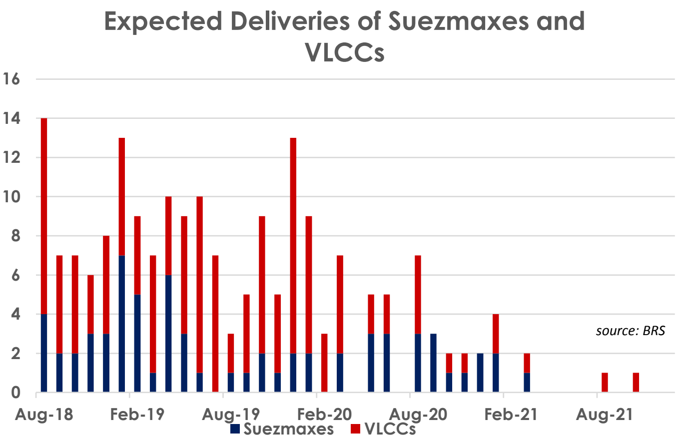
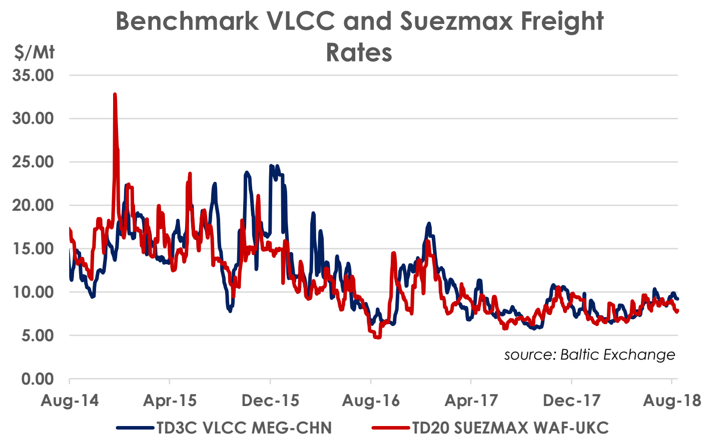
Cannibilisation Continues!

Late last year this *Newsletter* looked at how the 'cannibilisation' of east to west middle distillate trades by newly delivered Suezmax and VLCCs was impacting LR and MR tanker markets. We concluded that this trend was likely to continue for the foreseeable future driven by owners' desire to immediately relocate their carriers West of Suez and as Atlantic Basin middle distillate markets tightened. Evidently, this trend has continued into this year, with 5 VLCCs and 4 Suezmaxes so far voyaged or en-route between Asia and the Atlantic Basin. This week we take another look at cannibilisation and ask whether it is here to stay and where does it go from here?





Persistently poor freight rates. Crude tanker markets have remained in the doldrums for much of the last two years with owners looking wherever possible to extract more value from their vessels or to save money. This is one of the driving factors behind the chartering of newbuild crude carriers to transport products on their maiden voyage as market intelligence suggests that the rates for these vessels are very low, barely covering bunker costs.

Asian refiners playing their part. One of the drivers of cannibilisation has been the shifting Asian refinery landscape. Over the past decade, Chinese refining capacity has soared fueled by soaring domestic oil demand growth. However, over the past couple of years, China's oil demand growth has slowed. This has seen Beijing loosen the handcuffs on domestic oil companies and permitted them to export excess refined products. Accordingly, Chinese diesel exports have soared over the last 18 months and recently exceeded 400 kb/d. Considering that the majority of these new refineries are located near the Eastern seaboard and are of a scale which can easily produce large parcels of product, this makes chartering a newbuild crude carrier an attractive proposition. However, it is not only Chinese middle distillates which have been shipped to the Atlantic basin in this fashion. Shipping data suggests that most vessels have been firstly part-loaded in China and then 'topped off' in Korea or Singapore or in the most recent case with product from India and the Middle East.

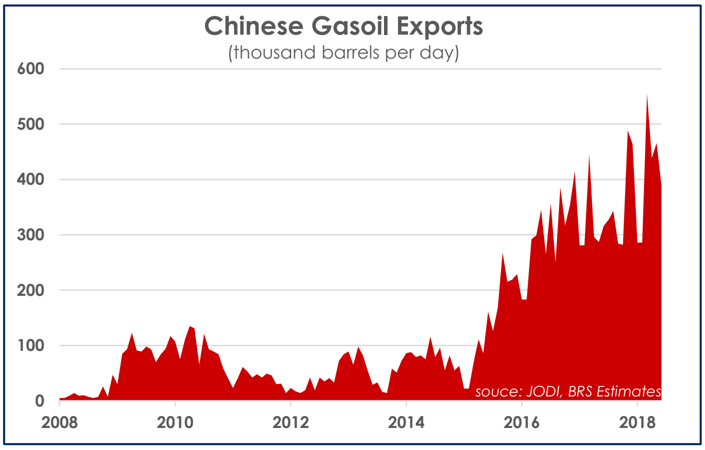
Complex logistics. There are very few destinations where a newbuild VLCC can directly discharge due to the need for a deepwater port with sufficient storage capacity. Many of the clean VLCCs which have sailed to the Atlantic Basin over the past year have lightered a portion of their cargo offshore West Africa onto MR or LR-sized vessels. These smaller vessels have then sailed into West Africa or even the US Atlantic Coast. The VLCCs have then proceeded to Rotterdam where they have discharged the remainder of their cargo.

Negative impact on smaller product carriers. A VLCC can replace 3 LR2 voyages which would normally carry products between Asia and the Atlantic basin. A laden LR2 voyage from Dalian to Rotterdam takes 38 days via…

... the Suez Canal. Thus VLCCs taking such voyages is depriving the LR2 market of a significant source of long-haul trade which ties up tonnage for a long time (especially considering a ballast or back haul to Asia). Clearly, this is one reason why LR2 markets have struggled so far this year to garner steady upward momentum.

Prospects for the shorter-term. We anticipate that cannibilisation will continue for the remainder of this year and into next year bearing in mind our expectations that crude tanker markets will remain extremely challenging for a while yet. Additionally, Atlantic Basin middle distillate markets remain tight with inventories unlikely to build strongly over the next few months. Thus traders are likely to continue to look outside the region, and especially East of Suez markets, for additional supplies. Looking into next year, there will be an incentive to build gasoil stocks with IMO2020 on the horizon. This could see the price mechanisms drawing product into the Atlantic Basin from Asia improve significantly. Additionally, BRS data suggests that there remain 14 Suezmaxes and 28 VLCCs to be delivered from Asian yards this year while next year 30 Suezmaxes and 70 VLCCS are due to be launched. Therefore, there will be no shortage of candidates to ship clean products westwards.

Prospects for the longer-term. When looking at China's ambitious refinery capacity expansion plans over the next couple of years and our projections that demand growth there will continue to slow, we fully expect that Chinese product exports will steadily increase going forward. Meanwhile, considering the stiff competition in Asian middle distillate markets, our expectation is that Chinese exporters will increasingly focus on the Atlantic Basin. *Ceteris Paribus* this should mean that economies of scale will continue to make the transportation of products by large newbuild crude carriers an economic proposition. However, obtaining a willing vessel could become more difficult due to three factors: Firstly, deliveries of VLCCs and Suezmaxes are set to fall from their peaks posted over the last few years. Secondly, our expectation is that Middle Eastern crude production will rise going forward which will likely see more vessel owners seek to initially position their newbuilds in the Middle East Gulf rather than the Atlantic Basin. Finally, if crude tanker rates rise significantly above product tanker rates, owners may decide not to take a clean cargo on their maiden voyage due to the extra time taken to load, discharge and then ballast to a crude loading zone.



The LR3 to become a more permanent fixture on tanker markets? Although more VLCCs then Suezmaxes have carried clean products between Asia and the Atlantic Basin so far this year, the chances of coated VLCCs (an LR4) becoming a regular fixture on clean tanker markets looks slim due to the expensive logistics outlined previously. However, the LR3 (a coated Suezmax) looks a more viable prospect. According to data from BRS, there are currently 11 LR3s trading. However, nine of these are currently trading dirty with the remaining two being used for semi-permanent product floating storage. Our expectation is that the LR3 will become a more common sight on the water, especially as the middle distillate net-import requirement of Europe is projected to soar in the wake of IMO2020. However, the economics supporting such vessels will need to fall into place. For instance, there is currently no back haul route for these vessels to triangulate with. Thus unless large-scale west to east gasoline or naphtha trade was to become more attractive, the front haul route would have to compensate for a costly and time consuming ballast leg back to Asia. Indeed, according to AXSMarine's AXSTanker, an unladen Suezmax would take 49 days to ballast between Rotterdam and Dalian. Thus we anticipate that, at least for the moment, these vessels would only permanently trade clean when freight rates would adequately compensate for the ballast leg.

This week's market pointers ↑↓

Benchmark crude oil prices have weakened over recent days on concerns that the ongoing trade war between the US and its trading partners will toll on the global economic outlook and as leading economic indicators appear to suggest that global trade volumes have fallen since the start of the year. Accordingly, ICE Brent had retreated towards $70/bbl and was last trading at $71.30/bbl. In the US further downward momentum came from crude stocks builds with regional benchmark NYMEX WTI falling steadily to last trade at $65.80/bbl.

US crude spared from Chinese import tariffs. Last week Beijing decided to leave crude oil off the latest list of US imports which it will impose higher tariffs upon. However, considering that neither the US or China are backing down in the ongoing 'tit for tat' trade war, we remain cautious and still expect US crude to be added to the list at some point in the near future. Indeed, considering the current destinations of recent US crude exports (which are still subject to change), it appears that no crude has been loaded for China since late July. This suggests that Chinese firms have already been instructed to halt their US crude imports and that once cargoes which are already enroute to China have cleared customs, the higher tariffs may be applied. Last week's list included higher tariffs on imports of refined products, LNG and coal with these 25% tariffs slated to come into effect on 23 August.

***Force majeure* at Reliance's Jamnagar refinery.** Reports suggest that gasoline production and exports at Reliance Industries' 660 kb/d Jamnagar has been placed under *force majeure* following a problem at the plant's fluid catalytic cracker (FCC) unit. If proved correct, it is likely that exports will fall over the coming days which could potentially hit clean tanker demand in the region. According to AXSMarine, over 50% of exports from Jamnagar are carried on LR-sized tankers and head to destinations in Asia and Europe. Meanwhile, smaller MR2 tankers carry products into East Africa and the Middle East.

Tanker demolition continues apace. However, Bangladesh, rather than India, is now moving towards the front of scrapping with three VLCCs at anchorage waiting to be beached in the country. According to reports, Pakistani breakers are reticent to accept tankers despite the recent lifting of the ban on demolishing tankers in the country. In comparison, Turkey is falling from vogue as the Lira remains in the midst of a crisis which has seen its worth plummet by 45% so far this year. Elsewhere, very little scrapping is taking place in China as Beijing moves ahead with a ban on the import and demolishing of foreign tankers.

No movement on the EU Ship Recycling Regulation. As of 31 December 2018 large commercial seagoing vessels flying the flag of an EU Member State may be recycled only in safe and sound ship recycling facilities included in the European List of ship recycling facilities. This list includes 21 facilities. However, none of these have experience of demolishing large commercial vessels. Moreover, an EU-based yard has never demolished a VLCC. This suggests that the EU-based shipping industry may soon be a great disadvantage versus their competitors abroad unless they flag their vessels elsewhere (which most operators already do).

Crude tanker markets remain difficult. Most publicly listed tanker companies have now released their 2Q results, with very few companies posting positive earnings. However, many companies are remaining positive for the future citing robust scrapping activity, especially among larger vessels, and healthy global oil demand growth. Many also mention IMO2020 on the horizon and the expectation that their preparations will help them compete favourably versus their competitors.

In its latest Monthly Oil Market Report, the International Energy Agency kept its estimate of global oil demand growth for this year unchanged at 1.4 mb/d with it projected to accelerate to 1.5 mb/d in 2019. However, it cites the downward risks to oil demand from an escalation of 'trade disputes' and persistently high oil prices. Meanwhile it assesses that compliance with the OPEC-led supply pact has slipped to 97% following the recent relaxing of output cuts. On the refining side, the IEA estimates that 2Q18 global refining throughputs rose by 2 mb/d year-on-year. OECD commercial stocks continue to trend below historical averages, although a slim month-on-month rise in inventories was reported at end-June.

More shippers continue to look at scrubbers and LNG propulsion ahead of IMO2020. This week, German-based container liner Hapag Lloyd announced that it will retrofit three of its vessels with either scrubbers or LNG-propulsion systems as pilot projects ahead of IMO2020. The company owns 226 vessels which burned 2.2 million tonnes of bunker fuel in 1H18. It already has 17 LNG-ready vessels in its fleet, the largest of which can carry 17,000 TEU.

Seaborne Crude Exports[1] for Selected Countries for week ending 10 August 2018 Million barrels per day	12-month rolling average	4-week rolling average	latest week (10 Aug)	change from previous week
Algeria	0.44	0.39	0.39	-0.03
Angola	1.49	1.19	1.41	-0.14
Gabon	0.19	0.16	0.10	-0.12
Iran	2.14	2.12	1.96	-0.18
Iraq	3.35	3.25	2.87	-0.54
Kuwait	1.77	1.89	1.90	-0.06
Libya	0.84	0.65	0.72	-0.08
Nigeria	1.91	1.91	1.82	-0.08
Qatar	0.61	0.64	0.65	0.04
Saudi Arabia	7.08	7.39	7.30	-0.11
UAE	2.00	1.86	1.78	-0.17
Venezuela	1.46	1.34	1.42	0.02
Azerbaijan[2]	0.77	0.80	0.77	-0.03
Kazakhstan[3]	1.10	1.13	1.19	0.09
Russia[4]	3.31	3.46	3.21	-0.21
Oman	0.84	0.82	0.79	-0.06
Sudan	0.10	0.08	0.22	0.12
Brazil	1.00	1.10	1.18	0.06
Colombia[5]	0.49	0.52	0.62	0.15
Mexico	1.06	1.09	1.08	-0.02
Canada	0.26	0.25	0.22	-0.03
US	1.49	1.69	1.41	-0.26
North Sea[6]	0.99	0.83	0.91	0.08

[1] *does not include pipeline flows*

[2] *adjusted for Turkmenistan re-exports*

[3] *does not include volumes exported via the Atasu - Alashankou pipeline, includes volumes exported via Russian ports*

[4] *does not include volumes exported via the Druzhba or Daqing ESPO Spur pipelines*

[5] *Does not include volumes re-exported via US ports*

[5] *Only includes volumes exported outside of UK or Norway*

Oil counted as exported when a vessel exits national territorial waters, includes volumes built on vessels over previous weeks

Data are subject to revision

Latest Crude, Refined Product and Bunker Prices and Freight Rates