

The PCTC Midsize Crisis

Although it will take time before the full implications of the UK's exit from the EU are known, there can be little doubt that European economies will be disrupted over the next 12-18 months as the UK grapples with both the terms of its exit and its status as a trading partner moving forward. The prospect of another European economic slowdown comes just as the major European economies were building some momentum in their drawn out post-2009 recovery.

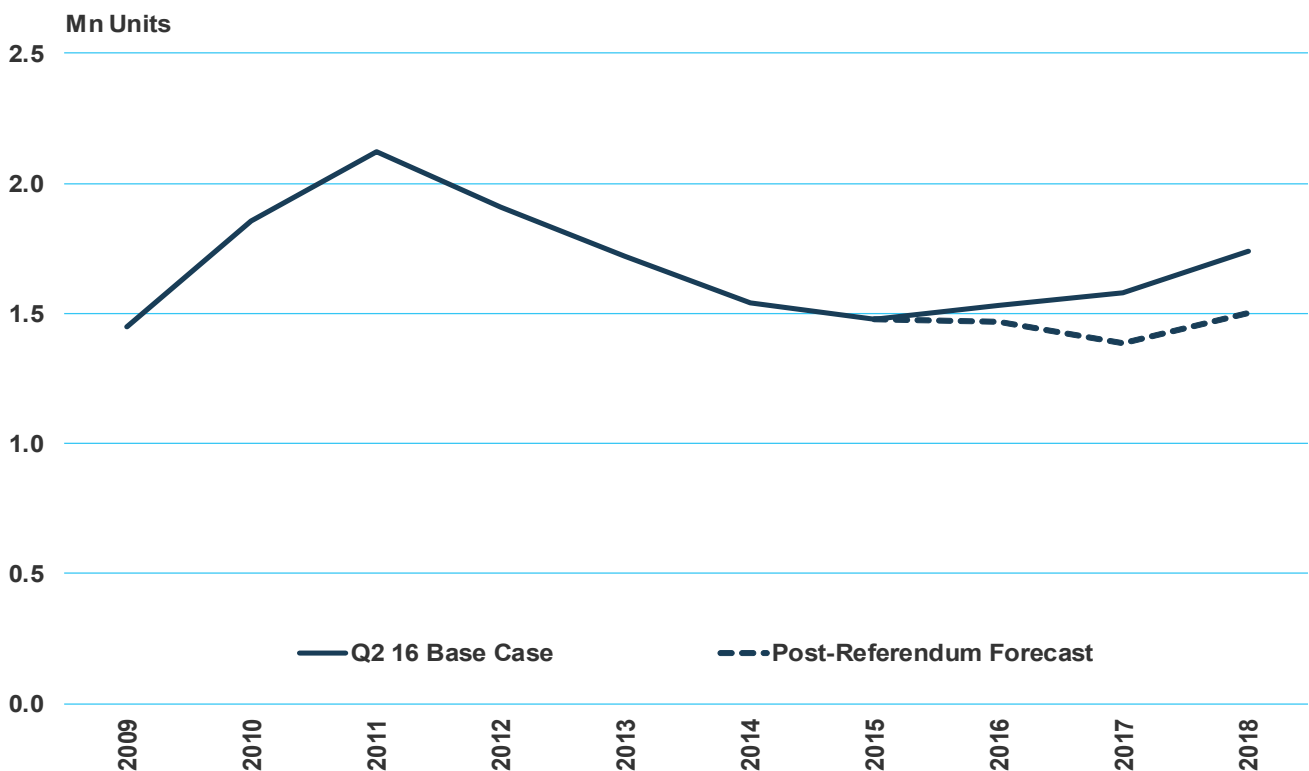
Market reaction to the UK's decision to leave the EU has been dramatic, with both the pound and London share prices slumping in the immediate aftermath, though the latter have since recovered. Needless to say, there are some diverging views on what the immediate implications are for the UK and European economies during the remainder of this year and 2017-18, but most forecasters are agreed that a choppy second half of 2016 will be followed by a mild to moderate recession

in 2017. MSI's preliminary post-Brexit referendum forecast calls for European GDP growth (including Russia) to slow to 1.2% this year, compared to 1.5% in 2015, dropping below 1% in 2017 as consumers and investors scale back. However, this is by no means a crisis of Lehman proportions, and any contagion is therefore likely to be limited, with consumers and investors expected to regain confidence as Brexit negotiations progress and a clearer picture emerges.

Asia-Europe: Recovery Delayed

As regular readers of MSI's PCTC market analysis will know, we have been optimistic for some time about the recovery in European light vehicle sales, and more importantly the long-suffering Asia-Europe trade. Indeed, after four consecutive years of decline, 2016 looked set to mark the turning point and beginning of a sustained recovery in the Asia-Europe trade - initial

Chart 1: Asia-Europe Westbound Light Vehicle Trade



trade volume estimates for the first five months of 2016 point to yoy growth of over 4%, with Japanese exporters leading the charge. That this recovery should come despite the continued collapse in Russian sales and imports augured well for a steady, if unspectacular, restoration of the Asia-Europe trade.

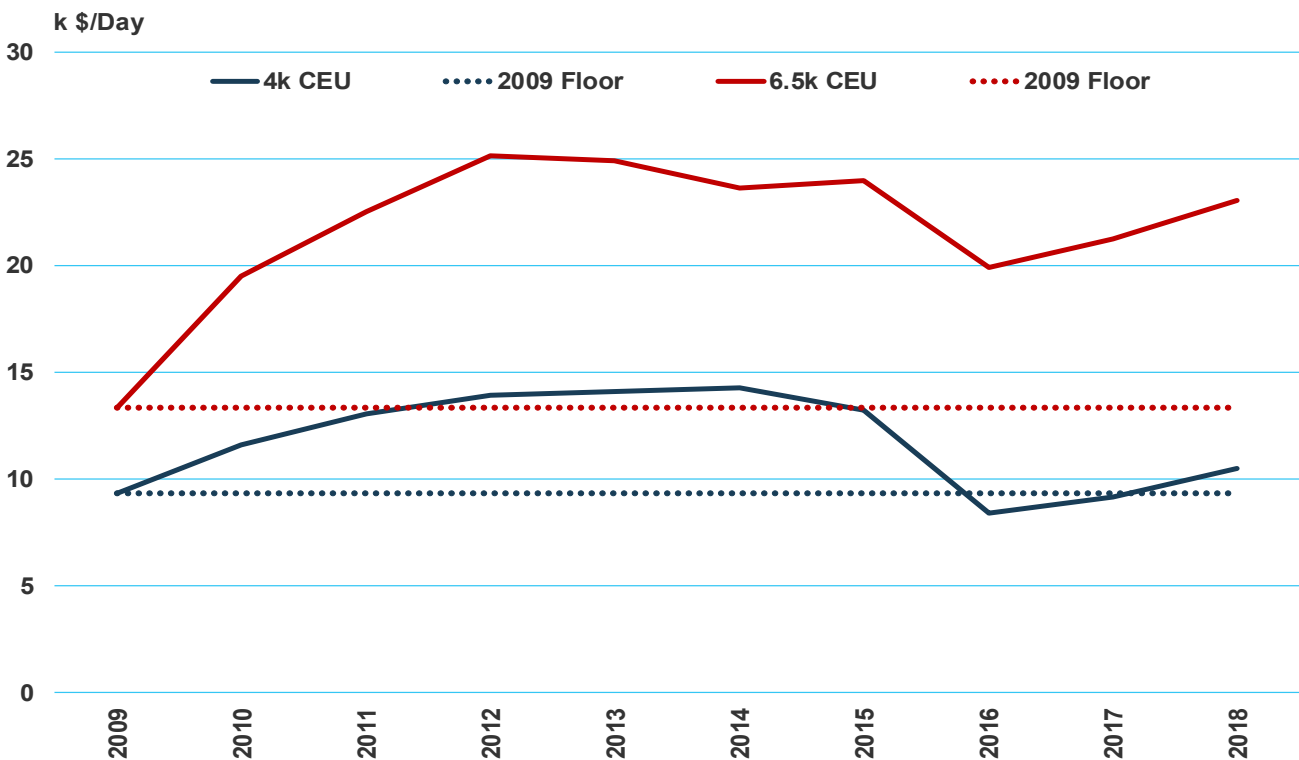
Post-referendum adjustments to our forecast, however, will change the recovery profile. We have revised down our growth forecast for European light vehicle sales from 4% to 3% in 2016, but the biggest change comes in 2017, where a European recession sees sales drop to 18.8 Mn units (-1.7% yoy). For European imports, there will be a double-whammy effect, as weaker sales combined with depreciating currencies hits trade. Although the yen had been appreciating against both the pound and the euro since the end of last year, this process has accelerated following the UK referendum. The latest forecasts from Oxford Economics show that the pound and the euro will bottom out against the yen during Q4 2016, having depreciated by 27% and 14% respectively from Q3 2015 highs, but any return to pre-referendum levels won't happen before 2018, hampering prospects for European imports. As

a consequence, we expect European imports from Asia to be flat this year before declining by 5% in 2017. Chart 1 illustrates MSI's near-term outlook for the Asia-Europe light vehicle trade.

The Midsize Crisis

As MSI has highlighted before, one of the key challenges currently facing the PCTC market is the integration of the new generation of post-Panamax vessels into the global fleet. Although it's rarely a seamless process, the cascade of midsize vessels from the mainlane trades into secondary and shortsea tradelanes has been far from efficient during the last 12 months. Light vehicle trade volumes were flat in 2015 and are forecast to fall this year, whilst 2016 will also mark the fourth consecutive year of falling trade volumes for heavy rolling equipment. Although mainlane trades have performed well in recent quarters, other trades have underperformed, thereby limiting the absorption of midsize ships displaced from other trades. As a consequence, there were more than 20 midsize car carriers owned by tonnage providers idle and awaiting redeployment during the first half of 2016.

Chart 2: PCTC 1-Year Timecharter Rates



Although we do still expect some growth in other trades, weaker prospects for the Asia-Europe trade will limit the upside for 2017, particularly as the influx of new tonnage from the shipyards adds to supply-side pressure. 10 new vessels were delivered during the first half of 2016 with a further 16 deliveries scheduled for the remainder of the year - of those 26 vessels, 18 are post-Panamax types. Next year's delivery profile is even more daunting, with 36 vessels (21 post-Panamax) slated for delivery, although some tonnage providers will delay delivery of unfixed ships.

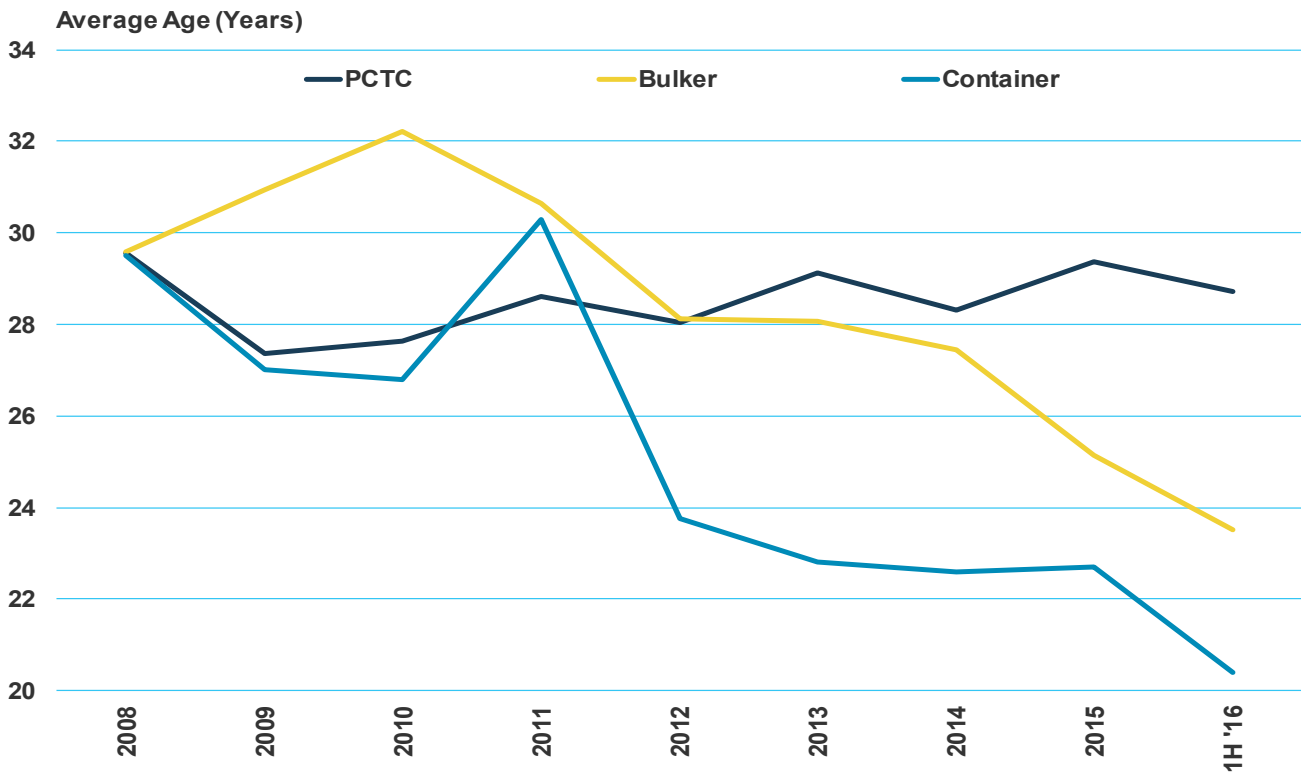
As such, the market is expected to move sideways in 2017, with 1-year timecharter rates unlikely to show any significant improvement before 2018. The gap between midsize and large PCTC charter rates has widened considerably since 2014, and midsize PCTC charter rates have dropped below previous historic lows witnessed in 2009 (Chart 2). Despite the 2018 improvement, T/C rates will still be almost 40% below the long term average for midsize vessels, with the equivalent number for larger vessels at 14% below. The earnings discounts are also filtering down to

vessel values, with far greater depreciation of midsize secondhand vessel values evident relative to their larger peers¹.

Redressing the Balance

Weaker market conditions and discounting of midsize earnings and values has already triggered a response, with 16 mainly midsize vessels scrapped during H1 2016. However, compared to other sectors the response remains modest – with the exception of 2009-10 when 149 vessels were scrapped (equivalent to approximately 20% of the end-2008 fleet), the average age of vessels scrapped has hovered in the 28-30 year age range (Chart 3). Contrast that with the bulker and container sectors, where the average age of vessels scrapped has fallen sharply in recent years as bulker and container players struggle to deal with excess supply, challenging demand conditions and, in the case of the latter, an aggressive cascading of tonnage through the tradelanes. A comparable response from PCTC players would go a long way towards redressing the balance between supply and demand.

Chart 3: Cross-Sector Comparison of Average Scrapping Age



¹ For information about our online vessel valuation platform MSI FMV, go to www.msilt.com/msifmv.aspx

MSI Foresight is a periodic series of articles on topical areas of interest across the commercial shipping spectrum. This article draws on MSI's ongoing PCTC sector analysis. To find out more about MSI's analytical, consulting and vessel valuation services for the PCTC or for other sectors, please contact Niklas Carlén at MSI on Tel: +44 (0)20 7940 7197 or email: niklas.carlen@msiltd.com



Maritime Strategies International Ltd.

6 Baden Place
Crosby Row
London
SE1 1YW

Tel: +44 (0)207 940 0070
Fax: +44 (0)207 940 0071
info@msiltd.com
www.msiltd.com