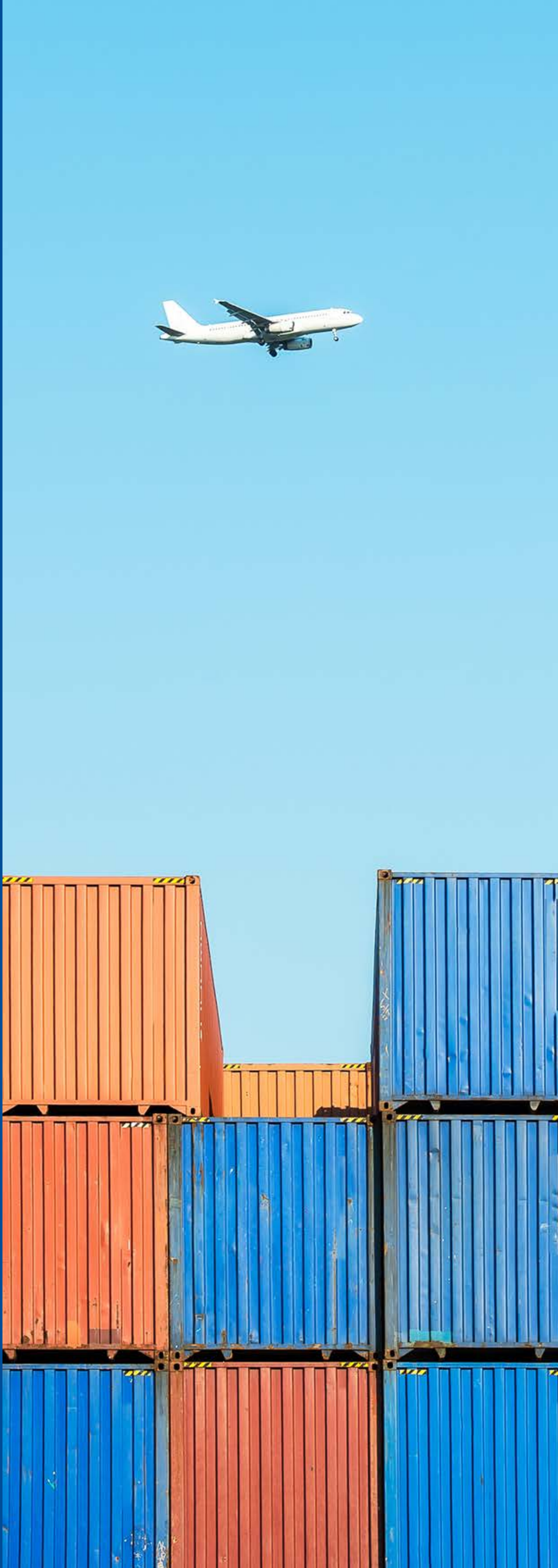
Transport Tracker

Global trade-the new normal



January 2019

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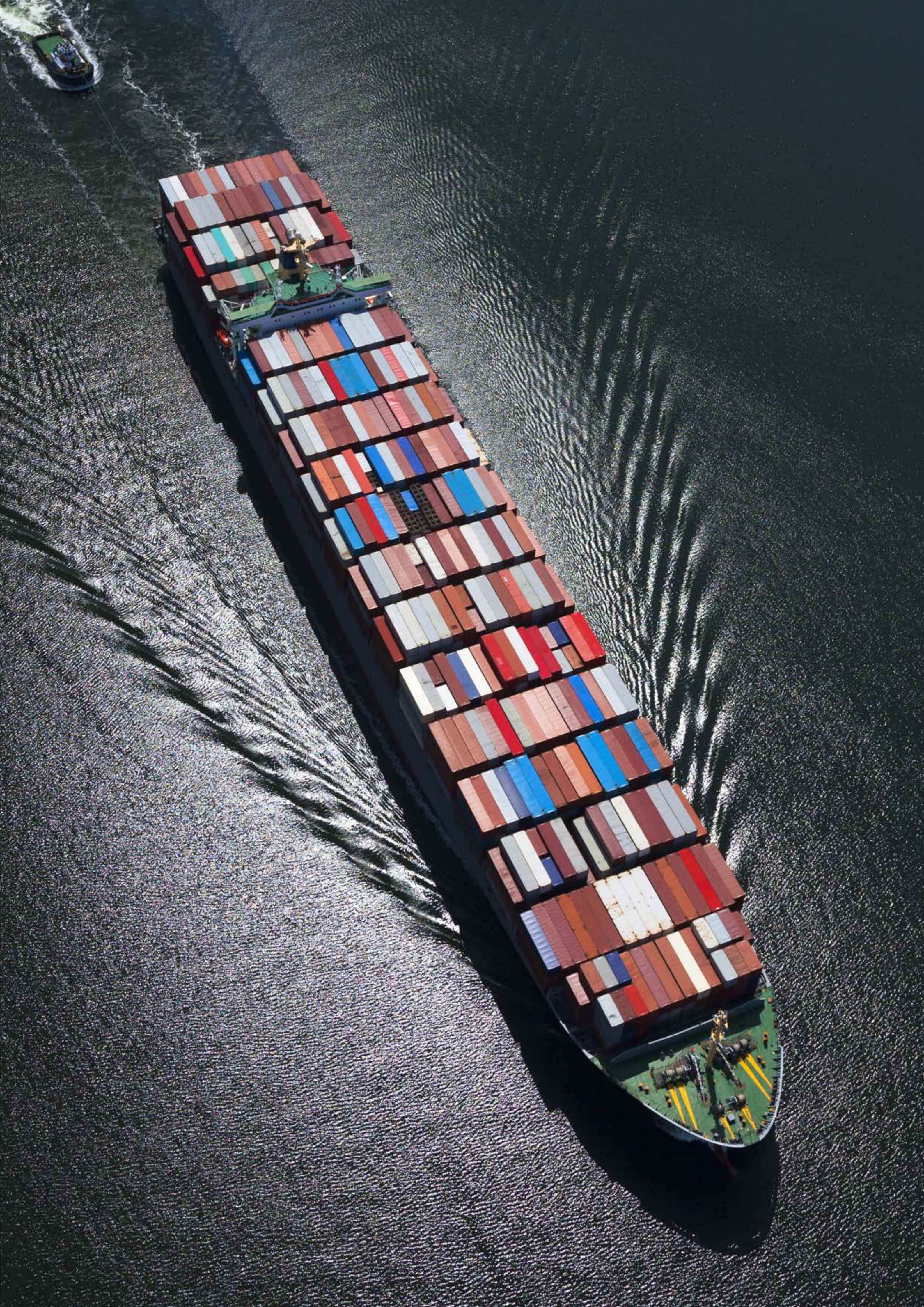


Contents

Market fundamentals

Share prices

(end of October2018 YoY)

-10%	-17%	-17%	2%	-19%
Transport and Logistics overall[(a)]	Transport infrastructure[(b)]	Airlines[(c)]	Road and Rail[(d)]	Shipping[(e)]

Challenging times in a growing market

Trading volume hit its highest peak since 2011 during 2017. This was mainly driven by cyclical factors and increased investment. The global economy has staggered a bit during 2018 and trade is expected to expand at a slower rate than previously forecast. Merchandise trade volume is expected to grow by 3.9 percent.[(f)]

The World Trade Organisation's trade-growth outlook for 2019, already revised down to 4.4 percent, now stands at 3.7 percent. Escalating trade tensions amid various government's restrictive trade policies began having an impact in the first quarter of 2018, making the weaker 2019 forecast foreseeable. Disruption appears to be far from over and the risk of protectionism, geopolitical tension and natural disasters will continue to affect upcoming 2019 forecasts.

Transportation of physical goods and passengers will undoubtedly remain the core business model of most transport companies. But traditional business models are being challenged at every turn and disruptors to the market may become the new key players in record time as digital technologies such as 3D printing, the IoT, AI and Blockchain continue to reshape global trade.

It remains challenging to collect accurate data to measure economic transactions involving digital trade. However, a number of estimates from multiple international organisations show the remarkable impact that emerging technologies are having on the magnitude of domestic and international trade.

Despite the weaker growth outlook for 2018 and 2019, the future of international trade can still be looked at positively. Many countries are still strongly linked economically and there has been a decline in trading costs. Furthermore, multinational initiatives such as China's One Belt, One Road program, and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP/ TPP11), could contribute to economic integration without the United States, could contribute to economic integration.

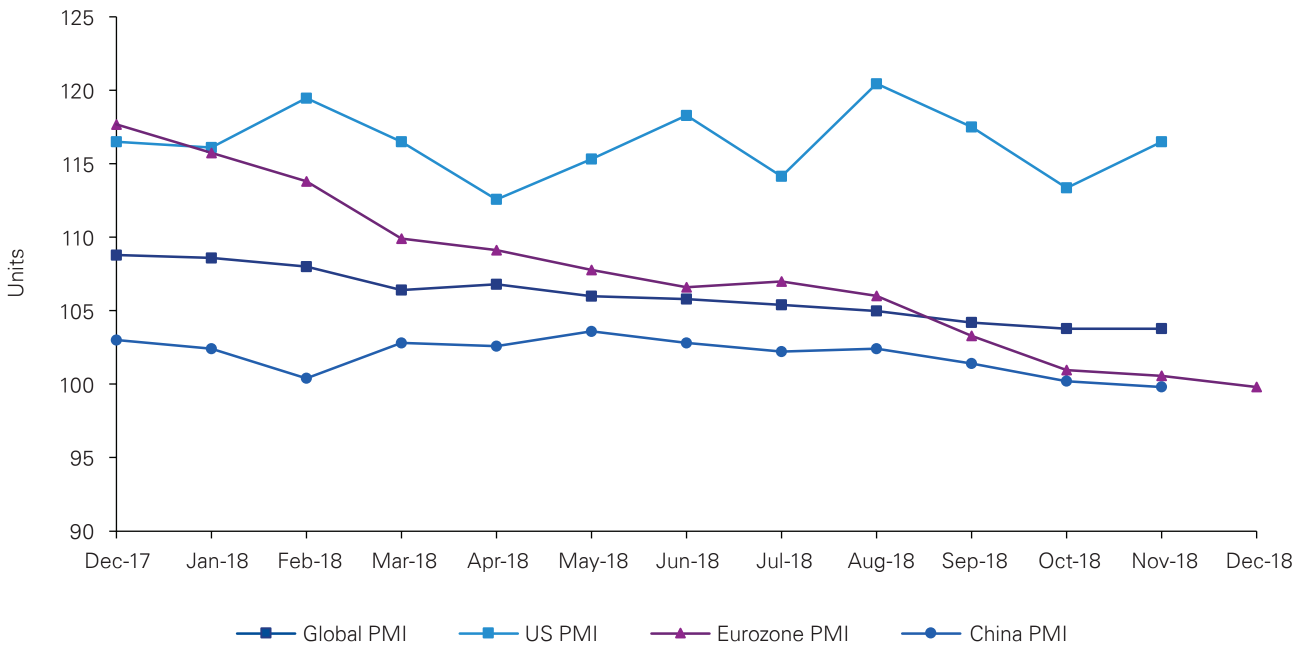
In spite of the creeping uncertainty about how world trade will progress in the coming years, one thing is certain: For trade and international cooperation to resume and succeed, governments should be seeking to advance an economic agenda that is not only outward looking but also fair and equitable.

Dr. Steffen Wagner
Global Head of Transport & Leisure

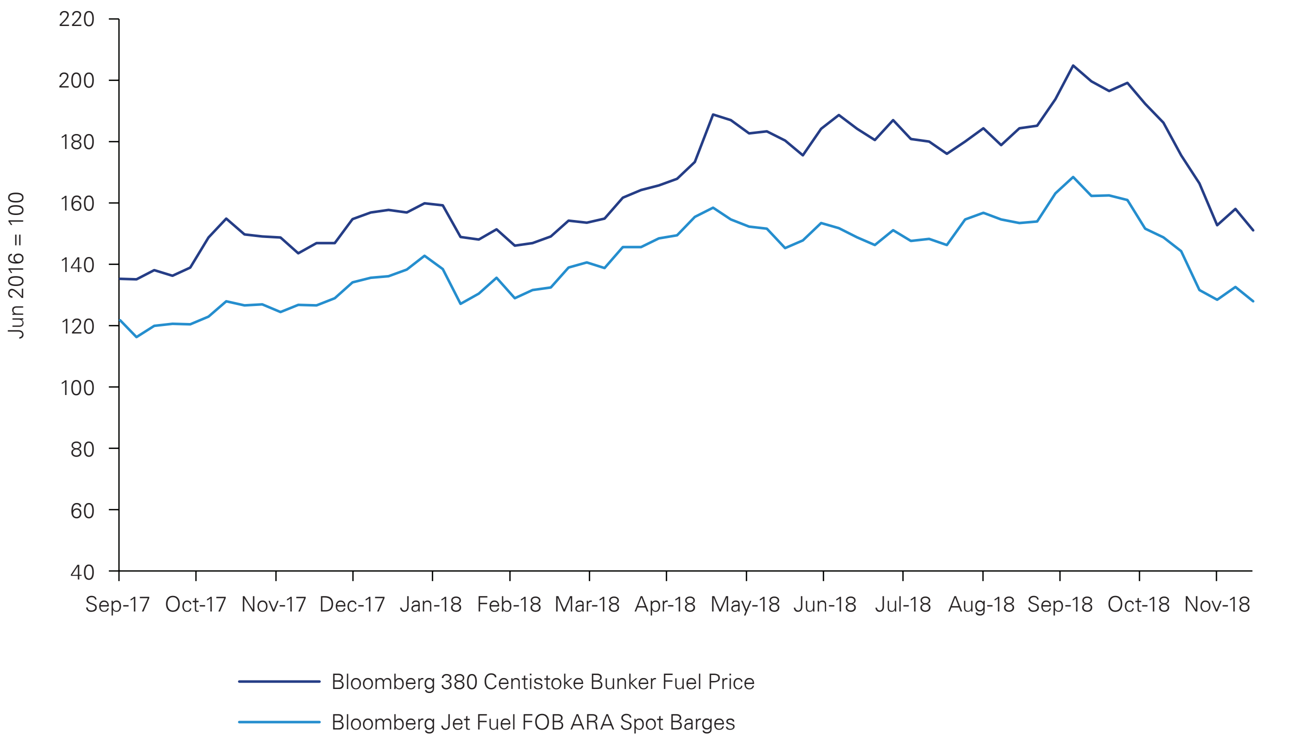
Note:

a). Source: Bloomberg World Transportation Index
b). Source: MSCI World Transportation Infrastructure Index
c). Source: Bloomberg World Airlines Index
d). Source: MSCI World Road & Rail
e). Source: Bloomberg Shipping Index
f). https://www.wto.org/english/news_e/pres17_e/pr800_e.htm
g). https://www.wto.org/english/news_e/pres18_e/pr820_e.htm

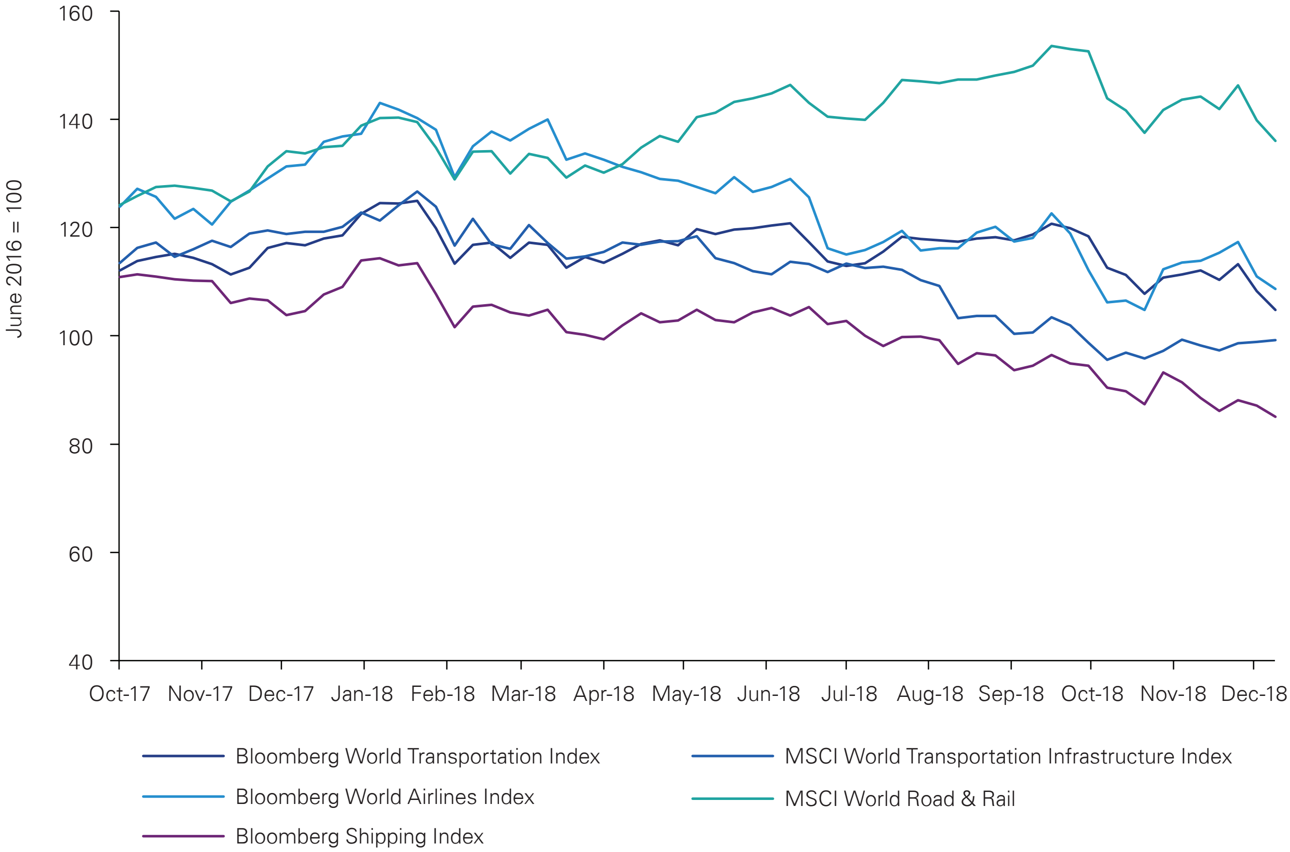
Global Purchasing Manager Indices (PMI)



Fuel and Oil Prices



Share prices of transport subsectors



The global growth picture

The Chinese economy (GDP) increased 6.5 percent[a] during the third quarter of 2018 from a year earlier, compared to 6.6 percent in a Bloomberg survey, and down from 6.7 percent in the previous quarter. That's the slowest since the aftermath of the global financial crisis in 2009.

The Purchasing Manager Indices (PMI) for the Eurozone has in general shown a declining trend throughout the first three quarters of 2018, potentially indicating the declining economic health of the manufacturing sector. Since the second quarter, Eurozone and China PMI trends seem to be going in opposite directions. Indeed China, the world's largest manufacturing nation, saw its PMI growth fall to almost below 50 percent in February, 2018, despite a stark increase in March, 2018. The US numbers, on the other hand, have zig-zagged throughout the year.

The IMF has projected global growth at 3.7 percent in 2018 and 2019, revised downward by 0.2 percent for both years versus its April, 2018 forecast. The downward revision reflects:

— Surprises (the difference between the decision regarding the monetary policy rate and the average forecast among analysts surveyed by Bloomberg the day of the policy announcement) that suppressed activity in early 2018 in some major advanced economies;

— The negative effects of trade measures implemented or approved between April and mid-September;

— A weaker outlook for some key emerging markets and developing economies amid country-specific factors, tighter financial conditions, geopolitical tensions and the higher cost of oil imports.

Oil prices have been roller coaster since a few years now, dropping from its peak in 2014 and recovering dramatically since record lows at the start of 2016. Oil prices began to show a rise during the third quarter of 2017 and increased consistently since August 2017 to reach new highs in the first half of 2018, hitting a four year high in early October and then dropping down to its lowest in the whole year.

There are multiple reasons for this sudden meltdown including rising inventories in crude oil and discovery of shale in America. Shale is also gaining popularity beyond American shores. For example, China and Argentina have drilled more than 475 shale wells between them in the last two years. Another contribution to the plunge was done by the global equity sell-offs and continued concerns that the OPEC/non-OPEC cuts may not be enough to rebalance an oversupplied market, especially if fears of slowing global economic growth materialize.

But reason for the dip in the oil price is not merely dependent on demand and supply mismatch. The slowdown in global economic growth appears to already be denting demand. The fears of slowdown have steered investors to be risk-averse on the stock market. As the apprehensions on growth remain persistent, it might be difficult for oil to recover until OPEC takes action.

Share prices for road and rail companies have shown an increase, while all other sectors – transport infrastructure, airline and shipping – have displayed significant share-price declines. Airlines have recovered remarkably well over the course of the last 18 months but remain particularly sensitive to the potential impact of Brexit and its implications for airspace freedoms. Shipping companies suffered at the hands of the global shipping crisis but have since started to recover as the gap between demand and capacity continues to narrow and freight rates start to rise.

Shipping update

The maritime industry is currently in a state of timid transformation and recovering from the most-recent shipping crisis, with conditions improving. Freight rates are steadily increasing, most likely due to the surprising bankruptcy of South Korea's Hanjin Shipping Co., the world's seventh-largest container shipping line in 2017[1], and its aftermath, which pressured shipping company customers to accept higher freight rates to ensure continuity of service. Additionally, the establishment of so-called alliances and mergers have played a part in driving up freight rates for companies gaining a much stronger position in freight-rate negotiations. Another reason for the recovery may be the general upswing of the world economy after the crisis, as the shipping industry and the global economy traditionally move in the same direction. This all would be a cause for careful optimism if not for apparent industry shortcomings that pose a danger to its future amid modernized supply chains.

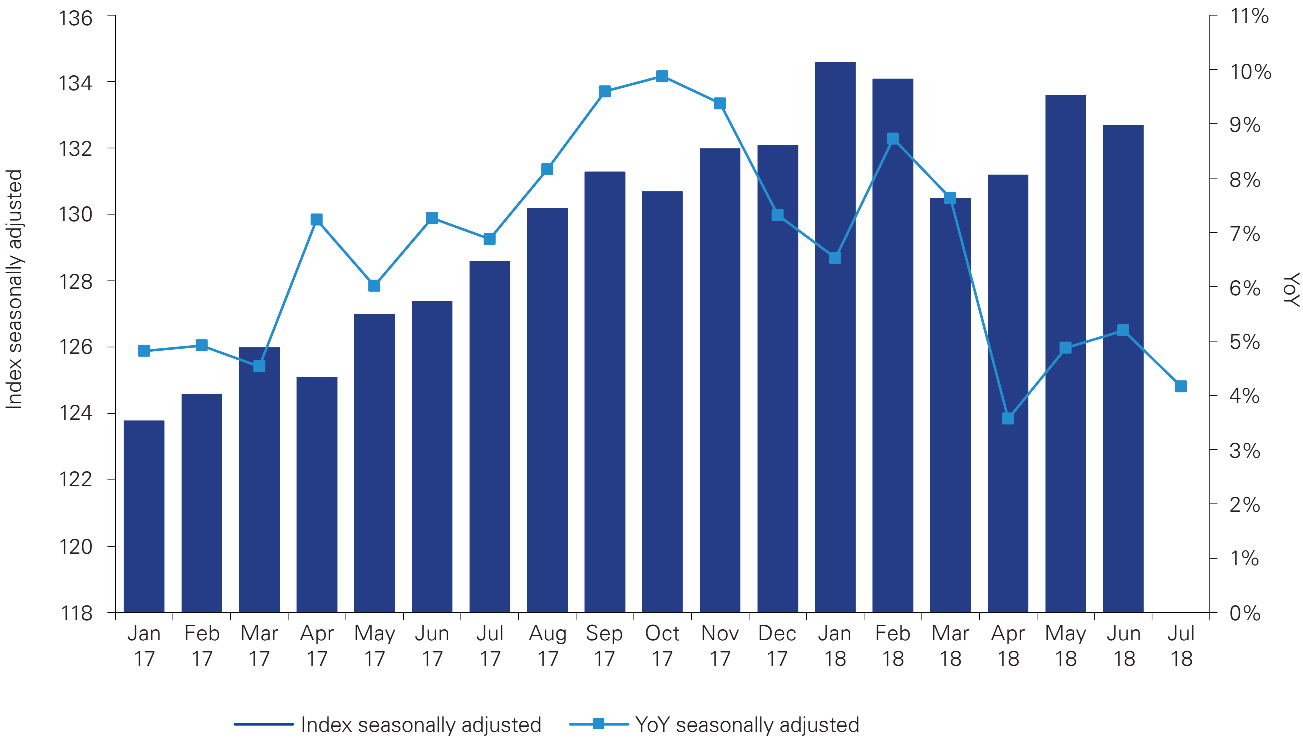
The challenge for the maritime industry is that it is only starting to move away from its traditional port-to-port business model. Indeed, first steps have been undertaken to integrate new customer-to-customer approaches and gradually abandon the outdated industry-wide strategy of solely concentrating on ports. Such innovation should continue in order to modernize the maritime industry and keep it aligned with the more-efficient global industries with which it shares economic interdependencies.

Another obstacle to overcome involves ensuring continuity of service and a renewed focus on efficiency amid increased reliance on today's ultra-large container ships (ULCS). The idea behind increased ULCS use is to enable new economies of scale and higher operating efficiency amid fierce competition.

Furthermore, shipping companies are not the only members of the maritime industry expanding their scope of operations and adjusting to new economic realities. Evidently, port operators have further expanded privately held port terminals to accommodate rising ULCS traffic. But they don't just stop there. Port operators have seemingly reevaluated their position in the modern supply chain and have concluded that they are positioned to increase their significance in the global supply chain. This is reflected by their growing investments into railway tracks and feeder services, further expanding their logistical expertise, footprint and overall efficiency.

[1]http://www.seatrade-maritime.com/news/asia/the-end-of-hanjin-shipping-officially-declared-bankrupt.html

Container Throughput Index



That said, digital innovation within the maritime industry is still lacking compared to other global industries. Multiple systems are still paper based and the lack of digital innovation was made painfully apparent by the widely reported case of shipping customers being unable to locate major global shipments. There is also the issue of efficiency, as a ship spends 40 percent of its time in port within a first-come, first-served system. Additionally, ships sail only 40 percent of their time at sea in ballast, resulting in ships utilizing only 36 percent of their time creating value for their companies.[2] A possible solution to this is data analysis to identify the most-profitable shipping routes, an idea currently undertaken by startups.

Finally, when looking at the modern shipping company amid today's rapidly changing economics, Moore's law comes to mind. It states that computer processing power will double approximately every two years – the implication being that performance improvements will continue to drive the replacement of human activity with digital tools.[3]

For the maritime industry, this essentially can be interpreted as follows. Every year that it does not adapt to the digital age, the difficulty to do so in the future will increase annually due to digitalization and the accelerating pace of change it is currently exhibiting. If these changes are not timely, the doors are open for upstart 'hub firms' delivering new digital tools and systems designed to maximize efficiency and profitability.

New business models do not approach shipping as a port-to-port facilitator of goods but as an industry possessing immense potential once inefficiencies are eliminated within a supply chain that cuts out the inefficient middle man.[4]

The biggest threat to today's maritime industry, however, may well be the industry itself. That is, its misjudgment of the precarious situation it faces – and the reality that profitable times are ahead once again after the crisis. Indeed, previous crisis periods in the shipping industry have always coincided with a global economic crisis.

For a detailed shipping update please visit Shipping Insights.

[2]https://www.trafi.fi/filebank/a/1460530147/685a20debbf9ed1f0f6d3f394603b376/20359-FINAL_Sundell_julkaisuversio.pdf

[3]Harvard Business Review September – October 2017

[3]https://www.forbes.com/sites/robinlewis/2016/04/01/planes-trains-trucks-and-ships/#9928d9f6d390

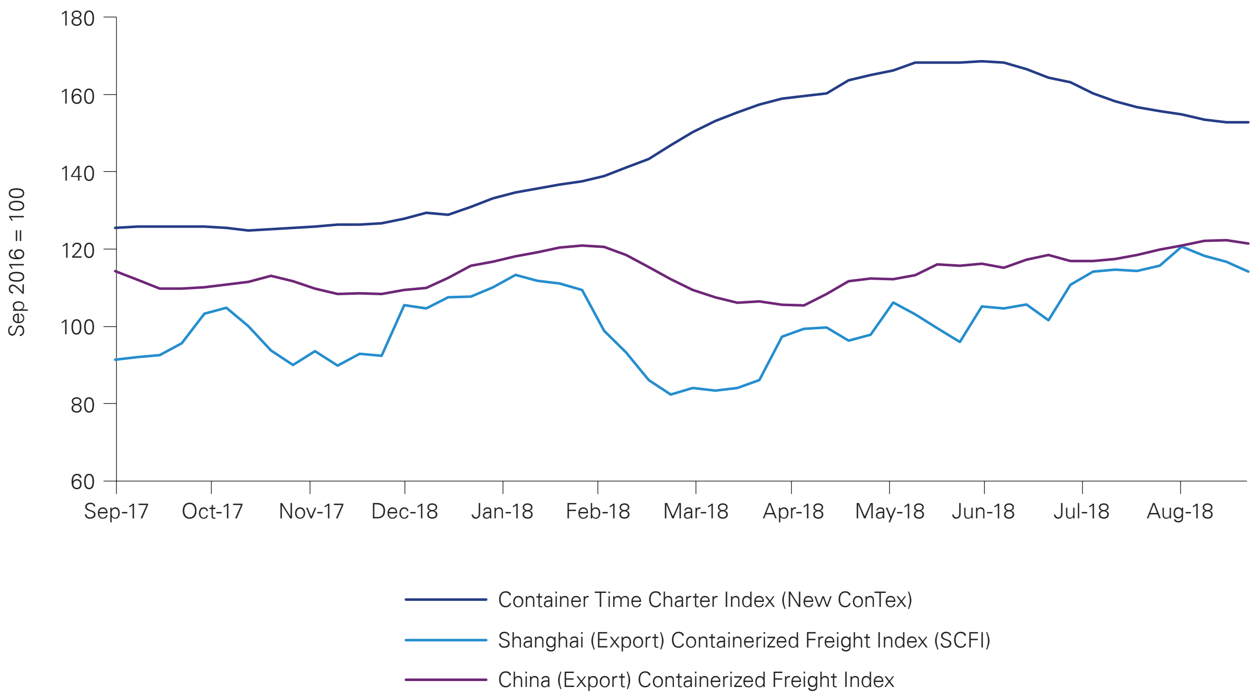
This synergy might have been reliable during simpler times but with trade tensions on the rise and 3D printing proliferating, declining imports seem likely. These new circumstances will challenge the traditional view that the industry will survive any crisis largely unscathed if it just holds out long enough while making appropriate adjustments.

For the maritime industry to survive, stringent improvements and innovations are needed without delay. Of course, the industry has begun exploring new strategies, modernizing their role in the supply chain and making investments to transform their role from a port-to-port facilitator of goods to a more customer-centric approach.

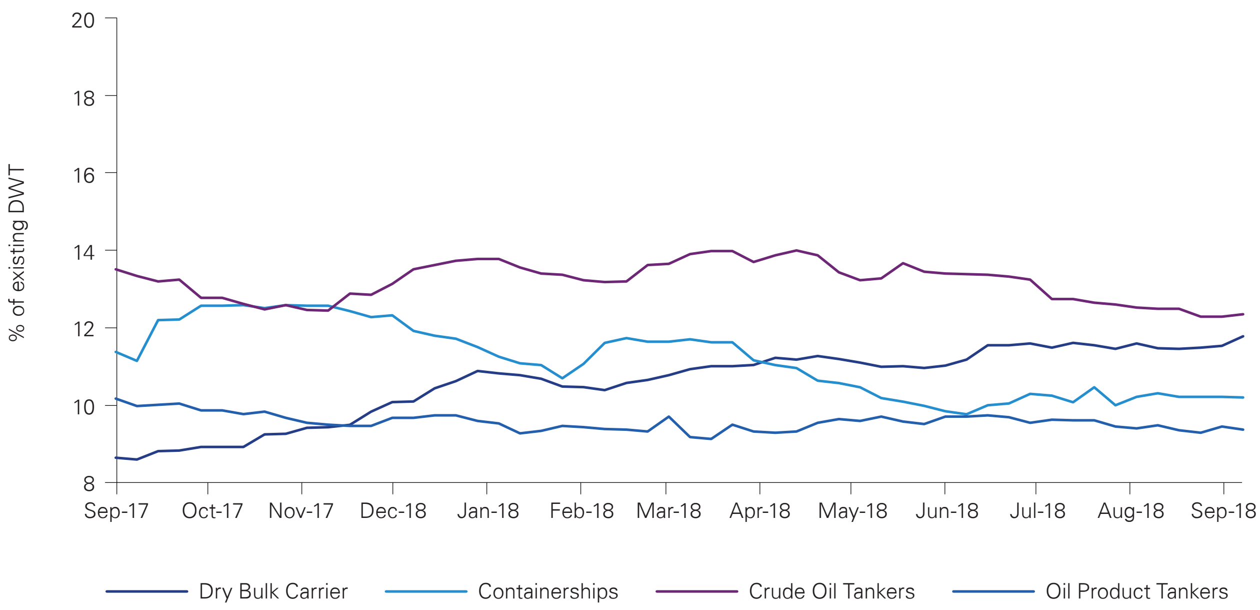
The shipping company of the future will look fundamentally different from today's players. It will be a global logistics entity, rivaling the global supply chain exhibited by hub firms, resolutely expanding operations on land to provide comprehensive customer-to-customer service.[5] This will allow it to remain competitive as a logistical service provider. Radical changes will also see the implementation of new capabilities focusing primarily on data science. Lastly, maritime industry firms need to begin working together in order to stimulate a change from within the industry. If this is not undertaken with a new sense of urgency, new industry players could take matters into their own hands and present current shippers with an extremely challenging new reality. If necessary changes are implemented quickly and decisively, the industry will be able to transition into the future – as a whole.

[5]https://www.dvz.de/rubriken/see/detail/news/maersk integriert damco in maersk line.html

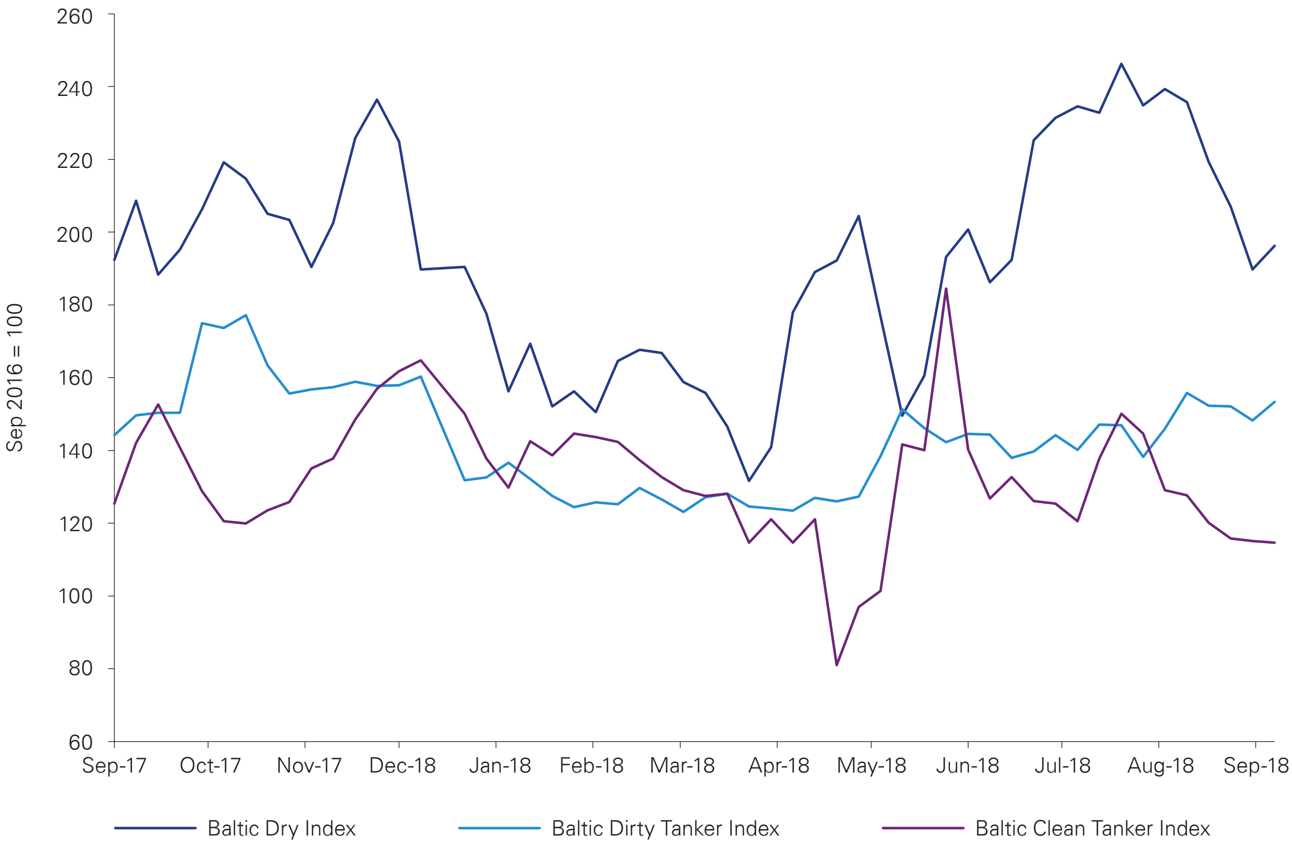
Container freight and time charter rates



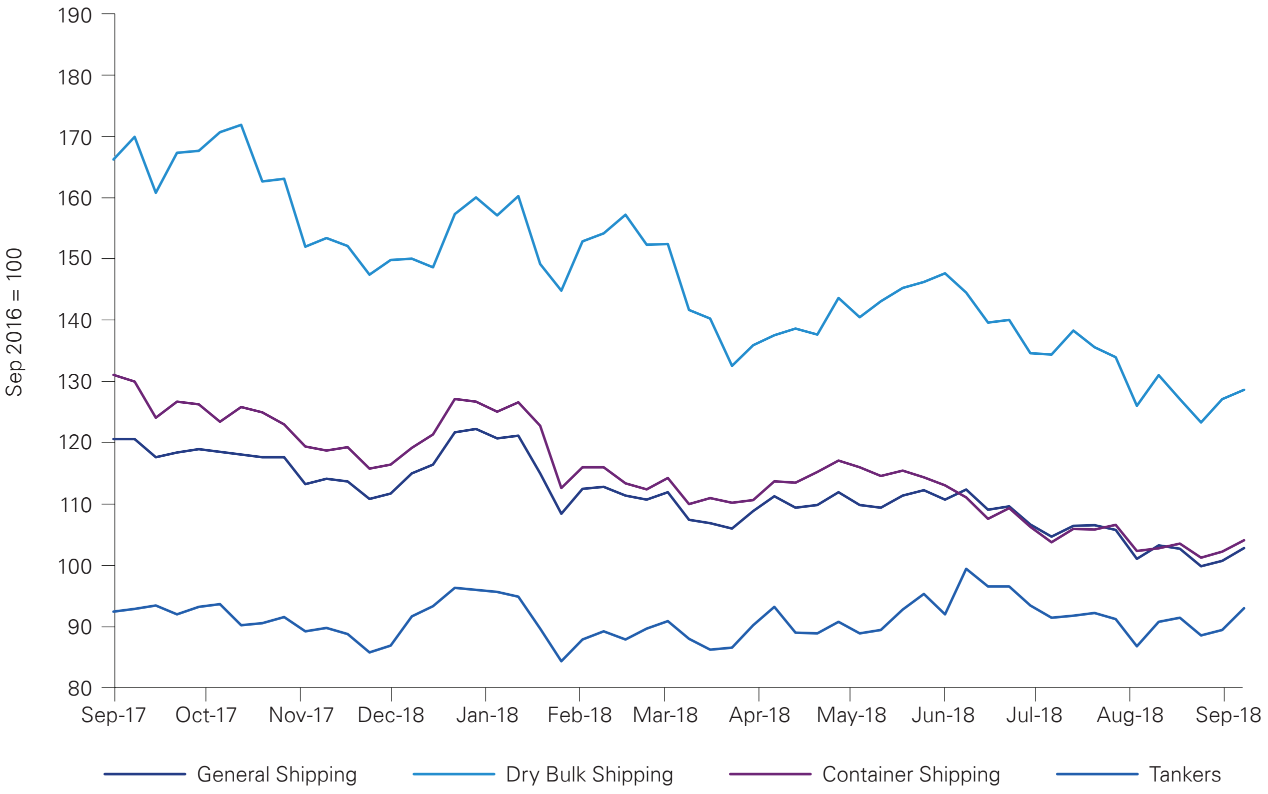
Orderbook in % of capacity



Baltic shipping indices



Share prices of shipping subsectors

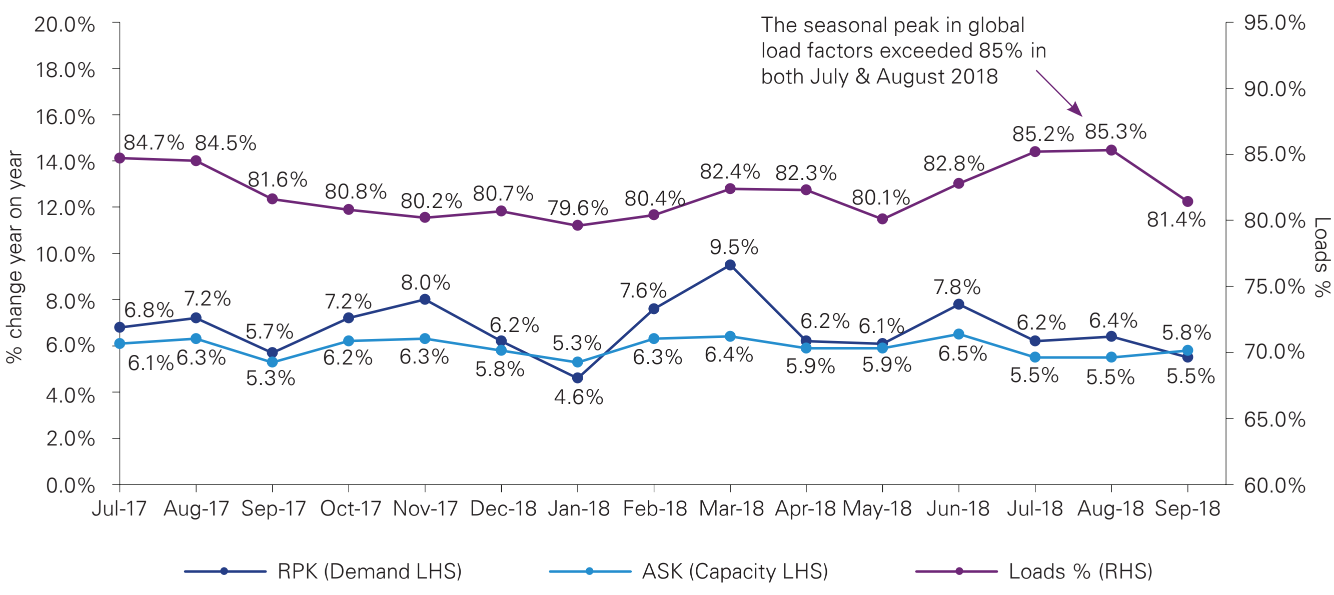


Aviation update

Growth in demand has exceeded growth in capacity over the last 12 months

— Demand has remained solid over the summer in the Northern Hemisphere, with only marginal weakness compared to the prior year. In the 12 months to 30 September 2018, year-on-year growth in passenger demand (RPK) has consistently exceeded capacity growth (ASK), with exceptions in January and September of 2018. These demand conditions have been broadly consistent around the globe for both domestic and international traffic. Global average load factors increased to a record high of 85.3 percent in August, 2018.

Growth in global passenger demand (RPK), capacity (ASK) and average load factors



Source: IATA air passenger monthly analysis reports August 2017 to September 2018

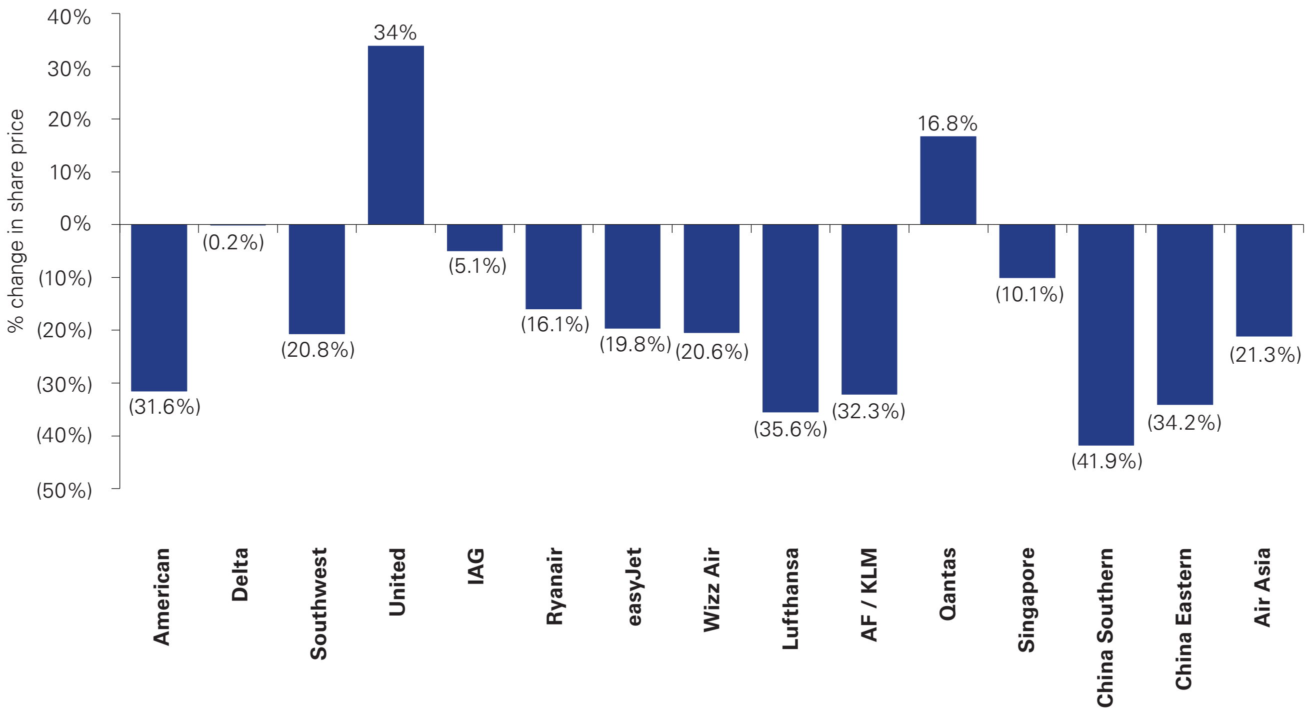
Yields continue to trend sideways

— After a spike in demand in March, 2018 the market was cautiously optimistic that FY18 would be a year of high growth and discipline in deployment of capacity. This would allow some of the increases in fuel and staff costs to feed through to yields and alleviate increasing cost pressures on earnings. Yields have continued to trend sideways since the middle of FY17, however, struggling to maintain any consistent upward momentum in the last 12 months. Recent downward revisions to global growth forecasts have created a new headwind the sector moves into the next seasonal cycle from October, 2018 to March, 2019.

— After two favorable years for airline profitability, FY18 will be the first test of earnings resilience in an environment of stubbornly low yields and the rising tide of costs. On 26 October 2018, jet fuel was trading in the region of US$750/MT ¬– levels not seen since the second half of 2014 and up by more than 70 percent since July, 2017. Recent equity-market turmoil, Iran sanctions that exclude some crude exports, plus worries regarding global trade wars have at the time of writing driven Brent crude below US$70. However, the elevated fuel prices which have persisted over the last 15 months are feeding through to earnings.

— According to recent estimates by IATA, higher fuel prices will impact global aviation industry earnings by an estimated US$50 billion for 2018. Both the yield environment and fuel have therefore been key factors affecting many airlines' results announcements for the last 12 months and they are key factors in the outlook for airline earnings. It is therefore not surprising that we are seeing increased volatility in both reported earnings and share prices for many of the world's major listed carriers.

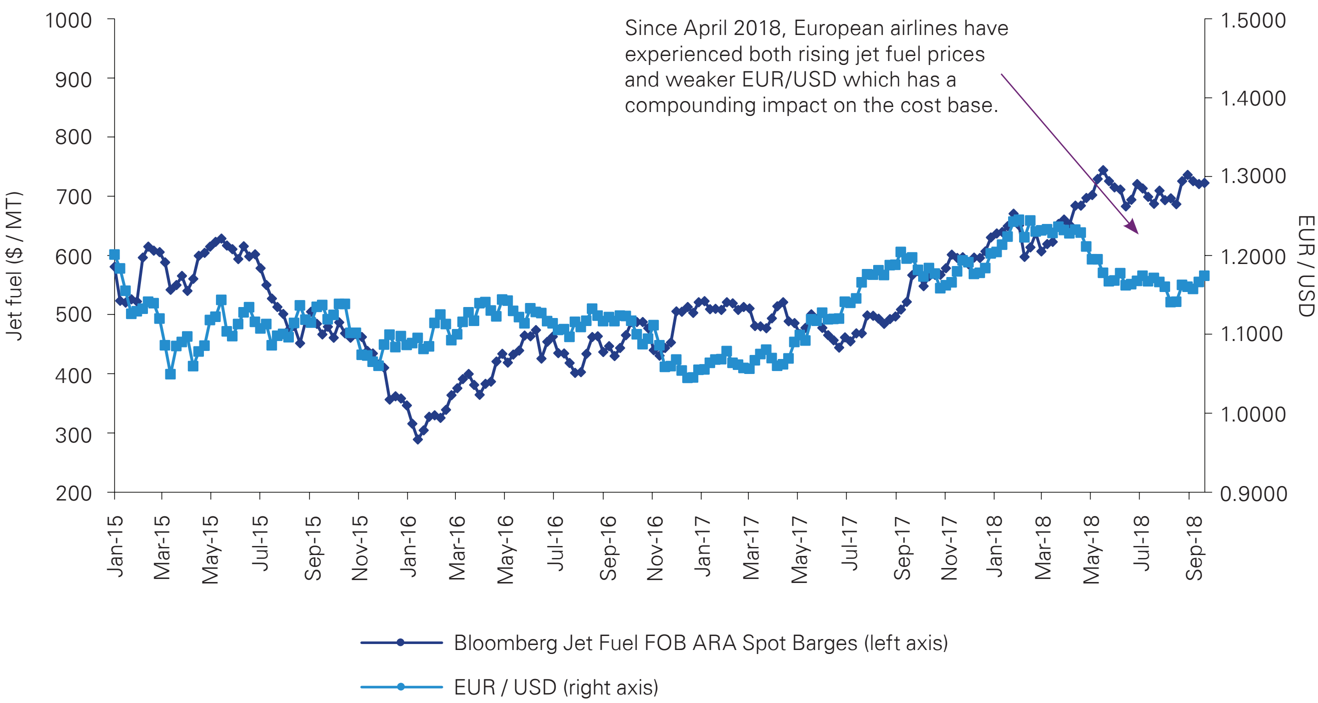
Movement in the share price of listed airlines from 2 January 2018 to 12 November 2018



Source: Closing share prices of airlines from 2 January 2018 to 12 November 2018 per the relevant stock exchanges

— The large US carriers are expected to be more resilient to rising costs given that their operations are generally larger and more profitable. United had a turbulent start to the year following some public relations incidents and has since recovered. The decline in the share price for Southwest occurred mostly in October, 2018 even after posting very strong Q3 2018 results, which highlights the sensitivity of investors to the sector and general apprehension over the earnings outlook.

Significant deviations in the correlation between fuel and EUR/USD produce a compounding impact (from both rising fuel and stronger USD) on the cost base of European airlines.



Source: Bloomberg

— Many airline-management teams have therefore spent much of FY18 intensely focused on the resilience of their operations in a higher-cost environment, squeezing out controllable costs and driving yield where possible. Airlines with more-agile operations and a strong history of developing new ancillary revenue streams to protect margins should fare better than those with longer-term structural cost inefficiencies.

— In Europe, KPMG professionals anticipate more consolidation, although we hope more can be achieved through strategic sales processes or mergers. The sale of Flybe will, we hope, produce more favourable outcomes for stakeholders than the recent spectacular airline failures. The recently proposed merger of Icelandair and WOW Air was however quickly abandoned with WOW Air being left to fend for itself. In all cases, our outlook for FY19 is for another challenging year across the industry, with increasing costs at the forefront of change.

Low Cost Long Haul

- In 2018, there are now 21 AOCs registered as Low Cost Long Haul airlines (LCLH) across 17 countries. Almost all of these LCLH airlines have either a low cost or legacy carrier parent with established short-haul networks. These short-haul networks, and operating of long-haul operations out of hubs, are key to the sustainability of long-haul operations.
- Asia Pacific is by some margin the largest and most mature market for LCLH. Air Asia X and Jetstar International were established more than 10 years ago, while Scoot was launched by Singapore Airlines in 2012. Air Asia X is arguably one of the most-successful LCLH airlines in the world using Kuala Lumpur International Airport (KLIA) as a hub for short- and long-haul operations. According to OAG data, in FY18 Air Asia X will operate 35 percent of seat capacity on long-haul flights out of KLIA using a low-cost product. Jetstar International has been progressively transitioning its fleet to more fuel efficient B787s aircraft, while Air Asia X is introducing new Airbus A330neos next year, each to drive LCLH operations forward.
- In the North Atlantic, the battle between LCLH carriers and the Transatlantic JVs has existed for a number of years, with significant inroads into market share emerging. LCLH carriers are forecast to operate 8 percent of capacity across the North Atlantic in FY18, with Norwegian leading the charge. Norwegian will surpass Air Asia X this year as the world's largest LCLH carrier. Eurowings, WestJet and WOW Air now also have well-established LCLH transatlantic operations, although these have not been without their own challenges.
- The sustainability of LCLH operations draws mixed views across the industry. Aircraft-related costs make up a larger portion of a low-cost airline's cost base and operating-cost efficiencies are therefore harder to achieve the longer the aircraft is in the air, while next-generation wide-body aircraft are expensive. The true test for the LCLH model will come from higher fuel, a stronger US dollar and a higher interest-rate environment – all of which will drive aircraft costs higher. Primera Air, meanwhile, is also a reminder that there is significant execution risk of the LCLH model as a stand-alone operation.
- One of the key things to watch will be how Norwegian navigates through the Winter in the Northern Hemisphere, how the launch of A321neos and 737 Max8s onto medium-long haul routes is received by the market, and whether low-cost carriers will collaborate to establish hubs to feed new LCLH operations. Also significant are the LCLH plans of SpiceJet and Indigo in India, which could be a high-performing market for LCLH.

Potential impact of US tariffs on air freight demand

- Increasing tariffs directly impacts the price of goods to consumers in the home market setting the tariffs, which affects demand. Given the nature of tariffs implemented to date, there seems to be limited impact on demand for air freight, since goods affected are not transported using air freight.
- US proposals for broader tariffs on imported goods from China are likely to impact any industries that have critical components or other aspects of their supply chain outside the US. Any manufacturers operating with components of their supply chain overseas and relying heavily on air freight could be affected by further restrictions, leading to a broader impact on air cargo volumes and yields that have improved significantly over the last 12 months.
- Manufacturers are likely to respond by adjusting their supply chains and moving their operations back onshore – having a longer-term impact on demand for global air freight.


'over-borrowing' risks new global crisis, warns IMF
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Global trade and customs

After decades of relative stability, steady tariffs and converging global trade rules, it seems clear that global trade has entered into a new phase of trade protectionism and uncertainty.

The US is taking a protectionist stance on trade amid perceived unfair treatment in the past while the UK government continues to pursue its withdrawal from the European Union. These new developments have a disruptive impact on businesses which will face potential roadblocks in the evolving – and unpredictable – global trade environment.

US trade under Trump Administration

The US President Donald Trump's approach on trade is having a global impact.

Among President Trump's first executive orders was the US withdrawal from both the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) with the EU.

Trump has also signed an executive order to review all existing FTAs, stating that previously negotiated FTAs have produced questionable results for the US. These include large trade deficits, a lack of reciprocal treatment of US goods and investment, offshoring of production, the loss of US intellectual property, reduced technological innovation, downward pressure on wage and income growth, and an impaired tax base.

The most-pressing FTA review to date by the Trump administration has been NAFTA. Negotiations on a new agreement – the United States–Mexico-Canada Agreement (USMCA) – have concluded the agreement is targeted in each nation for ratification and implementation within the next year.

Beyond North America, Trump has repeatedly said that unfair competition from abroad has harmed, among others, the US domestic steel and aluminium sector. As a result, the US has imposed new tariffs on many global steel and aluminium products and on US$ 200 billion worth of products. These additional tariffs have prompted a series of retaliatory measures by affected countries and regions.

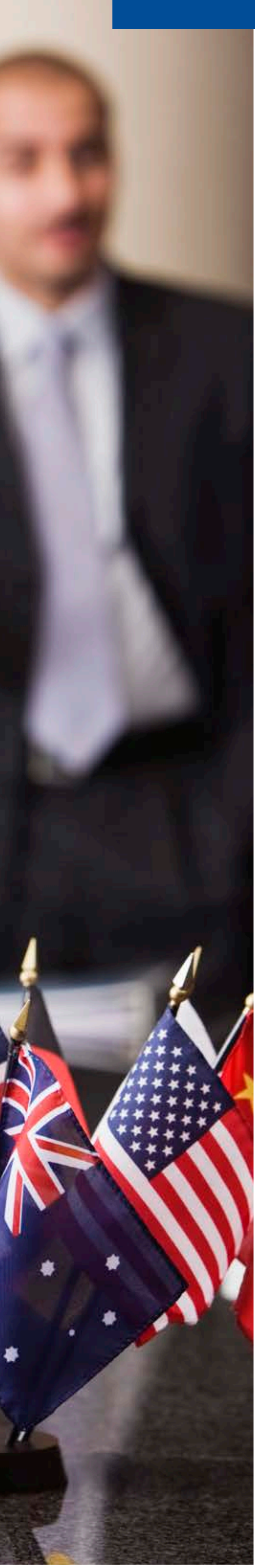
'New' borders and challenges loom under Brexit

Meanwhile, the UK government continues to negotiate its complex withdrawal from the EU.

It's important to keep in mind that EU member states have to date shared – and enjoyed the advantages of – a common external trade policy. Goods cross EU member-state borders without the need for customs declarations and related administrative or bureaucratic requirements and delays. There is no customs border between the UK and other EU member states. That said, Brexit will create a new customs border between the UK and EU nations.

Businesses doing trade on either side of the UK border will, under Brexit, face significant and disruptive new challenges as a new trading ecosystem emerges. These include the need to address customs declarations demands, increased bureaucracy, longer lead times on trading, and higher administrative costs.

Additionally, UK companies will no longer be considered EU-established companies, and for EU taxation purposes they will need fiscal representation. All FTAs that the UK enjoys by being part of the EU will no longer be applicable, requiring the UK to negotiate an array of separate new FTAs with entirely new terms and conditions.



What should businesses do?

For many decades global trade regulation has remained relatively harmonized and tariffs have remained stable, making the trade-compliance aspect of doing business reasonably predictable and easily managed. With trade duties low or non-existent, why would companies invest resources in trade compliance? Most customs-related work has typically been outsourced and companies have needed few dedicated staff to manage customs policies.

Now, however, companies will need to invest in innovations to their supply chain amid the inevitable impact of changing requirements, new regulations and emerging challenges. In particular, companies should seek to:

— **Understand your supply chain in new ways**

It will be crucial going forward for companies to understand and manage their supply chains in new ways, including how they can be seamlessly interlinked with emerging customs and trade-compliance requirements across the evolving global trade front. This includes identifying the origin of their goods and their suppliers, knowing how much the company is paying in duties, etc.

— **Strategize for new playing fields**

Once companies have a sharp lens focused on trade flows, they will need to be strategic when it comes to trading on unfamiliar playing fields. Identifying the best trade routes, the most-appropriate customs procedures and simplifications that allow for reduction in duties and increased competitiveness will be crucial.

— **Review the trade and customs ecosystem**

It will also be critical for companies to set up monitoring and reviewing mechanisms that position them to quickly understand their level of compliance and how any of the emerging new trade measures and policies will affect trade flows. Businesses will need to dedicate the appropriate level of time and resources to ensure smart and efficient responses.

In conclusion, serious challenges loom for businesses facing new rules and regulations on the global trading front. Acting now to anticipate these new challenges and to respond with timely, informed, precise new strategies and processes will be critical to their future growth and success prospects.

Case studies

Global case studies in transport and logistics

Project Emerald-Market Assessment-Credential-Commercial-11-2018

Client Challenge

- The client was a global player in marine and terminal business with operations across the marine and inland logistics services
- The client wanted to evaluate an opportunity to setup an FTWZ (Free Trade and Warehousing Zone) in Chennai region
- The client engaged KPMG to assist with the market study and business plan preparation exercise

KPMG Approach

Market Assessment

- Profiling of Chennai and nearby areas - Profiling of site and its proximity to nearby ports - air/sea and connectivity with nearby road and rail networks. Assessment of container traffic in Chennai and neighboring regions along with hinterland assessment for the same
- FTWZ assessment - Regulatory and policy overview, overview of operators for FTWZ in India, operating structure followed, overview of commodities handled in FTWZ, identifying the key industries
- Competing infrastructure - Customer and commodity profiles, overview of new infrastructure coming up
- Customer profiling - Estimating potential demand, customer segmentation and highlighting key insights & gap assessment

B plan preparation

- Technical assessment of site
- Business plan/ value proposition
- Financial Modelling

Benefits to Client

- The client could identify the potential clusters and major industries driving the demand for FTWZ. The existing and projected demand - supply gap analysis done by KPMG helped in fine tuning the client's investment strategy

Mombasa Special Economic Zone and Free Trade Port, Kenya – Economic Positioning, Market Study and Deal Structuring

Client Challenge

Kenya's Vision 2030 aims to transform Kenya into a newly industrialized, middle-income country via a number of strategic projects. One of those projects is to set up the first Special Economic Zone (SEZ) and Free Trade Port (FTP) in Mombasa on a 3,000-acre site to increase foreign direct investment, increase exports, create employment, generate foreign-exchange earnings and enable knowledge and technology transfer.

Key issues included the fact that the SEZ Act that will be applied on Mombasa SEZ was yet to be approved and enacted by the Kenyan Government

KPMG Approach

KPMG Kenyan firm was appointed by a confidential client to undertake an economic positioning and market study on the Mombasa SEZ and FTP. This engagement was extended into a second and third phase in support of the client's business case submission to government. The work included:

- Analysis of the SEZ and FTP in terms of key economic indicators, government business incentives, regulations, guidelines and policies and their impact on industrial development.
- Benchmarking study against three similar international free trade zones, SEZs and FTPs.
- Demand analysis and industry selection for the Mombasa SEZ and the smaller Miritini SEZ.
- Proposed industry land forecast by phases, in terms of key economic parameters such as investment, output, value adds for each selected industry cluster.
- Vessel Analysis and Projection Study for FTP.

Key features and facts

- Port tariff study and analysis
- Port connectivity analysis
- Feasibility study of a Transhipment Free Port at Dongo Kundu
- Economic Analysis
- Value chain analysis
- Residential population prediction
- Strategy and implementation
- Deal structuring for the development of the SEZ
- Financial structuring and risk profiling
- Land and property demand forecasting

Benefits to Client

- Using local economic data and benchmark data of successful zones/ports, KPMG positioned the projects vis-à-vis the two other SEZ/port surrounding countries in view of advantages, locality, proximity to raw materials and markets, and future growth and government objectives.
- KPMG considered the proposed PPP method, among other business, financial and operating models, and examined other methods for development types within the Mombasa SEZ.
- KPMG proposed business-friendly policies and incentives to compete with other SEZ, free-trade zones and ports.
- Using the output of industry positioning and real estate specialist data, KPMG forecasted the prices and uptake of land and property at the SEZ over the next 25 years.

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