Weekly Trading Education Article

The Baltic Dry Index: An Ideal Tool for Signaling the End of a Crisis

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How many times have investors or even traders wished they had a tool capable of signaling the precise timing of a market reversal, a tool that would draw a clear separation line between a bull market and a bear market? Well... it could be that the Baltic Dry Index -- BDI for short -- is one of those precious tools, the so-called Leading Economic Indicators!

Even though this indicator consists of a single value for each day, we can safely say that it acts as the missing link between Fundamentals and Technical Analysis. Why? Let's start by describing -- through text and charts -- its essential characteristics!

First of all, the definition...The BDI has only one value -- expressed in USD -- issued every day around 13.00 GMT and representing the price for moving major dry raw commodities (bulk type) by sea; the dry category comprises all raw materials, except oil, liquefied gas and so on. The daily value is issued by the London Baltic Exchange and has no relation whatsoever to the Baltic Sea or the neighboring countries -- the so-called Baltic States.

The price represents the average of all freight prices charged by the most important bulk shipping companies on 26 shipping routes that cover all the oceans and vessels of the Handymax, Panamax, Supramax and Capsize types. The freight transported on these routes consists mainly of building materials, iron ore, coal and grain -- the basis of any economy.

It goes without saying that the world shipping fleet has a fixed capacity on average; it takes up to two years to build a new vessel. When the world economy is in the grips of a recession, the output of end products shrinks considerably, causing a decrease in the demand for raw material, which, in turn, leads to a decrease in the demand for shipping capacity. The freight rates will go down -- in direct relationship to the shrinking demand! The BDI chart will certainly show a descending trend.

On the other hand, when the world economy experiences an expansion, which could eventually lead to an economic boom, the output of end products grows considerably and leads to an increase in the demand for raw materials. Because the number of vessels is relatively constant, the demand for shipping capacity increases. The freight rates will shoot straight up -- in direct relationship to the rising demand! The BDI chart will certainly show an ascending trend, with a more-or-less abrupt slope.

But, still, there is an If...If we want to perform a rigorous and detailed analysis of the BDI index, we must take into account the stability of the USD, which is the currency used to express the BDI value.

In times of USD devaluation, the BDI value increases, and this value no longer represents a true measure of the demand / supply equilibrium on the shipping market, whether we're talking about the dry commodities or the liquid cargo! So, we are dealing here with an unwritten rule... Never draw a final conclusion on the BDI index without first evaluating the value of the U.S. currency. And, always remember the inverse relationship between these two items: A devalued USD will increase the BDI index value, and the other way around.

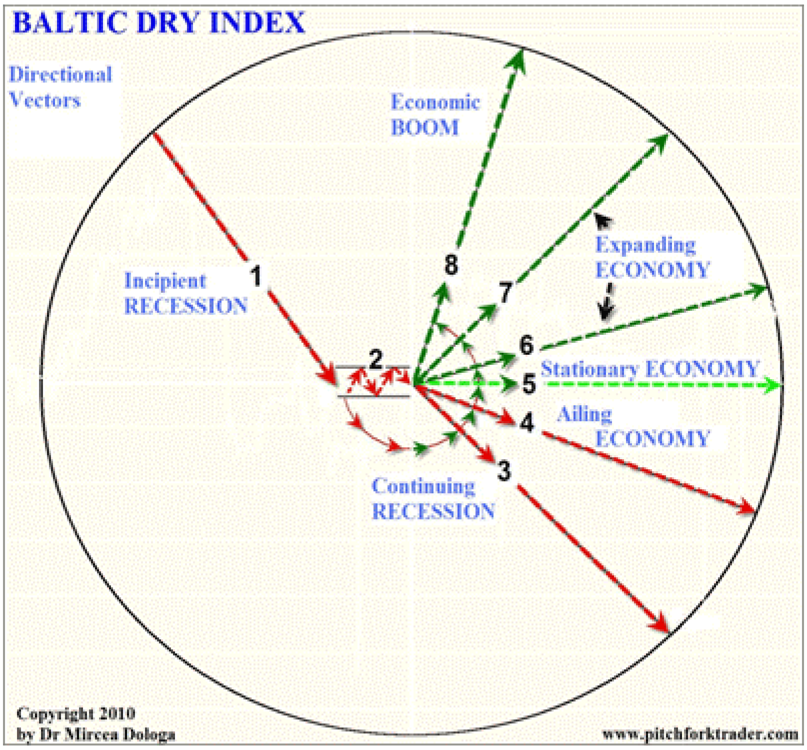

Figure 1. The Baltic Dry Index. The directional vectors express the shipping demand on the global market and the corresponding phases of the business cycle.

It is quite useful to monitor the angle of a descending trend, describing a recession-plagued economy, which will rotate clockwise -- with a certain rhythm and a certain acceleration -- depending on the recovery of economic activity; the angle may even reach a value of 60° during an economic boom (see Figure 1).

If the BDI index goes flat on the chart, it suggests that the economy is going through an indecision phase, which could be temporary or long-lasting, depending on the production cycle of the end products and the cost of carrying the raw commodities that are not yet processed into end products because of low market demand.

Before we study in detail the corresponding BDI charts, it's worth mentioning a few words on the index's behaviour during an economic crisis:

- Implicitly, when we talk about the cargo shipping process, the credit crunch causes a substantial decrease of the BDI value due to the reduction in the number of Letters of Credit, which is the preferred means of payment in the shipping industry.

- What's more, the number of vessels can't be supplemented overnight because it takes at least two years to build a new ship. The credit crunch also causes the number of ship-building orders to shrink dramatically and can even generate bankruptcy in the ship-building industry, where the shipyards can no longer cope with the lack of orders, taking into account the huge fixed costs.
- Eventually, the fluctuation of raw material prices, in direct relationship to the USD devaluation, is the element that makes the shipping industry plays such a major role in the economic recovery of the USA and any other country, for that matter.

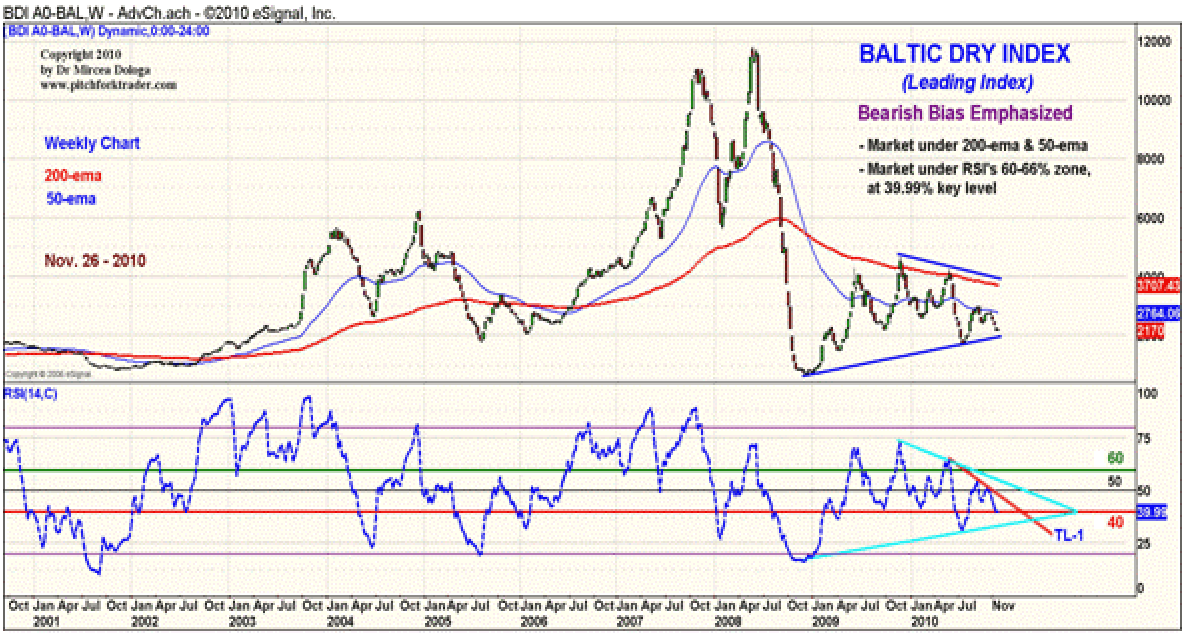

Figure 2. The Baltic Dry Index Weekly Chart

A closer look at the weekly chart of the BDI index (see Figure 2) reveals the following:

- The first major High at 11039 corresponds to the autumn of 2007 (November 16), confirming the fact that this crisis was generated by toxic financial assets, the so-called sub-prime crisis, which broke out in July / August 2007.
- In the following five months, the BDI index value fell almost 50 percent, reaching the 5616 level on February 1, 2008 -- even though it took the index more than six years to reach that high.
- The economic instability of the first half of 2008, characterized by a number of ascending swings on insignificant volume, fooled the uneducated public into believing in a quick recovery, with a BDI index that not only climbed back to the old High (11039) but also reached a new High (11793 on May 23, 2008).
- In spite of this vigorous spike -- without the proper volume -- the unstable economy was too weak to support a solid recovery in a period when the U.S. unemployment rate had reached more than 9 percent, a value unheard of since the 1980 - 82 crisis. As a result, the BDI index has dropped dramatically (a 94.31 percent retracement from the highest level) -- like a rock sinking to the bottom of a lake -- going below the 671 level on December 12, 2008. Since then, it has evolved sideways, inside a symmetrical triangle (see Figures 2 and 3), trying to recover very slowly on a 10° ascending slope…but not very successfully!

- As I am writing this article (on November 26, 2010), the BDI index has already spent two years in a consolidation pattern -- still inside it -- and it is currently hovering around its lower threshold at the 2170 level.

The index is still under the reign of the descending trend shown on the weekly chart (see Figure 2), with the current value below the significant moving averages (200 and 50 ema). Besides, the current value of the RSI indicator (39.99 percent) shows that this indicator is also in a downtrend, as long as it remains under the 66 - 60 percent zone.

The RSI trend line (TL-1), which represents the lower limit of a symmetrical triangle that contains the indicator, seems gradually to offset the descending move and implies that a breakout to the downside is imminent. Once the indicator enters the 40 - 33 percent zone, we can safely assume that the market has chosen to continue its downward movement begun on November 16, 2007 and renewed on May 23, 2008, with a drop from its highest high (11793).

Top-Down Technical Analysis teaches us always to compare the conclusions drawn from the weekly time frame with the conclusions drawn from the daily chart. You'd be amazed by the wealth of information revealed when we zoom in on the trading scene, knowing that a weekly bar comprises 5 daily bars.

It's not only the "zoom-in" effect, but also the fact that we're getting closer to the current market, and we can observe the symmetrical triangle formation more clearly. In this article, we employ only the classic tools of technical analysis, without making use of the modern tools (Elliott Waves and Wyckoff Theory, so specific to sideways markets).

Figure 3. The Baltic Dry Index Daily Chart

On the daily chart (see Figure 3), we can easily notice a blow-up version of the symmetrical triangle, which is a classic sign of a market recovery or consolidation. Market flow is located below the two important moving averages (200 and 50 ema) but also below the descending trend line (TL-A), which has imposed -- for six months already -- this downward movement.

The last hope for stopping this descending move is represented by the 1866 level, which coincides with the triangle's lower threshold. For the time being, such a ricochet is a bit hard to imagine because it's practically impossible to reveal a parameter that would reverse the current trend, given the "cranky" economic context, with an almost 10 percent unemployment rate and a chronic shortage of shipping orders.

As if on purpose, the RSI indicator not only corroborated the daily chart conclusions but also confirmed the existence of an aggravating down trend once it entered the 40 - 33 percent zone and went all the way to the 22.54 percent level.

There's a high probability for an even bigger drop in the RSI if the indicator breaks below the TL-B trend line and enters the 0 - 20 percent over-sold zone, where it could remain for quite a while. We wouldn't be surprised if the indicator were to bounce off the 6.19 percent level and fluctuate within the over-sold zone!

The scope of this article does not allow us to explore the Baltic Dry Index more deeply, but the main idea is that it's impossible to have a drastic economic change without a certain reaction from this sensitive index. What's more, it should be used in synergy and symbiosis with other indicators capable of confirming the reversal of the economic trend, such as the price of copper, South Korean exports and, of course, the evolution of the three U.S. indices (the Dow Jones Industrial, Dow Jones Transportation and Dow Jones Utility) in conformity with the Dow Theory, developed and published more than 100 years ago.

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