

What's crackin? US oil refiners going full throttle

Refinery margins in both Europe and Asia trended higher over much of August, hitting their highest levels since Hurricane Harvey in 2017. It has been a different story in the US, where record run rates have weighed on margins. With crude oil prices likely to remain well supported for the remainder of 2018, margins could come under further pressure



Source: Shutterstock

Keep on refining in the free world

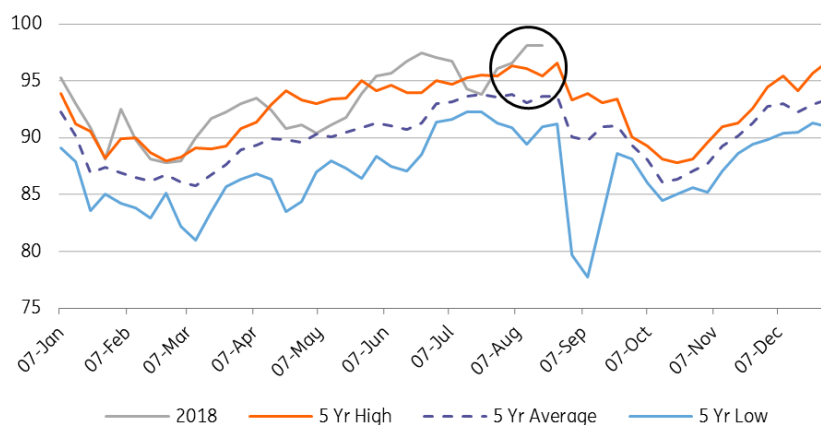
August has seen refiners in the US take operating rates to record levels once again. Over the last two weeks, refiners in the country have been operating at 98.1%, compared to a five-year average of 93.4%. Meanwhile, run rates for the industry on the Gulf Coast, where a little over 50% of US refining capacity sits, have been even more impressive, averaging 99.7% for one week over August. These run rates have kept margins in check, with them largely trending lower over August, despite the pressure seen in crude oil prices over the month.

These stronger run rates have meant that gasoline inventories are proving rather sticky, and at a

time when seasonally there should be draws, stocks are remaining at the top end of the five-year range. In fact last week, gasoline inventories increased by 1.2Mmbbls. Gasoline inventories generally trend lower towards the end of October, and if we were to see gasoline stocks return to the five-year average by then, we would need to see a draw of almost 20MMbbls in just over two months. How likely is this? Not very. We would need to have another active hurricane season, which disrupts the Gulf as much as it did last year. Gasoline stocks fell by 17MMbbls last year, but then run rates did fall to a low of 77.3% at one stage in September. If we omit last year and look at gasoline stock changes in the previous five years, gasoline inventories have declined on average by 5.5MMbbls over the period, whilst the largest draw over the period was in 2014, where we saw gasoline inventories fall by 10.5MMbbls.

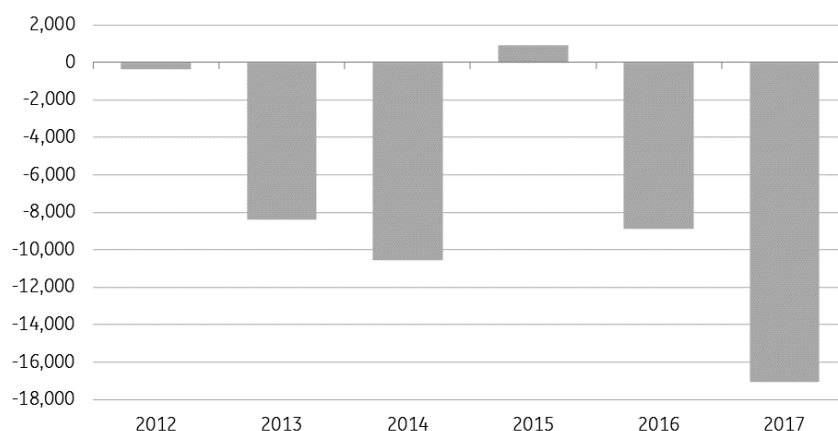
Looking at speculative positioning in RBOB, while the managed money net long has declined from its high of 132,065 lots in May to 80,513 lots currently, there still does seem as though there is somewhat of a disconnect between current stock levels and speculative positioning. Speculators appear to be focused on US gasoline demand instead, with it hitting record levels in a number of weeks over the summer. However, as we are fast approaching the end of driving season, demand should start to see its usual seasonal decline.

US refinery run rates hit record levels (%)



Source: EIA, ING Research

US gasoline inventory change between mid-August and end of October (Mbbbls)



Source: EIA, ING Research

The European refined product flip

Turning to Europe, and there has been quite the change in gasoline inventories in the ARA region. Since the end of March, stocks have generally trended lower, which has seen gasoline inventories in the region fall from above the five-year high in June, to now below the five-year average. Strong flows to the Americas appear to be the main driver behind this drawdown. Whilst total US gasoline inventories remain towards the top end of the five-year range, if we look at the gasoline stocks on the East Coast (PADD1), they are more in line with average levels for this time of the year, supporting this flow. Meanwhile, Petrobras' 415Mbbbls/d Replan refinery outage has offered further support. This refinery accounts for about 20% of total Brazilian refining capacity.

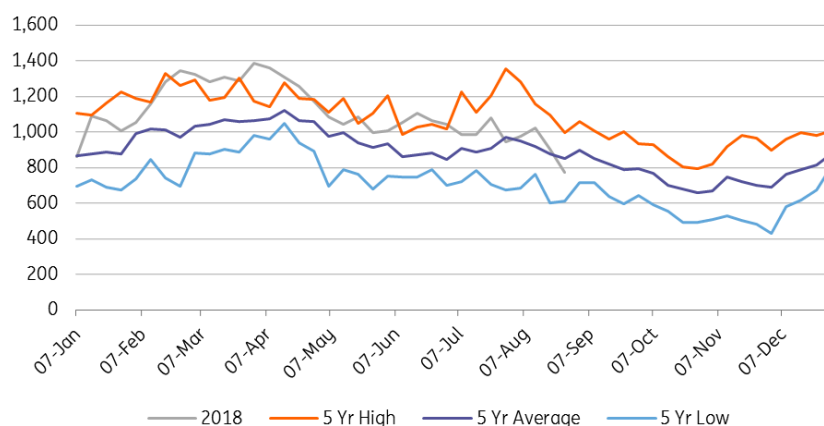
Drawdowns in Europe have been bullish for European gasoline cracks, with them rallying from around US\$4/bbl in late June, back towards US\$7/bbl currently. We would expect the crack to remain fairly well supported, with inventories seasonally continuing to draw through to the end of October, with refinery maintenance over September and October. However as mentioned given the end of driving season, flows to the US should slow, and in turn, slowing the draw in European inventories.

While the European gasoline market has tightened somewhat, middle distillates supply has improved, with gasoil inventories edging closer towards the five-year average according to data from PJK International. Stocks in the ARA region stand at 2.59mt, up from 2mt towards the end of June. This is despite ship tracking data showing that flows from the Americas to Europe will likely fall to a three-month low. This shouldn't come as too much of a surprise, given the low stock levels of middle distillate in the US. Whilst European supply appears to be improving, it is still seasonally low, and this combined with the weakness in crude oil prices in August has offered support to the gasoil crack, with it currently trading above US\$15/bbl.

Looking at speculative positioning in ICE gasoil reflects the view of an improving supply picture for middle distillates. The speculative net long stands at 142,829 lots, down from the record net long of 215,304 lots at the end of May. Despite this large decrease in the net long, we believe that there is little risk of a large short covering rally, given that the reduction in the net long has been largely driven by longs liquidating, rather than fresh shorts. Shorts are likely to remain reluctant to enter

the market, given the fact that there is plenty of uncertainty around middle distillate demand come 2020 with IMO regulations, and this is something the market will increasingly focus on over 2019.

ARA gasoline inventories fall below the 5 year average (k tonnes)



Source: PJK International, ING Research

Cracks forming for fuel oil

Having strengthened for much of the summer, the fuel oil market has come under pressure over August. Fuel oil cracks in both Europe and Asia have weakened considerably, with expectations of increased flows from the Middle East as we approach the end of summer.

While inventory levels in Europe have started to show a slight recovery, with stocks in the ARA region edging higher over the last two weeks, and in fact remain at the top end of the five-year range. Inventories seasonally increase in the coming weeks, and so we would expect pressure to remain on fuel oil cracks, particularly given the fact that the crude oil market is likely to remain well supported through until the end of this year, with still plenty of uncertainty around Iranian oil supply.

However looking at Singapore, increased fuel oil flows from the Middle East are yet to be reflected in inventory numbers. Singapore fuel oil stocks stand at 14.2MMbbls, well below the five-year low of almost 17MMbbls. These stocks should rebuild as we move into September, improving regional supply, and supporting the view of weaker cracks.

China was potentially one of the bullish drivers for the fuel oil market, with some teapot refiners in the country possibly looking to switch back to fuel oil as a feedstock, as a result of stricter enforcement of a consumption taxes. However looking at import data into China suggests that there has been no significant pick-up in Chinese fuel oil imports.

As we move into 2019, even more attention will turn to IMO regulations, and this is likely to keep fuel oil cracks under pressure. This is largely reflected in the forward curve when looking at the NW Europe cracks, with them falling from a US\$12/bbl discount at the start of 2019 to more than a US\$20/bbl discount by the end of 2019.

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