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ASSET MANAGEMENT

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Market views and strategy

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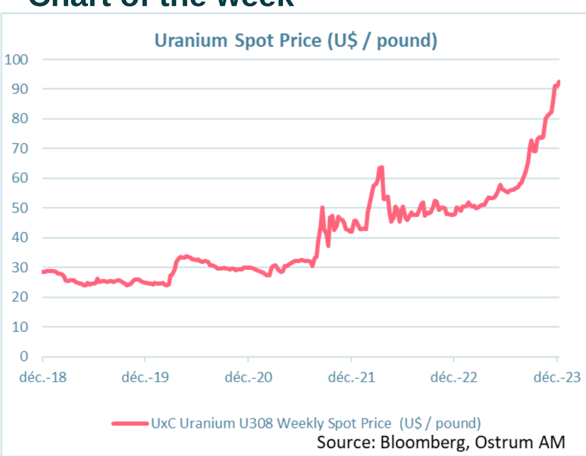
Topic of the week: Red Sea, Panama, and Inflation

- **Tensions in the Red Sea and Panama Canal have brought back the specter of distortions in the global supply chain;**
- **The consequences are higher freight costs, especially for sea routes from China to Europe;**
- **An inflationary shock as in 2021 seems unlikely;**
- **However, this should not be long-term. Contagion to other critical bottlenecks could also impact inflation through higher oil prices.**

Market review: An unsinkable market?

- **US inflation at 3.4% in December;**
- **T-note yields dip back below 4%;**
- **Strong demand at euro area sovereign bond syndications;**
- **Equities rebound as high yield spreads narrow.**

Chart of the week



Uranium prices are at their highest in 17 years. The benchmark contract is $90 a pound. The surge in prices is due to the revival of nuclear in the energy mix in Western countries.

Other factors also explain the surge in prices, such as fears of oil and gas supplies linked to geo-political tensions, particularly after the coup in Niger.

Global demand for uranium is expected to continue to grow. Kazakhstan is the world's largest uranium producer, producing 45% of the market supply.

Figure of the week

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Source : Bloomberg

U.S. debt reached a new all-time high of $34.002 trillion. It is also the age of the new French Prime Minister, the youngest of the 5th Republic.

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• Topic of the week

Red Sea, Panama and inflation

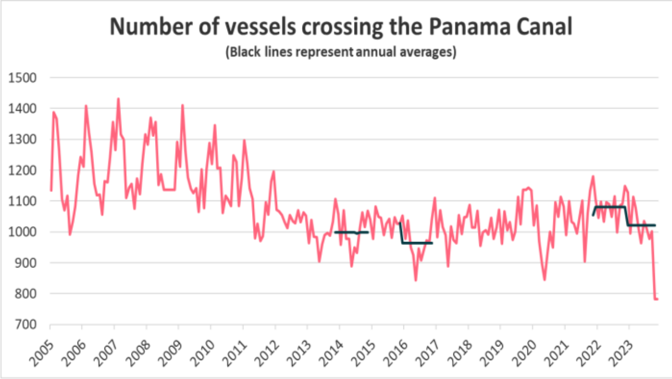
While global supply chain distortions largely related to the Covid-19 crisis seemed to be behind us, the clashes in the Red Sea and the persistent delays in containers using the Panama Canal related to drought represent another risk for global value chains and inflation. Is the increase in freight costs the black swan of the beginning of 2024?

Geopolitical and climate shocks: the new deal for global trade

80% of the world's merchandise trade is through the seas and oceans. The safety of sea routes is therefore essential for the dynamics of world trade. However, this seems to be called into question by the multiplication of geopolitical and climatic shocks revealing the strong dependence of world trade at important chokepoints such as the Panama Canal and the Suez Canal.

Panama Canal: climate and lack of infrastructure

40% of US shipping and 3% of world maritime trade pass through the Panama Canal. It is also an important source of revenue for Panama, which reached $4.3 billion in 2022, or 5% of GDP. However, the country experienced its worst drought in 73 years, exacerbated by the El Niño climate phenomenon, resulting in the decline of shipping traffic through its channel, as shown in the graph below.



At the end of December 2023, 748 vessels crossed the Panama Canal, the lowest traffic volume since 2005, including traffic during to the last severe El Niño episode in 2016. If the climate explains the persistent problems of the Canal, lack of infrastructure is also an important element to highlight. To compensate for chronic lack of water, a $2 billion project would involve digging an 8 km tunnel along the Indo River to Lake Gatún, its main reservoir. However, it faces serious environmental and social problems.

The Panama Canal crisis is expected to intensify. The ISM service survey for the month of December indicated that the blocking of the channel should continue for several more months, at the cost of an increase in freight costs and an extension of delivery times. In addition, the Panama Canal Authority also reported a decrease in traffic volume to 18 vessels on 1 February, compared to 24 vessels in January. The traffic volume is usually 36 ships. Despite recent rainfall exceeding expectations, the government is focusing on supplying the population with drinking water.

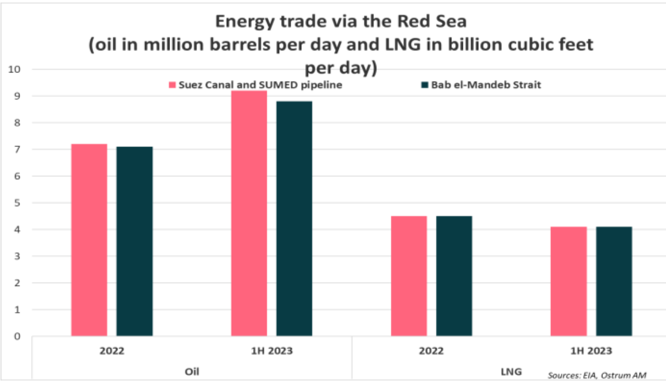
Suez Canal: key gateway for global trade and energy

Red Sea chokepoints are critical for international oil and gas flows :

- **The Suez Canal** (and SUMED pipeline) where 12% of international goods flows, 12% of global petroleum product flows (H1 2023), and 8% of international LNG flows transit;
- **Bab-el Mandeb** is a critical crossing point for the Gulf countries, as their oil and LNG exports have to cross this strait to reach the Suez Canal (and the SUMED pipeline) and ultimately Europe.

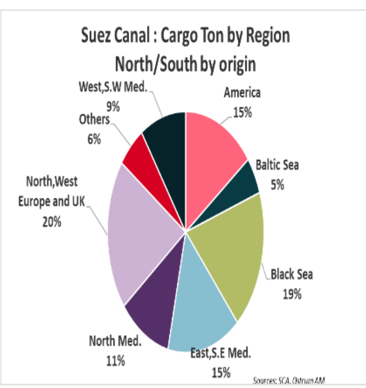
- **The Hormuz Strait** is a strategic route that connects the Gulf of Oman to the Persian Gulf. More than 20 million barrels per day pass through the Strait of Hormuz, which is equivalent to 20% of the world's crude consumption! Unlike the Red Sea, where diversions are possible through the Cape of Good Hope, there are very few alternatives for ships that must engage in the Strait of Hormuz.

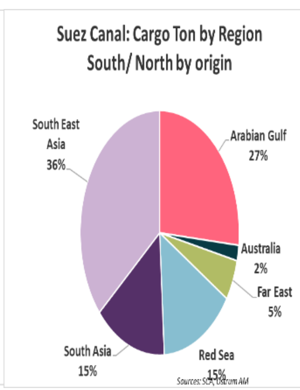
The graph below representing the volumes of crude and LNG transported via the Suez Canal and the Bab-el-Mandeb Strait.



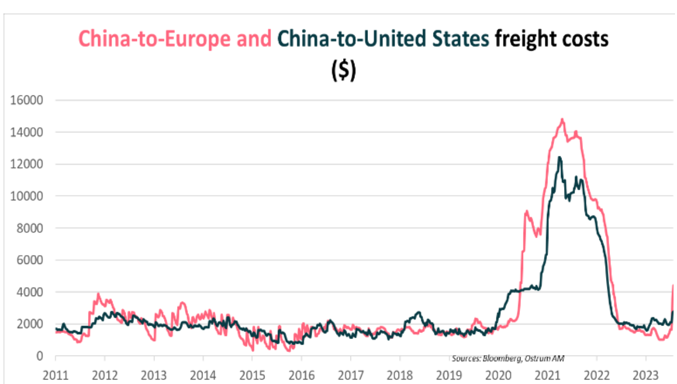
Western sanctions against Russian oil in early 2022 have profoundly altered international energy flows. Europe was forced to import more oil from the Middle East via the Suez Canal and the SUMED pipeline, explaining the 28% increase in crude volumes in the first half of 2023 compared to 2022.

Europe and Southeast Asia are the most affected by the distortions of the Suez Canal, as their exports account for 20% and 36% of the volume of goods transiting the canal, respectively, as shown in the graph below.





This explains the significant increase in freight costs from China to Europe compared to the US, as shown now.



The rise in sea freight prices is significant but remains contained compared to 2021. Between October 2020 and October 2021, freight costs had increased by 600%. The increase in journey time, the increase in shipowners' fuel costs, related to the diversion of ships to Africa, and the increase in insurance premiums from 0,02% to 0.5% explain the increase in freight costs for Europe.

What are the implications for inflation ?

Rising freight costs are an underestimated catalyst for inflation.

The freight cost angle in the 2021 debate on the transitory or sustainable nature of inflation had not been considered, leading to an underestimation of the sustainability of inflation.

Indeed, unlike oil and food, the contagion effects of higher freight costs on inflation are more persistent at 18 months compared to 2 and 7 months respectively for oil and food ("Shipping costs are an important, and understudied, driver of global inflation", according to the study by D. Ostry, D. Jiménez, P. Deb, D. Furceri and Y. Carriere-Swallow, published in the IMF blog).

The authors also calculated that the 600% increase in freight prices in 2021 contributed to 2 ppt to global inflation. A doubling of freight costs would, according to the authors, increase inflation by 0.7 ppt.

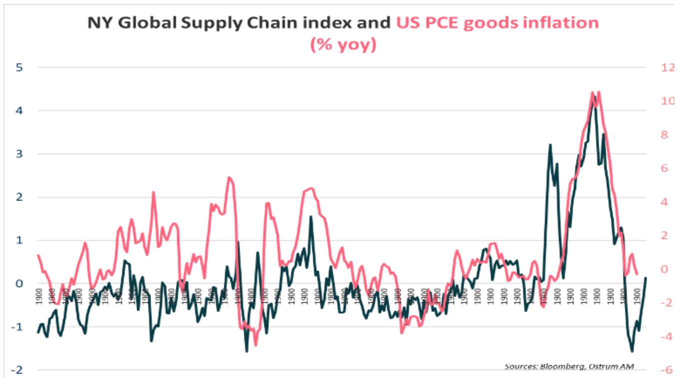
The impact also varies by country. Island countries are the most vulnerable, as well as low-income countries. The institutional monetary framework is also an important factor. In countries with a weak institutional monetary policy framework, the impact of freight cost increases on the inflation rate is strongest and most persistent.

An inflationary shock as in 2021 seems unlikely…

An inflationary episode, linked to rising freight costs like as in 2021, seems unlikely. Indeed, the opening of economies was accompanied by strong demand and low stocks of finished products. On the other hand, sea freight capacity to absorb strong demand was very low in 2021. The years 2023 and 2024 are expected to be record years in the delivery of new containers since 2000. The diversion of ships should make it possible to absorb the excess capacity of the sector.

…But disruptions are expected.

Since the beginning of December 2023, the global supply chains are under new tension as shown in the chart below representing the New York Fed Global Supply Chain Index and US PCE goods inflation.



The distortions of the Suez Canal and Panama should lead to longer delivery times and higher freight costs, particularly for Europe, whose contribution to inflation could be comparable to that of energy and food, because of its volatile nature.

The other transmission channel to inflation is the price of oil. When the oil company BP indicated that its ships would no longer use the Suez Canal, oil prices rose from $72 to $78 for brent. Saudi Arabia has lowered the price of its oil exports to Asia to compete with US crude exports. Crude oil prices are expected to remain volatile at these levels, especially if other oil companies decide to stop transiting through Suez Canal.

Finally, this is a significant cost for our planet. Ship diversion is expected to increase carbon emissions by 30-35%. Shipping accounts for 3% of global emissions.

Conclusion

Higher freight costs due to distortions in the Suez and Panama Canal are not expected to cause an inflationary shock as in 2021. Indeed, demand is lower and maritime cargo capacity has significantly strengthened. However, because of the persistent effects of rising freight costs on the inflation rate, this should not be long-term. The contagion effect to other critical chokepoint, such as the Strait of Hormuz, could potentially be a catalyst for higher prices, such as the January 11 Iranian attack on an oil tanker in the Gulf of Oman. While the contagion effect of higher freight prices on inflation is uncertain, one thing is certain: maritime routes that were once secure are so no longer. This is an important change.

Zouhoure Bousbih

Market review

An unsinkable market?

The deluge of bond issuance and an upside surprise on the US CPI appear to have no significant effect on bond markets and risky assets.

Financial markets have stabilized after the initial declines observed during the first week of 2024. The avalanche of bond issues has generally been met with strong investor demand, with a few exceptions within European credit in particular. Sovereign and credit spreads are holding up. High yield spreads have even fallen significantly in the United States and in Europe in the wake of the rebound in US equities. Risk-free bond yields are nevertheless moved higher (to a high at 2.24% on the Bund) but without significant acceleration despite the upside surprise on US inflation data and comments from Central Bankers (Fed, ECB) wishing to avoid preemptive monetary relief. Financial conditions are favorable and central banks do not wish to fuel further easing. Breakeven inflation rates are rising slightly given tensions in the Red Sea. Rising sea freight prices and the admittedly limited rebound in crude oil are contributing factors behind the rebound in breakeven inflation rates. The U.S. dollar was stable last week. The Japanese yen weakened again in response to the publication of wage increases, reducing the probability of a rate increase in the short term.

The latest batch of US economic data point to GDP growth above 2% in the 4th quarter of 2024. Household consumption should have increased by as much as 2.5% between October and December thanks to continued growth in wages and employment. The Atlanta Fed estimates the increase in wages at 5.2% year-over-year in December. Wage growth has been steady since September 2023. Furthermore, potential supply shocks linked to the upturn in maritime freight prices and possible supply chain issues should postpone the convergence of consumer prices towards the Central Banks' objective of 2%. Supply factors were indeed preponderant in the rise in inflation after the Covid crisis. US inflation stood at 3.4% in December, amid upward pressure from the usual drivers of domestic inflation such as housing (+0.5%) and, more generally, services including healthcare (+0.5%). Previous downward surprises on the consumer price index came mainly from imported goods' prices, which are outside the control of the Federal Reserve. However, producer prices fell in December (-0.1% month-over-month). In the euro area, a technical recession appears likely in the 4th quarter. German industrial production contracted by 4.8% from a year ago. In France, consumption and production data jumped in November but it is fair to say that activity has been quite sluggish in the past 15 months. A dreaded stagflation outcome looms in the euro area, which is arguably the hardest situation to deal with for the ECB.

As concerns financial markets, the deluge of bond issuance is met with strong demand from final investors fueled in part by global bond fund inflows of $7 billion since the start of the year. Global money market inflows reached $39.7 billion according to BofA data. A total equivalent to €192 billion in sovereign bonds and credit was issued in 2024.

In the euro area, the return of foreign central banks and sovereign funds is increasing demand for new sovereign bonds. The Spanish bond deal attracted €130 billion orders for €15 billion issued of a 10-year bono at 3.25% yield, while comparable securities were trading near 4% just a few weeks earlier. Belgium and Italy are also reporting record levels of investor interest. Post-deal allocations to hedge funds by government debt agencies are very low. Borrowers favor institutional accounts which are generally less likely to fuel volatility. The Bund rose above 2.20% temporarily due to hedging flows associated with primary market transactions.

On credit market, the average IG credit spread now stands at 140 bp against Bunds and within 100 bp against swap. High yield, less subject to primary market pressure, tightened by almost 30 bp in Europe last week. The iTraxx Crossover is almost back to its lowest levels at 322 bp, postponing a potential return of the decompression trade for the lower rating categories. This is perhaps a sign of complacency.

US stocks rebounded 2% after the initial weekly decline and outflows into funds. The first banking publications in the United States are nuanced. Europe gained 0.5% despite bank stock losses.

Axel Botte

Main market indicators

G4 Government Bonds	15-Jan-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.59%	+5	+9	+19
EUR Bunds 10y	2.24%	+11	+23	+22
EUR Bunds 2s10s	-35.4bp	+6	+14	+3
USD Treasuries 2y	4.14%	-23	-30	-11
USD Treasuries 10y	3.94%	-9	+3	+6
USD Treasuries 2s10s	-20.7bp	+14	+33	+17
GBP Gilt 10y	3.82%	+5	+13	+28
JPY JGB 10y	0.57%	-4	-11	-4
€ Sovereign Spreads (10y)	**15-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	50bp	-3	-4	-4
Italy	156bp	-12	-11	-11
Spain	92bp	-6	-4	-4
Inflation Break-evens (10y)	**15-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.15%	-2	+2	+2
USD 10y Inflation Swap	2.48%	+3	+8	+7
GBP 10y Inflation Swap	3.52%	-4	-5	-1
EUR Credit Indices	**15-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	140bp	-5	-5	+2
EUR Agencies OAS	69bp	-1	-4	-1
EUR Securitized - Covered OAS	77bp	0	-3	-1
EUR Pan-European High Yield OAS	382bp	-27	-42	-17
EUR/USD CDS Indices 5y	**15-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	61bp	-2	+0	+2
iTraxx Crossover	328bp	-6	-2	+14
CDX IG	55bp	-3	-3	-2
CDX High Yield	353bp	-11	-15	-3
Emerging Markets	**15-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	399bp	-4	+0	+15
Currencies	**15-Jan-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.094	-0.064	0.441	-0.9
GBP/USD	$1.272	-0.243	0.284	-0.1
USD/JPY	JPY 146	-1.138	-2.564	-3.3
Commodity Futures	**15-Jan-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$77.7	$1.6	$0.9	0.8
Gold	$2 052.3	$24.2	$32.7	-0.5
Equity Market Indices	**15-Jan-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	4 784	1.84	1.37	0.3
EuroStoxx 50	4 454	-0.70	-2.10	-1.5
CAC 40	7 403	-0.64	-2.56	-1.9
Nikkei 225	35 902	7.56	8.89	7.3
Shanghai Composite	2 886	-0.04	-1.91	-3.0
VIX - Implied Volatility Index	13.28	1.53	8.14	6.7

Source: Bloomberg, Ostrum AM

Additional notes

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