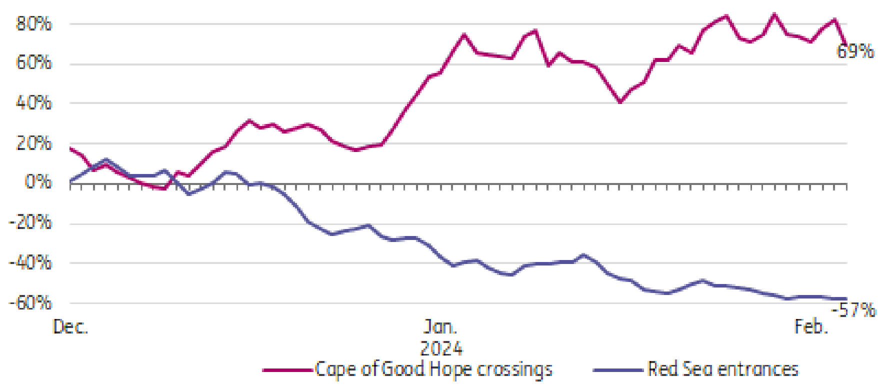
Red Sea crisis shouldn't spur inflation but the spillover to tankers is risky

The Red Sea shipping crisis has dragged on for two months, and a full resumption of transits is not in sight. This is rattling supply chains, leading to delays and higher costs, but it won't derail global trade and the inflationary impact of higher container rates remains limited. The more critical tanker markets are now involved though and this adds to risks

We don't expect a far-reaching spillover effect to hit end-products or inflation for the time being

Number of vessels entering the Red Sea is still declining while Cape roundings have gone up

Number of vessels crossing Bab el Mandeb strait (Red Sea entrance) and passing Cape of Good Hope per day (rolling seven-day average)



IMF Port Watch, ING Research

1. **What is the current situation in the Red Sea and what about supply chains and trade?**

More than 55% of vessels are avoiding the Red Sea, including an increased number of tankers

The Suez Canal route isn't blocked, as some think, but avoidance of the Red Sea still increased through January, despite efforts by the US-led Operation Prosperity Guardian. At the start of February, the weekly number of ships crossing the Bab el Mandeb strait dropped to 220, 55% lower than last year. This means that around 290 vessels have been re-routed around the Cape of Good Hope, carrying almost two-thirds of the shipped cargo. Over the course of January and following announcements from BP and Shell, the number of re-rerouted tankers mounted and increased by a similar amount.

Re-routing container trade is becoming the new normal and has been priced in

The risks are unlikely to disappear soon amid ongoing incidents, the war in Gaza and associated tensions in the Middle East. Several container liners have now included the Cape routing in their (next) sailing schemes, which suggests that this will be the new normal for now. The initial shock of re-routing was disruptive, but as things settle, the available overcapacity will be able to absorb the extra required vessels. And the still limited congestion indicates that it won't get much worse than this. Container spot rates, including surcharges, per twenty-foot equivalent unit from Shanghai to Rotterdam are still more than 3.5 times higher in early February compared to two months earlier but have stopped rising in recent weeks. After the Chinese New Year break (10-17 February) supply chains can start to recalibrate and rebalance in accordance with the new reality, although container rates will remain elevated for however long the re-routing lasts.

Production interruptions at manufacturers short lived – trade delayed than derailed

The re-routing, which started to gain traction before Christmas, has led to some quiet weeks at European ports at the start of the year. Tesla interrupted production at its German site for two weeks from the end of January and other automotive companies including Volvo, Suzuki and Michelin also ceased production at European locations for a short period due to shortages. According to the Kiel Trade Indicator, global trade fell by 1.3% month-on-month in December 2023 and the Red Sea delays are likely to weigh on the first quarter of the year as well, resulting in a minor negative impact on GDP. However, we do not expect current events to weigh heavily on global trade numbers this year. We feel comfortable sticking to our current goods trade forecast of 2.5% in 2024.

2. What is the impact on commodity markets?

Tankers increasingly re-routed – which leads to even longer miles and capacity depletion

In terms of commodity flows, oil markets appear most affected. Large volumes of both crude oil and refined product move through the Red Sea. EIA numbers show that around 9m bbl/d of oil and products moved through the region in the first half of last year. Tanker volumes have fallen significantly as attacks have escalated. According to IMF PortWatch, average daily tanker transit at the Bab el-Mandeb Strait was down around 48% year-on-year and the figure has fallen even further at the start of February. Northbound tanker flows towards Europe are most affected, which are now instead taking the longer route around the Cape of Good Hope. As for southbound cargoes, which move towards Asia, these flows have been less affected. However, following the recent attack on a tanker carrying Russian naphtha, there certainly is the potential for more southbound tankers to divert. Previously it was thought that Russian volumes would be able to move through the Red Sea largely unaffected. In addition, the impact is significant for oil product flows, with tonne-miles increasing most significantly for product tankers over the last two years. This also led to new highs in tanker earnings.

The ICE gasoil crack has strengthened from a little over US$22/bbl in early January to more than US$30/bbl by the end of January, suggesting tightness in middle distillates in the ARA region. Arrivals of middle distillates in Europe from Asia and the Middle East were down around 15% MoM in January, according to Refinitiv data. Jet fuel cracks in Europe have seen similar strength.

Nevertheless, we continue to hold our view that ICE Brent will average US$82/bbl over 2024, with a key assumption that the disruptions do not engulf larger parts of the Middle East.

3. What is the impact on inflation?

Higher shipping costs do have a transmission impact, but won't turn the course of inflation

A far-reaching spillover effect to end-products and inflation is unlikely at the current stage. In contrast to the sharp increase in global goods demand triggered by the pandemic, demand is now sluggish, meaning that there are limited price pressures. The situation in the Middle East could still escalate further and also the spillover to tanker and oil markets poses an upside risk to our outlook, but inflation levels should not reach those of the previous year. During the pandemic, the long-lasting supply chain disruptions added up to 2.5 percentage points to US personal consumption expenditure price inflation. However, supply chains are now far less disrupted and average shipping rates (including term contracts) are not anywhere near the peaks we saw then. With international shipping costs accounting for 3% of manufacturing's final costs and less than 1% of input prices, according to European Central Bank research, any transmission to inflation is likely to be limited to a fraction of this.

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