, 9 and even 12 months.

There is another effect of this change in behavior: increased savings. Both companies and consumers have been experiencing prodigious cash flows. While on the one hand they've been on a spending spree, they've also been retiring debt and salting away cash for a rainy day. In the short-term this represents a slight drag on the economy, but given how well it is performing overall, we see that as a minor problem and are optimistic about its impact on the future. These renewed balance sheets and cash piles will support future spending, which bodes well for the sustainability of this economic expansion.

Semiconductor shortages are only one source of inflation, while another is energy. Several factors have pushed oil prices up 66% this year. First and foremost, the sharp rise in demand for oil and gas has led to a supply/demand imbalance. In the past, shareholders reluctantly tolerated the extreme swings in profitability caused by cycles of over-investment in production that resulted in falling energy prices and then a contraction in spending that was followed by shrinking production and an eventual recovery in prices, which inevitably led back to the beginning of the cycle. Investors have said "Enough." Capital discipline is now the name of the game, as we see the rising use of alternatives and conservation impacting the outlook for oil and gas over the next 30 to 50 years. Thus, return of capital and dividends are more appealing. In short, discipline may finally be taking over wildcat culture. At the moment, this produces bottlenecks and higher energy prices, but it may also establish the glidepath for a profitable sunset of fossil fuels as they give way to cleaner forms of energy.

Additional hurdles include the supply disruptions caused by Hurricane Ida, prospects for a cold winter in both Europe and the U.S., rising electricity demand (which is now often generated from natural gas) and low inventories of natural gas in the U.S. and Europe. This has all contributed to the 135% year-to-date rise in natural gas prices.

In China, there are rolling blackouts because of exceptional demand for electricity, reduced stocks of coal and natural gas, and government closures of coal plants for emissions control. China is buying all the natural gas it can, outbidding the Europeans for Russian gas. This has caused prices to spike in Europe to a record $27 (quadruple U.S. prices). ESG considerations have exacerbated the situation, with the Dutch recently shutting off a huge gas field, forcing some European manufacturers to stop production. Many worry that Europe could have trouble heating homes if they have a cold winter.

This squeeze in oil and gas prices will filter into the economy as another pervasive source of inflation. Energy is used to produce all goods and services. One of the unintended consequences of carbon net-zero is a global increase in inflation that is unlikely to abate until renewable energy becomes predominant, an achievement that lies many decades in the future. Of course, there is a countervailing cost to continuing to use fossil fuels – the cost of global warming. This bill has been a long time coming, but may be with us for the foreseeable future.

You may recall that at the outset of the pandemic we wrote about how supply chains were far too delicate to handle the shock of something like COVID and that companies were going to have to invest in redundancy and capacity to make their businesses more resilient in the future. The future is here, but the investments have yet to take hold. Most consumer goods are still made in Asia. The aging port infrastructure in the U.S. was not built to service the number of ships it is seeing. Nor are there enough dockworkers to move the cargo, or truck drivers to haul it away. The American Trucking Association notes that there is currently a shortage of 60,000 truck drivers. All of this has led to record backlogs of ships waiting to unload their cargo. The port of Los Angeles has more than 70 container ships that have been waiting offshore for at least two weeks to unload their cargo. The East Coast ports are no better. Consequently shipping prices, are up *5 times* compared to pre-pandemic levels. These disruptions in the supply chain make their way into prices, creating inflation in goods and delays in delivery.

What all these problems have in common is that people think they are temporary. With this mindset, there is little focus on solving the long-term issues. The ports think this spike in demand is temporary, so they won't build more docks. The oil companies think the spike in oil and gas prices is temporary, so they won't drill more wells. The longer these issues go unaddressed, the longer the chokepoints will persist. Unfortunately, none of these challenges has a quick fix.

As we mentioned, there aren't enough truck drivers, nor are there currently enough workers willing to fill all the job vacancies. In fact, there is more than one job opening for each unemployed person. This is great news is you're looking for employment. The average job changer is making 4% more in their new job. But if you're an employer, this is an additional cost, and it too will filter into inflation. Wage inflation is stickier than oil prices – once you give someone a raise, it's hard to take it away.

Wage inflation, high energy prices, supply bottlenecks and insatiable demand will conspire to keep prices high. The Fed thinks that this phenomenon will be "transitory," but we have a feeling transitory may last longer than Chairman Powell would like. This is not to say that prices (or the economy) are going to gallop along at a consistent clip. Rather we expect a choppy march ahead, as is characteristic of an economic boom following a natural disaster like the pandemic. Eventually the percentage increases in prices will ebb; however, that will be at a higher level than we are seeing today.

What does this mean for your investments? Over time, the quality companies that you own should be able to pass along higher costs to their customers, helping them to grow sales and earnings. Long term bonds, which we have avoided for years, will continue to suffer. The shorter-term bonds you own can be reinvested at higher coupons as rates rise, and this will support modestly rising income.

How inflation turns from a murmur to a roar is always confounding. We can't say how long it will stay this time around, but we can say that your portfolio was and is positioned to have staying power in the sort of economy that we see ahead.

Please don't hesitate to contact us if you have any questions.

Sincerely,

Paul, Eric, LJ, Dan and Howie

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