

January 31, 2024

Dear Client:

We described the impact of Middle East hostilities on shipping through the Suez Canal in last month's letter, but there is another, critical choke-point canal that transits more cargo by tonnage that is rapidly turning into its own economic hot-spot (McKinsey 1/24). Since 1914, the Panama Canal has played a vital role in world trade and today more than 14,000 cargo vessels sail through annually moving from one sea to the other. The operation of the canal's locks (which use gates to raise or lower water levels in different sections of the canal) depends on water from a nearby lake; and severe, historic drought conditions have lowered the lake's water levels to historic lows, forcing the Panama Canal Authority to restrict the daily number of ship transits by ~35% (Bloomberg 1/24). The number of transits continues to fall at this writing, making clear that seaborne trade flows will be dramatically reshaped, creating an abrupt and profound change for global supply chains into and out of the continental U.S.

As with Suez, there has been limited time for customers to prepare for the disruption that supply chains have encountered. As with Suez, the diverted ships face substantially longer voyages and rapidly increased costs that will work their way up the value chain. These simultaneous disruptions are expected to be economically meaningful: recall that when a grounded container ship blocked the Suez Canal for just six days in 2021, the U.N. estimated \$9.6 billion dollars in trade were impacted daily. A major trade route connecting the western Pacific and the U.S. east coast, American companies are particularly reliant on the Panama Canal with ~14% of all east coast seaborne trade transiting its locks, so a loss of access is a big deal (WSJ 1/24).

A ship traveling from Asia to the U.S. east coast -- that would typically cross east across the Pacific and through the Canal -- is now forced south and west around the Cape of Good Hope, and then northwest across the Atlantic and through the Caribbean Sea; while a ship traveling from the west coast of South America to the Caribbean must instead travel south to the bottom of Argentina, east through the Strait of Magellan, and then north into the Caribbean Sea and America's southern ports. These are substantial re-routes for the ships and their cargo's, adding ~20% more time to a ship's journey. The knock-on effect is another mounting expense: the rapidly spiraling costs associated with fewer available containers, crew, and ships to move them.

The transit restrictions will likely not affect all supply chains equally. Liquefied natural gas carriers carry high operating and inventory-holding costs and are willing to pay the premium for the limited canal transit slots. But many others -- so called dry-bulk carriers (grains, coal) and general cargo ships (carrying unwieldy items like wind turbines or locomotives) -- incur about half as much in operating and inventory-holding costs and are more willing to make a longer voyage in order to avoid significant wait times and the steep canal booking fees.

According to U.N. data, ships handle more than 80% of global goods. Once calm, the oceans are back on the agenda as an interlocking set of maritime security crises has thrown up a troubling question: how much has the freedom and ease of navigation been a historical anomaly? We will keep an eye on these events and report back accordingly.

Regards,



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