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Emirates NBD

Commodities

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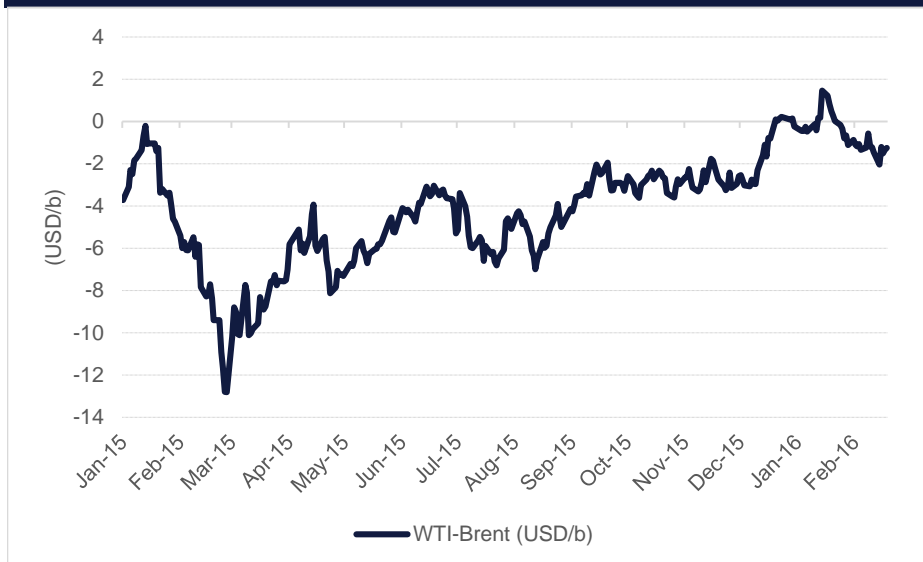
Crude oil update

Examining the WTI-Brent spread

The WTI-Brent spread has been widening in recent weeks, with the US benchmark last trading at a discount of USD 1.26/b to the international grade. This is sharply down from a few days where the spread inverted in January and the trend appears to be reversing the general tightening trajectory we witnessed for most of 2015. Is this reversal significant and is the market in store for further widening? Below we discuss several dynamics we feel will affect the spread over the next year.

First though, why is there a differential at all? Historically WTI traded at a premium to Brent as it is a lighter oil (easier to refine) and sweeter (less sulphur to process). Peak divergence between the two benchmarks on a relative basis was in Q1 1996 while on a per barrel basis the gap widened to as much as USD 14.88/b during the height of the financial crisis in September 2008. The relationship inverted from 2009 onward thanks to the rapid expansion of domestic production of crude oil in the US and the corresponding secular rise in US inventories.

WTI-Brent has turned downward in 2016

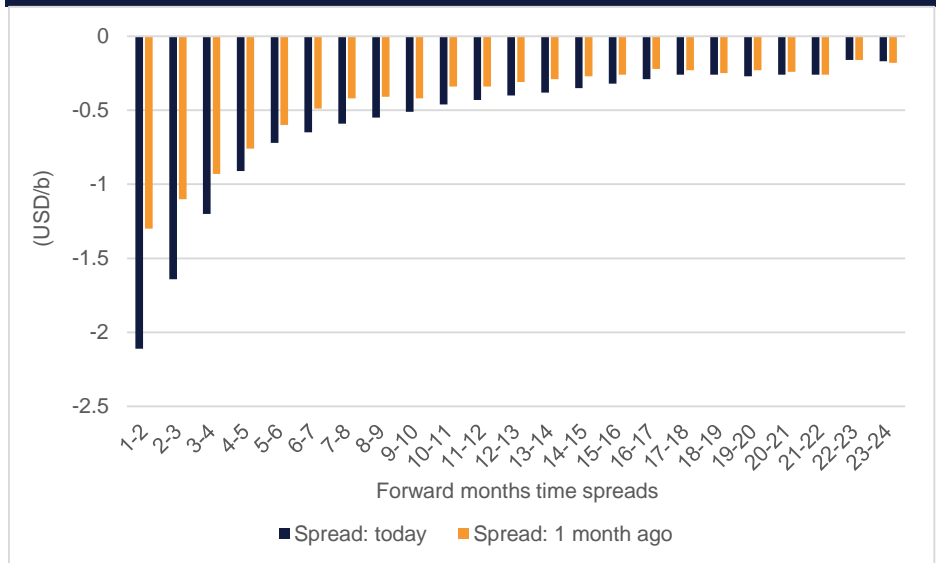


Sources: Bloomberg, Emirates NBD Research.

The status of US inventories is a prime contributor to the current WTI-Brent spread in our view. Despite a levelling off in crude output, total US inventories have continued to hit multi-decade highs, particularly at the Cushing, OK pricing point. Renewed concern over the availability of storage has heaped pressure on the near end of the WTI forward curve (see chart on next page). Inventories at both Cushing and the US Gulf coast have moved higher in 2016 year to date (ytd) and we estimate that close to 80% of the total storage capacity in these regions is being used (according to US government data, Cushing and the Gulf region represented 67% of total crude inventories). As estimates of storage use creep higher, we expect the steepness in the front-end of the WTI curve to persist and keep near-term downward pressure on the WTI-Brent spread.

While the spread has begun widening, it is not at levels that we believe would make exports of US crude oil competitive to international grades. Since the US removed its decades-long ban on exports of crude, export estimates from the EIA show shipments actually falling in 2016 rather than seeing importers suddenly rush in to buy US cargoes. The initial price action on the repeal of the ban was upward: exports offered a new avenue for crude oil disappearance in the US beyond refineries. But the jump in WTI prices in response to the repeal likely helped to deter interest in US shipments; the WTI-Brent spread moved from a USD 3/b discount to a USD 0.08/b premium. A wider WTI-Brent spread caused by higher exports would likely help to catalyse its own narrowing as the US oil balance tightens.

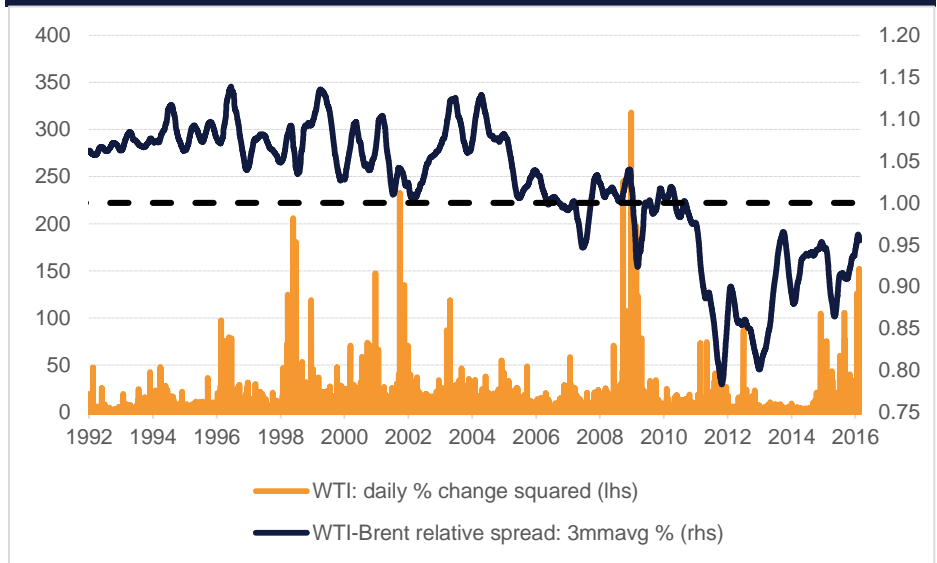
WTI time spreads are widening, steepening forward curve



Source: Bloomberg, Emirates NBD Research.

We believe these dynamics will hold true in the near term but they are unlikely to derail the general narrowing between WTI and Brent for 2016 as a whole. Generally, the spread between the two oil grades demonstrates a high degree of convergence during periods of heightened volatility. In 2008-09, the grades traded close to even, as they also did during the 2001 recession in the US. Volatility is being shaped by a bearish fundamental picture (most visibly in the US) contending with some form of production rationalization that we feel would hit international markets first as national oil companies make a policy-related decision to curb output (still a big if in our minds). The general risk-off tone affecting markets will hit both WTI and Brent equally given they are both highly liquid traded futures.

Volatility hits both Brent and WTI

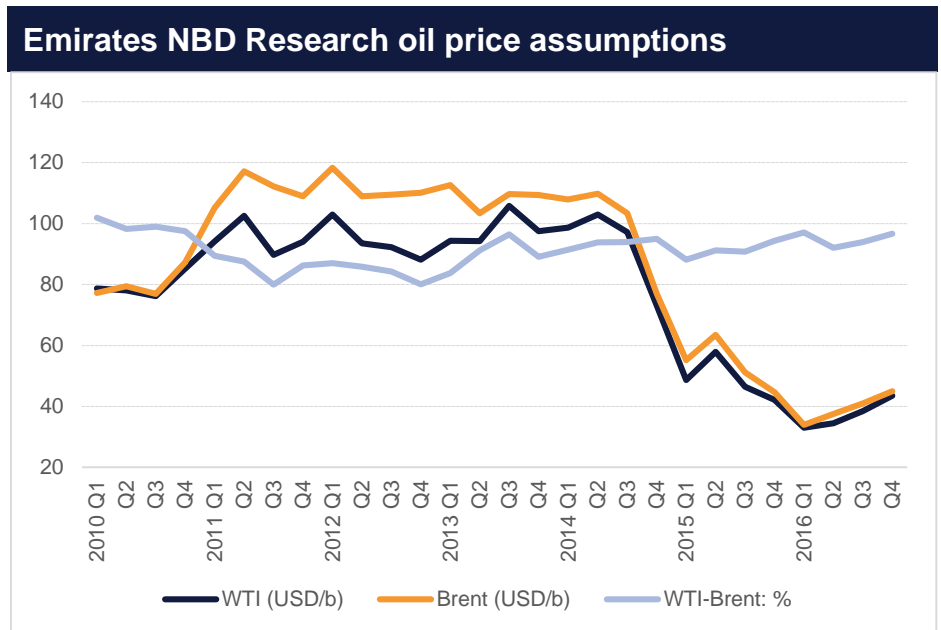


Source: Bloomberg, Emirates NBD Research.

Markets may also be over-pricing Brent in relation to the Saudi Arabia-Russia-Venezuela-Qatar deal to freeze production at January levels. Front month Brent futures have risen USD 3.76/b in the last month while contracts one-year forward are more than USD 4/b higher than they were a month ago. In the same period, WTI front month has moved only USD 0.11/b higher while contracts expiring in 12 months have moved USD 2.77/b. The agreement between these producing nations does not

address the immediate concern of over-production although it may be the first step in a longer process of negotiating the distribution of production cuts. If it becomes apparent that demand is not strong enough to help narrow the market surplus and US oil production only declines slowly, we expect the upside for Brent to be limited, helping to keep the spread to WTI narrow.

Our own forecasts are for a narrowing of the spread between WTI and Brent on both a per barrel basis and relative to one another as we expect volatility to characterise the markets, particularly in H1 2016.



Source: Bloomberg, Emirates NBD Research.

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