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**GLOBAL TRANSPORTATION ASPECTS –
WITH MAIN FOCUS ON DRY BULK**

by

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Global Transportation Aspects – With Main Focus on Dry Bulk

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At present practically all shipping markets are experiencing good - or extremely good - market conditions. Three years ago the situation was exactly the opposite, with all major market segments facing lousy rates and bleak short-term market prospects. Anyone who is well experienced in shipping knows that this business is highly cyclical. However, it seems that the present strong upturn could be of somewhat longer duration than what we have been used to in the past, and that shipowners could have a nice and protracted harvest season, may be even into the medium term of 1-2 years. Some talk about a paradigm shift caused by the enormous momentum in the take-off economies in China and several other countries in Asia. Rather few major downside risks are visible in the short term, albeit there are some, and unexpected or unpredictable events could create different scenarios.

On April 28, Wen Jiabao made his famous speech about the need to take “very forceful measures” to curb the economy. At the same time the State Council issued new guidelines on the use of debt to fund projects in the areas of steel, aluminium, cement and property. In our Monthly market report for May, our subsidiary Rodskog Shipbrokers in Hong Kong wrote the following under the column Frankly Speaking:

We would venture to predict that after a short period of correction China’s economy will get back to business as usual. The government may be cracking down on wasteful prestige projects in China’s 660 cities and 20,000 towns. And cyclical businesses such as car manufacturing and property are bound to experience ups and downs. But even China’s real estate boom should be seen in the context of a country where an unprecedented 300 million people are expected to relocate from the countryside to the cities over the next 15 years. In any case, if one thing is clear, it is that whatever the state of economy, China’s absolute imperative to build ever more and more power plants, pipelines, dams, roads and railways, bridges, tunnels, electrical grids, airports, water projects, port developments, and, dare we say it, ships, will survive. Therefore we expect that the so-called China shock of April 2004 will turn out to be ephemeral.

In a well orchestrated move the Chinese managed to cut down on congestion and demurrage, freight rates came down significantly (but it should be observed that the temporary troughs were still well above any previous peaks), and a somewhat stronger position was probably obtained in price negotiations for raw materials. However, the Chinese have later come back strongly in the markets for raw materials and port congestion again seems to build up in some areas.

The dry bulk market experienced a very substantial comeback around the middle of the year. After very strong downward corrections from the fantastic rate levels seen earlier this year, a substantial recovery took place from late June through mid-July, when the Baltic Dry Index increased 56% in just three weeks. Thereafter, dry bulk rate variations have been rather moderate at very solid levels. On September 24, the Baltic Dry Index was 2% higher than in mid-July and 59% higher than one year before, when rates were already pretty strong.

Compared with one year before, the Capesize index was up 40% towards the end of September, the Panamax index up 70%, and the Handymax index, which is probably most interesting for people in the fertilizer industry, was up as much as 90% from same date last year.

The tanker market continues to be highly volatile, but rates have hovered at very high levels for most of this year and the short-term outlook appears quite solid. The strong tanker market attracts some of the largest LPG carriers to trading in CPP, or clean petroleum products, which represent a silver lining for such vessels when the LPG trade is slack. This gives support also to rates obtained by the next largest size group of LPG carriers, the 54,000 cbm class, which either carry LPG cargoes or to a large extent find employment in ammonia shipments to the fertilizer industry. The LPG market has been rather sluggish for a couple of years compared with other shipping markets, but the largest LPG carrier size groups have seen a considerable strengthening lately and the outlook has improved considerably.

Also the container market has improved dramatically since the strong slump experienced three years ago, with more than a tripling in timecharter rates for some vessel sizes to new record-levels. Much of this clearly has to do with the strong increase in exports of industrial goods from China and other low cost countries in Asia. The container trade is very imbalanced with a lot of empty containers to be relocated. Whereas the USA imports roughly twice as much container cargo as they export, the situation is exactly the opposite in China. With the high dry bulk freight rates and the strong container trade imbalances it is not surprising to see a growing containerization of some dry bulk trades, especially for rather high-value bulk commodities. In particular on the route Northern Pacific USA and Canada to the Far East this has taken place to quite some extent, with commodities ranging from forest products to soybeans and many others.

The steel industry, which in total accounts for about 50% of total dry bulk tonnage demand, continues to surprise positively. In August, world crude steel production was 9.4% higher than in the same month last year, and the year-to-date production was up 8.5%. World production of pig iron, which requires iron ore and coking coal, was 8.4% higher than one-year before and up 7.7% over the first 8 months of the year. These high growth figures are strongly influenced by developments in China. In China, the pig iron production in August was 21.8% higher than one year before and up 20.5% year-to-date. Pig iron production in the rest of the world over the first 8 months of the year was up modest 2.2% (EU-25 up 4.1%, FSU +2.3%, USA +1.8%, Japan +1.4%, and S.Korea +0.7%).

Recently, China's steel products imports have shown significant decreases. This development is bad for shipowners. It requires much more tonnage if China would produce less steel at home and let others make more of the steel needed in China. China has at present more than plenty of coal and a lot of iron ore, albeit of low quality. Steel purchases from abroad will require more iron ore and coking coal transports for making that steel as well as transportation of the steel. Thus, there could well be a tonnage demand multiplier of some 2-2.5 for imported steel to China compared with domestic steel production, partly based on imported iron ore.

Against all odds, coal has definitely been the star performer among the main energy commodities in the last few years. Despite pollution concerns and the Kyoto Protocol on carbon dioxide emissions, the growth in global use of coal is now out-pacing oil and gas. Last year world coal demand increased almost 7%, whereas both oil and gas demand were up about 2%.

In addition to the phenomenal growth in China's steel industry with higher iron ore import volumes, the coal trade is the main contributor to the strong dry bulk market. Transient factors, such as congestion in coal ports and another round of shut-downs of nuclear power plants in Japan have recently tied up more tonnage in seaborne coal trade. Problems in the Middle East and high oil prices clearly stimulate demand for coal, although coal prices have increased about as much as the price of oil. Coal is abundant and, in some places, comparatively cheap to produce. The USA is said to have five times more energy resources in the form of coal than Saudi Arabia has in the form of oil. Many other countries also have vast coal reserves waiting to be tapped.

The grain trade shows fairly modest volume growth this year and a bumper crop is expected on a global basis. However, unusually low Chinese stocks are expected to induce high import growth. The trade in soybeans and soybean meal has now become larger in volume than the trades in wheat and coarse grains separately. Here, the strongest trade growth is into China.

The announced cooling down in China is at present not much visible in the major seaborne trades. Iron ore imports were up 37% over the first 7 months of the year and increased from a low of about 13 million tonnes in May to 18 million tonnes in July. Higher domestic demand for coal has resulted in just a marginal increase in coal exports over the first 7 months of less than 1 million tonnes to about 52 million tonnes, whereas China's coal imports over the same period was up 55% to 9.5 million tonnes. The stagnation in China's coal exports gives room for more exports to other Asian countries from more distant sources with significant upward leverage on coal tonne-miles. On the oil side, China's oil consumption over the first seven months of the year was up as much as 18%, compared with an estimated global oil demand growth of 3.2% this year and 2.1% next year according to OECD's International Energy Agency. China's domestic oil production is fairly stable at 3.5 million barrels per day, whereas net oil imports at 3.0 mbd in January-July were up stunning 45% both for January-July compared with same period last year.

The dry bulk market has benefitted from more focus on ordering of tankers and container vessels in recent years. The two latest dry bulk booms both saw substantial initial dry bulk newbuilding order volumes, but this was followed by rapid slowdowns before the freight market peaked. This resulted in a couple of fairly modest vintages of new bulkcarriers in 2002 and 2003. The 2006 and 2007 vintages will also be rather modest and could represent a new window of opportunity for dry bulk owners. New orders for bulk carriers today will not have any impact on the market balance before in late 2007 and 2008, due to exceptionally long delivery time from the shipyards because of full order books.

Ordering of new bulk carriers slowed down strongly after mid-year. The volume increased from 59 vessels of about 4.6 million dwt in 1Q to 64 vessels of 5.2 mdwt in 2Q, whereas July/August showed 27 vessels of only 1.9 mdwt, with only about 0.25 mdwt in August. As could be expected in view of the strong freight market, sales of bulk carriers for demolition remained insignificant. After 10 vessels of about 0.3 mdwt being sold to breakers in 1Q, just 4 vessels of less than 0.1 mdwt were reported in 2Q, thereafter only one handysize vessel in July and none in August.

At end August, the world fleet of bulk carriers over 10,000 dwt stood at 5752 vessels of 313.8 million dwt, up 4.1% from one year before measured in dwt. The order book amounted to 637 vessels of 48.4 mdwt, corresponding to 15.4% of the existing fleet. After deliveries of 12.3 mdwt during the first eight months of the year, scheduled deliveries for the remainder of the year stood at 6.1 mdwt, followed by 19.6 mdwt in 2005, 15.2 mdwt in 2006, and, so far, 5.7 mdwt in 2007.

Looking ahead, the latest quarterly scenario from Fearnresearch from July shows that after a modest dry bulk fleet growth of only 2.5% last year, this year could see about 5.5% growth, before about 4.5% in 2005 and only 3% in 2006.

On the trade side, the main dry bulk commodities in international seaborne trades were expected to develop as follows from 2003 to 2004: coal up from 610 million tonnes to 640 mt, iron ore up from 537 mt to 580 mt, and grain up from 240 mt to 250 mt. Total dry bulk trades were expected to increase from about 2340 mt to 2450 mt, or up roughly 4.5%, with about similar tonne-mile growth. Similar growth rates were expected for 2005. In 2003 the growth was about 5.5% in volume and 7% in tonne miles. Here, it should be stressed that congestion in ports have at times been estimated to correspond to roughly 5% of the total bulk carrier world fleet (some say even 7%). Thus, the relationship tonne-miles versus dwt capacity of the fleet is far from the ultimate market indicator. Still it is a valuable indicator.

I have above by purpose used the past tense for our trade forecasts. These will definitely be revised upwards in our next quarterly forecast due in a few weeks. Several year-to-date trade volumes are way above expectations and congestion still plays a vital role in the tonnage balance. I will not be surprised if our next tonne-mile forecast for this year is revised upwards from about 4.5% to 6-7%, i.e.somewhat higher than the fleet growth estimate, which could only see marginal revisions for this year and next. Economic forecasts for 2005 show slightly lower growth rates than for this year, but because of developments in the steel industry and strong growth in the use of thermal coal at power plants, our tonne-mile forecasts for 2005 might well be revised up to about 5% growth. These figures indicate a fairly balanced overall development in the dry bulk trade and fleet in the short and medium term.

The observed rate variations over the last couple years illustrate how risky it can be to be long on cargo and short on tonnage at the wrong time. This has given room for more activity in the futures market, which again seems to amplify rate variations in the dry bulk market. The fact that some of the major operators of dry bulk tonnage were able to lose money when the market was on top shows that this financial shadow market is not always helpful to hedge against freight rate variations and could actually increase risks and exposure dramatically. In my view, the physical market is fascinating enough in itself.

The challenges for the shipping people in the large commodity companies have increased significantly. What will, under changing market conditions, be the optimal tonnage portfolio? What is the best mix of owned tonnage, vessels on charter - in and out, various types of cargo contracts, and peak shaving in the spot market, including relets? Dynamic positioning must be based on fundamental tonnage supply and demand analysis, as well as surveillance of transient factors of various types and special events occurring in key areas of the individual cargo markets.

It is also important to watch general logistics, especially at the interface sea/land, traffic bottlenecks and general economics of different modes of inland transportation. These challenges, in my view, are just as great in periods of market consolidation and decline as they are when the freight market is increasing. Surveillance of regional macro-economics, commodity markets, and tonnage supply should be highly in focus. The ambitions should not be to estimate fairly exact future rate levels, but rather trying to see turning points and degrees of strength and weakness in the various market segments. For periods longer than the medium term, of say 3 years, rate forecasts have limited value, since tonnage supply will to a large degree adapt to demand.

In the longer term, there are some negative mega trends to observe in the market for dry bulk tonnage. They include market saturation in advanced economies, recirculation, and downstream involvement of raw material producing countries.

Looking ahead with focus on seaborne transportation cost elements, it seems that there are still gains to be made with regard to yard efficiency on the back of large industrial groups' integrated business, including their own steel production and financial resources to support their shipbuilding arm. On the other hand, consensus is that interest rates are likely to move upwards. So will also wages for skilled yard labour. Vessel operating costs are also likely to increase in the longer term. A very large share of the ship management is already outsourced to companies using seamen and officers from low cost countries. A gradual leveling out of wage differences between countries is expected to gain momentum as the general globalization escalates.

It will still be crucial to look East, with a focus on steel, thermal coal, and grain in order to assess tonnage demand development in the short to medium term. Tonnage supply is more or less given for the next couple of years. Scrapping will be delayed and upgrading of vintage vessels will prove to be good investment for quite some time. More rate volatility in a well-balanced dry bulk market will make dynamic tonnage positioning ever more important for shipowners and cargo owners.