

Machinery, E&C and Waste

Red Sea: potential implications on US Machinery

Industry Overview

Direct impact: longer transit routes, higher shipping costs

The global seaborne freight market has been pressured by escalating tensions in the Red Sea and the Suez Canal - an important trade route, particularly from Asia and the Middle East to Europe. Prior to the attacks, about 28% of containership volumes transited through the Suez Canal. Those volumes are now down 90% with tanker and bulk volumes down 20%. The recent attacks by Houthi rebels have caused a diversion of trade, as shipping lines re-routing cargo around the Cape of Good Hope, adding 10-14 days to journeys. Longer transit times could lead to temporary supply chain disruptions, higher freight rates, and some inflationary pressure going forward.

Commentary across the Machinery space (so far)

We expect the resulting inflationary impact to be more significant for Europe vs North America given undisrupted trans-Pacific routes to the US West Coast. That said, severe drought impacting the Panama Canal (represents 40% of all U.S. container traffic/5% of global maritime trade) has reduced capacity in recent months. We are in early innings of earnings season for the Machinery space. We expect companies to highlight the risk and are likely to monitor the situation going forward, particularly on their EMEA operations. Oshkosh noted that the situation remains a concern, adds a degree of complexity, yet not a significant impact to its operations at this stage (i.e., note 10-15% of Access sales tied to EMEA). BofA's European Capital Goods analysts noted that they expect the primary impact to be timing, and mildly higher costs. Some European names cite some early signs of impact to supply chains yet overall impact remains to be seen.

Indirect impact: potentially higher oil/energy prices

Oil prices have not been notably impacted by the attacks to date, however BofA's Global Commodities Analyst Francisco Blanch, noted that Russian sanctions have triggered a major re-routing of oil flow away from the Mediterranean into the Red Sea (Asia). Moreover, he sees growing upside risks in petroleum fuels (such as diesel) due to low inventory levels at main global hubs. Should Middle East tensions extend through 2024, longer trade routes could shift the mild oil surplus forecasted in 2024 to a deficit, thereby exceeding projected averages of \$80/barrel. In a recent interview Petrobras's CEO stated that oil prices could top \$90/barrel this year if the attacks escalate (Bloomberg).

Sector implications: price vs cost spread faces pressure

In our 2024 Year Ahead, *darkest before dawn yet Machines likely to rise in the end*, we highlight the biggest downside risk for the sector is a narrowing of the price vs cost spread: price momentum fades faster than expected as costs creep back up. In an event of rising geopolitical tension causing a spike in freight/inflation, the ability for Machinery OEMs to pass on higher inflationary costs could be a challenge from here. The sector already observed a multi-year stretch of outsized price increases to offset COVID-supply driven inflationary pressure – yet this was in a rising demand environment. In our view, there is less room to contend with another inflationary driven event this time around.

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