Crude Oil Weekly

Demand weakness hits European market sentiment

August 2022

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1.

Executive Summary

Amid falling US crude runs over July, backwardation in market structures has weakened and the Brent-WTI spread has widened, making US barrels more attractive for export.

With autumn refinery maintenance approaching, lowering Europe's crude requirements, regional producers are faced with a triple whammy of weaker demand, dropping flat prices and shrinking differentials.

Global onshore inventories have dropped to the lowest level on our records, driven by a recent drop from China as well as persistent weekly SPR releases in the US.

2.

Atlantic Basin

US crude exports to China increase fourfold in July

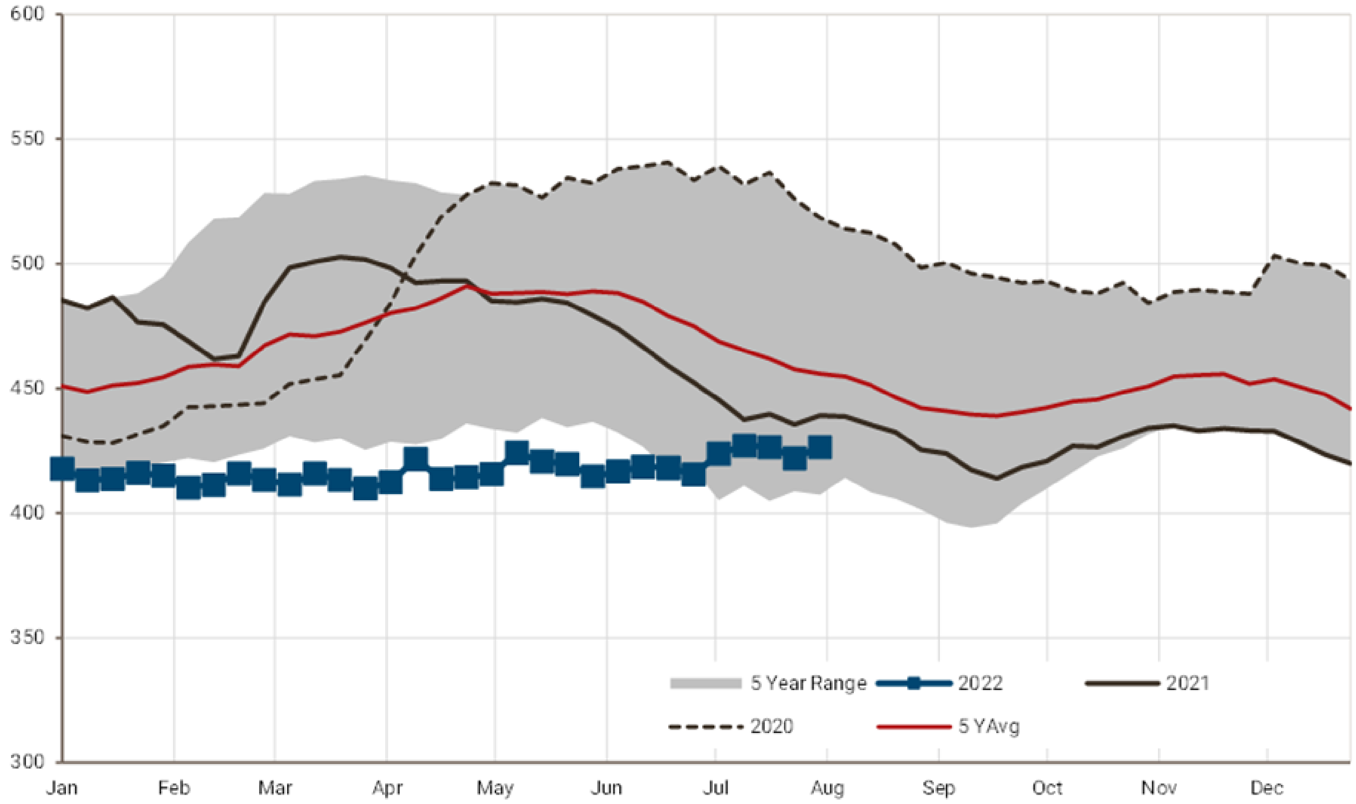
Despite US President Biden's attempt to persuade Saudi Arabia of a supply ramp-up, OPEC+ decided yesterday to increase output by only 100 kbd in September, a very low number that will in any case not materialise given the stark underproduction of the OPEC+ group so far (see yesterday's Crude Oil Daily). Nevertheless, with the market initially expecting a stronger OPEC+ output hike, persisting recessionary fears and building US crude stocks, WTI Houston futures fell over the past week from $98.6/bbl on 29 July to $90.66/bbl on 3 August (Argus Media).

According to our ship-tracking data, **US crude exports in July have climbed to the second largest monthly export number ever recorded** (after December 2019) at 3.3 Mbd (+3% m/m, +30% y/y), with EIA data in late July also showing an unprecedented high in the weekly average at 4.55 Mbd (+790 kbd w/w). This has been mainly driven by sweet crude exports to China quadrupling (from 130 kbd in June to 540 kbd in July) amid the recent issuance of new import quotas and rising Chinese refinery runs. **Strong export flows towards China have also been incentivised by the wide gap between the two major crude benchmarks, pushing refiners to source their light sweet crude from WTI-pegged rather than Brent-pegged grades.** As we expect the Brent-WTI spread to remain wide for the time being, this will support a continued stream of US export cargoes as we move into August, lifting outflows beyond their current levels of 3.3 Mbd.

Partly pressured by the Canadian Keystone pipeline outage, crude imports to the US have declined for the first three weeks of July, with US net imports falling to the lowest levels since April, below 2 Mbd in late July (3 Mbd below 5-year average; however rebounding again to more moderate levels in the latest data). Meanwhile, crude inventories have climbed in the latest EIA reading to 426 Mb (+4.5 Mb w/w), with July's monthly average increasing by 6.5 Mb m/m.

US crude inventories, Mb

Weekly EIA data releases show that US crude stocks have been growing in July

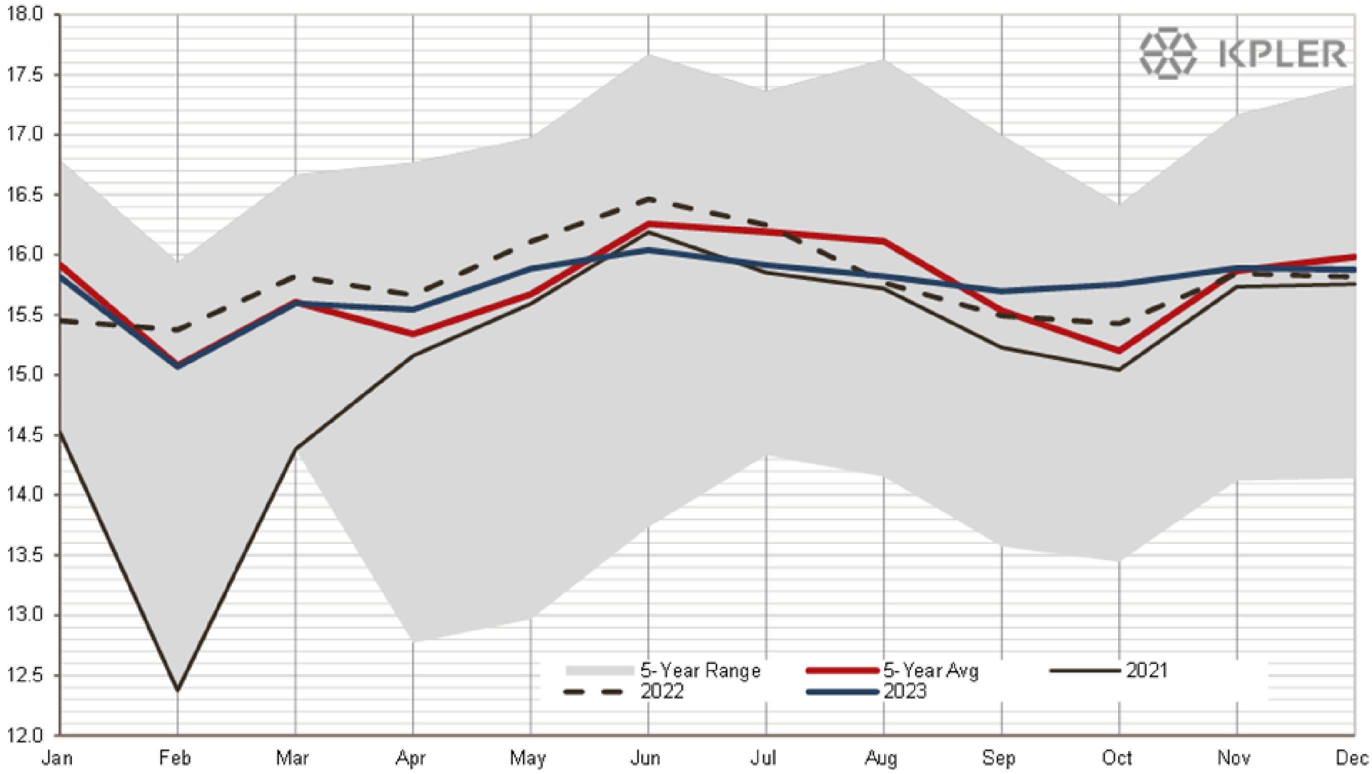


Source: EIA

These trade dynamics reflect falling US crude demand, with EIA data showing four weeks of consecutive declines in nationwide refinery intake, currently trending at 15.9 Mbd, some 900 kbd below historical averages. **A lengthening US crude balance last month has weakened backwardation across key US contracts over H2 July, with the WTI Houston M1-M2 spread falling from above $4/bbl in mid-July to $1.4/bbl in early August.** Moreover, the ICE Brent vs WTI Nymex spread is currently trending around $8/bbl, levels last seen during the onset of the pandemic in March 2020, indicating that crude markets are much tighter in Europe vs the US. Moreover, WTI Houston premium vs Dubai has decreased from above a $2/bbl premium in early July to below a $7/bbl discount over the last week (Argus Media pricing). **Despite growing products demand, we forecast US crude intake to fall for the rest of Q3, with August levels expected to come in at 15.77 Mbd, -480 kbd m/m and 585 kbd (or 4%) below historical averages for this month.**

US refinery crude intake, Mbd

After peaking in June, we see US crude demand decrease over the summer



Source: Kpler estimates

Regarding strategic inventories, US SPR sales (Biden pledged to release 1 mbd from strategic reserves over 6 months) have pressured stocks to their lowest levels since 1985 at 470 Mb (EIA). Between 16 August and 30 September, the US DOE sold more than 27 Mb of sweet crude and some 12.3 Mb of sour crude for delivery to the USGC. From 16 September to 21 October, the DOE plans to offer 2.8 Mb of sour crude and 17.2 Mb of sweet crude.

In July, Mexican crude exports (66% heavy sour Maya, 30% light sour Isthmus) hit a 12-month high on the back of higher outflows to the US and India, with the K-factor for Maya crude cargoes bound for the USGC decreasing in July by $1.90/bbl to a $9.45/bbl discount, its lowest levels since April 2020. Next to buyers capitalising on cheap prices, Mexico's ramp-up in crude exports can partly be explained by its attempt to finance its subsidies, with the country reportedly spending

$28 billion in 2022 on nergy- and food-related subsidies to tame inflation levels that recently reached 21-year highs. Even though Mexican crude intake in Q2 climbed by 20% y/y to some 800 kbd (-6.5% q/q) and gasoline and diesel production rose by 50% and 30% y/y, respectively, Mexican clean product imports continued to climb in July to almost 900 kbd (vs Q1average of 580 kbd). **Fuel imports were likely ramped up due to an expected rise in products demand and following the government's announcement of gasoline subsidies, enabling Pemex to purchase more fuel from overseas, consequently filling up storage tanks.** This lack of available storage has resulted in more than 60 ships mainly carrying gasoline and diesel (estimated 18 Mb of fuel) waiting off the coast of Mexico to unload, creating massive congestion, with the ship backlog increasing to three times the normal volume (Bloomberg).

3.

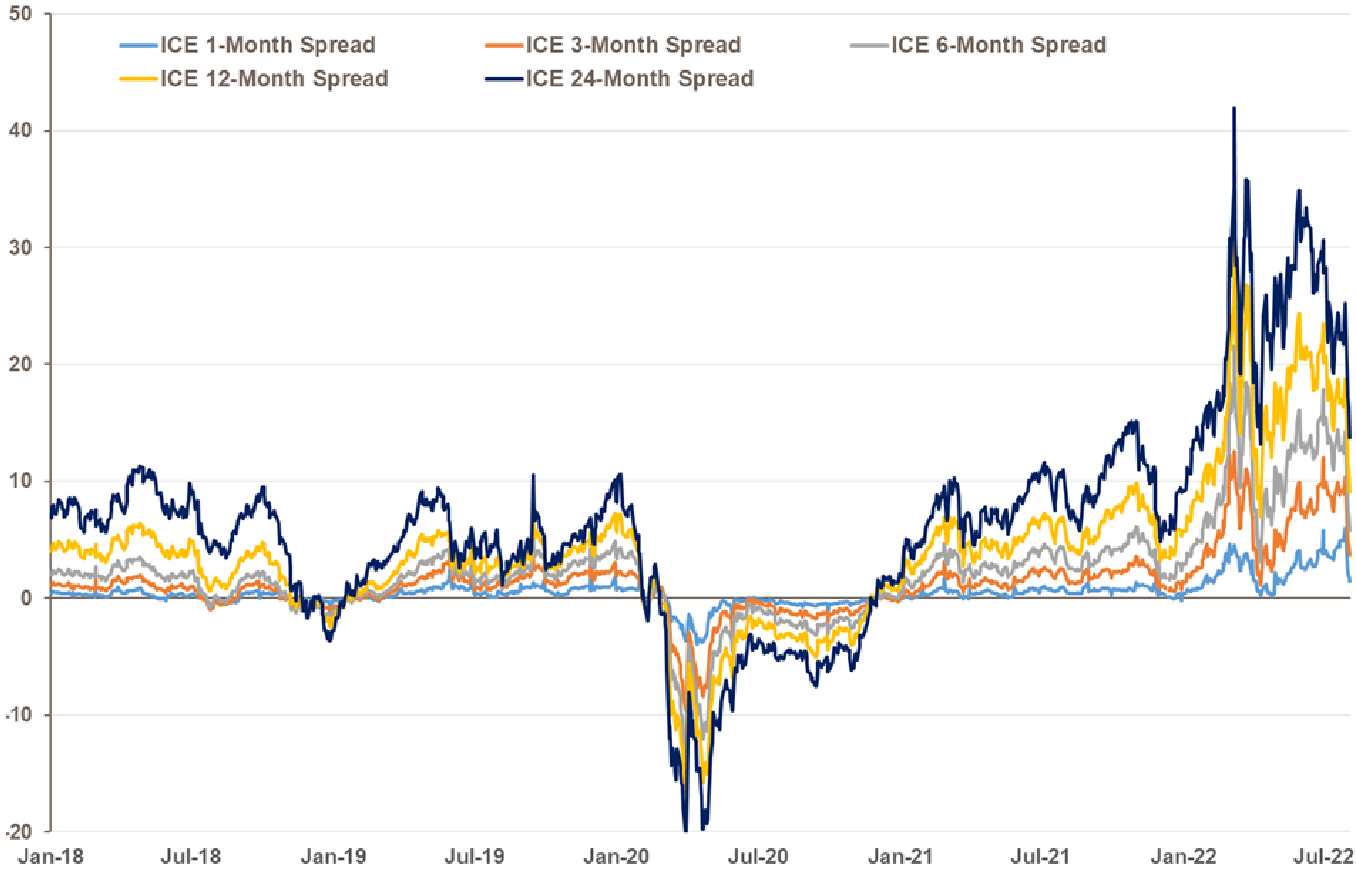
Europe and FSU

Demand weakness hits European market sentiment

Lackluster manufacturing data, IMF warnings of a global recession, inverted US yield curves – everything seems to be adding up to a grand picture of weakening demand as we head into the winter season. The futures curve took notice of the sentiment shift for the first time since the onset of Russia's invasion of Ukraine. This week has seen a flattening of curves across the entire spectrum of ICE Brent spreads – **the ICE 6-month spread now trades below $6/bbl, whilst only a week ago, it stood at $14/bbl.** Brent CFDs have started falling a week earlier, so there was no significant change over the reporting week, though the overall trend is also towards further declines ahead. The premium of calendar week 1 to the October ICE Brent contract now stands at a mere $3.7/bbl (Argus Media), down more than 60% compared to mid-July peaks.

ICE Brent Futures Spreads ($/bbl)

Curves showing extreme flattening in recent weeks

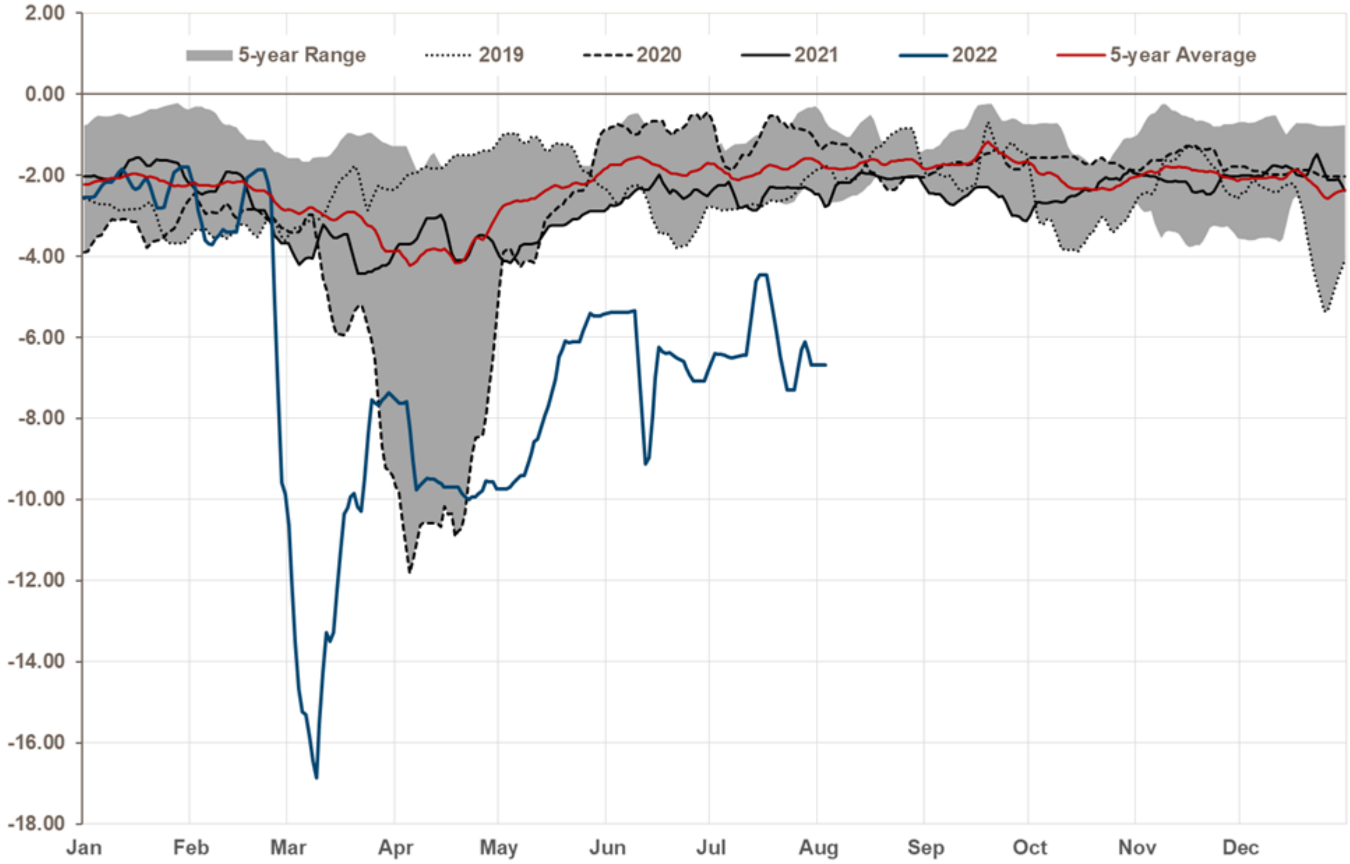


Source: Thomson Reuters

In the Mediterranean, the gradually strengthening realization that recession is not that far away from us is gradually eating into crude differentials. The fact that diffs are weakening should not come as a surprise amidst dropping refining profitability – to take just one example, **NWE gasoline cracks have fallen a whopping 80% from their peak readings in early June.** They have been nearing single-digit territory over the past couple of days. What is more, refining margins for simple setups have gone negative recently, for the first time since February, implying that we are gradually moving towards normalization of sorts. Moreover, the likes of BTC or CPC are still trading their remaining third-decade cargoes, and by early next week, the loading schedules for September will be made available. European crude demand will see a 0.5 Mbd drop next month At 12.1 Mbd, it will be the lowest level since March as many regional refiners go into planned (or postponed) maintenance. This does not bode well for Mediterranean grades – BTC Blend has already plunged from premiums of $16/bbl vs North Sea Dated to a mere $1.75/bbl vs NSD lately, and most probably, this is still not the end of the ongoing depreciation drive.

Three-Day Moving Average of CPC Blend vs North Sea Dated, FOB basis ($/bbl)

Lesser availability of CPC has helped narrow the spread vs NSD

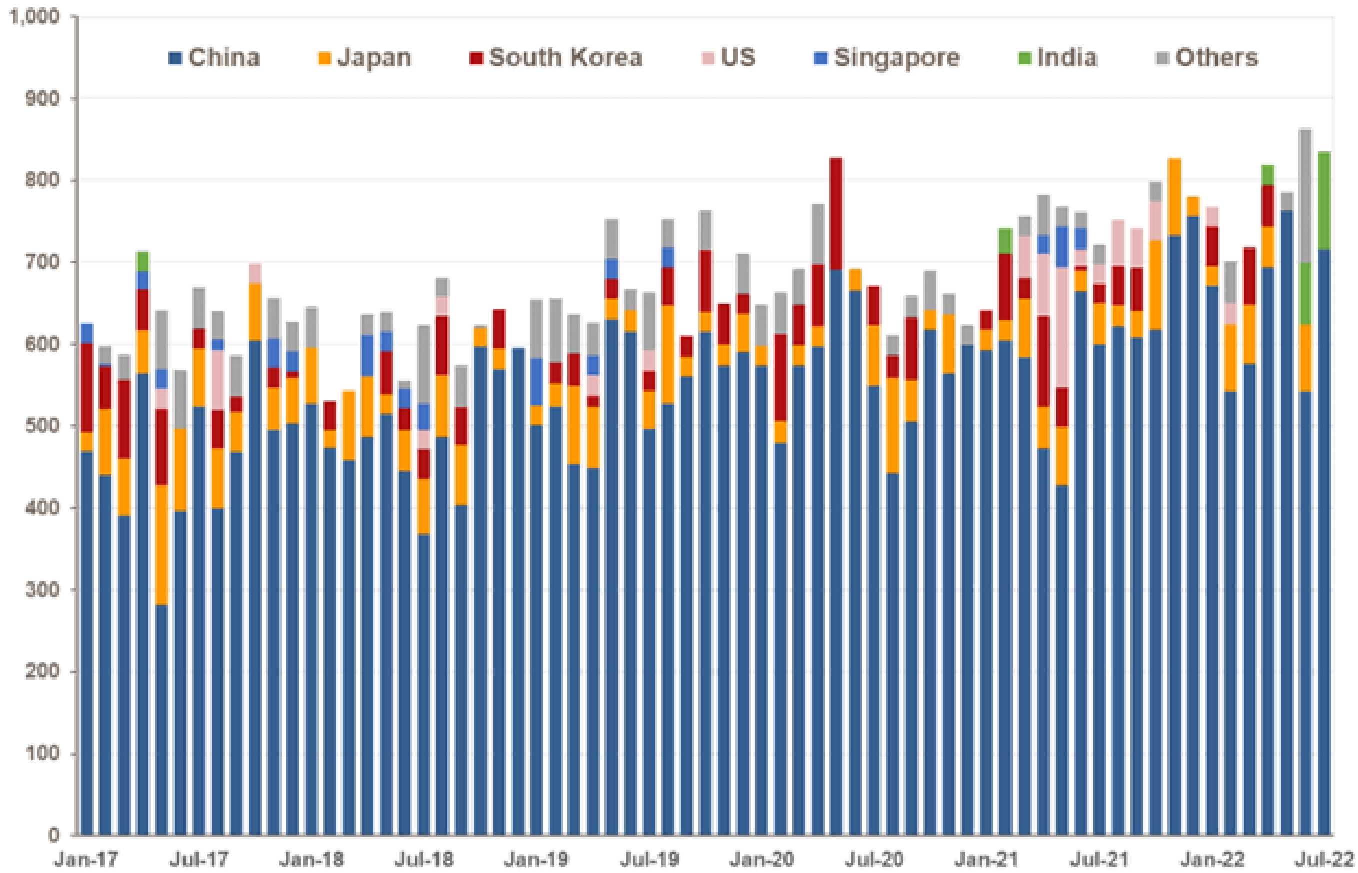


Source: Argus Media

The only major exception from this rule has been CPC Blend, Europe's largest light sour grade by volume. The availability of the Kazakh grade has fallen tangibly on the back of pipeline maintenance at the Tengiz field (most probably a consequence of the blast that happened in early July, reportedly after a hydro test of a pipeline filled with atmospheric gas) and an unforeseen production outage at the Kashagan field. In both cases, the ongoing production issues are unplanned events as both Tengiz and Kashagan underwent planned repair works in April and June, respectively. Consequently, **we have lowered our Kazakhstan crude and condensate production estimate for August by 100 kbd, averaging 1.74 Mbd. In September-December 2022, we expect the country's output to average 1.87 Mbd**, with all the three major producing fields ramping up production to nameplate capacity. In terms of CPC differentials, the Kazakh grade has been gradually recovering lost territory since its bottoming out in early March. The storm-induced damage to the CPC terminal first lifted the grade to a -$4.5/bbl discount to Dated (on a CIF Augusta basis), and now it has strengthened to -$2.75/bbl vs NSD. The situation is not that clear-cut when one is looking at FOB prices of CPC Blend, which have more or less stagnated over the past two weeks, trending slightly below -$6/bbl vs North Sea Dated (Argus Media). This is because freight costs from the Black Sea into the Mediterranean have soared recently amid tight tanker availability. A month ago, a Black Sea/Med Aframax voyage was assessed around WS215; now it has moved all the way up to WS360, the highest it has been since March.

ESPO Seaborne Crude Flows by Country of Destination, kbd

Record flows to India as total volume climbs towards 900 kbd



Source: Kpler

Looking into Russia's Far East, the medium sweet ESPO has seen its differential increase to the highest since February, at a $12.50/bbl discount to front-month ICE Brent futures. Whilst the number might still seem significant, the spread between ESPO and Dubai provides a much more insightful picture, with September cargoes heard to be trading at a $4/bbl discount to Dubai (Argus Media). For reference, in May-June, the ESPO discount to Dubai has been moving between $15-20/bbl. This would seem counterintuitive considering that ESPO flows have never been this high, averaging 840 kbd in July after the marginally higher all-time high recorded in June (860 kbd). Moreover, future deliveries – the trading window is now firmly in September – are set to become even more voluminous as **Transneft has revived rail deliveries to the port of Kozmino, meaning August might become the first month when average export volumes move above 900 kbd.** Pipeline throughput along the ESPO-2 pipeline has recently been hitting its upper limit as Transneft maximized the usage of drag-reducing agents (DRA). Hence, the only way of bringing more ESPO barrels into the markets was to rail them using the Uyar-Kozmino loop. It is estimated that incremental rail supplies would amount to roughly 100 kbd. Coming back to robust differentials, the return of trading majors into ESPO trade has definitely had an effect. Yet, the emergence of India as a prospective buyer has perhaps had an even more significant influence. July departures to Indian refiners have averaged 120 kbd, the highest-ever monthly reading.

4.

Middle East and Asia

Global onshore crude inventories hit record low as Chinese stocks drop

Global onshore crude inventories have dropped to 3.36 Bbbls by the end of July, down 103 Mbbls from the recent high achieved in mid-May. **A drop of 40 Mbbls over the last two weeks of July means that total inventories have dropped below the October 2018 low of 3.377 Bbbls, marking the lowest level on our records.**

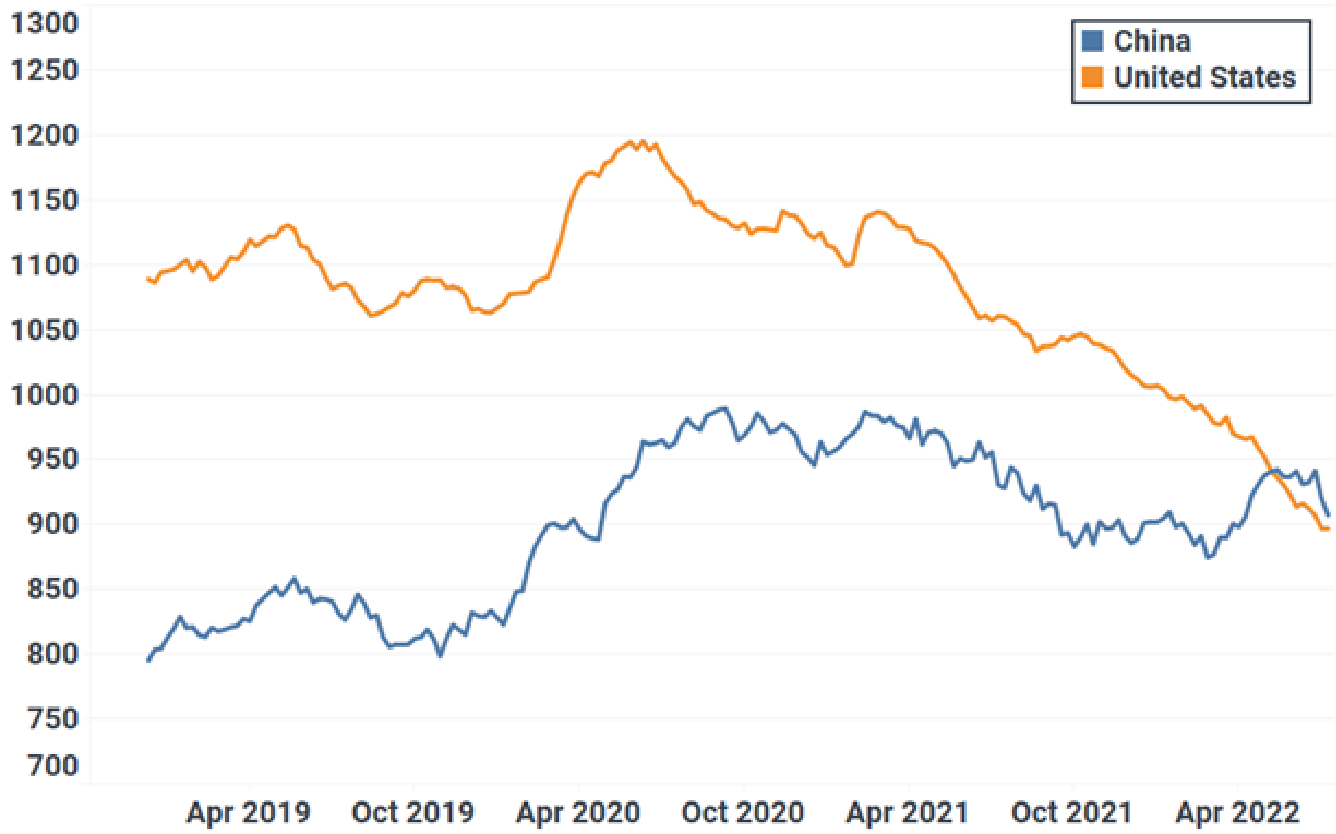
Global crude inventories, Mb

A recent drop from China has encouraged inventories to the lowest level on our records

In June, we highlighted how Chinese onshore crude inventories had eclipsed US crude inventory levels for the first time on our records (since 2017) and likely for the first time ever. This was the result of persistent Strategic Petroleum Reserve (SPR) releases in the US, which have helped ease total inventories lower, while widespread covidrelated lockdowns in China had crushed oil demand, reduced refining activity and bolstered stocks. This trend is still holding, although now China has emerged from lockdowns and oil demand has rebounded – while crude imports remain somewhat suppressed – it is drawing down inventories once more, down 33 Mbbls in the last three weeks. Meanwhile, US commercial inventories are holding only slightly higher than where they started the year, up 9 Mbbls to 427 Mbbls, while the SPR has drawn down by a whopping 124 Mbbls to 470 Mbbls - their lowest since 1985. **China and the US have such an outsized influence on global inventories because the two combined account for 54% of the total.**

China vs US crude inventories, Mb

Chinese inventories still higher than US after surpassing them in June



While Chinese onshore inventories appear to be being drawn down again, floating storage off China has dropped to one of the lowest weekly levels since before the pandemic. Floating storage dropped to under 15 Mbbls, down 9 Mbbls from early July. The drawing down of both onshore and offshore inventories has supplemented supply as refining activity is rebounding after the widespread lockdowns of Q2. Crude imports, however, remain subdued, finishing July at 7.95 Mbd, their lowest since September 2018.

Such a slow pace of imports appears to be a reluctance to buy during the rising oil price environment in Q2, as well as due to domestic oil demand taking a hit. But as both prices have dropped since mid-June and refining demand has increased so far in Q3, crude imports should begin rising. This is affirmed by our predictive data, which indicate **some 7 Mbd is already on the water and set to discharge in China in August, not including short-haul cargoes that could still load in the next few weeks and still discharge by month-end.**

Asia on the aggregate accounts for 55% of global onshore inventories, aided by Japan, which has the third-highest inventories in the world behind China and the US. They currently sit at 352 Mbbls, a 10% share of the global total, but have been little changed since the start of the war in Ukraine. Japan's crude inventories are currently made up of 77% SPR barrels and 23% held by domestic refineries. **Japan's SPR is part of the joint oil-producing countries stockpile program, where the Japanese government has agreements with National Oil Companies to provide storage for them, with the proviso that Japan has priority to the barrels in times of crisis.** The IEA announced back in March a coordinated release of 60 Mbbls from reserves in response to the invasion of Ukraine by Russia, to quell prices and help ease supply shortages. This was followed by a second commitment in April by IEA to release an additional 60 Mbbls. As part of this, Japan announced that some 15 Mbbls of crude and products would be released from privately held oil reserves.

This release may have all come from product inventories, because both refinery and SPR inventories rose over the release period, with total inventories rising 11 Mbbls from early March to late April to 355 Mbbls. Total inventories have been little changed since, holding around 350 Mbbls.

South Korea holds the third highest inventories in Asia, and they have just risen sharply in the last month and a half to a 10-month high of 117 Mbbls, driven by a rise in both its SPR and refinery inventories. It too was part of the IEA's emergency releases, with the government committing to release 14.82 Mbbls of crude and products from their SPR, but like Japan, this release appears to have favored products over crude, given little change in onshore crude inventories.

Global onshore crude inventories have dropped by 57 Mbbls year to date. The US has accounted for the biggest drop at 115 Mbbls while China has shown the biggest increase at 27 Mbbls. The other biggest moves have come from Egypt, dropping 7 Mbbls as Middle East NOCs drew down their inventories in March into April to boost crude flows to Europe as Russian supply fears arose, while **Kuwait has built inventories in the last month – likely in preparation to provide feedstocks for the start-up of the Al-Zour refinery.** While incremental moves from elsewhere have helped to limit the global stock draw, the data highlight the influence that China and the US have on both global inventory levels, and ergo, market sentiment.

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