Falling Inventory Levels Keep Downward Pressure on Tanker Market

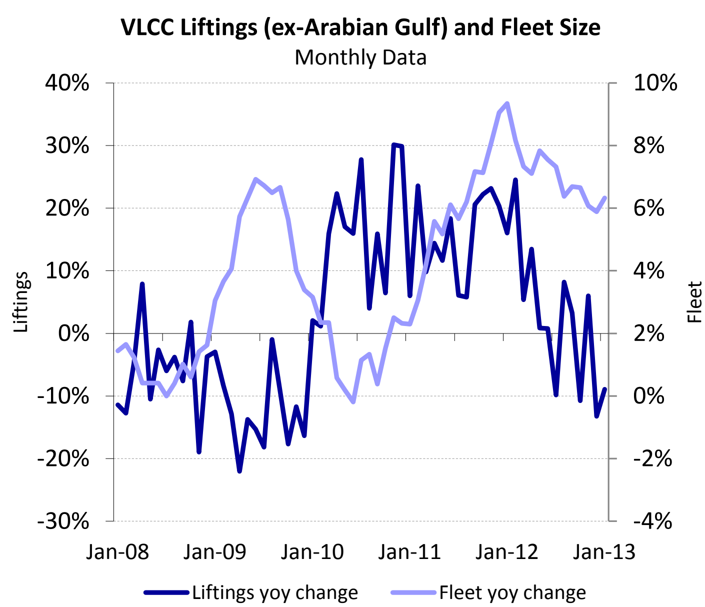
Continuation of weak earnings in conjunction with declining liftings

The weak earnings environment has obstinately continued in the spot market this week, as low cargo counts have persisted. VLCC liftings out of their primary loading zone in the Arabian Gulf have been on a decidedly negative growth trend for the past year, and actually contracted in three of the last four months. The current stubbornness of rates is consistent with the combination of these reduced liftings and headwinds associated with steady fleet growth over the same period of time.

Fleet growth continues, but should slow in 2h13

The VLCC fleet has continued to grow as the tail end of strong ordering from the last market cycle works it way through shipyards. Although fleet growth should slow after 2012 slippage delivers in 1h13, demolitions would have to begin at 17.5 years in order for the fleet to begin to actually contract this year. Lifting volumes, on the other hand, appear to be a victim of not only domestic production increases, but also the potential start of a reversion to historical crude inventory levels.

Liftings tapering off while fleet growth enters final push



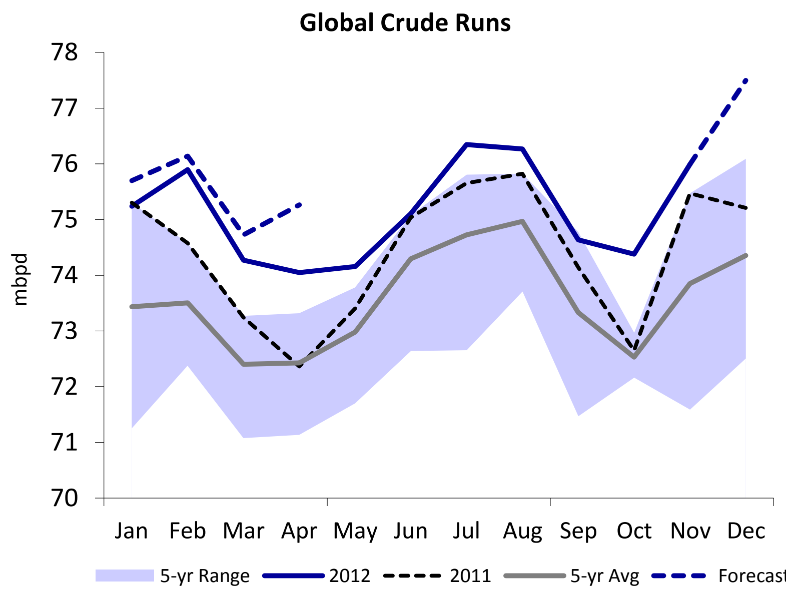
Source: Poten

Crude runs not the culprit, as they have been strong on emerging market demand

Crude runs are below recent averages in OECD countries, but global crude runs are up substantially and are forecast to be relatively strong in early 2013. A pop in demand drove a spike in 4q12 runs, led by China, reaching an estimated 77.5 mbpd in December.

This effect is expected to be subdued by March, perhaps because of the unusually strong nature of the increase in Chinese 4q12 crude runs.

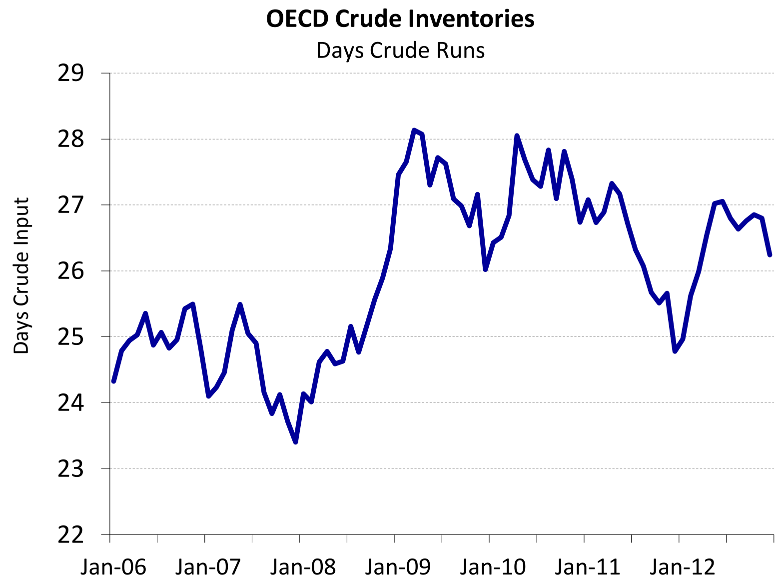
Crude runs maintain growth, though may slow after "borrowed" Chinese runs in 4q12



Source: IEA, Poten, Various

Financial crisis created a "new normal" for crude inventories…

The shifting supply story has been well covered, no doubt reducing the number of liftings from the Arabian Gulf to the West. Global crude inventory reductions play a role as well, though. After growing substantially since 2008 due to the impacts of the financial crisis, these inventories have softened. With the majority of excess stocks being in the US, recent infrastructure developments – the ability to get crude out of Cushing via projects such as the Seaway Pipeline reversal and its 1q13 expansion and the upcoming Longhorn Pipeline reversal – suggest this trend is poised to continue. As we have previously noted (see 11 January 2013 *Opinion*), the continuation of such a development – and bringing inventory days back to the 24-25 days range – looms ominously for tonne-mile demand.



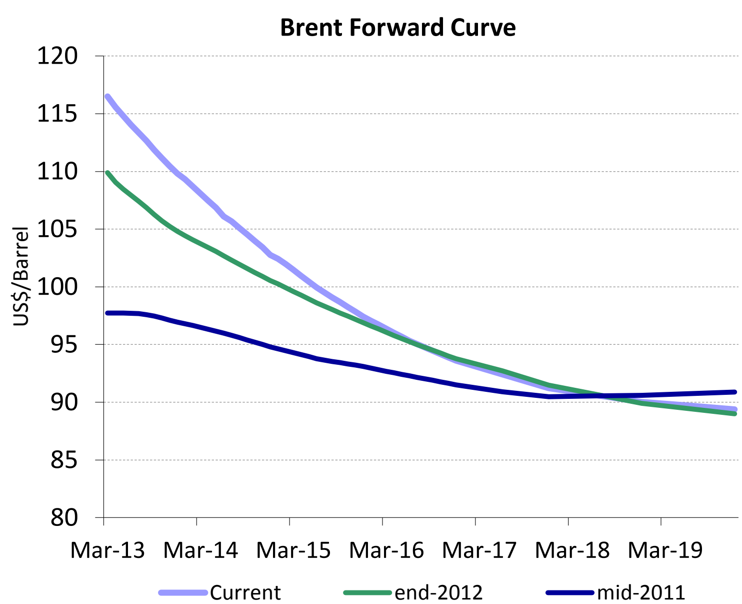
Source: IEA, Poten

…does economic recovery spell a return to "old normal?"

Implied volatility down, suggesting a lack of need for higher inventories

After several years of both real and perceived supply risks, volatility in crude oil markets – measured implicitly via options – has touched historically-low levels. This sentiment towards uncertainty helps to drive the reduction in crude inventories as well. Further supporting the reduction in crude stocks, the Brent forward curve became increasingly backwardated over the past year. This begets the usage of current stocks, while future needs can be contracted forward or financially hedged.

Shifting futures market would dictate a leaner inventory strategy



Source: Bloomberg

If inventories indeed return to historical levels, tanker demand story becomes more bearish

Owners have felt no shortage of market-induced pain of late, and a new source of it is potentially emerging. Despite sustained macroeconomic growth that is keeping global crude runs high, the convergence of evolving domestic infrastructure, a reduced perception of risk in crude oil markets, and a steeper backwardation curve has begun to bring crude inventories off their recent highs. While this development is hurting rates in the short-term, it has the ability to cause further damage if it eventually returns inventories to more historical norms.

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