Spread Normalization Threatens Refiners

Golf is alleged to be a humbling game, but it has nothing over market analysis. At least I get to do this without having to wear chartreuse pants. Only three months ago, here is what I had to say about refiners:

> *As much of the global demand for refined products is occurring outside of the U.S., domestic refiners are faced with global competitors who can bid the price of crude oil higher. In addition, the continued use of crude oil in contango storage as a financial asset is keeping the cost of crude oil higher than it would be otherwise. Refiners may wish for that lower crude oil price scenario, but wishing for anything never seems to work, does it?*
>
> *Despite a burst of recent good performance by the sector and by all resource-related stocks following the global money-printing extravaganza, the refining sector is unlikely to revisit its glory days anytime soon.*

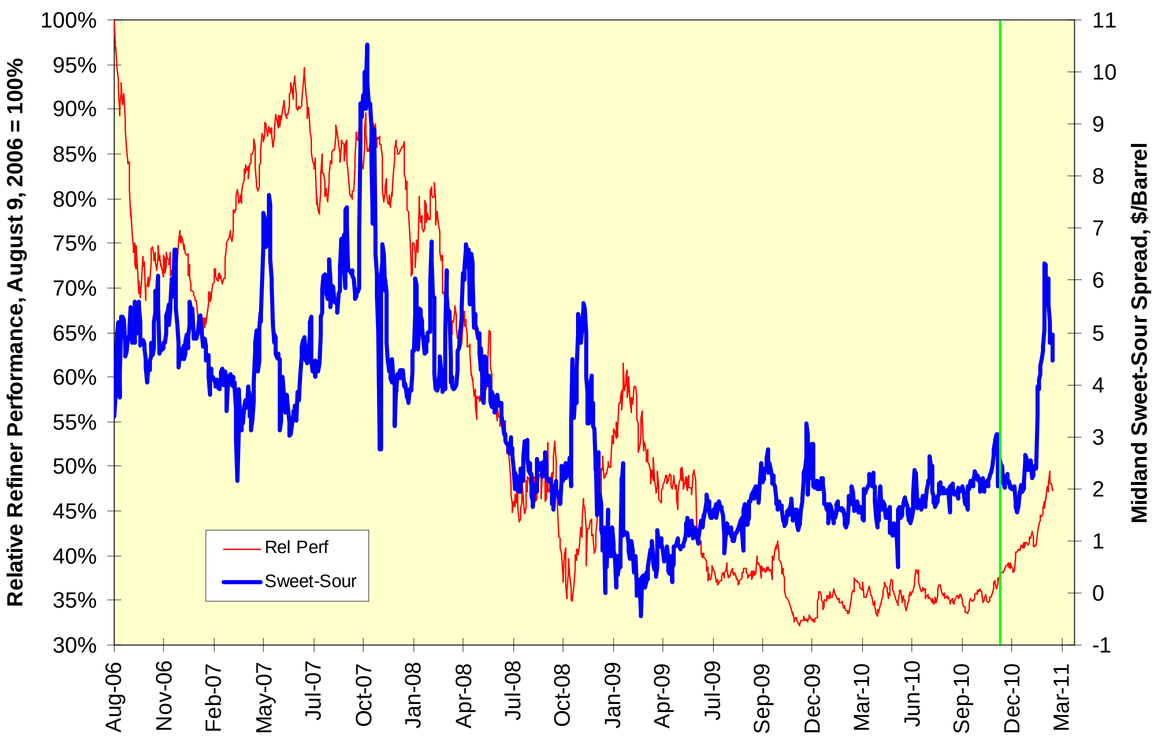
Now as the bridge players say, let's review the bidding: The contango storage trade pushed the back months higher and pushed low-sulfur sweet crude oil delivered at Cushing to a record discount vis-à-vis Louisiana Light Sweet at the U.S. Gulf Coast and to Brent Blend in the Atlantic Basin. So far, so good.

However, the S&P 1500 refiners group, which includes Valero, Sunoco and Tesoro along with Frontier Oil, Holly Corporation and World Fuel Services, has beaten the daylights out of the broad market, outperforming it by 24.7% over the past three months. If that is not a return to glory days, it is a pretty good start in that direction.

Sour Power

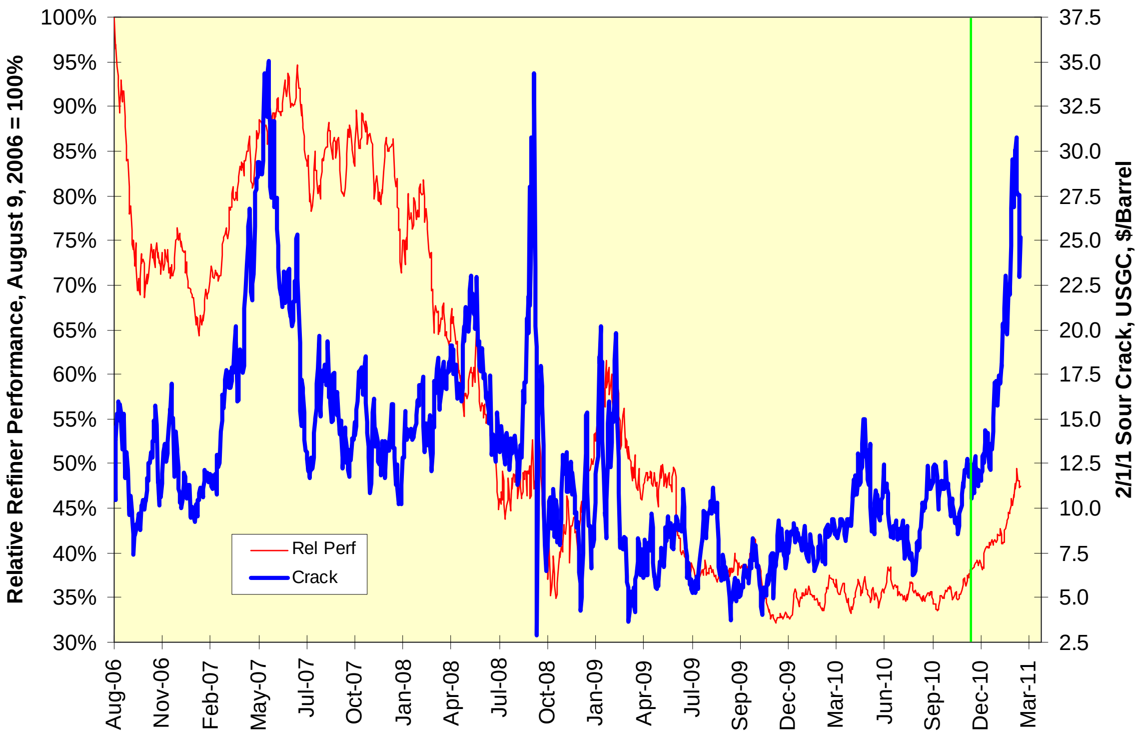
The key to all of this outperformance was relative weakness in West Texas Sour (WTS) at Midland, Texas. Even sweet West Texas Intermediate was falling under the Cushing storage glut, WTS was falling further. Complex refineries at the Gulf Coast have made the investment in desulfurization units to take advantage of the cheaper sour crude oil; this decline was literally manna from Midland. Note the jump in the sweet-sour spread on the chart below just after the December article was written (green vertical line) and how that propelled refiner performance higher.

Rising Sweet-Sour Spread Supportive For Refiners



Related to this was a similar jump in the refining margin for WTS at the Gulf Coast. That, too, shot higher just after the December article was written. The 2/1/1 crack spread, the conversion of two barrels of crude oil into one each of heating oil and gasoline using Gulf Coast, not New York Harbor, prices pushed toward historic highs not by virtue of a hurricane or some other disruption, but simply on the back of cheap sour crude oil.

Refiners Have Yet To Recapture Relative Performance



Nature abhors a vacuum and markets abhor sustained periods of high profitability. Once the seasonal glut at Cushing starts to wind down and refiners need to raise their bids for sour crude oil, the recent gaudy performance of the refiners should dissipate.