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Refinery margin weakness

The refined products market has remained weak, and this is no surprise given the impact on fuel consumption from Covid-19 restrictions. While consumption is recovering, it is still significantly below pre-Covid-19 levels. This, coupled with large stocks should cap the upside in product cracks in the months ahead

Refinery margin weakness

Weak products demand, and now rallying crude oil, along with a strengthening in the physical crude oil market continues to keep refinery margins under pressure. In North-West Europe and Singapore, we continue to be in an environment of negative margins, whilst margins in the US Gulf Coast are not far off from negative territory.

It is these weak refinery margins which make us believe that the strength in crude oil prices over the last month or so has got a bit ahead of itself. Clearly, margins are still telling refiners that they need to keep capacity offline.

Given weaker fuel demand and the resulting margin weakness, we have seen refiners cut run rates significantly in recent months. According to IHS Markit, the decline in global refining throughout peaked at around 19MMbbls/d in May, although in recent weeks capacity has started to return to the market, with throughput now down by around 17MMbbls/d.

Despite refinery cuts, we continue to see product builds in all regions. In the ARA region, independent storage stocks stand at almost 5.4mt according to Insights Global, this is up more than 45% from levels seen in mid-March, and the largest stock levels seen since early 2017. Meanwhile, in Singapore and the US, product stocks are at levels last seen back in 2016.

Jet fuel weighs on gasoil

Jet fuel has come under significant pressure, with Covid-19 related restrictions leading to airlines make severe cuts to capacity. This weakness has led to jet fuel in NW Europe trading at deep discounts to gasoil. This means that where possible refiners will try minimise jet fuel yields, and increase blending of jet fuel into distillates, which has weighed on gasoil cracks.

While air travel is set to recover in the months ahead, it will likely be the one demand segment which takes the longest to return to normality. Whilst countries are in the process of easing lockdowns, international travel restrictions, coupled with the prospect of quarantine is likely to continue limiting air travel, and therefore airline capacity. This suggests that jet fuel will remain weak relative to gasoil and as a result likely to keep the pressure on gasoil cracks in the months ahead.

Looking at middle distillate flows into Europe, these have also been larger than usual in recent months. Flows from the Middle East are expected to reach 2.5mt in May, according to Bloomberg tanker tracking data, which would be the largest volumes seen since July. Similarly flows from East Asia and India have also been strong in recent months.

Although given a narrowing in the East/West gasoil arb over April and May, it is likely that we see slowing inflows from the east in the months ahead. This does mean the potential for stock builds in Asia, limiting the upside to distillate cracks in Asia.

NW Europe jet fuel- gasoil spread (US$/t)

Source: Bloomberg, ING Research

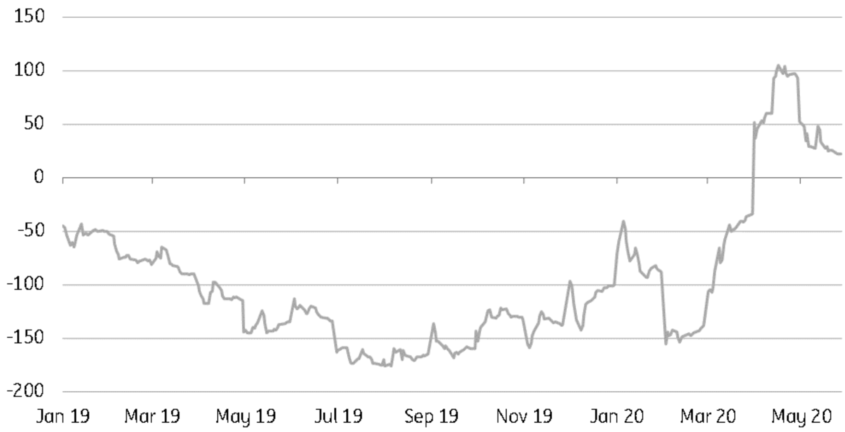
Naphtha crack recovery

The naphtha market came under significant pressure at the peak of the Covid-19 outbreak, with the naphtha crack in NW Europe trading at a discount of US$15/bbl to Brent, levels last seen back in 2012. The weakness in the market shouldn't have come as too much of a surprise, given the weakness we have seen in gasoline markets, whilst country lockdowns would have also weighed on demand from the petrochemical sector. Naphtha stocks held in independent storage have ballooned to record levels, with them standing at 569kt, up 97% since the start of the year.

Despite very large stocks, over much of April and May, naphtha cracks have seen significant strength, with them trading to a discount of just US$4.60/bbl. While the gradual re-opening of economies is constructive, it does appear that the key factor which has driven the rally in naphtha cracks is the fact that the propane-naphtha spread has shifted from a discount to a fairly large premium. Given the premium that propane now trades to naphtha, it should clearly make it an attractive feedstock for the petrochemical industry.

Although as we move into the summer months, we could see seasonal weakness in propane, reducing the advantage of using naphtha. However, this seasonal weakness in propane may not be as strong, given OPEC+ oil production cuts along with US market-driven declines will have an impact on propane supply.

NW Europe propane/naphtha spread (US$/t)



Source: Bloomberg, ING Research

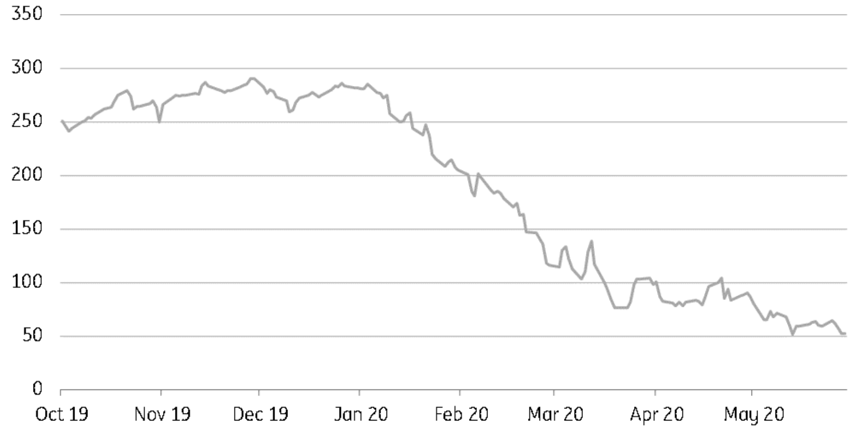
Fuel oil strength

Despite the slowdown that we have seen in global trade as a result of Covid-19 and the fact that fuel oil inventories in the ARA region have hit record highs in recent weeks, the fuel oil market has still managed to stand out for its strength. High sulphur fuel oil (HSFO) cracks have rallied for much of the year, whilst low sulphur fuel oil (LSFO) cracks have remained steady over the same period. The strength in the fuel oil market is reflective of the weakness that we have seen in crude oil prices, combined with refinery cuts reducing supply. Meanwhile increased use of fuel oil by refiners in the US has provided further support.

However with crude oil prices set to strengthen over the second half of this year, and the expectation that we will see refining capacity coming back online as we move through the year, suggests that fuel oil cracks will come under pressure later in the year.

Finally, the very low sulphur fuel oil (VLSFO)/HSFO spread continues to come under pressure, with it now trading close to US$50/t, compared to around US$280/t at the start of the year. The ramping up of VLSFO production and exports from China is likely to keep the pressure on this spread.

NW Europe VLSFO/HSFO spread (US$/t)



Source: Bloomberg, ING Research

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