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The shipping forecast

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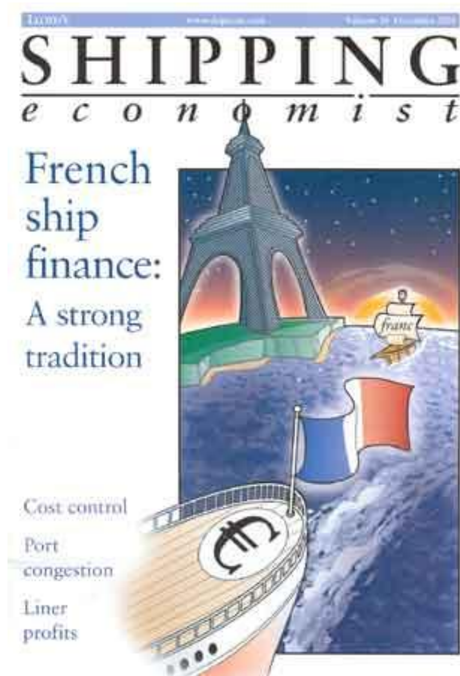

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As the key shipping markets hit record highs and in doing so confound most industry commentators, *Ted Petropoulos,* asks what the longer-term future holds for shipping

The 2004 shipping boom has caught up analysts wrong-footed. No one had forecasted either the enormous rise in the level of freight rates or the universality of growth across all market sectors.

There followed a period in which analysts sought to justify and explain why their forecasts were so wide off the mark. A number of reasons were presented, the main ones being China, higher than anticipated international growth, restricted shipyard capacity, record low interest rates, port congestion, and so on.

As the markets peaked in the first quarter of 2004 and declined in the second quarter, analysts become increasingly more and more convinced that the markets could look forward to steady declines over the next few years. The main arguments were that newbuilding supply growth was speeding up, scrapping had almost stopped, a world recession was looming, China could not keep up its high growth and import / export expansion rates, the US could not sustain for long its massive and growing trade imbalance and quite simply demand / supply imbalances do not last long.

Supported by classic economic theory, an analysis of the fundamentals and expectations of a slowdown in demand, most analysts suggested that vessel values and freight rates should and would fall. They expected the fall to commence in 2004, gather pace in 2005 and face substantially lower benefits in 2006 / 2007.

You can understand the surprise and disappointment to all when the markets strongly bounced back in the fall 2004 and retraced a large part of the fall from the first quarter. Most reported the recovery as a short term aberration to an otherwise clear downward trend. Were they right?

As the price of oil reached and exceeded $50 per barrel in the fall of 2004, China tried to control and direct its runaway growth by a series of restrictive measures and there was increasing evidence of a US and world slowdown in economic activity and expectations for 2005, most analysts become convinced that the third and fourth quarter market recovery would be followed by a much softer 2005 and 2006.

The recent further rise of the BDI to 5100 shows that the drybulk is only about 10% from the all time highs. For the BDTI, the index reached a peak of 2300 in February 2004, dropped to 1100 in May 2004 and is now standing at a proud 3150. So much for the Cassandras of this world!

So what is happening? Are we still talking of an aberration to a steady market fall or is there still some life left in these bull markets? Have we seen the market highs or are we about to see further highs being reached? More analysts, including myself, are quite nervous at the moment. We know that we are dealing with extraordinarily volatile and unprecedented markets. As such, our traditional analytical tools may not be as useful or accurate for short-term forecasting.

Disequilibria in market conditions are in themselves an anomaly. Since they represent an imbalance (usually temporary) between demand and supply they are by nature volatile and uncertain. Short-term forecasting, therefore, is both difficult and dangerous. Furthermore, relatively small changes may unduly distort the picture in the short term.

To give an example, the recent re-election of Mr. Bush, aside from political issues has given an impetus to the market in the short term. It is widely expected that the second Republican administration will tolerate increasing trade deficits, allow the US dollar to slide against other key currencies and in general allow the US to enjoy higher economic growth than her fundamentals might suggest.

Whilst this policy may be deemed by many economists to be most dangerous, to be undermining the future of the US economy and to possibly lead to a deep recession in a few years, the current momentum as a result of the election result and the recent subsidence in the price of oil may have given a new lease of life to the world economy. In addition, the stability factor of knowing what to expect as well as continuous strong Chinese growth and the beginnings of Chinese compliance to Western pressure for greater monetary restrain and possibly a mild revaluation of the Chinese currency all add weight to a prolongation of the current booming shipping markets for a while longer.

I wish to shift the emphasis though to longer term considerations and the outlook for shipping. What I am seeking to draw out are longer term changes and influences that not only have a bearing on shipping but may well have transformed shipping altogether.

Whereas it is inevitable that shipping freight rates shall decline sooner or later, I wish to point out that shipping has already generated an enormous and unprecedented net cash flow over the past couple of years. To emphasize the point, we are talking about an enormous shift in liquidity in favour of the shipping industry. In number terms, although very difficult to precisely estimate the amounts involved, we estimate a figure of about $150 to 175bn for 2004 alone (Petrofin Research©). Please bear in mind that shipping debt for the whole industry, including the offshore sector and leasing was estimated last year by Petrofin Research© at between $160-200bn. Although there has since been a rise in newbuildings orders and prices creating an upward momentum to shipping loan volumes, at the same time there has been a great deal of loan prepayment as a result of the record high cash in flows. Never has there been an equal to what has been experienced in 2003/2004 thus far. Previous bull markets have been shorter in duration, of considerably lesser magnitude and isolated to one or a few market segments. This time, we have sustained booming conditions across all markets.

Readers are aware that for decades the long-term returns on capital employed in shipping have been disappointingly dull and only via timely sales and purchases have owners managed to generate more attractive returns. To witness investment returns of 50%, 100%, 200% and in some cases, 300% in one year as a result of high leverage financing combined with rising vessel prices, earnings and low interest rates is unprecedented and very welcome in reducing

the leverage of worldwide shipping significantly. Whereas freight rates and values may fall, the build-up in liquidity is more permanent. Admittedly, a large part may have been channelled to newbuildings but a lot of owners have built up their liquidity reserves in anticipation of a market fall and the purchasing opportunities it may offer. One might say that it was about time that shipping enjoyed its place in the sun, at least for a short while.

The substantial investment and modernization taking place in shipping as a whole and in crude and product tankers, container vessels, chemical tankers and bulkers in particular, has been coupled by a younger, better maintained and inherently safer fleet subject to increasing scrutiny by port state control, flag states, insurers and other regulatory bodies. In addition, owning companies have improved their in-house safety and maintenance standards and have responded positively to the challenge of running safer vessels. The abundance of cash and positive outlook for shipping has also given everyone the means to carry out a quality drive. Banks too have added their considerable weight in financing clients that adhere to the above new model for shipping.

Another longer term effect has been that international and private investors as well as the public markets have re-discovered shipping. Whereas the enthusiasm may wane as markets decline, some of the interest will remain and will assist shipping to emerge as a suitable industry to follow for possible investment when the risk / reward characteristics justify.

The above process has also been helped by consolidation that has been taking place in shifting towards fewer but much bigger companies with a global rather than national or regional presence.

Lest anyone believe that shipping volatility and slumps are a thing of the past, I believe that inherent volatility has actually risen. The ratio of high / low freight rates I believe has risen substantially and calls for increasing caution among investors. Whereas the markets are highly unlikely to revisit the previous low freight rates that were seen in the last decade and average long-term rates are rising, such rates must be seen in the context of significantly higher newbuilding prices. Consequently, the volatility risk in shipping will remain and timely sale and purchase decisions will once again dominate the investment return perspective of owners.

There is another change that has been detected in shipping. It relates to the attitude towards longer period fixtures by charterers and owners. The increasing tendency has been for a higher number and longer period of period fixtures showing an underlying confidence by charterers in the outlook of the market and consequently a higher confidence by owners in accepting charterer risk. In addition, a great deal of charterers' interest is not speculative but a s a result of long-term contracts, which underpin their financial standing.

Owners and charterers are also beginning to enjoy new freight hedging tools such as FFAs which has provided them both with the ability to hedge without the need to physically charter in / out vessels.

Perhaps the greatest change that has taken place in shipping is the speed of information flow which is now instant. In addition, more and more owners are tuned into following and responding to such news.

Lastly there has been an increased international awareness of the importance of shipping and investing in shipping infrastructure. Whereas the industry had been in the past relegated to a low interest one compared to other more dynamic industries such as telecommunications, computer software and electronics, the importance of shipping has been re-assessed and investment in ships, terminals and logistics has grown enormously.

As the shipping transportation cost has risen over the recent years, the need for efficient low cost transportation has become a higher priority than before. Low cost sea transportation is no longer taken for granted.

To summarise, the current boom seems set to continue for longer than most analysts expect. Consequently, not only will this strong market have turned out to be the biggest and longer lasting bull market in shipping history, but it has already generated massive cash flows for the benefit of the industry. The above increased liquidity has allowed owners to invest in new tonnage, better maintained vessels, reduce their financial leverage and increase their cash reserves.

Irrespective of how long current booming conditions will last, the shipping industry has grown in stature, respect, financial standing, efficiency and investor attractiveness. Despite its continued volatility, the long-term benefits to shipping shall be both long lasting and significant.

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