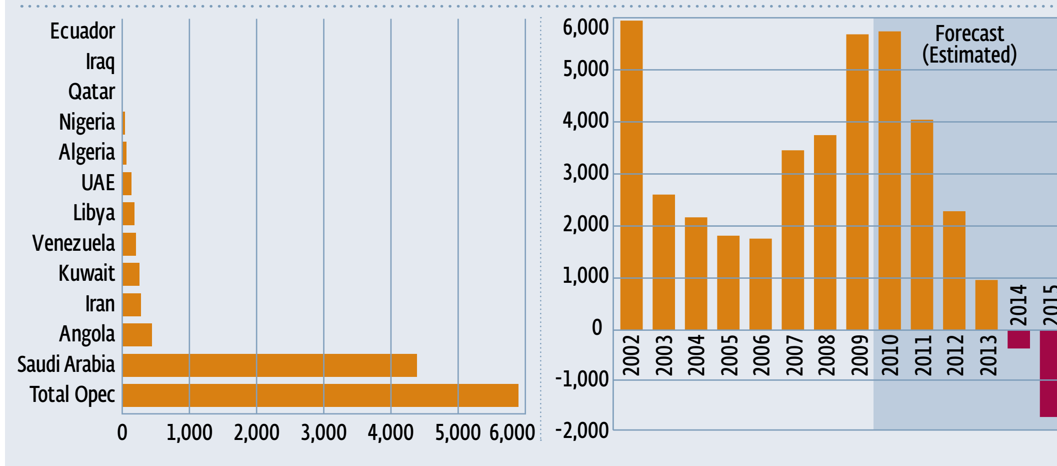

Tanker demand rises for Libyan replacement oil

Uncertainty in the ebb and flow of the Libyan crisis has created a demand for oil from other producers

Research by analysts at Morgan Stanley has put recent commodity market developments into a broader perspective and goes a long way toward explaining the stark contrast, so far, between rising oil markets and the tanker shipping rates.

Oil prices have surged dramatically since the protests in Egypt began last month, subsequently spreading to Libya, with stray sparks threatening to ignite trouble elsewhere in the Middle East. At the same time, and in marked contrast, the freight markets have barely budged, with the exception of cross-Med Aframax trades and other short-haul voyages that could fill the relatively small Libyan supply vacuum. (Its estimated production was 1.6M bpd in January 2011, according to Morgan Stanley).

A team at the financial services firm, led by head of commodity research Hussein Allidina, offered the thesis that oil's upward price move was demand driven, until a Brent crude price of about $100/barrel in early February. In contrast, the last $20/barrel increment, which has contributed to the widened spread above the widely followed WTI , has been driven by fears of supply disruptions.

The team went to considerable lengths to explain the fragile nature of spare capacity (see graph), which comes largely from Saudi Arabia. In essence, if only the Libyan supply is cut, the quantity shortfall could be comfortably absorbed by Saudi Arabia. Indeed, the Saudis have already indicated their intention to turn on the tap.

The quality side of the Libya equation is more nuanced. As the shortfall is in its light sweet crude, the prices of other grades, for example, Nigeria's 'Bonny Light', could be pulled upward.

Not surprisingly, a widening and prolonged disruption in the face of declining spare capacity over the next few years could have a significantly adverse impact. Following this line of thinking, prices could be lifted to a point that would force a broader economic malaise, even in the absence of upward demand pressure – in contrast with 2007-08.

Examining a complex measure called the oil burden, where the value of oil purchased by an economy is compared with its GDP, the Morgan Stanley analysis indicated that we are approaching a dangerous threshold, defined as 4%. Using the Brent price of $80 prevailing in 2010, its analysts calculate an oil burden of 3.4%. Simple numbers suggests that prices at current levels, even with a modest growth in overall GDP, would result in a higher oil burden.

Morgan Stanley looks for nearly 5% world average GDP growth in 2011, in a time of easy monetary policy. However, history may repeat itself with a salutary twist. The present oil price rise comes in the early phases of the economic cycle, when interest rates are quite low, rather than in the typical late-cycle 'exhaustion phase', where shipping is seen to be a lagging indicator.

Analyst Matthew Garman, discussing European equities, offered the view that "low rates and a strong economy can negate the impact of an oil price spike". This is consistent with the supply-driven nature of the present price dynamic.

Morgan Stanley equity analysts Ole Slorer and Fotis Giannakoulis, well known for their infamous downgrade of the entire tanker sector in 4Q10, issued a 'cautious' industry view. They suggest that "Libyan oil disruption could lift tanker demand", citing potential shifts in European oil imports. Acknowledging that the short-haul Aframax trade has been the beneficiary of the rush to load in Libya before the valves close, they say supply disruption there, where about 800,000-1M bpd of production is currently down, "increases the odds of a strategic supply response, renewing expectations for additional tonne-miles" .

Slorer and Giannakoulis also said: "The reported increase of Saudi output by 700,000-800,000bpd could help demand by eight or nine VLCCs if it all goes to replace the loss in Libyan exports." But, the impacts might not overwhelm – hence the word 'cautious' in the report's title – because the possible increased demand for ships comes at a time when "vessel availability in the Gulf is at record levels".

The analysts acknowledge that, "with European refiners showing preference for pipeline and West African crude, gains should be lower, but still higher volumes should serve well for Suezmaxes". F