DRY BULK SHIPPING; WHAT NEXT

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The rise of dry bulk ship values and freight rates continues unabated. New records are being set on a daily basis and the market seems to regard daily rises of 2% - 3%, as the norm. Moreover, these rises have grown stronger, as the market reaches exalted heights and 99% of all participants believe that there is only one way forward, which is UP.

The questions that arise and affect every dry bulk participant (from owners to investment funds to the public at large and of course banks) are:

1) How high can the market go?

2) When will the market turn?

3) Will there be a hard or soft landing?

4) How will vessel values and freight rates be affected?

5) What will be shipping market conditions in 3 – 5 years time?

6) What will be the impact to dry bulk shipping from the sub-prime bank crisis, the developing credit squeeze and the high price of commodities, including oil?

I will attempt to provide my answers to the above, based on reasoning and my personal experience, bringing together and weighing the various factors.

I will resist, in this article, however, using future estimated projections, based on the different analysts' estimates, as they are often contradictory and may distract us from the fundamental analysis of the factors that shall shape the market. Readers may wish to use the contents of this paper, in conjunction with their favorite analyst's report.

1) HOW HIGH CAN THE MARKET GO?

The short answer to this is that there is no limit beyond which it will not go in the short terms, as long as demand for dry bulk shipping exceeds supply.

As transportation still represents a very small percentage of the final price of a product to the consumer, there is no barrier as such to the rise in transportation costs. Of course, should the transportation costs rise to the point that, via consumer price increases, they begin to slow down the demand for products and hence for dry bulk shipping, then higher transportation costs will have an effect. However, as we have all witnessed already, the growth of the economy in the short run can withstand quite high increases in raw material and transportation costs with little or no slowdown.

Readers should be aware that in the short term the supply of shipping is inelastic. This is to say, in the short term i.e. upto one year, one cannot produce more ships, as all newbuilding slots are already contracted. Of course, if the dry bulk market continues to outperform the other shipping sectors, there may well be a tendency of orders being switched towards dry bulk shipping. However, upto now this has not occurred and it certainly cannot be done in the short term.

A second alleviating way would be for the rate of scrapping to slow down. In this market, however, we have no scrapping to speak of, anyway, so there is no influence that scrapping can bear to the issue of addressing the demand / supply disequilibrium.

Should container vessels, also, be used to carry dry bulk commodities, this could theoretically help address the disequilibrium. However, containers' use for bulk commodities is not cost efficient and freight rates will have to literally explode before this factor would assume any significance.

If vessels were run at economical speeds, increasing speeds (with higher fuel consumption) could have assisted but once again all vessels are being run, at present, at close to their highest speeds.

Another factor could be an easing of port congestion. This was thought to be a significant influence giving strength to the market. However, despite the recent easing of some port congestion in Australia, the market has continued to rise. Furthermore, as the number of vessels trading worldwide increases and such increase is at a faster pace than real port development and higher port efficiencies across the globe, the problem of port congestion is expected to rise rather than fall in the years to come.

To conclude, therefore, there are no immediate market responses (other than any sudden exogenous factors that are often unpredictable and unanticipated) to the excess demand over supply, in the short run, and as long as excess demand conditions continue, vessel prices and freight rates will continue to rise.

It is, therefore, possible and not unreasonable to witness a dry bulk shipping boom of massive proportions without a historic precedent in the short run with a serious upward spike from the long term trend.

2) WHEN WILL THE MARKET TURN?

The short answer is that it will turn when demand and supply shall be at equilibrium. When will this be, though?

On the demand side, we have conflicting developments. On the one hand, China, India and the rest of the growing economies of the developing world are growing at a sustainable high rate, which promotes a healthy annual increase of the demand for dry bulk commodities. It is this BRIC growth that has generated the buoyant demand conditions over the last 3 years.

US, Europe and Japan are not in the same growth league, however. They all anticipate more modest and slower growth levels in the next year. The sub-prime property crisis in the US has developed into an international banking crisis. However, its impact is still relatively limited and the financial authorities are very keen to promote stability and growth by lowering interest rates at the very time when interest rates should be rising to control inflationary pressures. Central banks want orderly markets first and control of inflation second. Once control shall be achieved and the sub-prime crisis effects shall dissipate, they will return to an anti-inflationary policy and raise interest rates, which shall slow down the growth of the world economy. Until then, relaxing the money supply simply fuels further short term growth in the world economy and in the US keeps the economy going and prevents it from going into recession.

In Europe, the effects of a strong Euro may slow down the rate of growth of the economy over the next year and in the US the housing and banking crisis may well drag the economy lower. However, it is unlikely to expect that the economy will be allowed to go into recession in a presidential elections' year and currently the central banks, by lowering interest rates are assisting the economy to pull through.

The IMF has recently reported that they estimate global economic growth for 2008, at 4.8% down from 5.2% in 2007. International trade growth is thus expected to slow down from the approx. 7% nowadays to about 6.5% next year, which is still quite strong.

With supply being inelastic in the short run and overall demand still expected to grow at a steady rate in the next year and in line with the increase in supply, continuous high dry bulk markets seem to be the only way to go. But is it so? Consumer confidence may be affected by sudden exogenous events. Significant news such as price of oil over $100 per barrel, a war or another threat to the world economy may drive stock markets down and lead to an abrupt change in sentiment and demand and growth expectations. Such a change will be difficult, if not downright dangerous to fight by lowering short term interest rates even further.

It is always difficult to predict sudden and exogenous effects and their effect on consumer and industrial confidence, as well as, the investment and banking community.

This dry bulk boom is not a bubble. Bubbles are artificial and can burst at any time. The current situation is one of excess demand in the short term and as such, will require real changes or events to stop it.

Expectations do, of course, influence all markets. However, changing expectations alone cannot generate a significant and sustainable physical shift in actual demand and supply conditions. A physical slowdown will be required to achieve this and this will require a consumer shift or loss of confidence. To conclude, therefore, excess demand conditions are being eroded but too slowly to significantly affect the markets in the very short term in absence of fresh exogenous and often sudden and unpredictable factors.

If I were to forward my personal opinion, I would predict that the dry bulk markets will top within the next 6 months, before retreating. Such a top and retreat, however, shall be quite choppy with frequent short term changes of direction that may well be quite confusing at times.

3) WILL THERE BE A HARD OR SOFT LANDING?

The short answer to this and seen in the context of 2 – 3 years and not a mere 6 – 12 months, is that when the market shall turn, we will face over the subsequent years a hard landing. One reason is that shipping prices and freights are way above their long term historic trend. Admittedly, this trend has been affected by the high growth of the BRIC countries, which has created a big upward shift that may be quite long lasting. However, when either a) demand slows down or b) supply growth increases (as expected) from next year onwards or c) both shall take place, and the excess demand conditions shall disappear, the return to a long term trend in real values and freight rates shall be abrupt.

Shipping markets do not stay at the equilibrium point for long. Demand and supply are like ships that pass each other in the night. At the brief point of equilibrium, market expectations do affect the market's direction and it is all too apparent for all to see how the over confidence that prevails today can quickly evaporate.

It will not require a world economic recession for shipping to go from excessive demand to excessive supply conditions. It will only require a slow down in international growth and hence international trade to slow down from, say, 6% - 7% per annum to, say, 4% - 5% per annum. This slowdown in the pace of massive overordering and a dramatic increase in newbuilding capacity and vessel orders for 2009 and especially 2010 and beyond, will generate excess supply conditions.

As dry bulk markets' indices have risen more than fivefold in the space of just 3 years, a 50% or more retracement should not be unreasonable to expect and would still leave shipping enjoying rates, which would be much higher than the long term trend.

The problem with shipping, just like any other industry, is that its participants grow accustomed and more comfortable every day with prevailing market conditions increasingly losing sight of how the market may change and their paper fortunes could evaporate.

One would normally expect in booming conditions involving such high vessel prices for more sellers to appear. Instead, as the market grows from strength to strength, there are fewer sellers, as nearly everyone succumbs to over confidence.

With every seller over the last 3 years regretting their decision to sell and for optimists being vindicated all the time, it is early to see how in the short run higher vessel prices do not bring forward more vessels for sale, despite the record high vessel prices.

Over confidence, though, can quickly turn to panic. With every purchase decision, owners increase their minimum fleet breakeven rates, which may well appear deceptively low in today's market but nevertheless do carry a significant additional future risk.

To summarise, after such a long and unprecedented rally and with shipping being "on a high", relatively small changes in economic growth coupled with massive over ordering are expected to bring a multiplied impact on to shipping when the market shall turn.

4) HOW WILL VESSEL VALUES AND FREIGHT RATES BE AFFECTED?

The newbuilding overordering will be with us for the next 20 years at least. Once built, short of scrapping or loss, a vessel carries on trading regardless.

When demand conditions shall slow down to rates below those of supply, the market shall fall. At that time, factors, such as congestion, lose their impact effectiveness and all participants run for cover. Many Charterers shall default in their obligations in the same way they have done in every market fall. The long term Charterers with financial strength will use the market to renegotiate charter rates down, often by extending the c/p period itself. Banks shall review their loan portfolios and shall identify and closely monitor their weaker clients.

Owners will try to preserve cash flow but this will be difficult. Those with abundant liquidity, including those with the foresight to have sold vessels earlier, will dominate the market and start bargain picking.

Owners that have grown aggressively over the last three years or have placed a large number of newbuilding orders, without quality Charterers and finance, will find the going very tough.

Over the last 50 years, the end of cyclical shipping highs has been followed by substantial and sustained falls in both vessel prices and freights. These falls will continue until either demand picks up, once again, or increased scrapping and a newbuilding order slow down reduces the rate of growth of supply. However, for the latter to occur, freight rates will need to fall massively and to levels close to operating costs (to set off scrapping), which would represent an enormous fall in freight rates. Once shipping goes into the soft section of its cycle and there are simply too many ships chasing business, there are no limits to how low vessel freights can go. Vessel values (especially for young vessels) will maintain a time premium but this will be eroded by the absence of short term cash flow.

It is true to say that the longer the current dry bulk boom lasts, the steepest and longer lasting shall be the fall of the market.

5) WHAT WILL BE SHIPPING CONDITIONS IN 3 – 5 YEARS' TIME?

The short answer is that they will be very different to those prevailing today. Given the overordering that is taking place today and the massive investment into existing or new shipyards, especially in China, Vietnam and India, it is difficult to see how the present market can sustain itself.

The optimists will point out (with justification) that all supply increases todate have been easily absorbed by rising BRIC and world demand that has exceeded expectations. Using this justification for the future, owners have proceeded with massive new orders that have raised the already high growth of supply even higher. To put it simply, owners have not only assumed that the world economy shall continue to grow into 2012 and beyond but that it will accelerate. This is a bold and dangerous assumption that will be even harder to realize.

Three to five years is a sufficient long time for any industry to adjust itself and overcome short term excessive demand or undersupply conditions.

In short, it is a very brave and confident owner that places orders for delivery in 4 – 5 years from now, influenced by today's strong market. Newbuilding prices have risen by more than 60% in just 3 years, due to the shortage of newbuilding slots and the strength of the market.

Consequently, owners who are accepting a 60% cost increase in their investment, no doubt, are unduly influenced by the high vessel prices today that are often 300% or more than those of only a few years ago.

To summarise, by far the highest probability is that the dry bulk market in 3 – 5 years' time shall be only a shadow of what it is today, with vessel prices and earnings significantly lower and with excessive demand conditions being replaced by excessive supply conditions. However, in shipping hope dies last and based on the extraordinary profitability of dry bulk shipping over the recent years, the industry has attracted an enormous following of "hot investment monies" that have poured into almost any shipping venture that has been presented to the market. The ease with which public and private shipping companies can raise capital is unprecedented and has fuelled enormous overordering.

The industry has also attracted a lot of short term aggressive asset traders, who do not anticipate taking delivery of their ordered vessels but to simply "flick them" for a profit, before any market correction.

No doubt, the music will stop sooner or later and many of the speculative new owners will find themselves without a chair. Unfortunately, such will also be the fate of many investors that pour monies into shipping today, in the expectation of continuing massive profits in the years to come.

As conditions in 3 – 5 years are expected to be considerably less attractive than today, I would advise that all owners, with delivery beyond 2009, should seek to secure long term charters with first class Charterers and / or obtain credit insurance, so as to shore up their future cash flows, as well as, build up as high a liquidity as possible.

Liquidity will be the driving factor in 3 to 5 years from now, not only for survival but also for exploitation of the significant opportunities that will arise at that time.

Robust and well positioned / liquid shipping companies can use the shipping cycle in their favour and derive enormous longer term shareholder value, as well as, a steadier earnings' base.

6) WHAT WILL BE THE IMPACT TO DRY BULK SHIPPING FROM THE SUB-PRIME BANK CRISIS, THE DEVELOPING CREDIT SQUEEZE AND THE HIGH PRICE OF COMMODITIES, INCLUDING OIL?

I shall be dealing more extensively with this subject in the next issue of NAVS. However, a few thoughts for the purposes of this article.

The sub-prime problem has so far been understated Only very recently has a study by the Wall Street Journal revealed that in the short period between 2004 to 2006 over US$ 1 trillion of sub-prime loans were concluded.

Recent huge write offs by Bank of America, Citibank, Deutchbank and other banks may point the way into what is coming.

However, I remain confident that the banking industry shall absorb the shock sooner or later.

A more significant byproduct of the sub – prime crisis is that it has brought to the attention of investors, banks and the authorities that investment premia had been abnormally low. As such, the investment reward for the risk involved was less than it should have been and this has brought about a huge and abrupt rise in investment premia.

The effects for this will be analysed further in the next NAVS issue.

Briefly, the effects of the above changes to the shipping finance industry has been threefold:

a) an increase in spreads / fees,
b) a reassessment and the imposition of higher credit standards for new business, and
c) the virtual dry up of the syndications' market, leaving overextended banks unable to place their excess loan book to other banks at the already contracted rates.

The above effects have been, thus far, quite marginal for the quality owners and more so for the middle to lower tier group.

Shipping banks have, so far, tried to use their relative strengths and / or spare capacity to gain market share among their quality target clients.

As such, thus far, the effect of the sub-prime crisis has been limited to dry bulk shipping and the dry bulk momentum has continued unabated. However, with higher vessel prices and a rise in shipping capacity, even a limited credit squeeze may be one of the short term factors that will finally result in the dry bulk shipping market to reach a top.

To summarise, therefore, dry bulk shipping goes from strength to strength, based on short term excess demand conditions. Forces are underway that will, sooner or later, bring about, initially, a market equilibrium ahead of supply excess conditions that shall lead to a pronounced fall. Thereafter, the sector is expected to require considerable time to absorb the excess supply. In the meantime, the market shall experience considerable volatility, as the shipping cycle shall assert itself.

To avoid the above scenario, BRIC and world growth will need to accelerate. Despite the overall longer term high probability of a weaker market, opportunities shall exist for robust owners to anticipate, overcome and profit from dry bulk shipping's future weaker market.