AFFINITY

MACRO TOPICS

19 June 2017

POLICY: MACRON'S SECOND VICTORY

… and ECB's new terms and conditions on the "Emergency Liquidity Assistance"

The majority in the parliamentary elections has been won by French President Macron, allowing him to proceed with the reforms to reinvigorate his country's economy and restore influence in Europe. Together with the centrist ally Modem, his party now controls 355 of 577 seats, according to the latest results. In contrast, the outgoing government of the Socialist party now only holds 34 of their 284 seats. Marine Le Pen's far-right Front National won its first ever seat in parliament, which is still below the target of 15 seats allowing it to form a parliamentary group providing access to top roles in the assembly. Turnout, however, was at a record low of 43 per cent.

In the meantime, the European Central Bank published new terms and conditions surrounding the "Emergency Liquidity Assistance", the emergency help provided to Eurozone banks, following the criticism regarding the lack of transparency in its past decisions. Since the increased scrutiny over its provision of ELA since the Greek debt crisis, the ECB was committed to clarify its decision-making process in the case of a lender requiring additional support. The ECB once again stated that ELA would be provided to banks facing "liquidity problems, where, in either case, such operation is not part of the single monetary policy".

But any requests for ELA are considered a task for the Eurozone's 19 national central banks instead of the Frankfurt-based ECB, with national central banks responsible for the costs of providing the funds while having to inform the ECB of the size, maturity, currency, and collateral against which ELA is provided. During the Greek debt crisis back in 2015, the ECB withdrew its ordinary funding for domestic lenders following the election of the Syriza government, adding critically more pressure to Greek banks. ELA is considered a more expensive form of central bank funding for domestic banks. According to Transparency International, there are some questions to be answered regards the process of providing ELA during the Greek crisis.

Requests for ELA should always be considered by the Eurozone-member country's national bank, exactly as happens around the world. No other central bank has the power to take any decision for supporting part of the union, e.g. the US Fed could not decide in favour of an ejection of a state from the Union. Additions to the ECB's terms suggest that any bank to receive ELA has to provide a "funding plan within two months following the first provision of ELA and for as long as the institution is receiving ELA", in parallel to monthly updates on its capital levels.

If the assistance for any bank or country exceeds EUR 2 Bn, then the ECB's executive board will judge whether or not the lifeline is affecting its separate monetary policy operations in the Eurozone. With a majority of two-thirds, the ECB's Governing Council could provide a ceiling or prevent ELA if it is in breach of the Eurozone's ban on monetary financing.

Source: Financial Times

CRUDE OIL: EXPECTATION VS REALITY

There is a disconnect between market fundamentals and market sentiment.

The divergence between market fundamentals and sentiment appears to be widening with each passing day. Oil prices have started the week on a low note after a slew of data and updates, all of which have contributed to bearish sentiment on the supply side. The US rig count rose for the 22nd consecutive week, while both Nigeria and Libya are in more optimistic moods about their short term production.

Yet both Libya and Nigeria are highly susceptible to conflict-imposed disruptions to their production. Tensions in the Niger Delta have risen again lately, with a spate of new attacks on oil infrastructure, and now militants have banded together and demanded that all 'northerners' leave the area by 1 October, and to return all oil blocs to locals. The newly-formed *Coalition of Niger Delta Agitators* are threatening to attack all oil wells belonging to northerners should their demands not be heeded.

Libya's National Oil Corporation, meanwhile, has announced that it has reached a deal with German firm Wintershall to immediately restart operations which will release around 160,000 bpd of production. By the end of July, Libya could be producing 1 Mn bpd. However, the political climate remains so volatile and unpredictable that any increase cannot be guaranteed.

Nevertheless, the market appears to have ignored these threats to production, and has continued to price in potential gains. The reality is that the market is already, if not soon will be, in balance. The cut deal has already removed more than 1.8 Mn bpd from the equation, while it has emerged that Chinese crude production was just 3.83 Mn bpd in May, down by 60,000 bpd on the month and 3.7 per cent on the year; May's output is its lowest since records began back in 2011.

Yes, the US is pumping out more oil than it has done since 2015, but output has only risen by under 400,000 bpd since the turn of the year. At the same time, production from the likes of Canada and Mexico have declined since the beginning of the year, further offsetting the gains in the US. Moreover, BP's latest annual energy market report has revealed that global crude oil production grew at its slowest pace in 2016 in seven years, rising by just 400,000 bpd, which equates to 0.5 per cent. Throw in the 1.8 Mn-bpd reduction at the beginning of this year, and supply over the past 18 months has markedly declined.

On the other hand, demand is showing no signs of letting up, rising by 1.55 Mn bpd or 1.64 per cent, according to BP's report. Despite concerns over AFVs (alternate fuel vehicles), the IEA believes that oil demand growth will continue beyond 2040. Chinese crude oil demand continues to defy market fears by continuing its strong rise. In May, crude imports rose by 13 per cent on the year to average 8.8 Mn bpd. The IEA forecasts that Indian oil demand will account for 5 per cent of growth this year, rising by 200,000 bpd.

As for oil prices themselves, pessimistic sentiment has pervaded the market to such an extent that it appears to drive prices almost exclusively. Perhaps once inventories are below last year's levels, the fundamentals will once more become the focus.

Sources: OilPrice, Reuters, MarketWatch, FT

GAS: GAS OUTPACES NUCLEAR, NOT JUST THROUGH PRICES

Political influence and fake news is helping to drive nuclear out of the US.

Usually any slowdown in nuclear power creates a perfect path for natural gas to gain market share, particularly during this period of low fuel prices. Overall in the last few years there has been a worldwide spate of declining nuclear power generation, even if you excluded those shuttered via stringent rules since the Fukushima incident.

The new wave of shuttering is simply occurring due to pressure from natural gas leading to some plants closing far earlier than expected. The three-mile island Nuclear plant, home of the 1979 accident, has threatened to close after five years of losses as it struggles to compete with generating stations burning natural gas. Elsewhere in the US, five plants have closed in less than four years with a further six more scheduled to shut within the next five years.

Fake news has also help spread the anti-nuclear rhetoric. The American Petroleum Institute has broadcasted anti-nuclear commercials, pushing fear of increasing electricity prices and radiation to the public. Nuclear already has a bad reputation so any slight bit of negativity in the public domain will go a long way. Somewhat ironic is the fact that that, in reality, it is natural gas that emits more radiation than all the nuclear plants in America combined, let alone coal plants. Once more this is without taking into account the carbon emissions.

Whilst natural gas prices have decreased in the US, production continues to climb. This has been helped by falling CAPEX and OPEX prices but, importantly, it has been these low prices that have spurred on new customers. Natural gas companies are now aggressively investing in marketing themselves to new customers and situating themselves in politically stronger positions.

Cheaper prices may not be so good for the long run but they can quickly force out competitors. The demise of nuclear will be an extremely lucrative market share for natural gas to uptake. Any help given so far to nuclear firms such as the subsidies offered in New York state are swiftly taken to court by the owners of natural gas plants, who say that the subsidies offer unfair advantages

Politics driven by public outcry have also helped to spur the decommissioning of nuclear plants. The new President appointed in South Korea is now seeking to diminish the impact of nuclear and drive the change through renewables and natural gas. One positive side of utilising gas over nuclear is that gas plants can support intermittent power, allowing growth of the renewables sector.

Sources: Reuters, Forbes, Bloomberg

DRY CARGO: COAL AS A CUCUMBER

How air-conditioning and the summer heat in China can affect freight rates.

Sweltering summer heats and prolonged hot spells have a significant effect on a nation's energy consumption. In China, the increased residential air conditioning such heat causes, combined with low water levels limiting available hydroelectric power, has encouraged energy companies and policy makers to look to coal. As seen last year, such a seasonal spike in energy demand can play a significant role on the thermal coal market, and this year is no exception. Increased buying has lifted futures for delivery in September to a premium of 6 yuan over October contracts, reversing the 4 yuan contango seen at the start of the month.

The low reservoir levels at hydroelectric plants in the south of China is potentially quite important for shipping, as coal is the only viable substitute. The coal market has taken notice, with prompt coal prices for cargoes out of Newcastle Australia rising 18 per cent since mid-May to USD 84 per tonne.

It looks then like the start of a rally, if last year's situation would repeat itself. The Chinese restriction on working days in mines caused a significant shortage, which sent prices for both coking and thermal coal soaring, resulting in increased demand for imports of both coal and high grade iron ore, which requires less coking coal per tonne in the refining process than what was available domestically. This carried the market at the end of 2016. However, while we would all like to see a repeat of that rally, it would appear that Chinese policy makers are now better prepared to deal with the potential consequences of this sort of demand surge.

The National Development and Reform Commission (NDRC) said last Friday that China will allow some coal mines, provided they meet certain requirements, to increase their capacity in an effort to secure sufficient supplies for the summer. The conditions on which the permits to increase capacity will be allowed include safety requirements and a good track record, and will be available to both open pit and underground mines. For instance, mines that have previously been required to cut capacity by the government will not be eligible to apply.

The question for shipping will then be how well Chinese regulators will be able to assess their actual demand, and how well their domestic mining industry will be able to meet it. Miscalculations have been the norm rather than the exception, as the working day restrictions have clearly, and rather dramatically, highlighted. Judging therefore whether China's import demand will remain steady, increase or diminish will be tricky, and will depend on the timing of the additional supply. Prices will however be a good indication of this balance, yet it should be noted that some of the Chinese price rally stems from the recent news by the country's securities regulator that it would support investment by wealth management companies in the commodities sector. While one would like to think that China has complete control over the sector it attempts to actively manage, this has rarely been the case. What can be said however is that these developments are a likely contributor to whatever volatility can be seen in freight rates over the coming months.

Sources: Affinity Research, FT, Reuters

CONTAINER: BRAZIL'S TRADE IMBALANCES CAUSING TROUBLE

...as a significant recovery is not expected any time soon.

Brazil's economy and trade are becoming tricky issues to deal with, not only for the country's citizens and politicians, but for some of the major liner operators as well. Most recent data suggest that South America's largest economy is now stabilising but will probably not return to levels last seen before the 2014 financial crisis until 2020.

The scandal involving the country's President, Michel Temer, recently recorded to allegedly endorse bribes, increased fears regarding the future of his ambitious reform programme to restore fiscal health to Brazil. But even if Temer faces a criminal investigation, investors look like supporting the reforms. Since the scandal, approximately USD 1.1 Bn has been invested in Brazilian equities, the highest level in five years. The benchmark Bovespa equity index moved above its lows of last month's shock, while government bond prices and the currency have improved significantly. Inflation stands at a decade low of 3.6 per cent, while the central bank cut interest rates at the end of May.

In terms of liner shipping, the country has to face a fundamentally serious issue for its economy and for its exporting companies. The shortage of reefer containers servicing the southern part of Brazil is linked to freight rates doing better in countries nearby. Even if the country is one of the world's most important agricultural nations, liner companies, such as Maersk Line, MSC, Hamburg Süd, and Hapag-Lloyd, were forced to move several of their reefer equipment to other regions in Latin America. The main reason has been the higher rates achieved elsewhere.

The situation has been worse for ports in the states of Rio Grande do Sul and Santa Catarina, where some of the country's major producers are located, exporting frozen meats and fruit to Europe and Asia. The lack of reefer containers since January seems to have had an impact on Latin America's biggest and most modern container port facilities at São Paulo's Santos terminal. As a result, the region's warehouses are already utilised to capacity, with limited space left unoccupied.

Without doubt, an important reason behind this story has been the massive consolidation among the largest liner operators, with fewer carriers to select from. Moreover, as their activities are improvingly organised, especially after Hanjin's collapse, there are less and less containers left empty in the region. Several ports such as Santos, Paranagua, Itapoa, Navegantes, Itajai and other ports in Rio Grande have been losing money due to the lack of container capacity.

JBS and BRF, the major food producers of Brazil, together controlling almost half of the country's reefer cargo volumes, managed to negotiate rates at such low levels, due to their enormous market share, at around USD 1,200 for a FEU container. This led to many carriers deciding to shift much of their container capacity to countries such as Chile, Peru, Ecuador, Costa Rica, Argentina, and South Africa to take advantage of higher rates.

In the meantime, due to its rather slow economic recovery, fewer empty containers have been calling at Brazil, transforming the country from a net importer to a net exporter in 2017. The imbalances in the trade equilibrium together added reasons to the lack of equipment from space on ships to containers to expand. Slowing down imports from Asia could last for two and half years or more, which could support the lack of space and empty containers.

Source: Financial Times, ShippingWatch

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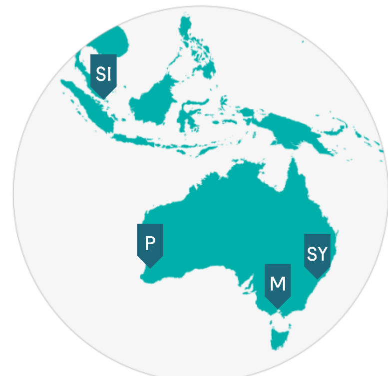

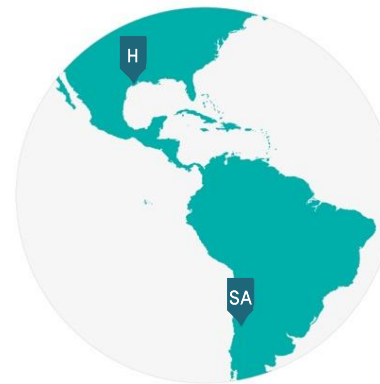

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