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Market Analysis, Research & Education
A unit of Fidelity Management & Research Company

Understanding Economic Indicators: Global Trade

The next in a series on key economic indicators and their implications for the financial markets

Baltic Dry Index (BDI)

What

Trade is at the heart of global economic growth. Globalization has increased the reliance on international trade for almost all economies, whether they are predominantly exporters or importers. For the most part, the reporting of trade statistics is inherently slow and not uniform across countries. However, the Baltic Exchange's Baltic Dry Index (BDI) does provide timely insight into global shipping rates (prices), which have been an important leading indicator of trends in trade, industrial production and global economic growth.

The BDI tracks average daily shipping rates for dry bulk over 26 shipping routes and for the four-largest weight classes of dry transport ships. Rates are only reported by Baltic Exchange members, which means the index is devoid of speculative trading. These bulk shipments are generally raw components (i.e. precursors) to production, such as iron ore, wheat and steel, as opposed to finished goods (e.g. cars and processed foods) or "wet" goods (e.g. gasoline and crude oil). These raw materials are required to begin the production of finished goods, which is why the BDI is considered a leading indicator of global economic activity.

Many factors influence shipping rates. The primary driver of the BDI is demand for dry goods, most notably raw commodities. However, the relatively fixed, or inelastic, short-term supply of ships in the dry bulk shipping market can translate into disproportionate swings in the BDI for a given change in commodity demand. It can take more than two years to build a single ship at a cost of tens of millions of dollars, and therefore because ship supply is essentially fixed at any point in time, changes in demand for dry goods can move the needle of the BDI rather significantly. Other factors that influence the index include seasonal weather patterns, oil prices (which the ships use for fuel), geopolitical turmoil in shipping choke points (such as the Straights of Hormuz in the Persian Gulf), and port congestion. In addition, shipping rates may be influenced by overall credit conditions, as most shipments require letters of credit upon delivery. All else being equal, tight credit conditions can result in higher shipping rates.

Strengths

- Timely: Data are released daily, providing much more immediate information than other trade statistics.
- Leading indicator: The raw components and timely nature of the BDI help the market anticipate trends in trade and global industrial production.
- Lack of revisions: The index is never revised.
- Non-speculative: Speculators have no influence on index levels because these prices are for actual delivery of goods, unlike commodity futures contracts.

Weaknesses

- Volatility (fundamental): Short-term dislocations in the shipping market, extreme weather patterns, and other non-trade factors can temporarily overwhelm fundamental economic forces, leading to volatility in the BDI.
- Volatility (magnitude): Due to the inelastic supply of transport ships, the values of the index can swing disproportionately relative to the underlying fundamentals of trade (e.g., a 5% jump in index levels should not be interpreted as a 5% increase in trade demand).

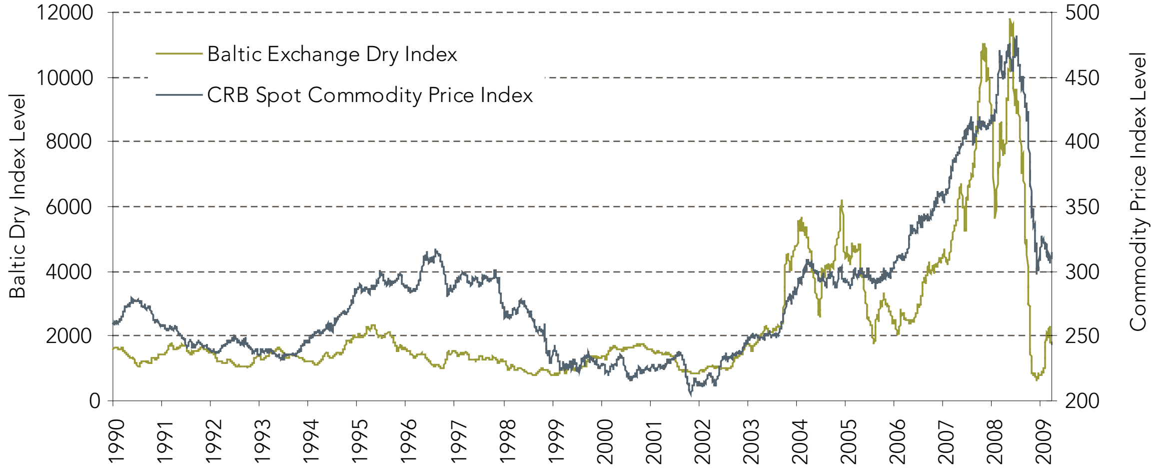
Who

The Baltic Exchange, a London-based independent organization of shippers, has been in continuous operation for more than 250 years.

When

Daily.

EXHIBIT 1: Shipping rates and commodity prices both lead global trade patterns. Volatility can mask trends, so looking for concurrent movements can be helpful.



Source: The Baltic Exchange, Commodity Research Bureau, Haver Analytics, FMRCo (MARE) as of 3/25/09.

Commentary

The world economy has slowed dramatically in recent months. A recent report from the World Trade Organization (WTO) estimates that global trade volumes will decline by 9% in 2009 compared to the previous year—the largest contraction since World War II.[i] Globalization has been a driver of growth for many countries, with supply chains for finished goods involving components from a myriad of different producers and locales. This global interconnectedness has proved to be a double-edged sword of late, contributing to a slowdown among all regions of the world.

In 2008, the Baltic Dry Index (BDI) effectively foreshadowed the abrupt downturn in global trade and economic activity. After peaking at an all-time high in May, the index began a sharp pullback in the summer of 2008. It ultimately bottomed in December, completing a 95% decline (see Exhibit 1).

As discussed on the prior page, however, volatility can sometimes mask trends in the BDI and make it difficult to differentiate between true economic changes and volatility inherent in the data. For example, the BDI in late 2007 fell nearly 50% in under four months, only to rally to a new all-time high about four months later. One way to confirm BDI movements is to measure whether commodity spot prices are moving in the same direction as shipping rates. [Editor's note: Spot prices are more reliable indicators of demand because they only measure prices paid for commodities with physical delivery, as opposed to futures prices that are affected by investment speculation.] Commodity spot prices fell dramatically in mid-2008, moving in near lockstep with the plunge in the BDI. In late 2007, the "false signal" of trade weakness signaled by the BDI was not accompanied by a broad-based decline in commodity prices (see Exhibit 1).

Outlook

There are many reasons for pessimism in the current global economic environment. The financial crisis has impeded the flow of credit around the world, falling asset values have pressured corporate and financial balance sheets, and global trade volumes have plunged. However, after the abrupt collapse of the BDI during the second half of 2008, the index stabilized toward the end of the year and ticked upward in early 2009. This stabilization has been accompanied by a rise in commodity spot prices. Some of the recent upward movement in the BDI might well be due to China's stockpiling of raw materials while they are "cheap" as opposed to a signal of recovery in current production. Indeed, there are few signs that global industrial production is growing.

Nevertheless, the stabilization in the BDI is a positive development that perhaps the rapid deterioration in global trade is no longer getting worse. Furthermore, massive stimulus still being put in place by governments around the world (including China) hold out the promise of firming up commodity demand for resource-intensive infrastructure programs. Investors may do well not to over-react to daily fluctuations in the BDI, but monitoring the overall BDI trend over time may provide a good barometer for whether a global economic recovery is gaining strength. ■

The Market Analysis, Research and Education (MARE) group, a unit of Fidelity Management & Research Co. (FMRCo.), provides timely analysis on developments in the financial markets.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.
Past performance is no guarantee of future results.

[i] "World Trade 2008, Prospects for 2009" report, March 24, 2009. Source: World Trade Organization.