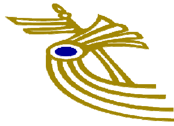

This Week's News: A snapshot on the economic and shipping environment

Week ending 29th June 2012

ECONOMIC ENVIRONMENT

This week's European summit in Brussels will be critical for easing the debt crisis of the eurozone, while EU confidence is at bottom low after credit rating agency Moody's downgraded 15 of the world's largest financial institutions. Moody's said that the banks risked massive losses and they were exposed to the rolling financial crisis and to each other. The 15 banks downgraded were: Bank of America, Barclays, Citigroup, Credit Suisse, Goldman Sachs, HSBC, JP Morgan Chase, Morgan Stanley, Royal Bank of Scotland, BNP Paribas, Credit Agricole, Deutsche Bank, Royal Bank of Canada, Societe Generale and UBS. Credit Suisse faced the largest downgrade, while US banking giant Morgan Stanley was the biggest winner by receiving only a two-notch downgrade.

The eurozone debt crisis continues to weigh heavily on the economic activity within the 17-nation bloc with the Purchasing Managers' Index, compiled by Markit data, standing at 46 in June, the same level as May, which is the slowest level in three years, and Germany's PMI falling to 48.5 from 49.3. Leaders from the leading euro zone economies, France, Germany, Spain and Italy, pledged to reinforce the single currency and to push together for a 130 billion euro program to stimulate economic growth. Under the recent euro zone's turmoil with signs for a further deepening, Spain and Cyprus became the fourth and fifth euro country requesting formally financial assistance from European Financial Stability Facility or European Stability Mechanism to support their banking system, without specifying the amount of aid.

Eurozone Finance Ministers have already accepted Cyprus' request for financial assistance and the country's Finance Ministry announced that representatives from the European Commission, the ECB and the IMF will begin assessing the size of the assistance towards the country, next week. It is unclear how much aid Cyprus may require, but there is speculation that the bailout bill could come as high as EUR10bn, or 60% of the country's GDP, while Cyprus officials had said that the Cypriot government continues negotiations for a possible loan from a country outside the eurozone, such as Russia or China. Cyprus, the third smallest economy in the eurozone, needs to raise at least 1,8billion euros, equivalent to about 10% of its GDP, to recapitalize Cyprus Popular Bank by June 30th, due to a EUR3,65 billion loss stemming from Greece's recent EUR200 billion debt restructuring. According to IMF, Cypriot banks have outstanding loans or other money at risk totaling EUR 152billion, or eight times the size of the country's GDP. Fitch downgraded Cyprus's credit rating to BB+ from BBB- and now Cyprus's government debt is rated as junk by all three of the world's major rating firms due to the amount of capital Cypriot banks will need to cope with their exposures to Greek households and businesses. Fitch estimates that the top three Cypriot banks could need up to EUR4 billion in additional capital, which is about 25% of the nation's overall economy.

In Spain, euro zone's fourth largest economy, Moody's downgraded by one to four notches the long term debt and deposit ratings for 28 Spanish banks and two issuer ratings, following the downgrade of Spain's sovereign rating at one level just above junk status earlier this month. According to Moody's, banks have several links to the sovereign and Spain's reduced creditworthiness implies a weaker credit profile for Spanish banks. Among the downgrades, Moody's cut Banco Santander's long term rating to Baa2 from A3, Banco Bilbao Vizcaya Argentaria SA to Baa3 from A3 - just barely above junk status and Bankia, which asked for a bailout last month, to Ba2 from Baa3.

According to Economy Ministry, Spain has formally requested from European authorities an aid of up to 100 billion euros to recapitalize its banks, while the government has agreed with the International Monetary Fund the aid to go directly to the banks rather than big channeled through a Spanish government. The European Central Bank is poised to relax its collateral rules for central bank loans in a

bid to ease strains on commercial banks in Spain and the rest of Southern Europe and offset a possible liquidity squeeze caused by downgrades from credit rating agencies. European Central Bank's officials have broadly agreed to make more types of securities, including certain mortgage-backed and asset backed securities, eligible as collateral at its lending facilities, while details of the plan still need to be finalized.

In the meantime, Brazil and China will sign an agreement for a currency swap deal worth 60 billion reais of 190 billion yuan, which was discussed by leaders of the BRICS at a group of 20 summit in Meixo. The agreement marks the first step in a deepening trade between the world's two largest emerging markets and allows members of the BRICS group of emerging markets to pool resources

In U.S., consumer spending stalled in May, a sign that the biggest part of the U.S. economy may struggle as employment and wages slow down. Purchases were unchanged from last month after a 0.3% gain in April, according to the median of 75 estimates in a Bloomberg News Survey before Commerce Department figures to be issued ton June 29th. Manufacturing activity is weakening, while housing shows further signs of stabilization and a slowdown in payrolls and unemployment above 8% weaken consumer confidence. Signs of a slower U.S. growth and concerns over Europe's debt crisis pushed Federal Reserve last week to extend a program for keeping borrowing costs low.

SHIPPING MARKET

Freight market confidence, is waning as near term improvement in vessel earnings is under pressure from vessels' oversupply and the economic growth prospects for the emerging BRIC economies are under uncertainty. Under the current distressed freight markets, ship demolition is on an upward trend with firm secondhand buying appetite and reversed newbuilding momentum. Fears of a China's slowdown and a worsening of eurozone crisis have impaired investors' confidence in shipping with bankers seizing ships to protect the value of their loans to struggling shipowners. Overall, shipping market sentiment remains relatively positive for the offshore and LNG and largely negative for the dry bulk and tanker sectors.

As the shipbuilding industry hunts the prosperity of the freight markets through the placements of new contracts and vessels' oversupply, the International Chamber of Shipping, on behalf of the world's national shipowners' associations, at the meeting of Organization for Economic Co-operation and Development in Paris last week, called on governments to resume negotiations on a new global agreement to eliminate market distorting measures from shipbuilding. The International Chamber of Shipping said that it is a source of great disappointment that OECD has terminated three years earlier negotiations on a new agreement to eliminate subsidies and market distorting mechanisms in the shipbuilding industry. ICS believes that current poor markets are demonstrating just how seriously damaging the oversupply of ships has been to shipowners' revenues, with many companies now struggling to meet their operating costs. ICS reiterates concern about the overcapacity that exists in many shipyards, with an almost obsessive commitment to market share being displayed by the three major shipbuilding nations: China, Korea and Japan, where 90% of world tonnage is built. ICS Director of External Relations, Simon Bennett remarked: "Even if shipyards go bankrupt, it is likely that in many cases their governments will step in so that they can continue to produce ships which few people want, other than speculators who may be foolishly tempted by knock down prices."

In the **dry market**, capesize average time charter earnings have increased this week to more than $3,500/day, but remain below operating expenses, with supramax units outperforming among other vessel categories by earning more than $12,000/day. The BDI moved higher this week by breaking the psychological barrier of 1,000 points mark, but elevated worries for the second half of the year persist from the waning Chinese iron ore demand. May Chinese iron ore imports improved after April's decline, but weak June imports should result in declining volumes

Chiefs of top 40 mining companies, including BHP Billiton, Rio Tinto, Vale, Anglo American, Xstrata, Glencore, are bullish about demand from China and India, which is expected to boost global markets

worldwide, according to a Report from global consultancy PWC. It said that India would require huge increases in coal import to meet its growing power generation and for industrial needs, which would benefit dry bulk cargo demand. In addition, China's commerce ministry said that the nation's trade growth is improving, adding to a rebound in lending and signalling that a slowdown in the world's second- biggest economy may stabilize.

As spot cargo demand remains relatively low with falls in Chinese iron ore and thermal coal fixture activity, it is encouraging that bank lending continues to surge and stimulate economic growth as the first priority of Chinese government supporting several new construction projects. Overall, capesize and panamax markets will remain under significant vessel supply related pressure with supramax and handysize vessels gaining from grain and minor bulk cargoes' demand. Global demand for iron ore cargoes has begun to increase, while Chinese thermal coal demand remains low due to an increase in Chinese hydropower production.

Chinese steel inventories are showing a decline by falling to 95,9million tons of iron ore, 600,000tons less than a week ago, according to Commodore Research. The fall of Chinese iron ore port stockpiles brings hopes for a firmer spot cargo demand and boost of vessel earnings in the capesize segment. One more positive note is that Brazil-China iron ore trade has shown signs of returning to full strength this month with spot fixtures closing in on normal high levels. According to Norwegian Investment Bank DNB, spot fixtures into China from Brazil reached their highest level since November during this month, with total tonne-mile demand amounting to 20billion tonne-miles, while there is room for further expansion of Brazilian ore in the second half of the year, a pre-condition for a rise in capesize rates.

The BDI after staying unchanged at 978 points for three days at the end of previous week, it has now closed at 1,004 points for the first time since the end of May, up by 2.6% from last week's closing and down by 29% from a similar week closing in 2011, when it was 1,420 points.BCI has follows an upward trend with BSI continuing its firmness, while there is a softness in the BPI and a stability in the BHSI.

The highest rate increase has been in the supramax segment, BCI up 3% w-o-w, BPI down 6.1% w-o-w, BSI up 6.6% w-o-w, BHSI up by 1.9% w-o-w. Capesize average time charter earnings showed an increase of 12% from last week, panamax earnings are down by 6.1%, supramax are up by 6.6% and handysize up by 1.6%.

Capesizes are currently earning $3,988/day, an increase of $418/day from a week ago, while panamaxes are earning $7,835/day, a decrease of $510/day. At similar week in 2011, capesizes were earning $12,664/day, while panamaxes were earning $13,064/day. Supramaxes are trading at $13,145/day, up by $822day from last week's closing, 229% and 68% higher than capesize and panamax earnings respectively. At similar week in 2011, supramaxes were getting $13,728/day, hovering at 8.4% higher levels than capesizes versus 229% today's levels. Handysizes are trading at $ 10,414/day; up $167/day from last week, when at similar week in 2011 were earning $10,591/day.

In the **wet market,** the VLCC has shown a modest improvement with a slow start of July Middle East program with the forward supply of VLCCs in the Arabian Gulf increasing to 97 vessels from 88 on a weekly basis and owners holding a bullish position on firmer WS. Rates in AG-SPORE and AG-JAPAN have moved to WS 42 from WS 40 and WS 43 in WAFR-USG, WAFR-CHINA from WS 42.5 and WS 41.5 respectively. An increasing supply of suezmaxes in the Atlantic had a negative pressure with the WAFR-USAC route dropping 7.5 points to WS 62.5 from WS 70 last week and B. SEA-MED to WS 70 from WS 75. In the aframax market, CBS-USG route dipped to WS 97.5, down by 12.5 points week-on-week.

Under the current weak freight environment for tanker operators, the brent crude spot price and bunkering expenses continue their downward trend with IFO 380 prices closing again below $600/barrel. Bunker fuel prices in the Fujairah market have fallen to the lowest level in 16 months as falling crude oil prices weigh on bunker and cargo fuel premiums in the region. Prices for IFO 380 have now dropped to

less than $580/barrel, from more than $700/barrel at the end of January this year, with price sentiment persisting low from the highs seen during 2011 for all the grades of bunkering in major ports. “Crude oil is dropping so tanker owners are not buying as they want to see how much it can fall, so basically delaying demand”, according to a Fujairah based oil trader. Oil is on track to post its biggest quarterly fall since the financial crisis in 2008 as the euro zone crisis and weak growth in the United States weigh on the global market, while ample supply from OPEC has added to the downward pressure on prices. “This puts pressure on premiums as sellers want to sell but there are not many buyers around in Fujairah,” Fujairah based oil trader said. Another trader said tanker owners who normally lift 2,000 tonnes of bunker fuel were buying only a quarter of that in the hope of buying more at a lower price later. But traders say underlying demand is strong and expect buyers to return to the market soon to snap up cheaper fuel they still need. “These very low prices should eventually help the market strengthen actually because the demand has not disappeared,” a Gulf-based fuel oil trader said

Barclays Research said that China’s oil demand and OPEC production are lying behind the overall weakness. Chinese oil demand growth has averaged in the second quarter just 0.7%, the slowest growth since the first quarter of 2009, while OPEC production has remained above 31 million barrels/day for seven straight months, for only the second time since the 12 months starting from October 2007. In addition, Saudi Arabian oil production has stayed above 9,5 million barrels/day and close to 12 million barrels/day for 12 straight months for the first time ever. Under the current market fundamentals, weak Chinese oil demand, increase of US oil production, high OPEC production and slow economic growth from the financial crisis that results in overall lower oil demand, oil prices are expected to keep falling through 2013, trimming the profits of the world’s biggest petroleum companies.

“The biggest challenge facing major oil-producing countries is maintaining oil prices at $100 a barrel regardless of any changes the markets may face in times ahead,” said Walid Khadduri, former information director at the 10-nation Organisation of Arab Petroleum Exporting Countries (Oapec). "The pressing question now is the following: how do major oil producing countries deal with the decline in oil prices? Before answering this question, we must first note that the earlier rise in prices to the level of $128 did not realistically reflect market fundamentals of supply and demand,” he said in an article published by the Abu Dhabi-based Emirates Centre for Strategic Studies and Research. He said the main reason behind such high price levels was the fear of supply shortages caused by Western sanctions on Iran’s crude exports, the state of political instability in some other oil producing countries and rising demand for crude oil in emerging markets. “It is worth mentioning that a fair price at the current stage for both producers and consumers is about $100 a barrel. Thus, it is expected that oil-producing countries will target this price level and maintain it even though officials of the International Energy Agency believe that this price could hurt global economic recovery and seek a lower price range for oil.” “Opec is aware that in times of crises, as was evident during the Asian economic crisis in 1998 and during the global economic crisis of 2008 – it is very difficult to initially arrest falling oil prices because in such times oil-producing countries generally increase their production to compensate for revenue losses resulting from lower prices,” he added. “He said this brings down prices further. For example, prices dropped from their record highs of above $140 a barrel to $35 per barrel within a few months of 2008….this underscores the need for greater cooperation among Opec members during times of crises to reduce the possibilities of a sharp fall in prices which could harm the interests of every side.”

In the **gas market**, Japan’s recent movement to restart two nuclear reactors and bring an end to last year’s total shutdown of the atomic power sector brings worries for the recent euphoria of LNG rates. The total global LNG fleet is estimated to be at 372vessels (53m cbm) with a small percentage of overaged fleet, which adds pressure on the supply-demand balance due to limited potential scrapping activity. The LNG carrier market is expected to face a temporary supply demand imbalance around 2014 with fears that the recent euphoria may be a bubble from Japan’s robust LNG demand and the excessive ordering of 2011 will bring an oversupply and slump in rates. However, new supply projects in Australia, Russia, Africa and shale gas in North American region should help long term LNG demand fundamentals after 2015 with estimations that new LNG projects could result in a 50% increase in total LNG production by 2020. There is a factor of high risk behind the strong long term fundamentals that is the delays in new LNG export projects and the overflow of new vessels deliveries. The LNG fleet is largely being constructed by South Korean yards that they are likely to deliver ships on time, but if LNG

supply projects are delayed the LNG spot market will face again supply-demand imbalance and weak freight rates as the current orderbook of 74 vessels, 21% of the existing fleet, is scheduled to be delivered by 2015.

In the **container market**, the Shanghai Container Freight Index has shown a downward revision of 1.7% after two consecutive weeks of rise by ending on Friday 22nd at 1,425 with falls across the four major routes. Without General Rate Increases, rates in Shanghai-North Europe are now $1,549/TEU, down by 2.4% week-on-week from $1,587/TEU and $1685/TEU in Shanghai-Mediterranean, down by 2% week-on-week from $1720/TEU. In transpacific routes, Shanghai-USWC and Shanghai-USEC are moving downwards in the last two weeks with rates at $2,678/FEU and $3,808/FEU respectively, down by 2.2% and 0.7%. On the beginning of July, General Rate Increases should give a further push up in spot rates. Singapore's APL, the world's seventh largest carrier, has announced that it will impose general rate increase on the westbound Asia-Europe route by $500 per TEU starting July 1st. In addition, Germany's Hapag Lloyd, the world's fourth largest container shipping line, has announced a wide range of rate increases on its Far East Services to Central and South America to be effective on July 15th.

Despite the recent fall, the Shanghai Container Freight Index is standing 39% above from last year's levels of 1,025, while rates in Shanghai-North Europe and Shanghai-Mediterranean are 83% and 77% higher respectively from $845/TEU and $953/TEU in similar week's closing last year. There is also an upward momentum in transpacific routes with a 64% and 25.4% rise in Shanghai-USWC and Shanghai-USEC routes respectively, from $1,633/FEU and $3,034/FEU year-on-year basis.

Time charter rates are flat with no changes from May's levels, when they have reached $12,500/day for boxship units of 4,400 TEU and $8,150/day for 3,500 TEU, while they are still at or near operating expenses breakeven levels and well below from last year's levels, when boxship units of 4,400 TEU and 3,500 TEU were getting $25,000/day and $19,000/day respectively. Boxship chartering market is moving better for larger vessels than small ships with Maersk Line picking up a 2006 built unit of 5,527TEU for 12months at a suggested rate of $22,300/day, while Yang Ming is said to have taken a 2010 built unit of 6,570 TEU as a sublet for 10 months at a daily rate of $27,500/day. There is generally a high pressure on the sub-panamax segment with lines replacing them by larger vessels and getting rates in the region of $7,000/day for four to twelve months, when last year were getting region $15,000/day.

The recent upward movement of spot market is not yet secured for the long term as the issue of overcapacity seems not to have been resolved despite the slower growth of fleet, as per data from Alphaliner shows the global containership fleet had passed the 16m TEU mark last week with 772,000 TEU delivered so far in the first six months of the year and a further 30,000 TEU this week. The capacity delivered during this semester represents 5.0% of the global cellular fleet at the beginning of the year. Alphaniler also commented that it has taken the fleet 12 months to climb from 15 to 16mTEU, while it took nine months to climb from 14 to 15mTEU and nine months to climb from 13 to 14mTEU. The slower rate of fleet growth could be explained by the increased scrapping activity with 89 ships aggregating 163,000 TEU being delivered so far to breakers or decommissioned during the first six months of the year, compared to total deletions of 107,000TEU for the whole of 2011. Despite the high scrapping level, the capacity removed remains only a fraction of the new vessel deliveries with a further 670,000 TEU due to be delivered in the second half of 2012, posing a significant challenge for an industry that is still suffering from excess supply and estimations for lower scrapping removals due to recent drop of scrap price levels.

In the **shipbuilding industry**, China and Japan are facing serious low volume of business as vessels' oversupply and weakened performance of freight markets have diminished investors' demand for the construction of new tonnage from previous years. According to the China Association of the National Shipbuilding Industry, the total industrial output value of China's shipbuilding industry reached 240,6 billion yuan, $38,2 billion, in the first five months, but the growth rate is only 0.7% year-on-year. Chinese shipbuilders finished 22,53 million deadweight tons of shipbuilding orders in the first five months of this year, a decrease of 10.1% year-on-year, while new ship orders amount to 9,54million deadweight, a fall of 47.3% year-on-year.

In Japan, just six ships totaling 305,370gt were ordered from Japanese yards in May, which is down from the previous three-year low of 10 ships totalling 515,767gt ordered in April and down by a 43% year on year drop from the 551,270gt for 18 ships ordered in May 2011, according to Japan Ship Exporters' Association. During the recession in May 2009, Japanese yards clinched orders for eight ships totaling 141,880gt. In May Japan's yards won orders for one VLCC, one Aframax tanker and four Handysize bulkers. During the first five months of the year, 61 vessels of cumulative 2,99m gt, down by 34% year-on-year, were contracted for export.

In the **shipping finance**, bankers are still lending under the current weak freight market and worldwide economic uncertainties, but at reduced levels on concerns over Basel III requirements, falling asset values and limited US dollar funds. Loan-to-value ratios have returned to 50-70%, with current bank debt pricing at spreads of 300-500 bps. Global syndicated lending to the shipping sector slumped to $245m in the second quarter of this year from over $3.9bn in the second quarter of 2011, Thomson Reuters data showed, while the Norwegian bond market remains active and a potential source of capital for the shipping industry.

European lenders are reshaping their portfolios from fears of their exposure to sovereign debt crisis. Following last week's sale of French bank Societe Generale shipping portfolio to Citibank, Germany's second biggest lender, Commerzbank quits shipping citing uncertain market conditions and it will now focus on core business as it has also dismissed its plans to launch its new Real Estate and Ship Finance arm.

US lenders such as Citigroup and Bank of America Merrill Lynch seem to be active at the current limited dollar funding by signing with Sovcomflot a USD 140 million, 7 year loan Agreement to finance the construction of two very large crude carriers, which are currently under construction for delivery in 2013. The vessels will operate on long-term charter agreements with PetroChina International (a subsidiary of China National Petroleum Corporation - CNPC).

Sergey Frank, Sovcomflot President & CEO, said: "We are very pleased to welcome Citi and Bank of America Merrill Lynch to join the core group of Sovcomflot's lenders. This is the first time Sovcomflot has established a long-term relationship with two such prominent global financial institutions. I hope that this transaction demonstrates that SCF Group has continued access to debt capital to finance its investment needs throughout the shipping cycle. We look forward to further developing our partnership with Citi and Bank of America Merrill Lynch. SCF Group has a long history in the international financial markets and has been raising funds from international banks since the late 1980's. We are grateful to our financial partners for their ongoing support for the growth of our business."

In one more ship financing deal, Qatar Shipping, a subsidiary of Milaha (Qatar Navigation), has secured a ten-year $110m ship financing facility. The proceeds from the facility with Qatar National Bank will be used by Qatar Shipping to fund the ongoing construction of 19 harbour assistance vessels.

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