Global Macro

Outlook for Global Oil Markets in 2019-2020

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Part V: Physical Dislocations Set to Upend Global Oil Markets in 2019

Key Question: How much market dislocation will be created by the one-two punch of the IMO and US light-sweet exports?

- Two key physical market "disruptors" will have an outsized impact on the market environment over the next 18-24 months: the International Maritime Organization (IMO) 2020 bunker fuel specifications change and the rapid transition of the US into a major global exporter of light sweet (LSW) crudes. Each of these would be disruptive in "normal" market conditions, let alone against a backdrop of coordinated supply cuts, US sanctions on two major OPEC producers and turbo-charged US growth. The result will create a "scramble" to match crude supply availability with changing product needs.
- The twin impacts of IMO specifications changes and the rise of US light sweet exports are creating one of the most challenging physical adjustments to the structure of supply and demand in modern oil market history, and we believe it has not been fully or adequately priced in yet due to the complexity of the adjustments needed. In the past, quality/availability issues for refiners have skewed bullish in terms of global price impact, particularly when distillate prices were pushed higher, and we believe a similar trajectory is likely to accompany the IMO transition.
- The global refining industry faces the daunting task of solving these multiple market dislocations, each of which would be taxing in its own right. These shifting trends will impact global crude demand patterns, crude trade flows, price differentials, and of course relative product prices and refining margins. Price dislocations and push-pull arbitrages are likely to emerge and create rapid shifts in market behavior starting in the summer of 2019.
- With less than a year to go, refiners are already seeing signs of crude supply quality skew, erosion in global spare refining capacity from years of above-trend global demand growth, and a loosening light ends market that will complicate the pass-through of margin signals to product output. In particular, the "associated" gasoline problem that has emerged of late, created by a divergence between gasoline and diesel margins, highlights the risk that the market will struggle to send the correct price signals to facilitate a smooth transition.
- A slew of pipelines set to alleviate Permian bottlenecks and infrastructure buildup to increase export capacity will create growing pains during 2019, but sufficient capacity should be available by end-2020 to enable the type of export flows our US production forecast requires. The bigger challenge lies two steps ahead and cannot be addressed by infrastructure investment: US growth has no baseload buyer and at a time when refiners are looking to maximize distillate yields, the incremental light crudes hitting oil markets will need to find a price to make them attractive. Unless a large-scale baseload buyer (e.g. China) emerges to absorb 1.0 MMb/d or more by 2020, we believe WTI-Brent differentials could once again widen until US barrels manage to muscle their way into the diet of the refining industry, be it domestically or abroad.