End of Financial Crisis
(and beginning of Shipping and Shipbuilding Crisis)

The Fed's March 18 announcement that it intends to purchase usd 300 billion US government debt plus other agency debt is not surprising. However it is still radical and a clear indication of the Fed's determination to do whatever it takes to bail out everything from banking and financial institutions, the US home-owners, and now the US government (the mother of all bailouts). In many ways, the US government has been operating like a giant hedge fund in that it is utilizing the gap between its cost of capital (close to zero) and that of the consumers/businesses to do whatever it wants (which is to support lending and consumption). As a side note, General Electric was also able to earn good returns over the years also because it operated like a hedge fund – it had been relying on its exceptional ratings to access low cost funds (which is possible thanks to the stable cashflows from its industrial businesses) to make money from GE Capital – until it lost its triple A rating. But the Fed just took the game one step further by monetising debt.

Mr.Ben Bernanke's biggest academic "achievement" was that he found one of the two main mistakes that the Fed made in the 1930s. The second sin was, in his own words "they let the banks fail." The first mistake of that era, was, in Bernake's eyes to allow money supply to contract.

Against this background of "liquidity worship" and mother of all bailouts, it seems that the moment that major financial institutions will fail has now passed us by. The market seems to feel less edgy. What does this seemingly narrow escape from collective meltdown mean for shipping and shipbuilding?

In our mind, one positive effect of this would be that it took away the most powerful excuse that the maritime sector used to justify severe errors in judgement. "We would have done OK were it not for the financial crisis." How convenient to blame an external force. In any event, there seems to be hope that the financial system will start functioning again, which will turn on trade and the credit tap to the maritime sector. Now more than ever, decision-makers will be forced to focus on the real issue at hand – we have a shipping crisis of historic proportions unfolding. We simply have too many ships. And too much shipbuilding capacity.

It is possible to make the argument that in "normal times" the shipping cycle would have ended in last quarter 2005. The market dipped at that time, and some alarm bells went off. But very quickly the market resumed climbing and raged ahead to new heights, for 3 more years. Those who were more conservative in outlook watched great opportunities passed them by. However, few realized (we didn't either except just having a feeling that something was amiss) that the past cycle was not "normal" in the sense that it was prolonged by super-charged private consumption in the US based on debt and hyper-leverage. The container ships to the US were full. The car carriers were full. Reacting to strong "demand", businessmen built up tremendous export capacity that led to long runs of increasing import of raw material and energy into China. Worldyards have argued repeatedly that lots of imports into China were embedded input into export, and export played a far more prominent role than domestic consumption in the Chinese demand for raw material and basic commodities (see, for instance, *The China Factor* dated 16th June 2008). Shortage of ships, particularly in the underordered bulk carrier sector, led to tremendous expansion by shipyards and massive ordering by owners. It all went well until consumption collapsed in the US under mountains of debt. We can regard housing also as a form of consumption which were both excessive and unsustainable – too many residences were built on credit for people who could not afford them, leading to downward spirals in values.

It is said that over-capacity in the Chinese steel industry is 30%. Unsold housing stock is more than 24 months (compared to 11/12 months in the US (a country in crisis). What is the extent of over-capacity in shipbuilding capacity and orderbook? Does any one want our opinion on these??

Given the massive liquidity injected into the financial system and the political will on the part of national governments to prevent systemic failures, we do not think anymore that main shipping banks who have committed to financing will fail to perform. And we believe that banks will stand behind every payment guarantee that they have issued on behalf of the owners to the Chinese shipyards. The banks have been taken over outright, or national governments have assumed all their liabilities and obligations (such as the case of RBS), and on their part they have been reluctant to enforce their minimum value clauses, that is the reason many owners are still operating. This may have been a good thing but then we can't criticize stakeholders in the shipyards which are doing incremental funding to prop up shipyards in order to "protect" their positions that they already committed (refund guarantees issued on behalf of the shipyards, or substantial amount of loans already extended). In the overall scheme of things, is this good or bad?

We consider this one of the major negative side effect of bailouts on every level (either huge international financial institutions which imposes "systematic risk" or car makers which for many years never carried their pension obligations on their balance sheet, or home owners who should have never been entitled to stay in oversize rooms with a huge TV for each of the many living rooms and refrigerators in every kitchen, all imported from China). For our industry (shipping and shipbuilding), we likewise think clearly that these "bailouts" were detrimental to the long-term health and quick recovery.

Normally, supply and demand would rebalance at a lower price and strong firms will take over the weak. But here, banks looked another way when their clients are clearly in breach of value covenants, yards defined as "too big to fail" get emergency loans to continue building the ships which were not needed. Some owners seem to think that the yard should "sacrifice" to contribute to the health of the shipping industry without regard to the tremendous problems that the shipbuilding industry is facing. But let us be honest, everyone involved in the Newbuilding frenzy has receives some rescue help so no one has the moral high ground.

Trade and shipping prospered when US borrowed and consumed, China invested and produced. Old habits die hard, so the natural instinct of the respective governments is to stimulate what they knew best – for the US to restore "lending and consumption" and China to further invest and produce. But the fundamental underlying forces are for US to save and produce, and China to develop its domestic consumption. This long-term adjustment will take a very long time, and it will in our view imply that shipping will be required to a lesser scale than it is currently assumed. Will we ever return to "normal" demand?

Worldyards proposed "collective re-negotiation to postpone delivery" in November last year (*A New & Radical Approach* dated 24th November 2008). But so far we only see piece-meal, incremental measures which only take care of issues of immediate concern of the day, on all sides. We need to have an equitable solution (for both owners and shipbuilders) over a longer term. But first we need to stop thinking that we only have a "financial crisis or financing problem". Until we admit that we collectively over-invested on a massive scale, and face the shipping and shipbuilding crisis squarely, no such strategic and collective solution will be in sight. If we keep bailing things out, the weak ones will stay, the strong ones will go nowhere, the downturn will just be prolonged. Just like China or Soviet Union in the command economy: people were equally poor.

Jumping back to shipping and shipbuilding equities, anyone?