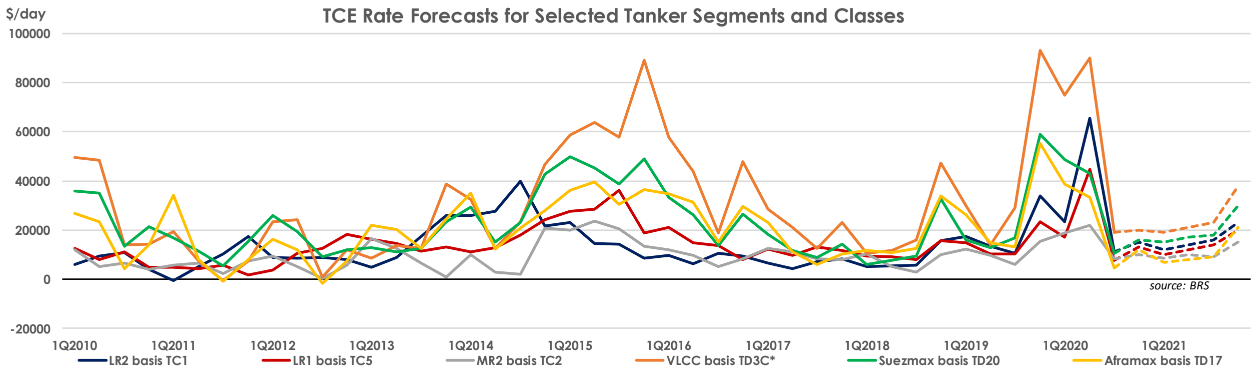
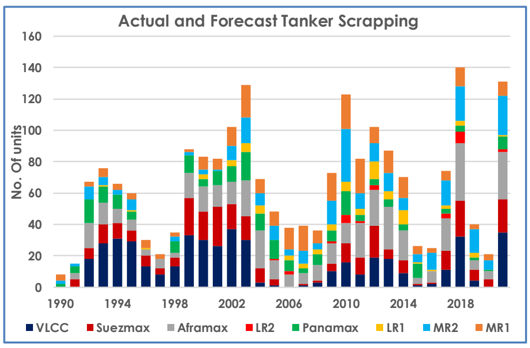
Short-term negative, long-term positive

Exactly six months ago we titled an article in this *Newsletter* 'Short-term positive, longer-term negative' in which we argued that despite then-stellar returns, tanker markets would be facing a prolonged downturn as of 2H20. Evidently, with hire rates for many segments and trades now plumbing multi-year lows this projection has been proved correct. Accordingly, we now project that tanker markets are potentially facing twelve months of low returns. However, looking to the long-term we believe that this period of low returns may help to sow the seeds for a sustained period of higher rates post-2022. This week, we outline the theory behind this statement.



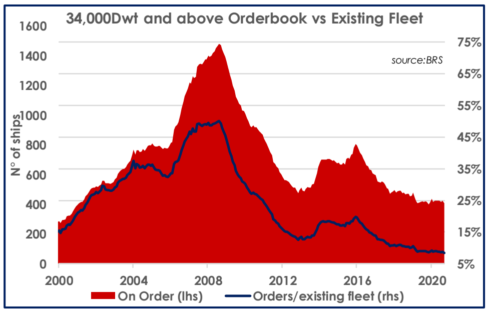
The global economy moves out of the doldrums. As outlined in our *2021 Oil Market Outlook* included in the September *Alphatanker Oil Market Monthly Monitor*, we project that global oil demand will only return to pre-Covid-19 pandemic levels in 2H22. In turn, this implies that tanker demand will likely remain low for the next two years. On the positive side, ss stated in *Alphatanker Weekly Newsletter* dated 17 July 2020, we do not believe that oil demand has peaked, nor do we project that the Covid-19 pandemic will cause oil demand to peak during this decade. Accordingly, moving into the period from 2023 onwards, we project that oil demand will resume its previous trajectory so that over 2023-30 growth is projected to average 0.75 mb/d. This suggests that once the Covid-19 pandemic passes, there will be growing demand for oil tankers. Furthermore, considering our forecast for refining to shift ever eastwards, we expect more ton mile demand as more long-haul trade between the Atlantic and Pacific Basins as crude is shipped west to east while products will move in the opposite direction.

Low returns and regulatory pressure to increase tanker demolition. This year has seen scrapping remain firmly in the doldrums with only 14 tankers of above 34,000 Dwt scrapped and although we project this to rise to 21 units by end-2020, this will still be the lowest level of scrapping since 1997. As we move into 2021, we project that interest in scrapping will surge. Much of this will be 'pent-up' scrapping held over from 2020. Owners are generally unwilling to scrap their older units during the third quarter as history suggests that the fourth quarter is normally characterised by seasonally stronger hire rates. However, this year is different as we do not project stronger rates towards the end of 2020 due to a combination of lacklustre tanker demand, amid bloated oil inventories, and significant fleet-side pressures as vessels are released from floating storage duties. Furthermore, we believe that a significant volume of older tonnage (>15 years old) tonnage will be pruned from the fleet next year due to the requirement to fit expensive ballast water treatment systems (BWTS) at their next dry docking. We understand that some of these vessels have been given a temporary stay of execution due to the Covid-19-related problems with crew changes and dry docking but these temporary waivers should only permit owners an extra few months before they must decide whether to fit the BWTS or scrap the tanker. All told, we believe that there will be…



…an uptick in vessels being sold for demolition during 4Q20 with these then hitting the beach early in 2021. Furthermore, we expect the interest in demolition to be maintained throughout 1H21. Accordingly, we currently project that 131 tankers of over 34,000 Dwt will be scrapped in 2021, the second highest level ever after 2018.

Regulatory uncertainty translating into a smaller tanker orderbook. The other part of the future supply equation is that tanker ordering has dropped off a cliff over the past couple of years so that the orderbook versus the existing fleet ratio now stands at a 31-year low. Firstly, this was driven by a period of low returns for owners but recently the uncertainty over future regulations has led owners across the whole shipping spectrum to hold off ordering new ships. The major uncertainty is how shipping is going to achieve the International Maritime Organisation's ambitious targets of cutting the average carbon intensity of shipping by 40% by 2030 with this then increasing to a reduction of 70% by 2050 which will be accompanied by a goal of a cutting shipping's total greenhouse gas emissions by 50% by the same date.



Tanker owners on the fence. It is noteworthy that the IMO has yet to publish a roadmap of how these ambitious goals will be achieved and is unlikely to do so until 2021 at the earliest. This leaves owners in a state of flux over what type of propulsion to order for their future vessels with several solutions being touted including ammonia, batteries, hydrogen, methanol and LNG. Of these, today, only LNG is a commercial solution for the wider tanker fleet and even then, LNG bunkering infrastructure remains at a nascent stage. Furthermore, LNG has regularly been touted as the fuel of the future but considering that it only cuts CO_2 emissions by around 20% compared with oil-based marine fuels, and considerably less when methane slip is taken into account, it is now starting to be viewed as of more as a 'bridge' fuel rather than the fuel of the future with shipowners having one eye on its zero carbon alternatives. Considering that an LNG-propelled vessel costs around 20-30% more than a conventionally propelled vessel, this is a risky investment for an owner to make as over the ship's lifespan, the IMO could introduce policies such a carbon tax which would penalise fossil-fuel powered vessels versus their zero carbon-emitting brethren. It is for this reason that almost all LNG-propelled tankers afloat and on order are backed by long-term time charters. Indeed, this elevated risk is one reason why owners are content to sit on the fence and hold off ordering for now.

Potential supply gap. The upshot of a looming resurgence in demolition against the backdrop of an extremely low orderbook is that there is the potential for tanker fleet fundamentals to tighten as tanker demand increases post-2022. Using the VLCC fleet as an example, assuming that 52 units are delivered between today and end-2021 and that a record 35 units are scrapped in 2021 (a forecast based heavily on the fleet's age profile), the fleet is projected to contract by 0.6% in 2021. Indeed, this is behind our forecast for a short-lived, modest uptick in rates in 4Q21, although this will likely be unsustainable given that tanker demand is forecast to decline seasonally in 1Q2022. Thus, owners will have to wait another year for a sustainable uptick which will then be driven by the tighter fundamentals. Evidently, this forecast depends on many factors, not least the discipline of tanker owners in ordering, although bearing in mind newbuilding delivery times, if orders are not placed soon, firmer future fleet fundamentals seem inevitable. Furthermore, we expect that newbuilding prices still have a way to fall before they reach rock bottom and it will be interesting to see whether low prices ultimately tempt owners to order. However, we reiterate that due to the uncertain regulatory environment which potentially impacts the amortisation of an investment, this newbuilding cycle is unlike any other experienced over the past 30 years. We also suggest that ordering will not exit its current slump without charterers help, as during this uncertain, transitional period they need to back tanker owners willing to invest in more-expensive alternative propulsion with long-term time charters thus reducing owners' risk. Indeed, this may be the only way which charterers may be able to avoid a sustained period of high freight rates.