

European Corporates: Muted Impact of Geopolitical Tensions on Energy, so Far

In this KBRA report, we explore the impact of geopolitical tensions on European corporations and energy markets. Rising geopolitical tensions pose indirect risks for corporate profitability and inflation in Europe via their potential impact on energy prices, transportation costs, and feedthrough into broader macroeconomic conditions. To date, the impact of the events in Ukraine and the Middle East and the ongoing risk of escalation have had a relatively mild influence on commodity prices. In contrast, shipping costs have experienced more volatility, and their impact on corporate profitability will largely depend on the current tensions being sustained. Despite a deterioration in terms of geopolitics, global economic forecasts and sentiment have improved, and energy prices have broadly remained range-bound. However, the risk of an increased impact remains high.

Key Takeaways

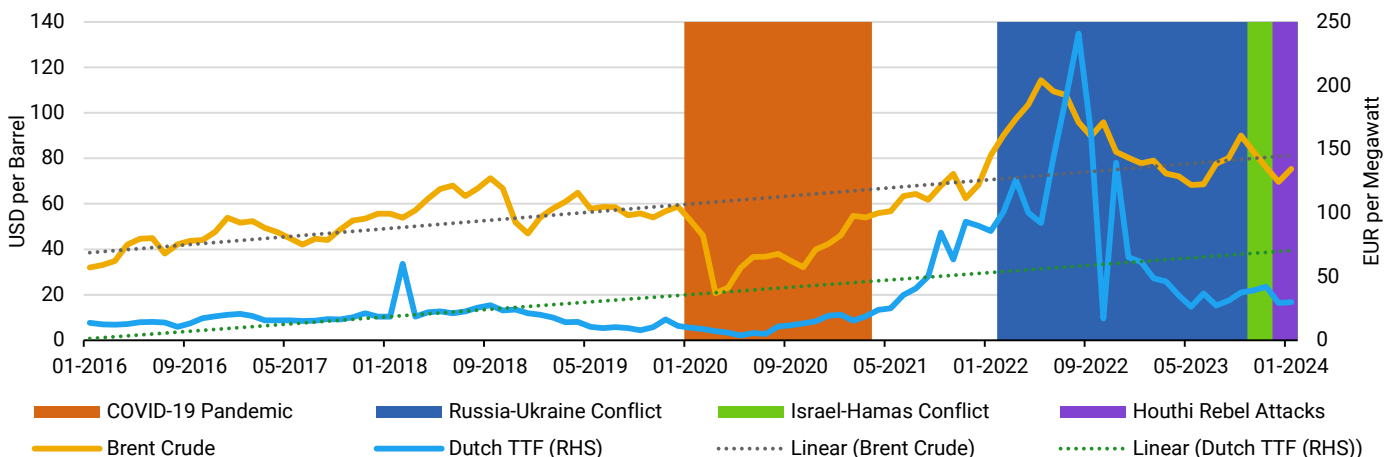
- Geopolitical risks remain elevated.
- Energy prices have not been dramatically impacted by the Israel-Hamas war and the recent Red Sea troubles owing to a number of reasons, such as the limited disruption to global supplies and muted demand.
- Shipping costs have endured the impact of the Middle East conflicts. While these have yet to have a major impact on European corporate input costs to date, there remains a significant risk that cost pressures will intensify should an already tense environment escalate.

Energy Impact

Oil and gas prices have remained range-bound since the Israel-Hamas war started in October 2023. This is due to a confluence of factors that include continuity of supply, muted demand levels, and the confined nature of the conflict, which has so far excluded a major direct confrontation between the US and Iran. Many market participants anticipated that escalation of the war might have been accompanied by more material swings in energy prices, placing pressure on inflation and global growth. Despite the impact of the conflict broadening to include Houthi attacks on shipping in the Red Sea, the effect on energy prices and global growth has been subdued to date. In contrast, the Russian invasion of Ukraine had a much larger impact on energy prices. It introduced key questions around the sustainability and security of supplies from a major energy-exporting nation and has sparked discussion on accelerating alternative energy supply developments.

Energy prices remain elevated in comparison to historical levels but have been restricted from a dramatic escalation despite ongoing geopolitical tensions and suggested production cuts from the Organization of the Petroleum Exporting Countries (OPEC). The average price per barrel for Brent crude oil was USD52.31 between 2016 and 2019. In 2023, the average price was USD76.30 and the average forecast for 2024 is USD77.5. For Dutch TTF prices of natural gas—a major feedstock for European power plants—the average price between 2016 and 2019 was EUR17.45 and the 2023 average was more than double that at EUR38.36 (see Figure 1). The average forecast for 2024 pricing is EUR32.5.

Figure 1: Monthly Energy Prices and Trendlines, 2016-2024



Sources: Bloomberg, KBRA



Factors Keeping Prices in Check

The broadening of the Israel-Hamas conflict to include regular Houthi attacks on shipping through the Red Sea has reduced freight container volumes by 65% compared to expected levels and has forced some large oil and gas shippers to reroute via the Cape of Good Hope (avoiding the Bab-el-Mandeb in the Red Sea). Further, some companies such as QatarEnergy have halted transportation of liquefied natural gas (LNG) owing to the Houthi attacks. That said, in KBRA's view the effects on energy prices have been muted because of the following mitigants:

- **Oil and gas shipping volumes through the Red Sea account for just 9% to 10% of global traffic.** The Strait of Hormuz is the more important route for oil and gas shipments from the Gulf Cooperation Council (GCC) to Europe and Asia. So far, the Strait has not been affected by the recent Houthi attacks on shipping or the counterattacks from the international US-led coalition.
- **Alternative routes (East-West Pipeline).** The East-West Pipeline is a 746 mile-long pipeline that runs from the Abqaiq oil field in the Saudi Arabian Eastern Province across the width of the country to the Red Sea. The pipeline allows oil and gas to bypass Bab-el-Mandeb, the strait between Yemen on the Arabian Peninsula and Djibouti in the Horn of Africa. The pipeline provides an alternative route for oil that is targeted to pass through the Suez Canal, although it is limited in capacity.

Large Players Mostly Sit on the Sidelines

While the Israel-Hamas conflict has expanded into a proxy regional war of sorts between Iran-backed militias (including groups in Iraq/Syria and Yemen) and the US-led international coalition, the war has yet to involve direct confrontation between Iran and the US or Iran and Israel. To date, the leading parties to the conflict (the US, Israel, and Iran) have acted with some restraint. In fact, there are diplomatic efforts directed towards brokering an agreement between Israel and Hamas that would lead to a temporary pause in military activity in Gaza in exchange for hostage release by Hamas. In KBRA's view, this has served to limit further escalation and avoid a scenario where oil and gas traffic through the Strait of Hormuz is disrupted. Further broadening of the conflict risks a much more significant impact on the global economy, and we will continue to monitor the situation with interest.

Demand Remains Muted

The recent US Energy Information Administration (EIA) short-term outlook (published February 2024) points to an expectation that crude oil prices will rise into the mid-USD80/barrel in the coming months, with downwards price pressures emerging in Q2 2024 as global oil inventories generally increase through the forecast period. The EIA does suggest that ongoing risks of supply disruptions in the Middle East could change the picture.

China, a key market for oil and gas deliveries from the Middle East, continues to display subdued demand for oil and gas. China's overall economic growth is expected to continue to be weighed down by pressures on the property sector. The soft demand environment in China is acting to broadly limit oil and gas prices, and it will be important to assess and monitor the evolving trajectory of this economy.

Existing Structural Risk Premium

While oil and gas prices have subsided since 2022 highs, they are still at levels well above pre-pandemic averages, as highlighted above. In KBRA's view, this creates a high starting point from which future oil and gas prices are expected to behave. The drivers for the structurally higher prices include the effects of the disruption in supplies from a major producer like Russia, as well as the market having already priced in geopolitical risk since the onset of the Russia-Ukraine conflict. The structural premium in oil and gas prices in 2022-23 compared to 2016-19 has nonetheless remained relatively stable and range-bound. In our view, this is linked to the ability of the market to seek alternative supplies (particularly LNG from the US) despite this coming at a higher price.

Russian Black Market

A degree of Russian activity has migrated away from official channels, according to a number of news reports. So, while official activity has remained relatively steady, there has been an increase in the amount of oil being sold to avoid sanctions. Russia has overtaken Saudi Arabia as the largest source of oil and gas to China, and a large number of shipments are also migrating to India from Europe. Russia's need to keep the taps on, despite the OPEC+ agreement to cut production, is driven by a costly war. Going forwards, this steady supply from a large supplier further works to keep a cap on oil price increases.

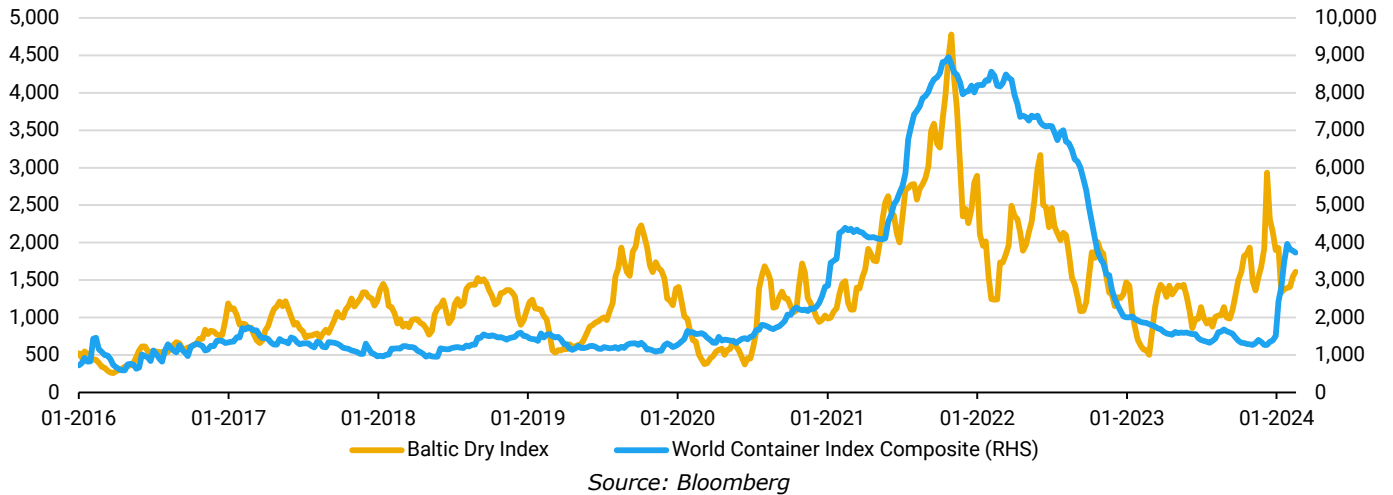
Container Shipping Takes the Brunt

After the pandemic-related disruptions and a subsequent surge in demand, shipping costs increased dramatically in 2021 and 2022. Since then, market pricing was on a downwards trend, returning close to levels prior to the pandemic. However, the cost of shipping has increased since October 2023 as a result of the Middle East conflict. In particular, the Red Sea disruptions caused by the Houthi rebels have forced an adjustment to product supply chains with liners containing oil and gas shipments diverting around the Cape of Good Hope.



The Baltic Dry Index and the Drewry World Container Index have both experienced increases in pricing on the back of the Houthi actions in the Red Sea (see Figure 2). These indices capture general container line behaviour across the globe. The Drewry Index covers the eight main East-West shipping routes across the globe, while the Baltic Dry Index covers more than 20 routes and focuses on the supply-demand balance. These elevated rates may decline from their immediate surge as supply chains adjust, easing pressures on pricing.

Figure 2: Baltic Dry Shipping Index and Drewry World Container Index



Corporate Feedthrough

Elevated energy costs and increased shipping rates can impact corporate profitability and corporate margins, as they weigh on a company's cost base. This coincides with a phase in which many companies are still recovering margins from the increased input costs and interest rate increases of the last several years. To date, the impact has been limited in contrast to the expected potential. As highlighted in a [recent report](#), European corporations are well positioned to absorb increased costs. Cost pressures for corporations are falling as inflation declines and rate pressures ease. However, the risk of a reversal of this trend is high and dependent on the geopolitical picture the length of the shipping interruption.

Not out of the Woods

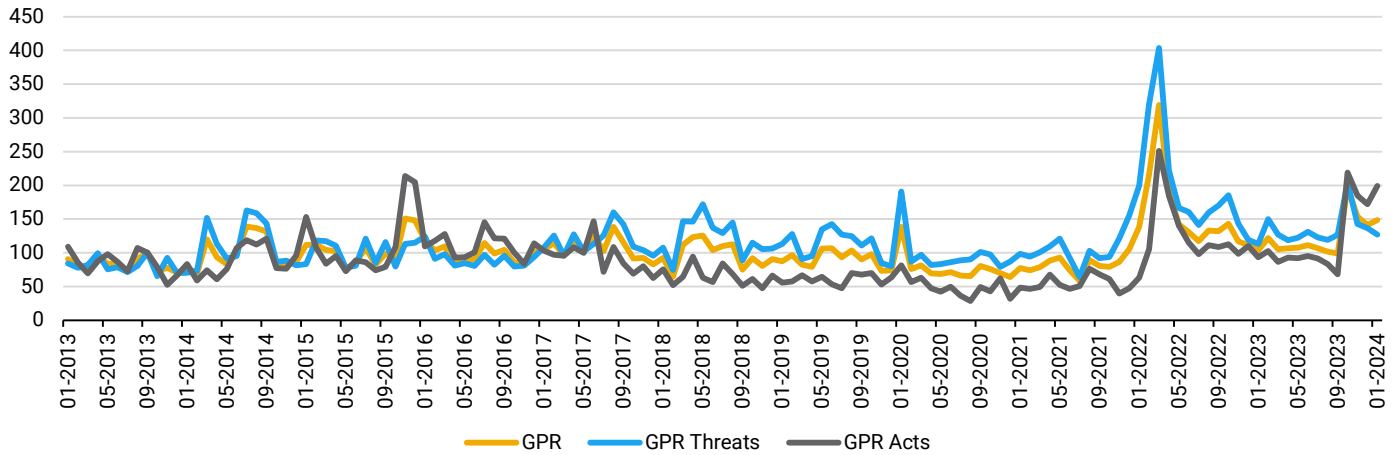
The range-bound trading in energy prices remains the status quo despite the current conflicts. However, the risk of corporates having to address further price increases remains elevated and subject to the geopolitical environment. For example, additional obstacles to oil and gas distribution could form if Houthi rebel activity increases further or spreads more broadly into the region. Any significant escalation in the conflict that causes oil and gas prices to meaningfully spike could have consequences for European corporates. This particularly applies to those that are exposed to energy input costs and have limited hedging or ability to fully pass through input costs increases in a timely manner.

European retailers who rely on inventory being transported from Asia and some of whom hold limited stock volumes could begin to experience more obvious effects to the extent current disturbances persist for another quarter in the Red Sea. For example, working capital, operating margins, and profitability could come under more significant pressure in such a scenario. Further, persistent interruptions to supply rerouting via the Cape of Good Hope will begin to impact these corporate functions.

Global geopolitical risks remain elevated, as identified by the Geopolitical Risk (GPR) Index, which monitors news mentions of war, conflict, and other key metrics via automated text-search results from electronic archives of 10 newspapers (see Figure 3). This measure remains elevated in comparison to the period prior to 2022 but remains below the onset of the Russia-Ukraine conflict. That said, the sub-index, which reflects the volume of acts of violence mentioned in the press, has increased in January close to that of the onset of the Israel-Hamas conflict.



Figure 3: Geopolitical Risk Index and Sub-Indices for Threats and Acts



Source: Geopolitical Risk Index (<https://www.matteoiacoviello.com/gpr.htm>)

Conclusion

The risk of price increases has risen since the Israel-Hamas conflict commenced in October 2023, which is further exacerbated by the escalation of the regional conflict affecting shipping through the Red Sea/Suez Canal. While oil and gas prices remain range-bound, they are still elevated compared to before the Russia-Ukraine conflict. Although damaging, the effects of higher shipping costs on corporate performance could potentially still be contained in certain sectors such as retail and among selected large retailers, given typical inventory levels have been maintained. Further, more positive sentiment around the trajectory of interest rates and inflation and alternative routes for transportation should provide some mitigants across the European corporate sector, as long as a solution is found in the near term regarding current geopolitical tensions, particularly in the Middle East. The outcome for this sector depends on whether the geopolitical risks remain contained. For example, wider negative consequences may evolve should the conflict in Gaza lead to more sustained Houthi attacks, or the conflict spirals into a larger regional one, or if further conflicts arise around the globe. Further, if issues emerge with supplies from other sources of energy, such as the US, which have been supportive to ensure the security of supply, there may be further price volatility ahead and consequences borne by corporations and consumers through escalating input costs.



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