POTEN TANKER OPINION

A Perfect Storm

Combination of factors drives product tanker rates higher

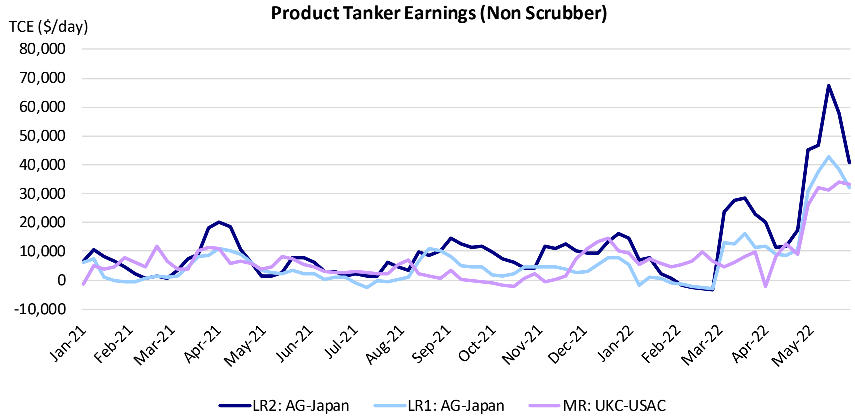
Product tanker rates have increased dramatically across the board (Figure 1). A combination of factors has driven rates to levels not seen since the Covid-induced rate spike in the spring of 2020. All product tanker segments (MRs, LR1s and LR2s) and all regions (both in the Atlantic and in the Pacific) are showing rates well in excess of the earnings in the crude tanker market. This begs the question: Why are product tankers doing so well and is this sustainable?

Let's start with the supply side. The product tanker fleet continued to expand during the pandemic, but the rate of growth clearly slowed down. Scrapping also picked up in 2021, so the product tanker segments started 2022 with a better supply/demand balance. The outlook for product tanker supply remains positive with limited ordering and continuing demand for tanker recycling (in particular in the MR segment).

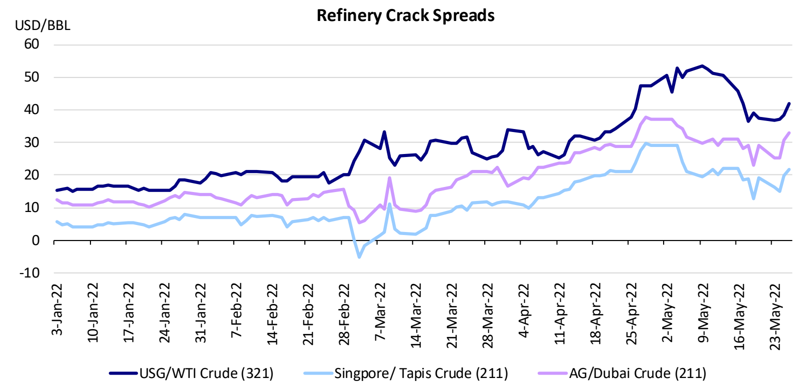
On the demand side of the equation, there are several factors that have contributed to a tight refined product market and resulted in strong ton-mile demand growth. First of all, global oil demand is recovering from the pandemic. According to the IEA, global oil demand grew by 4.5% in Q1 2022 compared to the previous year. Even though Covid has not yet been eradicated, many countries (in particular in North America and Europe) have loosened restrictions and reopened their economies. Not surprisingly, a lot of this growth was concentrated in the OECD countries in the America's (+6.8%) and Europe (+9.9%). In contrast, Asian oil demand grew by only 2.9%, no doubt influenced by the lockdowns in China, which have maintained a zero-Covid policy.

Another reason for the unexpected tightness in the oil markets has to with the cutback in refining capacity during Covid. At the depth of the pandemic, less sophisticated refineries in both Europe and the U.S. were losing money. At the same time, the longer-term outlook for the refining industry was cloudy because the world was intent on moving away from fossil fuels towards renewables. In 2021 global refining capacity fell, for the first time in 30 years. According to the IEA, global capacity fell by 730,000 b/d as approximately 1.6 million b/d was shut down or converted into bio-refineries, while only 850,000 b/d of new capacity was added. The cutbacks were primarily in Europe and the U.S., where demand growth was strongest, while the additions were in Asia (primarily China) and the Middle East, where demand growth was much less pronounced.

To make things even worse, much of the world came out of the pandemic with record low product inventories. The exception is China, where refined product inventories are high as a consequence of the lockdowns and the resulting economic slowdown. The Russian invasion of Ukraine has added further fuel to the fire. While crude oil flows have held up relatively well despite the western sanctions, Russian product exports have taken a hit. Diesel flows to Europe in particular have dropped substantially. Russian refiners have been forced to cut back runs, further exacerbating the global shortage of refined products.



Source: Poten & Partners



Source: Bloomberg

The product tanker market has been a major beneficiary of the tight refining market. The swift oil demand recovery in OECD countries, combined with low inventories and reduced refining capacity has led to very rapid price increases and exceptionally strong refining margins. The conflict in Ukraine tightened the market even further. Figure 2 shows how the Refinery Crack Spreads in several major markets increased after the Russian invasion in February. A crack spread is the pricing difference between a barrel of crude and the petroleum products refined from it. For refiners and traders alike, this market has created many arbitrage opportunities, boosting seaborne product movements.

The outlook for the product tanker market is very bullish. Refiners are running flat out, and demand has remained strong. Despite low domestic inventories, many refiners continue to export, as prices are very attractive. Russian refining utilization will likely remain compromised as long as the conflict in Ukraine continues. China could be a wildcard. Recent reports suggest that China is weighing the relaxation of their refined product export quotas to tackle swelling product inventories. As the global market would welcome more Chinese product exports, this would stimulate the product tanker markets even more, especially since these are likely long-haul movements.