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Shipping rates, world trade, oil and commodities

Summary

The recession in Japan, slow growth in the EU, subpar in the US and the slower China have all led to a drop in trade as decelerating economies import less but also export less to other economies. The fall in aggregate demand for hard commodities, and the excess supply of oil and for most soft commodities, pushed their prices down. It follows that dry cargo and container rates have fallen too, but VLCC (very large crude carriers) rates have kept high. During 2016 global trade may register a mild recovery as we expect that China will bottom by 1Q.16, while the US economy will perform moderately. Shipping rates will stay under pressure for most of 2016 but VLCC may maintain their relative higher position for now.

Investment Conclusions

During 2016 recovery in world trade and hence shipping demand will be slow and uneven. Over 75% of EU trade is intra-EU and Asia's trade may start to pick up after China bottoms in 1Q.16. Dry cargo rates may not recover till 2H.16 not helped by new fleet additions and weak demand for hard commodities. VLCC rates could decline from present levels as oil storage demand flattens out. Demand for oil, however, may recover after 1H.16 from China and most Asians, while pressure of supply will keep oil prices within the USD 40-50 range for 2016. Hence, on balance and percentage wise, VLCC rates may outperform Baltic Dry but from low levels.

Exports, oil and commodities

The pace of **exports and imports** is the key indicator of the demand for sea-carried trade. As Fig. 1 shows, the rate of growth of exports in the US and Japan (latter in volume terms) may be, just, bottoming but not so for Germany. Chinese exports are still decelerating but imports could be bottoming. In sum, "world trade" as proxied by these indices may not get worse but, at best, 2016 will register a slow recovery. Instrumental in all this will be the timing and speed of recovery in China, whose demand for iron ore and oil (even if only for storage) will be very important in the establishing a floor for the decline in these and other commodity prices. (Fig.2). The price of **oil** in 2016 will continue be determined by supply conditions and especially the persistence of Saudi Arabia to keep existing output levels. That determination was emphasized by Saudi Arabia entering the global bond market to raise funds in order to maintain its fiscal position which was severely depleted by the 50% drop in the price oil over the last 12 months. Should Iran's oil exports be added, after the nuclear deal, then prices pressure will be maintained thus outbalancing any slow pickup in Asian demand for, the now, cheaper oil. Similar supply related considerations would hold, for **soft commodities such as wheat, soybeans and corn** whose declining prices reflect more the good crops rather than falling demand. A cyclical uptick in

Asia and China will not mean more food consumed but diversification into meat and dairy products. A good example is China's large imports of corn which go into the rearing of pigs rather than directly into human consumption. The likely cyclical bottoming of Asia and China in 2016 will not necessarily bring relief to all commodity markets and may have differentiated impact on shipping rates. A good example here is the strong performance of VLCC rates.

Fig.1: Exports growth, US (red), Germany (blue), Japan (green), China (yellow), China imports (black) 2014-15



Source: Bloomberg

Shipping rates : Different markets different dynamics

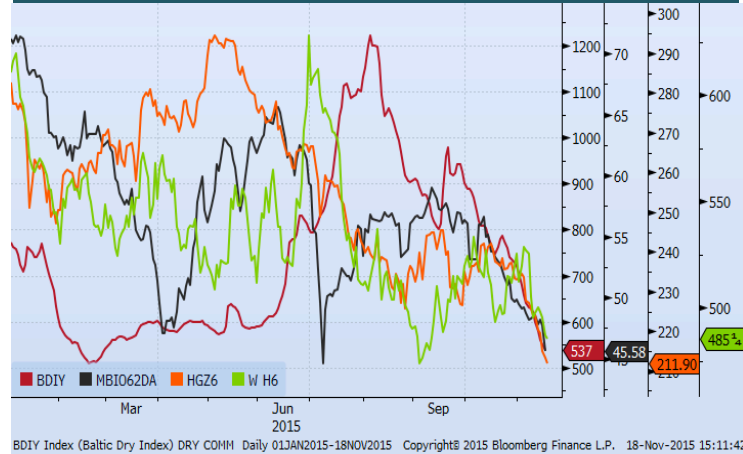
In Fig.2 the steep decline of the **Baltic Dry** index tells the tale of the deceleration in world trade as well as the continuing impact of the additions to the world fleet which had started before the 2008-9 crisis. In the **container market** the situation is not better with the main weakness registering in the Europe-Asian routes, not helped by the number of ultra large containers in place and on order, particularly by Chinese shippers. The only bright sign here has been the rise in the rates for **VLCC (supertankers)**, which with the exception of a dip in Sept.Oct. 2015, has kept on a rising trend in the course of 2015. (See Fact Box). This differentiated performance can be explained by various factors. **First**, during the summer and autumn of this year, China purchased very large amounts of oil which was then stockpiled for its strategic inventory. Part of the stockpile was held in supertankers thus diminishing the number of ships available for transporting oil. **Second** the un-

Fact Box: Not all shipping is created equal: VLCC !



undiminished production by Saudi Arabia and the shale boom in the US taxed the storage capacities of refineries and thus pushed more inventories to supertankers. **Third** the very low, and falling price of oil maintained reasonable demand thus keeping the working boats busy. **Fourth** the contango position in some oil futures has been interpreted as allowing holders of oil to take a long position on the expectation of off loading when prices rise, a tricky trade at best. In October storage demand by China was reported dropping and this sent the supertankers' rates crashing only to recover in November. It is unlikely that storage demand will continue unabated and hence supertanker rates may flatten. However the factors of demand for oil staying stable as prices fall, the continuing increase in oil output and the cost advantage of big tankers will help to put a floor on any future rates decline.

Fig 2: Baltic Dry (red), Prices of wheat (green), iron (black, prices paid by China), nickel (orange), 2015



Source: Bloomberg

Conclusions

Pulling all the threads together still gives a rather complex outlook. Dry cargo and containers will not see any improvement in shipping rates till trade recovers and this will not happen till China does better, and the process of flattening out in Asia accelerates. We showed in Econote 42 that not all Asian economies are decelerating and most Asian governments have taken expansionist measures including looser monetary policies. The latter will be important once the Fed hikes. China's repeated monetary loosening starting a year ago may have its fuller impact felt early in 2016. These trends are likely to become evident towards the end of 1H.16, although China may flatten out as early as the end of 1Q.16. VLCC fortunes will stay relatively brighter even if the price of oil does not recover, (and we do not expect that it will) as the low oil prices will sustain demand for oil and the rising output will put pressures on inventory space. Shipping companies with young fleets will benefit most from low bunkering costs as will ultra large containers, the latter remaining even more competitive compared to smaller containers should bunkering prices rise. Older boats will press the need for scrapping. Shipyards are under severe stress, see the dire straights of yards in S.Korea, and recovery there will not arrive till the end of 2016 at best.

Andrew Freris (writing completed on 19/11/2016)