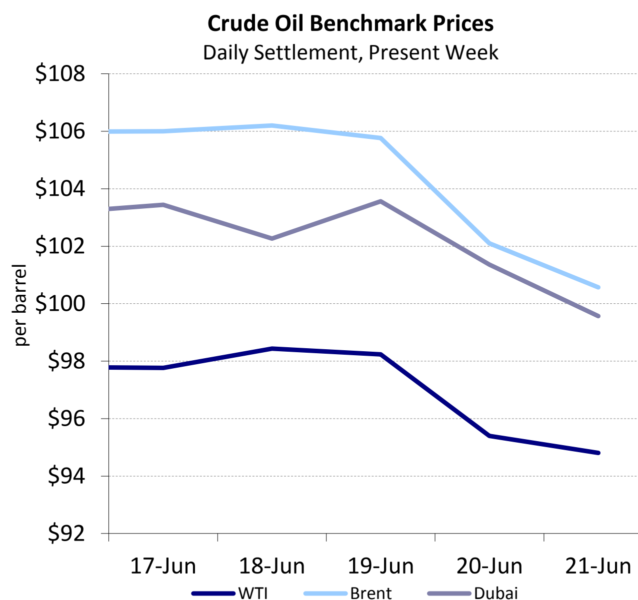
Will Turbulence in Financial Markets Impact Tankers?

Oil prices dropped significantly in the second half of this week

Marine Money Week made its annual appearance in New York this week, and everyone from owners to brokers to capital markets professionals were there to discuss where opportunities to capitalize on the current state of shipping markets might exist. The theme of the week was "Risk On," which is typically indicative of bullish sentiment driving investors to venture out along the risk spectrum on the notion that risk is underpriced in the market. Risk was anything but "on" in the broader financial markets this week, though, and there were pronounced implications for oil prices, which fell sharply across the board.



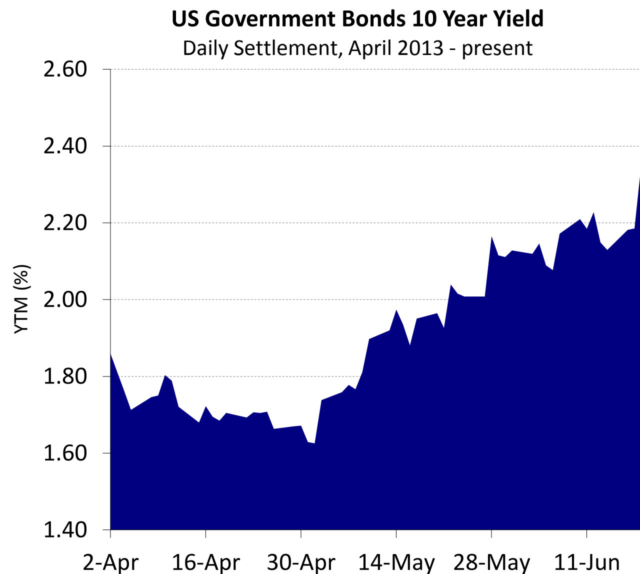
Source: Bloomberg

Comments about future Fed policy impacting interest rates

Ben Bernake, the Chairman of the Board of Governors of the Federal Reserve – or "Fed" – in the United States, commented on Wednesday of this week that he anticipates that the central bank will slow its purchase of US Treasury and mortgage-backed securities "later this year" and then end the purchases "around mid-year (in 2014)." This will remove combined demand for the two asset classes of $85 billion per month, reducing prices and implicitly driving up interest rates across the board. Movement in bond prices and yields are not waiting on the Fed to act, however, as investors who have been riding the wave of central bank liquidity view these statements as a signal of the inflection point in the direction of bond prices. Indeed, yields have jumped precipitously.

Higher interest rates may make restructurings more difficult

In addition to the macroeconomic impacts of rising interest rates, such a move could hinder the ability of those in the shipping space still looking to restructure their debts to be able to find terms that enable a deal to get done. Another point of concern to the shipping community should be that rising interest rates will remove the incentive of building or maintaining larger inventories in the United States. Rising rates would increase the carrying cost of these inventories, and a drawdown would displace demand for new crude oil and product imports, an obvious negative for freight rates.



Source: Bloomberg

Chinese central bank looking to slow access to credit…rates that they can impact rising

Elsewhere, China's central bank is attempting to cool credit markets on concerns that the breadth of "shadow lending," a practice of non-bank intermediaries making loans, in the country leaves it vulnerable to large-scale defaults that could wreak havoc on its economy. The *Financial Times* reports that the rate that unregulated lending occurs between financial institutions in China has tripled in the past two weeks "after the central bank rebuffed pleas to inject more cash in to the financial system." While almost certainly a prudent move in the long run, this could slow growth in the near term.

At the same time, China's broader economy has shown signs of slowing. After suggesting expansion in the manufacturing sector since the middle of last year, the Chinese Purchasing Managers' Index from HSBC and Markit has indicated a contraction for two consecutive months now. Capital Economics commented that the "worse-than-expected reading on China's flash PMI gives a further reason to expect GDP growth to slow this quarter. Policymakers care more about the state of the labour market than the headline GDP number and won't be panicking. But the continued deterioration in the employment component of the PMI will be a concern." Slower economic growth generally begets slower oil demand growth, a negative for tanker owners.

Chinese economy showing signs of slower growth

Source: HSBC, Bloomberg

Tightening credit markets could cramp economic growth and tanker demand in turn

China and the United States are major demand drivers for not only the world economy, but also for shipping markets. The general tightening of credit markets should serve to cool the pace of economic growth at some level by limiting access to and increasing the cost of capital. Rising interest rates have also pounded emerging market currencies. Emerging markets are currently responsible for most incremental gains in oil demand, and the continuation of such a trend would hurt their ability to purchase dollar-denominated oil contracts.

Is Fed correct that economy can stand without further monetary supply?

Although a sustained softening of oil prices could positively impact demand for the physical commodity, a slowdown in macroeconomic growth would be a negative for ton-mile demand. Interestingly enough, the reason for this week's sell-off was brought on largely by the position of the Fed that economic conditions have healed to a point of not needing the same magnitude of artificial support. It would not be the first time that the behavior of markets has diverged from macroeconomic fundamentals, but it will be interesting to find out if the credit hangover from the financial crisis has indeed subsided enough to support rising interest rates.

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