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

MACROCOSM

Oil Markets One Year On from the Ukraine Shock

Tuesday, March 7, 2023

Michael Warren

So far so good – but Europe's diesel price-cap could change everything as it starts to bite.

As the Russian invasion of Ukraine passed the one year mark last month, China offered a 12-point plan to ratchet down the fighting and reduce chances of further escalation. The plan was skewed to Russia's interests, but some European leaders and Ukrainian President Volodymyr Zelensky appear to be willing to meet with Chinese President Xi Jinping to engage in diplomacy – as *the war grinds into an apparent stalemate* with the chance of short-term military victory on either side increasingly unlikely.

While last year saw Russian sanctions enacted, 2023 is when their bite will hit global oil and refined product markets. The West needs Russian supplies to help keep the global oil market balanced, and Russia needs the export revenue to fund increased expenses brought on by the war. *But Russia will follow through on its pivot away from European to Asian markets regardless of whether the war continues or peace breaks out in Ukraine*.

From a strictly volumetric point-of-view, Russia has done remarkably well

Generative AI token: "Putin dressed like an Arabian, style of Technicolor widescreen movie"

Source: DreamStudio running Stable Diffusion 1.5

Update to strategic view

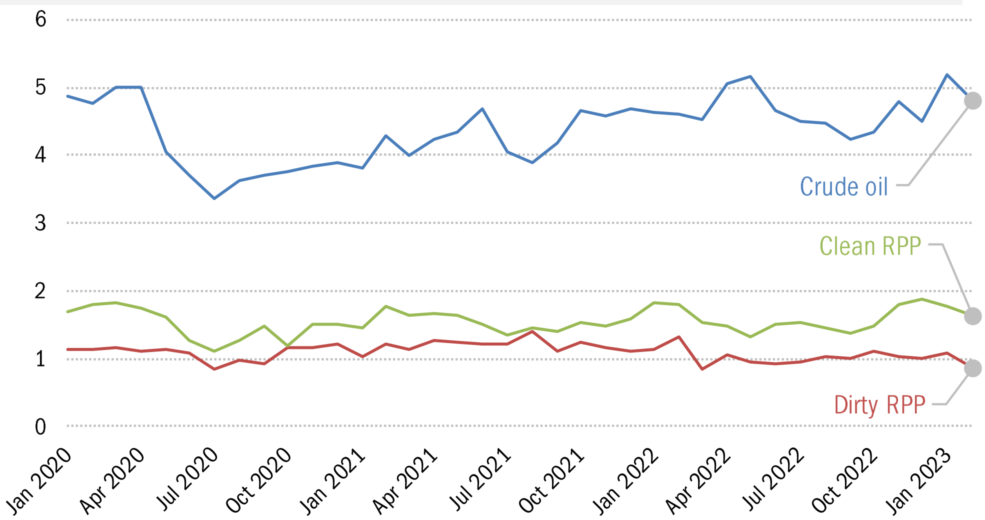
OIL: Russian sanctions will finally bite in oil and refined product markets this year. The G7 price caps will be breached – making importers take sides. Some will strictly follow the West's rules and stop importing cheaper Russian crude oil and products. Others will turn to the shadow fleet and keep importing Russian crude with no paperwork. And a few will try to deal with the bureaucratic tangles and possible penalties of continuing to import sanctioned crude and petroleum products. As Russian supplies are taken off the market with crude oil and diesel inventories low, global prices will rise as the West continues to convert fossil fuel refineries to renewable fuels production.

[Strategy dashboard]

at supplying new customers for its crude oil and refined products last year. Russian exports of crude oil and "clean" refined petroleum products (gasoline, jet fuel, and diesel) are back to their January 2020 pre-pandemic levels (please see the chart below). As we predicted right after Russia's invasion, so far so good – thanks to the deferral of Western bans and price caps, and Russia's ability to sell at a discount to Asian buyers (see "The Bear/Bull Case in the Russian Oil Ban" March 16, 2022).

But diesel makes up the majority of clean RPP – averaging over 1 million barrels per day – with Europe taking about 800,000 barrels. So *with the new cap on Russian diesel prices* (see "Crack Spreads Point North for Crude Prices" February 7, 2023), *there is some serious dislocation ahead for markets*. That could be exacerbated by any hiccup – a Gulf Coast hurricane or low river levels in Europe – given that US and European storage levels are at a multi-decades low. Russia's exports of "dirty" refined petroleum products (fuel oil, bunker fuel, and other low-cost bottom-of-the-barrel outputs that need to be further processed at more complex refineries) is the only category that is below the January 2020 pre-pandemic level.

Russian exports of crude and refined petroleum products (millions barrels per day)



Source: Bloomberg, TrendMacro calculations

For the first two months in 2023, sanctions still haven't hit fully. But the bite will come via Russian refined product exports – particularly diesel – as the $100 per barrel G7 price cap starts to back up refining runs and cut into overall crude oil production. Russia had already announced a 500,000 barrels per day reduction in crude production five days after the diesel price cap took effect on February 5. Cuts to Russian oil exports could exceed 25%, starting to take effect this month. That 1.25 million barrels cut is in line with what we envisioned earlier this year (again, see "Crack Spreads Point North for Crude Prices").

Customers of Russian crude and diesel are facing difficult decisions as prices rise above the caps set by the G7. Urals crude – Russia's largest

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

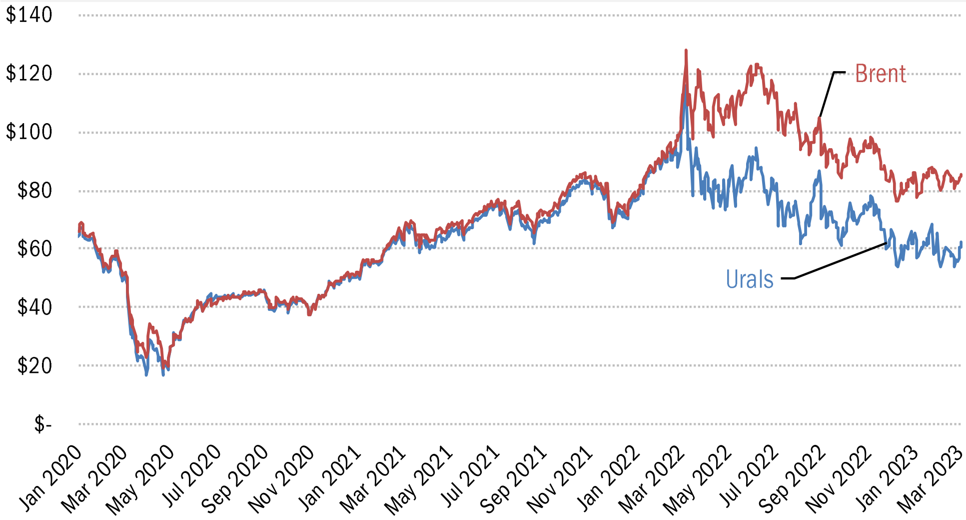
Donald Luskin
Dallas TX
214 550 2020
don@trendmacro.com

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

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

[About us]

Crude oil benchmarks (USD per barrel)



Source: Bloomberg, TrendMacro calculations

crude oil export grade by volume – traded under the $60 price cap when it was officially set on December 5 (please see the chart above), but has traded above the price cap this month. We expect Russian diesel prices to respond in a similar manner and rise above $100 per barrel sometime in the second quarter.

Not all customers of Russian petroleum products will respond in the same manner when prices breach their caps. Some will stop taking delivery, but others will continue to import despite the added bureaucratic paperwork and stress caused by possible legal action. *So sanctions and price caps will whittle away at demand for Russian crude and diesel on the margin, thus limiting supply*.

Also, the multi-modal transport of crude oil and refined products takes several smaller-sized ships to transport volumes to pooling points in the Mediterranean Sea where very large crude carriers set sail for Asian markets. The "shadow fleet" has grown since the Russian crude price cap announced last year and will need to add even more tankers now that Russian refined products face caps. Looking at total Russian crude oil seaborne exports, the share transported on European vessels has fallen from 47% to 31% since the price cap was enacted in December. Vessels labelled as Russian, Turkish, "other" and "unknown" have taken up the slack. While the shadow fleet continues to grow in February, several reports suggest that up to 2 million barrels of Russian diesel have been stored on seaborne vessels as buyers around the world are found. The result will be high diesel prices and crack spreads remaining close to the historical high set last year (again, see "Crack Spreads Point North for Crude Prices").

There are other tricks that Russia can use to surreptitiously push Russian crude to European partners through the Druzhba ("Friendship") pipeline. Instead of Russian crude oil, Germany will receive at least 24,000 barrels per day of nominally Kazakhstani oil with the possibility of up to 120,000 barrels starting this month. Although there could be some mixing of Russian and Kazakhstani oil, it doesn't really matter to Germany as long as Russia isn't paid directly. Remember that Slovakia, the Czech Republic, and Hungary still receive Russian oil through the southern leg of the Druzhba – up to 250,000 barrels per day – that, believe it or not, go through Ukraine.

As Russia transitions to Asian crude oil and fuel markets, *the West continues its religious war against fossil fuels* (see "Video: A conversation with Dr. John Constable on the energy crisis facing Europe" October 6, 2022). *This year we could see three more refinery conversions to renewable fuels that eventually could take over 450,000 barrels per day of Western refining capacity off-line*. Total Energy's Grandpuits refinery has already stop processing 101,000 barrels and will cease storing fossil fuel products at its site before year-end. LyondellBasell's Houston refinery will close its 268,000 barrels crude distillation units by year-end and is exploring a conversion to chemical recycling. Eni's Livorno refinery has already stopped processing its 88,400 barrels crude oil due to maintenance activities and might convert to biofuels by 2025.

Against this backdrop of likely disruption to global markets as diesel sanctions kick in – and Europe's continued self-inflicted reduction of refining capacity – we don't see how global crude prices can't work higher.

Bottom line

Russian sanctions will finally bite in oil and refined product markets this year. The G7 price caps will be breached – making importers take sides. Some will strictly follow the West's rules and stop importing cheaper Russian crude oil and products. Others will turn to the shadow fleet and keep importing Russian crude with no paperwork. And a few will try to deal with the bureaucratic tangles and possible penalties of continuing to import sanctioned crude and petroleum products. As Russian supplies are taken off the market with crude oil and diesel inventories low, global prices will rise as the West continues to convert fossil fuel refineries to renewable fuels production.