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Same Deep Ship, Different Day

New waves to buffet the world economy?

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Summary

- The Red Sea crisis reducing cargo transit via the Suez Canal is in line with our projections of a more 'geopolitical' world economy making it harder to keep inflation low
- Financial markets still focusing on "transitory" fail to see this looming impact
- Things aren't as bad as the last shipping crisis but could still get painful if Suez is not resolved soon, and if we see probable second- and third-order effects
- Worryingly, it's hard to see *how* this crisis can be truly resolved when it's so well anchored

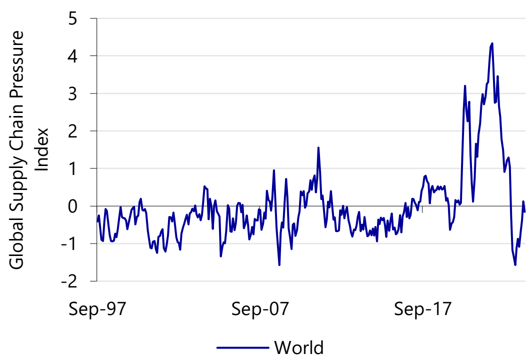
From deep to deeper ship

September 2021's 'In Deep Ship' argued "Too Big To Sail" concentrated maritime logistics and infrastructure were structurally vulnerable to supply *and* demand shocks, and a drop in US consumer spending was needed before inflation could normalize - which we have now seen. Looking at the Global Supply Chain Pressure Index (Figure 1) one may assume supply-side problems have also disappeared: yet few structural problems have been truly addressed[1].

Deep Ship also argued maritime geopolitical shocks were likely; and that the US would have to rebuild its merchant marine and expand its Navy; be paid to protect ocean carriers; *or only protect those of its geopolitical allies*, which would shipwreck conceptions of a frictionless, low-inflation world economy. The Ukraine War and impact on the Black Sea followed; the Israel-Hamas war has seen trade divert from the Suez Canal; Venezuela claims Guyana's offshore oil; questions over Taiwan linger post its election; and there are worrying signals from North Korea. Overall, the US maritime industry argues, 'We got too accustomed to peaceful seas: Say goodbye to the global 'conveyor belt'', as spot freight rates for Shanghai-Rotterdam are surging again (Figure 2).

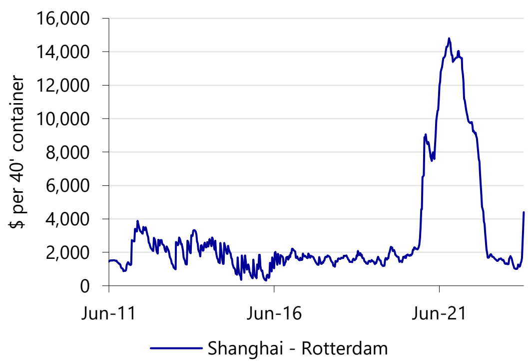
Yet markets see inflation as "transitory" again in 2024: is that a siren song or a real safe harbour?

Figure 1: The inflation wave has past, right?



Source: Federal Reserve

Figure 2: ...or is it building again?



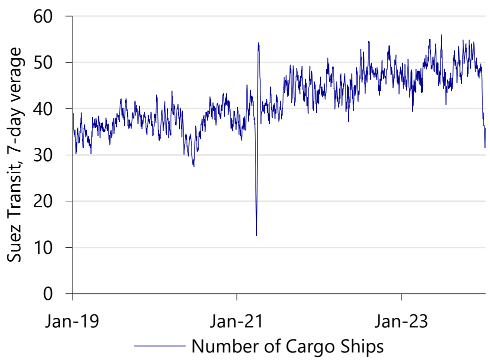
Source: Drewry

[1] While port investments have taken place, global ocean carrier alliances are seeing some break ups, and trade is diverting away from China, there are still many ultra-large vessels sailing between too few ultra-large ports, a system highly vulnerable to disruption and laden with potential choke-points.

Shipwreck

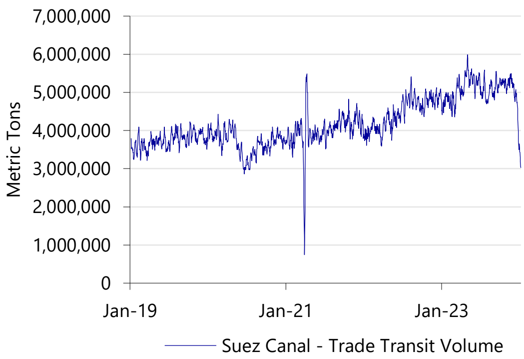
In particular focus here, total container transits and tonnage via the Suez Canal have slumped to Covid-era lows (Figures 3 and 4). Are markets right to still be sanguine about inflation when 30% of global container traffic has to go round the Cape of Good Hope rather than through the Suez Canal, adding at least 10-14 days to journey times?

Figure 3: Far fewer ships...



Source: IMF, PortWatch

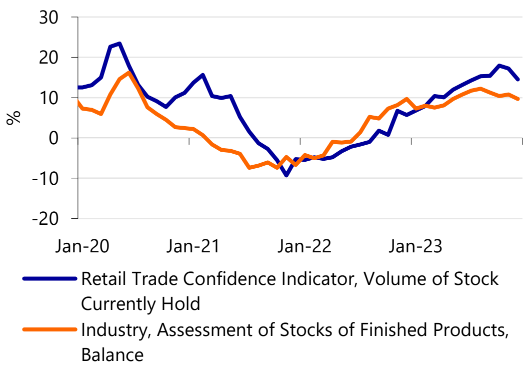
Figure 4: ...and far fewer goods



Source: IMF, PortWatch

True, European industrial inventory levels are broadly assessed to be 'above average' in many sectors, a sharp improvement from two years ago, even if overall industrial stocks are visually no higher than they were in the last shipping crisis (Figure 5). The Red Sea crisis also starts in the quiet retail period for retailers and carriers after Christmas, although looming Chinese New Year works the other way. Weaker consumer demand, and no new Covid-style stimulus, certainly mitigate risks of supply disruptions immediately seeing upwards price adjustments (Figure 6). However, none of this rules out structural *stagflation*, and despite a downturn in the Euro auto sector we already see that 'Tesla, Volvo Car pause output as Red Sea shipping crisis deepens'.

Figure 5: More inventory, perhaps



Source: Macrobond

Figure 6: Less demand, surely

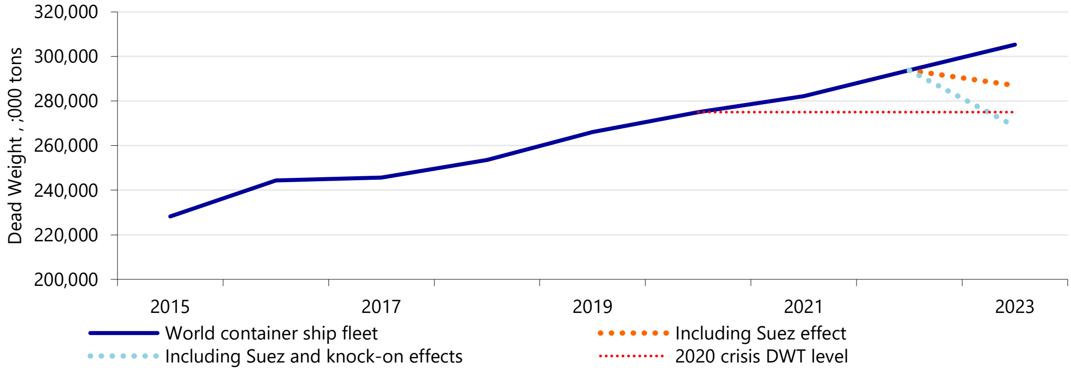
Source: Macrobond

Helpfully, ocean carriers have added 11% container ship dead weight tonnage capacity since Covid (Figure 7). However, a 6% drop in capacity occurs if only four Asia-Europe runs can be made in a year vs. five; and bunkering delays in Africa could mean effective capacity dropping *below* the levels in the last crisis. Indeed, African ports are not set up to provide services on the scale needed if the Suez crisis is sustained: reports already have port delays for refuelling at 10 days in Durban; 'Ships rerouted by Red Sea crisis face overwhelmed African ports', say others; and 'South Africa seeks emergency external help to remedy dire situation across the nation's ports'. That said, more new supply is due to flood the container market in 2024: the question then becomes if carriers will bring it all in if it pushes freight rates back down again when the year had looked like a flush for them until this crisis. That's a key structural issue we noted in 'In Deep Ship'.

Even within the West, the combination of the Suez and the Panama Canals both seeing far fewer transits is likely to put strain on ports and infrastructure having to compensate: e.g., the US West to East coast. Additionally, we could see a repeat of the Covid 'container crisis': might Asian exporters now seeing fewer shipments per year return to Asia after delivering cargo to Europe, or elsewhere, rather than waiting to refill their containers with other goods? The longer the Red Sea crisis continues, the greater the risk of these kind of eventualities occurring.

Going back to demand, what we would then risk is an echo of 2020-22's scissors effect of structurally reduced cargo capacity on the supply side combined with firms opting to hold even higher than normal inventory levels to provide a buffer against potential supply shocks.

Figure 7: Ocean carrier capacity has risen – but let's include direct and indirect Suez effects



Source: UNCTAD, Rabobank
*DWT = Dead Weight Tonnage

The deepest ship we are now in

Another reason to remain sanguine is the view that these problems are "transitory". Yet we are talking about the Middle East, where it is usually peace and stability that is short-lived. Indeed, the current crisis is serious, likely to get worse before it gets better, and *very* hard to resolve.

In response to the Houthi attacks on Red Sea shipping from Yemen, the US's Operation Prosperity Guardian (OPG) aims to shepherd cargo traffic through the Bab El-Mandeb chokepoint to allow normal use of the Suez Canal. However, initial US leadership was slow, few allies provided any useful ships, then France refused US command to only guard its own merchant fleet: worse, Denmark's Maersk at one point also refused to allow its few US-flagged vessels --subsidised by the US for Sealift of military materiel-- to transit the Red Sea even *with* a US naval escort before ultimately agreeing to do so. Looking at Figures 3 and 4, OPG is clearly not working.

Practically, the maritime area the US, UK, and France are now covering is too large for their navies to be 100% effective against Houthi attacks. Although the Ukraine War shows how cheap drone attacks can sink vastly more expensive naval vessels, dramatically shifting the balance of naval power, so far OPG has successfully shot down most drones and missiles fired. Yet OPG is massively, asymmetrically expensive vis-à-vis the Houthis. Each drone costs $2,000: each interceptor fired back costs $400,000 to $1.5m. One estimate of OPG costs is $500m+ a month vs. $10m for the Houthis. Moreover, OPG vessels can't remain in place indefinitely: crews must rest, repairs be made, and resupply done – and this presumes other calls aren't made on them.

The US and UK have therefore also launched separate (well-signposted) air and missile strikes on the Houthis. However, these are unlikely to have a long-term deterrent effect given the needle-in-haystack of mobile targets and fresh resupply: indeed, the Houthis, Hezbollah, and Iran have all pledged to *step up* attacks on global shipping in response, and the Houthis subsequently fired a missile at a US warship (which was shot down). Meanwhile, the US-UK attacks reportedly used more than a year's worth of the Navy's share of Tomahawk missile production, pointing to the weak supply side of the US military-industrial complex.

A true resolution of the crisis would in part require an end to the Israel-Hamas war. There, Israel states it is likely to be fighting Hamas for the rest of the *year*. Moreover, there is no clear plan for what happens next politically, a vacuum within which violence will thrive. The likelihood of major escalation with Hezbollah in Lebanon also continues to rise, potentially taking the war closer to regional energy production and flows.

However, it's in turn unrealistic to expect a resolution to the Israel-Hamas (or the wider Israel-Palestinian) conflict without recognising that behind the 'Axis of Resistance' of Hamas, Hezbollah, the Houthis, and the Shiite militias attacking the US military across the Middle East, lies Iranian funding and military support. Indeed, Iran's Revolutionary Guards Council (IRGC) is both entrenched in Yemen, reportedly playing a direct role in Houthi attacks on commercial shipping, and just fired missiles directly at the US consulate in Erbil, Iraq from within Iran – a major provocation and escalation from their side.

Unless and until Iran is made to stop these actions there is not going to be any stability in the Middle East: this is as in adjacent Somaliland–Somalia–Ethiopia war may also loom. At the very least, the current situation would require much tougher Western sanctions on Iran's oil exports (mainly flowing to China) when just recently the US was *releasing* frozen oil funds to Tehran, and before that removing the Houthis from the designated terrorist list to send them aid. Yet even tougher sanctions may involve confronting Iran, and/or China, and global energy markets.

Notably, on 18 April 1988, US President Reagan sank half of the Iranian fleet in one day in Operation Praying Mantis after an Iranian mine had struck a US warship in the Persian Gulf. The Atlantic now suggests 'The Decatur Option' to put an end to attacks on shipping, echoing how the US dealt with Barbary pirates in 1815: bombing Iranian targets that supply the Houthis. A very understandable US fear of another draining Middle East war, or inflation, ahead of the 2024 election means this is very unlikely to happen. Yet while there may be no Western appetite for war, that will sadly not bring peace. It's painful to grasp, *but Iran is deliberately destabilising the region* to make the economic cost of the US (and Israeli) presence there too high for it to bear.

Not at all ship-shape

Even looking at Iran fails to see the broadest problem, which we floated in 2018's 'The Rise and Fall and Rise of the Great Powers (and the Great Currencies)': that the US could face simultaneous threats from multiple regional 'Great Powers' aimed at undermining its total global position. Following the US retreat from Afghanistan, this crisis seems to again show a *physically* overcommitted US that is politically and economically *under-committed* to the high price of being global policeman against a constellation of adversaries – and in some eyes, Iran is coordinating with Russia, China, Venezuela, and North Korea, with each supporting the others in various ways in pushing back against the US global presence.

Notably, Russian tankers are still transiting the Red Sea unhindered, as are Chinese ocean carriers --an incentive for carriers to reflag container traffic to China(?)-- while state-owned COSCO has refused to deliver goods to Israel, as the Houthis demand, or to continue to cooperate with the Israeli carrier ZIM. China's PLA-N, with a base in Djibouti, has done nothing to confront Houthi attacks on shipping so far. Likewise, Houthi targets have largely been against Western container traffic rather than BRICS commodities bulk carriers or tankers – a deliberate choice given the West are primarily importers of finished goods (the US and UK) or net exporters of them (Germany).

That said, at time of writing Qatar's LNG tankers were also turning away from Suez. Whether this is because they fear or support the Houthis (Qatar is friendly with Iran, and hosts Hamas leaders) it still means this crisis will escalate as energy is also drawn into the crisis mix, albeit not yet in terms of any direct attacks on ships or related infrastructure.

Warship ahoy!

As the Economist notes: '[Welcome to the new era of global sea power: Naval might is back at the heart of competition - and conflict]'. Indeed, the geopolitical backdrop over two years after we wrote 'In Deep Ship' is the maritime, zero-sum, economics-and-finance-meet-geopolitics-and-the-military scenario that we saw through our monocular then. The US-led global order will only see more challenges ahead, especially on the high seas.

As such, the warning signs are also there that without a navy for protection one risks disruption to one's maritime commerce. As Noah Smith puts it: 'World commerce is dependent on America's fading naval power: the world is free-riding on the U.S.' role as the Ocean Police'.

Already we can see French ships are escorting French cargo through the Red Sea, German firms are calling for protection for their shipping, and the EU may send "at least three" ships ahead. That is after all how the world worked before US hegemony, and the US Navy was itself created to protect US merchant shipping from piracy. Even so, it's very unwelcome news for smaller, less well-armed countries and/or blocs. For example, can Europe really project naval power very far for very long? It seems unlikely with its present forces.

In the US, Navy Secretary Del Toro now aims for a whole-of-government "maritime statecraft", including building a new merchant marine, and linked to a Pentagon National Defence Industrial Strategy, to rebuild US power and challenge China's PLA-N expansion. However, this is still seen taking a generation to properly address – if funding can be found.

For now, as Quad ally India plans its own massive naval expansion, fellow member the UK can't send its aircraft carriers to the Red Sea due to a staffing crisis, a problem also forcing it to decommission two other ships. Fortunately, the Russian flagship Admiral Kuznetzov is also kept in port by a lack of trained sailors – for now.

Clearly the renewed emphasis on naval power, military and commercial, will see rising emphasis placed on both on- and near-shoring and on maritime industries, port to starboard: that will shake up global trade and productions patterns even more than we have already seen so far.

Weighing anchor

In short, the current Rea Sea/Suez crisis, on top of the ongoing Black Sea/Ukraine crisis and the risk of others to follow, provides a fat tail risk of potential fresh waves of inflationary supply-shocks for Western economies and financial markets currently predicting nothing but easing price pressures and large rate cuts in 2024.

We can all hope for plain sailing this year, but shall soon 'sea' if this transpires or not.

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