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Biden Pivots on Oil, Or At Least on Saudi Oil

Wednesday, June 22, 2022

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Inflation makes strange bedfellows. Suddenly the administration is out of love with Iran.

Crude oil prices have fallen sharply, but don't jump to the conclusion that it's because the Fed is about to engineer a recession to tame inflation – and temper demand for energy prices. *We think the more likely reason is a double-pivot by the Biden administration – made however reluctantly – to back away from policies that had broken the traditional US/Saudi Arabia alliance, and discourage domestic production and refining capacity.*

- The highs for crude in this cycle were hit March 7 with Brent at \$139.30 and WTI at \$130.50. That was when the Russian invasion of Ukraine was still new, and the demand for the West to "do something" was at its peak. The US Congress forced the Biden administration to ban US imports of Russian oil, and Canada and the UK instantly followed. *The fear was that the European Union – a far larger customer of Russian energy commodities – would do the same thing, throwing global energy markets into disarray as 3 million barrels per day are effectively taken out of the global market overnight. We said then and there that Europe wouldn't be that brave – or that stupid – and we were right* (see "Video: What you're not hearing about the coming oil shock" March 7, 2022). Crude prices haven't seen that peak since.
- *Now Europe has finally agreed on a Russian oil ban, and it's precisely the timid and loophole-ridden creature we expected* (see "A Very European Ban on Russian Oil. Maybe." April 18, 2022). Most significant, piped volumes (the barrels that can't be replaced) are exempted. Seaborne volumes can continue to be imported until the end of the year (and they can easily be replaced).
- So far, despite what are now six sanctions and bans passed by the EU Council, Russian crude oil exports have exceeded levels prior to the invasion of Ukraine and are expected to keep rising until at least July.
- We also said that less-aligned nations wouldn't unilaterally impose Russian crude oil bans – so long as Russia was willing to sell to them at steep discounts to global benchmarks, now running about 30%. China, India, Turkey, Indonesia, and South Africa are already or will soon be importing Russian crude oil at a combined volume greater than that previously exported to Europe. Russian seaborne crude oil exports reached a three-year volumetric high last month. And Russian fossil fuel export earnings remain elevated because

Update to strategic view

OIL: The Biden administration has given up on a new Iran nuclear deal, and is pivoting back to the US's traditional regional ally Saudi Arabia, with a visit from the president now set for next month. Biden will offer Saudi armaments in exchange for more OPEC oil production. This explains last week's decline in global crude prices. At the same time, there are small signs of a thaw between the administration and the domestic fossil fuel industry, with White House entreaties to expand refinery capacity. Discounted Russian oil is finding a home in the developing world where fuel demand is increasing, allowing Russia to pivot away from developed world customers where demand is decreasing. European refining capacity remains a pressure point, with consumers preferring to avoid Russia-branded products in favor of other brands even if they rely on Russian crude. Ultimately the Ukraine crisis must end for global oil markets to stabilize. Even if a …

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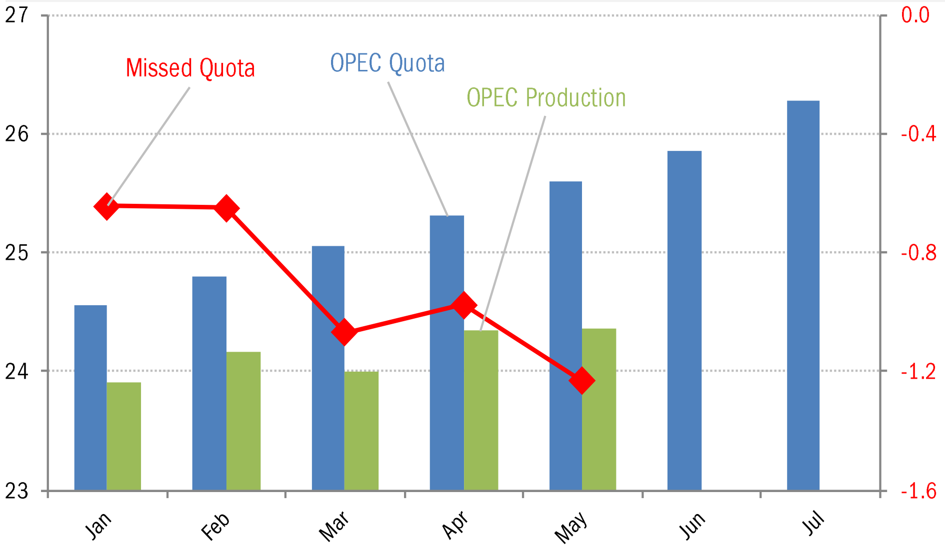
export prices are 60% higher than last year, even with the discounts. The simple lesson here is that discounted fossil fuels usually find a home. *A result of this purported punishment of Russia is that it is quickly increasing crude oil market share in emerging economies with growing oil demand, and exporting less to developed economies with stagnating demand*.

So even though they are well off the March peak, what's keeping crude prices as high as they still are?

We think there's surely a risk premium built into crude prices thanks to the residual possibility of various "black swan" events that could still emerge around Ukraine. For example, one could imagine the deployment of a nuclear weapon by Russia, even if only a demonstration, that would make even China and India not want Russian crude, however steep the discount. A global ban on Russian oil would have the effect of shrinking crude supply by about 7% – God only knows what would happen to prices if that happened. Brent $1000?

But away from the fat tails, *there remains the central fact that OPEC keeps missing its production quotas* (please see the chart below).

OPEC production versus production quota (millions barrels per day)



Source: DOE EIA, TrendMacro calculations

- At the conclusion of the 19th OPEC and non-OPEC ministerial meeting in July 2021, long-term crude oil production targets were set for the OPEC+ group. Only four OPEC members were expected to increase production after April 2022: Saudi Arabia, Iraq, Kuwait, and the United Arab Emirates.
- OPEC production remained basically flat last month and collectively missed its revised production target by more than 1 million barrels per day. *That is 2 million lower the long-term OPEC+ quotas agreed upon in July 2021*.

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…resolution involved annexation of Donbas, we think trade patterns between Europe and Russia will be quickly restored, and energy markets can return to pre-Ukraine norms. Absent a "black swan" from Ukraine, we've seen the peak in oil prices.

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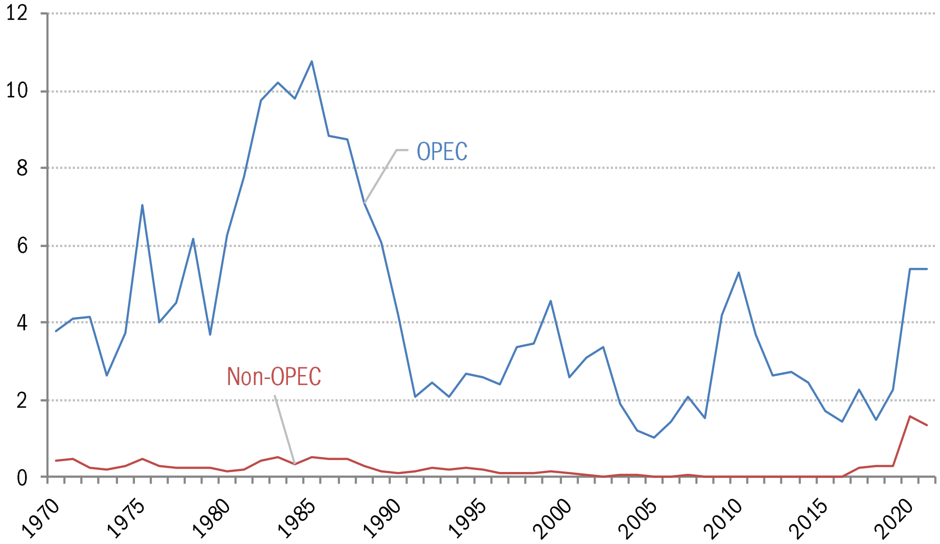
- But [the Energy Information Administration released a report](#) last week that suggested OPEC has more than 5 million barrels of spare capacity (please see the chart below).

Crude oil spare production capacity (millions barrels per day)



Source: DOE EIA, TrendMacro calculations

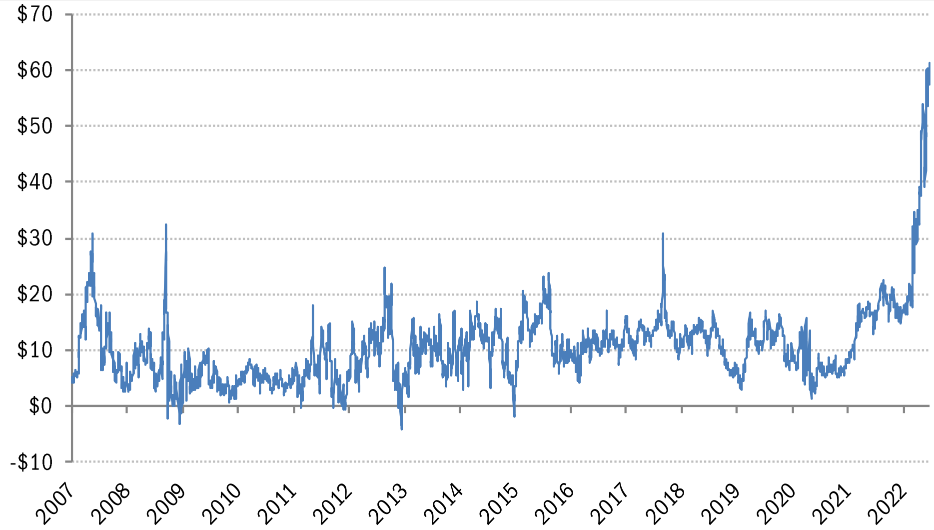
- So what gives? Why hasn't OPEC met its own production quota? *We think it's because Saudi Arabia hasn't had any reasons to do the Biden administration any favors – until now.*
- The Obama administration began a pivot away from Saudi to its regional rival Iran with the advent of the nuclear deal in 2015. The Trump administration pivoted back to Saudi by abrogating the deal and saying mum about the death of Jamal Khashoggi. The Biden administration pivoted back to Iran, after Biden himself had campaigned against Trump in 2020 by promising to make Saudi a "pariah" and to halt arms sales. Immediately upon his inauguration, Biden started to bring the nuclear deal back to life. Or at least try.
- In the ensuing multilateral negotiations, apparently Iran raised the stakes to the point where even the Biden administration couldn't call the bet. Now this game of poker appears to be over.
- *Time to pivot yet again, especially considering that Iran's share of that spare OPEC capacity probably isn't more than about a million barrels per day, and it would take over a year to get it flowing.*
- In mid-April, two Iranian laden oil tankers were seized in Greek waters on the request of US authorities.
- Two weeks later, Biden refused to drop the terrorist designation from the Iranian Islamic Revolutionary Guard Corps (IRGC).
- The Greek incident spurred a response when the IRGC landed on Greek ships in the Strait of Hormuz to take their cargos into Iranian waters at the end of May.
- Last week the Biden administration announced new sanctions on Iranian, Chinese, and Emirati individuals involved with Iranian oil exports from the Middle East.

- *And what do you know* – that EIA report showing all that spare OPEC capacity was released just two days before the White House confirmed that Biden would meet the Saudi crown prince in mid-July. Well, sort of – it's just an "international meeting" and the pariah will just happen to be there.
- *As long as they just happen to be in the same "international meeting" at the same time, we think Biden will offer military assistance to Saudi in order to combat Iran's increasing bellicose actions in the Middle East – oh, it just so happens the UN reported that Iran now has enough plutonium to make a nuclear bomb – as long as OPEC turns on the spigots*.

Of course what prompted Biden's foreign policy *volte-face* is high inflation and record-high fuel prices during an election year. *But while pushing for more global oil production may help, flawed green policies from his administration and Europe are the major reason behind sky-high global fuel prices, and the energy markets' lack of greater resiliency in the face of the Ukraine crisis*.

- Biden's re-signing on to the Paris Accords and the billions of stimulus spending for renewable energy has damaged America's ability to return to pre-pandemic levels of production and processing, even as demand has completely recovered.
- The White House initiative to suspend the federal gasoline tax is only a demand-side palliative. According to a Congressional Research Service analysis in March, it would only save the average household $13.58 per month. It's not even good political theater. Even House Speaker Nancy Pelosi (D-CA12) doesn't support it – disparaging it as "very showbiz." It doesn't have the votes to pass either the Senate or the House.
- *The issue is the supply side, anyway. And the supply side can't be fixed by more releases from the Strategic Petroleum Reserve.*
- *A key pressure point is the lack of refining capacity to process fossil fuels, whether they come from new drilling or strategic reserves* – in the US, and even more so in Europe. More than 1.6 million barrels per day of US and European throughput capacity has been or is in the process of being converted to make animal fats and plant-based feedstock into so-called sustainable airline fuel (SAF). Subsidies for SAF in the US under the 2021 Sustainable Skies Act can run as high as $2.00 per gallon. The EU, which has been trying to craft a "Fit for 55" SAF policy for many years, still hasn't agreed on either mandates with penalties or production subsidies. Add this amount of converted refinery capacity to American and European throughput volumes already lost due to demand destruction in the pandemic, and a crisis was guaranteed as soon as economies recovered and global fuel demand rebounded.
- As a result, refinery crack spreads – which are the margins refiners earn when processing a barrel of oil into fuels – blew out when Russia attacked Ukraine in February.
- In Europe, consumer demand for Russian-labeled fuels has been dented by the war – but not so much Russian crude turned into marketable gasoline and diesel by non-Russian refiners. So as of

Gulf Coast crack spread with Light Louisiana Sweet crude (USD per barrel)



Source: Per EIA, Bloomberg, TrendMacro calculations

March, about 900,000 barrels per day of Russia's 7 million barrel refinery capacity has been idled. The problem is replacing it. European refining capacity has been in a secular downtrend for a quarter-century – while it has expanded virtually everywhere else.

- Refined product prices globally have experienced crack spreads on a sustained basis never seen before (please see the chart above, for the US). Ultimately, like any profit margin, the crack spread finds equilibrium based on the cost of capital and the propensity to bear business risk. But any time there are risks to the stability of fuel markets, the spread temporarily widens as consumer end-demand trumps all other considerations.
- In another pivot – this time away from ESG movement that sustains so much of Biden's political base – the Biden administration has asked shuttered US refineries to restart production. But the plea to the industry has fallen on deaf ears after experiencing two years of anti-fossil fuel policies and messaging. Lost capacity isn't coming back online and refineries getting subsidies to produce renewables are not going to revert back to fossil fuels just because they get a call from the White House.
- And now a meeting has been scheduled so that Energy Secretary Jennifer Granholm can talk directly with energy executives about what can be done. Presumably the public face of the meeting will be to vilify them for profiteering – which they seem increasingly willing to push back against. But hopefully behind closed doors something more productive will happen.
- *But at least it's some sort of pivot back toward one of the "pariahs" who make the world go around. We can build on this. Elections clarify the political mind.*
- *Already, before even this slim evidence of a pivot, US oil and gas producers have continued* – slowly – to add rigs, and crude production is now forecasted by the EIA to reach 12.5 million

barrels per day before year-end, and to reattain pre-pandemic levels by mid-2023 (see "Data Insights: Oil" March 13, 2022).

The most immediate potential reprieve from high gasoline and diesel prices would be an end to the war in Ukraine.

- *Surely it will have to end sometime. We don't want to fall into the trap of calling it "transitory," but that's what it has to be.*
- We don't want to read too much into this, but in remarks last week Russian President Vladimir Putin seemed to be retreating to his original war aims, that is, to annex the Russian-speaking provinces in the Donbas region.
- And we don't want to read too much into this either, but we think it is not entirely insignificant that former US Secretary of State Henry Kissinger said last month at the World Economic Forum, of all places, that the West should accept such a compromise solution in the context of historical great-power politics. The West didn't exactly push back.
- *We are mindful that, unlike the US, Europe has to share a continent with Russia, and has historically had a substantial trading relationship. From the US perspective it will look like perfidious appeasement, but even with an obnoxious outcome like the Russian annexation of Luhansk and Donetsk, we think the elites of Europe will be eager to put European and Russian trade patterns back together – especially in energy.*

But until the Ukraine crisis abates, energy commodities will have to carry a risk-premium. In the meantime, Russia's deep discounting is keeping that risk premium lower than it would otherwise be.

- *And Biden's pivot to Saudi could make a real difference at the margin in the global oil balance – to some extent it already has.*
- *So while it's too soon to hope for crude prices to get back to pre-Ukraine levels, absent a "black swan" event, we continue to think we've seen the peak.*

Bottom line

The Biden administration has given up on a new Iran nuclear deal, and is pivoting back to the US's traditional regional ally Saudi Arabia, with a visit from the president now set for next month. Biden will offer Saudi armaments in exchange for more OPEC oil production. This explains last week's decline in global crude prices. At the same time, there are small signs of a thaw between the administration and the domestic fossil fuel industry, with White House entreaties to expand refinery capacity. Discounted Russian oil is finding a home in the developing world where fuel demand is increasing, allowing Russia to pivot away from developed world customers where demand is decreasing. European refining capacity remains a pressure point, with consumers preferring to avoid Russia-branded products in favor of other brands even if they rely on Russian crude. Ultimately the Ukraine crisis must end for global oil markets to stabilize. Even if a resolution involved annexation of Donbas, we think trade patterns between Europe and Russia will be quickly restored, and energy markets can return to pre-Ukraine norms. Absent a “black swan” from Ukraine, we’ve seen the peak in oil prices.