Global Macro Research - Insight

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#Global / #Geopolitics / #Inflation

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Middle East crisis: Transmission channel shifts to shipping

The spillover of the Israel-Hamas conflict into attacks on Red Sea shipping has led to a meaningful increase in maritime transit costs. However, our updated scenario analysis suggests this shouldn't derail global disinflation, although it may stay the hand of central banks in the very near term.

Key Takeaways

- In the months since Hamas's attack on Israel and the subsequent ground invasion of Gaza, regional security has deteriorated. In particular, Houthi attacks have disrupted commercial shipping, resulting in increased global shipping costs.
- These developments represent an escalation from our original 'contained Gaza ground invasion' base case and look more like our 'escalation to other Iranian proxies' alternative scenario.
- Our updated base case envisages continued near-term disruption to shipping, but an eventual degradation in Houthi capabilities such that maritime trade links subsequently normalise.
- The increase in shipping costs may put upward pressure on global inflation. IMF modelling suggests that, if sustained, the run up in freight rates would add perhaps 0.7% to headline CPI over a year.
- But the actual impact is likely to be smaller, partly because our base case scenario doesn't envisage maritime disruption lasting. The supply chain disruption is smaller than during the pandemic. However, these inflationary risks may delay the start of easing cycles relative to market pricing.
- But there is a meaningful risk of additional escalation should the US fail to restore deterrence. Israel may also escalate the conflict by switching focus to its northern border. Were global oil flows to be disrupted, the global inflationary consequences would be greater.

Middle East focus turns to Red Sea shipping

In October we published our initial scenarios for the Israel-Hamas conflict, anticipating that Israel would launch a ground invasion of Gaza and that this would be accompanied by some destabilisation to the region. In addition to increased geopolitical-risk premia, the locus of our concerns about transmission to global macro, especially in the escalatory scenarios, was through oil prices.

More recently, the situation in the region has changed. As Israel signals an intention to pull back in Gaza, Iranian-backed Houthi rebels in Yemen have increased attacks on commercial shipping in the Red Sea. Disruption to maritime traffic has resulted in increased global shipping costs and some global supply-chain disruption. In response, the US and its allies are attempting to guarantee maritime security in the region and have launched airstrikes in Yemen.

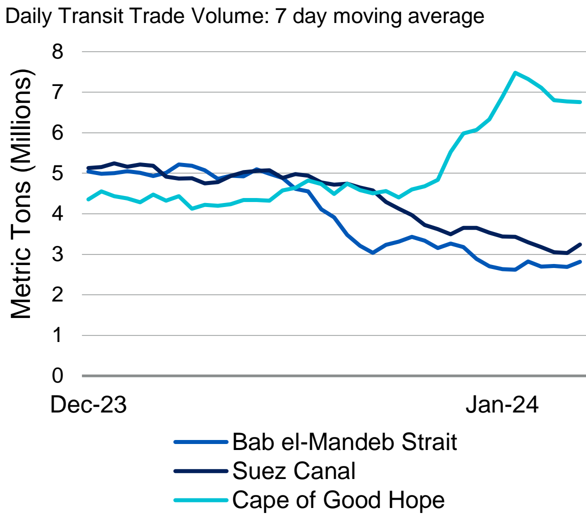
We've therefore updated our scenario analysis. Our base case anticipates a modest escalation over the short term, increasing shipping costs, but an eventual degradation in Houthi capabilities that eventually ends maritime disruption. The inflationary impacts through shipping disruption are therefore likely to be modest for now. However, in our more severe escalatory scenarios, global oil flows also become disrupted alongside rising shipping costs, leading to greater inflationary consequences.

Maritime trade disruptions

The Red Sea, running from Suez Canal to the Bab el-Mandeb Strait, is a key chokepoint for global trade. Almost 15% of shipping cargo passes through the Red Sea, including 8% of grain, 8% of LNG and 12% of seaborne oil.

Re-routing around the Cape of Good Hope (see Figure 1) has significantly increased transit and insurance costs, and Asia-Europe delivery times have risen by two weeks or more. The longer these disruptions persist, the more knock-on effects there are when it comes to the availability of ships, containers and staff on other global routes as well.

Figure 1: Shipping routes redirected



Source: abrdn, IMF Portwatch, January 2024

Current disruptions put upward pressure on inflation…

Supply-chain distortions played an important role in driving inflation during the pandemic (Figure 2). Goods inflation peaked in October 2021, when shipping costs and supply-chain bottlenecks were most stretched, amid strong durable goods demand during the pandemic. The Russia–Ukraine war also disrupted Black Sea shipping routes and commodity supply, delaying the moderation of global inflation.

Figure 2: Risk that supply-chain disruptions could return to delay disinflation trend

Source: abrdn, Haver, January 2024

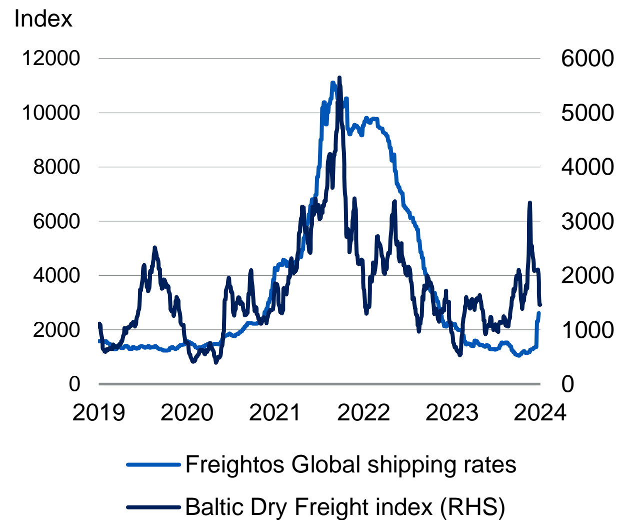
The recent spike in shipping costs could exert upward pressure on inflation. Estimates from the IMF suggest that a persistent doubling in maritime freight rates – roughly what has occurred over the past few months – would cause global inflation to pick up by 0.7 percentage points, with a peak impact after 12 months. The pass-through to core inflation is smaller, at about 0.2 percentage points.

However, the impact, at least in our baseline geo-military scenario, which expects an eventual reversal in the spike in shipping costs, is likely to be smaller than this. Supply-chain disruptions look mild compared to the perfect storm experienced at the height of the pandemic.

…but dwarfed relative to pandemic

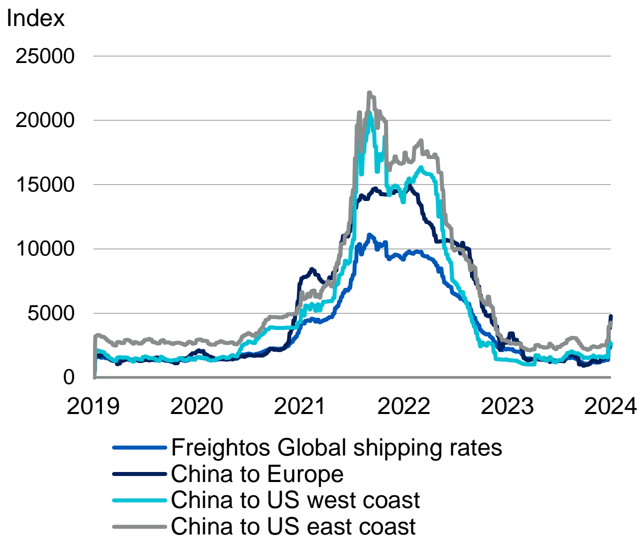
The rise in shipping rates pales in comparison to that experienced during Covid (see Figure 3). While shipping costs along the Shanghai-Rotterdam route have quadrupled since the start of the Houthi attacks, they started from a much lower base. Meanwhile, Asia-US shipping routes and costs have been much less affected (see Figure 4), with even more limited inflationary spillovers to the US.

Figure 3: Rise in shipping costs mild relative to pandemic



Source: abrdn, Bloomberg, January 2024

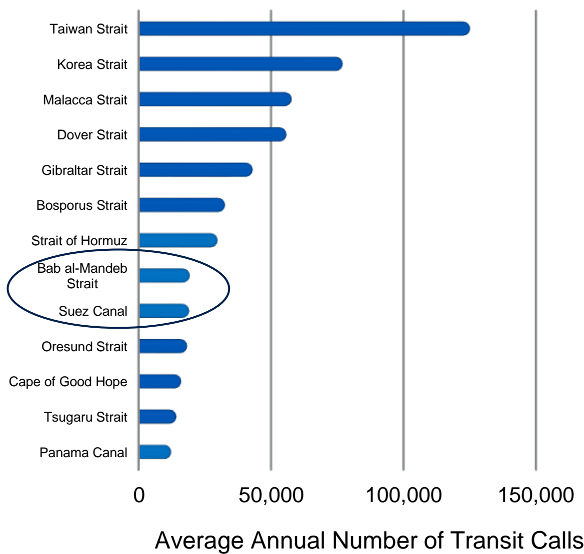
Figure 4: US-Asia shipping costs less affected



Source: abrdn, Bloomberg, January 2024

Although the Red Sea routes are significant, they remain modest in comparison to other transit points (Figure 5). Indeed, geopolitical tensions around Taiwan could in the long run have a much larger impact on global supply chains given the importance of the Taiwan Strait.

Figure 5: The biggest maritime chokepoints are in Asia not the Middle East



Source: abrdn, IMF Portwatch, January 2024

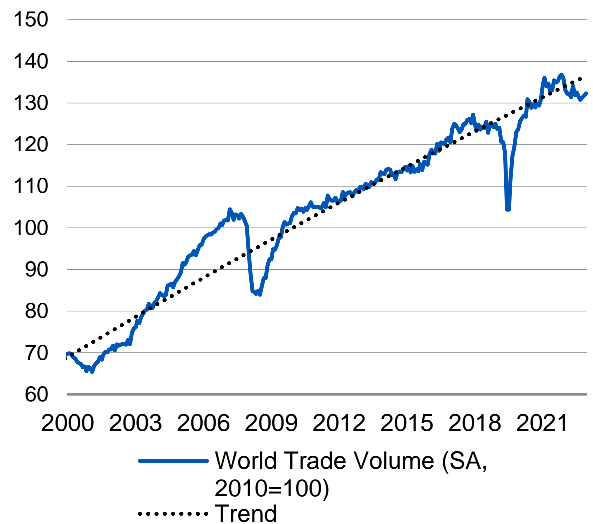
Admittedly, Middle East disruptions come alongside a significant reduction in the capacity of the Panama canal, which is suffering from drought and low water levels.

But, relative to Covid, the scale of global supply chain disruption is much smaller (again, see Figure 2). However, disruptions across Asian ports and factories are no longer at play, while infrastructure and logistics have improved substantially in major ports such as Los Angeles and Long Beach, where the prospect of multi-week queues is far lower. A record number of new ships were ordered during the pandemic, and by some estimates there was meaningful overcapacity in global shipping before the Houthi attacks.

Meanwhile, the direct weight of container shipping costs in producer price inflation baskets is small, around 0.15% in the UK and 0.09% in Europe, although indirect transmission through goods prices is much greater. Nevertheless, the pass-through to inflation is smaller than that associated with shocks to oil prices or food, which are much more pervasive. Despite some volatility, the overall oil price impact of events in the Middle East remains fairly limited. There have been no direct attacks on oil infrastructure, while spare capacity remains elevated.

The indirect effect of higher shipping costs would be largely felt in goods prices, and it is possible that some of the progress on global goods disinflation is reversed. However, compared to the pandemic, goods demand is weaker and indeed below trend (see Figure 6), reflected in weaker container demand. Central banks remain far more focused on underlying services inflation, which is unlikely to be materially affected by these disruptions.

Figure 6: Global goods trade already in contraction



Source: abrdn, Haver, January 2024.

Risks may stay central banks' hand in the short term

Despite the relatively modest impact on inflation, the obvious risks presented by a further shock to shipping and energy prices may delay the onset of monetary easing.

Even in our base case, bond market volatility could increase given how much easing has already been priced into markets.

Central bankers – notably including ECB President Christine Lagarde in Davos – have already begun to cite events in the Red Sea as one of the reasons why market pricing for rate cuts may have moved too far too fast.

We continue to expect major central banks to start cutting rates in Q2 rather than in Q1.

Transmission into US politics

Our two serious escalatory scenarios entail political consequences for President Joe Biden, who pledged to end US involvement in Middle Eastern conflicts. Donald Trump, his Republican rival, might pledge to remove the US from any activity still being undertaken, likely adding to the geopolitical risk surrounding the US election.

Updated geo-military scenarios

In light of the changing military situation in the Middle East and shifting inflation drivers, we've updated our scenario analysis (see Figure 7).

1. Red Sea security only gradually restored: 60%

In the base case scenario, Israel's ground operation in Gaza draws to a close and its military focus moves to its northern border.

Houthi attacks on commercial shipping continue for now, with supply-chain disruptions worsening somewhat in the near term.

The US and allies step up strikes on Houthi targets, which gradually degrade Houthi capabilities. Attacks on shipping significantly reduce after a few months.

2. Conflict spillover intensifies: 30%

US and Israeli efforts to use force as a tool of de-escalation backfire. Iranian-backed proxy groups and other actors in the region escalate their attacks, most seriously in the Red Sea. The US and allies are forced to deploy more troops to the region.

Most notably, the threat to shipping increases, with oil tankers also targeted, including potentially in the Strait of Hormuz. Strikes across the Israel-Lebanon border intensify, and the security situation in the West Bank deteriorates.

3. Full scale Middle East war: 5%

We see a small risk that escalation by Iranian-backed proxy groups could result in an even more significant conflict across the whole Middle East, bringing Israel, the US, Iran, and a variety of non-state actors into more open and larger scale conflict.

This extreme downside scenario could be triggered by attacks on commercial or indeed US or allied naval ships resulting in a sinking. Alternatively, attacks on US military bases in the region could involve loss of life. Another route into this scenario might be direct Israeli attacks on Iranian infrastructure.

Oil flows, and energy infrastructure are likely to be targeted, and Iran may take on a direct role in disrupting shipping through the Red Sea and Strait of Hormuz. This is likely to be much more disruptive to the global economy.

4. Conflict de-escalates: 5%

There is a small chance that the situation de-escalates without further military action. Military strikes conducted against the Houthis could have successfully impeded their ability to carry out attacks. Meanwhile more countries are sending naval vessels to the area to escort commercial shipping, which could also deter attacks.

Equally, as Israel pulls back from Gaza, its domestic political constraints and Hezbollah's desire to avoid a full conflict may successfully deter both sides from escalation on Israel's northern border.

Authors

Lizzy Galbraith, Sree Kochugovindan, Paul Diggle, Luke Bartholomew, and Mark Bell

Figure 7: Middle East geo-military scenarios

	Description	Indicative probability	Waymarks	Impact
Conflict deescalates	US and Israeli strikes on Iranian proxy groups restore deterrence, meaning attacks in the Red Sea stop and shipping routes return to normal. Israel pulls back from Gaza and there is no escalation with Hezbollah.	5%	• Initial military strikes conducted by the US and its allies reduce Houthi capabilities enough that attacks on shipping cease. • Israel turns its focus to domestic political matters and the restoration of a civilian leadership body in Gaza, ending major military operations.	• Short-term instability fades, though Israeli-Hamas tensions remain heightened for some time. • Market disruption is limited, as political crisis dissipates, and freight rates subside. • Small relief rally in risk assets and slightly decline in commodity prices.
Red Sea security only gradually restored	Israel pulls back in Gaza but carries out limited military action across its northern border. Houthi attacks on shipping continue for now. US undertakes repeated strikes against Houthi targets in Yemen, which eventually degrade Houthi capabilities and reduces threat to shipping. Terrorism risk continues to be elevated.	60%	• As the ground operation in Gaza draws to a close, Israel seeks to restore deterrence in the wider region, in particular responding to strikes by Hezbollah targeting northern Israel. • Repeated US strikes on Houthi targets are required to sufficiently degrade its capability, but the frequency and ambition of attacks decreases over time. • Regional terrorist activity increases, but remains contained. • Iran remains on the sidelines.	• Threat to shipping subsides within a few months, and US eventually withdraws from region. • Freight rates gradually normalise. Pass-through to inflation is limited relative to the pandemic. • However, central banks may cite upside inflation risks as a reason to delay the start of cutting cycles until closer to mid-year. • Oil price remains volatile but range bound.
Conflict spillover intensifies	Israeli and US efforts to deter escalation are not successful. The Red Sea continues to face significant disruption. Proxy groups in the region escalate attacks, resulting in the US deploying more troops, as well as carrying out increasingly significant military strikes. Terrorism risk and threats to shipping, including oil tankers, intensify.	30%	• The deteriorating security situation in the Red Sea causes the United States and allies to increase their military activity in the region, escorting ships and carrying out military strikes. • Initial military strikes fail to end attacks on shipping and lead to escalation from other groups, resulting in the US taking on a bigger policing role. • Iranian activity continues to inflame regional tensions. • Ongoing Houthi attacks on shipping may embolden other groups in the region to continue attacks on US and Israeli targets.	• Energy and freight costs increase. Spillovers to other supply chain channels lead to further increase in goods prices and wages in related sectors. • Oil flows through the Strait of Hormuz are reduced, putting upward pressure on oil prices. • President Biden faces pressure at home. Trump is likely to campaign on a withdrawal from the region. • Shipping costs at least double again from here. There is some upward pressure on oil prices.
Full scale Middle East war	Escalation by Iranian backed proxy groups could result in an even more significant conflict across the whole Middle East, bringing Israel, the US, Iran, and a variety of non-state actors into more open and larger scale conflict.	5%	• Attacks on shipping intensify and include the direct involvement of Iran. Oil tankers, and oil infrastructure, become targets. • Attacks on US military assets and bases across Syria and Iraq intensify. A civilian or military vessel is sunk, or loss of US service personnel. • Agreements like the ceasefire in Yemen come under threat.	• Significant increase in energy and freight prices and large spillover to the global economy through higher inflation and lower growth. • Large population movements and a deepening of the humanitarian crisis lead to social and economic strain in neighbouring states. • Negative political consequences for President Biden, swinging the election decisively to Trump. • Shipping costs revisit pandemic-era high, and oil prices rise well above $100.

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