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Brent/WTI spread continues on a slow path toward returning to more normal historical trading levels as structural change continues!

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From a fundamental perspective the main storyline in the oil complex continues to be the collapse of the Brent/WTI spread. The spread blew through several technical support levels over the last month or so but has retraced modestly and is now trading around the $2/bbl premium to Brent. Parity (as I have been predicting) has been hit a few times with WTI already trading at a premium to Brent on an intraday basis a few weeks ago. The spread is trading at levels not seen since August of 2010.

The fundamentals are continuing to drive the spread with assistance from the technicals. The spread has been in a consistent narrowing trend since February of this year with the trend still well in play. The momentum is still strongly suggesting that the spread will hit parity sooner than later and barring any reversals in the destocking pattern in Cushing and/or a sudden geopolitical surprise the spread will likely trade with WTI at a premium on a consistent basis.

The changing logistics of the Midwest have been impacting the surplus crude oil situation in the region. The infrastructure has changed and is continuing to change providing more outlets to move crude oil from the mid-west down to the US Gulf Coast. Cushing crude oil stocks are still higher than normal but they are now at the back to where they were back in April of 2012.

The combination of new and reversed pipeline outlets coupled with rail and barge movements have capped the surplus and pushed Cushing (as well as PADD 2) into a destocking pattern. Additional pipeline outlets (over a 1 million barrels per day) will be coming on stream by the end of the year or early next year which should result in a further destocking of the crude oil inventories in Cushing.

Further supporting the destocking of Cushing (and thus bearish for the Brent/WTI spread) is the steep backwardation that WTI has settled into over the last several months. The economics of storing crude oil in Cushing or in the US for that matter is completely uneconomical. With the steep backwardation the market is going to be economically incentivized to continue to reduce crude oil inventory levels in Cushing and elsewhere in the US.

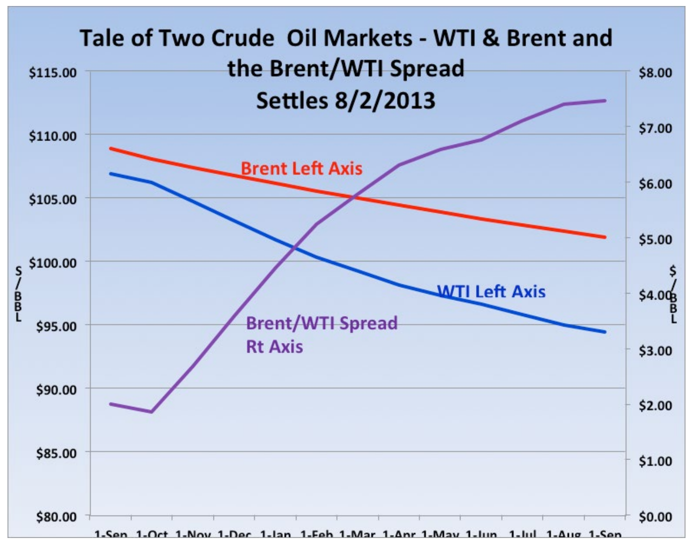
Finally the economic recovery in the US… although slow … is much better than what has transpired in Europe. As such oil demand growth in Europe is actually still in an oil consumption decline as Europe remains in a recession resulting in less call on North Sea crudes for Europe. On the other hand demand is picking up in the US with refinery utilization rates still near the highest level of the year and over the 90 percent level.

Overall most all factors suggest that the narrowing trend should continue to the point where WTI is trading consistently at a premium to Brent… much as it did for many years prior to the atypical move of the spread which began in 2010. The structure of the spread is not only in a narrowing trend but it is in a structural transition that is likely to last for the foreseeable future.

There has been a structural change in the relationship back toward a more normal historical relationship that existed prior to the first half of 2010. With Cushing stocks now at the lowest level of the year (albeit still above normal) and showing signs that the destocking pattern should continue and with new outlets for moving crude oil out of Cushing and thus PADD2 coming on-stream toward the end of the this year and into early next year the fundamentals should not only support WTI trading at a premium over Brent but the relationship should remain in place for the foreseeable future.

The spot Brent/WTI spread has been narrowing for the last six months with further narrowing likely to come. Over the last six months the spot spread has declined by $21.29/bbl or 91.8 percent (compared to where the spread is trading as of Monday morning). The spread currently remains in a trading range of parity (hit back two weeks ago) on the support side with around the $2.50/bbl on the resistance side.

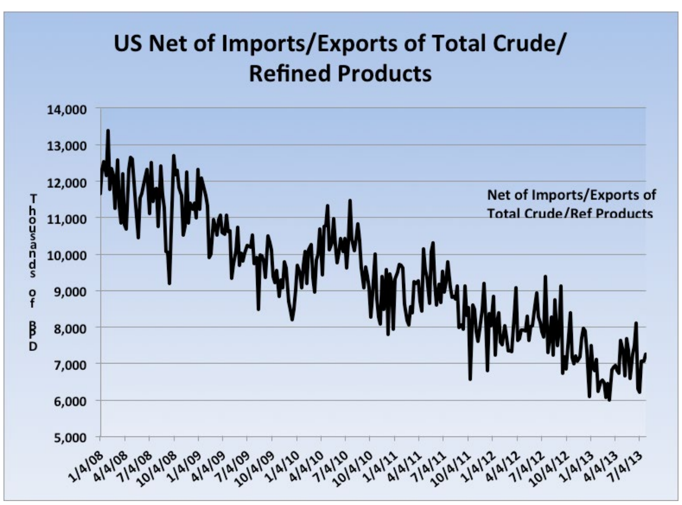
The following chart shows the forward curve of Brent/WTI spread along with the along with the individual forward curves for both Brent & WTI. As shown the forward curve is currently indicating that another widening of the spread could potentially occur going forward… although I am not of that view.



As mentioned above the destocking of the crude oil surplus in the Midwest has been the primary driver of the spread narrowing over the last six months. The destocking will continuing and accelerate heading into the end of the year as more outlets for moving oil out of the region come on stream. That said the main exposure to the spread remaining at more normal historical levels (WTI as a premium to Brent) in 2014 will be the impact the destocking of the Midwest has on the US Gulf coast crude oil balances.

Is the industry simply shifting the Midwest crude oil surplus to the US Gulf Coast? At the moment that has not been the case as PADD 3 (US Gulf Coast) crude oil stocks are about in the middle of the range they have been at since at least 2005. The combination of high refinery utilization rates (in the USGC) along with an eroding of the crude oil imports into the USGC have been enough to absorb the additional oil that is flowing to the Gulf at the expense of Cushing and the Midwest.

With the export market for refined products continuing to be robust...especially for distillate fuel refinery run rates in the USGC should remain relatively robust. In addition crude oil imports into the US Gulf coast should continue to decline as more crude oil moves to the Gulf. The following chart show the US net of imports and exports of total crude oil and refined products since 2008 (EIA data). As shown this chart is supportive for the Brent/WTI spread to continue to narrow as it is shows imports declining and thus making room for additional US domestic crude oil while exports are rising suggesting that refinery run rates may continue at higher than normal levels. Both of these factors could result in a potential crude oil surplus in the US Gulf coast not materializing anytime soon while the Midwest continues to destock.



Two additional factors may also support the spread trading at normal historical levels for a sustained period of time... the lack of approval of the Keystone XI line and the possibility of the US government allowing even more exports of US domestic crude oil. If Keystone does not get approval it will preclude a large amount of Canadian crude oil from coming to the US Gulf coast. In fact even if it is approved it will be a considerable period of time before it would be operational. Thus bearish for the spread. In addition additional exports of un-needed ultra-light sweet crude oil would also certainly preclude the formation of a large surplus of oil in the US Gulf and thus another potential bearish driver for the spread.

As I have been indicating for months the spread remains in a longer term narrowing trend that began back in February of this year. Crude oil stocks in Cushing and the broader PADD2 region of the US have been in a strong destocking pattern and are likely to remain in this pattern for the short to even medium term. The spread will trade at parity with a strong possibility of WTI trading at a premium to Bent on a consistent basis sometime over the next several months.

The short term direction of the spread is currently in a holding pattern or what I still view as light short covering within a broader longer term narrowing trend that has been in play since early February of this year. With Cushing stocks likely to show additional declines and maintain the destocking pattern currently in play and with European oil demand weak at best there will be a limited move to the upside before the spread starts to top out once again.

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