

Special Reports

Economic Impact of the Conflict in the Red Sea

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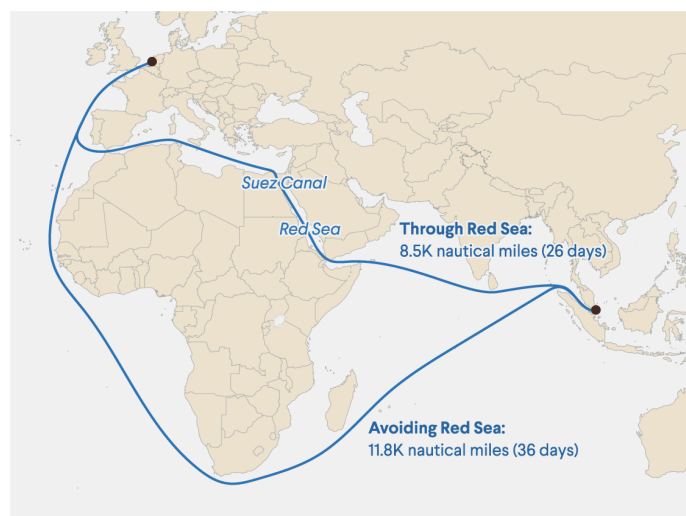


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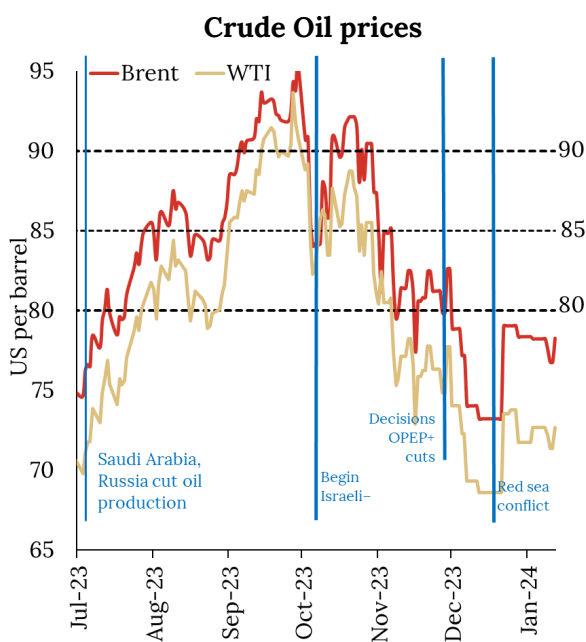
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Summary

The Red Sea is a critical maritime route that connects Europe, Asia, Africa, and holds immense strategic importance in the global economy. The Suez canal facilitates the movement of goods and energy resources, making it a gateway for a significant portion of the world's trade as it connects the Mediterranean Sea to the Indian Ocean. Due to its strategic location, many major global powers exert influence in the region in order to secure their economic interests. However, over the years there have been many threats to trade passing through the Red Sea such as the Somali pirates who caused disruptions in trade in the region about ten years ago. Now, the Houthi rebels, a Yemeni insurgent group, have started to cause trouble by attacking ships that are passing through the area. Although many have just started to hear about the attacks, due to the Israel-Hamas conflict, the Houthis had previously attacked ships associated with nations fighting alongside the Saudi-led coalition in Yemen. The Houthis specifically targeted crude oil tankers that are owned by Saudi Arabia's state shipping company, Bahri, when they were traveling through the Bab al-Mandab Strait to or from the Red Sea and Suez Canal.



Currently, they have been attacking Israeli owned oil tankers with drones and rockets following the Israeli raid on Gaza on October 7, in support of the Palestinians. Recently, they attacked a ship belonging to the Mediterranean Shipping Company (MSC), one of the largest shipping companies in the world. The ship that was attacked, Platinum Three, sustained enough damage to no longer be operational, luckily none of the crew was harmed. Due to the attack MSC and a few other companies suspended the transit of cargo through the Red Sea, forcing ships to take the long route all the way around Africa adding thousands of miles to the journey.



Source: EIA- Economic Research Accivalores

This detour has caused prices to rise to ship each container and barrel of oil, as well as fuel for the journey, and other costs. If this pattern persists, there could be a significant rise in the cost of items in the global market, meaning shipping companies and even consumers will eventually feel the aftermath of the attacks. The more frequent the attacks become, and the more marine traffic is disrupted, the more prices will be impacted. There is some hope however, due to the task force that was formed recently, led by the United States, called Operation Prosperity Guardian, which includes many European countries as well as Australia, Canada, and even Bahrain as the sole member from the Middle East. This task force has started to

defend against attacks and allow ships to move safely through the Red Sea, and has allowed many of the companies that diverted traffic to the area to resume operations.

This task force has already successfully deterred and repelled a few attacks, but it brings to question the bigger picture due to the fact that the Houthis are backed by Iran. This means that in certain conditions, while already a serious matter, the conflict could spiral into something a lot more significant as tensions in the Middle East are already high. The possibility of a regional war is very high due to the conflict between Israel and Palestine in Gaza. If more powerful countries were to get involved more significantly, it could mean the breakout of a much more catastrophic conflict. The US recently killed all crew members of three Houthi boats that had been attacking a container ship, and although this was not considered decisive in itself, although it is a significant departure from previous practices it falls short of strikes on militant bases within Yemen. If strikes were to occur this would definitely risk a wider confrontation with Iran and other allied countries. The Houthis have promised not to back down until humanitarian aid is allowed into Gaza and Israel stops its attacks on Gaza which inevitably lead to many civilian casualties.

After some traffic had started to be reintroduced to the Red Sea, the United States and the United Kingdom, initiated military strikes on Houthi bases after Iran attacked and captured an oil tanker off of the coast of Oman on January 11th. These strikes by the US and UK took place on January 12th, and struck nearly 30 locations using more than 150 munitions. The Houthis have responded and said that they will continue to target ships for as long as the war in Gaza continues. This is definitely a large escalation and points to the conflict not ending anytime soon, meaning dire consequences for the world economy.

Economic Impacts

The economic impacts of the conflict in the Red Sea are far reaching and although they have ramped up due to the Israeli-Palestinian conflict, Yemen has its own conflict with Saudi Arabia, and there are worsening situations in Sudan and Ethiopia. All of these could impact the world, but Europe is especially vulnerable as the conflict in Ukraine has

already caused a significant economic strain. The United States has failed in its attempts to construct a new regional security architecture, meaning that there is a need for an alternative process focused on inclusive regional cooperation. The EU should develop its own track of maritime security cooperation with regional powers like Saudi Arabia and the UAE.

Although the Suez Canal and the Red Sea is an important trade route for the entire world, European countries will be the most impacted by large scale conflict in the area, as well as the fact that they would be surrounded by even more conflict if there is more escalation.

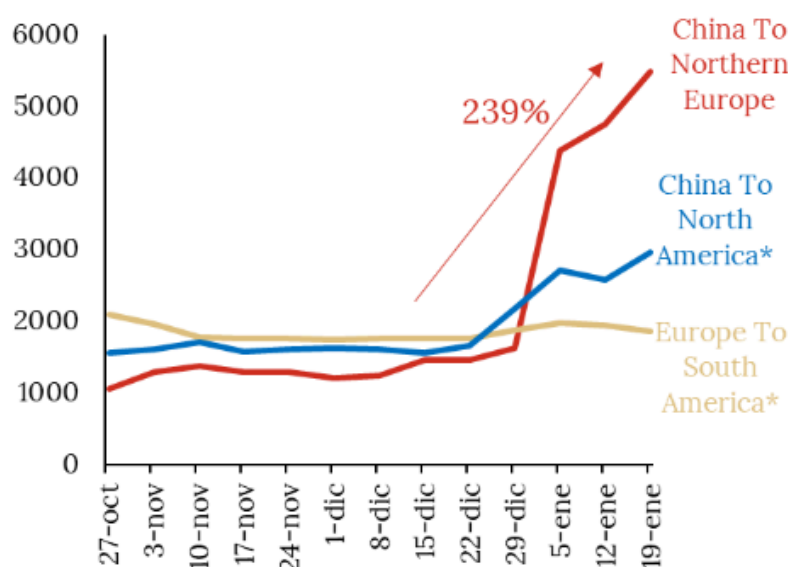
Although supply chains started to return to normal after the United States intervened, further attacks caused companies to start taking the southern route again. There is a possibility that the security threat alone could see prices more than double in the next few weeks. Since the Houthis have already stated that the security operation won't deter them from continuing the attacks, it is likely that prices will increase in terms of fuel costs, private security, and insurance premiums for these ships as well. So far more than 200 ships have reported incidents, with some 180 vessels forced to change course. This will inevitably trickle down to the average consumer, especially in Europe. The conflict could potentially incentivise more trade to the United States, Africa, and Australia as avoiding the Red Sea will be much

safer for the shipping companies bottom line and almost ensures profits.

Redirections of maritime traffic past South Africa and the Cape of Good Hope have already raised prices to about three times what they were before the attacks became more frequent since October 7th. Although not reaching the price of over USD\$20,000 per shipping container during the COVID 19 pandemic, the current surcharge is at about \$5,000 per container for the detour, and it adds at least a million dollars to the price of fuel per voyage. If it were just a few ships that were avoiding the Red Sea not much would have changed, but up to half of the ships were avoiding the region before the US task force was formed. If the conflict was to escalate it could reroute about 15% of global containers, which would definitely impact prices more than it has already. This without mentioning the additional two weeks that it takes to go around the horn of Africa.

Another complicating factor is the fact that a lot of the ports around Africa, Europe, and Asia may be more congested, and therefore experience delays. For example a company that handles 50,000 containers a week may have a week where nothing arrives due to redirections and longer transit times, but the following week twice as many containers arrive causing congestion and workforce problems as they may not have the machinery or manpower to handle that much of a load.

Ocean freight container pricing index



Source: Freightos- Economic Research Accivalores.
* Destination to West Coast

Higher fuel costs, shipping container costs, insurance costs, time costs, risk factors, congestion costs, and private defense costs, all add up to a monumental amount that really hurts the profits of these shipping companies. This is why although many companies resumed transit through the Red Sea briefly, most such as Maersk have suspended their voyages through the area again after more attacks occurred over the weekend. Also, many new surcharges for these vessels have appeared out of nowhere including contingency surcharges, contingency adjustment charges, and emergency contingency surcharges. If companies don't accept these surcharges, their cargo is not moved.

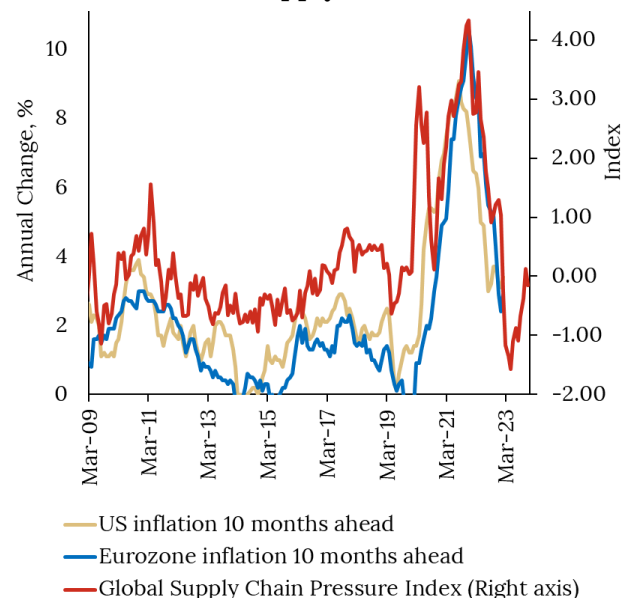
Additionally to the possible delays, there is a lot of confusion in the shipping industry in regards to timelines and deadlines for the arrival of ships and therefore products. There is a lot of uncertainty and chaos due to congestion and the rerouting of certain ships. This has caused companies, shippers, and site project managers to scramble to keep customers in the loop and content with their services.

All of these economic factors have left the markets uncertain, and will undoubtedly impact inflation, however it could go both ways. The issue is that the inflationary reaction to this will potentially not come into play for a few more months if the conflict continues. The first possibility is that the conflict ends, although it is unlikely since the Houthis are backed by Iran, there is a chance that if tensions fall in the Israeli-Palestinian conflict, the conflict in the Red Sea may die down. The second possibility is that it continues, which at this moment is more likely. If the conflict continues and ships are forced to reroute past the Cape of Good Hope in Africa indefinitely, inflation is sure to rise eventually as the cost of shipping and all the added costs mentioned above will cause companies that are shipping the products to eventually have to raise their prices.

Some experts say that inflation will be more localized to Europe, and the United States won't be affected as much since shipping from China can go directly towards the west coast of the country. Indeed, the ocean freight container price index has surged by approximately 239% since the end of December for routes from East Asia to Northern Europe. However, it's noteworthy that routes to the United States or South America have not shown evidence of such a substantial increase during the same period.

Historically, supply chain pressures have consistently influenced overall inflation, until in the 12 months ahead. Our estimations indicate that the strongest correlation is observed approximately 10 months into the future. Interestingly, the impact on European inflation is notably more pronounced compared to that on U.S. inflation. This discrepancy is a key factor contributing to the notion that developments in the Red Sea region could have a more direct and substantial effect on European prices.

Inflation and Supply Chain Pressures



The Correlation Coefficient

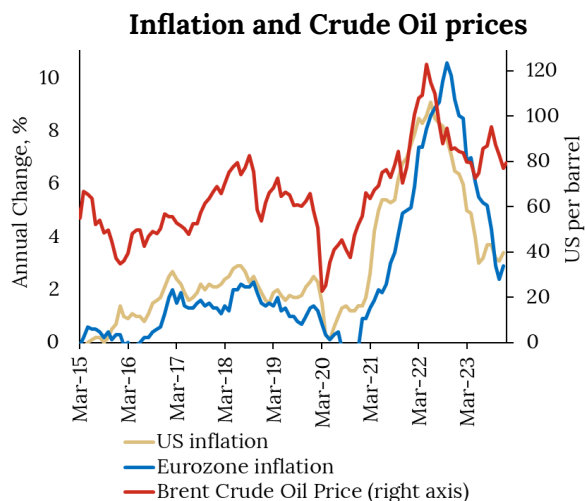
	Supply Chain Pressure	US inflation 10m ahead	EU inflation 10m ahead
Supply Chain Pressure	100%	33%	82%
US inflation 10m ahead		100%	90%
EU inflation 10m ahead			100%

Source: Eurostat, BLS, NewYorkFed,- Economic Research
Accivalores. *Data from 2016-2023

Regardless of the impact on European prices, the impact most likely won't be as bad as it was during the pandemic because that was more of a supply chain issue instead of a transportation problem. The fact remains that since last week, for instance, prices for shipping a 40 foot container have almost quadrupled, going from around \$2,000 a few weeks ago to being reported as high as \$14,000 recently. While this is half of the price during the pandemic it still represents a huge increase, meaning that if

nothing changes, it certainly will cause inflation, although it is too early to know exactly how much.

Furthermore, the rise in crude oil prices can directly impact inflation, as these two variables exhibit a strong correlation. This connection is primarily attributed to the influence of energy costs within the household basket.



The Correlation Coefficient

	Brent Price	US inflation	EU inflation
Brent Price	100%	83%	81%
US inflation		100%	90%
EU inflation			100%

Source: Eurostat, BLS, EIA- Economic Research
Accivalores.

*Data from 2016-2023

A few thoughts

The conflict in the Red Sea has the potential to change the economic landscape of the world but especially European commerce. The rerouting of ships to the Cape of Good Hope, and the failure of the task force implemented by the United States to make the Red Sea route safer may lead to the price of goods going up in the next year. Since anywhere from 12-20% of the world's commerce is supposed to travel through the Suez Canal, it could have a much larger impact than most experts expect.

The increases in prices of shipping each container, higher insurance premiums, more private security, fuel costs, and other expenses will all stack up if nothing is done to end the conflict promptly. Also, if a wider conflict were to erupt in the Middle East, it could lead to a further increase in attacks or other worse unforeseen consequences. Preventing the escalation of the conflict may well be impossible, especially if the conflict in Israel and Gaza continues. Investors should prepare accordingly and hope that the situation does not escalate into a more serious global crisis.

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