

## Shipping risks underestimated?

Frédérique Carrier – London

With two of the world's strategic maritime choke points, the Suez and Panama Canals, operating below capacity, global shipping costs are climbing. We explore the corporate sectors that may benefit and those that may suffer from the situation, and investigate the potential impact on inflation.

### **Danger near the Suez Canal**

Traffic in the Suez Canal, the waterway in Egypt which connects the Red Sea to the Mediterranean Sea, has plummeted. Iran-backed Houthi militants have been attacking commercial ships on this key trade route that connects China with both Europe and the U.S. East Coast. The militants said their attacks are in retaliation for Israel's war with Hamas in Gaza.

RBC Capital Markets, LLC's Head of Global Commodity Strategy Helima Croft estimates that around 12 percent of global trade (the equivalent of 10 percent of OPEC oil production) usually transits through the Red Sea, with most of the traffic being en route to or from the Suez Canal.

Data collated by the International Monetary Fund and Oxford University point to a 40 percent drop in daily Suez crossings compared to peak 2023 levels.

As a result of the Houthi attacks, most container ships are being rerouted, with many opting for the alternative route around the Cape of Good Hope at the southern tip of Africa. Eric Lascelles, chief economist at RBC Global Asset Management, said this diversion can add as much as

25 percent more time to trips, swelling the cost of goods being shipped.

### **Drought in the Panama Canal**

In a strange twist of fate, one of the world's other artificial waterways, the Panama Canal, a key route for goods from Asia heading for the U.S. as it connects the Atlantic and Pacific Oceans, is also struggling—though not for geopolitical reasons.

According to Bloomberg, \$270 billion worth of merchandise passes through the Panama Canal annually with 40 percent of all U.S. container traffic travelling through it. Lately, unusually low water levels have limited the number of ships passing through, while a mismanaged expansion of the canal completed in 2016 exacerbates the problem.

As the traffic jam has worsened, authorities have had to limit access to the waterway. Only 22–24 vessels now pass through each day, which is down from 36–38. In some cases, ships are also forced to reduce their cargo size in order to sit higher in the water. It thus takes longer for merchandise to reach the desired destination.

For perspectives on the week from our regional analysts, please see [pages 3–4](#).

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Priced (in USD) as of 1/24/24 market close (unless otherwise stated). Produced: 1/25/24 2:35 pm ET; Disseminated: 1/25/24 2:44 pm ET

According to Lascelles, the reduced ship throughput is anticipated to remain at just half the normal level through February 2024 at least, with repercussions set to linger well into the year.

### Freight rates surge

As a result of these disruptions, particularly the attacks in the Suez Canal area, spot shipping costs have been on the rise this year. The Drewry World Container Index, a barometer for the spot rate for shipping a 40-foot container on major East-West trade routes, has increased more than 139 percent so far this year, although it is well below the peak rates during the COVID-19 crisis.

In reality, few companies will feel the complete impact of the spot rate increase. Shipping costs tend to be long-term contracts which are less volatile than the spot rates. Yet even companies with long term contracts may have to face higher costs in the guise of the cost of diversion as well as foot the bill for higher insurance costs.

### Corporate sector good news/bad news

On one side of the spectrum, global shipping companies will likely benefit from higher freight rates. Logistics companies and air freight companies may also benefit as some shipping customers choose to transport cargo via air.

On the other side are the companies which may face higher transport costs and/or delivery delays. Some will try to pass the cost increases to consumers through higher prices. But those whose pricing power deteriorated in 2023 may have to absorb these higher costs, eroding margins.

Moreover, shipping delays may result in temporary shortages. For sectors which operate on a “just-in-time” basis, such as auto manufacturing, this can become problematic very quickly as inventory levels for components are kept at a bare minimum. Tesla recently announced a two-week production halt at its German plant as it awaits delivery of components.

In contrast, companies which keep large inventory in warehouses, as many retailers do, may be in a better position to bide their time. If disruptions and shortages persist, however, stockouts may result in lost sales.

### Inflationary pressures?

With part of the corporate sector reluctant to pass on higher costs to consumers, the direct risk to inflation of higher transport costs may be mitigated. With Europe most affected by the Red Sea attacks, Lascelles calculates

### 40-foot container freight rates spike, now twice their average 2023 levels

Drewry WCI composite container freight benchmark (spot rate per 40-foot container in USD)



Source - RBC Wealth Management, Bloomberg; weekly data through 1/25/24

that the higher shipping costs could add as much as half a percentage point to inflation in Europe over the coming months if the disturbance persists.

However, we still believe that the key risk to inflation is a further escalation of the Middle East conflict through an increased involvement of Iran. In this case, Croft thinks regional energy supplies could be jeopardized due to Iran having important energy assets. Iran could also, as it has done during previous times of conflict, imperil maritime traffic passing through the Strait of Hormuz, a passageway from the Persian Gulf to the open sea which is critical for global energy supplies. With regional energy supplies compromised, oil prices could surge, feeding inflation.

### New risks

So far, the recent disruptions in the Suez Canal have had little impact on financial markets overall. Markets seem to believe that Houthi attacks will recede now that the U.S. and UK are sending warships to the Red Sea to protect cargo vessels and the countries are making targeted attacks on Yemen.

Yet the disruption in the two key waterways could eventually result in an increase in inflation and have an impact on global supply chains. Equity markets' recent resilience as the soft landing and declining inflation narratives gained traction may be put to the test.

## UNITED STATES

Alan Robinson – Seattle

■ **U.S. stock indexes set all-time highs again during the week**, as economic data painted a picture of a resilient economy and management commentary from the Q4 2023 earnings season proved good enough to encourage the bulls.

■ The Commerce Department's initial read on Q4 2023 showed 3.3% annualized GDP growth for the U.S. economy (see chart), handily beating the 2.4% consensus forecast. Better-than-expected consumer spending provided most of the boost, with restaurant and pharmaceutical spending particularly strong. **The Q4 price deflator, a measure of inflation, was also more benign than expected at 1.5%, below the consensus of 2.3%.**

■ **The solid GDP report highlighted a notable disconnect driving stock trading volumes year to date: the difference between “hard” and “soft” data.** Soft data refers to surveys of managers' sentiment regarding their business prospects, whereas hard data refers to quantifiable actions like spending or hiring. Soft data has been pessimistic of late, with the ISM Manufacturing Purchasing Managers' Index flagging contractionary sentiment for 15 straight months. This has motivated the stock market bears. But hard data including GDP reports, employment data, and home prices has been remarkably strong, encouraging the bulls. In theory, survey data should lead hard data, but that hasn't been the case for several quarters, suggesting the U.S. economy is handily weathering the Fed's two-year campaign of interest rate hikes.

■ **While Q4 2023 earnings season has started out reasonably positively, there have been some notable surprises.** Tesla (TSLA) stock dropped 10% as management declined to provide clear guidance for 2024 vehicle deliveries, and shares of health care provider

Humana (HUM) fell 13% as patient treatment costs increased. Companies in the Information Technology and Communication Services sectors have generally fared better, with shares of streaming service Netflix (NFLX) up 11% on very strong subscriber growth, and IBM shares up 12% on bullish management commentary regarding AI-related orders.

## CANADA

Josh Nye &amp; Luis Castillo – Toronto

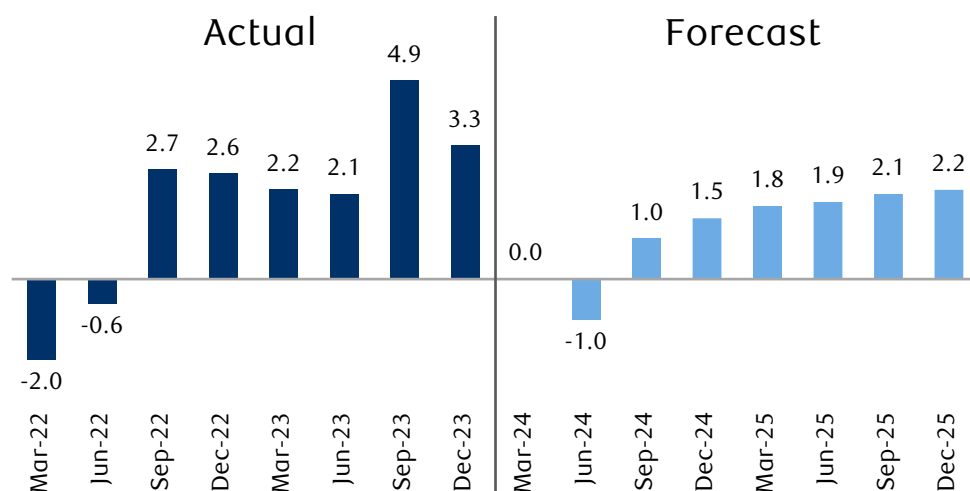
■ **The Bank of Canada (BoC) shifted into neutral, holding its policy rate steady at 5% for a fourth consecutive meeting**, with Governor Tiff Macklem noting a “clear consensus” on the Governing Council to leave rates unchanged. Policymakers appear increasingly confident that interest rates are now restrictive enough to get inflation back to 2% over time. The post-meeting statement dropped an earlier reference to being prepared to raise interest rates further, but Macklem didn't rule out additional tightening if inflation reaccelerates. At the same time, he indicated the BoC considered it too early to discuss rate cuts. The economy is feeling the effects of higher rates and the BoC now estimates it to be in excess supply, which should cause disinflationary pressure over time. However, wage growth remains too strong and there is limited evidence that underlying inflationary pressures are easing. The market is pricing in four rate cuts in 2024 starting in June, roughly in line with RBC Capital Markets' forecast.

■ **Canadian preferred shares appear to be turning the corner after two years of underperforming equities and other risk assets**, outperforming since October with a noticeable jump in January. Despite this late-2023/early-2024 rally, Canadian preferred shares are still down more than 20% from their 2021 peaks. We think they still offer an attractive risk-adjusted relative yield pickup,

along with the prospect of capital appreciation, particularly when compared to corporate bonds. Two major factors affect preferred shares' performance: the interest rate backdrop and market risk sentiment. However, we think it is difficult to approach preferred share investing with a high-conviction view solely on the basis of these two factors, as there have been multiple periods when preferred shares have disconnected from both. Instead, we prefer to approach preferred share investing on a relative-value basis, often weighing them against other risk categories.

## Recession? What recession?

U.S. real gross domestic product (GDP) growth and RBC forecasts (%)



Source - RBC Wealth Management, U.S. Commerce Department, RBC Capital Markets estimates, data as of 1/24/24

## EUROPE

Rufaro Chiriseri, CFA &amp; Thomas McGarrity, CFA – London

■ **As widely expected by market participants, the European Central Bank (ECB) held interest rates at 4% for the third consecutive meeting.** In its policy statement, the central bank retained its stance on maintaining elevated interest rates for a “sufficiently long duration” to bring inflation back to its 2% target. However, this higher-for-longer narrative is at odds with the market, which currently expects cuts to commence in April and reach a cumulative 141 basis points by year’s end.

■ During the post-meeting press conference on Thursday, ECB President Christine Lagarde relayed the voting members’ consensus that “it’s too premature to talk about cuts.” However, she did not push back explicitly against the possibility that a rate cut could come earlier than “summer.” Wage data was a hot topic during the conference. Lagarde stated that, according to the ECB wage tracker, 40% of wages in the region were yet to be determined through collective bargaining processes, but noted that there is evidence higher wages are being absorbed by company profits, which is positive for inflation. Indeed, **we think the policy statement and recent comments from several members of the ECB Governing Council may indicate the central bank is moving cautiously with increased data dependency.**

■ **Semiconductor equipment manufacturer ASML gained almost 10% on Wednesday** after reporting order intake of €9.2 billion in Q4, over 150% ahead of consensus expectations and more than three times the orders it received in Q3. This included a record quarterly level of orders (€5.6 billion) for its extreme ultraviolet (EUV) lithography equipment, a cutting-edge technology for printing chips at lower nodes (i.e., consisting of smaller features). On the results call, ASML’s CEO stated that the company is starting to see “positive signs of a recovery” in the industry, with inventory levels continuing to improve and lithography tool utilization levels beginning to pick up.

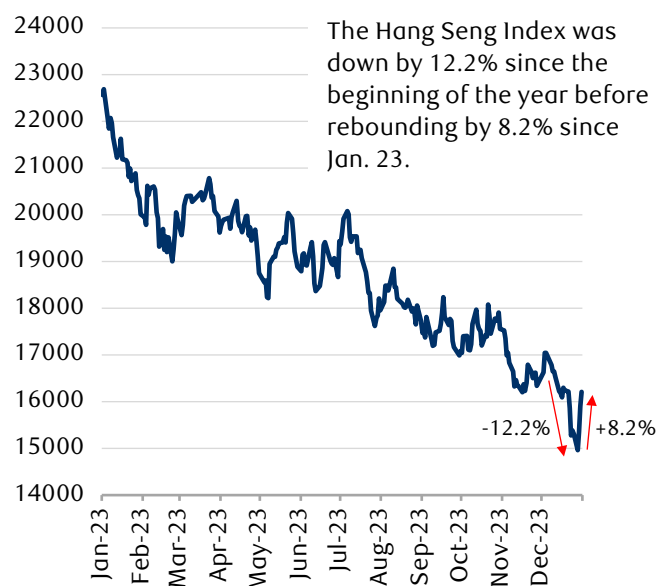
■ **Mining stocks were boosted by China stimulus hopes** following a statement by China’s central bank that it will cut the reserve requirement ratio for banks in an effort to bolster the economy. In our view, an improvement in sentiment around the economic outlook for China would be more helpful to European equities on a relative basis than to equities in other developed market regions, as European companies derive a higher proportion of sales (approximately 8%) from the Chinese market. Industries with the highest revenue exposure to China include automotive, luxury goods, and mining.

## ASIA PACIFIC

Jasmine Duan – Hong Kong

■ **Sentiment towards Asian equities has been predominantly positive throughout the week, fueled by China’s announcement of expedited stimulus measures.**

## Hong Kong’s Hang Seng Index having a volatile start to the year



Source - RBC Wealth Management, Bloomberg; daily data through 1/25/24

Chinese equities have experienced a three-day rally since Tuesday, with the onshore CSI 300 Index up 5.4% and the offshore Hang Seng Index rising 8.2%.

■ **The People’s Bank of China announced on Wednesday a move to cut the required reserve ratio for all financial institutions by 50 basis point to 10%, effective Feb. 5.** Separately, Chinese authorities signaled their intention to begin factoring market capitalization management into the performance assessments of state-owned enterprises’ senior managers. An unattributed Bloomberg report that policymakers were considering an RMB 2 trillion stock-market rescue package further boosted investors’ hope for market-supporting measures.

■ **The Chinese equities market had experienced a sharp selloff prior to this week’s rally.** We attribute a significant portion of that selloff to shifts in market positioning and capital withdrawals, rather than to economic fundamentals, and note that persistent outflows have been observed from European active funds and Hong Kong passive funds since the start of the year.

■ **While we acknowledge that China’s post-COVID-19 economic recovery has not met expectations, we also recognize the presence of enduring structural challenges,** such as those in the property sector, that require decisive action. Despite these issues, we dispute the narrative presented by some media outlets that China is on the precipice of an “economic collapse.”

■ **Investors are now faced with the question of whether this rally has the momentum to persist.** We have a positive view of the actions being taken to stabilize market sentiment. However, amidst ongoing geopolitical tensions and concerns over policy predictability, we believe many investors are waiting to see more concrete catalysts before committing to long-term investments in the region.

## MARKET Scorecard

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Tuesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -2.1% return means the Canadian dollar fell 2.1% vs. the U.S. dollar year to date. USD/JPY 147.49 means 1 U.S. dollar will buy 147.49 yen. USD/JPY 4.6% return means the U.S. dollar rose 4.6% vs. the yen year to date.

Source - Bloomberg; data as of 1/24/24

| Equities (local currency)  | Level      | MTD   | YTD   | 1 yr   | 2 yr   |
|----------------------------|------------|-------|-------|--------|--------|
| S&P 500                    | 4,868.55   | 2.1%  | 2.1%  | 21.2%  | 10.4%  |
| Dow Industrials (DJIA)     | 37,806.39  | 0.3%  | 0.3%  | 12.1%  | 10.0%  |
| Nasdaq                     | 15,481.92  | 3.1%  | 3.1%  | 36.6%  | 11.7%  |
| Russell 2000               | 1,961.87   | -3.2% | -3.2% | 4.0%   | -3.5%  |
| S&P/TSX Comp               | 21,025.78  | 0.3%  | 0.3%  | 1.9%   | 2.2%   |
| FTSE All-Share             | 4,120.13   | -2.6% | -2.6% | -3.0%  | 0.5%   |
| STOXX Europe 600           | 477.09     | -0.4% | -0.4% | 5.2%   | 4.5%   |
| EURO STOXX 50              | 4,564.11   | 0.9%  | 0.9%  | 9.9%   | 12.6%  |
| Hang Seng                  | 15,899.87  | -6.7% | -6.7% | -27.9% | -35.5% |
| Shanghai Comp              | 2,820.77   | -5.2% | -5.2% | -13.6% | -20.0% |
| Nikkei 225                 | 36,226.48  | 8.3%  | 8.3%  | 32.7%  | 31.3%  |
| India Sensex               | 71,060.31  | -1.6% | -1.6% | 16.5%  | 23.6%  |
| Singapore Straits Times    | 3,153.33   | -2.7% | -2.7% | -4.3%  | -4.0%  |
| Brazil Ibovespa            | 127,815.70 | -4.7% | -4.7% | 13.1%  | 18.4%  |
| Mexican Bolsa IPC          | 55,419.55  | -3.4% | -3.4% | 1.0%   | 8.9%   |
| Gov't bonds (bps change)   | Yield      | MTD   | YTD   | 1 yr   | 2 yr   |
| U.S. 10-Yr Treasury        | 4.176%     | 29.7  | 29.7  | 72.4   | 240.6  |
| Canada 10-Yr               | 3.500%     | 39.0  | 39.0  | 64.6   | 168.8  |
| UK 10-Yr                   | 4.010%     | 47.3  | 47.3  | 73.3   | 288.4  |
| Germany 10-Yr              | 2.342%     | 31.8  | 31.8  | 18.7   | 244.9  |
| Fixed income (returns)     | Yield      | MTD   | YTD   | 1 yr   | 2 yr   |
| U.S. Aggregate             | 4.75%      | -1.4% | -1.4% | 0.9%   | -7.7%  |
| U.S. Investment-Grade Corp | 5.26%      | -1.3% | -1.3% | 3.1%   | -7.2%  |
| U.S. High-Yield Corp       | 7.86%      | -0.5% | -0.5% | 8.9%   | 2.1%   |
| Commodities (USD)          | Price      | MTD   | YTD   | 1 yr   | 2 yr   |
| Gold (spot \$/oz)          | 2,015.26   | -2.3% | -2.3% | 4.0%   | 9.3%   |
| Silver (spot \$/oz)        | 22.68      | -4.7% | -4.7% | -4.2%  | -5.4%  |
| Copper (\$/metric ton)     | 8,312.00   | -1.8% | -1.8% | -10.5% | -14.9% |
| Oil (WTI spot/bbl)         | 75.64      | 5.6%  | 5.6%  | -5.2%  | -10.1% |
| Oil (Brent spot/bbl)       | 80.29      | 4.2%  | 4.2%  | -6.8%  | -6.9%  |
| Natural Gas (\$/mmBtu)     | 2.64       | 5.1%  | 5.1%  | -18.9% | -34.4% |
| Currencies                 | Rate       | MTD   | YTD   | 1 yr   | 2 yr   |
| U.S. Dollar Index          | 103.2430   | 1.9%  | 1.9%  | 1.3%   | 7.6%   |
| CAD/USD                    | 0.7395     | -2.1% | -2.1% | -1.1%  | -6.5%  |
| USD/CAD                    | 1.3523     | 2.1%  | 2.1%  | 1.2%   | 7.0%   |
| EUR/USD                    | 1.0886     | -1.4% | -1.4% | 0.0%   | -3.9%  |
| GBP/USD                    | 1.2725     | 0.0%  | 0.0%  | 3.2%   | -5.7%  |
| AUD/USD                    | 0.6577     | -3.4% | -3.4% | -6.7%  | -7.9%  |
| USD/JPY                    | 147.4900   | 4.6%  | 4.6%  | 13.3%  | 29.4%  |
| EUR/JPY                    | 160.5500   | 3.1%  | 3.1%  | 13.3%  | 24.4%  |
| EUR/GBP                    | 0.8555     | -1.3% | -1.3% | -3.1%  | 1.9%   |
| EUR/CHF                    | 0.9391     | 1.1%  | 1.1%  | -6.5%  | -9.3%  |
| USD/SGD                    | 1.3388     | 1.4%  | 1.4%  | 1.5%   | -0.6%  |
| USD/CNY                    | 7.1580     | 0.8%  | 0.8%  | 5.5%   | 13.1%  |
| USD/MXN                    | 17.2359    | 1.6%  | 1.6%  | -8.3%  | -16.2% |
| USD/BRL                    | 4.9328     | 1.6%  | 1.6%  | -4.1%  | -10.2% |



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|-----------------------|-------|---------|--|---------|
|                       |       |         | Count  | Percent |
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| Sell [Underperform]   | 46    | 3.17    | 6  | 13.04   |

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