MARKET UPDATE: DRY BULK & TANKERS

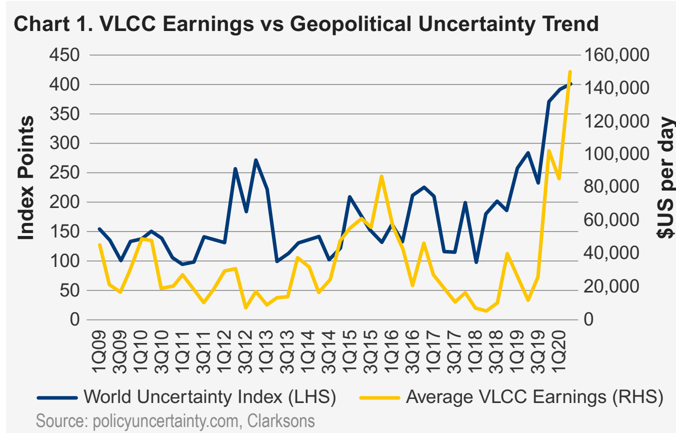
MICHAIL BEGLERIS, MARKET ANALYST

April 2020

THRIVING IN UNCERTAIN TIMES

The Baltic Exchange VLCC earnings index has averaged $80,000/day since October 2019, which is 160% higher than the 5-year average October-April trend. Robust tanker earnings have coincided with increased geopolitical uncertainty ***(see Chart 1)***, amidst a confluence of attacks on Saudi Arabian oil infrastructure (3Q19) and tankers in the Middle East Gulf (several instances since 3Q19), ii) sanctions on entities of Cosco (3Q19) and Rosneft (1Q20) and iii) a crude price war (1Q20). Geopolitical risk factors have somewhat persisted, with a US-Iran war of words developing during the last couple of weeks and sparking new fears of a potential military clash in the Middle East. Tanker rates are expected to be the key beneficiaries of any rise in regional tensions.

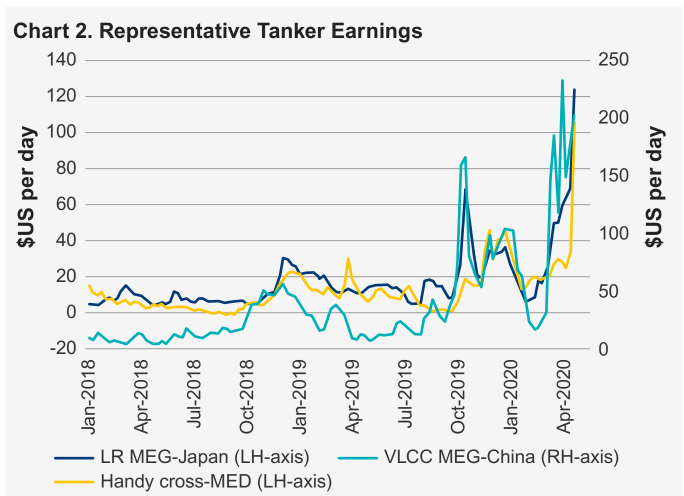
Chart 1. VLCC Earnings vs Geopolitical Uncertainty Trend



LIQUIDITY BUFFER

Tanker earnings are currently undergoing their third spike since October 2019, with levels reaching fresh record highs in both the crude and product sectors ***(see Chart 2)*** amidst robust demand for floating storage.

Chart 2. Representative Tanker Earnings



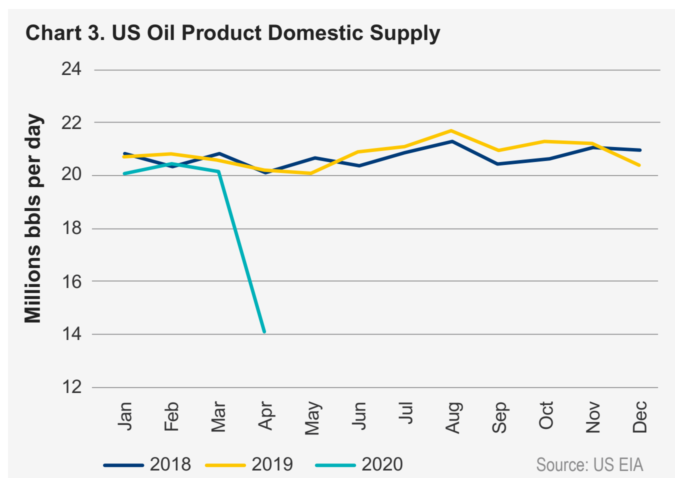
The global shortfall of available capacity in land-based inventories leaves floating storage on tankers as one of the few viable options to address the unprecedented oil surplus. Meanwhile, the steep contango in the oil markets has triggered the most favourable floating storage economics on record. Initially, there was a flurry of VLCC floating storage time-charter fixtures in the 1H

Peninsula Petroleum

April (around 8-9% of the VLCC fleet is estimated to be currently storing crude, and this percentage is bound to increase). This was followed by a jump in product tanker storage plays. Data from ship brokerage Braemar show that over 200 clean tankers are potentially storing fuel right now. For LR2s, accounting also for the number of ships that have switched to trading dirty cargoes due to robust crude tanker rates, it is estimated that just about 45% of the fleet is available to trade in the clean spot market. Fleet capacity is also constrained by discharge delays (as limited on-land storage is near capacity) and low Rhine water levels which restrict barge movement.

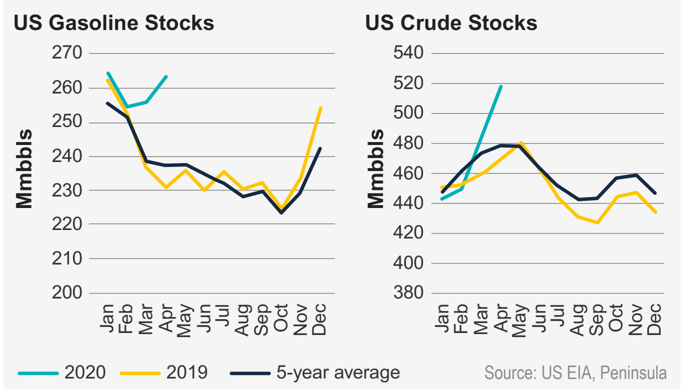
Data from the US Energy Information Administration (EIA) show a sharp fall in domestic oil consumption and steep increases in stock levels ***(see Charts 3, 4)***. This foreshadows similar storage utilization in the rest of the world. Rapidly developing demand/supply imbalances are anticipated to exacerbate growth in crude stocks, therefore sustaining the need to secure tankers to store excess oil.

Chart 3. US Oil Product Domestic Supply



There is consensus among industry analysts (including Platts and the US Energy Information Administration) that global oil supply will continue to outpace demand until at least early August. This underscores expectation of sustained near-term floating storage enquiry, which should prolong elevated rates.

Chart 4. US Gasoline and Crude Oil Stocks (commercial)



A normalization in tanker rates is anticipated in the 2H 2020, as: i) the gradual shift of the market into deficit will erode the economics for floating storage and ii) the supply of cargoes continues to be constrained by OPEC/non-OPEC production cuts and well shut-ins globally due to distressed oil prices. But there will still be several supporting factors which should help to cap the scale of losses. Firstly, oil demand from Asia is expected to be resilient, as refiners seek to take advantage of distressed crude prices to fill up their strategic inventories. Chinese crude imports, which account for around 23% of world seaborn crude oil trade, are set to rise in line with a recovery from coronavirus and supportive government initiatives. Beijing recently issued a second batch of crude oil import quotas for independent refiners, taking total allocations to 158M tonnes so far in 2020, up 64% from the quotas issued in the first four months of 2019.

In the clean sector, a steep discount of naphtha's price to propane caused by falling oil prices incentivises more naphtha imports from Asian petrochemical producers at the expense of the gas. Further cracker demand is expected to switch to naphtha moving forward at the expense of alternative feedstocks ***(see Chart 5)***, which should support primarily the LR sector.

Finally, at a time when tanker fleet capacity is already tight due to extensive floating storage employment and severe

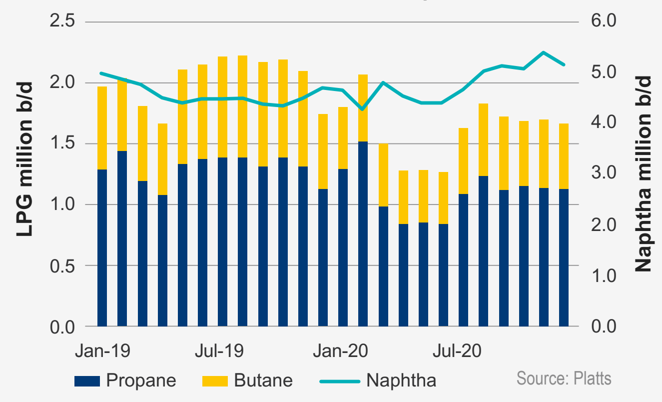


Chart 5. Cracker Demand Switches to Naphtha

delays at discharge ports, the recent legal proceedings involving Ocean Tankers could now remove additional vessels from the spot market. The company owns 18 VLCCs, 24MRs, 5 LR1s and 12 LR2s. If charterers refrain from fixing these vessels due to the legal risks, tanker availability will drop significantly, and rates will spike further.

Overall, there are numerous silver linings in support of the tanker market. However, this should not detract from the main message; although momentum may slow down during the second half of the year, tanker owners will likely have substantial cash reserves to face any challenges following a prolonged period of strong earnings.

DRY BULK SECTOR MONITOR

The dry bulk sector has struggled in early 2020 amidst seasonal trends and disruption to Brazilian iron ore supply. There have been some tentative signs of improvement since the middle of February, but the BDI remains at uncharacteristically low levels ***(see Chart 6)***.

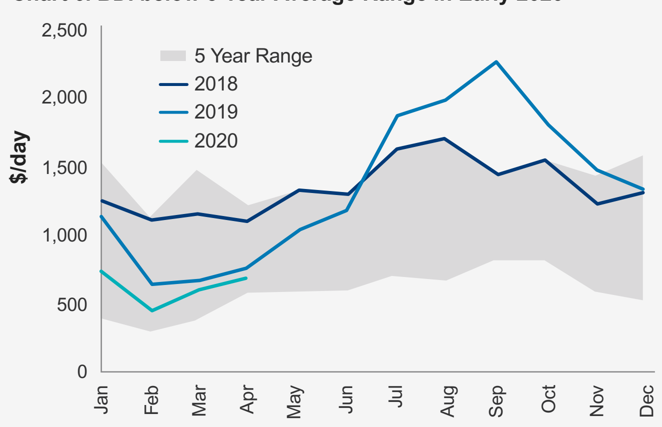


Chart 6. BDI below 5 Year Average Range in Early 2020

Preliminary 2020 demand/supply balances per bulk carrier segment are shown in ***Chart 7***. Estimates are made basis the shares of the respective bulk cargoes carried by each size and take into account fleet inefficiencies caused by slow steaming and scrubber retrofitting. Logically, results are subject to significant uncertainty and should be treated for guidance purposes only.

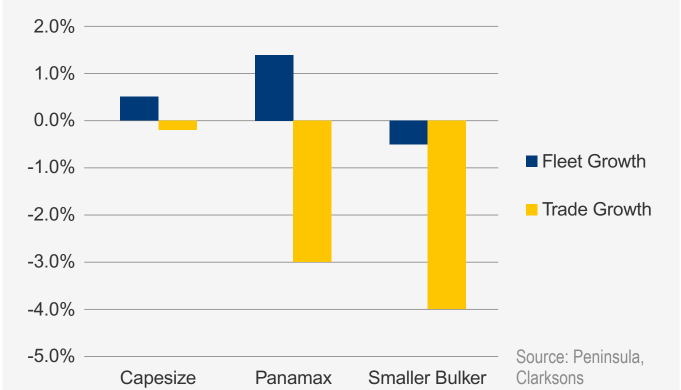


Chart 7. Dry Bulk Demand/ Supply Balances per Segment
Preliminary Estimates, subject to revision

The Capesize sector is preliminary projected to face the most favourable supply/demand balance for the year as a whole, as low fleet growth barely outpaces slightly negative trade growth. Although iron ore trade is projected to remain largely steady year-on-year in

2020, coal and minor bulk trades seem more exposed. Therefore, despite healthy growth in grain shipments, trade opportunities for Panamaxes and smaller bulkers are expected to fall by around 4% this year.

It should be noted, that although all segments will likely face a contraction in trade this year, this is due to a steep fall in 1H 2020 volumes, which means there is room for improvement during the latter half of the year. Highlighting this, SSY forecasts dry bulk trade in the 2H 2020 will increase by 1% year-on-year and 10% from volumes during the first half of the year.

Overall, although a strong dry bulk market is unlikely to be seen in 2020, there is some consensus that the trough has been left behind. Cautious improvements are also expected in the macroeconomic outlook, with the IMF forecasting world GDP to grow at 5.8% year-on-year in 2021, the highest since 1973. This underpins more favourable conditions next year, when dry bulk trade growth is preliminary projected to outpace fleet growth by around 2.5%, the largest extent since 2003.

With expectations of gradual improvements in the freight market, the attention of credit teams naturally shifts towards smaller dry bulk owners who tend to be significantly leveraged. Companies that are already under financial pressure and have vessels opening up before any recovery kicks in are in the worst position.

Contact us for further information
analysis@peninsulapetroleum.com