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Global transit & trade: in rough waters

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Allison Nathan: Transit on the seas, the planet's most important means of trade, has become more fraught and undersea infrastructure more vulnerable amid numerous geopolitical and climate-related developments. This is especially the case in the Red Sea today as the conflict in Gaza drags on. I'm Allison Nathan, and this is Goldman Sachs Exchanges.

Every month, I speak with investors, policymakers, and academics about the most pressing market-moving issues for our Top of Mind Report from Goldman Sachs Research. On this episode, I'll share parts of my conversations with two experts featured in our latest report that breaks down maritime risks today and the threat to global trade, Admiral James Stavridis, a retired four-star US naval officer and former supreme allied commander of NATO, and Tobias Meyer, CEO of leading logistics firm DHL Group.

Admiral Stavridis and I first discussed just how important and fraught the seas are today. Here's our conversation.

Walk us through how control of the oceans really shapes geopolitical power in the world.

Admiral Stavridis: Let's start with a British Royal Navy expression, which is the sea is one. Meaning that it connects everywhere. And if you look at a globe of the world, only 30% of it is land. 70% is the ocean. And 70%, by the way, of the oxygen you're breathing comes from photosynthesis in the sea. So water defines this planet in so many ways. And to the commercial world, 95% of internationally traded goods go by sea, and that is because of weight, density, low friction. Think of the difference between trucking and training and flying as opposed to gliding across the surface of the sea.

The salient thing for us as we look at this network of global trade is that everything I've said so far is good news. Here's the bad news. The bad news is, at a variety of places around the globe, we find global chokepoints. That's the expression people use, and it's pretty appropriate. It's where the funnel narrows down, and all of that shipping on any given day, tens of thousands of merchant ships carrying goods and oil and liquefied natural gas, they all funnel down to a few chokepoints around the world.

Some of those places are relatively benign. The Malacca Strait, which is off Singapore that connects essentially the Pacific with the Indian Ocean, no prospect there of real military conflict. But as I do this conversation, I'm thinking a lot about a chokepoint, and that would be the Red Sea and Suez Canal. 15% of the world's shipping passes through those waters, and currently they're under attack by an Iranian-sponsored terrorist group known as the Houthis. So that's a pretty prominent, immediate example of why the oceans really matter.

Allison Nathan: If you think about the risks that we face today, how does that compare to what we have observed historically?

Admiral Stavridis: I've been looking at this for close to

45 years, and I have never seen a higher level of maritime risk and I'll tell you why. First and foremost, it is the return of great power competition. We sort of thought that would be parked when the Berlin Wall fell, the Soviet Union collapsed. That's well over 20 years ago of course. And in that period of time, China was not a big factor.

But over the last 30, almost 40, years now, China has risen to become a very serious naval power, the second-most powerful navy in the world, largest navy in the world by pure numbers, by the way. China has more warships than the United States does. Russia, for all of its challenges, has continued to finance a very powerful navy. And of course, we're watching today the Iranians and the North Koreans in particular I would point to have fairly capable naval assets.

So when you put all that together, it's a moment of high risk geopolitically. And then unfortunately, I have to add to that the wave of terrorism that has really been with us since 9/11, so almost 25 years. And we see, for example, these Houthi terrorists operating on the Horn of Africa. Google "Houthis take down a merchant ship" and watch the videos. These folks look like Navy SEALS. They are kitted out. They've got very capable weapons systems, sensors, communications. Their tactics as I observe them taking down a merchant ship, exactly the way US Navy SEALS would. These are not the Somali pirates of ten years ago. Houthis are seagoing warriors, and that, alongside the great power competition, is a pretty heady mixture.

And final point, I mentioned the Somali pirates. There is piracy that occurs as distinct from terrorism, political activity, and great power competition. There's pure profit-driven piracy. For example, in the Gulf of Guinea on the West Coast of Africa has a terrible problem with for-profit private pirates who are taking down ships, stealing the cargo. So for all those reasons, I cannot recall a time in my 40-plus years of looking at this that has more risk to the seagoing community.

Allison Nathan: The other risk is undersea infrastructure. How concerned are you about the risk to that, and who thinks it's their job to protect that?

Admiral Stavridis: Let's start with the basics. A lot of people, if you ask them: What does the Internet run on?

They would say, "Oh, it's satellites. It must be. You know, everything bounces around up there, and that's how that email gets from your iPhone to my uncle's iPad in Dublin, Ireland." Nope. 97% of what moves on the Internet runs on cables that go under the sea, on the very deepest parts of the seabed.

And here's another newsflash. There aren't millions of those. You might think there are at least 100,000, right? Or tens of thousands. Nope. Under 500 cables carry the entire Internet. It is a point of immense vulnerability. And it can be attacked at the highest degree of difficulty by vessels -- submarines, unmanned vehicles. The US has these, Russia has these, China has these, Iran does, North Korea, some capability here, can go down to the bottom of the oceans and destroy those cables, tap into them for intelligence purposes, manipulate them. They can do it in a way that looks like an accident or a failure of material, for example.

And then a second point of vulnerability and a pretty obvious one is how about on land where those cables come up finally? Those are very significant and not terribly well defended chokepoints. So that's a long way of saying I'm very concerned about it.

So whose responsibility is it to protect these cables which obviously run largely through international waters? The high seas on the bottom of the seabed? And the short answer is all of us who want a functioning global economy. So here's what I would recommend as we think about the cables. Think international, meaning what coalitions can we bring together that will protect this critical infrastructure? Including the West but I would say we ought to be talking to the Chinese about this. The Chinese have very high level of interest in protecting that global economy. Even as we have all our difficulties with Russia, we ought to be talking to Russia about this. This is like arms control and nuclear weapons. Everyone has a vested interest in not making those things go off.

Allison Nathan: But are we seeing that type of cooperation? Or is it likely to see that type of cooperation in the current moment?

Admiral Stavridis: That's the right question to ask. I'd say in descending order pretty easy and already happening between US, NATO, Japan, South Korea, Australia, and

New Zealand -- the West, if you will. That's about 60% of the world's GDP. Here's the key. It has to include China, with about 25% of the world's GDP. So if you want to put your finger on a soft concerning point, it would be where will China land in all of this?

I would argue China, which is utterly dependent on both trade and incoming commodities, will want to be part of the global community in positive ways. At times, those relationships will feel a little speed bumpy, but bet on China to be in on this over the long term because they have to be.

Allison Nathan: That's an interesting take because, when we think about China right now and their aggressiveness in the South China Sea, it feels like a more adversarial relationship.

Admiral Stavridis: I think these are two different issues in the context of China, the South China Sea and the global international trade routes. China absolutely needs these big global networks to work for them, to bring raw materials in and to send exports out. But there is a body of water, the South China Sea, which is vast. It's half the size of the continental United States. China claims it as territorial waters. They are continuing to build artificial islands. They're continuing to press against all other territorial claims in the South China Sea, for example, against the Philippines, a treaty ally of the United States. That is a specific problem set.

China's claims have been adjudicated in the international courts and rejected. But Allison, that is a manageable discussion between China, United States, and above all the other nations around the South China Sea -- the Philippines, Vietnam, Malaysia, Indonesia, etc. So I think we can manage through that challenge. I stand by my case that China has very broad interest in ensuring freedom of the high seas.

We haven't injected into this and we must at this point the island of Taiwan. If there is a flashpoint and there is a nonnegotiable challenge in all this, it would be the redline of Taiwan declaring independence. I don't see that happening at least in the foreseeable 5- to 10-year future. Taiwan has just had an election. The President-elect William Lai is someone who, in my view, is not going to push China's buttons in terms of independence. I think so long as that scenario remains quiet -- and I think it will -- then I think we have every reason to believe we can pull China into the big effort work.

Allison Nathan: Okay, interesting. Let me go back to the Red Sea for a moment. You've already talked about the threats that we are experiencing today in the Red Sea. Do you think that the worst, though, is behind us? Or how concerned are you about further escalation there, given everything we're observing?

Admiral Stavridis: I think the worst is not certainly behind us. I worry about mines, sea mines implanted in the waters of the Red Sea or, god forbid, the Strait of Hormuz by the Iranians, who have tried it in the past. So yes, there are risks, but I'm not overly concerned about a massive escalation.

Let me explain. The Houthis have done this occasionally for ten years. They've popped a missile or sent a drone or circled a ship. But their behavior has spiked as a result of the war in Gaza. That is their cause célèbre at the moment. So I think it is very likely that, when that situation reduces -- which I think will probably come in the

2- to 3-month range, simply because at that point Israel will have completed its military campaign, the international system will have brought in some kind of peacekeeping force. I think those are likely outcomes, not certainties of course. I think that will take some of the -- no pun intended -- some of the fire out of the Houthis.

The second reason I don't think it'll continue to go up is because Iran ultimately knows, if it continues to go up, the next set of strikes are not going to be against Houthis in Yemen. They're going to be against Iranian infrastructure. I foresee if the Houthis don't bring this thing down, I think it's quite likely the West is going to have to continue to pound Houthi infrastructure in Yemen but probably send a signal to Iran, going after either Iranian shipping, Iranian offshore oil-and-gas platforms, Iranian intelligence platforms that are embedded in some of those offshore platforms, or, at the really dark end of the spectrum, go after the munitions factories themselves in Iran that are building these missiles. We know exactly where these missiles are coming from, and let's hope we don't get there. I don't think we will. I think Iran will tether the Houthis, and over two to three months we'll see a reduction in Gaza. The Houthis will then diminish.

Allison Nathan: Right. Contingent on the Gaza conflict.

Admiral Stavridis: 100%. 100%.

Allison Nathan: Understood. Let me go to the other major area that we're focused on. Russia, as you said, still has a very strong navy. And they're building naval bases in the Arctic. How important will that be to maritime trade and to maritime security?

Admiral Stavridis: Yeah, great question. I'll come to the Arctic in one minute. I just want to make a point about Russia's Black Sea fleet, which was a very capable military force. About a third of it is now on the bottom of the Black Sea. It's been sunk by the Ukrainians. The Ukrainians don't have a navy. Russia confiscated it or sank it in the opening days of the war. But the Ukrainians have used drones and missiles to sink about a third of the Black Sea fleet, including, most shockingly, the flagship of the Black Sea fleet, the aircraft carrier striped cruiser, *Moskva.* It means Moscow in Russian.

So Russia's navy is quite capable, but it's been punched hard in the mouth by the Ukrainians. And that's why grain prices have remind at least somewhat reasonable because Ukrainian grain is still flowing out of Odessa through the Black Sea to the Arctic. Yes, Russia is invested in the Arctic and why? It's because of global warming and the melting of the icecap in the north as well as the ice shelf in Antarctica.

As that ice in the north melts, it opens up resources. It opens up oil, gas, and trade routes, a little bit of fisheries, all that kind of opens up for competition. Who is up around the Arctic Ocean? About half of it, the front porch, is Russia. So they have a highly vested interest, they have by far the longest coastline.

Who else is on the Arctic? It's NATO nations. That would be Canada, United States, Denmark by virtue of Greenland, Iceland, Norway. And Sweden and Finland are both Arctic nations because of islands they have. So you've got Russia on one side and NATO on the other and the ice melting and resources available. It's a Thunderdome. It is a place where conflict is going to be tempting on the side of the Russians.

So what NATO is doing to prepare for that, watching Russia build these bases across the Arctic, is training, creating its own systems to operate more effectively up there, putting more intelligence gathering, using the Arctic Council to try and ameliorate some of these tensions.

And I'll close with a practical example. US Navy SEALS, who we think of famously, correctly, in the deserts of Iraq, in the mountains of Afghanistan, Navy SEALS have just created a specialized Navy SEAL unit that is going to focus on the Arctic.

Allison Nathan: Interesting. Okay, very last question. Is naval capacity up for the task of really defending our trade routes and our critical infrastructure?

Admiral Stavridis: Yeah, I think that the two words I would give you are "stronger together." Meaning, yes, the US has a very capable blue water navy that can sail anywhere in the world and does. About 300 ships, including big nuclear-powered aircraft carriers, the quietest nuclear submarines in the world, very capable strike destroys and cruisers like the ones I commanded. We have a big navy, about 300 major warships.

China has 350. Their warships aren't as big. They have far less experience operating them globally. They don't have the system of bases around the world that we do. But, as the saying goes, quantity has a quality all its own. So head to head match, US-China, pretty close. But on the US side are our allies -- the Brits and the French, both operate, for example, nuclear-powered submarines with nuclear-tipped ballistic missiles on them. The Italians, the French, the British all have aircraft carriers.

As I look to the Pacific, Japan is doubling its defense budget. A lot of that, as is appropriate for an island nation like Japan, will go into the Japanese navy, which is very capable. South Korea has a good navy. Australia, small but excellent. Singapore, small but excellent. So when you add up this maritime coalition in the West and you match it up against China, we're in fairly good shape.

Where I worry, to conclude this tally, is if China and Russia were to combine, then you've got a lot of capability on that side of the ledger. Again, I don't see the Chinese falling into the Russian orbit. If anything, Russia might find itself in a position of dominance from China, but I think that's decades away.

Allison Nathan: I then spoke to Tobias Meyer, CEO of DHL Group, for a first-hand perspective on the impacts of this more challenging maritime environment, on global commerce, and supply chains. Here's what he had to say in our recent conversation.

So you have a front-row seat on global commerce today. What are you observing in terms of the biggest disruptions to trade flows today?

Tobias Meyer: Well, the day-to-day often worries very much about the physical disruptions. And I come to that in a minute. But I think what keeps us actually, if you look at along the period of time, more busy is the regulatory disruptions.

We had many years where global trade has become easier and the WHO or basically two decades in the '90s and early 2000s played a very good role in facilitating multilateral trade agreements, dispute settlement mechanisms, and other elements that helped global trade. Unfortunately, that is not the case now since five to ten years where the multilateral perspective has slowed. And some people feel it has kind of stalled. And also bilateral trade agreements have come forward rather selectively. Several jurisdictions have established higher hurdles to trade, higher tariffs for reasons of industrial policy.

We also have a stronger element of sanctions, which is obviously the flip side of geopolitical tensions that tools are used that influence trade. And also extraterritorial reach of other regulation. Europe, for instance, is pushing regulation in the area of ESG reporting that has influence on companies operating abroad. So this is I think an underappreciated disruption to trade. It creates a lot of complexity, not only for companies like us but particularly our customers who obviously want to stay compliant to the regulations in different jurisdictions, but this has become significantly more complicated over the last years because the regulation in one jurisdiction isn't necessarily consistent with what another jurisdiction wants to achieve.

Allison Nathan: Interesting. Let's talk a little bit about physical disruptions, obviously concentrated in the Red Sea. What are you observing in terms of the impact of the Red Sea attacks on maritime transit?

Tobias Meyer: So most goods nowadays are shipped in containers. Companies, investors, and so forth are focused around this containerized trade. So let's focus on that for a minute. And this is actually quite an interesting statement because it's not so complicated. You have a certain number of containers at a given point in time, you have a certain number of slots on vessels. Those vessels have a certain range of speeds they can operate in with a cost curve of going faster being a bit more expensive because of higher fuel burn. And that system can be modeled quite well.

Now, why is that relevant? Because those disruptions -- the Red Sea, the Suez Canal incident -- have a very different impact depending on the balance of the overall system. What we have seen during corona, when the *Ever Given* got stuck in the Suez Canal, this only had such a huge impact because the overall system was at the border of stress due to a very tight demand-supply balance. Demand was high. Supply in shipping doesn't come by easily. It takes, from contracting to delivery, it's typically three years at minimum to build a vessel. So it just takes time for the system to react. And during that inertia phase, if you then have disruptions, they can have a disproportionate impact.

Now, zoom into 2024 and the situation in the Red Sea. We have quite a relaxed demand-supply balance because global trade is still quite slow, and shipping lines have ordered quite a number of vessels from the money they earned during the pandemic. So there's a strong pipeline of new-build vessels coming in. The fleet is actually quite young, so there isn't much scrapping potential. So that's why currently, even though the extended voyage around the Cape of Good Hope requires several percentage points of global capacity and global supply is absorbed in that, this overall demand-supply balance is relaxed enough to absorb that. So that's why, yes, we see some elevation in rates because obviously the production costs are also increasing if a longer journey needs to be conducted. But it doesn't have that disproportionate element.

Now, if two, three, four of these moderate disruptions happen at the same time and we still have the situation in the Panama Canal, which also has some impact on the supply-demand balance. So if you have multiple things happening, that can change but it's much less likely really now to have a severe disruption because, again, the overall demand-supply balance is quite relaxed and will remain relaxed into '25 and '26 that I think is very foreseeable.

Allison Nathan: But just in terms of the implications, though, as you mentioned, costs of a longer voyage, uses more capacity. Could you give us a ballpark of the cost increase that is still associated with that type of disruption or longer voyage?

Tobias Meyer: The voyage lengthens by depending exactly where you start and where you end in Asia and Europe, let's say 30-40%. And that's roughly also the cost increase from the portion on the water. Now, if you have a container that you ship from A to B, you also have the port cost, potential dredge, the trucking costs on the land side. So the end-to-end cost from a hinterland location to a hinterland location might then be 10-20% higher.

Now, obviously the short-term impact on rates is a bit higher because the circulation of vessels, if you suddenly add ten days to a string, then obviously in the port in Asia you will have ten days where basically no vessel arrives because the one that was supposed to arrive needed ten days longer. So in that period, you do have some short-term shortage, and that really leads to short-term rate spikes, as we have seen over the last 2-3 months. But that will balance out pretty quickly.

Allison Nathan: Are you seeing other implications of these disruptions in the sense of a higher demand for airfreight versus containers? Have you seen a redirection in that sense?

Tobias Meyer: No, we haven't and that's a bit of surprise. There doesn't seem to be that great urgency. We don't see that dynamic recovery in global trade as of now. It's very likely that will change as we go through Q2 and into the second half, but currently it is still pretty soft. And one indicator of that is at this extended voyage on the Asia-Europe trade doesn't translate to much more airfreight.

The airfreight market has more been characterized by demand from Asian ecommerce platforms that have substantial export into developed economy. That has absorbed quite a bit of airfreight capacity in the fourth quarter and also into this year. So this is currently the much bigger weight on the demand-supply balance of airfreight.

Allison Nathan: When we think about trade patterns, some people say we hear a lot about deglobalization, but it's not actually happening. We aren't seeing much impact on trade patterns. So it would be useful to hear what you are actually observing in trade patterns.

Tobias Meyer: So definitely globalization has decelerated. We have seen for three decades trade grew at a substantial multiple to global GDP, particularly in the 1990s, early 2000s. It was a factor of two basically for ten years. That is not the case anymore. Trade is more growing in line with GDP, but it is also cyclical and has always been. Trade contracts stronger in a recessionary environment and expands stronger when the economy grows, so that is also what we have been seeing the last 12-18 months. So that is not a surprise either, and it's not proved that the trend would further slow down. It's just what we have been seeing for many economic cycles.

But the multiple is not there anymore, so we'll see more growth in line with GDP. The pattern has changed. We do see that strong growth on the transpacific from China to US clearly has taken a hit. Certain commodities have gone substantially backwards. You could also argue it has been relatively resilient given the amount of tariffs put in. So there you can have two perspectives on the matter. It was resilient relative to the increase in hurdles, yet it obviously hasn't grown anymore.

What we do see is that people do what we call omni shoring. So it is not really a trend of bringing manufacturing back home or near shoring. Though Mexico has clearly benefited from this new framework, new boundary conditions that geopolitics put upon us. But if you look at Europe, for instance, there's not necessarily coming to Eastern European countries. And also Southeast Asia plays a strong role. The Middle East plays a strong role, including Turkey.

So it is quite differentiated, and the region-by-region, the footprint that companies aim to set up diverge quite a bit. It is also not true that really everything leaves China or that China would lose its dominance in manufacturing certain parts and components. What we've seen mainly shifting so far is manufacturing of the final assembly of goods. A lot of parts and components are still coming from China, and so the sourcing of parts and components still happens here.

But what people diversify away from is the single uniform setup of their supply chain for their most critical components and for their most important products. So they seek to have alternatives and not a single choking point or a single source. Though some people might not recognize that, at the second or third level in their supply chain, it flows back together. And a critical part still comes from one source in a specific country.

Allison Nathan: Right. But just to put a fine point on this, are you actually seeing companies implementing changes?

Tobias Meyer: Yeah, we see places like Mexico and also in Southeast Asia being very crowded. We have sold out, so to say, on the warehousing side in these locations. We made some investments ahead -- land purchases, land banking -- which enables us to know fill the pipeline relatively quickly. But there is substantial increase in demand in some of those markets that are talked about, so it's real.

Now, does it mean the entire supply chain shifts? No, it doesn't. Parts and components might still come from the very same source they came from before. But some parts of that value chain are shifting. So it's not a black-or-white shift, but there is something happening in the global supply chain of manufacturers.

Allison Nathan: With a lot at stake for companies, investors, and the world more broadly, we'll keep a close eye on how risks to maritime transit and the impact on trade evolve from here. If you enjoyed this show, we hope you follow us on Apple Podcasts, Spotify, or Google Podcasts, or wherever you listen to your podcasts, and leave us a rating and comment. And if you'd like to learn more, visit GS.com where you can find a copy of this report and also sign up for Briefings, a weekly newsletter from Goldman Sachs about trends spanning markets, industries, and the global economy.

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