FISCHER STRALEM
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Dear Client:

Of all the events that will come to define 2023, it was for many the morning of October 7. Now in its third month, the Middle East has superseded Eastern Europe as the world's most pressing geopolitical concern and has sent a shot across the bow of global economic growth. The further spread of hostilities will be felt far and wide. For investors, let us not forget March 2021 when the container ship Ever Given blocked the Suez Canal for just six days but created a disruption which rippled across the global supply chain. Supply chains today face worse prospects if, as expected, an escalation effectively closes the Bab al Mandab -- the narrow strait at the other end of the Red Sea from Suez between Africa and the Arabian Peninsula -- for an extended period of time. Already, Red Sea security fears have cut container shipments, potentially inflicting a new inflationary shock on the global economy.

Faced with a soaring risk of ships being crippled and their crews killed, the shipping industry has gone on the defensive. In just the last few weeks, the four largest container-shipping companies -- who collectively account for ~53% of global container trade -- have paused or suspended their services through the Red Sea, the route through which traffic to/from the Suez Canal must pass. A vital and strategic link between the Indian Ocean and the Mediterranean Sea, the Bab al-Mandab choke point is a narrow passage between Djibouti and Yemen through which ~15% of all global trade flows. Bulk carriers account for ~35% of traffic and container ships another 24% (S&P Global). What's more, ~33% of global seaborne oil supplies also transit these waters, pushing any economic costs dramatically higher.

As is to be expected, the associated costs from wide-scale rerouting around South Africa's Cape of Good Hope is steep, as measured in time, container rates, and insurance premiums. According to the global shipping company Clarkson's, the number of commercial ships passing through the strait has fallen by half in the last three weeks (from 80 to 40), with nearly all of the traffic being redirected around southern Africa. Such a major rerouting is expensive: sailing from Shanghai to Rotterdam via the Cape, rather than through the Suez Canal adds an additional 6,000 miles to what was already a 12,000 mile voyage, taking 92 days to complete a round trip, up from 48 days (Jefferies). It also increases fuel costs, which can be managed by reducing speed, but adds an additional two weeks to the roundtrip voyage time. The accelerating diversions has pushed the costs of moving a single, 40ft container from China to Europe to its highest rate since the Covid disruption, nearly tripling in price just a few weeks. And there have been secondary effects on other routes as container ships are forced to make longer journeys, cutting the overall availability of ships. Ships traveling for longer than expected have been late to their next loads, and short-term supply-chain snarls are expected to result.

The big question is how long the disruption lasts and this feeds into our current quarterly letter, West of the Hudson. If global trade is hampered so easily, then countries and companies will need to build up precautionary inventories of key inputs. Given the recent trauma of supply chain dislocations, if key trade routes can no longer be protected, will reshoring and near-shoring trends be further amplified? Will this further boost current wage pressure trends even as firms order emergency stocks? What impact will this have on corporate profit margins? These are questions we will seek to address in the coming months.

Regards,

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