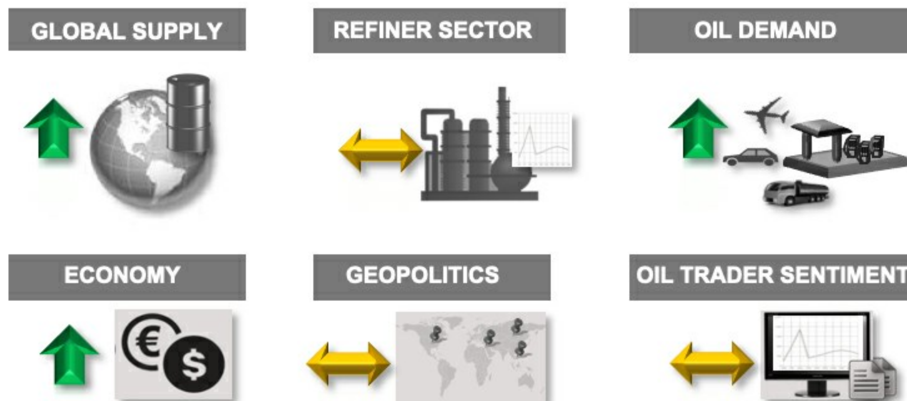
Market Balance in the Most Positive Context for Weeks, But With a Delicate Equilibrium

Market fundamentals have not been this supportive of oil prices for almost three months, particularly in the US, the center of a massive unbalance that had impacted WTI price during this period.

US crude supply and refining patterns seem to be slowly but firmly adapting to the new COVID-market, particularly when considering the pace at which consumers are returning to partial activities. In this context the price of WTI ended the week of May 15th at $29.43/bl, while Brent was priced at $30.19/bl. Both have enough strength to keep their current levels and a potential to edge slightly higher for this week, but there is not too much room for a significant price increase. A possibility of profit taking is also feasible, due to the June contract expiration.

Several countries preceded the US regarding relaxation of shelter-at-home restrictions, among them China, Korea, Spain, Italy and Germany. With more industrial activity and additional vehicles in the streets in several countries, refinery runs are increasing across major economic centers, which help to reduce marine crude storage and provide support to Brent. Major crude flows like those from the Middle East to Asia or to Europe should slowly return to partial normalcy, adjusting shipping nominations to this reality.



With all this under consideration it is likely that crude production will be reduced even more this week in the US, but crude stocks could see a slight increase (due to expected lower refinery utilization than the week before) and overall crude prices remaining similar to the week before. The potential variation is weighted more on the positive side, as economics and geopolitics could provide additional arguments for the bulls in this week, but the expectation hinges heavily on a smoother WTI contract expiration than what we witnessed last month.

Furthermore, the recovery of demand side has some caveats, which lean to the negative side. For example, Korea and Germany reported cases of several people being infected after they allowed restaurants, pubs, bars and other non-essential locations to reopen. If infected people arriving to hospitals were to surge again in these countries, additional restrictive measures could push back a return to activities, which would

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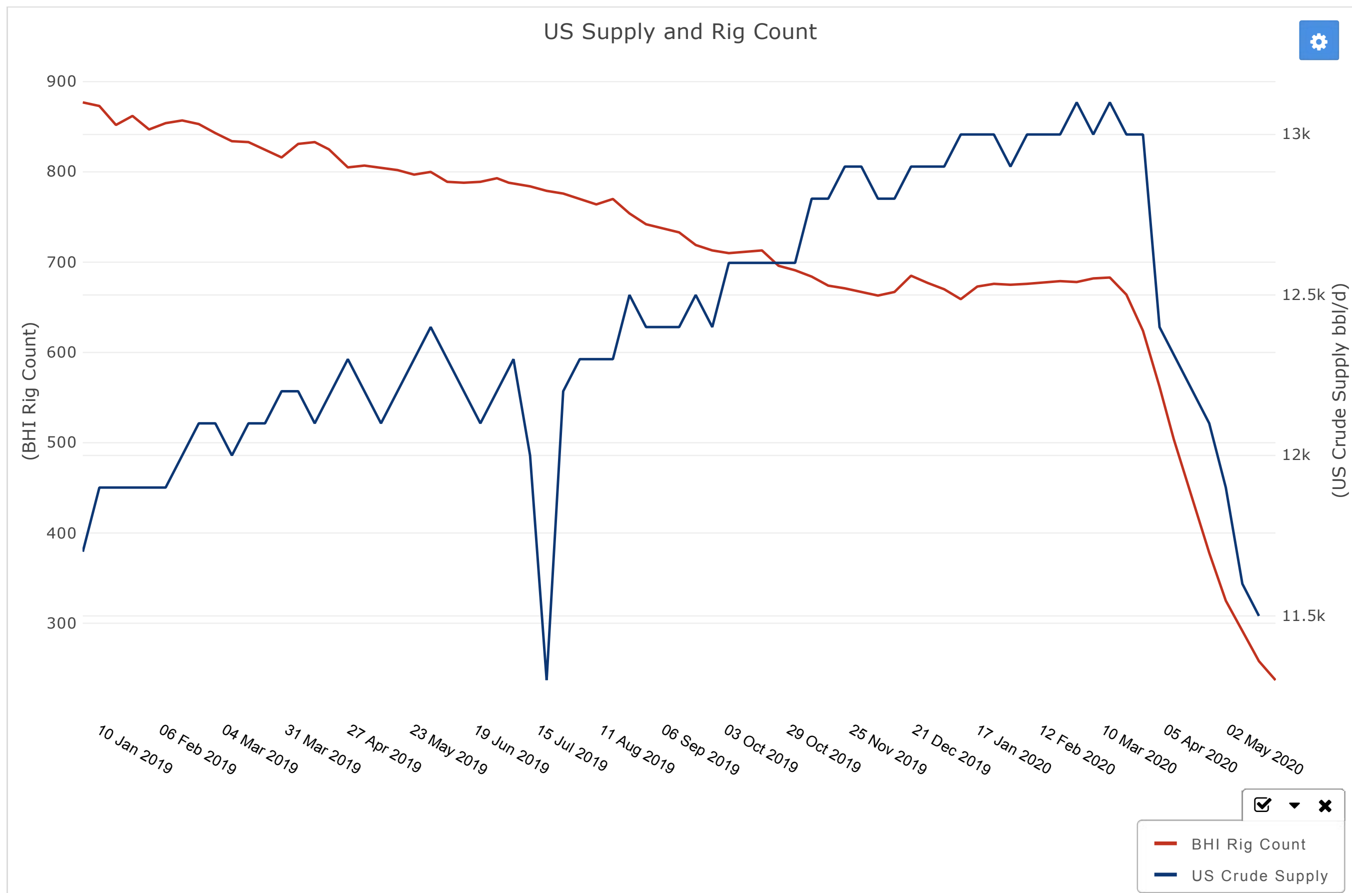
negatively impact the energy sector by extending low demand patterns across the economy. Similar risk is also associated with the US, as illustrated by California recently reporting an increase in infections as a result of their relaxation that allowed people to return to beaches, beauty parlors and other locations.

For this week, however, the largest price risk is by far the expiration of the June WTI futures contract, due in May 19th. After the nightmare of Monday April 20th (last month's expiration) it is likely that market participants are now anticipating with days in advance how to either complete their rollover to the next contract, or move forward with planned physical delivery. But the shadow of that surreal day in the history of the oil industry is too fresh, and it will be interesting to see if a few market participants will again be taken over by anxiety and seek a way to get rid of their June contracts by discounting the price way beyond what is reasonable. A repeat, even if not approaching the April 20th chaos in the futures market would undermine the delicate balance that market fundamentals have slowly established. That said -- our expectation is that the upcoming contract expiration will not be nearly as bad as last's month.

The supporting rationale for each of the variables is provided below.

Global Supply – Positive

The most encouraging topic providing support to global prices and particularly to WTI is the fact that US crude production declined by another 300 MBPD over the last week, as reported by the EIA. This means US crude production has been reduced by 1.5 MMBPD since mid-March. This additional lost production was a big driver that halted stock builds for the first time in over three months. US Crude Stocks marginally decreased, which provides a strong market signal and could define a new price equilibrium for the new short term normality, hovering the mid $20's for WTI and closer to $30's for Brent.



Additional to this, Saudi Arabia announced early last week that they would voluntarily cut an additional 1 million BPD to their crude production, in order to underpin more a price recovery. Shortly afterwards after the

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announcement Saudi Arabia's closest OPEC allies also announced voluntary cuts – including Kuwait and UAE.

Geopolitics - Neutral

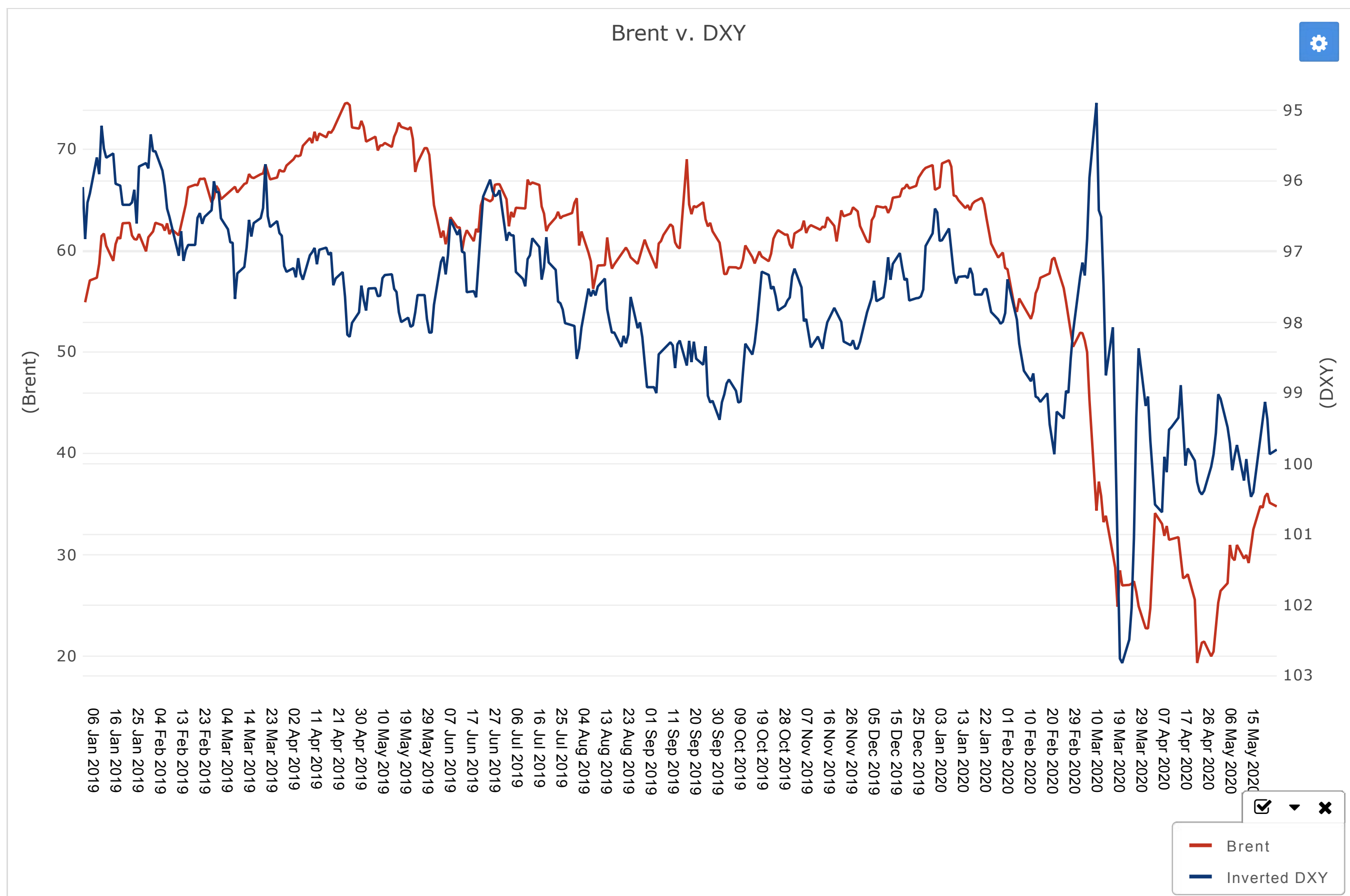
The most important geopolitical event that can significantly impact prices is the current tension in the South China Sea, with presence of US and Chinese vessels patrolling the area, within the context of China's claim for sovereignty over this territory (as reported by Stratas Advisors in this note). Further tensions in this area in the form of additional marine presence from either country, or participation of Indonesia, Vietnam, Thailand or other incumbent could threaten marine traffic and increase crude prices.

On the other hand heightened rhetoric pertaining to the US-China relationships could also spawn economic-trade complications that instead of supporting prices would hamper global recovery. US officials have stated already that the trade deal with China is not a given 100%, leaving the door open to the possibility of tariff increases or other kinds of economic sanctions.

Considering the above developments jointly -- Geopolitics ends up in a neutral area. The potential for interruption in marine transporting that would typically increase prices would be offset by announcements of economic actions/reactions between the US and China, that would weaken market sentiment and dampen global trade.

Economy - Positive

Private companies are announcing ways to reduce costs and optimizing cash flow in the current environment, so there seems to be a relative calm after the stormy weeks of March-April. Global currencies have a relative equilibrium with the context of a week US Dollar, which underpins positively crude prices.



Oil Demand - Positive

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There is no ambiguous way to see oil demand in this week: consumption recovery is well under way and this week it is likely that we will witness additional increases reported by the EIA, which will provide support for prices at the pump in the US.

US Refined Product Demand

(bbl/d)

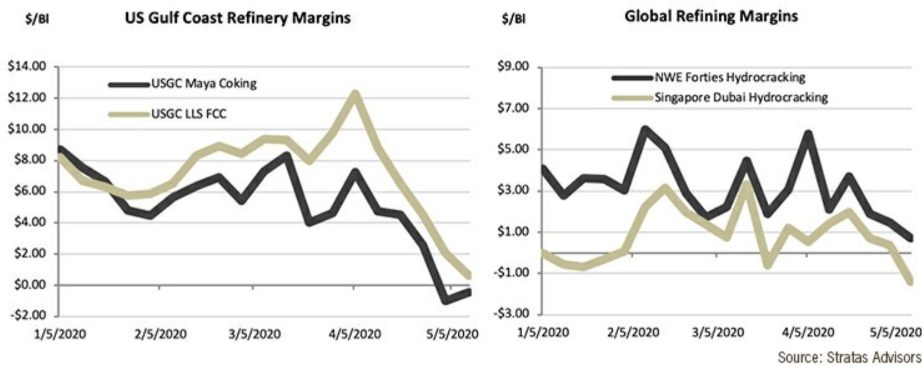
0
5k
10k
15k
20k

05 Jan 2019
02 Feb 2019
02 Mar 2019
30 Mar 2019
27 Apr 2019
25 May 2019
22 Jun 2019
20 Jul 2019
17 Aug 2019
14 Sep 2019
12 Oct 2019
09 Nov 2019
07 Dec 2019
04 Jan 2020
01 Feb 2020
29 Feb 2020
28 Mar 2020
25 Apr 2020

Kerosene-type Jet Fuel
Residual Fuel Oil
Propane and Propylene
Distillate Fuel Oil
Other Oils
Finished Motor Gasoline
Total Products

Refinery sector - Neutral

While oil consumption is increasing, the pace at which gasoline or diesel prices have responded is not sufficient enough to provide reasonable refining margins. This can be seen in the refining sector around the world.



Gasoline, diesel and jet fuel stocks have increased around the world for several weeks, so their prices will have a limited opportunity to increase until draws can be reported. This will likely happen over the next three weeks, thanks to refiners across the board slashing refinery runs, but will be a balance that will take more

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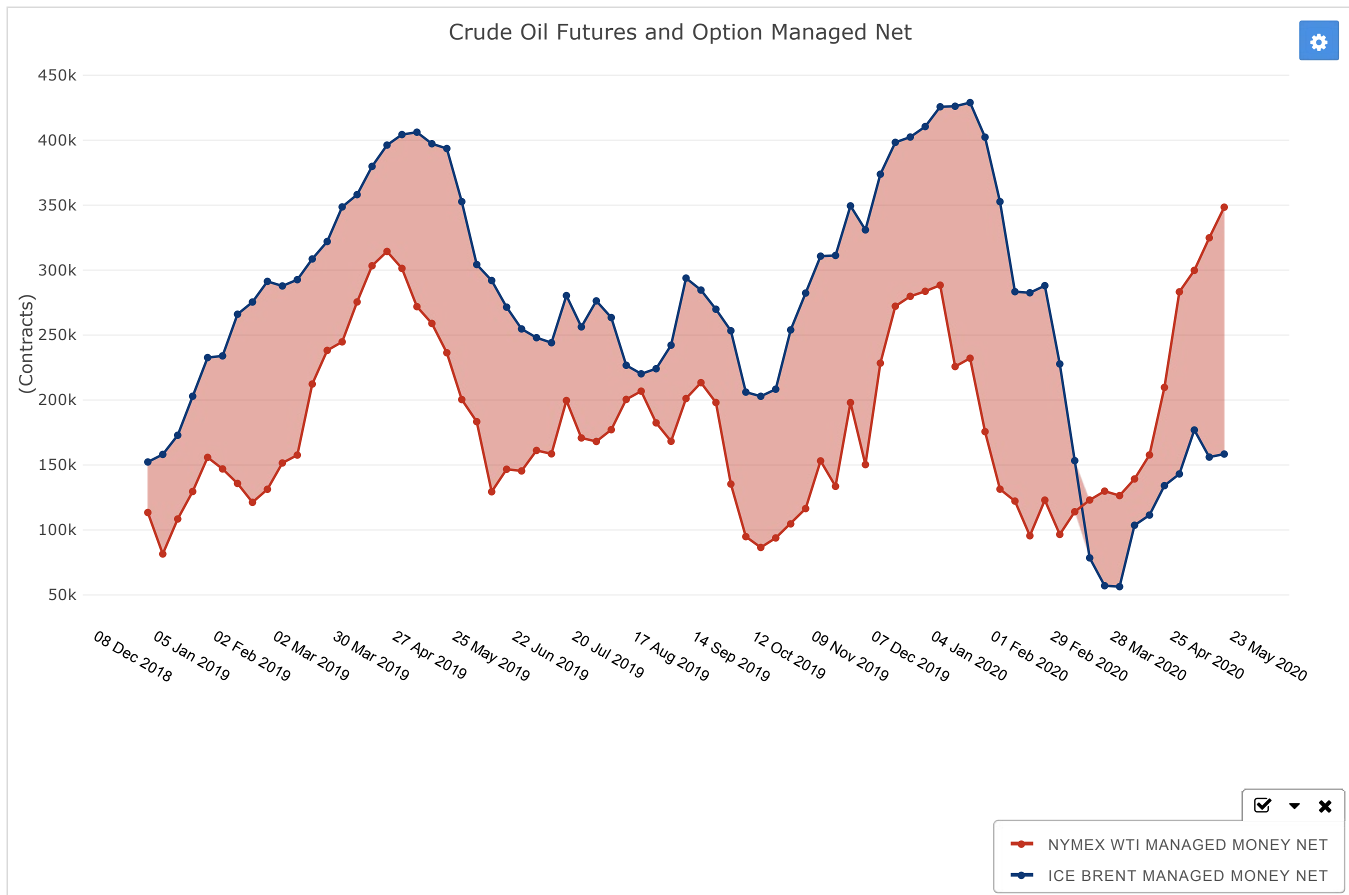
time to be completed.

Deep conversion refineries in the US are especially under pressure, and these struggles will likely to be reflected in lower refinery runs in this week's EIA report. Heavy sour crudes, particularly in the Americas are feeling the pinch of a low-price environment and their pricing mechanisms do not allow exporting countries like Mexico to adjust their differentials immediately to make their barrels more competitive. The WTI-Maya differential is especially narrow in this market environment, and Mexico only adjusts their formula every month, which seems like an eternity in this rollercoaster of events we have witnessed since March. Therefore, because of WTI and Brent strength in recent days, coking refiners are losing money or barely breaking even with current heavy crude prices - which are disproportionally high – and the accompanying unfavorable margins will result in reduced refinery runs.

In addition to lower prices for heavy grades, US refiners would benefit from higher product prices. Gasoline and diesel prices are already increasing and are poised to continue in this trend for this week, as more workers around the world return to their activities, but their price gains have lagged those from benchmark crudes so far.

Oil Trader Sentiment - Neutral

Evidence of increasing oil demand and a relaxation of social distancing restrictions has provided a bullish sentiment to the trading community, with increased Managed Net and Long positions in the NY Light Sweet Contract for Managed Money participants. On the other side of the trading spectrum, Merchant participants in the Light Sweet contract are net short, which makes sense due to current refining margins and the upcoming contract rollover. The WTI NYMEX June contract expiration this coming May 19th is likely to create a sudden increase of short positions, but the impact should disappear by Wednesday 20th. Due to this it is also possible that a brief price correction due to profit taking could be seen over the next few days.



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