FISCHER STRALEM

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Dear Client:

We are about one third of the way through corporate first quarter earnings season and, as is often the case, certain broad themes materialize. Currently, this theme is inventories. As the global supply chain disruptions of the Covid years abates, and after businesses rebuilt inventories from the abnormally low levels of 2021, companies are now beginning to shift away from their recent “just-in-case” mode of inventory management back towards more of a “just-in-time” approach. February’s ISM services PMI survey showed more businesses running down inventories than building them up (GaveKal).

As our friend (and lead U.S. GaveKal economist) described it, this inventory moderation reflects a tug of war in action: there are legitimate *structural* reasons to maintain inventories at elevated levels, even as intensifying *cyclical* incentives demand that companies drive inventories lower.

The primary long-term rationale for just-in-case inventory management is the global environment of heightened geopolitical risk. The attacks on Red Sea shipping -- where freight traffic is down more than 50% from a year ago as highlighted in a prior communiqué -- is a sharp reminder how vulnerable globalized supply chains are to local disruptions. Meanwhile, the possibility that the former president could be reinstalled in the White House next January reminds businesses that despite the recent lull, the US/China/Europe economic cold war is not over, and that trade tensions could erupt once again. These factors, coming hard on the heels of the Covid disruptions are a stark reminder that globally-optimized, just-in-time supply chains, are highly fragile, and that an element of just-in-case inventory management may be advisable as an insurance policy against future disruptions.

On the other hand, that insurance policy has gotten more costly. Inventory finance has become more expensive and harder to obtain. According to an (easily-missed) survey by the National Federation of Independent Business (NFIB), the average interest rate paid on short term loans has almost doubled over the last two years, from 5% in January 2022 to 9% in January 2024. With little sign that borrowing costs are set to fall in the near term or that credit conditions will ease, maintaining large inventories will remain expensive and difficult over the coming months.

In the 2021-22 post-Covid period when the price of goods were rising, businesses had a powerful incentive to build inventories before prices rose further. Goods prices are now starting to fall, and the incentive has begun to reverse, so it makes sense for businesses to run down inventories and restock later at cheaper rates.

Given the trend, it is financially reasonable for businesses to revert back to a just-in-time approach to inventory management. However, potential disruptions to this trend back to just-in-time inventory management are lurking. In stretching to meet Wall Street’s short-term profit expectations, businesses would be well advised to not forget the pain suffered in 2020 because of widespread inventory shortfalls.

Regards,

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