12 January 2024

Research Global

Tensions rise in the Red Sea – should we worry?

- **For now, we are not overly concerned that the events in the Red Sea would affect global markets. Risk markets could take a hit from the rising geopolitical uncertainty, but at this point, we do not see this constituting an inflation shock.**
- **Although freight rates have increased significantly over the past few weeks, energy markets remain calm. In a late business cycle environment, supply side issues are not as inflationary as in an environment where the economy is booming.**
- **Risks rise in a scenario where the war in Gaza expands. Lebanon's involvement would raise the risk of Iran also drawing in. Such a scenario could be a gamechanger for the energy markets, for inflation and the major central banks.**

Geopolitical tensions are again rising after US and UK launched strikes against the Iran-backed Houthi rebels in the Red Sea. The US and UK assaults on the militant group should not be considered a big surprise since the US has been vowing to protect vessels using the important Suez Canal Route. That said, the events serve as a fresh reminder that the war in Middle East could still expand and escalate. For now, we are not overly concerned about the implications for global markets and trade. However, should the situation drag on for months, it does pose an upside risk to inflation, implying higher interest rates for longer – let alone the dangers it poses to global peace and security.

Who are the Houthis and why are they attacking ships?

As we highlighted in our *Research Global: The Middle East unveiled – how a regional storm could ignite global flames*, 28 November, the Houthi rebel group, which is part of Iran's axis of resistance, is a potential threat to stability in the Middle East. Back in 2019, Houthi's attacks on Saudi Aramco's Abqaiq oil processing facility led to a reduction in global oil supply of 5%. This time around, after the war between Israel and Hamas started in early October, the Houthis have been attacking dozens of commercial ships voyaging via the Red Sea. Most attacks have taken place near the Bab al-Mandab Strait.

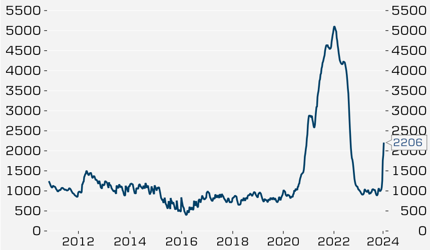
A Houthi spokesman, Yahya Sarea, has said that the group's attacks against Western commercial ships are to protest the '*killing, destruction and siege'* in Gaza and the group has said more attacks will follow the US and UK strikes. The US President Joe Biden has said he '*will not hesitate to direct further measures to protect our people and the free flow of international commerce'*. For now, it is fair to assume that Houthi attacks on commercial traffic in the Red Sea will continue at least for as long as the war in Gaza drags on.

What are the implications for trade?

The Suez Canal Route is one of the most important trade routes and the shortest sea route from Asia to Europe. Over the past few weeks, several international shipping companies have announced that they will resort to using an alternative route due to security concerns. Shanghai container rates have more than doubled since early December on the back of container vessels now re-routing around Africa, which increases average Asia-Europe sailing time from around 25 days to around 35 days.

Houthi rebels are part of Iran's axis of resistance

Shanghai export container rates have doubled since early December



Source: Bloomberg, Macrobond Financial

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As the Asia-Europe trade lane accounts for more than 20% of global container capacity, the impact on container shipping and hence supply chains is significant. To what extent the impact will be transitory will depend on how the situation evolves, and if the US/UK led coalition will be able to restore safe passage for container vessels. If so, the impact should be short-lived. As the orderbook in the container industry is more than 25% of the current global fleet, we expect the inflow of new vessels to put renewed pressure on freight rates in H2 24.

What are the implications for global energy markets?

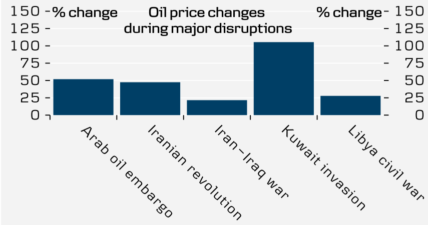
We know from history that conflicts can cause disruptions in the energy market. In the 1970s, the world experienced two severe commodity price shocks not too far apart. In 1973, an Arab oil embargo targeting the nations supporting Israel in its Yom Kippur war, led to an app. 7.5% reduction in global oil supply and prices quadrupled during the 5-month embargo. The second major disruption occurred during the Iranian revolution in 1978-79 when up to 5.6mb/day was withdrawn from the market over a 6-month period. However, the oil market is not nearly as vulnerable today as it was in the 1970s (see *World Bank October 2023 Commodity Markets Outlook*). This is thanks to a substantial increase in US production, the development of oil futures markets, and the high strategic reserves held my major states such as the US. It also helps that global economic activity is slowing down, and hence, the market is not as tight as it was a year ago when major economies were still growing.

In our view, the current situation does not give rise to expectations of meaningful implications for the international oil and gas markets. As long as the situation is confided to passage problems in the Bab Al-Mandab strait, the main implication is the risk of delivery delays of LNG (Liquified Natural Gas) cargoes and some seaborne oil shipments. Europe imports around 55MCM/day of Qatari natural gas. This is by far the lion's share of gas imported from the Middle East and comprises roughly 5% of the European consumption. Given that we still have quite strong gas inventory levels in Europe (82% full), an LNG shipment delay of 20-30 days, will not impact the market price. In this regard, we also note that the gas price (1M TTF) currently hovers at quite sanguine levels of only EUR32/MWh. This compares to an average of EUR41/MWh in 2023 and as such does not indicate stress in the market.

The logic in the oil market is largely the same, although the net amount of sea-borne oil passing the Bab Al-Mandab strait is relatively lower compared to LNG. This is because most West-bound oil-cargoes are shipped out of Western Saudi-Arabia, where the oil terminals are situated North of the Bab Al-Mandab strait and therefore is not in harm's way when sailing to Europe. The Asian cargoes mostly originate from the Persian Gulf. That said, we estimate that roughly 1m bbl/d of net passages through the Bab Al-Mandab strait is in danger of facing rerouting around South of Africa. This amounts to only roughly 1% of the global daily oil trade and should have minimal price impact all things equal.

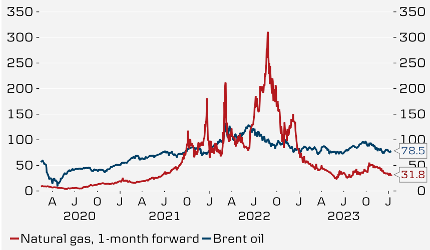
As such, we only see price implications for oil and gas products, if the situation escalates further to a point where the Persian Gulf is closed for seaborne trades, or indeed if the conflict escalates to strikes that result in production outages. This risk seems low currently. Our base scenario is subsequently that the situation in the Middle East will not lead to higher energy prices.

Impact on oil prices from conflicts



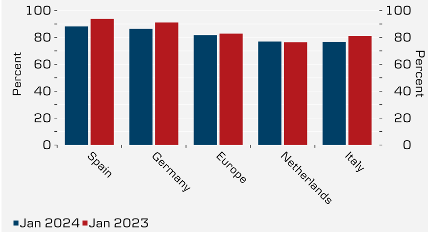
Source: World Bank. Changes in average monthly oil prices three months after the onset of the event

Energy prices have barely moved



Source: Macrobond Financial

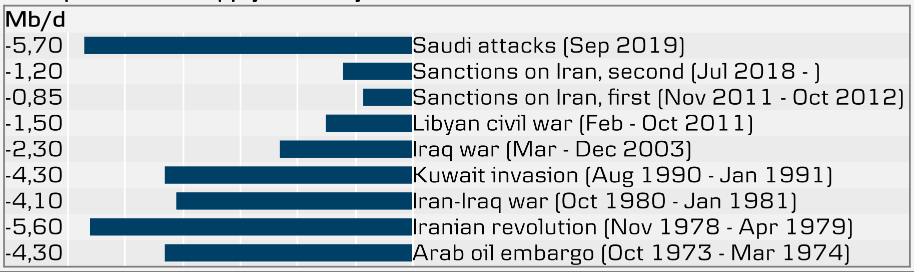
Natural gas stock levels (% of full)



Source: GIE, Macrobond Financial

Houthi attacks against Saudi oil facilities are the most recent disruption in the oil market caused by a conflict

Disruptions in oil supply driven by conflicts



Source: World Bank

How do we see situation unfolding from here?

As said, we do not consider US and UK counter attacks on Houthis a major surprise. It was expected that the US and its allies would respond by force if necessary to protect safe passage through the Red Sea. At this point, we are not overly concerned although we think the situation could get worse in the coming weeks if and when the UK and US backlash against Houthis will most likely continue. This could induce volatility in risk markets and drive shipping rates higher still.

A key question is whether this will escalate? Here, we highlight that there are other potential triggers, and that these triggers are most probably interrelated. The most dangerous scenario would be one where Iran intervenes directly in the conflict and confronts the US. The risk for such to happen will rise if fighting between Houthis and the US and its allies escalates further, or if a war erupts between Israel and Lebanon.

Until now, leaders of Iran and the Lebanese Hezbollah have seemed reluctant to trigger a full-blown war. As we have written before, both leaders were most probably caught by a surprise when Hamas attacked Israel on Oct 7, and did not like the fact that they were uninformed and ill prepared. Iran's main priority is to protect its own soil, and hence, it does not mind its deterrents (including the Houthis) doing the dirty work in terms of annoying Israel and its allies. Yet, it is well aware of the devastating consequences a full-blown war with the US would bring. Remember, last year before Hamas' attack, the US and Iranian officials were known to be having talks regarding a sanctions relief in exchange for curbing its nuclear program and releasing US prisoners.

A war between Lebanon and Israel would definitely raise the risk of drawing Iran into the conflict. Israel and Hezbollah have been trading fire on a daily basis since the war in Gaza started in early October, but Hezbollah leader Hassan Nasrallah *has still seemed careful* not to provoke Israel and its allies too much. For now, it seems going into a full-blown war is their last option, but it is an option. Raising the stakes recently, in early January, senior Hezbollah and Hamas leaders were killed in separate incidents, and Israel most likely is behind these attacks. The assassination of Hamas deputy leader Saleh al-Arouri took place in the Lebanese capital, Beirut.

Israeli leaders communicated in late December that they expect the war in Gaza to continue for 'many more months'. Yet, in a signal that the most aggressive phase of the operation is over, they have started to withdraw troops from Gaza. Also, we think the US will continue to pressure Israel for a ceasefire. The longer the war drags on, the higher the risk of escalation, as tensions continue to build up among groups standing in solidarity with people in Gaza. Attaching probabilities to different scenarios is difficult, but the table below is our best effort to understand market implications of different outcomes.

In our baseline, we do not foresee a significant impact on global inflation, and hence, do not at this point see this as a gamechanger for central banks. Yet, the risk of escalation remains, and in such a scenario, the world would face another severe stagflationary shock.

Scenarios and market implications

Scenario (probability)	Implications on trade	Implications on energy and shipping	Implications on inflation and central banks
Baseline: Israel war ends in Gaza in Q1 (60%)	Suez Canal Route disrupted, ships use alternative routes	Longer delivery times, higher freight rates but impacts temporary, no impact on energy markets	Insignificant impact on global inflation and central bank reaction function
Risk scenario1 : Israel war extends beyond Q1 (30%)	Disruptions on Suez Canal Route drag on	Longer delays and higher shipping costs for longer, negligible impact on energy markets	Upside risk to inflation, central banks consider keeping rates higher for longer
Risk scenario 2: Israel-Lebanon war (10%)	Risk for higher tensions between the West and the Arab world, potential disruptions in energy supply	Risk of a more severe supply side shock, including the energy markets	Increased uncertainty drives market volatility and tighter financial conditions but inflation re-accelerates, central banks forced to keep rates high
Risk scenario 3: Israel-Iran war (<10% and contingent on scenario 2)	Risk for very high tensions between the West and the Arab world, potential disruptions in energy supply	High risk of Iran closing the Strait of Hormuz implying severe disruptions in energy supply	Increased uncertainty drives market volatility and tighter financial conditions but inflation re-accelerates, central banks forced to keep rates high

Source: Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Minna Kuusisto, Director, Jakob Magnussen, Global Head of Credit Research and Brian Godsk Børsting, Associate.

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Ad-hoc

Date of first publication

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Report completed: 12/01/2023, 13:20 CET

Report first disseminated: 12/01/2023, 13:45 CET