8 February 2024

Global Markets Research

Research Alert

Red Sea risks to have muted impact on freight costs

Red Sea risk and geopolitical tensions raised concerns over spiking freight costs
Soft demand for commodities and global outlook should however cushion such risks
Expect relatively contained spillover to global inflation and monetary policy

Geopolitical risks have raised freight cost concerns

Red Sea troubles have not only sent crude oil prices spiralling upwards, but also prompted shipping companies and tankers to change routes and take longer detours around the Cape of Good Hope in South Africa. This has pushed freight rates higher and raised hopes that a global shipping slowdown in 2023, due to high inventories and pullback in demand, could end. One frequently used benchmark for freight rates is the Baltic Dry Index (BDI), a composite of the dry bulk timecharter averages of the Capesize (40%), Panamax (30%) and Supramax (30%) indices.

There are other determinants of freights costs/BDI, like the world economy and commodity costs

- Primary factors being supply and demand dynamics, driven by economic factors like global trade patterns, GDP growth and commodity prices.
- Geopolitical events, like the current geopolitical tensions in the Middle East or the Ukraine-Russia war which could serve as a noise to freight rates (through the rerouting of shipping routes) and/or oil prices (Russia is a major oil exporter) (Please refer to Figure 1)
- Regulatory changes which could hinder operations in ports. Recent example being the stringent China lockdown during the pandemic
- Weather conditions. Recent example being the Panama Canal drought which forced Maersk to start using 'land bridge' for the Oceania cargo.

Why is Baltic Index important

- It is considered a leading economic indicator as it predicts future economic activity and is also often used as a gauge of demand for raw materials as well.
- Noise to freight rates (through the rerouting of shipping routes) and/or oil prices (Russia is a major oil exporter) could ultimately heighten global inflationary pressures. In fact, a study by the IMF shows that:

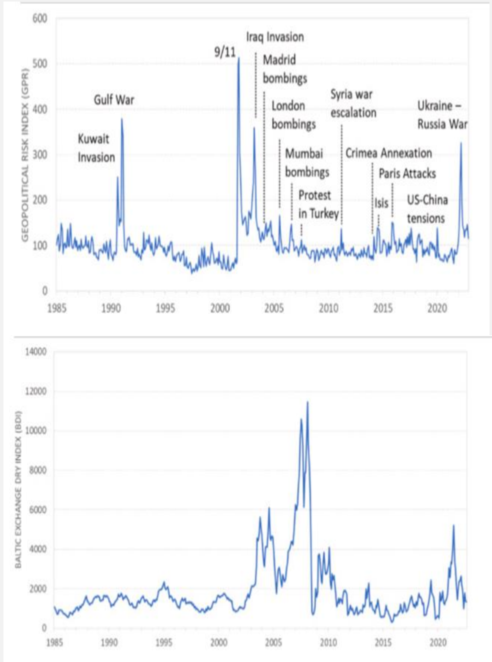
  1) ***When freight rates double, inflation picks up by about 0.7ppts. Effects peaked after a year and lasted up to 18 months.*** (Refer to Figure 3).

  2) Contribution to the changes in inflation due to shipping charges is similar to changes due to shocks to global oil and food prices.

  3) Higher shipping costs hit prices of imported goods at the dock within 2 months, quickly pass through to PPI but the impact on CPI builds up more gradually.

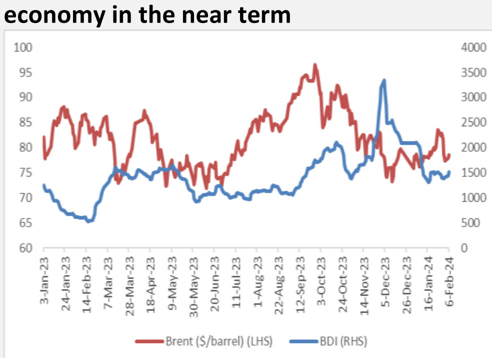
  4) Countries that import more of what they consume, more integrated into global supply, landlocked countries, low-income countries and island states will be the hardest hit.

Figure 1: The Geopolitical Risk Index has impact on the Baltic Dry Index



Source:https://www.sciencedirect.com/science/article/pii/S0360544223001731#fig1

Figure 2: Muted BDI due to softer commodity prices and weak global economy in the near term



Source: Bloomberg

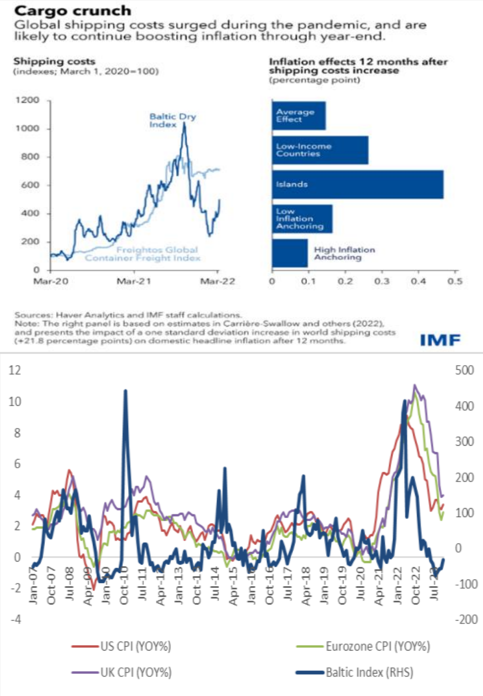
Conclusion: Upside risks to freight rates, but expect rates and inflation to be largely contained given slower economic growth in the near term, low commodity prices and ample supply in the freight market

The latest Red Sea tension and uptick in the BDI recently has raised expectations that a global shipping “recession” will end. In fact, the index rallied from as low as 1,385 on 2nd November to 3,346 on 4th December. However, BDI has since retreated to 1,516 at the point of writing and we do not expect any significant upward pressure from now, to end the shipping recession and to exert further pressure to global inflation (In fact, ***IMF is projecting inflation to moderate from 6.8% in 2023 to 5.8% in 2024 and 4.4% in 2025***). Reason being:

- IMF expects world GDP growth to stay stagnant at 3.1% in 2024 before inching up to 3.2% in 2025 and in tandem with this, oil prices are expected to fall 2.3% to $79.10/barrel in 2024 and -4.8% to $75.31/barrel in 2025. As it is, Brent has fallen from its peak of $83.55/barrel on 26 Jan 2024 to $78.59/barrel at the point of writing on supply glut and demand concerns despite the Red Sea risk. In the same breath, copper prices have also retreated from $390.85/lb to $378.65/lb for the same cycle and iron ore from CNY1,083.50/mt to CNY981.50/mt, suggesting that economic activity should stay soft in the near term (Refer to Figure 3).

- According to UPS’s Insights Into 2024: Your End-to-End Supply Chain Outlook, the logistic specialist is expecting recovery of global demand and flatter capacity growth to keep market rates relatively flat in the air freight market. Rates will likely remain low for the first nine months of 2024, with a potential for growth and a return to peak shipping season in 4Q. In the ocean freight market, 2024 is set to be a record-breaking year again with an estimated 3m TEUs of new capacity entering the market. Excessive available capacity and low demand points to overcapacity, and with this, the Drewry Supply/Demand Index forecast for 2024 is 74.3, its lowest ever reported. (100 is the benchmark for market equilibrium, and anything below 100 represents that supply is outpacing demand).

Figure 3: Shock of the pandemic resulted in a 7-fold increase in cost to ship a container in the 18-months following March 2020



Source: IMF, Bloomberg

Hong Leong Bank Berhad
Fixed Income & Economic Research, Global Markets
Level 8, Hong Leong Tower
6, Jalan Damanlela
Bukit Damansara
50490 Kuala Lumpur
Tel: 603-2081 1221
Fax: 603-2081 8936
Email: HLMarkets@hlbb.hongleong.com.my