



Of silly seasons, sulphur, supply and demand

Are the good times really here again, or should investors continue to employ the same rigorous approach that has been needed over the last decade asks Dr Adam Kent of Maritime Strategies International (MSI)

Shipping is set to benefit from a period of positive demand over the next four years, but faces significant challenges including the risk of overcapacity and the effects of potential trade war. After years of shipyard oversupply, reductions are finally taking effect while newbuilding prices are set to rise and second hand values are benefiting from the upbeat mood.

However in contrast to some of the headlines seen over the summer, we would caution that owners banking on a bump in earnings from the IMO 2020 sulphur cap may be disappointed. The last time bunker prices were at comparable levels in 2013, there was no impact on the one year time charter rate.

MSI also takes a cautionary line on the effect of 2020 on market balances. Back in 2013 when the bunker price was high we saw a boom in ordering. Assuming that we will see higher bunker prices in 2020, our concern is that owners and capital providers will quickly go back to the shipyards because they have a very easy story to tell investors.

We are also cautious on the impact of the escalating trade war, despite the daily warnings. We think that the sectors most at risk are containers and car carriers. There will be a marginal impact on dry bulk but if there is a serious step up in tariffs across a wider range of goods, then containership owners and operators can kiss goodbye to any upside.

Improved demand, lower supply

Taken in aggregate we see a positive picture for seaborne cargo growth over next four years. The improvements go pretty much across the board - though oil trade growth is more fragile - and LNG and container trades should see continued healthy growth.

In the tanker sector, the changes going on in oil production are having a major impact with a tug of war over the last three years between OPEC/Middle East producers, Russia and the US driven by price, policy and costs.

We are also seeing new destination markets with China's crude imports recording stellar growth from a variety of sources with the US chipping away at the dominance of the Middle East. Recent trade disputes have threatened this growth trade, but even as Q3 has seen US crude flows to China disrupted (and subsequently resume), US exports have found new destinations elsewhere in Asia. Middle Eastern crude export growth meanwhile is likely to be restricted by both the Iranian sanctions and growing regional refinery capacity.



In the dry bulk sector, we forecast positive incremental demand in the four main categories, and for small ships in particular with around 70m tonnes of extra minor bulks to be carried in 2018.

When this uplift is translated into tonnage required, the market needs few additional Capesizes – a potential problem when one looks at the orderbook – but good numbers of new Handysizes are needed.

We are cautious longer term on prospects for iron ore and coal demand. Actual Chinese consumption of iron ore has been flat for five years though the market continues to see substitution of domestic ore for better quality imported foreign ore. Domestic ore will fall to 5% of consumption by 2021 but a capping out of the market is coming.

At the same time, developments steel production see a move away from iron ore-fed blast furnace production to the use of Electric Arc Furnaces, together with a build-up of scrap which China is also exporting.

Coal provides a contradictory picture with production in decline as more electricity supply is switched to renewables, making coal the fuel of last resort. However we are also seeing electricity used for more and more new processes such as transportation.

Containers also show a split dynamic. From stellar growth on the three mainlanes in Q3 2017, Q2 2018 saw anaemic growth on Asia-Europe, a positive Transpacific and a sustainable picture on the Transatlantic.

There has been a rapid reduction of the idle fleet with larger post-Panamaxes coming into a liquid charter market thanks to some efficiency in the cascade. In 2013 75% of 7600-9000 teu vessels were employed in mainlane trades. By the end of 2017 this was closer to 50% as larger vessels were deployed on North-South trades as well as the Middle East and Indian Sub-continent.

Those are also the routes where freight rates have struggled the most, in contrast to a robust charter market. The majority of these vessels are chartered in by non-vessel owners and will be the first back into the idle tonnage count if the market weakens further.

There is some cheer on the supply side with, at last, lower fleet growth and even negative fleet growth for some smaller asset types. This stands in contrast to the high levels of contracting seen last year, although we should never underestimate the ability of the industry to shoot itself in the foot.

Many of the contracts placed were for bigger vessels, a trend which reflects the desire to capitalise on economies of scale. It must also be remembered that there are a limited number of routes bigger ships can be deployed upon and a limited number of cargoes they can carry.

Earnings and values

Looking at the relative position of earnings one year ago our data was packed with vessels at the bottom of their cycles which are now branching out and up the earnings curve.



To pick out a few highlights, the strength of the LNG charter rates in the last 12 months has surprised many people while tankers are near the bottom of their five year range and we forecast improvements out to 2021.

Panamax bulker one year timecharter rates have recently been at the highest levels seen for the last five years and there will be further improvement in the next three years before a gradual topping out. Boxships are never going to see again the markets of 10 years ago but in general we are starting to see a more sustainable recovery thanks to a healthier balance between supply and demand.

For the past two to three years our concern was the elasticity of shipyard capacity and now we are finally seeing that in a positive way with a reduction in shipyard capacity across the board. This is despite the output of certain China's shipyards last year surpassing the year before.

The outlook for newbuilding prices is for an increase, albeit from very low levels. Prices should have fallen further than they did in 2017 but were saved only by the huge increase steel plate prices and should increase up until 2021.

For second hand values the positive mood means that in historical terms there is an improvement in prices almost across the board, though gains are stronger in some sectors than others.

Let's not forget the shipping industry will always have the power to surprise. We ran a series of vessels through MSI's online FMV valuation tool for a 0, 5, 10, and 15 year-old asset and assumed holding it for three years to judge where their best internal rate of return (IRR) would be found.

The best bet – for a brave investor – would be a small Anchor Handling Tug Supply vessel, though the returns will depend greatly on the degree of utilisation. A safer bet would be a small containership, though one thing we can observe is that investors are always ready to listen to a positive story and there are plenty of those around at the moment.

Ends