ECONOMIC VIEWPOINT

Supply Chains: Is the Worst behind Us?

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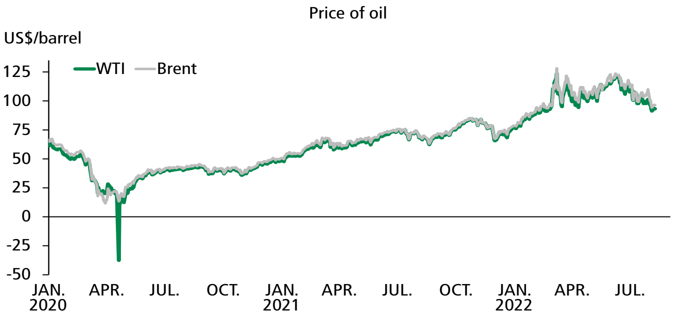
Supply chain disruptions finally seem to be easing as prices for oil, grains and industrial metals gradually return to levels seen before the war in Ukraine. Container rates, delivery times and port congestion are all starting to improve. Moreover, high prices and the global economic slowdown are cooling demand, which should lead to a better balance with supply. But while the worst appears to be behind us, there's still a long way to go. And economic uncertainty and geopolitical tensions could halt or reverse the supply chain recovery.

The Return of Oil Surpluses

Just over a month ago, market distortions from the war in Ukraine and limited global oil supply pushed West Texas Intermediate above US$120 per barrel (graph 1). Prices surged on expectations of sustained demand and a drop in Russian production of roughly 3 mbd (million barrels per day). However, Russian oil output has proved resilient, even increasing in May and June. At the time of writing, it's down just 0.3 mbd since the beginning of the war. It's now clear that Russian oil production will decline slower than initially anticipated. At the same time, other oil-producing countries like Canada and the United States have boosted production in recent months. With more oil on the market than expected and weaker demand, crude prices are back to their pre-invasion level at around US$90 per barrel. Rising recession risks have dampened the demand outlook lately, pushing prices even lower. This should help alleviate price pressures on gasoline and other petroleum products. But oil producers are still contending with labour shortages, high input costs and drilling delays. Moreover, the Organization of the Petroleum Exporting Countries and its partners (OPEC+) greatly reduced their growth target. It's likely that supply issues will improve gradually and oil prices will remain volatile.

GRAPH 1
Oil prices are back to pre-war levels



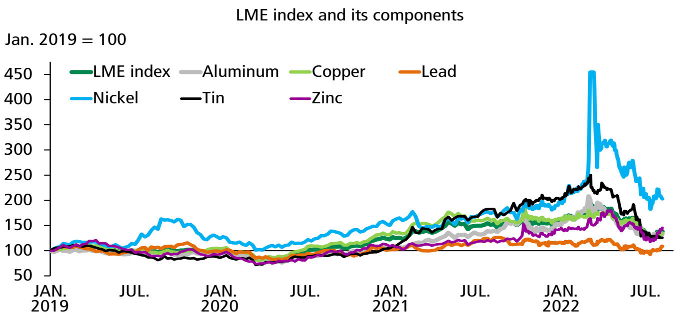
WTI: West Texas Intermediate
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

A Gloomy Demand Outlook for Base Metals

Since the start of the pandemic, there has been strong demand for industrial metals for infrastructure projects and consumer goods despite limited supply. Prices reached a turning point during China's latest COVID wave. China is the world's largest consumer of base metals, so its strict lockdowns and economic challenges[1] have hampered global demand. Weaker demand, slower economic activity and the shift to more service spending has sent the London Metal Exchange (LME) Index plunging 29.8% below its March peak. The index is now back to a more typical level of around 3,800 points (graph 2 on page 2). Every component of the index is down, with nickel and tin prices off 55.4% and 47.4% respectively. However, the metal supply remains constrained despite increased global production. That means price fluctuations are driven by heightened demand uncertainty. Lower metal prices should therefore help alleviate rising input costs in the manufacturing sector.

[1] For more details, see: *China's Economic Slowdown: Root Causes and Implications*, Desjardins, Economic Studies, *Economic Viewpoint*, June 30, 2022, 6 p.

GRAPH 2
Demand fears have driven down industrial metal prices

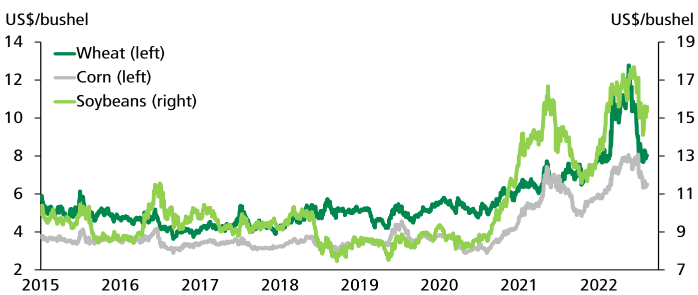


LME: London Metal Exchange
Sources: Datastream and Desjardins, Economic Studies

Grain Prices Are Also Falling

Wheat, corn and soybean prices have been falling over the past few months as well, especially in recent weeks. Wheat prices were the first to soften. They began to slide in mid-May on three pieces of news (graph 3). After banning wheat exports due to low expected yields, India backtracked just weeks later. Then Russia announced it would produce more wheat than originally planned. And at the end of May, Europe upgraded its wheat production forecast. Together, this news helped boost the global supply and availability of wheat.

GRAPH 3
Improved supply has pushed grain prices lower



Sources: Datastream and Desjardins, Economic Studies

Corn and soybean prices began falling in late June. That's when rumours started circulating that Ukraine would open its silos and export last year's harvest. It's also when encouraging early crop yields were announced for the northern hemisphere. Since then, prices have fallen sharply. They've fluctuated in recent weeks on news about the first grain shipment out of Ukraine.

Since this spring, grain prices have moved mostly in response to three factors: geopolitics, economics and the weather. But it's hard to say how much effect each is having. All three are subject to sudden and unpredictable changes, driving price volatility. Good weather in the northern hemisphere may mean a slightly better than expected harvest, and that in turn is easing pressure on supply and prices.

On the geopolitical front, Russia and Ukraine agreed in late July to export Ukrainian grain that's been stranded since the Russian invasion, bolstering the global supply and sending prices lower. But this agreement could collapse at any moment. If it does, it would strain the market and push prices back up. On the economic side as well, nothing is guaranteed. The risk of recession is growing, clouding the outlook for global grain demand next year and dampening prices. Lower prices should help alleviate pressure on input costs in the agri-food industry in the coming quarters. Prices are trending down but remain volatile. They could move higher if we see a shift on the political, economic or weather front.

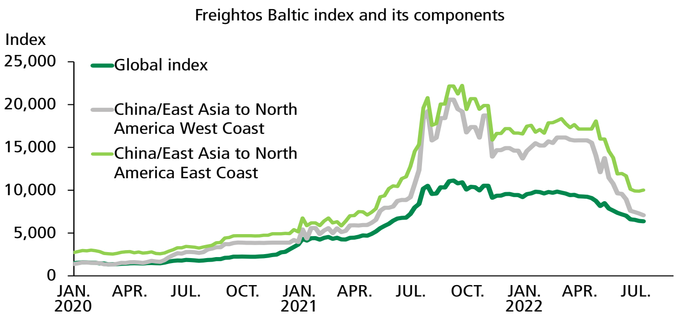
Early Signs of Improvement

There are signs that supply chain pressures are easing. The Federal Reserve Bank of New York index has been declining since the initial shock of the war in Ukraine (graph 4). Moreover, ports along the US West Coast, in particular Long Beach, are experiencing shorter dwell times, and container rates have been falling sharply since April 2022, particularly for the China/West Coast route (graph 5 on page 3). However, ports along the East Coast are experiencing higher volumes, which means ships are being rerouted from one coast to the other. Additionally, delivery times and order backlogs as measured by the US ISM manufacturing surveys have been increasing at a slower pace over the past few months relative to their peak last fall. As orders are slowly filled and inventories are rebuilt, global demand is expected to shift from goods to services, further easing supply chain tensions.

GRAPH 4
Supply chain pressures have eased

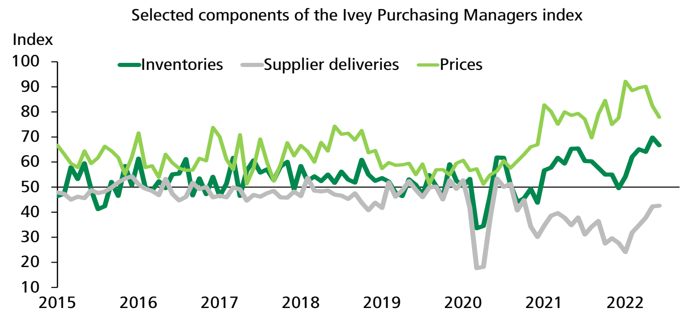
Sources: Federal Reserve Bank of New York and Desjardins, Economic Studies

GRAPH 5
Container rates continue to normalize



Sources: Datastream and Desjardins, Economic Studies

GRAPH 6
Supply pressures appear to be easing in Canada



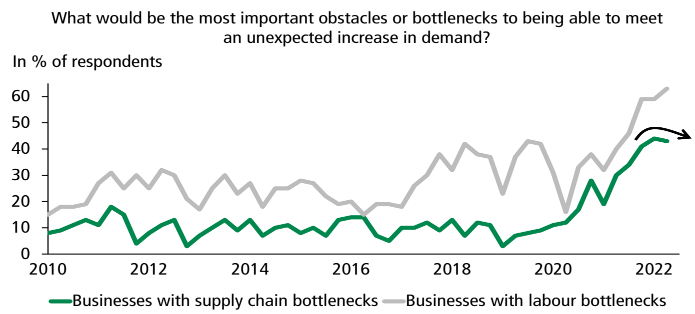
Sources: Datastream and Desjardins, Economic Studies

We're starting to see this improvement in Canada, where the supplier delivery component of the Ivey Purchasing Managers Index is recovering (graph 6). It's back to a level not seen since October 2020. And for the first time in a year, the Bank of Canada's *Business Outlook Survey* in July showed a drop in the percentage of respondents reporting supply chain bottlenecks (graph 7). This could mean the worst is behind us. With commodity prices tumbling and supply chains starting to clear, we could see supply chain pressures ease in the coming quarters.

Still a Long Way to Go

Although there's been some improvement, several indicators such as port congestion, delivery times and energy prices remain historically high. Economic and geopolitical uncertainty will be with us the rest of the way, making for a long and winding supply chain recovery. Inflationary pressures caused by supply chain tensions could therefore take several months to subside.

GRAPH 7
Supply chain issues continue to be a major roadblock for Canadian businesses



Sources: Bank of Canada and Desjardins, Economic Studies