May 31, 2018

Oasis Energy Group Ltd.

Market Pulse

This issue

Iranian Sanction P.1

US, China and North Korea P.2

Venezuela P.3

Diesel Market P.4

"Trump vs Obama Administration"

It's no secret that President Trump disagrees with many policies and deals implemented by the Obama Administration and he has demonstrated that he will not hesitate to overturn them as he sees fit. Since being elected, President Trump has successfully overturned the following:

- The Affordable Care Act, January 20, 2017
- Trans-Pacific Partnership, January 23, 2017
- Nullified Obama's Gun Control, February 28, 2017
- Paris Climate Agreement, August 4, 2017
- Rescinded DACA Dreamers programs, September 5, 2017
- Restrictions on Cuba, November 8, 2017
- Reversal of Net Neutrality, December 14, 2017
- Offshore and Arctic oil drilling, January 4, 2018
- Transgender Military Service, March 24, 2018
- Withdrawal from 2015 JCPOA agreement, May 8, 2018

Reimposing Iranian Sanction

On May 8, 2018 the US President Donald Trump announced the withdrawal from the Iran nuclear deal, reimposing unilateral sanctions on Iran and fulfilling an election campaign promise.

A year into his Presidency, Trump has managed to deliver on a number of campaign promises and while some may be considered visceral, it is evident that President Trump will not allow the US to be on the wrong side of a deal. With that said, any deal that cannot be altered or renegotiated to his terms, he will expeditiously withdraw and enact his own plans (usually in the form of tariffs, or in this case sanctions) while paying little attention to any global implications.

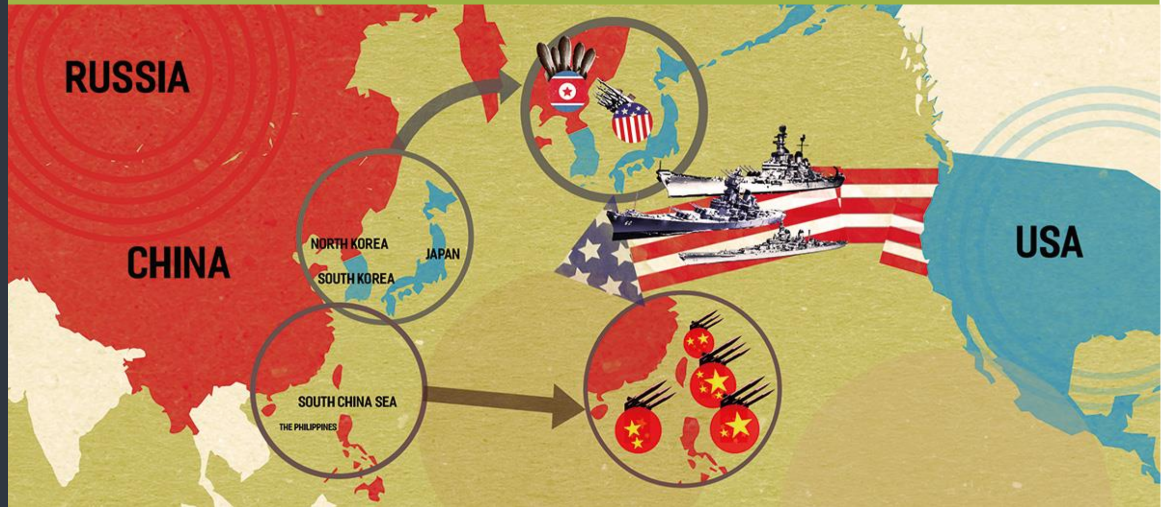
It is now clear that Trump was unable to revise the JCPOA agreement in a way that he could accept, which would curb Iran's nuclear ambitions (including ballistic missile development), reduce its growing influence in the Middle East and renounce its support for terrorist groups (i.e. Hezbollah, Hamas and PIJ). As expected, Trump promptly withdrew from the agreement and reimposed sanctions on Iran, leveraging on these sanctions to pressure Iran on multiple fronts to force compliancy.

But by doing so, the US has caused a rift between signatories of the JCPOA (China, Russia, UK, France and Germany) and could ultimately impact transatlantic cooperation in security and foreign policy.

In addition, and more importantly, President Trump imposed secondary sanctions, which could have significant economic implications as the secondary sanctions are aimed at pressuring any third parties to stop their activities with Iran. Trump has provided two wind-down periods, a 90-day and a 180-day period. The first period will end on Aug 6, 2018 and initial sanctions will commence the day after, which are focused primarily around currency, precious metals, metals and automobiles. The second period will end on Nov 5, 2018, with subsequent sanctions focusing on Iran's shipping industry, petroleum & petrochemical products and Iran's Central Bank.

The second wave of sanctions certainly carries the most weight, as it aims to restrict Iranian revenue generated from crude and product exports, which makes up approximately 15% of their GDP. While top consumers like China, India and Europe/Russia have indicated that they may ignore or outright block US sanctions and keep importing Iranian crude, the susceptibility of the Iranian market from oil prices may give Iran no choice but to comply with sanctions. Given that crude prices were artificially raised in preparation for sanctions, if no Iranian cuts materialize, prices will most certainly correct. Furthermore, there is threat of OPEC deciding to increase production, which in combination, would be detrimental to Iranian revenue. Therefore, it is likely in Iran's best interest to comply and maintain current levels of price.

US, China, and North Korea



"Trumping US economic growth through GDP formula"

GDP = Consumption + Investment + Government Spending + Net Exports

Several policy changes were made since Trump's inauguration. First, the Federal Reserve has taken the steps to increase interest rate while exiting the Quantitative Easing Program amid strong labour market and rising wages. Despite the reading on inflation remaining subdued and below the 2% target, underlying conditions supports further rate hikes. By raising the interest rate, consumer spending would be at risk, however, because the US GDP growth has been largely supported by relentless spending it wouldn't be detrimental to move away from higher consumption given the increasing consumer debt levels and risk of defaults.

Second, corporate tax was reduced from 35% to 21% that should prompt and induce corporate investments as profits improve for corporations. Favorable tax regime should also attract foreign investments.

Third, government boosts its spending to $4.17 trillion, about $200 billion more than 2017 on Pensions, health care, defense and protection while a reduction in education and welfare. This in theory boosts GDP.

Lastly, Trump has imposed tariffs on aluminum and steel but also engaging discussions with China on potential trade war with tariffs imposed on various goods. In 2017, US trade deficit with China was $375 billion with export to China amounts to $130 billion while imports from China were $505 billion. Reversing the trade deficit will greatly contribute to its GDP growth.

The idea of Trade War is not new. The world had experienced many recessionary periods that either imposing tariffs or currency devaluation was adopted to stimulate export in attempt to achieve growth for the country.

Trump has made it clear during his campaign that America First is his approach to running the country. Since the financial crisis in 2008-2009, US economic growth stagnated below the historic 3-5% levels. As we witnessed, the policies change on corporate tax, interest rate hikes, and tariffs are all parts of the plan to boost US economy. China specifically was targeted by Trump who believes trades between the two nations have been unfair in the past 40 years. Boldly and aggressively, Trump announced his intention to reverse the trade deficit by $200 billion with China on various goods, but that figure may be out of reach. China responded with the plans to hit back with tariffs on more than 120 US goods. However, all the posturing opened discussions between two nations which never would have taken place in the past. Trump is in the driver seat for this one.

On May 20, 2018, it was reported that the "Trade War" was on hold as both nations agreed to work on the framework. As a result, the trade war tension was reduced. However, it is rather interesting as the timing coincides with the potential meeting between the US and North Korea leaders in Singapore on June 12, 2018.

Though, not clear, Trump previously hinted he would cut China some slack on trade if Beijing helped pressure North Korea on the nuclear issue. Trump's willingness to halt the trade war, and to go easier on the US-sanctioned Chinese Telecom giant ZTE were seen in part as a tradeoff for China's cooperation on North Korea. The talks between US and North Korea were on schedule before Trump abruptly refused to attend the meeting due to hostile comments from North Korea. The question is that if summit fails to materialize, is the trade war with China back on? One thing we know for certain is that Trump is irrational and tends to change his stance in a heartbeat. Shortly after he refused to meet North Korea leader Kim Jong Un, he swiftly reversed and mentioned the summit may still be in progress. Whether or not it takes place, US is putting pressure on both China and North Korea to achieve de-nuclearization of the peninsula. It is fair to assume, should the summit fail, trade war escalation between China would be heightened.

As of May 29, 2018, Trump once again signaled his intention to impose tariffs on $50 billion in Chinese imports, sending a hawkish message days before more trade talks. The final list will be released on June 15.

Once Latin America's wealthiest country, Venezuela has become one of the poorest in the world. In the past decade, the oil rich country has seen a decline in oil production from an average of 3,000 kbpd in 2002 to an all-time-low of 1,500 kbpd in 2018.

"What's at the root of Venezuela's economic crisis?"

Venezuela is rich in oil. It has the largest proven oil reserves in the world. But it is arguably precisely this wealth that is also at the root of many of its economic problems. Venezuela's oil revenues account for about 95% of its export earnings. This means that when oil prices were high, a lot of money was flowing into the coffers of the Venezuelan government. When socialist President Hugo Chávez was in power, from February 1999 until his death in March 2013, he used some of that money to finance generous social programs to reduce inequality and poverty. Two million homes have been created through a socialist government program called Misión Vivienda (Housing Mission), according to official figures. But when oil prices dropped sharply in 2014, the government was suddenly faced with a gaping hole in its finances and had to cut back on some of its most popular programs.

"Any light on the horizon?"

Oil prices have been rising and should inject much-needed cash into the government's coffers. But a lack of investment in its infrastructure means state-owned oil company PDVSA's output has dwindled, making it harder for it to recover.

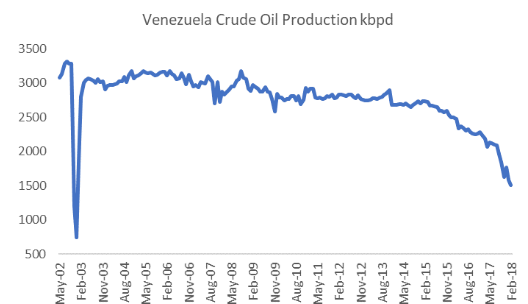
Add to that the fact that hundreds of thousands of Venezuelans have left the country, causing a massive brain drain, and prospects are not looking very bright. Widespread allegations of corruption and the government's hostile attitude towards private businesses have also alienated potential foreign investors. Several countries have already said they will not recognize the new government, among them Brazil, Canada, Chile and Panama. But what could really put the screws on the Venezuelan government would be US sanctions on Venezuela's oil industry. With the US calling the elections a "sham", they may not be far off.

Source: BBC

The oil rich country gets 95% of its export revenues from oil. During Hugo Chavez's presidency (1999-2013), oil was sold to various countries at discounted rates to secure goodwill and no investment from these revenues was put back into the oil industry. Federal debt put constraints on available funding to the oil industry for necessary maintenance and repairs. Given the government's mounting debt levels and decreasing revenue, the government implemented an expansionary monetary policy by printing more money to continue importing goods causing the Bolivar currency to decline drastically in value, to the point where it is practically worthless. Citizens stopped working because it was no longer worthwhile, and thousands fled the country with their families with high hopes of a better life.

The lack of investments into the largest revenue generator drove Venezuelan crude oil production to decline to 1.5 million barrels/day and could potentially fall further to as low as 1 million barrels/day by the end of 2018. Venezuela produces heavy crude oil and it requires dilution for the product to be sold at a better price, but with U.S. sanctions, the heavy crude producer will struggle to acquire light crude to upgrade. With the low value of the Bolivar, Venezuela can import crude for up to $80 a barrel but sold for virtually nothing. Likewise, the U.S. will see a decline in imports given that Venezuelan crude exports to the US amount to approximately ~400kbpd on most recent data. Canadian heavy crude production is the logical choice to replace missing Venezuelan imports, however given Canada's ongoing transportation problems the US may have to go elsewhere for a more reliable source to fill the need.

This month, President Nicolas Maduro locked in another six-year term despite the sham election and leaders have already acted. President Trump placed sanctions on Venezuela to prevent the sale of debt. Canada and fourteen other Latin American countries have downgraded diplomatic ties with Venezuela including Maduro and the European Union is calling for a re-election or sanctions will be placed if Venezuela does not comply. Despite the backlash from the election, China and Russia still congratulate Maduro for his victory. In the past, China has provided loans to Venezuela to secure energy supplies and could be the purpose behind the commendation. Beijing has recently declined to renew financing to the state-owned oil company and have also ignored requests for new funding and is likely that Venezuela will continue exporting oil to China to pay off debt. Russia, another ally of Venezuela has also provided financing in the past. Furthermore, we can expect Venezuela production to decline to ~1,000 kbpd in remaining months of the year as there has yet to be a saviour for the catastrophe. It will be likely for other countries in OPEC to fill potential shortages while the United States can increase their production to offset demands.



Perfect Storm in Diesel Market

The diesel market has become exceptionally tight as global inventories in all major regions have been drawn down to near 5-year low levels. This year has seemed to be a perfect storm of events to result in such a bullish diesel market. Coinciding refining maintenance in the USGC, Europe and Asia markets put a hindrance on global production, but demand remained exceptionally strong, specifically from countries such as India. US distillate export remains elevated, averaging around 1.15Mbpd of exports through the first 5 months of this year. The amount of exports heading to Latin and South America has steadily increased, which has been propelled by escalating problems in Mexico and Venezuela. A large portion of US diesel exports used to make its way to Europe as European diesel demand continues to be one of the largest in the world. However, in recent years that trade flow has slowly been in decline, as European demand has softened (thanks to the VW diesel scandal) and exports from the USGC are diverted more towards favorable destinations in Latin/South America.

However, the slow rise in gasoline vehicles is nowhere close to offsetting the major diesel reliance in the EU, but with the reduction of USGC diesel imports into the region, EU thus relies heavily on Russia to help fill the gap. The problem this year was shipments out of the key Baltic port of Primorsk began seeing declines, both because of refining maintenance (mentioned earlier) and port operational issues. These factors combined with NW Europe/Mediterranean refining maintenance caused steeper drawdowns in distillate inventories. Furthermore, consider the crude price arbitrage between the US and NW Europe (Brent-WTI), which has widened to an incredible $9.00/bbl of late. With such a steep discount of US grades, European refiners would absolutely prefer to run the cheaper WTI grade versus the staple Russian Urals blend, especially since European refiners began shunning the Russia crude blend this year, citing poor quality. However, this desire for US Light grades has an impact on product yields, given that US grades produce less diesel versus a grade like Urals. This recent switch only compounds the problems in the EU/Mediterranean and the imbalance of middle distillates.

The other major region of diesel consumption we will discuss will be Asia. Asian demand growth in diesel has largely been driven by India and their increasing appetite for the fuel to help facilitate their ambitious industrial plans. China's diesel demand remains healthy so far this year, but China's reliance on product exports remains as they continue to be long product. Thankfully, increases of diesel demand (India included) from neighboring regions has helped keep China from flooding the product market as was once feared in recent years. Similar to Europe and the US, refining maintenance was a main contributor to a drawdown in South East Asian distillate inventories (Singapore).

Lastly, because of increased tanker traffic and the impending IMO fuel regulation change, several vessels have already begun switching from the high sulfur fuel oil to marine gas oil. This pattern is only expected to continue up to the 2020 deadline.

"Refinery issues in Mexico and Venezuela"

Refinery issues in Mexico are not new, as the country has been plagued by declining refining output for the last several years, but last year was the lowest output in several decades. PEMEX changed their operational strategy last year, shifting from processing crude to meet demand to wanting profitability instead. This caused the closure of two major refineries and even pushed some to operate at significantly reduced rates. Mexico had always been reliant on product fuel imports and this shift in refining operations resulted in large incremental changes. Venezuela needs no introduction as we have already discussed the economic crisis and the impact of the decline on the domestic oil industry. Needless to say, PDVSA's refining sector has been drastically reduced as well, operating at around 31% combined capacity in the first quarter of 2018, which is approximately a reduction of 120kbpd versus 2017 levels. With such a drop in refining production, product deficits are fast mounting, forcing Venezuela to import more products to help facilitate vital crude export contracts.

US Distillate Export