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ECONOTE No. 63: Plain sailing: Shipping freight rates, commodities and oil — 26/8/2017

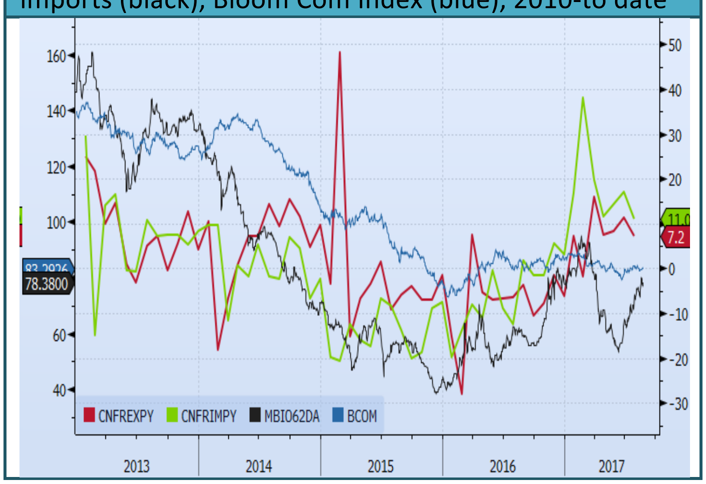
Summary	Investment Conclusions
Our reading of the state of the “global” economy (note the inverted commas given the desynch in world trends, notwithstanding OECD recent views to the contrary!) is basically flat with the US doing better than the EU and Japan, while Asia’s diversity should not obscure China’s near 7.0% flat growth. Furthermore, on the evidence of exports/imports growth, world trade has recovered. It would also follow that commodity prices, subject always to capacity constraints, have been mildly boosted, except for oil where the increasing supply will keep prices flat. A weak USD helps commodity trade, which is priced in USD, as it lowers domestic prices. Shipping benefits by the recovery in trade, and by the cheaper bunkering oil.	The recovery of “global” trade is, on it’s own, too wide as a sectoral investment recommendation. However individual items can be teased out ,such as direct or indirect investment in cargo, containers or tankers via specialist funds or even in shares of quoted shippers and carriers. Tankers, oil and LNG, might be less attractive as competition, and steady rather than rising freight rates, may make returns less attractive. Investment in mining could be selectively attractive as majors are cash rich and looking for investments after a long period of consolidation. China’s high, albeit possibly flat, demand for commodities will help.

Sail away !

To the extent that China’s trade tends to obsess the markets as being the proxy of the health of “global” trade,the evidence in Fig.1 should be encouraging.Since the start of 2016 both imports and exports growth has reaccelerated, while the indicator of iron ore prices delivered to China has now re-established an upward trend.

Freight and shipping trends, as shown in Fig.2, have improved especially in terms of the dry rates of the Baltic index which had reached a peak of 12,000 in 2008, compared to a current level of around 1,200.The index is likely to have formed a longer term bottom, a trend also mirrored in the Shanghai containers index, but not yet in the VLCC 300 class of tankers. That sector had a spectacular 2014-15, driven not so much by pure freighting but their use as floating storage tanks, especially by China, which was restoring stockpiles and inventories of oil at the time.The price of crude can, at times, have a complex relationship with freight trends.Lower crude translates to lower bunkering and, possibly, oil freight costs.There is also the issue of the overcapacity of the oil industry, especially under the pressure of the US shale sector which survived and overcame the period of the falling crude prices during 2012-2015.The on-going “voluntary” consolidation of the major shipping firms (see Fact Box) does include a reaction to Hanjin’s bankruptcy.Another very important consideration is the growth of capacity in shipping, expected to reach 3.1% in 2017, well above the 2016 average of 1.1%.Scrapping rose to a record of 0.6 ml TEU during 2016 in the container sector.This, plus emissions controls, will continue to impact shipping costs keeping in mind that maritime oil use accounts for 5.3% of total vrs the road passenger’s use of 26.0%.Trump’s threats of trade wars will have little impact on shipping.NAFTA is primarily land-based and canceling the TPPA was a case of lost opportunities than of added costs.The use of electrical large ships is still limited as is the integration of IT in shipping and not just in logistics.

Fig. PRC: Exp (red), Imp (green), yoy%, Price of iron ore imports (black), Bloom Com Index (blue), 2010-to date



Source: Bloomberg

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Commodities and oil

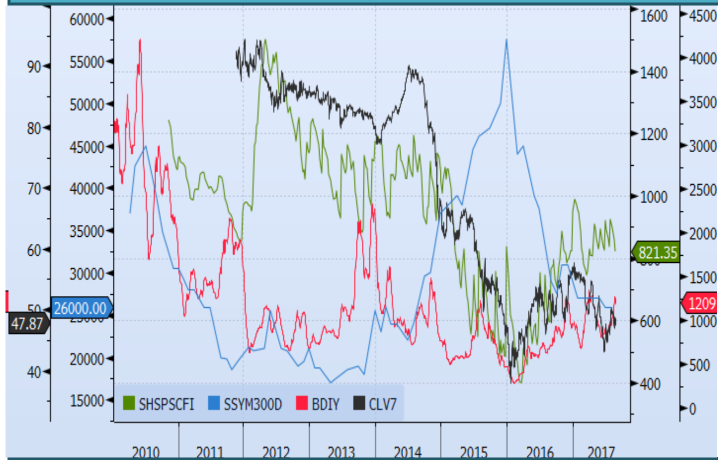
Turning once again to Fig. 1, The Bloomberg commodities index has been flat since 2016 to date, and that, in a sense, is the good news after the continuous decline in the previous years.Common to all broad indices, more is hiden than revealed. For all major soft commodities, such as wheat, corn and soya, prices are falling while for basic metals,such as iron ore, copper, nickel and alluminum prices are rising.For major commodities exporters such as Brazil and Australia, the picture is unclear with equal pluses and minuses.

OPEC's attempts at price control via quantity restrictions started at the end of 2016 and have, so far, failed for the usual reasons of members' reluctance to let go of short term gains for possible longer term benefits.The spectacular rise of shale gas and oil output in the US, has created a kind of virtuous price circle for US shale producers versus the OPEC. Estimates tended to differ in the last few years, but shale output break-even prices varied between USD 30.0 to 50.0 per barrel. Now, however, since 2013, the average shale break even price for key producers has dropped from USD80 to USD35 per barrel. Should OPEC be succesful (Venezuela notwithstanding !) in pushing prices past the USD 50.0 mark in 2017, the shale sector will pump more profitable oil and thus add to the quantity pressures on OPEC's own output controls.So the more succesful OPEC becomes, the less effective will be its output controls.Perversely, a collapsing OPEC would be bad news for the US shale given the extremely low production costs of Saudi oil, always the key mover here.Bottom line for oil producers is a flat oil price while for tankers lower bunkering costs in a relatively flat market.

Fact Box: Consolidation in shipping-bad for competition?

The long years of falling shipping rates as well as poor trade growth led to a push for consolidation among major shipping firms. It looks now likely that 77.0% of all global container capacity will be taken over by just three major players. with the same three accounting for about 96.0% of all East-West trades. Although current developments in terms of participation and extend of agreements are continuing, the following four alliances are dominating the industry: **Ocean Three** (including China Shipping), **CKYHE Alliance** (including COSCO), **G6** (including Hapag-Lloyd) and **2M** (with Maersk). As any 101 Economics major will tell you, when firms get together their only aim is to reduce competition and, hence, raise prices. The rest will be history.

Fig.2: Baltic Dry (red), VLCC (blue), Shang cont (gr), Oil(bl)



Source: Bloomberg

Where to from here ?

For the rest of 2017 and on to 2018, the pure macro outlook remains supportive.The ECB and BoJ will not hike rates or even reduce quickly their QE operations.The US Fed may delay further rate hikes, but the likelihood of a truly expansive fiscal initiative from the Trump administration may seem as remote as ever given the total disarray in the Congress and the failure of the abolition of Obamacare which would have allowed the steep tax cuts promised by Trump.Hence the period of very low interest rates expands for another two years or so, with a weak USD supporting commodities while oil stays low.All mildly good news for the sectors involved including shipping in general.

Andrew Freris (writing compled 26/82017)