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Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

The Bear/Bull Case in the Russian Oil Ban

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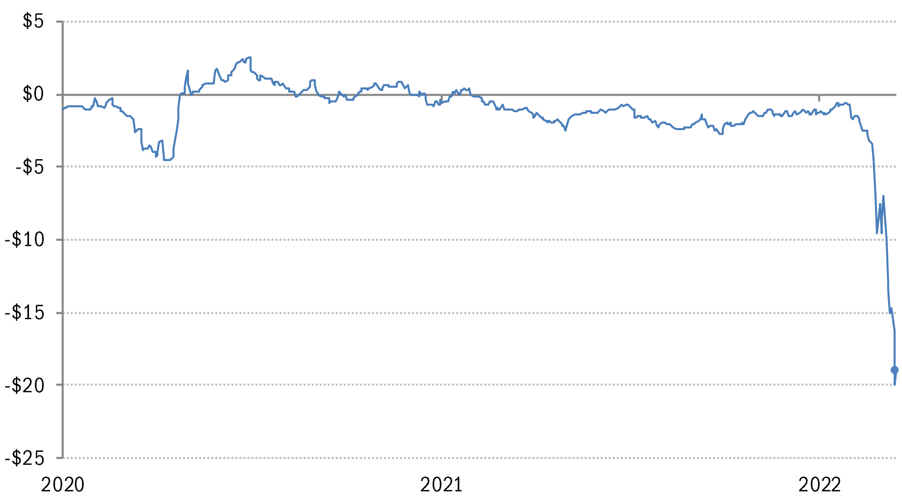
Michael Warren and Donald Luskin

If Europe bans, it's a recession. But Russia becomes a desperate oil seller. Unless…

Early last week Brent crude traded near $140, and WTI near $130, lofted by war-fever as the US Congress pressured a reluctant President Joseph R. Biden, Jr. to ban oil imports from Russia. The UK and Australia have, too. As we warned at the time, *the most substantive risk was that Europe would be pressured by global sentiment to do the same thing, and given its dependency on Russia for a third of its oil consumption, effectively commit economic suicide* (see "Video: What you're not hearing about the coming oil shock" March 7, 2022). Those high crude prices were the result of uncertainty about a sudden forced reconfiguration of global oil trade, against the backdrop of all-time lows in storage of crude and refined product.

- *But the sharply lower prices now, as of this writing, may reflect more than just that Europe and Russia seem to have no appetite to cut each other off* (as we said all along: see "Our Hot Take on Russia's Attack on Ukraine" February 24, 2022). *It may well be that, even if they do, the result once the dust settles will be an excess of oil in world markets.*

Premium or discount, Ural crude to Brent crude



Source: Bloomberg, TrendMacro calculations

Update to strategic view

OIL, EUROPE MACRO: Oil markets have significantly recovered from the upside shock of two weeks ago when the US, the UK and Australia banned importation of Russian crude and product. In part that's because Europe hasn't followed along, and neither has Russia embargoed Europe, so a shock to global markets was avoided at a time when storage is at an all-time low. That said, a ban in Europe would likely be a bear case for crude prices. Europe could not easily replace the 1 million barrels per day it gets from Russia by pipeline, so while it would likely throw Europe into recession, it would also reduce global demand. Russia could sell the 1.3 million barrels it sends to Europe by ship in eastern markets, but only with significant price discounts, which would ripple through global markets and reduce oil prices overall as more and more volumes seek new…

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2021 Energy Information Agency numbers released yesterday suggest that OECD Europe constitutes about 49% of Russian crude oil and condensate exports, or about 2.3 million barrels per day. Of that, non-OECD European countries – including Belarus and Ukraine – import about 2% of Russian petroleum. Although Russia, for almost a decade, has had a stated objective to implement an energy strategy that pivots east, it has made little progress. If it loses Europe as an oil customer, it would have to scramble to get that pivot accomplished in a hurry.

- In a nutshell, of Russia's 2.3 million barrels per day exported to Europe, 1 million comes by pipeline and 1.3 million by ship.
- Theoretically Russia could redirect its 1.3 million by ship to eastern markets such as China, Japan, South Korea or India.
- As to the 1 million now coming into Europe by pipe, we believe Russia has something like 750,000 barrels per day of spare seaborne shipping capacity.
- *So just by the numbers, Russia has the capacity to redirect about 2 million of the 2.3 million barrels per day now going to Europe.*
- *But to horn into eastern markets that already have existing supply relationships, Russia would have to discount its exports – Ural crude is already at an historic discount to Brent* (please see the chart on the previous page) – *driving the whole platform of global pricing lower.*

Abstractly, any Russian oil imported by China, Japan, South Korea or India would displace imports from some other supplier – which could then be exported to Europe instead, to make up for its lost Russian oil.

- That works for the 1.3 million barrels coming into Europe's ports, but not the 1 million coming in by pipeline – which would have to come in now by ship. *It is naïve to think that Europe's ports have the berthing, storage or personnel capacity to deal with what would have to be a throughput increase of 75%.*
- *That means 1 million barrels comes out of global demand while Europe does without – but only 250,000 comes out of global supply while Russia redirects most of its exports east (and at a discount).*

Could Russia, in fact, find new homes in the east for 2.3 million barrels per day?

- Japan and South Korea, together, import between 300,000 to 400,000 barrels per day from Russia and could import more, but as US allies they would come under pressure from Washington not to do so.
- India imports 60,000 to 70,000 barrels per day of Russian crude. India could be a possible market for light oil and heavier-grade Ural oil given their refinery complexity. They are a US ally, too, but they have significant engagement with Russia, especially in armaments.
- China is in a quasi-alliance with Russia, and would no doubt be delighted to buy more of its oil. But there's no more capacity in the Eastern Siberian pipeline. Russia has been sending 200,000

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… destinations. The bull case for prices arises if all, or many, or Russia's customers ban imports as well – then as much as 4.7 million barrels per day of Russian oil are effectively removed from supply. To replace that, almost all the visible spare capacity and potential production growth in the world would have to be mobilized to fill the gap. The status quo, without further bans, impounds a risk premium in prices that should evacuate if the Ukraine crisis is resolved.

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barrels per day in the Atasu-Alashankou pipeline through Kazakhstan. It could send another 100,000 that way, with Russia having intervened to keep the current Kazakhstani president in office.
- Turkey is another candidate market. It has had a contentious relationship with Russia. But President Recep Tayyip Erdogan usually finds his own path and might choose to import more than the present 100,000 to 200,000 barrels per day from Russia.
- *But in all these cases, even China, the most Russia-friendly nation, there are successful existing supply relationships with other countries that would have to be abandoned. Why would any importing country do that unless Russia offered a significant price concession?*
- *That would have a ripple effect, because, next, volumes displaced by Russia would, themselves, have to seek new destinations where there are also existing supply relationships – after all, Europe doesn't have the capacity to take it, as much as it would like to. With each displacement, another price discount.*

Obviously, Russian President Vladimir Putin doesn't want to see this happen. Ideally he'd like to continue to prosecute his war on Ukraine while retaining Europe as a customer for his oil. No wonder Russia's negotiators working on a new Iran nuclear deal let it be known that Russia wouldn't support any deal – which would release US sanctions against Iran – so long as the US kept imposing sanctions on Russia. *Why do anything that would increase supply at this point?*

- Putin knows that Biden is pushing hard for a new Iran deal because the US President wants lower gasoline prices to help his party in the midterm elections, especially when Iran is reportedly just weeks away from gathering enough plutonium to make a nuclear bomb. Not that it would make an immediate difference anyway – though a deal would be little more than a US bribe to Iran to produce and export more oil, it would take at least a year for Iran to significantly do so. It took 19 months for Iran to ramp up production by 1 million barrels per day after the first nuclear deal in 2015.

To be sure, there's another way this could go – and it's the bull case for oil prices. If Europe and Russia abort their oil trade, we can't rule out that substitute consumers would succumb to US pressure, or for that matter find their own scruples, and refuse to buy more Russian oil. Indeed, we're already seeing some degree of "self-sanctioning" by financiers, shippers, insurers, receivers and refiners of crude oil – that had already begun even before the US ban.

- *In that scenario, in extremis, the entire 4.7 million barrels per day that Russia now exports would be withdrawn from world supply.*

Are there other sources that could step up and replace this crude that would be left stranded in Russia?

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Donald Luskin
Chicago IL
214 550 2121
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

- *Europe:* No, we're not going to tell you that Europe is a source of additional oil production. But as we explained earlier, disengaging from Russian supplies would reduce Europe's consumption by the 1 million barrels per day now coming by Russia – and even forced conservation like that is, effectively, a demand offset against the isolation of Russia's 4.7 million barrel export volumes.
- *Saudi Arabia*: The Kingdom has excess capacity of more than 1 million barrels per day, but with the US practically bribing its regional archrival Iran to produce more oil, we doubt that it will be eager to open the pumps. That said, perhaps the US turning away from Iran is what it would take with Saudi. Besides, it appears that Saudi has become closer to Russia over the last several years, as evidenced by the informal conversion of OPEC into OPEC+ -- to include Russia. That said, Saudi didn't hesitate to get into a production war with Russia as recently as two years ago, at the worst possible time, just when the pandemic lockdowns were killing global fuel demand (see "Just What We Didn't Need: An Oil Price War" March 8, 2020).
- *United Arab Emirates*: The UAE could also open its taps and probably deploy an incremental 1 million barrels per day. The UAE has not grown as close to Russia as Saudi has, but if either producer were to step in, it would likely mean the end of Russia's participation in OPEC+.
- *Iran*: The former Persian empire could also ramp up production by a million barrels per day, but again, it would take time. If the US were desperate, a good-enough bilateral nuclear deal could be consummated bilaterally, over Russia's objections.
- *United States*: The US could push production higher by a million barrels per day, but it would likely take a year. This month the EIA has sharply upgraded its shale production forecast to do just that, and then do it again in the following year, hitting all-time highs (see "Data Insights: Oil" March 14, 2022). Today's higher prices should indeed inspire faster production growth – but we can't help wondering if these government forecasts are intended more to support the Biden administration's narrative that US producers are not being held back by its anti-fossil fuels agenda. Even putting politics aside, the reality is that the US oil and gas industry is dealing with the same supply, transportation and labor pressures that have hit other American industries.
- <u>*Taken altogether, that's a big lift. Effectively the entire spare capacity of the world, and considerable production growth in the US, would have to be mobilized immediately and all at once.*</u>

These two scenarios – a counterintuitive bear case for all of Europe alone imposes a ban, and a more straightforward bull case if the whole world does – are both merely possibilities. If the status quo persists – with only the US, the UK and Australia banning – those scenarios are simply cause for a risk premium in oil prices, lingering only until the Ukraine crisis resolves, at which point oil would fall back to its pre-crisis levels. The status quo is always the best bet. But this is a tough time to be in the prediction business.

Bottom line

Oil markets have significantly recovered from the upside shock of two weeks ago when the US, the UK and Australia banned importation of Russian crude and product. In part that's because Europe hasn't followed along, and neither has Russia embargoed Europe, so a shock to global markets was avoided at a time when storage is at an all-time low. That said, a ban in Europe would likely be a bear case for crude prices. Europe could not easily replace the 1 million barrels per day it gets from Russia by pipeline, so while it would likely throw Europe into recession, it would also reduce global demand. Russia could sell the 1.3 million barrels it sends to Europe by ship in eastern markets, but only with significant price discounts, which would ripple through global markets and reduce oil prices overall as more and more volumes seek new destinations. The bull case for prices arises if all, or many, of Russia's customers ban imports as well – then as much as 4.7 million barrels per day of Russian oil are effectively removed from supply. To replace that, almost all the visible spare capacity and potential production growth in the world would have to be mobilized to fill the gap. The status quo, without further bans, impounds a risk premium in prices that should evacuate if the Ukraine crisis is resolved.