Capital Link Shipping
Weekly Markets Report

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IN THE NEWS

# Wariness and weariness

Contributed by

**Barry Parker**

Barry Parker is a financial writer and analyst. His articles appear in a number of prominent maritime periodicals including Lloyds List, Fairplay, Seatrade, and Maritime Executive and Capital Link Shipping.

Capital Link's Closed End Funds and Global ETF's Forum (actually the 14th annual iteration of this event), held last Thursday, covered a world way beyond my maritime comfort zone. Nevertheless, shipping was touched on directly, and obliquely, in presentations on Master Limited Partnerships, and on investments impacted by energy prices. Though we've heard last week's themes before, they start to crystallize with the passage of time. In contrast to Conference #13, a year ago, oil prices are somewhere in the $50's, about half of last year's value. Consequently, this year, there was less emphasis on investments related to energy- for example funds owning a package of MLP's (concentrated in the energy space), for example. But the views of two speakers, Mr. Ganesh Jois, from Goldman Sachs Asset Management, and Mr. Daniel Spears, from Swank Capital, attracted tremendous attention. With varied forces tugging in multiple directions, forecasting precise movements of oil prices is impossible; when the subject got to shale oil, and whether production will continue (in the face of the new price environment) both speakers pointed to lower costs in the oil patch. Thus, wells may still be operated profitably in the face of lower market prices. Both speakers also pointed to new production technologies enabling a quicker response to price fluctuations (whether up- bringing production online, or down- shutting a particular well).

GS has achieved the status of one long-gone investment house- when they talk, everybody listens. Mr. Jois, whose research covers energy and infrastructure, offered a very cautious view of oil dynamics going forward, noting that OPEC (which has proven its capabilities to surprise the markets) has another meeting coming up in June. After suggesting a preference for investments without commodity price risk, he pointed to recent M&A activity as a sign that weak companies (often tending towards smaller size) may be ripe for "consolidation" overtures.

Swank Capital, based in Dallas, has been a long-time proponent of the "U.S. Energy Renaissance" as an investment theme; and Mr. Spears , though not making explicit forecasts, pointed to both fundamental and technical evidence that oil prices may have already seen a bottom in the past two months. Citing recent reductions in rig counts, the speaker suggested that production would "roll over" in the next quarter. Reading news reports from a big European commodities conference, hosted by the Financial Times, held just east of Geneva on the Lake, it seems that top oil executives agree with this view.

Indeed, more bullish sentiments on commodity prices seem to be percolating though mainstream media. Even iron ore (that fuel for the Capesize drybulk market) has seen pricing increases since reaching bottoms in March , according to analyst reports. A look at the S&P GSCI Spot Index suggests, to me anyway, that it's bouncing up after making a double bottom, mirroring the price action of a major component commodity- oil. But it needs to get up above resistance and start to retrace the perilous moves downward of October-November.

With thoughts of the OPEC cartel's possible impacts on oil pricing, Mr. Spears suggested that the U.S. is the new swing producer (a view not shared by ex-BP honcho Tony Hayward- speaking at the same FT conference, half a world away). And, reprising the thoughts of Cohen & Steers' Portfolio Manager Tyler Rosenlicht (who had spoken on a previous panel- at the same Capital Link event), Mr. Spears noted that distributions from many MLPs without commodity price risk have grown steadily (even with lowered oil prices) but the Alerian Index (reflecting MLP pricing) has lagged. In other words, MLP price performance has not reflected the continued growth in distributions to unit holders. Presumably, as sentiments about the oil prices turn upward, price performance of MLPs, including those tied to shipping packagers, will also do better.

As far as the impacts on shipping, Mssrs .Rosenlicht and Spears both lamented the volatility in spot charter markets, and voiced a clear preference for structures where vessels are on term charters. Indeed, in his remarks on a Cohen & Steers panel, the Portfolio Manager indicated a preference for shipping shares among various asset classes from which the firm can assemble baskets of MLPs.

So, what's different here than in previous weeks, when I've been reporting similar observations from other conferences (including the excellent Capital Link Shipping/ Offshore event in March, and the MLP conference two month ago in February)? After all, I've been bifurcating shipping into MLPs and similar, versus "the rest of them…" for a few months now. Though the burst upward in iron ore prices is fresh news, it may be more supply driven (ie BHP deferring a project, similarly to actions by the oil majors) rather than demand driven (ie a pickup on the China front). So, while it bears watching, there's no big institutional bid on the Capesize shares. In one deal announced over the weekend, Fredriksen-linked and newly "expanded" Golden Ocean has sold eight Capesize vessels to Ship Finance Limited (another Fredriksen company), with a complicated charter-back structure providing additional "value" to the buyer. In a bad market, good financial engineering ( enhanced through profit-sharing and an option provision) will trump piles of iron ore on docks in China anyday! The base rate, for years 1-7, is $17,600/day- roughly in line with long-dated drybulk swap contracts. A cursory glance at the structure and hires does not reveal any "ah-ha" moments about prospects for ore shipments into China. So, buy-side conjecture about a recovery circa 2017 may not be so far off. But at least these eight vessels will break even.

The oil news creates something of a dilemma for tanker watchers- higher prices might reverse the trend of oil stockpiling, which has been an important determinant of the outsized ton-mile demand over the past. And certainly the all-important tanker storage, which never really got legs this time around, won't be happening. In 2009 and into 2010, period time charters for larger vessels took significant capacity out of the market, significantly tightening the supply and demand dynamic. The reduction of landside oil storage built up to record-high levels would likely keep WTI low relative to Brent, raising the question of where oil might go (if not to the U.S. where release of storage would substitute for imports). Presently, a burst of shipments to Asia has buoyed the market for big tankers. Commodity watcher Simon Jacques, in a soon to be released report "Oil and Wet Freight: From an Oil Trader's Perspective" points out that: "A weak European demand relative to Asia causes the Brent/Dubai swap to fall incentivizing traders to lift crude from the Atlantic Basin to East of Suez"

But, then there's geopolitics- a topic that Mr. Jois from GS professed a certain wariness about- justifiably, his bigger focus is corporate catalysts such as mergers. I would like to profess some weariness about issues such as Iran, Yemen, Libya, ship attacks near Aden and the like, but they can't be ignored when following shipping. Some of these possible triggers were mentioned at the Capital Link conference. On the brighter side, a deal in Iraq would increase oil supply (though not instantly), Libya could come back online and get up to, say, 700,000 barrels/day of oil. More ominously, the situation in Yemen could get ugly and could temporarily restrict vessel traffic in the region- starting a scramble for tanker freight from other loading areas. But, wary and weary, it's all conjecture.