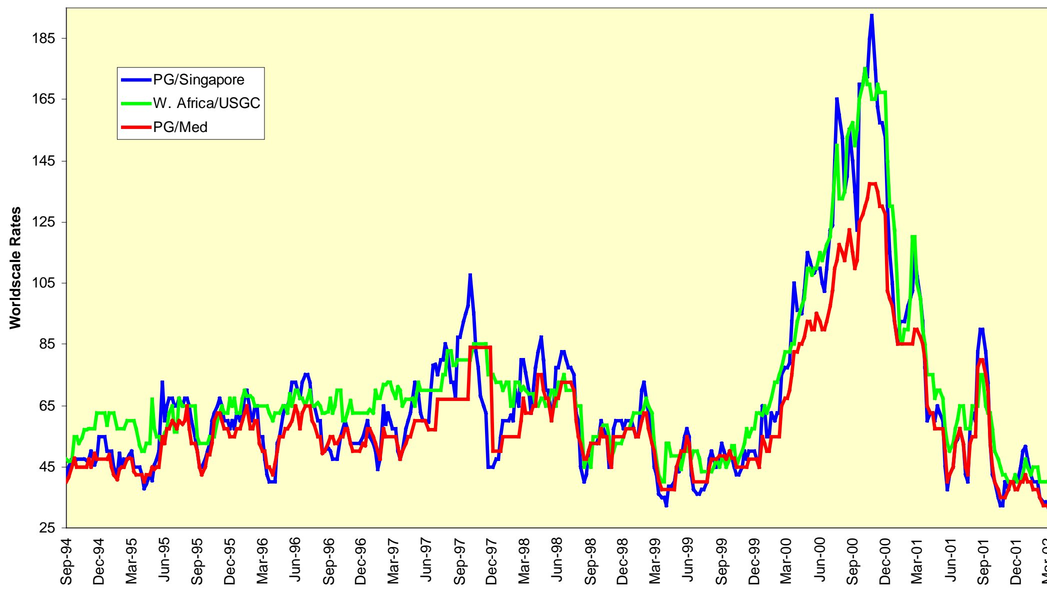
Tankers And Bankers Agree: Crude's Looking Strong

The impending release of yet another *Star Wars* prequel takes me back to 1977 original and the famous “bar scene” contained therein. We’ve all been caught in one of those moments when we’re immersed in what appears to be a genetic bouillabaisse. Sometimes this is fun, and that’s why I hope to be invited to the next OPEC meeting.

Yep, there I’ll be, knocking down the hors d'oeuvres – no pickled eggs, please – next to axis of evil members Iraq and Iran, botched coup d’etat impresario Venezuela, civic virtue paragons Indonesia and Nigeria, and fun-loving Saudi Arabia. Who couldn’t look good in that crowd?

Before we go overboard lamenting their presence on our planet, let’s remember that we do have to buy crude oil from these folks, and once you buy it, you have to ship it. So, with world crude oil demand close to 78 million barrels per day, up more than 50% from the first oil shock of 1973, why are crude oil tanker rates at or near all-time lows? More important, what do these low tanker rates imply for energy prices and for oil-related stocks?

Tankers Alight, Sailors' Delight



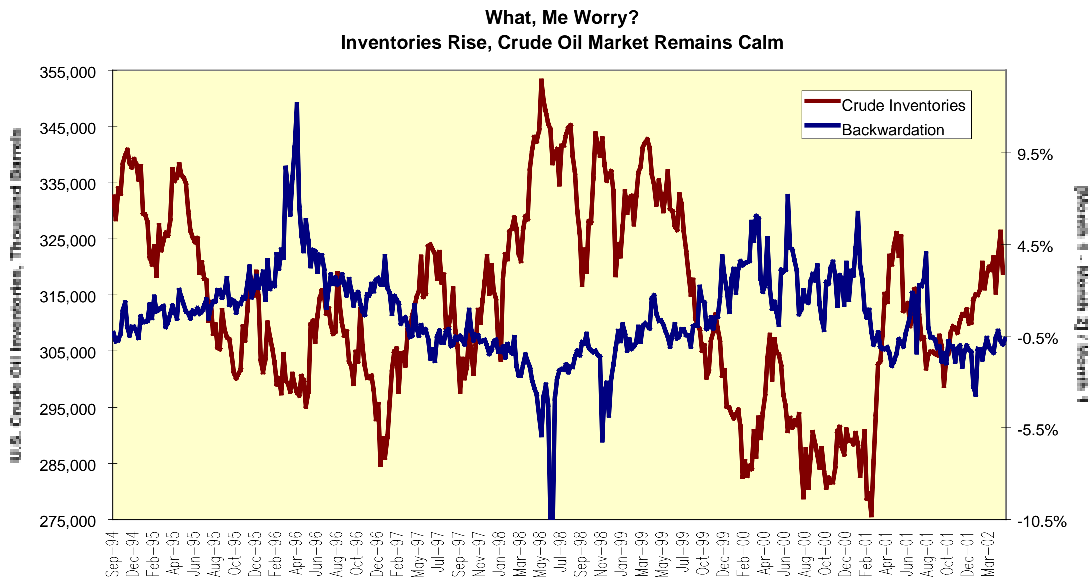
No Ship, Sherlock

The collapse of tanker rates in the face of a strong crude oil market is a bit of a mystery. Yes, it's true that Iraq announced an embargo on crude oil exports two weeks ago to show its displeasure over world affairs, but this embargo failed immediately when the Saudis announced they would make up the shortfall. And, as the chart above shows, tanker rates have been falling since late 2000 on a variety of routes, including West Africa to the U.S. Gulf Coast, the Persian Gulf to Singapore, and the Persian Gulf to the Mediterranean. The Worldscale numbers are the percentage of the expected shipping cost.

The economics of running a tanker fleet have gotten so bad that old vessels are being sold for their scrap metal value; the last time this happened in a big way was during the oil price collapse of the early 1980s. So far in 2002, 17 vessels have been sent to the breaking yards, as opposed to two at this time last year. A VLCC (Very Large Crude Carrier, or "supertanker" around the Central Park lagoon) has a break-even operating rate of around $21,000 per day; the present Worldscale rates mean they are earning less than $7,000 per day. At the end of 2000, ship owners were cashing checks for $100,000 per day. Sounds like a telecom stock, doesn't it?

Few shipping fleets are publicly traded in the U.S. The adventurous can try Bergesen, a Norwegian shipper up 10% on the year, or Frontline, a British shipper up 13.5% on the year; they are denominated in Norwegian kroner and British pounds, respectively, and can give you that international diversification you so crave.

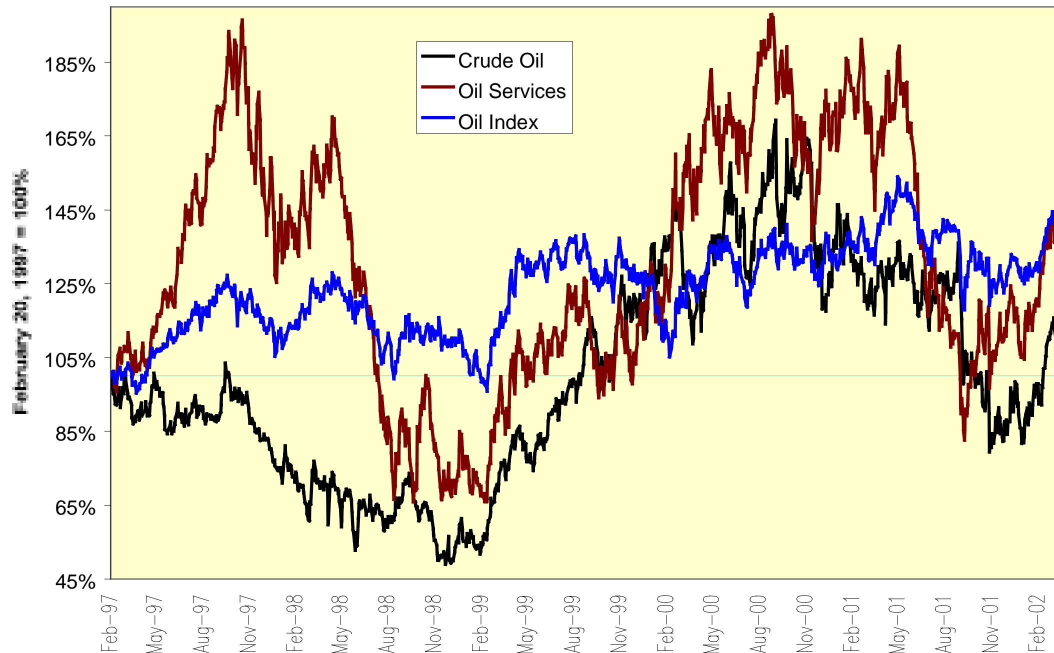
Implications For The Oil Market
You might think that the low shipping demand would mean a drop in inventories and a scarcity of supply that would create backwardation, or a premium of the front month to the back months, in the crude oil futures market. Neither condition has occurred.



But, please notice how inventories jumped in early 2001 following the late-2000 peak in tanker rates. The present low tanker rate regime and flat backwardation structure in crude oil futures signal that U.S. refiners are not building inventories. This is setting us up for a supply shock later in the year.

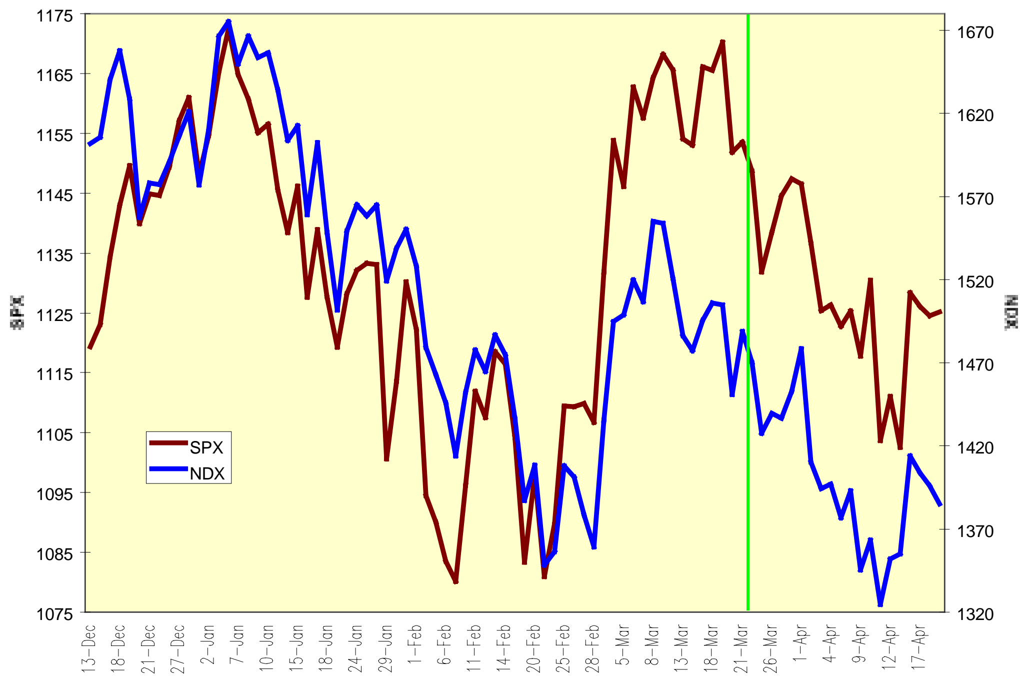
If this is the case, stay with the oil service sector, not the major integrated oil companies. The 15-member Amex Oil Service index not only moves in advance of crude oil prices, but it tends to move much more rapidly both up and down than the price of crude oil. So far this year, nine of the 15 stocks – Cooper Cameron, Halliburton, Rowan, Weatherford, Nabors, Noble Drilling, Smith International, Tidewater and Varco International – have gained more than 25%. By contrast, the 14-member Amex Oil Index is a dullard; only Amerada Hess has scored a 25% advance.

At Your Service: Service Firms Lead Crude Higher



Scorecard Time

Sometimes you get the bear, sometimes the bear gets you. I constructed an option spread a month ago, and promised to report back on it after expiration. The trade involved the purchase of 4 April 1125/1175 SPX straddles, so wouldn't you know it that the SPX went out at 1125.17 last Friday, rendering this portion of the trade a complete loss as both the 1125 put and the 1175 call turned to dust. To make matters worse, the second half of the trade, selling the April NDX 1475 straddle, went against me as well; the NDX settled at 1385.01. The gross tally: A loss of $8,680 on the SPX strangle and a gain of $480 on the NDX straddle for a gross loss of $8,200.



What happened? The tight correlation between the two indices seen since the December 2001 rebalancings broke down prior to the trade's construction. Did this relationship converge back to its original state after the March 22 trade date? It did not.

I'll pass the hat at the next OPEC soiree.