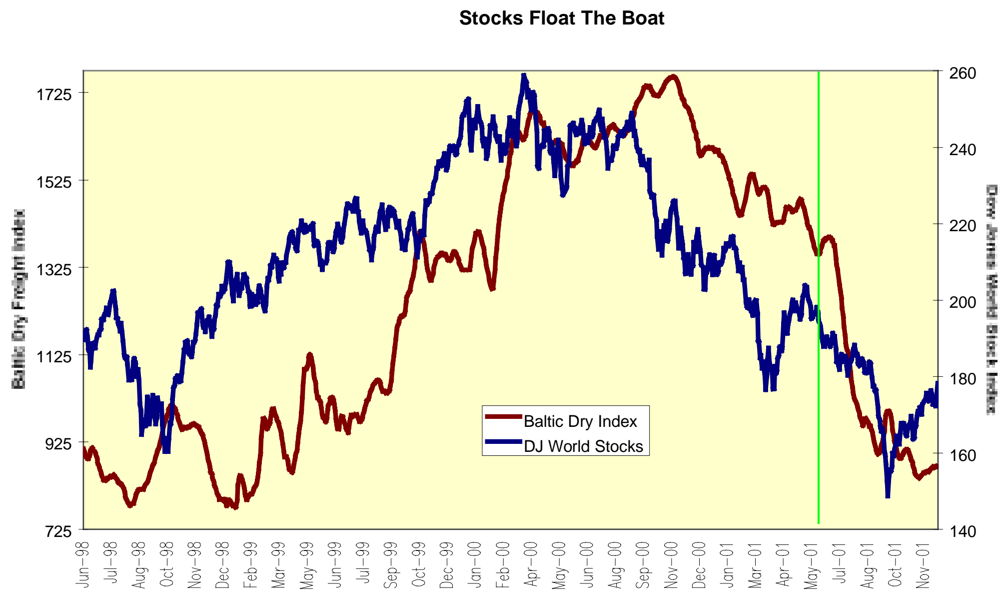
The Market's Hauling. Are Ships?

Trading, market analysis, and investing are to some extent loser's games. The outcomes are determined not by the efforts of the winning party, but rather by those of the bloody and bruised. Think about your own practices: Do you go home after a winning day and study what you did to make you money? Probably not, but most of us do reflect on our failures and resolve to avoid them in the future. So, nobody makes the same mistake twice, right?

I've tried to break this cycle of negative reinforcement for myself and replace it with a study of tools and techniques that have worked at least once, and for good, solid fundamental reasons.   I also try to put myself in a position where the accidents and unexpected events will work for me. To that end, let's revisit an analysis done exactly one-half year ago on shipping rates and their implication for the oil industry (see "Shipping Rates Signal Rough Seas Ahead"). This analysis forecast the deepening economic recession and the break in global energy prices correctly. The premise behind using an indicator such as shipping rates, as noted at the time, is quite simple: Nobody books tankers and freighters on a whim, so their tariffs must be an accurate reflection on underlying economic conditions. We can put purchasing manager data in the same "reality economics" category.

At the time of the earlier analysis, global equities as measured by the Dow Jones World Stock index were completing a retracement rally from the spring selloff. Shipping rates, as measured by the Baltic Dry Freight index and available on the Baltic Exchange's Web site, www.balticexchange.com, showed no such tendencies toward consolidation, however. They dropped precipitously throughout the summer. If we eliminate the September lows in the stock markets that followed the terrorist attacks, we find that freight rates remain under greater pressure than do equity prices. This is not that unusual; stock prices are a leading indicator, while freight rates, like paperboard container prices, are a coincident indicator of economic activity.

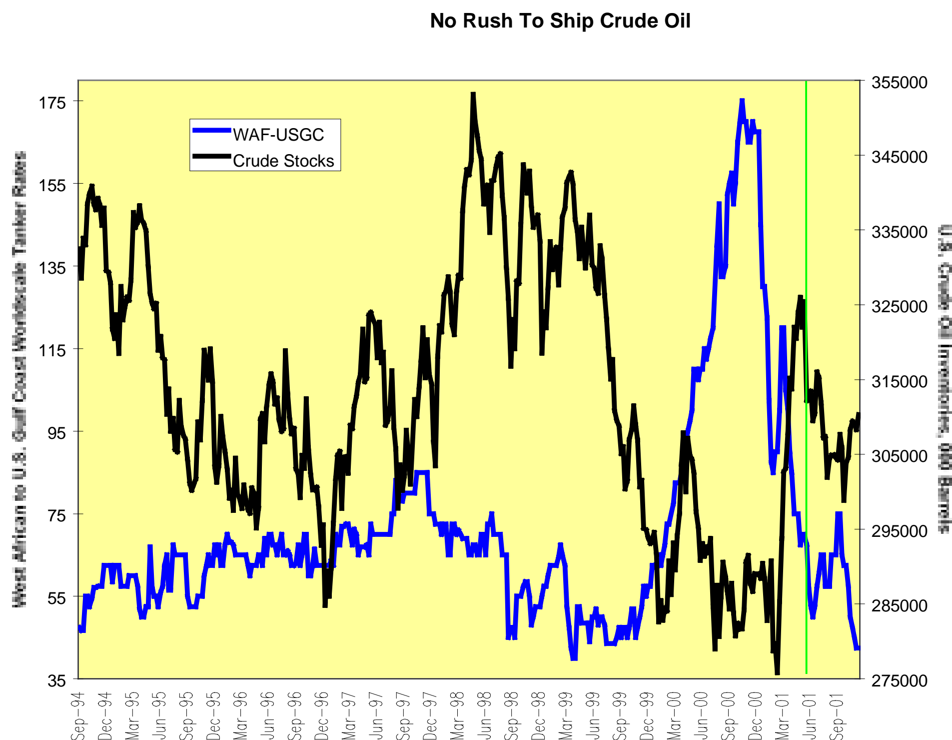


If stock prices are calling an end to the recession correctly, we should start to see a significant pickup in freight rates as the volume of ocean freight rises. If the tepid attempt of freight rates to move higher is evidence of a still-struggling economy, then the present equity rally is one more liquidity-driven exercise in foolishness. Let's look for additional evidence.

Crude, But It Will Do

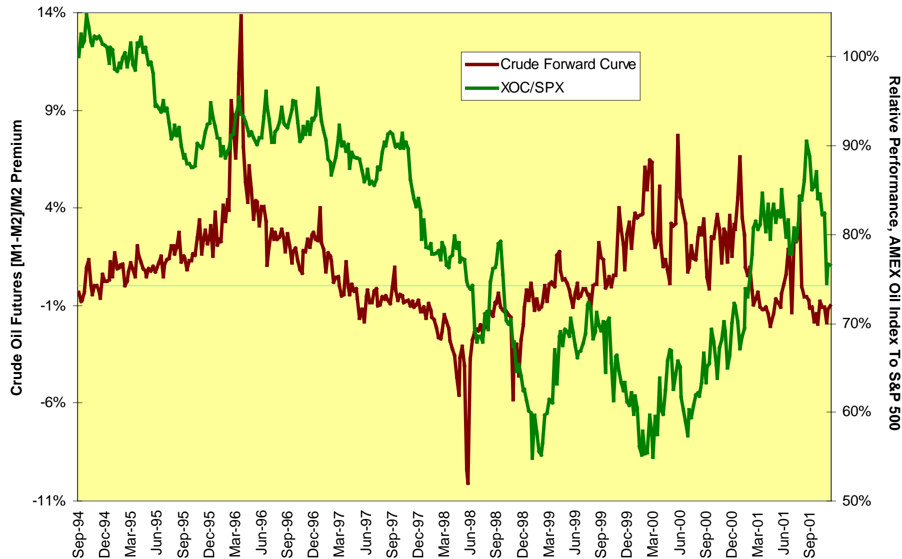
The crude oil tanker rate between West Africa (WAF, principally Nigeria) and the U.S. Gulf Coast (USGC) is critical in the world oil markets. The expensive light, low-sulfur crude oils from Nigeria tend to be the marginal barrel purchased by the least-sophisticated American refiners. When demand for shipping these cargoes rises, it is usually a sign that crude oil inventories in the U.S. refining system have fallen about as far as they will go, and that refining margins will start to be squeezed by higher crude oil costs. At present, tanker rates from West Africa as

measured on Worldscale, or percentage of normal for that route, are at the low end of their range as American refiners work off this spring's large build in inventories.



The low demand for West African cargoes and the end of an inventory build are inevitably setting the stage for the next upward cycle in crude oil prices. This soon will be apparent in the forward curve of crude oil futures. As inventories fall, which is equivalent to saying refiners have adopted a just-in-time inventory policy at risk to disruption, we should expect to see the forward curve move into a condition called backwardation. This means that the delivery month, now January, will sell for more than the nearby month, now February. At present, this isn't the case, but the low shipping rates will lead to low inventory levels, which in turn will produce backwardation.

The investment implications for the U.S. oil industry as a whole are muddled. The two previous shifts toward backwardation since 1994 had no apparent effect on the relative performance of the 14-member AMEX oil index (XOC) relative to the S&P 500. However, the historical data is less useful than normal. The massive consolidation within the oil industry has changed its economics far more toward a narrow oligopoly than a competitive market in which no firm could enjoy pricing power. The names in this index are something of a joke: ExxonMobil, ChevronTexaco and TotalFinaElf soon will be joined by ConocoPhillips; the recently-named BP Amoco has returned to being just BP.



Service With A Smile

The XOC members tend to be vertically integrated and net purchasers of crude oil. Should inventories tighten and prices rise for crude oil, much of the gains will go to those national oil companies who actually produce the crude oil. Since we cannot invest in these companies, we need to find a sector that will benefit from higher crude oil prices, and that will be the oil service sector. Firms such as Schlumberger, Smith International and Baker Hughes have some pricing power in such an environment.

We do not know yet whether the stock market's recent rally is correct in calling an economic rebound. If it is, then we'll see shipping rates rise as industries, including the refining industry, scramble to replenish inventories. Prices will rise and the gains will go to the service sector. This is learning from past experience and putting yourself in position to benefit from the accidents. It's hard to do much more.