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MACRO TOPICS

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POLICY: YOU MAY DELAY, BUT TIME WILL NOT

China, Brazil and Greece are now having to take measures to correct past sins.

It took more time than anticipated, but the Chinese economy now seems willing to tackle the bad debt issue in the domestic banking system, with a loans-for-bonds scheme supported by the state, having provided around USD 100 Bn during the last couple of months. According to it, banks exchange short-term loans to local government companies for bonds with much longer maturities. In parallel, debt-to-equity swaps reached USD 152 Bn, forcing banks to accept equity in ailing companies and write off bad debt in exchange.

But recapitalising the financial system must have some limits, even for Beijing, as bad loans currently represent almost a fifth of banks' balance sheets. The pressure on local governments to finance public works taken with bank loans in the absence of municipal bond markets has been presented as successful by the central government. But since most debt-to-equity deals mainly refer to companies unable to pay back loans, global observers suggest that stability is undermined.

Analysts suggest that Beijing will have to add close to RMB 11 Tn of fresh capital to support the banking system, around 16 per cent of the gross domestic product. "Shadow financing", the banks' off balance-sheet lending that skirts regulations, hit about RMB 40 Tn last year, representing 59 per cent of GDP. Even though the majority of that is not distressed, its opacity causes difficulties in terms of regulating it and estimating its risk.

Moving to another BRICS country, the new government of Brazil has to quickly defuse fiscal "time bombs", as the country's budget is already strained. The plan to increase spending on education and pensions which would cause the gross domestic product to expand by 12 per cent will have to be postponed, if not abandoned completely.

During the last couple of years, Rousseff's government ran a 2 per cent primary fiscal deficit, effectively borrowing money to meet its interest payments, which are among the highest in the world. The benchmark rate is currently at 14.25 per cent, while the total budget deficit was about 10 per cent. The country's gross public debt increased from 51.7 per cent of GDP in 2013 to 66.5 per cent last year. Moreover, including other liabilities and the most probable need to recapitalise the state-owned Petrobras, public debt could reach 80 per cent of GDP.

The Temer government would need to dedicate up to 6 per cent of GDP, by cutting public expenses or establishing new taxes, to start posting a primary fiscal surplus of around 4 per cent of GDP. The plans to double spending on education from 5 per cent to 10 per cent of GDP and to grow the cost of the pension system by 7 per cent of GDP during the next decade will most probably have to be adjusted.

Elsewhere, Greeks will see another legislation on tax increases taking effect on 1 June, including a one percentage point rise in the main value added tax rate to 24 per cent on foodstuffs and consumer goods. Moreover, property tax was restructured to increase revenues from larger buildings.

In parallel, a privatisation agency will be set up, allowing Greek banks to make deals with international funds on restructuring and selling non-performing loans. The new privatisation agency would have a 99-year remit to develop and sell a much bigger portfolio of state-owned property than the current fund set up in 2010, which faced difficulties in disposing state-owned companies and infrastructure organisations.

GAS: DEVELOPMENT IN THE EAST MED IS DEEMED KEY FOR EU GAS IMPORTS

The EU has set its sights firmly on the East Med, including Cyprus, with its increasing appetite for gas.

There is a fast growing gap between domestic natural gas production and demand in Europe, with an ever increasing desire to diversify its supply sources. During a press conference, Jakub Adamowicz (European Commission Spokesperson for Transport) stated that the East Mediterranean gas finds could play a very important role in helping both producing and neighbouring countries to address energy security problems, and that bringing new gas to the EU from a vulnerable region such as southeastern Europe is of key importance.

One of the crucial components that will promote growth in the area and help improve energy infrastructure are the projects of common interest (PCIs). The PCIs are authorised by a simplified procedure and will gain financialsupport from the Connecting Europe Facility (CEF). In 2015, the East Med pipeline project was designated EUR 2 Mn in funding from the CEF and is proposed to link Cyprus to Crete and then mainland Greece or Italy. The second PCI program to link Cyprus with the EU was proposed in late 2015 and is currently awaiting funding.

Cyprus is keen to bolster its existing 4.5 Tcf reserves by launching a third licensing round based on the huge interest by international companies. In total, three blocks are up for grabs (6, 8 and 10). Geologically the blocks contain similar lithology and carbonate structures to the Zohr discovery in Egypt. Prior to this discovery a lack of exploratory drilling had occurred in these reservoirs. The carbonate Zohr structure has now encouraged Total to reassess its geological data previously collected in its blocks in Cyprus (10 and 11), having now extended its licence by another two years, with plans to drill exploration wells later this year. As always though there is a continued political debate, with Southern Cyprus keen to press ahead with its development plans, while Northern Cyprus has declared that there should be no development until a new federal government is installed.

Elsewhere in the region, after long delays Israel has now approved a deal that it hopes will help fast track the development of the huge Leviathan offshore. Energy Minister Yuval Steinitz announced a deal that will give the state some flexibility in changing some fiscal parameters but offers enough stability to the Leviathan partners. After being discovered in 2010, the government hopes that this will be the final hurdle that has halted its potential in exporting gas to the worldwide market. This agreement will also see a wider positive feedback with the exploration sector set to increase once more as many companies have been waiting to see how the government acts before investing in new offshore endeavours.

Sources: Forbes, Natural Gas Europe

DRY CARGO: CHINESE FINGER TRAPS AND THE MARKET THAT SHOULD NOT BE

Chinese iron ore imports are continuing to rise as stockpiles build, but is there fundamental support?

The latest AIS data tracking iron ore shipments into China suggest a modest increase in imports compared to April's official customs figures, with an expected 86 Mn tonnes in May, an approximate increase of 2 Mn tonnes month-on-month.

This robustness is maintained as a result of the sustained output levels of China's numerous steel mills, many of which have increased output as a result of the optimism, and subsequent price gain in various steel products, surrounding talk of increased infrastructure expenditure and improvements in the Chinese construction sector. The 2-month futures driven boom which saw large funds, as well as retail investors, scramble to buy steel contracts has however died down significantly, returning to levels last seen in early March.

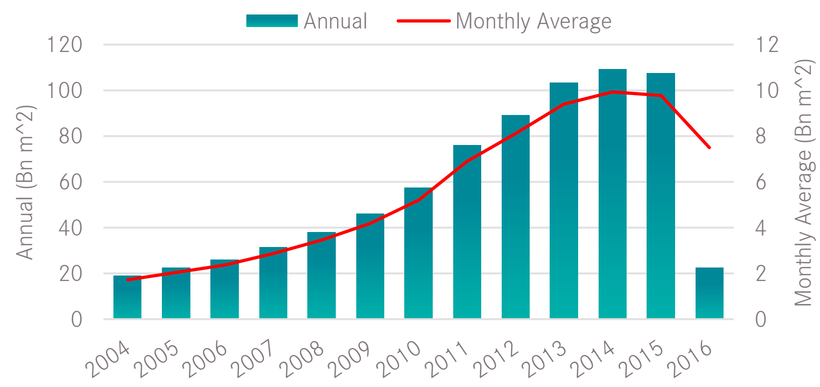
While an increase in regulatory constraints and oversight measures introduced in April initiated the gradual calm in futures activity, the fact that the underlying economy is still in distress is something which the market is coming to terms with. The Chinese construction sector has experienced a marginal increase in investment with regards to residential buildings, but as a whole the construction sector is contracting, with the number of square meters under construction in April falling 4.2 per cent year-on-year from 8.29 Bn to 7.94 Bn. This is part of a broader trend that captures the extent of the Chinese slowdown.

Why then do Chinese steel mills continue their relentless production, further exacerbating their own lack of profitability? The answer most likely lies in the socio-economic consequences and dreaded political unrest that closing the unprofitable capacity would lead to. Propped up by increasing amounts of debt, much of the Chinese steel industry as a result has been kept alive far beyond the point where a free market economy would have resolved the issue organically.

In some ways the current situation can be likened to that faced by a child encountering the Chinese finger trap for the first time. The initial reaction is one of resistance and increased effort, much the same as China's official reaction to the slowdown of its economy with promises of more growth and higher output to compensate for weaker demand. However, as with the novelty puzzle, if China is to succeed in returning its industrial sector to a sustainable equilibrium, it needs to ease its grip on the unprofitable operations. This does not solve the social issues involved in making millions redundant, but it is the only way out of the current gridlock. As it stands now from an economic perspective, Chinese steel is the industry that should not be.

For the shipping sector this is not all bad news as it supports medium term iron ore demand, but for the longer term it creates a false sense of security. The supply side issues are far from resolved, and the consequences of an overly optimistic health check with regards to the red dragon may very well have the effect of prolonging the current dry cargo situation.

China: Area Under Construction (m^2)



Sources: Affinity Research, Bloomberg, Reuters

CONTAINERS: MI NOMBRE ES PANAMÁ

The new project announced in the Latin American country depicts the sector's importance for the region's economies.

Autoridad Maritima de Panama awarded the construction and operation of a new container terminal at Colon to the Chinese consortium Panama Colon Container Port (PCCP). The agreement for the container terminal, able to handle Post-Panamax vessels, is estimated to be worth close to USD 900 Mn.

This would be the fourth container terminal on the Panama Canal's Atlantic terminus. Apart from the construction of a container terminal with a capacity of up to 2.5 million TEU, the plan includes additional private lands with multipurpose possibilities, including LNG facilities and other energy projects. With four berths, the Colon container terminal will have a total quay line of 1.2 km pier with a depth alongside of 16 metres. This is expected to be a significant addition to the Evergreen-led Colon Container Terminal, the SSA Marine-led MIT Terminal at Manzanillo and the Hutchison-run PPC Cristobal Container Terminal of the Panama Ports Company. In reality, this is a single port, with the Atlantic docks and piers on the Panama Canal traditionally considered as three independent ports: Colon (known as Coco-Solo), Manzanillo and Cristobal.

The construction will begin later during the current year, once approved by the Panama Ministry for the Environment. This is not the first time the development of a new box terminal at Colon Margarita Island has been proposed, but this time seems to be the correct one. Earlier efforts were unsuccessful due to the slow world economy and the shipping downturn.

With limited details on the setup of the Chinese developers' consortium available so far, the PCCP group is believed to include Landbridge Group, based in Shandong, which already controls part of port of Darwin, Australia. China Communications Construction Company, the Chinese giant civil engineering contractor and project developer, will build the terminal at Margarita Island, with the design to be done by the Beijing-based Port Design Institute (PDI).

The duration of the construction is scheduled to last for 33 months, with the launch expected somewhere in mid-2019.

Even though the port will be equipped to handle up to ultra-large container vessels, it is believed to mainly focus on Neo-Panamax ships. With a capacity of between 9 and 13.5K TEU, this is the new class of Panamax vessels which will just fit the expanded Panama Canal. The new terminal will cover 40 hectares and it will be developed together with an adjacent logistics park.

Of great interest, Margarita Island is not the only container terminal development in Panama. A similarly large-scale terminal is being developed at Corozal, on the Pacific terminus on the Canal. In parallel to that, the capacity and capability of the Colon Container Terminal has been increased by recent upgrades.

Sources: Alphaliner, WorldMaritimeNews

TANKERS: IN IT FOR THE LONG HAUL

Strong demand from China and supply outages provide hope for traders and debt-fuelled storage.

Nigeria has been displaced as Africa's largest exporter of crude oil as the militant attacks take their toll on production. But the Niger Delta Avengers have shown little intention of slowing their attacks, issuing further threats to oil majors operating in the country.

According to Emmanuel Ibe Kachikwu, the Group Managing Director of Nigerian National Petroleum Corporation, output has fallen to just 1.4 Mn bpd from 2.2 Mn bpd. It is Nigeria's lowest level of production in 20 years. This fall in output, coupled with the unpredictable outages in Canada, Libya and Venezuela, have all contributed to the oil prices' recent gains.

About 2 Mn bpd are estimated to have been taken out of the market by these outages, fuelling optimism that a rebalancing of the market is in the midst of a rebalance, aided by strong demand from China.

Last month, China imported 7.96 Mn bpd, resulting in an average of 7.46 Mn bpd for the first four months of the year. Imports of Russian oil hit a record in April, according to China's General Administration of Customs. China imported 1.17 Mn bpd of Russian oil last month, a 52.4 per cent year-on-year rise, and a 3.4 per cent rise on the month. The previous record was in December, during which 1.13 Mn bpd was imported.

By contrast, Chinese imports from Saudi Arabia fell by 21.8 per cent on the year, down to 1 Mn bpd. However, on the month it was still a rise of nearly 65,000 bpd. China's independent teapot refiners remain the key driver of growth.

Iraq has also been a significant contributor in satisfying their appetite; imports of Iraqi oil is also up, by 11.25 per cent year-on-year to over 760,000 bpd. Over the first four months of the year, Iraqi imports were up 10.24 per cent.

Iran continues to offset this though. Its surging exports are expected to continue their rise this month by an estimated 60 per cent on the year.

Moreover, there are concerns about the volume of floating storage and how traders continue to borrow from banks to fund it. The practice is currently unprofitable; Morgan Stanley estimates that the one-month Brent storage arbitrage currently produces a loss of USD 0.48 per barrel, while the six-month arb is producing a loss of USD 6.11 per barrel. Debt-fuelled storage is likely to raise concern should expectations of a rise in prices prove false.

Sources: Reuters, Bloomberg

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