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MACROCOSM

A Very European Ban on Russian Oil. Maybe.

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This could be the first global oil crisis that drives prices lower.

As the war in Ukraine drags on, we warned that pressure would mount for Western allies to "do something" – and at this point about the only way to move beyond the sanctions already imposed would be to ban imports of Russian oil into Europe (see "The Bear/Bull Case in the Russian Oil Ban" March, 16, 2022). Europe is highly dependent on these imports and can't quickly replace them with other sources, so after two months of hostilities a ban remains a bridge too far. But now the *New York Times* is reporting that *some form of a ban is under active consideration*. It's one of those not quite believable stories based exclusively on anonymous sources, and it hasn't been echoed anywhere else. But oil markets last week were acting like it's worth worrying about, with the Brent crude benchmark rising above $110, after a month's sharp correction from the March peak at $140 to below $100. *If put into place, a European ban would destabilize global oil markets and likely push crude prices to all-time highs for at least a short period. But in the longer-term it would likely lower global prices by leaving Russia a desperate seller* (again, see "The Bear/Bull Case in the Russian Oil Ban").

- According to the *Times* story, the plan under consideration would rapidly phase out imports of seaborne volumes but allow pipeline volumes to flow for a longer period.
- That's because the seaborne volumes can be replaced – but the piped volumes cannot. This would seem to be aimed at placating Germany, which has stood most firmly against a European ban on the grounds that it would be too economically painful. The *Times* story quotes Emily Haber, the German ambassador to the United States:

> *"Going cold turkey on fossil fuels from Russia would cause a massive, instant disruption. You cannot turn modern industrial plants on and off like a light switch. The knock-on effects would be felt beyond Germany, the EU's economic engine and 4th largest economy in the world."*

- Indeed, because of those "knock-on effects," the ban would reportedly not even be announced until after the hotly contested French elections, pitting incumbent President Emanuel Macron against populist Marine LePen. The last thing the French

Update to strategic view

OIL: Reportedly Europe is considering a ban on importing Russian oil – gradually and partially, if at all. Russia is already finding alterative buyers at a deep discount – but the net price realized is still so high that Russian oil revenues (and related tax revenues) could be as high as last year's even on lower volumes. Russia's need – and willingness – to sell at a discount points to lower world prices, following an initial shock, if a European ban materializes. India and China are the big buyers so far, with Latin America possibly coming on as the US diverts refined product shipments to Europe. Saudi, UAE and Kuwait could contribute more oil if needed. Production is accelerating in the US, and the Biden administration is tentatively backing off its anti-fossil fuel agenda. The SPR release is a short-term palliative. The US continues to pursue a nuclear deal with Iran, even as Iran keeps moving the goalposts. Regional rival Saudi looks on, and conducts friendly diplomacy with Putin while mercilessly satirizing Biden on television.

[Strategy dashboard]

establishment needs is to give Eurosceptic LePen the talking point that Macron is throwing France into recession at the whim of Brussels elites over a foreign conflict in which France has no compelling interest.

- *All in all, if it even happens at all, it will be a very European ban – that is to say, a muddle-through compromise.*

A future in which Russia has to sell its oil to buyers other than Europe can be seen in Russia's success at finding Asian buyers for deeply discounted barrels – with the Urals crude benchmark underwater to Brent by something like 25% (please see the chart below). The huge discount, according to Russian Energy Minister Nikolay Shulginov, is less important than keeping the industry functioning by keeping volumes flowing. For that matter, the present $80 a barrel is about the pre-Ukraine high that Russia received for its Ural benchmark back in 2018. And production costs are still estimated in the mid-$20 range. *If Russia earns on average $80 per barrel in 2022, it would only need to pump 8.35 million barrels per day to meet*

Urals crude benchmark

Source: Bloomberg, TrendMacro calculations *last year's earnings*. In other words, Russian oil company earnings (and President Vladimir Putin's tax revenues) could equal last year while producing 1.5 million barrels per day less.

As we expected (again, see "The Bear/Bull Case in the Russian Oil Ban"), India and China were by far the biggest incremental buyers of Russian crude volumes – particularly the Ural grade oil – due to the complexity of their refining industries that allows them to process heavier crudes. Indian oil companies are still signing large tenders for Russian crude, which drew a scolding from the White House. Chinese independent "teapot refiners" are receiving more pipeline volumes and seaborne shipments while large state-owned energy companies are currently more cautious about possible US sanctions. Russia has stepped up to the challenges of redesigning its supply logistics by rerouting cargoes and aggregating smaller volumes from Aframax and Suezmax vessels onto VLCC (Very Large Crude Carriers) for longer high seas routes to Asia.

Latin American markets are searching for 750,000 barrels per day of distillates that the US has redirected to Europe to displace Russian diesel imports. We can't prove it with granular facts, but aggregate April data suggests that Russian crude and refined product volumes are holding steady – so one possible destination is Latin America.

While virtue-signaling about "self-sanctioning" still dominates the headlines, we think there are, in reality, widespread attempts to avoid official sanctions.

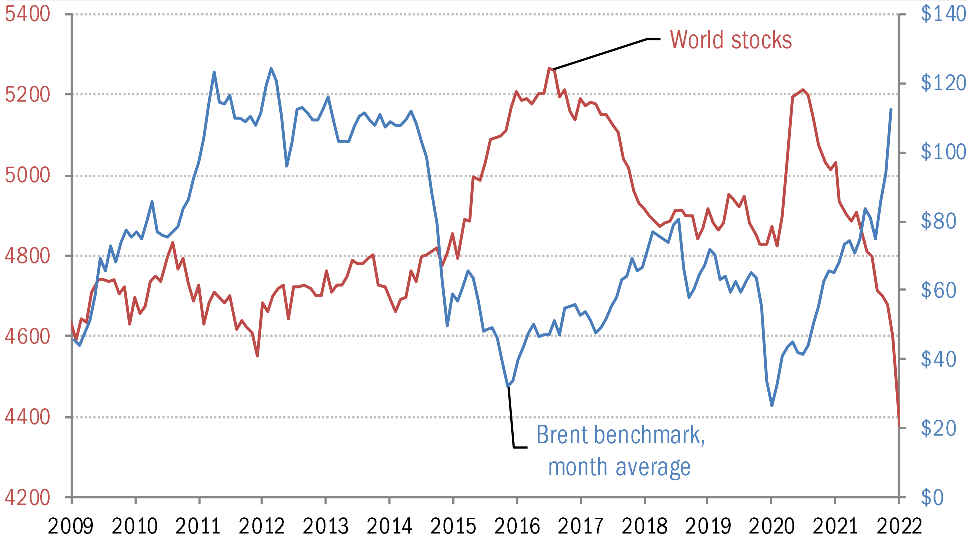
- While trading firms Vitol and Trafalgar announced they will phase in bans, Trafalgar will probably run long-term contracts to the end of next year and Vitol until at least October 2022. Glencore, Gunvor and Petraco haven't announced any bans.
- For payment options, there is a possibility that bitcoin could be used to pay for crude oil and refined products to avoid the SWIFT international banking system – should more thorough sanctions close the current loopholes for oil trading.
- A recent merger of Frontline and Euronav creates the biggest fleet of VLCC tankers in the world. John Fredrisksen, who owns Frontline and will run the new combined company, gained notoriety for running crude oil shipments out of Iran during their conflict with Iraq in the 1980s. Frontline just recently took a shipment of a naphtha from the Russian Black Sea port of Novorossiyk to world markets.
- US sanctions on maritime insurance have reportedly driven insurance costs higher than the costs of the transportation being insured – yet the insurance goes on, and so does the transport.

All of this demonstrates the self-equilibrating nature of the global oil markets when pre-existing commercial relationships are arbitrarily perturbed by government edict.

__But what if some future sanctions regime is more effective at removing Russian barrels from the global oil market entirely?__

- Unfortunately, we face historically low inventories of both crude oil

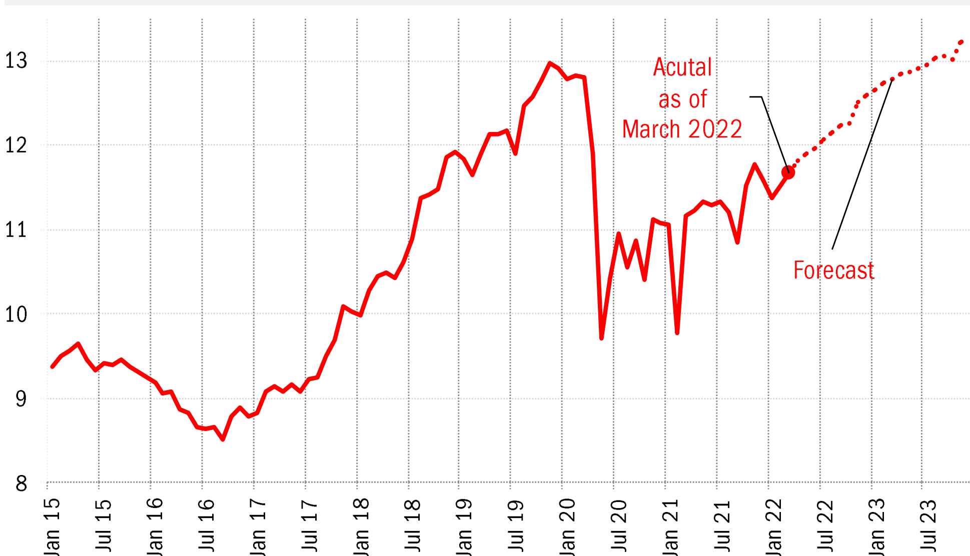
Stocks (crude and product, including strategic reserves) versus price



Source: JODI, Bloomberg TrendMacro calculations

  and refined products, similar to the time when oil prices were elevated over $100 before US shale oil production grew significantly from 2011 to 2014 (please see the chart below).
- *__Where can the oil come from to replace lost volumes from Russia?__*
- Recent data points in rig counts and frack crews suggest that US production will be rising. [Permian permits for new wells are at an]

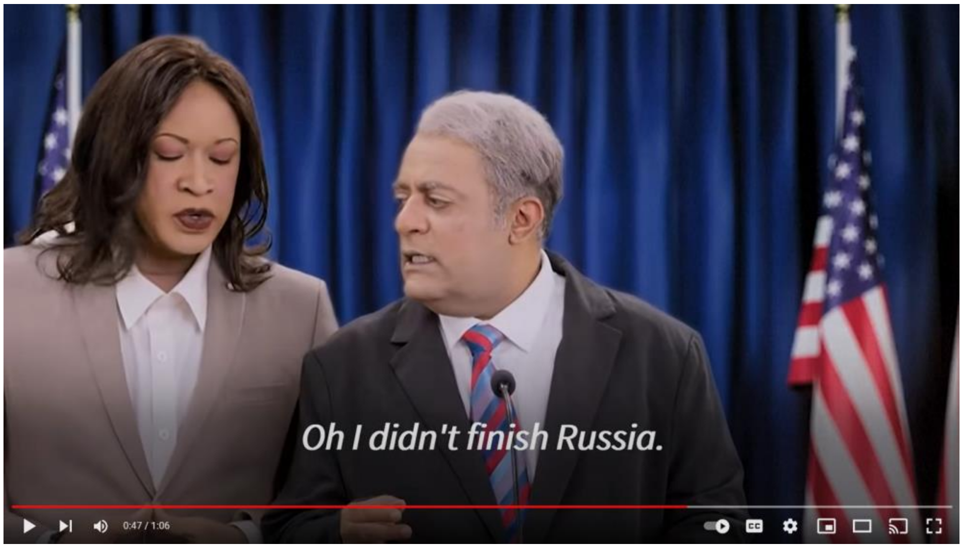
US crude production



Source: DOE IEA, TrendMacro calculations all-time high. And the Energy Information Agency is projecting a million barrels per day production increase over just the coming ten months (please see the lower chart on the previous page). While we don't see production ramping up quickly until after October, an extra million barrels per day is possible in America's oil patch as drillers find increased locations to drill and fracture when oil prices are as elevated as they are now.

- It’s a challenge, though. President Joseph R. Biden's anti-fossil fuel agenda and the ESG investor community have conspired to suppress capital investment in the oil patch – at least suppress it to levels well below what we would expect given current pricing. There may finally be some relief there, though – last week the administration announced, with much fanfare, that it would resume leasing federal lands to producers – albeit with sharply higher royalties, and dripping with recriminations about corporate greed.
- Meanwhile, Biden’s short-term fix is a globally coordinated release from Strategy Petroleum Reserves. While this may relieve some short-term pressure in the spot oil market, it doesn’t solve the problem of high gasoline prices. The historically low global inventory picture *includes* strategic inventories. When these are drawn down, the inventory picture gets even tighter – and tight inventories are highly associated with higher prices (again, please see the chart on the previous page).
- Even if the US ramps up production going forward, there doesn't appear to be any producer in the world – outside of Saudi Arabia, the United Arab Emirates and Kuwait – that can add significant volumes fast enough to offset the loss of Russian exports. And as always, other OPEC producers – Libya, Iraq, and Nigeria – face possible outages in production due to civil wars, terrorist attacks, and neglected infrastructure.
- Biden, for his part, continues to press for an Iran nuclear deal. The Iranians, probably sensing US desperation, keep moving the goalpost. Most recently they have begun demanding removal of the US designation of the Islamic Revolutionary Guard Forces as a terrorist organization. That's right, the same organization that supported its surrogates in launching drone attacks on Saudi and UAE critical infrastructure. *So the US finds itself in the absurd position of seeking Iranian oil volumes by condoning an Iranian organization that reduces Saudi and UAE volumes.*
- And there matters stand – deadlocked. But we expect the Biden administration will eventually cave to whatever Iran asks, if that offers the slimmest hopes of getting gasoline prices down before the mid-term congressional elections. A European ban would make a US/Iran deal nearly a sure thing, no matter the terms.
- No wonder Saudi Crown Price Mohammed bin Salman – who presides over Iran’s regional super-rival – met on Saturday by phone with Putin, saying they “discussed bilateral relations that bring the two countries together.” No wonder Saudi television cruelly satirizes Biden as a doddering old man (please see, and click on, the image on the following page). It adds an element of uncertainty about whether Saudi, despite its large spare capacity, if

push came to shove, would indeed step in and make up for Russian shortfalls.



At the same time, the demand picture is fluid as well. [COVID lockdowns in China] are reportedly spreading from Shanghai to other cities – though we take with a great deal of skepticism any statistic or other report about the pandemic coming out of China. This may or may not affect China's interest in buying discounted Russian oil – if that interest is impaired, Russia becomes an even more desperate seller.

So we continue to think that if a European ban materializes, especially if it is gradual and partial – and assuming bans are not adopted by other buyers such as China and India – that after an initial dislocation, oil prices are likely to end up lower, despite a seeming crisis.

Bottom line

Reportedly Europe is considering a ban on importing Russian oil – gradually and partially, if at all. Russia is already finding alterative buyers at a deep discount – but the net price realized is still so high that Russian oil revenues (and related tax revenues) could be as high as last year's even on lower volumes. Russia's need – and willingness – to sell at a discount points to lower world prices, following an initial shock, if a European ban materializes. India and China are the big buyers so far, with Latin America possibly coming on as the US diverts refined product shipments to Europe. Saudi, UAE and Kuwait could contribute more oil if needed. Production is accelerating in the US, and the Biden administration is tentatively backing off its anti-fossil fuel agenda. The SPR release is a short-term palliative. The US continues to pursue a nuclear deal with Iran, even as Iran keeps moving the goalposts. Regional rival Saudi looks on, and conducts friendly diplomacy with Putin while mercilessly satirizing Biden on television.