LatAm Natural Resources

The inflationary potential of Red Sea and Panama Canal trade disruptions

Industry Overview

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Equity
Latin America
Natural Resources

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Two key trade routes under strain = inflationary pressure

The global seaborne freight market has been pressured by escalating tensions in the Red Sea resulting from attacks made by Houthi rebels on commercial vessels, which adds to a severe drought affecting the Panama Canal operations. Seaborne trade corresponds to ~80% of global trade while the Red Sea and the Panama Canal represent ~15% and ~5% of seaborne trade, respectively.

Implications are global, oil & gas markets most exposed

Direct effects for Europe are more likely given the importance of the Red Sea for Asia-Europe trade. Recent trade disruptions could have a similar effect (although much smaller in magnitude) as the supply chain crisis that unfolded in 2021-22 – boosting freight rates, lead times and energy prices, ultimately leading to a surge in global inflation. Sector-wise, oil & gas markets are the most directly exposed, but other commodity and export markets could also be affected.

Oil & Gas: muted impact so far but prices could rise fast

The Red Sea is a key energy trading route. We note, however, that oil prices haven't increased yet as demand concerns have prevailed coupled with strong output in recent months. At the same time, it is important to highlight that escalating tensions in the region pose a serious risk to oil flows, and prices could change very quickly if the conflict leads to a major supply disruption in the Middle East.

Steel could see some pricing support but imports a threat

Although the Red Sea is not really an important route for South American trade flows, we see some potential indirect effects. Asia accounts for ~52% of steel imported into the EU, while China last year exported a net of 83.6Mt of steel. Extended lead times/higher freight costs could ultimately support global steel prices, particularly as regional prices are mostly set based on either import or export parity. On the other hand, we note the risk of some Asian exports being redirected to Latin America as Europe becomes a less accessible and more costly destination (given higher freight). This offers some cushion to Chinese exports and thus iron ore demand.

Limited impacts on pulp & paper, some support for SW

The trade disruptions should have a relatively minor impact on global pulp markets, as they coincide with weaker Chinese demand. Softwood (SW) could find US$20-40/t of support when searching for its next bottom in the wake of LNY and SPW, but this in turn will also likely work to prevent additional supply closures. Fluff pulp prices are more likely to experience inflation due to higher container rates, as price increases have decelerated in recent months but have yet to turn over. Separately, paper exports being redirected to LatAm could pressure local prices, but cushion some of the impact on Chinese paper exports and support paper production, and in turn pulp demand.

LNY = Lunar New Year

SPW = Shanghai Pulp Week

Two key trade routes under strain

Throughout the last few months, escalating tensions in the Red Sea resulting from attacks made by Houthi rebels on commercial vessels triggered a response from countries such as the US and the UK. The conflict is putting pressure on the global seaborne freight market due to the region's relevance as a trade route. In addition, a severe drought in Panama is leading to a backlog of vessels that need to wait longer to cross the Panama Canal. Seaborne trade corresponds to close to 80% of global trade while the Red Sea and the Panama Canal together represent ~20% of seaborne trade.

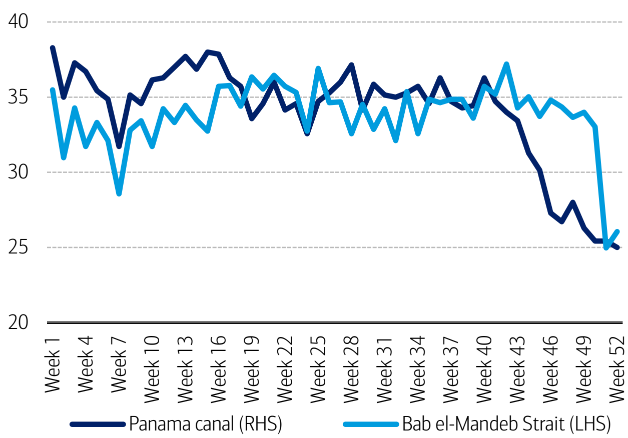
It all starts with oil generating ripple inflationary effects

Close to 5% of seaborne trade passes through the Panama Canal while the Red Sea is an important trading route for oil and gas, dry bulk and container shipping, representing 15% of seaborne trade. More than 1/3 of the vessels that cross the Red Sea passing through the Bab-el Mandeb Strait and the Suez Canal are tankers. In fact, around 12% and 8% of seaborne oil and LNG passes through this trade route.

Statistics on transiting ships through the Panama Canal and the Bab el-Mandeb Strait in the Red Sea have dropped significantly, by 30% and 10% YTD. Meanwhile the Baltic Dry Index (BDI) and the World Container Index (WCI) have risen by 139% and 195% from the lows immediately preceding the Panama Canal disruptions to the recent peaks.

Exhibit 1: Daily average per week of ships crossing the Panama Canal and Bab el-Mandeb Strait

The number of vessels dropped significantly by the end of 2023



Source: BofA Global Research, IMF Portwatch

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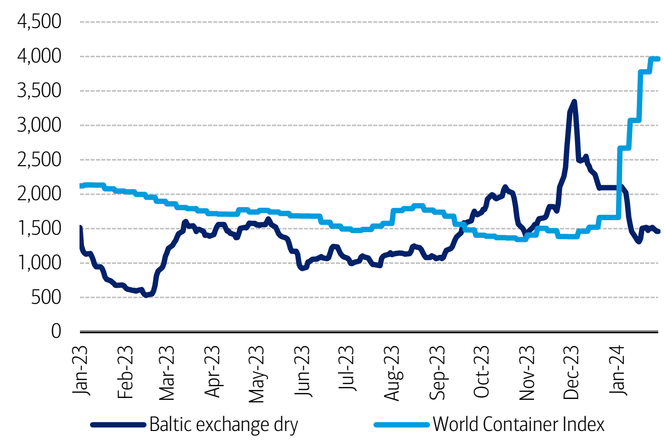
Exhibit 2: Baltic exchange dry (BDI) and World Container index evolution

Freight rates spike on the onset of the Red Sea crisis



Source: BofA Global Research, Bloomberg

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In addition, the nearby Strait of Hormuz is also a particularly sensitive zone for energy trade given that around ~20% of oil and LNG flows through it. So ultimately an escalation of the conflict in the Red Sea can have a very significant inflationary implication for oil & gas markets.

As a result of the conflict in the Red Sea, oil and shipping companies are diverting vessels away from the region. The alternate route via the Cape of Good Hope around Southern Africa adds around 7—14 days to the voyage between Europe and Asia.

It is worth mentioning that the Panama Canal Authority has recently alleviated the restrictions on the number of ships that are allowed to cross the canal as of this month. The limit on transiting ships was increased from 20 to 24 given the expectation of more rainfall in the next few months as well as water conservation measures adopted by the Canal.

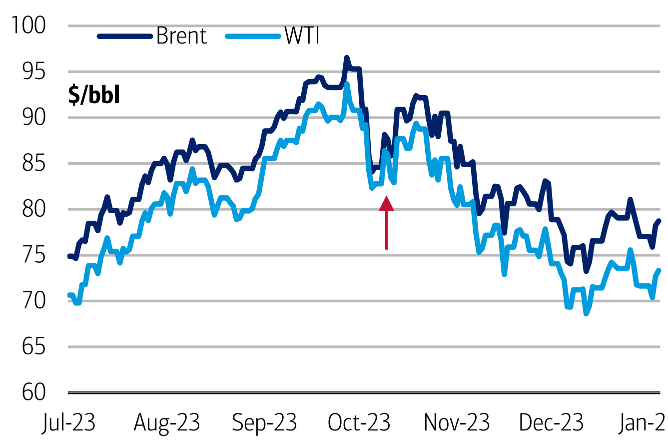
However, the conflict in the Red Sea is still fluid and could continue to drive up container and freight rates. In addition, the conflict also has the potential to push up energy prices. In fact, the current situation is reminiscent (but to a much smaller extent) to the supply chain crisis that unfolded in 2021-22 which led freight rates to increase sharply and generated significant backlogs of stranded ships that were unable to dock at busy ports. This in turn led to a surge in global inflation.

Recent trade disruptions and the resulting impact on freight rates, higher lead times and energy prices have the potential to generate ripple effects and once again drive the price of goods up. This is most likely to generate direct effects for Europe given the importance of the Red Sea for Asia-Europe trade. But it could also have global inflationary impacts especially if energy prices catch a bid. However, the impact this time around should be much smaller in comparison to the supply chain crisis in 2021-22. Back then the inflationary impact was exacerbated by Covid-relief checks and a higher proportion of consumer spending allocated towards goods (vs. services) and lockdowns which generated significant supply and demand deficits.

It is also worth mentioning that higher lead times also have the potential to result in customers increasing consumption patterns to prevent inventory shortfalls.

We recently cut 24' oil price forecast yet geopolitical tensions could push it up
Having peaked at $95/bbl in September and rebounded again to almost $91/bbl in the second half of October, WTI crude oil prices have pulled back considerably since the Hamas-linked spike (Exhibit 3) on a weakening fundamental backdrop. Despite continued efforts by Saudi Arabia to keep removing crude volumes from an oversupplied market (Exhibit 4), growing US output and a slowing global demand picture in 2024 have nudged oil prices lower. Yet, after a brief drop below $70/bbl in early December and again in early January (see the report Energy held by a thread of diesel), crude oil prices have bounced from the lows on rising geopolitical concerns.

Exhibit 3: Daily Brent and WTI prices
WTI crude oil prices have pulled back considerably since the October 7 Hamas-linked spike...



Source: Bloomberg

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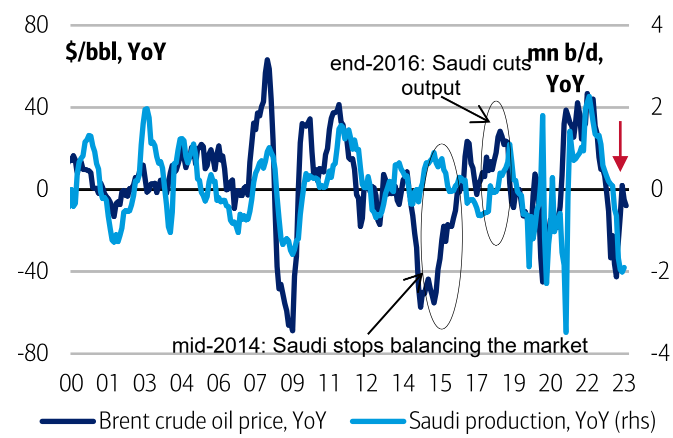
Exhibit 4: Brent crude oil price and Saudi production changes
...despite continued efforts by Saudi Arabia to keep curbing crude volumes



Source: Bloomberg

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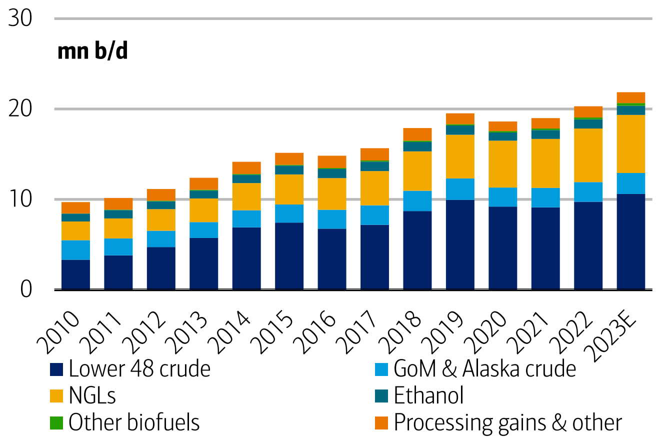
...due to expanding US shale oil supplies and...
While prices are lower than where they were three months ago, the geopolitical backdrop has not improved (see the report Geopolitics create oil asymmetries). It is precisely this volatile political and geopolitical backdrop that could keep the oil market on edge over the course of 2024, as fundamentals paint a softer picture. As we explained in our 2024 Year Ahead (see the report Year Ahead 2024: Energy outlook), the oil market needs firm OPEC+ cuts to support Brent prices above $80/bbl this year. In that regard, the fact that total US liquids production reached a record 21mn b/d at the end of last year (Exhibit 5) driven by a very large expansion in shale supply across various basins (Exhibit 6) is a major headwind for the producer group.

Exhibit 5: Total US liquids production
Total US liquids production reached a record 21mn b/d at the end of last year...



Source: EIA

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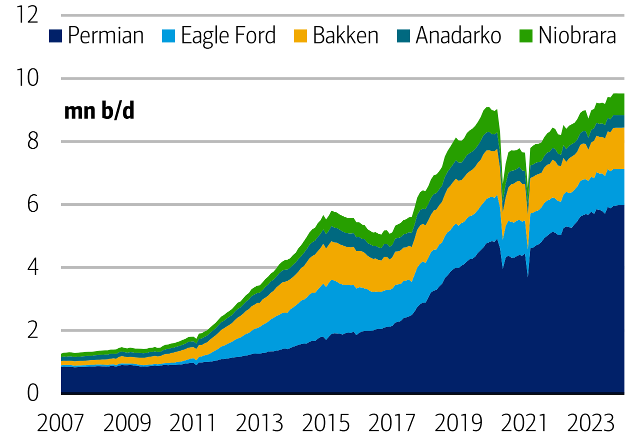
Exhibit 6: US oil production by major shale basins
...driven by a very large expansion in shale supply across various basins



Source: Bloomberg

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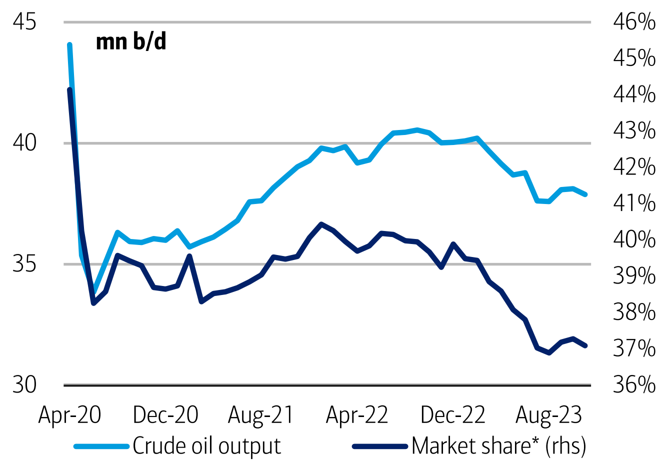
...a weak OPEC+ commitment to limit volumes

Precisely because of rapidly rising US shale supplies, as well as ongoing production growth in Guyana, Brazil, Canada, and other corners of the market, OPEC+ production and market share has come down significantly in the past year (Exhibit 7). Yet Saudi Arabia has carried most of the weight of the output cuts in the last 18 months with its voluntary production reductions. Although Saudi hoped to build goodwill to encourage others to join in the cuts, the unilateral action has led to a breakdown in OPEC cohesion and internal tensions (Exhibit 8). As the group gathered in their last meeting of 2023, some countries (such as Angola) refused to play by the new rules, ultimately leaving the organization and triggering a confidence crisis in the producer group.

Exhibit 7: OPEC+ crude oil production and market share (vs global liquids supply)
While OPEC+ production and market share has come down significantly in the past year...



Source: IEA, BofA Global Research

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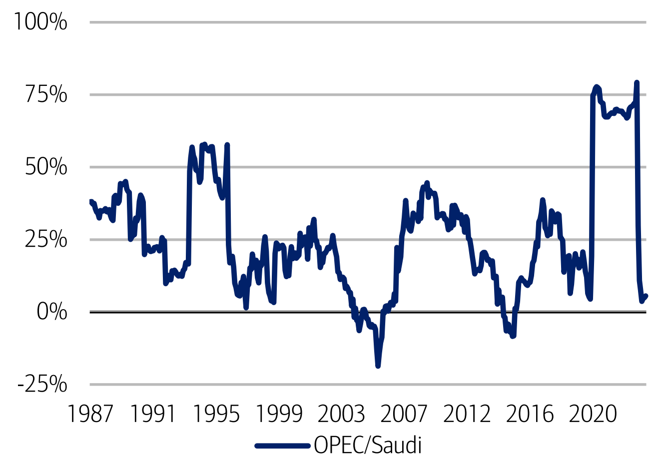
Exhibit 8: OPEC cohesion (correlation between Saudi supply changes and other OPEC supply changes)
...Saudi Arabia has carried most of the weight, leading to a breakdown in OPEC cohesion



Source: IEA, BofA Global Research estimates

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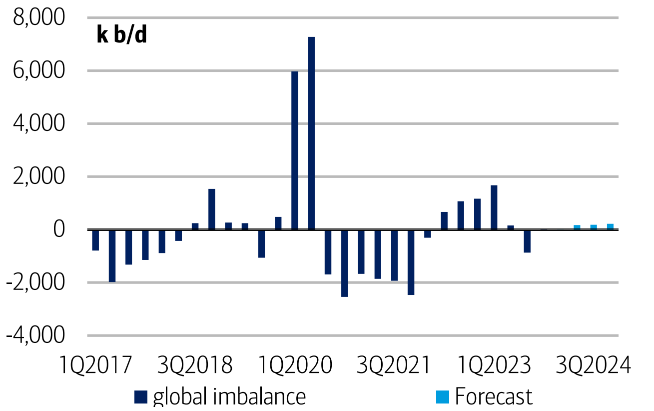
Balances look soft unless OPEC+ curbs output

Will OPEC+ cohesion increase in 2024 with others joining Saudi to manage production and ultimately market prices? This is one of the key questions for the oil market over the next few quarters. In our year ahead outlook in November, we projected a balanced oil market in 2024 and a $90/bbl Brent average for 2024, but fundamentals have softened since then (Exhibit 9). Now, Saudi oil production volumes likely must remain flat at 9mn b/d for the remainder of the year and (Exhibit 10) contributions from other members will be needed to prevent global oil balances from deteriorating further. While we assume additional cuts from other OPEC+ members, we think the group will fall short of its headline 2.2mn b/d 'cut'. Internal disagreements dominated the November meeting, so the group has spent much of the last four weeks trying to convince the market that the level of internal cohesion is still high despite the Angolan exit.

Exhibit 9: Global oil surplus (current)
In our year ahead outlook in November, we projected a balanced oil market in 2024, but balances have softened since then...



Source: IEA, BofA Global Research estimates

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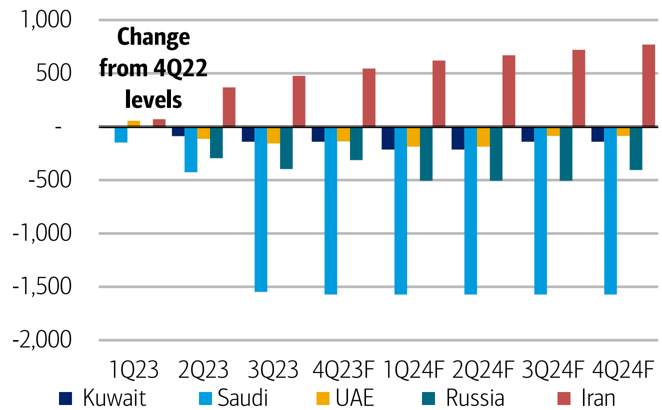
Exhibit 10: Change in supply from select countries
...and we assume Saudi oil production volumes of 9mn b/d during 2024 and cuts from other members to prevent balances from weakening further



Source: IEA, BofA Global Research estimates

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Still, growing spare capacity in Saudi and the UAE...

Moreover, while OPEC+ released a communique in their last meeting with large production cut commitments (Exhibit 11), there were a range of issues with it, starting with the lack of clarity with regard to exact quotas and production commitments levels. Further marring the view, the communique referred to both production and exports, making it difficult to gauge how balances will play out in the first half of this year. Meanwhile, spare crude oil production capacity has already increased to ~4mn b/d from a low of 1.8mn b/d in late 2022 and could continue to grow throughout 2024 (Exhibit 12) as OPEC+ continues to cut production volumes and the UAE maintains its energy investment programs.

Exhibit 11: Select press release text from recent OPEC meetings

While OPEC+ released a communique in their last meeting with production cut commitments…

Meeting	Action
10/5/2022	"Adjust downward the overall production by 2 mb/d from the August 2022 required production levels, starting November 2022 for OPEC and non-OPEC Participating Countries as per the attached table."
4/3/2023	"The Meeting noted the following voluntarily production adjustment announced on 2 April 2023 by" Saudi Arabia (500kb/d); Iraq (211kb/d); UAE (144 kb/d); Kuwait (128kb/d); Kazakhstan (78kb/d); Algeria (48kb/d); Oman (40kb/d); and Gabon (8kb/d) "starting May until the end of 2023"
6/4/2023	"Adjust the level of overall crude oil production for OPEC and non-OPEC Participating Countries in the DoC to 40.46 mb/d, starting 1 January 2024 until 31 December 2024, which is to be distributed as per the attached table."
11/30/2023	"The OPEC Secretariat noted the announcement of several OPEC+ countries of additional voluntary cuts to the total of 2.2 million barrels per day, aimed at supporting the stability and balance of oil markets. These voluntary cuts are calculated from the 2024 required production level as per the 35th OPEC Ministerial Meeting held on June 4 2023, and are in addition to the voluntary cuts previously announced in April 2023 and later extended until the end of 2024."

Source: OPEC, BofA Global Research

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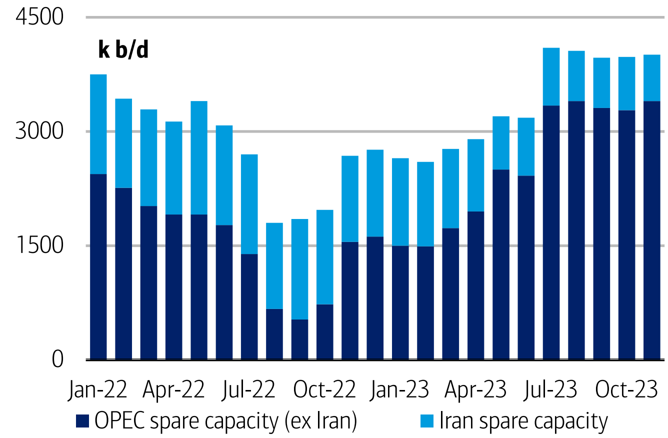
Exhibit 12: OPEC spare capacity

…spare capacity has already increased and could continue to grow throughout 2024



Source: IEA, BofA Global Research estimates

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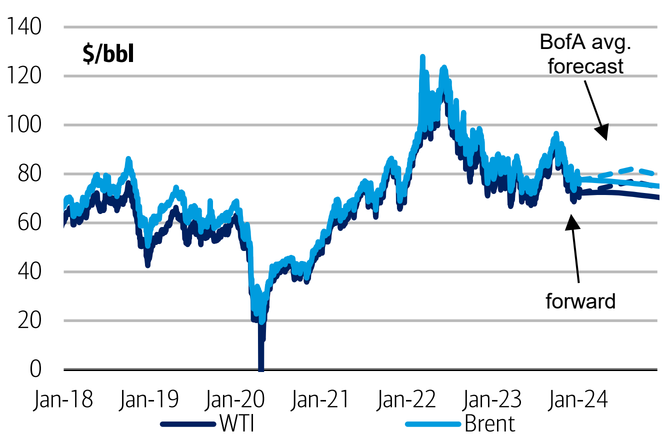
…and softer balances contribute to lower the prices in 2024

With spare capacity on the rise, OPEC+ credibility under the spotlight, and a weakening global supply/balance, oil prices have been on a downward slide for three months, even if the last month has provided some relief. From our perspective, however, we maintained our $86 and $90/bbl WTI and Brent crude oil forecasts for 2024 (Exhibit 14) despite these headwinds, but we acknowledge that fundamentals have softened and the economy continues to slow down (Exhibit 14). In the light of this, we reset our projected annual averages for Brent and WTI crude oil prices in 2024 to $80 and $75, down from $90 and $86 prior.

Exhibit 13: Brent & WTI crude price history, forecast, forward curve

We now project average prices of $75 and $80/bbl for WTI and Brent crude oil in 2024…



Source: Bloomberg, BofA Global Research estimates

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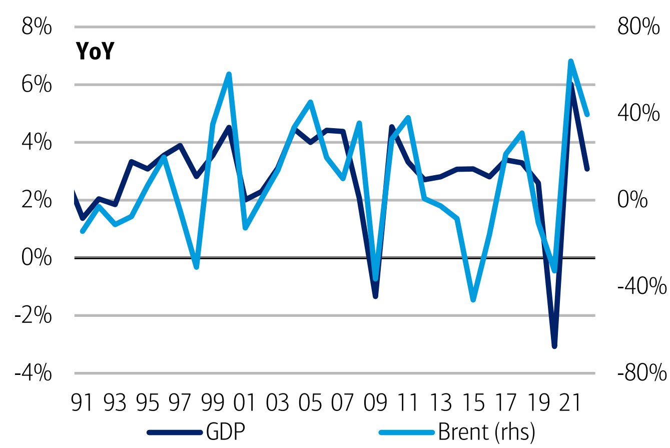
Exhibit 14: World GDP and Brent price growth

…and we acknowledge that fundamentals have softened and the economy continues to slow down



Source: IMF, Bloomberg

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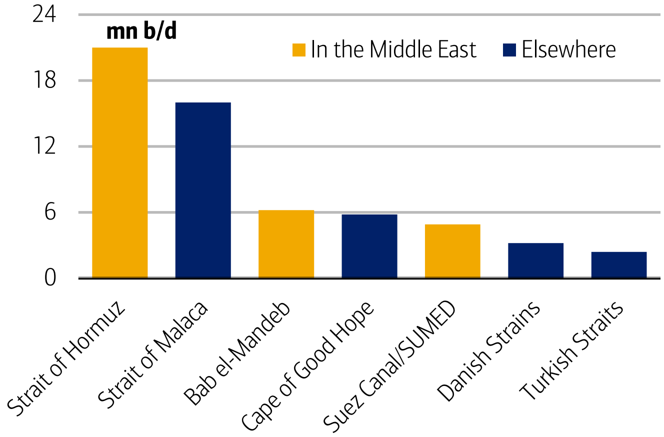
Yet geopolitical tensions in the Gulf continue to rise…

Even then, we remain concerned about (geo)politics. Not only are military tensions high across the world, but we are also facing a historical election year where over 60 countries representing about half of the world's population, from India to the US to the European Parliament, will go to the polls. Energy prices matter to voters the world over and the Biden Administration has been dealing with foes for much of the past 18 months to ensure ample supplies, allowing Russia, Iran, or Venezuela to increase their export volumes relative to market expectations. Against slowing demand and a growing supply backdrop, we note growing risks at key energy trading choke points (Exhibit 15) from the Persian Gulf to the Red Sea to the Panama Canal, as well as the sharp increase in armed conflict deaths witnessed in 2022 and 2023 due to both the Ukraine and Gaza wars (Exhibit 16). NATO can hardly afford to stretch itself thinner into more global conflicts ahead of major elections, and autocrats are taking notice.

Exhibit 15: EIA chokepoints

Against this slowing demand and growing supply backdrop, we note growing risks at choke points…



Source: EIA (estimates as of 2019), BofA Global Research

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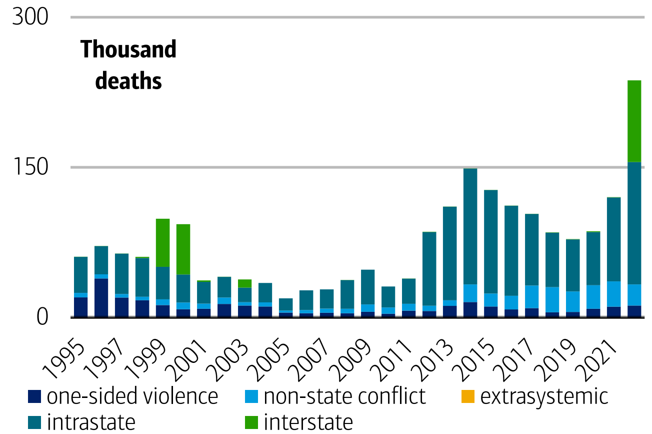
Exhibit 16: Deaths in armed conflicts

…and the sharp increase in conflict deaths witnessed in 2022 and 2023 due to both the Ukraine and Gaza wars



Source: United Nations Office for the Coordination

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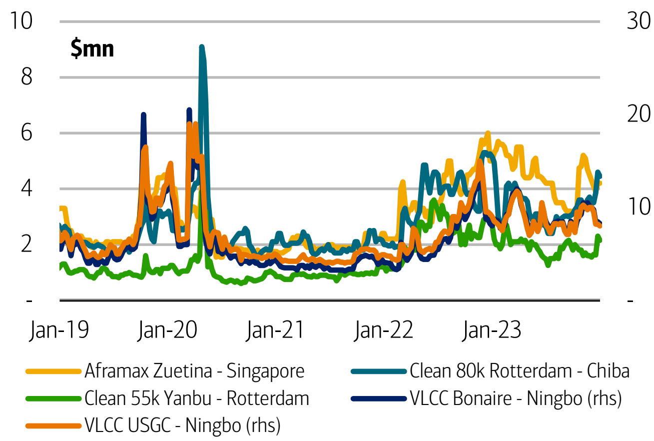
…and crude inventories are declining again…

For the time being, ample shipping capacity has kept freight rates in check despite geopolitics and weather disruptions (Exhibit 17), a factor that has surely alleviated some of the pressures on global energy markets. Yet (geo)politics remain front and center of an energy market looking for a clear direction. Importantly, the ability to manage unexpected events over the coming quarters is much thinner than in previous periods due to the lower government strategic energy stocks available at present. Saving the fact that Saudi Arabia has ample spare production capacity, there are limited tools across OECD economies to cap an unexpected surge in oil prices. Even if onshore, aboveground crude oil inventories increased in recent months from post covid lows of ~2.9bn barrels to ~3.1bn during 2023, they have started declining once again (Exhibit 18) and are now at ~3bn barrels.

Exhibit 17: Tanker spot rates
Ample shipping capacity has kept freight rates in check despite geopolitics and weather disruptions



Source: Clarksons

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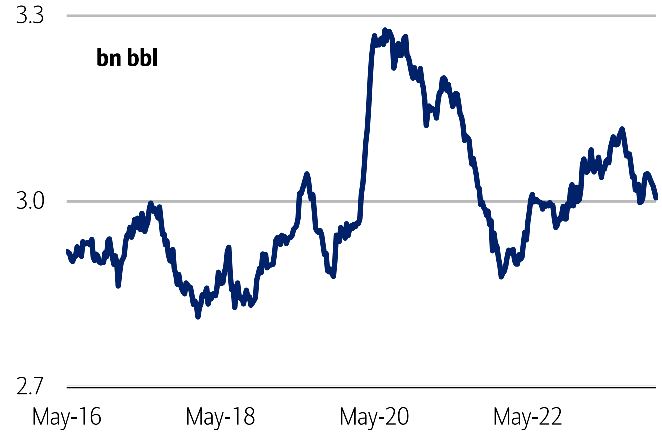
Exhibit 18: Kayrros global onshore aboveground crude oil inventories
While onshore crude oil inventories increased in recent months, they have started declining once again



Source: Kayrros

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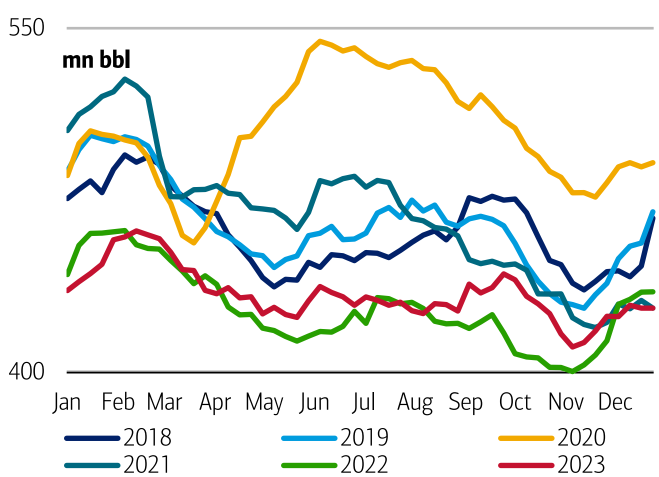
…while product stocks remain remarkably low…

While commercial crude stocks are low-ish, a much starker picture emerges for fuels like diesel, jet or even gasoline. Looking at aggregate petroleum product inventories across the main hubs, we note that stocks of transportation fuels are at very low levels and nearly 30mn barrels below five-year averages (Exhibit 19). As a result of the relatively tight petroleum product market situation, refining margins have yet to normalize after the big disruptions caused by the Ukraine war (Exhibit 20) and the banning of Russian petroleum product imports in Europe and the US. We believe new refineries will eventually expand capacity to bring crack spreads lower, but it may take some time (see the report [Waiting for Dangot(e)]).

Exhibit 19: Gasoline, diesel, and jet fuel inventories in the US, ARA, and Singapore
Aggregate petroleum product inventories across the main hubs are at very low levels…



Source: Bloomberg

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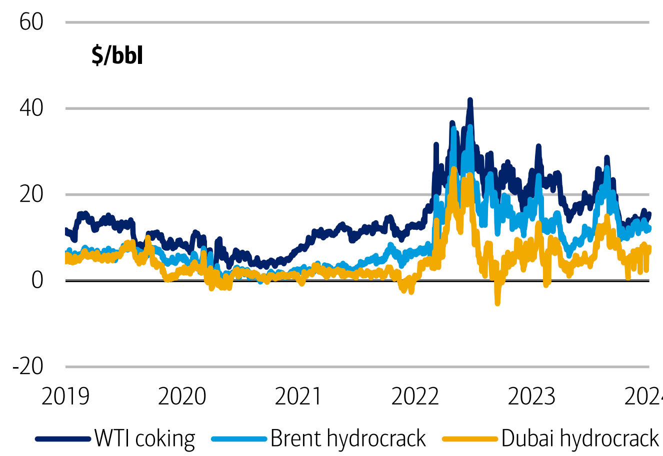
Exhibit 20: Regional refining margins
…and refining margins have yet to normalize after the big disruptions caused by the Ukraine war



Source: Bloomberg

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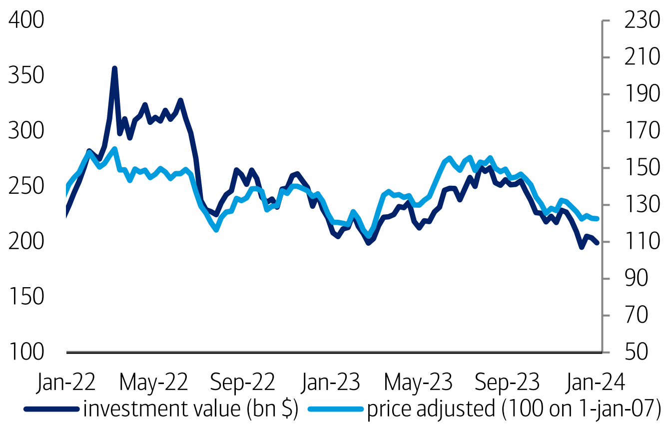
…just as speculative positioning has turned short

When it comes to investor positioning in commodity markets, we note that long exposure is down considerably in commodity indices (Exhibit 21) from a high point of ~$350bn in March 2022 to today's levels of ~$200bn. If we adjust this figure for price effects, we note that the value (indexed to Jan 1, 2007) of 122 is closer to 2020's low of

112 and even 2009 low of 91. Put differently, investor portfolios do not have much exposure to the asset class. Similarly, speculative positions across both Brent and WTI crude oil futures and options markets are down significantly (Exhibit 22) from a high last year of 545k contracts in September to 307k contracts recently after falling as low as 135k in December. So, sentiment and positioning can change on a dime, leading to large price swings, as we saw on January 3 on the back of the terrorist attack in Iran.

Exhibit 21: Index money invested in commodities (long) (nominal and price-adjusted)
Looking at investor positioning in commodity markets, we note that exposure is down considerably



Source: Bloomberg, BofA Global Research estimates

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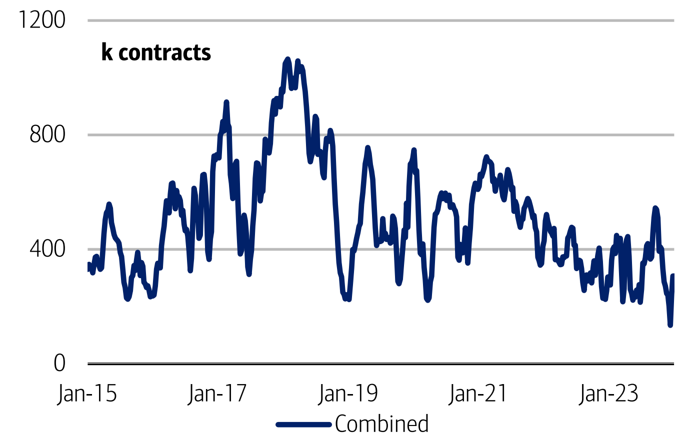
Exhibit 22: WTI and Brent managed money net length (futures only)
Similarly, speculative positions across both Brent and WTI crude oil markets are down significantly



Source: Bloomberg

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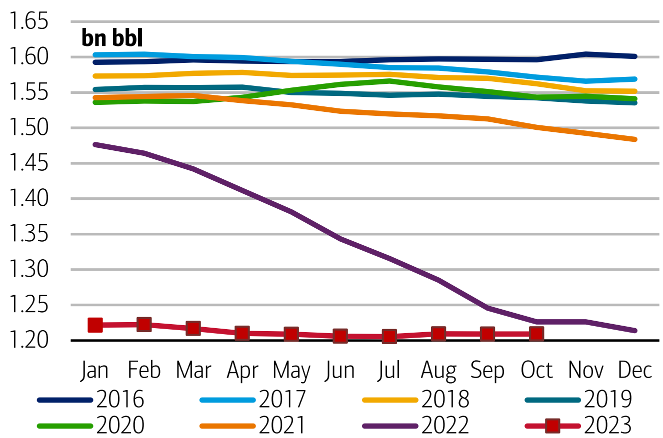
Also, OECD strategic stocks have yet to rebuild…

Beyond the fact that crude oil spec positioning length is light and commercial oil stocks are generally on the low side, strategic oil inventories across OECD economies are at the lowest point in decades (Exhibit 23). Although the US has started to push some barrels into strategic stockpiles in recent months (Exhibit 24), it is important to note that the ability of Western governments to limit an oil price rally, should there be one, has been reduced. Conversely, should oil WTI prices drop below $70/bbl for a sustained period of time, we would expect a pickup in the refill of government oil stocks globally, contributing to create a soft put for oil prices.

Exhibit 23: OECD government petroleum stocks
Strategic oil inventories across OECD economies are at the lowest point in decades...



Source: IEA

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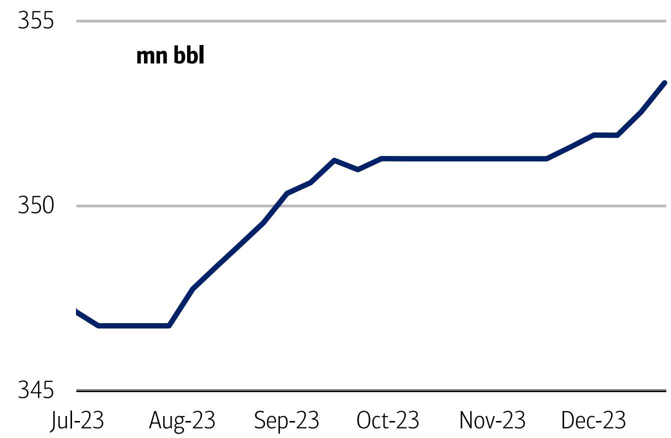
Exhibit 24: US Strategic Petroleum Reserve
...although the US has started to push some barrels into strategic stockpiles in recent months



Source: Bloomberg

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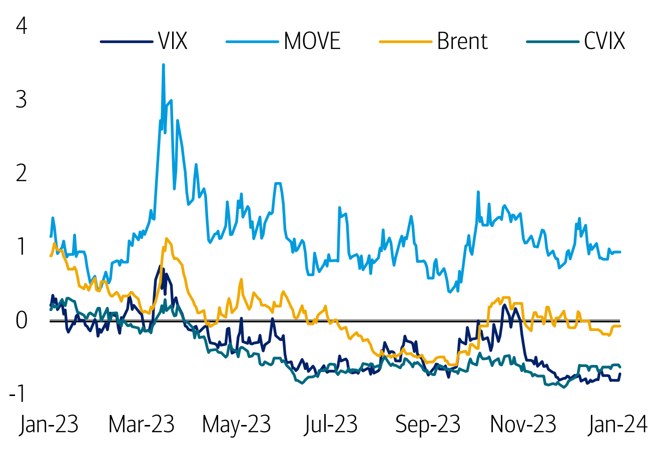
...leaving oil vulnerable to upside price swings...

With oil prices trapped in a $25/bbl range for most of last year compared to a $50/bbl range in 2022, volatility implied in crude oil options prices has been declining steadily but it has not collapsed. On a relative basis, volatility in the Brent crude oil market is not as high as it has been in the interest rates market (Exhibit 25) but has stayed persistently above the depressed vol levels witnessed in the equity and foreign exchange markets. Importantly, oil options continue to price a marked put skew due to continued dominance of producer hedging flows (Exhibit 26) and the relative absence of consumer hedging activity, a potential opportunity for investors concerned about geopolitical risks.

Exhibit 25: Z-score of cross-asset implied volatility since 2006
On a relative basis, volatility in the Brent crude oil market is not as high as in the rates market



Source: BofA Global Research, Bloomberg

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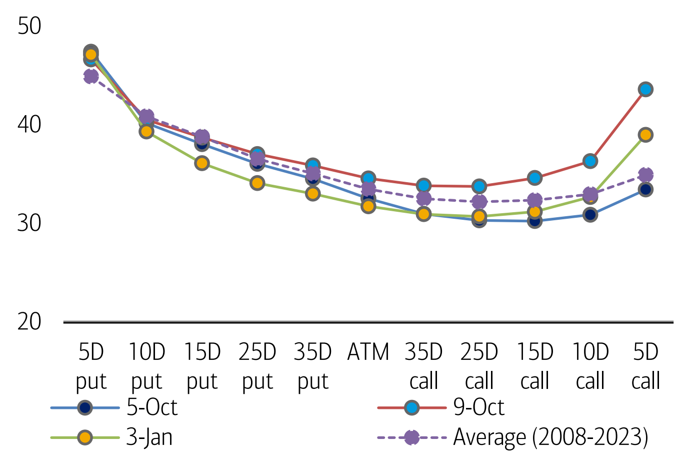
Exhibit 26: Brent crude 3-month option skew
Oil options continue to price a marked put skew due to continued dominance of producer hedging flows



Source: Bloomberg

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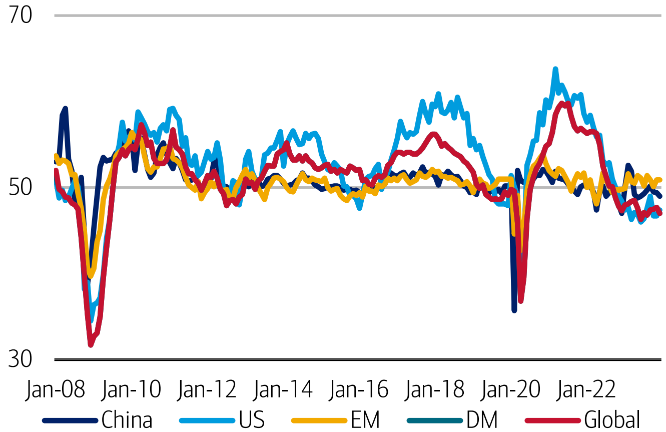
...especially if the economy improves on rate cuts

Another factor that has caused oil prices to drop is the worsening macro conditions across the global economy, particularly in the industrial and trade sectors. For starters, PMIs have been sinking for quite some time and are in contraction mode around the globe (Exhibit 27). However, industrial activity cannot contract forever if the economic outlook brightens. So, an eventual upturn in global manufacturing could quickly lead to rising metals prices and eventually energy prices too (Exhibit 28). Put differently, unless a recession unfolds over the coming months, industrials will have to restock on their finished and intermediate goods, as well as their raw materials this year, which would trigger a round of fresh commodity demand (see Rates, recession, and restocking are the keys to energy).

Exhibit 27: Global manufacturing purchasing manager indices
PMIs have been sinking for quite some time and are in contraction mode around the globe...



Source: Bloomberg

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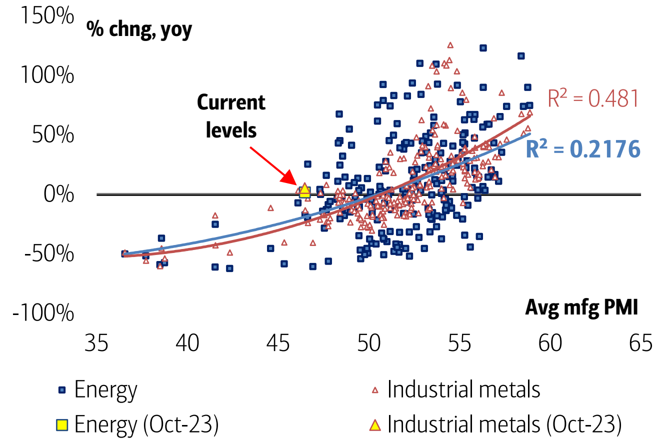
Exhibit 28: Average manufacturing vs (US, China, Eurozone) and annual commodity sector index returns
...but an eventual upturn in global industrial activity could quickly lead to rising metals and energy prices



Source: ISM, Markit, Bloomberg

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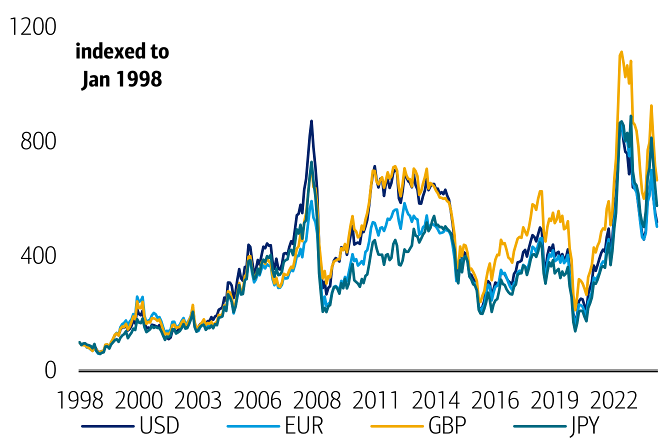
With fuel prices dropping relative to income…

Beyond the tailwinds that a cyclical inflection point could create for the energy sector over the course of the next few weeks, there are also important demand and price-level considerations related to the inflation-adjusted and relative prices of energy. While fuel prices measured in local currency have risen in absolute levels compared to history and fuels are somewhat expensive in a range of economies including the United Kingdom and Japan (Exhibit 29), fuel prices adjusted for income and inflation have come down considerably (Exhibit 30) in other places like the United States. After all, $1 in 2024 has the purchasing power of $0.84 in 2019 before the pandemic.

Exhibit 29: Front-month gasoil futures price in local currency indexed to January 1998
While fuel prices measured in local currency have risen in absolute levels compared to history...



Source: Bloomberg, BofA Global Research

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Exhibit 30: US gasoline price as a share of hourly wages
...fuel prices adjusted for income or inflation in the US have come down considerably

Source: Bloomberg, BofA Global Research

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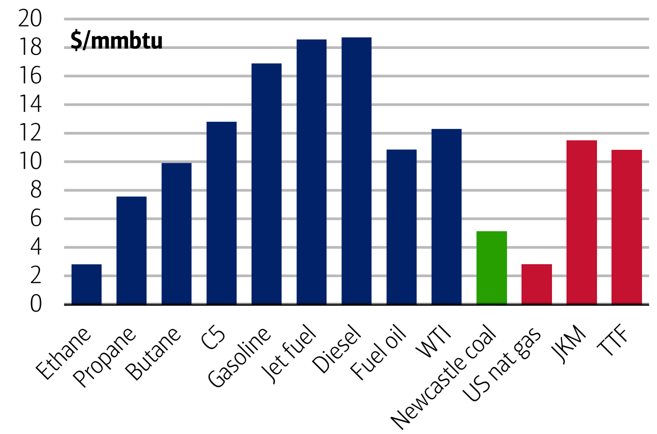
...and nat gas and thermal coal staying high...

Beyond the inflation considerations that define the real price of energy, it is also crucial to understand relative fuel prices to capture how high or how low Brent and WTI prices can trade over the course of this year. On this point, when looked at from a relative calorific value cross-fuel perspective, crude oil is not particularly expensive right now given its position as the king of thermal fuels (Exhibit 31) even after the slight drop in European TTF natural gas prices below EUR35/MWh in the first week of the year. In part, this is because Australian thermal coal and JKM liquid natural gas prices have held up (Exhibit 32) better than the European counterparts, although admittedly warm winter weather has been a headwind for prices.

Exhibit 31: Fuel prices in Mmbtu

When looked at from a relative calorific value cross-fuel perspective, oil is not particularly expensive right now



Source: Bloomberg, BofA Global Research

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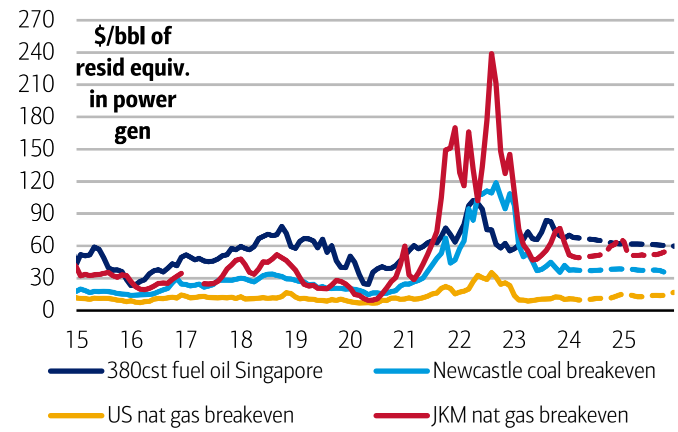
Exhibit 32: Asia resid fuel oil prices and breakevens with coal and gas in power generation

In part, this is because Australian thermal coal and JKM liquid natural gas prices have held up



Source: Bloomberg, BofA Global Research

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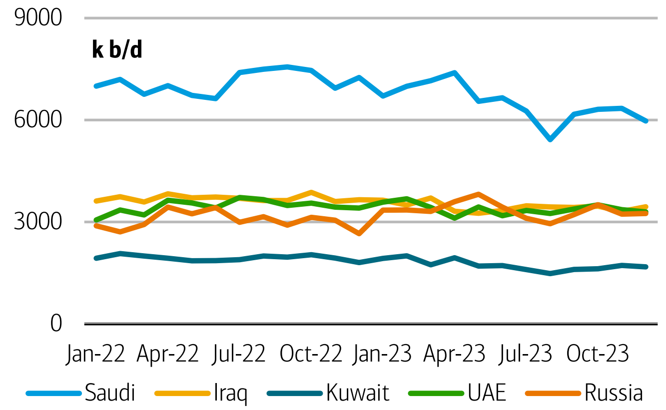
...prompt oil has limited downside near-term...

So, what happens next over the coming weeks? Given the geopolitical risks involved and the relatively low starting point for stocks, we see limited downside for Brent and WTI prices in the near-term. Even then, looking at loadings for Russian and Middle East oil across a range of shipping terminals, we note that exports have yet to start dropping (Exhibit 33) to reflect the agreement that OPEC+ came to last month. If these loadings start to decline in earnest as we expect, the Brent oil market will likely gain support and rally above $80/bbl, further boosted by geopolitics. But if loadings increase further and reflect a fractured OPEC+, crude prices could take again a downward path below $70/bbl. If it comes to that, we would emphasize that China's energy imports have tended to increase sharply when Brent prices drop below $65/bbl (Exhibit 34).

Exhibit 33: Monthly crude loadings by country

Looking at loadings for Russian and Middle East oil, we note that exports have yet to start dropping



Source: Bloomberg

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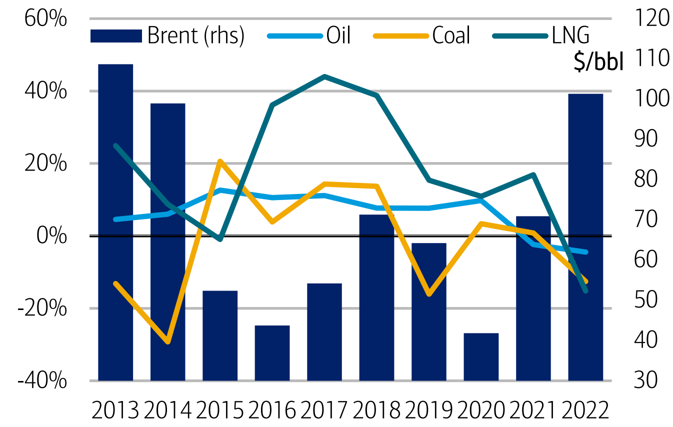
Exhibit 34: YoY change in imports to China by fuel versus Brent prices

China's energy imports have tended to increase sharply when Brent (oil or gas) prices dropped below $65



Source: Energy Institute

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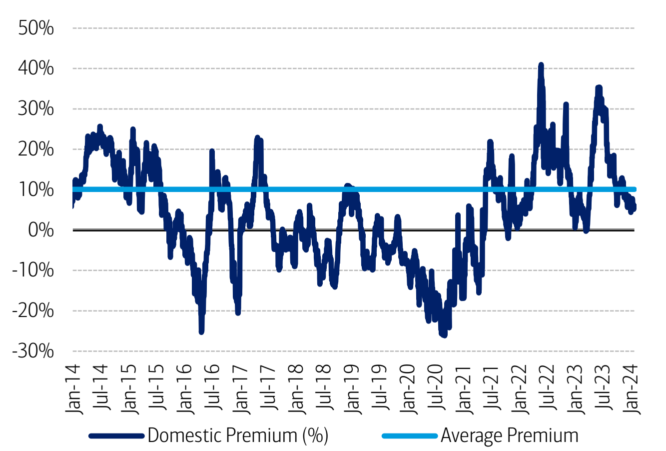
Steel could gain price support but imports a threat

Although the Red Sea is not really an important route for South American trade flows, we see some potential indirect effects that could unfold. Ultimately around 52% of steel imported into the EU comes from Asia with China alone representing 9%. Last year China exported around 83.6Mt of steel on a net basis (exports - imports). In our opinion, escalating tensions in the Red Sea could lead Chinese steelmakers to try and pass on higher freight rates onto customers. We don't expect them to significantly deter export volumes as there are alternate routes available but rather increase the costs of shipping those volumes and increase the lead times.

Given that most regional steel prices are mostly set based on either export parity or import parity, higher Chinese export prices and consequently higher European prices could generate some positive implications for regional prices in LatAm. In Brazil for example, we currently calculate that import premia remain at -6.5% for long steel (Exhibit 36) and 5.9% for flat steel (Exhibit 35) vs. a normalized premium of 5-10%. In fact, Brazil steelmakers have been signaling 5-10% hikes for February and if international steel price references rise on the back of the Red Sea conflict, then pass-through conditions could improve.

Exhibit 35: Brazilian HRC import parity premium/discount

The premium is currently at 5.9%



Source: BofA Global Research estimates, Bloomberg, Platts

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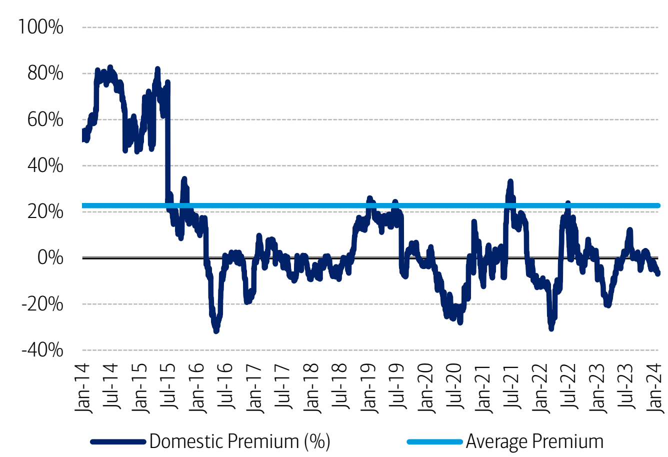
Exhibit 36: Brazilian rebar import parity premium/discount

The discount is currently at 6.5%



Source: BofA Global Research estimates, Bloomberg, Platts

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Risk of higher Asian exports to LatAm the key negative implication
Conversely, we also note the risk of some Asian exports, particularly Chinese, being redirected to Latin America as Europe becomes a less accessible destination. For steels specifically, we already saw a 64% surge in Brazilian imports from Asia in 2023 (led by China adding over 1.1Mt) – also benefitting from the 80% drop of imports from Türkiye (particularly important for long steel) in 2023 given reconstruction efforts after the earthquake in early 2023. This trend drove import penetration up in 2023, with imported steel accounting for 18.6% of apparent consumption (+5pp y/y), and could continue to pressure domestic markets.

Paper could also see a similar effect, and in fact we saw some anecdotal commentary from our industry sources suggesting Chinese paper & board producers, particularly for graphic paper, are looking into alternatives to European markets and plan to shift some of these volumes to Latin America. This could ultimately pressure domestic paper prices given higher import penetration. On the other hand, this could cushion some of the impact on Chinese paper exports and support paper production, and in turn pulp demand. Additionally, higher paper prices in Europe could offer some support to local prices for some grades such as kraftliner, and also benefit LatAm paper exports to Europe (e.g. Klabin's liquid paperboard exports).

Softwood, paper and fluff markets could also be impacted
We ran some channel checks with our industry contacts in the pulp & paper market and received the feedback below:

Shipments of paper and board out of China Europe are being restricted by the Red Sea conflict. That is providing some relief for EU paper & board suppliers and to a lesser extent US producers.

This in turn is leading China paper and board producers to focus more on the domestic market and less on exports meaning paper quality is less of an issue and using pulp that is certified to an international Forest Management Standard is not required. As such, they are using more domestic pulp and less imported pulp, especially when it comes to BCTMP.

In some non-China Asian pulp markets like India, a smaller share of pulp imports arrive via direct routes compared to China and are more subject to delays. Some buyers there are starting to increase pulp orders with a just-in-case sentiment, fearing a repeat of the extended lead times that unfolded as a result of the global supply chain crisis in 2021-22.

According to our industry contacts, softwood pulp is most at risk for disruption, particularly Nordic NBSK (Northern bleached softwood kraft pulp) and fluff pulp, which primarily use the Suez route for shipping to Asia. The conflict is driving an additional 2-week delivery time and approximately $40-50/tonne in additional transportation costs have been cited for Nordic NBSK shipped to China.

As of last week, the shock appeared likely to be absorbed/managed by existing excess shipping capacity and the fact that 4 of 10 major container carriers remain active in the Red Sea, including notably COSCO and Evergreen. The attacks on American flagged vessels in recent days adds a new dynamic for shipping rates this week. Prices are likely to continue rising in the short term, especially with the disruption of Lunar New Year likely only adding to the inflation in container backhaul rates. Investments in vessels, port infrastructure and containers have already demonstrated a dampened effect on global shipping rates in 2023, which pushed major lines to restrict capacity. This idle capacity will now likely play a role in helping to limit the inflation beyond the initial shock.

Nordic producers have proposed a $20/tonne hike on NBSK in China, although buyers have reportedly shrugged this off given the seasonally low demand leading into LNY and declining paper and board prices. Fluff could prove more sensitive to container rate inflation, as was witnessed in 21/22.

Our conclusion given the current state is that the Red Sea crisis will likely have a relatively minor impact on global pulp markets, as the disruption is coinciding with weak demand in China. NBSK is likely to find $20-40/tonne of support when searching for its next bottom in the wake of Lunar New Year and Shanghai Pulp Week, but this in turn will also likely work to prevent additional supply closures. Fluff pulp prices are more likely to experience inflation due to container rate inflation, as price increases have decelerated in recent months, but have yet to turn over. The 2-week extension of the softwood supply chain to China will one day contract when the security of the Suez route is guaranteed. This represents a future downside risk to softwood prices, similar to when shipping rates quickly declined in 2H22.

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R1]Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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