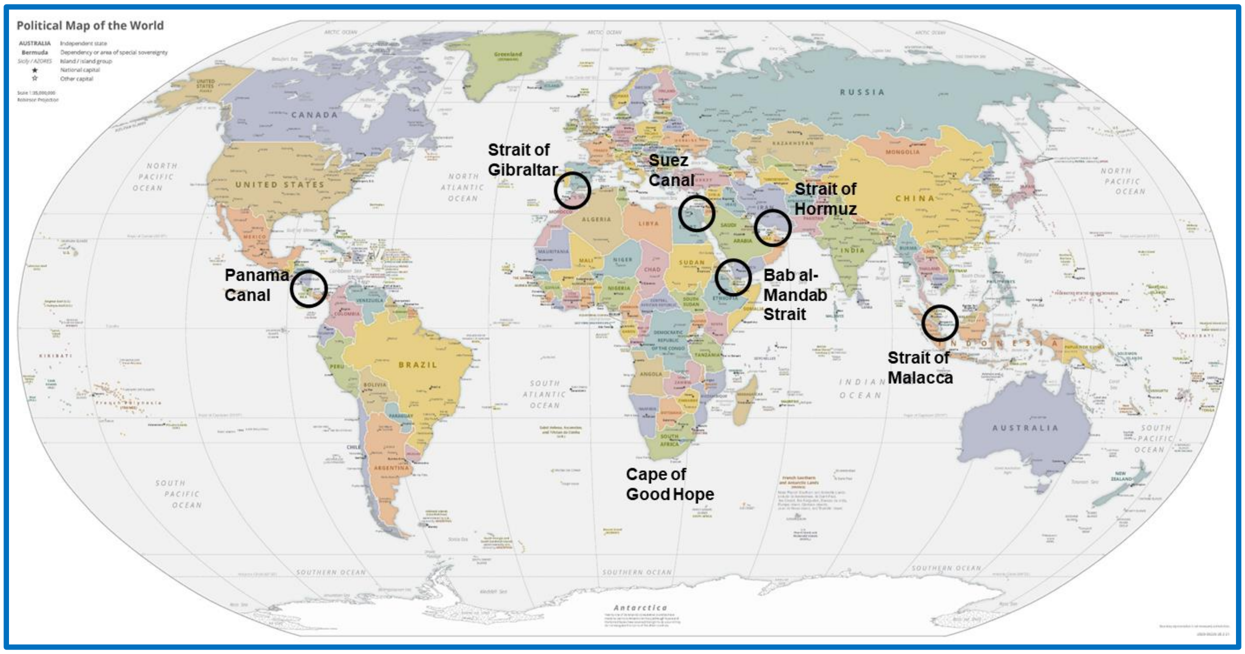
IN THE NARROW SPACES: CHOKED STRAITS AND IMPLICATIONS FOR GDP, INFLATION AND CRE

Stewart Rubin
Head of Strategy and Research
Senior Director

Dakota Firenze
Senior Associate
Strategy and Research



There are several major shipping choke points in the world, including the Panama Canal, Suez Canal, Bab el-Mandeb Strait, Strait of Malacca, Strait of Hormuz, and the Strait of Gibraltar. Should any of these straits become impassable for an extended period, globalization, inflation and GDP would be adversely affected. In addition, demand for industrial and retail properties could also be negatively impacted.

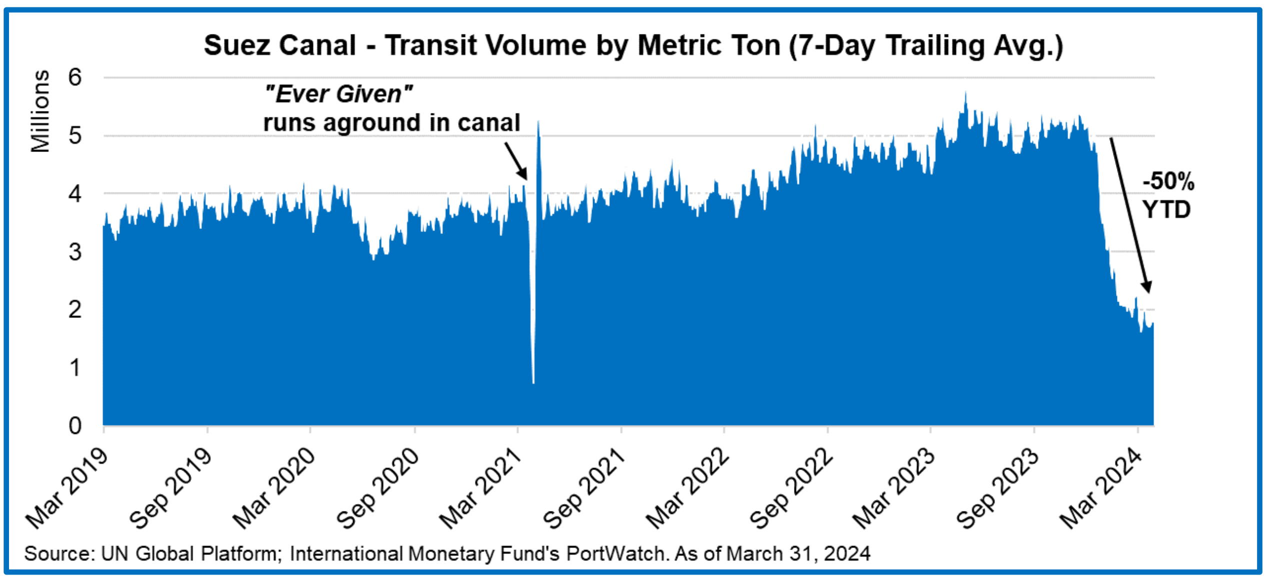
Maritime piracy and disruption have a long history. For example, piracy was rampant in the Mediterranean Sea in the first half of the first century BCE. Rome set out to render the Sea conducive for commerce, and in 67 BCE deployed over 500 ships to defeat the pirates. This was accomplished in just three months and culminated in the capture of the pirate's stronghold in Cilicia.

In the 18th century CE, and the beginning of the 19th century, state-supported piracy, extortion, and the enslavement of crews in the Mediterranean Sea was not unusual. The United States fought two separate wars with Tripoli (1801–1805) and Algiers (1815–1816) to provide safe passage for U.S. ships.[1]

[1] https://history.state.gov/milestones/1801-1829/barbary-wars

Piracy and attacks along international trade routes have persisted throughout history and the twenty-first century is no exception. Most recently, attacks against ships in the Red Sea in 2023 and into 2024 have disrupted global trade.[2] Ships traveling through the Red Sea carry about 40% of the goods that are traded between Asia and Europe.[3] The **Suez Canal** and **Bab el-Mandeb Strait** – the choke points at both openings to the Red Sea – have experienced significant disruption, as the Red Sea route is being subject to attacks by the Iran-backed Houthi terrorist group.

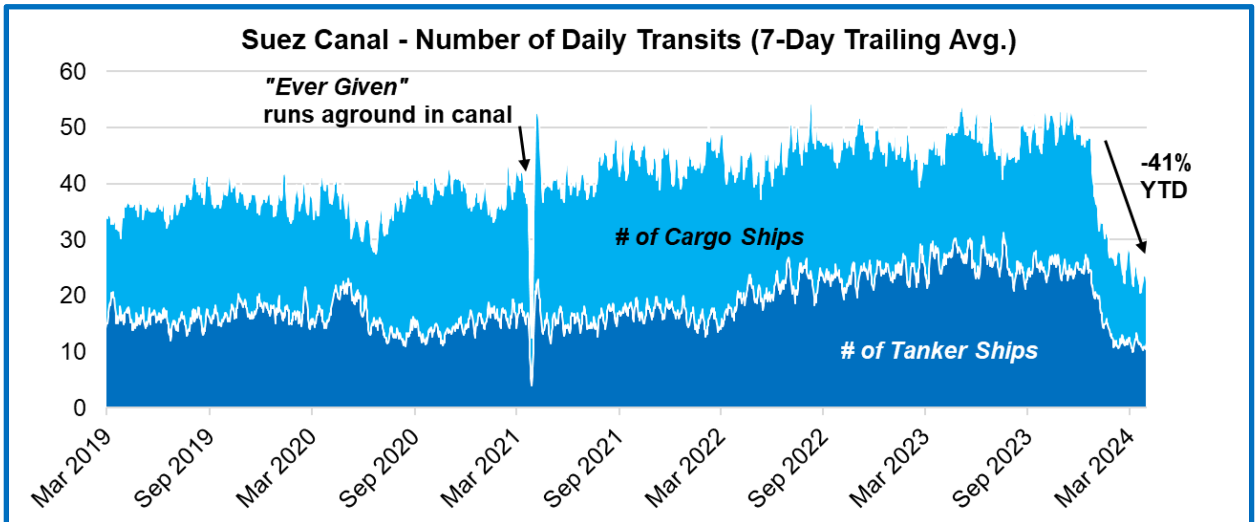
Not surprisingly, daily freight capacity through the Red Sea has declined. According to the International Monetary Fund, maritime traffic as measured by volume, through the Suez Canal is down 50% so far in 2024 from a year ago.



Source: UN Global Platform; International Monetary Fund's PortWatch. As of March 31, 2024

[2] Before 2023, the most recent disruption was logistical – the ship "Ever Given" became wedged across the waterway blocking canal traffic for six days in March 2021.
[3] https://www.wsj.com/world/europe/the-red-sea-conflict-is-scrambling-shipping-europe-is-bearing-the-brunt-a0aac0e3

The number of transits through the canal has declined 41% year to date.



Source: UN Global Platform; International Monetary Fund's PortWatch. As of March 31, 2024

Ships that continue to sail through the Red Sea endure higher insurance, labor, and security costs. Ships that avoid the route altogether and instead travel via the Cape of Good Hope (CGH) also pay substantially higher costs in time and money. Major international shipping companies, including Moller-Maersk of Denmark and Hapag-Lloyd of Germany, have rerouted containerships around the CGH resulting in an additional week or more in transit times. Oxford Economics estimates that a ship traveling at 16.5 knots from Taiwan to the Netherlands via the Red Sea and the Suez Canal takes about 25½ days to complete the journey. But this rises to about 34 days if the journey is diverted around the Cape.[4]

It's axiomatic that additional travel time increases costs for Asia-Europe trips, but perhaps less intuitive is that it indirectly raises costs on ***all*** international shipping, since the added time reallocates ships away from other routes.

Shipping costs increased substantially during COVID and then receded as COVID's effects ebbed. But recently, with the terrorist attacks on Red Sea shipping – costs have risen again. According to Drewry Shipping Consultants, the average worldwide cost to ship a 40-foot container increased 76% between the end 2023 and the week ending March 28, 2024. Many companies are paying surcharges of 20% or more to account for higher fuel and insurance costs, even if they are protected from outright increases due to long-term contracts.

Other Global Choke Points at Risk

While the Red Sea has been the major focus of recent maritime disruption, other global choke points are not free from risk. Should Iran decide to widen the regional conflict, it could attack ships carrying oil from Kuwait, Bahrain, and the UAE through the **Strait of Hormuz**. In the past, Iran has threatened to close the Strait of Hormuz to international shipping.[5] Should Iran be successful in carrying out such a threat – the price of oil would likely skyrocket. Between 40% to nearly half of the world's oil exports pass through the Strait.[6]

[4] https://www.oxfordeconomics.com/wp-content/uploads/2024/01/20240104-RB-Global-Shipping.pdf
[5] https://www.euronews.com/2019/06/28/strait-of-hormuz-why-does-iran-threaten-to-close-it
[6] IBID

In southeast Asia, the **Strait of Malacca** has also been subject to heightened pirate activity.[7]

In the western hemisphere, plentiful water is necessary for a properly functioning **Panama Canal**. Currently, the Canal Zone is suffering from a drought which has substantially lowered capacity in the form of ship size restrictions and fewer passages. Recent conditions have resulted in traffic being reduced to two-thirds of pre-drought capacity.

In the aggregate, the results of these blockages may lead to further deglobalization, higher energy prices, and more expensive imports. All the above are tailwinds for inflation, while less exports would have a negative impact on GDP.

More Deglobalization

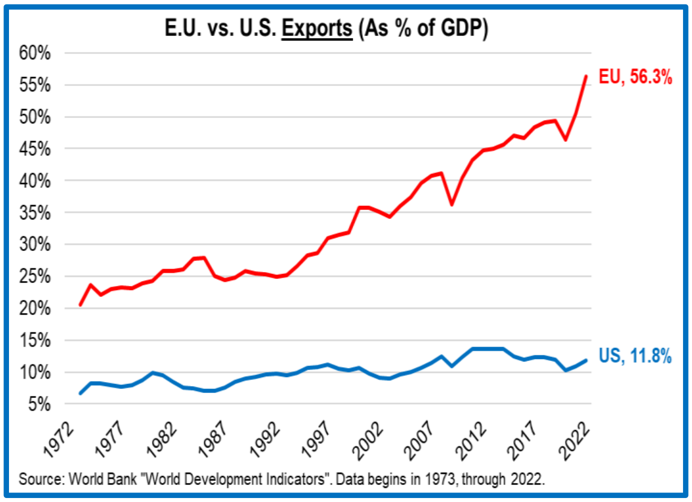
Globalization, already under stress prior to the pandemic, has suffered mid-to-longer-term damage from COVID-19, the Russian invasion of Ukraine, and attacks by the Houthi Iranian-backed terrorist group against global shipping in the Red Sea. Meanwhile, the U.S. is seeking to reduce its reliance on China and other countries for critical supplies including semiconductor chips, active pharmaceutical ingredients, generic medicines, and personal protective equipment. This trend will likely be accelerated by geopolitics, national security considerations, and labor shortages.

In the wake of the terror attacks perpetuated against Israel on October 7, 2023, war broke out between Israel and Hamas. Other regional proxies and beneficiaries of Iran have joined the war at varying degrees of engagement and, in addition, have attacked U.S. positions resulting in the deaths of U.S. troops. There is the potential for the conflict to expand more broadly which could potentially have a very negative impact on the global economy.

The blockages at the Suez Canal and the Panama Canal result in less trade and more products being manufactured domestically or in neighboring countries - which means more deglobalization.

A Negative Impact on GDP

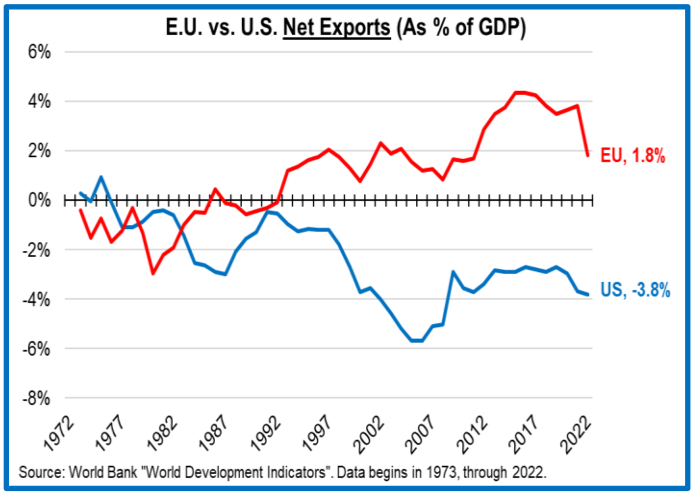
The Suez Canal (opened 1869) and the Panama Canal (1914) were built to facilitate world trade by substantially shortening shipping routes. If trade is rerouted away from global choke points and gets more expensive (i.e. higher labor, ship rental, fuel, and insurance costs) global GDP will be negatively impacted.



Europe is far more reliant on exports as a positive contribution to GDP than is the U.S. Exports constitute 56.3% of E.U. GDP compared to just 11.8% of U.S. GDP. Net exports (exports minus

[7] https://www.hellenicshippingnews.com/new-imb-report-reveals-concerning-rise-in-maritime-piracy-incidents-in-2023/

imports), which is the way trade is computed as a contribution to GDP, was +1.8% in the E.U., meaning exports exceed imports, compared to -3.8% in the U.S., where imports exceed exports. The global choke point most exposed now is the Suez Canal-Red Sea-Bab el-Mandeb route, which is the fastest way to move goods between trading partners in Asia and Europe.



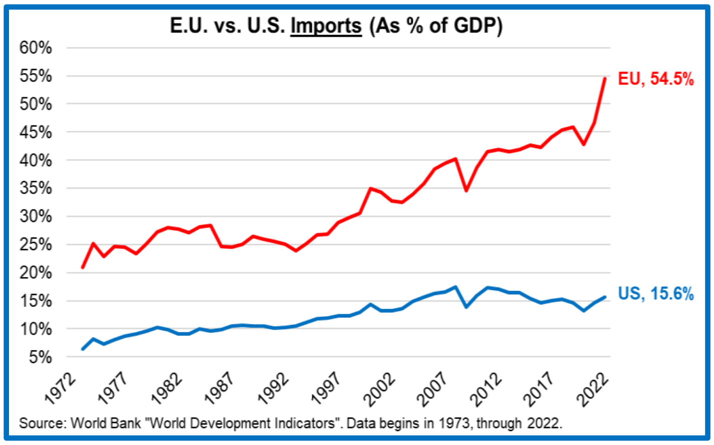
In addition, the cost to Egypt and Panama, the host countries of the canals, is not inconsequential. President Abdel Fattah El-Sisi of Egypt stated that Suez Canal revenues were down 40% to 50% due the Red Sea crisis.[8] The Panama Canal Authority (ACP) announced that they expect to post a $600 million to $800 million decline in revenue.[9]

A Tailwind to Inflation

Iran-backed Houthi terrorist attacks on cargo ships in the Red Sea have resulted in higher costs as major shipping companies reroute around the CGH for travel between Asia and Europe. As noted earlier, the cost of shipping via the CGH requires higher labor, ship rental, fuel, and insurance costs. Those that chance a passage via the Red Sea endure higher insurance, labor, and security costs, as well as the risk of losing their ship and having sailors taken hostage.

The Organisation for Economic Co-operation and Development (OECD), representing 37 countries including the U.S., stated on February 5, 2024, that an escalation in attacks "could result in renewed price pressures" and jeopardize what has now been two years of resilience in the global economy.[10] According to the OECD, a doubling in shipping costs would add 0.4 percentage points to consumer inflation for OECD countries after about a year.[11]

The impact of higher import costs and the resultant higher inflation would also impact Europe more than the U.S. because imports constitute 54% of E.U. GDP versus 15.6% for the U.S. International insurance company Allianz Trade contends that "a doubling of freight costs sustained for more than three months could push the eurozone's inflation rate up by three-quarters of a percentage point and reduce economic growth by almost a percentage point."[12]



[8] https://www.al-monitor.com/originals/2024/02/egypts-sisi-suez-canal-revenue-down-much-50-over-red-sea-attacks
[9] https://gfmag.com/economics-policy-regulation/panama-canal-crisis
[10] https://www.oecd.org/economy/growth-continuing-at-a-modest-pace-through-2025-inflation-declining-to-central-bank-targets.htm
[11] https://www.oecd.org/economy/growth-continuing-at-a-modest-pace-through-2025-inflation-declining-to-central-bank-targets.htm
[12] https://www.wsj.com/world/europe/the-red-sea-conflict-is-scrambling-shipping-europe-is-bearing-the-brunt-a0aac0e3

Should Iran decide to widen the regional conflict by attacking ships carrying oil from Kuwait, Bahrain, or the UAE through the Strait of Hormuz, the price of oil could skyrocket, creating substantial inflationary pressure.

CRE Demand – Logistics, Retail

The Red Sea conflict may weaken goods consumption and potentially force retail sales lower in the near term, which could cause a disruption in logistics and retail space demand. Should prices rise to account for higher shipping costs, sales would likely decline and result in less demand for logistics and retail space. To the extent that international shipping blockages contribute to deglobalization, U.S. manufacturing facilities would potentially benefit.

Recent drought conditions in Panama, resulting in the canal functioning at only two-thirds capacity, render U.S. Pacific ports more attractive. The widening of the Panama Canal to allow Panamax ships to navigate the isthmus resulted in more Twenty-Foot Equivalent (TEU) containers shipped via Gulf and Atlantic ports. However, Gulf and Atlantic Port markets could potentially be negatively impacted if disruptions were to continue for a significant period.

Conclusion

Several of the world's major shipping choke points are challenged. The Bab el-Mandeb Strait (and effectively the Suez Canal) is threatened by terrorism and the Panama Canal is experiencing drought conditions negatively impacting shipping traffic. Should Iran close the Strait of Hormuz, major oil producers will have great difficulty shipping their primary export. The potential result of these blockages or potential blockages is more deglobalization, higher energy prices, more expensive imports – both a tailwind to inflation, and a drag on GDP.

Disclosures

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