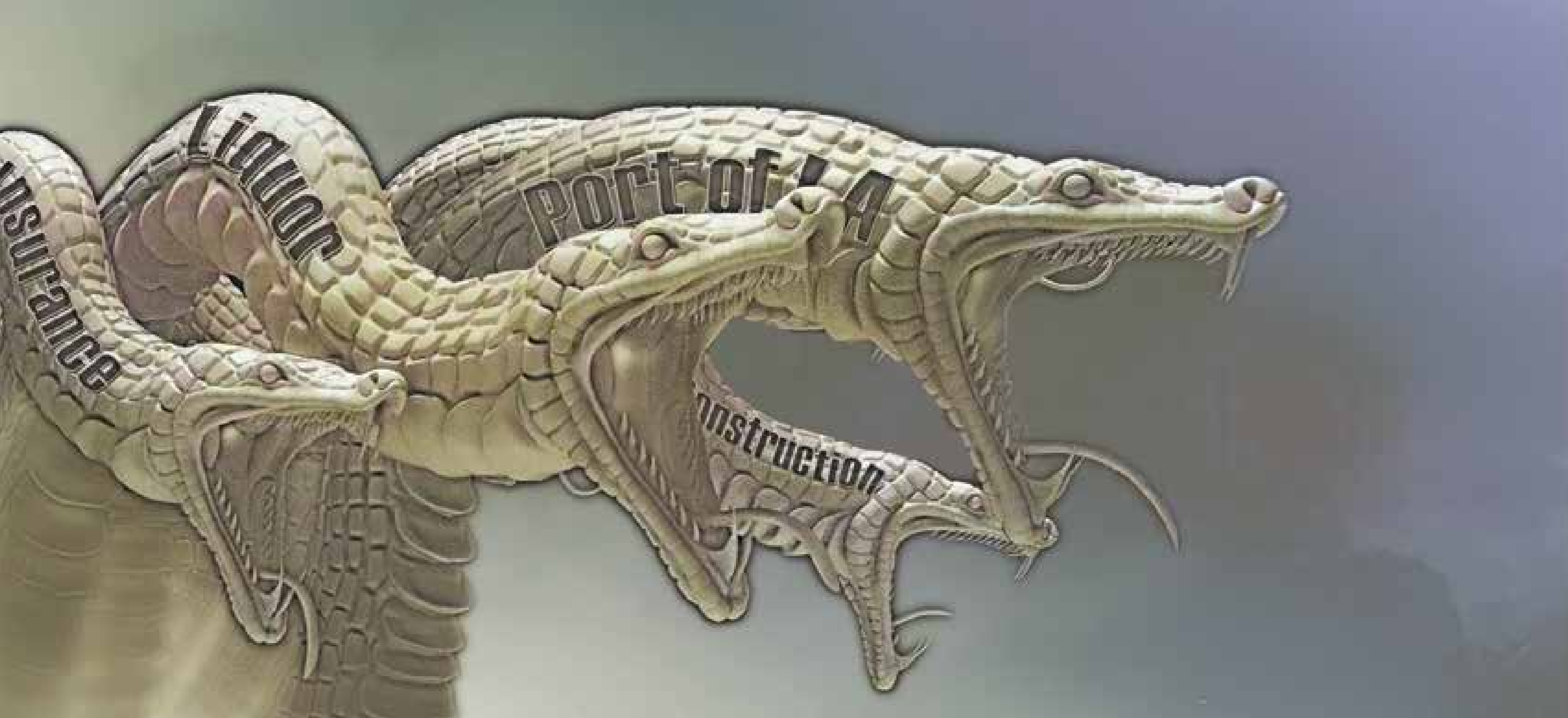


SUPPLY CHAIN & THE INFLATION HYDRA

It should come as no surprise for regular Profit readers that inflation is turning out to be a much bigger and not-so-transitory phenomenon. I started writing about this almost a year ago now. In the pre-COVID years, from my vantage point running Metros Capital, I watched as QE-induced asset inflation silently waged war on standards of living across the US and large parts of the rest of the world. With CPI and PPI flashing red and house price and apartment rent charts starting to look like altcoin charts, even the Fed is backing away from the "this is transitory" story.

The dominant optimistic narrative around inflation today is that what we're seeing today is still ultimately a function of transitory supply-chain related issue. Yeah, maybe things are taking a little longer to sort out but eventually they will. Or so the story goes.

On the other side of the debate, people are thinking we're basically at the onset of the long-awaited for hyperinflation. This includes, of course, all the usual cast of characters—the gold bugs and the sound money philosophers—but also some newcomers like crypto enthusiast Twitter founder Jack Dorsey.

Jack's Tweet set off a virtual storm of likes, dislikes, debates, quotes, retweets and vitriol. It even spawned a predictable side debate between the gold bugs and Bitcoin maximalists about whether gold or Bitcoin was the better hyperinflation hedge. I hate to break it both sides in this fight but there's no amount of gold or Bitcoin that will help you if hyperinflation comes. You might feel comparatively better than others but your society will be crumbling before your eyes. Your standard of living will be wrecked whether you own gold or Bitcoin or not.

I think the answer lies somewhere in between these two opposing camps. Inflation is here to stay and will be much higher than people expect—uncomfortably so for households and for the Fed—but we'll probably avoid hyperinflation, at least in the big, developed economies. It takes a rather unique set of circumstances for hyperinflation to set in and ultimately it's more a function of a sudden and profound loss of faith in governance capabilities than economic and business conditions. I know these things are related but as bad as our government may seem, we're far from that.

In the pre-COVID days, inflation was largely a consequence of QE. The headline numbers were low but almost certainly underreporting real inflation in areas like multifamily rents, education and healthcare. Back then, it was easier for central banks to hide behind the veil of obfuscated statistics. Now, inflation is manifesting seemingly everywhere and there is nowhere or no way to hide. So called supply chain anomalies keep popping up all over and, like a hydra, the second one of these situations gets resolved, another emerges. From PPE equipment to semiconductors to lumber to concrete to steel to the price of transoceanic shipping…On and on it goes.

Here's the problem: the end result of all these inflationary flare-ups is a permanently higher price level somewhere in our economy. Lumber is a great example of this. When it had its moment, the price went parabolic for a while, rising from around $280 per board foot to almost $1700 per board foot. As things calmed down, prices came off a lot from these highs—you could even say they crashed—but they are still in the $500-$700 range today. For most of the previous decade, lumber traded in the $300-$400 range, so we're talking about a serious increase here.

Lumber

Source: Tradingeconomics.com

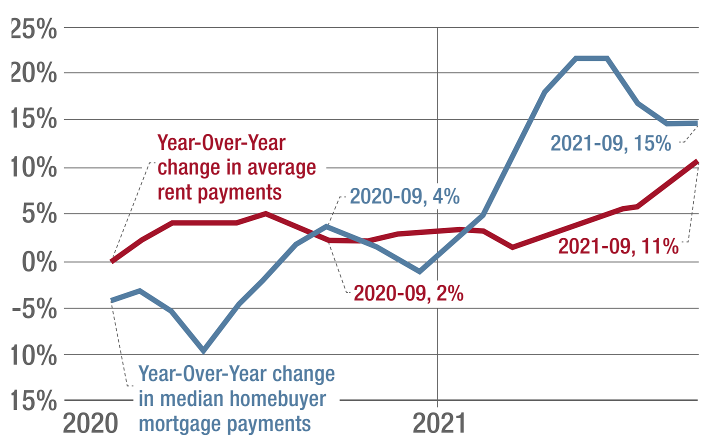
Make no mistake about it, prices are still rising in construction and rising fast. At Metros Capital, we recently went out to bid on one of our projects, a midrise concrete tower in Hancock Park, one of the best neighborhoods in all of Los Angeles. To be fair, this is an ambitious project—11 stories of twisting concrete over two levels of subterranean parking designed by a visionary architect Lorcan O'Herlihy.

Our experience estimating and bidding this project sadly demonstrates perfectly what's happening with inflation in the real economy. This project was estimated to cost $10M when we designed it all the way back in 2018, $13M when we bid it in the summer of 2020, $15M when we bid it in early 2021 and just this week the latest bids came in at $19M. So, we're

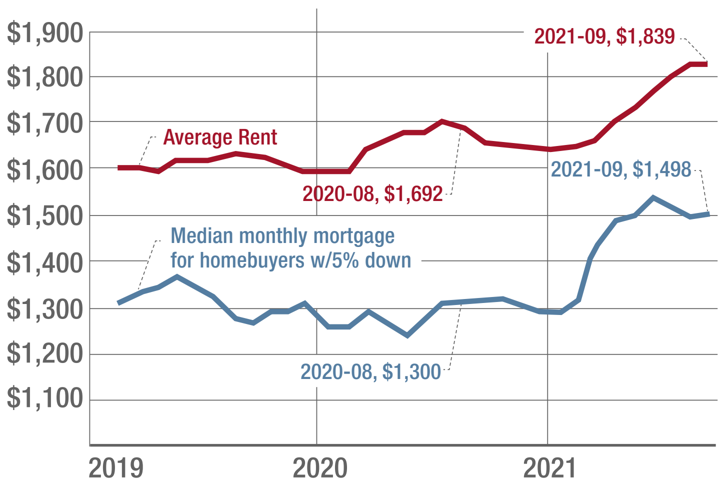
talking about a 90% increase from 2018 and almost 50% over the last 12-months. Interestingly and perhaps not-so-surprising given all the news flow about the supply chain, most of that 50% increase over the last year is due to materials pricing.

I don't know what we are going to do with this project now. We cannot build it for $19M, that's for sure. The deal economics just don't make any sense at that cost. Rents are rising fast in LA but not at 50%! Plus, even if they were, LA has rent control. We'll probably have to redesign to something less ambitious or maybe not build anything at all. I suspect many developers around town are facing this same dilemma. In the end, what this inflationary pressure is going to amount to is even less new supply, as developers scale back their plans. This, in turn, will pave the way for even more inflationary pressure in the existing stock (both in terms of rent and asset value). You can see so clearly how this vicious cycle will go. And remember, inflation is already running out of control in real estate:

Rents and Homebuyer Mortgage Payments Both Rising Sharply in 2021



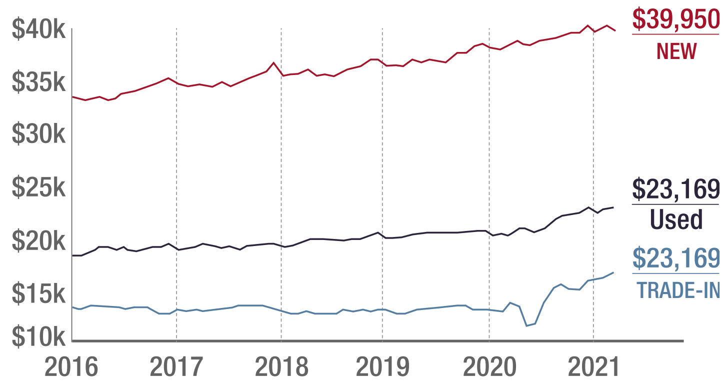
Source: Redfin analysis of asking rents & home sales from the MLS & public records
Note: Mix of homes for rent and homes purchased are not directly comparable.



Source: Redfin analysis of asking rents & home sales from the MLS & public records
Note: Mix of homes for rent and homes purchased are not directly comparable.

Climbimg car prices

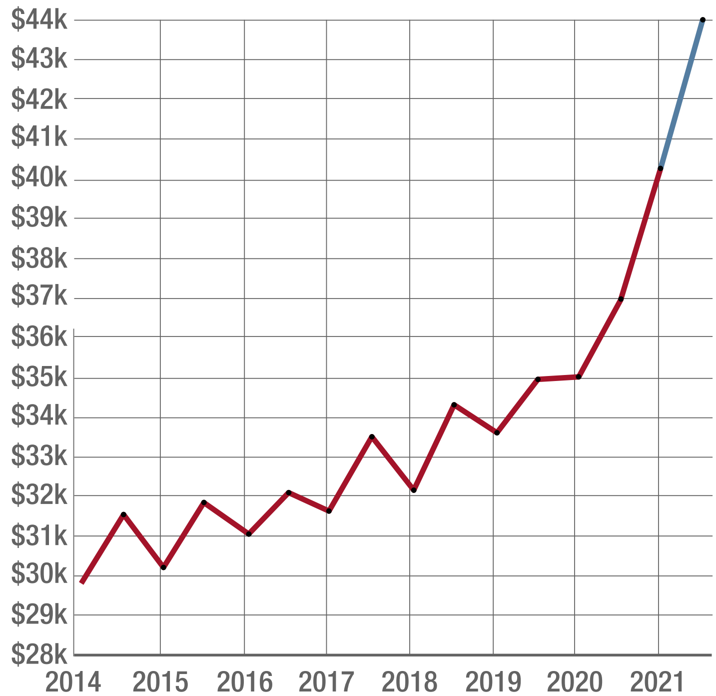
Average cost of a new, used and trade-in vehicle.



Source: Edmunds.com

Every transaction price of new vehicles

Every year: December & June; October 2021



Source: J.D. Power

Similar things are happening in other industries as well. One of my family members is a supply chain executive at one of the largest alcohol companies in the world. We caught-up recently and as he was describing his working environment for the last eighteen months—basically a series of back-to-back, seemingly unrelated crises—this idea of the inflation hydra came to me. As part of a "global supply chain crisis resolution team" he has been spending almost all his time going from one fire drill to the next. First, they had a problem with a glass supplier. The story there is a good example of whatever is happening in the labor market. Apparently, their main supplier used the COVID crisis as an opportunity to "right-size" their employee base and offered early retirement. They lost so many people and so much expertise, they can hardly run the company anymore! Then, they had a problem sourcing a certain kind of paper used for labels. Then they started struggling with booking transportation and started running out of warehouse space. In each case, the resolution of the "anomaly" was a higher input cost. Interestingly, when I asked him if they started passing along these increased costs to consumers he said "not yet." I guess that's the benefit of being in a super high margin business. I wonder though how long can that last?

The more research I do, the more concerned I get. Even though many of these inflationary situations are manifesting as seemingly transitory anomalies, when you get underneath and into the deals you realize that things are not so simple. Take, for example, the car market. What started off as an acute problem in the form of a semiconductor shortage has now turned into an all-out inflationary assault across the entire supply chain, everything from base metals, to rare earths, to rubber for tires. Prices for both used and new cars have been ripping higher:

And auto manufacturers around the world have signaled that they are permanently raising prices.

What's happening at our ports is another good example. Here in Los Angeles, I am part of a civic activist group called the LA Coalition. It's basically a bunch of leaders from business, education and the non-profit world who care enough about the city to try to make some difference now and then in important public policy matters. The other day we had an opportunity to meet with Gene Seroka, the head of the LA port, to discuss the situation there. What I learned in that meeting was sobering. No, the situation at the port is not getting any better anytime soon.

The current crisis there is long in the making and not really addressable in the short-term. We're talking about a nation-wide shortage of over 30,000 truck drivers, where 30%-40% of all available truck pick-up slots go unused each day at the port, warehouse occupancy at 99% across the Southland and a bunch of companies who are stuffing trade channels with just-in-case inventory orders. Gene told us there's so much uncertainty around delivery from China, both in terms of timing and quantity, that big American retailers are planning to spend the first half of 2022 aggressively stockpiling their most valuable items.

At the time of our meeting, there was something like 70 ships at anchor just waiting to get into the port and another 30 on the way. The timeline for a typical container coming from Asia looked like this:

13 days to cross the Pacific
12.5 days at anchor
5 days sitting on dock
9 days on a truck or train to a warehouse

And who knows how long these goods and materials sat on the dock in Asia….It's taking twice as long to get from the port to a warehouse as it does to cross the entire Pacific Ocean. What's crazy is that this is the timeline after a 50% improvement in productivity at the port. Makes you wonder what was going-on before.

No story like this would be complete without a dramatic example of good intentions gone wrong. One of the main issues right now at the port is simply just a lack of physical space to place containers while they wait to be picked up by trucks and trains. Gene and his team identified some adjacent industrial properties that could serve perfectly as over-flow staging areas. But of course, when the anti-everything powers got wind of the idea they threatened an environmental lawsuit--using CEQA, a much abused state-level environmental law, to stop the port. I want to say "Only in California" but that's probably not even true these days.

I'm starting to see signs of inflation in ordinary life as well. I tried using Uber the other day for a lunch meeting just a few miles away from my house. Not only was the estimated price ridiculously high—something like $25 for what used to cost less than $10—the pick-up time estimate was over 20-minutes. I opted to take the scooter. Later that day, I looked into the Uber situation a bit and discovered that higher prices and long wait times was a thing. No wonder Uber was finally able to report a quarterly profit! Their service might be completely unusable and more expensive than taxis but at Wall Street is happy. So much for the promise of innovation and deflationary disruption.

I noticed something similar with my caffeine habit. Part of my routine involves walking up from the house to Melrose for a cappuccino, usually in the afternoon when I'm starting to feel tired. I rotate steadily between Joe and the Juice, Urth Café and Strings of Life, all really good places. The Italian cappuccino at Urth is by far the best though. In the pre-COVID days, I was paying $4 or $4.50 and now it's more like $5.50 or $6.00. So, we're looking at 20% plus inflation for over-priced cappuccinos on Melrose. I looked into the coffee price chart and of course…

Coffee prices are soaring

Source: tradingeconomics.com

At least with something like this I can always just stop buying, as much as that would make me sad! But the same thing is happening with food prices in general:

Soaring breakfast prices are the latest sign of hot global food inflation

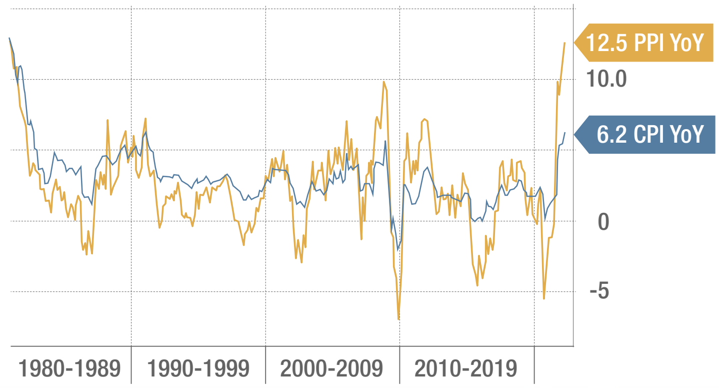
FT breakfast indicator (2019=100)

Average of US futures for coffee, milk, oats, orange juice, wheat
Source: Refinitiv, FT calculations

And you cannot just stop eating! The story here is a perfect example of the hydra-like nature of the problem. The issue first emerged when adverse weather conditions in some key growing regions started to hurt supply. At the same time, there was a surge in demand as economies around the world started to re-open and buying patterns changed to just-in-case instead of just-in-time. In normal more optimistic times, you might think that this would just resolve itself like all commodity price shocks. Planters would adjust their plans to respond to higher prices, the weather would return to normal and excess supply next season would solve the problem. But this time around, rapidly rising input costs like transportation (up almost 300% for some regions) and fertilizer (rising because of dynamics in the energy market) coupled with more just-in-case buying could very well overwhelm the traditional supply-demand dynamics. Food prices might stay higher for longer.

Inflation is manifesting today in so many places at once, it's hard to keep track of—food, cars, home prices, apartment rents, Uber rides, Bitcoin…. And the causes are just as numerous—labor and raw material shortages, shipping and transportation bottlenecks, component and finished good shortages…It's like the entire intricate web of globalization, something we built-up over the past 30-40 years with ruthless capitalistic efficiency, is now suddenly crumbling under the weight of its own inevitable logic. As crazy as it sounds, perhaps we evolved to be too connected, too efficient, and too sure of ourselves and our system. By God, we even convinced ourselves that we had solved the problem of financial crisis. In retrospect, our faith looks naïve.

Now we are looking at a world where unless this chart resolves in some unexpected way:



We are in for some turbulent times. ▫