Ep. 188 - Supply chain outlook for Q4 2023

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Chris Rogers

Kristen Hallam

Announcer

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You're listening to the Economics & Country Risk podcast from S&P Global Market Intelligence. In each episode, our experts will provide you with the where, how and when to make decisions that transform your business.

Kristen Hallam

The supply chain story of 2023 so far has been one of normalization. Demand has slowed down with U.S. seaborne imports of consumer goods falling in the first 8 months of the year. The seasonality of shipping patterns also appears to be returning to normal and global trade activity is likely to stabilize.

But as ever, we see risks on the horizon. To name a few, trade policies are becoming more restrictive and sustainability policies are starting to have real consequences for supply chains. Water risks are affecting shipping worldwide.

I'm Kristen Hallam, Content Strategist at S&P Global Market Intelligence. Here to guide us through the minefield of supply chain risks is Chris Rogers, Head of Supply Chain Research at S&P Global Market Intelligence.

Welcome back to the podcast, Chris.

Chris Rogers

Thanks for having me, Kristen. It's good to be back.

Question and Answer

Kristen Hallam

So Chris, let's start with the good news, as it were, about normalization. What is driving the return to normal that you're seeing in supply chains?

Chris Rogers

Yes. So the good news is bad news, as is sadly often the case with supply chains. The primary reason I think we're seeing a normalization is effectively a reduction in loading of products going through supply chains very broadly.

If you remember during the pandemic -- we talked about this last time -- there was a big jump in demand for consumer goods. That effectively overloaded the manufacturing systems, overloaded logistics networks, led to blockages at the ports.

We've been through this story a few times. And what we've seen more recently is a reduction in demand for those goods. And we see that very tangibly in the rate of flows of goods on things like our U.S. seaborne import data where we can see year-over-year throughout this year, a double-digit reduction in shipments of consumer goods.

The good news is, of course, that the shipments that are coming in are coming in with kind of a normalized seasonality. So we're starting to see a pickup in our data for August and September, as you would normally expect, albeit at a much lower level.

Just looking ahead a little bit, clearly, when we look at the macroeconomic data for consumer spending, it's still reasonably strong at the headline level, but that's partly being driven by the ever-present inflation. But looking into next year, our economics team are actually seeing the potential for a reduction in durable goods sales in the first quarter.

And I think companies are probably preempting that a little bit as well by scaling back their inventory. So we could probably talk about inventory strategy a little bit later on, but we have seen companies destocking to a certain extent. And that again reduces some of the pressure on supply chains.

Kristen Hallam

And that leads me right into my next question, which is how have companies responded to this normalization of the supply chain? I think you've partly answered that already.

Chris Rogers

Yes. So we can look at some of the short-term measures for lessons about some of the longer-term measures. If we look at the S&P Global PMI, the Purchasing Managers Index, what we can see there is that companies have cut back their inventories so far this year.

Now we don't yet know whether this is just basic cyclicality. So overbuilt last year, you got to hang back and not use -- not bring in as much. So cut back your inventories this year. Maybe some cyclicality there.

And certainly, when we speak to our customers, there are lots of concerns that companies feel they've lost the ability to adequately forecast where their business is going because historic patterns have been disrupted, but the PMI for manufacturing has shown a decline for 13 months.

So it's very clear that what we've got is a well-established downturn in manufacturing and in inventories and in, frankly, logistics as well in response to this kind of demand-driven return to normal. We have seen companies that generally return to normal seasonality approaches.

So when you make your shipments last year, a year before we saw companies trying to import or ship early in order to avoid either getting crushed by a shortage of logistics capacity or just failing to meet consumer demand when it came.

A couple of anecdotal examples though show how those patterns aren't entirely settled. We published a piece looking at the shipment of Halloween decorations and found that generally, they were being shipped earlier than previously.

Clearly, all those kind of 20-foot tall skeletons require a lot of early shipping. And on the other hand, Christmas decorations, we're halfway through the peak shipping season at the moment. September is the first half, October is the second half.

Pattern seems to be back to normal. Again, different companies following different approaches there. But trimming inventories, trimming demands, return to normal seasonality, those are some of the short-term policies.

Some of the longer-term policies, though, we are seeing some adaptations, I think, to what companies were maybe saying previously around inventories, multi-sourcing, reshoring and so on, but we'll get into those in more detail later.

Kristen Hallam

That does explain why I was seeing more bats and pumpkins and skeletons on my street on the early side in September, because of the early shipping, I guess.

Chris Rogers

Yes. And I think there's an interesting point here about whether retailers are concerned about a downturn in demand later in the year. And so are trying to attract some of that seasonal shopping earlier than normal. So trying to beat your competitors to the punch by making the products available sooner. I don't want to read too much into that, but I think that might be a possibility as well.

Kristen Hallam

Could be, could be. So let's talk about some of the risks that are cropping up, starting with trade policies. What's on the trade policy mood board at the moment, Chris?

Chris Rogers

Yes. It's a very dark kind of emo mood board at the moment.

Kristen Hallam

They're listening to The Cure, yes.

Chris Rogers

Yes, that's right. The interest paid for trade policy is mostly black and gray. I would say that it's probably a certain amount of clarity that will come this year, which is a good thing, but there's still plenty of policies where there's uncertainties running into next year.

If we're looking at the U.S. side, the big element that's ongoing at the moment is a review of the Section 301 duties that have applied to imports from Mainland China. Those are the tariffs that were applied during the Trump administration and we're due to have a decision from the government on what to do about those anytime soon during October or November.

Those are basically reviewed every 4 years, and they were put in place in a series of waves in 2018 and 2019. That's one definitely to watch. Remember, those tariffs are about 25% on a large proportion of imports from China.

The EU have just gotten into the process of launching a subsidy review of the Chinese electric vehicle manufacturing industry. There's been obviously a big uptick in shipments of electric vehicles from Mainland China to Europe, and the EU are clearly concerned about the state of EU manufacturing as a result of that.

To complete the circle, another one to keep an eye on during the fourth quarter this year and going forward is negotiations between the EU and the U.S. around the future of the steel and aluminum industries.

Basically, there are a series of tariffs that the U.S. applied during the Trump administration. Those were transmuted into kind of an informal arrangement that they would hold the tariffs back whilst it's somewhat long name, Global Arrangement on Sustainable Steel and Aluminum, was negotiated.

That's supposed to be negotiated by the end of this month. If it isn't, there's the risk that tariffs could be brought back in and -- those were around 25% on bilateral trade in steel and about 10% in bilateral trade on aluminum. Plenty of rakes in the garden. We're using mood boards. Plenty of pictures on the mood board, should we say.

Kristen Hallam

Yes. Although you said rakes in the garden and that made me think of the Cape Fear episode of The Simpsons where Sideshow Bob steps on all the rakes. Something else for the mood board, maybe. So what is driving governments to take these steps with their trade policies, Chris?

Chris Rogers

There's a whole bunch of different reasons. And before I get into that, I would say the other area to watch in terms of -- I don't know if it's trade policy as such, but we're seeing a lot of resource protectionism as well around critical minerals and food.

India has been a major mover. And we talked about that last time around. But we've also started to see more on critical minerals, particularly rare earths and lithium where we've seen most recently, Mexico and Argentina start to change some of the contracts that are in place.

Now those sorts of restrictions along with what we've seen in terms of some of these other investigations are often dressed up in national security concerns. So I think that's certainly true for what we've seen for advanced semiconductors and to a lesser extent, that can be justified for the electric transitions, development of electric vehicle supply chains.

And the second driver has been a desire to capture some of these one-off shifts in supply chains, particularly, in the automotive industry. If you're seeing a generational shift in technology, you want to make sure that your country is going to have manufacturing capability there rather than being frozen out for potentially years.

And obviously, a lot of these industries are significant employers either in terms of manufacturing or in terms of the associated parts or even the ongoing services. And then the third part is good old friendly inflation.

Price rises, particularly for food, have been behind some of these restricted measures. One would hope as inflation comes down, so would the driver of that desire to intervene in international trade. But again, that's something that comes and goes.

Kristen Hallam

Yes. It will be very interesting to see what happens with inflation in the near term. Still a very persistent issue globally. Sustainability policies are also coming into focus this quarter in a more meaningful way, mainly coming out of the EU. Are these taking effect in Q4? Or is Q4 the preparation period for when they take effect?

Chris Rogers

Yes, I think sustainability policies or policies particularly around environmental policy, but also around corporate commitments are, I would say, slow moving in a bad way, but they're being put in place in a very intentional deliberate way and rolled out over a period of years rather than months.

I think that's quite important, not just because they're dealing with very serious issues but because they do require significant investments by a lot of companies to actually deliver. The big one is the Carbon Border Adjustment Mechanism in the EU as well as the steel deal with the U.S. that I mentioned as well.

The Carbon Border Adjustment Mechanism formally started on October 1, but that's only in terms of reporting requirements. The actual requirement to pay out real cash is still a year or 2 down the line. So yes, that impact, if you like, is not yet there.

But the reporting standards are quite strict and those do need to be complied with. And obviously, it's not just companies who are based in the EU that they're going to have to deal with that. It's any company importing the relevant products into the EU. It's quite wide-reaching there.

The other one that's about to kick in is the maritime sector joining the European emissions trading scheme for carbon permits. We started to see already some of the container lines start to apply surcharges or provide notice that they're going to apply surcharges for those extra costs from January.

We don't yet know how significant those will be, how sustainable -- to excuse the pun, and how sustainable those charges will be, but they are nonetheless attempting to apply those. And it's also worth bearing in mind that we've already now got the EU deforestation rules and the forthcoming corporate sustainability directive coming up.

Those are also effectively data provision requirements, but that doesn't change their seriousness or the costs that can be associated with delivering on those commitments. The Carbon Border Adjustment Mechanism is the one that's potentially the most serious of the ones that I've talked about here because it has the room to have an impact on the widest range of sectors.

You take a look around the room you're in right now and see how many things are made with steel or aluminum. They're all going to be affected in some way, shape or form over the next 3 years or so. There's also still some uncertainty about how the implementation, the policy will work.

For example, the German authorities are reportedly looking to have a lot of smaller companies, even smaller than they're currently exempted to extend that exemption, obviously, for the middle-sized companies that Germany is well known for.

So there is that to bear in mind. We're also -- this has often been the case with some of these big European policy areas seeing other countries start to adapt their policies on climate change. Indonesia and Australia, for example, are adapting their rules.

And that, again, will introduce some uncertainty as to how supply chains work, but it does provide an example of how the EU kind of almost exports its regulatory requirements as was very much the case with the GDPR privacy requirements.

Kristen Hallam

You also mentioned water stress in your report, and that's something that has crept up in other areas of research. Our PMI economists spoke about this in a recent episode of the podcast. Where are water risks making themselves felt at the moment in the supply chain? And what do you see heading into next year?

Chris Rogers

Yes. So I think my ability to do a 24-month weather forecast is probably limited. Where we are seeing very tangible effects of water stress, whether that's directly because of climate change or El Nino or just simple fluctuations in the weather is in terms of shipping.

Not just international shipping, but local shipping as well. We've seen examples of stress in the Panama Canal due to reduced availability to provide the balancing water in the locks of that canal. We've seen reduced river levels on the Mississippi in the U.S., on the Amazon in Brazil and Rhine River in Germany.

Just this year, leading to reduced ability to ship out food and commodities -- which are certainly in the case of the Mississippi and the Amazon -- we've seen disruptions to shipments as a result of that. If we think about the longer-term issues, then, clearly, the placement of manufacturing plants is important.

Any kind of heavy industry is a significant user of water and where industry and agriculture or the local population come into conflict. You can bet it's not necessarily going to be the factory that wins the hearts and minds of politicians when allocating water rights. There's been some really interesting work from our colleagues in Sustainable1 and the climate service on this topic as well.

Kristen Hallam

Yes, something for our listeners to check out. And I've got one more risk that you mentioned in the report that I didn't actually mention in the intro and that is labor action. The auto workers are striking in the U.S. as we speak, and I know that's something you've been tracking along with our pricing and purchasing and econ colleagues. What impact are we seeing at this stage?

Chris Rogers

In the short term looking kind of small. The UAW strike, the United Auto Workers strike, in the U.S. has been implemented in a very different way to previous strikes. So by effectively closing specific plants, it causes a lot of widespread disruptions without actually completely collapsing the automotive supply chain more broadly.

But nonetheless, we've seen the automakers themselves have had to lay off people outside of the factories where strikes have gone on because of the interconnected nature of the supply chains. And we've seen layoffs occur in industries across steel and automotive components as well in response to just the strikes as far as they've gotten so far.

Clearly, our belief is this strike could last for quite some time. The union, the UAW, has an appetite for making some fairly significant gains and they've had wins, for example, with one of the truck manufacturers in terms of getting some fairly widespread concessions.

Now that is a lesson for broader issues that we're seeing for labor. You wouldn't want to spot where the next issues are going to come up. But I think particularly in Europe, we've got a lot of labor agreements, which were reached a couple of years ago when inflation is much lower.

Those will start to be negotiated. And then, of course, the longer-term issue where higher labor costs will eat into companies’ ability to either maintain their profitability or to make investments in some of these resilient strategies that we mentioned earlier on in terms of inventory management, multi-sourcing and reshoring.

All of which require significant investments over a significant period. And if your labor costs have gone up and your other costs have gone up because of inflation, that can lead to a tough time for a lot of different companies.

Kristen Hallam

So in light of all these risks that we've talked about, Chris, what strategies are companies exploring to make their supply chains more resilient?

Chris Rogers

Yes. So I think there'll be no surprise that things like reshoring and multiple sourcing are very much on the agenda and certainly a lot of the companies we speak to are pursuing those strategies. Whilst recognizing they take many years and millions of dollars of investment to make.

Those are underway and they are being rolled out steadily over time. Inventory management, so holding higher levels of inventory or so-called just-in-case approaches, those don't seem to be emerging. And the big reason there is the cost of resilience.

And in fact, one of the big themes we're going to be looking at throughout 2024 in our forthcoming research is going to be around the affordability of resilience in a situation where margins are under pressure.

The cheapest option actually funny enough for building resilience in the near term is just building out visibility on the supply chain. It's interesting to see the U.S. government have just relaunched a semiconductor early warning system effectively.

It's certainly a very simple e-mail box you can send in worries to. But that focus on visibility even if we can't prepare, we don't have the money to prepare for the next disaster. At least, we can flag it early.

That seems to be an early area. But I think investment in visibility tools is an area that companies are using and don't maybe cost as much as a complete retooling of the rest of the supply chain.

Kristen Hallam

Well, I look forward to reading what you'll be writing about next year. Plenty of fodder for 2024 as always. So Chris, what would you say are your top 1 or 2 takeaways?

Chris Rogers

Yes, we can summarize it as we're back to normal operationally, but there's considerable policy uncertainties, which are only going to be partly resolved this quarter. I think looking ahead, it's all going to be about the willingness of firms to commit funding to resilience.

It's clearly needed. It's clearly needed, whether it's because of that policy uncertainty or water stress or labor risk or so on. But actually paying for it is unanswered question and one that hopefully we'll be able to answer for you in the not-too-distant future.

Kristen Hallam

All right. We look forward to having you back again on the podcast to talk about that. And thank you to our listeners for tuning in. Let us know what you thought of this episode by interacting with us on social media and tell us what you'd like to hear on the podcast next.

Announcer

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