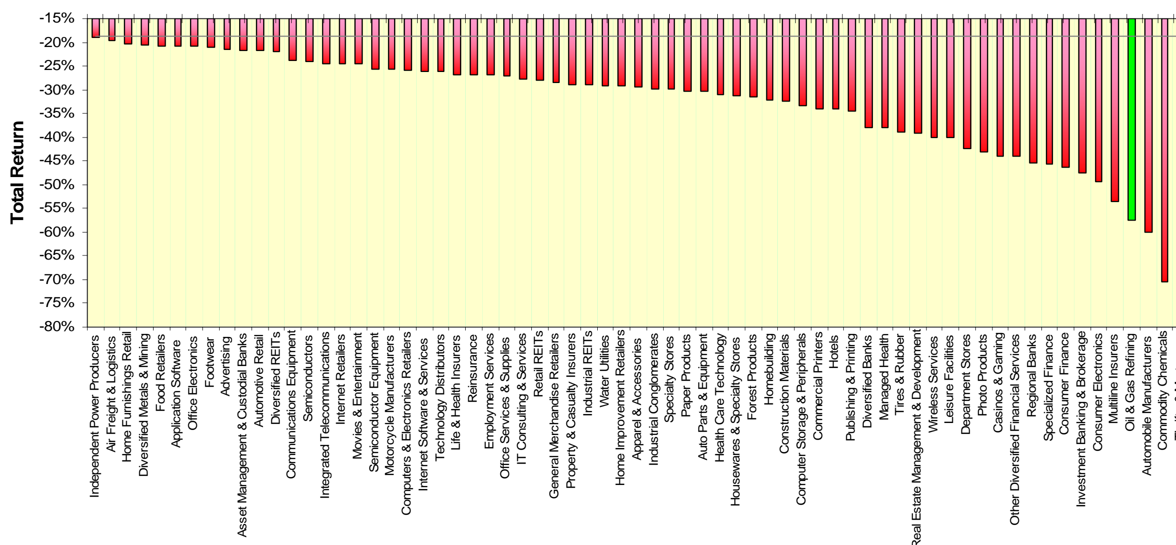
Refiners Still Getting Squeezed

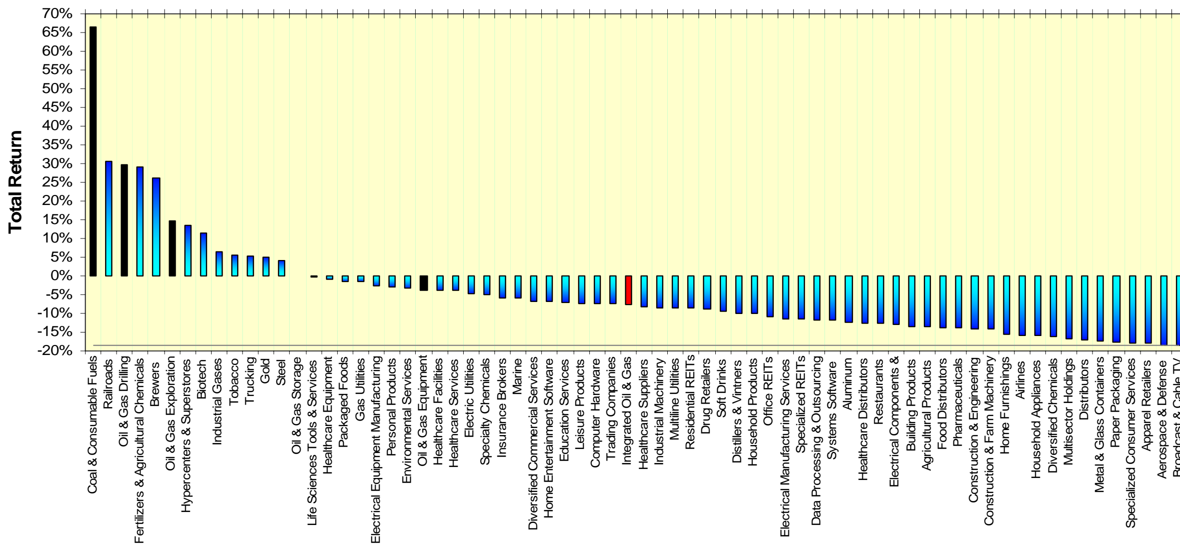
One of the hardest things with which investors have to come to grips is the leaders of one cycle seldom are the leaders or even the mediocre performers in the next cycle. As an aside, this is an interesting juxtaposition to another difficult thing in trading, and that is following one long or short trade with another trade in the same direction. We like to believe previous winners will return and positions should be alternated.

When I last visited the topic of refiners facing a profit squeeze last [October](), there was more than a little bustle in the hedgerow. After all, not only was the S&P 1500 refiners' index still four weeks away from what would prove to be its all-time high, the broad market was just under two weeks from its all-time high and the prices of all energy-related commodities were still in the early phases of the spectacular rally that just paused earlier this month.

The total return on the refiners since that time is -57.4%. That is a shellacking in anyone's book. In fact, the total return of the refining sector since the October 11, 2007 market high is worse than only three other industry groups, the automobile manufacturers, the thrifts & mortgages and commodity chemicals. The performance of the refiners is marked with a green column in the chart below of all industry groups underperforming the broad market.



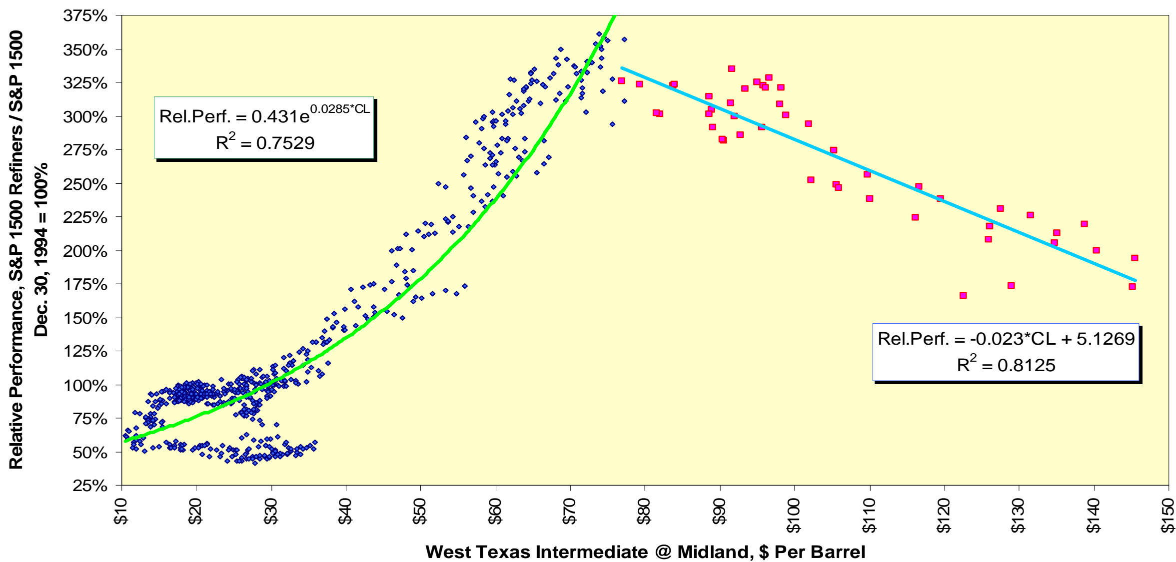
For the sake of completeness, we should depict the performance of all groups outperforming the broad market since last October. The overall energy sector is not as overrepresented as you might think. Yes, coal is the top performing group, and both drilling and exploration and production rank in the top six, but take a look at where the integrated oil and gas firms, marked with a red column, lie. As noted in a [December 2007 column](), the performance of groups within the energy sector can differ widely.



Cost Squeeze

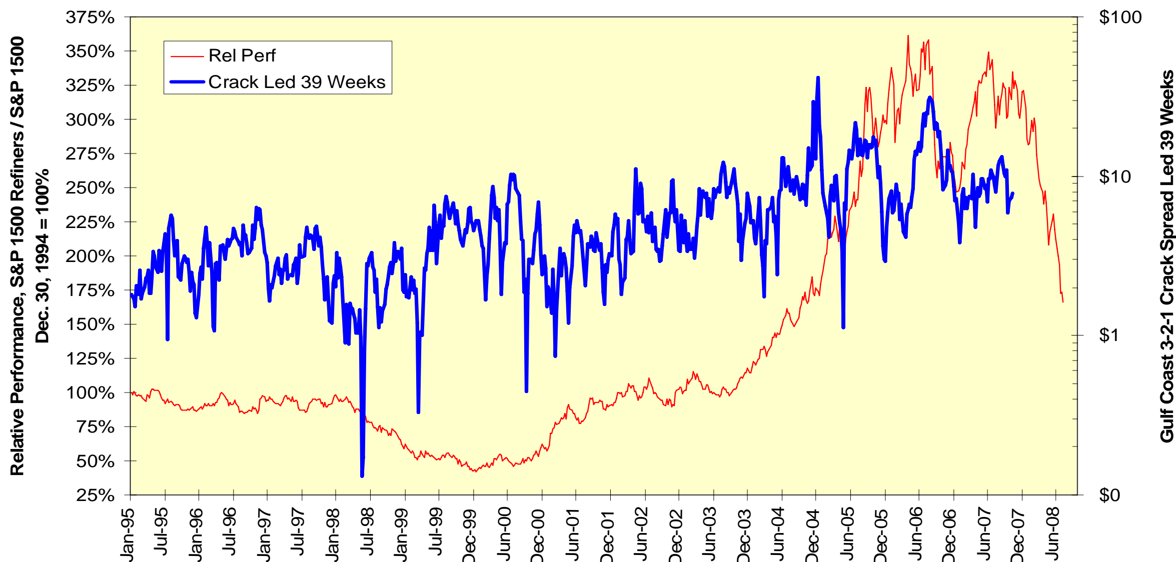
A refinery is a margin operation; it buys crude oil, processes it into value-added products after a good deal of chemical engineering magic and then turns the products onto the market. That margin, often simplified as a "crack spread" between crude oil, heating oil and gasoline, can vary widely. Up until the widespread closure of U.S. refining capacity in the early 1990s in response to the costs imposed by the Clean Air Act Amendments, refining margins compressed when crude oil prices rose, but during the 2002-2007 golden era for this industry, refiners were able to take advantage of the constrained capacity in their industry and relatively price-insensitive demand to prosper.

When the change came, it came abruptly. If we map the relative performance of the refining sector against the S&P 1500 from December 1994 onwards, we see an exponential relationship between relative performance and crude oil prices up until the explosion in crude oil prices beginning in August 2007. Then the relationship flipped to a negative and linear one. It is as if the golden age of refining stepped off the edge of a cliff.



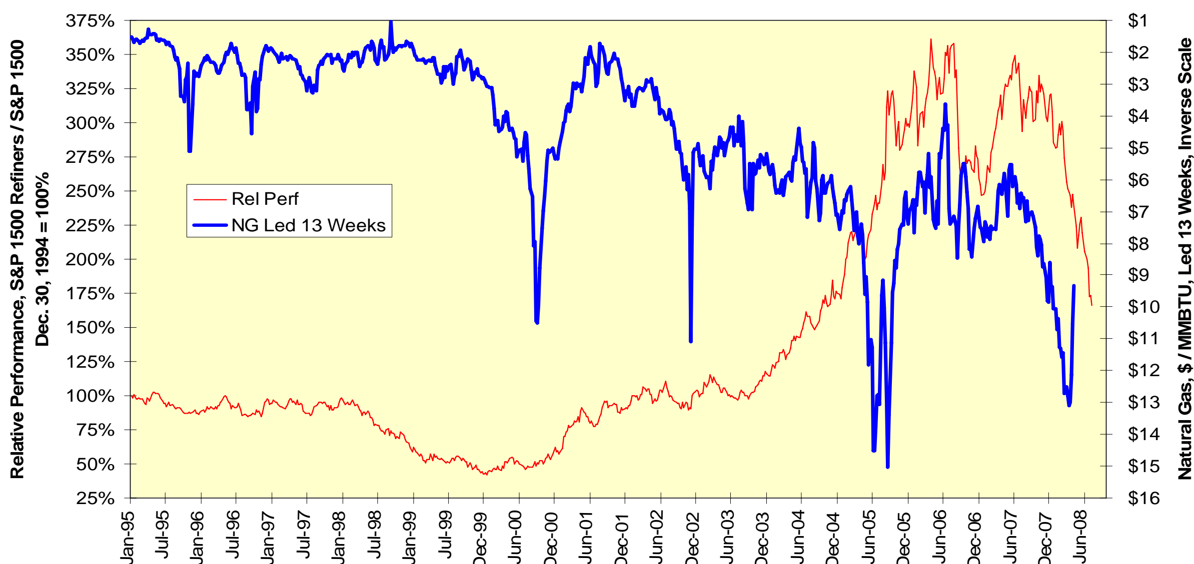
Anticipation

Stock prices are supposed to discount future developments; it is a lovely theory, and one capable of making us wonder sometimes whether the theorists ever pay attention to the real world. But here it applies. The relative performance of the refining sector leads movements in the 3-2-1 crack spread at the U.S. Gulf Coast (three barrels of crude oil into two of gasoline and one of heating oil) by 39 weeks on average. As relative performance is declining still, we have to believe refining margins are seen as remaining under pressure. This is consistent with evidence high prices for petroleum products are changing energy usage patterns at last.



In addition, refiners face cost compression from another source, and that is the natural gas they consume in their operations. Even though refineries have made enormous gains in their own energy efficiency over the past three decades from heat recovery systems to the cogeneration of electricity, the first step in refining still is heating crude oil to about 900 degrees Fahrenheit in a vacuum distillation tower.

If the price of natural gas rises, as it had been doing relentlessly until this month's sheer break – can we fall off a cliff twice in one column and still remain within the bounds of rhetorical propriety? – it will come straight out of refiners' profitability. The relative performance of refiners has led the price of natural gas by 13 weeks on average.



I noted way back in March 2005 how veterans of the oil industry were cautious on expanding capital budgets because they all grew up during the massacre of the early 1980s. The first firms to suffer in 1981-1982 were the

refiners, followed by the oil service stocks. By the time the cycle was over in 1999, dozens of oil-related firms disappeared via bankruptcy or merger. Those who bet on the oil industry as a value play in 1983-1986 got mauled, pure and simple.

Maybe it will not be as bad this time around, and maybe I am cautious by virtue of experience. But overall experience indicates betting on a firm like Valero or Tesoro to repeat its stellar performance so soon after years of stellar performance go "poof" is a bad idea in a market dedicated to turning everything into a bad idea.