Shipping + C-Virus Update

I've received a number of emails over the last week asking whether I think now is a good time to get back into shipping stocks.

My longer-term bullish thesis on the shipping industry is based on basic supply and demand. Factors such as (1) IMO2020 regulations will pinch supply into foreseeable future (2) that supply is already tight with a historically low order book, aging fleet, and tight financing to fund new builds (3) trade wars and the secular trend from globalization to regionalization which is leading to new less efficient trade routes in the interim (read: greater distances traveled = less available supply).

All while demand continues to steadily grow along with global GDP.

None of this has changed since I first wrote it up back in March 19'.

So why then are shipping stocks, such as our prior positions in STNG, DHT, and EURN, plus many others, down 20-30+% over the last month?

Here's what I think:

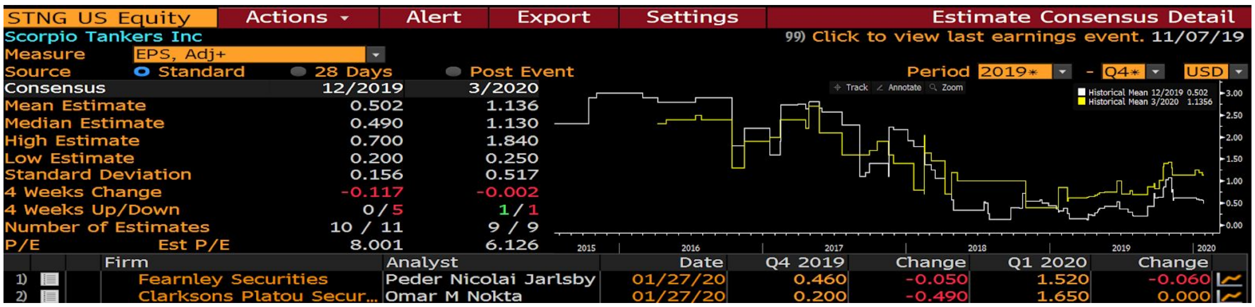
1. **Sentiment/expectations got hot too fast**
2. **Seasonality**
3. **Coronavirus**

We'll start with the top and go down.

Going into the end of the year I became bothered by the cottage industry that had sprung up on FinTwit to espouse how bullish on shipping they were. It's like the uranium bulls that sprung up in 18' or the TSLAQ community who still persist today.

Typically when you're long a stock you don't want a crowd of people cheerleading it, especially when you have a difficult time finding reasonable dissenters.

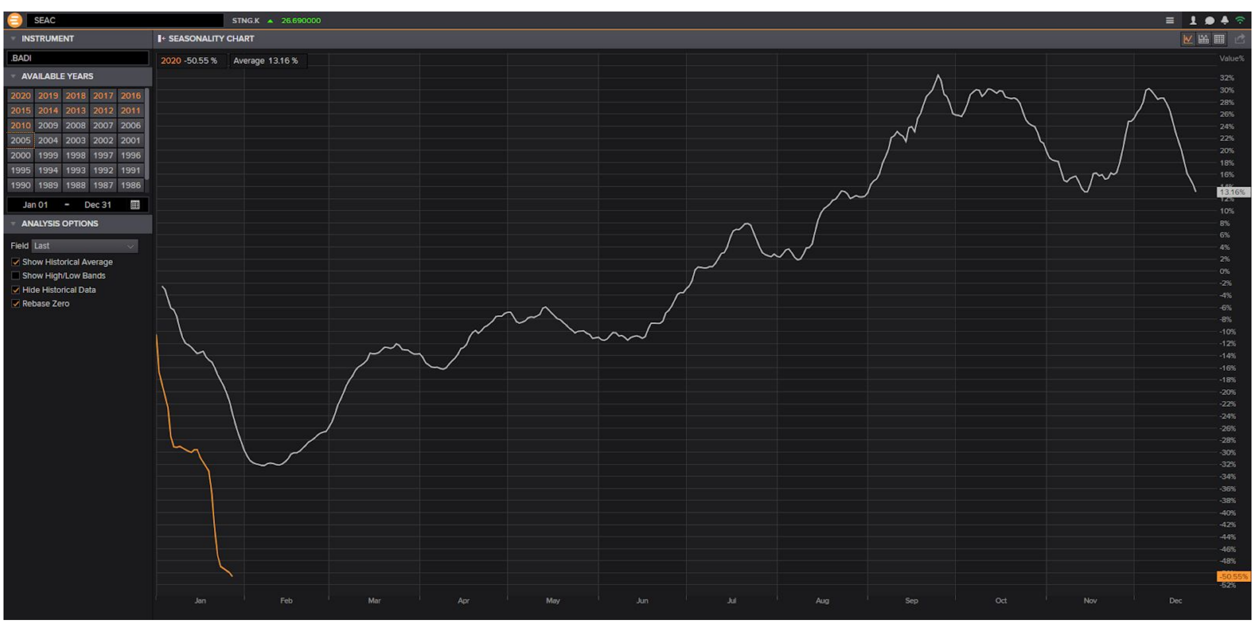
And while general sentiment is often a difficult thing to measure, earnings estimates give us hard quantifiable evidence. And here we saw bullish analysts return to the space, revising guidance higher, after a long hiatus.



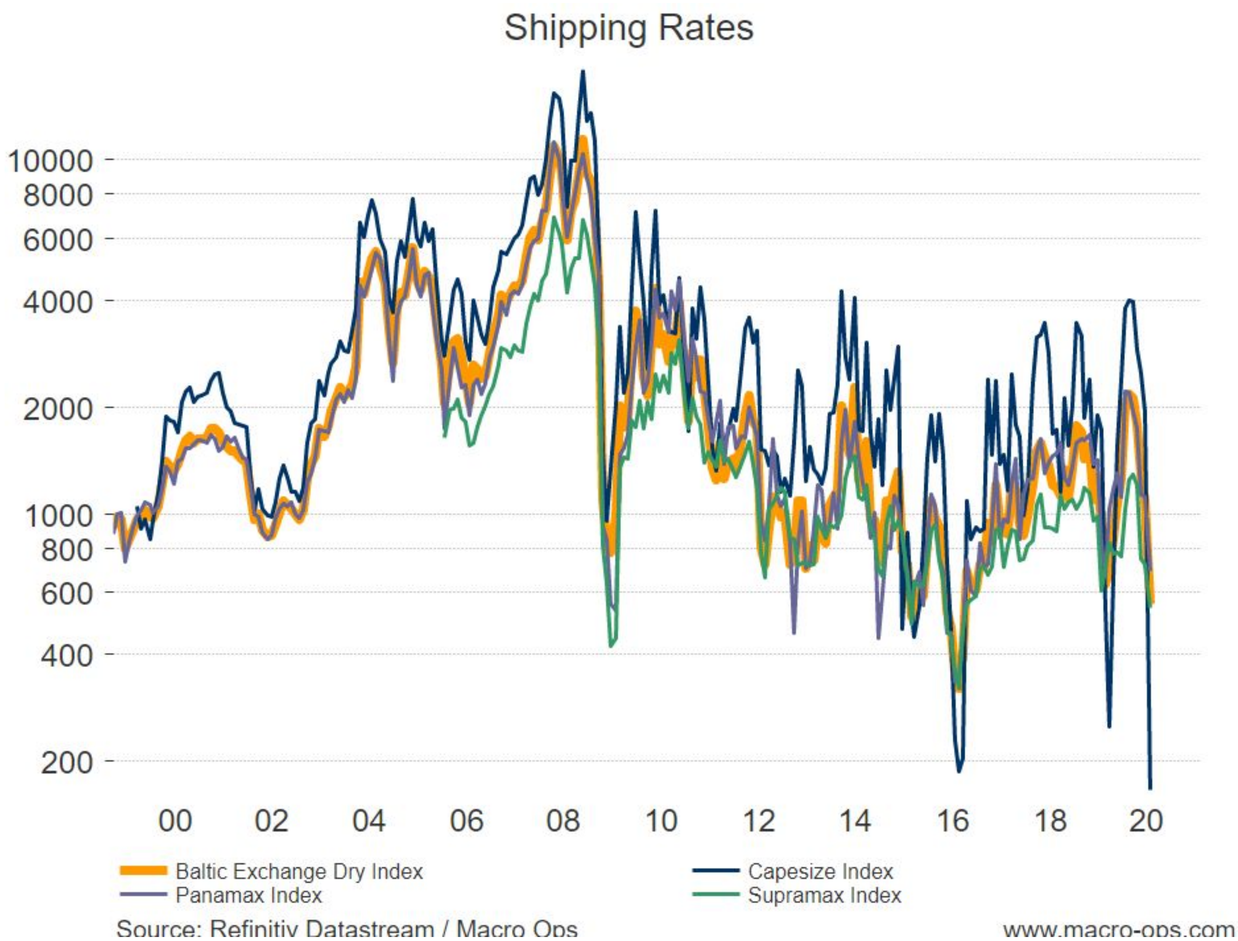
This led to a critical build-up of weak hands and that is now getting properly washed out.

Seasonality.

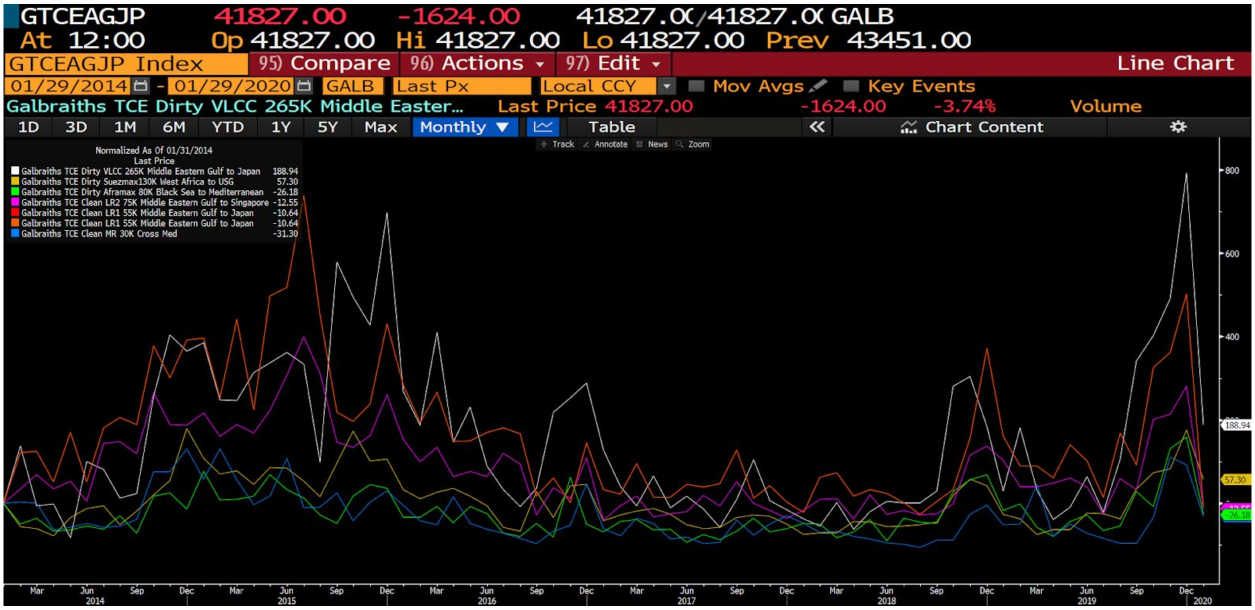
The beginning of the year is always bad for shipping. Below is the seasonality for the Baltic Dry Index (BDI). There's a number of reasons for this such as the Chinese New Years (typically in Jan/early Feb) driving front-loading going into the end of year. A few people, myself included, thought IMO2020 would dampen this seasonality effect somewhat. That was the wrong take.



In fact, the turn in rates has been more pronounced than usual. The BDI is back near multi-year lows.



Charter rates have collapsed from their end of year highs for various ships.



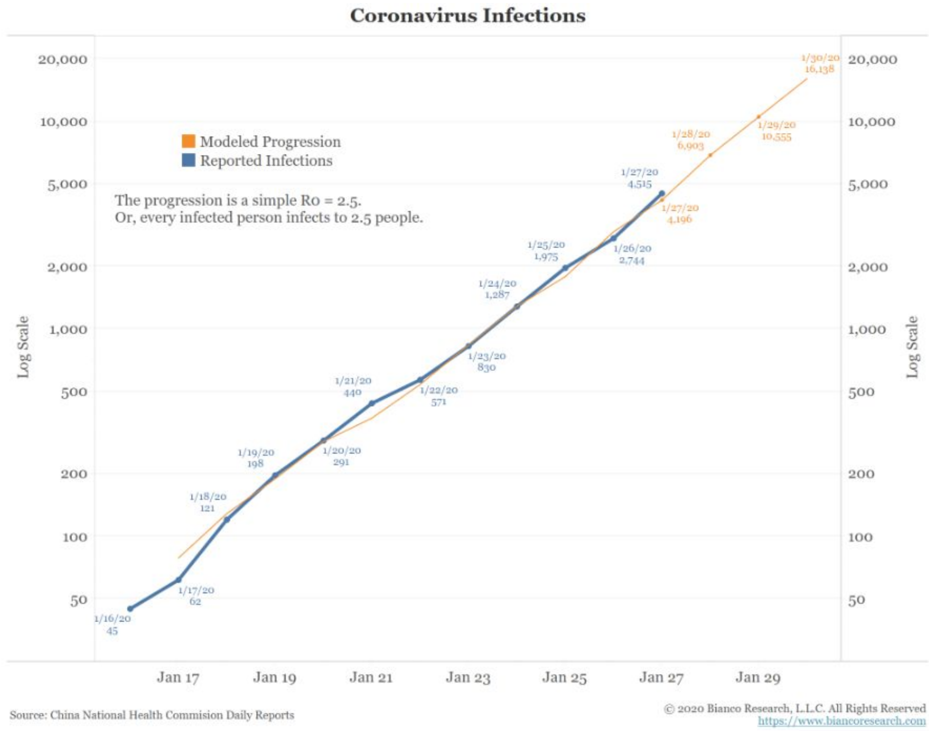
Seasonality should begin to work in shippings favor starting in a few weeks. But, regardless, this weakness isn't a great start.

Which brings us to our third reason: **the coronavirus.**

I've been talking to a number of people over the last few days about this. I reached out to an old college buddy of mine who's an actual epidemiologist and have spoken with a few fellow MO members who are based out of China/Hong Kong. Here's the quick skinny on what I've gathered so far.

The coronavirus has a high contagion rate. On average, each carrier infects 2.6 others which puts it roughly in line with influenza. There's also speculation that the virus can be transmitted while the carrier is in the incubation period — meaning they have no symptoms.

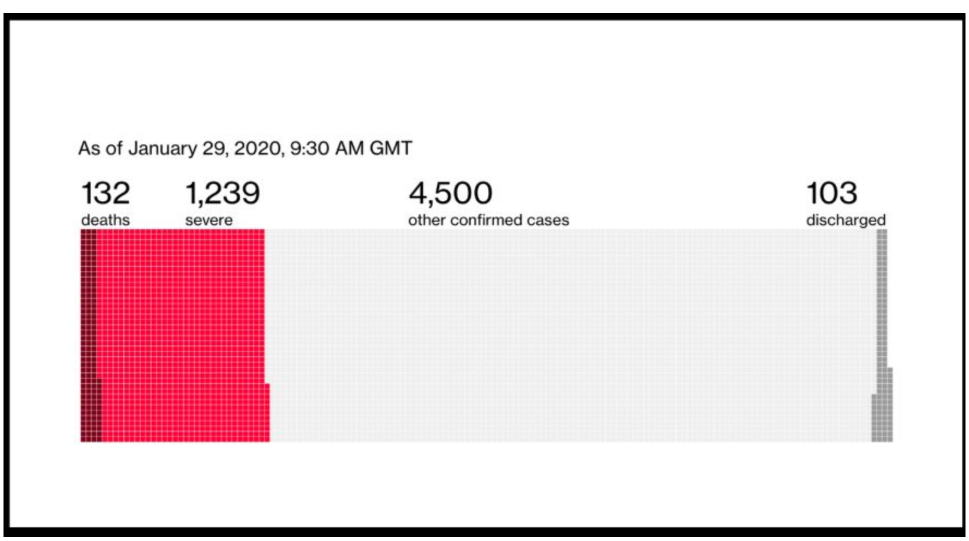
This makes for a geometric growth rate. Bianco Research recently suggested that "this type of growth rate would suggest 80,000+ infections next Monday and 138 million by February 20.
To many, such a geometric progression is alarming (see the tweet immediately above). Chart below is from [Bianco Research](#).



The good news is that it has a low fatality rate. According to Bloomberg, the coronavirus appears to kill approximately 2% of people who contract it. To put that in comparison, SARS kills roughly 10% and Ebola over half.

But this low fatality rate and the general mildness of the virus' symptoms actually work to make it more viral, since it's often difficult to detect and distinguish from the flu or a bad chest cold.

The official numbers state that there's 6,000 confirmed cases around the world.

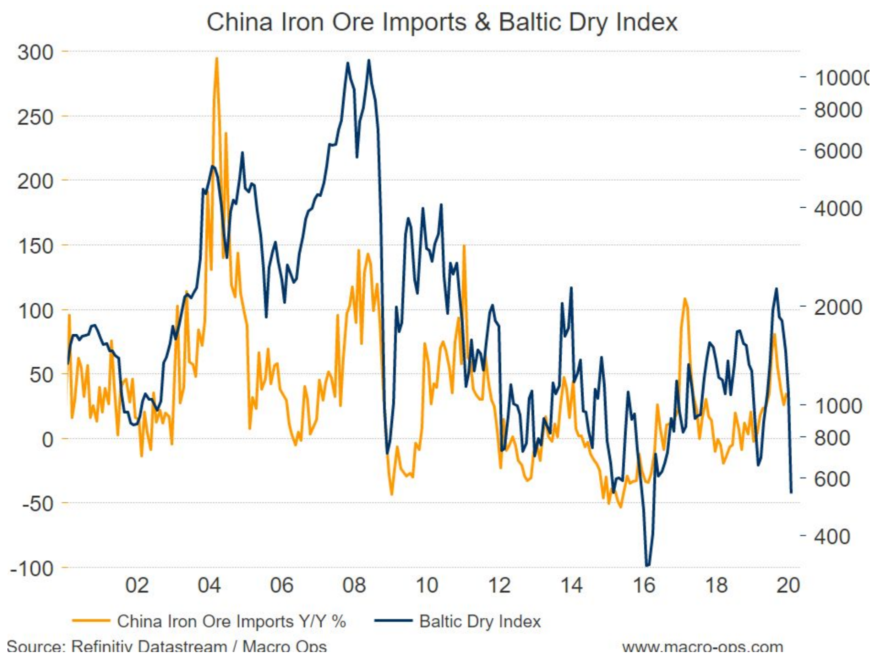


But I've talked to three people now who are on the ground there or have family in China and they're telling a very different story, which seems to confirm a much higher infection rate that's in the 15k-25k range.

There's no way we can know for sure but then again it's not like China doesn't have a long history of making up their numbers. So I'd error on the larger size.

Anyways, why could this matter for shipping and markets in general?

Well, China is the largest consumer of the world's commodities. They make up over half of global demand for a number of key commodity markets. This is why the BDI tracks China Iron Ore imports so nicely.



S&P Global Platts wrote in a recent report that "in best case, it drops by 900,000 b/d in February and 650,000 b/d in March. Crucially, both scenarios are assumed to be short-lived… Therefore, we assume the impact will fizzle out by June -July." But… "In a worst case, due to travel curtailments, demand drops by a massive and almost catastrophic 2.6m b/d in February and 2m b/d in March."

That's the problem with this virus — besides the obvious horrible human toll — is that it drastically widens the cone of probabilities for a number of markets.

For instance, the coronavirus began accelerating around early to mid-January. That just happens to be around the time when copper, oil, and shipping stocks began selling off.

This brings us back to our original question: are shipping stocks a buy here?

Well, if authorities are able to contain the coronavirus' growth then I'd say absolutely — though I'm waiting for the charts to tell me this selloff is done, first. If not, then we probably have bigger things to worry about.

Barring a viral pandemic, the larger bullish shipping thesis still stands.

After years of being in a painful downcycle, the order book is near multi-decade lows (read about how Capital Cycles work here).

Shipping companies still have very limited access to capital as most banks have killed their loan desks to the industry over the last 10-years. Furthermore, capital markets are enforcing a bit more capital discipline which is keeping a lid on newbuilds and instead shifting focus to the resale market.

And considering that, there's once again incredible value to be had in the space.

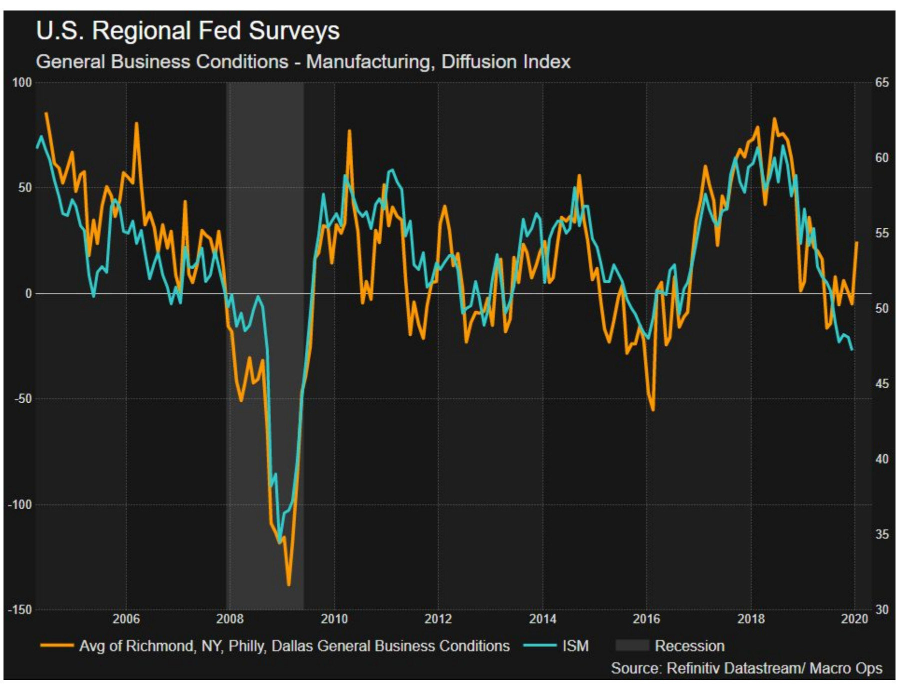
Take Euronav (EURN) for example. Following its recent 20+% haircut, the company now has a market cap of roughly $2.2bn.

My conservative back of the envelope math has them doing anywhere between $230-$250m in EBITDA this quarter and expect they'll produce well north of $2.50 a share in FCF this year, which would give them a FCF yield above 25% at current prices.

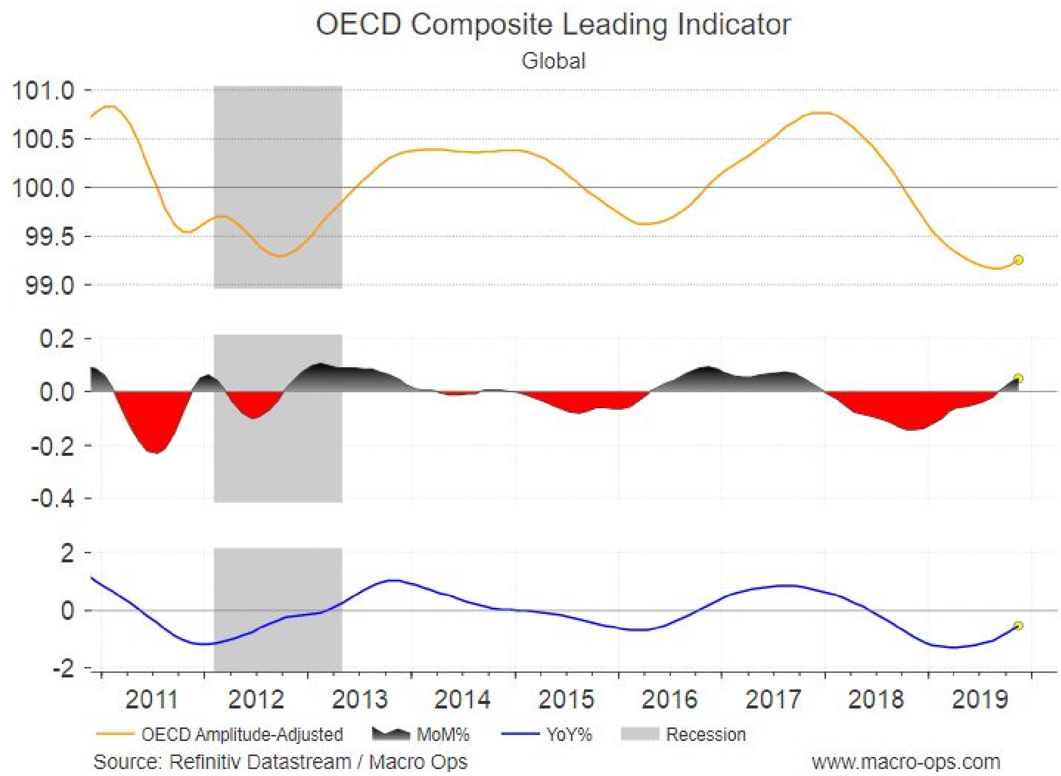
Not too shabby, especially considering the company is going to begin paying quarterly dividends targeting 80% of Net Income this year. They report tomorrow so I guess we'll soon find out how far off my estimates are.

Oh, and I forgot to mention, as long as the coronavirus doesn't go viral then the bottom in global growth that we've been pounding the table about over the last year, looks to have finally arrived and we should be seeing dramatically better econ numbers in the months ahead.

Take the US ISM for example. Our Regional Fed Surveys index, which leads the ISM, points to a strong upwards inflection business conditions coming soon.



The Global OECD CLI is back to trending up on an absolute basis.



So what I'm going to do is watch the charts of my favorite shipping plays (STNG, EURN, DHT, LPG) intently over the coming weeks and will put positions back on when setups arrive.

I'm hoping they sell off a little bit more along with the market on this second leg down that I'm expecting. But that might be me being too hopeful and they could very well rip higher on earnings. We'll see.

Your Macro Operator,

Alex