

Refinery margins strengthen

Refinery margins have seen significant strength in recent weeks, with support coming from middle distillate cracks. Surging natural gas prices have been supportive for refined products, with substitution likely to lead to stronger demand. This is happening at a time when we continue to see a broader recovery in demand following Covid-19



LPG strength supports naphtha

NW Europe naphtha cracks are back in positive territory. This strength has predominantly been driven by a stronger LPG market. Surging natural gas prices have led to increased demand for LPGs, particularly as we move into the winter. This has left propane prices trading at a large premium to naphtha prices—as high as \$124/t at one stage. As a result, for the petrochemical industry, there is a clear incentive to favour naphtha over propane as a feedstock.

We would expect this trend to continue through the northern hemisphere winter, which should prove supportive for naphtha cracks for the next couple of months. However, once we are through winter, we believe that the naphtha market will come under pressure once again as we move through 2022. We would expect propane prices to fall back to a discount to naphtha (in line with seasonal norms), while we also expect to see an improvement in naphtha supply. As we continue to see a broader recovery in oil demand next year, this should drive refinery runs higher.

Naphtha inventories in the ARA region are broadly in line with the five-year average, standing at 291kt according to Insights Global.

A downside risk for naphtha is if power rationing in China intensifies through to year-end. The petrochemical industry is identified as an energy-intensive industry. So, if it is forced to reduce operating rates significantly, this would weigh on feedstock demand.

We currently forecast that NW Europe naphtha cracks will average US\$3/bbl and US\$1/bbl in 4Q21 and 1Q22, respectively. Our full year 2022 average for the crack is negative US\$2/bbl.

Gasoline to be more subdued

Eurobob cracks have been more subdued recently, and in fact have trended lower over September and October so far. US gasoline inventories have started to edge higher once again, after bottoming in mid-September, and with peak demand now behind us, and refineries in the Gulf Coast having largely recovered following hurricane Ida, stocks will likely continue to edge higher. It's a similar story for the US East Coast where inventories are moving higher from the recent lows.

US implied gasoline demand is already back at pre-Covid levels, which suggests limited further upside in demand. If anything, we will see a seasonal slowdown in gasoline demand towards the end of the year.

European gasoline inventories are still near to the five-year low for this time of year, but with seasonally weaker flows to the US towards the end of the year, we should see these build.

Relative to middle distillates, we would expect the gasoline market to be more subdued. We currently forecast the Eurobob crack to average \$8/bbl and \$9/bbl in 4Q21 and 1Q22 respectively. While over full year 2022, we forecast the crack to average between \$11-12/bbl amid a further recovery in travel demand.

Tighter times ahead for gasoil

The ICE gasoil crack has seen significant strength, breaking above US\$10/bbl and climbing as high as US\$14/bbl - the highest since March 2020. Stronger coal and natural gas prices have been supportive for middle distillates, given the increased usage for power generation. Cracks are likely to remain well supported through the winter as well.

From a supply perspective, China exports of diesel have also fallen significantly, totaling just 540kt in August, down from 1.4mt the previous month, and a peak of a little over 2.8mt in March this year. Lower processing at Chinese refineries, tax consumption changes, as well as a reduction in export quotas for refined product, are behind the decline. This is a trend which is expected to continue in the months ahead. Independent refiners in Shandong province have reduced run rates due to the government's power rationing.

Offering further support to middle distillate cracks is the continued improvement in jet fuel demand as more countries reopen. This is reflected in the jet regrade, which hit the highest level since February last year - in excess of US\$30/t.

In terms of inventories, middle distillate stocks are low in all regions. In the US, inventories are close to a five-year low for this time of the year, and at the lowest level since April 2020. In ARA, gasoil stocks in independent storage are at a more than five-year low for this time of the year. And in

Singapore, middle distillate stocks are also hovering at a five-year low.

With the middle distillate market going into winter with tighter inventory, as well as the potential for stronger demand, it suggests there could be some more upside in gasoil cracks in the months ahead.

From a positioning point of view, there is also more room for speculators to push the market higher. The most recent COT report shows that speculators hold a net long of a little over 140k lots, well above the basically flat position we saw at the start of this year, but still some distance from the record net long of 215k lots seen in 2018.

While there is the potential for cracks to spike higher this winter, we do believe they will remain relatively well supported through 2022, although at lower levels than over the winter. This will be driven by a further recovery in jet fuel demand offering support to middle distillates.

We forecast the ICE gasoil crack to average \$12/bbl over 4Q21 and 1Q22. While for full year 2022 we expect the crack to average around US\$13/bbl.

Natural gas strength support fuel oil

Much like we have seen with middle distillates, fuel oil cracks have also been well supported more recently. The strength in the gas market has forced a fair amount of gas to oil switching for power generation. This is particularly the case for markets in Asia, like Pakistan and Bangladesh, as well as the Middle East. This shouldn't be too much of a surprise when spot LNG in Asia is trading at an oil equivalent of more than \$180/bbl. The LNG forward curve is trading at an oil equivalent of around \$180/bbl through until March next year, which suggests that we should continue to see gas to oil switching for several months.

The Hi-5 spread for 2022 is also trading at above US\$100/t which suggests that bunkering demand for high sulphur fuel oil should remain well supported next year. However, much will depend on how much strength we see in the fuel oil market in the coming months with power generation demand.

Fuel oil inventories in ARA stand at 1mt, which is below the five-year average for this stage of the year, while it is a similar story in Singapore, with stocks standing at around 20MMbbls, slightly below the five-year average.

We forecast the NWE HSFO crack to average negative \$9/bbl in 4Q21 and 1Q22. While for full year 2022, we expect it to average around negative \$12/bbl.

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