Weekend Flows

What are the "Bad Boys" up to? – August 19th, 2023

Iran has been in the news lately, as Biden essentially traded $6bn for 5 US hostages, fuelling speculation he's been working with Tehran to subtly allow oil export increases. While Iranian crude and condensate production has been steadily increasing over the past year, with well over 3mb/d of production, and exports touching 1.5mb/d – there's a lot at play – how is Iran going to move their fresh barrels they need to export, and where does their crude end up? All together, we talk about the five bad boys of the crude market today – **China, Greece, India, Iran, and Russia**.

(Fig. 1) Urals Basis to Brent

(Fig. 2) Chinese Crude Inventories

Source: Kpler, S&P Platts, HTM Analysis

Crude inventories in China have started to roll, with Kpler estimated stockpiles, cresting to 1bn barrels through July, and now down 40m, to 960m barrels. In our view, this is ultimately conducive to OPEC cuts as we see some typical China stomping ground softness during the next trading cycle. While inventory draws may not seem immediately bullish, our view is that Chinese destocking while either **a**) waiting for seasonally softer demand, or **b**) seeing barrels seep back into the market via Russia or Saudi Arabia is ultimately the healthiest thing for the market at current. We believe it's not in China's interest to see significantly higher oil prices in the coming months, as their economy sputters along. Given we have outlined our view that China is the main 'wild card' in the coming years, we think that they will use their interim position to manage the market. We would see continued *local* inventory adds as bearish (on account of clearly struggling demand), while we see draws as medium term bullish (demand on track, and conducive to lower-for-longer OPEC+ cuts) **and** longer term bullish (OPEC+ achieves their goal of normalizing global inventories and can resume as the major market cartel). Bonus if China issues additional export quotas and can solve some of the middle distillate stock shortages that we are seeing, especially West of Suez.

Daily Pricing & Week on Week Benchmark Chg.

CAD Priced Liquids

Condy | **$106.06** (-1.3%)
Bonny Light | **$117.17** (-3.9%)
Synthetic | **$113.30** (-2.5%)
WCS | **$85.70** (-5.6%)

USD Priced Liquids

LLS | **$84.35** (-1.6%)
MEH | **$82.80** (-2.4%)
NYMEX | **$81.25** (-2.3%)
WTI FOB | **$82.50** (-0.8%)

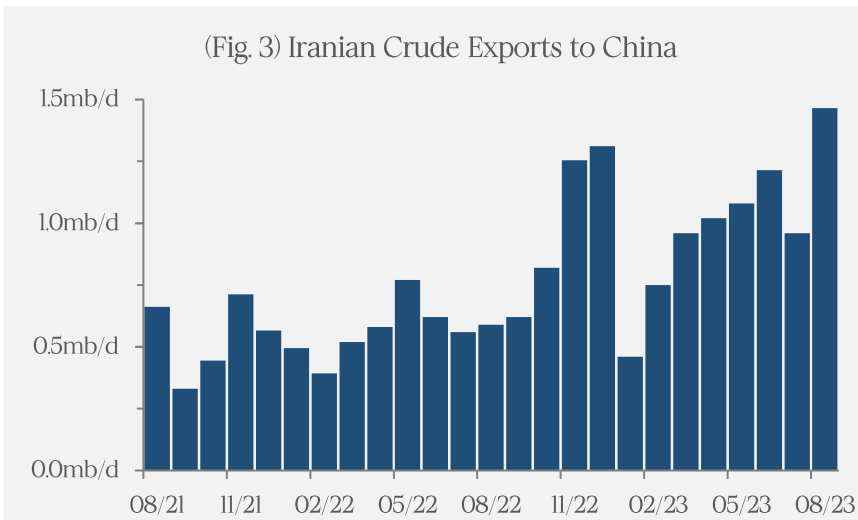
CAD Priced Gas

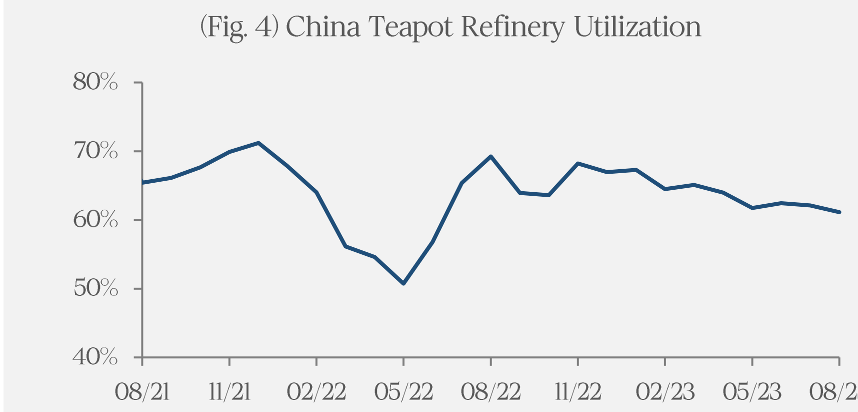
AECO | **$2.63** (-14.0%)
Alliance | **$2.31** (-17.7%)
Empress | **$2.63** (-15.3%)
Station 2 | **$2.64** (+23.9%)

USD Priced Gas

Dawn | **$2.30** (-10.3%)
Houston | **$2.43** (-9.3%)
Malin | **$3.45** (-16.6%)
PG&E | **$5.20** (-8.8%)
SoCal | **$5.74** (+16.0%)
Waha | **$2.14** (-12.0%)

Now that other dark barrels (including Iranian Light trading -$12/b to Oman) are competitive with a now more expensive Urals as feedstock (see fig. 1, and note, that Iranian Light is API 33.7°/1.5% sulfur, while Urals is spec at 30.6°/1.48%) shifting demand from Urals, towards Iranian crude – we are only more confident in our view that Russia, really is mostly noise on a 2H23 macro basis. With Iranian crude coming through Malaysia (and recent crackdowns on this triangle routing, and blending with Venezuela heavy generally eased), and independent refinery usage low (and able to pivot quickly into strong margins on a product, or feedstock basis) – we continue to believe that China will act as the market sponge, for better or worse. Of our forecast 2H23 global inventory draw of ~185mb, we see most of this coming from China, and for the best.





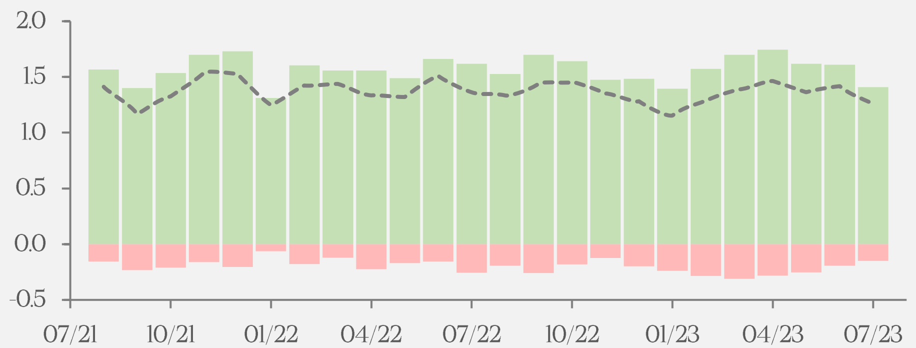
Source: Bloomberg, ICIS, Kpler, HTM Analysis

Given the tanker market has shifted. The question we think is most important – is can Iran and Russia continue to export their crude and condensate production, or are they ship constrained? With more boats on ballast voyage to the Middle East (rather than Russia), partially due to some softness of volumes out of Novorossiysk, and partially due to the sheer number of older vessels now owned by Russian shell corporations, we see the crude tanker trade, rates wise, holding steady to slightly softer into the rest of 2023, with a more constructive view on later year product tankers (especially long range) on account of increased tonnage allocated to Russia and the later-year need for gasoil to move east to west. With Iran floating storage lower, we think they have the capacity to move crude. Ultimately we'd be interested in adding spot long range product exposure, especially should it soften in coming weeks. We aren't specifically hyper-bullish gasoil prices, like some market commentators have been this past week (first instinct would be to fade diesel on account of increased Indian demand due to refinery outages, and the beginning of stockpilings reversing their draws in both Singapore, and at Fujairah) and would tend to play the rest of the trade through spot product tanker exposure (Frontline and Scorpio both come to mind here). What we'd like to see play out is Chinese economic weakness, and increased diesel exports – with independent refineries taking advantage of strong cash margins and pivoting utilization (and thus exports) higher. With an east to west arb open, stocks move to where they're needed, and longer range tankers are beneficiaries. We are cautious here, as we are not sure which way we are going to see the Chinese government act – if they would allow increased export quotas in the first place. Given that Sokol flows remain strong (yields ~45% diesel) and Iranian Light flows (at times mixed with heavier Venezeulan product) flows continuing into China (yields ~30% diesel) are ramping (and fuel oil feedstock still viable) – we are keeping a keen eye to see what the teapots do, and how Far East products move into the various inventory hubs.

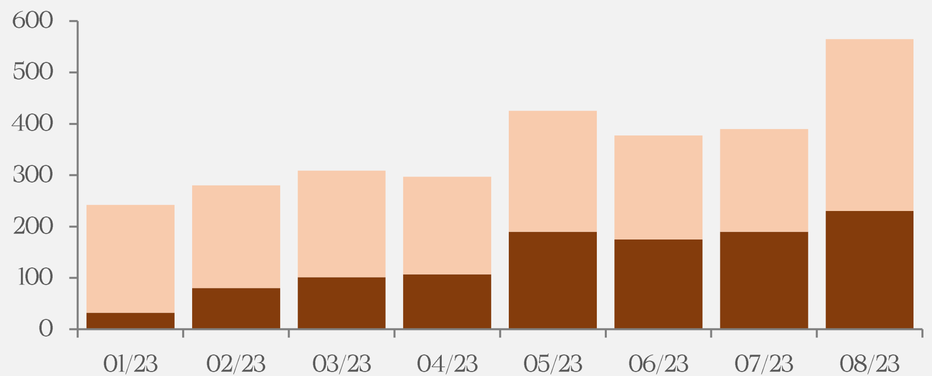
We are also keeping an eye on the Middle East which has become a buoy for global product markets, one as local refining capacity plugs into the trade, and as Russian sellers have lost export destinations post-invasion, and note that India (shown in light orange in fig. 6) has been ramping their gasoil imports from Russia, along with Brazil. As Russian barrels find new homes, we think the market allocates the new slack correctly. We'd be interested in adding refiners as a trade to capture what we believe to be the highly likely scenario of market disorganization, especially as US distillate stocks. Across our refinery coverage, PBF stands out as not only being exceptionally cheap compared to peers, but well positioned in PADD 1 as distillate inventories are still sorely lacking. PBF we believe, on an equity multiple basis has been hampered due to their foray with irresponsible leverage over the past decade, but this is a positive going forward, as they are in a net cash position, with a brutal lesson behind them. The shakeout of MLP stock beneficiaries (after their MLP absorption in a cash/stock deal) possibly put some selling pressure earlier in the year, but with a solid technical setup (really, all refiners look close to breaking out on the charts here), and a clean balance sheet and now, ownership structure, we are happy to add PADD 1 focused distillate refining capacity. Especially companies that screen cheap, and have a line on increased renewable fuels capacity.

While the California refining penalty is a slight incremental negative, given their two sites in Torrance, and Martinez – but digested by the market (and perhaps cause for part of their valuation discount). Given that retail fuel prices in California are some 20% lower than the "outrage" prices that caused the bill to be passed, we are still comfortable owning PBF, especially at a 3x multiple. Other risks to refiners in general include the squeeze on heavy feed (given that PADD 1 only imports inconsequential volumes of Canadian heavy, and PBF by rail to their Wilmington site) as they lack a direct pipe connection to the WCSB, though as the heavy market starts to calm, this becomes less of a concern, especially given China's quietness in West Africa.

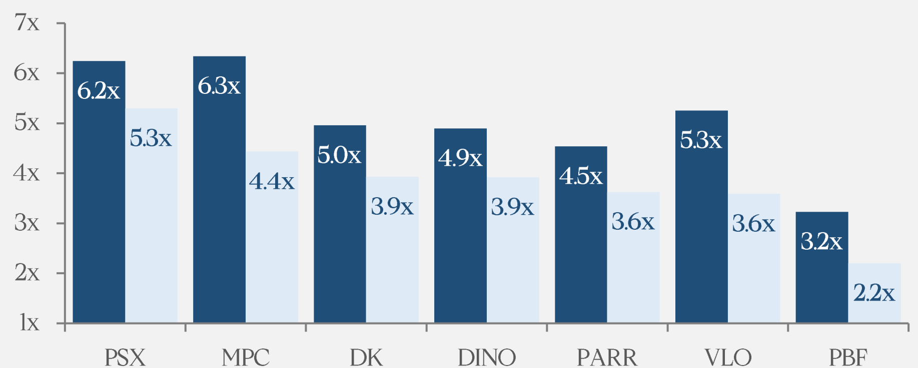
(Fig. 5) KSA Net Clean Product Flows (mb/d)



(Fig. 6) Russian Gasoil Exports to India and Brazil (kb/d)

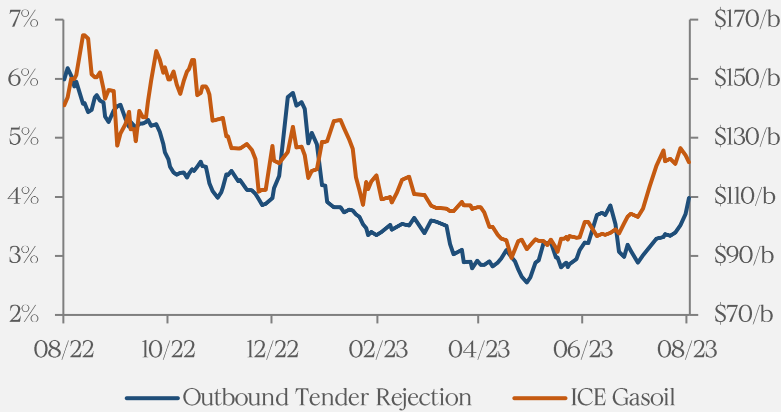


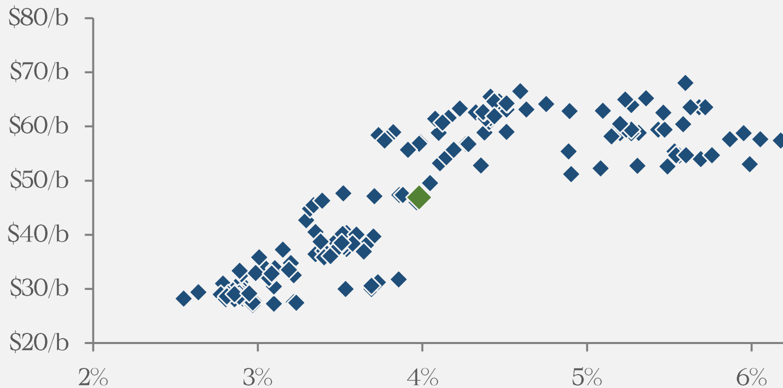
(Fig. 7) US Refiners 2024E & 2023E EV/EBITDA



Source: Bloomberg, Kpler, HTM Analysis

As most business indicators perk back up in the US, freight rejections have begun to increase. While the correlation between diesel cracks, and flat diesel price is strongly positive, other factors come into play around 4% (where we are right now), which further adds to our caution on going max long distillates here – we want to be very selective.



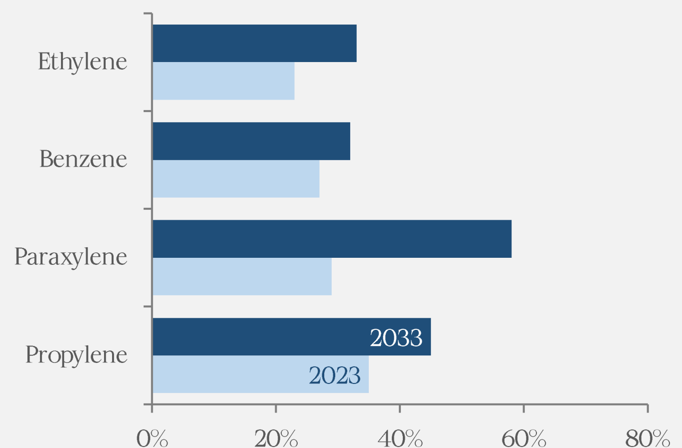


Source: Bloomberg, HTM Analysis

While there is room for the outbound tender rejection index to move higher (we are more bullish spot freight into the back half of the year though still note higher retailer inventories than seasonally expected that are not clearing as fast as many had hoped for), and think that freight has mostly run its course on diesel.

Broadly, another thematic flows theme is – steam cracker demand from the east should, on a very long term trade, support LPG carriers, and also, should put some damper on the Permian bull's continued cry that the basin is getting gassier, and producing lighter liquids, rather than crude oil (the Magellan East Houston terminal assesment is 38-40° API, which is already an incredibly light grade compared to most others worldwide). While the Permian indeed will get lighter, gassier, and grow slower, we believe, that long term liquids flows will become increasingly important, and not oft discussed (rather, how the increased non-crude cut is becoming worrisome). We would be long term bullish on the relative value of non-crude products to the price of WTI as global product demand evolves away from straight gasoil/gasoline.

For weekend flows – we see themes as – Greeks stepping out of the Russia trade, Iran exporting more crude, and Russia becoming mostly irrelevant in the short term. We believe that increased Chinese crude draws are long term bullish on account of OPEC+ production cut supports. While we would hope to see Chinese export quotas increased, which would help to temper the gasoil run (and Shandong refineries are in a position to respond to any such activity), there is a good chance that we will see some wonkiness this winter, in which case selective exposure to refiners, and long range product tankers look attractive (and even moreso, later year, early 2024 call spreads on mentioned equities). We see next week as mostly quiet – with incremental economic news out of China leading the trade higher or lower.



Source: ICIS, HTM Analysis