Overview of the Freight Derivatives Market

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Developments in the Freight Derivatives Markets

• Growth of the paper market on Shipping Freight
  • due to high levels of freight rates and high volatility
• Extensive use of risk management techniques and instruments
  • increase in trade sophistication
  • use of options in trading strategies
• Entrance of new players in the shipping markets
  • trading houses and energy companies as well as investment banks and hedge funds
• “Commoditization” of Shipping Freight
Average annual growth since 2002: 33%
Estimated Volume for 2008: 2.3 m lots
1 lot is equal to 1,000 mt of cargo or 1 day of a trip-charter hire
FFA Volume –Composition of Trades

• Dry Market
  • Volume for 2008 (est): 2.3 m lots
    • Panamax and capesize volume corresponds to two times the underlying physical base of the fleet
  • 60% of trades for 2008 are cleared
    • For Sep and Oct 08 75% of traded contracts were cleared reflecting the tighter credit conditions

• Tanker Market
  • Volume for 2008 (est): 0.450 m lots
    • 40% trades are on the ME Gulf – Japan VLCC Route (TD3)
  • 75% of trades for 2008 are cleared
Freight Market Volatility – Coal Routes


US$/ton

June-08: 62$/ton

November-07: 50.5$/ton

Feb-05: 25.2$/ton

Aug-05: 8.8$/ton

Oct-08: 8.0$/ton

15.7 $/ton increase (130%) over 1.5 months

16.5 $/ton decrease (51%) over 3 months

150k mt Coal Richards Bay to Rotterdam

150k mt Coal Bolivar to Rotterdam
Capesize TC Forward Curves – October Settlement

Forward Curves for Q3-08 remained consistently higher than spot rates

A long October 08 FFA bought in January 08, would settle at a loss of 85,000 $/day

85% drop in Capesize Freight rates in October

Source: Baltic Exchange
**FFAs – Market Volatility**

- October 2008 witnessed the largest drop ever in dry freight rates
  - Rates in January 2008 were 20 times higher than the average October 2008 rate.
    - E.g. a long October 2008 FFA that was bought in January 2008, would settle at a loss of 85,000 $/day or around $2.7 million for the October settlement
  - Market Volatility did not appear to have an impact on the settlement process due to:
    - large proportion of cleared trades
    - arrangement of emergency netting facilities
    - large outstanding positions for the rest of 2008
    - cash-flow mismatch between paper and physical.
The Capesize Forward Curve is currently in Contango
Average Forward rate for 2009: 16,000 $/day
Average Forward rate for 2010: 24,000 $/day:
FFAs – Current and Future Developments

• The market has grown rapidly over the last five years
  • High volatility in the market has also attracted interest from investors outside shipping such as hedge funds

• Credit Risk and Clearing
  • More extensive use of clearing due to tighter credit requirements
  • However, initial margins and marking-to-market tie up capital

• Potential knock-on effects from defaults in the paper and/or physical markets
  • Closer links between the physical and the paper market

• Increase in trading interest in the options market
  • More trading opportunities for hedgers and investors
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