Shipping Rates Signal Rough Seas Ahead

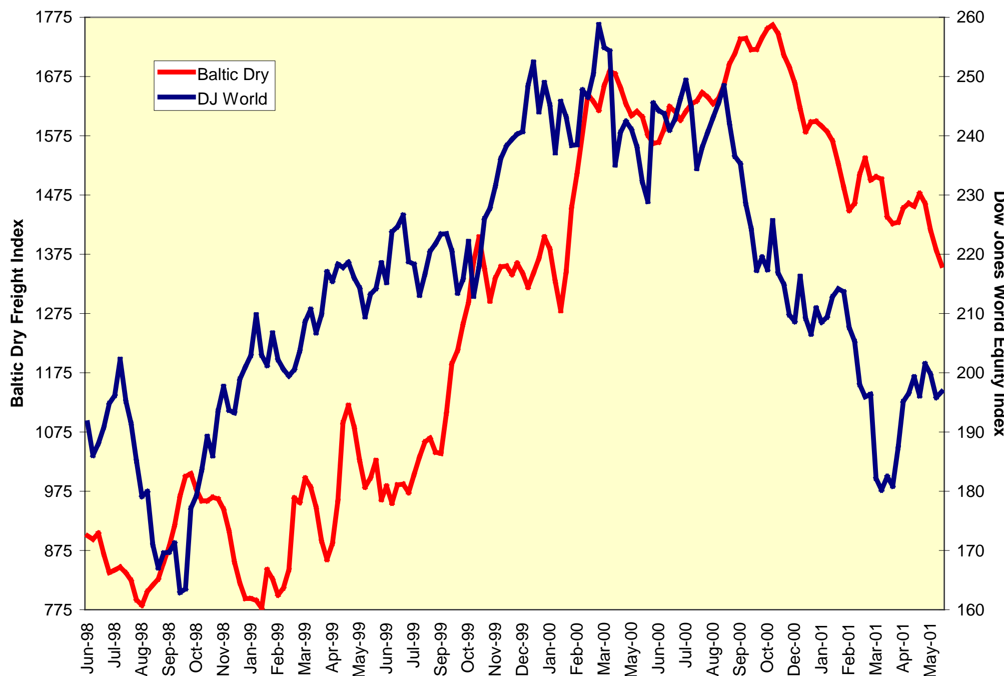
Wall Street economists are a funny bunch, sometimes intentionally. The crew spends endless hours divining what the next announcement out of Washington's numbers mills will be, without a single scintilla of evidence that even a correct forecast will make anybody any money. The most common outcome of all this is a fast market in the unexpected direction as the actual number comes in well off the consensus.

The economic data of real value comes from the less well-compensated troops in the trenches, such as the purchasing managers and logistics agents. These folks deal with unfiltered reality, and cannot be fooled into joining a consensus. No one blathers on about ocean freight or crude oil tanker rates, yet these are some of the best coincident indicators of general economic activity, and leading indicators of where prices are headed. As an aside, shipping is one of the world's oldest professions. Like others of its class, it is a bare-knuckles affair. Legend has it the late Aristotle Onassis gave to charities under an assumed name so that his competitors wouldn't think he was getting soft.

Well, the Greek tycoon may not have been soft, but the same cannot be said for the global economy, or as we shall see, for crude oil prices. You can follow the money, or you can follow the ships. You'll get the same answer.

Economic Implications

The link between stock prices and shipping rates is simple: A weakening economy produces lower demand for shipping capacity, and this in turn will reduce supplies and firm prices eventually. The link is global, so we should compare the Baltic Exchange's dry freight index, a composite, to the capitalization-weighted Dow Jones World Index. Over the past three years, equity price movements, which lead economic activity, have led freight rates as well. That the Baltic Index is still quite weak should come as no surprise to those who accept we're in a recession; it won't head higher until an economic recovery is well underway.

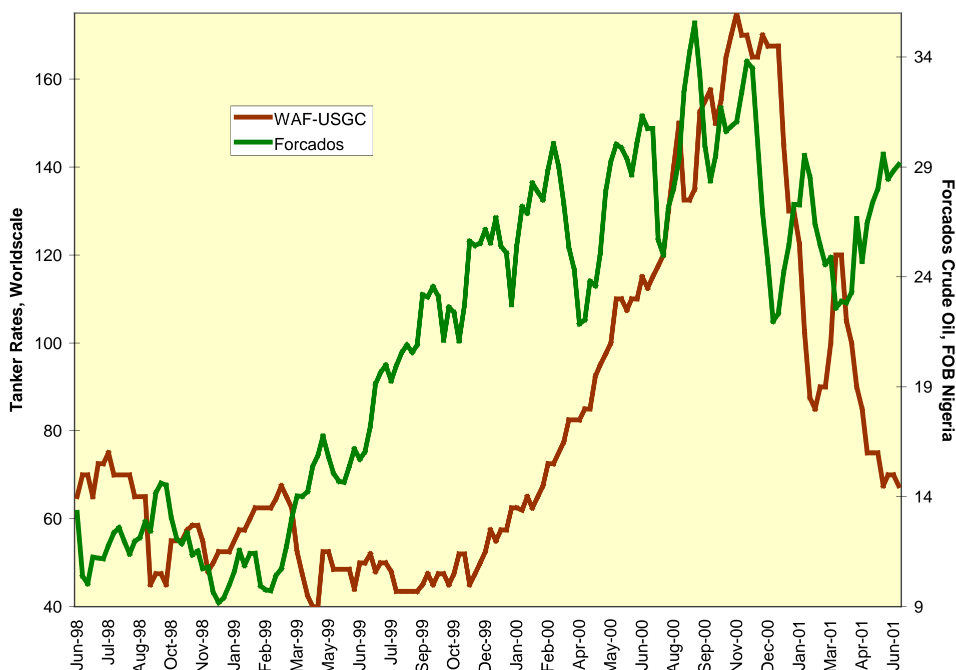


Crude Oil Markets

The most important commodity in ocean shipping is crude oil, which is shipped in specialized tankers with no other purpose. This is not a minor point for tanker operators; while other types of ships can carry cargo on both legs of a voyage, oil tankers usually return to the exporter carrying only a load of seawater as ballast. Tanker rates normally

lag crude oil prices; refiners tend to work down inventories in the early stages of crude oil bull markets, and there usually is a glut of vessel capacity at the same time.

An interesting situation is developing at present, however. While crude oil prices have stayed in a trading range for more than a year, tanker rates have fallen precipitously. Let's take a look at the West Africa to U.S. Gulf Coast route, and a high-quality Nigerian crude oil, Forcados. This light, sweet crude oil is representative of the marginal demand for crude oil at U.S. refining centers. Tanker rates are displayed as "Worldscale," or the percentage of normal shipping tariffs for that route.



Higher prices, as always, have started to reduce marginal demand for petroleum products. Inventories of crude oil, as reported by the American Petroleum Institute, have jumped from under 290 million barrels at the start of 2001 to 325 million barrels today. With final demand starting to fall under the combination of higher price and lower economic activity, and with an inventory overhang starting to build, demand for OPEC crude oil is starting to fall. The cartel will be able to forestall the inevitable by a combination of bluff, bluster, and announced production cutbacks, but don't be fooled. The revenue hungry crude oil exporters of the world – Venezuela, Russia, Mexico, Indonesia, Nigeria – will do what they've always done in this situation, cheat on their quotas. The price of crude oil will break, and break hard, by the end of the year.

Investing Implications

This expectation may explain why it has been so difficult to make money in energy stocks this year. We see our higher energy costs and think *someone* has to be making money here. For investors, the money was made last year, primarily in oil service firms and utility construction firms. Going forward, the uncertain economic and energy price environments, combined with these suppliers' higher costs, will erode profitability. It's a cycle we've seen before in the energy industry.

Wall Street is still awash in all sorts of prattle about earnings visibility, inventory reductions, and other forms of augury bordering on the self-delusional. You don't need to pay attention to any of this, just watch freight rates (watch, please don't try to get involved in the brutal game of trading shipping contracts). No economists need apply.