Key Private Bank

Key Questions

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What Risks to the Recovery Are Chip Shortages Causing?

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There is a global shortage of semiconductors or chips. While we do not expect this shortage to derail economic recovery in a meaningful way, the issues in the short and intermediate term could cause some notable disruptions.

As has been widely reported, there is a global shortage of semiconductors or chips as they are colloquially known. Semiconductors are present not only in things like cell phones and computers but in automobiles and home appliances. They are a crucial component for many goods.

Due to stockpiling by many Chinese firms triggered by ongoing trade tensions and high demand for products containing semiconductors, manufacturers cannot obtain critical components for many goods sold in the developed world. Further, given lean inventories and a faster-than-anticipated recovery, shortages, higher prices, and delayed demand for many consumer products have ensued.

That being said, we do not expect this shortage to derail the economic recovery in a meaningful way: In our view, many of the issues are temporary.

In economic terms, a shortage is a condition where demand exceeds supply at a given price. When we assess how shortages may threaten the post-COVID recovery, we expect inflationary pressures to rise so that the equilibrium price adjusts upward to induce new supply and temper demand as buyers and sellers react to the changing economic backdrop.

Some of the issues facing the supply side of the equation are likely to have a short-term impact. However, we also think many of the problems are more persistent and could create short- and intermediate term inflation conditions. These include further supply chain and operational bottlenecks and continued stockpiling as businesses place renewed emphasis on resiliency following COVID-19 disruptions.

It is important to note, given the ubiquitous nature of semiconductors, the production of these components is now beginning to be considered a strategic asset. While the majority of the world's chips are produced by Asian countries, the US has a large manufacturing base and is the second-largest producer globally. The European Commission is now beginning to consider adding production capacity locally. We think that this behavior is likely to result in longer-term inefficiencies in the supply chain and cause prices to rise on a more sustainable basis.

As we previously discussed in a previous Key Questions article comparing inflation and reflation, inflation is when your dollar buys you fewer goods and services. Due to the pervasive use of semiconductors in products, we think that a shortage and subsequent increase in prices of such a crucial component will create price inflation in many of the goods that contain them. These price increases will lower disposable income available to other areas of the economy, resulting in reduced demand in those parts of the economy that do not benefit from higher prices in these specific sectors.

Finally, we examine the impact of delayed demand. Consider an auto manufacturer that needs semiconductors to produce a vehicle. If the auto manufacturer cannot obtain these components, the company must shut down production, which temporarily lowers the demand for other companies involved in the automotive production process. More damaging, however, is when auto manufacturers start to omit features to make volume production goals, which some have done recently. When consumers are faced with the inability to obtain a feature, this is demand destroyed. Fortunately, it is a minor consideration at this juncture.

There are plenty of these ripples throughout the economy; in the end, this demand is (for the most part) merely delayed for companies. While this will negatively impact firms' profitability during the shortage, especially for those with high operating leverage, investment analysts typically adjust for this impact and view higher prices as a more significant positive.

We think it is important to distinguish the difference between the economy and the equity market on this topic. The chip shortage will have a negative impact on consumers, but it is a distinct positive for pricing, profitability, and the share price of semiconductor companies. In the short term, we would expect there to be an inability to obtain specific products. In the intermediate term, while we would expect higher prices until demand cools and supply chains adjust, we would not be surprised if higher prices persist longer than the consensus expects. That said, we think this issue is a minor speed bump for the recovery as most of the impact is temporary in nature.

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